SECTION I: ECONOMIC AND EUROPEAN UNION ISSUES

Estonian hyper-crisis lessons confirm importance of more effective high quality coordination/regulation and harmonisation: Mechanism design theoretic approach

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Preface: Meta-remark

From the viewpoint of Modern Political Economics the most powerful economic policy statement by the European Union was made in Lisbon Agenda 2000: the economy should be knowledge based. That means – in modern understandings – that socio-economic institutions (mechanisms, coordination, regulation and rules, etc.) of the EU and member countries should be knowledge based. Meaning that these should be based on modern, high level mechanisms design theory, decision theory, evolutionary economics, and information theory, information technology etc.

In other words, regulations should not be based on ruling incumbent political camps beliefs, pre-election myths and utopias. And mechanisms should not be adapted and changed with the change of ruling political camps, but these should be adapted, enhanced, complemented and their quality enhanced according to the real socio-economic, technological and ecological developments. Political changes may only take place in the sphere the socio-economic desiderata, especially the income redistribution and inequality structure. And most importantly, we have by that to keep in mind Rothstein's (2009) anti-devolutionary third argument: **"*The third argument is that it is unlikely that such mechanisms will be efficiently designed/evolved/adapted endogenously by communicating actors. Moreover, if such institutions have been created, we should expect market agents to try to destroy them.*"**

Coordination theme is the basic socio-economic problem, as Friedman (1962, 12) has postulated: ***"The basic problem of social organization is how to co-ordinate the economic activities of large numbers of people."***

(By the way in macro-economics the dominant general term is “coordination” – “regulation” means a kind of coordination.)

Coordination theme in the Modern Macro-Economics generally belongs to the domains of Evolutionary Economics and Mechanism Design Theories – the first is happily enough more or less a narrative one. But the last one is nowadays rigorously formalized, based on heavyweight mathematics: see e.g. Note (N1) on 2007 Nobel Prize in economics:

“***Mechanism design theory is a branch of game theory*** **(**NB: generally dynamic Bayesian mathematical game theory. ÜE**)** ***… and extends*** (*sic*! *e.g.* on the field of social behaviour, animal spirit *etc.* ÜE) ***the application of game theory to ask about the consequence of applying different types of rules to a given problem.*****”** and see also e.g. (N2) on an example of theoretic optimization model of building of national socio-economic institutional structure.

As the politicians and lawmakers (the implementers of institutions) as a rule don’t know mathematics and hate it and high level tedious scholarship in general, they try, especially in this very crisis period to claim that mathematical macro-economics is to blame as the significant destabilizing factor (lately especially Lord Roland Skidelsky: “***They were preoccupied with sophisticated mathematical models – a serious weakness,...”(***Lunch with FT August 28 2009 and (N3)), and mathematical dismal science is also not able to forecast important socio-economic events and is no good altogether and whatsoever.

But, this is absolutely not true ((N12) Bezemer 2009a), actually slander: first of all, the high level, e.g. Nobel domain, mathematical macroeconomic theories, are in the mainstream credible, these contain all the uncertainties and moral hazards of *animal spirit* in all varieties (limited rationality, strategic manipulative distortion of communication, incompetence, greed etc), and these theories should be implemented especially in the times of crisis (Bezemer 2009b).

For example the extant definition of Maastricht inflation (complex) criterion is methodologically defective: semi-formalized mathematically and therefore non-transparent (restrictive information level is mathematically defined

by +1.5%, but prices stability/sustainability restriction is only vaguely verbally defined and so open for all kinds of interpretations).

And, just in 2008 the Estonian Parliament enacted abortive “advance-payment income tax law”. The law was dynamical (several years interactively involved) and so to be transparent should have been mathematically formalized, it was not, and so in the end on the basis of public protests the law was abolished before enforcement – tens of millions kroons wasted.

But interpretations of excellent mathematical macro-theories by dominating politicians, policymakers, jurists, journalists, spin doctors etc, are generally incorrect caricatures, e.g. (N4). And secondly, there are certainly some distorting biases and divisions in dismal science community globally and locally, on the basis of regrettable biases of independence and divisions towards different political power-camps:

“*Consensus economics does exist. The Obama administration and the Federal Reserve are trying to apply it. The economics professoriate has an obligation to criticize and improve those policies. But if politics is allowed to split the discipline, and communication across that divide continues to break down, the science of economics will forfeit what little respect it still commands.*” – *C. Crook* “*Politics is damaging the credibility of economics*” (FT February 8 09).

1. Introductory remarks: The central dilemma

Wide discussions have already started about the immediate necessity for time consistent adaptations of European economic mechanisms and member counties versions versus mechanisms and multilateral harmonisation on the fresh knowledge base of the crisis lessons: as for greater coordination/regulation and harmonisation, and as for relaxation and liberalization.

