Eesti Pank
Bank of Estonia

Report on the Adoption of the Euro

February 2009

CONTENTS

SUMMARY

Eesti Pank started to publish a regular report on the adoption of the euro in 2007. The purpose of the report is to share with the public the information about Estonia's readiness to change over to the single currency of the European Union – the euro – and introduce the points of view of Eesti Pank in this matter. The current report is based on the assessments given by the European Central Bank and the European Commission in the Convergence Reports published in May 2008. It takes account of the latest economic forecasts and includes an updated estimate of compliance with the Maastricht criteria necessary for the adoption of the euro. These criteria comprise price stability, long-term interest rates, exchange rate stability and compliance of public finance and legal framework with the requirements for joining the euro area.

The introduction of the euro at the first opportunity is the priority of Estonia's economic policy. Estonia has been moving towards close integration with the euro area during the whole independence period. By joining the European Union Estonia also committed to adopting the euro. The changeover to the euro must be viewed as a natural development for Estonia, because Estonia is a member of the European Union and the fundamentals of our economic policy are very similar to those of the euro area. The peg of the Estonian kroon to the euro and close economic ties with the euro area mean that the Estonian economy must already at this point operate practically the same way as the euro area economy. Estonia's accession to the Economic and Monetary Union is the best and most reliable way of ensuring the stability of the currency in circulation and low inflation. Increasing reliability, in turn, helps to enhance Estonia's economic potential.

The European Commission and the European Central Bank regularly assess whether the EU countries that do not belong to the euro area meet the requirements for the introduction of the euro (the Maastricht criteria). The most recent regular Convergence Reports on non-euro area Member States were published on May 7, 2008. The assessment showed that Estonia meets all the criteria for the launch of the euro except the criterion of price stability.

Estonia's inflation has been boosted by high fuel and food prices as well as administered price rises. The impact of fuel and food prices and domestic price pressures started to ease at the end of 2008, bringing about a decline in the growth rate of prices. According to Eesti Pank's estimates, Estonia is likely to meet the inflation criterion at the beginning of 2010. At this point, targeted activities to join the euro area are vital. In order to be able to meet the inflation criterion, Eesti Pank considers it necessary to avoid administrative measures that could increase prices. It is also essential to continue with strong fiscal policy. The current budget cuts should stabilise the budget deficit for 2009 within the Maastricht budget deficit criterion (3% of GDP). However, given the faster than expected economic decline, the Government should be ready to take additional steps in order to keep the deficit within the Maastricht budget deficit criterion both in 2009 and 2010. If all the criteria are met, Estonia could adopt the euro in 2011.

In the long run, Estonia's growth potential is 2–3 percentage points higher compared to the more prosperous EU countries. The key determinants of Estonia's future competitiveness and economic growth include a stable economic environment (that is, the adoption of the euro), surplus-oriented fiscal policy and a flexible labour market.

1. ESTONIA'S READINESS TO ADOPT THE EURO

The introduction of the single currency of the European Union – the euro – is obligatory for all Member States of the European Union.[1] At present, 16 Member States of the European Union belong to the euro area.[2] The latest member is Slovakia who adopted the euro at the beginning of 2009.

The rest of EU countries are regularly assessed by the European Commission and the European Central Bank to determine whether they meet the requirements for the introduction of the euro – the Maastricht criteria. The assessment in May 2008 showed that Estonia meets all the criteria for the launch of the euro except the criterion of price stability. The Estonian Government and Eesti Pank have set the goal to adopt the euro at the first opportunity; that is, as soon as Estonia meets all the necessary conditions. The exact date of the adoption will be announced at least 12 months in advance so that the state and the private sector could complete the necessary preparations.

1.1. Conformity of non-euro area EU Member States to the Maastricht criteria

The adoption of the single currency and the single monetary policy of the European Union require meeting certain economic and legal requirements. The specific prerequisites known as the Maastricht criteria are included in Article 121 of the Treaty on European Union and Protocol No 21 annexed to the Treaty. The objective of the Maastricht criteria is to ensure the smooth functioning of the European Monetary Union and a stable price level by means of a single monetary policy. These criteria require price stability and low interest rates, a stable exchange rate, and sound public finances. In addition, an appropriate legal framework is essential to designing and implementing the single monetary policy. The degree of fulfilment of the Maastricht criteria is assessed by the European Commission and the European Central Bank, who compile regular Convergence Reports.[3] These reports provide a basis for the European Commission to submit proposals to the ECOFIN and the European Council listing the Member States ready to launch the euro.

