II
ECONOMIC DEVELOPMENTS

EXTERNAL ENVIRONMENT

In the first quarter of 2002 economic activity increased, as had been expected. In major economies enlivenment was mostly based on the increase of manufacturing industry, due to the need to replenish inventories, including high technology products. The early year optimism was, however, significantly dampened by the weakness of end demand, first of all private consumption and investments. Therefore, the International Monetary Fund (IMF) believes that the average growth rate of previous years will be achieved only in 2003. This year, world economic growth is expected to remain below the average trend (2.7%).

Inflationary pressure remained weak in major economies. Inflation was a problem only in the euro area, which gave rise to expectations that the European Central Bank might abandon its neutral monetary policy stance. The surge of oil prices, caused by political pressures, can also weaken end demand and extend the time needed for restoring the growth trend of the world economy. Higher energy prices lead to higher production costs and lower profitability for the manufacturing and this, in turn, made new investments less attractive.

Due to the weakness of economic growth and uncertainty of its prospects the central banks of the USA, Japan and the European Union maintained the base interests on the level that stimulates economic growth. First of all, strengthening of end consumption is waited for, in order to get confirmation of the sustainability of economic growth. Some countries – Canada, Australia, Sweden and New Zealand, for example – have already begun to tighten monetary policy.

The United States of America and Japan

According to the annualised indicator, in the **US** the GDP grew by 5.6% in the first quarter. Most of the rapid growth can be contributed to temporary factors, first of all, replenishing of inventories, which accounted for 3.5 percentage points of the GDP growth. The demand boom on the housing market due to low interest rates also supported economic growth. However, the total growth of end demand amounted to just 2%, caused by the fall of investment volumes of companies. The IMF has upgraded this year's US economic growth forecast to 2.2% (see Table 2.1).

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

	GDP growth (%)			CPI change (%)			Unemployment (%)		
	2001	2002	2003	2001	2002	2003	2001	2002	2003
World	2.5	2.7	4.1						
USA	1.2	2.2	3.4	2.8	1.4	2.4	4.8	5.5	5.3
Japan	-0.4	-1.0	0.8	-0.7	-1.1	-0.5	5.0	5.8	5.7
Euro area	1.5	1.2	2.9	2.7	1.7	1.6	8.4	8.7	8.4
Germany	0.6	0.7	2.7	2.4	1.1	1.2	7.4	7.8	7.6
France	2.0	1.3	3.0	1.8	1.4	1.4	9.0	9.4	9.0
Great Britain	2.4	2.0	2.8	2.1	2.4	2.5	5.1	5.4	5.4
Finland	0.6	1.4	3.1	2.6	1.5	1.6	9.2	9.8	9.7
Sweden	1.3	2.0	2.8	2.6	2.3	2.1	4.0	4.4	4.3

Source: International Monetary Fund, World Economic Outlook, March 2002

Strengthening of end consumption in the USA is still prevented by various factors. The economic situation of both households and businesses has weakened over previous quarters. Private consumption has so far been supported by very favourable terms of credit, which has kept up the growth of the debt burden of private individuals and increased the share of borrowing-based consumption. However, the turnaround in industrial production has not had a significant positive effect on the labour market. At the beginning of 2002, the unemployment level continued to rise in the USA and climbed from 5.8% to 6.0% by April. This means that the US economy lacks considerable internal reserves for the possible re-acceleration of consumer spending. The uncertainty of outlook was also caused by the weaker than expected level of some other real economy indicators. The more moderate view on the US economic recovery was also reflected in the fall of stock markets and weakening of the dollar.

In the first months of 2002, US inflation rate fell to the historical low of 1.1% but climbed to 1.6% by April. Excluding changes in energy and food prices, the April inflation rate was 2.5% but it is likely to fall in the coming months.

According to the Federal Reserve, economic recovery has consolidated, although certain risks on further development remain. Due to low inflation and inflation expectations the dominating view is that the Federal Reserve may delay tightening of monetary policy. The US government, on its part, applies extensive fiscal policy measures that cover tax cuts, investments and additional consumption.

