Vahur Kraft: Challenges facing Estonian economy in the European Union

Speech by Mr Vahur Kraft, Governor of the Bank of Estonia, at the Roundtable "Has social market economy a future?", organised by the Konrad Adenauer Foundation, Tallinn, 19 August 2002.

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A. Introduction, review of the early 1990s and comparison with the present day

First of all, allow me to thank Konrad Adenauer Foundation for the organisation of this interesting roundtable and for the honourable invitation to speak about "Challenges of Estonian economy in the European Union". Today's event shows yet again how serious is the respected organisers' interest towards the EU applicant countries.

I personally appreciate highly your support to our reforms and convergence in the society and economy. From the outside it may seem that the transformation and convergence process in Estonia has been easy and smooth, but against this background there still exist numerous hidden problems. One should not forget that for two generations half of Europe was deprived of civil society, private ownership, market economy. This is truth and it has to be reckoned with.

It is also clear that the reflections of the "shadows of the past" can still be observed. They are of different kind. If people want the state to ensure their well-being but are reluctant to take themselves any responsibility for their own future, it is the effect of the shadows of the past. If people are reluctant to pay taxes but demand social security and good roads, it is the shadow of the past. In brief, if people do not understand why elections are held and what is the state's role, it is the shadow of the past.

But, of course, in ten years a lot has been achieved. We have built up democratic institutions. Market economy functions. Private ownership has a solid foundation. Banks provide credit to people for new housing developments. But our current success should not be taken for granted. And we should also bear in mind that much needs to be done yet. The public has to understand the role and possibilities of the state and the government in the market economy. Everybody should feel responsible for their own welfare as well as their family's and the state's well-being. Our new generation should be able to cope with the complicated processes of the modern society much better than we did.

In our efforts to achieve this goal it is impossible to underestimate the support provided by our partners. The Estonian society and politicians need partners with whom to exchange experience and from whom still to learn the fundamentals of the functioning civil society. At that, I would like to thank Konrad Adenauer Foundation for the work it has done and is doing in Estonia and elsewhere for the promotion of political co-operation, preservation and support of free democracies throughout the world, development and consolidation of the social market economy and respective values.

Allow me to express in my address also full recognition to Prime Minister Mart Laar who has been the leader of the Estonian government during several critical periods. Mart Laar was the head of the Estonian government during one of the most difficult periods - from the autumn of 1992 to November 1994. This was the turbulent period of initial reforms not only in the economy but the entire society, immediately after the monetary reform and adoption of the constitution. But, with your kind consent, I shall hereby focus on economic issues.

These were the times when Estonia's foreign reserves, in the current denomination, could have been expressed in hundreds millions of euros, the average monthly wage was slightly above one thousand kroons and, by the end of 1992, three big banks had collapsed. These were the years just after the monetary reform when the question "for how long this kroon is going to last" was often asked in Estonia, but even more frequently abroad.

The central bank has always stressed the essential backing provided to the stability of the kroon's exchange rate and the financial system by the economic reforms at large and a stable, predictable budget in particular. We have repeatedly stressed that the foundation for our relative economic success was laid in 1992 and 1993. Our banks would not be so strong to date without solid customers - private enterprises, individuals. The quick and resolute privatisation of former state-owned companies in the beginning of 1990s was a decisive factor in the establishment of a sound and strong customer base. Due to that Estonian banks have been able to extend credit to the strong private sector, in particular. Thus we managed to avoid the situation that many former socialist economies were forced to experience - floating of problem loans directly or indirectly to state-controlled, often corrupt industry.

In the course of the reorganisation of the financial sector in the early 1990s we did not hesitate to liquidate badly-managed, insolvent banks in the first half of 1990s. Neither did the government hesitate when it was necessary to liquidate badly-managed, insolvent enterprises that were manufacturing for stock. Privatisation of state-owned companies for real money to core investors, and, if necessary, liquidation of state enterprises that were operating in the red, created a good basis for the emergence of a strong and free competition-driven business sector. Without it the real wages in Estonia would not have increased by almost one-third in the second half of 1990s, without it we would not be approaching the finish line in our EU accession process. Steps taken ten years ago for the demolition of the old, impotent and perspective-lacking system and for the building up of a new, viable and future-oriented economy are now bearing fruit.