The European Central Bank and the European Commission published the latest regular Convergence Reports on the non-euro area Member States on May 7, 2008. In addition to Estonia, the euro readiness of nine other countries was assessed: Latvia, Lithuania, Poland, the Czech Republic, Slovakia, Bulgaria, Hungary, Romania and Sweden. As Slovakia fulfilled all the necessary criteria in the period under review, the Council of the European Union adopted a decision allowing Slovakia to change over to the euro at the beginning of 2009.

The assessment showed that Estonia meets all the criteria for the launch of the euro except the criterion of price stability. The following gives an overview of Estonia's compliance with the criteria and the steps taken to meet them.

1.2. Price stability

According to the Treaty on European Union, a Member State's inflation rate must not exceed the average of the three best-performing Member States in terms of price stability by more than 1.5 percentage points.

[1] Denmark and the United Kingdom are exceptional in this case, as at the time of agreement on the principles of the monetary union (at the beginning of the 1990s) they were allowed to choose whether or not and when to adopt the euro. Future joiners were not given (incl. Finland and Sweden) this option.

[2] The Member States of the European Union are divided into two groups based on their participation in the Economic and Monetary Union: full-fledged members of the Economic and Monetary Union (Member States that belong to the Eurosystem) and countries with derogation (Member States that do not belong to the Eurosystem).

[3] The Convergence Reports are available on the following websites:
European Commission: http://ec.europa.eu/economy_finance/publications/specpub_list9259.htm
European Central Bank: http://www.ecb.int/pub/convergence/html/index.en.html

In general, price stability refers to an inflation rate that does not affect people's decisions concerning production, consumption, investment and saving. The European Central Bank interprets the price stability of the euro area as the inflation rate close to but below 2% in the medium term. In the new EU countries a balanced inflation rate, i.e. not endangering price stability, can also be slightly higher in the medium term.

Estonia's inflation has been higher than the reference value of the Maastricht criterion almost every year. (In recent periods, the high prices of fuel and food have also raised euro area inflation above the objective set by the European Central Bank.) Estonia's relatively high inflation has resulted from our economic developments that have been characterised by low prices in comparison with other EU countries, rapid economic convergence with the European Union and structural changes related to the development. The convergence of the Estonian income and price levels towards the EU average has been accelerating the price increase in Estonia since in order to diminish the differences, incomes and prices as well as productivity have had to rise in Estonia somewhat faster than in the European Union on average. For stable economic growth it is essential that prices rise in line with the growth in productivity.

Estonia is likely to meet the inflation criterion in 2010

Similar to the euro area, the inflation in Estonia has been boosted by high fuel and food prices. As the share of these prices in the Estonian consumer basket is higher compared to the euro area countries, they have exerted stronger upward impact on Estonia's inflation rate, along with administrative measures. At this point the price pressures stemming from fuel and food prices as well as domestic price pressures have clearly eased (see Figure 1).

Inflation will be slowing at a rapid pace in the first half of 2009. Eesti Pank expects a 2% growth in consumer prices for 2009. As various surveys indicate, both the households and companies anticipate a decline in the inflation rate. In 2009, labour costs and productivity growth will be more in line and price pressures will weaken. Based on the risk scenario of the forecast, average consumer price growth may be even lower in 2009. Consequently,

