Andres Lipstok: How to exit the economic crisis?

Presentation by Mr Andres Lipstok, Governor of Bank of Estonia, at the conference "Majandus, kuhu lähed? Kas õigus saab aidata?" (Quo vadis, economy? Is law able to help?), Tartu, 8 May 2009.

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Dear ladies and gentlemen,

I would like to thank the conference organisers, especially my good friend Paul Varul, for the invitation to speak at today's very topical conference.

How to exit the economic crisis – this is the most urgent question for the policy and economy of both Estonia and Europe in 2009 and also the next years. The destiny of the Estonian economy greatly depends on what is going on around us, i.e., in the EU and entire world. Therefore, the first part of my presentation addresses the possibilities and ways out of the crisis from a slightly broader perspective, in the context of the world and the EU.

First, let us have a look at the global economic situation.

The global economy is in a deep recession at the start of 2009. For the first time after World War II, the global GDP is forecast to decline in 2009. According to the IMF's forecast, the decrease may amount to 1.3% We all know the global crisis originated in 2007 from the USA with the collapse of the high-yield bonds market. This event caused loss of confidence in bonds, investment funds and large banks. When the financial system stopped functioning, investment consumption and trade contracted as well. This process, which many analysts considered in the beginning to be a temporary correction, escalated rapidly and turned into a crisis.

But the solvency problems of US lower-income residents and their inability to repay their mortgages were naturally not the main causes of the current situation. Every economic crisis is in its nature overproduction, when new services and goods find no buyers. Therefore, enterprises squeeze their production, lay off employees and refrain from new investments. The current situation is no exception to this rule. It also lies in overproduction and insufficient demand, which are caused by two main reasons.

One reason is excessive optimism which prevailed in many parts of the advanced economies and in financial markets, encouraging people to consume more and save less. The demand based on over-optimism was driven by overly large fiscal deficits in major economies and probably also by unduly low interest rates in many parts of the world. Another factor contributing to exorbitant demand was the regulation of the financial system, which practically rewarded risk-taking.

The other, just as significant reason is economic policy pursued by several Asian countries which was based on relatively cheap exports and low currency exchange rates. Broad-based and sustainable domestic demand was and is too little valued in economies based on cheap labour force, goods exports and related investment. Therefore, it can be assumed that private consumption and domestic demand were below par in Eastern Asia. The result was large current account surpluses and accumulating foreign reserves that were lent to the rich USA.

It was impossible for such an economic model to be stable and by now, as I already mentioned, the situation has thoroughly changed.

GDP in leading industrial countries will decrease 3.8% this year with growth in the USA contracting by 2.8%. For the rest of the world this means the USA foreign trade deficit will reduce notably, which, in the IMF's estimate, will lead to shrinkage in the USA imports.

Therefore, global economic growth will not be able to lean on the US domestic demand and exports of goods and services to the States either this or the next year.

The recession in the USA has hit hard exports-dependent East-Asian countries, where goods exports have declined by more than a third year-on-year. Therefore, smaller and more open Asian countries have suffered a very sharp downturn. For instance, Singapore is expected to undergo a 10% and Taiwan a 7.5% contraction. Larger Eastern-Asian countries, such as China, maintain their economic growth by launching foreign assets accumulated over the past ten years and reducing interest rates. National expenditure on infrastructure has been markedly boosted and it is also hoped cheap bank loans will help keep up consumption. The IMF forecasts Asian new industrial countries' economic growth will be –5.6% in 2009 and 0.8% in 2010.

In conclusion, the current crisis has thoroughly changed the past ten year's development scenario of the global economy. The end of the current growth model is characterised, at least in short term, by catastrophic contraction in trade in the whole world. At the same time it has to be borne in mind that in the case of free market economy, a temporary fall is always replaced by a rise. All major crises are almost always caused by national policies, which affect people's expectations and decisions made on the ground of these expectations. When trying to make up for previous mistakes in a crisis situation, national policies have often stood in the way of free market economy corrections and thus also the recovery of growth.

This was the case also in the 1930s, when recuperation from the Great Depression was too slow in many countries. Governments mistakenly thought that the best choices would be hindering external trade, artificially high wages, administrative regulation of production and protectionism. This resulted in a further decline of private demand and corporate production and investment. Thus now, at the start of the 21st century, the most important thing to do is to refrain from protectionism, restrictions on the movement of goods and capital. The current global crisis is not a market economy slump, but a crisis of national policies amplifying discordances and imbalances. As I mentioned before, fiscal policy was too weak in good times and reforms needed for balanced economic growth have in several cases been insufficiently implemented. This does not mean the state should now do nothing at all – vice versa. But national policies across the world must take into account that the policy to take us out of the crisis must support the functioning of market economy, not constraining it.

In this light, the growth prospects of the EU are very insecure. In the IMF's opinion GDP in EU countries will decrease 4% in 2009 and may decline by 0.3% next year. Industrial production in the EU has lowered to a level last recorded nearly ten years ago. Such pessimism contrasts rather sharply with the opinion quite widespread in the middle of 2008 – that Europe will not be hit very hard by the crisis. Reality, however, has turned out rather different.