Remarkable among first versions-in the Estonian context-has been the paper of FT June 17, 2009 by PM of Finland Matti Vanhanen **„*Europe will need to raise taxes in harmony*”** (N5):

"EU policy with respect to tax competition is currently based on member states refraining from implementing new tax competition measures and on dismantling old measures perceived to be harmful. These codes of conduct are not legally binding. I do not think this could or should be changed. But member countries could agree, for example, to change the levels of certain taxes in parallel. Parallel measures would help all of Europe: tax competition risk would be reduced and the public finances of individual countries would improve. Such co-ordinated tax changes could set also an important global example."

From the mechanism's theories point this is an extremely important paper for Estonia, but alas, has already here received publicly but in the form of sarcastic side-remarks.

And in the same vein the Letter to the FT from the President of the Party of European Socialists Poul Nyrup Rasmussen ***"Sustainable growth requires greater regulation"***: ***"Our future must be based on real jobs in a green economy. We need transparent, highly competitive and low-cost financial markets to serve that purpose. No amount of short-sighted industry lobbying will stop policymakers from pursuing this goal."*** (*etc* (N3)).

In the vein of deregulations the most outstanding publication in the Estonian context seems thus far to be ***"OECD urges rich countries to strive for flexibility"*** By Chris Giles, The Economist March 3 2009. There we may read: ***"The countries should redouble efforts to increase flexibility in labour markets and boost competition even though they are suffering the worst recession since the second world war, ..."***

Arguing that liberalisation was the surest route to a speedy recovery, the Paris-based international organisation locked horns with a vocal group of European economists, who have been extolling the virtues of labour market rigidities as a way of preventing deflation and depression.

Thus, our main dilemma will be: to regulate more, or to deregulate, and where so. To figure out some Estonian solutions, first of all let us look for the Estonian crisis idiosyncrasies.

2. Main Estonian hyper-crisis idiosyncrasies

Estonia started to solve the crisis in the own way

First of all we have to notice that all the Eastern-European countries have their differences and had already applied different varieties of crisis management strategies: ***"That highlights an important problem. Outsiders tend to lump "the ex-communist world" or "Eastern Europe" together, as though a shared history of totalitarian captivity was the main determinant of economic fortune, two decades after the evil empire collapsed. Though many problems are shared, the differences between the ex-communist countries are often greater than those that distinguish them from the countries of "old Europe" (The Economist "The whiff of contagion". Feb 26th 2009.*** (N8).

Estonian crisis started relatively earlier and was foreseeable

In the second half of 2007 Estonian exports actually began to decline in real terms (according to the Eurostat). In particular, the decrease of competitiveness began because of relatively much higher inflation than in partner countries (without increase in the quality the products of services). The export crises worsened due to the start of the global financial crisis in 2008, and unemployment started to increase rapidly. As the Government started to alleviate the crisis by severe cuts of the budget, the local demand also started to decline and GDP started to fall rapidly "and so on" in repeating cycles.

The Economist regular Table "Output, prices and jobs" implicitly classified/s Estonia in 2009 and at the moment into the group of most high magnitude crisis countries, as in the EU and more broadly as well. Although the indexes may be roughly approximate, we may still with great certainty claim that the combined magnitude of the Estonian complex crisis is at the moment 2-3 times higher than in the EU member countries in general (for Estonian QIII 09 statistics in more details see (N9): it is important to add that according to the Bank of Estonia Statistics, Estonian national gross external debt has been in the last years and is presently excessively high - about 120-140% of GDP, and the Current account deficiency has been chronically relatively high, international investment position retreating etc;

according to Eurostat economic Inequality index by quintiles barbarically high etc.

Truth value of Estonian public socio-economic knowledge structure is at the moment low.

Examples: *Estonian research paper on euro-area accession from TUTWPE 2005 (133): M. Sõrg 2005. Estonia's Accession to the EMU.*

Abstract. ***E countries have passed the process of transition to market economy and eight of them, including Estonia, joined the European Union in 2004. Estonia has been very successful in the transition process, mainly owing to the currency board-based monetary system, which serves as a signal of commitment to prudent monetary policy and as a guarantee of sound money during the transition period. The current paper discusses the thirteen years of experience in operating the currency board – based monetary system in Estonia. Estonia's accession to the European Union will soon be accompanied by membership of the Economic and Monetary Union (EMU). The article also explains why Estonia wants to join the EMU as fast as possible and what the prospects are to do it on time – at the beginning of 2007.***

Notice that in this very late 2005 paper the Abstract contains no word that Estonia started to spoil Maastricht inflation criterion already in 2004 and continued so in 2005, and high inflation risk is not discussed in the text and the plan to join euro at the beginning of 2007 was roughly abortive because of this criterion, although immense resources were spent for preparations. Notice also that Prof Sõrg was – at the time the paper was written – the Head of the Board of the Bank of Estonia. See also (N12).

