PREFACE: RENAISSANCE OF THE SUPPLY-ORIENTED ECONOMIC POLICY THROUGH THE GLOBAL ECONOMIC CRISIS

This is already the 17th publication "Disputes on Estonian Economic Policy" (although published only the third year under this name). The papers have been published on CD-ROM and their summaries in another language in the collection printed on paper media.[1] All papers have been anonymously peer-reviewed by economists from mostly other countries. "Disputes on Estonian Economic Policy" are independent collections of research papers which have been published since 2001 in cooperation by the Berliner Wissenschafts-Verlag publishing house (the former Berlin-Verlag Arno Spitz) in Berlin and the Estonian Mattimar publishing and consultation company.

The aim of the publications is to analyse and evaluate as much as possible the economic developments both in the Republic of Estonia and in the whole European Union. It has become particularly topical this year, considering the crises which have hit the global economy.

Estonia joined[2] the Exchange Rate Mechanism II (ERM II) on 28 June 2004 and has consequently taken the commitment according to the EC Treaty to adopt the euro after meeting the convergence criteria. When joining the ERM II, Estonia was allowed to retain the currency board framework it had followed until that time. The Estonian kroon is exchangeable on the basis of the so-called central exchange rate fixed by the European Central Bank.

Estonia has unfortunately not fulfilled the inflation criterion[3] in the recent years. While movement towards a greater stability of the price level could be observed until 2003, the inflation has considerably increased above all in the course of the last three years, namely from 4.4% (2006) to 6.6% (2007) and further to 10.4% (2008), and has therefore moved farther away again from the reference value of the European economic and monetary union (which was 3.2% in 2008).[4] This dynamics becomes even more evident if we compare the growth rates in two consecutive years: at the beginning of 2007 (ca +5%) and in March 2008 (+11.2%). Such a pressure on inflation is caused above all by the increase in the prices of food products and energy and also from the dramatic increase in regulated prices. Also harmonisation of excise taxes made a contribution to the price increase by almost one percentage point. Development of inflation should be viewed in the context of the very powerful growth of the real GDP, which was 9% on an average in 2000-

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[1] The summary is either in Estonian, German or English according to the choice of the author. The collection has been published in this form (on CD-ROM and on paper) since 2007.

[2] Together with Lithuania.

[3] The inflation rate – according to the harmonised index of consumer prices (HICP) it must not exceed by more than 1.5% the average inflation of three countries with the most stable prices.

[4] Concerning these statistics and those provided below, see: Europäische Zentralbank, Konvergenzbericht [*Covergence Report of the European Central Bank*], May 2008, pp. 31 ff.; The due date for the submission of statistical materials for the Convergence Report was 18 April 2008.

2007. The increasingly strained situation in the labour market has considerably increased unit labour costs: by 8.1% in 2006 and by 18.9% in 2007, which gave additional impulses to the inflation due to increased demand but particularly due to increased costs.

On the other hand, the financial situation of the public sector has been good. The balance of the state budget has been positive in the previous years but has shown a decreasing trend since 2007, namely with respect to GDP: from 3.4% in 2006 to 2.8% in 2007. For 2008 the European Commission forecast a further decrease in the surplus, to 0.4% of the GDP. The debt level decreased respectively from 4.2% in 2006 to 3.4% in 2007 and therefore remained still considerably below the 60% reference value.[5]

Market interest rate[6] is another important monetary policy criterion next to the inflation rate for joining the euro area. As the government debt level of the country is low, no market based on government debt in kroons has developed in Estonia. Therefore there are also no long-term harmonised interest rates and it was possible to state, considering the market interest rate criterion: „there are at present no indications which are sufficiently strong to warrant a negative assessment overall.“[7]

The situation of the Estonian economy has also acquired dramatic features in connection with the global financial crisis and the economic crisis which has developed as a result. In addition to the deepening slowdown of the GDP growth which became evident already at the beginning of 2008, now also the sins of the financial sector are coming to light. Banks make efforts to limit their losses and have offered extremely tough borrowing conditions for some time already. Particularly Swedish banks, such as SEB and Swedbank, which are dominating the market and issued loans too easily during the boom period which has ended by now. The situation of SEB, which has signed loan transactions in the three Baltic countries in total for the value of 18.1 billion euros, has become particularly problematic. Meanwhile, their central office in Stockholm has considerably limited its lending activities. Besides, a special committee has been set up for the timely protection of companies from insolvency in the Baltic states.

