I
GLOBAL ECONOMY AND ESTONIAN ECONOMY

External Environment

Global Economic Cycle

Global economic activity in major economic areas started to slow down at the end of 2004 and further on in the first half of 2005. The **annual GDP growth** remained below the previous year's level: in the US, real GDP increased 3.6% in the first as well as in the second quarter, the euro area experienced a growth of 1.3% and 1.1% respectively, and in Japan the GDP grew 1.3% and 2.1%.

The dynamics of **industrial production and retail growth** have been controversial. While in the third quarter the growth indicators of industrial production were smaller compared to the same period in 2004 (see Figure 1.1), the year-on-year retail growth has been stronger thanks to low interest rates and consumption growth spurred by asset prices. Various activity and confidence indices have also been slightly more positive than other economic indicators, implicating faster growth in the fourth quarter. All in all, the total global economic growth of 2005 should remain 0.8 percentage points below the level of 2004 (3.8%) and maintain its pace (3.0%) also in 2006.[1]

Inflation remained stable in the US as well as in the euro area until July (staying in the range of 2.5–3.2% and

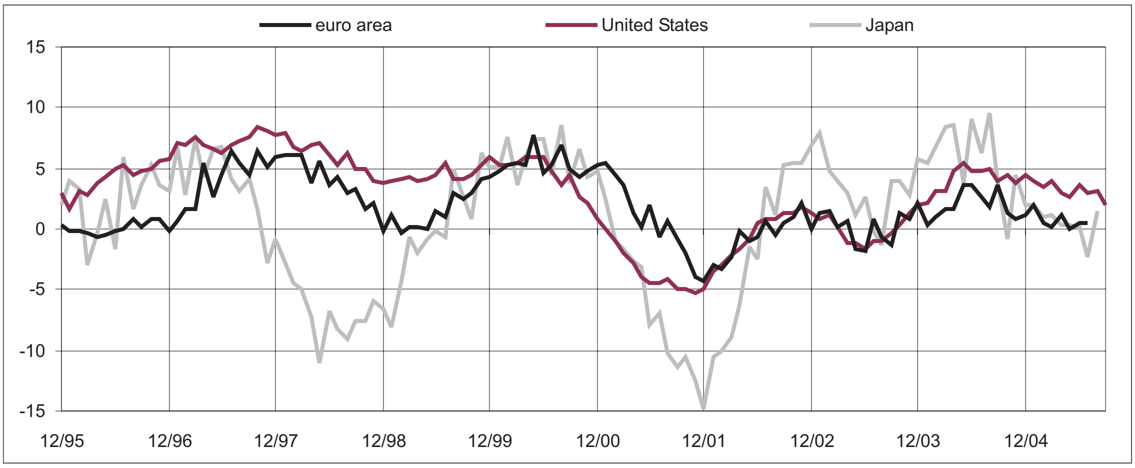

Figure 1.1. Annual growth in the industrial production of the euro area, the United States and Japan (%)

Source: EcoWin

2.0–2.2%, respectively), but further oil price increase in August and September boosted the annual growth of consumer prices at the end of the third quarter to the highest level of recent years (see Figure 1.2). In September, the year-on-year growth of the consumer price index (CPI) rose to 4.7% (the highest level in 14 years) in the US and to 2.6% in the euro area. The impacts of the oil price increase have not yet affected the core inflation of consumer prices (CPI, excluding energy and food) and thus it decreased slightly from March until September. Consumer price growth in Japan ranged from -0.5% to -0.2% from March to September.

[1] Source: Consensus Forecasts, September 2005.

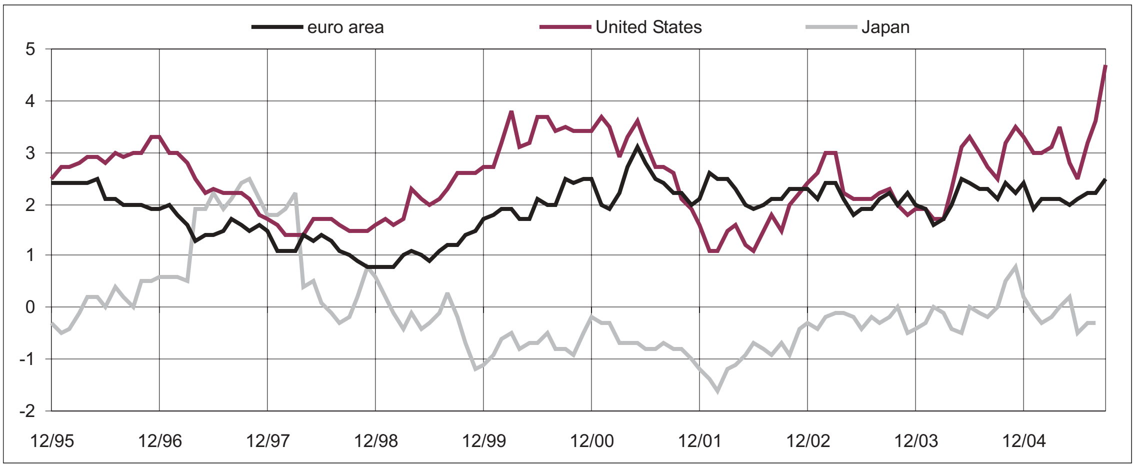

Figure 1.2. Consumer prices in the euro area, the United States and Japan (%)

Source: EcoWin

The relatively fast economic growth of Finland and Sweden slowed down slightly in 2005. Though domestic demand (including private consumption as well as investments) remained strong, the relative weakness of external environment (primarily the euro area economy) still inhibited the positive contribution of the external sector. Inflation was further affected by the high level and fast increase of raw material prices, primarily oil prices. At the same time, a decrease in the prices of some goods and services kept the price rise at a relatively low level.

