

Challenges for economic convergence

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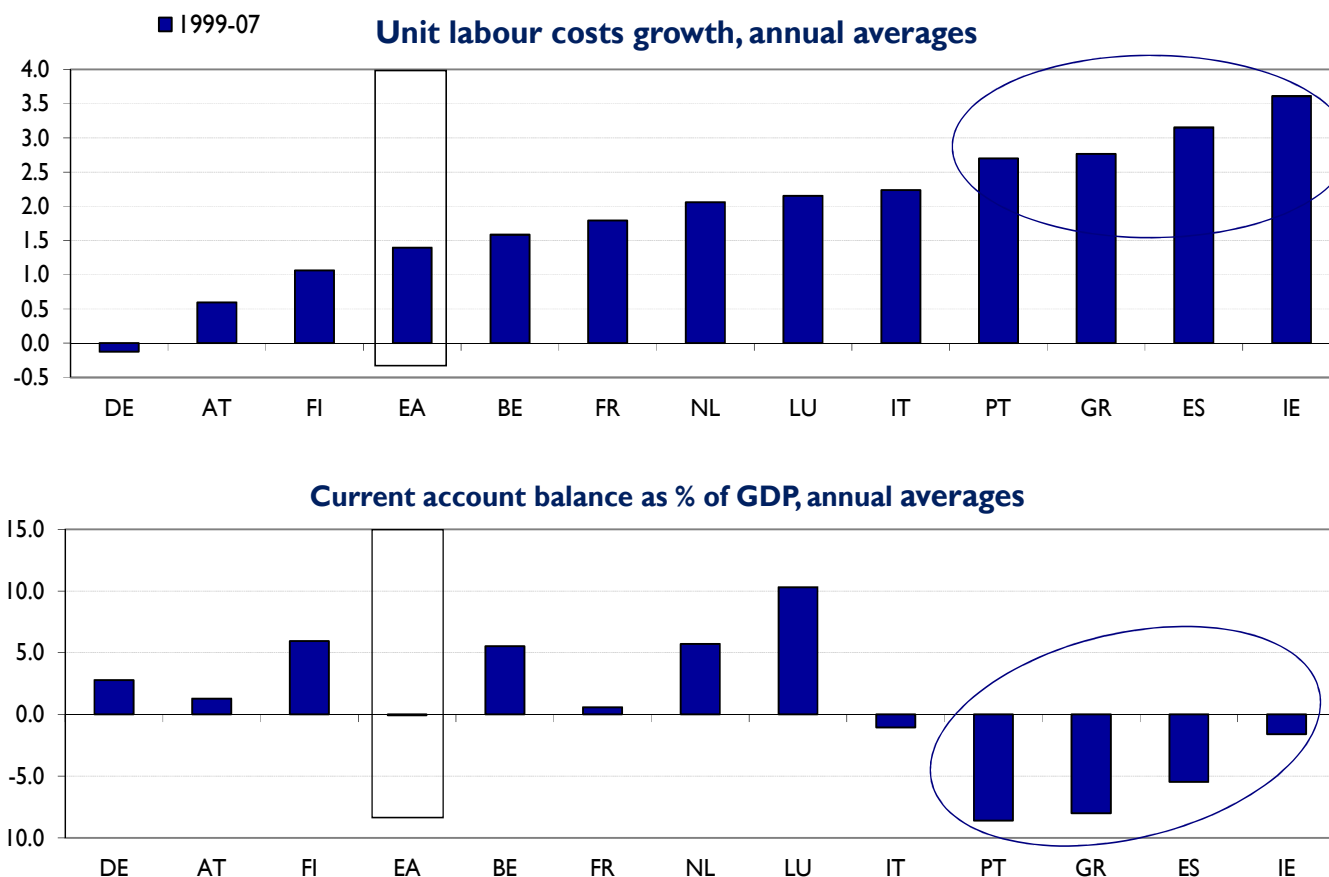
Outline

- 1 Lessons from the euro area sovereign debt crisis**
- 2 The experience in non-euro area countries**
- 3 Benefits and risks of euro adoption**
- 4 The ECB's 2012 Convergence Report**
- 5 Conclusions**

I Lessons from the euro area sovereign debt crisis

I.1 Unit labour costs and current account

Rapid convergence in terms of financial conditions and overly optimistic income expectations contributed to macro-economic and financial imbalances gradually accumulating.