The EU has, on the one hand, been affected by loan losses suffered by major banks due to the financial crisis and, on the other hand, by drastic contraction in demand in its main export markets. The European Union is, for instance, much more open than the USA, thus the share of exports in its GDP is larger and its economy is more severely affected by dwindling global trade. In addition, banks in Europe have difficulties with financing enterprises, since on top of the losses suffered in securities markets, asset quality is also expected to deteriorate. To put it more simply, the share of bad loans will increase due to the recession.

The economic crisis has affected EU Member States differently. On the one hand, tougher financing conditions and the drop in property prices have hit hard countries that have been relying on financial services and domestic demand in recent years, mostly Great Britain, Spain and Ireland, but also Estonia. On the other hand, the crisis has not spared

countries that have been focusing on industrial production exports, primarily Germany, but also Sweden and Finland. Thus, the political choices of the Member States vary as well.

Different conditions for countries borrowing from financial markets make up an additional problem in the EU. General distrust in the global financial markets as well as growing fiscal deficits, expanding government debts and insecure growth prospects have caused investors to become more risk-averse. As a result, the spread between the yields of government bods in the EU has notably widened. Some Member States must pay higher interest compared to a couple of years ago when they wish to borrow. This makes it harder to finance state expenditures.

Based on the above, the EU's economic policy measures to exit the crisis can be divided into three large categories that were agreed upon in the European Economic Recovery Plan at end-2008.

The shorter-term goal is to stop the downturn and to stabilise the economy. In longer term, it is necessary to restore the confidence of enterprises, households and financial markets in the growth potential of the European economy.

The short-term economic policy objective to reinforce aggregate demand by monetary and fiscal policy measures belongs to the first category. The ECB has lowered interest rates and considerably increased money market operations, i.e., the total volume of short-term loans to banks. In addition, EU countries have agreed to support the economy in 2009 and 2010 by raising fiscal expenditure in the total amount of 1.8% of GDP. However, this is constrained by rapidly expanding deficits and external debts. Therefore it is important that EU Member States make already plans for reducing fiscal deficit in the next years. The European Commission stresses that in the current complicated economic environment the Stability and Growth Pact is still relevant. The longer-term objective in the EU is to achieve fiscal balance or surplus.

Second of all, it is extremely important to restore confidence in the financial sector. The minimum rate of guaranteed deposits in the EU was raised to 50,000 euro already in 2008. Thereafter Member States have agreed upon common principles to support the banking system. At the end of 2008 Member States put the main focus on the banks' liabilities side to ensure banks would be able to finance their operations also in a more adverse market situation. To this end many countries have offered collaterals to loans taken by banks, i.e., the state guarantees the repayment of loans taken by banks. In several countries the government has made contributions to banks' capital and acquired holdings in commercial banks. At the beginning of this year a common accord was reached on the principles to be implied in the case of bad loans if necessary. Up to now, the guarantees promised to the banking sector, primarily by older Member States, amount to some three billion euro, which is about 24% of GDP. In addition, countries such as Ireland, the Netherlands and Great Britain, have injected a lot of national capital into their banks. In Great Britain, for example, it has become necessary to segregate bad loans.

Third of all, to maintain economic growth potential, Member States should implement the structural reforms set out in the Lisbon Strategy. The reforms help reinforce competitiveness, i.e., increase the flexibility of the economy and the labour market. The European economic policy must take into account that external demand and exports may not bounce back to the recent levels for several years. Therefore, the EU should start making even more use of the possibilities of its large domestic market. In Member States that have so far been focusing on exports this may mean an increase in the share of services, changes in employment, and more flexible forms of work.

Thus, it can be said the principles agreed upon in the EU give the Member States all the possibilities for exiting the economic crisis. Fiscal policy in the EU as a whole is forecast to loosen around 5% of GDP in 2009 compared to "normal" times and the ECB has lowered the interest rate to 1.25%. Thus, the EU economy has already received a significant macroeconomic stimulus, which should lead the EU back to the growth track in 2010. This

will create the conditions needed for economic restructuring, but every country has to take the necessary steps itself.

What are the measures that should be taken to help Estonia out of the crisis?

Estonia is part of the EU and the single market, so the framework agreed upon in the EU is also suitable to our economic policy. The general principle we would like to stress is that we must strengthen our ties with Europe and the EU single market even more. This is essential for ensuring the stability and development of the Estonian economy and the financial sector. In order to overcome the crisis, the stability and possibilities offered by the EU and the single market are vital to Estonia.

The speed of overcoming the crisis depends on the flexibility of Estonia's enterprises and their success in reorganising production and activities, considering changes in the world and in the EU market. The task of the state is to create conditions supporting the reorganisation and investment. Estonia's economy has, in fact, already displayed a rather good ability to adjust. The main changes include labour market adjustments and decelerating wage growth. This is definitely a difficult, but highly necessary process, which requires state support in the form of both a well-functioning and efficient unemployment insurance system and retraining possibilities. If we rely on strong macroeconomic policy, the principles of an open economy and future-looking investment, Estonia will continue to have all the possibilities for defeating the crisis. But what are the national economy level measures the government should take and how should they support the financial system?

