II
ECONOMIC DEVELOPMENTS

EXTERNAL ENVIRONMENT

General Background

In the first quarter of 2004 rapid economic growth continued. In the second quarter, however, economic growth stalled to some extent – mainly because of surging crude oil prices. The annual GDP growth rate in the United States was 5.0% in the first quarter and 4.7% in the second quarter. In the euro area the respective growth rates were 1.3% and 2.0% and in Japan 5.9% and 4.2%. Preliminary third quarter economic indicators (industrial production, different business climate indices) show that similar growth will continue also in the near future. According to forecasts, economic growth might slow down a bit in 2005 (see Table 2.1).

Table 2.1. Economic growth and inflation forecasts (%)

	GDP growth		Inflation	
	2004	2005	2004	2005
United States	4.3	3.5	2.7	2.4
Euro area	1.8	2.0	2.1	1.8
Germany	1.8	1.6	1.6	1.4
France	2.5	2.3	2.2	1.7
Italy	1.2	1.8	2.3	2.1
Finland	2.8	3.0	0.4	1.5
Sweden	3.3	2.9	0.6	1.7
Japan	4.3	1.8	-0.1	0.0
World economy, total	4.0	3.1	2.5	2.4

Source: Consensus Forecasts, September 2004

Exchange rates in international financial markets have remained within a relatively narrow range, moving without a clear trend since March. The dollar-euro exchange rate has fluctuated between 1.18–1.24 and the yen-dollar exchange rate between 103.5–114.5. Trading in stock markets proceeded without clear trends as well. As for the commodity market, the crude oil price continued to surge and several consecutive historical records were made. By the middle of August the oil price had grown as much as nearly 50% since the beginning of the year.

Regarding inflation, some acceleration was evident towards the end of the second quarter due to rising oil prices. Price pressures stabilised further on, since weak internal demand did not allow companies to pass rising input prices on to consumers. Therefore, labour costs were cut, which is why the labour market remained weak in most economic centres, regardless of the consolidation of global economic recovery.

In line with reviving economic growth and in some countries (above all in the United Kingdom) also in order to restrain fast price increases in the real estate sector, several central banks raised key interest rates. The US Federal Reserve raised key interest rates by the total of 50 basis points at the end of summer and the Bank of England by altogether 75 basis points in May, June and August. The central banks of Canada, Switzerland and New Zealand raised key interest rates in summer as well and the rise of rates from historical lows to more neutral levels should continue further. International financial markets expect key interest rate increases in the euro area starting from the first quarter of 2005.

United States of America

Economic activity in the US reached its peak in the first quarter when economic growth as well as several confidence indices achieved their highest level in the past decades (in the first quarter the US GDP growth (5.0%) was the fastest in the past 19 years and the ISM Purchasing Managers Index in the manufacturing sector was the highest in the past 20 years in January, i.e. 63.6 points). In the second quarter economic growth slightly decreased due to surging oil prices, which inhibited growth in internal demand. The US unemployment rate declined from 5.7% in March to 5.4% in August, and the employment rate continued an upward trend in spite of extensive fluctuations. Because of rising oil prices the inflation rate increased from 1.7% in February to 3.3% in June. By August the rate had declined to 2.7%.

The US budget and current account deficits still remain on record levels. In April, the US budget deficit of the last 12 months amounted to more than 450 billion dollars (over 3.5% of GDP); the near-record level was sustained also during the following months. The current account deficit, too, increased to a record 5.7% of GDP in the second quarter.

Japan

In the first quarter, Japan's annual economic growth was the fastest in 13 years (5.9%), reflecting the country's definite exit from a long-lasting recession. Fast economic growth continued also in the second quarter: even though annual GDP growth slowed down to 4.2%, the annual rise in industrial production (8.9%) was the fastest in the last 15 years. Japan's economic growth was supported by exports and investments while private consumption has been improving as well.

Economic recovery has also cut consumer price deflation in Japan: in June consumer prices did not fall and in July the year-on-year decline in consumer prices was only 0.1%. The annual decline in the GDP deflator in the second quarter was considerably larger (2.7%). According to the central bank of Japan, consumer price increases are expected again in early 2005.

Euro Area

The annual GDP growth rate of the euro area was 1.3% in the first quarter and 2.0% in the second quarter. The growth was supported mainly by external demand, while growth in private consumption and investments remained weak. In the second quarter, the annual growth in exports stood at 8.1% in the euro area while the annual growth in private consumption and investments was only 1.1% and 0.7%, respectively. According to the estimates of the European Central Bank, economic growth in the euro area is expected to pick up slowly; however, the rise in different activity indices (PMI, IFO, ZEW) has stopped and has been replaced by periodic falls.

