II
ECONOMIC DEVELOPMENTS

EXTERNAL ENVIRONMENT

In the first half of 2000 the external developments were favourable for Estonian economy. The International Monetary Fund (IMF) revised upward the world economic growth forecast for 2000 by 0.5 percentage points, ie to 4.7% against spring. The growth supported by the US economy's consistent strength and increasing economic activity in Europe, Asia, Latin America and Africa should remain good all over the world (see Table 2.1).

Table 2.1. The most important economic indicators of some selected countries

	Growth of GDP (%)		Inflation (CPI change, %)		Current account surplus/ deficit (% of GDP)	
	1999	2000	1999	2000	1999	2000
USA	4.2	5.2	2.2	3.2	-3.6	-4.2
Japan	0.2	1.4	-0.3	-0.2	2.5	2.6
Euro area	2.4	3.4	1.2	2.1	0.6	0.9
Germany	1.5	2.8	0.7	1.7	-0.9	-0.3
Great Britain	2.1	3.1	2.3	2.0	-1.2	-1.9
Finland	4.0	5.0	1.3	2.7	5.2	5.6
Sweden	3.8	4.4	0.4	1.4	2.6	2.6
Czech Republic	-0.2	2.3	2.1	4.9	-2.0	-3.4
Poland	4.1	5.0	7.3	9.5	-7.5	-7.4
Hungary	4.5	5.5	10.0	8.3	-4.3	-4.5
Latvia	0.1	4.0	2.4	3.5	-9.7	-8.6
Lithuania	-4.1	2.5	0.8	1.6	-11.2	-7.4
Russia	3.2	7.0	85.9	18.6	11.3	13.4

Source and prognosis: International Monetary Fund, August 2000

Contemporaneously the increasing crude oil price accelerated inflation, pushing upward short-term interest rates both in the USA and Europe. Nevertheless, long-term interest rates have dropped.

The United States of America and Japan

The rapid economic growth has been sustained in the United States, although some slowdown has become manifest as well. In the second half of 1999 the GDP growth against the year-ago period was 7% whereas in the first quarter of 2000 it slowed down to 4.75%, still exceeding the anticipation in the second quarter by being 5.3%. The latter contains some reference to declining consumption: private consumption underwent a twofold slowdown, with stocks still growing. Major trade deficit (record high in June – 30.6 billion dollars) is a sign of unbalanced domestic demand and supply, partially caused by the increased crude oil prices. The national budget surplus has been sustained (the surplus forecast for end-2000 is 1.5% of GDP).

The long-lasting US economic surge mostly results from an experienced economic policy, as well as from product and labour market flexibility. The productivity growth brought along by high-tech investments reduced inflationary pressure, although unemployment has been contained very low (in June 4% of the labour force). Major investment banks and international organisations forecast slight cooling in the US economy in the second half of 2000 and in the first half of 2001, without the inflation accelerating significantly, although the risks of a sharp economic slowdown have not disappeared. The US Federal Reserve, having raised federal interest rates by 50 basis points, ie to 6.5% in May, did not raise interest rates any further in August.

The economic activity in Japan has increased in some sectors whereas outlooks due to low private consumption remain vague. The growth in the industrial sector is accompanied by recovering consumer confidence, supported by larger employment and improving profit indicators. The gross production against the last year increased by 0.7% in the first quarter and by 0.8% in the second quarter. The economy is not yet strongly moving uphill, considering the large budget deficit and government debt (125% of GDP) the state support would inevitably diminish in future. Taking into account the decreased deflation threat and stabilising financial markets and business climate, the central bank decided to give up its zero-interest-rate policy and increased interest rates by 25 basis points.

Emerging countries

The economy of emerging countries is recovering from the 1998 crisis. The inflation is decreasing, current account deficit shrinking and non-debt generating capital is flowing in.

