Eesti Pank
EUROSÜSTEEM

Stabilisation in small, open economies: with or without an independent monetary policy?

The case of Estonia

Madis Müller
Eesti Pank

The rationale for choosing the currency board arrangement (CBA) in 1992 and the euro in 2011

CBA: macroeconomic stabilisation had to be achieved as fast as possible; before the Estonian kroon was introduced there was hyperinflation in the rouble zone and the exchange rate was depreciating rapidly

The CBA was also chosen for its simplicity and credibility as central banking expertise was very limited and the financial sector was underdeveloped

Structural features of the Estonian economy supported the exchange rate anchor

The experience with the CBA increased confidence that the Estonian economy would cope with shocks in the currency union

The euro removed any remaining credibility issues

Structural features of the Estonian economy: a high degree of openness

The small size of the Estonian economy and the high degree of openness have strengthened the case for a fixed exchange rate regime

The diversification of the economy means that terms of trade shocks have had a relatively small role

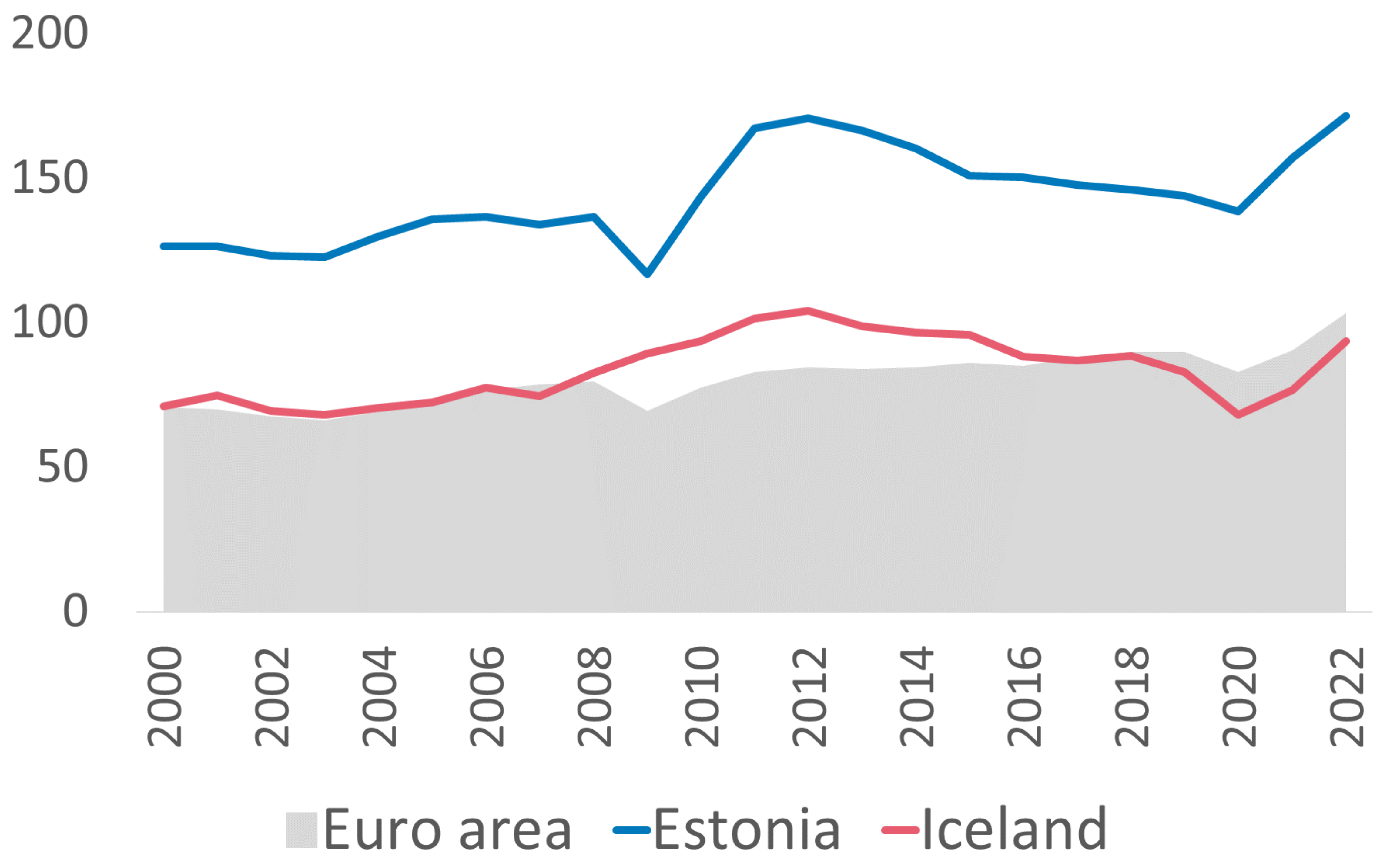


Figure 1. Sum of exports and imports of goods and services to GDP (2000-2022, % of GDP)

Source: World Bank database

Structural features of the Estonian economy: it is relatively diversified for a small economy

