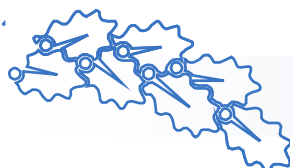


Eesti Pank



Economic policy statement of Eesti Pank

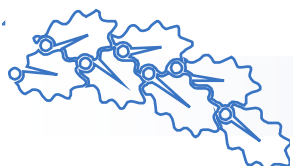
14 December 2011



The topics



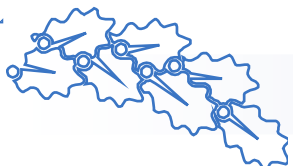
- Global and euro-area economic outlooks
- Situation of and outlook for the Estonian economy
- Main economic policy related conclusions



The global economy is facing unfavourable conditions in 2012



- Growth will slow in most regions and global trade along with it
- Global inflation is under control, though monetary policy continues to be lenient
- Additional support by economic policy is more restricted this time
- The euro-area economic situation is complicated, but the current difficulties can be overcome
 - Growth impetus is waning, because some euro-area economies have to make adjustments that have so far been postponed
 - Problems springing from general government debt and imbalances will not disappear before their root cause is eliminated
 - It is essential to avoid economic damage arising from uncertainty

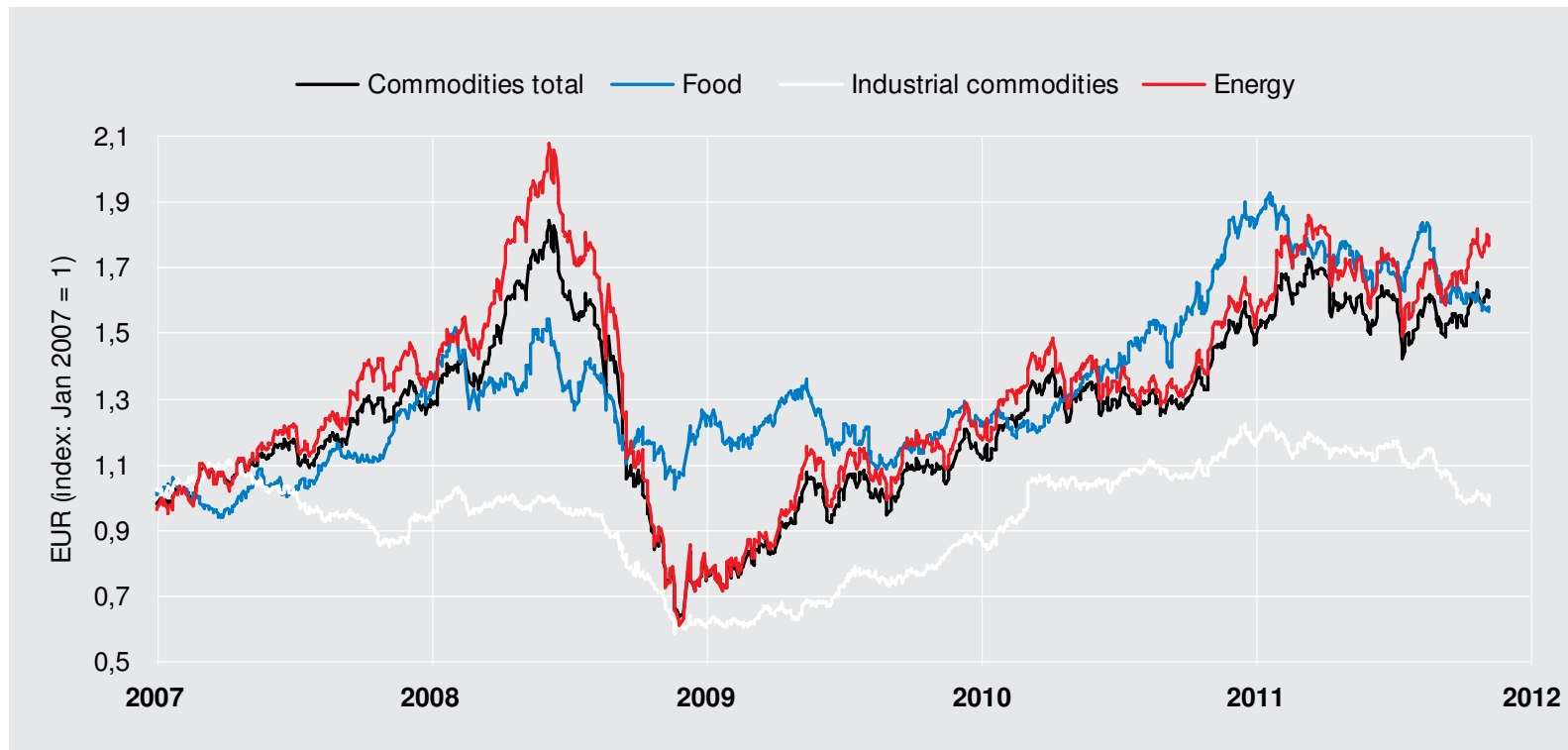


Commodity prices have not added to price pressures since spring



We forecast that the current level of commodity prices maintains, so the contribution of both food and energy to inflation will decrease significantly in subsequent years

Price indices of world-market commodities



Last observation: 2.12.2011

Source: Hamburg Institute for Economic Research

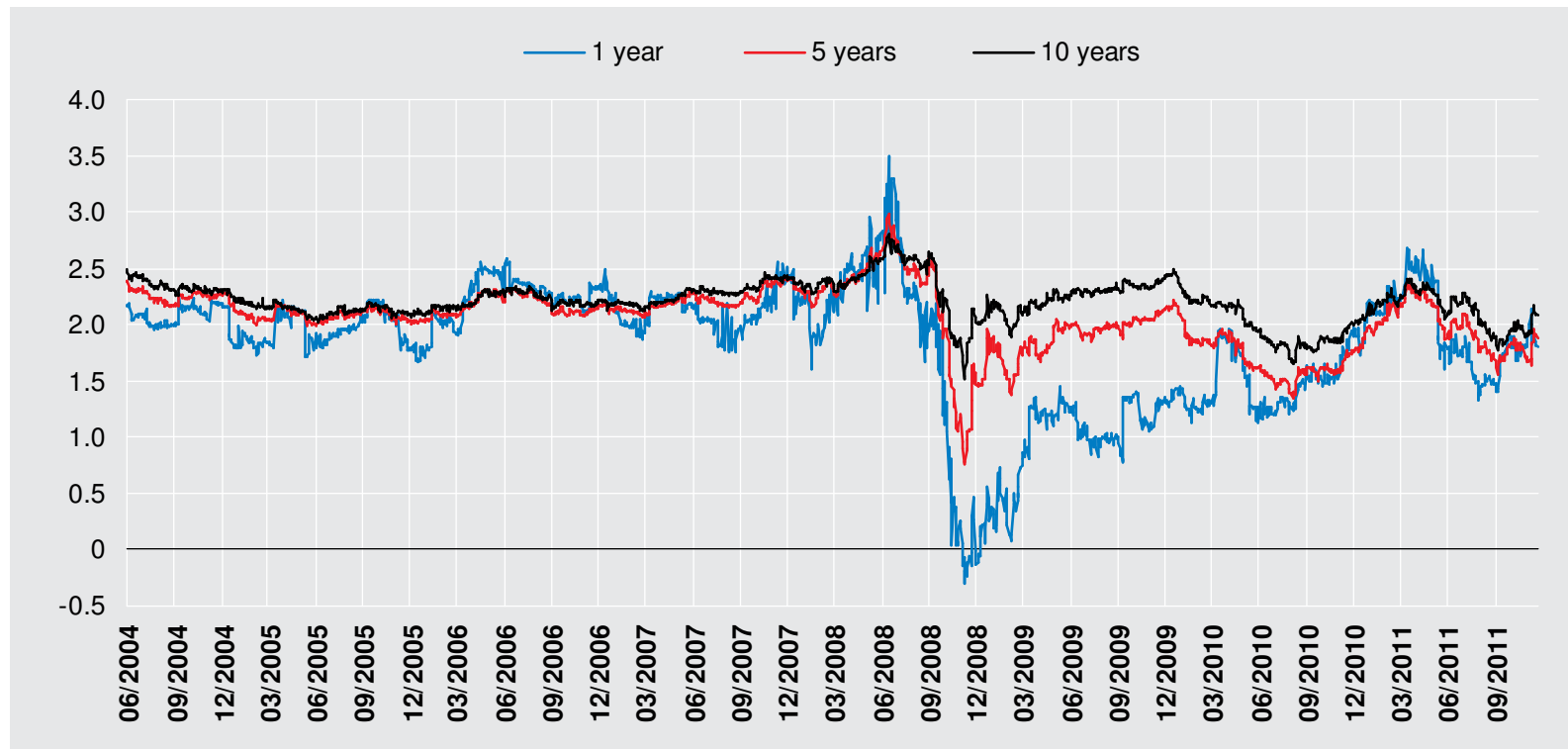


Euro-area inflation expectations are firmly anchored, despite those hoping to benefit from prompting panic



