Foreword by Governor of Eesti Pank

The year 2006 was successful for Estonia's economy and also the second consecutive year of extremely fast growth. The unemployment rate was the lowest of the last decade and real wages grew over 12 per cent. A lot of people decided to take a loan to improve their living conditions.

However, rapid economic expansion may also involve higher risks. The central bank drew attention to this issue several times during the year. Apparently, explanations aiming at cooling down excessive optimism have made an impact. The year 2006 showed a breakthrough in general attitudes: earlier, there was the question whether the central bank voices its concerns on risks and dangers too often, but now people would rather ask why the central bank and the Government do not take even more decisive measures to manage risks. What should the measures be like and – should there be any specific measures at all?

Eesti Pank expects the 2007 economic growth stand at 8.4% and at about 6.5% the year after. With figures like these Estonia should remain among the fastest growing EU Member States also in the years to come. Over the long term, rapid development will persist and living standards of the leading European industrial countries can be reached only if the economy will smoothly move towards a slightly slower and more sustainable growth path.

It is vital, however, that further growth is not merely based on domestic demand. Estonian exports increased robustly in 2006, exporters' future expectations at the end of the year were even more optimistic than early in the year, and the economy's competitiveness remained high. If competitiveness is maintained, also economic outlook will remain favourable.

Sustained competitiveness of Estonia's economy presumes a flexible labour market and sufficient supply of qualified labour. Recent rapid developments and integration with the European Union might imply that upward wage pressures might persist. At the end of 2006, risks related to unit labour costs (labour costs per unit of production) began to emerge. Wage pressures are expected to continue in 2007. Should this involve an increase in labour costs at the expense of profitability, it indicates a risk for competitiveness. It is important that wage growth did not exceed growth in productivity.

Estonia's economy will continue rapid development in the next few years. This suggests a strong need for investment since in Estonia's economy there is significantly less capital per employee than on average in

the EU. Therefore, the current account deficit will remain rather large, accounting for 15 per cent in 2006. The deficit displays the difference between domestic savings and investments and the share of foreign capital in financing investment made in the Estonian economy today. Foreign capital inflow into Estonia is only natural regarding the current stage and reliability of economic development. A gradual decrease in the current account deficit can be expected when the need for investment diminishes. Given the above, we should emphasise that the government's prudent fiscal policy has inhibited deficit growth. It is also worth mentioning that along with income growth residents' savings kept growing in 2006, whereas in terms of savings Estonia's economy may already be compared to industrial countries with higher income levels.

Should changeover to the euro in Estonia be indefinitely postponed, all the risks to the economy may aggravate. The changeover is an economic policy priority for Estonia and should also remain one. We are highly unlikely to meet the Maastricht inflation criterion in 2007–2009. Nevertheless, we should maintain readiness to adopt the euro at the first opportunity.

In the longer run, Estonia's rapid progress can be maintained through further changes in the production structure and an increase in productivity. From the national point of view, it entails providing favourable investment and growth environment, acknowledging the importance of business and the willingness to take risks, as well as a clear understanding of how vital for us is an educational system ensuring high quality and good results.

At the same time, we should preserve these factors that have guaranteed our success until now: sustainable and transparent fiscal policy, open and clear tax system, and economic climate conducive to business.

In conclusion, adjustment to changed conditions does not require any special or totally different economic policy but rather follows a normal course of market development. Estonia's successful economic policy should be consistently pursued.

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