II. GLOBAL ECONOMY

MAIN GLOBAL TRENDS

After a recovery in 2003, global economic growth stabilised at the highest level of recent years in the first half of 2004. In the second half of the year global economic activity declined slightly. According to the International Monetary Fund (IMF), the global GDP increased by 5.1% in 2004 (4.0% in 2003, see Table 2.1). The growth rate is forecast to drop to 4.3% by 2005.

Table 2.1. Economic indicators of industrial countries

	GDP growth (%)		Annual average CPI growth (%)		Annual average unemployment rate (%)		Budget surplus/deficit (% of GDP)		Current account (% of GDP)	
	2003	2004*	2003	2004*	2003	2004*	2003	2004*	2003	2004*
World	4.0	5.1								
United States	3.0	4.4	2.3	2.7	6.0	5.5	-4.6	-4.3	-4.8	-5.7
Japan	1.4	2.6	-0.2		5.3	4.7	-7.8	-7.1	3.2	3.7
Euro area	0.5	2.0	2.1	2.2	8.7	8.8	-2.8	-2.7	0.3	0.4
Germany	-0.1	1.7	1.5	1.2	9.6	9.2	-3.8	-3.7	2.2	3.6
France	0.5	2.3	2.0	1.9	9.5	9.7	-4.2	-3.7	0.3	-0.3
Finland	2.4	3.7	1.3	0.2	9.0	8.8	2.3	1.9	4.2	4.5
Other EU Member States										
United Kingdom	2.2	3.1	1.7	2.0	5.0	4.8	-3.3	-3.0	-1.7	-2.2
Sweden	1.5	3.5	2.3	1.1	4.9	5.5	0.5	0.7	7.6	8.1

* The data for 2004 are preliminary.

Sources: IMF, World Economic Outlook, April 2005; Eurostat, March 2005

Regionally the largest economic growth in 2004 took place in the Asian industrial countries. Chinese economy grew at the most rapid pace (9.5%) of the last eight years. The US economy grew the fastest among the developed countries (4.4%); euro area countries (2.0%) and Japan (2.6%) displayed the weakest growth. Compared to the forecasts made earlier in the year[1], economic growth in the US remained 0.2% below and in the euro area 0.2% and in Japan 0.5% above the target.

[1] Consensus Forecasts, January 2004.

The main factors affecting global economy over the year were highly volatile oil prices, which repeatedly reached the historic highs (a barrel of oil cost 30–35 dollars at the beginning of the year, exceeding 55 dollars by October but decreasing then to 40–45 dollars by end-year), continued extensive imbalance in major economic regions (soaring US and euro area budget deficits, US current account deficit and increasing private sector debt burden) and a transition to a more conventional monetary policy in the US, Canada, the UK and other large countries. Over the year, the inflation rate picked up in major economic areas primarily due to rising oil prices. According to labour market statistics, unemployment decreased in the US and Japan but remained high in the euro area countries.

UNITED STATES AND JAPAN

The US maintained its role as a driving force of global economic growth in 2004 – its pace exceeded that of the other developed countries by far. As in 2003, growth in 2004 was primarily driven by domestic demand, supported by continued expansionary monetary policy in the first half of the year. Trade did not contribute to economic growth: current account deficit exceeded 5.5% of GDP. The US fiscal policy remained expansionary as well: the government deficit in the fiscal year of 2003–2004 (412.6 billion dollars, i.e. approximately 3.5% of GDP) was the highest of the decade. Both current account and budget deficits were covered by a capital inflow into US, mainly in the form of bonds. Most of them were purchased by Asian central banks.

Economic growth was the fastest in the first quarter, though slowed slightly after that. At reaching the growth trend, the Federal Reserve started normalisation of the expansionary monetary policy. In the second half of the year, five successive interest rate increases (each by 25 basis points) caused the key interest rate to rise from record low 1.0% to 2.25%.

Inflation, which was below 2.0% in the US at the beginning of the year, reached 3.0–3.5% over the year, due to the rising oil price and a downward trend of the dollar. Labour market statistics showed an increase in the share of economically inactive people. Unemployment decreased from 5.7% in January to 5.4% in end-year; however, employment growth did not accelerate as expected together with increasing economic activity.

Economic growth was high in Japan in the first half of the year too: annual GDP grew in the first quarter (4.4%) at the fastest pace in the last twelve years. Starting from the second quarter, Japan's economic activity decreased considerably. Negative quarterly growth in the second (-0.3%), third (-0.3%) and fourth (-0.1%) quarter was primarily caused by a rise in the oil price and strengthening of the yen. The annual GDP increased by 2.6%. The more than five-year-long decline in consumer prices was replaced by a slight increase in prices at end-2004, the continuation of which is largely dependant on further oil price dynamics. The unemployment rate decreased from 5.0% at the beginning of the year to 4.5% in end-year (the lowest level in six years).

