BACKGROUND INFORMATION

CHANGES DURING RECESSION PERIOD IN ESTONIA'S ECONOMY

Following cardinal changes that took place in early 1990ies, Estonia reached significant economic growth in 1995. The rapid development lasted till mid-1998, when as a result of the Russian crisis and an overall decline in external demand, a three-quarters-long recession period followed.

By now the economy is back on the growth track. The statistical information concerning 1999 is available almost in full and now it is possible to look back at the changes in real economy structure that happened in the years following the crisis. Among those changes one can distinguish those, which are long-term trends inherent to countries in transition but also changes resulting from business cycle.

As the regulations were dominantly market-based, quick adjustment to the business cycle was expected. A drop in demand and prices had to reflect inevitably not only in output volumes but also in production cost. The necessity to cut expenses materialised in different ways.

In 1999 according to corporate financial statements the number of people employed decreased by 5.3% (including 7.5% in manufacturing). Thanks to this, turnover per worker, which had considerably fallen during the first quarter of the year, recovered the year-ago level during the second quarter and in the second half of the year even exceeded the level of 1998. Also the growth of average salary slowed down, especially in the open sector. In the fourth quarter of 1998 and in the first quarter of 1999 there was an upsurge in the share of labour cost in turnover whereas later on it has consistently decreased, indicating the need to optimise the number of workers (see Figure 1b).

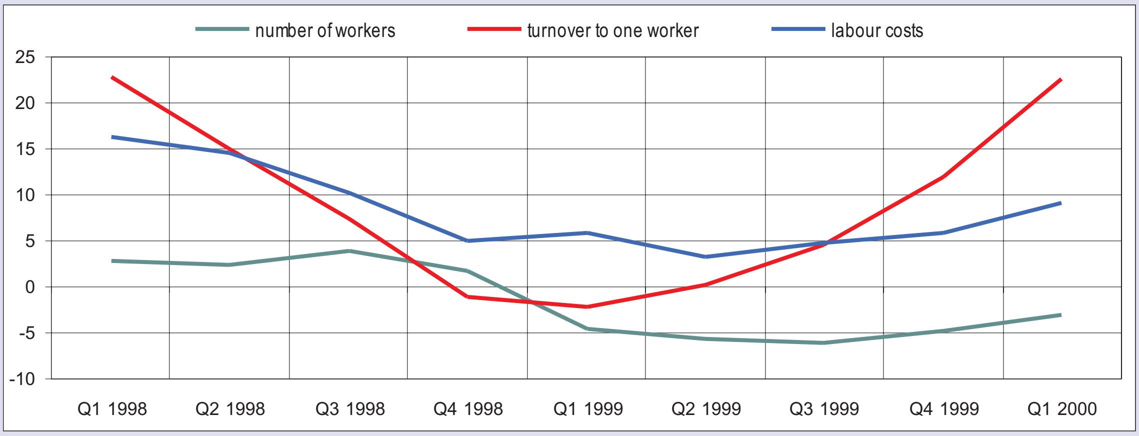

Figure 1b. Annual change of indices related to labour force based on corporate financial statements (%)

Also the stock reserves were downstreamed. At the end of 1998 there was a 16-day stock of end products in manufacturing , which by the fourth quarter of 1999 had shrunk to 11 days, being the lowest of recent years. At the same time the share of outsourcing in expenditures increased and the number of workers decreased. This change may refer to deeper concentration on primary activities but also to appreciation of prices of services bought from the sheltered sector even during recession period.

According to the preliminary data in 1999 the net profit of enterprises was about 70% of the level of 1998, ie the profit was smaller and losses were larger. There is no single answer to the question whether the above indicates inadequate adjustment in economy. First, we do not know how the enterprises themselves estimated the seriousness and durability of the external shock and how big changes had been planned thereof. Secondly, it is difficult to assess what would have been the "normal" pace of adjustment. It is possible that profitability was also subject to an incentive arising from the amendment in the Income Tax Act to transfer the corporate profit into the year 2000 when its investment would be tax exempt.

