

Eesti Pank
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LABOUR MARKET REVIEW

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MAIN DEVELOPMENTS IN THE FIRST HALF OF 2009

This Labour Market Review focuses on the developments of the labour market in the first half of 2009, when the economic decline in Estonia continued. Based on the data available, Estonian labour market indicators appeared to respond to economic changes with a varying delay, but still relatively rapidly compared to other countries (the delay generally remained within six months). However, regarding the flexibility of the labour market, it is still not clear whether the reactions were sufficient.

Rapid changes in labour market indicators appeared already at the end of 2008. In mid-2008, the Estonian labour market was still characterised by a much higher employment and a lower unemployment rate compared to the EU average. However, with the arrival of the economic decline the unemployment rate started to increase rapidly, rising by almost twice from the second to the fourth quarter (from 4.0% to 7.6%). Therefore, in the first half of 2009 when the decline probably bottomed, further large adjustments in the labour market were already easier to forecast. In the first quarter, unemployment soared to 11.4%, the employment rate plummeted and wage growth was replaced with a decline. In the second quarter the unemployment rate rose to 13.5% and the number of the unemployed increased to 92,000. The speed of unemployment growth started to wane, though, and the general extreme pessimism regarding the near-future outlook started to ease.

The number of the employed started to drop already in 2008, though modestly at first. Compared to the same periods last year, from the second until the fourth quarter the drop in employment ranged within 0.2–0.3% and the rate of employment remained the same, since with the year the overall number of working-age people also decreased to the same extent. In the first quarter of 2009, however, a relatively abrupt change occurred:

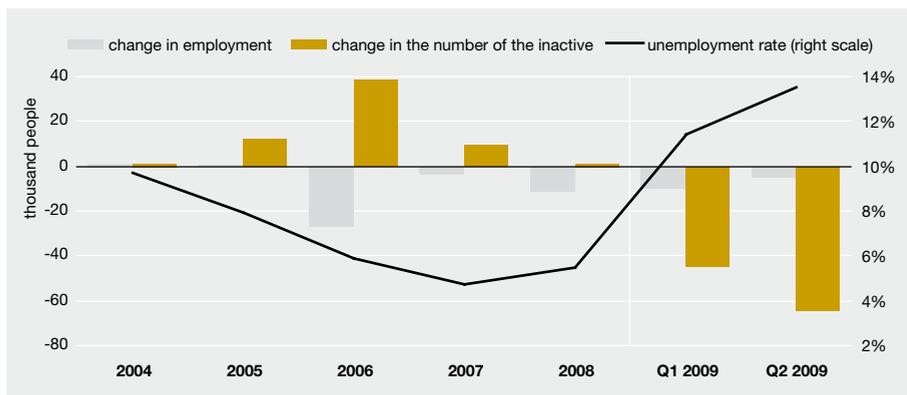


Figure 1. Main labour market indicators

year-on-year, the number of the employed decreased 6.8%, i.e. by 44,400. The number of the unemployed grew by 50,300, as labour supply increased due to a decrease in the number of the former inactive¹ (see Figure 1).

The number of the working age population, i.e. people aged 15 to 74, declined by 4,000 (0.4%), year-on-year. Their activity and employment, however, developed in different directions: the labour participation rate continued to rise (by 1.5 percentage points in the first quarter, year-on-year), whereas the employment rate dropped by 6 percentage points (to 57%). The decrease in employment was caused by a considerable decline in labour demand, whereas the labour participation (activity) grew primarily due to demographic changes. In the first half of 2009, even more people in retirement age left the labour market. At the same time, the total number of the inactive decreased, as a new generation of school graduates entered the labour market.

The changes in general labour market indicators were caused by significant structural changes. For instance, non-salaried workers, e.g. entrepreneurs, were affected more by the recession and their number also decreased relatively more than that of salaried employees. The global nature of the crisis has also entailed a change in labour migration flows: in the first quarter, the amount of people returning to Estonia was greater than in previous periods and this tightened the competition in the Estonian labour market. Regarding economic sectors, the crisis mainly affected construction and construction material industry, timber and real estate, vacating relatively more labour force.

In the first quarter, the unemployment rate rose to the highest level in the past eight years, i.e. to 11.4% and the number of the unemployed increased to 79,000. Second-quarter data indicate a further rise in unemployment, though at a slower pace. As the economic decline is likely to continue throughout 2009, the employment rate will probably drop further due to the weakening demand. Nevertheless, the slowdown in unemployment growth gives reason to expect that the decrease in employment should reach the bottom with a two-quarter delay after surviving the lowest point of the economic decline. If the current forecasts are accurate and the economy reaches the bottom in the second and third quarters, the number of the employed should achieve the lowest point in autumn. This might be influenced by the new Employment Contracts Act that entered into force in July, which among other things simplified lay-offs. According to the available data, however, the fears connected to the amended Employment Contracts Act have not come true. Third-quarter data indicate further growth in unemployment, but at a decelerating rate. At the end of July, the number of the registered unemployed had increased by 2,700 to 70,200, lowest in the past nine months.

¹ A person is inactive when he/she does not work and is not looking for work either (the retired, students, homemakers and the discouraged).

The strong wage pressures witnessed in recent years started to ease gradually in the second half of 2008. In the final months of the year, a significant deceleration in nominal wage growth and even a decrease in real wage growth could be discerned. At the beginning of 2009, growth in nominal wages turned into a decline, causing an expected rapid easing in inflationary pressures.

Due to the great inertness of wage changes they appear later than the changes in nominal economic growth. Thus, the period of rapid decline is characterised by positive growth in unit labour costs and the dropping share of profits in GDP. The stabilisation of the latter ratio directly depends on lower growth in unit labour costs, but this can probably be expected only in the second half of the year.

At times of strong recession, the key goal of the labour market policies is to focus on the so-called flexicurity strategy. The European Commission confirmed in its Communication of 18-19 June that the priorities of the European Union regarding the labour market area include the preservation of employment, the creation of new jobs, an increase in mobility and the organisation of advanced training.

In the years of decline, labour market and social policies must support the swift and adequate response of the labour market to the changes in the economic environment in order to foster the rapid relocation of labour force into more competitive companies along with appropriate training. The new Employment Contracts Act entered into force on 1 July this year only partially: several measures, primarily regarding social guarantees, were postponed because of the need to curb the budget deficit. However, the measures aimed at improving the flexibility of the labour market were enforced as planned.

LABOUR SUPPLY AND DEMAND

Labour force participation and inactivity

According to the labour force survey, the number of the inactive aged 15 to 74 decreased 2.7% (by 9,900) in the first quarter of 2009 and 1.3% (by 4,900) in the second quarter. In the first half of 2009, inactivity mainly decreased owing to a drop in the number of students. The total number was also reduced by a decrease in the number of people attending to children (see Figure 2). People in retirement age who lost their jobs during that period did not start to seek new jobs and became inactive. With the year, also the number of the discouraged (people who have lost hope in finding a new job) increased. Employment did not grow during that period and thus the number of the unemployed rose, as economic activity increased.

With the decrease in the number of the inactive the labour participation rate² of the

² The labour force participation rate equals the share of the employed and unemployed in the working age population.

