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Frank Moss
European Central Bank

Economic challenges for EU candidate and potential candidate countries and the road to membership of a genuine EMU

Seminar: Institutional Challenges for Candidate and Potential Candidate Countries on the Road to the EU and EMU

Vienna, 16 May 2014

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

Outline

I. Key challenges for the CPCCs on their way to the EU and EMU

II. Early lessons from new euro area entrants in Central Europe

III. Key challenges for EU/EA members in the implementation of a reinforced EMU

IV. Conclusions: a medium-term policy agenda

Outline

I. **Key challenges for the CPCCs on their way to the EU and EMU**

Challenges for CPCCs

Medium to long term challenges:

Macroeconomic challenges

- achieving sustainable growth and convergence
- further unwinding external imbalances
- fully anchoring inflation
- containing budget deficits and public debt

Financial stability challenges

- financing sustainable convergence
- addressing asset quality and repairing the bank lending channel
- fending-off risks posed by fx lending

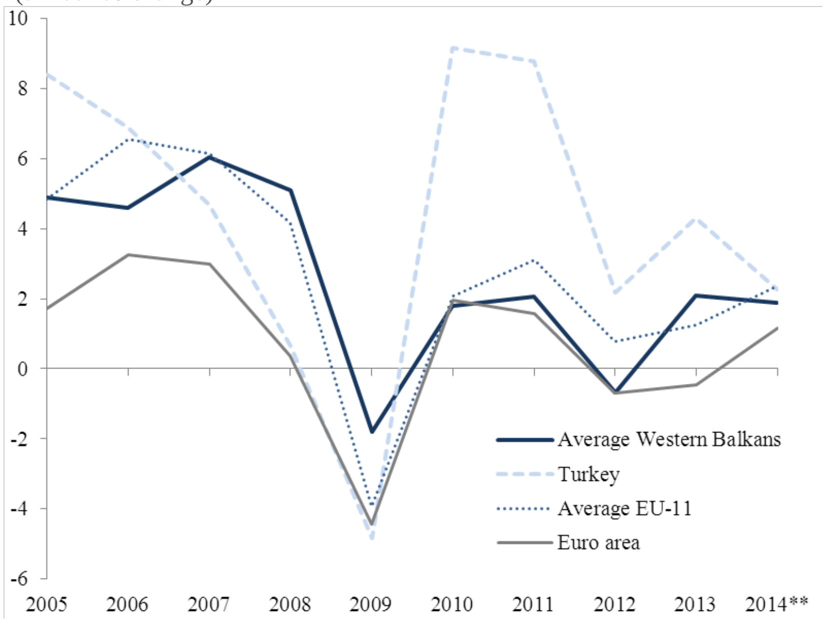
Institutional and Governance Challenges

- Improving governance

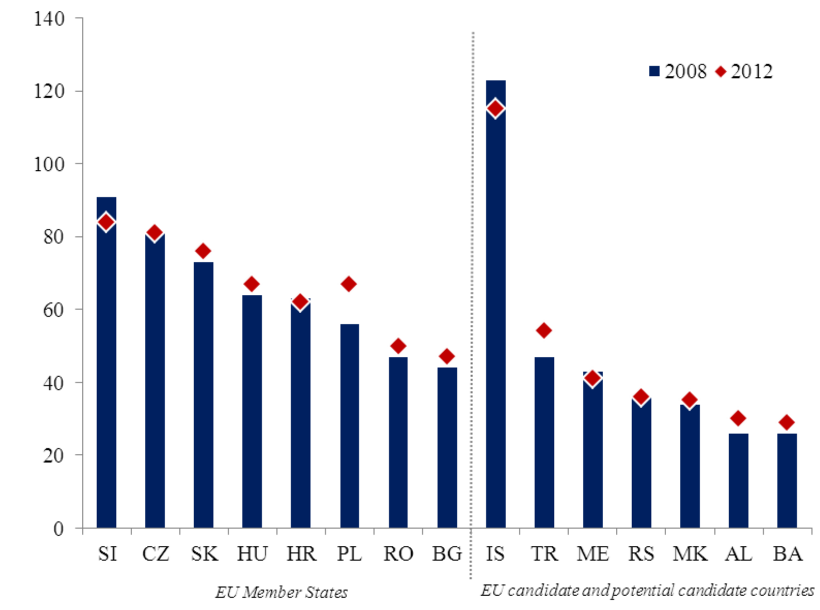
Macroeconomic challenges

Macroeconomic challenge #1: achieving sustainable growth and convergence

Real GDP growth for selected economies
(annual % change)



Real GDP per capita in PPS
(Index EU-20=100)



*This designation is without prejudice to positions on status, and is in line with UNSCR 1244 and the ICJ Opinion on the Kosovo Declaration of Independence.

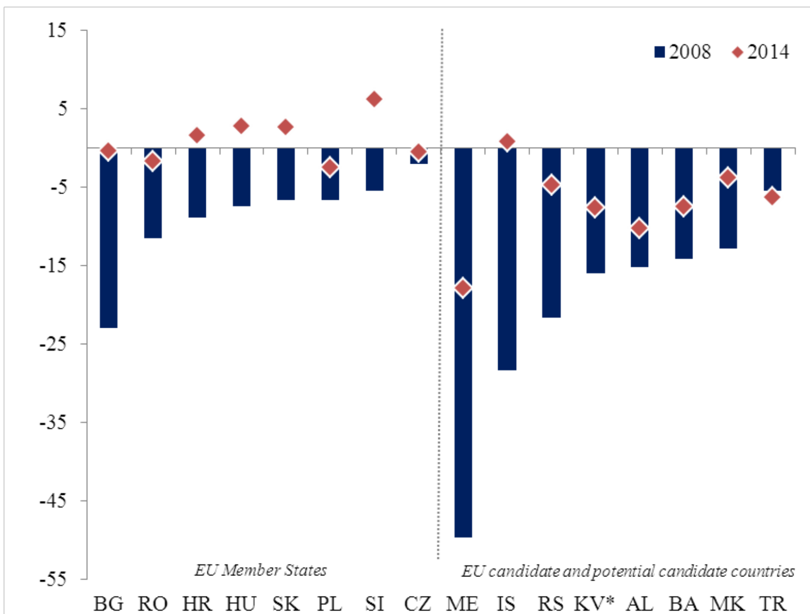
*Sources: Eurostat, IMF/WEO (** indicates projections) and ECB staff calculations.*

Notes: Western Balkans include Albania, Bosnia and Herzegovina, Kosovo *, FYR Macedonia, Montenegro and Serbia. EU-11 covers EU member states that joined in and after 2004, except Cyprus and Malta. Regional aggregates are calculated using the share of each country in the total annual nominal GDP of the region times the country's annual real GDP growth in order to obtain a weighted average reflecting the size of the economies. PPS refers to Purchasing Power Standard.

