1. Recent Developments of the Estonian Economy

1.1. Economic growth and its main components

Estonia like two other Baltic States Latvia and Lithuania are the only former Soviet republics that are the new member countries of the EU since May 2004. The success of the Estonian economic development as a result of rather stable economic policy[1] which has been developed after regaining independence in 1991 is comparatively highly estimated by various international evaluations. For instance, International Institute of Management Development (IMD) World Competitiveness Yearbook (WCY) named Estonia the most competitive European post-socialist country among 49 leading and emerging world economies included in the IMD competitiveness survey. According to the IMD evaluations 2002, Estonia placed on the position 21. Since 2003, the IMD has distinguished the countries into two groups: the big countries (population over 20 million) and small countries (population under 20 million), and Estonia placed on the 17th place among 29 small nations (IMD, 2003). Another organization evaluating competition is the World Economic Forum (WEF), whose competitiveness survey includes 120 countries. The WEF competition growth index (grades national economic growth potential per capita for the next 5–8 years) placed Estonia in the 22nd position; microeconomic index (grades national productivity or GDP per capita) gives Estonia 28th position among 120 economies (WEF, 2003). Thus, also according to the WEF evaluations, Estonia got the highest competitiveness grade among the European post-socialist economies.

One distinct characteristics of Estonia's economy is the high level of economic freedom. The Heritage Foundation's economic freedom index 2004 placed Estonia on the 6th position among 161 other nations. Such a high place was given to Estonia due to the liberal trade and open foreign investment policies, low control over prices and a well-developed banking sector (Heritage Foundation, 2004).

Economic freedom and the openness of the Estonian economy have played an important role in attracting foreign direct investments and promoting economic growth, particularly in the context of preparing the EU accession. Estonia was nominated as an EU candidate country in 1997. [2] Since that time the economic growth of the Estonian economy has been faster than that of the Euro area (Figure 1.1). The exceptional periods were only the 4rd quarter of 1998 and the 1-3rd quarters of 1999 due to the Russian crisis in August 1998. Estonia's economy is also continued to grow despite the backdrop of the global economic slowdown and the declining world demand and thus worsening conditions for export in the years 2001-2003.

In 2003 Estonia's economic growth slowed down to 4.7% (Table 1.1). This indicator is lower than the average growth over the last three years but considerably higher than the EU and Euro area economic growth (respectively 0.8% in EU and 0.4% in Euro area). In recent years Estonia's economic growth was mainly supported by investments and private consumption (Table 1.1).

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[1] After regaining their independence in 1991, Estonian governments have followed economic policy as those which guided solving the following main tasks: 1) liberalization of prices; 2) privatization of state-owned enterprises; 3) introduction of a separate currency by means of a currency board system; 4) maintaining a conservative fiscal policy; 5) implementing a very liberal foreign trade regime.

[2] The EU candidate countries of the eastward enlargement formed two groups: 1) the Luxembourg group of candidate countries (formed in 1997): Poland, the Czech Republic, Hungary, Estonia, Slovenia, Cyprus, and 2) the Helsinki group of candidate countries (formed in 1999): Latvia, Lithuania, Bulgaria, Romania, Slovakia and Malta. The enlargement in May 2004 involved ten countries out of twelve (excluding Bulgaria and Romania).

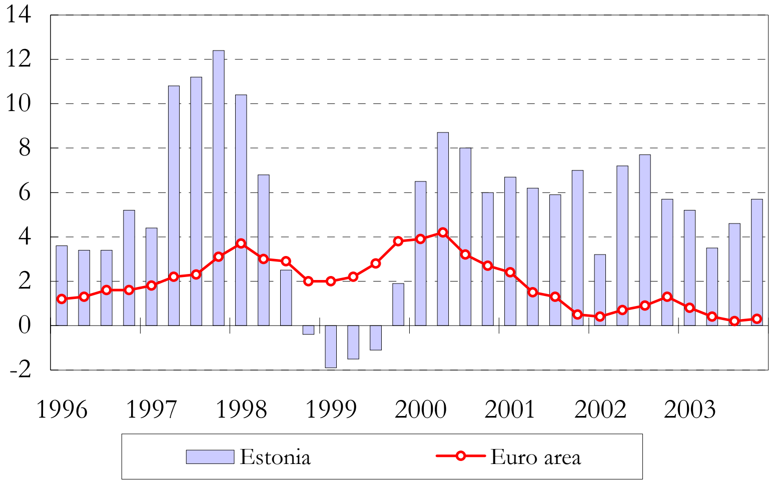

Figure 1.1. Economic growth in Estonia and Euro area in 1996-2003 (%).

Sources: Convergence Programme 2004; Statistical Office of Estonia; Eurostat; Bank of Estonia.

