WORRISOME FIGURES

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The series of statistical data characterising economic development (see Table) and supplied by the State Statistical Office, Eesti Pank and the Ministry of Finance are getting longer every year. With the improved collection and processing, the reliability of these databases has improved and whenever possible the

Indicators of economic growth between 1994 and 2000 (current prices, EEK billion)

	1994	1995	1996	1997	1998	1999[1]	2000[2]
Real growth of GDP (%)	-1.8	4.3	3.9	10.6	4.0	-1.1	4.1
Nominal GDP	29.6	40.7	52.4	64.3	73.2	75.1	81.3
compared to 1994 (%)	100	138	177	217	247	254	275
Domestic demand	33.1	44.5	58.7	72.2	81.2	79.0	86.0
% against GDP	112	110	112	112	111	105	106
compared to 1994 (%)	100	133	179	219	245	232	260
private consumption	17.4	23.8	31.5	37.6	43.2	43.3	47.0
compared to 1994 (%)	100	137	181	216	248	249	270
government sector	7.0	9.8	12.6	14.2	16.5	17.8	18.7
compared to 1994 (%)	100	140	180	203	236	254	267
investments to fixed assets	8.0	10.6	14.0	18.0	21.3	17.7	20.3
compared to 1994 (%)	100	133	175	225	266	222	270
change in stock	0.7	0.3	0.6	2.4	0.2	0.2	...
compared to 1994 (%)	100	43	86	343	29	29	...
Export	23.8	29.4	35.2	50.3	58.6	57.9	61.5
goods	17.1	19.4	21.8	31.9	37.8	36.0	...
services	6.7	10.0	13.4	18.4	20.8	21.9	...
compared to 1994 (%)	100	124	148	211	246	243	258
Import	27.0	32.7	41.2	57.6	66.3	62.3	66.1
goods	21.7	27.0	34.1	47.5	53.5	49.0	...
services	5.3	5.7	7.1	10.1	12.8	13.3	...
compared to 1994 (%)	100	121	153	213	246	231	245
Current account balance	-2.1	-1.9	-4.8	-7.8	-6.8	-4.6	-4.6
% against GDP	-7.1	-4.7	-9.2	-12.1	-9.3	-6.1	-5.6
Financial account balance	2.2	2.8	6.4	11.0	6.8	7.1	6.1
% against GDP	7.4	7.1	12.2	17.1	9.3	9.5	7.5
direct investments	2.8	2.3	1.3	1.8	8.0	3.4	4.5
portfolio investments	-0.2	-0.3	1.8	3.7	0.0	0.2	2.0
other investments	-0.4	0.8	3.3	5.5	-1.1	3.5	-0.4
Change in reserves	0.4	1.2	1.2	2.8	0.1	2.2	1.5
External assets	...	...	17.6	30.2	31.7	38.9	
o/w claims (for payment)	...	...	16.0	27.0	29.2	35.5	
External liabilities	...	...	24.4	54.8	60.6	81.6	
o/w liabilities	...	...	18.0	36.8	38.9	43.8	
Net external debt	...	...	2.0	9.8	9.7	8.3	
% against GDP	...	...	3.8	15.2	13.3	10.8	
o/w government sector	...	...	2.5	2.4	2.3	1.7	
Broader money supply M2	10.0	13.5	18.3	26.0	26.0	32.2	
% against GDP	33.8	33.2	34.9	40.4	35.5	42.8	
Balance sheet volume of commercial banks	10.1	14.9	21.9	38.8	41.0	47.1	
% against GDP	34.1	36.6	41.8	60.3	56.0	62.7	
deposits	6.9	9.7	14.0	21.3	23.5	26.4	
loans	4.4	6.7	11.7	20.3	23.8	26.7	
Reserves of the central bank	0.9	1.1	1.4	1.9	2.3	2.3	
% against GDP	3.0	2.7	2.7	3.0	3.1	3.0	
% against M2	9.0	8.1	7.7	7.3	8.8	7.1	
CPI (%)	47.7	29.0	23.1	11.2	8.2	3.2	4.5

[1] Officially unpublished data is evaluative.
[2] Derived from the Economic Development Plan of Estonia for 1999-2003. March 2000

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data of the previous periods has been revised. Last year we began a similar chain of thought with a statement that the developments back then had not been totally up to expectations[2] and explained it with the aftermath of the 1997 stock exchange crash. The developments of 1999 are a logical extension of the changes of earlier periods and thus mostly in line with expectations. However, the reasons for these changes deserve some attention.

