

Eesti Pank
Bank of Estonia

Economic Forecast for 2008–2010

Spring 2008

Estonia's economic growth has been mostly in line with the autumn expectations; however, the growth has decelerated faster than foreseen in the autumn forecast base scenario. This has been caused by the higher-than-expected uncertainty in the real estate sector, slower increase in the external demand and the price hikes of food and other raw materials in the world market.

Compared to the time the autumn forecast was prepared, the external environment is currently much less favourable for the Estonian economy (see Figure 1). The past half-year has been characterised primarily by events in financial markets, where liquidity and credit problems have led to risk-related fears among investors. The economic activity indicators have been following a downward trend in many countries (including Estonia's main trading partners). Therefore, this year, the support from external demand to the Estonian economy will be weaker than forecasted in autumn and will not completely recover to its historical average by 2010 either. The slowdown in external demand is partly reflecting the difficulties in the US and European financial sectors that are gradually transmitting to the

real economy. Similar to Estonia, economic growth in other Baltic States is expected to slow in the next few years and this will further reduce our growth potential.

The period from the second quarter of 2005 to the first quarter of 2007 will be remembered in the history of the Estonian economy as a period of exceptionally steady growth. The robust growth of recent years has exhausted several sources that have been supporting growth. On the supply side, there is much less unoccupied labour force available; however, the credit-driven domestic demand reserve has also decreased considerably. Consequently, growth can be boosted only through increased productivity, especially in the exporting sector.

The real estate sector is showing signs of cooling, which is one of the primary reasons why the investment growth figure has been substantially curbed in the current forecast. In this economic sector, buyers' confidence is low and, therefore, corrections are still under way.

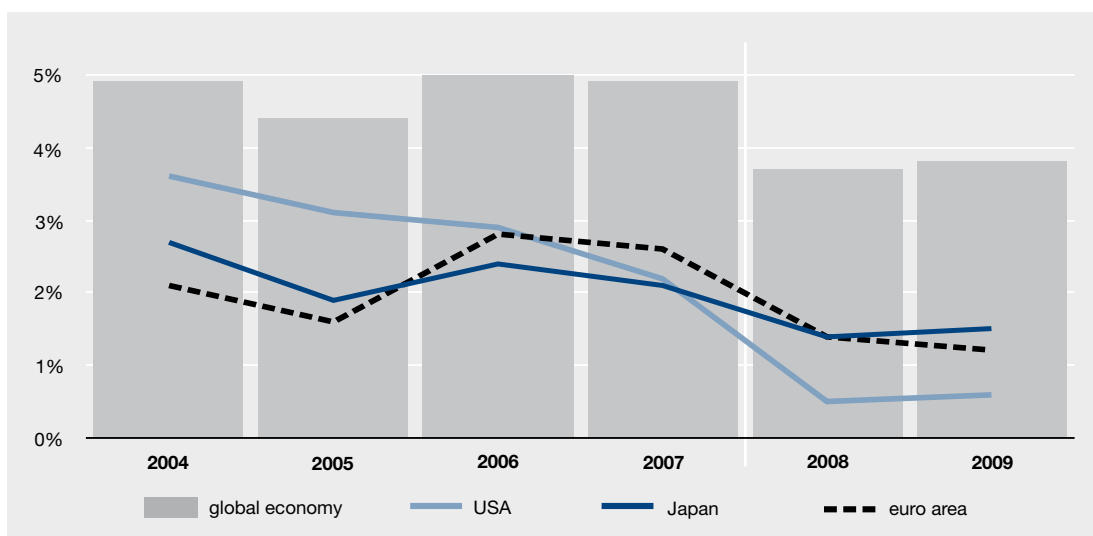


Figure 1. Global economic growth forecast

Source: IMF (April 2008)

Labour market flexibility will be the key factor determining the success of economic adjustment. The prolonged discrepancies between wage and productivity growth will continue this year as well. Similar to the autumn forecast, we also now expect a decline in employment, an increase in unemployment, and moderation of wage growth in 2008.

The rapid wage growth brought about a rise in prices in 2007 and probably also increased inflation inertia. The key concepts characterising inflation in Estonia in the next few years are a decline in domestic demand pressures, planned tax increases, volatile prices of food products and other raw materials in the world market as well as a rise in energy prices. All in all, due to the above factors, the inflation rate of 2008 will remain high for a while and will then slow in the next few years closer to the long-term average.