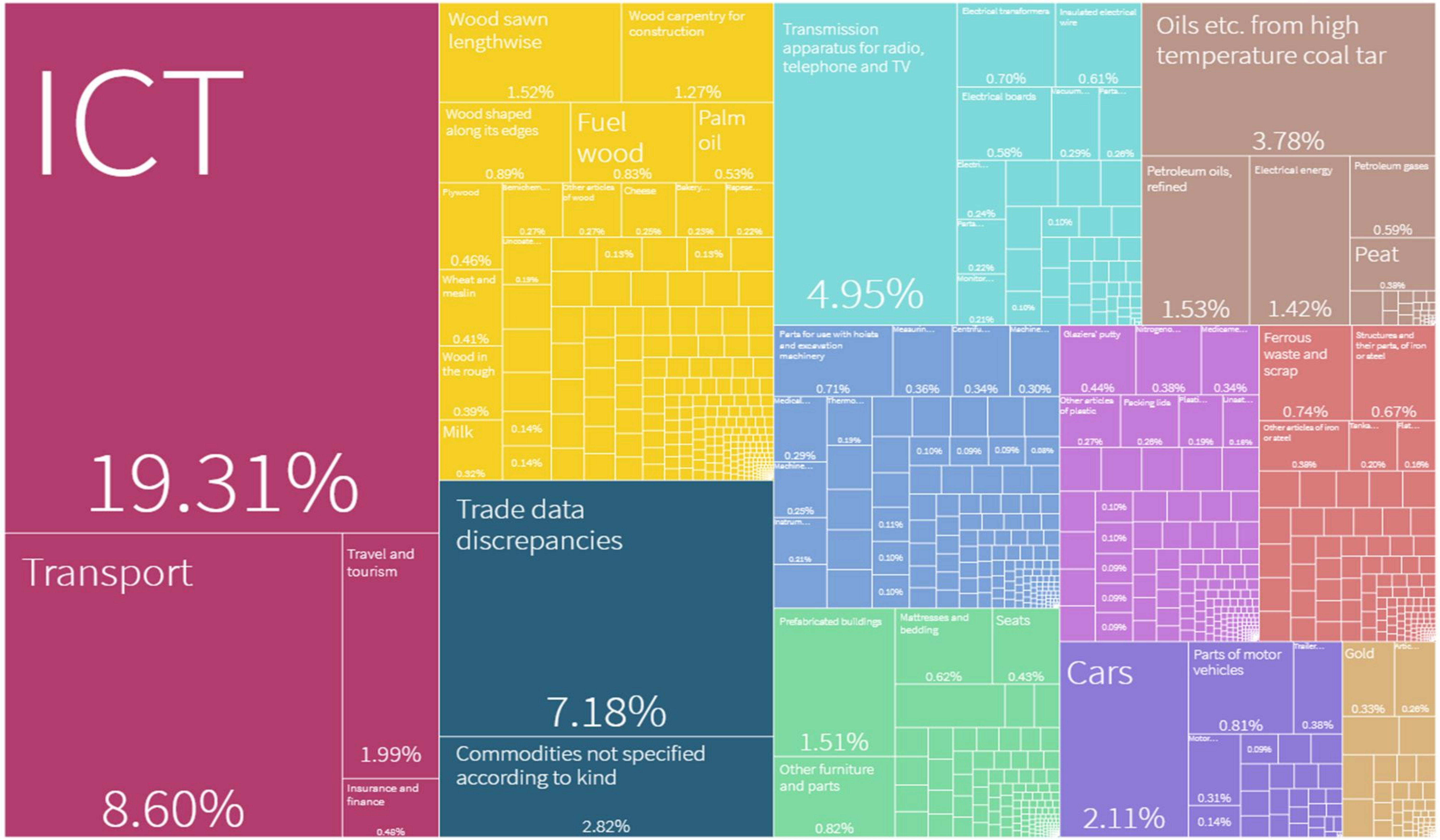


Figure 2. Structure of Estonian merchandise exports by product categories in 2021

Source: MIT Harvard Economic Complexity Observatory

Structural features of the Estonian economy: symmetry of shocks with those in the euro area

Over the past 20 years the correlation between the Estonian and euro area business cycles has been visible but not always strong