The consumer price inflation in the euro area accelerated to 2.5% in May due to rising oil prices, but fell back to 2.3% by August. The core consumer price inflation stayed between 1.8% and 1.9%. According to the European Central Bank, price pressures arising from expensive oil will continue in the near future, but in the longer run the central bank expects the inflation to remain stable. Unemployment in the euro area stayed at 9.0% in April-July while low mobility of the labour force remains the most essential problem on the labour market.

The European Commission made a proposal to alleviate the conditions of the Stability and Growth Pact by adding to the number of circumstances that would allow the countries to exceed the 3% budget deficit limit. According to the Commission, in 2004 the respective limit will be exceeded by the total of six countries: Germany, France, the Netherlands, Italy, Portugal, and Spain.

Nordic Countries

Finland's annual GDP growth accelerated from the average of 1.9% last year to 2.6% in the first quarter and to 3.2% in the second quarter of 2004. Stronger external demand also contributed to the recovery in the industrial sector – while in the first quarter the volumes were still comparable to the same period in 2003, then in the second quarter growth accelerated to nearly 4.0%, which was mainly supported by the electronics industry as well as by the wood processing industry.

The high consumption propensity of households that had significantly contributed to economic growth last year, remained robust also in 2004: the annual growth rate of retail sales remained at 5% on average throughout the first half-year. Affected by the reduction in the alcohol excise duty and the base effect of energy prices, Finland's consumer prices showed a decline towards the end of the first quarter, which continued throughout the second quarter at 0.1% rate. Price pressures, however, have grown again in the second half of the year mainly because of high raw material prices, and small inflation is expected on annual basis.

Economic activity in **Sweden** increased too: GDP growth picked up from 2.3% in the fourth quarter of 2003 to 3.6% in the second quarter of 2004. The main contributing factor was the significant improvement of external demand for Sweden's electronics (including information technology and telecommunications) and vehicles.

Weak labour market prompted Swedish government to focus on reducing unemployment in the coming years; nevertheless, throughout the first six months unemployment remained at a higher level year-on-year, rising as high as 5.8% in the summer months. The household confidence has remained quite stable and internal demand is persistently one of the major growth engines of economy.

Central and Eastern European Countries

Latvia's economic growth, which reached 8.2% in the first half of 2004, was the fastest in the Baltic states. Supported by favourable loan conditions and pay growth, the main growth component was strong internal demand with retail sales increasing 8.3% year-on-year. External balance was adversely affected by imports outpacing exports, so that the estimated current account deficit exceeded 10% of GDP.

Price pressures grew considerably in the spring due to changes in indirect taxes arising from the accession to the European Union, as well as high fuel prices. The average inflation rate was 5.8% in the second quarter, accelerating to 6.7% in July. So as to restrain the rise in consumer prices, Latvia's central bank raised the refinancing rate by 50 basis points in March, i.e. to 3.5%.

Lithuania's economic growth was somewhat slower compared to 2003, but similarly to Latvia it remained fast mainly due to strong domestic demand, staying at an estimated 7.3% level in the second quarter.

The trend of lower consumer prices that had begun in 2003 changed in May resulting in price increase due to raising oil prices and the harmonisation of tax rates with the respective EU rates, similarly to Latvia. In July the annual consumer price growth increased to 1.9%.

The GDP in the **Czech Republic** increased mainly because of investment activity in the private sector and external demand arising from global economic recovery with the growth reaching the highest level in the past 3.5 years in the second quarter, i.e. to 4.1%. Growing government deficit made the rating agency Standard & Poor's lower the country's local currency credit rating from A+ to A-.

The Czech central bank has, within the framework of its monetary policy based on inflation management, raised interest rates already three times this year, so that the key interest rate amounts to 2.5%.

Hungary's economy grew by 4.1% in the first half of 2004. Regardless of slower growth in real wages, private consumption remained strong (the average annual growth rate of the retail sector was 6–7%). In September, the government deficit exceeded the target for the whole 2004 (5.8% of expected GDP) and is estimated to reach 6.5% of GDP on annual basis. Since Hungary's central bank raised key interest rates to the highest level in Central Europe, i.e. 12.5%, last year due to fluctuations in the financial markets, the rates have been gradually reduced in 2004 – by the total of 1.5 percentage points to 11%.

Poland's economic growth reached 6.1% in the second quarter. The main underlying reason for growth was increasing industrial production supported by strong external demand. Labour market witnessed certain improvement too: unemployment fell from 20.6% at the beginning of 2004 to 19.3% in July.

