Jean-Claude Trichet: The new EU Member States - convergence and stability

Concluding remarks by Mr Jean-Claude Trichet, President of the European Central Bank, at the Third ECB Central Bank conference on “The new EU Member States: convergence and stability”, Frankfurt, 22 October 2004.

*   *   *

Ladies and Gentlemen,

It is my honour and pleasure to draw some conclusions at the end of the third ECB Central Banking Conference on “the new Member States: convergence and stability”. I hope that you found the last two days inspiring and stimulating. The road from EU enlargement to the euro is indeed a fascinating challenge for policy makers, academics and economic agents. During these two days we engaged into in-depth discussions about the past, present and future paths of the new Member States joining the European Monetary Union and the challenges that these countries are confronted with. Let me briefly elaborate on the main arguments and issues that were raised at the Conference. I would then also like to take the opportunity to share with you the ECB’s view about the main challenges for the new Member States on their way to the euro.

In his presentation, Gerard Roland raised some key institutional and structural questions concerning the enlargement of the European Union. First, how have institutions of the new Member States changed during the last decade? Second, what role has the European Union played during the transition phase and finally how will EU enlargement affect the functioning of the EU-25 in the future? As expected, institutions matter. The idea of the European Union acting as an “external anchor” for most of the new Member States has played a major role and incentives to meet the entry conditions set by the EU have worked well for the new Member States. According to many indicators which Gerard Roland presented yesterday the new Member States’ performances have been good; for example, price and trade liberalisation have been fully adopted, competition policy has been successful and most importantly individuals live in democratic societies. This success can also be seen in how these countries have adopted and implemented the acquis communautaire.

Taking stock of the progress made so far the paper stresses that more work still needs to be done. Reforms and progress especially in the banking and other financial sectors should be continued to create a solid and sustainable base for the economies of the new Member States, which can also be seen as important requirements for joining the euro area. I agree with discussants that the new member states will be active and will contribute positively to the functioning of the EU.

Jürgen von Hagen’s presentation complements Gerard Roland’s presentation. His findings also support the macroeconomic stabilisation achieved by the new Member States. On top of that most of the new Member States have undertaken major reforms to restructure their public sectors. Spending ratios have fallen remarkably and public sectors operate in a much more efficient manner than previously, but there still seems to be room for improvement. A well structured public sector and sound fiscal policy are necessary ingredients for a successful participation in a monetary union today and in the future. Jürgen von Hagen also commented on the future adoption of the euro and I will shortly touch upon this topic later in my speech.

Doug Laxton and Michael Kumhof’s presentation today dealt with the macroeconomic performance of the new Member States, or more specifically the performance of the Czech Republic, from a different angle than the two other presentations. It is an extremely challenging task to utilise a modern structural Dynamic (Stochastic) General Equilibrium model to study the pros and cons for a country to join EMU. I think the authors have done a good job in their brave attempt. Because of the nature of the model, in theory, one is able to get a coherent picture about the costs and benefits of joining EMU. In the analysis the authors concentrate on the trade sector where trade is determined endogenously between the two countries. The results from their exercise are intuitive and mostly convincing. A reduction in trade costs creates a significant long-term increase in trade and most importantly the main winners will be the joining members. The single currency will lower uncertainties and costs of transferring money. Eventually this will lead to welfare gains. I share the view of commentators that the exact values of outcomes are not that important because of the uncertainties involved in numerical exercises utilising macro models. What is important is to show the basic outcomes and most likely scenarios. I also share the point raised by the commentators that inclusion of analysis of financial integration’s effect on welfare would be beneficial.

In his speech, my colleague, Otmar Issing, talked about EU enlargement and monetary integration. The adoption of the euro by the New Member states will be the final step in monetary integration. As Otmar mentioned, a sufficient degree of economic and financial integration is necessary for adopting the euro successfully. Fulfilling the Maastricht criteria is a sign that sustainable convergence has been reached and countries are on the right path. Monetary authorities also play an important role in this process by conducting a credible policy which leads to price stability and thus creating an environment where entering into ERM II will be smooth and credible.

