V
ECONOMIC FORECAST OF EESTI PANK FOR 2005–2007

Global Economy in Coming Years

Global economic outlook is favourable for 2005–2007. Although global output growth is projected to decline to approximately 4% in 2005-2006, the growth rate will still remain at the potential level. Despite the fact that several central banks consistently increased their key interest rates in the first half of 2005, the level of nominal and real interest rates is relatively low. The European Central Bank has not yet started to tighten monetary policy, whereas markets are expecting a rise in key interest rates in the next months. Fiscal policy stance in the advanced economies is also going to be more restrictive in 2006. The rise in oil prices is posing a major risk to global economic growth and price stability. The autumn forecast of the International Monetary Fund[1] listed also regional imbalances between savings and investment as well as increasing protectionism as factors jeopardising economic growth.

The 2006 economic growth will remain diverged among the world's major economies. In the US the output growth will slow down towards the long-term average, which corresponds to the neutral monetary policy stance. Nevertheless the US economy will continue to grow considerably faster compared to the euro area and Japan. Several risks surround the sustainability of the US economy, as the private consumption is inflated by the increasing debt burden and record low level of household saving. In order to retain fast economic growth, the US current account deficit should either decrease or stabilise in the forecast horizon.

The second half of 2005 saw several indications of an expected recovery of economic activity in the euro area, although regarding the persistent structural bottlenecks (primarily the high level of unemployment), several international forecasting centres have downgraded the growth outlook. Positive tendencies have revealed themselves mainly in soft indicators, which provide only a circumstantial evidence that the economic growth has become more virtuous. An extensive recovery in the euro area depends mostly on faster growth of capital investment and private consumption. Favourable financial conditions and high profitability of enterprises will serve as a solid basis for an increase in capital accumulation. Private consumption will probably accelerate at a slower pace, as consumer confidence is still low and employment indicators remain at their cyclical low. This will reduce demand-driven inflationary pressures in the euro area, although the rising oil prices are coming more sharply to the fore in the first half of 2006.

Mainly due to domestic demand, economic growth is still considerably faster in the Nordic countries than in the euro area. Economic activity is expected to continue to grow in the coming years. In Sweden, low interest rates have induced housing-related capital investments, but this should slightly decline in 2006. Finland's economic growth is also expected to gather momentum after a temporary slowdown because of labour disputes in wood and paper industry.

The 2006-2007 economic growth of the new EU Member States is expected to remain broad based. Growth in employment in these countries depends on economic restructuring in the old EU Member States. The Baltic States form an exception among the new EU Member

[1] World Economic Outlook, September 2005. http://www.imf.org/external/pubs/ft/weo/2005/02/index.htm

States with respect to the employment growth, as their increase in output volumes mainly relies on capital accumulation and total factor productivity.

Estonia's Economic Outlook

Economic Growth

Estonia has experienced a fast economic growth in recent years. Although the rapid growth has been partially based on growing debt burden, it can still be claimed that Estonia's economic outlook is relatively favourable. The growth of productivity, household income and corporate profitability has been growing fast and this trend is projected to continue in the medium term.

According to the autumn forecast of Eesti Pank, economic growth will constitute 8% in 2005 and remain slightly below 7% in 2006 and 2007 (see Table 5.1). The demand conditions will continue to be favourable as they rely on the rapid income growth, excessive credit supply and optimistic expectations. On the other hand, the gradually improving external environment and the impact of integration into EU trade market will ensure sufficient export demand growth.

