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I ECONOMIC POLICY SUMMARY

European economic growth started to accelerate in the third quarter of 2005 but did not continue as rapidly in the fourth quarter. Nevertheless, in the second half of 2005 and at the beginning of 2006 the faster growth of Estonia's major trade partners also boosted Estonian economic growth.

Higher oil prices and their impact on transport prices and other fuels largely affected the price rise of the consumer basket in the second half of 2005 as well as at the beginning of 2006. In addition to the oil price also other commodity prices increased.

The difference between the inflation rates in Estonia and in the euro area mainly stemmed from the fuel price rise. With the exception of the construction sector, domestic price pressures did not exceed the level considered sustainable in the long-term.

ESTONIA

Monetary policy environment

Contrary to market expectations the ECB raised monetary policy interest rates only in December 2005, followed by another increase in March 2006. As the difference between the money market interest rates in Estonia and in the euro area decreased, the interest rates of Estonian banks on housing loans continued shrinking until the end of the summer. Only at the end of the year did the rise of EURIBOR start affecting also the Estonian economy. Nevertheless, the increase of loan interest rates has remained marginal and has not interfered with further rapid loan growth.

Compared to 2004, the Estonian kroon appreciated against most of the currencies of the non-euro area partner countries in 2005. As an exception, it depreciated against the Swedish krona. However, at the end of the year and the beginning of 2006 the trend reversed, as the kroon depreciated against major currencies.

The appreciation of the real exchange rate against the currencies of industrial trading partners remained within the range of 3.0–3.5% both in 2005 and at the beginning of 2006. This can be considered a sustainable long-term level stemming from fast productivity growth.

External and domestic demand

In the second half of 2005, GDP growth accelerated almost up to 11%, with an annual average of 9.8%. According to preliminary estimates, growth remained fast also at the beginning of 2006.

The growth in demand on Estonia's main export markets was one of the fastest in recent years. Against expectations, the growth rate of goods and services exports did not decrease but even sped up. The intense investment activity of earlier years made it possible to increase exports hand in hand with demand. It can be summarised that broad-based growth was driven by both external and domestic demand. Growth was dynamic in almost all fields of activity and branches of manufacturing.

In the second half-year, domestic demand grew faster than external demand. Though also **private consumption growth picked up**, it still remained slower than income growth and led to **increased savings**. Low interest rates and tight competition on the banking market boosted the supply of loans, which, together with increased savings, fostered residential construction. This raised the issue of the long-term balance of economic development back on the agenda. The matter became even more topical as the decrease of the current account deficit in the second half of 2006 came to a halt and investments increased faster than household savings.

It was the high construction activity together with real estate development that accelerated GDP growth over the potential level. In the construction sector it became clear that supply would not catch up with demand, which resulted in increasing production costs. Therefore, driven by loan growth, real estate prices rose nearly 30%.

As the investment level remained high thanks to active residential construction, external balance failed to improve as much as the growth of household savings would have implied. Compared to the previous year, in 2005 the current account to GDP ratio still decreased by 1.5 percentage points. Direct investment was not sufficient to cover the continuously great investment needs and therefore, about half had to be financed by external loans. By the end of the year, Estonian external debt amounted to nearly 90% of GDP.

General government

Fast economic growth stimulated the **collection of tax revenue** and the **fiscal year 2005 ended in surplus already for the fifth year in row**. The surplus formed 1.6% of GDP and slightly exceeded the surplus of 2004, but given the acceleration of economic growth it should have been even larger.

Just like in earlier periods, government savings greatly supported the improvement of external balance. Public debt decreased to 4.8% of GDP.

In 2006, the income tax rates for private persons and enterprises were further reduced. Nevertheless, this does not entail a significant drop in the general tax burden, because at the beginning of the year the minimum rates of environmental and social taxes were raised and wages are also expected to grow faster than GDP.

Continuous fast growth and the state budget approved in the Riigikogu, which sets a moderate surplus as a goal, allow forecasting a general government surplus of up to 1.2% of GDP in 2006. However, an increase in the debt burden of local governments may pose some risks.

Inflation

While 2004 witnessed a rise in food prices after applying the common agricultural policy of the European Union, **in 2005 consumer prices were mostly affected by fuel and energy prices**.

After the electricity price rise scheduled for the beginning of March the inflation rate started decreasing, as expected. This lasted until June, when the oil prices shot up on the world market. The continuous appreciation of motor fuel prices also affected the prices of transport services and caused a price rise of all fuel types when the heating season started in autumn. Consumer price growth was therefore volatile and the annual **average inflation rate stood at 4.1%**. As the oil price remained high, consumer price growth did not slow down even in the first months of 2006.

Due to a lower income level, fuel-related goods and services play a greater role in the Estonian consumer basket than in the European Union on average. For that reason, the appreciation of oil also affected the Estonian inflation to a larger extent. Compared to countries in the euro area, the inflation rate rose up to nearly two percentage points. In the longer term, such difference is well expected, given faster productivity growth and the resulting convergence of income levels.

Domestic inflation pressures remained quite subdued also in 2005 with the exception of the construction and real estate sectors. Though nominal wage growth accelerated almost up to 11%, this was in line with the increase in productivity. Unit labour costs decreased at constant prices for the second year in row. Thus, also the core inflation accelerated moderately.

Forecast

Europe expects economic revival in the second half of 2006. Although global economic growth is expected to slow down slightly at the end of 2008, the export sector might continue fast growth. According to the forecast of Eesti Pank, economic growth will remain robust – 8.1% in 2006 and 7.6% and 6.9% in the next two years, respectively.

Despite faster wage increase, there is no sign of considerable price pressures and the main factor threatening price stability will be the price rise on the global commodity market. In 2006–2008, the annual consumer price growth will remain within the estimated 3.0–3.7%.

The general government is expected to maintain prudent policies and the budget will remain in surplus or in balance throughout the forecast horizon. Presumably already 2005 will witness government investment growth, primarily driven by infrastructure investments. The gross external debt of the general government will keep decreasing steadily, reaching 2.8% of GDP by 2008.

Balanced economic development is mainly jeopardised by loan demand, which may exceed the forecast. Active borrowing mostly boosts the growth in household investment but also private consumption, which may hinder the improvement of external balance or even bring it to a temporary halt.

Table 1.1. Key economic indicators of Estonia

	1995	1999	2000	2001	2002	2003	2004	2005
Real GDP growth (%)	4.5	0.3	7.9	6.5	7.2	6.7	7.8	9.8
Growth in goods and services exports (%)	5.4	0.8	28.4	-0.2	0.8	5.8	16.0	21.3
Growth in goods and services imports (%)	6.3	-5.4	28.1	2.1	3.8	10.6	14.6	17.4
Current account balance (% of GDP)	-4.4	-4.4	-5.5	-5.6	-10.2	-12.0	-12.5	-10.5
General government budget balance (% of GDP)	0.4	-3.7	-0.4	0.3	1.0	2.4	1.5	1.6
Consumer price index of 12 months (%)	29.0	3.3	4.0	5.8	3.6	1.3	3.0	4.1
Consolidated balance sheet of banks (% of GDP)	36.1	57.6	62.2	65.5	69.9	77.6	94.4	112.2
Capital adequacy of commercial banks (%)	14.5	16.1	13.2	14.4	15.3	14.5	13.3	11.7
TALSE/OMX Tallinn index change (%)		38.3	10.1	4.7	20.6	34.4	65.6	48.0
Consolidated loan portfolio of commercial M2 (% of GDP)	17.3	32.4	36.4	38.5	42.2	54.3	65.4	76.1
M2 (% of GDP)	26.3	32.0	35.1	38.6	38.3	39.4	41.1	50.1
External debt (% of GDP)	43.6	54.8	54.4	55.5	60.1	68.7	81.2	89.9
3-month TALIBOR (%; annual average)		7.8	5.7	4.0	3.5	2.6	2.4	2.6

II ECONOMIC DEVELOPMENTS

EXTERNAL ENVIRONMENT

General background

In the second half of 2005, **global economic activity remained high and growth reached 3.4%**[1], year-on-year. Meanwhile, especially in the last quarter, economic development varied across regions: in the US growth slowed down, accelerated in Japan, and the euro area witnessed a gradual improvement. Based on the economic data (manufacturing, retail sales and activity indices) received in the first months of 2006, Japan has maintained high economic activity and growth is picking up again in the US and also in the euro area.

All in all, the economic growth of 2006 is estimated at 3.5%, which is one percentage point faster than in 2005. In 2007, a slight slowdown in global economic activity is expected.

At the end of 2005 and the beginning of 2006, inflation primarily followed the oil price changes with some delay. After the rapid oil price rise to nearly 70 US dollars per barrel at the end of August 2005, the consumer price growth accelerated as well. In September, the annual CPI growth rose to 4.7% in the United States and to 2.6% in the euro area. Japanese consumer prices started increasing at the beginning of 2006, when the year-on-year price growth reached 0.5%. Contrary to general inflation, the faster price growth was not reflected in core inflation, which does not include oil prices. Rather, core inflation slowed down in the United States and the euro area. For 2006 and 2007 a slight fall in inflation is expected, though it might not materialize if the rapid price increase of oil and other commodities continues.

In view of long-term stability of economic growth and the need to curb inflation, several central banks increased their key interest rates. Most probably, monetary policy stimuli will be reduced and the key interest rates will be raised further.

Table 2.1. Global economic forecasts

	GDP growth (%)		Inflation (%)	
	2006	2007	2006	2007
Unites States	3.3	2.9	2.9	2.3
Euro area	2.0	1.8	2.0	2.0
Germany	1.7	1.0	1.6	2.3
France	1.9	2.0	1.7	1.6
Italy	1.2	1.2	2.0	1.9
Finland	3.2	2.7	1.5	1.8
Sweden	3.4	2.7	1.2	1.9
Japan	2.9	2.2	0.4	0.5
Total global economy	3.5	3.1	2.6	2.4

Source: Consensus Forecasts, April 2006

[1] Consensus Forecasts, April 2006.

United States

Economic activity in the United States decreased in the second half of 2005. The annual GDP growth was 3.6% in the third quarter and only 3.2% in the fourth quarter. The growth rates of private consumption, government consumption and investments declined steeply. The contribution of stocks to economic growth increased substantially.

Manufacturing and retail sales indicators confirmed the decline in economic activity. In September, the year-on-year growth of industrial production decreased to 2.0% and in December, retail sales growth fell to 5.8%. However, the data received in the first months of 2006 indicate only a temporary decrease in economic activity: the annual retail sales growth stayed over 7.5% from January to March 2006, and the annual growth of industrial production rose to 3.6% in March. Employment continued to increase fast and unemployment decreased to 4.7% in January and March 2006. Consumer price inflation picked up in September 2005, mainly because of the oil price rise to 4.6%, and dropped then to the range of 3.4–4.0%. A further increase in commodity prices may cause a new inflation rise in 2006.

The government deficit, which reached 3.5% of GDP in the middle of 2004, decreased to 2.7% by the end of 2005. Meanwhile, the current account deficit increased even further: it reached a historical high in the fourth quarter of 2005, exceeding 7% of GDP.

Due to a rise in interest rates, consumer credit growth started to slow down rapidly and initial signs indicated that the real estate market was beginning to cool off.

Japan

Japan's economic growth strengthened in the second half of 2005. Year-on-year GDP growth in the fourth quarter was the highest since the economic downturn (4.0%). Rapid growth continued at the beginning of 2006. The annual growth of industrial production was the strongest of the past 15 months (3.9%) and the annual growth of exports reached the highest level since the past eight and a half years (20.7%). Such fast growth has also decreased unemployment, which declined to its lowest level since seven and a half years in February (4.1%).

