EUROPEAN CENTRAL BANK

EUROSYSTEM

Transmission embargo until 9 p.m. ECB time (C.E.T.) on Monday, 20 November 2006

Dinner Speech

"ECONOMIC AND MONETARY CHALLENGES OF EURO AREA ENLARGEMENT"

held at the conference "The changing landscape of FDI in Europe"

organized by the Oesterreichische Nationalbank

20-21 November 2006

by
Jürgen Stark
Member of the Executive Board
and the Governing Council
of the European Central Bank

20 November 2006

Vienna

Check against delivery.

European Central Bank
Directorate Communications - Press and Information Division
Kaiserstrasse 29, D-60311 Frankfurt am Main
Tel.: 0049 69 1344 7455, Fax: 0049 69 1344 7404
Internet: http://www.ecb.int

Ladies and gentlemen,

I would like to thank the Oesterreichische Nationalbank and the European Bank for Reconstruction and Development for inviting me to this conference. Vienna is certainly one of the best places in Europe to deliver a speech about the economic and monetary challenges of euro area enlargement. After all, the city serves in so many ways as a bridge between "old" and "new" European Union countries in West and East as well as between current European Union members and candidate and potential candidate countries in the South-East of our continent.

Let me go back to 1 May 2004. On that day the European Union witnessed its biggest enlargement so far. Ten central European and Mediterranean countries joined the Union. In January 2007 two other countries – Bulgaria and Romania - will follow suit and the European Union will then comprise no less than 27 members. These events mark real milestones in the history of Europe. After more than half a century of political and economic division, the enlargement of the European Union has finally brought economic stability and a hitherto unthinkable degree of political co-operation, based on democracy and the rule of law to large parts of Europe. The enlargement process has been long and involved many efforts both from the then accession countries as well as from the old members of the Union.

The new Member States had to undertake far-reaching legal and economic reforms in order to comply with the EU acquis communautaire and to cope with the market pressures of the single market. Although further work still needs to be done, they have significantly liberalised and modernised their economies and now are expanding dynamically. For the old Member States the enlargement meant tougher competition and additional pressures to pursue structural adjustments and intensify innovation. Moreover, in the spirit of solidarity, they supported the enlargement process financially through the EU budget.

Enlargement has contributed greatly to growth and employment in the new Member States. This is mainly attributable to strengthened trade and financial integration including significant foreign direct investment flows, and the availability of EU funds. But the old Member States benefit from this process as well. Fears in the old Member States about job losses and downward pressure on wages due to massive migration and the relocation of activity have proved to be exaggerated. At the same time enlargement has created new opportunities for firms in the old EU countries. They have gained better access to new Member States' markets, enabling them to sell their products and obtain cheaper inputs for their production, which in turn enhances their productivity vis-à-vis third countries. Also European Union consumers – in the old and new Member States alike – have benefited from a greater choice of products that are available at lower prices. In addition, the enlarged single market has been conducive for enhancing dynamism and strength of the European Union economy, placing it in a better position to weather global competition.

Despite this very positive picture and the fact that the functioning of the enlarged European Union has been smooth so far, let me also stress that many of the old and new Member States still face considerable economic challenges. Although the catching-up process in the new Member States was rapid in recent years, it is not over yet. Most of the new Member States have still a significantly lower level of income per capita than most old Member States. Consequently, after the recent enlargement, the European Union has become a more heterogeneous region in terms of economic development.

Full membership in Economic and Monetary Union is still to come for the new Member States and this poses another important challenge for them. This aspect of further integration is of course particularly close to my heart. Seven of them have already advanced in the process of monetary integration by joining the Exchange Rate Mechanism II. Among this group, Slovenia has managed to complete the process and as of 1 January 2007 it will become the 13th member of the euro area. A development that it warmly welcomed not only by myself but also by the Executive Board and the Governing Council of the European Central Bank.

