I
GLOBAL ECONOMY AND ESTONIAN ECONOMY

External Environment

Global Economic Cycle

Late summer and early autumn in 2003 was the turning point in the global economic cycle. After a standstill in all major economic areas the economy started to recover again. The recovery was the briskest in the United States, where annual economic growth amounted to 3.1%, as well as in Japan (2.7%). The recovery was the slowest in the euro zone, where economic growth was just 0.4%. Growth rates slowed down also in Finland and Sweden where production volumes declined. Economic growth forecast for the United States in 2004 stands at 4.6% while the economy of Japan is expected to grow by 2.8% and that of the euro zone by 1.7%[1].

Annual **industrial production** growth indicators, which had been negative in the meantime, also turned positive at the start of 2004, amounting to 2.7% in the United States and to 2.1% in the euro zone (see Figure 1.1). In Sweden, too, growth in industrial production accelerated again. In Finland, however, product output has in some months even declined.

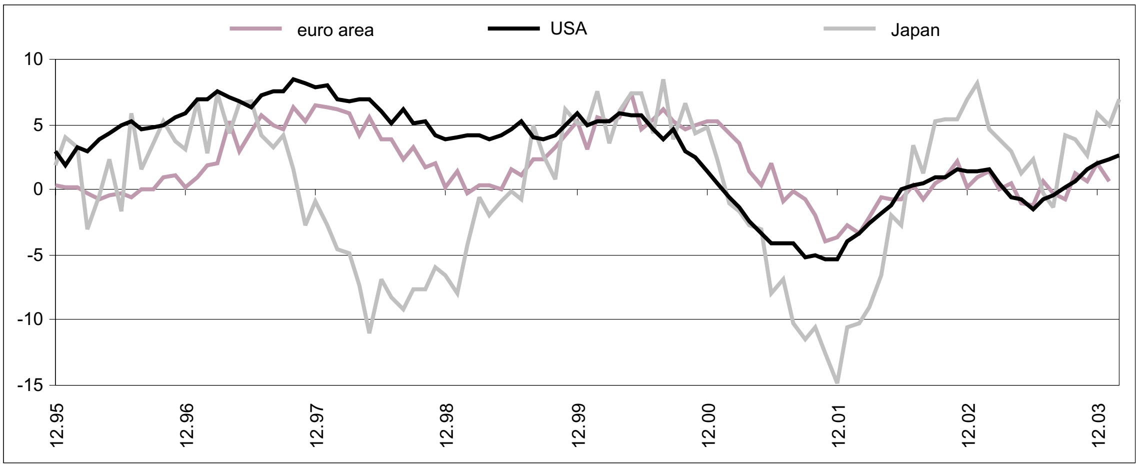

Figure 1.1. Annual growth in the industrial production of the euro area, the United States, and Japan

In the countries posting faster economic growth also **employment** has gone up. For example, in the United States unemployment fell from 6.3% in June 2003 to 5.7% in March 2004. In the euro zone, however, unemployment has remained stable at 8.8% since 2003. In Finland, too, unemployment has remained on the 2003 level, but has grown in Sweden (in February the unemployment rate was the highest in four years – 5.6%). **Consumption readiness** of households was strong both in Finland and Sweden in 2003, but due to the deterioration in the labour market the confidence of Swedish households has declined.

[1] Consensus Forecasts, March 2004.

Meanwhile increased economic activity did not manage to halt further growth in **the budget deficit** in the United States and the euro zone. In the United States, the deficit soared to 3.6% of GDP by the end of 2003 while in the euro zone the budget deficit in Germany and France outpaced the 3% limit established by the Growth and Stability Pact. Besides the countries above, the European Commission forecasts a deficit in excess of 3% also to Italy, the Netherlands, Portugal, and Greece in 2004.

Inflationary pressure in larger economic areas was insignificant. Even though rising commodity prices (crude oil rose to the highest level in 13 years in March while the commodity prices (CRB index) shot up the highest point in 7.5 years) put pressure on the input prices of US companies[2], much of the effect was offset by cheap imports from Asia. In the United States, annual growth in consumer prices slowed down to 1.7% in February-March 2004 while in Japan a slight deflation (up to -0.5%; see Figure 1.2) was sustained at the end of 2003 and at the beginning of 2004.

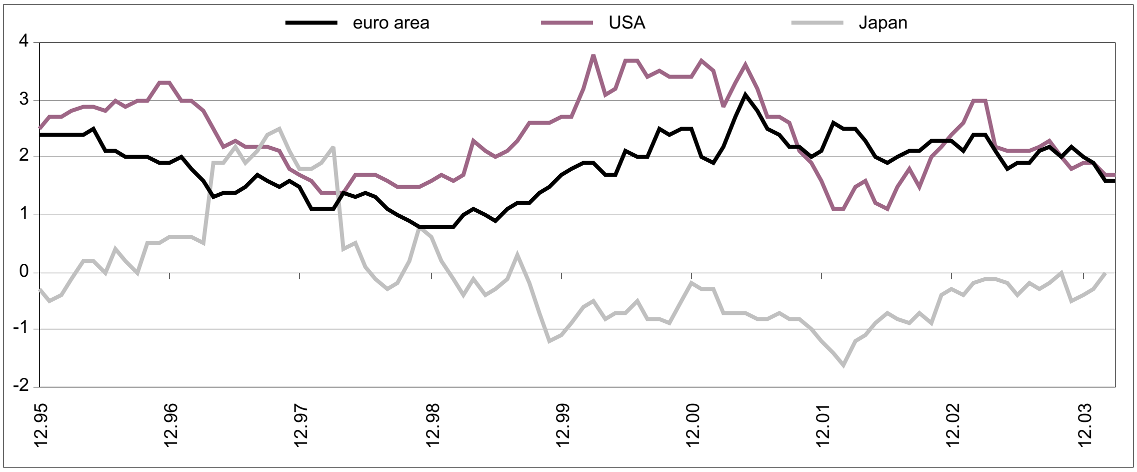

Figure 1.2. Consumer prices in the euro area, the United States, and Japan (%)

In the euro zone, the inflation rate declined to 1.6% by February-March 2004, which was the lowest level since 1999. Finland's inflation rate was among the lowest in the euro zone and arising from the changes in the currency exchange rate and taxation, in March the country posted a slight deflation (-0.4%) for the first time ever. Also in Sweden, where the inflation rate had stood at a comparatively stable level of 2% in 2003, the indicator has consistently declined in 2004 (stood at 0.4% in March). Therefore Sweden's central bank reduced key interest rates on 1 April by 50 basis points – to 2%.

International Financial Markets

Stock markets have witnessed a growth trend in recent quarters, which has been underpinned by global economic recovery and improved outlooks. Summing up the period under review[3], growth in Finnish stock prices compared to the average of the euro zone and Sweden remained rather modest (see Figure 1.3). This was partly related to the announcement concerning a slump in Nokia's sales. On a global scale, further rise in the stock markets at the end of the first quarter was hampered by the fear that the growth phase of the economic cycle might run out in 3–6 months. Besides, heightened political tensions in Iraq and the terrorist attack in Madrid had a certain negative impact on the markets. Owing to the growth phase of the economic cycle, principal indicators should still encourage stock investors in the near future; meanwhile some markets might differ greatly from the rest.

