II
ECONOMIC DEVELOPMENTS

EXTERNAL ENVIRONMENT

In summer, the slowdown in the world economy continued. A slight rise could be expected only in the last months of the year. High oil prices and rapidly growing interest rates deepened implications of deteriorating business and investment conditions that had started already in 2000. Unreasonably inflated profit expectations fell sharply inhibiting demand for investments. Changes affected the high-tech sector most as reductions in increasing stocks arising from shrinking demand led to production cuts. Therefore, also growth in trade has slowed down on the global level.

By now it is clear that lower profitability and insecure future make businessmen curb investments and reduce workers. In many countries growing employment has come to a halt and unemployment has started to climb up. In most of the industrial countries shrinking demand and tougher competition have slowed down the price growth. The International Monetary Fund (IMF) forecasts a mere 2.7% growth in the world GDP for 2001 and 3.6% for 2002. These indicators remain significantly below the year 2001 when economy grew by 4.7%. The GDP growth rate will remain below the average of recent decades[1].

The United States of America and Japan

The economic growth recovery in the **United States** has remained below the forecasts made at the beginning of the year. While in 2000 the growth reached 4.1%, it was barely 0.2% in the second quarter of 2001. The slowdown is forecast to end only in the last months of the year and gross production to increase by about 1.5% this year (see Table 2.1).

Table 2.1. The most important economic indicators of some selected countries

	Growth of GDP (%)					CPI change (%)					Current account balance (% of GDP)				
	2000	2001		2002		2000	2001		2002		2000	2001		2002	
		A	S	A	S		A	S	A	S		A	S	A	S
USA	4.1	1.5	1.5	2.5	2.5	3.4	3.2	2.6	2.2	2.2	-4.5	-4.0	-4.3	-3.9	-4.1
Japan	1.5	-0.2	0.6	0.5	1.5	-0.6	-0.7	-0.7	-0.7	-	2.5	2.1	2.7	2.5	2.8
Euro area	3.5	1.9	2.4	2.3	2.8	2.4	2.7	2.3	1.7	1.7	-0.1	0.3	-0.1	0.5	-
Germany	3.0	0.9	1.9	1.9	2.6	2.1	2.4	2.0	1.3	1.3	-1.1	-0.7	-1.2	-0.4	-1.0
France	3.4	2.1	2.6	2.2	2.6	1.8	1.8	1.5	1.3	1.4	1.8	2.4	2.1	2.6	2.3
Great Britain	3.1	2.0	2.6	2.4	2.8	2.1	2.2	2.2	2.4	2.4	-1.7	-1.7	-1.8	-2.0	-2.2
Finland	5.7	2.8	4.2	3.0	4.0	3.0	2.6	2.6	2.2	2.4	7.4	6.5	7.3	6.2	7.6
Sweden	3.6	1.9	2.6	2.6	2.8	1.0	2.5	1.8	2.2	1.9	2.6	2.4	2.4	2.4	2.3
Czech Republic	2.9	3.3	3.0	3.9	3.5	4.0	3.9	4.2	3.8	4.4	-4.6	-5.0	-4.7	-4.9	-4.3
Poland	4.1	2.5	4.0	3.7	4.5	10.1	5.7	7.0	5.7	5.0	-6.3	-5.2	-5.4	-5.0	-5.0
Hungary	5.2	4.5	4.9	4.5	4.7	8.2	4.5	8.5	4.0	6.4	-3.6	-4.8	-5.1	-4.8	-5.1
Estonia	6.9	4.5	5.5	5.0	5.5	4.0	5.7	5.0	3.8	2.8	-6.4	-7.2	-7.2	-6.8	-6.7
Latvia	6.6	6.0	6.0	6.0	6.0	2.6	2.3	2.1	3.0	3.0	-6.8	-6.3	-6.6	-5.8	-5.5
Lithuania	3.3	3.6	3.2	4.7	3.8	1.0	0.6	1.3	2.8	2.6	-6.0	-6.7	-6.7	-6.6	-6.3
Russia	8.3	4.0	4.0	4.0	4.0	20.8	22.1	17.6	12.9	12.3	18.0	11.5	12.0	7.9	8.2

Source: IMF, World Economic Outlook
S - IMF prognosis, spring 2001
A - IMF prognosis, autumn 2001

[1] All these and other forecasts have been made prior to the anti-US terrorist attack.

