V ECONOMIC FORECAST FOR 2006–2008

Eesti Pank publishes forecasts twice a year – the spring forecast in May and the autumn forecast in November. The current spring forecast covers the years 2006–2008. The forecasting process consists of several stages: first, the external environment is analysed, then the base scenario is laid out, and finally the possible risk scenarios are prepared. The forecast, which is based on the data available as of the end of March 2006, was compiled using the macro model EMMA[1].

According to the spring forecast, Estonia's rapid economic growth will continue in the near future. Both domestic and external demand are expected to increase, although supply might not always keep up with the rapidly increasing demand (see Table 5.1). If economic growth above the potential level[2] continues, it will increase the possibility of a sharp downturn in the growth rate.

Due to the economic boost in the euro area, the external environment should improve, supporting Estonia's economy in the next few years as well. Financial markets expect the financial environment, with its low interest rates, to sustain Estonia's economic growth in the coming years. However, it has to be kept in mind that so far each additional rise in interest rates has been accompanied by an increase in interest expectations.

Although external demand is strong, Estonia's current account deficit is slow to improve due to the rapid growth in domestic demand, which has been increasing due to a persistently robust growth in

Table 5.1. Economic forecast by key indicators

								difference (spring 2006 / autumn 2005)		
	2002	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2005**	**2006**	**2007**
GDP (EEK bn)	116.9	127.3	141.5	164.9	186.2	206.9	228.4	4.8	9.7	11.8
Real GDP growth (%)	7.2	6.7	7.8	9.8	8.1	7.6	6.9	1.8	1.4	0.7
HICP growth (%)	3.6	1.4	3.0	4.1	3.6	3.0	3.7	0.0	0.2	0.1
GDP deflator growth (%)	4.4	2.1	3.0	6.1	4.4	3.3	3.3	1.4	1.2	-0.1
Current account (% of GDP)	-10.2	-12.0	-12.5	-10.5	-9.6	-9.4	-9.0	-1.1	-1.1	-1.6
Current account plus new capital account balance (% of GDP)	-9.9	-11.4	-11.8	-9.4	-7.9	-7.9	-7.5	-2.1	-1.2	-1.7
Real private consumption growth (%)	10.3	7.4	4.2	8.1	7.7	7.2	7.1	0.8	1.0	2.0
Real government consumption growth (%)	6.2	5.9	6.9	7.5	9.4	7.0	6.9	0.6	1.8	-0.1
Real investment growth (%)	17.2	8.5	6.0	13.9	11.9	8.6	7.6	5.4	6.3	2.5
Real export growth (%)	0.8	5.8	16.0	21.3	15.0	14.1	12.5	5.2	1.4	2.0
Real import growth (%)	3.8	10.6	14.6	17.4	15.1	13.7	12.2	6.1	2.3	2.9
Unemploment rate (%)	10.3	10.0	9.7	7.9	7.0	6.4	6.2	-1.1	-1.8	-1.8
Change in the number of the employed (%)	1.4	1.5	0.2	2.0	1.3	0.6	0.3	0.6	0.3	0.2
Value added growth per employee (%)	5.8	5.1	7.6	7.6	6.7	6.9	6.5	1.1	1.1	0.5
Real wage growth (%)	7.6	8.8	5.1	7.7	8.3	7.1	6.7	0.4	1.6	0.2
Nominal money supply growth (%)	11.1	10.9	15.8	42.0	33.0	25.0	23.0	15.1	20.0	10.1
Nominal credit growth (%)	26.1	27.7	31.8	49.4	40.1	30.7	22.7	11.4	10.3	7.4
External debt (% of GDP)	56.7	62.7	75.5	89.9	96.2	102.6	106.0	-0.4	-0.8	3.0

[1] See the Eesti Pank publication "EMMA – a Quarterly Model of the Estonian Economy" (Working Papers 2005, No 12).
[2] Level of gross domestic production, where all the economic production resources have been engaged.

income on the one hand and in lending on the other. Taking into consideration the current economic situation, it is unlikely that loan supply will be reduced. Based on the developments of the second half of 2005 and the statistics of the beginning of 2006, it can be said domestic demand is on the rise. Thus, in order to keep up with the strong demand, enterprises have to invest more. Household investment growth, on the other hand, is showing signs of a slowdown. The impact of the general government on economic growth will remain neutral – the growth rate of general government expenditure will not fall below that of GDP.

For most of the period under review, the inflation rate is expected to fluctuate between 3.0–3.5% and pick up slightly towards the end of the forecast period. The energy sector will be one of the main inflation factors in the coming years. In addition, several administrative price changes are outlined for the near future. The rise in the inflation rate at the beginning of 2008 will be mainly due to an increase in the alcohol, tobacco and fuel excise duties. The inflation rate may climb as a result of economic growth above the potential.

The price developments that took place in the real estate market at the end of last year may be referred to as overheating. According to the forecast, the share of household investment in GDP will remain substantial, although its contribution to real growth will not be as high as in 2005. The growth rate of households' loan burden will slow even more. Owing to the real estate and credit boom, the loan burden has increased remarkably. This has been accompanied by a rapid growth in real estate prices, but unfortunately not by a longer-term increase in productivity.