[2] Due to the decline in the dollar exchange rate the pressure on the input prices of euro zone companies was immaterial.
[3] The review covers developments from 30 September 2003 to 14 April 2004.

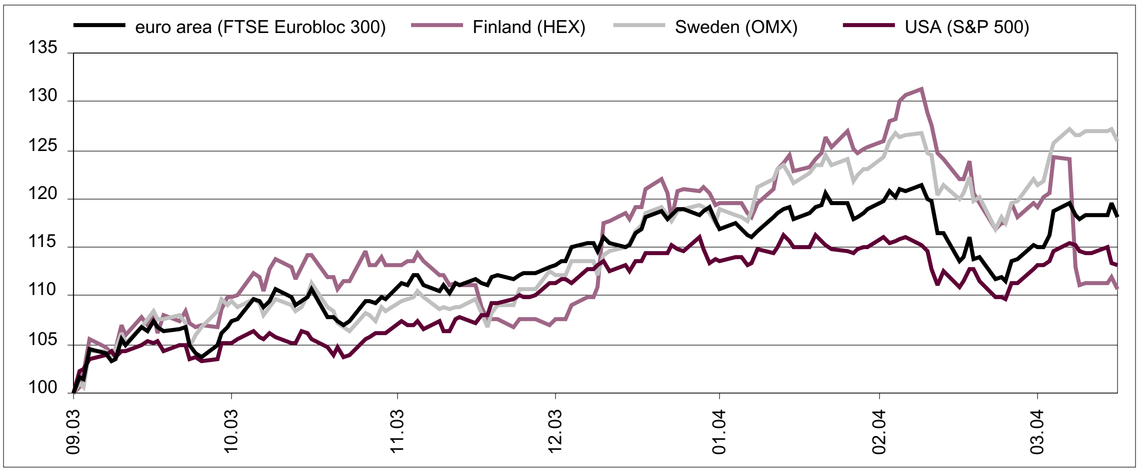

Figure 1.3. Stock indices in the United States, euro area, Sweden, and Finland (30 September 2003 = 100)
Source: EcoWin

Money markets. Central banks' monetary policies vary in different countries, depending on the course of the recovery process:

- The European Central Bank and the central banks of the United States and Japan maintained neutral monetary policy, estimating possible risks to economic growth and inflation as being relatively balanced;
- Central banks in the countries showing faster economic growth (Australia, New Zealand, and the United Kingdom) embarked on tightening their monetary policies by raising key interest rates;
- The central banks of Sweden, Norway, and Canada lowered key interest rates by 75 basis points.

Short-term (3 months) interest rates in the United States remained roughly on the previous level (see Figure 1.4). Future transactions show that by mid-April the market had assumed that key interest rates would rise by 25 basis points by September 2004 and by 50 basis points by November-December. In the euro zone, the 3-month interest rate fell since the market had assumed for a while that the key interest rate might be lowered in 2004 because of slow economic growth. By mid-April such a prospect had essentially been replaced by an expectation that with some 80% certainty the European Central Bank would raise its key interest rate by 25 basis points in the fourth quarter of 2004.

10-year interest rates fell in the United States, the euro zone, and Sweden until mid-March 2004 to be followed by a swift rise because of the US labour market indicators (see Figure 1.5).

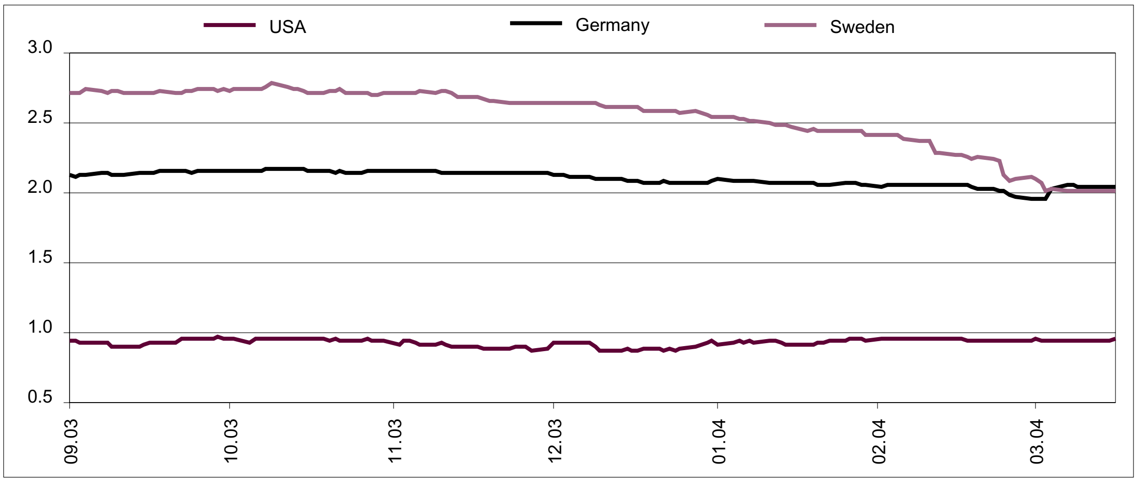

Figure 1.4. 3-month interest rates in the United States, Germany, and Sweden (%)
Source: EcoWin

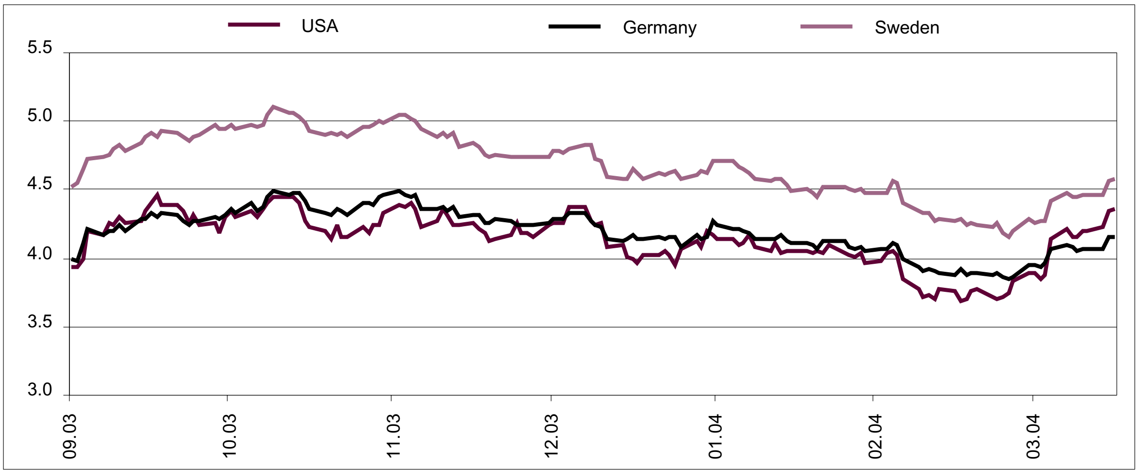

Figure 1.5. 10-year interest rates in the United States, Germany, and Sweden (%)
Source: EcoWin

In the currency markets, the US dollar continued to drop against other leading currencies in the fourth quarter of 2003. The trend weakened in the first quarter of 2004, contributing to major fluctuations in several currencies. Four principal factors can be distinguished in the change of the euro exchange rate:

- The euro zone is lagging behind in the current economic cycle while economic activity has considerably increased in the United States and Asian countries;
- Changes in interest rate differences have been unfavourable to the euro since expectations of a higher key interest rate have shifted towards a later period;
- According to the data from recent months, capital has flown out of the euro zone;
- The status of the euro as a lower-risk currency compared to the dollar weakened because of the terrorist act in Madrid.