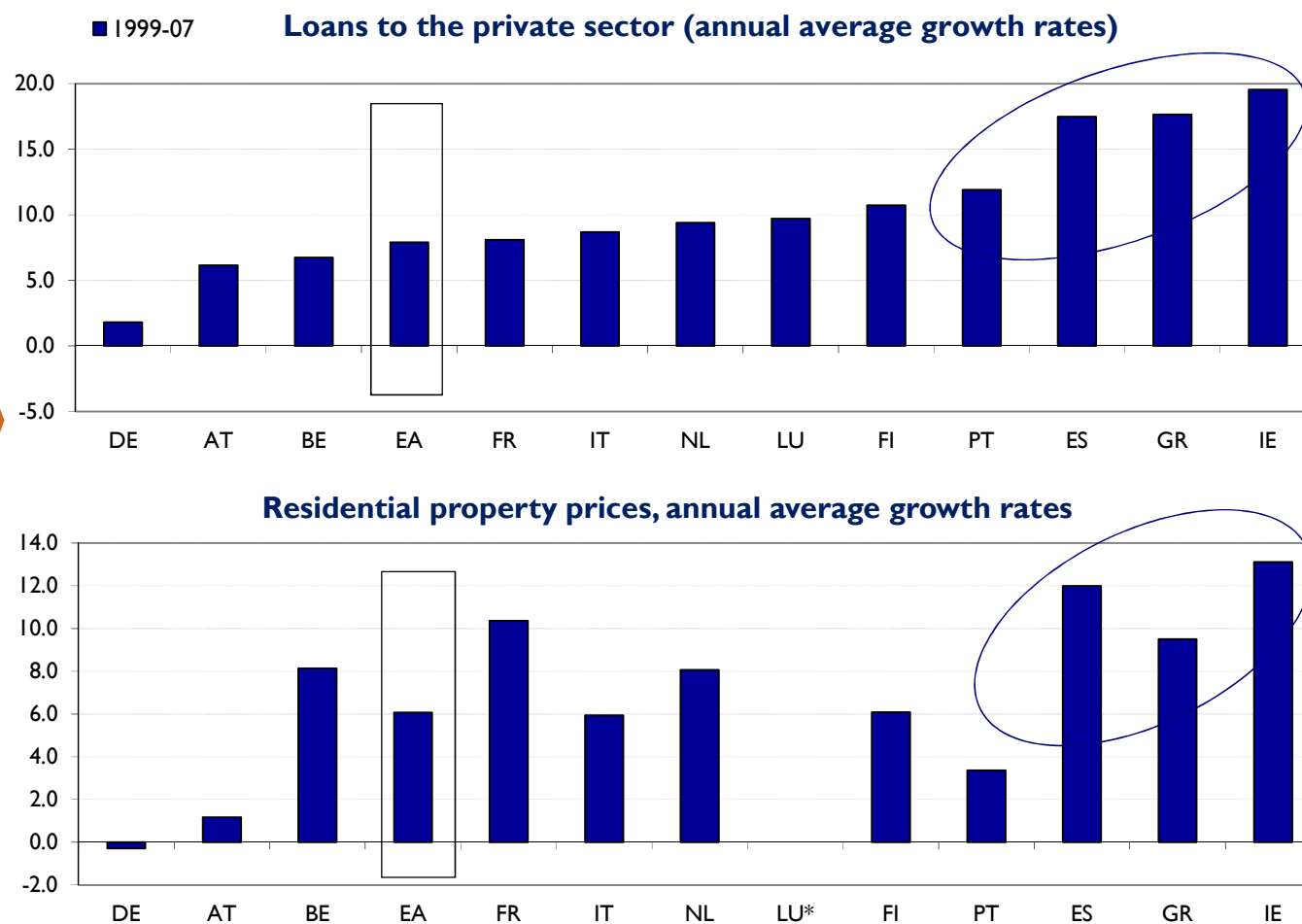
Source: Eurostat and European Central Bank.

Note: Countries are ranked in ascending order according to the average unit labour costs growth in 1999-2007.

