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## **Estonia: amid export boom, current account problems remain**

The Estonian economy has registered annual real growth rates of over 6% on average since 2000. The preliminary figure for 2004 shows a healthy 6.2% GDP increase. Gross fixed capital formation increased by 7% in 2004, following a strong investment boom with average annual growth figures exceeding 10% in the five preceding years.

Exports experienced a vigorous boost of over 18% in 2004. Imports expanded even more rapidly, by over 19%. The current account deficit hit a new record high of EUR 1.3 billion, which is almost 15% of the GDP, an increase from 13.2% in 2003. At the same time, net inflows of FDI clearly decelerated.

In its fiscal policy, Estonia applies an interesting trick: corporate income tax is zero for reinvested profits. Dividends are taxed with a 26% rate. This dual system, which has caused amazement in the high-taxed Scandinavian countries, has obviously contributed to the strong investment boom in Estonia. Estonian fiscal policy seems to be permanently prudent. The general government budget ran annual surpluses in 2001-2004. Thus, public sector debt is being kept well under control, and amounts to less than 5% of GDP.

Private consumption increased by 6% in real terms in 2004, even though average gross monthly wages rose only by less than 4%, after an 8% boost in 2003. Amid strong economic growth, the unemployment rate remained at a rather high level of about 10% in 2002-2004. This fact obviously explains the rather modest increase in the average pay in 2004. CPI inflation accelerated from 1.3% in 2003 to 3% in 2004. Thus, there is no indication of an overheating of the booming Estonian economy.

In the early post-Soviet period, Estonia established a currency board system and pegged its currency (the Estonian kroon, EEK) first to the German mark and then to the euro with a fixed exchange rate of EEK/EUR 15.65. In June 2004 Estonia joined the ERM II; the official fixed exchange rate became the central rate in the managed floating system of the ERM II. In this context it is worth noting that Estonia's fiscal policy in the entire transitional period has been extremely prudent. Thus, fulfilling the main requirements of the monetary union (balanced budget with no excess public sector debt burden) has posed no problems.

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A political scandal erupted in Estonia in 2004, when it became known that some sensitive documents had leaked from the foreign ministry. There were even calls for dissolving the parliament. However, the issue has been settled by sacking Foreign Minister Kristina Ojuland, who was one of the most popular ministers of the current Estonian government. The centre-right coalition of Prime Minister Juhan Parts will remain in office. The investment-friendly fiscal policy will be continued (for instance, the corporate income tax rate will be cut by 2% in 2005, to 24%).

Economic prospects for **Estonia** are fairly good. The economy in neighbouring Finland, where the bulk of tourists to Estonia are coming from, is growing more rapidly than the eurozone on average. Tourism from Russia seems to develop dynamically as well. Estonia is benefiting from its reputation as a tourist destination with a very good price-quality relationship. Given its budget surplus and low public debt, Estonia may join the eurozone by the end of 2006.

