II
ECONOMIC DEVELOPMENTS

EXTERNAL ENVIRONMENT

Global Background

The third quarter of 2002 and the following months have been full of contradictions in the world economy. Since the recovery of the first half of the year, which was stimulated by the need to increase stocks, the growth of industrial production has fallen in major economic regions and several risks threatening the entire process have increased. The growth rate was faster in the USA, where low interest rates encouraged private consumption, and in Japan. In the euro area, the growth remained slower than expected. The outlook for the fourth quarter and the year 2003 has worsened, which can be seen from the downgrading of earlier forecasts. The global economic climate has deteriorated also due to the geopolitical tensions related to the possible war against Iraq.

Economic indicators of November and December also reflected the continuing weakness of the world economy. Industrial activity was low, as well as consumer confidence. Quarter-on-quarter, the results were, however, slightly more positive (mostly in the USA). The JP Morgan's global indicator of economic activity rose for the first time in the past five months. Among other regions, the leading position belongs to developing Asia where activity growth is based on the electronics industry. No significant improvement took place in the euro area and Japan, where changes could rather be interpreted as stabilisation. Rapid growth of production still needs higher demand. This is also indicated by the relatively low stocks in all the regions.

The fall of stock markets continued in the third quarter and even accelerated since demand for investments remained low. In October and November, the markets stabilised and even moved upwards temporarily. Annual inflation in the OECD member countries amounted to 2.4% in September, which is 0.5 percentage points down since the beginning of the year. As economic growth remains weak, there is no danger that the inflation rate would accelerate significantly and it is even expected to slow down. Only the price of crude oil can speed up inflation in the near future, due to the increase of geopolitical risks. In December, the oil price climbed again above 30 dollars a barrel.

Monetary policy interest rates were cut in order to reduce the risks threatening economic growth and increase confidence. On 6 November, the US Federal Reserve cut base rates by 50 basis points – to 1.25%; the European Central Bank cut the rates to 2.75% on 5 December. Base rates were also reduced by the central banks of Sweden and Denmark.

United States of America

Year-on-year, the adjusted GDP growth amounted to 3.2% in the third quarter. The main source of growth was private consumption as low interest rates encouraged purchases of durable goods. However, the growth of investments remained negative for the eighth consecutive quarter, which means that businesses are still insecure about the near future.

Despite the positive economic results of the third quarter, industrial activity fell quickly. In October, industrial production dropped for the third month in a row and the industrial activity index ISM showed a downward trend also in November. Private consumption, which had increased relatively fast in the third quarter due to housing loans and low interest rates, stood still in October and November. Regardless of the certain stabilisation of the labour market, the increase of employment has remained modest and in November unemployment climbed again to 6%. The combination of the above factors and the fall of the stock market undermined consumer confidence, which had improved in the first half of the year, and brought it down to the lowest level of the past nine years by October. Therefore, the growth forecasts of the fourth quarter are relatively modest, at 1–2%. On the positive side, some economic indicators published in November were better than expected – the Michigan index reflecting consumer confidence was up, as well as some regional industrial activity indices. The increase of the number of jobless has slowed down.

Energy prices pushed the inflation rate from 1.5% to 2.1% in November, while underlying inflation stood at 2.2%. As the GDP deflator's annual increase was just 0.8% in the third quarter, there is a somewhat higher possibility that the further decline of economic activity could lead to deflation. However, the probability of such a development is currently small.

Regardless of the extensive economic incentives plan (the volume of 2002 fiscal stimuli is estimated at 2.4% of the GDP and after the 6 November cuts in base rates these are the lowest since 1961), the basis for economic recovery was still weak as could be seen from the slowdown of the growth rate. Alongside with the bigger than expected rate cuts, the Federal Reserve changed its monetary policy position back to neutral, evaluating risks to economic growth and price stability to be balanced. Although at the same time it was assured that recovery will continue, further loosening of monetary policy may not have the same positive effect as so far, since private consumers have taken advantage of low interest rates for some time already and the increase of purchasing demand is thus limited. The real base rate is already negative. Financial markets believe that the Fed will not cut rates any further.

