EUROPEAN CENTRAL BANK

EUROSYSTEM

Euro area convergence & enlargement

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Central Banking Seminar

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With input by I. Pablos Nuevo

Agenda

1 Real convergence in the euro area – developments and challenges

2 Drivers of real convergence

3 The euro adoption process

4 Key elements of the ECB’s convergence assessment

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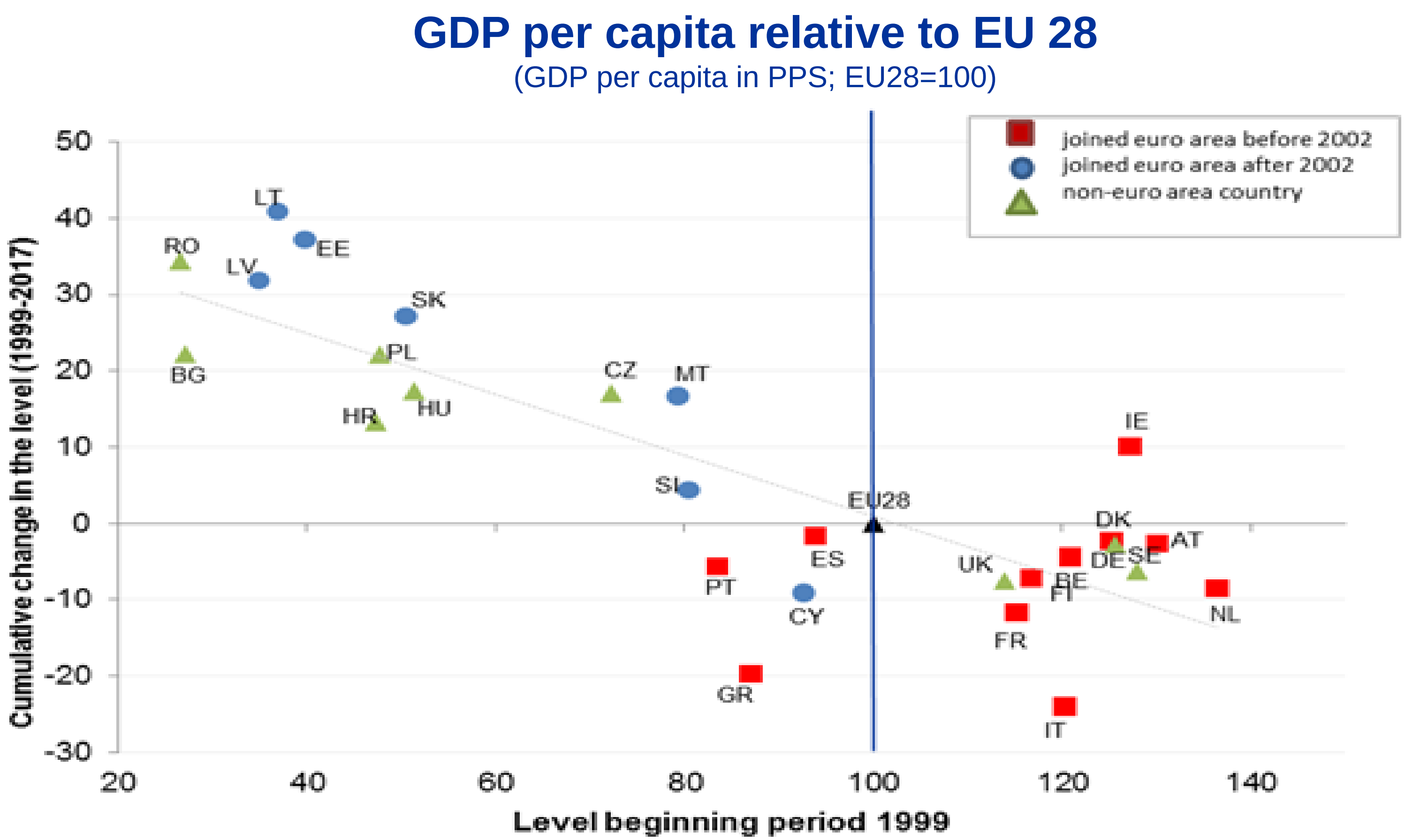
Real convergence in the EU since 1999



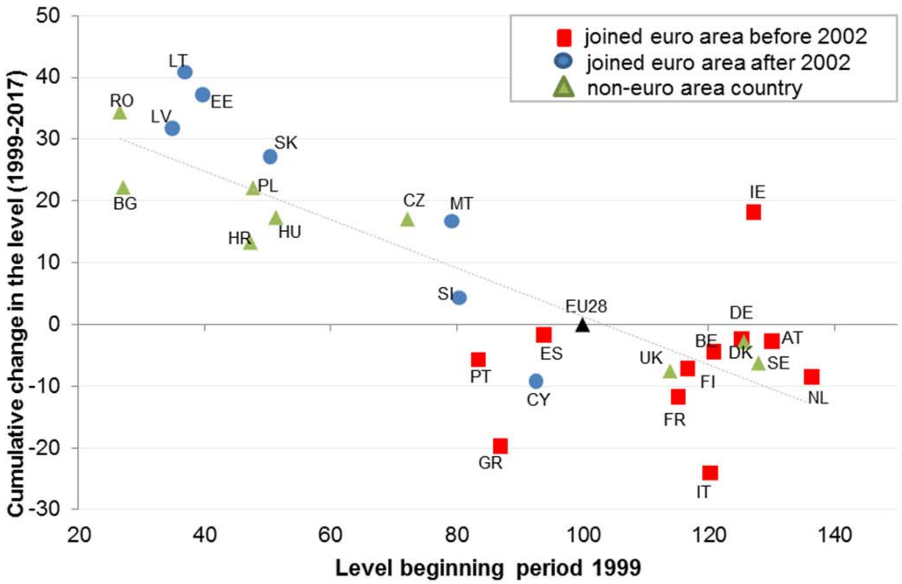
Source: European Commission and ECB staff calculations.
Notes: Luxembourg is excluded because GDP per capita computations are distorted by the high number of cross-border workers. Data for Ireland are adjusted to control for the exceptional GDP revision made for the year 2015, which did not reflect an actual increase in economic activity.

Real convergence before and after the crisis

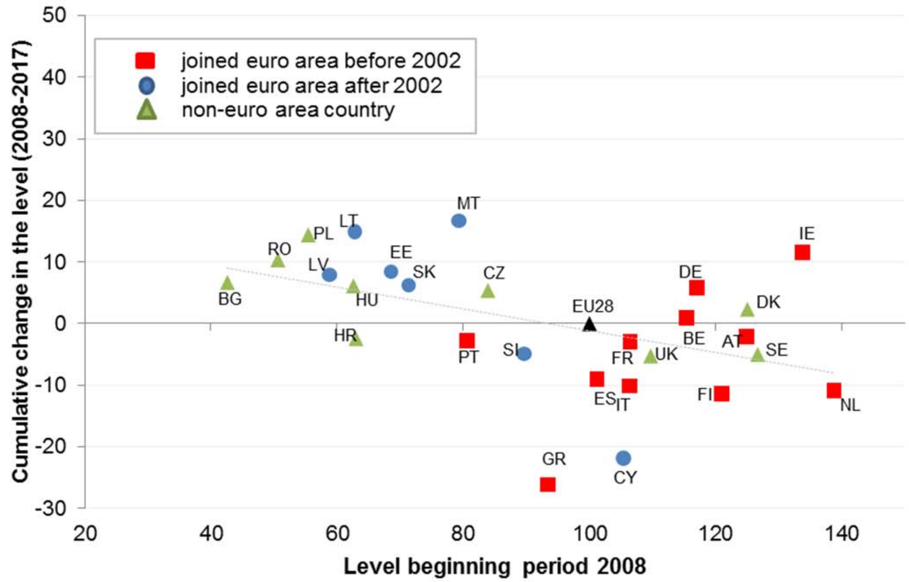
GDP per capita relative to EU 28

(GDP per capita in PPS; EU28=100)

Pre-crisis period (1999-2007)



Post-crisis period (2008 – 2017)

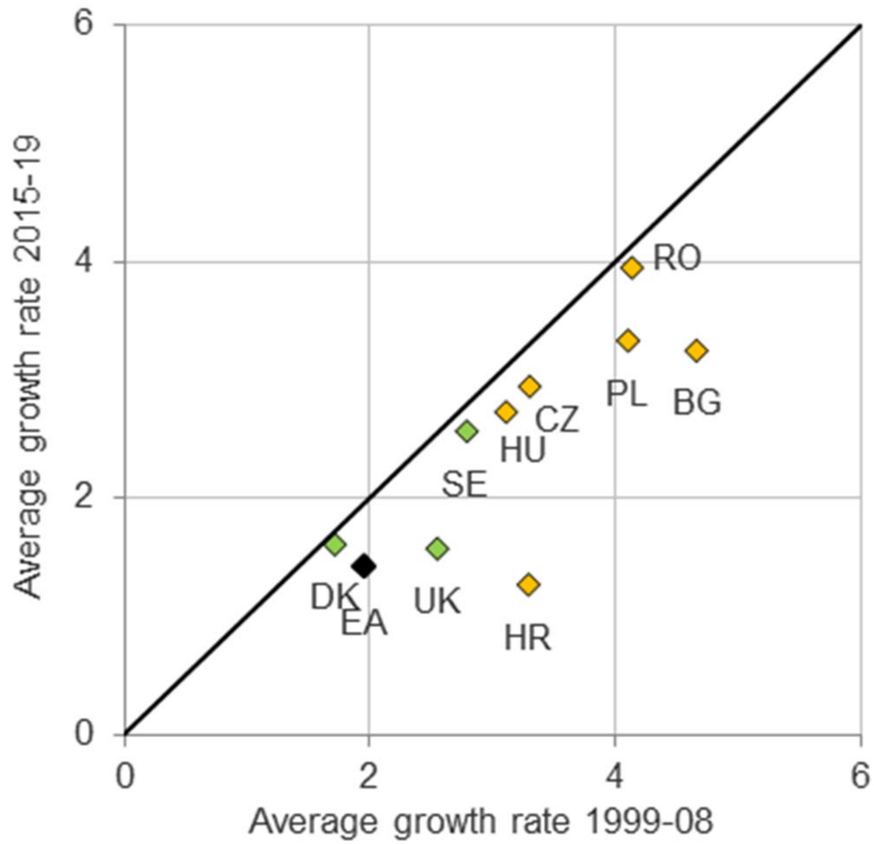


Source: European Commission and ECB staff calculations.
Notes: Luxembourg is excluded because GDP per capita computations are distorted by the high number of cross-border workers. Data for Ireland are adjusted to control for the exceptional GDP revision made for the year 2015, which did not reflect an actual increase in economic activity.