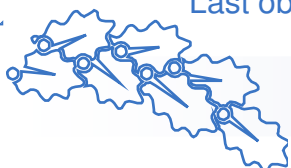
European central banks' (or the Eurosystem's) aim is to keep medium-term inflation rate below but close to 2%

Euro-area inflation swaps



Last observation: 2.12.2011

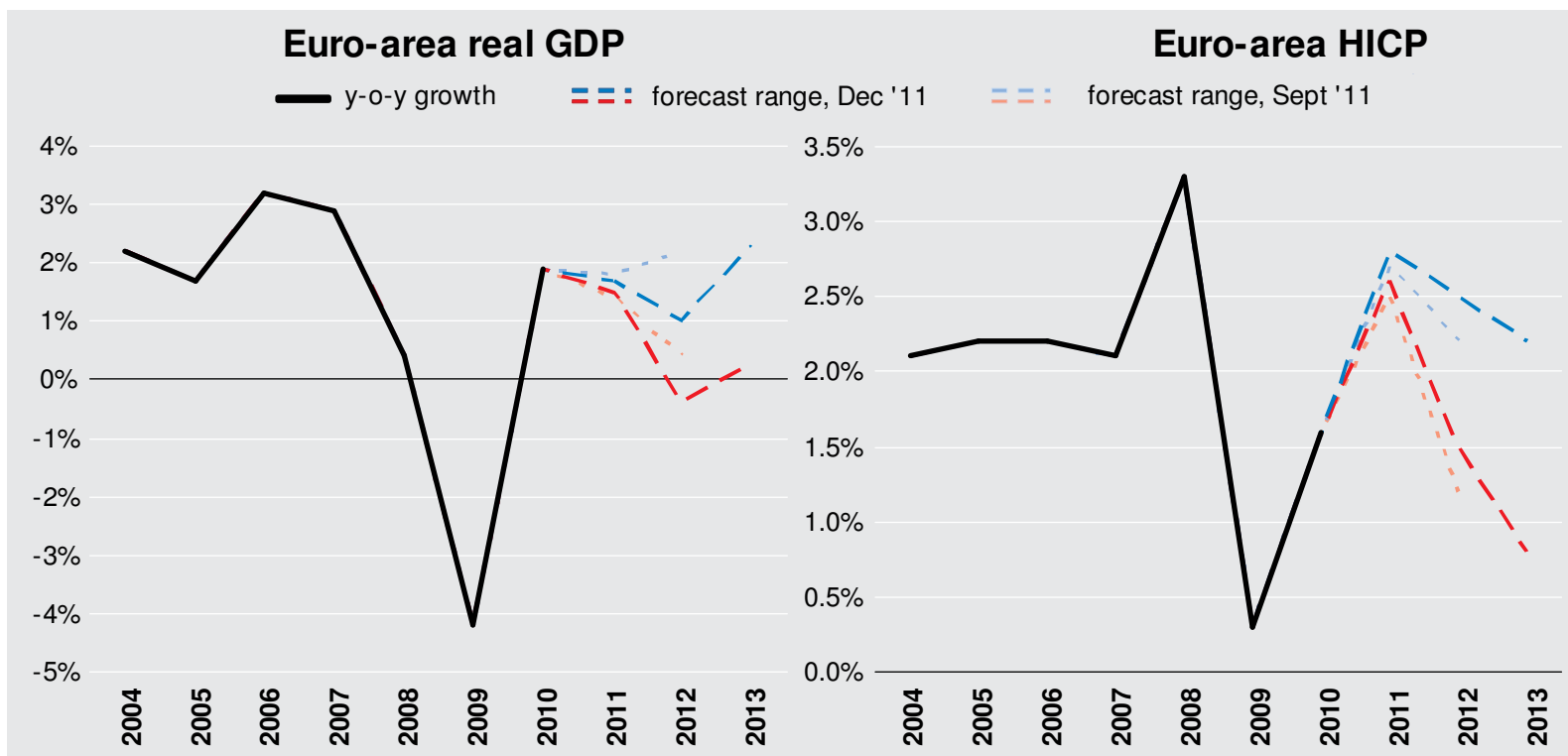
Source: Bloomberg



The Eurosystem revised both inflation and growth outlook more pessimistic



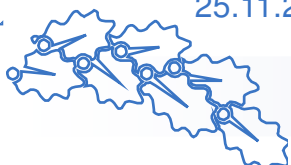
Risks to the economic activity forecast are downwards and risks to the inflation forecast are in balance



