

BACKGROUND INFORMATION

ECONOMIC FORECAST FOR 2000–2002

External Environment

The favourable external environment in early 2000 boosted rapid improvement in Estonia's economic situation, finding an outlet in the 6.4% GDP growth in the first half of the year. This was even beyond a more optimistic prognosis.

Positive development trends of the world economy are sustainable. Rapid growth is forecast for 2001, remaining still slightly below the year 2000. The growth slowdown in the United States will have major impact here. Although the growth rate in Northern Europe, the most important region for Estonia, will also decline slightly, its growth is going to be above the EU average anyway. Latvia and Lithuania, like Estonia, are in the growth phase, too, and Russia's development is also stability-oriented.

The growing oil price was a significant factor slowing down the rapid economic growth in 2000. The appreciation of fuel on the world market is expected to come to a halt in end-2000, followed by a slight drop in prices. Nevertheless, the relatively rapid inflation period is going to last at least till summer 2001.

Estonia's outlooks under these conditions continue to be optimistic. By today the post-shock adaptation process is mostly over, although restructuring pursuant to long-term trends is still underway. During the period under review Estonia will continue merging into the world economic structures.

Export

The main source of Estonia's growth is exports. The rapid growth of exports will continue in upcoming years as well, although the growth rate will drop significantly against the supergrowth in 2000. In 2000 the real growth of exports is going to reach 23...26% whereas in 2001 a 10...15% growth can be expected (see Table 1b). The GDP and export growth rates do not correspond one-to-one; both export-created added value and implications of growing exports in other branches of economy are significant. The export growth is sustained by low production costs and supply of niche products.

Subcontracting plays a significant role in the export of goods. Currently it has developed in leaps and its

Table 1b. Most important indicators of the main prognosis (%)

	2000	2001
GDP	6.1...6.3	5...6
Inflation (CPI)	4.1	4.2...5.3
Exports	23...26	10...15
Imports	21...25	10...15
Balance of the goods and services / GDP	-3.7...-4.8	-4.5...-6
Current account / GDP	-6.5...-7.2	-5.9...-8
Investments / GDP	24...25.5	25...27

impact on the economic growth is hardly noticeable. Investments in the electronic industry indicate expanding subcontracting. The export of goods originating from Estonia should also develop well during the period under review. Larger EU quotas and

growing demand on the eastern market will facilitate the export of foodstuff. The export of timber products will grow through products of higher value added whereas that of round timber will keep shrinking. The export of chemical goods could grow only with new

investments, their volume being currently relatively modest. Export outlooks for textile products will depend on their competitiveness with other emerging countries, which is not going to change significantly during the forecast period.

In the export of services a sharp growth downfall is looming, mostly due to shrinking transport services. During the forecast period the oil price will drop and oil transit decline whereas other freight will grow. The export of travel services will keep growing. Although the growth in the number of tourists will be slightly inhibited, their structure changes for the larger stake of tourists staying longer and spending more money in Estonia.

Gross Domestic Product

As of summer 1999 economy has turned around and growth has been significantly accelerating. The record GDP growth was 7.4% in the second quarter of 2000. Although in the second half of the year it slowed down, the GDP growth has been rapid throughout the year 2000 anyway – 6.1...6.3%. In the upcoming years Estonia's relatively rapid economic growth will be sustainable due to favourable external environment and finalised domestic adaptation processes, being 5...6% in 2001. Somewhat modest investments during the last couple of years have slowed down the growth.

The investment demand will probably recover in 2001. According to the Estonian Institute of Market Research (Eesti Konjunktuuriinstituut) a considerable number of businessmen plans investment growth for 2001. The investments should primarily increase production capacities and streamline production. Environment and safety at work are playing an ever-increasing role in investments as a new tendency. Investments in the public sector will diminish below previous levels in 2001. In 2000 the share of investment in GDP is 24...25.5% and in 2001 – 25...27%.

