REAL CONVERGENCE AND FINANCIAL STABILITY – SOME BACKGROUND TO THE APPROACH TAKEN BY ESTONIA

Speaking notes by

Vahur Kraft

Governor, Bank of Estonia

I.

There is no universal recipe for a successful monetary and financial policy that would suit everybody. But there are some general principles that economic policies must adhere to to be effective. One of the more important ones of these principles is that **the strategic choices of an effective economic policy must take into account the realities of the environment the economy must function in**.

- In Estonia, for example, the very early stages of transition were characterized by non-existent financial markets and the lack of a predictable monetary transmission mechanism. These factors have influenced Estonia's monetary choices. Estonia has had to rebuild its most basic elements of credibility from nothing – and that is where our monetary strategy has been probably one of the key factors (albeit not the only one), anchoring the functioning of the market economy and supporting a stable framework for the reallocation of resources.

II.

Performing the main central bank task - maintaining price stability – Eesti Pank has relied on fixed exchange rate within a currency board arrangement since 1992.

That means:

- full reserve backing of the monetary base (in other words – all the central bank liabilities are backed by the reserves),

- automatic intervention on the spot forex market as the sole active policy instrument
- no central bank interest rates; for all practical purposes, the key monetary policy interest rate for Estonia is the ECB main refinancing rate,
- banking policy is a responsibility of the central bank while supervision is carried out by an independent financial supervision authority;
- reserve requirement is used to ensure proper levels of liquidity in the banking system as Eesti Pank does not act as a lender of last resort ;
- Estonian financial sector refinances its operations in European money and repo markets and consequently, banks obtain kroon liquidity by trading euros to kroon via the central bank's automatic forex window. This is, in fact, tantamount to a continuous intervention on the local spot forex market by the central bank.
- the central bank does not have any margin on buying/selling the euro (as the anchor currency). To facilitate the smooth functioning of the forex market there have been no restrictions on capital account transactions for the last ten years, since 1994.

III.

A strong financial sector is a Must for a country like Estonia

- It is well known that financial sector soundness is crucial for monetary policy to effectively safeguard price stability and support economic growth. This relationship is even more critical under the currency board arrangement where the real economy lacks one adjustment channel, namely the exchange rate (in that sense – a CBA might be said to have some slight similarities with the present euro-area framework). **Under the CBA, the financial sector is the first line of defense at the time when external or domestic shocks dry up liquidity and force market interest rates to rise.** If the financial sector is not capitalized strongly enough to withstand the losses caused by high interest rates on the real economy, the very existence of the CBA might come into question. In Estonia we

have successfully passed this type of real test as early as mid- nineties - during the Asian and Russian crises.

- What offers a real challenge for a central bank in our circumstances is the question **to what extent should regulatory measures be taken into account in a broader financial policy context.** There are arguments for designing the regulations with a view to business cycles, especially as it seems that in the modern world financial systems have become more pro-cyclical than before. In that case, anticipatory measures may pre-empt the possibly devastating effects of asset price volatility and loan losses once the economy starts to cool down.

- This approach has a particular appeal under the currency board as the active use of monetary measures is excluded and reserve requirements are essentially the only available monetary tool. In these circumstances, sound prudential measures have had an important role. It should be underlined that in a heavily bank dominated financial system, banking regulations might also serve as an instrument to affect domestic demand more directly than under other circumstances. Indeed, Eesti Pank increased the capital adequacy ratio to 10% with a view to promoting resilience against cyclical risks in 1997 at the onset of Asian contagion, before the peak of the cycle.

We have been investing a lot into safeguarding financial stability in Estonia. **The key to financial sector stability is a high standard of legislation, transparency and supervision**. **In a way we were lucky to be able to start from scratch and create a relatively modern environment from the start.**

- Banking supervision in Estonia has been developing together with the banking sector. Ever increasing cross-sector integration and internationalization has led us to merge the supervisory functions of all financial market segments (banking, insurance, securities market) into a single entity – **Estonian Financial**

Supervisory Authority. The rapid development and dynamism of the financial sector are the key motivators for the banking supervision in Estonia today. In terms of banking sector soundness, both the EU Peer Review[1] and the Financial Sector Assessment Program by the IMF have concluded that banking supervision is strong and in compliance with best international practice. There is an adequate legal framework for financial sector crisis management and a really comprehensive set of policy and regulatory tools.

