Estonia's euro adoption: green light from the EU Commission

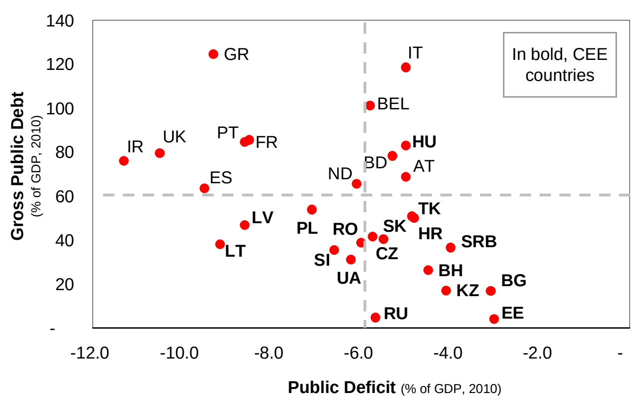
- Estonia will be the 17th eurozone member, the third of the ex-communist countries after Slovenia (2007) and Slovakia (2009) to join the common currency, the euro. Indeed, the EU authorities gave a positive assessment on Estonia's readiness to join the eurozone, despite several macroeconomic and structural risks underlined by the authorities. The ECB report was more critical than that of the EU Commission, especially on inflation.

- The positive assessment is an important step for Estonia, the Baltics and other Central Eastern European countries. The risk of a different decision was tangible, since Estonia was knocking at eurozone's door at the worst possible moment, in the midst of turmoil affecting the area following the Greek troubles. This could have prompted Brussels to further tighten the Maastricht criteria for eurozone entry, possibly stressing the issue of "sustainability" (of public finances, or inflation). However, this is obviously not the case.

- Estonia, with 1.3mn inhabitants and the second-smallest eurozone economy, is ready to adopt the euro, which it will do from the beginning of 2011. The country has "clearly" achieved the Maastricht criteria: Estonian debt reached a mere 7.2% of GDP in 2009 (it will remain lower than 10% in 2010, we estimate), the deficit stood at 1.7%, and average inflation was negative (despite it moving significantly upward this year).

- Estonia is probably the best-placed country in terms of fiscal metrics in Europe. Estonian country risk (in terms of 5Y USD CDS) sensibly decreased during the past months and it is now lower than that of Italy and Spain. Surely, the eurozone is not going to allow a profligate member into the club just to have to rescue it later. The message from the EU authorities is clear, in our view: the door will remain open for virtuous countries.

PUBLIC DEBT AND DEFICIT IN EUROPE (2010 EXPECTED, % ON GDP)



Source: EU Commission (Spring forecasts), UniCredit Research

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Estonia accession: the road ahead

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Estonia, with 1.3mn inhabitants and the smallest among the three Baltic economies, has been given the green light to adopt the euro, from the beginning of next year. The EU and the ECB Wed (12 May) gave a positive assessment on Estonia's readiness to join the eurozone. Estonia may expect the final decision to be made in July 2010, although this is just a formality. Possible concerns from EU authorities on the sustainability of public finances and inflation are no longer a source of risk on the Estonian path to euro adoption.

The country has achieved the Maastricht criteria: Estonian debt reached a mere 7.2% of GDP in 2009 (it will remain lower than 10% in 2010, according to our calculations), the deficit stood at 1.7% of GDP, and average inflation was negative also, despite it moving significantly north this year. According to the ECB, the Estonian increase in inflation reflects temporary factors. A solid fiscal position of the country is out of the question:

(a) The public deficit is moving upward, but increasing from 1.7% of GDP to only 2.4% in 2010 (while it should remain higher than 6.6% this year on average in the eurozone, according to the recent Spring Forecasts of the EU Commission).

(b) With the lowest level of public debt in percentage of GDP among EU members, interest expenses will remain around 0.3%-0.4% of GDP this year (again the lowest level among the 27 EU members also on these metrics).

(c) On the contrary, Estonia's problems lie in the very high external indebtedness (mainly driven by the private sector), to remain between 120% and 130% this year, but this variable is not part of the Maastricht criteria.[1]

In summary, Estonia is probably the best-placed country in terms of fiscal metrics in Europe. It is unlikely that the eurozone would allow a profligate member to join the club and then have to rescue it sometime in the future. Given the fiscal solidity, and the perspectives of euro adoption, Estonian country risk (in terms of 5Y CDS) sensibly decreased during the past months and it is now lower than that of Italy and Spain.

