

Foreword by the Governor of Eesti Pank

Estonia's monetary system has been based on the currency board system for over 17 years now. This means that the exchange rate of the Estonian kroon is pegged to the euro and that all the central bank's liabilities, including the monetary base of the economy, are fully covered by gold or foreign exchange reserves.

Flexibility in the non-financial sector, especially the labour market, is the key condition for a smoothly functioning currency board system. The exchange rate may not be changed to balance the economy, so adjustments have to happen in wages and prices in the non-financial sector. It has sometimes been asked whether this monetary system is too strict for the Estonian economy, but today it is safe to say that the currency board system has helped our economy to react rapidly to the uncertainty in the rest of the world. Inflation and credit demand abated rapidly and wage growth slowed, resulting in a surplus on the current account. However, had the exchange rate been too volatile, it would have jeopardised the competitiveness of the non-financial sector and threatened financial stability.

It is important to remember here that financial stability plays an essential role in shaping future expectations. These expectations, in turn, are a major factor in how fast and flexibly the economy responds to hard times. Had Estonian business leaders not foreseen future events so clearly, they would have reacted to the global recession in demand later, which would then have prolonged the adjustment of the economy.

For many Estonian companies and households, the year 2009 was a time to revise earlier plans. By now, this reorganisation is nearing its end and a sense of security is returning. Estonia's near-term growth rate largely depends on how quickly the underused production resources will be brought back into use. In the longer term, however, the key is the attractiveness of our economic environment to new investments.

The Government's decisive actions in 2009 halted the deterioration of the imbalances in the consolidated budget. The low government debt means that Estonia has not been threatened by the turmoil in global financial markets. Our reserves have ensured that the country will not encounter short-term liquidity problems, should tax collection contract rapidly. Despite the increased uncertainty about the economic development of our region, we have remained almost entirely untouched by the crises faced by other countries in funding their government costs. Public support for balancing the state budget and curbing government debt remained strong in Estonia even during recent difficult times.

In the next few years, the central government's fiscal position must be improved further, because the recovery of economic growth does not mean that the deficit will automatically disappear. To achieve this, we must increase revenues or cut spending. The debt burden in Estonia has increased considerably over the past years, and therefore cuts in spending should be preferred.

The primary goal of the Estonian monetary system is to keep long-term inflation close to the inflation level of the euro area. During the recent boom, when domestic demand and the prices of foreign goods such as food and energy grew rapidly, this goal was more difficult to achieve than ever before in our history. Inflation expectations, however, remained relatively subdued even at the height of the boom. In the longer term, inflationary pressures should ease because even though Estonia's income level has fallen significantly, the relative price level has remained virtually the same. So far, the drop in wages has made only a modest contribution to the decline in prices. In the future, price growth is only likely to be accelerated by an increase in global commodity prices. Meanwhile, in the next few years it is essential to contain the inflation caused by administrative measures and to limit the pass-through of one-off price rises to other prices. When making economic policy decisions we must not forget that excessive price growth may hinder Estonia's economic recovery.

Joining the euro area has become an important landmark for us. The difficult decisions made in 2009 have brought us closer to achieving this goal. However, regardless of whether we adopt the euro sooner or later, we must keep in mind that the euro does not signify the end of our journey, but rather the beginning of a new one. New goals are already being set. Estonia probably does not need any major economic policy changes right now, but we need to carry out several unfinished reforms and to adhere strictly to the principles of responsible economic policy that we already adopted and successfully tested long ago.

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Governor