Not all changes in the structure of economy were caused by the business cycle. At the beginning of the transition period Estonia was among the so-called over-industrialised countries in which the faster growth in the service sector could be considered natural. After the Russian crisis this tendency was reinforced by changes in export possibilities which brought along a shrinking of the share of the primary sector and manufacturing in the GDP structure (see Figure 2b). Also during the recession period the investments into the service sector continued, which was financed also by bank loans. In the first quarter of 1999 investments into the service and manufacturing sector were approximately of equal size whereas in the second half of the same year about 60% of investments made into business were investments into the service sector and at least half of new jobs were created there. In entire 1999 a little more than 70% of GDP became from the service sector. This indicator has reached a level comparable with the share of service sector in developed countries, and is in a kind of logical contradiction with the level of development in Estonia as a whole and gives an impression as if the economic structure were more or less fully developed now. The share of the service sector in GDP is evidently one of those indicators which was "overboosted" by growth recession. The growth of recovering manufacturing, which is underpinned by external demand, has cut the share of service sector already in the first quarter of 2000 by 1–2 percentage points[1]. This does not mean that the growth trend of the service sector has been reversed.

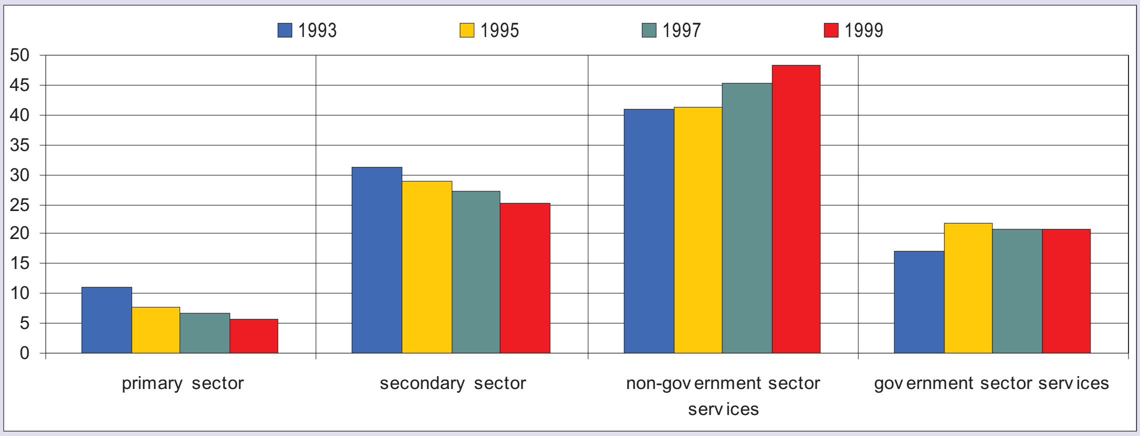

Figure 2b. Structure of value added in 1993, 1995, 1997 and 1999 (%)

[1] Over 60% of Estonia's workforce is employed in the service sector. This figure is somewhat lower than the average in the European Union. This refers to the fact that services, which are not labour-intensive and are not directly oriented to private consumers, have a relatively big share in the domestic supply of services. Among those services are, for example, services related with transit and therefore, eg the share of transport, warehousing and communications in GDP is big (14%). Another characteristic feature of Estonia is the relatively large government sector.

More important than the decrease in the share of manufacturing was the change in the structure by branches. Also here one can distinguish the influence of the business cycle and continuation of development which started already before the crisis. The food processing industry has been historically strong in Estonia. Since 1993, ie almost throughout the transition period, the share of the food processing industry decreased on an on-going basis in the sales turnover of the manufacturing. In the beginning of 1997 the recovery of economic growth in Russia created a possibility to restore partially the onetime export markets. The increased export of foodstuff stopped for a short while the decline in the share of the food processing industry. The devaluation of the Russian rouble in the autumn of 1998 made the products of Estonia's food processing industry not competitive in the Russian market and finding new markets has progressed slowly. Hence, the export of foodstuff in the first half of 2000 formed only 56% of the level of the first half of 1998. The same concerns also the chemical industry, which had been heavily oriented towards the eastern trade, whereas it has temporally found a support from high oil prices and strong dollar. In general the share of Russia in exports had dropped from 14.8% of the first half of 1998 to 5% in the first half of 2000.

