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PRESS RELEASE

ECB PUBLISHES ITS CONVERGENCE REPORT 2010

The European Central Bank (ECB) publishes today its Convergence Report 2010, in which the economic and legal convergence of nine Member States of the European Union (EU) is assessed: Bulgaria, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania and Sweden. The report examines whether a high degree of sustainable economic convergence has been achieved in these countries. In addition, it gauges compliance with the statutory requirements to be fulfilled for national central banks to become an integral part of the Eurosystem (legal convergence).

Overall, the report concludes that in many countries important challenges have come to the fore related to previously accumulated imbalances and vulnerabilities, which have led to a deep adjustment process over recent years. Exacerbated by the global financial and economic crisis, real GDP in most countries under review collapsed or declined strongly. While this weakening of economic activity together with external influences contributed to dampening inflation, fiscal positions deteriorated sharply, and country risk premia, as evidenced by long-term interest rates, rose significantly.

Looking at the individual convergence criteria, the 2010 Convergence Report shows the following results.

Price stability

Over the 12-month reference period from April 2009 to March 2010, inflation was very low in the EU as a result of negative global price shocks and the significant downturn in economic activity in most countries. Accordingly, the reference value for the criterion on price stability was 1.0%. It was calculated by adding 1.5 percentage points to the unweighted arithmetic average of the rate of HICP inflation over these 12 months in Portugal (-0.8%), Estonia (-0.7%) and Belgium (-0.1%). HICP inflation in Ireland was significantly lower owing to a number of country-specific factors. However, in line with the approach followed in previous reports, the inflation rate for Ireland has been considered an outlier and has therefore been excluded from the calculation of the reference value. Over the reference period average HICP inflation rates were below the reference value in the Czech Republic, Estonia and Latvia, whereas in the other six

countries inflation was above the reference value, with the largest deviations being observed in Romania, Hungary and Poland.

Government budgetary position

In the majority of the countries, the fiscal situation has deteriorated strongly since the 2008 Convergence Report, largely reflecting significantly worsening macroeconomic conditions. Bulgaria, the Czech Republic, Latvia, Lithuania, Hungary, Poland and Romania posted a fiscal deficit-to-GDP ratio above the 3% reference value in 2009. The European Commission is initiating an excessive deficit procedure against Bulgaria, while the remaining countries listed are subject to a Council decision on the existence of an excessive deficit. Only Estonia and Sweden recorded fiscal deficits below the reference value in 2009.

As regards general government debt, only Hungary exhibited a debt ratio above the 60% of GDP reference value in 2009. In the other countries, debt ratios were lower, although they increased in all nine countries under review, in some cases substantially.

Exchange rates

Among the countries examined in this Convergence Report, Estonia, Latvia and Lithuania are currently participating in ERM II. The currencies of these Member States have been in ERM II for more than two years before the convergence examination, and none of their central rates were devalued in the period under review. There have, however, been some episodes of severe market tension within ERM II in the case of the Latvian lats.

Long-term interest rate

Over the 12-month reference period from April 2009 to March 2010, the reference value for long-term interest rates was 6.0%. As Estonia has no harmonised long-term interest rate, this value was calculated by adding two percentage points to the unweighted arithmetic average of the long-term interest rates of the two other EU countries entering the calculation of the reference value for the criterion on price stability with a harmonised long-term interest rate, namely Belgium (3.8%) and Portugal (4.2%). Over the reference period, only the Czech Republic and Sweden had average long-term interest rates below the reference value.

Estonia

In this report, Estonia is assessed in somewhat more depth than the other countries under review. This is because the Estonian authorities have expressed their country's intention to adopt the euro as of 1 January 2011. The ECB Convergence Report 2010 gives the following assessment of Estonia.

Over the reference period from April 2009 to March 2010, the 12-month average rate of HICP inflation in Estonia was -0.7%, i.e. well below the reference value of 1.0% for the criterion on price stability. On the basis of the most recent information, the 12-month average rate of HICP inflation is expected to increase in the coming months.

