I GLOBAL ECONOMY AND ESTONIAN ECONOMY

EXTERNAL ENVIRONMENT

Global economic cycle

Some discrepancies in the **economic growth** in different regions emerged in the second quarter of 2006. While in the euro area growth accelerated in the second quarter from the first quarter (from 2.2% to 2.7%), then in the United States and Japan it slowed down instead (from 3.7% to 3.5% and from 3.6% to 2.5%, respectively). Industrial production indicators in the euro area confirmed the above trend: the year-on-year growth reached 5.4% in August, being the fastest in the past six years (see Figure 1.1). Industrial production showed an upward trend also in the United States and Japan, posting a faster than 5% annual growth in August and September.

Inflation in the United States and in the euro area took its cue from oil price developments, picking up speed until the end of the second quarter and declining in the third quarter. As a result, annual consumer price growth in the United States accelerated to 4.3% in July before slipping back to 3.8% in August (see Figure 1.2). In the euro area, it remained at 2.5% from April through June, and then slowed down to 1.7% by September. The US and euro area core inflation indices excluding energy and food prices did not yet react to the fall in oil prices in the third quarter and in places rose to the highest levels in recent years: to 2.8% (the highest in then years) in the United States in August and to 1.5% (the highest in the past year) in the euro area in September. In Japan, the year-on-year rise in consumer prices accelerated to 0.9% in August. Unlike in other major economic areas, the inflation-reducing impact of falling oil prices did not reflect at least in the August data yet.

Finland's GDP growth amounted to 5.9% in the first half of 2006. The Finnish central bank expects

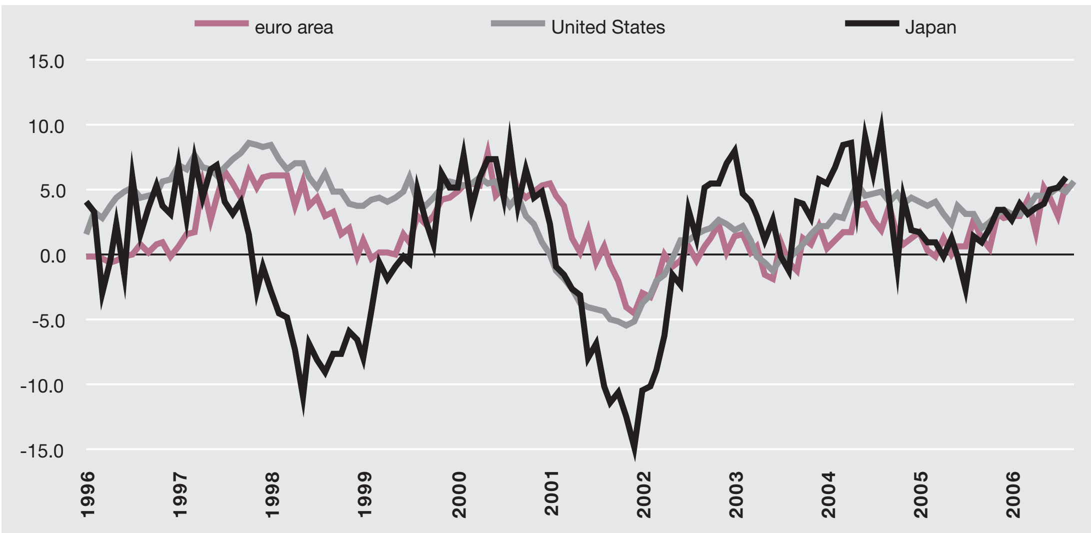

Figure 1.1. Annual growth in the industrial production of the euro area, the United States and Japan (%)

Source: EcoWin

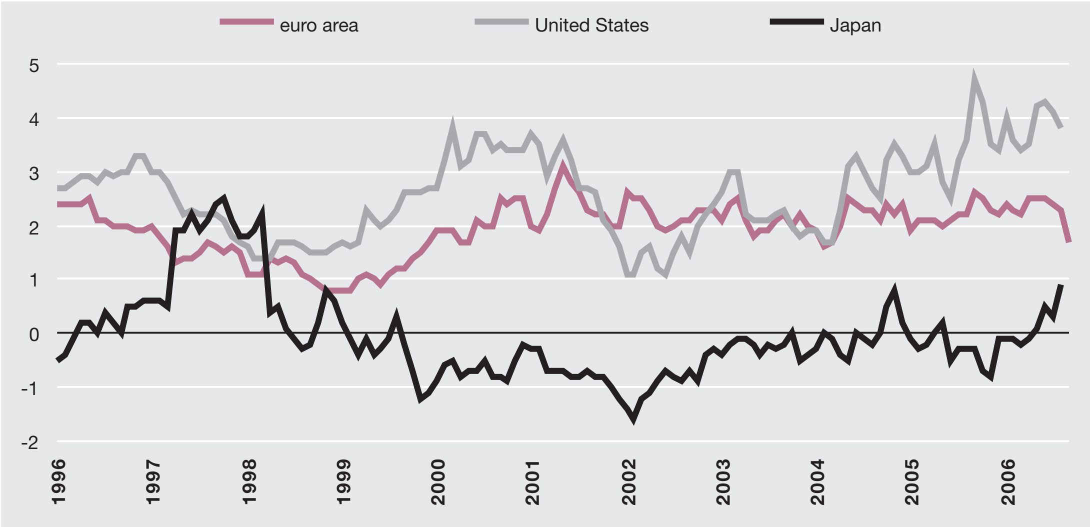

Figure 1.2. Consumer prices in the euro area, the United States and Japan (%)

Source: EcoWin

a 5.4% growth rate in 2006 and 3.2% in 2007. The fast growth in the first six months of the year was partly affected by the low comparison basis with last summer (last year, there was an extensive strike in the paper industry). As a result, also manufacturing saw fast growth in the first half-year, amounting to 10%. Moreover, export growth exceeded 12% in the first half and the annual growth rate is expected to be 12%. Private consumption and investments have increased briskly as well.

