

Eesti Pank  
Bank of Estonia



17 February 2009

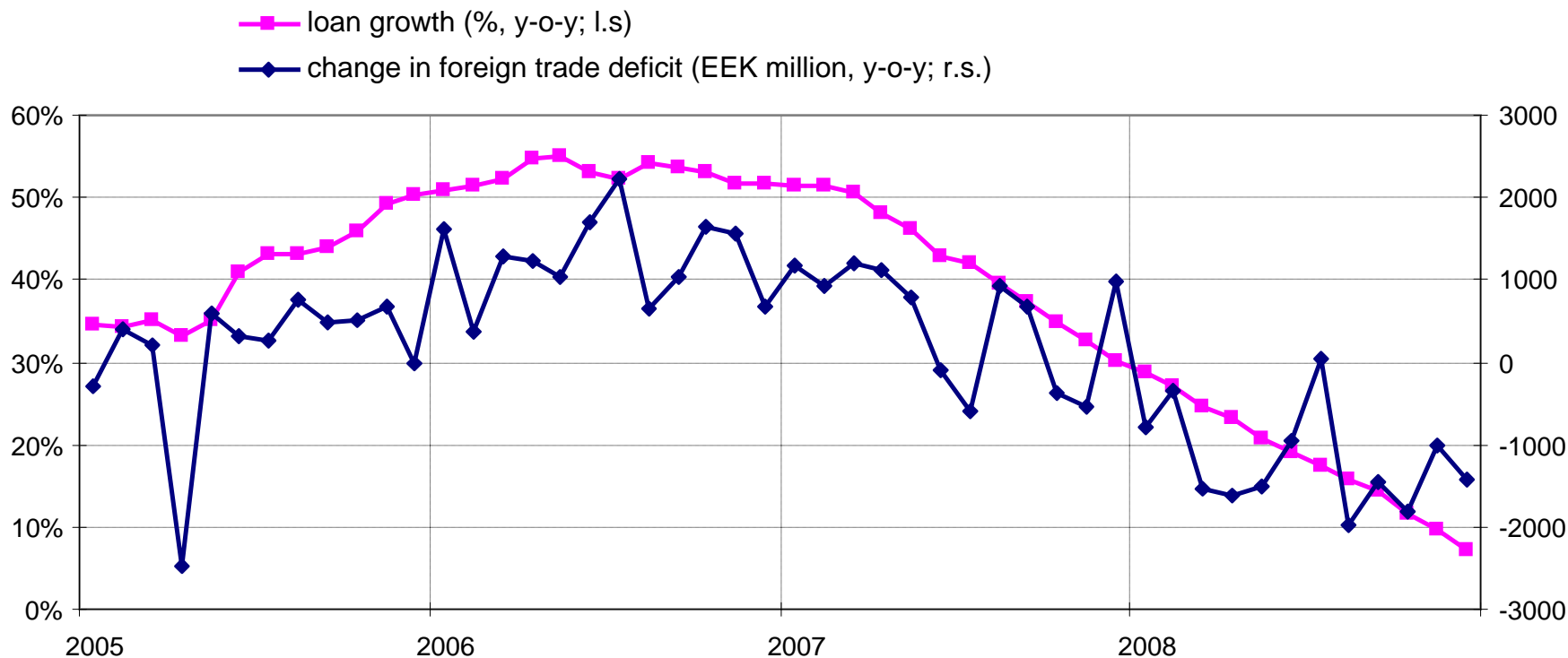
# Eesti Pank's economic policy statement

# Main issues



- The world has changed and so far it is not yet clear what the new world is like.
- Are our markets flexible enough to cope in the new world?
  - What is stopping companies from being more courageous?
- What is the appropriate fiscal policy reaction?