I Lessons from the euro area sovereign debt crisis

I.2 Loans to private sector and house prices

Persistently low “real” interest rates in some countries supported strong credit growth and housing booms.



Sources: Eurostat and European Central Bank.

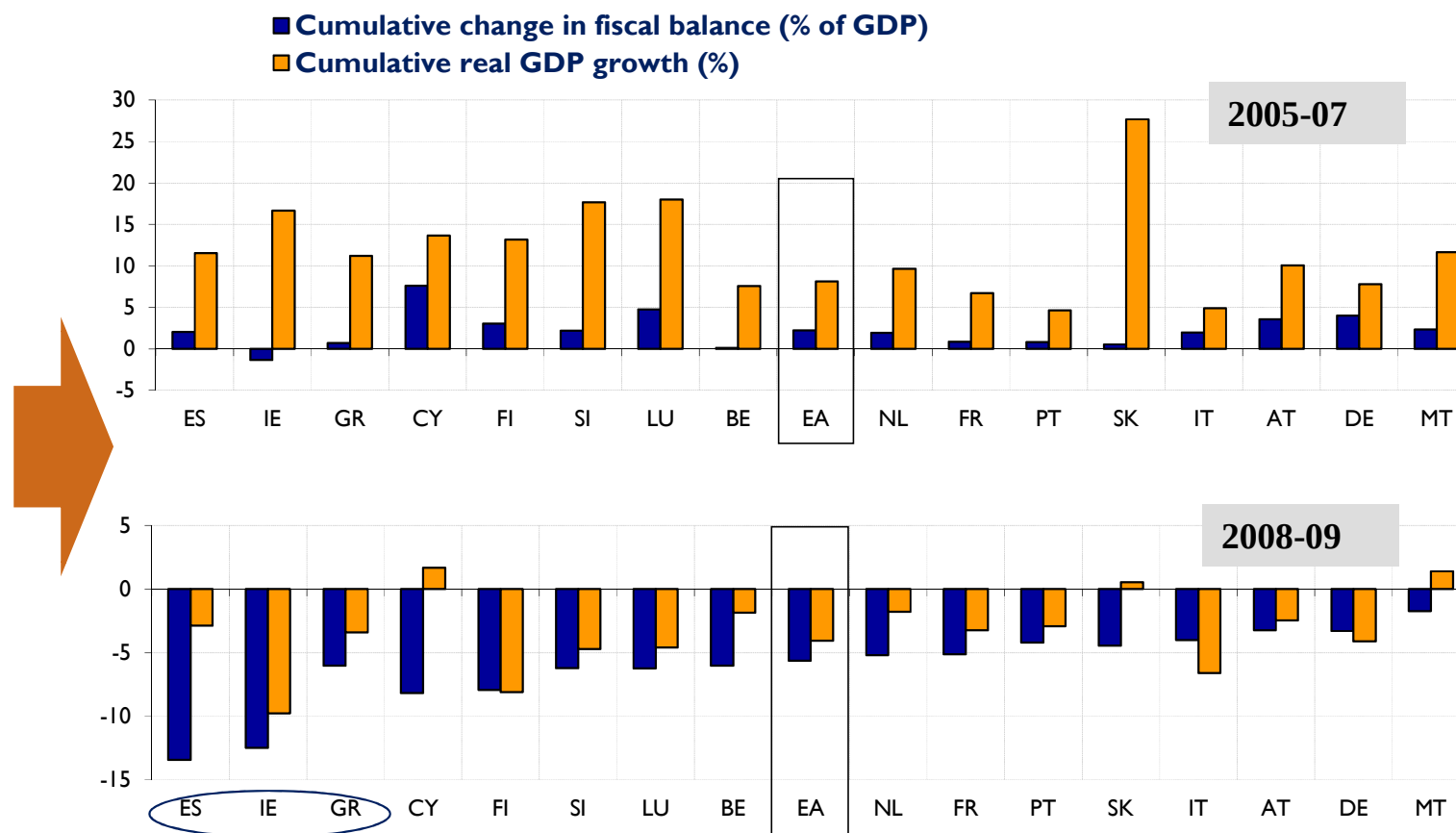
Note: Countries are ranked in ascending order according to the average loans growth in 1999-2007. *House prices data for Luxembourg not available.

