Estonia and the Euro: They Just Did It

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Estonia is remarkable. On January 1 of this year, Estonian Prime Minister Andrus Ansip fulfilled one of his government's most fervent policy goals by changing his nation's currency to the euro. At the stroke of midnight he withdrew 20 euros from an ATM in the heart of Tallinn's Freedom Square. It marked the latest (and one of the most important) milestones on Estonia's two-decade journey from occupied Soviet republic to a prosperous, stable and democratic example for others to follow. The mechanics of the switch-over were handled flawlessly. Not only the Prime Minister's ATM worked—all of the machines worked all over Estonia. Why was I not surprised?

It was a much different picture when I arrived in Estonia in late 2009. The Estonian economy had shrunk by 19 percent over the previous two years. Unemployment was over 20 percent in some regions and still rising throughout the country. Analysts around the world said Estonia would not be able to meet the Maastricht criteria for joining the euro zone and would have to devalue its currency. What a difference a year makes!

Despite the bad statistics and dire prognoses, those of us on the ground saw in the Estonians the same resolve that they used in their "Let's do it!" campaign. This innovative combination of high technology and community activism brought out 50,000 people in this compact country to clean up trash on one particular day all over Estonia. "Let's do it!" has now spread around the globe.

Estonians' sense of community, commitment to fiscal discipline, trust in government, and long-term outlook enabled the country to successfully manage an internal devaluation and stay on course to adopt the euro. Most importantly, Estonia did this without any protests or internal strife despite falling wages and very high unemployment. To put it simply, the Estonians decided on a goal, and then just did it with stoic determination.

Estonia's fiscal discipline during the boom years (Estonia's government debt is the lowest in the European Union at approximately seven percent of GDP), strict currency peg to the euro, tighter lending policy, and higher productivity allowed it to fare better than its Baltic neighbors during the global financial crisis. In fact, Estonia was even able to pledge to contribute to the IMF package for Latvia. However, many in Estonia felt the outside world did not see these successes, and instead viewed the Baltic States as all facing the same fiscal difficulties. Estonians feared this would hurt foreign investment, giving them yet another reason to strengthen their resolve to meet the Maastricht criteria.

Although my embassy team was confident Estonia was still on track for adopting the euro, there were a number of troubling unanswered questions. Most importantly was whether Estonia would be able to keep its budget deficit below three percent of GDP, particularly as many countries, including the United States, were deficit spending to boost employment.

As tax revenues plummeted along with GDP, the Estonian government spent much of the second half of 2009 cutting the budget and attempting to boost revenue. It raised the value added, income and payroll taxes (although these remained low compared to most other EU members), cut government salaries by seven percent, and conducted a number of one-off revenue raising measures. These included the sale of numerous plots of land and buildings that were legacies of the Soviet era and extracting extra dividends from successful state-owned enterprises such as the ports and the electricity producer. These measures combined with the bottoming out of the recession to give Estonia a year-end budget deficit of only 1.7 percent of GDP—significantly lower than anyone had hoped for just a few months earlier. In fact, this remarkable discipline made Estonia one of just two European Union countries that kept their deficit under three percent.

At one point some Estonian authorities feared that Estonia's fiscal discipline would actually come back to haunt them. One of the Maastricht criteria's measures of a country's fiscal health is the interest rates paid on a government's long-term bonds. However Estonia, with its aversion to debt and history of budget surpluses, does not issue bonds, and so there was nothing to measure. During the Greek crisis, when some European leaders questioned the wisdom of bringing in new euro members from Eastern Europe, it was uncertain whether Estonia would be given the green light. For the government in Tallinn every potential barrier became a cause for concern. Fortunately for Estonia, the inescapable logic for their admission to the euro zone prevailed.

Estonia's logistical and public relations preparations for the euro switchover were well underway by the time it received the last of many approvals for euro accession in July 2010. Banks, government institutions and other companies spent millions of euros to ensure Estonia's consumer and social services, which are remarkably e-based, would continue to work smoothly when switching from kroons to euros.

Simultaneously, the government and the Estonian Central Bank began their public education campaign. This program, supported by the European Central Bank and European Commission, focused primarily on the security features of the new euro bills. A secondary concern was educating the public of the process of switching from the kroon to the euro. This included informing the public of the two-week period in January when consumers would be allowed to use both kroons and euros. Keeping this period to the minimum allowed by the European Union reduced the costs to merchants and was made possible by the extremely low proportion of cash transactions in Estonia.

The Estonian government was particularly concerned about familiarizing the public with the new bills' security features. Euro bills have many more security features than the Estonian kroon did since, not surprisingly, euros are considered to be at a much higher risk of counterfeiting than were Estonian kroons. The educational campaign included television commercials demonstrating the security features, training sessions for people who supervise cashiers and a travelling exhibit for the public to get hands-on practice with the new bills.

Many in Estonia and elsewhere believed that switching from a domestic currency to the euro would cause significant inflation. They reasoned that unscrupulous businesses

would take advantage of the switch to round prices upwards. With parliamentary elections approaching, Estonia's largest opposition party raised this concern and the effect it would have on pensioners and the poor throughout the lead-up to "Euro Day." Unfortunately for the Estonian government, this period coincided with significant structural inflation, led by rising world energy and food prices, which had nothing to do with the euro. Practical Estonian euro opponents in Estonia even complained that the euro relies too much on hefty coins, and that Estonians would receive a psychological jolt from seeing their salaries cut 16 times (the kroon-euro exchange rate was 15.65 to one).

Today, inflation remains the top concern of the roughly 30 percent of the population that continues to oppose the switchover. This opposition is concentrated among Estonia's lower educated, lower income, and Russian-speaking populations. Polls taken in January show over 60 percent of Estonians approved of the switch to the euro and over 90 percent said the changeover process went smoothly.

Estonia hopes the elimination of foreign investors' devaluation risk and the significant free publicity that came with euro accession will provide a significant boost to foreign investment and exports. Despite all of this country's past successes, in today's highly competitive global economy, fiscal responsibility and free publicity alone will not be enough to take Estonia to the next level. I look forward to seeing how this country's tough inhabitants shape the next 20 years since regaining their independence.