Much boast about "Baltic Shining Star" and slander on the addresses of other member states

E.g.: "Openeurope" 2006 (p.7) "Beyond the European Social Model": ***"Meelis Kitsing notes that success in the information economy has made the Nordic model "as hot as stones in a sauna" among EU policymakers. But studies which try to show a link between Nordic welfare systems and the information economy suggest that this is less of a "model" and more***

of a coincidence. He argues that success stories like Nokia can be explained by getting a few big things like telecoms regulation right, and also by the "gales of creative destruction" unleashed on Scandinavia in the early 1990s by the collapse of the Soviet Union. He argues that if poorer member states want to break into the new economy they should learn from low-tax Estonia instead. He notes the story of the revolutionary telecoms company Skype: technology developed entirely in Estonia - by entrepreneurs who had left Denmark and Sweden."

By the way, low are only Estonian 0-profit taxes, and just this "low-tax" thing forced the Estonian Government to implement high inflationary and money illusionary policies, and may be blamed for relatively excessive crisis phenomenon at the moment, and more importantly – the probabilities of successes certainly depend on development of information technology.

And there is no credible proof whatsoever known till now that low-tax system helped Estonia "to break into the new economy" in other ways.

All kinds of "high-octane power-brain" geniuses from all political camps are regularly flooding the entire mass-media just before elections with cascades of irresponsible, incompetent, populist, socio-economic gibberish.

In the Estonian mass-media the strange caricatures of socio-economic realities are customarily circulating:

E.g.: ***(the EU) = (the SU)***

– perhaps one explanation for that kind of slander can be found in: ***"Stalin still looms large over eastern Europe" By Stefan Wagstyl FT August 30 2009: "Lies are allowed to multiply with, for example, an official historian recently denying the 1940 occupation of the Baltic states took place and saying they joined the Soviet Union voluntarily."***

The problem is that the Estonian Press has considerable commercial interest connected with the large Russian speaking Diaspora, many with very strange irredentist beliefs of anxieties about market economy and the EU expansion to Estonia (Ott and Ennuste 1996).

No research centres for macroeconomic studies in Estonia, R&D expenses pc are magnitude lower than in Nordic countries

Unfortunately, the current system of financing universities is such that universities are not at all interested in (independent) macro-economic research activities. There is an extreme shortage of second-degree macro-economists in Estonia.

On the basis of these idiosyncrasies, I am trying schematically to tackle enhancements and complementation problems of the three most urgent regulation and harmonisations areas: Maastricht criteria, tax system, and communication mechanisms; mainly on the basis of the following concepts of mechanism design theory:

* Combined vertical (included hierarchical e.g.: Brussels > Baltic Rim > Estonia) and horizontal (e.g.: Estonia-Finland-Sweden-Russia) coordination;
* Complex and parallel coordination networks (e.g. governmental and nongovernmental, optimally detailed, updated);
* Complex coordinating instruments (e.g. material and moral); *Complex coordinating principles (e.g. incentives and constraints, bargaining, consultations, updated);
* Complex incentive and restriction mechanisms and consultations.

3. Most urgent Estonian regulation and harmonization strategies and conceptions

A. The Maastricht inflation criterion amendments

*Criterion** consists of economic quantitative component: anchoring of the three best national averages of annual inflation + 1.5 percentage points. Secondly, it includes a qualitative not numerically calibrated component: requirement for the sustainability of prices where the “sustainability” and “prices” are not rigorously defined and specified and so offers ways for diverse political interpretations and manipulations. This methodological error has to be corrected by the Commission immediately.

In addition to that the Commission has to rigorously formalize the definition of the price stability for the case of deflation (crisis period).

But one thing is certain: theoretically in 2009-2010 prices instability is high in Estonia and according to extant criterion it is not transparent; is it unfulfilled or fulfilled, or what will be the respective probability?

* **Note**: The inflation criterion is formally set out in Article 1 of the Protocol is the Convergence Criteria of the Maastricht Treaty (European Union, 1992b: 29-30): [A] *Member State has a price performance that is sustainable and an average rate of inflation (observed over a period of one year before the examination) that does not exceed-by more than 1 1/2 percentage points - that of, at most, the three best performing Member States in terms of price stability.*

B. New member countries tax-systems harmonization should be more rigorous

Matti Vanhanen is absolutely right (FT June 17 “Europe will need to raise taxes in harmony”) claiming:

“We should avoid tax competition and the damage this would cause to Europe’s economic growth.” Understandably this kind of damage comes first of all from incompetent competition instead of rationally coordinated cooperation between the partner countries, as e.g. Prof Krugman has proved.”

It is easy to see that in given case the incompetence that he had in mind comes from Baltic-States, first of all from Estonia (0-profittax). And it seems evident that these countries are not yet mature enough to design a civilized tax systems. In other words the Baltic-Rim falls short of the more advanced Nordic-Counties model (rational cooperation between countries in the region and avoiding political instability in the country via excessive income inequality etc). Thus it is first of all in the interest New-Member sustainability to introduce, without any delay, a more rigorous taxing harmonization, to save some countries from deepening their socio-economic degeneration.