Comparison with the September assessment

Sources: Eurostat, European Central Bank

The forecast considers information available as at 25.11.2011



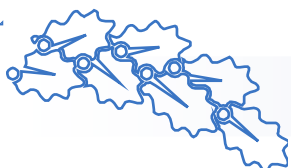
Due to the external environment, economic growth will slow down in Estonia as well



GDP growth



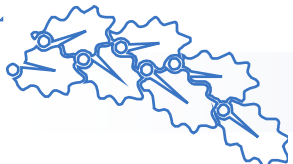
Sources: Statistics Estonia, Eesti Pank



Estonian economy's resistance to deterioration in the external environment has improved



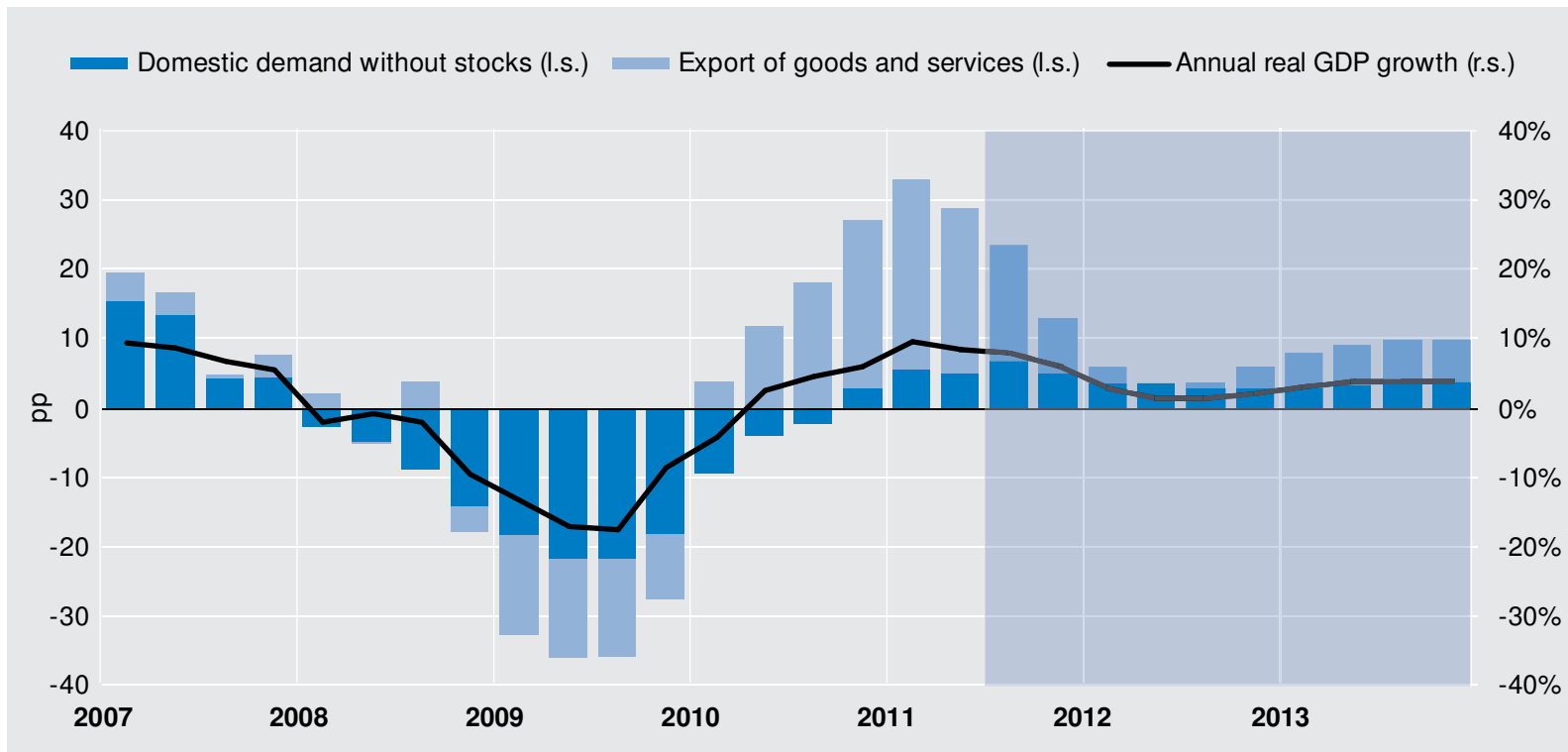
- Susceptibility to worsening outlooks and financing conditions has decreased
 - The current account is in surplus now
 - Expectations are more subdued
 - The private sector's debt burden has shrunk
- The restoration of profits has also reduced vulnerability
- Reduction in the gap between wages and productivity has improved economic competitiveness
- Unemployment has declined and problems with employment structure have eased



