# I
# GLOBAL ECONOMY AND ESTONIAN ECONOMY

## External Environment

### Global Economic Cycle

The upturn in economic activity that had started in 2003 continued also in 2004 (see Figure 1.1). In the first quarter, **the year-on-year GDP growth** was the fastest in the past 15–20 years both in the United States and Japan (5.0% and 5.9%, respectively). The annual GDP growth in the euro area remained considerably slower (1.3%). In the second quarter, the soaring oil prices affected domestic demand in the United States and Japan unfavourably, thus slowing economic growth down to 4.8% and 4.2%, respectively. Meanwhile a moderate rise in economic activity continued in the euro area and the annual GDP growth rate stood at 2.0% in the second quarter. Certain slowdown in global economic growth has been forecast for the second half of 2004 and the next year[1].

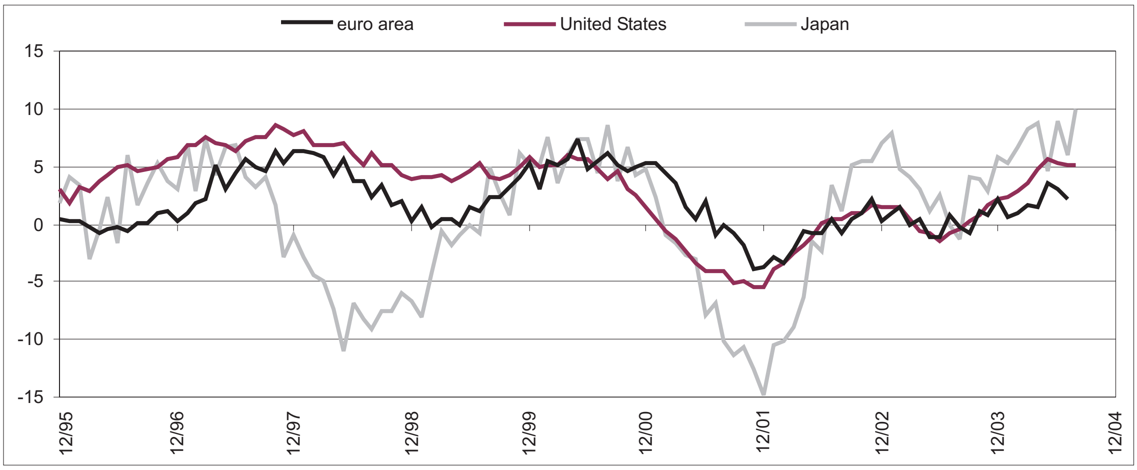



*Figure 1.1. Annual growth in the industrial production of the euro area, the United States and Japan (%)*

Source: EcoWin

Economic growth in the United States and Japan also led to **improvements in the labour market**. In the United States unemployment decreased from 5.7% in March to 5.4% in August whereas in Japan it fell from 5.0% in January-February to 4.8% in August. Due to structural problems (above all little mobility of the labour force) moderate economic growth did not have a positive impact on the labour market in the euro area – the unemployment rate remained stable at 9.0% April through August.

**Budget deficit** growth both in the United States and the euro area came to a halt in the summer of 2004. However, the deficit level remains very high (in excess of 3.0% of GDP in the United States and in the largest economies of the euro area) and there has been no clear turn for the better. The relatively fast economic growth in the United States has led to a sharp increase in the current account deficit, which rose to as much as 5.7% of GDP in the second quarter of 2004.

[1] Consensus Forecasts, September 2004.

Arising from fast-growing oil prices, **inflationary pressure** temporarily increased in the summer of 2004 – the annual rise in consumer prices stood at 3.3% in the United States, 2.5% in the euro area and 0.0% in Japan (see Figure 1.2). During the following months the pressure subsided somewhat since rising oil prices curbed consumption and did not allow companies to pass rising input prices on to customers. Due to the weakness of private consumption inflation is not expected to increase in the near future. In addition, the possible increase of key interest rates in several large economies puts the brakes on price rises.

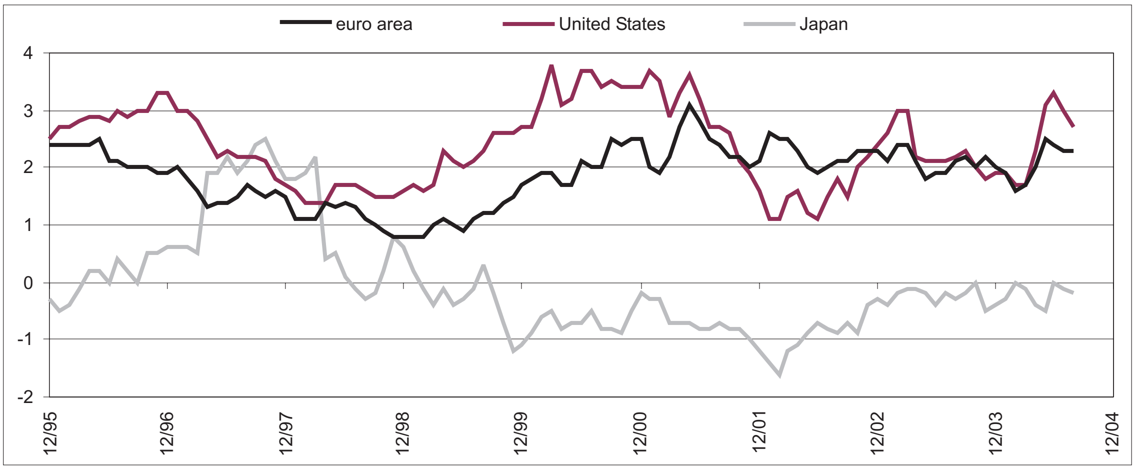



***Figure 1.2. Consumer prices in the euro area, the United States and Japan (%)***

Source: EcoWin

**In Finland and Sweden, economic growth** again outpaced that of the European average in the first half of 2004, amounting to 3.2% and 3.6%, respectively, in the second quarter. The growth in the Nordic countries was underpinned by increased external demand in the electronics as well as in timber industry. The central banks of Sweden and Finland are optimistic about future economic development – in their forecasts of autumn 2004 both corrected their economic growth outlook upwards for this as well as for the next year.

Despite brisk economic growth the situation in the **labour market** did not improve. In the second quarter the unemployment rate stood at slightly below 9% in Finland and slightly below 6% in Sweden. However, the confidence of households and their consumption readiness has remained relatively high in that context and domestic demand can still be considered an important growth factor.