Against this background, I would like to share my views on the challenges of further euro area enlargement with you. First, I will briefly describe the formal stages of the euro adoption process and elaborate on the main challenges for the new Member States stemming from this process. I will stress the need for achieving a high degree of nominal, real and legal convergence as well as the strict assessment of the convergence criteria. Then, I will delve into challenges of current and prospective members of the euro area, dealing in particular the need for responsible structural and fiscal policies. These policies are a matter of common concern in a monetary union, and are essential for an effective conduct of a common monetary policy and for sustained growth in a highly competitive global environment.

Challenges on the road from EU to euro area membership

Starting with challenges for the new Member States, let me briefly remind you about the formal stages of euro adoption, which are given by the Treaty. The new Member States, unlike Denmark and the United Kingdom, do not have an opt-out clause and are currently members of the Economic and Monetary Union with a derogation. This means that they are expected to adopt the euro once they fulfil the convergence criteria. The first step on this "road to the euro" is to join the Exchange Rate Mechanism II. Participation in this mechanism is meant to be a testing period, during which countries have time to prepare their economies for euro adoption and to ensure the sustainability of the convergence process. After remaining in the Exchange Rate Mechanism II for at least two years, a country may qualify to adopt the euro. This involves a formal assessment of the fulfilment of the convergence criteria, relating to price, fiscal, exchange rate and long-term interest rate developments.

Without going into too many details on the convergence criteria, I would like to stress just two things.

- First, the examination of the sustainability of the convergence process is undertaken on the basis of a coherent analytical framework specified in our Convergence Reports. This framework has in the past been used consistently across time and for all examined countries and we will continue to use this framework for analysis in the future. Another Convergence Report in prepared by the EU-Commission.
- Second, we always emphasise in our examinations that the compliance with the convergence criteria must be achieved on a sustainable basis and not only at a specific point in time. These two considerations are of utmost importance for the credibility of Economic and Monetary Union.

Let me also draw your attention to legal convergence, which is sometimes a bit overlooked due to discussions about progress in economic convergence or the lack thereof. However, achieving convergence in both dimensions is required by the Treaty and these dimensions are equally important. In general, legal convergence requires the compatibility of national legislation, including the statutes of the central bank, with the Treaty and the Statute of the European System of Central Banks. In this context the legal assessment considers various types of central bank independence, namely functional, institutional, personal and financial independence. Against this background, I would like to stress again that the independence of a central bank from political institutions is absolutely crucial. It must not only be safeguarded by legal acts in all its dimensions. It must also be observed in practice.

Given the formal procedures of adopting the euro, the main challenge for the new Member States is to achieve a high level of sustainable convergence. Let me stress that giving serious consideration to this goal is in the new Member States' own interest. A premature entry to the euro area might have negative consequences for a particular country and an insufficiently prepared newcomer may have problems with maintaining economic and financial stability as well as low inflation.

The current monetary policy framework of the European Central Bank has been very successful and there will be no changes in the monetary policy objectives and strategy. This implies that the new Member States joining the euro area will have to adjust to the current regime and a careful preparation for this is of the essence to achieve a high degree of real convergence prior to the adoption of the euro. At the same time, it goes without saying that such a careful preparation is also important for the credibility of the entire EMU project, and confidence in the ECB and the Euro.

Against this background, let me briefly note that many new Member States have recently postponed their euro adoption plans. These decisions resulted in some cases from the inability to

fulfil the convergence criteria due to rising inflationary pressures and in some cases from unsound government budgetary positions. Obviously it is up to individual countries to decide whether to set euro adoption dates or not. But if dates are fixed this should be done in a credible and realistic manner, taking into account the need to fulfil the criteria of economic convergence on a lasting basis. Setting a realistic timetable for euro adoption will help to anchor domestic economic policies and avoid unwanted market tensions. By contrast, setting unrealistic timetables can result in challenging situations when it comes to communicating with markets and the general public.

Challenges for current and prospective euro area members

Now let me shift to the challenges faced by current and prospective euro area members. As already indicated, participation in a monetary union has important implications for domestic economic policies. The key objective of the European Central Bank is to maintain price stability in the euro area. A successful implementation of this objective is the key channel via which monetary policy contributes to economic growth and job creation. However, the creation of conditions those are equally necessary for economic expansion, prosperity and for a smooth functioning of EMU lie beyond the scope of monetary policy. These are in particular sound fiscal policy and sufficiently flexible labour, product and capital markets, which in turn often require the implementation of comprehensive structural reforms. Therefore, the challenge is to implement a set of structural reforms in those areas where major deficiencies had been identified. Specific priorities may differ from country to country, but the general directions are common.

