II ECONOMIC DEVELOPMENTS

EXTERNAL ENVIRONMENT

General background

In the second half of 2005, **global economic activity remained high and growth reached 3.4%**[1], year-on-year. Meanwhile, especially in the last quarter, economic development varied across regions: in the US growth slowed down, accelerated in Japan, and the euro area witnessed a gradual improvement. Based on the economic data (manufacturing, retail sales and activity indices) received in the first months of 2006, Japan has maintained high economic activity and growth is picking up again in the US and also in the euro area.

All in all, the economic growth of 2006 is estimated at 3.5%, which is one percentage point faster than in 2005. In 2007, a slight slowdown in global economic activity is expected.

At the end of 2005 and the beginning of 2006, inflation primarily followed the oil price changes with some delay. After the rapid oil price rise to nearly 70 US dollars per barrel at the end of August 2005, the consumer price growth accelerated as well. In September, the annual CPI growth rose to 4.7% in the United States and to 2.6% in the euro area. Japanese consumer prices started increasing at the beginning of 2006, when the year-on-year price growth reached 0.5%. Contrary to general inflation, the faster price growth was not reflected in core inflation, which does not include oil prices. Rather, core inflation slowed down in the United States and the euro area. For 2006 and 2007 a slight fall in inflation is expected, though it might not materialize if the rapid price increase of oil and other commodities continues.

In view of long-term stability of economic growth and the need to curb inflation, several central banks increased their key interest rates. Most probably, monetary policy stimuli will be reduced and the key interest rates will be raised further.

Table 2.1. Global economic forecasts

	GDP growth (%)		Inflation (%)	
	2006	2007	2006	2007
Unites States	3.3	2.9	2.9	2.3
Euro area	2.0	1.8	2.0	2.0
Germany	1.7	1.0	1.6	2.3
France	1.9	2.0	1.7	1.6
Italy	1.2	1.2	2.0	1.9
Finland	3.2	2.7	1.5	1.8
Sweden	3.4	2.7	1.2	1.9
Japan	2.9	2.2	0.4	0.5
Total global economy	3.5	3.1	2.6	2.4

Source: Consensus Forecasts, April 2006

[1] Consensus Forecasts, April 2006.

United States

Economic activity in the United States decreased in the second half of 2005. The annual GDP growth was 3.6% in the third quarter and only 3.2% in the fourth quarter. The growth rates of private consumption, government consumption and investments declined steeply. The contribution of stocks to economic growth increased substantially.

Manufacturing and retail sales indicators confirmed the decline in economic activity. In September, the year-on-year growth of industrial production decreased to 2.0% and in December, retail sales growth fell to 5.8%. However, the data received in the first months of 2006 indicate only a temporary decrease in economic activity: the annual retail sales growth stayed over 7.5% from January to March 2006, and the annual growth of industrial production rose to 3.6% in March. Employment continued to increase fast and unemployment decreased to 4.7% in January and March 2006. Consumer price inflation picked up in September 2005, mainly because of the oil price rise to 4.6%, and dropped then to the range of 3.4–4.0%. A further increase in commodity prices may cause a new inflation rise in 2006.

The government deficit, which reached 3.5% of GDP in the middle of 2004, decreased to 2.7% by the end of 2005. Meanwhile, the current account deficit increased even further: it reached a historical high in the fourth quarter of 2005, exceeding 7% of GDP.

Due to a rise in interest rates, consumer credit growth started to slow down rapidly and initial signs indicated that the real estate market was beginning to cool off.

Japan

Japan's economic growth strengthened in the second half of 2005. Year-on-year GDP growth in the fourth quarter was the highest since the economic downturn (4.0%). Rapid growth continued at the beginning of 2006. The annual growth of industrial production was the strongest of the past 15 months (3.9%) and the annual growth of exports reached the highest level since the past eight and a half years (20.7%). Such fast growth has also decreased unemployment, which declined to its lowest level since seven and a half years in February (4.1%).

As a result of the oil price increase and the acceleration of economic growth, the prolonged deflation in Japan may come to an end. In January and February 2006, the year-on-year consumer price growth was positive (0.4–0.5%) and for the first time after 15 years, the year-on-year growth in land prices also turned positive.

A change in the Japanese monetary policy is worth highlighting. As long-term deflation finally ended, the national central bank decided to terminate the monetary policy that had been strongly favouring economic growth and to decrease monetary growth. Moreover, an increase in the key interest rates is under consideration.