In Latin America economic growth is anticipated to accelerate. In spite of the stock market downfall in early second quarter, the exports of the region has increased, consumer confidence strengthened and consumer expenditure grown significantly. The real GDP of the region which did not grow much last year, should grow this year by 4% whereas the inflation rate will remain low (the IMF forecast for the annual growth of inflation in the region is 8.8%). Due to growing exports and improving trade environment the current account deficit is anticipated to shrink, although the countries also differ significantly from each other – oil states have their current account in surplus; **Brazil** as the largest economy of the region will have current account deficit of 3.5% of GDP this year according to the IMF forecasts. The economy of the countries undertaking major efforts to achieve macroeconomic and exchange rate stability (Brazil, Mexico and Chile) should grow an average of two percentage points faster than that of their neighbours.

Large Latin American countries depending largely on financial resources recruited from the world market could face difficulties due to a potential interest rate rise in the United States, which would appreciate borrowing. Throughout the economic revival they should continue with budgetary and labour market reforms.

According to the International Monetary Fund a strong economic growth is sustained in Asia. The region's economy showed a 6% growth in 1999 whereas this year an up to 6.5% real growth of GDP is anticipated. The economic growth is backed by growing domestic demand and in faster developing countries like China, India and Thailand investments are also increasing. The large economic growth (7% in 2000) in the most populous countries **(China, India)** enhances the regional development even further. The inflation rate is low (the forecast of the region for this year is 2.4%) and due to large exports also manifests current account surplus. In order to make economic growth sustainable, structural reforms should be continued, especially in the banking sector. Asian governments still keep supporting banks that got into difficulties during the 1997–1998 financial crises and suffer from a large debt burden.

Development in European Economic Space

European Union and Euro Area

The European Union and the euro area revealed rapid growth throughout the first half-year, although the increasing inflation rate could slow it down later. The gross output grew at about 4% (a year). At the beginning of the year the growth was sustained mainly by high external demand and competitive currency. The high consumer and producer confidence is forecast to boost private consumption. The growth in 2000 is forecast to be 3.5% on the average (IMF – 3.4%), accompanied by a significant downfall in unemployment against the year-ago level of over 10%. A similar development is taking place in the entire European Union as well. Although in Great Britain the strong currency has its implication on the competitiveness of the industrial sector, the private consumption is high and the service sector strong.

The flying economic growth together with revenue collection and exceptional revenue (eg selling of mobile communication licences in Great Britain, Germany and elsewhere) have created a favourable setting for the implementation of fiscal reforms and reduction of government debt. The best-known tax reform package was adopted in Germany over the last months: the private and corporate income tax and income tax on the sale of stock between listed companies will be reduced by 50 billion German marks (about 23 billion US dollars) in the foreseeable future. This year France curbed the value added tax (by 30 billion francs a year) and disclosed a reform plan for the next three years to reduce taxes by 120 billion francs (about 17 billion dollars). The main focus will be on decreasing the income tax and social tax of low-salaried workforce. Other EU member states are also planning tax reforms (eg in Spain, Italy and Sweden). Such “fiscal competition” is conducive for business.

It is essential to continue with reforms to enhance the employment in labour and commodity market, make wages more flexible and strengthen competition. Labour market and commodity market reforms would help to avoid well-known historic scenarios, with any economic activity outbreak inhibited by inflationary pressure already in its early stage, leading to tighter monetary policy and higher unemployment rate.

The function of the European Central Bank (ECB) is somewhat complicated in the current environment: the central bank will have to reduce inflationary pressure without inhibiting economic growth. High oil prices and weak euro have raised high (2.4% in July) the primary indicator of the inflation rate reflected in consumer prices and also had an implication on base inflation[1] (1.3% in July). A threat to ECB price stability target[2] could be spreading anticipation of inflation growth which influences wage agreements for the next year. The ECB raised monetary policy interest rates by 50 basis points in July and by another 25 basis points in August, yielding the key refinancing rate of 4.5%. As the current interest rate level is considered low under the rapid economic growth, the financial markets anticipate another up to 50 basis point increase.

Finland

The economy of Finland continued in the second quarter at the flying growth rate gained last autumn. This year a minimum 5% GDP growth is expected. The growth is supported by the export increasing by a third and conducive domestic conditions. In the first quarter of the year the domestic demand recovered as well, supported by a record-low unemployment rate against the early 1990ies (8.2% of the workforce).

