



Convergence and euro adoption prospects in CEE Member States: Where do we stand? Where are we headed ?

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Paul Kutos,

Head of Unit - Monetary policy, exchange rate policy of the euro area, ERM II and euro adoption

DG ECFIN, European Commission

Overview

- 1) Euro area enlargement**
- 2) Convergence prospects for the NMS**
- 3) Policy conclusions**

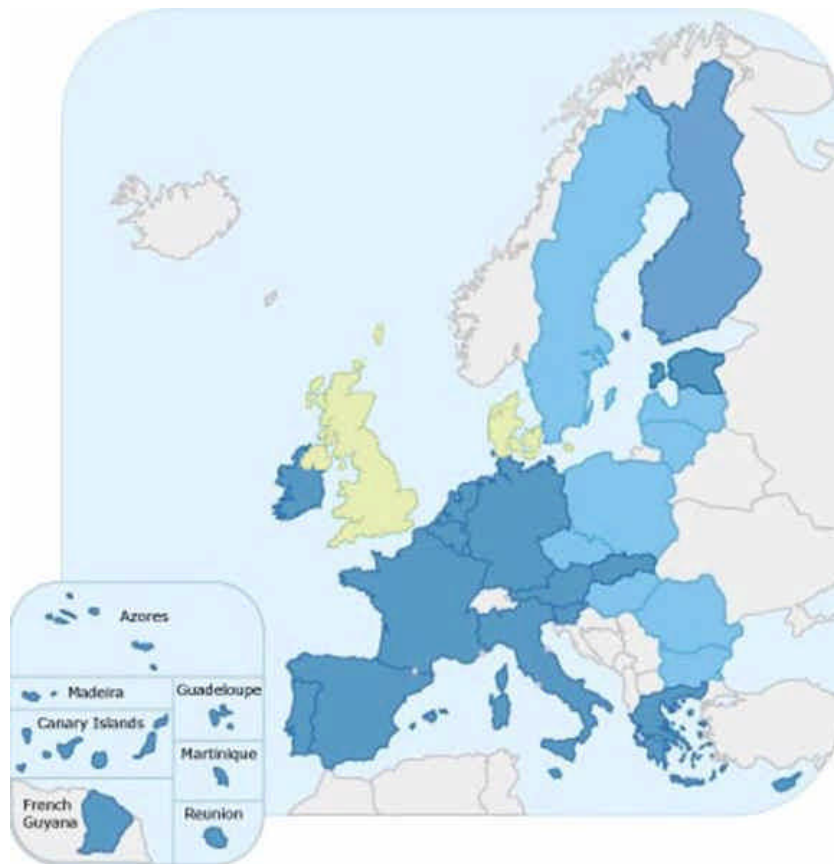
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Euro area enlargement - overview



Euro area:

- Germany
- France
- Italy
- Belgium
- Netherlands
- Luxembourg
- Ireland
- Greece
- Spain
- Portugal
- Austria
- Finland
- Slovenia (2007)
- Malta (2008)
- Cyprus (2008)
- Slovakia (2009)
- **Estonia (2011)**

Outside euro area:

- Czech Republic
- Poland
- Hungary
- Latvia
- Lithuania
- Bulgaria
- Romania
- Sweden
- UK (opt-out)
- Denmark (opt-out)

Key challenges of euro adoption

Euro adoption challenges

1. To get there
2. To prosper in the euro area

TFEU (Treaty):

- When rather than whether
- Rules-based framework (Maastricht criteria)

'Cost' of euro adoption

- Loss of independent monetary / exchange rate policy
- Cost is function of domestic policies and structures

Strategy

- No one-size-fits-all strategy
- Two groups of countries (floaters vs. fixers)

State of convergence

- **Convergence Report 2012**

- at least every 2 years or at the request of a Member State, COM and ECB assess whether MS have achieved a “high degree of sustainable convergence”
 - MS assessed in line with the principle of equal treatment.
 - convergence framework to ensure that MS follow policies supporting the smooth functioning of EMU – sustainability is key
 - embedded in broader European Semester surveillance, including MIP
- in 2012, 8 Member States assessed (BG, CZ, LV, LT, HU, PL, RO and SE).

- **‘Convergence criteria’**

- compatibility of legal framework
- economic convergence (inflation, public finances, exchange rates, LT interest rates)
- 'additional factors' (external balance, financial and product markets)



Setting the scene: Nominal convergence in the crisis context

- The 2012 assessment took place against the background of a still difficult external environment, with a fragile recovery in the region and recurrent headwinds on financial markets.
 - Public finances face still difficult times, but consolidation under way in most MS.
 - Modest increase in inflation in line with a fragile recovery, though price developments largely affected by volatile import prices and indirect tax changes.
 - Sizeable volatility in floating currencies, partly mirroring shifts in global risk aversion; official financial assistance currently in RO.
 - Mixed performance in long-term interest spreads, reflecting fiscal positions in NMS and global market developments.

Convergence Report 2012

Uneven progress towards convergence

Compatibility of legislation and fulfilment of convergence criteria (as of 30 April 2012)

	Legal compatibility	Inflation (Mar '12) (%)	Fiscal Balance (2011) (% of GDP)	Government Debt (2011) (% of GDP)	Excessive Deficit Procedure	ERM II entry	Long-term interest rates (Mar '12) (%)
Reference value		3.1	-3.0	60.0		2 years	5.8
Bulgaria	no	2.7	-2.1	16.3	yes ⁽¹⁾	no	5.3
Czech Republic	no	2.7 ⁽²⁾	-3.1	41.2	yes	no	3.5
Latvia	no	4.1	-3.5	42.6	yes	02/05/2005	5.8
Lithuania	yes ⁽³⁾	4.2	-5.5	38.5	yes	28/06/2004	5.2
Hungary	no	4.3	4.3	80.6	yes	no	8.0
Poland	no	4.0	-5.1	56.3	yes	no	5.8
Romania	no	4.6	-5.2	33.3	yes	no	7.3
Sweden	no	1.3	0.3	38.4	no	no	2.2

(1) A Council decision on the abrogation of the excessive deficit for Bulgaria was pending at the cut-off date of this report.