Regardless of fast economic growth, the inflation rate has not gone up considerably. The harmonised index of consumer prices (HICP) stood at 1.3% in August. Inflation was mostly affected by growing fuel prices, but also by the rise in housing costs and food prices. Meanwhile the prices of entertainment electronics and phone calls fell.

Sweden's gross domestic product grew 5.5% in the first and 3.5% in the second quarter. In the first quarter, growth was underpinned by rising exports and investment. In the second quarter, private consumption and investments increased faster than expected. Export growth, however, slowed down to 6.6% in the second quarter. Even though the year-on-year growth in industrial production was volatile in the first six months of the year, it amounts to an average of 4%, which considerably outpaces the 1.5% indicator in 2005. Further growth prospects are good and domestic demand continues to expand. The Swedish central bank expects a 4.3% growth in 2006 and 3.1% in 2007.

In the second quarter, inflation accelerated to 1.9% but slowed down again in the third quarter. The HICP amounted to 1.6% in August. Similarly to Finland, Sweden's inflation is also being affected most by fuel and energy prices and housing costs.

International financial markets

In major **stock markets**, the most significant event was the extensive sell-off of stocks in May and June, which is why stock prices decreased considerably during these months (see Figure 1.3). This was affected by the rise in monetary policy interest rates in advanced economies, complemented by the prospect of the US growth slowing down and the threat arising from inflationary pressures that the US Federal Reserve might raise

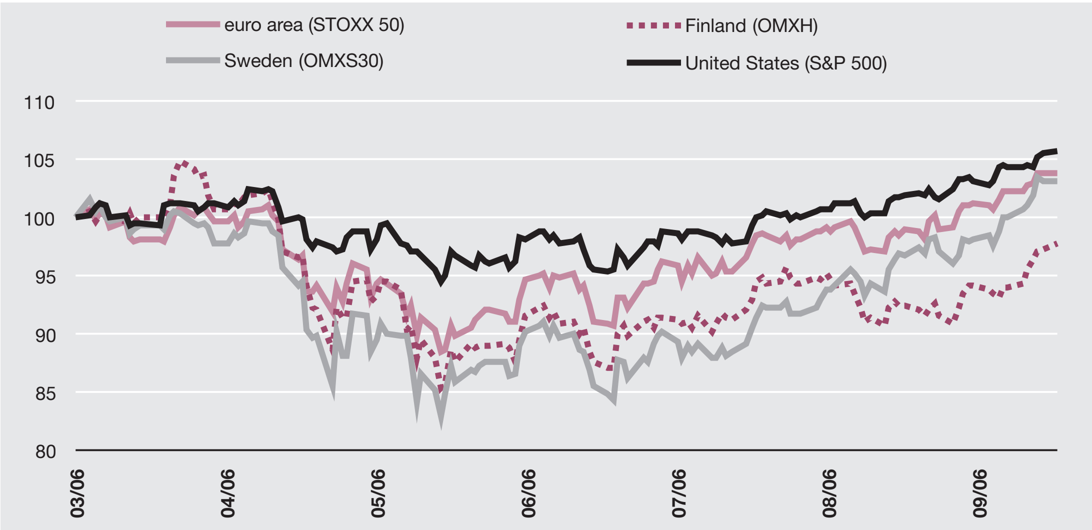

Figure 1.3. Stock indices in the United States, the euro area, Sweden and Finland (30 September 2005 = 100)

Source: EcoWin

the key interest rate more than expected. In mid-June the stock prices started to rise again, which was also facilitated by reduced inflationary risk. Hence, all in all, the changes in the stock markets in the United States, the euro area and Sweden remained positive.[1]

Bond market development was supported by relatively high economic activity, though a slight slowdown could also be observed (primarily in the United States). Therefore, major central banks tightened their monetary policy even further. In half a year (second and third quarters), the European Central Bank has increased the key interest rates three times, each time by 25 basis points, while the US Federal Reserve and Sweden's central bank have increased rates twice and the Bank of England and Japan's central bank once. As a consequence, short-term interest rates (3-month Libor) increased in Sweden and the euro area by nearly 70 basis points and in the United States by 40 basis points (see Figure 1.4). Long-term interest rates rose until July but started to decline then because of the combined effects of reduced inflationary risk and a slowdown in global economic growth (see Figure 1.5). All in all, the interest rates increased relatively little in these markets.

In **foreign exchange markets**, the US dollar depreciated against most major currencies, except the Japanese yen. The euro slightly strengthened against the dollar in the third quarter while still trading the range of 1.25–1.30 dollars per euro (see Figure 1.6). The dollar depreciated largely as a result of the slowdown in the US economic growth and the resulting decrease in the interest rate spread with other countries. The yen-dollar exchange rate went up in April and May but altogether changed little over the whole review period. The weakness of the yen was still caused by Japan's low base rate, which is why the yen largely retained its status as a lending currency.

[1] The US S&P 500 index increased 5.7%, the euro area Stoxx 50 index 3.9% and Sweden's OMXS30 index 3.2%. Finland's OMXH fell 2.2% during the given period.

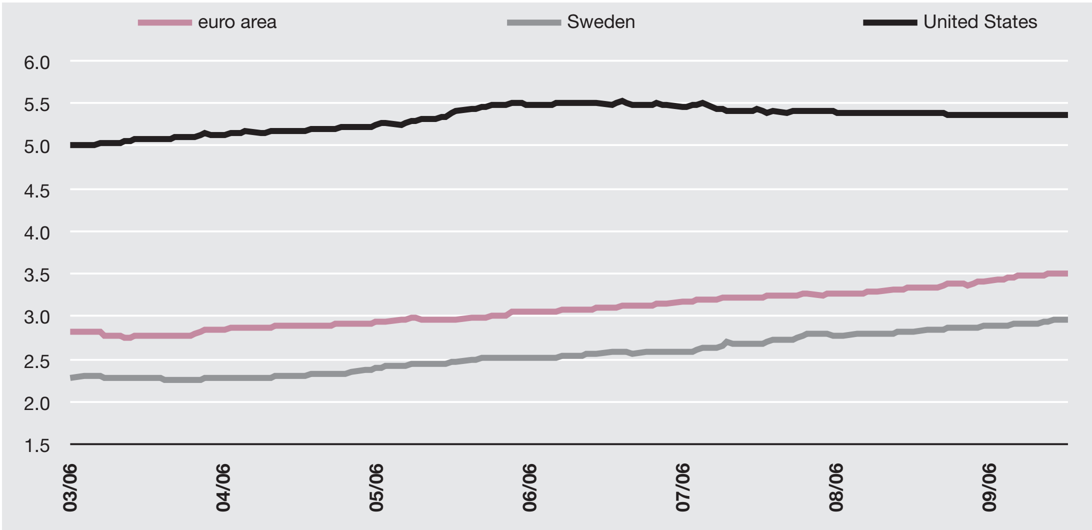

Figure 1.4. 3-month interest rates in Germany, Sweden and the United States (%)

