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The Eastern Enlargement of the Monetary Union

Estonia Wants to Move from the Periphery into the Centre of the Union

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The year has just begun, yet in many parts of Europe, 1 January 2007 is being eagerly anticipated. This is the day when three of the new member states of the European Union, Estonia, Lithuania and Slovenia, intend to join the monetary union. Although the European Central Bank and the European Commission supported this step up until the end of last year, more and more critical voices in these institutions are now speaking of a "premature" accession. At the centre of the criticism is the level of inflation, which is to some extent still too high and the fact that the candidate states still need to catch up economically. The debate, however, completely neglects the political signals and economic impetus which would be sent by an Eastern enlargement of the euro area. Up until now, new economic insights and economic-political developments have played an insufficient role in the evaluation of the candidate states. Estonia has long been considered by experts as a favourite for the first round of the enlargement of the euro area. Taking this country as an example, this paper shall show that the decision to be made on accession to the monetary union is neither trivial nor insignificant for the future and further development of Europe and the European integration process.

Estonia, a country with a population of 1.35 million at the eastern border of the European Union, regained its independence in August 1991. After the first free elections in 1992, the Estonian government implemented a consistent policy of reform. The long-term success of this policy gained the country the reputation of being the "economic miracle on the Baltic coast".

Accession to the European Union in 2004 gave these efforts renewed momentum. The next major goal of the government, headed by Prime Minister Ansip, is the introduction of the euro on 1 January 2007.

4:1 for Estonia

Accession to the monetary union is formally dependent on fulfilling the Maastricht convergence criteria (art. 121 EC Treaty). According to these criteria, the public finances of the candidate country must be sustainable in the long term. In the previous financial year, government debt cannot be higher than 60 percent of the gross domestic product (GDP), the government budget deficit can be no more than 3 percent of the GDP.

The government in Tallinn has fulfilled these criteria exemplarily. *Government debt* has remained constant at 6 percent since 1998; this is the best value within the European Union—Greece (2004: 109%), Italy (107%) and Belgium (97%) on the other hand, have never achieved this goal and remain far from fulfilling this criterion.

Similarly, in terms of *government budget deficit* and annual public debt, in the past four years Estonia has always managed to achieve a budget surplus (2004: 1.7% of GDP). This means the country has its public finances as well under control as Denmark (2.3%), Finland (2.1%) and Sweden (1.6%) and should also be considered exemplary in this respect, particularly in comparison to the high deficits of some of the old EU member states.

Providing a stable *exchange rate* is the third basic prerequisite for accession to the euro area. The currency of the applicant country has to have taken part in the exchange rate mechanism for at least two years without strong fluctuations or devaluations. The exchange rate mechanism allows a fluctuation band for each national currency of maximum plus/minus 15 percent with respect to the euro.

In Estonia's case, fluctuations in the exchange rate can principally be ruled out. As early as 1992, the exchange rate of the Estonian kroon was pegged to the German Mark (Currency Board). Since 1999, the kroon has been pegged to the euro at the same rate. In June 2004, Estonia joined the exchange rate mechanism. The exchange rate has therefore been fixed at 15,6466 kroons per euro since 1999—an exchange rate which has so far been maintained without too much pressure being exerted on the Estonian currency.

Finally, low *long-term interest rates* represent the fourth important criterion for membership of monetary union, as the interest rate provides an indicator of the expected rate of inflation in the future. The long-term interest rate must not be more than two percent higher than the interest rates of the government bonds of the three best-performing EU states in terms of price stability (2005: 3.3%). At the end of 2005, the nominal or limit value amounted to 5.3 percent.

Due to the low rate of Estonian government debt it is not necessary to issue any long-term government bonds. For evaluation purposes, Estonian bank lending rates with maturities of over five years are therefore taken as the interest indicator. In this area too, Estonia is characterised by positive developments: since accession to the EU, the interest rate reference has sunk from 4.5 (May 2004) to 3.9 percent (December 2005) and is therefore well within the target margin.