Finland's and Sweden's **inflation rates** showed a considerable decline at the start of the year – mainly because of the base effect of energy prices. In Finland another contributing factor was the reduction of the excise duty on alcoholic products. Like elsewhere in Europe, high raw material prices have started to affect also Nordic consumer prices in the second half of 2004. The central banks predict a rise in consumer prices by 0.2% in Finland and by 0.5% in Sweden at the end of the year.

## International Financial Markets

**Stock markets** were rather hectic in the second and third quarter of 2004[2]. This was brought about by a turn towards slower economic growth (above all in the industrial sector) as well as by surging oil prices, which led to increased insecurity and a decline in the investors' willingness to take risks. The earlier trend of rising stock prices stopped and was replaced by trading within a limited range. All in all, the changes in the stock indices in the United States and the euro area remained modest: the S&P 500 index in the United States increased by 1% while the Eurobloc 300 index rose by 1.6% (see Figure 1.3). In Sweden the stock index increased by 4.9%, whereas the index in Finland fell by 11.5% as a result of a decline in the price of Nokia's shares.

[2] The survey covers the period from 31 March 2004 to 13 October 2004.

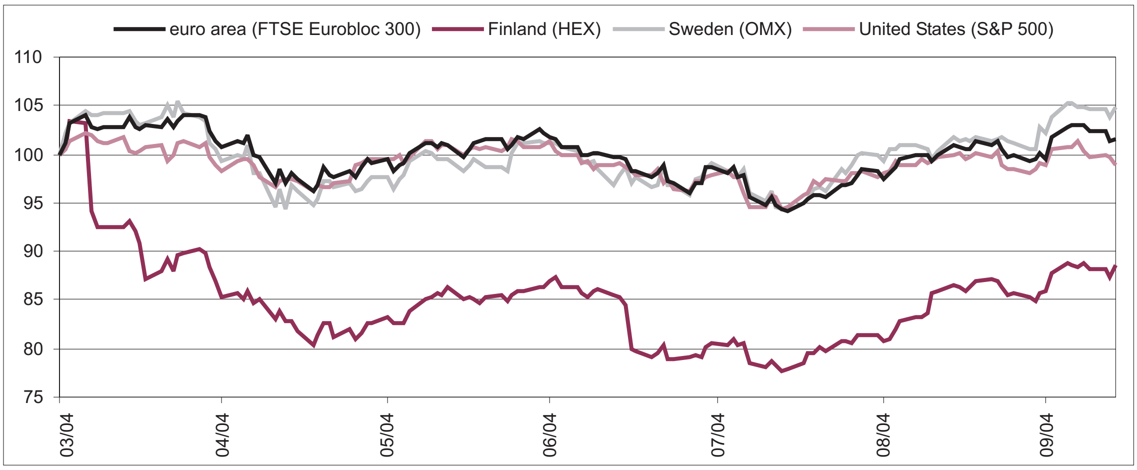



***Figure 1.3. Stock indices in the euro area, Finland, Sweden and the United States (31 March 2004 = 100)***

Source: EcoWin

**In the money markets** the dynamics of short-term and long-term interest rates was different. Because of fast economic growth inherent to the process of revival, several central banks (e.g. in New Zealand and the United Kingdom) continued to raise **key interest rates**. For the same reason the US central bank also embarked on raising the key interest rate, increasing it from 1.0% to 1.75%. In its September statement the US central bank estimated that the risks to economic growth and inflation are roughly equal while expressing the opinion that the shift towards more neutral monetary policy might continue at a moderate pace. At the beginning of April the Swedish central bank lowered its key interest rate from 2.5% to a level that matched that of the euro area, i.e. 2.0%. All in all, during the period under observation **3-month interest rates** rose by 78 basis points in the United States and by 19 basis points in the euro area while falling by 8 basis points in Sweden (see Figure 1.4).

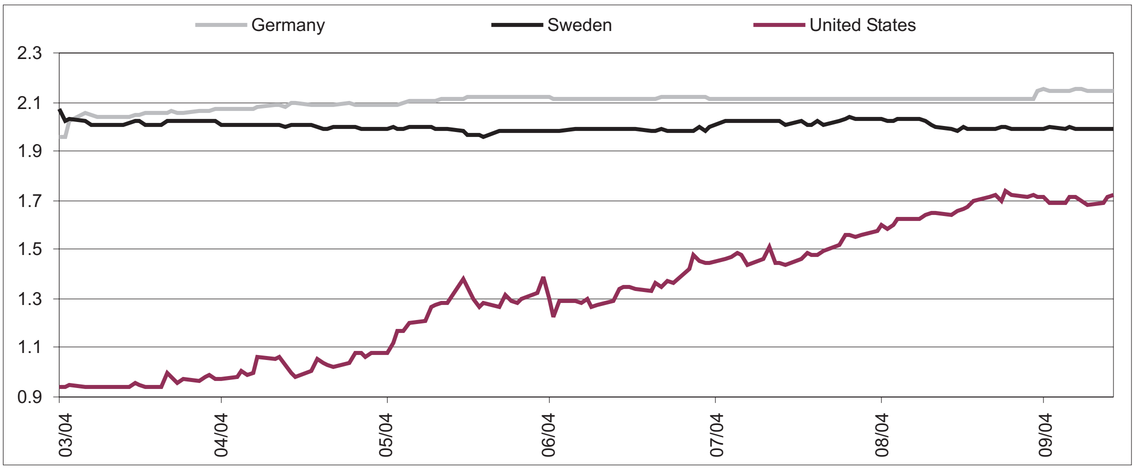



***Figure 1.4. 3-month interest rates in Germany, Sweden and the United States (%)***

Source: EcoWin

**Long-term interest rates** moved in both directions during the period. The period from the end of March to June was marked by a rise spurred by economic revival (see Figure 1.5). As of June, along with indications of weaker current economic indicators and future outlook, a downward trend dominated. All in all, the 10-year interest rate increased by 22 basis points in the United States, while small changes occurred in Sweden and the euro area.

