KEY ISSUES OF ESTONIAN ECONOMIC POLICY[1]

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The stability of the exchange rate and usefulness of the fixed rate depend, first of all, on whether an economy is flexible enough to survive even the most serious shocks. This dependence also applies to Estonia. Our currency board and the fixed exchange rate of the kroon have persisted and supported the development of the economy because the Estonian state as a whole has pursued a sensible economic policy over the past decade. Now, when EU membership is but a year away and introduction of the euro currency lies in not too distant future, sensibility of economic policy in the coming years is more important than ever before. It is our choices today that will largely determine the development of the Estonian economy in the European Union.

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Current Situation and Outlook of the World Economy

The small Estonian economy depends directly on the development of the world economy. The year 2002 was full of uncertainties, exchange rate fluctuations, fulfilled and unfulfilled expectations. But most of all it was characterised by the persistence of various risks.

The US economic activity was, throughout the year, sustained by private consumption and housing construction, based on the rapid fall of interest rates. At the same time, industrial output decreased by 0.7%. However, rapid growth of private debts, budget deficit and nonexistent profits of companies mean that US economic growth depends more and more on the inflow of foreign capital. In order to maintain the growth of the US economy, the rest of the world has to invest approximately 1.7 billion dollars into the United States every day, since the US current account deficit – the gap between savings and investments – amounts to 4.6% of the GDP.

[1] The article is based on the public lecture by Governor of Eesti Pank Vahur Kraft given at the University of Tartu on 21 March 2003.

The faster than expected growth of the US economy has so far been based on the capital accumulated during the rapid rise of the 1990s. The utilisation of the budget surplus accumulated in previous years and the growing debt burden of households have compensated for the decline of industrial output and investments. This, in turn, has made the US economy more and more dependent on the willingness of the rest of the world to invest in the USA.

While in recent years, the US economic growth has been extensively financed by the European countries, then in 2002 capital flows between the US and Europe reached equilibrium. Currently, the financing of the US economic growth largely depends on the countries of East Asia. However, a considerable part of their own growth has been based on export, first of all to the USA. The decline of consumption in the US would therefore be a direct blow on Asia. Moreover, the increase of external reserves of those countries has largely been achieved by suppressing domestic demand. If domestic demand in Asia increases, the amount of money these countries are ready to invest in the USA will also decrease.

The economy of the European Union turned out to be weaker than predicted in 2002. Instead of the expected convergence of the US and European growth rates, the difference even increased in favour of the USA. The traditional problems of continental Europe re-emerged acutely – the slow adaptability of the economy and shortcomings of fiscal policy.

A year ago most analysts underestimated the impact of economic problems of the rest of the world and particularly the USA on the economy of the European Union. The EU as a whole is a relatively closed economic region and it was thought that the growth rate could be maintained independently. However, the majority of European large corporations made considerable investments into the US in the late 1990s. The drop of profits and stock prices in the US, thus, affected a large part of European businesses. The telecommunications sector was also affected by the large debt burden related to the acquisition of next-generation mobile communication licenses.

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While in the US the growth of private consumption compensated for the impact from decreased investments, the increase of consumption in Europe was and is limited for several reasons. First, the fiscal position of major continental European countries is considerably weaker than that of the USA. Figuratively speaking, the EU did not use the economic boom for creating a budget surplus, but for cutting taxes. However, this was not accompanied by expenditure cuts.

Since the possibilities of economic policy to support growth were and are limited, acceleration of growth in Europe depends, first of all, on the continuation of reforms. On the EU level, it has become topical to expand the internal market to areas that the member countries have so far kept closed. Estonia, for example, will be considerably affected by the opening of the energy market to outside competition and greater impact of consumers on electricity prices.

The real problems, however, are in areas that are not regulated by Brussels but the member countries themselves. The most important of these is the rigidity of the labour market. Relatively high minimum wage, costly social policy and high costs related to labour cuts have led to persistently high unemployment in a number of EU countries. The Old World's main problem lies in the fact that Europeans just work less as compared to Americans. Labour productivity of Europeans is only slightly below that of Americans, but working hours are shorter in the EU and efficiency is therefore considerably lower than in the USA. Labour market problems, in turn, hold back investments and consumption and are thus, the main reason for the relatively slow economic growth.