The Swedish krona weakened against the euro until the end of March 2004. Loosening of the monetary policy on part of the central banks partly contributed to the process. In April the krona began to strengthen again due to weakening fundamental euro indicators (see Figure 1.6).

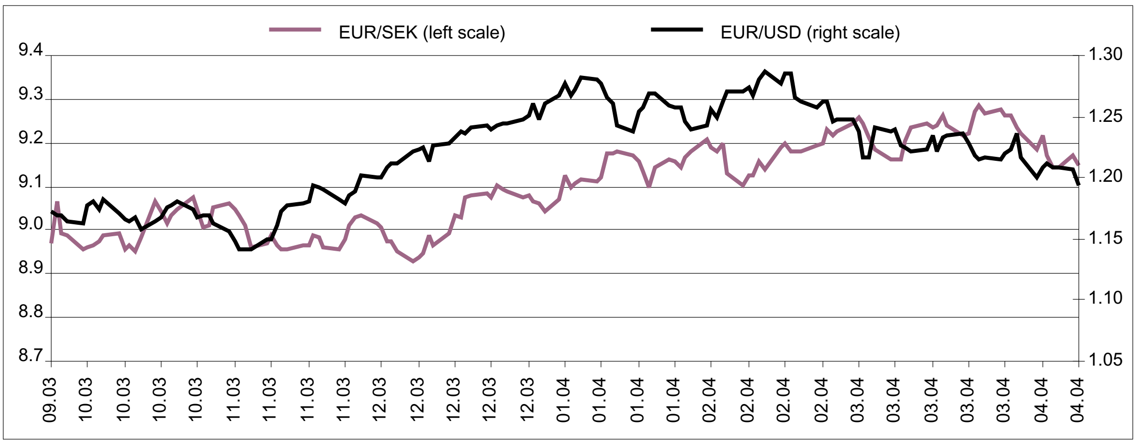

Figure 1.6. Exchange rate of the euro against the Swedish krona and the US dollar
Source: EcoWin

Estonian Economy and Macroeconomic Risks

Economic Growth and External Balance

In the second half of 2003 **the pace of economic growth** started to recover gradually, achieving a near-potential level in the fourth quarter (5.7%). **All in all, Estonia's economic growth outpaced that of the**

euro zone by 4.4 percentage points in 2003, which indicated that comparatively fast convergence was sustained also against the backdrop of sluggish global economy (see Figure 1.7).

Favourable international interest rate environment consistently supported domestic demand in Estonia. Meanwhile the balance of payments statistics indicates that the expansiveness of domestic demand has somewhat declined: even though **foreign trade** deficit was larger in the second half of 2003 compared to the preceding period, it was compensated by growth in the balance of services surplus. As a result, the goods and services deficit, i.e. the rate by which internal demand exceeded the gross domestic product, declined to 9% of GDP in the second half of the year.

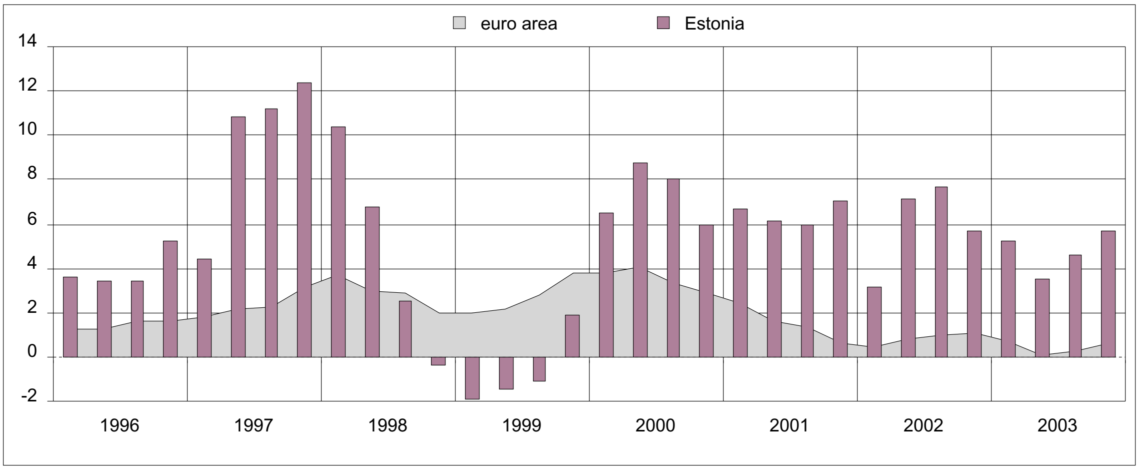

Figure 1.7. Real growth of GDP by quarters (%)
Sources: Statistical Office of Estonia; Eurostat

However, a certain decline in the deficit regarding goods and services was not sufficient to offset the increase in the outflow of net earnings, which is why the **current account deficit** soared to 13.7% of GDP (see Figure 1.8). Also Estonia's investment position deteriorated: compared to the end of 2002 the foreign debt to the GDP ratio surged by some 10 percentage points (to 75% of GDP). **In order to balance out the economy it is vital that the balance of savings and investments would improve and that internal demand driving the debt obligations would halt in the coming periods.**

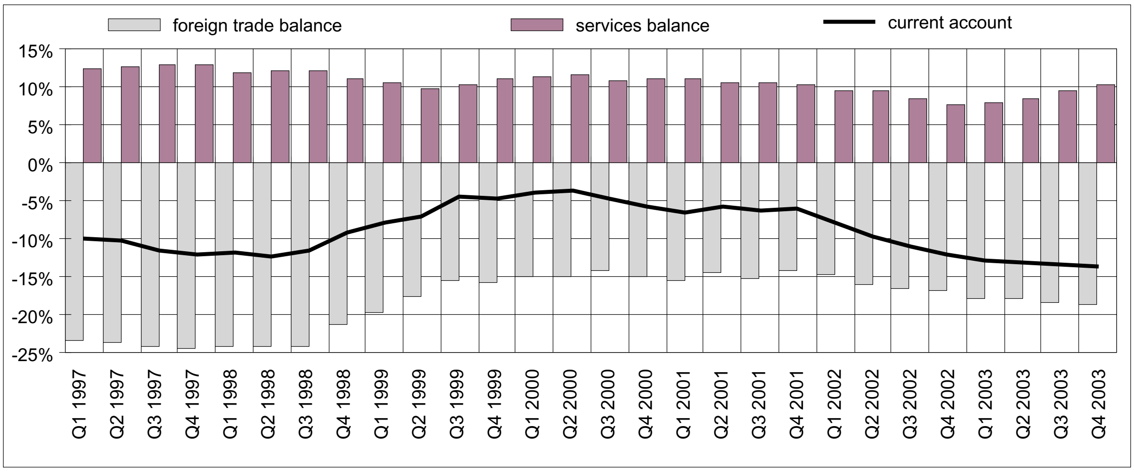

Figure 1.8. Foreign trade balance, services balance, and current account balance relative to GDP (4-quarter average)