Some European institutions and member states of the euro area are however concerned by the relatively high inflation in Estonia. In order to fulfil the criterion of *price stability* the inflation rate can only be a maximum of 1.5 percent higher than the average (weighted) inflation rate of the three best performing member states in terms of price stability (in 2005 those countries were Finland at 0.8%, Sweden also at 0.8 and The Netherlands at 1.5%). This means that inflation must not be higher than approximately 2.6 percent.

Estonia was not able to reach this target in 2004 (3.0%) or in 2005 (4.1%)—only Latvia recorded a worse value within the EU in 2005 with an inflation rate of 6.9 percent. However other euro countries such as Spain (3.4%), Greece (3.5%) and Luxembourg (3.8%) would also have difficulties with this hurdle at the moment.

Economic Growth and Falling Unemployment Strengthen Euro-euphoria

In 2004, 54 percent of Estonians were in favour of joining the euro area; only 39 percent were against this step. When deciding if Estonia is ready for the euro, other aspects, apart from the formal convergence criteria should also be considered, such as the growing economy, the prosperity of the population, which has been steadily increasing for years and the fall in unemployment. Between 2000 and 2005, the unemployment rate sank from 13.7 to below 8 percent. During the same time period, real economic growth averaged 7 percent p.a. For the coming years, a growth rate of 6.5 percent p.a. is predicted. Only Latvia (2005: 9.1%) and Lithuania (7.0%) attained similarly strong values within the EU. Of the old EU member states, Ireland still has the best value with 4.4 percent (EU-25: 1.6%). The largest states in the EU (Great Britain: 1.8%, France: 1.5%, Germany: 0.9%) can only dream of such growth rates.

In addition, other "soft" indicators such as the Corruption Perceptions Index of Transparency International show that Estonia is on the right track. The government in Tallinn has achieved significant progress in fighting corruption. Estonia is the best rated country of the EU-10 (2005: number 27 with 6.4 points). It is on equal footing with Portugal (number 26 with 6.5 points) and ranks above countries of the present euro area (Italy: number 40, 5.0 points; Greece: number 47, 4.3 points).

Almunia, Verheugen and Trichet Doubt if Estonia is Ready for the Euro

Despite these excellent economic indicators the EU commissioner for economic and monetary affairs, Joaquín Almunia, has declared that Estonia does not fulfil the accession criteria due to the high inflation rate. Similarly, Günter Verheugen, Vice President of the European Commission and former commissioner for enlargement particularly emphasised that caution is advisable regarding enlargement of the euro area and that the stipulated criteria must be fully met.

The German Bundesbank and Jean-Claude Trichet, President of the European Central Bank too have clearly stated that accession to the monetary union must not be rushed into, but should rather be dealt with slowly. According to Trichet, there is no time pressure. At the same time, he appreciates Estonia's ambitions: "It is understandable that a young, talented and ambitious athlete wishes to play in the Champions league. Perhaps, however, it is better in the end if he first continues to train and strengthen his talents in a protected surrounding."

What Advantages Are there in a Slow Approach?

The question if there really is no time pressure involved in enlarging the euro area to include Estonia should not be answered too hastily. The key issue is what specific opportunities are linked to a swift introduction of the euro and which risks need to be kept in mind.

In order to assess opportunities and risks of a swift introduction of the euro, it is helpful to analyse Estonian foreign trade. What is striking here is that Estonia's economy is characterised by very high export and import volumes. Between 2002 and 2005, the export rate (share of the export of GDP) rose from 49 to 62 percent, the import rate from 68 to 81 percent.

What is even more significant is how strongly the Estonian economy is integrated in the EU, particularly however with the euro area. In 2005, 40 percent of exports went to the euro area (77% of exports in the EU). A similar situation can be observed regarding imports: 45 percent of Estonian imports came from the EU in 2005; 75 percent from the whole EU-25. Between 2002 and 2005, Estonian exports to the euro area rose by about 14 percent p.a. after adjustments relating to inflation; imports rose by about 16 percent p.a.

In light of these developments, it can be expected that the introduction of the euro could lead to considerable savings in the costs for the currency changeover. The entire trade with the members of the euro area would be unaffected by this cost driver. In addition, the outstanding remainder-currency risk (exchange rate risk of the Estonian kroon), which would have had to be covered by expensive financial derivate business would largely become obsolete. Apart from this, it is expected that these changes would have a positive impact on the amount of direct investments in Estonia. On the one hand, non euro states within the EU would presumably re-adjust investments to Estonia's benefit; on the other it is probable that the flow of capital from outside the EU would increase due to a boost in confidence through the introduction of the euro.

