Ardo Hansson: Experience with and preparations for the euro

Speech by Mr Ardo Hansson, Governor of the Bank of Estonia (Eesti Pank), at the opening of the conference on "Experience with and preparations for the euro", Riga, 22 February 2013.

*   *   *

Honourable Mr. President, Honourable Madame Speaker, Honourable Mr. Prime Minister, Excellencies, Ladies and Gentlemen,

It is a great honor to be here today in Riga at this important conference and to be able to express my support for Latvia's euro area aspirations. Looking to the future, and remembering all of the good help which we also got from other countries in the past, we would also like to give that same support other European countries joining the euro area.

Let me begin by stressing that Latvia's long track record of fiscal prudence and your recent very difficult but ultimately successful crisis management are recognized, welcomed and greatly respected in the euro area. In fact, Estonia and Latvia are good examples of the benefits of implementing decisive reforms, demonstrating that the beneficial effects of front-loaded fiscal consolidation, deep structural reforms and economic flexibility outweigh the initial higher costs, especially by quickly restoring the confidence that is so crucial for ending a crisis and getting a country on a path towards recovery and growth. One of the lessons we learned from this crisis is the importance of the issue of confidence. It is intangible, it is hard to measure, but it is so crucial.

In order to join euro area, Latvia, like any other potential member, needs to be deemed to have fulfilled the "Maastricht criteria", and to do so in a sustainable fashion. The recent euro area crisis has clearly revealed what can happen when the agreed rules are not followed, especially how damaging this can be for the country concerned. As a corollary, countries which sustainably adhere to these rules, and which have a clear track record of prudence and adjustment capacity, act as net providers of stability, bringing benefits to other members of the euro area. That additional benefit should be remembered. Also, the sheer signal of countries wanting to join the euro area right now is also another contributor to this confidence that we all need.

This morning, I would like to briefly touch on three themes. First, a bit about the reasons for joining the euro area. Second, a bit about the process and making the point that it is more a process than an event. And finally, our experience to date as a member of the euro area.

Starting with the motivating factors, in one sense we do not need a motivating factor because when we all joined the European Union in 2004, we made a commitment that the euro would be our currency. Thus, the "if" question has already technically been answered and it is only a question of timing. For Estonia as a small European economy highly dependent on trade, euro area membership was a natural goal stemming from close economic ties and similar cyclical behavior. A common currency with many of our main trading partners would reduce the costs of trading and more importantly deepen the economic integration that can drive all of the productivity improvements that will ultimately lie behind higher living standards. Our main trading partners are in Europe, so it is not an international issue for us but domestically important if we want to grow. In any case, our strategic choice two decades ago to tie our currency first to the DM, then to the euro, and a clear determination to never change this peg, meant that our macroeconomic environment was already very similar to that of a euro area member, and that the extra step towards full euro area membership would only be logical and natural.

Let me now turn to the process. When discussing such currency reforms, we often speak in terms of the date on which this takes place, which can leave the impression of a single event which suddenly brings great changes. In fact, the process element is crucial. We have been on a given path for 20 years, and we will be on this path for another few decades. Therefore, it is many small steps that contribute and the actual date of conversion is somewhat less of an event. It is important, but especially if you have been tied to the euro for a very long period of time. It is of crucial importance that a country's economic policy mix as a whole is credible and consistent. Based on our own experience, we can say that much of the impact was already felt even before formal euro accession in terms of the investment flows and in terms of the restoration of confidence.

Finally, what have been some of the experience over the last more than two years? The precise impact of the adoption of the euro is very hard to determine as there were so many other things going on, most notably the global financial crisis. Future generations of economists, with the benefit of hindsight and data will be better placed than us to make a firm evaluation of costs and benefits. Nevertheless, we can point to several positive developments which appear to be related to the broader agenda of reforms and policies, including euro adoption. Most notably, the Estonian economy has successfully weathered a fragile global economy and come through the uncertainties within the euro area.

Over the last few years, our export sector has led the economy to a path of relatively rapid and well-balanced growth. That has, in turn, created the scope for a still quite significant contribution from domestic demand to growth. Indicators of better balance include a much lower current account deficit, better consistency between productivity and wages and lower private sector indebtedness. These improvements, along with sound fiscal policy, have increased trust in the Estonian economy and, furthermore, made it more resilient to economic shocks than before the crisis.

Turning to some other indicators, the output level in our manufacturing sector already exceeded pre-crisis levels in 2011. Our exports are now at record levels. Compared to the third quarter of 2009, they have grown by 67%. Investments have also rebounded, becoming the fastest growing component of domestic demand. Over the last two years, our GDP has grown robustly and somewhat faster than we had expected, by around 8% in 2011 and about 3.2% last year. This is lower than the rates we would like to see in more normal times, and slower than the rate which Latvia achieved last year, but still a very respectable outcome given the state of the world economy. By now, we have recovered to about 95% of our somewhat unsustainable pre-crisis level. As a result, our unemployment rate has fallen steadily, most recently to 9.3%, which is lower than the euro area average. Our employment has risen to about the same level as it was in the middle of the boom period.

Clear positive impacts are also evident in the financial sector. Joining the euro area removed any remaining risk of devaluation, working to lower interest premia, which are now near Nordic levels. Access to eurosystem liquidity support has decreased the risk of sharp interest rate fluctuations and sudden stops in capital inflows. The reduction in costs stemming from the equalized charges for domestic and cross-border settlements has brought measurable savings. Homeowners have benefited from the elimination of the financial risks which come from earning income in one currency and repaying their mortgage in another currency. Consumers and businesses have benefited from being able to easily compare prices, and from the reduction in currency conversion costs.

Finally, let me make a few remarks about inflation. Fears are regularly expressed about the possible inflationary impacts of euro adoption. Our evidence suggests that this was positive but very small and one-off, similar to what was seen in older euro area members where euro introduction effects accounted for about 0.2–0.3% one-off increase in prices, mostly in services sectors, but no measurable effect on inflationary expectations or in terms of core inflation. Over the past few years, our inflation has indeed been higher but we believe that this can be largely explained by a range of other factors not directly related to euro adoption, including the catching-up effect, commodities prices, the specific timing of changes in tax policy, and so on. Most importantly, the ECB has built up a very strong track record in keeping inflation in the euro area near our targeted level, and our commitment to continue on this path is very strong.

In conclusion, Estonia's two-year euro area experience has affirmed our belief that our place is within the euro area, not outside. Our economy, which once was very much out of balance, is now in balance and developing about as well as could be expected in difficult circumstances. Furthermore, and this is very crucial, opinion polls show that public support for the euro appears to be rising and has clearly been above 50%. If one also considers recent improvements in the outlook for the euro area as compared to 6 or 12 months ago, I believe the support will continue rising in the future. Never in our history has Estonia been engaged in shaping Europe to such an extent. We have a say in the processes affecting us, from monetary policy decisions to the euro area's future. For us, it is a matter of economic security, future prosperity and international credibility. I wish Latvia determination and success in following the same path.

Thank you!