Source: EcoWin

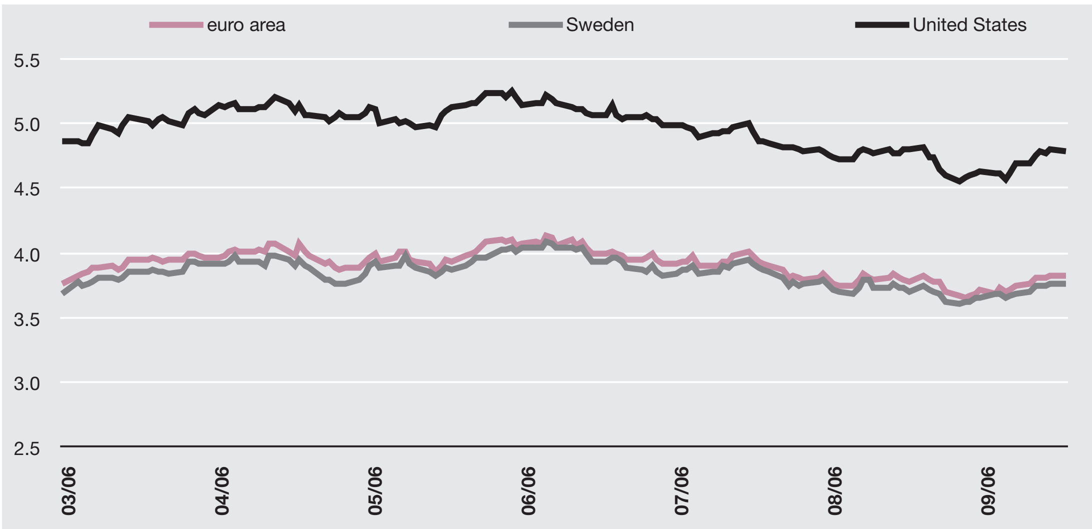

Figure 1.5. 10-year interest rates in the euro area, Sweden and the United States (%)

Source: EcoWin

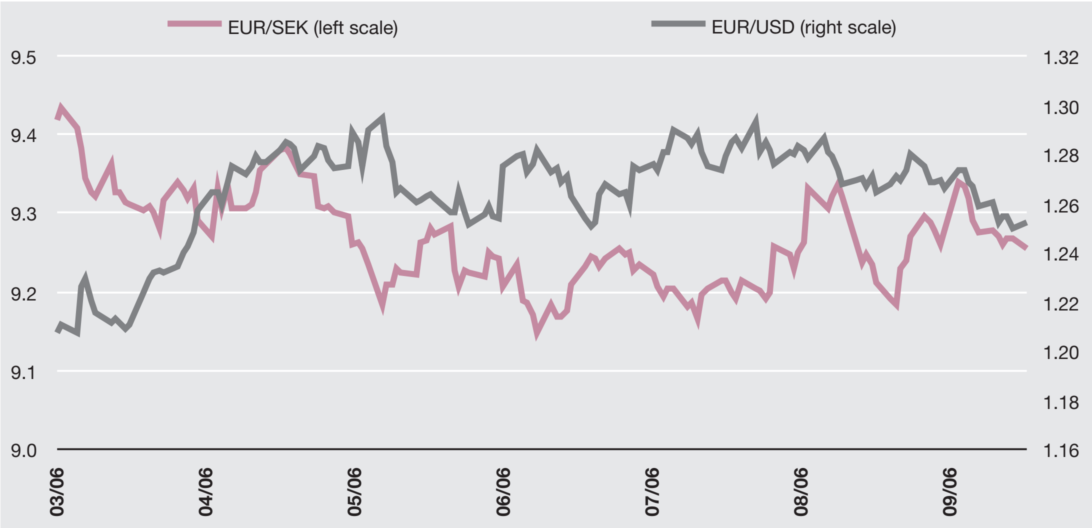

Figure 1.6. Exchange rate of the euro against the Swedish krona and the US dollar

Source: EcoWin

ESTONIAN ECONOMIC GROWTH AND MACROECONOMIC RISKS

Economic growth, external balance and inflation

Estonian **economic growth** remained very fast in the first half of 2006. Real GDP growth amounted to 11.7% both in the first and second quarters (see Figure 1.7). However, considering the extraordinary fast economic development, neither external nor internal balance has improved: the current account deficit has not decreased and the inflation rate has stayed high.

Domestic demand increased faster than incomes in the first half of 2006. Meanwhile **private consumption** posted the fastest increase, amounting to 17.6% at current prices and to 14.6% at constant prices in the second quarter. The growth in private consumption was underpinned by strong confidence of residents and rapid increase in incomes.

Investment activity was high also in the second quarter of 2006. Together with stock building, investments took up 36.7% of the nominal GDP. Residential construction projects remained popular investment targets. Also the general government sector made large investments, some of which were financed by foreign funding. The utilisation rate of corporate production capacity increased (again over 80% in the second quarter). This shows a consistently high need for additional production capacity.

The extremely strong economic growth also brought along fast growth in **general government** revenue and the collection of most taxes exceeded expectations. By the end of September, the State Treasury had collected 80.4% of the revenues for the central government budget. Compared to the first nine months of the previous year, the revenues grew by an average of 18.4%. Despite the cost-enhancing supplementary budget, the government budget surplus should be larger than in 2005.