The external balance will continue to improve during the entire forecast horizon due to cyclical factors. We expect the current account deficit to decrease already this year as well as in the coming years. As a result of the slowdown in economic growth, external debt growth will inhibit and reach the level of nominal GDP growth in 2008–2010.

The three risk scenarios of the current forecast underline the possible development paths set out in earlier forecasts:

- stronger correction in domestic demand owing to the excessive credit expansion in the preceding years;
- materialisation of the wage and price spiral;
- faster improvement of the external environment and partial reallocation of domestic demand oriented capacities to exports.

Although there is no separate risk scenario for a less favourable external environment, we do not rule out the materialisation of this possibility.

FORECAST BASE SCENARIO

Economic growth

In 2007, economic growth slowed to 7.1% and the rapid cool-down period in the Estonian economy will continue at the beginning of this year. The economic confidence indicator calculated by the Estonian Institute of Economic Research has decreased to the level below which it has fallen only in 1998–1999. Since the historical experience of the Estonian economy includes only the recession following the Russian crisis, it is difficult to foresee the depth and duration of the downward phase of the current business cycle.

When comparing the current period of economic downturn to the period ten years ago, the financial sector supports the rest of the economy more efficiently and the corporate sector has better access to credit. Nevertheless, the current period of economic decline is likely to be longer and deeper than in 1999. The main underlying reasons are the following.

- Economy is operating close to the natural rate of unemployment, which is likely to reduce price and wage flexibility. Currently there are only modest signs of a downward correction in employment – the decline in employment has not yet started to alleviate labour market tensions.
- In 2000, the growth of external demand was the strongest of all time (EU economies were growing rapidly); however, the global economy is now cooling and thus external demand will not provide similar support.
- Too moderate decline in wage growth might undermine the competitiveness of export-oriented companies, which will hinder the fast recovery of export growth.

While in autumn we assumed that the real estate and construction sector would reach its low in 2008, we have now extended the period of recession until 2009. According to the Estonian Institute of Eco-

conomic Research, the order books of construction companies have remained relatively healthy for the time being; however, further outlooks are less encouraging. Higher economic activity supported by a more favourable external environment can be expected no sooner than at the end of 2009 or at the beginning of 2010 (see Figure 2). Therefore, the **economic growth forecast for 2008–2010**

is 2%, 3% and 5% respectively (see Table 1). Compared to the recent years' average, the economic growth of the coming years seems to be weak; however, this should be interpreted as an adjustment from the level of extremely strong growth caused by recent years' one-off factors to a more sustainable level.

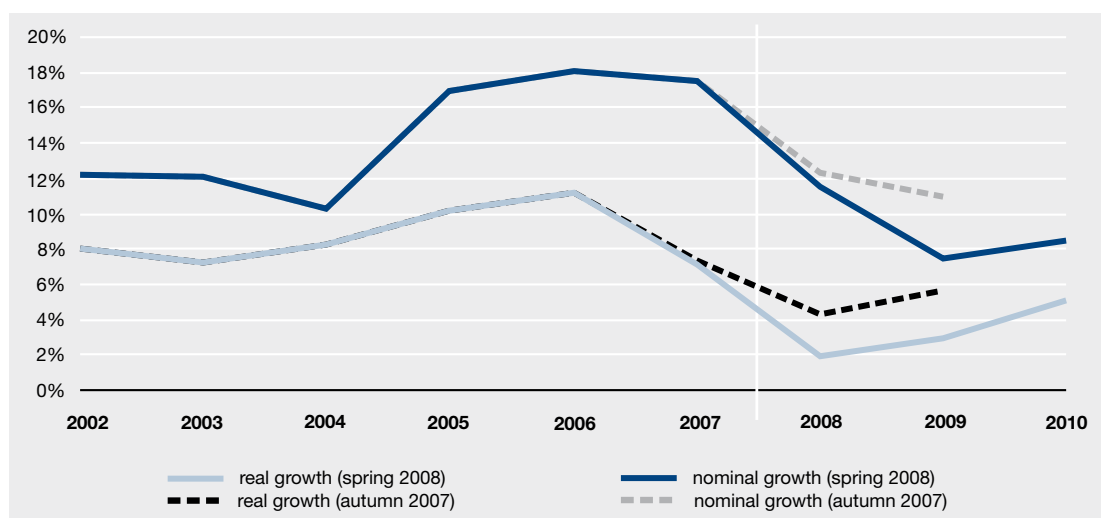


Figure 2. GDP growth forecast

Sources: Statistics Estonia, Eesti Pank

Domestic demand

The common feature in recent economic forecasts has been that the adjustment of domestic demand growth will be smooth and that current account deficit is not expected to decline rapidly once economic growth slows. Arising from the higher inflation rate and setbacks in the real estate market, the current forecast significantly reduces the domestic demand growth estimates for 2008. Over the recent years, domestic demand has been boosted by an expansive credit cycle, which is now coming to an end.