THE DECISION-MAKING PROCESS OF THE EUROPEAN UNION

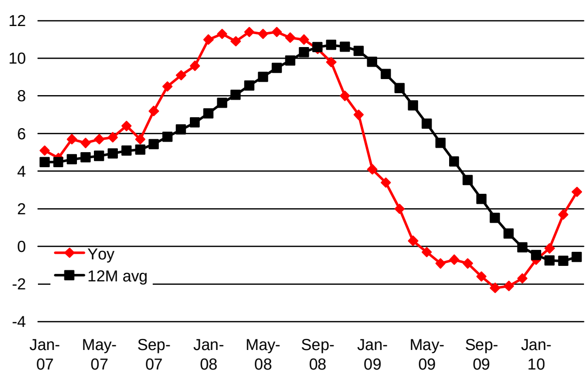
The decision-making process	Information activities
12 May – publication of Estonia's convergence report.	**May**: Arrangements to conclude the Agreement on Best Practices for fair pricing, preparations for the fair pricing campaign and informing consumers.
June – recommendation of eurozone Member States and consultations with the European Parliament. **8 June** – ECOFIN meeting, discussion of Estonia's compliance on the basis of the assessments made by the Commission and the ECB and of the Commission's proposal. **18 June** – the European Council discusses Estonia's readiness to join the eurozone.	**June**: Launch of information activities for the clientele of major companies and training for entrepreneurs.
6 July – ECOFIN's final decision about Estonia's accession to eurozone and confirmation of exchange rate.	**July**: Press events regarding the decision of ECOFIN in Brussels and Tallinn; signing of the Agreement on Best Practices and launch of the fair pricing campaign.

Source: EU Commission

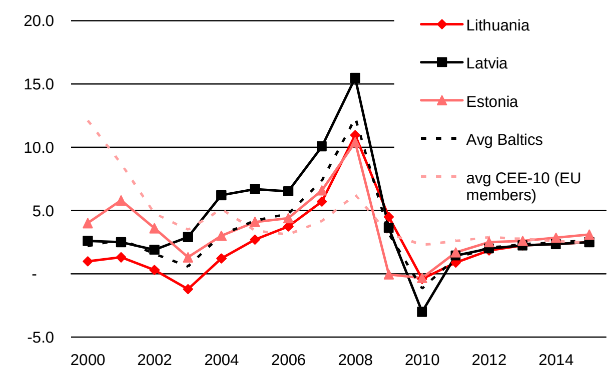
[1] The Maastricht criteria are the following: i) CPI must be no more than 1.5pp higher than the average of the three best-performing countries; ii) Bond yields not higher than the avg. of the three best EMU members +1% point; iii) Public debt/GDP ratio not over 60%; iv) Budget deficit not over 3% of GDP; v) FX stability (the band is in the +/-15% range) and presence in the ERM-II mechanism.

PRICE DYNAMIC IN THE BALTICS

Estonian CPI Inflation (yoy change)



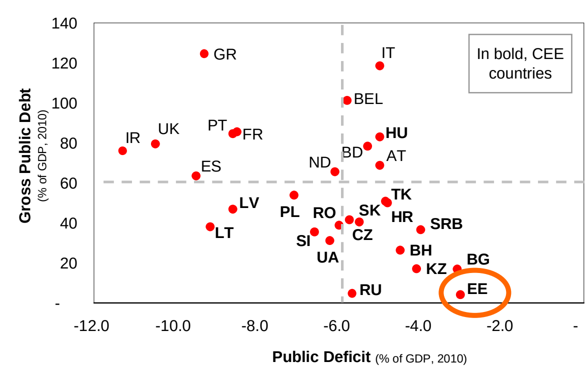
Average inflation in the Baltics (CPI, %)



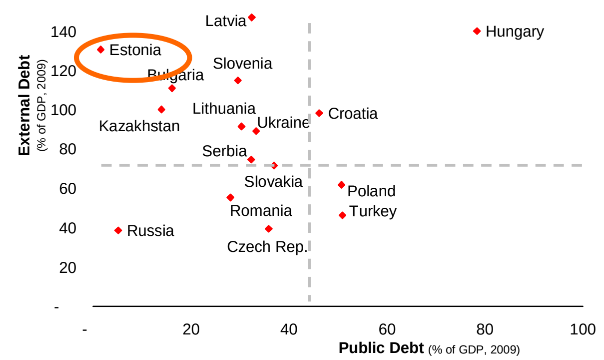
Source: Estonian Statistical office, Eurostat, UniCredit Research