Euro Area

As predicted, the annual economic growth of the euro area was low in the third quarter, amounting to just 0.8%. Like in the USA, industrial activity has dropped – industrial production decreased in July and September and in November, too, the respective purchasing managers' index pointed downwards. Thus, industry faces a real danger of a new recession. Among the member countries, Germany is still lagging behind – it suffered from flooding in the third quarter and recession is threatening its entire economy.

The main difference of the euro area as compared to the USA is the weakness of domestic demand, which has been felt since the beginning of 2001, and greater dependency on external demand. Due to the worsening of global economic climate the 2002 economic growth forecast was downgraded from 1.3% to 0.8% in the third quarter, which would mean the smallest growth since the recession of 1993. The European Commission, too, cut its forecasts in November, predicting 0.8% growth for 2002 and 1.8% for 2003 (see Table 2.1).

Table 2.1. Economic indicators of some selected countries (forecast)

	GDP growth (%)			CPI change (%)			Unemployment (%)		
	2001	2002	2003	2001	2002	2003	2001	2002	2003
World	2.2	2.6	3.6						
USA	0.3	2.3	2.3	2.8	1.6	2.3	4.8	5.8	6.0
Japan	-0.1	-0.6	1.2	-0.6	-1.0	-1.0	5.0	5.2	5.3
Euro area	1.5	0.8	1.8	2.5	2.3	2.0	8.0	8.2	8.3
Germany	0.6	0.4	1.4	2.4	1.4	1.5	7.7	8.1	8.2
France	1.8	1.0	2.0	1.8	1.9	1.8	8.5	8.8	9.0
Great Britain	2.0	1.6	2.5	1.2	1.2	1.5	5.0	5.0	4.9
Finland	0.7	1.4	2.8	2.7	1.9	1.8	9.1	9.1	9.3
Sweden	1.2	1.6	2.2	2.7	2.1	2.3	4.9	4.9	5.3

Source: European Commission, Autumn 2002

Growth stimulation in the euro area is difficult due to various structural problems, first of all the rigidity of the labour market and the tax system, but also the big deficit of the government sector budget. Countries with the budget deficit of nearly 3% of the GDP or more cannot apply extensive fiscal incentives for boosting economic growth. And such is the case with the euro area major economies. For example, the European Commission predicts Germany's budget deficit to reach 3.8% in 2002 and 3.1% in 2003. France is expected to have a fiscal deficit of 2.9% in 2003 and the entire euro area's deficit would amount to 2.3% in 2003 and 2.1% in 2003.

Unemployment remained at 8.3% in the third quarter and no change for the better took place. The number of jobless has continued to increase and in October the unemployment level reached 8.4%. The weakness of the labour market, falling stock market and worsening of economic growth outlook dragged consumer confidence to its lowest level since 1997.

The November annual inflation of 2.2% meant that the price increase has been above the European Central Bank's 2% goal for four successive months. Due to the weak economic growth and in anticipation of the predicted further decrease of the demand-side price pressure, the ECB decided to cut base rates in December by 50 basis points, to 2.75%. Markets believe that if the exchange rate of the euro remains stable there will be no more cuts in the interest rates. However, should the growth rate slow down even further and the inflation drop lower than expected, the ECB can carry out more rate cuts. The lowering of the rates is more likely if the German economy suffers a setback in early 2003.

Japan

Japan's GDP grew slightly more than expected in the third quarter – by 1.3%. Thus, the GDP has been growing for the third consecutive quarter, with growth rate climbing as high as 4.2% in the second quarter. While in the second quarter the recovery had mostly relied on external demand, then in the third quarter the increase of domestic demand, due to the acceleration of the growth of private consumption, became more important. At the same time, investments decreased. On the whole, the outlook of economic growth did not improve and in the fourth quarter economic growth is expected to slow down as consumer savings have dropped again and the growth of export fell from 5.9% to 0.5% in the third quarter. Therefore, the consensual growth forecast for 2002, based on the poll conducted in early October, is still negative: -0.9% (the IMF forecast was -0.5%).

