II ECONOMIC DEVELOPMENTS

EXTERNAL ENVIRONMENT

General background

In the first half of 2006, **global economic growth** followed the trend. The annual GDP growth indicators of the first and second quarter remained at the same level as in 2005 in the United States, the euro area as well as in Japan. However, in the second quarter minor variations could be perceived in the economic activity of different regions: while the euro area economic growth accelerated compared to the first quarter, growth in the United States and Japan slowed down. Based on economic data for the third quarter, similar trends (the persistence of a relatively high economic growth rate in the euro area and a decline in the United States and Japan) should continue also in the second half-year. According to Consensus Forecasts, in 2006 global economic growth should be 0.4 percentage points faster than in 2005 (3.4%; see Table 2.1). In 2007, global economic growth is expected to slow down to 3.2%.

Headline inflation indices in major economic areas remained generally in line with oil price changes: price growth accelerated until the end of the second quarter and declined in the third quarter. The annual growth of consumer prices in the United States reached 4.3% in July, dropping to 3.8% in August. In the euro area, it remained at the level of 2.5% from April to June and shrunk to 1.7% by September. In the third quarter, core price indices excluding the prices of energy and food did not react to the oil price decline yet and at times even rose to their highest level in recent years: to 2.8% in August in the United States (the highest in ten years) and to 1.5% in September in the euro area (the highest level of the past year). According to Consensus Forecasts, inflation should reach its peak in 2006 and after that price growth is expected to slow down.

As inflation picked up, the increase in key interest rates also continued in the first half of 2006. Key interest rates were raised by the central banks of the United States, euro area, Canada, Australia, Sweden, Norway and England; the zero interest rate policy enforced by the Japanese central bank so far was also ended. In the third quarter, US trends took a different turn: as economic activity and inflation decreased, the upward cycle of the key interest rate halted at 5.25%.

Table 2.1. Global economic forecasts

	GDP growth (%)		Inflation (%)	
	2006	2007	2006	2007
Unites States	3.4	2.6	3.5	2.5
Euro area	2.6	1.9	2.3	2.2
Germany	2.2	1.2	1.8	2.3
France	2.3	2.0	1.9	1.6
Italy	1.6	1.2	2.2	1.9
Finland	4.0	2.7	3.3	3.0
Sweden	4.2	3.0	1.5	2.0
Japan	2.8	2.2	0.3	0.5
Total global economy	3.8	3.2	2.7	2.5

Source: Consensus Forecasts, October 2006

[1] Monthly activity index published by the National Association of Home Builders, which reports on developments in the residential market.

United States

The US economic growth (measured as the annual GDP growth rate) stood at 3.7% in the first quarter of 2006 (the fastest in the past year and a half) and at 3.5% in the second quarter. At the end of the second quarter and in the third quarter, however, signs of weakening economic activity appeared. The fastest decline in activity was experienced by the real estate sector, where the NAHB[1] activity index, which had reached its highest level of the past six years in last year's July, dropped to its lowest level of 15 years within 15 months (by September 2006). A similar steep fall (from the record high of recent years in the second half of 2005 to the lowest level in the past years by the third quarter of 2006) was also experienced by other time series reflecting the activity of the real estate market: the number of construction permits issued, new residential constructions commenced and loan applications, and the sales data on used and new houses. However, hope remains that in the near future this rapid decrease will not spread to other US economic sectors and that the decline in economic growth will stop at the annual GDP growth rate of 2.5–3.0%.

Unemployment remained low in 2006, ranging between 4.6–4.8%. Stimulated by rising oil prices, the inflation of consumer prices increased in the first and second quarter, reaching 4.3% in June. The decrease in oil prices and economic activity in the third quarter also reduced the annual growth of the consumer price index (CPI), which dropped to 3.8% in August. Meanwhile, the core inflation (excluding energy and food prices) followed an upward trend from April to August and reached its highest level in ten years (2.8%).

The US budget deficit was 248 billion dollars in the fiscal year of 2005/2006[2], which is the lowest level in three years. The current account deficit remained the same also in the first half of 2006, amounting to 6.6% of GDP in the first as well as the second quarter.

Due to the inflation rise, the US Federal Reserve continued increasing the key interest rate in the first and second quarter up to 5.25%. In the third quarter, the Federal Reserve decided to stop raising the key interest rate in view of the decreased inflation and economic activity.

Japan

Economic growth in Japan reached 3.6% in the first quarter and 2.5% in the second quarter of 2006. The strongest sector was manufacturing: by August, the annual growth of industrial production rose to 5.9%, which is the fastest growth rate in the past two years. In the first and second quarter, also industrial orders experienced very strong growth (12.2% and 17.7%). Meanwhile, retail sales remained weak with the annual growth ranging from -0.8–1.1% from April to August. Various activity indices remained stable also in the second and third quarter without any particular trend.