GLOBAL ECONOMY IN COMING YEARS[3]

Global economic growth prospects are favourable for 2006–2008. Although growth is expected to slow a little during the forecast period, it will still exceed the long-term average. Growth is supported by favourable financial conditions, external trade integration, and beneficial economic policy. Several countries have tightened their monetary policy, and interest rates should continue rising towards a neutral level this year as well. In 2007–2008, fiscal policy support for economic growth will weaken in the US as well as in several euro area countries. Due to the modest secondary impact of oil prices, global inflationary pressures have so far remained moderate. Markets expect oil prices to stabilise at 67 US dollars per barrel by 2007–2008. So far, the surge in oil prices has been counterbalanced by the strengthening of international competitive pressures, slow wage growth and tightening of monetary policy.

The growth of the major economies should be more uniform in the coming years than in the previous couple of years. The economic expansion of the US is expected to slow slightly, whereas Asia and the euro area countries will enjoy increased economic activity. In 2006, several private consumption growth factors will lose significance in the US – the rise in interest rates will result in increased household saving, and the pace of activity in the real estate market is expected to weaken. The risks arising from the imbalances in household balance sheets and in the current account are still topical. The US trade balance deficit increased to more than 700 billion dollars in 2005 and this development was accompanied by a considerable inflow of capital into US assets. As the key interest rates increase, foreign investors have every reason to hold dollar-denominated assets, which in turn eases the pressure for dollar depreciation. Various forecasting centres agree that eventually the US current account deficit will have to decline, but disagree on when and how it will happen. The rapid and extensive reduction of imbalances and its impact on the economic growth of other regions constitutes a risk.

[3] According to the Consensus Forecasts.

In 2006–2008, Asian countries will continue to enjoy broad-based economic expansion supported by a more vigorous domestic demand. China's economic activity will show no apparent signs of weakening throughout the forecast period. In Japan, the low unemployment rate and wage growth will contribute to a further increase in private consumption. The extraordinary income growth of the previous year, as well as the decline in the share of corporate debt and bad loans, allow for the forecasting of more dynamic investment activity for the current year. The positive developments in the real economy, the decline in monetary policy support regarding the real economy, and the recovery of core inflation indicate that Japan's economic growth is gradually reviving.

At the beginning of 2006, expectations regarding the recovery of euro area economic activity increased again. The positive tendencies are currently reflected by indirect indicators, which imply that euro area-economic growth is back on track. Despite the optimistic short-term forecasts, the euro area economy is still facing the challenge of using investment to boost potential economic growth and employment. Weak investment growth has been characteristic of the euro area for several years, notwithstanding the favourable financial environment and relatively high rate of return. Private consumption is growing, although at a slower pace than investment, as employment stays near its cyclical low. That is why the demand-induced inflationary pressures are also weak.

The economic growth of the Nordic countries will exceed that of the euro area by a percentage point in 2006. The inflation rate will increase by the same amount. Finland's economic growth is expected to return to its long-term average after a temporary slowdown in 2005 due to labour disputes and a shutdown in the wood and paper industry. Broad-based economic growth supported by both domestic demand and a growth in exports should continue in Sweden.

The GDP growth of most of the new EU Member States will pick up in 2006, but its components vary by country. While the 2005 economic growth of the old EU Member States was mainly fostered by net exports, the contribution of domestic demand is expected to increase in the next years. Private consumption will increase because of income and borrowing growth. Final demand is also supported by investment and exports to other euro area countries. The inflation rate in the new EU Member States is predicted to increase by 0.1 percentage point a year during the forecast period to reach 2.7% in 2008.

Russia's economic growth declined in 2005. This was caused by the country's modest oil and gas exports due to insufficient capacity. As a result of sluggish growth in both net exports and private consumption, the GDP growth is forecast to slow even more over the next years. The appreciation of the real exchange rate of the rouble is impeding Russia's net export growth.

ESTONIA'S ECONOMIC OUTLOOK: THE MAIN SCENARIO

Economic growth

Estonia's economic growth picked up last year on account of both domestic and external demand. It is likely that the surge in demand was temporarily accompanied by vaster potential growth, but the GDP gap remained nevertheless positive. The expectations of economic agents have been high since the beginning of the year, which allows for the prediction that high demand will continue. The fields of activity targeted at both domestic and external demand are expected to enjoy robust growth. The rapid economic expansion is forecast to persist – 8.1% in 2006 and 7.6% and 6.9% in the next two years, respectively (see Figure 5.1).