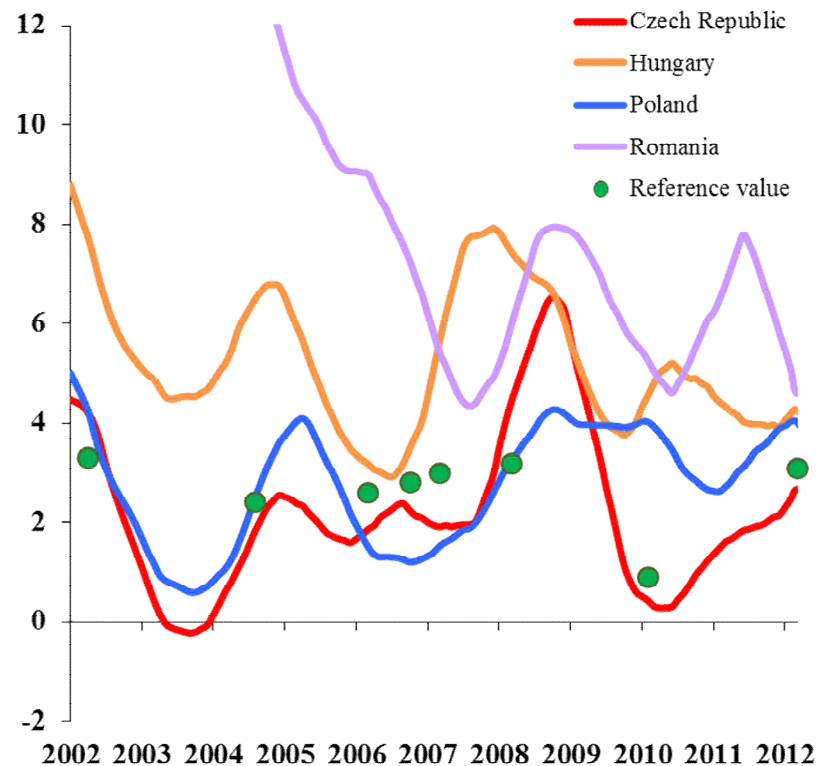
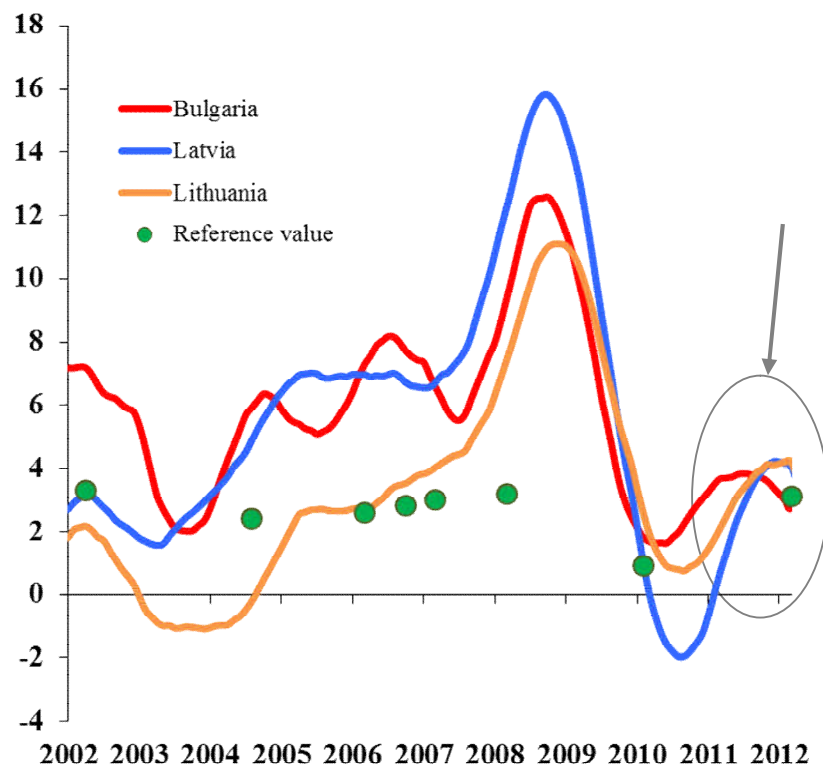
(2) Inflation in the Czech Republic is expected to move above the reference value in the months ahead, therefore it is assessed as not fulfilling the price stability criterion.

(3) Legislation in Lithuania is compatible with the Treaty requirements, but there is one imperfection regarding central bank independence.

State of convergence - HICP inflation

- Inflation influenced by volatile commodity prices and indirect tax changes....

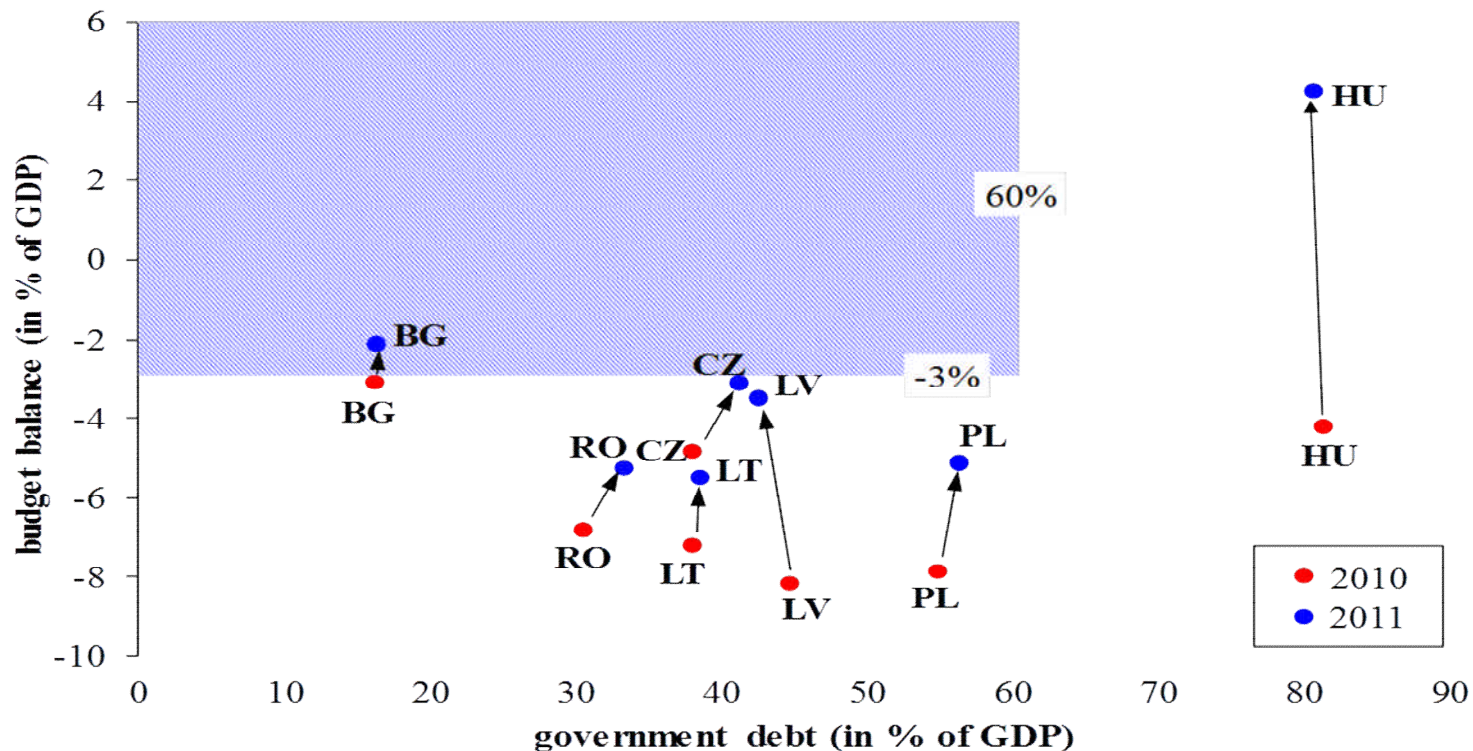
12-month average inflation (in %, y-o-y)



