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SURVEY OF THE ECONOMIC POLICY

The summer neither enlightened on the further development of the world economy nor provided an answer to the question whether the growth slowdown has hit the bottom already or not. The negative impact of the world growth rate has had a six months delay on the euro area. The euro area growth rate, still high at the beginning of the year, displayed clear signals of slowdown in the second quarter.

It is too early to say to what extent the terrorist attack against the United States has changed the world and the economic perspective of Estonia. Thereby it is clear that **uncertainty vis-à-vis the future has grown significantly**. The world economy was in slowdown even before terrorist acts against US. The general development trend of the world economy did not change as the result of the tragic events; however, September 11th increased significantly the likelihood of negative scenarios. Upcoming months will show how and to what extent the world economy can adjust itself to new circumstances.

Monetary Developments

Against the clearly fallen external demand, the external monetary environment of Estonia was quite turbulent and subject to controversial trends in the first half-year. In the early second quarter the appreciation of the euro came to a halt and started weakening again whereas the exchange rate of the US dollar reached close to its year 2000 peak. Thereafter the euro appreciated again and reached its peak of the year in August. The euro money market interest rates were declining according to the forecast until the tragic events in US. Thereby the impact of Estonia's money market interest rates on the real sector's deposit and loan interests has been stronger than before, bringing along a higher-than-anticipated decline of loan interest rates in spring. In compliance with the downfall in the general economic activity, the loan demand of the domestic real sector has also contracted.

Today it is clear that **insecurity in world financial markets involves an explicit recommendation to avoid risks as much as possible**. Meanwhile, central banks all over the world have done their utmost to reduce market uncertainty in the wake of the US events. The US Federal Reserve cut interest rates by 50 basis points prior to reopening of stock exchanges on September 17th. The European Central Bank as well as a number of other central banks followed the example. It is difficult to forecast the developments of monetary policy environment, including movements of loan interest rates, in upcoming months.

In summer 2001 the first stage of Estonia's monetary policy operational framework reform came to an end, providing the banks a possibility to meet up to a half of the reserve requirement in high quality bonds denominated in the euro. Although banks were actively using this possibility, the expansive impact of the second stage on the economic environment was neutral: deposits with the central bank were just replaced by foreign assets.

Financial Sector

No significant changes took place in Estonia's financial sector in the first half of the year. Assets of banks and leasing companies continued growing below the same period in 2000.

The acquisition of the Lithuanian Savings Bank (*Lietuvos Taupomasis Bankas*) by Hansapank was the highlight of the period. The share of lending to financial institutions continued to grow in banks' loan portfolios, accompanied by **a rapid surge in leasing financing under deteriorating economic conditions, which has become a growing concern.** In the second quarter the securities market has become slightly more active and prices went up whereas unfavourable developments in international markets started inhibiting Estonia's share prices during summer months.

Inflation

Inflationary external pressure was unexpectedly strong in the beginning of the second quarter. **In May inflation accelerated reaching its peak both in the euro area and in Estonia.** At the end of the quarter, lower energy and foodstuff prices and strengthening exchange rate started to hold back the consumer price growth. The inflation continued to slow down in July and August as well, falling nevertheless short of expectations. Briefly, the inflation accelerating factors typical to Estonia (foodstuff price dynamics, administrative steps) came to an end in the second quarter of 2001 and developments in anchor currency countries have become determinant again.

The euro has strengthened in several waves since the beginning of the year. It was the appreciation of the euro beginning from July that took the real exchange rate of the Estonian kroon temporarily back to the level of the year 2000. Thus, the general conclusion is that in the first half-year the appreciation of the US dollar balanced the impact the temporarily accelerating inflation had on the real exchange rate of the kroon. **Due to deteriorating prospects of world economic growth the continuation of strong inflationary external pressure remains unlikely should the oil price maintain its current level.**

Real Economy

Compared to the development of the external environment, the more than 5% real growth of Estonia's economy in the first half of the year was even faster than anticipated and remained sustainable in mid-term forecasts. However, there is no sufficient ground to say whether this was due to the enhanced competitiveness of single sectors or delayed implications of external influence. **It cannot be excluded that Estonian economy could reach the bottom in the growth around early 2002.** In this case, unlike previous forecasts, Estonia's economic growth next year could remain significantly below 2001. The public and private sector will have to consider also this scenario in drafting their activity. **The main prerequisite to maintain economic balance is to contain domestic demand, primarily private consumption based on loan financing, within the tolerable level.**

Most of the external impacts on Estonian economy come from Nordic countries, more specifically from Finland and Sweden who are Estonia's major trade partners and depend, in their turn, on the development of US and the European Union. Finland has downgraded its current economic forecast from about 4% to 1.5%[1]. Also Sweden has cut its growth forecast for 2001 – according to different sources it could be about 2% or less. **As the impact of the external environment on Estonian economy has a delay of a quarter or two, it is clear that although the first half-year was successful for Estonian economy, optimistic forecasts made in May are not valid any more.** The upcoming months will show the extent of adjustment whereas downward revision of economic forecasts is going to be realistic. There is no reason to assume that Estonian economy will do significantly better than the Nordic economies.

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[1] The latest forecast by *Suomen Pankki* for 2001.

