Euro area enlargement: The convergence criteria in practice

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Outline

- The pre-ERM II phase
- Exchange Rate Mechanism II
- The formal enlargement process – role of the ECB
- The economic convergence criteria and the state of convergence
- Key policy challenges in the run-up to euro adoption
The road to the euro

(as stipulated in the Treaty)

1. Accession to the EU
2. Entry into ERM II
3. Optional: Pre-ERM II phase
4. ERM II membership
5. ERM II membership Technical preparations
6. Assessment of convergence, formal decision on entry and conversion rate
7. Adoption of the euro
The pre-ERM II phase

- Member States are expected to direct policies towards achieving the preconditions to join the euro area. This includes ERM II participation at some stage.

- Member States participate in EU economic policy coordination and surveillance procedures; inter alia they need to prepare Convergence Programmes.

- Exchange rate policy to be treated as a matter of common interest. Real exchange rate misalignments and excessive nominal exchange rate fluctuations should be avoided.
Main features of ERM II

- System of fixed but adjustable exchange rates vis-à-vis the euro with a standard fluctuation band of ±15%
- The central rate and the fluctuation bands are mutually agreed
- Both the ECB and the Member State concerned can trigger a review of the central parity
- Not a ‘waiting room’ but a ‘training room’ to foster convergence. Fixed exchange rates increase the need for credible policies
• Considerations relating to ERM II entry
  – Case-by-case assessment based on equal treatment
  – Major policy adjustments (e.g. foreign exchange market and price liberalisation) to be undertaken prior to entry
  – Need to follow credible and appropriate fiscal policy
  – Labour and product markets need to be flexible in order to reduce the pressure on inflation to adjust to shocks and changes in the economic environment
  – The central rate should be close to the equilibrium value
  – New members are asked to undertake policy commitments
• Length of participation
  – Minimum two-years prior to a (positive) convergence examination
  – No restrictions on length of participation beyond minimum period
  – Length of participation should be assessed on the basis of what is most helpful to accompany the convergence process
The road to the euro

(as stipulated in the Treaty)

- **Accession to the EU**
- **Entry into ERM II**
- **ERM II membership**
- **ERM II membership Technical preparations**
- **Adoption of the euro**

**Optional:**
- Pre-ERM II phase

**Assessment of convergence, formal decision on entry and conversion rate**
Formal enlargement process - role of the ECB

• Every second year, or at the request of a country, the ECB and the European Commission report on the state of convergence in their Convergence Reports

• Case-by-case examination based on the convergence criteria and the principle of equal treatment (DK and UK have opt-out)

• Based on such examinations and on a proposal by the Commission, the (ECOFIN) Council decides which countries fulfil the conditions needed for adopting the euro

• The Council will also decide the conversion rate at which the national currency will be replaced by the euro (based on a proposal by the Commission and after consulting the ECB)
Principles underlying the ECB’s convergence report

Convergence criteria:

• **Strict interpretation**

• **All criteria must be satisfied (no hierarchy)**

• **Criteria must be met on the basis of actual data**

• **To be achieved on a lasting basis (sustainability)**
  
  – A range of backward and forward-looking economic indicators are used to assess sustainability.

  – Sustainability depends on a sound starting position and appropriate policy responses to existing and future challenges.
Convergence criteria

• Convergence (Maastricht) criteria for examining economic convergence, as laid down in Article 121 of the Treaty:
  – Price stability
  – Fiscal position (general government deficit and debt)
  – Exchange rate
  – Long-term interest rate

• In addition, “legal convergence” (i.e. compatibility of national legislation) is examined
Convergence criteria: price stability

The criterion on price stability

“the achievement of a high degree of price stability;
this will be apparent from a rate of inflation which is
close to that of, at most, the three best performing
Member States in terms of price stability”

- Reference value: average HICP inflation rate of, at most, three best performing EU Member States + 1.5 percentage points
State of convergence – price stability

HICP inflation (12 months average annual percentage change)

