

Jean-Claude Trichet: Looking at EU and euro area enlargement from a central banker's angle - the views of the ECB

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Diplomatic Institute, Sofia, 27 February 2006.

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Ladies and gentlemen,

I am very honoured to be able to speak here today before such a distinguished audience. I would like to thank our hosts for their kind invitation. I must say, I actually feel quite at home here at the Diplomatic Institute. I would like to share with you today my views as a central banker on an issue that has many dimensions, namely EU enlargement. Of course I will focus my attention on the economic and, in particular, the monetary aspects of this process, and on the issue of euro area enlargement.

Permettez-moi, Mesdames et Messieurs, de commencer mon intervention par quelques mots en français. En effet, la Bulgarie est membre à part entière du mouvement de la francophonie; à cet égard, dans moins de trois mois, la Banque nationale bulgare accueillera la treizième réunion des gouverneurs des banques centrales des pays francophones. J'ai toujours pris part à ces réunions avec le plus vif intérêt; cette année aussi, j'aurai le plaisir de revenir à Sofia à la mi-mai comme invité du Gouverneur Iskrov pour une réunion consacrée à la stabilité financière.

Avant de présenter la structure de mon discours, permettez moi d'abord de faire une remarque d'ordre général. Je crois que l'on est pas toujours sensible au fait que l'élargissement n'est pas un présent offert aux nouveaux Etats membres; en effet, pour ceux qui souhaitent adhérer, l'élargissement occasionne à la fois un travail assidu et aussi parfois des choix difficiles. Je ne veux pas dire par là qu'il faudrait qu'il en soit autrement. Prenez par exemple le monde du sport: lorsqu'un sportif rejoint sa nouvelle équipe, c'est lui qui doit travailler dur pour faire évoluer son talent et c'est d'abord lui qui doit s'ajuster au style de jeu de l'équipe, et non le contraire. Ceci garantit l'efficacité et permet à l'équipe de fonctionner comme une équipe plutôt qu'un ensemble d'individus. Ceci dit, l'équipe doit aussi savoir apprécier les efforts d'ajustement importants du nouveau venu car elle peut devenir plus forte grâce à lui. Par conséquent, je respecte et j'admire les autorités et le peuple bulgares pour leur travail assidu dans leurs préparatifs à l'entrée dans l'Union Européenne.¹

Let me continue in English and set out the structure of my speech. There are two main facets of preparing for accession that I will focus on today because they are particularly relevant from an economic point of view. The first concerns catching up to play *at the level* of the team. For the economy, this entails institutional development and stable macroeconomic policy-making. In the first part of my speech, I will deal with Bulgaria's achievements and the outstanding challenges in this regard. The second facet is the commitment to play *along with the rules and strategy* of the team. In this part, I will set out the path to eventual euro adoption that would need to be followed when Bulgaria joins the EU. I will illustrate some of the challenges that tend to arise along this path, drawing on our experiences with the new Member States.

So, how has Bulgaria done in terms of institutional development and stable macroeconomic policy-making? The first indicator that you have done well is the European Commission's Comprehensive Monitoring Report for 2005. The Report makes clearly the difference between the institutional realm where shortcomings are stressed and the economic preparation which is judged rather positively. It notes, for instance, that the rule of law must be strengthened and that more should be done to combat corruption and organised crime. The economy, on the other hand, is described as having "a *high degree of macroeconomic stability with strong economic growth, relatively low inflation and falling*

¹ But before I set out the structure of what I will say, let me first make a general remark. I believe it is not always fully appreciated that enlargement is not simply a present to the new entrants; indeed, for those who want to join, enlargement entails both hard work and, sometimes, difficult choices. And I am not saying that it should be any other way. Take the world of sport, for example: when a sportsman joins a new team, it is he who must work hard to improve his skills and it is he primarily who must adjust to playing the styles and techniques of the team, not the other way around. This is efficient and enables the team to function as a team instead of as a set of individuals. That said, the team should appreciate that the new entrant makes most of the efforts of adjustment and that the team can become stronger as a result of the new entrant. So, I respect and admire the Bulgarian authorities and the Bulgarian people for your hard work in preparing to join the EU.

