

What after the euro?

17.03.2010, 09:55  Read comments (7)

Estonia is going through the tail of what seems to be the perfect storm, but in reality is a giant rebalancing process of dimensions not seen often before, writes Martin Breuer, chairman of Foreign Investors' Council in Estonia.

By the time we join the eurozone in January 2011, we will have gone through a process of impoverishment of historical dimensions. By the time the economy is expected to stabilize Estonia's citizens and companies will have lost more than 20% of their national income, and this all will have happened in a short timeframe of only two years.

As a comparison, during the Great Depression in the first half of the last century the unemployment rate in Germany, Austria and Poland rose to 20% while output fell by nearly 40%. By November 1932 every European country had increased tariffs or introduced import quotas. This inward focus was a reaction to the threat that nations felt, but giving in to protective measures then only increased the harm and prolonged the crisis. The point that I like to make is that we have gone through an even worse perfect storm before and most of what was then the center of the world then afterwards witnessed a very long period of prosperity.

To avoid misunderstanding: the policy choice to enter the eurozone is not what caused the perfect storm we are in, but rather the beacon of the port we have kept our focus on as the destination to sail to. During this storm it became ever clearer how important it is to keep on course.

Nevertheless the magnitude it can be said that Estonia and its citizens are weathering the storm remarkably well, with its social fabric taking only limited damage. Estonia can take pride in this, but at the same time it should be noted that it is highly unlikely that a similar period of contraction could be successfully overcome by society in the near future. There are implications for the choice of policy options available for the future.

Adopting the euro in January next year will definitely bring us into calmer waters, but other than that not much will happen on that magical date. What concerns us most is the fact that the economic growth needed to boost employment and then reach a level of welfare similar to the surrounding nations we admire, will not come by itself!

For economic growth we cannot rely much on internal demand, as wealth has diminished. Growth must come from abroad, through export and trade of goods, services and tourism. For our natural trading partners growth is forecast, but it will be slow, and dimmed by the overcapacity of the economies of our natural trading partners. A drastic improvement of the competitive advantage of Estonia will therefore be a key to growth.

Improvement of our competitive advantage is urgently needed

In order to create this improvement of competitive advantage we have to realize a convincing and sustainable mix of the following variables:

- Higher productivity per unit of labor cost
- Structurally and substantially lower cost of labor in Estonia compared to countries like Finland, Sweden, Denmark, Germany and maybe even Poland will be needed.
- Substantially lower tax levels (income, profit, capital, social) than in the countries that we compete with
- Lower levels of bureaucracy than competitors, resulting in lower operational costs of businesses
- Preferential living and working climate for professionals and an educated workforce (in social, cultural, entertainment (fun to live) terms and in terms of educational opportunities for foreign nationals and their families)
- More flexibility in the operational environment of companies (regulations, permits, labor law, migration and immigration)
- Investment incentives
- Improving Estonia's internationality (education, immigration, English as a second language)
- Better local infrastructure (roads, public transport, digital highway)
- Improved, frequent and reliable air connections for passengers and freight

What the euro will bring

The euro will bring many clear benefits, but also limitations. The impossibility to quickly gain a competitive advantage by adjusting our exchange rate is one of them. While Estonia has never used this mechanism in its recent history it could have done so as a last resort in case of a needed improvement of its competitive position.

Once in the eurozone this possibility is lost more or less forever. This means increasing importance of the other tools we have to boost our competitive position. It also reminds us of the need for a stable and consistent policy with regards to these variables; while for an exchange rate adaption a stroke of a pen is sufficient, the impact of most other tools is felt only in the long run.

Prudence

Prudence in economic policy after joining the eurozone is needed, because a society can endure an adaption process such as the one we are going through at the moment, only once in a generation.

Seven lean years are followed by seven fat years. The saying gives us hope, but it might also warn us to be prudent. Over the past years we have for good reasons chosen to resolve our lack of competitive advantage and the need to contract the self-made bubble in our economy through what is called 'internal devaluation'. In this huge crisis we actually behaved exactly according to the rules all euro countries would have to follow should they end up in a similar situation. Indeed ours will have been the same painful process that Ireland has now only started to go through, and the one that is awaiting Greece and Spain at this moment. Actually, you can say that Estonia (with Latvia) is the true--and, as it seems not unsuccessful--pioneer in this.

Estonia will come out of this perfect storm with one of the lowest debts per capita and per BNP of all European countries. That is a great starting position for the future. Already now many countries envy us for this. But it is also a dangerous position, as it might invite future governments to start irresponsible borrowing, and if that should happen there would be no other remedy than going through the same painful process of contraction again. But as long as government policy remains prudent, we will not allow our economy to overheat again, and if we allow increased migration of labor in Estonia (and Europe) to match demand, a repetition of the storm is unlikely.

The seven fat years might then as well turn out to become 14 healthy years.

FICE - Foreign Investors' Council in Estonia is a lobby group acting on behalf of the Austrian, British-Estonian, Danish, Finnish, German-Baltic, Holland, Norwegian and Swedish Chambers of Commerce, Business Clubs and Marketing Offices in Estonia. Together, the eight countries represented in FICE account for more than 80 % of the total foreign direct investments in Estonia [source: Eesti Pank]. More background on FICE can be found on www.fice.ee



Toomas Hõbemägi@bnaaripaev.ee