Country Report

Estonia

Estonia at a glance: 2007-08

OVERVIEW

The three-party coalition government comprising the free-market Reform Party, the left-leaning Centre Party and the centre-left Estonian People's Union is set to remain in office until the March 2007 parliamentary election. The Centre Party's unsuccessful manoeuvring in the September 2006 presidential election has damaged its relations with most other political groups and may also have reduced its popular support. As a result, the next government is likely to be another coalition led by the Reform Party. The general government budget will remain in surplus throughout the forecast period. Real GDP growth is set to slow gradually, from an estimated 10.7% in 2006 to 8.9% in 2007 and to 7.2% in 2008. Inflation will fall back as oil prices stabilise, but will still be too high to allow Estonia to join the euro zone in 2008. The current-account deficit is estimated to have risen to 12.2% of GDP in 2006, but is projected to fall to 10.2% of GDP in 2008.

Key changes from last month

Political outlook

- Recent opinion polls showed the Reform Party with the most support, followed by the Centre Party. Support for the new conservative party to be created from the Pro Patria Union and Res Publica remains low. This tends to back the Economist Intelligence Unit's view that the Reform Party will lead the government formed after the March 2007 election.

Economic policy outlook

- The Bank of Estonia (BoE, the central bank) has confirmed that Estonia is unlikely to be able to join the euro zone in 2008 and now sees 2010 as the earliest feasible entry date.

Economic forecast

- Although headline inflation has fallen in the past couple of months, it is increasingly clear that underlying wage and cost trends are deteriorating. We have therefore increased our forecasts of inflation to 3.8% in 2007 and 3.7% in 2008 (from 3.4% and 3.1% previously).

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The Economist Intelligence Unit

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Estonia

December 2006

Summary

Outlook for 2007-08

The three-party coalition government comprising the free-market Reform Party, the left-leaning Centre Party and the centre-left Estonian People's Union is set to remain in office until the March 2007 parliamentary election. The Centre Party's unsuccessful manoeuvring in the September 2006 presidential election has damaged its relations with most other political groups and may also have reduced its popular support. The next government is likely to be another coalition led by the Reform Party. The general government budget will remain in surplus during the forecast period. Real GDP growth is set to slow gradually from an estimated 10.7% in 2006 to 8.9% in 2007 and to 7.2% in 2008. Inflation will fall back as oil prices stabilise, but will still be too high to allow Estonia to join the euro zone in 2008. The current-account deficit is estimated to have risen to 12.2% of GDP in 2006, but is projected to fall to 10.2% of GDP in 2008.

The political scene

Toomas Hendrik Ilves was elected president in September, defeating the incumbent, Arnold Ruutel. Despite divisions between the coalition partners over the presidential election, the present government looks set to remain in office until the end of the parliamentary term in March 2007. Villu Reiljan, the leader of the People's Union, was forced to resign as environment minister following a property scandal.

Economic policy

The government budget accumulated a surplus of EEK6.5bn (US$520m) in January-October 2006. The government has proposed a limited supplementary budget, and some of the additional funds will be used to renationalise Eesti Raudtee (EVR; Estonian Railways) by buying back the 66% stake in the firm currently held by Baltic Rail Services (BRS). The Bank of Estonia (BoE, the central bank) has indicated that it expects Estonia's entry into the euro zone to be delayed until at least 2010.

The domestic economy

Real GDP rose by 11.7% year on year in the second quarter, maintaining the very rapid rate of growth seen in the first quarter. The labour market tightened further and real wage growth looks to have quickened. Lower oil prices caused the inflation rate to fall to 3.7% in October, but underlying inflationary pressures are rising.

Foreign trade and payments

Imports grew more quickly than exports in the third quarter, causing the trade and current-account deficits to increase further. In the 12 months to September 2006 the current-account deficit was €1.6bn (US$2bn), or around 13% of GDP.

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Political structure

Official name	Republic of Estonia
Legal system	On October 7th 1992 the Estonian State Assembly, the Riigikogu, declared legal continuity between the 1918-40 republic and the present state. A new constitution was adopted in June 1992 by referendum
National legislature	Unicameral assembly, the Riigikogu, of 101 members. All members are directly elected, but parties need a minimum of 5% of the vote to enter the Riigikogu. Members can later sit as independents. The Riigikogu's term is for four years
Electoral system	Proportional representation. There is universal suffrage for Estonian citizens (as defined by the reinstated 1938 citizenship law) over the age of 18, whether resident in Estonia or abroad. Other residents, mainly Russians and other minorities, cannot vote in general elections, but are able to vote in municipal elections
National elections	March 2nd 2003 (parliamentary); June 13th 2004 (European parliament); October 16th 2005 (local); and September 23rd 2006 (presidential); next election is scheduled to be held in March 2007 (parliamentary)
Head of state	President, currently Toomas Hendrik Ilves, who was elected to a five-year term by an electoral college in September 2006, after three ballots in the Riigikogu failed to produce the constitutionally required majority
National government	A majority coalition government led by Andrus Ansip, comprising the liberal Reform Party, the left-leaning Centre Party and the rurally oriented Estonian People's Union. Officially, it has 52 seats in the Riigikogu, but, including those who have left other parties, in effect it controls 58 seats
Main political parties	Res Publica (26 seats in the Riigikogu); Centre Party (20 seats); Reform Party (22 seats); Estonian People's Union (16 seats); Pro Patria Union (seven seats); Social Democratic Party (SDP; nine seats); United People's Party (no seats in the Riigikogu). These figures include MPs who have changed party affiliation since taking their seats, although formally they cannot join another parliamentary group. One MP, formerly from the Centre Party, is not aligned with any parliamentary group

Council of Ministers	**Prime minister**	Andrus Ansip (Reform)
Key ministers	**Agriculture**	Ester Tuiksoo (People's Union)
	Culture	Raivo Palmaru (Centre)
	Defence	Jurgen Ligi (Reform)
	Economic affairs & communications	Edgar Savisaar (Centre)
	Education & research	Mailis Reps (Centre)
	Environment	Rein Randver (People's Union)
	Finance	Aivar Soerd (People's Union)
	Foreign affairs	Urmas Paet (Reform)
	Internal affairs	Kalle Laanet (Centre)
	Justice	Rein Lang (Reform)
	Population & ethnic affairs	Paul-Eerik Rummo (Reform)
	Regional affairs	Jaan Ounapuu (People's Union)
	Social affairs	Jaak Aab (Centre)
Central bank governor	Andres Lipstok	

Economic structure

Annual indicators

	2002[a]	2003[a]	2004[a]	2005[a]	2006[b]
GDP at market prices (EEK bn)	121.4	132.9	146.7	173.1	201.5
GDP (US$ bn)	7.3	9.6	11.6	13.8	16.1
Real GDP growth (%)	8.0	7.1	8.1	10.5	10.7
Consumer price inflation (av; %)	3.6	1.3	3.0	4.1	4.3
Population (m)	1.4	1.4	1.3	1.3	1.3
Exports of goods fob (US$ m)	3,506	4,596	5,983	7,785	9,680
Imports of goods fob (US$ m)	-4,623	-6,162	-8,003	-9,631	-12,034
Current-account balance (US$ m)	-779	-1,115	-1,458	-1,446	-1,958
Foreign-exchange reserves excl gold (US$ m)	1,000	1,373	1,788	1,943	2,340
Total external debt (US$ bn)	4.7	7.0	10.0	11.6[b]	14.2
Debt-service ratio, paid (%)	14.4	17.2	15.7	15.4[b]	14.2
Exchange rate (av) EEK:US$	16.61	13.85	12.59	12.58	12.52

[a] Actual. [b] Economist Intelligence Unit estimates.

Origins of gross domestic product 2005	% of total
Agriculture, forestry & fisheries	3.7
Manufacturing, mining & electricity	21.2
Construction	7.3
Transport, storage & communications	12.1
Trade	15.2
Business services & real estate	18.8

Components of gross domestic product 2005	% of total
Private consumption	51.8
Public consumption	17.4
Gross fixed capital formation	31.1
Change in stocks	4.2
Exports of goods & services	80.0
Imports of goods & services	-86.1

Principal exports 2005	% of total
Machinery & equipment	28.1
Wood & paper	13.2
Metals & metal products	9.0
Clothing & footwear	8.7
Furniture	8.3

Principal imports 2005	% of total
Machinery & equipment	31.0
Chemicals	11.9
Metals & metal products	10.3
Transport equipment	10.2
Fuels & mineral products	9.3

Main destinations of exports 2005	% of total
Finland	26.7
Sweden	13.2
Latvia	8.8
Russia	6.5
Germany	6.3

Main origins of imports 2005	% of total
Finland	19.7
Germany	14.0
Russia	9.2
Sweden	8.8
Lithuania	6.0