The cyclical volatility of the Estonian economy has also been much higher

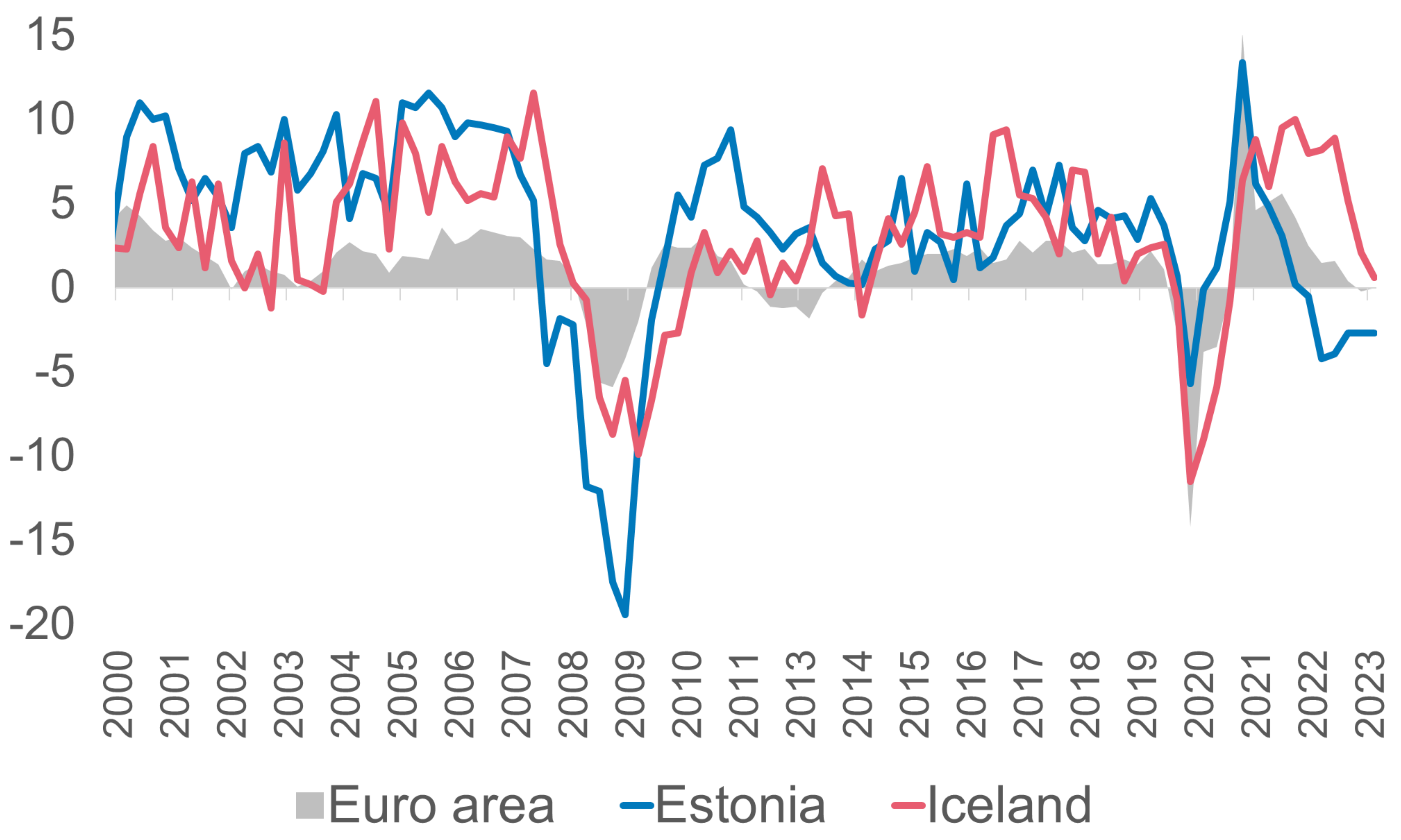


Figure 3. Economic growth in 2000-2023 (y/y, %)

Source: Eurostat

Eesti Pank
EUROSÜSTEEM

Structural features of the Estonian economy: flexibility and fiscal policy discipline

The flexibility of the labour market and fiscal policy discipline (in most years) have helped to maintain the fixed exchange rate regime

