I. WORLD ECONOMY

In 2000 the world economy continued developing faster than expected, although the growth slowed down at the end of the year. The world GDP grew by an estimated 4%, for 2001 the growth forecast is somewhat smaller (see Table 1.1).

Table 1.1. Forecasts of real growth of GDP and changes in CPI

	GDP (%)				CPI (%)			
	2000		2001		2000		2001	
	IMF[1]	Other analysts[2]	IMF[1]	Other analysts[2]	IMF[1]	Other analysts[2]	IMF[1]	Other analysts[2]
World	**4.8**	**4.1**	**3.4**	**2.9**		**3.9**		**2.5**
Industrial countries	**4.1**	**3.7**	**2.2**	**2.6**	**2,3**	**2.2**	**2.1**	**1.6**
USA	5.0	5.0	1.7	1.6...2.3	3.4	3,4	2.7	2.2...2.7
Euro area	3.4	3.4	2.7	2.4...3.3	2.4	2,3	2.2	1.7...2.3
Japan	1.5	1.3...2.0	1.0	0.8...1.7	-0.7	-0,6	-0.7	-0.4
Developing countries	**5.7**	**5.6**	**5.1**	**4.3**	**6.1**	**11.2**	**5.4**	**5.8**
Latin-America	4.2	3.9	4.5	3.4…4.3	8.0	6.3…7.6	6.5	5.5
Asia	6.9	6.1	6.1	5.0…5.9	1.9	1.6	3.0	2.4
Transition economies	3.7	5.8	4.0	3.9	20.1	20.4	15.3	14.9

[1] The source of the IMF forecasts is World Economic Outlook, March 2001.
[2] Estimates of other analysts are based on the data of Lehman Brothers, JP Morgan and Reuters.

The United States continued as a leading economy: the US demand sustained export-based growth both in Europe as well as elsewhere in the world. Optimistic global growth outlook helped to lift stock indices to a record high in spring 2000, boosting consumption and investments. Higher producer and consumer prices were negative aspects accompanying economic growth. OPEC's production restrictions and increasing world demand doubled the oil prices. Central banks in industrial countries tightened monetary policy to avoid inflationary pressure.

Tighter financial environment and energy prices remaining high longer than expected reduced profits in industrial countries and inhibited consumer and investor optimism. Declining demand in the industrial countries at the end of the year had an impact on developing countries in which growth is based on exports. Therefore the world economic growth slowed down at the end of 2000 and faster growth is forecast to recover only in the second half of 2001. The downside risks to this forecast are high oil prices, lower-than-anticipated impact of the rapid growth-supporting economic policies and a potential recession in the United States.

AMERICA

The **US** economy sustained rapid growth in the first half of 2000, slowing down in the second half of the year. According to the US official statistics the GDP grew by 5%.

The rapid growth in the first half of the year deepened the imbalances in the economy and financial system. The rapidly growing domestic demand – private consumption and investments – brought along generally optimistic outlook on the national economy, pushing stock prices to an unjustifiably high level and boosting borrowing. Apart from domestic resources a significant inflow of external capital, supported by the strong dollar and relatively high profitability of investments, helped to finance high investment and credit demand in the private sector. The current account deficit reached about 4.3% of GDP. Tight competition has kept the inflation level moderate (3.4%), regardless of high employment and growing energy prices (see Table 1.2).