Quarterly indicators

	2004	2005				2006		
	4 Qtr	1 Qtr	2 Qtr	3 Qtr	4 Qtr	1 Qtr	2 Qtr	3 Qtr
State finance (EEK m)								
Revenue	13,143	11,706	14,077	14,599	14,767	13,161	17,666	18,580
Expenditure	14,321	11,187	13,306	12,149	16,094	13,513	15,346	14,817
Balance	-1,140	519	771	2,450	-1,327	-353	2,320	3,763
Output								
GDP at constant 2000 prices (EEK m)	33,465	32,390	36,257	36,061	37,261	36,188	40,503	n/a
GDP at constant 2000 prices (% change)[a]	6.1	8.3	10.1	11.9	11.3	11.7	11.7	n/a
Industrial production index (2000=100)	155.3	145.8	158.9	157.1	168.5	158.1	171.0	165.9
Industrial production index (% change)[a]	10.6	7.1	11.1	9.9	8.5	8.4	7.6	5.6
Employment, wages and prices								
Unemployment rate (% of the labour force aged 15-74)	8.6	9.6	8.2	7.1	7.1	6.5	6.2	n/a
Gross wages (EEK per month)[b]	7,704	7,427	8,291	7,786	8,690	8,591	9,531	n/a
Gross wages (% change, year on year)[b]	8.1	10.1	11.8	10.9	12.8	15.7	15.0	n/a
Consumer prices (1997=100)	134.9	135.9	137.8	139.7	140.3	141.8	143.9	145.9
Consumer prices (% change, year on year)	4.6	4.6	3.5	4.3	4.0	4.4	4.4	4.4
Producer prices (1995=100)	143.6	144.4	144.1	145.1	146.5	148.9	150.2	152.1
Producer prices (% change, year on year)	3.8	3.3	1.8	1.3	2.0	3.1	4.2	4.8
Financial indicators								
Exchange rate EEK:US$ (av)	12.08	11.93	12.42	12.83	13.15	13.04	12.45	12.28
Exchange rate EEK:US$ (end-period)	11.47	12.08	12.95	13.01	13.22	12.92	12.31	12.34
Deposit rate (av; %)	2.2	2.1	2.1	2.1	2.2	2.4	2.7	3.0
Lending rate (av; %)	5.6	4.9	4.9	4.8	5.1	4.9	4.8	5.0
M1 (end-period; EEK m)	36,178	36,498	42,650	43,547	48,673	50,673	56,490	59,269
M1 (% change, year on year)	17.4	21.1	28.6	28.7	34.5	38.8	32.4	36.1
M2 (end-period; EEK m)	58,251	61,557	69,974	71,844	82,674	86,175	92,881	97,355
M2 (% change, year on year)	15.8	22.2	31.4	32.0	41.9	40.0	32.7	35.5
Sectoral trends								
Manufacturing production (2000=100)	159.5	147.3	171.1	164.1	174.5	161.0	184.0	176.2
Energy production (2000=100)	135.4	151.4	84.0	99.8	136.9	153.5	89.7	85.2
Oil shale production ('000 tonnes)	4,026	3,719	3,119	3,552	4,144	3,836	3,066	n/a
Construction activity (EEK m)	8,514	5,771	8,513	10,838	11,413	7,455	11,664	n/a
Foreign trade								
Exports fob (EEK m)	20,853	21,224	23,398	24,776	27,526	28,132	30,580	n/a
CIS	2,056	1,586	1,911	2,270	2,614	2,493	2,918	n/a
EU25	16,437	16,633	18,642	19,382	20,990	18,526	19,613	n/a
Imports cif (EEK m)	-28,682	-27,203	-31,389	-33,012	-36,139	-36,214	-41,477	n/a
CIS	3,511	3,603	3,683	2,995	4,674	7,051	6,918	n/a
EU25	22,230	20,229	24,343	25,543	26,917	25,254	29,816	n/a
Trade balance	-7,829	-5,979	-7,991	-8,236	-8,613	-8,082	-10,897	n/a
Balance of payments (US$ m)								
Merchandise trade balance fob-fob[c]	-513	-366	-500	-481	-498	-442	-656	-723
Services balance[c]	225	186	273	299	243	145	315	322
Income balance[c]	-254	-209	-240	-144	-108	-183	-213	-286
Net transfer payments[c]	98	14	46	13	27	-10	44	19
Current-account balance[c]	-444	-375	-422	-313	-336	-489	-511	-669
Reserves excl gold (end-period)	1,788	1,925	1,697	1,694	1,943	1,883	2,105	2,371

[a] Year on year. [b] Excluding health insurance benefits. [c] Bank of Estonia.

Sources: Statistical Office of Estonia, *Estonian Statistics*; Bank of Estonia; IMF, *International Financial Statistics*.

Outlook for 2007-08

Political outlook

Domestic politics

The present government, Estonia's 12th since independence in 1991, is headed by Andrus Ansip, leader of the liberal Reform Party. It is a coalition between the Reform Party, the left-leaning Centre Party and the centre-left Estonian People's Union. Between them, the coalition parties hold 52 seats in the 101-member Riigikogu (parliament), although a further six independent parliamentary deputies also support the coalition. The government has a limited agenda, and policy issues are unlikely to threaten the government's unity ahead of the March 2007 parliamentary election. The next election is likely to be a clear left-right struggle between the Centre Party and the Reform Party. Even if the Centre Party emerges as the largest grouping in the next parliament, it is likely to find it difficult to construct a parliamentary majority.

Res Publica, which is currently the main opposition party in parliament, has responded to its weak showing in the opinion polls by merging with the conservative-nationalist Pro Patria Union to form a new conservative party, provisionally named the Party for Estonia. After an internally divisive election, the new group has chosen Mart Laar, a former prime minister from the Pro Patria Union, as its candidate for prime minister, in preference to Jaak Aaviksoo, a former rector of Tartu University. However, Mr Laar has so far done little to set out the party's approach. Until he does so, the new party's potential level of support and its relationship with the Reform Party will remain unclear.

The Centre Party has sought to increase its chances of leading the government that will be formed after the next parliamentary election by entering an alliance with the People's Union. In exchange for the Centre Party committing itself to work for the re-election of Arnold Ruutel as president, the People's Union in effect promised to support the nomination of Edgar Savisaar, the controversial leader of the Centre Party, as the next prime minister. However, this arrangement appears to have backfired on the Centre Party, since its tactics in the presidential election—along with the People's Union, it boycotted the first, parliamentary stage of the process—appear to have alienated many independent delegates in the second, electoral college stage of the election. As a result, Toomas Hendrik Ilves, a member of the European Parliament from the opposition Social Democratic Party (SDP) and a former foreign minister, was unexpectedly chosen as president by the electoral college at the end of September.

Moreover, the agreement between the Centre Party and the People's Union may encourage the new conservative party to work with Reform in order to prevent Mr Savisaar from becoming prime minister. The Centre Party's tactics in the presidential contest may also make it more difficult for it to attract the support of floating voters in the parliamentary election.

The Economist Intelligence Unit expects the Centre Party to emerge as the strongest party in the next parliament, but it will find it hard to construct a government with a working majority, even if it can keep the support of the

People's Union. As a result, the most likely outcome is the formation of another coalition led by the Reform Party. Even if Mr Savisaar were to become prime minister, he would be unlikely to be able to make dramatic changes in the substance of policy. The tone of politics would, however, shift in a more populist direction under a government led by the Centre Party, and links between government and business groups would become closer and less transparent.

International relations

Along with the other new central and east European members of the EU, Estonia will continue to oppose EU harmonisation in areas that could damage its competitiveness, such as on corporate tax rates, even if a government headed by the Centre Party were to emerge after the 2007 parliamentary election. Relations with Russia remain cool following the 2005 dispute over the interpretation of the abortive Russian-Estonian border treaty. Estonia's membership of the EU and NATO limits the potentially negative consequences of poor relations with Russia, and any moves to resolve the issue of the border treaty will be postponed until after the 2007 parliamentary election.

Economic policy outlook

Policy trends

The present government has only a limited policy agenda and it implicitly acknowledged in August 2006 that one of its main targets—to join the euro zone in January 2008—was already out of reach. The government's tax policy from 2007 will depend on the result of the next parliamentary election. A government led by the Centre Party is likely to move away from Estonia's present flat-rate system of income tax, replacing it with a progressive structure. By contrast, a government led by the Reform Party will maintain the flat tax, gradually reducing the single tax rate.

Fiscal policy

Fiscal policy is expected to remain prudent, even if the centre-left takes power after the election. The general government budget will stay in surplus in 2007-08, in line with the legal restriction against passing a state budget with a planned deficit, other than in extraordinary circumstances. The low level of government debt—just 4.6% of GDP in 2005—means that Estonia will have no difficulty in meeting the Maastricht criteria on the budget deficit and public debt.

The state budget ran a surplus of EEK6.5bn (US$530m) in the first ten months of the year, and although the government is proposing to increase spending in a supplementary budget, partly to finance the renationalisation of Eesti Raudtee (EVR; Estonian Railways), the budget will end 2006 with a substantial surplus. The government's budget proposals for 2007 target a surplus of EEK1.13bn, which we expect it to exceed. However, government spending will continue to grow rapidly and the Bank of Estonia (BoE, the central bank) is likely to continue to worry that this is contributing to Estonia's large external deficits. If economic growth does not soon begin to slow to a more sustainable pace, fiscal policy may have to be made even more restrictive in order to maintain macroeconomic balance.

Monetary policy

Estonia's currency board regime limits the ability of the central bank to influence the economy through monetary policy. Instead, the BoE tries to influence monetary conditions through regulation of the banking sector and by lobbying the government to run a restrictive fiscal policy. Bank lending, especially for property, has been growing strongly, and, in response, the BoE raised reserve requirements on Estonian banks from 13% to 15% in September 2006. With interest rates in the euro zone set to go up further, the effective policy stance is likely to tighten significantly in 2007.

Whenever it takes place, entry into the euro zone will make little difference to monetary policy as, in effect, the key interest rate is already set by the European Central Bank (ECB). Adoption of the euro will remove any residual doubts about the stability of the link between the kroon and the euro, and is therefore likely to make access to foreign capital slightly easier. Nevertheless, the economic impact of any delay to euro adoption is likely to be small, as long as the delay is seen to be temporary.

Economic forecast

International assumptions

International assumptions summary
(% unless otherwise indicated)

	2005	2006	2007	2008
Real GDP growth				
World	5.0	5.3	4.6	4.8
EU25	1.7	2.7	2.2	2.2
Euro zone 12	1.4	2.4	1.8	2.0
Finland	3.0	3.2	2.7	2.4
Exchange rates				
¥:US$	110.1	116.2	105.0	97.5
US$:€	1.245	1.250	1.363	1.338
SDR:US$	0.677	0.681	0.645	0.644
Financial indicators				
€ 3-month interbank rate	2.15	3.06	3.65	3.90
US$ 3-month commercial paper rate	3.38	5.05	4.83	5.09
Commodity prices				
Oil (Brent; US$/b)	54.7	65.8	65.0	63.3
Gold (US$/troy oz)	445.0	631.5	700.0	650.0
Food, feedstuffs & beverages (% change in US$ terms)	-0.5	12.3	-0.4	0.8
Industrial raw materials (% change in US$ terms)	10.2	48.8	-3.4	-10.6

Note. Regional GDP growth rates weighted using purchasing power parity exchange rates.

World economic growth is currently strong, but is set to decelerate in 2007-08, as slower growth in the US weighs on the international economy. The euro zone economy is currently expanding robustly, and euro zone real GDP growth is estimated at 2.4% in 2006. However, tax increases in Germany and tighter monetary policy will cause growth in the euro zone to slow to an annual average of 1.9% in 2007-08. The ECB raised interest rates in October 2006, and euro zone interest rates are expected to go up again at the end of 2006, with a further rise expected in 2008. Higher euro zone interest rates will help to slow the growth of bank lending in Estonia.

The external conditions facing Estonia are likely to remain favourable in 2007-08, as the country's main trading partners in the Baltic area are set to record faster economic growth than the euro zone. However, high world oil prices will make it difficult to bring down inflation in Estonia; we expect prices for dated Brent Blend crude to average US$65/barrel in 2007—almost unchanged from the estimated 2006 level—and to fall only slightly in 2008. The main risk from the global economic outlook is that worries about the large US current-account deficit could lead to an even sharper fall in the US dollar than we now forecast. This would cause the euro to appreciate significantly, leading to a more serious slowdown in the euro zone in 2007-08, in this way weakening demand for Estonian exports.