As a result of the oil price increase and the acceleration of economic growth, the prolonged deflation in Japan may come to an end. In January and February 2006, the year-on-year consumer price growth was positive (0.4–0.5%) and for the first time after 15 years, the year-on-year growth in land prices also turned positive.

A change in the Japanese monetary policy is worth highlighting. As long-term deflation finally ended, the national central bank decided to terminate the monetary policy that had been strongly favouring economic growth and to decrease monetary growth. Moreover, an increase in the key interest rates is under consideration.

Euro area

Economic growth in the euro area remained stable in the second half of 2005, decreasing slightly quarter-on-quarter, but increasing year-on-year. The twelve-month GDP growth reached 1.6% and 1.8% in the third and fourth quarters, respectively, and it was relatively stable across different countries as well as sectors. Based on the data received during the first months of 2006, economic activity is gaining momentum. Activity indices have increased drastically: the German IFO index rose to its highest level in 15 years and the Eurozone Manufacturing Purchasing Managers' Index (PMI) to its highest in the past five and a half years.

Driven by the oil price surge, consumer price inflation in the euro area boosted up to 2.6% in September 2005, dropping to 2.2% again by March 2006. Core consumer price inflation decreased to 1.2% at the beginning of January and February 2006, which is the lowest level in the past five years. Higher economic activity has brought along a decrease in unemployment: by February 2006 unemployment dropped to its lowest level (8.2%) in the past three and a half years.

Because of the acceleration of economic growth and inflationary pressures, the European Central Bank started to raise the key interest rate. According to the forecast of international financial markets, the key interest rate will be raised another two or three times during 2006.

Nordic countries

Finland's economic activity started to recover in the third quarter of 2005 and picked up even further at the end of the year. The annual economic growth rate stood at 2.1%. In January 2006, it accelerated up to 3.3%. The main driving force behind growth was the increasing domestic demand.

Retail and wholesale volumes have been growing steadily, indicating households' propensity to consume. Last year, retail trade recovered from the low levels recorded at the beginning of the year – the annual growth reached 2.2%.

The recession in the industrial sector deepened even further in the last quarters of 2005 and the production output decreased rapidly across almost all major sectors. Year-on-year, the industrial production decreased 2.8% for the first time in ten years.

In external trade, earlier trends continued at the end of 2005: imports grew faster than exports (15% and 7%, respectively), and the balance surplus decreased to 8.5 billion euros. The average annual inflation rate reached 0.9% in the past year. The consumer price growth stemmed from an increase in liquid fuel prices, but inflation was also affected by growing living costs and rental and restaurant prices. After a slight slowdown in January 2006, inflation accelerated again to 0.9% in February and stayed at the same level in March.

Sweden's economic growth was fast in 2005 – GDP increased 2.7% year-on-year. In the last quarters of 2005, household consumption grew considerably, mainly because the central bank reduced the key interest rate by 50 basis points in June 2005.

Extremely fast retail sales growth towards the end of 2005 (10.7% in December – fastest year-on-year growth in 15 years) testifies to the increased household consumption. Compared to the same period in 2005, in January and February 2006 retail trade grew 7.9% and 7.7%, respectively.

The industrial production increased 1.5% in 2005. The production output of January 2006 exceeded expectations, adding 1.7%, month-on-month. The production output started growing in the middle of 2005 and the annual growth amounted to 5.9%.

In 2005, the Swedish external trade followed similar trends as in Finland: the export growth remained slower than the import growth (4.4% and 7.1%, respectively year-on-year) and the balance surplus decreased to 141 billion Swedish kronas. At the beginning of 2006, however, exports started increasing faster than imports (23% and 18%, respectively year-on-year).

Inflation has remained relatively low in recent years. Towards the end of 2005, the consumer price growth mainly stemmed from the rising electricity prices (caused by higher fuel prices). The inflation rate stood at 0.5%, year-on-year. In February 2006, inflation accelerated to 0.6%, and in March already to 1.1%. In order to protect the economy from inflation, the Swedish Central Bank has increased the key interest rate already twice in 2006 – by 0.25 basis points to 1.75% on January 25, and by another 0.25 basis points to 2.0% on February 22.

Central and Eastern European countries

The **Czech** economic growth accelerated in the final quarters of 2005 and reached 6.0%, year-on-year, which was the highest level in 13 years. Such dynamic growth was stimulated by exports which, for the first time, caused a surplus of 40.36 billion Czech korunas in trade. The annual growth rates of exports and imports stood at 7.7% and 4.6%, respectively. The industrial production increased 5.7% in 2005. The consumer price growth remained low and amounted to 1.6%, year-on-year. At the beginning of 2006, the inflation rate accelerated to 2.8%. The general government deficit was 2.8% of GDP in 2005.

The **Polish** GDP increased well at the end of 2005. The annual economic growth was 3.2%. Consumer prices rose by an average of 2.2%. In January 2006, however, the annual growth rate of inflation slowed down to 0.6%. The Polish Central Bank decreased the key interest rate several times, and in 2006 it reached a historical low. Excessive government deficit (in 2005 it reached 3.4% of GDP) and public sector debt remain the primary challenges for Poland.

Economic growth in **Hungary** slowed down slightly at the end of 2005, but nevertheless reached 4.1%, year-on-year. As in earlier years, growth was mainly stimulated by the exports of goods and services. Last year, the average annual growth rates of exports and imports increased 11% and 6%, respectively. The annual growth in industrial production reached 7.3%. Consumer prices rose by 3.5% in 2005 but in January 2006 inflation slowed down to 2,7%, which is the lowest level since 29 years. The greatest risk factor for the country is the government deficit, which reached 6.1% of GDP in 2005.

Economic growth in **Slovakia** picked up even further in the last quarters of 2005 (by 7.5% in the fourth quarter) and stood at 6%, year-on-year. The industrial production increased 3.8% in a year. The production output was restrained above all by the mining and electronics industry. The annual growth in imports exceeded that of exports (13.7% and 11.5%, respectively) and the external trade deficit reached 76 billion Slovakian korunas. Inflation decreased considerably (to 2.8%) in comparison with 2004 (7.5%).

The **Latvian** economy thrived. While in 2004 economic growth reached 8.5%, in 2005 it totalled 10.2%. Thus, Latvia posted the largest growth in the European Union. According to the Central Statistical Bureau of Latvia, year-on-year growth was the strongest in the second and third quarters: 12.8% and 12.3%, respectively. Latvian economic growth was again stimulated by the services sector: in 2005 the trade volume grew by 16.2%, the volume of transport and communications by 15.9% and that of construction by 15.5%. In this light, the 6.3% annual growth in industrial production remained relatively modest.

The fast growth was mainly driven by wage growth, which also encouraged private consumption. In 2005, Latvian gross wages increased nearly 16.5%, while the wage growth of 2004 was less than 10% compared to the previous year. The main problem for Latvia's economy is the rapid price increase that started in the middle of 2004. Back then prices were mainly driven up by one-off factors related to the EU accession, whereas in 2005 these after-effects were also accompanied by a robust rise in energy prices. As the prices of natural gas are expected to go up in the next few years, a further rise in energy prices is expected as well.

Latvia's external balance deteriorated because of strong domestic demand. While in 2004 the current account deficit formed 10% of GDP, in 2005 it amounted to 15%.

Lithuania's economic growth was somewhat lower compared to other Baltic States. In 2005, the annual GDP growth was 7.5% (7.0% in 2004). Considering the entire European Union, though, Lithuanian economic growth was nevertheless very fast. Just as in Estonia and Latvia, it was driven by stronger goods exports and domestic demand. Although the consumer price growth was slower than in other Baltic States, it accelerated by an additional 3% at the beginning of 2006.

Lithuania's external balance deteriorated due to fast economic growth. All the same, the 7.5% current account deficit in ratio to GDP is the smallest among the Baltic States.

The economy of **Russia** maintained the growth rate of 2004, though the GDP growth declined from 7.2% to 6.4%. At the beginning of 2006, economic growth remained relatively low. For instance, the industrial production increased only 3% in the first quarter.

The rapid consumer price increase continues to be a problem. The 10.8% growth in consumer prices in the first quarter was considerably faster than the government target of 8.5%. On the positive side, after ending the fiscal year 2005 with a 7.5% surplus in ratio to GDP, the Russian federal budget surplus increased to 10.9% in the first quarter of 2006.

The central bank foreign reserves totalled 212 billion dollars in the middle of April, which is five times more than at the beginning of 2003.

International financial and commodity markets

In **foreign exchange markets**, the US dollar exchange rate had no clear trend vis-à-vis other major currencies. The dollar quotations against the euro remained within 1.16–1.23, strengthening by 2.7% during the period. The pound sterling-dollar exchange rate changed little (1.1%). The Japanese yen depreciated by 3.2% against the dollar, because the Japanese Central Bank did not raise the key interest rate despite positive economic indicators (incl. robust economic growth) and therefore the difference between interest rates continued to increase in favour of the dollar.

The dollar exchange rate was affected by controversial factors. The US current account deficit, which rose to 7.1% of GDP in the fourth quarter, had a negative impact, whereas optimistic economic news and an increase in the key interest rate had a positive influence.

As far as other major developments are concerned, the weakening of several currencies with high interest rates (e.g. the Icelandic krona, the New Zealand dollar) should be mentioned. These currencies, having strengthened for a long time due to rising interest rates, started to weaken as economic growth slowed down.

Table 2.2. Changes in exchange rates of major currencies

	30/09/2005	18/04/2006	Change (%)
EUR/USD	1.2026	1.2347	2.7
GBP/USD	1.7643	1.7833	1.1
USD/JPY	113.51	117.13	3.2

Major **stock markets** continued a strong upward trend. Japan's Nikkei 225 index increased the most, which reflected both the optimism accompanying high economic activity as well as the reaction to signs marking the end of a prolonged deflation. The euro area FTSE Eurobloc 300 index also grew considerably (by 10.2%), as the euro area economic growth accelerated. Stock prices increased more modestly in the United States, where the S&P 500 index rose by 6.4%. The growth in US stock prices is inhibited as the Federal Reserve has been raising the key interest rate for some time now. Some investors are also considering the possibility that US economic growth might slow down in the second half of 2006.

Table 2.3. Major stock market indices

	30/09/2005	18/04/2006	Change (%)
USA (S&P 500)	1,228.81	1,307.65	6.4
USA (Nasdaq)	2,151.69	2,356.14	9.5
Japan (Nikkei 225)	13,574.3	17,232.86	27.0
Euro area (FTSE Eurobloc 300)	1,300.85	1,457.94	12.1

Bond markets witnessed an increase in interest rates, since several central banks raised their key interest rates. This arose from high economic activity and the looming inflation threat.

The US Federal Reserve continued decreasing the monetary policy stimuli that favoured economic growth, raising the key interest rate on four occa-

Table 2.4. Changes in yields of major bond markets

	3-month interest rates			10-year interest rates		
	30/09/2005	18/04/2006	Change (basis points)	30/09/2005	18/04/2006	Change (basis points)
USA	3.55	4.72	117	4.33	4.99	66
Japan	0.002	0.049	4.7	1.48	1.96	48
Euro area	2.17	2.69	52	3.15	3.95	80

sions (by 100 basis points to 4.75%). Another North American central bank, the Central Bank of Canada, also raised the key interest rate to the same extent.

