BACKGROUND INFORMATION

ECONOMIC FORECAST FOR 2003–2004[1]

Despite the uncertainties in the external environment, the world economic growth is still expected to accelerate in the near future. This allows us to hope that Estonia's economic growth in 2003 will not differ much from the medium term trend. In the longer run, Estonian economic environment will continue to be influenced by the trade-based integration with world economic structures. The present risks are likely to disintegrate by 2004 and Estonian economic growth will continue near the potential rate.

Summing up the future scenarios, it is most likely that for Estonia the stagnation of the world economy will be relatively painless. However, should the standstill last longer, the risks would also mount for Estonia. As compared to the previous forecast[2], the year 2002 is seen in a more optimistic light, while the outlook of 2003 has been somewhat downgraded due to the persistence of external dangers.

External Risks

Within the past year, there have been exceptionally many changes in the expectations about the development of the global economic environment. By now, the belief in the impact of expansive economic policy has diminished considerably, as there are no sure sings of improvement. Due to the continuing uncertainty, it is now predicted that economic recovery will be slower than previously expected, and this applies to both Europe and the USA. The continuing recession has also changed the evaluation of potential sources of danger.

According to the summer forecasts, the 2002 economic growth was expected to reach approximately 1.5%. Now the growth expectations have been downgraded to 1%. The initial 3% growth forecast for 2003 has been cut back to 2%. However, expectations differ across regions – in Finland and Sweden, for example, economic growth is predicted to accelerate faster than in the rest of the EU. The smaller than expected economic growth of the euro area is, in turn, thought to reduce the increase of prices, which should remain below 2% in 2003. On average, however, inflation is growing in the world. The development of the Russian economy is expected to be relatively favourable for Estonia. No setbacks are expected in Estonia's movement towards the EU membership.

According to the above expectations, the external environment will probably improve somewhat, but not fast. For Estonia this means an additional effort to cope in the conditions of lower than usual external demand.

Discord of Internal and External Demand

The year 2002 was characterised by modest external demand of goods and high domestic demand. The latter was encouraged by expansive monetary policy signals from abroad, which in turn were amplified by domestic factors, such as optimistic expectations and major one-time deals. According to presumptions on external environment, the situation will reverse in the second half of 2003 – the external demand of goods will increase, while monetary policy will toughen. Consumption activity will probably be lower in Estonia than investment activity and hopefully the growth of the real sector's debt burden will slow down as the external environment changes.

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[1] This is the base scenario of the forecast.
[2] See Monetary Policy Survey, March 2002.

Cyclical Stabilisation Scenario

Under the base scenario of this forecast, Estonia will experience ***cyclical stabilisation on the demand side of the economy.*** *The growth rate of domestic demand will remain high, although it will be slightly slower than so far, while external demand will increase. According to this scenario, 2003 will be a year of moderate growth. Judging by the predicted 5% growth rate, the year could even be called successful, but at the moment this outlook is clouded by several serious risks. The situation will improve in 2004 when economic growth is expected to accelerate to 6% and the risks should disappear (see Tables 1b and 2b).*

Table 1b. Cyclical stabilisation scenario by most important economic indicators

	1999	2000	2001	2002[1]	2003[1]	2004[1]
GDP (EEK billion)	76.3	87.2	96.6	106.3	115.6	128.2
Real growth of GDP (%)	-0.6	7.1	5.0	5.3	5.0	6.0
Inflation (%)	3.3	4.0	5.8	3.7	3.3	4.5
Current account balance (% of GDP)	-4.7	-5.8	-6.1	-11.1	-9.4	-8.8
Primary current account/GDP (%)[2]	-2.8	-1.8	-1.0	-5.6	-4.2	-3.2
Real growth of private consumption (%)	-2.7	6.7	4.8	6.7	4.4	5.4
Real growth of public sector's consumption (%)	3.8	0.1	2.1	6.1	4.0	4.1
Real growth of investments (%)	-14.8	13.3	9.1	19.9	8.7	10.0
Real growth of exports (%)	0.5	28.6	-0.2	5.4	15.1	17.9
Real growth of imports (%)	-5.4	27.9	2.1	8.0	12.4	17.0
Employed (thousand inhabitants)	575.1	566.2	572.0	580.9	585.5	590.2
Growth of production (%)	4.0	8.8	4.0	3.7	4.2	5.2

[1] forecast
[2] primary current account equals the current account less income balance

Table 2b. Gross domestic product by components

	1999	2000	2001	2002[1]	2003[1]	2004[1]
Private consumpiton expenditures	57.5	55.7	55.7	56.0	55.9	55.8
Public sector end consumption expenditures	24.0	21.5	20.9	21.0	20.6	20.2
Total capital expenditures into fixed assets	24.9	25.4	26.1	289.0	29.4	30.1
Change of stock	-1.6	1.5	1.6	2.3	0.8	-0.1
DOMESTIC DEMAND	4.9	4.1	4.4	8.1	6.7	6.0
Export of goods and services	77.2	93.8	90.6	86.1	93.7	104.2
Import of goods and services	-82.1	-97.9	-94.4	-94.2	-100.5	-110.2
GDP IN MARKET PRICES	100.0	100.0	100.0	100.0	100.0	100.0

