II
ECONOMIC DEVELOPMENTS

EXTERNAL ENVIRONMENT

Global Background

Global economy that witnessed a slump already in 2001 failed to show signs of recovery in the first quarter of 2003. Growth in major economic areas remained even more modest than analysts had expected: in the United States the GDP grew by 2.1% year-on-year, in the euro area by 0.8% and in Japan by 2.5%. **Regardless of the comparatively fast relief in political tensions, modest economic activity indicates that global economic problems have not been solved.**

Neither have the increasingly lower interest rate level and more expansive budgetary policies managed to invigorate major economic centres – in 2003 the European Central Bank has lowered key interest rates by 0.75 basis points while interest rates in the Unites States have remained on the lowest level of the past decades since 2002. The restrictions arising from the Stability and Growth Pact in Europe and lower nominal interest rates in the United States indicate that **utilisation of economic policy incentives is becoming increasingly more restricted.** Even though the fundamental indicators (budgetary discipline, current account balance, debt burden of households) of Estonia's neighbouring markets – Finland and Sweden – are considerably more favourable than these of most major economic centres, economic growth has slowed down also in these coutries as a result of their extensive openness and globally modest demand. External demand has declined more in some branches of the industrial sector than at the same time in 2002 and economic growth has been largely underpinned by private and public consumption alone.

The consistently subdued global economic activity has again led to forecast adjustments virtually everywhere. Starting from early 2003, economic growth forecasts both for the United States and the euro area have been cut by an average of 0.4 percentage points. Proceeding from the consistent decline in the inflationary pressure on the demand side and initial stabilisation of commodity prices, inflation rate forecasts have been equally revised. Potential growth resumption expectations have been adjourned by nearly a year – to the second half of 2004 (see Table 2.1).

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

	GDP growth (%)			CPI growth (%)			Unemployment (%)		
	2002	2003	2004	2002	2003	2004	2002	2003	2004
USA	2.4	2.4	2.5	1.6	2.0	1.7	5.8	6.0	6.0
Japan	0.3	1.5	1.3	-0.9	-0.6	-0.7	5.2	5.4	5.4
Euro area	0.9	1.0	2.3	2.2	2.1	1.7	8.3	8.8	8.8
Germany	0.2	0.4	2.0	1.3	1.3	1.2	8.2	8.9	8.9
France	1.2	2.0	2.3	1.9	1.9	1.5	8.7	9.2	9.1
Great Britain	1.8	2.2	2.6	1.3	1.9	1.8	5.1	5.1	5.1
Finland	1.6	2.2	2.9	2.0	1.7	1.5	9.1	9.4	9.3
Sweden	1.9	1.4	2.7	2.0	2.5	1.8	4.9	5.3	5.3

Source: European Commission, March 2003

United States of America

Preliminary annual growth estimates for the United States stood at 1.4% in the first quarter. The indicator remained some 0.2 percentage points lower than the average expectations of analysts and outpaced the respective figure for the fourth quarter of 2002 by just as much. Annual GDP growth rate declined to 2.1% in the first quarter from 2.9% in the fourth quarter. Compared to the first quarter of 2001 both investments and stocks declined, by 1.5 and 1.4%, respectively. Annual growth was consistently supported by private consumption (4.1%), but due to seasonal factors the rise in consumer spendings slowed down too from the fourth quarter of 2002.

The start of the second quarter did not bring about anything highly positive. Regardless of the slight post-Iraqi-war optimism, latest surveys show that the slump in the economy of the United States has been sustained. The Institute for Supply Management (ISM) index witnessed another decline in April – by 0.8 points to 45.4 points. In the past five months the index has plummeted by 9.8 points. Large unutilised corporate production resources and low investment activity has spurred consistent increase in unemployment – January through April the unemployment rate rose by 0.3 percentage points to 6%. Judging by the ISM index as well as industrial production and labour market statistics, economic growth in April was estimated to remain near zero.

In the medium and longer term the biggest problems will be the consistently growing current account deficit and the debt burden of private persons. In the first quarter the nominal goods and services deficit was record high, outpacing the respective figure for 2002 by nearly a third. The fast depreciation of the US dollar and structural problems in other economic centres also reduce the probability that the US current account deficit might improve as a result of faster global economic growth.

Japan

Japan’s economic indicators were predominantly weak in the first quarter. Even though private consumption and corporate investments were comparatively large, net exports and public investments had a negative impact on the economy. In effect, the GDP remained on the level of the fourth quarter of 2002 (+0.01%) while annual growth stood at 2.5%. Meanwhile, sharp decline in the GDP deflator (to an annual -3.5%) was a negative surprise. Stock market slump also resumed – at the end of April the Nikkei 225 index declined to 7,600 points, which is the lowest level since the autumn of 1982.

