IV. ENSURING MONETARY POLICY STABILITY

ESTONIAN MONETARY SYSTEM

The objective of the Estonian monetary policy is to maintain and strengthen domestic and international confidence in the continuity and integrity of the Estonian currency and the Estonian monetary system. A reliable monetary system ensures a moderate rate of inflation, which serves as a basis for balanced economic development. A stable price level in Estonia is achieved by maintaining a fixed currency exchange rate. Ensuring price stability is also the primary objective of the monetary policy of the European System of Central Banks (the Eurosystem).

The fixed exchange rate system effective in Estonia has been based on the currency board principle since the monetary reform in 1992. The currency board system with some operational amendments has successfully supported the development and restructuring of Estonia's economy. The exchange rate of the Estonian kroon has been fixed at the time of against the euro at the rate of EUR 1 = EEK 15.6466, which is equivalent to the exchange rate against the German mark fixed at the time of the monetary reform in 1992 (DEM 1 = EEK 8). The Estonian kroon has been freely convertible since it was introduced.

Since the monetary reform, Eesti Pank has met the requirement arising from the currency board arrangement that domestic liabilities must be fully covered with foreign currency reserves (see Figure 4.1).

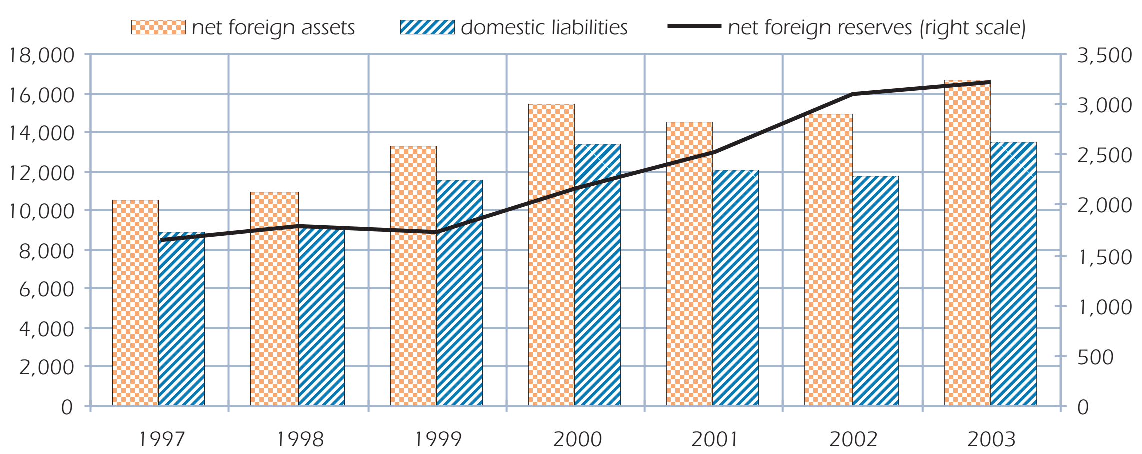

Figure 4.1. Eesti Pank`s net foreign assets, domestic liabilities and net foreign reserves (EEK million)

The fact that Eesti Pank's liabilities, including the monetary base, are fully covered with the reserves guarantees that the fixed exchange rate of the kroon is maintained when demand for kroons changes. According to the law, the central bank is not allowed to extend credit to the government. This creates a prerequisite for a transparent and conservative fiscal policy.

Since the Estonian monetary system is tied to the euro, the broader economic policy environment is above all shaped by the actions of the European Central Bank, which is based on the economic development in the euro area. The impact of the ECB monetary policy decisions swiftly passes on to the Estonian economy, affecting deposit and loan interest rates in Estonia. The range of Eesti Pank's own monetary policy instruments is comparatively limited due to the currency board arrangement. The central bank applies mainly conservative reserve policy and supervisory measures.

ESTONIAN MONETARY POLICY IN 2003

Monetary Policy Operational Framework

It is the task of Eesti Pank to establish conditions for maintaining public confidence in the monetary policy and shape the monetary policy operational framework to ensure smooth performance of the currency board system.

As it is the strategic aim of Eesti Pank that Estonia should become a full member of the Economic and Monetary Union[1] in the near future, the central bank plans **to be technically prepared for adopting the euro by the middle of 2006.** Monetary policy operational framework, i.e. monetary policy instruments and their application should therefore be adjusted taking into consideration the upcoming full membership of the EMU in addition to improvement of the efficiency of the financial system.