As to the euro area, the European Central Bank started to tighten the monetary policy at the end of 2005, raising the key interest rate in December and March by a total of 50 basis points, i.e. to 2.5%. Of other European central banks, also the central banks of Sweden and Norway increased the key interest rate to the same extent (2.0% and 2.5%, respectively). In addition, a change in Japanese monetary policy should be mentioned: the central bank decided to decrease monetary growth. Ten-year interest rates increased by 66 basis points in the United States, 80 basis points in the euro area, and 48 basis points in Japan.

Commodity markets witnessed a new hike in the last quarter of 2005 and the first quarter of 2006. The CRB index, which covers the prices of major commodities, increased 7.8%, having fluctuated only within a narrow range for nearly two years. The increase in commodity prices could be explained by the acceleration of economic growth, which has entailed an increased demand for the main commodities. The oil price was extremely volatile: at the end of last year, it dropped to 55 dollars but rose to 70 dollars per barrel (by nearly 7.7%) in the middle of April. The price of gold rose by 32% from 469 dollars to over 600 dollars per ounce. Unlike in previous years, the main reason for the rapid rise in gold prices was not the weakening of the dollar but rather the increased inflation risk in advanced economies and the general hike in metal prices (the CRB index of metal prices increased over 50%).

Table 2.5. Changes in commodity markets

	30/09/2005	18/04/2006	Change (%)
CRB index	294.61	319.28	8.4
Crude oil (WTI; USD/barrel)	66.24	71.35	7.7
Gold (USD/ounce)	469.30	621.07	32.3

ESTONIAN ECONOMY

Estonian economic growth gained momentum in the second half of 2005 in light of the improving external environment and domestic demand. The real GDP growth exceeded 10% at year-end and continued rising rapidly also at the beginning of 2006.

Contrary to expectations, merchandise exports increased considerably while the export growth of services remained modest. Domestic demand was stimulated by investment growth, especially in residential construction. Increasing incomes also led to the growth of household savings, which entailed a moderate external balance improvement. Just as earlier, the general government budget surplus played a key role here.

Domestic demand

Domestic demand increased faster than incomes in the second half of 2005. Meanwhile, the growth of private consumption, general government final consumption and investments accelerated (see Figure 2.1).

The rapid increase in domestic demand continued in the first months of 2006. The strengthening consumer confidence and the acceleration of retail growth from 11.0% in the fourth quarter to 16.5% in January-February implied the growth of private consumption. The latter was also fostered by the increased household income and rapid loan growth. At the beginning of this year, also investment activity remained high and the estimates of the construction companies on the economic situation improved even further.

Investment

Most surveys on the convergence of income levels admit that economic growth and capital investment are closely related. Also in Estonia, the convergence of income levels with those of advanced economies requires above-average fixed investment over decades.

Year 2005 was by no means exceptional in that sense. After a slight downturn, the share of investment at current prices increased again to 32% of GDP in mid-2005. Meanwhile, the share of corporate investment in total investment kept rising, which was very positive. In the second half of 2005, the growth of corporate fixed investment comprised 43% of the total fixed investment growth (31% in the previous half-year). Investment activity picked

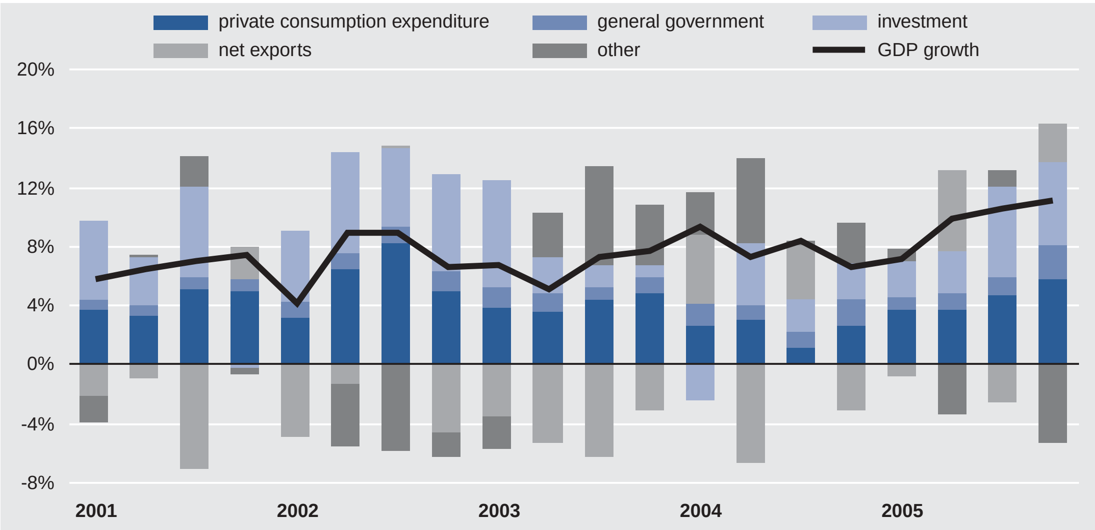

Figure 2.1. Real GDP growth and its components

up in companies dealing with transport, storage and communications, construction and real estate as well as in the public sector.

A further surge in residential construction in the second half of 2005 was stimulated by the increased optimism of households concerning economic growth and the acceleration of income growth. On top of that, the maturities of new housing loans were extended.

The favourable economic outlook facilitated the investment activity also at the beginning of 2006. In addition to residential construction projects, extensive general government investment, part of which were EU funded, contributed to general investment growth.

Private consumption

Private consumption increased in the second half of 2005 and caused a modest rise in the imports of consumer goods. Consumption was stimulated by faster growth in average wages and improved employment. In the second half-year, the average gross monthly wages increased 11.8%; the growth in nominal net wages again exceeded the 14% level. The fast rise of an average pension was even more remarkable: from 8.5% in the first half-year to 18.3% in the second half. Nevertheless, the pension level is still relatively low, comprising approximately one third of the average gross monthly wages. In April 2006, retirement pensions grew nearly 20%, which marks the completion of government's programme to increase pensions in addition to the indexation system.

All in all, both private and government consumption grew slower than incomes, and this contributed to the improvement of macro-economic balance.

General government

Dynamic growth brought about rapid growth in general government revenue and better than expected revenue from taxation. Despite the cost-enhancing supplementary budget, the surplus of general government budget formed 1.6% of GDP in 2005. Revenue exceeded expenditure for the fifth consecutive year. Given the acceleration of economic growth, the surplus should be substantially greater than in 2004 when it amounted to 1.5% (see Figure 2.2).

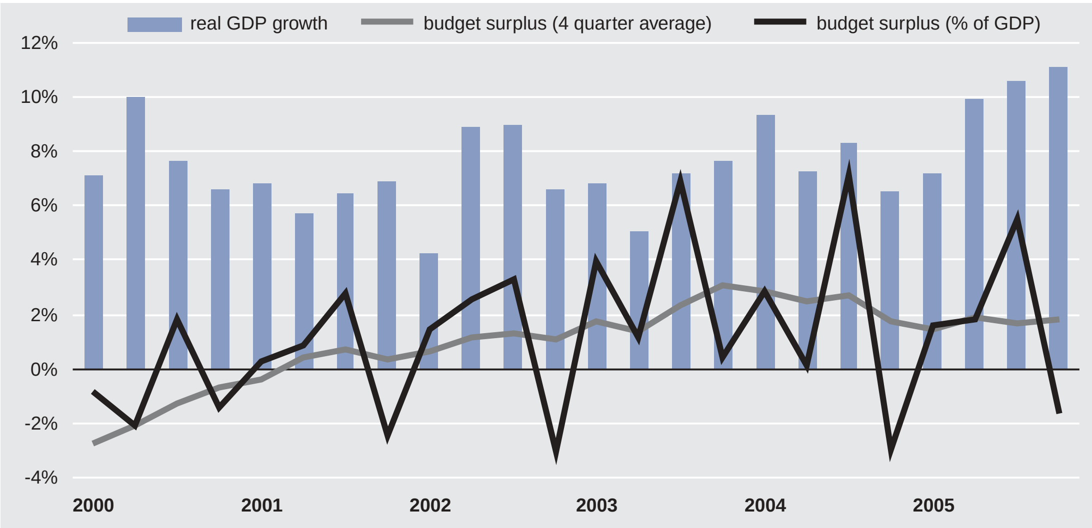

Figure 2.2. Real GDP growth and consolidated budget balance (% of GDP)

Despite strong investment growth the general government expenditure in ratio to GDP decreased slightly.

In the near future, the government intends to go on with the programme encompassing both the reduction of the income tax as well as imposing higher consumption taxes. The plan to reduce personal and corporate income tax rates is more well-defined. The tax reduction began in January 2005 when the tax rate was decreased by two per cent. As taxes on consumption, which were raised simultaneously with acceding to the European Union, also increased the tax revenues in 2005, the general tax burden remained virtually at the level of 2004. The tax reduction continued at the beginning of 2006 when the income tax rate was reduced from 24% to 23% and the basic exemption was raised to 2,000 kroons per month. Nevertheless, this will probably not decrease the tax burden considerably in 2006 either. The current tax level is maintained through an increase in the minimum rate of social and environmental taxes, and the expected acceleration of wage growth.

The increase in expenditure has been planned on the basis of a relatively modest growth outlook and the consolidated budget surplus for 2006 is likely to be 1.2% in ratio to GDP. This forecast is supported by the successful collection of tax revenue characteristic of the beginning of the year. Compared to earlier years, however, the fiscal policy is currently somewhat looser.

Domestic supply

Industrial development

Stimulated by good export opportunities and strong domestic demand, growth in the output and sales of the export sector as well as manufacturing companies targeting the domestic market picked up in the second half of 2005 (see Figure 2.3).

Contrary to expectations, the Estonian goods export growth gained momentum. The increase in exports, which exceeded 30% already in the second and third quarters, accelerated even further in the fourth quarter. Compared to the imports of Estonia's major trade partners, the export growth was extremely rapid in 2005, meaning that the market position of Estonian companies improved even further.

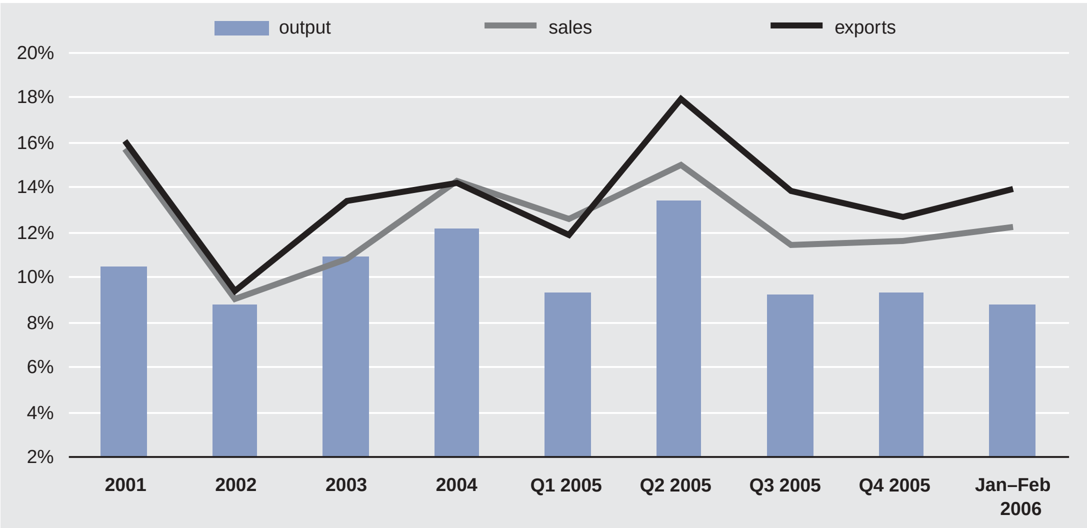

Figure 2.3. Growth in the output, sales and exports of manufacturing

Thanks to strong external demand, the industrial production and sales growth increased to 13.5% towards the end of the year. Moreover, the higher domestic demand boosted sales. The timber, food, chemistry and electric machinery industries made a substantial contribution. Higher sales volumes of textile and furniture products contributed as well.