Consumer prices increased in the spring of 2004 after which the inflation rate stayed close to 4.5% in the summer months. In order to slow down the price rise, Poland's central bank raised key interest rates in August by 50 basis points, the key interest now standing at 6.5%.

Russia

Due to high raw material prices and fast-growing volumes of raw material exports, Russia's economic growth has stayed consistently above 7.0% in 2004. Internal demand is continuously being promoted by fast growing real income and decreasing unemployment.

Fast economic and export growth has resulted in successful revenue collection. According to the Russian Finance Ministry, the budget surplus was 3.2% of expected GDP at the end of July.

International Financial and Commodity Markets

In **foreign exchange markets**, there has been no clear trend since March. The dollar-euro exchange rate remained between 1.18–1.24 and the yen-dollar exchange rate between 103.5–114.5 (see Table 2.2). The fluctuations in the range were affected by rising oil prices, which had a negative effect on the dollar (among developed countries the US economy is relatively more dependent on oil), and the consistently high US budget and current account deficit. The dollar was supported by the relatively faster growth in economic activity in the United States compared to other regions.

Table 2.2. Changes in exchange rates of major currencies

	31/03/04	17/09/04	Change (%)
JPY / USD	104.18	110.04	5.6
USD / EUR	1.2175	1.2294	1.0
USD / GBP	1.7919	1.8404	2.7

Major **stock markets** were also trading within a relatively narrow range and without a clear trend (see Table 2.3). Although recovering economic activity supported stock prices, the latter were still under pressure due to the low investor confidence, which was the result of rising oil prices and anticipated interest rate increases arising from growing inflation expectations.

Table 2.3. Major stock market indices

	31/03/04	17/09/04	Change (%)
USA (S&P 500)	1,126.21	1,128.55	0.2
USA (NASDAQ)	1,994.22	1,910.09	-4.4
Japan (Nikkei 225)	11,715.39	11,082.49	-5.4
Euro area (Eurobloc 300)	1,031.94	1,045.16	1.3

Bond markets witnessed a rise in short-term interest rates in the second quarter, which was related to the increase in key interest rates in several countries. The rise in interest rates was particularly fast in the United States, where the key interest rate was raised by the total of 50 basis points at the end of June and in August, and where the rise is expected to continue (see Table 2.4).

Table 2.4.Major bond market interest rates

	Interest rates of 3 months			Interest rates of 10 years		
	31/03/04	17/09/04	Change (basis points)	31/03/04	17/09/04	Change (basis points))
USA	0.94	1.7	76	3.84	4.11	27
Japan	0.01	0.02	1	1.45	1.51	6
Euro area	2.02	2.16	14	3.93	4.03	10

Improved US economic indictors and increasing key interest rates led to growing short-term interest rates in the euro area as well, but on a considerably smaller scale. Two sub-periods can be distinguished in the dynamics of long-term interest rates. The first lasted until mid-June and was characterised by the release of increasingly more positive economic data on the first quarter, bringing about a rise in interest rates. As of mid-June weaker economic indicators and the short-covering of bond positions led to a downward trend.

On **commodity markets** the upward trend of oil prices continued, which was mainly brought about by growing demand, spurred by increased economic activity, and coupled with limited supply. In addition, several political factors (the turmoil surrounding the Russian oil company Yukos, political tensions in Venezuela, military activities in Iraq, etc.) as well as hurricanes in the Gulf of Mexico contributed to rising oil prices. Oil prices reached their historical peak (48.7 dollars a barrel) in the middle of August, declining later to some extent. Since oil supply has reached a level of testing the limits of maximum production capacities while the demand remains strong, oil prices are not expected to decline significantly in the near future. The prices of other commodities declined slightly – the CRB index covering the prices of 22 major raw materials fell by 3.0% and the price of gold by 4.9% (see Table 2.5).

Table 2.5. Changes in commodity markets

	31/03/04	17/09/2004	Change %
CRB index	307.88	298.68	-3.0
Crude oli (WTI; USD/barrel)	35.76	45.59	27.5
Gold (USD/ounce)	426.45	405.65	-4.9

ESTONIAN ECONOMY

On 1 May 2004 Estonia joined the European Union. This marked the achievement of a strategic economic policy goal, the realisation of which market players had taken for granted long before the actual accession. Therefore the short-term effect of de jure membership in the European Union was mainly reflected in the economic policy measures in trade and tax policy regarding third countries, which were timed to coincide with the moment of accession.

