



**EXCHANGE RATE STABILITY
AND FINANCIAL STABILITY
AROUND THE EUROZONE:
ESTONIAN EXPERIENCE**

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Many 'wrongs' are ruling discussion

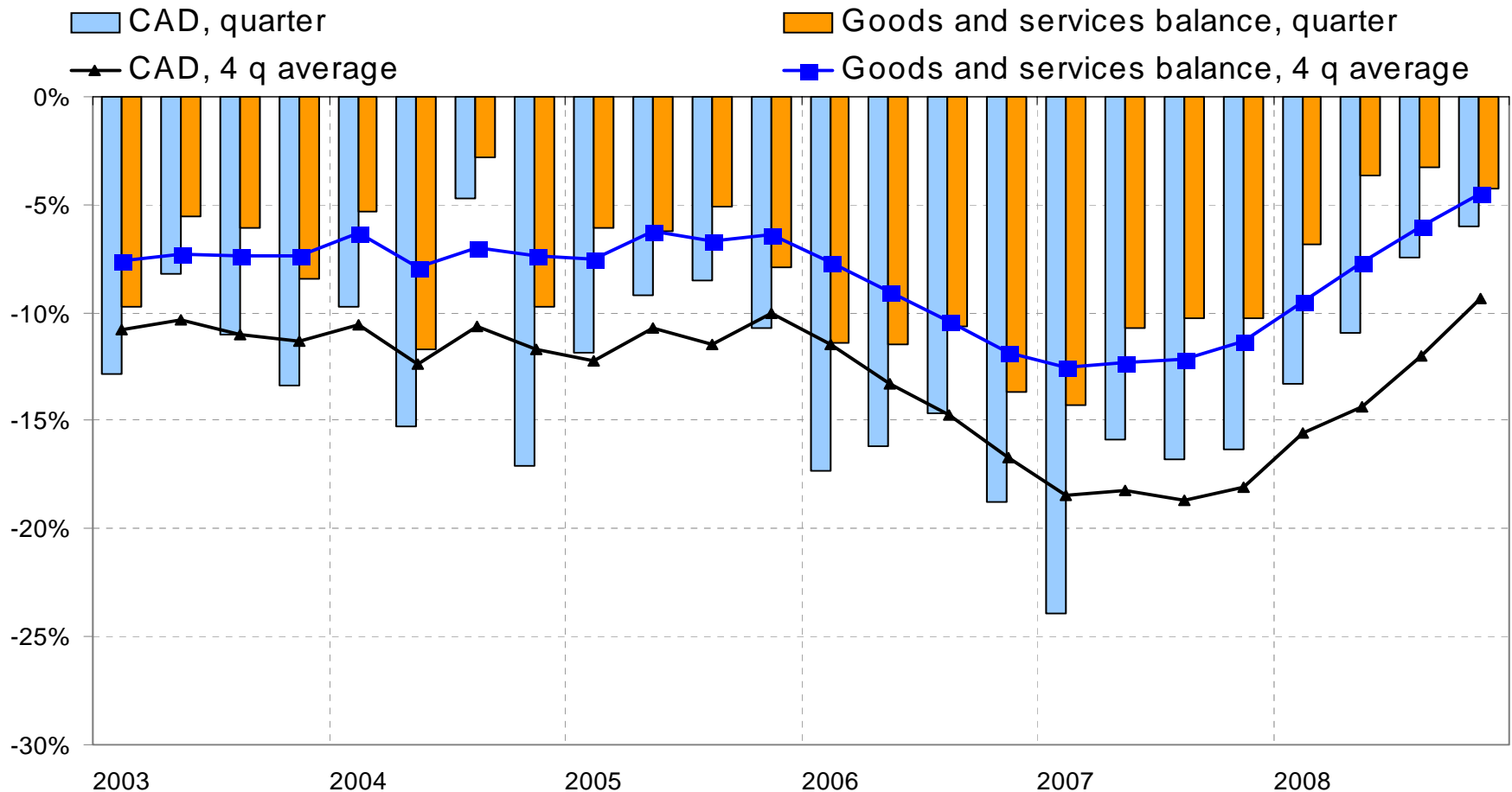
- “Current account surplus – good, deficit – bad”;
 - Is ideal that all countries have surpluses?
- “Currency floating – good, fixing – bad”;
 - But euro? Assumption that economy adjusts only through exchange rate is crazy...
- “Foreign debt -- bad, domestic debt – good”
 - What matters is overall debt burden!
- “Real exchange rate appreciation always bad”
 - But how convergence then even theoretically happens?