The central bank decided to respond to weak economic outlook by easing its monetary policy: the balance surplus target was raised from 5 trillion yens to 22–27 trillion yens initially and then to 27–30 trillion yens, also the list of securities accepted as loan collateral was supplemented. In order to boost the stock market, it was decided to expand the ratio of shares in the investment portfolios of state-owned companies (Japanese Post and state-owned insurance companies). Nevertheless, these measures are unlikely to solve the banking crisis and give the economy a boost.

According to the International Monetary Fund (IMF), in order to escape from deflation Japan should adopt a policy of inflation targeting, otherwise there is the risk of faster deflation.

Euro Area

According to the preliminary estimates of the Eurostat, the seasonally adjusted GDP of the euro area economies remained on the level of the IV quarter of 2002 during the first three months of 2003 while the year-on-year economic growth stood at 0.8%. Both internal demand and exports were estimated to have remained weak.

Monthly growth slowed down throughout the first quarter. This is manifested in production and retail sales indicators: in March the production growth indicator turned negative (-1.2% compared to February) and the PMI index reflecting activity in the servicing sector slided below 50 points. The competitiveness of the most open euro area economies (among larger countries mainly Germany, but from Estonia's point of view also Finland is important) has been reduced throughout 2003 because of the appreciation of the euro. In early May the euro reached its peak of the past four years against the dollar, which turned the net exports growth indicator that had supported economic growth in 2002 negative in the first quarter.

Economic growth is unlikely to resume neither in the second nor in the third quarter. The first survey data that include the period after the Iraqi war or immediately before the end of the war do not indicate improved security and future outlook – in April the purchasing managers' index in the industrial sector declined by another 0.6 points (to 47.6 points); the new orders component declined in the indices of several member countries while unemployment that had remained stable in 2002 showed increasingly evident indications of growth. Also, the indicator model suggests a close to zero growth rate for the second and third quarter.

The weakening economic environment in the monetary union is being increasingly conspicuously reflected also in the declining price pressure. If in the first quarter the inflation rate stood at annual 2.4%, in April the indicator declined to 2.1% and in May to 1.9%. The subdued price pressure enabled the European Central Bank to resume lowering its interest rates – on 5 June the key interest rate was reduced by 0.5 basis points to 2%.

Nordic Countries

In the first quarter 2003 **Finland's** economic growth slowed down. Even though fundamental economic indicators (debt burden of residents, budgetary position of the government sector) were comparatively good, the GDP indicator remained below expectations (-1.3% compared to the fourth quarter of 2002). The year-on-year growth rate of 1.2% was the slowest in the past four quarters.

The principal underlying reason behind declining economic activity was the consistently weak external demand and the appreciation of the euro that curbed the competitiveness of the industrial sector. Therefore, real revenues from exports decreased by 1% quarter-on-quarter, which was further amplified due to the decline in export prices.

The slump in industrial production deepened further at the beginning of the second quarter – in April industrial production declined by 3.8% and capacity utilisation in manufacturing by two percentage points (83%) against the same period in 2002. Of branches of economy precision electronics and metal industry are consistently the weakest. According to surveys carried out in May companies are continuously pessimistic regarding production volumes in the coming months. In the producer confidence index most of the subcomponents related to orders for the coming months and production volumes declined, and only 56% of industrial companies are currently working at full capacity.

Modest export revenues and lack of clarity regarding external demand recovery also keep a lid on corporate investment activity. Therefore, investments were the second major component that contributed to the GDP decline in the first quarter – investment demand decreased by 1.5% in three months and by 3.6% year-on-year.

Regardless of the deterioration in the growth outlook of exporting companies, other conditions affecting the consumption and investment behaviour of private persons remain consistently favourable (at least if compared to most of the euro area countries). Interest rates are historically low and the decline is likely to continue while the debt burden of the residents is comparatively small (*ca* 35% of the GDP), the government is planning to cut direct taxes and price growth is under control. All this maintains consumer confidence at a considerably higher level than that of the respective producer indicator while promoting both loan-taking activity as well as growth in investment and consumption outlay. The latter were actually the principal growth engines in the first quarter, having increased by 2.5% year-on-year and by 0.1% quarter-on-quarter.

In **Sweden** the GDP increased by 2.2% in the first quarter of 2003 against the first quarter 2002 and by seasonally adjusted 0.6% against the fourth quarter. The growth was supported by internal and external demand alike.

Despite the frailty of global demand, Swedish companies managed to boost their exports in fixed prices by an annual 3.4%. A contributing factor was improvement in competitive conditions through the decline in the nominal exchange rate of the krona against the euro. Meanwhile, exports to the neighbouring countries whose economic growth has remained faster than average while exchange rates have appreciated soared above all – nominal exports to other Nordic countries surged by 8% and to the acceding countries by 10%.