Fiscal positions

GGB and government debt (in % of GDP) against “Maastricht” reference values

- worsening in GGB halted due to consolidation measures/helped by the recovery
- debt ratios continue to deteriorate due to low growth and still negative deficits



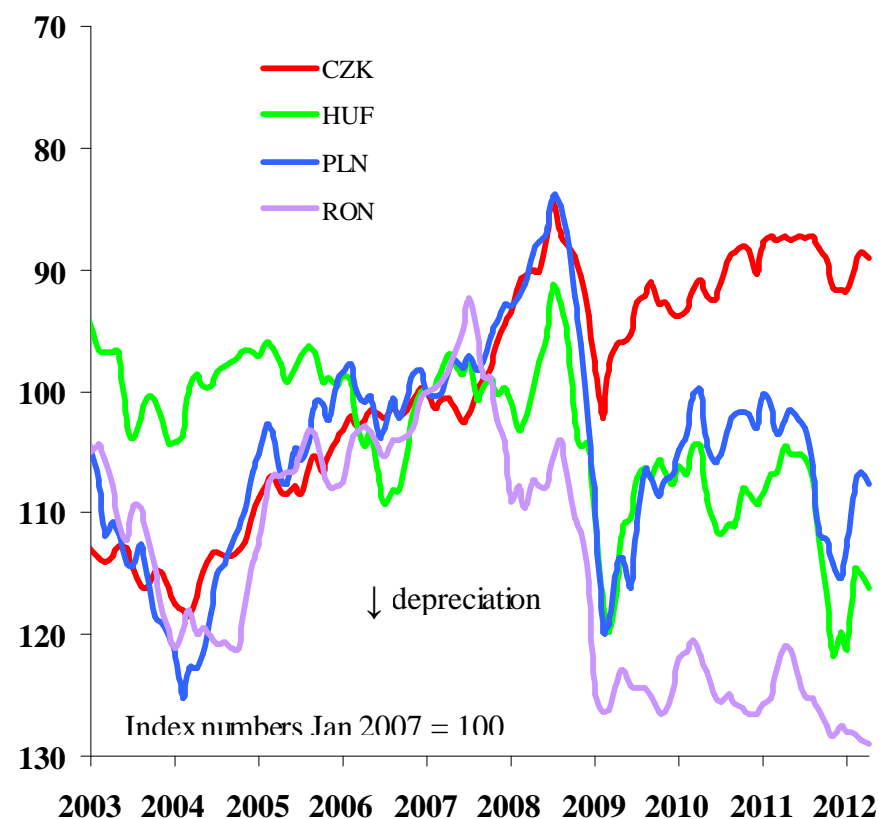
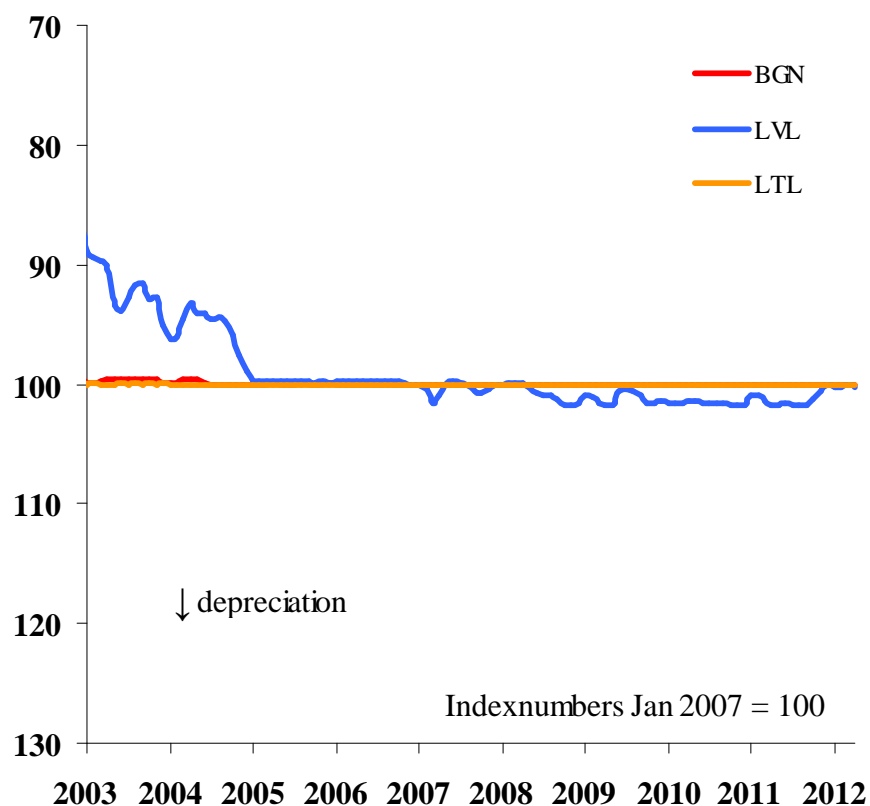
ERM II Member States (from NMS)

Key features of the membership

	<i>ERM II entry</i>	<i>Unilateral commitments</i>
Latvia	2 May 2005	Narrower band of +/- 1%
Lithuania	28 Jun 2004	Currency board