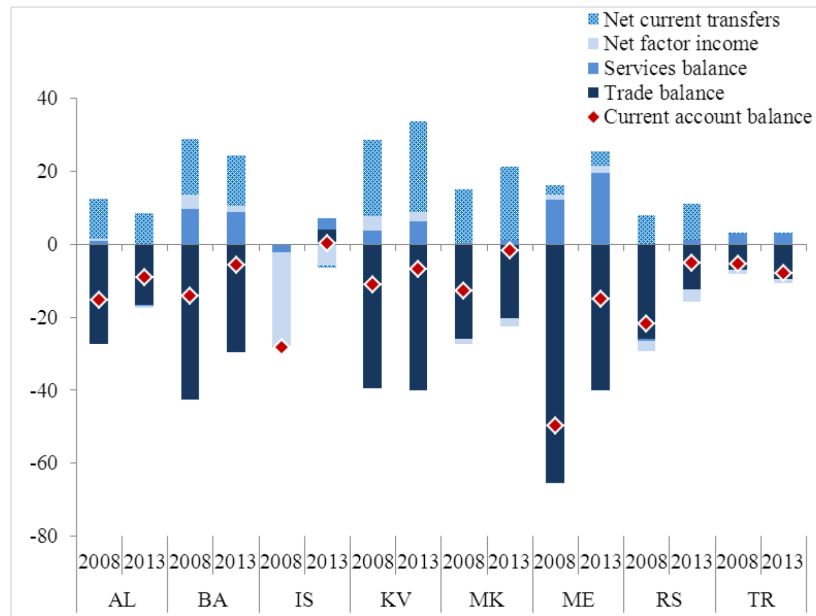
Macroeconomic challenges

Macroeconomic challenge #2: further unwinding external imbalances

Current account balances in selected economies
(% of GDP)



Components of the current account balance in 2008 and 2014
(% of GDP)

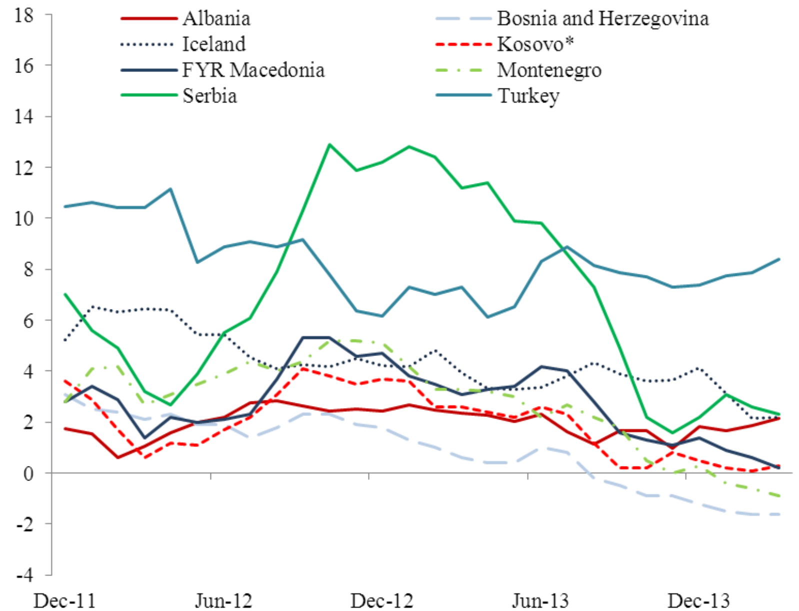


* Under UNSCR 1244
Source: IMF/WEO (figures for 2014 are projections).
Notes: EU-11is a median observation for all member states which joined the EU in and after 2004, except CY and MT.

Macroeconomic challenges

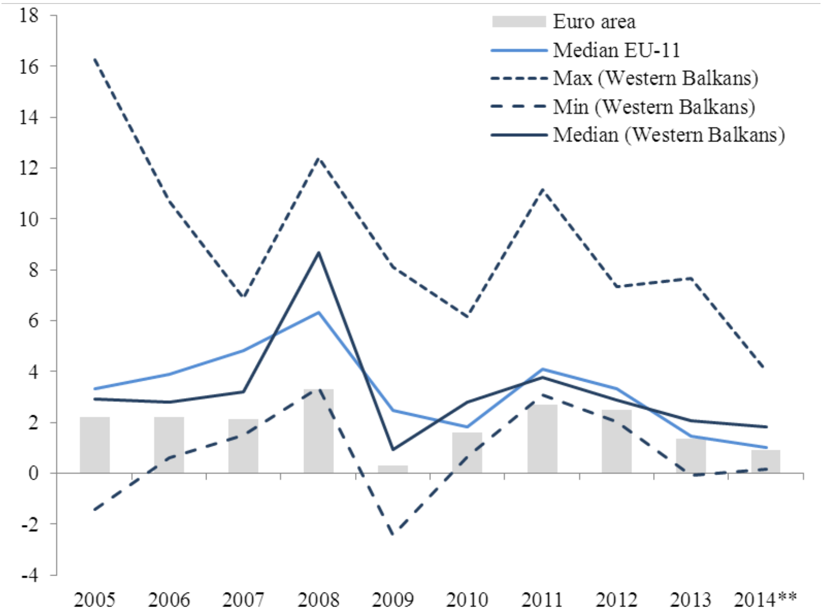
Macroeconomic challenge #3: fully anchoring inflation

CPI inflation
(annual % changes, p.a)



* Under UNSCR 1244
Sources: IFS, national central banks and ECB staff calculations.