Of demand components, economic growth was traditionally mostly supported by private consumption and soaring investments. While **private consumption** increased in line with GDP, **investment** growth rate was demonstrated by the rise in the respective ratio to around 33% of GDP. Similarly to earlier periods, the second half of 2003 saw mainly investments into domestic areas of business (including major one-off energy and transport projects). Faster growth in investments into the closed sector covered the decline in investments into branches more directly related to manufacturing for exports.

Inflation

External price pressure continued to decline in the second half of 2003. Besides modest global demand, the inflation rate was kept low also by a rise in the nominal exchange rate of the euro against most major currencies as well as declining food and fuel prices. Of domestic factors, an additional inflation-curbing element was the absence of a rise in administrative prices. The joint effect of the listed factors curbed annual consumer price rise to 1.3% (see Figure 1.9) in 2003.

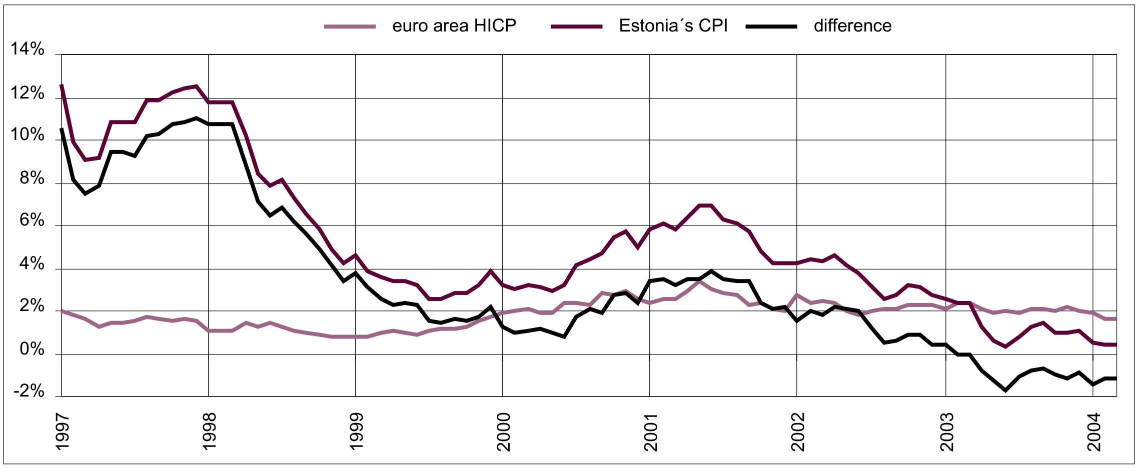

Figure 1.9. Annual growth of consumer prices in Estonia and the euro area
Sources: Statistical Office of Estonia; Eurostat

Regardless of high inflation expectations that had characterised the beginning of 2004, pressure on price rise was absent in the first four months. The effect of the factors that had supported low inflation rate last year (strong euro, weak demand environment, stable oil price in euros) has not yet faded.

Corporate Business Situation

Confidence

According to the Estonian Institute of Economic Research, Estonian companies became more optimistic about their development outlook in the autumn and winter of 2003 (see Figure 1.10). The positive trend continued also at the beginning of 2004. Differently from earlier, this time the growth in optimism was based not directly on the indicators reflecting demand (e.g. the number of orders in domestic and foreign markets) but above all on estimates of future periods.

The indicators collected in March 2004 show that the estimates of all the monitored branches of economy have improved compared to December, though partly due to seasonal reasons. However, since the estimates of industrial, construction, and trading companies alike were higher than in March 2003, one might conclude that economic activity has grown even if seasonal factors are left aside.

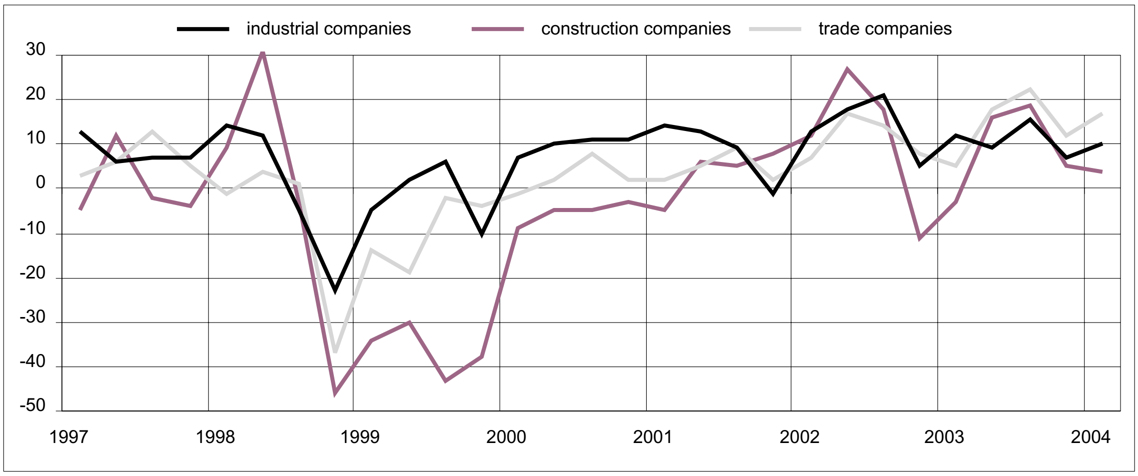

Figure 1.10. Confidence indicators of Estonian companies
Source: Estonian Institute of Economic Research

In the second half of 2003 also external demand estimates of **industrial companies** became more optimistic (see Figure 1.11). A more positive estimate of production and staffing needs in the following months has most likely been based on the positive synergy resulting from the accession to the EU.

