

Economic Survey of Estonia, 2009

Why is the boom ending in a bust?

What are the key policy challenges?

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Summary

Estonia grew faster than most emerging market economies during 2000-07, but it is now in a severe recession. While the initial reversal of GDP growth was caused by a collapse of domestic demand, at the current juncture Estonia is vulnerable to external shocks as well. The current-account deficit has been reduced, but there are risks of further cut-back in credit that could intensify or prolong the reduction of output. The main challenge facing the policymakers is therefore to bring the economy quickly back to trend growth, which is complicated because of past policy commitments. Towards this goal, this Survey makes the following recommendations:

Fiscal policy should evolve into a more flexible, rule-based counter-cyclical framework

During the past boom, the fiscal policy amplified an already highly pro-cyclical growth of credit and wages. The current downturn presents the opportunity to adopt a fiscal rule of balancing the budget over the cycle to allow automatic stabilizers to work. The deficit target could be anchored in a medium-term budgetary framework incorporating expenditure ceilings and a mechanism that claws back expenditure or debt overruns.

Financial stability should be strengthened, while distortions that contributed to the housing boom should be removed

Given the role of foreign-financed credit in the boom, and then the current recession, the Estonian Financial Supervision Authority should carefully monitor risks and intensify co-operation with the foreign supervisory bodies. The favourable tax treatment and credit guarantees of housing loans amplified the housing boom and should be phased out over the medium term to facilitate allocation of capital to its most productive use.

This Policy Brief presents the assessment and recommendations of the 2009 OECD Economic Survey of Estonia. The Economic and Development Review Committee, which is made up of the 30 member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

Labour needs to become more mobile across occupations, sectors, and regions

The importance of labour market flexibility is further underscored by the goal of adopting the euro in an environment of low, though rising, synchronisation with euro area business cycles. The recently-adopted Employment Act eases employment protection and enhances labour market flexibility. The parallel reform of the unemployment benefit system increases benefits and strengthens the financing responsibility of social partners. To improve incentives the unemployment benefit increase should be accompanied by additional measures supporting active job search. At the same time, job creation by firms could be enhanced through reductions in the social security tax. To prevent erosion of competitiveness, both minimum and public-sector wages should grow in line with productivity in the private sector. Over the medium term, regional labour mobility could be enhanced through increasing housing allowances and further improvement of public transportation infrastructure.

A competition-friendly business environment needs to support innovation-driven productivity gains

OECD's product market regulation (PMR) indicator confirms the overall very open and business friendly regulatory environment, although several specific weaknesses still need to be tackled. In particular, the impact of limiting the corporate tax liability to distributed profits should be carefully monitored and this tax regulation reconsidered if it is established that serious distortions arise. In addition, competition in the electricity sector could be increased, and cost effectiveness of programmes supporting business and innovation activities enhanced. Private sector activities in less developed areas of the country should be encouraged, in particular through facilitating access to credit for small and medium-sized enterprises. ■

Why is the boom ending in a bust?

During 2000-07, the Estonian economy experienced one of the highest growth rates among emerging market economies and, until 2005, low inflation. However, in recent years, domestic demand was mainly driven by a housing investment boom, fuelled by high expected income growth and accommodated by large capital inflows and cheap credit, as well as tax incentives. Tightening loan standards in the wake of the severe international financial crisis, falling house prices and an abrupt turnaround of consumer confidence have put an end to expanding domestic demand, which has been shrinking since mid-2008. Pro-cyclical fiscal policy is adding negative stimulus. Moreover, strong wage growth real appreciation weakened Estonia's external competitiveness.

Estonia was one of the first countries to enter recession in 2008 and is now going through most challenging times. Real GDP growth is expected to be significantly negative in 2009 and turn positive only towards the end of the year and pick up in 2010, due to a more favourable outlook for exports. This recovery will depend on the ability to shift resources from serving domestic demand to producing for export demand. While the initial causes of the slowing and reversal of GDP growth largely affected domestic demand, Estonia is now highly exposed to external risks, especially to a deeper or more prolonged recession in the euro area and further fallout from international financial markets crisis. Even though the current-account deficit has been reduced, risks of an accelerated reversal of capital flows could lead to a further reduction of output. While a diversified small economy like Estonia may hardly hit an effective demand constraint on external markets, it might nevertheless need to accept lower prices and wages to secure the increase in export market shares necessary to compensate the collapse of domestic demand. ■

What are the key policy challenges?

