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SURVEY OF THE ECONOMIC POLICY

Although the first months of 2002 marked certain recovery of the world economy, several threats for further development remained. Due to low economic growth and uncertainty outlooks, the central banks of bigger economies kept the interest rates on the level that would stimulate economic growth. For Estonia's monetary policy environment it meant a sustained low interest rate and favourable liquidity environment. In the second half-year the euro area benchmark rates are expected to rise and this will spill over also into Estonian interest rates.

External Development

Compared to end-2001 the economic growth accelerated significantly in the USA and to a lesser extent also in Europe and Japan. At the same time, the optimism of early-2002 in rapid growth recovery has somewhat shrank. The annualised comparison shows that growth has remained below the average of recent years in all large countries, including Estonia's main trade partners.

Further assurance in global economic growth in the second half of the year will depend primarily on capital investments and private consumption. Currently, there are still several obstacles interfering with the more rapid growth recovery of the above costs. First and foremost, high level of fuel prices, weak situation in the labour market of developed countries and weak consumer confidence, underutilisation of corporate production resources and constantly low profitability. Nevertheless, most of the foreign economic forecasts assume that the economy of most large countries will recover at the average level of recent years at the end of 2002 or at the beginning of 2003.

Real Sector

In early 2002 it became clear that the current business cycle would not peak in the annualised recession in Europe but rather in growth slowdown. Thus, relatively pessimistic forecasts made after terrorist attacks against the US in autumn 2001 have been revised. Estonia has not been an exception. Optimism in the world economy in the second half of 2002 has made possible to revise growth forecasts upward. However, this year the GDP growth rate will probably not reach the level of 2001 (see Background Information, pp 8–10).

Low external demand has suspended growth in export and production volumes in nearly all major industries in the first months of the year. The volumes of Estonia's direct export grew by merely 6.8% between January and March, remaining a third below the level of end-2001. The 3.6% economic growth in the first quarter of 2002 reflected the weakest external environment of the recent years in Estonia, but this result was to be expected.

Despite inhibited growth in export income, the rapid development in domestic demand continued, sustained by low level of international interest rates and increasingly favourable credit terms offered by domestic financial sector. The growth in domestic demand was primarily maintained by investment activity, receiving an additional impetus from launched projects, large for Estonia.

Such developments inevitably involve pressure that would deteriorate external balance. In the first quarter the 12-month current account deficit reached 8.1% of GDP, reflecting high investment

demand. Despite the increasing saving in the government sector and the about 1.5%-surplus of GDP, the level of savings in the Estonian economy has slightly shrank compared to the beginning of 2001.

Inflation

The price growth recovered on the level of Estonia's current development phase by end-2001, when shrinking external price pressures accompanied by moderate internal and external demand started to inhibit growth in the open and sheltered sector prices. A component analysis shows that external inflationary pressure has reached Estonia mostly through foodstuff and fuel prices.

In the first quarter of 2001 consumer prices appreciated by 4.3%. The price growth differential between Estonia and the euro area decreased to 1.8 percentage points in the first quarter of 2002, which in mid-term could even remain below balanced difference. This was not really the result of Estonia's inflation pace slowing down, but rather the outcome of high inflation rate in the euro area. The increase of administered prices in early-2002 was also more moderate than average.

Small inflation spread against the euro area meant a modest appreciation of the real exchange rate of the kroon against the euro at the beginning of 2002. The real exchange rate of the Estonian kroon against the currencies of transition economies has been depreciating throughout the last two and a half years. During the first four months of 2002 the depreciation reached 5.3%. This is primarily caused by the sustained high inflation rate in Russia after the crisis of 1998, as the depreciation of the nominal exchange rate of the rouble has been significantly smaller.

Monetary Policy Environment

Larger central banks in the world, including the European Central Bank, did not change benchmark interest rates during the first five months of 2002. Therefore, the short-term money market interest rates of the euro area also remained relatively stable. Contemporaneously the inflation rate of the euro area exceeded anticipation, deepening market confidence that the European Central Bank would enter an interest rate growth cycle in the second half of the year.