Exchange rate developments

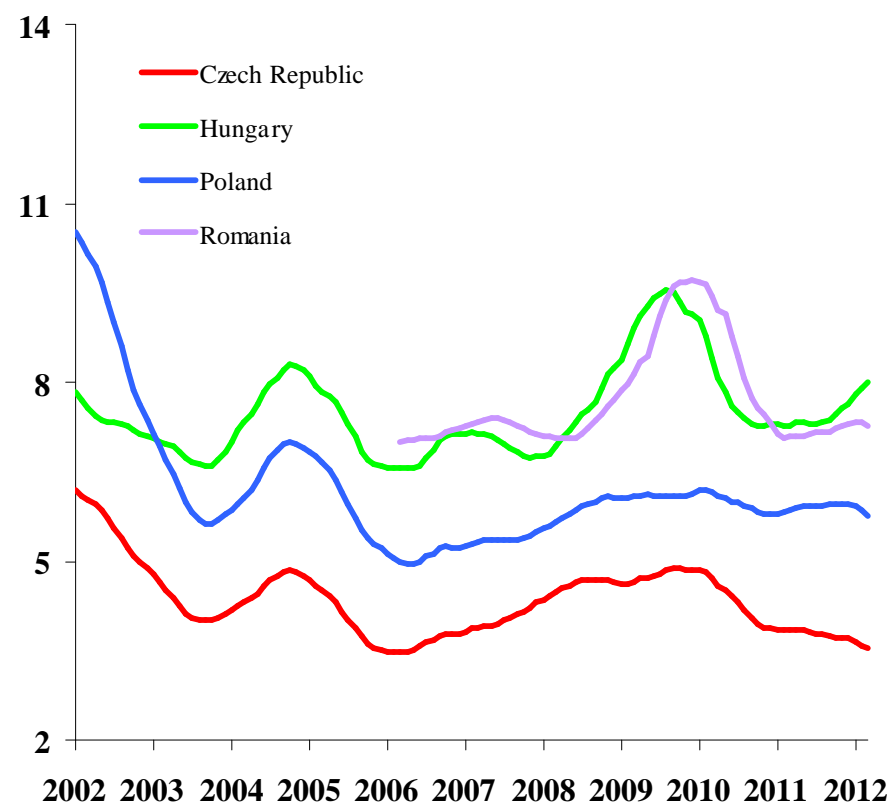
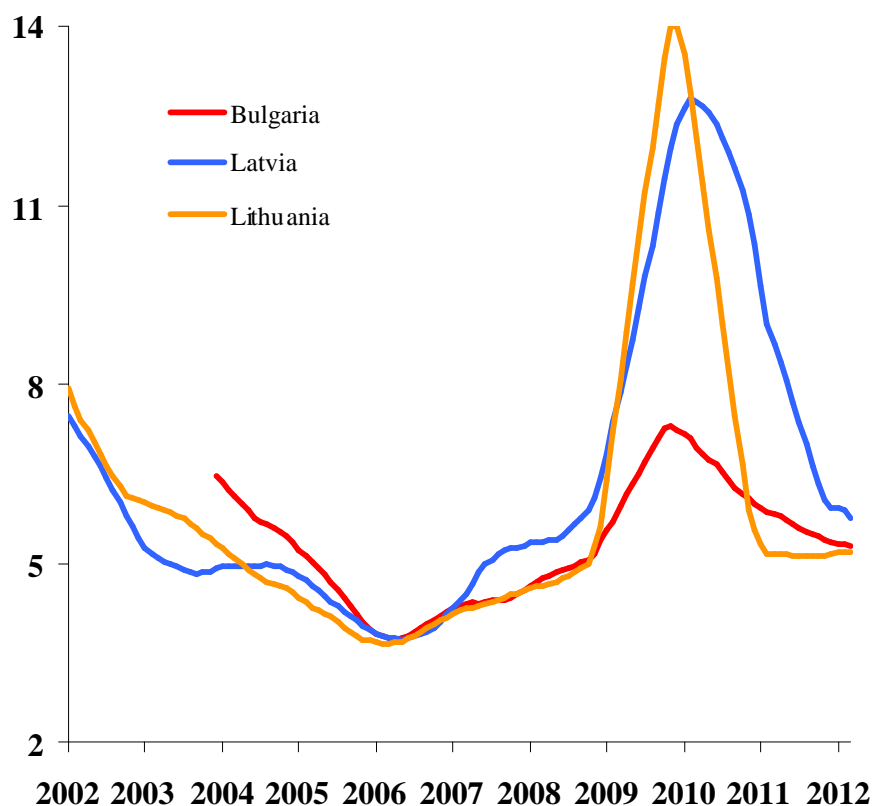
vs. euro, monthly averages (index numbers, Jan 2007 = 100)



Long-term interest rates

12-month averages (in %, y-on-y)

- *Some moderation observed in line with easing of global sentiment and fiscal consolidation measures*





Overview of convergence in EU-8

- Price stability: two countries (BG and SE) meet the price stability criterion.
- Public finances: two Member States (SE, BU) are not subject to an excessive deficit procedure.
- Exchange rate criterion: Lithuania and Latvia are the only countries to fulfil it (ERM II members),
- Long-term interest rate: all countries examined, except for HU and RO, fulfil it.
- Additional factors: 3 countries subject to in-depth studies under MIP (BG, HU, SE); none proposed for corrective arm; RO not covered as programme country

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Euro area enlargement: an outlook

Postponement of euro adoption plans

- Deterioration in economic outlook in the midst of crisis (e.g. fiscal positions)
- High financial market volatility: NMS markets react strongly to swings in global risk perceptions (while very sensitive to policy weaknesses and macro-instability)
- Lack of political consensus on the euro adoption time-line

Perceptions of benefits of the euro adoption may have shifted recently...

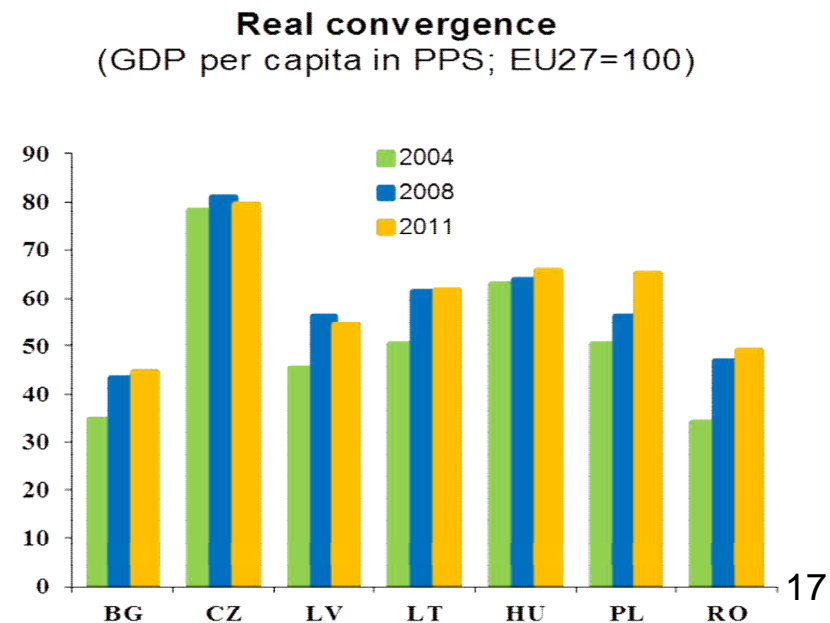
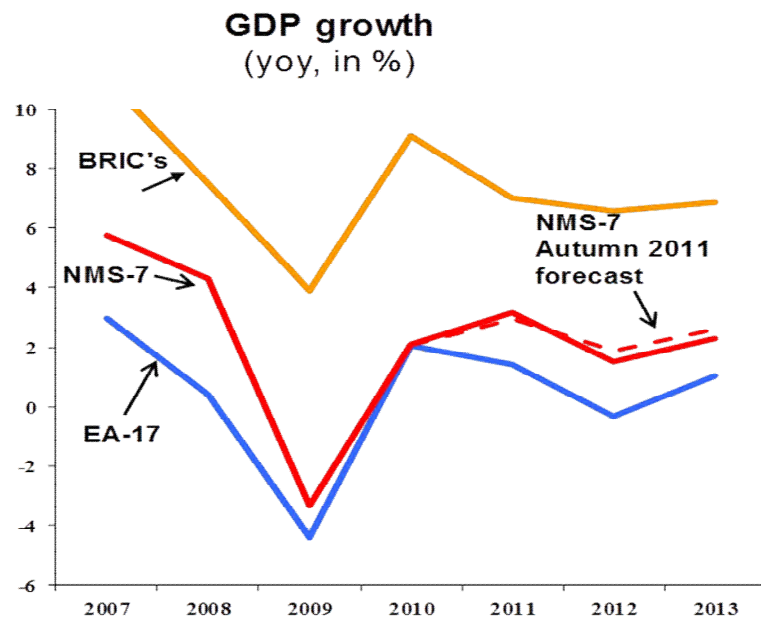
- Elimination of currency risk (↑)
- Strengthened EU policy framework (↑)
- Divergences in the euro area (↓)
- Further reduction of risk premia (↓)

