

Andres Lipstok: Estonia's economic environment and central bank activities

Speech by Mr Andres Lipstok, Governor of the Bank of Estonia (Eesti Pank), at the the presentation of Bank of Estonia's 2008 Annual Report to the Riigikogu, Tallinn, 11 June 2009.

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Dear Riigikogu,

Thank you for the possibility to present you Eesti Pank's 2008 Annual Report. I am going to start with a brief retrospect of the Estonian economic environment and then address issues concerning the activities of Eesti Pank.

The Estonian economic environment in 2008 and 2009

2008 was an exceptional year in the world economy. Developed economies have not faced the risk that banking and financial markets could collapse and the global financial system stop functioning since the beginning 1930s. But the financial crisis, which was caused by previous years' incorrect decisions, made this a very likely scenario. In the final months of the past year major banks were too afraid to lend money to each other and trading with private-sector bonds nearly ceased. Loss of confidence in financial markets, loan losses amounting to 3-4 billion dollars and a sharp decline in crediting the private sector had an immediate impact on global trade, investment and economic growth. Global trade contracted 17% in the fourth quarter of 2008 and at the beginning of this year.

Major central banks and governments have taken unprecedented steps to alleviate the economic situation. The Federal Government and the central bank of the USA have channelled funds worth over 787 billion dollars into banking and the private sector. In the European Union, the fiscal stimulus amounts to 1.8% of GDP and to 225 billion euro. Banks have received direct support and state guarantees in the amount of 393 billion euro. Such massive intervention has put brakes on the rate of recession.

The past couple of months' stabilisation in the global economy has come at a high price. Major economies face rapidly expanded fiscal deficits and central banks' balance sheets and total volume of base money have promptly increased. Therefore it cannot be said for sure whether the current "green shoots" refer to a new growth cycle. Only structural reforms and maintaining confidence in fiscal and monetary policy can help the economy out of the crisis on a more permanent basis.

When speaking about this year's forecasts, the EU economy as a whole is expected to undergo a 4% recession. Small economies which are more dependent on exports and international capital flows suffer from the crisis disproportionately more. Sweden and Finland, our close neighbours, can expect a recession of up to 4.7%. As we know, the global financial crisis and the collapse of markets caused serious difficulties to several new Member States.

It is clear the events that took place at the end of the last and at the beginning of this year were real challenges for the Estonian monetary and financial system, testing their resilience and ability to adjust to the changing external environment. Today I dare to look at the situation with moderate optimism and repeat what has already been said in March: Estonia has all the possibilities of successfully passing through the crisis.

Estonia's monetary policy and financial stability in 2008

Turning to the tasks of Eesti Pank, I would like to start with an overview of the functioning of the monetary policy framework. The objective of Eesti Pank, member of the European System of Central Banks, is to ensure price stability in Estonia. To this end, we rest on the currency peg to the euro, the currency board arrangement and the EU exchange rate mechanism ERM II. The success of this system is confirmed by the slowdown in the price rise which started in 2008, and the halt in the growth rate of consumer prices in recent months. Looking ahead, Eesti Pank forecasts the price level to decline somewhat in both this and next year. It is clear the Estonian monetary policy or the monetary policy framework will not and must not be changed. The exchange rate of the Estonian kroon will remain as it is and we will accede to the euro area at the current exchange rate. I would also like to stress that price stability is one of the most important factors supporting economic growth.

The second main objective of Eesti Pank is to support the stability of the financial system, especially the credibility of the banking system. Similarly to choices made in monetary policy, Eesti Pank has over the years proceeded from clear and comprehensible principles also in banking. We have firmly supported the common banking market of the EU and the Nordic-Baltic region. In addition, we have emphasised the relevance of the capitalisation and liquidity of the banks operating here. Eesti Pank kept the obligatory minimum capital adequacy ratio at the level of 10% and increased the reserve requirement to 15% of the total liabilities of a bank.

