Eesti Pank
Bank of Estonia

Report on the Adoption of the Euro

December 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 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.

By joining the European Union Estonia committed to adopt the European single currency, the euro. Owing to the Estonian monetary system, the Estonian kroon has been firmly pegged to the euro for more than 17 years. Therefore, the changeover to the euro should be regarded as a natural development for Estonia, given its close integration with the European economy. The euro would contribute to the ongoing economic integration, increase Estonia's credibility for the investors, and enable Estonia to have more say in Europe's economic policy making. The clear perspective of joining the euro area is of utmost importance for supporting Estonia's economy and the credibility of its economies policies in the current conjuncture.

The adoption of the single currency calls for meeting certain economic and legal requirements laid down in the Treaty establishing the European Union – the Maastricht criteria. The aim of these criteria is to ensure that the economy adopting the euro is ready for operation in the Economic and Monetary Union, and thus guarantee the smooth functioning of the monetary union and a stable price level. These criteria include 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 objective of Eesti Pank is to change over to the euro as soon as Estonia meets all the necessary requirements. Based on current estimates, Estonia is likely to meet the Maastricht criteria already at the end of this year, and thus be able to adopt the euro in 2011 as is targeted in the Estonia's National Changeover Plan.

Previous official assessments of compliance with the criteria have shown that Estonia meets all the necessary requirements, except the criterion of price stability. However, the external price pressures that boosted inflation in the previous years have eased and also domestic inflation pressures have abated along with the economic slowdown. Based on the autumn economic forecast of Eesti Pank, consumer prices rise 0.1% in 2009. Estonia was able to meet the inflation criterion in November 2009.

Although recent economic developments have contributed to Estonia's compliance with the price stability criterion, meeting the budget deficit criterion is the key issue for Estonia in the current global and domestic conjuncture. The adopted budgetary consolidation measures for 2009 amount to about 9% of GDP. This is a major step towards fulfilling all the Maastricht criteria. However, Eesti Pank considers it necessary to focus on planning the incomes and expenditures of the state budgets for 2010 and 2011 to maintain the budget deficit below 3% of GDP also in the coming years. Therefore, Eesti Pank deems it necessary to continue with securing long-term fiscal sustainability.

Furthermore, it should be borne in mind that besides meeting the criteria for the adoption of the euro, budget balance is necessary also for ensuring the credibility and sustainability of the Estonian economic policy.

1. ASSESSMENT OF READINESS FOR EURO AREA MEMBERSHIP

The introduction of the single currency of the European Union – the euro – is an obligation for all Member States of the European Union.[1] The adoption of the single currency and the single monetary policy of the European Union call for meeting certain economic and legal preconditions. These requirements, known as the Maastricht criteria, have been laid down 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 every two years.[2] Member States are also entitled to require an extraordinary assessment. In addition to the Maastricht criteria, the European Commission and the European Central Bank also take account of other factors of economic integration, such as market integration and balances of payments. Based on the Convergence Reports and the qualified majority of the Eurogroup Member States[3], the European Commission submits proposals to the ECOFIN and the European Council with regard to the Member States that are ready to join the euro area.

The European Central Bank and the European Commission published the latest regular Convergence Reports on the non-euro area Member States on 7 May 2008. Besides Estonia, the euro readiness of nine other countries was assessed, namely Bulgaria, the Czech Republic, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia 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 adopt the euro at the beginning of 2009. Consequently, the euro area now comprises 16 European Union members.[4]

The next regular Convergence Reports will be prepared in spring 2010 to assess the euro readiness of nine non-euro area EU Member States. Estonia has good opportunities to fulfil the Maastricht criteria in spring, which would allow to adopt the euro in 2011.

[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. Those who joined later (incl. Finland and Sweden) were not given this option.
[2] 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
[3] In connection with the entry into force of the Treaty of Lisbon on 1 December 2009, the roles of the European Parliament and the Eurogroup (i.e. euro area members) gained significant importance. The Eurogroup's recommendation is now included in the proposal regarding the enlargement of the euro area. According to the Lisbon Treaty, the Eurogroup members have up to six months to adopt a decision on the enlargement of the euro area as of the receipt of the proposal from the European Commission.
[4] 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).

2. ESTONIA'S READINESS TO ADOPT THE EURO

The changeover to the euro must be viewed as a natural development for Estonia. Estonia is a member of the European Union, which means that as soon as Estonia will comply with all the necessary criteria it will be able to join also the euro area. The Estonian economy is closely related to the European single market and also the fundamentals of Estonia's economic policy are very similar to those of the euro area. The fixed peg of the Estonian kroon to the euro has served as the basis for Estonia's economic policy and financial stability for already more than 17 years. In other words, the Estonian economy and entrepreneurs have been operating in an environment similar to the euro area. The adoption of the single currency would further tighten the close relations between Estonia and other EU countries and increase Estonia's credibility for the investors.

The high inflation rate has been the main obstacle on Estonia's way to joining the euro area. Consumer prices growth stood at 10.4% on average in 2008, being far above the Maastricht price stability criterion. High inflation in the previous years was caused by both the external price pressures and domestic economic growth. However, the external price pressures have eased during 2009 and also domestic inflation has decreased along with the economic slowdown and declining wage pressures. Eesti Pank expects consumer price growth to be only 0.1% in 2009. Estonia met the Maastricht inflation criterion as at November 2009.