Potential output growth stays below pre-crisis levels

Potential output estimates

(% change compared with the previous year, 2010 market prices)



Source: EC Spring 2018 economic forecasts.
Note: Data for HR start in 2002.

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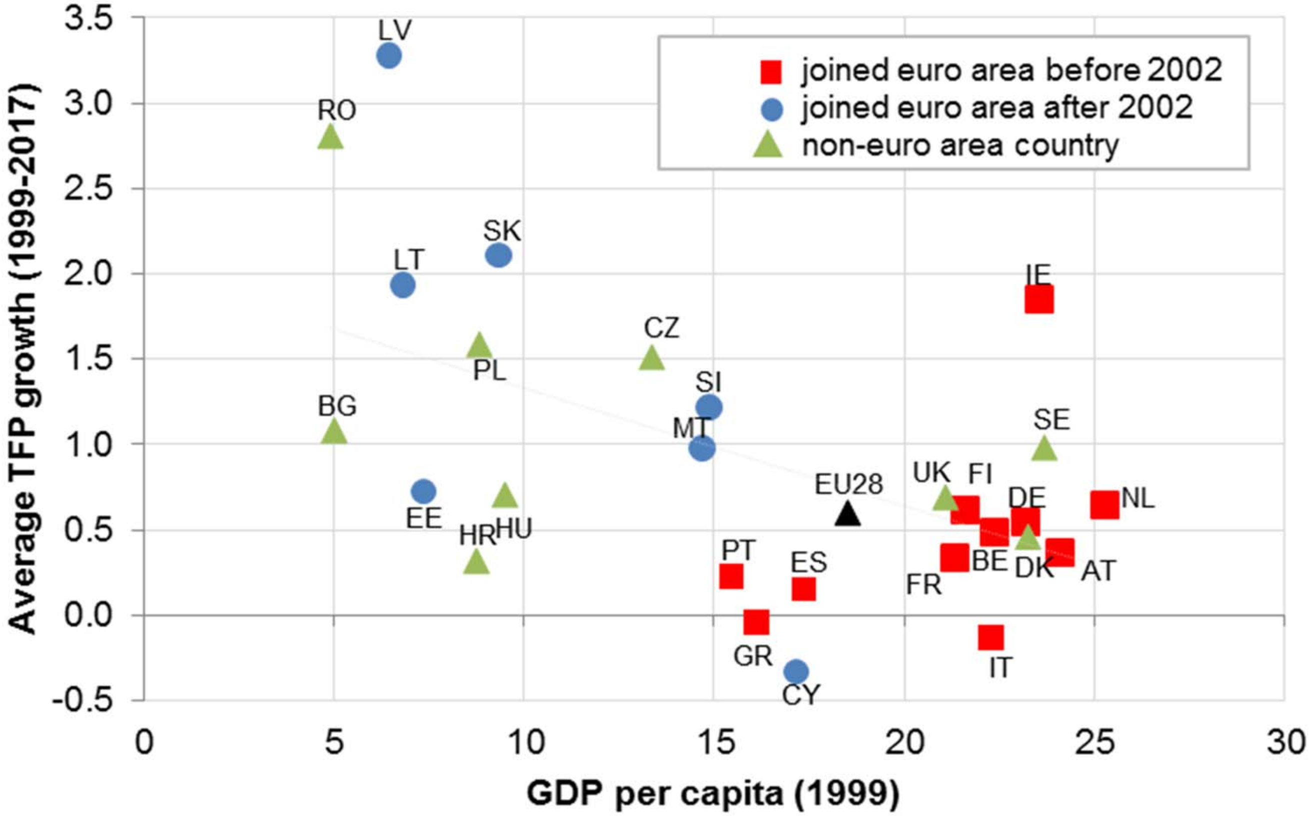
The role of productivity growth in the convergence process

GDP per capita and average TFP growth

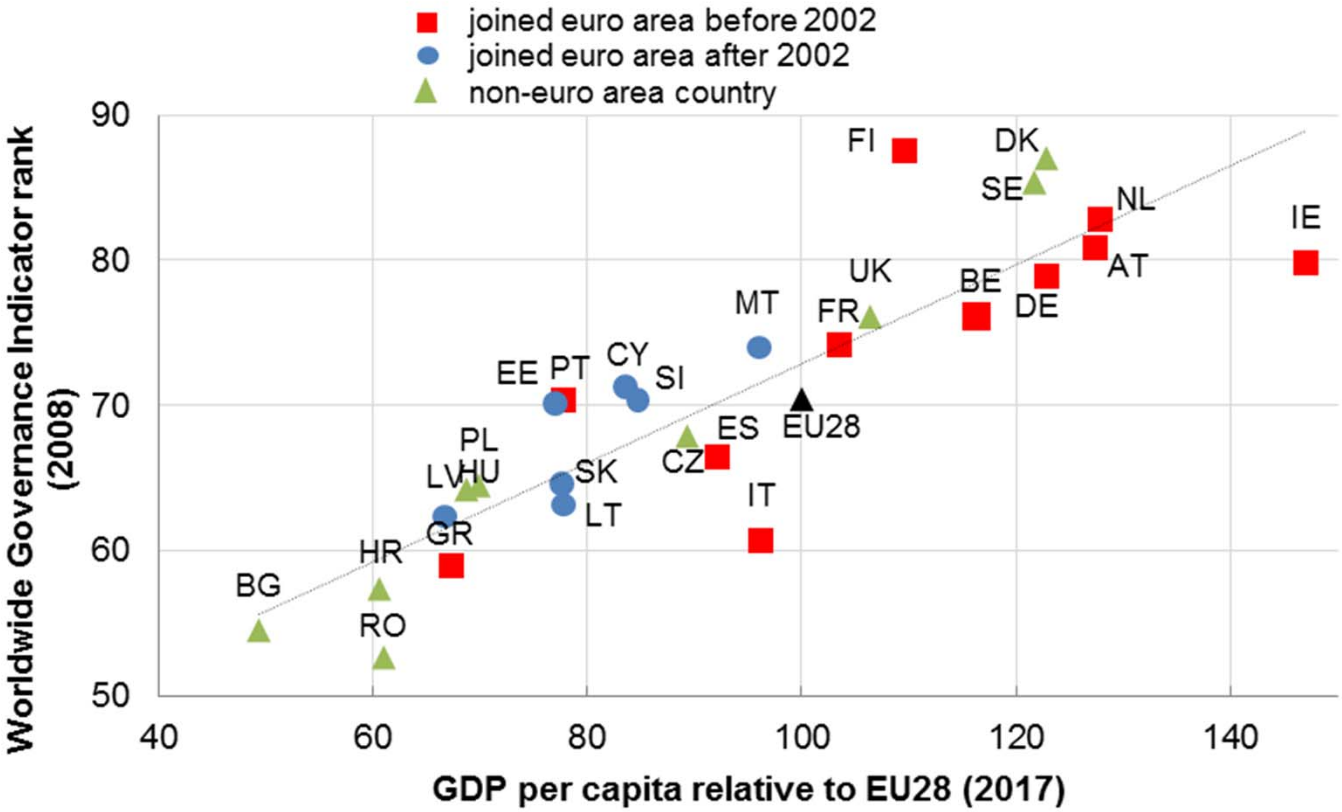
(GDP per capita in 1,000 PPS, percentage changes)



Sources: European Commission and ECB staff calculations.
Notes: Luxembourg is excluded. Data for Ireland are adjusted to control for the exceptional GDP revision made for the year 2015, which did not reflect an actual increase in economic activity.

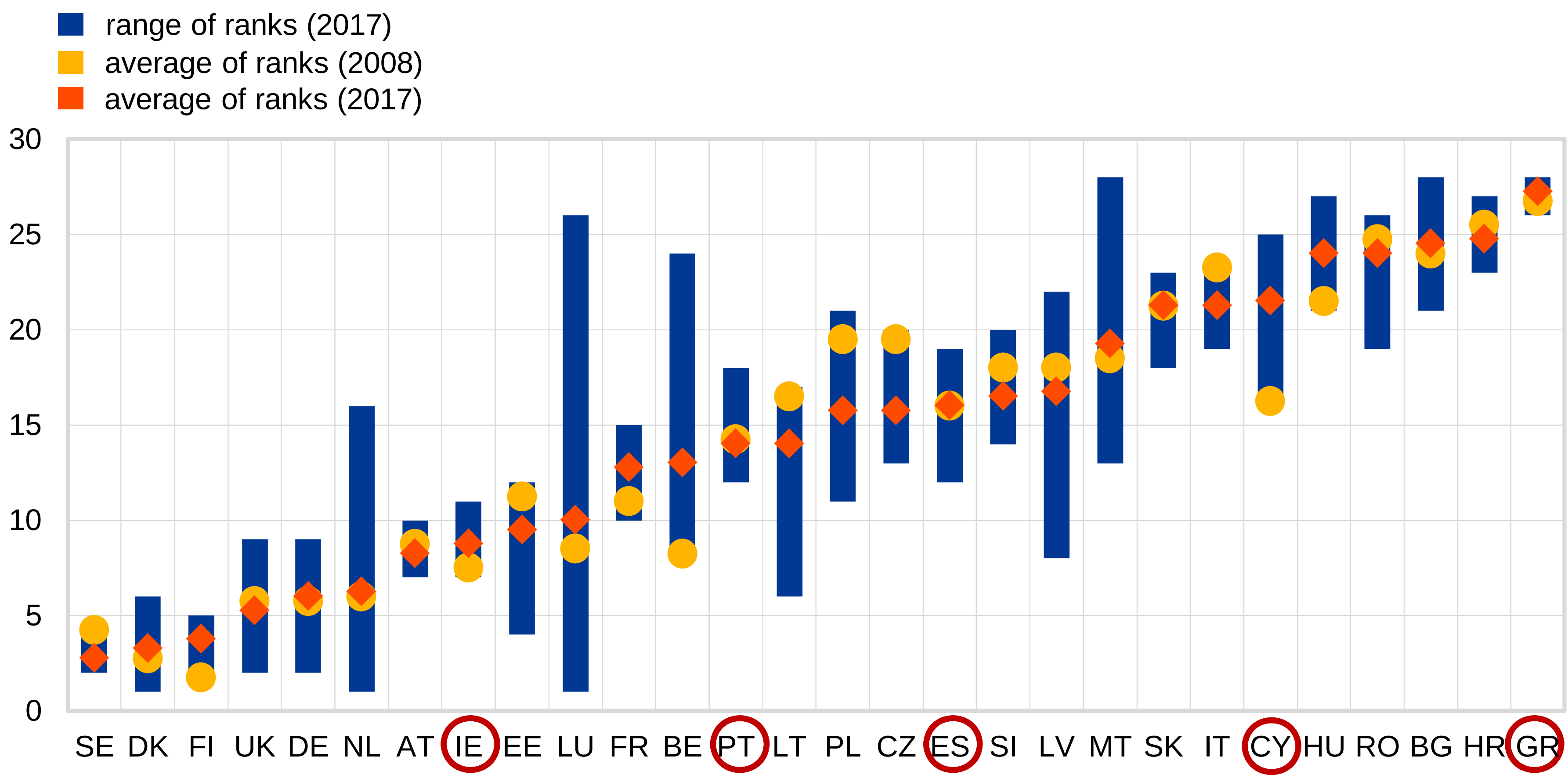
Worldwide Governance Indicator rank and GDP per capita levels