The basis of the economic reforms undertaken by the government in the early 1990s was a strong fiscal policy. Let's be honest, at that time none of us knew exactly what a national budget really means and how the amount of state-collected taxes and public expenditure in practice affect the economy. One thing was clear - public expenditure should not exceed public income or the value of the Estonian kroon would immediately be put at stake. The 1992-1993 strictly balance-oriented strategy helped to create the social foundation that would even to date be suitable for developing a fiscal policy capable of even better supporting the balanced economy.

I touched upon the economic policy key issues of the past decade because the same issues that were topical then are on today's and tomorrow's agendas. How to achieve better economic efficiency and improve competitiveness? How to avoid the deterrent impact of local lobby-groups on the economic policy and ensure a truly effective and free market? How to develop a truly balanced and forward-looking fiscal policy? These issues are in the focus not only in Estonia but also in the European Union. Naturally, today's problems - like the society itself - have a completely different look than 10 years ago. It is not only Estonia that has changed, it is the entire world. However, the key questions - likewise the optimum solutions to them - are, in essence, the same.

I would like to offer just a few examples for the illustration of the above-said. In the beginning of 1990s we created in Estonia conditions for truly free competition in the financial sector and the entire economy. Estonia abandoned all possible barriers to import and export of goods and services, created equal opportunities to all investors and privatised state-owned banks. These steps laid the foundation for our current success. To date, 10 years later, Estonia like the European Union discusses widely how to create a truly free market of infrastructure services which until now have been either directly or indirectly protected by the state. And principal solutions to this problem shall not differ from the decisions made in the first half of 1990s.

It is true that, for example, opening up of the electricity market to free competition is definitely more time-consuming than privatisation of many industrial enterprises. But, surely, restructuring of the electricity sector does not differ in principle from the reform in the banking sector. In both cases the state must ensure the availability of the critical infrastructure in Estonia and communication with the external markets - in one case, it means payment systems, in the other case interconnections with the European and Scandinavian grids. In both cases the government has to ensure supervision over the market actors' behaviour and establish clear rules. In both cases the government must have action plans or guidelines for crisis management. And when these guidelines and relevant national policies are in place, there will be no impediments to the complete opening of the market. The task of the government is not to delay the opening of the market but rather to speed it up. I am positive that, like in the banking sector, the society will benefit from this. It will result in more efficient production, lower prices, better service quality and curb the power of the monopolistic producers.

To date, as in the early 1990s, we again face the question of what is the right fiscal policy. Of course, today this problem is raised in a slightly different way. But, in essence, it is the same question - what fiscal policy shall ensure the stable development of the Estonian economy within the fixed exchange rate regime and as part of the euro area. I shall return to this question towards the end of my presentation. Thus the economic policy key issues we are facing in the beginning of the 21st century resemble in many aspects the problems we tried to resolve in the beginning of 1990s. We have achieved progress in finding solutions to some of the problems, others have remained unresolved. One thing is clear - undue postponement of tough issues is no good to anybody. If we want to be treated as equal partners in the European Union, if we want to sustain the rapid growth rate and growing income level, we must tackle these problems with similar resolution and energy we did 10 years ago.

B. Challenges facing Estonian economy on its way to the European Union - internal policy

So - what are today's and tomorrow's challenges facing Estonian economy? Filled with pride for the economic development of our country over the past decade, we must now concentrate more on the future. Estonia's goal is not only the sustainable economic growth target of 5.5-6 per cent per annum but also the preparedness to join the European Union and to make maximum use of the opening opportunities. What should we then focus on especially?

B.1 Challenges facing Estonian economy on its way to the European Union - overall economic policy stance

Estonian economy is already strongly integrated into the European economic area. From the perspective of the central bank I would like to refer to the clear convergence of the interest rate fluctuations and inflation cycles in Estonia and the European Union.

The share of current and future EU member states in Estonia's export is about 81%. In 1994-2001 Estonia's export to the European Union increased on the average 25% per annum. Our exports to the European Union have steadily grown quicker than imports from the European Union. It means that we have been steadily increasing our market share in the European Union - although it is small. The export structure also characterises our competitiveness - exported goods reflect changes that have taken place in the economy. Our traditional export items are timber, textile and foodstuffs, but also, for example, parts and components of electric motors, cables, mobile phones, antennae and the like. We export not only goods but also services - primarily transport and travel services - also computer and IT services and the volume of these services has been increasing rapidly during the last three years.