Owing to improved **external demand**, goods and services exports increased fast in the first half this year, although slowing down slightly compared to the preceding half-year (from 26.9% to 23.6% at current prices). However, since imports of goods

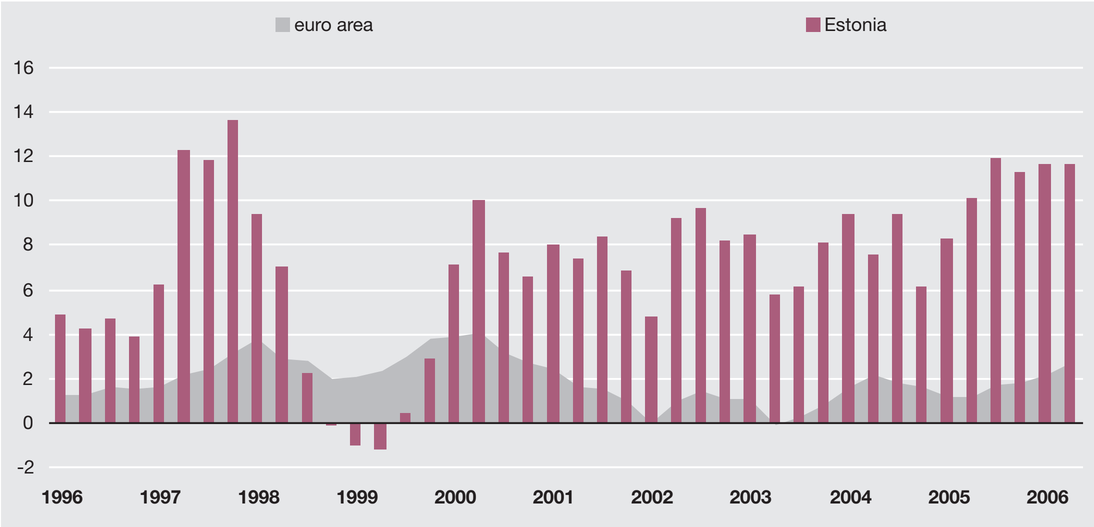

Figure 1.7. Real GDP growth by quarters (%)

Sources: Statistical Office of Estonia; Eurostat

and services meanwhile increased because of a robust growth in domestic demand, the contribution of **net exports** to economic growth was again negative. The **current account deficit** was 11.2% of the GDP of the last four quarters (see Figure 1.8). The deficit in the goods and services account increased from 6.5% in the second quarter of 2005 to 8.2%. External balance probably deteriorated further in the third quarter: according to July data the balance of trade deficit stood at 4.2 billion kroons (over 20% of the expected GDP), which is the worst result after May 2004.

While the rise in **consumer prices** somewhat slowed down in the fourth quarter of 2005, this year the rise has been faster than average and also steadier: consumer prices increased at the rate of 4.4% in all three quarters (see Figure 1.9). Monthly fluctuations again mainly stemmed from the oil price developments. The difference compared to the euro area inflation rate was approximately 2 percentage points.

Even though the weight of motor fuel in the consumer price index (CPI) has not decreased this year and high fuel prices prevented inflation from slowing down, stronger core inflationary pressures began to play a bigger role in shaping the inflation. **Core inflation** accelerated to 3.8% in the third quarter. The underlying reason was the rise in housing costs with the prices of construction materials as well as rental and renovation services increasing significantly. The growth in food prices has also accelerated significantly (to 6.1% in the third quarter), generally following the trends in the euro area. Moreover, inflation was boosted by the rise in the expenses related to leisure activities as well as faster price growth of clothing and footwear.

Corporate business situation

Confidence

The **economic confidence index** calculated by the Estonian Institute of Economic Research rose by 10 points in the first half of 2006, year-on-year. Meanwhile, in the middle of the year the consumer confidence as well as construction, trading and manufacturing companies' confidence indicators stood at the historically highest level (see Figure 1.10).

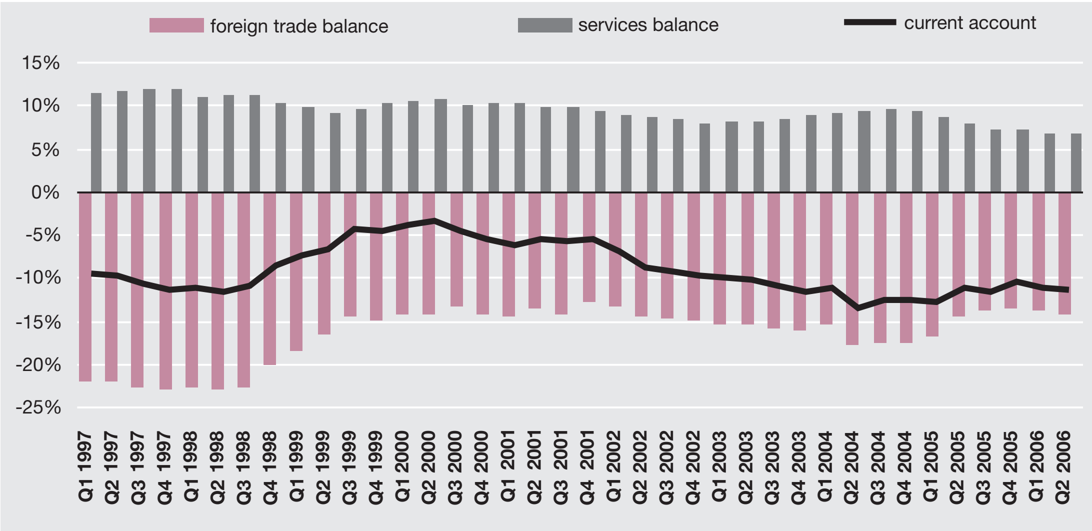

Figure 1.8. External trade account, services account, and current account balance in ratio to GDP (4-quarter average)