According to the GDP statistics, the growth rate in the value added in manufacturing reached 13.1% at constant prices in the second half of the year (see Table 2.6).

The situation remained favourable also at the beginning of 2006. The industrial confidence indicator calculated by the Estonian Institute of Economic Research was relatively strong in the first quarter of 2006, though it did not substantially exceed last year's estimates. Meanwhile, the output estimates for future periods remained positive.

Services and other sectors

The interest rate environment remained favourable, contributing to sustained extensive demand for real estate development and related construction services. The annual growth of the value added in the construction sector accelerated up to 17.6% at constant prices in the second half of 2005. Its share in the GDP structure rose to 6.7%. According to the estimates of the Estonian Institute of Economic Research, the confidence in the construction market will remain exceptionally favourable also in 2006 and the majority of companies expect a rise in workload during the following months.

Economic growth was also stimulated by hotels and restaurants, financial intermediation and trading companies, where the growth of value added reached 20% or even more at constant prices (see Table 2.6). The increased household income as well as the rising number of foreign tourists fostered the rapid development of companies. Towards the end of the year, only three fields of activity fuelled economic growth, namely real estate, financial intermediation, and wholesale and retail trade.

Employment

Strong domestic demand and investment activity also reflected in the labour market in the second half of 2005. The demand for labour increased in

Table 2.6. GDP growth by sectors (%)

	2003	2004	2005
Agriculture and hunting	2.0	6.2	-1.9
Forestry	-7.5	-4.7	-7.2
Fishery	-34.4	-3.8	-3.3
Mining and quarrying	10.3	-7.5	6.0
Manufacturing	10.5	10.7	11.9
Electricity, gas and water supply	9.1	1.3	4.4
Construction	6.3	10.5	13.2
Wholesale and retail trade	9.2	5.4	11.8
Hotels and restaurants	5.1	14.1	19.7
Transport, storage and communications	9.4	7.2	9.9
Real estate, renting and business activities	1.5	5.5	5.2
Financial intermediation	20.7	29.3	26.6
Public administration and defence; statutory social insurance	2.4	0.1	2.7
Education	0.6	1.4	1.3
Health and social care	-3.4	5.0	2.8
Other services	2.5	7.1	9.7
Total GDP	**6.7**	**7.8**	**9.3**

domestic demand oriented fields of activity, including construction and trade. All major labour market indicators improved with the creation of new jobs (see Figure 2.4).

Thus, the **employment growth reached 2.3% at the end of 2005** and the number of the employed rose by 13,600 persons, compared to the fourth quarter of 2004. Whereas during the first three quarters of 2005 employment increased thanks to the declining number of the unemployed, later the labour participation rate started to rise and the unemployment rate stopped decreasing. The number of jobs grew mainly in the services sector. In manufacturing the number of the employed remained at the previous year's level.

By fields of activity, rapid employment growth continued in the sectors of hotels and restaurants (34.3%), real estate, renting and business activities (22.3%), and construction (9.1%).

In the last quarter of 2005, the number of the unemployed amounted to 46,500, which is 17% less than in the previous year. The annual unemployment rate reached 7.0%. Unemployment decreased among the short-term as well as the long-term unemployed. Only the number of persons unemployed for less than six months increased, probably due to the economically inactive returning to the labour market. The number of persons unemployed for over 12 months declined by 27.4% – slightly faster than in the previous two quarters.

Regionally, the labour market varied quite significantly. The employment growth was the fastest in Ida-Virumaa – 14% compared to the fourth quarter of 2004. Meanwhile, the number of the unemployed also increased 14% and the rate of the economically inactive decreased 20%. In Northern Estonia the employment rate remained virtually unchanged, decreasing 0.8% in Tallinn and increasing 4.3% in Harjumaa, while unemployment declined and economic inactivity increased slightly.

As to the reasons for economic inactivity, the number of the discouraged and people inactive due to retirement or attending to children or other family members decreased. Though in recent years the number of the discouraged has ranged from 15,000 to 21,000 despite declining unemployment, it decreased to 10,000 at the end of 2005.

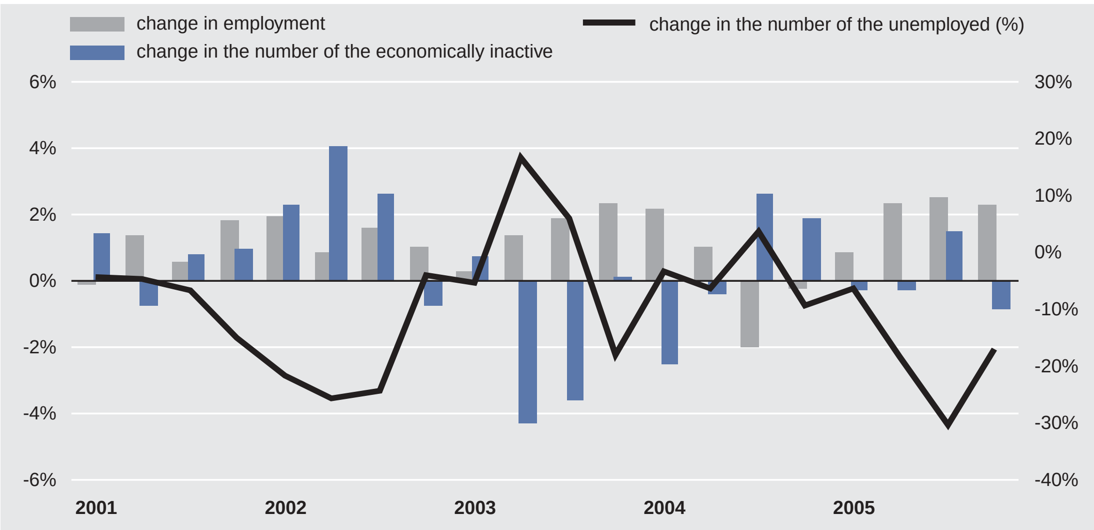

Figure 2.4. Key labour market indicators

The number of the registered unemployed fell also in the first quarter of 2006 by 32%, year-on-year. This number has been decreasing fast since the middle of 2005. At the beginning of April 2006, it fell below 20,000 for the first time, amounting to 2.3% of the working age population.

Although towards the end of 2005 additional labour resources supported economic growth, the contribution of labour productivity was more substantial. The situation common to structural unemployment partly persists in some areas, which lack labour force concurrently.

External balance

2005 was relatively favourable for Estonia in terms of external demand. By the end of the year, the deficit of goods and services decreased to 6.3% of GDP. Economic growth was boosted by the exports of goods, whereas domestic demand grew as well. Consequently, export revenues still remained insufficient for financing the domestic demand. Increased household savings were mainly channelled to investment and therefore the current account deficit did not decrease considerably. In annual terms, the current account deficit diminished to 10.5% of GDP (see Figure 2.5).

The structure of capital inflow remained unchanged. The acquisition of the shares of Hansapank was an exception here. This deal reflected in a decrease in portfolio investment and an increase in direct investment. Due to the takeover of Hansapank the positive balance of direct investment rose to a record high level. Excluding the takeover of Hansapank, foreign direct investment in Estonia amounted to 7.9 billion kroons, which can be considered even less than the long-term average.

Excluding the takeover of Hansapank, foreign direct investment largely consisted of reinvested earnings. Virtually all direct investment originated from the European Union.

As direct investment did not cover the shortage of financing, Estonian external liabilities increased by nearly a third in a year and stood at 148.2 billion kroons at the end of 2005 (90% in ratio to GDP). Estonia's net external debt (external assets less liabilities) comprised 19.8% in ratio to GDP.

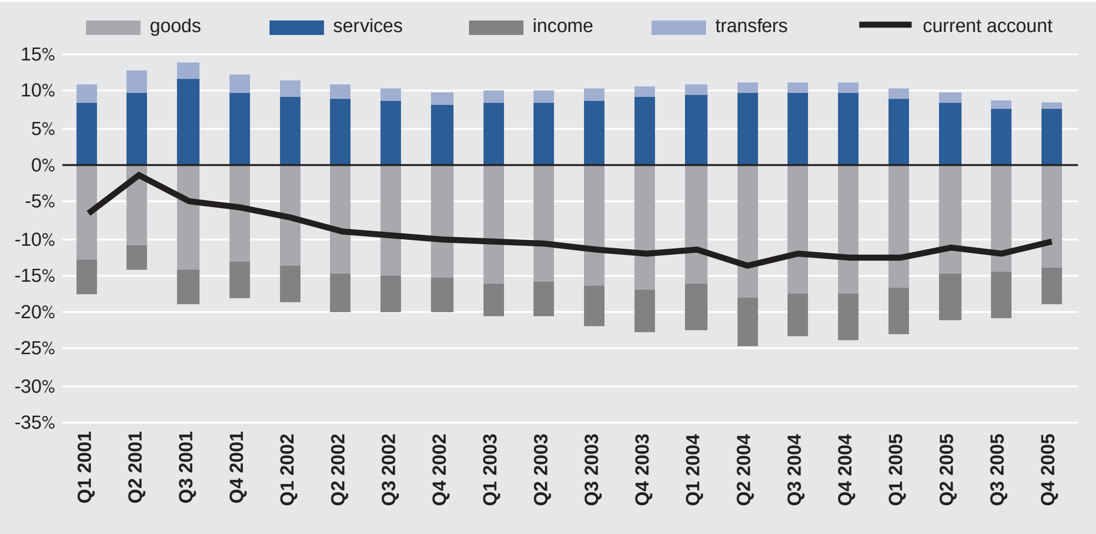

Figure 2.5. Balance of current account and its components (% of GDP)

GOVERNMENT DEBT

With a few exceptions, the Estonian government's fiscal policy has aimed to keep the annual budget in balance and the target has often been outperformed. Thus, for the past five years the general government budget has remained in surplus and the public debt is the lowest among the Member States of the Euopean Union.

The Estonian public debt is divided almost equally between the central government and local governments (see Table a).

About 70% of the central government debt is borrowed from abroad for investments and major acquisitions. According to loan contracts, the majority of loans have been granted in the past decade by international financial organisations (e.g. the World Bank, Nordic Investment Bank, European Investment Bank, Council of Europe Development Bank). The stock of respective loans is constantly decreasing due to repayments and the share of euro-denominated bonds, issued in 2002 for financing dollar loans, has increased to 60%.

The fiscal policy of local governments has been looser and therefore the Rural Municipality and City Budgets Act has set limits on their borrowing. These limits link the loan stock as well as the upper limit of loan servicing costs to the revenue of local governments. The total amount of loans taken must not exceed 60% and the sum of loan servicing costs 20% of the revenue of the current fiscal year. According to the current revenue levels, the debt of local governments should not exceed 5.5% of GDP. Though many local governments have exhausted their possibilities to borrow, in larger cities the situation is different. Thus, presumably the debt of local governments will increase further. As the average Estonian local government is small, it is difficult to get direct access to external funders and 90% of local governments' debt is loans from Estonian banks.