CPI inflation
(annual % changes, p.a)

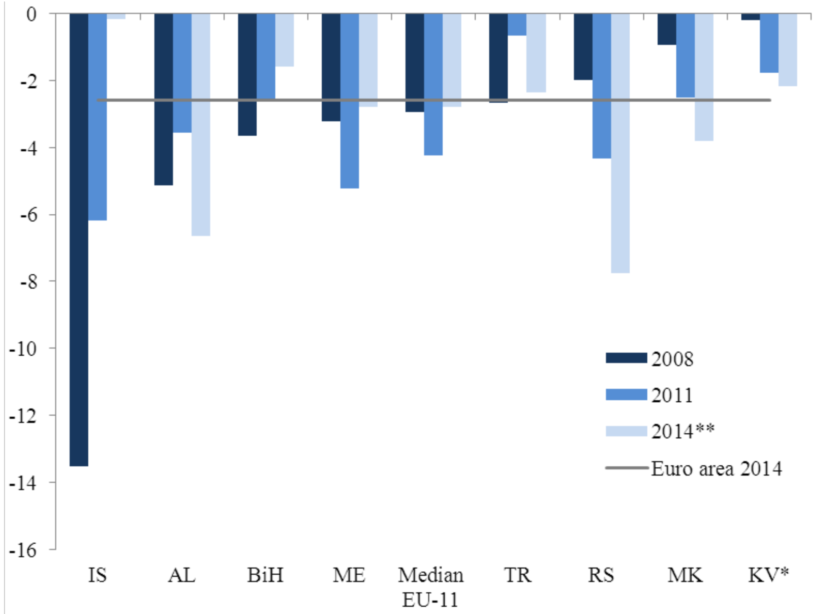


Notes: Western Balkans include AL. BiH, KS * (under UNSCR 1244), MK, ME and RS. EU-11 is a median of all member states which joined the EU in and after 2004, except Cyprus and Malta.
*Source: IMF/WEO (** indicates projections).*

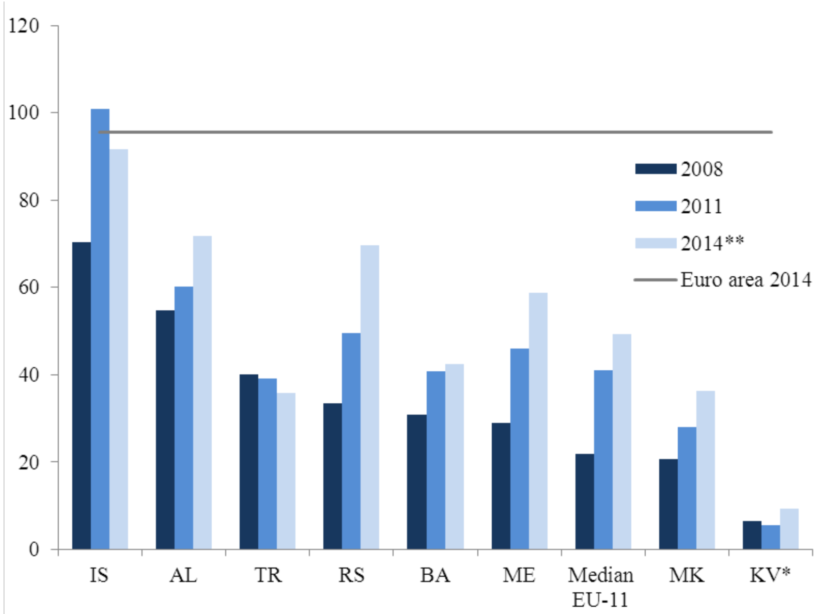
Macroeconomic challenges

Macroeconomic challenge #4: containing budget deficits and public debt

General government net lending/borrowing
(% of GDP)



General government gross debt
(% of GDP)



* Under UNSCR 1244
*Sources: IMF/WEO (** indicates forecasts), Ministry of Finance of the Republic of Kosovo and ECB staff calculations.*
Notes: EU-11 covers EU member states that joined in and after 2004 and 2007, except Cyprus and Malta. Earliest data point for public debt Kosovo is 2009 and public debt data for 2014 are as of Q1 2014.

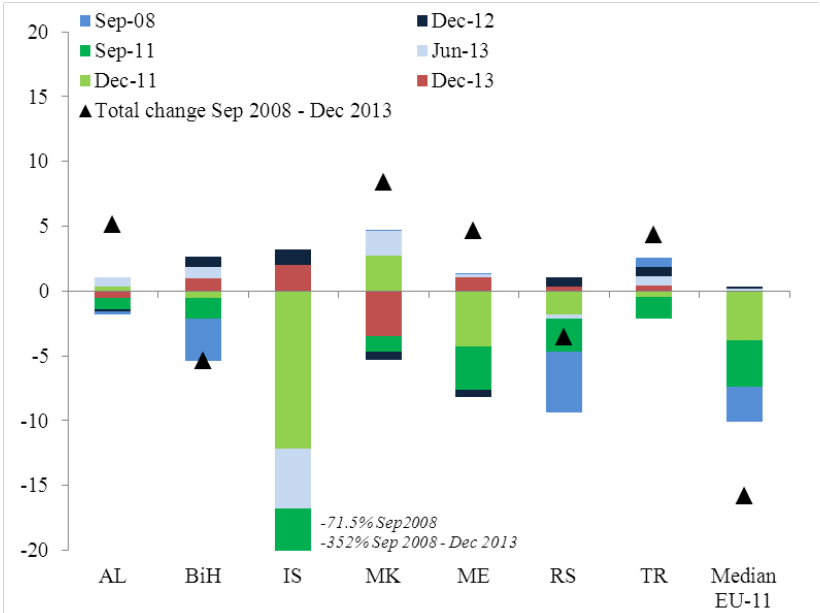
Financial Stability Challenges

Financial stability challenge #1: financing sustainable convergence

In the short-term:
Coping with parent bank deleveraging and raising domestic sources of funding

In the medium term:
Recalibrating banks' business models and developing local capital markets

BIS reporting banks' cross-border claims on banking sectors in selected countries
(quarter-on-quarter changes, % of full-year nominal GDP)

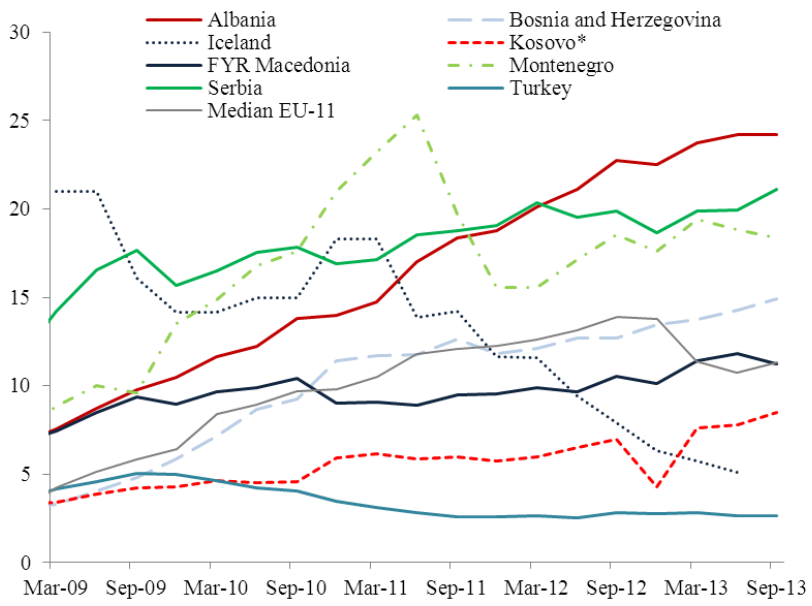


Sources: BIS locational banking statistics, IMF/WEO and ECB staff calculations.
Notes: EU-11 covers EU member states that joined in and after 2004 and 2007, except Cyprus and Malta. Data are not fx-adjusted.