The growth of industrial output could be inhibited by limited production capacity in Finland, although current investment growth has increased production. According to the International Monetary Fund there are no clear signs of overheating in economy in Finland. It is rather a “recovering growth”, following the early 1990ies crisis brought mainly along by the collapse of the Soviet Union.

[1] An indicator of the inflation rate without the impact of energy and food prices.
[2] The growth of the harmonised consumer price index up to 2% in mid-term, ie within two years.

Sweden

Swedish economic growth could reach 4.5% in 2000 and is based on strengthening domestic demand and export sector. The flying growth of the industrial output has been maintained. Contemporaneously inflationary expectations are low (the consumer price index is forecast to grow by 1.5% in 2001) – the major threat lies in increasing wage demands at the end of the year. The government is intending to reduce the tax burden, which could slightly tighten monetary policy.

Central and Eastern Europe

Central and East European countries survived the economic recession of 1998–1999 better due to the growing external demand. The sustained high external demand and exports supported the growth of the gross output also in the Baltic countries.

In Poland the economic situation has improved thanks to the strengthening of the export sector: in 2000 GDP is expected to grow up to 5%. The major concerns are the high inflation rate (the annual growth of the consumer price index was 11.6% in July) and large current account deficit, exceeding 7% of GDP in the first half of 2000. The deficit growth has been suspended. Exports grew by 12.3% and imports by 9.8% in the first half of the year.

In Hungary the economic growth is beyond anticipation: GDP grew by 6.8% in the first quarter. The growth of the gross output finds support apart from the strong export sector and investments, also from the improving national budget (already in early-June the deficit of the social security budget was 126% of the annual plan). The industrial output grew by 20–25% in the second quarter against the year-ago period. The current account deficit, reaching 3.3% of GDP in July, generates fewer problems than in Poland; the inflation rate is still high and contracts below anticipation (the annualised inflation rate was 9.6% in July, the end-year target being 5%). For the year 2000 a 5% growth is forecast for Hungary.

The Czech Republic has recovered from the economic recession of previous years, the growth being 4.4% in the first quarter. According to the latest prognoses a 2.5% growth is anticipated in 2000. A major obstacle here lies in undergoing banking and business sector reforms, being a burden for the state budget (the deficit prognosis for 2000 is up to 3.5% of GDP). The banking sector is burdened with bad loans (as of 30 June 28.5% of all loans issued by the banking system), the business sector is continuously facing management problems. The payment system needs changing and several laws, especially the Bankruptcy Act, have to be implemented.

The Latvian economy grew by 5.3% in the first quarter. This was sustained by timber export and oil transit. The increasing domestic demand, reflected in the accelerating growth of retail trade and wages, would not let the low current account deficit (4.1% of GDP) reoccur. The growth of exports and industrial production picked up in the second quarter: exports grew by 15% and manufacturing by about 6% against the year-ago level. Due to the appreciation of the dollar the SDR-pegged Latvian lat has appreciated as well which could potentially inhibit export growth.

In Lithuania the economy has recovered from the recession due to large external demand, although the economic growth is far below Estonia or Latvia. The 4.1% growth in the first quarter is due to low comparison base of the first quarter of 1999 and large oil products export. In the second quarter the industrial output shrank due to inhibited growth in the oil industry by an average of 5% against the previous year. The current account deficit decreased to 2.8% of GDP (the lowest level in history) during the first quarter but it is endangered by growing domestic demand and increasing imports. The growing domestic demand is fed by strengthening corporate confidence and larger household consumption demand. Solving of economic concerns is hindered by low support to the government and parliamentary elections on 8 October.

In Russia the economy grew by 7% in the first half-year. The extremely rapid recovery from the 1998 financial crisis is mainly sustained by oil and natural gas export. This year due to increasing world prices and partial liberalisation of the trade metal export has increased as well. The export of raw materials accompanied by export duties is responsible for growing government tax revenues and foreign exchange reserves of the central bank. The growth of the inflation rate contained at the beginning of the year came to a halt in July (the annualised inflation rate was 19.5% in July). The simplified tax code entering into force on 1 January 2001 and the administrative reform launched by President Putin have contributed to the improved economic outlooks. The reduction of power of the Federal Council strengthens the power of the president who currently also enjoys the support of the significant part of the Duma.