Against the background of overall decline, fast growth of new branches (for example instrument engineering) continued. Capital investments into timber and wood processing industry continued, though, in the first half of 1999 the development of that branch was inhibited by low external demand. The above-mentioned development trends have brought along also changes in the structure of foreign trade, both by countries and by commodity groups. By the beginning of 2000 the share of foodstuff in exports had decreased to 7% against 16% in the first half of 1998 and the share of machinery and equipment had increased from 19% to 33%. A question arises whether such a structure is sustainable. It can be said that the recession period somewhat decreased east-oriented export (Central and East European countries and CIS) as its share is currently below one fifth.

Also growth in unemployment figures belongs to those developments where more than the impact of the recession cycle is involved. The so-called stage of technological development which manifests itself in capability to produce more with less workers or at least without creating new jobs, had not yet been completed in the period prior to the crisis. The growing external demand in 1996–1997 had an inhibiting effect on such development in some fields of activity.

In 1995–1998 the unemployment rate (the share of the unemployed in workforce) was around 10%. By the end of 1999 the unemployment rate had reached to about 12%. By the end of the first quarter of 2000

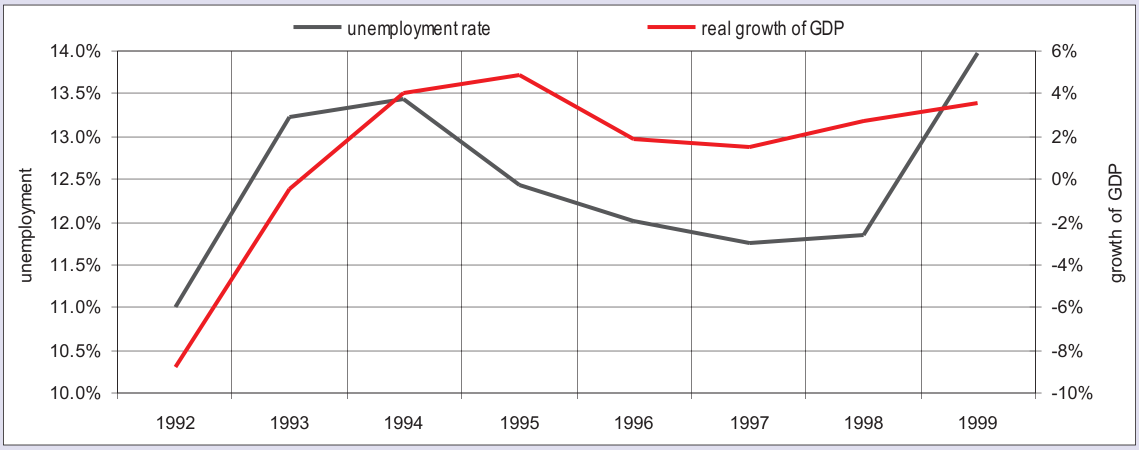

Figure 3b. Real growth of GDP and unemployment rate in Eastern Europe

the unemployment had grown up to 15% and by the end of the second quarter decreased again – mainly because of seasonal factors – to 13.8%. In the period following the crisis the total number of the unemployed has clearly been influenced by the difficult-to-assess cyclical and external-shock related component (for example, the eastern-market-oriented branches of the food processing industry) but this is not the only and the main reason.