Financial Stability Challenges

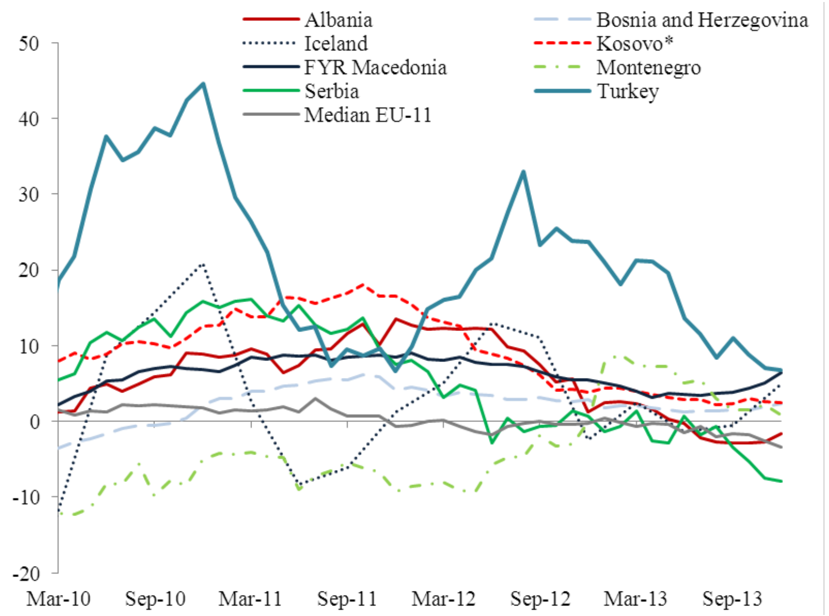
Financial stability challenge #2: addressing asset quality and repairing the bank lending channel

Non-performing loans to total gross loans
(%)



* Under UNSCR 1244
Sources: Haver Analytics, IFS and national central banks.
Notes: EU-11covers all new EU member states that joined in and after 2004, except Cyprus and Malta. Data for Bulgaria are on an annual basis.

Credit to private sector
(percentage change on a year earlier)

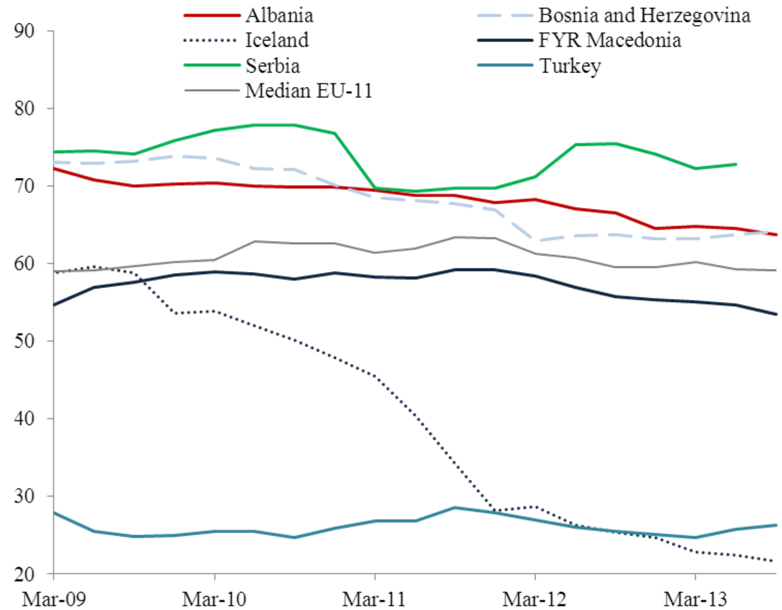


* Under UNSCR 1244
Sources: National central banks and ECB staff calculations.
Notes: The time series are converted into euro and fx-adjusted with the difference in the exchange rate compared to the same month the previous year.

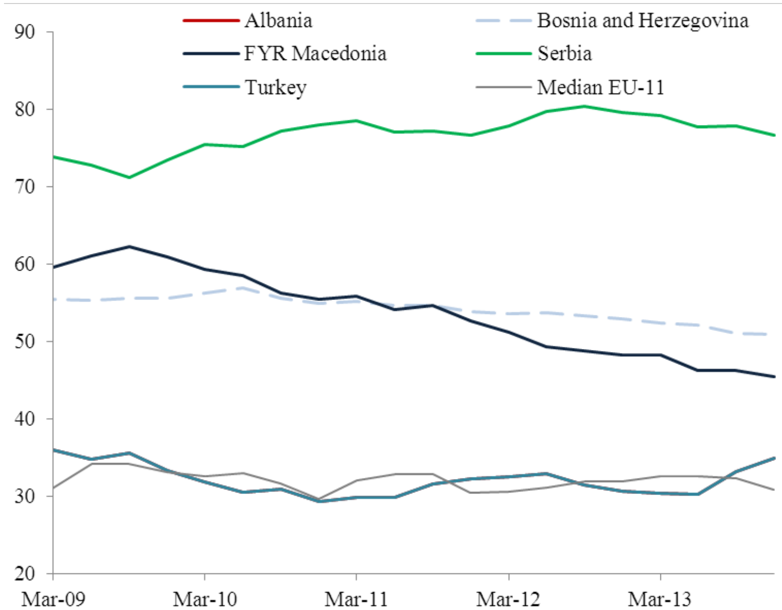
Financial Stability Challenges

Financial stability challenge #3: fending-off risks posed by fx lending

Foreign currency indexed or denominated loans to total loans
(%)



