EUROPEAN CENTRAL BANK

EUROSYSTEM

The quest for sustainable convergence in EMU: the EMI’s convergence assessments

* The views expressed are those of the author and do not necessarily reflect the position of the ECB.

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Overview

Treaty requirements on convergence

Type of report	Legal basis	Time of publication	Comparable EC product
1994 Annual Report	Art. 7 + 11 EMI Statute	April 1995	Report on Convergence in 1994 (January 1995)
Ad Hoc Report on Progress towards Convergence	Art. 7 EMI Statute	November **1995**	Report on Convergence in 1995 (January 1996)
1995 Annual Report	Art. 11 EMI Statute	April 1996	
Progress towards Convergence	Art. 109 j (1) TEU	November **1996**	Report on Convergence in 1996 (November 1996)
1996 Annual Report	Art. 11 EMI Statute	April 1997	
1997 Update on Legal Convergence	Art. 7 EMI Statute	October 1997	
Convergence Report	Art. 109 j (1) TEU	March **1998**	Convergence Report 1998 (March 1998)
1997 Annual Report	Art. 11 EMI Statute	May 1998	

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  4. *the Treaty also requested to take account of "other factors" (which the EMI essentially treated as auxiliary indicators of sustainability)*

Strong central bank focus on sustainability

- *Already emphasised by central bank governors in the Delors Committee report*

  "… The Committee is fully aware that the process of achieving monetary union is only conceivable if a high degree of economic convergence is attained."

- *Clear conclusion of the EMI Council's approval of its first fully-fledged Convergence Report in November 1995*

  "The sustainability of positions regarding inflation and public finances has to be emphasised. We will try to introduce that naturally in the main report as well as in the executive summary … so that it really hits the reader right at the beginning and provides a very good basis for the rest."

- *Later on echoed in all EMI convergence assessments as well as in the ad hoc assessments of de Nederlandsche Bank and the Deutsche Bundesbank in March 1998*

  "The economic fundamentals must be right upon entry into monetary union and be sustainable on a permanent basis."

Overview

The EMI assessment of the sustainability of price developments

- Focus on special factors affecting the point-in-time outcome but which were unlikely to be sustainable (indirect tax changes; debt deflation conditions; deep recession → ‘outlier’ value)
- Attention for past inflation trends (even if not available on a harmonised basis)
- Emphasis on long-term policy drivers of inflation (monetary policy; fiscal policy; structural factors)
- Close look at underlying factors affecting inflation outcomes (commodity prices; exchange rate; ULC; capacity utilisation → bringing in some of the “other factors” as a complementary sustainability check

The EMI assessment of the sustainability of the government budgetary position

- Attention for underlying budgetary trends (change in public deficit ratio exceeding the change in public investment ratio; structural budget deficit reductions being lower than the nominal budget deficit reductions; tendency of rising gross public debt ratios)
- Clear focus on the breakdown of public debt ratio developments into its 3 main components (primary budget balance; GDP growth/interest rate effect; stock/flow adjustment)
- Calculation of public debt convergence gaps to bring down the public debt ratio to 60% (with forward-looking analysis based on the prospective SGP)
- Emphasis on the importance of fiscal sustainability impacting the sustainability of the three other convergence criteria (even if no hierarchy in the four criteria)

The EMI assessment of the sustainability of exchange rate stability and of long-term interest rates

- **Sustainability of exchange rate stability:**
  - Focus on the link between nominal and real effective exchange rate stability as an indicator of sustainable convergence
  - Small technical difference in the choice of the benchmark against which to measure exchange rate stability
  - Use of current account balances as an auxiliary indicator for the assessment of sustainable exchange rate stability
- **Sustainability of long-term interest rates:**
  - Reference to the main drivers of long-term interest rate differentials (differentials in expected inflation, in real interest rates and in risk premia)
  - Attempt made to account for the “convergence play” effect by looking at long-term interest rate convergence with the “core” countries
  - All in all considered the least telling indicator of convergence and sustainability

Overview

The legacy of the EMI's convergence assessments

- **EMI warnings on fiscal and real exchange rate sustainability were not heeded in an overall weak implementation of an incomplete economic governance framework during the first decade of EMU** (flexibilisation of the SGP; BEPGs and Lisbon Strategy ineffectual)
- **EMI assessment methodology, in rigorously sticking to the Treaty requirements, remained by and large unaffected by the challenge of EU enlargement** (some discussion on the appropriate benchmark for inflation and the need for ERM II participation)
- **EMI focus on public debt as a key driver of fiscal sustainability and the importance of real exchange rate stability (maintenance of competitiveness) were eventually recognised in the euro area's reinforced economic governance framework** (Six-Pack)

Overview

Concluding Observations (1)