Euro area

Economic growth in the euro area remained stable in the second half of 2005, decreasing slightly quarter-on-quarter, but increasing year-on-year. The twelve-month GDP growth reached 1.6% and 1.8% in the third and fourth quarters, respectively, and it was relatively stable across different countries as well as sectors. Based on the data received during the first months of 2006, economic activity is gaining momentum. Activity indices have increased drastically: the German IFO index rose to its highest level in 15 years and the Eurozone Manufacturing Purchasing Managers' Index (PMI) to its highest in the past five and a half years.

Driven by the oil price surge, consumer price inflation in the euro area boosted up to 2.6% in September 2005, dropping to 2.2% again by March 2006. Core consumer price inflation decreased to 1.2% at the beginning of January and February 2006, which is the lowest level in the past five years. Higher economic activity has brought along a decrease in unemployment: by February 2006 unemployment dropped to its lowest level (8.2%) in the past three and a half years.

Because of the acceleration of economic growth and inflationary pressures, the European Central Bank started to raise the key interest rate. According to the forecast of international financial markets, the key interest rate will be raised another two or three times during 2006.

Nordic countries

Finland's economic activity started to recover in the third quarter of 2005 and picked up even further at the end of the year. The annual economic growth rate stood at 2.1%. In January 2006, it accelerated up to 3.3%. The main driving force behind growth was the increasing domestic demand.

Retail and wholesale volumes have been growing steadily, indicating households' propensity to consume. Last year, retail trade recovered from the low levels recorded at the beginning of the year – the annual growth reached 2.2%.

The recession in the industrial sector deepened even further in the last quarters of 2005 and the production output decreased rapidly across almost all major sectors. Year-on-year, the industrial production decreased 2.8% for the first time in ten years.

In external trade, earlier trends continued at the end of 2005: imports grew faster than exports (15% and 7%, respectively), and the balance surplus decreased to 8.5 billion euros. The average annual inflation rate reached 0.9% in the past year. The consumer price growth stemmed from an increase in liquid fuel prices, but inflation was also affected by growing living costs and rental and restaurant prices. After a slight slowdown in January 2006, inflation accelerated again to 0.9% in February and stayed at the same level in March.

Sweden's economic growth was fast in 2005 – GDP increased 2.7% year-on-year. In the last quarters of 2005, household consumption grew considerably, mainly because the central bank reduced the key interest rate by 50 basis points in June 2005.

Extremely fast retail sales growth towards the end of 2005 (10.7% in December – fastest year-on-year growth in 15 years) testifies to the increased household consumption. Compared to the same period in 2005, in January and February 2006 retail trade grew 7.9% and 7.7%, respectively.

The industrial production increased 1.5% in 2005. The production output of January 2006 exceeded expectations, adding 1.7%, month-on-month. The production output started growing in the middle of 2005 and the annual growth amounted to 5.9%.

In 2005, the Swedish external trade followed similar trends as in Finland: the export growth remained slower than the import growth (4.4% and 7.1%, respectively year-on-year) and the balance surplus decreased to 141 billion Swedish kronas. At the beginning of 2006, however, exports started increasing faster than imports (23% and 18%, respectively year-on-year).

Inflation has remained relatively low in recent years. Towards the end of 2005, the consumer price growth mainly stemmed from the rising electricity prices (caused by higher fuel prices). The inflation rate stood at 0.5%, year-on-year. In February 2006, inflation accelerated to 0.6%, and in March already to 1.1%. In order to protect the economy from inflation, the Swedish Central Bank has increased the key interest rate already twice in 2006 – by 0.25 basis points to 1.75% on January 25, and by another 0.25 basis points to 2.0% on February 22.

Central and Eastern European countries

The **Czech** economic growth accelerated in the final quarters of 2005 and reached 6.0%, year-on-year, which was the highest level in 13 years. Such dynamic growth was stimulated by exports which, for the first time, caused a surplus of 40.36 billion Czech korunas in trade. The annual growth rates of exports and imports stood at 7.7% and 4.6%, respectively. The industrial production increased 5.7% in 2005. The consumer price growth remained low and amounted to 1.6%, year-on-year. At the beginning of 2006, the inflation rate accelerated to 2.8%. The general government deficit was 2.8% of GDP in 2005.

The **Polish** GDP increased well at the end of 2005. The annual economic growth was 3.2%. Consumer prices rose by an average of 2.2%. In January 2006, however, the annual growth rate of inflation slowed down to 0.6%. The Polish Central Bank decreased the key interest rate several times, and in 2006 it reached a historical low. Excessive government deficit (in 2005 it reached 3.4% of GDP) and public sector debt remain the primary challenges for Poland.

Economic growth in **Hungary** slowed down slightly at the end of 2005, but nevertheless reached 4.1%, year-on-year. As in earlier years, growth was mainly stimulated by the exports of goods and services. Last year, the average annual growth rates of exports and imports increased 11% and 6%, respectively. The annual growth in industrial production reached 7.3%. Consumer prices rose by 3.5% in 2005 but in January 2006 inflation slowed down to 2,7%, which is the lowest level since 29 years. The greatest risk factor for the country is the government deficit, which reached 6.1% of GDP in 2005.

