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Initial Conditions as Factors in Economic Transition: The Case of Estonia

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Abstract: This paper provides a framework for studying initial conditions of transition vis-à-vis European Union (EU) candidacy and accession. Emphasis is placed on initial conditions that characterized Estonia in the early stages of its candidacy in the EU. Included in this paper is an overview of output changes and the dynamics of employment in the Central and Eastern European (CEE) countries during the period 1989-1999, focussing on Estonia, Poland and Slovenia. A connection is made between favorable initial conditions for a given transitional country and the expediency and radicalism of macroeconomic reforms in advance of EU accession.

Keywords: Initial Condition, Economic Transition, Candidacy

Introduction

The new candidates of the EU eastern enlargement are challenged to manage transition processes in concert with mandates for accession. The transition from a command to a market economy is a singular case of economic, social, and political developments of nations, which should be administered within the EU integration processes carefully.

Each accession country's economic structures and institutions have to gradually adapt in order to adhere to the requirements for full membership in the EU. A country's initial condition plays a crucial role in determining parameters of its adjustment process. Therefore, it is essential to consider EU eastward enlargement processes on a case by case basis, given the divergence of initial conditions among candidate countries.

The transition from a command economy to market economy is a unique process. It represents one of the most fundamental economic phenomena of recent centuries. Employment, output, wages and prices abruptly ceased from being set by central planners and, rather, became a function of market forces in the context of newly emerging institutions. The process has been turbulent for countries in transition, and in the early phases of the transition one typically observes major changes in the values of key economic variables. These visible developments, together with increasing availability of data, have attracted economists to examine the underpinnings of this phenomenon.

Economists recognize that important mechanisms of economic transition include macroeconomic stabilization, price liberalization, privatization and institutional reform. However, due to disparate economic and political scenarios that characterize various countries' initial conditions, every economy in transition requires a specific package of political and economic measures to build a well-functioning market economy and to achieve a flexible, market-driven allocation of resources. The intent is to attain regional and global integration.

There is a much economic literature that attempts to explain structural changes in transition economies and to generalize the outcomes of transition processes (Aslund, 1994; Balcerowicz, 1995; Lavigne, 1995; Blanchard, 1997; Hansson, 1997; Roland and Verdier, 1999; Sachs et al., 2000; Pajuste and Högfeldt, 2001) which stress both theoretical and empirical aspects of transition. But there is a paucity of solid theoretical background to explain processes of transformation from one economic system to another, vis-à-vis a country's initial conditions.

Initial Conditions of Transition: The initial conditions possessed by a given country play a crucial role in the performance of transition and in the construction of a credible framework for the evaluation of transition and integration processes. There are three main categories of initial conditions:

- Fixed initial conditions are those that are invariant and impossible to change (geography, topography, natural resource endowment, culture, history, climate, etc.);
- Hard initial conditions are primarily those that can be changed but not expeditiously (the quality of institutions [private, public and market], industrial structure, ownership, public attitudes, composition of economic output, level and quality of human and physical capital stocks, etc.); and
- Soft initial conditions primarily refer to government policy such as tax codes, as well as the status of international relations and agreements (Sachs *et al.*, 2000).

The initial conditions of transition are ordinarily grouped in the following main categories (Table 1): physical geography, macroeconomic variables, demographics, human capital, industrialization, political situation, market memory and culture. In several papers it has been found that countries initial conditions have also been important in explaining the dimension of economic depression (Berg *et al.*, 1999; Havrylyshyn, and Van Rooden, 2000).

Estonia: Initial Conditions Vis-à-vis Poland and Slovenia: According to a country cluster topology based on initial conditions of transition, Estonia mirrors to some degree the Western Former Soviet Union (FSU) countries of Belarus, Moldova, Russia, and Ukraine, especially with respect to aspects of industrialization, population, and human capital. At the same time, Estonia draws parallels with European Union (EU) border states of Czech

Republic, Hungary, Poland, Slovakia, Slovenia, and Croatia, particularly in market memory (social memory), culture, and various macroeconomics aspects (Sachs *et al.,* 2000). It is important to note, however, that the unreliable official statistics of the former socialist countries in the early 1990s, often expressed at divergent stages among countries' transition processes, seriously complicate the capacity to cross-analyze even seemingly comparable figures.

Estonia is undergoing a transformation similar in many respects to that being experienced by Central Eastern Europe (CEE) socialist countries. At the same time, Estonia had stabilized its economy under much less favorable conditions than those of most CEE socialist countries and Russia. For example, Estonia experienced more intense terms-of-trade shocks due jointly to its higher dependence on energy imports and relatively low energy prices that prevailed in the FSU as compared to the CEE. Due to its small size, Estonia was also more acutely affected by the collapse of trade than other economies in transition, like Russia. In spite of being within the FSU, Estonia inherited more distortions in its economy than, e.g. Poland and Slovenia, which had introduced market mechanisms in the previous decade. In virtually only one sense could Estonia's initial conditions be viewed as more attractive than those in CEE countries could; Estonia started from a position of zero foreign debt, because Russia had taken over all of the foreign assets and liabilities of the FSU.