On the other hand, some differences remain in Estonia's monetary policy operational framework compared to the ESCB before Estonia becomes a full member of the Eurosystem. Fast and complete convergence of the monetary policy operational framework with that of the Eurosystem is not an aim in itself. Nor is it necessary since liquidity management in the financial sector is carried out efficiently and monetary policy transition mechanisms are increasingly similar to these of the Eurosystem. Besides, Estonia's current operational currency board framework is in most parts in line with the requirements of the exchange rate mechanism II (ERM II). That means that Estonia's participation in ERM II does not call for significant changes in the monetary policy operational framework of Estonia.

These objectives were the basis for improvement of the monetary policy operational framework continued in 2003. **The amendments that were implemented in March essentially unified calculation of the reserve base of the minimum reserve requirement with that of the Eurosystem** (see Table 4.1). The amendments introduced differentiation by maturity of the credit intitutions' liabilities included in the reserve base also in Estonia. However, bearing in mind the stability of the Estonian financial sector, financial guarantees issued to the financial institutions belonging to the consolidation group were maintained in the reserve base.

In 2003 several projects were prepared that convert the minimum reserve system into a more market-based structure and converge it with that of the Eurosystem. As of 1 March 2004 high-quality bonds with a floating coupon rate (floaters) are included among the foreign assets appropriate for meeting the reserve requirement. This step increases the options of credit institutions to meet the reserve requirement with foreign assets. Another relevant change is that as of 1 March 2004 cash deductibility in meeting the minimum reserve requirement is abolished. Also in the Eurosystem the cash deductibility is not allowed in meeting the reserve requirement.

[1] See the Strategic Development Plan of Eesti Pank for 2004–2006, I, 4.

Table 4.1. Eesti Pank`s monetary policy operational framework

Monetary intruments	Activities
1. `Forex window`	**Eesti Pank is obliged to conduct exchange transactions with Estonian credit institutions without constraints between EUR, USD, JPY, GBP, SEK and EEK.**
Exchange rate spread	No exchange rate spread of EEK-EUR purchase and sale transactions between credit institutions and Eesti Pank (1 EUR = 15,64664 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 base	a) Liabilities to customers; b) bonds issued by banks; c) gross liabilities to foreign credit institutions; d) repurchase agreements; e) financial guarantees to financial institutions belonging to the consolidation group; f) subordinated liabilities; g) government lending funds and counterpart funds. As of 1 March 2003[1].
2) Monthly minimum reserve requirement	General 13% and special requirement 13% of the reserve requirement calculation base. As of 1 March 2003[2].
3) Assets eligible for meeting reserve requirement	a) Deposits with Eest Pank; b) quality foreign securities – up to 50% of reserve requirement. As of 1 March 2004[3].
4) Averaging	Averaging on monthly basis. Averaging begins on the first calendar day of each month and ends on the last calendar day. As of 1 July 1996.
Daily minimum reserve requirement	40% of kroon reserve requirement. As of 1 January 2001.
5) Remuneration of the reserve requirement	European Central Bank deposit interest rate. As of 1 July 1999.
3. Standing 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.**
	European Central Bank deposit interest rate. As of 1 January 1999.
4. Facility to sell foreign securities to Eesti Pank	**Eesti Pank is ready to buy such securities from credit institutions which meet the quality requirements set to meeting the reserve requirement.** As 1 January 2001.

[1] As of 1 March 2003 claims on foreign credit institutions are not deducted from credit institutions' liabilities to non-resident credit institutions any more. Reserve requirement base also includes subordinated liabilities, goverment lending funds, and counterpart funds.
[2] As of 1 March 2003 general and special ratios of reserve requirement were introduced. Special ratio is used for liabilities with maturities over 2 years and for repurchase agreements.
[3] Up to 1 March 2004 cash (up to 20% of the minimum reserve) was taken into account in meeting the minimum reserve requirement of credit institutions.

Eesti Pank continues technical preparations to harmonise the monetary policy framework fully with the Eurosystem. When devising the monetary policy framework, including the minimum reserve system, Eesti Pank proceeds, above all, from the economic situation in Estonia and in the European Union. The objective is to avoid such monetary policy steps that would not be in line with the economic environment.

