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SURVEY OF THE ECONOMIC POLICY

Stable monetary environment is characteristic of the first half of 2000. Developments towards tightening in Europe were not fully reflected in Estonian economy due to shrinking interest spread. The further external pressure to push interest rates upwards is more welcome than regrettable in the current development phase of Estonian economy.

Although US-economy related risks are still on the agenda, growth prospects as regards the external demand are good. In the first quarter Estonia's economic development was closer to the optimistic rather than the pessimistic growth scenario whereas the preliminary estimates of 7.5% growth in the second quarter exceed even the most optimistic forecasts. Apart from the continuously high external demand, the growth in the domestic demand has also accelerated. Outlooks to reach annualised 5.5% growth of the optimistic scenario or even higher are promising in 2000.

The domestic demand growth was slightly inhibited compared to the external growth and therefore the deficit in goods and services remained within 4% of GDP in the first half of the year. The anticipated deterioration of external balance following the downfall would be contained within forecast (current account deficit reaching 7% of GDP) over the year. **As there are no real restrictions on the loan growth, the threat of a too rapid growth of current account deficit cannot be eliminated either in near future.**

The inflationary external pressure did not loosen in the last months of the first half-year either, inducing, thus, the continuous price increase of open sector goods. The latter was opposed by price growth gradually slowing down in the sheltered sector. In the beginning of the second half-year this trend is likely to reverse due to external pressure hitting goods of the sheltered sector, administrative actions and increasing demand in the domestic market. As external pressure on prices is probably not going to slack off in the second half of the year either, the growth of consumer prices will gain speed and the annualised consumer price index could grow about 4%. The short-term acceleration of inflation is assumed not to end at the end of 2000 but would rather stretch to the first half of the next year as well. **Against the background of the previous recession this period should be treated as a recovery of the regular price convergence and as a short-term deviation from the shrinking trend of inflation spread with Western Europe in medium term.**

The fiscal policy of 2000 focuses on containing the consolidated budget deficit below 1.3% of GDP. Regardless the deficit surge in the second quarter, the outlooks are good. The main objective for the government lies in opposing the pressure to increase budgetary expenditure and ensure balanced budget by 2001. **As after the recession there is a real threat of decreasing external balance induced by potential rapidly growing demand, such an objective could rather be a minimum one.**

Monetary Developments

The continuous pressure to increase interest rates in Europe accompanied by slight appreciation of the euro against the US dollar at the end of May and beginning of June was not fully expressed in Estonia's monetary environment. The tightening of Estonia's monetary environment remained weaker whereas margins between euro interest rates and Estonian interest rates shrank: both in respect of short-term (money market) as well as of long-term loan interest rates. In future rather the growth not the fall of interest rates is anticipated.

Due to the consistently large domestic saving, the money supply continued to grow rapidly in the second quarter as well. Unlike the beginning of the year, it became more pronounced in domestic loans and less in increasing foreign reserves. It is not yet clear what the balanced lending pace could be: considering the still rapid growth of deposits and capital inflow, the credit growth would probably lack supply side restrictions.

Unlike the first quarter, the second quarter witnessed a significant capital inflow. The growing external reserves offset their decrease in the first months of the year. Over the gap of two years, the financial sector recovered its active role in involving foreign capital.

Financial Intermediation

The trends prevailingly characteristic of financial deepening continued in the second quarter as well: lending volumes gained space, with the significant part used in leasing; savings growth rate was contained on the previous level; the share of the securities portfolio was reduced as follow-up to curb excessive liquidity; silence in the stock market, slight growth in insurance premiums and profitability of insurance companies.

The banking sector grew mainly due to growing savings, both in corporate as well as retail sectors. Although banks continued channelling a significant part of the lending portfolio to leasing companies, direct lending to industrial and commercial sectors accelerated as well, securing an increasing share of lending to the exporting sector.