Here I start with a firm standpoint that the fixed exchange rate of the kroon to the euro is the pillar of Estonia's economic policy and the accession to the euro area as soon as possible is its logical continuation. The experience of the past half a year show that monetary policy that is based on the fixed exchange rate and the currency board supports economic stability also in more difficult times. But how does the fixed exchange rate help us overcome the crisis?

First of all, it helps stabilise inflation expectations and stop price rises. Price corrections after the accession to the EU were sharper then we expected. The opening of the labour market and price rises of many goods in the global market had a strong impact on Estonia. This stage, which was, in a sense, unavoidable and paradoxically also the result of successful reforms at the start of the century, is now over. The price level is expected to decline somewhat both this and next year.

Second of all, the currency board arrangement brought about a relatively fast correction in several sectors of the economy, which displayed clear signs of overheating after the accession to the EU. The fixed game rules in banking, the economy and policy arising from the fixed exchange rate and the currency board notably contributed to smothering excessive euphoria already prior to the global crisis.

Third of all, the fixed exchange rate is the pillar of our financial system as well.

As a result of all this, the vulnerabilities of the Estonian economy have decreased significantly. This will enable us to concentrate on measures supporting economic growth once the crisis is over. I would like to stress once again that in a small and open economy like Estonia, the fixed exchange rate based policy is the best way to ensure the stability of money for both enterprises and households. Confidence in our own money is one of the most important factors in defeating the crisis.

Thus, joining the euro area will be a logical continuation to our current monetary policy and accelerate exiting the crisis. It is clear the adoption of the euro will offset the risks that have been overly amplified in the current market situation. Moreover, the changeover will reinforce the credibility of Estonia's financial system and the banks operating here. To sum up, Estonia's accession to the euro area is the country's short-term economic policy priority, which increases confidence in Estonia's economy.

Like we have said before, Estonia has all the possibilities for meeting the Maastricht criteria already at the end of 2009.

The stability and credibility of the banking groups operating here, supported by close cooperation between Baltic and Nordic countries also help Estonia overcome the crisis.

Banks in Estonia have sufficient funds to support restructuring in both the business sector and the entire economy. Eesti Pank's analyses confirm that the current capitalisation is sufficient to cover possible larger loan losses without banks having to include additional capital. The resources of banks allow their lending decisions to be based on favourable medium-term and longer-term economic outlooks, since Estonia's economic convergence, i.e., the movement of our income level towards that of EU richer countries, will continue also in the future.

Thus, the goal of banking and financial sector policy is cooperation with the home countries of the banks operating in the EU and Estonia to ensure the functioning of the common banking market and group-level stability. The steps taken by the home countries of the banks operating in Estonia have considered the interests of the entire group and thus supported financial stability in Estonia. In this light it has to be emphasised that the measures to support the economy approved in Estonia allow state aid also in a situation where financial markets no longer function normally. But the main aim of the state support measures is to organise the financing of starting and exporting enterprises. The total debt burden of Estonia's enterprises is relatively big and a decline in the total volume of debt in 2009 is a natural reaction to previous years' rapid increase.

The sustainability of fiscal policy is very important for restoring confidence in Estonia and adopting the euro. When looking at the changes made in the budget this year and at the new fiscal strategy, it has to be pointed out that the support of fiscal policy to the economy was remarkable in 2008. The state budget swung from a 2.7% surplus to a deficit in the course of one year. This year, the share of state expenditures in GDP may rise to 43%. Thus, it is important to ensure fiscal sustainability this year and also in the next years. Thereafter reserves must be restored. In Eesti Pank's estimate this means an extra 7 billion kroon cut in addition to the curtailments already made.

Actions related to fiscal policy must be decisive, but thoroughly considered. I am not so pessimistic as to absolutely agree with the opinion that the government has reached the stage where it faces just "bad and very bad solutions". But it is also clear that there is no simple or simplified way to rekindle growth. Measures need to be taken on both the revenue and the expenditure side. But I think it should be kept in mind that it is state expenditure that has soared over the past years. On the other hand, the tax burden that has been relatively stable so far is one of the main strengths of the Estonian economy, leaving sufficient room for private initiative.

To conclude, I will repeat the main message of Eesti Pank's spring forecast. According to the current outlooks, the economy should stabilise in the second half of this year and it may start growing again either at the end of 2009 or at the beginning of 2010. However, all forecasts continue to be insecure. If our main trading partners' growth recovered faster, it would also give impetus to Estonia's economic activity, whereas a protracted global economic downswing would put a drag on rekindling growth here. Recent days' messages from the world have been slightly more optimistic after several months of bad news. It is thought the large support packages have finally started to render results. This requires even more urgently that countries be ready to take stapes to ensure long-term growth potential. It has happened before in the world that economic crises have been defeated by creating assumptions for a new crisis.

Thank you for your attention!