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I ECONOMIC POLICY SUMMARY

Despite the risks and declining global economic activity indices associated with the deceleration of economic growth in the US, the **external environment has favoured Estonian economic growth throughout 2006**. In the first half-year, economic growth in the euro area reached the highest level in recent years and also the growth of Estonia's main trading partners has remained faster than average.

Oil price, one of the principal factors endangering economic growth, started dropping at the beginning of the second half-year and reached the previous year's level. However, this did not bring about a general price decrease in commodity markets. The main problems of the Estonian economy are still related to internal market developments, including strengthening price and wage pressures as well as supply-side constraints in some sectors.

ESTONIA

Monetary policy environment

Due to the rise of monetary policy interest rates that began at the end of 2005 and continued in 2006, Estonian money market quotations also appreciated. By the end of September, however, they had grown by 1 percentage point compared to the beginning of the year. In comparison with the lowest interest rates witnessed in 2005, the interest rates on long-term household and corporate loans increased by an average of 1.5 percentage points. However, this did not decrease the loan demand and household indebtedness continued rapid growth. The large inflow of foreign capital continued and the economic environment can still be regarded expansive in terms of money supply.

The exchange rate of the Estonian kroon mainly strengthened, particularly since the second quarter. Like earlier, the nominal exchange rate of the kroon was primarily influenced by changes in the dollar exchange rate. The growth rate of the real exchange rate of the Estonian kroon remained the same as in 2005 and ranged within 3.0–3.5% during most months.

External and domestic demand

According to preliminary estimates, **gross domestic product (GDP) growth in Estonia remained at the level of 11% also in the first half of 2006**. Though the quarterly growth rate was slightly lower in the final months of the half-year compared to the first quarter, this does not denote the start of a slowdown.

Increased demand in foreign markets guaranteed the rapid export growth of goods and services. Nevertheless, the growth rate of merchandise exports did not reach as high as in the second half of 2005, raising the question whether the capacity of the export sector is sufficient to benefit from robust global growth.

The **domestic demand growth started accelerating** since the second half of 2005. The increase in private consumption gave cause for concern as it rapidly picked up speed in the first half of 2006 owing to bank loans, amounting to more than 15%. As a result of strong investment demand, the gap between savings and investments increased and, based on external trade data, the deterioration of the external balance that had begun already in the second half of 2005 continued even further. Though the inflow of foreign direct investment remained near its historical average, the majority of capital inflow was comprised of cash flows channelled through banks. Therefore, the Estonian external debt increased up to nearly 91% of GDP by the end of the first half-year. The issue of the potential economic imbalance thus remained high on the agenda and Eesti Pank decided to take additional measures in order to support macroeconomic balance.[1]

[1] For more details see background information "Measures of Eesti Pank implemented in 2006" on page 7.

Economic growth accelerated in almost all fields of activity and was extremely fast in the real estate sector as well as in financial intermediation.

Strong external demand and rapidly growing domestic demand underpinned by loans brought about an increase in the number of jobs. This reduced unemployment to nearly 6%, which is the lowest level since the past ten years. Owing to young people entering the labour market, but mainly due to a decrease in the number of the unemployed and discouraged, employment growth exceeded the previous years' levels of up to 2% by two or three times.

General government

The unexpectedly fast and broad-based economic growth secured **more successful collection of tax revenues than planned** throughout 2006. Although the general government carried out the planned reduction of corporate and personal income tax from 24% to 23%, the overall tax burden remained at the earlier level of 31% of GDP. Last year's income tax rate reduction was offset by increased excise duties and faster private consumption growth.

As the collection of tax revenues exceeded expectations, the government drafted a **supplementary budget** with the primary goal of **increasing the pension insurance reserves** and **providing additional funding for some investment programmes**. Although in the first half-year government savings were larger than in 2005, the expenses grew even faster in the second half. According to forecasts, the general government budget surplus will amount to a total of 1.7% of GDP, provided that supply-side constraints on the construction sector do not compel government agencies to postpone any investment projects. Compared to last year, the fiscal policy has somewhat loosened.

At the end of September, the Government approved the next year's draft state budget, which foresees at least a 0.5% surplus of GDP. This is the first time such a large surplus is projected.

Inflation

In the first half of 2006, oil prices on the world market proved to be much higher and more volatile than expected. As some food prices increased, the **decrease of consumer prices in Estonia** that had occurred during the final months of 2005 halted. The annual price rise of the consumer basket ranged near 4.5% from January to September 2006. Greater deviations from that level mainly stemmed from oil price changes on the world market.

In the final months of the first half-year, the extremely rapid development of the real estate sector also started to considerably affect the consumer basket appreciation rate. The prices of construction and repair materials as well as construction works and rental prices experienced faster growth than before. Increased income fostered the rise in the prices of all services and ultimately caused the core inflation to accelerate.

Real estate price growth remained brisk in the first half-year and reached 40%, year-on-year. Meanwhile, the rapid price increase no longer continued in all segments of the market and the real estate sector showed some signs of balancing between supply and demand.

This summer's weather was unfavourable for agriculture and horticulture, which is why the seasonal decrease in food prices was also minimal. In autumn, the inflation rate remained at its previous level also because of heating costs. In some fields of activity, labour costs started increasing at a disturbing pace.

The average consumer price inflation rate is expected to reach 4.4% in 2006. The inflation rate will probably remain the same also next year. In the future, it may be significantly affected by changes in tax policy.

Projections

The external environment will continue to foster Estonia's economic growth also in 2007–2008. The large inflow of foreign capital will keep the growth rate of domestic demand high. Though real GDP growth will drop to 7–8%, it will nevertheless exceed the estimated potential level also in the forthcoming years.

Strong demand will characterise private consumption as well as investments. The increase in funding by the European Union and investment programmes launched in 2006 give reason to expect higher investment activity also from the general government.

For 2007, the government has developed a draft state budget with a revenue surplus, the planned surplus being the largest ever.

Primary risks are related to the private sector, the deterioration of the external balance and increasing pressures on the prices of workforce, goods and services. According to forecasts, the average rise of consumer prices will remain at 4.5% level and may even speed up in case of certain tax policy decisions.

It is safe to conclude that the rapid growth rate will continue, but on account of a moderate deterioration regarding internal and external balance. Therefore, keeping the general government budget surplus at the necessary level is more important than before and both the Government as well as the central bank must be prepared to take additional measures in order to curb domestic demand, if necessary.

Table 1.1. Key economic indicators of Estonia*

	1995	1999	2000	2001	2002	2003	2004	2005	2006 (I h/y)
Real GDP growth (%)	4.5	0.3	7.9	7.7	8.0	7.1	8.1	10.5	11.7
Growth in goods and services exports (%)	5.4	0.8	28.4	2.0	1.7	7.6	17.1	21.5	17.0
Growth in goods and services imports (%)	6.3	-5.4	28.1	3.5	6.0	10.6	15.2	15.9	17.6
Current account balance (% of GDP)	-4.4	-4.4	-5.4	-5.4	-9.8	-11.5	-12.1	-10.0	13.0
General government budget balance (% of GDP)	0.4	-3.6	-0.2	-0.3	0.4	2.0	2.3	2.3	4.1
Consumer price index of 12 months (%)	29.0	3.3	4.0	5.8	3.6	1.3	3.0	4.1	4.5
Consolidated balance sheet of banks (% of GDP)	36.1	57.6	60.5	63.2	67.3	74.3	91.1	106.8	114.2
Capital adequacy of commercial banks (%)	14.5	16.1	13.2	14.4	15.3	14.5	13.3	11.7	12.1
TALSE /OMX Tallinn index change (%)		38.3	10.1	4.7	20.6	34.4	65.6	48.0	-8.3
Consolidated loan portfolio of commercial banks (% of GDP)	17.3	32.4	35.5	37.2	40.7	52.0	63.1	72.4	81.2
M2 (% of GDP)	26.3	32.0	34.1	37.3	36.9	37.7	39.6	47.7	49.3
External debt (% of GDP)	43.6	54.8	53.0	53.6	57.9	65.9	78.3	85.6	91.1
3-month Talibor (%; annual average)		7.8	5.7	4.0	3.5	2.6	2.4	2.6	3.1

* The Statistical Office of Estonia has adjusted the time series for 2000–2005. See also background information on page 8.

MEASURES OF EESTI PANK IMPLEMENTED IN 2006

Contrary to expectations, Estonia's economic growth did not decelerate in the autumn of 2005 but rather picked up. The external balance, which had improved in the first half-year, began deteriorating. In order to minimise risks and promote balanced development, Eesti Pank made a decision at the end of 2005 to enforce new procedures for calculating capital adequacy as of March 2006.

According to the new procedure, banks had to increase the risk weight used for calculating capital adequacy to 100% from the earlier 50%. This amendment increased the share of banks' own funds in financing housing loans.[1] Banks reacted by increasing their own funds at the expense of retained earnings. Money from the parent banks abroad was also further included.

Although banks' increased liquidity buffers added to the stability of the financial sector, the growth rate of housing loans showed no sign of slowing down. Therefore, Eesti Pank decided at the beginning of July to raise banks' reserve requirement from 13% to 15% from 1 September 2006. This also aimed to limit risks to the Estonian economy arising from the rapidly growing domestic demand and mortgage borrowing.

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[1] See the background information "Regulations on housing loans" of the Monetary Developments and Policy Survey, March 2006.

ADJUSTMENT OF THE TIME-SERIES OF GROSS DOMESTIC PRODUCT AND NATIONAL ACCOUNTS

In the autumn of 2006, the Statistical Office of Estonia used a renewed methodology for the adjustment of the time-series of gross domestic product (GDP) and national accounts retroactively since 2000. The changes arose from combining the GDP methodology with that of supply and use tables. Information contained in the supply and use tables allows to completely balance the production and consumption sides in the case of GDP calculated at current prices, and to remove statistical errors that may occur on the consumption side of GDP. However, the supply and use tables are compiled three years after the end of the accounting period of the relevant year and therefore, the complete harmonisation of the production and consumption sides of GDP takes some more time. GDP data is considered final only after integrating the supply and use tables into the system of national accounts (except in case of methodological updates under special procedures).

The renewed methodology enables to specify the amount of added value created in the non-financial corporate sector, and also the principles of calculating the intermediate and the final product (for example, methods for the evaluation of software produced for personal use were improved). The above changes caused a 2.7–4.9% rise in GDP at current prices in 2000–2005, and a 2.7–6.0% rise at constant prices (see Table a).

All the accounts of national accounting and public finance accounting were adjusted simultaneously and the indicators of public finance were updated as well. As a result, general government income decreased along with expenditure. Changes on the income side mostly occurred due to the specification of the volume of official transfers. A more complete initial information on local governments, non-budgetary funds and accrual capital expenses changed the previously published volume investments and capital costs. Moreover, the indicators of the consolidated budget balance changed, especially for the years 2004–2005 (see Table a).

In 2007, it is planned to revise the time-series for 1995–1999 using the renewed methods.

Table a. GDP and consolidated budget balance after the adjustment of time series

	2000	2001	2002	2003	2004	2005
GDP at constant prices of 2000 after adjustment (EEK m)	95,491	102,809	111,050	118,912	128,508	141,969
Change compared to the previous period (%)	2.7	3.9	4.7	5.0	5.3	6.0
GDP at current prices after adjustment (EEK m)	95,491	108,218	121,372	132,904	146,694	173,062
Change compared to the previous period (%)	2.7	3.6	3.8	4.4	3.7	4.9
Consolidated budget balance after adjustment (% of GDP)	-0.2	-0.3	0.4	2.0	2.3	2.3
Change compared to the previous period (percentage points)	0.1	-0.6	-0.6	-0.2	0.9	0.8

II ECONOMIC DEVELOPMENTS

EXTERNAL ENVIRONMENT

General background

In the first half of 2006, **global economic growth** followed the trend. The annual GDP growth indicators of the first and second quarter remained at the same level as in 2005 in the United States, the euro area as well as in Japan. However, in the second quarter minor variations could be perceived in the economic activity of different regions: while the euro area economic growth accelerated compared to the first quarter, growth in the United States and Japan slowed down. Based on economic data for the third quarter, similar trends (the persistence of a relatively high economic growth rate in the euro area and a decline in the United States and Japan) should continue also in the second half-year. According to Consensus Forecasts, in 2006 global economic growth should be 0.4 percentage points faster than in 2005 (3.4%; see Table 2.1). In 2007, global economic growth is expected to slow down to 3.2%.