- Regarding the financial sector safety net, all major building blocks are in place, comprising of
  - (i) a monetary operational framework that is supportive despite the limitations to the lender-of-last-resort facility under the CBA,
  - (ii) an effective deposit protection scheme and
  - (iii) effective crisis prevention and resolution.

- **At the present time the concerns of the Estonian regulators are probably not too dissimilar from the issues claiming the attention of regulators elsewhere in Europe** - a more efficient exchange of information between supervisors and regulators; narrowing the possibilities for regulatory arbitrage; striving for a more uniform regulatory burden to lessen the temptation to make otherwise not too well grounded changes in the structures of financial groups. - to name but a few.

- **The is still, perhaps, one peculiarity that should be mentioned here – the close Scandinavian connections of the Estonian financial sector** mean that the cooperation of the Estonian regulators and supervisors with their colleagues in our neighboring countries must be rather close as well as their contacts with the Scandinavian owners of the larger Estonian banks. That can be especially

[1] An assessment of the compliance to best international practices and EU requirements in financial supervision conducted by specialists of the present EU member countries

significant in case the competition in the more lucrative market sectors becomes very aggressive, like it tends to do in Estonia.

While the currency board arrangement and the strict limits it sets on the lender of last resort function are often referred to as a potential source of instability, Estonian experience, so far, provides a convincing counter-example.

- The banks' forced reliance on their own capital and liquidity have had a direct impact on the market structure as they were forced to look for strong partners and the authorities were keen to have foreign reputable institutions 'coming in'. Foreign ownership has provided Estonian banks with strong capitalization and transfer of international best practices. And that, together with the high liquidity requirements, has clearly reduced the likelihood of sudden liquidity shocks. For the purposes of fostering the financial sector ability to resist the shocks in an environment of vast credit growth, the capital adequacy ratio of banks was increased from 8% to 10% in 1997. Reserve requirements (at 13%) are also relatively strict compared to what is usual in Europe as well.

It is fair to say that Estonian banking system is presently strong, well capitalized and liquid.

- Indeed, over the recent years, Estonian banking sector has proven its robust creditworthiness and competitiveness. Banks offer their customers a wide range of modern banking services from depositing to pension products. Their efficiency has increased (average cost/income ratio was slightly below 56% in December 2003) and the banks are profitable (the ROE in 2003 was 12,6%), in fact, the larger Estonian financial institutions are responsible for a very respectable share of the profits of their owner groups. More than a quarter of our bank customers regularly use electronic channels (customers of major banks also use on-line investment services services). 96 per cent of all payment orders are submitted

electronically. And - speaking about the latest developments, the average Estonian business manager following the price comparisons offered by the local press is presently slightly confused or wary of the reputedly high service fees charged by the banks of some of the present EU member countries.

To sum it up – the rapid improvements in the legal and regulatory infrastructure that have taken place over the last 10-15 years have resulted in a generally sound banking system that is comparable to the best international practice. Currently, there are six banks and one branch office operating in Estonia. Approximately 85% of the share capital of the banking sector is foreign-owned.

IV. Besides the Estonian financial sector the whole economy has benefited from the choices made more than a decade ago.

- Today, in 2004, after more than a decade of successful reforms, **Estonia's economic developments might look quite dynamic against the background of the lingering slowdown on the broader regional scene.** Investor and consumer sentiments have remained high, partially supported by positive future outlook and partially encouraged by lower-than-expected interest rates.

- **In 2003** Estonia's real GDP growth was 4,7% - the actual growth figures have come rather close to the theoretically calculated lower limit of the potential growth rate - 5-6%. The CPI growth was 1,3% - still, the core inflation in Estonia (i.e. inflation excluding various volatile components like fuel and food prices), is approximately 1 percentage point higher than the euro area inflation. The long-term (kroon) lending rate for the real sector was 5,5-5,6% at the end of 2003. Estonian kroon real exchange rate increased by 1,8%., the current account deficit amounted to an estimated 13,5% ; the government budget was in 2%

surplus, there government revenues have exceeded its expenditures for three years in row by now.

- **Estonian economy is already strongly integrated into the European economic area.** The share of current and future EU member states in Estonia's exports is about 80 %. Estonia is no longer the country as it was three-four years ago. However, it would be most certainly premature to say that the restructuring of our economy has been completed.

V.

What does this all mean from the point of view of Estonia as an EU member country ?