Though the general government budget has been in surplus for the past few years, the total sum of government debt has not decreased (see Table a and Figure a). One reason for this is that only the central government budget has been in surplus, while the revenues of local governments have remained lower than their expenditure. Secondly, the central government debt has decreased but the respective repayment decisions are not determined by the budget surplus of the current year but by the repayment terms of loans in the loan contract. As a rule, the central government has used the revenue surplus to increase reserves and make financial investments. In principle, the deficit-debt adjustment may also be caused by the methodical differences of accounting, changes in debt's market value or simply by statistical errors.[1]

Thanks to the forthcoming central government loan repayments, the government debt-to-GDP ratio will decrease to about 3% by 2008.

Table a. Government debt as at the end of 2001 and 2005

	2001		2005	
	EEK m	**% of GDP**	**EEK m**	**% of GDP**
Government debt	4,845	4.6	7,895	4.8
central government debt	2,915	2.8	3,552	2.2
local governments' debt	1,930	1.8	4,343	2.6

[1] For information on deficit-debt adjustment see also the "Updated Convergence Programme 2005" on the web site of the Ministry of Financial Affairs (http://www.fin.ee/doc.php?14532).

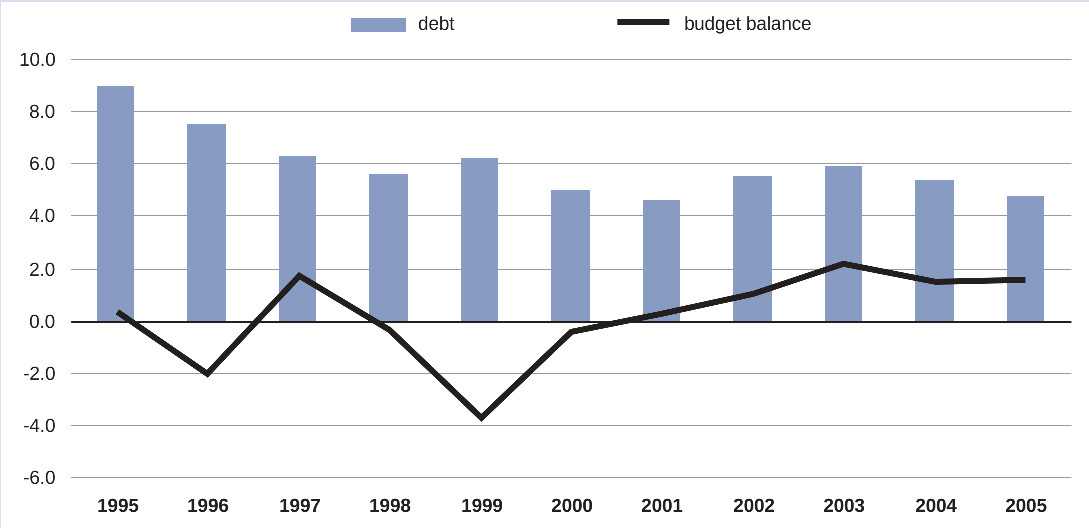

Figure a. Government debt and budget balance in 1995–2005 (% of GDP)

III INFLATION

Consumer price index

The consumer price growth slowed down slightly from 4.3% in the third quarter to 4.0% in the fourth. The inflation was again mainly affected by the fluctuation of oil prices.

In the first quarter of 2006, the consumer price growth increased again. According to the Statistical Office, consumer prices rose 4.4%, year-on-year (see Figure 3.1). In addition to the rapid price increase of motor fuel, this time the consumer basket was substantially influenced also by the prices of housing-related goods and services. Compared to January 2005, for instance, this January the prices of water supply, sewerage services and heating grew 8.7%.

The Estonian core inflation indicator continued its ascent as well. While in autumn it was mainly brought about by the higher prices of clothing, footwear and headgear and the impact of rising motor fuel prices on other prices (mainly transport services), at the beginning of 2006 the increased spending on leisure activities was the main driving force behind inflation. Although the prices of communication services decreased, they failed to balance the price pressures (see Figure 3.2 and 3.3).

According to the forecast of Eesti Pank, the price increase is not expected to slow down considerably before the summer. Potential changes in fuel prices continue to be the major risk factor that might increase the level of inflation.

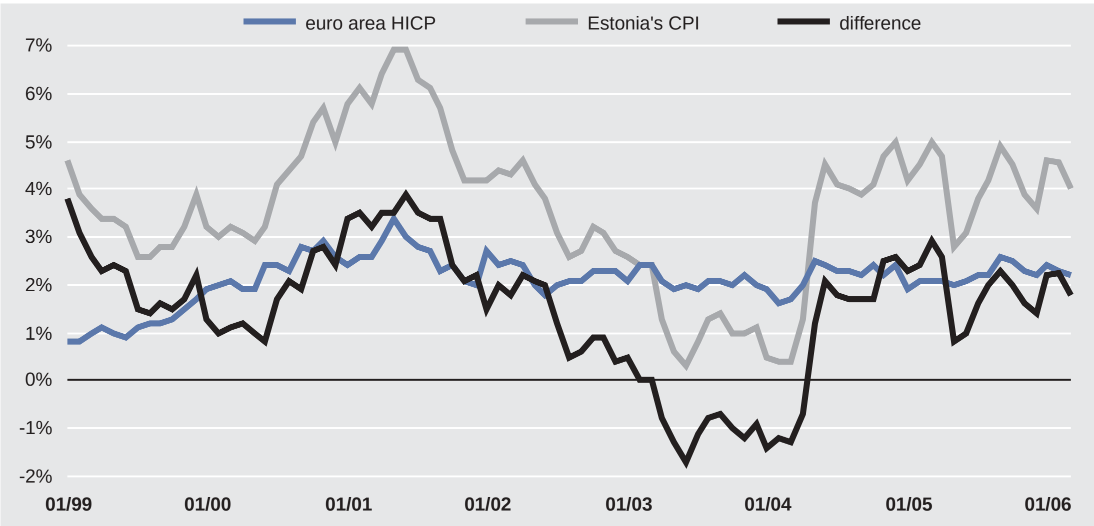

Figure 3.1. Annual growth in consumer prices in Estonia and in the euro area

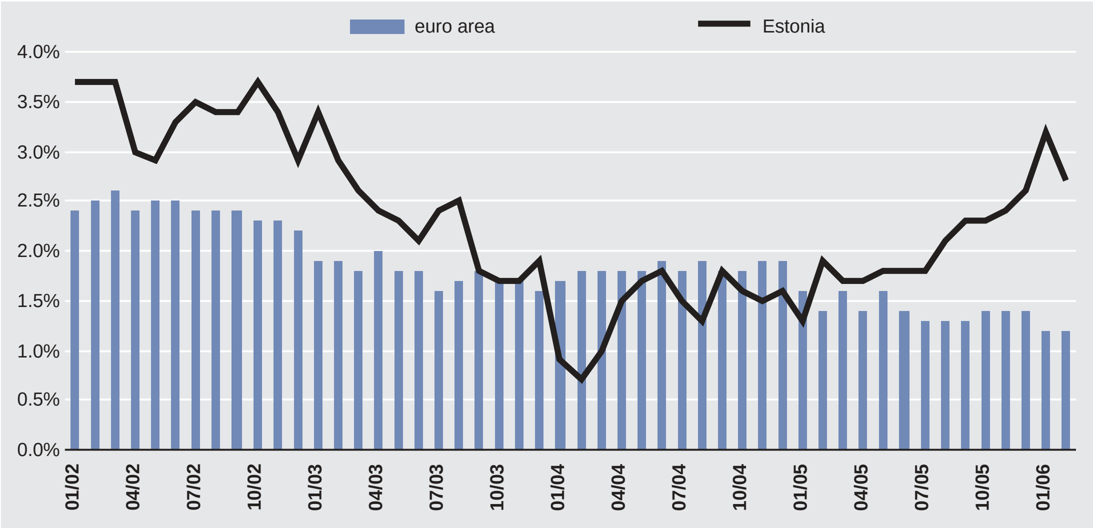

Figure 3.2. Core consumer price inflation (all components, except food, alcohol, tobacco and energy)

Source: Eurostat

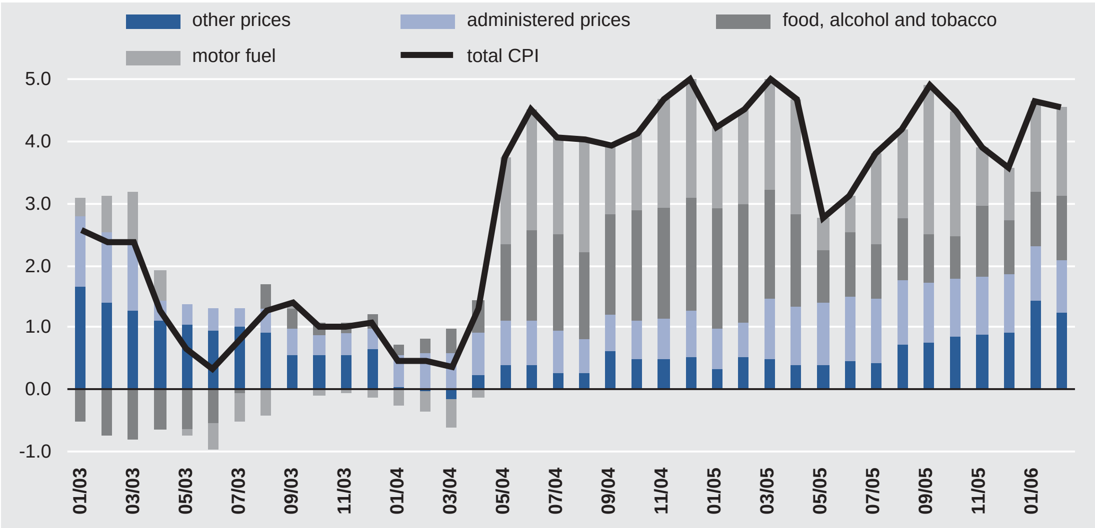

Figure 3.3. Contributions of various goods and services to CPI growth (percentage points)

Labour costs

In the fourth quarter of 2005, the average gross monthly wages amounted to 8,690 kroons. This means that nominal annual growth accelerated to 12.8% again (10.9% in the third quarter and 11.8% in the second quarter). The average gross hourly wages grew from 9.5% in the third quarter to 15.9%. According to the Statistical Office, the wage rise was influenced by one-off premiums paid in the fourth quarter. Such premiums increased 25.5%, year-on-year. As a result of the income tax reduction, net monthly wages increased faster than gross monthly wages, reaching 13.5% in the third quarter and 14.5% in the fourth quarter.

By fields of activities, in the fourth quarter of 2005 average gross monthly wages increased the most in the sphere of hotels and restaurants (24.3%) and decreased only in fishery (7.4%), compared to the fourth quarter of 2004. Rapid wage growth continued in the primary sector probably thanks to the Structural Funds (17.3% in forestry and 19.8% in agriculture). In manufacturing wages also increased somewhat faster – by 14.4%. As wages in industries with lower wage levels generally grew faster than average, the distribution of wages in terms of the amount became slightly more homogeneous.

The wage increase was again faster outside Tallinn, yet wages rose also in Tallinn from 6.9% in the third quarter to 9.2%. For the first time, the average wages exceeded 10,000 kroons. Over the year, the average wages grew the fastest in Jõgevamaa (24.6%), probably owing to the wage rise in agriculture.

