

# I GLOBAL ECONOMY AND ESTONIAN ECONOMY

## EXTERNAL ENVIRONMENT

### Global economic cycle

**Global economic activity remained high in the second half of 2005.** Economic growth slowed down in the last quarter in the US and accelerated in Japan. The economic data of the first months of 2006 indicated that the decrease in economic activity at the end of the previous year was temporary and growth picked up pace again in the first quarter. Also the annual growth of industrial production and retail sales increased in January and February. In the euro area, the annual growth of industrial production underwent a decline at the end of 2005 and accelerated then to 2.5% by January 2006 (see Figure 1.1). Different economic activity indices refer to further rapid growth, especially in the euro area where the German IFO index, for instance, rose to the highest level since the past 15 years in March 2006. The annual global economic growth of 2006 should be 0.1 percentage point faster than in the previous year.<sup>1</sup>

High economic activity exerted a continuously positive influence on the labour market: in the second half of 2005 and at the beginning of 2006 unemployment dropped in all major economic areas. In September 2005, the swift rise of the oil price in the third quarter of 2005 lifted the inflation level to 4.7% in the US and to 2.6% in the euro area (see Figure 1.2). After the oil price rise subsided, also inflation slowed down, remaining in the range of 3.4–4.0% in the US and 2.2–2.4% in the euro area at the turn of the year and during the first months of 2006. After a lengthy deflation period, price growth in Japan also started turning positive: in January and February 2006, the year-on-year CPI growth remained in the range of 0.4–0.5% and for the first time since the past 15 years also land price growth turned positive.

Economic activity in **Finland** started recovering in the third quarter of 2005 and gained even more momentum towards the end of the year. Supported

by domestic demand, the annual GDP growth accelerated to 2.9% in the fourth quarter and to 3.3% in January 2006. Due to high economic activity in the past year, the Finnish government increased this year's economic growth forecast from 3.2% to 3.7% (see Figure 1.3).

The average inflation of 2005 stood at 0.9% and remained at the same level also in the first months of 2006. The strong confidence of households, the increasing employment and the sudden acceleration of loan growth foster the growth in consumption. Therefore, this year also inflation is expected to rise up to 1.1%.

Domestic demand has remained strong and both retail as well as wholesale volumes have grown steadily, indicating households' continuing propensity to consume. The year-on-year growth of retail sales stood at 2.2%, despite a standstill at the beginning of 2005. At the start of 2006, the growth of retail trade accelerated even further and in February the year-on-year growth stood at 6%.

**Swedish** economic growth was brisk in the past year – the GDP growth reached 2.7%. Household consumption was considerably greater in the last quarters, owing also to the central bank interest rate cut by 50 basis points in June 2005. Considering the strong economic growth, the Swedish government increased the growth forecast for 2006 from 3.1% to 3.6% (see Figure 1.4). Moreover, labour market conditions are expected to improve and unemployment is expected to decrease this year as well as the next year.

The extraordinarily fast growth rate of retail sales in the final months of 2005 (in December the year-on-year growth stood at 10.7% which is the fastest level of the past 15 years) reflected the increased household consumption. These trends also continued in 2006, when the year-on-year growth of retail sales reached nearly 8% in January-February.

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<sup>1</sup> Source: Consensus Forecasts, March 2006.

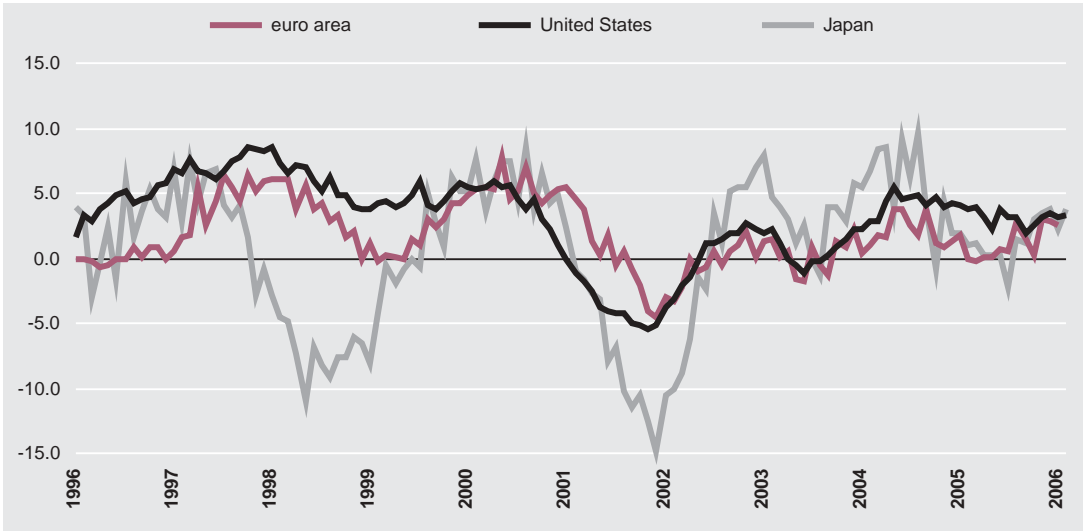


Figure 1.1. Annual growth in the industrial production of the euro area, the United States and Japan (%)

Source: EcoWin

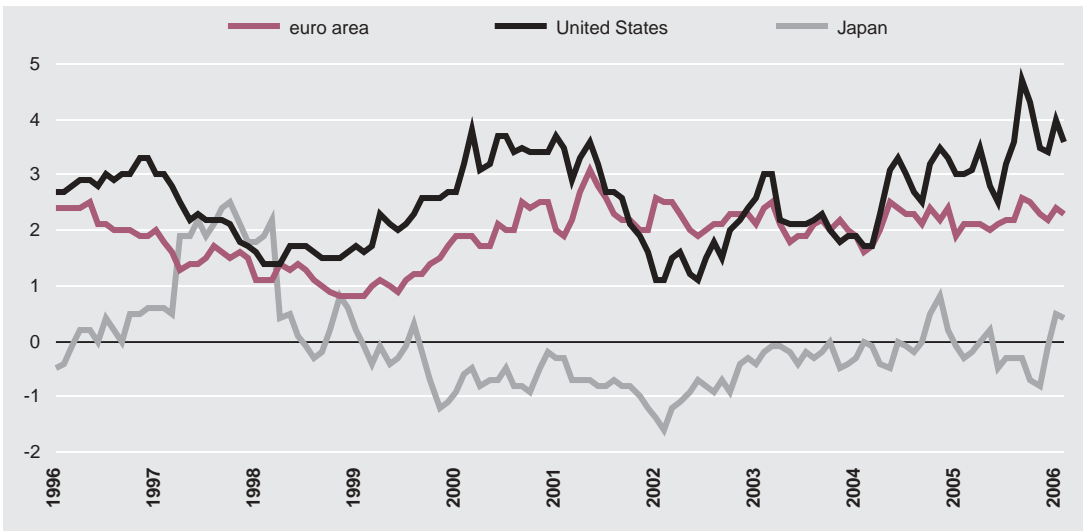


Figure 1.2. Consumer prices in the euro area, the United States and Japan (%)