Comparison of Time Series Helps to Understand What Has Happened

Economic development of a small country is fuelled by its export capacity and in transition economy, where domestic sources of accumulation are scarce, foreign investments, particularly foreign direct investments, play an important role. **1999 was the first year after the restoration of independence when the rapid growth of export was replaced by a decline.** This was caused by the decrease of the goods export by nearly 2 billion kroons. At the same time, the increase of the services export was smaller than ever before.

The nominal growth of the GDP was achieved by the increase of prices, since real growth was negative. The reduction of the added value also curbed domestic demand, which fell by 2.2 billion kroons, ie by 2.7%. Despite this, domestic demand still exceeded domestic supply (GDP) by 6%, dropping to a more acceptable macroeconomic level than in earlier years – living beyond one's means became less obvious.

Private consumption did not increase, while the government sector consumption was up by 8% against 1998, despite a negative supplementary budget. This resulted from the need to fulfil the socially-oriented promises of the previous government. Additional expenditures were partly covered from the Stabilisation Reserve Fund.

Domestic demand fell the most in the case of investments into fixed assets. Besides the shortage of local resources this was also caused by the reduction of direct foreign investments. Domestic investments also decreased due to the outflow of domestic capital in the form of direct investments worth more than 1 billion kroons. In search of higher profits, investments were mostly made into Latvia and Lithuania. The considerable drop in investment demand reduced the import of goods by over 8%.

As the volume of private consumption remained stable, these changes allowed to reduce the current account deficit against the GDP from 9.3% to 6.1%. This is one of the lowest indicators and indicates either an improvement of macroeconomic proportions or at least a positive shift towards it. The fact that the medium-term economic development plan foresees the continuation of this tendency in the future, however, speaks in favour of improvement.

We could continue such comparisons through expanding the database by adding new time series. However, let us confine us with to above and look deeper into what has happened. Two closely intertwined problems seem to strike the eye, the relations between supply and demand and the development of domestic demand.

Supply and Demand Are out of Balance

This claim is substantiated by the fact that domestic demand exceeds domestic supply. As we know, for a small country, market relations are vital for meeting domestic needs, but in the interests of macroeconomic balance we have to find ways to match import with a more equivalent sales.

Unfortunately, the GDP data does not allow to specify neither the exact domestic supply of **goods** (production) nor domestic demand (consumption). **Estimates indicate, however, that on the basis of net payments distribution goods accounted for 40% of the 1999 GDP, ie 30 billion kroons, and services for 60%, ie by 45.1 billion kroons. So far the trend has been towards the share of services increasing.** Approximately 60% of services are used internally as they are meant to meet everyday needs. Here we should note that the consumption of export services (transit traffic, tourism, etc) mostly starts or takes place in Estonia. This has great significance in the improvement of supply. **The competitiveness of the services sector has so far been considerably higher than that of the manufacturing sector and it is also characterised by a more stable development.** Time series of the Table show that the share of goods in export has decreased from 72% to 62%, and the share of services has increased respectively.

Proceeding from these data we can say that in 1999 out

[2] See In Order to Look Forward You Should Look Behind, Eesti Pank Bulletin No 2, 1999, pp 50 to 60.

of the 79-billion kroon domestic demand 42.8 billion kroons constituted goods and 36.2 billion kroons services. **Thus, the domestic demand of goods exceeded domestic manufacturing by 13 billion kroons.** The surplus of the services balance covered 8.6 billion kroons of this deficit (21.9 billion kroons minus 13.3 billion kroons) and the remaining 4.4 billion kroons indicates the surplus of domestic demand against domestic supply (the GDP). The result is the same when we compare exports to imports. Although these figures are estimates they certainly point to what direction we should move – **the main emphasis should be put on developing export-oriented manufacturing of goods that would be able to replace imports**. The export of services alone is not enough to guarantee the necessary external balance.

The stability of the services export has been guaranteed by the geographical position of Estonia, more or less satisfactory infrastructure, the novelty of Estonia's openness, relatively low prices, certain attractiveness of Estonia's nature, and some other factors. But all this is relative, subject to changes and/or needs developing. An important source of the further growth of export should be the goods export which should not be dominated by re-export of processed goods (currently approximately 30%) that derives from Estonia's low wage level and depends on foreign contractors.

Keeping in mind international experience, the key position should belong to locally manufactured goods suitable for mass consumption by their quality and price, goods of high market demand and rapidly renewable through research and development. However, this task is extremely complicated for a small country, because lasting research and development can be very expensive and beyond the reach of medium and small-size companies. The ability to provide large quantities of goods for international markets at a short notice can also be a problem, as well as advertising, lack of marketing and distribution networks, etc. Therefore, improving Estonia's export potential needs a development strategy that would take into account all these specific moments.