Headline inflation indices in major economic areas remained generally in line with oil price changes: price growth accelerated until the end of the second quarter and declined in the third quarter. The annual growth of consumer prices in the United States reached 4.3% in July, dropping to 3.8% in August. In the euro area, it remained at the level of 2.5% from April to June and shrunk to 1.7% by September. In the third quarter, core price indices excluding the prices of energy and food did not react to the oil price decline yet and at times even rose to their highest level in recent years: to 2.8% in August in the United States (the highest in ten years) and to 1.5% in September in the euro area (the highest level of the past year). According to Consensus Forecasts, inflation should reach its peak in 2006 and after that price growth is expected to slow down.

As inflation picked up, the increase in key interest rates also continued in the first half of 2006. Key interest rates were raised by the central banks of the United States, euro area, Canada, Australia, Sweden, Norway and England; the zero interest rate policy enforced by the Japanese central bank so far was also ended. In the third quarter, US trends took a different turn: as economic activity and inflation decreased, the upward cycle of the key interest rate halted at 5.25%.

Table 2.1. Global economic forecasts

	GDP growth (%)		Inflation (%)	
	2006	2007	2006	2007
Unites States	3.4	2.6	3.5	2.5
Euro area	2.6	1.9	2.3	2.2
Germany	2.2	1.2	1.8	2.3
France	2.3	2.0	1.9	1.6
Italy	1.6	1.2	2.2	1.9
Finland	4.0	2.7	3.3	3.0
Sweden	4.2	3.0	1.5	2.0
Japan	2.8	2.2	0.3	0.5
Total global economy	3.8	3.2	2.7	2.5

Source: Consensus Forecasts, October 2006

[1] Monthly activity index published by the National Association of Home Builders, which reports on developments in the residential market.

United States

The US economic growth (measured as the annual GDP growth rate) stood at 3.7% in the first quarter of 2006 (the fastest in the past year and a half) and at 3.5% in the second quarter. At the end of the second quarter and in the third quarter, however, signs of weakening economic activity appeared. The fastest decline in activity was experienced by the real estate sector, where the NAHB[1] activity index, which had reached its highest level of the past six years in last year's July, dropped to its lowest level of 15 years within 15 months (by September 2006). A similar steep fall (from the record high of recent years in the second half of 2005 to the lowest level in the past years by the third quarter of 2006) was also experienced by other time series reflecting the activity of the real estate market: the number of construction permits issued, new residential constructions commenced and loan applications, and the sales data on used and new houses. However, hope remains that in the near future this rapid decrease will not spread to other US economic sectors and that the decline in economic growth will stop at the annual GDP growth rate of 2.5–3.0%.

Unemployment remained low in 2006, ranging between 4.6–4.8%. Stimulated by rising oil prices, the inflation of consumer prices increased in the first and second quarter, reaching 4.3% in June. The decrease in oil prices and economic activity in the third quarter also reduced the annual growth of the consumer price index (CPI), which dropped to 3.8% in August. Meanwhile, the core inflation (excluding energy and food prices) followed an upward trend from April to August and reached its highest level in ten years (2.8%).

The US budget deficit was 248 billion dollars in the fiscal year of 2005/2006[2], which is the lowest level in three years. The current account deficit remained the same also in the first half of 2006, amounting to 6.6% of GDP in the first as well as the second quarter.

Due to the inflation rise, the US Federal Reserve continued increasing the key interest rate in the first and second quarter up to 5.25%. In the third quarter, the Federal Reserve decided to stop raising the key interest rate in view of the decreased inflation and economic activity.

Japan

Economic growth in Japan reached 3.6% in the first quarter and 2.5% in the second quarter of 2006. The strongest sector was manufacturing: by August, the annual growth of industrial production rose to 5.9%, which is the fastest growth rate in the past two years. In the first and second quarter, also industrial orders experienced very strong growth (12.2% and 17.7%). Meanwhile, retail sales remained weak with the annual growth ranging from -0.8–1.1% from April to August. Various activity indices remained stable also in the second and third quarter without any particular trend.

Japanese inflation data indicated a decisive end to the deflation period. The annual growth of consumer prices rose to 0.9% in August and, unlike other major economic regions, the inflation-reducing impact of dropping oil prices did not manifest itself in August's data yet. The annual growth of the core CPI rose to its highest level in eight years (0.3%) and also the GDP deflator decrease rate is slowing down (-0.8% in the second quarter). In May, unemployment in Japan dropped to the lowest level of eight years (4.0%) and stayed close to that level until August.

As economic growth remained in line with the trend and inflation recovered, the Japanese central bank

[2] In the United States the fiscal year lasts from October until September.

terminated the zero interest policy that had lasted for several years: in August, the key interest rate was raised to 0.25%.

Euro area

Unlike the United States and Japan, the euro area economic growth accelerated both in the first and second quarter of 2006, year-on-year. According to preliminary data for the third quarter, economic growth remains relatively fast also in the second half-year. The year-on-year GDP growth was 2.2% in the first and 2.7% in the second quarter (the fastest in the past five years). As regards GDP components, investments increased most rapidly (3.7% in the first and 4.6% in the second quarter). The contribution of other components (private consumption, general government and net exports) was also positive. In the third quarter, the annual growth of industrial production accelerated to its highest level since the past six and a half years (5.4%) and also the annual retail sales growth was the greatest of the past 12 months (2.4%) in August.

Mainly owing to the oil price increase, the annual growth of euro area consumer prices stayed at 2.5% level from April to June, but decreased to 1.7% in September after the oil price declined. Core inflation remained stable throughout that period, ranging within 1.3–1.5%. Unemployment declined even further during the first three quarters of 2006, reaching its lowest level since decades in July (7.8%). The euro area current account was negative in the first and second quarter, amounting to 0.8% and 0.7% of GDP, respectively.

Due to higher economic activity and inflation, the euro area key interest rate kept increasing. From July to September, the European Central Bank (ECB) raised the key interest rate on two occasions up to 3.0%. According to market expectations, the raising of key interest rates in the euro area should continue at least over the next half-year[3].

Nordic countries

Finland's gross domestic product growth reached 5.9% in the first half of 2006. According to the forecast of the Finnish central bank, the year-on-year growth of 2006 will reach 3.4%. The rapid growth witnessed in the first half-year was partly influenced by the low comparison basis with last year's summer, when the paper industry conducted a massive strike. As a result, the growth of manufacturing also reached nearly 10% in the first half-year. What is remarkable, however, is the export growth in the first half-year: it exceeded 12% and the year-on-year growth is expected to amount to 7%. Private consumption and investments have also increased dynamically. Despite strong economic growth, inflation has not accelerated considerably. The Harmonised Index of Consumer Prices (HICP) stood at 1.3% in August. Inflation was mainly affected by the fuel price rise but also by the increase in housing costs and food prices. At the same time, entertainment electronics and phone call prices dropped.

Sweden's gross domestic product growth stood at 5.5% in the first and 3.5% in the second quarter. In the first quarter, economic growth was boosted by a dynamic increase in exports as well as investments (14% and 12%, respectively). In the second quarter, private consumption grew considerably, whereas export growth decelerated sharply (growth amounted to only 6.6%, year-on-year). Unemployment has decreased remarkably. In the second quarter, inflation accelerated to 1.9% but has been slowing down again since the third quarter. HICP reached 1.6% in August. Similarly to Finland, inflation in Sweden is also mainly affected by fuel and energy prices and housing costs. This year, the Swedish central bank has raised the key interest

[3] At the beginning of October, the ECB raised the key interest rate again, namely to 3.25%.

rate by 0.25 basis points on four occasions, i.e. to 2.5%.

Central and Eastern European countries

Latvian economic growth has been extremely fast, exceeding 10% since the second quarter of last year. In the first half of 2006, growth amounted to 12% and was mostly influenced by strong private consumption, but also by the rapid development of the construction and real estate sectors. The growth of manufacturing and exports has slowed down slightly. The latter has brought about a growing foreign trade deficit and a record high current account deficit, which reached 17.9% in the second quarter. Unemployment has decreased to 7.2% (8.1% in the second quarter of 2005). Inflation remained at 7% level in the first half-year. This resulted from the increase in fuel prices, housing costs and food prices. In August, HICP stood at 6.8%, being higher year-on-year.

Economic growth in **Lithuania** has remained relatively stable at 8.5% level since the second quarter of 2005. Unlike Latvia, manufacturing in Lithuania experienced strong growth in the first half-year, amounting to 10–15%. Export and import growth has also been very dynamic. The external balance deteriorated in the first half of 2006, year-on-year. Unemployment, which stood at 8.5% in the second quarter of 2005, decreased rapidly to 5.6% by the second quarter of this year. HICP growth picked up speed in the second quarter and exceeded 3% in July and August (3.2% and 3.4%, respectively).

The economic outlook of the **Czech Republic** for 2006 still remains positive. According to forecasts, in 2006 the gross domestic product should increase 6%, year-on-year. After reaching 7.1% in the first quarter (the highest since 1995), economic growth slowed down again to 6.2% in the second quarter. Growth was mainly driven by the industrial sector (annual growth amounted to 11.9% in the first half-year), exports and household consumption. Inflation has remained close to the goal of 3% set by the central bank. HICP increased 2.3% in June. In the first half-year, the external trade surplus shrunk to 1.3 billion euros (1.4 billion in 2005). The year-on-year export and import growth amounted to 12.9% and 13.8%, respectively.

The **Polish** gross domestic product increased 5.2% within the first six months of the year (3.2% in 2005). The total economic growth of 2006 is expected to reach up to 5.5% underpinned by the increase in private consumption and investments. Inflation in Poland is accelerating but still remains low: the consumer price growth of 0.6% in January accelerated to 1.1% in July. HICP reached 1.5% in June. In the first half-year, the foreign trade deficit amounted to a total of 4.4 million euros. Year-on-year, exports and imports have grown 23.1% and 20.8%, respectively.

In **Hungary**, the year-on-year economic growth slowed down to 3.8% in the second quarter; the first half-year's growth amounted to 4.2%. The main growth factors included the strong industrial sector (the first half-year's growth reached 10%) and exports. The overall economic growth of 2006 is estimated at 3.9%. Within the first six months, inflation accelerated to 2.8% mainly because of higher food and fuel prices. HICP growth reached 2.9% in June. The total foreign trade deficit of the first half-year stood at 1.1 billion euros. Within the same timeframe, the year-on-year increase in exports and imports reached 16% and 15%, respectively. The excessive budget deficit remains the greatest challenge for the country. This year, it will amount to almost 10% of GDP, whereas by 2009 the government plans to reduce it to 3.2%.

Economic growth in **Slovakia** remained robust also at the beginning of 2006. In the first quarter, growth reached 6.3% and accelerated to 6.7% in the second quarter. The overall half-year growth was 6.5%. Its rapid pace was stimulated by domestic as well as external demand, but also by industrial production (which increased 9.3% within six months).

During the first six months, the foreign trade deficit increased to 1.2 billion euros. The year-on-year growth in exports and imports amounted to 23.1% and 24.5%, respectively. Inflation has accelerated by an average of 4.5% within the first six months of the year. HICP also reached 4.5% in June.

Russia

The economic outlook for **Russia** continues to be good. Year-on-year, the gross domestic product increased 5.5% and 7.4% in the first and second quarter, respectively. This partly resulted from the growing services sector and the price rise of the country's key export article, namely crude oil. The economic growth of the first half-year amounted to a total of 6.3%. The industrial sector has also remained strong, having grown 4.4% in the first half-year. Within the first six months of 2006, household income has increased 11.1% and wages 12.1%. Due to the revenues from the exports of oil and minerals, the real exchange rate of the rouble appreciated by 6.6% by June. As inflation slowed down in June, the central bank reduced the key interest rate to 11.5%. The increase in consumer prices reached 6.6% in the first half-year.

