

IV. ENSURING MONETARY POLICY STABILITY

ECONOMIC POLICY OUTLINES FROM MONETARY POLICY STABILITY PERSPECTIVE

The primary objective of Eesti Pank is to ensure **price stability** in Estonia. This is the objective of most of the developed countries' central banks – economic studies and decades of experience have proved that stable, low and easily predictable inflation rate ensures the most favourable conditions for long-term economic growth. Stable price environment allows companies and households to better plan their long-term investment and consumption decisions as well as to ensure efficient placement of resources.

As appropriate for a small open economy, Estonia's price stability strategy lies in a **currency board arrangement (CBA) based fixed exchange rate system**. The experience of Estonia as well as of many other countries has shown that maintenance of a stable exchange rate is one of the most efficient ways to achieve price stability. **Transparency** of central bank's operation and **targeted implementation of the monetary policy strategy** are also very important. As the CBA-based monetary policy has fully justified itself, Estonia has unilaterally committed to continue with the currency board arrangement and central rate until the adoption of the euro.

Along with the CBA-based fixed exchange rate regime, the main features of Estonia's economic policy throughout the regained independence have been following **balanced budget principles** and **economic policy that supports free and open competition**. These underlying economic policy principles sustain credibility of our exchange rate policy, contributing to price stability. Eesti Pank ensures price stability participating in Estonia's economic policy through monetary policy implementation, advising government and also through international cooperation.

Upon accession to the European Union on 1 May 2004, Estonia became a **member of the Economic and Monetary Union (EMU), enjoying the status of a country with derogation** (see Background Information *Economic and Monetary Union*). This step involves significantly increased responsibility, as being in the EU common economic space Estonia has an opportunity and obligation to have a say in shaping of the EU economic policy. Presumably, in a few years Estonia will join the euro area and will also participate in the single monetary policy.

Accession to the European Union has not brought about significant changes to Estonia's economic policy. EMU has two central economic policy objectives: stable and sustainable economic growth and a stable and low inflation rate. These are objectives Estonia's economic and monetary policy has and still is aspiring to.

EUROPEAN ECONOMIC AND MONETARY UNION

The European Economic and Monetary Union is an integral part of the European Union, all Member States are participating in one or another way in EMU. Upon accession to the EU a Member State will have a status of a country with derogation. Adoption of the euro will deliver full membership.

*EMU is based on two pillars. The first pillar lies in the **coordination of Member States' economic and fiscal policy**. All Member States draw regularly up an economic programme (either stability or convergence programme), which is coordinated among themselves and with the European Commission. Programmes shall be consistent with the budget balance requirement in the Growth and Stability Pact and in case of non-euro area countries with meeting the Maastricht criteria. In addition, Member States also coordinate majority of the remaining economic policy areas.*

*The second pillar is the **EU single monetary policy**, implemented by the European System of Central Banks and the European Central Bank. The objective of the policy is to maintain a low inflation rate (price stability). The single monetary policy is implemented only in the countries that have met the Maastricht criteria and joined the euro area. The sole legal tender in these countries is the euro.*

The Maastricht criteria are as follows:

- **Criterion on price stability** – the applicant country's rate of inflation must not exceed by more than 1.5 percentage points that of, at most, the three best performing Member States in terms of price stability;
- **Interest rate criterion** – long-term interest rates of government bond quoted in the applicant country's currency must not exceed by more than 2 percentage points that of, at most, the three best performing Member States in terms of price stability;
- **Exchange rate stability** – observance of the normal fluctuation margins provided for by ERM II for at least two years, without devaluing against any other Member State's currency;
- **Sound public finance** – at the end of the financial year preceding the accession government budget deficit must not exceed 3% and stock of government debt 60% of gross domestic product;
- **Legal convergence** – above all, the independence and integration of central banks in the Eurosystem are monitored.

MONETARY POLICY IN 2004

In 2004, Estonia's **annual average consumer price growth reached 3.0%, which is one of the lowest indicators over the period of regained independence**. Although prices grew faster than in 2003, most of the accelerated inflation rate was due to one-off factors of the EU accession in the second quarter of 2004. **Despite the favourable overall situation, there were still several external and internal risks to economic development in 2004.**

From the aspect of risks to price stability, both credit environment favourable for domestic demand and increasing external vulnerability of Estonia's economy over the recent years are important. Subject to low interest rate, strong confidence and financial sector's active marketing strategy, the non-financial sector's debt burden continued rapid growth in 2004. Over the year, the debt burden increased by more than 20

billion kroons, i.e. by 11 percentage points of GDP. Household debt burden accounted for about a half of the increase. Rapidly growing borrowing involves a risk that shrinking demand would jeopardize corporate growth outlooks. This could deteriorate the situation in the labour market and bring about bigger solvency problems for borrowers. On the other hand, banks could enter high-risk sectors so as to maintain high profitability. There is always a threat that under extremely favourable interest rate environment of recent years, borrowers have not become sufficiently aware of a risk arising from a rising interest rate.