In spite of faster export growth, industrial companies view near future outlook as being comparatively modest. According to the surveys carried out in May, 75% of the companies are satisfied with the current level of orders, however, at the same time there are plans to reduce workforce and cut other costs.

Besides export income another principal source of economic growth in the first quarter was private consumption that went up by 1.8% year-on-year. Consumption was largely supported by government sector transfers that increased significantly already in 2002 along with consistently declining interest rates. The latter spurred households' loan demand and investments into the real estate sector.

Due to the consistently strong assets and liabilities structure and growth in disposable income, consumers' evaluation of their economic future improved in the second quarter as well – in May the respective index soared for the third consecutive month and approximately third (31%) of the households assumed that their financial situation would improve during the next year. Hence, private consumption is likely to remain an essential economic growth engine also in the second quarter.

Regardless of the comparatively large growth in export revenues in early 2003, corporate investment activity remains low – in the first quarter investments into fixed assets decreased by 0.7% year-on-year (incl by 1.5% in the private sector). According to the estimates of manufacturing companies, also stocks are larger than ordinarily and because of the global insecurity further reduction in labour costs is planned. Therefore it is likely that private and public consumption expenditure is to remain the foundation of internal demand throughout 2003.

Declining electricity and fuel prices curbed price growth in April and May. After peaking in February (3.4%) the 12month consumer price index fell to 2.3% in April and to 1.9% in May. Referring to slumping global demand and reduced internal and external inflationary pressure

Sweden's central bank lowered the repo rates by 0.5 basis points on 5 June – to 3%. In its concurrent inflation report also the GDP prediction was adjusted downwards by 0.5 percentage points compared to the estimate in March – to 1.2%. The most adjusted outlook was that of investments: instead of the earlier 2.5% growth a decline of 0.8% is expected. The central bank also lowered its 2004 GDP growth forecast by 0.3 percentage points – to 2.1%. Notwithstanding the lower forecasts, the central bank regards risks to be actually bigger than earlier, should economic growth slow down.

Baltic Countries

Latvian economy maintained its growth trend also in the first quarter of 2003, remaining largely unaffected by the sustained weakness in Western Europe: in the first quarter the registered GDP growth stood at 8.8%. Annual growth in industrial production soared from 6.7% in January to 11% in March, but this was greatly affected by the fact that the first quarter of 2002 was a modest basis for comparison. Last year internal demand was largely related to private consumption and the same trend seems to be maintained also this year. Retail sales increased by 13% year-on-year. In line with the year 2002, internal demand is supported by rapid loan growth. Increase in consumer prices accelerated gradually in the first quarter – from 1.4% in January to 2.5% in April. One of the reasons behind such growth was the increase in fuel prices. Faster inflation rate has been predicted for the future as well (see Table 2.2).

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

	GDP growth (%)			CPI growth (%)			Unemployment (%)		
	2002	2003	2004	2002	2003	2004	2002	2003	2004
Estonia	5.8	4.9	5.1	3.6	3.5	4.0	10.3	10.0	9.6
Latvia	6.1	5.5	6.0	1.9	2.5	3.0	12.3	11.1	10.4
Lithuania	5.9	4.5	5.0	0.3	1.0	2.5	16.9	16.2	15.3
Poland	1.3	2.5	3.7	1.9	1.1	2.3	20.0	20.6	20.0
Czech Republic	2.0	2.8	3.9	1.4	1.5	2.8	7.3	7.0	6.3
Hungary	3.3	3.7	4.1	5.3	5.0	4.5	5.8	6.2	6.0

Source: European Commission, March 2003

Exports soared in the first quarter by 18.5% but large domestic demand has resulted in even faster growth in imports (22.5%). Therefore, foreign trade deficit was larger than in the first quarter of 2002. The structure of exports has not changed with timber and textiles still dominating. Also the most important export partners have remained the same as a year ago. The services account surplus remained on the 2002 level. The growth in services has been curbed because of oil transit whose turnover has significantly reduced from last year.

The Bank of Latvia has become more active lately and has urged the government to take serious steps in order to reduce high budget deficit (planned at 3% of the GDP in 2003), which is inappropriate considering the situation in the economy, and has promised to contemplate raising interest rates, if the current account deficit continues to expand.

Lithuanian economy expanded by 9.1% in the first quarter according to preliminary estimates. Growth in exports and industrial production was vigorous in January and February. A major contributor was the strong growth in the oil industry, which had consistently suffered from supply problems at the beginning of 2002. Growth in industrial sales accelerated to an annual 33% in February, but in March the impact of the base effect faded away and the growth rate decreased to 6.5%. The quarterly growth rate stood at 19.2%. Moderate growth in private consumption continued as well. Lithuania's price level still remains lower than in 2002 due to fallen food prices. In January and February consumer prices fell by 2.2% and in April by 1% year-on-year.