- As the ECB Governing Council has pointed out[2] the acceding countries differ greatly in their economic structure and no single path towards ERMII and the adoption of the euro can be recommended. (It should be noted that there has been no single path for the current Euro area members either.)

- The case of Estonia offers a good example of the arguments for a case-by case approach to ERM membership and the adoption of the euro.

- **On January 15 2004 Estonian Government decided that after becoming an EU member Estonia shall submit an application for ERMII membership as soon as** possible. Estonia should be *technically (and let me stress it once more – technically)* ready to adopt the euro by mid-2006. _Estonia would like to participate in the ERM II with the standard fluctuation band and unilaterally maintain the currency board arrangement at the same time.

[2] Policy Position published on December 18 2003

- The ECB has suggested[3] that given the risks implied by premature exchange rate rigidity, it might be appropriate for some new member states to only consider applying for ERMII membership after a further degree of convergence with the Euro area has been achieved. Pedro Solbes has[4] stressed that the ERM should not be considered as a waiting room pending adoption of the euro (but rather as a tool allowing Member States to implement sound economic and monetary policies that foster price and exchange rate stability.

VI.

For Estonia, a relatively speedy adoption of the euro is a natural step .

- It must be stressed that Estonia's eventual entry into the euro zone is contingent on the **fulfillment of the economic criteria applicable to the single currency** countries . But still, there are some aspects of the Estonian framework that might speed up the process.

- **The costs related to the possible loss of independent monetary policy are negligible in case of Estonia**. Estonia has operated a successful currency board vis-à-vis EUR (DEM) since 1992 – that means we could talk about something akin to a quasi-monetary union with euro area core countries that has lasted for almost 12 years by now.
- The loss of monetary sovereignty could, in some cases, increase the pressure for greater budgetary constraint and greater flexibility in salaries and prices. IMF has recommended[5] that the acceding countries implement " ambitious budgetary policies" which, for some of them, could go well beyond the Maastricht criteria for public deficit and public debt. (The recent experience in Western Europe has also shown that the lack of constraints on exchange rate can lead to somewhat over-relaxed budgetary stance.)
- Estonia has maintained **one of the most prudent fiscal policies among the accession countries,** we have balanced budget and Estonian public debt remains

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[3] Policy Position published on December 18 2003
[4] see eg 03 02 2004, Prague

the lowest among the accession countries and current EU members. Thus, joining the monetary union does not entail any significant change in Estonia's fiscal policy. *De facto* it has been in line with the Stability and Growth Pact principles. Moreover, the government sector's liquid foreign assets accumulated from privatization receipts and recent fiscal surpluses exceed 10% of GDP (in addition to central bank reserves), double the value of gross government debt.

- **Estonia is already closely integrated with the EU**. Current EU members account for about two thirds of Estonia's total exports and imports. EU is a major source of FDI inflows. 67% of the FDI stock (and 86% of the Estonian banking sector) is owned by Swedish and Finnish investors, whereas the rest of EU account to additional 18% of FDI.
- The economic structure of the Estonian economy (both by value added and employment) disaggregated into three main sectors, has practically converged with the economic structure of the present EU.
- A relatively long period of stable exchange rate has brought **significant and successful stabilization of inflation and interest rates.** Inflation in Estonia has remained at single-digit levels since 1998 and is currently even below the EMU level (annual CPI was 1.3% in 2003). Still, the medium-term inflation rate in Estonia is expected to remain ca 1-2%-points higher than in present EU member countries reflecting primarily the Balassa-Samuelson effect due to higher productivity growth. Interest rates have closely followed Euro area interest rates, as monetary policy transmission from ECB interest rate decisions to Estonian financial sector has been increasingly evident.
- Estonia has maintained its **competitiveness.** The dynamics of different REERs has been relatively stable since mid 90ies. The moderate appreciating trends in CPI and ULC based REERs in recent years can be connected to Balassa-Samuelson effect driven (wage) inflation differential rather than to loss of competitiveness. Estonian exports have performed reasonably well since the beginning of transition. Exports of the manufactured goods to the EU have grown about five times since 1995. EU imports having increased only around two times

[5] Horst Köhler, 03 02 2004

during the same period, it is evident that Estonian companies have found additional markets within the EU. The robustness of the result is confirmed by the fact, that the latter conclusion also holds true for each individual EU country.