After a downturn in the previous nine months, **Japan's** year-on-year GDP growth was estimated at 5.7% in the first quarter of 2002. The growth was achieved thanks to the global economic recovery that stimulated both export and domestic demand. The growth of external demand accounted for 2.6 percentage points of the GDP increase, among the domestic demand components, both government and private consumption strengthened, although investments continued to fall. Despite the first quarter growth, production decrease or zero growth is feared in the next quarters. Therefore, Japan's economic growth forecasts have been repeatedly cut (the IMF's forecast for this year is still negative at -1.0%).

Unemployment decreased to 5.2% in April, reflecting the positive effect of economic recovery on the labour market. However, deflation remained, being a long-term problem of the Japanese economy. Overcoming deflation presupposes further strengthening of economic growth as well as structural reforms. Economic difficulties and high debt burden forced the Moody's rating agency to lower Japan's sovereign rating to the level of A2.

European Economies

Euro area economy passed the low point around the turn of the year and a slight growth was achieved in the first quarter of 2002 (annualised 0.9%). The first quarter growth on the whole was, however, characterised by decreasing domestic demand, the steepest since early 1993 (private consumption fell by 0.2% and investments by 0.7%). Unlike in the USA, inventories continued to decrease in the euro area. Thus, economic growth was entirely based on the growth of export and net export accounted for 0.7 percentage points of the GDP. Due to the weakness of economic growth, unemployment continued to rise, reaching 8.3% in April. According to the IMF forecast, the euro area economic growth will not exceed 1.7% in 2002.

At the beginning of 2002, inflation rose to 2.7%, but decreased to 2.4% in April, still above the European Central Bank's target of 2%. However, the central bank's forecast foresees the drop of the average inflation rate to 2% already this year. In the first quarter, pressure on consumer prices mostly came from the weakening of the euro, the euro cash changeover and volatile energy prices.

Continuing high inflation and weaker economic policy incentives have kept European consumer spending considerably lower over the past six months than in the USA. Last year the ECB lowered interest rates by 1.5 percentage points, but this was considerably less than in the USA. Besides monetary policy, fiscal policy, too, has failed to encourage demand sufficiently. The budgets of most euro area countries were in deficit already in 2001 and therefore the governments of these countries have more limited possibilities to stimulate economic growth.

Sweden and Finland

Sweden's first quarter economic growth was based on strong domestic demand and the expansion of the so-called old economy industries. In the conditions of export-based economic structure the determining factors were the gradual increase of economic activity in the USA and the euro area countries.

The outlook of the Swedish economy is considered to be better than that of Finland's. In the first quarter of 2002 Swedish industrial production grew by 0.9% compared to the fourth quarter of 2001. For the first time, the USA became Sweden's biggest export market for industrial products such as passenger cars, pharmacy products and communication equipment. The development of the telecommunications sector is slower.

The negative impact of the global recession of the technology cycle on the economic development of **Finland** proved stronger and longer than predicted. Considering Finland's relatively narrow export range, the growth of end demand on world markets was modest at the beginning of the year. Therefore, the total output of the Finnish economy decreased by 2% in the first quarter and, according to forecasts, will reach the euro area average only in 2003.

While the weakening of the krona created additional inflationary pressure in Sweden, growth of prices is subsiding in Finland, like in most euro area countries. The expectations of the Swedish central bank on the slowdown of inflation have not materialised so far and the annual increase of base inflation accelerated to 3.3% in the first quarter. Both in Finland and Sweden the inflation growth will be affected in the near future by the development of the supply-side temporary factors, including oil prices.

In Finland as well as Sweden economic policy supports growth. Expansive fiscal policy is possible thanks to the reserves accumulated in previous years. The Swedish central bank, which exercises independent monetary policy, has increased the repo rates already twice in the spring of 2002 (up to 4.25%). The interest rates turned upward already before the definite strengthening of end demand, since the effect of monetary policy tightening on inflation becomes evident after a lag of more than a year. The markets expect an additional increase of interest rates to 5% by the end of this year.

Emerging Countries

Several **developing countries of Asia** are already overcoming the recession, while others need a little more time. With the upturn of the US economy and global economic recovery, an increase of economic activity is expected in this region as well. The more open countries of the region depend on the revival of external demand, first of all in the information technology sector. Year-on-year, most production and export volumes are still below the 2001 level. Month-on-month growth, however, is mostly positive. Confidence indicators continue to rise as well. Of industrialised countries, recovery has been the fastest in South-Korea where year-on-year production and export growth are both positive. The rapid rate of Chinese economic development has not slowed down and in the first quarter industrial output increased by 10.9%. In China, sustainability of the fiscal sector is an important risk factor. The 2002 GDP growth of the region is expected to be positive due to the acceleration of broader growth in the second half of the year (see Table 2.2).

