Challenges of Convergence

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In connection with the advancement of the process of integrating candidate countries into the EU, discussions on the sequence of steps and conditions to be undertaken by associated countries are gaining in intensity.

The European authorities have recently focused on explaining the necessity of introducing strategies for economic integration of candidate countries into the EU in a number of stages: (1) the pre-accession phase; (2) the EU membership (3) the ERM II involvement and (4) the phase of a fully-fledged membership in the Economic and Monetary Union (EMU), as confirmed by the adoption of a single euro currency. Although all these phases are equally important, at each of them the countries should focus on accomplishing different criteria. The purpose of such a phased progression is to steer candidate countries in the pre-accession period preferably onto the course of catching-up economically, or onto the course of real convergence set out by Copenhagen economic criteria, thus establishing a basis for sustainable nominal convergence as defined by the Maastricht criteria.

Since the integration into the EU and, later on, into the EMU is a highly complex process, I shall just focus on some of the challenges of this process that directly bear upon the implementation of the central bank's monetary policy.

According to the Copenhagen criteria, **the pre-accession stage** is to involve the processes of real economic convergence defined as: (1) the existence and functioning of a market economy and (2) the ability to face competitive pressures and market forces in the European Union. Quite naturally, the fulfilment of these criteria will presuppose structural, institutional and legislative convergence and an orientation of the foreign trade to the EU countries. Another important prerequisite for integration is the amplification of investment flows from the EU. The progress made by candidate countries is regularly assessed by the European Commission.

At this stage, it is necessary to complete the privatisation of banking and financial institutions, clear the corporate sector off entities making loss in the long run, as well as to liberalise local markets, which will help to do away with disproportions between relative prices that still endure notably in the case of administratively controlled prices.

Real convergence, or the process of catching up is a key element in the process of integration. Candidate countries must catch up – both in terms of economic performance, which means an increase in their per capita income, and approximating their price level to that in the EU countries.

By virtue of its substance, the catching up process has very important implications for the central bank's monetary policy. Catching up process implies a certain standard inflation potential, which is due to a greater pace of GDP growth in the "catching-up" countries. Catching up in terms of performance as a result of a greater pace of growth in the labour productivity leads to pressures towards the appreciation of real exchange rate (the well-known Balassa-Samuelson effect).

Monetary policies of candidate countries should be implemented so as to make it possible to attain and maintain the stability of prices over a medium term. At the same time, there must be a room left for structural changes to be reflected in the so-called dual inflation. **Maintaining low inflation in the long run upon accession to the EU will present a challenge. The developments in candidate countries so far indicate that in some instances low inflation may coincide with the preconditions for cyclic recession. In such an event the advancement of real convergence comes to a halt and even "divergence" may occur.**

Since the process of catching up will continue to be translated into price adjustments that primarily show in the non-tradeable sector, it would be probably more adequate to assess the progress made by candidate countries in accomplishing the price stability criterion based on price developments in the tradeable sector, rather than according to the development of the entire consumer price index.

By joining the ERM II, a country shows its interest and readiness to join the monetary union. Reaching a high degree of convergence with the eurozone countries should become a precondition for a country to be admitted to the ERM II, because at this stage, the emphasis will unanimously be on the fulfilment of the Maastricht criteria. Reaching a high degree of real convergence before admission to the ERM II facilitate that aforementioned monetary effects of the catching-up process will not constrain the fulfilment of the Maastricht criteria on inflation as well as the exchange rate stability.

As a matter of fact, an exchange rate can only be used as a monetary policy tool prior to the admission to the ERM II, and even then subject to certain restrictions, since from their accession to the EU onwards, countries must consider their exchange rate policies as a matter of common interest. Candidate countries employing a flexible exchange rate mechanism – as is for example the case of the Slovak republic at the present time – will upon their admission to the ERM II realize their exchange rate policy in room defined by the width of fluctuation band.

Meeting (nominal) Maastricht convergence criteria is a precondition for a country to be admitted to the EMU**. Upon their entry into the EMU, candidate countries will no longer be able to use national monetary policy tools to promote the process of real convergence.**

Because of the long-term nature of the catching up process, also at this stage the B-S effect can be expected to prevent inflation rates in candidate countries from dropping to the level of other EMU member countries. Nevertheless, I do not see as justified any concerns about candidate countries posing, upon their entry into the EMU, a potential risk to the price stability in the eurozone. Due to the low economic weight that candidate countries have on the economy of the eurozone as a whole, the rate of inflation in these countries would only have a negligible impact on the overall price stability in the eurozone. In the long run, hand in hand with growing performance of the economies in candidate countries, the economic weight of these countries on the eurozone's economy can be expected to enlarge, still the magnitude of impact due to the B-S effect will concurrently decrease.

Since even among the current members of the eurozone themselves there are differences as to the performance of their economies, I believe that an exchange of experience gained in the process of convergence of the EU countries at this forum will greatly contribute towards the identification and evaluation of challenges that candidate countries are confronted with on their way to the EU and EMU.

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