Economic growth

Gross domestic product by expenditure

(EEK bn at constant 2000 prices where series are indicated; otherwise % change year on year)

	2005[a]	2006[b]	2007[c]	2008[c]
Private consumption	77.663	89.079	96.384	102.167
	8.2	14.7	8.2	6.0
Public consumption	20.615	21.398	22.083	22.812
	1.1	3.8	3.2	3.3
Gross fixed investment	46.243	53.179	59.029	63.928
	12.7	15.0	11.0	8.3
Final domestic demand	**144.520**	**163.656**	**177.495**	**188.906**
	8.5	13.2	8.5	6.4
Stockbuilding	5.895	4.200	4.300	4.400
	-0.7[d]	-1.2[d]	0.1[d]	0.1[d]
Total domestic demand	**150.415**	**167.856**	**181.795**	**193.306**
	7.4	11.6	8.3	6.3
Exports of goods & services	129.321	151.693	168.379	184.880
	21.5	17.3	11.0	9.8
Imports of goods & services	-137.677	-162.459	-179.029	-194.784
	15.9	18.0	10.2	8.8
Foreign balance	**-8.356**	**-10.766**	**-10.650**	**-9.904**
	0.0[d]	-1.5[d]	0.1[d]	0.4[d]
GDP[e]	**141.969**	**157.161**	**171.225**	**183.493**
	10.5	10.7	8.9	7.2

[a] Actual. [b] Economist Intelligence Unit estimates. [c] Economist Intelligence Unit forecasts. [d] Contribution to real GDP growth (as a percentage of real GDP in previous year). [e] Break in series in 2000. Real GDP may not equal the sum of its components owing to statistical discrepancies.

Real GDP growth in the first half of 2006 was around 12%—stronger than expected. In addition, changes to the official national accounts figures have led to a significant upward revision in recent growth figures, so that real GDP is now thought to have risen by 10.5% in 2005, compared with an earlier estimate of 9.8%. As a result of these changes, we now estimate real GDP growth at 10.7% this year. Domestic demand has been the main driver of Estonia's recent rapid economic growth, with private consumption and fixed investment rising strongly. We expect both to continue to grow robustly in 2007-08, although higher interest rates and the BoE's tighter controls on bank lending are expected to lead to slower growth in consumer spending from the second half of 2006. We also forecast a "soft landing" for the currently booming construction sector, but there is a danger that tightening monetary conditions and a shortage of labour could lead to a much sharper slowdown in construction and, hence, in investment and GDP growth in 2007-08. Exports will continue to increase rapidly, but the pace of expansion is likely to decelerate as the growth of import demand in Estonia's main markets weakens. Slower growth in investment, which is particularly import-intensive, will lead to a marked deceleration in the growth of imports. Overall, we forecast that real GDP growth will slow to 8.9% in 2007 and to 7.2% in 2008.

Inflation

Consumer price inflation declined to 3.7% in October 2006 as fuel prices fell sharply. However, because of high inflation earlier in the year, we estimate inflation at an average of 4.3% for 2006 as a whole. Headline inflation is set to fall back a little in 2007, as the increases in food and fuel prices in 2006 drop out of the year-on-year comparison, but wage pressure from the tightening labour market will keep inflation well above 3% in 2007-08. The government has admitted that inflation is unlikely to be low enough to allow Estonia to meet the relevant Maastricht criterion next year, preventing Estonia from adopting the euro in January 2008. In the 12 months to September 2006 the highest rate of price growth consistent with the inflation criterion was 2.8%, whereas Estonia's inflation rate over this period was 4.3% on the EU's harmonised measure.

Exchange rates

Under the currency board, the monetary base is fully backed by foreign-exchange reserves in the economy and the kroon is pegged to the euro at EEK15.6466:€1. This system is set to remain in place until Estonia joins the euro zone. Estonia joined the EU's exchange-rate mechanism (ERM2) in June 2004, but this move was a formality and has had no real impact on the kroon's relationship with the euro. The euro is set to average US$1.25:€1 in 2006, strengthening to US$1.36:€1 in 2007 and then weakening only slightly in 2008. Given Estonia's strong trade ties with the EU, the real effective exchange rate (REER) is not greatly affected by fluctuations in the exchange rate of the US dollar to the euro, and the REER is set to appreciate only moderately in 2007-08.

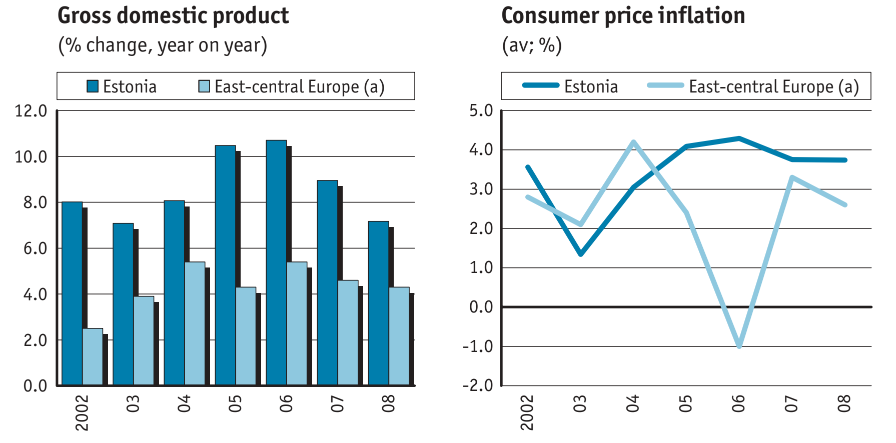
External sector

Both exports and imports grew very rapidly in the first nine months of 2006, with imports rising more quickly. Export growth is expected to slow in 2007-08, as import demand in Estonia's main trading partners eases. Growth in imports is forecast to slow sharply as domestic demand slows, and as world oil prices finally stabilise and then begin to fall. The recent rapid rise in earnings from travel and tourism is likely to decelerate, whereas demand for foreign skills and services will increase, leading to only slow growth in the surplus on services. Progress in obtaining EU structural funds has not been as quick as expected this year, but we forecast a rise on the transfers surplus in 2007-08, as inflows from the EU and earnings from Estonians working in Finland mount. Overall, the current-account deficit is estimated at 12.2% of GDP in 2006, and is forecast to fall back to 11.1% of GDP in 2007 and to 10.2% of GDP in 2008.

Forecast summary
(% unless otherwise indicated)

	2005[a]	2006[b]	2007[c]	2008[c]
Real GDP growth	10.5	10.7	8.9	7.2
Gross agricultural production growth	2.3	-5.0	1.2	1.0
Gross fixed investment growth	12.7	15.0	11.0	8.3
Consumer price inflation (av; national measure)	4.1	4.3	3.8	3.7
Consumer price inflation (year-end; national measure)	3.6	4.2	4.0	3.4
Consumer price inflation (av; EU harmonised measure)	4.1	4.3	3.8	3.8
Lending rate (short-term; av)	4.9	5.5	6.2	6.2
General government balance (% of GDP)	1.5	1.7	0.7	0.4
Exports of goods fob (US$ bn)	7.8	9.7	11.8	13.4
Imports of goods fob (US$ bn)	9.6	12.0	14.3	15.9
Current-account balance (US$ m)	-1,446	-1,958	-2,215	-2,229
Current-account balance (% of GDP)	-10.5	-12.2	-11.1	-10.2
External debt (year-end; US$ bn)	11.6[b]	14.2	17.0	18.7
Exchange rate EEK:US$ (av)	12.58	12.52	11.48	11.70
Exchange rate EEK:US$ (year-end)	13.22	12.08	11.42	11.90
Exchange rate EEK:€ (av)	15.65	15.65	15.65	15.65
Exchange rate EEK:SDR (av)	17.63	18.54	17.77	18.63

[a] Actual. [b] Economist Intelligence Unit estimates. [c] Economist Intelligence Unit forecasts.



(a) Excluding the Commonwealth of Independent States.

The political scene

Toomas Hendrik Ilves is unexpectedly elected president

The main political event of the past few months was the presidential election. A special electoral college chose the former foreign minister Toomas Hendrik Ilves as Estonia's new president on September 23rd, defeating the incumbent, Arnold Ruutel. The result was a surprise, as Mr Ruutel had been expected to have an advantage in the electoral college. In the end, however, the intensive campaign waged by Mr Ruutel's backers, the leftish Centre Party and the rural-based People's Union, for the re-election of the 78-year-old president backfired, prompting many voters in the electoral college to opt for a change.

The choice between the two men had to be resolved in the electoral college after efforts to elect a president in parliament had failed. Since early 2006 five out of Estonia's six main parties—the Reform Party, the Pro Patria Union, Res Publica, the Social Democratic Party (SDP) and the Centre Party—had organised a series of consultations aimed at agreeing on a single candidate to be elected in the parliamentary stage. Although the first four parties eventually reached consensus around two candidates—Mr Ilves and a former parliamentary speaker, Ene Ergma—the Centre Party refused to accept this result and announced that it would join Mr Ruutel's former party, the People's Union, in seeking the president's re-election.

These two groups together had enough parliamentary seats to prevent any candidate from obtaining the two-thirds majority required to select a president in parliament, thus shifting the decision to the electoral college. However, in order to ensure that there was no prospect of electing the president in parliament, the Centre Party and People's Union agreed that they would not even take part in the voting. This immediately led to accusations that the party leaders did not trust their deputies and were keeping them from fulfilling their constitutional obligation. Moreover, since both parties knew that Mr Ruutel would not win in parliament, they also declined to nominate him as a candidate, making it obvious that they were counting on the contest going to the electoral college. When the final votes were held, first Ms Ergma and then Mr Ilves were just short of the two-thirds majority, and Mr Ilves's candidature was forwarded to the electoral college.

Centre Party's aggressive tactics backfire

The confidence with which both the Centre Party and the People's Union entered the presidential race showed also in a co-operation agreement that was signed by the parties on August 14th. In it, the two sides pledged to join forces not only for the presidential selection, but also for the longer term, including the March 2007 parliamentary election. However, in an act of hubris, the parties concluded their text with a phrase designating Mr Ruutel as the "guarantor" of their agreement, thus leaving the impression that they considered Mr Ruutel's re-election a foregone conclusion and that the head of state, who is supposed to be politically neutral, was being used to underwrite a party-political alliance. Although Mr Ruutel himself did not sign the document, he subsequently came in for heavy criticism for having compromised his office just before the election.

