V ECONOMIC FORECAST FOR 2006–2008

Eesti Pank publishes economic forecasts twice a year – the spring forecast in May and the autumn forecast in November. The current autumn forecast covers the years 2006–2008 and is based on the information available at the beginning of October. In addition to the base scenario, the forecast also includes two risk scenarios.

SUMMARY

The rapid expansion of the Estonian economy is continuing (see Table 5.1), which cannot be sustainable in the longer run. Therefore, the principal question is, how fast and extensive the impending cyclical downturn is going to be. However, now it is clear that the rapid growth has induced price pressures stronger than forecast in spring and a deterioration in the external balance. The risk of facing a sharp adjustment after some time is higher than ever.

The external economic environment is expected to remain favourable in the next years, although some downward adjustments will occur in the global output growth. This will be mainly due to a slowdown in the US economy, where the rapid wealth accumulation period is coming to an end. Economic growth in Europe has considerably picked up speed year-on-year, and the above potential growth rate is expected to continue in the next two years as well, although the value-added tax reform in the largest economy in Europe, Germany, is going to have its impact on the next year. The assumption on oil price dynamics is based on futures contracts, as previously. These show a slight growth, although the threat of a demand-driven price increase of oil has recently started to decline. However, the prices of other inputs have not fallen. Notwithstanding more expensive raw materials, long-term inflationary expectations have remained subdued. Therefore, further tightening of monetary policy is not expected but rather a rise of interest rates to their historical average.

Estonia's economic growth can only decline from current high rates. The question is when it will take

Table 5.1. Economic forecast by key indicators

						difference (autumn 2006 / spring 2006)		
	2004	2005	2006	2007	2008	2006	2007	2008
GDP (EEK bn)	146.7	173.1	205.5	236.1	268.3	19.3	29.2	39.8
Real GDP growth (%)	8.1	10.5	11.8	8.3	7.6	3.6	0.7	0.8
HICP growth (%)	3.0	4.1	4.4	4.5	4.7	0.9	1.4	1.1
GDP deflator growth (%)	2.1	6.7	6.2	6.1	5.6	1.8	2.8	2.3
Current account (% of GDP)	-12.6	-10.4	-12.5	-13.5	-13.3	-2.9	-4.2	-4.2
Current account plus new capital account balance (% of GDP)	-11.8	-9.4	-10.9	-12.2	-12.0	-3.1	-4.3	-4.5
Real private consumption growth (%)	7.0	7.9	15.4	12.5	8.8	7.6	5.3	1.7
Real government consumption growth (%)	2.2	1.1	2.5	1.8	1.6	-6.9	-5.2	-5.3
Real investment growth (%)	13.5	12.7	14.7	12.0	9.7	2.8	3.3	2.1
Real export growth (%)	17.1	21.5	13.1	11.0	10.0	-1.9	-3.1	-2.5
Real import growth (%)	15,2	15.9	14.9	12.6	9.8	-0.2	-1.1	-2.5
Unemploment rate (%)	9.7	7.9	5.7	5.1	5.1	-1.2	-1.3	-1.1
Change in the number of the employed (%)	0.2	2.0	7.1	1.9	0.4	5.8	1.2	0.1
Value added growth per employee (%)	7.8	8.3	4.4	6.3	7.2	-2.4	-0.6	0.7
Real wage growth (%)	5.9	8.3	12.0	10.6	9.3	3.7	3.5	2.6
Average gross wage growth (%)	7.8	11.4	15.8	15.1	14.1	4.1	4.8	3.5
Nominal money supply growth (%)	15.8	42.0	33.0	25.0	16.2	0.0	0.0	-6.8
Nominal credit growth (%)	33.0	50.4	45.5	34.9	21.1	5.4	4.2	-1.6
External debt (% of GDP)	78.3	86.0	81.8	90.4	98.5	-14.4	-12.2	-7.4

place and how rapid the adjustment will be. The inflow of foreign loan capital has created a very strong demand environment, where it is relatively easy to raise prices. Although demand is high, this might not realise in economic growth of the same size – there are not enough resources to expand production. Lack of resources is reflected in their growing prices and this, in turn, may bring about a decline in competitiveness. Thus, demand, capacity utilisation, and competitiveness are the three main factors shaping together Estonia's economic cycle in the next years. The base forecast scenario sees tensions between the abovementioned factors to moderate without serious complications. This means the allocation of production resources has been efficient and there is no need for reallocation on the production side of the economy. Part of the competitive edges resting upon lower production costs will be lost, but not to a very big extent. As before, the country's economic expansion still relies on domestic demand, mainly supported by extremely fast credit growth. Faster wage growth at the beginning of this year points to the fact that free labour resources in the economy are practically exhausted, despite the fact that in the next years more people will enter the labour market than leave it. Thus, the main problem is how enterprises will be able to control their wage growth or increase their productivity. The growth in corporate profits is expected to decline in the near future. This will cause an increase in real unit labour costs, which will last until the end of the forecast horizon.

