WHAT DID THE YEAR 2002 DELIVER FOR THE ESTONIAN ECONOMY? WHAT TO EXPECT OF 2003?

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Facts

In 2002 Estonian economy revealed remarkable development in many sense of the word. Despite the relatively modest forecasts made at the beginning of the year, according to preliminary estimates the GDP grew to 5.3%, faster than in 2001. **As the economic growth in the European Union was low, the growth difference between Estonia and the EU spread to more than four percentage points, ie more than the long-term average trend allowed to hope.** Insecurity in the world economy had its implications also on Estonia – by quarters our real annual growth of GDP differed more than twofold.

For the first time since 1997 and 1998, the economic growth had clearly been sustained by domestic demand – domestic consumption and investments. After the Russian crisis, export of goods and services, growing by 33% in 2000–2001, remained the main source of growth for our economy. Domestic demand was primarily investment-sustained, the consumption of both the private and public sector displayed little real growth in these years. However, in 2002, the real consumption in the private sector increased by about 8%. Investments gained 20% and amounted to over 30% of the annual GDP.

Although large domestic demand overcast Estonian trade throughout 2002, the year was good also for the export sector. Despite the relatively modest economic growth in the European Union, Estonia's exports (furniture, timber, paper, etc) remained viable. Direct export – export of goods produced in Estonia minus subcontracting – increased by 11% over the year. The recession in telecommunication and IT sector in the world had its implications also for the manufacture of electronic equipment and machinery in Estonia, which is directly exposed to Nordic giants. As a result, Estonian subcontracting shrank by a fifth. The year was successful for transit companies and ports.

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Rapidly growing domestic demand exercised no additional pressure on prices: consumer prices rose in Estonia by merely 3.6% in 2002. By commodity groups the changes were quite different. Cheapening of foodstuff and fuels reflected European trends and contained the inflation rate low. However, in the sheltered sector of Estonian economy (services and administered prices) prices went up by 7% during a year.

While increased domestic demand did not significantly raise the price level, **the changes in the ratio of domestic and external demand had a considerably larger impact on external equilibrium.** The ratio of Estonia's current account deficit to GDP nearly doubled, reaching an estimated 11%. This was primarily caused by a sharp growth in import – the difference of import and export of goods and services to GDP spread to 9%. On the side of capital and financial account, the expanding external borrowing, both through corporate bond issues and banks, covered rapidly growing current account deficit. Also banks' external reserves shrank. Direct investments as a ratio to GDP shrank both in gross and net terms – investments in Estonia shrank below previous years, Estonian undertakings, primarily the financial sector, continued investing mostly into Latvia and Lithuania.

The banks' loan portfolio grew rapidly in 2002 – together with loans to financial institutions total lending gained 23%. More than a third of the growth came from private persons' housing loans. Corporate lending displayed modest growth – 9.4%. From the private sector's point of view the share of the so-called real sector – undertakings and families – loan burden added 20%, ie 5.4 billion kroons. Besides bank loans, also purchasing of goods and housing with leasing or instalment grew rapidly. In brief, loan commitments grew faster than assets, ie corporate and private persons' net debt went up. Banks' balance sheet reflected the situation as deposit growth below credit growth. As already mentioned, the banks financed the difference from external reserves and in the second half of the year from rapidly accelerating external borrowing. Declining interest spread between deposits and loans curbed also banks' profitability.

Faster than anticipated economic growth brought along larger-than-planned tax collection, however, there were also other facilitating factors. **Despite two supplementary budgets** – totalling 1.2 billion kroons – **for the second time since 1997 the state budget had a slight surplus.** The surplus was 1.5% of GDP.

