

Speech at the High-Level Euro Conference in Estonia

20 September 2010

Andres Lipstok, Governor of Eesti Pank

Excellencies, colleagues, Ladies and Gentlemen,

It is my sincere pleasure to address such a distinguished audience at this remarkable moment for Estonia. The events marking the 100 days that Estonia still has to prepare for the actual changeover to the single European currency, the euro, are drawing to a close. Let me offer some remarks from the Estonian viewpoint which will explain our understanding of the importance of the single currency in Europe. It is clear that the euro and all its benefits do not come for free.

Let me start by thanking the expert panellists, whose discussion has highlighted that the most important questions are related to maintaining the stability of the euro and the economies of the euro area.

It is vitally important for the whole Europe that the European monetary system is in good health. The Estonian economy depends a lot on exports and on European economy. If Estonian businesses have problems selling their goods abroad, the Estonian people will have less work and consequently less money. It follows that as we join the euro area, Estonians want to be sure that the European monetary system is working as well as possible.

The euro has proved to be a success in many ways. Average inflation in the euro area during the last decade has remained at its target. The strong institutional foundation guarantees the independence of the central bank system to fulfil monetary policy goals. This provides confidence that inflation will remain under control in the future. The stabilisation of inflation expectations has been very successful given global turbulences over the past years. There is no doubt that without the monetary union, European countries would have struggled more with the negative impact of the financial crisis. We have seen it before. Nobody can deny that during the past ten years the performance of the financial markets has improved and doing business in euro area has become easier than ever before. This would not have been possible without the single currency and we should acknowledge the role of the euro in these developments. Therefore we can say without any doubt that the monetary union has confirmed its ability to achieve its objectives and has fully justified itself.

At the same time, there are many challenges ahead of the euro area, as has been discussed thoroughly today. In addition to what has been said, I should also add that there are still too many European Union countries that have not joined the monetary

union. This is not good for those inside the currency union or for those outside. The smooth trading of goods in the Single Market is subdued, there is less cross-border pressure on prices to adjust and Europe cannot reach its full economic potential due to that. Although the single currency cannot solve all the problems of the European economy, it can minimise the intra-EU currency shocks. These shocks are still an additional risk that must be considered today.

The enlargement of the euro area is important for European economies and businesses, given how high global competition is at present. Estonia is a good example to prove that if a country works hard, it is possible to join the euro area as it is not a closed club, like some analysts have suggested. Therefore, continued efforts are needed from those EU countries that still remain outside of the euro area.

Currently, however, the uncertain financial situation in some countries is seen as a bigger problem than the limited size of the euro area. Although the gravity of the situation must not be underestimated, it is now clear that the difficulties that emerged in early 2010 did not bring us any closer to the worst case scenario that the sceptics predicted – that is the dissolution of the economic and monetary union. On the contrary, the reaction of the member countries, both independently and together with the EU institutions, has proved that the desire to keep the single European currency is much stronger and longer-lasting than the temporary problems that the countries encountered.

Therefore I see the crisis as a test of strength for the functioning of the euro area. It needs to be understood that the single currency is important to Europeans not for some short term fiscal benefit. It is important because the whole region's monetary policy aims for long-term price stability. Of course, it is true that a country that follows weaker policies may gain more from the monetary union in the short-term. But in the long-term the benefits it receives is really of secondary importance as we know today.

As the crisis abates, confidence in the monetary union, which had barely been tested since the introduction of the euro, has stabilised. And as confidence recovers, it is important to continue working on shortcomings of the policy framework. The political leaders and the EU institutions have made good progress in this regard. I believe the year 2010 will see a political agreement on strengthened governance. This calls for an urgent implementation. As it is said, never waste a crisis...

In conclusion, with the revised framework in place, Estonia will be joining a stronger monetary union than it would have done three years ago.

Now let me turn to the most important objective of the euro system - the price stability. I will give you some observations based on Estonia's experience. The Estonian Government has followed the Treaty rules when setting fiscal targets.