Source: EcoWin

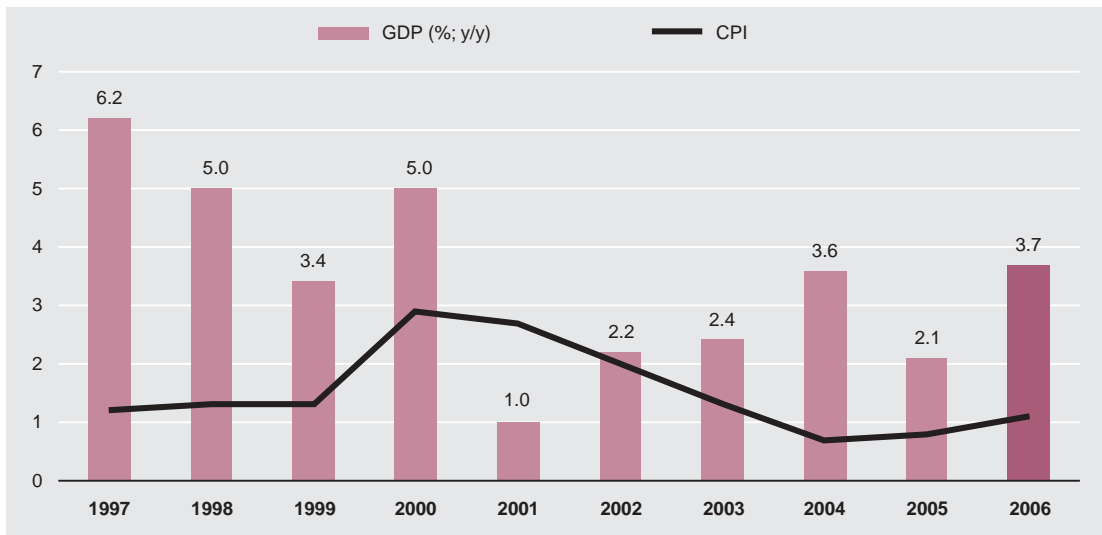


Figure 1.3. Finland's economic growth, inflation and forecast for 2006

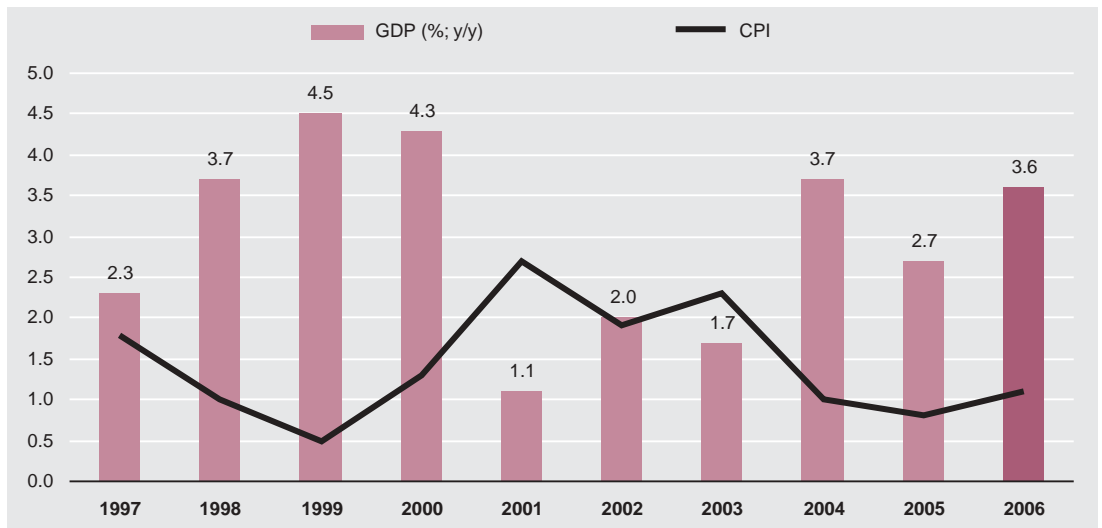


Figure 1.4. Sweden's economic growth, inflation and forecast for 2006

Inflation has been relatively low in recent years. In the final months of 2005, consumer prices accelerated mainly due to the oil price rise. The overall inflation of 2005 was 0.5%. In March 2006, however, it accelerated already to 1.1%. In order to protect the economy, the Swedish central bank raised interest rates twice in 2006 to 2%. The decision to increase interest rates has been explained by the unexpectedly fast economic growth and the improved labour market situation as well as by rising residential prices and high household debt.

#### International financial markets

The upward trend on the **stock markets** of advanced economies continued. The euro area stock index STOXX 50 grew 10.2% within a half-year and the growth of other stock indices could also be expressed by double digits: in Japan 26.4%, in Finland 19% and in Sweden 17.1% (see Figure 1.5). The steady positive outlook of global economic activity and corporate profit growth supported this trend. Stock prices changed slightly less in the US, where the S&P 500 index rose by 4.5%. The continuous raising of the key interest rate by the Federal Reserve has inhibited the growth of stock prices. Some investors also reckon with the possibility that US economic growth might slow in the second half of 2006.

