II
ECONOMIC DEVELOPMENTS

EXTERNAL ENVIRONMENT

The world economic growth has significantly slowed down against the same period in 2000. Shrinking profits and profit forecasts accompanying manufacturing fall have also inhibited investor confidence, making stock prices drop at nearly all stock markets. The decline in stock prices damaged the financial status of households and corporate prospects to involve capital, undermining confidence in future. This restricted growth of private consumption. The impact of shrinking profitability and confidence on investments and employment is going to be a major threat in the upcoming months. **The International Monetary Fund forecasts the world GDP to grow just by 3.2% in 2001 and by 3.9% in 2002, remaining far below the factual growth of 4.8% in 2000.** According to the published statistics the second quarter is likely to be the worst period of 2001. The less active economy slows down growth in foreign trade and brings along less inflationary pressure.

The United States of America and Japan

The economic growth of the **United States** slowed down from 5% in 2000 to 1.5% in the first quarter of 2001. In the second quarter the slowdown is forecast to deepen and the GDP to grow by about 1.5% during the year (see Table 2.1).

Shrinking growth is due to a downfall in investment and private consumption growth. Consumer confidence has shrunk significantly in the first months of the year due to diminishing wealth arising from dropping stock prices. Stock indices have recovered but increasing unemployment (unemployment reached 4.2% in the first quarter) and contracting investments in equipment are going to threaten economic development in near future. These factors could slow growth in private consumption and encourage saving.

The external economic imbalance has been preserved but it has not yet inhibited foreign investor confidence in the US economy. The strong American dollar and shrinking external demand prevent export growth whereas foreign investment continues to flow into the United States.

The inflation rate stays moderate, although prices for energy have been above expectation. Similar to the fourth quarter of 2000 consumer prices have grown by 3.4% in the first quarter of 2001 against the year-ago period.

The US Federal Reserve cut interest rates in order to support consumer and corporate confidence in economic outlooks. By early May the Federal Reserve had lowered interest rates by 250 basis points, more than compensating interest increase in 2000. In longer term the tax cut plan is also going to support economic development. According to the plan the tax burden will be reduced by 100 billion dollars by the autumn of 2001 and by 1.25 trillion dollars during ten years.

The economic growth in **Japan** remained low whereas confidence in economic policy is moving upwards. Growth forecasts for 2001 are all below 1% as external demand has significantly shrank and restructuring of the economy will inhibit growth in near future.

Table 2.1. The most important economic indicators of some selected countries

Indicator	Year	Source	USA	Japan	Euro area	Germany	France	Great Britain	Finland	Sweden
Growth of GDP (%)	2000	IMF	5.0	1.7	3.4	3.0	3.2	3.0	5.7	3.6
		EC	5.0	1.7	3.4	3.0	3.2	3.0	5.7	3.6
		CF	5.0	1.7	…	3.0	3.2	3.0	5.7	3.6
	2001	IMF	1.5	0.6	2.4	1.9	2.6	2.6	4.2	2.6
		EC	1.6	1.0	2.8	2.2	2.9	2.7	4.0	2.7
		CF	1.7	0.9	…	2.1	2.8	2.4	4.0	2.7
	2002	IMF	2.5	1.5	2.8	2.6	2.6	2.8	4.0	2.8
		EC	3.0	1.3	2.9	2.6	2.8	3.0	3.6	3.0
		CF	3.1	1.6	…	2.6	2.9	2.7	3.7	2.9
CPI change (%)[1]	2000	IMF	3.4	-0.6	2.4	2.1	1.8	2.1	3.0	1.0
		EC	3.3	-0.7	2.3	2.1	1.8	0.8	3.0	1.3
		CF	3.4	-0.7	…	1.9	1.7	…	3.3	1.3
	2001	IMF	2.6	-0.7	2.3	2.0	1.5	2.2	2.6	1.8
		EC	2.7	-0.3	2.2	2.0	1.3	1.4	2.4	1.5
		CF	2.9	-0.3	…	2.0	1.3	…	2.3	1.7
	2002	IMF	2.2	…	1.7	1.3	1.4	2.4	2.4	1.9
		EC	2.1	0.6	1.8	1.5	1.6	1.7	2.0	1.5
		CF	2.3	-0.2	…	1.6	1.4	…	2.0	1.9
Current account surplus/deficit (% of GDP)	2000	IMF	-4.4	2.5	-0.2	-1.1	2.1	-1.7	7.7	2.6
		EC	-4.3	2.5	0.1	-1.2	1.2	-1.7	7.7	3.2
	2001	IMF	-4.3	2.7	-0.1	-1.2	2.1	-1.8	7.3	2.4
		EC	-4.2	2.7	-0.1	-1.6	1.1	-2.1	8.1	3.2
	2002	IMF	-4.1	2.8	…	-1.0	2.3	-2.2	7.6	2.3
		EC	-4.2	2.8	-0.1	-1.7	1.1	-1.5	8.1	3.0

