



EUROPEAN CENTRAL BANK

EUROSYSTEM

THE ENTRY OF ESTONIA INTO THE EURO AREA

Keynote speech by

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at the Euro Conference hosted by Eesti Pank

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Distinguished guests,

Ladies and gentlemen,

It is a great pleasure for me to be here today, in Tallinn, to participate in the Euro Conference. On 1 January 2011 the euro will become legal tender in Estonia, and Estonia will become the 17th country to join the euro area. Let me first congratulate all parties involved in this outstanding achievement on their efforts and determination to prepare Estonia for the adoption of the euro.

The creation of the single currency has been a very important step forward in the achievement of the historical endeavour of creating a single market for the Europeans, which was what the founding fathers had in mind more than fifty years ago. Its inception has been, at the same time, a powerful symbol of the will of the European countries to pursue actively their strategic road towards unification. We were eleven countries when we started the euro on 1 January 1999. We will be seventeen on 1 January 2011. There is no better way to demonstrate that the euro area is not a "closed shop" but is open to those countries and economies that are fully compliant with the entry criteria in a convincing and sustainable manner.

1 January 2011 will become a landmark in the history of Estonia, reflecting the long and challenging process of economic and monetary integration that has enabled Estonia to join the euro area. After regaining independence in 1991, Estonia embarked on a rapid and far-reaching programme of social and economic reform. In addition to being a determined reformer, it became a model for stable multi-party democracy. Estonia transformed itself into a dynamic economy, gaining recognition for its sound fiscal record, economic freedom and capacity to develop new technologies.

For several years, Estonia was also one of the world's fastest growing economies, but its growth was far from balanced. Notwithstanding some very difficult years following its regaining of independence, Estonia's real GDP grew at an average rate of 7.2% per annum over the period from 1995 to 2007. However, this growth rate came to a halt in 2008. Real output declined sharply in 2008 and 2009, and, after Latvia, Estonia became the second most severely affected EU Member State in terms of output decline. The severity of the adjustment revealed that the period of rapid output growth was, to some extent, also a period of imbalanced growth and economic overheating. During the years of economic expansion, strong domestic demand was the main driving force behind economic growth, with domestic demand itself being fuelled by, among other things, rapid increases in real disposable income, and overly optimistic expectations about

future income. The significant financial inflows into Estonia fuelled credit growth and increases in asset prices, notably in housing markets, with the resulting imbalances then being unwound in the context of a severe recession. In addition, the very rapid growth of real GDP in the Estonian economy until 2008 resulted in the accumulation of sizeable, double-digit current and capital account deficit to GDP ratios. Booming domestic demand and capacity constraints supported an unsustainable rise in unit labour costs, with a cumulative increase of over 50% during the period from 2000 to 2007. The strong increase in wages outpaced productivity gains and had a negative impact on the competitiveness of the economy.

Today, as we look forward to the introduction of the euro in Estonia, I would like to point out two key aspects of the country's experience on its road to adopting the euro. The Estonian experience may encourage some euro area countries to tackle the pressing need for adjustment that they currently face and inspire Estonia, as well as current and other prospective euro area countries, to contribute to a sustainable functioning of Economic and Monetary Union in the years ahead.

The first key aspect refers to the importance of maintaining a sound fiscal record. Even during exceptional times, Estonia has demonstrated a strong commitment to maintaining sound national fiscal policies, which are a crucial element of the policy framework for Economic and Monetary Union. There has been a clear consensus in Estonia that fiscal consolidation should never be compromised. Indeed, despite the significant degree of uncertainty about the recovery of both external and domestic demand, the Estonian authorities implemented significant fiscal consolidation measures in 2009. This was a strong advantage for Estonia in its efforts to join the euro area. Indeed, the country's fiscal policy record since 1992 supports the view that prudence is a key element of its fiscal policy.

The second key aspect of Estonia's experience refers to the importance of both the effective prevention and, if necessary, decisive correction of economic imbalances. With the benefit of hindsight, it is clear that Estonia's overall policy stance should have been tighter in order to contain demand pressures and the emergence of significant macroeconomic imbalances during the time of very fast growth. This is particularly true over the period from 2005 to 2007, when the overheating pressures became most apparent. Efforts to reduce wage growth and contain rapid credit growth during that period also proved largely ineffective. In the end, the macroeconomic imbalances accumulated by the

Estonian economy were quite significant, and the magnitude and speed of the adjustment that followed were indeed dramatic.

