

THOUGHTS ABOUT ECONOMIC GROWTH

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Introduction

Major changes in Estonia's economy started after the restoration of independence. The 1992 monetary reform should also be mentioned, as a quick breakaway from the rouble zone facilitated the implementation of sovereign economic decisions. The data on the gross domestic product, balance of payments and other economic indicators regularly published since 1993 provide a concise survey of the developments. Setting new strategic goals the 1995 data would still be a more adequate comparison base as the current economic development differs significantly from the primary restructuring undertaken in early nineties.

The structure of the economy as whole (expressed through gross domestic product) and its changes are characterised

by absolute terms and ratios measuring its components. The official statistics reflects this by production approach through institutional sectors breakdown by fields of activity and by earnings and consumption approach. The GDP dynamics is subject to changes in growth rate and structure (see Table 1) and mutual links between institutional sectors and fields of activity (see Table 2). The basic outlines of the overall situation appear through interlinkage of production, consumption and trade (balance of payments; see Table 3).

In order to achieve the above the author has singled out financial intermediation and the government sector from the economic activities. Now we get a more or less true picture of **the share of goods, production services,**

Table 1. Changes in the structure of GDP (% , based on constant prices, 1995 = 100)

	str 1995	1996	1997	1998	1999	str 1999
Goods:	33.1	103.1	116.0	113.8	115.8	32.2
manufacturing	15.7	102.7	121.3	129.2	125.8	16.6
agriculture and hunting	5.5	93.4	91.0	86.7	81.8	3.8
forestry	1.2	112.4	125.0	139.5	156.0	1.7
fishing	0.4	115.3	150.0	144.5	133.7	0.5
mining	1.5	107.4	121.8	113.2	105.8	1.3
energy, gas and water supply	3.5	102.3	100.0	92.0	84.6	2.5
construction	5.3	109.9	127.2	154.5	130.1	5.8
Services:	39.8	106.3	116.5	125.1	128.6	43.1
wholesale and retail trade	14.8	109.2	113.6	119.8	119.2	14.9
hotels and restaurants	1.0	111.2	121.4	137.2	141.0	1.2
transport, storage and communication	9.4	107.3	127.8	140.6	147.8	11.7
real estate, leasing and business activities	8.5	100.7	114.7	132.4	138.8	10.0
other services	6.1	104.8	108.1	102.3	102.7	5.3
Net taxes	12.3	102.2	119.6	117.9	114.2	11.8
FISIM ¹	-1.9	108.1	116.7	100.5	114.3	-1.9
Total goods and services	83.3	104.8	116.3	120.0	122.8	85.2
Financial sector	3.3	108.0	116.6	99.1	107.9	2.9
Public administration	4.4	100.1	105.5	106.1	106.7	3.9
Education	5.4	101.5	102.3	103.7	103.1	4.7
Health and social care	3.6	98.3	101.9	105.5	107.4	3.3
GDP	100.0	103.9	114.9	120.3	119.1	100.0

¹ FISIM – financial intermediation services indirectly measured

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financial services and government sector services in the gross domestic product (see Table 2). The overall picture as well as the conclusions can upon necessity always be specified through more detailed approach to larger positions (eg manufacturing).

The regrouping of the official classification allows (conditionally, of course) to distribute net taxes between

activities **producing** goods and non-financial services. The need for distribution arises from the very fact that **most of the value added expressed in net taxes is created by production activities and the place of the generation, not of the collection of profit is determining**. The analysis based on the distribution of net taxes (see Table 3) helps to open up **relations and causal links between production, domestic consumption and trade**.

The Services-sustained Economic Growth

Table 1 displays that **services have brought along the largest changes in the GDP growth and structure**. The comparison of the balance of payments and GDP manifests that most of the services have been exported (over 60% in 1999)². **Transport services are dominant among services by volume, growth and export, with freight taking the lead. The latter has been the main driving engine in Estonia**. Following international development trends and knowing that the volume of transport services has grown during the last seven months by 25% against the same period in 1999, the continuation of a similar trend is likely in medium term as well, although recent developments somewhat undermine the expectation. There is enough feed for thought here for taking economic policy decisions, let alone specific business projects. Transport services connect railway, ports, shipping, roads and other infrastructure components into one system.

Besides transport services travel services have a significant role as well in securing the GDP growth and balancing the current account deficit of the balance of payments. Shopping tourism is still prevalent among these services. This is due to the kroon's highly favourable purchasing power parity and official exchange rate ratio for foreigners; trade in pirated goods has also had its implications. Whether and to what extent other attractions (holiday, culture, nature and other trips) can replace this in short or even medium term, remains questionable.

In absolute terms commerce is responsible for most of the services. This, in its turn, is in close correlation with private consumption. Private consumption has constituted a stable 58–60% in the consumption structure of our GDP. In the OECD countries it averages slightly above 60%. Such a share could be our target. The possibility that commercial growth will accelerate quickly and increase its share of GDP is unlikely in near term. A counteraction would here be a need to increase saving and creative investments, characteristic of the

current stage of transition economy. Nevertheless, investments in commerce are relatively high – this field ranks the third after manufacturing and transport by investments. The main underlying reason is the relatively quick capital turnover and shorter payback period than in production. Taking into consideration the shrinkage of shopping tourism and other circumstances, preferential investment in commerce remains doubtful in the current development phase.