Economic growth in **Slovakia** picked up even further in the last quarters of 2005 (by 7.5% in the fourth quarter) and stood at 6%, year-on-year. The industrial production increased 3.8% in a year. The production output was restrained above all by the mining and electronics industry. The annual growth in imports exceeded that of exports (13.7% and 11.5%, respectively) and the external trade deficit reached 76 billion Slovakian korunas. Inflation decreased considerably (to 2.8%) in comparison with 2004 (7.5%).

The **Latvian** economy thrived. While in 2004 economic growth reached 8.5%, in 2005 it totalled 10.2%. Thus, Latvia posted the largest growth in the European Union. According to the Central Statistical Bureau of Latvia, year-on-year growth was the strongest in the second and third quarters: 12.8% and 12.3%, respectively. Latvian economic growth was again stimulated by the services sector: in 2005 the trade volume grew by 16.2%, the volume of transport and communications by 15.9% and that of construction by 15.5%. In this light, the 6.3% annual growth in industrial production remained relatively modest.

The fast growth was mainly driven by wage growth, which also encouraged private consumption. In 2005, Latvian gross wages increased nearly 16.5%, while the wage growth of 2004 was less than 10% compared to the previous year. The main problem for Latvia's economy is the rapid price increase that started in the middle of 2004. Back then prices were mainly driven up by one-off factors related to the EU accession, whereas in 2005 these after-effects were also accompanied by a robust rise in energy prices. As the prices of natural gas are expected to go up in the next few years, a further rise in energy prices is expected as well.

Latvia's external balance deteriorated because of strong domestic demand. While in 2004 the current account deficit formed 10% of GDP, in 2005 it amounted to 15%.

Lithuania's economic growth was somewhat lower compared to other Baltic States. In 2005, the annual GDP growth was 7.5% (7.0% in 2004). Considering the entire European Union, though, Lithuanian economic growth was nevertheless very fast. Just as in Estonia and Latvia, it was driven by stronger goods exports and domestic demand. Although the consumer price growth was slower than in other Baltic States, it accelerated by an additional 3% at the beginning of 2006.

Lithuania's external balance deteriorated due to fast economic growth. All the same, the 7.5% current account deficit in ratio to GDP is the smallest among the Baltic States.

The economy of **Russia** maintained the growth rate of 2004, though the GDP growth declined from 7.2% to 6.4%. At the beginning of 2006, economic growth remained relatively low. For instance, the industrial production increased only 3% in the first quarter.

The rapid consumer price increase continues to be a problem. The 10.8% growth in consumer prices in the first quarter was considerably faster than the government target of 8.5%. On the positive side, after ending the fiscal year 2005 with a 7.5% surplus in ratio to GDP, the Russian federal budget surplus increased to 10.9% in the first quarter of 2006.

The central bank foreign reserves totalled 212 billion dollars in the middle of April, which is five times more than at the beginning of 2003.

International financial and commodity markets

In **foreign exchange markets**, the US dollar exchange rate had no clear trend vis-à-vis other major currencies. The dollar quotations against the euro remained within 1.16–1.23, strengthening by 2.7% during the period. The pound sterling-dollar exchange rate changed little (1.1%). The Japanese yen depreciated by 3.2% against the dollar, because the Japanese Central Bank did not raise the key interest rate despite positive economic indicators (incl. robust economic growth) and therefore the difference between interest rates continued to increase in favour of the dollar.

The dollar exchange rate was affected by controversial factors. The US current account deficit, which rose to 7.1% of GDP in the fourth quarter, had a negative impact, whereas optimistic economic news and an increase in the key interest rate had a positive influence.

As far as other major developments are concerned, the weakening of several currencies with high interest rates (e.g. the Icelandic krona, the New Zealand dollar) should be mentioned. These currencies, having strengthened for a long time due to rising interest rates, started to weaken as economic growth slowed down.

Table 2.2. Changes in exchange rates of major currencies

	30/09/2005	18/04/2006	Change (%)
EUR/USD	1.2026	1.2347	2.7
GBP/USD	1.7643	1.7833	1.1
USD/JPY	113.51	117.13	3.2

Major **stock markets** continued a strong upward trend. Japan's Nikkei 225 index increased the most, which reflected both the optimism accompanying high economic activity as well as the reaction to signs marking the end of a prolonged deflation. The euro area FTSE Eurobloc 300 index also grew considerably (by 10.2%), as the euro area economic growth accelerated. Stock prices increased more modestly in the United States, where the S&P 500 index rose by 6.4%. The growth in US stock prices is inhibited as the Federal Reserve has been raising the key interest rate for some time now. Some investors are also considering the possibility that US economic growth might slow down in the second half of 2006.