C. Conceptual suggestions for designing optimal public socio-economic communication mechanism

*See (N10) and following Abstract about this theme (**Keywords: Public socio-economic knowledge structure, Complex implementation, Side-payments, Moral and material incentives, Voluntary webs, Optimal coordination structure, Coordination magnitude, Over-coordination, Under-coordination, Substitute- and complementary coordination instruments**):*

This note discusses implementing mechanism design Conceptions compiled for Optimizing public socio-economic information structures. Also proposed for discussion is the meta-synthesis concept that emphasizes compiling methods with the imitation variety of implementations of theoretical models and empirical evolutionary principles of real world mechanisms.

The main idea of the proposed design is to sequentially and adaptively coordinate reasonable learning and private information disclosure of the actors with the help of stimulating their reporting credibility (non-Distorting with sufficient disclosure and transparency) and respectfulness for incoming reports (reasonable learning from credible actors). Incentives and constraint may be heterogeneous: relevant material and moral side-payments etc and consultations and informational constraints.

The main Suggestion is to complement extant respective public reporting coordination mechanisms with more complex instruments, especially moral ones with voluntary and non-governmental monitoring Webs" (Ennuste 2009).

4. Summary: under-coordination and low quality harmonization stunt Estonian socio-economic sustainability probabilities

First, For recovery of hyper-crisis perhaps Estonia shouldn't all together rush to exit from the variety of significant, direct regulation mechanisms and instruments like fiscal stimulus and monetary relaxation, intervention policies etc, categorically. Perhaps it is not yet too late to ensure a proper sequencing of these instruments complementary to budget cuts, with the goal of preventing a hyper- unemployment (20%), massive euro loan-

bankruptcies of households and double-dip recession. This, first of all based on domestic recourses (e.g. from Bank of Estonia, State-bonds etc).

Second, Estonia should instantly rush to establish "harmonization" with the EU Commission regarding the amendment of the extant Maastricht inflation criterion: in present form it is methodologically defective, non-transparent, and with that may be cause irretrievable socio-economic and credibility losses for Estonia; and perhaps in the crisis situation, it may be rational for Brussels to move beyond a rigorous adherence to the whole stability and growth pact altogether (see also: *Sapir, A. (Editor) 2009 Sept. Bruegel memos to the new Commission: Europe's economic priorities 2010-2015*).

Third, reform of the Estonian tax system is probably necessary instantly: in the sense of harmonization of investment competition with member countries, for enhancement of Estonian socio-economic sustainability, lowering the risks of domestic capital flight without domestic taxing and avoiding worsening of the Estonian International investment position. And most importantly, presently there is a lack of coordination between income tax law and national pension law, etc.

Fourth, the crisis has shown that macroeconomic policy in the Baltic Rim region needs to be better coordinated regionally, especially when it comes to protection of the Baltic Sea from Russian "sub-military" seabed actions; and for post-crisis management, e.g. about „free" movement of "all kinds" of labour, credit, investments, financial obligations etc, considering seemingly growing economic differences between the Baltic- and Nordic-Countries in after-crisis etc (by the way: to alleviate euphemistically these inequalities the Eurostat is using imaginary PPS "parity-prices" – actually local deflators).

Fifth, the extant low quality coordination mechanism of the Estonian public knowledge space building and communication should be basically adapted to IT and liberal non-censorship conditions and made more efficient. Unfortunately, e.g. at present such significant indicators as Estonian high national gross external debt, current account being chronically relatively in high deficiency, international investment position retreating, Estonian economic inequality quintile index barbarically high compared to nearby Nordic countries, The Estonian tax system and inflationary budget policy,

the hidden strategy (ironically) “survival in the crisis only for richest” etc are theoretically non-sustainable etc. These indexes and facts are, alas, in an overshadowed/postponed position making them unavailable to the Estonian public knowledge space by administrative and incumbent political camp rhetoric, by the Estonian mass media and by administrative statistics. Thus helping to play down cognition of the real severity of the present socio-economic hyper-crisis situation, and not enabling making high quality forecasts – and in turn significantly magnifying the national socio-economic sustainability risks.

Unfortunately, most of the suggested points stand no chance of easy implementation. Adopting these policies would require high competence and quality of political leadership, Estonian leaders, according by existing policies, lack these qualities, and the current Commission staff in Brussels seemingly prefers (by existing policies) not to notice these local objective idiosyncratic, shortcomings of economically insignificant countries in the bilateral consultation and harmonization processes.

Caveat: All arguments are based purely on theoretical and public knowledge, no administrative and political inside information has been involved.

Notes and Extracts

(N1) Nobel Museum 2007: **Press Release**

“The Royal Swedish Academy of Sciences has decided to award The Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel 2007 jointly tom **Leonid Hurwicz,** University of Minnesota, MN, USA, **Eric S. Maskin,** Institute for Advanced Study, Princeton, NJ, USA and **Roger B. Myerson,** University of Chicago, IL, USA *"for having laid the foundations of mechanism design theory."*

The design of economic institutions

Adam Smith's classical Metaphor of the invisible hand refers to how the market, under ideal conditions, ensures an efficient allocation of scarce resources. But in practice conditions are usually not ideal, for example, competition is not completely free, consumers are not perfectly informed

plus privately desirable production and consumption may generate social costs and benefits. Furthermore, many transactions do not take place in open markets but within firms, in bargaining between individuals or interest groups and under a host of other institutional arrangements. How well do such different institutions, or allocation mechanisms, perform? What is the optimal mechanism to reach a certain goal, such as social welfare or private profit? Is government regulation called for, and if so, how is it best designed?