During the first half of September both the centre-right and centre-left blocs manoeuvred intensely to gain advantage in the electoral college vote. Under Estonia's constitution, the presidential electoral college is comprised of all 101 members of parliament, along with 246 delegates from local municipalities, a disproportionate number of which are small, rural communities. The Centre Party and the People's Union expected that the large number of rural representatives would enable Mr Ruutel to win, just as it had done in 2001.

Little campaigning was carried out for the benefit of the public, since the population as a whole could not vote. Nevertheless, the contest soon took on an air of "old against new", with a number of questions being raised about Mr Ruutel's advanced age, and about his past as a high-ranking communist official. At 52 years of age, Mr Ilves represented not only a younger generation, but also an entirely different culture, as he had grown up in the US and only returned to Estonia as an émigré in the early 1990s. Following an initial posting as ambassador to the US, Mr Ilves served four years as foreign minister, in 1997 spearheading the initial campaign for Estonia's accession to the EU. In 2004 he was elected with overwhelming support to the European Parliament and became a prominent member of the European Parliament's Foreign Affairs Committee.

However, this extensive international experience left Mr Ilves vulnerable to accusations of not knowing enough about average Estonians to be a good president. Supporters of Mr Ruutel openly derided the fact that Mr Ilves had not been born in Estonia, had never lived through the Soviet era and did not speak Russian (in a country in which the Russian minority makes up 30% of the population). They argued that this meant that Mr Ilves would be unable to unify the nation.

Although there were two rounds of balloting available at the electoral college stage, Mr Ilves won on the first ballot, by 174 votes to 162. The final number of delegates had been reduced by one, since one local government could not agree on a representative. Discrepancies in some other municipalities eventually led to another delegate being unseated by the Supreme Court after the vote, but this did not change the official outcome.

The president's powers are limited

Given that the functions of Estonia's president are largely ceremonial, Mr Ilves's election will probably change little in terms of policy. In Mr Ilves's area of expertise, foreign policy, the president's powers are especially limited, although he has promised to name a special adviser for EU affairs. In his inaugural address on October 9th Mr Ilves concentrated on domestic policy, promising to work for a state that would serve its citizens, and not just politicians or special interest groups. He also called on Estonians to forget recriminations from the past and to desist from using history as a political weapon—a particularly apposite statement given the themes of the presidential election campaign.

Land board scandal causes environment minister to resign

Mr Ruutel's defeat also cast a shadow over the new alliance between the Centre Party and the People's Union. Although neither side blamed the other for the loss, Mr Ilves's victory caused the two parties to lose political momentum, and prompted Villu Reiljan, the leader of the People's Union, to pronounce that some of the agreement's provisions—such as Mr Ruutel's role as its guarantor—would have to be reviewed.

However Mr Reiljan had little time to elaborate on these thoughts before a new scandal engulfed him. On October 3rd the Security Police Board detained three men allegedly involved in a series of questionable property deals sanctioned by the Estonian Land Board. Among those arrested was the director of the Land Board, Kalev Kangur, whom the security police accused of masterminding the scheme. According to the authorities, Mr Kangur allowed a small group of businessmen to exchange a number of rural properties for some prime pieces of real estate in the centre of the capital, Tallinn, and elsewhere, based on a special provision in Estonia's environmental law that permits the state to make such swaps if the rural area in question can become part of a nature conservation area. Mr Kangur, however, consistently overestimated the value of the rural properties to be acquired by the state, thus giving away lucrative urban plots for a fraction of their commercial value.

Because each such exchange had to be explicitly sanctioned by the environment minister, Mr Reiljan, questions were soon asked as to why he had not examined the deals more closely. Mr Reiljan vigorously denied any wrongdoing and at one point intimated that the investigation was retribution for Mr Ruutel's defeat. However, on October 6th he announced his resignation, and the acceptance of it was Mr Ruutel's final official act as president.

Government remains stable, despite a split over presidency

The presidential election split the governing coalition between the Reform Party of the prime minister, Andrus Ansip, on the one hand, and Mr Savisaar's Centre Party and Mr Reiljan's People's Union on the other. Tensions in the cabinet broke out into the open again in October, when Mr Ansip came out in favour of a draft bill allowing the government to remove controversial historical monuments erected on the territory of a local municipality. The bill was in response to the controversy in May 2006 surrounding the "Bronze Soldier", a Soviet-built memorial to the second world war in Tallinn, which had prompted a series of demonstrations by opposing Estonian and Russian nationalist groups. The Centre Party and the People's Union were against the bill, saying that it would aggravate interethnic relations.

Ultimately, however, these disputes had little impact on the stability of the cabinet, as all three parties acknowledged that they had no interest in breaking up their government so close to a parliamentary election (the next election is due to be held in March 2007). With most of the coalition's promises fulfilled, the economy continuing to grow strongly and the state budget posting a record surplus, all three parties had more interest in remaining in office than in provoking a public argument that could lead to the collapse of the government.

Right-wing merger is troubled by leadership struggle

Instead, it was the opposition that fell victim to internal disputes. The two main opposition conservative parties, the Pro Patria Union and Res Publica, had announced in April 2006 that they would be merging in advance of the March 2007 election. In September the two sides met to select a candidate to head their electoral list (the person chosen would be the two parties' nominee for prime minister). In a surprise move, the chairman of Res Publica, Taavi Veskimagi, proposed the rector of Tartu University, Jaak Aaviksoo, for this role. Although Mr Aaviksoo had earlier been proposed by Res Publica as a presidential candidate, he had not previously been a member of any party. Despite this, he was generally seen as a strong potential leader and, more importantly, as a fresh face to head the newly merged party.

However, a number of established political figures from both parties objected to having such an untried figure take over as leader. They appealed to Mart Laar, a former leader of the Pro Patria Union who had twice been prime minister, to run for the office again. In mid-October Mr Laar edged out Mr Aaviksoo in a preliminary vote of the party's executive board, and subsequently Mr Aaviksoo backed down. However, the wrangling showed that different factions continue to exist within the new party, which raises the risk that these internal divisions will resurface during the campaign for the forthcoming parliamentary election. So far, popular support for the two conservative parties remains weak: in an opinion poll carried out by TNS Emor in mid-October, support for the merged party was just 11%, far behind that for the Centre Party (19%) or the Reform Party (20%).

The new party received a brief boost in late August, when the commander of Estonia's defence forces, vice-admiral Tarmo Kouts, announced that he was resigning and joining the new formation in advance of the parliamentary election. Mr Kouts served six years as military chief, helping to steer the country into NATO in 2004, but was known to have had serious disagreements with Jurgen Ligi, the current defence minister. In October Mr Ligi released a report accusing Mr Kouts, along with other members of the general staff, of poorly organising the command structure of Estonia's mission to Afghanistan, causing unnecessary confusion in the ranks.

In late-October Mr Ilves began to review possible successors, including Major-General Ants Laaneots, a candidate passed over several times before because of his extensive career in the Soviet Army during the 1970s and 1980s. However, since Estonia's independence General Laaneots has also spent two years studying at different colleges of higher officer training in Italy and Finland, thus making him a more politically acceptable candidate to head the armed forces now that Estonia is firmly established as part of NATO.

Economic policy

Budget is running a strong surplus

The budgetary position continues to be very strong, with revenue substantially higher than projected in the original budget plans. As of the end of October the state budget recorded a surplus of EEK6.5bn (US$520m). Total revenue, at EEK55.5bn, made up 90.3% of the annual plan and tax revenue, at EEK45.1bn, 91.9%. Income tax revenue reached EEK5.7bn, equal to 94.5% of the 2006 target. Nevertheless, despite the higher tax-exempt minimum and lower rate (the single tax rate was reduced by 1 percentage point to 23% at the start of 2006), income tax revenue was up by 19% year on year in nominal terms, reflecting rising wages and profits, as well as higher employment. These factors also accounted for a similar rise in social security tax contributions, which totalled EEK17.7bn as of the end of October.

As a result of the booming economy and high consumption, receipts of value-added tax (VAT), at EEK15.1bn, had already exceeded the planned target for the year by the end of October, and were up by 26% year on year in nominal terms. However, receipts from excise duty have been much less buoyant. Revenue from alcohol duties came in at only 79.6% of the annual target, and from tobacco at only 76%, in the first ten months of the year. Evasion is becoming a significant problem in the collection of these duties.

The main shortfall in the budget was in EU funding: total grant income, at EEK4.4bn, was only 60% of the annual plan. Estonia's capacity for disbursing EU funds is also poor, especially for agriculture and rural development. Overall budgetary expenditure has also been restrained, which has contributed to the large budget surplus. As of the end of October spending had achieved some 80% of the annual plan.

Budget plans for 2007 envisage another big rise in spending

In September the government finally presented its 2006 supplementary budget to parliament. It proposes additional revenue of EEK5.5bn and expenditure of EEK2.3bn, leading to a planned surplus of EEK3.2bn. The Bank of Estonia (BoE, the central bank) has been calling for the government to aim for a budget surplus equivalent to 2% of GDP—or around EEK4bn—and has criticised the government for the extent of the spending increase. However, the additional expenditure includes financing for the repurchase of Eesti Raudtee (EVR; Estonian Railways), which, in contrast to spending on items such as higher salaries for public-sector employees, will not add to domestic demand—the main reason for central bank's concern about the rise in government spending.

At the same time, the government presented its draft 2007 budget. This is based on revenue of EEK75.7bn and expenditure at EEK74.6bn, with a planned surplus of EEK1.1bn. However, both revenue and spending are again projected to rise sharply, so that the revenue target is 13% higher than the revised target for 2006, and spending is set to be 17% higher than the target set out in the 2006 supplementary budget and 21% above the original target for 2006. As a result, budgeted spending is set to rise further as a share of GDP, even if economic growth continues at its present blistering pace. As of early November, both budgets were still completing their passage through parliament.