Table 2.3. Major stock market indices

	30/09/2005	18/04/2006	Change (%)
USA (S&P 500)	1,228.81	1,307.65	6.4
USA (Nasdaq)	2,151.69	2,356.14	9.5
Japan (Nikkei 225)	13,574.3	17,232.86	27.0
Euro area (FTSE Eurobloc 300)	1,300.85	1,457.94	12.1

Bond markets witnessed an increase in interest rates, since several central banks raised their key interest rates. This arose from high economic activity and the looming inflation threat.

The US Federal Reserve continued decreasing the monetary policy stimuli that favoured economic growth, raising the key interest rate on four occa-

Table 2.4. Changes in yields of major bond markets

	3-month interest rates			10-year interest rates		
	30/09/2005	18/04/2006	Change (basis points)	30/09/2005	18/04/2006	Change (basis points)
USA	3.55	4.72	117	4.33	4.99	66
Japan	0.002	0.049	4.7	1.48	1.96	48
Euro area	2.17	2.69	52	3.15	3.95	80

sions (by 100 basis points to 4.75%). Another North American central bank, the Central Bank of Canada, also raised the key interest rate to the same extent.

As to the euro area, the European Central Bank started to tighten the monetary policy at the end of 2005, raising the key interest rate in December and March by a total of 50 basis points, i.e. to 2.5%. Of other European central banks, also the central banks of Sweden and Norway increased the key interest rate to the same extent (2.0% and 2.5%, respectively). In addition, a change in Japanese monetary policy should be mentioned: the central bank decided to decrease monetary growth. Ten-year interest rates increased by 66 basis points in the United States, 80 basis points in the euro area, and 48 basis points in Japan.

Commodity markets witnessed a new hike in the last quarter of 2005 and the first quarter of 2006. The CRB index, which covers the prices of major commodities, increased 7.8%, having fluctuated only within a narrow range for nearly two years. The increase in commodity prices could be explained by the acceleration of economic growth, which has entailed an increased demand for the main commodities. The oil price was extremely volatile: at the end of last year, it dropped to 55 dollars but rose to 70 dollars per barrel (by nearly 7.7%) in the middle of April. The price of gold rose by 32% from 469 dollars to over 600 dollars per ounce. Unlike in previous years, the main reason for the rapid rise in gold prices was not the weakening of the dollar but rather the increased inflation risk in advanced economies and the general hike in metal prices (the CRB index of metal prices increased over 50%).

Table 2.5. Changes in commodity markets

	30/09/2005	18/04/2006	Change (%)
CRB index	294.61	319.28	8.4
Crude oil (WTI; USD/barrel)	66.24	71.35	7.7
Gold (USD/ounce)	469.30	621.07	32.3

ESTONIAN ECONOMY

Estonian economic growth gained momentum in the second half of 2005 in light of the improving external environment and domestic demand. The real GDP growth exceeded 10% at year-end and continued rising rapidly also at the beginning of 2006.

Contrary to expectations, merchandise exports increased considerably while the export growth of services remained modest. Domestic demand was stimulated by investment growth, especially in residential construction. Increasing incomes also led to the growth of household savings, which entailed a moderate external balance improvement. Just as earlier, the general government budget surplus played a key role here.

Domestic demand

Domestic demand increased faster than incomes in the second half of 2005. Meanwhile, the growth of private consumption, general government final consumption and investments accelerated (see Figure 2.1).

The rapid increase in domestic demand continued in the first months of 2006. The strengthening consumer confidence and the acceleration of retail growth from 11.0% in the fourth quarter to 16.5% in January-February implied the growth of private consumption. The latter was also fostered by the increased household income and rapid loan growth. At the beginning of this year, also investment activity remained high and the estimates of the construction companies on the economic situation improved even further.

Investment

Most surveys on the convergence of income levels admit that economic growth and capital investment are closely related. Also in Estonia, the convergence of income levels with those of advanced economies requires above-average fixed investment over decades.