Developments of Financial Markets

Prices for Raw Materials

The growth of industrial output, high demand for oil products and their limited supply have all contributed to the growth in prices for raw materials. Besides the oil price, also prices for metals and, to a lesser extent, for agricultural products (grain) have moved upward. The International Monetary Fund forecasts a 45% increase in the oil price in 2000 against the previous year. The CRB index grew by 5.6% in the second quarter but nearly 10% during the first eight months of the year.

Currencies

Regardless the strength of main economic indicators, the euro has kept weakening against the currencies of major trading partners and the appreciation in June turned out to be short-lived. Among the causes for the weak currency the relative strength of the US economy as compared to the euro area and the accompanying preference to invest in the United States should be mentioned first. The euro is weak against the Japanese yen as well, although the yen has depreciated against the dollar. Thereby the weakening of the yen has not been continuous, it has also appreciated against the dollar a couple of times. The British pound has weakened against the dollar by about 10%.

Table 2.2. Changes in exchange rates of major currencies

	31.12.99	30.08.00	Change (%)
JPY / USD	102.31	106.58	4.0
USD / EUR	1.008	0.8947	-8.9
USD / GBP	1.6186	1.46	-9.8

Stocks

The major stock markets have been fluctuating since April. The persistent uncertainty in US economic outlooks and high-tech stocks had an implication on other stocks as well. *Summa summarum* the change as of end-July was slight, except in Japan in which Nikkei 225 index surpassed 20,000 by the end of the first quarter and has dropped by over 10% against the beginning of the year.

Table 2.3. Indices of major stock markets

	31.12.99	30.08.00	Change (%)
USA (S&P 500)	1,469.30	1,502.59	2.2
Japan (Nikkei 225)	18,934.30	16,861.26	-10.9
Germany (DAX)	6,748.10	7,185.56	6.1
Great Britain (FTSE 100)	6,666.20	6,615.10	-0.8

Interest Rates

Due to the tightening of monetary policy in most of the industrial countries, short-term interest rates continued the upward trend originating from the previous year. The growth was most significant in the euro area and the United States of America (reflecting the rising of benchmark rates by the European Central Bank and US Federal Reserve by 125 and 100 basis points, respectively) in which apart from potential overheating, the central banks were also concerned about growing inflation. The money market interest rates of Japan underwent a significant increase as well against the beginning-of-the-year low level in anticipation and implementation of the end of the zero-interest-rate policy.

In contrast to the above, long-term interest rates mostly fell due to the shrinking supply of government bonds (mainly in the United States) and declining inflation anticipation in longer-term (in the euro area). In Japan the long-term interest rates fluctuated in anticipation of the termination of the zero-interest rate in 2000. After the rise of monetary policy interest rates by 25 basis points an upward trend was revealed and by end-August the ten-year interest rate had reached 1.9%.

Table 2.4. Interest rates of major bond markets

	Interest rates of 3 months			Interest rates of 10 years		
	31.12.99	30.08.00	Change (basis points)	31.12.99	30.08.00	Change (basis points)
USA	5.20	6.32	112	6.44	5.79	-65
Japan	0.09	0.33	24	1.70	1.90	20
Euro area	3.22	4.79	157	5.35	5.29	-6
Great Britain	5.54	6.07	53	5.47	5.33	-14

Note: here the euro area interest rate of 10 years is the German government bonds interest rate.

Capital Markets in Emerging Countries

The credibility of the capital markets in emerging countries for foreign investors has increased, the foreign investor base has expanded and new loan sources have emerged. More borrowing is done in local currencies and for a longer period of time. Nevertheless, the assets of the emerging countries are still considered risky, explicitly manifested in the price downfall of the assets of the emerging markets in March-May, bringing along a significant gap in the yield on the bonds of developed and emerging markets as well as a shrinking inflow of capital. Still after May prices for bonds are strengthening again, mainly because world stock and bond markets are undergoing growth. By end-July the return spread between the bonds included in J. P. Morgan's emerging countries' bond index EMBI Plus and respective US bonds had decreased to 680 percentage points.