The FDI inflow that has reached the 9 billion kroon level in recent years proves our competitive position in the Baltic Sea region as well as a broader region. Equal distribution of investments between the main sectors of economy is an indication of the balanced economic development (in 2001, for example, manufacturing industry - 20%, transport and communications - 23%, wholesale and retail trade - 14%). It is also important to note that the FDI inflow was not contingent on the privatisation of former SOEs. And finally, our competitiveness is demonstrated by the yield of investments made in Estonia and reinvesting of substantial part of annual profits which in 2001 amounted to 3,8 billion kroons. This is also shows our competitiveness.

The readiness of Estonian economy for the integration with the European economic system is demonstrated especially well by such key sectors of our economy as the financial and telecommunication sectors. Here we talk about the complete opening of the market to domestic and foreign competition, strong state supervision and integration of Estonian enterprises in the big multinational corporations.

What should we focus on in the future?

Estonia is no longer a catching-up candidate country as it was three-four years ago. However, we still cannot say that the restructuring of our economy has been completed. On the contrary, the forthcoming member status in the EU will mean many more responsibilities. Our goal is not simply to be ready for the EU accession but to ensure maximum use of the opportunities concurrent with the membership. What should we focus most on?

First, a clear vision of the state's role in the organisation of the economic system. The task of the state is not to produce goods or services - be it in such specific areas as energy or rail transport. The task of the state is to ensure the functioning of the market wherever it for some or other reason requires its support.

Secondly, unemployment has become a problem in Estonia. Without dwelling on concrete statistics, I would like to emphasise that labour market is subject to the same set of rules as all other markets. If labour is too expensive, entrepreneurs will not recruit new workers. I stress this fact because in recent years our political measures for the mitigation of unemployment have, as a rule, been driven by the so-called active labour market strategy - focusing mainly on retraining and further education. Although an active labour market policy is necessary to increase the mobility of the labour force, it can reduce unemployment only if the legislative regulatory framework and the overall structure of the labour market foster the creation of new jobs. I think that we should in Estonia seriously and comprehensively analyse factors that influence employment, including absolute or relative taxation of the workforce and costs related to hiring and layoffs.

Thirdly, the balanced growth. Reforms are not an objective per se, we undertake them with the assumption that they will lead to a higher economic growth rate, higher income and improved living standard.

Leaving aside the turbulent years of economic reforms immediately after the 1992 monetary reform which lasted until 1995, the average annual economic growth rate in Estonia has been above 5%. Between 1995 and 2001 the average salary increased from 2086 kroons to 5721 kroons. During the same time period real wages increased by one-third. We believe that our mean economic growth rate will continue to be about 6% per annum. The quality of the economic growth in Estonia is consolidated by growing productivity - in 1995-2001 the GDP per capita (in fixed prices) increased by almost 40%. It is also demonstrated by the remarkable interest of the private sector and its readiness to invest. Structural changes in the economy can also be regarded as quality indicators - changes in the distribution between the industrial, agricultural and service sectors.

Still, in the forthcoming years we must keep a watchful eye on the external equilibrium of our economy, the current account deficit and its financing, changes in the productivity and competitiveness. It is obvious that no country, not even Estonia, when planning its economic policies should assume, for example, a 8-8% current account deficit spanning several years. Even if the latter is in the initial years financed through foreign direct investments, the adaptation of the economy is inevitable. The slower the economic growth is during the adaptation period, the more painful it is for the society. The goal of the economic policy should be the prevention of the internal demand-driven boom immediately prior and after the EU accession which will be followed by a significantly slower growth phase.

Pre-accession economic programme and macroeconomic risks

All these important issues are, to a certain extent, reflected in Estonia's pre-accession economic programme which was recently approved by the government of the republic. I stress that the projections which form the basis of the national pre-accession programme and the premise that in Estonian economy the real total output is going to increase at the rate of about 6% per year are attainable only if the current economic policy continues. Keeping of the macrobalance is of critical importance for sustaining the economic growth and credibility of the monetary policy. The kroon's fixed exchange rate and the forthcoming entry into the euro zone are by no means "free lunches".