Year 2005 was by no means exceptional in that sense. After a slight downturn, the share of investment at current prices increased again to 32% of GDP in mid-2005. Meanwhile, the share of corporate investment in total investment kept rising, which was very positive. In the second half of 2005, the growth of corporate fixed investment comprised 43% of the total fixed investment growth (31% in the previous half-year). Investment activity picked

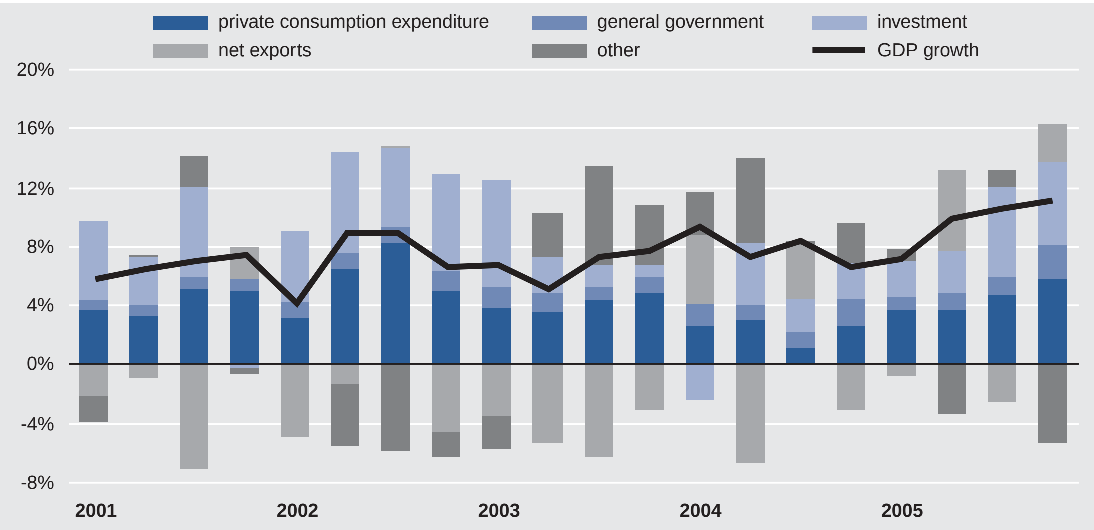

Figure 2.1. Real GDP growth and its components

up in companies dealing with transport, storage and communications, construction and real estate as well as in the public sector.

A further surge in residential construction in the second half of 2005 was stimulated by the increased optimism of households concerning economic growth and the acceleration of income growth. On top of that, the maturities of new housing loans were extended.

The favourable economic outlook facilitated the investment activity also at the beginning of 2006. In addition to residential construction projects, extensive general government investment, part of which were EU funded, contributed to general investment growth.

Private consumption

Private consumption increased in the second half of 2005 and caused a modest rise in the imports of consumer goods. Consumption was stimulated by faster growth in average wages and improved employment. In the second half-year, the average gross monthly wages increased 11.8%; the growth in nominal net wages again exceeded the 14% level. The fast rise of an average pension was even more remarkable: from 8.5% in the first half-year to 18.3% in the second half. Nevertheless, the pension level is still relatively low, comprising approximately one third of the average gross monthly wages. In April 2006, retirement pensions grew nearly 20%, which marks the completion of government's programme to increase pensions in addition to the indexation system.

All in all, both private and government consumption grew slower than incomes, and this contributed to the improvement of macro-economic balance.

General government

Dynamic growth brought about rapid growth in general government revenue and better than expected revenue from taxation. Despite the cost-enhancing supplementary budget, the surplus of general government budget formed 1.6% of GDP in 2005. Revenue exceeded expenditure for the fifth consecutive year. Given the acceleration of economic growth, the surplus should be substantially greater than in 2004 when it amounted to 1.5% (see Figure 2.2).

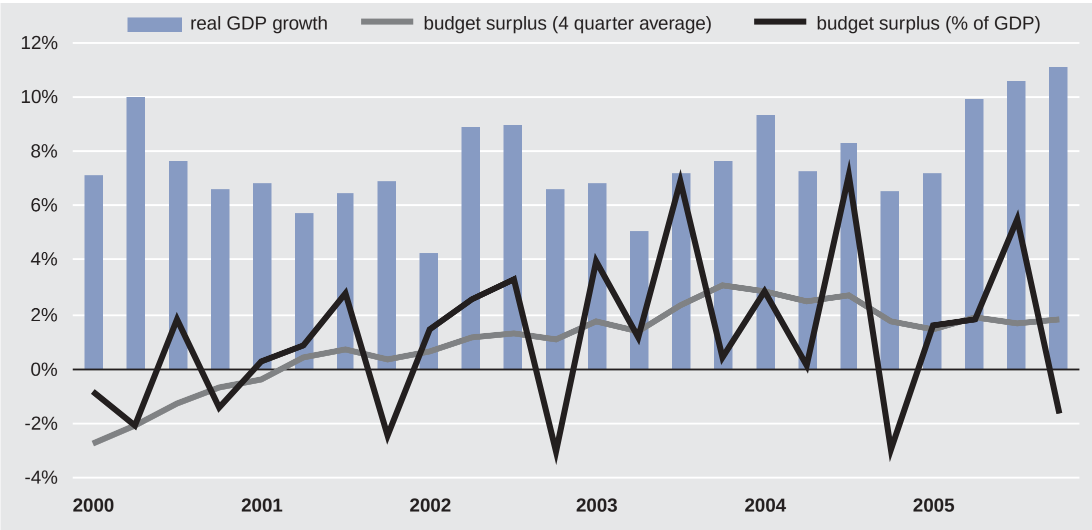

Figure 2.2. Real GDP growth and consolidated budget balance (% of GDP)

Despite strong investment growth the general government expenditure in ratio to GDP decreased slightly.