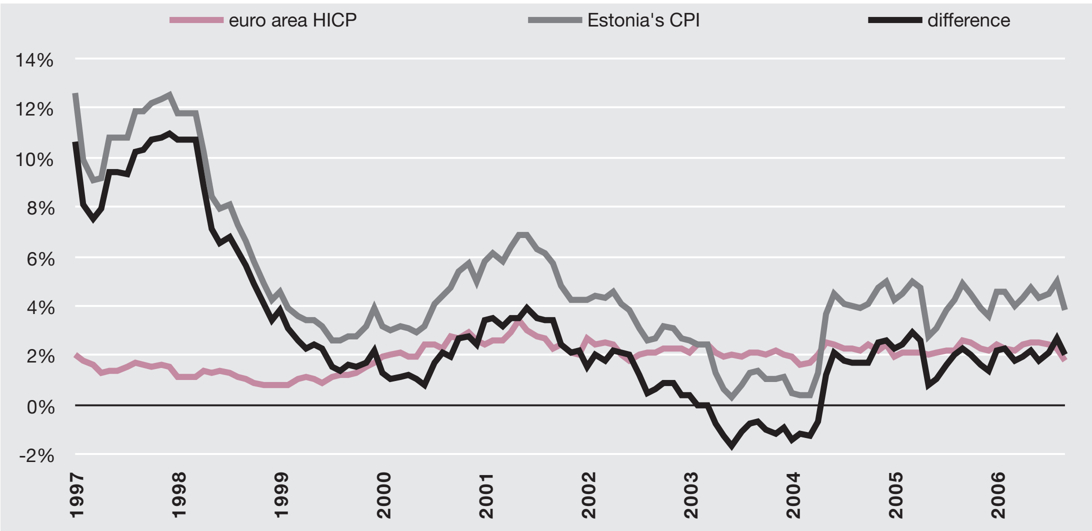

Figure 1.9. Annual consumer price growth in Estonia and the euro area

Sources: Statistical Office of Estonia; Eurostat

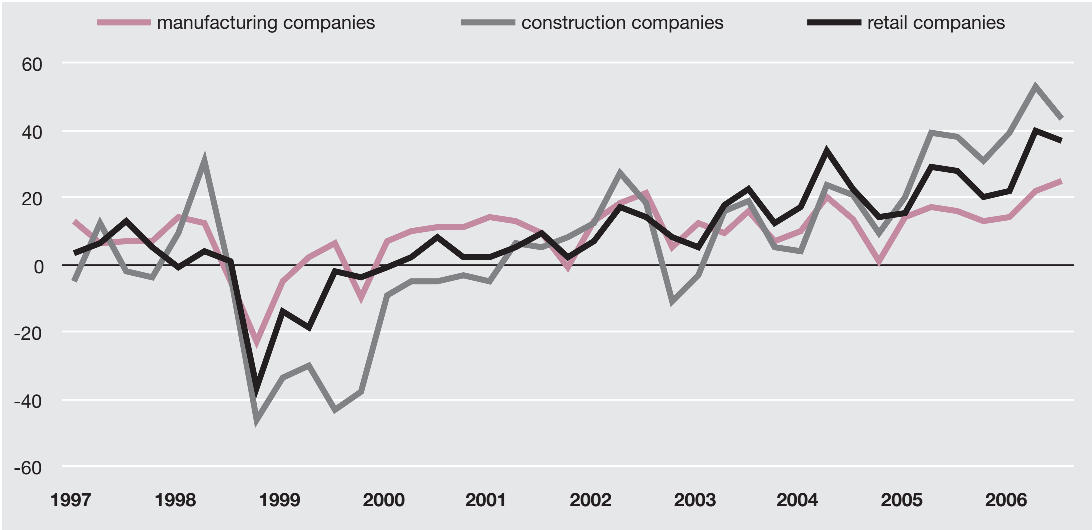

Figure 1.10. Confidence indicators of Estonian companies

Source: Estonian Institute of Economic Research

The situation in the **construction market** remains very good. According to the Statistical Office of Estonia, in the second quarter of 2006 construction companies built 34% more in Estonia and in foreign countries than in the second quarter of 2005. The last time the construction volumes increased that fast was at the beginning of 1998. The weight of the added value of the construction and real estate sector in the GDP structure increased from 19.2% to 20.1%, year-on-year.

According to the Estonian Institute of Economic Research, in the second quarter of 2006 contracts guaranteed work for 5.7 months (4.2 months in the second quarter of 2005). According to construction companies, 88% of the production capacity was utilised, which is the highest level of spring periods throughout 12 years of monitoring. Construction companies mentioned lack of qualified labour as the main factor hampering development, whereas the problem seems to be aggravating (last year the factor 67% of the companies identified it as a problem while in June 2006 this figure was as high as 77%).

The confidence of **manufacturing companies** remained strong in September and exceeded the year-ago indicator by 8 points (see Figure 1.11). Estimates concerning the volume of exports orders improved and satisfaction was expressed also regarding domestic orders. As regards factors inhibiting development, lack of qualified labour and inflation have been mentioned ever so often. According to the Estonian Institute of Economic Research, the utilisation rate of production capacity has remained high (80% at the beginning of the third quarter), which indicates increasingly large corporate investment needs.

Industrial sales

During the past year and a half, external demand has been the main driving force for Estonia's economic growth. Compared to the imports of our major trading partners, the growth in the **exports** of Estonian goods and services was very fast, which means that the market position of our companies improved further. However, compared to the second half of 2005, growth slowed down slightly, particularly regarding the exports of traditional goods (see Figure 1.12).