ESTONIAN ECONOMY

Domestic Demand

Private Consumption and Investments

The post-crisis domestic demand was recovered slightly later than the external demand. At the beginning of the year the economic agents were relatively modest in making new consumption and investment decisions whereas as of the second quarter positive future anticipation found an outlet in consumption and investment patterns.

Although both the nominal and real wages kept growing relatively well throughout 1999 and the first half of 2000, it did not boost consumption as was feared whereas the growing unemployment and resultant lack of confidence in future prevented flying consumption. More active borrowing by private individuals (the highest level over the last two years) and growing retail trade turnover manifest a pronounced rise in private consumption in the second quarter.

Although undertakings responded to the post-crisis shrinking demand by optimising the workforce, wages in most sectors turned out to be more rigid than anticipated. Therefore the first half of 1999 witnessed a preferential growth of the labour cost over that of the production volume. By now the labour cost policy has finally been adjusted to the new economic environment, reducing the share of the labour cost in the corporate turnover to the lowest of recent years. **In the second quarter of 2000 the growth of the nominal wages (10.5%) was contained below the nominal GDP growth and the share of the labour costs decreased even further.**

Investments are most significant in creating a new foundation to secure long-term economic growth in changed external environment. Under current economic circumstances its not any more possible to implement a large number of ineffectual pre-crisis investments without additional capital and the investments made in the first stage of the economic recovery may not secure rapid sustainable economic growth. Although the investment volume was partially recovered already during the first quarter, it did not reach 25% of GDP.

The second quarter manifested several signs of the fast-recovering investment demand. Growing borrowing and import of intermediate goods indicate that undertakings have started to implement their development plans. Together with accelerating construction and issuing of construction permits, it could mean more than a 25% increase in investments' nominal volume against the year-ago period. Nevertheless, the low level of investments in the second quarter of the last year should be taken into account.

Public Sector

The government had set as the main target of its fiscal policy in 2000 to return to the balanced budgeting, ie to contain the consolidated budget deficit below 1.3% of GDP.

At the beginning of the year the tight expenditure restraint helped to adhere to the target and the budget deficit of the government sector was 1% of the quarter's GDP. Despite several administrative measures applied at the turn of the year and reviving domestic demand in the second quarter, the revenue collection in the first half-year was contained below anticipation, making the further balancing of the budget only through expenditure restraint practically impossible. Therefore the general government's budget deficit more than doubled in the second quarter, reaching 513 million kroons, ie about 2.5% of the GDP of the quarter (see Figure 2.1).

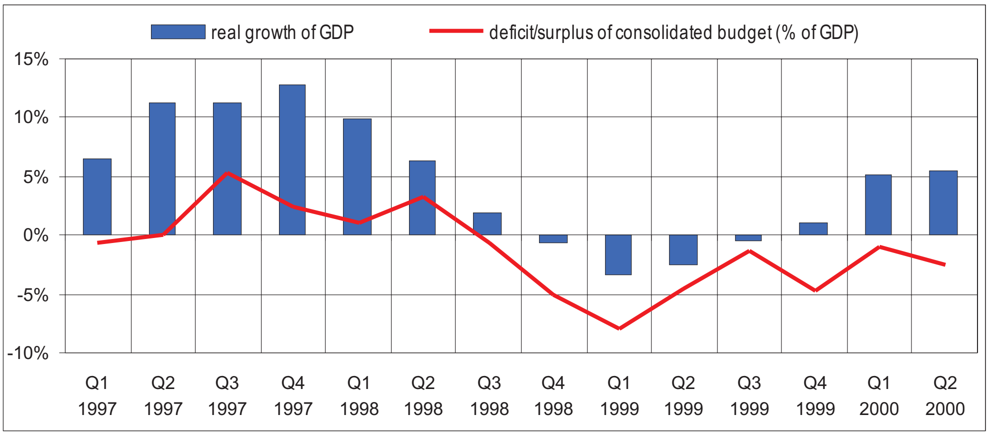

Figure 2.1. Real growth of GDP and balance of the consolidated budget

Under the current growing domestic demand it would be significant for the government not to facilitate with its expansive budgetary policy the spread of positive anticipation into consumption.