[1] CPI figures are not fully comparable: the IMF prognosis do not reflect the growth of HCPI.
IMF - IMF, World Economic Outlook, April 2001
EC - European Commission, Economic Forecasts, Spring 2001
CF - Consensus Forecasts, April 2001

In 2000 the growth was fed by corporate investments, exports and government sector expenditures. At the beginning of this year exports fell sharply. Declining external demand and changes in the financial markets have inhibited corporate profit outlooks and probably also influenced investment schemes. Growing unemployment (4.7% of the total workforce in March) and pessimism in future restricts the growth in private consumption. Low domestic demand facilitates price decline – the consumer price index fell an annual 0.4% in the first quarter.

The reform-minded government led by Prime Minister Koizumi and expansive monetary policy have strengthened economic policy. Koizumi visualises structural reforms (including writing off of bad loans[1] and a stock market reform) and containing government bond issues below 30 trillion yens.

European Economic Space

The economic growth in the **European Union and the euro area** is slowing down whereas inflationary pressure has not yet receded. The GDP is forecast to grow by 2.3…2.8% in 2001, although the longer-than-anticipated contraction in external demand could slightly slow the growth.

[1] In Japan banks' volume of non-performing loans is about 25 trillion yens, just under 5% of the total loan portfolio.

Lower external demand and capital spending remaining below expectations have an impact on the economic growth of the European Union, including the euro area. However, domestic demand remains high. The current slowdown is a test for the success of economic reforms: whether the economy is flexible enough to avoid strengthening of the inflationary pressure and irreversible growth of unemployment?

In order to achieve growth anywhere close to the potential in Europe in 2001 (about 2.5%), the external environment, especially the US economy, should recover in the second half of the year. The growing US domestic demand would support exports in developing countries. Although insecurity in future remains high, signs of the downfall coming to a halt are visible in the US manufacturing sector and stock prices have recovered.

The price level is still on the rise but by end-2001 the European Central Bank forecasts the HCPI-measured inflation rate to drop to 2%. Consumer prices grew an annual 2.5% in the first quarter. Prices are still subject to the weakening of the euro last year; prices for energy have been relatively high, too.

The EU economic policy is growth supportive. The ECB monetary policy has a neutral impact on the economic growth. The ECB responded to shrinking inflationary pressure by lowering ECB interest rates by 25 basis points. The Bank of England has lowered interest rates by 75 basis points this year. Easing of the fiscal policy both in the euro area, in the UK (about 0.7% of GDP) and Sweden (about 1.5% of GDP) to support economy is well timed.

Having rapidly increased for several years, the economic growth in **Finland** and **Sweden** is slowing down. In Sweden the growth forecast is about 2.4% for 2001 and 2002, more sustainable than in previous years, according to official sources. The economic growth in Finland is forecast to be 3.4…4.2% and 4%, respectively.

There is a threat for Finland and Sweden that if external demand remains modest in the second half of the year and domestic demand grows less than anticipated, the growth of total output could slow down significantly. Falling stock prices have undermined consumer confidence considerably in Sweden. Despite of decreasing stock and real estate prices, the Finns value their industrial financial assets still highly. Investments in the telecommunication sector that should add about 3 percentage points to the growth of investments in Finland can be postponed by deteriorating external environment.