... but NMS remain well placed to benefit from euro adoption ...

- High level of integration of business cycle correlation
- Relatively flexible markets
- ...though the benefits are not unconditional (as the crisis has shown)

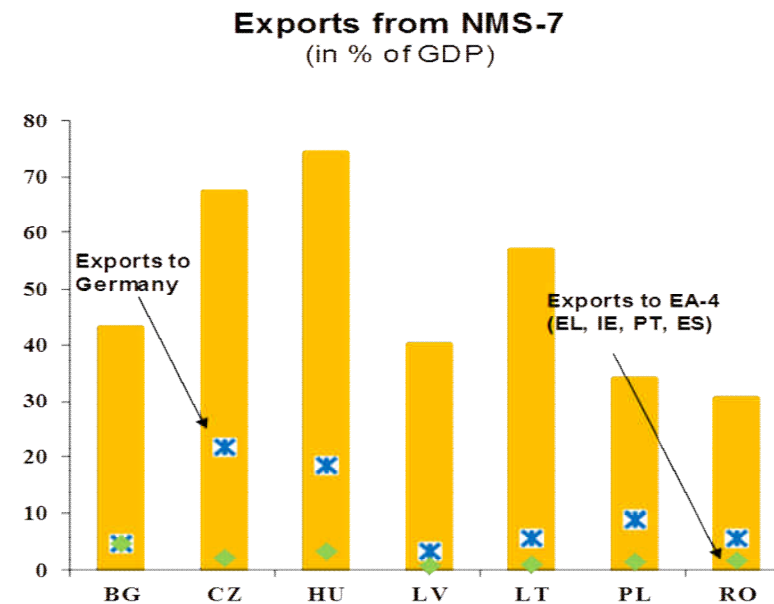
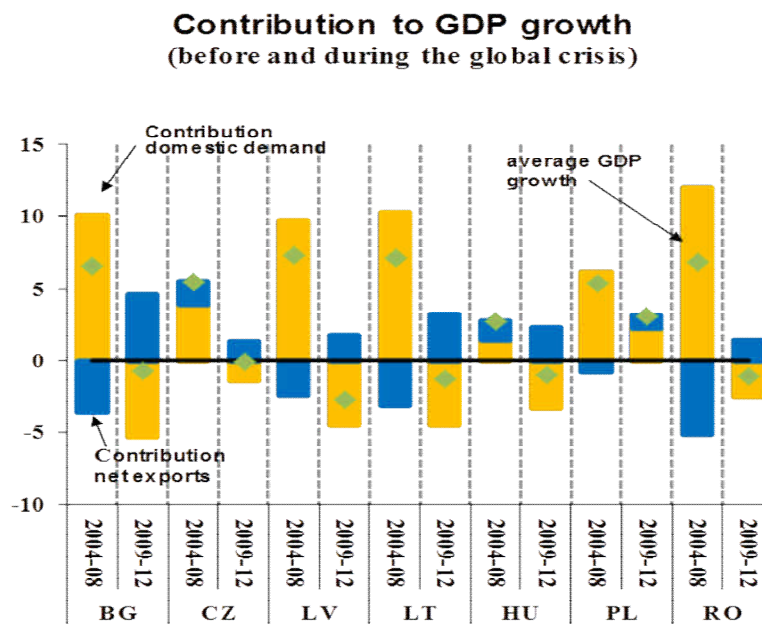
Non-euro area NMS economies rebound...

- short-term growth outlook deteriorated (as compared to pre-crisis)...
- real convergence gap increased for some NMS during the crisis...
- ...but positive growth differential vis-à-vis EA to be maintained going forward