The recovery of economic growth that had started in the second half of last year continued in 2004, stabilising at 5.9% in the second quarter. According to preliminary estimates, GDP growth reached 6.3% in the first half of the year. Due to the recovery in the world economy external demand played a more significant role as a growth component compared to last year. It was particularly evident in the first months of the year. In April, however, the exceptionally large growth of inventories prior to the EU accession led to a temporary surge in imports and consumption volumes. The accession brought about also a short-term acceleration in the inflation rate, resulting from the rise in excise and customs duties. While the one-off and short-lived nature of the increase in inflation was evident as soon as during the following months, the issue of temporary growth in goods imports remained on the agenda for a longer period of time.

Internal Demand

Investments

Until the second quarter of 2004 the conclusion was that the peak of internal demand, as far as its growth was concerned, remained at the end of 2002 and at the beginning of 2003, while the dynamics of the main components was somewhat different. While fixed assets investments grew over 20% in real terms in the first quarter of 2003, the growth rate of private consumption slowed down to 5–6%, i.e. below the average GDP growth. The growth in fixed assets investments eased throughout 2003, reaching a decline of 10% in real terms in the first quarter of 2004. **Due to high investment activity in the past two years the ratio of fixed assets investments to GDP measured in current prices still remained near the level of 25% in the first quarter of 2004,** which, according to many experts and considering Estonia's development level, can be regarded sustainable in the medium-term perspective.

The dynamics of inventories has been much more volatile because of the specifics of that component, and this does not indicate any trend. **While in 2003 the growth of inventories slowed down and their relative size even decreased when compared to GDP, then the beginning of 2004 marked an increase in growth.** The growth accelerated particularly in April because of the fears that possible administrative incapacity to impose a new customs regime during the months immediately after the EU accession might disturb the functioning of the established supply chain. Such stocking was also prompted by the anticipated increase in the prices of goods from the third countries and the price rise arising from the harmonisation of indirect tax rates. Therefore the growth of inventories turned out to be bigger than usual in the first half of 2004, growing by more than 10% year-on-year and also increasing the foreign trade deficit of that period.

However, it was the growth of fixed assets investments, and not the growth of inventories, that turned out to be surprisingly fast, increasing by 20% in the second quarter. The continuously high investment activity (e.g. in housing) does not explain such an increase. The faster than average growth in the retail and wholesale sector indicates that fixed assets investments might also include investments that can be classified as the growth of inventories (see Figure 2.1).

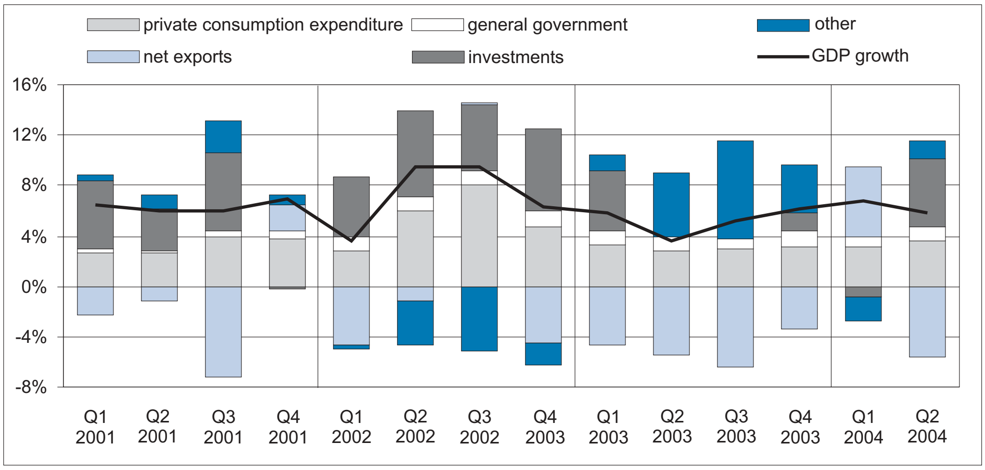

Figure 2.1. Real growth of GDP and its components

Private Consumption

In private consumption the 5–6% real growth that originated in early 2003 continued almost until the second quarter of 2004. In April individuals also began to stock goods that came from third countries or that were expected to be affected by the price growth arising from the harmonisation of economic policy. Consequently, the annual real growth in private consumption accelerated again in the second quarter to 6.6% and throughout the first half-year private consumption contributed to economic growth slightly more than a year before. According to preliminary estimates, savings decreased as well.

The growth in private consumption was also consistently supported by active borrowing from banks and leasing companies. Annual growth in the stock of household loans issued by the financial sector amounted to 43.9% in the second quarter and remained on that level also at the end of August. Even though the direct weight of consumer credit as a source of covering private consumption remains consistently low and in January-September of 2004 the consolidated portfolio grew only by 0.8 billion kroons, the demand for consumer credit shows an upward trend.