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>9.4%</td>
<td>8.3%</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>4.4%</td>
<td>3.7%</td>
</tr>
<tr>
<td>Estonia</td>
<td>8.3%</td>
<td>6.8%</td>
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<tr>
<td>Latvia</td>
<td>12.3%</td>
<td>11.2%</td>
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<td>9.3%</td>
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<tr>
<td>Hungary</td>
<td>7.5%</td>
<td>4.4%</td>
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<td>Poland</td>
<td>3.2%</td>
<td>4%</td>
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<tr>
<td>Romania</td>
<td>5.5%</td>
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<tr>
<td>Sweden</td>
<td>2%</td>
<td>2.8%</td>
</tr>
<tr>
<td>Ref. Value</td>
<td>3.2%</td>
<td>3%</td>
</tr>
</tbody>
</table>

%
The criterion on the government budgetary position

“the sustainability of the government financial position...will be apparent from having achieved a budgetary position without a deficit that is excessive...”

- Reference value: the ratio of the government deficit to GDP should not exceed 3%.
  (unless the ratio has declined substantially and come close to the reference value, or the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value)

- Reference value: the ratio of government debt to GDP should not exceed 60%.
  (unless the ratio is sufficiently diminishing and approaching the reference value)
State of convergence – government balances

General government surplus or deficit (in % of GDP)

<table>
<thead>
<tr>
<th>Country</th>
<th>May 2008 CR (left axis)</th>
<th>EDP 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>3.4</td>
<td>1.5</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>-1.6</td>
<td>-1.5</td>
</tr>
<tr>
<td>Source: Estonia</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Latvia</td>
<td>-3</td>
<td>-4</td>
</tr>
<tr>
<td>Lithuania</td>
<td>-3.2</td>
<td>-3.2</td>
</tr>
<tr>
<td>Hungary</td>
<td>-5.5</td>
<td>-3.4</td>
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<tr>
<td>Poland</td>
<td>-2</td>
<td>-2</td>
</tr>
<tr>
<td>Romania</td>
<td>-2.5</td>
<td>-3.9</td>
</tr>
<tr>
<td>Sweden</td>
<td>-3.5</td>
<td>-5.4</td>
</tr>
<tr>
<td>Ref. Value</td>
<td>-3</td>
<td>-3</td>
</tr>
</tbody>
</table>
State of convergence – government debt

General government debt (in % of GDP)

<table>
<thead>
<tr>
<th>Country</th>
<th>May 2008 CR</th>
<th>EDP 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>18.2</td>
<td>14.1</td>
</tr>
<tr>
<td>Czech Rep.</td>
<td>28.9</td>
<td>29.8</td>
</tr>
<tr>
<td>Estonia</td>
<td>3.5</td>
<td>4.8</td>
</tr>
<tr>
<td>Latvia</td>
<td>9</td>
<td>19.5</td>
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<tr>
<td>Lithuania</td>
<td>17</td>
<td>15.6</td>
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<tr>
<td>Hungary</td>
<td>65.8</td>
<td>73</td>
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<tr>
<td>Poland</td>
<td>44.9</td>
<td>47.1</td>
</tr>
<tr>
<td>Romania</td>
<td>12.7</td>
<td>13.8</td>
</tr>
<tr>
<td>Sweden</td>
<td>40.5</td>
<td>38</td>
</tr>
<tr>
<td>Ref. Value</td>
<td>60</td>
<td>60</td>
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</tbody>
</table>
Convergence criteria: exchange rate

The exchange rate criterion

“The observance of the normal fluctuation margins provided for the exchange rate mechanism of the EMS, for at least two years, without devaluing…”

– The ECB examines whether a Member State has participated in ERM II for at least two years prior to the examination without severe tensions, in particular, without devaluing its currency against the euro

– Focus is put on the exchange rate being close to the central rate against the euro, while also taking into account factors that may have led to an appreciation
## State of convergence - exchange rate: ERM II participation

(of those countries examined in the May 2008 Convergence Report)