Supporting Economic Stabilisation

The currency board framework has secured a reliable monetary system for Estonia's small open economy and has served as a basis for sustainable economic development. The options of Eesti Pank to adopt monetary policy instruments other than the tools arising from the currency board in order to balance the economy are restricted because of the rules of the currency board. The principal focus remains on the measures supporting financial stability and the government's fiscal policy.

Regardless of comparatively fast economic growth, there were several risks present in the Estonian economy in 2003. Extensive inflow of foreign funds accompanied by high domestic demand and rapid credit growth in the context of slower-than-expected rise in exports kept Estonia's current account deficit high also in 2003. At the same time rapid growth in the debt burden of households continued. Even though the first signs of domestic demand adjustment were visible in the middle of the year, Eesti Pank in cooperation with the government and the Financial Supervision Authority decided to **implement measures to support economic stabilisation and draw attention to the risks associated with fast loan growth and a large current account deficit**[2]. The principal aim of the measures was to affect the behaviour of households, enterprises, and credit intitutions, thus contributing to a slowdown in credit growth.

In 2003, Eesti Pank continued its conservative reserve policy, maintaining the general and special reserve ratio at the level of 13% (the general ratio in the euro zone stands at 2% and the special ratio at 0%). **Besides, the central bank removed an advantage – cash deductibility – upon meeting the minimum reserve requirement** (the amendment took effect on 1 March 2004). The total cash held at credit institutions amounted to almost one billion kroons. Now the credit institutions have to deposit more funds with Eesti Pank or obtain appropriate additional foreign assets in order to meet the reserve requirement.

A large current account deficit increases the vulnerability of a country's economy to external factors, thus threatening monetary stability. Arising from the monetary policy decisions of the European Central Bank, the monetary policy environment in Estonia was rather expansionary in 2003 and did not facilitate a decline in the current account deficit. This required application of alternative policies. **The restrictive reserve policy of Eesti Pank and the activities of the Financial Supervision Authority gave a clear signal to the financial sector and the public that in the interest of sustainable economic growth, lending decisions should be more thoroughly considered. Also the government's fiscal policy supported economic stabilisation,** since a surplus of 2.6% relative to GDP was achieved. In order to achieve external balance, coordinated application of different policies is important also in the near future.

According to Eesti Pank, economic stabilisation began in 2003. This was evident in a certain slowdown in the growth of domestic demand and private consumption compared to 2002 (see Figure 4.2). According to a survey carried out at the beginning of 2004, households are more cautious in their financial decisions than they were six

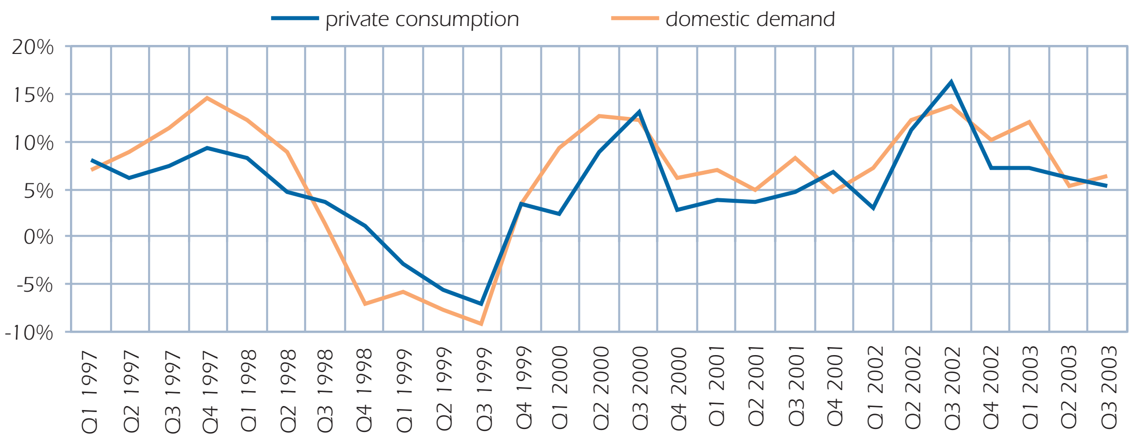

Figure 4.2. Growth of private consumption and domestic demand in constant prices (%)

[2] See the Measures Adopted by Eesti Pank in 2003 to Reduce Financial Sector Risks, Chapter V.

months ago. Leaving aside the impact of temporary large one-off transactions, also growth in investments and their ratio to GDP has somewhat declined compared to 2002. Predicted improvement in the external environment in 2004 should boost growth in exports and thus also promote improvement of external balance. Even though the adjustment process has started, possible threats require close monitoring also in the future.