The key current policy challenge for the government is to bring the economy back to trend growth. To this end, distortions introduced during the past boom and the misallocation of resources toward the non-tradable sector will need to be corrected. However, the real exchange-rate appreciation that has already taken place will make the reallocation of resources from non-tradable to tradable sectors and an export-driven recovery more challenging. From this perspective, the following policy issues stand out:

- *Removing the pro-cyclical bias of fiscal policy.* Up to now, fiscal policy has exhibited a pro-cyclical bias. Some of the windfall revenues were saved, but a considerable part was used to initiate structural tax cuts as well as, but to a lesser extent, expenditure increases
- *Strengthening financial stability and unwinding distortions in the housing market.* Pro-cyclical lending conditions and wages, as well as a fiscal bias in favour of

home ownership, have re-enforced each other and led to an over-expansion of real estate and construction.

- *Reforming labour markets to enhance wage flexibility as well as regional, sectoral and occupational mobility.* Reallocating labour smoothly to more productive activities, typically in the export sectors, will hinge on more flexible labour markets.
- *Making the business environment even more competitive.* While recent GDP growth was driven largely by capital deepening, productivity gains from innovation will need to play a greater role in the future. In that context, it will be important to remove remaining obstacles to investment, entrepreneurship and innovation.

The currency board introduced in 1992 has served Estonia well. The main motivation at the time was to rapidly enhance the credibility of policies and reduce inflation, effectively by taking over the monetary stance of a well reputed central bank. While the business cycle is only loosely synchronised with those of the euro area, its alignment seems comparable to some smaller EMU countries. Moreover, synchronisation of shocks and cycles with the euro area seems to have increased somewhat, mainly due to policies and institutions that facilitated EU accession. However, in the absence of exchange-rate flexibility, the response to asymmetric shocks and the consequences of the remaining cyclical divergence from the euro area will have to be mitigated by fiscal policy as well as by policies enhancing structural flexibility.

With inflation falling and risks originating from the international financial crisis, an early adoption of the euro has re-emerged as a key government priority. Regardless of whether this goal is achieved, given that the Kroon is pegged to the euro, the relatively low level of synchronisation implies that effective counter-cyclical fiscal policy and labour mobility are required to avoid excessive volatility. ■

How can fiscal policy smooth the business cycle?

The period 2000-07 was characterised by rapid foreign-financed credit growth, which in turn fuelled an investment boom, especially in real estate. While credit growth contributed strongly to the overheating of the economy during 2005-07, the liberalised capital account and the currency board – although serving the country well – severely limited the options of policy-makers to manage the highly pro-cyclical capital inflows. Wages also grew rapidly in recent years, reflecting labour and skill shortages and mismatch. Even though these developments called for countercyclical fiscal policies, in practice budgets were pro-cyclical, with the government increasing expenditures and cutting tax rates during this upswing. Moreover, with some of the higher revenues during the past years being of a one-off nature, the expansionary policies worsened the underlying budgetary balance and will make achieving fiscal sustainability more challenging.

The balanced budget rule that Estonia has adhered to since independence has been important in keeping its public debt at very low levels. However, it has also meant that the country has not used enough the counter-cyclical role that fiscal policy can play. While respecting the Stability and Growth Pact, in the current downturn the government should abstain from the usual practice of *ad hoc* expenditure cuts and allow the automatic stabilizers to operate. This is particularly important since the approved budget for 2009, which was based on a forecast of 2.8% GDP growth, will result in considerable restrictive measures to prevent an excessive deviation from the targeted balance.