Considering the slowdown of inflation to 4.0% in the last quarter of 2005, the real growth of average gross wages increased up to 8.5% in the fourth quarter (6.5% in the third quarter) and the real growth of net wages rose to 10.1% (8.8%).

All in all, in 2005 the real growth of labour productivity remained in line with the real wage growth. Compared to the previous year, the share of the wage fund in GDP (i.e. real unit labour costs) decreased by 0.1 percentage points to 35.0% of GDP, despite faster employment and wage growth (see Figure 3.4).

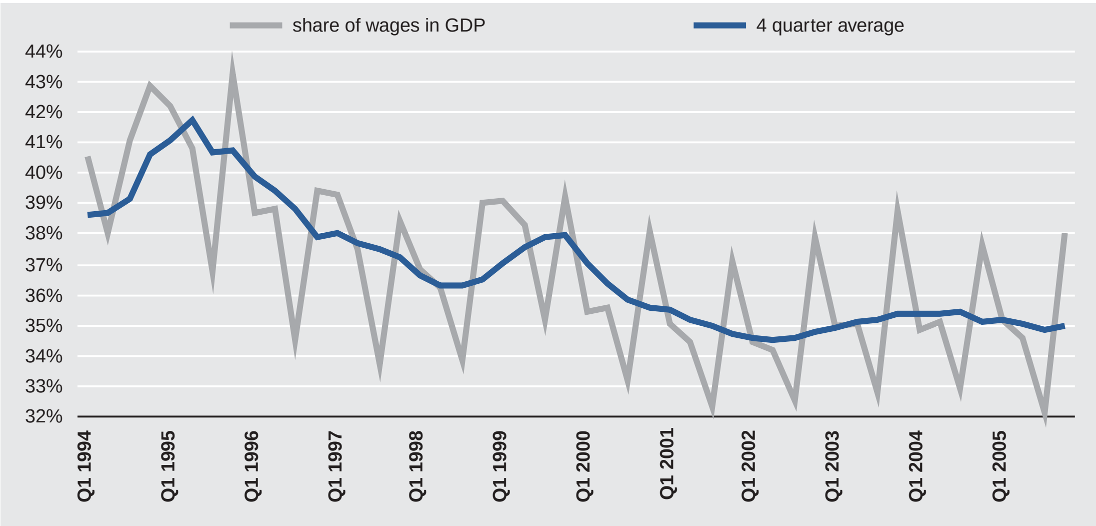

Figure 3.4. Share of wage costs in GDP structure

Real exchange rate of the kroon

Although inflation picked up in Estonia in 2005, the growth of the real effective exchange rate[1] of the kroon was not as substantial. The real exchange rate of the Estonian kroon appreciated by 1.1% against the currencies of major foreign trade partners, year-on-year (see Figure 3.5). Estonian inflation in 2005 exceeded the average inflation of trade partners by 0.7%. The real exchange rate appreciated by 0.4 percentage points, owing to changes in the nominal exchange rate (mainly the euro and the US dollar).

While there is price competition between Estonia and transition economies (due to a similar price level), the prices of industrial countries still remain much higher than Estonian prices. The appreciation of the real exchange rate against the latter may be regarded as an indication of price convergence.

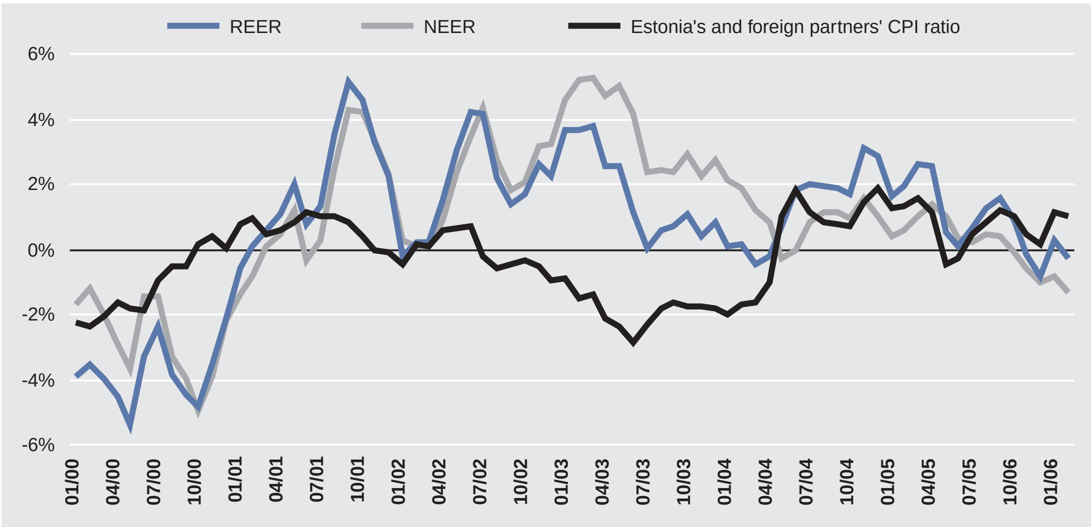

Figure 3.5. Change in the real (REER) and nominal (NEER) exchange rate of the Estonian kroon

[1] The index of the real effective exchange rate (REER) of the kroon describes exchange rate changes of the kroon against the currencies of nine major trading partners of Estonia and changes in Estonian consumer prices against the prices of these trading partners. It is based on the structure of Estonia's foreign trade turnover.

ELECTRICITY PRICES IN ESTONIA

Foreign trade and tax policies were to be brought in line with those of the Economic and Monetary Union by the time of the EU accession on 1 May 2004. Consequently, consumer prices grew significantly in May and June. Later on inflation decreased until March 2005, when electricity prices were raised as planned. In retrospect, this can be viewed as the first impulse from the prices of energy carriers, which influenced the annual price rise of the consumer basket quite substantially in 2005 and at the beginning of 2006.

The role of energy and fuel in the acceleration of inflation has concealed the fact that electricity is still cheap in Estonia. This is not only in comparison with the average prices in the European Union but also compared to the Nordic countries and even Lithuania and Latvia (see Table a). The low price of electricity has helped to restrain the price increase of other energy carriers (except motor fuel).

In the near future, electricity prices will most probably increase. This is caused by the following circumstances:

- Stricter environmental regulations, due to which Estonia will have to shut down the majority of currently operating power stations by 2015;
- Growing need for investments in the Baltic States due to electricity shortages. The demand is increasing in all three Baltic States, whereas the production capacity is declining;
- Tax reform oriented to a more environment-friendly management and the imposition of excise duties on electricity at least at the minimum level required by the European Union by 2010, which is related to the gradual opening of the electricity market.

Opening the electricity market completely in 2013 will create new market conditions. Their impact on the electricity price rise will depend on the demand-supply ratio in the Baltic States at that time.

In short-term, Estonian investments in electricity generation and distribution networks can be financed also by revenues from waste trading. For instance, in the financial year 2005-2006 Eesti Energia earned about half of its annual profit from the sales of carbon dioxide quotas.[1] In the near future, this is expected to reduce pressures to increase electricity prices.

In the long run, prices are expected to increase substantially and the issue is the extent of the price increase. The development plan of Estonian electricity management for the period of 2005–2015 completed in 2005 implies the possibility that electricity prices will increase 50–60% over the next ten years. However, this is based on some expectations of the future prices of energy carriers on the world market that may have become outdated by now.

[1] Source: The Äripäev, 25 April 2006.

Table a. Electricity prices in Estonia and neighbouring countries (euro/100 kWh)

	Annual household consumption				
	600 kWh	**1,200 kWh**	**3,500 kWh***	**7,500 kWh****	**15,000 kWh**
Estonia					
taxes included	8.7	7.4	7.1	6.9	6.4
taxes excluded	7.4	6.2	6.1	5.8	5.4
Lithuania					
taxes included	9.0	9.0	7.2	7.3	5.4
taxes excluded	7.6	7.6	6.1	6.2	4.5
Latvia					
taxes included	6.5	6.5	8.3	6.7	5.1
taxes excluded	5.5	5.5	7.0	5.7	4.3
Finland					
taxes included	19.3	13.6	10.4	8.7	6.7
taxes excluded	15.0	10.4	7.8	6.4	4.8
Sweden					
taxes included	28.8	19.5	13.3	12.3	11.4
taxes excluded	20.5	13.0	8.1	7.3	6.5

Source: Eurostat
* Average consumption in the Baltic States
** Average consumption in Sweden and Finland

Liquidity environment and domestic financial markets

Compared to 2005, interest rates have increased slightly both in the euro area as well as in Estonia, but the **monetary environment still remains favourable for economic activity**. **The liquidity of the Estonian financial sector continues to be high** in the context of low interest rates. The share of liquid assets in the balance of banks rose to 26% by the end of February 2006. Also the liquidity of the kroon stays high. Banks have had no problems with meeting the reserve requirement.[1]

Estonian money market interest rates have developed in line with the dynamics of euro area interest rates. As the European Central Bank (ECB) raised key interest rates in December 2005 and March 2006, money market interest rates increased both in the euro area as well as Estonia (see Figure 4.1). The increase of quotations was timed differently in Estonia and the euro area, and therefore the difference between money market interest rates turned temporarily negative for a few weeks prior to the decisions to raise key interest rates. In the second half of March, the difference between interest rates on money market loans with varying maturities in Estonia and the euro area stabilised at 13–20 basis points. This is comparable to the level of 2005 before the emergence of interest rate rise expectations.

The rise of interest rates in the euro area also caused an **increase in the interest rates on loans and deposits granted to Estonian enterprises and households**. The weighted average interest rate on long-term household loans rose to 5.4% in February 2006 (4.0% in September 2005), including the interest rate on housing loans which increased to 3.7% (in October 2006 it decreased by 0.1 percentage points to 3.2%). The average interest rate on long-term corporate loans rose to 4.5% in January 2006 and declined to 4.3% in February. The weighted average interest rate on long-term kroon deposits in the non-financial sector[2] increased to 2.9% in February 2006 (see Figure 4.2).

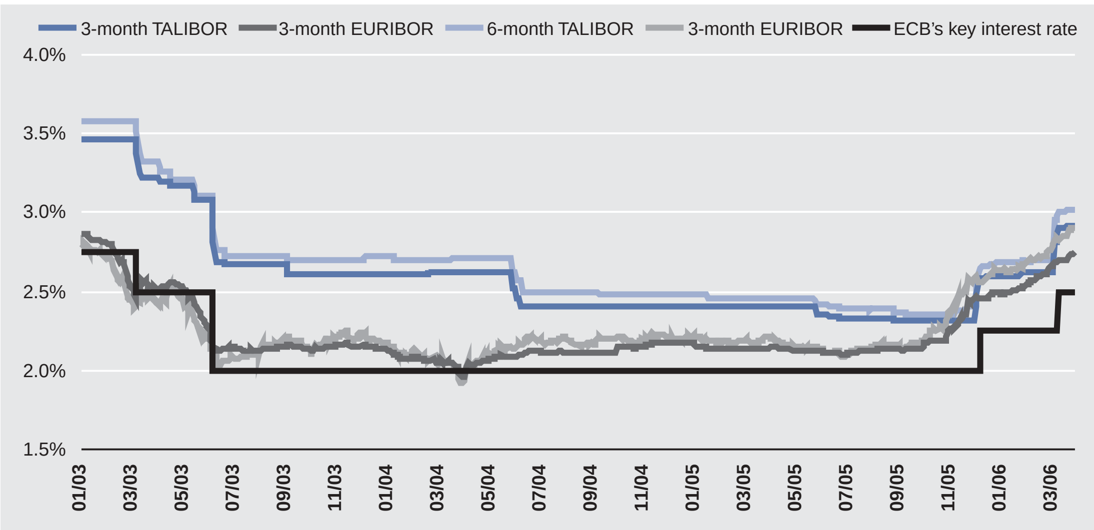

Figure 4.1. ECB's key interest rate and money market interest rates of the Estonian kroon and the euro

[1] In January 2006, the balance of the settlement account of one bank fell below the daily minimum level. This was a minor technical error (over 90% of the required minimum level was met).