Table 2.2. The most important economic indicators of some selected emerging countries

	GDP growth (%)			CPI change (%)			Current account balance (% of GDP)		
	2000	2001	2002[1]	2000	2001	2002[1]	2000	2001	2002[1]
Argentina	-0.5	-3.7	-8.4	-0.9	-1.1	15.9	-3.2	-2.1	0.9
Brazil	4.4	1.5	2.5	7.0	6.8	5.8	-4.1	-4.6	-3.8
Mexico	6.9	-0.3	1.7	9.5	6.4	4.4	-3.2	-2.7	-3.2
China	8.0	7.3	7.0	0.4	0.7	0.8	1.9	1.5	1.0
Czech Republic	2.9	3.6	3.1	4.0	4.7	3.5	-4.8	-4.8	-5.2
Poland	4.1	1.1	1.8	10.1	5.4	3.8	-6.3	-4.0	-4.3
Hungary	5.2	3.7	3.5	9.8	9.1	5.1	-3.3	-2.2	-2.9
Estonia	6.9	5.3	5.0	4.0	5.8	3.5	-6.4	-6.5	-6.8
Latvia	6.6	7.6	5.0	2.6	2.5	3.0	-6.9	-10.1	-7.0
Lithuania	3.9	5.7	4.0	1.0	1.3	2.8	-6.0	-4.8	-5.8
Russia	8.3	5.4	3.4	20.8	20.7	14.1	18.0	11.2	6.1

[1] Forecasts
Source: International Monetary Fund, World Economic Outlook, March 2002

The outlook of the **Argentinean** economy is unclear in the short term, but decrease of the GDP and acceleration of inflation are unavoidable in 2002. Year-on-year, industrial output dropped by 17% in the first quarter. The fiscal situation is complicated and tax revenue low. On 6 January 2002 the Argentinean Congress decided to abandon the fixed exchange rate of the peso against the dollar, which had been in place for 11 years, and thus gave the government free hands to devalue the peso. Two exchange rates were introduced – the so-called official rate was set at 1.4 pesos for a dollar, which was applied to large government and business transactions, and the market rate for all other transactions. This two-rate system was maintained for a much shorter period than planned, only for a month. On 2 February the peso was allowed to float. Despite restrictions, the outflow of deposits caused major liquidity problems in the banking sector. The weakening of the peso is again undermining price stability after a break of a decade. In the first quarter of 2002 consumer prices climbed by 9% and wholesale prices by 28.3%. Producer prices have increased even faster than consumer prices. The IMF has promised to support Argentina, but in what form and to what extent is another matter. Talks between the IMF and Argentinean authorities have not made any rapid progress so far. In 2002 several private institutions expect the GDP fall to exceed more than 10%.

In the **Central and Eastern European countries** the US and European recession was felt less than in other developing countries. In 2002, economic growth is expected to recover, although it depends mostly on the economic development of West European countries.

The growth of **Latvian** economy has slowed down after the 2001 takeoff. In January, the volume of industrial output increased by 4.8% year-on-year at constant prices. In February the year-on-year increase amounted to just 0.2% and in March the growth was even negative (-5.5%). The main reason for the slowdown was the weakening of external demand. Domestic demand was strong in the first months of the year and retail sales grew by 12% in the first quarter (in constant prices). The trend of foreign trade deficit expansion continued in the first months of 2002. The growth rate of both export and import slowed down throughout the first quarter. The inflation rate has been slowing down since the beginning of the year. While in January the 12month increase of consumer prices was 3.5%, then in April only 2.9%. The annual CPI growth is expected to be 3%. The budget revenue intake was successful in the first quarter. Thedeficit was even two times smaller than the 20 million lats agreed upon with the IMF. The collection of tax revenue exceeded the target by 7.7%. Budget revenue exceeded expenditure by 5.3 million lats in April.