In Sweden the inflation rate having been low for a long while started to accelerate in April – consumer prices having had an annual growth of merely 1.6% in the first quarter, grew by an annual 3% in April. However, inflation in Finland has slowed down: while in December 2000 the HCPI increased by about 3% against the year-ago period, this March – by only 2.5%.

Both in Finland and Sweden the resistance to external shocks is magnified by current account surplus and government budget surplus. In 2001 Swedish fiscal policy is going to be a significant contributor to the economic growth. Tax reduction should reach about 1.5% of GDP, being twice above the year 2000. In Finland fiscal policy schemes also include tax cuts.

Emerging Countries

The attitude of financial market participants towards emerging economies is continuously dependent on confidence in Argentina and Turkey. Rising stock markets and shrinking investor risk aversion have not bolstered confidence in emerging markets, primarily in Latin America. Emerging countries' bond interest rates comprising the EMBI Index vary largely from

US bond interest rates – in early 2001 by about 700–900 basis points. As Latin American bonds comprise over 70% of the EMBI Index – equal to their stake in the emerging countries' debt – the high index level originates from the complicated situation in Argentina.

Private institutions expect economy to grow by 2...3% in **Latin America**. The economic growth of the region is anticipated to recover by end-2001. The anticipation is partially fed by presumable economic recovery in the United States and partially by potential tightening of the fiscal policy. The global impact of manufacturing recession, initiated by the falling demand in the US, is strongest on Mexico that depends on US exports and whose industrial production has shrank in the spring of 2001.

Distrust in **Argentina** has caused problems for other countries in the region as well – capital inflows in the area have sharply decreased and bond interest spread against the US level grown. In April Argentina got a new Prime Minister and an economic policy programme to overcome the crisis was adopted. However, indicators manifest low economic activity – both exports and imports have contracted, tax collection is irregular and lending by banks has come to a halt. Argentina's growth forecast for 2001 is negative (-0.3%).

The economy in **Asian emerging countries** depends on external demand by the US and Japan. According to different estimates the economy in the region will grow by just 4...6% in 2001 against 7.1% in 2000. Excluding more closed large economies like China and India, the regional economic growth is going to be half below the year 2000. Private institutions forecast merely 3.2…3.3%. Economic growth will significantly slow down in countries depending on exports of electronic products like Hong Kong, Korea, Malaysia, Singapore and Taiwan.

Shrinking export income has negative implications on domestic demand in these countries. Domestic situation is in economic policy terms favourable: relatively low inflation rate (regional consumer price index grew an annual 4.8% in the first quarter), interest rates declined together with easing of the monetary policy by the Federal Reserve and growth-supportive fiscal policy in some countries. Supposedly end-2001 will be a start of another growth phase in Asia, presuming that the US economic growth has recovered by that time.

The global economic growth slowdown has not had a major impact on **Central and East European Countries** in the first quarter of 2001. This is partially due to larger dependence on the internal demand of the European Union that has not fallen as sharply as the demand in the United States. Weaker economic indicators reflect signs of global slowdown as late as in March and April. The Central and East European countries are encouraging domestic demand in order to offset shrinking external demand, easing monetary and fiscal policy.

Cutting of **interest rates** in early 2001 supported economic development in the first quarter. Similar to the European Central Bank central banks of Central European countries have to monitor inflation level. A slight rise in the level caused problems mainly in Hungary earlier this year. In the Czech Republic the inflation moved in April (annual 4.6%) considerably towards the central bank target of 2001. Despite of rapid decline (annual growth rate of 6.8% in April) inflation remains problematic in Poland. Strengthening of national currencies' exchange rate since end-2000 has complicated maintenance of competitiveness. The Polish zloty has strengthened by 30% against currencies (primarily the euro) of its major trade partners during the last six months, the Czech koruna by 10% and the Hungarian forint has also started to strengthen after the standard fluctuation band was raised in early-May 2001. In longer term it could have a negative impact on the production growth and boost current account deficit.