[2] Non-financial sector refers to households and non-financial corporations.

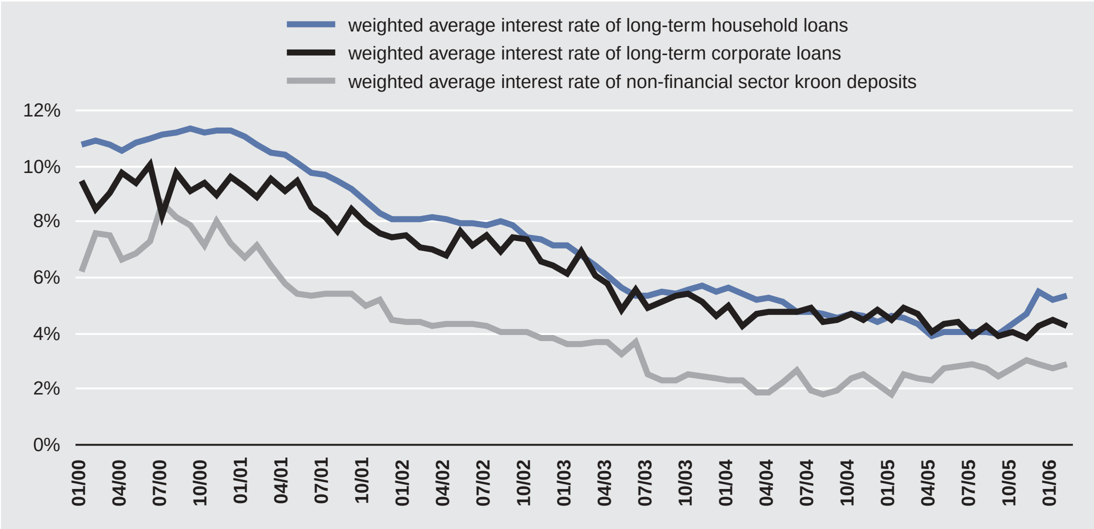

Figure 4.2. Interest rates of domestic non-financial sector

The **primary bond market** remained relatively subdued in the second half of 2005 and at the beginning of 2006. The secondary market was volatile as usual by months; the turnover was relatively high in September and December 2005. After the delisting of Hansapank from the stock exchange, trading on the **stock market** gained momentum again at the end of 2005 and at the beginning of 2006. Share prices reached their peak in September 2005, which was followed by a gradual decrease. At the beginning of 2006, share prices showed no common tendency: some rose, some fell.

Money supply

In the second half of 2005 and at the beginning of 2006, the **money supply growth accelerated even further**. Compared to the beginning of 2005, the annual growth rates of the intermediate (M2) and the narrow (M1) monetary aggregate are approximately 2.5 times higher, reaching 44% and 39% respectively in February 2006 (see Figure 4.3).

After large receipts in the second quarter of 2005, which were related to the sales of Hansapank's shares, the annual growth of monetary aggregates picked up at year-end primarily due to the **strong growth of corporate deposits**. The annual growth of corporate deposits reached 67% in February 2006, as demand deposits and time deposits increased fast in the fourth quarter of 2005. The growth of household deposits has also accelerated slightly, reaching 34% at the end of February. At the end of 2005 and at the beginning of 2006, demand deposits experienced the strongest growth, whereas time deposits started to increase fast at the beginning of 2006. The annual growth of currency in circulation has stabilised at 12-13% after a gradual pick-up from the beginning of May 2005 which lasted for almost a year.

Financing the non-financial sector

The **domestic financing**[3] **of the non-financial sector** continued rapid growth at the end of 2005 and at the beginning of 2006. After a record growth (11.9 bn kroons) in the second quarter of 2005, it slowed down slightly in the third quarter, but reached another peak in the fourth quarter (13.9 bn kroons). Active borrowing continued at the beginning of 2006 (see Figure 4.4).

[3] Includes bank loans and leasing.

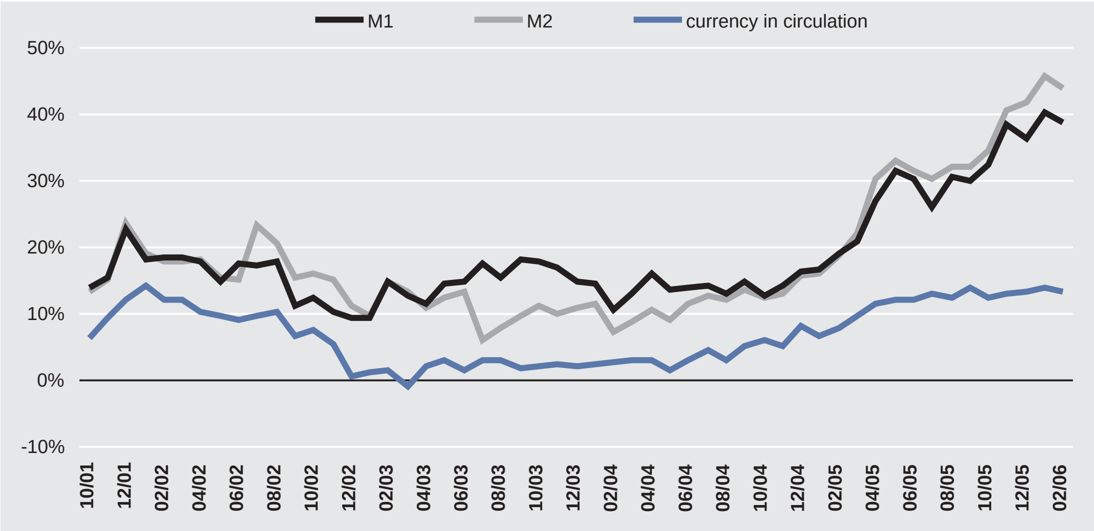

Figure 4.3. Annual growth in money supply

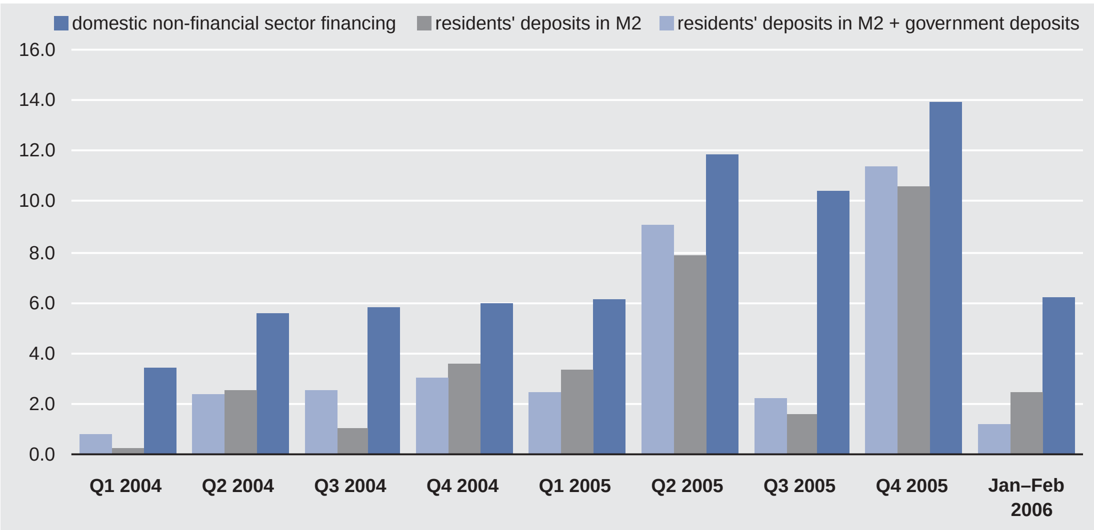

Figure 4.4. Quarterly growth in residents' deposits and domestic non-financial sector financing (EEK bn)

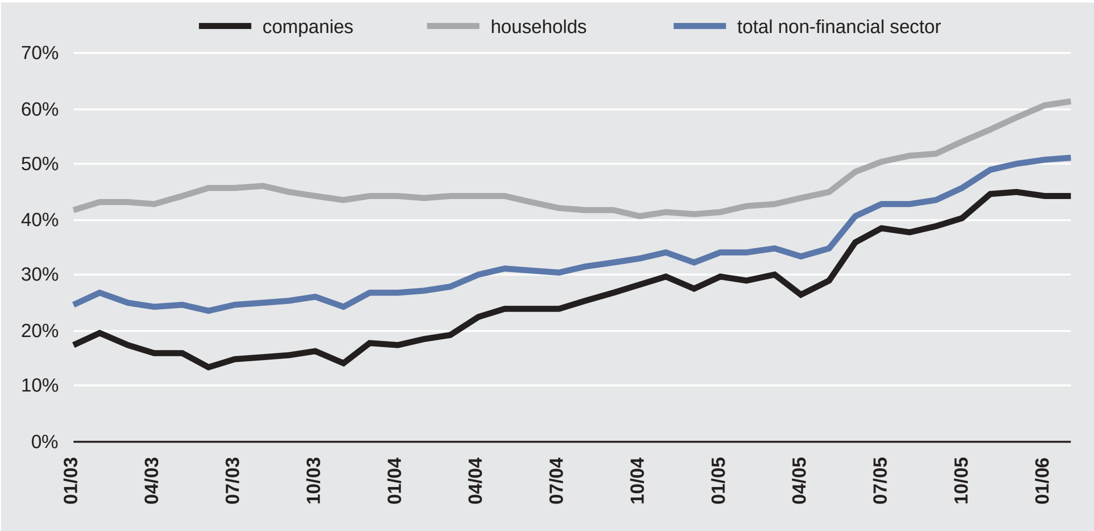

Figure 4.5. Domestic bank loans and leasing of resident non-financial companies and households (annual growth)

The annual growth of the non-financial sector's domestic financing gradually picked up to 51% from June 2005 to February 2006. The annual growth of domestic corporate financing stabilised at 44%, while that of household loans and leasing reached 61% (see Figure 4.5).

Corporate and household loans and leasing have gained quite similarly by quarters. By fields of activities, as of September 2005 the credit to real estate companies again grew the most. The loan growth of trading companies has been fast as well. In recent months, also the loan and leasing volume of manufacturing companies has increased more than in earlier periods. Household loans are still dominated by real estate loans, which have receded to the level of the second quarter after their robust growth in the fourth quarter of 2005. Other household loans increased rapidly as well.

Capital flows

The net capital inflow picked up strongly in the second half of 2005, reaching 11.7 billion kroons (the total of 2005 was 20.2 bn kroons). The net capital inflow mainly relied on credit institutions' capital attracted through loans and deposits of foreign banks. In the second half of 2005, some capital net outflow was experienced among direct as well as portfolio investment in relation to the growth in foreign investment of Estonian residents.