(GDP per capita in PPS; EU28=100)



Notes: Worldwide Governance Indicator represents an average position in six broad dimensions of governance: (1) Voice and Accountability, (2) Political Stability and Absence of Violence/Terrorism, (3) Government Effectiveness, (4) Regulatory Quality, (5) Rule of Law, and (6) Control of Corruption. 100 is the maximum relative level in the rank. Data for Ireland are adjusted to control for the exceptional GDP revision made for the year 2015, which did not reflect an actual increase in economic activity.

Institutional convergence: Country rank in the EU

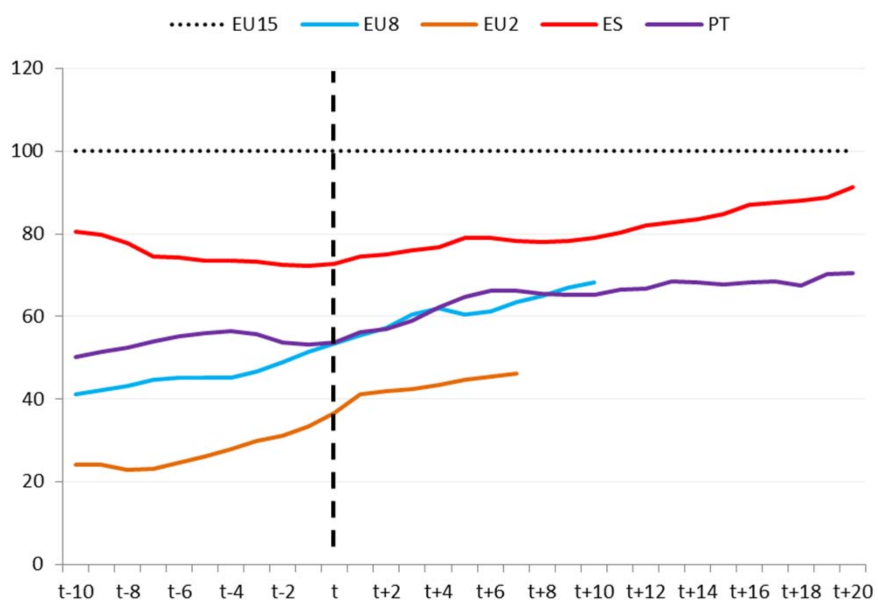


Sources: **(1)** Worldwide Governance Indicators 2017, **(2)** The Global Competitiveness Report 2017-2018 rankings (World Economic Forum), **(3)** Corruption Perceptions Index 2017 (Transparency International) and **(4)** Doing Business 2018 (the World Bank).
Note: Countries are ranked from one (best performer in the EU) to 28 (worst performer in the EU) and ordered according to their average position in the 2017 rankings. **The countries with an IMF/EU programme are circled in red.**

Real convergence before and after t = EU entry

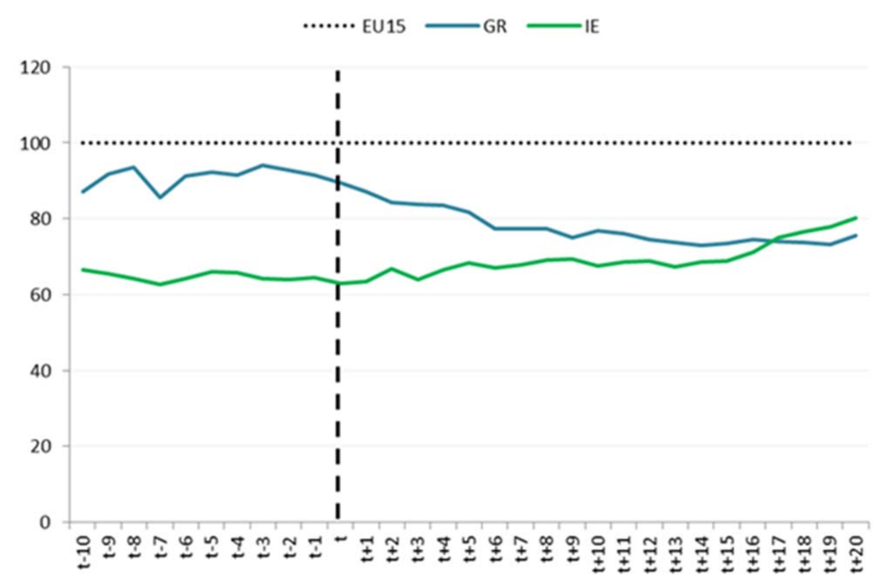
(GDP per capita in PPS; EU15=100)

EU entry – and, in some cases, its perspective – may have acted as a catalyst for convergence …



Notes: EU8: Countries in Central and Eastern Europe that entered the EU in 2004 (CZ, EE, HU, LT, LV, PL, SK and SI). EU2: Countries that entered the EU in 2007 (BG and RO).

… but Greece and, partly, Ireland stand out

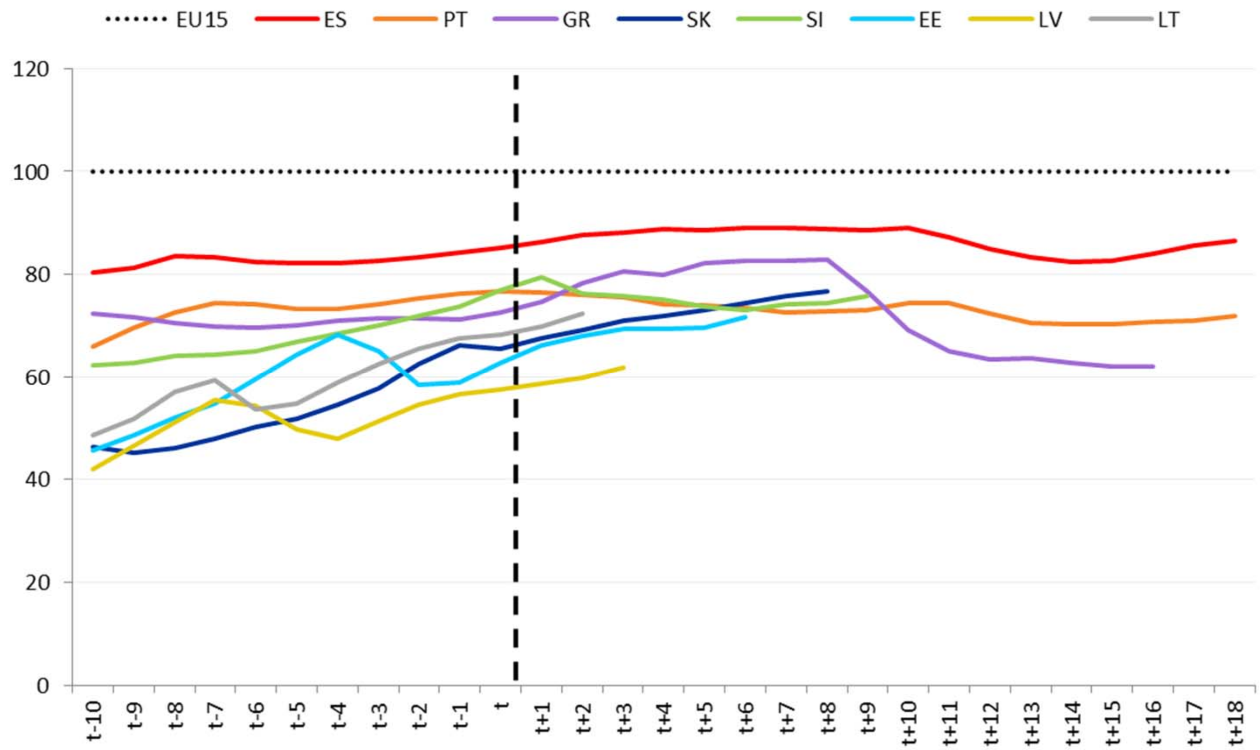


Notes: IE entered the EU in 1973. GR entered the EU in 1981. Data for Ireland are adjusted to control for the exceptional GDP revision made for the year 2015, which did not reflect an actual increase in economic activity.

Did euro area membership matter for real convergence?