Estonia has been complying with the public finance criterion successfully so far, but is now facing some difficulties, given the current recession. The state budget surplus turned into a deficit in one year, and national expenditure has increased considerably as a ratio of GDP. The main responsibility of the Government is to ensure the credibility and sustainability of Estonia's economic policy in a longer term. Eesti Pank considers it necessary to take further steps in addition to the recent budget cuts to improve the budget balance.

The 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. According to the latest regular assessment conducted in spring 2008, Estonia had met all the criteria for the launch of the euro except the criterion of price stability. In summer 2009, the Government adopted the Estonia's National Changeover Plan where the target date was set at 1 January 2011. In case Estonia complies with all the necessary criteria, the decision regarding Estonia's accession to the euro area will be taken approximately six months before the changeover to the single currency, so that the state and the private sector could complete the necessary preparations in time.

The following gives an overview of Estonia's compliance with the Maastricht criteria and the efforts made towards meeting the criteria.

2.1. 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.

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. Given the current price convergence in the new EU countries, the medium-term inflation rate, which does not endanger price stability, can also be slightly higher. The Maastricht price stability criterion also takes that into account by adding 1.5 percentage points to the average inflation rate of the three best performing EU countries in terms of price stability. In addition, a stable inflation level must be sustainable.

Experience has shown that the calculation of the criterion has included only the inflation rates of these countries where price growth is positive; however, short-term negative price growth does not contradict the price stability criterion. The European Commission evaluates the sustainability of the inflation level in its economic forecast. For instance, the Commission analyses potential factors that might boost the inflation above the reference value of the criterion in the coming years. The European Commission's Autumn Forecast published on 4 November 2009 does not expect Estonia's inflation to pick up in 2009–2011.

The price stability criterion is calculated on the basis of the average inflation rate for the 12 months preceding the evaluation. To this end, the Harmonised Index of Consumer Prices (HICP) of the European Union is used, not the Consumer Price Index of the individual country.

Estonia is likely to meet the inflation criterion at the end of 2009

Estonia's inflation has been higher than the reference value of the Maastricht criterion almost every year. Inflation was primarily boosted by the hike in global oil and food prices in 2007-2008. The double-digit inflation rate was not sustainable for the Estonian economy, as it contributed to the gradual decrease in economic activity. Inflation in the external environment has decrease to very low levels, which has significantly eased the inflation pressures also in Estonia.

The inflation developments in the last six months point to the adjustment of the economy, which is expected to continue in the coming years. Slight price and wage cuts are necessary to support growth in productivity. Moreover, price and wage developments must be in line with productivity growth also in the future to guarantee a stable economic environment.

Based on the autumn forecast of Eesti Pank, Estonia's price level will diminish further at the end of 2009 as well as in the first half of 2010. Eesti Pank expects a 0.1% increase in average inflation for 2009 and a 0.4% decrease for 2010. The 12-month average inflation rate, which is used for assessing compliance with the inflation criterion, slows at a somewhat more moderate pace. Nevertheless, Estonia was able to fulfil the criterion in November 2009 (see Figure 1).

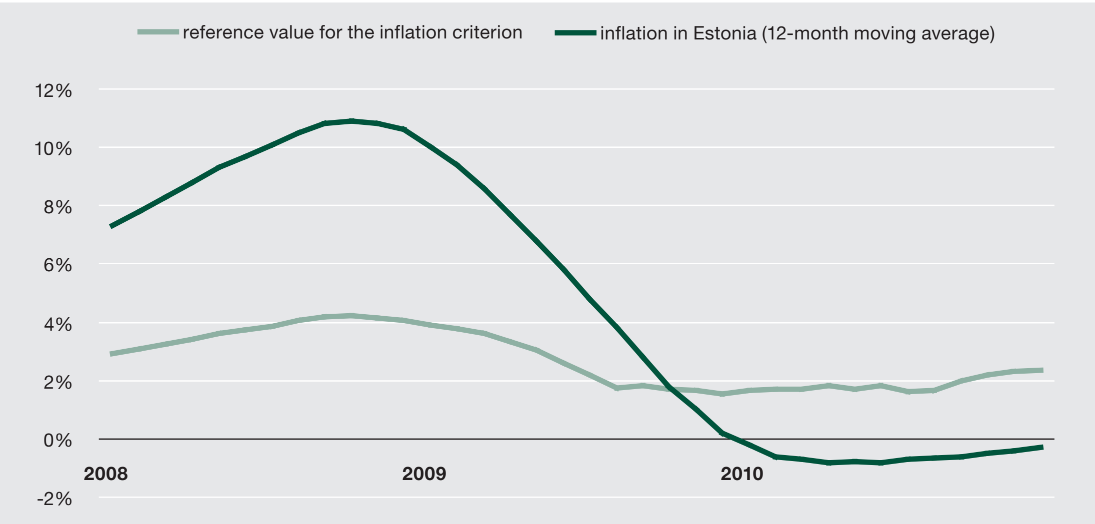

Figure 1. Meeting the inflation criterion

Sources: Eesti Pank forecast (autumn 2009), European Commission forecast (Nov 20

2.2. 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 small risk premiums) reflect market participants' estimation 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 the average long-term interest rate of the three Member States with the lowest inflation rates by more than 2%.