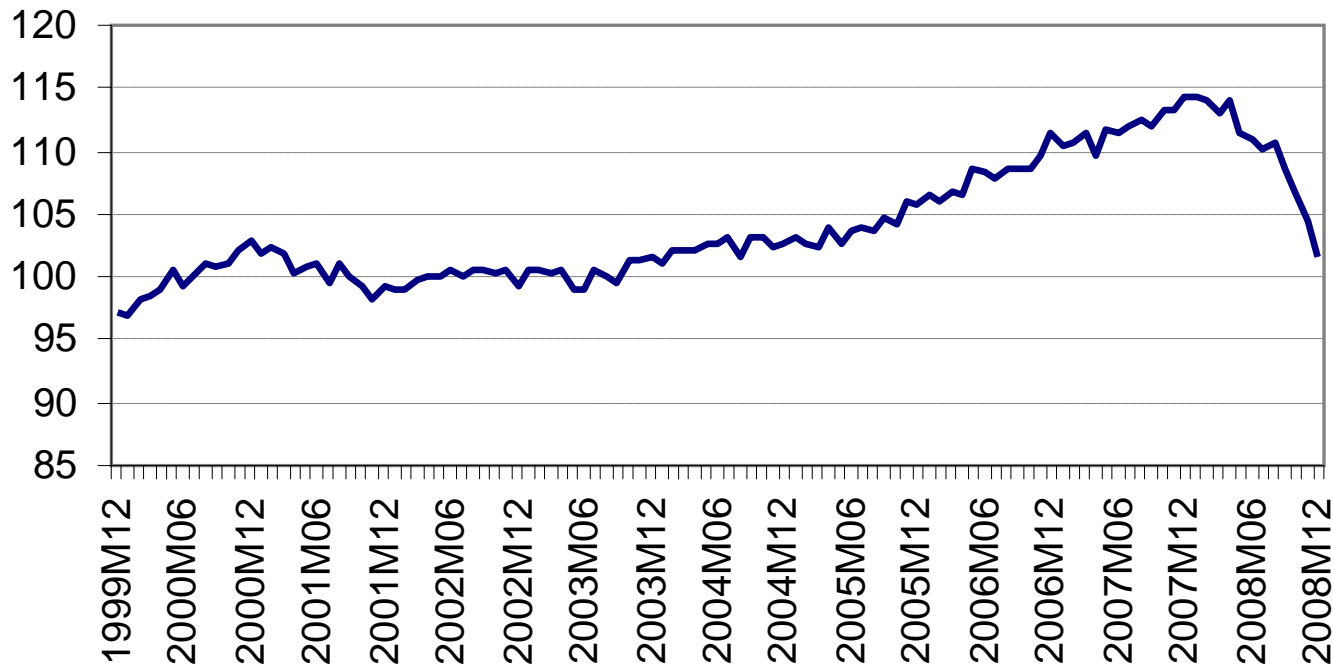
# The growth prospects of Estonia's economy are inhibited by getting used to post-boom life