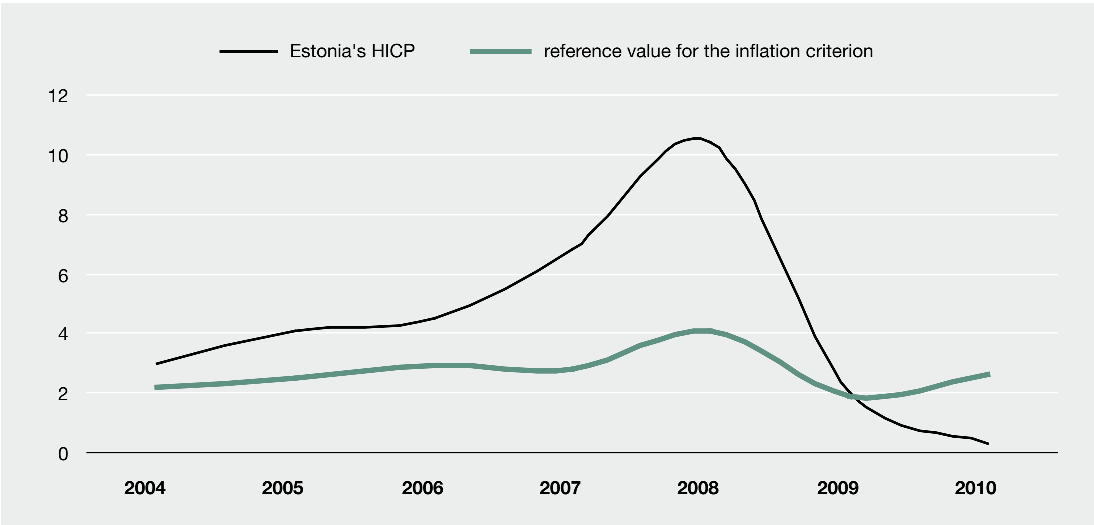

Figure 1. Meeting the inflation criterion (%)

Sources: Eesti Pank forecast (February 2009), Eurostat, European Commission Interim Forecast (January 2009)

Estonia is likely to meet the Maastricht inflation criterion in the fourth quarter of 2009 or at the beginning of 2010 (see also Annex *Inflation developments and prospects for joining the euro area*).

The risk factor surrounding the inflation forecast is administered price rises. In order to be able to meet all the Maastricht criteria, the Government should avoid any administered price rises and in 2009-2010 postpone all political actions that might give cause to such rises.

1.3. Long-term interest rate

The long-term interest rate of a Member State must not exceed the average interest rate of the three best performing Member States in terms of price stability by more than 2 percentage points.

The long-term interest rate shows the expectations of market participants and the financial market's level of integration. Low interest rates (which comprise expectations of low inflation as well as low risk premiums) reflect market participants' understanding that the development of the economy will also remain stable in the future. According to the criterion, the interest rate on the long-term (10-year) government bonds denominated in the applicant country's currency must not exceed by more than 2 percentage points the average long-term interest rate of the three Member States with the lowest inflation rates.

The long-term interest rate has been relatively low in Estonia but as we lack long-term government bonds denominated in kroon, there is no directly comparable interest rate indicator either. The long-term interest rate is calculated on the basis of long-term kroon loans issued to the private sector.[4] Therefore, when assessing the interest rate criterion, the European Commission and the European Central Bank also take other factors into consideration.

According to the 2008 Convergence Report of the European Commission, the Estonian interest rate level and the low government debt level allow to conclude that Estonia is fulfilling the interest rate criterion. The European Central Bank also gave a positive assessment, based on a general analysis of the financial environment.

1.4. Stable exchange rate

The country must, for at least two years, participate in the currency exchange rate mechanism ERM II and keep the exchange rate of its currency stable against the euro (in particular without devaluation on its own initiative).

The smooth operation of the Estonian currency board since 1992 reflects the competitiveness and stability of our economy. Thus, Estonia was one of the first Member States to join the exchange rate mechanism ERM II soon after accession to the European Union in 2004.

Estonia has fulfilled its (unilateral) commitment to maintain the rate of the kroon against the euro within the zero per cent fluctuation band (see Figure 2). Both the European Commission and the European Central Bank have noted that the exchange rate of the Estonian kroon has not experienced any problems within the framework of the ERM II and that Estonia complies with the exchange rate criterion.

[4] The long-term interest rate indicator for Estonia was developed in 2004 in cooperation between Eesti Pank, the European Commission and the European Central Bank. It is based on the interest rates of the kroon loans with the maturity of up to five years.