Only Hungary can afford short-term easing of **fiscal policy** due to surplus tax collection in the first quarter. Considering Hungary's significant dependence on external demand and sharp fall in the annual growth of the industrial production to 5.9% in April, tax collection could shrink in upcoming months. In Poland the problem is even worse: this year the country cannot probably contain the budget deficit on the level of 1.8% of GDP vis-à-vis upcoming general elections. Already by the end of the first quarter three quarters of the annual intended deficit was met, by end-May the deficit for the entire 2001 should be used up. A sharp rise in unemployment should boost budgetary expenditures this year as well (in April 15.8% of the working-age population was unemployed). In the Czech Republic the budget deficit is presumably 9.4% of GDP whereas budget outlays are mainly going up due to the financial sector reform. The high budget deficit in the Central and East European countries is a threat to current account as its negative balance has grown under shrinking exports and continuous relatively high domestic demand anyway.

*The most problematic state of the region is **Turkey** caught in the financial crisis. The crisis was caused by loss of confidence in private banks starting in November 2000 and speculations against the Turkish lira that forced the central bank to release the exchange rate of the lira at the end of February 2001. The interference of international organisations (the International Monetary Fund, the World Bank) has helped to devise reform programme for crisis resolution. Programme priorities include banking sector reform and increasing the weight of private sector in the economy (including speeding up of privatisation). This year the international organisations support Turkey with about 15.7 billion US dollars, to cover fully the debt-servicing gap (of 11 million dollars) in 2001. It is not so sure that the programme objectives can be met. Sharply declining economic activity has complicated the situation, thereby the IMF growth forecast for 2001 is –3% and that of private institutions up to –5% (in 2000 the economic growth was +7.2%). The problematic situation in Turkey, especially growing external debt (55% of GNP at the end of 2000) could undermine confidence in the entire Central and Eastern Europe in long term. The Turkish case is an excellent example of the significance of the strong banking sector and low openness of the public sector to business-related external shocks.*

In **Latvia** the economy grew faster than expected mostly due the development of the services sector in 2000. In the fourth quarter the estimated growth of GDP was 8.7%, raising the annual growth of GDP to 6.6%. Large growth is anticipated in the first quarter of 2001 as well. Accelerating industrial production and retail sales serve as indicators. Currently the world economic slowdown has had no significant impact on Latvian economy. This is primarily due to the perseverance of a growth-sustaining factor – transit of Russian oil and oil products. Despite of large domestic demand and rapid credit growth, inflation was low in Latvia in the spring of 2001, in April the annual growth rate was just 1.4%.

In **Lithuania** the economic growth accelerated to 3.6% in the fourth quarter of 2000. The industrial production and commerce took Lithuania's economic growth to 3.3% in 2000, reflecting recovered economic activity. The export of oil and textile products is significant for the country. In the first quarter of 2001 exports continued growing significantly (15.2% against the first quarter of 2000), equalling the growth of imports (15.3%), manifesting improved domestic demand. March 2001 was the first month in more than a year when the annual loan growth to private sector became positive (for the entire first quarter it was still –0.6%). The annual growth of the consumer price index remained below 1% in the first quarter whereas growing food prices have facilitated price acceleration over the last months.

Both official and private institutions anticipate the economy to grow by 4% in **Russia** in 2001, the growth remaining significantly below 8.3% [2] in 2000. Slower growth increases need for economic reforms in Russia. Apart from budgetary reform the current government has not

[2] Russian Statistical Committee revised substantially growth indicators of 1999 and 2000 in May 2001. According to revised estimates the economy grew by 5.4% (previously 3.5%) in 1999 and by 8.3% (7.7%) in 2000. The upward revision was due to significant revaluation of added value in industry and agriculture.

been able to speed up reforms necessary for strengthening both the banking and the private sector. Therefore lending by banks in financing the economy (in 2000 bank loans constituted just 2.9% of investments into the fixed capital) is continuously shrinking and this year the growth of investments has also started to slow down. Considering the increasing dependence of Russia's economic growth on domestic demand, shrinking investments become the main growth inhibitor as consumption continues growing on the last year's level. Increasing domestic demand and continuous inflow of export income have accelerated inflation (the annual growth reached 22.3% in the first quarter). Tax collection has been excellent – in the first quarter the government primary budget displayed surplus of 9% of GDP, general budget surplus (without debt servicing costs) was 4.4% of GDP.