Regular Economic Analyses, Forecasts, and Economic Research as Basis of Economic Policy Decisions

The analyses and economic research carried out by Eesti Pank allow the central bank to perform its duties stipulated by the law, participate in Estonia's economic policy discussions, and inform the public of the developments in the economy and in the financial markets. Short-term economic forecasts compiled by Eesti Pank as well as results of analyses are made available to the public on the Bank's website and in most cases also in the printed format. At the end of 2002 the process of regular analysis developed into in-depth treatment of the financial sector, which was initially accesible only internally, but has become publically available by now. The first Financial Stability Survey was issued in November 2003.

Since May 2003 participation in the working groups (fiscal policy, economic forecast, and econometric modelling) **supporting the decision-making process of the ESCB Monetary Policy Committee has become a new form of analytical work.** Besides the traditional observer status, which is to last until 1 May 2004, this involved also drawing up analyses and conveying the viewpoints of Eesti Pank regarding the development of Estonia's economy.

The aim of conducting economic research is not just to enhance the system of daily analysis; the opportunity to participate in research belongs to the human resources policy applied to the economists of Eesti Pank. Research is mainly carried out in the Research Department, but current economic analysis and shorter studies are also made in other departments.

Economic research carried out by Eesti Pank is based on a strategic research plan that defines the overall framework for studies carried out at the Bank. In 2003 the strategic plan was reviewed and new priorities were established. These priorities are developing a system of models, studies related to monetary policy, monetary system, and the financial sector[3].

In 2003 the Research Department of Eesti Pank carried out 12 studies of which a significant number were related to Estonia's labour market: labour market institutional framework, connections between the labour market and the tax system, the impact of reservation wages and other factors on the length of unemployment, the impact of minimum wage rise on employment, and wage and job search differencies among Estonia's workforce. Also the labour market block in the macroeconomic model was completed. Several studies were also introduced to the President of the Republic, the board of Estonian Employers' Confederation, the Confederation of Estonian Trade Unions, etc.

In the area of modelling, the principal tasks of Eesti Pank in 2003 and at the beginning of 2004 were developing the macroeconomic model of Eesti Pank in line with the models used by the European System of Central Banks – besides the labour market block, the general government block was added to the Estonian model.

The sustainability of the convergence process was a special topic under discussion. Within that framework a study of balanced real exchange rate of the Estonian kroon was completed. The study was introduced at a special seminar held by the European Central Bank.

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[3] See the Strategic Development Plan of Eesti Pank for 2004–2006, V, 21.

In 2003 international and national cooperation continued. The second consecutive joint study with the central banks of Latvia and Lithuania was carried out. This time the research topic was 'Monetary Transmission Mechanisms in the Baltic States'. The supervisor of the project was Professor David Geoffrey Mayes, research supervisor at Eesti Pank and advisor to the Board of Suomen Pankki.

Another noteworthy undertaking was the annual science award granted to young Estonian economists with the aim of valuing degree studies, promoting research in the field of economics, and recognising outstanding scientific research. In 2003 the award was presented for the first time, and was given to Toomas Hinnosaar, doctoral student at the University of Tartu.

ESTONIAN MONETARY POLICY ON THE WAY TO THE ECONOMIC AND MONETARY UNION

Upon joining the European Union on 1 May 2004 Estonia will also became a member of the Economic and Monetary Union as a country with a derogation. The arrangement of Estonia's monetary policy as it is today is not going to change, and the system of fixed exchange rate against the euro based on the currency board principles will be maintained. **In order to become full members of the EMU the new EU Member States, including Estonia, must adopt the euro in the future**[4].