B.2 Challenges facing Estonian economy on its way to the European Union - internal policy - joining the EMU

Estonia's entry into the euro zone is contingent on the fulfilment of economic criteria applicable to the single currency countries - on the other hand, one can say that only these economies that meet the requirements can benefit from the transition to the single currency. And Estonia's monetary and exchange rate policy during the pre-accession period and immediately after the EU accession should be considered against this background.

First, the fixed exchange rate of the Estonian kroon against the euro and the currency board system will remain unchanged before and after the accession to the European Union. The adoption of the euro will take place in three stages in accordance with the *acquis* - joining the European Union, joining the ERM2 exchange rate mechanism and, once the Maastricht criteria are met, joining the euro area. The condition of the Estonian economy and financial system as well as integration with the EU markets that I commented upon earlier in our view fully support this principle.

Also the European Commission and the European Central Bank have affirmed us that the euro-based fixed exchange rate and currency board regime, in principle, are in harmony with the *acquis* and conform to the requirements set for the monetary policy of the non-euro zone economies.

Secondly, ERM2 provides to the new member states a necessary and useful interim stage between the EU accession and the adoption of the euro. The choice of monetary and exchange rate policies in new member states has been diverse. ERM2 is a suitable and flexible means for the harmonisation of varied monetary policies and applied tools.

The post-accession period will most likely be a serious test phase to most member states - definitely Estonia - in elaboration of their economic and fiscal policies and relevant co-operation with the EU institutions. Participation in the development of economic policy guidelines sets relatively high demands both on actual policy formulation and institutional co-operation. Naturally this process will have two parties - the present applicant countries will have joining in the EU processes whereas the "old" member states will have to study the key problems the new members states face in their economic development. The post-accession ERM2 phase is an appropriate time for the establishment of the comprehensive co-operation in the economic policy area on the national as well as the European Union level.

The "testing" of the economies' competitive abilities will also be crucial - not by means of the exchange rates but interest rates.

Maastricht criteria

For Estonia like for all new member states the only possible way to join the euro system is to do it in full compliance with the letter and spirit of the EU Treaty. As we well know, the key issue here is the fulfilment of the Maastricht criteria. Most new member states, Estonia included, will obviously have no great difficulties in meeting the sovereign debt and budget deficit criteria. The remaining two criteria - low inflation and exchange rate stability - are connected with some specific problems.

The fulfilment of the inflation criteria might not in reality be as difficult as is feared - and achievable in not so distant future. However, in the context of rapid accession, the meeting of the inflation criteria becomes a main issue. This is due to the interaction of the so-called real and nominal convergence. Together with the rapid growth of productivity and earnings, prices are going to rise quicker in the new member states. Considering great price gaps in applicant countries v?s a v?s present member states, one can assume that price equalisation will take time. Thus we can conclude that inflation rates in the new member states will for several years stay higher than the mean rate of the three lowest inflation economies in the European Union plus 1.5 per cent. We have estimated that for Estonia the "optimum" pace for streamlining of prices would be ca 2 to 3 per cent points per year. In our opinion this difference reflects the quicker productivity increase trend in Estonia.

In conclusion, a few comments on the main economic policy issues that the European Union faces. After the introduction of the euro the issue of potentially new co-operation modes has been raised repeatedly, This is also discussed at the Convention on the Future of Europe. Figuratively speaking, the question means which policy measures foster the best utilisation of the possibilities offered by the single currency.

C. Challenges facing Estonian economy on its way to the European Union - the EU perspective

The first priority issue is naturally the further improvement of the EU internal market. The on-going convergence and improved operational efficiency of the internal market will make prices more flexible and allow better use of resources. It is extremely important to develop the common market for all goods and services, including telecommunication services and other utilities - also financial services in order to ensure free competition and price formation based on the demand and supply on the Pan-European market. A well-functioning common market should help to reduce transaction costs, by offering more and more services via the internet, for example. A common innovation policy, system of business support measures and dissemination of experience of different businesses, availability of start-up capital - all this is deemed to promote productivity and further convergence.