The long-term interest rate on kroon loans 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 assessment of the long-term interest rate has earlier been based on an indicator calculated on the basis of long-term kroon loans issued to the private sector.[5] As this indicator is not directly comparable to the criterion indicator, the European Commission takes also other quantitative or qualitative factors into consideration when assessing the interest rate criterion, such as government debt.

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.

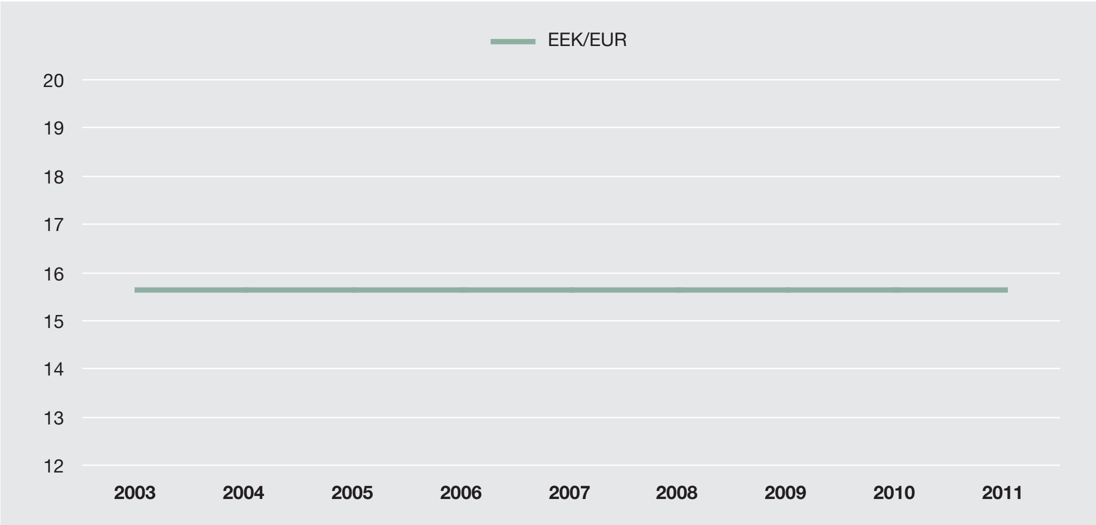

Figure 2. Exchange rate of the Estonian kroon and the euro

Source: Eesti Pank

[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.

2.3. 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 0% 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 stability criterion.

2.4. 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.

In the years of rapid economic expansion, Estonia's general government budget used to be in balance or surplus owing to a relatively conservative fiscal policy (see Figure 3). Government debt (as a ratio to GDP) has been the smallest among the EU Member States (see Figure 4). Thus, Estonia has been complying with the public finance criterion successfully so far.

However, Estonia's economic situation changed as a result of the global crisis and the 2.7% budget surplus as a ratio of GDP recorded in 2007 turned into a 2.7% deficit in 2008. The deficit is expected to be close to 3% of GDP also this year and the next. Therefore, it is necessary to bring expenditure back in line with revenue.

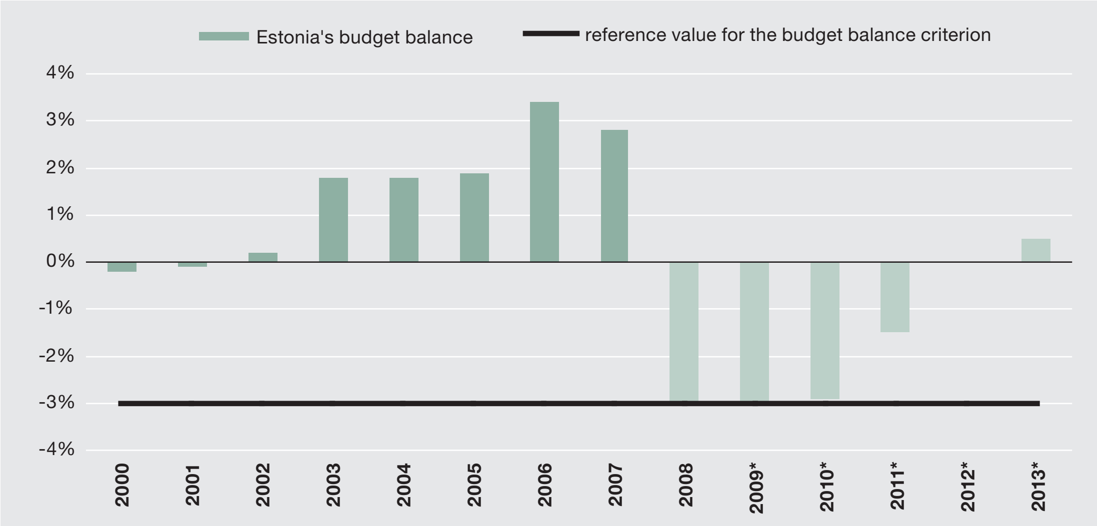

Figure 3. Estonia's budget balance and reference value for the budget balance criterion (% of GDP)

Source: Eesti Pank Forecast, State Budget Strategy 2010–2013 (May 2009)