- The parameters for the assessment of convergence were tightly circumscribed in the Treaty (as was the obligation for the EMI to conduct annual assessments)
- Yet, analytical room could be used to explore the concept of sustainability (by applying a wide-ranging, backward and forward-looking, approach)
- The EMI's sustainability assessment left a strong imprint on the ECB's subsequent convergence assessments and also influenced the EC's assessment methodology

Concluding Observations (2)

- Strong emphasis on fiscal sustainability and public debt-to-GDP ratio more specifically (even if no hierarchy in the four convergence criteria)
- Link between primary balance and the 60% public debt-to-GDP reference value was pointed out unambiguously
- But requirement to apply the EDP constrained the EMI to push the EC towards a more critical analysis of fiscal sustainability

Concluding Observations (3)

- The clear messages on fiscal consolidation requirements and the pointers to ULC and current account developments in the EMI reports were not taken to heart by euro area governments in the first decade after the start of Stage III
- Which contributed to diverging budgetary positions, real exchange rates and eventually long-term interest rates
- Which in turn triggered a deep crisis and created the need for a reinforced economic governance framework, which was delivered upon

Concluding Observations (4)

- High compliance by the EMI with the legal provisions for its mandatory task of convergence assessment
- Proved robust when new situations materialised (such as EU enlargement)
- But it implied that some aspects of relevance for sustainable convergence were underdeveloped in the convergence reports (notably private sector debt developments)

Concluding Observations (5)

- Treaty convergence requirements were near-silent on the role of the financial sector (and private debt developments) for securing sustainable convergence
- Only among “other factors” were limited references made to financial issues (development of ECU markets & the integration of markets)
- But EMI was of course not ignorant of the importance of financial stability for a well-functioning EMU, nor were the drafters of the Maastricht Treaty

Concluding Observations (6)

- Exclusive focus on macroeconomic policy in the Treaty convergence requirements led to under-emphasis of the role of structural policies in a well-functioning EMU
- EU enlargement & euro area sovereign debt crisis highlighted the importance of structural policy tools
- Again, the EMI was not oblivious to the importance of structural policies in countries entering into a sustainable monetary union, but found insufficient room for conveying this message in its convergence assessments

Concluding Observations (7)

- The **EMI**, a small and temporary institution, played a remarkable role in shaping the thinking on the conditions for sustainable convergence in EMU
- A considerable part of the praise must be attributed to the **first EMI President,** *Baron Alexandre Lamfalussy,* who oversaw the production of the initial EMI convergence reports

Thank you for your attention!

Article 109j (1) Treaty on European Union (TEU)

- "*reports shall include an examination of the compatibility between each Member State's national legislation including the statutes of its national central banks, and Articles 108 and 109 of this Treaty and the Statute of the ESCB. The reports shall also examine the **achievement of a high degree of sustainable convergence by reference to** the fulfilment by each Member State of the **following criteria**:*

  1. *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;*
  2. *the **sustainability of the government financial position**; this will be apparent from having achieved a government budgetary position without a deficit that is excessive as determined in accordance with Article 104(6);*
  3. *the **observance of the normal fluctuation margins** provided for by the **exchange-rate mechanism of the European Monetary System**, for at least two years, without devaluing against the currency of any other Member State;*
  4. *the **durability of convergence achieved by the Member State** and of its participation in the exchange-rate mechanism of the European Monetary System being reflected in the **long-term interest-rate levels**.*"

Protocol (No 13) on the convergence criteria

1. "*price stability* […] *shall mean that a Member State has a price performance that is sustainable and an average rate of inflation, observed over a period of one year before the examination, that does not exceed by more than 1 ½ percentage points that of, at most, the three best performing Member States in terms of price stability.*"

2. "*government budgetary position* […] *shall mean that at the time of the examination the Member State is not the subject of a Council decision under Article 126(6)* [EDP] *of the said Treaty that an excessive deficit exists*"

3. "*participation in the Exchange Rate mechanism of the European Monetary System* […] *shall mean that a Member State has respected the normal fluctuation margins provided for by the exchange-rate mechanism on the European Monetary System without severe tensions for at least the last two years before the examination. In particular, the Member State shall not have devalued its currency's bilateral central rate against the euro on its own initiative for the same period.*"

4. "convergence of interest rates […] shall mean that, observed over a period of one year before the examination, a Member State has had an average nominal long-term interest rate that does not exceed by more than two percentage points that of, at most, the three best performing Member States in terms of price stability."

Article 109j (1) Treaty on European Union (TEU) – contd. -

Article 109j (1) went on to stipulate that the reports of the European Commission and the EMI should also

"take account of the ***development of the ECU****, the results of* ***the integration of markets****, the situation and* ***development of the balance of payments on current account*** *and an* ***examination of the development of unit labour costs*** *and other price indices."*