(Speaking notes) DRAFT

Exchange Rate Regimes: Hard Peg or Free Floating?
Washington D.C.
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From Fixed to Fixed – the case of Estonia
Peter Lõhmus

OUTLINE

- Historical background;
- Running the CBA:
    - Macroeconomic development,
    - Financial system development,
    - Financial crises 1997-98.
- Pro and con;
- Recent developments.

STARTING POINT

- Adopted in 1992, in the midst of the ruble zone collapse;
- Significant national/political background. The choice was more a function of an external rather than of an internal stability (although inflation around 100%);
- Anchor currency – DEM (illustrates the strive 'back to Europe') ;
- Market rate chosen for DEM-EEK exchange rate; as a result of significant market imperfections kroon undervalued;
- Very weak banking sector.

INSTITUTIONAL and LEGAL FRAMEWORK

- Constitution and the Act on Bank of Estonia (BoE) makes BoE responsible for maintaining the stability of the national currency:
    - No details about internal or external stability;
    - No limits on BoE activities on the subject of CBA;
    - High degree of BoE independence;
    - BoE not responsible for the state's financial obligations and vice versa;
    - No government financing.
- Law on Security of Estonian Kroon (1992) as a legal basis for CBA:
    - Issue of kroon fully secured by gold and convertible foreign exchange reserves (illustration);
    - Exchange rate of the kroon will be determined by the BoE with respect to the German mark and the BoE has no right to devalue the kroon;
    - BoE guarantees unconditional current account convertibility of the kroon;
    - BoE has the right to change the amount of kroon in circulation only if there is a corresponding change in its gold and foreign exchange reserves.

DEVIATIONS FROM THE 'CLASSICAL' CBA

- Limited capital controls 1992 – 94 (easily circumvented, minimal impact);
- Some LLR functions performed on a case-by-case basis during the banking distress to avoid excessive systemic risks (activities limited to the amount of excess reserves);
- Required reserves (10 -13 %), at times used as a discretionary quasy-monetary instrument;
- Standing deposit facility;
- Foreign exchange window limited only for banks, although cash window was in use for some years;
- Very limited amount of BoE CD-s – (enhancing liquidity management);
- Nevertheless, more orthodox than most CBA-s after the II WW.

POLICY FRAMEWORK 1992 -2000

- Strong political support throughout the political spectrum;
- Liberal economic policy: solid backing for market-oriented policies, including flexible labor market;
- Fiscal conservatism, as a minimum *ex ante* (as a result - no domestic government debt markets) (illustration, to be added);
- No capital account restrictions since 1994 (& no trade barriers);
- Strong backing from the business community;
- High importance for external credibility.

MAIN (ECONOMIC) ARGUMENTS BEHIND THE CBA

- Small economy, limited resources → solution: openness → (a) important: stable external value of the currency; and → (b) reality: limited monetary management options in highly integrated financial markets;
- To overcome structural inefficiencies inherited from the past, there was a strong need for high flexibility → CBA: focus on long-term convergence rather than on short-term effects for cushioning temporary fluctuations;
- European Monetary Union as a fixed exchange rate environment.

MACROECONOMIC PERFORMANCE

- Table – main economic indicators;
- Graphs (…)

FINANCIAL SYSTEM

- Rule no 1 for an efficient CBA: banking sector ought to be strong;
- Several waves of banking 'crises', none of them systematic, limited state support;
- Policymakers standpoint: banks are set to bear the burden of interest rates adjustments, supervisory standards at times stricter than international standards (illustration);
- High capitalization and adequate reserves as preconditions for CBA safe-guard;
- With no LLR facilities, the principal task is to ensure a stable liquidity system, the responsibility of which is entirely in the hands of the banking system;

- Narrow domestic financial markets; liquidity management based on foreign financial markets and on limited CB facilities;
- Foreign banks/capital encouraged (94% of banking system foreign owned).

