I
SURVEY OF THE ECONOMIC POLICY

The start of the powerful growth of the world economy has been delayed once again, at least until the second half of 2003. There has been a certain pick-up, but this has not taken place as rapidly as expected. The 2002 growth forecast for the euro area is 0.8–0.9% and 2.2–2.4% for the USA, which is considerably below the predictions made in the spring. For the future, it indicates that even in 2003 the average economic growth in Europe will not regain its potential level. The growth rate has been relatively faster with Estonia's closest neighbours – the Nordic countries and Central and Eastern Europe.

The delay of the restoration of economic growth and lower inflationary pressure has enabled central banks to reduce base rates and maintain them at the lowest level of recent decades. No increase of interest rates is expected until the second half of 2003.

The sluggish growth of the world economy and uncertainty of future outlook is reducing price pressures. While in the third quarter such development kept the monetary policy interest rates of major economic centres low, then the following months were dominated by the desire to boost the economy. In November and December 2002, both the Federal Reserve and the European Central Bank cut the base rates by 0.5 percentage points.

ESTONIA

Financial Sector

The capitalisation of banks continues to be strong and liquidity buffers remain adequate. In the third quarter and the subsequent months the banking sector was still under the influence of the favourable interest rate environment and continuing high demand for loans, which was supported by the expansive monetary policy with the low interest rates of the external environment.

At the end of November, the annual increase of the non-finance sector debt burden was estimated at 24.6%, which is lower than the 28% peak indicators of June and July. The increase of the debt burden was smaller in August–October than in the respective period of 2001. A certain slowdown is also indicated by the slight decrease in the growth of monthly loan stocks in most banks. The increase of loans was still mostly related to households – by the end of October the annual growth of the stock of loans and leasing amounted to 47.5%.

In the autumn the central bank, the Financial Supervision Authority and the government took measures to support economic balance. On the recommendation of Eesti Pank the government sector reduced its deposits in domestic banks by more than one billion kroons between September and November. The central bank and the Financial Supervision Authority draw the banks' attention to the need to tighten the lending conditions.

According to preliminary estimations, these steps have had a positive effect, although their full impact can be seen in the longer run. However, it would be bad for the balance of the banking sector and the entire economy if the growth of loans would be financed through the increase of external liabilities, in case the growth of domestic savings remains small.

Inflation

In the summer of 2002, the increase of consumer prices was one of the lowest since the restoration of independence. Year-on-year, the cost of an average consumer basket was up 2.8% in the third quarter. The low point of inflation was registered in August when the increase of consumer prices dropped to 2.6%. Subsequently, the annual growth of consumer prices has accelerated due to external pressure, as could be expected. In October-November, inflation climbed to 3.1–3.2%, ie a level predicted for 2003.

The dynamics of Estonian consumer prices has been in line with the development in the euro area where the increase of consumer prices accelerated somewhat. The gap between price rises in Estonia and the euro area narrowed to less than one percentage point in the summer. In the longer run, such a small difference cannot be regarded as sustainable, since it has been strongly affected by the most volatile components of the consumer basket – the prices of food and fuel. The growth rates of core inflation differed by approximately two percentage points in the summer.

The increase of the real exchange rate of the kroon has slowed down alongside with the reduction of differences in the inflation rate. In the third quarter, the annual increase of the real exchange rate amounted to 1.2% against the currencies of industrial countries and to 5.6% against the currencies of transition countries. The latter figure was mostly determined by the weakening of the Russian rouble.

The 5th of December decision of the European Central Bank to lower interest rates indicates that the inflation rate is expected to fall in 2003, although this trend might not emerge in the next months.

Real Economy

The 6.7% annual growth of the Estonian economy in the third quarter proves that despite the external weakness growth is still fast due to high domestic demand, although this has required a lot of resources. Economic growth and the development of domestic demand were still contrary to the external environment.

