Talking point

Estonia: The next EMU candidate has earned a fair assessment

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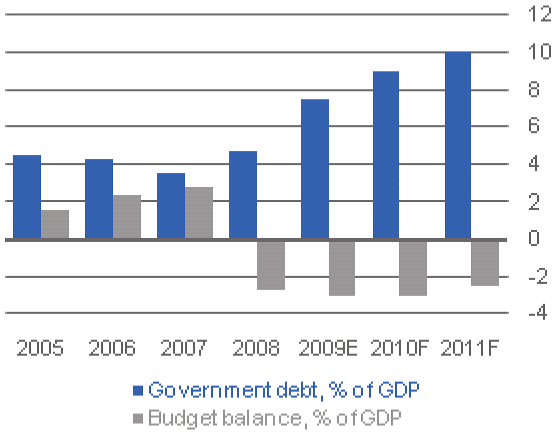
An enlargement of the euro area is drawing nearer. A long way ahead of all the other candidates, Estonia has a good chance of becoming the 17th country to join the Euroclub. The question is only whether it can already do so in 2011.

Every euro candidate has to fulfil the Maastricht criteria. A budget deficit of less than 3% of GDP and government debt totalling less than 60% of GDP must be accompanied by price stability, two problem-free years in the exchange rate mechanism II as well as a long-term nominal interest rate that is a maximum of two percentage points higher than the average of the three EU member states with the most stable prices. Besides these necessary quantitative criteria there are sufficient qualitative aspects which focus on long-term real convergence, external sustainability and international competitiveness (e.g. the state and development of the current account, unit wage costs and other price indices).

According to a report published in December, Estonia's central bank believes the situation is clear: all the criteria have been fulfilled for EMU accession at the turn of the year 2010/2011. Not all external observers share this optimism. Estonia experienced one of the deepest recessions worldwide in 2008 and 2009. The government allowed this deep descent in order to unwind domestic and external imbalances that might be a barrier to euro accession. The hard landing fostered doubts about the sustainability of convergence. No comprehensive stimulus packages were devised, however. They would have jeopardised compliance with the 3% deficit limit. In addition to the austerity measures special efforts were made to keep the still-to-be-published deficit figures for 2009 below 3%. The central bank increased its profit distribution and state-affiliated companies paid out record dividends. Although legally speaking such action is above board it could seem all Greek to the external observer. These measures are the consequence of the existing fixation on numerical values for assessing convergence.

Estonia: Sound public finances per se ...



Sources: National statistics, DB Research

Otherwise Estonia is one of the fiscally most sound EU member states. In the period 2002-07 budget surpluses of 1.7% of GDP were achieved, while its government debt is the lowest in the EU at just under 10% of GDP. That is why it has no market for long-term government securities and the interest rate criterion for euro readiness cannot be formally assessed. The standard approach is therefore that a broad analysis of financial stability should be conducted; presumed stability risks can be a barrier to euro accession. Since these risks are probably even greater for Estonia outside EMU such a precedent would be neither appropriate nor sensible given the delicate state of global financial markets and the dominance of European banks in the Estonian banking market. Above all, Estonia is one of the few countries in eastern Europe that has attempted to place regulatory restrictions on the credit and real estate boom stoked by foreign capital. The exchange rate criterion, by contrast, should be met as a matter of course, given the currency board.

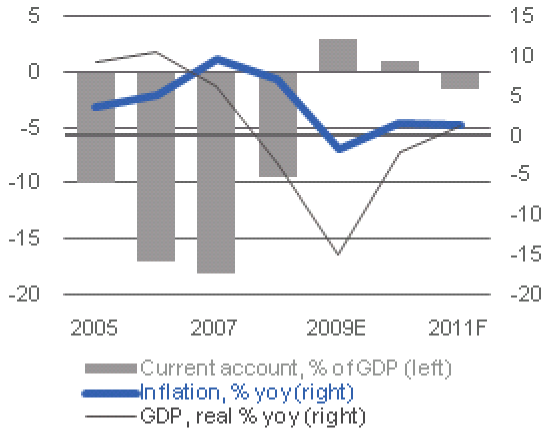
Estonia would also set a precedent for the assessment of price stability: the country has downsized its way to health – deflation was the consequence. Deflation is not per se a reason for deciding against admission from the ECB's point of view. Nonetheless, countries with deflation are seen as outliers and are not considered among the countries with the greatest price stability.

This means there are two conceivable outcomes:

1. Estonia satisfies all the Maastricht criteria that can be assessed in its case and enters the eurozone in 2011. Potential uncertainties regarding the interest rate criterion and/or the financial stability analysis are not relevant for the decision on accession – but the positive overall assessment could then, however, be enhanced by a positive evaluation of the qualitative aspects.
2. Estonia does not fulfil one of the quantitative Maastricht criteria. The budget criterion is the only potential problem area defined in domestic and/or European terms. Estonia will then not become a member of the eurozone. A positive assessment in the qualitative analysis of convergence will nevertheless provide a clear indication that the readiness for admission to the eurozone exists in principle and if the Maastricht criteria are fulfilled in 2010 there should of course be no problem in joining in 2012.

Estonia is a borderline case. The Commission and the ECB could feel compelled to provide special justification for their assessment of Estonia's readiness to join the eurozone. Uncertainties over the interest rate could be dispelled with an analysis of the long-term qualitative aspects of convergence and sustainability. In such an analytical framework the future prospects for Estonia would be seen as trending positive. Above all, Estonia's population and politicians – unlike their counterparts in several EMU countries – have already accepted the adjustment mechanisms of EMU via factor markets. On account of its currency being pegged to the euro the country already has an impressive internal adjustment process behind it (which primarily consisted of wage cuts).

... but extreme macroeconomic volatility



Sources: National statistics, DB Research

On the other hand the ECB recently called for the independence of the Estonian statistical authority. In its monthly report for January it also called into question the sustainability of the country's current account, in a similar vein to those of Lithuania, Latvia, Bulgaria and Romania. The Estonian kroon is still considered to be overvalued. If EMU entry occurs at too high an exchange rate, tough reforms will have to be implemented subsequently. There is certainly room for doubt about whether the current pace of reform can be maintained following early euro accession.

A number of other arguments, albeit without relevance for Maastricht, suggest that Estonia will achieve early EMU accession. Speculation about ending the euro peg would cease. This could have a positive impact on risk premia, investment activity and the stability of the financial system. Foreign exchange and balance of payments risks, which mainly affect European banks, would be defused. Institutionally, Estonia's accession as the 17th member of Euroland would also not change anything for the ECB. The rotation process in the Governing Council is only due to come into effect when there are 18 members.

How will the Commission and the ECB decide? It is less a matter of "yes or no" but rather of "when". There is no doubt that Estonia will join EMU in 2011 if it satisfies all the measurable Maastricht criteria. If one criterion – such as the deficit or the financial market analysis – should narrowly fail to be met, we can look forward to heated debate with good arguments for and against accession.

A debate in which consideration might also be given to the question of whether the time has come to make more discriminating decisions about countries' readiness to join EMU, ones that incorporate not only the necessary convergence criteria but also sufficient sustainability aspects. This could also show that lessons have been learned from past number-fixated (misguided) decisions to approve accession and their consequences for the stability of the euro area. Regardless of whether the country becomes the 17th EMU member in 2011 or somewhat later under probably less contentious circumstances – Estonia deserves a fair assessment.

Gunter Deuber (+49) 69 910-31718
Nicolaus Heinen (+49) 69 910-31713

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