Analysis

It is difficult to say clearly whether the economic year of 2002 was *good* or *bad*, especially compared to 2001. Larger-than-anticipated growth of GDP against the world economy is a positive surprise. We can also state that the GDP is more than before relying on domestic demand and private consumption, characterising thereby the vitality of the economy and increasing purchasing power of Estonian residents whereas large investments are inevitable in order to secure rapid growth in upcoming years. Increasing domestic demand displays that **in the short-term Estonian economy will not only depend on external markets but will be able to create value-added also on its own.** However, it is also important that despite the increasing domestic demand – the meeting of which is going to take increasingly more labour and capital – and lower-than-expected growth of the world economy, **also exports of our traditional commodities went up.**

Apart from all these positive facts, there are also a few worrying signs. The main one being the sharply soared current account deficit, which has only one message – **foreign investors**

are financing Estonian economic growth. The truth is simple: **sustained rapid economic growth will primarily depend on the confidence of the rest of the world, first and foremost, European undertakings, banks and private persons** – whose money Nordic banks are relending to Estonia – **in the development capability and stability of Estonian economy.** Thus, in 2002, the growth derived from Estonian corporate investment need and Estonian household consumption need whereas the need was sustained more than ever before by external borrowing.

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The structure of foreign funds flowing to Estonia in 2002 differed significantly from previous years. **Shrinking direct investment pushed sharply up the share of bank loans and other loan money.** It is natural that under deepening integration with the rest of the world, different flows of capital can be more and more replaced with each other. Last year a significant part of foreign exchange flew into Estonia from Eesti Energia's bond issue. A few other large undertakings followed the example as well. Bank loans and leasing growth rate was record high of the last five years.

All in all, in 2002 Estonia – similarly to the rest of the world – left several questions unanswered and therefore forecasts for 2003 involve a considerably larger risk than we would have guessed just six months ago. However, for analysing these risks we have to single out all the factors, which secured faster-than-anticipated economic growth in 2002.

It might be slightly surprising but **the first factor is linked to our most significant trade partners.** While the year 2002 was as a whole disappointing, the economic recovery of Estonia's main partners – Finland and Sweden – started somewhat earlier than elsewhere. The budget and trade of the two countries has for years had significant surplus, ie revenues have exceeded expenditure. In case of the national budget, the goal has been to curb the national debt, in the private sector – high corporate profitability and preparation of the so-called large generations to upcoming retirement. Both considerable surplus of the state budget and balance of payments provide the economy with essential adaptability – should export revenues shrink, larger domestic demand could compensate. Domestic demand is financed from the surplus accumulated during the years of rapid growth. Also Nordic banking sector has been strong after the early-1990s crisis.

The economy of Estonia's other significant partners – Latvia and Lithuania – grew rapidly in 2002. Growth factors have mostly been similar to Estonia, although the economic cycle in Latvia and Lithuania has had a slight time lag against Estonia, as our rapid growth rate recovered before other Baltic States. In Latvia the domestic demand remained strong throughout 2002. The demand was sustained by capital inflow, rapid lending by banks and in the second half of the year increasingly also by fiscal policy. In Lithuanian economy growth in the share of exports was most significant. Domestic demand displayed more modest a growth and banks' loan portfolio grew moderately.

Yet another neighbour – Russia – has had stable economy throughout 2002. Primarily oil-and-gas-sustained export revenues and balanced national budget maintained the current account at a soaring surplus, although real income, which grew over the year, boosted also consumption and imports.

In brief, the relatively stable external environment sustained Estonia's economic growth quite remarkably. The situation with our main economic partners was – especially compared to the rest of the world – more growth-supportive than inhibiting.

The other growth factor, even more significant than the external environment, was **sustained confidence in the economy of EU candidate countries – more specifically, in future Member States.** During 2002, fundamental enlargement-related issues were solved and the accession of the so-called former socialist countries in the near future is very likely.

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Acceding to the European Union, the new Member States will also accept economic-policy rules, without which modern market economy would be impossible. Becoming closely integrated with the EU *acquis* and economic policy cooperation principles, the new Member States will set prerequisites for rapid economic growth. Most analysts and investors believe that residents' income in the new Member States, including Estonia, will grow faster than the EU average in the upcoming years. Thus, also the market of former socialist countries is becoming more attractive, as purchasing power and consumption grow parallel to increasing income. But not only, larger incomes permit also to borrow more. Therefore, Nordic banks are deeply interested in the Baltic market – the average loan burden in Estonia, Latvia and Lithuania has been relatively low, thus, the volume of the financial market is likely to rise.