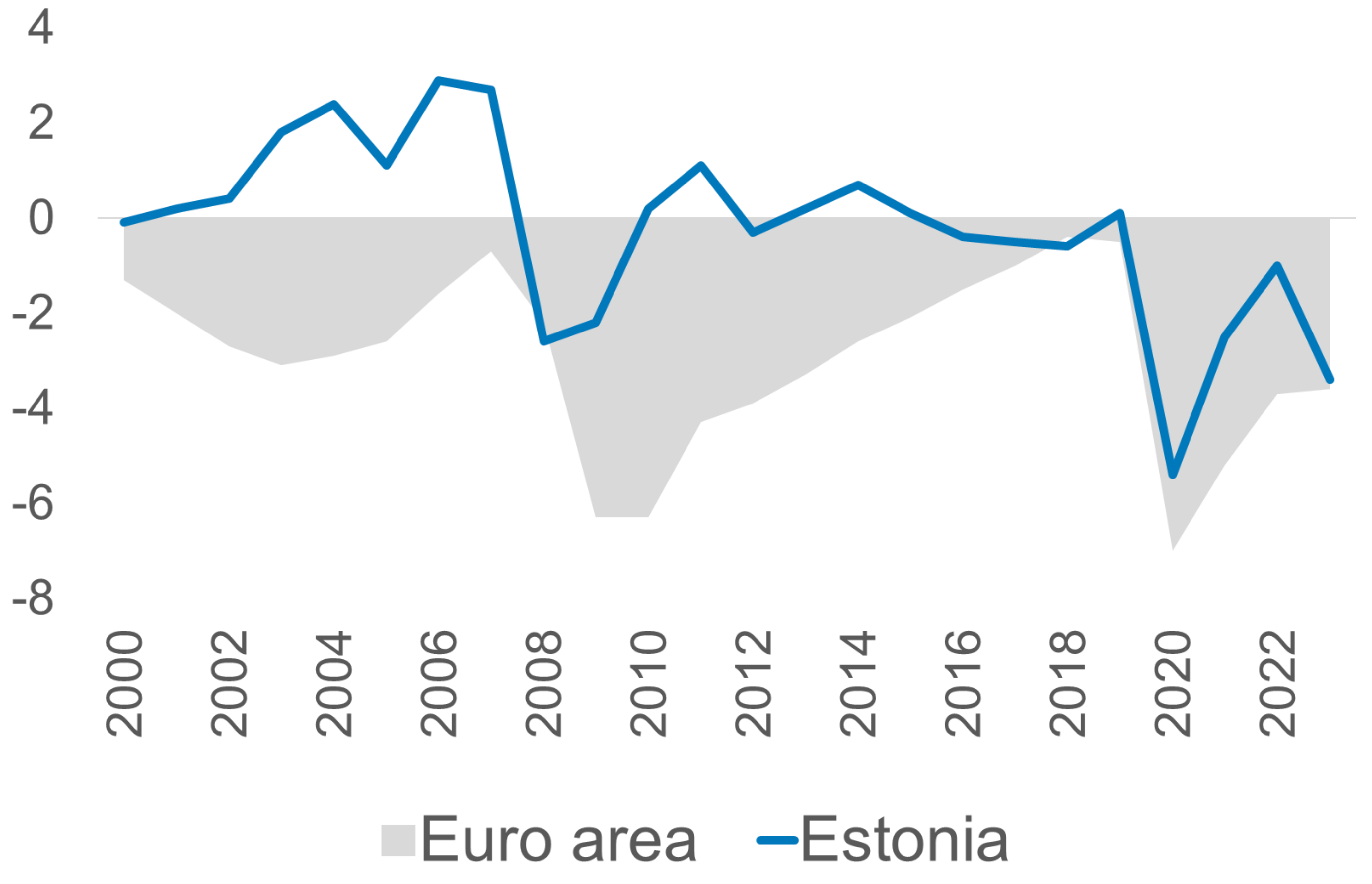


Figure 4. General government deficit (% of GDP)

