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ECONOMIC POLICY SURVEY

Global economic recovery showed further signs of robustness in early 2004. In addition to the US economy, the euro zone and the Japanese economy showed stronger signs of growth as well. Towards the middle of the year, however, soaring oil prices began to increasingly restrain further recovery. Due to strong demand in the Asian region and the joint impact of several problems on the supply side, at times the oil price on the world market soared as high as over 40 dollars per barrel. Besides restraining economic growth, this began to have a stronger effect on global price pressure and led to accelerated price growth in most major economic centres.

The sustainability of economic growth at the beginning of the year coupled with the expected strengthening of the supply-side price pressure encouraged many major central banks to raise key interest rates. Thus, the interest rates have risen during the year by 0.5 percentage points in the United States and by 1.0 percentage points in the United Kingdom. The European Central Bank has so far not changed the rates, but financial markets expect interest rate increases in the euro area starting from the first quarter of 2005.

ESTONIA

Monetary Policy Environment

Since the euro zone interest rates remained stable at the beginning of 2004, the interest level in the Estonian economy did not change significantly. Estonia's accession to the European Union in May and joining the exchange rate mechanism ERM II in June, while maintaining the currency board system as a unilateral obligation, had been taken into consideration by the international financial markets already before, and so these steps did not bring about significant changes in the Estonian money and financial markets. Thus, the overall interest rate environment in Estonia and the difference between the Estonian and the euro area interest rates remained comparatively stable in the first half-year and also in the third quarter.

Financial Sector

Financial deepening has been the fastest in loan volumes in the past years. Since mid-2001 the growth in the stock of loans issued by the Estonian financial sector has consistently outpaced the rise in domestic deposits. These tendencies also continued in the first half of 2004 – the growth in non-financial sector debt burden reached 30.7% in the second sector and stabilised on that level during the following months. This means that the banks are covering an increasingly larger part of the loans issued by resources attracted from abroad and that the external debt of the Estonian economy is consistently increasing.

The stock of housing loans continues to grow fastest with the year-on-year growth rate remaining above 40% for several consecutive years. So, the household debt burden has soared to as high as 22% of GDP, which is the highest indicator among the new European Union member states.

Inflation

In Estonia, consumer price growth reached its lowest level in 2003 and the start of 2004, when the year-on-year inflation rate was slower than the respective euro area indicator. The one-off rise in customs and excise duties that accompanied Estonia's accession to the European Union accelerated price growth in Estonia again as of May. The rising oil prices on the world market also began to affect price growth more and more during the summer months. Even though the annual inflation rate is likely to remain near 4% in the second half of 2004, the growth in labour costs has not shown signs of acceleration and therefore no significant rise in domestic price pressure is expected. The core inflation rate remained below the average of the euro area from January to August. During the following six months developments in oil prices can bring about fluctuations in the inflation rate.

Non-Financial Sector[1]

In the first half of 2004 supply-side conditions were favourable both for the export sector and local service providers. Global economic recovery was consistently brisk; meanwhile euro zone interest rates remained on a very low level. Underpinned by external demand, the real GDP growth was over 6% both in the first and second quarter. As regards economic sectors focused on the domestic market, growth was fastest in the construction business.

Employment growth, supported by increasing demand, continued slowly but consistently in the second half of 2004, and the unemployment rate declined to 10%. Meanwhile, nominal and real wage growth slowed down significantly too.

While at the beginning of the year domestic demand growth showed signs of a slowdown and external balance improved, then at the beginning of the second quarter fast growth of inventories contributed to widening current account deficit. This was consistently supported also by declining private saving and, according to preliminary estimates, the four-quarter moving average of the current account deficit again exceeded 14% of GDP.

General Government

In the first half of 2004, fiscal policy supported external balance – the general government budget surplus remained about the same as at the beginning of 2003. In the second half of the year fiscal policy changed from before. Faster than expected revenue growth encouraged the government to adopt a supplementary budget, which boosts expenditure by some 0.7 percentage points measured against GDP. **The annual consolidated budget surplus will be minimal, unlike in previous years.** The balanced budget drafted for 2005 actually indicates fiscal loosening.

Outlooks

Even though soaring oil prices began to affect global economic recovery, the growth forecasts of major economic centres have not been significantly reduced. Thus, the

[1] Here and below the non-financial sector refers to households and non-financial corporations, excluding general government.

expected average economic growth in the euro area is 1.8% in 2004 and 2.1% in 2005. In early summer these figures were 0.1–0.2 percentage points lower on average. Along with continuing global economic growth interest rates should continue to go up in most areas. In the euro zone the upward cycle is expected to get under way in the first quarter of 2005, and the US Federal Reserve is also expected to forge ahead with increasing the interest rates started in summer.

For Estonia, sustained global economic growth should mean that the relatively strong growth in export earnings will continue in the following quarters and that it should also uphold comparatively fast-paced economic growth.

Faster than predicted growth in fuel prices and bigger than expected impact of the rise in customs and excise duties upon accession to the European Union indicates that the average annual increase in consumer prices will turn out to be faster than the 2.8% predicted in the spring.

The developments so far have shown that growth in export earnings is not sufficient so as to achieve definite improvements in external balance, if it is not accompanied by slower domestic demand growth. Although most economic indicators show a slowdown in domestic demand growth in the second half-year, there is a certain risk that deepening deficit of the goods account will lead to bigger than expected overall deficit in 2004. The interest rate environment is expected to remain demand stimulating and the government's fiscal policy is also expected to be more expansive in the second half of the year.

Table 1.1. Main indicators of Estonian economy

	1995	1996	1997	1998	1999	2000	2001	2002	2003	Q1 2004	Q2 2004
Real growth of GDP (%)	4.5	4.5	10.5	5.2	-0.1	7.8	6.4	7.2	5.1	6.8	6.0
Growth of special exports (%)	31.0	19.5	42.7	16.7	0.6	38.8	7.0	-1.1	8.9	19.2	15.2
Growth of special imports (%)	27.2	25.9	39.8	15.0	-5.4	36.2	6.7	4.1	10.0	10.2	26.1
Current account balance (% of GDP)	-4.2	-8.6	-11.4	-8.6	-4.4	-5.5	-5.6	-10.2	-13.2	-11.6	-20.4
General government budget balance (% of GDP)	-1.1	-1.5	2.1	-0.2	-4.3	-1.0	0.3	1.0	3.1	2.9	0.0
Consumer price index of 12 months (%)	29	23.1	11.2	8.2	3.3	4	5.8	3.6	1.3	0.4	3.2
Export price index of 12 months (%)	15.2	11.4	7.5	2.1	-0.4	7.8	32.9	-0.6	6.6	3.8	1.0
Consolidated balance sheet of banks (% of GDP)	36.1	41.0	59.4	52.3	57.7	62.4	65.6	69.9	78.5	80.4	87.2
Capital adequacy of banks (%)	14.5	12.4	13.6	17.0	16.1	13.2	14.4	15.3	14.5	14.0	13.0
TALSE index change (%)		60.3	65.6	-65.8	38.3	10.1	4.7	20.6	34.4	19.9	1.6
Consolidated loan portfolio of banks (% of GDP)	16.5	22.0	31.2	30.5	32.7	36.9	39.0	42.8	55.0	57.0	60.2
M2 (% of GDP)	25.1	26.5	30.0	27.2	32.3	35.5	39.1	38.8	39.9	39.1	40.4
3 months TALIBOR (%, annual average)		8.0	8.6	13.9	7.8	5.7	5.3	3.9	2.9	2.6	2.6