Lucas Papademos: On the road to the euro - progress and prospects of the new member states

Speech by Mr Lucas Papademos, Vice-President of the European Central Bank, at a panel discussion at the conference: The ECB and its Watchers VIII, Frankfurt am Main, 5 May 2006.

Slides to the speech can be found on the ECB's website.

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I. Introduction

The progress and prospects of the new Member States on the road to the euro is obviously a very topical issue. As you know, Slovenia and Lithuania have asked the European Commission and the ECB to prepare reports as part of an examination of whether they have achieved "a high degree of sustainable convergence" in accordance with the Treaty. The Convergence Reports on these two countries will be published on 16 May. Of course, I cannot discuss the substance of our convergence assessment of these two countries now, only days before the publication of our Reports. However, there are many important and pertinent issues related to the general theme of this session that could, and should, be usefully discussed at this juncture.

Let me start by recalling that all of the new Member States that joined the EU in 2004 are committed to adopting the euro, as soon as they fulfil the conditions set out in the Treaty. None of them has an opt-out clause, as is the case with Denmark and the United Kingdom. Indeed, all of the new Member States aim to adopt the euro over the next few years because of the expected benefits and opportunities that it will entail. The envisaged time schedules for entry into the euro area, as announced by the new Member States, are somewhat diverse, but they all currently plan to introduce the euro by the end of the decade, at the latest (see slide 3). A number of them have set concrete target dates in the years to come, while others have stated their envisaged euro adoption dates in more vague terms. In this context, let me emphasise that revising a target date in a pragmatic manner – as Estonia recently did – should not be perceived as a sign of failure. Rather, it should be seen as a sign of political realism and economic prudence in the light of the latest facts and assessments of current circumstances and likely prospects.

What are the prospects for euro adoption by the envisaged target dates? What are the main pertinent policy issues and challenges for the new Member States? With regard to the first question, I will present some facts that can provide a basis for some answers, which can only be tentative bearing in mind the forthcoming publication of our Convergence Reports. In my remarks, I will concentrate on discussing, first, a number of *general* policy issues concerning the prerequisites and prospects for euro adoption, and second, some *specific* policy challenges that the new Member States are likely to face in fulfilling the Treaty requirements for euro area entry. The general policy issues I will discuss are:

- the importance of the sustainability of nominal convergence;
- the role and significance of real and structural convergence; and
- certain aspects of the legal framework and statistical basis for euro area participation.

II. Some general policy issues: the sustainability and nature of convergence

According to the Treaty, the fundamental economic requirement for joining the euro area is "the achievement of a high degree of sustainable economic convergence" (Article 121). This is assessed by examining the fulfilment of the four well-known convergence criteria, as well as on the basis of a range of additional economic indicators deemed useful for a more thorough examination of the sustainability of convergence. The main reason for requiring a high degree of sustainable convergence is to ensure that a country participating fully in EMU has established economic conditions that are conducive to the preservation of price stability and that contribute to the coherent and smooth functioning of the euro area economy. Attaining a high degree of sustainable economic convergence is also important for the successful performance (in terms of competitiveness, growth and employment) of a country's economy after it has joined the euro area.

The previous arguments imply that the application of the Treaty provisions in a strict manner and the fulfilment of the convergence criteria on a sustained basis are essential for substantive reasons relating to the economic performance of the euro area and its prospective member countries. In a sense, the rigorous fulfilment of the convergence criteria can be thought of as an "insurance policy" both for a country joining the euro area and for the euro area itself. As with any insurance policy, it is wise – before underwriting it – to exercise prudence, to make a diligent and comprehensive assessment of the situation on the basis of all available information, including a careful examination of past behaviour and the likely future prospects. Similarly, countries aiming to enter the euro area are assessed with regard to the sustainability of their economic convergence, by examining to what extent the country's current achievements on the road to the euro are the result of structural measures with permanent effects and underlying long-term policy orientations, rather than the outcome of one-off measures taken to achieve the objective for a specific year. Moreover, a backward-looking analysis of the nature and sustainability of convergence (covering the previous ten years) is supplemented by an examination of the available information on the economic outlook and the role of potential factors and policy responses that could affect the sustainability of convergence. The point I would like to emphasise is that such a comprehensive assessment focusing on sustainability is clearly in the interests of the country concerned and not, as is sometimes portrayed, an arbitrary consideration, intended to make entry to the euro area more difficult.