In 2004, strong domestic demand and accession-related factors sustained high current account deficit. Despite an export peak, current account deficit remained comparable to the year-ago period, although it slightly recovered. In other words, Estonia's economy kept financing its domestic demand, to a significant extent, from external savings and economy's external liabilities continued soaring. However, similar to domestic borrowing, such long-term trends could diminish external confidence in Estonia's economy.

As Estonia's monetary system is pegged to the euro, broader monetary policy environment is shaped by the activities of the European Central Bank (ECB), based on the euro area economic development. Implications of ECB monetary policy decisions transmit rapidly into Estonia's economy, into deposit and loan interest rates as well as into the exchange rate of the Estonian kroon against other currencies, having, in turn, an impact on non-financial sector performance and price stability in Estonia. The range of Eesti Pank's monetary policy instruments is relatively limited due to the currency board arrangement. First and foremost, Eesti Pank can draw public and government attention to emerging macro risks, exert moral pressure on the financial sector and implement a conservative required reserve policy and supervisory measures.

In 2004, Eesti Pank repeatedly drew public, financial sector and government attention to risks. Expansive borrowing and high current account deficit encouraged Eesti Pank to maintain the reserve requirement ratio of credit institutions at 13% both for liabilities with the maturity of up to two years as well as for liabilities with the maturity of over two years and repurchase agreements. In the euro area the reserve requirement ratio for liabilities with the maturity of up to two years is currently at 2%, and at 0% for liabilities with the maturity of over two years and repurchase agreements. Besides, in March 2004, Eesti Pank abolished cash component in meeting the reserve requirement. As intensive borrowing could deliver problems rather on the side of borrowers, the government together with Eesti Pank revised the national support policy for the housing market. Therefore the role of KredEx was specified in supporting availability of housing loans.

Table 4.1. Monetary policy operational framework of Eesti Pank

Monetary policy instruments	Activities
1. Forex window	Eesti Pank is obliged to conduct exchange transactions with Estonian credit institutions without constraints between EEK and EUR, USD, JPY, GBP and SEK.
Exchange rate spread	There is no exchange rate spread of EUR-EEK purchase and sale transactions between credit institutions and Eesti Pank (1 EUR = 15.6466 EEK). As of 1 January 1999
2. Reserve requirement	Estonian credit institutions are obliged to keep a certain amount of their incorporated assets liquid in assets determined by Eesti Pank.
1) Reserve requirement calculation base	a) Amounts owed to customers; b) Debt securities issued by banks; c) Amounts owed to foreign credit institutions; d) Repurchase agreements; e) Financial guarantees to financial institutions belonging to a consolidation group; f) Subordinated liabilities; g) Government loan funds and counterpart funds. As of 1 March 2003
2) Monthly minimum reserve requirement	General 13% and special requirement 13% of the reserve requirement calculation base. As of 1 March 2003*
3) Assets eligible for meeting the reserve requirement	a) Deposits with Eesti Pank; b) Quality foreign securities – up to 50% of the reserve requirement. As of 1 July 2001**

Table 4.1 continued

4) Calculation principle for meeting the monthly minimum reserve requirement	Compliance with meeting the monthly average. Calculation of the average starts on the first calendar day and ends on the last calendar day of each month. As of 1 July 1996
Daily minimum requirement	40% of the kroon reserve requirement. As of 1 January 2001
5) Remuneration	ECB deposit interest rate. As of 1 July 1999
3. Deposit facility	Eesti Pank offers credit institutions the possibility to earn interest on the average monthly balance exceeding the minimum reserve requirement on the settlement account with Eesti Pank.
	ECB deposit interest rate. As of 1 January 1999
4. Facility to sell foreign securities to Eesti Pank	Eesti Pank agrees to buy such securities from credit institutions, which comply with the quality requirements established to meeting the reserve requirement. As of 1 January 2001

* The special ratio is applied to liabilities with maturity over two years and repurchase agreements.

** Until 1 March 2004, cash (up to 20% of the minimum kroon reserve) was also taken into account in meeting the reserve requirement of credit institutions.

MONETARY POLICY IN COMING YEARS

Like all other countries acceding to the European Union in 2004, Estonia will become a full EMU member (see also Background Information *European Economic and Monetary Union*). Only the membership will allow a new Member State to make full use of opportunities arising from accession to a strong economic area.