The growth in consumer spending will be similar to GDP growth during the period under review. The private consumer confidence will improve moderately, although the entire payroll will not grow rapidly.

Government spending will show inhibited increase: the planned nominal growth of expenditure is 4.5% in the budget for 2001, referring to the government's intent to curb the share of the public sector in GDP by revising sectorial functions and making the sector more efficient.

The GDP growth is primarily generated in external-markets-oriented industries (manufacturing). Among key industries the foodstuff industry is undergoing sustained consolidation and restructuring. Larger and more upgraded undertakings are going to benefit from improved export opportunities whereas some smaller domestic-market-oriented undertakings will either disappear or merge. Growing exports and domestic demand will boost the export in the timber industry. Investments in the timber industry have been significant and oriented to enlarge assortment and make better use of materials. Sustained investments will also take volumes in the electronics industry upward.

Out of domestic-market-oriented fields commerce and financial intermediation but also real estate development and building will develop faster, should investment volumes recover. The growth in public sector services will remain modest.

Growing efficiency will be characteristic of the business sector in the upcoming period. The need to optimise costs could find several outlets. First, deepening specialisation. Second, curbing of labour costs. Most of the branches of the manufacturing industry had surpassed the 1998 production level with lower employment. Thus, although growing investment demand and a growth cycle in economy also mean creation of new jobs, this cannot always significantly cut unemployment.

External Balance and Financing of Economic Growth

In the first half of 2000 the import growth rate remained below that of export. The economic growth cycle will bring along growing investment demand as well during the review period. Firstly, imports will be boosted by the importation of subcontracting

products; secondly, growing investment demand will contribute to import of capital goods.

In 2000 the balance of goods and services is going to get better, being -3.7% ... -4.8% of GDP, due to larger-than-anticipated growth in the export of goods and services. In 2001–2002 the trade deficit will sustain a reasonable level, worsening slightly through higher investment demand and reaching -4.5% ... -6% of GDP in 2001. Due to the outflow of investment income, current account deficit is going to be slightly larger.

Both the domestic and external sectors play a role in financing economic growth. The resources of the financial sector are sufficient to finance the growth. In banking the restructuring process is coming to the end and competition is anticipated to expand. Private saving is also going to grow whereas other saving instruments besides deposits will be more actively used. All this will not be sufficient to cover growing demand for resources, characteristic of the growth phase and external resources will be applied more intensively. Foreign direct investments will continue

as the main source of foreign capital. Expansion of earlier investments and reinvested profits play an ever-increasing role in the FDI structure, although several single large investments can be possible as well.

Inflation

In 1999 and early 2000 inflation remained below the long-term trend in Estonia whereas in end-2000 it has accelerated as expected. External price pressure was manifest in export and import prices already in early 2000, although implications of import prices, growing significantly in the first half-year, were not yet visible in the domestic consumer price in autumn.

During the period under review consumer prices will mostly be subject to external price pressure, domestic administrative actions and growing domestic demand. In 2000 consumer prices are going to increase by 4.1% and in 2001 by 4.2...5.3% whereas at the beginning of 2001 the price increase could reach up to 6% (see Figure 1b).

