

## **FOREWORD BY GOVERNOR OF EESTI PANK**

Year 2008 was the year of global financial crisis, which intensified in the second half of the year and drove the economic downturn also in Estonia. The economic environment has changed considerably compared to previous years and calls for changes in the behaviour of all economic agents.

The economic downturn has made inflationary pressures nearly non-existent. On the one hand, this has been caused by the decline of global commodity prices; on the other hand, the price fall is affected by domestic factors. Strong economic growth has been accompanied by the current account deficit stemming from large investment needs. At this point, both the households and businesses spend considerably less owing to their uncertainty about the future. Budget constraints will also be tighter because of the decrease in incomes, and the cautious behaviour of banks and investors restrains borrowing. All this has resulted in the current account deficit turning into a surplus.

Similar to many other countries, Estonia's export revenues have decreased significantly owing to the strong decline in external demand. The Estonian economy also has to cope with the decreasing confidence of foreign investors, which means a considerably smaller foreign capital inflow compared to the previous levels. The adoption of the euro would help restore confidence as soon as Estonia joins the euro area.

The objective of adopting the euro needs to be borne in mind when planning any economic policy measures. A postponement of the euro objective would make the return to a sustainable convergence path more challenging in the current global financial crisis situation.

In order to adopt the euro, additional fiscal consolidation efforts are needed. However, budget balancing measures are crucial not only for meeting the Maastricht criterion. It is also important to bring public finances in line with the changed economic environment and to ensure long-term fiscal policy sustainability. The national budget strategy is expected to answer the question when Estonia will regain balance between consolidated budget revenue and expenditure and start restoring its fiscal reserves. One of the lessons to be learnt from the current recession is the great significance of extensive liquid public-sector reserves in safeguarding Estonia's economic security and cushioning the impact of unanticipated changes in the economic environment. This is why the measures planned for 2009 and 2010 should be viewed as an integral package.

For a small open economy like Estonia it is essential for future growth that the external conditions start to improve. According to the present expectations, the situation might start to improve only in 2010, but it is not yet clear how broad-based and how long the current recession will be for our main trading partners.

In addition, it is necessary that the post-shock restructuring be completed in large part and the imbalances recede. The economy has moved into a period of restructuring, which might be relatively painful. The ability of the product and labour market to adjust to the rapidly changing economic situation will pose a major challenge for the Estonian economy.

However, banks operating in Estonia have sufficient funds to support restructuring in both the business sector and the entire economy. This allows to face the future with cautious optimism. Economic decisions should be based on favourable medium- and long-term economic outlooks, since Estonia's income convergence towards the level of more advanced EU countries will continue also in the future. This is supported by sustainable fiscal policy and Estonia's accession to the euro area as soon as possible.

The central bank on its part will do everything necessary to ensure a stable monetary system and financial environment also in the coming years.



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