Table 1.2. Economic indicators of industrial countries

	GDP (%)		CPI (%)		Unemployment (%)		Budget surplus/deficit (% of GDP)		Current account balance (% of GDP)	
	1999[1]	2000[2]	1999[1]	2000[2]	1999[1]	2000[2]	1999[1]	2000[2]	1999[1]	2000[2]
World	3.4	4.0		3.1						
USA	4.2	4.9	2.2	3.4	4.2	4.0	0.7	2.3	-3.6	-4.3
Japan	0.8	1.3...2.0	-0.3	-0.6	4.7	4.7	-7.0	-6.0	2.5	2.8
Euro area	2.6	3.4	1.2	2.3	9.9	9.1	-1.3	0.3	0.4	0.0
o/w Germany	1.6	3.1	0.7	1.9	8.3	9.6	-1.4	1.4	-0.9	-0.9
France	3.2	3.2	0.6	1.7	11.3	9.7	-1.8	-1.4	2.6	2.3
Finland[3]	4.0	5.3	1.3	3.2	10.3	9.8	1.9	4.0	5.9	5.5
European Union	2.6	3.4	1.4	2.1	9.1	8.2	-0.7	0.7	0.3	-0.2
o/w Great Britain	2.3	3.0	2.3	2.9	6.0	3.8	1.5	2.7	-1.1	-1.5
Sweden	4.1	3.9	0.5	1.3	5.6	4.7	1.9	3.4	3.5	2.4

[1] The source of 1999 data is the IMF
[2] Estimates of 2000 are based on the data of Lehman Brothers, JP Morgan, Reuters and OECD
[3] Finland's estimates of 2000 are based on the data of Nordea and Sampo

In order to reduce the imbalances in economy, the Federal Reserve raised interest rates by 100 basis points, to 6.5%, in 2000. Besides monetary policy also a drop in stock prices and the strong dollar tightened the financial environment. Increasing energy prices reduced income. The interaction of the above factors slowed down the US domestic demand and export growth more than forecast. The industrial and consumer confidence declined remarkably, fuelling speculations about recession.

Monetary policy is the most efficient short-term policy tool to boost the US economy, although fiscal policy plays an important role in the medium term. In order to restore economic agents' confidence, the Federal Reserve cut interest rates by 100 basis points already in January 2001. Large budget surplus (about 2.5% of GDP in 2000) allowed the US government not only to buy back bonds but also to elaborate a tax reduction scheme. The 1.6 trillion-dollar cut in income tax during ten years should strengthen the growth potential over the medium term.

The flexibility of the US economy, high productivity and economic policy measures allow one to forecast that the sharper-than-expected growth slowdown will be short-lived. According to the widespread scenario, output growth will recover in the second half of 2001. Nevertheless, in 2001 the GDP is forecast to grow by 1.6…2.3%, remaining below the potential level (3…4% a year). There is also a danger that the recovery will be delayed. The need for external financing remains a downside risk factor. A serious contraction in investment flows into the US could have serious consequences.

The economic growth in **Latin American countries** was rapid, 4%, due to high import demand in the US. Brazil (4.1%) and Mexico (7.3%) benefited the most. Higher interest rates in the United States made debt-servicing significantly more expensive for countries with large external debt (Argentina, Peru), leading to a sharp decline in confidence in the Argentine economy and financial solvency. Although with the assistance of international financial organisations the situation stabilised by the end

of the year, weak Argentine economy (falling 0.5% in 2000) is still under continuous attention. The deteriorated outlook for the US economy is not expected to have strong adverse implications on Latin American states. Private institutions anticipate the region's economy to grow by 3.4…4.3% in 2001.

Asia

Output growth in **Japan** remained far below other large countries in 2000, and the outlook for 2001 is not better. Higher corporate profitability enhanced investment, making capital expenditure the growth engine. Unfortunately, effects of improved economic conditions did not reach consumers: consumption rather declined and the propensity to save remained high.

Low consumer confidence and high propensity to save go back to the bursting of the asset price bubble in early 1990s; the undergoing economic and financial sector reforms have not yet managed to remove the after-effects of collapsed stock and real estate prices. Japan has few political tools to support the economy: easing of fiscal policy is difficult due to domestic-demand boosted debt burden (about 130% of GDP); monetary policy interest rates are barely on the level of 0.25%.