Estonian Railways to be renationalised

The saga of Estonia's most controversial privatisation looks to be drawing to a close following the government's decision in October to repurchase the 66% stake in Eesti Raudtee that was sold to Baltic Rail Services (BRS) in 2001. BRS is made up of Railroad Development Corporation and RailWorld Estonia (US), Ganiger Invest (Estonia) and the Emerging Europe Infrastructure Fund (UK). The government, which still owns the remaining 34% of Eesti Raudtee, intends to pay EEK2.35bn to buy back the stake, which was sold to BRS for EEK1bn in 2001. According to the prime minister, Andrus Ansip, this a fair offer, reflecting some EEK2bn invested by BRS. BRS had been seeking to sell its stake to an outside buyer, but although there were reports that other companies, including Germany's Deutsche Bahn, were initially interested, BRS does not seem to have received any alternative offers. The poor relations between BRS and successive governments since 2001 will have acted as a strong deterrent to any outside buyer. Mr Ansip announced that the railway company will stay in state hands for at least five years, and dismissed claims that his government intended to allow the renationalised business to offer discounts to Russian transit firms.

The initial sale of Eesti Raudtee as a vertically integrated rail unit was unique in Europe, but its responsibility for both track and freight operations contributed to the subsequent deterioration of relations between the government and BRS. The government accused BRS of failing to invest sufficiently in track infrastructure, and in August 2006 it rejected BRS's last financial plan for that reason. The government now appears likely to split the company into separate track and operating companies, in line with current EU directives, and hopes to use EU structural funds to modernise the track network—something that BRS, as a private rail company, found difficult. For its part, BRS accused the government of using EU legislation as a means of changing the ground rules for the railways, in order to favour other private operators. It specifically blames the 2003 Railway Act, which gave other operators greater access to the rail network (reducing BRS's ability to run its own trains) and established a Railway Inspectorate to set tariffs. BRS has accused the inspectorate of setting tariffs at too low a rate, eroding Eesti Raudtee's market share of freight traffic, and forcing the company to bear the financial brunt of track maintenance.

The Ministry of Finance hits out at euro zone criteria

High inflation has, in effect, forced Estonia to postpone its entry into the euro zone until the end of the decade. Earlier this year, the government moved back the target date for adopting the euro from 2007 to 2008. However, persistently high inflation over the mid-year months of 2006 made it almost impossible to meet the 2008 target, and in August 2006 the prime minister acknowledged that entry in 2008 was looking increasingly unlikely. The government has not adopted a new formal target date for adoption of the euro, but the BoE suggested in its November 2006 economic forecast that the earliest date for Estonia's euro zone entry was 2010.

Estonia meets all the Maastricht criteria for entering the euro zone, with the exception of the requirement to have inflation within 1.5 percentage points of the average of the three EU member states with the lowest inflation rates. Estonia has begun to express dissatisfaction with the European Commission's strict interpretation of the inflation criterion. Following a meeting of EU finance ministers in October 2006 Aivar Soerd, the finance minister, issued a statement criticising the exclusion of rapidly growing economies such as Estonia's from the euro zone, as well as the refusal of finance ministers from euro zone countries to revisit the basis for the Maastricht inflation criterion. In particular, the Estonian government has suggested that the inflation criterion should be based on the three members of the euro zone with the lowest inflation; currently, Poland and Sweden, which are not members of the euro zone, are among the three EU member states with the lowest inflation rates. However, it is clear that the existing members of the euro zone are reluctant to agree to any modification of the Maastricht criteria.

Main economic policy indicators

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
State budget revenue (EEK m)[a]												
2004	3,331	3,179	3,191	4,827	3,046	3,133	5,059	3,928	3,839	4,303	3,627	5,214
2005	4,085	3,444	4,177	3,897	4,914	5,266	6,049	4,432	4,118	4,473	4,400	5,894
2006	5,121	4,023	4,017	5,869	5,495	6,302	6,495	5,418	6,668	6,068	–	–
State budget expenditure (EEK m)[a]												
2004	2,569	2,342	3,891	3,317	3,631	3,909	5,766	1,663	3,540	3,438	3,605	7,277
2005	3,167	3,670	4,351	4,342	3,990	4,974	4,118	4,029	4,002	4,256	4,453	7,386
2006	4,206	4,352	4,956	4,505	5,067	5,774	5,471	4,721	4,626	5,270	–	–
State budget balance (EEK m)[a]												
2004	762	837	-701	1,509	-585	-776	-707	2,265	300	864	22	-2,025
2005	918	-226	-174	-445	924	292	1,931	403	117	218	-52	-1,492
2006	915	-329	-939	1,364	428	528	1,024	697	2,042	797	–	–

Main economic policy indicators

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Exchange rate (EEK:US$; av)												
2004	12.40	12.37	12.76	13.04	13.01	12.89	12.75	12.86	12.81	12.53	12.06	11.67
2005	11.92	12.02	11.86	12.09	12.32	12.85	12.99	12.73	12.76	13.01	13.27	13.19
2006	12.92	13.09	13.10	12.75	12.25	12.35	12.33	12.21	12.28	12.40	–	–
Real effective exchange-rate index (CPI-based; 1997=100)[b]												
2004	118.7	118.7	117.1	116.6	118.7	119.2	119.5	119.0	119.1	119.8	121.7	122.9
2005	122.4	122.3	122.7	121.9	121.3	120.4	120.5	121.2	121.2	120.2	119.7	119.5
2006	121.5	121.3	120.7	121.8	123.5	123.5	124.2	125.4	124.9	–	–	–
Real effective exchange-rate index (PPI-based; 1997=100)[b]												
2004	109.1	109.2	107.8	106.6	106.6	107.7	107.6	107.2	108.2	107.4	108.3	110.1
2005	109.4	108.5	107.7	106.6	106.1	104.5	103.5	104.7	103.0	101.9	101.9	102.6
2006	103.2	103.1	102.9	103.1	104.1	104.1	103.6	104.5	105.8	–	–	–
M2 (EEK m)												
2004	49,188	49,690	50,359	51,726	51,966	53,268	53,724	53,405	54,409	55,085	55,576	58,251
2005	57,106	59,029	61,557	67,419	69,088	69,974	69,923	70,604	71,844	74,142	78,093	82,674
2006	83,180	84,965	86,175	88,718	91,719	92,881	93,256	95,881	97,355	–	–	–
M2 (% change, year on year)												
2004	11.7	7.4	8.7	10.7	9.2	11.5	12.6	12.0	13.7	12.4	13.0	15.8
2005	16.1	18.8	22.2	30.3	32.9	31.4	30.2	32.2	32.0	34.6	40.5	41.9
2006	45.7	43.9	40.0	31.6	32.8	32.7	33.4	35.8	35.5	–	–	–
Lending rate (%; av)[c]												
2004	6.0	6.5	5.7	5.4	5.4	5.5	5.2	5.6	5.9	5.7	5.6	5.5
2005	4.9	5.2	4.7	4.7	4.8	5.1	5.0	4.8	4.7	5.3	5.0	5.0
2006	4.9	5.0	4.8	4.9	4.6	5.0	4.9	5.1	5.1	–	–	–
Deposit rate (%; av)[c]												
2004	2.1	2.1	2.1	2.1	2.1	2.2	2.2	2.2	2.2	2.2	2.2	2.3
2005	2.1	2.1	2.2	2.1	2.1	2.2	2.1	2.1	2.1	2.1	2.1	2.3
2006	2.3	2.3	2.5	2.6	2.6	2.8	2.8	3.0	3.1	–	–	–

[a] Central government. [b] Economist Intelligence Unit calculations. [c] Commercial bank interest rates on short-term kroon-denominated loans and kroon-denominated deposits of all maturities.

Sources: Statistical Office of Estonia; Ministry of Finance; IMF, *International Financial Statistics*.

The domestic economy

Output and demand

Economic growth continues at double-digit rates

The economy continued to grow at a scorching pace in the second quarter. Real GDP rose by 11.7% year on year in April-June 2006—the same rate as in the first quarter—to EEK51.8bn (US$4.1bn) at current prices. This performance is all the more impressive in view of the upward revision to the official GDP series for 2000-05 in September. The Statistical Office raised the rate of real GDP growth for 2004 to 8.1% from 7.8%, and that for 2005 to 10.5% from 9.8%.

In expenditure terms, domestic demand remained the principal driver of growth, rising by 11.5% year on year. Consumer demand continues to grow very strongly, with consumer expenditure up by 14.5%. In contrast, public consumption rose by less than 3% year on year in the second quarter, despite the sharp rise in government spending planned for the year. Investment spending lost some momentum in this period, rising by 10% year on year, a significant slowdown compared with year-on-year rates of just under 20% recorded in the previous six months.

Net trade again made a negative contribution to overall growth in the second quarter, for although exports of goods and services grew more rapidly than imports—by 16.4%, as against 15.4%—the import base is significantly larger. More recent trade data suggest that the net trade position deteriorated further in the third quarter (see Foreign trade and payments).

Gross domestic product by expenditure, Apr-Jun

(EEK m at current prices unless otherwise indicated)

	2005	2006	% share[a]	% change[b]
Private consumption[c]	22,126	26,002	50.2	14.5
Public consumption	7,928	8,981	17.3	2.9
Fixed capital investment	13,884	16,191	31.3	10.0
Change in stocks	2,041	2,837	5.5	0.8[d]
Export of goods & services	33,794	41,763	80.6	16.4
Imports of goods & services	36,609	45,902	88.6	15.4
Statistical discrepancy	442	1,928	3.7	-
GDP	**43,607**	**51,800**	**100.0**	**11.7**

[a] 2005. [b] % change year on year at constant 2000 prices. [c] Includes non-profit institutions serving households. [d] Contribution to GDP growth.

Source: Statistical Office of Estonia.

Growth is driven by industry, construction and services

On the production side, real estate and business services, the largest component of gross value added (GVA), recorded 16% growth. Related activities such as construction and financial intermediation (the latter providing mortgage finance) also recorded double-digit growth. Manufacturing, the second-largest sector overall, also performed strongly, as a result of robust growth in exports and in domestic consumer demand. Growth in the transport sector was weaker, at 9.2% year on year, and reflects increasing turnover at the Port of Paldiski and rising air traffic, which were partly offset by weak growth in cargo traffic through Port of Tallinn (up by 4.3% in the first nine months of 2006) and a decline in passenger traffic in Tallinn. Growth in GVA in hotels and restaurants has slowed now that the novelty of Estonia as a destination for visitors from western Europe has begun to wane.

Growth in publicly provided services such as public administration, education and health continues to lag well behind the increases in output in the rest of the economy. GVA in the health sector is rising a little more quickly than in other public services, helped by the automatic growth in the revenue that the sector receives from the social tax, which has been boosted by the recent rapid rise in both employment and wages. Agriculture and forestry was the one sector to record a decline in GVA—a substantial one of 17.4% in the second quarter, following on from an 11% drop in the first. Agriculture was hit by a prolonged summer drought, but it also continues to be hampered by poor take-up of EU agricultural and rural development funds, reflecting the neglect of the sector in the period since independence.

