OPPORTUNITIES AND CHALLENGES FOR ESTONIA'S ECONOMIC CONVERGENCE TO THE EU

Written by Willem Buiter, Chief Economist,
and Vanessa Mitchell-Thomson, Principal Economist,
at the European Bank for Reconstruction and Development (EBRD)

Since its independence in 1991, and despite the difficult early years of the transition, Estonia has made remarkable progress in stabilising its economy and building market-supporting institutions. Rapid price stability was achieved with the introduction of the currency board system in 1992. Under the aegis of IMF Stand-By programmes and, since late 2001 without an IMF programme, Estonia has implemented tight fiscal policies with the government budget close to balance in recent years. *Nominal convergence* is therefore well advanced. At the same time Estonia has made remarkable progress in price and trade liberalisation, enterprise privatisation and financial sector reform. Estonia is now progressing fast in its negotiations for EU accession (by the beginning of July 2002, Estonia had provisionally closed 27 out of 29 chapters opened of the *acquis communautaire*).

As a result of these achievements, Estonia's economy has also achieved some degree of *real convergence* with the EU, although quite sizeable differences in per capita income persist. Between 1995 and 2001, the country has grown at an average of 5% per annum, far surpassing the average growth rate of the EU during that time. This has meant that its per capita income measured in purchasing power terms relative to the EU average rose by six percentage points from 32% of the EU average in 1995 to 38% in 2000. Of all the accession countries, only Hungary and Slovenia made similar progress. Furthermore, its level of trade with the EU is now comparable to that among existing EU members. The stock of foreign direct investment is among the highest in per capita terms in accession countries and the investment to GDP ratio has been impressive at 24-30% every year since 1993.

Accession to the EU and subsequent membership of EMU will further improve Estonia's long-term growth prospects. It will provide Estonia with unimpeded access to a large single market and eventual free movement of goods, services, capital and people, thus further stimulating trade and investment. Membership in the EU will anchor Estonia securely in a democratic union of nations. Furthermore, Estonia is already benefiting from substantial transfers from the EU in preparation for accession. Key improvements in infrastructure and environmental enhancements are being financed by these funds. These transfers (mainly for structural and agricultural assistance) will increase further at the time of accession, although the details still depend on the outcome of upcoming negotiations.

However, even if current growth differentials between Estonia and the EU were to persist, it would still take Estonia around 20 years to reach 75% of the EU average income per capita in purchasing power terms. In order to sustain the growth rates that achieve this convergence, Estonia will need to address a number of remaining challenges, which include:

- *Maintaining high levels of investment by raising domestic saving (private and public) and by pursuing policies capable of attracting continued high levels of* *external financing.* In the short-run, given the low level of domestic savings (which stands at only around 17% of GDP), high investment will continue to require very large amounts of external financing. Given the already high deficit on the current account, the continuation of tight fiscal policies and high inflows of foreign direct investment will be crucial in order to keep the external position sustainable. Over the medium term, it will be essential to further deepen financial intermediation in order to increase the level of domestic savings and reduce the reliance on external financing, in particular through the smooth transition to the 3-pillar pension system.

- *Reducing regional income disparities and high unemployment.* Regional income disparities within Estonia remain significant. In addition, unemployment is high (12.7% of the labour force in 2001). The situation is most unfavourable in some of the counties located on the eastern border, where the unemployment rate is close to 20% and income per capita is much less than in Harju county. Overcoming regional income disparities and high unemployment will require significant efforts for retraining and support to small and medium-sized enterprise development.
- *Progressing with structural reforms that will lay the basis for sustained growth over the long-term.* This should include further reform and restructuring in the energy sector, further commercialisation of municipal infrastructure, efficiency improvements in public administration and the judicial system, and increased financial intermediation.

EU enlargement represents an obvious and major potential net gain for Estonia, as for the EU, but sustained effort is needed to realise and maximise these potential benefits. Some of these reforms will be painful in the short term, but as Estonia’s own experience has amply demonstrated, determined and thorough reforms can pay off quickly in the form of higher growth and rising incomes.