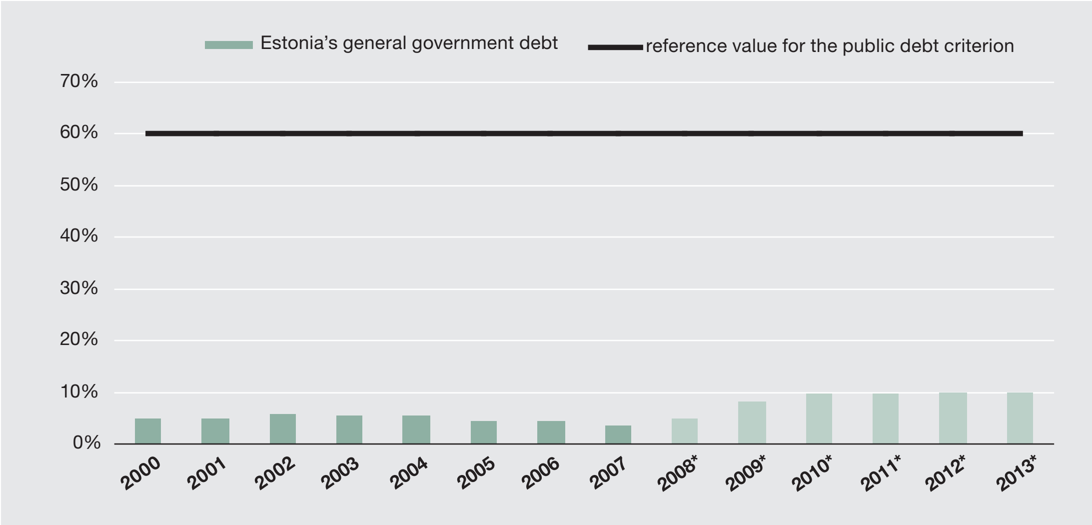

Figure 4. Estonia's general government debt (% of GDP)

Source: State Budget Strategy 2010–2013 (May 2009)

As Estonia has set out to adopt the euro, it is important to keep the state budget deficit within the Maastricht budget criterion. This is necessary also for long-term fiscal sustainability. The adopted budgetary consolidation measures for 2009 amount to about 9% of GDP. This is a great effort towards restoring the sustainability of public finances and complying with the Maastricht budget criterion in 2009 and 2010.

Based on the autumn forecast of Eesti Pank, Estonia is likely to maintain the budget deficit at a lower level than 3% of GDP both in 2009 and 2010. Since the safety margin is small, Eesti Pank deems it necessary to take further additional measures in the coming months to reduce the deficit. The medium-term objective is to achieve a surplus in an upward phase of the economic cycle and restore the reserves. Strong fiscal policy helps preserve Estonia's economic credibility and supports the future outlook of the economy.

If Estonia is unable to keep the budget at a sustainable level in the long term, this will undermine the reliability of the state in the eyes of foreign investors. If the Government fails to meet the budget criterion this year and the possibility of joining the euro area is postponed, the coming years might witness a considerable economic contraction.

2.5. 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).

As soon as the date of the changeover becomes clear, the Act on the Introduction of the Euro needs to be adopted. In November, the Ministry of Financial Affairs sent this Act to the other ministries for approval. The Act on the Introduction of the Euro will provide the basis for repealing the Currency Law of the Republic of Estonia and the Law on the Security of the Estonian Kroon as of the time of the euro changeover.

3. NATIONAL PREPARATIONS FOR THE INTRODUCTION OF THE EURO IN ESTONIA

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 1 January 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 single currency was very positive for Estonia. However, Estonia's inflation rate has been higher than allowed by the price stability criterion, which is why Estonia has not yet been able to change over to the euro. But as Estonia complied with the inflation criterion in October 2009 and there are good prospects to meet also the budget deficit criterion, the necessary preparations are currently being revised and updated. Based on the Estonia's National Changeover Plan, Estonia targets to adopt the euro on 1 January 2011.

3.1. 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 9 December 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.

The committee has established six working groups who address the following issues: cash and settlements (Eesti Pank and credit institutions), business environment, public sector technical readiness, consumer protection, legal matters, and communications. In January 2009, a seventh working group was established, which deals with monitoring compliance with the Maastricht criteria. Besides public sector experts, the working groups involve also private sector representatives in the technical preparations for the introduction of the euro.

In order to prepare for the changeover to the euro, the Estonia's National Changeover Plan was compiled under the instruction of the National Changeover Committee, which includes guidelines for government authorities and information for the general public. The latest euro plan, version 7, was approved on 25 June 2009 and is available on the websites of the Ministry of Finance and Eesti Pank[6] and on the euro web at http://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 group is responsible for coordinating the implementation of the economic policy measures necessary for meeting the Maastricht criteria.

3.2 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 close cooperation with the European Commission, the European Central Bank and other EU Member States.

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

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. The central bank completed all preparations not directly dependent on the date for the adoption of the euro. In addition to the supply and distribution of euro cash, Eesti Pank is responsible for changing the settlement and payment systems over to the euro. Some of Eesti Pank's tasks depend on the final decision of the Council of the European Union regarding Estonia's accession to the euro area. For instance, it is not possible to start minting the Estonian euro coins beforehand.