The Bank of Latvia upgraded the 2002 economic growth forecast to 5%. The upgrade is based on the halt of economic downturn in the USA and Europe, which is expected to have a positive effect on developments in Latvia. Later the IMF, too, adjusted its forecast to the same level.

Due to the worsening of external environment **Lithuanian** economic growth was weaker in the first months of 2002 than it had been at the end of last year. The statistical office estimated Lithuania's first quarter GDP growth at 4.1%. Lithuanian economic growth depends largely on export and the impact of unfavourable external developments was felt already at the beginning of the year. The sale of industrial production dropped by 4.6% in January and 3.5% in February. Lithuania's foreign trade balance deteriorated in the first months of 2002, but in March a definite change for the better occurred. Export increased by 10.6% against March 2001. The share of domestic demand has begun to grow strongly and the year-on-year retail turnover was up by 12.8% in the first quarter. After the higher price increase in January-February (3.2 and 2.8%, respectively) the growth of consumer prices slowed down considerably in March, amounting to just 1.6%, year-on-year. The budget revenue collection proceeded as planned in the first quarter and fell within the set boundaries.

Expectations of economic growth acceleration are based, first of all, on the improvement of external environment and recovery of export growth. Proceeding from this presumption, the Lithuanian Ministry of Finance upgraded the 2002 growth forecast from 4% to 4.4%.

Economic development of the **Czech Republic** was rather stable in the first quarter. Since the mid-2001 the Czech industrial growth has been the fastest among the three most important countries of Central Europe (the Czech Republic, Poland and Hungary). At the beginning of this year the robust growth of industry continued and even the ever increasing exchange rate of the Czech koruna against the euro was unable to slow it down. However, exporters and the central bank are worried about the strengthening of the national currency, as its effect may become apparent later on. The increase of consumer prices continued to be moderate.

In **Hungary,** the first quarter GDP growth was estimated at 2.9%. Retail sales were strong, as well as the growth of investments in the public sector. The annual growth of industry, however, failed to turn positive in the first two months of the year, despite all efforts. Still, in March industrial output increased by 3.1%, which also pointed to the improved outlook of the industrial sector. Inflation continued to fall in the first quarter, but in April the 12month CPI increase was steeper than expected – 6.1%. The change of the trend resulted from higher fuel prices, rapid wage increase and higher than expected budget incentives. Therefore, the fall of interest rates has come to a halt by now and the central bank has taken the course to the rate increase.

In **Poland**, the economic indices of the first quarter were not as positive. The GDP growth was just 0.3%, according to preliminary estimates. The year-on-year decrease of industrial output was 1.6%. Private consumption increased against the first quarter of 2001. The CPI growth was between 3.3% and 3.5% and the trend was still down. Low investment demand dragged down import in the first quarter and due to the recession in the EU (mostly Germany) and the strong zloty export fell too. Further lowering of the interest rate is being considered due to the slowdown of economic growth.

The **Russian** economy grew by 3.3% in the first quarter, according to the estimates. Economic growth is supported by strong domestic consumption and fuel export, which increased by 19%. Other manufacturing sectors, however, have been declining since the end of 2001. An additional negative blow was received from the US decision to introduce custom tariffs on steel import.

Economic growth is not expected to accelerate in Russia this year. The growth is hindered, first of all, by the weak export potential that largely depends on the demand of oil products on the world market. The main internal obstacle is the further decline of profitability (20.8% in January-February), caused by the fast tariff hikes of infrastructure monopolies. The weakening of economic growth is also undermining the fiscal outlook of Russia – in the first quarter tax collection (excluding social tax) fell 3.5% short of the target and in February the federal budget deficit amounted to 2.1%.

International Financial Markets

On **currency markets** the weakening of the dollar was the most important change, which began in February 2002 and gained particular momentum in April and May (see Table 2.3). This could mean the end of the long-term investment boom-related strengthening of the dollar, activated by the weakening of US growth expectations and further decline of the stock market, although a number of other factors can be mentioned – first of all, the large and growing deficit of the current account. Thus, it is not the strength of the economies of the euro area and Japan, but rather the weakening of the leading position of the US economy. The continuing weakening of the dollar can encourage further outflow of money from US assets into other assets, including those of the euro area, which would further undermine the position of the dollar. Therefore, this can become a serious risk to the US economy and its growth prospects.