International Financial Markets

The strengthening of the US dollar against other major currencies was the most significant trend **in the foreign exchange markets**. The dollar strengthened against the yen by 7.9%, against the euro by 5.7% and against the pound by 4.4% (see Table 2.2). The main underlying reason lies in economic data slightly above anticipation and the economic growth of the US in the first quarter. The other factor was the role of the dollar as investors' secure currency in the environment of weakening stock markets.

Table 2.2. Changes in exchange rates of major currencies

	29.12.00	30.04.01	Change
JPY / USD	114.41	123.48	7.9%
USD / EUR	0.9427	0.8891	-5.7%
USD / GBP	1.4930	1.4278	-4.4%

Slower economic growth and deteriorating outlooks sustained the downward trend in major **stock markets** (see Table 2.3). The downward slide was really quick and extensive in technology sector stocks, taking the high-tech Nasdaq index down by 14.3% (the index weakened by about a third in the fourth quarter of 2000). Indices with broader capitalisation fell as well. Japan remained an exception, sustaining a modest growth in stock prices. Major breakthrough took place in stock markets at the beginning of April when rapid fall was replaced by a rise. Investor optimism thrived on confidence in the rapid recovery of the US economy in the second half of 2001 and on the decisive interest rate cut by the Federal Reserve.

Table 2.3. Indices of major stock markets

	29.12.00	30.04.01	Change
USA (S&P 500)	1,320.28	1,249.46	-5.4%
USA (Nasdaq)	2,470.52	2,116.24	-14.3%
Japan (Nikkei 225)	13,785.69	13,934.32	1.1%
Euro area (Eurotop 300)	1,533.47	1,458.38	-4.9%

Out of developed countries short-term **interest rates** changed most in the United States, with the Federal Reserve cutting interest rates five times by 50 basis points each time in order to encourage economic growth and reject recession threat. The central bank of Japan responded to worse growth outlooks by restoring zero interest rate policy. Although economic slowdown as a trend appeared in the euro-zone as well, the European Central Bank refrained from cutting benchmark rates and short-term interests maintained their previous level. Long-term interests rose slightly in the United States and the euro area as markets had anticipated the economic growth to accelerate in the second half of the year. In Japan the 10year bonds' interest rate dropped by 31 basis points (see Table 2.4). The fall came to a halt in mid-March and the interest rates started to rise again as risks associated with the expansive fiscal policy drafted for the next year started to appear.

Table 2.4. Interest rates of major bond markets

	Interest rates of 3 months			Interest rates of 10 years		
	29.12.00	30.04.01	Change (basis points)	29.12.00	30.04.01	Change (basis points)
USA	5.89	3.88	-201	5.11	5.34	23
Japan	0.41	0.03	-38	1.65	1.34	-31
Euro area	4.68	4.68	0	4.85	5.03	18

Prices for raw materials declined from January to April: the CRB index based on the most commonly used raw materials dropped by 5.9%, reflecting implications of global economic slowdown. Prices for crude oil increased to 28.5 dollars in end-April. Energy prices have been sustained on a relatively high level over the last months primarily due to energy shortage in the United States.

ESTONIAN ECONOMY

Domestic Demand

Private Consumption and Investments

Inhibited world economic growth has increased a threat that domestic demand will be more inert than external demand and will, thus, threaten the internal and external balance of the economy.

Although compared to 2000 the growth of domestic demand is slightly slowing down, domestic demand played a more significant role in generating economic growth in the first quarter. Investments and growing government consumption support it more than before. The increase of consumption loans has not accelerated according to the data of the first quarter, although crediting conditions (eg real interest rates) are even more favourable than in 2000. With external demand and growth of money supply slowing down, the renewed growth of the potential expansive impact of loan money requires heightened attention.