Finnish economic activity decreased significantly in the first half of 2005 compared to the previous year: in the first quarter the year-on-year GDP growth reached 2% and in the second quarter only 0.2%. The already unfavourable condition of the industrial sector was further aggravated by a relatively long-term paper industry strike that began in spring. In July the situation improved, indicated by a modest growth of 0.6% (see Figure 1.3) in the total output of industrial production. The consumption willingness of residents and private sector investments remained at a stable level in the first half-year and strongly supported economic growth. Nevertheless, due to the paper industry strike and relating issues the Finnish central bank downgraded its economic forecast of 2005 by 0.8 percentage points, expecting a 1.6%[2] GDP growth in 2005. In 2006, GDP growth is expected to accelerate up to 3.7%.

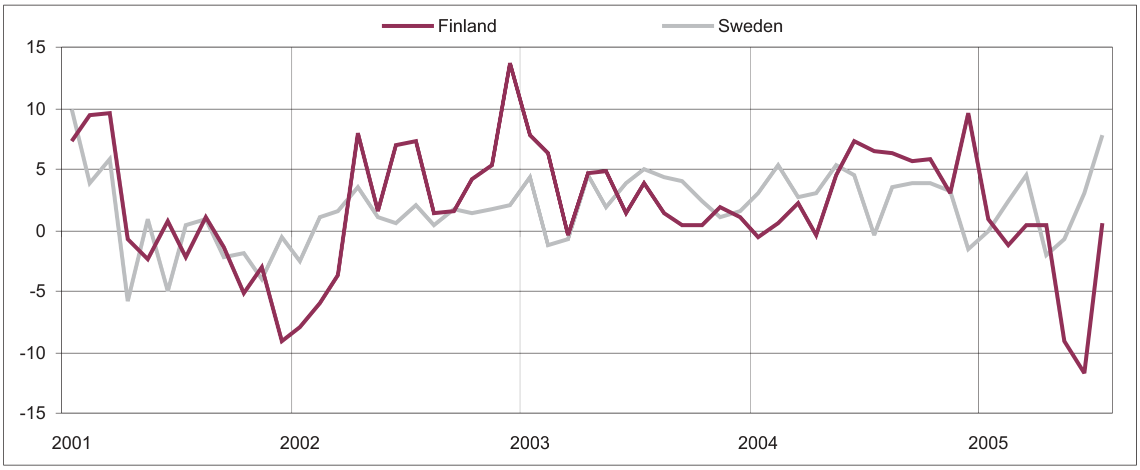

Figure 1.3. Annual growth in the industrial production of Finland and Sweden (%)

Source: EcoWin

[2] Source: Bank of Finland, *Euro ja talous*, No 3/2005.

The rise in Finnish consumer prices was primarily caused by high raw material prices, especially oil prices. This was offset by the price decrease of electronics and telecommunications products and services. All in all, the inflation of 2005 has remained close to 1%. According to the forecast of the Finnish central bank, the average annual growth of consumer prices in 2006 will reach 1.6%.

Swedish economic growth has been supported mainly by private sector fixed investments and the consumption willingness of households. The year-on-year GDP growth reached 1.4% in the first and 2.3% in the second quarter. The annual growth of industrial production has been particularly volatile this year: in spring the sector's production output decreased slightly, but in July the growth rate exceeded all expectations and reached a record high level of 7.8%. Meanwhile, the volume of retail sales has been fostered by households' fairly strong confidence and great willingness to consume.

The consumer price increase has followed trends similar to Finland: an upward pressure is exerted mainly by raw material prices and a downward pressure stems from the price decrease of electronics and telecommunications products and services.

Although in summer the economic forecast was downgraded also in Sweden due to unexpectedly low macroeconomic indicators, the Swedish central bank's expectations concerning its economic outlook expressed in the inflation report of October were more favourable than in June. Therefore, the central bank upgraded the expected GDP growth indicator of 2005 to the level of 2.3%, while next year the indicator is expected to accelerate up to 3%[3]. According to the forecast, consumer prices will increase 0.5% in 2005 and 1.5% in 2006.

International Financial Markets

In most developed countries, the **stock markets** witnessed a strong upward trend (see Figure 1.4)[4]. The euro area stock index STOXX 50 increased 9% and in several countries major stock indices experienced double digit growth rates (e.g. 15.3% in Japan, 14.9% in Finland and 13.4% in Sweden). Stock price dynamics were slightly exceptional in the US, where the S&P 500 index decreased a little. Such a result can be explained by recent hurricanes as well as the fact that the US stock market prices have already reached a level where investors have increasing difficulties in finding long-term values, i.e. hope for further increase.

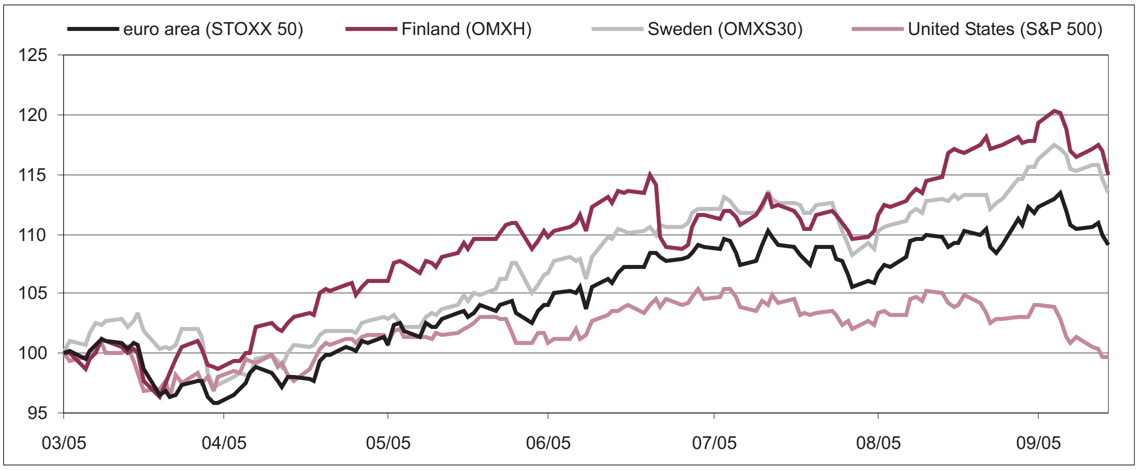

Figure 1.4. Stock indices in the United States, the euro area, Sweden and Finland (31 March 2005 = 100)

Source: EcoWin

[3] Source: Swedish central bank, Inflation report, October 2005.
[4] The review covers the period from 31 March 2005 to 13 October 2005.

