II
ECONOMIC DEVELOPMENTS

EXTERNAL ENVIRONMENT

In the second quarter of 2002, global recovery continued with industrial production increasing and several indices reflecting economic activity pointing up. However, initial fast recovery halted – stock reserves were supplemented but final consumption did not increase. This holds notably true of the United States, where economic growth proved to be weaker in the second quarter than had been expected. In July and August, signs of faltering manufacturing growth could be seen in the United States and the euro-zone alike.

Future recovery prospects were significantly overshadowed by rapid decline in the stock markets from mid-March to 24 July. Further on the markets have stabilised, but by 17 September the leading US and euro area indices (S&P 500 and FTSE Eurotop 300) had fallen by 24 and 29%, respectively, from the start of the year. The potential impact of such a decline is reflected in an estimate by ABN-AMRO, which shows that in the course of two years a steady 20% per cent decline in share prices wipes off an average of 1.75% of the GDP in industrial countries, amounting to 2.25% in the United States and around 1.25% in the euro area and Japan.

These developments led to concerted downward revisions in economic growth forecasts for 2002 (mainly in August), from 2.8% to 2.3% in the United States and from 1.0% to 0.7% in Germany (see Table 2.1). In most cases the feared double-dip recession in the United States is not the predominent development scenario, however, the risks of sluggish economy and insecurity about the future have increased. Unemployment in the member countries of the Organisation of Economic Co-operation and Development (OECD) has gone up so far, amounting to 7.0% according to the data from July.

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

	GDP growth (%)			CPI change (%)			Unemployment (%)		
	2001	2002[1]	2003[1]	2001	2002[1]	2003[1]	2001	2002[1]	2003[1]
World	2.2	2.8	3.7						
USA	0.3	2.2	2.6	2.8	1.5	2.3	4.8	6.0	6.5
Japan	-0.5	-0.5	1.1	-0.7	-1.0	-0.6	5.0	5.5	5.6
Euro area	1.4	1.1	2.5	2.6	2.2	1.6	8.0	8.3	8.1
Germany	0.6	0.7	2.1	2.4	1.4	1.0	7.7	8.1	8.1
France	1.8	1.3	2.4	1.8	1.8	1.4	8.7	8.9	8.6
Great Britain	1.9	1.7	2.4	2.1	1.9	2.1	5.1	5.2	5.3
Finland	0.7	1.1	3.0	2.7	2.2	1.9	9.1	9.4	9.3
Sweden	1.2	1.5	2.5	2.6	2.3	2.2	4.0	4.2	4.1

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

In the second quarter, the OECD countries witnessed continued slowdown in the inflation rate, which had fallen to 2.4% by July. The low comparison basis should halt further decline in consumer prices. Should there be a military conflict with Iraq, also the rise in oil prices could have some inflationary impact.

The current situation will probably compel the leading central banks to postpone planned rises in interest rates, meanwhile, it is not excluded that base rates may even be reduced, particularly in the United States. Eventual decisions by the central banks depend on the developments in real economy and the financial markets in the coming months.

The United States of America

Financial markets took a central role among standard US economic indicators in the second quarter, considering the above-mentioned slump in the stock markets accompanied by the faltering dollar. By 24 July the S&P 500 stock market index had lost around half of its value from the peak in early 2000. The slump in the stock market was accompanied by a 13.7% fall in the dollar exchange rate against the euro in the second quarter. This was caused by record high annual current account deficit amounting to 4.2% of the GDP for the last 12 months. In August, the stock market stabilised to a certain extent, but it is too early to talk about a change in the trend.

Annual GDP growth slowed down in the second quarter from 5.0% to 1.1% with the decrease in private consumption to 1.9% from 3.1% and domestic ultimate consumption to 1.6% from earlier 3.0% (capital investments dropped by 1.6%). The share of stock reserves in GDP growth fell from 2.6 percentage points to 1.4 while the negative input of net exports increased from 0.8 percentage points to 1.7 (foreign trade deficit reached a record high of 37.8 billion dollars in May). It is also significant that the 2001 economic growth was revised downwards: if preliminary estimates showed GDP decline just in the third quarter of 2001, then revised data shows that the decline started already in the first quarter and continued throughout three quarters.

Faltering manufacturing activity was reflected in the decline of the ISM index, which fell from 56.2 to 50.2 in July and remained on the same level also in August. In July, manufacturing increased only in the automotive industry followed by a decline in August (for the first time this year).