Estonian Independence: After regaining its independence in 1991, Estonia was devoid of a comprehensive macroeconomic policy. The economy was collapsed and it had assumed a legacy of hyperinflation from the Soviet Union. The cornerstones of Estonian economic policy was to remedy the conditions by pursuing the following chief objectives:

- liberalization of prices and gradual elimination of all state subsidies;
- privatization of state owned enterprises;
- introducing separate currency by currency board system;
- maintaining conservative fiscal policy; and
- implementing a very liberal foreign trade regime.

Initial Conditions - GDP: All post-socialist countries experienced significant output decline during their transition processes (Table 2). The output decline was primarily associated with supply side shocks and structural imbalances, which had accrued for decades under the socialist regime (Holzmann *et al.*, 1995).

In the nascent stages of the EU eastward enlargement processes (1998), Estonia had yet to restore its GDP level to that which it enjoyed before the onset of transition. In contrast, both Poland and Slovenia managed to do so (Table 2). Each had embarked on market-economy-oriented reforms early, and their initial conditions were more conducive to engendering economic reforms and promoting serious restructuring of their economies. Poland applied shock therapy, whereas Slovenia instituted gradual reforms; Poland came out on top with respect to healthier economic growth than Slovenia.

Estonia's economy is heavily influenced by the political and economic situation in Russia. Russia had an important role in Estonian trade relations until the Russian crisis in August 1998, but the share of Russian export and import is now on the decline. For instance, Russia's share in Estonian exports fell from 13.5% in 1988 to 9.2% in 1999. In 2000, the share fell further to 2% in Estonian export and measured 8.5% in import (Statistical Office of Estonia, 2001). In the aftermath of the Russian crisis in August 1998, the prominent changes in Estonia's economic development could be summarized as follows:

1. Exports and imports declined, driven by the collapse of the Commonwealth of Independent States (CIS) markets.
2. Economic growth turned negative; and 3) the budgetary positions weakened. At the same time, the recession led to a pronounced improvement in the current account to a deficit of only about 6% of GDP in 1999 (in the previous years the deficit was about 10% and even higher). Estonia also learned to diversify its trade relations in order to reduce its risks; it bolstered its trade relations with countries around the Baltic Sea (the Baltic Sea region) instead of relying solely on volatile (albeit potentially lucrative) partnerships with Russia.

Initial Conditions - Employment: Transition reforms that drastically reduced output adversely affected employment by increasing the number of unemployed persons as well as the number of inactive individuals. But the mode of adjustment varied widely among countries both in terms of how strongly employment was affected and which non-employment destinations were used. Indeed, the emergence of large-scale unemployment as reported in Table 3 was one of the most conspicuous consequences of the reforms instituted by any former socialist nation.

Thus, transition to a market economy produced a new faction of unemployed persons within the population that required both income transfers and welfare-type programs to facilitate the adjustment process. Economies where open unemployment had been unheard of before transition were confronted with an arduous task of protecting the unemployed without imposing undue fiscal costs on the economy.

At the beginning of the EU accession processes (1998), unemployment rates in Estonia, Poland and Slovenia were reported as, respectively, 9.6%, 10.6%, and 7.9%. There have existed some variations in the dynamics of unemployment rates among these countries over the period 1991-1998. Slovenia's unemployment rate was rather stable, between 7% and 9%. Poland's unemployment rate had increased rapidly during the first years of transition (1991-1994), had declined in 1994-1998, and has been on the rise again since 1999.

Estonia's unemployment rate was fairly modest during the first years of transition, and it has significantly increased in recent years. In 2000 Estonian unemployment rate reached 13.7% (Table 4).

In 1989-1990 unemployment was virtually non-existent in Estonia. By 1992, subsequent to initiating economic reforms in Estonia, unemployment became a hard reality for Estonian society. Remarkably, the fall in GDP had not led to high unemployment (Tables 2 and 3). The main reason for moderate unemployment increases during the first years of transition was a sharp drop in labor force participation.

A rapid increase in unemployment was evidenced in 1999, a year following the Russian crisis. The number of unemployed persons increased to 86.2 thousand, 23% up from the figure in 1998, and the unemployment rate increased to 12.3%. The instability of the Estonian labor market increased in 2000 (Table 4), which also marked the emergence of increasing structural unemployment. It is possible to assume that part of cyclical unemployment, caused by external shocks (Russian crises), was also responsible for structural unemployment. Estonia's initial conditions of gradual unemployment increases were not accompanied by a surge in social disturbances like that of other transitional countries.