Table 2.2. Key economic indicators of Central and Eastern European countries and Russia

	2005	2006*	2007*
Real GDP growth			
Finland	3.3	3.2	3.4
Sweden	2.9	2.5	2.5
Latvia	10.2	11.0	9.0
Lithuania	7.5	6.8	6.5
Poland	3.4	4.9	4.5
Czech Republic	6.1	6.0	4.7
Hungary	4.1	4.5	3.5
Slovakia	6.1	6.4	7.0
Russia	6.4	6.5	6.2
Inflation			
Finland	0.8	1.1	1.3
Sweden	0.8	1.5	1.8
Latvia	6.8	6.6	6.3
Lithuania	2.7	3.6	3.3
Poland	2.1	0.8	2.0
Czech Republic	1.8	2.9	3.3
Hungary	3.6	3.5	5.8
Slovakia	2.7	4.5	3.3
Russia	12.6	9.6	8.5

*IMF forecast
Source: IMF World Economic Outlook, August 2006

International financial and commodity markets

In **foreign exchange markets**, the US dollar depreciated against most major currencies in the given period, with the exception of the Japanese yen (see Table 2.3). The euro appreciated against the dollar by 4.6% and the pound sterling by 7.8%. The dollar depreciated largely as a result of the slowdown in the US economic growth and the entailing decrease in the interest rate spread. The exchange rate of the yen also appreciated in April and May, but altogether changed very little. The underlying reason for the yen's relatively weak result was still Japan's low key interest rate, which is why the yen continued to be used as a loan currency.

Table 2.3. Changes in the exchange rates of major currencies

	31/03/2006	30/09/2006	Change (%)
USD/JPY	117.78	118.18	0.3
EUR/USD	1.2118	1.2674	4.6
GBP/USD	1.7372	1.8723	7.8

In major **stock markets**, the most significant event was the extensive sales pressure in May and June, which is why stock prices decreased considerably. This was affected by the rise in monetary policy interest rates in advanced economies, complemented by the prospect of the US growth slowing down and the threat arising from inflationary pressures that the US Federal Reserve might raise the key interest rate more than expected. From the middle of June, stock prices started rising again and in some regions reached their previous levels by the third quarter. Thus, the ultimate result of the two quarters was different: the US S&P 500 index rose by 3.2%

and the FTSE Eurobloc 300 index by 1.5% in the given period, whereas the Nasdaq Composite Index decreased 3.5% and Japan's Nikkei 225 index 5.5% (see Table 2.4).

Table 2.4. Major stock market indices

	31/03/2006	30/09/2006	Change (%)
USA (S&P 500)	1,294.83	1,335.85	3.2
USA (Nasdaq)	2,258.43	2,339.79	-3.5
Japan (Nikkei 225)	16,127.58	17,059.66	-5.5
Euro area (FTSE Eurobloc 300)	1,508.1	1,486.26	1.5

Bond market development was supported by relatively high economic activity, though a slight slowdown could also be denoted (primarily in the United States). Therefore, major central banks tightened their monetary policy even further. Key interest rates were raised twice by the central banks of the United States, euro area, Canada, Australia, Sweden and Norway (by 25 basis points on both occasions). The Bank of England and the Japanese central bank raised key interest rates once. This step taken by the Japanese central bank also meant abandoning the former zero interest rate policy, as the long-term deflation period reached its end. Thus, short-term interest rates increased in all G3 countries (in the US by 27, in the euro area by 65 and in Japan by 27 basis points; see Table 2.5). Long-term interest rates rose from April to July but started to shrink then because of the combined effects of decreasing inflationary risks and decelerating economic growth. In conclusion, their increase in G3 markets remained relatively small (6–10 basis points).

Prices in **commodity markets** fluctuated up and down. At the beginning of the period, the upward trend of the oil price remained in the limelight, while the price of gold also rose. The latter peaked in the middle of May, whereas the oil price reached its highest level in August. Later, however, the upward trend turned. All in all, price rise prevailed: the CRB index reflecting the prices of 22 major raw materials rose by 10%, oil by 5.6% and gold by 2.5% (see Table 2.6). The stabilisation of raw material prices (mainly oil and gold) was supported by the outlook for a slowdown in global economic growth, which reduced the demand for raw materials. The price drop was also fostered by the decrease in speculative purchases that had been stimulated by the earlier upward trend.

Table 2.5. Changes in yields in major bond markets

	3-month interest rates			10-year interest rates		
	31/03/2006	30/09/2006	Change (basis points)	31/03/2006	30/09/2006	Change (basis points)
USA	4.61	4.88	27	4.85	4.76	-13
Japan	0.09	0.35	26	1.78	1.68	-10
Euro area	2.72	3.36	65	3.77	3.71	-6

Table 2.6. Changes in commodity markets

	31/03/2006	30/09/2006	Change (%)
CRB index	312.98	344.71	10.1
Crude oil (WTI; USD/barrel)	62.91	66.63	5.6
Gold (USD/ounce)	598.3	598.30	2.5

ESTONIAN ECONOMY

Estonia's economy continued growing fast in the first half of 2006. According to preliminary data, real GDP growth amounted to 11.7%.

Further rapid economic development did not, however, entail an improvement in the external or internal balance, i.e. the current account deficit did not decrease, nor did the inflation rate slow down.

Compared to the first months of the year, economic growth remained slightly more balanced in the second quarter and the difference between the growth rates of domestic demand and GDP shrunk both in nominal as well as real terms. Unfortunately, this was primarily a seasonal adjustment and compared to last year, only government savings increased notably.

Domestic demand

In the first half of 2006, domestic demand grew faster at constant prices than the economy as a whole. Private consumption increased most intensely, whereas growth in the general government final consumption expenditure picked up only slightly and the growth rate of investments even remained slow in view of last year's acceleration (see Figure 2.1).

Several indicators show that the growth of domestic demand remained fast also in the initial months of the third quarter. This development was stimulated by the persistently strong confidence of residents and the rapid increase in income. Investment activity remained high and the estimates of manufacturing, retail trade and construction companies on the economic situation once again improved. As usual, also general government expenditure started rising faster in autumn.

Investment

Investment activity remained high in the first half of 2006. For instance in the second quarter, investments together with stock building comprised 36.7% of the nominal GDP. Considering the aforementioned decrease in the real investment growth, it can be concluded that investments appreciated significantly. This also explains why the deceleration of real growth did not entail an improvement in the external balance. The main contributors to fixed investment growth were still private companies.

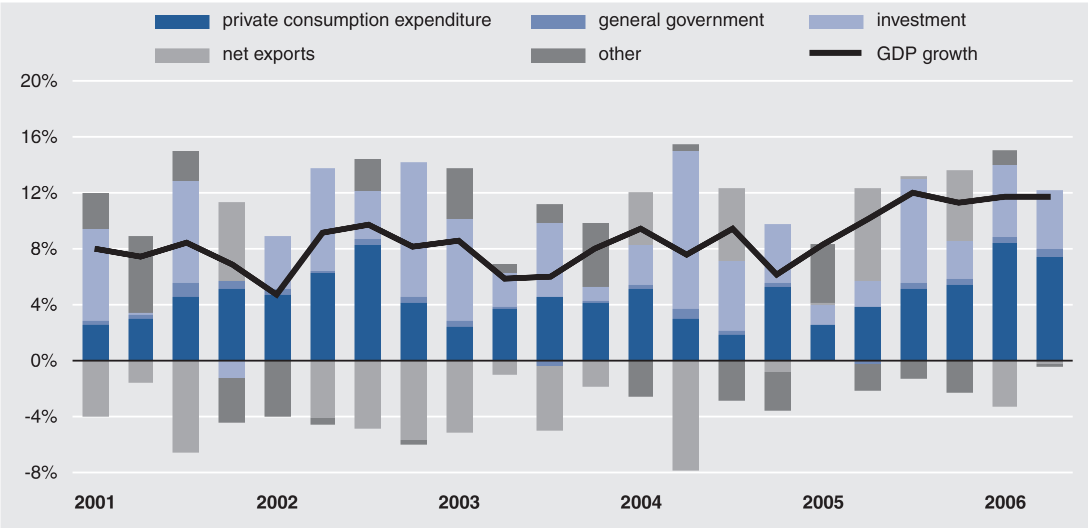

Figure 2.1. Real GDP growth and its components

According to the statistics of major enterprises, which does not include all companies, investment activity varied by fields of activity. The growth rates of manufacturing, trade, hotels and restaurants decreased, whereas the growth of investments in the areas of energy, gas and water supply as well as transport, storage and communications picked up. Residential construction projects remained popular investment targets, and their share in the capital investment structure increased at the previous pace. Also the general government made large capital investments, some of which were financed by foreign funding.

Private consumption

In the first half of 2006, the real growth of private consumption was faster than in earlier years and also exceeded GDP's growth rate. In the second quarter, the volume of private consumption increased 14.6% at constant prices compared to last year.

Besides the robust increase in bank loans, the growth of private consumption was also fostered by extremely rapid wage growth, faster employment growth, one-off additional pension increases and curbed income tax rates. Although in the second quarter, wages and employment increased slightly less than in the first quarter, the extent and persistence of growth may have influenced the behaviour of economic agents even more than earlier.

The third quarter probably witnessed the continuation of similar developments. According to the Estonian Institute of Economic Research, in September 2006 the consumer confidence indicator was 19 points higher, year-on-year. Increased wage expectations were confirmed both in the course of budget negotiations as well as by the demands of trade unions and statements of politicians. In July and August, the retail sales growth rate remained close to the level of the second quarter (23.3% at current prices, 18.4% at constant prices), which also refers to further rapid growth of private consumption. Moreover, also foreign trade data confirmed the persistence of strong domestic demand.

General government

The extremely strong economic growth also guaranteed the rapid growth of general government revenue and the collection of most taxes exceeded expectations. By the end of September, the State Treasury had collected more than 80% of the revenues for the central government budget. Compared to the first nine months of the previous year, the revenues grew by an average of 18.4% and exceeded expenditure by 5.7 billion kroons.

In September, the Government approved the draft supplementary budget of 2006 with revenue amounting to 5.519 and expenditure to 3.216 billion kroons. The Government decided to channel the surplus into the pension fund. According to conservative forecasts, the general government surplus will amount to 1.7% of GDP, year-on-year (see Figure 2.2).

At the end of September, the Government also prepared the draft state budget for the next year. A goal was set to achieve at least a 0.5% surplus of GDP. Although such a great surplus has never been attempted before, the goal is not too ambitious in view of the business cycle.

Although the general government continued reducing the income tax rate from 24% to 23% as planned, the overall tax burden remained at the earlier level of 31% of GDP.[4]

[4] See background information "Overall tax burden stable despite the income tax reform" on page 22.

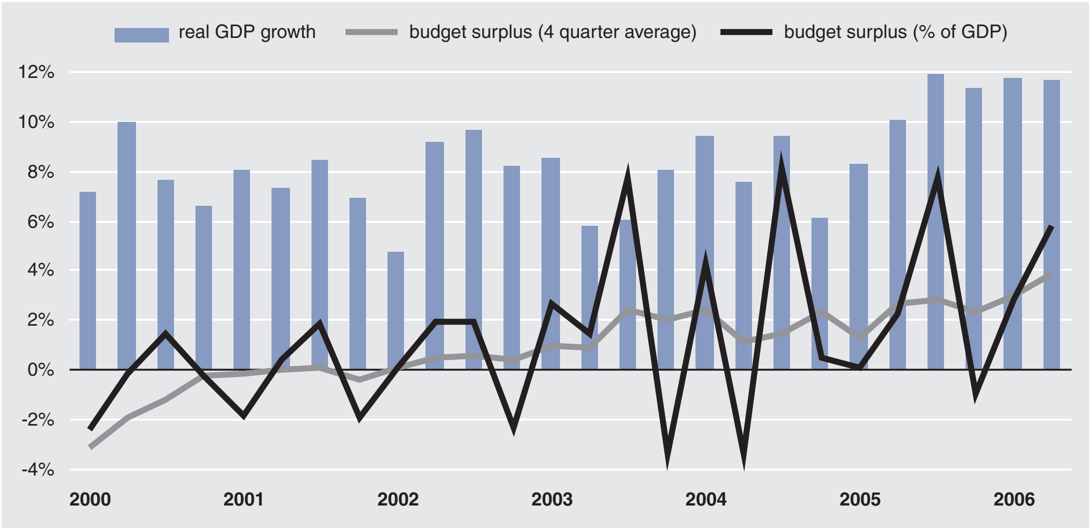

Figure 2.2. Real GDP growth and consolidated budget balance (% of GDP)

Domestic supply

Industrial development

During the past year and a half, external demand has been the primary stimulus for the Estonian economic growth. Compared to the imports of Estonia's main trading partners, export growth was extremely fast and reached over 24% at current prices and 17% at constant prices in the second quarter. This means that the market position of Estonian companies improved even further.

Thanks to the favourable economic situation, the rapid sales growth of the export sector as well as manufacturing companies targeting the domestic market continued in the second quarter (see Figure 2.3).