It is worth pointing out that, according to the Treaty, the examination of the sustainability of convergence can rely on a whole range of relevant macroeconomic indicators. The reports by the ECB and the Commission assess the fulfilment of the nominal criteria by also taking into account – and here I quote the Treaty – "[…] the results of the integration of markets, the situation and development of the balances of payments on current account and an examination of the development of unit labour costs and other price indices". Moreover, the structural features of the economy that are relevant for maintaining an environment conducive to price stability over the medium term, and especially after adoption of the euro, are also examined, such as the degree of liberalisation in the economy, the functioning of labour markets and the degree of competition in product markets.

This leads me to another issue, namely the role and significance of "real convergence". The Treaty does not foresee an assessment of real convergence, for instance in terms of a country's GDP per capita (see slide 4). However, there is another notion of real convergence that relates to the adjustment of economic structures and institutions, be it in labour or product markets, or with regard to administrative capacity and judicial efficiency. This concept of real convergence, that might be termed "institutional" or "structural" convergence, will play a role in determining the overall economic performance of a Member State. And, through manifold channels, it will have an impact on the attainment and sustainability of nominal convergence. Real convergence and nominal convergence are interdependent processes that can reinforce each other. For example, advances in nominal convergence can foster structural change and create an environment that supports higher economic growth, and thus, the convergence of real income per capita. Progress in real convergence – understood in terms of adjustments in economic structures and market institutions – can support the sustainability of nominal convergence, for example by improving competition in product markets, increasing labour market flexibility and reducing the likelihood and impact of asymmetric shocks. The experience of a number of the current euro area countries over the past few years underscores the importance of structural and institutional adjustments – that is, of real convergence to the norms of market competition and flexibility, for sustaining a high degree of price stability, maintaining competitiveness and supporting higher and durable growth.

Before coming to policy issues related to the fulfilment of the individual convergence criteria, I would like to briefly address two other general issues that I regard to be crucial for the examination of the economic convergence process: the reliability of the statistical base and the legal framework for central banks. The assessment of economic convergence is highly dependent on the quality and integrity of the underlying statistics supplied by the countries concerned. The ECB, therefore, has repeatedly emphasised that Members States should consider the quality and integrity of their statistics as a matter of priority. To achieve the high standards required in the domain of statistics, it would be useful to reinforce the independence, integrity and accountability of national statistical institutes.

The Treaty also requires the examination of "legal convergence", i.e. the compatibility of national legislation with Articles 108 and 109 of the Treaty and with the Statute of the ESCB. The conditions for euro area entry in the legal domain refer, in particular, to central bank independence, the prohibition of monetary financing and privileged access to credit, and the integration of the national central bank of the country concerned into the Eurosystem. In this context, I should like to emphasise that central bank independence comprises various aspects, notably functional, institutional, personal and financial independence. Unfortunately, we have had to point out on a number of occasions in the recent past that all of these aspects of independence need to be respected, not only in principle, as a formality that can be satisfied by aligning national legislation, but also in practice. Independence is important both for the effective performance of a national central bank's tasks and for its participation in the Eurosystem.

III. Policy challenges pertaining to individual convergence criteria

Let me conclude by commenting on some policy challenges that the new Member States may face on the road to the euro and in fulfilling the convergence criteria. I will start with the **inflation criterion**. Where do the new Member States stand in terms of inflation convergence? Looking back, these countries have generally made significant progress in disinflation in the past years by bringing their average inflation rates close to those of the euro area (see slide 5). For each new Member State, the chart shows the 12-month average rate of HICP inflation in March 2006 (which is the relevant measure for the convergence examination in the May Convergence Reports), as well as the annual rate of inflation in March. At the same time, inflation rates have been rather volatile and diverse across countries. This is partly due to the fact that the new EU Member States are mostly small and open economies, and are thus very exposed to changes in import prices, including energy prices. It is clear, however, that the dynamics of inflation in many of these countries, which are still undergoing significant structural changes, can be relatively complex, as they are influenced by certain specific factors relating to the catching-up process. These include the phenomena described by the Balassa-Samuelson-effect, the changes in consumption patterns towards services and the convergence of real incomes. Strong domestic demand growth accompanied by a tightening in labour markets, as observed in a number of countries, is likely to lead to wage pressures. Finally, in many of the new Member States, structural price adjustments, including changes in administered prices and the alignment of excise taxes with EU levels, are still ongoing. Containing inflationary pressures under such circumstances is obviously a challenging task. It is therefore important that all policy instruments in the countries concerned – including monetary policy, fiscal policy and structural reforms – need to be employed to foster convergence, both in nominal and in real terms.