The example of Tallinn gives some food for thinking as well. According to the official statistics the share of the capital in national retail trade is close to 52%. Considering the share of population (28%), average net earnings (per household member it is 1.3 times above the average in Estonia) and the attractiveness of Tallinn as the capital, its share should not exceed 45% in the national retail trade even in the best case.

The share of the government sector, including that of education, public health and social security as quite different services in creating GDP has shrank due to slow growth rate from 13.4% to 11.9% during the period under review. Judging by the **consumption** of these services, the costs of this sector have grown relatively fast. In 1999 they constituted about one fourth of GDP in constant and current prices. We can conclude that the faster growth of social consumption has been sustained by the redistribution of profits through the budgetary system. In developed countries private consumption covers a significant part of the education and public health costs. In our country the relatively modest earnings of people set a limit here. The funds received as the result of the redistribution through the national budget are mostly used to maintain the sector's material base. Wages and the related social tax, ie the value added of the sector, have been depreciated due to the modest state of our economy and below the productivity of educational and public health personnel. Unfortunately this is not the only such example, although most conspicuous.

² The numerical value and ratio of goods and services differs slightly in Tables 2 and 3. In Table 2 net taxes are entered on a separate line whereas in Table 3 they are distributed between goods and services. The objective for distribution is to compare production, domestic demand and trade.

Manufacturing of Goods Deserves Higher Focus

Out of the changes in the goods producing sector **the rapid and stable growth in forestry, constant decline in agriculture and relative standstill following the 1997 slight leap in manufacturing** (at the expense of the 1.5time increase in exports to the European Union and Central and Eastern Europe) have caught the eye. The mining and energy industries are characterised by declining internal consumption due to structural changes and thrifty management. Construction has a certain, not too strong correlation with investments as there is some time shift in its response to changing economic circumstances. The return on investments has also a delayed implication on the GDP growth.

Manufacturing is responsible for most of the goods produced. According to statistics there are over thirty positions to consider whereas **food industry, with its share continuously decreasing, is responsible for about one third.** It is followed by the production of machinery, equipment, apparatus and tools (the consolidated position is about 30%, characterised by rapid growth), wood processing and furniture production (the consolidated position is about 19%, also growing), textile industry, etc. The major impact agents in manufacturing are **the**

quality of the production (its compliance with the EU standards in particular, which to some extent explains the above-described 1997 leap in exports), **export capacity and opportunities, domestic demand and imports.**

The manufacturing growth has currently been boosted by exports. The exports have exercised the largest impact on the production growth of machinery and equipment (with subcontracting being predominant) and timber and wood products. The reasons underlying the retarded development of food industry are more complicated (the share has shrunk from 35% to 30%). The inability to be an equal partner in the international competition as well as the recent scarcity of local raw materials (milk and meat) has also contributed to the problem. The lack of raw materials is also caused by short-sighted pricing policy pursued by the local manufacturing, inadequate regulatory mechanisms to support agriculture and shortcomings in providing efficient advice to farmers. Therefore the import of foodstuffs (meat and meat products, grain and grain products in particular) has significantly increased.

Table 2. Gross domestic product by institutional sectors and fields of activity (EEK mn, in current prices)

	1998	1999		1998	1999
Goods and non-financial services	45,793.1	46,693.8	Goods		
			manufacturing	10,788.7	10,359.1
			agriculture and hunting	2,810.0	2,463.2
			forestry	1,062.4	1,206.4
			fishing	282.7	199.4
			mining	796.3	801.3
			energy, gas and water supply	2,411.3	2,422.3
			construction	4,234.2	3,681.2
Households and services rendered to them	8,135.2	8,096.2	Total goods	22,385.6	21,132.9
			Services		
			wholesale and retail trade	10,890.4	10,907.0
			hotels and restaurants	778.5	906.0
			transport, storage and communication	9,122.6	9,915.5
			real estate, leasing and business activities	7,307.3	8,325.1
			other services	4,017.9	4,279.4
			Total services	32,116.7	34,333.0
FISIM (-)	999.2	1,169.2		999.2	1,169.2
Net taxes	8,406.5	8,221.7		8,406.5	8,221.7
Total producing of goods and services	61,335.6	61,842.5		61,909.6	62,518.4
Financial sector	2,562.5	2,841.5	Financial intermediation	2,562.5	2,841.5
Government sector	9,427.2	10,676.2	public administration	2,900.4	3,384.3
			education	3,584.4	4,013.9
			health and social care	2,368.4	2,602.1
GDP	73,325.3	75,360.2		73,325.3	75,360.2

The attention should also be turned to the ratio of the domestic demand for goods and manufacturing

of goods. Table 3 displays that the domestic demand is significantly above the domestic production.

