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Estonia Currency Architect Sees ‘No Rush’ on Euro (Update2)

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(Updates with Estonian Finance Ministry comment in 12th paragraph.)

By Ott Ummelas

June 3 (Bloomberg) -- Estonia, Lithuania and Bulgaria shouldn’t rush to adopt Europe’s common currency given the euro- region’s turmoil and the limited benefits of the switch, said Steve Hanke, the architect of the nations’ currency regimes.

The three eastern European economies with currency boards would do better to focus on improving competitiveness than joining the euro, said Hanke, a professor at Johns Hopkins University and a senior fellow at the Cato Institute in Washington, in a phone interview from Baltimore yesterday.

Hanke’s proposals served as the basis for Estonia’s currency board, adopted in 1992, that pegged the kroon to the German mark, followed by Lithuania in 1994 and Bulgaria in 1997. The European Commission last month approved Estonia’s bid to join the euro in January. Lithuania aims to follow suit in 2014.

Under currency boards, nations back money in circulation with foreign reserves at a fixed exchange rate to the euro, making their currencies virtual “euro clones,” Hanke said. The Estonian and Lithuanian central banks don’t make their own interest-rate decisions, while Bulgaria uses a base rate. Bosnia and Herzegovina also has a currency board from 1997, which Hanke helped to create.

“I don’t have any particular problem with adopting the euro in these currency board countries, but I don’t see any particular rush to do it either,” Hanke said. “The narrow technical benefits they will receive will be very small, if any at all, and those can all be accommodated by just making the currency boards even more orthodox and tighter than they are.”

Removing Risks

Estonia and Lithuania joined the ERM-2, a two-year waiting room for the euro, in the months following European Union membership in 2004. Bulgaria is ready to apply for the exchange- rate mechanism next year, deputy Prime Minister Simeon Djankov said on May 26.

Estonian euro adoption would remove the “small” political risks of either the EU halting euro-zone expansion or the political preference for a speedy entry eroding in Estonia, Hanke said. It also means Estonia wouldn’t be able to “re- anchor the kroon to the dollar or the German mark, if it was re- established, in the event the euro would collapse, though it is a very small risk,” he said.

Interbank rates that are “almost identical” to those of Germany show there would be “little further improvement” for Estonia after entry, Hanke said.

‘Keep the Clone’

“Estonia must choose between either joining the euro area and dealing with the small risk that the euro area problems will be reflected as increased uncertainty in the economy,” or “belonging to the ‘Baltics’ and dealing with the uncertainty exerted by the Latvian devaluation speculation,” said Annika Lindblad, a Helsinki-based analyst with Nordea AB, in an e-mail. “On top of the technical benefits,” increased confidence will particularly support foreign investment.

“You’ve got most of the benefits already by being in the formal EMU, by having the currency board,” Hanke said. “So why not just keep the clone and be happy with it and get on with your business doing other things and not worry about all these bureaucratic and political tangles that it involves?”

Prime Minister Andrus Ansip has said euro adoption would spur foreign investment and boost economic recovery by removing investors’ fears about a possible devaluation. It would also scrap foreign-currency transaction costs.

“Almost all our private sector loans are in euros and most are tied to the Euribor, most trade is in euros with European Union and euro-zone countries, which are also where our investments come from,” said Tanel Ross, deputy finance ministry chancellor, in an e-mail. “Everything that goes on in the eurozone, will therefore indiscriminately affect us regardless of the currency denomination, except that a big currency has the credibility that a little unknown one doesn’t.”

Spreads Narrow

Spreads between Estonian and euro money market rates have declined to 30-month lows from record highs last March, when the government was struggling to meet the EU budget-deficit limit of 3 percent of gross domestic product. The difference between the cost of borrowing krooni and euros for three months, based on asking prices, fell to 93 basis points today, the lowest since November 2007, according to Bloomberg data.

Euro-area finance ministers and the International Monetary Fund approved a 110 billion-euro ($135 billion) aid package for Greece on May 2. A week later, the EU pledged almost $1 trillion to counter fears of contagion and protect the euro.

Latvia, which was forced to take a 7.5 billion-euro bailout during the credit crisis, has a “credibility problem” because its peg to the euro isn’t backed by a legal structure, making it easier for individual officials to influence policy, Hanke said.

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