Table 2.3. Changes in exchange rates of major currencies

	31.12.02	31.05.02	Change
JPY / USD	131.66	124.22	6.0%
USD / EUR	0.8895	0.9342	5.0%
USD / GBP	1.4546	1.4553	0.1%

The dynamics of the **stock market** varied across different regions. Decline continued in the USA and the euro area, as investment growth failed to recover in the first quarter and its prospects are unclear. Despite the fall of stock prices, the earnings of companies have decreased even faster: the respective ratio of the stocks included in the S&P 500 index climbed to 46 last year, which is three times higher than the historical average. The Nasdaq index dropped the most among the stock indices, reflecting continuing unpopularity of the US technology shares (see Table 2.4). Prices on the Japanese stock market were up, thanks to the strengthening of the yen and faster growth of industrial production as compared to other leading economies.

Table 2.4. Indices of major stock markets

	31.12.02	31.05.02	Change
USA (S&P 500)	1,148.08	1,067.14	-7.1%
USA (Nasdaq)	1,950.40	1,615.73	-17.2%
Japan (Nikkei 225)	10,542.62	11,763.70	11.6%
Euro area (Eurotop 300)	1,261.06	1,176.12	-6.7%

Bond markets were under the influence of contradicting forces at the beginning of the year. On the one hand, economic data pointed to recovery in Japan, the USA and the EU countries, but at the same time growth expectations decreased. Relatively low inflation allowed the central banks to maintain base rates on the level that stimulated economic growth and wait for the strengthening of end demand. Decline of the US and euro area stock markets, surge of crude oil prices and increase of geopolitical risks (conflicts in the Middle East and between India and Pakistan, continuing threat of terrorist attacks in the USA) also added pressure to interest rates. Thus, short-term rates remained unchanged and only the 10-year interest rate of the euro area increased slightly, reflecting the higher than expected inflation in the region this year (see Table 2.5).

Table 2.5. Interest rates of major bond markets

	Interest rates of 3 months			Interest rates of 10 years		
	31.12.02	31.05.02	Change (basis points)	31.12.02	31.05.02	Change (basis points)
USA	1.73	1.73	0	5.05	5.05	0
Japan	0.01	0.01	0	1.37	1.39	2
Euro area	3.38	3.41	3	5.00	5.17	17

On the **raw material markets** the price increase, which resulted from the global economic recovery of the fourth quarter of 2001, continued: the CRB index, which includes the prices of all basic raw materials, climbed by 7.1% in the first five months of 2002. The most important development was the 27.6% rise of crude oil prices (21.5% expressed in euro) that was seen as a serious risk to global economic growth as well as inflation outlook. The increase of crude oil prices derived from limited supply and growth of political tensions in the Middle East, while demand has been constantly below production capacities due to the weakness of economic growth.

ESTONIAN ECONOMY

Domestic Demand

Private Consumption and Investments

At the beginning of 2002 there was a favourable environment for the development of domestic demand in Estonia. Although the decrease of foreign interest rates came to a halt at the turn of the year, it was not followed by a surge of loan costs as expected by the markets. As a result, the interest rates of the Estonian money market and bank loans have remained stable since the beginning of the year, near the all-time low. This keeps demand for loans high and in the first quarter the financial sector mediated almost 2 billion kroons into the Estonian economy, which is 50% more than in early 2001. The loan demand of private individuals still exceeds the growth of private bank deposits.

Favourable financing terms for investment and consumption combined with growing government spending meant that the rapid growth of domestic demand in Estonia continued in the first quarter. **Like in 2001, domestic demand relied strongly on investment activity, although private and public consumption picked up as well.** While investment activity is supported by the favourable interest rate environment combined with the realisation of some large-scale (in the Estonian context) projects, then consumption of both private and public sector is encouraged by the 2002 state budget, in which spending grows faster than income. In private consumption this could be seen from the 25% growth of state benefits in the first quarter, in public consumption it was manifested by the increase of all basic current expenditures.

Public Sector

In early 2002 the government sector balance was maintained thanks to higher than expected tax receipts (see Figure 2.1). In four months, the revenue of the central government exceeded the forecasts by approximately one billion kroons and grew by 20% year-on-year. As a result, the general government budget had a surplus of more than 700 million kroons in the first four months.

