II
ECONOMIC DEVELOPMENTS

EXTERNAL ENVIRONMENT

Although the economic growth slowed down in the second half against the first half of 2000 (see Table 2.1), the external environment was still conducive to Estonia's economic growth. Economic indicators and forecasts have been subject to sustained high oil prices and the ongoing weakening of the exchange rate of the euro against the US dollar in the euro area and related countries: the growth of gross output is slower and that of inflation rate faster than in the United States.

Apart from growth slowdown, future outlooks are also slightly more uncertain. The financial environment has tightened: stock indices have dropped and credit conditions deteriorated. Accompanied by reduced external demand, such an environment would worsen the emerging countries' outlooks. In larger industrial countries interest rates have probably peaked for the time being and will start falling.

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	2001	1999	2000	2001	1999	2000	2001
USA	4.2	5.2	3.4	2.2	2.9	2.5	-3.5	-4.3	-4.4
Japan	0.2	1.7	2.0	-0.3	-0.6	-0.1	2.5	2.5	2.3
Euro area	2.5	3.4	3.4	1.1	2.0	2.0	0.3	-0.2	-0.1
Germany	1.7	3.1	3.1	0.6	2.0	1.7	-0.9	-0.7	-0.6
France	2.9	3.3	3.4	0.6	1.7	1.5	2.5	2.3	2.6
Great Britain	2.2	3.1	2.9	2.0	2.1	2.3	-1.2	-1.5	-1.9
Finland	4.0	5.1	4.4	1.1	2.5	2.5	5.3	5.8	6.4
Sweden	3.8	4.1	3.5	0.5	1.3	1.7	2.5	2.6	2.6
Hungary	4.5	5.5	5.4	10.0	9.5	8.0	-4.3	-3.6	-4.0
Poland	4.1	4.9	4.6	8.6	10.0	7.6	-7.8	-7.2	-6.3
Czech Republic	-0.2	2.5	3.2	2.2	4.0	4.6	-2.0	-3.9	-4.3
Russia	3.2	6.6	4.5	61.3	20.4	15.6	17.4	24.8	16.1
Latvia[1]	-0.7	3.8	5.3	2.4	3.5	3.3	-	-9.4	-8.7
Lithuania[1]	-4.1	2.4	3.6	0.8	1.3	2.3	-	-8.2	-6.4

[1] Data of the current account deficit of Latvia and Lithuania are based on the data of the European Commission.
Source and prognosis: International Monetary Fund, Organisation for Economic Cooperation and Development, European Commission, J.P. Morgan and Lehman Brothers. Average indicators are calculated based on the data of November 2000.

The United States of America and Japan

The economic growth in the United States has slowed down but the threat of a hard landing remains low[1]. In the third quarter of 2000 the annualised quarterly GDP growth slowed down to 2.4% according to preliminary estimates, remaining about twice below that of the first half-year[2]. Declining corporate investments and curbed government spending were conducive to growth slow-down. However, private consumption recovered slightly and further outlook is

[1] Hard landing: annual growth below 2% for two or more consecutive quarters whereas the unemployment rises sharply (eg 0.5 percentage points). Soft landing: annual economic growth maintains the long-term trend (of about 3%) and unemployment manifests no pronounced increase.
[2] The GDP in the US grew by about 5.2% in the third quarter against the year-ago period.

stable: consumer confidence remains high and the effect of high interest rates will start to diminish in 2001.

Various forecasts consider declining investment a growth suppressant due to decreasing corporate profits and tightening credit conditions in stock, bond and loan markets. The strong dollar makes US products expensive abroad, dampening export growth.

In September-October the inflation rate accelerated due to energy prices. Core inflation keeps growing, mostly because prices grow in the service sector. Meanwhile the wages have remained stable as compared to 1999. Although the number of people applying for unemployment benefits is growing, the situation in the labour market is tight. Large trade deficit (a record 34.4 billion dollars in September) manifests ongoing **imbalance in domestic demand and supply**, although it is also backed by higher crude oil prices. The federal budget has sustained surplus: the end-2000 forecast is 1.5% of GDP.

The Federal Reserve has not changed the 6.5% benchmark interest rate but has remained vigilant. With current economic indicators financial markets expect a transition to a neutral stance as well as a cut in interest rates within a few months.

Japan manifests a slight recovery. In the second quarter gross output grew by 1% against the same period in 1999 (0.7% in the first quarter). Although investments boost economic growth, private consumption remains relatively low due to high unemployment (4.7% in the second quarter) and low incomes. Thus, the restructuring of economy has not yet become conducive to consumption. The economic environment continues to be deflationary (CPI is -0.8%). The sustained bankruptcy wave and collapse of two insurance giants reveal the ongoing weakness of the financial sector.

The annual growth of gross domestic output for 2000 should still be positive (about 1.5...2%). The forecast is supported by the continuous growth in investments, private consumption that has been recovering since the second quarter and fiscal policy that contributes to economic growth.