Throughout 2000 productivity growth has been above wage costs and the share of labour costs has dropped below the pre-1999 crisis level. Although in early 2001 the growth of nominal wages accelerated, it did not directly threaten the balance. The wages grew primarily in the domestic-market-oriented activities, remaining roughly on the level of productivity growth in sectors open to external competition (see Figure 2.1). It is possible that the preferential growth of wages against economic growth in the first quarter of 2001 was just a single indexation case at the beginning of the year. Nevertheless, the potential acceleration in the growth of wages arising from "false interpretation" of inflation indicators, could push private consumption into accelerated growth again.

Although developments in the first quarter do not manifest any direct threat for the balance of the economic cycle in short term, they do not confirm either the disappearance of potential

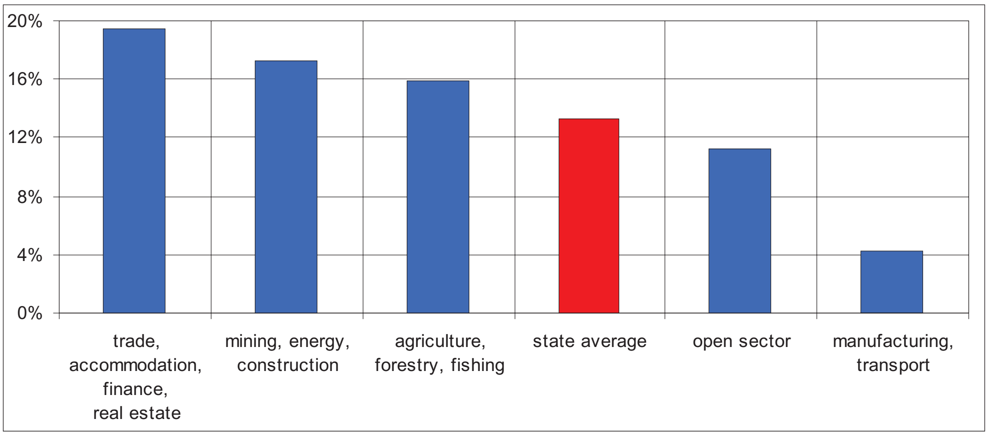

Figure 2.1. Annual growth of wages by spheres of activity in the first quarter of 2001

threat. It is significant to see whether temporary deviation of some economic indicators (accelerating inflation rate) will change corporate (more rapid growth in wages) and private (larger credit demand) behaviour patterns. The financial sector should also follow more conservative policies.

Public Sector

Due to deteriorating world economic outlook as well as uncertainty in the implications on the local economic environment, the fiscal policy of 2001 should fully support balanced economic development.

The 60-million-kroon surplus of the state budget in the first quarter confirmed the intention of the government to return to the balanced budget principle after more than three years (see Figure 2.2). The surplus was mostly due to better administration of indirect taxes and successful tax collection sustained by expanding domestic demand. Achieving the target of balanced budget in the second half of the year could be increasingly hindered by local governments' questionable fiscal policy. Besides, the central government is inhibited in balancing the easing of fiscal policy on other government levels as it was decided to increase expenditures of the social security budget by about 200 million kroons in the first quarter.

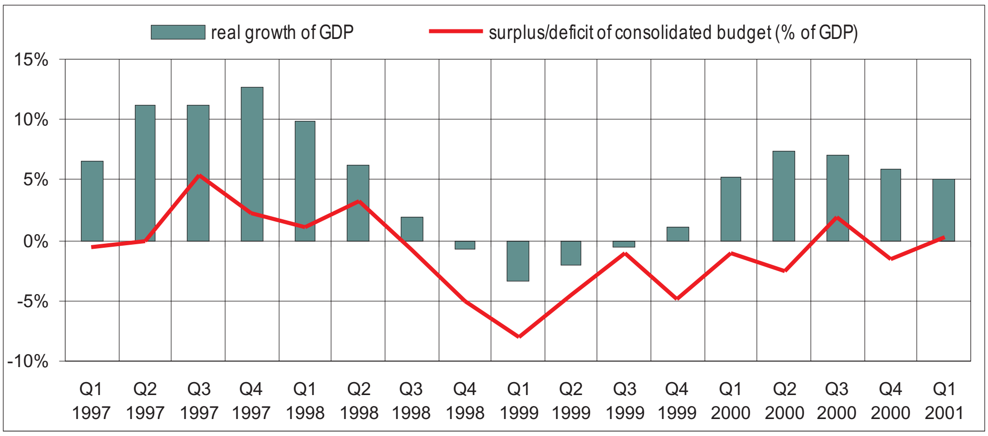

Figure 2.2. Real growth of GDP and balance of the consolidated budget

According to the Pre-accession Economic Programme the need to continue with structural reforms and approaching accession deadline will boost the expenditure side in the coming years. **Together with deepening uncertainty of the economic development in near future, it is very important to remain conservative in drafting the budget for 2002.**