The real estate sector is the main source of corrections when it comes to investment growth. The share of investment in GDP will decrease to the levels recorded prior to the real estate boom but will still remain higher compared to more developed economies. Real private consumption growth will

also remain more modest than expected in autumn, because the stronger-than-expected price growth will reduce households' purchasing power. Moreover, compared to last autumn, people have become somewhat more pessimistic, which is partly caused by the negative signals from the labour market.

Private consumption

This year, private consumption growth is going to decelerate quite sharply: from 8.9% last year to only 2.8%. If all negative circumstances (stronger price growth, faster slowdown in wage growth, and a steeper decrease in employment) coincide, private consumption growth might well be lower than GDP growth. In the next years, when confidence is gained in the new growth cycle, private consumption growth will also pick up speed (see Figure 3).

Table 1. Economic forecast by main indicators

							Difference from the autumn forecast		
	2005	2006	2007	2008	2009	2010	2007	2008	2009
GDP (EEK bn)	175.4	207.1	243.3	271.3	291.6	316.3	1.5	-0.2	-9.8
Real GDP growth (%)	10.2	11.2	7.1	2.0	3.0	5.0	-0.2	-2.4	-2.7
HICP growth (%)	4.1	4.4	6.8	9.8	4.5	3.0	0.5	2.4	-0.1
GDP deflator (%)	6.1	6.2	9.7	9.5	4.4	3.3	0.8	1.8	-0.7
Current account (% of GDP)	-10.0	-15.5	-17.4	-10.2	-7.5	-6.6	-2.3	1.7	2.1
Current account plus new capital account balance (% of GDP)	-9.3	-13.2	-15.8	-8.3	-6.1	-3.9	-2.9	1.6	1.7
Real private consumption growth (%)	10.6	15.1	8.9	2.8	3.8	4.5	-2.5	-3.6	-2.3
Real government consumption growth (%)	1.6	2.6	4.8	4.5	-0.3	1.6	0.7	2.4	-3.0
Real investment growth (%)	9.9	22.4	7.8	-9.8	-2.2	5.0	0.4	-8.2	-4.0
Real export growth (%)	20.5	8.3	1.5	2.2	4.8	6.5	-3.7	-3.1	-2.3
Real import growth (%)	16.3	17.1	2.8	-1.9	0.8	5.0	-2.2	-5.8	-4.5
Unemployment rate (%)	7.9	5.9	4.7	6.4	6.6	5.9	-0.5	0.7	0.4
Change in the number of the employed (%)	2.0	6.4	1.4	-2.4	-0.2	0.8	0.1	-2.2	-0.2
GDP growth per full-time employee (%)	8.2	5.3	6.7	3.1	3.2	4.5	0.6	-1.4	-2.7
Real wage growth (%)	8.5	11.9	13.8	5.7	2.7	3.5	-1.3	-3.1	-2.4
Average gross wage growth (%)	11.4	16.2	20.4	15.0	7.0	7.0	0.1	-0.0	-2.7
Nominal money supply growth (%)	42.0	28.2	13.4	11.6	8.5	8.9	-11.0	-3.4	-3.1
Nominal credit growth (%)	50.4	51.6	30.2	9.3	8.5	8.2	1.7	-6.3	-3.5
External debt (% of GDP)	85.3	96.4	110.3	110.1	110.3	110.0	2.8	1.2	1.9
Budget balance (% of GDP)	1.8	3.4	2.8	-1.2	0.0	0.0	-0.0	-2.3	-0.7

