Vahur Kraft: The euro in Estonia - the agenda and practical aspects

Speech by Mr Vahur Kraft, Governor of the Bank of Estonia (Eesti Pank), at the international conference "Euro currency - French-German experience and Estonia future", Tallinn, 30 September 2003.

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I. Introduction

Based on the requests addressed to Eesti Pank information service we can say that there is a most encouraging - if somewhat surprising interest in Estonian national euro-coins among the general public - although these coins do not exist as yet. Some people are convinced that we have the euro coins already; the others would like to register in order to be the first to receive the new coins.

But every coin has two sides - and in this case it means that a very significant percentage of the Estonian population are not at all eager to take leave of the Estonian kroon and replace it with the euro. They would like the central bank to proceed slowly.

That puts the central bank into the unusual position of arguing for speed and decisive action instead of a conservative approach while the public is still somewhat confused by the recent results of the Swedish euro referendum. The Swedes would have liked, perhaps, to be a bit more papal than the pope - and they certainly have achievements to be proud of. But for Estonia - and with a long-term view in mind - proceeding rapidly and adopting the euro as soon as feasible would be the best. There are some very good arguments for that.

II. Economy

The best argument lies in the Estonian economy. Regardless of the lingering global uncertainties, economic growth in Estonia has been strong - 5.8% in 2002. That means a growth figure approximately 4% higher than that of the euro area. It could even be said that during the last two years Estonian economy has had to face something akin to a positive external shock as the EU membership became more and more of a certainty and the risk margins correspondingly lower. And there was also a parallel negative economic shock - the continuing weakness of external markets. All that has meant certain advantages - for instance, lower interest rates and significant inflows of foreign direct investment, <u>but there are also certain risks involved</u>.

<u>Estonia's high economic growth of the last year and a half is mainly based on high domestic demand</u>. High domestic demand, a continuously strong inflow of foreign investments and a lower than expected export growth have resulted in a significantly high current account deficit - an estimated 14% or more of the GDP by end-2003.

Of course, it could be argued that the present external imbalance is, to a certain extent, 'an attendant phenomenon of success'. FDI inflows having been strong through the entire transition period, reinvested earnings and dividend payments have become increasingly important among the factors determining the current account balance in Estonia. The current account figures for the second quarter of this year offer a good illustration for this phenomenon - the primary current account deficit was 7% of the GDP - more than 6 pp below the actual deficit. At the present time foreign investors are taking into account the perspective of Estonia's EU membership within the near future, the optimistic growth forecasts and continuing increase of living standards. Due to favourable financing conditions, total investment activity has recently been the highest since the beginning of the transition period - during the first quarter of 2003 investments together with stock building accounted for 38% of the GDP in Estonia. At the same time, a number of small and medium-size enterprises are bringing their production plants in line with EU requirements. And of course, borrowing at the present low interest rates is very attractive to private individuals.

But despite all the exceptional one-off factors behind the present high external deficit figures, we must not close our eyes to the fact that the level IS high. And reducing the imbalances - with all the attendant stress on increased public and private savings - is presently one of the main priorities for Estonia.

It must be stressed, in this context, however, that one indicator taken alone - even if it were an indication of possibly unfavourable developments - would not give an adequate picture of the relative health of an economy. That is certainly true of Estonia where the level of wages, inflation figures and the changes in productivity would indicate that economic stability is not affected as seriously as indicated by the current account figures taken alone. For instance, the CPI growth in Estonia and in the euro area was almost equal in the first half of 2003. According to the present estimates, Estonian CPI growth will remain at 1.5% in 2003. It could be said that recent inflation developments have been most encouraging. Although some temporary effects and weak external pressures have recently helped to ease the inflation pressures, the role of the domestic factors contributing to a steady disinflation process should not be underestimated.

But at the same time it should not be forgotten that a gradual increase of price level is an inevitable result of real convergence under a fixed rate of exchange. It is a well-established fact that the income and price level of a given country are positively related. Thus, we believe that a small difference between Estonia's and Euro Area inflation would be natural taking into account the ongoing real convergence and the related productivity improvements.

There have been no significant changes in the average wages and productivity figures (in QI the estimated real growth of productivity was 4.7%). The cumulative productivity growth in Estonia relative to the weighted average productivity growth of its main trading partners has clearly outpaced the real exchange rate appreciation. Over the last 6 years the cumulative productivity growth in Estonia, relative to its main trading partners, has amounted to 25 per cent. The corresponding CPI-based real exchange rate appreciation amounts to 22 per cent.

The share of current and future EU member states in Estonian exports is about 80%. By now, Estonian economy is strongly integrated into the European economic area. Can we say that the restructuring of our economy has been completed?

III. On the way to Europe

What are the challenges ahead? For Estonia, like for all new member states, the only possible way to join the euro system is to do it in full compliance with the letter and spirit of the EU Treaty. Speaking about the present accession countries as a group, it can be said that the key challenge of the policy maker is similar everywhere - to foster real convergence and at the same time maintain macroeconomic stability. But although the underlying processes are the same for all, earlier national economic policy choices - and also the size of the country in question - play a very significant role. Thus, the optimal approach to euro area membership can in no case be a uniform one suitable for one and everybody.