The economic growth in the **emerging markets of Asia** was above expectations, 8.3% in the first half of 2000. In the second half of the year external demand for electronic products shrank and the economic growth rate lapsed to 7%. According to forecasts GDP growth will slow to 5…6% because of lower external demand. Asian countries have not conducted enough structural reforms (especially in the banking sector) and domestic demand cannot fully replace the impact arising from lower external demand. The suppressed demand has put downward pressure also on the exchange rates of Asian national currencies.

Europe

The **European Union** (EU) economies, especially those of the **euro area** had record high growth of the last decade in 2000. The output is forecast to grow by 3.4%. Inflationary pressure remained moderate (2.3% at the end of the year, 2.1% in the entire EU) despite of increasing employment, high oil prices and the weakening euro, although it exceeded the European Central Bank (ECB) target for medium term (2%).

The weakening of the euro supported the export sector but together with high energy prices inhibited purchasing power of consumers. Therefore the trade balance remained in surplus. The relatively high expected rate of return on investments abroad sustained a net outflow of direct and portfolio investments.

Good performance is based on improving structure of the economy – primarily due to successful labour and product market reforms. Pursuant to priorities set at the Lisbon Summit, in 2000 labour market reforms focused on enhancing employment through lower taxes on labour and changes in the benefit system. The reforms in the goods market were especially successful in harmonisation of legislation and deregulation of telecommunications and electricity sectors. Common monetary policy has improved co-operation in fiscal and structural policies as well as enhanced the commitment of Member States to maintaining competitiveness by moderate wage growth. Under rapid economic growth the government budget is in surplus in many countries.

The monetary policy of the ECB has helped to maintain price stability, despite the unexpected surge in oil prices and weakening exchange rate of the euro. Tighter competition in the region's internal

market (eg electricity sector) also helped to slow the rate of inflation. The weaker euro prompted the ECB to raise interest rates (up to 4.75%) in August and October and led to foreign exchange interventions.

Compared to the US the development of the EU economy has been more balanced. As the US growth slowdown is forecast to be short-lived and will only affect export demand, it is assumed that growing domestic demand in Europe will somewhat balance the declining role of the US in 2001.

The ongoing growth of the EU and the euro area output presumes measures for strengthening domestic demand. These measures comprise a monetary policy focused on price stability, structurally balanced national budgets, and strengthening of the supply side (through tax, public expenditure and structural reforms) that would enhance the growth potential of European economies.

In 2001 the euro area output growth forecast is 2.5…3%. There are both domestic and external downside risks to the forecast of faster-than-potential growth. Major internal risks involve lagging reforms, which increase the rigidity of the structure of the economy, or over-expansive fiscal policy. Out of external factors, Europe will be subject to declining demand in export markets, and the euro area – to the strengthening single currency.

Finland and Sweden

Output growth both in Finland and Sweden was above the EU average in 2000 (similar to 1999) whereas differences in the growth structure of the two countries became more pronounced. The rapid growth was supported by convergence with the European Union as well as the characteristic features of the so-called new economy – eg higher productivity in the environment of relatively low price increases – in the sectors serving as the growth basis of industrial production (electronics and telecommunication). Continued fast output growth requires productivity growth increase in other sectors as well. Economic policies promote growth in both countries.

The end-1999 rebound in the **Finnish** economy continued throughout 2000: output growth forecasts are above 5%. Contrary to expectations, the growth was led by export-oriented industrial sector, mostly by the electronics sector (growth 38%).

The economic growth based primarily on exports outside the euro area makes Finland vulnerable to the global growth slowdown. Within Finland the growth can be inhibited by the high rate of capacity utilisation (above 90% in the industry). The positive scenario (about 4% production growth in 2001 and 2002) presumes sustained growth in domestic demand – investments and consumption – and maintained competitiveness. Corporate productivity and higher consumption enhanced by higher employment level, reduced taxes and slightly lower inflation should be conducive to investment growth. The Finnish government continues to lead a tight fiscal policy and reforms that allow reducing the relatively high tax burden.