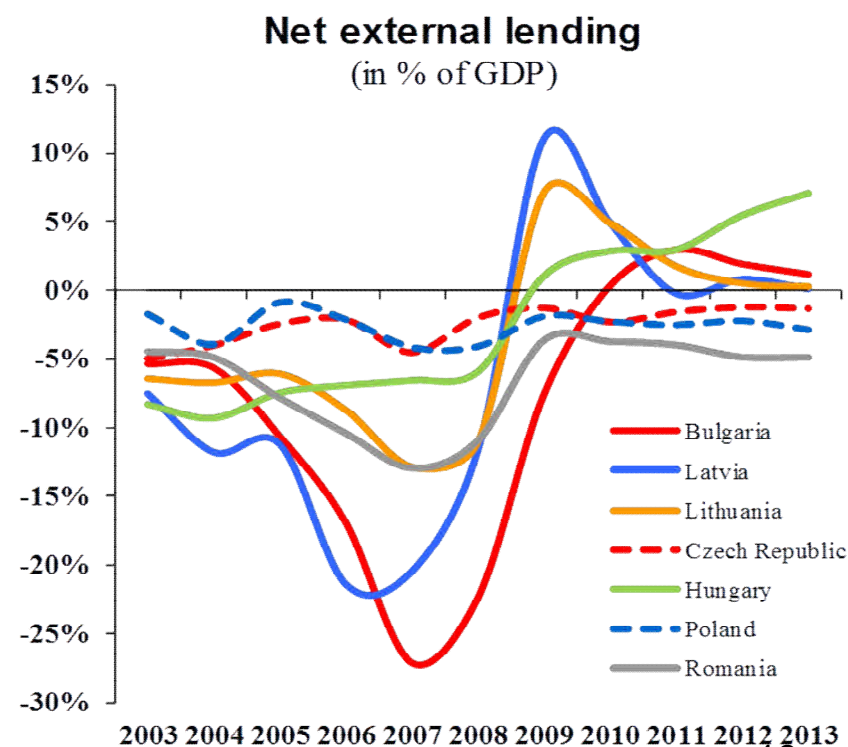
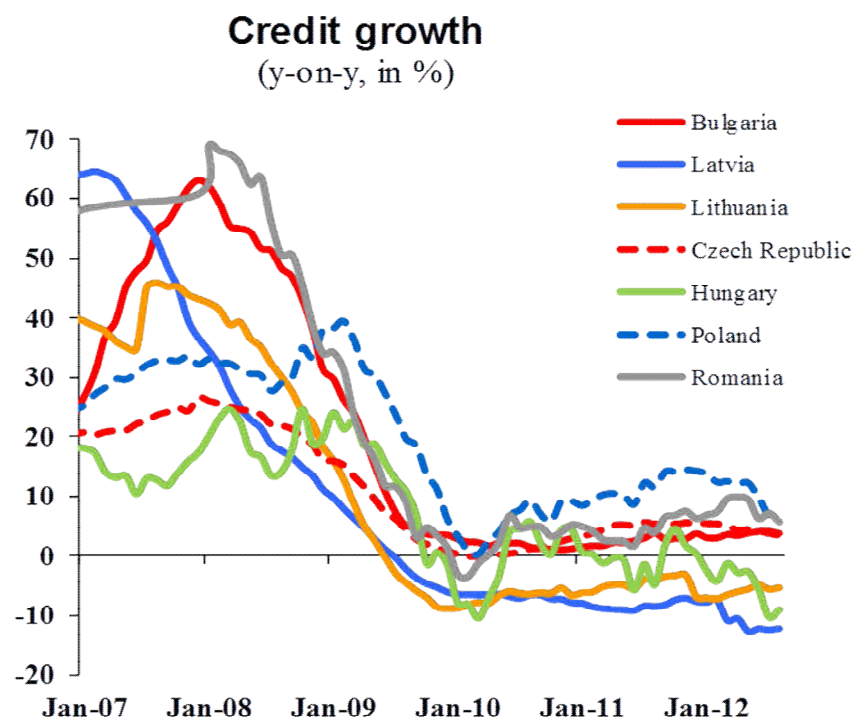
... an uneven recovery across countries

- driven by net exports (strong links to Germany, weak to euro peripherals)...
- ...though heterogeneous picture across the region reflecting crisis experience
- domestic demand needs to regain importance (e.g. PL case)



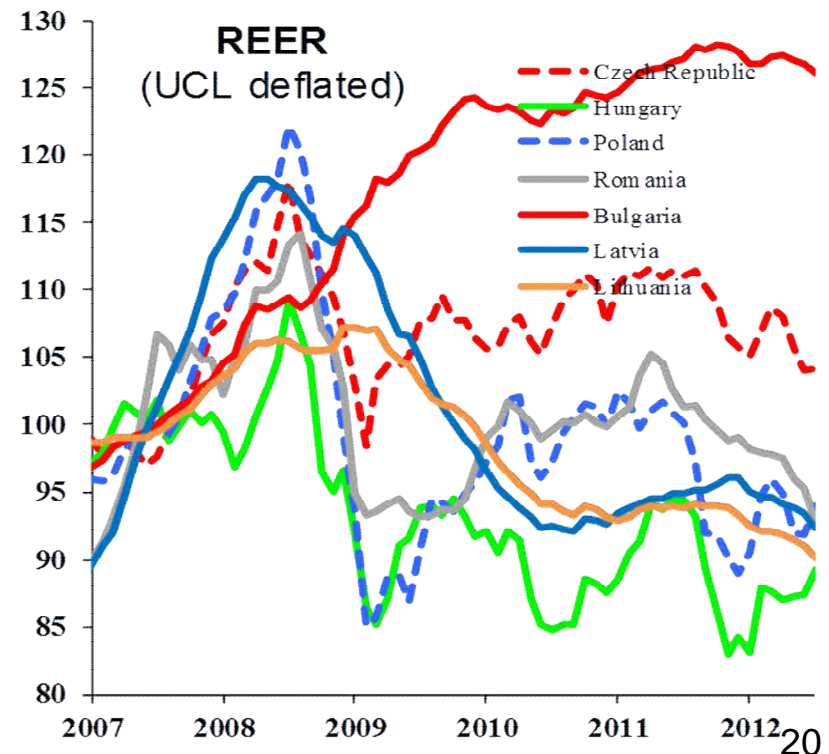
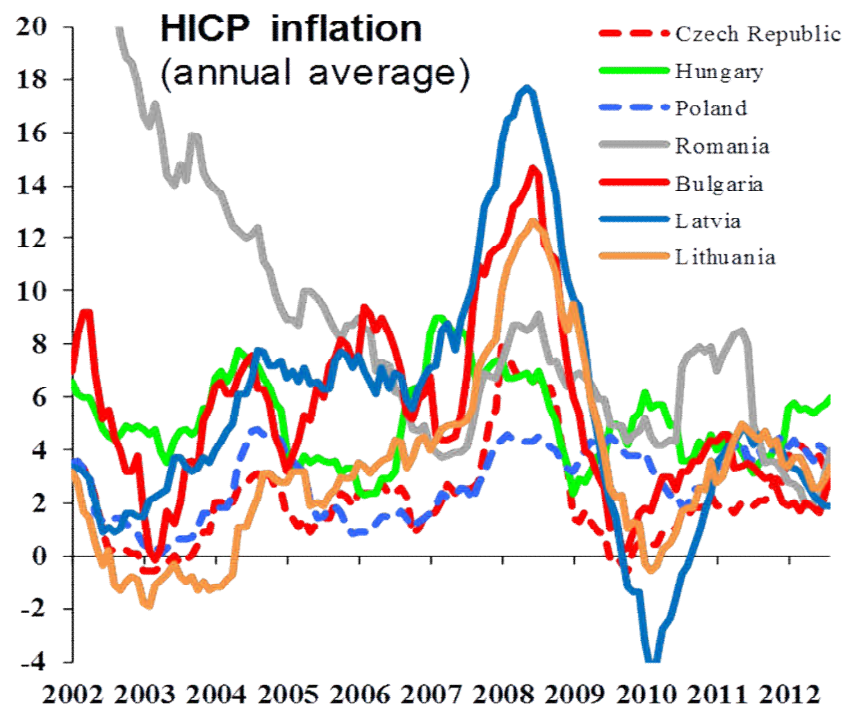
...while pre-crisis imbalances unwind ...