Japanese inflation data indicated a decisive end to the deflation period. The annual growth of consumer prices rose to 0.9% in August and, unlike other major economic regions, the inflation-reducing impact of dropping oil prices did not manifest itself in August's data yet. The annual growth of the core CPI rose to its highest level in eight years (0.3%) and also the GDP deflator decrease rate is slowing down (-0.8% in the second quarter). In May, unemployment in Japan dropped to the lowest level of eight years (4.0%) and stayed close to that level until August.

As economic growth remained in line with the trend and inflation recovered, the Japanese central bank

[2] In the United States the fiscal year lasts from October until September.

terminated the zero interest policy that had lasted for several years: in August, the key interest rate was raised to 0.25%.

Euro area

Unlike the United States and Japan, the euro area economic growth accelerated both in the first and second quarter of 2006, year-on-year. According to preliminary data for the third quarter, economic growth remains relatively fast also in the second half-year. The year-on-year GDP growth was 2.2% in the first and 2.7% in the second quarter (the fastest in the past five years). As regards GDP components, investments increased most rapidly (3.7% in the first and 4.6% in the second quarter). The contribution of other components (private consumption, general government and net exports) was also positive. In the third quarter, the annual growth of industrial production accelerated to its highest level since the past six and a half years (5.4%) and also the annual retail sales growth was the greatest of the past 12 months (2.4%) in August.

Mainly owing to the oil price increase, the annual growth of euro area consumer prices stayed at 2.5% level from April to June, but decreased to 1.7% in September after the oil price declined. Core inflation remained stable throughout that period, ranging within 1.3–1.5%. Unemployment declined even further during the first three quarters of 2006, reaching its lowest level since decades in July (7.8%). The euro area current account was negative in the first and second quarter, amounting to 0.8% and 0.7% of GDP, respectively.

Due to higher economic activity and inflation, the euro area key interest rate kept increasing. From July to September, the European Central Bank (ECB) raised the key interest rate on two occasions up to 3.0%. According to market expectations, the raising of key interest rates in the euro area should continue at least over the next half-year[3].

Nordic countries

Finland's gross domestic product growth reached 5.9% in the first half of 2006. According to the forecast of the Finnish central bank, the year-on-year growth of 2006 will reach 3.4%. The rapid growth witnessed in the first half-year was partly influenced by the low comparison basis with last year's summer, when the paper industry conducted a massive strike. As a result, the growth of manufacturing also reached nearly 10% in the first half-year. What is remarkable, however, is the export growth in the first half-year: it exceeded 12% and the year-on-year growth is expected to amount to 7%. Private consumption and investments have also increased dynamically. Despite strong economic growth, inflation has not accelerated considerably. The Harmonised Index of Consumer Prices (HICP) stood at 1.3% in August. Inflation was mainly affected by the fuel price rise but also by the increase in housing costs and food prices. At the same time, entertainment electronics and phone call prices dropped.

Sweden's gross domestic product growth stood at 5.5% in the first and 3.5% in the second quarter. In the first quarter, economic growth was boosted by a dynamic increase in exports as well as investments (14% and 12%, respectively). In the second quarter, private consumption grew considerably, whereas export growth decelerated sharply (growth amounted to only 6.6%, year-on-year). Unemployment has decreased remarkably. In the second quarter, inflation accelerated to 1.9% but has been slowing down again since the third quarter. HICP reached 1.6% in August. Similarly to Finland, inflation in Sweden is also mainly affected by fuel and energy prices and housing costs. This year, the Swedish central bank has raised the key interest

[3] At the beginning of October, the ECB raised the key interest rate again, namely to 3.25%.

rate by 0.25 basis points on four occasions, i.e. to 2.5%.

Central and Eastern European countries

Latvian economic growth has been extremely fast, exceeding 10% since the second quarter of last year. In the first half of 2006, growth amounted to 12% and was mostly influenced by strong private consumption, but also by the rapid development of the construction and real estate sectors. The growth of manufacturing and exports has slowed down slightly. The latter has brought about a growing foreign trade deficit and a record high current account deficit, which reached 17.9% in the second quarter. Unemployment has decreased to 7.2% (8.1% in the second quarter of 2005). Inflation remained at 7% level in the first half-year. This resulted from the increase in fuel prices, housing costs and food prices. In August, HICP stood at 6.8%, being higher year-on-year.

Economic growth in **Lithuania** has remained relatively stable at 8.5% level since the second quarter of 2005. Unlike Latvia, manufacturing in Lithuania experienced strong growth in the first half-year, amounting to 10–15%. Export and import growth has also been very dynamic. The external balance deteriorated in the first half of 2006, year-on-year. Unemployment, which stood at 8.5% in the second quarter of 2005, decreased rapidly to 5.6% by the second quarter of this year. HICP growth picked up speed in the second quarter and exceeded 3% in July and August (3.2% and 3.4%, respectively).

