Monetary Policy and EMU Enlargement: Issues Regarding ERM II and Adoption of the Euro in Estonia

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Abstract

The aim of the paper is to give an overview of the issues related to Estonia's entry into ERM II. For that purpose the article describes the official position of the Estonian authorities regarding entry into ERM II and the adoption of the euro, explains the rationale for early entry into ERM II, and presents the reasons for maintaining the currency board arrangement until full membership in EMU. Also, the challenges of the adoption of the euro are discussed. The article concludes that early entry into ERM II is appropriate as the perceived costs—short-term costs of fiscal consolidation and the cost of giving up independent monetary policy and flexible exchange rates as stabilization tools—are practically non-existent in Estonia. The paper argues that the high level of exchange rate stability and nominal convergence, relatively high flexibility of the economy, and integration with the euro area support the rationale for maintaining the currency board arrangement and adopting the euro early. (JEL E42, E65, F31)

Official Position on Membership in ERM II and the Euro Adoption

Estonian authorities have declared that Estonia seeks to join the European Economic and Monetary Union as soon as possible, with the goal of being technically prepared to adopt the euro in mid-2006. The Estonian government and the central bank intend to seek participation in the ERM II exchange rate mechanism soon after joining the EU, in accordance with all relevant multilateral procedures and within the established framework. The intention of the authorities is to participate in ERM II with the standard fluctuation band and to maintain unilaterally the currency board arrangement (CBA). The latter implies that the Estonian authorities will unilaterally guarantee a zero percent fluctuation margin of the Estonian kroon. As the authorities intend to be prepared to adopt the euro in mid-2006, the length of the stay in ERM II would be as short as possible.

What is the Rationale for Early Entry into ERM II?

The main motive for early entry of Estonia into ERM II is to reap the benefits of the monetary union as soon as possible. The latter include: (1) the maintenance of a strong policy discipline; (2) an increase of the economic and financial integration of the Estonian economy with the euro area; (3) a reduction of transaction costs; and (4) a decrease in the interest rates via an elimination of the exchange rate risk premium. All of these in turn should intensify trade, foster economic growth, and real convergence.

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Usually, premature participation in ERM II is deemed to entail potential costs in other areas, such as short-term costs of fiscal consolidation and the cost of giving up independent monetary policy and flexible exchange rates as stabilization tools. Those costs are practically non-existent in the case of Estonia, as the ERM II and later full participation in the euro area do not call for major adjustments in Estonia's macroeconomic policies.

Fiscal discipline has been strongly entrenched in the political culture of Estonia. During the last 12 years, Estonia has maintained one of the most prudent fiscal policies among the acceding countries (see Figure 1 and 2). Throughout this period, the budget deficit has