TRANSMISSION (ADJUSTMENT) MECHANISM

- CBA adjustment mechanisms - specie flow in the form of interest rate arbitrage and exchange rate (cash) arbitrage, have functioned well …(illustration);
  - … although interest rate spreads remain;
  - ‘dollarization’ as a solution? …
  - …not entirely, as it does not eliminate credit risk.
- Wage and price adjustments have proved sufficient;
- To achieve efficient adjustment, CBA needs to be perceived as a credible and long-term system.

TURBULENT YEARS: 1997-98

- Boom in 1997: GDP growth 10.6%, credit growth exceeded 100%, current account deficit 12.1% and net capital inflow 17% of GDP (illustration);
- CBA and small market volumes lead short-term interest rates rocket (money market rates from 7% to 20%); strong downward correction of financial assets (illustration - 2);
- Bank failures (although limited) and financial sector consolidation;
- Sharp GDP contraction: by 3.9% in the I half of 1999; rapidly ‘improving’ current account balance;
- Nominal wage growth down from 19% to 9% during 1998;
- Adjustments were [in hindsight] not only unavoidable but even necessary, and…
- …relatively short-lived;
- However, recovery was expected to take place somewhat faster.

POLICY RESPONSES TO ‘OVERHEATING’ AND TO FOLLOWING FINANCIAL CRISES

- Re-enforcing credibility and bolstering banking system;
- Restrictive fiscal policy in 1997-1998: respectively + 2% (Stabilization Reserve Fund created) and - 0.2% of GDP;
- Effective reserve requirements for banks up from 10 to 13 %; base was broadened by net short position in respect to foreign financial institutions;
- Capital adequacy minimum level increased from 8% to 10%.

AFTER 9 YEARS OF EXPERIENCE: ‘IN FAVOR’

- CBA has withstood economic reforms and two global external financial shocks;
- Good economic performance both on macro and on structural levels;
- Monetary policy driven discipline has enhanced economic reforms in different areas (e.g. enhancing foreign investments) → CBA not only requires discipline but also imposes it;
- Limited moral hazard in banking system → strong financial system;
- Smooth convergence with the euro area monetary policies.

AFTER 9 YEARS OF EXPERIENCE: 'QUESTIONS'

- Long time to overcome distrust among the financial community;
- Volatility (although short-term, if well managed);
- Balassa-Samuelson: price convergence and higher inflation compared to flexible exchange rate systems, compare Latvia and Estonia 1992-93;
- Risk of overshooting in non-tradables prices;
- Short-term problems could be 'hidden' under the superficial calm of the peg.

RECENT DEVELOPMENTS: CHANGES IN THE MONETARY OPERATIONAL FRAMEWORK

- Continuing high importance to improve operational framework – smoothing the operations of existing standing facilities and enhancing CBA transmission mechanism;
- Increasing the amount of eligible assets for meeting the reserve requirement, including prime foreign securities;
- Intra-day liquidity management upgrade by introducing RTGS and developing international real-time FX settlement;
- Lowering the liquidity buffers before entering the EMU not reasonable.