Compared to the spring forecast, we estimate the next years' inflation rate to be higher. Inflation is broad-based, which is characteristic of a rapid economic expansion. It is likely the inflation of food and households' energy as well as core inflation will increase. Administered prices will also grow more than presumed in the spring forecast. Only the price rise of motor fuel may be smaller than indicated in spring.

External balance will be less favourable than we expected in spring, remaining so also in the next two years. The deficit in the goods and services account will be somewhat offset by income inflow, which is slightly larger than forecast in spring, owing to the inflow of workers' remittances. Although the new financial perspective of the European Union has been disclosed, it will not be able to exert a considerable impact on the next years' transfers account.

In the spring forecast, we expressed concern over the price hikes in the real estate market at the end of 2005. By now, the price growth has slowed down and relative prices are in the process of adjusting (the prices of apartments are stabilising, whereas those of land and houses are increasing even more). Although the real estate market is still rather active, including outside the capital city, the time of rapid changes is hopefully over.

Two risk scenarios complement the autumn forecast and both of them focus on competitiveness. In the spring forecast, both the rapid growth of domestic demand and labour market issues were pointed out as risks to Estonia's economic expansion. In light of recent developments the risks have partly materialised. This has contributed to the risk of economic overheating, which may bring about faster price and wage growth and declining competitiveness. These developments will be followed by downward corrections in economic growth and income, and probably also by the need to reallocate resources on the production side of the economy. Under such circumstances, the speed and extent of economic adjustment are determined by the flexibility of the labour market, and recovery from overheating may take place as late as after 2008. These processes might, in turn, be augmented by the declining international credibility of the Estonian economy.

External environment

The global economic growth of 2006 has been very strong, being the fastest over the past twenty years (see Figure 5.1). It is above 4.5% for the third year in row, but should decline by 0.5 to 0.7 pp. in the next years. Owing to the rapid economic growth, core

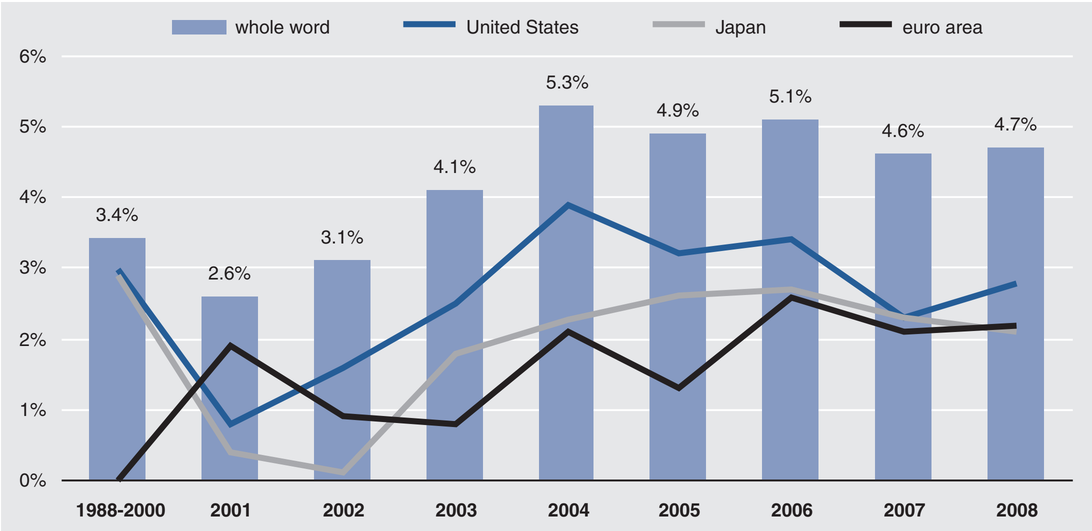

Figure 5.1. Real GDP growth

Source: European Commission's autumn forecast

inflation pressures have become stronger. At the beginning of October, oil prices saw a considerable fall in the world market. The pressures arising from the demand for oil have temporarily drawn back, so in the near future oil prices will mainly depend on production output. Based on futures contracts, markets expect the average price of oil in 2007 to be approximately 65 dollars per barrel.

The US GDP projection has not been changed compared to the spring forecast, but the next years' growth expectations have become more modest. The US real estate market has cooled faster than expected, and this will lower investment activity. The current account deficit exceeded its earlier records at the beginning of the third quarter and there are no signs of a decrease in capital inflow. The exchange rate of the dollar has remained stable. Employment growth will facilitate the increase in disposable income in the years to come, whereas wage growth is expected to slow. Inflation growth will speed up to 3.6% in 2006, but is expected to drop in the following years. The US Federal Reserve will probably not increase the key interest rates further.

The euro area saw a fast and broad-based economic growth in the first half-year of 2006. Out of domestic demand components, the contribution of corporate investment to GDP was the largest. Over the forecast horizon, investment made in machinery and equipment will continue to increase, whereas the growth of the real estate sector will dwindle. The development of the labour market will support private consumption and several euro area countries are adjusting to external competitive pressures. Consumer confidence is gaining strength and the drop in real wages has come to a halt. According to the Consensus Forecasts, euro area economic growth is expected to slacken to 2.6% and 1.9%, respectively, in 2006–2007. Owing to stricter monetary policy, inflation growth will decline in 2007. Wage pressures will remain weak and will not affect prices so easily due to tight competition. The dynamics of currency exchange rates also favour a fall in inflation. According to market expectations, euro area key interest rates should climb back to the neutral level.

