

Box 2

ESTONIA ADOPTS THE EURO

On 1 January 2011 Estonia adopted the euro and became the 17th member of the euro area. The conversion rate between the Estonian kroon and the euro was irrevocably fixed at 15.6466 kroons to the euro. This was the central rate of the Estonian kroon throughout the country's membership of the Exchange Rate Mechanism II (ERM II).

Estonia is a very small economy in comparison with the rest of the euro area. The aggregate macroeconomic data of the euro area do not change significantly following the latest enlargement (see table below).

Estonia's GDP accounts for only about 0.2% of the GDP of the enlarged euro area. In 2009, its GDP per capita in purchasing power parity (PPP) terms was slightly below 60% of the euro area average. For several years, Estonia was one the EU's fastest growing economies.

Key economic characteristics of Estonia and the euro area

	Reporting period	Unit	Euro area excluding Estonia	Euro area including Estonia	Estonia
Population and economic activity					
Total population ¹⁾	2010	millions	330.0	331.3	1.3
GDP	2009	EUR billions	8,955.7	8,969.6	13.9
GDP per capita	2009	EUR thousands	27.2	27.1	10.3
GDP per capita (PPP)	2009	EA16=100	100.0	99.8	57.9
GDP (share of world GDP) ²⁾	2009	%	15.1	15.1	0.0
Value added by economic activity³⁾					
Agriculture, fishing, forestry	2009	% of total	1.6	1.6	2.6
Industry (including construction)	2009	% of total	24.2	24.2	26.4
Services (including non-market services)	2009	% of total	74.2	74.2	71.0
Monetary and financial indicators					
Credit to the private sector ⁴⁾	2009	% of GDP	146.1	146.0	107.2
Stock market capitalisation ⁵⁾	2009	% of GDP	49.3	49.2	2.6
External trade					
Exports of goods and services ⁶⁾	2009	% of GDP	19.7	19.7	69.9
Imports of goods and services ⁶⁾	2009	% of GDP	18.9	18.8	64.3
Current account balance ⁶⁾	2009	% of GDP	-0.6	-0.5	4.5
Labour market⁷⁾					
Labour force participation rate ⁸⁾	2010 Q3	%	71.4	71.4	73.7
Unemployment rate	2010 Q3	%	9.8	9.8	15.7
Employment rate ⁸⁾	2010 Q3	%	64.4	64.4	62.1
General government					
Surplus (+) or deficit (-)	2009	% of GDP	-6.3	-6.3	-1.7
Revenue	2009	% of GDP	44.5	44.5	43.4
Expenditure	2009	% of GDP	50.8	50.8	45.1
Gross debt outstanding	2009	% of GDP	79.2	79.1	7.2

Sources: Eurostat, IMF, European Commission, ECB and ECB calculations.

1) Estimated annual average.

2) GDP shares are based on a purchasing power parity (PPP) valuation of the countries' GDPs.

3) Based on nominal gross value added at basic prices.

4) Comprises loans, holdings of securities other than shares and holdings of shares and other equities.

5) Defined as the total outstanding amount of quoted shares excluding investment funds and money market fund shares issued by euro area/Estonian residents at market value.

6) Balance of payments data. Euro area data are compiled on the basis of transactions with residents of countries outside the euro area (i.e. excluding intra-euro area flows). Data for Estonia include transactions with residents from the rest of the world (i.e. including transactions with the euro area).

7) Referring to the working age population (i.e. those aged between 15 and 64). Data from Labour Force Survey.

8) Share of the working age population (i.e. those aged between 15 and 64).

However, the strong economic expansion, with clear signs of overheating from 2005 to 2007, proved unsustainable and Estonia experienced a pronounced turnaround in economic activity and a severe contraction in 2009. The country's economic adjustment has contributed to the unwinding of some of the external and internal imbalances that built up in the years of very fast growth. More recently, economic activity has started to recover: annual real GDP growth turned positive in the second quarter of 2010 and stood at 5.1% in the third quarter of last year.

Estonia's production structure is broadly similar to that of the euro area. In the Estonian economy, the services sector contributes 71% to total value added and the share of industry (including construction) amounts to 26.4%. Agriculture contributes to the total value added slightly more than in the rest of the euro area. Furthermore, Estonia is a very open economy

and the rest of the euro area is its key trading partner, accounting for 34.2% of its total exports and 38.5% of its total imports. Other important trading partners are Latvia, Lithuania, Russia and Sweden.

The country's financial sector is heavily bank-based. Bank credit to non-government residents amounted to 107.2% of GDP in 2009. Nordic European banking groups dominate the banking sector. The non-banking financial sector plays a more limited role in Estonia than in the rest of the euro area. This is reflected, for example, in its stock market capitalisation, which is low relative to the euro area. Moreover, the Estonian financial system is characterised by the absence of a well-developed market for long-term debt securities denominated in Estonian kroons, which reflects mainly the low level of government debt.

Reflecting the sharp economic adjustment of recent years, Estonia's unemployment rate is high, standing at 15.7% on average in the third quarter of 2010 compared with 9.8% in the euro area in the same period. While the labour force participation rate in Estonia has remained above the level of the rest of the euro area, the employment rate is currently below the average for the euro area.

Following a series of surpluses or budgetary positions close to balance between 2000 and 2007, fiscal deficits have been recorded since then. As a result of a tight fiscal policy, the deficit remained nonetheless contained in 2009, at 1.7% of GDP, the third-lowest deficit among the EU Member States and well below the euro area average deficit of 6.3% of GDP. The public debt-to-GDP ratio rose to 7.2% in 2009. Estonia is one of the few EU countries currently not subject to the excessive deficit procedure.

In order to fully reap the advantages of the euro and to allow adjustment mechanisms to operate efficiently within the enlarged currency area, Estonia needs to conduct policies that are fully geared towards ensuring the sustainability of its convergence process. Crucial from an ECB perspective, the Estonian authorities must support a low-inflation environment in the years to come, and take forceful action if necessary. In the short term, following the euro changeover, it needs to be ensured that the conversion of kroon prices into euro should not affect the price level.

Looking further ahead, it will be important for Estonia's economy to maintain sustainable convergence. To that end, non-monetary policy areas must enable the economy to cope with country-specific shocks and prevent the recurrence of macroeconomic imbalances. Significantly, the Estonian authorities have emphasised their commitment to ensuring an economic environment that is conducive to sustainable output and employment growth, with balanced macroeconomic conditions, including price stability. Specifically, this implies: i) maintaining prudent fiscal policies; ii) continuing structural reforms to enhance cost competitiveness and productivity; and iii) implementing appropriate financial sector policies to ensure financial stability and avoid any build-up of imbalances. An adherence to this commitment, underpinned by the stability-oriented monetary policy of the ECB, represents the best way to bring sustainable economic growth, job creation and social cohesion to Estonia.