I
SURVEY OF THE ECONOMIC POLICY

In the third quarter of 2000 the economic growth slowed both in Europe and the United States. Nevertheless, the real growth of the GDP in Estonia remained on the level of the first half-year, ending the year at a higher than 6% real growth. Trade export continued to be the main source of growth.

The Estonian economy is on the sustainable development path in medium term. Although the development has taken place and supposedly will take place in a relatively stable monetary policy environment in the near future, it does not exclude deviations from a longer-term trend. Thus, between autumn 2000 and the second half of 2001 temporary acceleration of inflation is going to take place, mainly encouraged by external pressure.

In the first half of 2000 the inflation was contained below anticipation whereas in summer the factors neutralising external pressure discontinued functioning (low food prices, inflation slowdown in the sheltered sector). In the third quarter consumer prices grew by 4.4% and in November even 5.7% against the same period in 1999. The gap with the euro-area inflation reached again more than two percentage points. The significant temporary price increase for more than six months is novel experience for Estonia. Therefore it is important to avoid unjustified income anticipation based on accelerating inflation.

In the third quarter mostly seasonal factors improved the fiscal position. There are positive outlooks to curb consolidated budget deficit far below the target 1.25% of GDP and achieve balanced budget in 2001.

According to preliminary estimates third quarter saving was as predicted the record high of the year and probably satisfied the investment demand. Therefore the import-export balance of goods and services was more or less in equilibrium.

Although neither internal nor external balance differs much from expectations, the question whether loan-sustained growth of domestic demand is not too rapid, remains on the agenda. Herewith not the entire domestic demand is considered but only consumption and investments to the domestic-market-oriented service sphere. Contemporaneously the investment level itself is raising questions, ie whether new balance has been achieved with smaller capital investments than before or can low investments inhibit economic growth in upcoming periods.

Most questions arise from the fact that it is difficult to describe performance mechanisms of the Estonian economy under changing circumstances. This applies both to the possible impact of the current investments and unemployment level on the production potential and to what extent implications of the interest rate policy pursued by the European Central Bank (ECB) could spread into Estonia's economy.

Monetary Developments

The modest rise in the euro interest rates, characteristic of even the third quarter, has not been sustained and any further increase remains unlikely. The third quarter brought to a halt the weakening of the euro as well, replacing it with strengthening at the end of the year. *Summa summarum*, the external environment was relatively neutral for Estonia. According to markets, neither significant changes in the interest rate level nor appreciation of the euro can be expected in short-term.

For Estonia undergoing the period of temporarily accelerating inflation this means that in the near term it is not possible to find support in the euro area monetary policy signals. Anyway in Estonia up to now only money market interest rates have closely followed changes in the euro area interest rates. Due to the continuously highly liquid banking system, the ECB restrictive monetary policy signals have not fully reached the real sector.

The current development does not yet indicate imbalance in the economy. Slight acceleration in the gross lending to the real sector by banks and leasing companies is in compliance with domestic saving and investment activity which according to preliminary estimates is said to have grown in the third quarter. The growth of consumption loans has also maintained high pace, although in absolute volume they are a modest source in covering private consumption.

Developments towards imbalance cannot be excluded as under high bank liquidity loosening of the monetary policy in the euro area could have more implications on the real sector of Estonia's economy than tightening.

Financial Sector

The banking sector was still highly liquid in the third quarter. The core shareholders in *Eesti Ühispank* and *Optiva Pank* offered a take-over bid to other shareholders and *Skandinaviska Enskilda Banken* acquired 95.1% of the shares in *Ühispank* and *Sampo* 93.4% of the shares in *Optiva Pank*. The accompanying decline in Estonia's banking risks is well characterised in the announcement made by Moody's Investors Service in November that ratings of both banks have been raised to Baa1/P2, ie to the same level with *Hansapank* and the Republic of Estonia.

On the stock market take-over bids have been dominant since the second quarter, temporarily increasing the exchange turnover (the peak of the year was in September) and raising stock prices in short-term. They continued slight growth in end-August and early-September, followed by adjustment at the end of September and TALSE remained on the level of the fist half-year. After summer holidays bond issues started to grow and recovered their previous volumes. Non-residents have increased their stake among issuers even more.

The gross growth of the leasing and factoring portfolio came to a standstill in the third quarter. The volume of the portfolio achieved half of the growth of the second quarter – 0.6 billion kroons, reaching 9.1 billion kroons. Most of the growth falls to motor vehicles and to some extent also to real estate leasing. The share of household contracts in the leasing portfolio has not changed significantly, although the quarterly 50million-kroon growth was the highest of the year. Regardless of the relatively modest growth in the leasing stock, the new sales in the third quarter equalled to previous periods as most of the transactions involved replacement of expiring contracts with new ones[1]. Despite such a development the annual change of the leasing stock is exceeding 40% due to the low comparison base.

Inflation

In the first half of 2000 the inflation was contained below anticipation whereas in summer factors neutralising external pressure (low food prices, inflation slowdown in the sheltered sector) discontinued functioning. In the third quarter consumer prices grew by 4.4% against the same period in 1999. In October the growth in the annualised consumer price index accelerated to 5.4% and in November to 5.7%. Thus, inflation pace is at growing variance with the euro area, exceeding 2 percentage points (2,7 percentage points in October and close to 3 in November).