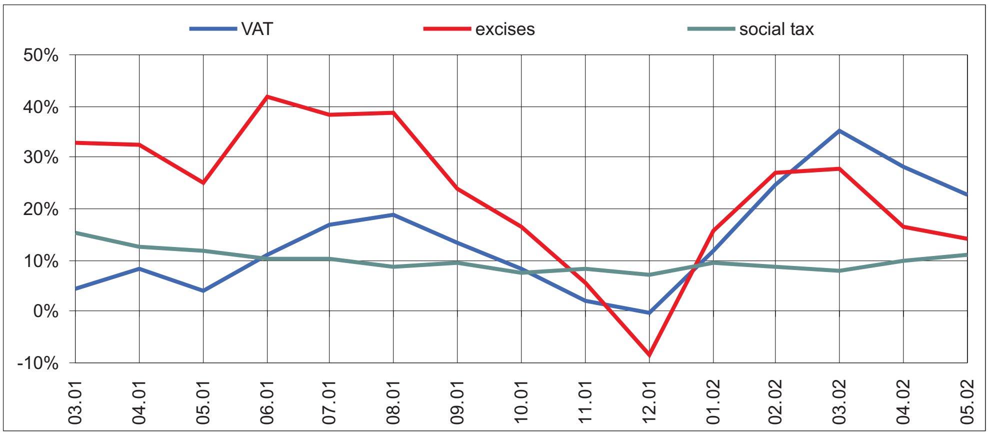

Figure 2.1. Annual growth of tax income receipts to the central government budget (sliding average of last 3 months)

The good intake of tax revenue was based on indirect taxes. This was achieved through better tax administration as well as factors of temporary nature. Due to the slowdown of exports, VAT refunds have been lower throughout 2002 than they were at the beginning of 2001. **Thus, the better than expected intake of indirect taxes did not result from rapid economic or tax basis growth, but rather from the reduction of refunds related to the weakness of exports.** However, this kind of tax revenue growth is always temporary, therefore, the increase of tax intake is expected to slow down in the second half of the year.

Besides the temporary nature of good tax intake, it is extremely important to maintain the conservative line of the fiscal policy in the present conditions when the growth of domestic demand exceeds export earnings. In near-term the external economic environment continues to favour (through low interest rates) the development of Estonia's domestic demand rather than the export of goods. Therefore, all additional revenues should be used for strengthening the structure of state budget. **The adoption of new supplementary budgets should be excluded and, instead, attention should be focused on further improving the balance of the state budget.**

Domestic Saving

Although the deterioration of the external balance in the first quarter was mostly related to the lively investment activity, private sector saving (probably in both households and businesses) decreased as well.

While in case of private individuals the decline of saving is expressed by increased borrowing, then in the business sector it can be seen from decreasing profitability. The latter resulted mainly from the increase of labour costs that exceeded the growth of productivity. Although in the short term it does not have a particularly negative impact on the competitiveness of businesses, the continuation of such a development reduces the growth opportunities of the Estonian economy and puts additional domestic pressure on inflation.

Domestic Supply

Regardless of the industrial production based acceleration of world economic growth, the import demand of Estonia's major trade partners did not improve at the beginning of 2002. The import volumes of Finland and the majority of other euro area countries are still smaller than last year.

Continuing weak external demand began to affect more and more the sale opportunities of Estonian companies. The production volume of manufacturing increased by 4.9% in four months, with negative growth registered in March (see Figure 2.2). Although different factors affected production in different branches of the industry, these can be broadly put under one common denominator – overall weak external demand. Therefore, the growth of export and production volumes slowed down in almost all major branches of industry in the first quarter.