The relative weakness of the Japanese economy and modest growth outlook is also testified by the fact that stocks fell by another 12% in the third quarter, dropping to the lowest level in 19 years. The government is trying to purge the banking sector of bad loans, which are estimated at 52.4 trillion yens (approximately 438 billion US dollars), but any rapid success is unlikely in this area as it could lead to the increase of bankruptcies. Borrowing from banks has not increased in more than six years. This indicates that the economy lacks sufficient resources for financing growth, although the central bank lowered the base rate to 0% already in March 2001.

The growth of domestic demand is still blocked by stubborn deflation – in September the annual CPI was -0.7%. Unemployment stood at 5.4% for the fifth month, ie just 0.1 percentage points below the all-time high.

Nordic Countries

In **Sweden**, economic development has been more stable than in the euro area countries. Although industrial activity slowed down slightly in the autumn, the expectations of businesses became more optimistic in November and the purchasing managers' index climbed from 51.6 to 53.6 points. New export orders were announced as well as plans to create new jobs. The annual GDP growth amounted to 2.1% in the third quarter, being faster than in the first half of the year. Growth was mostly based on private consumption and higher government spending (annual growth 2 and 8.6%, respectively). The low import demand of trade partners limited the development possibilities of industry and as a result investments and export volume decreased by 3.4 and 0.6%, respectively. Industrial output is estimated to grow 1.7–2.1% in 2002 and in the third quarter the forecasts were mostly upgraded.

Domestic demand-based branches of industry and services have grown faster than the average – retail trade increased by nearly 8% in September and October. Private consumption is encouraged by the expansive economic policy, the increase of the disposable income of households and the stabilisation of unemployment at the level of 4%. In 2003, the fiscal policy incentives will weaken and sustainable development needs a wider basis for growth. In December, the Swedish central bank cut the repo rate to 3.75%, already a second rate cut in three weeks.

The activity of the industrial sector of **Finland** is falling, regardless of the good economic results of the third quarter. In October, however, signs of a certain recovery in traditional manufacturing emerged (1% growth, month-on-month). The annual GDP growth was 2.3% in the third quarter, due to the low comparison basis, and mostly came from export and private consumption (which were up 6.6% and 2.7%, respectively). Fore the first time in 2002, the growth of capital investments into fixed assets was registered (1.5%, year-on-year).

Unemployment was 8.5% in October and its growth accelerated. Due to the weakening of the labour market and instability of the financial markets, consumer confidence dropped to 7.8 points in October, which is the lowest level of 2002.

The third quarter CPI increase was about one percentage point slower in Finland than the euro area average (1.3%, year-on-year). In October, the inflation rate accelerated to 1.5%, due to the growing impact of components not included in the underlying inflation indicator.

Baltic Countries

In Latvia and Lithuania, the main engine of economic growth is domestic demand. Although the setback of the export sector, resulting from the recession of the world economy, was less felt than in Estonia, domestic demand fuelled the growth of import and the trade balance deteriorated in 2002. In the second half of the year, the growth of export gained speed, contributing to the further increase of economic activity. October did not bring any significant changes.

Latvian economy gained momentum in the second half of the year supporting earlier expectations that economic growth would accelerate. In the third quarter, the GDP growth was estimated at 7.4%. Private consumption was high throughout the year but in the third quarter retail surged by 20%, year-on-year. The growth of export continued also in October, amounting to 16.7% year-on-year. Robust consumption combined with higher sales on external markets facilitated the growth of industrial production, which climbed from 3% in August to 12.4% in October.

Despite high domestic demand, the annualised CPI increase has remained between 0.9% and 1%. In October and November the year-on-year inflation rate was 1.6%. The deterioration of economic balance is first of all reflected in the trade balance.

Lithuanian economic growth has been faster than Latvia's in 2002. Preliminary estimates put Lithuania's GDP growth in the third quarter at 6.6%. The situation in industry improved in the third quarter and the annualised growth rate accelerated to 7.8% in September. The October result was poorer due to the high comparison base – production fell 0.8% year-on-year. Economic growth was supported by high domestic demand (retail trade increased 14.2%) as well as the favourable development of export (annualised growth in October – 13.9%). In ten months export increased 9.4% and import grew 12.6%. Despite the difference of the growth rates, Lithuania's export-import ratio was considerably more favourable than that of Latvia (72.6% *vs* 57.3%).