These questions are difficult, particularly since information about individual preferences and available production technologies is usually dispersed among many actors who may use their private information to further their own interests. Mechanism design theory, initiated by **Leonid Hurwicz** and further developed by **Eric Maskin** and **Roger Myerson**, Has greatly enhanced our understanding of the properties of optimal allocation mechanisms in such situations, accounting for individuals' incentives and private information. The theory allows us to distinguish situations in which markets work well from those in which they do not. It has helped Economists identify efficient trading mechanisms, regulation schemes and voting procedures. Today, mechanism design theory plays a central role in many areas of economics and parts of political science."

(N2) Ennuste 2003: **A Linear Planning Analysis of Institutional Structure in the Economy: Abstract**

The paper uses the paradigms of the New Institutional Economics to quantify a linear optimal choice model as a way of designing perspective institutional clusters for a national economy. This model uses binary integer institutional choice variables and structural parameter values based on subjective probabilities collected from experts by calibration questionnaires. The optimisation goal may be e.g. a high expected probability of stable national economic performance under socio-economic development-credibility constraints, dependent on the realization of prospective significant events. The model may be useful as a complementary tool for the social design of the effective institutional structure, and especially for evaluation of the socially optimal values of co-ordinating shadow prices and implementing side-payments in the political institutional design game. We use the Estonian case as an example. The model variables and data calibration table illustrations are provided mainly to demonstrate the broad spectre of issues that may be involved in this analysis.

Journal of Economic Literature Classification numbers: B4, D71, E5, K0, P3, F15.
Keywords: The New Institutional Economics, market design, comparative institutional analysis, economic sector institutional design, institutional structures, credibility effects, linear programming, implementing side-payments, co-ordinating shadow prices, computational economics, data calibration.

(N3) Skidelsky 2009: "For 30 years or so Keynesianism ruled the roost of economics – and economic policy. Harvard was queen, Chicago was nowhere. But Chicago was merely licking its wounds. In the 1960s it counter-attacked. The new assault was led by Milton Friedman and followed up by a galaxy of clever young disciples. What they did was to reinstate classical theory. Their "proofs" that markets are instantaneously, or nearly instantaneously, self-adjusting to full employment were all the more impressive because now expressed in terms of mathematics. Adaptive Expectations, Rational Expectations, Real Business Cycle Theory, Efficient Financial Market Theory – they all poured off the Chicago assembly line, their inventors awarded Nobel Prizes. No policymaker understood the math, but they got the message: markets were good, governments bad. The Keynesians were in retreat. Following Ronald Reagan and Margaret Thatcher, Keynesian full employment policies were abandoned and markets deregulated. Then along came the almost Great Depression of today and the battle lines are once more drawn."

(**N4) Wickens 2009**: "The problem is not with the theory but with its interpretation. Nobody believes that people are rational or that they are identical. These are just simplifying assumptions to make the analysis of complicated economies more tractable.

From time to time economies are hit by large shocks. What we have learnt from the current crisis is that it is crucial to have financial systems that correctly price the risks that these shocks generate, to have appropriate regulatory structures in order to avoid bank failures and to use the theory to stabilise the macro-economy in the short term."

(N5) Vanhanen 2009: **Europe will need to raise taxes in harmony:** "The global recession is forcing Europe to re-evaluate the co-ordination of

economic policies. Surviving the present crisis, ensuring the sustainability of European countries' public finances and maintaining the continent's competitiveness will compel us to co-operate more deeply than ever before.

We have to initiate discussions at the European Union level about how to prepare for the post-crisis period. Getting public finances in order is a must if we are to grow, create employment and provide the welfare services that we in Europe value so much.

After the recession, we will have to reduce elevated public debt-to-GDP ratios if we are to cope with the expenditure pressures that will come with the aging of EU's population. This will require tight control and, in many countries, painful cuts. However, it would be unrealistic to assume that all the balancing could be done on the spending side alone.

The overall tax rate will have to rise as well over the longer term. In some areas that can be done without much consultation between the countries. …………………………………………………………………………...

I am not advocating overall tax harmonisation. But I believe that in the taxation examples we should follow what we did in the banking policy and fiscal stimulus last autumn. In both areas, EU member states decided to co-ordinate their policies in important ways. Decisions to provide banks with guarantees and capital injections, and to create national stimulus packages of a certain minimum scale, have proved important in stabilising Europe's financial system and arresting a free-fall in economic activity.

These measures were not based on the authority of the Union but on the fact that member states considered parallel measures and recommendations to be sensible policy. The same co-ordination will be needed to balance public finances after the recession. It is important that different countries do not find themselves with very different tax solutions. We should avoid tax competition and the damage this would cause to Europe's economic growth.