The US Federal Reserve continued decreasing monetary policy stimuli, raising the **key interest rate** altogether on four occasions (by 100 basis points, i.e. to 3.75%). Hence, the US three-month interest rates increased in line with that (see Figure 1.5). Key interest rates were also raised by the central banks of Canada and Norway; the Bank of England and the central bank of Sweden, on the other hand, lowered monetary policy interest rates. An increase in the key interest rate is also expected in the euro area – a rise of 25 basis points is forecasted by the end of the first quarter of 2006. This will be brought about by the improved economic outlook as well as stronger inflation pressures stemming from the oil price increase.

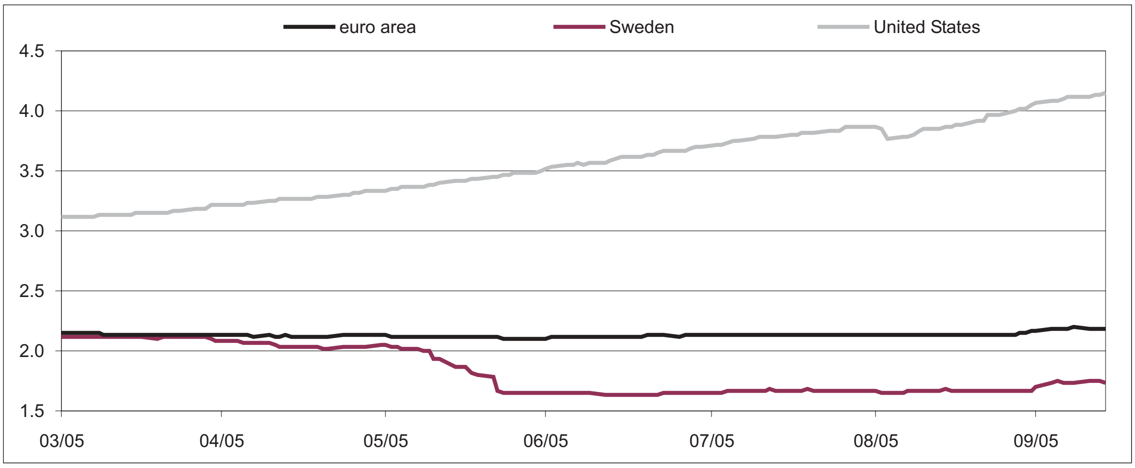

Figure 1.5. 3-month interest rates in Germany, Sweden and the United States (%)

Source: EcoWin

The dynamics of long-term (ten-year) interests in **government bond markets** varied across the countries monitored: in the US they remained closed to previous levels, but decreased in the euro area and in Sweden (by 35 and 54 basis points, respectively; see Figure 1.6).

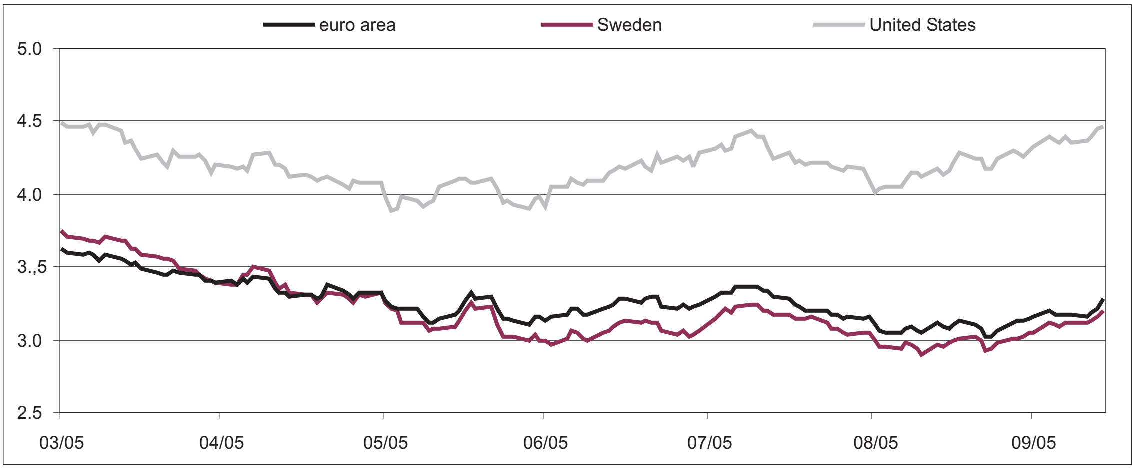

Figure 1.6. 10-year interest rates in the euro area, Sweden and the United States (%)

Source: EcoWin

Currency markets saw further appreciation of the dollar against other major currencies, which had started at the beginning of 2005 (see Figure 1.7). The euro depreciated against the dollar by 7.6%, the yen depreciated by 7% and the pound sterling by 7.2% in the given period. The appreciation of the dollar was supported by raising monetary policy interest rates by the US central bank, while the euro was weakened due to lower economic indicators in the euro area and inert reform processes. Although the dollar has appreciated significantly against the euro in 2005, the process may halt or even reverse when the upward cycle of the US key interest rate comes to an end (in 2006, according to market estimates). At the end of June, the Swedish krona depreciated against the euro to its lowest in past three years (1 euro = approximately 9.4 kronas).