Growth in private consumption plays a significant role in the further dynamics of US economic growth. In 2002, consumption has been underpinned by low interest rates, which has promoted car and house sales. Besides, refinancing of housing loans has boosted personal income. Increasing private consumption is expected to underpin economic growth in the third quarter, which should amount to around 3.0%–3.5%. However, the impact of the financial factors is temporary, therefore a new slowdown is expected in the fourth quarter. As of June, also consumer confidence has been shaken, primarily due to the slump in the stock market. Unemployment grew to 5.9% in July.

In June, the inflation rate fell again to the lowest level this year (1.1%) followed by a rise to 1.8% in August. Since the disappearing base effect is affecting the inflation indicator towards growth and the price of oil has gone up again, deflationary risk is currently non-existent. Base inflation is characterised by a moderate downturn trend, and the indicator stood at 2.4% in August.

As for economic policy, the most significant factor was the change in the central bank‘s monetary policy approach from neutral to stimulating. The central bank essentially showed willingness to lower the base interest rate even further while expressing hope that the current monetary policy should be stimulating enough to sustain and cement recovery.

Euro Area

At the beginning of September, Eurostat issued its official second quarter GDP estimate, showing annual growth identical to the first quarter (1.4%). Private consumption increased by 1.6% and public spending by 1.5% while capital expenditure decreased by 3.2%. Domestic demand rose by just 0.8%, contributing 0.5 percentage points to GDP growth (stock reserves gave 0.3 and net exports 0.6 percentage points). The indicators show that the euro area has not yet overcome weakness in domestic demand.

Similarly to the United States, industrial growth in the euro area has slowed in recent months. The PMI index in both the industrial and services sectors slipped to 50.8 in August, thus remaining only slightly above the reading of 50 that divides growth from contraction. In Germany, the indices in both sectors slipped below 50, reflecting a risk of zero third quarter GDP growth or even a drop. Modest economic activity is also reflected in exports and imports that have been decreasing since March-April. Since the decline in imports has been steeper, foreign trade surplus has grown.

The unemployment rate remained at 8.3% in July, but there was no improvement since the number of unemployed continued to grow.

According to Eurostat, the rate of inflation rose from 1.9% to 2.1% in August. The base rate of inflation, after subtracting volatile energy and food prices, went up to 2.5%. Next year both the general and base inflation rates should drop to around 1.5% since inflationary pressure is weak due to sluggish economic growth.

Taking into consideration the current situation, it is obvious that economic growth in the eurozone can no longer be supported by net export expansion, therefore it is necessary to stimulate domestic demand so as to avoid stagnation or even double-dip recession (especially in Germany). Since private consumption remains weak, differently from the United States, manufacturing of cars and durable goods cannot pick up considerably. As the options of applying fiscal incentives are limited due to the EU Stability and Growth Pact, monetary policy measures could be considered. As the focus of the central bank remains on the level of inflation, a fall in the base interest rate cannot be anticipated in the near future. At a news conference on 12 September, European Central Bank President Willem Duisenberg said that the current interest rate level was appropriate in the present situation and stated that the bank had opted for neither toughening nor easing the monetary policy.

Sustaining fiscal discipline remains the central issue in the eurozone economic policy: in 2001 Portugal exceeded the allowed 3.0% public deficit margin, this year the same may happen in Germany. The pressure is caused by sluggish economic growth, which curbs government revenues, as well as large expenditures related to the floods at the end of summer.

Japan

Annual GDP growth in Japan in the second quarter was 2.6%, however, the indicator for the previous quarter was revised downwards from 5.7% to 0% due to changes in computing methods. Annual growth in the second quarter was negative (-0.7%). The principal growth generator was exports that soared by 5.7%. However, the rapid export growth rate witnessed so far is not sustainable and may slow down if private consumption in the United States tumbles and is not followed by sufficient growth in capital expenditure.

Domestic demand has remained weak. Growth in private consumption is not expected to pick up since wages go down and companies cut payrolls. In July, pay growth was affected by a steep cut in summer bonuses, which has not yet had an impact on consumption. Unemployment is continuing to rise, and the unemployment rate stood at 5.4% in July. Consumption climate surveys gave controversial results in July. Among retailers only car dealers claimed that the situation was improving.

Japan‘s investment growth prospects are not good either, taking into consideration weak US economic indicators and the recent slump in the stock markets. The options to support growth through public consumption are limited since the country‘s public debt amounts to nearly 140% of the GDP. So far the indicators have reflected controversial tendencies. While the impact of recovery is visible, signs of weakness may become more prominent in the future. Continuing deflation (in July the change in the consumer price index was -0.8%) is restricting domestic demand. Sluggish economic growth outlook was also reflected in the stock market where the Nikkei 225 index stumbled to the lowest level in 19 years in early September.

Japanese government has confirmed willingness to continue tax and financial reforms and speed up clearing the economy of bad loans. The latter, however, may increase the number of bankruptcies, thus further exacerbating the economic situation.