Real convergence before and after t = EA entry

(GDP per capita in PPS; EU15=100)

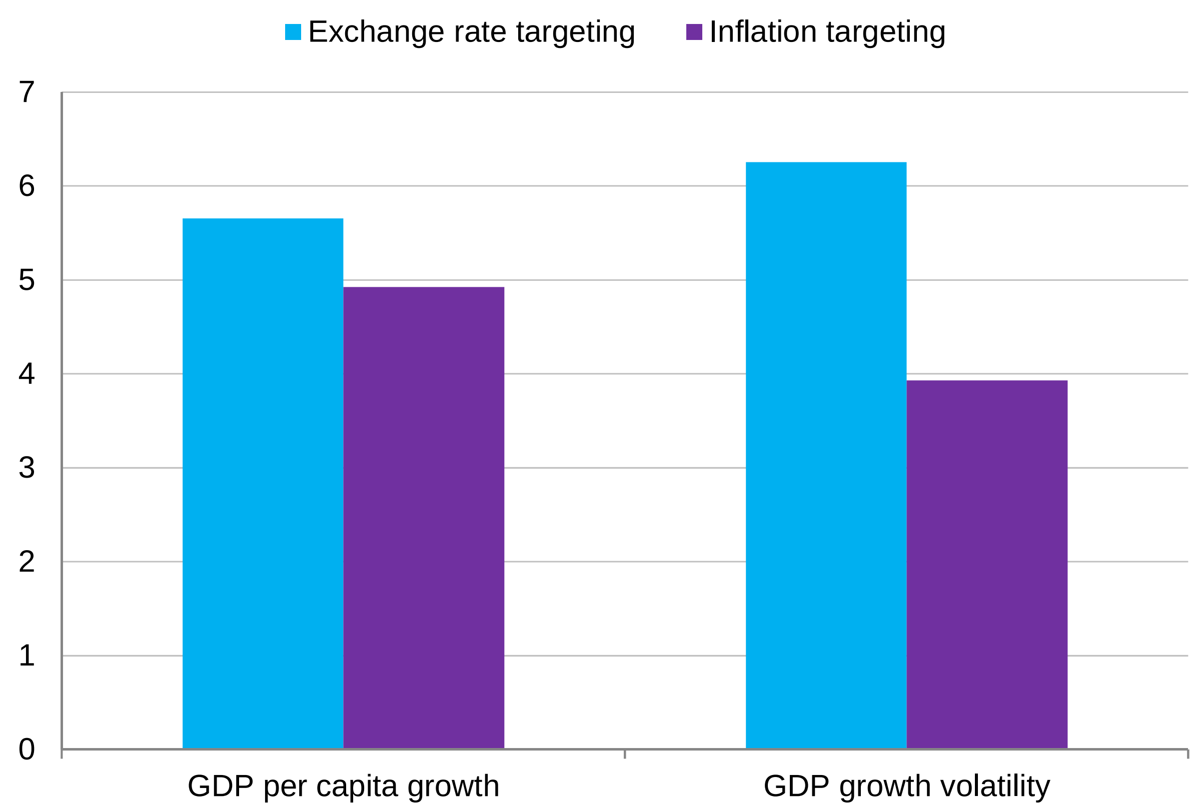


Source: European Commission and ECB staff calculations.

Does the exchange rate regime matter for real convergence?

Exchange rate regime, output volatility and GDP per capita

(selected New EU Member States, 2004-2017)



Notes: Exchange rate targeting countries: unweighted average for BG, LT, LV, HR and EE (EE adopted the euro in 2011 and LV and LT adopted the euro in 2014 and 2015 respectively); Inflation targeting countries: unweighted average for PL, HU, RO and CZ.

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Enlargement of the European Union

