

Scenarios 2018

FOUR ALTERNATIVE FUTURES FOR THE ESTONIAN ECONOMY



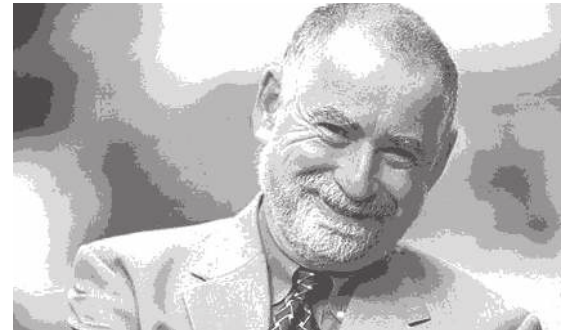
ARENGUFOND
ESTONIAN DEVELOPMENT FUND

This policy brief sums up four plausible and alternate narratives about the future of economic development in Estonia. It outlines a set of implications each future has on Estonia's economic development.

The scenarios were developed with the aim of helping key stakeholders in Estonia to start a strategic conversation about the vision for Estonia's future growth.

Scenarios are a tool for helping us to take a long view in a world of great uncertainty.

Peter Schwartz, distinguished futurist and co-founder of Global Business Network (GBN)



Plausible futures

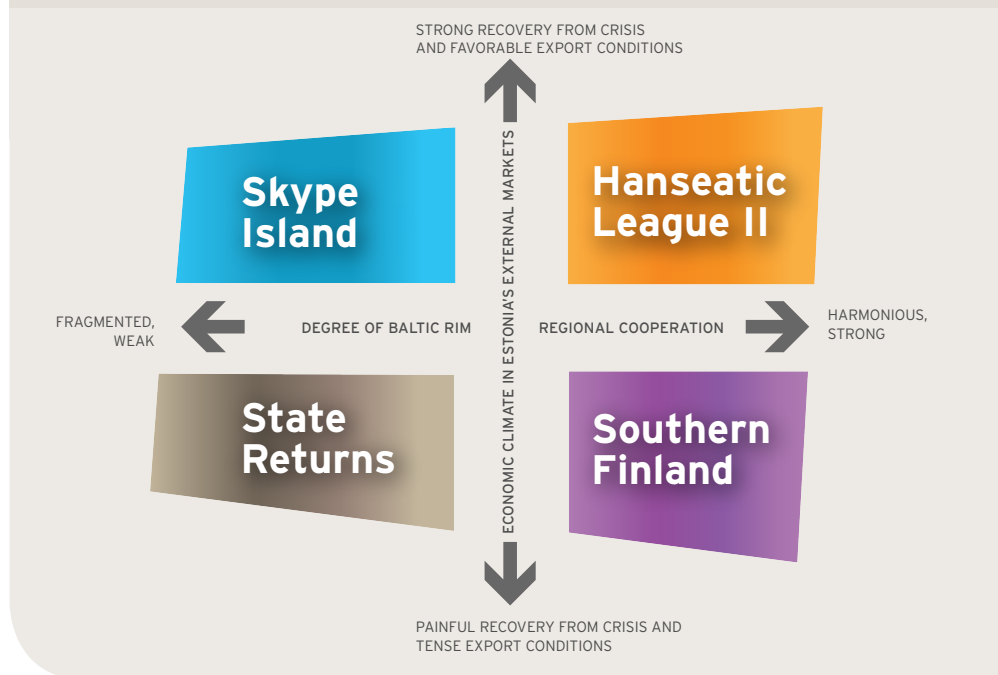
The purpose of scenario thinking is not to identify the most likely future, but a set of alternative, divergent and plausible futures. They are designed to stretch our thinking about emerging changes, opportunities and threats that the future might hold.

On the one hand, scenarios lead us to key choices of how to prepare for diverse conditions. On the other hand, scenarios offer a „testing space“ for present and future ideas, strategies or single decisions. They allow us to analyse the likely results of our actions under different circumstances, and in which direction our decisions should be changed.

When envisaging scenarios for the Estonia's economy, relative certainties and critical uncertainties that significantly shape our future were identified. Two uncertainties - "Economic Climate in Estonia's External Markets" and "Degree of Baltic Rim Regional Cooperation" were then combined into a scenario matrix. Plausible future developments were then played through by taking unexpected assumptions and building scenarios based on „What if...?“ questions.

