I
SURVEY OF THE ECONOMIC POLICY

World growth outlooks have become more pessimistic in the first half of the year. The specific feature of the first quarter lies in the fact that trade did not decrease in the speed forecast and Estonia's export growth was above the annual average prognosis. Together with the continuously strong domestic demand, the annual growth in GDP exceeded 5% according to preliminary estimates. Estonia's export sector has to be highly flexible, penetrate new markets and be competitive in the market of goods of high demand in order to be able to maintain this growth rate over the whole year. Together with shrinking growth outlooks the external monetary conditions have become more expansive in the first half of the year and have been relatively difficult to forecast.

In early 2001 the inflation accelerated more than anticipated and was record high of the last two and a half years both on the monthly as well as annual terms. The impact of internal factors characteristic of Estonia after the Russian crisis is fading and once again inflation is mainly subject to external pressures. Recent developments in Europe enhance the outlook that Estonia's inflation rate is going to fall in the second half of the year. Due to continuously strong external pressures the fall will take more time than expected.

Monetary Developments

The first half of 2001 has been rather turbulent as regards expectations. Anticipations of rapid strengthening of the euro have not been fulfilled this year and the European Central Bank (ECB) made an unexpected decision for markets to cut interest rates. Although the ECB lowered interest rates in May when the peak of the temporary acceleration of inflation pace had not yet passed either in Estonia or the euro area, the ECB decision was based on inflation decrease outlooks for the second half of the year.

As regards the expansive aspect of lowering the interest rate, the previous experience shows that it is quite unlikely that implications of lower interest rates would reach interests of long-term loans issued to Estonia's real sector. The loan interests in the real sector have remained unchanged for more than a year.

In the situation where world economic growth is inhibited, there is a danger that domestic demand displays more inertia than external demand, is excessively loan-sustained and endangers, thus, Estonia's economic balance. Banks are sufficiently liquid to finance domestic-demand-oriented business projects even if export income does not significantly increase money supply. The stabilisation of loan growth, which started in the last months of 2000, has continued. Most of the funds released due to the reform of the monetary policy operational framework (see Background Information, pp 43–45) have not been used to inflate domestic lending but have rather been placed abroad.

Preliminary estimates show that the inflow of external capital into the business sector was sustained on the regular level whereas the FDI flow was above regular. Thus, the current account deficit was covered by non-debt-creating capital flows.

Financial Intermediation

Processes taking place in financial intermediation in the first half of 2001 varied by sectors. Following the Russian crisis of 1999 financial deepening started to recover in the first half of 1999 and continued at the regular pace. While growth in the volume of banking and leasing remained slightly below previous quarters due to inhibited demand, the growth in bonds and funds accelerated gently. These are the segments of securities market in which market activity has increased. Low turnover in the first months of the year brought prices down at the stock market, decreasing market capitalisation. This was followed by another rise in April and May.

The growth and turnover in the loan portfolio were modest compared to previous quarters, the same applies to the leasing portfolio. Crediting of business and individuals through leasing companies expanded even further. The banks' return on equity has improved at the beginning of the year. Primarily due to shrinking loan losses as major writing off of bad loans took place in 2000.

Inflation

The acceleration of inflation in early 2001 was faster than anticipated both in Estonia and in the euro area and achieved the highest level of the last 2.5 years in May. While in the first half of 2000 Estonia's economy operated in the environment of relatively low inflation and the pace of price growth was below long-term trend, by today the situation is reverse. This becomes manifest in provisionally accelerated inflation compared to the euro area: while in 2000 the growth of the average consumer price index of the first four months was only 0.7 percentage points above the one of the euro-zone, this year the indicator was 3.4 percentage points.

At the beginning of the year price growth acceleration was mostly related to the prices of the sheltered sector. In Estonia housing costs were responsible for about a third of the consumer price growth in the first quarter. The appreciation of electricity by 26% and heat energy by 11% had the largest impact. In both cases they were administered prices whereas appreciating fuel pushed heat prices up as well. These were anticipated changes. Meanwhile price growth should have started to slow down in the open sector. Similar to the euro area, beef-related concerns made food prices grow faster than forecast and the after-effects of tripled crude oil prices inhibited the slowdown.

Continuing external pressure indicates that the upcoming inflation slowdown will be slower than anticipated and significant annual fall can be expected only in autumn. Recent developments in Europe strengthen the outlook that inflation is going to slow down in the second half of the year. It can also be noted that the impact of post-Russian-crisis internal factors characteristic of Estonia is fading. In other words, price developments in the euro area and price convergence characteristic of Estonia as a transition economy will become significant again.

Real Economy

World economic outlooks are more pessimistic than a year ago. As regards economic growth, it is only natural that shrinking external demand will inhibit growth prospects in Estonia as a country with very open economy. In the first months of 2001 external demand of EU Member States was clearly slowing down but being faster than the annualised average of most forecasts. The EU countries are main trade partners for Estonia and any change in their demand has decisive impact on Estonia's export flows. Although the growth of exports remained high (above

30% in current prices), the growth rate still slowed down. Thereby, according to preliminary estimates, the external demand played a smaller role in generating economic growth than in early 2000. Due to rapidly growing investments the economic growth was also sustained by strong domestic demand.