*unemployment*⁷. Moreover, it states that continuing the current pace of reform will make the economy robust to competitive pressure and market forces within the EU.

I agree with the Commission that economic progress in Bulgaria has been significant. Of course this has not been automatic. It is the result of difficult choices taken and a lot of hard work. So, let me mention three aspects of this preparatory process that seem to me particularly important.

First, the introduction of a currency board arrangement eight years ago was a significant decision on Bulgaria's road towards economic and monetary stability. The currency board has been successful in finally bringing much-needed macroeconomic stability to post-communist Bulgaria. This has been helped by its strong credibility both with the Bulgarian population and internationally. So clearly, it has been the backbone for macroeconomic stability in your country.

Second, I would like to highlight the policy consistency of the various successive policy-makers. You understood from the outset that currency board arrangement can only be sustained if supporting policies are in place. Let me emphasise in particular the role of fiscal policy. As you know, a currency board does not allow for discretion in the conduct of monetary policy. Indeed, monetary policy becomes entirely endogenous. So, the only macroeconomic management tool at the disposal of policy-makers is fiscal policy. I find that the conduct of fiscal policy in Bulgaria has been appropriate. Before looking at some numbers, I would like to stress that what impresses me most is that fiscal management has remained prudent over time. The broad consensus among policy-makers on the absolute need to follow a prudent fiscal policy has prevented harmful policy reversals.

This is also shown by the figures. When I look at the deficit and debt performance between 1997 and 2005, I see that the budget position has remained consistently close to balance. I also see that fiscal policy has judiciously been tightened. The surplus increased to 2.4% of GDP last year and I understand that a 3% surplus has been agreed upon for this year. This will certainly contribute to the maintenance of macroeconomic stability.

The third and final facet I want to touch upon concerns cooperation, and I would like to focus here on cooperation in the field of central banking. When I said earlier that the entrant does most of the adjustment, I meant *most*, not all. The team also prepares for the entry of the new member. The European System of Central Banks (ESCB) has worked with Bulgaria to prepare it to join the EU and the ESCB, involving activities at many levels. An early example was the cooperation project involving the Bulgarian National Bank, the Banque de France and De Nederlandsche Bank. As part of this project, experts exchanged knowledge and experience on issues such as forecasting tools for bank reserves, risk management processes and the cash operations strategy. I believe that such cooperation helps in itself to create a family spirit among the central banks. It forms a good example of what such cooperation can achieve in mobilising our vast amount of knowledge and expertise. Indeed, the cooperation was so good that the project was commended by the European Commission for setting an example. We have followed up on this with a new project, which has just started and, besides the original participants, also includes the Banca d'Italia. In general, cooperation between Bulgaria and the ESCB now extends across most areas of central banking, from exchanging statistics to our annual bilateral policy dialogue. Moreover, since the signing of the Accession Treaty, the Bulgarian National Bank has participated as an observer in the ECB's General Council and in meetings of ESCB committees and task forces. In this way, Bulgaria is already contributing to the work of the ESCB.

Besides these successes, there are naturally also challenges. Let me now turn to what are in my view the two most important economic challenges that still remain for Bulgaria. As I mentioned earlier, growing external imbalances are seen as a possible source for concern. From the economic literature, we know about the difficulty of assessing the sustainable level of the current account, particularly in the context of transition. But the recent dynamic of Bulgaria's external accounts indisputably calls for enhanced vigilance. This dynamic has been largely fed by robust credit growth to the private sector. In this context, the measures taken by the Bulgarian National Bank [*credit growth limits for banks, higher reserve requirements*] to contain credit expansion are fully justified. Their impact has already been visible. At the same time, we should be aware of the limitations of these measures in an environment of an open capital account. I have no doubt that the Bulgarian National Bank will continue to monitor the situation closely and take additional measures if necessary.