Eesti Pank shares the government position that the euro should be adopted as soon as possible. Joining the euro area is a necessary step for Estonia's economy so as to ensure sustained favourable investment climate, improve competitiveness and strengthen prerequisites for long-term and balanced economic growth and, thus, for an enhanced living standard.

As only a state whose economy is closely integrated with other Member States would benefit from EMU membership, it is not insignificant that Estonia's main trade partners are EU Member States. In Estonia, Member States account for most of the investments made both as foreign direct investment and through the financial sector. Besides, the Estonian kroon is pegged to the euro and monetary policy transmission mechanisms similar to those in the euro area apply to our economy. Thus, already today we are almost members of the euro area. Actual joining with EMU will be a logical continuation of Estonia's current monetary policy.

EMU Membership Preconditions

In order to become an EMU member, a state has to participate in the **European exchange rate mechanism ERM II**¹ for two years and be sustainable in meeting the Maastricht criteria. Estonia has a good starting position to become an EMU member. Our exchange rate has been stable for more than twelve years, the inflation rate and budget balance are under control and interest rates low. However, meeting all Maastricht criteria is strenuous.

¹ Three new EU Member States (Estonia, Lithuania and Slovenia) have joined ERM II since 28 June 2004. All three have expressed a wish to adopt the euro as soon as possible. Pursuant to the new Member States' plan of the changeover to the euro, Cyprus, Latvia and Malta are expected to join ERM II in 2005.

On 28 June 2004, in order to strengthen Estonia's monetary policy confidence and participate in EMU, Estonia joined the European exchange rate mechanism ERM II, remaining unilaterally committed both to the CBA and the fixed exchange rate of the Estonian kroon against the euro. Joining ERM II did not involve any changes for Estonian monetary policy framework, which has been successfully in use for more than twelve years. As Estonia's joining of ERM II was a step both analysts and financial markets have been looking forward to, it had no direct impact on money markets of the Estonian kroon. However, there is an indirect impact there, as Estonia's good prospects to join the euro area and to participate in ERM II have been a factor contributing to an increase in Estonia's economic credibility and sustained decrease in the risk premium.

EUROPEAN EXCHANGE RATE MECHANISM ERM II

An applicant to the euro area has to participate in the exchange rate mechanism ERM II for at least two years. This is a framework within which during multilateral negotiations (between euro area Member States, ECB, European Commission, other ERM II participants and euro aspirants) the aspirant country's currency is agreed to peg to the euro with an exchange rate accepted by all parties. Participation in ERM is a transition phase in a changeover to the euro. The primary legal basis for ERM II is the Treaty of Maastricht signed in 1992².

ERM II participation entails that the currency in question is maintained stable against the euro. The allowed fluctuation band relative to the central parity is $\pm 15\%$. Apart from the exchange rate criterion also other Maastricht convergence criteria are assessed in ERM II: criterion on price stability, interest rate, budget balance and public debt criteria. Subject to the success in meeting the criteria, the participation in the exchange rate mechanism might be longer than two years.

The history of ERM II goes back to 1979 when the European Monetary System (EMS) was established as well as the exchange rate mechanism (ERM). ERM aims at supporting a stable exchange rate policy and coordination in Europe. All ten members of the European Community with the exception of the United Kingdom joined the exchange rate mechanism. With the adoption of the euro on 1 January 1999 ERM was replaced with ERM II. The main difference between the initial exchange rate mechanism ERM and ERM II is that under ERM member currencies' exchange rates were fixed against the European currency unit ECU and the standard fluctuation band was $\pm 2.25\%$ of the central rate.

Estonia's tight and balance-oriented fiscal policy has established a sound foundation for meeting the Maastricht criteria for **budget balance** and **public debt**. Currently Estonia's debt burden is among the lowest in the EU (below 5% of GDP). Government budget deficit exceeded the ceiling only in 1999 (in 2004, it was in surplus with 2% of GDP). However, we should take into consideration that meeting the balanced budget criterion does not guarantee the state a successful participation in EMU. Under single monetary policy, the fiscal policy will be the main economic policy instrument for the Member State to independently influence

² The Treaty of Maastricht was amended in Amsterdam in 1997 and in Nice in 2001.

its economic development (e.g. stimulating its economy during a period of slow growth). Ensuring adequate fiscal policy options for the above presumes that consolidated government budget would remain balanced throughout the economic cycle – in surplus during rapid growth periods and in 3% of GDP deficit maximum during economic downturn. Thus, it is essential that Estonia continued pursuing reliable and balanced fiscal policy also in the coming years.