Sources: Statistics Estonia, Eurostat, Eesti Pank

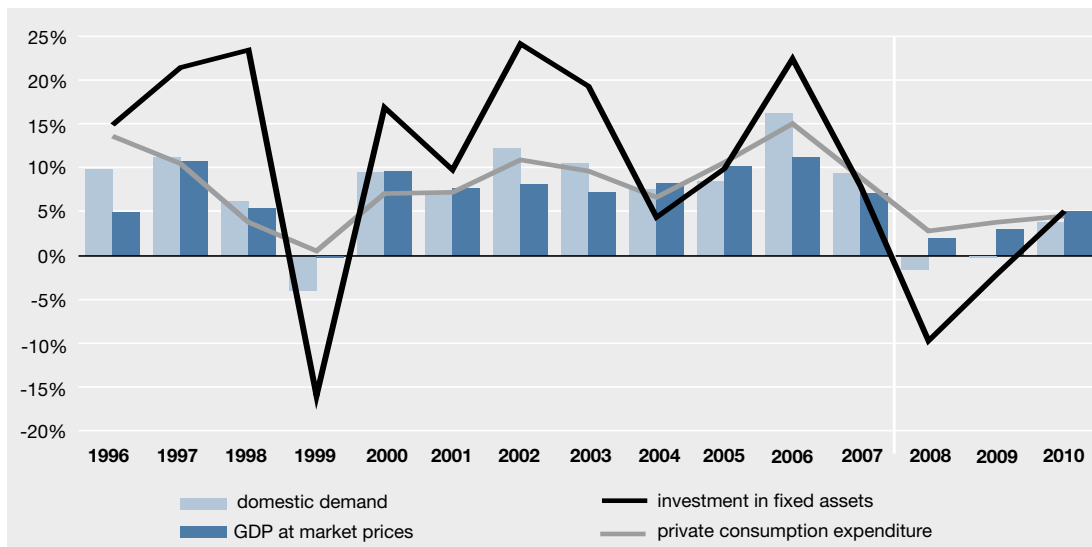


Figure 3. Real growth of domestic demand

Sources: Statistics Estonia, Eesti Pank

In 2008, the basic expenditure components – food, housing and transportation – which constitute nearly a half of total consumption expenditure and are difficult to give up – will undergo the highest price hike. Thus, expenditure on other goods and services (durables, recreational services) is far more likely to be curbed. Households whose consumption basket largely consists of basic commodities will suffer the most. The increased loan burden has raised consumers' sensitivity to changes in interest rates. So far, the possible negative impact of the heavy loan burden has not revealed itself that strongly in the context of low interest rates and fortunately, market participants are not anticipating a further interest rate increases in the near future.

Investment

In the next years, economic growth will be largely shaped by the investment growth cycle. Investments together with finished goods inventory react to the slowing economic growth faster than the rest of the domestic demand components. According to the spring forecast, investment activity will decrease further at the beginning of 2008 and will start increasing again in 2009–2010.

The keyword of further investment developments is adjustment in the real estate sector, which will greatly affect also the growth of the economy as a whole. In 2005–2006, the improvement of credit availability temporarily increased demand in the real estate market, which resulted in a price hike. The same reaction can now be seen on the supply side – there is an oversupply which has brought about a decline in prices. Companies that are better capitalised and have diversified their activities will survive the price corrections and the difficult times; however, the number of small enterprises going bankrupt will increase. Consequently, the economic growth potential will decrease as well.

Investment in production capital has not been that sensitive to the economic cycle compared to real estate investment, which allows, in their case, to expect smaller corrections. Further value add-

ed growth should be based more on productivity growth, which is why it is necessary to continue investments in production capital (including with the help of EU funds). According to the forecast base scenario, general government investment will partly offset the volatile growth of private sector investment. We will probably not witness a new household investment growth cycle before 2009–2010 and this will be more modest than seen in the recent past.

Labour market

In the spring forecast we still expect a decline in employment, an increase in unemployment, and wage growth moderation, but the projected changes are somewhat sharper than expected in the autumn forecast (see also Figure 4). Unemployment and wage growth have reached levels that will not be sustainable over the next few years. At the beginning of this year, employment growth adjusted slightly due to lower economic activity, but the same cannot be said about wage growth.

Wages and labour costs

The relatively rapid nominal wage growth in the near future will be driven, among other things, by an increase in minimum monthly wages and public sector wage fund as well as higher-than-expected inflation in the first half-year. Real wage growth will be 5.7% this year and is expected to slow further next year. The lack of available unoccupied labour force and high wage expectations are the main reasons forcing entrepreneurs to focus on enhancing productivity and developing more capital-intensive production.