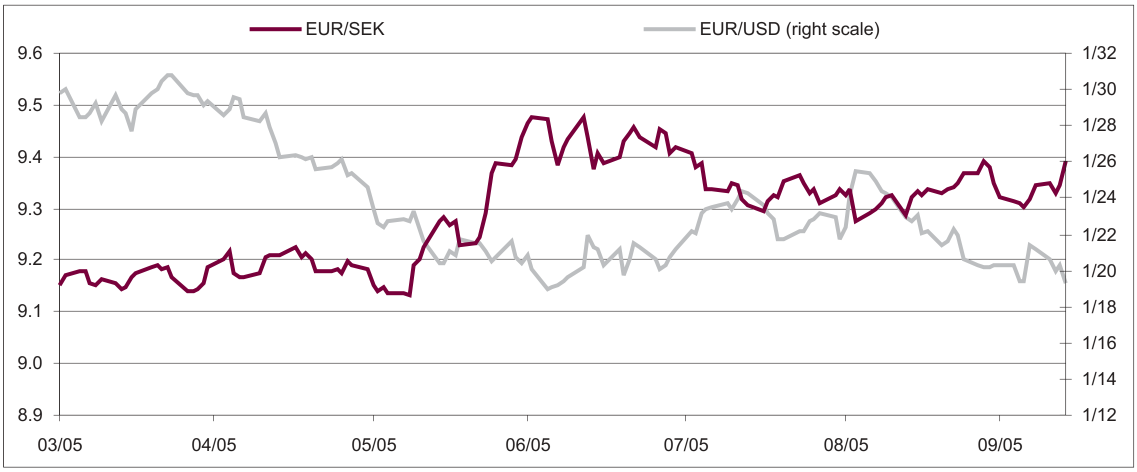

Figure 1.7. Exchange rate of the euro against the Swedish krona and the US dollar

Sources: EcoWin

Estonian Economy and Macroeconomic Risks

Economic Growth, External Balance and Inflation

Estonian economy continued rather rapid growth in the first half of 2005. While in the first quarter the **GDP growth** at constant prices reached 7.2%, in the second quarter economic growth accelerated to 9.9% (see Figure 1.8). Increase in domestic demand slowed down while the contribution of net exports to growth was exceptionally large. All in all, growth reached 8.5% in the first half of 2005, exceeding that of the euro area by more than 7 percentage points. Domestic demand remained relatively modest but net exports increased, also improving external balance indicators.

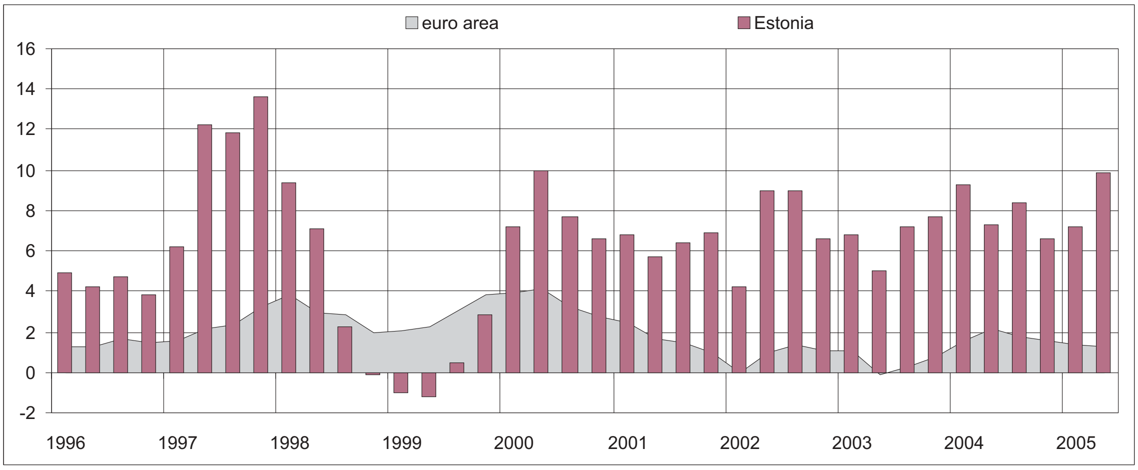

Figure 1.8. Real GDP growth by quarters (%)

Sources: Statistical Office of Estonia; Eurostat

The slower growth of **domestic demand** in the second quarter of 2005 was quite expected in light of the high comparison base. It was primarily affected by a decrease (-34%) in the purchase of stocks. Fixed investments continued to increase rapidly. Growth relied mainly on new business projects, including residential construction, though the fixed investments of companies already operating in the market also increased by approximately 9% at current prices. The share of the investment volume made up 30.1% of GDP at current prices.

In the first half of 2005, **private consumption** growth remained at an average level of 6.7%, accelerating by 1.7 percentage points, year-on-year. This was facilitated by stronger real income growth. The annual growth of gross wages reached approximately 12% in the second quarter. In net terms, wages increased even more due to raising the non-taxable income threshold and lowering the income tax rate at the beginning of the year.

The **current account deficit** decreased to 10.8% of GDP in the second quarter of 2005; goods and services deficit decreased to 5.7% of GDP (see Figure 1.9). The income account deficit increased even further, comprising 5.3 billion kroons, i.e. 6.8% of GDP, in the first half-year.

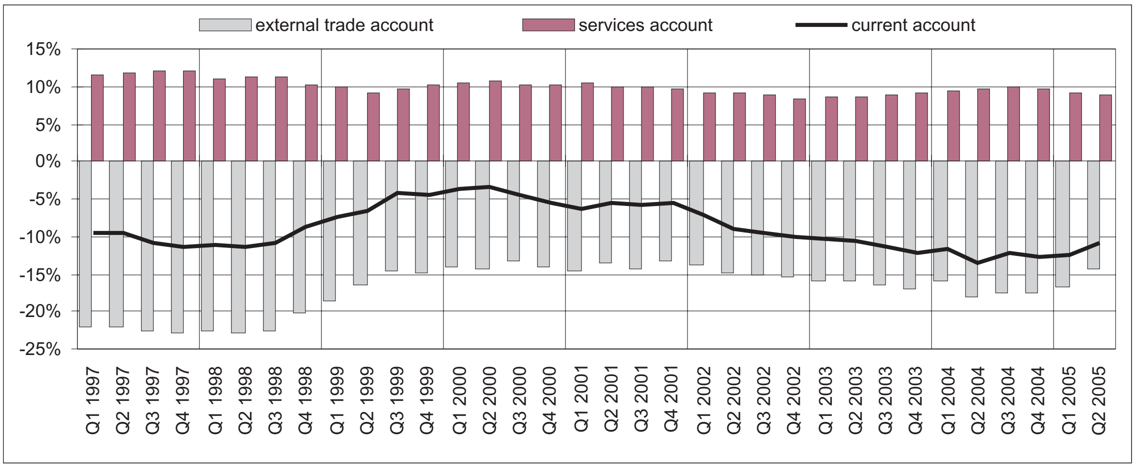

Figure 1.9. External trade account, services account and current account balance in ratio to GDP (4-quarter average)