3.3. 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. Account money will be converted into euro automatically, simultaneously and in full.

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. All ATMs should be ready for dispensing euro cash within 48 hours from the €-day. 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 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 retailers will be required to display the prices at points of sale in both kroons and euros, converting the prices at the exchange rate established by the Council of the European Union, or in the event of non-availability of such a rate at the official exchange rate of Eesti Pank. 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.

APPENDIX 1. ESTONIA'S EURO COMMUNICATION ACTION PLAN

The Appendix to the Report on the Adoption of the Euro published in July 2009 focused on the preparations of Eesti Pank for joining the euro area. The current Appendix gives an overview of the organisation and principles of euro-related communication in Estonia.

Nation-wide communication activities

National euro-related communication is coordinated by the communications working group of the National Changeover Committee established by the Government. The working group includes representatives from the Ministry of Finance, Eesti Pank, the Ministry of Economic Affairs and Communications, the Government Communication Office, the Ministry of Foreign Affairs, the Ministry of Social Affairs and the Representation of the European Commission in Estonia. The working group is responsible for the preparation and implementation of the national euro communication strategy and action plan. Euro communication is carried out in cooperation with different partners and stakeholders.

The underlying principle of the communication of the adoption of the euro is to guarantee the smooth introduction of the single currency in Estonia. This calls for a public information campaign to inform people of the practical and economic aspects of the changeover. To make the transition to the euro as smooth as possible, it is necessary that people be well aware of what to do once Estonia's legal tender changes. It is vital that relevant information and explanations regarding the practical issues of the changeover reach everybody in Estonia.

Targeted communication

Active communication will be started six months before the adoption of the euro and after extensive preparations. Among other things, surveys will be conducted during the preparations phase and also later to establish the population's awareness of the euro changeover. Based on the surveys already carried out, Estonian residents already know quite well what the euro looks like and what its value is vis-à-vis the Estonian kroon.

The communication action plan is two-dimensional, consisting of more general and targeted communication. The majority of the information materials are oriented to the general public and the business sectors. Targeted communication, on the other hand, is focused on more specific target groups.

The general public will be informed through different means of mass communication: local and national media, television and radio. To ensure the efficiency of the communication, various partners and stakeholders from the public, private and the third sectors will be involved. General communication will also include media and outdoor ads on the euro. Every Estonian resident will be able to participate in the following activities and receive the following information materials:

1) Exhibitions on the design, security elements and history of the euro, organised by the European Communication and the European Central Bank
2) A euro hotline, providing answers to any kind of questions regarding the adoption the euro
3) The euro web at http://euro.eesti.ee, providing comprehensive information on the reasons for the adoption of the euro as well as practical preparations
4) An information brochure on the practical aspects of the change of the legal tender to be sent to every household in Estonia

[7] The conversion of accounts will take banks approximately two hours; the conversion of the entire banking system into euros will take around 12 hours.

5) A campaign to collect the kroon coins, organised together with the Estonian Banking Association and the commercial banks
6) Distribution of souvenirs and information brochures at euro-related seminars and trainings and through professional associations
7) Distribution of practical information to companies

Besides the general public and the business sector, special attention will be paid to more specific target groups, such as cash handlers, retailers, journalists, pensioners, tourists, people with special needs, children and the young. More specific information materials, seminars and trainings will be developed for these target groups in cooperation with professional associations, local governments and other representative bodies.

APPENDIX 2. ESTONIA'S ECONOMIC DEVELOPMENT IN LIGHT OF THE OUTLOOK FOR JOINING THE EURO AREA

History in brief

The Estonian economy is small and very open, thus it is largely dependent on developments in the rest of the world. Starting from the resumption of independence in 1991, the country has undergone rapid economic reforms, orienting toward market economy, liberal trade and free movement of capital.

The introduction of the currency board arrangement (the fixed exchange rate) in June 1992 was one of the cornerstones of the reforms. It helped vigorously curb inflation and laid good foundations for economic restructuring. The institutional development of the economy also supported the effective functioning of the currency board. A successful implementation of the fixed exchange rate requires more flexibility from markets. The Estonian labour market as well as the wage and price setting of companies have shown great flexibility in both crisis and growth years. Estonia's fiscal policy has followed the balanced budget principle since the beginning of 1990s.

The Estonian economy started to grow rapidly owing to successful reforms. At the beginning of 1990s, the income and productivity level in Estonia accounted for less than a third from the EU average. When market forces started to function, it helped Estonia converge to the level of the rest of Europe. This was also supported by the close economic integration with neighbouring countries, especially Finland and Sweden. The Estonian economy proved its flexibility by displaying the ability to adjust during the Asian and Russian crises. Growth in the country recovered quickly after these crises owing to the favourable global economic environment.

Estonia's accession to the EU and NATO in 2004 provided an additional impetus to economic expansion. This had several one-off reasons.

- Joining the EU common market broadened the possibilities of Estonia's enterprises to market their products and made the country a more attractive investment region, which **increased companies' productivity**.
- The EU accession enlarged opportunities to work outside Estonia, **so the number of people working abroad, as well as the mobility and wage expectations of employees increased**.
- The rapid integration of the financial sector with Nordic banking groups brought along **the harmonisation of credit conditions across banking groups, including low interest rates and longer maturities**, since Nordic banks started to view the banking sector in Estonia as part of their domestic market. Global financing conditions also supported the decline in interest rates.