One of the problems originating in the year 2000 is the assessment of the investment level from the perspective of sustainable economic growth. In 2000 the share of investments kept growing throughout the year but did not exceed 25% of GDP. Preliminary estimates on the first quarter of 2001 indicate the continuation of this trend as well as a slight shift towards investments in the structure of domestic demand. Beginning from the end of 2000 the growth in private consumption has revealed a gentle slowing trend. At the beginning of 2001 also lending and leasing remained below the second half of 2000 in financing private consumption. Growing investments have boosted import of capital goods. As saving in economy remained on the level of last year, the deficit in the balance of goods and services did not exceed 5–6% of GDP in the first quarter of this year, being in line with the moderate growth in the current account deficit forecast for the year.

Excluding the slowdown in the early transition period and the post-Russian-crisis period, the average wages in Estonia have been growing hand-in-hand with productivity. Data of the first quarter of 2001 confirm that this causal link has been most efficient in the export sector, where rapid adjustment to changing external demand is the main precondition for business success. In domestic-demand-oriented activities, especially in case of monopolies, such “performance control” takes place at longer intervals and is based not only on the results of the previous period but also on future expectations. In the first quarter of 2001 the nominal wages were 13.3% above the year-ago level. Assuming that labour cost dynamics should be in harmony with the growth of productivity by quarters as well, the wages grew too fast according to preliminary estimates of GDP. Hopefully it was more past-related adjustment than anticipation. The probable slowdown in the economic growth against the year 2000 accompanied by slower inflation in the second half of the year assume inhibited wage growth during the next quarters. Otherwise rapidly growing wages could lead to re-acceleration of inflation in the sheltered sector and decline of competitiveness.

The faster-than-expected growth of wages is hopefully not related to the supply side rigidity of the labour market. Increasing labour supply flexibility is an economic policy objective primarily from employment and unemployment perspective. Estonia is still going through the decline-in-employment phase characteristic of the transition period (in the first quarter of 2001 the number of employees roughly equalled the year 2000 level). Thus, the unemployment level is going to remain high for a long while and the labour market policy should apply for maximum increase in labour market flexibility in order to ensure as rapid growth in the economic potential as possible (see Background Information, pp 23–25).

Government Sector

Due to deteriorating world economic outlooks and uncertainty to what extent Estonia’s economic environment will be affected, the key priority of the fiscal policy in 2001 is to fully support balanced economic development.

The 60-million-kroon surplus of the government sector budget in the first quarter confirmed the government’s intent to return to the principle of balanced budget after three years. The surplus was achieved due to better administration of indirect taxes and sound tax revenues under favourable economic environment. Tight fiscal policy offset the estimated decrease in corporate saving.

Maintaining balanced budget in the second half of the year will be more difficult than in the first quarter. Speeding up the implementation of investment programmes financed from local government borrowing assumes a larger-than-intended surplus on the level of the central government. Besides as in the first quarter social security budgetary expenditure was raised by about 200 million kroons, the central government as a balancing force is under higher pressures.

Strategic development plans of economy prepared both on the central government and local government level in the first half of the year indicate that the need to finance structural reforms will be additional burden for the budget. New ways to save traditional expenditure should be identified. Although the need to finance structural reforms makes the link between the economic cycle and balance of the budget more difficult to perceive, the necessity to use budgetary policy for securing macro balance will not decrease.

World economic outlooks and related prospects of Estonia's economic and tax revenue growth are likely to remain uncertain throughout the preparation of the next year's budget as it is very difficult to forecast actual growth. Private sector's economic decisions, rate of saving and investment demand are always at least partially uncertain and the government sector has to be ready to apply cost-reducing measures.

Table 1.1. The most important indicators of economy

	1995	1996	1997	1998	1999	2000	Q1 2001[1]
Real growth of GDP (%)	4.3	3.9	10.6	4.7	-1.1	6.4	5.1
Growth of special export (%)	21.6	11.8	48.8	18.8	-2.1	50.9	32.8
Growth of special import (%)	36.4	26.4	41.0	13.0	-8.5	43.1	31.6
Current account balance (% of GDP)	-4.4	-9.2	-12.2	-9.2	-5.8	-7.5	-7.0
General government budget deficit (-) / surplus (% of GDP)	-1.2	-1.5	2.2	-0.3	-4.6	-0.7	0.3
Consumer price index of 12 months (%)	29.0	23.1	11.2	8.2	3.3	4.0	5.9
Export price index of 12 months (%)	15.2	11.4	7.5	2.1	0.0	7.8	13.1
Consolidated balance sheet of banks (% of GDP)	38.1	43.7	63.1	55.9	62.5	68.7	70.3
Share of the foreign ownership in banking sector (% of share capital)	29.0	33.4	44.2	60.7	61.6	83.6	83.9
Capital adequacy of banks (%)	13.7	12.1	13.5	17.0	16.2	13.2	14.2
Change TALSE (%)	-	60.3	65.5	-65.8	38.3	10.1	-9.7
Consolidated loan portfolio of banks (% of GDP)	25.3	27.5	30.3	30.7	33.4	40.7	41.3
M2 (% of GDP)	33.2	34.9	40.4	35.5	43.1	48.7	50.2
3 months TALIBOR (%)	-	7.9	15.7	18.1	5.1	6.1	5.9

[1] Data are preliminary