Nominal and real convergence in Estonia: The Balassa-Samuelson (dis)connection
Does disaggregation provide better understanding?

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The objective of the paper is to analyse the nominal and real convergence process in Estonia drawing on the Balassa-Samuelson (B-S) framework. A 15-sectoral breakdown for GDP and a 5-digit level CPI data disaggregation with over 260 items is used for the period 1993:Q1 to 2002:Q1 to show that the productivity differential is related to the GDP-deflator relative price of nontradable goods in the long-run. Furthermore, the role of regulated prices in the CPI basket is also investigated: we show that excluding regulated prices makes it possible to detect a robust relationship between productivity and the relative price of market services in CPI. The B-S effect could have possibly contributed to CPI by a yearly average of 2% to 3% over the sample period, with 1% to 4% at the beginning of the period and 0,5% to 1% in 2000 and 2001. The potential long-run impact of the B-S effect in Estonia is estimated to amount to 1%-2% . The analysis of the influence of the B-S effect on the inflation differential and the real appreciation of the exchange rate against Finland, Sweden, Germany and the UK shows that whereas the inflation differential attributable to the B-S effect seems to be higher in the early 1990s, it explains better the real appreciation, which has occurred in recent years.

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