With growth picking up speed, the economic vulnerability indicators increased as well. Private sector indebtedness hiked along with the dynamic credit growth and capital inflow widened the current account deficit. The rapid economic expansion and the large wage gap between Estonia and the Nordic countries allowed companies to meet the increased wage expectations, which, in turn, intensified inflationary pressures. Irrespective of the very fast wage growth of the boom-years, the average wage level in Estonia is some three to four times lower compared to our main trading partners Finland and Sweden. The signs of overheating peaked in 2006, but started to withdraw already in the spring of 2007, before the start of the global downward cycle. With domestic demand contracting, the economy started to shrink at the beginning of 2008. As a result, external balance improved and economic vulnerabilities diminished. However, the contraction in external trade in the wake of the financial crisis hit also Estonia's main trading partners and falling export volumes decreased total production and employment in the entire region.[8]

Economic policy has supported the functioning of the currency board arrangement

The rapid increase in investment, which relied on over-optimistic income growth expectations, along with imbalances originating from the fast growth brought along higher risks, which Estonia managed with the help of various economic policy measures. However, the measures were of limited impact in the light of the unexpectedness of the shock and the high capital inflow. Moreover, the range of economic policy tools at the disposal of a small and open economy is limited in shaping the demand in the context of the EU domestic market. Thus, market flexibility and sufficient fiscal and financial sector buffers were more important.

The currency board arrangement has helped the economy cope well with different shocks. At the same time, the non-financial sector bears the main burden of the economic adjustment in this monetary system and the financial sector's strength and ability to intermediate savings are also important. Except for ensuring the stability of the exchange rate, the currency board arrangement leaves little room for resorting to various traditional monetary policy operations to support the economy. On the other hand, a simple, rule-based monetary policy in a small and open economy gives economic agents more clarity on future monetary policy. It helps them make decisions and adjust to changing circumstances.[9]

The Estonian economic policy has actively used moral persuasion of the society to guarantee the functioning of the economic system, also if risks to it should materialise. To this end, people were warned against excessive borrowing and over-optimistic plans for the future already at the outset of the boom. It is difficult to define the importance of economic policy in shaping the expectations of companies and households. It is partly reflected in a somewhat earlier withdrawal of the signs of the overheating and the tightening of requirements to loan collaterals.

Estonia pursued conservative fiscal policy in order to reduce risks. As a result, the general government's budget was in constant surplus since 2002,[10] and funds were accumulated for possible setbacks in the future. When the crisis started, the general government debt was almost non-existent and the reserves accounted for 12% of GDP. (The fiscal reserve will exceed the public debt also at end-2009.)

With the aim of reinforcing the banking sector, Eesti Pank required larger capital and liquidity buffers from commercial banks by raising the reserve requirement and the risk weighting on housing loans in the calculation of capital adequacy[11]. In order to be better prepared for possible setbacks, cooperation with the central banks and supervisory bodies of parent banks' home countries was made more efficient. Moreover, various institutions were reorganised to further improve the functioning of markets. Other measures included, *inter alia*, the simplification of establishing companies, increasing the flexibility of the labour market and the transparency of the price-setting of monopolies. In

[8] The majority of the decline in employment is related to the rapid shrinkage in global trade volumes at the end of 2008. Industry is currently utilising about 60% of its production capacity, and if orders resume, it will be able to engage labour force quickly and for smaller wages.
[9] Above all, the currency board arrangement has helped ease speculations related to the exchange rate that are every now and then associated with developing economies.
[10] The budget surplus showed a clear upward trend in 2002–2007; the surplus for 2007 constituted 2.7% of GDP. Tax receipts, which were larger than forecasted irrespective of the declining tax burden, supported the accumulation of reserves.
[11] The reserve requirement and prudential ratios in Estonia are among the strictest in Europe.

hindsight, it can be said that despite the steps taken, more attention should have been paid to tax policy related measures helping control the credit boom[12]. Considering the magnitude of the current crisis, the role of the fiscal reserves should have been even more clearly defined.

It must be admitted that both in Estonia and elsewhere, excessive optimism was also fuelled by increasingly positive assessments of potential economic growth and by extensive asset price inflation. Both global and regional investment behaviour changed, when asset prices reached double digits, bringing along expectations of further price rises.

We have coped with the crisis

With capital inflow being so extensive, the impact of national measures is limited in a small and open economy. Therefore, the impact of the measures implemented during the boom years was not very sizable, considering that the private sector had unlimited possibilities to obtain credit from elsewhere in the world.

In spite of easy access to loan money, first signs of a cooling appeared in the Estonian economy already at the end of 2006 and start of 2007, when the rest of the world was still unscathed by the crisis. First the real estate market activity started to slow. Then the entire economy cooled, mostly because of the need for adjustment in the wake of the real estate boom. Due to the adjustment of domestic demand, the Estonian economy started to contract at the start of 2008. At the same time, this led to the improvement of several vulnerability indicators.