In addition to stocking consumer goods prior to the EU accession, the growth in household expenditure was also supported by the sustained increase in income. In 2003, nominal wages continued to grow at a rate close to 10% and because of the slowing down of the price growth, the rise in real income was the largest in recent years. In the first half of 2004 the nominal wage growth rate slowed down to nearly 7%, but consumption was additionally supported by the rise in the income tax exempt at the beginning of the year.

The indicator reflecting the confidence of Estonian private consumers showed consistent improvement in the second quarter. The main underlying reason was reduced fear of anticipated inflation associated with the EU accession. The fear of inflation, which had begun to grow immediately after the 2003 September referendum, reached its peak in April-May to decline in July-August to the level seen a year before. The fear of job loss was reduced as well and estimates on saving options improved.

General Government

The expenditure of the general government grew at a slower pace in the first half of 2004 than internal demand on average.

Better than expected revenue collection at the beginning of the year was at least partly related to temporary growth in internal demand arising from stocking inventories. In April the revenue collection of most indirect taxes set records – the annual rise in the value added tax amounted to more than 80% and that of excise duty to 98.6%. After the accession to the European Union the tax collection system also changed, which led to an initial turn in the cash flow trend, and during the period from May to July VAT collection was smaller than a year ago.[1] In August the VAT cash flow rose again to its customary level.

Faster than predicted increase in collection of excise duties continued also after the accession. This was the result of successful alcohol excise collection, which, in turn, was based on growth in production and exports (tourists). For example, in June the collection of alcohol excise was 44% higher year-on-year. In July this was supplemented by a rise in the tobacco excise rate, which contributed to increasing revenues. All in all, this resulted in the implementation of the excise tax collection plan several months before the end of the financial year (see Figure 2.2).

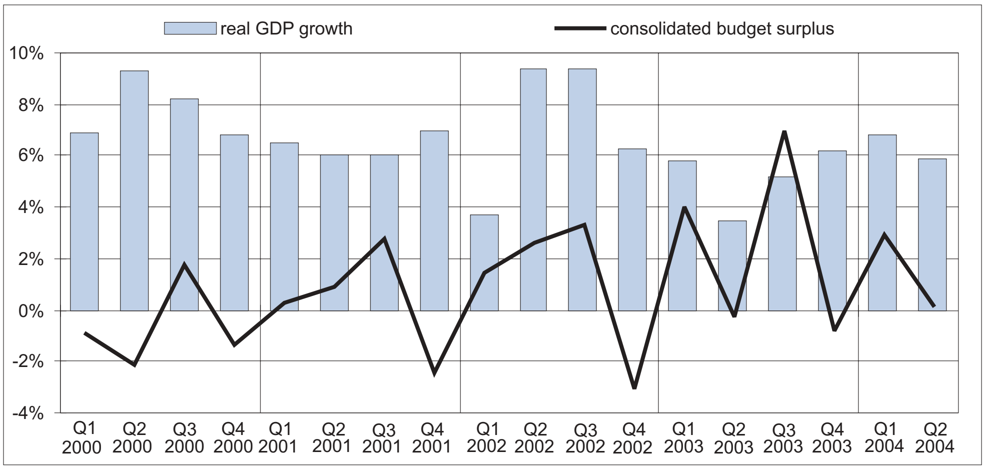

Figure 2.2. Real growth of GDP and consolidated budget surplus (% of GDP)

Better than expected personal and corporate income tax collection also contributed to larger than planned revenue. This allowed the government to draft a supplementary budget, which increased expenditure by approximately a billion kroons. **Unlike recent years, this indicates more expansive fiscal policy since the annual general government budget surplus is expected to remain minimal (at about 0.3% of GDP).**

For 2005, the government drafted a consolidated budget, in which revenue and expenditure are balanced. The level of expenditure is expected to be slightly lower than in 2004 due to a decline in the overall tax burden. Compared to earlier plans, it was still decided that the anticipated reduction in the growth of revenue collection arising from lower direct taxes would be partly compensated through a rise in alcohol and tobacco excise duty. Together with the likely continuation of non-budgetary financing of several investment projects, it serves as an indication that the earlier plans of reducing the increase in expenditure are not likely to be fully realised. In addition, the relatively large increase in the adopted budget is based on the optimistic assumption that Estonia will be able to utilise all EU structural funds available to Estonia.

[1] The change in tax collection essentially meant postponement of the moment of taxation of the sales within the EU.