The government economic policy programmes and signals for further sustainable development became more vague and less credible against the setting of the second-quarter developments. Promises made before the parliamentary elections and drafting the budget were changed or will be changed along the lines and in the way uncharacteristic of rational economic policy. Having a large budget deficit, the revenue income in the second half-year was undercut by a lower-than-intended increase in the district heating VAT. Against the above-prognosis positive economic development the above should still not endanger the fiscal policy targets of the year, which is also proved by the large consolidated budget surplus in July (300 million kroons), partially due to low seasonal current expenditure.

The government consumption, remaining nominally on the level of the previous year, slightly inhibited the growth of domestic demand, boosted by investment demand and private consumption in the second quarter.

Domestic Saving

In the second quarter the domestic saving level is usually high due to seasonal factors. Also in the second quarter of 2000 the private individuals' and corporate saving was relatively high. The savings by private individuals continued to grow (19% over the year) and the undertakings have also managed to get the single expenditure, arising from changing economic environment, under control. The relatively high government expenditure against the moderate tax collection offset the growth in private saving. Therefore in the second quarter the domestic saving level remained moderate (about 21% of GDP) against the record-high figures at the beginning of the year whereas government saving was close to zero.

Domestic supply

In the first half of 2000 the economic environment at the major trade partners was the most favourable in the recent years. The large growth of trade volumes all over the world indicates that the growth cycle is characteristic of the entire world economy. **In the first quarter the scarce domestic demand did not favour targeting the ceiling of the growth prognosis (5.5%) whereas in the second quarter the largest economic growth of the last two years (7.5%) was supported besides external demand also by domestic demand.**

In industry the output volume grew an average of 10% during the first half of 2000. In the second quarter the industrial output sales volume was slightly inhibited but varied greatly by branches. In mostly export-oriented manufacturing the sales still grew by 15% in the second quarter as well (see Figure 2.2). With the gradual disappearance of trade barriers in exporting

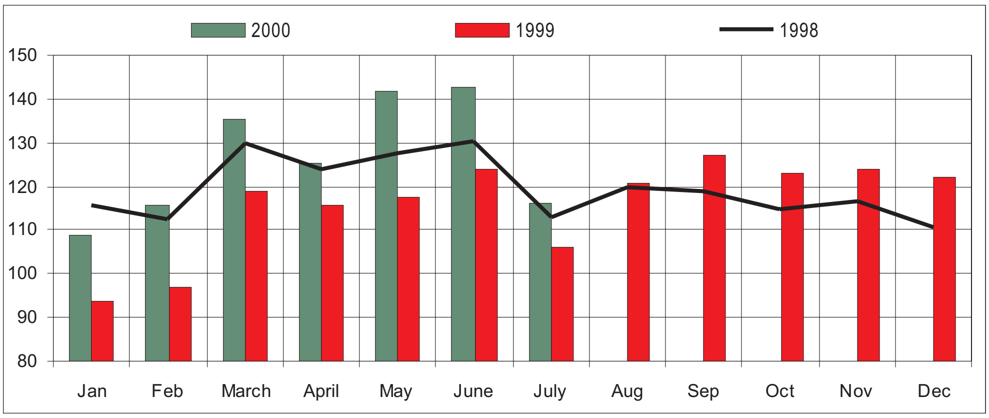

Figure 2.2. Monthly sales of the manufacturing in constant prices (%, January 1997 = 100)

dairy products to the European Union and/or regaining the competitive eastern market for food exports, the sales in manufacturing have ample growth space ahead as dairy and fishery industry operate at 60% capacity currently.