Fundamental starting point in Estonia before global crisis



- 16 years of experience under currency board/fixed exchange rate
 - Not always easy times (early banking crises, Russian crisis etc)
- Now fully integrated banking market
 - Essentially all resident deposits in high-rated Nordic banking groups
- EU integration induced investment boom in 2005-2007
 - Internal stabilisation starting from 2007

Estonian current account: big adjustment is possible without recourse to exchange rate

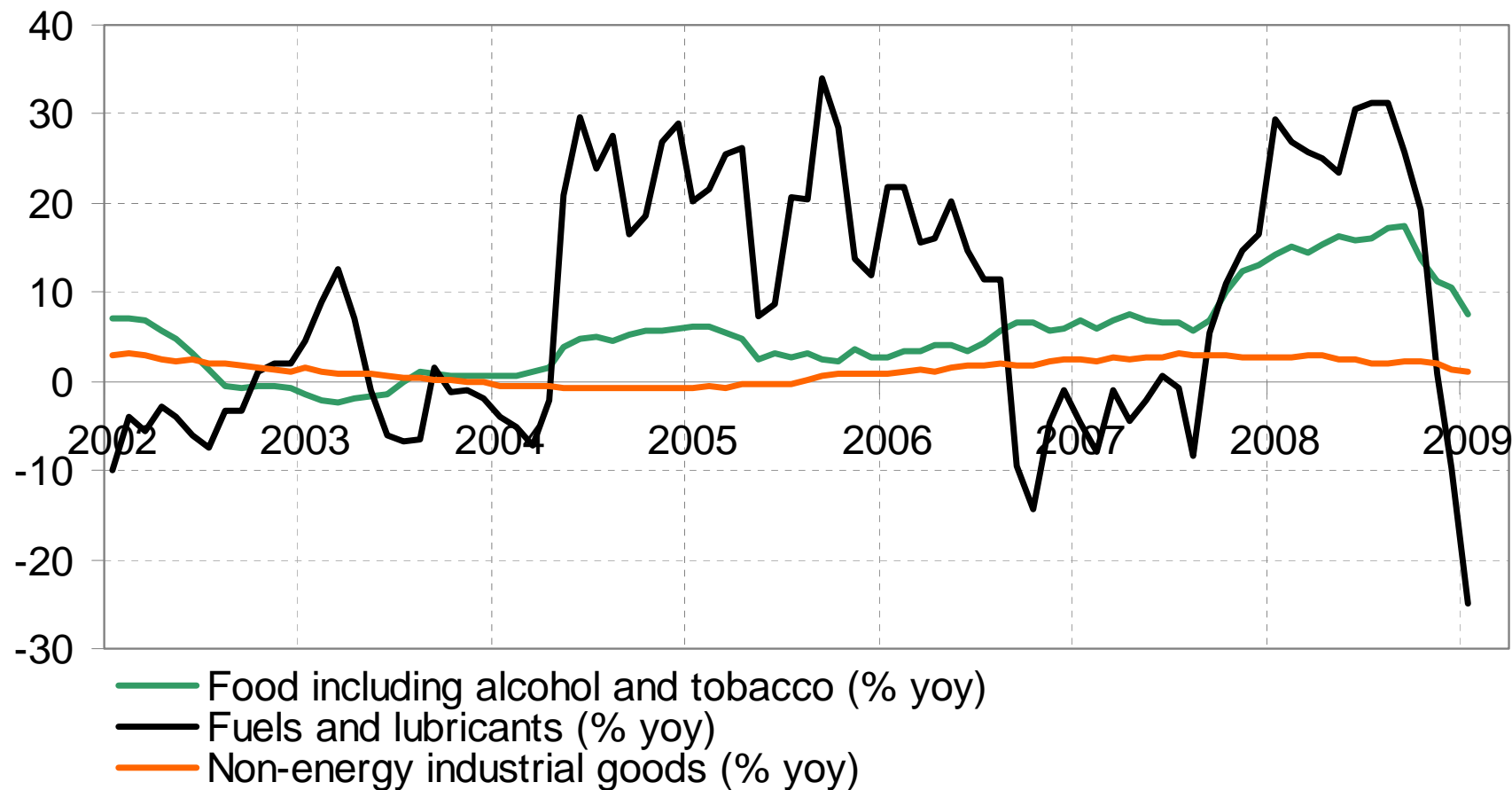