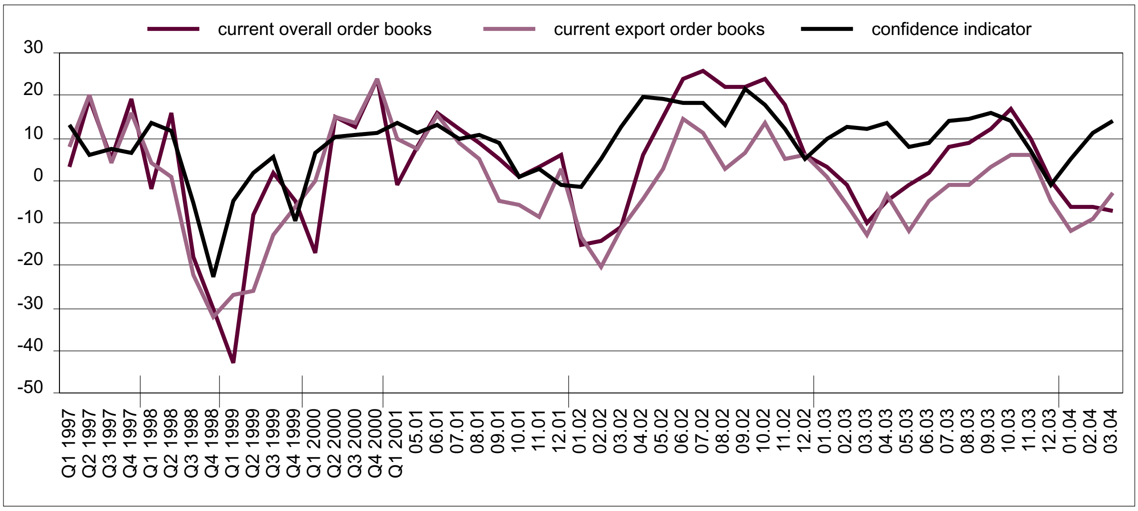

Figure 1.11. Production demand of industrial companies and confidence indicator
Source: Estonian Institute of Economic Research

Industrial Sales and Investments

The development of real indicators verifies that the confidence indicators reflecting the expectations of companies are valid. In the second half of 2003 both exports (from 9.2% in the first half of the year to 10.8%) and sales (from 9.3% to 10.8%; see Figure 1.12) accelerated in the manufacturing.

Due to diverse demand in different branches **growth in exports** was very different per commodity groups and target countries. While exports in chemicals, metal, and mineral products soared by more than 20% and that of machines and equipment as much as 33%, growth remained more modest in more export-oriented branches (timber products 8%, furniture 14%, and textiles 1.5%). Meanwhile direct exports in food products even showed negative growth (-1%).

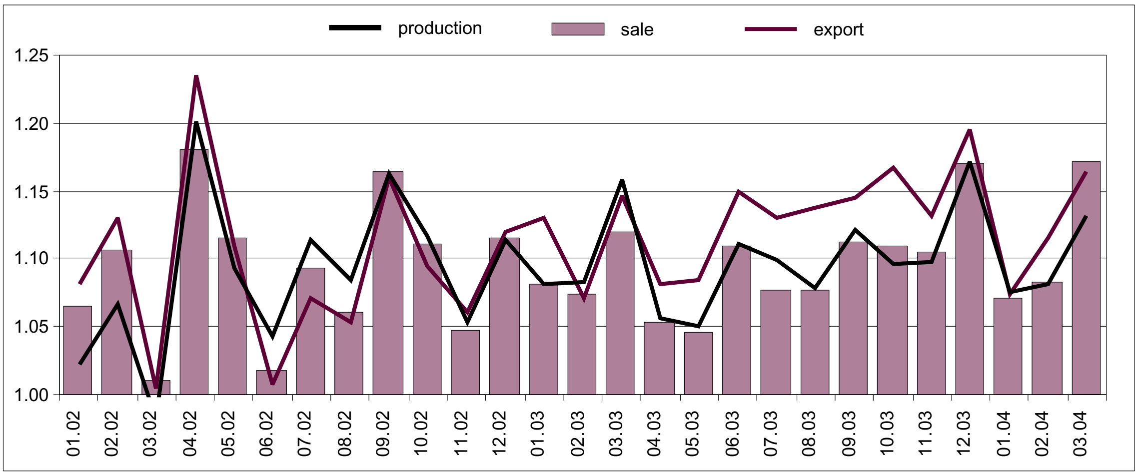

Figure 1.12. Production and sale indices of manufacturing
Source: Statistical Office of Estonia

Corporate **investments** statistics shows that investments into primary sector branches declined. Investments into secondary sector branches (including manufacturing) remained approximately on the level of 2002, meanwhile investments into the traditionally significant branches for Estonia's exports – timber, paper, and furniture production – were smaller in 2003 than they had been in previous periods (see Figure 1.13). Investments into transport, storage, communication, energy, gas and water supply, and construction increased.

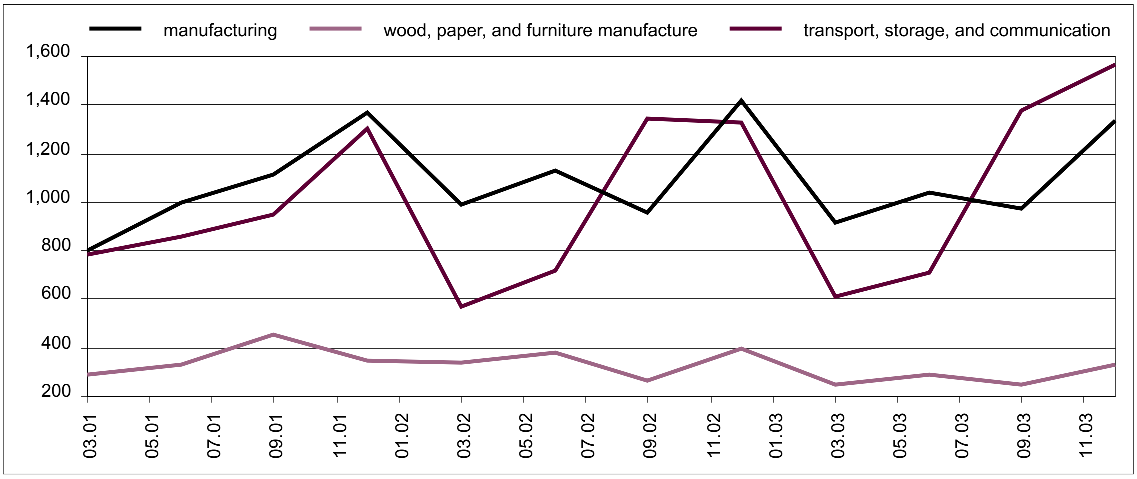

Figure 1. 13. Investments in tangible fixed assets (EEK millions)
Source: Statistical Office of Estonia

New Companies and Bankruptcies

In December 2003 the **number of bankruptcies** (see Figure 1.14) that had remained stable for several months shot up again. Still, there were fewer bankruptcies (238) than in the preceding three years. Also the first quarter of 2004 was characterised by a larger than average number of bankruptcies. More than a third of the bankrupted companies were operating in the construction business. Termination of operations was most likely related to the specifics of the branch and does not indicate serious problems in the area.

In 2003, most of the **new companies** were born in commerce (50% of all the new companies) but the rate of growth was the fastest (121%) in the construction business. By the end of the first quarter of 2004, the number of trading companies had grown by 346 from the first quarter of 2003.