In line with the increase in industrial production exports expanded in January and February by approximately 40% year-on-year. The main booster was oil products export, which soared by nearly twice a year. All in all, quarterly export of goods outpaced the level of 2002 by 25.9%. Since the oil products processed at Mazheikiai have been channeled through Switzerland, the latter has become the biggest export partner for Lithuania (a share of 14.9%, having surged 46 times). Imports have increased from month to month and the quarterly growth stood at 9.5%, if compared to 2002. Foreign trade deficit remains lower than at the start of 2002. The current account balance showed a surplus during the first two months as a result of faster growth in exports, but on the quarterly level there was still a slight deficit that amounted to an estimated 1% of the GDP.

Central Europe

In major central European countries moderate economic growth continued in the first quarter. Industrial development was comparatively stable at the start of the year while exports have fluctuated. These are more affected by the fragile state of the German economy. Inflationary pressure has remained modest, yet there have been no interest rate reductions after the ones at the start of the year (except in Poland). Acceleration in the economic growth still relies on the situation in the EU member countries.

Czech industrial production increased at a rather favourable pace early this year (5–7% compared to 2002), export indicators fluctuated and internal demand remained comparatively significant. Industrial growth in **Hungary** slowed down in February to annual 1.5% followed by faster speed in March. Exports declined year-on-year and remarkable improvement is not anticipated in the near future. **Poland's** industrial production and export growth was rather good but imports declined. This indicates comparative instability in internal demand, even though the first signs of recovery had appeared in 2002.

Inflation rates were low in the first quarter. In April the annual inflation rate declined to 0.3% in Poland and to 3.9% in Hungary while both indicators stood at record low. In the Czech Republic the 12month consumer price index was even negative; in April the monthly rate was somewhat higher as a result of price regulation.

The fiscal policies do still not comply with the requirements of the European Monetary Union. Besides the Czech Republic also Hungary is anticipating that in the coming years it will be impossible to meet the Maastricht fiscal criteria. Also, there is a risk that fiscal deficit in Poland will increase.

Russia

The first quarter of 2003 was the most successful one for the Russian economy in the last three years – according to preliminary government estimates, annual GDP growth stood at 6.4% (the last time quarterly GDP growth was that fast was in the fourth quarter of 2000). Due to soaring real income of the residents (16%) the growth was largely underpinned by private consumption that increased by annual 8–9%. Because of the high oil prices and the peak in the metal market also growth in exports was remarkable (41%). Oil and oil products account for as much as 60% of Russia's total export of goods.

Arising from favourable external demand on commodities markets and due to the development in the engineering sector, industrial production increased by 6% in the first quarter, which is the best performace after the peak of 2000. A growth rate of 7.1% has been predicted for April. Taking into consideration the decline in the oil prices that occurred in April one might expect that namely metal and engineering industries will become increasingly important regarding industrial growth. Resulting from the faster growth in commodities' export the current account surplus soared by almost twice year-on-year – to 11.9 billion dollars. The surplus of trade balance was even larger – by 22% – and stood at 14.6 billion dollars.

Fast economic growth is likely to continue also through the second quarter. This is supported be several factors: a) the price of oil started to go up, which will pave the way for stable economic growth at least; b) the growth trend has been maintained on the metal market for the time being; c) optimism is underpinned also by the comparatively good outlook of the engineering industry that is based on arms exports. Initially, slowdown in private consumption (also growth in real income) is not anticipated. The contributing factors to the favourable external situation are OPEC's efforts to maintain oil prices at the mid-May level and Russia's tacit support to Iraq not coming back to the global oil market in its full capacity before the end of 2003. According to the estimates of the IMF, oil price will remain at 25 dollars per barrel for another few years and that would be a strong guarantee for sustained economic growth in Russia.

International Financial and Commodity Markets

In major **stock markets** prices predominantly rose in the second quarter reaching the level sustained in the second half of 2002 (see Table 2.3). The main reason behind the rise was the speedy end of the Iraqi war and the associated expectations as to swift resumption in economic activity. The Japanese stock market was also underpinned by the decision of the central bank to increase the share of local shares in the investment portfolios of state-owned companies. Compared to the record low levels in March and April, the S&P 500 index, the Nasdaq composite, Eurobloc 300 and Nikkei 225 alike have surged by 20%, and in some cases even by 30%. Regarding further development of the markets, the key question is whether the currently predominant rather positive expectations towards resumption of the US economic arvtivity actually materialise or not.