Though the growth in investment demand and the end of recession cycle mean, inter alia, also creation of new jobs, it does not necessarily mean that the unemployment rate will drop extensively. For transition countries, at least for the countries that have undergone significant structural changes, it is characteristic that the unemployment rate will stay relatively high also during the growth stage (see Figure 3b). The high level of unemployment in those countries in which the GDP has again achieved the level enjoyed before the transition, refers to the fact that high unemployment cannot be attributed only to hidden unemployment of the command economy, now revealed. Estonia is no exemption in this sense. The majority of the manufacturing branches had exceeded pre-crisis production level by this spring with less number of workers employed. This indicates that the above-mentioned stage of technological development is still continuing and the discussion about the natural level of unemployment in Estonia as in a transition economy will rather intensify in foreseeable future.

In conclusion, it can be said that in 1998–1999 the market-based economic regulation secured fast adjustment to changes in the external environment. Contemporaneously structural changes in economy that had already started prior to the crisis and were accelerated by the recession, continued.

RUSSIA AFTER THE 1998 FINANCIAL CRISIS

In August 1998 a classical financial crisis – currency, debt and banking crisis – seemed to take place in Russia. The value of the rouble dropped, the Government stopped debt servicing and foreign currency transactions of the banks were suspended. The Russian crisis followed the 1997 financial crisis in Asia, which had its implications on financial markets all over the world.

Closer scrutiny reveals that the financial crisis in Russia was to a great extent caused by internal reasons – inappropriate economic policy and budget deficit in public sector.

Retrospective View

On 17 August 1998 the central bank yielded to the strong selling pressure allowing the rouble exchange rate to float and causing a rapid decline in the exchange rate of the rouble from 6 roubles per dollar to 20–25 roubles per dollar. Currently the exchange rate is 28 roubles per dollar (see Figure 4b). After the crisis the purchasing power of the people in Russia declined considerably, real income diminished almost by 40% and has regained gradually 70% of the pre-crisis level.

At the same time the two post-crisis years have revealed a number of interesting and promising trends both in economy and in government administration. Changes initiated by President Vladimir Putin have substantially enhanced confidence in Russia in the eyes of the outside world and improved economic indicators further reinforce that confidence. Though the outflow of capital continues, there are signs referring to the stabilisation of the situation.

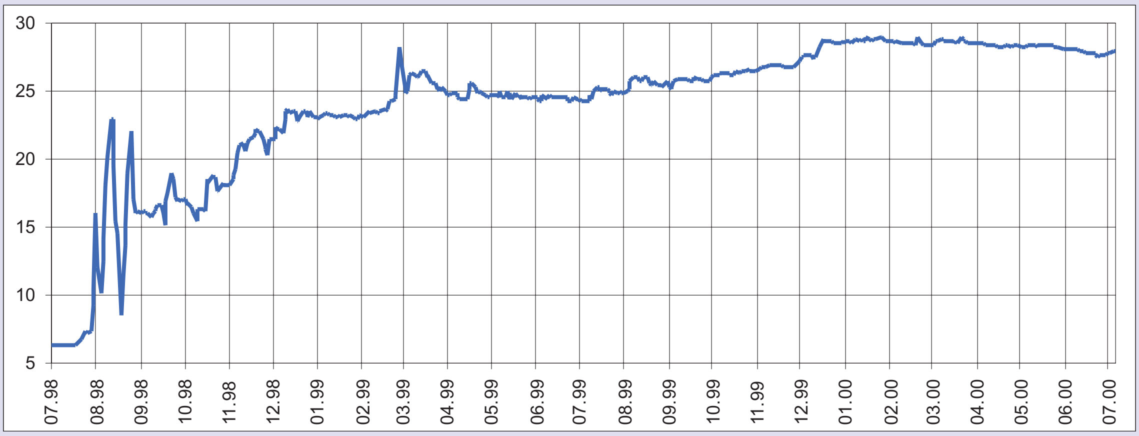

Figure 4b. RUB/USD exchange rate between July 1998 and July 2000

The growth in external demand and high world market prices of inputs has had a positive impact on Russian economy. *Oil and gas are the main export goods and increasing oil and gas prices have facilitated the growth in exports (see Figure 5b). Export volume of energy products has not grown mainly due to the lack of additional production capacities and export restrictions set by the Government whereas the value of exports (consequently receipts from exports) has grown. Surplus of the current account in the first quarter of 2000 was 25% of GDP, which exceeds twice the result of the same period a year before. Due to an increase in import prices and weak real purchasing power of people (devaluation of real income and savings has not been compensated) growth in imports has been very small, though since this spring there have been signs manifesting some increase in demand. The trade balance surplus, decreasing outflow of capital and the obligation of undertakings to exchange 75% of their export income into the roubles have increased the reserves of the central bank. During the year 2000 the foreign currency reserves have grown approximately by a half and*