EU policy with respect to tax competition is currently based on member states refraining from implementing new tax competition measures and on dismantling old measures perceived to be harmful. These codes of conduct are not legally binding. I do not think this could or should be changed. But

member countries could agree, for example, to change the levels of certain taxes in parallel. …"

(**N6) Rasmussen 2009**: "Sir, Jonathan Russell, chairman of the European Private Equity and Venture Capital Association, misunderstands the European Union treaties when he attacks proposed the EU regulation of private equity funds for allegedly undermining their free movement of capital principle ("Private equity attacks EU plan", June 27).

The EU's free movement principles are meant to apply to the European single market, not the world. The forthcoming European directive will indeed introduce a uniform regime to enable the marketing of alternative funds to professionals across the entire European single market.

Business as usual is not an option. We cannot afford financial crises of this kind in the future, causing the worst recession since the 1930s. I believe moves towards regulation in the EU and US will lead to a welcome regulatory convergence at the global level, which will benefit us all. Private equity executives - who (by their own admission) pay less tax than their cleaners - have generated moral outrage at their use of offshore tax havens to avoid paying their fair share. If the UK's Financial Services Authority has not been able to review the exposure of funds until now, it is because they are located offshore. …"

(N7) Giles 2000: OECD urges rich countries to strive for flexibility. The Organisation for Economic Co-operation and Development said on Tuesday that "Rich countries should redouble efforts to increase flexibility in labour markets and boost competition even though they are suffering the worst recession since the Second World War."

Arguing that liberalisation was the surest route to a speedy recovery, the Paris-based international organisation locked horns with a vocal group of European economists, who have been extolling the virtues of labour market rigidities as a way of preventing deflation and depression.

Klaus Schmidt-Hebbel, OECD chief economist argued: "More flexible product and labour markets are likely to strengthen country resilience to weather future downturns with less disruption to output and employment."

But the OECD did not limit itself to its perennial calls for greater economic flexibility in its latest "going for growth" report.

It also identified higher spending on infrastructure, increased spending on training and reduction of personal income taxes for low earners as policies that gave a "double-dividend" of limiting the depth of the recession and boosting longer-term growth prospects.

The list will please the new US administration of Barack Obama since it reflects much of the thinking behind Washington's stimulus plan.

The OECD also says that recessions have previously proved a good time to introduce reforms because the complacency and inertia of good times is swept away, "although it is easier to cope with adjustment costs of reform when the economy is strong".

The main message of the report is that the drive for economic flexibility must continue. Flexible markets for goods and services "will induce producers to cut profit margins", lower prices will help to support demand", the OECD argues, that flexible labour markets allow workers to agree to lower wages, which will protect jobs.

The US (the report concludes) has tended to rebound form recessions faster because it has been more flexible even if its original downturn was deeper.

Mr Schmidt-Hebbel insists that "the debacle in financial markets does not call into question the beneficial effects of recommended reforms of product and labour markets in this report". It urges countries to avoid policies that allow people to lose contact with the world of work.

In the early 1970s, many European countries responded to the recession with early retirement programmes, something the OECD said, "proved to be a failure".

"Attempts to cut unemployment by reducing labour supply would prove as damaging as in the past and leave our societies poorer; keeping markets

open and avoiding new protectionism is key to strengthening prosperity throughout the world," Mr Schmidt-Hebbel insisted.

The difference between the OECD's view and those who have praised rigidities – such as professor Paul De Grauwe of the University of Leuven – is that the latter worry that debt remains fixed in a downturn and so flexibility in other prices and wages potentially increases its burden.

The OECD argues that rigidities take their toll on company profits and will end up-raising unemployment even higher, in any case exacerbating the problem of debt. Its solution is to urge compulsory training for those out of work, big spending on infrastructure if it can be introduced quickly and improves the efficiency of the economy, and tax cuts to boost the spending power of low earners when borrowing is constrained.

Separately, the OECD says the gap between underlying US and European economic performance, which opened up in 1995, might have closed, ending an unusual decade where the US appeared miles ahead of Europe in boosting productivity and household incomes.

(N8) "*The whiff of contagion" 2009:* "… At one extreme is Russia, which enjoyed huge external surpluses thanks to its wealth of raw materials. But its big companies borrowed lavishly on the strength of that, creating a potential short-term debt problem. Russian corporate borrowers have to pay back around $100 billion this year. At the other extreme lie countries such as Slovakia. They attracted billions from foreign car manufacturers, drawn by a skilled workforce, low taxes and decent roads in the heart of high-cost Europe.

