

## KEY POINTS OF EESTI PANK'S ECONOMIC FORECASTS IN 2007

Eesti Pank published the spring forecast of 2007 in May and the autumn forecast in October. The following summary is primarily based on the autumn forecast and the information available at that time. Updates were introduced to the base model for the Estonian macroeconomic forecast. This mainly concerned the segment of the labour market, but also the credit market's block.

In 2005–2006 the Estonian economy grew by over 10%, whereas in 2007 growth slowed as expected. In spring 2007 we estimated a 8.4% growth for 2007 and in autumn we revised it slightly down to 7.3%. Actual growth stood at approximately 7%. Economy will cool further also in 2008 due to slowing growth in domestic demand and weakening external environment. It is highly unlikely that economic activity will gain a new momentum before 2009. The continuing inflow of loan money supports a new growth cycle, which should, however, rely more on productivity growth.

Generally, 2007 was relatively favourable for Estonia in terms of external demand, despite the emergence of several negative circumstances. In summer, global financial markets were overwhelmed by uncertainty, which is why external demand will be slightly weaker in 2008. Another negative factor was the political tension, which affected the volume of re-exports that largely rely on Russia's natural resources. In 2008, the neighbouring economies will grow slower compared to earlier periods and thus also the export growth potential will be smaller. This also applies for 2009. External balance will improve along with an adjustment in domestic demand, but at a very moderate pace.

Inflation offered more surprises. At the beginning of 2007, Eesti Pank expected the price rise to be 5.1% and in autumn 6.3%, whereas the actual price level increased 6.6%. The autumn forecast anticipated the culmination of domestic inflation factors, i.e. upward price pressures stemming from robust economic growth, at the end of 2007 and the beginning of 2008. Inflation will continue to rise also in 2008, as several excise duties were raised at the beginning of the year. However, in 2009 the price rise will probably decelerate.

The inflation forecast largely relies on the assumption that the labour market will cool. The market's macroeconomic indicators for 2007 still indicated rapid changes. Employment growth slowed considerably and although the decline in unemployment halted, wage growth continued at an accelerating pace. Rapid wage growth in the conditions of a cooling economy increased discrepancies between productivity and wage growth. This trend will remain one of the key factors undermining our economic competitiveness also in the forthcoming years, which, in turn, hinders balanced economic development.

In 2007, the risk of a steep slowdown in growth increased when the real estate sector entered a phase of adjustment. Substantial decline in activity in that sector curbs economic growth considerably, as real estate investment has been making large contributions to growth in recent years. Another risk surrounding economic sustainability is the possibility of Estonian banks encountering difficulties with raising capital from external markets. In that case, an extensive correction is in store for domestic demand.