Confidence indicators also refer to the continuation of rapid growth in the near future. This is especially true regarding the construction sector, where the duration of work in hand and already contracted was for

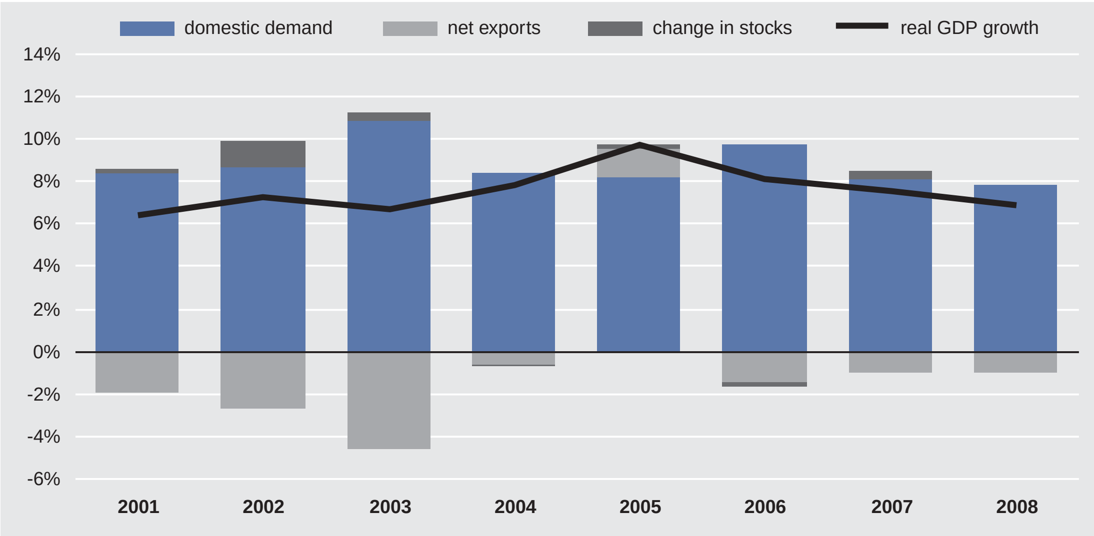

Figure 5.1. Real GDP growth and its components (%)

longer periods at the beginning of this year compared to earlier years. Industrial enterprises are enjoying sufficient demand, and the retail-trade barometer is showing better results, year-on-year. The beginning of the year looked slightly gloomier only to service enterprises, yet they too, are rather optimistic.

Looking further ahead, finding skilled labour force is becoming increasingly more difficult, as the local workforce is starting to shrink due to demographic reasons. Thus, economic growth is primarily determined by capital accumulation and a growth in productivity. It is likely that in 2005 the GDP growth potential increased mainly on account of productivity (including internal economic resources), and it is presumed the same processes will contribute to the growth potential in the future as well.

The key challenge of Estonia's economy is to achieve success in the context of international competition. The key concepts characterising the manufacturing operations of Estonian enterprises in the next years include: the better utilisation of economies of scale and specialisation, the segmentation of products and markets, and openness to outsourcing.

The economic activity of the real estate sector has increased considerably over the past years. It reached its peak at the end of last year, causing extremely rapid price increases. The contribution of the real estate sector to last year's economic growth was markedly higher than in previous years. Rapid changes always raise the question of whether we are dealing with balanced processes or if there exists a need for adaptation. Currently it is clear that the real estate sector poses a risk. The inhibition in the real estate and loan boom related to the existing housing resources will have an indirect and modest impact on economic growth. This will be mostly influenced by the construction of new housing, which should remain at the same or slightly slower pace than last year. If interest rates rise above the expected level, the setback may be more extensive than expected.

The supply side of the economy is facing the risk that local enterprisers will be unable to meet the demand due to insufficient capacity. Manufacturing is becoming increasingly restricted by the labour market situation. The rapid growth in both domestic and external demand over the past years has already exhausted the investment made to expand activities, so in order to fully meet the existing demand, new investments are needed, especially in more productive machinery and equipment.

Domestic demand

The economic boost in the second half of 2005 was accompanied by an increase in domestic demand. The beginning of this year has revealed signs that domestic demand growth will continue or even rise. According to the forecast, the growth rate of private consumption, investment and general government expenditure will remain more or less at the same level as last year.

Private consumption is expected to grow approximately 7–8% in the next years. This development will be supported by a rise in the disposable income of households, which turned out to be one of the steepest ever in 2005. Income growth was favoured by a more rapid increase in the wage fund (which partly resulted from the faster growth in employment) and income transfers, as well as by business income and the appreciation of assets. The lowering of the income tax also had a role to play here, because as a result, the growth in net income exceeded that of gross income.

The rapid growth in disposable income will continue in 2006, supported by a further expansion of the wage fund (accompanied by an additional reduction in the income tax rate). The average annual growth of pensions will also be larger than in previous years. The robust growth of business income is persisting. However, the growth of disposable income in 2007–2008 will slow somewhat, as nominal growth is reaching its long-term average level (approximately 11%).

The real estate boom has been playing an important role in the domestic demand structure since 2004. Real estate investments have crowded out a share of private consumption expenditure. However, from this point onward, private consumption is expected to gradually revive. The ratio of household saving to GDP will remain at the same level over the forecast horizon due to changes in household investment. Rising interest rates will set a limit on the private consumption growth rate. The interest payments of households will increase faster than disposable income. Thus, the private consumption growth rate will be surpassed by the GDP growth rate.