Growth slowdown is currently most pronounced in industry whereas the first signs appear also in other branches of economy. Lower profits make businessmen cut capital investments and reduce stock. Both shrinking external demand and the high exchange rate of the US dollar sustained by a continuous inflow of foreign investments inhibit exports. In the second quarter economic growth was based on the consumption and investments by private households and the government sector consumption. Continuously growing unemployment (in July the unemployment rate was 4.5%) and stock prices that fell again during the summer threaten consumption.

Slower growth is accompanied by inflationary pressure. Decreasing input prices (especially energy and fuel) and tough competition inhibit price increase. Inflation expressed as consumer price index slowed to an annual 2.7% in July (having been around 3.4% in January-May).

The economic policy has been strongly conducive to the economic environment. The deteriorating economic environment has made the US Federal Reserve to cut interest rates by 300 basis points down to 3.5% against the beginning of 2001[2]. The fiscal policy has also a role to play in improving the economic environment. In summer, 38 billion dollars of income tax refund took place and the payment of corporate income tax has been postponed.

The recession in **Japan** complicates economic policy choices. The volume of national economy grew an annualized 0.5% in the first quarter whereas investments and exports which had previously sustained growth had a reversed impact in the second quarter. The really high unemployment rate for Japan (5.0%) and continuously falling prices inhibit growth in consumption. In 2001 the economy is forecast to fall by 0.2…0.5%.

For Japan, difficulties in the financial sector will have a more lasting impact than the global setback. The banking sector has numerous bad loans. Compared to the peak in March, stock prices have fallen and investment outflow slightly increased.

In the post-election atmosphere the government of Japan is expected to provide more specific reform plans. Prime Minister Koizumi's plans foresee structural reforms (including a write-off of bad loans in the banking sector and reforms vis-à-vis the stock market) and reduced issuance of government bonds. As structural reforms will deteriorate the economic situation even further in the near future, an active discussion has been launched on macroeconomic measures at the disposal of the state to mitigate the situation. The central bank will probably be primarily responsible for supporting economy. The bank is expected to be creative in increasing the amount of money circulating in the economy whereas nominal interest rates are close to zero.

European Economic Space

The economic growth in the **European Union, including the euro area,** has slowed down as high import prices and slack external demand have inhibited export and investments growth above forecasts. While in 2000 gross production in the euro area grew still by 3.5%, the annual growth forecast for the second quarter of 2001 is expected to barely reach 1% and outlooks for faster growth in the second half-year are quite unrealistic. For the entire year of 2001, the growth is forecast to be slightly faster than in US – up to 1.9%.

According to the European Central Bank, suppressed growth in energy and food prices, lowering of tax rates and relatively favourable lending environment could support economic growth in

[2] After the terrorist attack against the US central bank reduced interest rates by another 50 basis points on September 17.

the euro area in the autumn and winter of 2001. Suspended decrease in unemployment could undermine consumer confidence. Until summer, unemployment shrank fast – down to 8.3% in the euro area and to 7.6% in the entire EU.

The setback in the US economy and financial markets has its implications on Europeans' confidence, too. Vis-à-vis earlier years, the underlying reason is in the falling profitability of foreign investments, whereas, by the end of 2000 about two thirds of foreign investments made in US were from Europe.

Despite of the relatively slack economic growth, the inflation rate is slowing down tenaciously. In the first quarter the HICP (harmonized index of consumer prices) displayed an annual growth of 2.5% in the euro area, in May already 3.3% and in July – 2.8%. Declining energy, raw materials and food prices and strengthening of the euro should push consumer price growth rate below 2% only in 2002.