I Lessons from the euro area sovereign debt crisis

I.3 Fiscal policy

During the boom period insufficient fiscal buffers were built up.

When the crisis came, public finances deteriorated markedly.



Sources: European Commission and Eurostat.

Note: Countries are ranked according to the change in the fiscal position over the period 2008-09.

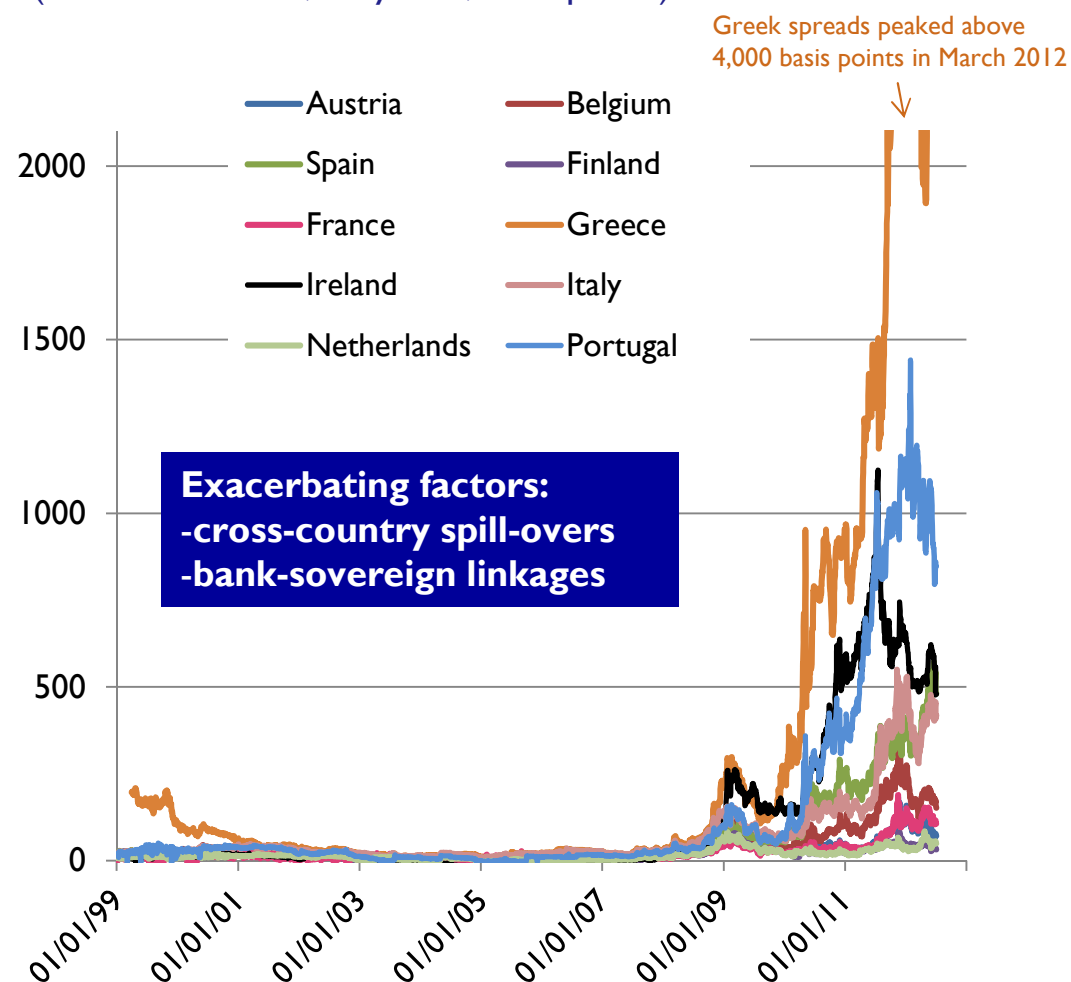
I Lessons from the euro area sovereign debt crisis

I.4 Imbalances are now painfully exposed



10-year government bond spreads

(vs. German bond; daily data; basis points)