Another complicated issue is the possible effect of geopolitical risks on the economy. The views of analysts differ greatly on this subject. True, the easing of the Middle East crisis will restore part of the lost investor confidence and stock prices may increase at least temporarily. But even after the war ends, America will still be facing current account deficit, excessive investments and growing unemployment, and Europe will suffer from adjustability problems and slow economic growth.

Key Issues of Estonian Economic Policy in Coming Years

Can the Estonian economic growth slow down considerably already in 2003? In order to answer this question we should begin with the financial account of the Estonian balance of payments and analyse whether the inflow of foreign investments could decrease rapidly. A short answer to this is “no”. The bulk of foreign investments made into Estonia over the recent years have not been short-term speculative capital. Although the decline of direct investment inflow in 2002 was noticeable and it was mostly replaced by company and bank loans, foreign loans taken by companies, for example, were usually long-term.

We should also keep in mind that a considerable part of foreign capital placed in Estonia is reinvested income, which has been earned from earlier foreign investments amounting to more than 60 billion kroons. This, in turn, reduces the vulnerability of the economy as the decision whether or not to reinvest profits depends more on the Estonian economic policy than economic development in the rest of Europe, which we cannot influence.

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Fiscal Balance and Tax Policy

In the medium term, balanced budget enables smoothing of the ups and downs of the national economy and thus helps to reduce adjustment problems. For example, Estonia survived the recession following the Asian and Russian crisis mostly due to the money received from the privatisation of Eesti Telekom in 1998. This buffer helped to finance the 4% budget deficit in 1999. Otherwise, Estonia's public debt would have increased sharply.

The balance of the budget is important for Estonia in several respects. First, current account deficit that increased sharply in the second half of 2002 is the main risk factor of our economy. One of the main goals of economic policy should be the reduction of risks deriving from ever increasing dependence on the inflow of foreign capital. On the national economy level, budget provides the best opportunities for this. The balance or moderate surplus helps to partly balance the over-optimistic future outlook of the private sector and the related growth of investments and debts.

Secondly, the balance of the budget is also important for our accession to the European Union and the euro area. Just like now, the success of our economy in the EU will depend directly on strong economic and fiscal policy. The EU gives us a chance to use the advantages of common economic space and common currency, but actual success of Estonia relies on ourselves. The introduction of the euro will guarantee our country and economy another stable currency, but we will not benefit from it if the economy is unable to react flexibly to the changing conditions of the European common market. If the rapid development of areas oriented to domestic market and domestic consumers continues in the Estonian economy instead of the export-oriented industry and services, our rapid economic growth will not continue. As we can see from the experience of several EU member countries, even the common currency will not help in such a case. On the contrary – the common currency and the common market will punish us severely for weak economic policy.

Joining EU will also impose some important formal rules on the Estonian fiscal policy. Prior to the introduction of the euro, Estonia will join the exchange rate mechanism ERM2, which will guarantee EU's support to the kroon/euro exchange rate. Through negotiations both Estonia and the EU must become convinced that the current exchange rate of the kroon and the euro is also suitable for our membership in ERM2 and, after that, in the euro area.

It is not an easy task for us regarding the present level of the current account deficit. Should it appear that the government has no wish to reduce external vulnerability of the economy, it could cause serious problems at the negotiations. Furthermore, increasing budget deficit in the current phase of the economic cycle coupled with a remarkably high foreign debt level can literally be called wrong economic policy. It will not increase Estonia's economic security; on the contrary, will add gas in the conditions where brakes should be used. If we cannot see it ourselves, our partners in the EU will notice it very soon. This year and the next couple of years the economic situation and accession to the EU requires wiser and more statesman-like behaviour from us than ever before.

But looking a few years ahead, we must already consider the rules of the EU and euro area economic policy. The Stability and Growth Pact, which guarantees the strength and credibility of the euro, sets clear limits on budget deficit. I would like to emphasise that the so-called normal policy of the EU members does not mean keeping the budget at a 3% deficit of the GDP, on the contrary, keeping the budget balanced or having a surplus over one economic cycle. **It would be naive and, in economic policy terms, also dangerous to think that chronic budget deficit could be corrected in a short time in future**, as the current problems of major accession countries significantly indicate.