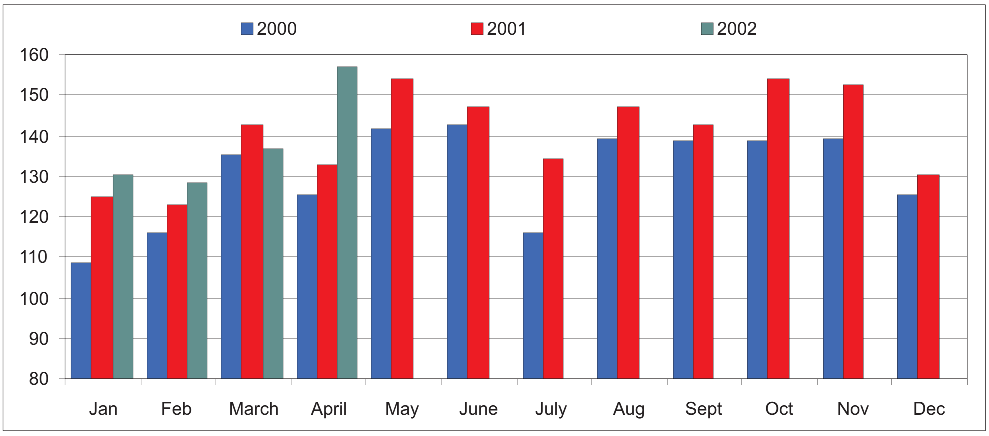

Figure 2.2. Monthly sales of the manufacturing in constant prices (January 1997 = 100)

In food industry, production was hindered by the legal controversy around the export of fish products at the beginning of the year and overproduction of dairy products on European markets. In the first quarter, the production volume of the dairy industry was down by 15% year-on-year and the export prices of food fell by 3.1% in three months, mostly due to oversupply in Europe. The precise electronics sector is affected by the recession of the global technology sector, which has lasted longer than expected, with no recovery in sight in the near future. Most of the world's major companies of this sector have downsized their 2002 sales forecasts after learning the results of the early year. Due to weak global demand, export of the subcontracting sector of the Estonian electronics industry was 50% smaller in current prices than it had been in the first quarter of 2001 (see Figure 2.3).

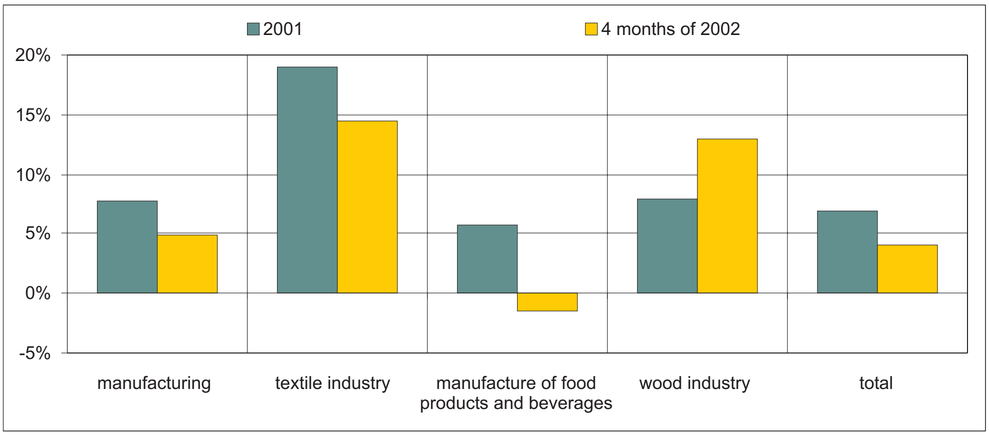

Figure 2.3. Growth of industial output by economic activities

Thus, the slowdown of economic growth in the first quarter of 2002 to 3.6% reflected the weakest external demand environment of recent years. Preliminary estimations on the euro area economic growth for the same period are, on average, three percentage points lower. **This means that despite the slowdown of growth, the Estonian economy managed to maintain the rate of convergence that can be considered sustainable also in the middle term.**

Regardless of the slowdown of the growth of export and industrial production, the fall of unemployment that had begun last year continued also in 2002 and unemployment decreased to 11.2%. The growth of labour demand was based on the strong service sector and fields of activity orientated to meeting domestic demand. However, compared to previous quarters the improvement of the labour market indicators is slowing down – while employment growth accelerated throughout 2001, the creation of new jobs stabilised at the beginning of 2002. This means that the positive impact of rapid economic growth is wearing off on the labour market. The positive outlook of the services sector and continuing strong domestic demand, however, allow us to presume that labour demand is unlikely to fall in the near future.

External Sector

While at the end of 2001 Estonian companies managed to oppose the deterioration of the external economic environment by penetrating new markets, then in early 2002 the weak external demand began to affect local export more clearly. The recession of the subcontracting export, affected by the global weakness of the technology sector, was accompanied by the slowdown of the growth rate of normal export (see Figure 2.4).