Emerging countries

The second quarter of 2000 can be considered the peak of the current economic cycle as regards the economic development expectations. In the third quarter doubts about the sustained growth of the world economy have gained more proof and several forecasts have been revised downward. The dependence of the emerging countries' economic growth on exports makes their economies sensitive to shrinking demand in developed countries and the sustainability of growth is increasingly subject to domestic demand.

Latin America with its large debt load has experienced lower growth expectations of world economy the fastest. Decreasing external demand was evident already in the third quarter and although in some regions the export growth reached 20%, it is lower than the high level of mid-year. High oil prices still maintain the level of export income whereas prices of other raw materials are low. Argentina with its fiscal and debt-servicing problems, worsening economic conditions and low economic growth continues to be the region's source of concern. The International Monetary Fund (IMF) forecasts only a 0.5% growth of GDP in Argentina for the year.

In Asian countries economy has recovered significantly in 2000. The third quarter was slightly weaker than the previous ones but in Hong Kong GDP grew by 10.4% even in the third quarter. Household consumption is still low and prices have not yet started to grow after the 1997 crises. Stock and real estate markets are insecure. The economic growth is mainly sustained by exports and corporate and government investments. Therefore lower external demand (especially in the US) and high oil prices could have a highly negative impact on Asian industry.

European Economies

The economies of the euro area and the European Union countries (including Germany) enjoy the best position of the last decade. Both domestic factors and external demand have contributed to it. Although all signs indicate a slowdown in gross output growth in the second half of the year, for the year as a whole growth above 3% is forecast. A sharp rise in the oil prices and sustained high level have downgraded growth forecasts. This factor together with the sustained weakening of the euro against the dollar has raised the consumer price growth above the targeted annual 2% set by the European Central Bank. In October the indicator was 2.7% but domestic inflationary pressures are still modest.

Higher than expected fiscal revenues due to rapid output growth and exceptional revenues (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 the government debt. The growing employment rate and reduction of tax burden are going to be conducive to the growth of income and therefore also to private consumption.

Monetary policy decisions taken by the European Central Bank (ECB) have been more targeted than before to the prevention of inflationary pressure arising from the weak euro. The ECB raised interest rates by a total of 50 basis points in August and October. In addition the European System of Central Banks together with the US Federal Reserve and central bank of Japan and the Bank of England made several foreign-exchange interventions to support the euro in September and independently in November. These interventions had no long-term impact on the exchange rate.

In Finland and Sweden output growth continues to be faster than EU average. In Finland it is increasingly and in Sweden continuously based on private consumption. Although export outlooks have somewhat deteriorated against the extremely favourable conditions earlier in the year, the above 10% growth in industrial production and exports is sustained in both countries. The employment rate is going up and public sector budget is in surplus. The growth forecasts for Finland in 2000 and 2001 are 5.1 and 4.4% and for Sweden 4.1 and 3.5%, respectively.

In Finland the further acceleration in the growth of industrial production is inhibited by production capacity constraints: in autumn more than 90% of the manufacturing capacity was put to use. In Sweden the major risk is associated with the labour market as the rapid economic growth and low unemployment rate (about 4% of the workforce) contribute to growing wage demands and an increasing number of companies complains about the lack of skilled labour.

Unlike Finland, in Sweden the inflationary pressure is not yet significant regardless of the rapidly growing domestic demand. Over the recent months consumer prices have increased by 1.3–1.4% against the same period in 1999 (in Finland the growth has been pursuant to the EU harmonised index methodology 3.4%). This is more and more explained by *new economy*: price stability results from increasing productivity and tougher competition.

Central and East European Countries

In **Central and East European** countries inflation accelerated in the third quarter but only due to growing energy and food prices. Against weakening world economic growth expectations it is essential to note that as the growth in Central and East European countries has been mostly export-generated, the decline in external demand elsewhere in Europe had an impact on GDP growth already in the third quarter. The prerequisite of sustained economic growth in Central and East European countries is growing domestic demand.

In **Poland** GDP is anticipated to grow only by 4% in the third quarter, revealing a drop in the economic activity against the 5–6% of previous quarters. Accelerating inflation and complicated fiscal policy situation made the central bank raise interest rates, which are currently 21–23%. The dual deficit in economy remains an ongoing concern – the IMF anticipates current account deficit of 7.4% of GDP and the government forecasts budget deficit of 2.2% of GDP. Political tension in the 2001 budget procedure and probably overestimated economic growth (5.1%) could bring along a larger deficit than the currently planned 1.6% of GDP whereas the sustained shrinkage of domestic demand should reduce current account deficit.

The growth in the **Czech Republic** was unexpectedly low in the second quarter (1.9%) and 2.5% growth is anticipated by the end of the year. The GDP growth forecast for **Hungary** is 5.5% in 2000 but growth rate has fallen during the year. According to the preliminary data GDP grew by 4.6% in the third quarter (6% in the first and 5.8% in the second quarter). The growth of industrial production has slowed down during the recent months but is still very high – 16–20% against the same period in 1999. The relatively loose fiscal policy in upcoming years (the anticipated budget deficit of 3% of GDP in 2001 and 3.4% in 2002) should support the economic growth through increasing domestic demand.