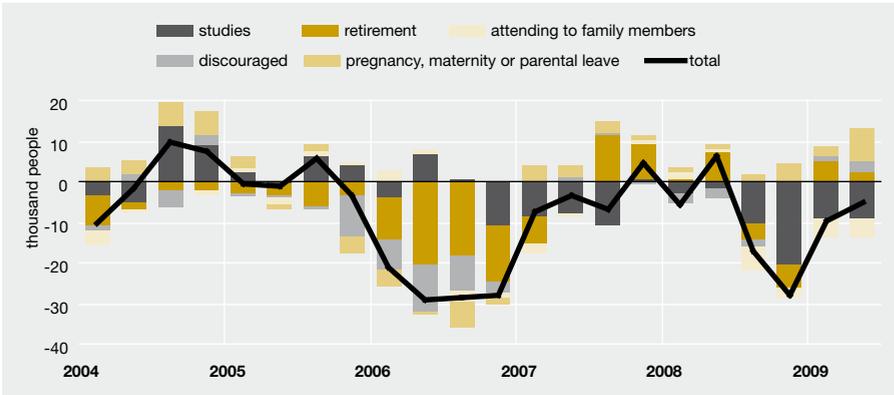


Figure 2. Change in the number of inactive and reasons for inactivity

working age population increased to 66.5% in the first quarter of 2009, exceeding the year-ago figure by 1.2 percentage points.

Although the working age population (aged 15 to 74) decreased in the first half of 2009, active workforce grew. In other words, at difficult times people are more willing to find a job. Labour force mostly grew on account of the young (aged 15 to 24) and the elderly (50 to 74).

The increased activity of the young was mainly induced by the demographic trends of Estonia. More specifically, a great number of students graduated from school in the summer of 2008 and entered the labour market. Thus, the decrease in inactivity and growth in labour force participation was more pronounced among the young.

By regions, the developments in the Estonian labour market were quite uneven. In the first half of 2009, activity dropped the most in Western Estonia and increased in North-Eastern Estonia (see Figure 3).

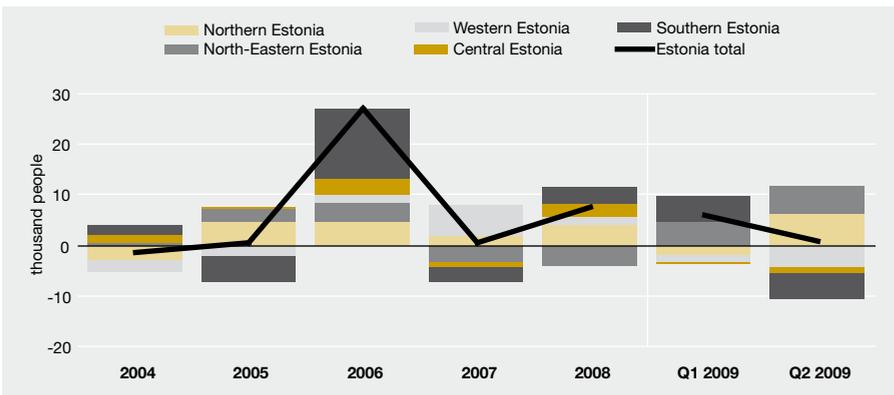


Figure 3. Contribution to employment growth by regions

Employment

The number of the employed started to decrease already in 2008, although relatively slowly at first compared to the accelerating economic decline. Compared to a year ago, employment declined around 0.2–0.3% from the second until the fourth quarters, which means that the employment rate remained unchanged, because the total working age population declined to a similar extent. At the backdrop of robust contraction in production, the relatively high level of employment pointed to a rapid decrease in productivity.

The first quarter of 2009 witnessed a sudden change year-on-year: the number of the employed dropped 6.8%, i.e. by 44,400 to 612,000. Relatively few of them became inactive (started to study or attend to children, retired, gave up job-seeking, etc.), whereas the majority became unemployed. The number of the unemployed increased by 50,300 on account of the newly unemployed as well as the former inactive.

By fields of activity, the first quarter witnessed significant structural changes. Changes in employment were the most remarkable in manufacturing and construction, which also entailed a decrease in total employment (60% of the total decline in employment could be attributed to manufacturing and 40% to construction).

The share of the employed in manufacturing in total employment decreased by 2.8 percentage points to 18.5% and that of employees in the construction sector fell by 2 percentage points to 10.4%. Employment in manufacturing and construction will probably diminish even further.

According to the labour force survey, in the first quarter the number of employees in manufacturing shrank by 19.1% (26,700 people). Manufacturing provides the most jobs and a decrease in employment was thus directly related to the contracting production volumes. Employment decreased more in the manufacturing of construction materials, timber products, furniture and textiles, where demand also suffered more. The number of employees in manufacturing dropped quite rapidly, but initially at a somewhat slower pace compared to the decline in production. The output of the manufacturing sector decreased by a third in that period. As a result, the decline in productivity gathered pace, although this may well have been a delayed reaction to earlier events. This will become clear if the indicators of next periods become available.

However, there is no reason to expect absolute concurrence between the decline in employment and the decline in production (even considering lags in the long run), because not all companies opt for lay-offs in dire times. Many of them try to keep their employees and lower wage costs by reducing working hours or wages. The more specific skills and training a job requires, the more willing is the employer to keep the employee.

Due to the cyclicity of economic developments, reaching the low of the cycle will thus entail an increase in disguised unemployment (under-utilisation of labour force) and underemployment (involuntary reduction of working hours), for which no exact statistical data are available.

The construction sector, which had experienced robust employment growth in recent years, witnessed a 22.2% annual decline in the number of the employed in the first quarter; that is, by 18,000 people. As expected, it was also related to the shrinking demand and construction volumes: in the first quarter of 2009, Estonian construction companies built a third less than in the same period last year. The downturn of the real estate market (the total number of transactions shrank 39% and the total value by 50%, year-on-year) also decreased employment in that sector by almost a half (47.6%, i.e. 6,000) in the first quarter. Employment continued to grow only in transportation (by 6,500 year-on-year) and in non-financial sector (electricity, water supply, education, administration, public defence and healthcare), where the changes were smaller. Employment decreased in all areas, but mostly in Northern Estonia, especially Tallinn.

Difficulties with finding a job and tighter competition in the local labour market spur interest in working abroad. According to the European Job Mobility Portal EURES, this year their website had three times more visitors than last year. In 2008 they recorded about 6,500 visits per month, whereas in the first five months of 2009 16,000 people browsed that site per month.

Considering the global nature of the economic crisis, it is difficult to find a job outside Estonia, as demand has diminished sharply everywhere. After losing their jobs people become unemployed or inactive rather than go abroad. The first quarter of 2009 also saw more labour migrants returning to Estonia, which boosted labour supply even further. This, however, puts a greater strain on the Estonian unemployment insurance system and social benefit schemes.

The labour force survey regards Estonian residents as employed regardless of whether their place of employment is located in Estonia or abroad. To estimate labour migration, we can use Eurostat's employment data, which is based on the concept of domestic and total employment³. Their difference indicates the net migration, i.e. the number of Estonian residents employed abroad less the number of the residents of other countries working in Estonia (see Figure 4).

According to Eurostat, the number of Estonian residents employed abroad grew also in the first quarter of 2009. This has not been offset by the inflow of foreign residents or

³ Total employment includes domestic employment and also Estonian residents working abroad; it does not include non-resident foreigners working in Estonia.