In those conditions both short- and longer-term money market interest rates remained more or less unchanged in Estonia as well during the first five months of 2002. With the decrease of the euro area interest rates coming to a halt, the decline of loan interest rates in the real sector became suspended as well. This becomes clearly explicit in private individuals' long-term interest rates, which remained at the level of 8.1% throughout the first five months of 2002. In corporate lending slow interest rate decline was sustained due to the shrinking interest margin. In April the corporate long-term loan interest rate reached historic low – 6.8%.

During the first quarter of 2002 no significant changes took place in the exchange rate of the euro. However, in April the exchange rate of the US dollar against the euro started to weaken bringing along a slight strengthening in the exchange rate of the Estonian kroon against the dollar. In brief, the conclusion is that during the first months of 2002 the monetary policy environment has been stable for Estonia.

Financial Intermediation

Apart from slower economic growth financial deepening was subject to seasonal factors as well. In the first quarter of 2002 the most remarkable development in the financial sector was

growing securities market capitalisation based on price appreciation. Bank assets grew slowly as usual in the first months of the year and recovered only in April. Continuously favourable lending conditions and low interest rate level in the real sector has sustained credit demand.

Regardless of the slowdown in the economic growth, the quality of banks' loan portfolio has not deteriorated. The share of provisions and bad loans did not significantly differ from the average indicators of 2001. Capitalisation of banks remained strong and liquidity buffers high.

In February 2001 the Tallinn Stock Exchange started trading in the system of Helsinki Exchange Group. The trading takes place in euro whereas settlement remained kroon-based. In order to enhance transparency and confidence in the stock market, regulations of the Tallinn Stock Exchange will be upgraded.

In payment intermediation payments maintained their rapid growth, reaching seven million transactions a month by the end of the first quarter of 2002. At the beginning of the year Eesti Pank completed testing of two new inter-bank settlement systems. High value payments are now processed in Real Time Gross Settlement System and retail payments in Designated Time Net Settlement System. The new settlement systems provide services for all Estonian commercial banks and the Central Depository for Securities. More than 50,000 payments daily are processed on the average in these systems.

Table 1.1. The most important indicators of economy

	1995	1996	1997	1998	1999	2000	2001	Q1 2002
Real growth of GDP (%)	4.3	3.9	10.6	4.7	-1.1	6.4	5.3	3.6
Growth of special export (%)	21.6	11.8	48.8	18.8	-2.1	50.9	3.6	-19.1
Growth of special import (%)	36.4	26.4	41.0	13.0	-8.5	43.1	4.1	-11.4
Current account balance (% of GDP)	-4.4	-9.2	-12.2	-9.2	-5.8	-7.5	-6.7	-15.1
General government budget deficit (-) / surplus (% of GDP)	-1.2	-1.5	2.2	-0.3	-4.6	-0.7	0.4	1.6
Consumer price index of 12 months (%)	29.0	23.1	11.2	8.2	3.3	4.0	5.8	4.3
Export price index of 12 months (%)	15.2	11.4	7.5	2.1	0.0	7.8	32.9	23.9
Consolidated balance sheet of banks (% of GDP)	38.1	43.7	63.1	55.9	62.5	68.7	71.6	73.5
Share of the foreign ownership in banking sector (% of share capital)	29.0	33.4	44.2	60.7	61.6	83.6	85.4	86.0
Capital adequacy of banks (%)	13.7	12.1	13.5	17.0	16.2	13.2	14.4	15.9
Change Talse (%)		60.3	65.6	-65.8	38.3	10.1	4.7	43.7
Consolidated loan portfolio of banks (% of GDP)	25.3	27.5	30.3	30.7	33.4	40.7	42.6	44.0
M2 (% of GDP) ¹	26.5	28.3	32.0	29.0	34.5	38.6	42.9	42.2
3 months Talibor (%)		8.0	8.6	13.9	7.8	5.7	5.3	4.0

¹ In January 2002, Eesti Pank (Bank of Estonia) changed the definitions of monetary aggregates. The main aim of the changes is to adjust and standardise the content of monetary aggregates M1 and M2. Monetary policy analysis has been adopting definitions of money supply excluding the deposits of non-residents and the central government. The elimination of the latter from the domestic money can be explained by the necessity to analyse, first and foremost, the behaviour of the local real economy. See more <http://www.ee/epbe/en/release/20020220.html>