Economic growth in **Sweden** has been more moderate compared to Finland (the forecast was 3.9% for 2000) but it has had a wider base – both domestic and external demand.

The rise in the high-tech heavy stock market index in spring and adjustment at the end of the year had a significant impact on consumption and investments. The main risk factor in 2001 is a sharp fall in external demand, having an impact for example on machinery and electronics industry.

Both in 2001 and over the long period political measures support economic development. Large budget surplus (3.5% of GDP in 1999) allows reductions in the tax burden whereas government spending is

reduced by labour market and pension reform. Partially due to the so-called new economy with rapid productivity growth and tight competition ensuring low inflation regardless of the rapid economic growth, the Swedish monetary policy has been relatively lax compared to the euro area (the key interest rate is 4%). With the growth slowing and wages rising moderately, official interest rates are not expected to rise in the first half of 2001.

Transition Economies in Central and Eastern Europe

In 2000 all Central and East European transition economies achieved economic growth (see Table 1.3). The growth was based on export-facilitating large external demand leading to an increase in industrial production. The economic growth in the EU accession countries belonging to the so-called first group of enlargement was above average (4.6%) and based on a broader basis than in other accession countries (average growth 3.4%). However, the growth difference between these two groups shrank significantly as compared to 1999.

Table 1.3. ***Economic indicators of Central and East European countries and Russia[1]***

	Real growth of GDP (%)		Average annual change of CPI (%)		Current account balance (% of GDP)		Unemployment (%)		Budget surplus/deficit (% of GDP)	
	1999	2000	1999	2000	1999	2000	1999	2000	1999	2000
CEE countries										
Estonia	-1.1	6.4	3.8	4.0	-5.8	-6.8	13.0	14.7	-4.7	-0.5
Latvia	1.1	5.5	3.2	2.7	-9.6	-7.2	14.0	14.4	-4.0	-2.8
Lithuania	-4.2	2.7	0.3	1.0	-11.2	-6.9	13.0	14.7	-8.2	-3.3
Hungary	4.5	5.3	10.0	9.8	-4.3	-3.5	9.7	6.5	-3.4	-3.5
Poland	4.1	4.1	7.3	10.1	-7.5	-6.1	12.0	13.0	-2.0	-1.8
Czech Republic	-0.8	2.8	2.1	3.9	-1.9	-3.9	8.6	9.4	-0.6	-5.2
Slovenia	4.9	4.7	8.0	8.9	-2.8	-3.2	13.0	13.5	-0.6	-1.4
Slovakia	1.9	2.2	10.6	12.0	-5.6	-3.4	19.2	16.5	-3.4	-3.6
Bulgaria	2.4	5.0	0.7	10.4	-5.3	-5.5	16.0	17.8	-0.9	-1.0
Romania	-3.2	2.0	54.8	45.7	-4.2	-3.7	11.3	10.3	-2.8	-2.9
CIS countries										
Russia	3.5	7.5	36.5	20.2	14.0	20.9	11.7	10.2	-1.7	3.2

[1] Indicators of 2000 are preliminary
Sources: JP Morgan, BIS, Business Monitor International (BMI), Bank of Finland, Eesti Pank

The rapid growth in the United States and the European Union established a favourable environment for the countries in Central and Eastern Europe. Export growth accelerated considerably, especially in those CEE countries that had had a slower growth in previous years – Bulgaria, Croatia and the Czech Republic. Stable growth in exports continued in Poland, the Slovak Republic and Slovenia. In the first half of 2000 exports supported regional economic growth significantly. In the second half of the year the role of domestic demand increased, facilitating the growth of trade deficit. The largest CEE economy, Poland, was able to reduce the current account deficit (8.3% of GDP in twelve months up to March 2000) arising from high import demand in spring. Simultaneously accelerating inflation prompted the central bank to tighten its monetary policy already in early summer. The desired outcome became evident in the second half of the year – the growth of domestic demand slowed considerably. The shrinking of real wages induced by an inflation rate of about 10% improved exports regardless of the strengthening of the zloty against the currencies of the main trade partners (including the euro), and export growth accelerated to more than 20% in the last months of 2000.