Table EE

## Estonia: Selected Economic Indicators

	1998	1999	2000	2001	2002	2003	2004 <sup>1)</sup>	2005	2006
	forecast								
Population, th pers., mid-year	1386.2	1375.7	1369.5	1364.1	1358.6	1353.8	1349.3	.	.
Gross domestic product, EEK mn, nom.	78341.2	81639.7	92717.1	104337.7	116869.0	125832.1	138700	151100	163700
annual change in % (real)	5.2	-0.1	7.8	6.4	7.2	5.1	6.2	6	5.7
GDP/capita (EUR at exchange rate)	3581	3793	4327	4888	5498	5940	6570	.	.
GDP/capita (EUR at PPP - wiiw)	7410	7640	8600	9180	9890	10380	11280	.	.
Gross industrial production <sup>2)</sup>									
annual change in % (real)	4.2	-3.4	14.6	8.9	8.2	9.8	8.5	7.5	7
Gross agricultural production									
annual change in % (real)	-3.6	-10.4	8.2	-9.7	.	.	.	.	.
Construction industry <sup>2)</sup>									
annual change in % (real)	.	-13.4	14.8	4.6	25.2	10.6	.	.	.
Consumption of households, EEK mn, nom.	44361.6	45832.9	51036.5	57351.9	65135.3	69201.7	.	.	.
annual change in % (real)	5.2	-2.7	8.5	5.9	9.9	5.4	6.0	.	.
Gross fixed capital form., EEK mn, nom.	23365.6	20238.6	23769.4	28134.3	33554.7	35749.7	.	.	.
annual change in % (real)	14.0	-15.6	14.3	13.0	17.2	5.4	7.0	6	5.5
LFS - employed persons, th, avg. <sup>3)</sup>	606.5	579.3	572.5	577.7	585.5	594.3	595	.	.
annual change in % <sup>3)</sup>	-1.7	-4.5	-1.2	0.9	1.4	1.5	0.1	.	.
LFS - employed pers. in industry, th, avg. <sup>3)</sup>	156.5	147.2	151.1	151.3	144.4	150.0	160	.	.
annual change in % <sup>3)</sup>	-2.3	-5.9	2.6	0.1	-4.6	3.9	6.7	.	.
LFS - unemployed, th pers., average <sup>3)</sup>	66.1	80.5	89.9	83.1	67.2	66.2	66.3	.	.
LFS - unemployment rate in %, average <sup>3)</sup>	9.8	12.2	13.6	12.6	10.3	10.0	10.0	9.5	9
Reg. unemployment rate in %, end of period	4.0	5.2	5.9	6.1	5.4	4.9	3.9	3.5	3.3
Average gross monthly wages, EEK	4125	4440	4907	5510	6144	6723	7150	.	.
annual change in % (real, gross)	.	6.9	6.3	6.1	7.6	8.0	3.8	.	.
Consumer prices, % p.a.	8.2	3.3	4.0	5.8	3.6	1.3	3.0	2.8	2.5
Producer prices in industry, % p.a.	4.2	-1.2	4.9	4.4	0.4	0.2	2.9	2.5	2
General governm. budget, EU-def., % GDP <sup>4)</sup>									
Revenues	38.9	38.8	37.7	37.2	38.0	38.9	39.3	39.6	39.0
Expenditures	39.2	42.6	38.2	36.8	36.6	35.7	38.7	39.4	38.9
Deficit (-) / surplus (+)	-0.3	-3.7	-0.6	0.3	1.3	3.1	0.5	0.2	0.1
Public debt in % of GDP <sup>4)</sup>	.	.	4.7	4.4	5.3	5.3	4.8	4.4	4.2
Money market rate, % p.a., end of period <sup>5)</sup>	.	4.4	5.8	3.7	3.4	2.6	2.4	.	.
Current account, EUR mn	-428	-231	-326	-376	-759	-1059	-1337	-1380	-1400
Current account in % of GDP	-8.6	-4.4	-5.5	-5.6	-10.2	-13.2	-15.1	-14.3	-13.4
Total reserves minus gold, EUR mn	695	850	990	927	964	1089	1300	.	.
Gross external debt, EUR mn	2505	2864	3233	3707	4490	5658	7000	.	.
FDI inflow, EUR mn	609	284	425	603	307	797	713	.	.
FDI outflow, EUR mn	131	79	67	226	140	130	291	.	.
Exports of goods, BOP, EUR mn	.	2364	3601	3749	3728	4061	4813	5280	5760
annual growth rate in %	.	.	52.3	4.1	-0.6	8.9	18.5	10	9
Imports of goods, BOP, EUR mn	.	3138	4441	4630	4878	5457	6611	7150	7790
annual growth rate in %	.	.	41.5	4.3	5.4	11.9	21.1	10	9
Exports of services, BOP, EUR mn	.	1403	1629	1845	1807	1969	2259	.	.
annual growth rate in %	.	.	16.1	13.3	-2.0	9.0	14.7	.	.
Imports of services, BOP, EUR mn	.	870	1017	1195	1189	1218	1380	.	.
annual growth rate in %	.	.	16.9	17.5	-0.5	2.5	13.3	.	.
Average exchange rate EEK/USD	14.06	14.69	16.98	17.48	16.61	13.86	12.59	.	.
Average exchange rate EEK/EUR (ECU)	15.78	15.65	15.65	15.65	15.65	15.65	15.65	15.65	15.65
Purchasing power parity EEK/USD, wiiw	6.62	6.79	6.95	7.32	7.70	7.80	8.09	.	.
Purchasing power parity EEK/EUR, wiiw	7.62	7.77	7.87	8.34	8.70	8.96	9.11	.	.

Notes: 1) Preliminary. - 2) Enterprises with 20 employees and more. - 3) Persons aged 15-74. - 4) According to ESA 95, excessive deficit procedure. - 5) TALIBOR 1 month interbank rate.

Source: wiiw Database incorporating national statistics; AMECO Database; forecasts by wiiw and European Commission.