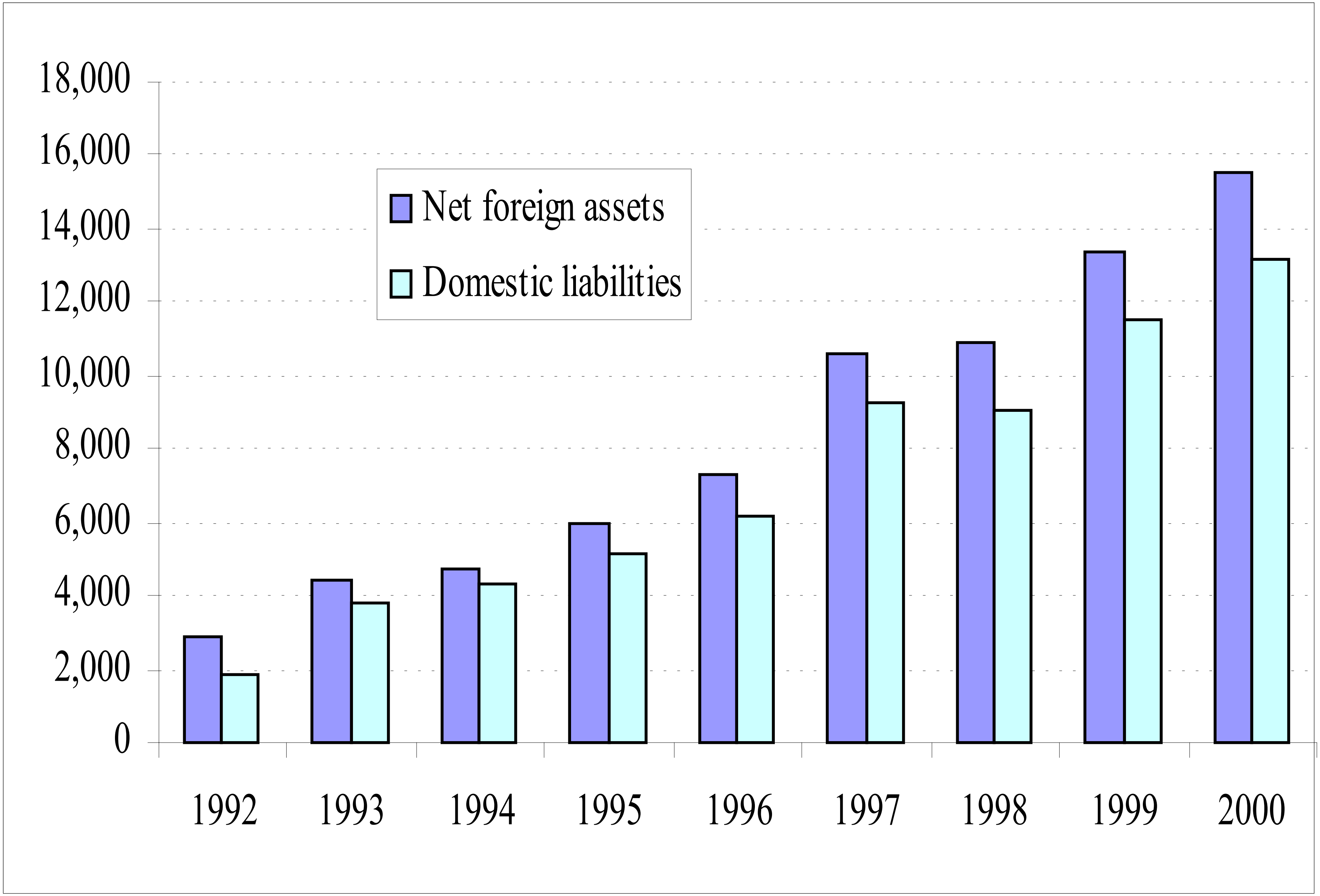
NEXT TO COME

- EMU accession – real and nominal convergence;
- EMU accession – adjusting operational framework;
- Handling large capital inflows.