Interest rates on **government bond markets** rose, because economic activity remained high and the risk of inflation increased. The rise resulted from several central banks raising their key interest rates. The US Federal Reserve continued to reduce monetary policy stimuli by raising the key interest rate on four occasions by a total of 100 basis points, i.e. to 4.75%. The European Central Bank started to tighten the monetary policy at the end of the previous year by raising the key interest rate on two occasions by a total of 50 basis points to 2.5%. This also caused the three-month interest rate to rise by 59 basis points (see Figure 1.6). Also the central banks of Sweden and Norway increased key interest rates two times (to 2% and 2.5%, respectively). A remarkable change occurred in the monetary policy of Japan. As the long-term deflation came to an end, the Japanese central bank decided to terminate its "quantitative easing"

monetary policy that had been strongly favouring economic growth. In addition, the central bank is considering an increase in the key interest rate in the second half-year. Due to the abovementioned factors the ten-year interest rate rose by 65 basis points in the US, 73 basis points in the euro area and 76 basis points in Sweden (see Figure 1.7).

As regards the **currency markets**, the US dollar has shown no clear trend vis-à-vis other major currencies during the past six months. The euro traded against the dollar in the price range of 1.16–1.23 (see Figure 1.8). Meanwhile, the Japanese yen depreciated against the dollar by 4.5%, as despite the positive economic data the Japanese central bank did not increase the key interest rate and therefore the difference between interest rates continued to widen in favour of the dollar. Although the US current account deficit reached 7.1% of GDP in the fourth quarter, the dollar was still supported by positive economic indicators and the increase in the key interest rate.

#### ESTONIAN ECONOMIC GROWTH AND MACROECONOMIC RISKS

##### Economic growth, external balance and inflation

In the second half of 2005, Estonia's **economic growth** picked up even more thanks to the improving external environment and strengthening confidence: growth accelerated from 8.6% in the first half-year to 10.8% in the second. It exceeded the euro area economic growth by 9.2 percentage points (see Figure 1.9).

Such fast growth might have stemmed from the fact that the current economic cycle reached its peak, i.e. its maximum growth rate, and economic growth should stabilise at a more moderate level already in the near future. Eesti Pank estimated the economic growth for 2006 to be 8.1%, and 7.6% and 6.9% in the following two years.

Economic growth in 2005 remained broad-based, being supported by strong domestic demand as

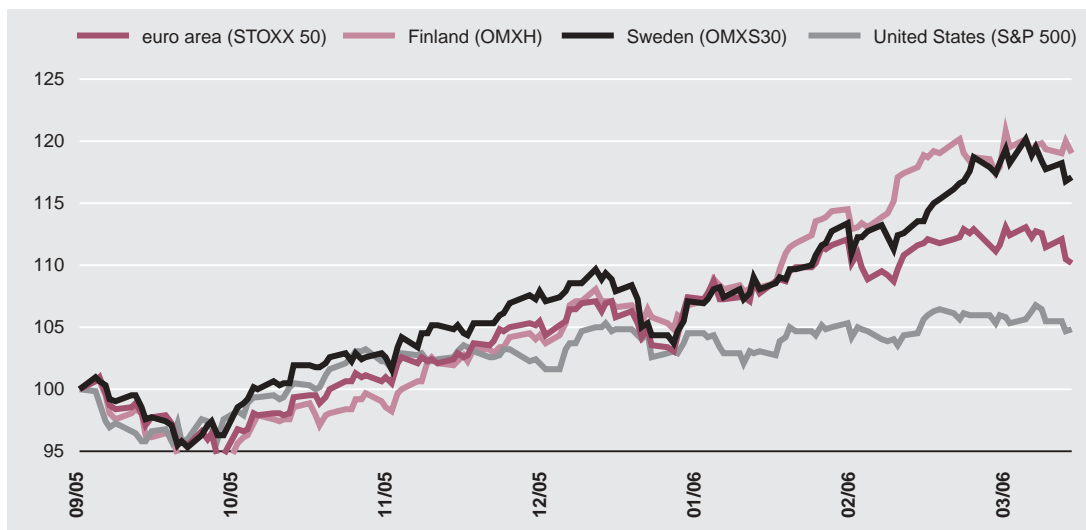


Figure 1.5. Stock indices in the United States, the euro area, Sweden and Finland (30 September 2005 = 100)

Source: EcoWin

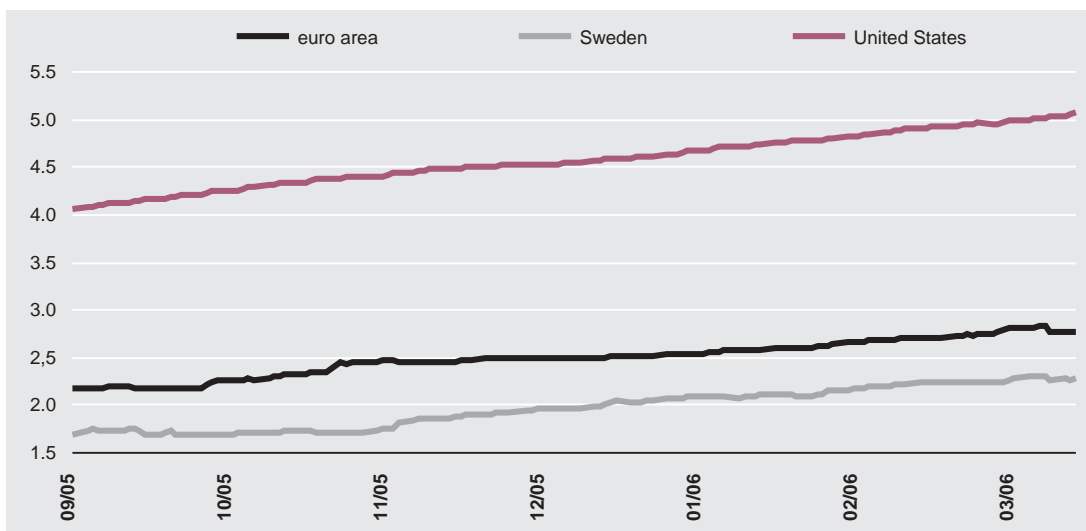


Figure 1.6. 3-month interest rates in Germany, Sweden and the United States (%)