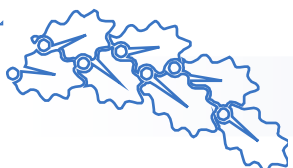
In a small and open economy, domestic demand is unable to keep up long-term growth



Contribution of domestic demand and exports to GDP growth



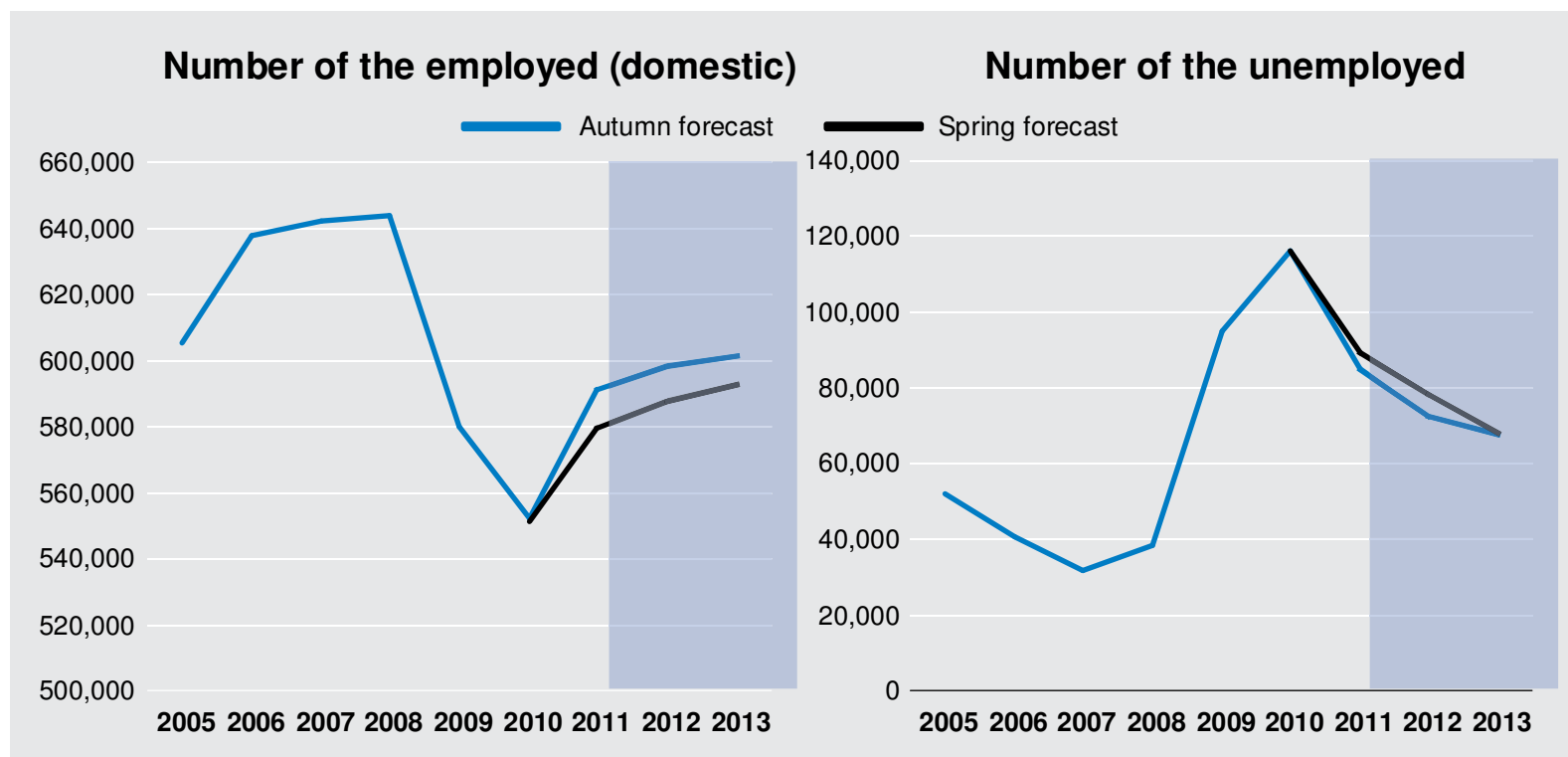
Sources: Statistics Estonia, Eesti Pank



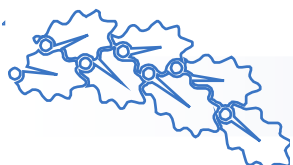
The labour market situation has improved faster than expected this year



The external environment situation and signs of a widening gap between needs and skills mean that labour market improvement may not continue