1952 Belgium, Germany, France, Italy, Luxembourg, Netherlands

1973 Denmark, Ireland, United Kingdom

1981 Greece

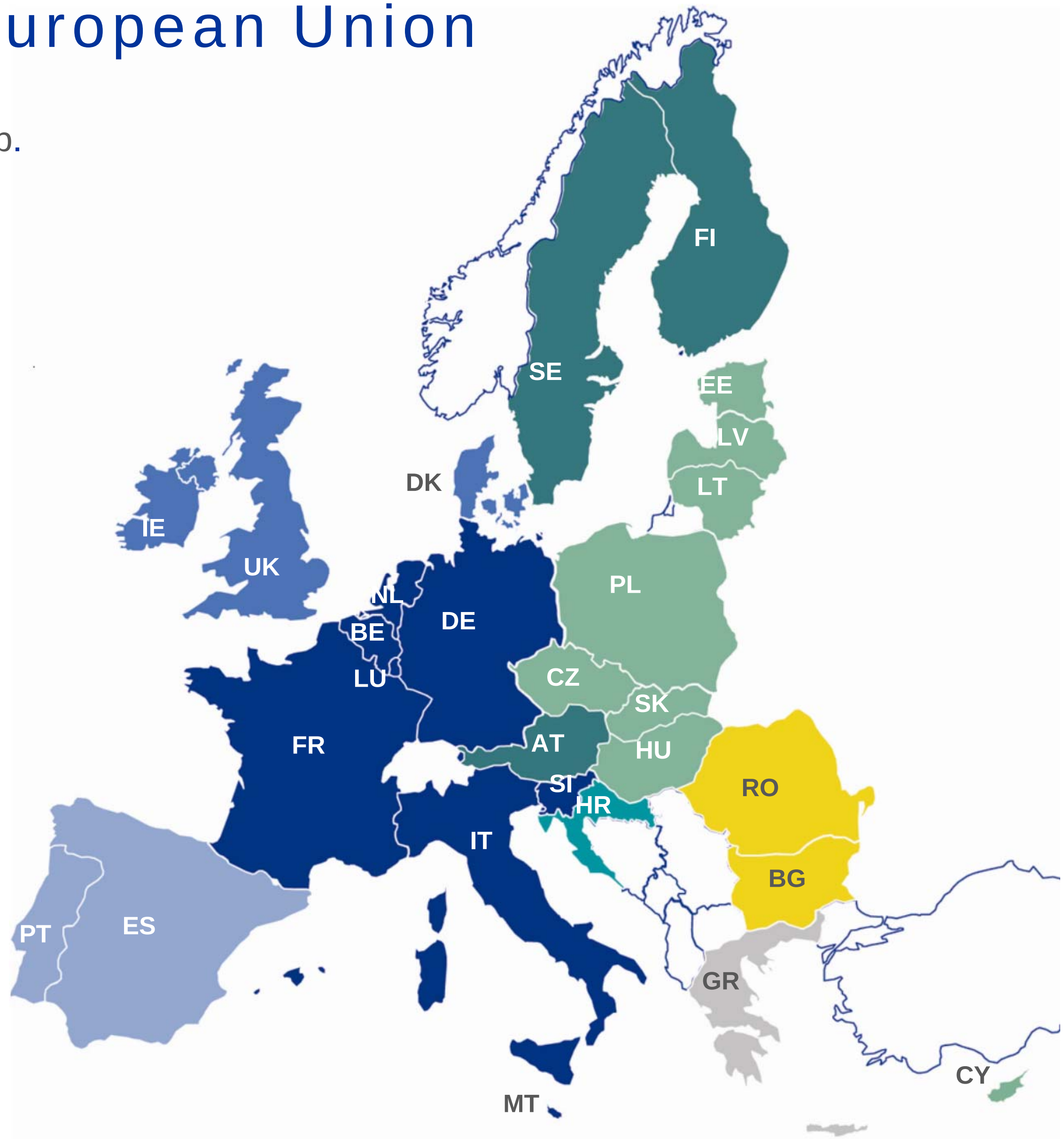
1986 Spain, Portugal

1995 Austria, Finland, Sweden

2004 Czech Rep., Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia, Slovakia

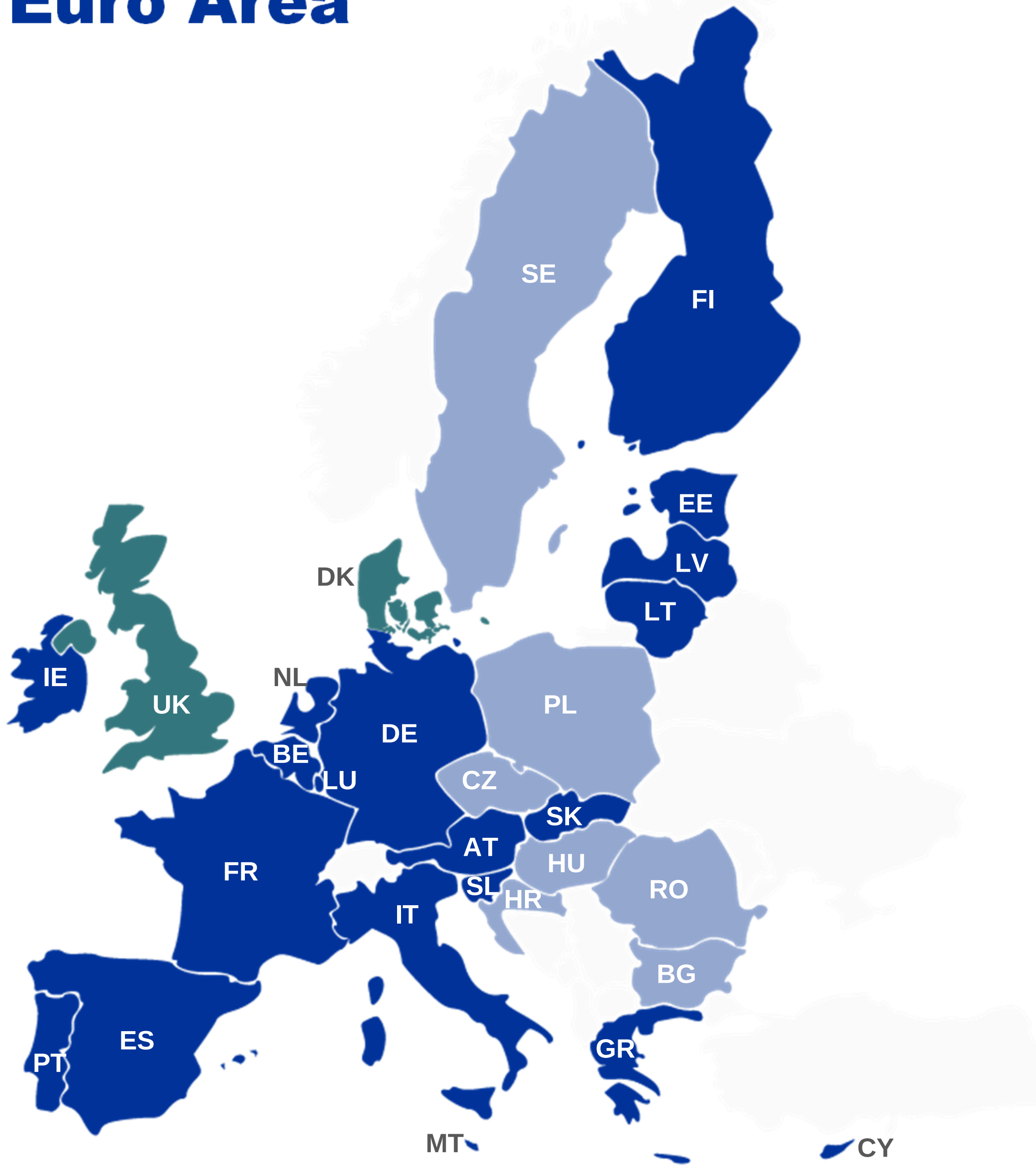
2007 Bulgaria, Romania

2013 Croatia



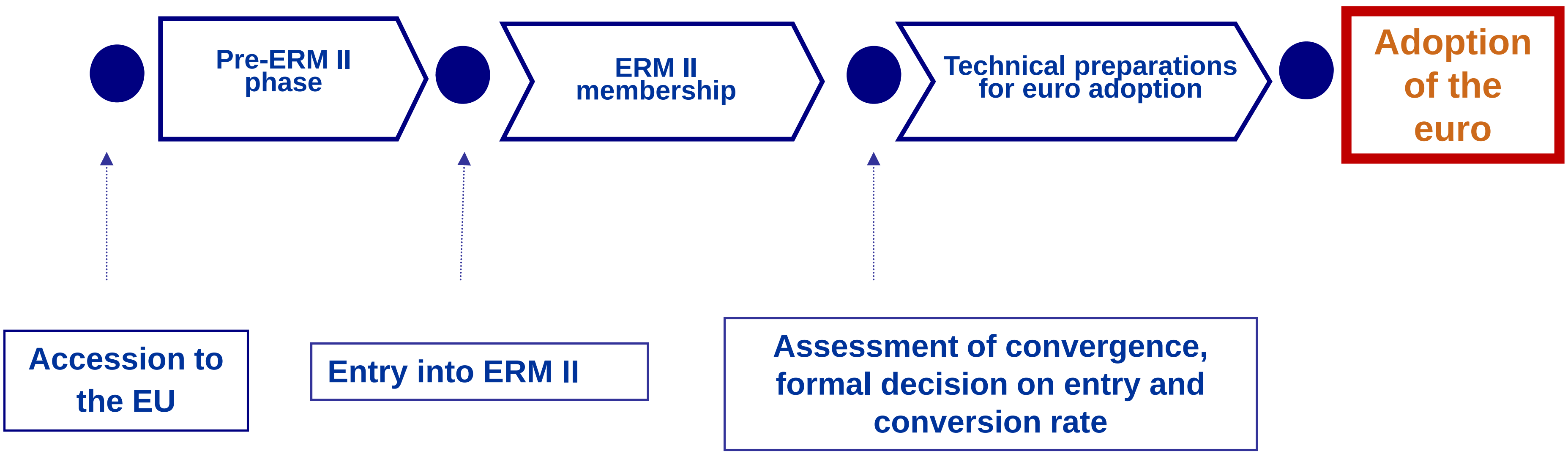
Enlargement of the **Euro Area**

- EU Member States which have adopted the euro
- EU Member States with a special status
- EU Member States with a derogation



The euro adoption process

(as stipulated in the Treaty)



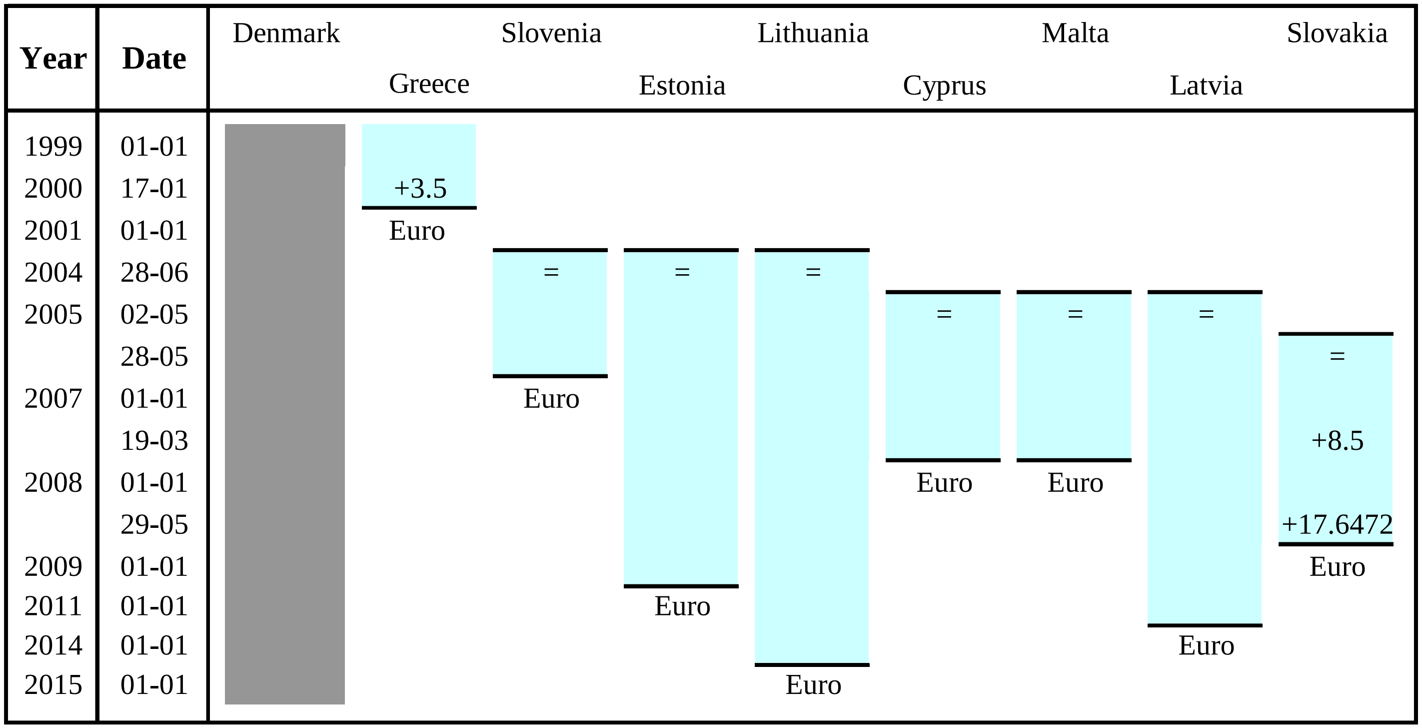
ERM II membership is a precondition for the eventual adoption of the euro

- All Member States with a derogation are expected to join **ERM II** at some stage
- There is a **minimum of two years** before euro adoption, but no maximal restriction
- Decision regarding participation in ERM II must be taken by **mutual agreement**, based on a sound and thorough analysis of readiness and risks
- **No pre-specified criteria** for joining the mechanism
- **Case-by-case** assessment based on equal treatment

- ECB Governing Council policy position on exchange rate issues relating to the acceding countries (18 December 2003)

Duration of ERMII participation

The Exchange Rate Mechanism II (ERM II)



± 2.25% fluctuation margins.

± 6% fluctuation margins.

± 15% fluctuation margins.

What are the prerequisites of a successful participation in ERM II?

- **Macroeconomic stability**, i.e. absence of imbalances based on broad range of indicators similar to EU Macroeconomic Imbalance Procedure
- **External balance,** i.e. BoP sustainability and IIP, including presence of possible financial assistance/liquidity provision programmes.
- **Monetary and exchange rate regime**, needs to be fully compatibility with the functioning of ERM II.
- **Financial stability,** in particular relevant for countries operating under currency board arrangement
- **Quality of institutions and governance**, labour and production market rigidities can be harmful with limited nominal exchange rate flexibility
- **Global factors**, which may under exceptional circumstances call for a postponement of ERM II participation.

What are the prerequisites of a successful participation in ERM II?

- ✓ **Major policy adjustments** (e.g. foreign exchange market and price liberalisation) to be undertaken prior to entry
- ✓ Need to follow **credible fiscal consolidation path**
- ✓ **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**

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When is the convergence report published and which countries are covered?

- Every second year, or at the request of a country, the ECB and the European Commission publish their **Convergence Reports**

- The Convergence Reports examine the preconditions for euro adoption by the EU Member States "with a derogation" (so-called **"pre-ins"**):
  - **Bulgaria, Czech Republic, Croatia, Hungary, Poland, Romania and Sweden**

