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SURVEY OF THE ECONOMIC POLICY

In the spring, various international forecasts predicted that the acceleration of world economic growth would continue and that by the end of 2002 major economic regions would reach the average growth rate of recent years. It was believed that besides the need of major economies to replenish their stocks, business sector investments as well as consumer spending would begin to grow already in the summer months. By now it has become clear that the expected revival of investments and private consumption has occurred neither in Europe nor in the USA. **This means that the economic recovery of the first quarter has failed to continue the way it was predicted.**

The slower than expected enlivenment of major economies means less favourable growth conditions for Estonia's export-based economy. Thus, there are no grounds to expect considerable improvement in external demand or rapid growth of the export volume. **This means that Estonia's 7% economic growth of the second quarter was partly based on the unrealistic expectations of companies and individuals about the near future and was extensively financed from foreign credits.**

Monetary Policy Environment

The delayed economic recovery has been accompanied by low demand-side price pressure in most major economies, and the inflation rate remains under control. In the euro area, the 12-month price increase dropped below the central bank's 2% target and in the USA inflation is even lower. This allows the central banks to keep base interest rates on the lowest level of recent years in the near future and continue stimulating economic growth through cheap credits.

Besides the fall of interest rates abroad, the difference between the interest rates of Estonia and the euro area has continued to narrow. Tight competition in the Estonian banking sector has also encouraged the decrease of interest rates. **As a result, the expansion of the monetary policy environment has been quicker in Estonia than in the euro area, which may not guarantee balanced development in the current economic policy situation. Therefore, Eesti Pank decided to take steps in mid-September aimed at tightening the monetary policy environment and, in co-operation with the government, to withdraw part of the government sector funds from the Estonian banking system.**

Financial Sector

According to different ratios, financial deepening has varied greatly throughout 2002. Thus, the growth of domestic savings has dropped to the level of the nominal growth of the GDP (approximately 10%), while the debt burden of the real sector climbed to 28% by the end of the second quarter. This points to a constantly growing deficit of domestic financing, which the banks have been covering with more and more foreign credits. At the same time, banks have maintained high capitalisation and profitability levels.

The financing of real estate deals is still increasing at the fastest rate and, on the whole, lending to households is growing. The share of loans to individuals has increased from 8.2% of the GDP at the beginning of the year to 10.5% of the GDP. This development raises the question of whether preferential development of the sheltered sector with foreign credits is indeed rational and would not lead to major setbacks in the future (due to growing interest rates or delayed increase of export income, for example).

Inflation

External pressure on Estonian prices has been decreasing throughout 2002 due to the weakness of the world economy. The moderate price increase has also been favoured by the wage development that has corresponded to productivity. However, cheapening of food has been the main factor that has kept inflation in check. This has been due to the weak external demand as well as the seasonal oversupply on the domestic market. Besides food products, external price pressure on fuel components has decreased as well.

The reasons for the current lowering of inflation are rather unstable. Therefore, their effect on the inflation rate can be considered temporary and August's 2.6% price increase is likely to be the lowest of 2002. In the autumn and the final months of the year the annual inflation will again climb to 4%.

Real Economy

Today, economic growth and import demand of Estonia's major export markets are still below that of 2001. Neither has there been any considerable global recovery. Despite a certain acceleration, the nominal growth of Estonia's direct export amounted to just 13% in the second quarter. This indicates that the export conditions are the toughest of recent years for Estonian companies and that the external demand environment does not favour the increase of the Estonian economic growth.

Unlike external demand, rapid increase of Estonia's domestic demand continued in the second quarter. Export income fails to cover investments and consumption expenditure and dependence on loans is deepening. Thus, the 7% growth estimate of the second quarter was mostly financed from foreign borrowing. Unlike in the first quarter, private consumption increased in the summer months as well, not just corporate investments. The increase of private spending exceeds the increase of income and therefore households are borrowing more and more from banks to cover this gap.