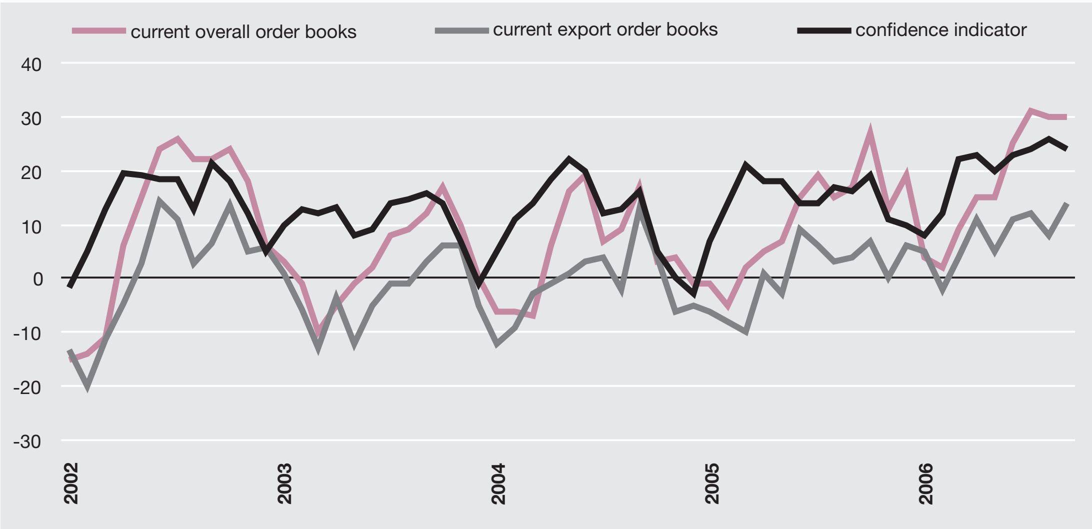

Figure 1.11. Demand for the production of manufacturing companies and confidence indicator

Source: Estonian Institute of Economic Research

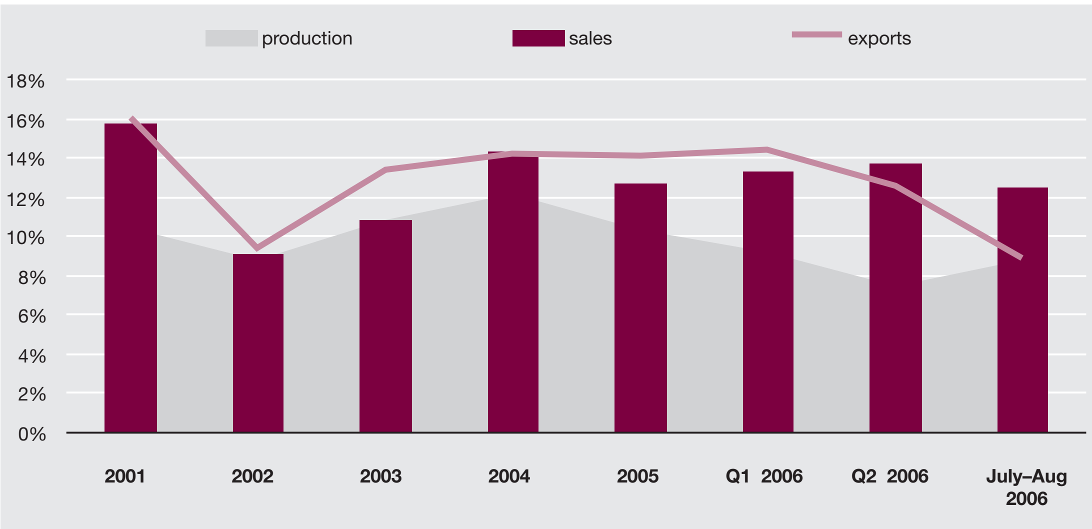

Figure 1.12. Production and sales indices of manufacturing

Source: Statistical Office of Estonia

Manufacturing **sales** grew faster in the second quarter compared to earlier periods as a result of higher sales in the domestic market, which accelerated from 11.9% in the first quarter to 15.2%. The growth was largely facilitated by increased food, timber and clothes manufacturing and sales of construction materials and electrical equipment.

New companies and bankruptcies

The registration of **new companies** has picked up even more speed. During the first nine months of 2006, 30% more enterprises were registered, year-on-year (see Figure 1.13). Unlike in 2005, the number of companies established has increased across nearly all fields of activity, except for manufacturing where the respective figure has slightly decreased. Similarly to earlier years, nearly half of the newly established companies are trading companies. The share of real estate, renting and business services companies has remained close to 25% while the share of construction companies in total companies established during the period has risen to 10%.

In parallel to the increase in the number of new companies, the number of **bankruptcies** has consistently decreased. During the first nine months of 2006, 109 companies went bankrupt, which is 30% less than during the same period the year before. 39% of the bankrupt companies were operating in the trade sector and 18% in manufacturing.

Corporate investment and economic indicators

According to the business statistics compiled by the Statistical Office, the **net sales** growth of companies increased 22% in the second quarter, year-on-year (see Table 1.1). The turnover increased in all fields of activity, except for forestry where it declined 8%. The turnover was the largest in construction, real estate, renting and business services as well as in energy companies. The **added value** increased very fast also in the first half of 2006 (27.1% at current prices). Even though the growth in **costs** sped up, it was outpaced by the turnover. Hence the growth in **total profits** accelerated nearly 40% and **total profitability** 8%.

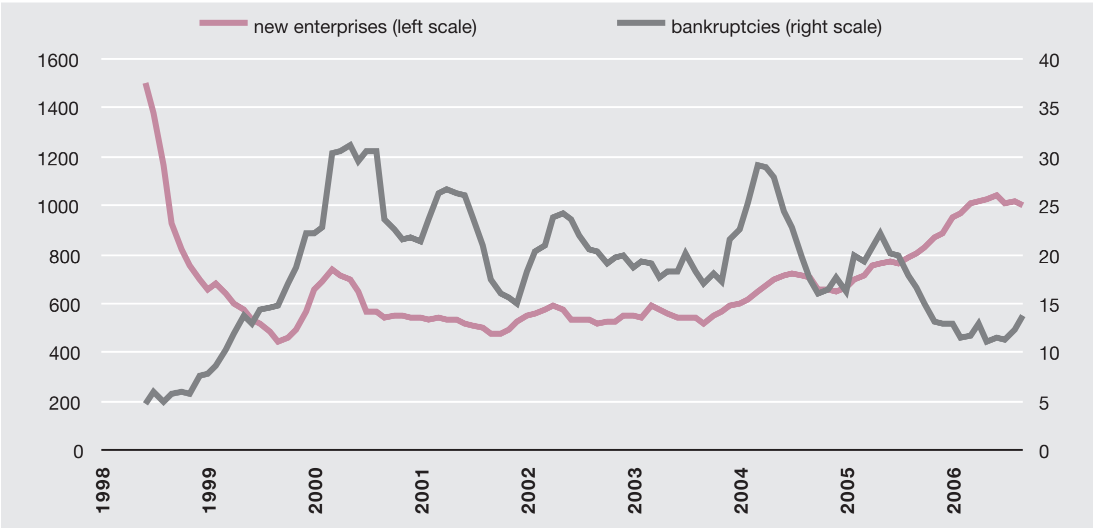

Figure 1.13. New enterprises entered in the commercial register within a month and bankrupt enterprises (6-months moving average)