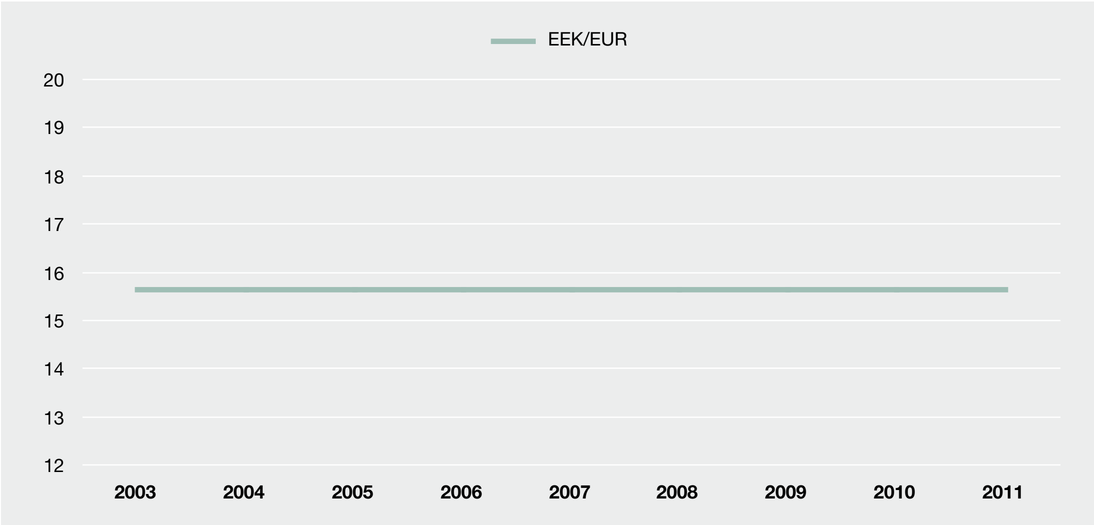

Figure 2. Exchange rate of the Estonian kroon and the euro

Source: Eesti Pank

1.5. Public finances

The general government deficit must be lower than 3% of GDP. Government debt must be less than 60% of GDP or approaching the required level at a satisfactory speed.

Owing to a relatively conservative fiscal policy, the state budget has been in balance or surplus in the years of rapid economic expansion (see Figure 3). Government debt (as a ratio to GDP) has been steadily decreasing as a result of repayments and strong economic growth, being the smallest among the EU Member States (see Figure 4). Thus, Estonia has been successful in fulfilling the criteria for public finances.

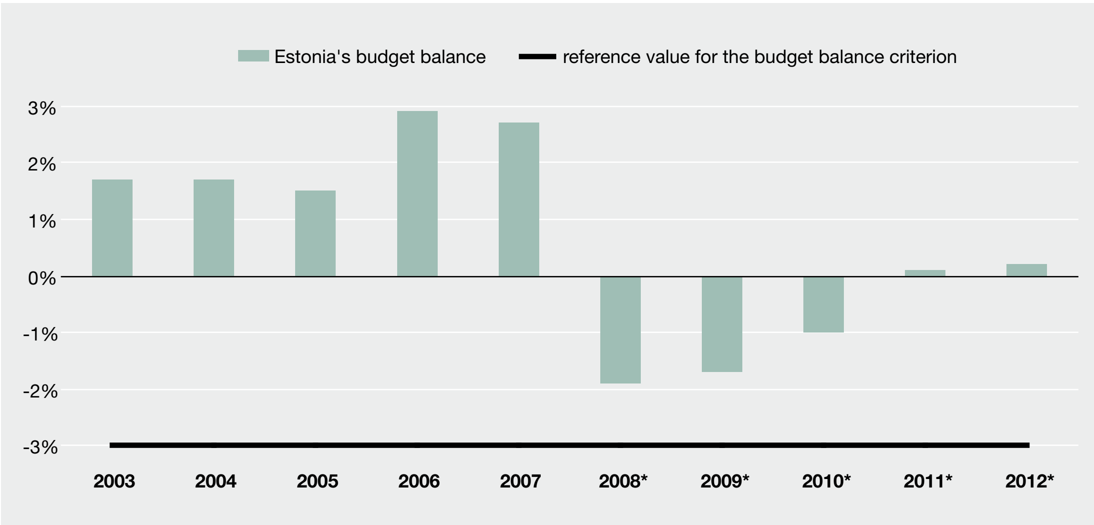

Figure 3. Estonia's budget balance and reference value for the budget balance criterion (% of GDP)

Source: Updated Convergence Programme 2008 of the Republic of Estonia (November 2008)