In **Latvia** the economic growth is slowing down. The second-quarter 4.8% growth was mostly due to the service sector. Exports, responsible for 60% of GDP, are sustained mostly by timber. As in the third quarter the growth of both industrial production and exports shrank, GDP growth was lower in this quarter as well. The IMF forecasts a 4% growth for Latvia by end-year. The expansive economic policy pursued by the Latvian government is of political concern as the dual deficits as a ratio to GDP are higher than in Poland – the IMF anticipates current account deficit of 8% in Latvia for 2000, and according to the latest government prognosis the budget deficit will reach 3.2%.

Lithuania had zero growth in the second quarter, like a year ago, whereas growth above 2% is anticipated in the third quarter. In the third quarter the growth of industrial production and exports was remarkably high (annualised rates being 5.7 and 31.4%, respectively), although both indicators are extremely volatile in Lithuania depending on the oil refining sector. The parliamentary elections on 8 October brought to power the centre party led by Rolandas Pakshas who fully supports market reforms and integration to the European Union. Similar to Latvia, the previous government of Lithuania announced that due to low tax revenue collection it could not contain the budget deficit within the limits promised to the IMF. The latter agreed to increase deficit from 2.8% to 3.3% of GDP. For 2001 they agreed on a 1.4% deficit.

In **Russia** the GDP is anticipated to grow by 6.7% in the third quarter. This is very high growth considering the base effect (GDP increased by 13% in the third quarter of 1999). Exports were 38.5 and imports 13.8% higher than in 1999. Due to high oil prices energy is still among most significant export commodities and the agreement concluded with the European Union will improve energy export outlooks even more for Russia.

Financial Markets

Prices for Raw Materials

Prices for **raw materials** have not much changed against the second quarter; oil and other energy prices have sustained their high level. The question is how long the current oil shock is going to last and what kind of implications it will have on the growth of world economy. The International Monetary Fund anticipates an oil price drop to an average of 23 dollars per barrel whereas other institutions are not that optimistic. Thus the Organisation for Economic Co-operation and Development (OECD) forecasts an average of 29.5 and the European Commission 30 dollars per oil barrel for 2001. Prices for other raw materials, mostly for metals and, to a lesser extent, for agricultural products also started to move upward in the second half of 1999 and should maintain their current level if economic growth continues. Regardless of the anticipation of contracting growth, prices for timber and paper have not fallen: in November prices kept moving upward both on the European as well as on the US timber market.

Foreign Exchange Markets

Foreign exchange markets reflected growth slowdown at the end of the third quarter and beginning of the fourth quarter. The euro kept weakening against the dollar and the European Central Bank had to make several foreign-exchange interventions to halt the slide. Interventions were still more political and managed to support the exchange rate for a short while.

Slowly recovering Japanese economy and declining external demand for Asian goods weakened the yen against the dollar beginning from September as well. Deteriorating world economy and domestic political confusion also contributed to the above. The yen has dropped by 5% against the dollar since early-September, reaching 111 JPY/USD (see Table 2.2 and Figure 2.1).

Table 2.2. Changes in exchange rates of major currencies

	30.11.99	30.11.00	Change (%)
JPY / USD	102.12	110.34	8.0
USD / EUR	1.0089	0.8722	-13.5
USD / GBP	1.5984	1.4259	-10.8

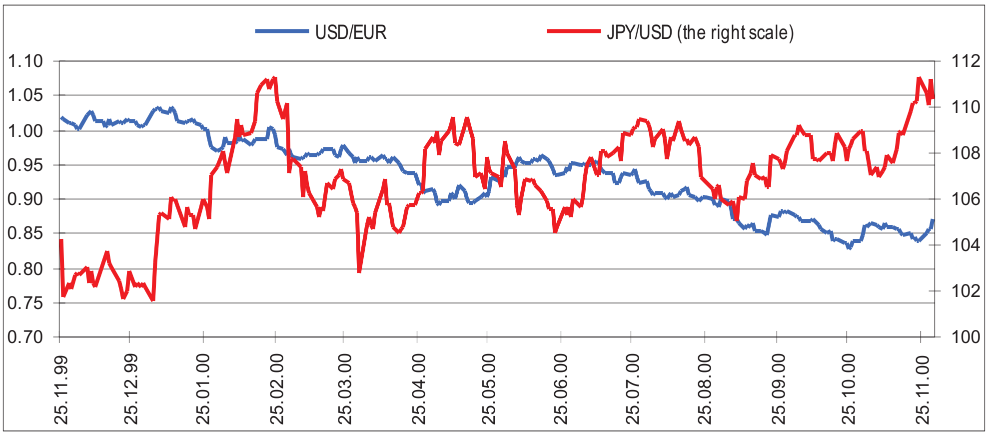

Figure 2.1. Exchange rates of major currencies

Stock Markets

Major world **stock markets** started to grow rapidly at the end of October 1999. High economic expectations favoured investment in stocks and all indices were at a record high in early 2000. By end-November stock markets had reached the year-ago level. The main index of Nasdaq had dropped the most, being 22% below the same period in 1999.