As expected, **consumer prices** rose to 3.5% in the second quarter of 2005, reflecting the changes that took place in the previous year's comparison base. In July the decrease of inflation halted and, due to the increase in oil prices, consumer price growth accelerated to 3.8% (see Figure 1.10). The slightly greater than 1.5 percentage point difference with the euro area inflation may be considered a natural price convergence indicator in Estonia in the long run.

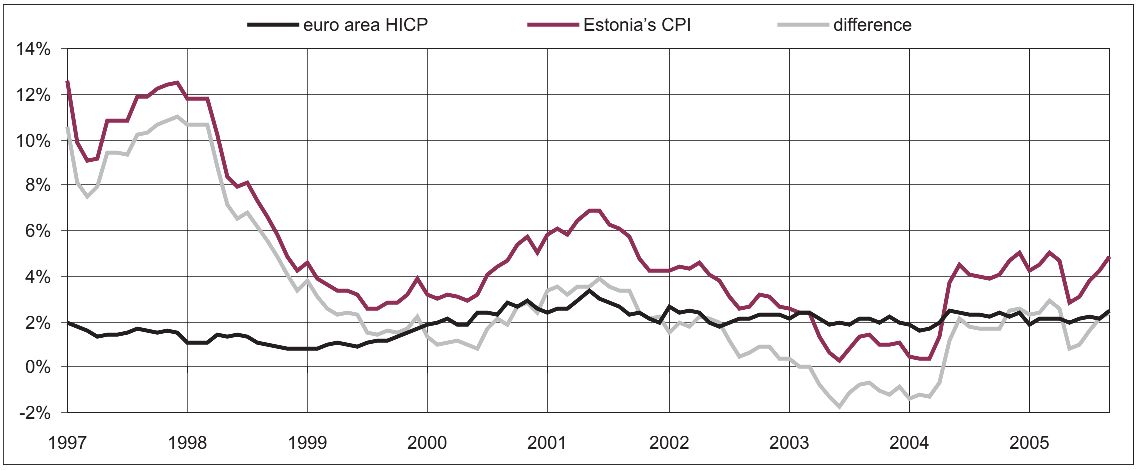

Figure 1.10. Annual consumer price growth in Estonia and the euro area

Sources: Statistical Office of Estonia, Eurostat

Corporate Business Situation

Confidence

In the second quarter of 2005, the economic confidence index calculated by the Estonian Institute of Economic Research increased by 2 points, year-on-year. Besides consumer confidence, economic confidence was boosted by the construction confidence indicator, which reached its historical high (see Figure 1.11). The retail trade confidence indicator also stood high in the second quarter, even though it remained slightly lower, year-on-year.

Figure 1.11. Confidence indicators of Estonian companies

Source: Estonian Institute of Economic Research

The **construction sector** continued rapid growth – the annual growth of its value added at constant prices accelerated to 13.9% in the second quarter and its share in the GDP structure rose to 7%. According to the estimates of the Estonian Institute of Economic Research, the confidence in the construction market will remain exceptionally favourable. In the following months, companies expect a rise in workload as well as in construction prices. The factor most inhibiting to construction activities is the lack of qualified workforce.

The improved **industrial confidence** in 2005 probably derived from the optimism emerging after the accession to the European Union (see Figure 1.12). However, tighter competition and expanding economic

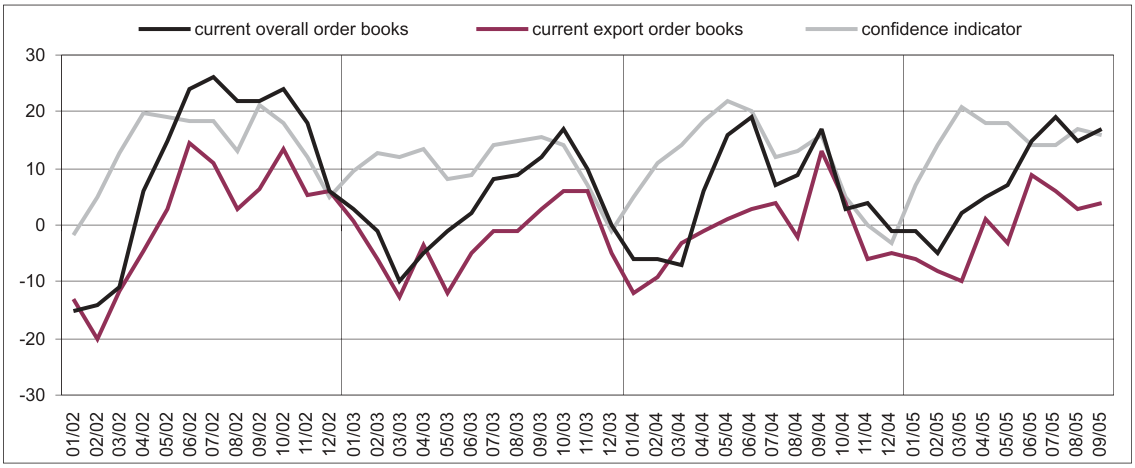

Figure 1.12. Demand for the production of manufacturing companies and confidence indicator

Source: Estonian Institute of Economic Research links have brought along new problems as well. For instance, some enterprises have increasing difficulties in finding qualified workforce.