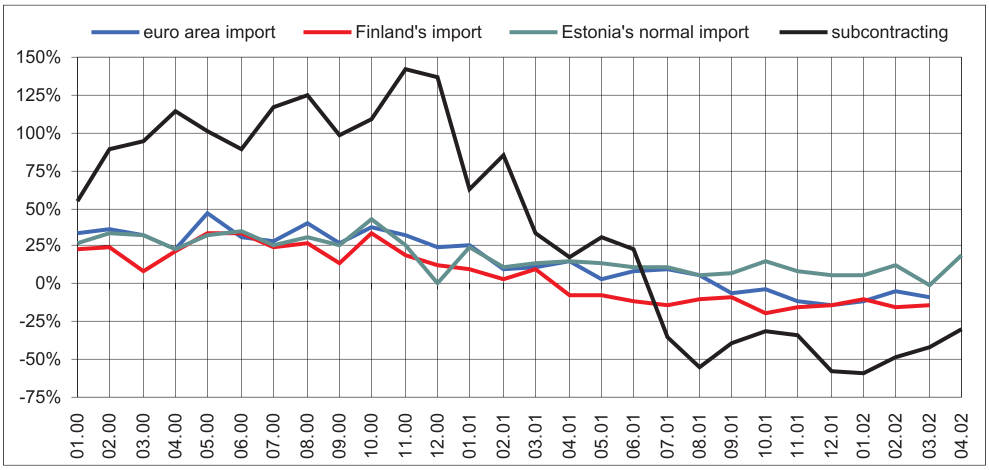

Figure 2.4. External demand and Estonia's export (annual nominal growth)

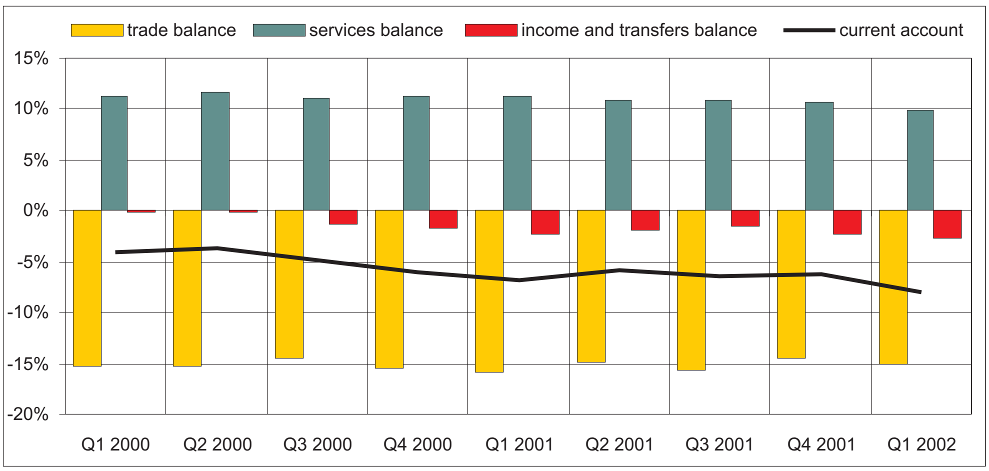

Figure 2.5. Current account and its major components (% of GDP; moving average of 4 quarters)

In the first quarter, the nominal volumes of normal export were up by just 7%, which is one third less than in the last months of 2001. As foreign experts expect the recovery of world economic growth only in the second half of 2002, it is unlikely that export would offer substantial support to Estonia's economic growth in the coming months.

The growth of domestic demand at a faster rate than exports put increasing pressure on the external balance at the beginning of the year. The four-quarter sliding average deficit of the current account increased by 1.9 percentage points, reaching 8.1% of the GDP of the respective period (see Figure 2.5). A new source of volatility was the growth of services import, which reduced the year-on-year surplus of the services balance to the GDP by 3.4 percentage points in the first quarter.

The growth of domestic demand regardless of the slowdown of export can only last for a short period of time. The continuation of the present growth rate of domestic demand presupposes the recovery of export volumes already in the near future. Otherwise, increasing borrowing will deepen imbalances.