I ECONOMIC POLICY SUMMARY

Despite the risks and declining global economic activity indices associated with the deceleration of economic growth in the US, the **external environment has favoured Estonian economic growth throughout 2006**. In the first half-year, economic growth in the euro area reached the highest level in recent years and also the growth of Estonia's main trading partners has remained faster than average.

Oil price, one of the principal factors endangering economic growth, started dropping at the beginning of the second half-year and reached the previous year's level. However, this did not bring about a general price decrease in commodity markets. The main problems of the Estonian economy are still related to internal market developments, including strengthening price and wage pressures as well as supply-side constraints in some sectors.

ESTONIA

Monetary policy environment

Due to the rise of monetary policy interest rates that began at the end of 2005 and continued in 2006, Estonian money market quotations also appreciated. By the end of September, however, they had grown by 1 percentage point compared to the beginning of the year. In comparison with the lowest interest rates witnessed in 2005, the interest rates on long-term household and corporate loans increased by an average of 1.5 percentage points. However, this did not decrease the loan demand and household indebtedness continued rapid growth. The large inflow of foreign capital continued and the economic environment can still be regarded expansive in terms of money supply.

The exchange rate of the Estonian kroon mainly strengthened, particularly since the second quarter. Like earlier, the nominal exchange rate of the kroon was primarily influenced by changes in the dollar exchange rate. The growth rate of the real exchange rate of the Estonian kroon remained the same as in 2005 and ranged within 3.0–3.5% during most months.

External and domestic demand

According to preliminary estimates, **gross domestic product (GDP) growth in Estonia remained at the level of 11% also in the first half of 2006**. Though the quarterly growth rate was slightly lower in the final months of the half-year compared to the first quarter, this does not denote the start of a slowdown.

Increased demand in foreign markets guaranteed the rapid export growth of goods and services. Nevertheless, the growth rate of merchandise exports did not reach as high as in the second half of 2005, raising the question whether the capacity of the export sector is sufficient to benefit from robust global growth.

The **domestic demand growth started accelerating** since the second half of 2005. The increase in private consumption gave cause for concern as it rapidly picked up speed in the first half of 2006 owing to bank loans, amounting to more than 15%. As a result of strong investment demand, the gap between savings and investments increased and, based on external trade data, the deterioration of the external balance that had begun already in the second half of 2005 continued even further. Though the inflow of foreign direct investment remained near its historical average, the majority of capital inflow was comprised of cash flows channelled through banks. Therefore, the Estonian external debt increased up to nearly 91% of GDP by the end of the first half-year. The issue of the potential economic imbalance thus remained high on the agenda and Eesti Pank decided to take additional measures in order to support macroeconomic balance.[1]

[1] For more details see background information "Measures of Eesti Pank implemented in 2006" on page 7.

Economic growth accelerated in almost all fields of activity and was extremely fast in the real estate sector as well as in financial intermediation.

Strong external demand and rapidly growing domestic demand underpinned by loans brought about an increase in the number of jobs. This reduced unemployment to nearly 6%, which is the lowest level since the past ten years. Owing to young people entering the labour market, but mainly due to a decrease in the number of the unemployed and discouraged, employment growth exceeded the previous years' levels of up to 2% by two or three times.

General government

The unexpectedly fast and broad-based economic growth secured **more successful collection of tax revenues than planned** throughout 2006. Although the general government carried out the planned reduction of corporate and personal income tax from 24% to 23%, the overall tax burden remained at the earlier level of 31% of GDP. Last year's income tax rate reduction was offset by increased excise duties and faster private consumption growth.

As the collection of tax revenues exceeded expectations, the government drafted a **supplementary budget** with the primary goal of **increasing the pension insurance reserves** and **providing additional funding for some investment programmes**. Although in the first half-year government savings were larger than in 2005, the expenses grew even faster in the second half. According to forecasts, the general government budget surplus will amount to a total of 1.7% of GDP, provided that supply-side constraints on the construction sector do not compel government agencies to postpone any investment projects. Compared to last year, the fiscal policy has somewhat loosened.

At the end of September, the Government approved the next year's draft state budget, which foresees at least a 0.5% surplus of GDP. This is the first time such a large surplus is projected.