PUBLIC AND EXTERNAL INDEBTEDNESS IN EUROPE

Public debt and deficit in Europe (2010 expected, % on GDP)



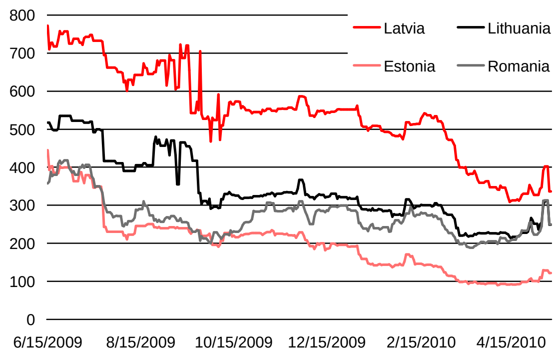
Public and external debt in Central Eastern Europe (% of GDP, 2009)



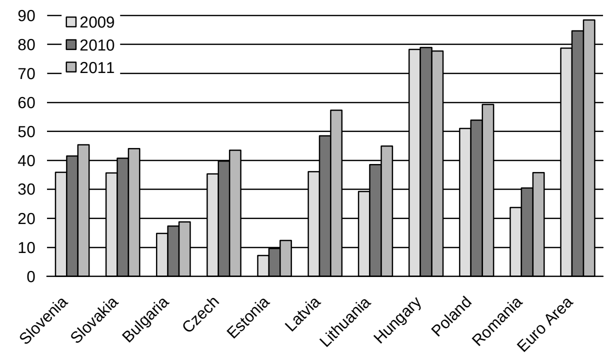
Source: EU Commission, UniCredit Research

ESTONIAN CONVERGENCE

Country risk in the Baltics and Romania (5Y USD CDS)



EU Commission expectation on public debt (public debt, % of GDP)



Source: EU Commission (Spring forecasts)

The Estonian economy – whose size reaches only EUR 13bn – has been one of the worst-performing in the world in 2009, after having been among the top 20 high-growing countries worldwide in 2000-07. Namely, considering the GDP evolution in 2009, the Estonian economy was the fifth-worst performing in the world (-14.1% in terms of real GDP), after Latvia (-18%), Ukraine (-15.1%), Lithuania (-15%) and Armenia (-14.4%).

Regarding the first months of this year, the Estonian economy contracted by 2.3% yoy in the first quarter of 2010, following a drop of 9.5% in 3Q09 and 15.6% in 4Q09. Estonian unemployment moved to 15.5% in 4Q09 and should remain higher than 15% for the whole 2010. On the positive side, the adjustment in the external accounts was very fast: the current account deficit moved from 18% and 9.4% in 2007 and 2008, to a surplus.

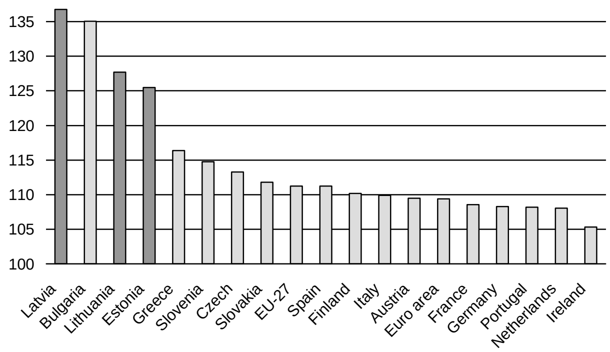
The fixed peg of the Estonian kroon versus the euro had, of course, a role in explaining the downturn. While most of the Central Eastern European countries saw their currencies depreciating sharply during the crisis and re-gaining export competitiveness via a weaker exchange rate, the Baltic economies, Estonia included, more intensively suffered the adjustment in a process of "internal devaluation" that could turn out to be a point of reference for some EMU "peripheries" such as Greece.

