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Challenges to convergence in the larger EU

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1 Introduction

Thank you for inviting me to this important conference. In fact, all three roundtable topics highlight major aspects of the further integration of the European economies, of progress in terms of the Lisbon Agenda and, ultimately, of successful enlargement of monetary union.

EU enlargement last year was, above all, an administrative and political challenge. The economic challenge of the EMU enlargement still remains to be tackled.

European monetary union may be seen as a unique economic experiment surpassed, in terms of its historical importance, only by a handful of reforms.

One such reform project which is of even greater historical importance is the vast international experiment involving the simultaneous transformation of more than 30 former centrally planned economies into market economies. And now eight of them are members of the EU and are aiming to become members of monetary union as well.

And it is our task as central bankers to lay the groundwork for this further historical step of monetary unification through growing monetary integration.

2 State of convergence

At the core of our preparations is a uniform analytical framework for assessing the state of economic convergence. This framework has already been applied to the current member states of the Eurosystem.

The rationale behind the convergence criteria which are to be assessed every other year by the Eurosystem is that countries may join the euro area only if their participation is conducive to the maintenance of price stability and the viability of EMU. The convergence criteria form a coherent and integrated whole, so all of them must be met.

Looking at nominal convergence, it has to be admitted that the new member states have made considerable progress over the past few years. However, they still have a long way to go before they finally achieve entry into the euro area.

None of the countries in question formally meets the exchange rate criterion of participation in ERM II for 2 years at the moment. Three new member states have been participating in ERM II since 28 June 2004 on the basis of a unilateral commitment.

The aim of having a high level of sustained nominal convergence is not only a precondition for entering monetary union, it is also in the interests of every individual state.

It will also remain in their interests after entry into monetary union. We experienced the positive momentum generated by the systematic and credible consolidation of government budgets and the anchoring of inflation expectations at a low level prior to monetary union.

The new member states are just in the process of experiencing this. But the “convergence dividend” cannot be perpetuated by a declaration of political will. Entry into European monetary union has to be prepared in a credible manner.

In saying that, country-specific differences are possible and, given the great diversity that exists, necessary, too. Four of the ten new member states are practising active inflation targeting. Three are already members of ERM II. Two other countries are gearing their monetary policy to an exchange rate peg (to the euro and to a basket of currencies).

Ultimately, the crucial need is to pursue a credible stability-oriented policy. Falling inflation rates – and even falling inflation expectations – lead to a growing “convergence dividend” of lower long-term interest rates and greater investment certainty for enterprises.

Besides nominal convergence, it is also important to assess the degree of real convergence. This covers such topics as business cycle synchronisation, the degree of trade and financial integration, factor mobility as displayed in wage and price flexibility, and the risk of asymmetric shocks and the capacity to absorb them.

3 Interlinkages between monetary and fiscal policies

It is not least fiscal policy that benefits very considerably from the “convergence dividend”. Increased growth and a declining interest rate burden significantly widen the scope of fiscal policy action.

Fiscal policy thus benefits directly from a stability-oriented policy. But fiscal policy can and must also contribute to a stability-oriented policy.

Allow me to bring to mind the three fundamental reasons for limiting the general government deficits under the terms of the Stability and Growth Pact.

(1) In the long run, stable money can only exist if there are stable public finances. That applies, above all, to a monetary union in which the stability costs of government debt and deficits also have to be borne by others.

(2) Only budgets which are on average over the cycle balanced in surplus provide scope for the steadying influence of the automatic stabilisers and at the same to reduce long term debt levels.

(3) Not least, we have to counter the growing costs of government debt at an early stage. I am referring here to the existing explicit and implicit debt and to the fact that due account has to be taken of the dramatic demographic trends in an aging society.

Sound fiscal consolidation contributes directly to credible macroeconomic stabilisation.

If we look at the new member states, only two of them, in fact, show a level of debt above the reference value, but no fewer than six countries exceed the reference value for the budget deficit.

On top of this we have wittnessed a marked expansion of the level of public debt in most of the countries over the past eight years. If the current overall and primary deficit ratios were maintained, the two high debt new membercountries referred to above would move even further away from the 60% reference value. Three others would break the ceiling very soon. In the case of the remaining new member countries a continuation of the present deficit ratios would lead to a further rise in the debt ratio, even so they are today still confortably below the reference value.

