Mario Draghi: A central banker’s perspective on European economic convergence

Speech by Mr Mario Draghi, President of the European Central Bank, at the Anchor 2013 Conference, organised by the Magyar Nemzeti Bank (the central bank of Hungary), Budapest, 7 December 2012.

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Ladies and Gentlemen,

It is a great pleasure to be here in Budapest and to participate in the annual Anchor conference. I understand that this will be the last Anchor conference for András Simor in his position as Governor of the Magyar Nemzeti Bank. So this is an excellent opportunity for me to pay him a sincere tribute for his work here and as a valued member of the General Council of the European Central Bank (ECB).

In my remarks today, I would like to focus on the process of *economic convergence* in Europe. As the experiences of recent years have made clear, this process does not end with a country’s adoption of the euro. Nor does participation in the single monetary policy provide automatic delivery of convergence.

I will first talk about the challenges facing the euro area as a result of shortcomings in the process of convergence and integration. I will then discuss the challenges of convergence for those members of the European Union (EU) that have not yet adopted the euro.

1. Two challenges in the process of European integration

The institutional challenge

Over a period of many years, the EU has provided an unprecedented framework for successful regional integration. The process of integration has involved not only the creation of a common market and the harmonisation or coordination of several economic policies, but also the conduct of some of these policies at a supranational level.

A central pillar of the EU’s institutional architecture has always been the principle of subsidiarity. This is the rule that action shall only be taken at the supranational level if the objectives to be pursued cannot be sufficiently achieved by EU members, either at the level of central government or at the regional and local level.

While we should continue to preserve the principle of subsidiarity, the recent challenges for the euro area have provided us with a major institutional lesson: maximising the benefits of the single currency requires not only a strong ECB; it also requires additional strong common institutions.

We need strong institutions to guarantee competitiveness and to encourage sustainable growth; to guide fiscal policies and ensure fiscal sustainability; and to supervise and stabilise the single financial market. We also need strong institutions to engage citizens more closely in the European project.

In other words, the future prosperity of Europe hinges on our ability to complement monetary union with economic union, fiscal union and financial union. This more advanced institutional architecture will in turn need to be embedded in some form of political union that engages citizens more deeply in European decision-making. As a result, joining the euro area in the future should imply greater sharing of sovereignty and a deeper European accountability than it did ten years ago.

The institutional challenge is the first major challenge with which we are currently confronted. We have already made much progress in addressing the challenge. But a great deal of work remains to be done.

The economic challenge

The second and complementary challenge is economic. The benefits of adopting the euro are greater the more consistent the economic structures of existing and prospective members are. Convergence can be broadly defined as a process in which cross-country differences in economic structures are reduced over time. The success of the convergence process ultimately depends on the *sustainability* of the underlying policies.

Shortcomings in the process of convergence across euro area members have been at the root of the challenges we have faced since 2010. But I am pleased to report that progress in addressing those shortcomings is being made.

External imbalances and fiscal imbalances are starting to be unwound. Efforts to regain price and non-price competitiveness are bearing early fruit. Deleveraging is generally proceeding in an orderly way, even though credit flows to the real economy seem to be negatively affected in parts of the euro area. Debt is being reduced in some countries, while others are devising strategies to make debt reduction sustainable over time. And financial sector weaknesses are being addressed along with their links to sovereign risk.

As I have said, progress is being made but much still needs to be done. The recent experiences of some current euro area members also serve as a cautionary tale to EU members bound by the Treaty to adopt the euro in the future. I will now turn to the challenges facing these countries in the process of convergence.

2. The perspective of EU countries which have still to adopt the euro

The framework for convergence

With two exceptions, all EU members that are not yet in the euro area are expected to adopt the single currency on meeting certain convergence criteria. As you know, the Treaty defines these criteria along three dimensions.

The first dimension is the degree of *nominal* convergence with the euro area. This implies achieving price stability; ensuring the sustainability of the government's financial position; realising sustainable convergence of long-term nominal interest rates; and maintaining a stable exchange rate between the national currency and the euro.

The Treaty also requires that nominal convergence is sustainable. This is not possible without it being underpinned by a high degree of *real* convergence. According to this second dimension, adopting the euro makes sense only if the economic structure of a prospective member has converged sufficiently towards the prevailing structures in the euro area.

The success of the real convergence process in turn depends on the sustainability of the relevant policies. The challenges that we have faced since 2010 highlight the dangers that large and persistent macroeconomic imbalances pose, not only for the stability of domestic economies, but also for the smooth functioning of the euro area as a whole. We all know the dire implications of prolonged losses of competitiveness, excessive indebtedness and housing market bubbles.

Recognising this fact, EU members have moved towards stronger surveillance of domestic policies. Let me remind you of two examples. One is the new *Macroeconomic Imbalance Procedure*, which aims to prevent the build-up of new macroeconomic imbalances and enforce the correction of existing imbalances. The other is the "fiscal compact", which was signed by all EU members except the UK and the Czech Republic in March this year and which strengthens the sustainability and credibility of fiscal policies.

The third dimension of convergence is *institutional*. The relevant national legislation, including the statute of the national central bank, needs to be compatible with the EU Treaties and the Statute of the European System of Central Banks (ESCB).

More generally, a lesson we have learned the hard way is that the strength of the institutional environment is crucial for the sustainability of economic integration and convergence. Improvements in the institutional environment entail, among other things, better regulations, better governance, better quality of statistics and a more business-friendly environment. Removing impediments to the efficient use of factors of production helps to enhance the growth potential of each country.

How to achieve a high degree of sustainable convergence?

So how can countries best prepare their economies to reap the benefits of closer European integration? There are four building blocks: monetary policy, structural policy, fiscal policy and financial policy. Let me reflect briefly on each of these.