I Lessons from the euro area sovereign debt crisis

I.5 Some lessons

- **Insufficient attention was paid to economic imbalances and vulnerabilities**
- **Fiscal policy surveillance was not effective**
- **Financial markets failed to induce discipline**



New EU economic governance framework was put in place to ensure sound fiscal policies and to avoid the emergence of economic imbalances in the future

Outline

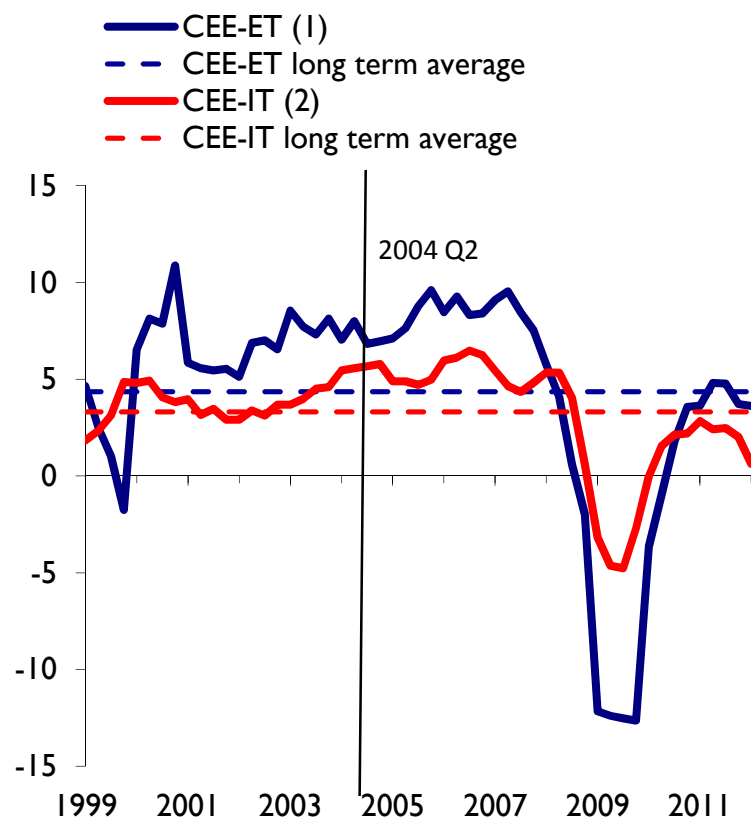
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2 The experience in non-euro area countries

2.1 Economic activity more volatile in fixed exchange rate countries...

Real GDP growth

(quarterly data; percentages)



Source: Eurostat.

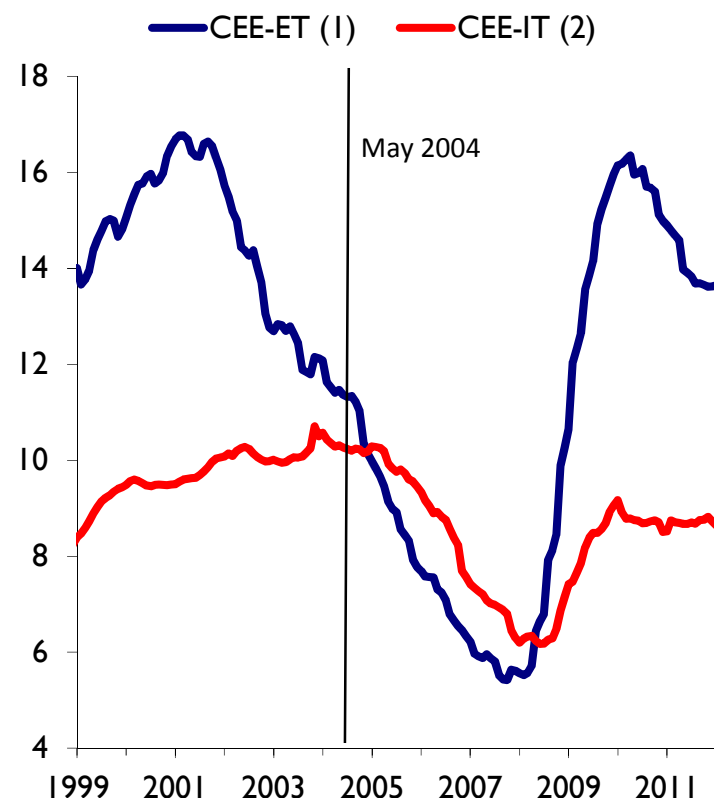
Note: Last observation: 2012 Q1. Long term average refers to 1999Q1-2012Q1.