Nordic Countries

Sweden. The 2.1% annual economic growth in the second quarter was mainly supported by private consumption and increasing government expenditure. Continuing recovery is questionable if external demand remains weak.

The consumption side of the indicators reflects the impact of the precision electronics sector. The cycle of declining stock reserves continued – by annual 4.2% in the second quarter. In the context of non-existent final consumption growth it was impossible to expand production output (annual -0.8%). Investments into fixed assets tumbled after the slump in the stock markets. Since foreign investors are more apprehensive of risks, it translates into more unfavourable capital flows for Sweden at large. As a result, the net position of direct investments decreased by 50% in the first half-year.

Regardless of the weakness in the financial markets, household confidence was sustained. Consumption is underpinned by the growth in real income, higher real estate prices and loose fiscal policy. Manufacturing capacity was reduced mainly in the high technology sector where labour is not the principal input. Therefore, the labour market did not suffer against the backdrop of weak economic activity in the first half of the year, rather the opposite. The unemployment rate remained at 3.8% in the second quarter. Jobs were created primarily in the services sector, which balanced out declining employment in the companies manufacturing goods.

Compared to the second quarter, loss of confidence in the business sector accompanied by tumbling stock markets resulted in the 3.0% fall in the exchange rate of the Swedish krona against the euro in the third. As long as the recovery of the external environment remains questionable, the krona may continue to weaken. Therefore, Sweden‘s central bank has refrained from restricting monetary policy for the time being.

Finnish economy is characterised by a certain increase in economic activity. In spite of weak external demand the country‘s gross output expanded in the second quarter by 2.5% from the same period last year. Under consensus, Finland‘s economic growth forecast for 2002 has been reduced by 0.2 percentage points (to 1.0%) from the start of the year. Exports are still growing faster than the gross output in the economies of the country‘s trading partners, but in the context of possible stagnation in the external environment there is no reason to assume that the rate would be sustained at the average level of earlier years.

Finland‘s industrial output expanded by 3.0% in the second quarter from the same time last year. However, developments in traditional industries resulted rather from stock reserves correction than an increase in ultimate consumption. By way of exception, external demand has been expanding in the Baltic countries whose share in the target area of Finnish goods increased to 4.3%. Also, the downturn in Finland‘s electronic industry has stopped and - due to low comparison basis - manufacturing soared by nearly a third in June.

In recent years Finland‘s budget surplus has been the largest in the EU countries, eg amounting to a record of 7.0% of the GDP in 2000. The reasons behind the decline to 3.0% this year are income tax cuts, an increase in unemployment benefits, and regional subsidies.

Latin America

The economic situation in Latin America is complicated. Even though the crisis in Argentina did not spread panic in the financial markets, it has still left a mark on the neighbouring countries. The impact has been most significant in Uruguay that decided to float its currency as a result of the spillover of the crisis in Argentina. In connection with approaching elections, Brazil was hit by a confidence crisis in summer. Meanwhile Argentina‘s economy has been showing some positive signs. Manufaturing has increased on a monthly basis, giving grounds to expect that the crisis may have bottomed out. To avoid escalation of the crisis in Brazil the International Monetary Fund (IMF) decided to allocate to the country the so far largest aid package in the history of the fund – 30 billion dollars. Aid disbursements are to be made in stages provided the country pursues effective economic policy. Because of the above-mentioned problems the economic growth in the region has been quite anemic and may even remain negative this 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)		
	2001	2002[1]	2003[1]	2001	2002[1]	2003[1]	2001	2002[1]	2003[1]
Argentina	-4.4	-16.7	2.4	-1.1	41.2	52.3	-1.6	10.2	14.5
Brazil	1.9	1.8	2.0	6.8	6.5	4.3	-4.6	-4.0	-3.3
Mexico	-0.3	1.7	4.0	6.4	4.8	3.7	-2.9	-2.8	-3.3
China	7.3	7.5	7.2	0.7	-0.4	1.5	1.5	1.5	1.0
Czech Republic	3.3	2.9	3.2	4.7	2.7	3.0	-4.6	-4.7	-4.3
Poland	1.0	1.0	3.0	5.5	2.4	3.0	-4.0	-4.0	-4.5
Hungary	3.8	3.5	4.0	9.2	5.5	4.5	-2.2	-3.3	-3.5
Estonia	5.0	4.5	5.0	5.8	4.4	3.6	-6.1	-6.9	-7.4
Latvia	7.6	5.0	6.0	2.5	3.0	3.0	-10.0	-8.5	-7.5
Lithuania	5.9	4.4	4.8	1.3	1.3	2.5	-4.8	-5.9	-5.7
Russia	5.0	4.4	4.9	20.7	15.8	11.0	10.3	7.0	6.3

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

Asia

Economic activity in Asia outside Japan has increased considerably. Domestic demand is being supported by favourable monetary environment, cutting savings and continuing transfer of manufacturing into sectors with greater added value. Growth in exports is also brisk while capital flows are once again channelled into Asia. Trade within the region, particularly with China, is becoming increasingly important. Export growth in China is very fast due to the weak dollar, but the economy needs vigorous structural reforms to sustain development. Economic growth in Asia outpaces the rest of the world with forecasts for 2002 amounting to 6.0% (except in Japan).