The major shareholder in *Ühispank*, *Skandinaviska Enskilda Banken*, offered to buy all shares, making the second largest bank in Estonia a 100% affiliate of a foreign bank. Previously Eesti Pank had already sold its qualifying holding in *Optiva Pank* to the Finnish insurance company *Sampo* and the latter also offered to buy the rest of the shares. **As a result of this transaction no bank belongs to the public sector in Estonia.**

In order to partially improve the return on equity, the banks have started to decrease the capitalisation, which dropped to 13.8% by end-June. Other factors inhibiting this indicator were dividend disbursement and foreign investments.

Consolidation led to first positive results in the insurance market, becoming manifest in the increasing profitability of companies and in the improving collected premium/cost ratio. The insurance market is characterised by companies owned by foreign investors and two-three small insurance companies belonging mostly to local investors.

Inflation

Over the last three quarters of the year the reacceleration of inflation has been one of the main messages of Monetary Developments & Policy Surveys published by Eesti Pank. This can be considered a regular feature for a small open transition economy, just emerging from the downfall cycle, especially under the ever-increasing external pressure. The post-crisis period is characterised by inflation accelerating in the open sector and slowing down in the sheltered sector. In the environment of these two controversial impacts the consumer price index remained quite similar in the first and second quarters of 2000 (3.1%), although in the open sector the consumer prices accelerated from 2.2% at the beginning of the year to 3.4% in June. The growth of prices for foodstuff remained below anticipation in the second quarter as well, offsetting fully the strengthening inflationary external pressure. The further acceleration in the price level growth was suspended also by continuous disinflation in the sheltered sector. There is ground to believe that the inhibited price growth in the sheltered sector “hit the bottom” in the second quarter and already in the second half of the year the prices in the sheltered sector will be responsible for inflationary pressure as well. This is mostly due to the external pressure reaching via the open sector the prices of the sheltered sector, as well as administrative actions and increasing domestic demand. The annualised consumer price index growth could reach about 4%.

Over the last two years the nominal exchange rate of the kroon has had an unusually large impact on the real exchange rate of the kroon. Although as regards the regular convergence, the real effective exchange rate of the kroon (REER) should reflect price differences in the open and sheltered sectors but due to large fluctuation of nominal exchange rates significant “over-reaction” has taken place since 1998. After the devaluation of the Russian rouble in August 1998 the REER surpassed significantly in a very short period of time the short-term equilibrium. Beginning from 1999 a reverse process has been taking place due to the weakness of the euro towards the currencies of the major trade partners and low domestic inflation. In the first half of 2000 the REER was about 4% below the year ago level. It is the first time after the restoration of independence of the Republic of Estonia that the real exchange rate of the kroon has favoured Estonia’s competitiveness in external markets during such a long period of time.

Private Consumption and Investments

The post-crisis growth in domestic demand recovered slightly later than in external demand. At the beginning of the year economic agents were relatively modest in making new consumption and investment decisions, whereas later in the year domestic demand has been increasingly fostering the economic growth.

Although both the nominal and the real wages grew significantly throughout 1999 and the first half of 2000, the previously high unemployment rate, banks’ conservative lending policy in giving consumption loans and high propensity to save prevent excessive consumption.

In the second quarter there were several signs referring to recovering investment demand. The growing lending and import of capital goods indicate that companies have started to implement their development plans.

External Balance

The message of previous Monetary Developments & Policy Surveys was that the growing investment demand and low saving characteristic of transition countries is anticipated to increase the current account deficit following a decline. As the share of investments was still contained below 25% in the first quarter of 2000, the growth of the current account deficit remained below expectations. The demand for investments accelerated in the second half of the year, bringing along worsening trade balance. The earnings from the growth in the export of services improved the balance of goods and services and the current account deficit remained below 5% according to preliminary estimates.