The current low inflation rates in Estonia reflect mainly temporary factors, including the ongoing severe economic adjustment process, which led real GDP to shrink by 14.1% in 2009 following a long period in which significant macroeconomic imbalances and vulnerabilities built up. In addition, the current lack of inflationary pressures in the Estonian economy reflects the necessity for an economy with fixed exchange rates to restore earlier losses in its competitive position. Once the adjustment phase is over, maintaining low inflation rates will be very challenging given the limited room for manoeuvre for monetary policy. The catching-up process is likely to have a bearing on inflation over the coming years, given that GDP per capita and price levels are still lower in Estonia than in the euro area. Once output growth resumes, with a fixed exchange rate regime, the underlying real adjustment is likely to manifest itself in higher inflation. Given the currency board arrangement and the limitations of alternative counter-cyclical policy instruments, it may be difficult to prevent macroeconomic imbalances, including high rates of inflation, from building up again. The experience with the strong growth over the past few years highlights the challenges that the Estonian authorities face in achieving price stability in the virtual absence of independent monetary policy. In sum, there are concerns regarding the sustainability of inflation convergence in Estonia.

Estonia is not subject to an EU Council decision on the existence of an excessive deficit. In the reference year 2009 the general government budget balance showed a deficit of 1.7% of GDP, i.e. well below the reference value. The general government gross debt-to-GDP ratio was 7.2% of GDP, i.e. far below the 60% reference value.

The Estonian kroon has been participating in ERM II for over two years prior to the convergence examination. Estonia joined the exchange rate mechanism with its existing currency board arrangement in place as a unilateral commitment. Over the period under review, the kroon has continued to be stable and has not exhibited any deviation from its central rate against the euro in ERM II, reflecting the unchanged Estonian exchange rate policy under the currency board regime. Moreover, within ERM II, Estonia has not devalued its currency's central rate against the euro on its own initiative.

The Estonian financial system is characterised by the absence of a well-developed market for long-term debt securities denominated in Estonian kroons, which reflects the low level of government debt and a very widespread use of the euro. In this context, it is not possible to identify an indicator that would be comparable to, or that could

replace, long-term government bond yields, which complicates the process of assessing the sustainability of convergence in Estonia. Against this background, a broad-based analysis of financial markets has been conducted taking into account a variety of relevant indicators. Overall, developments in financial markets over the reference period suggest a mixed assessment. A number of indicators show that market participants had significant concerns regarding the sustainability of convergence in Estonia. These concerns were especially pronounced during the peak of the global crisis. From late 2009, a decline in global risk aversion, fiscal developments and perceptions among market participants about Estonia's prospects of adopting the euro, all contributed to an easing in market pressures.

Achieving an environment conducive to sustainable convergence in Estonia requires the conduct of economic policies geared towards ensuring overall macroeconomic stability, including sustainable price stability. Given the limited room for manoeuvre for monetary policy under the currency board arrangement, it is imperative that other policy areas provide the economy with the wherewithal to cope with country-specific shocks and to avoid the reoccurrence of macroeconomic imbalances.

Legal convergence

By 12 March 2010, which is the cut-off date for amendments to legislation assessed in the ECB Convergence Report 2010, in the nine countries examined the legal framework was not fully compatible with all the requirements for the adoption of the euro, as laid down in the Treaties and the Statute of the European System of Central Banks and of the ECB. However, on 22 April 2010 the Estonian Parliament adopted the Law on the introduction of the euro, which removed the remaining incompatibilities in Estonia. Otherwise, in all other countries under review, incompatibilities remain regarding central bank independence. In particular, this refers to the institutional, personal and financial independence of central banks. In addition, in all countries under review except Lithuania, there are incompatibilities as regards the prohibition of monetary financing as well as the legal integration of the respective central banks into the Eurosystem.

In producing this report, the ECB fulfils the requirement of Article 140 of the Treaty to report to the Council of the European Union (Council) at least once every two years or at the request of a Member State with a derogation "on the progress made by the Member States with a derogation in fulfilling their obligations regarding the achievement of economic and monetary union".

At present, 11 EU Member States are not full participants in Economic and Monetary Union. Two of these countries, namely Denmark and the United Kingdom, have a special status in accordance with the terms of the relevant protocols annexed to the

Treaties. As a consequence, Convergence Reports only have to be provided for these two Member States if they so request.

The Convergence Report can be obtained in 21 Union languages on the ECB's website.

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