Let me now turn to inflation, which is certainly a major challenge on the road to future EMU membership after entry in the European Union. Indeed, at 6.5% at the end of last year, headline inflation is high. That there remains a lot to be done to fully control inflation is illustrated by its volatility over the recent years, moving from 10.3% in 2000 down to 2.3% in 2003 and now back up again.

Fiscal policy and the stepping-up of structural reforms will play a key role in efforts to contain inflation. I know that the Bulgarian authorities are aware of these challenges and I encourage them to exert sufficient vigilance. It is particularly important as regards the stated objective of Bulgaria to enter the exchange rate mechanism (ERM II) quickly after accession and to do what will be necessary to join the euro area. I appreciate very much your determination to do all what is necessary to meet the ultimate goal that you have in mind. As you know the ECB, when time comes, will apply a very simple principle when making its judgement: the criteria set out by the Treaty will have to be met in a sustainable fashion, nothing but the criteria and all the criteria.

Euro area enlargement

This brings me to the second part of my speech, in which I will discuss the path towards joining the euro area that should be followed upon accession. Along this path, every team member can have their own style, as long as the style respects the rules. Pre-euro-entry “euroisation” for example is not acceptable. I will now explain in more detail the process of monetary integration and the rules that apply to it.

With the exception of Denmark and the United Kingdom, EU Member States do not have an opt-out clause. The path towards euro adoption is embedded in a well-defined multilateral institutional framework and comprises three phases:

- The first phase is the period from **EU accession up to the country joining ERM II**. In this phase, the respective Member States continue to be fully responsible for their monetary and exchange rate policies. Yet, EU 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. More generally, during this phase, Member States are expected to undertake major policy adjustments – such as to implement a credible fiscal consolidation path and advance with price liberalisation – in order to already prepare for the next steps of monetary integration.
- The second phase relates to **participation in ERM II**. As you know, the mechanism defines a regime characterised by fixed, but adjustable, exchange rates, with a mutually agreed central rate against the euro and a standard fluctuation band of 15%. The euro plays a central role as the anchor currency in the mechanism. At the moment, eight countries are participating in ERM II. Besides the long-standing participant Denmark, most of the new Member States that joined the EU in 2004 entered the mechanism over the past 18 months. As regards the entry conditions for ERM II, there are no legal criteria to be met beforehand. Thus, participation can be requested at any time by a Member State. As regards the length of participation, the Treaty foresees a minimum of two years prior to the examination of convergence. This should certainly not prevent a Member State from remaining within the mechanism for more than two years, if this is deemed supportive in accompanying real and nominal convergence. With respect to Bulgaria and its monetary integration plans, it is important to note that ERM II can accommodate features of a number of exchange rate regimes, including currency boards, so that countries operating currency boards might not be required to go through a double regime shift. I should stress, however, that participation in ERM II with a currency board is regarded as a fully unilateral commitment by the respective country. It involves no obligations whatsoever on the part of the ECB.
- The third phase is the period from the **fulfilment of the Maastricht convergence criteria to the eventual adoption of the euro**. To qualify to join the euro area, each country must achieve a high degree of sustainable economic and legal convergence. It is in the interest of all parties involved that the achievements in convergence are sustainable and can be maintained over the long term. To assess the state of economic convergence, the ECB makes use of a common framework of analysis, which is based on the Maastricht convergence criteria. In addition, a range of backward and forward-looking indicators are used to back up the analysis, which is done in the so-called Convergence Reports. These Reports are prepared regularly by both the European Commission and the ECB. The last Convergence Report was published in October 2004 and included for the first time the ten new Member States that joined the EU in May 2004. As required by the Treaty, we will again prepare a Convergence Report in the second half of 2006.

- For the sake of completeness, let me briefly mention that, for those countries complying with the convergence criteria, more practical arrangements will have to be set in motion to prepare for euro adoption. Once the ECOFIN Council has decided that an EU Member State outside the euro area can adopt the euro, the country needs to prepare for example the cash changeover and the full integration of its central bank into the Eurosystem.