The role of exchange rate policy

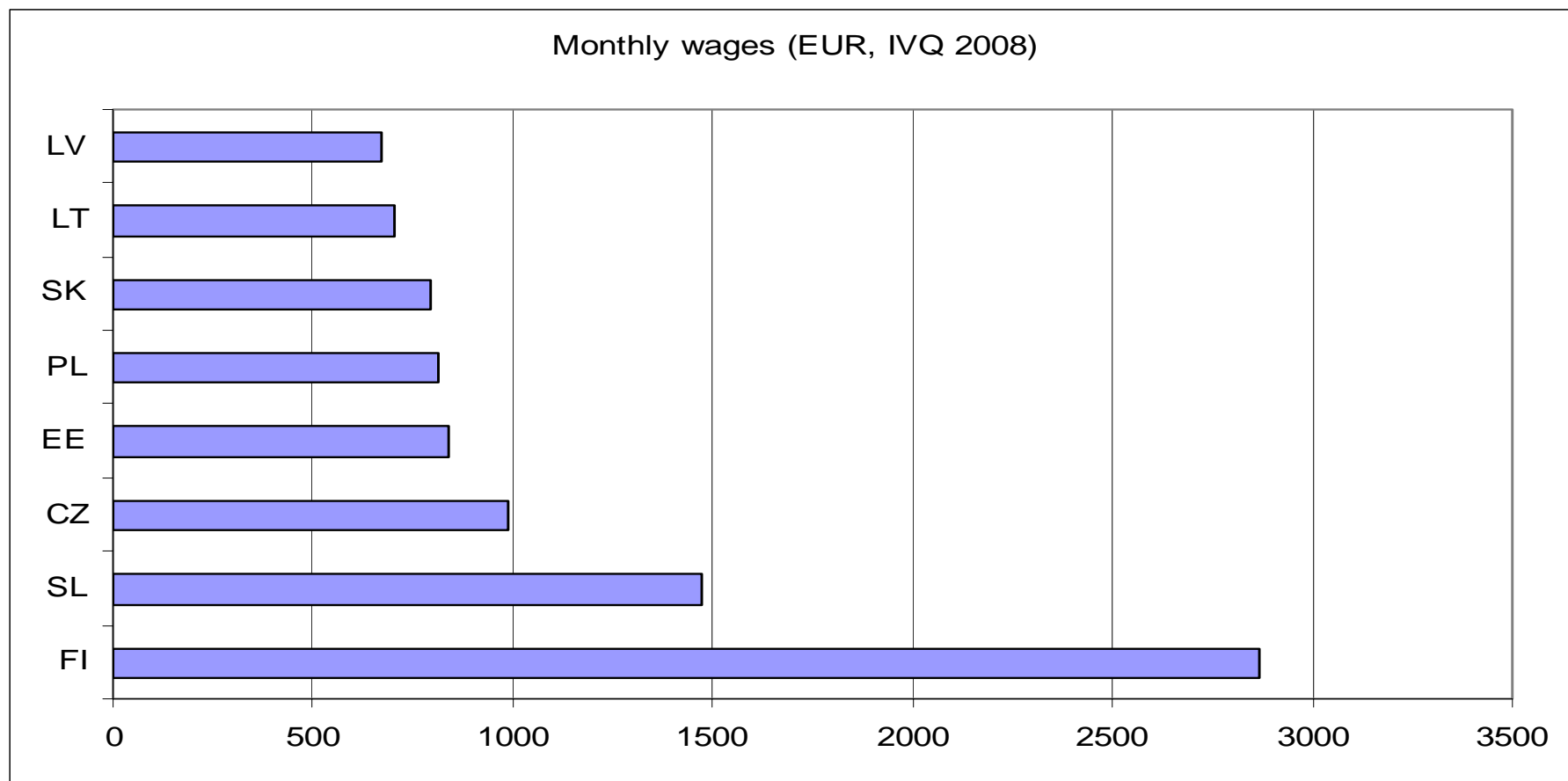


- Currency board fixed inflation expectations well
 - But can not shield from global inflation
- REER appreciated, but not in excess to real convergence assumptions
 - REER has actually been relatively stable
- Exchange rate stability has been an anchor also for financial stability during stress
- Countercyclical fiscal and financial sector policies would help a lot
 - Currency board does not issue uncovered money, so you need your own reserves