New Companies and Bankruptcies

The large number of **new companies** entered in the commercial register in 2005 also refers to a positive macroeconomic outlook. Within the first nine months of this year the number of new companies registered exceeded the past year's indicator by more than 14% (see Figure 1.13). Nearly half of them are wholesale and retail companies. Since the second half of 2004, establishing companies in real estate and other business services has been picking up pace. By months, 170–190 new business enterprises are set up in this sector on average.

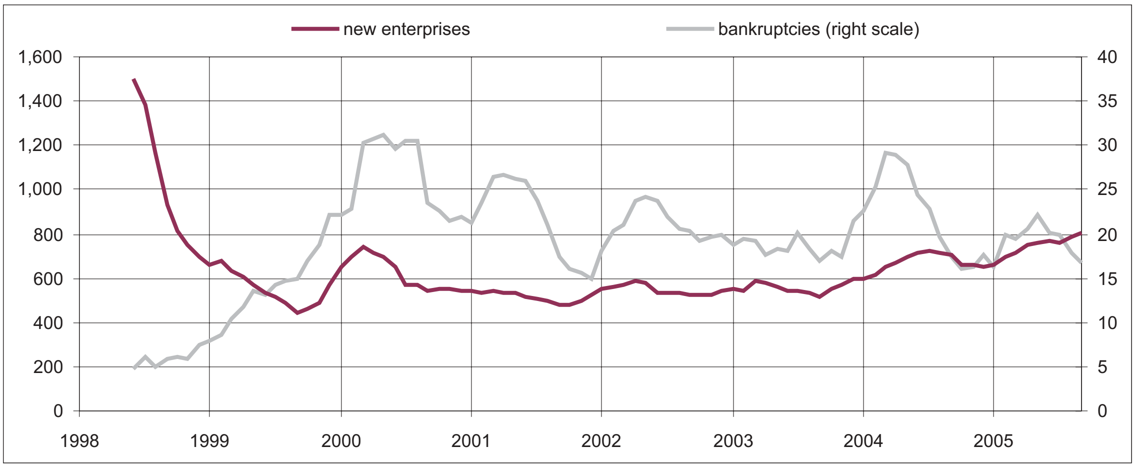

Figure 1.13. New enterprises entered in the commercial register within a month and bankrupt enterprises (6-month moving average)

Source: Estonian Enterprises Register

The **number of companies going bankrupt** remained nearly 19% lower (155 companies) in the first nine months of 2005, year-on-year, which shows that the business climate has improved. Just as in earlier years, the greatest number of bankruptcies occurred in the wholesale and retail sector, where the number of companies is also largest. As to the total number of companies, going bankrupt was slightly more intense in fishery and manufacturing, but the indicators are marginal (bankruptcies comprised less than 0.5% of the total number of companies in the sector).

Industrial Sales

In the first half of 2005, the demand-side conditions remained favourable for both the export sector and local providers. The euro area interest rates stayed low and although global economic growth did not pick up speed yet, the close integration of Estonian economy after the accession to the European Union was seen as an additional positive factor.

The rapid growth of Estonian goods exports continued in the first half of 2005, with a 9 percentage points higher growth rate than in the second half of 2004. In addition to fast export growth, the production and sales output of manufacturing also increased (see Figure 1.14). The growth rate was boosted by the timber and furniture industry, where production growth accelerated thanks to higher domestic demand and rapid export growth. The subcontracting machinery and electric machinery manufacturing made a substantial contribution to the output growth of the manufacturing industry.

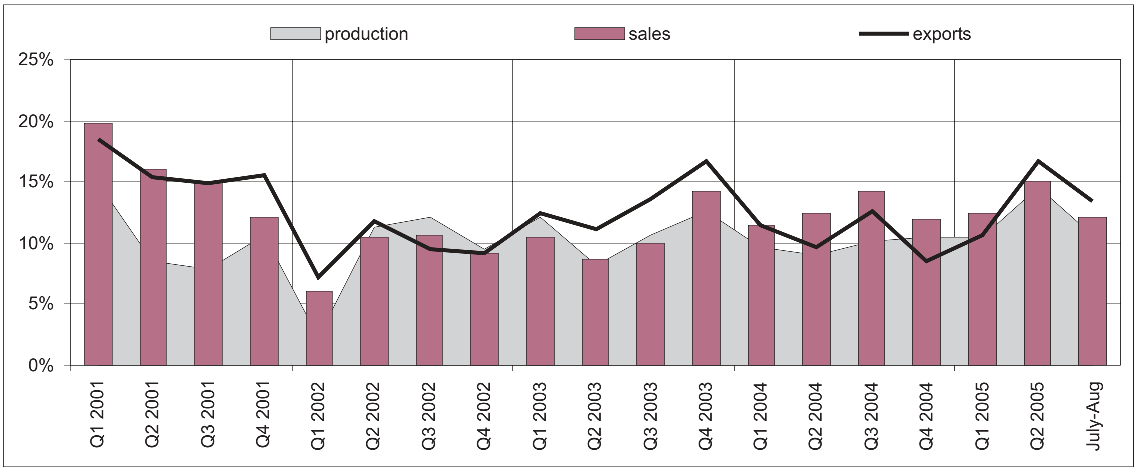

Figure 1.14. Production and sales indices of manufacturing

Source: Statistical Office of Estonia

Corporate Profitability

According to the business statistics of the Statistical Office of Estonia, the **net sales of enterprises** accelerated from 13.7% in 2004 to 16.9% in the first half of 2005 (see Table 1.1). Meanwhile, the profit of the corporate sector increased, resulting in an improved total profitability[5] indicator compared to 2004. However, due to a rapid rise in expenses total profitability remained smaller in the first half of 2005 in comparison with 2003.