Consumer credit, which supports private consumption, is gaining momentum (the loan stock will increase by approximately 5 billion kroons in 2006). Nearly a half of private consumption growth is based on credit, and the loan stock is predicted to continue growing at the same pace in the next years as well. Thus, the trend that the consumption of durable goods exceeds several times that of non-durable goods should continue.

The investment growth forecast for the current and the next two years is 11.9%, 8.6% and 7.6%, respectively. The share of investment in GDP has been and will remain persistently high, but changes are predicted to occur in the investment structure. Whereas growth has so far been sustained mainly by household investment, the growth rate of the latter is expected to decline, and that of corporate investment is expected to increase starting in 2007. The volume of investment in fixed assets by non-financial sector enterprises has been at almost the same level for the past four years. In order for the positive GDP gap to shrink (i.e. actual growth should not exceed potential growth), it is necessary that non-financial sector enterprises increase their investment in fixed assets.

Based on the market participants' estimates, it can be shown that spare capacity existed in the industry sector at the beginning of this millennium, but now signs of insufficient capacity are surfacing. Thus, in order to maintain rapid economic growth, new corporate investment is essential. Moreover, taking into account the limited labour supply, it is crucial to increase the share of capital accumulation in economic growth. Interest rate increases are not predicted to exceed the level that would have a marked impact on the investment demand of enterprises.

Household investment, one of the most dynamic domestic demand components after stocks, is likely to grow faster than GDP at the beginning of this year as well, although the growth rate is expected to subside. Housing credit growth is maintaining its high level this year, but as no considerable influx of new customers is likely to happen, it is predicted to decline in the future.

A certain rise in interest rates will not necessarily mean a decline in household investment: if interest rates develop according to current expectations, no significant changes in demand will follow. Even so, sensitivity to further increases in interest rates may heighten, as it is likely the loan demand of households with lower income will grow.

The general government as a whole can be expected to remain rather conservative in its activities during the next years. General government consumption expenditures will increase somewhat faster this year compared to 2005, but the growth rate thereof will remain at the same pace over the forecast horizon as that of GDP. General government investment will grow mainly on account of infrastructure investments in 2006. The budget will be either in balance or in surplus during the entire forecast period. The tax burden will undergo no considerable changes and remain at the same level as in 2005 – below 33% of GDP, whereas the increased social tax revenues resulting from the robust wage fund growth will counterbalance the depletive effect of the income tax reform on the tax burden. The impact of the increase in indirect taxes will be moderate. The gross external debt of the general government is in a steady fall, reaching 2.8% of GDP by 2008.

The domestic demand risks are primarily related to credit demand, which may turn out to be more extensive than predicted. Active lending will contribute to the growth rate of both household investment and private consumption. This may erode the external balance. The increasing loan burden and subsequent economic imbalances may pose a threat to economic growth, as even slight changes in either the external or internal environment (e.g. interest rate increases, steeply declining demand in an economic sector) may lead to setbacks in future economic development.

Labour market

Although the labour market has been rather stable for the past three years, a decline in unemployment and an increase in employment have occurred. The percentage of the inactive among the working age population has grown, although at the end of last year there were some signs that this trend would discontinue. However, the labour market situation has tightened – the unemployment rate is approaching the level where it is becoming increasingly more difficult to hire additional employees. In addition, the marginal productivity of those currently unemployed is usually lower than in the case of those already employed. Thus, the winning over of good employees, as well as supplementary upward wage pressures, can be expected. No significant reduction in wage growth is expected during the next years. On the contrary, it may even accelerate. Due to the free movement of labour and the scarcity of local workers there exists the risk that wage growth will outpace productivity growth, which would lead to a slight fall in unit labour costs. According to the forecast, wage growth will be 11.7%, 10.4%, and 10.6% in 2006–2008, respectively, whereas unemployment will fall to 7.0%, 6.4%, and 6.2% over the same period (see Figure 5.2).

The fairly extensive movement of labour between fields of activity should maintain the high level of transitional unemployment. For example, employment should fall in the agricultural sector, textile and clothing industry, and, in the longer term, in the electronics industry, which is still currently expanding at a rapid pace. Therefore, it is necessary that those people undergo retraining so they could find work in other sectors. Most of the jobs created during the forecast period will be in the services sector. More rapid growth will take place in the field of tourism, and, due to the aging population, in the areas related to healthcare and welfare services.