Japan's GDP growth will reach 2.8% in 2006, being the fastest over the past ten years. The country's economic outlook for 2007–2008 depends on the US domestic demand. The 2006 rapid economic expansion of the Nordic countries is exceptional, although it is expected to continue also over the forecast horizon at a rate over 3.5%.

The influence of developing countries on global economy is expected to grow even more in the years to come, offsetting the decrease in economic activity of industrial countries. In 2005, the contribution of developing countries to the global economic growth constituted approximately a half, whereas the total contribution of China and India formed a third thereof. As the level of income increases in these countries, the purchasing power of consumers and the demand for imports grow as well.

Risks to global economy lie in the deterioration of the external balances in several industrial countries. Owing to the price increases of components not included in the core inflation, such as oil and food, global inflation may pick up speed more than expected.

Economic growth

The double-digit economic growth that has been continuing for over a year now will not be feasible for Estonia in the coming years (see Figure 5.2). The period when economic growth has been based on fast creation of jobs is likely coming to an end. In the future, economy should receive more support from productivity growth. According to the base scenario of the forecast, economic growth will reach its record level this year at 11.8% and remain above the potential level for at least two more years, increasing by 8.3% and 7.6%, respectively, in 2007–2008. The risks surrounding these estimates refer to the possibility that short-term economic growth will be faster and longer-term economic growth slower than expected.

As regards confidence indicators, there are no considerable changes in trends compared to the spring forecast. The external environment has remained favourable and supportive of economic expansion, whereas domestic demand has been stronger than we expected in spring. The near-term expectations

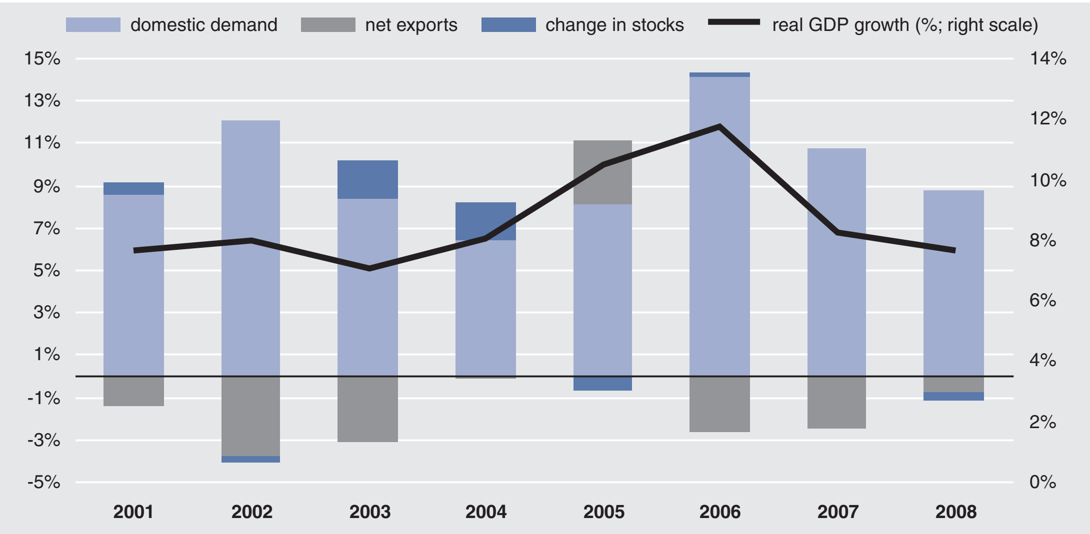

Figure 5.2. Contribution of components to growth

of consumers and enterprises are optimistic. The confidence indicators of the construction sector, the trade sector and the industrial sector are still growing fast. The services sector does not show very high confidence, but its general situation is still favourable. The construction sector is enjoying a lot of orders and is provided with work for approximately half a year. However, rapid development also reveals bottlenecks – stocks are low both in trade and industry, and production capacity is exploited at the highest level over the past five years. Shortage of materials is the most evident in the fast-expanding construction sector. Strong demand and supply-side constraints are reflected in price dynamics barometers, which show the clearest upward trend in the industrial sector.

Whether the current fast growth continues or starts to draw back depends on three main factors: demand, competitiveness, and limited production resources. Short-term economic developments will be shaped by the combination of the abovementioned factors, but it is difficult to get a clear picture of each factor due to contradictory employment statistics. The factors behind the favourable demand environment are likely to persist in the next year as well. There is a risk that economic growth might be inhibited by high capacity utilisation, which will be accompanied by price hikes against the backdrop of high demand. If productivity does not increase along with growing expenditures, competitiveness will inevitably decline and growth will slow down. According to the base scenario, demand pressures will gradually subdue without being accompanied by a remarkable loss of competitiveness or increasing constraints on resources. At the same time, the materialisation of a risk scenario where the decisions adopted in light of rapid growth are not in line with the needs of the economy cannot be completely ruled out.