Table 3. Links between GDP, domestic consumption and balance of payments (EEK mn, in current prices)

	1998	1999
GDP	73.3	75.4
Producing of goods and services	61.9	62.5
o/w goods	25.4	24.1
services	36.5	38.4
financial and government sector services	11.4	12.9
Total services	47.9	51.3
Domestic demand	81.2	80.4
o/w private consumption	43.2	43.6
government sectors' end consumption	15.9	17.8
non-profit institutions' end consumption	0.5	0.5
investment in fixed assets	21.8	18.9
change in stock	-0.2	-0.4
Export	58.6	58.0
o/w goods	37.8	36.0
services	20.8	22.0
Import	66.3	62.5
o/w goods	53.5	49.0
services	12.8	13.5
Domestic demand for goods	41.1	37.1
Domestic production of goods	25.4	24.1
Surplus of domestic demand over production	15.7	13.0
Surplus of imports over exports	15.7	13.0
Balance of the current account of balance of payments	-6.8	-4.3
Trade balance	-15.7	-13.0
Services balance	8.0	8.5
o/w transport services	4.2	4.8
travel services	5.4	4.9
Financial account	6.8	6.7
o/w direct investments	8.0	3.2

Although it is quite natural under current transition processes that the provision of services develops faster than producing of goods, the author would like to repeat the idea of the role of goods producing outlined in the previous article³. It is important both to meet the domestic demand better and to increase exports. Definitely a small country cannot produce all necessary goods due to the lack of local raw materials and other circumstances whereas the supply should cover all local needs and satisfy consumer interest in as wide a range as possible. A somewhat arbitrary comparison manifests that local producing of goods covers about 60% of the domestic demand. The gap (about 13 billion kroons in 1999) was covered from the import of goods.

In order to get a better picture the local producing, domestic demand and trade should be compared and analysed in greater detail. It would be highly necessary in food processing industry. Food at our current income level is responsible for about one third of the household

costs, totalling 14 to 15 billion kroons a year. About one fifth of it is covered outside the market, mostly from self-production. The food market needs about 11–12 billion kroons' coverage, 8–9 billion kroons thereof can be provided by the local food processing industry (drinks and tobacco products excluded). The supply deficit is about 2–3 billion kroons. The import of foodstuffs exceeds that of the export by about this amount.

The positions in which domestic demand is better provided for should also be compared, mainly considering GDP, trade balance and balance of payments. Table 1 reveals that forestry has developed fast. This is expressed in the export of wood products, which has shown stable growth and was responsible for about one fifth of the special export in 1999, ranking the second after machinery and equipment. The relatively low manufacturing level remains a problem although about 80% of the exports goes to the EU countries.

³ See *Worrisome Figures*, Eesti Pank Bulletin No 3, 2000, pp 16 to 19.

Some Conclusions

- This survey has attempted to characterise the recent development trends and tendencies in Estonia's economy. A more scientific approach would need the evaluation through growth models. **In models and in transition economy models in particular, the main growth factors involve investment, technology level, labour and human capital growth rate.** Through the international movement of capital and other factors they reflect to a certain extent also the changes arising from global economic processes. **Implications from political development, fierce competition and other factors outside the model are not taken into consideration. For small countries, especially for a country like Estonia, a change in the international economic situation would be of decisive significance: risks are to be considered.**
- **Anticipation of risks, risk assessment, changes and potential changing of risk factors require continuous attention in all fields. In the current development transport has had the largest impact on the GDP growth and structural changes, its share of GDP being over 10% and annualised growth 10.3%. This finds a specific output in transit freight, mostly from east to west, transporting mainly oil products, ports being the key conjunctions. Risks in Estonia arise from price changes in the world market, development trends in Russia, competition between countries organising transit freight and between ports, capacity of the local transit chain, pollution threats, etc. A more detailed risk analysis and assessment would be useful for planning further action.**
- **Operation within common economic space helps to soften and overcome risks.** The growth of Estonia's exports to the EU countries serves as a good example. In 1995 the EU share in Estonia's export was 55%, while it exceeded 70% in 2000. Sweden and Finland are responsible for about two thirds of it. The situation in imports is quite similar. The share of Latvia and Lithuania in our trade is modest, being about 13% in exports and 8% in imports. The above figures indicate development of special dimensions. Interaction in the common economic space should also be critically analysed. In our trade with Finland and Sweden export of less processed goods (eg timber) and import of highly processed goods (eg machinery and equipment) are prevailing, being inevitable in the first development stages of the transition economy. **Foreign investments play a significant role in shaping the economic space in order to facilitate faster completion of transition processes. FDI speeds up establishing of local manufacturing units.** Unfortunately, such developments are often subject to emotional criticism, accusing proponents in giving up national economy. Under the current international integration such assessments would be mostly misleading.
- **In conclusion. In all fields of life progress requires development visions.** We should take a look further ahead. In our rapidly changing economy we should probably focus on forecasting basic targets (eg the growth factors listed above). Tasks and actions in medium term should be considered in a more detailed and systematic way. Currently this is limited to the government-made development schemes, which neither exclude nor replace deeper research of the issue.