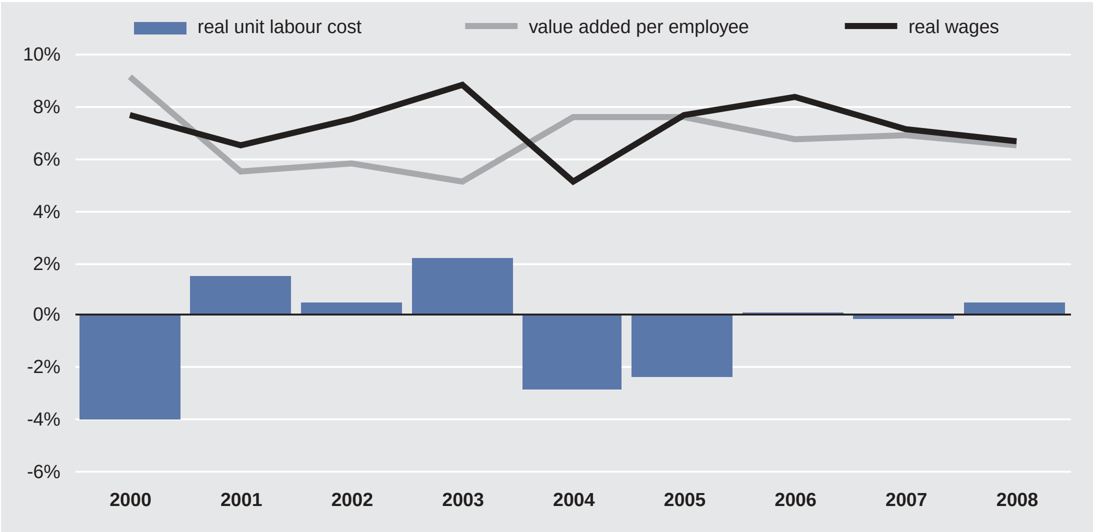

Figure 5.2. Productivity, real wages and real unit labour cost

The relatively free movement of the workforce in the European labour market poses additional tensions and risks to Estonia's economy. In the case of Estonia, the free movement of labour means people move abroad to work, whereas not that many come here to work. The competition between employers for the existing labour force might bring about an even wider discrepancy between wages and productivity. The situation could be mitigated slightly if young people became more active in the labour market. This might happen if the possibilities for part-time employment are increased or if the period of study is shortened, enabling students to start participating in the labour market sooner.

Employment should reach its critical limit within the next five years, during which the number of the employed may reach 620,000–625,000 and unemployment drop to 5%. From that point onward, it will no longer be possible to achieve employment growth using the local workforce.

Inflation

The inflation rate will drop to 3.6% this year and 3.0% next year, but it will grow to 3.7% again in 2008 (see Figure 5.3). The energy sector, where the prices are noncompliant with world market prices, will constitute one of the most significant inflation factors in the coming years. In addition, several administrative price changes will also intensify the upward price pressures. The increase in the inflation rate at the beginning of 2008 will be mainly due to the rise in the alcohol, tobacco and fuel excise duties. The oil price forecast, which is based on futures, does not predict a considerable decline in prices, either. The growth in the price of food will continue at the same level at a uniformly decelerating pace. Although the share of high oil prices, which have so far boosted inflation, is slowly declining over the forecast period, the role of price convergence is recovering. The exchange rate fluctuations of the US dollar probably contributed to Estonia's low inflation rate in 2003. However, the latter was a one-off event, which was mistakenly considered permanent, and as a result, the respective inflation forecasts were too optimistic.

According to the spring forecast, the 12-month inflation rate will decline until the third quarter of 2006, after which inflation will again gain momentum due to a rise in thermal energy prices. The price rise is

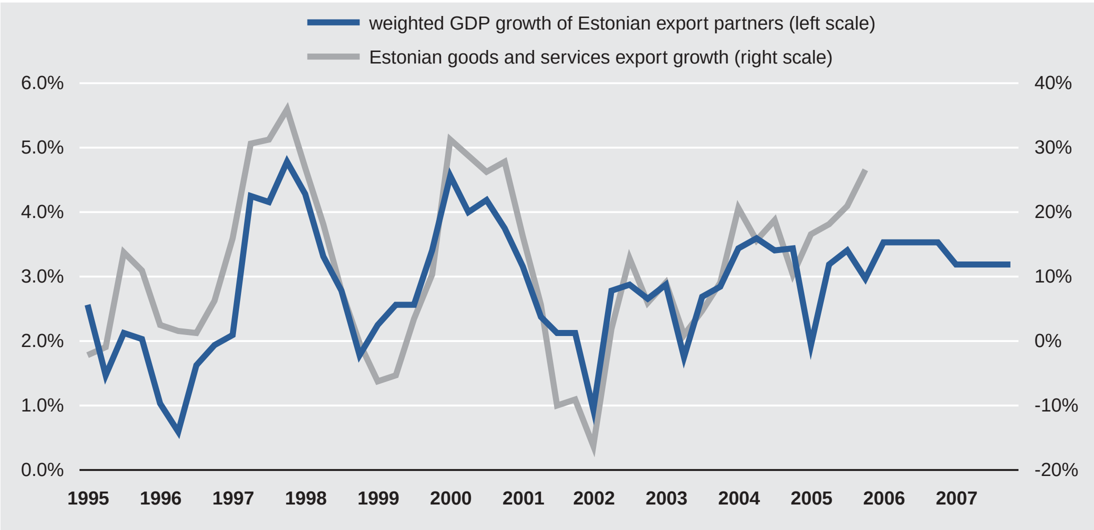

Figure 5.3. Estonia's real exports growth

expected to be the most rapid at the end of the year (between 3.0–3.5%), after which it will fall until summer 2007, when the 12-month inflation rate will exceed 3% due to the addition of VAT to thermal energy prices. The increase in excise duties planned for January 2008 will raise the inflation rate level to 4%, and it will remain there until the middle of the year, when the price rise is predicted to fall and stay around 3% until the end of 2008.