In the next years, rapid economic growth will be able to persist only if supported by productivity growth, as almost all fields of activity are experiencing labour shortage (see Figure 5.3). Development in the business sector has mainly been expansive with optimal exploitation of resources receding into the background. Thus, a more efficient combination of production inputs makes it possible to increase productivity, at least in the short term. In the longer term, productivity growth follows technological developments, which calls for investments

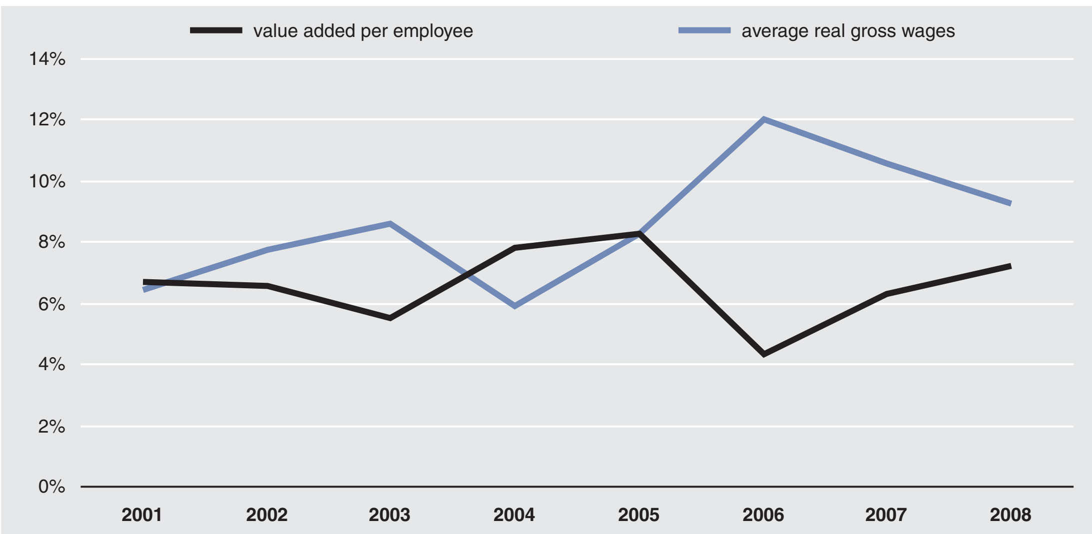

Figure 5.3. Productivity and wages

in new machinery and equipment and technological solutions. In the spring forecast, we concluded that investment made in machinery and equipment has increased at a relatively modest pace. By now, the growth has somewhat picked up, but enterprises still prefer to invest their capital in real estate.

By fields of activity, the statements made in the spring forecast remain valid: the construction and real estate sector is operating on the brink of its production capacity and the real growth of this branch is likely to slow down, despite the extensive investment made there in the first half-year. The growth of Estonia's internal demand oriented services sector is stable and swift. Export enterprises will be favoured by the strong external demand environment also in future, but the problem of maintaining competitiveness is becoming more and more important against the background of growing costs.

Domestic demand

Domestic demand has substantially been supporting economic growth for quite some time now, and this trend is expected to continue both this year and the next, mainly owing to robust income growth and active borrowing. Currently, domestic demand has been boosted by credit growth and the growth of external debt is picking up. This points to the risk of a drastic reaction by domestic demand if unrestricted lending from abroad is coming to an end. Presumably, commercial banks will have no problems with attracting external savings. The contribution of the real estate sector to the growth in internal demand has been remarkable, but by the end of the forecast horizon, i.e. by 2008, the activity of this branch of the economy should subdue. Compared to the spring forecast, domestic demand growth is more substantial arising from the developments in the labour and credit markets.

The first sign of a slowdown in demand growth is when wage growth starts to erode profits. As the data available so far do not confirm it, rapid wage growth is expected to continue next year as well, which means the growth of private consumption will also be fast. The base scenario of the forecast sees no considerable drop of the share of profits in the value added, but real unit labour costs will still slightly increase. Therefore, enterprises will have no problems with servicing their existing loans, but investment growth is expected to decline to some extent. When enterprises' investment activity slows, the same will inevitably happen with economic growth. This, in turn, will inhibit the rate of wage and private consumption growth.

Private consumption

Although the increase in private consumption is weakening, it is still the most rapidly growing domestic demand component both this year and the next, owing to the sharply improved employment and quickening growth of real income. The growth forecast for private consumption is 15.4% for 2006 and 12.5% and 8.8%, respectively, for 2007-2008.

Rapid wage growth and the low level of unemployment have considerably increased people's expectations regarding their future income and encouraged them to consume more on account of credit. The expected rise in interest rates will be relatively modest over the forecast horizon and it will not slacken lending against the backdrop of the fast income growth. In addition to the robust growth of wage income, the continuation of rapid pension growth is also worthy of mentioning. During the next two years, pensions should increase by 16.1% and 9.6%, respectively. Net income growth is also backed by the ongoing gradual reduction of the income tax rate.