In the first half of the year changes in the external balance followed the scenario, the current account deficit reaching about 7% of GDP whereas at least 60% of the deficit is covered by foreign direct investment. The discussion of the actual current account deficit over a longer period of time in a transition economy like Estonia would be on the table for another few years. **Just like before the crisis, the threat is lying not that much in consumption but rather in the potential excessive growth of investments. Already beginning from the next year investments related to the privatisation of the infrastructure could have significant implications on the current account deficit. Thus, the current account deficit in 2001 could exceed that of 2000.**

Fiscal Policy

In 2000 the main objective in fiscal policy was to return to the principle of balanced budget. The annualised consolidated budget deficit should be contained below 1.3% of GDP.

At the beginning of the year tight expenditure policy was successful and the budget deficit in the government sector was 1% of the quarterly GDP. In longer perspective the further balancing of the budget just by curbing expenditure was practically impossible. Thus, the general government budget deficit more than doubled in the second quarter, reaching about 2.5% of the quarterly GDP. A third of that was local government deficit, financed mainly from loans. In case of the consolidated central government the reserves of previous periods were used for financing, just like at the beginning of the year.

Despite the efficient tax collection plans remaining unfulfilled and local government deficit exceeding anticipation, the accelerating economic growth has offset the deficit and set preconditions for achieving the annual target.

Apart from adjusting current fiscal policy, the government was intensively involved also in improving the legal framework of the budget. Besides the new draft of the Basic Budget Act, the budgetary strategy for the years 2001 to 2004 was prepared in spring 2000. In this document the government is focusing on keeping the consolidated government budget at about 5% of real growth balanced, decreasing simultaneously the tax burden. The parallel pursuance of the two objectives arises from the public sector expenditure reduction reform.

Today the public sector reform scheme is still relatively abstract compared to that of the reduced tax burden. The budget preparation for 2001 shows that such a discord could threaten the fiscal balance. The initial consolidated central government draft budget was based on the balanced budget principle and reduction of tax burden (about 0.5 percentage points of GDP). The growth outlooks for 2001 are good both for major trade partners as well as for Estonia and therefore giving up the long-term budgetary strategy would not have economic policy justification. **Emerging from the recession cycle there is a threat of the deterioration of external balance due to potential speedy growth of demand, requiring not looser but rather tighter than “average” fiscal policy. Thereby the balanced budget should rather be a minimum objective in 2001.**

The pressure exercised by the coalition partners of the Government has increased the expenditure side during budgeting and there is a major pending threat that the budget for 2001 could be too tight as regards the budget balance. A proactive plan to prevent potential deficit is necessary.

Table 1.1. The most important indicators of economy

	1995	1996	1997	1998	1999	1st half of 2000[1]
Real growth of GDP (%)	4.3	3.9	10.6	4.7	-1.1	6.5
Growth of special export (%)	21.6	11.8	48.8	18.8	-4.6	48.6
Growth of special import (%)	36.4	26.4	41.0	13.0	-8.6	41.3
Current account balance (% of GDP)	-4.4	-9.2	-12.1	-9.2	-5.8	-5.4
General government budget deficit (-) / surplus (% of GDP)	-1.2	-1.5	2.1	-0.3	-4.6	-1.7
Consumer price index of 12 months (%)	29.0	23.1	11.2	8.2	3.3	3.1
Export price index of 12 months (%)	15.2	11.4	7.5	2.1	0.0	8.4
Consolidated balance sheet of banks (% of GDP)	36.5	41.8	63.1	55.9	62.5	65.2
Share of the foreign ownership in banking sector (% of share capital)	29.0	33.4	44.2	60.7	61.6	78.4
Capital adequacy of banks (%)	13.7	12.1	13.5	17.0	16.2	13.8
Change TALSE (%)	-	60.3	65.5	-65.8	38.3	9.0
Consolidated loan portfolio of banks (% of GDP)	25.3	27.5	30.3	30.7	33.0	34.8
M2 (% of GDP)	33.2	34.9	40.4	35.5	43.1	42.4
3 months TALIBOR	-	7.9	15.7	18.1	5.1	5.7

[1] Data are preliminary