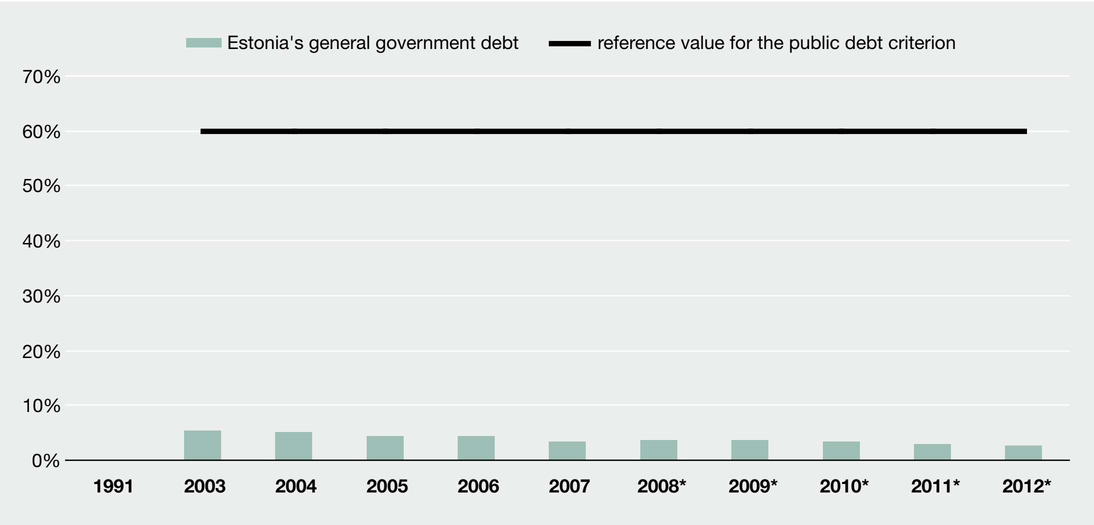

Figure 4. Estonia's general government debt and reference value for the public debt criterion (% of GDP)

Source: Updated Convergence Programme 2008 of the Republic of Estonia (November 2008)

However, although Estonia complies with the public finance criteria, it is of the utmost importance to continue with the current conservative fiscal policy principles in order to maintain a stable economy and sustainable public finances. In 2009-2010 general government expenditure will grow faster than revenue owing to the current economic downturn. Eesti Pank estimates the consolidated state budget to be in deficit both in 2009 and 2010.

In the current economic situation a budget deficit is, in principle, acceptable if it is temporary and does not jeopardise Estonia's economic reliability or the adoption of the euro at the first opportunity. However, we should maintain the general objective of the fiscal policy; that is, to keep the budget in surplus over the entire economic cycle. The currently agreed budget cuts should stabilise the budget deficit for 2009 at 3% of GDP. However, considering the great uncertainty surrounding our economic environment the Government should be ready to take additional steps in order to improve the budget balance and keep the deficit within the Maastricht budget deficit criterion both in 2009 and 2010.

1.6. Legal requirements for the adoption of the euro

First and foremost, an assessment is given of the compliance of the objectives of the central bank with those of the European Central Bank and of the independence of the central bank.

In 2006, the Eesti Pank Act was amended so as to be in compliance with the Treaty on European Union and the Statute of the European System of Central Banks (ESCB). When the time for the changeover to the euro becomes more certain, the Act on the Introduction of the Euro needs to be adopted. In addition to the legislation mentioned above, it is necessary to change the Currency Law of the Republic of Estonia and the Law on the Security of the Estonian Kroon. These acts will be repealed with the Act on the Introduction of the Euro. The draft Act on the Introduction to the Euro has been approved by the relevant ministries but due to the postponement of the date for the changeover the proceedings on the draft Act have been temporarily suspended.

1.7. Timing of the adoption of the euro

Estonia's open economic policy and accession to the European Union has laid a good foundation for strong economic growth and for catching up with other EU Member States. The changeover to the euro must be viewed as a natural development for Estonia, because Estonia is a member of the European Union and the fundamentals of our economic policy are very similar to those of the euro area. The openness of the Estonian economy and the fixed exchange rate of the kroon force our enterprises to be competitive under very similar economic and political conditions as the present Member States of the euro area. This, in turn, supports the stability of the Estonian kroon's exchange rate and compliance with the respective criterion. At the same time, the Government has pursued the balanced budget principle and, consequently, Estonia meets the public finance criterion. Estonia also complies with the interest rate criterion, which indicates that financial markets are globally integrated and investors believe in Estonia's economic competitiveness and policy. If our economic policy makers and enterprises justify that belief, Estonia will not have any fundamental problems with fulfilling these criteria in the future either.