The relatively rapid price growth has prevented the European Central Bank to cut monetary policy interest rates. In 2001 the ECB cut was merely within 50 basis points whereas the Bank of England has cut interest rates by 100 basis points[3]. While monetary policy implications on economic growth have remained neutral, slackened fiscal policy (about 0.7% of GDP) has been growth supportive both in the euro area and Great Britain.

Shrinking demand for high-tech products has sharply slowed down the rapid economic growth in **Finland** and **Sweden**. According to the IMF forecasts, gross production in Sweden will grow by 1.9% and in Finland by 2.8% in 2001. *Suomen Pankki* anticipates a mere 1.8% growth in Finland this year. All the above forecasts have shrank by about one percentage point against the beginning of the year.

The growth has slowed down primarily due to a sharp fall in exports. Forest and electronics industries have suffered most and have, thereby, also curbed investment schemes. Meanwhile, consumption in private households is increasing beyond expectations. Relatively favourable labour market and fair lending terms have been really conducive.

The significant difference between growth rates of Finland and Sweden in previous years has vanished. For 2001, the IMF forecasts an about 2.5% growth in consumer prices in each of the countries. Apart from conventional factors (energy and food prices), also the low exchange rate of the Swedish krona is influencing internal price level in Sweden. In order to strengthen the krona and inhibit inflation, the *Sveriges Riksbank* raised monetary policy interest rate by 25 basis points.

Both in Finland and Sweden current account surplus and government budget surplus magnify the resistance to external shocks. In both countries, fiscal policy is going to be a significant contributor to the economic growth in 2001. Tax reduction in Sweden should reach about 1.5% of GDP (being twice above the year-ago level). In Finland fiscal policy schemes also include tax cuts.

Emerging Countries

The summer of 2001 has put to test the sustainability of the economic policy of both developed and emerging countries. Weaknesses in the economic policy of the emerging countries have become pronounced due to the sharp slowdown in the world economic growth. Any improvement will be subject to domestic policy decisions, as well as, global growth recovery.

[3] After the terrorist attack against US the European Central Bank reduced interest rates by another 50 basis points.

For **developing markets,** financing conditions have been deteriorating despite of the constant decline in interest rates in the United States and the euro area. This happens because confidence in emerging economies has drastically declined, well displayed in the spread between the emerging countries' bond interest rates comprising the EMBI index and the level of the US bonds' interest rates. The EMBI index has been fluctuating between 800 to 1000 basis points in summer and stopped at above 900 basis points in July-September. Negative attitude to emerging markets originates from Argentina that has not yet revealed any improvement.

In **Latin America,** economic growth has remained below anticipation - the annualized GDP fell in Mexico and Argentina in the second quarter. The IMF has significantly lowered growth forecasts: the economic growth in 2001 is expected to remain below the year-ago level (1.7% *versus* 4.2%). The global slowdown exercises the broadest impact on the economic growth in the region. This is most explicit in Mexico and Chile. In Brazil, economic growth is restrained by weak neighbouring economies, on the one hand, and by internal energy crisis, on the other hand. In Argentina, economic problems arise from the large debt load the country cannot get rid of; and from the lack of political consensus.

Emerging and extremely open economies of Asia have lost most through the global slowdown. Last summer the GDP grew by 6.8% in the region. This year the growth forecast reaches barely 5.8%, mostly because of the anticipated 7.4% growth in the relatively closed economy of China, the largest country in the region, reviving its economy through fiscal policy measures. Thereby, China has not been untouched by global growth slowdown, either. Having increased by 9.9% in 2000, the gross domestic product in Singapore, largely dependent on external demand, will probably shrink this year. Sharply fallen demand for electronic goods in the United States and Europe, as well as, continuously high oil prices have had the largest impact on emerging economies of Asia.

The global economic growth slowdown has not had as strong an impact on **Central and East European Countries** (CEEC) as on Asian and Latin American countries. Lower growth rate in the euro area has inhibited economic activity in CEEC as well. The IMF anticipates a 3.4% growth in 2001 against 3.8% in 2000 in the region. The growth is contained on the relatively high level primarily because domestic demand has started to increase in some countries only this year. In Czech Republic, Slovakia and Romania the economic growth has been faster than last year. According to the IMF estimates, the gross domestic product in financial-crisis-shaken Turkey will decrease by 4.3%.