Finally the introduction of the euro in Estonia would strengthen the entire Baltic region of the Union, both politically and economically, as well as other neighbouring countries at the EU's eastern border. In addition, a stronger eastern periphery would be able to generate positive impulses for countries between the centre of the EU and other states at the periphery (in particular, Poland and the Czech Republic).

The countries in the eastern neighbourhood of the EU (Belarus and Ukraine) could also benefit from this step, as intensified trade through establishing this currency bridge would also have a stabilising effect on them. Even if these countries do not become members of the EU in the foreseeable future, the Union must still have an interest in strong national economies developing at its borders.

All in all, there is certainly a case for arguing that there is some amount of time pressure to enlarge the euro area. Unnecessary hesitation can lead to attempts to improve prosperity being unsuccessful and opportunities for stronger economic growth remaining unexploited. In addition, the euro area enlargement would allow trade barriers to be further eliminated and reduce transaction costs, which would strengthen the EU internal market.

A slow approach, which Trichet has called for, would simply result in not being able to take full advantage of the potential to maximise benefits and reduce costs.

Slovenia Heading for the Target, Lithuania Heading for Confrontation

At the same time as Estonia, Slovenia and Lithuania are also aiming to join the monetary union at the beginning of next year. Slovenia is considered by all decision-makers to be the country which is the least cause for concern in this respect. Almunia has acknowledged that Slovenia has a good chance and Günter Verheugen has said that it is conceivable that an initial enlargement of the euro area could take place in 2007 even with only Slovenia. The eastern European state was also the first country to officially apply to join the monetary union in March 2006.

Apart from inflation, which was only barely within the target margin in 2005 at 2.5 percent, the country has no difficulties fulfilling the Maastricht convergence criteria. The government budget deficit has remained constant at below 3 percent since 2002 (2004: -2.1% of GDP) and government debt too gives little cause for concern, as it rose only slightly between 1998 and 2004 from 24 to 30 percent of GDP. Similarly, the exchange rate of the tolar to the euro is stable. Since June 2004, the Slovenian currency has taken part in the European exchange rate mechanism. Furthermore, long-term interest rates of Slovenian government bonds have remained stable at under 4 percent p.a. (January 2006: 3.59% p.a.) and thereby within the target margin. Other economic indicators such as reduction in the unemployment rate (2002: 12.2%; 2006: 6.5%) and its unrestricted economic growth (an average of 3.8% p.a. since 1998) smooth the way for Slovenia to join the euro area.

In comparison, Lithuania suffers from a similar problem to its Baltic neighbour Estonia: the government budget deficit has remained consistently below minus 2 percent of GDP since 2001, government debt has fluctuated between 17 and 20 percent since 1998, long-term interest rates have remained below 4 percent p.a. since the end of 2004, the exchange rate between the litas and the euro is also stable (Currency board) and since June 2004 Lithuania's currency has been part of the exchange rate mechanism. However, here also inflation is still too high: the nominal value was barely missed in 2005 at 2.7 percent p.a.; although rising inflation rates are expected for the future. Similarly to Estonia, the EU commissioner for economic and monetary affairs Almunia cites high inflation as the critical obstacle.

Despite strong criticism, Lithuania continues to pursue its strategy of introducing the euro next year. Although particularly the European Commission has strongly warned the country several times against a formal application for accession, as an official rejection would be the first in the history of the monetary union, and would represent a crucial political test, the government in Vilnius formally applied in mid-March 2006.

Are High Inflation Rates Undoubtedly a Sign of Weakness?

The main reason cited against a swift accession of Estonia to the euro area is its high inflation rate and that this could have a negative impact on confidence in the community's currency and price stability (imported inflation). Considering Estonia's size and economic power, however, there is little cause for concern in this respect.

At the same time, the question of the reason for Estonia's high inflation can be raised, and if this can really be seen as a sign of weakness or ineffective reforms.