Starting with fiscal policy, in recent years a few EMU Member States have exhibited considerable fiscal imbalances and have been under the excessive deficit procedure. Similar situations have also been observed in several non-euro area EU Member States. Although some progress with regard to fiscal deficits has been made recently, much of this progress was due to the improving economic environment and revenue windfalls. Structural consolidation has often not been sufficient. There is hence no reason for complacency and the "current good times" must be used determinedly to eliminate the remaining fiscal imbalances on a sustainable basis.

One should remember that sound fiscal polices are important not only for the credibility of Economic and Monetary Union, but also for long-term growth. Sound fiscal policies, in accordance with the EU stability and growth pact, support macroeconomic stability and ensure a predictable economic environment. The resulting reduction in uncertainty promotes longer-term decision-making, notably with regard to investment decisions, and fosters economic growth. In this respect, adhering to the rules of the Stability and Growth Pact is very important. And we must be aware of sound fiscal positions being also crucial for meeting increasing fiscal costs due to population aging. In this regard, an important challenge for fiscal policy is to design the expenditure and revenue structure in a way that reduces inefficient public spending and supports productivity-enhancing physical and human capital accumulation.

Regarding labour markets, a major challenge for structural reforms is to find the right balance between social considerations and individual incentives that maximise economic welfare. Areas of particular interest are the social transfer systems, employment protection laws and the wage setting mechanisms, including wage indexation. Equally important are policies supporting the creation of new businesses. From the monetary policy point of view it is also important that labour market reforms contribute to wage adjustments that reflect more closely regional and sectoral productivity differences.

Turning to product market reforms, they play a key role in enhancing innovation, ensuring an efficient allocation of resources, and creating a business-friendly environment. In recent years, much headway has been made in the European Union regarding the integration and the level of competition in product markets. Nevertheless substantial barriers to free competition continue to exist in some areas, preventing for example integration of services markets and effective competition in a number of network industries.

With regard to financial markets, structural reforms in this area should aim at facilitating a more effective allocation of savings toward the most rewarding investment opportunities and at the same time at securing financial stability. Greater financial integration fosters financial developments and the modernisation of the financial system and, ultimately, economic growth. A part of this integration is evident in large foreign direct investment flows within Europe – a topic you have been extensively discussing during this conference.

It must be stressed that although non-monetary economic policies are at the discretion of particular Member States, they must be treated as a matter of common concern. Neglecting reforms in one country can have negative implications not only for this country, but also for other members of the union. Therefore, all the euro area countries should do their best to advance with the reform agenda. Sharing a common currency means sharing a common destiny. In addition, let me add that the need for structural reforms and sound fiscal policies is not limited to members of a monetary union. Flexible and well functioning markets are a universal need in the highly competitive and rapidly changing global economic environment. From this point of view, the general call for structural reforms and sound fiscal policy applies equally to the current as well as the future euro area countries. Let me also stress that in the case of the new Member States such reforms, will not only allow them to cope with the challenges of the monetary union, but also to enhance the current catching-up process and to alleviate any transition costs of the still ongoing restructuring of their economies.

Conclusions

Let me conclude. Given that the new Member States are sooner or later expected to join the euro area, the key challenge for this enlargement process is to ensure a high degree of durable convergence in these countries. This should be reflected in nominal, real as well as legal

convergence. The fulfilment of this goal will be important not only for the successful macroeconomic performance of the new EMU members, but also for the credibility of the entire Economic and Monetary Union. For this reason, let me stress again that the examination of the convergence criteria must be undertaken and will be undertaken in a strict manner according to the principles stipulated by the Treaty. The success of the enlarged Economic and Monetary Union hinges also on how well labour, capital and product markets in the current and prospective members are functioning. Under the framework of the euro area's single monetary policy it is of key importance for all member countries to identify and effectively implement the appropriate structural and fiscal policies.