Estonian cost competitiveness is the key point. After more than a decade with a fixed exchange rate versus the euro, and following an unprecedented economic crisis in 2008-09, the deterioration in Estonian competitiveness was remarkable: if we take into account only the past five years, the Estonian price level is 25% higher than in 2005, while for most of the eurozone countries it is limited to an increase of 10%. Coherently, the increase in compensations was sensibly higher than in the eurozone, and higher than productivity.

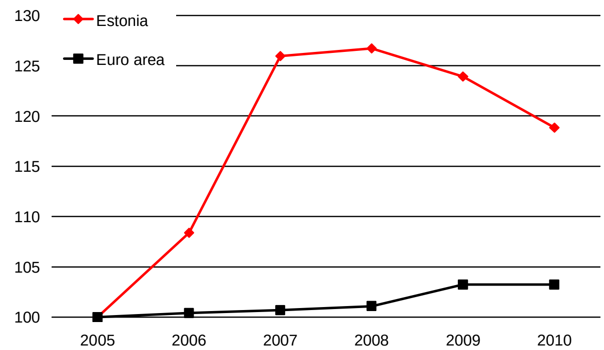
That is why we believe that the Estonian competitiveness issue – as for the other two Baltic states – is not a mere obsession, but something to be faced in the next future. If cost competitiveness is no longer the main driver of the economy as it was during the nineties, a broader concept of competitiveness (education, productivity, infrastructures, efficiency of the public sector, etc.) will have to be enhanced, in our view, to maintain an already weakened manufacturing sector in the country.

PRICE COMPETITIVENESS DETERIORATED

Inflation in Europe (HICP - all items, 2005=100)



Real compensation of employees per head (2005=100)



Source: Eurostat, UniCredit Research

Estonian banking sector: return to normality takes time

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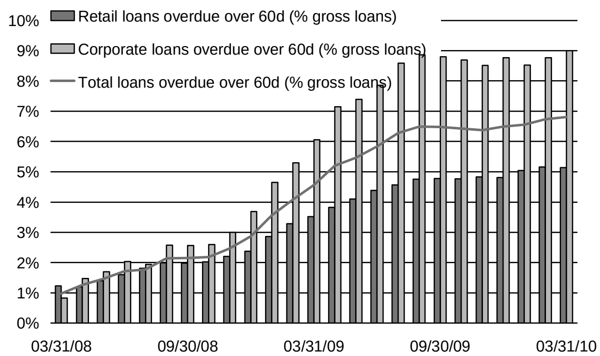
The Estonian banking sector has been seriously affected by the global credit crunch and economic recession. Deceleration in lending activity became visible in late spring 2008 and intensified in the aftermath of the Lehman collapse. Retail credit (both for consumer and mortgage financing) and the corporate segment have all been affected. To date, no major signs of re-starting in borrowing activity have emerged: in the first 3M of this year, lending activity remained subdued, with new business volumes anchored at historical lows particularly in the real estate segment. Overall, total outstanding loan volumes growth was still in negative territory down by -0.6% vs. end of last year. Funding from abroad continued to decrease reflecting the rebalancing of the Nordic players' exposure (which dominates the market).

The aggregate banking sector recorded a loss last year but banks' capitalization levels have remained fairly strong, with the average total capital ratio for the Estonian banking sector at 22.1% in March 2010 (up from 16.2% at the beginning of 2008) well above the minimum regulatory requirement (set at 10%), the support from mother banks having been crucial to avoid structural consequences. The sharp adjustment in economic activity, which took place during 2009, clearly had an impact on the pace of revenues generation. Overall, total banking system net revenues went down by more than 25% last year. The skyrocketing increase in the level of provisioning on the back of fast deterioration in the quality of loan books was, however, mainly responsible for the loss recorded last year. The banks' write-down increased by more than 400%, topping at EEK 8.5bn (EUR 0.5bn) at the end of 2009. The growth rate of problematic loans has sensibly slowed down in recent months but the peak in credit quality problems will probably be delayed to around mid/end of 2011. The banks' write-down of loans amounted to EEK 1.3bn in 1Q10, more than half the level recorded in the previous quarters.