Competitiveness of Estonian businesses has turned out to be better than expected – regardless of the weak external demand, the growth of production and export volumes has been stable in almost all economic sectors.

The rapid growth of capital investments in the business sector, including the sheltered sector, indicates trust in the Estonian economic policy. This is also supported by the evaluations of the rating agencies and the progress of NATO and EU expansion plans as expected. For example, the share of investments as a percentage of GDP has constantly been above 30%, remaining close to the all-time high.

In the third quarter, investments were one of the main sources of GDP growth, supported by the still favourable lending terms, optimistic future outlook of companies and the impact of major one-time projects. The deficit of the current account remained relatively high also in the third quarter, growing by approximately six percentage points year-on-year.

The growth of private consumption also remained robust in the third quarter. It was sustained by the continuing increase of household borrowing. Households differed from the business sector in their loan demands – the loan demand of companies began to decrease at the end of summer, reducing the overall annual growth of the real sector loans from above 28% in the second quarter to 25.7% at the end of October. The consumer confidence was also supported by the more than 10% nominal growth of the average wage and creation of new jobs in the service sector.

Although the large deficit of the current account can partly be attributed to major one-time projects, the worsening of the external balance is also affected by the low saving level of the private sector. Thus, the growth of private sector savings is the main precondition for the improving of external balance.

Public Sector

The adoption of two supplementary budgets accelerated the growth of consumption also in the government sector. Despite the growth of expenditures, the surplus of the government sector budget was the strongest economic stabiliser in 2002. The nine-month government sector surplus amounted to 2.2 billion kroons, which was more than 2.5% of the GDP of the same period.

The budget surplus was supported by faster than expected nominal growth of the economy and better tax collection. By the end of the year, the surplus of the state budget is likely to exceed 1.5% of the GDP. Due to the launch of the mandatory funded pensions system, the central government will lose part of the social tax income in 2003 and, regardless of cuts in the growth of current expenditures, spending will exceed income by approximately 0.3% of the GDP. The balance of the entire government sector budget also depends on the decisions made on the local government level.

Table 1.1. The most important indicators of the Estonian economy

	1995	1996	1997	1998	1999	2000	2001	9 months of 2002
Real growth of GDP (%)[1]	4.3	3.9	9.8	4.6	-0.6	7.1	5.0	5.7
Growth of special export (%)	21.7	11.8	39.0	19.1	-0.6	53.9	7.3	-4.7
Growth of special import (%)	36.4	27.3	40.1	12.9	-8.7	43.2	4.0	3.7
Current account balance (% of GDP)	-4.4	-9.2	-12.2	-9.2	-4.7	-5.8	-6.1	-12.2
General government budget deficit (-) / surplus (% of GDP)	-1.2	-1.5	2.2	-0.3	-4.6	-0.7	0.4	1.9
Consumer price index of 12 months (%)	29.0	23.1	11.2	8.2	3.3	4.0	5.8	3.8
Export price index of 12 months (%)	15.1	11.3	7.5	2.1	-0.4	7.8	32.9	4.0
Consolidated balance sheet of banks (% of GDP)	38.0	43.8	63.4	55.7	61.7	66.3	70.8	73.0
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	86.4
Capital adequacy of banks (%)	14.5	12.4	13.6	17.0	16.1	13.2	14.4	15.5
Talse change (%)		60.3	65.6	-65.8	38.3	10.1	4.7	20.6
Consolidated loan portfolio of banks (% of GDP)	17.4	23.5	33.3	32.5	34.9	39.3	42.2	44.7
M2 (% of GDP)[2]	26.5	28.3	32.0	29.0	34.5	37.8	42.2	41.7
3months Talibor (%)		8.0	8.6	13.9	7.8	5.7	5.3	3.9

[1] This year the Statistical Office of Estonia recalculated the GDP time series into the 2000 constant prices. Therefore, in the above Table the GDP growth rates and figures having ratio to the GDP differ from the earlier published ones.
[2] 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