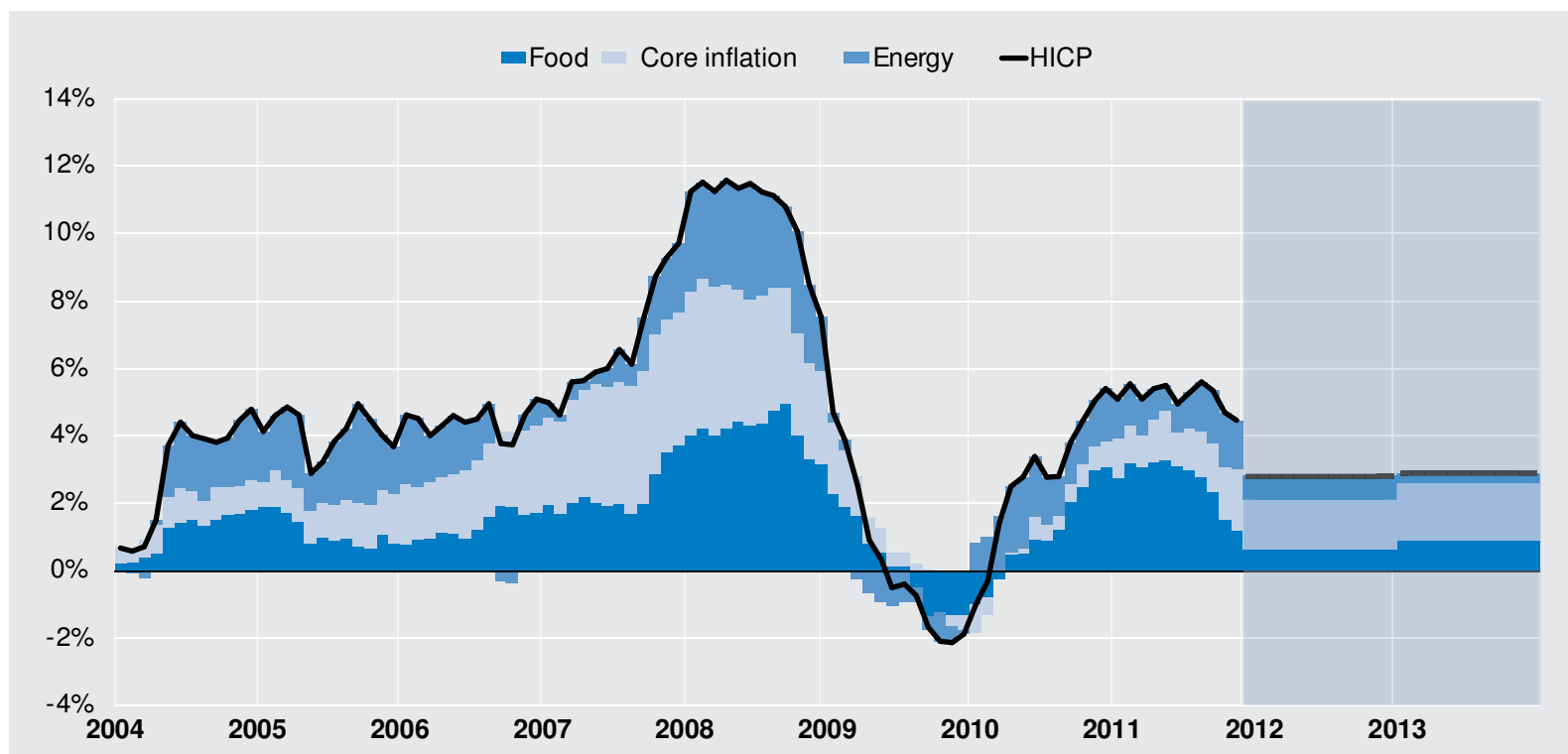
Sources: Statistics Estonia, Eesti Pank



Inflation will slow at the end of 2011 and in 2012

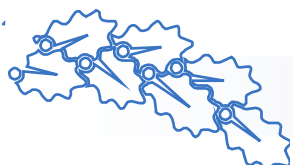


HICP annual growth by components



Eesti Pank publishes only annual inflation forecast.

Sources: Statistics Estonia, Eesti Pank

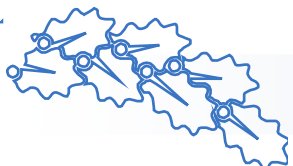


In tough times, the strength of the economy is measured by its preparedness for the worst



- Has the string of failures in devising rescue packages for the euro area come to an end?
- Are political tensions in several euro area countries over?
- Is the distrust of markets a thing of the past?

- Downside risks prevail in the GDP growth forecast
- If the external environment deteriorates even more, a recession cannot be ruled out in Estonia either
 - Shrinking export income
 - Financing conditions may become stricter
 - Credibility may diminish