Based on GDP statistics, in the first half-year the growth of value added in manufacturing amounted to 14% at constant prices (see Table 2.7).

In the second quarter, sales in manufacturing grew more dynamically owing to the increased sales to the domestic market, which accelerated from 11.9% in the first quarter to 15.2%. Growth was largely driven by higher sales of food, timber and clothing as well as construction materials and electrical machinery.

According to preliminary estimates, industrial production continued rapid growth in the third quarter: the confidence of manufacturing companies remained strong in September and exceeded the year-ago indicator by 8 points. At the same time, estimates concerning the volume of export orders improved compared to last year and previous month. Companies were also very satisfied with orders in the domestic market. Lack of qualified labour force and inflation were again highlighted as the main problems. According to the Estonian Institute of Economic Research, the utilisation rate of production capacity remained high, i.e. approximately at the level of 80%, and the investment needs of companies remained great.

Services and other sectors

The environment continued to be excellent for the construction market. According to the Statistical Office, in the second quarter of 2006 construction companies built 34% more in Estonia and foreign

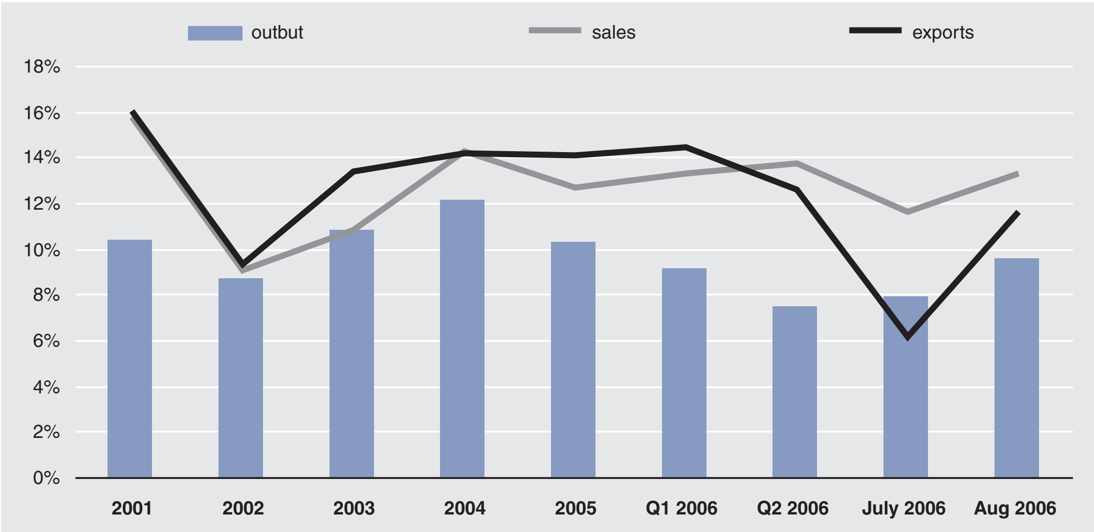

Figure 2.3. Growth in the output, sales and exports of manufacturing

Table 2.7. GDP growth by sectors (%)

	2003	2004	2005	2006 (I h/y)
Agriculture, forestry and hunting	1.1	-7.1	2.4	-14.2
Fishery	-5.2	-8.4	0.5	10.3
Mining and quarrying	13.5	-4.9	6.3	9.7
Manufacturing	7.0	11.5	12.6	13.9
Electricity, gas and water supply	12.9	0.9	7.0	13.4
Construction	2.7	7.1	19.8	19.2
Wholesale and retail trade	14.3	7.8	16.0	10.5
Hotels and restaurants	4.2	16.3	23.6	11.2
Transport, storage and communications	9.6	12.5	7.7	8.9
Real estate, renting and business activities	4.0	5.6	8.8	14.7
Financial intermediation	18.9	22.6	25.2	23.6
Public administration and defence; statutory social insurance	4.7	1.1	2.3	2.5
Education	-0.9	0.9	0.9	4.6
Health and social care	-0.6	4.2	6.5	6.6
Other services	1.6	5.5	5.7	6.5
Total GDP	**7.1**	**8.1**	**10.5**	**11.7**

countries than last year. Such brisk growth in construction was last seen in the first and second quarter of 1998. Measured by value added, growth in the construction accelerated to 22%, while building costs rose by 8.4%.

Demand for new dwellings persists: in the second quarter, permits were issued for building more than 4,000 residential spaces. Apartments continue to be the most popular type of dwelling. According to the Estonian Institute of Economic Research, contracts concluded in the second quarter of 2006 guaranteed work for 5.7 months (4.2 months in the second quarter of 2005). According to construction companies, 88% of the production capacity was utilised, which is the highest level of spring periods throughout 12 years of monitoring. The lack of qualified labour force was again emphasised as a restrictive factor, whereas the problem seems to be aggravating: while in June 2005, 67% of construction companies identified it as a problem, this year 77% did so.

In the second quarter, the increase in the number of real estate transactions slowed down rather than accelerated, but year-on-year, the price rise is still fast. According to the Statistical Office, the total number of purchase-and-sale transactions increased merely 7%, whereas their total value grew by 75% and value added by 16%.

Economic growth was well supported also by financial intermediation and trading companies, where the value added reached 23.4% and 11.7% at constant prices, respectively (see Table 2.6). The prompt development of these companies was fostered by increasing household incomes and active borrowing as well as by the rising number of foreign tourists.

Employment

The rapid growth of domestic demand and investment activity reflected also in the labour market. Demand for labour force increased the most in the fields of activity targeting domestic demand, including construction and trade. With the creation of new jobs, all major labour market indicators improved (see Figure 2.4).

In the second quarter of 2006, the number of the employed reached its highest level since 12 years, i.e. 650,000, having increased 6.7% year-on-year. The greatest contributor was the construction sector, where the number of employees rose by 36.1%. Employment in the construction sector climbed significantly (19%) also in the first quarter. This may partly stem from the growing number of people finding employment abroad. Similarly to the first quarter, employment growth thrived in wholesale and retail trade (by 11.8%) as well as in transport, storage and communications (by 22.1%).

All in all, the share of the services sector in employment growth increased further. In agriculture, employment continued decreasing slowly and also manufacturing companies employed 5.3% less than a year ago.

Employment improved in nearly all regions. Compared to the first quarter, the share of Harju County

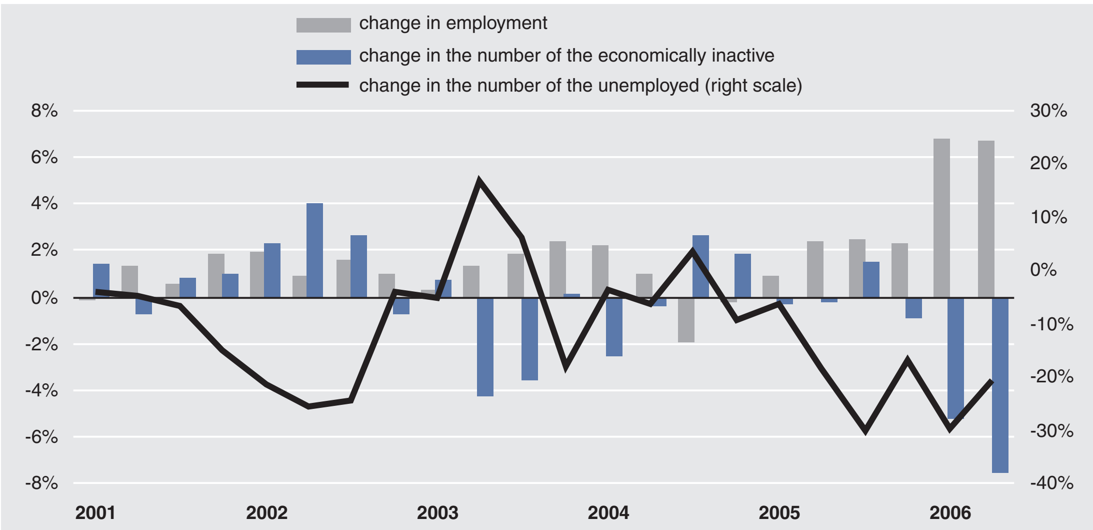

Figure 2.4. Key labour market indicators

(excluding Tallinn) and Southern Estonia in the growth increased.

Along with the swift rise in employment compared to the previous year, the labour participation rate improved as well and unemployment decreased. By the end of the first half-year, unemployment had shrunk to 6.2%. According to the International Monetary Fund, full employment has been achieved and thus no further significant decrease in unemployment is to be expected. The number of the registered unemployed also continued declining rapidly: as at October 1, the number of the registered unemployed amounted to 12,669, which is 45% less than a year ago.

The labour participation rate of persons aged 15 to 74 increased to 66% from 62.2% in the previous year. This resulted mainly from the higher activity of the elderly and the decrease in the number of the discouraged.

External balance

The external balance slowly deteriorated even further in the first half of 2006 owing to strong domestic demand. In the second quarter, the current account deficit amounted to approximately 12% of the quarter's GDP. Meanwhile, the deficit in the goods and services account increased from 6.5% in the second quarter of 2005 to 8.2%.[5]

Capital inflow again mainly consisted of cash flows channelled through banks. Deposits by parent banks and loans from parent companies prevailed.

As for direct investment, cash flows channelled through banks dominated again. The second quarter witnessed an extremely fast growth in direct investment made abroad. This arose from banks increasing the equity capital of their foreign subsidiaries. In conclusion, the inflow of direct investment in Estonia remained close to its long-term average. By the end of the first half of 2006, the volume of

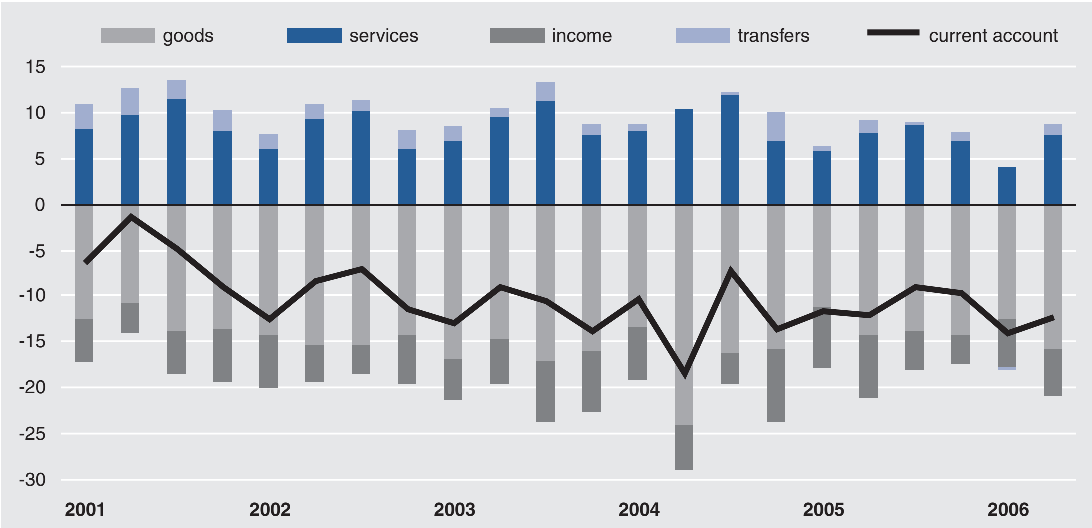

Figure 2.5. Balance of current account and its components (% of GDP)

[5] GDP data do not confirm such a remarkable increase in imbalance. Unfortunately, due to the preliminary nature of estimates it is impossible to completely align data on domestic demand and external trade. See also background information "Adjustment of the time-series of gross domestic product and national accounts" on page 8.

direct investment in Estonia had increased up to 95% of GDP.

The deficit on portfolio investment in the second quarter was quite unusual. However, this was not related to the decreasing confidence of foreign investors but reflected the increased savings stemming from brisk economic growth and Estonian investors' risk-sharing need. Foreign investment in Estonia remained at the usual level, as the number of Estonian stock market companies is small and no significant bond issues occurred either in the second quarter.

Estonia's gross external debt reached 91% of GDP at the end of the first half of 2006. The gross external debt grew mainly owing to the increase in the long-term liabilities of credit institutions. The external debt of credit institutions accounted for 56% and that of other sectors for 24% of the gross external debt. The net external debt (assets less liabilities) increased at a slower pace, amounting to 22% of GDP.