The monetary policy decisions taken in CEE countries were mostly subject to external environment, primarily to high oil prices throughout the year and the strong dollar. Besides

Poland, where inflation accelerated, also Hungary underwent a large price level increase (an annual 9.8%), forcing both central banks to raise monetary policy interest rates (between November 1999 and end-2000 by 600 basis points in Poland and throughout 2000 by 100 basis points in Hungary). Another important factor was the euro's exchange rate, dropping against the US dollar until October. The CEE countries with their currencies directly or indirectly pegged to the euro were therefore in a more favourable competitive environment.

The EU negotiations had the strongest impact on economic policy decisions. Several studies about the transition economies admit that the longer the structural reforms (including privatisation) take, the more complicated and expensive they get. The CEE countries have undergone major changes but decisive steps in several fields have not yet been taken. Thus, the privatisation of remaining state-owned enterprises and reforming of the social system and labour market are still problematic.

Latvia and Lithuania

Favourable external environment boosted the economic growth in Baltic countries. Lithuania was still recovering from the 1998 Russian crisis and the economic growth fluctuated quarterly. The economic growth (the forecast for 2000 is 2.7%) was largely dependent on increasing exports whereas domestic demand showed mild rebound only over the last months of the year. The Latvian economy developed rapidly thanks to trade and services. The GDP is forecast to grow by up to 5.5%.

In both countries the fiscal sector supported domestic demand, the budget deficit exceeded targets. In Latvia the budget deficit leaped from intended 1% of GDP to 2.8% and in Lithuania from 2.8% to 3.3%. The reason was deteriorating external environment (rising oil prices, strong dollar) and in Lithuania growing deficit in the social insurance fund arising from low collection of the social tax. In 2001 Latvia and Lithuania will continue pursuing expansive fiscal policy.

Unlike other Central and East European countries (including Estonia) inflation did not accelerate significantly in Latvia and Lithuania during 2000. Low increase in food prices in Latvia and unchanged prices in Lithuania sent consumer prices downward. The strong dollar brought along strengthening of the Lithuanian litas and partially also of the Latvian lats against the euro. Both oil transit in Latvia and export of oil products in Lithuania were little exposed to the impact. Lithuania could reduce fiercely growing current account deficit (6.9% of GDP in 2000), primarily by cutting import demand. In Latvia the demand for imports was sustained and the trade balance deficit remained high whereas only due to larger surplus of services' balance the current account deficit was brought slightly down against 1999. In 2001 the economic growth in Lithuania could accelerate to 3.5–4% and remain at 5% in Latvia.

Relations with the European Union were important for both of the countries. Latvia and Lithuania joined the accession negotiations in the so-called second round in December 1999. Ever since they have worked hard to catch up with the countries of the first round in the negotiation process. Reforms in the social insurance system and energy sector remain high on the agenda. Lithuania joined the World Trade Organisation in 2000.

Russia

High oil prices in the world market and relative stability achieved under Putin's government helped Russia to achieve surprisingly high economic growth in 2000 – 7.5% according to preliminary estimates. A 9%-growth in manufacturing and surging domestic demand were the main growth facilitators. Profits from oil exports bolstered Russian budget significantly leading to a primary

budget surplus for the first time. A drop in the oil prices in early 2001 indicates that this year the economic growth in Russia could be slower. The money supply in 2000 grew mostly at the expense of external currency (export earnings) flows, 75% of which has to be exchanged immediately for roubles according to Russian legislation. The inflation rate was low for Russia, 20.2%, and should diminish even further in 2001.