The Maastricht **interest rate criterion** shows whether a euro area applicant could sustain balanced economic development also in the long run. If international financial markets and investors see that the applicant state has met the budget criterion with non-sustainable one-off instruments or there are other signs in the economy indicating a potential problem in the long term, the state would mostly likely have difficulties in meeting the interest rate criterion. Therefore, it is important that an applicant country's economic policy be oriented towards balanced development and meeting Maastricht criteria in as early a phase as possible. Economic policy and market mechanism credibility have taken Estonia's interest rate quite close to that of the euro area and, thus, Estonia should not have any substantial problems with meeting the interest rate criterion.

For Estonia, meeting the criterion on price stability would be most difficult. Vis-à-vis inflation the markets will be sufficiently flexible and ready for the changeover to the euro provided that the inflation rate in the reference period does not exceed by more than 1.5 percentage points that of, at most, the three best performing Member States in terms of price stability. However, in several EU Member States the inflation rate is very low and therefore several euro area countries would not meet the criterion on price stability today.

A strenuous factor for Estonia in meeting the criterion on price stability lies in price convergence accompanying income convergence. In other words, as in the near future our income will supposedly be growing faster than the EU average, the growth in the price level will be slightly above the EU average as well. Potential slight volatility in food and oil prices should also be considered. However, Eesti Pank is of the opinion that Estonia's price stability will suffice to meet the Maastricht criteria in the coming years. Nevertheless, we should avoid jeopardising price stability with turbulent tax policy and administered prices.

Convergence Reports

In spring 2004, both the European Central Bank and the European Commission drew up convergence reports on new Member States with the objective to evaluate compliance with the Maastricht criteria and issue recommendations on EMU membership with derogation or abolition thereof (see Background Information *Convergence Reports 2004*). Both reports gave an overall positive evaluation of Estonia's economy, although in order to meet fully all preconditions for the adoption of the euro, certain changes are inevitable.

Estonia hopes to be in full compliance with the Maastricht criteria by the next report, i.e. by spring 2006. Compliance will be assessed during a 12-month pre-report period. Readiness for the changeover to the euro pursuant to the Maastricht criteria requires Estonia's economy to have sustained price and exchange rate stability. The evaluation singles out the necessity to maintain fiscal discipline: convergence of Estonia's economic environment to that of the euro area should be sustainable. In addition, close cooperation with European institutions should continue to assess the interest rate.

The Convergence Report leads to a conclusion that the contents of some Estonian legislation should be re-explained to the European institutions in the coming years. Convergence Reports refer to a provision in the Estonian Constitution stipulating that Eesti Pank has the sole right to issue Estonian currency whereas according to the Treaty on the European Union the European Central Bank shall have the exclusive right to authorise the issuance of euro banknotes. The Legal Chancellor of the Republic of Estonia, Minister of Justice, Minister of Finance as well as Eesti Pank have analysed the question and all the institutions have reached a conclusion that an act amending the Constitution of Estonia would eliminate this controversy.

CONVERGENCE REPORTS 2004

Every two years (if requested by the Member State also at other times) the European Commission and the European Central Bank (ECB) compile Convergence Reports³ for all states that are not full EMU members. Based on the reports, the European Commission makes a proposal to the Council of Ministers and the Council of Heads of State and Government on Member States who meet prerequisites to join the euro area.

The Convergence Reports assess both economic policy and legal convergence to Maastricht criteria. Evaluating the legal framework, the level of integration of Member States' central bank objectives, independence and the Eurosystem are compared with the requirements set out in the Treaty on the European Union and Statute of the European System of Central Banks and of the European Central Bank.

In 2004, ten new Member States (Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia, and Slovakia) and Sweden⁴ were evaluated but none of them was fully in compliance with the euro area requirements. In several states expansionary fiscal policy was the largest problem, resulting in large budget deficit, faster price increase and higher interest rates. In addition, legal frameworks of all Member States need improving prior to the adoption of the euro and single monetary policy. However, the European Commission as well as the European Central Bank recognised the accomplishment of recent years.

Preparations for Full EMU Membership

The Estonian government and Eesti Pank are of the opinion that by mid-2006 Estonia should be technically ready to join the euro area. Changeover to the euro will probably take place on 1 January 2007.

Domestic preparations for the changeover to the euro have started. On its session on 27 January 2005, the government decided to set up an **Expert Committee for Changeover to the Euro**. The Committee comprises representatives from the Ministry of Finance, Eesti Pank, Ministry of Justice, Ministry of Economic Affairs and Communications, Ministry of Internal Affairs and the European Union Secretariat of the State Chancellery.