OVERALL TAX BURDEN STABLE DESPITE THE INCOME TAX REFORM

Throughout the period of regained independence in 1991, the Estonian Government has been trying to keep the overall tax burden as low as possible. While in 1995 the tax burden stood at 37%, by now it has decreased to 31% of GDP. At the same time, a clear trend of attempting to tax consumption rather than income can be perceived. Namely, decreasing the overall tax burden has derived from the reduction of personal and corporate income taxes (see Figure a).

As of 1994, an equal income tax rate of 26% was applied to both private persons as well as corporations. Later on, the income tax system has been vigorously reformed twice. In 2000, the procedure of imposing taxes only on dividends paid on corporate profit entered into force.[1] In 2005, the Government started to curb the personal and corporate income tax statutory rate, aiming to reduce it to 20% within three years.

In order to ensure budget balance, the new government coalition that came to office in 2005 prolonged the period of reducing the income tax rate until 2009, but the goal remained unchanged and by 2006, for instance, the statutory income tax rate had shrunk to 23%. The general tax rate virtually experienced no decrease because the Government has increased taxes on consumption.

On the one hand, this stems from the need to bring excise duties on fuel and tobacco products to the EU minimum level by 2010, as foreseen in the state budget strategy for 2007–2010. Pursuant to this goal, the excise duty rates on tobacco products were raised in 2005. In addition, the same year excise duties on alcohol were increased as well. The increase in revenue from consumption taxes in 2005–2006 has also been supported by strong domestic demand. Therefore, the overall tax burden has actually remained at the level prior to tax reductions, i.e. at the level of 2004 (see Figure a).

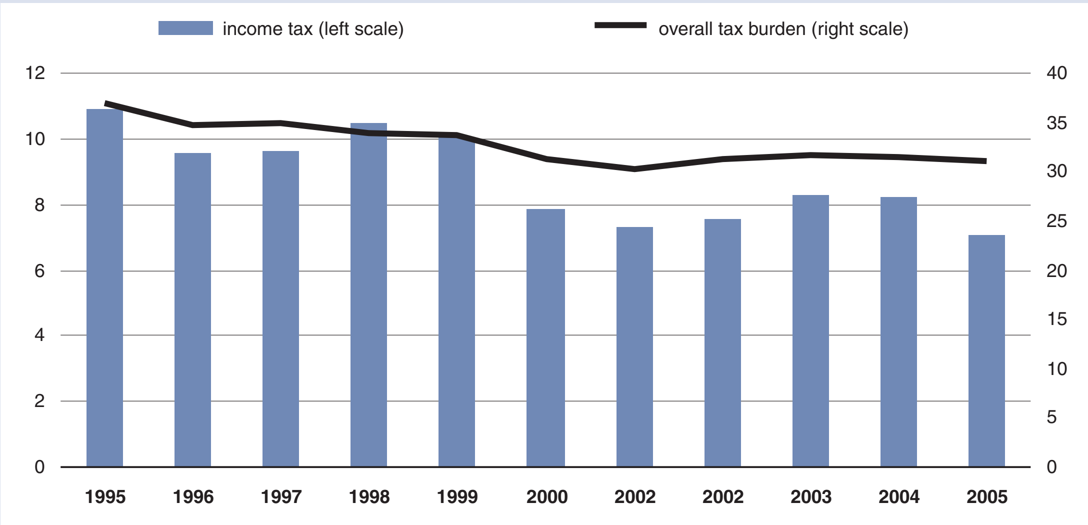

Figure a. Overall tax burden and collection of personal and corporate income tax during 1995–2005 (% of GDP)

[1] The fact that retained earnings are not subject to taxes has sometimes been associated with a complete absence of corporate income taxes. In reality, this is but a postponement of taxation.

Although this has not been an end in itself, Estonia is one of the three or four countries with the lowest tax burden in Europe. Reducing taxes has always been associated with the Government's ability to control the increase in expenses. The general government budget balance has not deteriorated due to the decrease in the income tax rate either; on the contrary, the surplus even exceeds the level prior to reducing income taxes (see Figure b).

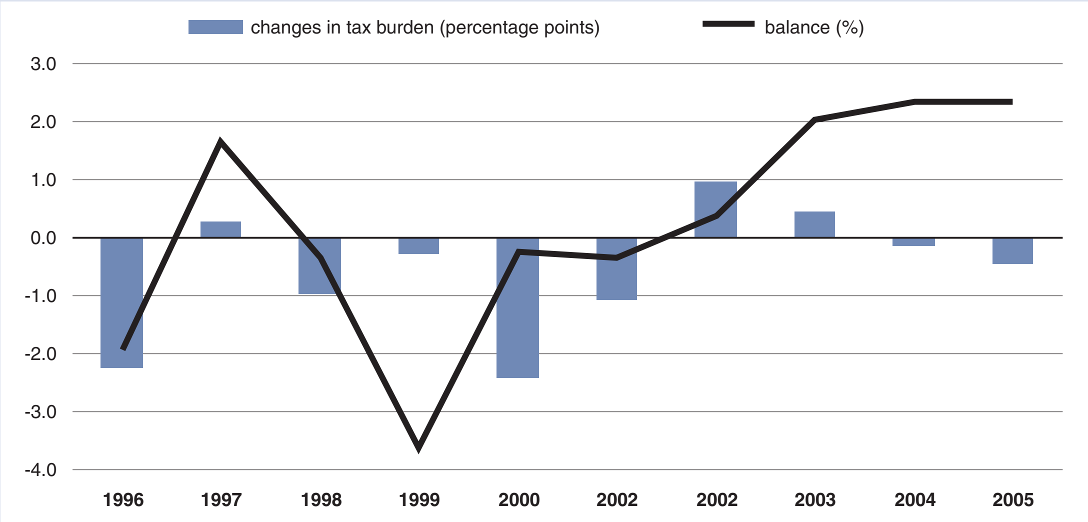

Figure b. Consolidated budget balance and changes in the overall tax burden during 1996–2005 (% of GDP)

III INFLATION

Consumer price index

Contrary to expectations, the decrease in consumer price inflation that occurred in the final months of the previous year ended in 2006.

Already in the first months of this year, inflation exceeded 4% again and remained in the range of 4.5% until the end of the summer. According to the Statistical Office, in the second and third quarter consumer prices rose just as much as in the first quarter, i.e. by 4.4% (see Figure 3.1). Therefore, a nearly 2 percentage point difference with the respective euro area indicator persisted.

By months, the inflation rate proved to be rather different, remaining in the range of 3.8–5.0% from January to October. The underlying reason for such instability was the oil price volatility in the global market. Although the share of motor fuel in the consumer price index (CPI) did not decline year-on-year and high fuel prices prevented the inflation from dropping until September, inflation started to be increasingly affected by core inflation pressures. The persistence of inflation gradually began to reflect the rapid economic and wage growth more explicitly.

The Estonian core inflation accelerated from less than 3.0% at the beginning of the year to 3.2% in the second quarter and stood at 3.7% in July and August. Inflation picked up mainly owing to the larger than usual increase in housing costs: both the prices of construction materials as well as rental and repair services rose faster (see Figure 3.2).

In addition to the aforementioned goods, inflation was also substantially influenced by the increase in expenses related to leisure activities and the accelerating price growth of clothing and footwear. Moreover, the growth of food prices accelerated (up to 3.5% in the second quarter and 6.1% in the third quarter), generally adhering to prevalent trends in the euro area, but exceeding the price rise in the euro area by 2 percentage points (see Figure 3.3). As this summer's weather was unfavourable for agriculture and horticulture, the seasonal price decline of food at the end of the summer also remained minimal.

Fast price dynamics were also supported by import price pressures that affect several goods groups. In July, the inflation of import and producer prices reached nearly 5%, also exerting pressure on the consumer price inflation.

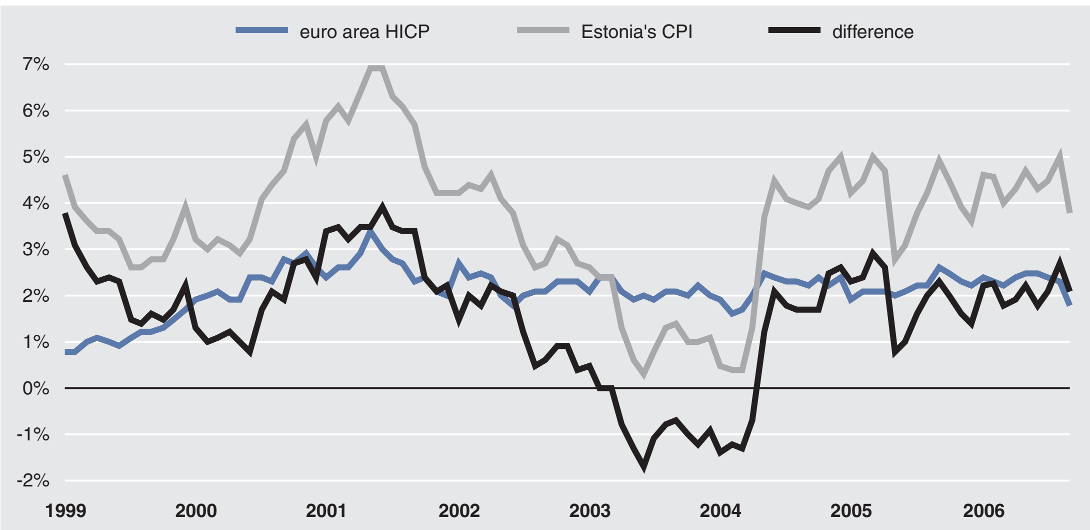

Figure 3.1. Annual growth in consumer prices in Estonia and in the euro area

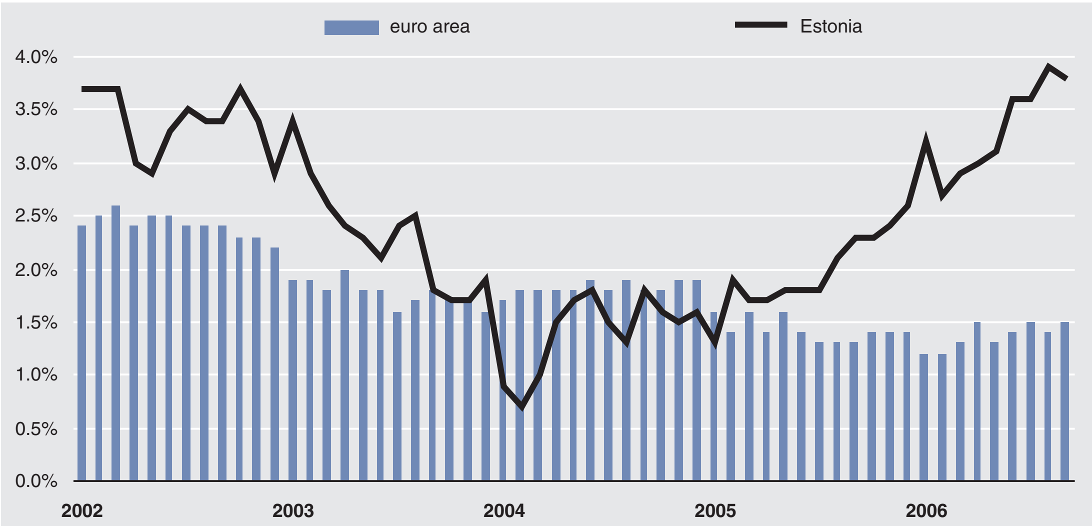

Figure 3.2. Core consumer price inflation (all components, except food, alcohol, tobacco and energy)

Source: Eurostat

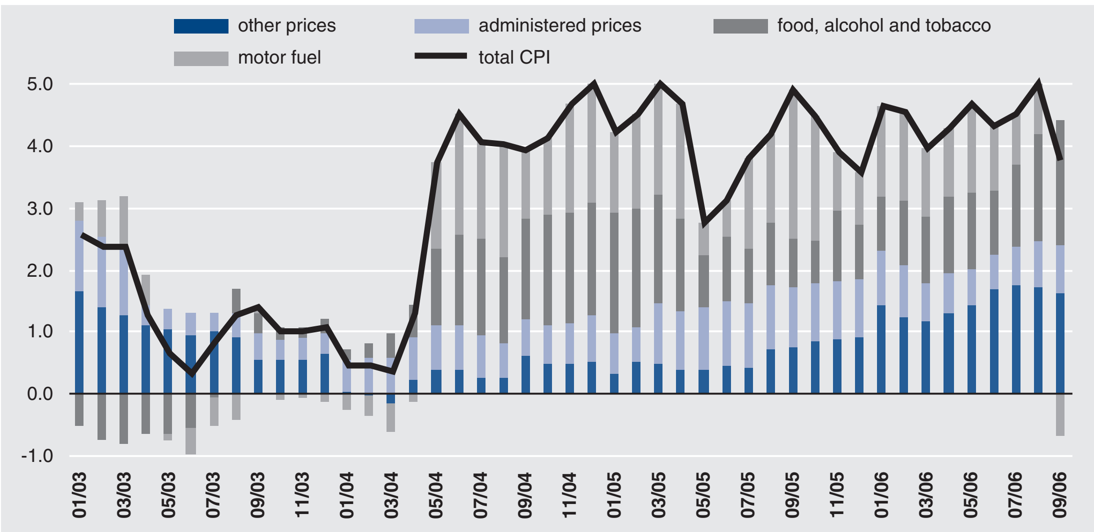

Figure 3.3. Contributions of various goods and services to CPI growth (percentage points)

Labour costs

In 2006, labour costs also increased faster than expected. Average gross monthly wages rose by 15.7% in the first and by 15.0% in the second quarter of 2006. Meanwhile, the growth of gross hourly wages excluding holiday pays and benefits amounted to 17%. Wages rose by 43.4% in fishery, which has a small share in the overall employment; however, the significance of increasing wages was far greater in the fields of wholesale and retail trade (21.7%), hotels and restaurants (15.8%) and manufacturing (15.6%), namely in areas with a greater number of employees. Wages continued growing rapidly also in agriculture – by 22.5%.

