

Andres Lipstok: Overview of Bank of Estonia's first year of the euro

Speech by Mr Andres Lipstok, Governor of the Bank of Estonia (Eesti Pank), at the presentation of Eesti Pank's 2011 Annual Report to the Riigikogu (the Parliament of Estonia), Tallinn, 29 May 2012.

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Honourable President of the Riigikogu, honourable members of the Riigikogu,

My mission today is to present you with an overview of Eesti Pank's first year of the euro. I will first run through the activities of Eesti Pank in 2011. Then, I am going to focus on the euro area economic and monetary policy, as well as on economic developments in Estonia and the activities of the central bank against the backdrop of the euro area financial crisis.

[EESTI PANK IN THE YEAR 2011]

1. 2011 was an action-packed year for Eesti Pank. First of all, the central bank had to carry out the work required for the changeover to the single currency. Second of all, the transition to the euro bestowed Eesti Pank with new duties and a greater responsibility – the central bank became an equal partner in monetary policy decision-making in the euro area. Our main task is to contribute to price stability in the euro area along with other Eurosystem central banks. From the beginning of 2011, the Governor of Eesti Pank partakes in decisions affecting not only the people of Estonia, but also the 300 million residents of the euro area. Third of all, we had to continue fulfilling the traditional central bank's functions – ensuring currency circulation, maintaining payment systems, contributing to ensuring financial stability, collecting statistical data and analysing the Estonian economy and financial system.
2. For a small nation, the transition to the euro can be considered high recognition. However, it was also a challenge. The smooth changeover required the joint effort of the entire nation. Residents and retail traders, entrepreneurs and banks – we all managed very well.

[EURO AREA ECONOMY AND MONETARY POLICY IN 2011]

1. Monetary policy-making proved quite a challenge in the euro area in 2011. The second half of the year bore no resemblance to the first. The beginning of the year witnessed a continued, albeit slower, economic recovery, both on the global scale and in the euro area. Liquidity was plentiful and oil and other commodity prices soared, exerting price pressures in the euro area. To maintain price stability, the Governing Council of the European Central Bank decided to raise the monetary policy rates. This was done in April and in July.
2. The tide turned in the second half of the year, when waning confidence and growing uncertainties in the financial markets started curbing global growth. This was brought about by market participants' concerns about the public finances development in several euro area countries. Changes in the economic environment were accompanied by a sharp decline in consumer and corporate confidence in August. Companies were cautiously optimistic in the first half of the year, but summer saw a postponement of investment and recruitment decisions. Confidence loss slowed economic growth, easing inflationary pressures. In November and December, we thus lowered the interest rates to an all-time low.
3. Under normal circumstances, changing interest rates alone would have sufficed to influence prices and economic activity. Unfortunately, the crisis proved extensive

enough to disrupt the functioning of the monetary policy transmission mechanism. The ability of commercial banks to issue loans to companies and households was thus significantly reduced. This compelled us to take various non-standard measures, starting from August. We supported the securities market in order to prevent paralysation of the activities of banks; we continued the unlimited provision of liquidity loans to banks; we offered banks three-year loans on highly favourable conditions; we expanded the list of eligible collaterals for liquidity loans, and lowered the minimum reserve requirement from 2% to 1% at the end of the year.

4. Looking back, it has to be admitted that the annual growth in consumer prices was faster than expected, amounting to 2.7%. Inflation picked up mostly due to the price growth of commodities. This is confirmed by core inflation remaining below 1.5%. Inflation expectations are also in line with our long-term goal.

[THE PRICE OF CRISIS-TIME MONETARY POLICY FOR CENTRAL BANKS]

1. These bold and crucial steps came with a price – the risks inherent in the central banks' balance sheets have increased. Risk analysis and buffer-raising will also be a challenge for Eesti Pank in the forthcoming periods. The central bank just finished its first year as a member of the euro area, with one of the lowest equity to monetary policy assets ratios among euro area central banks. We must bear in mind that the revenues and expenditures of monetary policy operations are shared within the Eurosystem in proportion to the central bank's participation in the total capital. The Supervisory Board of Eesti Pank thus resolved to raise the central bank's capital adequacy ratio to the average level of euro area central banks in the long term. In order to bring the ratio into line with Eesti Pank's participation in the Eurosystem, the capital adequacy ratio must be raised. This means that the central bank's equity must be raised from 0.37 billion euros to approximately 1.3 billion euros. Eesti Pank's equity currently stands at 0.07% of the Eurosystem's total equity, while Eesti Pank's participation in the Eurosystem stands at 0.26%.