The economic situation in **Poland** has deteriorated the fastest. Despite the strong zloty, private consumption has not accelerated growth: compared to the 4.1% GDP growth in 2000, the anticipation for 2001 is contained at 2.5%. The main underlying reason lies in high interest rates, inhibiting economic activity whereas interest rates are the only political instrument for the central bank to contain inflation rate and current account deficit. Parliamentary elections on September 23 have sharply deteriorated government budget – slower economic growth has reduced revenue base whereas the elections have pushed expenditure upward. Unless the state tightens fiscal policy significantly, budget deficit in 2002 could be around 10%. Growing budget deficit (forecast to reach 3.9% in 2001) could raise inflation rate and increase current account deficit and inhibit confidence in Polish economic policy in the eyes of the rest of the world, complicating access to foreign investments.

The **Czech Republic** has recovered from the two-year-ago economic slowdown and rapid growth is sustained in 2001. Due to continuous FDI inflow Czech businessmen have been able to sustain investing regardless of the deteriorating external environment and growth rate of industrial output and export has remained high (in the first half of 2001 the year-on-year growth of industrial output has been 8.5% and in exports 19%). Costs related to restructuring of financial and business sectors are forecast to push state budget deficit upward by 8% of GDP. Growing domestic demand and higher food prices have raised annualized inflation rate from 4% in 2000 to 5.9% in July 2001.

In **Hungary,** the economic growth has been contained within 4–5% over the recent years. Inhibited but still a large 8% growth of industrial output characterized the first half of the year; although, in June the annualized growth was negative. High inflation rate has been a problem (annualized 9.4% in July). Current account deficit was only an annualized 3.3% of GDP in June due to continuing exports (annualized growth of 15%) and direct investments. The objective of monetary policy changes intended for April-October 2001 and partially implemented already is to curb inflation rate. In April, the central bank stretched the fluctuation band of the forint from 4.5% to 30%, strengthening the national currency decisively. On October 1, the central bank is going to abolish the annual devaluation rate of the currency (0.2% currently), putting an end to the artificial depreciation of the currency.

The global growth slowdown has had little impact on **East European** countries as the demand has been sustained by stabilizing economic situation in the CIS countries and expanding domestic demand.

The economic growth in **Latvia** and **Lithuania** has accelerated primarily due to the development of the services sector in 2001. The IMF forecast a growth of 6% for Latvia and 3.6% for Lithuania. In the second quarter, the annual growth in manufacturing was very high, reflecting primarily faster growth rates in traditional sectors (foodstuffs, timber, textile). Shrinking demand in the European Union has been offset by new markets in the CIS increasing, thereby, the share of former Soviet republics in the trade of Latvia and Lithuania. Permanently high oil prices have also played a significant role, favouring Russian oil transit via Latvia and demand for Lithuanian oil products. In Latvia, domestic demand is fed by rapidly growing lending and expansive fiscal policy of the government, in Lithuania domestic demand grows more slowly.

In **Russia** the economic growth has remained above anticipation, mostly due to higher-than-expected oil prices and internal policy stability, encouraging local businessmen to compile long-term plans. The IMF anticipates a 4% GDP growth in Russia in 2001. During the first seven months the annualized growth has been 5.5%. The current budget is highly conservative, facilitating revenue collection above expectations. This has happened due to larger tax revenues than anticipated arising from continuously high oil prices and faster inflation rate than the government had forecast (the actual annual growth was 24% in June, the forecast being just 14–16%). Although the economic situation continues to improve, banking and business sector reforms to support significantly economic development in Russia are not moving forward.

