I. WORLD ECONOMY

In 2003, the world economy recovered considerably and growth accelerated. The IMF estimated GDP growth of developed countries at approximately 3.8% (3.0% in 2002; see Table 1.1)[1]**. Recovery is predicted to continue in 2004 and stabilise in the longer run.**

Table 1.1. Economic indicators of industrial countries

	GDP growth (%)		Annual average CPI growth (%)		Annual average unemployment rate (%)		Budget surplus/deficit (% of GDP)		Current account balance (% of GDP)	
	2002	2003[1]	2002	2003[1]	2002	2003[1]	2002	2003[1]	2002	2003[1]
World	3.0	3.8								
G7 countries	1.4	2.2	1.3	1.7	6.5	6.8	-3.6	-4.7	-1.4	-1.6
United States	2.2	3.1	1.6	2.3	5.8	6.0	-3.3	-4.9	-4.6	-5.0
Japan	-0.3	2.7	-0.9	-0.2	5.4	5.2	-7.9	-8.0	2.8	3.2
European Union	1.1	0.8	2.2	2.0	7.7	8.2	-1.9	-2.6	0.9	0.4
Euro area	0.9	0.4	2.3	2.1	8.4	8.8	-2.3	-2.9	1.1	0.7
o/w Germany	0.2	-0.1	1.3	1.1	8.6	9.9	-3.5	-4.0	2.8	2.4
France	1.2	0.2	1.9	2.2	8.8	9.3	-3.1	-4.3	1.8	0.8
Finland	2.3	1.9	2.0	1.3	9.1	9.0	4.6	2.1	6.8	6.0
Other EU countries										
o/w Great Britain	1.7	2.1	1.3	1.3	5.2	5.0	-1.5	-3.0	-1.7	-2.2
Sweden	1.9	1.6	1.9	2.3	4.0	4.9	1.1	0.2	4.5	4.5

[1] The data for 2003 are preliminary.
Source: International Monetary Fund, World Economic Outlook, March 2004.

In early 2003, the main problems of the global economy were still low activity and geopolitical uncertainties related to the Middle East. Although a shift for the better was expected in both areas, the forecasts were predominantly cautious: GDP growth in the US was predicted at 2.7%, in Japan at 0.4%, and in the euro area at 1.5%[2]. In reality, economic growth in the US and Japan turned out higher than expected (3.1% and 2.7% respectively, according to preliminary estimates). In the euro area, however, growth fell short of expectations as well as the respective 2002 indicator, reaching just 0.5%. For the Estonian economy, external demand remained moderate also in 2003.

[1] IMF's World Economic Outlook, March 2004.
[2] Consensus Forecasts.

After the geopolitical tensions had eased, the global economy picked up, although growth varied across regions. The leading position belonged to the US and Asian countries. The inflation rate continued to fall, but the surge of economic activities reduced the risk that inflation could drop to an undesirably low level. In developed countries, the recovery failed to lead to any significant increase of employment, although some stabilisation of the labour market could be noticed. The predominantly expansionary monetary policy of central banks in the first half of the year came to an end in the second half and was replaced by raising key interest rates in some countries (Australia, the UK). In the US and the euro area, central banks expressed opinions that base rates could remain low for a longer period in the interests of stable economic growth. Therefore, there were no major external factors at the beginning of 2004 that could have increased interest rates in Estonia.

Acceleration of growth is predicted to continue in major economic regions in 2004. This should guarantee higher employment and create prerequisites for further sustainable development.

UNITED STATES AND JAPAN

In 2003, GDP growth turned out higher in the US than expected and the country maintained its role as the engine of global economic growth. Economic results of Japan were also better than predicted.

US economic growth is estimated at 3.1% in 2003. This was largely based on considerably more expansionary economic policy than that of the euro area or Japan, for example. Thus, buoyant consumption of US households remained one of the main pillars of the world economy, although growth of corporate investments also showed signs of faster recovery. A turn to optimism was also reflected by the relatively extensive surge of stock markets and growing consumer confidence due to labour market stabilisation. Year-on-year, unemployment fell from 6% to 5.7%, and the inflation rate dropped from 2.5% to 1.8% by the end of the year.