Domestic Supply

Industrial Development

In the first half of 2004, demand-side conditions were favourable both for exporting companies as well as for local providers. An exception was the mining industry in which production decreased because of a warmer winter compared to the last year. In the processing industry, however, the added value measured in real terms remained consistently above 9% both in the first and second quarter, i.e. it was higher than the average GDP.

In line with stronger economic growth in Estonia's major exports markets, the Estonian exports of manufacturing goods increased significantly as well in the first half of 2004, and the annual growth indices fluctuated near 10% from January to August. The development in the exports of goods has become more even by products and markets. While in 2003 the main export components were new and non-traditional sectors (chemical products, metal products), then in the first half of 2004 more traditional sectors (e.g. timber and dairy industries) were in a clearly better situation. Even though the volumes of the subcontracting business in the electronics sector are still lower than at their peak in 2000–2001, Estonia's industrial exports increased by nearly 20% in the first quarter as a result of recovering global technology sector.

Considering together exports and production for the domestic market, a slight slowdown in the industrial production growth was evident in the second quarter. The annual growth rate of manufacturing was about 2.5 percentage points lower than in the first quarter, reaching 7.7%. However, this did not occur because of a general and broad-based slowdown in the growth of most industrial sectors. As to major industrial sectors, the biggest decline took place in the metal industry where production volumes were nearly 10% smaller in the second quarter than at the same time in 2003. On annual basis, production volumes were also smaller in the furniture industry and a significant slowdown occurred in the chemical industry, and in machinery and equipment manufacturing. Strong growth continued in the three largest sectors (food, timber and textile industries) in the second quarter. The growth rate of food and textile industry accelerated (in food industry from last year's 1.3% to 6.2% in the first quarter and to 8.7% in the second quarter; the 4.7% decline in the textile industry in the first quarter was replaced by a growth rate of 5.9% in the second quarter, and soared to 17.3% in July), and the growth of the timber industry is consistently one of the fastest (see Figure 2.3).

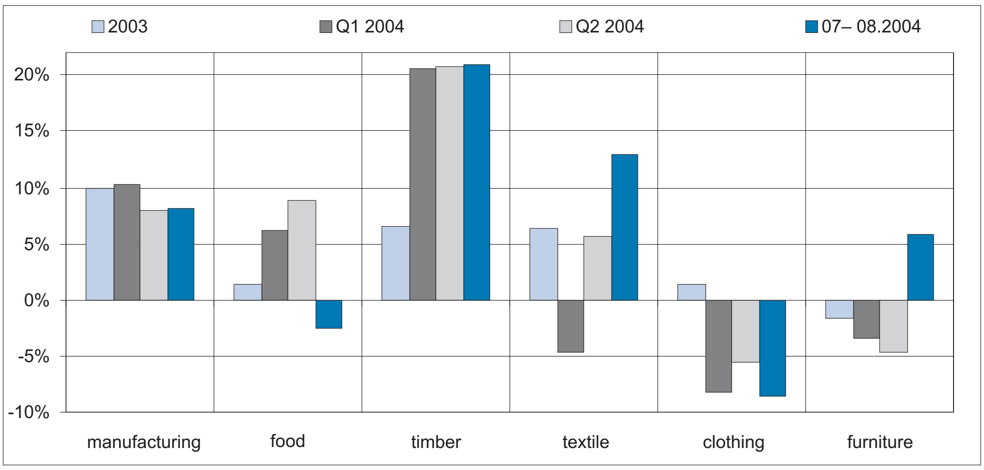

Figure 2.3. Growth in industrial production

In July and August industrial growth remained on previous levels, but export indicators pointed to increased exports. This implies that the growth in domestic demand slowed down at the beginning of the third quarter. The industrial confidence indicator calculated by the Estonian Institute of Economic Research indicates that the comparatively strong output growth should continue also in the second half-year.

Services and Other Sectors

The first half of 2004 was characterised by slow growth or even a decline in the primary sector as well as in the energy sector (see Table 2.6). At the same time, continuous favourable interest rate environment contributed to sustained extensive demand for real estate development and related construction activities. Indeed, the construction sector was the fastest growing area in the first half of the year, where annual growth in the value added exceeded 20% in the first quarter and amounted to 16% in the second quarter. In the first six months this was the fastest growing sector of all.