The recent robust economic growth is influencing prices as well, but not very extensively. However, it cannot be discounted that the impact will become widespread. This is, after all, an indication of demand-related inflation due to rapid income growth, which causes enterprises to raise prices more than before.

Food, alcohol, and tobacco

The rise in food prices is predicted to slow in the coming years. The increase in prices of unprocessed food will slacken to around 3% in 2008, and that of processed food to 2%. The prices of raw materials for food have been rising in the world market since the beginning of 2001, and this trend is forecast to continue, although at a slightly slower pace. The inflation rate is fluctuating due to tobacco and alcohol. The price level of these components will remain more or less stable until the beginning of 2008, when the planned increase in excise duties will bring about a remarkable leap – tobacco and alcohol prices will rise by approximately 10%.

Whereas the price of tobacco and alcohol is largely influenced by administrative price changes, both the non-tradable sector and increasing export volumes contribute mainly to the convergence of food prices towards the average EU level. The price level of Estonia's foodstuffs is slightly below 70% of the EU average, but below 60% of the Finnish average, thus there is plenty of room for further price convergence.

Core inflation

Core inflation picked up in 2005. This was mainly due to the price rise of manufactured goods and several services, whereas the prices of communications services have been falling steadily. Core inflation is based on a complex system of factors, where, according to recent estimates, the contribution of external factors (e.g. the dollar exchange rate) is much more influential than previously thought. In addition, the indirect impact of oil prices (e.g. on transport services) plays a (temporary) role in the formation of core inflation. Due to these factors, it has been impossible to specify the likely pressures arising from economic cycles. Although the average price level of core inflation components is relatively low compared to the EU average, several components are rather close to those of the EU. It is presumed that in 2006–2008, core inflation will rise to 2.6%, 2.6%, and 3.0, respectively. Here it has to be taken into account that the 2.6% of this year includes a temporary component – the price of fuel – without which core inflation would be lower. Services, which will have appreciated approximately 7% per year by the end of 2008, comprise the fastest-growing core inflation component. Communications services, on the other hand, will become even less expensive.

Energy used by households

The energy resources used in Estonia are one of the cheapest among European countries. The opening of markets followed by a gradual price convergence will, in the longer term, cause the energy used by households to become one of the most rapidly appreciating consumer basket components.

According to the current forecast, the rise in thermal energy prices will affect Estonia's inflation the most in coming years. This is mainly due to the hike in the price of gas imported from Russia. In 2006, the gas price is expected to rise by almost a quarter, and this trend should continue next year as well, taking into account that high oil prices will persist. This means households will have to pay a quarter more for gas from the beginning of 2007. In addition, the price increase of thermal energy is continuing – the price will rise by a tenth on average both this year and next. Environmental taxes should bring about a slight rise in the price of electricity, but in the medium term, inflation will be primarily influenced by the opening of the electricity market, which must be completed by 2013.

Motor fuel

The forecast on motor fuel is based on the development of the US dollar and oil futures as at the beginning of March. The price of oil is expected to peak at 67 dollars per barrel in the middle of 2007 (e.g. the price of one litre of 95E petrol will rise to 14.5 kroons at automated filling stations). In addition, the motor fuel prices of 2008 will be influenced by the rise in excise duties, which has so far been repeatedly postponed. According to the Accession Treaty, Estonia is obliged to harmonise its fuel excise duties by 2010, which means this will not be the only increase in excise duties over the medium term. However, its rise will not have a very marked impact on the price of petrol.

Due to several risks, the actual inflation rate may turn out to be either higher or lower than predicted, although the former is more likely. Proceeding from the traditional approaches to inflation, all signs refer to the existence of inflationary pressures: labour market developments, the positive GDP gap, trade margin changes in retail trade, the rapid growth of monetary and loan aggregates, the persistence of administered price pressures, and the scarcity of capacity.

External balance

Estonia is a small country with an open economy, so its income, which determines domestic demand, depends mainly on exports. Currently, however, domestic demand and imports are expanding on account of easily available credit. As a result, the favourable influence of the external environment on the external balance has been less than expected. Estonia's external demand will be stronger in the coming years compared to 2005, when it was primarily inhibited by Finland's economic growth due to a strike in the timber industry. Finland's economic outlook has improved, and, in addition, the general growth structure of the global economy is providing more support to Estonia now compared to earlier years, as Europe's economic growth is gaining momentum. Although next year the robust growth of the global economy is predicted to weaken slightly, it will still remain at its long-term average level. The number of foreign tourists is growing continuously. The favourable financial environment should hold during the entire forecast period, at least compared to earlier periods (see Figure 5.4).

The increase in imports and exports will probably be more uniform this year, reaching 15% by the end of the year, but annual growth will fall to 12% by 2008. The rise in energy input prices will decrease Estonia's competitive advantages in the medium term.

