# I
# ECONOMIC POLICY SURVEY

**World economy showed signs of recovery in late summer and autumn of 2003. Positive signs were seen not just in expectations but also in economic indicators reflecting recent developments.** Third quarter growth in the United States was even faster than predicted and slight acceleration was also registered in the euro area. Economic revival could also be seen in the Nordic countries, as well as in a number of future EU member countries. Various preliminary and confidence indicators point to global recovery continuing also in 2004.

In the monetary policy of the central banks of industrial countries major changes concerned the increase of key interest rates by the Australian central bank and the Bank of England (by 50 and 25 basis points, respectively), which can be regarded as the beginning of the interest rate upturn cycle. Still, for the time being, it only points to the weakening of the stimulating monetary policy. The interest rate policy of the euro area remained unchanged.

Despite the continuing weakness of internal demand, the euro area 12-month increase of consumer prices remained stably near 2% in the summer of 2003 and the respective third quarter indicator was the same. In November, the annual increase of consumer prices edged up to 2.2%. The inflation level was sustained by the increase of oil and food prices and the growth of indirect taxes. The appreciation of the dollar, which began in June, came to an end in September. From that month the euro continued to appreciate against the dollar and in early December the euro-dollar exchange rate crossed the 1.20 threshold for the first time.

## ESTONIA

### Financial Sector

**Faster than expected increase of borrowing and leasing continued also in the second half of 2003 and the annual growth of real sector loans continued to fluctuate around 25%.** The bulk of borrowers and lease takers were service sector businesses and households. The annual increase of households' deposits was just 10% and banks had to resort more and more to external resources.

**The fall of lending rates came to a halt at the end of summer.** The spread between loans and deposits continued to narrow, reaching 3.23 percentage points in October. Nevertheless, the increase of service fees and cutting of costs helped to improve the profitability of banks. Although the rise of profitability slowed down in the third quarter, the total nine-month profit of banks increased by nearly 20% year-on-year. Capital adequacy ratio was high and the quality of loan portfolio remained good throughout the year.

On the Tallinn Stock Exchange, the upward trend continued until the end of September, based on real sector stocks. In the final months of 2003 stock prices were volatile and remained slightly below the price level of the post-EU referendum period.

### Inflation

**The slowdown of the growth of consumer prices ended in the second half of 2003 and was replaced by a moderate acceleration.** The third quarter average CPI growth was 1.2%.

Although in October-November annual inflation again fell to 1%, this did not mean the reversal of the inflation acceleration trend. The 12-month increase of consumer prices amounted to 1.3%, which is the lowest annual average since the restoration of independence.

Particularly small price increase also meant that, despite the extensive depreciation of the US dollar, the increase of the real exchange rate of the Estonian kroon against the currencies of industrial countries came to a halt. Low inflation balanced the increase of the nominal exchange rate of the kroon and the competitiveness of the export sector remained practically unchanged – in the third quarter the growth of the real exchange rate of the kroon slowed down to an annual 0.5%, remaining all-time low also in the coming months.

## Real Economy

**Thanks to the improving external environment and high domestic demand, the annual GDP increase accelerated to 4.6%** in the third quarter**, according to preliminary estimates, which is close to the predicted annual average.** Although the annual growth of the export of both goods and services increased by 4 percentage points in the first half of 2003, the growth rate of import also increased slightly. Therefore, the financing shortage of domestic demand remained large.

**Regardless of the slowing growth, the investments-to-GDP ratio remained above 30%. According to preliminary estimates, the increase of private consumption slowed down as well.** Domestic demand was driven by lower than ever interest rates, which encouraged housing construction besides business sector investments.

The level of investments was kept high by large investments into the transport sector. Therefore, the growth of goods import continued to accelerate and the trade deficit of the third quarter was even larger than that of the second quarter. Experts believe that extensive projects of replacing the fleet of rail tanks would continue at least until the end of 2003, which leaves no grounds to expect a quick and considerable drop in the trade deficit. Although the domination of the transport sector in the structure of investments implied lower import of services and services export increased by nearly 10%, it was not enough to improve the overall external balance.