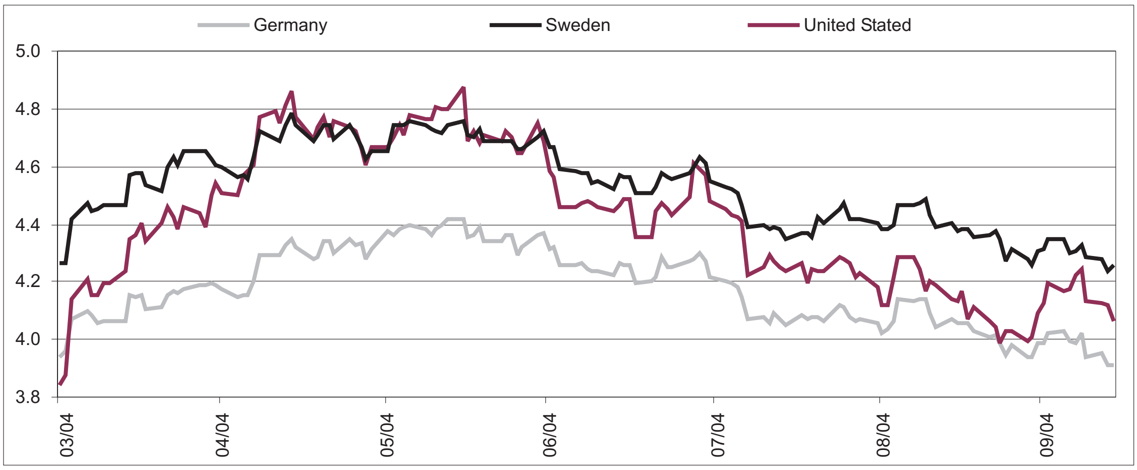



***Figure 1.5. 10-year interest rates in Germany, Sweden and the United States (%)***

Source: EcoWin

**Currency markets** were characterised by a lack of persistent direction in the exchange rate changes of the dollar against other main currencies. For investors the risks arising from the large US current account deficit were offset by the sustained position of the United States as the global economic leader. Therefore the exchange rate of the euro against the dollar stayed mostly within the range of 1.18–1.24 and changed very little all in all (see Figure 1.6). The stabilisation of global economic growth and deepening ambiguity regarding future growth outlook led to a gradual decline in the volatility of the currency markets.

The exchange rate of the Swedish krona strengthened by 2.2% against the euro during the given period. As of 2002 the EUR/SEK exchange rate has remained within a comparatively limited range (9.0–9.3) most of the time, above all due to close economic links between the euro area and Sweden and the increasing harmonisation of economic cycles.

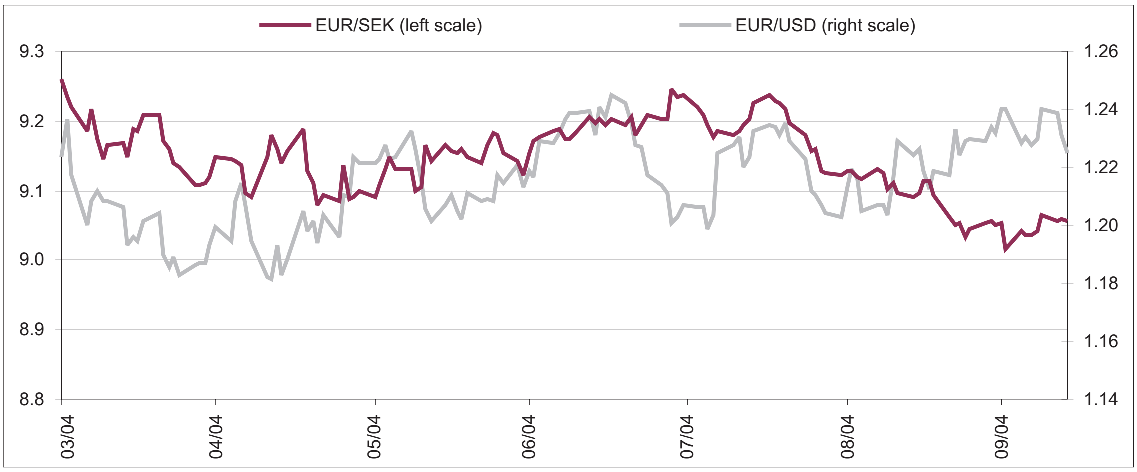



***Figure 1.6. Exchange rate of the euro against the Swedish krona and the US dollar***

Source: EcoWin

The developments in **the commodities market**, mainly the rise in oil prices, significantly affected the economy as well as the financial markets. From end-March to mid-October the price of crude oil soared more than 50%, rising above the level of 50 dollars per barrel in October. Thus, by the end of the period oil prices had turned out to be a major risk factor regarding both economic growth and inflation. According to the OECD, should the price of oil barrel remain near 50 dollars, it could slow global GDP growth down by approximately 0.5 percentage points in 2005. Responding to increased insecurity and decline of the dollar, the upward trend of gold price resumed in the middle of June and rose close to record highs in recent years by the middle of October.

## Estonian Economy and Macroeconomic Risks

### Economic Growth, External Balance and Inflation

Against the background of more sustained global economic revival, Estonia's **economic growth rates** continued to stabilise on relatively high levels during the first six months of 2004. According to preliminary estimates, the GDP growth amounted to 6.3% in the first half of the year (see Figure 1.7). Thus the respective euro area indicator was outpaced by 4.7 percentage points, which implies that convergence continued at a comparatively fast rate (in 2003 the difference was 4.6 percentage points). Due to stronger economic growth in the main target markets the role of external demand as a source of economic growth has strengthened this year.

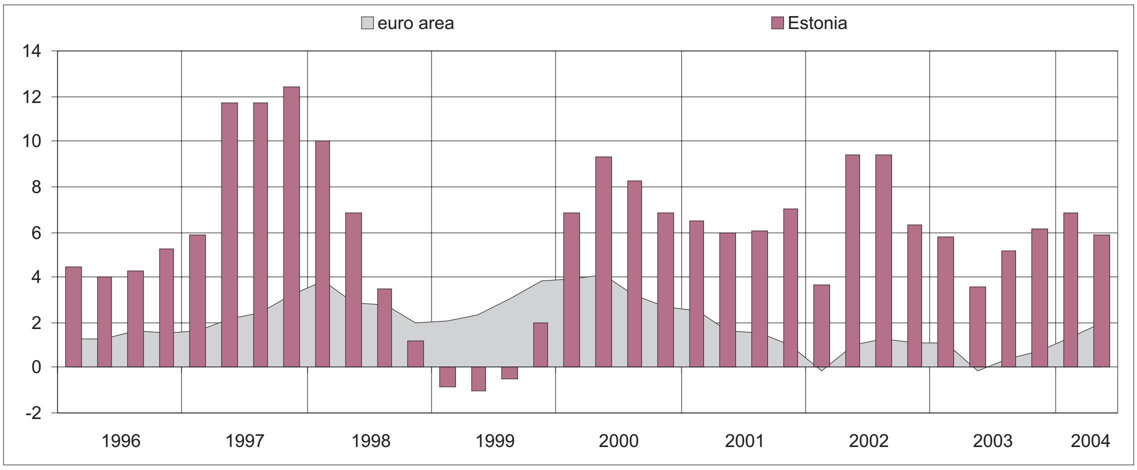



***Figure 1.7. Real growth of GDP by quarters (%)***

Sources: Statistical Office of Estonia; Eurostat

The growth rate of domestic demand slightly balanced in the first quarter of 2004 compared to last year's average. However, already in April the greater than average stocking of inventories prior to the accession to the European Union led to a temporary leap in import and consumption volumes. As a result, the nominal growth in domestic demand outpaced GDP growth by 6.1 percentage points in the second quarter and the comparative extensiveness of domestic demand increased again. As regards demand components, economic growth was most supported by the rise in investments and private consumption. The real growth in **private consumption** did not exceed GDP growth in the first half of the year and was even outpaced by the latter by 0.2 percentage points. But the growth in **investments** outpaced that of the GDP, which is reflected in the fact that the share of this component again increased to 33% of the second quarter GDP.