In the near future, the government intends to go on with the programme encompassing both the reduction of the income tax as well as imposing higher consumption taxes. The plan to reduce personal and corporate income tax rates is more well-defined. The tax reduction began in January 2005 when the tax rate was decreased by two per cent. As taxes on consumption, which were raised simultaneously with acceding to the European Union, also increased the tax revenues in 2005, the general tax burden remained virtually at the level of 2004. The tax reduction continued at the beginning of 2006 when the income tax rate was reduced from 24% to 23% and the basic exemption was raised to 2,000 kroons per month. Nevertheless, this will probably not decrease the tax burden considerably in 2006 either. The current tax level is maintained through an increase in the minimum rate of social and environmental taxes, and the expected acceleration of wage growth.

The increase in expenditure has been planned on the basis of a relatively modest growth outlook and the consolidated budget surplus for 2006 is likely to be 1.2% in ratio to GDP. This forecast is supported by the successful collection of tax revenue characteristic of the beginning of the year. Compared to earlier years, however, the fiscal policy is currently somewhat looser.

Domestic supply

Industrial development

Stimulated by good export opportunities and strong domestic demand, growth in the output and sales of the export sector as well as manufacturing companies targeting the domestic market picked up in the second half of 2005 (see Figure 2.3).

Contrary to expectations, the Estonian goods export growth gained momentum. The increase in exports, which exceeded 30% already in the second and third quarters, accelerated even further in the fourth quarter. Compared to the imports of Estonia's major trade partners, the export growth was extremely rapid in 2005, meaning that the market position of Estonian companies improved even further.

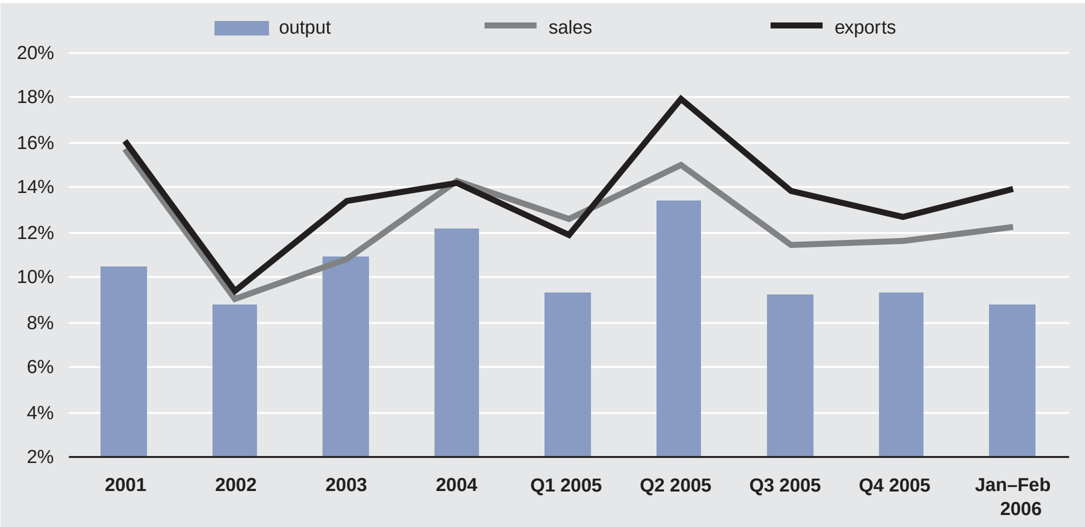

Figure 2.3. Growth in the output, sales and exports of manufacturing

Thanks to strong external demand, the industrial production and sales growth increased to 13.5% towards the end of the year. Moreover, the higher domestic demand boosted sales. The timber, food, chemistry and electric machinery industries made a substantial contribution. Higher sales volumes of textile and furniture products contributed as well.

According to the GDP statistics, the growth rate in the value added in manufacturing reached 13.1% at constant prices in the second half of the year (see Table 2.6).

The situation remained favourable also at the beginning of 2006. The industrial confidence indicator calculated by the Estonian Institute of Economic Research was relatively strong in the first quarter of 2006, though it did not substantially exceed last year's estimates. Meanwhile, the output estimates for future periods remained positive.