In 2000 Russia paid more attention to relations with other countries. President Putin visited superpowers and neighbouring countries as well as former socialist states, warming up relations also with international financial organisations. Among economic policy decisions the most important were amendments in the income tax law adopted in summer and the balanced budget for 2001 of 1,194 billion roubles, ie 15.4% of GDP. 15% of the budget goes for servicing both Russian and former Soviet external debt.

Financial Markets of Developed Countries

Foreign exchange markets were subject to economic growth and forecast revisions in different countries. The US dollar continued to strengthen in 2000 as well, reflecting the relatively faster development of the US economy in the first half of the year. The dollar strengthened most against the yen – 11.6% during the year. In the second half of the year the US growth outlook deteriorated, giving rise to a rebound in European currencies. Having hit a historic low against the US dollar (0.8272) in October despite several interventions by the European Central Bank, the euro recovered rapidly and partially offset its earlier decline (its total change against the dollar being –6.3%; see Table 1.4). The weakening of the yen accelerated at the end of the year.

Table 1.4. Changes in exchange rates of major currencies

	31.12.99	29.12.00	Change (%)
JPY / USD	102.51	114.41	11.6
USD / EUR	1.0062	0.9427	-6.3
USD / GBP	1.6182	1.4930	-7.7

The year 2000 was negative for the **stock market**. Tightening monetary policy and deteriorating growth outlook reversed dominant bullish stock markets both in the US and in other significant markets. The technology sector underwent a major fall as here the stock prices had surged to an unjustifiably high level: the Nasdaq slumped by about 40% (S&P 500 shed about 10% at the same time; see Table 1.5). The stock market in Japan tumbled as well, primarily due to increasingly pessimistic outlook of the economy.

Table 1.5. Indices of major stock markets

	31.12.99	29.12.00	Change (%)
USA (SP 500)	1,469.25	1,320.28	-10.1
USA (Nasdaq)	4,069.31	2,470.52	-39.3
Japan (Nikkei 225)	18,934.30	13,785.70	-27.2
Euro area (Eurotop 300)	1,583.55	1,533.47	-3.2
Great Britain (FTSE 100)	6,930.20	6,222.50	-10.2

Fundamental factors influencing **bond markets** changed significantly during the year. At the beginning of the year both the United States and the euro area tightened monetary policy because of rapid

economic growth and inflationary pressures, aggravated by rising oil prices. The US Federal Reserve raised its benchmark interest rate by 100 basis points, ie to 6.5% between January and May, the European Central Bank by 150 basis points, ie to 4.75% between January and October. Japanese central bank responded to the rebound in economic activity by terminating its zero interest rate policy in August. Short-term interest rates rose in all of the above countries. Long-term interest rates were primarily affected by the bond buyback programme due to the US budget surplus that lowered the supply. The resulting downward trend in interest rates continued in the second half of the year both in the US and in the euro area as output growth decelerated and inflationary pressures receded. The interest rate of 10year bonds shrank by 133 and 46 basis points, respectively (see Table 1.6).

Table 1.6. Interest rates of major bond markets

	Interest rates of 3 months			Interest rates of 10 years		
	31.12.99	31.12.00	Change (basis points)	31.12.99	31.12.00	Change (basis points)
USA	5.33	5.90	+57	6.44	5.11	-133
Japan	0.05	0.41	+36	1.68	1.65	-3
Euro area	2.95	4.68	+173	5.36	4.90	-46
Great Britain	5.40	5.73	+33	5.41	4.91	-50

In the **raw materials market** oil continued to appreciate in 2000. The price had reached the historic high since early 1990s (37 dollars per barrel). The average price in 2000 was approximately 30 dollars per barrel. The rising oil price was the main inflation factor both in developed and emerging countries. High demand made other raw materials appreciate as well in 2000: the CRB index grew by 11.1%. Prices of foodstuff and timber significant for Estonia also increased in the world market.