FOREWORD BY GOVERNOR OF EESTI PANK

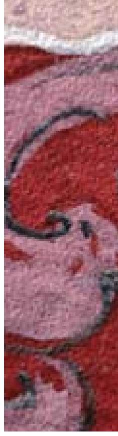
In 2007, Estonia's economy witnessed fundamental changes in many respects. After several years of exceptionally strong growth, we started to move towards a more stable and sustainable development path: rapid credit and wage growth slowed and the external balance started to improve as well.

The external environment, which is a major factor in the development of a small open economy, continued to deteriorate in 2007 and expectations regarding the US and other advanced economies weakened further. The pessimism of late 2007 peaked in January 2008 along with the rapid decline in global stock markets in January 2008. By the end of 2007, the price of oil barrel had reached nearly 96 dollars. Food prices kept rising throughout the year and particularly sharply in the second half.

This was particularly significant considering the relatively large share food and fuel represent in the consumer basket in Estonia. If we then consider the ongoing convergence of our economic indicators towards the EU average levels and the accompanying increase in incomes and prices, which is exceeding the EU average, the 6.6 per cent rise in inflation in 2007 was well expected.

Today prices are growing much faster in Estonia than is desirable from the point of view of long-term sustainable development but this is a temporary process and will gradually slow over the next couple of years. Inflation arising from rapid wage growth should also decelerate this year but the convergence of tax rates towards the EU levels also pushes up prices. The joint impact of various factors is therefore likely to give a significant boost to the inflation rate in 2008. Last year, real GDP growth reached 7.1 per cent in Estonia, whereas Eesti Pank forecasts a much lower growth rate this year. That points to the start of a gradual adjustment period in economy.

How smooth the adjustment period will be and how long it will take to regain higher growth rates, is largely, but not only, dependent on global economic developments. It is crucial that we use our export potential. For the entry to a new growth cycle to be smooth, the central bank deems it necessary to partly redirect domestic demand oriented resources to the export sector. We have to take into consideration that several resources underlying the strong growth of recent years have now been exhausted. On the supply side, there is much less unoccupied labour force available; however, the domestic demand reserve relying on credit use has also decreased considerably. Under such circumstances, growth can be primarily boosted through increased productivity, especially in the exporting sector. It is similarly important that the financial sector continues funding sound business projects.



The strong economic growth of recent years relied mostly on real estate investment. Now, however, the real estate sector is going through an adjustment phase, which affects also the growth of the economy as a whole. In 2005-2006, the improvement of credit availability temporarily increased demand in the real estate market, which resulted in a price hike. Today we are facing an oversupply which has brought about a decline in prices. Companies that are better capitalised and have diversified their activities will survive the difficult times; however, the number of small enterprises going bankrupt will increase. Consequently, the economic growth potential will decrease as well. Investment in production capital has not been that sensitive to the economic cycle compared to real estate investment, which allows, in their case, to expect smaller corrections.

Another precondition for sustainable and rapid economic recovery is the continuation of economic policy measures that support market flexibility and productivity growth. Moreover, EU funding should be carefully considered and used as effectively as possible. The government sector can best support economic adjustment through a responsible fiscal policy. This is crucial for maintaining Estonia's economic reliability in the phase of adjustment and supporting investment.

It is clear that 2008 will be more difficult than 2007 in many ways. The scope of further adjustments should not, however, be overestimated. The ability to cope in a different economic situation does not call for any fundamental changes in the current economic policy. It rather depends on how smooth the adjustment will be, not on how strictly we follow the principles established a long time ago.

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