The volume of external liabilities as well as external assets grew considerably in the banking sector in the fourth quarter of 2005 and at the beginning of 2006. The total volume of banks' net external debt reached its peak in November 2005 (51 bn kroons). It decreased at the end of the year, but reached 49 billion kroons again at the beginning of 2006. The volume of external resources decreased slightly at year-end due to the robust rise of deposits in the non-financial sector. Although deposits grew significantly, the share of institutional foreign borrowing remained at 40%.

REGULATIONS ON HOUSING LOANS

Economic growth reached nearly 10% in 2005, the real estate sector being the main driving force behind acceleration. Although the Estonian economy as a whole did not show signs of imbalances, the real estate sector experienced excessive demand. Contrary to expectations, the growth rate of housing loans did not decrease at the end of 2005 but increased to approximately 70% in annual terms. The robust loan growth, in turn, brought about a 30% increase in residential property prices. In construction, prices increased by an annual average of 7-8%.

Considering the above factors, Eesti Pank decided to change housing loan regulations for banks by:

- Raising the risk weight on housing loans in capital adequacy calculation to 100% instead of the earlier 50%, as a result of which banks have to increase the share of own funds in financing housing loans;

- Including 50% of the housing loan portfolio in the reserve requirement base, in case the bank's risk weight in capital adequacy calculation is lower compared to what Eesti Pank has established.

Taking into account the impact of close cross-border relations of Estonian banking on the Estonian loan market, a proposal was made to the supervisory authorities of foreign banks with branches in Estonia and some foreign central banks to apply a 100% risk weight also on the housing loans of Estonian residents, if possible.

As a result of these measures, banks have to increase the amount of their own capital in financing lending, which increases their own responsibility when granting housing loans. The new regulations may cause the banks to review their loan conditions. The regulations entered into force on 1 March 2006.

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

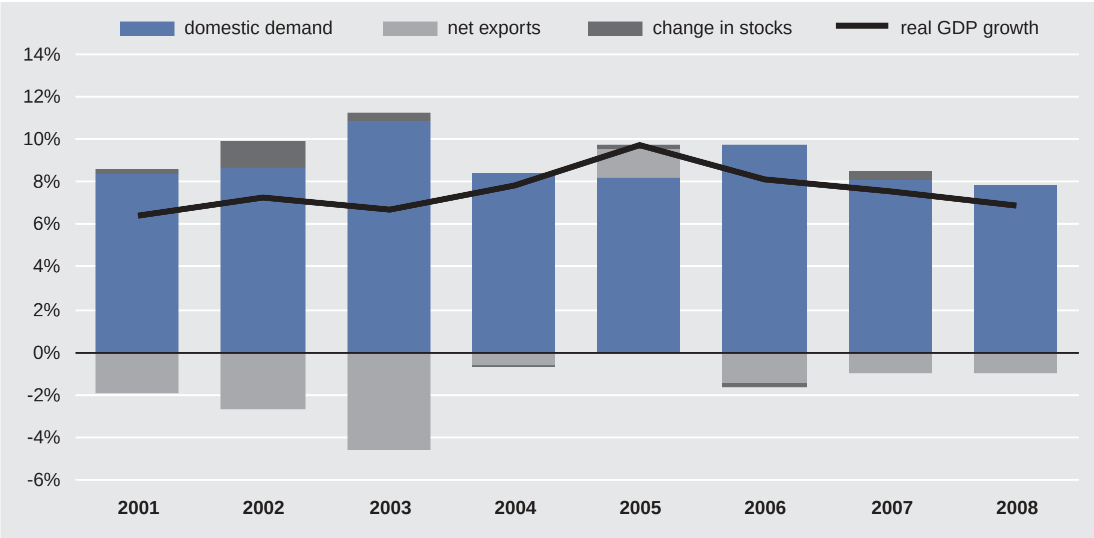

Figure 5.1. Real GDP growth and its components (%)

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.

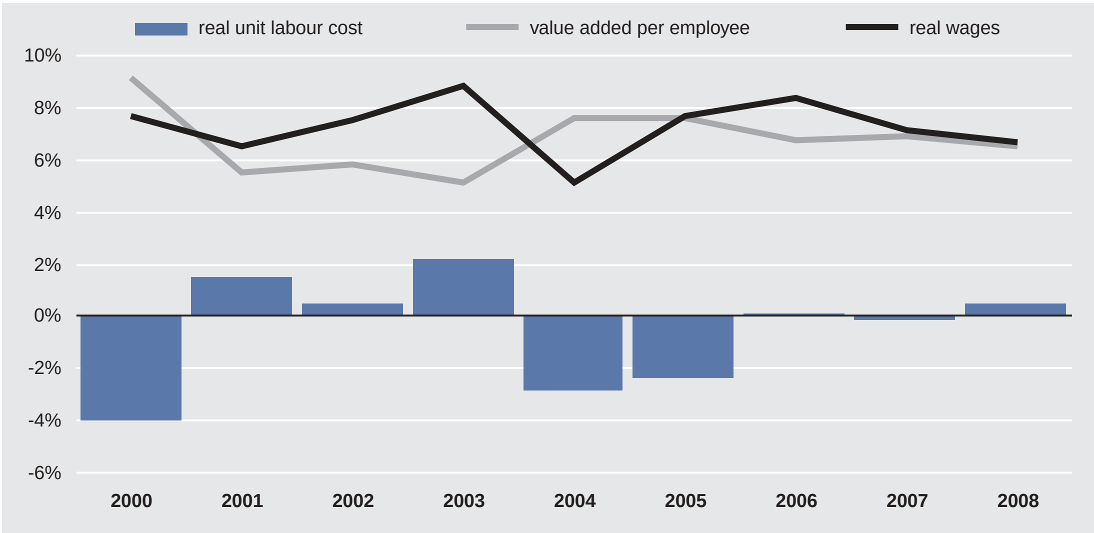

Figure 5.2. Productivity, real wages and real unit labour cost

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

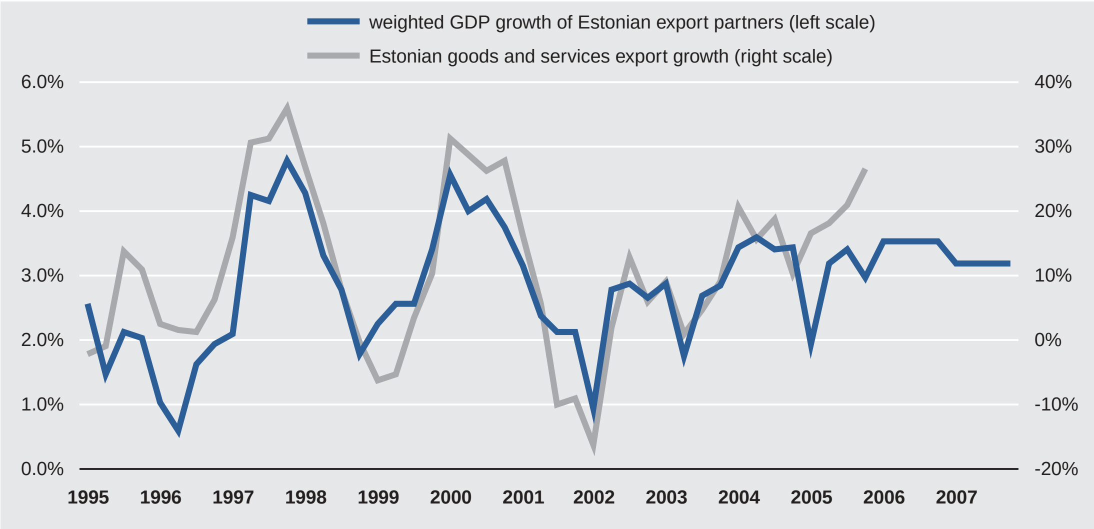

Figure 5.3. Estonia's real exports growth

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

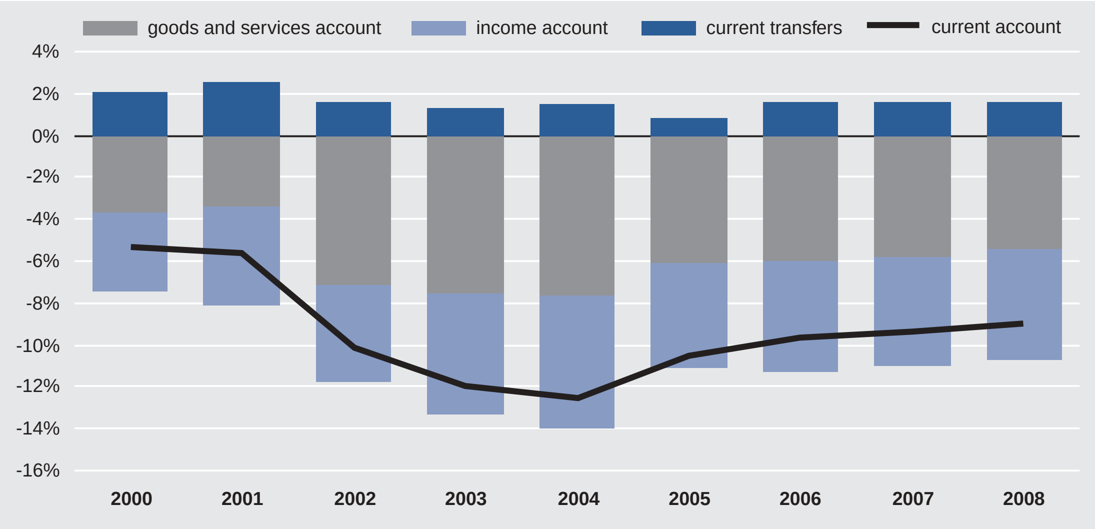

Figure 5.4. Current account structure (% of GDP)

[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.

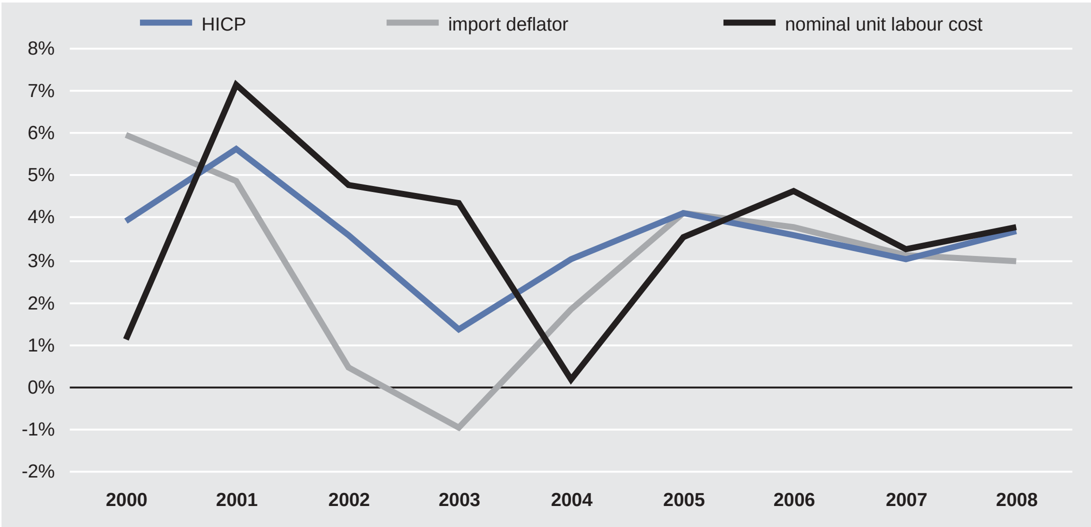

Figure 5.5. Inflation forecast (% year-on-year)

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