[QUO VADIS, EURO AREA?]

1. It is not only the central banks that can contribute to a successful exit from the crisis – the governments of member states must, as soon as possible, implement the measures taken and agreements made by the European Council and the euro area heads of state and government. Closer cooperation in the field of economic policy, along with clear-cut, functional rules, serve the interests of all members.
2. Even though budget adjustments may curb economic growth in the immediate future, they will help ensure the sustainability of public finances and lower the risk premia of sovereign bonds. We must reverse the growth in debt burden and establish a framework which would support market confidence in the sustainability of public finance management in euro area countries. This is the common interest of all euro area Member States.
3. Alongside crisis management measures, we must lay emphasis on ensuring stability in the long perspective. To ensure an outlook for growth, we must implement structural reforms to enhance economic flexibility, competitiveness and employment.
4. The key task of the Eurosystem central banks, including Eesti Pank, is to ensure general price stability in the euro area. This should be the principle goal of monetary policy and the main mission of the central bank in its efforts to facilitate economic growth and create jobs.

[CONCERNING ESTONIA]

1. Unlike several other euro area countries, Estonia had no need to engage in local crisis management in 2011.
2. The Estonian economy showed notable adjustment ability against the backdrop of the uncertain environment. Our annual economic growth (7.6%) was the fastest in the euro area. Moreover, the economic developments were far more balanced than before the crisis: the current account was in a moderate surplus and domestic price pressures remained subdued. Unfortunately, it has to be admitted that food and energy prices affect the cost of the consumer basket more than in older euro area Member States. Thus, consumer prices accelerated to 5% in Estonia.
3. Estonia stands strong, compared to the EU average. In the midst of a crisis, we demonstrated our ability to quickly fix the balance in times of trouble. We now need to make plans for regulating our behaviour at times of joy.
4. Our State Budget Strategy has set out a budget policy framework for the medium perspective. Unfortunately, we have yet to see the binding nature of the document in the decision-making process. For example, the budget strategy prepared in the spring of 2011 set its sights on restoring the consolidated budget surplus. As at 2012, the attainment of the objective has been postponed. This is worrying. It shows that the current framework enables to change long-term goals too easily. The current framework also provides no solutions to managing the cost increase at times of growth. It would thus be reasonable to establish rules for restricting expenditure alongside the established rules for ensuring a balance. These rules would reduce the volatility of the cost increase, prevent unjustified expectations and alleviate the pains of cost-cutting.
5. At the beginning of 2012, the euro area heads of state and government resolved to launch the European Stability Mechanism sooner than initially planned.
6. In public relations, Eesti Pank has repeatedly emphasised that central banks are being forced to take on a role that does not suit them. Functions that are alien to the Eurosystem are best left to the European Stability Mechanism. There are two advantages to such a solution. Firstly, establishing conditions for the award of financial support allows guiding the recipient country's economic policy in the desired direction. As we all know, monetary policy measures cannot be used for eliminating the causes of the sovereign debt crisis. Secondly, this will tighten the control of the member states' governments and parliaments over crisis measures and ensure a better overview of the costs of the crisis measures.

[TO SUM UP]

1. The right decisions can only be made when we understand the economy. It does not serve our interests to monitor just our own activities – we also need to monitor the development plans and objectives of other euro area countries (and not only Greece or Portugal).

The European Economic and Monetary Union already has all the good characteristics for the achievement of which the union was established to begin with. We now need to enhance the union's efficiency, potency and security in the service of our best interests.

Honourable President of the Riigikogu, honourable members of the Riigikogu. I would like to finish the speech by expressing my gratitude for the seven years of cooperation. Thank you for taking notice and account of the messages of Eesti Pank! On its behalf, Eesti Pank has always provided you with the best knowledge at its disposal. I sincerely hope that the constructive cooperation between the Riigikogu and Eesti Pank will continue in the years to come.

Thank you for your attention!