Table 2.3. Indices of major stock markets

	31.12.02	26.06.03	Change (%)
USA (S&P 500)	879.8	985.8	12.0
USA (Nasdaq)	1,335.5	1,634.0	22.4
Japan (Nikkei 225)	8,579.0	8,923.4	4.0
Euro area (Eurobloc 300)	876.7	900.2	2.7

In **bond markets** the most significant event in the second quarter was the lowering of interest rates in June by 50 basis points in the euro area and by 25 basis points in the United States – to the record low of 2.0 and 1.0%, respectively. Both central banks explained their decisions with the need to reduce deflation risks and stimulate economic growth. Regarding growth outlooks, the US central bank was comparatively more optimistic and their interest cut was smaller than some analysts had expected. As a result, the stable decline in short- and long-term interest rates sustained throughout the quarter (see Table 2.4) turned into a rise by the end of June.

Table 2.4. Interest rates of major bond markets

	Interest rates of 3 months			Interest rates of 10 years		
	31.12.02	26.06.03	Change (basis points)	31.12.02	26.06.03	Change (basis points))
USA	1.20	0.89	-31	3.82	3.55	-27
Japan	0.01	0.01	0	0.91	0.64	-27
Euro area	2.93	2.17	-76	4.20	3.81	-39

In **foreign exchange markets** the euro resumed its climb after levelling off during two months. This lasted until the end of May, which brought the euro above 1.19 dollars and 140 yens at its highest level. The continuing appreciation of the euro was above all underpinned by the consistently growing US current account deficit and economic difficulties in the euro area and other regions, which is why it is unlikely that the US current account deficit might decrease as a result of growing demand elsewhere in the world. In June, after receiving somewhat more positive news about the US economic activity and a smaller interest rate cut by the central bank than some analysts had expected, the dollar appreciated slightly (see Table 2.5).

Table 2.5. Changes in exchange rates of major currencies

	31.12.02	26.06.03	Change (%)
JPY / USD	118.8	119.4	0.5
USD / EUR	1.049	1.143	9.0
USD / GBP	1.610	1.662	3.2

No major changes occurred in the **commodities markets** in the second quarter**.** After a decline at the end of March the price of oil fluctuated between 26–32 dollars per barrel with short-term changes resulting from growing oil stocks in the United States and speculations around the OPEC production quotas. Also the price of gold and the CRB commodity index fluctuated in the range of 5 to 10% throughout the quarter with no clear trend emerging (see Table 2.6).

Table 2.6. Changes in the commodity markets

	31.12.02	26.06.03	Change (%)
CRB index	244.3	250.5	2.5
Crude oil (WTI; USD/barrel)	31.2	29.0	-7.1
Gold (USD/ounce)	348.1	344.2	-1.1

ESTONIAN ECONOMY

External Demand

The expected positive turn in external environment had not emerged by April-May 2003, regardless of the end of the Iraqi war and the insecurity preceding it. **The slow recovery in external demand has curbed growth in Estonia's export revenues.** The 8.5% nominal growth in export of goods outpaced the respective figure in 2002 by 9 percentage points, but this largely resulted from increased export of industrial products compared to the low level early last year. Meanwhile growth in normal exports slided below the respective figure in 2002 by around a percentage point (7.4%).

Even though Estonia's growth rate can be considered rather fast if compared to the modest economic indicators of its trading partners, it was a rather rare phenomenon that the role of goods export as an economic growth generator was reduced and growth was more heavily supported by internal demand than a year ago.

Meanwhile, annual growth in normal exports was underpinned by the **increase in the export** of traditional main components – **furniture and timber** – accounting for more than two fifths of the rise, even though growth in timber export was more modest than in 2002, which was partly explicable with harsh ice conditions. Normal export of food and clothing items fell in the first quarter (see Table 2.7).

Table 2.7. Volume of normal export by groups of goods (EEK m)

	Q1 2002	Q1 2003	Change	Influence
Furniture etc	1,138	1,293	155	23.4%
Machinery and equipment	783	922	139	21.0%
Timber, paper and products thereof	2,271	2,384	112	17.0%
Mineral products	290	377	87	13.1%
Other	338	419	81	12.3%
Metals and metal products	616	692	76	11.5%
Chemical products	743	794	52	7.8%
Transport equipment	438	450	12	1.8%
Clothing and footwear	1,156	1,139	-17	-2.5%
Food and non-alcoholic beverages	1,063	1,028	-35	-5.3%
Total	**8,836**	**9,498**	**662**	**100.0%**

One of the factors curbing exports in the first quarter might have been the **euro exchange rate** that soared by 22.4% against the dollar. The value of goods exported for dollars decreased by 34.1% in the first quarter while exports denominated in other currencies soared by 14.4%. The dollar exchange rate had the biggest impact on food (fish products in particular) and chemical products, which reduced the growth rate of direct export by 3 percentage points.