- muted credit growth and fiscal consolidation → unwinding of imbalances
- short-term outlook: no strong pick-up in domestic demand/credit growth



Inflation and competitiveness

- inflation pressures eased, now mainly driven by commodity prices
- some NMS gain competitiveness, though differentiated picture across the region





Long-term convergence in the NMS-7: summary

Supporting factors (+)

- real convergence gap remains large for most NMS
- comparatively flexible labour markets
- low penetration of banking services (but high private debt in some NMS)
- single EU market, geographical proximity*
- EU funds support *
- eventual euro adoption may further boost growth prospects*

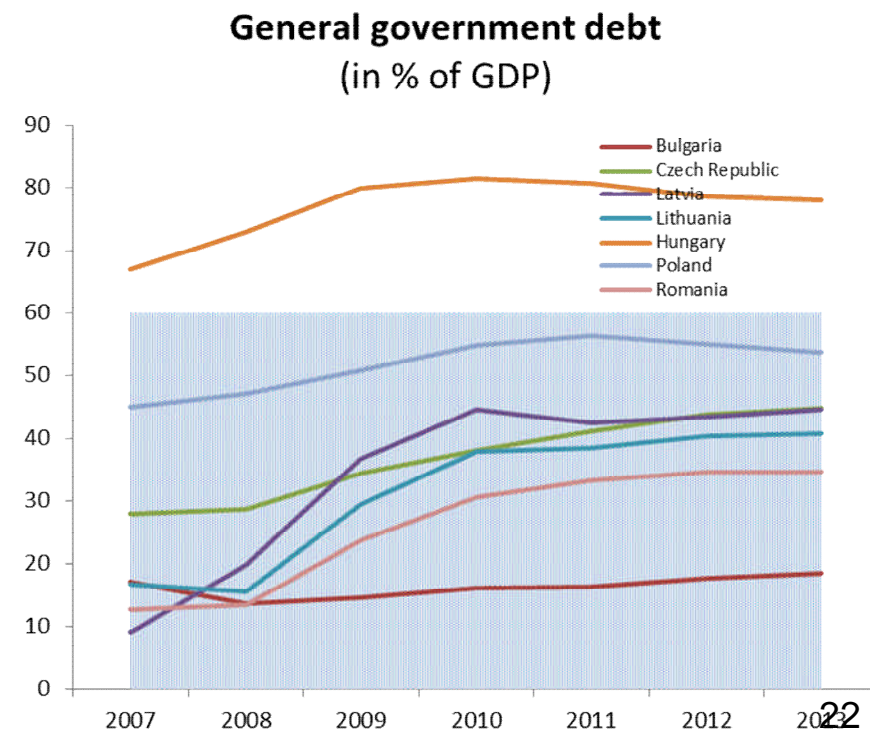
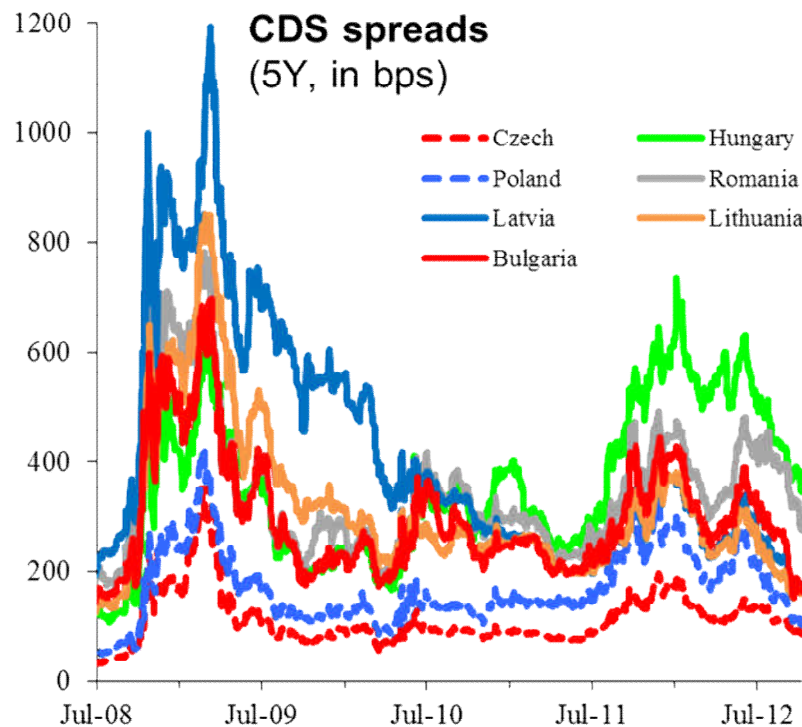
Constraining factors (-)

- the post-crisis adjustment may be long for some countries
- fiscal sustainability: unfavourable demographic outlook in some NMS
- structural weaknesses (e.g. business environment)
- some vulnerabilities remain in place (see below I-III)

* EU-specific factors

Potential vulnerabilities I.

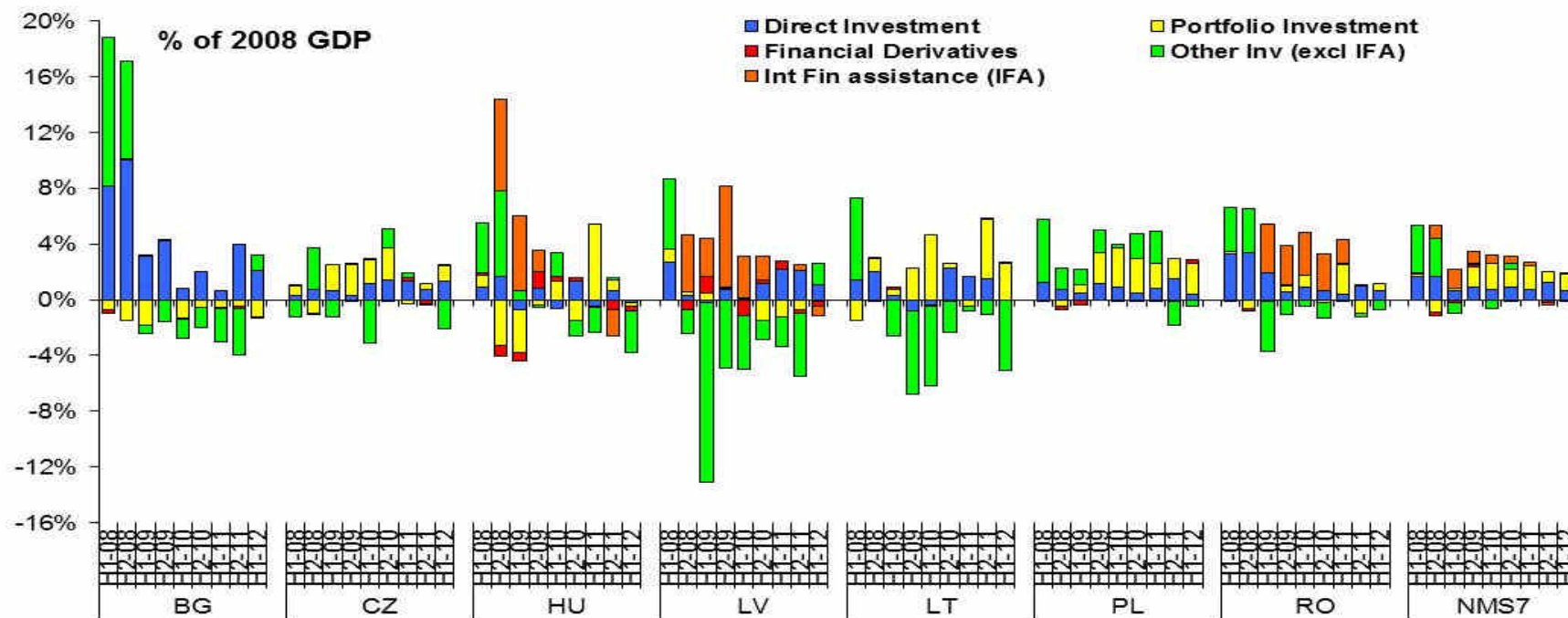
- Access to financing improved, though differentiated picture across the region and high volatility remains (\approx global risk aversion)...
- ...despite comparatively low government debt