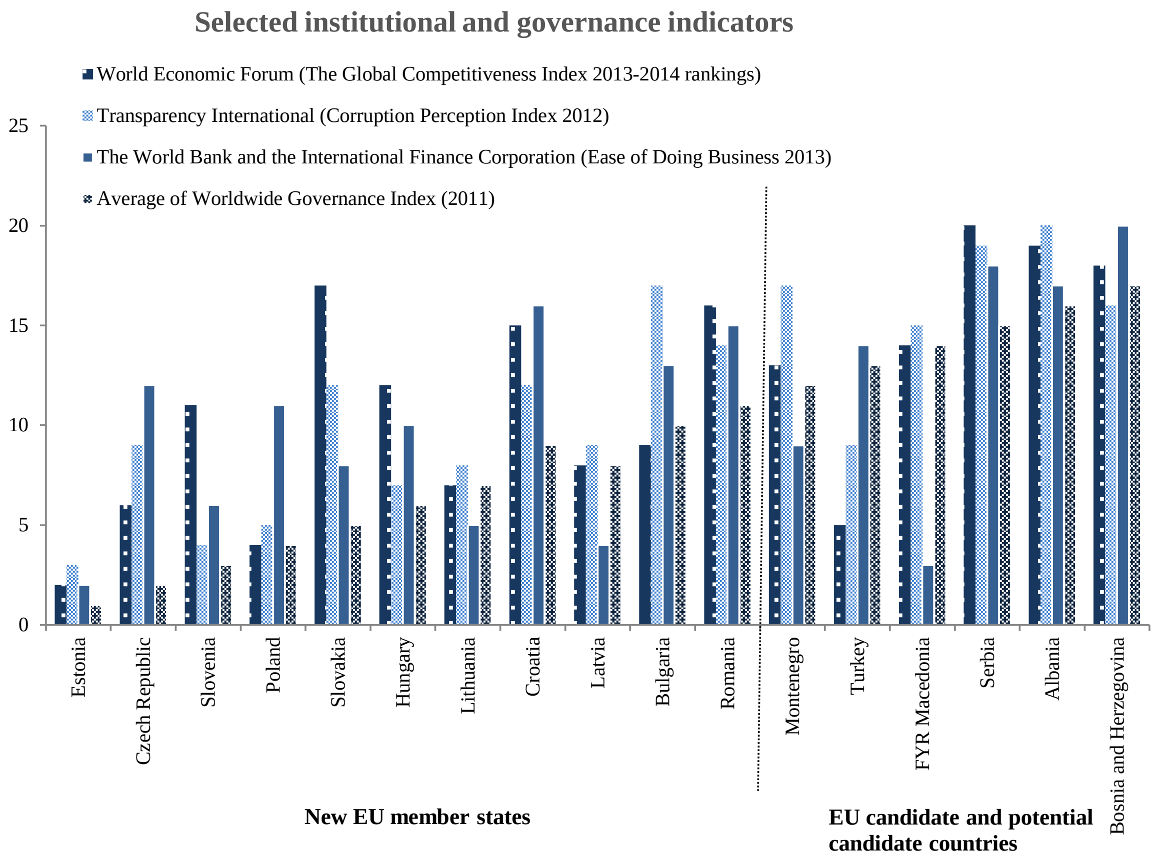
Foreign currency indexed or denominated deposits to total deposits
(%)



* Under UNSCR 1244
Sources: ECB, Haver Analytics, IFS and national central banks.
Notes: EU-11covers all EU member states that joined in and after 2004, except Cyprus and Malta. Iceland is excluded from the right chart due to lack of data.

Governance Challenges for CPCCs

Institutional indicators show CPCCs edging closer to regional average, but still far from standards of EU member states….



Sources: World Economic Forum, Transparency International, World Bank, IFC.
Note: For presentational purposes, countries are sorted by the World Bank's average of worldwide governance index. Lower rank indicates better performance.

Governance Challenges for CPCCs

- **Apart from mastering macroeconomic and financial stability challenges, strong governance and high-quality institutions remain key for underpinning the structural reforms needed to generate sustainable convergence**

- **The EU accession process should not be seen as a mechanic exercise of fulfilling the condition of EU ‘acquis’ adoption, but as an opportunity to fundamentally improve institutions and policies at home**

- **The improved EU governance framework can provide orientation already before it becomes formally applicable upon EU accession**