Central and Eastern Europe

The 2.5% second quarter GDP growth in the **Czech Republic** exceeded predictions to some extent. Private consumption slowed down slightly (the growth stood at 3.6% after 3.8% in the first quarter) and investments declined by 0.5% (mainly due to changes in stocks). GDP growth was driven by the 4.6% increase in public consumption. Meanwhile the negative impact of floods may amount to 0.5–1.0 percentage points in the third sector. In summer manufacturing picked up considerably in Central and Eastern Europe. In the Czech Republic, growth was as fast as 10.8% compared to July 2001 (1.3% in June). Foreign trade was rather frail in summer with both exports and imports declining during several consecutive months. Inflationary pressure remained weak with the CPI staying at 0.6% in August, just like in July. Due to lower inflation expectations and high exchange rate of the koruna, the central bank cut interest rates in July by another 50 basis points. The central repo rate now stands at 3.0%, which is lower than in the eurozone.

Moderate growth in the economic activity in **Hungary** continued in the second quarter, even though there has been some delay due to the external environment that has been more unstable than was expected. The 3.1% GDP growth remained slightly below expectations. Investments went up by annual 5.1% (by 8.6% in the first quarter). Rapid manufacturing growth may indicate strengthening in the industrial sector: if manufacturing growth stood at 4.1% in June compared to the same period in 2001, then the respective figure in July was 8.5%. Weak external demand, the strong forint along with the government's fiscal policy and rapid growth in wages have stimulated private consumption and aggravated the country's external balance. The current account deficit for 12 months had soared to 3.6% of the GDP by mid-year. Exports increased by 5.7% and imports by 7.0% in the first half-year from the same period last year. Inflationary pressure continued to decline with the CPI falling to the lowest level in 16 years – 4.5% compared to August 2001. Owing to anticipated economic growth and some weakening in the forint exchange rate, the Hungarian central bank increased interest rates early in July by 50 basis points for the second time this year.

Polish economy has activised. Compared to the hectic conditions at the beginning of the year, manufacturing improved in June from the preceeding months to 2.2% compared to the same period last year. In July, manufacturing soared by as much as 6.0% from last year, considerably outpacing consensus predictions. This was the largest growth figure for the last 18 months. In June, Poland‘s exports picked up significantly by as much as annual 24%, according to the balance of payments calculations. Measured in euros, the annual growth indicator was 8.0%. Besides the cheap zloty, modest internal demand is considered to be a growth generator since it makes companies more aggressive in external markets. The inflation rate continued to fall with the CPI dropping to annual 1.6% in June and as low as 1.3% in July. Owing to the continuing weakening of the inflationary pressure, Poland‘s central bank cut interest rates at the end of August by another 50 basis points – to 8.0%. Previously the central bank had revised the interest rates down in June.

Latvia‘s economic development was fast. In the second quarter the GDP soared by 4.9% (by 4.4% in the first half-year). Still, Latvian second quarter economic growth was the weakest in the Baltic countries. The growth is supported mainly by internal consumption. Manufacturing increased by around 6% with growth picking up in food, textile and timber industries.

The negative impact of external demand remained moderate as can be seen from the annual 5.0% increase in exports in the second quarter after considerably weaker growth during the preceeding months. Exports to the EU soared by 6% and to the CIS countries by 13%. In exports to Russia, food plays a major role with timber exports also picking up. Despite brisker exports, the external balance deteriorated from the same period in 2001. The underlying cause is the fact that imports outpaced exports (annual 15%) owing to strong domestic demand. Domestic consumption is characterised by the 15% retail sales growth in the second quarter from the same period in 2001. Despite brisk domestic demand, the inflation rate continued to decline during the first half-year to annual 0.9% in June.

In the first half of the year Latvia managed to maintain fiscal discipline better than had been expected. The surplus of the central government budget stood at 2.3 million lats while the consolidated public sector deficit was 3.8 million lats. The estimated deficit-to-GDP ratio was 0.2, remaining significantly lower than the limit set by the IMF. The initial planned budget deficit for 2002 was 2.5% of the GDP, which caused serious frictions between the country‘s government and the IMF. Currently the annual deficit is expected to amount to 1.8% of the GDP.

