KfW Research
Economics in Brief

Estonia is a technologically savvy place but not all is future-oriented yet

One Pager

No. 190, 23 January 2020

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Estonia is undergoing rapid transformation

Estonia's economic transformation began when it regained independence in August 1991. The monetary reform of June 1992, which introduced the Estonian krona to replace the ruble (pegged to the Deutschmark and, from 1999, to the euro) was the basis for the independent development of the country's economy. It was restructured into a market economy relatively quickly and very consistently. As the political system also proved to be efficient and motivated labour was available, by 1994 the rather peripheral country Estonia posted the fourth largest per-capita investment rate of all central-eastern European countries. The restructuring of public administration was closely linked to the digital solutions that were emerging at the time, soon turning Estonia's bureaucracy into a role model of efficiency and transparency. Its far-sighted macroeconomic planning was already a guarantor for meeting the Maastricht convergence criteria. The post-soviet country joined the EU in 2004, when it was already regarded as a model of successful system transformation. In 2011 it was the first Baltic state to adopt the euro.

Tallin remains on a solid growth path

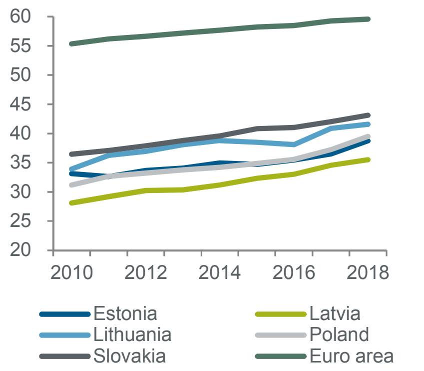
Estonia recently posted strong growth. Real GDP grew at an average 4.1% between 2016 and 2018 and growth in 2019 is expected to have been 3.2%. The EU Commission predicts 2.1% growth in 2020. However, the IMF recently highlighted risks from wage increases – driven by the skills shortage – that significantly exceed productivity growth rates, and the resulting relatively high recent inflation, which hit 3.41% in 2018. However, that rate already dropped to around 2.4% in 2019.

A digital stronghold with weaknesses

Although Estonia is rated very positively as a business location (ranked 18th of 190 countries in the World Bank's most recent Doing Business Report 2020), gradually established a superb IT infrastructure and recorded positive net immigration again in 2017, its productivity remains clearly below the euro area average and is also lower than that achieved by the leading central-eastern European countries (see figure).

Figure: Macro-economic labour productivity

GDP per hour worked in USD, constant prices, 2015, in purchasing power standards (PPS)



Source: OECD

This backlog is due to technological deficits, as Estonia has not yet succeeded in sufficiently expanding its clearly high expertise in the digital sector across the breadth of its manufacturing industries and other service sectors. According to the World Bank, cutting-edge technology exports have been declining in the past five years. As a second shortcoming that adds to the productivity weakness of individual sectors, the country has a general structural problem: Its mix of industries is rather unfavourable, with a heavy presence of production sectors that have relatively low value-added potential, such as timber products and furniture, food and textiles. The share of more productive and hence more profitable industries such as mechanical and automotive engineering is still low. Estonia's services sector has the same problem. Standardised products predominate, such as in the retail, transport and travel sectors, while products with high human capital content and, hence, high value added (such as the modern financial technologies in Lithuania) are still underrepresented.

What can help Estonia make further progress?

The country on the EU periphery is rightly regarded as a forerunner in many ways – including the best European PISA results in 2018! – and it should more strongly promote the development of 'new' high value-added sectors while pushing forward with putting more competitive production structures in place within existing sectors. The main goal should be to improve its currently still weak competitive position in high-quality, technology-intensive (commercial) goods. Estonia is the EU country with the lowest public debt level (8.4% of GDP in 2018) and has encouragingly broad fiscal-policy scope that allows it to significantly expand its hitherto relatively low research and development expenditure. It should also continue to gradually align private sector research activities with those of its northern neighbours such as Finland. The excellent electronic administration system ('e-Estonia'), which bundles public services and largely replaces the need to go to public offices, should be made even more effective as a driver of more comprehensive digitalisation in Estonia. Finally, greater emphasis should be placed on aligning vocational training more closely with the needs of the labour market and overcoming the sharp regional disparities.