In the United States many investors take into account the possibility that the soft landing of the economy could develop into a hard one. According to J. P. Morgan there is a 40% chance for it. As the US stock market dynamics has a significant impact on private consumption, the weak market has become an agent contributing to the hard landing scenario, thus amplifying the downward trend.

To understand the plunge of the US stock market, the earlier boom between end-October 1999 to early-March 2000 has to be considered, with stock prices rising to the level reflecting the unrealistic expected return in future periods (especially in case of Nasdaq but also other stocks; see Figure 2.2). Although in the environment of the rapidly developing *new economy* and accelerating labour productivity growth the slightly higher growth in the prices for high-tech stocks was justified, it was not in compliance with the so-called fundamental factors. It cannot still be stated that the balance between the latter and stock prices has been achieved. The

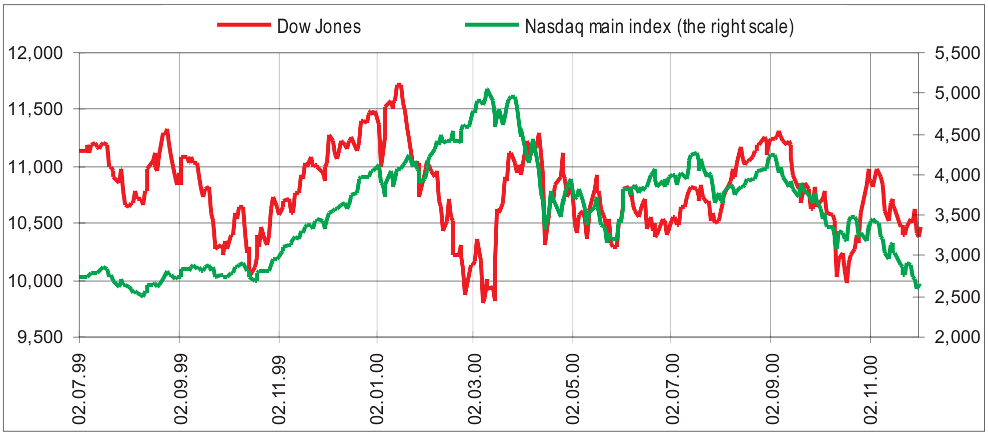

Figure 2.2. US stock indices

economy has entered a slowdown phase and any further developments on the stock market depend on the length and depth of the phase. According to Goldman Sachs the rate of growth of net profit will drop from about 11% in 2000 to 2.5% in 2001.

The decline on US stock markets determined the trend of the stock markets in the euro area and Japan in the second half-year as well. The stock markets in Asia have hit the lowest of recent years (Nikkei 225 is 21% below end-November 1999; see Table 2.3) whereas stocks in Europe have not dropped to the 1999 level (except British stocks; see Figure 2.3). Even German DAX and Finnish HEX reflecting largely price changes in the technology sector are still above the level of 1999.

Table 2.3. Indices of major stock markets

	30.11.99	30.11.00	Change (%)
USA (S&P 500)	1,388.90	1,314.95	-5.3
Japan (Nikkei 225)	18,558.23	14,648.51	-21.1
Germany (DAX)	5,896.04	6,372.33	8.1
Great Britain (FTSE 100)	6,597.20	6,142.20	-6.9

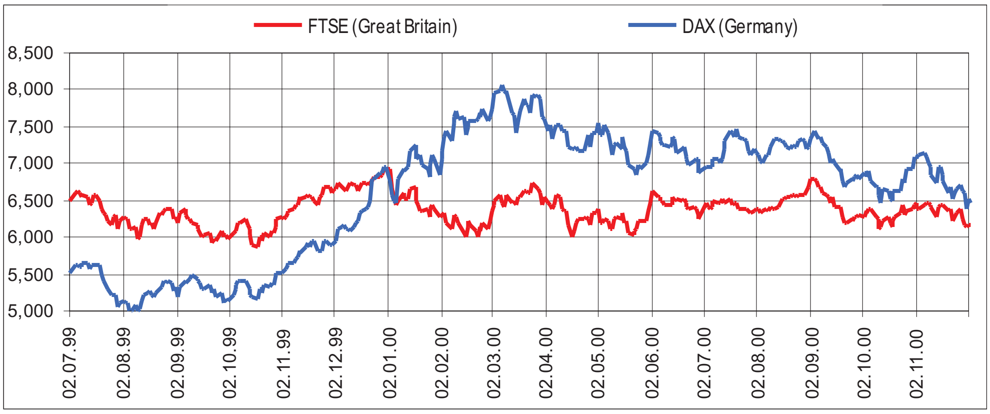

Figure 2.3. European stock indices

Interest Rates

On **bond markets** money moves from riskier assets to securer ones. In other words: the investors' attitude towards emerging markets is more negative than in mid-year. Interest rates of short-term bonds are increasing. In the United States the interest rate of three-months bonds grew by 17.6% (93 basis points) in the period from November 1999 to November 2000, in Europe by 48.4% (163 basis points) and in Japan by 3.6 times (although "only" by 29 basis points; see Table 2.4). Interest rates of long-term (ten-year) bonds have dropped about as much, except in Europe where they have fallen only by 14 basis points (see Figure 2.4). On emerging markets both short- and long-term interest rates have moved upward during the above-mentioned period, evidenced also in an increasing spread between J. P. Morgan's emerging countries' bond index EMBI Plus and US government bonds (the spread was 860 basis points by end-November, having grown by 24% against August).