Southern-Finland, Hanseatic League II, Skype Island and State Returns are scenario-stories of multifaceted futures. Taken together, they help capture the range of uncertainty that Estonia faces and describe four plausible, divergent scenarios or stories about the future of Estonia's growth over the next eight years.

Scenario-planning allows us to make future-proof decisions today



Future Savvy Decisions

Identifying recurring themes that span across different scenarios allows us to be ahead of time and anticipate future obstacles and opportunities that are more likely to pop up.

Conclusions based on these themes help us to prepare for both positive and negative, expected and unexpected circumstances - to give an impulse with future savvy decisions to gain from

favorable developments and steer clear of unwanted ones.

Playing through the possible future paths of the Estonian economy showed that maximizing the outcome whatever the future developments, requires several changes in policies. The key choices that emerged from scenarios became the main building blocks of the Estonia's Growth Vision 2018.

Skype Island



In a world that has emerged from recession, tensions exist between East and West. Europe struggles to maintain its position in the world arena, despite continued EU integration. Russia and Germany build a strong alliance but Nordic cooperation falters.



Estonia actively seeks for new partners and advances bilateral relations with more distant (large) states. After proactive economic policy and ambitious education rearrangements are introduced, Estonia becomes a globally considerable hub of innovation and entrepreneurs - especially in ICT.

- In big countries, economic recovery based on green technologies and ICT is fast.
- Due to the ascent of Asia, competitive pressures increase all over the world and this leads to somewhat protectionist policies. However, globalization continues from advancing global debundling of value chain activities, outsourcing and offshoring.
- International cooperation enlivens, yet mostly through bilateral ties with chosen partners as opposed to regional cooperation.
- Russia warms relations with rapidly growing China and starts challenging the NATO alliance politically in addition to building a strong alliance with Germany.
- Although the EU emerges from the crises and adds new members, its economic growth lags behind the rest of the world. In the same vein, Scandinavia's success and outlook on the world market weaken, leading to a decreased regional cooperation.
- In this environment, Estonia seeks to build new partnerships and alliances, reinforcing economic and political ties with afar large countries (e.g. US, China, Brazil) and small progressive states (e.g. Singapore and Israel).
- In a fragmented geopolitical environment, the state assumes an active role in setting the new sights in economy and in rearranging the educational system, in particular.
- The government is focusing its actions on supporting the joining of global networks, and a wide-scale technology-based FDI attraction programme is launched.
- At the same time, the inflow of talents is incentivized. Foreign students are attracted by the emergence of competitive ICT and business schools, following the reforms in education. Talented Estonians are sent to study abroad on condition of returning to Estonia.
- Private equity and venture capital flow into the country due to fast growth in skilled labour pool and government-promoted favorable business environment. This facilitates the flourishing of high value-added sectors and boom of start-up companies, especially in ICT.
- Estonia leapfrogs with its astute foreign policy. At the same time, structural unemployment and social tensions grow in face of rapid changes. Yet, the fruits of economic success allow to easily mitigate unrest.

FRAGMENTED,
WEAK



DEGREE OF BALTIC RIM



Economic growth stutters in the developed world while emerging economies continue to grow. As a result, new global order and balance of power emerge, igniting competitive tensions and protectionism. The neighbourly relations along the Baltic Rim and within the EU are also not what they used to be - every country is acting primarily in their own interests.



Estonia finds it difficult to carve a place for itself. The economic model is not modernized and remains inward-oriented, cost- and resource-based. In order to maintain employment, the state has to start taking control of enterprises. Estonia's development outlook remains meager even once the external conditions start improving.

- Aftershocks of global financial crisis continue to ripple the world economy through 2016. The economic recovery of 2010-11 turns out to be short-lived, with the exception of big emerging markets. Capital shortages create an obstacle to finding new sources of growth and making technological breakthroughs.
- Rearranging of economic balance of power speeds up to the disadvantage of Western countries. Due to high unemployment and dissatisfaction levels the governments react in populist manner by adopting protectionist measures.
- Bilateral relations are advancing and driven by self-interest whereas multilateral relations come to a standstill. This takes the Western countries and wider economic cooperation into a vicious circle that becomes ever harder to break.
- The Baltic Sea region and the EU take a back seat in the world as investors strongly turn to East. Economic self-preservation instincts prevail in the EU and Nordic countries with attempts to protect domestic companies and markets. Regional integration is reversed.
- After Vladimir Putin is again elected as president, Russia starts turning more attention to achieving control over the weakened neighbours.
- Estonia has a hard time finding its place in this harsh environment. High unemployment persists, foreign investors have at best lukewarm interest for investing in Estonia and business opportunities are lacking. Many talented and experienced people emigrate.
- In the name of survival, the government tries to direct the economic life and decisions more centrally by regulating and interfering more. The little state finances remaining available for investments are used to develop low-cost manufacturing based on local resources.
- In doing so, the economic model remains cost- and resource-based. The hardships of getting access to foreign markets leave us dependent on meagerly growing internal market. The capacity for investment has fallen even further by 2016, while Estonia-Russia tensions have grown.
- In order to maintain stability and employment, the state decides to take control of key enterprises by buying up their assets or taking over management control. Yet, the government has neither resources nor capabilities to turn these enterprises around.
- The economy stagnates. Even with the global economy starting to improve towards the end of decade, the Estonian outlook remains poor - it takes a while to be able to progress from such a situation.

