I ECONOMIC POLICY SUMMARY

European economic growth started to accelerate in the third quarter of 2005 but did not continue as rapidly in the fourth quarter. Nevertheless, in the second half of 2005 and at the beginning of 2006 the faster growth of Estonia's major trade partners also boosted Estonian economic growth.

Higher oil prices and their impact on transport prices and other fuels largely affected the price rise of the consumer basket in the second half of 2005 as well as at the beginning of 2006. In addition to the oil price also other commodity prices increased.

The difference between the inflation rates in Estonia and in the euro area mainly stemmed from the fuel price rise. With the exception of the construction sector, domestic price pressures did not exceed the level considered sustainable in the long-term.

ESTONIA

Monetary policy environment

Contrary to market expectations the ECB raised monetary policy interest rates only in December 2005, followed by another increase in March 2006. As the difference between the money market interest rates in Estonia and in the euro area decreased, the interest rates of Estonian banks on housing loans continued shrinking until the end of the summer. Only at the end of the year did the rise of EURIBOR start affecting also the Estonian economy. Nevertheless, the increase of loan interest rates has remained marginal and has not interfered with further rapid loan growth.

Compared to 2004, the Estonian kroon appreciated against most of the currencies of the non-euro area partner countries in 2005. As an exception, it depreciated against the Swedish krona. However, at the end of the year and the beginning of 2006 the trend reversed, as the kroon depreciated against major currencies.

The appreciation of the real exchange rate against the currencies of industrial trading partners remained within the range of 3.0–3.5% both in 2005 and at the beginning of 2006. This can be considered a sustainable long-term level stemming from fast productivity growth.

External and domestic demand

In the second half of 2005, GDP growth accelerated almost up to 11%, with an annual average of 9.8%. According to preliminary estimates, growth remained fast also at the beginning of 2006.

The growth in demand on Estonia's main export markets was one of the fastest in recent years. Against expectations, the growth rate of goods and services exports did not decrease but even sped up. The intense investment activity of earlier years made it possible to increase exports hand in hand with demand. It can be summarised that broad-based growth was driven by both external and domestic demand. Growth was dynamic in almost all fields of activity and branches of manufacturing.

In the second half-year, domestic demand grew faster than external demand. Though also **private consumption growth picked up**, it still remained slower than income growth and led to **increased savings**. Low interest rates and tight competition on the banking market boosted the supply of loans, which, together with increased savings, fostered residential construction. This raised the issue of the long-term balance of economic development back on the agenda. The matter became even more topical as the decrease of the current account deficit in the second half of 2006 came to a halt and investments increased faster than household savings.

It was the high construction activity together with real estate development that accelerated GDP growth over the potential level. In the construction sector it became clear that supply would not catch up with demand, which resulted in increasing production costs. Therefore, driven by loan growth, real estate prices rose nearly 30%.

As the investment level remained high thanks to active residential construction, external balance failed to improve as much as the growth of household savings would have implied. Compared to the previous year, in 2005 the current account to GDP ratio still decreased by 1.5 percentage points. Direct investment was not sufficient to cover the continuously great investment needs and therefore, about half had to be financed by external loans. By the end of the year, Estonian external debt amounted to nearly 90% of GDP.

General government

Fast economic growth stimulated the **collection of tax revenue** and the **fiscal year 2005 ended in surplus already for the fifth year in row**. The surplus formed 1.6% of GDP and slightly exceeded the surplus of 2004, but given the acceleration of economic growth it should have been even larger.

Just like in earlier periods, government savings greatly supported the improvement of external balance. Public debt decreased to 4.8% of GDP.

In 2006, the income tax rates for private persons and enterprises were further reduced. Nevertheless, this does not entail a significant drop in the general tax burden, because at the beginning of the year the minimum rates of environmental and social taxes were raised and wages are also expected to grow faster than GDP.

Continuous fast growth and the state budget approved in the Riigikogu, which sets a moderate surplus as a goal, allow forecasting a general government surplus of up to 1.2% of GDP in 2006. However, an increase in the debt burden of local governments may pose some risks.