The growth rate in industrial export amounted to 13% in the first quarter, which is higher than the 2002 average (-9.1%) but only because of the **low basis of comparison**. Regardless of the resumption in growth, demand for the products of the subcontracting sector has remained sluggish: in the first quarter total industrial export outpaced the average of last year, but plummeted by 19% from 2001.

If early 2003 development in the services exporting sectors was hampered by **climatic conditions** that had a negative impact mainly on the economic activities of ports (in the first quarter the Port of Tallinn reloaded 1.4% less goods than at the same time in 2002), then in April the situation somewhat improved: the port reloaded 3.5 million tons of goods, which was the best indicator for April in the last seven years. As a result, the port managed to post a 1.1% growth in four months. The indicators for Eesti Raudtee (Estonian Railway Company) and Tallinn Airport showed customary growth: cargo transport on the railway increased by 6.5% in the first quarter while air transport went up by 4.5%.

Internal Supply

Regardless of the slowdown in Estonia's export revenues producer confidence in the industrial sector remained quite strong in the first quarter and even increased in April. In May, however, the confidence declined both quarter-on-quarter and year-on-year. All in all, it can be said that **in the first quarter growth in the optimism of industrial companies halted and confidence levelled off followed by a decline in April and May.** This probably indicates insecurity regarding the development in external demand.

In the first quarter growth in manufacturing sales accelerated from 8.2% in 2002 to 11% and due to the 25.6% growth in the energy sector total industrial sales were boosted even further (from 7.5% to 12.3%). **In April, however, growth in industrial sales slowed down**: total industrial sales increased by 7.8% while in manufacturing the indicator was only 5.2%. Even though the decline in the growth rate can be associated with the unusually high comparison basis (in April 2002 industrial sales in the manufacturing increased by 17.9% and total industrial sales by 17.5%), sales problems emerged in some branches (see Figure 2.1). The development in the industrial sector in the first quarter was in line with the economic growth that, according to preliminary estimates, amounted to annual 5%. Industrial sales in manufacturing indicate declining growth rate in the second quarter.

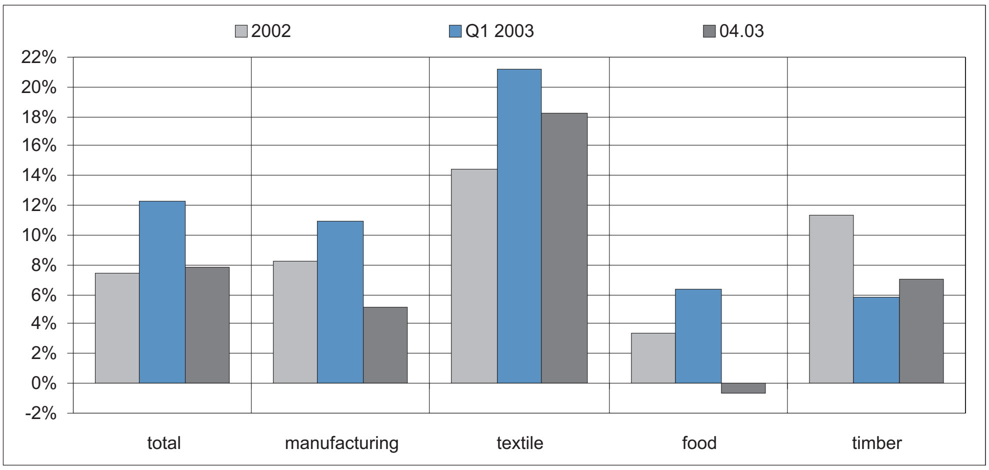

Figure 2.1. Annual growth of industrial sales

Internal Demand

In the first quarter of 2003 the relatively extensive difference in Estonia's economic growth compared to that of the euro area that characterised last year was sustained (according to preliminary estimates the difference was some 4 percentage points), which was more than before underpinned by internal demand. Even though the nominal growth rate in internal demand slowed down to a certain extent (remaining below the 2002 figure of 15.5% according to preliminary estimates), real growth most likely remained on the same level as in 2002 because of the low inflation rate.

Investmentents

The fast growth in internal demand was largely underpinned by increasing investments, indicated by the accelerated growth in capital goods imports in the first quarter compared to the same time in 2002. Therefore, the investments to the GDP ratio will likely soar above 35%. The underlying factors contributing to investment growth are low interest rates as well as sustained corporate optimism towards the future.

In order to finance investments, foreign savings were attracted in large volumes while the share of domestic savings fell. **Positive is the growth in the share of direct foreign investments as the source of covering domestic financing shortage** (the volume of net direct investments covered some 60% of the current account deficit in the first quarter).