Consumer prices continued to fall in Lithuania. In September, prices were 1.5% lower than a year ago. Food, clothing and transport prices dropped the most. In October, the decrease of prices slowed down and in November consumer prices were up 0.1% month-on-month.

Central Europe

The situation in major economies of Central Europe varied in the third quarter. In some countries, floods affected both production and foreign trade and worsened the overall indicators. This was particularly true about the **Czech Republic** where GDP growth was somewhat faster than expected but still only 1.5%, and the second quarter growth was downgraded to 1.9%. In **Hungary** and **Slovakia** the annual GDP growth accelerated to 3.4% and 4.3%, respectively, in the third quarter.

The annual growth of industrial production was smaller in October than it had been in September, amounting to 3% in the Czech Republic and **Poland**. In Hungary, the growth rate of industrial production fell to 0.8%, which is in contradiction with the 20% growth of export.

Inflation remained low throughout the region and this has allowed the central banks to cut interest rates. In November, rate cuts were carried out by the central banks of Slovakia (-150 basis points), Hungary (-50 basis points) and Poland (-25 basis points). Hungary cut interest rates by 50 basis points also in December.

The economic indicators of the EU candidate countries are given in Table 2.2.

Table 2.2. Economic indicators of some selected emerging countries (forecast)

	GDP growth (%)			CPI change (%)			Current account balance (% of GDP)			Unemployed (%)		
	2002	2003	2004	2002	2003	2004	2002	2003	2004	2002	2003	2004
Cyprus	2.2	3.5	4.1	3.0	4.2	2.1	-6.0	-4.4	-3.6	4.3	4.0	3.9
Czech Republic	2.2	3.2	3.8	2.0	1.9	2.8	-4.3	-4.2	-3.8	8.8	8.8	8.6
Estonia	4.5	4.7	5.1	3.8	3.8	4.0	-11.4	-7.6	-6.2	10.5	10.0	9.3
Hungary	3.4	4.5	4.9	5.2	4.3	3.5	-4.4	-4.2	-3.3	5.8	5.9	5.8
Latvia	5.0	5.5	6.0	1.9	2.2	3.0	-8.2	-8.1	-8.0	13.5	12.7	12.1
Lithuania	5.0	3.5	4.5	0.2	1.0	2.5	-6.0	-5.4	-5.2	16.6	16.0	15.2
Malta	2.8	3.4	3.6	2.7	2.5	2.6	-6.1	-6.1	-4.9	6.9	6.6	6.2
Poland	0.8	3.2	3.9	2.1	2.5	3.3	-3.0	-3.3	-3.5	18.5	18.3	17.7
Slovakia	3.9	3.9	4.8	3.7	8.2	7.0	-8.3	-6.8	-6.0	18.9	18.4	17.6
Slovenia	2.6	3.6	4.0	7.6	6.5	5.4	0.1	0.1	0.0	6.3	6.1	6.0
Average	**2.1**	**3.6**	**4.2**	**2.9**	**3.3**	**3.6**	**-4.1**	**-3.9**	**-3.7**	**14.6**	**14.4**	**13.9**

Source: European Commission, Autumn 2002

Russia

Judging by growth rates, the third quarter was the most successful for the Russian economy. The 5.5% increase of industrial production exceeded the level of 2001 by one percentage point and the annual growth of the GDP was estimated at 4.3%, which is the highest in 2002. Growth was mostly based on the favourable development of trade, industry, transport and communication.

However, data on the last quarter of the year indicate that economic growth is slowing down again. Since the industrial sector and tax revenue depend heavily on the production and export of oil, the drop of oil prices on the world market in October and November had a negative effect. In November, industrial production was up just 0.8% year-on-year. Tax collection also fell short of the target – in 11 months 4% less revenue had been collected than planned at the beginning of the year. This gap has been filled by income from privatisation and sale of state property.