International Financial Markets

In July, the exchange rate trend of the US dollar changed in the **foreign exchange markets**. The dollar having strengthened throughout the first half of the year started to weaken primarily because earlier US growth expectations of rapid recovery were not realized in the second half-year. Weak economic results of the second half-year have led to an understanding that economic slowdown could continue and recovery could take longer. The dollar weakened against the yen by 5.1%, against the euro by 4% and against the pound by about 1.9% (see Table 2.2).

Table 2.2. Changes in exchange rates of major currencies

	30.03.01	27.08.01	Change
JPY / USD	126.33	119.91	-5.1%
USD / EUR	0.8767	0.9115	4.0%
USD / GBP	1.4161	1.4435	1.9%

Changed anticipations vis-à-vis economic growth have brought along contradictory movements in **stock markets**. While in April and May, an upward trend was dominant in major markets as investors expected the weakening growth in three major economic regions to be over soon, another drop took place in the markets between May and August as economic outcome remained below expectations. The US stock markets barely made it during the period under review whereas the euro area and especially Japan suffered a fall (see Table 2.3).

Table 2.3. Indices of major stock markets

	30.03.01	27.08.01	Change
USA (S&P 500)	1,160.33	1,179.21	1.6%
USA (Nasdaq)	1,840.26	1,912.41	3.9%
Japan (Nikkei 225)	12,999.70	11,275.01	-13.3%
Euro area (Eurotop 300)	1,371.12	1,296.89	-5.4%

The development of **short-term interest rates** reflected mostly monetary policy of central banks. The US interest rates suffered the largest decline as the benchmark rate was cut by 1.5 percentage points due to continuously small economic growth. Although financial results were explicitly weaker than expected in the second quarter, no major changes took place. While in Japan it is not possible to cut the benchmark rate as the real interest rate is zero anyway, the European Central Bank has focused on inflation indicators and has been more inert responding to growth trends. **Long-term interest rates** changed relatively little in all three regions: in US they maintained the previous level but rose slightly in Japan and the euro area (see Figure 2.4).

Table 2.4. Interest rates of major bond markets

	Interest rates of 3 months			Interest rates of 10 years		
	30.03.01	27.08.01	Change (basis points)	30.03.01	27.08.01	Change (basis points)
USA	4.28	3.46	-82	4.92	4.92	0
Japan	0.06	0.02	-4	1.28	1.42	14
Euro area	4.44	4.42	-2	4.70	4.87	17

In the second quarter the trend of price decline dominant this year continued in **raw materials markets**, arising from global growth slowdown. The prices-based CRB index dropped by 5.3%. The price for crude oil as a basic raw material was between 25–30 dollars a barrel between April and August (being about 26 USD a barrel in end-August). The oil price falling from the beginning of the year accompanied by growth slowdown has had a positive impact on inflation indicators that have started to decline both in US and in the euro area.

ESTONIAN ECONOMY

Domestic Demand

Private Consumption and Investments

Domestic demand continued to grow rapidly in the second quarter, although it was slightly slower than earlier in the year. The larger inertia in domestic demand against external demand is, in most cases, inevitable whereas too high and long a gap will threaten the economic balance in a small and open economy.

In the second quarter, according to estimates, the main source of growth has continued to be investment growth in its broadest sense (including capital investments together with stocks). Favourable credit terms, larger turnover and sometimes even over-optimistic corporate development prognoses facilitated the growth. Although new consumption loans were roughly equal to the amount of the first quarter, due to the shrinking money supply and external demand the issue remained on the agenda.

Similar to the beginning of the year, average wages maintained rapid growth in the second quarter of 2001, as well. Labour costs were estimated to keep pace with GDP growth and the share of labour costs remained on the year-ago level. **Should the external demand continue shrinking in the second half-year, the current growth of wages will be evidently too rapid.** In order to avoid strengthening of the domestic inflationary pressure and a potential decline in competitiveness, businessmen will have to revise the remuneration policy prevalent in the first half of 2001.

In the second half of the year, the key issue will be when the deeper and longer-than-expected economic slowdown in developed countries is going to impact Estonia's domestic demand through external demand. The main prerequisite for sustainable economic balance lies in domestic demand, primarily in borrowing-sustained private consumption, responding to changes in an adequate way.