The active real estate market has increased the value of people's assets and liquidity, part of which is also leaking into consumption. The price hike of real estate, which has already taken place, is going to affect consumption in the next year as well.

The consumption of durable goods is growing the fastest. Whereas in 2005, durable goods accounted for about 1/8 of private consumption, more than a quarter of private consumption growth can be attributed to durable goods. As the range of different types of loan products in the market is increasing, household confidence is growing stronger, and high activity in the real estate market continues, this trend (i.e. the prompt growth in the share of durable goods in consumption) is expected to persist in the years to come. The ratio of consumer credit to private consumption will be approximately 5% in the next two years.

Investment

Taking into account Estonia's rapid economic development, investment activity should also remain high. The autumn forecast expects a slowdown in investment growth (during 2006–2008, 14.7%, 12.0% and 9.7%, respectively), but growth is still going to be faster than we expected in the spring forecast. More positive expectations are related to corporate investment and general government investment should also remain high.

Household investment has, in line with the spring forecast, reached its growth peak. Considering the poor quality of Estonia's housing stock and the small number of square metres per dweller, the ratio of housing stock investment to GDP is expected to remain higher than in more advanced economies. The demand side has the necessary potential even in the context of declining credit growth. Based on the autumn forecast, the share of household investment in GDP will reach its peak at 9%.

In the spring forecast we expressed concern over the structure of corporate investment and hoped that investment in machinery and equipment will increase. Although recent statistics show this is what has happened, it is still too early to say conclusively that really is the case. The share of real estate in investment has again considerably increased, constituting a component on account of which capital investment growth might start to slow.

Government consumption growth

Real government consumption is dependent on changes in the number of the employed in the sector. Despite the fact that the ratio of vacancies to the total number of positions is the largest in the public sector, the strenuous labour market situation does not allow to take on a lot of new employees. This is why the public sector is experiencing strong wage pressures and the nominal growth in general government consumption expenditure will be at least as fast as economic growth on average.

Drafting the next year's budget with the goal to achieve a surplus is a relevant signal for economic agents, stressing the importance of saving.

Labour market

The recent robust development of the Estonian labour market has reached a tense situation, where wage pressures may appear to be stronger than they have been so far. Owing to rapid economic expansion and opening of the labour market, the number of available unoccupied employees is almost non-existent and tensions arising therefrom will persist during the entire forecast period. The autumn forecast expects the rate of unemployment to decline to approximately 5% and gross wages to increase by 15.8%, 15.1%, and 14.1% between 2006 and 2008, respectively.

Several signs show the continuation or even acceleration of the robust wage growth characteristic of the first half-year of 2006. At the beginning of 2007, many enterprises will most probably again review wages, the size of which will primarily depend on whether wage costs affect corporate profitability. Recent statistics show that owing to price rises and an increase in production output, profitability has remained high. Thus, rapid wage growth is expected at least next year as well.

Wages have grown as a result of labour demand exceeding that of supply, and the number of vacancies has thus continued its prompt growth. The unemployment rate is close to the so-called natural rate of unemployment, which is the reason why wages are growing more rapidly. Demand for labour is strong across all fields of activity. It is possible that in the public sector, where the number of vacancies is the greatest, the wage fund will be increased considerably with the help of good tax revenues to ease the situation. Raising the minimum wage may have a significant role in wage growth expectations. Although minimum wage growth will have a direct impact on a relatively small number of employees, the growth figure may create unjustified expectations also in those employees whose income exceeds the minimum wage.

Rapid wage growth has brought along greater mobility of employees, both between countries and different regions within one country and between fields of activity and occupations. The mobility of people between regions should have an alleviating effect on wage pressures, but it is currently unable to offset the impact arising from the international opening of the labour market.

The number of people going to work abroad from Estonia has nearly doubled in the first half of 2006 year-on-year, and this trend is going to continue in the coming years as well. Speaking of more labour-intensive fields of activity, such as furniture, textile, clothing and leather industry, the (out)flow of employees is increasing. As a result, labour force is easily moving from the labour-intensive production sector to the services sector. The mobility of employees to higher positions has also increased during the past year, so the fast wage growth can be partly attributed to structural changes across occupations.

However, a positive tendency is that the people born during the baby boom of end-1980s and constituting the most numerous age group are entering the labour market. At the same time, it has to be admitted finding a job it is not very easy for young people (the greatest unemployment rate across age groups). This indicates that those fresh from school may not meet labour market expectations. Thus, from a purely statistical point of view, the decline in the unemployment rate may be temporarily inhibited. In addition to the young, the working age population contains human resources that can be brought back to the labour market. This is done with the help of special programmes devised within the framework of active labour market policy and aiming at helping people that have passed special training re-enter the labour market and find jobs requiring simpler skills and knowledge. However, this does not considerably alleviate the problems in the labour market.