As regards the sources of growth of domestic demand, they were a reflection of the last year in the first quarter of 2001, ie investments grew faster than private consumption. Supported by growing government consumption expenditures and more active demand for investments, the domestic demand maintained the nominal growth above 10%.

Domestic Saving

Together with slowly weakening external demand and currently high domestic demand, the level of private and corporate saving was slightly below the level of the same period in 2000. The relatively efficient control of current expenditures on the level of the state budget compensated for low private saving. Balanced fiscal policy developments encouraged government sector saving that is estimated to reach about a fifth of gross saving and the level of gross saving of the economy did not change.

Domestic Supply

Despite of the world economic growth slowdown, the sustained high demand for Estonia's export production leaves the growth forecast on the level of 5% for the year. This can realistically be achieved only if supply is flexible enough to respond to a presumable change in the demand structure with our major trade partners: growth is increasingly dependent on satisfying Europe's private consumption.

The rapid growth of 2000 in the industrial sector continued at the beginning of the year 2001 as well but lost some of its pace (the large growth of 2000 reflected partially also the post-1999 adjustments). Among larger industries **the textile industry** accelerated growth, constantly expanding product range and increasing exports to the so-called non-traditional markets (like the United States). **The timber industry**, on the other hand, has continuously problems with raw material whereas the demand environment is deteriorating in Europe as well. Despite of making increasing use of Russian and Latvian raw timber, several wood-processing companies worked at reduced capacity in the first quarter. The gross manufacturing sales increased by 8.5% in constant prices in the first quarter of 2001 (see Figure 2.3).

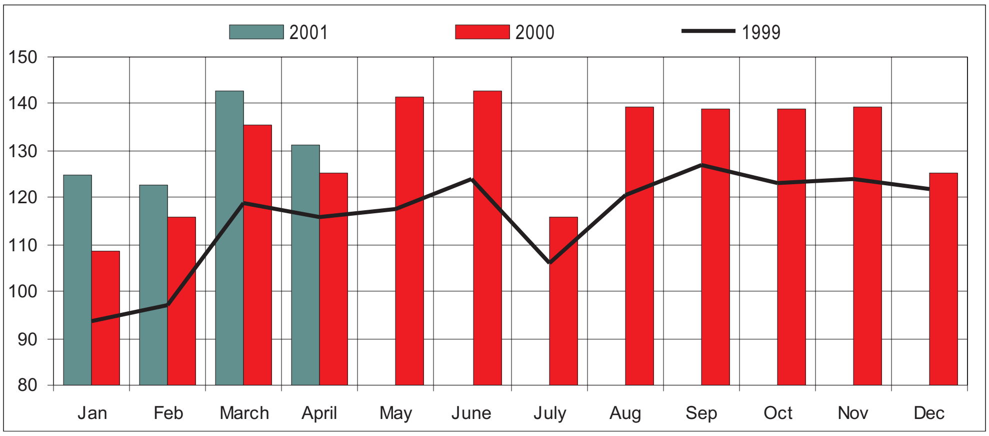

Figure 2.3. Monthly sales of the manufacturing in constant prices (%, January 1997 = 100)

Out of other industries merchandising companies contributed most to the economic growth in the first quarter. Retail trade grew by 14.6% between January and March against the same period in 2000. Favourable financing terms activated construction and real estate companies. Whereas transport services remained more or less on the level of 2000 as transit volumes and export of services had shrunk.