Public Sector

At the end of the first half-year, the government budget had a surplus of 308 million kroons, mostly originating from the second quarter (see Figure 2.1). During the first six months 47.5% of the annual tax revenue plan was collected. The surplus was mostly due to rapid nominal growth of economy and better tax (primarily excise tax) administration, on the one hand, and the government capacity to monitor current expenses, on the other hand. **Adherence to tight fiscal policy confirms the intent of the government to support balanced economic development.** Hopefully the trend will be sustained even if the growth of external demand slows down faster than anticipated in the second half of the year.

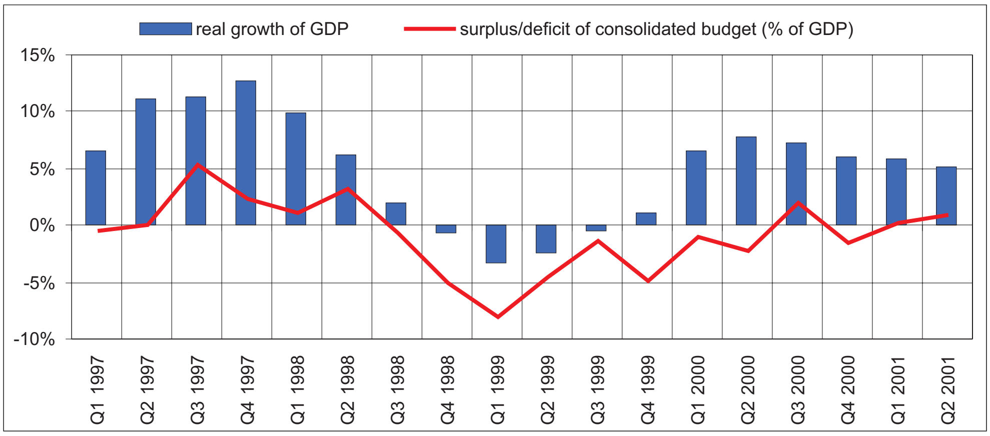

Figure 2.1 Real growth of GDP and balance of the consolidated budget

Although in the second half-year growth outlooks seem to be worse the collection of budget revenues according to the plan should not be difficult. The revenue forecast for 2001 was based on a 10% nominal growth, the real growth was above an annualized 11% in the first half-year. The administration of taxes has also improved significantly. **In order to maintain economic**

balance, in the second half of the year it would be most important to contain budget outlays under control, primarily on the level of local governments, as well as, to avoid over-optimistic prognoses in drafting budget for 2002.

Domestic Saving

Together with the growing demand for investments, the level of saving increased throughout the first half of 2001. This is primarily due to the successful fiscal policy of the government sector – more efficient administration of taxes (mostly excise tax) and maintenance of current expenditures under control. The level of saving of GDP in the public sector has grown by about four percentage points against the year-ago period. **Under the expanding demand for investments the growth in government spending has ensured maintenance of external balance** (see Figure 2.2).

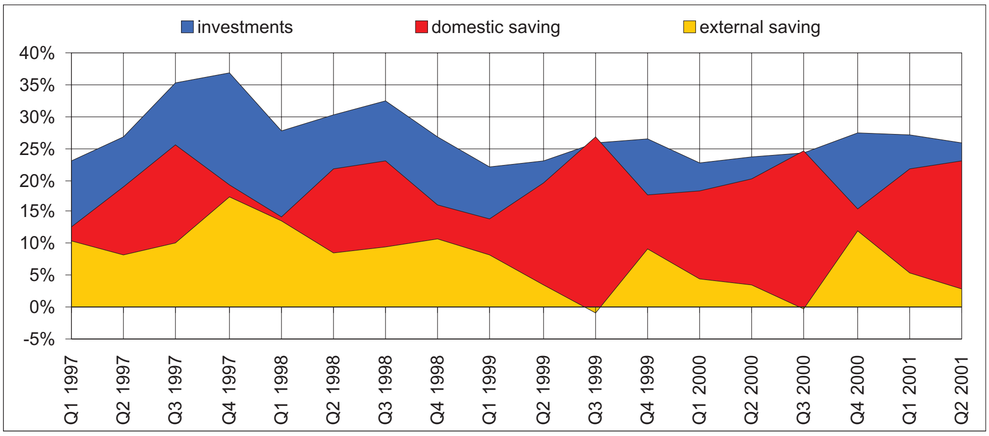

Figure 2.2. Investments and their covering sources (% of GDP)