It is important to bear in mind that the process of monetary integration, which I have just illustrated, is based on some **general principles** that guide the process. These are defined by the Maastricht Treaty and other key documents. One basic principle that I would like to draw your attention to is that there is **no single trajectory** towards the euro that can be identified and recommended to all EU Member States at all times. This principle reflects the fact that most Member States are far from being a homogeneous group of countries. The current EU Member States outside the euro area 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. Yet, diversity in economic structures and policies is not an obstacle per se to qualify for the euro. Incidentally, this was also not the case for the current euro area countries when they adopted the euro back in 1999.

In this context, another important principle evolves, namely that the economic situations and strategies of the respective Member States and their readiness to adopt the euro are assessed on a **case-by-case basis**. Thus, the examination of economic and legal convergence is done on the basis of the countries' own individual merits and particular situation. With respect to the new Member States, their progress towards nominal convergence varies widely across countries. Consequently, they are expected to join the euro area at different points in time.

The third and last key principle that I would briefly like to touch upon 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 forthcoming Convergence Report, I can assure you that the application of the convergence criteria, as laid down in the Treaty, will not change. No new criteria will be added; and the existing criteria will not be relaxed. More specifically, on the assessment of exchange rate stability against the euro, this will be done – as in the past – on the exchange rate being close to the central rate, while also taking into account factors that may have led to an appreciation. In this context, let me also re-state that the exchange rate criterion requires participation in ERM II for at least two years without severe tensions and without devaluing. On the inflation criterion, I would like to be clear that, in line with the Treaty requirements, the reference value will be calculated on the basis of the three best performing EU Member States in terms of inflation.

EU and euro area enlargement can be seen as a process that is mutually beneficial for all parties involved as it is expected to foster economic and financial integration among the Member States. Currently the new EU Member States exchange around 55% of their total exports and imports with the euro area. Also, financial integration has advanced strongly in recent years, with around 80% of FDI inflows in the new EU Member States currently originating from the euro area countries. Moreover, there are reasons to assume that further monetary integration will impact positively on economic growth in the new Member States. Besides lower transaction costs and the elimination of currency risks, the process of monetary integration is expected to act as a catalyst for sound macroeconomic policies, which is assumed to be conducive to economic growth in the region as a whole. Yet, the size of these effects and their time profile seem to be uncertain. Moreover, it needs to be borne in mind that enlargement, in particular euro area enlargement, could also bear some risks if a country were to rush too quickly to join the euro area. To illustrate this point let me return to sporting imagery. While it is fully understandable for a young, ambitious and talented sportsperson to want to join the champion's league as soon as possible, this person might sometimes be better off taking a bit more time for training in order to further develop and strengthen his talents in a favourable environment. When he joins the Champions League team, the rules are strict and the flexibility for playing one's own strategy is limited. This might dampen his performance. Coming back to the euro area, I am convinced that the various stages of the road to the euro as stipulated by the Maastricht Treaty can offer talented aspirants excellent "training opportunities" to perform even better at a later stage.

Experience with the new member states on their way to adopting the euro

Let me now turn to the experience that the new Member States have made so far on their way to the euro and look at whether any lessons can be drawn from them for Bulgaria. I would like to touch upon basically three issues that in my view are of key importance for the new Member States with respect to

their euro adoption plans, namely to preserve price stability, to advance with real convergence and to conduct sound fiscal policies.

- Let me start with the need to achieve and maintain **price stability**. Price stability is an essential requirement for a successful monetary integration process. At the same time, it could contribute to a more rapid catching-up process in real income levels by fostering trade and investment. Where do countries currently stand with respect to price stability? The new Member States have made significant progress in terms of disinflation in the past years, by bringing their average inflation rates close to that of the euro area. Yet, inflation developments in the new Member States continue to be rather volatile and diverse across countries. Following a substantial rise in inflation in the course of 2004, from on average 1.9% in 2003 to 4.1%, inflation moderated again to 2.5% in 2005. The pick-up in 2004 was mainly driven by factors related to EU accession [*such as higher food prices and increases in indirect taxes and administered prices*] and the strong increase in world energy prices. Looking ahead, while in some countries inflation is currently below the euro area level, inflation dynamics require high vigilance in some of the fastest growing countries.