Fiscal policy also has a second dimension – the size of the state budget. It is an ancient question whether a smaller state budget and lower involvement of the state in the economy and the everyday life of people will guarantee faster economic growth, greater wealth and stronger citizens than a large budget and considerable state involvement in the economy. The answer to this question goes beyond the borders of economic policy and reflects social choices and common values as a whole.

However, it is clear that simple solutions are often suggested to this problem. One of the most usual and humanly also the most understandable one is the following argument: the state is too big and takes too much money from people in taxes; if we lower the taxes, the economy will spontaneously take off and tax income will increase. Thus, everybody wins – people pay less taxes and the government will not have to cut expenditures. This activity is called unfunded tax reduction.

Unfortunately, older and more recent history of the world economy confirms that there are no simple solutions to complicated problems. **The acceleration of economic growth can be maintained only if tax cuts are combined with economic reforms.** A typical example here is the Thatcherism and Reaganomics of the 1980s: tax reductions were accompanied by thorough changes in economic structure, abandoning of the so-called big power ideology and privatisation.

It is, however, more common to solve only the simpler side of the issue – to cut the taxes. The harder work – reforming of the economy – has been left undone, although it would accelerate economic growth. In other words, for the seeming enlivenment of the economy the income side of the budget has been reduced while state expenditures have been increased. This results in a budget deficit, growing debt burden and considerably slower, not faster, economic growth than expected. We can say with certainty that such a policy is the main reason for the current economic problems in a number of EU member countries. If we want Estonian economic growth to

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Labour Market

While fiscal policy has to guarantee the necessary stability on the national economy level, sustained rapid growth in Estonia – just like elsewhere in Europe – depends largely on the development of the labour market. **The level of investments remains high only when there are qualified and motivated workers who can successfully utilise invested capital.**

Labour force is a strategic asset and, at the same time, a multifaceted problem in very many countries. As we already noted, rigidity of the labour market hinders the acceleration of economic growth in the EU. However, increasing unemployment also characterises several acceding countries where problems include the lack of qualified labour, the need for educational system reforms and long-term unemployment caused by too high social benefits. In Estonia, too, high unemployment and extensive lack of labour coexist. According to the Statistical Office data, more than half of the unemployed (53%) have been without a job for a year or longer. This indicates that unemployment is still structural in nature in Estonia, which means that the skills of the unemployed do not match the needs of the market.

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Labour market policy, too, has to proceed from the basic truths of economic policy. Demand for labour and new jobs are created by private sector. Private sector companies invest and create new jobs only when they are confident about their future. Stable currency, low inflation and balanced budget guarantee trust in the future, encourage investments and are thus a necessary precondition for the creation of new jobs.

The most important aspect of the labour market, besides balanced economic policy, is its flexibility – the ability to react to what is happening in the economy. The question is how well are wages adjusting to changes and whether workers are able to move from one production branch to another. The flexibility of the labour market is particularly important for an open economy of a small country like Estonia that can be affected by external shocks and where external factors can often lead to changes.

The flexibility of the labour market depends on the established framework and rules. First of all, it is important to keep layoff regulations and unemployment benefits on a sensible level in order to increase employment. If it is hard or costly for the employer to fire the workers during an economic recession, he or she will not hire new workers during an economic boom. But if the state guarantees generous unemployment benefits to workers this is not just a burden to the budget but also reduces people's motivation of finding a new job. As a result of the combined effect of these two indicators, the Estonian labour market is already relatively strictly regulated as compared to the EU countries. On the state level it would be more purposeful to facilitate investments into human capital – this would make employees stronger and reduce the socio-political weight of the rules on layoffs and unemployment benefits.

Another example. Although high minimum wage can improve the welfare of some low-wage employees, it automatically reduces demand for labour. In Estonia, the minimum/average wage ratio is approximately on the same level with Great Britain and Canada and higher than the respective indicators of Portugal, the USA and Japan.