Instead, the government should aim at balancing the budget over the business cycle. To maintain hard-won fiscal credibility, discretionary fiscal measures should be reserved mainly for longer-term issues, and otherwise be used only in exceptional circumstances such as natural disasters or severe recessions. To facilitate sustainability and efficiency of public spending, the deficit target could be accompanied by an expenditure rule, incorporated in a medium-term budgetary framework. Debt overruns stemming from lower-than-forecasted medium-term revenues or overestimating the structural part of the budget balance should be clawed back with a mechanism, which effectively targets the debt to GDP ratio, similar to the Swiss debt rule. A welcome side effect of a transition to a more flexible fiscal rule would be the development of a well-functioning government bond market, which could also play an important benchmark role for financial markets and thereby increase competition in the financial sector. ■

How can financial stability be strengthened?

While the economy has benefited from strong financial integration, it has also exposed the economy to risks. In particular, the private investment boom, mainly in residential housing, was financed by massive capital inflows. Private-sector credit largely mirrored the capital inflows and surged during 2000-07, albeit from a low base. A growing share of credit went to the housing sector, fuelling house price increases and an overexpansion of the construction sector. As credit was mostly financed by intra-group loans from foreign parent banks, the net foreign asset position of Estonian affiliates deteriorated, and risks to financial stability increased. This has exposed Estonia to risks of a change in foreign lenders' sentiment in the wake of the global financial crisis. Some of these risks have already materialised in the form of tightening lending standards.

The strong presence of foreign banks in the financial sector underscores the importance of close co-operation with the Nordic countries in the area of crisis management. In this context, the Estonian government is currently preparing welcome legal amendments, which would expedite expenditure decisions. Moreover, the Memorandum of Understanding with the Swedish central bank specifies practical modalities of possible actions by central banks. Co-ordination in the supervision of cross-border

financial groups also needs to be strengthened, as some supervisory responsibilities fall on the home country's supervision authority, while others rest with the Estonian authorities. Building on the already existing bilateral Memoranda of Understanding with Nordic supervision authorities, the Estonian Financial Supervision Authority should intensify reciprocal visits and information-sharing. In addition, the Estonian financial supervision authorities should carefully monitor financial stability risks and communicate findings to the public in order to sustain confidence in the financial system. Given the risks stemming from the large share of variable rate-loans, households should be informed more effectively about the pros and cons of loan conditions, and an apparent bias in favour of risky loans (95% at variable rates and 80% in foreign currency) should be addressed.

In addition to cheap credit, the favourable tax treatment of housing has amplified the housing boom. Eliminating the tax deductibility of mortgage interest payments has been on the policy agenda for several years, and some ceilings have already been introduced. While difficult to implement in the current downturn, these distortions should be phased out over the medium term to facilitate the allocation of capital to its most productive use. ■

What role will labour mobility play for the recovery?

Persistent regional differences in employment and unemployment outcomes point to labour market rigidities and barriers to mobility, both of which need to be addressed. In spite of the recent housing boom, access to affordable housing for some segments of the population remains limited, thus impeding inter-regional movement of labour, in particular of low-wage earners. Policy challenges therefore include increasing the availability of affordable housing. In particular, the level of allowances could be increased over the medium term to take into account regional differences in the housing cost, which would allow for mobility from low housing cost areas to growth centres characterised by high costs. Mobility across counties and regions could be further enhanced by improving public transport system through investment in infrastructure.

In the past several years, overall labour market outcomes were favourable – unemployment declined and employment rates increased, including among women and older workers. At the same time, large regional differences have persisted and outcomes for low-skilled and young workers have improved only marginally. Moreover, skill and labour shortages have led to wage increases above productivity growth. More flexible labour markets, including wage growth reflecting labour market conditions and productivity gains, will be needed for re-employing laid-off workers in more knowledge-based export sectors. The importance of labour market flexibility is further underscored by the goal of adopting the euro in an environment of low, albeit increasing, synchronisation of Estonia's business cycles with those of the euro area. Barriers to internal mobility such as relatively underdeveloped job search

programs or high tax wedge on labour that would prevent labour reallocation into more productive activities across occupations, sectors, and regions thus need to be removed.