Although the surplus of services grew even further in the first six months of 2004, year-on-year, this was not sufficient to compensate for the increasing **trade deficit**. The goods and services deficit, i.e. the amount by which domestic demand exceeded the gross domestic product rose to 8.4% of GDP at the end of the second half-year. In addition to foreign trade, the growing income account deficit contributed to a rise in the **current account deficit** as well: the net income outflow accounted for 8.3% of GDP in the second quarter. All in all, the external balance deteriorated. In the second quarter the current account deficit amounted to more than 20% of GDP (14.9% of GDP as a four-quarter average; see Figure 1.8).

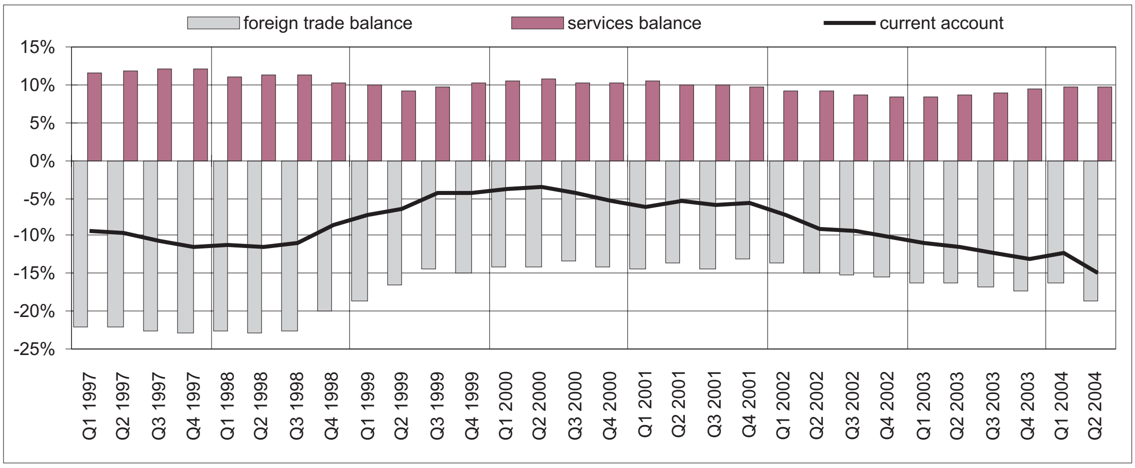



***Figure 1.8. Foreign trade balance, services balance and current account balance in ratio to GDP (4-quarter average)***

Estonia's investment position deteriorated as well: compared to the end of 2003 Estonia's **foreign debt** grew by nearly 5.0 percentage points (to 80% of GDP). From the viewpoint of balancing the economy, improvements in the savings-investment balance and reduction in the debt-boosting domestic demand growth will be of crucial importance in the near future.

After a period of record low inflation in 2003 due to declining external price pressures and comparatively few administrative price actions, **annual consumer price growth** started to gather pace in 2004, amounting to 4.0% in the third quarter (see Figure 1.9). The increase in the price level in April was a one-off event, which was brought about by the implementation of common customs tariffs set for the moment of EU accession as well as the harmonisation of fuel excise duties. Inflation was also spurred by rising oil prices in the world market in May and June.

Despite the acceleration in the annual inflation rate, there is no reason to talk about larger growth in inflationary pressures. Estonia's core inflation[3] rate remained consistently below the respective euro area indicator in the first nine months of the current year; meanwhile a decline has been conspicuous in the past few months.

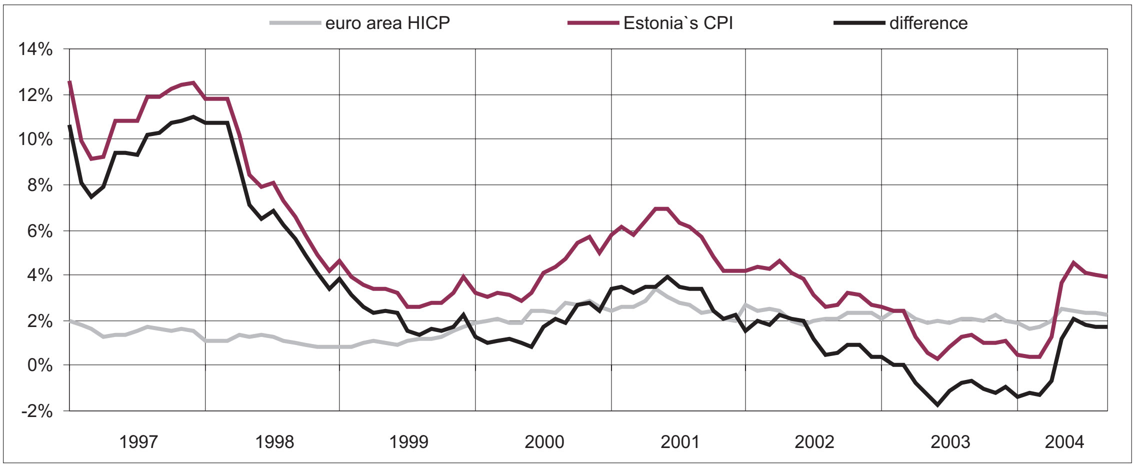



***Figure 1.9. Annual growth of consumer prices in Estonia and the euro area***

Sources: Statistical Office of Estonia; Eurostat

[3] As regards the core inflation indicator, the Harmonised Index of Consumer Prices does not include food, alcohol, tobacco and energy.

## Corporate Business Situation

### *Confidence*

According to the estimates of the Estonian Institute of Economic Research, Estonian companies continued to be increasingly optimistic about the future also in 2004. The confidence indicators of all the monitored sectors have improved year-on-year (see Figure 1.10). The growth in the optimism of **trading companies** was the most clear-cut and was confirmed by the addition of new retail space. The increased number of foreign tourists visiting Estonia also underpinned growing optimism. The estimates of **construction companies** were clearly more optimistic in the first half of the year than they had been a year before, but remained at the last year's level in the third quarter.