Gross value added by economic activity, Apr-Jun
(EEK m at current prices unless otherwise indicated)

	2005	2006	% share[a]	% change[b]
Agriculture, hunting & forestry	1,143	1,160	2.5	-17.4
Fishing	75	73	0.2	4.6
Mining & quarrying	361	407	0.9	8.0
Manufacturing	6,638	7,707	16.9	12.7
Electricity, gas & water	1,095	1,268	2.8	9.3
Construction	2,693	3,724	8.2	21.5
Wholesale & retail trade	5,635	6,666	14.6	11.7
Hotels & restaurants	715	806	1.8	7.8
Transport & communications	4,897	5,743	12.6	9.2
Real estate & business services	6,930	8,757	19.2	16.0
Financial intermediation	1,476	1,781	3.9	23.4
Public administration	2,097	2,379	5.2	2.4
Education	2,058	2,261	5.0	3.7
Health & social work	1,295	1,461	3.2	5.7
Other services	1,273	1,443	3.2	5.9
Gross value added	**38,381**	**45,637**	**100.0**	**11.4**

[a] 2006. [b] 2006 compared with 2005 at constant 2000 prices.

Source: Statistical Office of Estonia.

Domestic demand grows strongly in the third quarter

Retail sales growth, a proxy indicator for private consumption, remained strong in the third quarter of 2006, suggesting that the rapid expansion of domestic demand continued into the second half of the year. Retail sales volumes in the third quarter were 19.6% higher than a year earlier, compared with 18.8% in the second quarter. Growth in the retail sector has been broad based, driven by demand for higher-quality goods, as well as increases in physical sales. The year-on-year growth in the value of vehicle sales slowed in the third quarter to 13%, compared with 20% in the first half of the year. Sales of fuel declined marginally in the third quarter, as domestic fuel prices mirrored the fall in world oil prices. In other retail segments, the fastest growth rates in July-September were in household goods and appliances (where sales were up by 56% year on year), driven by the property boom; and in clothing (up 45% over the same period). Interestingly, given Estonia's reputation as a leader in Internet-based activities, sales of mail-order goods increased no more quickly than retail sales overall. Mail-order sales accounted for just 1.3% of non-automotive retail sales in the third quarter and Estonia still lacks the logistical infrastructure to make this more than a marginal business, at least for products that cannot be delivered directly over the Internet.

Employment, wages and prices

Labour shortages intensify as unemployment falls

Unemployment (as measured by registered unemployment at labour exchanges) continues to fall. According to monthly data from the Estonian Labour Market Board, the number of registered unemployed at the end of October 2006 had fallen to 12,019, just 1.4% of the workforce and 47% lower than in October 2005. The more comprehensive figures from the Statistical Office's quarterly labour force survey (LFS) were not available at the time of going to press. However, Eurostat, the EU's statistical office, estimates that the

Estonian unemployment rate, measured according to the definitions used in the LFS, was 4.4% in September 2006, the fourth-lowest among the 25 EU member states and the lowest among the EU members that joined in May 2004.

The low unemployment rate is the result of a combination of factors, including high economic growth and a declining population. The country's loss of workers to richer EU states following accession in 2004 has been estimated by the World Bank at 1% of the population of working age, the lowest of any the Baltic state. However, the small size of the overall labour force is creating labour shortages across the economy and threatens to act as a brake on growth. Large projects in particular are experiencing shortages. Estonian Energy, despite raising wages significantly, still plans to import up to 150 workers from Belarus and Ukraine in 2008 and 2010, when it is to upgrade the electrical network. Although Estonia has decided not to impose restrictions on labour from Romania and Bulgaria when they join the EU in January 2007, it will continue to be difficult to obtain labour permits for workers from outside the EU.

Unemployment

('000 unless otherwise indicated)

	2005			2006		
	2 Qtr	3 Qtr	4 Qtr	1 Qtr	2 Qtr	3 Qtr
Registered unemployed[a]	**25.9**	**23.0**	**22.3**	**19.5**	**14.4**	**12.7**
Unemployment rate (%)	3.2	2.8	2.7	2.3	1.7	1.5
Labour force survey[b]	**54.0**	**46.0**	**46.5**	**43.7**	**42.8**	-
Unemployment rate (%)	8.1	7.0	7.0	6.4	6.2	-

[a] End-period data of the Labour Market Board. [b] Based on International Labour Organisation (ILO) methodology for persons aged 15-74.

Source: Statistical Office of Estonia.

Wage growth seems to have been strong in July-September

Official figures for average wages in the third quarter were not available at the time of going to press, but survey and anecdotal reports suggest that wage growth remains strong. A survey from Fortes, a local consulting firm, is reported to have found that the year-on-year growth of total wages in the middle of 2006 was 14.7%, up from just 8.3% in the same period of 2005. Certainly, strong increases in receipts from income tax and social security contributions, the sharp tightening in the labour market and rising levels of consumer confidence all suggest that earnings continued to go up rapidly in the third quarter.

Fuel and food prices drive consumer price inflation

Consumer price inflation reached 5% year on year in August 2006, but it has since fallen back, dropping to 3.8% in September and 3.7% in October. Just as rising fuel prices explained much of the earlier increase in inflation, lower oil prices have been responsible for most of the recent fall. World oil prices dropped sharply in September and again in October, causing the transport component of the consumer price index (CPI) to drop by 6.2% year on year in October. Partly offsetting the decline in transport prices, food prices have been rising strongly, reflecting poor weather conditions across Europe. Excluding the prices of food, transport and housing (which is also strongly influenced by the price of gas for heating), underlying consumer price inflation still seems to be rising: this measure of "net" inflation was 1.7% in July 2006 but had risen to 2.4% in October.

Consumer prices, 2006
(% change year on year)

	Jul	Aug	Sep	Oct
Food & non-alcoholic beverages	4.6	6.3	7.5	7.5
Alcoholic beverages & tobacco	3.4	3.6	4.4	4.3
Clothing & footwear	2.6	1.2	1.4	1.9
Housing	9.9	10.2	11.0	13.3
Household goods	2.6	2.1	2.3	2.1
Health	2.8	3.3	3.0	3.2
Transport	5.9	5.9	-4.2	-6.2
Communications	-5.9	-5.3	-5.7	-5.8
Recreation & culture	4.8	5.7	4.9	2.8
Education	2.7	3.2	5.3	5.3
Hotels, cafes & restaurants	4.0	4.7	4.6	5.5
Miscellaneous goods & services	4.2	4.4	4.1	4.1
Consumer prices	**4.5**	**5.0**	**3.8**	**3.7**
Consumer prices, excl food, transport & housing[a]	1.7	1.9	2.6	2.4

[a] Economist Intelligence Unit estimates.

Sources: Statistical Office of Estonia; Economist Intelligence Unit.

The rise in underlying inflation and the increasing tension in the labour market tend to confirm the assessment of the Bank of Estonia (BoE, the central bank) that it will be difficult to bring down inflation quickly to meet the Maastricht criterion for entry into the euro zone. In the 12 months to September 2006 Estonia's inflation rate, as measured by the EU's annualised Harmonised Index of Consumer Prices (HICP), was 4.3%, the second-highest rate in the EU. The highest rate consistent with the Maastricht inflation criterion over this period was 2.8%.

Financial indicators

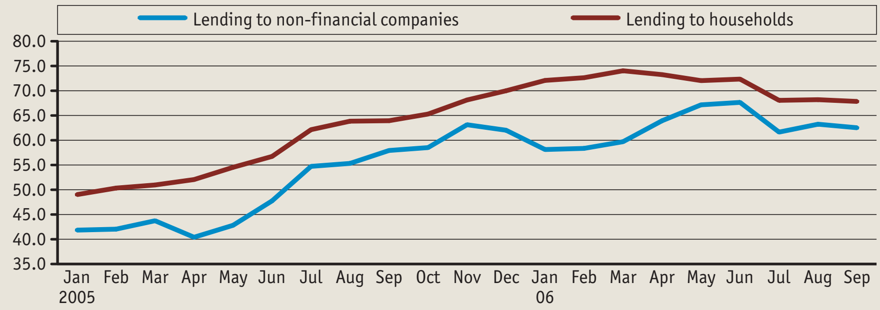
No sign yet of slowdown in lending growth

Borrowing from commercial banks continues to grow rapidly, with borrowing by households rising especially quickly. The stock of outstanding loans totalled EEK159.8bn (US$12.8bn) at the end of September 2006, a rise of 35% year on year and 27% higher than in December 2005. Lending to individuals grew at a faster pace, by 68% year on year, to EEK71.9bn. Individuals now account for 45% of all lending, compared with just 20% five years ago. Housing remains the main source of credit for individuals, with housing loans up by 67% year on year to EEK59.2bn. Other consumer credits have more than doubled, to EEK7.3bn by the end of September. Mortgage-backed credits accounted for EEK2.1bn of these.

Although the pace of lending growth has not yet begun to slow, lending conditions are gradually tightening. The Bank of Estonia (BoE, the central bank) announced in July that compulsory reserve requirements for Estonian banks would go up by 2 percentage points, to 15%, from September 2006 (September 2006, Economic policy). The European Central Bank (ECB) has raised its policy rate several times (the key refinancing rate was pushed up to 3.25% in October 2006, 100 basis points higher than its level at the end of 2005), and a further

ECB rate rise looks likely before the end of 2006. Estonia's currency board arrangement means that interest rate changes in the euro zone are quickly reflected in domestic interest rates. As a result, the average interest rate for long-term loans to individuals has risen from 3.6% at the end of 2005 to at 5.2% by the end of September.

Growth of bank lending
(% change, year on year)



Source: Bank of Estonia.

However, the BoE itself also acknowledges that the present boom in house lending is as much a factor of unfulfilled housing demand as of easy access to cheap mortgage credit. In a recent analysis of the Estonian housing market, the central bank concluded that the construction boom had not kept pace with demand, especially when taking into account the large existing stock of poor quality Soviet-era housing. Around one-third of the Estonian housing stock was built between 1971 and 1989. In Estonia, the average dwelling space per inhabitant is 28 sq metres, compared with 35-45 sq metres in the EU15. In addition, the dwellings themselves have two to three rooms on average, compared with four or five rooms in established EU member states. Furthermore, some 20% of Estonian dwellings lack flushing toilets, hot running water or a bathroom.