Employment and unemployment

Inevitably, the turn of the business cycle will be reflected in the labour market statistics with some delay. If entrepreneurs perceive economic difficulties as temporary, they prefer part-time work to redundancies, and thus the correction in the number of working hours is a rather natural reaction. Employment will decrease the most in construction-related fields. According to the base scenario of

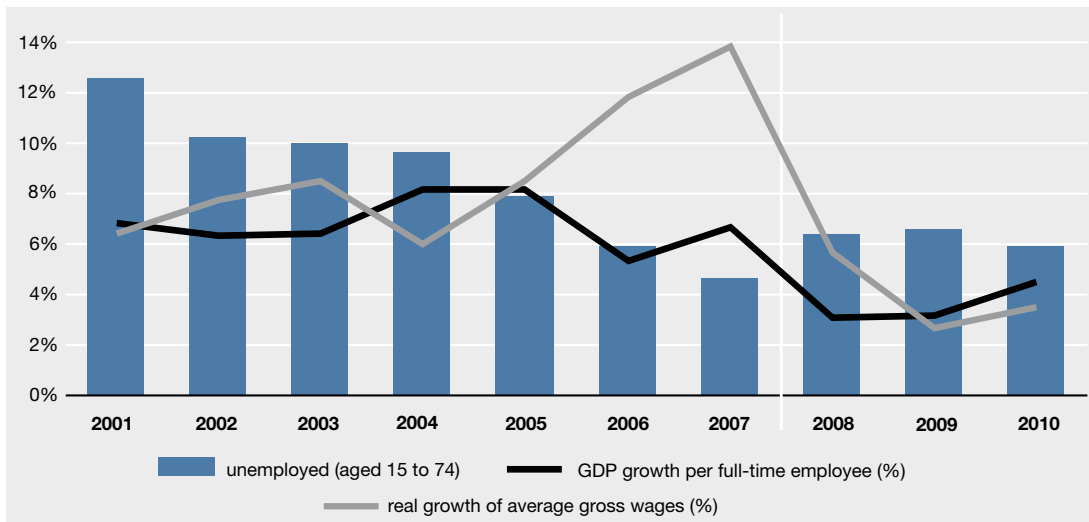


Figure 4. Employment development and wage growth

Sources: Statistics Estonia, Eurostat, Eesti Pank

the spring forecast, employment will decrease by about 15,000 this year, while the number of short-time unemployed is likely to grow the most. The unemployment rate expected for this year and the next is approximately 6.5%.

External balance and external debt

The external balance will continue to improve over the forecast horizon owing to cyclical factors. Last year's slowdown in private consumption and investment growth will continue also in 2008. Since the cooling real estate sector has a strong impact on domestic demand, the growth of imports will slow faster than expected in autumn.

The growth prospects of exports will weaken due to smaller import demand of Estonia's main trading partners and probably also because of strong cost pressures. The slowdown in export and import growth has also been boosted by decreased transit trade¹. Weaker import growth has also entailed a considerable decline in current account deficit. Another factor contributing to the decline is the decrease in income account deficit. Although in the

past year, the current transfers account decreased to 0.2% of GDP, in the next years, current transfers are expected to grow, primarily owing to the EU funds available for the new financial perspective and the use of previous period's funds. This year, current account deficit is expected to decline to 10.2% and in the following years, the balance will improve even more.

External debt growth will decelerate to a level comparable to nominal GDP growth. After the real estate boom, the private sector loan demand will decline and banks will be needing less external funds. So far, external debt growth has been driven by the increase in credit institutions' external liabilities and companies' intra-group direct investment in order to cover the need for corporate and household sector financing.

Inflation

In 2007, inflation continued to speed up, primarily because of strong domestic demand, administrative factors and external inflationary pressures. Although year-on-year price growth will accelerate

¹ Includes goods that are imported for processing and then re-exported.

this year, inflation is on the verge of a downward trend and thus a gradual decline in the upward pressures will be seen soon.

Compared to the autumn forecast, we have now increased the inflation estimate, mainly because of external factors. Owing to the extremely strong global economic growth of recent years, both energy and food prices will increase in the coming years. In the domestic economy, the inflation arising from rapid wage growth is declining this year, but the harmonisation of tax rates towards the EU level will continue feeding the inflation.

According to the forecast base scenario, Estonia's inflation rate will increase to 9.8% this year and decrease to 4.5% in 2009 and 3% in 2010 (see Figure 5). In 2010, price growth will slow to the long-term average level or even below that, bringing Estonia much closer to meeting the Maastricht inflation criterion.

Administrative factors

The inflation of 2008 will be raised by several excise tax increases that will account for up to 3 percentage points. This will make inflation growth very

volatile. The new excise duties on motor fuel, alcohol, tobacco and energy took effect in January; an additional rise in the alcohol and tobacco excise duties will follow in the second half-year. The biggest effect of administrative price increases will emerge in the final months of 2008 and continue also in 2009. Currently, there is little information on the changes in tax rates in 2010. Pollution charges and fees for the special use permits of mineral resources will certainly continue to increase, which will influence also the prices of water and refuse collection. However, the contribution of this increase to inflation growth will be smaller than that of the factors stepping in 2008.