Victims of SMS loans are a vivid example of too easy availability of loans in the earlier years. A large number of Estonians have been snared by extremely suspicious entrepreneurs who have no experience in finances and have acquired through mobile phones loans which arrive in just a few minutes. Such borrowers have agreed to usurious interest rates to be able to meet in some way their payment obligations arising from ordinary mortgage loans from traditional banks. When the debtors then

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[5] Also these figures have been provided with respect to GDP.

[6] Market interest rate is defined as the 10-year yield rate of the respective government bonds issued (time remaining to maturity, if appropriate). Such market interest rate is considered to be a criterion on price stability and consequently a criterion for joining the euro, indicating how markets evaluate the will of the candidate countries to maintain their stability.

[7] Europäische Zentralbank, Konvergenzbericht Mai 2008, pp. 37.

delay with the repayments of their SMS loan, debt collection companies, which are often subsidiaries of SMS loan providers, appear and collect the debts without any mercy.

Many construction companies have had to stop their uncompleted construction projects as the possible buyers had no opportunity for further financing (usually due to the inability to repay bank loans). Real estate prices have already dramatically decreased. Lending banks have to write off loans in their balance sheets and show losses.

Similar to other East European countries, Estonia is in a plight as it had a high export-import balance deficit (11.2% of GDP), low foreign currency reserves (ratio of gross reserves to short-term foreign loans only 0.2%), high foreign loans (net position with foreign banks 78.7% GDP) and its economic growth had largely been financed with loans (credits to the private sector +21.5%).[8]

Estonia also has to thoroughly reform its financial sector for its integration with the EU and before joining the currency union. Considering the above-mentioned circumstances, the following requirements should be met or at least thoroughly considered:

– Financing activities of the national economies of different countries have merged into a global structure, therefore countries have to harmonise the regulation of their financial markets and performance of supervision over these markets. It should be done in close cooperation with the International Monetary Fund (IMF) and the Financial Stability Forum (FSF) to create a global advance warning system which would consist of supervisory organisations of different countries, whose duty is to ensure continuous monitoring the activities of the most important banks in their area and to prepare regular risk analyses. This applies first and foremost to single-purpose companies which were established at many places some time ago to perform risky investment transactions off balance sheet.

– More transparency should be brought to financial markets. In the securitisation of loans, the exact risk structures should be clearly identified. Besides, crediting banks should be required to partly assume the risk of losses, comparable to risk for own account in insurance.

– Rating agencies should be subjected to more strict assessment guidelines and the registration obligation. Also hedge funds should be inspected more regularly in the future.

– The Basel II regulations based on formulas for establishing requirements to the equity of banks should be made more flexible to prevent procyclic behaviour in issuing loans, which may become particularly problematic in the decline phase of the economic cycle as demonstrated by the current situation.

– In that respect the *fair value* assessment rules of financial investments should be critically reviewed (if these are applicable). This need emerges particularly in the context of the most recent financial crisis. And bearing in mind the future, we could

[8] IMF, Global Financial Stability Report, October 2008.

also discuss the possibility for suspending even temporarily the disbursements of dividends earned from gains from exchange rates.

– And last but not least – the compensation and bonus systems of bank managers and other heads of companies should be modified to make their income dependent on meeting long-term objectives rather than on short-term success.

The current generally recognised macroeconomic theories and the resulting conceptions of economic policy are often based on assumptions which are far from reality – that markets are permanently efficient and that individuals always proceed from rational considerations. Non-economic motives and irrational behavioural patterns are probably not taken into consideration at all in the currently recognised models. This has led to the situation where the most valid reasons for recurrent crises are mostly ignored. George Akerlof and Robert Shiller rely on John Maynard Keynes in using the concept of „animal spirits“[9], which in their opinion has more effect on economic developments than rational economic factors. „Waves of optimism and pessimism cause considerable changes in general economic demand“. All economic crises are originally driven by psychological factors. What conclusion can be drawn from it? The state has to assume a proactive role in economy and take timely measures against convulsions of the market caused by „animal spirits“. In order to maintain the stability of capitalism, the market should not in principle be left to its own devices. *John Maynard Keynes is dead; long live John Maynard Keynes!*

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[9] Akerlof, G., Shiller, R. Animal Spirits – How Human Psychology Drives the Economy, and Why It Matters for Global Capitalism, Princeton 2009.