A strong argument against this theory is the so called Balassa-Samuelson effect, which is widely respected in economics theory. The effect arises due to different productivity developments in the traded goods sector in comparison to non-traded goods. The German Bundesbank estimates that approximately 2.5 percent of the entire inflation rate in the new EU member states, which are in a catching up phase, can be ascribed to the Balassa-Samuelson effect. In Estonia's case, this would mean a "real" inflation rate of only 1.6 percent in 2005.

In light of this insight, the question arises if it makes sense for Estonia as a candidate state to the monetary union to fight its inflation on the basis of the existing Maastricht convergence criteria with a restrictive fiscal policy (tax increases and reduction in public contracts). These measures have a restrictive effect on growth and would slow down the important catch up process. This cannot be in the interest of the European Commission or the European Central Bank.

For this reason, opponents to the Maastricht convergence criteria argue that fulfilling the criterion of price stability causes too high adaptation costs and that the inflation criterion should therefore be adapted to the economic situations in the countries which are in the catch up process. High inflation rates are not a sign of an undisciplined monetary policy, but rather a consequence of productivity growth.

Consequently, an elegant solution would be, for example, (instead of a blanket adjustment of the inflation rate by 2.5%) not to base the measurement of inflation on the harmonised indices of consumer prices (HICP), but on the prices of traded goods.

The Political Significance of Enlarging the Monetary Union

Up until now, the debate on Estonia's accession to the monetary union has been based exclusively on the Maastricht convergence criteria. The political component of this decision, its influence on the further development of the EU and the European integration process has been completely neglected.

After the failure of the referenda on the European Constitutional Treaty in France and the Netherlands in May and June 2005, the EU heads of state and government decided on a "period of reflection" in the ratification process. This period of reflection has led to a complete standstill in the whole process. The referendum in Great Britain, which had been planned for spring 2006, was postponed indefinitely (despite the fact that the House of Commons had supported the Constitutional Treaty with 345 to 130 votes). In Denmark too, the referendum which had been planned for September 2005 was subsequently postponed indefinitely, and in other EU states, the ratification process was put on hold.

The current state of play is that 14 member states have ratified the Constitutional Treaty and that 9 still have not. Despite the fact that in some countries the chances of a positive result and an adoption of the Constitutional Treaty appear to be promising (particularly Finland, Ireland and Portugal), the governments concerned have not undertaken any further steps to get the Constitutional process underway once again.

After the European Parliament called for a continuation of ratifications and Austria stated that it would strongly promote the Constitutional process during its EU Council Presidency in the first half of 2006, it was the Estonian government which set a clear political signal: in February 2006 the Estonian parliament approved ratification after the first reading and the final ratification of the Constitutional Treaty is due to take place at the end of the Austrian Council presidency, in June 2006.

In this way, Estonia has shown that its government and parliament support an effective and democratic EU and that politically the country wishes to belong to the centre of the Union. All in all, this can be considered a courageous step, which could also be expected of older members of the EU. Tallinn's leap forward, into the deep end of uncertainty regarding the Constitutional Treaty could represent a point of departure for the further European integration process. It is within this context that the question should be asked what signal would be sent to Estonia and the entire EU if the Baltic state was refused membership of the monetary union in the near future.

In light of Estonia's political and economic success story and the fact that the country more or less fulfils the convergence criteria, the European integration process would be hampered if Tallinn's efforts to join the monetary union were met with rejection. Estonia's accession to the euro area, on the other hand, would promote the deepening of the European integration process. This perhaps historic opportunity to send such a strong political signal throughout the EU should not be missed.

When the European Commission, the European Central Bank and the heads of state and government take their final vote on Estonia's euro membership, they will therefore have to be prepared to answer the question if they are for or against a more strongly integrated Europe. Formal noncompliance with the present Maastricht inflation criterion can certainly not be cited as the only reason for a negative decision.

Arguments against Watering down the Maastricht Convergence Criteria

An important argument frequently brought forward in the discussion on modifying or reinterpreting the convergence criteria and particularly the inflation criterion, is that allowing an exception to be made on a one off basis would lead to calls for further exceptions to be made. If a country was allowed to join the monetary union even though it had a high inflation rate, a similar special provision could also be demanded at a later stage by other euro candidate states. This would risk the limit of the permitted inflation rate being raised further and eventually becoming obsolete.