As to the taxation of labour, contrary to a fairly common view, changes in the taxation of labour need not have a significant impact on labour demand, on the condition that employers can transfer tax costs to employees. In such a case, tax wedge will change but the ratio of labour costs to the GDP remains unchanged. However, it is clear that, other things equal, high labour taxes will set considerable limits to the creation of low-wage jobs.

Indeed, reduction of labour taxes can facilitate economic development and accelerate the growth, if this is a part of the whole reform package. However, like with all tax policy measures, the expenditure side of the budget has to be considered when making changes in labour-related taxes. For example, when we reduce the social tax but the allocations to health care from the state budget remain unchanged, the result is a considerable gap in the budget that will most likely nullify the possible positive effect of the lower tax burden on labour.

Active labour market measures also have an important role in reducing structural unemployment. The most important factor is an effective system of (vocational) education and retraining, which would better satisfy the needs of businesses and increase the flexibility of the labour market. If the quantity and quality of the provided education fail to meet the requirements of the public and private sectors, it would be pointless to increase education expenditure to some ratio of the GDP.

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Thus, in order to guarantee economic growth, it is necessary to guarantee as free functioning of the labour market as possible. This will allow a considerable part of the working-age population to find jobs and wages corresponding best to their abilities and productivity. The negative experience of several countries has shown that political decisions increasing labour market regulation are difficult if not impossible to retract.

Due to the aging of the population, the decrease of employment has become a serious problem in Estonia. **How can we increase the share of employed population?** One way of increasing employment is to motivate those who could work but, for some reason, do not wish to work, for example, by paying social benefits only to those who really need them. Immigration is another matter. If it turns out that maintaining Estonia's current level of development is unthinkable without it, the problem has to be tackled as soon as possible and in a rational manner. Equally important is paying decent wages for good work; however, on the whole, the increase of the real wage has to correspond to the increase of productivity.

In Conclusion

As we know from economic theory, flexibility is the key to the success of a small country. This means the ability to react in a rapidly changing situation and to understand in time what is happening in the world. From our own experience we know that this is also true in real life.

The economy can be flexible only when certain preconditions have been met. The first of them is trust in the continuation of the basic values of economic policy. The basic values that guarantee the functioning of the economy are the rule of law, validity of contracts and stability of ownership relations. The stability of the currency deserves a special mention in this context.

An important precondition for economic flexibility is learning. I mean the professional skills that make our labour force competitive, as well as the general knowledge on life and the economy that allows us to understand the general working principles of capitalist economy.

A good framework for developing the economy is provided by the EU: macroeconomic stability, free movement of goods, capital and labour, and common market supervision regulations support the development of market economy. At the same time, the factors affecting the supply side of economic development are determined now and certainly at least in the medium term by the member countries themselves, and consequently, by Estonia. Based on experience so far I believe that as a small country Estonia can be more flexible than the larger members of the EU, and can arrange its economy and social system more efficiently, which would guarantee faster economic growth and boost economic welfare.

Perhaps the most important prerequisite of a flexible economy is the attitude of society towards entrepreneurship. Any attempts to stimulate economic growth are doomed to failure when there are no entrepreneurs in society and economy. The entrepreneur must have an opportunity to realise his or her ideas, raise capital, hire workers and get information for this with a minimum effort and at a fair market price.

In a sense we are currently at the crossroads of the Estonian economic policy. We have a functioning market economy. Estonian companies are already able to compete on the markets of rich industrial countries and our real income has increased quite rapidly. However, this sets new tasks to economic policy. On the national economy level, fiscal policy has to consider ever-longer time frame and also pay more attention to the impact of international cooperation. Structural reforms are definitely not over in the Estonian economy but have to be continued on the labour market and other areas. Only this way can Estonia's competitiveness be increased and productivity brought closer to the EU average. Economic policy has to be purposeful and consistent, take into account reality and already agreed principles, most of which have been laid down in the medium-term economic programme of the government. Our new parliament and governing coalition thus have a solid foundation from where to move on. But there are also a number of new and old problems that need to be solved, keeping in mind that in the economy and economic policy there are usually no second chances.

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