Estonia has set 1 January 2007 as the target date for joining the euro area. Prior to that, the EU will assess compliance with the Maastricht criteria. The following is an overview of the preconditions for joining the euro area, preparations for joining as well as some practical aspects related to the introduction of the euro.

ESTONIA'S PREPARATIONS FOR JOINING THE EURO AREA

RAOUL LÄTTEMÄE
Head of Office of the Economics Department of Eesti Pank

When it comes to the issue of joining the European Monetary Union (EMU), Estonia has been in the forefront among the new EU Member States. Estonia has always expressed the desire to join the euro area sooner rather than later and entered the European Exchange Rate Mechanism (ERM II) on 28 June 2004, shortly after acceding to the European Union. The authorities' target date for joining the euro area is 1 January 2007.

The main driver for Estonia's early entry is the wish to reap the economic benefits of the monetary union through **increased trade and financial integration**, as well as to **foster economic growth and real convergence**. The most visible advantages – the reduction of transaction costs and decrease in the interest rates via eliminating the exchange rate risk premium are also important.

Accession to the monetary union or participation in ERM II is usually deemed to entail some costs in other areas, e.g. short-term expenditure on fiscal consolidation, as well as the cost of giving up independent monetary policy and flexible exchange rates as stabilisation tools. These possible costs are almost non-existent in case of Estonia, as ERM II and later on full participation in the EMU do not call for major adjustments in our macroeconomic policy, EU and Estonian economies are increasingly integrated, the Estonian non-financial sector is sufficiently flexible, and our monetary policy transmission is similar to that of the euro area.

Estonia will not have to bear the costs related to the possible loss of independent monetary policy. Under the fixed exchange rate regime, we have not been trying to alleviate the monetary policy impacts of the ECB and market-driven adjustment mechanisms by our own active monetary policy. Estonia has been operating a successful currency board vis-à-vis EUR (DEM) for thirteen years now. Due to the success of the currency board arrangement (CBA), Estonia has decided to maintain it also in ERM II as a unilateral commitment.

Fiscal discipline has been strongly entrenched upon our political culture as well; together with the flexible labour market it is one of the most important prerequisites for the smooth operation of the currency board system. Therefore, joining the monetary union does not entail any significant changes for our fiscal policy, as it has been in line with the principles of the Stability and Growth Pact for more than twelve years now. Estonia has exceeded the three per cent deficit threshold only once (during the short recession of 1999 related to the Russian crisis), and our public debt, which is one of the lowest among EU members, constitutes less than five per cent of GDP.

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Estonia's strong trade links with EU Member States, especially when intra-industrial trade is included, are expected to reduce the exposure to asymmetric shocks. Estonia is a small and open economy with total exports and imports (including services) amounting to 170% of GDP. **EU members accounted for about 83% of our exports and approximately 86% of Estonian foreign direct investment (FDI) stock in 2004** (Estonia was one of the first acceding countries to fully liberalise its capital account already in 1994).

In general, Estonian economy is most closely connected to the economies of Finland and Sweden. These connections are visible in both trade and investment, as Finland and Sweden account for 40% of exports, about 70% of FDI inflows to Estonia, and own 97% of the Estonian banking sector. Sweden does not participate in the euro area, but its exchange rate vis-à-vis the euro is relatively stable, hence our foreign trade and investment composition still supports Estonia's motivation to soon join the euro area.

The interest rate transmission from the euro area into Estonia has been increasingly strong since 2000, when Estonia's EU prospects started to become clear. During the last five years, **Estonian short-term interest rate spreads against the euro area have continuously decreased**: they dropped to about 50 basis points before the accession to the European Union and, prior to joining ERM II, to about 25 basis points, which is the level where they have stayed since then. This development clearly points to the relevance of the integration process with the European Union and ERM II for the credibility of the Estonian monetary system.

Developments after the entry into ERM II

As discussed above, in the absence of theoretical reasons for delaying the monetary integration process, Estonia joined the exchange rate mechanism ERM II on 28 June 2004 together with Lithuania and Slovenia. Participation in ERM II should be viewed as an additional test for possible tensions that may stem from joining the euro area.

When Estonia joined ERM II, a communiqué on Estonia was issued stating,

"The agreement on participation of the kroon in ERM II is based on a firm commitment by the Estonian authorities to continue with sound fiscal policies, which are essential for preserving macroeconomic stability, for supporting an orderly and substantial reduction of the current account deficit and for ensuring the sustainability of the convergence process … To help reduce the external imbalance and contain it at a sustainable level, they will take the necessary measures to contain domestic credit growth and ensure effective financial supervision, and they will promote wage moderation."

When comparing the commitments of the authorities in the communiqué and the developments in Estonian economy during the 12 months that have passed since Estonia joined ERM II, it can be concluded, with some satisfaction, that for the most part, things have developed as predicted last spring. Domestic demand grew more or less at the expected pace. The government's fiscal position helped to balance economic developments more than it was assumed: while the central bank forecasted a balanced budget outcome for 2004, and the European Commission and the Ministry of Finance expected a very small surplus, the **actual surplus was 1.7% of GDP**. Looking ahead, the government intends to continue its balanced budget policy and both of the Maastricht fiscal criteria are expected to be fulfilled with a comfortable margin.