Potential vulnerabilities II.

Capital inflows

- Recovered in post-crisis environment (e.g. portfolio inflows)...
-but present challenge especially for NMS with less developed capital markets
- role of EU funds /absorption capacity (new MFF 2014-2020)

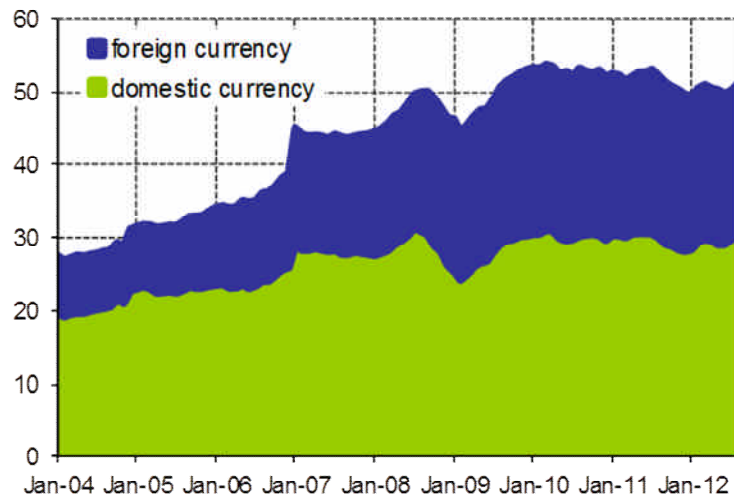


Potential vulnerabilities III.

FX lending and external funding

- share of FX lending remains (and increased) elevated in most NMS
- vulnerability to remain, developing local markets likely a long-term process

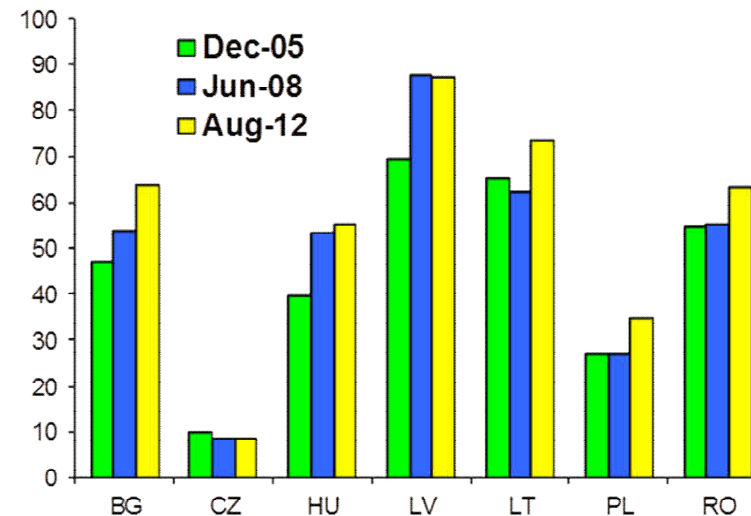
7 NEACs: Credit to GDP (in %)



Note: 2004-2006: CZ, LV, HU, LT, PL; as of 2007: incl BG, RO

Source: Reuters Ecowin, Central Banks websites, Commissionservices

Share of FX lending
(in % of credit to private sector)



Source: Reuters Ecowin, Central bank websites 24

A new growth model for the NMS?

The crisis has affected short-term economic outlook for NMS-7...

- export-driven growth more balanced
- high trade dependency (manufacturing) in most NMS, but probably no alternative to it (as in the past)

...while crisis also weighs heavily on euro adoption plans...

- deterioration in economic outlook and high financial market volatility
- perceptions of cost & benefits of the euro may have shifted, but
- NMS still well placed to benefit from the euro (e.g. recent NMS entrants/forerunners)...
- ...but success of euro adoption is not unconditional (crisis experience)

... growth model remains in place, though sustainability needed

- long-term growth model based on competitiveness gains, capital inflows and higher per capita income
- integrated into the new EU economic governance framework/ the EU Semester

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Policy agenda ahead for NMS

1. Fiscal policy

- need for credible medium-term framework and LT sustainability
- quality of public finances (incl. absorption of EU funds)
- building buffers (esp. at times of high global risk aversion)

2. Competitiveness and adjustment capacity

- enhance the functioning of labour and product markets (incl. wage setting)
- allow efficient resource allocation
- business environment and investment climate (innovation, FDI)

3. Safeguarding financial stability

- contain balance-sheet risks and prevent re-emergence of imbalances
- supervision of financial institutions



Strengthening EMU economic governance

New economic surveillance of EU economies

- broadened (macro-imbalances and competitiveness developments)
- deepened (increased focus on public debt and fiscal frameworks)
- better integrated across policy areas/national level (EU Semester)

Improved governance structures

- more effective enforcement mechanisms (incl. sanctions);
- stronger surveillance role for the Commission, and reinforced commitment of ECOFIN/ Eurogroup

Latest initiatives

- European Semester – ex ante/integrated approach
- Governance “six-pack” (Dec. 2011)
- Treaty on Stability, Coordination and Governance in the Economic and Monetary Union (“fiscal compact”, signed in March 2012)
- Banking union...



Euro adoption and the medium-term policy strategy

- Policy agenda not only because of the euro → **long-term interest of countries**
- *An orderly convergence path* → key to **preserve investor sentiment**
- Plans for euro adoption may serve as a **policy anchor**
- ...in an environment of **strengthened economic co-ordination in the EU**



Thank you!

The European Semester