By economic sectors and ownership, this time wage growth remained relatively homogeneous. In companies belonging to Estonian private persons, the average gross monthly wage growth was only 2.7 percentage points faster than in companies owned by foreign private persons. Wage growth in the public sector remained in the range of 12–13%. The ongoing reduction of the personal income tax rate did not cause a slowdown in wage growth owing to the increasing demand for labour force. Tax changes brought along a nearly 1 percentage point decrease in the real effective personal income tax rate. Therefore, the growth rate of average net wages accelerated to an estimated 17%.

Given the inflation rate of 4.4%, the real growth of average gross wages picked up to 10–11% in the first half-year. This can be regarded as the highest indicator of the past years, as in 1997, for instance, real wage growth remained below 10%, although GDP growth exceeded 11%.

In the economy as a whole, the real growth of labour productivity remained in line with real wage growth. The share of the wage fund in GDP (i.e. real unit labour costs) decreased further in the first half of 2006. This occurred despite faster employment and wage increase (see Figure 3.4). Nevertheless, in some fields of activity, for instance in manufacturing, wage growth even picked up alarmingly.

Real exchange rate of the kroon

In the first half of 2006, the Estonian inflation rate was higher than the euro area average. Although Estonia's inflation was 0.9 percentage points higher

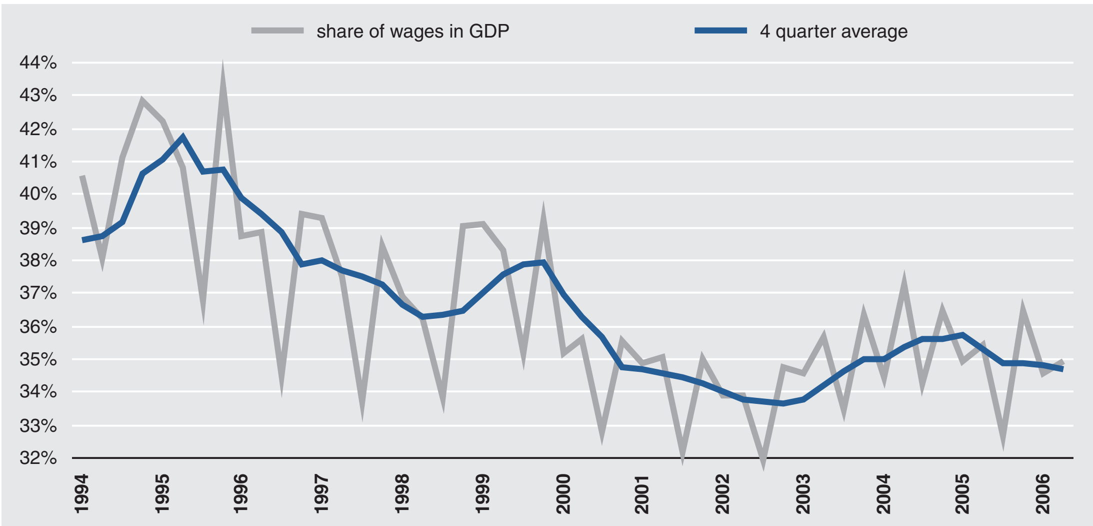

Figure 3.4. Share of wage costs in GDP structure

compared to the weighted average inflation rate of our trade partners, the real exchange rate of the Estonian kroon appreciated against the currencies of major foreign trade partners merely by 0.2%, year-on-year (see Figure 3.5).

Though the Estonian kroon has appreciated against the US dollar since the beginning of 2006, the kroon exchange rate did not reach the year-ago level. Year-on-year, the nominal exchange rate of the Estonian kroon depreciated altogether by 0.7%, mainly owing to changes in the exchange rates of the euro and the US dollar. The depreciation of the kroon's nominal exchange rate may in turn have fostered the relatively fast and persistent price rise.

In 2006, the real exchange rate of the Estonian kroon appreciated against the currencies of advanced economies as much as last year and ranged within 3.0–3.5% in most months. This indicates the ongoing price convergence, as according to estimates, the average price level of Estonia does not even exceed 60% of the average price level of old EU Member States (with the exception of a few goods groups).[1]

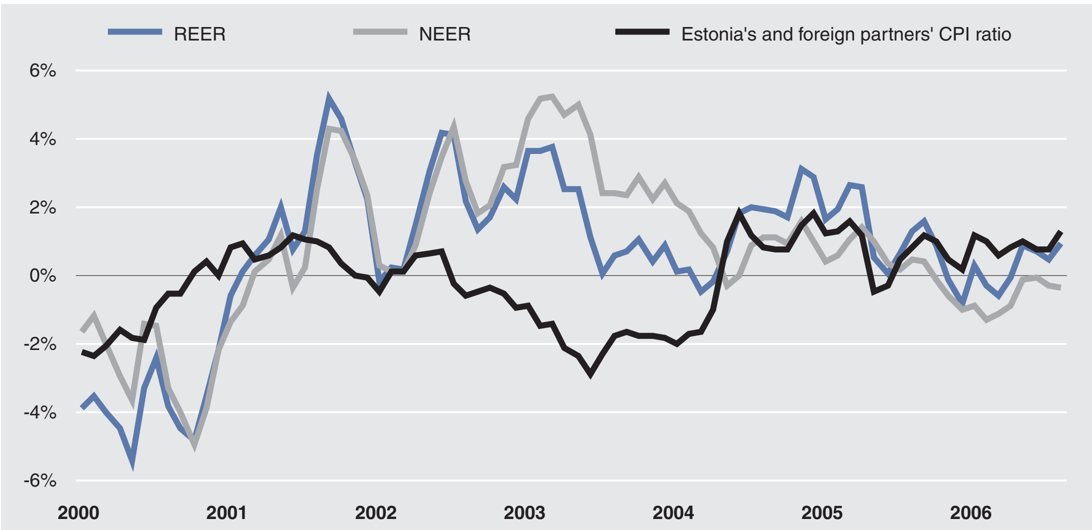

Figure 3.5. Change in the real (REER) and nominal (NEER) exchange rate of the Estonian kroon

[1] See also background information "Prices in the Estonian construction sector closest to the EU-15 average" on page 28.

PRICES IN THE ESTONIAN CONSTRUCTION SECTOR CLOSEST TO THE EU-15 AVERAGE

The convergence of income levels inevitably leads to price convergence. The process starts up with the convergence of prices of goods exposed to international competition and is expected to end with the levelling off of the prices of personal services.

Over the last few years, Estonia has stood out for the price hike in the construction sector. According to the Statistical Office of Estonia, residential construction prices have risen by 40–45% during 1999–2006, whereas prices of goods have increased about 20%. Consequently, the prices of construction have converged most rapidly, having also raised the general price level of investment (see Table a).

Comparing the price levels in Estonia and in the old EU Member States (EU-15), it appears that construction prices in Estonia have picked up with the prices in the old Member States the most. The data on construction presented in Table a also include road construction, sports grounds and other structures. The harmonisation of construction prices in Estonia has probably been facilitated by the larger share of residential construction in total investment. Apart from the comparison of price levels, also other indicators confirm the rapid rise in the relative prices of construction, for example the ratio and dynamics of price per square metre of a dwelling to average wages.

Table a. Comparison of price levels in new EU Member States with the average of old EU Member States (%)

	GDP	Private consumption	Investment in machinery	Construction
EU-15	100.0	100.0	100.0	100.0
Sweden	112.7	115.8	96.8	136.0
Finland	107.6	116.5	105.2	76.2
Malta	65.0	67.3	98.6	49.6
Estonia	54.9	52.4	92.9	63.3
Cyprus	86.9	88.6	106.8	61.4
Lithuania	46.4	44.7	86.8	52.8
Latvia	47.5	47.0	85.2	52.8
Poland	46.1	45.2	84.7	41.0
Slovakia	50.1	47.1	94.7	53.4
Slovenia	69.8	70.2	90.9	54.3
Czech Republic	51.0	48.6	88.1	46.7
Hungary	56.3	53.9	90.4	59.7

Source: Eurostat, 2004

IV MONETARY AND FINANCIAL SECTOR

Liquidity environment and domestic financial markets

Since September 2005 when quotations on the euro money market started rising in the expectation of an interest rate increase, the 6-month Euribor serving as the basis for Estonian housing loans has rose by almost 1.5 percentage points.

Despite the gradual rise in euro area monetary policy rates, the Estonian monetary environment has remained expansive. Quotations on the Estonian money market have generally stayed in line with the dynamics of euro area money market interest rates. Nevertheless, the reaction of Talibor to the increase in the euro area interest rates has been relatively slow, owing to the low activity of the Estonian money market. Estonian money market interest rates rose by an average of one percentage point compared to the beginning of the year (see Figure 4.1).

The **primary bond market** was quite active in the first half of 2006 and in autumn. Bond market capitalisation increased to a record 7 billion kroons by the end of August.

Global stock markets saw a decline and thus also the value of the Tallinn Stock Exchange index OMXT fell by 8% during the first half-year, but then started to increase again. The decrease in total capitalisation at the stock exchange was slightly offset by listing the shares of the construction company AS Eesti Ehitus. In autumn, the shares of Olympic Entertainment Group incorporating casino businesses were listed. The secondary bond and stock markets were volatile as usual.