The economic outlook of the **Czech Republic** for 2006 still remains positive. According to forecasts, in 2006 the gross domestic product should increase 6%, year-on-year. After reaching 7.1% in the first quarter (the highest since 1995), economic growth slowed down again to 6.2% in the second quarter. Growth was mainly driven by the industrial sector (annual growth amounted to 11.9% in the first half-year), exports and household consumption. Inflation has remained close to the goal of 3% set by the central bank. HICP increased 2.3% in June. In the first half-year, the external trade surplus shrunk to 1.3 billion euros (1.4 billion in 2005). The year-on-year export and import growth amounted to 12.9% and 13.8%, respectively.

The **Polish** gross domestic product increased 5.2% within the first six months of the year (3.2% in 2005). The total economic growth of 2006 is expected to reach up to 5.5% underpinned by the increase in private consumption and investments. Inflation in Poland is accelerating but still remains low: the consumer price growth of 0.6% in January accelerated to 1.1% in July. HICP reached 1.5% in June. In the first half-year, the foreign trade deficit amounted to a total of 4.4 million euros. Year-on-year, exports and imports have grown 23.1% and 20.8%, respectively.

In **Hungary**, the year-on-year economic growth slowed down to 3.8% in the second quarter; the first half-year's growth amounted to 4.2%. The main growth factors included the strong industrial sector (the first half-year's growth reached 10%) and exports. The overall economic growth of 2006 is estimated at 3.9%. Within the first six months, inflation accelerated to 2.8% mainly because of higher food and fuel prices. HICP growth reached 2.9% in June. The total foreign trade deficit of the first half-year stood at 1.1 billion euros. Within the same timeframe, the year-on-year increase in exports and imports reached 16% and 15%, respectively. The excessive budget deficit remains the greatest challenge for the country. This year, it will amount to almost 10% of GDP, whereas by 2009 the government plans to reduce it to 3.2%.

Economic growth in **Slovakia** remained robust also at the beginning of 2006. In the first quarter, growth reached 6.3% and accelerated to 6.7% in the second quarter. The overall half-year growth was 6.5%. Its rapid pace was stimulated by domestic as well as external demand, but also by industrial production (which increased 9.3% within six months).

During the first six months, the foreign trade deficit increased to 1.2 billion euros. The year-on-year growth in exports and imports amounted to 23.1% and 24.5%, respectively. Inflation has accelerated by an average of 4.5% within the first six months of the year. HICP also reached 4.5% in June.

Russia

The economic outlook for **Russia** continues to be good. Year-on-year, the gross domestic product increased 5.5% and 7.4% in the first and second quarter, respectively. This partly resulted from the growing services sector and the price rise of the country's key export article, namely crude oil. The economic growth of the first half-year amounted to a total of 6.3%. The industrial sector has also remained strong, having grown 4.4% in the first half-year. Within the first six months of 2006, household income has increased 11.1% and wages 12.1%. Due to the revenues from the exports of oil and minerals, the real exchange rate of the rouble appreciated by 6.6% by June. As inflation slowed down in June, the central bank reduced the key interest rate to 11.5%. The increase in consumer prices reached 6.6% in the first half-year.

Table 2.2. Key economic indicators of Central and Eastern European countries and Russia

	2005	2006*	2007*
Real GDP growth			
Finland	3.3	3.2	3.4
Sweden	2.9	2.5	2.5
Latvia	10.2	11.0	9.0
Lithuania	7.5	6.8	6.5
Poland	3.4	4.9	4.5
Czech Republic	6.1	6.0	4.7
Hungary	4.1	4.5	3.5
Slovakia	6.1	6.4	7.0
Russia	6.4	6.5	6.2
Inflation			
Finland	0.8	1.1	1.3
Sweden	0.8	1.5	1.8
Latvia	6.8	6.6	6.3
Lithuania	2.7	3.6	3.3
Poland	2.1	0.8	2.0
Czech Republic	1.8	2.9	3.3
Hungary	3.6	3.5	5.8
Slovakia	2.7	4.5	3.3
Russia	12.6	9.6	8.5

*IMF forecast
Source: IMF World Economic Outlook, August 2006

International financial and commodity markets

In **foreign exchange markets**, the US dollar depreciated against most major currencies in the given period, with the exception of the Japanese yen (see Table 2.3). The euro appreciated against the dollar by 4.6% and the pound sterling by 7.8%. The dollar depreciated largely as a result of the slowdown in the US economic growth and the entailing decrease in the interest rate spread. The exchange rate of the yen also appreciated in April and May, but altogether changed very little. The underlying reason for the yen's relatively weak result was still Japan's low key interest rate, which is why the yen continued to be used as a loan currency.