Development of Domestic Demand

Domestic demand is based on needs, paying capacity and the supply side factors such as prices, quality, design, advertising, as well as psychological aspects. In special exports the share of Estonian-made goods has decreased from 77% in 1996 to 68% in 1999. A slight positive shift can be noticed in domestic consumption where the share of locally produced goods has grown from 13% to 15%. Judging by the volume of consumption, exports and imports, the share of local products is the biggest in the market of food products.

Being a transition country, the level of meeting the consumption need is several times lower in Estonia than in developed countries (three times lower than in Nordic countries, for example) if we proceed from the GDP purchasing power parity per capita. **Thus, paying capacity imposes a considerable constraint on domestic demand.** From the Table we can see that this has been increased by the surplus of the financial account which has been higher than the deficit of the current account throughout the years analysed. The only exception here was 1998 when a balance was registered (mostly due to the aftermath of the 1997 stock exchange crash). Foreign loans, which so far have been modest in volume, have been replaced by the capital of foreign investors establishing themselves as owners in Estonia (at the end of 1999 foreign investments into Estonia amounted to 81.6 billion kroons, of which direct investments made up 38 billion kroons). This explains Estonia's relatively low foreign debt. **However, the above does not suggest that we should live beyond our means.**

The structure of domestic demand – private consumption (58% of the GDP in 1999), final consumption of the government sector (24%) and investments into fixed assets (24%) – differs from the respective indicators of developed countries. According to the Organisation of Economic Cooperation and Development (OECD), private consumption usually amounts to over 60% in developed countries, the share of the government sector is below 20% and investments into fixed assets approximately 20%. In Estonia, the main reason for this structural difference has been **bigger investments into fixed assets**, mostly in the form of foreign investments. This explains why domestic demand exceeds the GDP. Another reason is the **high expenditure of the government sector**, which derives from the peculiarities of a small country, the large number of local governments and relatively high socially-oriented spending redistributed by the state. The latter were bequeathed to this transition country by the previous social order.

Besides economic factors, demand is very strongly influenced by psychological factors. **As a rule, interest groups characterised by some field of activity, social orientation, economic basis or other distinctive features tend to overestimate their role in society.** This is particularly noticeable in a period of transition when the impact of the previous economic basis is overamplified. Therefore, shifts are slower and cause additional tensions and costs. It is extremely complicated and probably also fruitless to influence these processes.

The key indicators of the Estonian economy give food for thought. Here some aspects of importance have been tried to stress. Understandably, there are no universal remedies to solve these problems – solutions can be found through concrete analysis and joint mental efforts.

Let s Think Together

Here some ideas are suggested.

- **Attention has been focused on the need to achieve greater macroeconomic balance (GDP–domestic demand, export–import, current account–financial account).** Proceeding from the market barometers[3] of Eesti Konjunktuuriinstituut (Estonian Institute of Economic Research), better balance is not prevented, with some exceptions, by limited capacity (equipment, labour force, premises, etc) but rather by weak demand, low international competitiveness, and in some areas also obsolete technology and financial problems.

- **Investments into fixed assets have been relatively large in the structure of the GDP.** Although this is characteristic of a transition period and totally justified, attention should be paid to the growth rates of the investments and the GDP. The two rates are nearly equal, which does not indicate any increase of efficiency, even if we take into account the time delay, certain decrease of investments into purchasing machinery and equipment, higher investments into office space and such other factors.

- **Final consumption of the government sector is high** which has been partly explained above. If we compare the share of the government sector in the GDP by the production and the consumption analysis we can see that from 5.2 billion kroons in 1996 the redistributed part has increased to 7.2 billion kroons in 1998. Although there is no data yet for 1999 the higher increase of the government sector expenditures against the GDP and in domestic demand speak for themselves. **Consequently, the planned administrative reform deserves serious attention.** Connected with it is the tax strategy suggested by the Ministry of Finance and aimed at lowering the tax burden, which in turn presupposes definite cutbacks in the government sector's final consumption costs. In case of such reforms the produced income will not decrease while the redistribution pattern will change. In the current situation the social aspect is most important. On the other hand, the administrative reform will cause significant changes in the labour market, which will undoubtedly require additional social spending during the period of transition.

- **An important balancing factor of the Estonian economy has so far been the services market. This can be seen from the share of services in the GDP as well as export.** The factors influencing external demand – transport services, travel services, communication services, construction services, etc – can be controlled to some extent, on the basis of the data of the balance of payments. **The problems of domestic services also deserve special attention due to their growing share, increasing volume and structural changes (the rapid increase of computer and information services, for example).** Besides, the processes of producing and supplying of domestic and export services are closely intertwined and in many cases inseparable.

[3] *Konjunktuur* No 1 (132). Tallinn, March 2000.