Domestic Supply

There are no supply-side signals rendering the 4.5–5% growth forecast of GDP for 2001 unrealistic. The year-on-year growth in the export of goods has slowed down, but has been stable at a significant 20% level since March.

The world economic growth slowdown was not yet reflected in the volume of industrial products' sales in the second quarter. The confidence indicator used by the Estonian Institute of Economic Research reached the record high of the last five years. Production had grown by 6% in the manufacturing by the end of the quarter (see Figure 2.3).

The situation varied by industries. Although **timber industry** recovered in the second quarter, the confidence indicator indicates merely modest further growth as production capacity has been mostly used up already, the level of orders has been recovered and prices could start declining in the sector. In other more significant industries – **foodstuff, textile, furniture industries and engineering** – the production has increased more rapidly.

The services sector has also had controversial implications on the economic growth. The growth in the export of services is not comparable to the year 2000, although in domestic-demand-oriented activities the value added has increased significantly. In **trade,** sales at constant prices have been about 15% above the year-ago level throughout the first half-year, also supply of accommodation services has significantly risen. In the main services exporting sector – **transport, storage and communication** – the value added increased by more than 6% and net sales by about 20% in the first quarter. Turnover went up primarily through a price-growth-

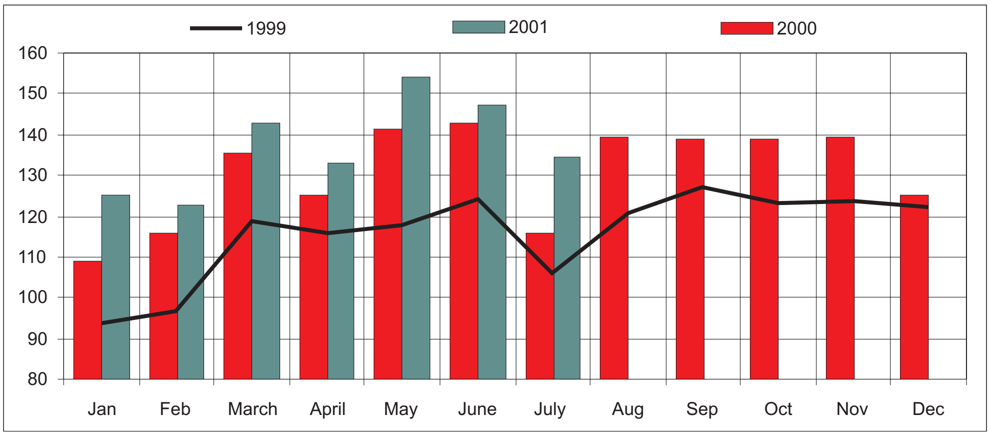

Figure 2.3. Monthly sales of the manufacturing output in constant prices (%, January 1997 = 100)

related increase in the export volume of Russian fuel. The growth in the turnover of other modes of transport, especially in ports remained modest after the fall in the first quarter.

Throughout 2000 the economic growth was sustained by more efficient use of production capacities that inhibited employment. **In the first half of the year, for the first time since 1997, together with growing additional investments the demand for additional labour has gone up.** While in the first quarter the number of the employed was on the year-on-year level, it grew significantly – by 1.5% – in the second quarter. This does not yet mean a sustainable rapid fall in unemployment (the longer-than-anticipated recovery of the world economy could make the manufacturing decrease more jobs). Nevertheless, development trends of the first half of 2001 raise hope that a period has come to an end in Estonian economy when relatively rapidly growing domestic and external demand does not facilitate an additional demand for labour.