Table 1.1. The main sources and contributions to economic growth in Estonia in 1997-2003 (in %)

INDICATORS	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
GDP real growth	9.8	4.6	-0.6	7.3	6.5	6.0	4.7
Sources of economic growth							
Private consumption	7,8	4,3	-2,9	6,5	4,8	9,1	6,2
General government consumption	1,8	4,5	3,8	1,5	0,9	5,0	5,6
Gross fixed capital formation	17,6	11,3	-14,8	13,3	12,2	16,1	11,5
Change in inventories (% of GDP)	2,9	-0,3	-0,4	2,4	2,4	2,9	-1,4
Export of goods and services	29,5	12,0	0,5	28,6	-0,2	0,6	6,0
Import of goods and services	29,1	12,9	-5,4	27,9	2,1	5,4	9,0
Contribution to GDP growth							
Domestic demand (excl. Inventories)	9,3	9,2	-5,5	4,9	8,4	9,7	8,0
External balance of goods and services	-1,7	-1,7	5,1	-0,5	-2,2	-4,5	-3,4
Growth of added value by the main sectors							
Agriculture	5,8	0,0	-2,5	-1,0	-5,0	1,4	-3,5
Industry	10,8	2,1	-3,6	13,9	8,5	8,6	8,4
Construction	15,2	18,3	-8,2	13,8	4,3	13,9	6,9
Services	8,7	5,3	2,1	5,5	7,2	4,6	3,7

Sources: Ministry of Finance of Estonia, Statistical Office of Estonia, Bank of Estonia.

In 2003, the growth rate of added value has been the most remarkable in industry; but the growth rate declined in all sectors being negative in agriculture sector. The slowdown of growth rate of added value in industry sector (particularly in processing industry) was caused by inhibited growth of export and slow development of sub-contracting industries. At the same time the growth of added value in transport and communications sectors accelerated; this is attributable to optimisation of costs in transit companies and improved profitability of telecommunications sector. Real growth of real estate and other business related services also showed acceleration – this was supported by rise of real estate market and good economic results of companies involved in information technology, advertising and other business related services. The decreased growth of added value in construction sector in 2003 can be explained by slowed growth of construction market, brought on by recession in road construction. Energy sector's contribution to the growth of added value grew also remarkably due to the domestic consumption and increase of exports[3].

Low level of interest rates and high real wages and employment growth in the conditions of declining inflation and increasing investments are the main factors behind the recent economic growth in Estonia. Economic growth of Estonian economy is also supported by the economic development in the Nordic countries, where the economic growth has been faster than the EU average during recent years. Finland and Sweden are the main trading partners of Estonia and the majority of FDI came to Estonia from these countries. Thus, the impact of the Nordic countries' neighborhood on the Estonia's economic development is significant.

1.2. Current account deficit as the most problematic Estonia's macroeconomic indicator

The high level of current account deficit is a problematic macroeconomic indicator; it was significantly high in Estonia in 2003: -13.7%. By the way – this is the highest level of the Estonian current account deficit over the period 1997-2003 (Table 1.3).

Table 1.3. Main macroeconomic indicators of the Estonian economy in 1997-2003 (%)

INDICATORS	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
GDP (bln EEK)	64,0	73,5	76,3	87,4	97,9	108,0	116,2
GDP deflator	11,3	9,8	4,5	6,7	5,4	4,1	3,0
Consumer price index	11,2	8,2	3,3	4,0	5,8	3,6	1,3
Employment (15-74 years old, thousands)	617,2	606,5	579,3	572,5	577,7	585,5	594,3
Employment growth	-0,3	-1,8	-4,5	-1,2	0,9	1,4	1,5
Productivity growth	10,1	6,5	4,0	8,6	5,5	4,4	3,2
Unemployment rate	9,6	9,9	12,2	13,6	12,6	10,3	10,0
Average wages (EEK)	3 571	4 100	4 418	4 876	5 511	6 144	6 709
Wage real growth	7,6	6,0	4,3	6,1	6,9	7,0	8,3
Investments and inventories (% of GDP)	28,0	29,3	24,5	27,8	28,9	31,4	32,9
Current account (% of GDP)	-12,1	-9,2	-4,7	-5,8	-6,0	-12,3	-13,7

Sources: Ministry of Finance of Estonia, Statistical Office of Estonia, Bank of Estonia.

