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ECONOMIC POLICY SURVEY

In 2003, external demand was relatively unfavourable for Estonia. Although global economic revival, which had started in the second half of the year, continued throughout the fourth quarter into the beginning of 2004, it varied by major economic centres. In the US the economy grew by 4.3%, in Japan by 3.6%, while in the euro area by 0.6% in the fourth quarter. However, according to forecast, growth is accelerating in all major industrial countries.

Small economic growth kept monetary policy rates very low in 2003. Potential growth recovery and monetary interest rate increase expectations were revised several times. Such an environment was characteristic also of early-2004.

The rapid appreciation of the euro against the US dollar took place in end-2003, and since mid-January 2004 the exchange rate has fluctuated significantly around 1.20–1.25 USD/EUR.

Inflationary pressure remained weak in most economic centres throughout 2003. In the euro area the inflation rate somewhat exceeded projections but is forecast to shrink below 2% in 2004.

ESTONIA

Financial Sector

The monetary policy environment was expansive in 2003. In the first half of the year non-financial corporate lending rates declined to the lowest level ever and the difference between euro area interest rates and Estonian banks' lending rates shrank as well. **In the second half of the year interest rates stabilised.**

Previous trends continued in end-2003 and early-2004. **Due to moderate deposit growth, booming bank lending and leasing activity was financed from external sources.** Resources were primarily channelled into housing, business real estate, and major infrastructure. Households' housing loans exceeded 13% of GDP in end-2003 and the debt of non-financial corporations was close to 20%.

However, rapid growth in borrowing did not deteriorate the quality of the loan portfolio, and despite the contracting interest spread, banks maintained high profitability and capitalisation.

Inflation

Weaker external pressure arising from food and oil prices, and also the appreciation of the euro against the US dollar, stand out from 2003. The joint impact of the above factors contained the average consumer price growth at the historic low of 1.3%. The high share of food in the Estonian consumer basket held the consumer price growth below that of the euro area. Although price convergence with developed countries continued

in the non-tradable sector, it did not involve administered prices. The lack of administered price increase can be taken as a special feature of 2003.

In early-2004, the annual consumer price increase was still at historic low: 0.5% in January and 0.4% in February. As due to the accession to the European Union indirect tax rates will be harmonised and a few administered price rises are planned, such a low annual growth cannot be sustained.

Both in 2003 and early-2004, the real exchange rate of the kroon changed, primarily because of the dollar's depreciation against the euro. The real exchange rate of the kroon rose 1.8% as an annual average of 2003, increasing by an average of 0.4% against the currencies of industrial countries and 5.5% against the currencies of transition economies. In January the kroon's real exchange rate increased by 0.5% and in February 0.1%.

Non-Financial Sector[1]

In 2003, the growth of real GDP decelerated slightly to 4.7%. The economic growth was based on domestic demand rather than on exports, although the increasing IT subcontracting accelerated growth in the exports of goods and services beyond 2002 and took it to 6% in real terms. Domestic demand contracted in the second half-year, yet remaining 7.3%, approximately 2.5 percentage points below 2002.

Sustained fast growth of domestic demand was mainly based on increasing investment inflow. This brought about also large imports of investment goods and soaring trade deficit in 2003. Although the deteriorating trade balance was offset by a more than 5% growth in services export earnings, and domestic saving stayed at the level of 2002, the current account balance continued deterioration, which had started as early as in 2002 – the current account deficit reached 13.7% of the anticipated GDP. Such a difference characterised all quarters. Increased government saving could not balance declining private saving. There is also no confidence whether growth slowdown in domestic demand, characteristic of the second half of 2003, has continued in 2004. As direct investments accounted for about 60% of the financing gap, external liabilities kept growing and gross debt was at about 75% of GDP in end-year.