[1] In the third quarter of 1997 the leasing portfolio grew by 1.1 billion kroons, ranking second ever after the second quarter of 2000.

Supposedly the inflation growth exceeding that of the first half-year will last till autumn 2001. According to the forecast, the price growth is anticipated to slow down later due to the declining external price pressure. The period of faster inflation is relatively long and fresh experience for the entire society. From the early transition period Estonia's annualised consumer price index has been continuously shrinking and 2001 is forecast to be the first with the inflation rate surpassing the previous year. Therefore it is important to avoid unfounded expectations as regards inflation and related income growth (see Background Information, Inflation, pp 11 to 12)

In the third quarter the euro continued depreciation against the US dollar. Therefore the consumer-price-based real effective exchange rate of the kroon continued falling, although not as rapidly as in the second quarter (by 3.6 and 4.4%, respectively, against the year-ago period). The halt in the depreciation of the euro in October-November and the end-of-the-year appreciation together with spreading inflation disparities between Estonia and the euro area would mean a rise in the real exchange rate of the kroon against the currencies of the industrial countries in the near time.

Real Sector and Foreign Trade

In the second half of 2000 the economic growth slowed down both in Europe and the United States. Nevertheless, the growth was sustained in Estonia by the export of goods and the real growth of the GDP was according to preliminary estimates contained on the level of the first half-year in the third quarter. Regardless of the growing investments, the growth rate of domestic demand should remain below the first half-year.

Due to large external demand manufacturing sales in constant prices during nine months of 2000 exceeded by 7% the pre-crisis (the same period in 1998) level. Thereby the dairy industry was still a quarter and the fishery a third below the period before the crisis. The production of radio, television and communication products and devices had more than doubled. The rapid growth in the above fields can be considered as the main high trade export growth rate (50% against the 1999 current prices) sustaining factor, although the growth in the export of Estonian origin was not small either.

It is still not clear whether maintaining the post-crisis low level of investments will lead to new balance or economic slowdown in near future. The question has remained unanswered, although the investments ratio of GDP could reach 25% in the third quarter.

According to preliminary data domestic saving was record high of the year in the third quarter as predicted and probably covered the investment demand. Therefore the import-export balance of goods and services was more or less in equilibrium. Its nine-months deficit was below 4% against GDP of the same period. This is primarily seasonal recovery and sustainable external balance within limits is going to remain a major economic policy concern.

The labour market performance was regular as the about 10% growth of the average nominal wages remained below the nominal growth of GDP in the third quarter as well. It is possible that the fall in employment underway since early 90ies has come to a halt: in the third quarter the employment flagged a slight recovery against the same period in 1999. This does not mean a further rapid slide in the unemployment.

Due to seasonal factors the fiscal position improved in the third quarter. Seasonally shrinking expenditure and recovering tax revenue established the consolidated budget surplus for the first time in the last two years, reaching about 2% of GDP. Prospects to curb the consolidated budget deficit below the annualised target of 1.25% of GDP are good.

The fact that government consumption expenditure has not displayed factual growth against 1999 confirms the intention to pursue more balanced fiscal development. The balanced central government budget for 2001 adopted at the end of the year is about 4% larger than the previous one. The growth in expenditures could not be avoided during budgetary procedure, which manifests that MPs still consider fiscal policy only as an opportunity to swell expenditure, not as an economic policy instrument in its broader meaning.

Slowing world economic growth and potential supply-side restrictions lead to a conclusion that in 2001 Estonia's real growth of GDP will be rather below than above the 2000 level (see Background Information, Gross Domestic Product, p 10).

Table 1.1. The most important indicators of economy

	1995	1996	1997	1998	1999	9 months of 2000[1]
Real growth of GDP (%)	4.3	3.9	10.6	4.7	-1.1	6.6
Growth of special export (%)	21.6	11.8	48.8	18.8	-4.6	50.2
Growth of special import (%)	36.4	26.4	41.0	13.0	-8.6	40.1
Current account balance (% of GDP)	-4.4	-9.2	-12.2	-9.2	-5.8	-5.5
General government budget deficit (-) / surplus (% of GDP)	-1.2	-1.5	2.2	-0.3	-4.6	-0.4
Consumer price index of 12 months (%)	29.0	23.1	11.2	8.2	3.3	3.5
Export price index of 12 months (%)	15.2	11.4	7.5	2.1	0.0	8.0
Consolidated balance sheet of banks (% of GDP)	38.1	43.7	63.1	55.9	62.5	67.0
Share of the foreign ownership in banking sector (% of share capital)	29.0	33.4	44.2	60.7	61.6	83.0
Capital adequacy of banks (%)	13.7	12.1	13.5	17.0	16.2	14.1
Change TALSE (%)	-	60.3	65.5	-65.8	38.3	8.1
Consolidated loan portfolio of banks (% of GDP)	25.3	27.5	30.3	30.7	33.4	37.9
M2 (% of GDP)	33.2	34.9	40.4	35.5	43.1	46.0
3 months TALIBOR	-	7.9	15.7	18.1	5.1	6.1

[1] Data are preliminary