Table 5.1. Economic forecast by main indicators

									difference (autumn 2005–spring 2005)			
	2000	2001	2002	2003	2004	2005*	2006*	2007*	2004	2005	2006	2007
GDP (EEK bn)	92.94	104.46	116.92	127.33	141.49	160.15	176.46	195.08	2.3	7.9	9.5	12.8
Real GDP growth (%)	7.9	6.5	7.2	6.7	7.8	8.0	6.8	6.8	1.7	2.3	0.5	0.8
HICP growth (%)	3.9	5.6	3.6	1.4	3.0	4.2	3.4	2.9	0.0	0.8	0.8	0.3
GDP deflator growth (%)	5.4	5.6	4.4	2.2	3.1	4.7	3.2	3.5	-1.1	1.2	0.0	0.6
Current account (% of GDP)	-5.3	-5.6	-10.2	-12.0	-12.5	-9.4	-8.5	-7.8	0.1	1.9	2.3	2.5
Current account plus new capital account balance (% of GDP)	-5.0	-5.6	-9.9	-11.6	-11.8	-7.3	-6.6	-6.2	-0.2	1.8	2.2	2.4
Real private consumption growth (%)	8.8	6.2	10.3	7.4	4.2	7.3	6.7	5.2	-1.9	2.5	-0.7	-1.3
Real government consumption growth (%)	1.0	1.6	6.2	5.9	6.9	6.9	7.6	7.1	1.7	1.3	7.1	4.9
Real investment growth (%)	14.3	13.0	17.2	8,5	6.0	8.4	5.6	6.1	-0.9	1.6	-0.9	0.3
Real export growth (%)	28.4	-0.2	0.8	5,8	16.0	16.0	13.6	12.1	-0.2	6.9	4.2	2.1
Real import growth (%)	28.1	2.1	3.8	10,6	14.6	11.3	12.8	10.9	0.8	5.1	4.3	1.5
Unemployment rate (%)	13.6	12.6	10.3	10,0	9.7	9.0	8.7	8.2	-0.1	-0.7	-0.9	-1.2
Change in the number of the employed (%)	-1.2	0.9	1.4	1,5	0.2	1.4	1.0	0.4	0.1	1.2	0.7	-0.2
Value added growth per employee (%)	9.1	5.5	5.8	5,1	7.6	6.5	5.7	6.4	1.6	1.0	-0.2	0.9
Real wage growth (%)	7.7	6.5	7.6	8,8	5.1	7.3	6.8	6.9	-0.9	3.8	2.1	1.7
Nominal money supply growth (%)	25.1	23.7	11.1	10,9	15.8	26.8	13.0	14.9				
Nominal credit growth (%)	22.1	24.4	26.1	27,7	31.8	38.1	29.8	23.3				
External debt (% of GDP)	54.4	55.5	60.1	68,7	81.2	90.3	97.0	99.6	-2.9	-0.2	3.7	3.9

* forecast

The contribution of net exports to economic growth is projected to be positive in 2005. The growth of exports will be remarkably faster than that of imports, and the contribution of domestic and external demand to economic growth will diverge considerably from the trend of the past five years (see Figure 5.1). Due to the favourable external demand, the export-oriented branches will be successful in the coming years, but the influence of the non-tradable sector (incl. real estate) on economic growth will also remain considerable. Construction, real estate, retail and wholesale sector, and the respective services sector (e.g. financial intermediation; see Figure 5.2) also account for growth. The success looming for the real estate sector is expected to continue, which makes the non-tradable sector a significant driving force behind economic growth for the years ahead.

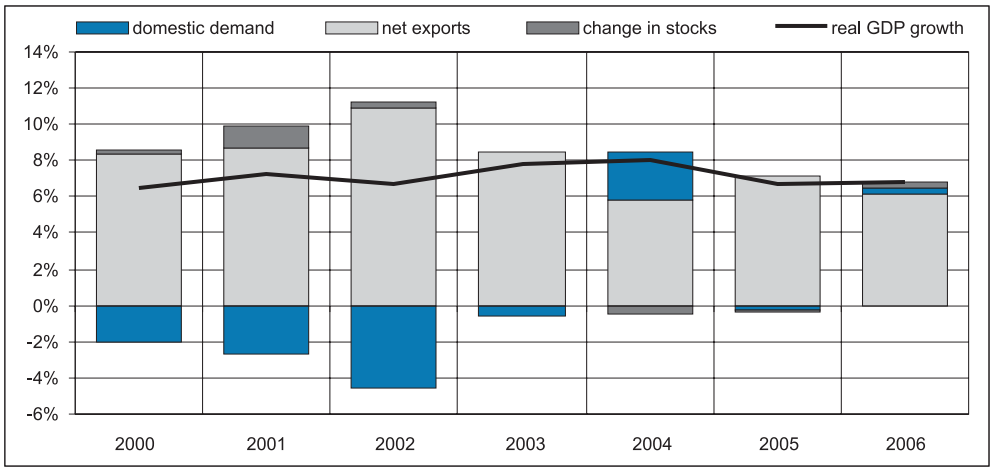

Figure 5.1. Real GDP growth and its components (%)