Increased reliance on borrowing and domestic demand that considerably exceeds the growth of export income are feeding the deficit of the current account. In the second quarter, Estonia's current account deficit was estimated at approximately 10% of the GDP. Besides high investment activity, the deficit is caused by the decline of the level of domestic saving, which has mostly occurred in the private sector.

The share of debt-related money flows increased in the external financing of the current account deficit. While direct investments used to cover approximately 90% of the external financing needs of the Estonian economy then in the first half of 2002 this cover decreased and has been partly replaced by long-term credits. This, however, leads to the growth of Estonia's gross and net external debt. Nevertheless, the latter has not exceeded the 10% level of the GDP.

Government Sector

Estonia's growing current account deficit means that thanks to indirect taxes collected from imported goods the conditions for the revenue intake were the most favourable of recent years in the first half of 2002. Therefore, the government sector reached a six-month budget surplus amounting to 2% of the GDP of the corresponding period. Thus, from the point of external balance, the fiscal policy had a positive effect, although it was unable to balance the unusually high investment demand and lowering of the private sector savings level.

The drafting of the second additional budget in the summer months means, however, that the positive effect on the external balance will no longer be the case. In the second half of the year the effect of the fiscal policy on the current account is probably going to be negative. Therefore, only the increase of private sector saving can improve Estonia's external balance.

Outlook

The halt of global economic recovery and great fluctuations of international financial markets in the summer months forced most international analysts to adjust their forecasts. Thus, for example, the average economic growth of the euro area is now predicted to reach 1.1% in 2002 and 2.5% in 2003. In the spring, 0.2–0.3 percentage points higher indicators had been suggested. Forecasts of the US economy have been downgraded even more. Despite the considerable downgrading of the prospects of global economic recovery, the majority of forecasts still predict acceleration of economic growth in the second half of the year. Still, there are some doubts as to whether the world economy would reach the near-potential growth by the spring of 2003.

For Estonia, the slower than predicted growth of external demand means that there will be no rapid increase of export income in the near future. Although it is still possible that external demand environment might improve in the second half of the year, maintaining of sustainable external balance will remain a problem for Estonia. **Therefore, the only way to achieve this balance is through curbing domestic demand and borrowing. As external interest rate signals are unsupportive in this respect, Eesti Pank can apply additional monetary policy tightening measures besides the withdrawal of government sector deposits from the banking sector, should the imbalance of the economy deepen.**

Table 1.1. The most important indicators of economy

	1995	1996	1997	1998	1999	2000	2001	1st half of 2002
Real growth of GDP (%)[1]	4.3	3.9	9.8	4.6	-0.6	7.1	5.0	4.9
Growth of special export (%)	21.7	11.8	39.0	19.1	-0.6	53.9	7.3	-14.2
Growth of special import (%)	36.4	27.3	40.1	12.9	-8.7	43.2	4.0	-4.1
Current account balance (% of GDP)	-4.4	-9.2	-12.2	-9.2	-4.7	-5.8	-6.1	-12.5
General government budget deficit (-) / surplus (% of GDP)	-1.2	-1.5	2.2	-0.3	-4.6	-0.7	0.4	2.1
Consumer price index of 12 months (%)	29.0	23.1	11.2	8.2	3.3	4.0	5.8	4.2
Export price index of 12 months (%)	15.1	11.3	7.5	2.1	-0.4	7.8	32.9	8.0
Consolidated balance sheet of banks (% of GDP)	38.0	43.8	63.4	55.7	61.7	66.3	70.8	74.2
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 (%)	14.5	12.4	13.6	17.0	16.1	13.2	14.4	14.7
Talse change (%)		60.3	65.6	-65.8	38.3	10.1	4.7	6.6
Consolidated loan portfolio of banks (% of GDP)	17.4	23.5	33.3	32.5	34.9	39.3	42.2	45.1
M2 (% of GDP)[2]	26.5	28.3	32.0	29.0	34.5	37.8	42.2	42.5
3 months Talibor (%)		8.0	8.6	13.9	7.8	5.7	5.3	4.0

[1] This year the Estonian Statistical Office 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