EMU – CHALLENGES AND RISKS. ESTONIAN POINT OF VIEW

Vahur Kraft[1]
Governor of Eesti Pank

Ladies and gentlemen,

I am most happy to welcome you at the conference *Economic and Monetary Union: Challenges and Risks*. For the next two days, we are going to discuss the risks and challenges of the Economic and Monetary Union – or at least some of the most important risks and challenges. Certainly not all of them. For the list is a long and an extremely varied one including elements that are probably unexpected at first glance. Let me offer you a few examples.

Estonia as a Part of Europe

At first, in a sense it is quite natural that the applicant countries tend to focus on the more immediate challenges of becoming full members of the Economic and Monetary Union. However, I would still suggest that maybe it is time to take a further step – and try to take a look at the challenges and risks inherent in the situation after the enlargement has taken place.

In a report recently presented to the Third Geneva Conference on the World Economy a group of international experts argued that some of the specific problems rooted in the formulation of the ECB's monetary policy strategy are only likely to grow worse as the size of the Executive Board expands. The experts, in this case, referred to the vagueness inherent in the constant references to the two pillars of the ECB monetary strategy. Namely, to the compound effects of the imprecision of the first pillar, the rate of money growth, and the catchall nature of the second pillar.

Is there a problem; is it a serious problem and what could be the solutions?

Secondly, the Bundesbank recently held a conference on *Ageing, financial markets and monetary policy*. Maybe we should take a closer look at those issues within the context of the pre- and post-enlargement EMU as well. Estonia is a country with a rapidly ageing population. So are some of the other applicant countries. So are most of the Member States of the Economic and Monetary Union. Population ageing might involve major shifts in financing, which may give rise to financial turbulence and systemic risk.

Thirdly, on the 8th of May, Commissioner Günter Verheugen – the European Union's top official for eastern enlargement, warned in a public speech that support for joining the EU was waning in candidate countries, due, partly, to crises like the foot-and-mouth disease. Estonia is one of the applicant countries that has recently seen a catastrophic drop in support for EU membership. But the foot-and-mouth disease is probably not the reason. Rather – it seems that the public would like to know more about real convergence while the leaders tend to concentrate on nominal convergence. I think it should be stressed – and often – successful adjustment will imply both real and nominal convergence.

The Economic and Monetary Union has already met numerous risks and challenges – and proved its staying power. When the European Union adopted its own single currency less than 2.5 years ago even some well-known economists ranked among the sceptics. Today, we can be certain that the single currency has been a success.

But there are still challenges to meet and risks to manage.

[1] Introductory speech at the international conference *Economic and Monetary Union: Challenges and Risks*, on 11 May in Tartu, Estonia.

It is most important that Europe have common goals and values. It is most important that stability-orientated policies aimed at the integration of the euro area economies prevail.

For the candidate countries, the goal of joining the EU and EMU, feeling being part of Europe where we do belong, has been one of the core driving forces behind

- reaching common objectives and political commitment,
- re-alignment of economic structures and
- streamlining economic policies.

Estonian Experience with Fixed Exchange Rate

Let me offer a few closer remarks on the particular developments and concerns of Estonia.

Since the very start of radical reforms in the early 90s Estonia has clearly orientated itself towards Europe, even not to mention the introduction of a DEM-based currency-board system in 1992. Exchange rate peg to a European currency has played a vital role in anchoring inflation expectations – Estonian consumer price index dropped from 89% in 1993 to 4% in 2000. Moreover, it has helped to shape an understanding of how crucial a role forward looking and transparent policies play both for the private and the public sector in dealing with uncertainties.

The fixed exchange rate regime has been one of the major components of the general economic policy framework aimed at macroeconomic stabilisation. Nevertheless, other policies, such as liberal external trade regime, labour market policy and fiscal discipline, have also been important.

Due to the exchange rate peg, for more than 8 years we have experienced what it means to participate in the EMU in terms of macroeconomic adjustment. The latter holds due to the impossibility of using exchange rate for resolving the economic issues. Thereby, most of the burden of adjustment was left to the private sector and other economic policies. As a result, we have a rather long experience of EMU-type macroeconomic policy-mix. In terms of systemic approach to economic policies, this is very useful in the light of future EU and EMU membership.

Recent foreign shocks, the so-called Asian and Russian crises, did test the strength of the Estonian financial system. They also gave impetus to structural adjustments and reorientation of trade links towards EU. By the end of 2000 exports to the EU accounted for more than 70% compared to less than 5% in 1991. The mergers and acquisitions in the banking sector resulted in increasing foreign participation and left us with much better capitalised financial sector. A sound banking sector has been one of the factors supporting economic recovery since the second half of 1999. In this light, a sound financial system is a precondition for quick recovery at the macroeconomic level.