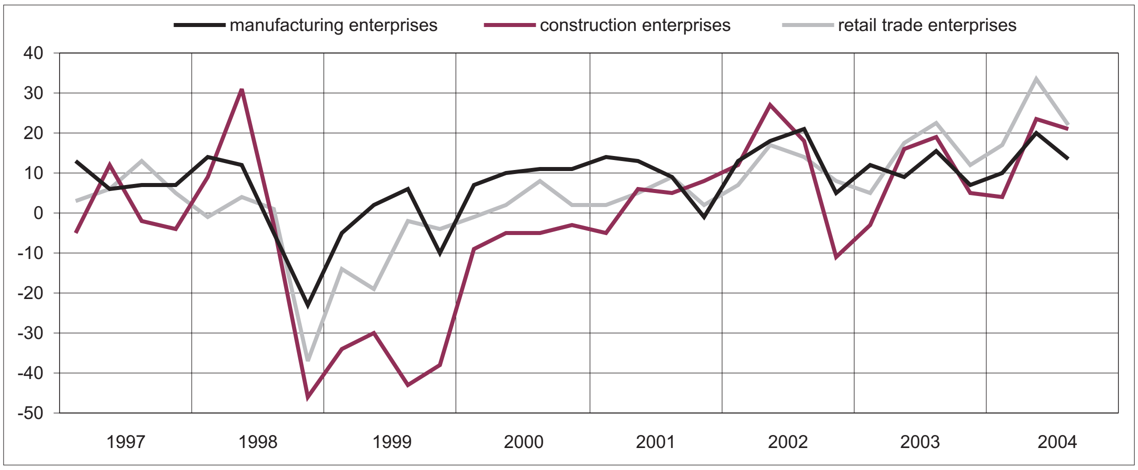



*Figure 1.10. Confidence indicators of Estonian enterprises*

Source: Estonian Institute of Economic Research

The improvement in the confidence of **manufacturing companies** is above all related to the impact of restored external demand (see Figure 1.11). In the months following the accession to the European Union a certain downward correction in the optimistic expectations of manufacturing has taken place.

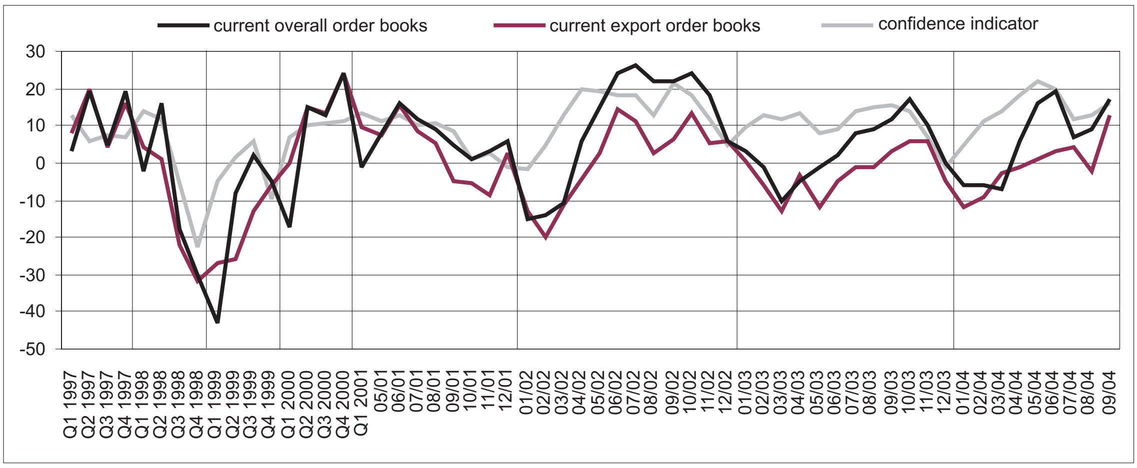



*Figure 1.11. Production demand of manufacturing enterprises and confidence indicator*

Source: Estonian Institute of Economic Research

### *Industrial Sales and Investments*

As regards real indicators, **sales growth** in manufacturing accelerated in the first half of 2004 from 9.4% last year to 11.2% (see Figure 1.12). Fast growth was above all spurred by increased demand in the domestic market; meanwhile the rise in industrial exports has slowed down from 13.0% to 10.3%.

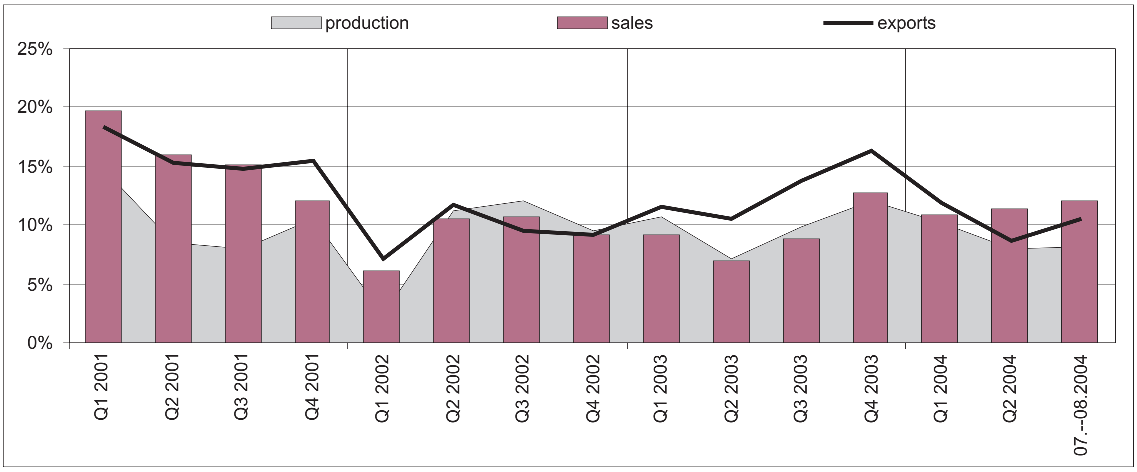



***Figure 1.12. Production and sales indices of manufacturing***

Source: Statistical Office of Estonia

Estonian **goods exports** also demonstrated a strong increase in the first six months of 2004 (16.0% in f.o.b.) in line with stronger economic growth in the main target markets. The development of exports has begun to even out this year also by components and different markets. While last year the main drivers of export growth were new and “untraditional“ sectors (chemical, metal industries), then in the first half of 2004 the situation of traditional sectors (timber industry, dairy products) has considerably improved.