Source: Estonian Enterprises Register

Table 1.1. Corporate indicators (%)

	All fields of activity			Manufacturing		
	2004	2005	2006 I pa	2004	2005	1 h/y 2006
Growth of net sales	13.7	20.3	22.4	13.8	15.3	17.1
Growth of total costs	14.8	19.4	21.1	15.1	14.3	16.6
Growth of total profit	0.1	32.8	39.5	0.6	27.0	22.4
Total profit to net sales*	6.8	7.6	8.0	8.0	8.8	8.8

Source: Statistical Office of Estonia

According to the statistics on corporate economic indicators, **investment growth** picked up to 44.9% in the second quarter (see Figure 1.14). While investment in energy, gas and water supply as well as in transport, storage and communications grew faster, the growth rate of investment in manufacturing, trade and hotels slowed down.

Investments were mainly channelled to constructing and reconstructing buildings and civil engineering works as well as to machinery and equipment. The biggest investors were real estate, renting and business services companies, whose share in total corporate investment stood at 27%.

Economic situation of households

Confidence and household budget surveys

According to the consumer survey compiled by the Estonian Institute of Economic Research, **household confidence** remained strong during the first nine months of 2006 (see Figure 1.15). Fear of unemployment decreased and also saving prospects were estimated to be higher.

Labour market

Strong economic growth in the first half of 2006 also boosted **employment** growth significantly (see Figure 1.16). The employment rate of persons

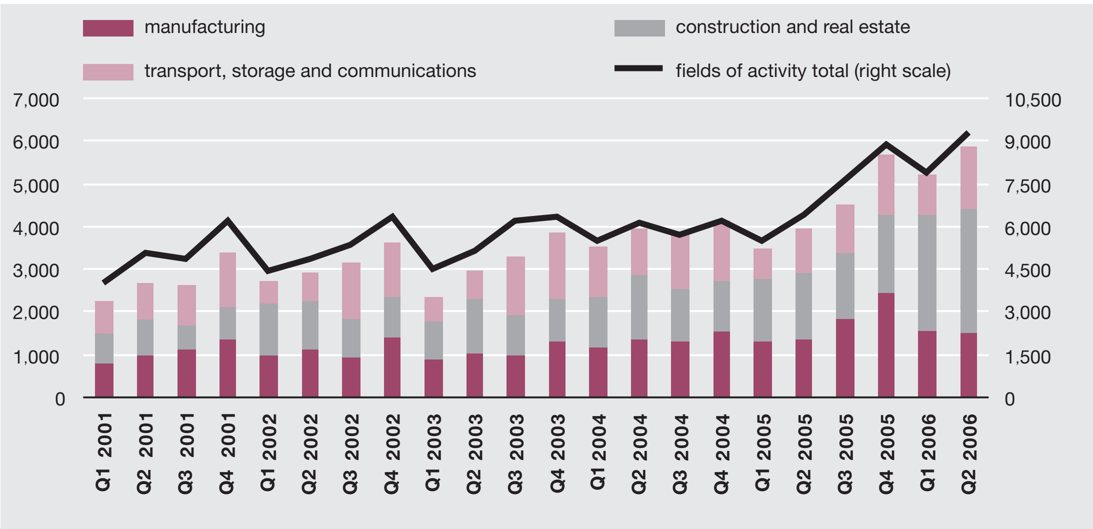

Figure 1.14. Corporate fixed investment (EEK m)