[1] forecast

Despite the stabilisation of the growth of domestic demand, investment activity will remain high and the investments-to-GDP ratio should amount to 30% (see Table 3b). The share of investments into the infrastructure will be large or even growing, and thus the economic growth stimulating impulses will emerge only in the medium term. Additional investments aimed at meeting the EU requirements are important among the cyclical factors. The spring forecast that consumption expenditure would grow faster than the GDP in 2002 held true in the first half of the year. Actually, the growth of consumption was even slightly faster than predicted. Therefore, the growth of

Table 3b. Balance of consumption and investments and components of current account (% of GDP)

	1999	2000	2001	2002[1]	2003[1]	2004[1]
Consumption	19.8	22.0	21.6	19.2	20.8	21.2
Investments	24.5	27.8	27.7	30.3	30.2	30.0
Primary current account	-2.8	-1.8	-1.0	-5.6	-4.2	-3.2
Current account	-4.7	-5.8	-6.1	-11.1	-9.4	-8.8
Balance of goods and services	-4.9	-4.1	-3.8	-8.1	-6.7	-6.0
Income balance	-2.0	-4.0	-5.1	-5.5	-5.2	-5.6
Current transfers	2.2	2.2	2.8	2.5	2.5	2.8

[1] forecast

private consumption for the entire 2002 has been upgraded, while the respective forecast for 2003 has been downgraded. Ungrounded optimism can be felt in the dynamics of both investments and consumption, which can become a source of additional danger.

The rapid decrease of the current account deficit is unlikely, due to the relatively rapid growth of domestic demand and gradually recovering external demand. The shrinking of the deficit predicted in spring presupposed a faster improvement of the external environment. Under the present forecast, the growth of the export of goods and services will exceed the growth of import in 2003. This will be the main source of improvement of the current account balance. In 2004, the growth rates of export and import will level out. The growth of the export of Estonian-made goods will remain larger than the growth of the import of products of our trade partners. Besides trade integration, this also points to Estonia's growing competitiveness. The balance of income would remain on more or less the same level against the GDP as in 2002, but in the longer run it is bound to worsen. According to the base scenario, the current account deficit of 2003 and 2004 would amount to 9.4 and 8.8% of the GDP, respectively (see Figure 1b).

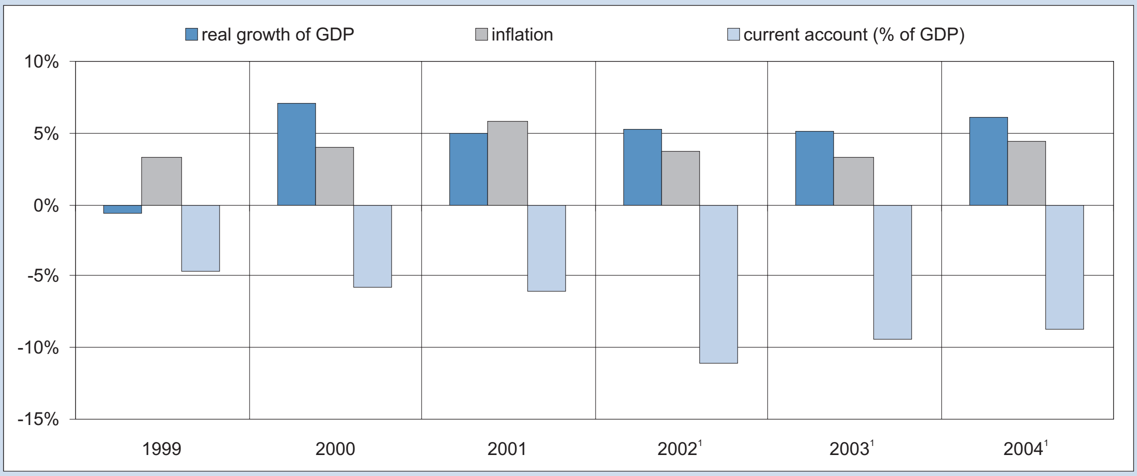

Figure 1b. Most important indicators of economic forecast

[1] forecast

Interest rates will change mostly due to domestic factors and the external interest rate pressure will affect Estonian rates only in the second half of 2003.

According to the base scenario, the price increase will be similar to that of 2002 and the inflation gap with the EU will remain practically unchanged. The 3.3% price increase predicted for 2003 is relatively small due to the lowering of external price pressure and postponement of administrative price hikes. In 2004, inflation is likely to accelerate to 4.5%.

In 2003, inflation will remain moderate due to the continuing impact of the lowering of import prices in 2002. The parliamentary elections will keep price increases below the annual average in the first half of 2003. However, the second half of the year will bring along the increase of administratively regulated prices, which will accelerate the inflation rate. The adjustment of administratively regulated prices will continue in 2004 and the external price pressure will also increase, alongside the acceleration of global economic growth.

There is no consensus on the development of oil prices, due to the uncertainty of the geopolitical situation. Different forecasts proceed from different Iraq-related scenarios. The prices of all other major raw materials will probably increase in 2003.