Services and other sectors

The interest rate environment remained favourable, contributing to sustained extensive demand for real estate development and related construction services. The annual growth of the value added in the construction sector accelerated up to 17.6% at constant prices in the second half of 2005. Its share in the GDP structure rose to 6.7%. According to the estimates of the Estonian Institute of Economic Research, the confidence in the construction market will remain exceptionally favourable also in 2006 and the majority of companies expect a rise in workload during the following months.

Economic growth was also stimulated by hotels and restaurants, financial intermediation and trading companies, where the growth of value added reached 20% or even more at constant prices (see Table 2.6). The increased household income as well as the rising number of foreign tourists fostered the rapid development of companies. Towards the end of the year, only three fields of activity fuelled economic growth, namely real estate, financial intermediation, and wholesale and retail trade.

Employment

Strong domestic demand and investment activity also reflected in the labour market in the second half of 2005. The demand for labour increased in

Table 2.6. GDP growth by sectors (%)

	2003	2004	2005
Agriculture and hunting	2.0	6.2	-1.9
Forestry	-7.5	-4.7	-7.2
Fishery	-34.4	-3.8	-3.3
Mining and quarrying	10.3	-7.5	6.0
Manufacturing	10.5	10.7	11.9
Electricity, gas and water supply	9.1	1.3	4.4
Construction	6.3	10.5	13.2
Wholesale and retail trade	9.2	5.4	11.8
Hotels and restaurants	5.1	14.1	19.7
Transport, storage and communications	9.4	7.2	9.9
Real estate, renting and business activities	1.5	5.5	5.2
Financial intermediation	20.7	29.3	26.6
Public administration and defence; statutory social insurance	2.4	0.1	2.7
Education	0.6	1.4	1.3
Health and social care	-3.4	5.0	2.8
Other services	2.5	7.1	9.7
Total GDP	**6.7**	**7.8**	**9.3**

domestic demand oriented fields of activity, including construction and trade. All major labour market indicators improved with the creation of new jobs (see Figure 2.4).

Thus, the **employment growth reached 2.3% at the end of 2005** and the number of the employed rose by 13,600 persons, compared to the fourth quarter of 2004. Whereas during the first three quarters of 2005 employment increased thanks to the declining number of the unemployed, later the labour participation rate started to rise and the unemployment rate stopped decreasing. The number of jobs grew mainly in the services sector. In manufacturing the number of the employed remained at the previous year's level.

By fields of activity, rapid employment growth continued in the sectors of hotels and restaurants (34.3%), real estate, renting and business activities (22.3%), and construction (9.1%).

In the last quarter of 2005, the number of the unemployed amounted to 46,500, which is 17% less than in the previous year. The annual unemployment rate reached 7.0%. Unemployment decreased among the short-term as well as the long-term unemployed. Only the number of persons unemployed for less than six months increased, probably due to the economically inactive returning to the labour market. The number of persons unemployed for over 12 months declined by 27.4% – slightly faster than in the previous two quarters.

Regionally, the labour market varied quite significantly. The employment growth was the fastest in Ida-Virumaa – 14% compared to the fourth quarter of 2004. Meanwhile, the number of the unemployed also increased 14% and the rate of the economically inactive decreased 20%. In Northern Estonia the employment rate remained virtually unchanged, decreasing 0.8% in Tallinn and increasing 4.3% in Harjumaa, while unemployment declined and economic inactivity increased slightly.

As to the reasons for economic inactivity, the number of the discouraged and people inactive due to retirement or attending to children or other family members decreased. Though in recent years the number of the discouraged has ranged from 15,000 to 21,000 despite declining unemployment, it decreased to 10,000 at the end of 2005.