This brings me to the issue of **real convergence**. The process of real economic convergence of the new and future Member States such as Bulgaria to the euro area, i.e. their catching-up in standards of living with those of the euro area, will remain one of their most important economic developments in the coming years. Although remarkable progress has been made in the past in terms of catching-up, most of the countries display GDP per capita and price levels which are still considerably below those of the euro area. In 2004, the average GDP per capita level, as expressed in purchasing power standards, was roughly half of that of the euro area. Catching-up in income levels is partially accompanied by a certain element of rise in price levels. Thus, the process of real convergence can be expected to continue to play a role in the inflationary developments in these countries. To limit the inflationary impact of real convergence, it is therefore crucial that policy-makers continue to pursue a policy directed towards macroeconomic stabilisation to avoid excessive domestic demand and the resulting price pressures in the countries concerned. Moreover, it underlines the need for structural reforms to limit nominal price and wage rigidities and to allow for improved supply-side conditions.

This brings me to the third issue that I wish to discuss briefly, namely the need to foster **fiscal consolidation** and achieve sound fiscal positions. Although the fiscal situation varies across countries, fiscal deficits are on average high or even very high in a number of new Member States. As I mentioned before, Bulgaria stands out as an example to the contrary. It is clear that fiscal consolidation is a major challenge for most of the new Member States. Their governments are confronted with competing expenditure demands, including *inter alia* public investment in infrastructure and the need to strengthen the effectiveness of public administration and the judicial systems. At the same time, in some of the new Member States, the fiscal deficits are largely of a structural nature, reflecting rather generous social benefits. High lasting fiscal deficits can be expected to be impediments to economic growth and to bear risks to the sustainability of the government debt levels in some countries. Consequently, policy-makers have to design and implement a credible consolidation path based on durable and growth-enhancing structural reforms in the public sector.

Conclusion

Let me conclude, first with a few words in French. *La Bulgarie a fait des progrès notables dans la poursuite d'une politique macro-économique de stabilité. Avec la caisse d'émission (currency board) vous vous êtes engagés dans une voie qui requiert parfois des choix difficiles. Grâce à la cohérence de votre politique, en particulier dans le domaine budgétaire, vous avez prouvé que vous êtes à la hauteur de la tâche. De plus, la Banque nationale bulgare a démontré sa capacité de coopération au sein du SEBC. En résumé, je crois que la Bulgarie s'est bien engagée dans la voie des efforts pour préparer son économie à l'entrée dans l'Union.*

Bulgaria has made noticeable progress in terms of conducting a stable macroeconomic policy. With the currency board, you have embarked upon a path that sometimes requires tough choices. Through policy-consistency, especially in the fiscal realm, you have shown you are up to the task. Moreover, the Bulgarian National Bank has demonstrated its capacity for cooperation with the ESCB. In short, I believe Bulgaria has correctly engaged itself in preparing its economy for EU entry.

I have also set out the process of monetary integration. There, I have emphasised the importance of playing along with the team and respecting the rules that come with each of the three stages of

integration. There are several challenges associated with the process of monetary integration, which I discussed. At the current juncture, the main challenge for Bulgaria with regard to nominal convergence will be price stability. I noted the importance of using structural policy, not temporary measures, to contain inflation. Amongst the other challenges that Bulgaria is presently facing, I would like to mention the level of the current account deficit and the rapidity of the growth of outstanding credit. All these challenges call for a high level of prudence in the fiscal policy - which I understand is the policy of the government - and a careful monitoring of the unit labour cost which is always of the essence in such circumstances.

In that context, I also touched upon the speed of entry. There, my main message is, do not worry about whether it will be quick or slow. The team is ready and happy to receive new members when they are ready and patient for them to become ready.

Thank you very much for your attention.