International experience has taught us that in a small and very open economy, domestic monetary policy may be constrained by efforts to reach pre-set internal monetary targets. Therefore, our policy has been to follow the fiscal rules of the euro area, the currency area which we have aimed to join since joining the EU and the currency which has been a nominal anchor for the Estonian kroon for some time already.

However, the Commission and the ECB noted in their Convergence reports this spring a point with which I must agree. Estonia should remain vigilant about inflation developments and must maintain an ambitious fiscal policy stance and domestic demand to reflect its fundamentals. To ease the potential longer-term concerns, Estonia has taken fiscal commitments in its Convergence Programme. Moreover, stable inflation expectations in the euro area will have a positive impact on the stability of prices in Estonia.

The inflation outlook has always received special attention in the Bank of Estonia's forecast. Global developments in the past two or three years have caused greater volatility in economic indicators, including inflation rates, and Estonia is no exception here. After a brief period of deflation, inflation in Estonia has accelerated lately again because of an increase in the prices of imported energy and food, which influence the prices relatively more in Estonia than they do on average in the euro area.

Nevertheless, domestically driven price pressures are still subdued because of weak domestic demand and underutilised production inputs. From now on administrative measures are expected to have less impact as well. Excise duties have been brought to EU minimum levels. Tax rises that were introduced to balance the state budget in 2009 have been already passed through to prices. In addition, given the relatively high price and income convergence that Estonia has already achieved, pressures from price convergence will remain relatively subdued. According to many different estimates the convergence component in Estonia's inflation is below 2 percentage points of the annual inflation.

Still, it is important to emphasise that the competitiveness of Estonian companies and the flexibility of markets will continue to matter in achieving price stability. Therefore, we should continue to improve it. Our experience during the boom years was that prices in some sectors increased relatively more than could be explained by the fundamentals. Joining the euro area will reveal much more clearly the drawbacks of such events as prices will be more easily comparable across countries. Even though the price levels for some sectors in Estonia are still lower in relative terms than they are in the euro area on average, gradual developments in prices should be preferred. I believe that Estonian companies understand it. For example, if wages increase faster than can be justified by productivity improvements, it means that they are shooting themselves

in the foot. Price stability is the key to Estonia's success in the long term if we are to preserve our competitiveness.

The same understanding has to be kept in mind during the changeover. It is not the euro that will raise prices, but companies. And the companies, who will try to use the euro as an excuse to raise their prices, are behaving very irresponsibly. They are clearly giving an advantage to those companies who will maintain the current price level. Of course, the changeover process itself has to be as smooth as possible to avoid negative expectations. This will be a cooperative effort of the public and the private community.

Now, let me conclude my address with some more practical issues. The events these days, including the Euro conference which is slowly approaching its *grande finale*, mark the beginning of the active euro information campaign in Estonia. The preparations for the actual changeover are well under way and I would like to take this opportunity to emphasise once more the basic principles of the actual changeover.

First, the changeover will be made as smooth as possible. The euro will be introduced as account money and in contractual relations under the "big bang" scenario on the 1st of January 2011, that is to say, without a transitional period.

Second, a two-week period of dual cash circulation of the kroon and the euro will start from the 1st of January 2011. After the period of dual circulation the euro will become the sole legal tender in Estonia.

Third, the credit institutions will exchange kroons to euros without any service fee and at the central exchange rate of 1 euro to 15.6466 kroons for one month before and six months after the 1st of January. After this period, Eesti Pank will continue to exchange kroons for euros for an unlimited period of time.

The Government and the Bank of Estonia, in cooperation with the EU institutions and private sector representatives, have worked hard since the end of last year to make the adoption of the euro in Estonia a success. We have taken many important and sometimes difficult decisions on how to achieve as smooth a changeover as possible, but there is still work to be done if the whole process is to be successful.

It has been my pleasure to speak here today, marking another small step along Estonia's route to the euro.

I would like to take this opportunity to thank all of you for taking the time to share and celebrate this moment with Estonia.

Thank you.