Lithuanian gross domestic product increased by 6.9% in the second quarter (4.5% in the first quarter). Manufacturing growth was restored already in the first quarter. In the first half-year, production increased by 4.8% from last year. The situation in the oil and food-processing industries improved in the second quarter while in the first half-year the fastest growth was seen in transportation equipment manufacturing, which soared by 75% from the same period last year. Continually growing consumption increased retail turnover in the first six months of the year by 14.1%.

Regardless of slow improvement in the external environment, Lithuania increased exports in the first half-year by 3.0%. In the second quarter, export growth slowed down. Owing to growing domestic demand, imports soared (11% in the first half-year), thus exacerbating the country‘s foreign trade balance. Exports to the EU increased by 6.2% and to the CIS by 23.1% from last year. Russia became Lithuania‘s second largest export partner after the United Kingdom (growth of 55.2%).

Consumer price growth was rapidly subdued. In May, the annual inflation rate slipped to 0.5% and in June the indicator was negative (-0.5%). The main factors putting pressure on consumer prices are the strengthening of the litas against the dollar and tough competition in the trading sector.

Budget revenue collection in Lithuanian outpaced plans. Both central and local government revenues improved while expenditures remained on the planned level. As a result, Lithuania achieved a surplus of 0.5% of the GDP in the first half-year. The planned budget deficit in 2002 was 1.5% of the GDP (1.9% in 2001).

Russia

The economic growth estimate of the statistics committee for the second quarter was 4.1%, which is in line with the 2002 tax revenue forecast. The share of manufacturing output in the GDP structure fell to 39.5%.

Russia is mainly profiting from oil prices that have soared as a result of Middle-East tensions. Continuously high oil price supports the country's economic growth as well as its external balance since fuel exports account for more than 50% of Russia's total exports and for 25% of its budget revenues.

Balance of payments forecasts show certain recovery in the Russian economy after the slowdown in the fourth quarter of 2001, however, the level achieved in the first three quarters of 2001 remains to be reached. Declining imports have an impact on the current account balance while growth in net direct investments is not foreseen.

International Financial Markets

In currency markets the predominant trend was the continued weakening of the US dollar, which started in February and marked the end of the currency's extended upward movement. In five months the dollar fell by 12.7% against the euro (see Table 2.3). To a large extent, this was brought about by the rapid decline in the stock markets. Consequently, the changes in currency exchange rates have not been determined by improved economic growth outlook in the eurozone and Japan, but rather by the slump in the US stock market and the weakening of the country's leading position. Extensive and growing current account deficit is another major factor undermining the dollar's positions in the longer perspective.

Table 2.3. Changes in exchange rates of major currencies

	29.03.02	30.08.02	Change
JPY / USD	132.73	118.46	-10.8%
USD / EUR	0.8717	0.9823	12.7%
USD / GBP	1.4259	1.5505	8.7%

Stock markets witnessed rapid decline during the period: the US S&P 500 index plunged by around 20% and the eurozone FTSE Eurotop 300 index by 25% (see Table 2.4). The slump that started in 2000 has been generally treated as an investment bubble burst, which was exacerbated by deteriorating economic growth outlook this year. The market bottomed out on 24 July when the US stock market index was around 50% lower than at its peak in 2000. Regardless of the following stabilisation in the market, several analysts do not exclude further declines as long as the risk of further economic weakening lingers and investment activity is low. Euro area markets have moved in line with the US market, but the slump has been even steeper since economic development in the euro area has not come up to earlier optimistic expectations.

Table 2.4. Indices of major stock markets

	29.03.02	30.08.02	Change
USA (S&P 500)	1,147.39	916.07	-20.2%
USA (Nasdaq)	1,845.35	1,314.85	-28.7%
Japan (Nikkei 225)	11,024.94	9,619.30	-12.8%
Euro area (FTSE Eurotop 300)	1,279.74	956.55	-25.3%

In the **bond markets** the predominant trend was the decline in interests throughout the yield curve, which was mainly provoked by the slump in stock markets. The steepest fall occurred in the United States, where the 10-year yield was down 125 basis points (see Table 2.5). Changes in three-month yields were marginal since central banks maintained their base interest rates. To some extent, bond markets were underpinned by the currency crisis in Brazil and the looming military conflict with Iraq. Further yield dynamics depends on the developments in the financial markets as well as in real economy. Leading central banks acknowledge the threat of economic slowdown, but keep hoping for continued recovery. Therefore, further trends in monetary policy remain unsettled. If needed, central banks might cut base interest rates even further.