Inflation

Consumer price growth is expected to quicken to 4.4% this year, to 4.5% in 2007, and to 4.7% in 2008. Compared to the estimates made in spring, we have revised the inflation forecast upwards mainly owing to strong economic expansion and the price hike of food. In addition, households' energy prices are rising much faster in Estonia than expected. The exception is motor fuel whose contribution to inflation is declining. As to administered prices, the rate of value added tax on thermal energy will be increased in 2007. An acceleration in the inflation rate at the beginning of 2008 will be mainly due to the rise in the alcohol, tobacco and fuel excise duties. If excise duties were left unchanged, the inflation rate would start declining already in 2008.

Inflation is going to remain at a level higher than the average during the entire forecast horizon. The price growth accompanying rapid economic growth will be most evident in non-tradable sectors, which are closed to foreign competition. Real estate price increases are reflected in consumer prices as more expensive renting services and their influence on inflation should persist for at least one more year. The favourable demand environment enables enterprises to raise wages and producer prices simultaneously. At the same time, declining unemployment and strong wage pressures point to the fact that there are insufficient resources to expand production. From the point of view of stable economic development, it is essential that inflationary expectations remained contained and would not affect the mechanisms of price and wage formation.

According to the forecast, inflation is picking up speed until the end of 2006, because food, thermal energy and the services included in the core inflation are becoming more expensive. These factors are somewhat offset by the cheapening of motor fuel in the fourth quarter, year-on-year. Price increases will then decline until the summer of 2007, when the rate of the value added tax on thermal energy will be raised. In January 2008, several changes in excise duties will be implemented, and these have an upward effect on annual consumer price growth, which should rise above 5% for a short while. However, inflation should drop again by the end of the year, reaching approximately 4%.

Food, alcohol, and tobacco

In the winter of 2006, the price increase of food will exceed normal seasonal price rises to a great extent. There are several reasons behind the faster-than-expected price increases. The unfavourable weather conditions of last summer now affect the prices of food in several regions in Europe. It is likely the price hike of imported goods will continue in Estonia in the first half of 2007 as well. The situation will be complemented by wage pressures, which are reflected in prices more than in previous years, owing to strong demand.

Core inflation

In 2006–2008, core inflation is expected to speed up to 3.4%, 4.2%, and 4.3%, respectively. The components of core inflation are communications and personal services and manufactured goods the price growth of which is shaped by several factors. Core inflation is currently mainly dependent on wage growth, which will remain fast in the near future. It is possible the pace of growth will speed up even more, as compared to wage growth, the price increases of several services are falling behind. Communications services are an exception. Their decline in prices is caused by tight competition and fast technological developments. The price hike of manufactured goods has not been as sharp as that of services, as the prices of several imported goods are relatively close to the EU average. The appreciation of the US dollar, which started in 2005 and lasted until the spring of 2006, also contributed to price rises. In addition, price pressures were enhanced by the price growth of raw materials in the global market. It is likely the price growth of manufactured goods will slow at the beginning of 2007.

Motor fuel

The motor fuel price forecast is based on market expectations as at end-October and on the presumption that the dollar exchange rate will remain unchanged. According to expectations, the price of oil should increase to 65 dollars per barrel by mid-2007. This means Estonian petrol stations will sell petrol for 13–14 kroons a litre. Moreover, it is expected that fuel excise duties will be increased in January 2008, and also at the beginning of 2009 and 2010, until Estonia reaches the EU minimum rates.

Energy used by households

In the next years, the energy sector will form a significant source of inflation, as it is undergoing gradual price convergence towards the world market level. Natural gas experienced a price hike in October 2006, and this will be followed by thermal energy price rises across Estonia. No decisions have been adopted regarding a further price increase of natural gas in the second half of 2007, but it is likely to happen. This constitutes a remarkable risk factor of the inflation forecast. Inflation might also be boosted by a growth in electricity prices, which mainly depends on the investment needs of Eesti Energia (Estonian Energy; see also Figure 5.4).

External balance and external debt

In the longer run, in a small and open economy income is mainly dependent on export revenues. In Estonia, however, domestic demand and imports has been supported by credit supply and in contrast to the expectations of the spring forecast, external balance has not shown signs of improvement. The external environment has been more favourable to exports growth than in earlier years. External demand is expected to remain strong over the entire forecast horizon, although its growth rate should