The EU enlargement is significant also for sustained capital inflow. In reality there is already a large economic area where goods and capital move freely but capital productivity varies largely by states. It is assumed that in Central and Eastern Europe the marginal productivity of capital could be several times higher than in old Member States, ie the potential efficiency of new investments is very high. But the potential will be realised only if the new Member States can continue with their currently relatively stable and predictable economic policy.

The opinion that the EU enlargement by the new Member States, including Estonia, is a resolved and irreversible process had a remarkable impact on our economy in 2002. The investor confidence increased, showing that the new Member States are worth investing in, as their purchasing power is

> **increasing and the market is becoming more attractive, while also the potential of investment productivity is very high. An increase in confidence is sustained by capital inflow into former socialist countries but also continuously rising sovereign ratings.**

Thirdly, it should be stressed that **the capital accumulated during the post-Russian-crisis period served as one of the main growth factors in 2002 in Estonia, both in the direct and indirect sense.** Our trade partners' relatively good economic condition and generally increasing confidence in the EU new Member States were necessary but not sufficient prerequisites for rapid growth. The impact of these factors finds expression under corresponding economic policy, which ensures stable environment. Although Estonia and its economy have undergone a major change during ten years, principles underlying economic policy have remained unchanged. These are the fixed exchange rate policy, supported by timetable to join the single currency, which became more transparent last year, as well as balance-oriented and predictable fiscal policy and ongoing structural reforms in the economy. Balanced macro-economy allows keeping taxation clear and simple. Reforms have allowed reducing direct and indirect state interference to economy and thus, allowed the labour and capital moving to sectors where the profit is the highest.

It is difficult to overestimate the actual impact of the current fiscal policy on the economy. Since 1999, the government has been able to more or less maintain fiscal balance, thus, ensuring fiscal policy flexibility under changing tax revenues. The so-called automatic stabilisers have performed reasonably well in Estonian fiscal policy over the recent years – also in 2002 budget surplus was due to accelerated economic growth and above-forecast budget revenues, although broadening tax base, rapidly growing loan-sustained private consumption and deepened interest in paying social tax, induced by pension insurance, play a role as well. It is very important that such a fiscal policy will allow the government to respond to the changing economic circumstances the best possible way for residents and undertakings – without increasing tax load. Each economy develops in cycles, ie periods of faster and slower growth interchange. The main aim of the national economic policy is to reduce too high a fluctuation of gross production during an economic cycle. The automatic stabilisers are one way to achieve the objective through fiscal policy – surplus accumulated in the years of more rapid economic growth can be used in the years of slower growth, when revenues, as a rule, are smaller and expenditure remains unchanged or even increases. Otherwise, the state should under slower economic growth raise taxes or sharply improve borrowing.

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The economic growth achieved in 2002 derived apart from stable macroeconomic policy also from economic reforms conducted in previous years. The rapid growth of bank lending and increasingly improving access of households to loans would have been impossible without changes in the banks' ownership structure in the last years of the past century and without strong competition on the market. For the economic growth in general relatively large flexibility of the labour market is relevant. Although after the Russian crisis the unemployment went up considerably, closure of inefficient undertakings allowed establishing jobs in other sectors. A remarkable fall in the unemployment in 2002 was definitely one of the growth factors, which also ensured ongoing growth in productivity and contained wage-related costs on the level of general economic development.

In conclusion, Estonia's economic policy in previous periods had set favourable ground for sustained growth throughout 2002. The fixed exchange rate, balanced budget and clear and simple tax system, on the one hand, and strong financial system and reforms of the previous years, on the other hand, created a situation in which undertakings and private persons had sufficient capital for investment. Contemporaneously, shrinking unemployment, rising productivity and larger real incomes encouraged gradual growth in private consumption.

As a fourth factor, we could add **the situation in the European financial markets, which boosted Estonia's economic growth.** Because of the general growth slowdown in the European Union, interest rates in Europe as well as in Estonia were under strong pressure throughout the year, founding outlet in the falling banks' lending rate. The strengthening of the euro against the dollar from the beginning of the year did not that much influence Estonia's export-import volumes, but rather inhibited price growth, as imported goods, primarily fuel, depreciated. Thus, also the situation at world money markets sustained short-term Estonian economic growth and domestic demand.