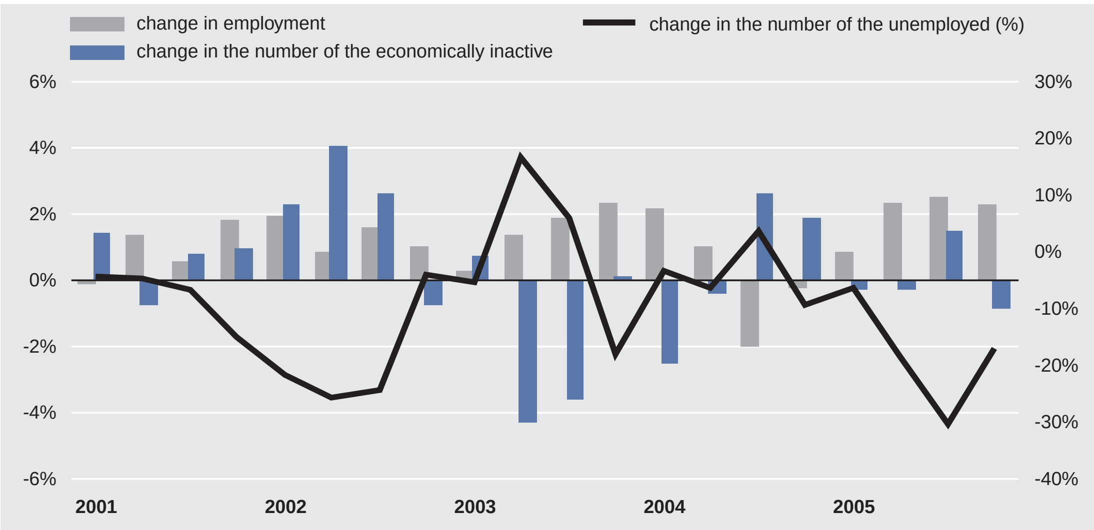

Figure 2.4. Key labour market indicators

The number of the registered unemployed fell also in the first quarter of 2006 by 32%, year-on-year. This number has been decreasing fast since the middle of 2005. At the beginning of April 2006, it fell below 20,000 for the first time, amounting to 2.3% of the working age population.

Although towards the end of 2005 additional labour resources supported economic growth, the contribution of labour productivity was more substantial. The situation common to structural unemployment partly persists in some areas, which lack labour force concurrently.

External balance

2005 was relatively favourable for Estonia in terms of external demand. By the end of the year, the deficit of goods and services decreased to 6.3% of GDP. Economic growth was boosted by the exports of goods, whereas domestic demand grew as well. Consequently, export revenues still remained insufficient for financing the domestic demand. Increased household savings were mainly channelled to investment and therefore the current account deficit did not decrease considerably. In annual terms, the current account deficit diminished to 10.5% of GDP (see Figure 2.5).

The structure of capital inflow remained unchanged. The acquisition of the shares of Hansapank was an exception here. This deal reflected in a decrease in portfolio investment and an increase in direct investment. Due to the takeover of Hansapank the positive balance of direct investment rose to a record high level. Excluding the takeover of Hansapank, foreign direct investment in Estonia amounted to 7.9 billion kroons, which can be considered even less than the long-term average.

Excluding the takeover of Hansapank, foreign direct investment largely consisted of reinvested earnings. Virtually all direct investment originated from the European Union.

As direct investment did not cover the shortage of financing, Estonian external liabilities increased by nearly a third in a year and stood at 148.2 billion kroons at the end of 2005 (90% in ratio to GDP). Estonia's net external debt (external assets less liabilities) comprised 19.8% in ratio to GDP.

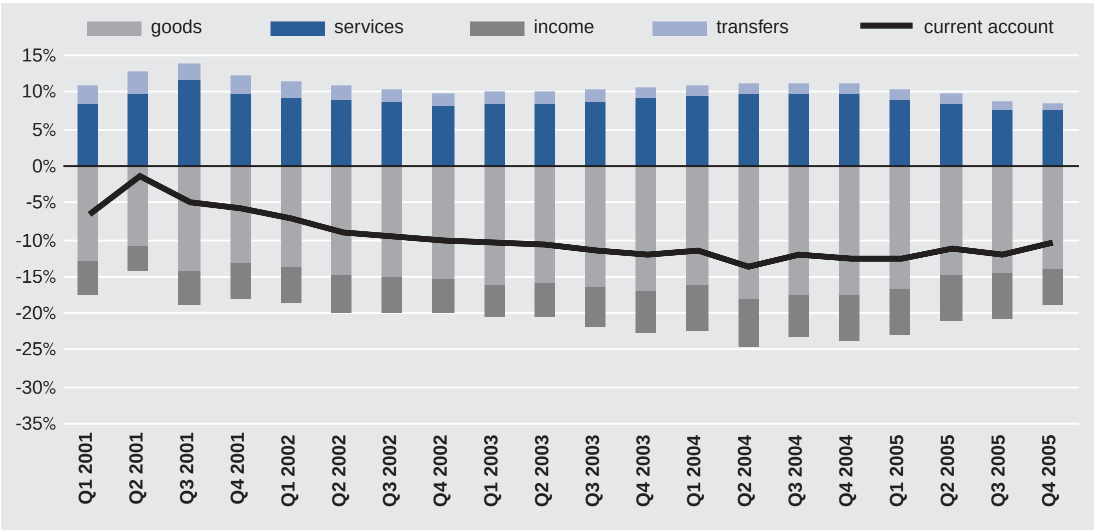

Figure 2.5. Balance of current account and its components (% of GDP)