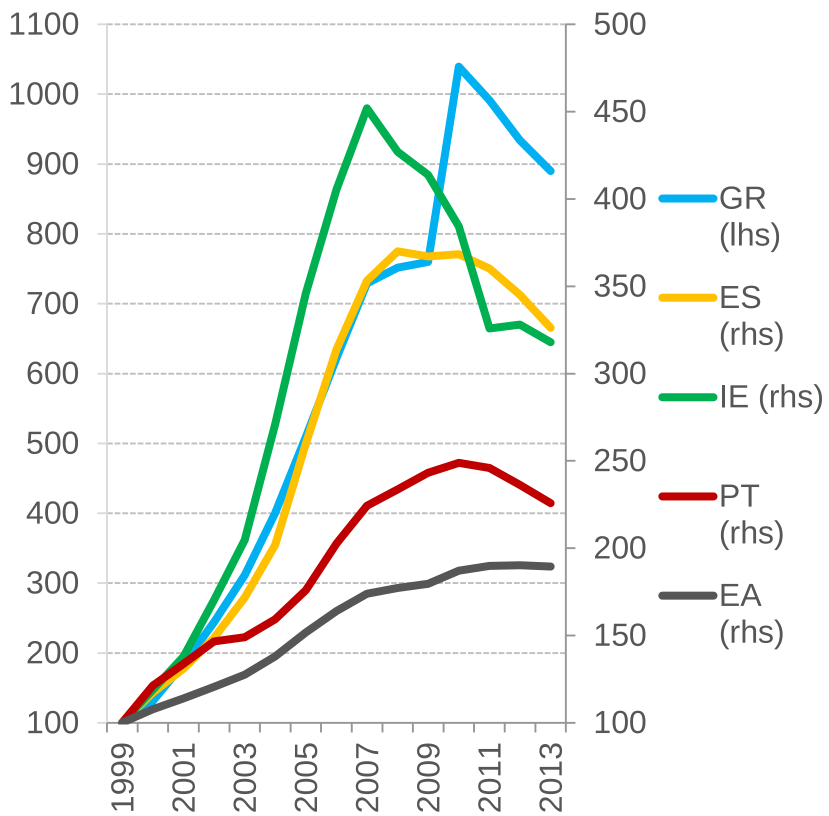
Outline

II. Early lessons from new euro area entrants in Central Europe

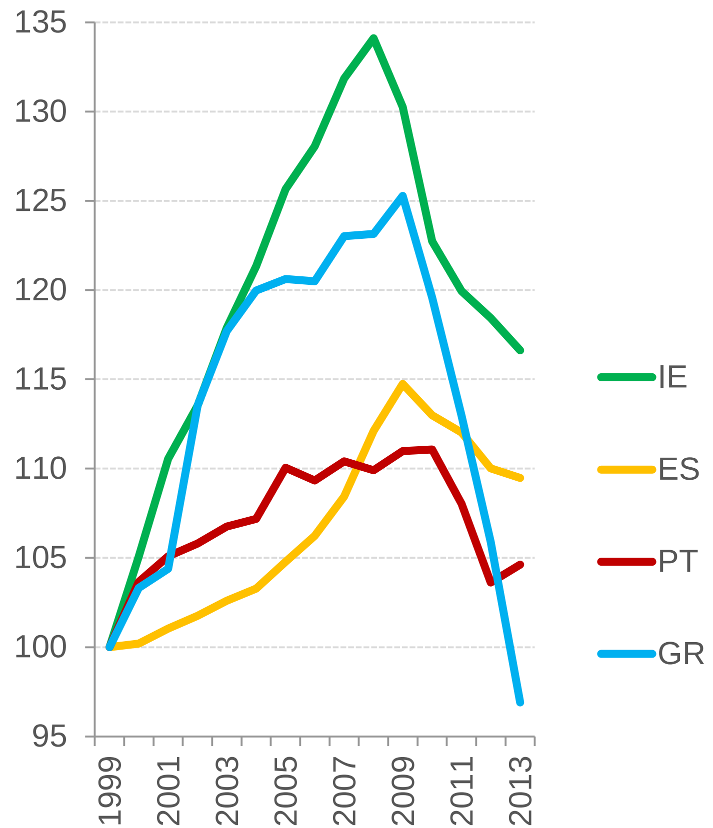
Lessons from the euro area

Since the start of EMU a catch-up in overdrive produced large imbalances before the crisis…

Credit to households (1999=100)



Compensation per employee relative to the euro area (1999=100)

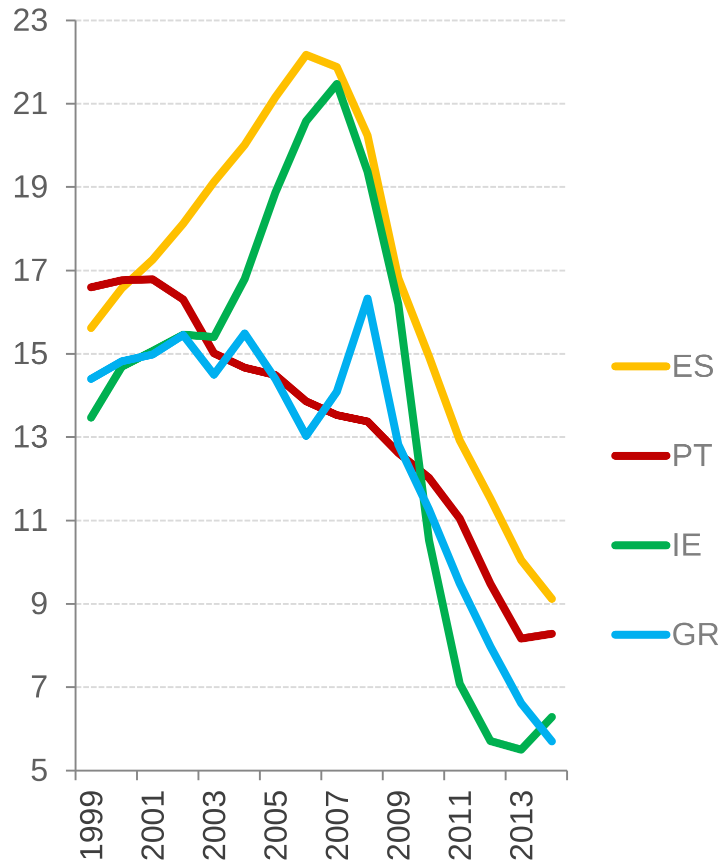


Source: European Commission and ECB.

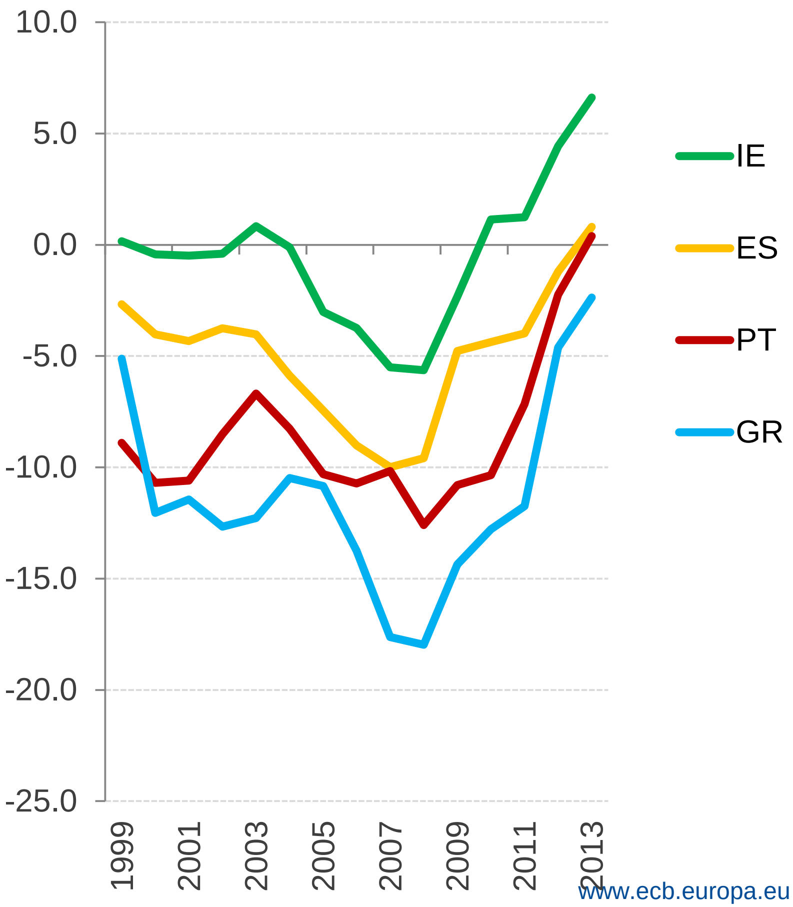
Lessons from the euro area

… and saw a strong correction afterwards.