Currency board has kept goods inflation and expected inflation well-leashed



Relative price level never appreciated too much during the boom time

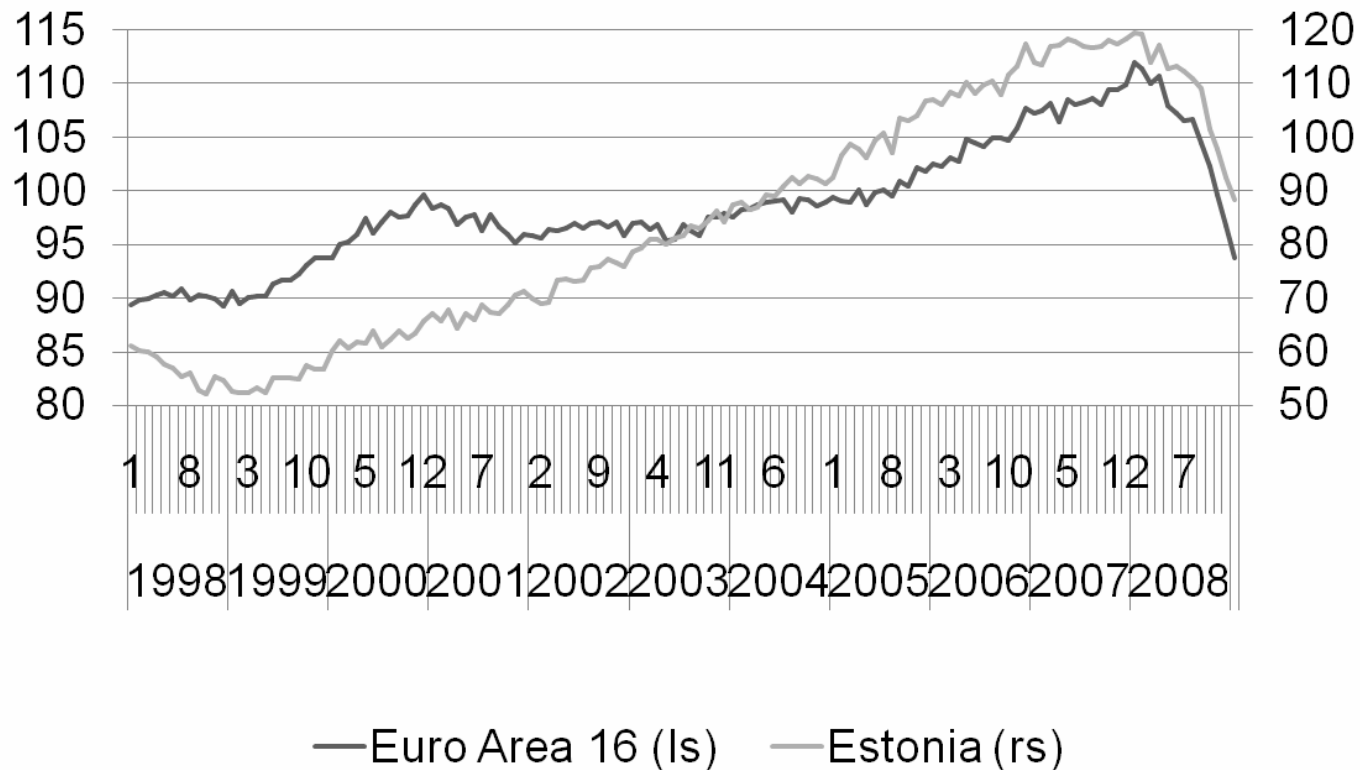


Source: National Statistical Institutions

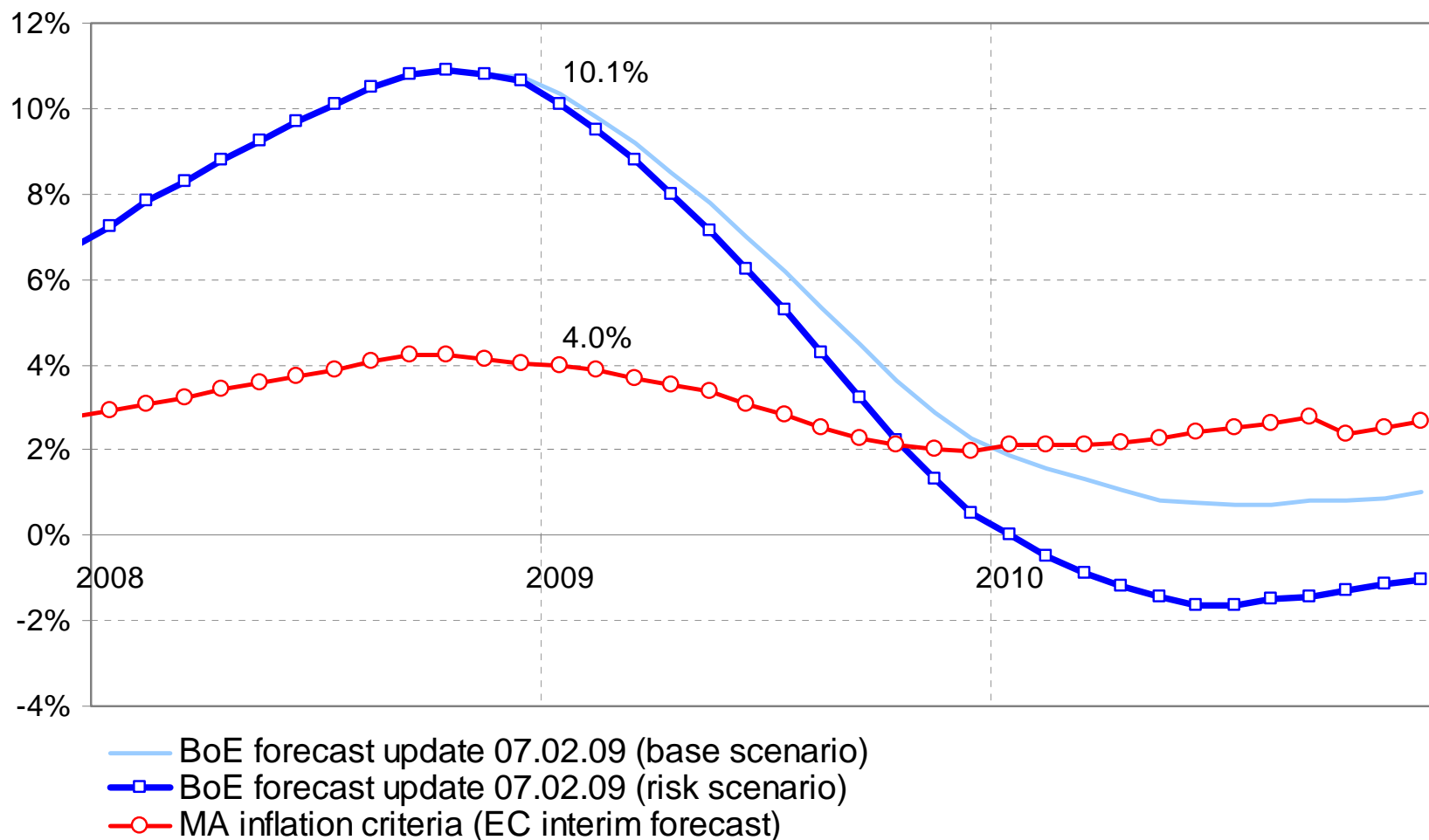
Why should symmetric shock bring us to exchange rate question anyway?



Industrial production - total industry (index 100=2005, excluding construction)



Euro adoption is an additional aspect in this game: exchange rate stability supports this

