

MONETARY POLICY

The monetary policy objective of Eesti Pank, up to the moment of Estonia's accession to the euro area, was to ensure price stability by maintaining the fixed exchange rate of the Estonian kroon. Within the framework of the currency board system, the main monetary policy instrument of Eesti Pank was the standing facility for buying and selling foreign currency, the forex window available to credit institutions. The forex window enabled banks to increase their Estonian kroon reserves by selling an amount of foreign currency to the central bank equivalent to the amount they wanted in Estonian kroons, and vice versa, buying foreign currency for Estonian kroons. The reserve requirement was another important monetary policy instrument used by Eesti Pank, obliging banks to keep a part of their assets as buffers in Eesti Pank or in high-quality external assets.

The external monetary policy environment was lenient throughout 2010. The monetary policy rates remained low in the euro area, as the key policy rate of the European Central Bank remained unchanged at 1%.

The risk premiums of the local money market dropped significantly in 2010. Whereas 12 months ago the local money market interest rate (the 6-month Talibor) was nearly triple the euro area money market interest rate (the 6-month Euribor), the differences in interest levels vanished during the year. The volume of forward premiums continued to drop during the year, with the market participants having no interest in hedging the risks related to the Estonian kroon. This was prompted both by the imminent accession to the euro area and by a conservative fiscal policy which kept the debt burden low and the budget deficit significantly below the maximum allowed by the Stability and Growth Pact.

In connection with the changeover to the euro, the minimum reserve requirement was gradually lowered from 15% to the 2% in the euro area from September 2010 onwards. From the beginning of 2011, all Estonian credit institutions must thus adhere to the 2% reserve requirement in the euro area. The change of the reserve requirement did not cause any significant changes in the behaviour of the banks. In the second half of 2010, Eesti Pank's monetary policy activities also revolved around the preparation for participation in the Eurosystem monetary policy operations.

Estonia used the fixed exchange rate and the currency board system successfully for 18 years. The strengths of the system have been revealed during the recent economic downturn, when the flexibility of wages and prices allowed Estonia to cope well with the difficult conditions in the changed economic environment. It also helped to prepare for participation in the euro area, the single currency area.

Estonia has joined the euro area and since 1 January 2011, Eesti Pank has participated in shaping and implementing euro area monetary policy decisions. As a result, Eesti Pank's monetary policy activities started to change in 2010. Preparations for participation in the Eurosystem cooperative analysis work had already started at the beginning of the year. With the permission to accede to the euro area, Eesti Pank started to participate actively in the analytical exercises concerning all NCBs and in preparing the Eurosystem forecasts.

The primary objective of the Eurosystem monetary policy is to maintain price stability in the euro area. This objective has been stipulated in Article 127 (1) of the Treaty on the Functioning of the European Union. In 1998, the Governing Council of the ECB gave a quantitative definition

¹ Decision of the Governing Council of 13 October 1998.

of price stability: "Price stability is defined as a yearly increase in the Harmonised Consumer Price Index (HCPI) of the Euro Currency Area of less than 2%. Price stability shall hold over the medium term."¹ In addition, the Governing Council explained in May 2003 that, in the pursuit of price stability, it would aim to maintain inflation rates "below but close to 2% over the medium term".² **Price stability is thus defined as the Harmonised Consumer Price Index of the Euro Currency Area at below but close to 2% over the medium term.**

Monitoring

Monitoring in Eesti Pank in 2010 can be divided into two periods: monitoring before and after July 13 when the Economic and Financial Affairs Council (ECOFIN) adopted the final approval of Estonia's accession to the euro area. In addition to standard monitoring of the domestic and external economy, the focus laid on monitoring and evaluating the fulfilment of the Maastricht criteria. In the second half-year, the focus fell on the monitoring of the economy of the euro area, and on preparations for participation in euro area analysis and monitoring, and in the monetary policy decision process in the euro area.

Monitoring by Eesti Pank focused mainly on analysing and commenting on major current economic and political topics in the domestic and external environments. Owing to the debt crisis faced by several euro area countries in 2010, Eesti Pank started regular in-depth monitoring and analysis of the economies and financial markets of these countries in order to ascertain the risks of any potential spillover, so as to be able to respond promptly to such risks. The results of the monitoring are published in the central bank's various publications, press releases and public comments.

Economic reviews

During the global financial and economic crisis, Eesti Pank resolved to comment on Estonia's economic situation and development in more detail six times a year. In 2010, five comments from Eesti Pank were published. Twice in the year, Eesti Pank published a longer economic overview including the latest economic forecast.