Interest rates on long-term loans granted to the non-financial sector[1] have followed the dynamics of the 6-month Euribor just as expected. Compared to the lowest interest rates of 2005, interest rates on long-term loans to the non-financial sector have increased by an average of 1.5 percentage points. Interest rates on housing loans grew even further in the third quarter, reaching 4.4% in September. The average interest rate on all long-term household

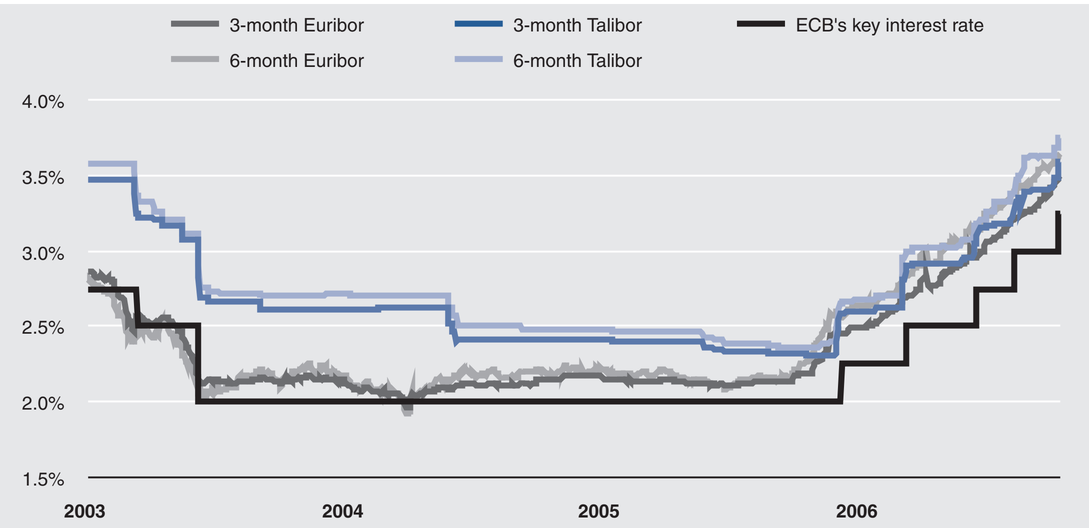

Figure 4.1. ECB's key interest rate and money market interest rates of the Estonian kroon and the euro

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

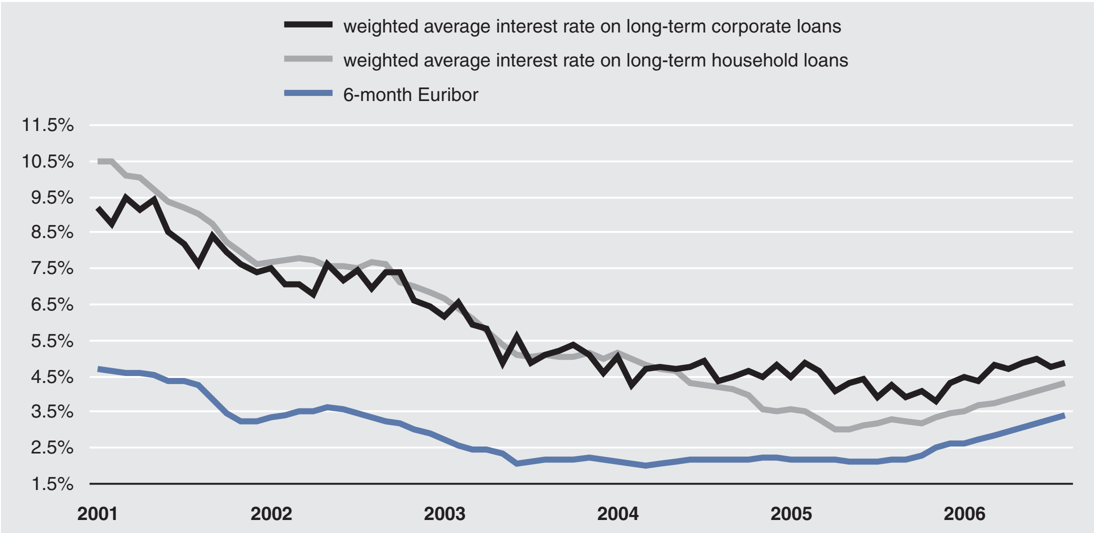

Figure 4.2. Interest rates of the domestic non-financial sector

loans increased to 5.8% in September, whereas the average interest rate on long-term corporate loans reached 5.1% (see Figure 4.2). The further growth of interest rates on loans granted to the non-financial sector should also be fostered by **raising the minimum reserve requirement ratio for banks**. The new ratio entered into force on 1 September 2006.[2]

Money supply

The money supply growth remained strong in the first half of 2006. The annual growth in the intermediate monetary aggregate (M2) stood at an average of 38% in the first and second quarter of 2006, while that of the narrow monetary aggregate (M1) was 35% (see Figure 4.3).

The growth of M2 continued to be influenced mostly by its liquid components, i.e. currency in circulation and demand deposits. Due to the beginning of the summer vacation period, the second quarter witnessed a larger than expected increase in the currency in circulation, namely by 0.7 billion kroons.

In the second quarter, the demand deposits of the non-financial sector grew by a total of 6 billion kroons, whereas the share of households was more or less equal with that of companies. In the third quarter of 2006, the respective increase of 1.7 billion kroons was slightly more modest compared to the second quarter. This was mainly related to an increase in the stock of corporate demand deposits.

The time deposits of the non-financial sector grew relatively modestly in the second quarter, but increased by 1.7 billion kroons in the third quarter. This resulted mainly from an increase in the stock of household time deposits (by 1.4 billion kroons), which shows that saving has increased.

Non-financial sector borrowing

The **loan and leasing stock of the non-financial sector** set a new record in the second quarter of 2006, increasing by a total of 18.8 billion kroons quarter-on-quarter. Despite such remarkable growth indicators, the annual growth of the non-financial sector's domestic financing[3] slowed down

[2] See background information "Measures of Eesti Pank implemented in 2006" on page 7.
[3] Includes bank loans and leasing.

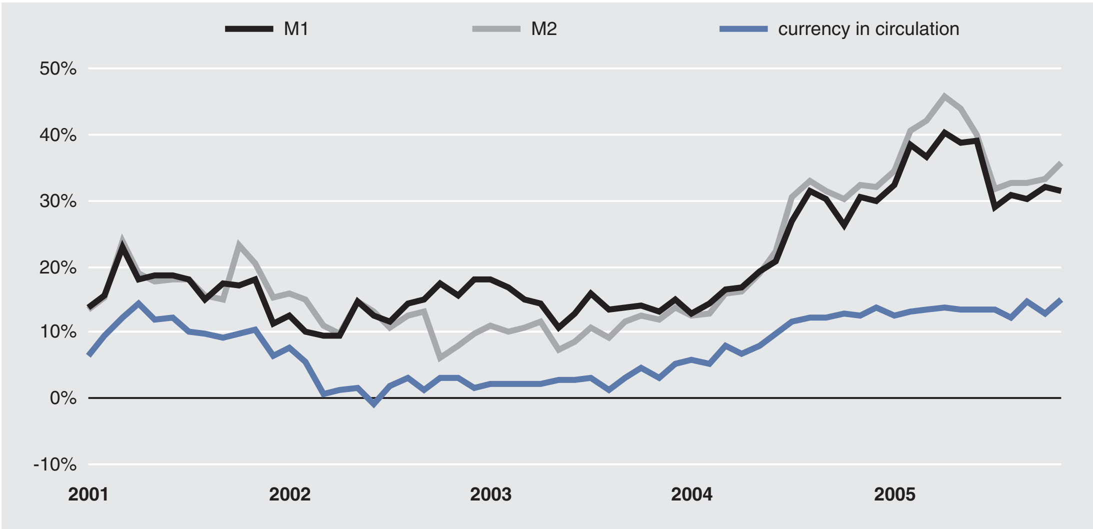

Figure 4.3. Annual growth in money supply

slightly by the end of the second quarter, amounting to 52.7% in June. In July and August, the loan and leasing stock grew by nearly 11 billion kroons and year-on-year growth picked up to 53.9% by the end of August.

The **stock of household loans and leasing** increased by 7.8 billion kroons in the second quarter and by another 5.6 billion kroons in July and August. Due to the high basis of comparison, the annual growth of domestic household financing has still decelerated by 2 percentage points compared to record levels in the first quarter of 2006. As expected, the year-on-year growth of household loans and leasing consisted mostly of housing loans, which increased by 6 billion kroons in the second quarter. The rapid growth of housing loans continued in July and August, when the loan stock grew by approximately 4 billion kroons. In addition, the share of other loans in the annual growth of household financing has risen further. As to the increase in other loans, household consumer credit prevailed. In the second quarter, consumer credit increased by 1.1 billion kroons (up to 6.1 billion kroons) and year-on-year growth accelerated to 92.6% by the end of the quarter.

The **stock of corporate loans and leasing** soared by a record 11 billion kroons in the second quarter. Consequently, compared to the end of the first quarter also the year-on-year growth of domestic corporate financing accelerated by 2.6 percentage points, i.e. to 47.3%. In July and August, the corporate loan and leasing stock increased by an additional 5 billion kroons and the year-on-year growth accelerated to 48.7% by the end of August. By sectors, approximately 90% of the growth in the stock of corporate loans and leasing derived from an increase in the non-tradable sector which is oriented to the domestic market. The majority of the stock consisted of loans and leasing to the real estate sector. The volume of loans and leasing of export companies increased modestly compared to that of the non-tradable sector. A slight acceleration in the year-on-year growth of domestic financing in manufacturing could be detected (see also Figures 4.4 and 4.5).

Capital flows

The **rapid inflow of foreign capital** continued in the first half of 2006. The foreign exchange reserves of Eesti Pank grew by 1.8 billion kroons in the second quarter. The net capital inflow mainly

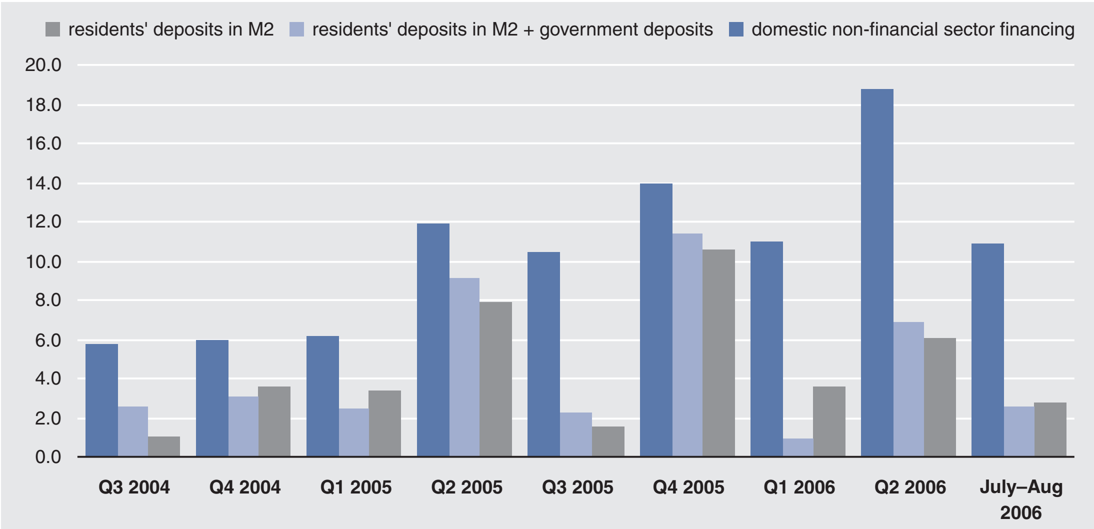

Figure 4.4. Quarterly growth in residents' deposits and domestic non-financial sector financing (EEK bn)

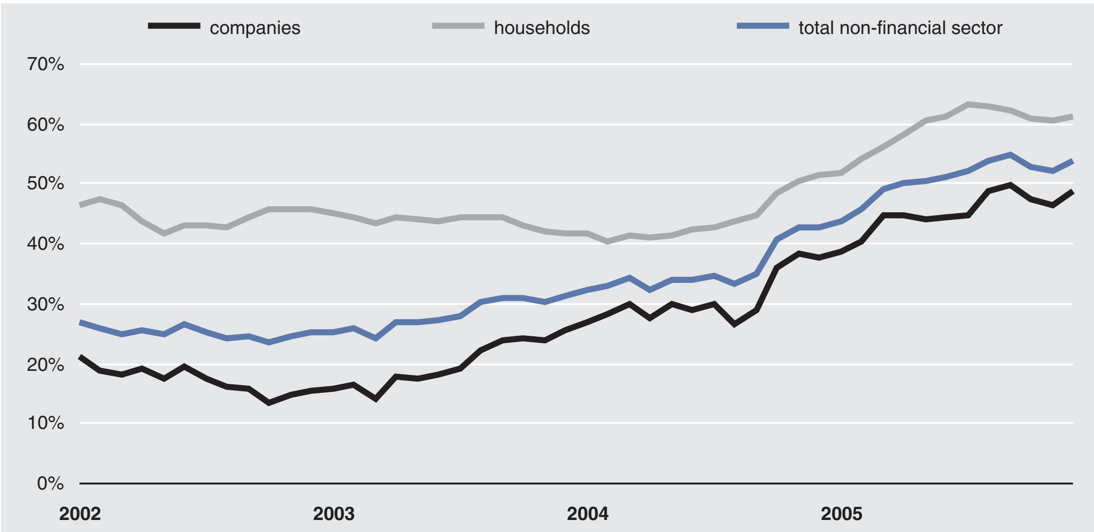

Figure 4.5. Domestic bank loans and leasing of resident non-financial companies and households (annual growth)

relied on credit institutions' loans and deposits. The net capital inflow via the banking sector reached 7 billion kroons in the second quarter. Banks' external assets decreased by 3 billion and external liabilities increased by 4 billion kroons. As for direct and portfolio investment, a slight net capital outflow occurred in the second quarter of 2006 owing to the increased foreign investment made by Estonian residents. This happened due to the general government budget surplus as well as banks' decision to increase the equity capital of their subsidiaries in Lithuania and Latvia.