Joining the EMU and the subsequent adoption of the euro is the best choice for Estonia to achieve the country's monetary policy objectives. The EMU membership helps to secure currency stability and thus also maintain price stability. Prior to the introduction of the euro the monetary policy of the Eurosystem continues to influence the Estonian economy, but Estonia does not have the possibility to participate in decision-making. After becoming a full member of the EMU Estonia will have the opportunity to participate in the decision-making process concerning the Eurosystem's monetary policy.

Estonia is seeking to join the Eurosystem as fast as possible to improve our economic competitiveness, economic growth, employment, and to support consistent rise in the living standard. Fast integration with the euro area will be one of the most important economic policy priorities both for the Government of the Republic of Estonia and Eesti Pank in the near future. Due to the similarities between the monetary policy objectives and transmission mechanisms of Estonia and the euro zone, joining the single currency system is a logical continuation of Estonia's current monetary policy. Therefore Estonia does not need a long preparatory period in order to adopt the euro.

Prior to joining the euro area Estonia, similarly to other EU Member States, has to participate in ERM II. Participation in ERM II is necessary to assess the suitability of the countries seeking to join the euro zone. A prerequisite for accession is meeting the Maastricht criteria. Estonia's conservative monetary and fiscal policies contribute to ensuring the conformity of the Estonian economy to the criteria.

The European Central Bank and the European Commission have declared that the exchange rate systems that are based on the currency board arrangement and pegged to the euro are in principle acceptable for participation in ERM II. This allows Estonia to maintain its current monetary system until full membership of the Eurosystem. The euro is to be introduced in Estonia after the end of the period of participation in ERM II. Estonia is going to be ready to join the euro zone by mid-2006 at the latest.

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[4] See the Strategic Development Plan of Eesti Pank for 2004–2006, I, 1 and I, 2.

ECONOMIC AND MONETARY UNION

Economic and Monetary Union is an integral part of the European Union, and in a way all EU Member States participate in the EMU. Upon accession to the EU a country becomes a member of the EMU as a country with a derogation. A country becomes a full member when it adopts the euro.

The EMU is based on two pillars. The first pillar of EMU embracing all Member States is ***coordination of the economic and fiscal policies of the Member States****. For that purpose all Member States draft regular economic programmes (either stabiliy or convergence programmes), which are coordinated between the countries and with the European Commission. The programmes are targeted at following the fiscal balance requirement stipulated in the Stability and Growth Pact and in the case of the countries that have not joined the euro zone also at meeting the Maastricht criteria. Besides, the Member States and institutions coordinate with each other in most other economic policy areas.*

The second pillar of the EMU is the ***single monetary policy of the European Union*** *implemented by the European System of Central Banks and the European Central Bank. The objective of that pillar is to maintain a low rate of inflation (price stability). Single monetary policy can only be implemented in those Member States that have met the Maastricht criteria and joined the euro zone. The only legal tender in these countries is the single currency – the euro.*

The Maastricht convergence criteria are:

- ***inflation criterion*** *– the inflation rate of the country seeking to join the Eurosystem must not be higher than the average of the three best-performing countries in terms of price stability plus 1.5 percentage points;*
- ***interest rate criterion*** *– the interest rates of long-term (10 years) treasury bonds denominated in the currency of the country seeking to join the Eurosystem must not be more than the average long-term interest rates of the three best-performing Member States in terms of price stability plus 2.0 percentage points;*
- ***exchange rate stability criterion*** *– the exchange rate of the country seeking to join the Eurosystem must not fluctuate against the euro more than by 15% during the ERM II period, and the country is not allowed to devalue its currency during that period;*
- ***public finance stability criterion*** *– the ratio of budget deficit to GDP must not be higher than 3% as a rule, and the ratio of public debt to GDP not more than 60% per annum.*

The idea of a monetary union is based on the optimal currency area theory established by Robert Mundell at the beginning of the 1960s. The benefits of joining a monetary union depend on the ratio of the costs of lost monetary policy independence to the gains derived from joining the union. According to the optimal currency area theory, gains outweigh costs if private sector shocks of the monetary union members are similar and if the fiscal sector is sufficiently adaptable. Since exchange rate changes cannot be used for adjustment in the monetary union, prices and salaries have to be flexible and production factors (capital and labour) must move freely. As a rule, countries with more open economies whose economic cycles are similar benefit from the monetary union.