

## MONETARY POLICY

The objective for Eesti Pank is to ensure price stability by maintaining the fixed exchange rate of the Estonian kroon.

Eesti Pank ensures the smooth operation of the monetary system through monetary policy instruments and through active participation in economic policy discussions. The central bank's main monetary policy instrument is the standing facility for buying and selling foreign currency, the forex window, which is available to credit institutions. The forex window enables banks to increase their Estonian kroon reserves by selling an amount of foreign currency to the central bank, and vice versa, buying foreign currency for Estonian kroons. The reserve requirement is another important monetary policy instrument used by Eesti Pank, obliging banks to keep a part of their assets as buffers in Eesti Pank or in high-quality external assets.

In 2009, the central bank left the banks' reserve requirement unchanged at a comparatively high 15%. The underlying reason for this decision was the turmoil in global capital markets. The level of liquidity and capitalisation in the Estonian banking system is still high.

Trading on the Estonian kroon money market remained thin in 2009 and the Estonian money market interest rate, the Talibor, did not affect the cost of capital for the domestic non-financial sector.

Estonia has been using the fixed exchange rate and the currency board system successfully for 17 years, and the strengths of the system have been revealed during the recent economic downturn. The flexibility of wages and prices allowed to cope well with the adjustment of the internal and external balance in the changed economic environment. Inflation, credit demand and wage growth eased rapidly, resulting in a current account surplus. Had the exchange rate been too volatile however, it would have jeopardised both

non-financial sector competitiveness and financial stability.

### **ECONOMIC ANALYSIS, FORECAST AND RESEARCH**

#### **Monitoring**

The deepening of the global economic crisis in autumn 2008 significantly affected Eesti Pank's economic monitoring and forecast processes. The focus of the monitoring of non-financial and financial sector developments shifted more towards the external environment. Analyses were conducted on a monthly basis and ad hoc analyses were also introduced at the peak of the global crisis to provide an up-to-date evaluation of the financial situation. When the situation started to stabilise in the second half-year, these ad hoc reports were gradually dropped. Almost all of the departments responsible for shaping the central bank's monetary policy decisions were involved in additional monitoring work. The results of the monitoring provided input for the central bank's press releases and public statements. In a small and open economy such as that of Estonia, an understanding of external developments has always been an integral part of regular monitoring. The centre of focus used to be EU Member States, but during the global economic and financial crisis, the emphasis was shifted towards developments in major countries around the world.

As well as looking at developments in price stability and market flexibility, monitoring focused on the volatility of the external environment, including the possible spillover effects of the crisis and the situation of global and regional financial markets. Financial stability issues were high on the agenda in both domestic and international cooperation. Given the changed economic environment, there was an increasing need to assess the ability of companies and households with heavy loan burdens to adjust to the changing economic structure.

Cooperation and consultation with the Government on major economic policy issues heightened considerably too.

### **Economic reviews**

In 2009, Eesti Pank increased communication with the public to better address the global financial and economic crisis and it started to release statements on Estonia's economic situation six times a year. Twice a year the central bank publishes a longer economic overview including the latest economic forecast (see also "Key points of the economic forecasts of Eesti Pank in 2009", pp 125).

Once every six months the central bank analyses the situation in the financial sector, and the results of this analysis are published in the Financial Stability Review. Due to the expected changeover to the euro in Estonia, the sustainability of Estonia's economic trends is analysed twice a year, and the results are published in the Report on the Adoption of the Euro. The flexibility of the labour market plays an important role in the fixed exchange rate regime and smooth income convergence with more prosperous countries requires flexible wage setting based on productivity growth, and so the central bank has started to publish regular Labour Market Reviews twice a year.

### **Economic forecast**

Eesti Pank issues economic forecasts twice a year, in April and November (see "Key points of the economic forecasts of Eesti Pank in 2009", pp 125). The forecast horizon comprises the current year and the two next years and usually also includes two risk scenarios. Both the spring and autumn forecasts are published on Eesti Pank's website.

The sudden drop in global trade after the bankruptcy of Lehman Brothers in the USA required

a rapid reassessment of the economic situation, and so in January 2009 Eesti Pank compiled an additional interim forecast. This was particularly important for discussing the instruments for restoring the sustainability of Estonia's public finances and speed with which they could work.

Rapid changes in Estonia's economic structure require regular improvement of the forecast models. When the base model is updated, the forecast methods and procedures are harmonised with those of the European System of Central Banks. This is done jointly by the Research Department and the Economics Department of Eesti Pank. The Financial Stability Department is responsible for the forecasts for the financial sector and for developing the forecast methods to be used. Eesti Pank conducts regular banking sector stress tests on the basis of economic forecasts and regularly improves the methodology of the stress tests to improve their effectiveness.

### **Economic research**

Eesti Pank's economic research projects are based on the strategic research plan, which determines the general framework for the studies conducted in the bank. The priorities for 2007–2009 included activities related to the development of the macro model of the Estonian economy and the monetary policy simulation model; research on monetary policy and financial sector, as well as analysis of the sustainability of the Estonian monetary system. In 2009, thirteen research projects on these issues were conducted.

The projects studied the impact of economic shocks on firm creation; factors of productivity and wage rigidity in Estonian companies; the impact of the opening of the Estonian labour market; long-term sustainability of the state budget; the dynamics of overdue loans during an economic cycle, etc. In 2009, further improvements were made to the credit risk model of the bank-

ing sector, the model of profitability of Estonian banks, the monetary policy simulation model and the macro model for the Estonian economy.

In addition to publication in the Eesti Pank Working Papers Series, the central bank's economic researches gain recognition on the international arena. Various research papers and articles were published in internationally recognised academic journals and introduced at international conferences.

Traditional cooperation on research at international and domestic level continued in 2009. Central bank's economists attended the Working Group of Econometric Modelling and the Wage Dynamics Network, composed of members of the European System of Central Banks. In cooperation with the European Association of Labour Economists (EALE) and the Faculty of Economics and Business Administration of the University of Tartu, Eesti Pank organised a high-level conference "European Association of Labour Economists Annual Meeting 2009" in Tallinn with altogether over 300 participants from Europe, the United States and elsewhere. Eesti Pank also participated in the preparation of an international conference "Economies of Central and Eastern Europe: Convergence, Opportunities and Challenges 2009", organised by the Tallinn University of Technology in June 2009.

In 2009 Eesti Pank introduced its own surveys and also invited several well-known foreign experts to Estonia to present their research results. For instance, Julián Messina, professor of economics at the University of Girona and economist at the World Bank, introduced a survey entitled "Educational Mismatch and Wages in Estonia". R. Anton Braun, professor of economics at the University of Tokyo, held a seminar "Spain, Japan and the Dangers of Early Fiscal Tightening". Seppo Honkapohja, member of the Executive Board of Suomen Pankki, analysed the 1990s' financial crises in Nordic countries.

The annual series of lectures dedicated to the internationally renowned Estonian economist Professor Ragnar Nurkse continued in 2009 with a lecture by Stefan Ingves, Governor of Sveriges Riksbank (central bank of Sweden).

In 2009, Eesti Pank organised twelve open seminars. Ten of them had guest lecturers from abroad and two presented the central bank's research projects.

The central bank's visiting researcher programme has contributed to research cooperation for years now. In 2009, five visiting experts took part in the economic research projects of Eesti Pank. The traditional annual research award of Eesti Pank was given to Helen Poltimäe from the University of Tartu for her research on the distributional effects of environmental taxes in Estonia.