- **Wages and labor market are flexible**. According to the Optimum Currency Area theory the need for nominal exchange rate adjustments is lower if wages and prices are flexible (especially downwards) and/or production factors are mobile across and within countries. Wages in Estonia have demonstrated downward real flexibility and in some sectors even nominal wage flexibility during the adverse shock of Russian crisis in 1998.

VII.

The key challenge for Estonia, like for most of the new EU member countries is, however, to <u>speed up real convergence while safeguarding the achievements of nominal convergence</u>.

- In Estonia, like in many acceding countries **inflation** has come down considerably, the macroeconomic environment can be regarded as fairly sound and financial sector is stable. But still the **gap with the EU in terms of per capita income** is very wide…
- While Estonian inflation has been by now reduced to low (even very low) levels, upward pressures on prices will probably emerge at some point in the future – eg in the context of the harmonization of indirect taxes and food price increases in the context of the EU accession
- A big gap in per capita income is usually accompanied by a gap in the level of prices and the real convergence process usually entails a parallel narrowing of both these gaps. Rising inflation rates, in particular if they are not clearly associated with GDP-per-capita convergence, could make the economies vulnerable to increasing inflation expectations and wage-price spirals. That, in its turn could negatively affect growth.

VIII.

We should also keep in mind that there are some areas of common concern where both the 'old' and the 'new' EU member countries could work together to achieve the best outcome for everybody. Below, I would indicate but a few of them.

- **First - structural reforms?** For the last 3 years European economic growth potential has not been realized. A relatively weak growth with a strong dependence on the external environment and low domestic demand on the one hand and a relatively rigid inflation on the other hand would seem to indicate the necessity for some structural reforms in the present member countries - and continuing similar reforms in the new member countries.

- **The fiscal policy** principles of the EU and its member states are another important area that demands close attention - especially from the common monetary policy viewpoint. The question has been raised whether or not the requirements of the Stability and Growth Pact are too rigid.

- It is true that balanced fiscal policy is part of the political culture of any country successfully operating a currency board. So it might look as if adhering to the 3% rule, for example, might come easier to Estonia than to some other countries – but still, one should keep in mind that there is at least one important similarity between a currency board environment and the common monetary policy environment - in neither case can the exchange rate be used for an adjustment tool.

- Generally speaking, it seems that the Stability and Growth Pact has performed its function reasonably well. This is proved by the fact that most of the EU member states now have a much stronger fiscal position than in earlier years. Could it be that any major changes in the Pact framework would be more likely to cause additional insecurity than bring some new benefits?

- Within the EU the realisation of the **Financial Services Action Plan** should lead to a complete integration of European financial markets by 2005. Creating a more fully integrated European financial market would certainly mean some changes in the regulatory environment. The outcome of should be a more flexible framework and better cooperation between regulators and supervisors. But one must always keep in mind that adequate regulatory framework is a moving target.

- For instance, I would like to ask every regulator to think about what are the developments to expect after the first 'European' financial institutions have been set up. Let it be noted that at the present time this problem has relatively low immediate priority from the Estonian viewpoint - the Scandinavian Nordea preparing for its 'European' status is already represented by a branch, not a daughter banking institution, in Estonia. But one could imagine scenarios where other large financial groups might follow Nordea's example and the financial landscape of Europe might be transformed, with a relatively small number of 'European' mother companies operating numerous branches in different countries… The role of the leading supervisor and other supervisory and regulatory bodies might well take on some new dimensions ….

In conclusion I would like to stress that the fact that most of the new EU member countries have weathered the recent global slowdown relatively well does not mean that they are immune to adverse developments in the external environment. Therefore it is very important that every member country , both 'new' and 'old' give its full support to the efforts aimed at **improving the competitiveness of the European economy**. For the new member countries it means productivity gains – but also maintaining the momentum of ongoing structural reforms and real convergence. An attractive business environment is crucial from the viewpoint of attracting investments .

Estonia is one of the new member countries that hopes to be ready to adopt the euro in a relatively near future. But the challenges will not end there. We should not forget about the policy efforts necessary after becoming part of the EU and the EMU - fiscal policy will remain an important stabilization tool, also, issues concerning the flexibility and efficiency of labor, product and capital markets will remain important challenges, just as they have been up to then.

Taking a look at the future of Estonian financial system, **it is necessary to stress that we have taken on some very serious commitments as a future euro area country**. **It is universally expected that Estonia shall fulfill these commitments – and fulfill them sooner rather than later.**