Main goods and services

The rise in food prices in the final months of 2007 in Estonia was rapid and broad based. In the fourth quarter of 2007, the prices of dairy products, cereals and meat grew 30%, 20% and 10%, respectively, year-on-year. The autumn forecast did not expect the price growth to be that robust. Estonia was affected by the strong price pressures from external markets, caused by the rapid growth of demand and the poor weather conditions of 2006 and 2007 that were unfavourable for agriculture in

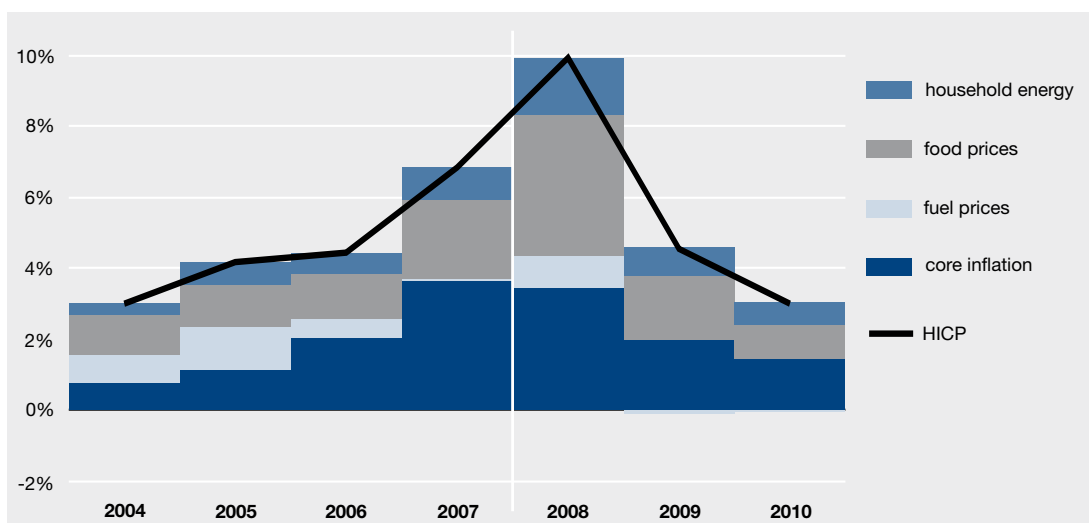


Figure 5. Inflation structure

Sources: Statistics Estonia, Eurostat, Eesti Pank

the whole world. Due to the adverse weather conditions the crop was smaller than usual and demand-side pressures were stronger than expected.

The spring forecast relies on the assumption that the rise in food prices in the world market will stop in the second half of 2008. Moderation in the rise of food prices is also favoured by the slower global growth. In the second half of the forecast horizon, the increases in food prices depend, among other things, on income growth and changes in consumption preferences in less advanced economies, but also on energy prices.

Based on the above, we can assume that the peak of food price increases in Estonia was reached in October 2007. In the coming months, price growth will exceed the average level in the case of unprocessed foods: imported fruit and also domestic meat products. According to the forecast, the robust price growth of processed foods will come to an end in summer.

The prices of imported durables will continue to fall this year, favoured by the declining dollar exchange rate. The impact of changes in the dollar exchange rate will manifest itself in Estonia's consumer prices with a lag of up to a year. As competition in the retail market is tightening, there is room for noticeable price falls. The trade margin of retail sales has currently reached a record level. For example, the price level of clothes and footwear in Estonia already exceeds the EU average.

Motor fuel and energy

Inflation is strongly influenced by oil price changes. In February, the price of oil rose to over a hundred dollars per barrel in the global market. Given also the excise duty increase of January, the year-on-year average price growth of motor fuel is expected to be 21% this year in Estonia. Based on the first quarter's futures prices, markets expect the price of oil to fall to 94 dollars per barrel by end-2009.

The Estonian Competition Authority has approved the requests of several manufacturers to increase thermal energy prices by 10–15% in April 2008. The pressures for raising energy prices will strengthen throughout the forecast horizon, caused by the growing share of renewable energy, the opening of markets, the smaller number of pollution quotas and growing investment needs. From 2008 to 2010, we expect the price of electricity to increase 5% a year, but the rise might also well be higher.