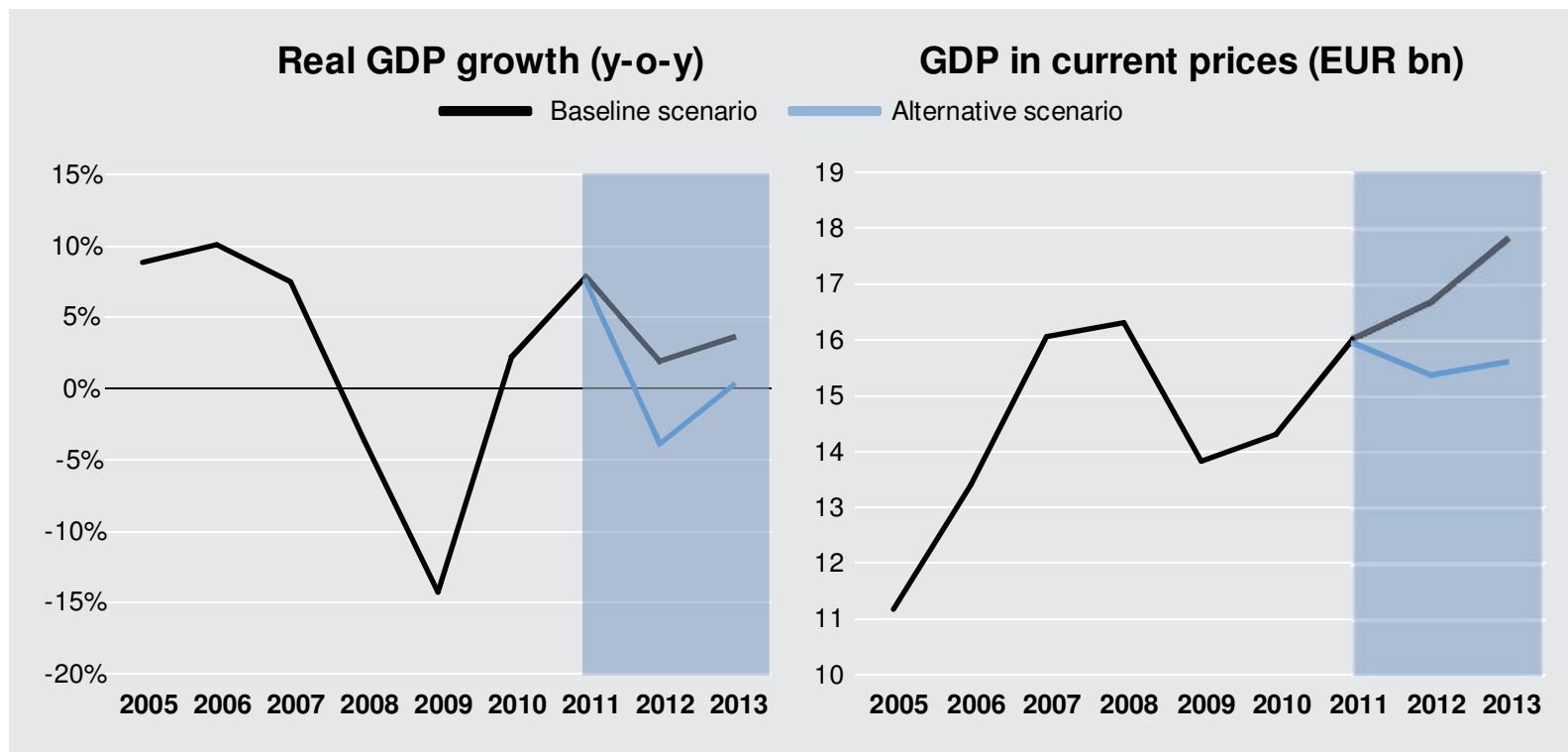


The more pessimistic scenario cannot be ruled out

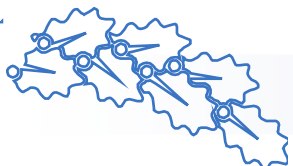


Assumptions in the alternative scenario:

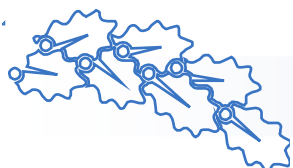
- Extrenal demand 6% lower than in the baseline scenario
- Loan risk premia 50-100 bp higher than in the baseline scenario
- Oil price 75 USD per barrel (in the baseline scenario 104-107 USD per barrel)



Sources: Statistics Estonia, Eesti Pank



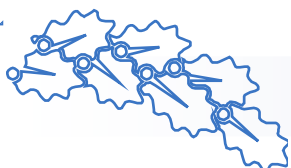
Conclusions



During the last session The Governing Council of ECB took additional measures in order to avoid financial distress



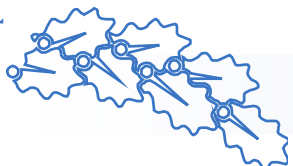
- Measures in regular monetary policy
 - We lowered the key interest rate to 1%
- We eased the conditions of non-standard monetary policy measures to improve the liquidity of euro-area banks and the functioning of money markets
 - We have made available LTROs with a maturity of three years
 - We lowered thresholds for collaterals used in monetary policy loans
 - We reduced banks' reserve ratio to 1%
- We lowered the interest on swaps providing liquidity in US dollars to ease tensions in global financial markets



The current complicated situation includes also opportunities



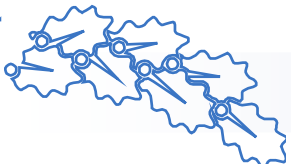
- Monetary policy supports the economy in both Estonia and the euro area
 - The monetary policy of euro-area central banks creates favourable conditions for companies to use investment opportunities
 - Eesti Pank provides to banks operating in Estonia monetary policy loans with interest rate of 1%