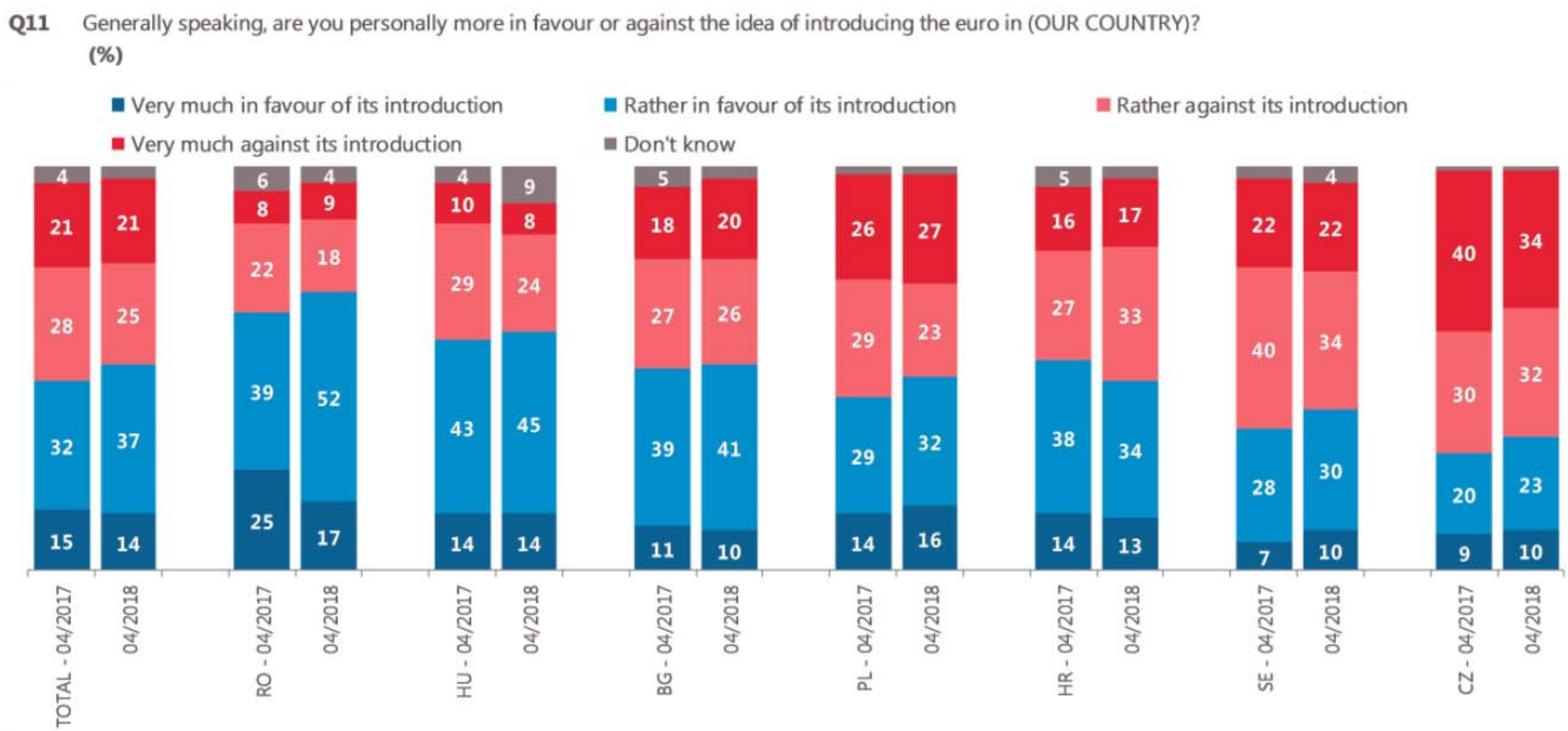
- Denmark and the United Kingdom are not covered as they have a **special status** in the Treaty. For these two countries, Convergence Reports have to be provided only if they so request

What are the attitudes towards introducing the euro, today?

- In **Romania, Hungary and Bulgaria** there is a relative majority in favor of euro adoption

- Skepticism is reported especially in the **Czech Republic and Sweden.**

Eurobarometer survey results on euro adoption



Source: European Commission (Eurobarometer, April 2018).

What are the economic criteria to assess convergence?

- Four main **quantitative criteria** for economic convergence:
  - **Price stability**
  - **Fiscal position (general government deficit and debt)**
  - **Exchange rate**
  - **Long-term interest rate**

- The assessment takes into account **other relevant factors** such as the **development of ULCs**, **enhanced economic governance framework of the EU** and the **strength of the institutional environment** in each country (incl. statistics)

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

- Criteria need to be satisfied on a **sustainable** basis

What does it mean that a "high degree of sustainable convergence" has to be achieved?

- It means achieving convergence on a **lasting basis** and not just at a given point in time. This is in each country's own interest, not only in the interest of the euro area as a whole

- In order to live up to the **permanent commitments** which euro adoption involves, it is necessary to:
  - ✓ **Lock in** the improvements in the **fiscal criteria**
  - ✓ Pursue adequate macroeconomic and macro prudential policies to **prevent the build-up of imbalances**
  - ✓ Develop an appropriate framework for the **supervision of financial institutions**
  - ✓ Implement **structural reforms** to establish sound institutions and economic governance

- 'EU Member States with a derogation that are subject to an **Excessive Imbalance Procedure** can hardly be considered as having achieved a high degree of sustainable convergence as stipulated by Article 140(1) of the Treaty'.

ECB 2018 Convergence Report. Convergence criteria: price stability (1)

- Report looks at price stability in relative terms = in comparison with other EU countries → **sustainable inflation differentials across countries**

- **No country** was identified as an **“outlier”** in terms of price developments
- “Outlier” concept referred to in previous ECB/EMI Convergence Reports:

  (i) 12-month average inflation rate **significantly below** the comparable rates in other Member States, and

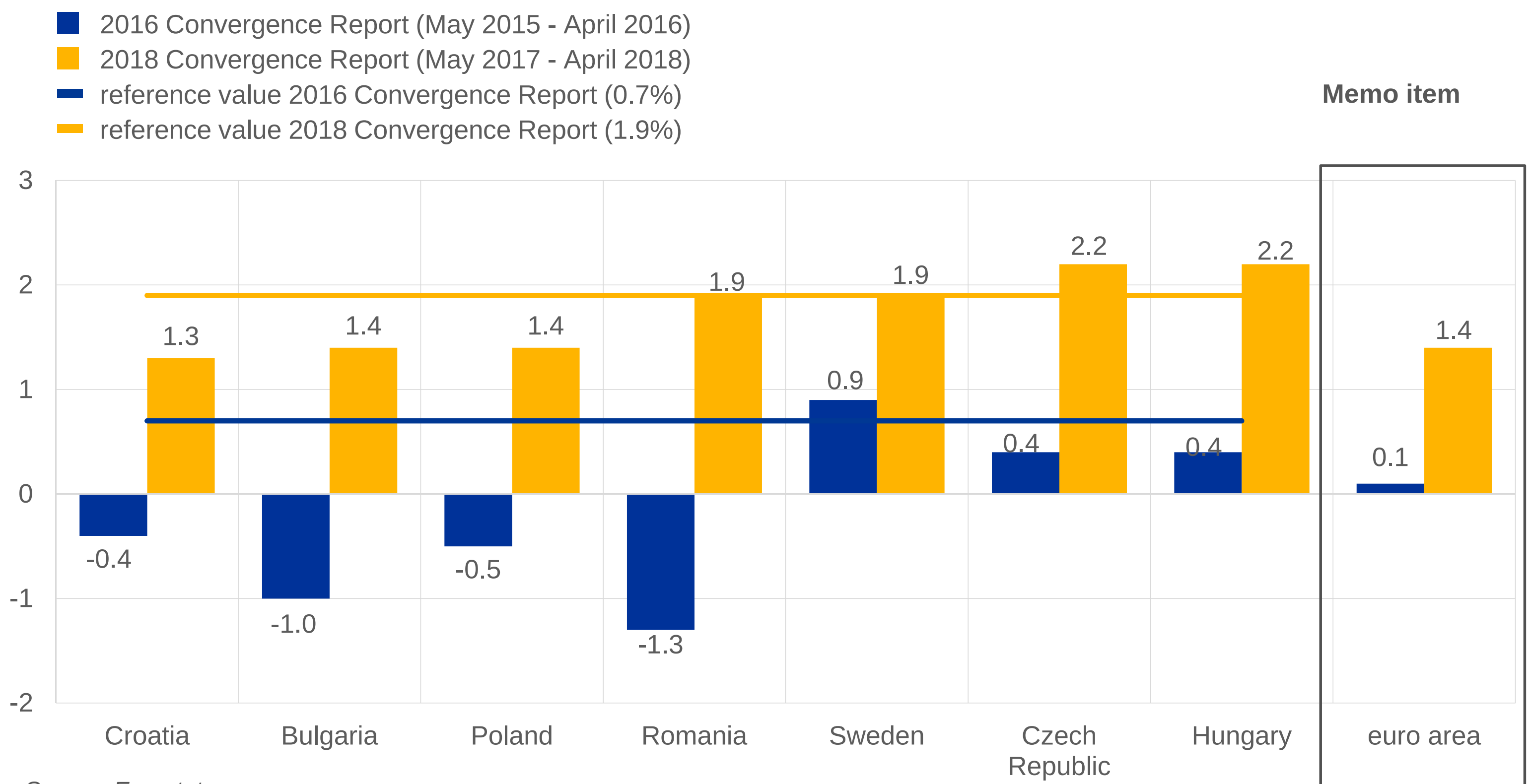
  (ii) price developments have been strongly affected by **exceptional, country-specific factors**

- **Reference value: +1.9%** based on Cyprus (0.2%), Ireland (0.3%) and Finland (0.8%)

- Over the reference period from April 2017 to March 2018, **two out of seven countries** recorded an average rate of inflation above the reference value of 1.9%.

HICP inflation

(average annual percentage changes)