Source: Statistical Office of Estonia

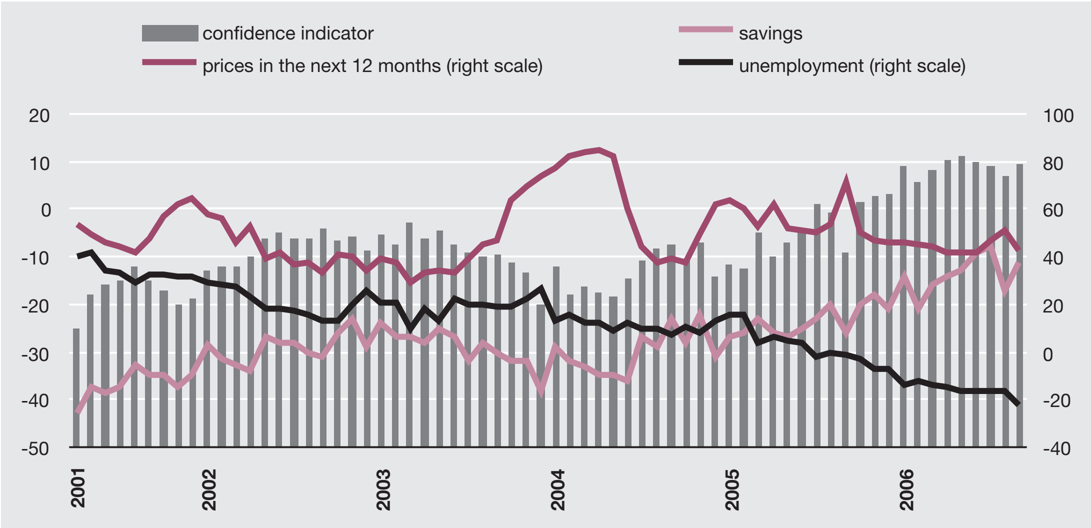

Figure 1.15. Consumer confidence indicators

Source: Estonian Institute of Economic Research

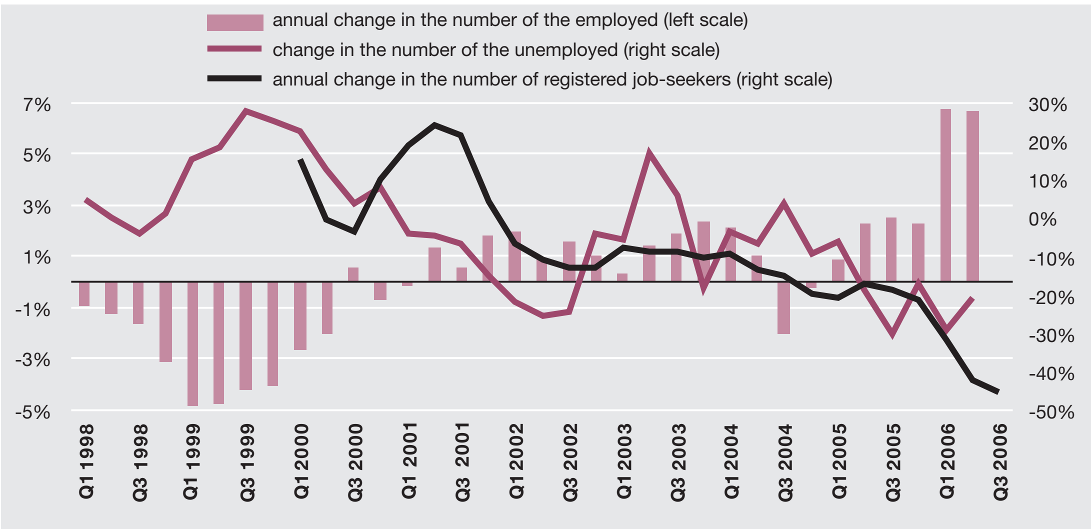

Figure 1.16. Annual change in the number of the employed and the unemployed and registered job-seekers

Source: Statistical Office of Estonia

aged 15 to 74 years increased to 61.2% (57.4% in the first half of 2005). Employment increased above all in the services sector, including 13% in trade, 12% in transport, storage and communications and 28% in construction. This shows that along with increased income, domestic demand has grown, the situation in the real estate sector remains very good and also the number of those working abroad has probably increased fast.

The **unemployment** rate fell to 6.2% in the second quarter. The total number of the unemployed stood at 42,800, i.e. at 20.7% less year-on-year. Also the number of the registered unemployed is consistently declining, standing at 12,690 as at 1 October 2006 which is 40% smaller than the year before.

The **labour participation** rate of people aged 15 to 74 increased from 62% in the first quarter to 66% in the second quarter. It went up mainly in Southern Estonia and the Ida-Viru County, where the respective rate is lower than in Northern Estonia. As for the reasons behind the inactivity, the number of the discouraged and those inactive because of retirement age decreased the most.

Wages

The growth in average **gross monthly wages** accelerated further in the first half of 2006, amounting to 15% in the second quarter (see Figure 1.17). Based on the successful receipt of social tax, wage growth did not presumably slow down in the third quarter either.

Average **net monthly wages** outpaced gross wages by approximately 1.5 percentage points due to the reduction of the income tax rate and the rise in non-taxable income threshold to 2,000 kroons per month.

Similarly to 2005, wage growth in the first half of 2006 was again mainly driven by the private sector. Wages grew fast in agriculture (23%), but the average wages also went up fast in trade (21.5% as a six-month average), construction (18.1%) as well as real estate, renting and business activities (17.4%).

Since inflation did not accelerate as fast as wages, the **real growth in average gross monthly wages** increased over 10% in the first half of 2006. The real growth in labour productivity remained in line with the real wage growth. The share of wage fund in GDP, i.e. the **real unit labour costs**, decreased by the end of the second quarter of 2006 by 0.7 percentage points year-on-year, amounting to 45.6% of GDP together with the social tax.

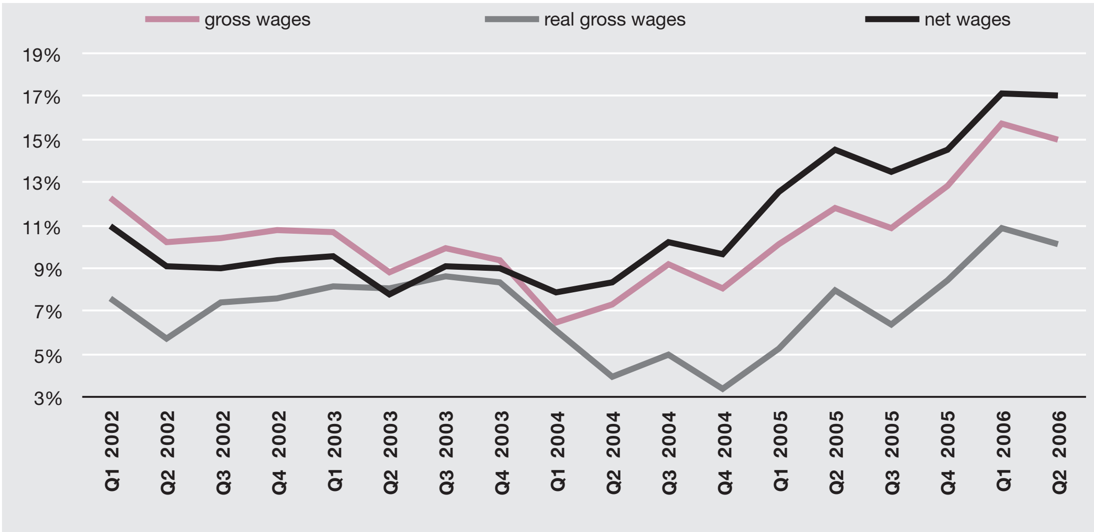

Figure 1.17. Average annual wage growth

Source: Statistical Office of Estonia