Deepening slowdown in the world economy was most evident in the deceleration of Estonian trade growth also in the first half-year. The annual 50% growth in the gross export of goods shrank to about 17% by the second quarter. This reflects primarily a slowdown in the export of Estonian precise electronics subcontracting and low tide in forest and timber industry. At the same time, Estonian textile industry could broaden its product range and discover even new, sometimes untraditional, export markets. According to preliminary estimates Estonia's GDP growth reached 5.2% also in the second quarter against the same period in 2000. The growth in the export of goods and services by the end of the first half-year was sufficient to achieve about 5% annual growth of GDP. **Under larger investment demand, the growing government saving could contain external balance within expectations and the current account deficit remained below 4% of GDP in the second quarter and below 7% as the average of the last four quarters.**

Vis-à-vis internal balance the high level of nominal growth of average wages (14% against the previous year, being 0.5 percentage points above the first quarter) is continuously under attention. Therefore, it is possible that labour input per GDP unit could grow. According to adjusted data the nominal growth of wages was about equal to the nominal growth of economy in the first quarter, in other words, competitiveness was sustained. Assuming that the growth of external demand will continue to slow down, the current wage growth is too fast. Therefore, wage increase stays under focus, as continuing first half-year developments will undermine Estonia's economic competitiveness in long term. **In order to avoid strengthening of domestic inflationary pressure and decline in competitiveness, business undertakings in non-tradable sector should revise their remuneration policy prevailing in the first half of the year.** Wage setting in the export sector has so far been relatively flexible.

Growth slowdown or, according to worse scenarios, even rapid slowdown could mean too slow an adjustment of consumer anticipation to changing circumstances, problems in meeting liabilities and a concomitant fall in confidence. Deteriorating economic environment rapidly decreases investments as was explicitly displayed in the Russian crisis. During the 1998 Russian crisis it was just a loss of a specific market for a few sectors of economy and its aftermath. Now the overall economic growth could slow down and it will not be compensated through growth in other markets, the way it worked in the Nordic market in 1999.

Government Sector

As regards the balance of budget, the first half of the year ended better than anticipated. Here faster-than-forecast growth and more efficient tax collection, as well as better expenditure control played a facilitating role. By the end of the half-year, the government sector budget surplus was 0.7% of GDP of the same period, whereas the surplus was characteristic of namely the second quarter. During six months the consolidated budget tax revenue was 47.5% of the annual plan. Although growth outlooks for the second half-year are more modest, the collection of the annual tax revenue in the amount intended should not be difficult.

The fourth quarter will be decisive as expenditure will undergo seasonal growth and economic growth rate could be the slowest of the year, especially vis-à-vis increasing uncertainty due to recent events. Local-government-financed investments have exceeded the forecast and the end-year balancing of the consolidated budget revenues and expenditures could ask for a cut in central government expenditure.

Adherence to the tight fiscal policy will confirm government intent to support balanced development of economy even if external demand slows down faster than expected. **Under uncertain global economic outlooks it is most important for the fiscal policy to contain costs under control and avoid over-optimistic forecasts in drafting budgets for 2002 as well as 2003.**

It is clear under changing circumstances that **budget revenue forecast should be realistic.** Taking into consideration that under global uncertainty balanced budgeting will be especially significant, conservative approach to revenue forecasting today will help to avoid problems in the future. **In case of the worst development scenario, the unforeseen low revenue collection could mean rapid depletion of existing reserves, leading to budget cuts (including reduction in social expenditure) or a rapid increase in national debt. Restoring reserves will be more difficult than before as privatisation has been substantially completed in Estonia. The rapidly growing debt burden, however, could endanger currently high country rating and bring along an entirely new economic-policy situation.**

Table 1.1. The most important indicators of the Estonian economy

	1995	1996	1997	1998	1999	2000	1st half of 2001[1]
Real growth of GDP (%)	4.3	3.9	10.6	4.7	-1.1	6.4	5.5
Growth of special export (%)	21.6	11.8	48.8	18.8	-2.1	50.9	24.7
Growth of special import (%)	36.4	26.4	41.0	13.0	-8.5	43.1	21.5
Current account balance (% of GDP)	-4.4	-9.2	-12.2	-9.2	-5.8	-7.5	-6.1
General government budget deficit (-) / surplus (% of GDP)	-1.2	-1.5	2.2	-0.3	-4.6	-0.7	0.7
Consumer price index of 12 months (%)	29.0	23.1	11.2	8.2	3.3	4.0	6.3
Export price index of 12 months (%)	15.2	11.4	7.5	2.1	0.0	7.8	27.9
Consolidated balance sheet of banks (% of GDP)	38.1	43.7	63.1	55.9	62.5	68.7	71.5
Share of foreign ownership in banking sector (% of share capital)	29.0	33.4	44.2	60.7	61.6	83.6	85.7
Capital adequacy of banks (%)	13.7	12.1	13.5	17.0	16.2	13.2	14.2
Change TALSE (%)	-	60.3	65.5	-65.8	38.3	10.1	13.5
Consolidated loan portfolio of banks (% of GDP)	25.3	27.5	30.3	30.7	33.4	40.7	42.1
M2 (% of GDP)	33.2	34.9	40.4	35.5	43.1	48.7	51.4
3 months TALIBOR (%)	-	7.9	15.7	18.1	5.1	6.1	5.5

[1] Data are preliminary