The expansionary economic policy of the US came at a price – the current account deficit swelled to nearly 540 billion dollars (about 4.9% of GDP) and the budget deficit increased to 390 billion dollars (3.6% of GDP). These indicators reflect great imbalances and have led to the weakening of the dollar. Continuation of the expansionary economic policy could result in faster inflation. However, it might be complicated to slow down inflation through increasing the base rate, as higher debt burden has made economic growth increasingly dependent on cheap financing.

Japanese economic growth turned out higher than anticipated (2.7% according to preliminary estimates) mostly thanks to high export demand on account of rapid economic growth in Asian countries and the US. Although deflation, which slows down growth, decreased somewhat in 2003, Japan was unable to overcome it completely. Thus, defeating deflation and boosting domestic demand still remain the main economic policy goals in Japan.

EUROPE

In 2003, economic growth of the EU countries and the euro area was the smallest of recent years and the lowest among the world's three major economic regions (0.8% in the EU and 0.4% in the euro area; see Figure 1.1**). Difference in growth rates increased across Member States, and for the first time in the past decade economic recession was registered in Germany, the biggest member of the Economic and Monetary Union (EMU).**

Besides globally subdued economic activity, economic recovery of the euro area was slowed down by the high volatility of the nominal exchange rate of the euro and appreciation of the euro against the US dollar by 20%. The European Central Bank (ECB) tried to boost the economy by lowering the base rates by 0.75 percentage points (which also facilitated the drop of interest rates in Estonia), but despite the effort economic growth and domestic demand in particular (including consumption of households) remained weak in the euro area throughout 2003.

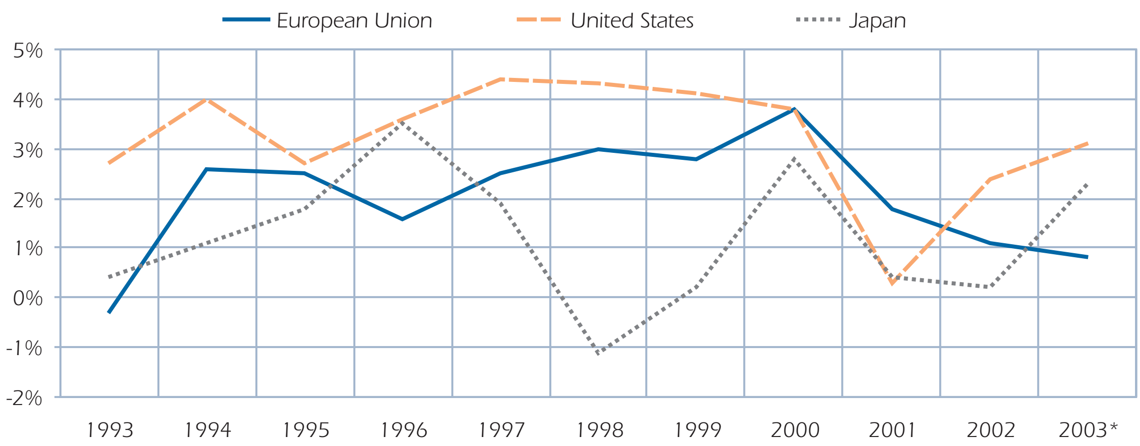

Figure 1.1. Annual growth of GDP in major global economies over the last decade
* The data for 2003 are estimated.

Regardless of moderate economic activity and an increase of the nominal exchange rate of the euro, inflation level remained near the ECB's targeted ceiling (2%) or slightly above it throughout 2003. Although this was due to several temporary factors (increase of indirect taxes in larger Member States and hike of food prices), faster-than-expected inflation rate combined with weak domestic demand pointed to structural rigidities of EMU members (see EU Economic and Financial Policy, Chapter II).