- The sufficient capitalisation of banks operating in Estonia and the improved loan-to-deposit ratio provide a good basis for financing households and companies



How to manage with slowing economic growth more successfully?



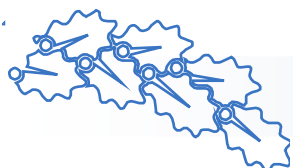
- In the case of a period of sluggishness, a **temporary** reduction in working hours should be preferred to laying off
 - Overreacting by laying off employees may hinder the economic growth potential
 - The situation is different in case of a long-term stagnation or recession
- The sale of emission quotas has made it possible to cushion the slump period by general-government investment



Fiscal policy is also facing greater challenges due to the external-environment uncertainty

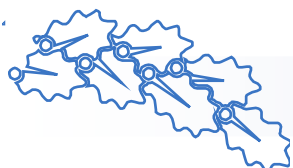


- It is important not to overestimate next years' growth potential
- If the alternative scenario materialises, there will be a wide fiscal deficit unless costs are cut
- Speaking of the 2012 budget, we recommend flexibility in responding to changes in the external environment:
 - In case of a more severe recession, there may occur the need for a supplementary negative budget
 - In longer term, the importance of achieving a balanced budget should be borne in mind



Thank you!

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Economic forecast by key indicators



	2011	2012	2013
Nominal GDP (EUR bn)	16.0	16.7	17.8
GDP, chain-linked volume change (%)	7.9	1.9	3.6
HICP inflation (%)	5.1	2.8	2.9
Exports, chain-linked volume change (%)	23.5	1.6	6.4
Budget balance (% of GDP)	0.7	-2.0	-0.7

Source: Eesti Pank