Despite the slight slowdown of industrial production, domestic demand remained high. The growth of retail trade was similar to that of previous quarters and real income of the population kept growing. This facilitated the creation of new jobs and in summer unemployment again dropped below 8% after a long time. The same trend continued in October when unemployment fell to 7.1%. The monthly growth of consumer prices has accelerated somewhat in recent months (monthly growth was 1.1% in October and 1.6% in November). This was mainly caused by the increase of food prices and the advance of the regulated prices of services.

The Russian purchase managers' index fell to 50 points in December, giving no indication of economic recovery in the near future. After the rapid growth in the third quarter

(7.8% in July, 5.5% in September, year-on-year), industrial activity dropped to 3.9% in October. The growth base narrowed to fuel industry (9.0%) and metallurgy (6.8%). Growth was mostly affected by the relatively low prices of oil in October, which reduced the impact of the growth of production volume.

Russian export exceeded import by nearly two times in October and the surplus of the trade balance amounted to 4.46 billion US dollars. Financial stability was secured by the strong foreign reserves of the central bank, which reached the all-time high of 48.2 billion US dollars in November.

International Financial Markets

After the weakening of the dollar in the first half of the year, **foreign exchange markets** traded in relatively broad ranges from early July until mid-December (JPY/USD 115–125; USD/EUR 0.965–1.014 and USD/GBP 1.52–1.59), without any clear trend. In December, however, the depreciation of the dollar continued (see Table 2.3) and the exchange rate of the euro climbed to its highest level of the past three years. The resumption of the downward trend of the dollar was mostly related to the weakening of the US stock market due to the slower than expected recovery of the economy. Other factors included the growth of global political tensions around Iraq and persistently large deficit of the current account.

Table 2.3. Changes in exchange rates of major currencies

	28.06.02	27.12.02	Change
JPY / USD	119.47	119.88	0.3%
USD / EUR	0.9914	1.0440	5.3%
USD / GBP	1.5335	1.6039	4.6%

The downward trend continued in major **stock markets**. Although US markets have the deepest impact on other stock markets, the fall was even stronger felt in the euro area and Japan (see Table 2.4), where 2003 growth forecasts were cut significantly. European and Japanese stock indices fell by 21 and 18%, respectively. The hope of investors for the revival of the growth trend and investment activity experienced both highs and lows, with the most pessimistic moods registered in July and October. In 2003, economic growth is mostly expected to accelerate and hopefully this would provide the necessary support to the markets. The time frame of the growth is difficult to forecast, however. The immediate prospects are most influenced by the danger of a military conflict in the Middle East. As compared to the 2000 levels, the S&P 500 had lost over 40% by the end of December 2002, Nasdaq was down over 70% and Eurotop 300 had fell by approximately 50%. The Japanese stock market has been falling since 1990 and the Nikkei 225 index has dropped approximately 4.5 times.

Table 2.4. Indices of major stock markets

	28.06.02	27.12.02	Change
USA (S&P 500)	989.82	875.40	-11.6%
USA (Nasdaq)	1,463.21	1,381.69	-7.9%
Japan (Nikkei 225)	10,621.84	8,714.05	-18.0%
Euro area (FTSE Eurotop 300)	1,071.74	842.32	-21.4%

On **bond markets,** the most important event of the second half of the year concerned the cut of the base rate by 50 points in November in the USA and in December in the euro area, to 1.25 and 2.75%, respectively. Thus, base rate cuts continued after a break of nearly a year. Both central banks justified their decision with the worsening economic outlook. In the USA, the need to reduce the danger of deflation was also emphasised. In the third and fourth quarter, base rates were also cut in Norway, Poland, Sweden, Denmark, the Czech Republic and Hungary. The fall of base rates and deteriorating economic outlook dropped the interest rates of both short- and long-term bonds in the second half of the year (see Table 2.5).

Table 2.5. Interest rates of major bond markets

	Interest rates of 3 months			Interest rates of 10 years		
	28.06.02	27.12.02	Change (basis points)	28.06.02	27.12.02	Change (basis points)
USA	1.69	1.16	-53	4.80	3.81	-99
Japan	0.00	0.00	0	1.32	0.95	-37
Euro area	3.35	2.93	-42	4.94	4.20	-74

In the **raw material markets**, prices continued to grow in the second half of 2002. In December, the CRB index, which reflects the prices of 17 major raw materials, reached its highest level of the past five years, edging up 13.4% in six months. The price of crude oil rose by 22% (to 32 dollars a barrel) in connection with mounting political tensions in the Middle East, general strike in Venezuela, etc. Thus, the price of crude oil rose by nearly 65% in 2002 and possible military operation against Iraq can increase the price even further. Growing political and economic uncertainties also increased the price of gold to the highest level of the past five years – 350 dollars per ounce (up 25% in 2002).