General government

Based on the base scenario of the spring forecast, the consolidated budget of the Estonian general government will be in a deficit of 1.2% this year and balanced in the next two years. To achieve the balance, expenditure should be cut by 8 billion kroons in 2009 and 11 billion kroons in 2010 compared to the state budget strategy.

Although the structural balance of the budget will worsen in the following years, it will presumably not affect the real indicators of the economy considerably. This is due to the great degree of openness of the economy, which mitigates the impact of budgetary balance on domestic demand.

The tax burden will diminish slightly in the coming years and up to 1.3% of GDP in 2010. This is caused by the income tax reform and by domestic demand that will grow slower than in the past couple of years. No major changes (except for the corporate income tax) are expected in the tax framework in the coming years. Therefore, the tax environment will neither promote nor suppress economic developments (provided that the rise in excise duties has only a one-off effect on the consumer price index).

Banking sector

The accelerating domestic demand growth in recent years can be largely explained by strong credit growth. However, the time of strong credit growth is coming to an end. From the point of view of sta-

ble economic development, it is important that the support of the banking sector should enable the domestic demand to smoothly enter a new growth phase and that this support is strong enough to stimulate a new growth cycle.

Despite the cyclical recession, the Estonian economy continues to provide favourable investment opportunities in the medium term and it is inevitable that economic development must be financed, among other sources, with the help of foreign savings. A part of the (loan) resources necessary to finance the economy comes from the banking sector and therefore it is vital that the parent banks of Estonia's commercial banks have access to necessary resources. The base scenario of the spring forecast relies on the assumption that raising funds will not pose any difficulties.

Housing loans

Changes in the volume of new housing loans depend directly on the level of interest rates and the direction taken by the housing market that has been cooling while waiting for greater confidence about the future. The stock of housing loans is influenced by the repayment of old loans on the one hand, and by the taking of new loans on the other hand. Based on the spring forecast, the growth of loan stock will remain between 9–10% in the coming years.

Currently, real estate market participants are characterised by the wait-and-see attitude, which has caused the transaction activity to reach the lowest point of recent years. The key question is whether and how much the price corrections of new development projects will affect the prices of old apartments. In our spring forecast we expect the gap between the price of a square metre in old and new apartments to narrow, but the impact of new apartments on the prices of old apartments will remain small. As regards interest rate levels, we do not foresee significant changes in our spring forecast.

Consumer credit

Lately, increased uncertainty can be observed among households in respect of taking consumer credit: borrowing decisions are more careful and loans are taken more cautiously. Furthermore, consumer credit growth is inhibited by slow economic growth, high inflation and a slightly higher unemployment rate. In 2008, the annual growth rate of consumer credit will decline to 21% and then below nominal economic growth (5–6%).

Corporate credit

The slower growth in corporate loans is also influenced mainly by the real estate market. Another important factor is the sustainability of the exporting sector in launching new projects and the overall flexibility of the corporate sector while shifting their focus away from the real estate sector. Based on the spring forecast, corporate credit growth will decline to 6% in 2008 but will then accelerate to 8–9% in the following years, remaining close to nominal economic growth figures. In the long term, the growth rate of corporate credit will be twice the rate of economic growth.

This year, the growth of corporate credit will be inhibited by the decreased volume of loans taken for real estate development (for speculative purposes). Arising from the overall economic background, credit growth in other sectors will also be more balanced.

Overdue loans

The share of overdue loans in banks' loan portfolio will increase in the coming years and may exceed the current level by several times in the next two years, remaining, however, comparable at the international level. The growing share of overdue loans will be mainly facilitated by the less favourable general economic environment and weaker credit growth. Despite this outlook, various stress tests have shown that Estonia's banking sector is strong enough to manage with loan losses.

RISK SCENARIOS

The current risk scenarios surrounding the base scenario call attention to the same aspects we have pointed out also in the earlier forecasts. All in all, the economic growth outlined in the base scenario may be slower over the next year and a half. What comes after depends to a great extent on the business cycle of the external environment. Inflation growth, on the other hand, may be stronger this year than suggested in the base scenario, although there is a possibility of a sharp decrease in the years to follow. The source of uncertainty in respect of the impact of different inflation factors is the reciprocal impact of external and domestic inflation.

Risk scenario 1: Correction in domestic demand

The ratio of the private sector loan stock to GDP has increased from 70% to 100% over the last two years. The economy has absorbed a considerable amount of credit. Although this has boosted economic growth, it has also increased price levels. The use of loan money is not problematic if it is used in a way that steadily increases the volume of economy. However, it cannot be ruled out that the increase is only temporary. The first risk scenario describes the situation where economic growth has been supported by a temporary component.