# It would be great to export, but who is going to buy the goods?



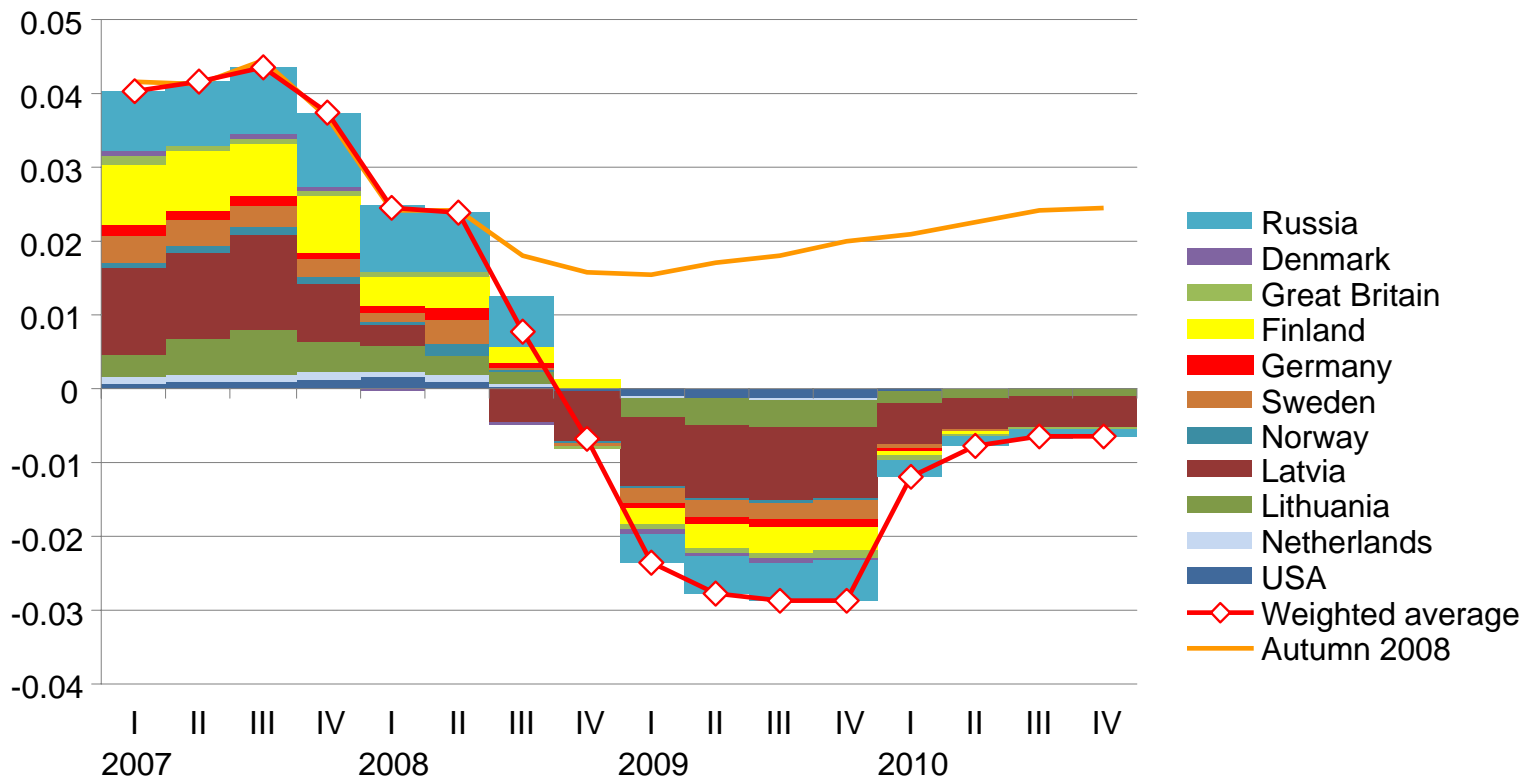
Euro area industrial production volume index  
(2000=100, excl. construction)



# It cannot be ruled out the economic downturn of our trading partners will last several years



## Trading partners' weighted GDP



# What are the implications for Estonia?

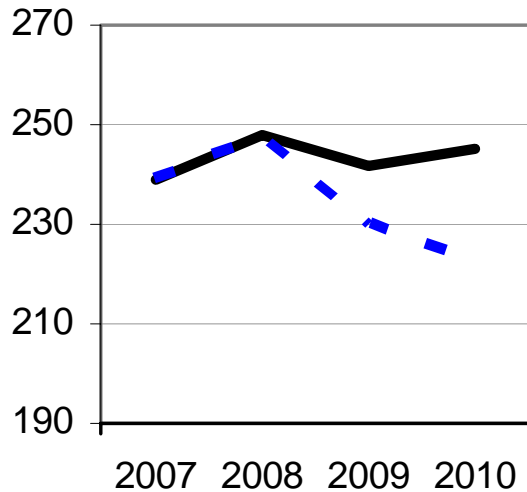


- General background:
  - If exporters' target markets decline permanently up to 10-20%, the economy's turnovers and profits will generally decrease by the same magnitude.
- How to avoid it (at least partly)?
  - The only option is to increase productivity faster than others and/or step up the restructuring of companies.
    - In part this means weaker companies will disappear from the market.