Based on the component analysis of the shift in the volume of direct imports, one can say that investments increased in the first quarter largely at the expense of so-called extraordinary investments, which resulted in the larger than expected size of imports. According to foreign trade statistics, railway engines and other rolling stock were brought to Estonia along with reactors, electrical machines and ships in such volumes that these items boosted the total size of traditional imports by some 1.2 billion kroons and accounted for 45% of the rise in overall imports. One-off investments into the development of technical infrastructure accounted for an estimated 4 to 5 percentage points of the growth in the current account deficit measured as a percentage of the GDP.

Private Consumption

Private consumption is assumed to have remained brisk also in the first quarter, even though fastening pace thereof halted. Consumer confidence remained high. The sentiment was underpinned by reduced fear of losing a job, stable pay rise, low inflation and interest rates. The growth in private consumption was also spurred by continuing inflow of loan resources into households. In April and May consumer confidence still shrank slightly.

Even though growth in retailing was fast in the first quarter (10.4%), it still remained nearly 5 percentage points slower than at the same time in 2002. Meanwhile, consumer goods import was reduced year-on-year. Apparently the shift in private consumption continued, whereby, the share of goods purchased to satisfy daily needs is declining while that of durable goods is increasing.

Public Sector

Also central government tax revenues indicate strong internal demand. The biggest boost in the first quarter was seen in gross VAT revenues from imported goods (15.4%). In April, however, the growth in VAT revenues slowed down to 2.6%.

According to preliminary data, the funds paid into the state budget during the first four months of 2003 outpaced expenditure by nearly 0.9 billion kroons, however, there was a slight deficit on the municipal level. On the whole, the public sector has played a balancing role in the economy and the difference between revenues and expenditure in the first quarter might have amounted to 3% of the quarterly GDP.

External Balance

The slowdown in the export revenues growth that occurred concurrently with fast rise in internal demand resulted in a current account deficit that outpaced that of 2002 (in the first quarter the estimated average of four quarters was in excess of 14% of the GDP).

The principal reason behind the increase in the negative balance of the foreign trade account was the above-mentioned **imports of supplementary investment goods.** Extensive imports also brought about the need to buy transport services, meanwhile the opportunities to export transport services did not improve because of weak external demand. Besides, services not offered in the Estonian market had to be imported for a few major projects, which is why services export outpaced imports by just 3–4% of the quarterly GDP. All in all, these factors contributed to the increase in the deficit of the total balance of goods and services (see Figure 2.2).

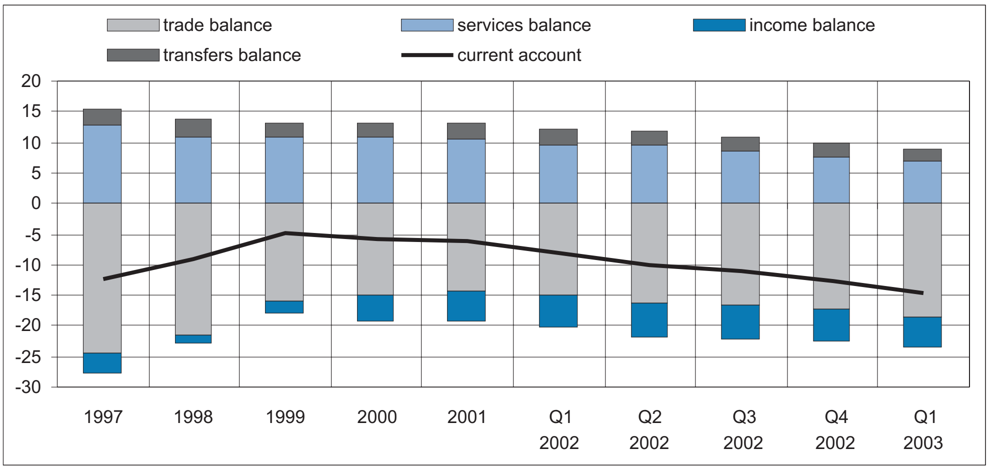

Figure 2.2. Current account and its sub-balances (% of GDP)

Because of the changed structure of foreign trade it is difficult to evaluate the impact of the depreciation of the dollar on external balance. The depreciation of the dollar should have reflected on the imports side, however, due to the fact that major one-off deals were made in dollars, all other processes were shadowed by these transactions.

Employment and Unemployment

Employment continued to rise in the first quarter, even though the growth rate (0.3%) remained slower than in the quarter before and the average of 2002 (1.4%; see Figure 2.3).