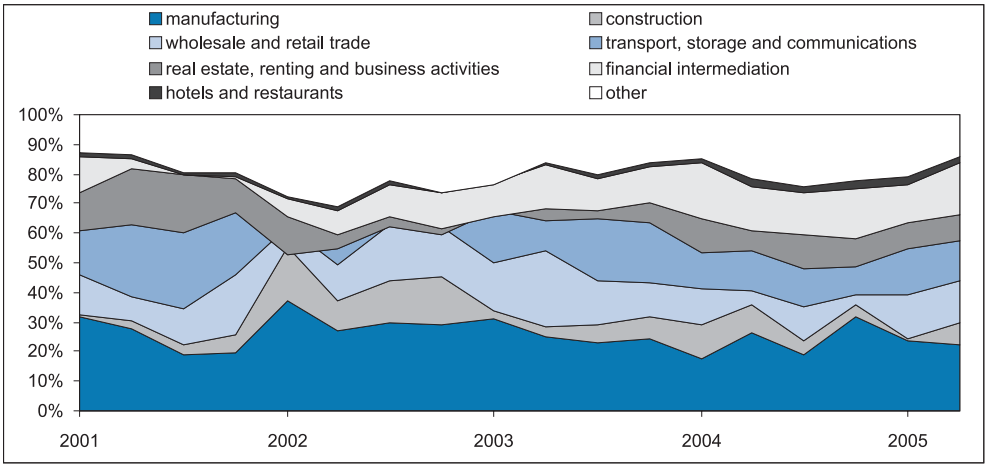

Figure 5.2. Share of fields of activity in real GDP growth (%)

As regards longer-term risks, the supply side of the economy has to cope with the upward movement in the value added chain. We are facing a transition to more knowledge-based products and services, and this will happen against the background of limited labour force and human capital resources. Estonia's demographic situation is anything but favourable. The sectors of economic activity that are more labour intensive will be most affected by the limited labour resource.

Domestic Demand

One of the key processes treated in an earlier forecast – adjustment of private consumption to a stage of lower growth – took for the most part place already in 2004. The share of private consumption in GDP decreased by more than 2 percentage points; on the one hand, the income growth was inhibited, and on the other hand, households preferred to invest more in real estate. The real estate boom will continue in 2005, and this causes the year-on-year share of private consumption in GDP remain almost unchanged. The volume of private consumption will increase 7.3% this year and 6.7% and 5.2% in the two following years, respectively.

The main factor affecting consumption expenditure in Estonia is the disposable income of households. Mainly it is still wage income, although government transfers and business income have recently increased faster than the employment income. **According to the forecast, household income in 2005–2007 will increase faster than private consumption expenditure.** Such expectations are based on both the administrative changes in taxation (rising of the tax-free minimum and lowering of the income tax rate), which will deepen the gap between net and gross wages, and the slight increase in interest rates, which should limit consumption.

Taking into consideration the existing data, it can be stated that the increased income of households would have allowed them to consume considerably more than they actually did (see Figure 5.3), thus it may be concluded that **households have started to save more**. This development has primarily been conditioned by investment into housing. In addition, saving is fostered by obligatory saving related to pension funds, as well as by the increased supply of saving and investment products provided by the financial sector.