# Eesti Pank's revised forecast

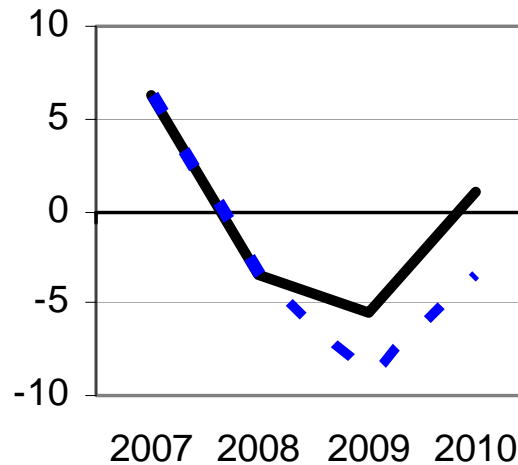


### GDP volume (EEK bn)



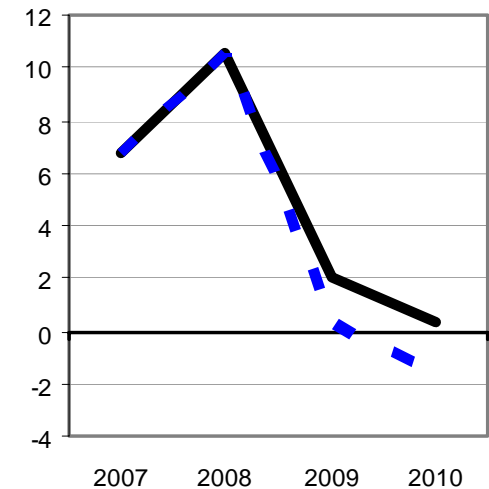
— base scenario  
- - risk scenario

### Real GDP growth (%)



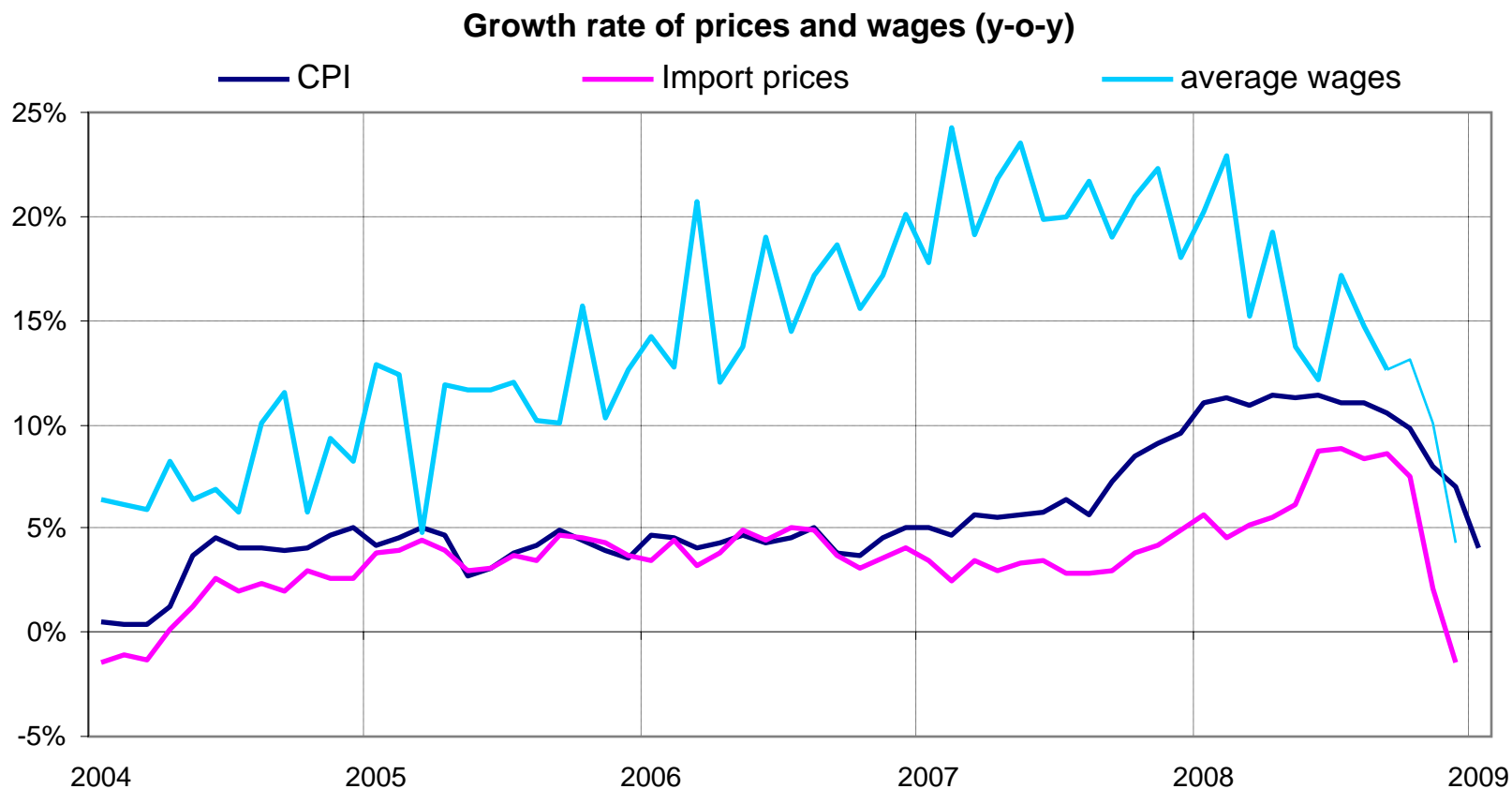