Flexibility and mobility of production factors

Another set of critical issues is related to flexibility and mobility of production factors. Here I must stress the importance of capital and labour market flexibility. Both need all possible support in order to increase the efficient use of resources in the common market economies. In addition to the unified money market in the euro zone, we should aspire towards the full integration of capital markets. Simplified procedures for the adoption of secondary legislation that regulates the financial services area are an important step forward. The convergence of financial markets calls for a more extensive harmonisation of the legal environment in various countries. But it also requires closer co-operation between various national supervisory authorities and/or better co-ordination of supervision functions on the EU level. In addition, it should be taken into account that capital transfers between the member states would be easier if business laws and regulations of different countries are harmonised. Here I could mention rules governing companies' mergers and takeovers, bankruptcy procedures, state aid distribution terms and conditions.

A flexible labour market is extremely important for the effective common monetary policy purposes. However, it is unlikely that in the near future Europe will see any notable crossborder migration of the labour force - it is not expected to happen before or after the EU enlargement. Therefore, limited flexibility of the labour market should be offset by an efficient internal market, high capital mobility and greater flexibility of the domestic labour market.

Fiscal policy - fiscal federalism

In addition to the above-mentioned supply-related issues, the EU and its member states' fiscal policy principles in the context of the common monetary policy have been under special scrutiny. It has been stated that enhanced co-operation within the fiscal policy area will allow to mitigate potential economic difficulties in various countries. In principle, the question is whether and to what extent automatic balancing mechanisms should be invoked on the EU general fiscal stance level and be targeted at the smoothing of regional disparities with automatic income transfers from the wealthy to the less-wealthy regions - thus, in fact, compensating for the lack of the exchange rate mechanism within the single currency regime. Also in recent months the question has been raised whether or not the requirements of the Stability and Growth Pact are too rigid.

By way of general comment, I should say that there are sufficiently many examples of great disparities between different regions of a federal state. Regional policy is crucial also for states with high labour mobility. Ultimately, the success of regional economies depends primarily on the efficient resource management and extensive income transfers can even slow down the adjustment process.

In my view it is obvious that as long as the European Union remains to be the alliance of independent member states, there will be neither need nor possibility for any additional communitisation. Exceptions could include precisely defined circumstances when an intervention on the EU level would be justified in order to ensure the uninterrupted functioning of the internal market. Harmonisation of the fiscal policy on the macro level would be automatically accompanied with the tax rate equalisation. At that, taxation policies of any given member state reflect principal choices of their internal policy and preferences of the entire society.

Stability and growth pact

With the regard to the Stability and Growth Pact, it is assumed that automatic stabilisation mechanisms shall function smoothly within the 3% GDP scale. This threshold could be exceeded only in case of an abrupt or unexpected shock situation. Additionally, the Stability and Growth Pact aims at a balanced budget during the economic cycle. Thus it presumes that one should not look for structural reasons if some member state experiences a long-term budget deficit or surplus. In my opinion, the Stability and Growth Pact has performed its function very well in recent years. This is proved by the fact that most of the EU member states now have a much stronger fiscal position than in previous years.

Any major changes in the Stability and Growth Pact are likely to cause additional insecurity and significantly affect the credibility of the entire framework. Therefore I believe that the Stability and Growth Pact should remain a cornerstone of the EU economic policy also in the years to come. Further convergence of markets and various national economies should by itself prop the framework of the Stability and Growth Pact. In addition to the potential approximation of the business cycles, the common market should create preconditions enabling each country to invest its savings effectively within the Union. And even more importantly, harmonised and flexible commodity markets will help to reduce adjustment costs - and thus minimise the need to use budget stabilisation mechanisms during the short-term adjustment period.

D. Concluding remarks

To date the European Union faces several complicated but well-known economic policy problems from the recent past. Estonia as the future EU member state must take this into account. It is not enough to be able to overcome challenges on the WAY to the European Union. We must become equal partners to other European states, be able and willing to participate in the discussions on the monetary and fiscal policy issues, perceive Estonia in Europe and Europe in Estonia. Today the European Economic and Monetary Union within which 12 states have adopted the single currency, offers a historic chance to create a truly strong, flexible and efficient economic area. I believe that potentials of the single currency will be exploited in the best possible way. It would serve the interests of the current as well as future member states and the whole of Europe.