In addition, proponents of the convergence criteria also argue that in allowing an exception to be made for one criterion (e.g. price stability), this would inevitably lead to calls for exceptional provisions for other unfulfilled convergence criteria (e.g. government debt, government budget deficit). In this way, each convergence criterion would gradually be watered down and their obligatory nature would be lost.

If these consequences were unavoidable, a modification of the inflation criterion would certainly pose a significant risk. On the whole, the Maastricht convergence criteria can be said to be a useful instrument. Their at times strict application has certainly contributed considerably to economic stability within the euro area and to the positive reputation of the euro.

Adapting the Convergence Criteria to the Economic Situation

Concerns and fears concerning completely watering down the convergence criteria are therefore understandable. However, this could easily be avoided by using new economic insights to carefully clarify to partners of the euro area why only the criterion of price stability would have to be modified. A conclusive argumentation based on the economic situations in the countries in the catch up phase with a very clear calculation of the inflation of traded goods should be sufficiently convincing to nip any efforts to modify the convergence criteria in the bud.

In this context, it is worthwhile mentioning that when the euro was first introduced, considerable exceptions were made and the supposedly strict convergence rules were broken. When monetary union began in 1999, Italy and Finland had not yet been in the obligatory exchange rate mechanism for two years. The previous year, 1998, Italy and Belgium had a government debt which was much higher than 100 percent of GDP (Belgium 120%, Italy 117%). It was agreed that the tendency in the development of government debt was positive and it would continue to be reduced in the future. It should also be mentioned that Greece knowingly falsified figures to achieve the Maastricht benchmarks for the euro accession in 2001. Figures determined in retrospect show that the annual budget deficit had been consistently above 3 percent of GDP since 1997.

Despite these failures of some countries to meet the Maastricht convergence criteria and the targets of the Stability and Growth Pact, no negative impact on the monetary stability of the euro can be determined—the inflation rate within the euro area has been stable between 2.0 and 2.2 percent p.a. since 1999 and is thereby on target.

Opponents to enlarging the euro area have further criticised the fact that introducing the euro in Estonia at the present time would have a particularly strong effect in terms of a sharp increase in prices. This effect was particularly noticeable in countries such as Germany and France. Prices for groceries and in the gastronomy sector rose disproportionably, which lead to protest among the German and French population as well as an increasingly negative attitude towards the common currency. Critics of an enlargement of the euro area in the near future warn that this effect will be even stronger in countries which already have high expenditure for goods from these areas, in comparison to the old industrialised states.

However, in this respect too, Estonia has learnt from past mistakes. The government in Tallinn has already planned useful measures to counter these tendencies. It has declared that trade will be obliged in the long-term to clearly display prices in the old and new currency after the introduction of the euro. This should largely prevent a hidden price increase as was the case in the present member states of the euro area.

A Case for Making Use of the Present Momentum

In light of the outlined economic as well as general European political arguments, partners of the monetary union should quickly decide to include Estonia, Lithuania and Slovenia, as this step would certainly improve prosperity development within the EU. Particularly in Estonia's case, which has proven itself through reforms, long-term stability and economic success, the accession process should not be prolonged.

This decision should also take into account political motives based on Estonia's efforts in the ratification process. For decades, the European integration process has significantly contributed to peace and prosperity within Europe. This process which extends to the new EU states should not be blocked by applying the Maastricht inflation criterion too stringently.

In March 2006, Estonia abandoned its political goal of joining the euro area on 1 January 2007 for the time being and refrained from a formal application contrary to its original announcement. The reason for this, however, was constant pressure from the European Central Bank and the European Commission and repeated statements that Tallinn's prospects of success were low and that the final negative vote was neither avoidable nor politically desirable. Faced with this criticism and these signals, the stance of the most northern Baltic state became less of one of acceptance, than one of resignation.

The European Commission and the European Central Bank should rethink their approach and get Estonia back on board. Within the context of the new dynamic economic climate within the EU, now is a bad time to display a stubborn, tough approach with regard to the inflation criterion. It would be regrettable if this led to the current palpable economic and political momentum remaining unexploited.

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