Table 2.4. Interest rates of major bond markets

	Interest rates of 3 months			Interest rates of 10 years		
	30.11.99	30.11.00	Change (basis points)	30.11.99	30.11.00	Change (basis points)
USA	5.28	6.21	93	6.17	5.47	-70
Japan	0.11	0.40	29	1.82	1.62	-20
Euro area	3.37	5.00	163	5.11	4.97	-14
Great Britain	5.49	5.89	40	5.21	4.87	-34

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

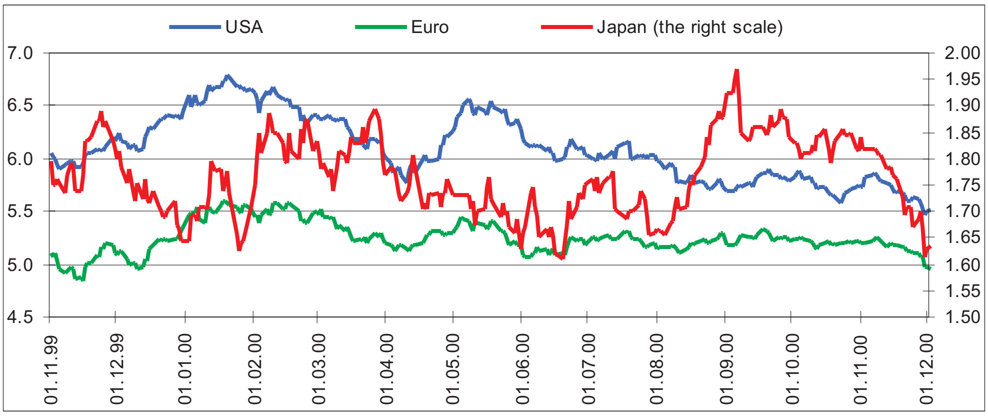

Figure 2.4. Interest rates of ten-year bonds

Capital Markets in Emerging Countries

The capital markets in emerging countries, still looking credible in the second quarter, are losing their prosperous future outlooks against the setting of weakening economic indicators of the developed countries as well as of the emerging markets. A downfall on the developed countries' stock markets and higher debt servicing costs due to higher interest rates are the most pronounced in high-debt Latin American countries. In October-November 2000 Argentina and Peru disclosed that they either need to restructure debt-servicing or a loan from international organisations. The share of Latin American countries is about 80% in the index, therefore the growing spread between EMBI Plus and interest rates in Argentina reaching about 900 basis points in the last week of October had a significant impact on the index.

ESTONIAN ECONOMY

Domestic Demand

Private Consumption and Investments

The post-crisis domestic demand recovered mostly with the support of private consumption. Although recovered external demand accompanied with the lower interest rate level and favourable leasing conditions boosted consumer confidence for future, investments still remained below the pre-crisis level during the first three quarters of 2000 (see Figure 2.5).

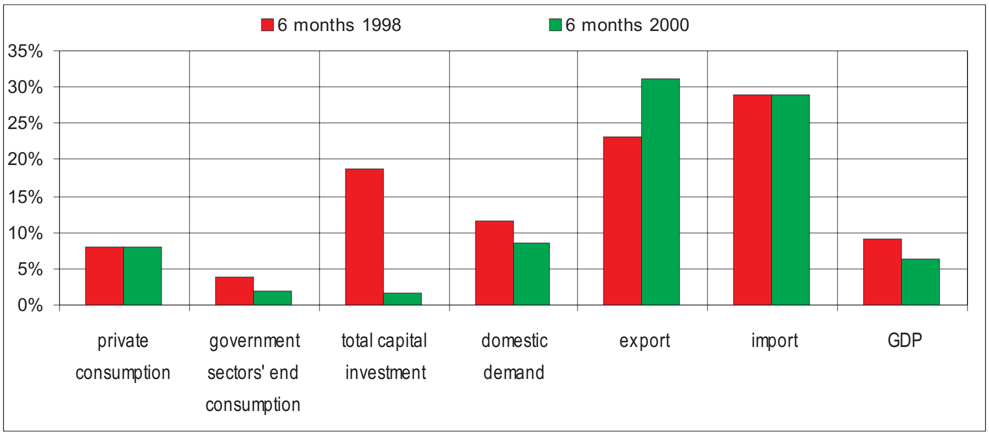

Figure 2.5. GDP and its consumption-driven components before and after economic decline (%)

During the last three years the growth of the annual real wages has been close to a stable 7% and the nominal growth has slid downward keeping pace with inflation. Consumption remained unaffected during the recession because undertakings optimised workforce and population confidence in future had declined. Saving was rather preferential over consumption, taking the annual growth rate of private deposits close to 30%.