In 2010, the central bank analysed the situation in the financial sector once in every six months, as usual. The results of the analysis were published in the Financial Stability Review. Due to the changeover to the euro, the experts of the central bank also analysed the sustainability of the Estonian economic development, with the results published in the Report on the Adoption of the Euro. Smooth income convergence with more prosperous countries requires a flexible labour market and wage setting based on productivity growth. Therefore, Eesti Pank also published the Labour Market Review on a regular basis in 2010. The central bank now prepares and publishes labour market comments over a shorter period of time than usual. From 2011, the Labour Market Review will no longer be published, as the topics covered by the review are now discussed in the economic forecast.

Economic forecasts

Eesti Pank usually issues economic forecasts twice a year. In 2010, Eesti Pank issued the spring forecast in April and the autumn forecast in September. The forecast comprises the baseline scenario and the risk scenario, addressing the economic development in the current year and the next two years, as well as background information on current economic and political subjects. The results of the macro-economic model and expert assessments are used as

² Decision of the Governing Council of 8 May 2003.

the basis for the economic forecast. Risk scenarios mostly reflect the risks endangering the economy.

In connection with the accession to the euro area, Eesti Pank started to participate in the preparation of the Eurosystem staff projections³. The Eurosystem staff projection is included in the materials used by the Governing Council twice a year for evaluating risks related to price stability and economic development. In connection with its participation in the preparation of Eurosystem projections, Eesti Pank published a comment on the adjusted forecast for inflation and economic growth in December. Due to its participation in the common Eurosystem projection process, Eesti Pank is publishing economic forecasts in June and December from 2011 onwards.

Economic research

Eesti Pank's economic research projects are based on the strategic research plan, which sets the general framework for studies conducted in the bank. The priorities for 2010 included the development of the macro-economic and banking sector model system, research into monetary policy and the financial sector, and analysis of the sustainability of the Estonian monetary system. Ten research projects on these issues were conducted by the Research Department in 2010. Eesti Pank continued to improve its banking sector credit risk model and profitability model, to prepare the monetary policy simulation model and to develop the macro model of the Estonian economy.

In addition to being published in the Eesti Pank Working Papers Series⁴, the central bank's economic research gained recognition in the international arena. In 2010, various research papers

were published in internationally recognised academic journals such as the Journal of the European Economic Association and the Scandinavian Journal of Economics, and presented at international conferences, including the 70th International Atlantic Economic Conference organised by the International Atlantic Economic Society and the Conference on the Euro Area and the Financial Crisis organised by Národná Banka Slovenska, the central bank of Slovakia.

Cooperation on research at international and domestic level continued in 2010. Eesti Pank's specialists attended the Working Group of Econometric Modelling, composed of members of the European System of Central Banks, and participated in the Household Finance and Consumption Network and the Macro-prudential Research Network. Eesti Pank also participated in the preparation of the international conference *Economies of Central and Eastern Europe: Convergence, Opportunities and Challenges 2010* on economies in transition, organised under the leadership of the Tallinn University of Technology in June 2010.

Alongside the presentation of its own surveys, Eesti Pank also invited experts from foreign countries to Estonia to present the results of their research. A total of fourteen seminars were held in 2010, eleven of them featuring guest lecturers from abroad and three presenting the central bank's own research projects. For instance, Iikka Korhonen, Head of the Bank of Finland's Institute for Economies in Transition (BOFIT) presented research on the causes, development and impact of the financial crisis in various countries, while Mihails Hazans, research fellow with the Baltic International Centre for Economic Policy Studies and professor of economics at the University of Latvia, gave a presentation

³ For further information see "A guide to Eurosystem staff macroeconomic projection exercises", available on the ECB website at <http://www.ecb.int/pub/pdf/other/staffprojectionsguideen.pdf>.

⁴ For a complete list, see "Publications of Eesti Pank in 2010", pp 126-127.

on the adjustment of the Latvian labour market during the economic downturn. The annual series of lectures dedicated to the internationally renowned Estonian economist Professor Ragnar Nurkse continued in 2010 with a lecture by Stefan Ingves, Governor of Sveriges Riksbank, the central bank of Sweden.

Eesti Pank's visiting researcher programme continues to contribute to research cooperation. In 2010, three foreign experts took part in the economic research projects of Eesti Pank. The traditional annual research award for a young Estonian economist was awarded for the eighth time and was given to Marge Reinap, Doctoral candidate of the Tallinn School of Economics and Business Administration for her research on "The economic burden of major behavioural health risks".