V ECONOMIC FORECAST FOR 2006–2008

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

SUMMARY

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

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

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

Table 5.1. Economic forecast by key indicators

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

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

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

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

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

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

External environment

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

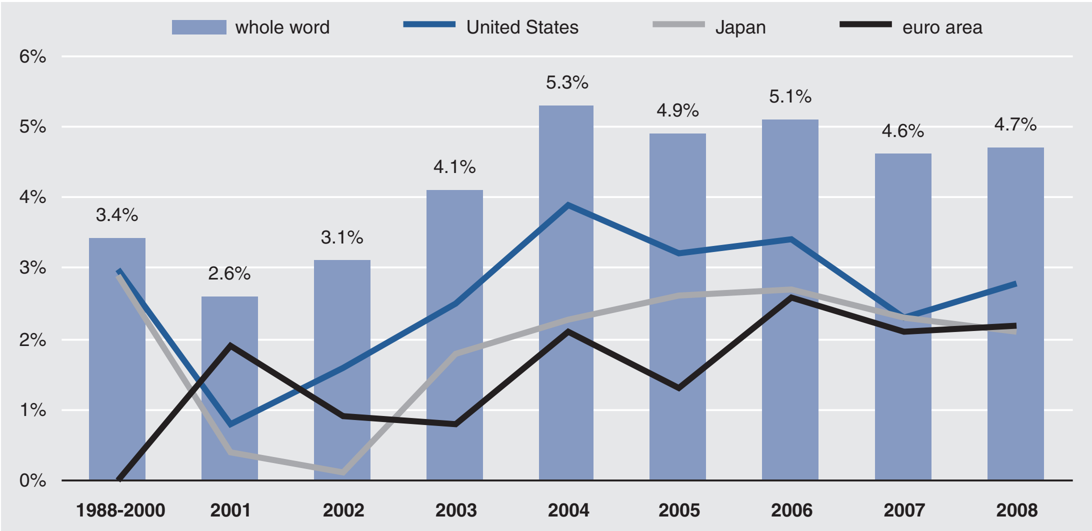

Figure 5.1. Real GDP growth

Source: European Commission's autumn forecast

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

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

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

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

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

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

Economic growth

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

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

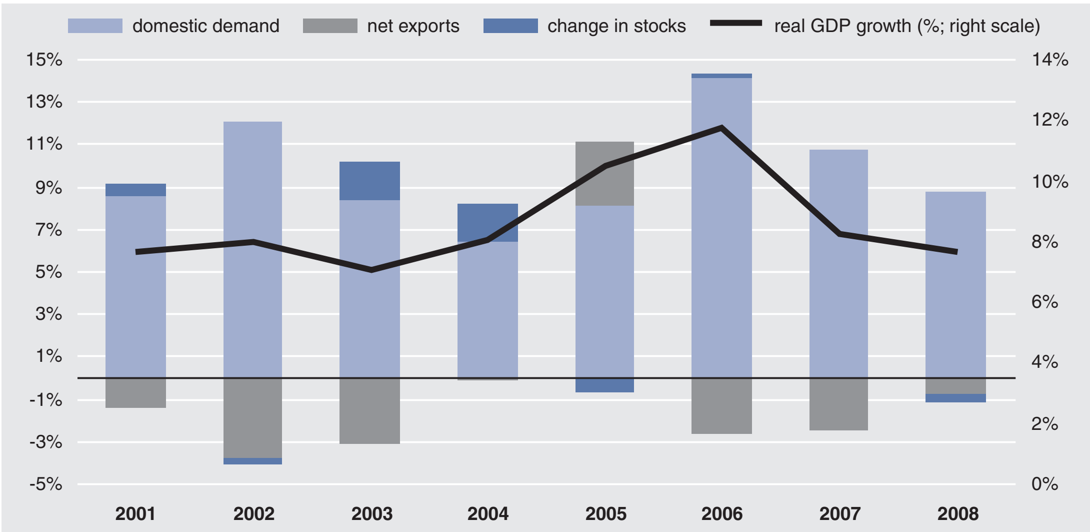

Figure 5.2. Contribution of components to growth

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

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

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

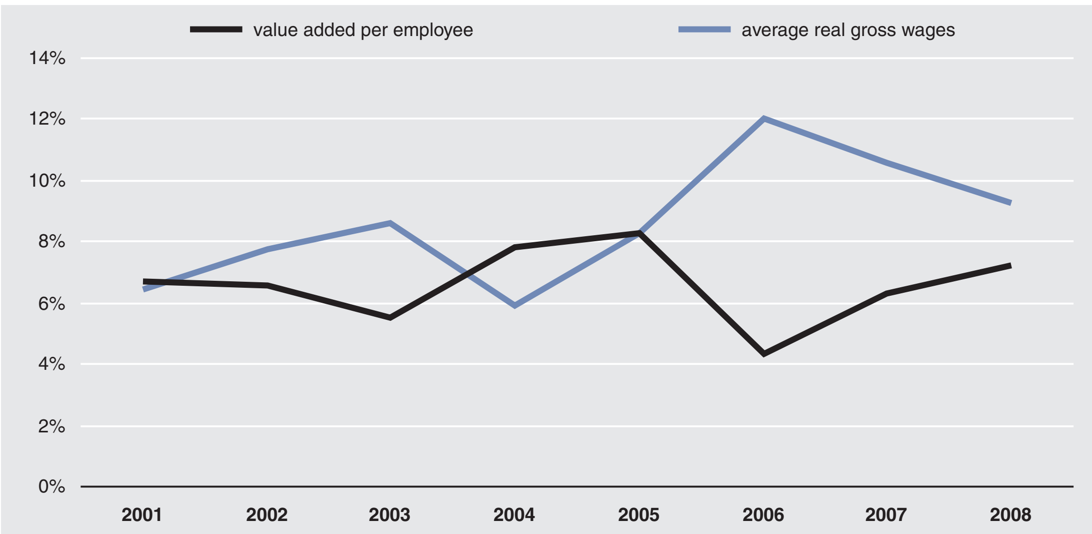

Figure 5.3. Productivity and wages

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

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

Domestic demand

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

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

Private consumption

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

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

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

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

Investment

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

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

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

Government consumption growth

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

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

Labour market

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

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

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

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

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

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

Inflation

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

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

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

Food, alcohol, and tobacco

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

Core inflation

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

Motor fuel

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

Energy used by households

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

External balance and external debt

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

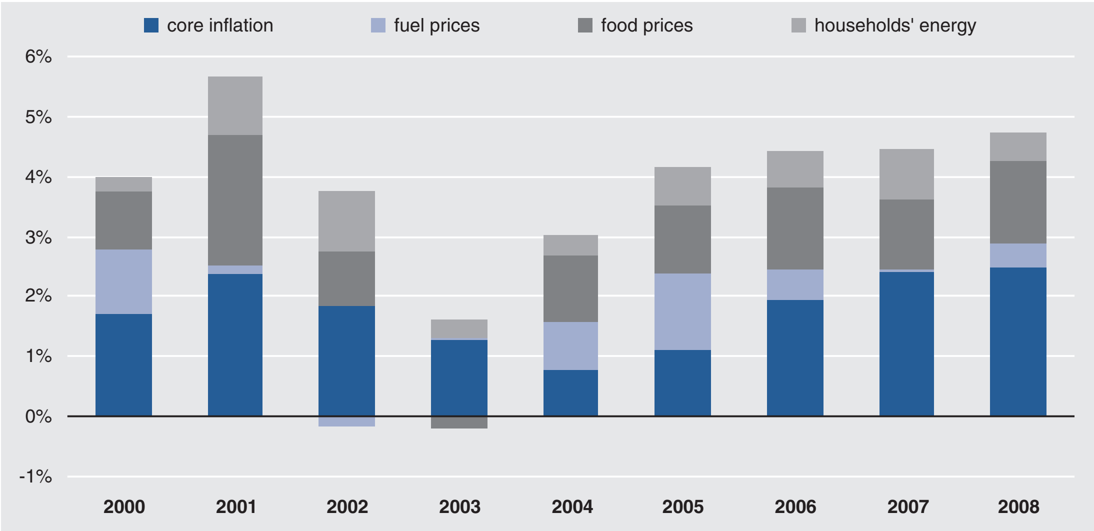

Figure 5.4. Inflation structure

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

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

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

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

Financial sector

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

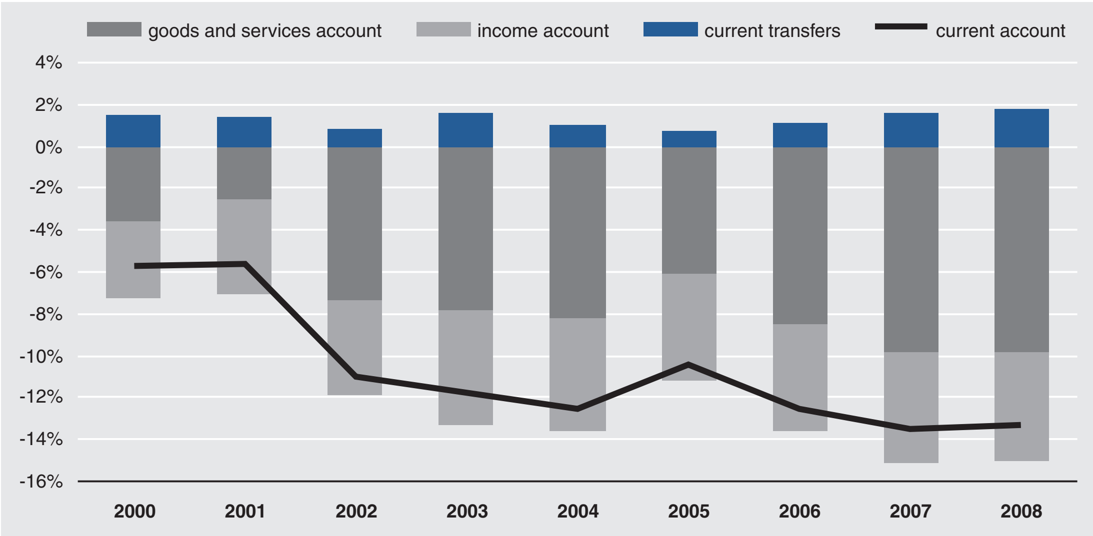

Figure 5.5. Current account structure (% of GDP)

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

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

RISKS TO ECONOMIC GROWTH

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

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

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

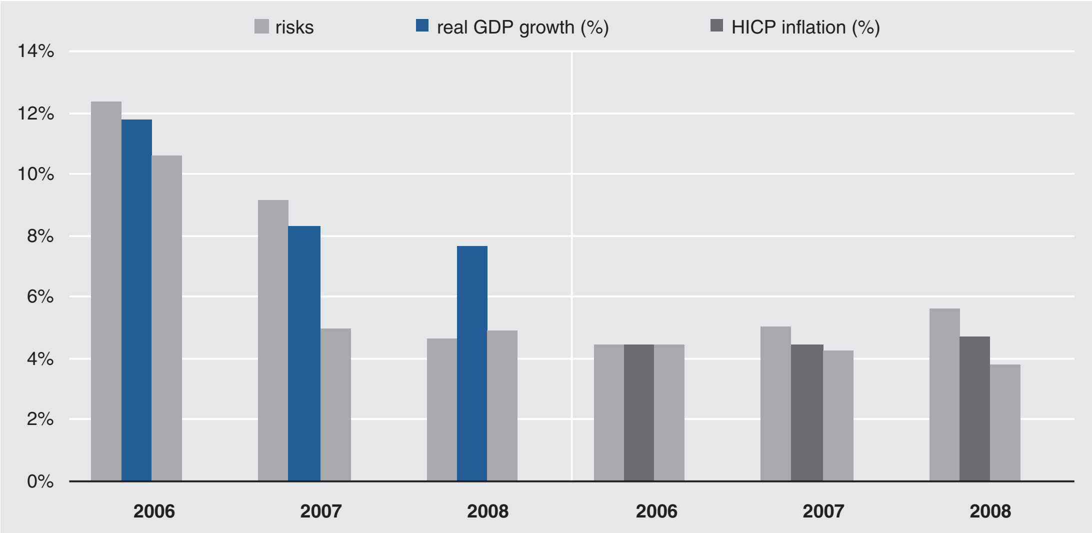

Figure 5.6. Real GDP growth and inflation forecast: risk scenarios I and II

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

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

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