With recovering growth and confidence, the private consumption started to increase in early 2000 as well. **In the first half-year its real growth reached nearly 8% and like in the previous rapid growth phase exceeded slightly the payroll growth.** Consumption was partly favoured by favourable borrowing and leasing conditions. By end-September the private leasing portfolio was 9.4%, ie 46.3 million kroons above the beginning-of-the-year level. The loan portfolio had meanwhile grown by 20%, ie 1.1 billion kroons, consisting mostly of housing loans.

The growth rate characteristic of nominal wages during the last two years (10.1% annually) was sustained in the third quarter as well. Seasonal growth in turnover made several service companies to increase their staff. Thereby the share of labour costs increased temporarily as well. The real wages growth kept up with productivity (see Figure 2.6).

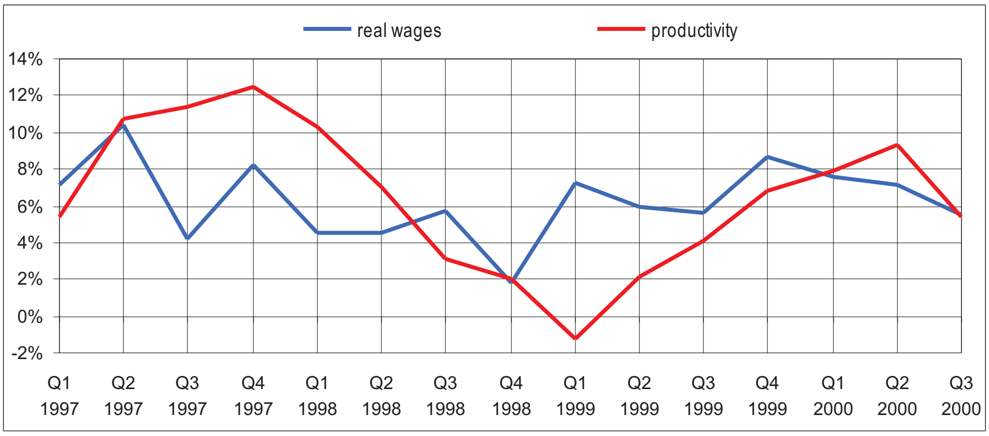

Figure 2.6. Annual growth of productivity and real wages (%)

Regardless of the increasing corporate profits growth and improved lending conditions, no significant acceleration took place in investment activity in the first half of 2000. Capital investments in fixed capital in constant prices surpassed the previous year by 1.7%, remaining 16% below the first half of 1998. The capital demand in the new contracting-oriented branches of industry is probably below that of traditional branches. Companies are also attempting to put to use production capacities set up before the crisis.

The initial investment stabilisation at the lowest level of GDP of the recent years could indicate new balance for economy but also be a sign of growth slowdown in upcoming periods. In the first case the adequate production potential created with pre-crisis investments can be implemented without additional capital under changed economic environment as well. In the second case Estonia's economic growth will increasingly be inhibited by production factors, hindering satisfaction of external and internal demand.

Although the absolute volume of corporate and institutional investments was in the third quarter above the previous quarters, it did not reach the 1998 level.

Public Sector

Seasonal factors improved the fiscal position in the third quarter. Increased tax collection on the background of smooth expenditure growth brought along budget surplus for the first time since 1998 in the sum of 424.1 million kroons (see Figure 2.7). The very fact that the government sector's final consumption has not increased against the year-ago period confirms the intent to continue along a more balanced development path. With the economy in the growth phase, budgetary balance continues to be a minimum objective.

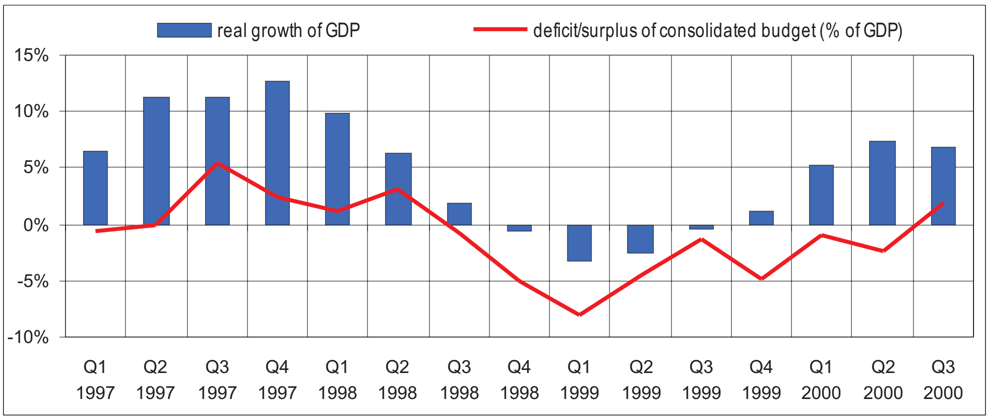

Figure 2.7. Real growth of GDP and balance of the consolidated budget

The central government budget continues to be the highly disciplined component of the consolidated budget. Revenues closely related to economic activity – VAT, social tax, income tax – are collected at a pace indicating reaching the level intended for the end-year. The insufficient collection of mixed and privatisation receipts endangers the achievement of fiscal criteria set for the entire sector, several smaller local governments have had difficulties collecting revenues. Besides, the extensive loan scheme for Tallinn (two loans totalling 420 million kroons) indicates a threat of slackening fiscal policies.