External Sector

The ever-deepening cooling in the world economy has a pronounced impact on slower growth rates of Estonian trade. The 50% annualized growth of total exports of goods in 2000 maintained only 17% in the second quarter. Subcontracting-related trade flows have gone through the deepest downfall. The record high surplus in the balance of processed goods (1.2 billion kroons) ensured trade balance comparable to previous years (see Figure 2.4).

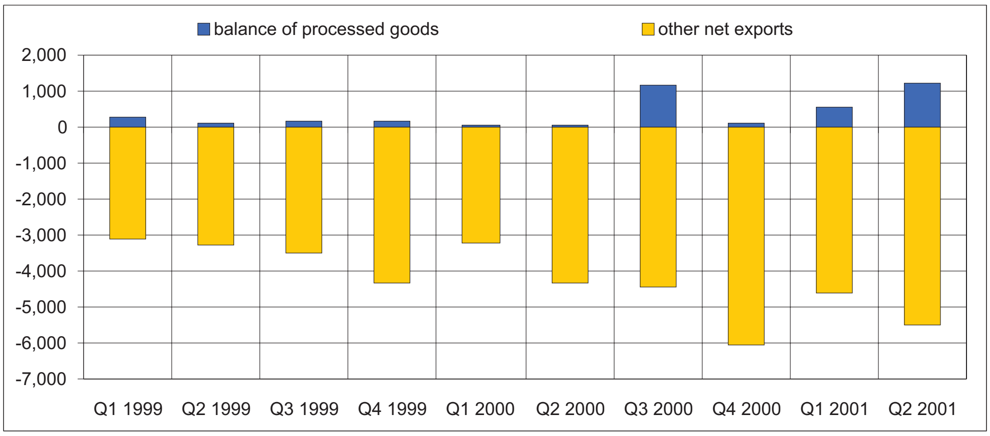

Figure 2.4. Balance of foreign trade and processed goods (EEK m)

It should be considered evaluating external balance that the deficit in the trade unrelated to subcontracting kept increasing. **The growth in the quantity of goods imported for domestic circulation indicates large domestic demand that together with slower growth in the export of services could raise the issue of external balance, should both trends keep deepening.** In the second quarter the largest quarterly surplus of processed goods ever offset suspended export of services, still, the surplus could be due to logistic aspects and not be sustainable. **In conclusion, the deficit in the balance of goods and services could remain in the second quarter even below the year-ago period according to preliminary estimates** (see Figure 2.5).

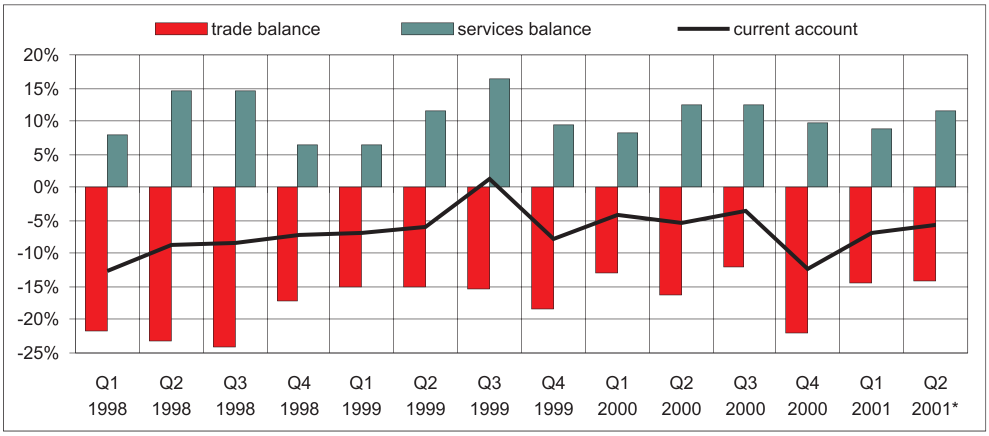

Figure 2.5. Current account and its major components (% of GDP)

* data are estimated