Against this background I dare to say that so far the banking sector has coped well with the crisis. The average capital adequacy ratio of the Estonian banking sector is currently above 22%. The capitalisation of the subsidiaries of the banks operating in Estonia is absolutely sufficient to cope with loan losses markedly bigger than the current estimated 2% level without including additional capital. The credibility of the banks operating in Estonia is thus not threatened by a possible increase in the share of so-called bad loans in the loan portfolio in the course of this year compared to the current 5.2%.

The integration of the banking system with the Scandinavian and European markets, which is one of the most important factors supporting stabilisation, is another issue. The banking groups operating in Estonia are able to manage capital and liquidity in a flexible way at group level. The integration of the banking system consists in the readiness of banking groups to promptly channel money flows to various subsidiaries and branches according to need.

The integration of banking is supported by cooperation in the Nordic-Baltic region. I am convinced the daily information exchange and cooperation agreements of our region set an example of ensuring financial stability for the entire European Union. In the final months of 2008, Sweden initiated support schemes, which have had a very positive impact on banking groups as a whole, i.e., national support measures have been implemented from group level also on subsidiaries and branches. In this context, Estonia has in the EU actively supported the principle that the implementation of rescue packages must not discriminate against other Member States.

2009 economic policy priorities in Estonia

Now I would like to say a few words about the current monetary and economic policy situation and the most important priorities for 2009.

By now it is clear that the Estonian enterprises and households have thoroughly changed their behaviour and expectations over the past half a year. In this respect, a big part of the adjustment process has already taken place and Estonia's primary macro vulnerabilities have considerably decreased. The current account, i.e., the difference between investment and savings, has practically balanced and the financing of the economy's current expenditure is ensured by current income. In addition, Estonia has no problems with financing its external

debt. Companies and people in Estonia have taken serious steps to pave way for getting through the global crisis and recovering growth.

Therefore, the state needs to implement some important macro-level objectives to support the recovery of economic growth. Here I mean, above all, the readiness to join the euro area as well as medium-term and long-term stability of fiscal policy.

In the current situation, accession to the euro area is Estonia's utmost short-term objective. The adoption of the euro will ensure the stability of the money used in Estonia and is extremely important for further reinforcement of the banking system and the investment climate. It can be said the clear perspective of joining the euro area is an absolutely necessary precondition at the national economy level for the permanent recovery of growth. Declining inflation has created all the possibilities in Estonia to meet the Maastricht criteria by end-2009, which makes it possible to join the euro area on 1 January 2011 at the latest.

In this context and from the point of view of monetary and financial system stability, fiscal policy has two tasks in 2009. First of all it must be made sure that the current account deficit, which cannot be avoided in the prevailing economic environment, remains below 3% of GDP both this year and in 2010. In order to achieve this, Eesti Pank is of the opinion that in addition to the steps taken in February, this year's fiscal deficit needs to be reduced by a further 6.5 billion kroons.

In addition to fiscal consolidation, it is important to ensure long-term fiscal sustainability. Once the acute crisis is over, the first thing to do is to achieve fiscal balance. Then it is necessary to restore the public sector's extensive fiscal reserves. The national budget strategy recently approved by the government creates a necessary macro framework according to which the budget should reach balance by 2011. Eesti Pank is of the opinion the new strategy is a timely and ambitious document which requires cooperation also at Riigikogu level.

Taking into account that government expenditure as a ratio to GDP has soared, budget adjustment must be done primarily on the expenditure side. Tax revenue increases may support the adjustment, but they should not play the main role. If only tax advances were used to finance costs at the current level, Estonia's long-term economic growth would be imperilled. Also, we support the principles of the current tax policy, according to which the share of indirect and pollution taxes would increase on account of direct taxes.

I would like to emphasise once again that the measures taken over the past half a year in both the public and the private sector have improved Estonia's ability to exit the crisis. This is confirmed by the fact that most of the rating agencies as well as the IMF's recent mission to Estonia have expressed positive assessments of Estonia's economic outlooks. To support economic growth, it is necessary to reinforce the principles of open economy and market flexibility and to ensure the stability of the national economy. In order to meet these goals, the best state support is the resumption of investment in the private sector and using the new possibilities that accompany every crisis.

Thank you for your attention!