

KEY POINTS OF THE ECONOMIC FORECASTS OF EESTI PANK IN 2006

Forecasts of Eesti Pank

Eesti Pank publishes forecasts twice a year: a spring forecast in May and an autumn forecast in November. To this end, the current year's economic development and the outlook for the two following years is analysed. This summary is based on the autumn forecast of 2006, which elaborates on economic developments in 2006–2008 and draws on the information available in October 2006. In addition to the base scenario, there are also two risk scenarios. A more thorough overview of the forecasts of Eesti Pank is provided on the web site of the central bank.

Key points of forecasts

Estonia's economic growth was swift in 2006, but the two-digit growth rate will no longer be feasible in the coming years. The increase in domestic demand, which has caused upward price pressures and the deterioration of external balance, will remain strong in 2007–2008. On the production side of the economy the rapid creation of new jobs will cease and further development should be stimulated more by the growth of productivity. The risk of facing a period of abrupt readjustment has increased.

Global economic growth in 2006 was one of the fastest in recent decades and in the following years the external environment will remain favourable for Estonia. The GDP growth will slow down slightly in the US, where the fast accumulation period of real estate wealth is nearing its end. The European economic growth is gaining momentum and should continue likewise also in the next two years. Owing to the rapid economic growth in the various regions of the world, 2006 saw a rise in the prices of natural resources and production resources. Though at the end of the year the oil price dropped, other commodity prices primarily followed an upward

trend. Based on future transactions, the following years promise a slight rise in oil prices, as the decrease of demand pressures is only temporary. Despite the increase in commodity prices, long-term inflation expectations have remained reserved. Thus, markets no longer expect the monetary policy to tighten much further.

In the near future, the Estonian economic cycle will be shaped by three essential factors. These are demand, resources engaged and competitiveness. The inflow of foreign loan capital has helped to create a very strong domestic demand environment. Several enterprises suffer from a scarcity of qualified labour force, machinery and materials, thus finding it easier to raise prices instead of expanding production. Arising from the appreciation of production inputs companies will partially lose their competitive abilities, but in the main forecast scenario this entails no major setbacks. There is no need for a significant reallocation of production resources on the production side of the economy.

In the near future, rapid economic growth can mainly persist on the support of productivity growth, as the workforce shortage concerns nearly all fields of activity. The production output of many companies has increased suddenly, overshadowing the aim of optimal resource usage. Thus, at least in the short-term perspective it is possible to increase productivity by smarter use of production inputs. In the long run, the growth of productivity will be in line with technological development, which requires investments in new machinery and equipment as well as in technological solutions.

In 2006, Estonia's economic growth was mainly based on domestic demand, which

will remain the primary growth factor also in the next two years.

If the increase in incomes is halted and/or the inflow of cheap loan money starts decreasing, Estonia's economic growth can only decelerate. The question is how drastic the change will be. According to the main scenario, there will be enough growth stimuli throughout the whole forecast horizon and demand pressures will gradually abate. **The first sign of a slowdown in domestic demand growth is that wages start to increase on the account of profits.** So far, data do not confirm such developments and rapid wage growth may also be expected in 2007. Private consumption expenditure will remain the most dynamically growing domestic demand component over this forecast horizon. **In case of brisk economic growth the investment activity should remain high, although presumably investments achieved their growth peak in 2006.** In some segments of the real estate sector, the price growth rate has decelerated and for households with lower incomes real estate prices have climbed too high. Nevertheless, there is no reason to claim that the real estate market has reached the level of long-term balance, as fast developments are presently taking place outside the capital city Tallinn. As to corporate investments, it is essential that the share of investments in machinery and equipment would increase. To date, however, statistics have not provided sufficient confirmation on this.

The Estonian labour market has developed rapidly in recent years and reached a situation where wage pressures are increasingly evident.

In the conditions of brisk economic expansion and the opening of the labour market, the number of available employees is virtually non-existent. The demand for labour force is strong in all fields of activity and the resulting wage pressures will persist throughout the whole forecast period. The acceleration of wage growth

has brought about greater mobility among employees – both in terms of countries and different regions within Estonia as well as across fields of activities and professions. The number of employees heading abroad for employment doubled within the first months of 2006 and this tendency will also continue in the following years. On the other hand, the number of the employed will decrease in the more labour-intensive fields of activity, such as furniture, textile, clothing and leather industry. So far, the released workforce has moved into the services sector without significant problems.

In the autumn forecast of 2006, Eesti Pank estimated the inflation in the coming years to be higher than it did in the spring forecast.

Inflation has become more broad-based, which is typical of fast economic growth. Meanwhile, the core inflation increasingly depends on wage growth, but the latter will remain fast in the near future. From the point of view of stable economic development, it is essential that inflationary expectations remained contained and would not affect the principles of price or wage formation. In addition, in autumn 2006 it became apparent that in the forthcoming winter the increase in food prices might considerably exceed the usual seasonal price rise. Weather conditions were unfavourable in the summer and this affected food prices throughout Europe. In the next few years, the gradual convergence of energy prices towards global market prices will continue and this is one of the main risks in the price growth forecast. As to regulated prices, in 2007 the VAT on thermal energy will be raised. At the beginning of 2008, inflation will increase abruptly due to the rise in the alcohol, tobacco and fuel excise duties. Without raising the excise duties the inflation rate would start decelerating already in 2008.

Owing to the great domestic demand the external balance is not expected to improve

any time soon, although the external environment fosters export growth. The current account deficit will decrease only in 2008, when internal demand starts waning. The price convergence pace of production inputs will determine how much Estonian enterprises can take advantage from the strong external demand. According to the primary scenario Estonia will not encounter serious competition problems, although the danger persists.

Major short-term risks are related to the danger of the economy becoming overheated, and long-term risks refer to problems with decreasing competitiveness. If those risks materialise, the adjustment speed of the economy will depend on the flexibility of the labour market and the recovery from overheating may take place only after 2008.