(N9) Bank of Estonia:

		01/15/10				
				% change comparing to		
		Period /as of		previous period	same period of previous year	Source
1.	**GDP [1]**					**SA**
1.1.	current prices (EEK mln)	III/2009	53,224.5			
1.2.	constant prices (EEK mln)	III/2009	33,720.8	-4.5	-15.6	
2.	**Industry**					**SA**
2.1.	Volume index of industrial production (at constant prices (2005=100); %)	III/2009		2.9	-27.4	
3.	**Investments in fixed assets (at current prices; EEK mln)**	**III/2009**	**6340.4**	**6.6**	**-26.1**	**SA**
4.	**Construction**					
4.1.	Construction activities of construction enterprises (at current prices; EEK mln)	III/2009	10096	-.4	-35	SA
4.2.	Usable floor area of completed dwellings (thousand m^2)	III/2009	76.9	-8.8	-10.1	
4.3.	Usable floor area of non-residential buildings (thousand m^2)	III/2009	156.3	-42.0	-40.3	
5.	**Consumption**					
5.1.	Retail sales volume index (at constant prices, 2005=100; %)	III/2009		-5	-17	SA
5.2.	New registration of passenger cars (pieces)	IV/2009	5,178.0	-4.5	-34.6	ARK
6.	**Prices**					
6.1.	Consumer price index (%)	IV/2009		-0.4	-2.0	SA
6.2.	Producer price index (%)	III/2009		0.4	-1.6	SA
6.3.	Export price index (%)	III/2009		0.0	-5.2	SA
6.4.	Import price index (%)	III/2009		2.6	-7.1	SA
6.5.	Construction price index (%)	III/2009		-1.4	-10.5	SA
6.6.	Estonian kroon real effective exchange rate index (REER; %)	IV/2009		-0.7	0.3	EP
7.	**Labour market and wages**					
7.1.	Employment rate (employed persons/working-age population, %; based on the Labour Force Survey) [2]	III/2009	57.6	57.0	63.3	SA
7.2.	Unemployment rate (unemployed/labour force, %; based on the Labour Force Survey) [2]	III/2009	14.6	13.5	6.2	SA
7.3.	Registered unemployed	IV/2009	83868	14.5	217.7	TK
7.4.	% of workforce [2]	IV/2009	12.8	11.1	4.0	TK
7.5.	Average monthly gross wages and salaries (EEK)	III/2009	11770	-7.4	-5.9	SA
8.	**General government budget [3]**					**RM**
8.1.	revenue (EEK mln)	IV/2007	25,768.0	1.3	21.6	

8.2.	expenditure (EEK mln)	IV/2007	26,887.0	30.0	17.0	
8.3.	balance (+/-; EEK mln) [2]	IV/2007	-1,119.0	4,759.2	-1,804.7	
8.4.	Period's revenue to the planned annual revenue (%) [2]	IV/2007	29.1	28.8	29.5	
9.	**Transport**					**SA**
9.1.	Carriage of passengers (thousands)	III/2009	48,572.0	8.8	-1.2	
9.2.	Carriage of goods (thousand tons)	III/2009	18790	1.6	-15.7	
10.	**Tourism, accommodation**					**SA**
10.1.	Visitors from foreign countries received by Estonian travel agencies (thousands)	III/2009	305.5	16.7	-9.5	
10.2.	Visitors sent to foreign tours by Estonian travel agencies (thousands)	III/2009	103.5	-14.0	-32.7	
10.3.	Accommodated visitors (thousands)	III/2009	755.7	33.1	-9.2	
10.4.	o/w foreign visitors (thousands)	III/2009	511.7	33.2	-1.8	
11.	**Foreign trade (special trade system)**					**SA, EP**
11.1.	exports (EEK mln)	III/2009	25,815.5	1.3	-25.0	
11.2.	imports (EEK mln)	III/2009	28,873.6	4.6	-33.9	
11.3.	balance (EEK mln) [2]	III/2009	-3,058.1	-2,132.7	-9,250.6	
11.4.	Foreign trade balance/exports (%) [2]	III/2009	-11.8	-8.4	-26.9	
12.	**Balance of payments [2]**					**EP**
12.1.	Current account balance (EEK mln)	III/2009	3,519.3	3,443.8	-4,402.6	
12.2.	Current account balance to GDP (%)	III/2009	6.6	6.4	-6.9	
12.3.	Foreign direct investment inflow (EEK mln)	III/2009	1,175.3	392.0	4,775.6	
12.4.	Foreign direct investment outflow (EEK mln)	III/2009	-3,718.2	-3,706.7	-2,996.6	
13.	**International investment position (at end-period)**					**EP**
13.1.	Net international investment position (EEK mln)	III/2009	-176,818.9	-3.4	-8.3	
13.2.	Direct investment in Estonia (EEK mln)	III/2009	166,580.2	-1.4	-9.3	
13.3.	Gross external debt (EEK mln)	III/2009	273,537.6	-2.7	-7.2	
13.4.	o/w government (EEK mln)	III/2009	10,132.1	-3.8	23.5	
14.	**EEK/USD average quarterly exchange rate**	**IV/2009**	**10.6**	**-3.3**	**-11.1**	