Source: EcoWin

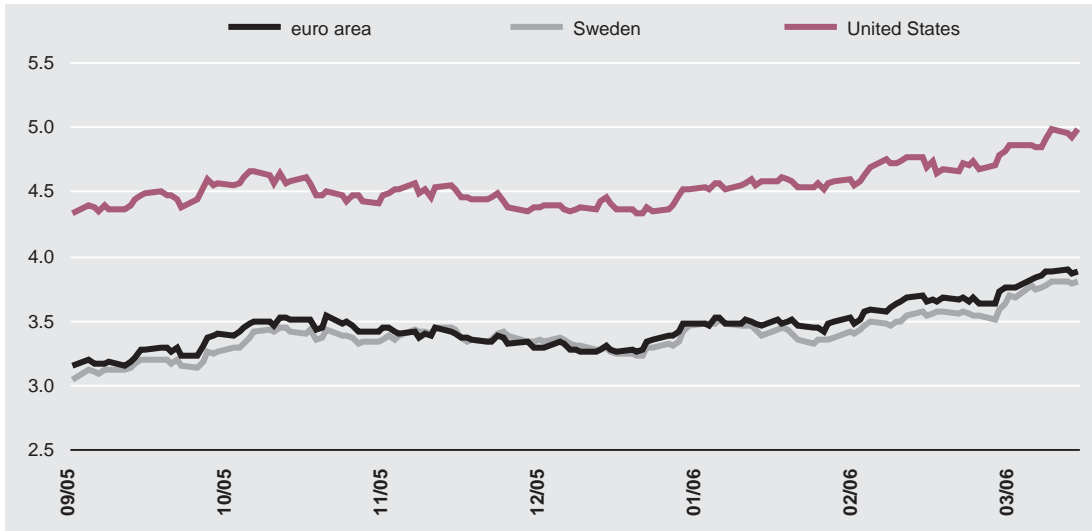


Figure 1.7. 10-year interest rates in the euro area, Sweden and the United States (%)

Source: EcoWin

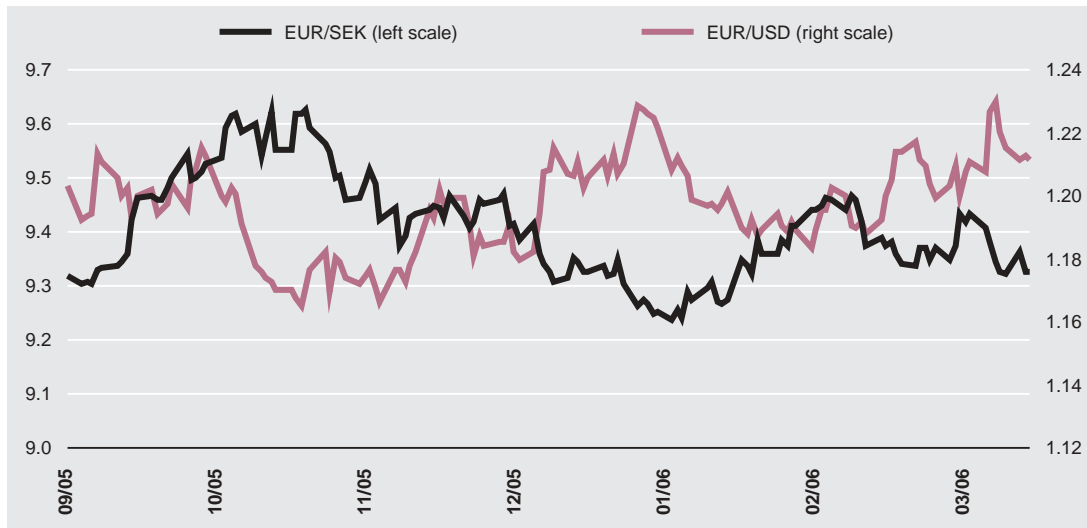


Figure 1.8. Exchange rate of the euro against the Swedish krona and the US dollar

Source: EcoWin

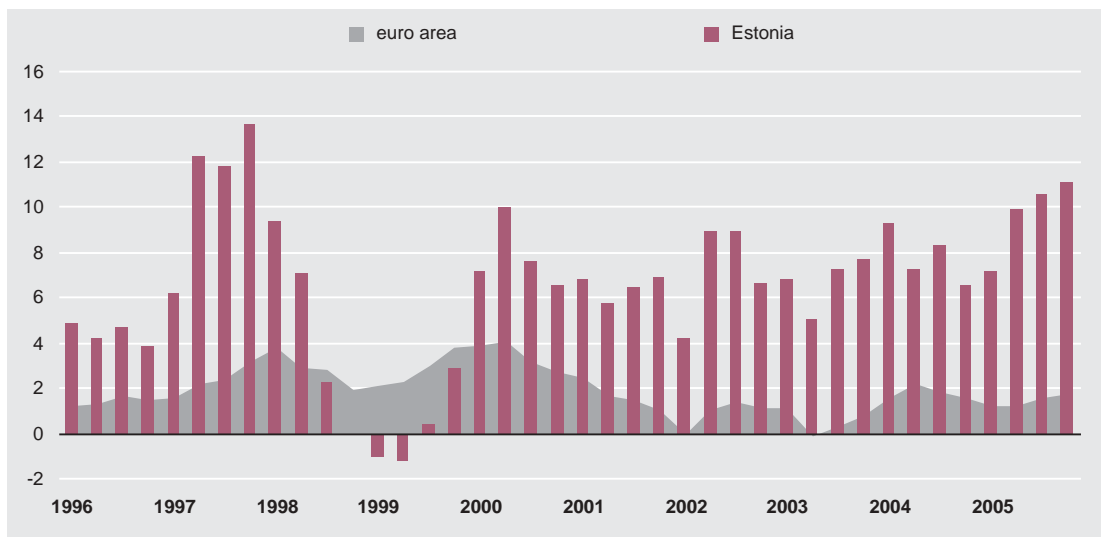


Figure 1.9. Real GDP growth by quarters (%)

Sources: Statistical Office of Estonia; Eurostat

well as improved external demand. In the second half of 2005, domestic demand was stimulated by **investment growth**. Although the share of investment in current prices decreased slightly in 2004, it rose to over 32% of GDP again in the middle of 2005. Another positive trend besides the increase in household housing investment and public sector infrastructure investment was the rise in corporate investment. During the following months good economic outlooks will continuously stimulate the investment activity.

Brisk economic growth also fostered the rapid growth of **government** revenues and the collection of several taxes exceeded expectations. Despite the supplementary budget the general government surplus comprised approximately 1.8% in ratio to GDP.

The purchasing power of consumers improved, owing to the increase in the average wages and pensions. This, in turn, stimulated the growth rate of **private consumption**, whereas at the same time it had a negative impact on the external balance through the import growth. Therefore, in conclusion the contribution of net exports to economic growth remained negative again, although the growth of **goods and**

**services exports** accelerated (from 22% in the first half-year to nearly 28% in the second). In 2005, the current account deficit reached 10.5% in ratio to GDP (12.7% in 2004; see Figure 1.10).