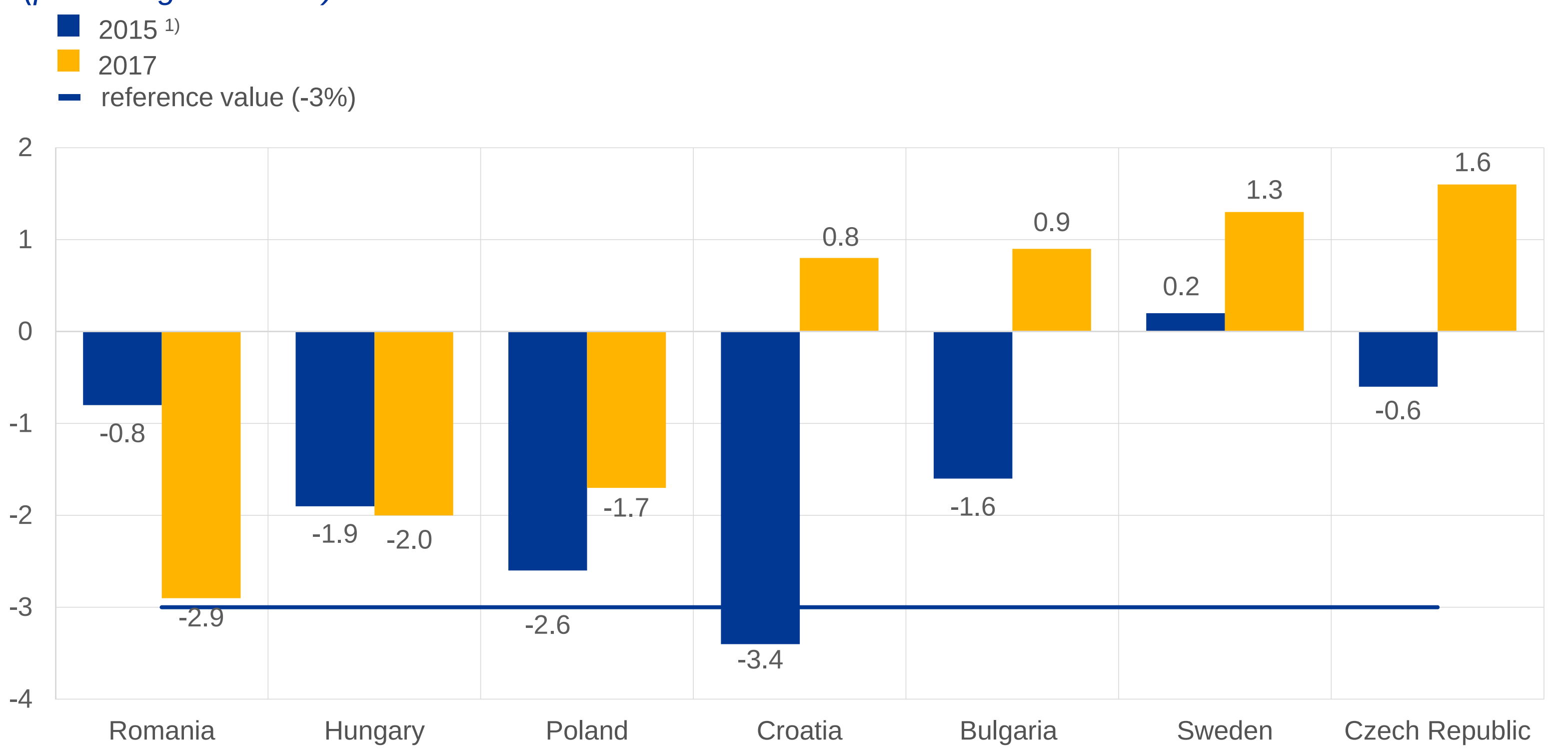
Source: Eurostat.

ECB 2018 Convergence Report. Convergence criteria: government budgetary position (1)

- In 2017, the headline fiscal deficits stood below 3% of GDP in all countries, and **no country** was subject to an excessive deficit procedure.

General government surplus (+) or deficit (-)

(percentages of GDP)

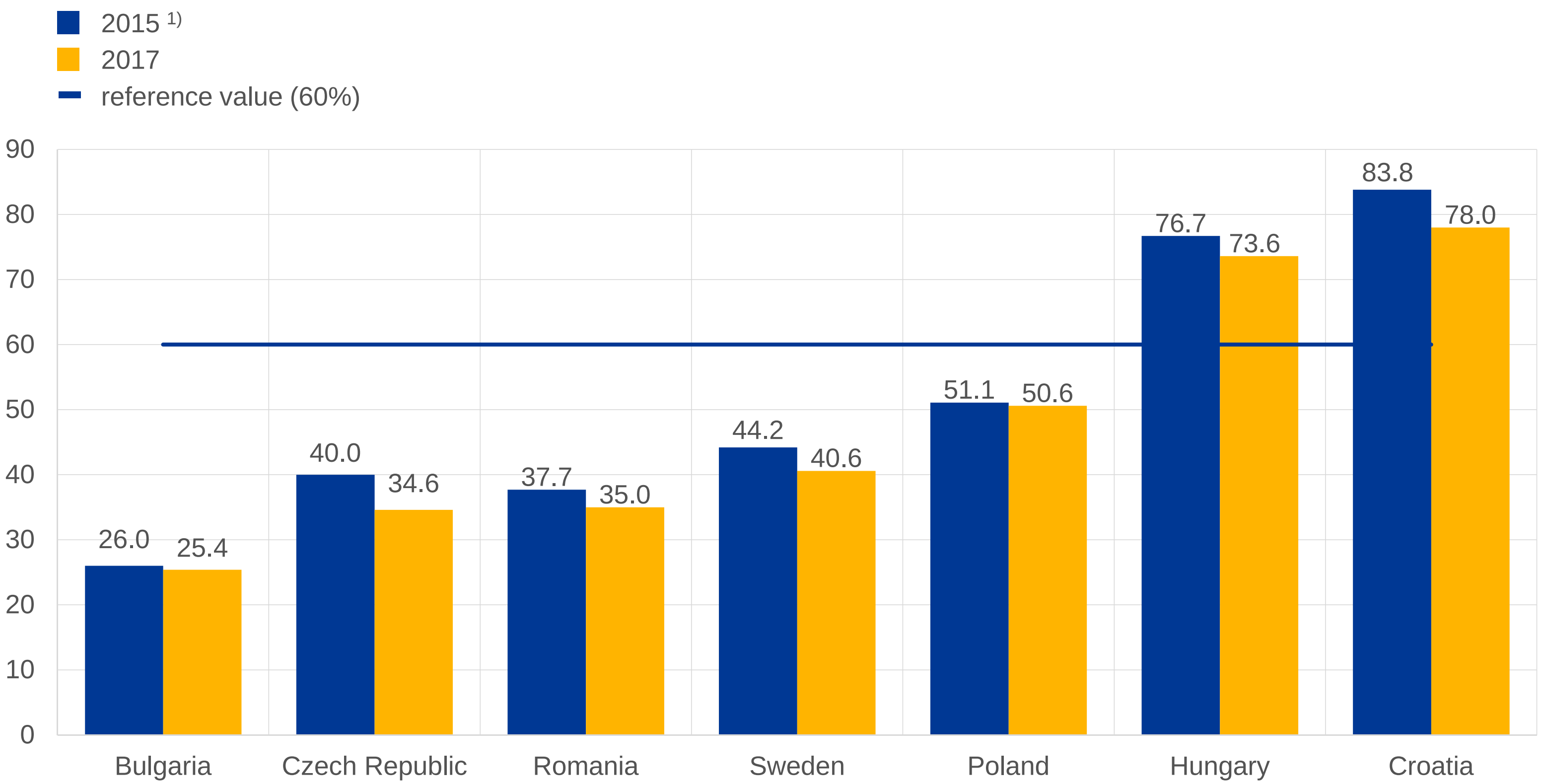


Source: Eurostat.
1) Data have been revised slightly since the 2016 Convergence Report.

- Only **Croatia** and **Hungary** exhibited a debt-to-GDP-ratio above the 60% of GDP reference value in 2017

General government gross debt

(percentages of GDP)



Source: Eurostat.

1) Data have been revised slightly since the 2016 Convergence Report.

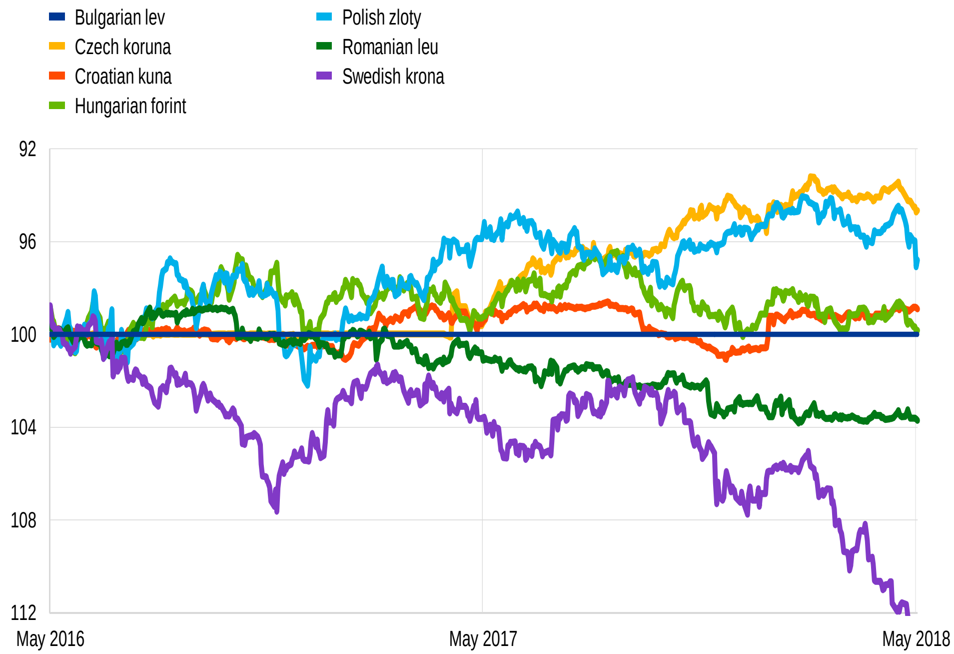
None of the countries examined in the report participates in ERM II.

The countries under review operate under different exchange rate regimes:

- The **Bulgarian lev** remained fixed at 1.95583 per euro within the framework of a currency board in the reference period
- The **Croatian kuna** and the **Romanian leu** traded under flexible exchange rate regimes involving – to different degrees – a managed float vis-à-vis the euro
- All **other currencies** traded under a flexible exchange rate regime amid relatively high exchange rate volatility in most countries

Bilateral exchange rates vis-à-vis the euro

(daily data; average of May 2016 = 100; 2 May 2016 - 3 May 2018)



Source: ECB.
Note: An upward (downward) movement indicates an appreciation (depreciation) of the local currency.