Risks and Outlook

Summarising the year 2002, it is most important whether and to what extent the positive impact of economic growth-sustained factors will last, which of the risks are going to be more likely and which will the resultant main threats be?

Forecasting economic growth for 2003 the world is relatively uncertain. Growth recovery in the larger regions – the European Union and the USA – is rather expected to take place in the second half of the year. The industrial growth rate in our neighbouring countries – Finland and Sweden – that gained pace in the second half of 2002, could slow down again due to the general uncertainty in the world and low investment level. In simpler terms, economic growth slowdown in large EU Member States, primarily in Germany, could have its implications even in the smallest Member States. As Latvian and Lithuanian economies are subject to the same factors as Estonian economy, we can say that an outlook that Estonian export growth could significantly accelerate is highly doubtful. **A prerequisite for significantly larger export volumes would not be expanding external demand but more efficient production or marketing of new export products.**

However, under insecure external demand, the economic growth rate depends, just like last year, largely on the domestic demand. **Sustained domestic demand growth at the**

level of 2002 would assume an equal inflow of continued foreign investments. The main economic policy question in 2003 was how and to what extent the volume of investments in Estonia will change and whether, after all, it is recommendable to maintain the share of the inflow to GDP on the level of 2002, considering the upcoming years.

In order to respond to this question, we should proceed from two simple facts. Firstly, last year the difference between the economic growth of Estonia and our main economic partners in the European Union, including Nordic countries, increased significantly. If Estonia's economic structure has not changed in principle and sharply boosted production growth, such a growth difference between Estonia and Western European countries cannot last longer than a year or two. The preliminary analysis of the economic performance of 2002 allows assuming that although productivity kept growing, it did not accelerate much and was mainly sustained by increasing volumes of capital and labour. **Thus, most likely the economic growth rate difference between Estonia and EU slows down this year and in the next year.**

The question is not whether the current account deficit will shrink but when and how it will shrink.

Secondly, we can firmly state that **the Estonian economy cannot forever count on an inflow of foreign money.** Our current account deficit to GDP was so high in 2002 that sustained growth in the same volume would sooner or later – and most likely sooner than later – raise a question whether Estonian economic growth is reliable. If growth is to such an extent financed by external investors, it will become too sensitive to external changes. **The question is not whether the current account deficit will shrink but when and how it will shrink. If the export growth rate and corporate profitability do not significantly increase, the difference between saving and investments should decrease through contracting investments, ie domestic demand.** In the financial sector inhibited borrowing and leasing growth rate would reflect such an adjustment.

Thus, the key point of the 2003 forecast is inevitably an assumption that slower economic growth at least in the first part of the year will be more likely than sustained or accelerating growth. Moderate growth slowdown is not necessarily negative *per se*. Should this take place at the expense of declining domestic demand, equally also the current account deficit will shrink and more resources will be available for the export sector. **From the economic policy point of view, the situation would be more problematic both for the central bank and for the government if domestic demand and GDP growth slow down sharply, as a result of which the collection of intended revenues is likely to fall and banks revise their lending policy profoundly.** This would mean that in a way the 1997–1998 scenario is going to repeat itself. The main issue is an answer to the question whether Estonian economy and economic policy are flexible enough to avoid accumulation of problems threatening economic equilibrium, which could lead to a painful adjustment.

To answer this question we should start from Estonian balance of payments' financial account and to analyse whether the FDI inflow could rapidly decline. A simple answer would be no, at least in the short-term. **Most of the external money invested in Estonia has not been**

short-term speculative capital. Although the FDI shrank visibly in 2002 and was primarily replaced by corporate and banks' borrowing, corporate foreign loans were, as a rule, long-term.

Besides the above, we should take into consideration that a significant part of the foreign capital invested in Estonia is reinvested profits, received from the previous FDI, reaching over 60 billion kroons. This, in turn, reduces vulnerability of the economy as the decision whether to reinvest profits or not depends more on Estonian economic policy than on the economic development in the rest of Europe, which we cannot affect.

