

# BACKGROUND INFORMATION

## ECONOMIC FORECAST FOR 2002–2003<sup>1</sup>

*The previous economic forecast was drawn up in the autumn of 2001, at a time when the development of the world economy was extremely uncertain – major economies were facing recession and the events on September 11<sup>th</sup> in the USA added to the uncertainty. By today, the situation has become considerably clearer. The decline of the world economic activity certainly did not culminate in a recession but was manifested merely in the slowdown of economic growth and major economies were already rebounding at the beginning of this year. At the same time there is still some uncertainty about the recovery*

*of economic growth which, among other things, can be seen by the relatively conservative forecasts of international institutions, particularly for the year 2002.*

*The present forecast is more optimistic than the one published six months ago. In addition to the improved outlook of the world economy, it has turned out that external developments affected the Estonian economy less than it was feared. Although foreign trade with the West decreased, this was compensated by higher activities on other markets and increase of domestic demand.*

### **Presumptions and Main Indicators of the Forecast**

#### **External Environment**

*The central presumption of the forecast is that world economic growth will accelerate to the normal level by the end of this year – 1.4% growth is predicted for the European Union this year and 2.9% next year. At the same time it is obvious that although the outlooks of developed industrial countries are improving the growth is mainly based on domestic demand. The world trade will remain relatively slow in 2002 which, in turn, affects the export opportunities of transition countries, including Estonia.*

*Short-term interest rates are likely to increase somewhat in the second half of the year, due to the recovery of economic activities. The forecast presumes that the development of the world economy is balanced during the takeoff phase and creates no significant inflationary pressure. Traditionally it is also presumed that the world financial markets remain stable and function without major price corrections and that Estonia's reliability remains high in the eyes of the outside world.*

#### **Exports**

*Import demand of western target markets has been low in the last six months and the improvement*

*prospects are still modest. The real volume of Estonia's normal export is predicted to increase by 6.6% in 2002 (see Table 1b). In 2003, when the import demand of the European Union is expected to recover, Estonian export growth is seen to accelerate to 12.7%. The present forecast is somewhat more optimistic than the one published last autumn, as the contribution of other markets has been more positive than previously and this tendency is expected to continue in the coming years.*

#### **Domestic Demand: Consumption and Investments**

*Conditions for the development of domestic demand are favourable. In 2002, the predicted 5.2% growth of private consumption should be supported by the restoration of consumer confidence due to the improved outlook of the external environment and the rise of various benefits and pensions. Unlike in the last couple of years when the real growth of the government's consumption expenditures was close to zero, they are expected to grow faster in both 2002 and 2003.*

***In view of the long-term favourable growth outlook and the continuing need for economic***

---

<sup>1</sup> Drawn up in Spring 2002.

**Table 1b. The most important economic indicators of Estonia for 2000-2001 and prognosis for 2002-2003**

	2000	2001	2002	2003
Private consumption	8.2	3.2	5.2	5.8
Government consumption	0.1	0.3	1.8	4.0
Investments to fixed assets	2.0	17.2	5.7	7.3
Domestic demand	6.8	6.0	4.6	5.8
Normal exports <sup>1</sup>	15.6	6.0	6.6	12.7
Normal imports <sup>1</sup>	16.1	6.7	6.4	11.8
GDP	6.9	5.4	4.2	5.7
Current account deficit/GDP <sup>2</sup>	-6.4	-6.5	-6.8	-7.2
Investments/GDP <sup>2</sup>	24.6	26.7	27.0	27.4
Growth of consumer price index (%)	4.0	5.8	4.3	3.8

<sup>1</sup> Export and import of goods and services without processing goods.

<sup>2</sup> Nominal item.

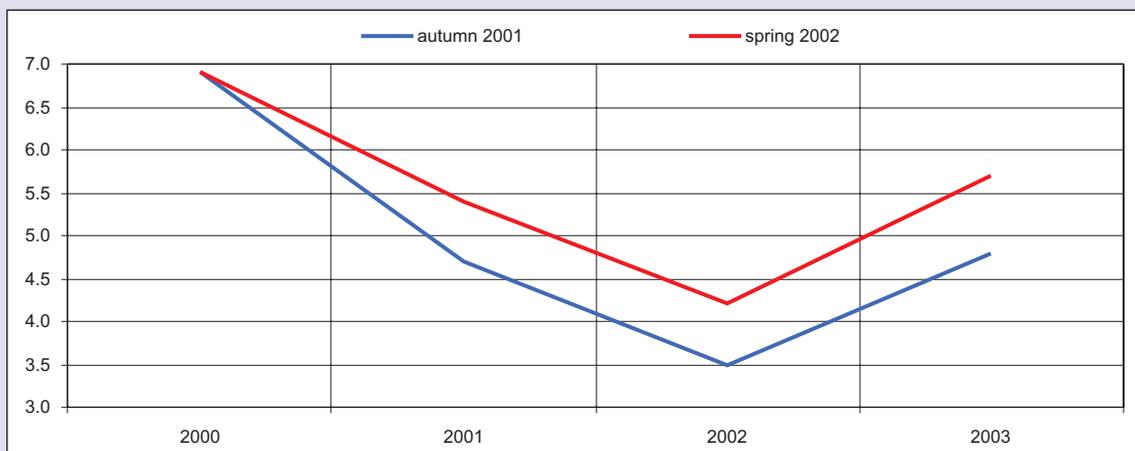
**restructuring, the level of investments will stay above the European average in Estonia in the next few years.** The forecast puts the share of investments at 27–28% of the GDP in the coming years. The investment activity of businesses should be supported by the higher potential profitability outlook as compared to the developed countries. Private businesses also need to invest in order to meeting the EU production requirements. The growth of the government sector investments will be mostly based on the EU funds and the co-financing requirement entailed.

In 2002, domestic savings will be lower due to growing private consumption and smaller saving tendency of

the government. **Alongside with high investment activity and the likely outflow of income the current account deficit is expected to reach approximately 7% in 2002 and even higher in 2003, should these tendencies continue.**

#### Economic Growth

**Estonia's economic growth will remain smaller in 2002 than in the two previous years and is expected at 4.2%, while in 2003 a 5.7% growth is forecast, which is considerably closer to the potential (see Figure 1b).** However, the risks entailed in the launch of the world economic growth may force us to review these estimates.



**Figure 1b. Economic growth according to different forecasts**

*In comparison with autumn 2001, the economic growth indicator in the current forecast has been upgraded by 0.7 and 0.9 percentage points, respectively. This expresses a more positive evaluation of the supply-side improvements in the Estonian economy in recent years, as well as greater confidence in the future of the world economy.*

#### **Inflation**

***The increase of consumer prices will amount to 4.3% in 2002 and decrease to 3.8% in 2003, mostly due to the smaller impact of administrative regulation. The difference of a couple of percentage***

*points from the EU inflation is normal and corresponds to Estonia's level of development.*

*Still, there are some factors that can make the inflation rate volatile. The most important risk factor is the price of crude oil which has been very unstable recently. Other factors do not pose a serious danger that could increase external pressure on inflation. One of the most substantial factors of inflation at the beginning of this year was the increase of food prices, particularly fruit and vegetables. Besides services, food is likely to remain one of the components that will affect the price of the consumer basket throughout the period under review.*