Table 2.3. Changes in the exchange rates of major currencies

	31/03/2006	30/09/2006	Change (%)
USD/JPY	117.78	118.18	0.3
EUR/USD	1.2118	1.2674	4.6
GBP/USD	1.7372	1.8723	7.8

In major **stock markets**, the most significant event was the extensive sales pressure in May and June, which is why stock prices decreased considerably. This was affected by the rise in monetary policy interest rates in advanced economies, complemented by the prospect of the US growth slowing down and the threat arising from inflationary pressures that the US Federal Reserve might raise the key interest rate more than expected. From the middle of June, stock prices started rising again and in some regions reached their previous levels by the third quarter. Thus, the ultimate result of the two quarters was different: the US S&P 500 index rose by 3.2%

and the FTSE Eurobloc 300 index by 1.5% in the given period, whereas the Nasdaq Composite Index decreased 3.5% and Japan's Nikkei 225 index 5.5% (see Table 2.4).

Table 2.4. Major stock market indices

	31/03/2006	30/09/2006	Change (%)
USA (S&P 500)	1,294.83	1,335.85	3.2
USA (Nasdaq)	2,258.43	2,339.79	-3.5
Japan (Nikkei 225)	16,127.58	17,059.66	-5.5
Euro area (FTSE Eurobloc 300)	1,508.1	1,486.26	1.5

Bond market development was supported by relatively high economic activity, though a slight slowdown could also be denoted (primarily in the United States). Therefore, major central banks tightened their monetary policy even further. Key interest rates were raised twice by the central banks of the United States, euro area, Canada, Australia, Sweden and Norway (by 25 basis points on both occasions). The Bank of England and the Japanese central bank raised key interest rates once. This step taken by the Japanese central bank also meant abandoning the former zero interest rate policy, as the long-term deflation period reached its end. Thus, short-term interest rates increased in all G3 countries (in the US by 27, in the euro area by 65 and in Japan by 27 basis points; see Table 2.5). Long-term interest rates rose from April to July but started to shrink then because of the combined effects of decreasing inflationary risks and decelerating economic growth. In conclusion, their increase in G3 markets remained relatively small (6–10 basis points).

Prices in **commodity markets** fluctuated up and down. At the beginning of the period, the upward trend of the oil price remained in the limelight, while the price of gold also rose. The latter peaked in the middle of May, whereas the oil price reached its highest level in August. Later, however, the upward trend turned. All in all, price rise prevailed: the CRB index reflecting the prices of 22 major raw materials rose by 10%, oil by 5.6% and gold by 2.5% (see Table 2.6). The stabilisation of raw material prices (mainly oil and gold) was supported by the outlook for a slowdown in global economic growth, which reduced the demand for raw materials. The price drop was also fostered by the decrease in speculative purchases that had been stimulated by the earlier upward trend.

Table 2.5. Changes in yields in major bond markets

	3-month interest rates			10-year interest rates		
	31/03/2006	30/09/2006	Change (basis points)	31/03/2006	30/09/2006	Change (basis points)
USA	4.61	4.88	27	4.85	4.76	-13
Japan	0.09	0.35	26	1.78	1.68	-10
Euro area	2.72	3.36	65	3.77	3.71	-6

Table 2.6. Changes in commodity markets

	31/03/2006	30/09/2006	Change (%)
CRB index	312.98	344.71	10.1
Crude oil (WTI; USD/barrel)	62.91	66.63	5.6
Gold (USD/ounce)	598.3	598.30	2.5

ESTONIAN ECONOMY

Estonia's economy continued growing fast in the first half of 2006. According to preliminary data, real GDP growth amounted to 11.7%.

Further rapid economic development did not, however, entail an improvement in the external or internal balance, i.e. the current account deficit did not decrease, nor did the inflation rate slow down.

Compared to the first months of the year, economic growth remained slightly more balanced in the second quarter and the difference between the growth rates of domestic demand and GDP shrunk both in nominal as well as real terms. Unfortunately, this was primarily a seasonal adjustment and compared to last year, only government savings increased notably.

Domestic demand

In the first half of 2006, domestic demand grew faster at constant prices than the economy as a whole. Private consumption increased most intensely, whereas growth in the general government final consumption expenditure picked up only slightly and the growth rate of investments even remained slow in view of last year's acceleration (see Figure 2.1).

Several indicators show that the growth of domestic demand remained fast also in the initial months of the third quarter. This development was stimulated by the persistently strong confidence of residents and the rapid increase in income. Investment activity remained high and the estimates of manufacturing, retail trade and construction companies on the economic situation once again improved. As usual, also general government expenditure started rising faster in autumn.

Investment

Investment activity remained high in the first half of 2006. For instance in the second quarter, investments together with stock building comprised 36.7% of the nominal GDP. Considering the aforementioned decrease in the real investment growth, it can be concluded that investments appreciated significantly. This also explains why the deceleration of real growth did not entail an improvement in the external balance. The main contributors to fixed investment growth were still private companies.