Increased disposable incomes are leading to a desire for more living space and many Estonians would prefer to live in houses rather than flats (currently, three-quarters of the population live in flats). Newly built properties have more living space, but account for only 1.7% of the housing stock. As a result, new construction is barely sufficient to replace existing housing that has become unfit for human habitation. In this context, the BoE acknowledges that the current high investment in property has been caused as much by the need to replace the ageing housing stock as by an "overheated" real estate market.

Hansa expands its insurance activities

Estonia's insurance market continues to grow. In the life insurance market, written premiums in the first nine months of 2006 were up by 22% year on year to EEK1.07bn. Non-life premiums grew by 15% to EEK2.32bn, and claims by 9% to EEK1.2bn. As in banking, the market is heavily concentrated. In the life insurance business, Hansabank's subsidiary accounted for 42% of written premiums and SEB Uhispank's subsidiary for 27%. In non-life business, the largest share, 37%, is held by If, followed by ERGO, with 26%. Hansabank entered the non-life business with a newly established subsidiary, Hansa Varakindlustus, in August 2006 and is selling policies through its banking network and the Internet. Its non-property insurance business had until recently been confined to a brokerage subsidiary, which had about 20% of the local market and which Hansa sold in October. Hansabank already has the highest market share in bank lending, leasing, pensions and many other financial activities, not just in Estonia, but also in other countries in which it is active, most notably Lithuania. In the third quarter of 2006 it accounted for 25% of the profits earned by its Swedish parent company, Swedbank

Sectoral trends

Labour shortages start to affect industrial growth

Total industrial output adjusted for working days and seasonal factors was up by 7.3% year on year in the first nine months of 2006, and by 8% in the case of manufacturing. Estonia's growing labour shortage has hit machinery production badly, especially of communications equipment. Elcoteq, the Finnish mobile telephone assembler and Estonia's largest exporter, is experiencing difficulties in recruiting skilled labour. Although it denies that it intends to shift its activities away from Estonia, the company is not expanding production in its Estonian plants. In the case of wage-sensitive industries such as textiles and leather goods, production has been in decline for several years, and even domestic firms are moving production to cheaper locations abroad. The EU's restrictions on imports of low-cost products from China are likely to give the branch only temporary relief. In the metals industry, output is rising again following the resumption of large-scale production at the steel galvanising plant at Muuga, after its parent company, Galvex, emerged from bankruptcy earlier this year.

The food and beverages sector (which accounted for 18% of manufacturing output in 2004), has been recording steady growth since EU accession. Food exports have increased not only to the EU, but also to Russia after the Russian side lifted its double import tariffs on Estonian goods. The wood industry, which accounted for 16% of industrial output in 2004, is currently boosting production using imported timber, following a clampdown on illegal local logging. The related paper and pulp industries are expected to increase production significantly in the final quarter of 2006, following the opening of a new pulp mill in Kunda in September. Most branches connected with construction and home refurbishment, including paints, building blocks, prefabricated units and cement, have recorded large increases in output, reflecting the continuing construction boom.

Industrial production by sector, 2006
(% change, year on year)

	Jul	Aug	Sep	Jan-Sep
Electricity & hot water	-4.1	10.8	-38.1	-3.1
Mining	15.4	25.3	-20.0	8.2
Manufacturing	7.8	9.7	7.6	8.0
Food & beverages	9.7	12.5	9.9	9.5
Textiles	4.9	3.1	0.9	-1.5
Clothing	-6.5	5.1	1.3	1.6
Leather & leather goods	-11.2	-20.1	-18.1	-20.1
Wood & wood products	0.6	-0.3	6.3	7.4

Industrial production by sector, 2006
(% change, year on year)

	Jul	Aug	Sep	Jan-Sep
Paper & paper products	6.7	14.8	11.2	9.4
Printing & publishing	7.4	11.4	5.6	11.8
Chemicals	-5.4	4.7	-1.7	3.8
Rubber & plastics	33.2	46.8	43.2	34.3
Other non-metallic mineral products	10.7	19.2	15.9	17.1
Metals	19.5	34.6	9.8	-10.9
Metal products	32.4	0.7	15.2	23.3
Machinery & equipment	-9.0	-6.5	-19.3	-11.8
Office machinery	22.6	31.0	27.9	23.9
Electrical machinery	13.3	22.9	19.8	13.2
Communications equipment	31.8	10.6	-20.7	-5.6
Medical & optical equipment	-16.7	-10.6	-6.8	10.2
Motor vehicles & trailers	-1.2	7.1	-7.0	1.1
Other transport equipment	-16.3	-2.5	14.8	-18.0
Furniture & other manufacturing	-9.0	8.3	10.0	0.5
Total industry	**7.4**	**10.7**	**1.9**	**7.3**

Note. Adjusted for working days and seasonal effects.

Sources: Statistical Office of Estonia; Economist Intelligence Unit.

Mining looks abroad

In the mining sector, domestic oil shale extraction was flat in volume terms, but sales increased owing to higher prices. The local oil shale industry, based in the north-east of the country, fuels the Narva power plants. However, Estonia is under pressure from the EU and local environmental groups to reduce oil shale mining. In November Eesti Energia (Estonian Energy, the state-owned electricity company) made its first venture outside the Baltic region when it paid US$250,000 to acquire a 76% stake in a Jordanian oil shale company, and signed a Memorandum of Understanding with the government of Jordan to explore local reserves and to study the feasibility of building a processing plant there. Jordan has one of the world's largest reserves of oil shale.

Energy spearheads pan-Baltic co-operation

Estonia's utilities' output, as measured by sales, declined in the first nine months of the year, largely as a result of lower electricity exports. Estonian Energy's electricity production is closely linked to developments in the electricity sectors in Latvia and Lithuania. The largest electricity generator in the Baltic states is currently Lithuania's Ignalina nuclear plant, but this is due to be closed down at the end of 2009. Latvia, which relies heavily on hydro-electricity—and consequently on rainfall—has the most volatile generating capacity and import requirements. A subsidiary of Estonian Energy is to sell electricity to Latvia from the start of next year, after receiving a trading licence. All three Baltic states wish to avoid becoming overdependent on Russia for their energy supplies. In March 2006 the three countries agreed to fund jointly a feasibility study for a replacement nuclear-power station for Ignalina. The study, completed in October, concluded that such a project was practical. The three countries now have to decide whether to go ahead with the project, which may prove politically controversial.

Estonian Energy's main investment project currently is Estlink, which connects the Estonian and Finnish electricity grids via an underwater cable. The

Lithuanian and Latvian national energy companies are also shareholders in the project, which is on schedule to become operational by December 2006. In anticipation of Estlink's commissioning, Estonian Energy acquired Solidus, the Finnish energy trading company and the clearing representative of Nord Pool, the Nordic power trading exchange. Estonian Energy joined Nord Pool in September. The purchase of Solidus also marked Estonian Energy's first foreign acquisition; the company could also bid in the planned privatisation of Rytu Skirstomieji Tinklai, Lithuania's largest electricity distributor. An earlier bid by Estonian Energy for the Lithuanian company in 2004 was blocked by local opposition.

Main macroeconomic indicators

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Industrial output (% change, year on year)[a]												
2004	7.2	7.9	12.7	7.3	11.7	13.1	8.9	14.3	10.4	4.6	13.9	13.9
2005	2.5	9.3	9.1	11.4	10.4	11.5	7.7	9.4	12.1	8.7	9.3	7.4
2006	12.5	4.9	8.2	1.2	11.6	9.7	7.7	10.6	-0.7	–	–	–
Retail sales volume (% change, year on year)[a]												
2004	13.2	13.7	15.3	23.0	12.3	10.9	9.7	10.5	14.1	7.7	14.9	12.8
2005	5.1	6.0	7.3	1.8	7.9	11.0	9.4	10.1	7.4	11.4	11.1	12.4
2006	18.8	16.3	17.9	16.0	19.8	20.4	18.8	17.8	22.4	–	–	–
Consumer prices (% change, month on month)												
2004	0.6	0.3	0.2	0.7	2.1	0.3	-0.3	-0.1	0.1	0.3	0.4	0.2
2005	-0.2	0.6	0.7	0.4	0.2	0.7	0.4	0.3	0.8	0.0	-0.1	-0.2
2006	0.9	0.5	0.1	0.7	0.5	0.4	0.5	0.8	-0.4	-0.1	–	–
Consumer prices (% change, year on year)												
2004	0.5	0.4	0.4	1.3	3.7	4.5	4.1	4.0	3.9	4.1	4.7	5.0
2005	4.2	4.5	5.0	4.7	2.8	3.1	3.8	4.2	4.9	4.5	3.9	3.6
2006	4.7	4.6	4.0	4.3	4.7	4.3	4.5	5.0	3.8	3.7	–	–
Producer prices (% change, month on month)												
2004	0.6	0.4	0.3	0.2	0.7	0.8	0.0	0.2	0.9	-0.4	-0.2	0.3
2005	0.6	-0.2	-0.2	0.1	-0.2	0.2	0.1	1.0	-0.3	0.6	0.0	0.5
2006	1.0	0.3	0.2	0.3	0.2	0.5	0.2	0.8	0.6	–	–	–
Producer prices (% change, year on year)												
2004	0.9	0.6	1.0	1.7	3.0	3.7	3.8	3.6	4.8	3.8	3.6	3.9
2005	3.9	3.3	2.8	2.7	1.7	1.1	1.2	2.0	0.7	1.8	2.0	2.2
2006	2.7	3.1	3.6	3.9	4.3	4.6	4.6	4.4	5.4	–	–	–
Average gross monthly wages (% change, year on year)												
2004	6.4	6.1	5.9	8.2	6.4	6.8	5.7	10.1	11.5	5.8	9.3	8.2
2005	12.9	12.4	4.8	12.0	11.6	11.6	12.0	10.2	10.1	15.7	10.4	12.7
2006	14.2	12.7	20.7	12.1	13.8	19.0	–	–	–	–	–	–
Registered unemployment ('000)												
2004	37.6	37.8	37.5	35.5	33.0	31.5	30.4	29.0	28.6	28.4	28.8	28.9
2005	30.0	30.2	30.3	29.5	27.6	25.9	24.7	23.8	23.0	22.7	22.6	22.3
2006	21.6	20.7	19.5	17.6	15.7	14.4	13.5	13.1	12.7	12.0	–	–
Registered unemployment rate (%)												
2004	4.6	4.6	4.6	4.3	4.0	3.8	3.7	3.5	3.5	3.5	3.5	3.5
2005	3.7	3.7	3.7	3.6	3.4	3.2	3.0	2.9	2.8	2.8	2.8	2.7
2006	2.6	2.5	2.3	2.1	1.9	1.7	1.6	1.6	1.5	1.4	–	–

[a] In real terms, not seasonally adjusted.