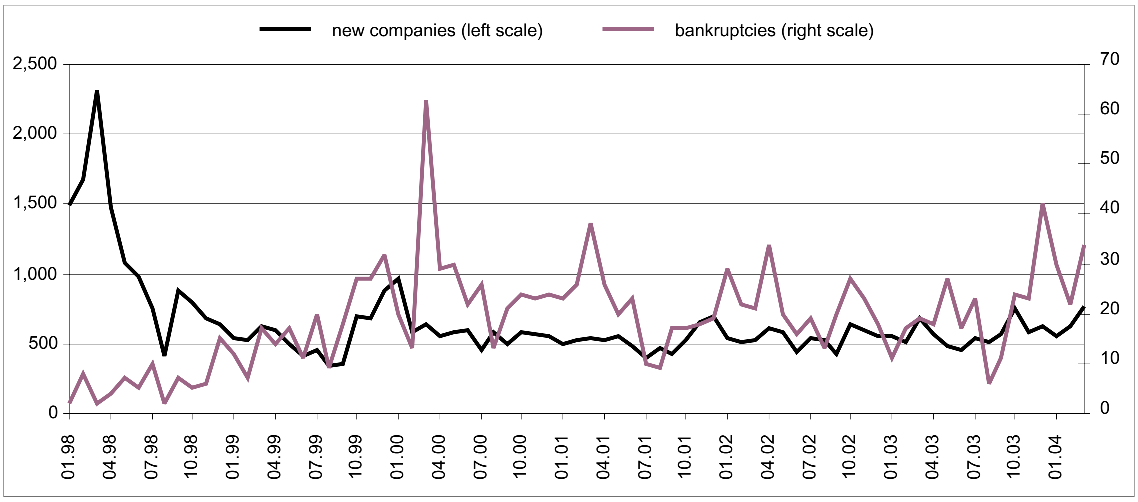

Figure 1.14. New companies entered in the commercial register within a month and bankrupt companies

Corporate Profitability

According to preliminary estimates, overall corporate profitability was quite high in 2003. This is indicated by comparatively good sales figures and also corporate optimism reflected by industrial confidence indicators.

In 2003, growth in corporate profitability was liable to have remained smaller than that of GDP: **nominal GDP** increased by 7.5% in 2003, but the concurrent rise in **operating surplus and mixed income** was 5%. Also preliminary financial indicators verify a halt in profit growth. In the core business areas of the economy **total profitability** declined to a certain extent. Compared to 2003, hotels and catering sector as well as local and foreign companies operating in agriculture showed more modest results.

Economic Situation of Households

Labour Market

In 2003, positive developments occurred in the labour market: compared to 2002, the residents were more active and employment increased while unemployment declined. The average annual **unemployment rate** fell to 10%, which is the lowest in five years (see Figure 1.15). The decline in the **number of registered unemployed** continued to fall also in the first quarter of 2004, which enables to predict a further fall in unemployment.

Employment growth accelerated in 2003, amounting to an annual average of 1.5%. Compared to 2002, an average of 8800 employed were added to the workforce. Growth was the largest in manufacturing, construction, and health care. Meanwhile the biggest decline in employment occurred in agriculture and commerce.

Regardless of the record low inflation rate, fast **wage growth** continued in 2003, which amounted to an annual average of 9.7% (see Figure 1.16). The wage increase was the fastest in the servicing sector, but the rise amounted to 9.6% also in manufacturing.

Accelerated growth in labour costs is particularly inadvisable because of the cyclical decline in overall economic growth, and it was an additional source of economic imbalance in 2003. **Bringing wage rise in line with profitability growth is a key issue in the coming periods.**

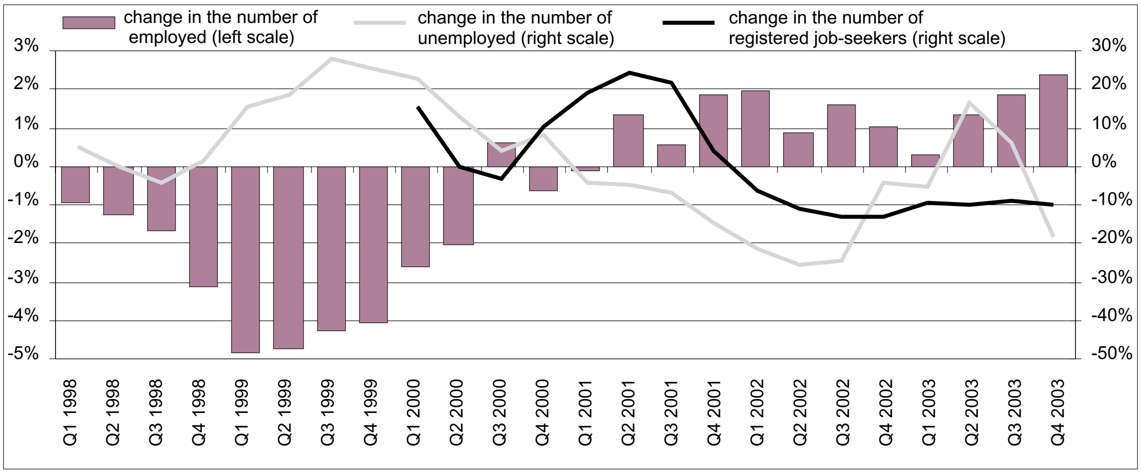

Figure 1.15. Annual change in the number of employed and unemployed persons and registered job-seekers
Source: Statistical Office of Estonia

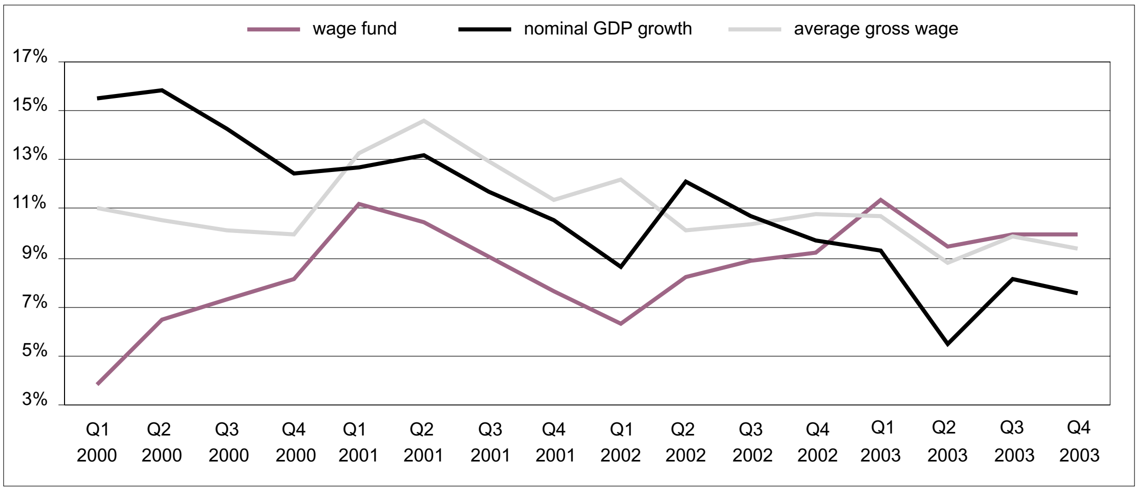

Figure 1.16. Annual growth of average wage, wage fund, and nominal GDP growth
Source: Statistical Office of Estonia

Confidence and Family Budget Surveys

After a prolonged peak the trend in the **household confidence indicator** issued by the Estonian Institute of Economic Research turned negative as of mid-2003. According to estimates, household confidence was reduced mainly because of high inflationary expectations related to the EU accession. Meanwhile the fear of becoming unemployed decreased (see Figure 1.17).

