

KEY POINTS OF EESTI PANK'S ECONOMIC FORECASTS IN 2009

In 2009, Eesti Pank published a spring forecast in April and an autumn forecast in November. The forecast consists of a baseline scenario and risk scenarios for the economic developments in the current year and the next two. The forecast is compiled using the output of a macroeconomic model and expert assessments. The risk scenarios address the key risks to the economy.

In 2009, the global economy was gripped by the deepest recession of the past few decades. At the beginning of the year it became evident that the crisis had hit global trade, although just a few months before it was thought to be limited to financial markets. Estonia's major export markets in the Nordic and Baltic States suffered more from the crisis than initially expected in the central bank's 2009 spring forecast. Growth in the euro area was barely positive in the second half of the year, being supported by extensive economic policy measures. External demand stabilised by the time of compiling the autumn forecast, but was still weak and did not provide any substantial support to Estonia's exports. At this point, the question is whether the global economy is strong enough to retain growth also without help from governments.

The first signs of a shock in Estonia's domestic economy appeared at the beginning of 2009. The spring forecast underestimated the scope of adjustment in the non-financial economy, especially with regard to unemployment. Household started to save considerably more because of great uncertainty about future incomes, which in turn reduced consumption almost 25%. Corporate investment plummeted even more. This was partly owing to the fact that the Estonian economy, which had been enjoying credit boom based growth, was now facing much tighter credit conditions. Banks and investors turned more cautious. Therefore the prospect of the

euro changeover becoming clearer in the second half of the year was especially important in terms of the forecast. The expected changeover to the euro will boost growth in various ways: facilitates local investment, reduces loan margins and increases the country's credibility for foreign investors.

Consumer price growth eased in 2009 in line with the forecasts and in November Estonia was able to meet the Maastricht inflation criterion. The rise in excise duties and VAT in July did not have a significant impact and passed through to consumer prices only partially. The prices of tradable goods, in particular food and durables, responded quickly to the economic slump. Price adjustments in the services sector were expected to take place through a decline in wages, which is a process that takes more time. Based on current data, the nominal adjustment of the non-tradable sector in the next years has been smaller than expected at the onset of the crisis. Downward price rigidity is particularly characteristic of regulated prices.

The challenge in the coming years is the capability of the product and labour market to adjust to the rapidly changing economic situation. Estonia's economy that had operated at full blast only a couple of years ago is entering an environment of abundant unused resources. The steep downturn in output and accompanying expenditure cuts have strongly reduced labour force demand. A considerable amount of production capacity is still underutilised, especially in the construction sector, which hampers the future outlook of the Estonian economy. Looking further ahead, Estonia has several competitive edges compared with euro area countries. These are mostly based on the lower wage and price level and allow Estonia to expand faster once the recession is over.