

I. ESTONIAN ECONOMY IN 2007

The adjustment of the Estonian economy started with the support of domestic demand in the middle of 2007. Therefore, the developments in the first and second half-year were different in many ways. Expectedly, the first signs of adjustment revealed themselves in the slowdown of economic growth. Lower investment activity and slower growth in private consumption reflected clearly also in the decreased trade deficit. The decline in labour costs and domestic price pressures manifested itself somewhat later.

MONETARY POLICY ENVIRONMENT

Considering the growing inflation pressures, the European Central Bank (ECB) continued raising monetary policy interest rates in the first half of 2007. The uncertainty arising from risky housing loans issued by the US banks spread all over the world in August and influenced also the rise of the Euribor. In Estonia, the prices of housing loans increased by 1.8 and long-term corporate loans by 1.2 percentage points by the end of the year. This together with the prospects of decelerating economic growth reduced loan demand and accelerated the slowdown in credit growth that had started already in the middle of 2006.

The real exchange rate of the Estonian kroon appreciated mostly due to dollar depreciation, reaching an average of 0.9% year-on-year.

As a result, the **monetary policy environment** was more **restrictive** in 2007 than in earlier years, although capital inflow was still high and the growth of monetary reserves continued.

MONEY AND CAPITAL MARKET

The turmoil that struck global financial markets last summer increased investors' risk aversion. In the case of Estonia, this was further exacerbated by the fact that the majority of macroeconomic balance indicators improved modestly until the end of the year and that the press published several articles discussing the possibilities of the devaluation of the Estonian kroon.

In such environment, risk-hedging transactions related to the kroon exchange rate gained popularity. This led to an increase in the kroon's money market interest rates in the second half of November. At the beginning of 2008, the upward trend turned but Talibor quotations remained at a much higher level than seen in recent years. At the end of January, the differences between interest rates across the maturity spectrum of three, six and twelve months were approximately 30, 35 and 40 basis points, respectively.

In the first half of November, the stronger demand for risk-hedging transactions related to the kroon exchange rate caused an increase in the difference between interest rate quotations that form the basis of future Estonian kroon and euro transactions (forward premiums). Quotations of forward transactions remained high and volatile until the end of the year. However, in January the derivatives market started to show signs of cooling since the quotations of forward transactions fell.

The end of the construction boom and the decreasing growth rate of private consumption inhibited growth in money demand in the second half-year. The increased interest rates had a similar impact. By the beginning of 2008, the interest rate on corporate kroon loans had risen to 6.6% and that on household housing loans to 6.2%.

Borrowing activity decreased steadily and by the end of the year, the size of loans granted to the non-financial sector had increased just about 30% on an annual basis. This trend continued also in the first months of 2008. The stock of consumer credit grew faster than average but displayed clear signs of a slowdown.

At the end of December, the stock of bank loans granted to the non-financial sector accounted for 90% of GDP; housing loans comprised 36% of that. It can be said that in the second half-year, financial deepening almost ceased and only the exporting sector continued to borrow at the usual rate.

Despite the decreasing demand, foreign capital inflow was large also in the second half of 2007 and monetary reserves continued to grow. The inflow of foreign direct investment in the non-financial sector was slightly higher than in the past few years. The majority (about 70%) of direct investment in Estonia were reinvested earnings. Similar to previous years, most of the external funds were raised in the form of loans and the stock of external debt increased to 110% of annual GDP by the end of the year.

EXTERNAL DEMAND

Growth in the partner countries remained relatively strong but did not pick up further or exceed expectations as in earlier years. Therefore, the exports of goods and services also maintained rapid growth in 2007.

The increase in goods exports was still broad-based. The exports of electronic products, timber and timber products and food products grew faster than average. The conditions for the sale of dairy products as well as other food products were very good. However, the slowly increasing production capacity of domestic agriculture became a restricting factor. The lack of raw material inhibited also growth in exports of timber products.

Exports of services increased considerably faster than in 2006. Transport services, especially maritime transport and construction, made the biggest contribution to growth. In tourism business growth remained modest.