According to **the household budget survey carried out by the Statistical Office,** net income of a household member soared by 12% in 2003 while expenditure grew by 3%. Average expenditure accounted for 91% of the income. The share of food and housing costs declined further – to 45.5%. The biggest rise occurred in communication and transport spending. Even though due to some differences in methods[4] household member statistics does not cover total private consumption[5], the slowdown in regular consumer spending might still indicate an indirect relationship with the increased repayment of housing loan liabilities.

[4] The survey of the Statistical Office does not show loan payments as costs, nor have loans been shown as income. Neither does expenditure include costs related to obtaining housing nor car leasing payments.
[5] Statistical differences are significant: (1) GDP private consumption growth in 2003 was 7.6%; according to household statistics, however, it was 3%. (2) The difference in volume was as much as 1.5 times.

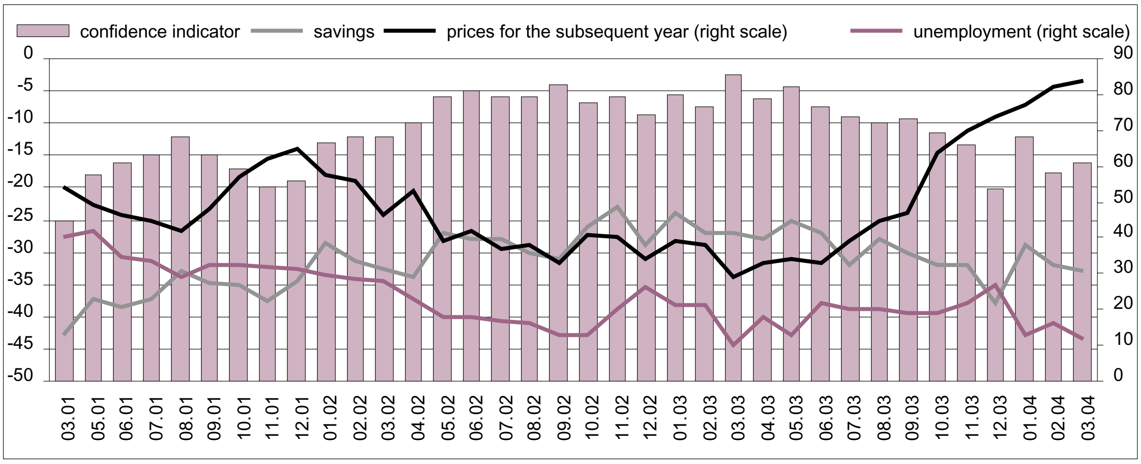

Figure 1.17. Consumer confidence indicators
Source: Estonian Institute of Economic Research

According to the estimates reflected in the **Estonian Institute of Economic Research consumer barometer,** the intentions of private persons to make big investments (buying a car, buying or building a house; see Figure 1.18) have significantly declined in recent periods. If such intentions materialise in real terms, the more balanced conduct of households might become a key factor in balancing out the whole economy.

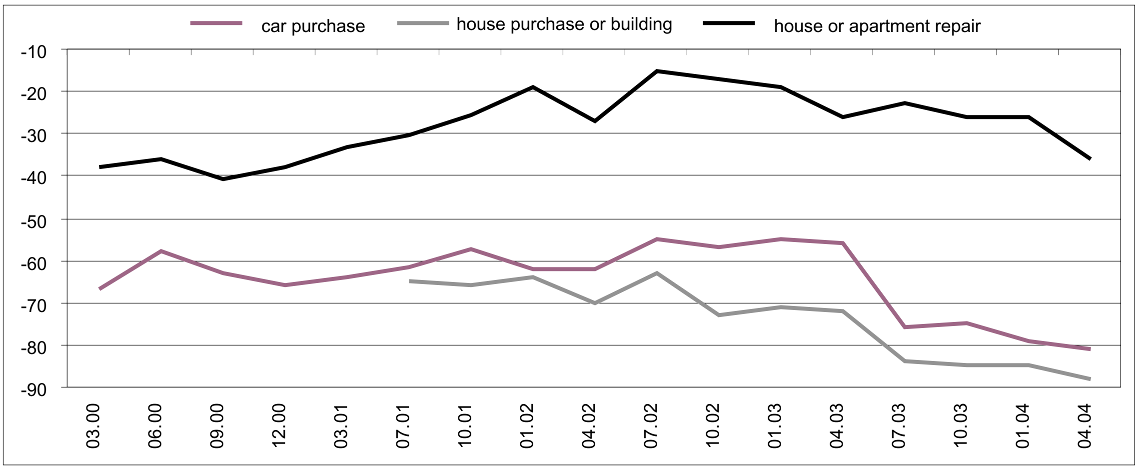

Figure 1.18. Households' cost estimates
Source: Estonian Institute of Economic Research

Structure of Financial Intermediation and Financial Deepening

Expansive monetary policy environment has also been reflected in the **financial deepening** in recent years. Low interest rates have promoted more extensive borrowing while saving is not very attractive. Extensive loan demand on part of private persons, which is being affected by favourable interest rates (loan burden as a ratio to GDP has increased by 5.7 percentage points in the last four quarters) has played a major role in the 9.6 percentage point growth (57.2% to GDP in the first quarter of 2004) in the loan burden of the entire real economy sector.

Banking continues to dominate in the structure of Estonian financial intermediation, however, while the rate of bank loans went up consistently both in 2003 and in the first quarter of 2004, the rate of leasing financing

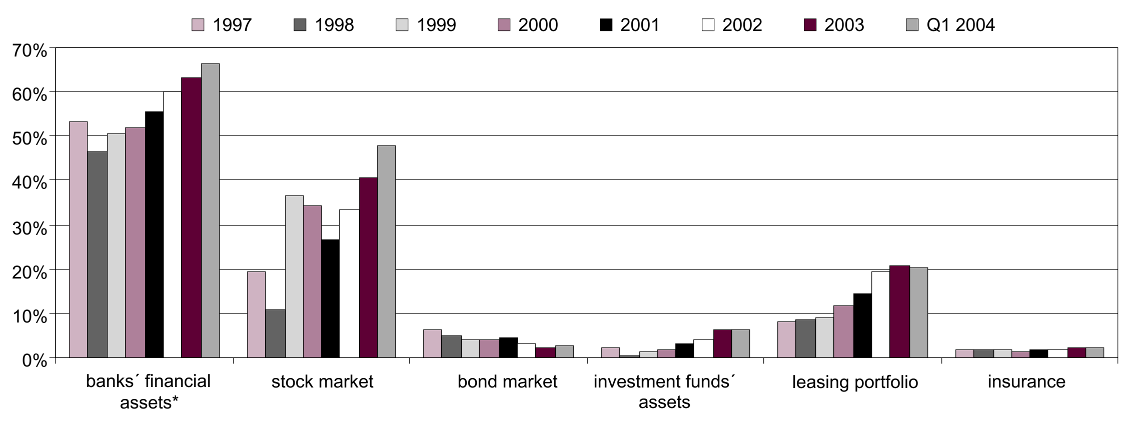

Figure 1.19. Structure of financial intermediaries (% relative to GDP)
* except loans issued to financial institutions (mostly leasing companies)