The **increase in consumer prices** decelerated slightly in the fourth quarter of 2005: from 4.3% in the third quarter to 4.0% (see Figure 1.11). Also this time the inflation rate was affected by the fluctuation of oil prices. In the first quarter of 2006, however, consumer price growth accelerated again with prices rising by 4.4% year-on-year. In addition to the re-acceleration of motor fuel price rise, this time the consumer basket was also significantly influenced by the prices of goods and services related to housing. The Estonian core inflation indicator also continued its rise. While in autumn it mainly stemmed from the growing prices of clothing, footwear and headgear and the transfer of the motor fuel price increase into other prices (mainly transport services), at the beginning of 2006 inflation was mainly stimulated by an increase in expenses related to leisure activities. According to the forecast of Eesti Pank, no significant slowdown in the price growth may be expected before the summer. Potential changes in fuel prices continue to be the main risk factor for inflation.

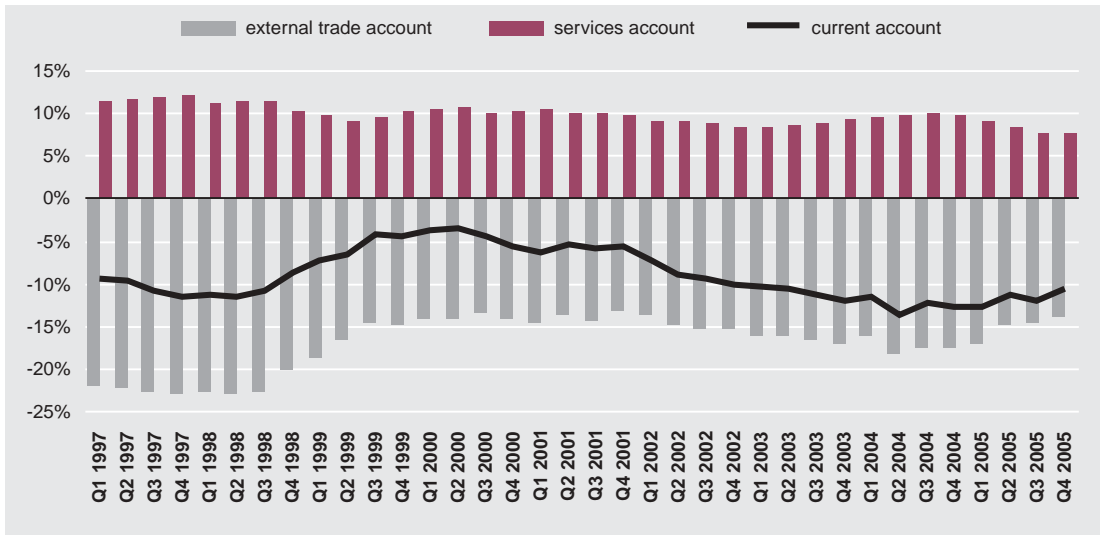


Figure 1.10. External trade account, services account, and current account balance in ratio to GDP (4-quarter average)

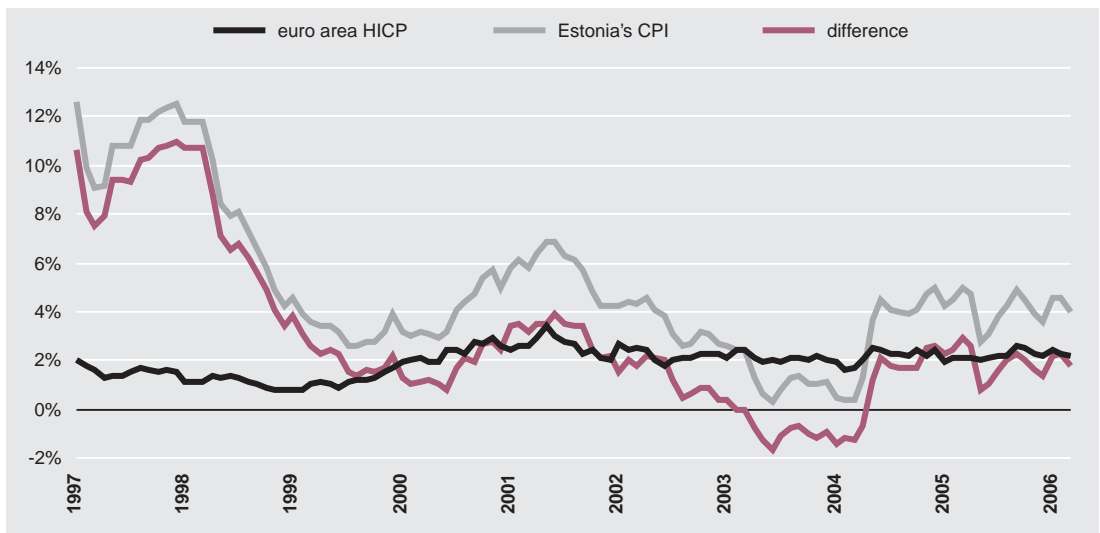


Figure 1.11. Annual consumer price growth in Estonia and the euro area

Sources: Statistical Office of Estonia; Eurostat



Corporate business situation

### **Confidence**

The **economic confidence index** calculated by the Estonian Institute of Economic Research increased by 10 points in the second half of 2005, compared to the same period in the previous year. In addition to consumers, the confidence indicator of **construction companies**, reaching a historical high, also boosted economic confidence. According to the estimates of the Estonian Institute of Economic Research, the situation in the construction market will remain exceptionally favourable. Also, the majority of companies were expecting a rise in workload in the following months. The **retail trade** confidence indicator improved substantially (see Figure 1.12).

The growing confidence of **manufacturing companies** in the second half of 2005 was largely supported by positive expectations on production as well as domestic and external demand for the following months. The confidence of manufacturing companies remained relatively strong also in the first quarter of 2006 but no longer significantly exceeded the estimations of the respective months in 2005 (see Figure 1.13). Nevertheless, the output estimates for future periods remained positive.

### **Industrial sales and investment**

Owing to relatively favourable export opportunities and higher domestic demand, the production and sales of both the export sector and local providers have grown quickly.