ERM II provides, in principle, a much-needed buffer zone before a country's EMU entry. However, there are obvious risks involved. It is of paramount importance that the decision on ERM II entry be taken only when macroeconomic fundamentals provide for a realistic deadline for the entry into the euro system in, say, two or three years' time.

Still, there are some really good arguments for as rapid a possible EMU accession... For an accession country, it is important that the experience of past enlargements has shown - high rates of real convergence can be achieved in connection with the EU accession. There are several explanations for this phenomenon, including full integration into the single market, reduction of various political and economic risks etc. Adopting the euro can support economic integration through a higher correlation in economic cycles - as well as lower transaction costs and lower risk premiums.

It is also clear that EMU participation reduces monetary uncertainty. For instance, had it not been for the EMU, European financial markets could probably have been much more turbulent during the Asian and Russian crises and the recent slowdown of the global economy. For an accession country, a rapid ERM-EMU accession could mean a further rise in its international credibility - take, for example, the developments in Greece who clearly benefited from ERM2 credibility in 1999, after the Asian crisis.

In case of Estonia, our earlier policy choices have resulted in an environment characterized by the openness of the economy - export and import reaching 179-180% of the GDP, by a stable fixed-exchange-rate, by a long tradition of balanced fiscal stance and rapid integration with the European markets - all of them features favourable to a relatively rapid real convergence. We could even say that the convergence that presently takes place in our real economy takes place in a *de facto* EMU environment.

According to an analysis recently conducted by the ECB, the correlation of manufacturing industries' business cycles between Estonia and the five larger EMU member countries is even higher than that for some of the present member countries, the correlation of overall economic cycles is slightly lower - but that is due to the more rapid economic growth in Estonia compared to the euro area.

But there is one more important aspect I would like to stress in this context - and that is the crucial role of the financial system in real convergence under a currency board based fixed exchange rate regime. <u>It is fair to say that Estonian banking system is presently strong, well capitalized and liquid.</u> The banks' forced reliance on their own capital and liquidity has had a direct impact on the market structure. Strategic foreign ownership - mostly by Scandinavian financial groups - has provided Estonian banks with both strong capitalization and transfer of international best practices. At the present time Estonian banking sector is responsible for a significant share of the profits of their owners. Profitability means effectiveness at least comparable to the financial sectors of our neighbouring EU member countries - and a somewhat greater flexibility of production factors, especially the flexibility of labour markets. Profitability also means a relatively rapid adoption of new technologies. For example, the number of card payments per capita in Estonia should be roughly equal to the respective German figures while the share of internet banking customers is somewhat higher (and the list of internet-based bank services somewhat more exhaustive) in Estonia.

Estonia would like to be one of the first new members of the club - we would like to become a member of the euro area at the earliest possible moment. That would mean joining the ERM2 as soon as possible, with the present EUR/EEK exchange rate and the currency board arrangement in place. Provided nothing adverse happens, Estonia might be in a position to submit its application for ERM2 membership as early as mid-2004. It should, perhaps, also be mentioned that at the present moment, Estonia is in a relatively advantageous position among the candidate countries as to its ability to meet the Maastricht criteria and other important requirements.

Comparing the level on nominal convergence among the present accession countries to the respective levels in some of the former accession countries five years prior to their EMU accession, it is evident that there should be no serious concerns as to most of the present accession countries' ability to fulfil the nominal criteria over the mid-term But Estonia's choice of a currency board based monetary regime holds some inherent advantages in this respect. Fiscal balance is a very important prerequisite for a smoothly operating and effective currency board arrangement, and that has had a strong impact on Estonian fiscal policies. The main goal of Estonian fiscal policy is balancing the budget over the cycle and absorbing the possible fluctuations in the private sector savings rate. We believe that a balanced fiscal stance together with strong financial system is also the most efficient way to avoid short-term speculative capital inflows within the context of EU accession. At this point, we expect no great difficulties in meeting the sovereign debt and budget deficit criteria.

In that sense - <u>Estonia, most likely, would be technically ready for joining the euro area even as early as 2006. The biggest challenge for the public sector, in that context, would be to avoid a lax macroeconomic policy mix that would over-stimulate domestic demand and result in significant real appreciation</u>.

And of course - there is really a huge amount of technical preparations that must be completed before joining the euro area. We have drawn our plans and the work has been going on for some time. In some cases we can take advantage of our still-remembered experience of the 1992 monetary reform. In other cases, like some settlement-systems-related issues, we must wait for European institutions to make up their minds about the details. There is no doubt, however that technical preparation would not slow us down.

IV. In conclusion

Speaking about future developments in Estonia in the light of the challenges shortly discussed above, it is good to bear in mind that policy efforts are necessary also <u>after</u> becoming part of the EU and the EMU. Fulfilling the Maastricht criteria and being 'admitted to the club' cannot be seen as 'the ultimate achievement'. For instance, the recent achievements of the economies of our Nordic neighbours compared to the developments in a wider Europe should make us very aware that there are real advantages in fulfilling the Stability and Growth Pact.

I am convinced that EU membership will be beneficial to Estonia. But I am also very sure that Estonia has something to offer to the EU in its turn - some experience on handling issues pertaining to the flexibility and mobility of production factors, for example. It is important that Estonia, like every other future EU member state, offer its contribution towards the common goal.