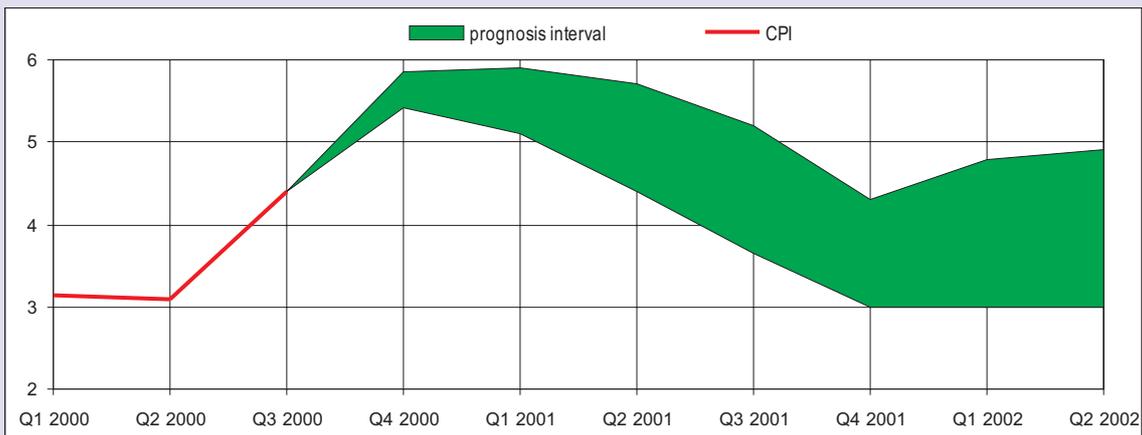


Figure 1b. Prognosis of the consumer prices (annual growth, %)

In the early stage of the prognosis external factors are rather facilitating than inhibiting price growth. Estonia's inflation is primarily exposed to the oil price. We can see that in the beginning freight service providers attempted to delay the growth in

prices but by autumn resources were exhausted and freight service providers had to adjust prices. Although by end-2000 the oil price growth is anticipated to come to a halt, the high level will have its implications into the beginning of 2001. Other raw

materials are also forecast to appreciate but they will have less significant and more indirect impact on the prices in Estonia. Another factor influencing our import prices is the exchange rate of the US dollar. Thereby both export and import prices should manifest downward pressure, slowing down growth in open sector consumer prices in the second half of 2001.

Administrative actions are a significant factor in influencing domestic consumer price growth. Now we already know that motor fuel excise tax will not be raised at the end of 2000, instead a single rise will be taken upon accession to the European Union. In summer 2000 only partial VAT was levied on heat. Although the value-added tax is considered in the draft budget for 2001, a new discussion could be launched next summer and the tax increase could be postponed. Electricity tariffs will be adjusted at the beginning of 2001 making electricity about 20% more expensive for households. Privatisation of Tallinna Vesi (Tallinn Water Company) contributes to the growth anticipation in water supply and sewage prices.

Passes for municipal public transport, agreed upon with the local government, should rather appreciate in near future. Contemporaneously new service providers and types of services could tighten competition. No additional assumptions are made on the potential price dynamics for the time when Eesti Telefon's (Estonian Telephone Company) market monopoly comes to an end, although we can expect that tighter competition and expiry of monopolistic agreements should inhibit price growth. The prognosis excludes also potential reduction of excise taxes as the idea is still in the embryo phase.

Apart from the above factors faster economic growth could also slacken price growth restrictions and some demand pressure is possible.

Why Can the Actual Development Differ from the Prognosis?

Although forecasts for immediate future are relatively optimistic, there are several inhibiting factors to consider.

Among external factors uncertainty about the world economic growth in 2001 is the dominant one. Although this prognosis assumes moderate growth slowdown (also in the United States), hard landing cannot be excluded either.

Among internal factors the low investment volume in the first half of 2000 is worth to be mentioned: placements in fixed assets reached a mere 23.2% of GDP. If investments have higher efficiency than before, it could be possible to achieve the forecast growth even with this volume. Still, relatively low investments have kept the prognosis also less optimistic.

Another factor is labour-market-related insecurity. Although in the growth environment the number of jobs should increase, the first half of 2000 displayed that economic growth and unemployment can go hand in hand. Nevertheless, growth reserves as well as the lack of skilled labour which could restrain economic growth, remain unclear.

A question might arise how likely is the reoccurrence of the 1997 unsustainable economic growth. Although there is no full security against such a scenario, increased conservatism in banking and more stable anticipation among economic agents refer to more sustainable development. The balanced budget drafted for upcoming years is also reassuring.