Construction investment in % of GDP



Current account in % of GDP

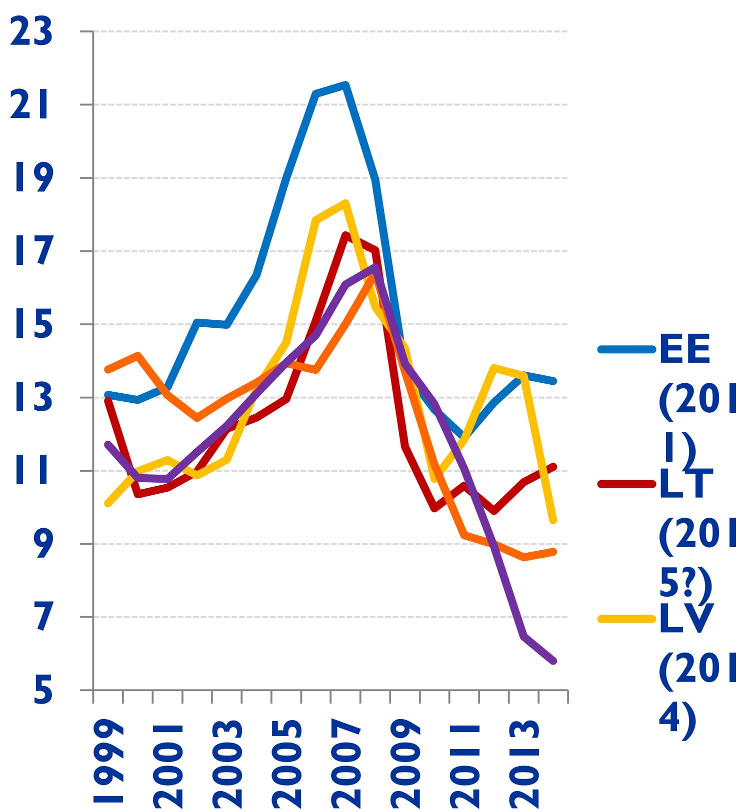


Source: European Commission

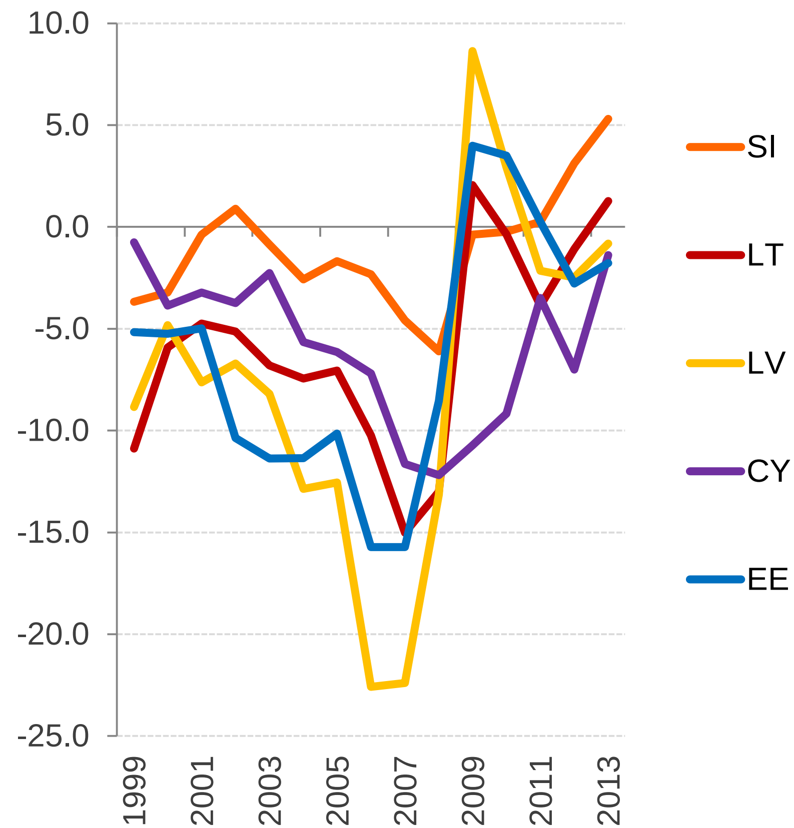
Lessons from the euro area

A similar story for the euro area entrants from Central Europe, notwithstanding their later entry