Table 1: Initial Conditions of Transition in Estonia

Initial Condition Category	Brief Characterization
Physical Geography	Estonia is located on the eastern shore of the Baltic Sea and has good access to seaports. Due to its favorable location, the country could serve as a bridge between East and West. Not Estonia is rich in natural resources.
Macroeconomic Variables	Poor starting conditions in the beginning of the economic reforms (1992) led to a significant drop in output (GDP change -14.2%), hyperinflation (1076%) and collapse of the trade relations with the former Soviet Union.
Demographics	The population was about 1.5 million. More than 70% of population was living in urban areas; about 20% of population were older than 60 years. The share of workers with higher education and vocational education was more than 30% in 1989 (Data of the Population Census 1989). Life expectancy at birth was about 70 years in 1989.
Human Capital	According to the World Bank measures of wealth of nations, Baltic's human capital is comparatively highly evaluated: the share of human capital is 72% in total wealth for Estonia (the world average is 64%).
Industrialization	Estonia was an industrial-agrarian economy. The share of industry was about 40% of Net Material Product (NMP), and agriculture more than 20% in 1990. Estonia produced a significant share of its primary energy. The industrial sector was characterized by a high degree of concentration (about 20% of all enterprises produced more than 60% of total industrial input). The economy was supply-sided.
Trade Orientation	The share of USSR and CMEA in imports and exports was 91.6%; trade with the rest of the world formed 4.5% of Estonian exports and 11.1% of imports in the beginning of transition.
Market Memory	About 50 years under central planning. Estonia was independent between the two world wars and its economy was market oriented till 1941.
Culture	The country belongs to the Baltic Sea region. The Baltic Sea region countries have economic and cultural relationships that were established already during the Middle Ages (Hanseatic League). Religion: mainly Christians (majority) and Orthodox.
Political Situation	The political situation was stable, no wars. People have a social memory of democracy due to the independence of the Baltic countries between the two world wars. Political changes have significantly influenced the economic cooperation of the countries around the Baltic Sea.

Source: Authors' considerations based on the data of the national banks and statistical authorities; also Hansson, 1997; Mundell, 1997, Sachs *et al.*, 2000.

Table 2: GDP Growth in the East and Central European Countries, 1989-1999 (GDP Index, 1989 = 100)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999*
Bulgaria	90.9	80.3	74.4	73.3	74.6	76.2	68.5	63.7	65.9	65.9
Czech Republic	98.8	87.4	84.6	85.1	87.8	93.4	96.9	97.2	95.0	95.0
Estonia	91.9	79.4	68.1	62.0	60.8	63.4	65.8	72.8	75.7	75.7
Hungary	96.5	85.0	82.4	81.9	84.3	85.5	86.6	90.6	95.2	98.1
Latvia	102.9	92.2	60.0	51.1	51.4	51.0	52.7	57.2	59.2	60.1
Lithuania	95.0	89.1	70.1	58.9	53.3	55.2	57.9	62.2	65.4	65.4
Poland	88.4	82.2	84.3	87.6	92.1	98.6	104.6	111.8	117.1	121.2
Romania	94.4	82.2	75.0	76.1	79.1	84.7	88.2	82.1	76.1	73.0
Slovakia	97.5	83.3	77.9	75.0	78.6	84.1	89.6	95.4	99.6	101.4
Slovenia	95.3	86.8	82.0	84.3	88.8	92.5	95.7	100.1	104.0	107.6

Source: EBRD Transition Report 1999: * - projection

Table 3: Unemployment Rate in the East and Central European Countries, 1991-1998 (%, Calculation Based on Labor force surveys)

	1991	1992	1993	1994	1995	1996	1997	1998
Bulgaria	-	-	21.4	20.5	14.7	13.7	15.0	16.0
Czech R.	-	-	3.9	3.8	4.1	3.9	4.8	6.5
Estonia	1.5	3.7	6.5	7.6	9.7	10.0	9.7	9.6
Hungary	-	9.3	11.9	10.7	10.2	9.9	8.7	7.8
Latvia	-	-	-	-	18.9	18.3	14.4	13.8
Lithuania	-	-	-	17.4	17.1	16.4	14.1	13.5
Poland	-	13.7	14.9	16.5	15.2	14.3	11.5	10.6
Romania	-	-	-	8.2	8.0	6.7	6.0	6.3
Slovakia	-	-	12.2	13.7	13.1	11.1	11.6	11.9
Slovenia	7.3	8.3	9.1	9.0	7.4	7.3	7.4	7.9

Source: Central European Countries' Employment and Labor Market Review, EUROSTAT, Theme 3, 1999-1.

Table 4: The Main Characteristics of the Estonian Labor Market, 1989-2000 (Annual Average, Thousands)

	1989	1992	1995	1998	2000
Total population (aged 15-69)	1096.4	1101.2	1061.6	1044.2	1104.1 (aged 15-74)
Labor force	842.6	794.8	726.9	706.4	705.1
Employed	837.9	765.7	656.1	636.2	608.6
Unemployed	(4.7)	29.1	70.9	70.2	96.5
Inactive	253.8	306.4	334.6	337.8	399.0
Participation rate, %	76.9	72.2	68.5	67.7	63.9
Unemployment rate, %	(0.6)	3.7	9.7	9.9	13.7

Source: Estonian Labor Force Surveys.

Conclusion

Different initial conditions partly explain the differences in speed and radicalism of economic and macroeconomic reforms among transitional countries. The EU eastward enlargement initiative looked to countries where macroeconomic stabilization had already been achieved. Yet even with favorable initial conditions of this sort, the emergence of disorders such as a country's social instability - areas not included among the initial condition groupings of Table 1 - prolong the adjustment process beyond that which is required to account for initial conditions.

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