The outlook for the EU economy in 2004 depends, first of all, on whether and how fast the growth of external demand would lead to an increase of employment and growth of consumer confidence. Household consumption would create prerequisites for an increase of domestic demand and expand the growth base of the EMU. The latter also depends on the continuation of global economic growth and implementation of structural reforms.

Finland and Sweden

Estonia's major trade partners Finland and Sweden had higher economic growth in 2003 than the EU average, an estimated 1.9% and 1.6% respectively (see Figure 1.2)**, but even in those two countries growth remained below the potential level.** In both countries, economic growth was mainly based on household consumption. This was supported by the lowest interest rates of recent decades, slowing inflation,

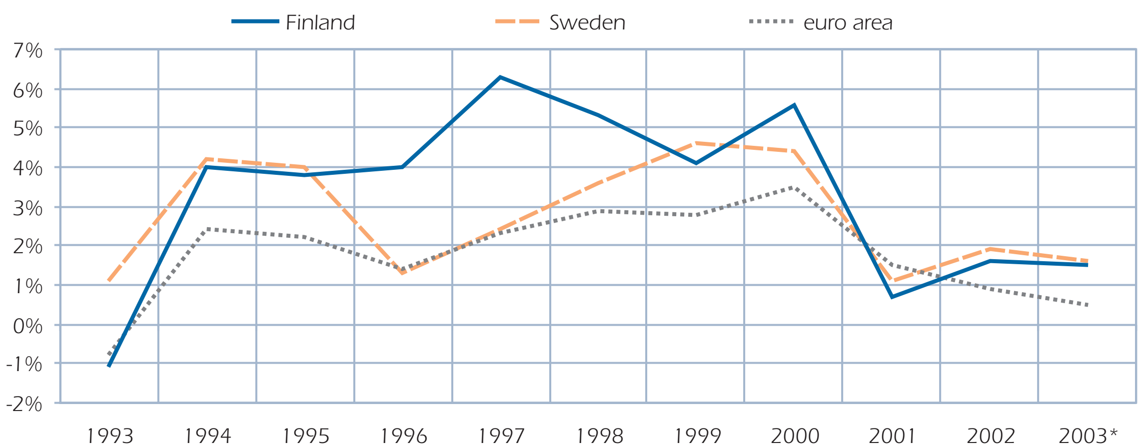

Figure 1.2. Economic growth of Estonia`s major trade partners
* The data for 2003 are estimated.

and in Finland also cutbacks in personal income tax and excise tax on cars. Thanks to strong fundamentals, the negative outcome of the Swedish euro referendum in September had no major impact on international financial markets.

Although the growth outlook for both countries in 2004 is considered relatively good, given the continuation of global recovery, further possible appreciation of the nominal exchange rate of the euro and the Swedish krona could have a negative impact on economic development. At the end of 2003, indicators of the extremely open industrial sector of Finland and Sweden were relatively moderate in the context of the general recovery of the world economy. The onset of economic recovery in Finland and Sweden has a long-term rather than immediate impact on Estonia's export volumes.

Baltic and Central European Countries

The Baltic and Central European countries continued their brisk preparations for EU accession in 2003. Changes were made in tax systems (mostly concerning VAT and excise taxes) and their harmonisation with EU requirements, structural reforms were continued, and economic ties were tightened with EU members and accession countries.

Table 1.2. Economic indicators of EU candidate countries

	GDP growth (%)		Average CPI growth (%)		Current account balance (% of GDP)	
	2002	2003[1]	2002	2003[1]	2002	2003[1]
Estonia	6.0	4.8	3.6	1.3	0.9	2.6
Cyprus	2.0	2.0	2.8	4.5	-3.5	-6.0
Latvia	6.1	7.5	1.9	2.9	-3,0	-1.8
Lithuania	6.8	9.0	0.3	-1.2	-1.4	-1.7
Malta	1.2	1.3	2.2	1.2	-6.2	-6.5
Poland	1.4	3.7	1.9	0.8	-3.9	-4.1
Slovakia	4.4	4.2	3.3	8.5	-7.2	-3.6
Slovenia	2.9	2.4	7.5	5.6	-2.3	-1.8
Czech Republic	2.0	2.9	1.8	0.2	-7.1	-8.0
Hungary	3.3	2.9	5.3	4.7	-9.2	-5.9

[1] The data for 2003 are preliminary.
Source: National statistical offices, central banks, and International Monetary Fund.