Table 2.5. Interest rates of major bond markets

	Interest rates of 3 months			Interest rates of 10 years		
	29.03.02	30.08.02	Change (basis points)	29.03.02	30.08.02	Change (basis points)
USA	1.78	1.68	-10	5.40	4.15	-125
Japan	0.00	0.00	0	1.40	1.19	-21
Euro area	3.26	3.25	-1	5.26	4.57	-69

The price rise **in the raw material markets** that started in the fourth quarter of 2001 and has been driven by the recovery in global economy continued: the CRB index went up by 7.0% from 29 March to 30 August (this year the index has soared by 15%). Crude oil prices soared by around 10%, reaching a peak of over 30 dollars per barrel. Oil prices have gone up by 46% this year because of limited crude oil supplies and escalating political tensions in the Middle East.

ESTONIAN ECONOMY

Domestic Demand

Private Consumption and Investments

Despite deteriorating growth outlook, both corporate and households' readiness to consume and invest has remained on the highest level of the recent years. In both cases this is sustained by low domestic and external interest rates and banks' readiness to finance also projects with higher-than-average risk (individuals' consumption loan and leasing, financing of the sheltered sector), which is currently in high demand. Therefore, the financial sector continues intensive lending to the real sector – in the second quarter up to 3.1 billion kroons, whereas the annual growth exceeded 28%.

Investments in the broadest sense of the word continue being the largest source of growth in domestic demand. Also implementation of large-scale (in the Estonian context) projects (renovation of a power plant, setting up a steel galvanised plant, upgrading of the railway) and extensive capital investments in the government sector (growth 22% in the second quarter) bolster growth. The share of investments was estimated to exceed 30% of GDP in the second quarter. According to the survey by the Estonian Institute of Economic Research, high investment activity is likely to be maintained also in the next few months as indicated in stable corporate future forecasts. It remains questionable whether the timing of investments and growth expectations are rationale.

Apart from investment activity also reviving **private and public sector consumption** sustained domestic demand. According to the household budget survey, the expenditure per member of a household underwent a nominal growth of over 10% in the second quarter. The growth of private consumption was sustained by growing wages (average gross wages increased by 10.1% in the second quarter) and rising employment (by an annual 0.7%) as well as higher lending activity. Also, the government consumption expenditure displayed a significant nominal growth, reaching 15% according to the cash-based budget execution.

Public Sector

In early-2002 the government sector was the largest saver as, due to strong domestic demand, tax receipts significantly exceeded forecast, while there is no reason to anticipate any additional revenue saving before elections in the second half of the year. Rapidly growing revenues made the Ministry of Finance to revise upward its revenue forecast by about 800 million kroons. The revised forecast foresees a considerable slowdown in tax collection in the second half of the year. This is well in harmony with the assumption that towards the end of the year indirect tax base will shrink, primarily due to recovering exports. Higher-than-expected tax intake was sustained by temporary factors – suspended export growth has reduced VAT refund (see Figure 2.1).

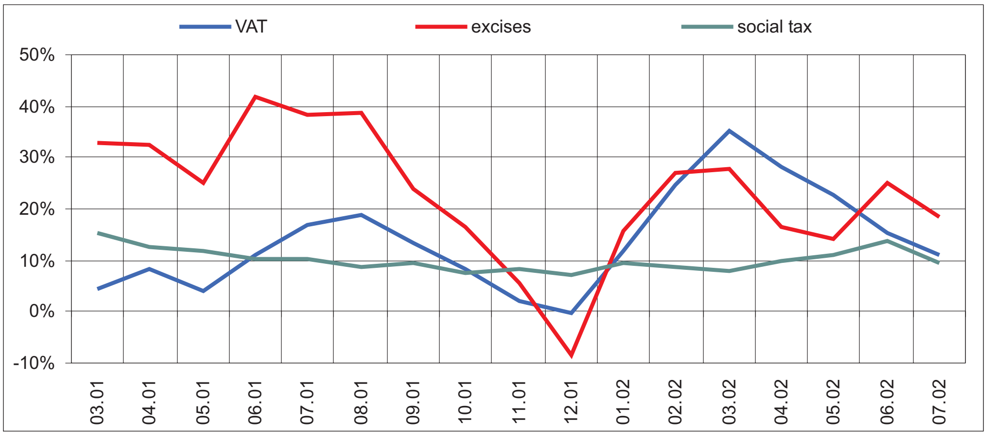

Figure 2.1. Annual growth of tax income receipts to the central government budget (sliding average of last 3 months)

Due to low interest rates the external environment has continuously favoured Estonia's domestic demand rather than export revenues (external demand has not increased). **The adoption of the second supplementary budget confirmed the opinion that the positive impact of the government sector on the external balance is declining as the new supplementary budget will boost the growth of domestic demand even further.**

Domestic Saving

The sustained high level of external disequilibrium of the economy is largely related to lively investment activity (including several single large projects). **Apart from high investment activity, also declining domestic saving has sustained current account deficit** (see Figure 2.2).