— base scenario  
- - risk scenario

### Inflation (%)



— base scenario  
- - risk scenario

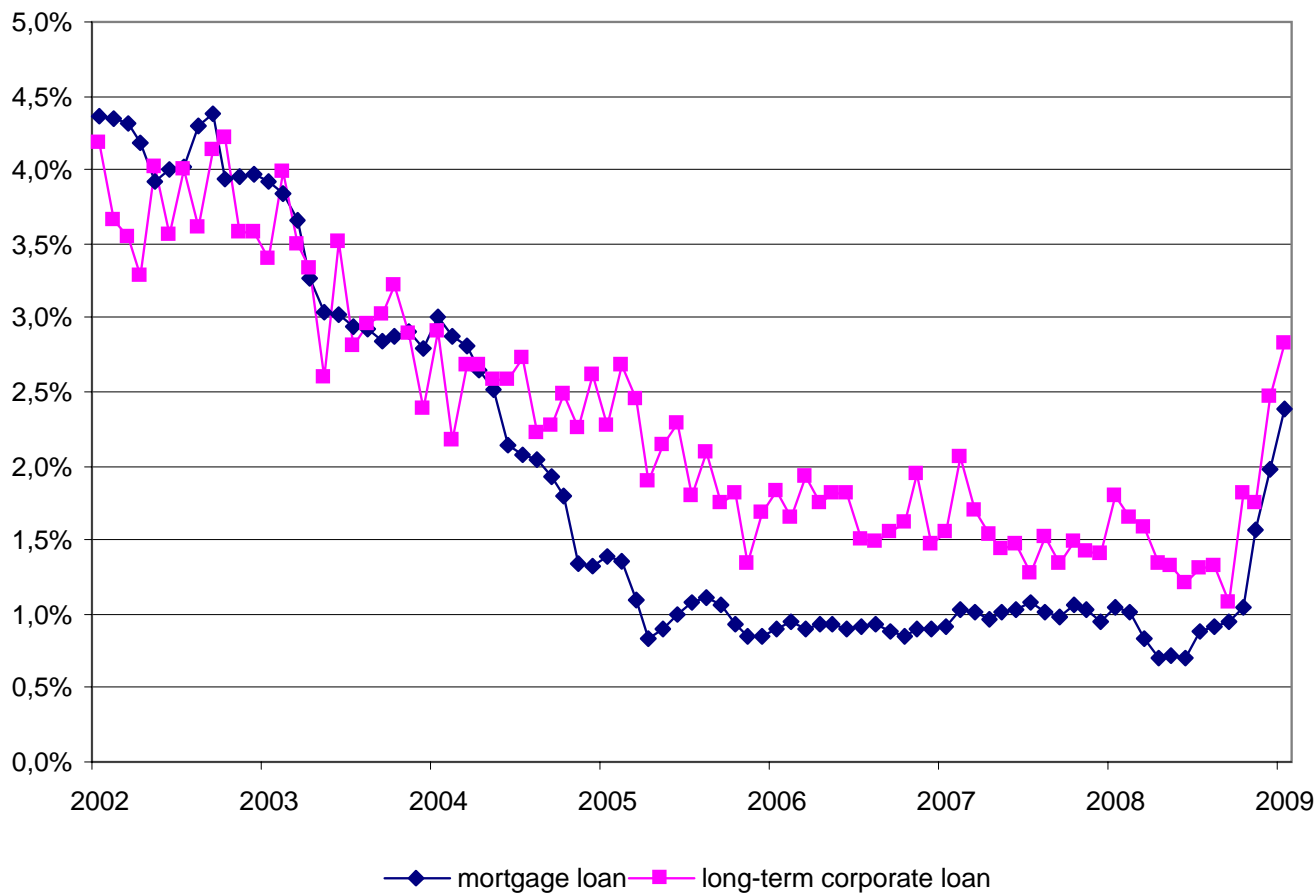
# The flexibility of the economy helps survive the crisis: are there enough encouraging signs?