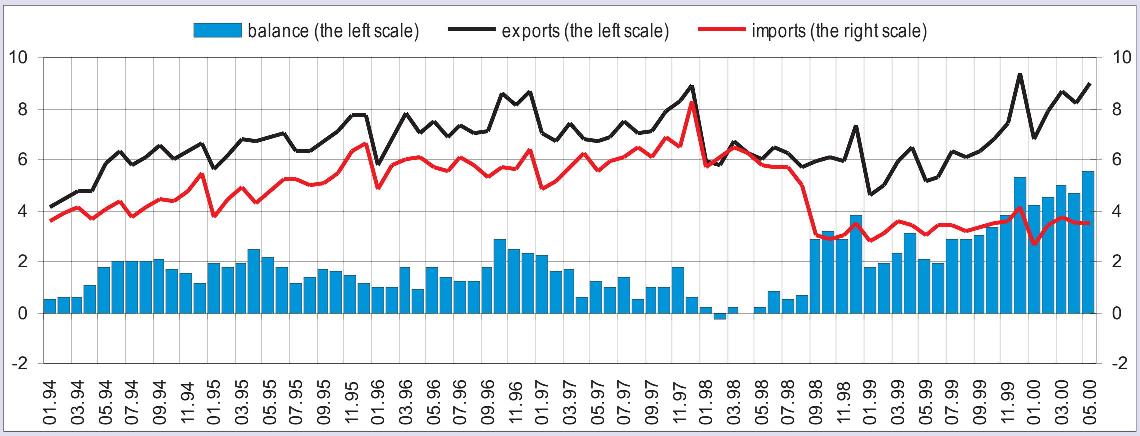

Figure 5b. Russia's foreign trade balance between 1994 and 2000 (USD billion)

have reached the amount of 24.1 billion US dollars in spite of the fact that 5.4 billion US dollars were used to reimburse external debt and no loans were taken from international financial organisations.

Together with acceleration of the economic development there has been also improvement in tax collections *and this year the state budget is in surplus having been in deficit throughout the period of transition. According to the data provided by the Ministry of Finance the overall budget surplus during the first half of 2000 was 1.6% of GDP or about 50 billion roubles (in 1999 budget deficit was 4% of GDP). The primary budget, which does not include debt-servicing costs, showed surplus of 4.6% of GDP. The budget was made with a deficit of 1.2% of GDP as considerably smaller tax revenues and lower oil prices (18 US dollar per barrel) were anticipated. As a result of the strong fiscal position there has been no need for the government to borrow from the central bank.*

The favourable external environment and stronger fiscal position have facilitated the improvement of economic situation in Russia. *In comparison with the same period in 1999, GDP grew by 7.5% and industrial production by 10% in the first half of 2000. Also domestic demand shows signs of improvement, real income has grown by 9%, investment 17%, retail trade turnover 8% during the first seven months of 2000. The support of the State Duma to the President enhances the probability of fulfilling political promises. In conclusion one can say that currently Russia has good economic and political preconditions for reforms.*

Current Situation and Further Steps

In order to ensure the continuation of economic growth, Russia needs broad-based reforms that the Government of Russia has already listed in its activity plan for 2000–2001.