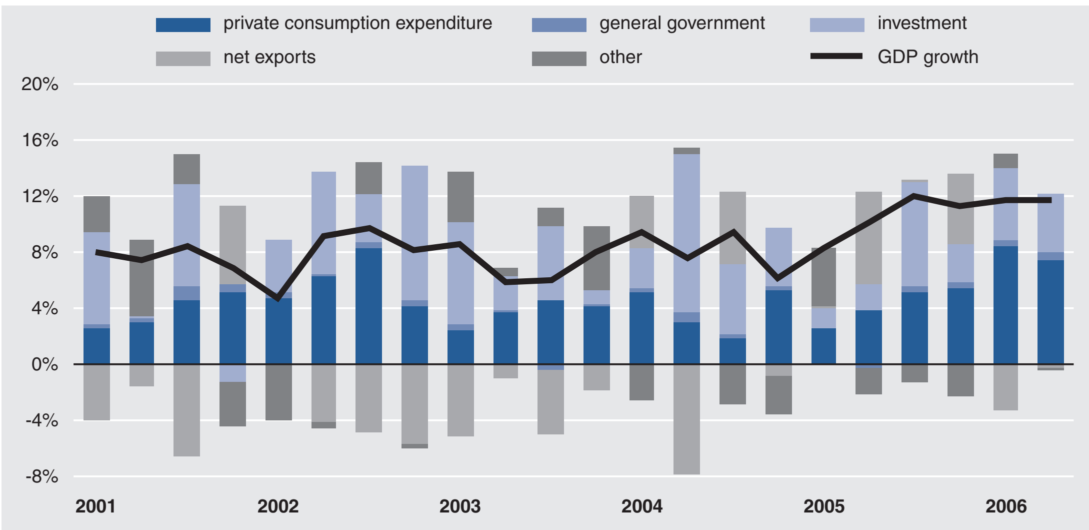

Figure 2.1. Real GDP growth and its components

According to the statistics of major enterprises, which does not include all companies, investment activity varied by fields of activity. The growth rates of manufacturing, trade, hotels and restaurants decreased, whereas the growth of investments in the areas of energy, gas and water supply as well as transport, storage and communications picked up. Residential construction projects remained popular investment targets, and their share in the capital investment structure increased at the previous pace. Also the general government made large capital investments, some of which were financed by foreign funding.

Private consumption

In the first half of 2006, the real growth of private consumption was faster than in earlier years and also exceeded GDP's growth rate. In the second quarter, the volume of private consumption increased 14.6% at constant prices compared to last year.

Besides the robust increase in bank loans, the growth of private consumption was also fostered by extremely rapid wage growth, faster employment growth, one-off additional pension increases and curbed income tax rates. Although in the second quarter, wages and employment increased slightly less than in the first quarter, the extent and persistence of growth may have influenced the behaviour of economic agents even more than earlier.

The third quarter probably witnessed the continuation of similar developments. According to the Estonian Institute of Economic Research, in September 2006 the consumer confidence indicator was 19 points higher, year-on-year. Increased wage expectations were confirmed both in the course of budget negotiations as well as by the demands of trade unions and statements of politicians. In July and August, the retail sales growth rate remained close to the level of the second quarter (23.3% at current prices, 18.4% at constant prices), which also refers to further rapid growth of private consumption. Moreover, also foreign trade data confirmed the persistence of strong domestic demand.

General government

The extremely strong economic growth also guaranteed the rapid growth of general government revenue and the collection of most taxes exceeded expectations. By the end of September, the State Treasury had collected more than 80% of the revenues for the central government budget. Compared to the first nine months of the previous year, the revenues grew by an average of 18.4% and exceeded expenditure by 5.7 billion kroons.

In September, the Government approved the draft supplementary budget of 2006 with revenue amounting to 5.519 and expenditure to 3.216 billion kroons. The Government decided to channel the surplus into the pension fund. According to conservative forecasts, the general government surplus will amount to 1.7% of GDP, year-on-year (see Figure 2.2).

At the end of September, the Government also prepared the draft state budget for the next year. A goal was set to achieve at least a 0.5% surplus of GDP. Although such a great surplus has never been attempted before, the goal is not too ambitious in view of the business cycle.

Although the general government continued reducing the income tax rate from 24% to 23% as planned, the overall tax burden remained at the earlier level of 31% of GDP.[4]

[4] See background information "Overall tax burden stable despite the income tax reform" on page 22.