ESTONIAN ECONOMY

Domestic Demand

Private Consumption and Investments

Estonian economic growth and domestic demand were still opposed to the external environment. In the first half of 2002, the real GDP growth amounted to 5.2% and the average year-on year increase of domestic demand was over 11%, with investments into fixed assets up nearly 17%.

According to preliminary estimates, the rapid growth of domestic demand continued in the third quarter. Investments (total capital investments plus stocks) were still the main source of growth. This can be seen from the continuing rapid growth of the import of capital goods, which nearly doubled against the second quarter. The ratio of fixed assets and stocks to the GDP remained over 30%. Investment demand was sustained by favourable credit conditions, optimistic forecasts of the businesses and the impact of major one-time projects. The optimism of companies was mostly based on domestic demand, but also relatively successful export of goods in the summer months.

Private consumption, too, is believed to have grown at a still rapid rate in the third quarter. This is shown by the fast and continuing growth of retail trade turnover, which amounted to 15.1% at constant prices in the third quarter – the fastest growth in the past 18 months.

The rapid growth of private consumption was sustained by the continuing inflow of loans into households. Households differed from the business sector in their loan demands. The loan demand of businesses began to decrease at the end of the summer, reducing the annual growth of loans of the entire real sector from 28% in the second quarter to 25.7% by the end of October. The consumer confidence was also sustained by the more than 10% nominal growth of average wages and the creation of new jobs in the service sector.

Public Sector

The adoption of two supplementary budgets accelerated the growth of consumption also in the government sector. In the first half of 2002, consumption expenditure increased one percentage point faster than a year ago and amounted to 4.5%. The increase of investment expenditure is planned even higher in the budget. **Regardless of the increase in the growth rate of expenditures, the surplus of the government sector budget was the strongest balancing factor in the economy in 2002.** The nine-month surplus of the government sector budget stood at 2.175 billion kroons. 45% of it was achieved in the third quarter when current spending is traditionally the lowest of the year. The surplus made up more than 2.5% of the expected GDP of the respective period (see Figure 2.1).

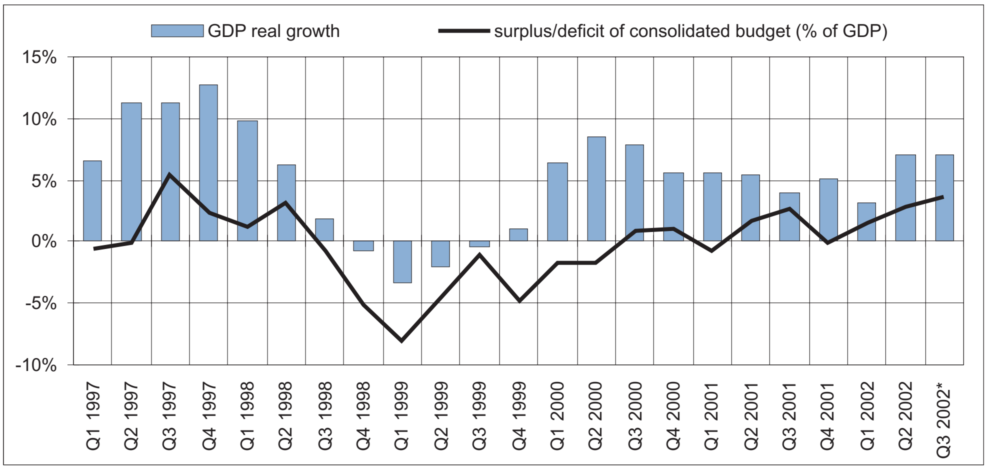

Figure 2.1. Real growth of GDP and balance of the consolidated budget

In 11 months, the central government had collected 94% of the projected annual tax revenue. Therefore, the revenue plan will most likely be exceeded by the end of the year. The budget surplus was achieved due to the faster than expected nominal growth of the economy (including VAT revenue associated with domestic demand) and improved tax administration. The total surplus is likely to amount to more than 1.5% of the GDP. Due to the launch of the mandatory pension fund system, the central government will lose **part of the social tax revenue in 2003 and despite cuts in the growth of current expenditures, expenditure will outstrip income by approximately 0.3% of the GDP. The entire government sector budget balance depends heavily on the decisions taken on the level of local governments.**