The tax reform. *By today the State Duma has adopted a considerably simplified tax code which will enter into force on 1 January 2001. The income tax will be a proportional tax (13% of income) and social taxes paid by undertakings are combined together into one tax. Employees pay a social tax of 7.5%. The new tax code will also increase the corporate income tax from 30 to 35%. In order to accede to the WTO, customs tariffs are going to be reduced. Nevertheless, Russia still has difficulties in implementing the legislation, especially as regards the implementation of ownership rights, competition and bankruptcy acts.*

The banking sector*. The biggest problem in Russia is the weakness of the banking and financial sector. The relative volume of loans to real sector has changed only slightly during the last 18 months (see Figures 6b*

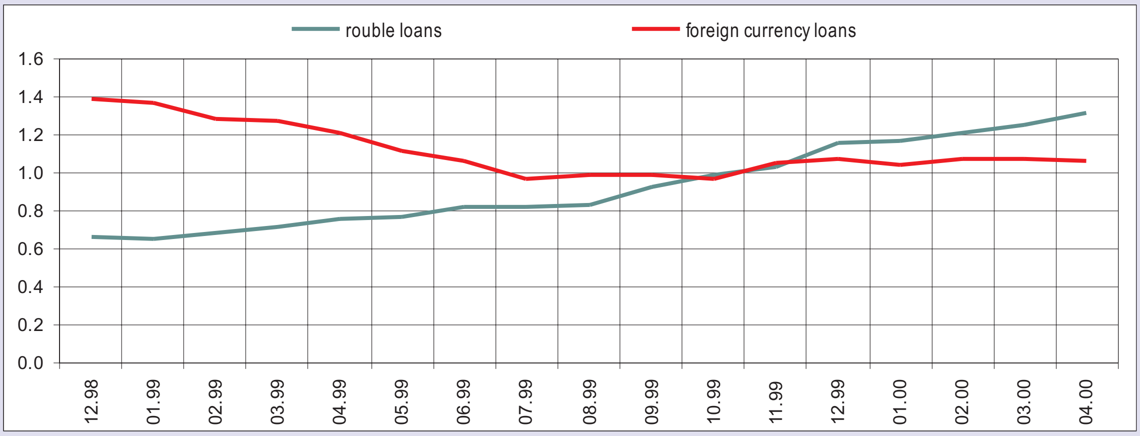

Figure 6b. Rouble and foreign currency real loans (billion roubles, by CPI)

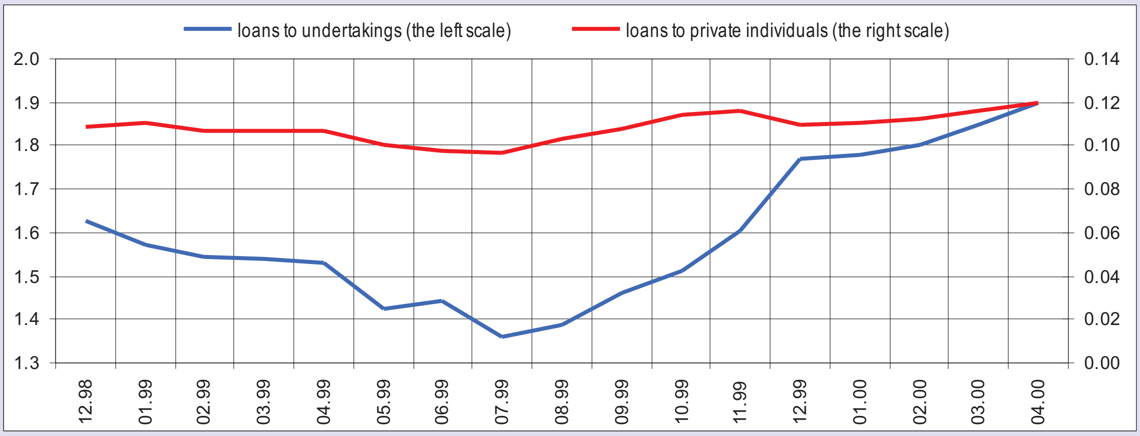

Figure 7b. Real loans to undertakings and private individuals (billion roubles, by CPI)

and 7b), the banks keep most of their deposits abroad, in government bonds or in the central bank. Although between January 1999 to April 2000 lending to the business sector has grown by 60%, ie 483.6 billion roubles, their share of GDP dropped from 11.2% to 9.5% during that period. Total lending to the private sector constitutes 11% of GDP, which is one of the lowest indicators among developing counties. Also in near future, before the implementation of essential structural reforms no credit growth (of GDP) is expected regardless of high liquidity in the banking system (in July the banks had 78 billion roubles in total on their correspondent accounts with the central bank). Banks still lack credibility for regular operational activity.

