LABOUR MARKET AND THE CENTRAL BANK

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One of the main topics in the current issue of Kroon and Economy is the Estonian labour market. The development and problems of the labour market are discussed in the following three articles:

- Estonian Labour Market in the Past Decade *by Tairi Rõõm and Natalja Viilmann provides a survey of the development of the labour market, its weaknesses and strengths;*
- *the analysis* Taxation of Production Factors and Unemployment in Estonia *by Tairi Rõõm takes a look at the relations between the labour market and taxation;*
- Estonian Labour Market Institutions in International Comparison *by Marit Rõõm compares the labour market institutions of Estonia with those of other Central and Eastern European countries and the OECD countries.*

What Makes Labour Market Problems so Important for the Central Bank?

In the production function labour force is one of the main inputs. Besides the fact that the labour market distributes the main production inputs, this market also has a great impact on various prices and hence the development of inflation indicators. Labour market affects the general price level through the cost of resources, particularly through labour force. The cost of labour force is based on productivity, the level of wages and employment, and taxation of the labour force. Therefore, the development of the labour market often also determines the development of the economy as a whole.

Changes in the cost of labour, as a rule, do not lead to changes in the general inflation indicators, provided that the cost of labour corresponds to productivity. In the long run, changes in the cost of labour can only proceed from productivity, although in the short term the dynamics of these indicators can be different. The gap between productivity and the cost of labour can lead to the faster or slower increase of inflation indicators.

The ability and speed of reaction of the labour costs to changes in productivity (but also changes in the economic environment, including economic shocks) can simply be called the flexibility of the labour market. Although flexibility usually also means the adjustment of labour supply through the participation rate and mobility, the impact of the latter is considered relatively small. Thus, the more flexible the labour market, ie the faster the cost of labour reacts to changes in the economic environment, the more stable the inflation indicators, all other things being equal.

Today, most central banks have, directly or indirectly, set price stability as their main goal. This usually means keeping the inflation rate at a relatively low level in medium term. The European Central Bank, for example, has set its inflation goal at 2% and the Bank of England aims at 2.5%. It is understood that the stable low inflation rate and its predictability simplifies the operating of various economic agents in such an economic environment and guarantees more effective resource allocation.

As changes in the labour costs and productivity have a considerable impact on inflation indicators, labour market and the factors influencing its flexibility play an important role in guaranteeing stable inflation and stability of the economic environment.

Why Is Labour Market Development Particularly Important in Countries with a Fixed Exchange Rate?

In open economies, the nominal exchange rate of a currency is the simplest way to influence the general price level and labour costs related to other countries. The weakening of the local currency can, at least temporarily, lower domestic price level (including labour costs) vis-à-vis other countries. The strengthening of the local currency against the currencies of other countries, in turn, leads to the increase of price level.

In countries where the national currency is pegged to some other currency or where a common currency is used there is no possibility to affect relative prices through the exchange rate. This means that in case of an economic shock that hits just this one country, the relative adjustment of prices to the new conditions can only occur in the real economy (through inputs and the price of products). Proceeding from the above, Robert Mundell argued already in 1961, when elaborating his now well-known theory of optimum currency areas, that one precondition for the adoption of a common currency is the flexibility of the price of one of the most important resource – the labour force. Thus, the flexibility of various markets (including the labour market) in securing the effective distribution (and relocation, if necessary) of resources is particularly important for countries with the fixed exchange rate.

Low employment and high unemployment, as well as the low wage level as compared to the developed industrial countries are still among the most acute and socially sensitive economic policy issues in Estonia. What is the most effective way to increase employment, without creating additional inflationary pressure for Estonia or other transition countries, is not clear even at the academic level. Questions are asked about the extent of hidden unemployment in the conditions of centrally planned economy as well as ways of evaluating the mobility of workers, production potential, etc. The following articles try to shed some light to those issues.