Klaus Liebscher: The Euro area - an anchor of stability in Europe and the world

Luncheon speech by Mr Klaus Liebscher, Governor of the Oesterreichische Nationalbank, at the East-West-Conference, Wien, 6 November 2001.

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Ladies and gentlemen,

I am glad to have this opportunity to personally thank you all for your participation and all speakers for their active involvement in this year's East-West Conference, which centers on topics that are of long-term relevance for Eastern, Central and Western European countries, of relevance to the growing integration and historic reunification of our continent, but certainly also of relevance outside Europe. It is a pleasure for the Oesterreichische Nationalbank to continue the long tradition of offering our annual East-West Conferences as a platform and a meeting place for debates on issues relevant to those countries – but not only to them – in order to help developing answers to the challenges ahead.

Since the very inception of transition, the Oesterreichische Nationalbank has had the opportunity to be an active partner for central banks in transition countries. At the same time, the Oesterreichische Nationalbank has been actively participating in another historic project, the realization of the European Economic and Monetary Union (EMU) and the introduction of the euro. The establishment of the euro as the single currency in 12 sovereign countries of the European Union was certainly not a purely economic move, but rather another major step in the process of European integration that began more than half a century ago.

Ladies and gentlemen,

The strong rise of commodity prices, in particular of the oil price, in 1999 and 2000, recent economic turbulences in some emerging markets and the tragic events of September 11 have not compromised stability in the euro area. On the contrary, and I would like to stress this especially, EMU, among other factors, contributed to avoiding possible exchange rate or financial tensions in Europe.

However, the terrorist attacks on the U.S. have further dampened global economic activity in 2001 and will postpone an economic rebound at least for one or two quarters in 2002.

Apart from the irreplaceable human loss, the direct effect of the terrorist attacks on the overall U.S. economy is likely to be limited. However, the indirect effects on private consumption, investment and savings could be more significant as confidence of consumers and business has already stated to fade. Due to increased uncertainty, investors have become more risk-averse. But policy makers reacted quickly. Central banks around the world, including the Eurosystem, acted swiftly by providing ample liquidity to financial institutions and lowering key interest rates decisively. This adjustment of interest rates came on top of earlier significant rate cuts. The Governing Council of the ECB has also lowered its key interest rate by 100 basispoints from 4 ¾ to 3 ¾ % since May 2001. Moreover, the United States and the euro area have grown increasingly resilient to shocks over the past decade. Structural reforms aiming at efficient and flexible product and labor markets, deregulated financial markets and improved public finances have enhanced the ability of our economies to cope with adverse shocks.

Thus I am confident that the world economy, after a <u>temporary</u> slowdown, will return to healthier growth rates in the course of 2002. In this assessment, the single currency plays a pivotal role, since the euro has established itself as a stable anchor not only for the European, but also for the global economy.

Among the benefits already being reaped from EMU are the following:

- a stable currency based on price stability throughout the euro area and
- a stable factor in the international financial system,
- a huge domestic market with 300 million inhabitants (with high purchasing power),
- deeper and further integrated European financial markets,
- lower transaction costs for intra-European trade, tourism and investment and, last, but not least,

- cross-border price transparency and increased competition.

Ladies and gentlemen,

These benefits are assured by a number of stability safeguards: The Eurosystem follows a monetary strategy whose primary objective is to maintain price stability over the medium term. Price stability is defined as a year-on-year increase in the Harmonized Consumer Price Index (HCPI) for the euro area of below 2 %. Currently, the euro area's inflation rate is somewhat above our definition of price stability (2.4 % October). This is mainly due to temporary supply shocks, among them the increase of oil prices until the end of 2000 and livestock diseases. But the latest forecasts confirm that inflation will most likely fall below 2 % in the first half of 2002. Still, at the present moment it is too early to conclude that the risks of inflation have been banished. But there is no doubt that these risks have been diminished due to the economic slowdown and weaker pressures from the demand side.