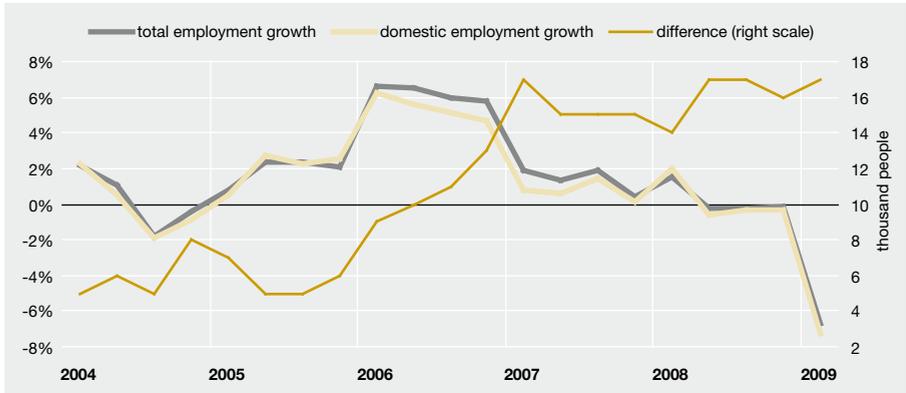


Figure 4. Total and domestic employment

Source: Eurostat; authors' calculations

the return of Estonian residents. Net migration continued to increase in the first quarter, which is why the gap between domestic and total employment widened to 21.4% (17,000). As a result, domestic employment decreased by 0.6 percentage points more than total employment, that is 7.3% year-on-year.

The share of full-time employees decreased in the first quarter of 2009: year-on-year, their number shrank by 56,600, whereas the number of part-time employees surged by 12,200. The fact that this was not a “voluntary” shortening of work hours is evidenced by growth in underemployment. In the first quarter, the number of the underemployed totalled 12,000 – three times more than a year ago.

The compliance of education levels to job requirements in Estonia

In April 2009, Eesti Pank held a labour market seminar where Prof. Julián Messina introduced a research entitled “Educational Mismatch and Wages in Estonia” prepared together with Ana Lamo, a labour market expert at the European Central Bank. It deals with the correspondence of education to job requirements in the Estonian labour market and its influences on labour market conditions in the years 1997–2003.

The relatively well-educated labour force is generally regarded as an advantage of Central and Eastern European countries. The goal of the research was to investigate how our education level meets job requirements. The outcomes revealed that a so-called structural mismatch and over-education of employees could be noted in the period analysed. It was discovered that 12.5% of Estonians capable of work

are not employed in their field of training, but are holding jobs with lower wages that are not in line with their level of education. This, in turn, means that Estonia has a problem of partial structural mismatch between labour force and the level of education.

A part of the Estonian labour force is over-educated, especially as regards older age groups. The education level of employees with long service is mostly high, but their skills do not fully meet the current labour market requirements; some areas of specialisation have also become obsolete. Most of these people are nearing the age of retirement.

With regard to the compliance of the education level and knowledge of the young with labour market needs, the authors concluded that while being a problem for Estonia as well as many other countries, it is not as pronounced as in the case of older people.

Vacancies

The weakening labour demand caused by the economic crisis is clearly expressed in the slowing creation of new jobs and in fewer vacancies.

The statistics of the Labour Market Board on vacancies does not include all jobseekers or offers, but it may be used as an indicator to describe the processes in the labour market. The number of valid job offers registered in the Labour Market Board decreased rapidly in 2008 and in the fourth quarter the number of vacancies dropped 65%, year-on-year. In the first quarter of 2009, their number continued to shrink, though at a slightly slower pace, and reached -47%. However, the number of new job offers declined at a faster rate: in the first quarter there were 896 announcements, i.e. 82% less than a year ago (see Figure 5).

The number of vacancies registered by Statistics Estonia includes all vacancies as at the 15th day of the second month of a quarter, including existing vacancies as well as new positions to be filled by someone outside the company or institution. The positions also include part-time vacancies. According to Statistics Estonia, the number of vacancies has dropped 67% from 2008.

The downward trend of vacancies is also characteristic of other countries. The global labour market survey "Manpower Employment Outlook Survey (MEOS)", which comprised employees from 33 countries, indicated that 23 countries have reached the lowest level of recruitment in 45 years.



Figure 5. Job announcements according to the Labour Market Board and Statistics Estonia

Sources: Labour Market Board, Statistics Estonia

Employment does not take place only through filling vacancies. According to the Labour Market Board, the number of the newly unemployed amounted to 33,339 in the first quarter of 2009. At the same time, the number of vacancies in the database of the Labour Market Board increased from 2,364 to 3,029, whereas 4,095 persons were employed. In April-May, according to preliminary data these trends did not change: growth in the number of the newly unemployed slowed, while the number of the registered unemployed who became employed increased slightly from month to month (see Figure 6).

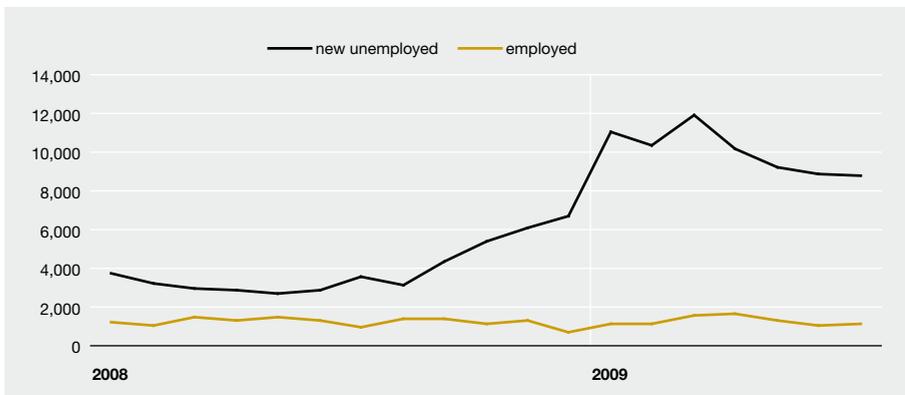


Figure 6. New unemployed and employed on a monthly basis

Source: Labour Market Board

According to the Ministry of Social Affairs, about 2,700 individuals terminated their unemployment status due to finding a job, which is about 1,000 more than this April and about 1,300 more than last April. At the same time, the number of people giving up

job-seeking increased further in May. Though the growth rate of this indicator is slowing, it is nevertheless on the upward trend.

Local governments have also shown some initiative in creating new jobs. For instance, the city district governments of Tallinn and the Labour Market Board concluded an administration contract to offer the unemployed 50 hours of public work per month with a monthly salary of 1,500 kroons. In addition, the Tallinn City Enterprise Board announced a competition to provide financial aid for companies that create social jobs for the unemployed; the submission of applications started on 1 June. Up to 5,800 kroons (including taxes) per month will be provided for the wage costs of a social job. The own-funding of companies must be at least a third of the costs. Applicants must be business associations with at least two years of operation and at least twenty employees. The first 2.9 million kroons of financial aid will be distributed among eight companies that were interested in creating fixed-term jobs in compliance with the prescribed conditions and will offer work for the cleaners of transport vehicles, passenger counters, maintenance workers of parking machines, gardeners, customer servers and assembly line operators. Although the impact of these measures is probably temporary and limited, it may nevertheless slightly change the labour market indicators.

Unemployment

Owing to the deterioration of the economy, the unemployment rate soared by 5.2 percentage points to 11.4% in the first quarter of 2009. The last time unemployment was so high was in 2001. In the first quarter, the number of unemployed jobseekers increased more than twice – by 35,000 to 79,000. The dynamics of unemployment is quite in line with the developments of economic growth with a slight delay. For instance, during the so-called Russian crisis the bottom of the economic decline reached Estonia in the third quarter of 1999. The unemployment rate reached its highest about a half a year later, increasing to 14.6% (97,000 people) in the first quarter of 2000. Compared to that period, the reasons, extent, course and depth of the current crisis are very different, but if the reaction speed of the labour market remains the same, the unemployment rate should peak in the second half of 2009.

In the first quarter, unemployment increased in all age groups, especially among the young, as school graduates started to look for a job. The unemployment rate of people aged 15 to 24 rose to 24.5%, meaning that almost every fourth young jobseeker was unemployed. The unemployment rate of people in their prime working age (25 to 49) rose to 11.2% and that of the elderly (50 to 74) to 6.9%.