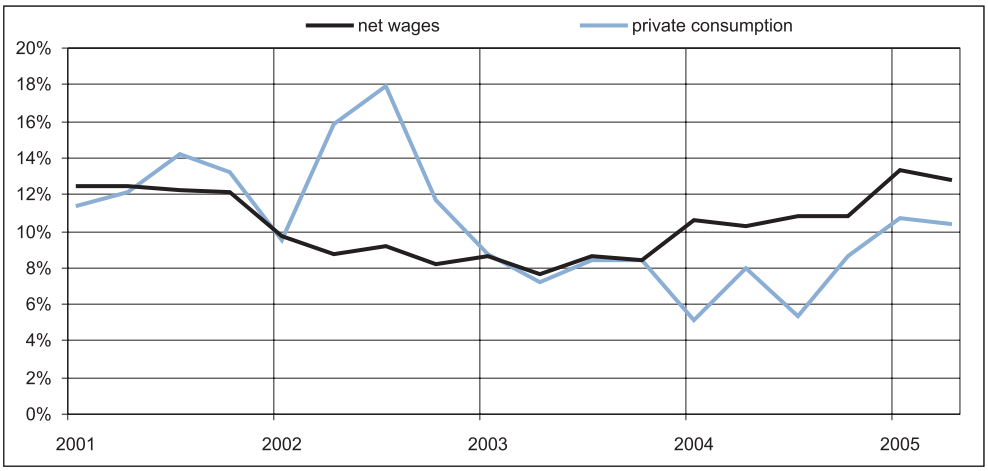

Figure 5.3. Growth in net wages and private consumption

Structural changes in private consumption refer to the fact that the share of durable goods in consumption expenditure has increased in recent years. Here expenditure on cars, electronics, household appliances, and furnishing can be pointed out. Trends in expenditures on durable goods is obviously the component of private consumption that reflects the influence of both the real estate boom and favourable credit conditions.

Private consumption related risks to the economy as a whole lie in the possible changes in households' saving behaviour. Should the risks originating from the labour market materialise, wage growth might accelerate to such extent that households would be able

to spend considerably more. On the other hand, private consumption may be increased by the pressure from the financial sector in the form of extensive supply of various short-term financing products.

In 2002–2004, the share of investment in GDP remained at a relatively high level – more than 30%. In 2005–2007, the share of investment in GDP is forecasted to constitute 29%, which is lower than the last three years' average, but still stands out among Central and Eastern European countries. The 2005 investment volume growth forecast is 9.6%, mainly supported by the fast increase in investment by households, as well as by the general government, the latter being facilitated by the capital from the EU structural funds. The 2006-2007 real total investment growth will remain in the range of 5–6%.

Last year households' investment, which has increased much faster than corporate investment in fixed assets, was the driving force behind investments. The higher investment activity of households has been supported by the continuously low level of the real interest rate of housing loans and the quickly developing real estate market. Household investment has also been sustained by the increase in income: disposable income is raised by wage growth, which has been accelerating since the beginning of the year and will remain around 10% in the forecast period.

Corporate investment in fixed assets has been inhibited for some time now, but has still preserved its notable volume. Taking into account the continuously favourable interest environment and good demand conditions, the macroeconomic environment should favour investment activity during the entire forecast period, i.e. 2005–2007.

As regards risks, further growth of export-oriented investment is important for Estonia. If the recent developments continue and investment increases mainly on account of investment in real estate, after a certain amount of time economic growth will slow down and the competitiveness of Estonian enterprises will decline.

Out of domestic demand components, the fast growth rate of general government expenditure will persist in the coming years. The growth in tax revenues is strong owing to both fast economic growth and improved tax obedience. The 2005 local government elections as well as the 2007 Riigikogu elections will boost the political will to spend.

Labour Market

Employment growth has been accelerating since 2005 – demand for labour as a production input has considerably grown against the background of increased economic activity. As a result, wage growth has been speeding up since the beginning of 2005 and employment growth will presumably constitute 1.4% by the end of the year. However, employment growth is expected to gradually slow down, reaching 1.1% and 0.4% in 2006 and 2007, respectively.

Labour market is showing more and more signs of turning into "employer market", as the demand for labour force is outpacing the supply and pressures for wage growth surpassing labour productivity are increasing. It is important to relate productivity and wage growth also in future wage negotiations in order to ensure a more efficient allocation of production resources.

According to the forecast, nominal wage growth will accelerate to 11.7% this year only and is expected to decline to the nominal GDP growth in the years ahead. The increases in real wages and productivity are in accordance, and real wages will grow 7.3%, 6.8%, and 6.9% respectively in 2005–2007 (see Figure 5.4).