As domestic demand continued to increase in the second half of 2004, the decline in the current account deficit (CAD) has been slower than expected. The high level of CAD in 2004 is partly related to the accumulation of goods imported prior to the EU accession, but it is also influenced by the low interest rate environment of the euro area. The low level of interest rates has kept Estonia's monetary environment expansionary. Financial integration with the EU has deepened even further, prompting the external indebtedness of the economy to grow faster than earlier predicted. In addition, about a half of the CAD is caused by the negative income balance, which reflects the strong profitability of FDI. In this vein, it is important to note that the continuously high level of current account deficit does not point to problems with competitiveness. **The productivity and exports growth of 2004 outperformed the forecasts of the Estonian and European authorities.** Furthermore, Estonian enterprises have continuously increased their market share in the total imports of our trade partners, and the growth rate of exports to our ten biggest trading partners has remained higher than that of imports from those countries (in 2004, 14.8% and 6.8%, respectively). The latest forecast of Eesti Pank estimates that both the level of the current account deficit and credit growth peaked in 2004.

The inflation criterion is the most difficult to comply with.

Out of all the Maastricht criteria, the inflation criterion is the most difficult to comply with. As expected, the inflation rate picked up after the EU accession. Our calculations show that the effect of the EU accession on HICP was around 1.8 percentage points, mainly due to the increase in the prices of sugar (which almost tripled after the introduction of customs tariffs) and fuel (increase in excise tax). The underlying inflation rate has remained stable and no broader price pressures can be observed. Thus, after the base effect of last May passed, the annual HICP was reduced to around 3% and will continue to fall to ca 2.7% in 2006, as the 2005 level was influenced by the increase in electricity prices on 1 March 2005. An inflation rate of around 2.7% is likely to be in line with the Maastricht criterion.

As Estonian monetary policy has sticked to pretty orthodoxical currency board arrangement it also means that fiscal policy is the main policy to absorb economic shocks. In order to counterbalance external imbalances and inflationary pressures in recent years, Estonia had significant budget surpluses (3% of GDP in 2003 and 1.6% of GDP in 2004). Goverment has promised to stick to its conservative fiscal policy, which should help to avoid domestic price pressures in Estonia.

Estonia continues to participate in ERM II with a unilateral commitment to the CBA. The exchange rate against the euro has remained stable without any tensions. One could even say that Estonia's accession to ERM II was a "non-event" from the point of view of forex markets.

Practical preparations

Besides the need to be able to fulfil the Maastricht criteria and maintain sustainable economic policy, every country needs to undertake an enormous amount of practical preparations before the adoption of the euro. Estonian authorities have declared that **Estonia should be technically ready for the euro changeover by summer 2006 and the target date for the euro adoption is 1 January 2007**. In January 2005 the government decided to establish a national changeover committee led by the Secretary General of the Ministry of Finance (MoF) and comprising representatives of the Ministries of Justice, Economic Affairs and Communications, Internal Affairs, State Chancellery and Eesti Pank. The changeover committee is answerable to the government. The committee has established six working groups: cash and settlements (led by Eesti Pank with participants from all credit institutions), legal issues (led by MoF), public sector readiness (MoF), communications (MoF), business environment (MoF), and consumer protection issues (Ministry of Economic Affairs and Communications). In the last two working groups business sector representatives are present as well.

Our timeline provides the national changeover plan be submitted to the government by end-August 2005. In addition, Eesti Pank has its own detailed master plan concerning the

Estonia intends to have a two-week dual circulation period.

activities of the central bank before summer 2006. The changeover scenario foresees the **"big bang" approach** regarding settlements, contracts, etc. In the cash area Estonia intends to have a two-week dual circulation period. In order to reduce the burden of the retail sector in the first two weeks of January 2007, Estonian credit institutions have agreed to exchange cash kroons for cash euros according to the central rate and without any service fees as from December 2006. After the end of the dual circulation period commercial banks will continue to exchange kroons to euros without additional charges for a further 6–12 months. Eesti Pank exchanges any remaining kroons for euros without extra charges indefinitely.

In order to ensure the changeover will be as smooth as possible, we have to lay strong emphasis on communication issues. The first priority is to make the entire necessary information available to different target groups in the way, which would enable the entire population and stakeholders to cope with the change. For example, the older generation might associate the changeover with monetary reforms of the past, which led to reducing the value of their savings. For example, some people, particularly from the older generation, feel that the monetary reforms of the past led to reducing the value of their savings (because the reform coincided with the period of hyperinflation). Hence, one of our main messages is that we are substituting one stable currency for another.

Conclusions

The first year in ERM II can be considered successful for Estonia, as economic development has largely followed the forecast and there have been no tensions in the forex market. Domestic demand has grown more or less at the pace expected, whereas the government's fiscal position has helped to balance economic developments. Although the low level of interest rates has kept Estonia's monetary environment expansionary and the external indebtedness of the economy has grown faster than predicted, Eesti Pank estimates both the level of the current account deficit and credit growth to have peaked in 2004. While the headline inflation picked up after the EU accession as expected, the underlying inflation rate has remained stable and no broader price pressures can be observed. Practical preparations are also well under way in order to join the euro area on 1 January 2007.