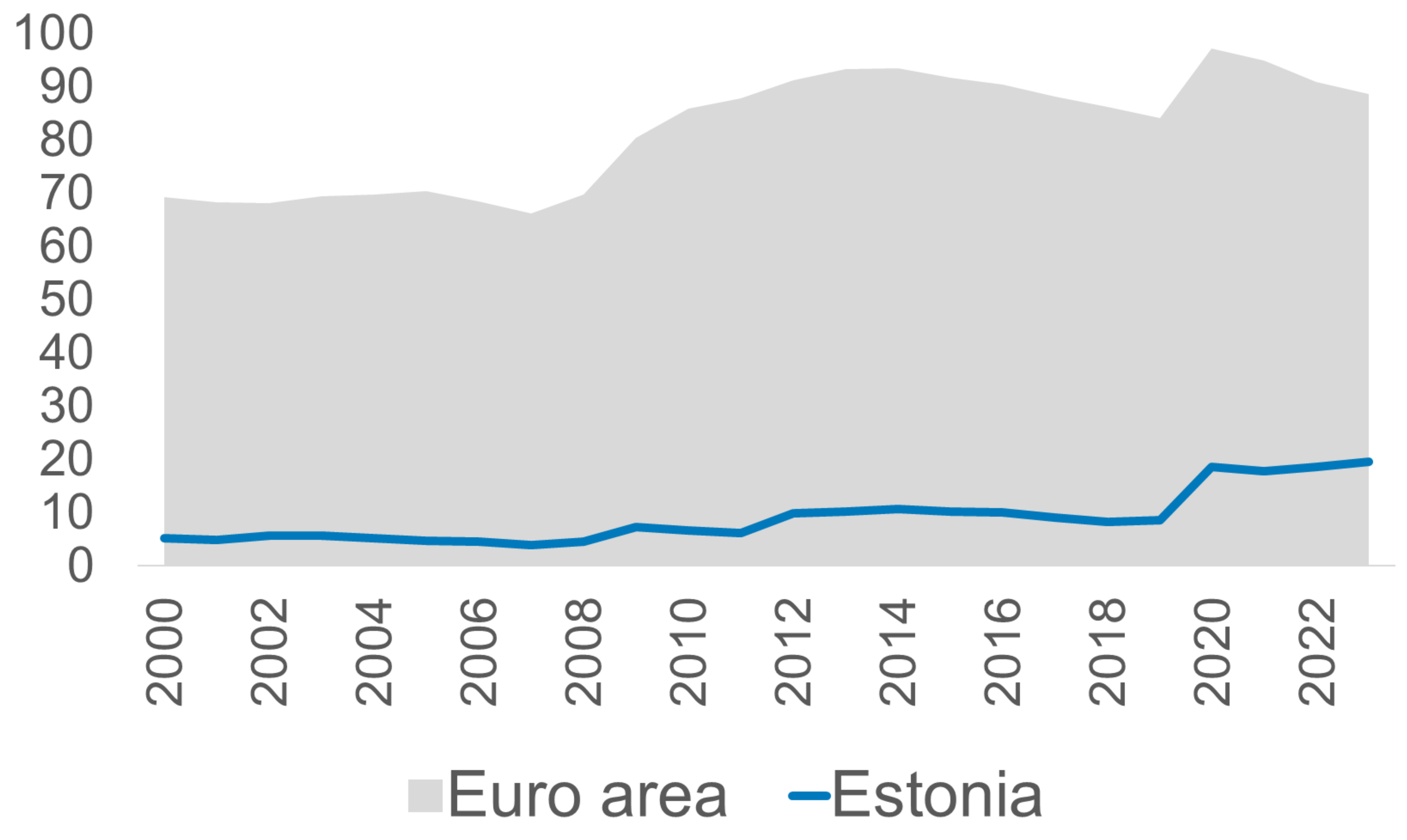


Figure 5. General government debt (% of GDP)

Source: Eurostat

Eesti Pank
EUROSÜSTEEM

High level of volatility in the Estonian macroeconomic variables: the role of a monetary regime

Under the currency board arrangement the Estonian economy, like those of Latvia and Lithuania, which had similar monetary regimes, also had highly volatile macroeconomic variables (*volatility was especially high in the dynamics of GDP, foreign capital inflows and real interest rates*)

It is also too much to expect that the common monetary policy will always be optimal for any single country in the euro area

One of the driving forces behind the high levels of volatility in the macroeconomic variables has been the change in capital flows

Measures to safeguard financial stability

… when Estonia was not yet in the euro area and the macroprudential policy toolbox was not yet defined by the EU