Against the slow economic growth in the rest of Europe, the future Member States are likely to be an attractive investment area in 2003, offering continuously potentially high marginal productivity. In case of Estonia, the structural surplus of Finnish and Swedish economies sustains foreign investor interest – in the next couple of years our partners are probably going to save more than invest at home.

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Judging from the above, we can assume that **at least in the short-term the FDI in Estonia does not have to decline sharply, even despite the large current account deficit.** Our sufficiently stable banking system supports this assumption as well. Regardless of the rapidly growing banks' loan portfolio, its quality remains good and banks' well capitalised and liquid. Considering also vibrant foreign owners and strong supervision of the financial sector, it is not likely that the volume of new bank loans could drastically contract.

The sharp adjustment of the financial account is not too likely in 2003 because of the above arguments. This will ensure continued financing at such a level, which should reduce the likelihood of rapidly declining investment and consumption growth rates. Estonia's corporate competitiveness has an encouraging impact on export developments, as seen from sustained improvement of market positions. **Thus, although Estonian economy could reveal subdued growth in 2003 against the previous year, it is rather beneficial for the further sustained growth of the economy.**

Such a positive base scenario could be subject to additional risks, which are less likely to occur but should be considered anyway. Some of them could threaten economic equilibrium already this year, in 2003. **Such a risk would be, for example, sharply falling demand for Estonian goods at our main export markets. The main domestic risk factor is ongoing accelerated growth of domestic demand at the expense of foreign exchange inflow**, which in the short-term will bring along subsequent increase of the current account deficit. In this case, the likelihood of a sharp adjustment will significantly rise, which does not have to deliver as serious a recession as after the Asian and Russian crises in 1999, but could contain growth below forecasts for several years. Both of the risks could be realised through several channels.

The other set of risks is related to changes in the economic structure and their implications can appear only in a few years. One of the risks is, for example, a **slowdown in the productivity growth rate of the Estonian economy**, which in its turn would bring along **gradual shrinking of real income and GDP growth**. Productivity growth could slow down if too large a share of investments goes into low efficiency, primarily domestic market-oriented activities and real estate, mostly at the expense of exporting industry. An inhibited FDI inflow is an early warning indicator vis-à-vis productivity growth. The risk, peculiar at a first glance, is linked to a low inflation level in the short-term. As the fixed exchange rate involves together with growing income also gradual increase in the price level, we **cannot exclude that a year of very low price increase will be followed by an accelerated growth rate.** Such a threat is larger in case timely adjustment of prices is inhibited through political agreements. The artificially suppressed price increase could also soar current account deficit, as larger real income will boost temporarily demand for imported goods.

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Apart from the two risk groups, risks on the level of national economy could occur as well. **An unconditioned prerequisite of further economic growth is fiscal policy, which will secure balanced and predictable budget.** Besides, a thorough analysis should be conducted whether one of the reasons of the current account deficit would not be the underestimation of accumulating expenditure in the economy and society in the mid- and long-term. In other words – **whether the current fiscal policy and corporate and private persons' behaviour does not overlook the fact that aging population as well as public health and education systems will bring along major expenditure in upcoming years.** If this is indeed the case, we can guess that in order to secure balanced development of the society and economy, significantly more money should be saved in future. Thus, the pension reform is a step in hedging long-term economic and fiscal policy risks, but the question is whether the two other expenditure components – public health and education reform – should not be reformed step-by-step, increasing personal liability.

To sum up, although Estonian economy grew surprisingly rapidly in 2002, several risks should be considered in securing balanced development of the economy. In 2003 and onward, the main economic policy task lies in gradually reducing current account deficit, which characterises external vulnerability of the economy, and to sustain rapid growth in productivity. The fact that the rapid slowdown of the economic growth is relatively unlikely simplifies the steps taken by the government and central bank. As the FDI inflow is not likely to suspend sharply either, in general, the environment is currently favourable for planning necessary economic policy steps.