The main obstacle in our way to joining the euro area has been the high inflation rate. Annual consumer price growth was 10.4% in 2008. The double-digit inflation rate largely arose from an increase in global energy and food prices. The upward pressure of energy and food prices on inflation decreased considerably in the second half of 2008 because of the cooling global economy. Moreover, also domestic inflation has decelerated owing to weaker demand and slower wage growth. Eesti Pank expects a 2% growth in consumer prices for 2009. The level of prices will not change considerably in 2010. Consequently, Estonia could meet the Maastricht inflation criterion in the fourth quarter of 2009 or at the beginning of 2010, which would allow to adopt the euro in 2011.

The gradual decline of inflation, however, depends on the developments of productivity and wages. Wage growth must be in line with productivity growth so as to ensure competitiveness and steady income growth.

The Government's role is to provide for stable macroeconomic conditions and help restore investors' trust in the Estonian economy. In the opinion of Eesti Pank, the best way to do that is to carry on with sustainable fiscal policy and maintain the changeover to the euro as the key objective of Estonia's economic policy. The Government must be ready to take steps to support compliance with the Maastricht criteria. As said above, from the perspective of the inflation criterion this means avoiding administered price rises and postponing political actions that might cause such rises. As regards fiscal policy, concrete measures should be implemented to improve fiscal balance in 2010 and keep the deficit within the Maastricht budget deficit criterion.

When Estonia fulfils all the criteria for the adoption of the euro, the exact date of the adoption will be announced at least 12 months in advance so that the state and the private sector could complete the necessary preparations.

2. INTER-AGENCY COOPERATION ON THE ADOPTION OF THE EURO

Upon joining the European Union and the Exchange Rate Mechanism II (ERM II), the Estonian authorities set the goal to be technically ready for the adoption of the euro by mid-2006 and to introduce the euro on January 1, 2007. The assessment of the European Commission published in November 2006 on the technical readiness of the non-euro area EU Member States to adopt the euro was very positive for Estonia. Estonia had completed all the preparations not directly dependent on the date for the changeover to the euro.

2.1. National preparations for the introduction of the euro in Estonia

Arrangements at the national level

To ensure a smooth changeover to the euro and coordinate necessary activities the Government decided at its cabinet meeting on December 9, 2004, to form the National Changeover Committee. The Committee is chaired by the Secretary General of the Ministry of Finance. The Committee also includes a Deputy Governor of Eesti Pank, the Secretary General of the Ministry of Justice, the Secretary General of the Ministry of Economic Affairs and Communications, the Secretary General of the Ministry of Internal Affairs, the Director for European Union Affairs at the State Chancellery, and an adviser to the Prime Minister. In addition to public sector experts, the private sector was also involved through the working groups of the Committee.

In order to prepare for the changeover to the euro, Estonia's National Changeover Plan was compiled, which includes guidelines for government authorities and information for the general public. The latest euro plan, version 6, was approved on November 29, 2007 and is available on the websites of the Ministry of Finance and Eesti Pank[5] and on the euro web at www.euro.eesti.ee.

In addition, a high-level working group has been set up and chaired by the Prime Minister. The members of the working group include the Minister of Finance, the Minister of Economic Affairs, the chairmen of the coalition parties of the parliament, Governor of Eesti Pank and Chairman of the Estonian Chamber of Commerce and Industry. The aim of the group is to coordinate the implementation of the economic policy measures necessary for meeting the Maastricht criteria.

Preparations of Eesti Pank

The central bank already started preparations for ensuring a smooth changeover to the euro in autumn 2003. Since joining the European Union in May 2004, Eesti Pank has been a member of the European System of Central Banks (ESCB). Preparations for joining the ERM II in June 2004 were equally important. For that purpose, Eesti Pank engaged in regular cooperation with the European Commission, the European Central Bank and other EU Member States.

In 2004, Eesti Pank started to draft the framework for changing over to the euro, taking into account the experience of other states and the specifics of Estonia. The principles developed by the central bank formed the basis for the official plan for the changeover to the euro, which was compiled in spring 2005. By autumn 2006, all major matters concerning the currency exchange had been agreed upon with market participants.