In year 2000 real GDP posted a hefty 6.5% and was driven mainly by a rapid growth of exports. With a global environment deteriorating and economic growth slowing down in Europe, economic activity in **Estonia is expected to moderate to about 5 to 6 per cent in 2001.** In order to sustain long-run economic growth of 5–6%, in the following years Estonia has to put emphasis on economic policies contributing to further European integration and maintaining high level of incoming investment flows.

Challenges for Estonia in Pre-accession Period

So, what is the biggest challenge for us as a candidate country? I would use just two words, *a moving target*. We do recognise that Europe is changing day by day and this makes the catching-up process even more demanding.

Successful adjustment will imply both real and nominal convergence. These are objectives, which do not contradict in the long term, but could be difficult to achieve in the short run.

Even in the context of appropriate fiscal policy, **inflation in Estonia will exceed the euro area inflation in the medium term by some, approximately 2–3 percentage points**. This is partly a result of ongoing relative price adjustments and productivity related inflation gains. Coming from a higher inflation environment we have to be extra cautious not to let the domestic factors drift us away from a non-inflationary growth path.

In order to foster real convergence, sustained positive growth differentials have to be maintained with the euro area. This would require first and foremost stability-orientated macro policies to go hand in hand with structural reforms and private sector initiatives.

Transitional costs and upgrading of supply factors would require substantial investments and savings. Given longer-term fiscal challenges, such as the pension reform, this task will imply trimming and streamlining of costs in the public sector. Taking measures to support growth of domestic savings is equally important.

As regards to credit growth, one of the potential risks is that successful accession process coupled with income growth and overoptimistic expectations could trigger excessive domestic demand. **Therefore, prudent and conservative credit policies are vital to avoid excessive private sector savings-investment imbalance and debt levels that could lead to the worsening of external balance.**

Financial Sector Reforms and Eesti Pank

Sound and competitive financial sector is an important prerequisite for monetary transmission to work efficiently and to increase resilience to deal with competitive pressures within the EU.

The Pre-Accession Economic Programme foresees some financial sector reforms:

1. Setting up of a unified financial supervisory agency in early 2002 to supervise a wide range of financial institutions. Prior to creation of a new agency, the work of current supervisory entities will be improved through supplementing regulation. At this stage, I have the pleasure to inform you that the Financial Supervisory Authority Act was successfully passed in Parliament on 9 May. According to the law the new supervisory agency will be created under the central bank.

In order to strengthen the supervision over the financial sector, it is necessary to apply international standards, such as the Basle Core Principles on Bank Supervision, IAIS for insurance supervision and IOSCO for securities market supervision.

2. In broader context, by establishing a unified market surveillance system the co-operation between different surveillance institutions and other relevant institutions (eg customs) have to be brought on a next qualitative level, as stated in Pre-Accession Programme.

Additionally to that, steps are to be taken for operational integration towards ESCB framework. Eesti Pank is currently pursuing a monetary policy operational framework reform with an aim to enhance the liquidity management system. One pillar of the operational framework reform is to upgrade the current minimum reserve system by introducing market-based elements.

As a result cross-border liquidity management on euro money and capital markets will assume a greater role. Financial sector integration has already contributed towards a wider understanding of how the euro area monetary policy and economic developments affect us. Interest rate transmission from the euro area, within the context of high capital mobility, will be an essential element supporting the economic convergence, besides trade integration and economic policy convergence.

It is important for the banks to be better positioned in a global competitive environment. Both the Eurozone and Estonian monetary policy framework rely on efficient liquidity management system and competitive markets.

In formulating the future strategies we have taken into account that regional integration and acceptance of common international regulations and principles is not only an unavoidable global trend, but also a factor contributing to long-term economic stability and prosperity.

The Key to Success

In conclusion, what are the means that will help in overcoming these convergence challenges and risks?

The key to success is a clear commitment to price stability. This will imply complementing exchange rate stability with medium-term oriented conservative fiscal policies and structural reforms. Structural policies should be employed to encourage wage and price flexibility in the medium term. Other vital reforms, such as the pension reform, the privatisation of infrastructure enterprises and the modernisation of the education system are crucial ‘second wave’ reforms for ensuring the competitiveness of Estonian economy within the European Union. The role of structural reforms is described in the first Pre-Accession Economic Programme.

I would like to finish my presentation by extending a warm 'thank you' to all the participants, organisers and initiators of this conference. I am sure that the global economic environment will provide the world economies with ample opportunities to come back to this topic of *challenges and risks* again and again.