State Returns

RECOVERY FROM
AND FAVORABLE
T CONDITIONS



ECONOMIC CLIMATE IN ESTONIA'S EXTERNAL MARKETS



RECOVERY
AND TENSE
CONDITIONS



Regionalization increases in the world, fast recovery and further growth are led by both traditional and new business areas. Within Europe, Northern and Southern countries distance from each other. Cooperation around the Baltic Sea develops strongly with Germany and Russia participating.

- Due to the post-crisis political backlashes and new balance of power, international cooperation and economic interaction shift more into regions. Leaning on more intense regionalization, the globalization megatrend persists.
- Post-crisis recovery is strong and quite fast, both in traditional business areas (based on growing investments, especially into infrastructure) as well as new industries (e.g. green economy) based on advances in technological breakthroughs.
- China, India and Brazil have become important players in global arena. Despite the interim critical moments in euro-zone, Europe has not lost its clout compared to large emerging economies.
- North-south polarization and distancing occurs within the EU. Germany values fiscal discipline and finds like-minded partners in the Baltic Sea region, adding momentum to already ongoing regional integration.
- Having become a stable, prosperous and Westward looking country due to rise of Asia, Russia then joins the cooperation network around the Baltic Sea.



In midst of deepening integration of Baltic Sea countries, Estonian companies thrive with nimble business models and especially in new business areas. Estonia becomes a prime investment destination in the region. In 2018, Estonia is an open, lively and cosmopolitan nation rich in skilled individuals.

- Favorable external economic climate and the tightening cooperation around the Baltic Sea offer a large market to Estonian companies that have nimble business models, especially in technological and new business fields.
- Post-crisis generational change of state and business leaders sparks wide-scale structural reforms.
- The educational reform and wisely selective immigration policy ensure fast growth of skilled labor-force. Estonian universities make a strong contribution to this after becoming regionally competitive through reforms.
- Educational system and the development of cross-border technology clusters make Estonia a prime destination for regional investments (including R&D centres).
- Although income inequality grows and creates some unrest, general welfare advancements create a good platform for keeping the tensions at bay.
- Estonia successfully carves itself a niche in the Baltic Rim and significantly benefits from the region's political stability, close economic integration and talent mobility.

Hanseatic League II

REGIONAL COOPERATION



HARMONIOUS,
STRONG



In a global slow-growth environment, large countries are mostly interacting with each other and wider cooperation is left for regional blocs. These emerge also within EU and one of them strengthens in the Baltic Sea area, although without Germany and Russia participating.

- Global economy recovers slowly from crisis. Growth remains slow but stable, except in fast-growing emerging markets. The sources of recovery are public investments together with slow-paced innovation in traditional business.
- The big countries US, China, Russia, etc interact with each other closely, realizing that mutual cooperation is beneficial for ensuring post-crisis stability.
- The role of wider cooperation is diminished and globalization slows down. Regional interaction and economic cooperation take off instead (especially in Asia and Latin America).
- Although there are new members joining the euro-zone (including other Baltic states and Poland), EU members recognize the limitations of intertwined economic policies. Further integration decelerates and European economic growth falls behind the rest of world's.
- Such internal weaknesses leave Europe aside and out of interaction between the big players. More progressive member states form intra-EU regional cooperation alliances.
- One such bloc develops in the Baltic Sea region, where the Nordic countries try to restore their growth by more tightly integrating lower-cost neighbours into their value-chains. Germany does not participate in regional cooperation and Russia is merely a trading partner.



Scandinavian capital continues to dominate in Estonia, the economic model remains static and brain drain accelerates. Cheap labor brings work in the less valuable parts of regional value chains, but growth is sluggish and development has a clear ceiling.