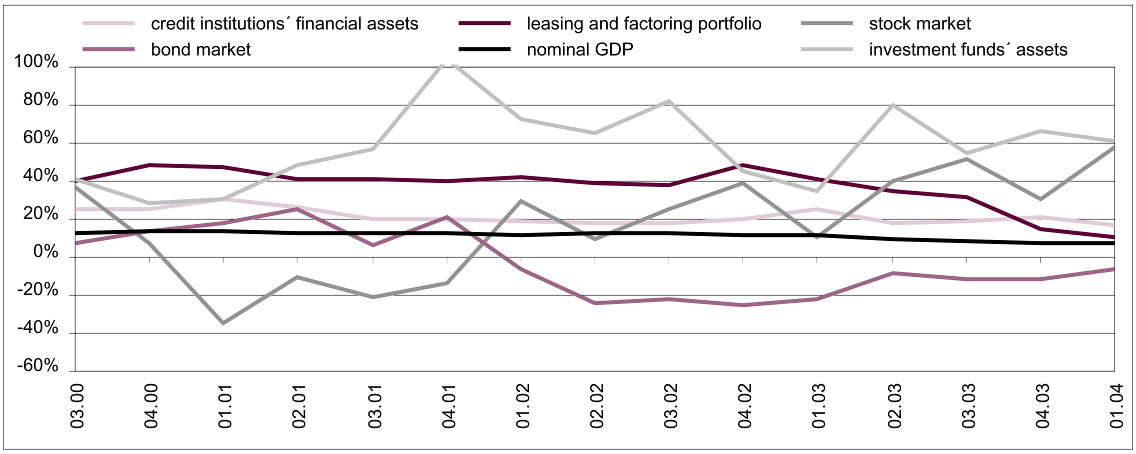

Figure 1.20. Yearly growth rates of financial assets and nominal GDP

began to slow down in the second half of 2003 and the same trend continued also in the first quarter of 2004 (see Figures 1.19 and 1.20).

Estonian securities market witnessed soaring **share prices** in 2003; such trend continued at a brisk rate also in the first quarter of 2004. This boosted stock market capitalisation relative to GDP in four quarters by 16 percentage points – to 48%. But Estonian **bond market** showed little activity both in 2003 and in the first quarter of 2004.

A significant role in the accelerated growth in the assets of **investment funds** has been played by mandatory funded pension funds. Having grown by more than a billion kroons in 12 months the II pillar pension funds accounted for as much as 17% of the consolidated assets of the funds at the end of the first quarter of 2004. Compared to earlier fast growth, the volume of money market and interest funds has remained more stable since the second half of 2003.

Even though Estonia's **insurance sector** soared by more than 25% in a year, the volume of insurance relative to GDP still remains modest. A significant boost in growth can be seen in the life insurance market where premiums collected from capital insurance and unit-linked life insurance products (including voluntary funded pension) have gone up significantly.

Background Information

THE EFFECT OF PRIVATE SECTOR DEBT BURDEN ON FINANCIAL STABILITY[6]

Several central and eastern European countries have recently witnessed rapid private sector loan growth. In the countries whose objective was to join the EU (including Estonia) rapid debt growth was above all boosted by the initially low debt burden and great expectations of foreign capital holders. This represents normal financial deepening since convergence of income levels presumes faster growth in financial assets.

High debt level is considered to be a factor threatening financial stability mainly for two reasons:

1. Loan-servicing costs require sustained economic growth since in the period of economic slump loan-servicing becomes expensive. Increasing loan repayment in turn can aggravate depression.

2. High loan level can be a preliminary indicator of financial crisis. A large loan burden of the private sector could exacerbate other macroeconomic problems and indirectly create prerequisites for a crisis.

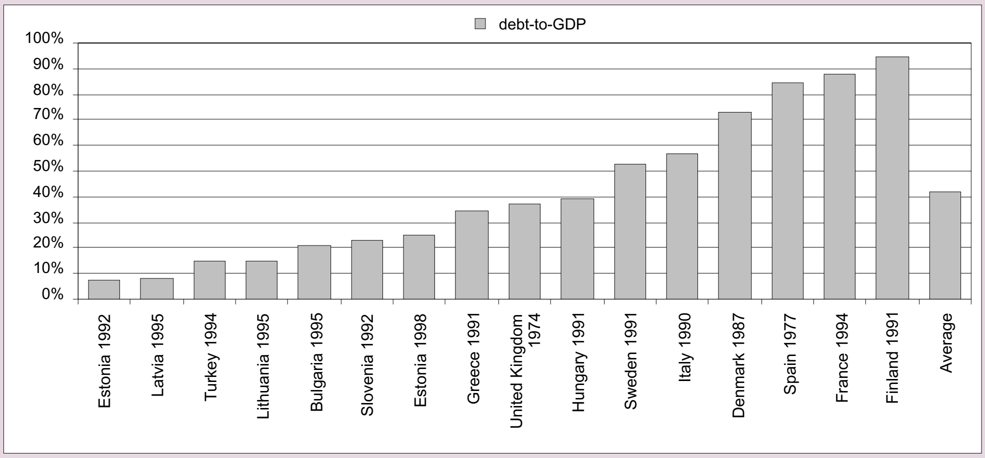

Figure 1.21. Indebtedness prior to banking crisis in different European countries

Experience shows that there is actually no such critical debt level at which the number of crisis episodes would increase. An analysis of the private sector debt level (the ratio of private sector loans[7] to GDP) before banking crises in European countries in the last decades of the last century shows that historically banking crises have occurred at very different debt levels (see Figure 1.21). Therefore debt level in itself cannot be considered a single indicator characterising financial stability.

Meanwhile rapid growth in the debt level might lead to inflated current account deficit, consumption and investment booms, stock exchange and real estate market bubbles etc., thus increasing overall economic instability. Such developments make a country's economy more sensitive to external shocks and amplify their destabilising effect.

An analysis carried out on European countries demonstrated that if the level of debt in a country is higher, the financial crisis might last longer and bring about considerably more adverse effects regarding economic growth.

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[6] The conclusions have been derived from a study conducted in Eesti Pank in April 2004, *Critical Level of Debt?* (authors Lenno Uusküla, Peeter Luikmel, Jana Kask).

[7] Private sector loans in this particular case are only the loans issued by the banking sector since due to the restricted availability of information the data might not be otherwise comparable. Considering the structure of the financial sector, such debt burden indicator is somewhat smaller than the indicator encompassing all financing forms.