<table>
<thead>
<tr>
<th>Country</th>
<th>Participation in ERM II with effect from</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>-</td>
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<tr>
<td>Czech Republic</td>
<td>-</td>
</tr>
<tr>
<td>Estonia</td>
<td>28 June 2004</td>
</tr>
<tr>
<td>Latvia</td>
<td>2 May 2005</td>
</tr>
<tr>
<td>Lithuania</td>
<td>28 June 2004</td>
</tr>
<tr>
<td>Hungary</td>
<td>-</td>
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<tr>
<td>Poland</td>
<td>-</td>
</tr>
<tr>
<td>Romania</td>
<td>-</td>
</tr>
<tr>
<td>Slovakia</td>
<td>28 November 2005</td>
</tr>
<tr>
<td></td>
<td>revaluation on 19 March 2007 and 29 May 2008</td>
</tr>
<tr>
<td>Sweden</td>
<td>-</td>
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</tbody>
</table>
Convergence criteria: long-term interest rate

The long-term interest rate criterion

“The durability of convergence achieved by the Member State and of its participation in the exchange rate mechanism of the EMS being reflected in the long-term interest rate levels”

– **Reference value:** average of long-term interest rates in the three best performing EU Member States in terms of price stability + 2 percentage points.
State of convergence – long term interest rates

Long-term interest rates (in %, annual average)

- Bulgaria: 4.7%
- Czech Rep.: 4.5%
- Latvia: 5.4%
- Lithuania: 4.6%
- Hungary: 6.9%
- Poland: 5.7%
- Romania: 7.1%
- Sweden: 4.2%
- Ref. Value: 6.5%

N.B. No comparable long-term interest rate is available for Estonia.
Key policy challenges in the run-up to euro adoption

• **Price stability**: challenging if structural, cyclical and external factors interact (e.g. Lithuania in 2006): **Strong domestic demand; external price shocks** (e.g. energy and food prices); **transition-related inflation** (e.g. price liberalisation and administered price changes) and **catch-up factors** (price level convergence, BS-effect). **Less of a problem in the coming years?**

• **Fiscal position**: **long-term fiscal prudence** indispensable to avoid internal and external imbalances and to create buffers for crises, in particular in ERM II and after euro area entry. **Can become key obstacle if current crisis is long-lasting!**
Key policy challenges in the run-up to euro adoption

- **Exchange rate**: real convergence can lead to upward exchange rate pressure (e.g. Slovakia 2007/08). Central and conversion rates should be close to equilibrium – but this is hard to estimate. *Devaluations may occur and how should IMF/EU ‘rescue’ packages be interpreted?*

- **Long term interest rates**: not a major hurdle in the past. *Will it become a ‘biting’ criterion in the future?*

- **Structural reforms**: continued product and labour markets reforms needed to increase flexibility and ensure sustainable economic expansion. *Should be a crucial point - but it is not in the treaty!*
Thank you for your attention!
ECB Convergence Reports – past and future

- 2004 – covering 10 Member States that joined the EU in May 2004 as well as Sweden
- May 2006 – covering Lithuania and Slovenia, special report on request of these countries
- December 2006 – covering the remaining nine Member States with derogation
- May 2007 - covering Cyprus and Malta, special report on request of these countries
- May 2008 – covering 10 Member States that joined the EU in May 2004 respectively January 2007 as well as Sweden
- 2010 – next regular report (same coverage as in May 2008 minus Slovakia)

CRs and other relevant material available at www.ecb.europa.eu
Convergence criteria: legal compatibility

Relevant ‘acquis communautaire’ required before accession

- Independence of the central bank
- Prohibition of direct financing of the public sector
- Prohibition of privileged access of public authorities to financial institutions
- Completion of the liberalisation of capital movements

Assessment in the Convergence Reports

- Article 108: central bank independence
- Article 109: legal convergence

The examination focuses on two areas:

- Central bank objective: primacy should be given to price stability
- CB statutes need to comply with ESCB requirements and other relevant legislation
Benefits of euro adoption

For the individual country:

- stable exchange rates in relation to most important trading partners;
- reduced transaction/information costs;
- credible framework for monetary policy and price stability = low risk premia and low long-term interest rates.

For the euro area:

- completion of the internal market for goods, services, labour and capital.
Risks of premature euro adoption

For the individual country:
- differences in business cycles may lead to “suboptimal” interest rates in the national context and the emergence of local “bubbles”/ “crises”;
- 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 losses.

For the euro area:
- could affect the credibility of EMU in case of lack of convergence.