Compared to the autumn forecast, the spring forecast is slightly more pessimistic regarding current account improvement – the decline in the current account deficit[4] will be sluggish in 2006–2008, reaching 9.6%, 9.4%, and 9.0%, respectively (see Figure 5.5). This pessimism is based mainly on the more expansive domestic demand and deteriorating foreign trade conditions. The slower-than-expected improvement of the goods-and-services balance was caused by the increase in domestic demand, which is supported by income and credit growth, as well as by the growth in the share of imports in the volume of exports. Although the growth outlook of travel services export is positive, the growth rate of business-related transit services will be slower than usual and may be surpassed by the growth in services import. The goods and services balance deficit to GDP will drop from 6.0% in 2006 to 5.4% at the end of the forecast period. The share of the income account decreased in 2005 due to a single exceptional transaction. In the longer term, the outflow of income will decrease, as corporate results and revenues will turn out to be positive. The inflow of wages earned abroad may temporarily counterbalance the income outflow, but not over the longer term.

In 2005, external debt was equal to 90% of GDP, as the private sector included, due to increasing domestic demand, a considerable amount of credit from the

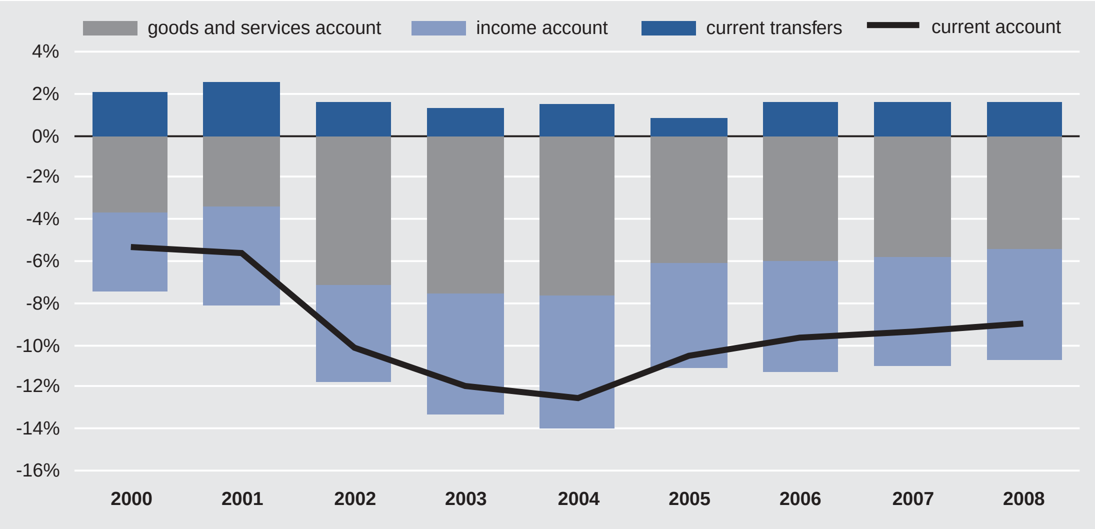

Figure 5.4. Current account structure (% of GDP)

[4] Due to technical reasons (the increase of GDP volumes in relation with the implementation of new methodology), the current account deficit will probably turn out to be smaller by 0.5 pp.

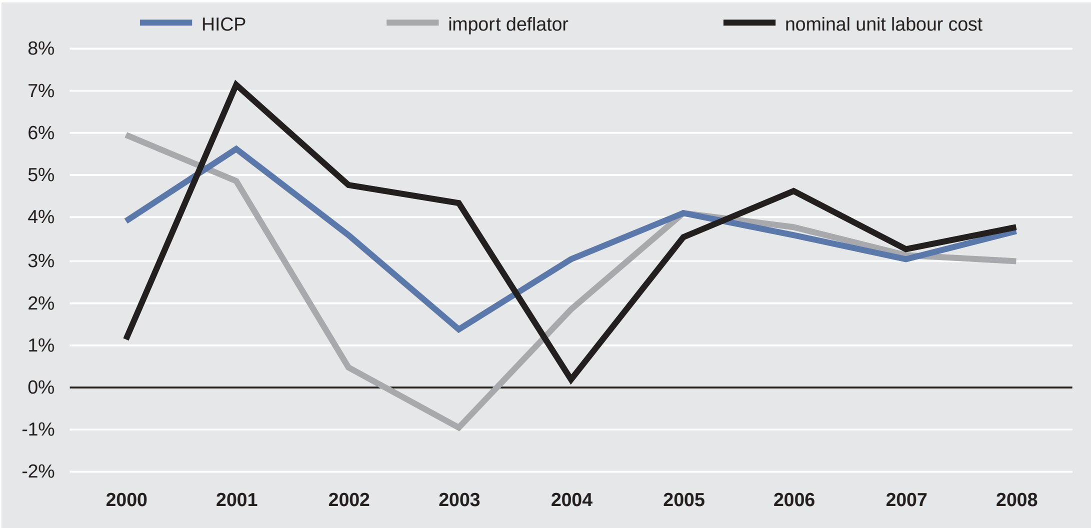

Figure 5.5. Inflation forecast (% year-on-year)

financial sector. The volume of external debt grew by a record amount – 41 billion kroons. As loan demand has also remained at a high level, external debt will increase in coming years, too, and equal approximately 106% of GDP by the end of 2008. In spite of the increase in deposit growth, domestic savings are insufficient to satisfy the demand for loans.