Unemployment grew in all regions, but mostly in Southern Estonia, as it caught up with North-Eastern Estonia – the area with the highest unemployment ratio so far (13.6%). Unemployment posted the lowest results in Western Estonia (7.3%).

In the first quarter of 2009, both short-term and long-term unemployment (persons who have been seeking employment for a year or longer) grew, but the number of the short-term unemployed rose much faster. With the year, the number of the long-term unemployed increased by 9,600 (87%). The share of long-term unemployment diminished owing to the rapid rise in the number of the newly unemployed. In previous years it had ranged close to 48%, whereas at the end of 2008 and in the first quarter of 2009 the share of long-term unemployment dropped to 26% (see Figure 7).

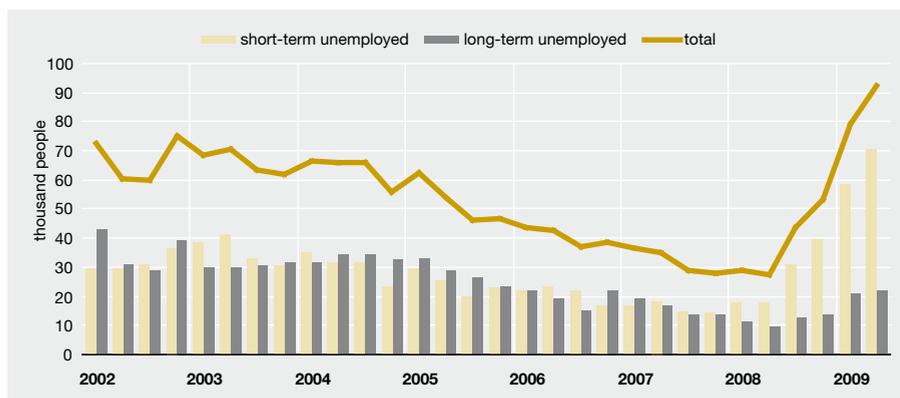


Figure 7. Short- and long-term unemployed

The long-term unemployed, who have remained inactive for a longer period, find it even harder to return to the labour market during the recession. Consequently, many of them become discouraged, which means that they give up job-seeking. According to the latest available data, the number of the discouraged in Estonia has not increased remarkably: in the first quarter of 2009 it posted 6,600, which is 1,200 (22%) more than a year ago, but 200 less than in the fourth quarter of 2008. This shows that at the time of crisis the former discouraged become more active in the labour market owing to poverty. According to the European Commission, about a quarter of the inactive are living below the poverty level and are thus expected to become active (this also includes registration as unemployed) in extremely difficult times.

The real decline in the economy started off in 2008, but did not boost the number of the unemployed immediately. In the first six months, the unemployment rate was relatively stable and the number of the registered unemployed stood at 17,000. In the fourth quarter, the decline in the economy was accompanied by a drop in prices, causing nominal corporate incomes to diminish for the first time. At the same time, growth in the number of the registered unemployed also picked up, reaching around 1,000 people per month in the third quarter and as much as 3,500 in the fourth quarter. In the first quarter of 2009, this process aggravated even further: the number of the registered unemployed increased by an average of 8,200 per month

and within four months their total number doubled (from 30,400 in December 2008 to 60,700 in April 2009). The share of people made redundant comprised about a third of all the registered unemployed.

In the following months, however, the increase in unemployment started to slow: in April the number of the registered unemployed rose by 5,700, in May by 3,800 and with the three first weeks of June by 2,100 (see Figure 8). This means that though their total number continued to grow, the growth rate was lower. The indicator reflecting the fear of unemployment, published by the Estonian Institute of Economic Research, has also started to fall. Although still high, a slight decrease in pessimism could be perceived in April-May.

The new Employment Contracts Act that was passed on 1 July simplified lay-offs significantly, making the procedure faster and less expensive for employers. However, the preliminary data for July and August did not confirm that the recent decrease in lay-offs had even partly been caused by postponing redundancies, as the number of redundancies continued to decrease. The structure of unemployment also remained relatively stable: people made redundant comprise less than 30% of the total number of the registered unemployed and the share of the registered unemployed in total unemployment stood at 60% in the first quarter and almost 70% in the second quarter. This means that the impact of lay-offs on total unemployment has not been as extensive as anticipated.

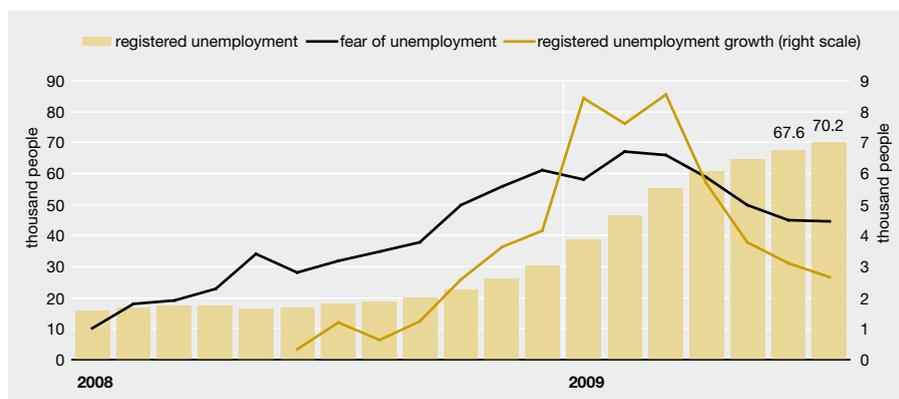


Figure 8. Registered unemployment and fear of unemployment

Sources: Estonian Institute of Economic Research, Labour Market Board

The developments of registered employment, which serve as the basis for Eurostat's monthly estimates regarding the number of the unemployed,⁴ is a relatively good preliminary indicator in the current economic crisis when unemployment is soaring and

⁴ The estimates are adjusted with actual unemployment indicators based on the data of the second quarter of each year.

the number of the registered unemployed is rising almost as rapidly (see Figure 9). In previous periods, these indicators have not overlapped to such an extent. Besides general developments in unemployment, registered unemployment increases also due to number of benefits (health insurance, unemployment benefits), which seem more or less attractive to the unemployed, depending on the phase of the economic cycle. In the second quarter, the spread between these indicators widened again, as the share of the registered unemployed in total unemployment rose.

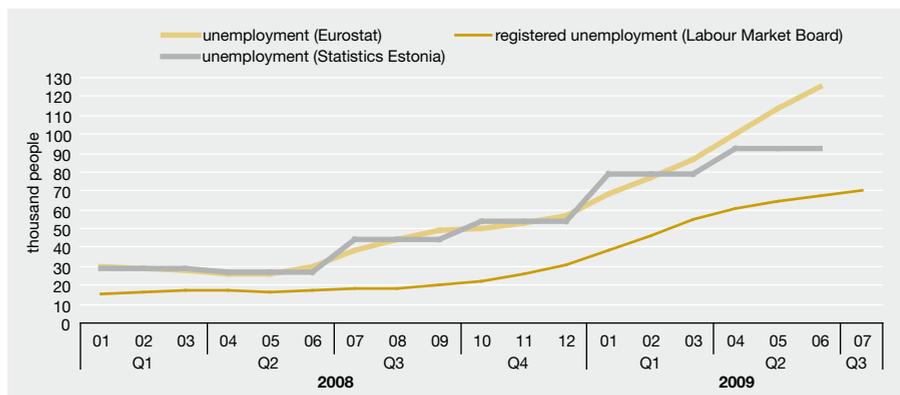


Figure 9. Registered and total unemployment according to Eurostat and Statistics Estonia

Sources: Eurostat, Labour Market Board, Statistics Estonia

In the first five months of 2009, unskilled workers comprised the greatest share of the registered unemployed. 16% of the registered unemployed were skilled and unskilled construction workers and 19% unskilled workers from other fields of activity. 14% were service and sales workers. There were quite many unemployed skilled workers also in the metallurgy and engineering industry, as well as equipment and machinery operators and skilled workers from other industrial sectors. 11% of the unemployed were mid-level specialists and office personnel, 5% were top specialists and 7% managers and top public officials.