The temporary increase in the volume of economy is particularly illustrative in the real estate sector: when credit growth slows, part of the demand will disappear and the number of square metres built in a year will decrease considerably compared to the level before the slowdown. The current decrease in the real estate sector is being signalled by the rapid decline in the number of new housing projects. As regards commercial property, the strong growth has continued so far but this segment may witness a later slowdown. When an enterprise goes bankrupt, there will be unengaged workforce, some of whom might go abroad and some to other sectors. Readjustments can also be expected in other fields

that were benefiting from the strong growth in the real estate sector, e.g. the building materials industry and commerce.

Risk scenario 2: Utilisation of export potential along with new global growth cycle in 2009

As regards the near-future developments of global economy, there is a lot of uncertainty at this point of time. Therefore, the forecast base scenario is based on the assumption that external demand growth will gradually start to recover in 2009. However, in a number of countries, economic policies put increasingly more focus on preventing economic decline and preparing for a new growth cycle. According to this risk scenario, the Estonian economy would grow faster than anticipated in the base scenario because the external environment would provide more support to productive capacity growth.

The slowdown in global economy might be temporary. In such case, the growth in oil and food prices is likely to continue and global price pressures will probably remain strong.

As a result of the extended domestic demand cycle, there will be production resources in Estonia that could be used to increase the export potential (e.g. in the case of the exports of goods and services related to construction). This will result in faster economic adjustment, which relies on the robust growth of export demand. This will continue to tighten the labour market and keep wage and price pressures high.

Risk scenario 3: Wage and price spiral

The rapid price increases have been fuelled by the robust wage growth that started in 2006. The inflation rate remains high also due to external factors (increase in energy and raw material prices) and administrative measures (changes in excise duties). There is a risk that if the price growth remains rapid for a while, economic agents will start to consider it

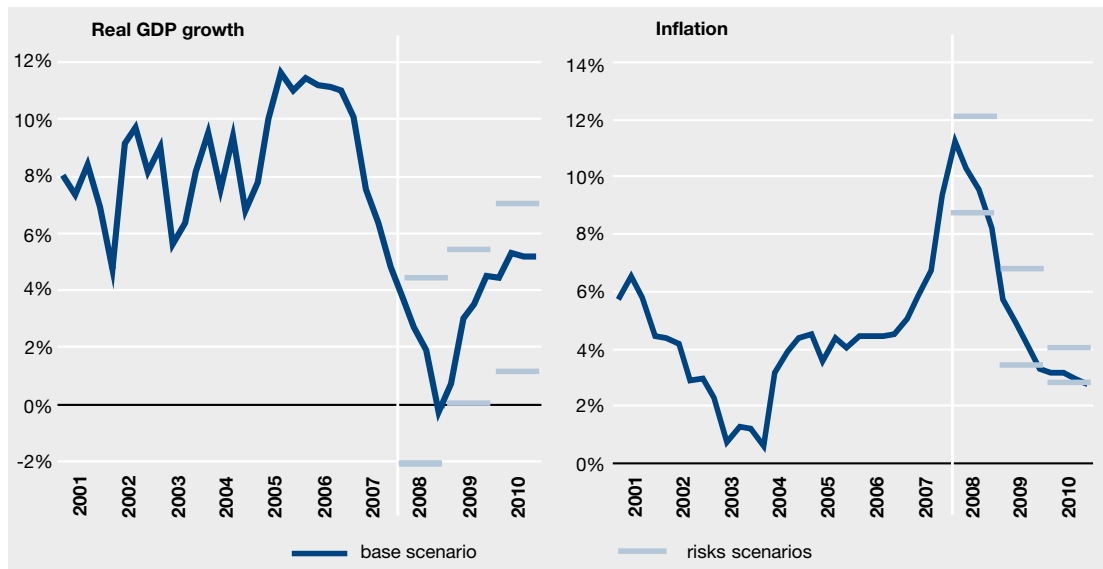


Figure 6. Risk scenarios for real GDP growth and inflation

Sources: Statistics Estonia, Eesti Pank

as something permanent. This, in turn, would affect price and wage formation (e.g. indexation) and also consumption and investment behaviour.

According to this scenario, Estonia's nominal convergence towards the EU average will accelerate, whereas real convergence will slow. Competitiveness problems in foreign markets keep export and GDP indicators low. High inflation cannot be sustainable over a longer period. Therefore, the wage-price spiral may end abruptly together with a longer-term correction in the real economy.