The development of the labour market was slightly controversial. Since mid-2000 the employment has continuously increased, slow growth continued also throughout 2003, being 1.2% as an average both in the tradable and non-tradable sector companies. In the fourth quarter the annual employment growth accelerated to 2.4%. In 2003, new jobs brought along a drop in the unemployment rate. Year-on-year, the unemployment level was two percentage points lower in the fourth quarter, i.e. 9.3%, the lowest after the Russian crisis. Long-term unemployment declined as well.

At the same time, the relationship between the growth rates of productivity and average wages has significantly changed. While a shift towards labour-intensive services in the demand structure can account for decelerated growth in productivity, the underlying reasons for accelerated wage growth remain somewhat unclear. In 2003, real wages increased by 8.3% on the average, exceeding productivity growth by more than twofold. The wages grew most in the non-tradable sector, although wage growth outpaced productivity also in the exporting sector. The anticipation of external demand growth could have been over-optimistic at the beginning of the year, facilitating preferential growth of labour costs in most fields.

[1] Households and non-financial corporations, excluding general government.

General Government

In 2003, year-on-year, consumption grew more rapidly also in the government sector and exceeded 5%. Government expenditure reached about 40% of GDP. Such growth was possible as tax revenue exceeded targets. Contrary to expectations, the overall tax burden did not shrink but rather increased, reaching 36.5% of GDP. It was characteristic of 2002–2003 that capital inflow and household bank loans supported domestic demand more than in the past, keeping the ratio of consumption taxes and GDP at 13–14% also in 2003. Income tax revenue exceeded anticipation as well.

Thanks to better than expected revenue collection, the central government budget was balanced even in the fourth quarter, which has not been the case in previous years. **Consolidated budget displayed a 2.6% surplus of GDP. Considering the large current account deficit such a surplus was economically justified.**

For 2004, the government drafted a balanced budget. However, it is rather tight, because the harmonisation of fuel and tobacco excise duties after EU-accession will keep the tax burden high or even increase it. Furthermore, the budget is based on an optimistic presumption that all EU structural funds available to Estonia will be utilised.

Cash flows indicate that revenue collection remained relatively strong also in early-2004, and revenue exceeded expenditure.

Table 1.1. Main indicators of Estonian economy

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Real growth of GDP (%)	4.3	3.9	9.8	4.6	-0.6	7.3	6.5	6.0	4.7
Growth of special export (%)	31.0	19.5	42.7	16.7	0.6	38.8	7.0	-1.3	9.2
Growth of special import (%)	27.2	25.9	39.8	15.0	-5.4	36.2	6.7	5.8	8.0
Current account balance (% of GDP)	-4.4	-9.2	-12.2	-9.2	-4.7	-5.8	-6.0	-12.3	-13.7
General government budget deficit (-) / surplus (% of GDP)	-1.2	-1.5	2.2	-0.3	-4.6	-0.7	0.4	1.2	2.6
Consumer price index of 12 months (%)	29.0	23.1	11.2	8.2	3.3	4.0	5.8	3.6	1.3
Export price index of 12 months (%)	15.1	11.3	7.5	2.1	-0.4	7.8	32.9	4.0	6.6
Consolidated balance sheet of banks (% of GDP)	38.0	43.8	63.4	55.7	61.7	66.3	70.8	75.6	84.8
Share of the foreign ownership in banking sector (% of share capital)	29.0	33.4	44.2	60.7	61.6	83.6	85.4	86.4	85.7
Capital adequacy of banks (%)	14.5	12.4	13.6	17.0	16.1	13.2	14.4	15.5	14.5
Talse index change (%)		60.3	65.6	-65.8	38.3	10.1	4.7	20.6	34.4
Consolidated loan portfolio of banks (% of GDP)	17.4	23.5	33.3	32.5	34.9	39.3	42.2	44.7	58.7
M2 (% of GDP)	26.5	28.3	32.0	29.0	34.5	37.8	42.2	41.7	43.2
3 months Talibor (%)		8.0	8.6	13.9	7.8	5.7	5.3	3.9	2.9