In the first five months of this year, 6,400 employees have been laid off collectively, which is four times more than last year. From January until the end of May, the average benefit paid by the Estonian Unemployment Insurance Fund stood at 14,132 kroons, i.e. 1.3 average wages of an employee. The majority (56%) of the collective lay-offs have taken place in manufacturing. The number of employees made redundant was the greatest in the electric and optical equipment industry and textile and leather industry. In terms of the number of lay-offs, manufacturing is followed by construction and real estate (10%), trade, catering and accommodation (9%), and transport, storage and communications (9%).

In the first five months of this year, bankruptcy compensations were paid to 2,090 people, which is 2.4 times more than at the same time last year. The average amount of bankruptcy compensations was 33,894 kroons; that is, 75% of the remuneration not received due to the bankruptcy of a company. The majority of those who received bankruptcy compensations were again from manufacturing (28%), mainly timber and paper companies. 17% of the compensations were paid to employees in trade and 17% to employees in construction. From January to April, the number of bankruptcy compensation recipients grew steadily and then started to decline. The number of people transferred to part-time employment or partly remunerated vacations showed the same tendency.

The costs of compensations exceeded the collection of unemployment insurance payments already in the three final months of 2008. In the first half of 2009, the deficit of the Unemployment Insurance Fund increased further due to a rapid increase in the number of people eligible for unemployment benefits. At the end of April, the current deficit of the Fund totalled almost 600 million kroons. The unemployment insurance tax rates (employees paid 0.6% and employers 0.3% of gross wages) were not able to cover the growing liabilities. Thus, as of 1 June this year, new tax rates were imposed: 2% for employees and 1% for employers.

LABOUR COSTS AND PRICES PRESSURES

Average wages

Until 2006, the profits of companies operating in Estonia grew significantly faster than the benefits of employees and the profit-to-GDP ratio increased steadily. With eleven years (compared to 1995), GDP grew by 4.75 times in current prices; the wage fund increased by 4.1 times and profits by 5.72 times. In 1995, the profit-to-GDP ratio stood at 35.1%, whereas by the end of 2006 it had risen by 8 percentage points to 43.1%.

Strong profit growth (in absolute terms and as ratio of wage fund growth) was perceived as an essential part of Estonia's competitiveness. However, the situation changed radically in the following years, when favourable loan conditions fostered growth in loan stock, which in turn increased demand for products and labour force. Labour supply became limited due to the gradual implementation of the free movement of labour force within the European Union. As a result, wage growth accelerated significantly, exceeding productivity growth. As wage fund growth was stronger than total productivity growth, by the end of 2008 the share of profit in end prices had decreased to the level of 1996 and raised concerns about the future competitiveness of Estonian companies. In the first half of 2009, the situation was still relatively difficult to assess. No one had anticipated such a deep recession and thus, it remains unclear whether the decrease of the wage fund will suffice to restrain the decline in profits.

The tensions arising from wage pressures gradually started to ease in the second half of 2008. In the fourth quarter, nominal wage growth slowed significantly, falling below the inflation rate, and a real decline in wages could be noted. General solvency, which had significantly deteriorated owing to lower incomes, considerably strengthened the position of employers in wage negotiations. In the first quarter of 2009, for the first time ever average gross monthly wages also dropped in nominal terms (−1.5% year-on-year). Although GDP decreased more in current prices (−11.6%), the change in wage growth was more abrupt and the differences in the growth rates narrowed (from 11.6 pp in the fourth quarter of 2008 to 10.1 pp in the first quarter of 2009). However, given that according to OECD the changes in nominal wages follow GDP developments with a two-quarter lag, it can be concluded that in Estonia the lag was shorter (3–4 months). The difference between wage growth and the changes in GDP growth two quarters ago gradually diminished, reaching 3.2 percentage points in the first quarter. A similar difference was recorded at the time of the previous decline (in 1998–1999), which waned only after GDP growth started to pick up (see Figure 10).

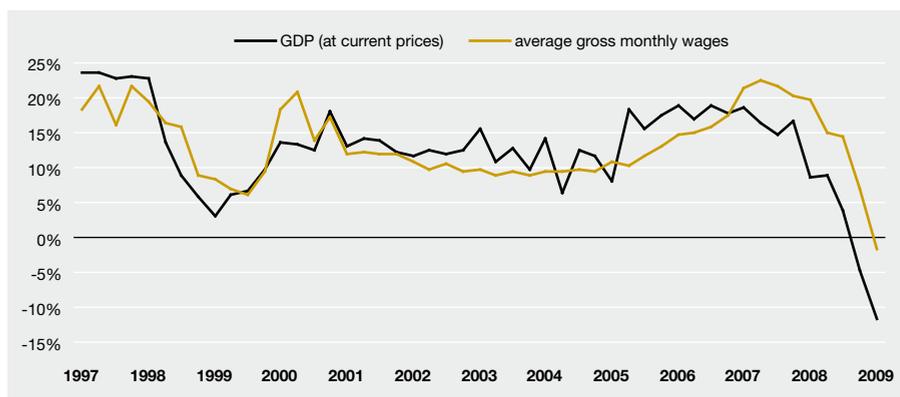


Figure 10. Nominal GDP growth and average gross monthly wages

At the time of recession, the inertia of wages may entail a rise in unit labour costs and a decline in the profit-to-GDP ratio. Apart from general inertia, at the time of economic crisis average wage developments may also be shaped by increased payments arising from lay-offs, unpaid vacations, part-time employment, etc. The stabilisation of the share of profit directly depends on when growth in unit labour costs ends, but this can probably be expected only in the second half of 2009.

While a slowdown in real wage growth could be perceived in the first three quarters of 2008, in the fourth quarter growth turned into a decline and wage growth expectations collapsed. In the first quarter of 2009, when nominal growth in average gross monthly wages started to decline, the decrease in real wages was already as much as 4.6% (see Figure 11). Year-on-year, only gross monthly wages decreased (−1.5%) in the first quarter,



Figure 11. Average wage growth

whereas gross hourly wages continued to rise (+2.4%). This indicates that initially the drop in wages only concerned the more flexible part of wage incomes (bonuses, additional remunerations, etc.) and many companies had not reduced real wages yet.

In the first quarter, average gross monthly wages grew primarily in the fields of electricity, gas, steam and conditioned air supply (14.0%); wages decreased in the finance and insurance as well as in construction (10.2% in both cases). Wage growth slowed robustly also in manufacturing, wholesale and retail trade, hotels and restaurants. In the first quarter of 2008 average gross wages in these fields grew by 16.4%, 18.7% and 20.6%, respectively, whereas in the first quarter of 2009 growth had diminished by almost 20 percentage points. Wages declined in manufacturing and trade (3.6% and 2.8%, respectively); in accommodation and catering wage growth decelerated to 0.8%.

The decline in wage growth in the construction sector was quite expected – during the real estate boom both employment and wage growth surged, which also stimulated wage growth in other sectors. The current lower wage levels in the construction sector wage levels help bring wage growth more in line with productivity growth. Furthermore, the rapid decline of wages (and employment) in the construction sector facilitates slower wage growth in other sectors.