Corporate **investments** statistics shows that investments into the primary sector have decreased. However, investments into the secondary sector increased – both in manufacturing as well as in transport, storage and communications (see Figure 1.13). Capital investments into the traditionally significant branches for Estonia’s exports – timber, paper and furniture production – were smaller in 2003 compared to earlier periods.

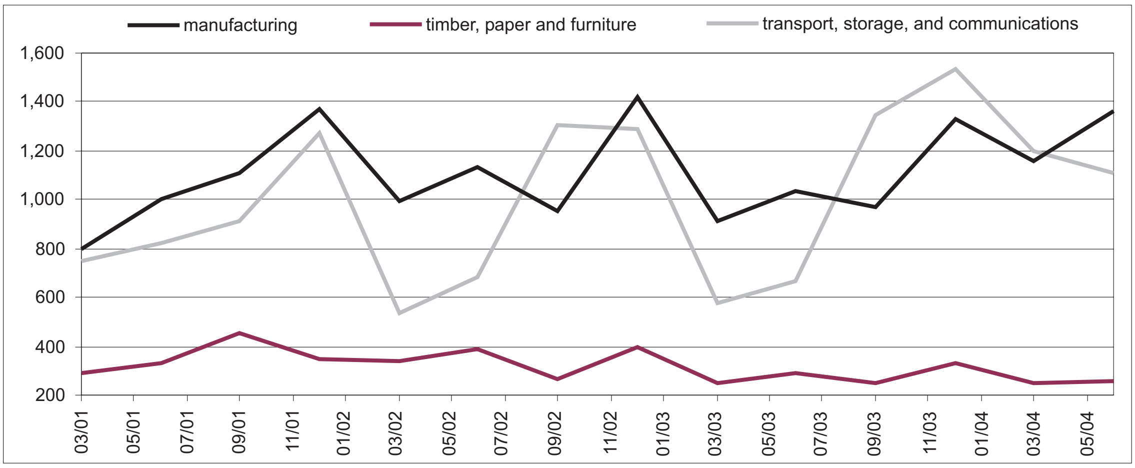



***Figure 1.13. Investments in tangible fixed assets (EEK m)***

Source: Statistical Office of Estonia

### *New Companies and Bankruptcies*

The surge in the number of **bankruptcies** seen at the end of 2003 and at the beginning of 2004 stopped early in the second quarter (see Figure 1.14). Thus the nine-month cumulative number of bankruptcies (191) was in effect as high as in the same period in 2001 and 2002; meanwhile significantly more bankruptcies were registered this year than in the first nine months of 2003. By industries there were most bankruptcies in absolute terms in wholesale and retail trade sector in the first months of 2004. Relative to the total number of companies active in the respective industry, bankruptcies were somewhat more frequent than average in construction and manufacturing.

Economic revival and positive outlooks were reflected in the larger number of **new companies** added into the commercial register compared to recent years. Still more than half of the new companies were set up in the wholesale and retail trade sector. A comparatively strong growth has also continued in the real estate sector and other business services sector.

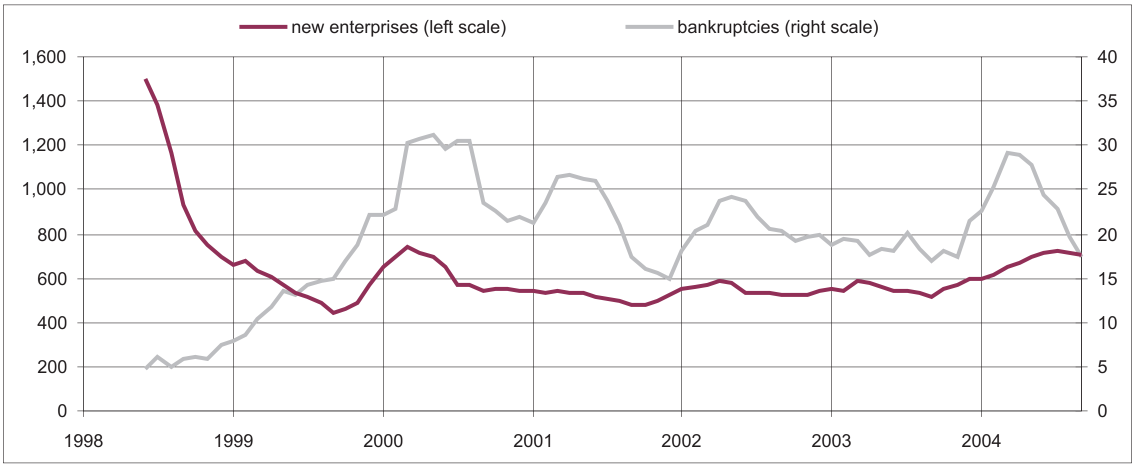



***Figure 1.14. New enterprises entered in the commercial register within a month and bankrupt enterprises (6-month moving average)***

Source: Estonian Enterprises Register

### *Corporate Profitability*

Based on preliminary estimates, the profitability of the corporate sector has further improved in 2004. GDP data indicate a particularly strong improvement of corporate earnings in the second quarter of the year, exceeding also nominal GDP growth.

## Economic Situation of Households

### *Labour Market*

Positive trends in the labour market continued in the first half of 2004. The economic activity of the population and the employment rate increased slowly but steadily; unemployment decreased year-on-year (see Figure 1.15).

The number of the unemployed fell by an average of 5% while the **unemployment rate** declined by an average of 0.6 percentage points, year-on-year. According to Eurostat, Estonia's unemployment rate (harmonised and seasonally adjusted) fell below the respective average euro area indicator in July-August (to 8.8% in July and 8.7% in August).

**Employment** growth, though, has somewhat slowed down in 2004, amounting to 2.2% year-on-year in the first quarter and to 1.0% in the second quarter. The number of the employed increased by an average of 9,300 in six months. Measured in numbers, the growth was the fastest in manufacturing, construction and public administration, and declined most in real estate, renting and business activities, education and agriculture.