However, the Estonian economy, and the citizens that support it, adapted rather quickly to the new economic environment, proving a remarkable capacity for adjustment. This speaks for the flexibility of Estonia's economy and the "alertness" of its people. The new economic environment required prompt, determined action and the adoption of difficult policy measures. The implementation of such measures contributed to Estonia's prudent fiscal record and the rapid unwinding of the external and internal imbalances that had built up during the boom years. Competitiveness is gradually being restored and the current and capital account balance has recorded a surplus since the beginning of 2009. The adjustment of nominal wages has been, and will continue to be, an essential element of the gradual correction of competitiveness losses and the return to sustainable output growth. Developments in the public sector, where nominal wages declined by around 10% in 2009, contributed to the adjustment of wages in the economy as a whole. Sustainable wage dynamics, with increases in line with productivity progress, will continue to be crucial to restoring competitiveness and maintaining a low inflation environment.

Encouragingly, Estonia's economic recession appears to be over, but as you know, this is no time for complacency. With this in mind, it will be particularly important for Estonia and other euro area countries to support the reallocation of domestic resources to export-oriented, high value added sectors in order to ensure a return to sustainable external positions. To encourage sustainable job creation, it is important to ensure that wages remain sufficiently flexible. Finally – but crucially from the ECB's perspective – the Estonian authorities must remain alert, and take forceful action if necessary, to ensure that the low inflation environment that has been achieved in the recent past is sustained over the years to come.

The experiences of Estonia and various euro area countries over the past few years highlight the importance of rigorous and effective surveillance inside the single currency area. In line with the Treaty, the ECB attaches great importance to the notion of sustainability. A country must only be eligible to adopt the euro when it has achieved a high degree of sustainable convergence and its economy is in a position to fully reap the benefits of joining the euro area. A lack of sustainability would inevitably result in serious economic challenges for the newcomer and would possibly also have negative consequences for other euro area countries, or even for the euro area as a whole. That is why a thorough and

diligent approach to ensuring adherence to the convergence criteria on a sustainable basis is in the interests of all current and prospective euro area countries.

In order to fully reap the benefits of the euro and to allow adjustment mechanisms to operate efficiently within the enlarged euro area, it is essential that Estonia adopt appropriate policies, thereby contributing to robust economic growth on a sustainable basis. The success of the euro depends on all euro area countries seriously engaging with the responsibilities that go hand in hand with the considerable benefits that euro area membership offers. Against this background, we, at the ECB, welcome the commitment by the Estonian authorities to ensure, after the introduction of the euro, an economic environment conducive to sustainable output and employment growth, with balanced macroeconomic conditions, including price stability.

I am also confident that Estonia, as the newest member of the “euro area family”, will make an important contribution to a strong and effective governance framework at the EU and euro area levels, thus helping to ensure that the implementation of sound economic policies is closely scrutinised. Recently, the ECB has set out a number of proposals for reinforcing economic governance in the euro area¹. These proposals, which are to be followed up by the Task Force chaired by President Van Rompuy, identify what is needed to strengthen governance and enforcement structures in the economic policy framework for the euro area. They require a “quantum leap” in terms of progress towards strengthening the institutional foundations of Economic and Monetary Union. It should contribute to a deeper economic union that is commensurate with the degree of economic integration and interdependency already achieved through monetary union.

The introduction of a new currency also represents a logistical challenge which requires careful preparation. Great efforts have been, and will continue to be, made to ensure that the people of Estonia are well-informed about the euro banknotes and coins, and in particular the banknotes' security features.

I am confident that the very close cooperation between the ECB and Eesti Pank that has been achieved over the last few years under the leadership of Governor Lipstok, and the cooperation that will continue into the future, will make a significant contribution to the smooth and successful introduction of the euro in Estonia.

¹ See “Reinforcing economic governance in the euro area”, available on the ECB's website (www.ecb.europa.eu)

We look forward to welcoming Estonia into the euro area! Thank you very much for your attention.