The relatively rapid decrease in labour costs was also signalled by the construction price index, which measures labour costs based on typical positions. In the first quarter of 2009, labour costs dropped by an average of 3.3% per month and 10.8% per year. The decrease in wages has gathered pace from month to month, reaching 15.2% in March (see Figure 12).

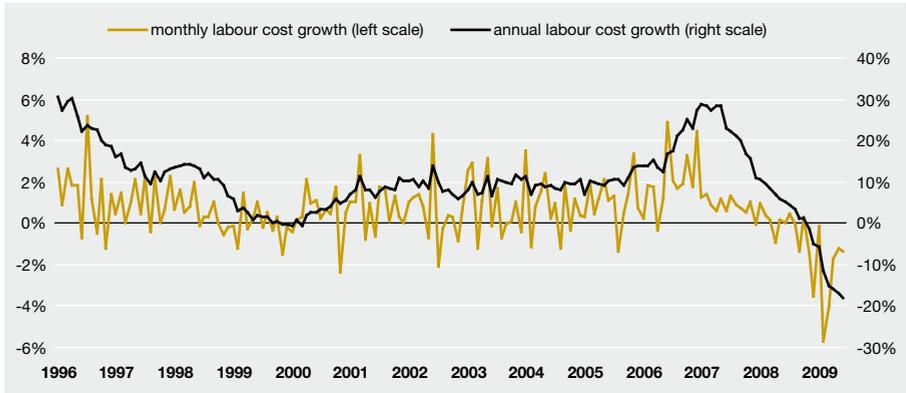


Figure 12. Labour cost growth according to the construction price index

In financial intermediation, the decrease in wages was caused by a significant reduction of bonuses in the first quarter. Nevertheless, wages are still high in this field (over 27,000 kroons per month), exceeding the average of fields of activity by 1.8 times.

In the real estate sector, average wages grew 4.6% in the first quarter, despite rapid adjustments and a considerable decrease in employment. This can largely be attributed to structural changes, as salaried employees who are engaged in real estate maintenance have been able to retain their positions. Meanwhile, the massive departure of self-employed brokers with minimum wages from this field has caused a rise in average wages.

Rapid wage growth in electricity, gas, steam and conditioned air supply (14.0%), however, was neither accidental nor structural (e.g. owing to lay-off compensations), as also gross hourly wages increased the most in that sector (16.4%). This may primarily be associated with the monopolistic position of the companies operating in these areas, which is why they are not very sensitive to changes in the economic cycle.

The downward wage pressures have been caused by an urgent need to bring wage costs into line with the reduced sales incomes of companies. Based on business statistics, the sales incomes of Estonian companies decreased approximately 20% and labour costs 10% in the first quarter of 2009. Therefore also profits continued to decrease, being 79% lower than a year ago. GDP statistics, which is compiled on the basis of a more sophisticated methodology, indicated that the decrease in profits remained three times smaller. According to GDP statistics, in the first quarter the GDP calculated in market prices dropped by 11.6%, year-on-year. Compensations of employees decreased 6.3% from 2008 (wage payments declined 7.2% and employer's social tax payments only 3.3%). Total profits decreased 23.8% in the first quarter (the operating surplus and mixed incomes declined 36.6%; the depreciation of fixed assets decreased only 0.4%).

Both data clearly indicate that the slower decrease in wage costs compared to that of sales incomes caused a robust fall in profits in the first quarter. The stabilisation of the share of profit as a ratio of GDP directly depends on the termination of unit labour cost growth.

At the same time, in the current phase of development it is slightly easier to make wage cuts due to the change in the labour supply-demand ratio. The stock of labour force has increased rapidly because of growing unemployment and wage expectations have significantly fallen. The decrease in wage growth expectations is also confirmed by a survey conducted in June among the visitors of the job portal CV Keskus (3,316 respondents).

According to the survey, 41% of the respondents were willing to work full-time for wages of up to 10,000 kroons. 4% were ready to work full-time for minimum wages, 37% would accept a job offer for 5,000–10,000 kroons per month. 20% would be satisfied with 10,000–12,500 kroons, 15% with 12,500–15,000 kroons, whereas 8% expected to be paid over 25,000 per month. The number of people who would settle for lower wages has increased considerably with a year. According to another survey compiled by CV Keskus (7,000 respondents), 71% of the respondents in construction, 61% in manufacturing, 52% in tourism and catering, 38% in healthcare and 26% in information technology expect their wages to decrease.

A survey conducted this April and May by the market research company TNS Emor among 400 salaried employees also confirmed that the recession and surging unemployment significantly affect people's work expectations and attitudes. The survey indicated that 35% of Estonian companies have downsized their personnel costs as a result of the economic decline. Nearly as many companies consider it likely in the future. To keep their current job, every other salaried employee is ready to accept part-time work hours and/or a wage cut for a fixed period. Other measures are less acceptable for salaried employees.

As demand is constantly decreasing, wage growth is expected to slow also in the near future. Further reductions of nominal wages may be expected on account of additional remunerations, shorter working hours and new contracts with lower base wages. Many companies have agreed to retain real wages and lay off some of the less productive employees instead. Although these arrangements help keep the more highly qualified labour force, the resulting reduced flexibility entails a rise in unit labour costs and a further drop in profits.

The flexibility of the labour market usually indicates the quickness of response of the labour market to various shocks in order to obtain optimum or at least slightly better

allocation of resources.⁵ The four key components of response are 1) the number of the employed, 2) the number of working hours, 3) redistribution of employees among different work functions, 4) and wages (the reaction of nominal and real wages to the changes in supply and demand).⁶

The key factor of the flexibility of wages in Estonia has been the relatively extensive use of bonuses that depend on work efficiency. According to a survey of Eesti Pank conducted in 2008, approximately 2/3 of manufacturing, construction, service and trade companies paid various bonuses, their share in wages ranging from 14% in manufacturing to 23% in trade. At the time of deep recession, additional remunerations and bonuses form a reserve on account of which wages can be cut. At the same time, the elimination of additional remunerations need not suffice to stabilise the rapid fall in profits, given that the workload of several companies has decreased robustly (by a third or even up to 50%).

By the owner of the place of employment, wage dynamics are still varied. In the private sector, wages respond to economic changes with a lag of one or two quarters, whereas public sector wages respond with a delay of up to one year. In the first quarter of 2009, average gross wages only dropped in private Estonian companies (5.6% year-on-year). Meanwhile, wage growth in the public sector continued although at a slower pace: with a year, wages grew 3.6% in state-owned companies and organisations and 2.5% in local government companies (see Figure 13).

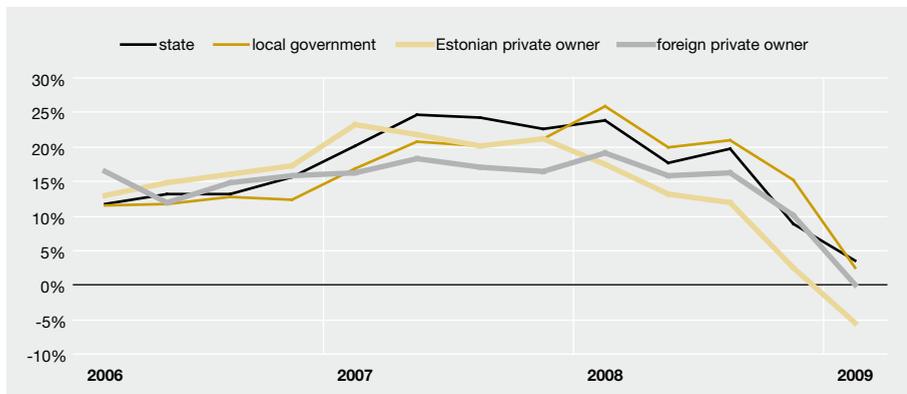


Figure 13. Average wage growth by the owner of the place of employment

⁵ Pissarides, C. (1997). The need for labour market flexibility in a European economic and monetary union. *Swedish Economic Policy Review*, No. 4, pp 513–546.