[1] *Preliminary estimation of the GDP growth has been calculated according to the new methodology. Whereas, Statistics Estonia previously calculated the GDP growth at the constant prices of fixed year 2000, since 2008 the growth is calculated by chain-linking method in which the year preceding the accounting period is applied as a base year.*
[2] *Instead of changes comparing to previous periods, absolute figures for the periods are shown by this indicator.*
[3] *Net borrowing is not included here.*

Source: SA – Statistical Office of Estonia; ARK – Motor Vehicle Registration Centre; EP – Eesti Pank /Bank of Estonia; TK – Estonian Unemployment Insurance Fund; RM – Ministry of Finance EKI – Estonian Institute of Economic Research

(N10) Pope Benedict XVI's "Caritas in Veritate": The Problem with Globalization is Man's Selfish Use of Markets

The Pope on "Love in Truth" by Father Robert Sirico from the Wall Street Journal is a penetrating analysis of Pope Benedict XVI's latest encyclical on the economic crisis, "Caritas in Veritate".

Sirico points out that Pope Benedict doesn't condemn markets, globalization - but rather man's selfish uses of these instruments.

<u>Caritas in Veritate</u> by Pope Benedict XVI

<u>Democrats Link Pope's 'Economic Justice' Plea With Obama Agenda</u>

Caritas in Veritate is an eloquent restatement of old truths casually dismissed in modern times. The pope is pointing to a path neglected in all the talk of economic stimulus, namely a global embrace of truth-filled charity.

Benedict rightly attributes the crisis itself to "badly managed and largely speculative financial dealing." But he resists the current fashion of blaming all existing world problems on the market economy. "The Church," he writes, "has always held that economic action is not to be regarded as something opposed to society." Further: "Society does not have to protect itself from the market, as if the development of the latter were ipso facto to entail the death of authentically human relations."

The market is rather shaped by culture. "Economy and finance . . . can be used badly when those at the helm are motivated by purely selfish ends."

(N11) ***Samuel Bowles and Sung-Ha Hwang 2008***: „Social preferences such as altruism, reciprocity, intrinsic motivation and a desire to uphold ethical norms are essential to good government, often facilitating socially desirable allocations that would be unattainable by incentives that appeal solely to self-interest. But experimental and other evidence indicates that conventional economic incentives and social preferences may be either complements or substitutes, explicit incentives crowding in or crowding out social preferences. We investigate the design of optimal incentives to contribute to

a public good under these effects would make either more or less use of explicit incentives, by comparison to a naive planner who assumes they are absent."

(N12) Bezemer 2009: Understanding Financial Crisis Through: Accounting Models

Table 1: Anticipations of the Housing Crisis and Recession
Analyst Capacity Forecast

Dean Baker, US co-director, Center for Economic and Policy Research: "… plunging housing investment will likely push the economy into recession." (2006).

Wynne Godley, Distinguished US Scholar, Levy Economics Institute of Bard College: "The small slowdown in the rate at which US household debt levels are rising resulting form the house price decline, will immediately lead to a …sustained growth recession … before 2010". (2006). "Unemployment [will] start to rise significantly and does not come down again." (2007).

Fred Harrison, UK Economic commentator: "The next property market tipping point is due at the end of 2007 or early 2008 …The only way prices can be brought back to affordable levels is a slump or recession." (2005).

Michael Hudson, US professor, University of Missouri: "Debt deflation will shrink the "real" economy, drive down real wages, and push our debt-ridden economy into Japan-style stagnation or worse." (2006).

Eric Janszen, US investor and *iTulip* commentator: "The US will enter a recession within years" (2006). "US stock markets are likely to begin in 2008 to experience a "Debt Deflation Bear Market." (2007).

Stephen Keen, Australian associate professor, University of Western Sydney: "Long before we manage to reverse the current rise in debt, the economy will be in a recession. On the basis of current data, we may already be in one." (2006).

Jakob Brøchner Madsen & Jens Kjaer Sorensen, Denmark professor & graduate student, Copenhagen University: "We are seeing large bubbles and

if they burst, there is no backup. The outlook is very bad." (2005). The bursting of this housing bubble will have a severe impact on the world economy and may even result in a recession." (2006).

Kurt Richebächer, US private consultant and investment newsletter, writer: "The new housing bubble – together with the bond and stock bubbles – will invariably implode in the foreseeable future, plunging the U.S. economy into a protracted, deep recession" (2001). "A recession and bear market in asset prices are inevitable for the U.S. economy… All remaining questions pertain solely to speed, depth and duration of the economy's downturn." (2006).

Nouriel Roubini, US professor, New York University: "Real home prices are likely to fall at least 30% over the next 3 years"(2005). "By itself this house price slump is enough to trigger a US recession." (2006).

Peter Schiff, US stock broker, investment adviser and commentator: "[t]he United States' economy is like the Titanic ...I see a real financial crisis coming for the United States." (2006). "There will be an economic collapse." (2007*).*

Robert Shiller, US professor, Yale University: "There is significant risk of a very bad period, with rising default and foreclosures, serious trouble in financial markets, and a possible recession sooner than most of us expected." (2006).

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