The high level of current account deficit is also stressed in the recent World Competitiveness Report as one of the major weaknesses of the Estonian economy (IMD, 2003). Therefore, the nature and causes of the high level of this indicator are also carefully analysed by the Estonian government institutions. The growth of trade balance deficit is the most notable component of the current account. Relatively slow growth in export of goods and services in 2002 and also in 2003 (respectively 0.6% and 6%) compared to import (respectively 5.4% and 9%; see Table 1.1) can be explained by the postponed recovery of foreign demand. Import growth increased in 2003, regardless of dropping growth of domestic demand, mostly due to the grown import of capital goods necessary for improving the competitiveness of the Estonian products in the world market and preparations for the EU accession. High current account deficit can also be explained by large volume of re-invested revenues, gained from profitable foreign investments (for instance, the re-invested revenues made up 4.8% of GDP in 2003).

The role of investments in economic development of Estonia has significantly increased during the recent years, establishing around 33% of the GDP in 2003 (1.3). The majority of investments were made into the energy sector, followed by hotels and restaurants and transport (particularly railway transport)[4], warehousing and communication.

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[3] For additional information about the main components of economic growth in Estonia see *Convergence Programme, …2004, pp 12-13; Eesti majanduse ülevaade 2003,…, 2004; pp. 7-9.*

[4] In 2002 and particularly in 2003, large loan-financed investments were made in the railway transport sector in order to rent the oil wagons mainly to Russian companies for transportation oil over the territory of Russian Federation. These investments were financed by the Estonian subsidiaries of Nordic banks. The extraordinariness of these transactions can be described by the fact that in 2003, the total imports of oil wagons increased by more than five times, reaching 4.1 bn EEK (compared with the 0.77 bn in 2002). Those investments are related to few private companies, operating mainly abroad and thus, they do not reflect general trends in the Estonian economy and do not thereby represent extra burden

In sum, there are specific reasons for the current account deficit, which are not related solely to the large trade balance deficit and consequently may not reflect significantly the balanced growth of the Estonian economy. The reasons of current account deterioration can be summarized as follows: 1) the high economic growth has been caused by the foreign rather than by the domestic demand, and the economic cycles of Estonia and EU have been slightly different so far; 2) Estonian economy needs big investments, particularly investments into infrastructure and energy sector; 3) optimistic expectations and big capital flows connected with the EU accession (see also Convergence Programme, 2004). Thus, in the conditions of rapid development of Estonia as a country with small very open economy, current account deficit may be considered as a so-called 'supplement good' for the high economic growth rate. By the way, the current account deficit was the lowest in 1999 (-4.7%) when the economic growth rate turned to be negative (-0.6%) due to the consequences of the Russian crisis.

1.3. Convergence programme and joining the EMU

The economic reforms which started after regaining independence and have progressed rapidly during the preparations for the EU accession are continuing in the conditions of the Estonian full EU membership. The main goal of the current reform process is the convergence to the EU economic development level. The framework for the reform process in order to achieve the convergence goal is set by the Estonian Pre-accession Economic Programme (PEP, approved by the Estonian government in August 2003) and the Convergence Programme prepared by the Ministry of Finance in collaboration with the Bank of Estonia and Ministry of Economic Affairs and Communications in May 2004[5].

According to the Convergence Programme, the primary macroeconomic objective of Estonia is to facilitate the real convergence of national economy by means of sustainable economic growth supported by low inflation and successful policy mix. The Convergence Programme sets out the conditions for sustainable growth in the medium term (2004-2008): prudent fiscal policy, open and flexible markets operating at full capacity, and investment in physical and human capital. The policy mix includes conservative fiscal policy with an explicit rule of nominal budget balance, which is making an effort in complying Estonian monetary policy to that of the EMU in order to adapt the euro. Sustainable economic growth also means significant investment into human capital (education, health, improvement of demographic situation, etc) and includes the policy measures and the corresponding structure of general government budget that support development of social security system. Particular attention should be paid to promoting liberal conditions on the labour market, including free movement of labour, reduction of tax burden, active labour market policies and coordination between education and employment policies.

Since June 2004, Estonia participates in ERM II maintaining the present Currency Board system unilaterally. The exchange rate of Estonian kroon with euro has been fixed since 1999 (1 euro = 15.647 EEK) and the EU institutions have asserted the conformity of currency board system for the participation in ERM-II. Before the adoption with euro zone, Estonia is not required to abandon the currency board system and the current fixed exchange rate with the euro. Thus, the entrance into ERM II does not entail high policy convergence costs for Estonia. There are no medium-term sustainability issues emerging at the current juncture that should be addressed through the exchange rate system rather than other policy measures. Therefore, it is also no reason to suppose that the currency board arrangement would become a less appropriate arrangement over the medium term (see also Convergence Programme, 2004, p. 9).