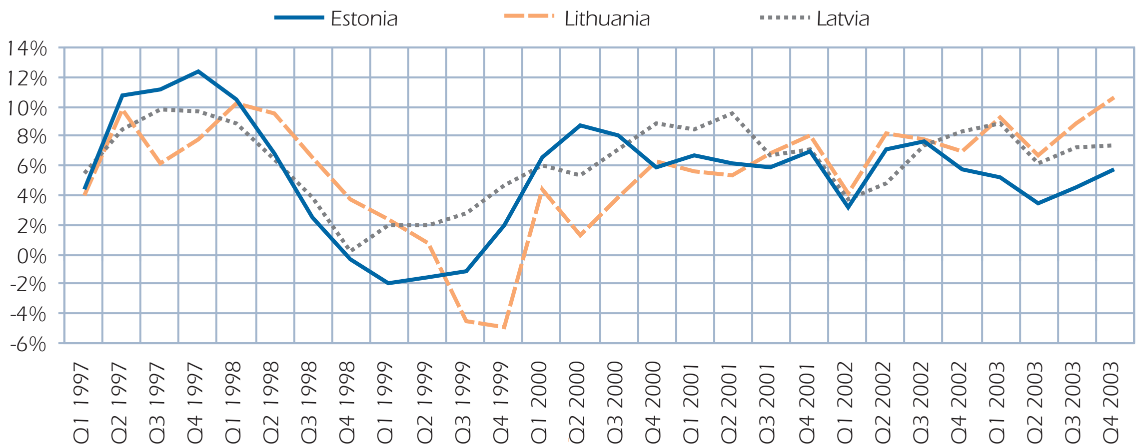

Figure 1.3. Economic growth in the Baltic States

Among the Baltic States, **Lithuania** enjoyed the fastest economic growth in 2003, which reached 9%. The **Latvian** economy grew 7.5% (see Table 1.2 and Figure 1.3). Growth was mostly based on high domestic demand, supported by favourable credit conditions offered by banks, low inflation (in Lithuania consumer prices even fell 1.2% year-on-year), and a rapid increase of real wages. Growth was also supported by relatively robust increase of exports and industrial production.

For Central European countries, 2003 was a complicated year as far as fiscal policy was concerned. In **Hungary**, the budget deficit, which reached 5.9% of GDP, led to instability in the currency and bond market and forced the central bank to increase interest rates to 12.5%, the highest level in Central Europe. Similar problems emerged in **Poland**, and a certain spillover effect could be felt in the financial markets of the **Czech Republic** and **Slovakia.** However, the international financial markets had enough confidence in the economic policy of these countries, and stability was quickly restored.

Russia

Favourable external demand and high commodity and fuel prices boosted Russian economic growth to 7% in 2003. The rapid increase of export income from oil products had a positive effect on the external balance and helped to improve the budgetary position of the government sector. This guaranteed regular servicing of foreign debt and occasionally even repayment ahead of schedule. The improved economic outlook allowed increasing the sovereign rating of Russia repeatedly in 2003, but stalling of structural reforms and commodity-based exports indicate continuing vulnerability of the Russian economy.

In order to curb price increases and lower inflation expectations, the Russian central bank changed its monetary policy goal – management of the nominal exchange rate of the rouble against the dollar was replaced with direct slowing of price increases in spring. As a result, the inflation rate was lowered to 12% by the end of the year, which had been the objective. The policy change led to the strengthening of the rouble against the dollar.