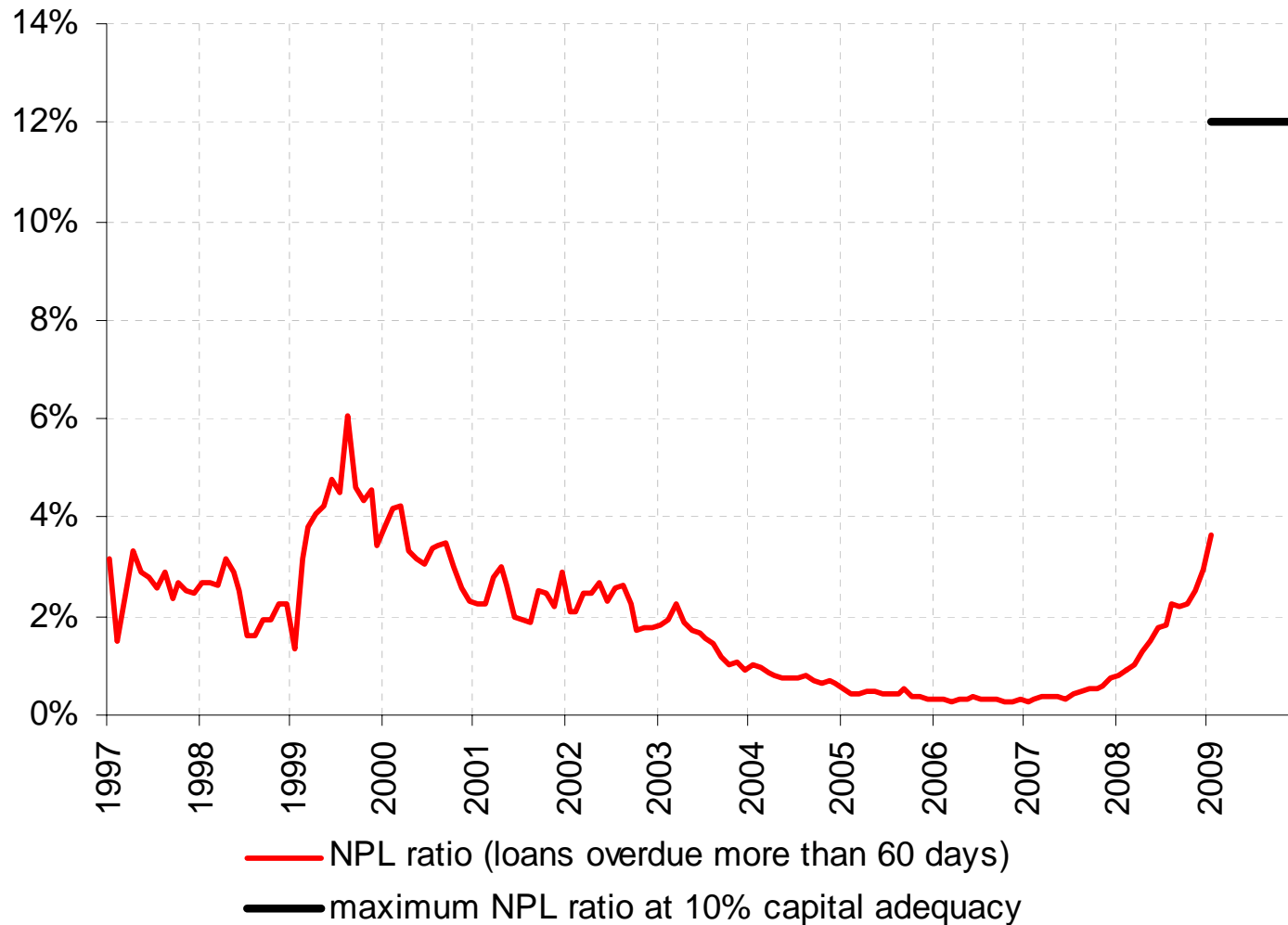


Financial stability gained a lot from integration



- Integrated banking sector has functioned well
 - Proof of that given by stress tests carried out by real-life!
- Ordinary external debt calculations can deliver totally wrong results to assess vulnerabilities
- BIS data is actually very useful!
 - Unfortunately, almost no commentator knows how it is calculated...
 - By BIS methodology Estonian short-term asset/debt ratio is 2 NOT 0,2 as analysts continue to think

Present environment obviously extremely challenging for banks, but things have to be put into the right context





All in all: policy conclusions

- Economy has shown its flexibility
- Fiscal prudence has paid off:
 - Deficits now are manageable
 - Reserves provide room for manoeuvring
 - Still: many things to do ...
- Financial system integration has paid off:
 - No extraordinary stress in financial stability
 - High reserve requirements and higher capital adequacy requirements now very valuable
- Currency board and fixed exchange rate has paid off:
 - Inflation expectations under control
 - Clear anchor for restructuring supports (wage) flexibility