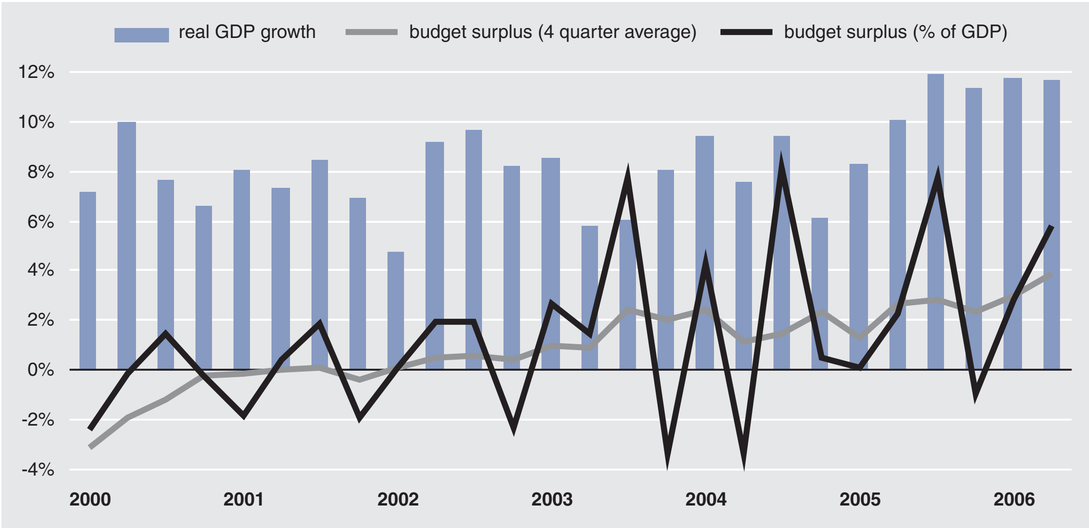

Figure 2.2. Real GDP growth and consolidated budget balance (% of GDP)

Domestic supply

Industrial development

During the past year and a half, external demand has been the primary stimulus for the Estonian economic growth. Compared to the imports of Estonia's main trading partners, export growth was extremely fast and reached over 24% at current prices and 17% at constant prices in the second quarter. This means that the market position of Estonian companies improved even further.

Thanks to the favourable economic situation, the rapid sales growth of the export sector as well as manufacturing companies targeting the domestic market continued in the second quarter (see Figure 2.3).

Based on GDP statistics, in the first half-year the growth of value added in manufacturing amounted to 14% at constant prices (see Table 2.7).

In the second quarter, sales in manufacturing grew more dynamically owing to the increased sales to the domestic market, which accelerated from 11.9% in the first quarter to 15.2%. Growth was largely driven by higher sales of food, timber and clothing as well as construction materials and electrical machinery.

According to preliminary estimates, industrial production continued rapid growth in the third quarter: the confidence of manufacturing companies remained strong in September and exceeded the year-ago indicator by 8 points. At the same time, estimates concerning the volume of export orders improved compared to last year and previous month. Companies were also very satisfied with orders in the domestic market. Lack of qualified labour force and inflation were again highlighted as the main problems. According to the Estonian Institute of Economic Research, the utilisation rate of production capacity remained high, i.e. approximately at the level of 80%, and the investment needs of companies remained great.

Services and other sectors

The environment continued to be excellent for the construction market. According to the Statistical Office, in the second quarter of 2006 construction companies built 34% more in Estonia and foreign

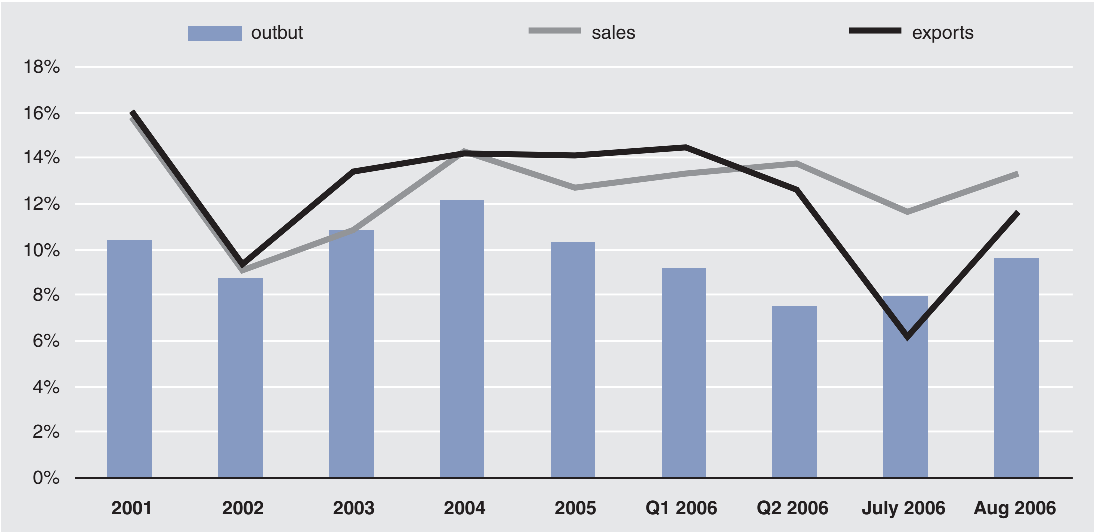

Figure 2.3. Growth in the output, sales and exports of manufacturing

Table 2.7. GDP growth by sectors (%)