The objective of Eesti Pank was to be ready by the middle of 2006 in terms of the organisation's everyday operations and for the introduction of the euro area's single monetary policy. By now, the central bank has completed all preparations not directly dependent on the date for the adoption of the euro. The activities that can be commenced only after the European Commission has made its final decision on the accession to

[5] http://www.eestipank.info/pub/et/EL/ELiit/

the euro area, such as minting Estonian euro coins, have been suspended.

2.2. How does the changeover to the euro take place in Estonia?

The euro will be introduced as account (electronic) money (e.g. accounts and deposits in commercial banks), and in accounting and contractual relations according to the "big bang" scenario on the so-called €-day[6]. This means that there will be no transitional period.

A two-week period of dual circulation will start from the €-day. During that time kroon cash and euro cash are considered equal payment means. Retailers will accept both the euro and the kroon, but change will be given in euro, as a rule. After the period of dual circulation the euro will become the sole legal tender in Estonia.

In order to simplify the launch of the euro cash into circulation, the credit institutions will exchange kroons to euros at the central exchange rate established on the transition to the euro and without a service fee for a month before and six months after the €-day. Later on, they will continue providing the same service within a limited branch network for at least another six months. When the credit institutions no longer exchange kroons to euros, Eesti Pank will continue to do so at the central exchange rate and without a service fee for an unlimited period of time.

Six months before and after the €-day the retailers will be required to display handwritten or printed prices at points of sale in both kroons and euros. Prices should be converted at the exchange rate established by the Council of the European Union, or at the official exchange rate of Eesti Pank in the absence of such a rate. The Government will serve as an example to the private sector by rounding taxes and state fees down – that is, for the benefit of the taxpayers – when calculating them from kroons into euros.

The expenditure related to the changeover will generally be covered by the market participants themselves.

[6] The date for the transition to the euro

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APPENDIX. INFLATION DEVELOPMENTS AND PROSPECTS FOR JOINING THE EURO AREA

The average inflation rate for 2008 was 10.4%, which was in line with the central bank's forecast. The double-digit inflation rate largely arose from an increase in global energy and food prices. At this point, both the external and domestic price pressures have eased. The remaining price pressures are primarily caused by administrative measures.

Energy and food prices dropped significantly in the external markets in the second half of 2008 because of the cooling global economy. From August to December global oil prices went down by 70% in US dollars. In February this year markets were expecting the price of oil to rise to 60 dollars per barrel by the end of 2010. In July the raw materials for bio-fuels also started to cheapen because of the easing demand for oil.

Global price trends gradually pass through to the Estonian market. The fall in oil prices is first evident in the prices of motor fuel and later on also in the cost of household energy. The price of imported natural gas depends on the global price fluctuations of fuel oil in the previous six months. The price of thermal energy is expected to decline until the second half of 2009, given the current oil price level. Although energy comprises nearly 14% of the Estonian consumer basket, cheaper oil prices will restrain inflation indirectly also through other components.

Domestic inflation grew rapidly until the end of 2008 regardless of the economic slowdown. The prices of services increased by an average of 10% in 2008. Transport services made the greatest contribution to price growth. The prices of services were primarily boosted by an increase in fuel prices and rapid wage growth. However, these factors are expected to abate in the next couple of years. Labour market data confirm the deceleration of wage growth, although the situation varies by field. In 2009, labour costs and productivity growth will be more in line and price pressures will weaken.

Inflation is expected to slow at a rapid pace in the first half of 2009. According to the flash estimate of Eesti Pank published this February, consumer prices will grow 2% in 2009. As various surveys indicate, both the households and companies anticipate a decline in the inflation rate. Based on the risk scenario of the forecast, average consumer price growth may be even lower in 2009 (0.2%). As regards 2010, the level of prices may well even decrease. Consequently, Estonia may be able to meet the Maastricht inflation criterion in the fourth quarter of 2009 or at the beginning of 2010.

The robust rise of global energy and food prices in the first half of 2008 more or less affected all European countries. Annual euro area inflation increased to 3.7% in the second quarter but then eased slightly in the second half of the year. The average inflation rate for 2008 stood at 3.3% in the euro area and 3.7% in EU27. Thus, the reference value of the Maastricht inflation criterion rose to 4.1% at the end of 2008. The European Commission's Interim Forecast expects the Maastricht inflation criterion to drop to 2.6% by the end of 2010.