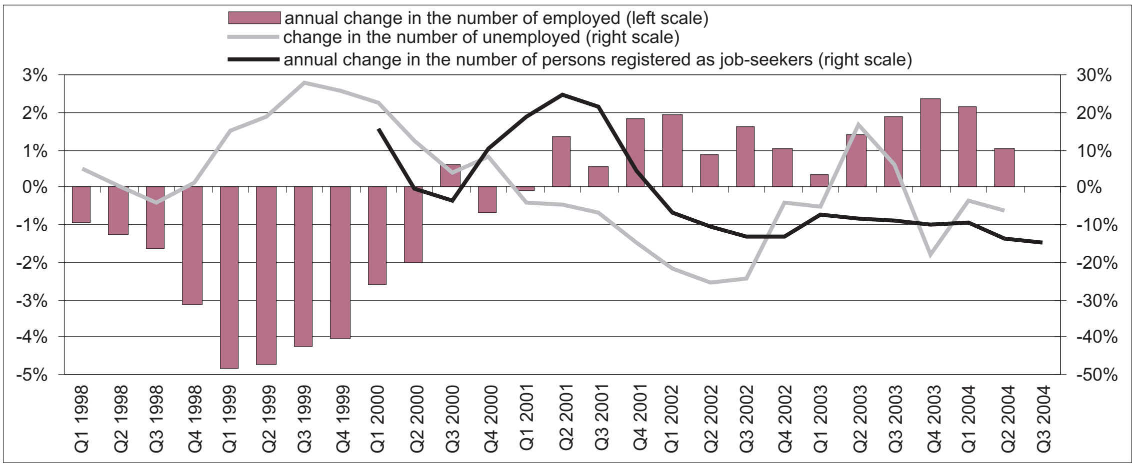
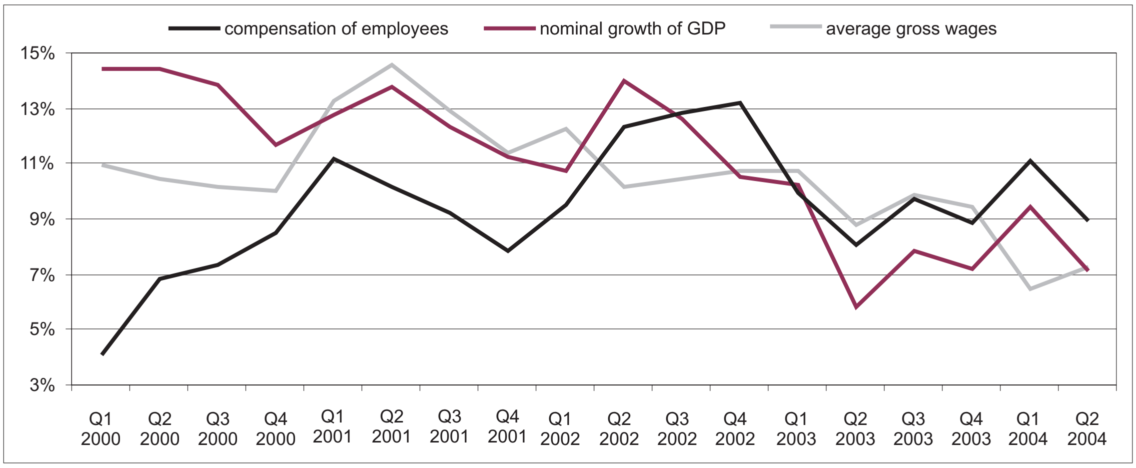



***Figure 1.15. Annual change in the number of employed and unemployed persons and registered job-seekers***

Source: Statistical Office of Estonia

Since the beginning of the year the growth in both nominal and real **wages** has slowed down (see Figure 1.16). In the first half of the year wage growth was the fastest in forestry as well as in the services sector. Meanwhile the wage growth in manufacturing remained slightly below 8.0% both in the first and second quarter of the year. As regards wage growth by owners, the slowdown appears to be the biggest in private companies, amounting to just 5.2%; pay rise in the offices, companies and organisations in state ownership did not show any signs of slowdown and the growth rate remained at nearly 10%.




***Joonis 1.16. Annual growth of average wages, compensation of employees and nominal GDP growth***

Source: Statistical Office of Estonia

Faster growth in **labour costs** in 2003 during a period of cyclical slowdown in economic growth turned out to be a supplementary source of economic imbalance. Regrettably, the same trend continued also in the first half of 2004. Bringing the rate of wage growth in line with productivity developments is the key issue in the coming periods.

### *Confidence and Household Budget Surveys*

The downward trend of the **household confidence indicator** that had started early in 2003 continued until May 2004 to turn positive after that (see Figure 1.17). The main reason behind insecurity was the deepening fear of inflation prior to the EU accession, yet which was dramatically reduced after joining the union and has receded by now. The households' fear of possible price rises turned out to be overblown and did not have a significant impact on the actual inflationary development.

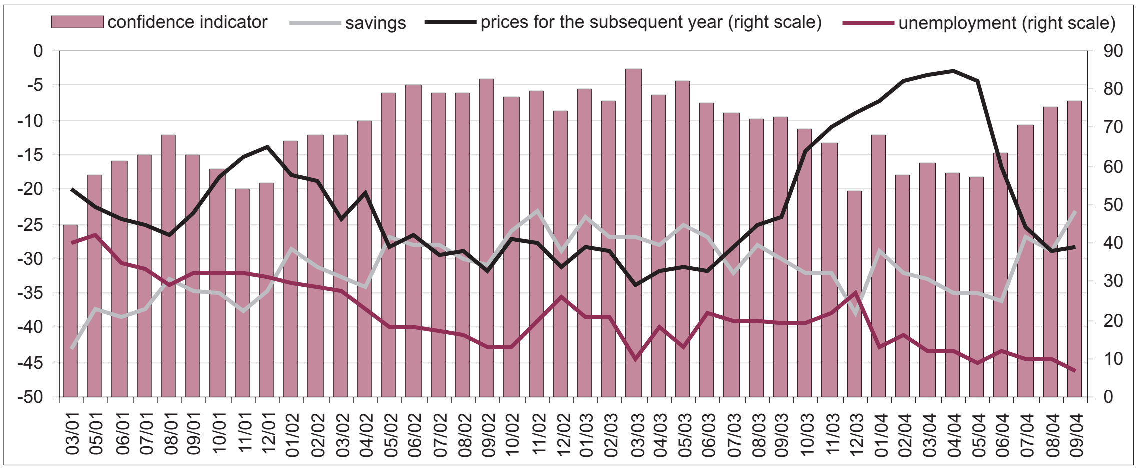



***Figure 1.17. Consumer confidence indicators***

Source: Estonian Institute of Economic Research

In 2004 the growth in confidence has also been underpinned by a lessened fear of becoming unemployed. The fear of unemployment reduced to its historical low in September. Since the third quarter households' estimates of their ability to save have significantly improved.

According to the estimates reflected in the consumer barometer of the Estonian Institute of Economic Research, households' **intentions to make major purchases and investments** (buying a car; buying, building or renovating a house or an apartment) were scaled down also in 2004 (see Figure 1.18). Neither do the results of the F-monitor survey carried out by TNS Emor in autumn indicate increased demand for durable goods (e.g. vehicles and real estate).