ESTONIA'S ECONOMIC OUTLOOK: RISK SCENARIOS

The economic forecast of Eesti Pank is made up of not only the main scenario but also risk scenarios. The risk scenarios of the current forecast are mainly related to domestic demand developments. In addition, the labour market risk, i.e. the threat that wage growth may outpace productivity, and the risk of global imbalances, i.e. the capital and trade flows from the US and Asia are not in balance, are still topical.

Risk scenario I: robust growth of domestic demand continues on account of credit growth

According to the first risk scenario, economic agents will continue to borrow at a greater rate than predicted by the base scenario (see Table 5.2). Larger credit volumes boost private consumption growth and household saving, the latter of which will be accompanied by a persistent increase in real estate prices. Besides real estate loans, more and more loans are taken out to obtain other durable goods – to replace furniture or home electronics, to decorate the home, to buy a car, etc. The robust growth of credit will intensify domestic demand and result in a larger import demand, which means the current account deficit will increase as the trade balance deteriorates. The current account deficit is financed by credit, which will result in a considerably higher ratio of external debt to GDP compared to the base scenario. Strong additional demand-side pressures will result in a tightening of the labour market, thus affecting wages and finally, prices.

In consequence of active lending, domestic demand will increase rapidly. As a result, capacity will be completely exhausted and investment decisions made against such a background may not turn out to be efficient in the longer term. Supported by domestic demand, annual economic growth will accelerate by only 1% during the next two years. The price of such development, however, is a loan burden 40 billion kroons greater than before and a slowdown in eco-

Table 5.2. Economic forecast by key indicators: risk scenario I

	2006	2007	2008	difference (risk 2006 / spring 2006) 2006	2007	2008
Real GDP growth (%)	9.0	8.8	5.8	0.8	1.3	-1.1
Real private consumption growth (%)	13.2	9.0	4.6	5.4	1.8	-2.5
Real investment growth (%)	21.3	13.9	5.4	9.4	5.3	-2.2
HICP growth (%)	3.8	3.6	4.4	0.2	0.6	0.7
Current account (% of GDP)	-13.8	-15.0	-13.3	-4.1	-5.6	-4.2
Real wage growth (%)	8.4	8.4	7.2	0.0	1.2	0.6
External debt (% of GDP)	99.3	108.8	117.4	3.1	6.2	11.4

nomic growth by the end of the forecast period. The loan burden of the economy will soon reach the limit after which further growth will be accompanied by difficulties in loan servicing. It is not yet known what the level of loan burden will turn out to be, but if it reaches its maximum, economic growth will undergo a steep downturn and probably remain sluggish for a long time.

Risk scenario II: correction in the real estate sector

The second risk scenario concentrates on a setback in the real estate sector (see Table 5.3). In 2005, the contribution of the real estate sector to economic growth was much more extensive than in earlier years, as both household and corporate investment increased substantially. At the beginning of this year, the real estate sector has issued reverse signals regarding further development. Taking into consideration the recent rapid rise in prices and the weakening of the major economic indicators, a correction of the current trend of price increases cannot be ruled out.

According to the risk scenario, supply and demand will stabilise at a relatively high price level. Due to the downturn in the real estate sector, economic growth is also going to drop. As household investment is perceptibly reduced, the total growth of investment will slow as well. Corrections will be smaller regarding the rest of the domestic demand components.

However, the aggregate impact of these corrections will not be too extensive. Despite a slight slowdown in wage growth, its level will remain high as there are a number of workers who will have no difficulty finding a job abroad. Compared to the base scenario, unemployment will turn out to be higher, further employment growth will be inhibited, and the optimism of economic agents will be dampened somewhat. The slowdown in the real estate sector will have no marked impact on inflation, just as it was the case when the activity was on the rise. The decline in optimism will be accompanied by a slowdown in domestic demand, because of which the demand for imports will fall and the current account will improve.

Table 5.3. Economic forecast by key indicators: risk scenario II

	2006	2007	2008	difference (risk 2006 / spring 2006) 2006	2007	2008
Real GDP growth (%)	7.7	5.2	5.0	-0.5	-2.4	-1.9
Real private consumption growth (%)	7.1	5.0	5.3	-0.6	-2.2	-1.9
Real investment growth (%)	8.0	3.9	4.4	-3.9	-4.7	-3.2
HICP growth (%)	3.6	3.0	3.6	0.0	0.0	0.0
Current account (% of GDP)	-8.6	-7.9	-7.3	1.0	1.4	1.7
Real wage growth (%)	8.2	6.3	5.7	-0.1	-0.8	-1.0
External debt (% of GDP)	95.6	103.1	109.8	-0.6	0.5	3.8