Table 1.1. Corporate indicators (%)

	All fields of activity			Manufacturing		
	2003	2004	2005 first half-year	2003	2004	2005 first half-year
Growth of net sales	8.4	13.7	16.9	9.8	13.8	14.2
Growth of total costs	8.3	14.8	16.4	9.9	15.1	13.1
Growth of total profit	10.5	0.7	25.5	9.3	0.6	27.1
Total profit to net sales*	7.7	6.8	7.1	9.1	8.0	8.5

* 4-quarter average
Source: Statistical Office of Estonia

Profitability indicators varied greatly by fields of activity. **Total profits** increased notably in the fields of construction (more than twice), trade, real estate and business services (both over 40%); on the other hand, the profits of forestry and mining companies decreased. Losses increased in agriculture.

The **total profitability** indicator remains the highest in the sector of real estate and business services, whereas the indicator improved to a great extent during the last half-year. Profit margins increased also in construction, though the sector's growth of net sales slowed down slightly. Profitability continued decreasing in the transport, storage and communications sector, its net sales growth being more modest compared to earlier periods.

[5] Total profitability is measured using the ratio between total profits (+/-) and net sales.

Economic Situation of Households

Labour Market

In the first half of 2005, unemployment dropped to its lowest level in the past ten years, resulting in an increase of employment and lower economic inactivity.

Employment growth recovered in the first half of 2005 after a slowdown in the previous half-year (see Figure 1.15). Growth was facilitated primarily by the non-tradable sector, especially by private sector service providers. In the second quarter, employment started rising also in manufacturing; however, as to the first half-year the number of the employed remained close to the year-ago level. According to the Statistical Office, the rapid employment boost was partially brought about by seasonal jobs, which is also reflected in the increased number of hotel and restaurant employees in the first half-year. Employment increased vigorously in construction and real estate.

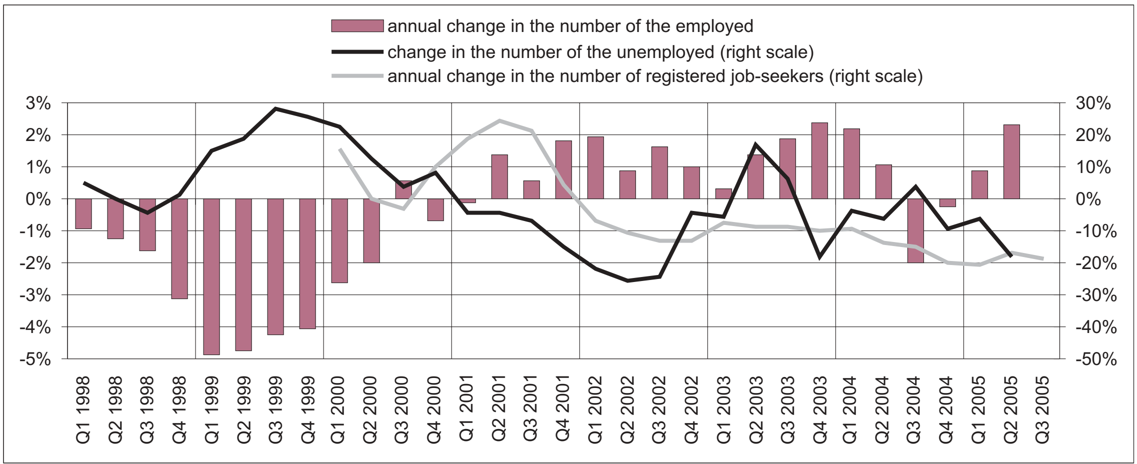

Figure 1.15. Annual change in the number of the employed and the unemployed and registered job-seekers

Source: Statistical Office of Estonia

Unemployment continued declining, reaching a record low level (8.1%) in the second quarter. While in the first quarters of 2004 and 2005 unemployment decreased only due to the short-term unemployed, the second quarter of 2005 witnessed a decline in short-term as well as long-term unemployment.

Meanwhile, the situation common to structural unemployment still persists, because some regions suffer from insufficient workforce. Besides the construction sector, labour shortages also occur in some manufacturing companies.

Wages

In the first and second quarter of 2005, the growth rate of average **gross monthly wages** accelerated to 10.1% and 11.8% respectively, comprising 7,427 and 8,291 kroons (see Figure 1.16).

Net monthly wages increased faster than gross monthly wages (12.5%), which stemmed from the lowered income tax rate and the raised non-taxable income threshold[6]. While in 2004 raising the non-taxable income

[6] As of 2005, the income tax rate was lowered from 26% to 24%; the non-taxable income threshold increased from 1,400 to 1,700 kroons.

threshold enabled employers to restrain labour cost growth, in 2005 the tax changes exerted a favourable influence on the situation of employees.

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

Source: Statistical Office of Estonia

The fastest wage growth took place in the field of hotels and restaurants as well as in health care and social welfare. In the second quarter, wage growth accelerated substantially in construction (19.6%) and agriculture (19.2%).

Consumer Confidence

Within the first nine months of 2005, the household confidence indicator calculated by the Estonian Institute of Economic Research has on average stood at a level higher than in the same period of 2004 (see Figure 1.17). The development of its subcomponents has varied: the risk of becoming unemployed is considered lower, which is consistent with labour market statistics; on the other hand, price rise expectations have surged again. Households' estimates of their ability to save have improved since the first half of 2004. This is also confirmed by TNS Emor's survey F-monitor 2005, reflecting the financial situation and behaviour of Estonian households.