The **growth of industrial production and sales**, which remained slightly slower in the second half of 2005 compared to the first half, stood at a relatively high level: industrial production grew by an average of over 9%, and sales by 12% (see Figure 1.14). Growth was facilitated primarily by the fast increase in timber product sales as well as the sales volumes of textile and furniture production, which had recovered from the previous low. According to the GDP statistics, the

growth of the value added in manufacturing reached 13.1% in constant prices in the second half-year.

**Corporate investment in tangible fixed assets** grew faster in the second half of 2005 than in the previous year. Growth in the investment of manufacturing companies, transport, storage and communications companies as well as real estate and construction enterprises accelerated (see Figure 1.15).

### **New companies and bankruptcies**

In the middle of 2005, the establishment of **new enterprises** increased drastically. Altogether approximately 10,000 companies were founded in 2005, i.e. a fifth more than in 2004 (see Figure 1.16). Similarly to earlier years, about half of the new companies were established in trade. A remarkable growth could be witnessed in the number of construction companies – nearly 800 new companies emerged (over 80% more than a year before).

The **number of bankruptcies** was the smallest of seven years in 2005. 199 enterprises went bankrupt, 35% of which operated in trade.

### **Corporate economic indicators**

In the second half of 2005, the **net sales** growth of companies started to accelerate remarkably. According to preliminary estimates, the year-on-year growth stood at 20.3%, being considerably higher than the respective indicator for 2004 (13.7%; see Table 1.1). Meanwhile, the growth of value added accelerated even more substantially – by approximately 17 percentage points up to 23.6%. Although also the growth of corporate expenses accelerated (to 19.4%), the increase in total profits reached an impressive 34.4%.

By fields of activity, there were significant differences: **total profits** grew by more than a half in construction, metal product manufacturing, wholesale trade, and furniture production (65%, 63%, 61% and 57%, respectively). In the real estate sector, where profit



Figure 1.12. Confidence indicators of Estonian companies

Source: Estonian Institute of Economic Research

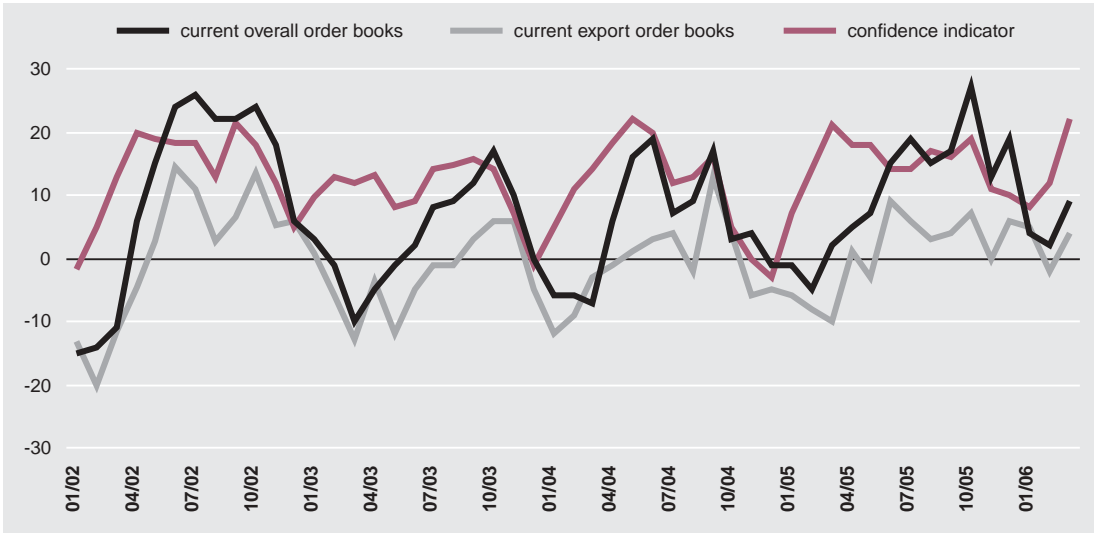


Figure 1.13. Demand for the production of manufacturing companies and confidence indicator

