BACKGROUND INFORMATION

ECONOMIC FORECAST FOR 2001–2002

External Environment

The external environment has significantly deteriorated compared to the previous forecast – world economic growth has slowed down and development prospects are less favourable. While in the autumn of 2000 the European Union growth forecast was above 3%, by today the estimates have shrunk to about 2.5%. Several countries have responded to the growth slowdown and declining inflationary pressure by loosening monetary conditions which should support growth recovery. The period of slow economic growth is expected to be relatively short.

Export, Economic Growth and its Financing

Although it is not clear how and to what extent the deteriorating external environment will affect Estonia, it will probably remain the major risk factor for economic development for some time. The economic slowdown inhibits global trade, which probably is going to impact Estonia's export. Besides export developments could be relatively turbulent in near future due to the structure of Estonia's export goods and services. Thus, for example subcontracting is fluctuating, transit flows could change and world timber industry has relatively difficult times. Thereby compared to 2000 the light industry and foodstuff industry have improved their position. The real volume of export is increasing by 8…14% this year and 7…13% in 2002 (see Table 1b).

Global growth slowdown curbs Estonia's growth outlooks as well and the forecast for 2001 has been revised downward to 4.5…5.3% from the 5…6% forecast last autumn. Shrinking external demand should be offset by larger internal demand. After two years of setback the investment demand is expected to recover and the share of investments in GDP to increase. Businessmen questioned by the Estonian Institute of Economic Research have confirmed this. The additional investment demand is primarily related to the need to upgrade capital stock and bring it into compliance with general requirements set by industrial countries. A large-scale reconstruction of infrastructure objects will be undertaken in upcoming years, which also increases the volume of investments. The central government's investment plans are more modest than last year but in upcoming years co-financing of EU assistance programmes requires increasing contributions. Private consumers' confidence is satisfactory, favourable interest rates and simplified lending and leasing terms promote consumption. At the same time, continuously high unemployment inhibits consumption.

Table 1b. Prognosis of the most important economic indicators

	2000	2001	2002
Growth of GDP (%)	6.4	4.5...5.3	5.1...5.7
Growth of export (%)	32.8	8...14	7...13
Investments (% of GDP)	24.1	25...27	25...27
Balance of goods and services (% of GDP)	-4.3	-5...-7	-5...-7
Current account balance (% of GDP)	-6.8	-7...-9	-7...-9
Growth of consumer price index (%)	4.0	5.7...5.9	3.7...4.2

A great part of the investments focus on increasing efficiency and do not facilitate creating of new jobs. Ongoing restructuring of recently privatised companies also reduces the number of jobs whereas the expansion of the services sector slightly increases them. As a result of these processes, the unemployment will not shrink significantly this year.

Larger investments bring along growing imports, and goods and services balance deficit could reach 5…7% of GDP in the next couple of years. The investment activity was expected to recover and the current account to deteriorate already in the previous forecast cycle. In the current cycle the current account deficit is forecast to be higher by about one percentage point of GDP due to the large-scale reconstruction of infrastructure objects.

In financing economic growth both internal and external financing continue being important. The financial sector is strong and ready to finance economic growth. In 2001 the implications of loosening external monetary environment could partially spread into Estonia if no new significant risks appear. The current trend that domestic borrowing is sustained by domestic saving is expected to continue at least this year, in long-term perspective banking groups can involve additional external capital to boost domestic loan portfolio.

However, external resources are necessary to finance economic growth. Foreign capital reaches Estonia mostly as FDI. Although current account deficit is partially financed from non-debt-generating capital, slight growth in the external debt is inevitable, whereas this is primarily private sector external borrowing.

Consumer Prices

Last autumn consumer prices were forecast to grow in 2001 faster than a year ago. The prices were anticipated to grow rapidly at the beginning of the year and inflation was expected to slow down later in the year. The actual price growth in the first quarter of the year was above the forecast, mostly because of external impact. The previous forecast had assumed lower oil prices since the end of 2000 as well as the depreciation of the US dollar whereas neither of them happened. Animal diseases in Europe have pushed food prices in Europe upward, with its implications providing an additional impetus to price growth in Estonia.

In the European Union the peak of price growth is believed to remain in the second quarter and the inflation to slow down in the second half of the year. Thus, the price growth in Estonia's open sector should also significantly slow down.

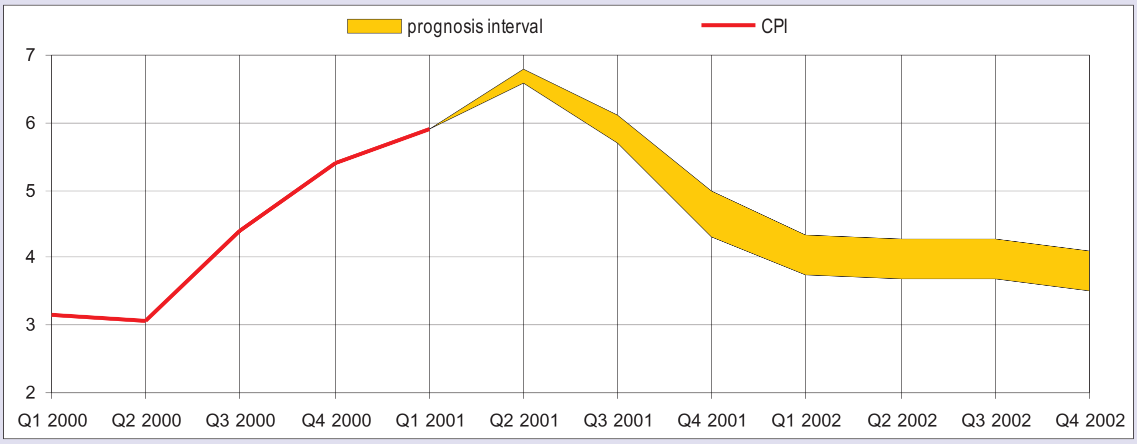

Figure 1b. Prognosis of the consumer prices (annual growth, %)

As domestic demand recovered, several administered prices were raised at the beginning of 2001. In the first quarter prices for electricity, telephone services, public utilities as well as for public transport went up. Although no significant increase in the price of services will take place (it is possible that some administered prices even drop), the leaps having taken place earlier in the year will maintain the high price level of the sheltered sector throughout the year. No such high price leaps are foreseen for 2002 for the time being and the inflation rate of the sheltered sector should remain below 2001. Among administered price changes of 2002 a change in tax rates should be singled out due to enforcement of the new VAT Act as well as potential appreciation of heat.

Dependant on external developments in the second half of the year, the consumer price index of 2001 is forecast to grow by 5.7…5.9%, in 2002 consumer prices will rise by 3.7…4.2% (see Figure 1b).