The above makes discussions of the budget for 2001 in the *Riigikogu* a real test in order to continue with sustainable economic development. Although the central government budget was initially drafted to grow by only 3.2%, the premise was a nominal growth of 10%. Thereby any attempt to increase budget would restore expansive fiscal policy, boosting the anticipated growth of private demand. In order to solve potential problems on other budgetary levels of the government sector, the central government budget should be at least balanced, preferably in surplus. This is the only way to contain general deficit within limits in long-term as well.

In the third quarter the growth in domestic demand followed that of GDP. In the fist half-year accelerating private consumption boosted domestic demand whereas in the third quarter investments grew as well.

Domestic Saving

Low current expenses in government and business sectors keep the domestic saving traditionally the year-high in the third quarter. The year 2000 was not an exception either as the private saving reached 23% of GDP in the third quarter. The ever-increasing profitability and regulated cost management policy secured primarily this “regular” level. The government intention to return to balanced budget principles increased the government saving from the close-to-zero level in the second quarter to about 6% of GDP. The 21%-domestic saving in the first three quarters of 2000 is in compliance with the anticipated recovery of saving in the wake of the crisis, taking the annualised saving above 20% of GDP.

Domestic supply

During nine months of 2000 the sales in manufacturing in constant prices exceeded the pre-crisis level (the same period in 1998) by about 7% (see Figure 2.8). The growth was mostly achieved through precise electronics, engineering and tool-making branches as production has more than doubled due to booming exports. Whereas dairy and fishery output has dropped by a fourth and a third respectively below the 1998 level as the pre-crisis eastern export markets have not been replaced (see Figure 2.9). Here the recovery of previous production levels depends on the extent the pre-crisis investments could be reoriented to catering for new export markets under changed economic environment. Should it be practically impossible, the current low investment demand would not be adequate for rapid production boom.

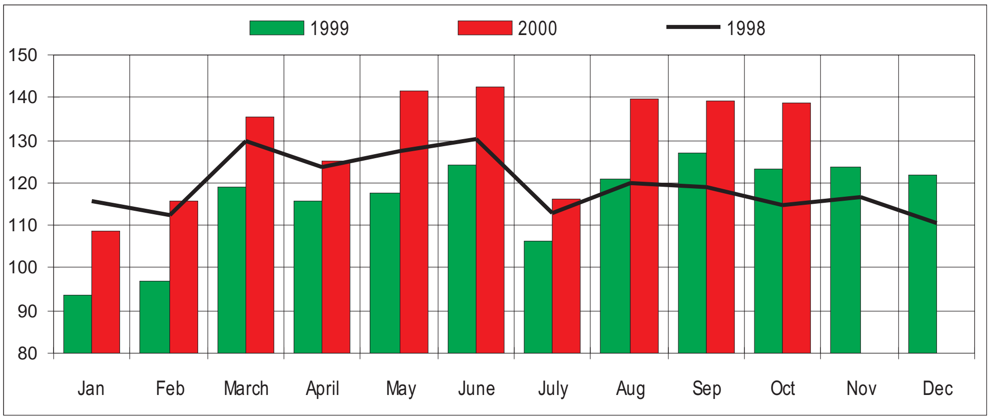

Figure 2.8. Monthly sales of the manufacturing in constant prices (%, January 1997 = 100)

In the first half of the year apart from manufacturing, also the service sector boosted the economic growth whereas due to shrinking freight services export, the growth of the sector was slightly inhibited as well in the third quarter. The setting up of fuel reserves for winter in Russia and raising of the export duties on oil contracted oil transit via Estonian ports. The sustained high crude oil prices on the world market make it attractive for Russia to export crude oil instead of refined oil products and fuel oil. Fuel oil plays a key role in port turnover and transit traffic in Estonia. In September and October Estonian Railway (*Eesti Raudtee*) carried a quarter less than at the beginning of the year.

According to the Estonian Institute of Economic Research (*Eesti Konjunktuuriinstituut*) the economic growth stabilised in the third quarter on the level of the first half-year and favourable

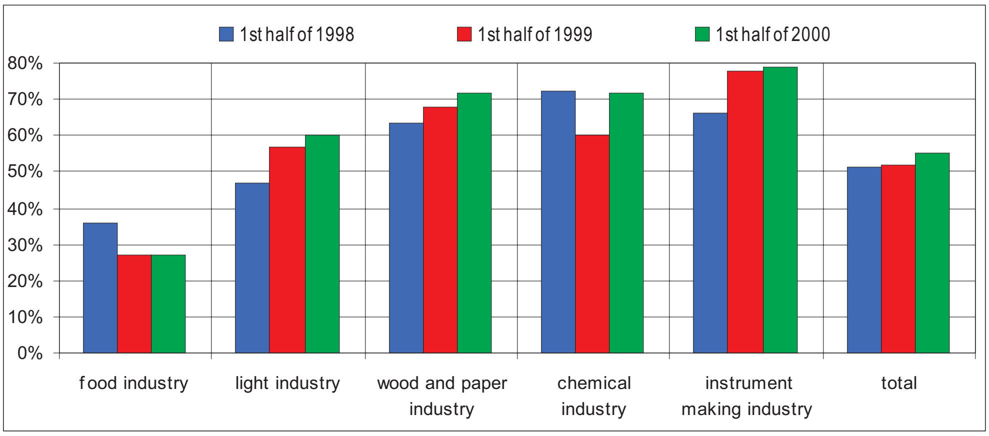

Figure 2.9. The share of export in the sale of manufacturing production (%)