Full EMU membership is decided by consensus and depends on the country's macroeconomic development and legal convergence (central bank independence, integration with the Eurosystem, etc.; see also Background Information *Procedure for Joining European Economic and Monetary Union*).

³ The ECB Convergence Report is available on ECB's web site <http://www.ecb.int/pub/pdf/conrep/cr2004en.pdf>. The European Commission's Convergence Report is available on the web site of DG for Economic and Financial Affairs http://europa.eu.int/comm/economy_finance/publications/european_economy/convergencereports2004_en.htm.

⁴ Due to the derogation, the United Kingdom and Denmark are assessed only upon their request.

PROCEDURE FOR JOINING EUROPEAN ECONOMIC AND MONETARY UNION

In accordance with Article 122 (2) of the Treaty Establishing the European Community the Council of Ministers⁵ shall, acting by a qualified majority on a proposal from the Commission, abrogate the derogations of (grant full membership to) the Member States concerned. The proposal comprises the following Annexes:

- *Report by the European Commission;*
- *Report by the European Central Bank;*
- *Opinion by the European Parliament;*
- *Results of the discussion in the Council⁶, meeting in the composition of the Heads of State or Government (European Council).*

To abrogate the derogation:

- *Member State's national legislation has to comply with the Treaty Establishing the European Community and the Statute of the ESCB and ECB;*
- *Member State has to fulfil Maastricht criteria.*

If the Constitutional Treaty enters into force before the abrogation of the derogation, the abrogation procedure will change. According to the Constitutional Treaty, the role of the euro area Member States has increased. Apart from consultation with the European Union and after discussions in the European Council, the euro area Member States should give a qualified majority recommendation to the ECOFIN Council.

REGULAR ECONOMIC ANALYSIS, FORECAST AND ECONOMIC RESEARCH AS A BASIS FOR MONETARY AND FINANCIAL POLICY DECISIONS

Economic research conducted in Eesti Pank helps the central bank to meet its statutory duties, support current analysis and forecasting, participate in economic policy discussions in Estonia and to inform the public about the development of the economy and financial markets. Research is primarily conducted in the Research Department, although current economic analysis and shorter studies are carried out in other departments as well.

Eesti Pank's economic research is based on the **Strategic Research Plan**, which defines the overall research framework in the bank. In 2004–2006, the key research fields are the **development of macroeconomic and banking model systems, monetary policy and financial sector research** and the **sustainability analysis of Estonia's monetary system**. Thirteen studies were completed on these topics in 2004.

⁵ As a rule, the Council of Economic and Financial Ministers (ECOFIN) takes a decision. However, if necessary, another council of ministers can do that.

⁶ As a rule, the European Council takes a decision. However, if necessary, Member States' Heads of State and Government take a decision in a different format.

Research involved the role of debt burden in financial crises, importance of financial deepening and bank-lending channel in monetary policy transmission mechanism, cyclical nature of the non-financial sector's loan demand and losses, and vulnerability of the banking sector. A seminar on the financial sector was organised together with the University of Tartu and Tallinn University of Technology, attracting a surprisingly large audience.

Two studies on fiscal policy were completed: fiscal policy rules and discipline in new EU Member States and dynamics of the national debt and economic growth in the new Member States. Modelling was also significant and, thus, a labour market model within a general equilibrium framework and Estonia's new macroeconomic model were completed; the inflation block of the macro model and forecasting model for banking were renewed.

In 2004, **cooperation continued both at international as well as national level**. The third seminar on economic research was organised together with the central banks of Latvia and Lithuania. Eesti Pank participated at a joint seminar in Helsinki hosted by ETLA (the Research Institute of the Finnish Economy). Presentations were held at ZEI (Centre for European Integration Studies at the University of Bonn) conference and IAES (International Atlantic Economic Society) annual conferences. A longer research secondment took place at the University of Helsinki.

Apart from presentations of Eesti Pank's research, also foreign experts were invited to Estonia: Charles Goodhart, professor at the London School of Economics and former member of the Bank of England Monetary Policy Committee, held a seminar on financial supervision in the euro area; Lars Calmfors, professor at the University of Stockholm, delivered a seminar on joining EMU; Professor Fabrizio Coricelli of the University of Siena on fiscal policy in the new Member States, etc.

Regarding national research cooperation, the **bank's visiting researcher programme** as well as the annual **research award** for young Estonian economists play an important role. In 2004, the award was issued for the second year and this time to Jaanika Meriküll, a PhD student from the University of Tartu for *Macroeconometric Modelling of the Estonian Economy*.