	2003	2004	2005	2006 (I h/y)
Agriculture, forestry and hunting	1.1	-7.1	2.4	-14.2
Fishery	-5.2	-8.4	0.5	10.3
Mining and quarrying	13.5	-4.9	6.3	9.7
Manufacturing	7.0	11.5	12.6	13.9
Electricity, gas and water supply	12.9	0.9	7.0	13.4
Construction	2.7	7.1	19.8	19.2
Wholesale and retail trade	14.3	7.8	16.0	10.5
Hotels and restaurants	4.2	16.3	23.6	11.2
Transport, storage and communications	9.6	12.5	7.7	8.9
Real estate, renting and business activities	4.0	5.6	8.8	14.7
Financial intermediation	18.9	22.6	25.2	23.6
Public administration and defence; statutory social insurance	4.7	1.1	2.3	2.5
Education	-0.9	0.9	0.9	4.6
Health and social care	-0.6	4.2	6.5	6.6
Other services	1.6	5.5	5.7	6.5
Total GDP	**7.1**	**8.1**	**10.5**	**11.7**

countries than last year. Such brisk growth in construction was last seen in the first and second quarter of 1998. Measured by value added, growth in the construction accelerated to 22%, while building costs rose by 8.4%.

Demand for new dwellings persists: in the second quarter, permits were issued for building more than 4,000 residential spaces. Apartments continue to be the most popular type of dwelling. According to the Estonian Institute of Economic Research, contracts concluded in the second quarter of 2006 guaranteed work for 5.7 months (4.2 months in the second quarter of 2005). According to construction companies, 88% of the production capacity was utilised, which is the highest level of spring periods throughout 12 years of monitoring. The lack of qualified labour force was again emphasised as a restrictive factor, whereas the problem seems to be aggravating: while in June 2005, 67% of construction companies identified it as a problem, this year 77% did so.

In the second quarter, the increase in the number of real estate transactions slowed down rather than accelerated, but year-on-year, the price rise is still fast. According to the Statistical Office, the total number of purchase-and-sale transactions increased merely 7%, whereas their total value grew by 75% and value added by 16%.

Economic growth was well supported also by financial intermediation and trading companies, where the value added reached 23.4% and 11.7% at constant prices, respectively (see Table 2.6). The prompt development of these companies was fostered by increasing household incomes and active borrowing as well as by the rising number of foreign tourists.

Employment

The rapid growth of domestic demand and investment activity reflected also in the labour market. Demand for labour force increased the most in the fields of activity targeting domestic demand, including construction and trade. With the creation of new jobs, all major labour market indicators improved (see Figure 2.4).

In the second quarter of 2006, the number of the employed reached its highest level since 12 years, i.e. 650,000, having increased 6.7% year-on-year. The greatest contributor was the construction sector, where the number of employees rose by 36.1%. Employment in the construction sector climbed significantly (19%) also in the first quarter. This may partly stem from the growing number of people finding employment abroad. Similarly to the first quarter, employment growth thrived in wholesale and retail trade (by 11.8%) as well as in transport, storage and communications (by 22.1%).

All in all, the share of the services sector in employment growth increased further. In agriculture, employment continued decreasing slowly and also manufacturing companies employed 5.3% less than a year ago.

Employment improved in nearly all regions. Compared to the first quarter, the share of Harju County

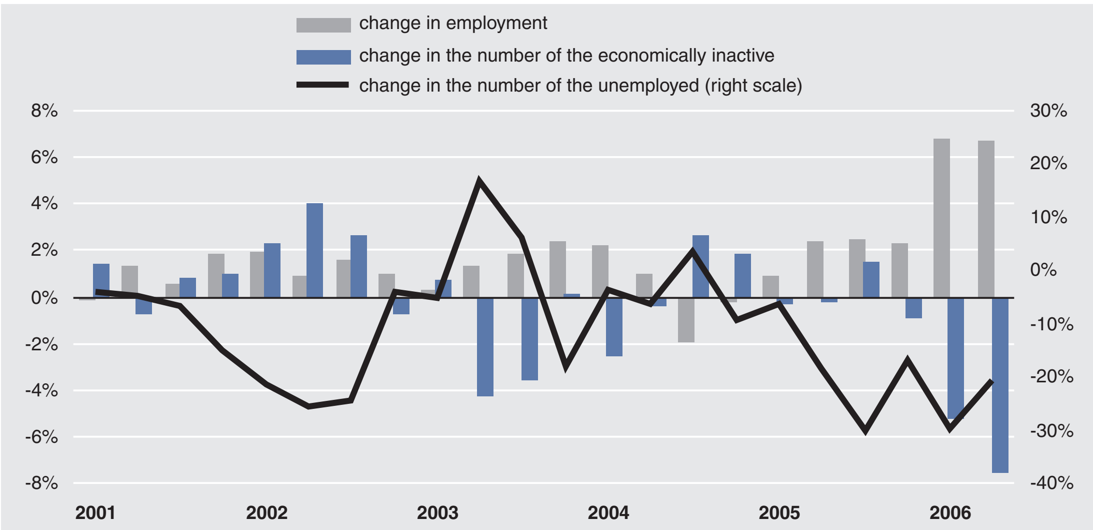

Figure 2.4. Key labour market indicators

(excluding Tallinn) and Southern Estonia in the growth increased.