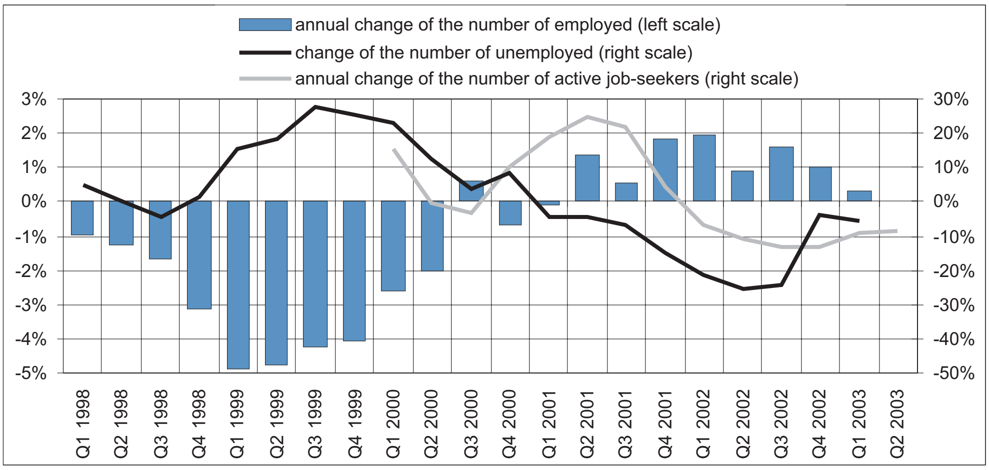

Figure 2.3. Annual change of employed and unemployed persons and active job-seekers

Year-on-year, employment went up the most in the closed sector (health care, education, real estate and public administration), where growth amounted to 14%. The growth in manufacturing was minimal and did not exceed 2.5%.

Unemployment rate (10.6%) was smaller than in the previous quarter (11.3%) and in the first quarter of 2002 (11.2%). The growth in the number of non-active people remained in line with the seasonal tendency.

The number of registered unemployed went down in the second quarter as well (stood at 10.8% in April and at 9.4% in May). Hence, labour market problems did not aggravate. According to the consumer confidence barometer, the fear of becoming unemployed actually increased slightly in April but the assessment still reflected decline in unemployment. In May the assessment declined again. Further rise in employment depends on the growth in external demand.

Wages and Productivity

In the first quarter the growth in average gross wages (10.7%) remained largely on the same level as the average in 2002, but stood at 1.5 percentage points lower than at the same time in 2002. The growth in payroll did not outpace that of nominal GDP in any of the quarters in 2002 and according to preliminary estimates, neither did it happen in the first quarter this year (see Figure 2.4).

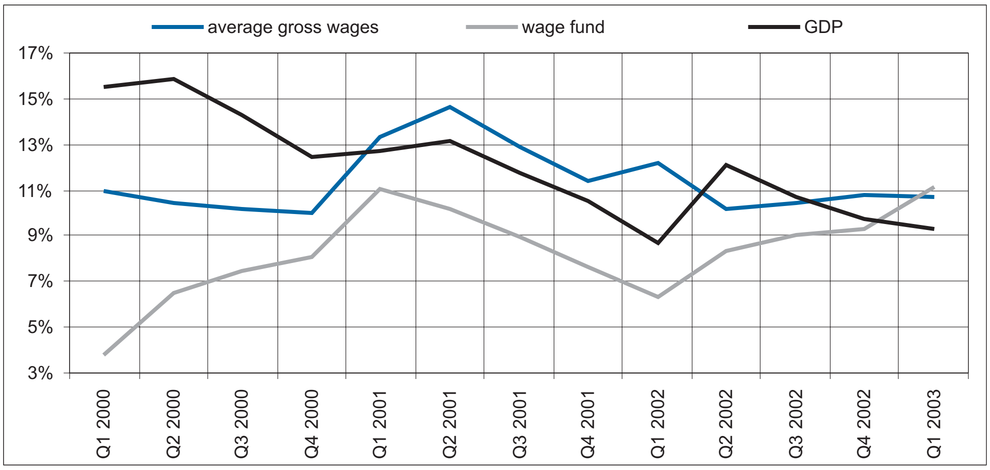

Figure 2.4. Annual nominal changes of average wages, wage fund and GDP

Early this year the growth in gross wages was diverse in different branches, reflecting among other things differences in remunerating last year's performance. For example, pay growth in financial intermediation where the average wages in the first quarter exceeded the average in all other areas by 3.1 times and was 30% higher than a year ago, can be considered extraordinary. It was claimed to have resulted from extraordinary disbursements and the difference should decrease further on. The growth in the pay in financial intermediation affected the average in the amount of an estimated one percentage point.

In sum, pay growth was the fastest in the closed sector branches. Growth in manufacturing was 8.6% and the pay level there amounted to 90.9% of the average. Due to modest external demand, operating costs in some areas (eg in fishing) had to be reduced and wages cut.

Since Estonia's inflation rate was extraordinarily low in the first quarter, annual growth in real wages was record high (8.1%). The growth in social tax payments in April and May indicates that the rate was sustained also at the beginning of the second quarter.