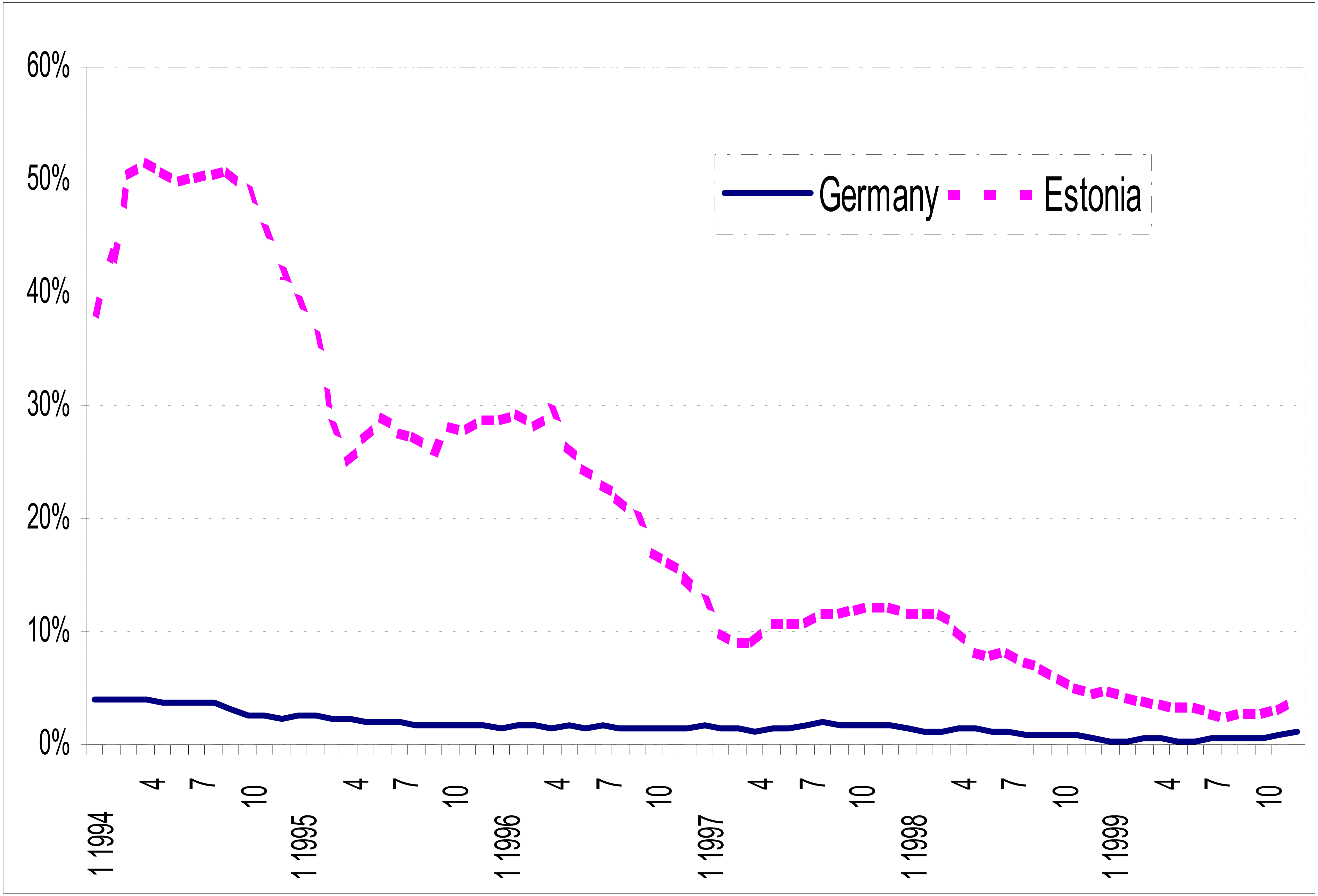
Estonia: Selected indicators

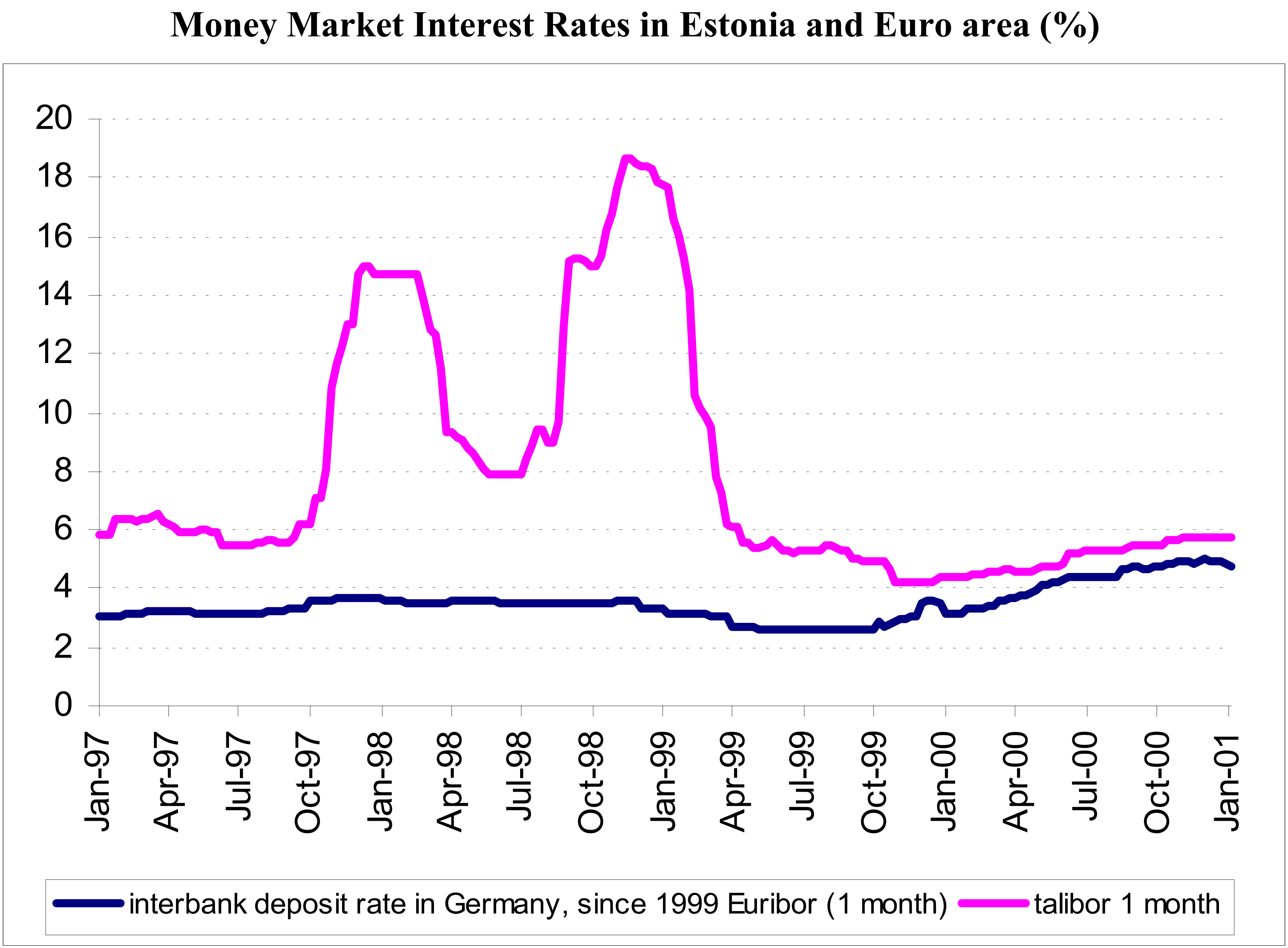
	1993	1994	1995	1996	1997	1998	1999	2000[e]	2001[p]
Nominal GDP (EUR mln)	1401	1932	2602	3352	4159	4679	4819	5330	5900
GDP real grow th (%)	-8.5	-2	-4.3	3.9	10.6	4.7	-1.1	6.3	5.5
CPI	89.8	47.7	29	23.1	11.2	8.2	3.3	4	5
Fiscal deficit (% of GDP)	-0.7	1.3	-1.3	-1.9	2.2	-0.3	-4.7	-0.4	0
Current account balance (% of GDP)	1.3	-7.2	-4.4	-9.2	-12.1	-9.2	-5.8	-7	-8.5
Gross external debt (year end, %GDP)					56.5	53.1	59		
Annual interest rates of loans (year end)	33	21.4	15.9	13.8	18.4	13.8	8.6	8.4	...
Assets of commercial banks (% of GDP)	29	33	39	44	63	55	63	69	...