⁶ Brixiova, Z. (2009). Labour Market Flexibility in Estonia: What More Can Be Done? OECD Economics Department Working Papers, No. 697, 8.

The minimum wage rate of state and municipal school teachers was raised by 8% at the beginning of 2009. Ministries have made efforts to cut their operating costs (more specifically the personnel costs) by curbing the number of employees, the number of working hours or other operating costs. Direct wage cuts have not been an issue so far.

On 25 June, the Government decided to reduce the minimum wage rates of teachers to last year's level as of 1 July. A respective agreement was reached with the associations of education workers and thus, teachers have agreed to refrain from striking. Another wage cut decision was made concerning the prosecutors – by 6% based on the principle of solidarity. In the second half of 2009, additional cuts (about 8%) are to be expected with supplementary budgets. But even if the additional cuts concern all public sector wages, the cuts will be smaller compared to the wage cuts in the private sector.

As long as public sector wage growth is not in line with productivity growth in the private sector, it will hinder the flexibility of the economy. The greater rigidity of public sector wages makes it difficult to find ways to finance them from the budget and increases inflationary pressures. Even so, instead of average wage developments it is more important to monitor the shifts in wage costs which, besides being affected by changes in gross wages adjusted to full-time employment, also depend on the decrease in the number of salaried employees as well as the increase in the number of employees with reduced working hours.

Labour productivity

Employment and wage developments always react to robust economic decline with a delay. Thus, in the first quarter of 2009 wage growth exceeded economic growth and productivity per employee dropped. Productivity growth indicators had been negative for five consecutive quarters, as the number of employees was not cut before the slow-down in economic growth and the following recession, but as a consequence of these two. In the fourth quarter of 2008, recession gained momentum yet employment still did not decrease to a similar extent, which is why the fall in productivity per employee was exceptionally great (9.5%). In the first quarter of 2009, the economic decline picked up further, whereas the decrease in employment was even bigger and thus the drop in productivity slowed slightly: to 9.0% in terms of total employment and to 8.4% in terms of domestic employment (see Figure 14).

As several companies have opted for fewer working hours, part-time employment and unpaid vacations instead of lay-offs, the decrease in hourly productivity should also be smaller. Unfortunately, there are no such reliable and internationally comparable data available in Estonia, but the statistics of working hours compiled to calculate average gross monthly wages may provide some information. Data on changes in working hours and the number of full-time employees are not available as yet.

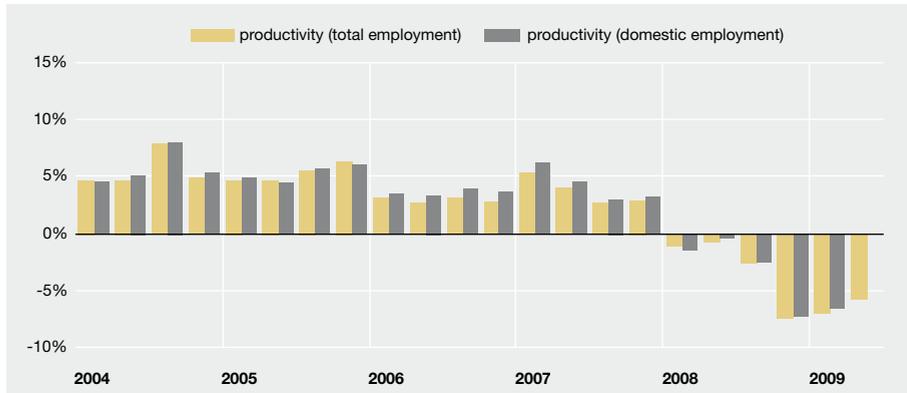


Figure 14. Labour productivity growth

Source: Eurostat; authors' calculations

Unit labour costs

The comparison of an employee's productivity and the average wage might contain "noise" that renders their comparability questionable. One alternative would be to calculate the real and nominal unit labour costs on the basis of GDP statistics. In that case, the overestimation of wage pressures, which is characteristic of average wage statistics, will decrease due the adjustment of wage costs to full-time employment.

The real unit labour cost indicator compares the amount of expenditure per employee (mostly wages and taxes on labour) and labour productivity (per employee) in current prices. Practically, the share of the value added spent on wages is calculated. Following the definition, the growth rate of unit labour costs is positive when labour costs per salaried employee grow faster (or drop slower) than labour productivity in nominal terms. Nominal unit labour costs compare labour costs per employee with real productivity, not with productivity calculated in current prices. The aim is to analyse inflationary pressures arising from wage growth, as enterprises have to increase prices of their products in order to retain profitability when wage growth exceeds productivity.

In the first quarter of 2009, the recession deepened significantly while the reduction of labour costs was less extensive. Unit labour costs, on the other hand, continued relatively strong growth. Real unit labour costs grew 5.6% and nominal unit labour costs 9.8%. However, growth has slowed compared to previous quarters (see Figure 15).

Real GDP decreased 11.6% in the first quarter, whereas compensations of employees declined 6.3%. The latter's decline could have been even bigger, if it were not for the slight rise in the minimum rate of social tax. Had the development of compensations



Figure 15. Unit labour cost growth by GDP statistics

depended only on wage payments, which dropped 7.2% year-on-year, the decrease in compensations would have been bigger and growth in unit labour costs would have been nearly 1 percentage point lower. The slightly smaller decline in the number of salaried employees compared to total employment (6.3% and 6.7%, respectively) did not play a great role in the first quarter.

Wages may be also affected by the payments resulting from an increased number of lay-offs. In the near future, however, this impact should be smaller. Unit labour cost growth will stabilise once the economic decline starts to slow, which can be expected in the second half of 2009.

According to Eurostat, growth in nominal unit labour costs in Estonia posted 3.7% in the first quarter of 2009, being 4.6 percentage points lower compared to the fourth quarter of 2008 and 9.4% lower compared to the third quarter. Latvia and Lithuania registered even slower growth in nominal unit labour costs in the fourth quarter of 2008 and the first quarter of 2009. In the United Kingdom, nominal compensations of employees decreased more than GDP in constant prices and nominal unit labour costs declined 5.5% in the first quarter.⁷ Compared to Estonia, unit labour costs grew faster in 12 EU Member States out of the 20 on which data are available (see Figure 16).

According to Eurostat, the economic decline of 2008 did not damage Estonia's situation remarkably in comparison with other EU countries. Estonia's GDP per capita (based on purchasing power parity) decreased only 0.5 percentage points to 67.2% of the EU-27 level.

⁷ According to Eurostat, this year UK's indicator was largely affected by the termination of the payment of high bonuses in the financial and insurance sectors (the statistics are incomparable across countries, as in several countries hourly wages also include bonuses, while in others they do not).