Just like earlier in the year, the service sector has remained the driving force of the economic growth in the second quarter as well. Due to growing trade turnover and transit freight the value added in transport and communication surpassed the previous year by about a tenth already at the beginning of the year, in the second quarter the increasing private consumption and for tourism secured an above-average growth in the commerce as well.

All confidence indicators in major industries singled out by the Estonian Institute of Economic Research (*Eesti Konjunktuuriinstituut*) kept improving throughout the first half of 2000. The overall economic situation had achieved a satisfactory level due to the favourable external environment already at the beginning of the year, whereas in the second quarter for the first time since the third quarter of 1998 the experts considered satisfactory also domestic demand components, ie investment and private consumption.

The financial indicators of the first quarter confirm that undertakings have fully got adjusted in the post-crisis changing environment. During the first three months of the year the undertakings earned 2.4 billion kroons of profit and increased the net sales turnover by about one fifth against the year-ago period (see Figure 2.3).

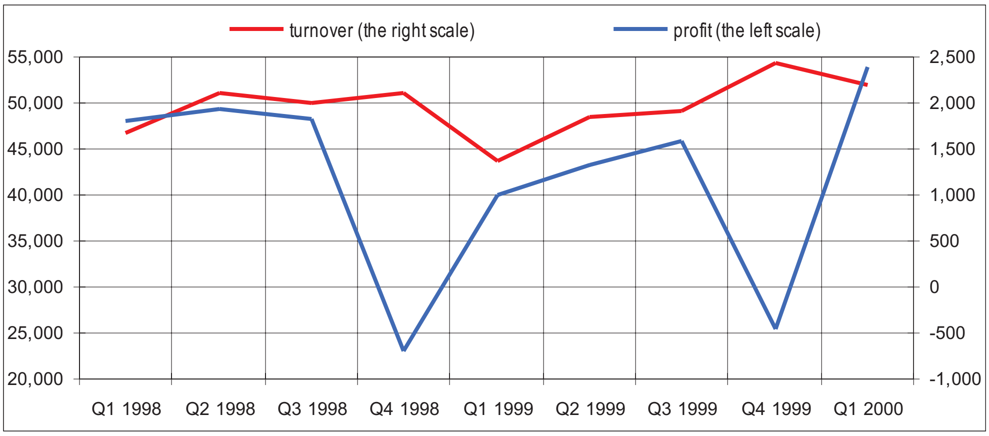

Figure 2.3. Net sales turnover and profit (EEK mn)

Although the economy had recovered already in the fourth quarter of 1999, it has not reduced unemployment. In the post-crisis period the mainly eastern-market oriented export undertakings had to revise significantly their pre-crisis relatively liberal cost (mainly labour cost) policy. In the new West European markets the production, manufactured by old production capacities at the previous expenditure level, would not be competitive. Therefore today the export sector requires less labour. Thus, in the second quarter the 10.5% increase of the average wages accompanying the reduction of labour force and rapid turnover can be considered normal. In the second quarter the unemployment is somewhat alleviated by seasonal additional jobs manifested in 2000 in the 1.5 percentage point decrease in the unemployment whereas in the medium- and long-term new jobs can be created only through investment.

External sector

The extremely favourable trade environment of the last year has become manifest in leaping export volumes of local production in early 2000. The close to 50% growth in trade export in current prices, which started in the first quarter, continued in the second quarter as well.

Subcontracting was still leading in export. Throughout the first half of 2000 the export of Estonian origin exceeded by a nominal third the indicator of the last year whereas the volume of re-export was more than twice above the year-ago level (see Figure 2.4).