# Credit conditions have tightened all over the world, including Estonia

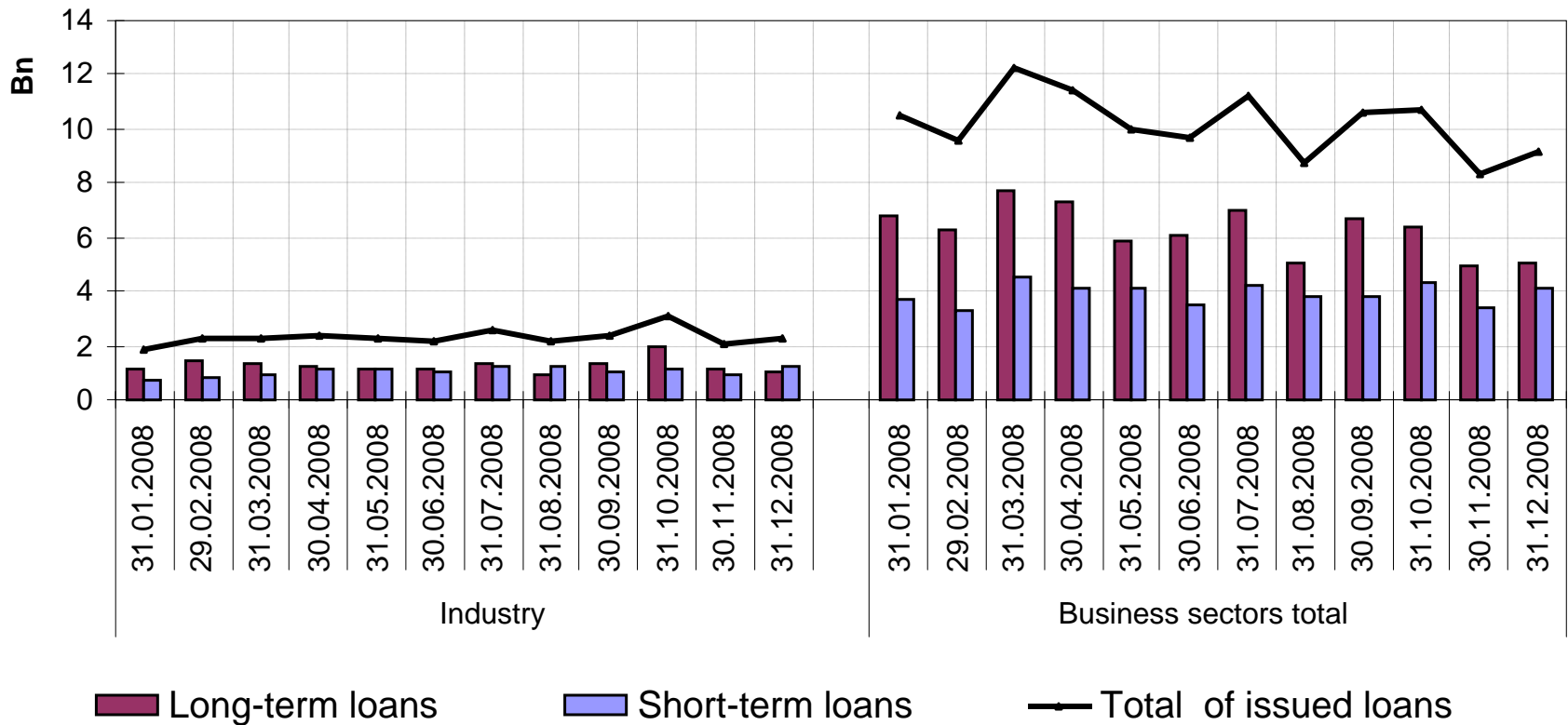


Average margin vis-a-vis 6-month Euribor



Interest margins on issued loans have risen across all business sectors.