Based on general indicators, growth in services exports was much stronger compared to goods exports. At constant prices, exports of services increased 8% year-on-year, while exports of goods remained virtually at the previous year's level. However, these indicators are not entirely comparable. To be more explicit, in 2006 the growth of merchandise exports was accompanied by a considerable increase in the re-export type of goods that contribute only marginal value added for the Estonian economy. In 2007, the flow of such goods did not

grow any longer, and their value even decreased. This, however, might lead to the wrong conclusion that growth in Estonia's export sector has slowed significantly. The competitiveness of goods produced in Estonia and their contribution to economic growth is better characterised by the export dynamics of manufactured goods. According to this indicator, the growth rate of goods exports in 2007 was only 1–2 percentage points lower than in the previous year.

ADJUSTMENT OF DOMESTIC DEMAND

The extremely rapid economic expansion in 2005–2006 relied mainly on the developments in the real estate sector. In spring 2007, the robust growth started to slow as expected.

Real GDP growth that had reached 9% in the first half-year decreased to around 5% in the second half. According to preliminary estimates, the annual average growth rate was 7.1%. Thus, economic growth slowed to the levels recorded prior to the EU accession. Expectedly, growth decreased above all in fields related to real estate development. In the second half-year, growth in these sectors decelerated considerably and practically ceased in the last quarter. The construction sector witnessed a smaller decline owing to the continuation of the ongoing development projects.

Investment activity decreased significantly in the second half of 2007, while the amount of fixed investment remained unchanged compared to 2006. The decline in investment activity resulted from real estate related developments, whereas in export-oriented fields, for instance, there were no changes. The rapidly decreasing growth rate overshadowed the fact that compared to the old EU member states, investment demand remained high and required continuous external financing.

Private consumption was another component of domestic demand that sustained the robust growth of previous years and started to grow slower in summer 2007. By the last quarter, the earlier double-digit real growth rate had decreased to 3–4%. Gov-

ernment consumption growth, on the other hand, picked up speed but was still below the average level of economic growth and did not exceed 5% at constant prices.

According to preliminary estimates, the growth rate of private consumption stabilised at the beginning of 2008, whereas investment activity declined further.

EXTERNAL BALANCE

Along with the start of economic adjustment, the deterioration period of the current account deficit came to an end in summer 2007. When domestic demand growth slowed, imports of goods decreased, which had a positive impact on trade balance.

In the first half-year when the growth rate of domestic demand still exceeded 12%, the current account deficit accounted for about 19% of GDP of the period. It was over 3 percentage points more than at the same time in 2006. In the second half-year, the growth of domestic demand at constant prices slowed to 6.3% and also the external trade deficit started to decrease. As a ratio of GDP, the external trade deficit was similar to that of the same time last year. Flash estimates of the first months of 2008 referred to the continuous decrease in the deficit.

Supported by freight growth and construction, the growth of services exports picked up significantly; however, the amount of imported services also started to increase faster. Similar to last year, the cost of exported services exceeded that of imported services by slightly more than 6% as a ratio of GDP. Thus, the services sector remained neutral as

regards the improvement of external balance, and the main determinant was imports of goods, driven by domestic demand.

Although the trade balance deficit decreased in the second half-year, this did not reduce the total current account deficit. The underlying reason for this was the increased outflow of investment income, calculated on an accrual basis. Income on investment in Estonia was about 45% larger than in 2006 also in the last months of 2007. This was at least partly related to the prices of services, which had been going up until the end of 2007, as well as to the fact that economic adjustment first reveals itself in the decrease of the growth rate and only then in the decrease of domestic price pressures. Therefore, the annual current account to GDP ratio was even worse in 2007 than in the previous year, standing at nearly 17%.

INFLATION

Similar to the past few years, **consumer price growth was stronger than expected** also in 2007. As an annual average, the cost of consumer basket increased 6.6%.