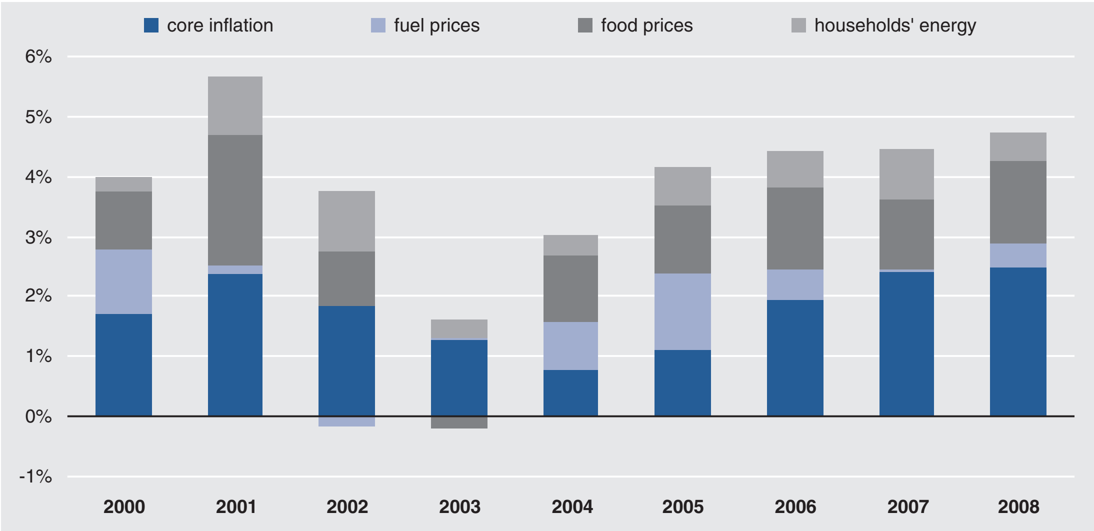

Figure 5.4. Inflation structure

undergo a turning point in 2006. The GDP growth of Estonia's main trading partners, the Nordic and Baltic countries, is rapid but the economic growth of Central European countries is gaining momentum as well. The speed of price convergence of production inputs will determine Estonia's ability to benefit from the favourable external demand environment. According to the base scenario of the autumn forecast, Estonia will have no major problems with competitiveness, although the risk is there.

In 2006–2007, Estonia's real export growth will be more than a percentage point slower than that of imports, which is why the balance of services and goods is going to deteriorate. In 2006, exports will grow by 13.1% and in the next two years by 11.0% and 10.0%. Under the conditions of expansive internal demand, imports will increase by 14.9%, 12.6%, and 9.8%, respectively.

The external balance is not expected to improve any time soon. The current account deficit will decline only in 2008, when domestic demand starts to weaken. In 2006–2008, the deficit will constitute 12.5%, 13.5% and 13.3% of GDP, respectively (see Figure 5.5). According to the adjusted statistics of national accounts, terms of trade improved sharply in the first half of this year. The forecast expects terms of trade to be neutral over the next years.

The non-financial sector will further finance the rapid growth of domestic demand on account of foreign savings. As a result, the level of external debt will constitute 81.8% of GDP in 2006. The high loan demand will persist in the next years and, according to the base scenario, in 2008 the volume of external debt will be almost equal to that of GDP. As regards the structure of external debt, the share of credit institutions is going to increase, approaching two-thirds.

Financial sector

Owing to low interest rates on loans, the activity of the housing market is still high. Euribor has been increasing since the second half of 2005, but households' loan demand has not declined against the background of income growth expectations. As interest rates continue to slowly increase over the forecast horizon, their impact on credit growth will remain subdued. In addition, the maturities of housing loans have extended significantly over the past five years, which has made it possible also

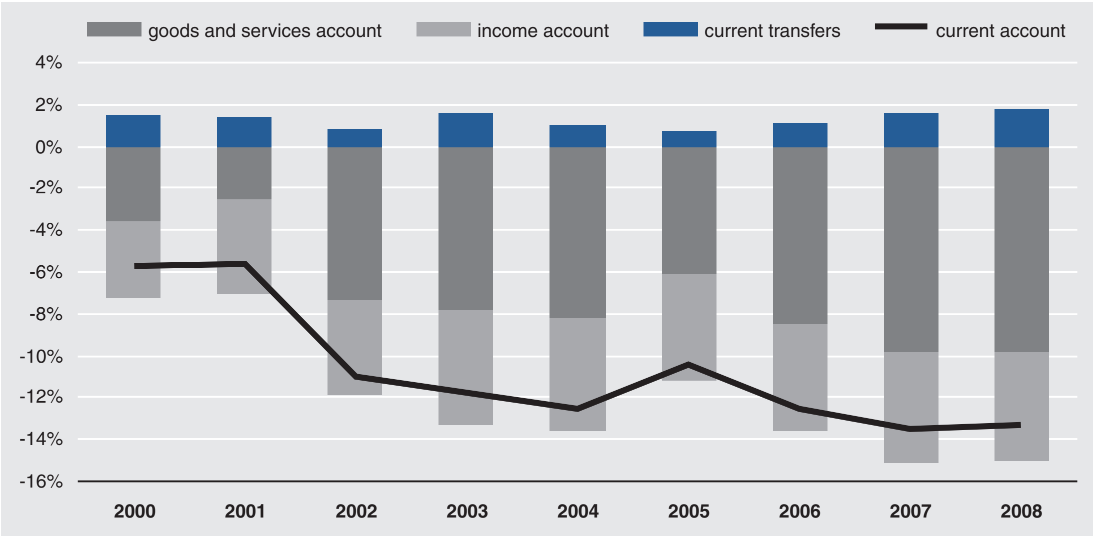

Figure 5.5. Current account structure (% of GDP)

for people with lower income to take larger loans. A further extension of maturities is, however, quite unlikely, and the impact of this factor on credit growth should decrease with time. The number of first-time borrowers is likely to decline over the next years, as many people have already taken a loan and real estate prices have become too high for households with lower income. Households' optimism for the future is reflected not only in the strong demand for housing loans but also in the robust increase in the demand for consumer credit. In the future, consumer credit growth should decline towards the total credit growth of households.