(1) Average of exchange rate targeting countries (Bulgaria, Latvia, Lithuania).

(2) Average of inflation targeting countries (Hungary, Poland, Czech Republic, Romania).

Unemployment

(monthly data; % of labour force)



Source: Eurostat.

Note: Last observation: May 2012 for CEE-IT and March 2012 for CEE-ET.

(1) Average of exchange rate targeting countries (Bulgaria, Latvia, Lithuania).

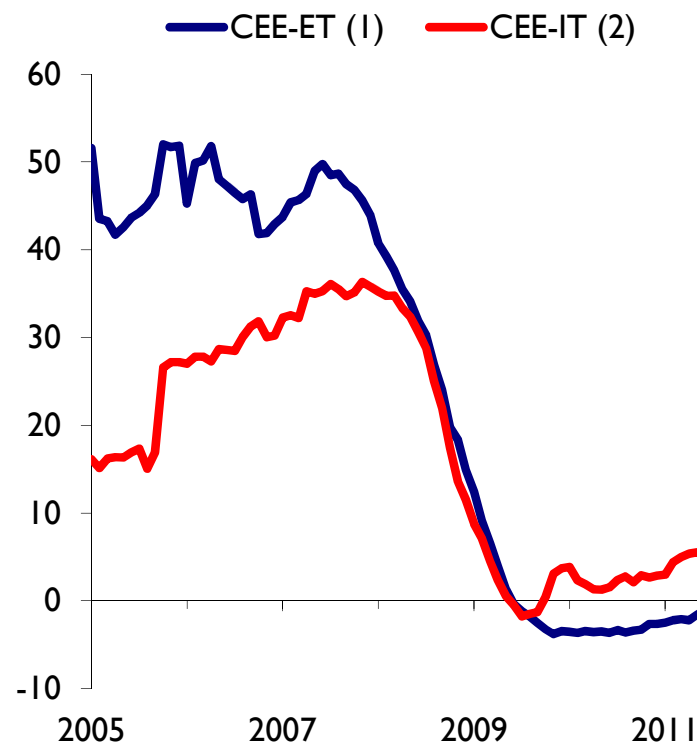
(2) Average of inflation targeting countries (Hungary, Poland, Czech Republic, Romania).

2 The experience in non-euro area countries

2.2 ...reflecting domestic boom-bust cycles...

Credit to the private sector

(monthly data; year-on-year percentage changes)



Source: European Central Bank.

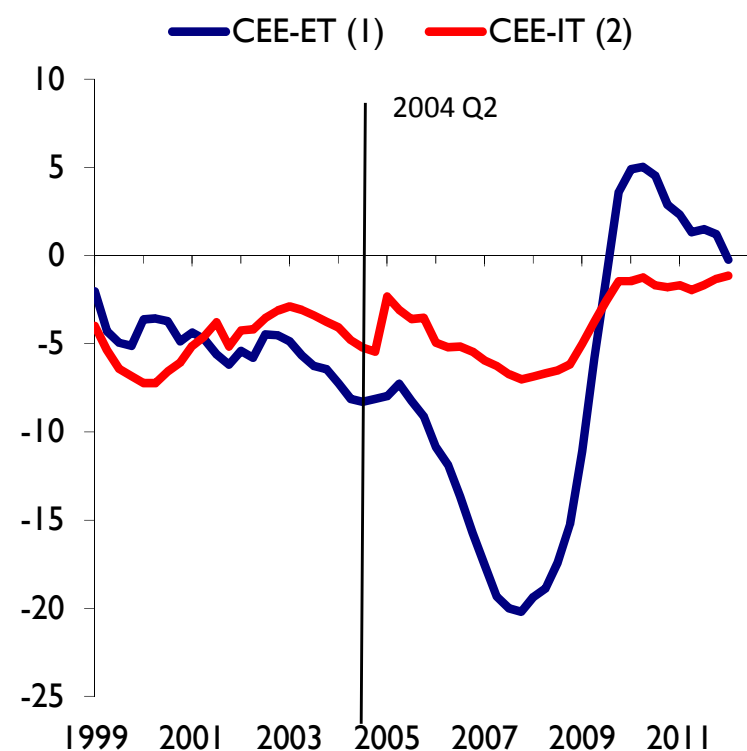
Note: Last observation: April 2012.