The inflation has been accelerating since the second quarter of 2000*, the growth was especially high in June (2.6% growth in comparison to May; see Figure 8b). Foodstuff prices were responsible for major, higher than anticipated, growth in consumer inflation (constituting 50% of the consumer price index). Last such high increase in consumer price index in Russia had been registered last July. The annual increase in June was 20.3% (in May 19.5%), showing an upward trend the first time during the year.*

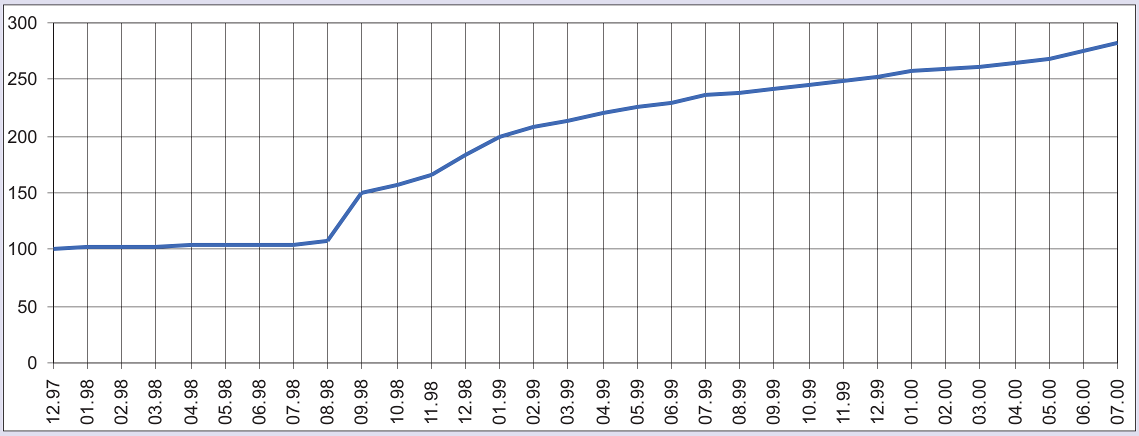

Figure 8b. Consumer price base index (December 1997 = 100)

The Central Bank of Russian Federation is in a difficult situation. *The inflow of foreign currency strengthens the rouble and it is necessary to choose whether to let the rouble gain in strength or to allow the inflation to accelerate. Until now the central bank has succeeded in keeping the major part of the currency inflow away from economy by using it for decreasing government agencies debt to the central bank, offering the commercial banks a possibility to deposit their free resources with the central bank and increasing the reserve requirement in order to reduce the liquidity of the banks. But in recent months due to strengthening of inflation there have been signs, which show that it is difficult to keep excessive money away from the economy. The central bank has announced that the rouble has been undervalued and that the bank does no see any danger in the strengthening of the current exchange rate. The key issue remains to be the implementation of reforms designed to strengthen economic structures, facilitating saving and investment by households and government institutions.*

The economic programme for the next ten years, commissioned by President Putin and approved by the Government, outlines at least a 5% economic growth, privatisation, increase in domestic investments, restructuring of natural monopolies such as Russian United Energy Systems and Gazprom, and hold on the outflow of capital. Changes that concern undertakings (introduction of international accounting standards, enhancement of transparency, strengthening of protection of small proprietors, implementation of the Bankruptcy Act) were postponed in the plan but the Government approved respective proposals. Is Russia capable to carry out those plans this time? Conditions for reforms have been set out.