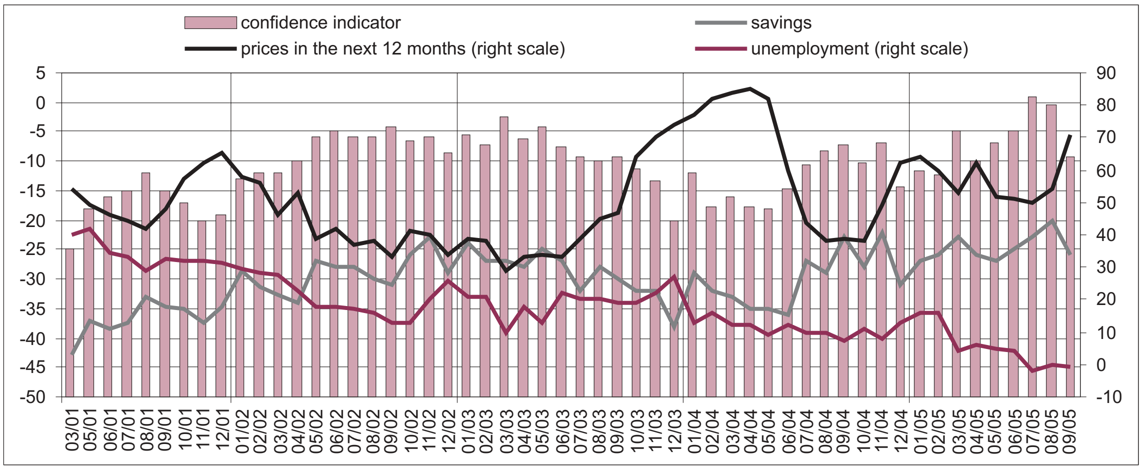

Figure 1.17. Consumer confidence indicators

Source: Estonian Institute of Economic Research

Structure of Financial Intermediation and Financial Deepening

The role of banks in the structure of the Estonian financial sector has continually increased (see Figure 1.18). In the low interest rate environment, the annual increase in **banks' assets** remained over 30% due to strong loan portfolio growth (see Figure 1.19). In the third quarter, the financial assets of the banking sector did not increase, quarter-on-quarter, because the loan portfolio kept growing and banks' liquid assets decreased. Due to the improved availability of loans and lending with real estate collaterals, the growth of the second segment of the loan market, namely the **leasing market,** has remained stable during recent years.

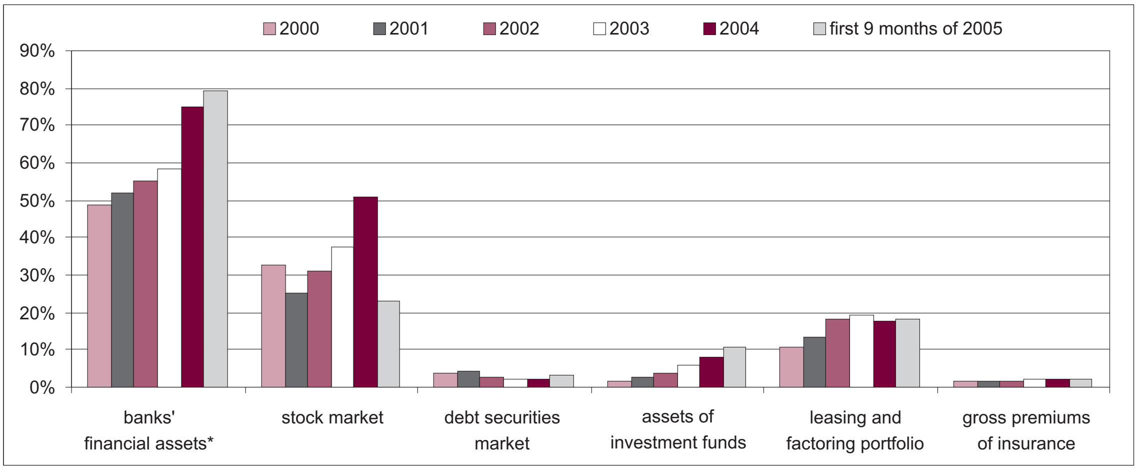

Figure 1.18. Structure of financial intermediaries (% of GDP)

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

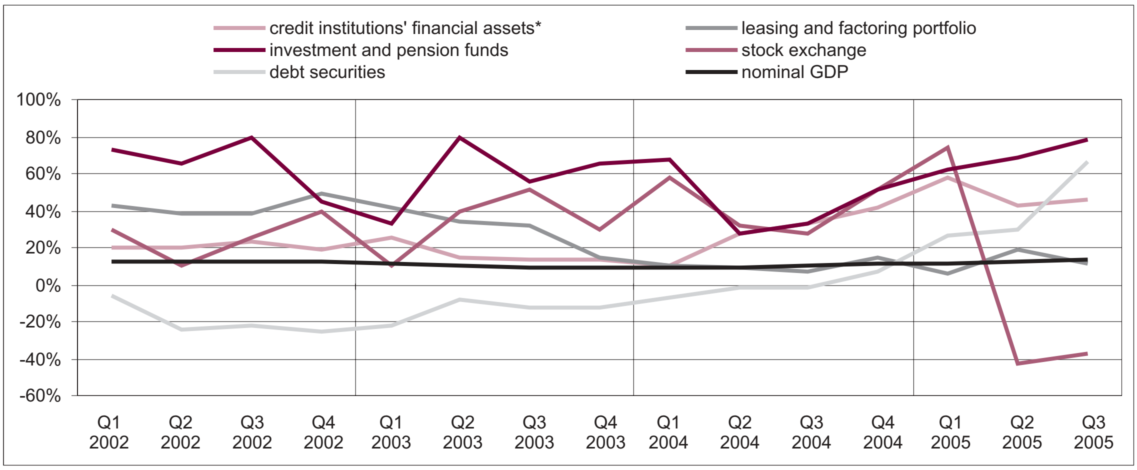

Figure 1.19. Annual growth of financial markets and nominal GDP

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

The market capitalisation of the **shares listed on the stock market** was significantly reduced in the second quarter as a result of the withdrawal of Hansapank from the stock market, the company with the largest market capitalisation. Nevertheless, the prices of newcomers and companies already operating in the market, as well as transaction activity have grown constantly, increasing the market capitalisation level of the third quarter up to a third of the level achieved before the withdrawal of Hansapank. Along with rapid economic growth the **bond market** volume and activity have also flourished.

Rapid growth in the assets of **investment and pension funds** continued thanks to fully funded pension and stock funds. Over the last four quarters, the year-on-year growth of assets amounted to 65%. The **insurance market** developments remained stable. Gross premiums collected by insurance companies increase steadily by 20% within a year.