Estonia: Currency Board Cover

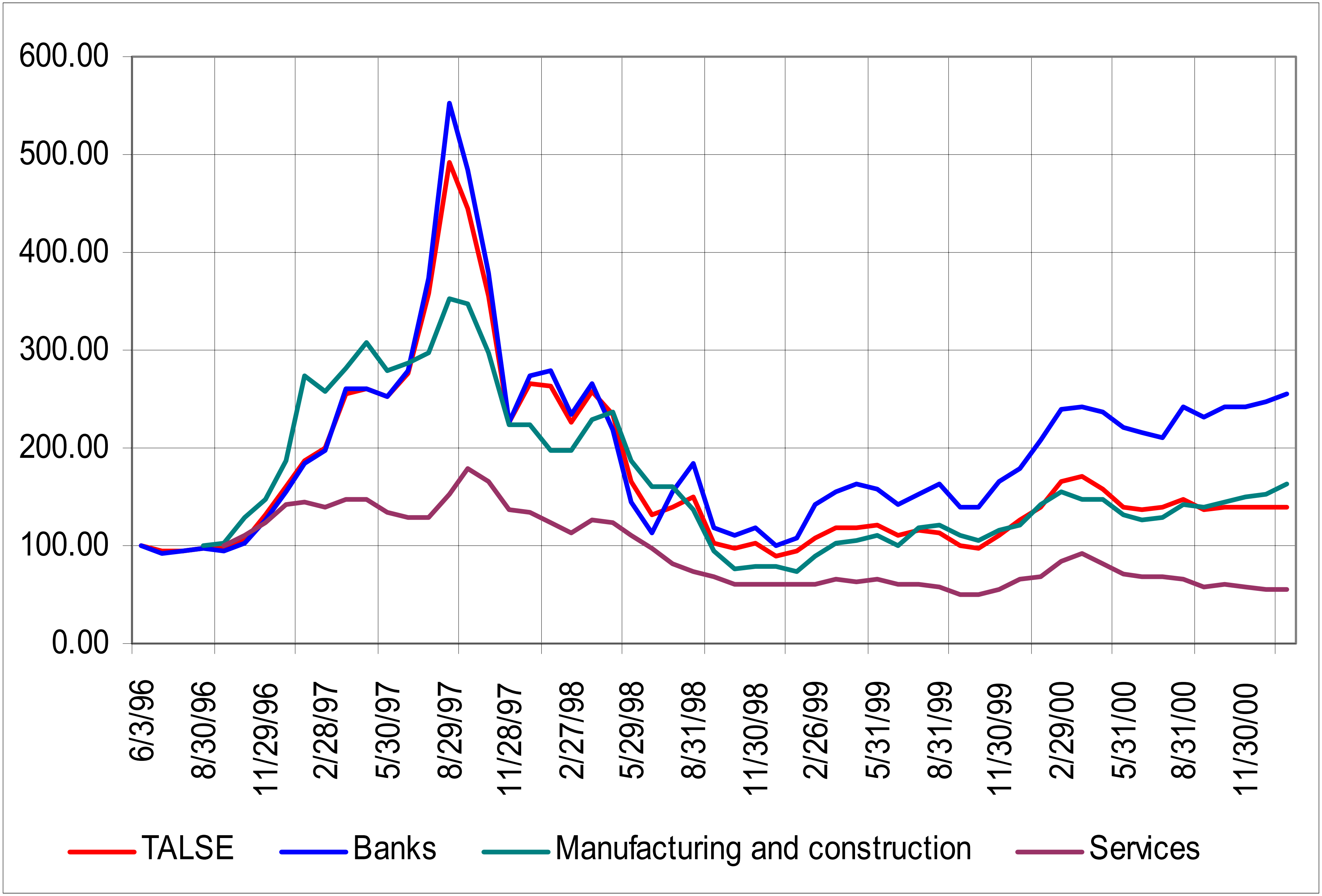


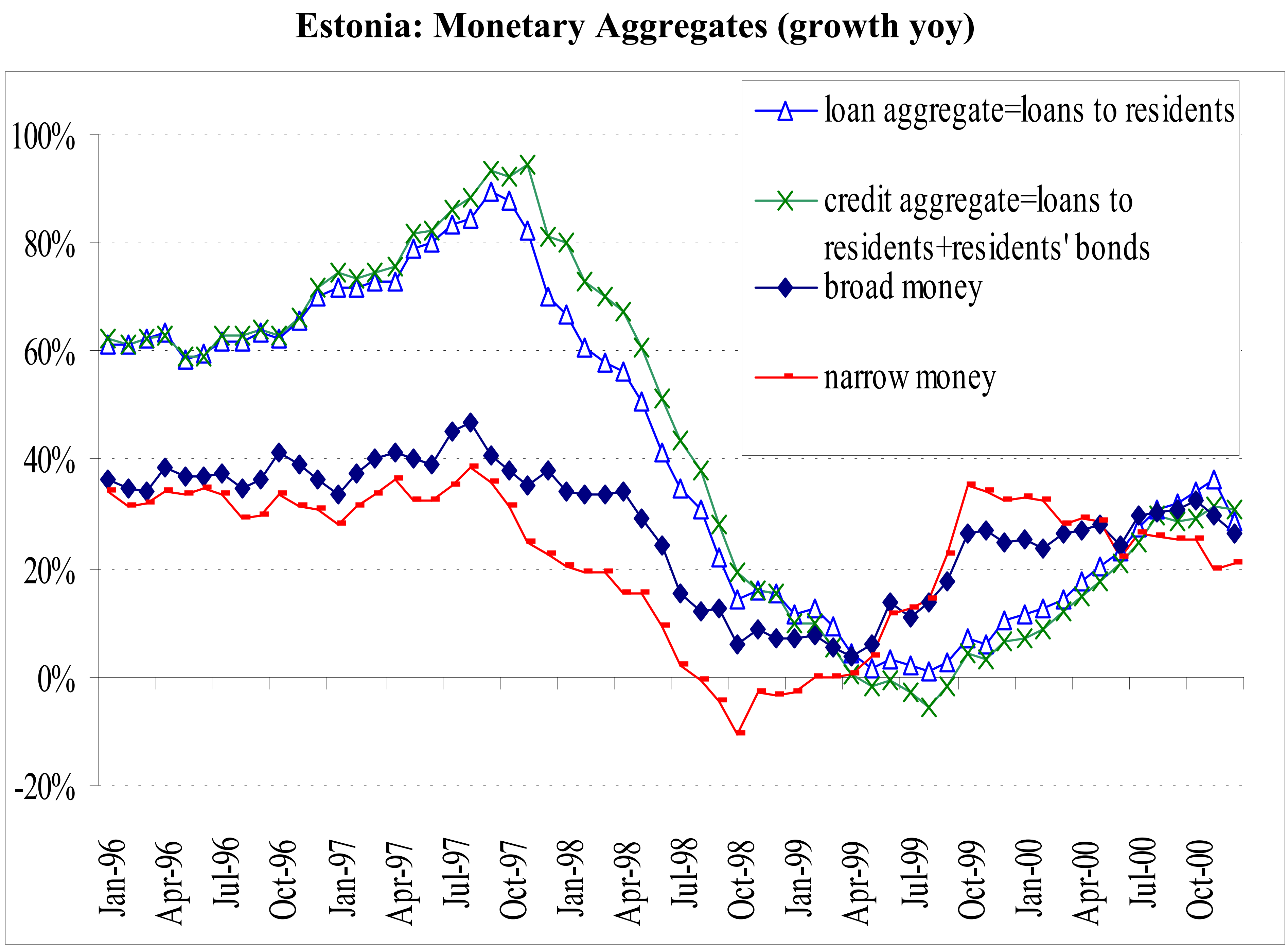
CPI: Germany and Estonia




Money Market Interest Rates in Estonia and Euro area (%)
20
18
16
14
12
10
8
6
4
2
0
Jan-97
Apr-97
Jul-97
Oct-97
Jan-98
Apr-98
Jul-98
Oct-98
Jan-99
Apr-99
Jul-99
Oct-99
Jan-00
Apr-00
Jul-00
Oct-00
Jan-01
interbank deposit rate in Germany, since 1999 Euribor (1 month)
talibor 1 month

Tallinn Stock Exchange index TALSE and sectoral indices (%)




Estonia: Monetary Aggregates (growth yoy)
loan aggregate=loans to residents
credit aggregate=loans to residents+residents' bonds
broad money
narrow money
100%
80%
60%
40%
20%
0%
-20%
Jan-96
Apr-96
Jul-96
Oct-96
Jan-97
Apr-97
Jul-97
Oct-97
Jan-98
Apr-98
Jul-98
Oct-98
Jan-99
Apr-99
Jul-99
Oct-99
Jan-00
Apr-00
Jul-00
Oct-00

Estonia: Banks' capital adequacy and minimum requirement