(1) Average of exchange rate targeting countries (Bulgaria, Latvia, Lithuania).

(2) Average of inflation targeting countries (Hungary, Poland, Czech Republic, Romania).

Current account balance

(quarterly data; percentage of GDP)



Sources: Eurostat and European Central Bank.

Note: Last observation: 2012 Q1.

(1) Average of exchange rate targeting countries (Bulgaria, Latvia, Lithuania).

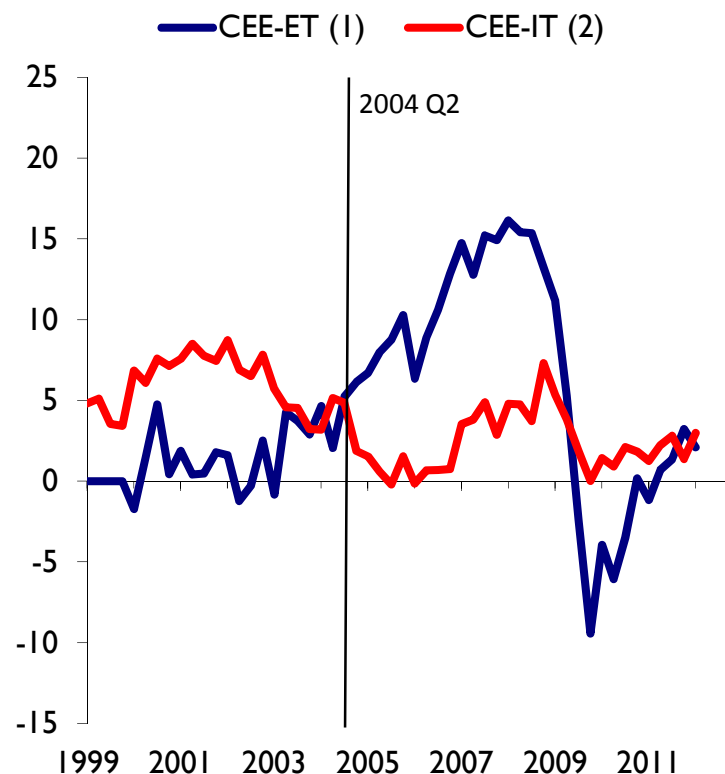
(2) Average of inflation targeting countries (Hungary, Poland, Czech Republic, Romania).

2 The experience in non-euro area countries

2.3 ... and leading to competitiveness losses, especially in CEE-ET countries

Unit labour costs

(quarterly data; year-on-year percentage change)



Source: Eurostat.

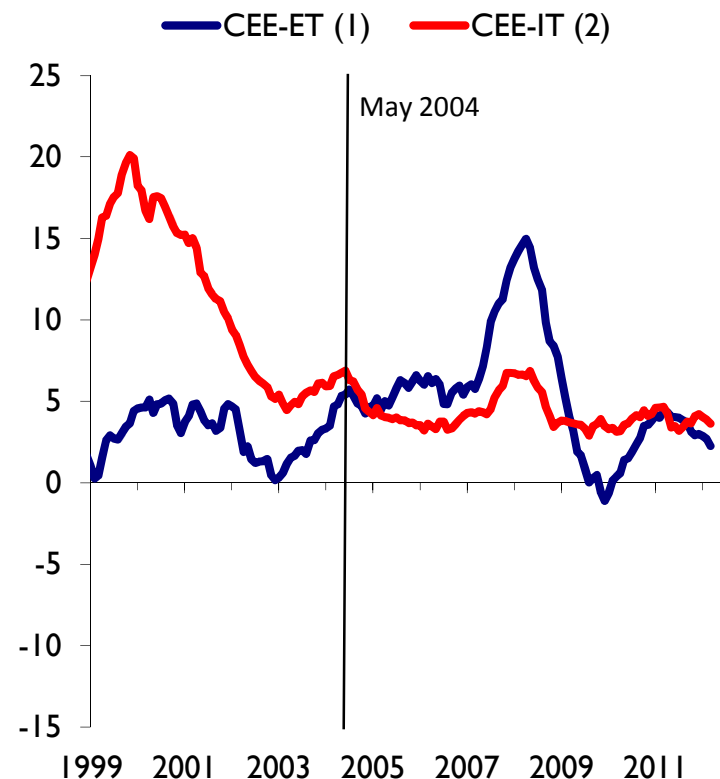
Note: Last observation: 2012 Q1.