According to the EU Maastricht Treaty rules, Estonia must meet the convergence criteria regarding the budget deficit (not exceeding 3% of GDP), state debt (not exceeding 60% of GDP), inflation and interest rates (close to the respective average of the three EU countries´ with the lowest indicators; inflation rate must not exceed of three EU member states' lowest inflation by more than 1.5 percentage points) in order to get the final acceptance of euro. The most problematic task for Estonia seems to be keeping of low inflation rate. For achieving the convergence goal, rapid growth of productivity and income is predictable and as a rule that accompanies with a serious pressure on rapid rise of prices. Estonia's small open economy is vulnerable to the foreign price level, particularly to the comparatively high price level of the Nordic countries. In the conditions of free movement of labour Estonia will have a serious threat that part of well-

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e.g. on labour resources. The latter investments should start to generate export revenues to cover made investments (see also *Eesti majanduse ülevaade* 2003,…).

[5] Information about the forecasts of the main macroeconomic indicators of the Estonian Economy for the years 2004-2008 and the general government budget are presented in the annexes 1-5.

qualified labour force may leave the country. Consequently, there will be a serious pressure on wage growth and Estonia can not any longer be a country of low labour costs for the foreign investors. It can be expected that many foreign firms which have benefited from the advantage of relatively cheap Estonian labour force[6] should change their business strategy in forthcoming 2-3 years. In order to be continuously attractive for FDI, the country should develop conditions for rapid increase of productivity and significant declining of structural unemployment.

1.4. From investments to innovation based economy as the main task of the Estonia's development

So far, the factors of the productivity growth mainly based on the structural and organisational activities; only few investments were made by the Estonian and foreign capital based enterprises into innovative production and qualified labour force. The contribution of private investments into R&D has been marginal, the investment into R&D has mainly been made by the Estonian government, and these amounts formed less than 1% of GDP (1.9% of GDP in EU in 2000; Figure 1.22). In the forthcoming years both, Estonian and foreign capital based enterprises should obviously invest much more in the R&D activities and educating and retraining labour force.

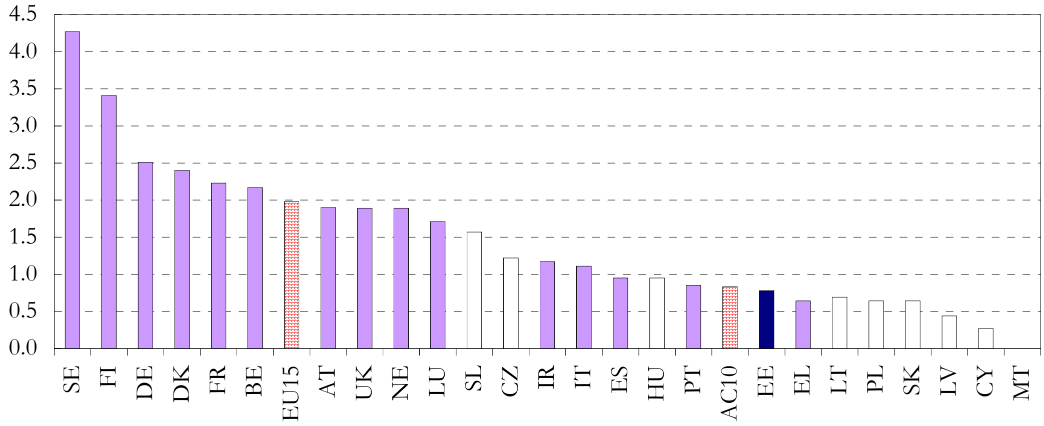

Figure 1.2. Research and Development (R&D) expenditure in EU-15 and accession countries (AC-10) in 2000.

Sources: Eurostat; Convergence Programme, 2004.

According to the Estonian research and development strategy *"Estonia based on knowledge"* (approved by the Estonian Parliament on December 6, 2001), Estonia's national's and government's strategic priority is remarkable to support R&D and innovation activities in order to achieve long-term economic competitiveness and to shift development from the investment based to the innovation based economy. In order to achieve this goal, it is planned to increase total R&D expenditure to the 1.5% level of GDP in 2006, which would bring Estonia closer to the average of EU members.

The shift of the Estonian economic development from the investment to the innovation based and the fulfillment of the convergence programme oriented on sustainable and balanced economic growth also stresses the necessity to improve the quality of analysis and economic data sets. The comprehensive, internationally comparable and reliable information is necessary in order to predict the main development trends and possible structural changes of the economy in short, medium and long run perspective. Globalization and EU enlargement processes are accompanied not only with the challenges for development of new business but also with the increasing competitiveness and new risks. Therefore, profound argumentation and forecasts are unavoidable for making proper public and private investments in both physical and human capital.

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[6] The average wages were ca 420 euros in 2003; the growth of nominal wages was around 88% and average yearly wage real growth about 7 during the period 1997-2003 (see Appendix 1).