The global financial crisis reduced the trade turnover of Estonia's main trading partners by some 30% at end-2008. This deepened heavily Estonia's economic downturn, to about 15% in 2009. On the one hand, the shock amplified the economic adjustment after the real-estate boom and on the other hand, it affected Estonia's exports, since the country's export volume has mostly been affected by the shrinking Nordic supply chains. As a result, the number of jobs and the volume of investment have declined in the exporting sector.

It is difficult to assess the effect of single economic policy measures on alleviating the boom and the overheating of the real estate sector. The importance of the entire measure package in tackling the crisis is much more evident. Financial-sector integration, international cooperation and sufficient liquidity and capital buffers have helped maintain the credibility of the Estonian financial sector. Thus, the Government (i.e. the tax-payer) has so far not had to provide additional support to the financial sector. In addition, the price of long-term capital for the real sector has remained at a level comparable to the euro area. There have occurred no remarkable deviations and banks continue to be able to issue loans.

The recent years' budget surpluses along with the accumulated buffers have left the Government sufficient room for manoeuvre to moderately support the economy while keeping the consolidated budget deficit within the boundaries set out in the Stability and Growth Pact. Considering the size and suddenness of the economic shock that hit Estonia, the budgetary position has been improved by about 9% of GDP and the general

[12] This primarily implies to the discussion regarding the cancellation of the deduction of housing loan interests from taxable income, which abated rather swiftly. The scope of the exemption was narrowed but it was not entirely cancelled. Estonia's tax incentives on housing loan interest rates are among the most generous in the EU. On the other hand, income from real estate transactions is taxable in the country. In 2006, the effective interest rate on housing loans declined to 2.5% as a result of low margins and key interest rates.

government debt has been maintained at the level of 6%. The main emphasis is on measures that ensure income growth or expenditure cutbacks also in the next periods.

The flexibility of markets has helped companies better cope with the crisis. Enterprises in Estonia have been quick in responding to the economic slump and have accordingly adjusted their expenditures. This has been notably supported by labour market flexibility: wages have decreased, companies have streamlined production, the number of working hours has fallen and prices have been cut in some sectors. Enterprises in the sectors that have been hit harder by the shock (i.e. companies engaged in the real estate business and exports) have responded more strongly to the downturn.

The most recent assessments of Estonia's competitiveness show that Estonia's exports have shrunk less than our trading partners' imports. According to the European Commission's estimation, Estonia's export market share has even grown, considering the contraction in our trading partners' imports. Estimates to the real exchange rate refer to moving towards a balanced level. In the context of heightened cost optimisation, which is natural at times of recession, the wage gap between Estonia and our major trading partners may refer to additional opportunities for our enterprises.

More balanced development in the future

Domestic reserves and flexibility are the most significant tools for coping with the shock in Estonia. From the viewpoint of the speed of future growth, it is important how our biggest trading partners (Finland and Sweden) as well as the rest of the world will get through the crisis. Positive developments are becoming more and more apparent. Both confidence indicators and new orders have grown remarkably compared to the low at the start of the year. Although the recovery of the economy has not yet taken off in real terms, the exporting sector has started to recuperate. Third-quarter export turnover was 5% higher from the first quarter. However, risks to the global economic recovery have not disappeared anywhere and the country's economic policy is facing a lot of challenges.

According to Eesti Pank's autumn forecast, the economy will not recover very fast. Future growth will mainly be based on the exporting sector, so the speed of the revival is directly dependent on developments in the export markets. Post-real-estate boom restructuring and high unemployment,[13] which weaken the purchasing power of households, hinder the resumption of growth. Convergence with wealthier countries will continue in the medium term, since Estonia's price and income levels are still considerably below the EU average. Taking into account that the stimuli conditioned by the rapid financial integration have already done their share to boost the Estonian economy, it is hard to expect as strong future growth as witnessed in previous years.

The economic boom also brought along a rapid increase in wages and prices. As a result, the price difference between Estonia and the EU average has narrowed to a great extent. The adjustment of the Estonian labour market will continue in the next couple of years, which means there will be considerable wage adjustments in the sectors (construction and real estate development) that ballooned during the time of rapid expansion.

[13] The last time unemployment reached such a high level was after the 1998 Russian crisis. The social guarantees the unemployed received back then were relatively modest compared to today. On the one hand, unemployment insurance enables the short-term unemployed to maintain a considerable part of their income. On the other hand, the debt burden has hiked over the past ten years, so the share of loan repayments in expenditures is higher than in the wake of the Russian crisis, although interest rates are lower.

Therefore, average wages will fall in both 2009 and 2010 (according to Eesti Pank's forecast, the wage level will not change in 2011). This, in turn, will greatly alleviate inflationary pressures emerging from the domestic economy.

In the long run, the dynamics of inflation in Estonia will depend on euro-area inflationary developments, the speed of convergence and the labour-market situation. Since it is difficult to forecast very rapid economic growth, unemployment is not expected to decrease very swiftly, either. Thus, in the medium term, risks to inflation may lie in developments in the rest of the world (e.g. in commodity markets).

The main precondition for economic recovery is the restoration of confidence in the Estonian economy. Fiscal policy plays a key role here. Estonia has set the objective of fiscal deficit below 3% of GDP in both 2009 and 2010. To meet the goal, the Government has taken several measures to curb expenditure and raise income. To fulfil the latter task, one-off measures were resorted to in 2009 (including sale of real estate and withdrawal of dividends from state-owned companies). In 2010, additional tax rises enter into force and these should provide steadier income. In order to ensure the credibility and sustainability of fiscal policy, the Government has undertaken the task of balancing the budget by 2012. To this end, several measures with long-term effect have been taken (see background information on page 21).