Sources: Statistical Office of Estonia; Estonian Labour Market Board.

Foreign trade and payments

Oil boosts trade turnover and the deficit

Trade turnover has risen rapidly this year, spurred on by strong economic growth in all three Baltic states. In the first eight months exports went up by 28% year on year to EEK77.5bn (US$6.2bn), and imports by 31% to EEK104.4bn. With imports already much higher than exports, the merchandise trade deficit over this period expanded by a substantial 40% year on year to EEK26.8bn.

Trade in oil is playing a significant role in boosting both imports and exports. Exports of mineral products rose by more than 250% year on year in the first eight months of 2006, to EEK14.2bn, accounting for 18.3% of total exports, compared with just 6.5% a year earlier. The rise is the result of a combination of higher transit volumes and higher prices. Likewise, mineral fuels have increased their share of total imports, from 8.4% in 2005 to 16.4% in 2006. In value terms, mineral imports soared by more than 150% to EEK17.1bn. The main export markets for oil are the US and Gibraltar, accounting for EEK4.8bn and EEK4.5bn, respectively, followed by Canada, with EEK580m (US$43m). Russia is the largest import source by far, accounting for EEK10.4bn of foreign purchases, or 61% of the total, followed by Lithuania (with 20%) and Belarus (with 8%). Imports from Lithuania have slowed recently, following a fire at the Mazeikiu Nafta (Mazeikiai Oil) refinery and a fall in deliveries of Russian crude oil to Lithuania. Excluding oil products, the growth in Estonia's merchandise trade has been less dramatic: in the first eight months of the year, non-oil exports were up by 12% to EEK63m, whereas imports rose by 20% to EEK87bn.

Overall, the EU accounted for 64% of exports, down from 79% a year earlier. Exports to the new EU member states rose by 18% year on year, but sales to the EU15 rose by just 2%. The main factor behind this pattern is the retrenchment by Elcoteq, the Finnish mobile telephone assembler and Estonia's largest exporter. The company, which has experienced acute labour shortages in Estonia, is now expanding production in Russia and Romania, although it denies that it intends to shut down its plants in Tallinn, the Estonian capital. This development is also responsible for the 2% fall in Estonia's exports to Finland. However, the country remains Estonia's leading export partner, accounting for 20% of all sales. China has been a notable export success this year, with sales up by more than 500% to EEK1.8bn. The country now ranks as Estonia's 12th-largest export partner; its main purchases are electrical goods, metals and wood articles.

Rapid growth in imports is driving the external deficit

The current-account deficit in the second quarter of 2006 totalled €406m (US$510m), significantly lower than the deficit of €463m given by the earlier flash estimates of Bank of Estonia (BoE, the central bank). However, on the basis of the BoE's initial estimates, the current-account deficit rose further, to €525m, in the third quarter, taking the deficit for the 12 months to September to €1.6bn (US$2bn), around 13% of GDP.

The rising trade deficit was the main factor behind the widening of the current-account deficit during this period, since imports grew significantly more quickly than exports in the third quarter and started from a much higher base. In addition, the deficit on the income account increased substantially. The rapid growth of the Estonian economy has led to a sharp rise in corporate profits, especially among foreign-owned firms. As a result, the deficit on investment income rose by €107m year on year to €224m in the third quarter.

Balance of payments
(€ m)

	2005			2006		
	2 Qtr	3 Qtr	4 Qtr	1 Qtr	2 Qtr	3 Qtr
Merchandise exports fob	1,508.7	1,618.3	1,777.5	1,813.9	1,939.0	1,904.4
Merchandise imports fob	-1,905.5	-2,012.4	-2,196.4	-2,181.0	-2,460.6	-2,471.6
Trade balance	**-396.8**	**-394.1**	**-418.9**	**-367.1**	**-521.6**	**-567.2**
Services, net	216.4	244.6	204.4	120.2	250.7	252.5
Income, net	-190.2	-117.6	-90.6	-151.8	-169.5	-224.5
Transfers, net	36.3	11.0	22.3	-7.9	34.7	14.5
Current-account balance	**-334.3**	**-256.1**	**-282.8**	**-406.6**	**-405.7**	**-524.8**
Direct investment, net	988.0	169.7	-184.1	368.6	-25.2	94.7
Portfolio investment, net	-1,339.5	-340.8	284.7	-765.4	-86.2	-295.1
Other investment, net	539.4	448.5	408.1	697.6	501.6	852.2
Capital account	20.9	11.6	50.5	76.1	83.2	64.5
Capital & financial account balance	**208.8**	**289.0**	**559.2**	**376.9**	**473.4**	**716.3**
Errors & omissions	30.1	-30.1	-43.5	-51.8	47.7	16.2
Overall balance	**-95.4**	**2.8**	**232.8**	**-81.4**	**115.4**	**207.5**
Reserves	95.4	-2.8	-232.8	81.4	-115.4	-207.5

Note. Data are local definition. Latest quarter is based on the Bank of Estonia's "flash estimate" and is based on partial information. Portfolio investment includes international bonds. Other investment includes financial derivatives.

Source: Bank of Estonia.

The services surplus was broadly unchanged from a year earlier at €252m. Transport and travel services, the largest components, tend to balance themselves out over the year. However, exports of smaller services, such as financial intermediation and computing, are increasing. The transfers account again showed a surplus, though this is small relative to the balances on the other lines of the current account. Inflows, which consist primarily of EU funds, have come in more slowly than initially expected because of delays in project approval and disbursement. Remittances from workers abroad permanently or on long-term contracts are another source of inflows, but the figures for transfers are likely to miss many of these informal flows. Outflows primarily consist of Estonian payments to the EU budget.

Estonia continues to be a net recipient of foreign direct investment (FDI), but investments by Estonian firms abroad are rising. As a result, the net inflow of FDI in the 12 months to September 2006 was €254m, just 16% of the current-account deficit over this period. With investment in portfolio assets continuing to record a net outflow, the substantial current-account deficit was, in effect, financed by a further large inflow of "other investment"—mainly foreign borrowing by Estonian banks. Despite the large current-account deficit, official reserves continue to rise, and stood at US$2.3bn at the end of October 2006, compared with US$1.9bn a year earlier.

Main external indicators

(US$ m, unless otherwise specified)

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Exports fob (EEK bn)												
2004	4.93	5.23	6.70	5.64	6.06	6.19	5.95	6.31	6.75	7.04	7.34	6.47
2005	6.63	6.84	7.75	7.46	7.91	8.03	7.50	8.25	9.02	9.53	9.59	8.41
2006	8.22	9.41	10.51	9.56	10.36	10.66	8.81	10.03	–	–	–	–
Imports cif (EEK bn)												
2004	6.65	7.07	9.05	11.00	8.07	8.52	8.21	8.35	9.28	9.62	9.72	9.34
2005	7.96	9.01	10.23	10.37	10.47	10.55	9.98	11.01	12.03	12.56	12.38	11.20
2006	10.91	11.49	13.81	13.44	13.45	14.59	13.16	13.53	–	–	–	–
Trade balance (EEK bn);												
2004	-1.72	-1.84	-2.35	-5.37	-2.01	-2.33	-2.26	-2.04	-2.52	-2.58	-2.38	-2.87
2005	-1.32	-2.17	-2.48	-2.91	-2.56	-2.52	-2.47	-2.76	-3.01	-3.03	-2.79	-2.80
2006	-2.69	-2.08	-3.31	-3.88	-3.09	-3.93	-4.35	-3.50	–	–	–	–
Current-account balance												
2004	-94	-82	-113	-268	-129	-119	-40	-46	-121	-120	-155	-171
2005	-83	-133	-159	-223	-56	-144	-84	-106	-123	-131	-99	-108
2006	-154	-116	-220	-151	-164	-195	-242	-198	-229	–	–	–
Foreign reserves												
2004	1,196	1,257	1,302	1,305	1,444	1,346	1,429	1,424	1,533	1,533	1,641	1,794
2005	1,681	1,618	1,927	1,654	1,745	1,700	1,771	1,812	1,696	1,867	1,769	1,946
2006	1,936	1,881	1,885	2,211	2,132	2,113	2,177	2,341	2,375	2,330	–	–
Gold												
2004	3.3	3.2	3.5	3.2	3.3	3.2	3.2	3.4	3.4	3.5	3.7	3.6
2005	3.5	3.6	3.5	3.6	3.4	3.6	3.5	3.6	3.9	3.9	4.1	4.2
2006	4.7	4.6	4.8	5.3	5.4	5.0	5.3	5.1	5.0	4.9	–	–
International reserves												
2004	1,199	1,260	1,306	1,308	1,448	1,349	1,432	1,428	1,537	1,536	1,645	1,797
2005	1,684	1,622	1,931	1,657	1,748	1,703	1,774	1,816	1,700	1,871	1,773	1,950
2006	1,941	1,886	1,890	2,216	2,137	2,118	2,183	2,346	2,380	2,335	–	–

Sources: Statistical Office of Estonia; Bank of Estonia.

Estonia. Country Reports on Human Rights Practices. - 2007. Released by the Bureau of Democracy, Human Rights, and Labor March 11, 2008. With a population of 1.34 million, Estonia is a constitutional parliamentary democracy with a unicameral parliament, a prime minister as head of government, and a president as head of state.Â Two police officers were charged in January 2006 in Viru district with assaulting a suspect. One was convicted and fined, a decision subsequently upheld by the Viru District Court in April. In December 2006 a Harju county court case was terminated by agreement of both parties after an officer acknowledged that he had used excessive physical force against three juveniles suspected of using drugs. Prison and Detention Center Conditions. Country report â€" estonia. Liis roovli. Enepri research report no. 27. Ahead WP2. November 2006. ENEPRI Research Reports publish the original research results of projects. undertaken in the context of an ENEPRI project. This paper was prepared as part of the AHEAD project â€" Ageing, Health Status and the Determinants of Health Expenditure â€" which has received financing from the European Commission under the 6th Research Framework Programme (contract no. SP21-CT-2003-502641). The views expressed are attributable only to the author and not to any institution with which she is associated. ISBN 92-9 Republic of Estonia: 2006 Article IV Consultation - Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Republic of Estonia. IMF Country Report No. 06/418, November 2006. Republic of Estonia: Selected Issues. IMF Country Report No. 06/419, November 2006. Estonia, 2005 IMF Article IV Consultation. Republic of Estonia - 2005 Article IV Consultation Mission.