Construction investment in % of GDP



Current account in % of GDP



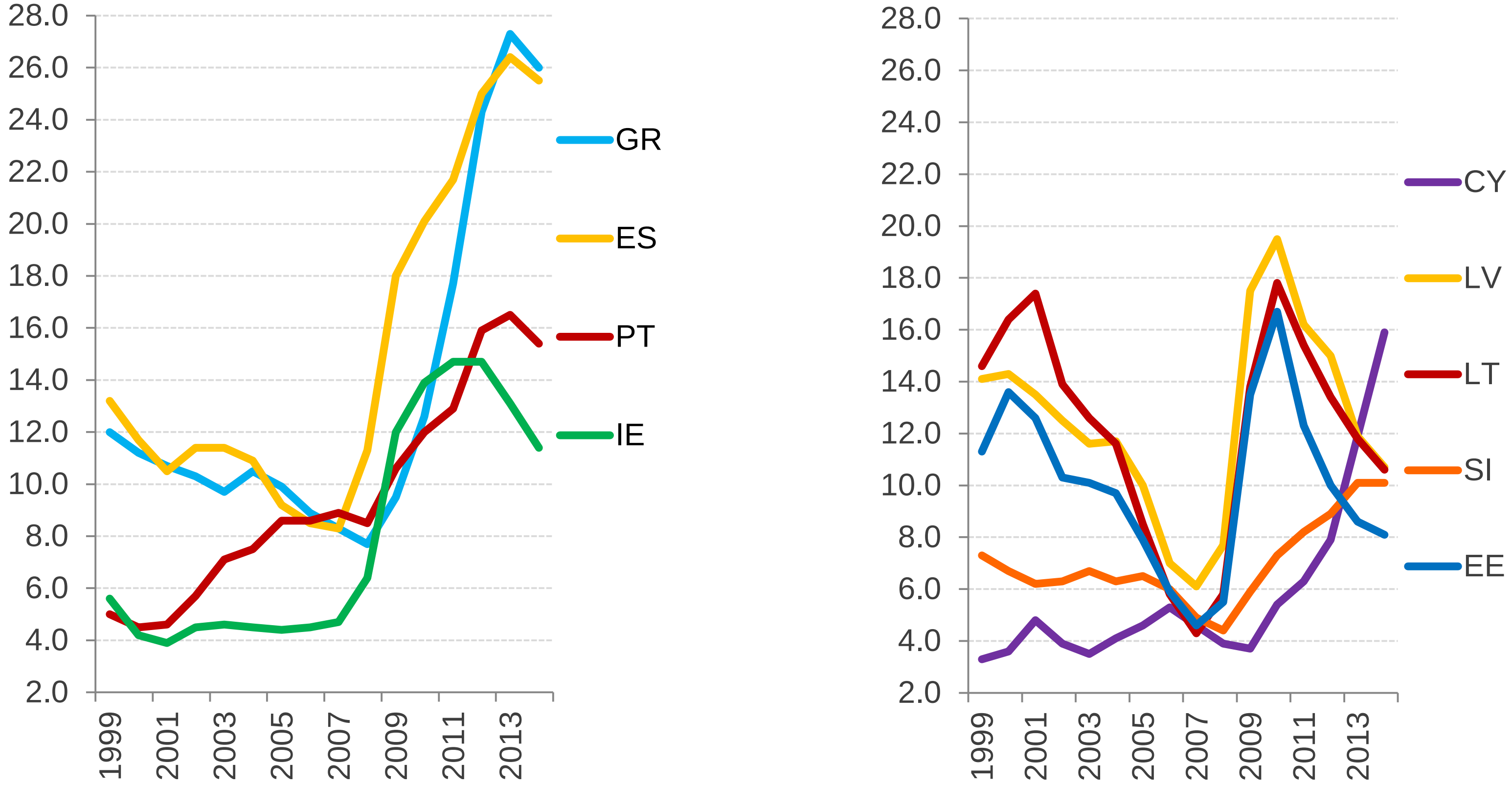
Note: in brackets date of euro adoption

Source: European Commission

Lessons from the euro area

The adjustment has been very costly, and more so in countries facing more rigidities, putting a further premium on structural reforms

Unemployment rate (in % of the labour force)



Source: EC.

Lessons from the euro area

How can CPCCs avoid repeating the mistakes?

Establish strong national policy frameworks: To reap the benefit of EU/EA membership, countries need to maintain sound and responsible macroeconomic and (micro plus macro)prudential policies, reduce large rigidities in product and labour markets, and build strong institutions

Foster national ownership of the EU economic surveillance processes early on: National Reform Programmes; Fiscal rules and Fiscal Council; an accountable monetary and exchange rate policy framework; monitoring of macroeconomic imbalances; maintaining a sound banking sector

Dispel false beliefs in short-cuts: Preparation times must not be squeezed, neither in political, macroeconomic or structural terms, even if realistic timetables can be helpful to build momentum

Outline

III. Key challenges for EU/EA members in the implementation of a reinforced EMU

A reinforced EMU framework after the twin (global and EA sovereign debt) crisis

Three key dimensions of a strengthened framework:

– fiscal

– economic

– financial

Other elements not dealt with in this presentation:

– crisis management tools (e.g. ESM)

– governance

Reinforcement of the fiscal framework

Four legal acts of the "six-pack":

- expenditure rule in the preventive arm of the SGP, debt-based Excessive Deficit Procedure, more automaticity and effective financial sanctions in the corrective arm, national fiscal frameworks

The "two-pack":

- strengthening budgetary surveillance in the euro area

The "Fiscal Compact" Treaty:

- National implementation of the balanced budget rule and automatic correction mechanism, to be verified by ECJ

Reinforcement of the economic framework

EU Semester with better embedded NRPs

- Integrated fiscal and economic surveillance

New Macroeconomic Imbalances Procedure

- Scoreboard, In-Depth Review, EIP

Intergovernmental additions still to be exploited

- Euro Plus Pact (for 24 MS)
- Treaty on Stability, Coordination and Governance - TSCG (for 25 MS) – new instruments under discussion (ex-ante coordination)

Reinforcement of the financial framework

Macro-prudential oversight leg for the entire financial system (ESRB)

Micro-prudential oversight agencies for three sectors (EBA, ESMA and EIOPA)

Building a banking union for the euro area plus:

- Single rule book (CRD IV/CRR)
- SSM with direct ECB supervision of significant banks
- SRM and SRF
- Harmonised features of deposit guarantee scheme features

Implementation challenges for the new frameworks

Fostering national ownership

- By implementing parts of the rule books in national legislation
- By making national policy makers co-responsible for the union’s well-being

Implementing the new rules to the letter and the spirit

- By the European Commission
- By the EU Council/Eurogroup
- By the Member States

Taking proper account of the economic environment

- Calling for a right mix of fiscal adjustment and a judicious sequencing of structural reforms in a still weak economic environment
- Seizing the occasion of the buoyant financial markets to repair the financial sector

Outline

IV. Conclusions: a medium-term policy agenda

IV. Conclusions: a medium-term policy agenda for CCs and PCCs

Draw policy lessons from EMEs in other regions

Use the EU neighbourhood factor in all possible ways

Don’t regard EU/EA membership as an end in itself, but as an additional vehicle to promote sustainable convergence

A policy agenda for CPCCs seeking sustainable convergence:

- Steer clear of doom loops
- Seek to develop boon loops

IV. Conclusions: boon loop 1 (monetary policy)

An independent central bank

Being able to conduct a credible monetary policy

Will boost confidence in the domestic currency

Will strengthen domestic savings, generate more sustainable capital inflows and generate real appreciation that will reduce the weight of the external debt burden and further strengthen the credibility of the monetary policy

IV. Conclusions: boon loop 2 (fiscal policy)

Strong fiscal administrations and a medium-term oriented fiscal policy framework

That creates additional fiscal policy space by keeping the ratio of public spending to GDP in check

Will make the economy more resilient to shocks

Will foster the credibility of monetary policy

Will create a predictable framework for the private sector and will in turn strengthen the fiscal administration

IV. Conclusions: boon loop 3 (structural policy)

A strengthening of the corporate sector and a well-educated labour force

Will boost non-price competitiveness

Stimulate trade and employment

Raise savings and investment

Which will further strengthen the corporate sector

IV. Conclusions: boon loop 4 (financial policy)

Strengthening banks' balance sheets by bringing down high NPL ratios

Will allow banks to extend new credit

That will boost investment (also in financial services)

And draw in more private savings

That will further strengthen banks' balance sheets

IV. Conclusions: boon loop 5 (external policy)

Stronger domestic policy frameworks will attract more foreign capital (FDI, bank loans, portfolio investment)

And keep well-skilled people in jobs at home rather than abroad

Which will boost domestic potential growth as well as actual growth

Which will provide the means to further strengthen policy frameworks and skill sets of people

Thank you for your attention