Table 2.6. Annual GDP growth by sectors (in real terms of 2000; %)

	2002	2003	Q1 2004	Q2 2004
Agriculture, hunting	-4.0	3.6	4.3	-2.0
Forestry	7.9	-8.2	-0.9	-7.5
Fishery	-12.3	-6.9	3.2	-10.0
Mining and quarrying	15.8	7.2	-5.2	-4.7
Manufacturing	14.0	8.3	9.0	9.9
Electricity, gas and water supply	5.3	6.5	0.2	1.8
Construction	20.6	7.7	21.5	15.5
Wholesale and retail trade	9.1	4.5	10.9	5.6
Hotels and restaurants	5.9	3.3	14.5	6.5
Transport, storage and communications	-0.1	10.1	10.1	8.9
Real estate, renting and business activities	2.4	1.2	5.1	4.7
Financial intermediation	18.4	5.4	2.8	8.4
Public administration and defence; statutory social insurance	3.9	1.0	2.4	4.6
Education	2.7	1.0	2.8	0.6
Health and social care	3.9	0.1	-0.4	1.5
Other community, social and personal service activities	5.5	4.6	0.2	2.5
GDP at market prices	**7.2**	**5.1**	**6.8**	**5.9**

In addition to the exports of goods, the exporters of the tertiary sector also showed signs of strengthening at the beginning of the year. **In the first quarter of 2004 the real growth in Estonia's services exports was the fastest in the past four years, amounting to 20%.** Even though the figures indicating such fast growth might have been partly affected by weather conditions that had disrupted the exports of transportation services at the beginning of 2003, most exporting sub-sectors of the tertiary sector showed positive growth. The real growth in exports of services remained strong also in the second quarter when the growth rate slowed down by just 3 percentage points.

Increasing stocks by households and sustained wage growth promoted the development of domestic trade in the first half-year. Extensive annual growth in the nominal volume of retail trade in April (almost to 25%) serves as an indication of increasing stocks of consumer supplies prior to the EU accession. Even though annual retail sales growth remained relatively strong also in May (13%), they were the lowest this year and the aggregate real growth in the first half-year was only 1.5 percentage points above the average GDP growth of 6.3%.

To conclude, it could be said that the fastest growing areas of the tertiary sector were those focused on exports or supporting it.

Employment

Slow but consistent employment growth continued also in the first half of 2004, supported by improved demand. While in 2003 the growth was mainly based on the increasing number of the employed in manufacturing (67%), construction and health care, then in the first quarter of 2004 the rise was mainly related to extensive growth in construction and transportation. In the second quarter the number of the employed stood at 595,000, which marks a 1% rise (6,000 people) year-on-year. On the other hand, the employment growth rate has been slowing down for the second consecutive quarter and is lower than in the four preceding quarters. Contrary to the first quarter, in the second quarter the employment growth was the fastest in manufacturing (11%). In the first six months, relatively many new jobs were created in manufacturing, construction, mining, as well as in public administration.

Since the second half of 2000 the total number of the employed has risen by almost 5%. The unemployment rate has also continued to decline, falling back to the 10% level in the first half-year, supported by consistent demand for labour. The unemployment rate fell from 10.7% in the second quarter of 2003 to 10%; regionally the biggest decline occurred in Tallinn (by 3.1 percentage points to 9.7%) and in Western Estonia (by 2.9 percentage points to 5.2%). The unemployment rate increased most in Southern Estonia (1.4 percentage points to 9.1%). Even though in the North-East Estonia the unemployment rate rose by 0.8 percentage points year-on-year, i.e. to 17.9%, it fell by as much as 2.7 percentage points quarter-on-quarter.

Compared to the second quarter of 2003, the number of economically inactive people decreased due to the young who completed their studies, although the number of discouraged people (those who have lost hope to find work) even increased slightly (see Figure 2.4). In the summer months the number of the unemployed registered in the employment office traditionally fell fast and was nearly 15% smaller in June-August, year-on-year.