Most of the results presented here are broadly in line with the ECB's view that EU enlargement has positive implications for economic growth and welfare in both the "previous" and "new" Member States; unfortunately, these benefits have often been set aside in the public debate. Already the prospect of the countries joining the EU had positive implications. As trade and capital movements have been to a large extent liberalised well before accession, the degree of integration had already reached a significant level between the new and previous Member States. In fact, at the eve of EU enlargement the euro area directed around 11% of its total exports and imports to the new Member States, an increase of almost 50% in 10 years; the 10 new Member States as a group represent one of the main trading partners of the euro area, exceeding trade with Japan by far (8%) and being only somewhat lower than the European trade with the United States (14%). Similarly, the share of the EU-15 total foreign direct investments that was orientated towards the new Member States was also around 12% and tripled since 1999. While these figures are still low compared to the FDI flows directed to the US, they are considerably higher compared to those flowing to Japan. In addition, the prospect of EU enlargement has significantly sheltered the new Member States from adverse spill-over effects coming from other emerging markets. With EU enlargement now in place, economic and financial integration will advance further. With the extension of the Single Market to the new Member States all remaining barriers to trade and capital flows have been removed by now, thereby supporting further integration. It is already observable that small and medium-sized enterprises from the EU-15 countries are becoming significantly more active in the new Member States, as the economic and legal environment has become more stable upon accession. Let me stress that enlargement has also led to higher competition in the EU and enhanced the scope for economies of scale following the increase in the market size. By this, productivity will rise, thereby contributing to an increase in the potential growth rate of the EU. It is important to note that also the "previous" 15 Member States will be affected by higher competition in the EU, which could accelerate structural reforms in these countries. In fact, the new Member States seem to be overall rather competitive and have already made large progress in implementing structural reforms in some areas, which in turn is an incentive for the EU-15 to embark actively on their reform agenda, as Tommaso Padoa-Schioppa stressed it yesterday evening.

As you know, accession to the EU is only the beginning of the process, which ends with the eventual adoption of the euro, given that these countries have no opting-out clause. The path towards euro adoption is embedded in a well-defined multilateral institutional framework. To guide the process of joining EMU the Governing Council of the ECB released a comprehensive policy position on relevant exchange rate issues in December 2003. Given its importance, I would like to speak about the main implications of the various phases of joining EMU. Upon EU accession and before joining the exchange rate mechanism (ERM II), the new Member States are required to treat their exchange rate policies as a matter of common interest and pursue price stability as the primary objective of monetary policy. With respect to ERM II participation, there are no formal criteria to be met prior to the entry. Nevertheless, a successful and smooth participation in the mechanism requires that major policy adjustments - such as sound fiscal policy frameworks and price liberalisation - are undertaken before joining the mechanism. Depending on the monetary and exchange rate strategies in place, ERM II can help orient macroeconomic policies to stability and anchor inflation expectations. At the same time, the mechanism allows for a degree of flexibility, if needed, through the wide standard fluctuation band and the possibility of adjusting the central parity. Eventually, the countries are expected to join the euro area. Their readiness to adopt the euro will be examined on the basis of a deep and precise analysis of their performance with respect to the Maastricht convergence criteria. This examination will be done in the so-called Convergence Reports, which are regularly prepared by both the European Commission and the ECB. As you probably know, the 2004 Convergence Report has been published two days ago, including for the first time the ten new Member States.

The process of monetary integration with the euro area is based on a number of general principles, which are defined by the Treaty and other key documents. One principle is that there is no single trajectory towards the euro that can be identified and recommended to all new Member States at all times. This principle reflects the fact that the new Member States differ substantially with respect to the size and structure of their economies, the present state of their fundamentals, and the monetary and exchange rate regimes that are currently in place. The wide diversity across the new Member States implies that the economic situations and strategies of countries will have to be assessed on a case-by-case basis. Against this background, it is natural that ERM II entry and the preferred length of participation in the mechanism will differ across countries. In fact, three new Member States, namely Estonia, Lithuania and Slovenia, joined ERM II with effect from 28 June 2004, while others have not specified a date when they intend to join. Another key principle is the principle of equal treatment. This means that comparable situations and cases will be treated in a comparable manner, both across countries and over time. With respect to the examination of nominal convergence in the ECB Convergence Report 2004, this implies that the same convergence criteria laid down in the Treaty have been applied as was the case in the past. Thus, no new criteria were added, while the existing criteria were not relaxed.

The process of monetary integration with the euro area should be accompanied by overall consistent and stability-oriented economic policies. Moreover, a stable macroeconomic environment and progress in structural and fiscal reforms are also essential to take full advantage of the benefits of EU enlargement. In my view, the most pressing challenges for the new Member States are to maintain price stability and to advance with fiscal consolidation.

With respect to price stability, the new Member States will be confronted with the challenge to complete the disinflation process and/or to contain increases in inflation rates in a controlled fashion, without substantial adverse effects on inflation expectations and wage developments. Besides solid macroeconomic policy frameworks and prudent wage policies, progress with structural reforms is conducive to price stability. With respect to fiscal consolidation, it is clear that this is a demanding challenge for most of the new Member States, as they are confronted with competing expenditure demands. And it is the reason why policy-makers have to design and implement a credible consolidation path based on durable and growth-enhancing structural reforms.

Ladies and Gentleman.

It is time for me to close the third ECB Central Banking Conference. We had very intensive and inspiring discussions. While there are still a number of open questions and issues, I am sure that we will all go home with some new thoughts and ideas in our minds.

Let me take the opportunity to thank the authors of the papers for their remarkable work. My thanks also are going to the discussants, chairpersons and participants for their personal contributions, which were enlightening and ensured that this conference was a success. Let me also express my deep gratitude to all the staff of the ECB that has been involved in the organisation of the conference.

Dear friends, I wish you all a safe trip back home.

Thank you very much for your attention.