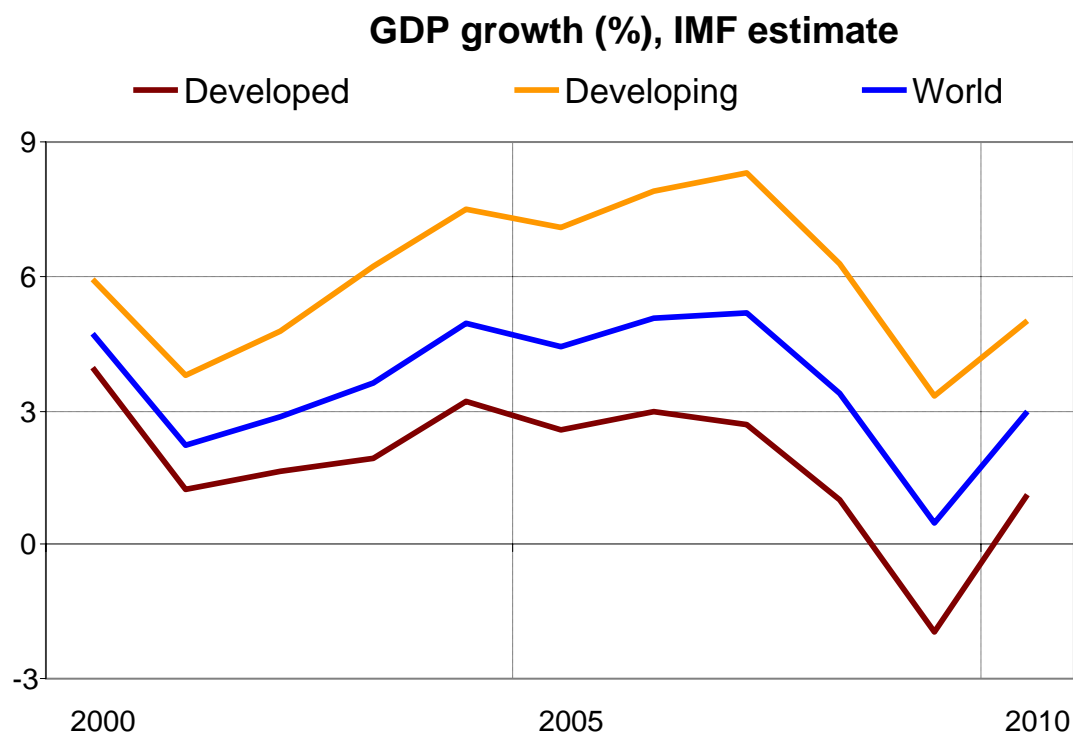
# Lending has dropped, but not drastically



# It is important to maintain loan support, but credit market is not the main issue right now



- Banks' capital and liquidity are sufficient to support the economy.
- However, the problems of many borrowers are not of one-off nature – their course of action and long-term financial standing need to be reviewed.
  - This problem cannot be solved by the credit market.



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# Monetary policy conclusions

# The fixed exchange rate of the kroon supports coping in the changed environment



- **Economic restructuring is supported by the currency board, which backs different decisions in the form of a sound currency.**
  - Both prices and the labour market have already responded to changes – this refers to the flexibility of the economy.
  - Similar adjustment is taking place in Ireland, for example, and should also take place here, once we will have joined the euro area.
  - The new growth cycle will be based on productivity and new investment; extensive borrowing based growth is over for now.
  - Reliable economic policy is the best support for the state.
- **The adoption of the euro is supported by the currency board, low inflation, and fiscal deficit within the 3% of GDP reference value (see *Report on the Adoption of the Euro, February 2009*).**