Along with the swift rise in employment compared to the previous year, the labour participation rate improved as well and unemployment decreased. By the end of the first half-year, unemployment had shrunk to 6.2%. According to the International Monetary Fund, full employment has been achieved and thus no further significant decrease in unemployment is to be expected. The number of the registered unemployed also continued declining rapidly: as at October 1, the number of the registered unemployed amounted to 12,669, which is 45% less than a year ago.

The labour participation rate of persons aged 15 to 74 increased to 66% from 62.2% in the previous year. This resulted mainly from the higher activity of the elderly and the decrease in the number of the discouraged.

External balance

The external balance slowly deteriorated even further in the first half of 2006 owing to strong domestic demand. In the second quarter, the current account deficit amounted to approximately 12% of the quarter's GDP. Meanwhile, the deficit in the goods and services account increased from 6.5% in the second quarter of 2005 to 8.2%.[5]

Capital inflow again mainly consisted of cash flows channelled through banks. Deposits by parent banks and loans from parent companies prevailed.

As for direct investment, cash flows channelled through banks dominated again. The second quarter witnessed an extremely fast growth in direct investment made abroad. This arose from banks increasing the equity capital of their foreign subsidiaries. In conclusion, the inflow of direct investment in Estonia remained close to its long-term average. By the end of the first half of 2006, the volume of

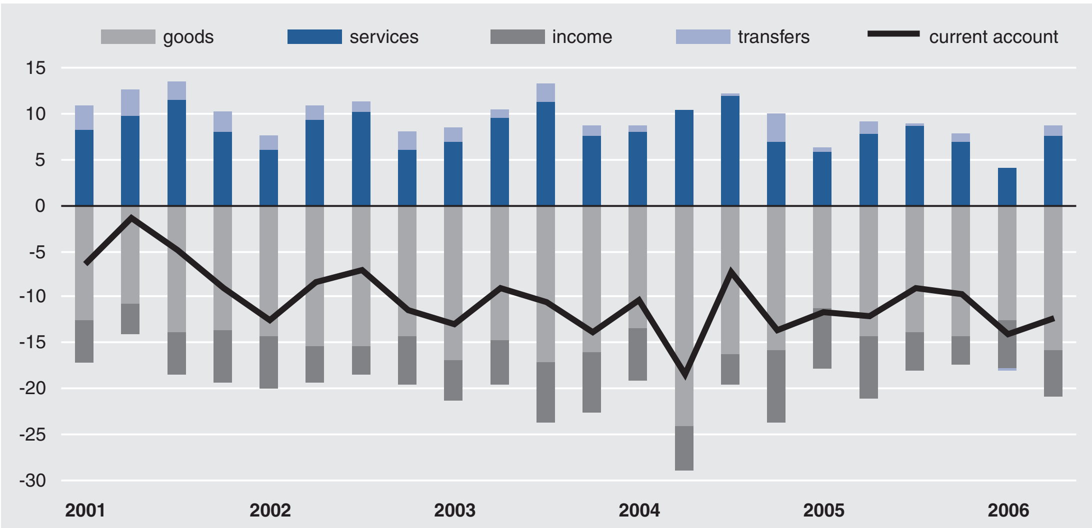

Figure 2.5. Balance of current account and its components (% of GDP)

[5] GDP data do not confirm such a remarkable increase in imbalance. Unfortunately, due to the preliminary nature of estimates it is impossible to completely align data on domestic demand and external trade. See also background information "Adjustment of the time-series of gross domestic product and national accounts" on page 8.

direct investment in Estonia had increased up to 95% of GDP.

The deficit on portfolio investment in the second quarter was quite unusual. However, this was not related to the decreasing confidence of foreign investors but reflected the increased savings stemming from brisk economic growth and Estonian investors' risk-sharing need. Foreign investment in Estonia remained at the usual level, as the number of Estonian stock market companies is small and no significant bond issues occurred either in the second quarter.

Estonia's gross external debt reached 91% of GDP at the end of the first half of 2006. The gross external debt grew mainly owing to the increase in the long-term liabilities of credit institutions. The external debt of credit institutions accounted for 56% and that of other sectors for 24% of the gross external debt. The net external debt (assets less liabilities) increased at a slower pace, amounting to 22% of GDP.