Domestic Saving

In 2002, saving decreased in the private sector but increased in the government sector. While in the first half of the year domestic saving was practically unchanged against

2001, then in the third quarter private sector saving probably decreased and made no contribution to the external balance of the economy.

The increase of investment activity and persistently rapid growth of consumption facilitated extensive import of goods and the negative balance of trade not related to subcontracting was very large, amounting to nearly 18% of the GDP. One reason can also be found in the fact that the import of goods of intermediate consumption increased in several spheres after the holiday season, but export did not. The same can be said about the subcontracting business where growth was limited to the import of the necessary production inputs in the third quarter.

On the whole, the current account deficit/GDP ratio increased by nearly six percentage points, year-on-year, and made up 10.6% of the third quarter GDP (the impact of a few major projects amounted to at least 2–2.5 percentage points). This can be attributed to the decrease of the saving level as well as investment activity (see Figure 2.2). In the near future, the growth of saving will depend on the behaviour of households. Without this there is no reason to hope for the improvement of the external balance.

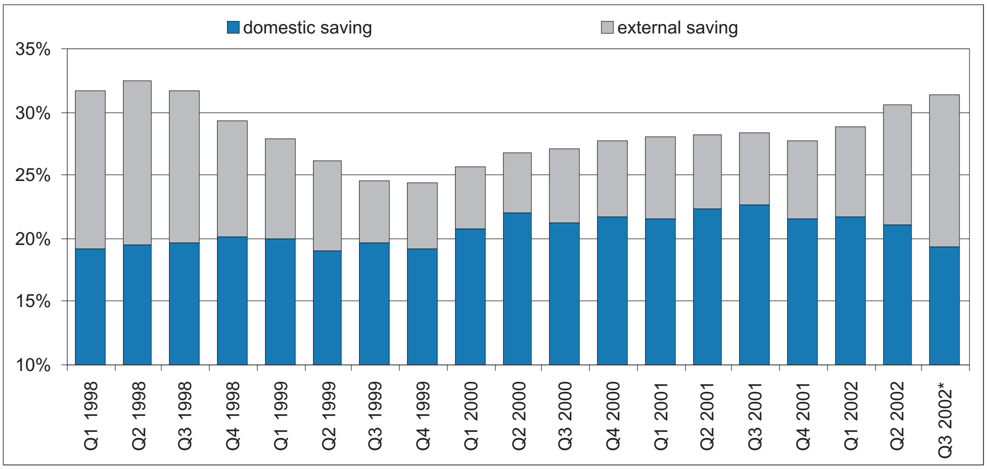

Figure 2.2. Financing of investments (% of GDP, sliding average of 4 quarters)
* data are estimated

Economic Growth

Throughout 2002, economic growth was sustained by additional capital investments and acceleration of the growth rate of consumption. **In the third quarter, the annual increase of the GDP was 6.7%.** This means that for the entire year economic growth will exceed Eesti Pank's forecast of 4.2% by more than one percentage point.

Regardless of the faster growth of domestic demand, the growth rate of the export of goods and services also remained relatively high and the business cycle of the euro area countries had a smaller impact than expected. Estonian economic growth maintained an approximately 5-percentage points difference with the euro area throughout the year, although this was achieved at a very high resources cost. In the longer run, such a difference and extent of external savings utilisation is unsustainable and even in short term it is justified only when it helps to increase the further growth potential of the economy.