The new Employment Act combines deregulation of the employment protection legislation (EPL) against higher unemployment benefits. The very comprehensive Act reduces both the notice period and the amount of severance payments for regular contracts, thereby making Estonia's EPL restrictiveness comparable to Central European OECD members. Furthermore, the severance payment obligation will be shifted from employers to the Unemployment Insurance Fund thereby lifting liquidity constraints on SMEs. However, the changes to the unemployment benefit scheme increase the initial benefit/wage replacement rate and de facto prolong the period during which the benefit can be collected, therefore discouraging job search. To shorten the search period, it would be preferable if benefit recipients start receiving the unemployment benefit immediately after being laid off. Furthermore, active labour market measures should give more priority to supporting job search. Conditions for active job search should be adjusted such that swift re-employment is facilitated in order to avoid putting the sustainability of the unemployment insurance system in danger. To encourage labour mobility further, Estonia could also consider replacing the severance payment system with a compulsory, transferable saving scheme, such as the one recently introduced in Austria.

To prevent the emergence of a high unemployment trap, active job search requirements should be stepped up, with effective sanctions imposed for non-compliance. In other countries, well-designed and targeted measures geared towards engaging workers in job search and reducing search cost have mitigated the disincentives stemming from changes in the unemployment benefit system and have improved unemployment outcomes. Strategies combining job search with selective training programmes seemed to have the greatest impact. Over the medium term, the incentives for firms to create jobs could be further enhanced by reducing the relatively high social security tax and replacing it by less distortionary sources of revenue, including on consumption and real estate.

Finally, to enhance flexibility of labour markets and maintain the competitiveness of the economy, increases of both minimum and public sector wages should reflect productivity gains. More specifically, outside economic expertise could be used in the negotiations between the trade unions and the employers' confederation as a means to de-politicise the process.

Labour market performance of non-Estonian ethnic minorities, who represent a significant portion of the total population, depends to a large extent on language capacity and has been lagging behind for a large part of this group.

Progress in this area is uneven. Important differences remain between the two main ethnic groups. Ethnic non-Estonians have also exhibited markedly worse social indicators than ethnic Estonians, a difference that has widened since independence. Better integration of ethnic non-Estonians into the economy is thus an important challenge.

The income and employment opportunities of ethnic non-Estonians seem to be strongly determined by their command of the Estonian language and language competence is also crucial for obtaining Estonian citizenship. The policies aiming at better integration of this group should therefore expand Estonian language and professional training (including the use of the Internet) for the considerable non-Estonian segment of the population. The work permit process for non-EU foreign workers could be simplified further. ■

How could Estonia's business environment be made even more growth friendly?

Since regaining independence in 1991, Estonia has progressed swiftly to establish a modern market economy. Today, the country is considered to have one of the most open and competitive economies in the world. The dynamism of the business environment is reflected in high rates of firm and job creation, also relative to other European emerging market economies, as well as by large inflows of FDI. Estonia is particularly highly regarded in the area of network readiness, and also scores relatively highly (for its level of development) on measures of corporate governance and transparency. Estonia's good business environment is further supported by e-government, which is considered as the most outstanding example in central Europe, and in several aspects (such as e-governance or delivering e-services for businesses) even exceeds the standards of the OECD countries on average.

However, the share of production in high tech sectors and knowledge-intensive services is still relatively low, and the share of high technology products in exports has slowed. To become a knowledge-based economy, production will need to shift towards knowledge-intensive sectors and productivity gains from innovation will need to drive growth in the future. Moreover, application of the OECD product market regulation (PMR) methodology indicated that the overall product market policies in Estonia were only slightly less restrictive than on average in the OECD countries, signalling room for further reforms to catch-up with best performers.

While acknowledging the significant achievements of past regulatory reform for a business and investment friendly environment, a few specific challenges still need to be tackled:

- Barriers to competition in the electricity sector should be removed. Unbundling of Eesti Energia remains a challenge. Increasing the share of the retail markets open to consumers and creating a liberalised wholesale market should be a priority.

- The impact of limiting the corporate tax liability to distributed profits should be carefully monitored and this tax regulation reconsidered if it is established that serious distortions arise.
- The cost effectiveness of the different programmes supporting business and innovation activities needs to be enhanced. Results of evaluation studies should be more rigorously implemented, including at Enterprise Estonia.
- Private-sector activities in less-developed areas of the country as a driver of growth and poverty reduction should be encouraged, in particular through facilitating a better access to credit for small and medium-sized enterprises. ■

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