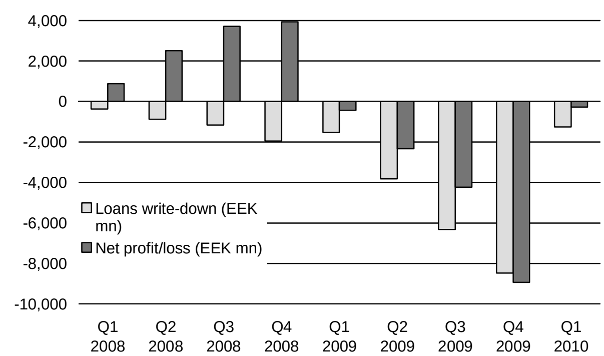
The deep recession will have long-lasting consequences, in our view. The credit market will continue to be characterized by sluggish dynamic, with loans growth expected to turn into positive territory (on a yearly basis) only around mid of this year. A large part of the Estonian banking sector will continue to keep a conservative approach toward lending. Despite some stabilization in the need for external funding, funding from parent banks will remain crucial. Pressures on the banks' margins are expected to ease somewhat on the back of still tight credit conditions, but full recovery in the banks' profitability will likely take some time. Under the current scenario, the risk of a loss continues to be high this year, with profitability returning positive only starting from 2011.

CREDIT QUALITY STILL DETERIORATING

Problematic assets still rising



The banking sector under pressure



Source: local CBs, BIS, UniCredit CEE Strategic Analysis

THE ESTONIAN BANKING SECTOR

	2007	2008	2009	2010f	2011f	2012E-2015f
Total loans (% yoy)	33.3%	7.9%	-4.8%	2.5%	3.2%	5.4%
Total deposits (% yoy)	13.8%	6.0%	5.9%	4.5%	5.2%	6.7%
Loan-to-deposits ratio (%)	1.96	1.99	1.79	1.76	1.72	1.64 (EOP)
Risk-adjusted revenues (EEK bn)	11.8	8.4	-5.0	2.4	4.1	9.4 (EOP)
Overdue loans more than 60 days (% gross loans)	0.7%	2.9%	6.5%	8.0%	9.0%	6.0% (EOP)
Return on assets (%)	2.4%	1.2%	-2.8%	-0.5%	0.1%	1.0% (EOP)
External liabilities (% of total liabilities)	52.9%	54.1%	52.2%	50.1%	48.0%	43.6% (EOP)
Cost of risk (provisions over average loans, bp)	28	81	521	214	148	38 (EOP)

Source: local CBs, UniCredit CEE Strategic Analysis

Eurozone enlargement: a bumpy road ahead

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In contrast to other countries that are EU members but have not adopted the euro, all the Eastern European members have the obligation to adopt the common currency in the future, provided the necessary level of nominal convergence has been achieved (the well-known Maastricht criteria, which provide the requirements for public finances, price stability, interest rates, and stability of the exchange rate, the latter through the participation in the ERM II mechanism).

On the contrary, UK, Denmark and Sweden are EU members but outside the eurozone and without any obligation to join the common currency. The UK, when the Maastricht Treaty was concluded in 1992, was granted accession with an opt-out clause: this means the UK is not obliged to adopt the euro. Denmark has an opt-out clause as well: the Maastricht Treaty was rejected in a referendum in 1992; currently the Danish crown is in the ERM II mechanism and it is trading within a very narrow band. Sweden chose to stay outside the exchange rate mechanism: hence, it can be considered having an opt-out clause *de facto*. Following the introduction of the euro in 1999, Greece joined in 2001, Cyprus and Malta in 2008; Slovenia in January 2007 and Slovakia in January 2009.

What's next? Is any other enlargement at the horizon? Following the Greek crisis, both sides (EU authorities and the Central Eastern European countries) are showing less enthusiasm towards any eurozone enlargement. Previously, most of the Central European countries were keen to adopt the euro, considered as a good anchor to help face the crisis but, in the wake of the eurozone's debt crisis, some EU members are in less of a hurry than just a few months ago.

Anyway, we should be able to put into perspective the current European difficulties. Euro adoption for Central Eastern European countries is more a question of “when” rather than “if”. All the Central Eastern European countries that are EU members will join the common currency during the next decade. At the moment, the Baltic countries are the most committed to adopt the common currency as soon as possible. After Estonia, Latvia and Lithuania are to follow in 2013-14. For the Baltic states, it also represents the best “exit strategy” from the fixed exchange rate regime and the possible emergence of devaluation pressures on their currencies. We expect Bulgaria and Hungary to join the eurozone in 2014, Romania around 2015. Poland and the Czech Republic will be in the last group: they have not set target dates and they can join the common currency only in 2015-18.

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