Based on global economic growth slowdown experts of the Estonian Institute of Economic Research concluded that the general conditions of Estonia's economy in the first quarter of 2001 deteriorated slightly. Nevertheless, they rated the general situation significantly better than in the same period a year ago. Primarily industrial, construction and merchandising companies had informed the Institute of sustained demand for Estonia's goods. The experts are relatively optimistic about the near future, assuming that in about six months the general economic situation in Estonia will be roughly similar to the first quarter.

Under economic recession of 1999 shrinking employment and increasing unemployment seemed inevitable whereas contrary to anticipation unemployment has been deepening in relatively rapidly growing economy in 2000 as well. Instead of increasing staff and investing in new jobs, companies have attempted to use existing resources in a cost-effective way. The pre-crisis production level was surpassed with lower employment and unchanged amount of capital. The volume of investments in 2000 did probably not suffice to sustain productivity growth in a transition economy. At the beginning of this year intensive application of existing resources made companies more actively invest and also to a lesser extent create new jobs. The first quarter statistics revealed that the unemployment rate was stabilising. Employment can grow and unemployment decrease only if investment-based productivity is going to grow in the open sector, primarily in manufacturing.

External Sector

With global growth slowdown and inhibited trade flows the high external demand for Estonia's goods has been sustained in the first quarter of 2001. Lower growth in subcontracting has slightly inhibited export of goods whereas the nominal volume has grown by a third anyway (see Figure 2.4). Considering changed external circumstances, this displays satisfactory supply side flexibility of the economy.

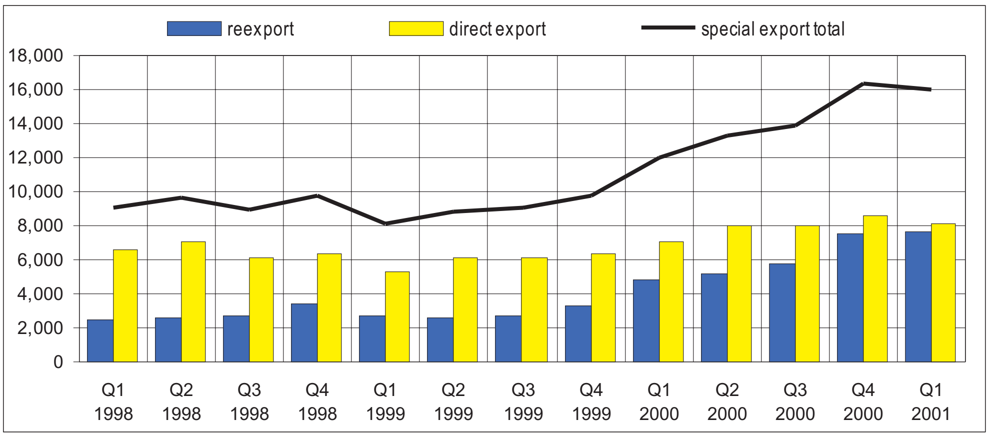

Figure 2.4. Structure of Estonian exports (EEK mn)

Exports have grown in all major commodity groups. Although the annual growth is still highest in subcontracting machinery and equipment, its export volumes were volatile in the first quarter.

Thanks to new export markets foodstuffs industry displays signs of recovery whereas the nominal volume of exports is still a third below 1998. Thereby the timber industry is inhibited by the above-mentioned difficulties in getting raw material and worsening external demand. Timber export was the only major industrial export remaining below the first quarter of 2000.

The rapid growth slowdown feared to appear in the export of goods and services in the first quarter of 2001 did not take place. **Despite of increasing investment activity, external balance deteriorated only slightly.** Considering the sustained high profitability of foreign owners' companies, the current account deficit increased to an estimated 7% of GDP in the first quarter of 2001.

The anticipated impact of the monetary policy operational framework reform together with banks' initiated restoration of external buffers dominated on the financial account in the first quarter (See Monetary Developments, pp 33 and 35 to 36). This increased foreign financial assets of banks again by about 4.5 billion kroons. The extensive FDI inflow arising from the successful privatisation of the first major infrastructure company (AS Tallinna Vesi) compensated for this. **According to estimates the privatisation receipts sufficed to cover the current account deficit, leaving the external debt of the economy on the level of end-2000.**