Corporate credit growth will in the next years greatly depend on the real estate market developments, which show signs of balancing out. This is due to the exhaustion of construction volume and production capacity – there are not enough builders, materials or equipment to meet the demands of real estate developers. In addition, banks have started to estimate real estate projects in a more conservative manner. The financing of corporate credit growth is currently characterised by a structural change – external financing is being replaced by domestic financing.

RISKS TO ECONOMIC GROWTH

Two risk scenarios complement the base scenario of the autumn forecast. The first of them expects the current expansive development to continue in 2007 as well, after which certain adjustment should take place. The adjustment process depends heavily on the behaviour of the labour market, especially on the flexibility of wages. According to the second risk scenario, problems with competitiveness will occur as early as in 2007 (see also Figure 5.6).

In this year's spring forecast, we emphasised the risks arising from the growth in domestic demand stemming from excessive borrowing and from the labour market. In light of recent developments we may say that both of these risks have partly materialised. Thus, the risk of economic overheating has become more serious. It may weaken competitiveness and call for reallocating resources on the supply side of the economy.

Due to rapid demand growth, the shortage of production resources has become more urgent than a year ago, and this has resulted in a fast appreciation of the labour force. The robust wage growth is

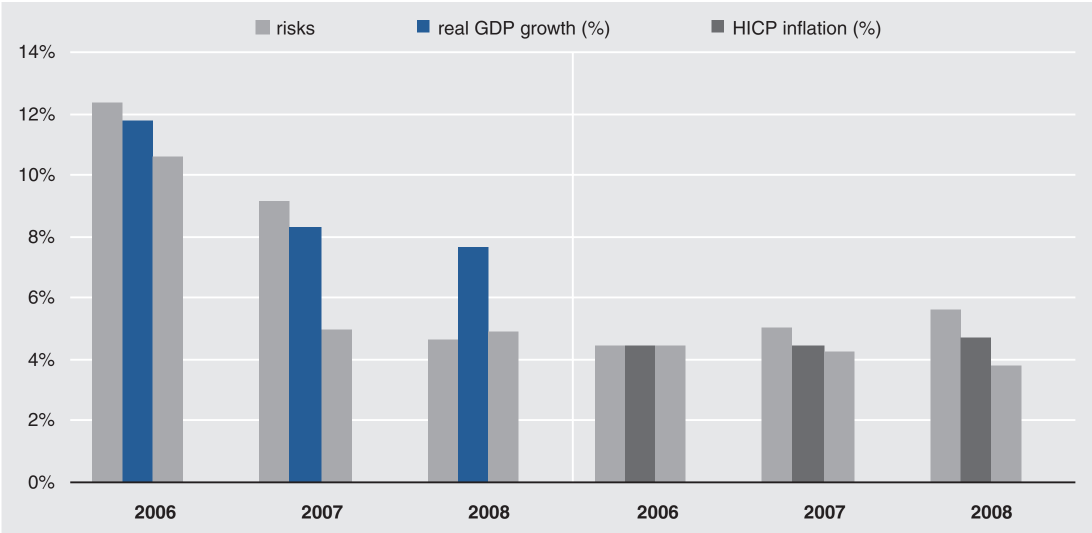

Figure 5.6. Real GDP growth and inflation forecast: risk scenarios I and II

strengthening the base of borrowers, which, in turn, boosts demand. If enterprises are unable to control their expenditure, a vicious circle like that might bring about additional costs and thus magnify price pressures. This will cause competitiveness to weaken.

Enterprises open to foreign competition are the first to fall under pressure as a result of wage growth. The fields of activity in the middle of the production chain (i.e. outsourcing-oriented) will suffer the most, as they are the price takers for both their inputs and outputs. At the same time, domestic demand oriented enterprises are able to temporarily transfer part of their expenditure growth to the end-consumer, which speeds up inflation. Robust price increase means that employees' wage growth expectations are also higher. One of the first indications of weakening competitiveness is declining profits. This forces enterprises to optimise and invest in increasing productivity, but such possibilities are limited in the short run. The mobility of labour force between countries may, in turn, have a negative impact on the abovementioned trends and this makes it harder for enterprises to cut wages, even if their profitability decreases. In the worst case, there may occur problems with servicing their existing loans.

When wage growth considerably exceeds productivity growth and this process lasts for an extended period of time, one may expect a sharp fall in low added-value and labour-intensive production in Estonia. Fields of activity like furniture, textile, clothing and electronics industry (where the share of research and development is not very remarkable) can choose between two options: to terminate their current activities or to reorient to production activities with higher added value. The latter option requires more investment. In any case, the result is that production and export volumes will decrease and the labour market will be supplied by available labour force.