# The government's measures are timely, but their application may constitute a problem

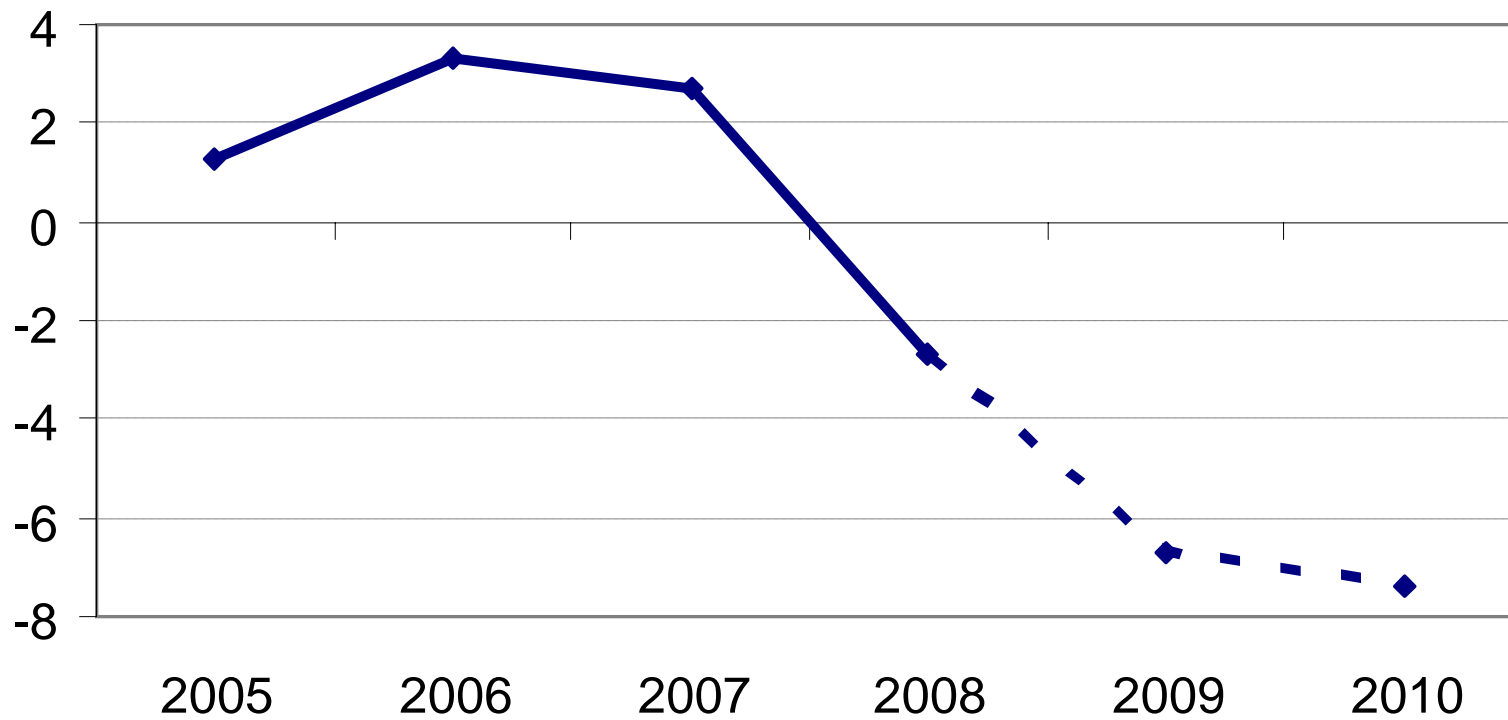


- Eesti Pank's estimate is that if the risk scenario materialises, a 8-9 billion kroon fiscal expenditure cut will be necessary.
  - This would reduce the deficit to a level of approximately 3%.
- The efficiency of the government's measures largely depends on how the steps will be applied.
- It is important to start looking at next years' budgets, since the global recession may last, and the planned cut relies largely on one-off measures, which will not work in the case of the 2010 budget.

If the level of expenditure is not reduced, the materialisation of the risk scenario will mean a large fiscal deficit



Fiscal deficit/surplus (% of GDP)



# The financial market is strong and has to fulfill its function



- **The capital and liquidity standing of banks allows to expect support to the economy and is sufficient to meet credit demand.**
  - Thus, the credit market does not need an additional boost from the state.
  - Extensive state aid to the credit market might put an unnecessary drag on private sector restructuring.
  - Compared with Swedish banks, it is more expensive for Estonian banks to borrow from the market.
- **As to the planned measures, it is important these help reduce market failures.**
  - We are in favour of increasing temporarily the volume of the measures already in use (e.g., export guarantees).
  - Support to new companies should not be decreased.

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Thank you!

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# Eesti Pank's revised forecast

## Key economic indicators

if external demand should drop more than anticipated

	<b>Eesti Pank's forecast</b>	<b>2007</b>	<b>2008</b>	<b>2009**</b>	<b>2010**</b>
GDP (EEK bn)	Base scenario	239	248*	242	245
	Risk scenario	239	248*	230	222
GDP growth (%)	Base scenario	6,3	-3.5*	-5.5	1.0
	Risk scenario	6,3	-3.5*	-8.9	-3.5
Inflation (%)	Base scenario	6,8	10.6	2.0	0.3
	Risk scenario	6,8	10.6	0.2	-1.7

\* Q4 data are estimated

\*\* Forecast