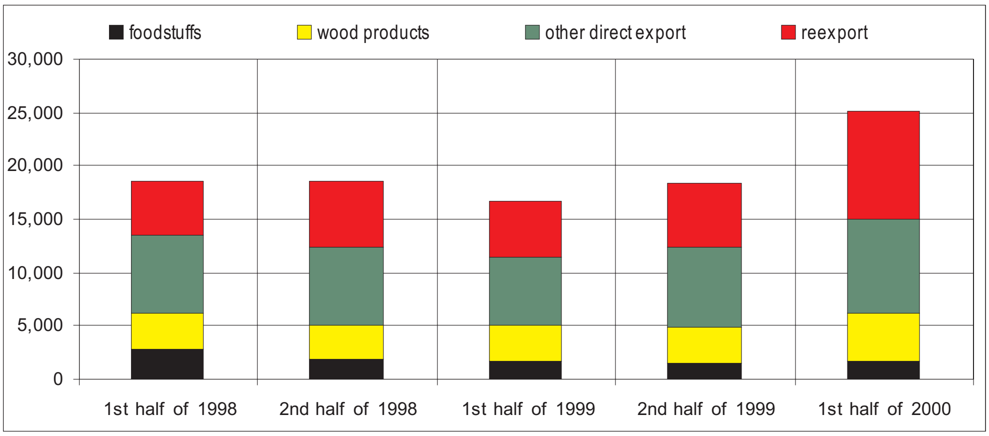

Figure 2.4. Structure of exports (EEK mn)

The leading exporters are industries exporting to Western Europe already from the very beginning – machinery and equipment industry together with timber industry. The 30% leap in foodstuff export in June-July should not be overlooked either – mainly due to increasing export of dairy products as well as fish and fish products. Currently it is still early to evaluate whether it is a single result or a start to the new agricultural products export mode to the European Union enforced in July.

The declining investment demand and population's propensity to consume in 1999 became manifest in a sharp fall in the importation of goods for free circulation. As in early 2000 the domestic demand was still quite low, mostly processed goods were imported. Due to the relatively low added value of new subcontracting products, any increase in their export volume would require a similar increase in imports. Together with growing confidence expressed by undertakings and individuals, the domestic demand started to pick up in the second quarter. The latter became visible in the 18% growth of goods imported for free circulation against the beginning of the year.

The increased domestic demand took the trade deficit to nearly 17% of GDP in the second quarter, which was offset by the growing surplus of the services balance (see Figure 2.5). The

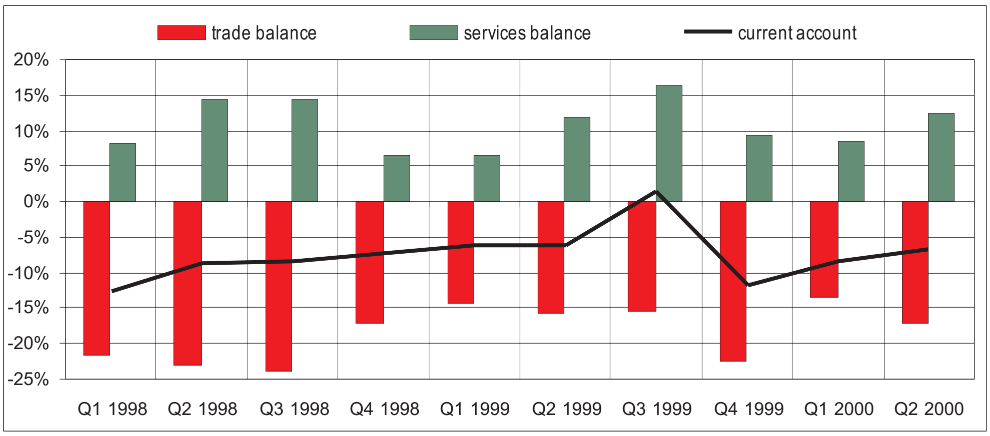

Figure 2.5. Current account and its major components (% of GDP)

export of services accelerated fast against the first quarter (about 30% in current prices), mostly at the expense of travel and transport services. The negative trade and services balance maintained its 1999-second-quarter level, improving by a 0.5 percentage points of GDP. In previous years the balance of goods and services nearly always determined the current account, now the income balance is gaining influence. This is only natural considering Estonia's pronounced negative investment position, which due to its fluctuating nature makes current account prognosis even more complicated. It can be noted that in the second quarter of 2000 the income balance impact on the current account deficit remained below the year-ago level, despite of the recovered profitability.