Ardo Hansson: European and domestic economic challenges for Estonia in 2014

Speech by Mr Ardo Hansson, Governor of the Bank of Estonia (Eesti Pank), to the Riigikogu (the unicameral Parliament of Estonia), at the presentation of Bank of Estonia's Annual Report 2014, Tallinn, 26 May 2015.

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Honourable President of the Riigikogu, Distinguished Members of the Riigikogu

I am here today to give you a summary of the year 2014 at Eesti Pank. I will speak on the economy in the euro area and on monetary policy, and I will discuss the Estonian economy and the work of the central bank last year.

The euro-area economy, monetary policy and fiscal policy

In 2014 the economy of the euro area as a whole grew, but the situation varied a lot between different countries and overall growth was slower than had been forecast. Data from the start of this year suggest that economic activity in the euro area is staging a modest recovery.

The competitiveness of the euro area has improved during the recovery from the crisis, but again the situation varies between countries. There are countries that have successfully introduced reforms, but there are also those where reforms have stopped or even gone into reverse.

- Here I must emphasise that long-term economic growth can only be built on reforms that raise economic competitiveness.
- The central banks of the euro area are able to offer support to economies in the short term, but there is a price to this, and such support can only be for a limited time. Central banks are not omnipotent and the responsibility for making reforms and explaining the need for reforms must fall squarely on the shoulders of governments and parliaments.

Monetary policy in the euro area had an eventful 2014. Inflation in the euro area was falling last year and the expectations for inflation among market participants were on the downside, which led the central banks of the euro area to maintain their accommodative stance on monetary policy. The accommodative monetary policy has three main elements:

- The Governing Council of the European Central Bank took the decision to cut the interest rates at which commercial banks can borrow from the euro-area central banks to their lowest levels ever under monetary union.
- Targeted long-term loans were offered to the commercial banks in the euro area. It is important that low interest rates be passed on to the real economy and that good business projects be able to get funding from banks on reasonable terms.
- Purchases of assets held by the private sector started and large-scale purchases of sovereign bonds were started in March this year.
- It is no secret that I am no supporter of the plan to purchase government bonds. Although the first small signs of success are apparent, we must still remain vigilant about the accompanying risks. Above all there is the moral hazard that would emerge were some government to lose its appetite for reform. The falls in interest rates provoked by the massive purchases of bonds will lower interest rates temporarily on government borrowing and this must not be used as an argument for pushing vital but painful reforms to some point far off in the future. Interest rates are only favourable for a short time and will support governments while they are making

changes. If governments were to ignore the budget rules agreed in Europe and were to start to increase their debts further, the measures taken by central banks would be of very little help.

The other main task occupying central banks alongside monetary policy last year was the launch of single banking supervision. Starting supervision and carrying out a thorough and comprehensive assessment of the assets of European banks needed a lot of work from central banks and financial supervision authorities. The successful conclusion of this work let us say with confidence that the biggest and most significant banks in a range of countries in Europe are now assessed and supervised on the same terms. In Estonia, Swedbank and SEB Pank have come under single supervision.

The Estonian economy

Looking more closely at the Estonian economy, it can be seen that the growth in Estonia in 2014 came primarily from the domestic market.

- Domestic consumption was lifted by rising employment, falling unemployment, and strong wage growth and a simultaneous fall in prices. The economy grew faster in 2014 than in 2013, but it should be remembered that no return to the growth rates seen in the boom years of the last decade is to be expected.
- It may be hard to get used to the idea of lower growth rates, but economic truths cannot be denied. The Estonian economy and Estonian demographics are in a different phase of development now, and long-term sustainable growth is notably lower at 3–4%.

Consumer price inflation in Estonia fell below zero in June 2014 for the first time since the crisis. Four years ago prices fell across a wide range of goods and services, but last year the fall in prices was mainly caused by cheaper energy and food. Eesti Pank is not forecasting any rise in prices this year, but rising wages will put upward pressure on the prices of domestic goods and services.

One reason for the rapidly rising labour costs has been the decline in the working age population, but faster growth in wages than in productivity could endanger the competitiveness of the Estonian economy in the longer term. Companies are for now able to cover the rapidly rising labour costs from their profit buffers, but in the longer perspective this will inevitably cease to be possible. Reduced profits threaten the ability of companies to invest in higher productivity and in the human capital needed for more complex and higher-value work. I have often said, and it bears repeating again today, that the key challenge in the development of the Estonian economy is how more complex work than hitherto can be accomplished with a smaller workforce.

The rapid rises in wage income and household consumption boosted tax revenues in 2014, which in turn improved the state finances and helped lift the state budget to a small surplus in 2014. Going forward it is important that the government stick to the target agreed in the budget strategy of maintaining a nominal budget balance and building up its reserves.

- Here I should note that the purchases of bonds by central banks and the resulting fall in interest rates have encouraged the belief or the conviction that there is a free lunch to be had and Estonia is denying itself a feed because the Estonian state does not issue bonds. We all know full well that there is no such thing as a free lunch. Even were the central bank to purchase one quarter of the bonds issued by the state, those bonds would still constitute a debt that would have to be paid back eventually.
- Financing new investment through state bonds could well prove inefficient and harmful for the Estonian economy as a whole, even if the investments are in good projects. The low unemployment and rapid wage rises that we see at the moment

would cause a large part of the extra money gained from the emission of state bonds to be lost, as infrastructure projects would cost much more than before. Large state construction projects that can only be temporary in nature would also cause economic and social problems in Estonia, because once the large projects finish, a great number of those working on them would find themselves unemployed, having left jobs in other sectors.