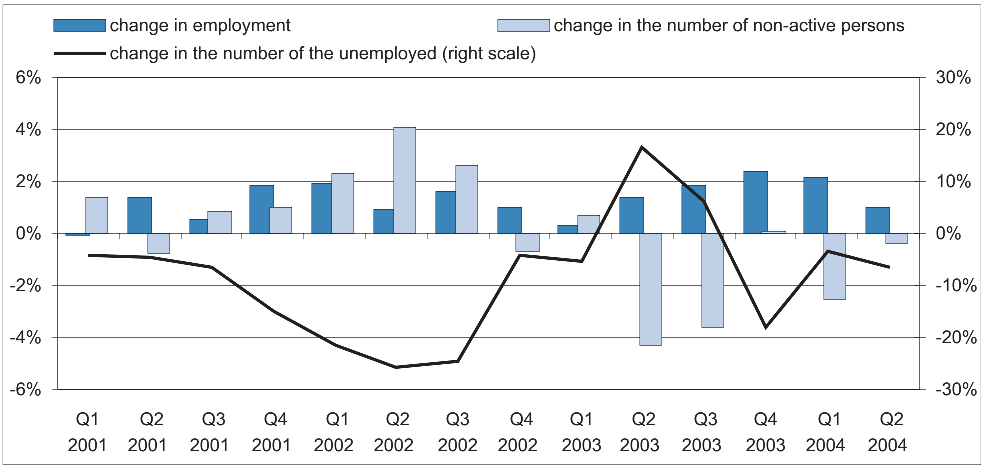

Figure 2.4. Labour market indicators

External Balance

The decline in the annual growth rate of domestic demand to 2.7% in real terms also led to improving external balance in the first quarter of 2004, when the deficit of the goods

and services account fell to 5.8% of the quarterly GDP. Last time the deficit was so small after the recession following the Russian crisis in the first quarter of 2000. The balances of both the goods and services accounts improved. As for the latter, besides increasing exports of services, it is also significant that due to the completion of the reconstruction of power stations the need to import construction and other services was smaller than in preceding years. Even though the share of export earnings in the economic growth increased in the first half of 2004, it still remained insufficient for achieving economic balance.

Increasing inventories, which led to growing domestic demand immediately prior to the EU accession, again brought about growing pressure on the external balance. In April 2004 the monthly deficit of the goods account turned out to be the largest ever and in April-June domestic demand growth outpaced that of gross domestic product by more than 8%. This, in turn, resulted in the deterioration of the external balance in the second quarter to more than 20% of GDP, according to preliminary estimates (15% of GDP as an average of four quarters). The external balance of the first half-year altogether also turned out to be worse year-on-year.

The temporary setback in the overall improvement trend of external balance was not only the result of increased imports of goods – declining savings enlarged the gap as well. In the first half of 2004, faster growth in current expenses characterised households as well as companies, while government saving remained on the same level year-on-year.

Even though most of the available economic indicators point to a slowdown in domestic demand growth in the second half-year, there is some risk that the deepening of the goods account deficit this time might lead to a larger than predicted current account deficit in 2004[2]. As far as interest rates are concerned, economic environment is expected to remain expansive and fiscal policy will also be somewhat more expansive than a year ago. Further development of the external balance depends above all on the foresight of economic agents and on their ability to bring their consumption habits in line with export earnings.

Due to favourable interest rate environment, the external balance has been financed increasingly by foreign loan facilities in recent years, in addition to direct investments. **Direct investments covered about 40% of the current account deficit in the first half of 2004. The total external debt of the Estonian economy amounted to 82% of GDP at the end of the first half-year,** increasing by 8 percentage points year-on-year. The net debt increased almost as much.

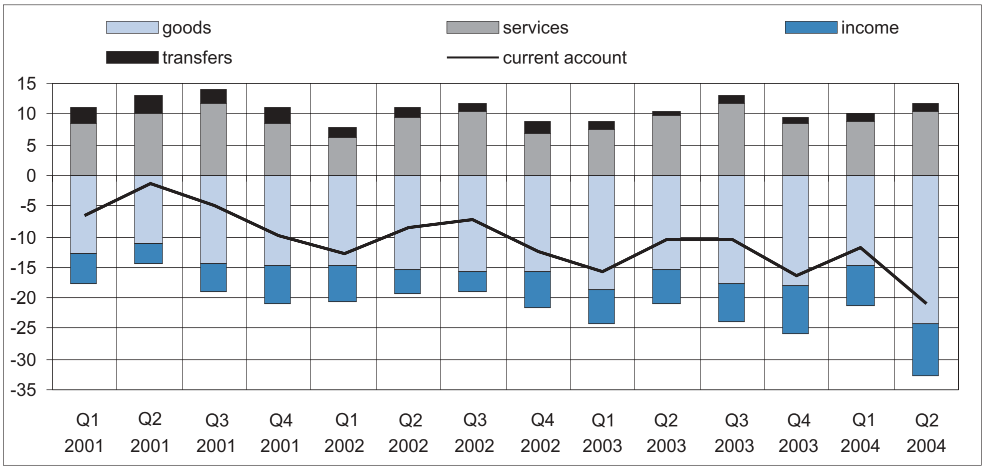

Figure 2.5. Current account and the balance of its components (% of GDP)

[2] The change in the system of collecting foreign trade statistics also makes it difficult to provide a quick answer to the issue of the temporary nature of the growth in goods imports. After final elimination of the customs border with the EU countries the analysts find it difficult, at least for the time being, to distinguish transit from the rest of the trade.