Dec 2002 & 2003

- Highlighting of risk and moral suasion

March 2006

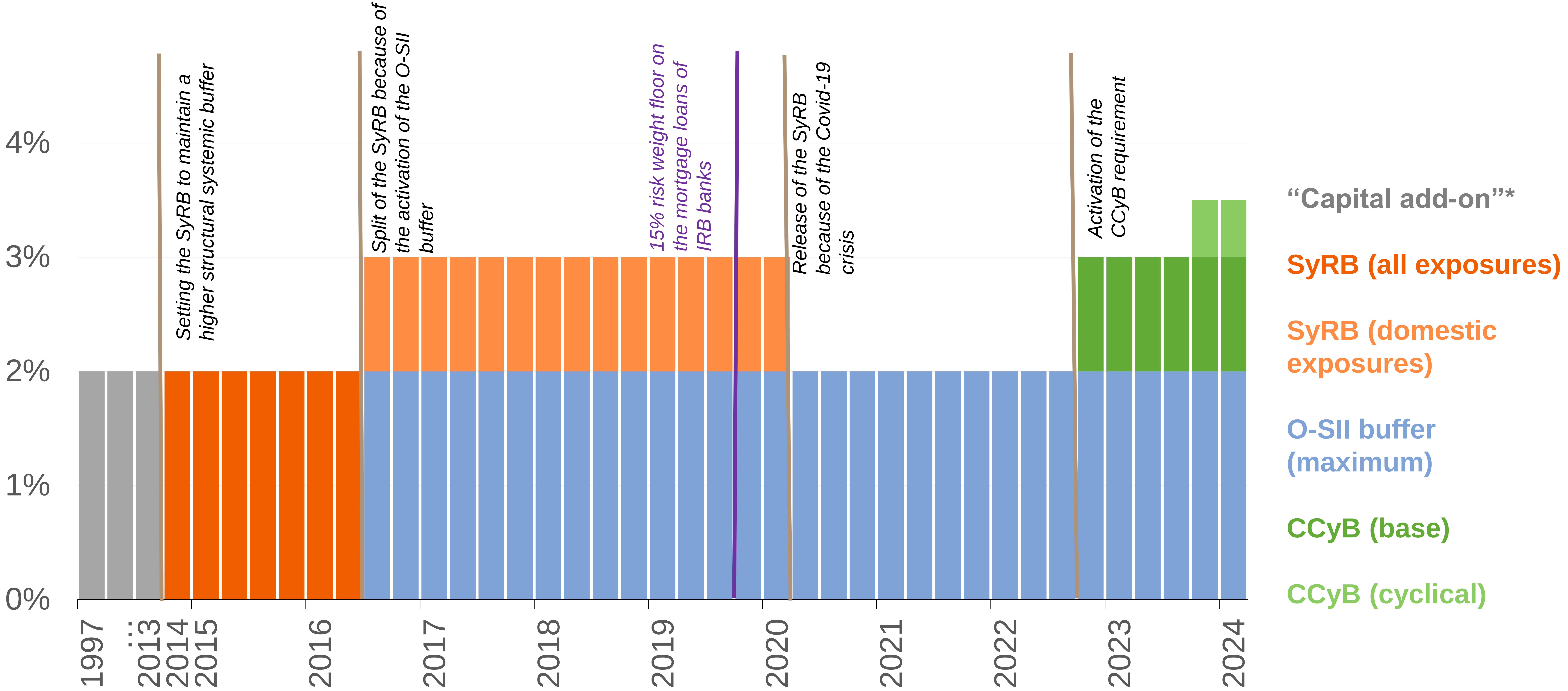
- The risk-weights of housing loans were raised from 50% to 100%
- The capital adequacy requirement was kept at 10%
- The home-country supervisors asked for similar risk weighting to be applied to the mortgage loans of banking groups in Estonia

September 2006

- The reserve requirement was raised from 13% to 15%
- Guidelines on LTVs were issued as a recommendation

- Cross-border communication and crisis testing increased (particularly in 2006-08)

Evolution of the macroprudential capital requirements in Estonia



*The capital adequacy requirement of 10% was applied from October 1997 (this was 2 pp higher than the international standard of 8%)
** In 2006 the risk weight for housing loans was increased from 50% to 100%

In addition, borrower-based measures (BBM) are essential for strengthening financial stability

- From the financial stability perspective, BBMs help to limit the build-up of risks and increase resilience while limiting excessive leverage by borrowers
- From the macroeconomic stability perspective, BBMs help to limit the amplification of real estate booms and busts and the associated volatility in consumption and construction

- In 2014, Eesti Pank was given the power to apply lending-related macroprudential measures for the banks
- Since March 2015 three measures have applied in Estonia
  - **Loan-to-value (LTV) limit of 85%** (90% if guaranteed by the state foundation KredEx)
  - **Debt service-to-income (DSTI) limit of 50%** (tested with an interest rate of at least 6%)
  - **Maximum loan maturity of 30 years**

In summary…

Whichever exchange rate regime is chosen in a small and open economy, the structural features and the policy mix have an important role to play:

- Trade patterns and the degree of openness
- The nature of economic shocks
- Flexibility of the labour and product markets
- Fiscal policy
- Financial sector / macroprudential policy