EURO AREA

In the first half of 2004, economic growth in the euro area accelerated due to growing external demand. In the second quarter, the annual GDP growth rate was the highest in three years (2.2%; see Figure 2.1), still remaining below the trend. Economic activity declined again in the second half of the year as external demand weakened due to slower economic growth in the US and Japan and a rapid rise in the euro exchange rate causing export growth to slow down. Contrary to expectations, domestic demand did not recover at the beginning of the year either.

Throughout 2004, inflationary pressure in the euro area was primarily caused by the changes in oil prices and administrative factors (especially a rise in the tobacco excise duty). Over the year, inflation increased from 1.9% in January to 2.4% in December. Due to continued weak domestic demand, the ECB does not anticipate further inflation acceleration in the near future. The unemployment rate remains high in the euro area, being around 8.8–9.0%. However, it should decrease in Germany in 2005, as the Hartz IV labour market reforms are being implemented[2].

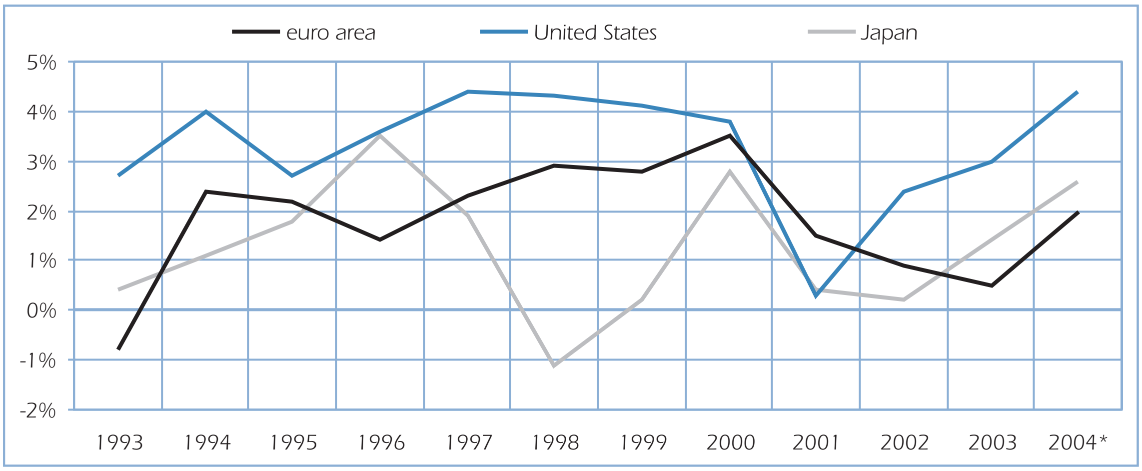

Figure 2.1. Annual GDP growth in major global economies over the last decade

* The data for 2004 are estimated.

Continued low domestic demand and lack of inflation and wage pressures kept the euro area key interest rate at a historic low of 2.0%. Due to economic growth below the trend, budget deficits in major euro area countries (Germany, France, etc.) exceeded the 3.0% ceiling of the Stability and Growth Pact for the second or third year; active political discussions on a potential relaxation of budget rules took place throughout the year.

The euro area economic outlook for 2005 depends both on further developments of external and on domestic demand. The latter has currently not lived up to expectations. According to ECB estimates, overall economic growth should accelerate slightly.

FINLAND AND SWEDEN

Estonia's major trade partners Finland and Sweden sustained economic growth rates above the euro area average in 2004, respectively estimated to having been 3.7 and 3.5% (see Figure 2.2) **but still remaining slightly below the potential level**. In both countries growth was driven by strong household consumption and supported by the most favourable interest rate levels of recent decades, an inflation rate significantly below the EU average, and in Finland also by changes in indirect taxes (including reductions in alcohol and motor vehicle excise duties).

Although growth prospects for 2005 in both countries are relatively strong under the conditions of global economic revival, further strengthening of the euro against the dollar and continuous increases in raw material prices could have an adverse impact. Further developments in the Finnish and Swedish industrial sectors that are very open to the world market (particularly under the circumstances of tough competition in the telecommunications market) will also play a relatively important role.

[2] The objective of the labour market reforms (the so-called Hartz IV package), which entered into force on 1 January 2005 in Germany, is to reform national social benefits' system (first and foremost, unemployment benefits).