(1) Average of exchange rate targeting countries (Bulgaria, Latvia, Lithuania).

(2) Average of inflation targeting countries (Hungary, Poland, Czech Republic, Romania).

Annual HICP inflation

(monthly data; year-on-year percentage change)



Source: Eurostat.

Note: Last observation: May 2012.

(1) Average of exchange rate targeting countries (Bulgaria, Latvia, Lithuania).

(2) Average of inflation targeting countries (Hungary, Poland, Czech Republic, Romania).

2 The experience in non-euro area countries

2.4 Some lessons

I Fixing the exchange rate poses challenges

- Boom/bust cycles may be difficult to contain in the absence of an independent monetary policy, especially in countries with large catching-up potential
- With fixed exchange rates, other policy areas must provide the economy with the ability to cope with country-specific shocks and avoid the emergence of macroeconomic imbalances
- But support from other policies is also needed in inflation targeting countries

2 “Internal devaluation” can work

- Downward price and wage flexibility
- Front-loaded fiscal adjustment
- Strong national ownership

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3. Benefits and risks of euro adoption

3.1 Benefits

a) For the individual country:

- stable exchange rates in relation to most important trading partners → reduced transaction/information costs → increased trade and financial integration
- price transparency → increased competition
- credible framework for monetary policy and price stability = one of the preconditions for low risk premia and low long-term interest rates

b) For the euro area:

- completion of the internal market for goods, services, labour and capital

3. Benefits and risks of euro adoption

3.2 Risks

a) For the individual country:

- differences in business cycles/potential growth may lead to “suboptimal” interest rates in the national context and the emergence of local boom-bust cycles
- unless convergence is sustainable, a country can run into competitiveness problems
- without sufficient flexibility to adjust to changes in competitiveness/shocks, risks of protracted economic weakness.

b) For the euro area:

- could affect the credibility of EMU in case of lack of convergence.

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4 ECB 2012 Convergence Report

4.1 Legal provisions

Treaty Article 140 and Protocol 13

Convergence Reports shall examine the achievement of a high degree of sustainable convergence of Member States with a derogation by reference to the fulfilment of the following criteria:

- A high degree of **price stability**;
- Sustainability of the **government financial position**;
- Observance of the normal fluctuation margins of the **ERM II**;
- The durability of convergence being reflected in **long-term interest rate** levels

In addition, the reports take into account **other relevant factors**, such as the integration of markets, unit labour costs and balance of payments developments

Convergence Reports shall include an examination of the compatibility between the national legislation of each of these Member States, including the statutes of its national central bank, and Articles 130 and 131 of the Treaty and the Statute.

4 ECB 2012 Convergence Report

4.2 Link to lessons from euro area sovereign debt crisis

- 1 New features of **EU economic governance framework** are to be taken into account in the convergence assessment

e.g. Countries subject to an “**Excessive Imbalance Procedure**” can hardly be considered as having achieved a high degree of sustainable convergence

- 2 Strong **governance** and sound **quality of institutions** (incl. statistics) do matter

These factors provide relevant information to assess whether integration into the euro area is likely to be sustainable over time but do not constitute new or additional convergence criteria.

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5 Conclusions

- **Adoption of the euro requires a high degree of sustainable convergence, i.e. more than fulfilling the convergence criteria at one point in time.**
- **Maintaining sound fiscal positions is a key requirement for a smooth participation in the euro area.**
- **Countries willing to adopt the euro need flexible adjustment mechanisms for preventing and correcting any macroeconomic imbalances.**
- **The strict implementation of the EU macroeconomic governance framework will be essential to ensure the smooth functioning of EMU.**