Inflation

In the first half of 2006, oil prices on the world market proved to be much higher and more volatile than expected. As some food prices increased, the **decrease of consumer prices in Estonia** that had occurred during the final months of 2005 halted. The annual price rise of the consumer basket ranged near 4.5% from January to September 2006. Greater deviations from that level mainly stemmed from oil price changes on the world market.

In the final months of the first half-year, the extremely rapid development of the real estate sector also started to considerably affect the consumer basket appreciation rate. The prices of construction and repair materials as well as construction works and rental prices experienced faster growth than before. Increased income fostered the rise in the prices of all services and ultimately caused the core inflation to accelerate.

Real estate price growth remained brisk in the first half-year and reached 40%, year-on-year. Meanwhile, the rapid price increase no longer continued in all segments of the market and the real estate sector showed some signs of balancing between supply and demand.

This summer's weather was unfavourable for agriculture and horticulture, which is why the seasonal decrease in food prices was also minimal. In autumn, the inflation rate remained at its previous level also because of heating costs. In some fields of activity, labour costs started increasing at a disturbing pace.

The average consumer price inflation rate is expected to reach 4.4% in 2006. The inflation rate will probably remain the same also next year. In the future, it may be significantly affected by changes in tax policy.

Projections

The external environment will continue to foster Estonia's economic growth also in 2007–2008. The large inflow of foreign capital will keep the growth rate of domestic demand high. Though real GDP growth will drop to 7–8%, it will nevertheless exceed the estimated potential level also in the forthcoming years.

Strong demand will characterise private consumption as well as investments. The increase in funding by the European Union and investment programmes launched in 2006 give reason to expect higher investment activity also from the general government.

For 2007, the government has developed a draft state budget with a revenue surplus, the planned surplus being the largest ever.

Primary risks are related to the private sector, the deterioration of the external balance and increasing pressures on the prices of workforce, goods and services. According to forecasts, the average rise of consumer prices will remain at 4.5% level and may even speed up in case of certain tax policy decisions.

It is safe to conclude that the rapid growth rate will continue, but on account of a moderate deterioration regarding internal and external balance. Therefore, keeping the general government budget surplus at the necessary level is more important than before and both the Government as well as the central bank must be prepared to take additional measures in order to curb domestic demand, if necessary.

Table 1.1. Key economic indicators of Estonia*

	1995	1999	2000	2001	2002	2003	2004	2005	2006 (I h/y)
Real GDP growth (%)	4.5	0.3	7.9	7.7	8.0	7.1	8.1	10.5	11.7
Growth in goods and services exports (%)	5.4	0.8	28.4	2.0	1.7	7.6	17.1	21.5	17.0
Growth in goods and services imports (%)	6.3	-5.4	28.1	3.5	6.0	10.6	15.2	15.9	17.6
Current account balance (% of GDP)	-4.4	-4.4	-5.4	-5.4	-9.8	-11.5	-12.1	-10.0	13.0
General government budget balance (% of GDP)	0.4	-3.6	-0.2	-0.3	0.4	2.0	2.3	2.3	4.1
Consumer price index of 12 months (%)	29.0	3.3	4.0	5.8	3.6	1.3	3.0	4.1	4.5
Consolidated balance sheet of banks (% of GDP)	36.1	57.6	60.5	63.2	67.3	74.3	91.1	106.8	114.2
Capital adequacy of commercial banks (%)	14.5	16.1	13.2	14.4	15.3	14.5	13.3	11.7	12.1
TALSE /OMX Tallinn index change (%)		38.3	10.1	4.7	20.6	34.4	65.6	48.0	-8.3
Consolidated loan portfolio of commercial banks (% of GDP)	17.3	32.4	35.5	37.2	40.7	52.0	63.1	72.4	81.2
M2 (% of GDP)	26.3	32.0	34.1	37.3	36.9	37.7	39.6	47.7	49.3
External debt (% of GDP)	43.6	54.8	53.0	53.6	57.9	65.9	78.3	85.6	91.1
3-month Talibor (%; annual average)		7.8	5.7	4.0	3.5	2.6	2.4	2.6	3.1

* The Statistical Office of Estonia has adjusted the time series for 2000–2005. See also background information on page 8.