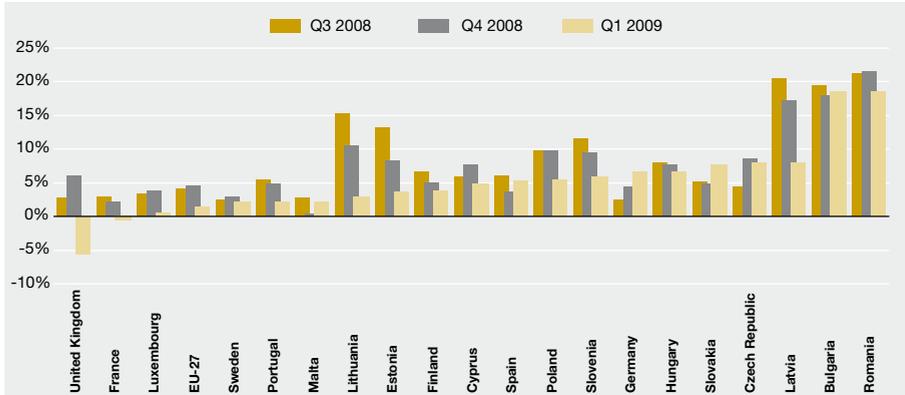


Figure 16. Nominal hourly unit labour cost growth in European countries

Source: Eurostat

INSTITUTIONAL DEVELOPMENTS OF THE LABOUR MARKET

Tax changes

On 28 May 2009, the Amendments to the Funded Pensions Act and the Social Tax Act entered into force, setting out the procedure for making mandatory pension fund payments in 2009–2017. As of 1 June 2009 until 31 December 2010, payments to mandatory pension funds will be temporarily suspended and in 2001, payments will be 50% smaller. Pursuant to the law, those who have joined the second pension pillar can continue payments to the mandatory pension fund as of 2010 should they apply for that. In addition, higher payments will be allowed for the years 2014–2017.

As of 1 June until 31 December 2009, the unemployment insurance tax rate of the insured is 2% and the unemployment insurance tax rate for the employer is 1% of the employee's monthly wages. Higher rates will increase employer's labour costs and reduce employee's net incomes.

The Government approved the draft Act to amend the Employment Contracts Act. Among other amendments, the planned increase in the unemployment insurance benefit to 70% of an employee's average wages during the first hundred days of unemployment will be cancelled. The amendments of the benefit schemes are expected to relieve the financial burden of the Unemployment Insurance Fund. Pursuant to the draft Act, a newly unemployed person will receive 50% of his/her wages for the first 100 days after being laid off and 40% of average wages during the rest of the unemployment period. The draft Act also comprises unemployment benefits already pending in the Riigikogu. The aim of this draft Act is to guarantee the financial stability of the Unemployment Insurance Fund.

As of 1 July 2009, the procedure for the payment of sickness benefits changed and is applied to sick leave certificates from 1 July 2009 or later. Sickness benefit will be paid to an insured person since the fourth day of illness (previously as of the second day). From the fourth until the eighth day of illness, the benefit will be paid by the employer in the amount of 80% of the employee's average wages. As of the ninth day of illness, the benefit will be covered by the Health Insurance Fund. The employer is not required to pay the benefit if sick leave is required because of an occupational disease, occupational accident, occupational accident in traffic, complications/illness caused by an occupational accident, injuries sustained by protecting the country's or society's interests and combating crime, transferring to an easier job or injury sustained during pregnancy. In these cases, sickness benefits are paid by the Health Insurance Fund as of the second day of illness pursuant to the procedures and rates that applied before 1 July 2009.

Minimum wages

The Government passed a regulation that establishes the minimum hourly wage rate at 27 kroons and the minimum monthly wage rate in case of full-time employment at 4,350 kroons. Compared to 2008, the minimum wage rate has not changed as social partners have not reached an agreement on the new rate. Employers are not allowed to pay less than minimum wages. In addition, the Government passed regulations that provide for the terms and procedures for the payment of average wages and the procedure for the compensation of holiday pay and average wages from the state budget. All these regulations entered into force on 1 July 2009.

OECD has recommended Estonia to keep minimum wage growth in line with productivity growth. According to empirical surveys, the reduction of minimum wages might increase employers' interest in hiring less qualified workforce.

Anti-crisis activities

At times of strong recession, the key goal of the labour market policies is to focus on the so-called flexicurity strategy. The European Commission confirmed in its Communication of 18-19 June that the priorities of the European Union regarding the labour market area are the preservation of employment, the creation of new jobs, an increase in mobility and the organisation of advanced training.

In the years of decline, labour market and social policies must support the swift and adequate response of the labour market to the changes in the economic environment in order to foster the rapid relocation of labour force into more competitive companies along with appropriate training.

At the meeting of 24 March 2009 in the Ministry of Social Affairs, the representatives of ministries, employees and employers agreed upon the principles for the preservation of employment and supporting the registered unemployed. This entails the following activities.

To preserve employment:

- People who have found a job while using a labour market training service are allowed to complete the training.
- Better training opportunities will be created for people in danger of being laid off or losing their jobs, in order to combine part-time work with upgrading qualifications and development.
- Together with the Ministry of Economic Affairs and Communications and the representatives of employers a training programme will be devised for employers/entrepreneurs on the options of preserving jobs to provide alternatives to lay-offs.
- The Employment Contracts Act will be amended with a regulation that will enable employers to apply part-time employment in combination with in-service training during one year.
- Companies will be encouraged to develop and increasingly implement the options of job-sharing. This means that in case of a need to lay off one of two employees, it would be more expedient in the long-term (when the economy recovers and the need for both persons resumes) to divide the job between two employees by reducing wages, but still preserving the jobs.
- The immediate implementation of budgetary as well as the so-called EURO investments will be accelerated.

For persons registered as unemployed:

- The registration of unemployment and notification of vacancies will be made electronically available.
- The maximum duration of the labour market training service, currently lasting for one year pursuant to the Labour Market Services and Benefits Act, will be extended to two years. This will allow the young to continue their interrupted studies.
- The system of personal training cards will be implemented as soon as possible. A card with a specific value given to the unemployed will enable them to start the desired training as soon as possible. In addition, the training card can be used to pay for professional examinations.
- In cooperation with the Ministry of Education and Sciences the options to use state-commissioned education also for training the unemployed will be developed. This will improve the speed and flexibility of providing training.
- An analysis will be conducted to identify the fields of activity, which will require more qualified workforce once the economic situation improves and for which the training

- of employees could be commenced already today.
- Once in a quarter, the Estonian Employers' Confederation informs the Ministry of Social Affairs about the training necessities (specific training areas) of the workforce of entrepreneurs in order to improve the training of qualified workforce through the labour market training service.
 - Local governments are encouraged to use the unemployed to carry out public work, especially gardening.
 - The start-up support for the unemployed will be amended on a similar basis with enterprise support to help the unemployed who wish to establish a non-profit association as an alternative form of employment.

SUMMARY

In the first half of 2009, the economic decline in Estonia picked up pace. The Estonian labour market indicators appeared to respond to economic changes with a varying delay, but still relatively rapidly compared to other countries.

The number of the employed dropped quite sharply in the first quarter. The number of the unemployed grew even faster, as labour supply increased due to a decrease in the number of the former inactive. The number of the working age population declined by 4,000 with a year. The labour participation rate continued to rise, whereas the employment rate dropped.

Wage pressures started to ease gradually in the second half of 2008 and at the beginning of 2009 growth in nominal wages turned into a decline. Due to the great inertness of wage changes they appear later than the changes in nominal economic growth. Thus, the period of rapid decline is characterised by positive growth in unit labour costs and the dropping share of profits in GDP. The stabilisation of the latter ratio directly depends on lower growth in unit labour costs, but this can probably be expected only in the second half of the year.

At times of strong recession, the key goal of the labour market policies is to focus on the so-called flexicurity strategy. The European Commission has confirmed that the priorities of the European Union regarding the labour market area include the preservation of employment, the creation of new jobs, an increase in mobility and the organisation of advanced training.

The new Employment Contracts Act entered into force on 1 July this year only partially: several measures, primarily regarding social guarantees, were postponed because of the need to curb the budget deficit. However, the measures aimed at improving the flexibility of the labour market were enforced as planned.