With regard to the **exchange rate stability criterion**, the ECB has continuously stressed that the minimum stay in ERM II serves a very useful objective, namely to provide a "testing room" for various purposes. It allows to test a country's ability to sustain a stable nominal exchange rate, especially of those undergoing deep structural transformations, where equilibrium exchange rates may change significantly over time, and it allows to test the eventual conversion rate. Therefore, a longer stay than the required minimum of two years might be desirable for some countries.

In most cases, the countries participating in ERM II have not experienced significant fluctuations in their currencies (see slide 6). The charts show exchange rate developments since the beginning of 2005 within the standard +/- 15% fluctuation band. These developments also reflect the fact that some of the ERM II participants have a currency board arrangement in place as a unilateral commitment, while others aim to maintain the exchange rate much very close to the central parity. At the moment, however, none of the new Member States has been participating in ERM II for the required minimum of two years.

Another challenge that might lie ahead for a number of the new Member States relates to their substantial and persistent current account imbalances. Although external imbalances are to some extent a natural and necessary part of the catching-up process, care needs to be taken to ensure that these imbalances remain sustainable and eventually decline. Even though the balance of payments appears to be less relevant once a country has joined the monetary union, economic adjustments in response to such imbalances will take place at some point in the future. In this respect, it is possible that the current account deficit might "naturally" narrow over time as the cyclical position in the country becomes more aligned with that of the euro area countries. However, if economic policy and market structures do not facilitate the adjustment process, it is also possible that the adjustment of the economy will be abrupt and severe – another reason to emphasise real convergence and the flexibility of economic structures, as I outlined before.

Finally, where do we stand with regard to the fulfilment of the **fiscal criteria**? Looking at recent fiscal developments in the new Member States, the picture is very diverse (see slides 7 and 8). Thee two charts show the fiscal positions in the new Member States and the reference values as defined in the Treaty. While many of the new EU members face no major problems on that front, others exhibit large and even growing fiscal imbalances. In addressing the fiscal policy challenges faced by these countries, one aspect deserves, in my opinion, particular attention: namely that the appropriateness of the budgetary stance cannot only be judged with reference to the fulfilment of the fiscal criteria. As I pointed out earlier, fiscal policy will have to be employed as a policy instrument to help contain inflationary pressures, when other policies (such as monetary policy) are increasingly constrained in the run-up to euro area accession. This is especially the case in the final phase of convergence and ERM II participation, when the convergence not only of long-term interest rates, but also of short-term interest rates progressively limits the room for manoeuvre for monetary policy. Moreover, as buoyant economic growth in these countries is often supported by very high credit growth, effective financial supervision is of the essence in order to ensure that credit expansion also takes place in a sustainable manner. Finally, it is evident that national fiscal policy has a crucial stabilisation role to play after euro area entry, when monetary policy is no longer available.

IV. Concluding remarks

To sum up, the new EU Member States have made considerable – and, in a number of cases, impressive – progress on the road to the euro. The adoption of the single currency will bring many benefits and opportunities to these countries. At the same time, it involves responsibilities and may pose new policy challenges. The adoption of the single European currency implies a permanent commitment. It is, therefore, of paramount importance that the economic policies pursued by the euro area member countries are conducive to price stability and consistent with the constraints imposed by the single currency. The successful participation of a country in the euro area and the smooth functioning of monetary union itself requires that prospective euro area members achieve the necessary high degree of convergence in a sustained manner and prepare their economies – market structures and institutions – so that they can effectively address potential policy challenges that may arise both before and after joining monetary union. Good preparation and the attainment of sustainable long-term convergence are crucial before joining monetary union. This is why the ECB – as well as the European Commission – take great care to examine the sustainability of convergence and make sure that Member States adopting the euro are ready for this momentous historical step.

Finally, let me stress that to ensure continuity and equal treatment, the ECB will, in its examination of the degree of convergence achieved, employ the same framework of analysis as in the past and will build on the same definitions and principles as set out in the previous Convergence Reports.

Thank you very much for your attention.