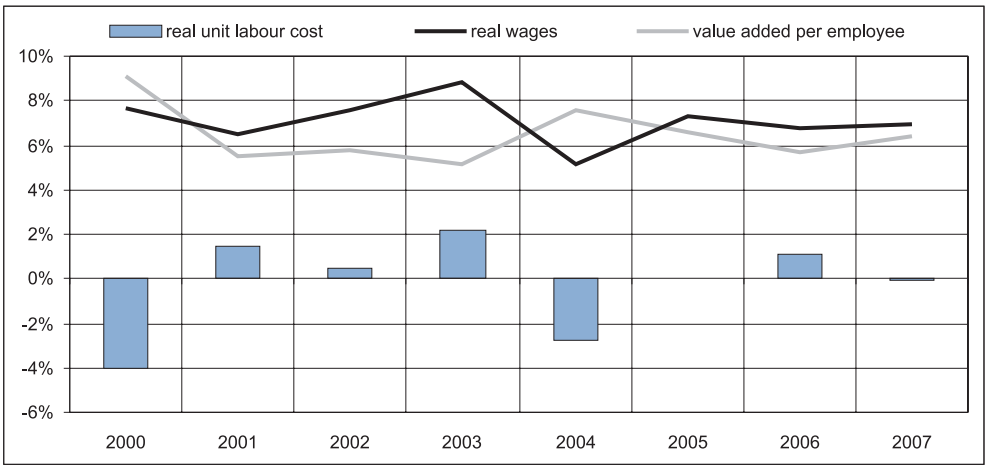

Figure 5.4. Productivity, real wages and real unit labour cost

The labour market related risk, which jeopardises the economy as a whole in both short and medium term, lies in the acceleration of wage growth arising from discrepancies between the demand for and supply of labour force. Taking into account the long-term population forecast, there is every reason to fear that labour force supply is going to inhibit economic growth over a longer period of time. The problem could be alleviated by a rise in the participation rate, as this is relatively low in Estonia compared with other European countries.

External Balance

As the developments of the first half of 2005 turned out more favourable than expected, it allows to be **more optimistic concerning the further improvement of the external balance.** Estonia's exports have been able to maintain a sound growth rate, which allows forecasting a somewhat faster convergence of the current account deficit. The current account deficit is expected to form 9.4% of GDP in 2005, and it should decline to 8.5% and 7.8%, respectively, in the next years. Such development presumes continuously high external demand on the one hand and a slowdown in domestic demand on the other.

The external balance will improve mainly with the support of the goods and services balance (see Figure 5.5). The strong export growth of the past two years will slightly decline in 2006-2007, primarily due to the disappearance of the short-term effects caused by the accession to the EU. Import growth will slow down mainly due to a slowdown in export growth. The negative balance of the income account will continue to increase (i.e. the negative balance of the income account will constitute an incremental share of the current account deficit) – it will reach 7.1% of GDP by 2007. The growth of the income account deficit is supported by corporate revenues. The transfers account forecast has remained unchanged compared with the previous forecast: its balance will remain below 2% of GDP during the entire forecast period. The surplus of the transfers account is ensured by capital flows from the EU structural funds.

Looking at the current account from the point of view of macro aggregates, it can be seen that the deficit has been decreasing from the beginning of 2005 due to both an increase in the share of private saving and a decrease in the share of investment in GDP. The increase in private saving is fostered by corporate profits, relatively fast real wage growth, investment in pension funds, and new saving products of commercial banks. The contribution of the general government in gross saving remains marginal, declining slightly due to a decrease in the budget surplus.