Inflation

While 2004 witnessed a rise in food prices after applying the common agricultural policy of the European Union, **in 2005 consumer prices were mostly affected by fuel and energy prices**.

After the electricity price rise scheduled for the beginning of March the inflation rate started decreasing, as expected. This lasted until June, when the oil prices shot up on the world market. The continuous appreciation of motor fuel prices also affected the prices of transport services and caused a price rise of all fuel types when the heating season started in autumn. Consumer price growth was therefore volatile and the annual **average inflation rate stood at 4.1%**. As the oil price remained high, consumer price growth did not slow down even in the first months of 2006.

Due to a lower income level, fuel-related goods and services play a greater role in the Estonian consumer basket than in the European Union on average. For that reason, the appreciation of oil also affected the Estonian inflation to a larger extent. Compared to countries in the euro area, the inflation rate rose up to nearly two percentage points. In the longer term, such difference is well expected, given faster productivity growth and the resulting convergence of income levels.

Domestic inflation pressures remained quite subdued also in 2005 with the exception of the construction and real estate sectors. Though nominal wage growth accelerated almost up to 11%, this was in line with the increase in productivity. Unit labour costs decreased at constant prices for the second year in row. Thus, also the core inflation accelerated moderately.

Forecast

Europe expects economic revival in the second half of 2006. Although global economic growth is expected to slow down slightly at the end of 2008, the export sector might continue fast growth. According to the forecast of Eesti Pank, economic growth will remain robust – 8.1% in 2006 and 7.6% and 6.9% in the next two years, respectively.

Despite faster wage increase, there is no sign of considerable price pressures and the main factor threatening price stability will be the price rise on the global commodity market. In 2006–2008, the annual consumer price growth will remain within the estimated 3.0–3.7%.

The general government is expected to maintain prudent policies and the budget will remain in surplus or in balance throughout the forecast horizon. Presumably already 2005 will witness government investment growth, primarily driven by infrastructure investments. The gross external debt of the general government will keep decreasing steadily, reaching 2.8% of GDP by 2008.

Balanced economic development is mainly jeopardised by loan demand, which may exceed the forecast. Active borrowing mostly boosts the growth in household investment but also private consumption, which may hinder the improvement of external balance or even bring it to a temporary halt.

Table 1.1. Key economic indicators of Estonia

	1995	1999	2000	2001	2002	2003	2004	2005
Real GDP growth (%)	4.5	0.3	7.9	6.5	7.2	6.7	7.8	9.8
Growth in goods and services exports (%)	5.4	0.8	28.4	-0.2	0.8	5.8	16.0	21.3
Growth in goods and services imports (%)	6.3	-5.4	28.1	2.1	3.8	10.6	14.6	17.4
Current account balance (% of GDP)	-4.4	-4.4	-5.5	-5.6	-10.2	-12.0	-12.5	-10.5
General government budget balance (% of GDP)	0.4	-3.7	-0.4	0.3	1.0	2.4	1.5	1.6
Consumer price index of 12 months (%)	29.0	3.3	4.0	5.8	3.6	1.3	3.0	4.1
Consolidated balance sheet of banks (% of GDP)	36.1	57.6	62.2	65.5	69.9	77.6	94.4	112.2
Capital adequacy of commercial banks (%)	14.5	16.1	13.2	14.4	15.3	14.5	13.3	11.7
TALSE/OMX Tallinn index change (%)		38.3	10.1	4.7	20.6	34.4	65.6	48.0
Consolidated loan portfolio of commercial M2 (% of GDP)	17.3	32.4	36.4	38.5	42.2	54.3	65.4	76.1
M2 (% of GDP)	26.3	32.0	35.1	38.6	38.3	39.4	41.1	50.1
External debt (% of GDP)	43.6	54.8	54.4	55.5	60.1	68.7	81.2	89.9
3-month TALIBOR (%; annual average)		7.8	5.7	4.0	3.5	2.6	2.4	2.6