Eesti Pank
Bank of Estonia

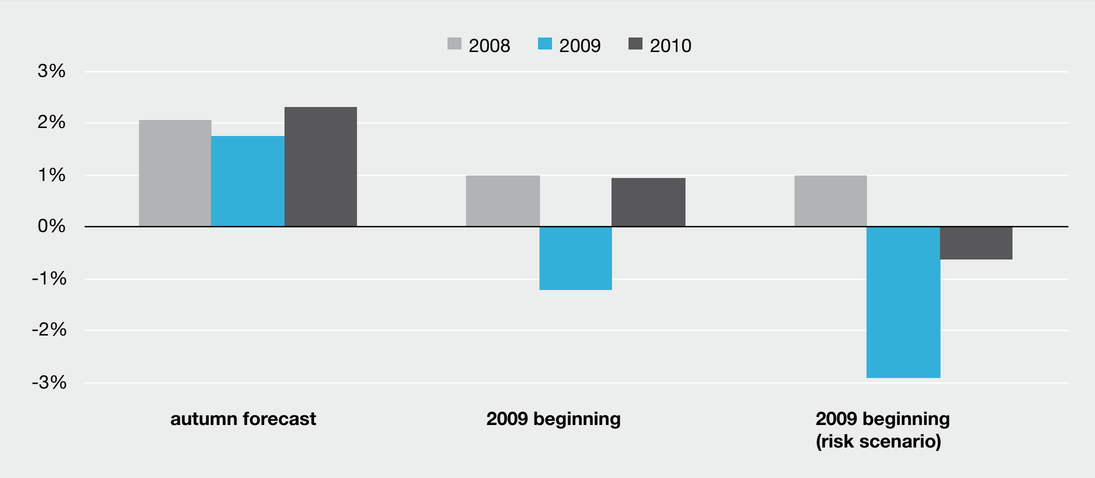
ESTIMATES OF ESTONIA'S ECONOMY IN LIGHT OF DEEPENING GLOBAL FINANCIAL CRISIS

Flash report, 5 February 2009

The deepening financial crisis and economic downturn in the external markets have significantly increased the risks facing Estonia's economy in 2009. Nearly all the forecasts of major international institutions (EU, IMF, Consensus Forecasts etc.) are now broadly in line with the risk scenario of Eesti Pank's autumn forecast. Based on these forecasts, we anticipated a 1.5 per cent growth for Estonia's trading partners in October, but the current projection allows to expect a 1 per cent decline instead.

However, substantial uncertainties are surrounding even the most recent forecasts and it cannot be excluded that Estonia's external environment would be even more unfavourable. The global economic and financial crisis has had a considerable impact on the corporate sectors of our main partners. External demand might partly recover in 2010, but the upturn is likely to be slow and depends on the ability of the economies to adapt to the new conjuncture. It should also be mentioned that the decrease in interest rates and large fiscal stimuli in all major economic regions will help the global economy survive the difficult times.

As external demand has eased considerably, Estonia's real GDP may decline up to 5.5 per cent this year. This estimate of Eesti Pank generally complies with the January estimates of the European Commission. If the economies of Estonia's trading partners decrease 3 per cent on average, Estonia's economy may decline up to 9 per cent.



Economic growth forecast for Estonia's trading partners

Source: Consensus Forecasts (2009); estimates of Eesti Pank

The inflation rate has been decreasing at a much faster pace than we expected in autumn, and is likely to remain below 2 per cent in 2009. The price level will not change in 2010. The underlying reason for that, besides the declining domestic demand, is the steep fall in oil and food prices. The risk scenario of the forecast, however, anticipated a more pronounced slowdown in growth, which would entail a decrease in the price level in

2010. In any case, the rapid moderation of inflation in 2009 and 2010 is an expected and appropriate reaction to the strong price growth witnessed in previous years, especially in the domestic market oriented sectors.

Estonia's foreign trade deficit has been rapidly shrinking in the past few months. Indeed, the projected level of current account deficit will ensure that there is no need for additional foreign capital net inflows in 2009 to finance the current account deficit, given the expected inflow of investment from EU structural funds. The sustainability of Estonia's external position is also supported by considerable growth in household saving.

When estimating the future growth outlook for Estonia, it should be borne in mind that the adjustment of the economy, following a period of excessive growth in domestic demand, started already in the second half of 2007. The real estate and construction sectors that had been overheating in recent years experienced a large decline in output in the second half of 2008. Private consumption has significantly eased too. Consequently, many companies have changed their operating strategies and have brought prices and wages in line with the new market situation. This is reflected in decreasing employment and increasing use of flexible working forms, including shorter working time. In 2009, the economic adjustment will be alleviated by the positive impact of lower interest and inflation rates on incomes.

The priority for the current economic policy is to reduce public expenditure in 2009 by approximately 3.5 per cent of expected GDP and bring the public sector budget in line with the new economic conjuncture. The budget should be cut by 8–9 billion kroons in order to stabilise the budget deficit at 3 per cent of GDP. This would contribute to meeting the Maastricht budget criterion and the perspective of joining the euro area. Moreover, we should also consider that the funds necessary for covering the budget deficit in 2009 are scarce. As the growth outlook for the coming years will be much lower than expected, both the growth and level of costs should be reviewed. Maintaining a reliable fiscal policy and economy calls for decisions aimed at reducing the budget deficit further in 2010 and recovering a surplus in the years to follow.

The new growth cycle will be able to rely on the continuously strong fundamentals of Estonia's economy: the credible banking system, flexible business environment and labour market, and the fiscal reserves accumulated in recent years. The structural strength of the economy, sustainable public finances and stable tax system are the key prerequisites for attracting new investment. In addition, the business sector needs support and credit from the banking sector. Economic restructuring takes time and will continue also in 2010. The recovery of the Estonian economy largely depends on the revival of the global economy.

Key economic indicators for 2007–2010

		2007	2008	2009**	2010**
GDP (EEK bn)	Base scenario	239	251*	242	245
	Risk scenario	239	251*	230	222
GDP growth (%)	Base scenario	6.3	-3.0*	-5.5	1.0
	Risk scenario	6.3	-3.0*	-8.9	-3.5
Inflation (%)	Base scenario	6.8	10.6	2.0	0.3
	Risk scenario	6.8	10.6	0.2	-1.7

* Estimate data for Q4.
** Forecast.

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