Source: Estonian Institute of Economic Research

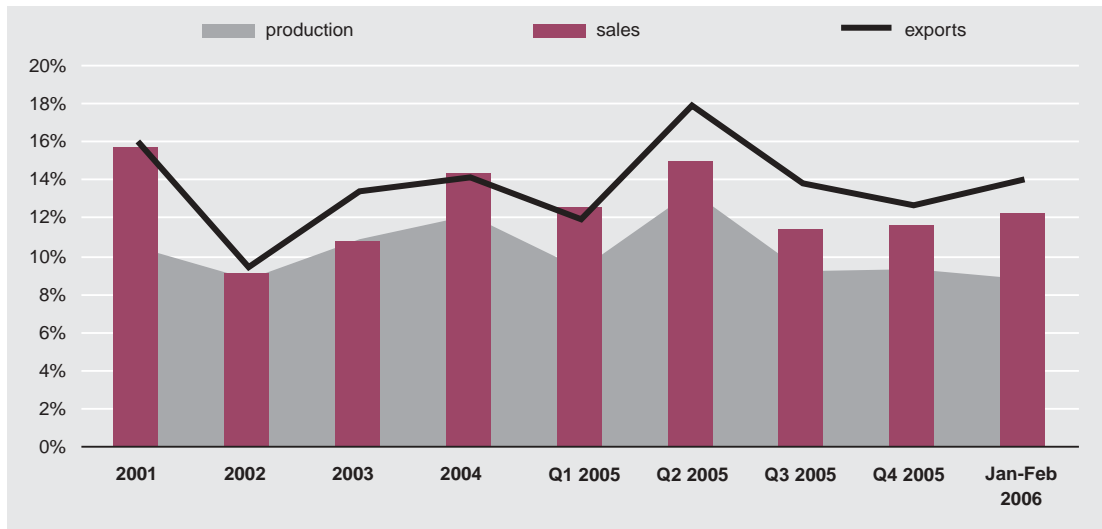


Figure 1.14. Production and sales indices of manufacturing

Source: Statistical Office of Estonia

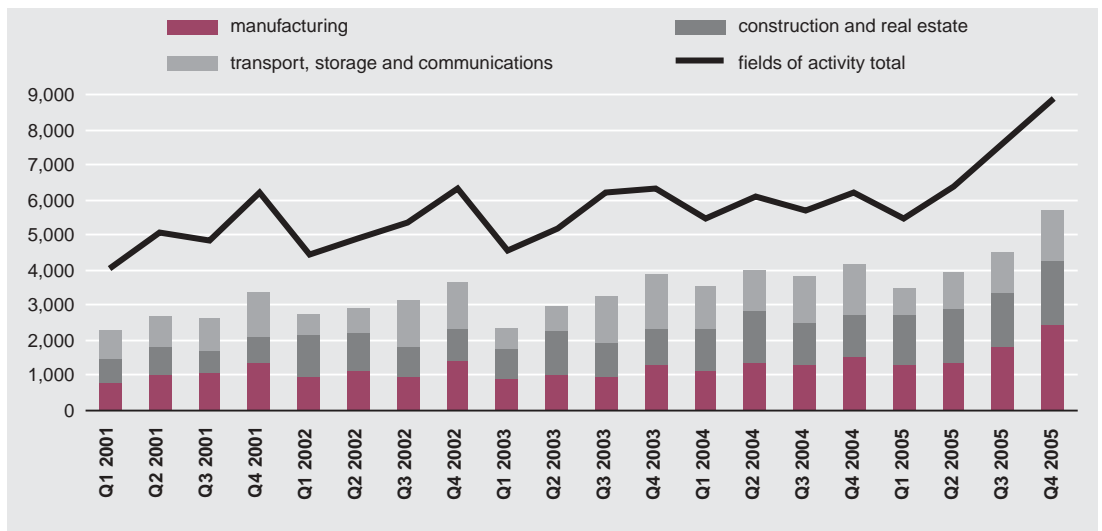


Figure 1.15. Corporate fixed investment (EEK m)

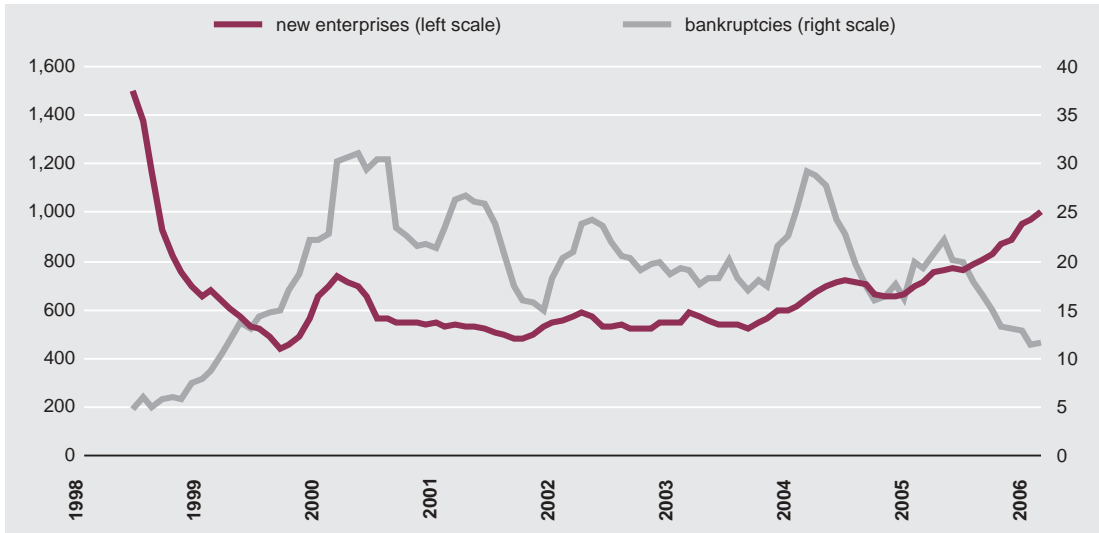


Figure 1.16. New enterprises entered in the commercial register within a month and bankrupt enterprises (6-months moving average)

Source: Estonian Enterprises Register

Table 1.1. Corporate indicators (%)

	All fields of activity			Manufacturing		
	2003	2004	2005	2003	2004	2005
Growth of net sales	8.4	13.7	20.3	9.8	13.8	15.0
Growth of total costs	8.3	14.8	19.4	9.9	15.1	14.0
Growth of total profit	10.5	0.7	34.4	9.3	0.6	26.8
Total profit to net sales	7.7	6.8	7.6	9.1	8.0	8.8

Source: Statistical Office of Estonia

comprised 77% of the value added, the profit growth of 2005 remained more modest (14%). Meanwhile, profits decreased for instance in textile and food industries.

#### Economic situation of households

##### Labour market

The keywords for the second half of 2005 were fast employment growth and low unemployment rate.

**Employment** grew by an average of 11,900 persons in 2005, which is probably the highest indica-

tor throughout the whole period of independence (see Figure 1.17). Growth was stimulated by the services sector; in other sectors employment decreased slightly. The increase in employment stemmed primarily from the rapid economic growth. In the field of hotels and restaurants, the rise in employment was affected by the more active tourism after joining the European Union. Employment also grew swiftly in construction and the real estate sector.

**Unemployment** shrunk from 9.7% in 2004 to 7.9%, while the number of the unemployed decreased 17.9%. A significant drop was witnessed in the unemployment rate of the young aged 15–24 (from 21%

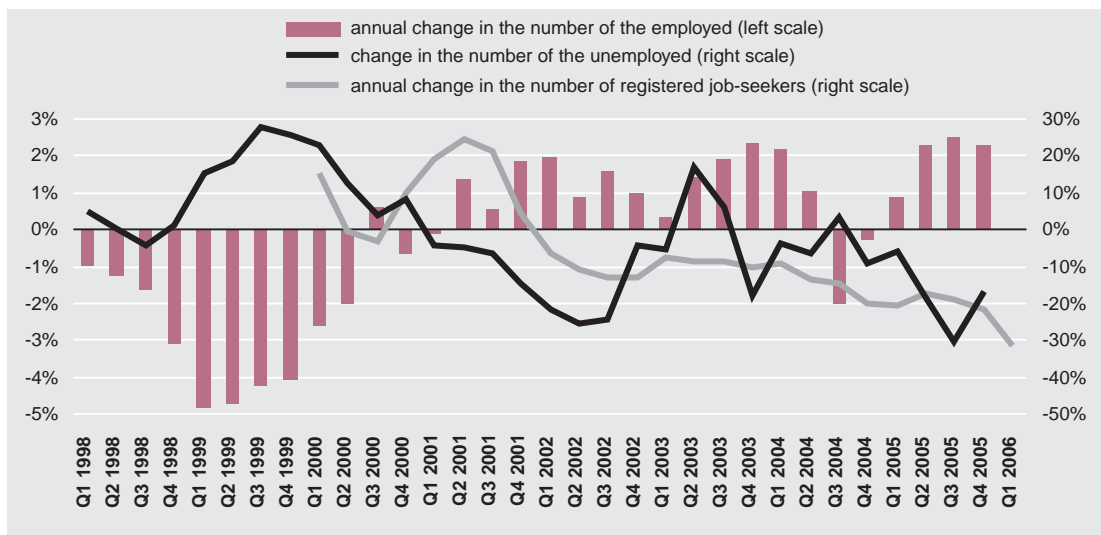


Figure 1.17. Annual change in the number of the employed, the unemployed and registered job-seekers