business environment is going to last during the following six months as well. In the third quarter experts considered the general economic conditions and the following half-year the best ever which could indicate the lack of supply side restrictions.

By corporate financial indicators the sales turnover hit an all-time high of 58.5 billion kroons in the second quarter. Pursuant to changes in the balance of payments non-resident-owned companies manifest the fastest growth both in turnover and profit. Due to a relatively high negative investment position the stake of non-resident private legal persons is anticipated to grow in the economic activity of the upcoming periods.

The post-crisis economic recovery has primarily taken place in industries with optimised demand for labour and thanks to more efficient use of production resources in traditional sectors. The economic recovery in the second and third quarters of 2000 has also contracted unemployment to 12.8%. Unlike previous years the labour market seasonality has become more pronounced – the employment increased mostly due to the use of the seasonal workforce. The permanent workforce constituted a mere quarter in the growth, the rest being casual labour, students, etc. Herewith the residents' economic activity moved upward temporarily as well, although the number of the unemployed remained stable. **As of early 1999 the number of the employed has been around 610 000, being possibly a first signal of suspending long-term employment shrinkage.**

External sector

The third quarter sustained the rapid annual growth rate in trade export – 50% in current prices. The growth is still backed by growing nominal volumes in manufacturing and export of Estonian-origin-goods (20% and 13%, respectively, against the first quarter).

A structural shift took place in processing machinery and equipment in the third quarter, increasing the value-added share of products. **In the first half of the year the value-added processing reached about one per cent of GDP in the trade turnover whereas in the third quarter estimates exceeded 5%.** Nevertheless, the improved processing figures could be artificial – due to price transfers between non-resident parent company and resident affiliate. Imported input prices dropped by more than 15% in subcontracting engineering and equipment industry in the third quarter. The positive balance in subcontracting reduced also trade deficit, being below 15% of GDP and having hit in the third quarter the record low since 1994.

Throughout the year 2000 the manufacturing sector together with private consumption have taken the lead in channelling import volumes. Although at the end of the third quarter the importation of machinery and equipment for free circulation increased, the imports growth rate remained still below that of exports, reaching 38% in current prices.

The rapid growth in the exportation of goods and services characterised the first two quarters of 2000 whereas by end-third-quarter the export of services shrank slightly in the category of freight services. **Thanks to the record low trade deficit of the recent years and traditionally high share of travel services export in summer, the balance of goods and services yielded zero in the third quarter for the second consecutive year** (see Figure 2.10).

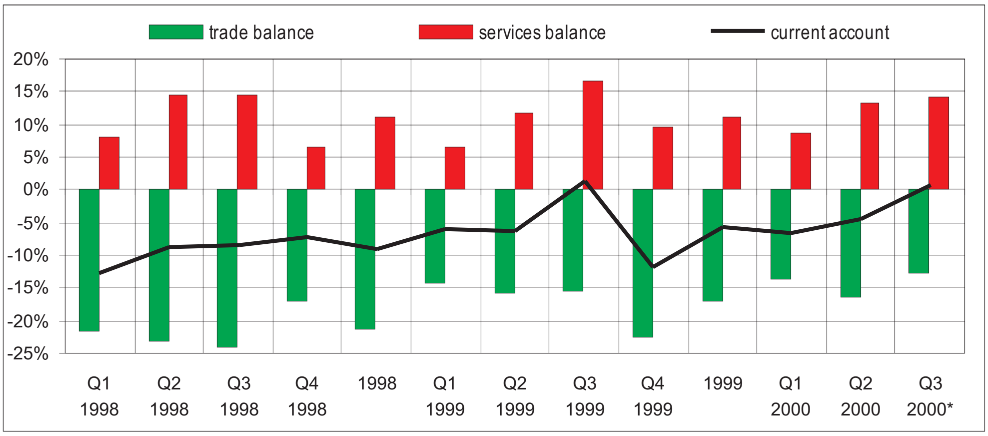

Figure 2.10. Current account and its major components (% of GDP)

* estimate

Reverse flows of direct and portfolio investments were dominant on the financial account in the third quarter. Two commercial banks became fully non-resident and a larger-than-regular inflow of foreign direct investments took place whereas sustained growth in domestic deposits and the euro-interest-rate-sustained growth in profitability attract banks to invest increasingly in external debt instruments. The largest FDI inflow in recent years exceeded significantly the outflow of portfolio investments and Eesti Pank's reserves grew by 270 million kroons.