As long as the period of rapid growth lasted, the robust increase in service prices continued as well. Housing costs grew also due to the increase in the value added tax imposed on district heating and the rise in world energy prices. In the light of the weakening domestic demand, the acceleration in core inflation also ended in the last months of the year. Unfortunately, a **hike in food prices on the world market** started off then. At the end of the

Table 1. Key economic indicators of the two periods of robust growth in Estonia

	1995–1998 Average	1998	1999 Year of recession	2000–2007 Average	2007
Real GDP growth (%)	6.4	5.4	-0.1	8.6	7.1
Real export growth (%)	11.5	13.7	0.6	10.8	1.5
Consumer price index (%)	17.9	8.2	3.3	4.1	6.6
Growth of average gross wages (%)	24.5	15.4	10.4	12.5	20.4
Current account (% of GDP)	-8.2	-8.6	-4.3	-11	-17.4
Fixed capital investment (% of GDP)	28.0	30.5	24.7	30.3	31.9
Nominal credit growth (%)	55.6	12.2	11.6	31.8	34.6
Fiscal balance (% of GDP)	0.5	-0.7	-3.5	1.4	2.8

year, inflation was stimulated by the new upward trend in oil prices. Food prices increased faster than expected also at the beginning of 2008. Since at the same time excise duties were raised, the inflation rate accelerated temporarily to 11–12%. In February, the growth rate of food prices decelerated almost to the usual level but the risk of the re-acceleration of price rise stemming from world market prices remained high.

In 2007, the real exchange rate of the Estonian kroon appreciated by nearly 3% on average. This was mainly facilitated by the stronger growth of consumer prices compared to that in the partner countries, which is why growth in the real exchange rate of the kroon accelerated to 4–5% in the second half-year.

Until autumn, inflation was boosted by robust income growth. New jobs were created almost throughout the year but at a slower pace compared to the previous year and considerably less in the last months of the year. The annual average employment rate increased approximately 1.5%. The unemployment rate also continued to decrease, falling to 4% at the end of the year. Average wage growth was stronger than a year ago, but showed signs of deceleration in the second half. Wage growth outpaced productivity growth in most economic sectors in 2007.¹

GENERAL GOVERNMENT

The general government budget was in surplus for the sixth consecutive year. According to preliminary estimates, the consolidated budget surplus for 2007 was 2.8% of GDP. Even though it was higher than targeted in the state budget strategy, compared to earlier periods, the surplus decreased more than might have been expected on the basis of slower domestic demand growth. The surplus was no longer induced by extra tax revenue but the planned increases in reserves as well as the postponement of some major projects at the local government level.

As concerns the tax policy, the Government continued efforts to reduce labour taxes and raise consumption taxes. At the beginning of 2007, both the corporate and statutory personal income tax rate was lowered by 1 percentage point to 22%. Since the non-taxable income threshold remained unchanged, the lower VAT rate that had been imposed on district heating and stove heating sold to households was increased to the usual level of 18% and wage growth accelerated further in the first half-year, the general tax burden increased by 1.5 percentage points as a ratio of GDP. The tax burden is expected to remain relatively similar also in 2008 if along with income tax rate reduction, excise duties on alcohol, tobacco and motor fuel are increased and an excise duty is imposed on electricity. After increasing tobacco excise duties, which is planned for July, excise duty rates will reach the minimum level agreed upon in the European Union and the harmonisation of tax policy can be considered completed.

On the expenditure side, the most significant change in 2007 was the abandoning of discretionary one-off pension increases and the introduction of a formula for calculating pensions so as to link them more closely with average wage growth.

As the budget surplus increased, the general government debt decreased even more. By the end of the year, the government debt-to-GDP ratio fell below the level of 3.5%.

For 2008, the Government is targeting a surplus of 1.3% of GDP. Although this target is more ambitious than in several earlier years, it may not be sufficient to support the soft landing of the economy. Moreover, by the beginning of the year it became clear that the revenue forecast might have been too optimistic and the investment programme in strategy documents too ambitious in order to achieve the aforementioned target of budget balance. This, however, means that the planned expenditure should be curtailed.

¹ For more details on the labour market see Eesti Pank's *Labour Market Review*, No 1/2008.