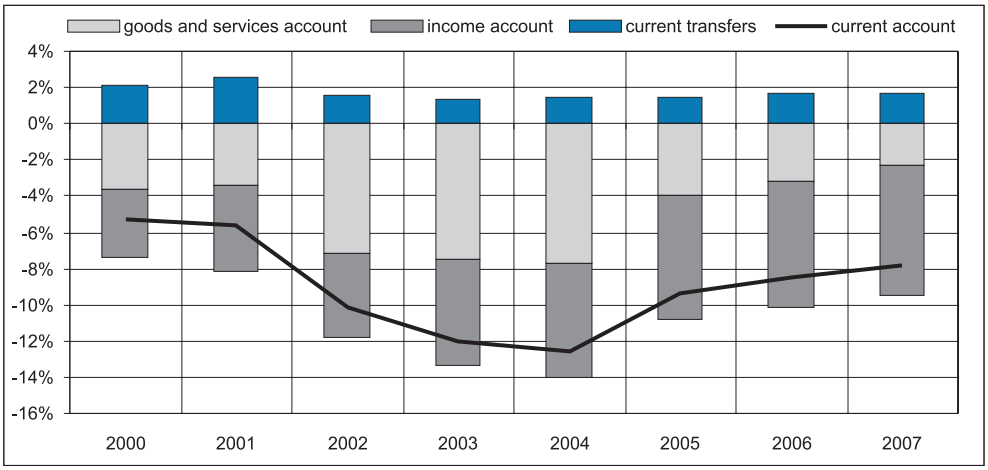

Figure 5.5. Current account structure (% of GDP)

In previous years the financing need of the private sector has remained at a high level and has grown year by year. In order to cover the need, credit institutions have attracted plenty of external resources. According to the forecast, this year the share of bank loans of the non-financial sector is going to reach 75% of GDP, which is approximately 15% higher, year-on-year. Despite a slight acceleration, growth in deposits is clearly unable to meet the need for credit. Taking into account additional financing through other channels and the share of foreign direct investment, the gross external debt of 2005 will constitute approximately 90% of GDP and will increase to around 100% by the year 2007.

Inflation

Inflation has been faster than expected during the past months. The main reason has been the rise in oil prices, which has caused upward adjustments of the inflation indicators in the autumn forecast. This year we can expect the harmonised consumer price index to rise 4.2%, but it will slow down to 3.4% in the next year and to 2.9% in 2007, when the base effect of oil prices will be cancelled out.

Whereas in spring it was expected that the price of oil barrel would stabilise at USD 45 by the end of the forecast period, now stabilisation at USD 60 per barrel can be expected. **The share of motor fuel in the consumer basket is twice bigger in Estonia than elsewhere in Europe, thus its impact in Estonia is also much stronger.** Considering the price of crude oil futures, it is likely that oil prices will not decline very fast. This means that in addition to oil, the prices of other types of energy will also stabilise at a level higher than before the shock. In Estonia, the prices of transport services have risen rather swiftly after the rise in oil prices, and other types of energy (e.g. firewood, shale oil) have witnessed a price increase as well.

Food price rises have diverged by groups of goods. Thus it is not clear at the moment what the general price trend will be like. The upward trend of dairy product prices is slowing down, whereas the deflation of meat products is coming to an end. In addition, we should consider adjustment of tobacco and alcohol excise, which should take place in the mid-2006. All the same, it can be said that the price growth of food is slightly slowing down. As regards risks associated with food prices, primarily the pressures accompanying the growth in export demand should be taken into account. Restrictions on external trade may cause an additional price shock, should the bird flu spread further.

Several adjustments in regulated prices will be made during the forecast period, which allows expecting the rise in regulated prices to cause acceleration of inflation by approximately 1.3

percentage points. According to estimates, this influence may extend to 1 percentage point in 2006, whereas the risk is upward, as some plans concerning price regulation may still be unknown. In 2006, the main administrative action will be a rise in thermal energy prices, which is influenced by the price growth of major production inputs, primarily shale oil.

Growth of domestic production costs should move hand in hand with changes in core inflation. However, the relation between domestic production costs and core inflation should be smaller in a small open economy. According to the forecast, core inflation should slightly rise. The main reason here is the fast convergence of income levels and the accompanying price increase of production inputs. The cyclical position has become less favourable to core inflation and this may soon increase pressures related to cost-push and demand inflation. Cost-push inflation pressures have remained relatively reserved so far, as the growth in income has helped compensate the increase in production costs. Demand inflation is fostered by the situation, where the rise in income makes consumers more tolerant as regards price increases, which makes it easier to raise prices.

As regards risks that might bring along lower price increases, the possibility of core inflation remaining below the expected level should be pointed out. This will happen if the price rise of transport services stops, the price war in the telecommunications sector reintensifies, competition in the clothing and footwear sector becomes tighter, and household goods cheapen due to the further reorientation of imports to the Asian market. It is a possibility that such factors might compensate for the upward price pressures accompanying the fast wage growth.