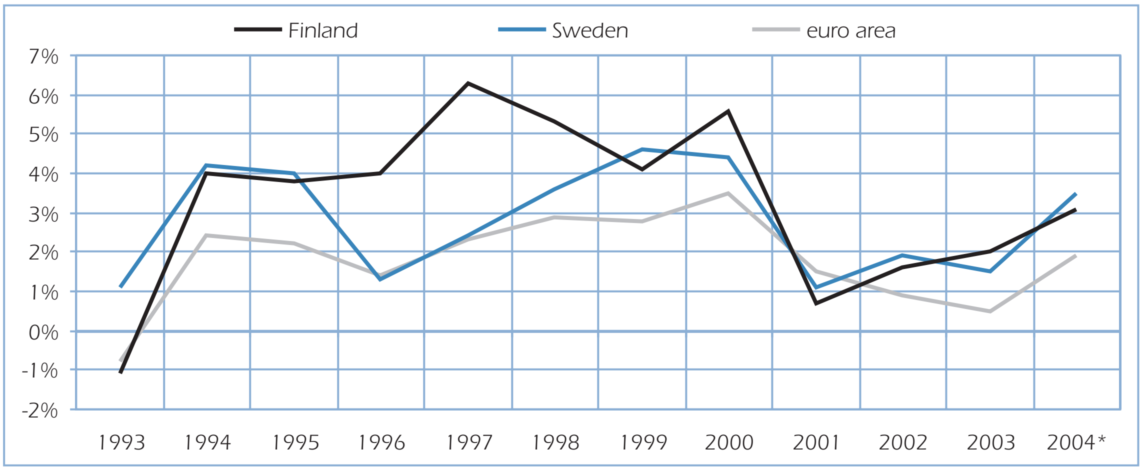

Figure 2.2. Economic growth of Estonia's major trade partners

* The data for 2004 are estimated.

BALTIC STATES AND CENTRAL AND EASTERN EUROPEAN COUNTRIES

The most significant event in this group of countries was accession to the European Union of all the Baltic States, Poland, the Czech Republic, Slovakia, Slovenia, Hungary, Malta and Cyprus on 1 May 2004. Estonia, Lithuania and Slovenia also took another step towards changeover to the euro by joining the exchange rate mechanism ERM II.

Latvia's economy, supported primarily by domestic demand, grew at the fastest pace among the Baltic States (8.5%), Lithuania's annual economic growth reached 6.8% (see Table 2.2 and Figure 2.3). In both countries prices grew relatively rapidly. In addition to rising prices of raw materials in the world market, the harmonisation of value added tax and excise duties with those of the EU that was started in 2003, contributed as well. In Lithuania, the price decline of 2003 was replaced by an inflation that reached its peak in August and started to decrease again after that.

Table 2.2. Economic indicators of the new EU Member States

	GDP growth (%)		Average CPI growth (%)		Budget deficit (% of GDP)	
	2003	2004*	2003	2004*	2003	2004*
Estonia	5.1	6.2	1.3	3.0	3.1	1.8
Cyprus	1.9	3.5	4.1	2.3	-6.3	-4.2
Latvia	7.5	8.0	2.9	6.3	-1.5	-0.8
Lithuania	9.7	6.6	-1.2	1.2	-1.9	-2.5
Malta	-0.3	0.6	1.3	2.9	-10.5	-5.2
Poland	3.8	5.4	0.8	3.5	-4.5	-4.8
Slovakia	4.5	5.3	8.5	7.5	-3.7	-3.3
Slovenia	2.5	4.4	5.6	3.6	-2.0	-1.9
Czech Republic	3.7	3.7	0.1	2.8	-11.7	-3.0
Hungari	2.9	3.8	4.7	6,8	-6,2	-4,5

* The data for 2004 are estimated.