**Growth of investments exceeded the increase of household savings.** Therefore, the current account deficit was exceptionally large for summer months, amounting to over 13% of the third quarter GDP. The increased profitability of foreign-owned companies also contributed to the current account deficit[1]. As the inflow of foreign direct investments covered only about half of the financing need, the increase of external debt continued. At the end of September 2003, Estonia's gross external debt was estimated at 69% of the GDP.

**Rapid export of goods supported the creation of new jobs in services as well as the open sector, which guaranteed a 2% growth in employment as compared to the same period of 2002.** 70% of the latter resulted from new jobs in industry. Employment in manufacturing largely depends on external orders and there is still a long way to go to the situation of two years ago when the number of jobs was nearly 5,000 bigger. Since development picked up mostly outside northern Estonia, employment indicators mainly improved in other regions.

[1] Proceeding from the principles of the accrual method of accounting, the profit of foreign-owned companies is recorded as outflow of investments under the current account of the balance of payments even if the profit is actually reinvested.

**In the third quarter wages continued to increase rapidly in Estonia, particularly in the sheltered sector. However, the ratio of wage increase and productivity is topical also in the open sector.** In the first nine months of 2003 the growth of labour costs exceeded productivity growth also in manufacturing.

## Government Sector

**Higher than expected internal demand based on foreign loans improved the collection of revenue and the government was among of the biggest domestic savers in the third quarter.** Regardless of the adoption of a supplementary budget of nearly one billion kroons, the nine-month surplus of the government sector budget amounted to 3.3 billion kroons or about 3% of the annual GDP. Local governments, Tallinn in particular, were still in the red though. The annual surplus of the government sector budget is expected at about 1.5% of the GDP.

For 2004, the government drafted a balanced budget, which includes larger than before transfers to households.

***Table 1.1. Main indicators of Estonian economy***

| | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 9 months 2003 |
|---|---|---|---|---|---|---|---|---|---|
| Real growth of GDP (%) | 4.3 | 3.9 | 9.8 | 4.6 | -0.6 | 7.3 | 6.5 | 6.0 | 4.4 |
| Growth of special export (%) | 31.0 | 19.5 | 42.7 | 16.7 | 0.6 | 38.8 | 7.0 | 3.9 | 7.4 |
| Growth of special import (%) | 27.2 | 25.9 | 39.8 | 15.0 | -5.4 | 36.2 | 6.7 | 10.9 | 9.2 |
| Current account balance (% of GDP) | -4.4 | -9.2 | -12.2 | -9.2 | -4.7 | -5.8 | -6.0 | -12.3 | -14.9 |
| General government budget deficit (-) / surplus (% of GDP) | -1.2 | -1.5 | 2.2 | -0.3 | -4.6 | -0.7 | 0.4 | 1.2 | 2.5 |
| Consumer price index of 12 months (%) | 29.0 | 23.1 | 11.2 | 8.2 | 3.3 | 4.0 | 5.8 | 3.6 | 1.4 |
| Export price index of 12 months (%) | 15.1 | 11.3 | 7.5 | 2.1 | -0.4 | 7.8 | 32.9 | 4.0 | 4.7 |
| Consolidated balance sheet of banks (% of GDP) | 38.0 | 43.8 | 63.4 | 55.7 | 61.7 | 66.3 | 70.8 | 73.0 | 79.4 |
| Share of the foreign ownership in banking sector (% of share capital) | 29.0 | 33.4 | 44.2 | 60.7 | 61.6 | 83.6 | 85.4 | 86.4 | 85.7 |
| Capital adequacy of banks (%) | 14.5 | 12.4 | 13.6 | 17.0 | 16.1 | 13.2 | 14.4 | 15.5 | 15.4 |
| Talse index change (%) | | 60.3 | 65.6 | -65.8 | 38.3 | 10.1 | 4.7 | 20.6 | 16.4 |
| Consolidated loan portfolio of banks (% of GDP) | 17.4 | 23.5 | 33.3 | 32.5 | 34.9 | 39.3 | 42.2 | 44.7 | 45.2 |
| M2 (% of GDP) | 26.5 | 28.3 | 32.0 | 29.0 | 34.5 | 37.8 | 41.7 | 42.0 | 42.0 |
| 3months Talibor (%) | | 8.0 | 8.6 | 13.9 | 7.8 | 5.7 | 5.3 | 3.9 | 3.0 |