How to better manage future booms

As a result of the transition period of the past 20 years, the Estonian economy is no longer surrounded by domestic threats and possibilities but global ones instead. When the economic system changed and rapid developments took place in the financial sector, economic policy concentrated on alleviating the impact of shocks characteristic of a transition period.[14] The current crisis has also pointed to several weaknesses in fiscal policy. Thus, the Government intends to make the system more efficient by increasing the flexibility of expenditures and the role of strategic planning.[15] At the same time, fiscal policy experience has shown that Estonia is able to keep its budget on track also in very difficult circumstances – Estonia's budget is one of the most sustainable ones in Europe.

In order to support more balanced economic growth and the export sector, it is planned to maintain the current volume of general government investment and to increase expenditure on research and development by some 0.2% of GDP. Fiscal policy measures should be aimed at increasing the added value of Estonia's products and services and improving the qualifications of the labour force.

In order to avoid the overheating of the real estate sector in the future, the Government is planning to reduce the factors that may have intensified the previous real estate boom. Moreover, it is intended to cancel the deduction of housing loan interests from taxable income and make the taxation of income on the purchase and sale of real estate more efficient.

Estonia's experience so far is limited to combating economic booms through banking regulations and banking sector stress-tests. However, in the future attention should be paid also to counter-

[14] Although the reserves continued to grow, their optimum size was not clearly defined. The current financial crisis confirms that the reserve necessary to mitigate risks originating from extraordinary circumstances should have been more sizable than considered sufficient in most countries.

[15] One of the tasks is to improve the supervision of budget implementation. Although the central government has had a relatively operational overview of the budget implementation, there have been shortcomings as regards the operational supervision of expenditures made by local governments and foundations. For example, there were establishments that even in 2008 still proceeded from seasonality in making expenditures; that is, they spent the remaining money in the last quarter of the year.

cyclical measures in case growth is below potential. There is no doubt that operating within the currency board arrangement helps the financial sector itself better identify possible risks.

The new Labour Contracts Act, which entered into force on 1 July 2009 and increases labour market flexibility, will contribute to the better functioning of the labour market. As regards wage formation, the Government has started to influence the private sector by cutting wages in the public sector faster than it is done in the private sector.

The currency board arrangement has considerably facilitated the stable development of the Estonian economy. Economic policy measures oriented towards fiscal sustainability and higher flexibility of the economy continue to be of vital importance against the backdrop of the fixed exchange rate. Exactly the same economic policies are applied also to euro area countries. For Estonia it is still very important to clearly distinguish such instruments that, when implemented independently, are effective in a small and open economy. The financial crisis has proved the importance of international cooperation in implementing measures of global influence.

Measures supporting fiscal sustainability

- Direct tax rises:
  - o the planned income tax rate reduction and an increase in non-taxable income as from the start of 2010 were omitted from the Income Tax Act (impact: 0.5% of GDP)
  - o in 2010, tax exemption on the birth of the first child is no longer valid (impact: 0.35% of GDP)
  - o the unemployment insurance premium was raised from 0.9% to 4.2% in 2009 (impact: 0.5% of GDP in 2009 and an additional 0.3% of GDP in 2010)
  - o measures to reduce tax arrears on land tax (impact:0.05% of GDP; the Government approved the draft Act on 19 November 2009 and it will enter into force at the beginning of 2010)
- Indirect tax rises:
  - o increase in VAT to 20% (impact: 0.4% of GDP in 2009 and an additional 0.4% of GDP in 2010)
  - o increase in the fuel excise duty as of 1 July 2009 and 1 January 2010 (impact: 0.25% of GDP in 2009 and an additional 0.4% of GDP in 2010)
  - o increase in the alcohol and tobacco excise duty at the start of 2010 (impact: 0.15% of GDP)
  - o increase in the electricity excise duty as of 1 March 2010 (impact: 0.1% of GDP)
  - o 20% increase in the tobacco excise duty at the start of 2011 (impact: 0.25% of GDP)
- Expenditure cuts:
  - o reducing the operational expenditure of state agencies in 2010 (impact: 0.85% of GDP in 2009 on 2008 and an additional 0.45% of GDP in 2010)
  - o reducing the cost of a treatment case of the Health Insurance Fund by 6% (impact: 0.25% of GDP in 2010)
  - o cutting the costs of the Health Insurance Fund in Q1 2009 (impact: 0.2% of GDP in 2009)
  - o measures to manage the expenditures and loans of local governments:
    - a decrease in the income tax revenue allocation from 11.9% to 11.4% on 1 April 2009 (impact: 0.2% of GDP in 2010)
    - borrowing restrictions on local governments, except for co-financing of EU funds (impact: 0.25% of GDP in 2009)
- A decrease in social benefits
  - o a change in pension indexation; i.e. a smaller pension rise than planned in 2009 (impact: 0.55% of GDP in 2009 and 0.75% of GDP in 2010)
  - o a change in pension indexation to diminish pension increases in case there has occurred an economic downturn in the preceding period.

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