Sources: IMF, World Economic Outlook, April 2005; Eurostat, March 2005

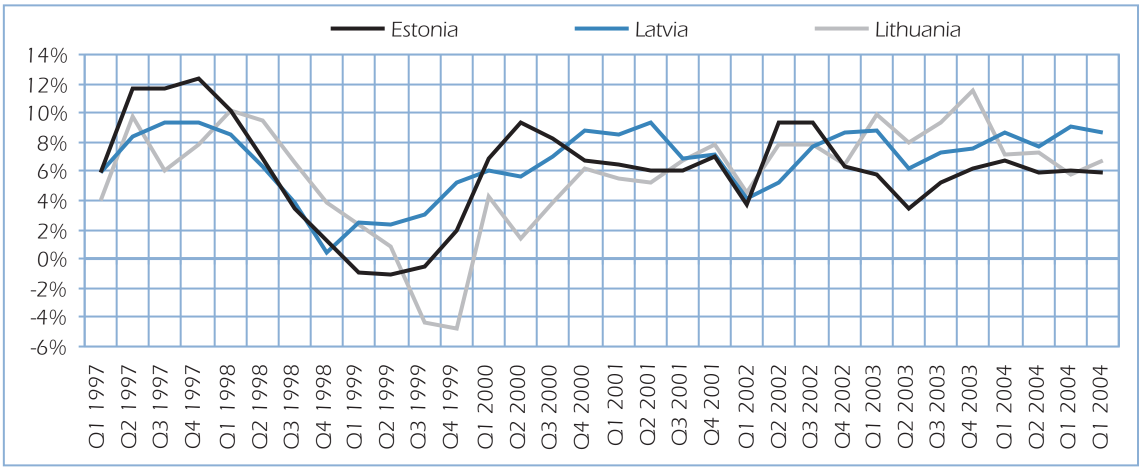

Figure 2.3. Economic growth in the Baltic States

Economic growth in the Central and Eastern European (CEE) countries exceeded 4.0% in 2004, thus exceeding the euro area average twofold. In 2005, growth will, first and foremost, depend on EU economic development and possible policy decisions of the CEE countries. Poland, the Czech Republic, Hungary and Slovakia will face a difficult year in fiscal policy, as budget deficit should be curbed in the light of upcoming general elections (in Poland in summer 2005, in other countries in 2006). These four countries are planning to introduce the euro in 2009–2010.

RUSSIA

Continuously high raw material prices kept Russia's annual economic growth rate high (7.1%) and external balance improved significantly as well. Economic activity recovered mostly due to the export sector, thriving on the exports of fuels and other raw materials but being also supported by household consumption. YUKOS related developments had a negative impact on the investment climate and caused a slowdown in investment growth. The growth rate of the industrial sector slowed down too. Rapidly increasing export revenues helped to generate the general government budget surplus, which reached 4.1% of GDP. Major rating agencies upgraded Russia's sovereign ratings to investment grade but still warned about the country's economic vulnerability because of economy's non-diversified nature and suspended structural reforms.

In 2003, the Russian Central Bank focused on restraining inflation. In 2004, inconsistent monetary policy and pressure exercised by growing foreign currency revenues increased prices over the annual target of 10.0%.

DEVELOPMENTS IN INTERNATIONAL FINANCIAL AND COMMODITY MARKETS

At the beginning of 2004, major **stock markets** continued the upward trend of 2003, primarily supported by recovering global growth outlook. The markets were later influenced by rising oil prices, which worsened the growth outlook and reduced investors' risk appetite. Therefore, share prices stalled until the fourth quarter when the oil price decreased and the upward trend recovered. All in all, stock markets remained on the positive side: the US S&P 500 index increased 9.0%, Nikkei 225 index 7.6% and Eurobloc 300 index 9.3% over the year.

In **bond markets** the dynamics of short-term interest rates reflected monetary policy developments. There was a major change in the growth cycle of the US key interest rate in the second half of the year caused by economic recovery. The Federal Reserve raised its key interest rate gradually from 1.0% to 2.25% in the second half-year. Monetary policy interest rates in the euro area and Japan remained at the previous level (e.g. at 2.0% in the euro area). Long-term interest rate dynamics, which were more directly exposed to growth outlook and developments in other financial markets, were quite volatile: in the first quarter the rates fell, while rose in the second quarter, followed again by a decline at the end of the year. All in all, the US long-term interest rates remained approximately at the level of the beginning of the year, falling merely by 3 basis points, whereas in the euro area 10-year interest rates decreased by 61 and in Japan increased by 7 basis points.

In f**oreign exchange markets** the main trend was the depreciation of the US dollar against other major currencies. The euro strengthened against the dollar by 7.6% and of the Japanese yen by 4.3%. The main underlying reason for the weakening of the dollar continued to be the economic imbalances in the US, primarily a large current account deficit that continued to soar in 2004. Earlier in the year US economic recovery contributed to a slight strengthening of the dollar followed by a rapid weakening in the last quarter, which determined the annual dynamics. By end-December the exchange rate of the euro against the dollar reached its historic high of 1.3637.

In **commodity markets** prices continued to rise. The oil price increase by 34% (from 32.5 dollars to 43.5 dollars a barrel) had the largest impact on global economy. The increase was caused both by the growth in demand arising from strengthened economic activity and supply-side limitations (political instability in some oil producing countries, bad weather, etc.). As a result, the price of oil reached the highest level in decades, exceeding temporarily 55 dollars a barrel in October. The increase in the oil price added investor uncertainty about the economic growth and inflation outlook and, accompanied by the depreciation of the dollar, brought about a 5.5% increase in the price of gold. The CRB index reflecting the prices of major commodities increased less than in previous years (by 3.3%).