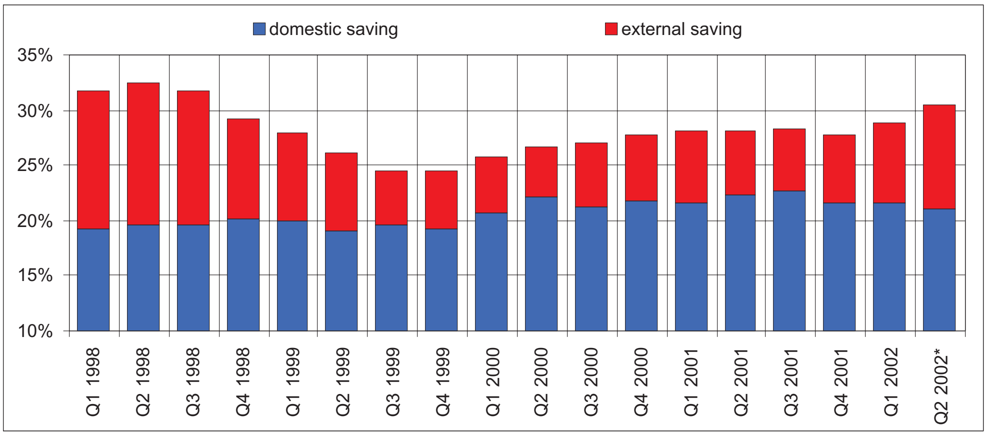

Figure 2.2. Financing of investments (% of GDP, sliding average of 4 quarters)

* data are estimated

Saving has declined primarily in the private sector (individuals' net position in the financial sector has been shrinking since the third quarter of 2001) as higher-than-expected tax revenue had boosted the budget surplus in the government sector to 700 million kroons in the second quarter (totalling 1.1 billion kroons after six months) and the level of saving was about two percentage points above the year-ago period.

A large gap in saving against the volume of investment is likely to decrease only in the private sector in the second half of the year. Fading impact of single projects should also be conducive. However, a postponed interest rise in the euro area would mean that the private sector would have no direct need to adjust. Also supplementary-budget-boosted government expenditure and slower tax collection indicate that there is hardly any hope for growing budget surplus.

Economic Growth

Sustained rapid growth in domestic demand indicates that mere export earnings are not adequate to finance it. Thus, lending for living would just deepen and external equilibrium deteriorate. Quick estimates reveal that current account deficit reached 10% of GDP in the second quarter pushing the crawling average deficit also to 10% in the fourth quarter.

In the second quarter, while the GDP grew by 7% according to preliminary estimates, and throughout the first half-year Estonia's economic growth was higher than external environment allowed to anticipate. Thus, **growth difference with the euro area was slightly above forecast and the growth was sustained apart from domestic demand also by reviving export of services in the second quarter.** Although external demand is assumed to rise in the second half of the year (recent downward revisions of international forecasts have not yet quite undermined this view), there is still no direct need to revise the growth forecast for 2002 (4.2%) significantly. Such a growth differential cannot be sustained long-term by purely domestic factors. In such a case Estonian corporate competitiveness should be continuously growing or the growth be sustained by ever-increasing debt-generating external financing.

Domestic Supply

Developments in the second quarter and leading indicators were conflicting for assessing external demand. **Due to slightly recovering external environment, the annual growth rate of the direct export of goods accelerated to 13%** (see Figure 2.3), **but the anticipated upturn indicating further buoyant recovery of external demand did not occur.** Although under the current world economic circumstances a more than 10% growth in normal export means that Estonian companies maintain their market position, the demand for import goods in Finland and most other euro-area countries still remains below year-on-year level. No rapid growth can be