Source: Statistical Office of Estonia

to 15.9%) and unemployment decreased in all regions. Labour force participation remained unchanged on average in 2005 but picked up remarkably in the fourth quarter. The upward trend of senior activity continued, whereas the participation rate of the young dropped (because of studies).

### Wages

The average **gross monthly wages** continued rising rapidly in the second half of 2005. Though in the third quarter it slowed down slightly, it accelerated significantly in the fourth quarter (up to 12.8%; see Figure 1.18). The average gross monthly wages in the third and fourth quarters of 2005 were 7,786 and 8,690 kroons, respectively (in Tallinn 9,111 and 10,113 kroons, respectively). The data on tax revenue collection from the beginning of 2006 indicate further wage growth acceleration also in the first quarter of 2006.

The rise in **net monthly wages** exceeded that of gross wages by nearly 2.5 percentage points due to the reduced income tax rate and the higher non-taxable income threshold<sup>2</sup>. Contrary to 2004, when wage growth was mostly driven by the public sector, in 2005 average wages increased the fastest in Estonian private enterprises. By fields of activity, the fastest wage growth was experienced in the sector of hotels and restaurants, in healthcare and social welfare owing to new wage agreements and also in agriculture.

As inflation slowed down in the last quarter of the year, the **real growth** of the average gross wages accelerated to 8.5% and the real growth of net wages sped up to 10.1% in the fourth quarter. All in all, the real growth of labour productivity remained in line with the real wage growth in 2005.

<sup>2</sup> In 2005, the income tax rate was reduced from 26% to 24%; at the same time, the non-taxable income threshold increased from 1,400 to 1,700 kroons. As of 1 January 2006, the income tax rate is 23% and the non-taxable income threshold is 2,000 kroons per month.



Figure 1.18. Average annual wage growth

Source: Statistical Office of Estonia

### Confidence and household budget surveys

The second half of 2005 and the first quarter of 2006 faced a continuing rising trend in the **consumer confidence indicator** (calculated by the Estonian Institute of Economic Research) which had begun in 2004 (see Figure 1.19). Households' fear of unemployment has been decreasing steadily and the increase in saving prospects has grown significantly. The price rise expectations for 2006 have generally diminished. The inflation expectations that grew drastically in September 2005 were affected by the rise in fuel prices stemming from the oil price increase.

According to the **household survey**<sup>3</sup>, the net income per household member increased from 3,029 kroons in 2004 to 3,431 kroons in 2005, i.e. almost 14%. Income from paid employment increased slightly faster than average (16%) and accounted for 66% of the total income. By income deciles the total in-

come growth accelerated most rapidly in the first, i.e. the lowest income bracket (approximately 20%), while wage income growth increased the fastest in the first, fourth and fifth income bracket.

Average spending per household member increased from 2,799 to 3,148 kroons, i.e. 12.5%. The share of spending on food in total expenses decreased from 28% in 2004 to 26.5% in 2005, i.e. to 834 kroons; food and housing costs comprised 41% of total costs and 38% of the average net income per household member. The gap between the average net income and average costs increased from 230 kroons in 2004 to 283 kroons.

In 2005, the expenses per household member grew due to active borrowing and increased incomes. However, growth was inhibited by real estate investment, which increased by more than two-thirds, and greater loan repayments compared to the previous year.

<sup>3</sup> Source: Statistical Office of Estonia.

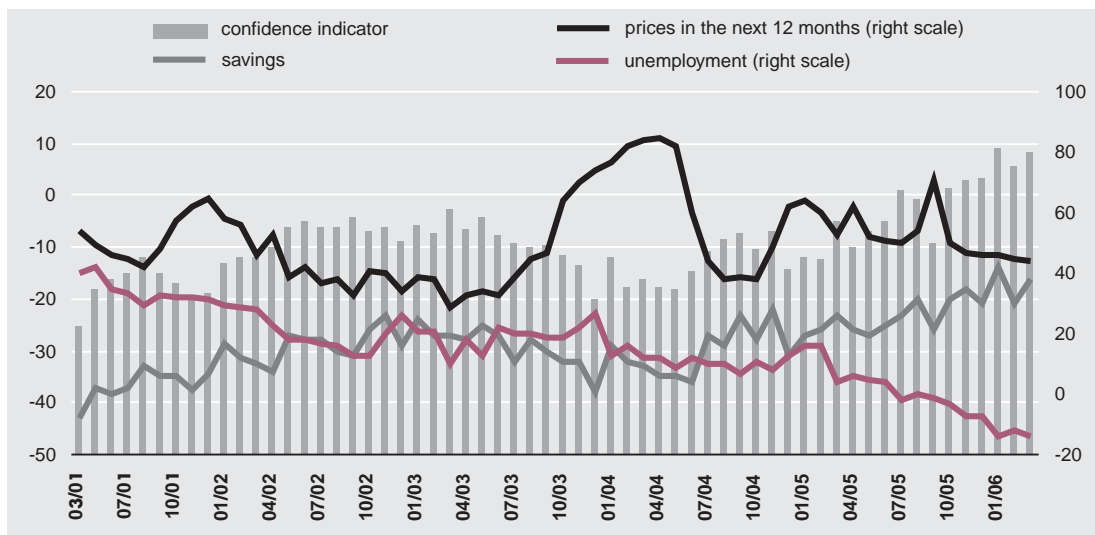


Figure 1.19. Consumer confidence indicators

Source: Estonian Institute of Economic Research