- The initially strengthening business opportunities in Nordic value chains and also in Russia create a sense of escaping from crisis. This leads to a continuation of current economic policy, major reforms are not introduced and economic model remains the same.
- New credit financing is impossible to get from Scandinavian banks, because Estonian outlook is not trusted and money is needed in home markets. Inflow of EU Structural Funds offer some refreshment though.
- The postponement of policy changes prevents a larger wave of FDI inflow apart from the initial transfer of production and support services from Nordic countries in the immediate aftermath of crisis. Finnish and Swedish capital acquires the last successful companies that have remained in the hands of Estonian owners.
- Cost-based economic model, slow momentum of development and lack of capital alienate talented entrepreneurs, innovators and college applicants. Emigration of best talents and skilled workers speeds up.
- Estonia somehow gets by and the situation remains relatively stable. Yet, there is a clear ceiling in productivity and the economy is destined to run out of steam - the cost advantages that were restored during crisis do not last long.

Southern Finland

Set of implications: recurrent themes and key choices

The baseline scenario for the Estonia's economy is Southern Finland. It is a familiar and low-risk path, that in the long run may not turn out to be viable. To benefit from favorable conditions and reach a more successful future like Hanseatic League II or Skype Island, several existing policies and general approaches need to be rethought.

1. The ability to create, retain and attract high-calibre **human capital** is crucial in all scenarios. Thinking more holistically about retaining and enhancing our talent pool, targeting immigration and creating incentives for staying in Estonia need to become an important part of Estonia's talent policy.
2. In most scenarios a key opportunity and challenge is the "**opening up of Estonian society**". Apart from higher tolerance within the society it also requires a better understanding of our geographic neighbours and afar trade partners. The ability to proactively create good bi-lateral relationships in addition to belonging to multilateral institutions (e.g. NATO and the EU) is increasingly important.
3. In virtually all the scenarios there is a need for Estonia to **project itself economically and politically outside its own borders**. A key question remains on how to break free of the mindset where Estonia perceives itself to be a "servant" (a junior partner at best) to other nations. Instead, we need to establish ourselves as a truly equal partner who can use its size as an **advantage** and can overcome its smallness by being quicker, more flexible and nimble than many of its larger neighbours and competitors.
4. Scenarios indicate that Estonian businesses have opportunities to **move up the value chain** and break through current structural limitations in productivity. This requires a more intelligent approach by both public and private sectors in attracting and deploying capital in the Estonia's economy. On top of that, tough choices and tradeoffs must be made between sectors by creating necessary incentives, for instance. Scenarios show the way: **it makes sense to focus on ICT, wellness services and cleantech**.
5. As part of the society does not cope well with change and demographic trends will create significant headwinds for the economy, **redesigning the social welfare system** will be a part of Estonia's economic path.
6. For carrying out the conclusions and reaching a more favorable development path (e.g. Skype Island or Hanseatic League II) **strong and decisive leadership** is required, especially at state's level. Achieving success under an increasingly complex set of choices within the constrained set of resources at Estonia's disposal implies proactive and creative decisions that are not stuck in silo-structured institutions and mentalities. At the same time, **readiness to take risk** is required to target education or economic policies, for instance.

Scenario-building process

In 2010, the Development Fund initiated a strategic conversation „Estonia's Growth Vision 2018“ to identify growth opportunities for the Estonia's economy and ways to achieve them.

In the first stage of vision-building, 30 creative minds of various backgrounds were invited by the Development Fund to participate in a workshop, during

which possible future developments of the world economy were played through to create a better understanding how relevant external forces might interact and evolve, providing Estonia's economy with different challenges and opportunities.

The scenario planning process was facilitated by GBN - an elite corporate strategy firm, specializing in future-

thinking and scenario planning.

Scenarios that were a product of a teamwork were introduced to the wider public at the Development Forum on May 6, 2010.

Key choices that were drawn from the set of scenarios became the core of goals and aspirations of the growth vision.

Eesti Arengufond
Tornimäe 5
10145 Tallinn
Ph: +372 616 1100
www.arengufond.ee/eng

The Estonian Development Fund is established by the Parliament to identify new sources of economic growth through foresight and to invest in knowledge-intensive and ambitious Estonian start-ups.



Further reading:

Policy Brief. Estonian Growth Vision 2018: goals and aspirations for the next decade
<http://bit.ly/HghII5>

See also:

Animated scenario-building: four alternative futures for the Estonian economy
<http://bit.ly/GZRatr>