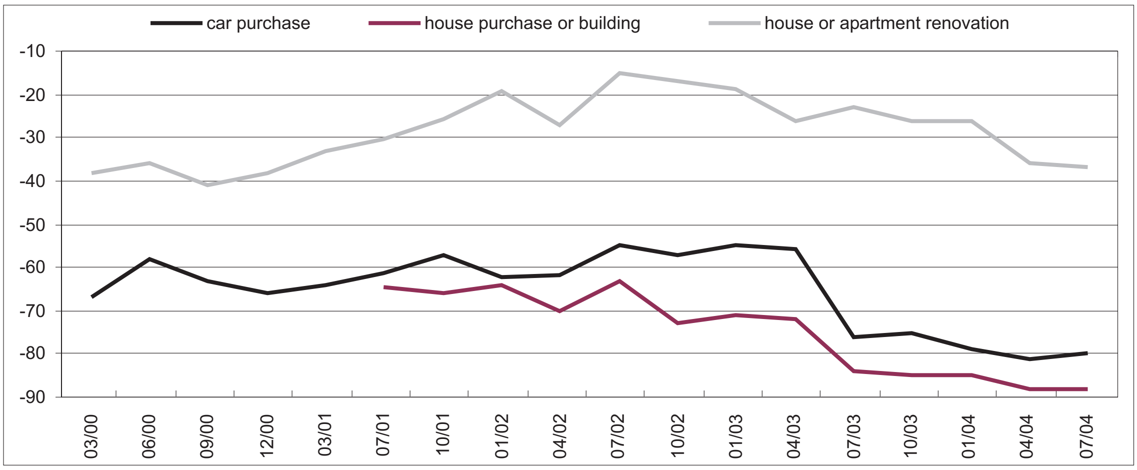



***Figure 1.18. Households' cost estimates***

Source: Estonian Institute of Economic Research

## Structure of Financial Intermediation and Financial Deepening

**The current structure of the Estonian financial sector** mostly evolved at the end of the last decade, and in recent years major changes have been related to intermittently faster growth rates of different components of the financial sector (see Figure 1.19)

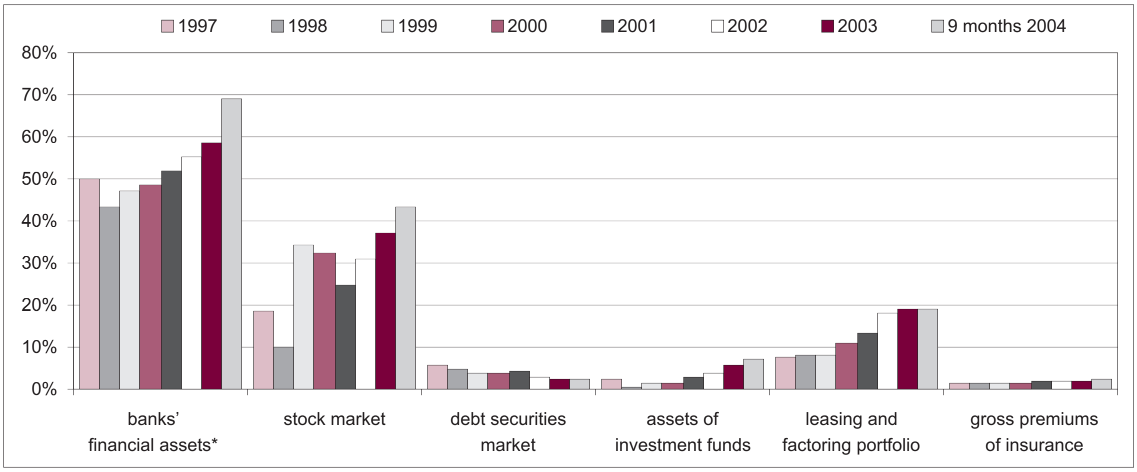



*Figure 1.19. Structure of financial intermediaries (% of GDP)*

* except loans issued to financial institutions (mostly leasing companies)

The **increase in the financial assets** of banks has been based on consistently strong loan demand, whereas leasing portfolio developments have been characterised by a slowing growth rate (see Figure 1.20). On one hand, this is a strategic choice of the banks to make more extensive use of the loan portfolio shown in the banks' assets, while on the other hand it is also indicative of the consumers' preferences for different loan products.

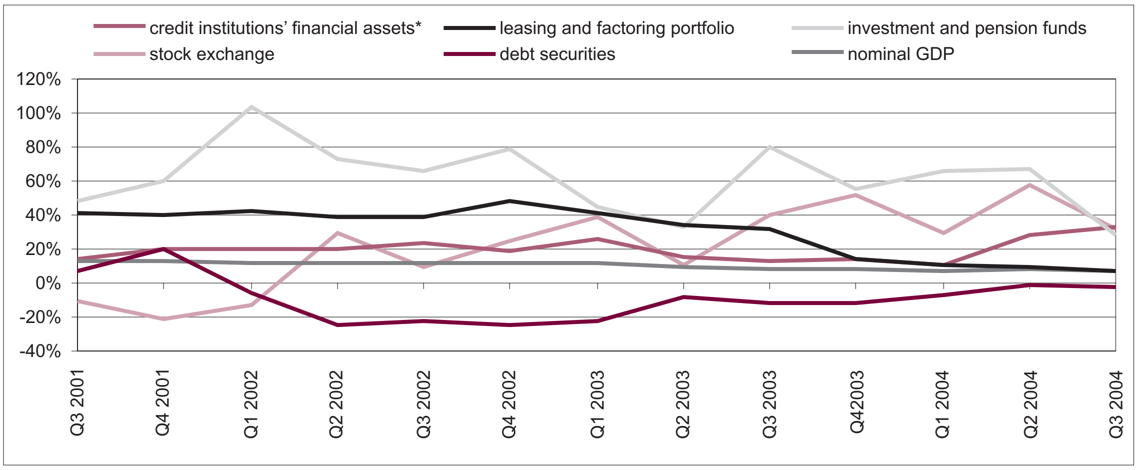



*Figure 1.20. Difference in the annual growth of financial markets and nominal GDP*

* except loans issued to financial institutions (mostly leasing companies)

The rate of financial deepening of domestic financial assets in the banks has been considerably faster (triple growth in the nominal GDP) in the last year compared to the average historical trend (approximately 50% of the nominal GDP growth), but on the **financial liabilities** side the rate of deepening has essentially remained static.

Investment funds, which have grown the fastest in the past three years, have increased their volumes comparatively slowly this year, remaining at the same level with the annual growth rate of stock market capitalisation, which is based on the increase in stock prices (annual growth exceeded nominal GDP growth three times). Compared to the nominal economic growth, bond market capitalisation has been in consistent decline. Neither have there been any significant changes in the insurance market volumes where the rise in premiums steadily outpaces nominal economic growth as much as twice.