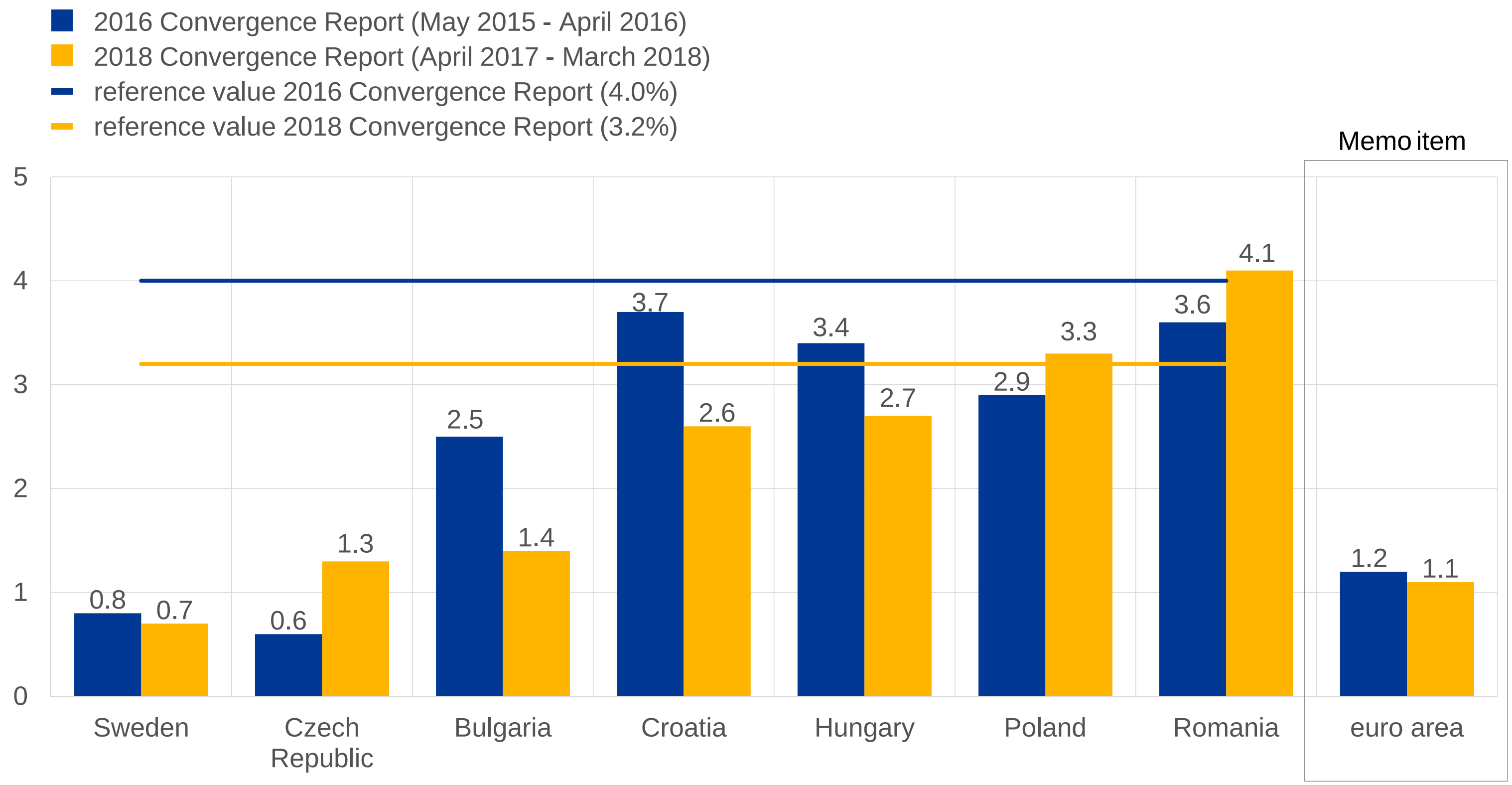
Note: Denmark, whose Danish krone is participating in ERM II, is not covered in the Convergence Report given that this country has an opt-out in place.

ECB 2018 Convergence Report. Convergence criteria: long-term interest rate

- Over the 12-month reference period from April 2017 to March 2018, long-term interest rates in **five out of seven countries** under review were – to varying degrees – below the reference value of 3.2%

Long-term interest rates

(percentages, annual average)

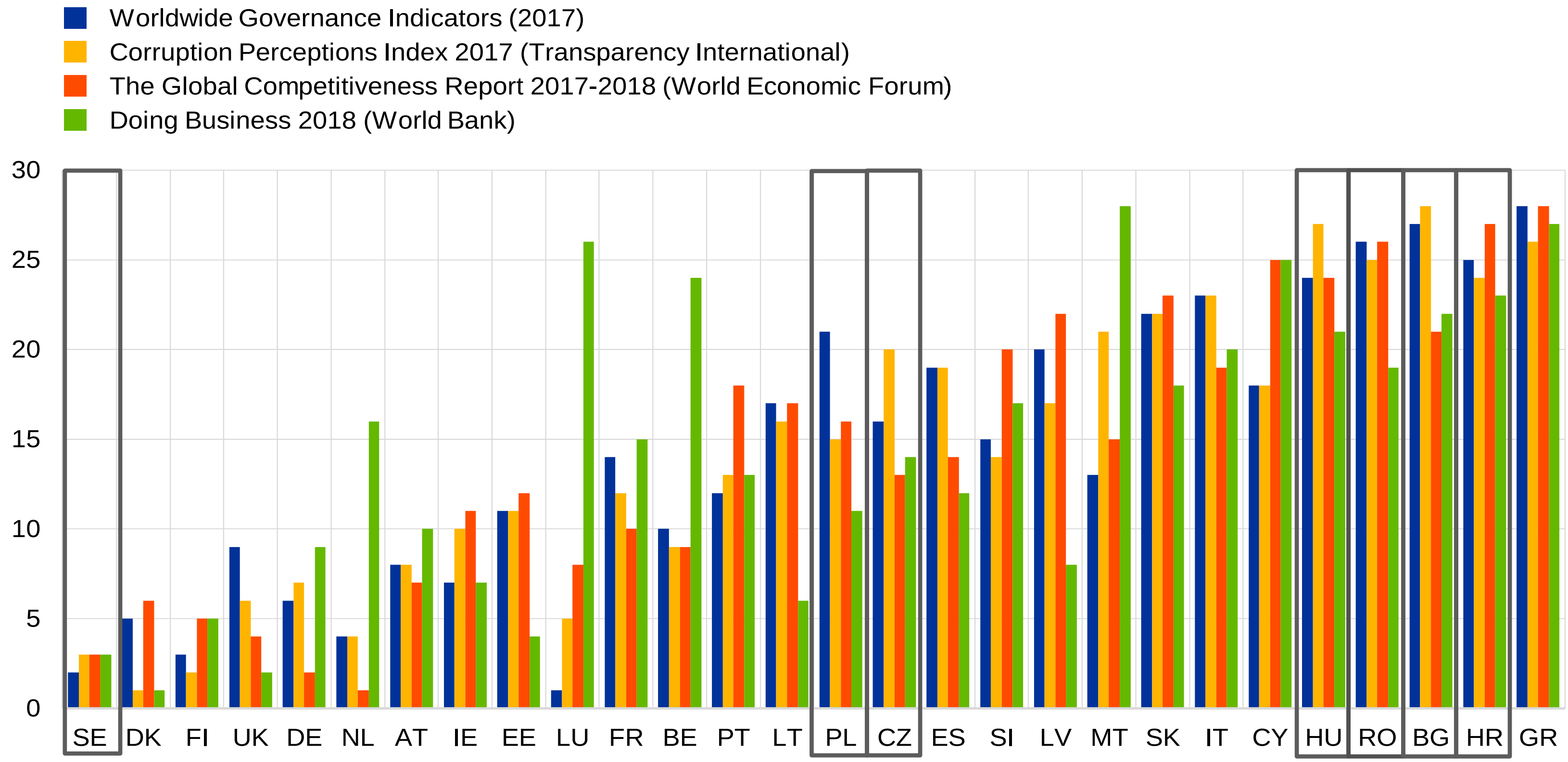


Sources: Eurostat and ECB.

The **quality of institutions and governance** is reported as being relatively weak in comparative terms for most of the countries under review

EU country rankings in terms of institutional quality by individual indicator

(percentages, annual average)



Sources: Worldwide Governance Indicators 2017, The Global Competitiveness Report 2017-2018 (World Economic Forum), Corruption Perceptions Index 2017 (Transparency International) and Doing Business 2018 (World Bank).
Note: Countries are ranked from one (best performer in the EU) to 28 (worst performer in the EU) and ordered according to their average position in the 2017 rankings.

Main messages of the ECB 2018 Convergence Report

- (1) Most EU Member States under review have made **some progress** with regard to compliance with convergence criteria

- **(2) No country examined currently fulfils all obligations** laid down in the Treaty, including **legal** convergence criteria

- (3) **Sustainable convergence** is needed for successful adoption of the euro

- (4) The ECB assessment follows an **approach** that is consistent over time, economically appropriate and in full compliance with the Treaty

Thank you!

For further information or questions

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Literature:

Diaz del Hoyo, Dorrucci, Heinz, Muzikarova (2017), *"Real convergence in the euro area: a long-term perspective"*, ECB Occasional Paper Series, No 203, December 2017: http://www.ecb.europa.eu/pub/pdf/scpops/ecb.op203.en.pdf

ECB Economic Bulletin, Issue 5/2015 – Article: *"Real convergence in the euro area: evidence, theory and policy"*: http://www.ecb.europa.eu/pub/pdf/ecbu/eb201505.en.pdf

ECB Convergence Reports: http://www.ecb.europa.eu/pub/convergence/html/index.en.html

ECB Website: http://www.ecb.europa.eu/explainers

Additional slides

Legal convergence

The Convergence Report is an assessment of compliance of national legislation, in particular the **statutes of national central banks** (NCBs), with the Treaties and the ESCB Statute.

In terms of legal convergence, the Convergence Report examines:

- The **Independence** of the NCBs (Article 130 TFEU).
- The compatibility of the legislation with the **monetary financing prohibition** (Article 123 TFEU).
- The **confidentiality** (Article 37 ESCB Statute).
- The **legal integration** of the NCBs into the Eurosystem.
- The compatibility with the Union requirement for a **single spelling of the euro.**

Central Bank Independence

The concept of central bank independence has been developed **in ECB Convergence Reports** and **ECB Opinions** on draft national legal instruments.

Dimensions of central bank independence:

- **Functional independence:** Providing the NCBs with the necessary means and instruments for achieving the primary objective of price stability independent of any other authority.
- **Institutional independence:** Prohibition on Member States giving instructions and on NCBs receiving instructions.
- **Personal independence:** Members of the decision-making bodies of the NCBs are shielded by clear provisions on their appointment, terms of office and dismissal.
- **Financial independence:** Sufficient means needed to perform ESCB-related tasks but also but also its national tasks.

Monetary Financing Prohibition

The ECB or NCBs are prohibited from:

- Providing **overdraft facilities** or any other type of credit facility in favour of the public sector; and
- Purchasing debt instruments **directly from the public sector.**

The **precise scope of application of the monetary financing prohibition** is further clarified by Council Regulation (EC) No 3603/93 specifying definitions for the application of the prohibitions.