It should also be pointed out that, on average, the new member states already maintain quite sizeable public sectors in relation to their levels of income. Possible pressure for additional government activity, given growing prosperity, would be likely to run counter to the countries' stability policy needs.

But we do not want to abandon hope. History, especially economic history, is an open process. Over the past 15 years, the new member states have achieved remarkable reforms. Even now, they are benefiting quite considerably from the "convergence dividend", which is based, not least, on the expectations of the international financial markets that with the prospect of joining EMU long run price stability can be achieved.

It is all the more regrettable that some of the existing members of monetary union are tending to set a bad example in terms of government deficits. Not only are they breaking the rules: even worse, having broken the rules, they now want the rules to be modified so that they can exonerate themselves.

This development may have a knock-on effect on monetary union's image and its credibility by underminding its institutional framework. EMU member states are about to risk the unexpected fiscal consolidation success of the convergence process in the years leading up to monetary union.

As you all know the ongoing discussions about the Stability and Growth Pact are reaching their final stage in these days. The head of states and governments and the finance ministers of the EU are planning to finalise the so called "reform package" until the end of this month. In my view the discussions need to be brought to an convincing conclusions with an outcome that safeguards fiscal discipline.

I do not want to comment on the ever changing proposals that have been circulated in Brussels during the last days. But let me emphasise that the Governing Council takes note of the assessment of ministers that the preventive arm of the pact and the governance structure of the pact could be strengthened. The implementation of changes in the preventive arm, however, need to remain clear and transparent so as to preserve fiscal discipline and equal treatment across countries.

The Governing Council is concerned about the changes to the corrective arm. By allowing a more lenient implementation of the Excessive Deficit Procedure, there is a risk that the 3% nominal deficit limit will be diluted. This could undermine confidence in sound public finance in the euro area Member States. The credibility of the excessive deficit procedure needs to be fully preserved. It is essential that Member States pursue fiscal policies that ensure the sustainability of public finances. The fiscal framework enshrined in the Treaty and the Stability and Growth Pact is a cornerstone of Economic and Monetary Union and thus key for anchoring expectations of fiscal discipline. It must be maintained.

The public can be assured that the Governing Council remains staunchly committed to maintaining price stability.

4 General challenges ahead

I hope that the new member states will not be perturbed by this. They must not weaken in their convergence efforts. As positive as the impact of the “convergence dividend” is (reinforced by the convergence expectations), it should be absolutely clear to new member states that a divergence penalty reflecting divergence expectations and the fear of fiscal laxity would have an equally negative and devastating impact on economic performance.

There are considerable challenges facing the new member states in the non-fiscal sector, too.

Inflation rates will probably be put under upward pressure by the Balassa-Samuelson effect owing to the process of catching-up with the other member states and by further convergence of administered prices to market levels.

Macroeconomic instabilities may also result from the high level of unemployment, which is largely structural, as well as high and rising unit labour costs. These factors deserve attention since the sustainability of the process of convergence hinges on a sound starting position and the policies pursued thereafter, which both influences the sustainability assessment of current policies.

In this context, let me briefly mention exchange rate policies. ERM II lends credibility to new member countries owing to the implied protection of the Eurosystem. However, vulnerabilities for the new member states remain. These stem mainly from rapid credit growth, the large debt denominated in foreign currencies, the current account deficits and the rapid worsening of their international investment position. Therefore, in tackling exchange rate risks, new member states should be keen to ensure sound public finances, stable financial systems, and macroeconomic stability.

Summing up, I would like to point out that successfully coping with the growing diversity of the EU economy after enlargement requires that monetary, fiscal and economic policy fulfil their respective tasks. To my mind, the large burden of public finances and the excessive deficits deserve our special attention and decisive action by fiscal authorities.

Countries inside and outside EMU must adhere to the Stability and Growth Pact. I do hope that the continuing fiscal laxity and reluctance to undertake structural reforms in the current euro area will not undermine the discipline needed for convergence in the hitherto successful new member states.

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