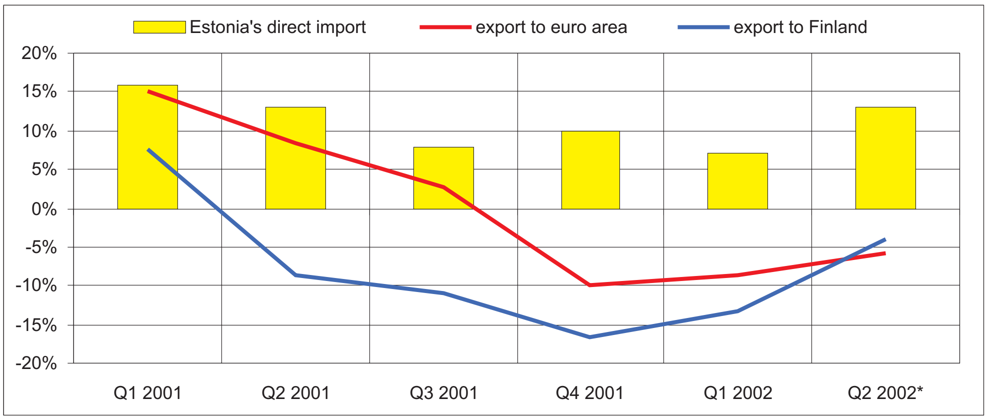

Figure 2.3. External demand and Estonia's export (annual nominal growth)

* data are estimated

expected in upcoming months either. However, hope for an accelerated growth in export earnings in the second part of the year is smaller than in previous months.

Although some specific factors may at times hinder sales of various manufacturing products, the very fact that both export and production volume have revealed modest growth by nearly all commodity groups and destinations indicates that global demand environment is uniformly weak. The preferential growth of the so-called niche products and new export markets has not been sustainable. The production volume of manufacturing increased by 3.3% in the first seven months, including 8.6% in July (see Figure 2.4).

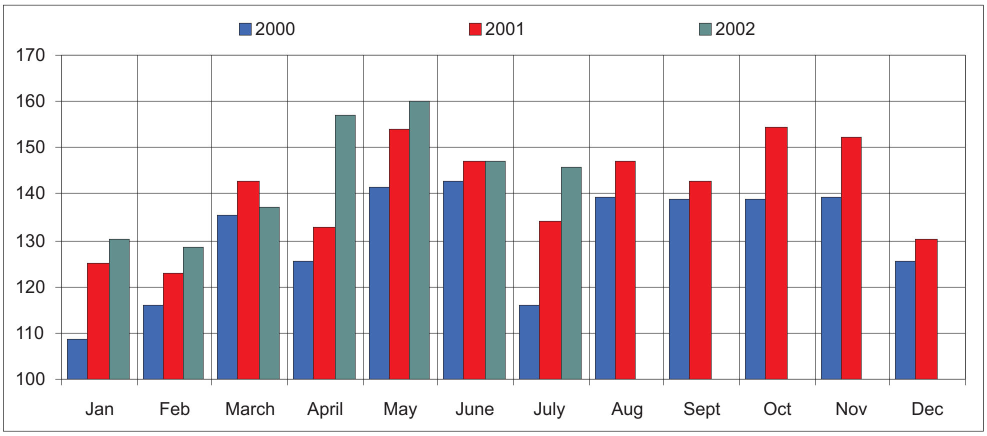

Figure 2.4. Monthly sales of the manufacturing in constant prices (January 1997 = 100)

In food industry, export was hindered by the legal controversy around the export of fish products at the beginning of the year; also competition in the eastern market has toughened. Besides, fishing industry is probably one of the industries, which might directly lose in competitiveness as a result of the depreciation of the dollar. **If primarily difficulties in the eastern market prevent the sale of fish products, then the largest overproduction of the recent years in European markets hinders export of dairy products.** In the second quarter, the production volume of the dairy industry was about 8% below the year-ago-period. Primarily due to the oversupply in Europe the export price for foodstuffs declined by an annual 3.4% during three months.

The longer-than-expected recession in the global technology sector affects the precise electronics sector, with no recovery in sight in the near future. Most of the world's major companies have downsised their 2002 sales forecasts repeatedly this year. Due to weak global demand and excessive investment in earlier years, export of the subcontracting sector of the Estonian electronics industry was 40% smaller in current prices than it had been in the year-ago period. Compared to 2001, only textile industry has increased production (16% in seven months). Foreign textile companies get an increasing amount of orders previously fulfilled in parent companies because of lower labour costs here. However, the appreciation of the Estonian kroon should not have any significant impact on the entire industry as despite of the relatively high stake of the American dollar as a contractual currency, it remains quite similar both for sales of production and purchase of raw materials.

Employment

Due to the development of the services sector and other economic activities oriented to meeting domestic demand, the fall of unemployment that had begun in 2001 continued also in the second quarter of 2002 and the unemployment rate reached 9.4%. However, compared to previous quarters the recovery of employment indicators is slowing down – if employment growth accelerated throughout 2001, while the creation of new jobs stabilised in the second quarter of 2002 (growing merely by 0.7%). In the open sector (industry) the demand for labour even decreased. This means that the positive impact of economic growth may start wearing off in the labour market.