- It must be understood that Estonia already profits from the purchases of bonds by the central banks of the euro area. Financial markets act as a series of communicating vessels, so that when interest rates in one area fall, the effect is passed on to other areas. The lower interest rates in the euro area mean that Estonian companies and households can borrow more cheaply, and were it necessary the Estonian state could also borrow more cheaply. If easier financing conditions spur on the European economy, Estonian exporters will be among the winners, and this is the goal towards which the bond purchase programme is striving.

In summarising the Estonian economy I should say our economy has grown at a satisfactory speed overall, as there is no little uncertainty in the global economy and there are protracted problems with growth in several of Estonia's export markets.

- The tensions in geopolitical relations last year, including the trade sanctions between the European Union and Russia, have left a mark on the Estonian economy, though fortunately not a deep one.
- Estonian exporters deserve recognition for the flexibility they have shown in finding new markets. Exports have managed to increase even as prices have been generally falling in foreign markets, while local production costs have been driven up by rapidly rising wages. That the market share for Estonian goods and services in the trade with partner countries has increased shows that Estonian export items are competitive in international markets.

The work of Eesti Pank

The Eesti Pank Act has given us a wide range of responsibilities. Our first responsibility is to keep inflation low and stable, setting a joint monetary policy together with the other central banks of the euro area and implementing it in Estonia. Secondly we must keep the financial system here stable, as strong and functioning banks are vital for economic growth.

On top of this we supply the country with high-quality cash, produce timely and authoritative statistics, manage and invest the state foreign reserves, and act as advisor to the government. Last year we succeeded in all of this.

Last year the previous Riigikogu issued the central bank with a clearer mandate than ever before for macroprudential supervision in Estonia, and we have started to act on this mandate. Macroprudential supervision aims to increase the resilience of the banks and the rest of the financial system to systemic problems and to restrain the accumulation of major risks.

- The first measure introduced by Eesti Pank was the requirement for commercial banks to hold a 2% systemic risk buffer. The systemic risk buffer is needed to manage the banking risks that are specific to a small and open economy. The introduction of the buffer did not imply any major changes for the banks operating in Estonia, as their capitalisation levels were already above that required. The measure was a precautionary step by the central bank to guard against possible risks in the future.
- The second step was taken three months ago when requirements for housing loans were applied to the commercial banks by the central bank with the aim of pre-

empting possible credit booms in the future. The requirements do not have any noticeable effect on the loan market as things stand, as the banks are in any case currently acting conservatively. Both of these measures are precautionary steps taken against any significant future increase in the risks in the real estate market should competing banks start to take on excessive risk.

The crisis management measures taken by the central banks of the euro area in recent years have been successful, but they have come at a price. Both the balance sheets of the central banks and the associated risks have increased many times over in consequence. However, the ratio of Eesti Pank's increased equity to the assets used for monetary policy remains one of the lowest of any of the central banks of the euro area. The comparison with the other central banks of the euro area is important, as the balance of risks to capital of the central banks of the euro area as a whole is considered when joint monetary policy decisions are made.

This makes it very important that the Supervisory Board of Eesti Pank decided to transfer three quarters of the 17 million euros that the bank made in profit last year to strengthening the capital of Eesti Pank. One quarter of last year's profit, or 4.3 million euros went to the state budget, and since 1992 Eesti Pank has allocated a total of 133 million euros to the state budget.

It may be asked what exactly the central bank's reserves are for, given that the Riigikogu bears the responsibility of last resort for capitalising Eesti Pank? History has shown that central banks fall into difficulties at times when there is a general economic or financial crisis. I want to make every effort to see that Eesti Pank has no need to come to the Riigikogu asking for capital at a time of such crisis. It is to avoid precisely this that the central bank builds up reserves and I am glad that the Eesti Pank Supervisory Board shares this opinion.

For the central bank to be financially independent, it needs to maintain and invest its assets. The current situation in the financial markets, where interest rates on sovereign bonds have fallen to very low levels, poses new challenges for the central bank as a long-term conservative investor. Eesti Pank has reacted to changes in the operating environment and has spread its risks by adding further asset classes to the investment portfolio and investing money in the sovereign bond markets of more countries than before.

- Eesti Pank's return on its investment was several times higher in 2014 than the target set at the start of the year, and reached 22.8 million euros. Falling interest rates throughout the year made investments in bonds profitable and the increasing share portfolio of Eesti Pank meant that we earned significant income from investments in shares.

As well as earning income, Eesti Pank is careful to keep control over its spending and to use its money efficiently. For this reason we have put the Maardu manor site up for sale, as we do not need it in carrying out the main functions of a central bank. We would have done this earlier, but first it was necessary to complete the process of registering the manor house and the land it stands on.

It is worth noting under cost efficiencies that Eesti Pank has added technical support for the Fiscal Council to its list of responsibilities together with the macroprudential supervision and increased requirements for compiling financial statistics. Despite this, the number of people employed at the bank is roughly the same as a year ago, and Eesti Pank remains the smallest central bank by staff size in the European Union. Eesti Pank's operating expenses fell last year to 17 million euros from the 17.4 million of a year before.

Although the central bank's duty is to keep inflation low and not to chase every possible source of higher revenues, it is good to be able to note that we ended last year comfortably in profit.

Conclusion

In conclusion I would like to emphasise again that it is important for stable development in Estonia and for improved public well-being that we remain ready to adapt to a changing economic climate, to react rationally to changes, and yet to maintain the conservative stance on monetary issues that has served us well so far.

Thank you for your attention.