Monetary policy

First, monetary policy, which, before the euro is adopted, remains a national responsibility. But a number of Treaty obligations already apply at this stage. In particular, the main objective of monetary policy should be price stability, and exchange rate policy should be treated as a matter of common interest.

Monetary policy best contributes to growth through the delivery of price stability. Overall price stability creates a predictable environment that fosters the efficient adjustment of relative prices and bolsters investor and consumer confidence. It also protects the purchasing power of the most vulnerable members of the population.

Different monetary policy frameworks have been devised to deliver price stability. Some EU members outside the euro area have fixed the exchange rate of their domestic currencies to the euro, which has a very good track record of low inflation. A different approach – which has been adopted by Hungary – has combined exchange rate flexibility with a regime of inflation targeting.

I understand that Governor Simor will focus his remarks on the past and future of inflation targeting in Hungary. So I will limit my comments to the importance of *central bank credibility* for the success of inflation targeting.

The ultimate success of a central bank in maintaining price stability depends on its credibility. Credibility anchors inflation expectations in line with the definition of price stability adopted by the central bank. Well-anchored inflation expectations in turn align the choices relevant for wage and price setting.

A key prerequisite for a credible monetary policy is the *independence* of the central bank. This principle is enshrined in the Treaty and the Statute of the ESCB. Each central bank in the EU should have institutional, personal, functional, and financial independence. Institutional and personal independence protect the central bank and members of its decision-making bodies from direct or indirect influences of third parties in the performance of their tasks. Functional independence requires that the central bank has the necessary means and instruments for achieving its objective independently of any other authority. And financial independence guarantees that the central bank has access to and control over sufficient financial and human resources to fulfil its mandate.

Credible inflation targeting in small open economies also depends on central banks' recognition of the impact of their monetary policy decisions on the *exchange rate*.

For example, in the presence of heavily indebted private and public sectors with large open foreign exchange positions, central banks have little space for manoeuvre when faced with a flagging economy. This is especially true when inflation is already high and there is not yet a

critical mass of structural and institutional reforms capable of reducing the country risk premium to sustainable levels.

In these circumstances, lowering the policy rate to stimulate the economy may risk sparking depreciation pressures on the domestic currency at some point in time. Depreciation of the currency may in turn further fuel inflation and offset the impact of economic stimuli through negative balance sheet effects on consumption and investment.

Structural policies

The second building block is structural policy. The sustainability of nominal convergence is to a large extent conditional on a sufficient degree of structural, or real, convergence. A broad indicator of the degree of real convergence with the euro area is the *catching-up* of per capita incomes and price levels of new members with those of the euro area.

Convergence in real per capita GDP levels has to be fostered by far-reaching structural and institutional changes aimed at enhancing the growth potential of the economy. Such reforms typically aim at strengthening the flexibility of adjustment mechanisms in the economy and improving the business environment.

When goods and labour markets are rigid, inflation and inflation expectations may remain high even in the presence of monetary regimes committed to the achievement of price stability. Both governments and social partners share responsibility for ensuring that wage determination takes sufficient account of labour market conditions and does not jeopardise competitiveness and employment. Active labour market policies should tackle persistent bottlenecks, such as skill mismatches.

Finally, protection of vested interests in the product markets and lack of mobility and adaptability in the labour markets undermine job creation, in particular for young and less qualified workers, as well as for all those who face problems entering the labour market. Lowering barriers to entry will increase competition, particularly in those domestic service sectors that are sheltered from international competition, and thus support price stability.

Economic growth led by the private sector needs to be fostered by a stable and business-friendly policy environment. In this respect, governments should strive for transparency and predictability of the policy regime, a low compliance burden, and effective governance in applying the rule of law.

Fiscal policy

It is also crucial that the achievement of price stability is supported by sound fiscal positions, the third building block of convergence. Irresponsible fiscal policies can jeopardise credibility, as higher inflation becomes desirable to reduce the real value of government debt.

Fiscal policies should be sustainable and oriented to the medium term. They should further aim at mitigating undesirable trend growth differentials through “high quality” expenditure and tax policies. In particular, high and inefficient public expenditure can put a brake on economic activity by imposing a high tax burden on the economy and channelling resources into unproductive uses.

Financial policies

The fourth building block is financial policy. A sound banking sector, liquid and well-functioning capital markets are important for the sustainability of nominal convergence.

On the one hand, well-functioning banking sectors and capital markets ensure efficient financing of capital accumulation in the economy, thus supporting potential output growth. On the other hand, they sustain the smooth functioning of the monetary policy transmission channels, such as the interest rate and bank lending channels. In this regard, financial sector vulnerabilities pose great challenges for the conduct of monetary policy.

Conclusions

Let me draw to a close. The experiences of the past few years have shown that participation in a monetary union places important demands on national economic policies.

Euro area governments are hard at work responding to those demands. They are correcting macroeconomic imbalances. They are establishing a stronger framework of governance to keep countries on the path of sustainable convergence. And they are improving the institutional set-up underpinning monetary union.

For those EU members that have not yet adopted the euro, the challenge is to achieve a high degree of sustainable convergence with the euro area. This requires credible commitment on the part of their central banks to achieve price stability and treatment of exchange rate policies as a matter of common interest.

For the members of the euro area, the challenge is to achieve full compatibility of their economies with participation in monetary union. Product and labour markets must possess sufficient adjustment capacity to buffer shocks while maintaining high output and employment. It is in this area that progress is most needed.

As I have indicated, much work remains to be done – in both the current and prospective members of the euro area, and both *individually* in each EU member, and jointly across Europe. But I have no doubt that this opportunity to continue progress will be seized and that together we will reap the benefits of sustainable economic convergence and lasting regional integration.

Thank you for your attention.