Domestic Supply

The increase of the total export of Estonian goods and the sale of industrial production were practically unchanged against the second quarter. However, direct export was up 13.7% year-on-year (see Figure 2.3). In the final months of the summer, economic activity increased rapidly in the subcontracting sector as well, which will significantly boost the export of goods at the end of the year. The growth of export has relied on the structural and volume-related changes of goods and markets and points to the continuing improvement of Estonia's competitiveness. At the same time, import demand of the Nordic countries and the majority of the euro area countries is still relatively low, which warrants certain caution in evaluating the outlooks of export growth. The indicators of 2001 have to be considered as well – as a comparison basis, these will reduce the growth indicators of direct export in the final months of the year and increase the growth indicators of the subcontracting export.

Figure 2.3. Annual growth of Estonia's exports

* data are estimated

As the competitiveness of Estonian companies has turned out better than expected, the growth of the sale of the manufacturing industry products has been stable in almost all sub-branches except the food industry. Due to high domestic demand, the main source of the growth of the sale of industrial production was still the domestic market and the share of export in the sale of industrial production dropped a couple of percentage points against the nine months of 2001. The total annual growth of the sale of the manufacturing industry products amounted to 11.7% in the third quarter (see Figure 2.4). Changes across the spheres of activity were somewhat different as compared to earlier times. Thus, for example, the timber industry grew by 10% in the third quarter, which was less than in the previous quarters. The growth of output in other major branches – textile, food and furniture industries, machinery and equipment – accelerated. In general, the growth base can be considered relatively wide.

Growth in the services sector was also mostly based on domestic demand. But the exporting sector of the services cannot be called weak either. According to preliminary estimates, the nominal export of services increased by nearly 15% year-on-year. The growth of transport, storage and communication as the main sectors of services export remained relatively rapid. Economic growth was also sustained by the continuing transit flows – the nine-month transport of oil products was up 13.2% year-on-year.

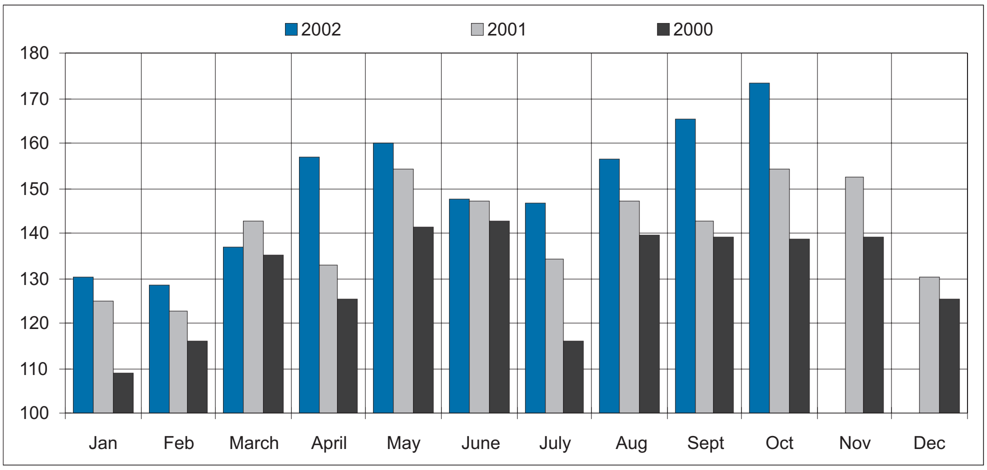

Figure 2.4. Monthly sales of the manufacturing in constant prices (January 1997 = 100)

Employment

Throughout 2002, economic growth relied on additional capital investments and the related demand for extra workforce. **The growth of employment continued also in the third quarter.** Unlike in previous years, the impact of cyclical factors was clearly felt – the number of jobs in the services sector increased, while in the open sector it decreased.

The growth of employment was accompanied by the reduction of unemployment, which fell to 9.1% in the third quarter. However, further rapid drop of unemployment is not to be expected – the delay of global economic recovery may force Estonian manufacturing industry to cut the number of workers in order to improve efficiency and the creation of new jobs in the service sector can come to a halt after the slowdown of the growth of demand. Although the average wage increased by 10.4% in the third quarter, the growth of the wage bill corresponded with the growth rate of the GDP and the share of labour costs did not change significantly.