Another stability safeguard are fiscal policies in the euro area that have become better coordinated in recent years. The Stability and Growth Pact obliges participating EU Member States to achieve budgetary positions close to balance or in surplus in a sustainable manner, in order to minimize the risk of breaching the budget deficit criterion of 3 % of GDP, according to the Treaty of Maastricht, in the course of a business cycle. Sound budgetary positions not only create enough leeway for automatic stabilizers to take full effect in economic slumps, they also contribute to reducing the debt-to-GDP ratio and consequently the interest burden for governments, increase investors' confidence in the euro area, keep interest rates lower than they would otherwise be and, as a consequence, lead to a crowding-in of private investment. Thus, the current economic slowdown should not distract governments from the successful consolidation process we have witnessed so far.

Ladies and gentlemen,

Perseverance in structural reforms of product, capital and labor markets constitute an important foundation for vibrant and strong euro area economies, underpinning the euro as an anchor of stability. <u>Product markets</u> in the European Union have already undergone sizable improvements, though we should not underestimate how important it is to fully implement internal market legislation and, for example, further reduce state aid. In concert with independent and powerful competition authorities, these types of measures would not only help make economies more efficient and competitive, but would also play their part in ensuring price stability. In addition, it is of utmost importance that the EU continues to be committed to trade liberalization and that we support the opening of a new trade round within the WTO.

Moreover, the introduction of the euro has accelerated structural reforms in the European <u>financial markets</u>. Apart from making financial markets less fragmented and more competitive, it is important that these developments lead to an efficient and stable financial system. The recent tragic events in the United States have shown how quickly financial markets can come under severe stress – and that sound and well supervised markets, with the backing of liquidity provided by central banks, can cope even with such dreadful events.

As regards <u>labor markets</u> in the euro area, continuing high structural unemployment and low participation rates in many member countries are a cause for concern. Obviously the functioning of labor markets needs to be improved to allow higher employment. Wage settlements in line with productivity developments appear crucial for the attainment of a sound macroeconomic policy mix. The social partners are called upon to continue to act in a responsible manner, thereby enhancing prospects for healthy growth and employment.

If the just mentioned macroeconomic and structural safeguards are adequately kept in place and reinforced, the euro area will remain an area of sustained stability.

Ladies and gentlemen,

Where do Central and Eastern European countries enter this picture? I am convinced that enlargement of the European Union and - in a later stage - of EMU will strengthen Central and Eastern European countries' positions and further enhance the importance of the euro as an anchor of stability. This brings me to the topic of our current East-West Conference "Convergence and Divergence in Europe" – a pivotal issue with regard to the afore-mentioned historic integration process in Europe.

As we all know, nominal convergence of inflation rates, interest rates, budget deficit and debt levels among initially 11, later 12 Member States of the European Union have ensured the launch of

Monetary Union and the introduction of the euro. This process has been accompanied by long-term movements toward real convergence also of income levels, i.e. poorer EU Member States have partly caught up in living standards with wealthier Member States.

Yesterday, the first two Sessions of this conference dealt with various aspects related to the history of European convergence in detail. The transition process in Central and Eastern Europe and preparations for EU accession are to a large degree about convergence in a very broad sense. The economic systems in the region are now approaching market economy standards; macroeconomic policy-making is pursued along the same principles as in Western Europe; and institution building and human capital formation are proceeding.

As we all realize, structural changes and modernization may often be very painful. On the other hand, privatization is largely completed in most countries of the region and strong flows of foreign direct investment have contributed to impressive advances in productivity and competitiveness.

Real convergence and the balance of real and nominal convergence have been the topics of the afternoon Sessions. Challenges for monetary and exchange rate policy were dealt with. As you know, the Eurosystem proposes a three-step approach for monetary integration of accession countries: Firstly, accession to the European Union, secondly, entrance into ERM II, and thirdly, joining the euro area and the Eurosystem.

Inflation continues to be on average somewhat higher and income-per-capita levels remain much lower in most "transition economies" than in the present-day European Union. In my view, the pace of further disinflation in accession countries should be determined in line with the overall economic situation, in particular with the need of countries to increase real convergence. The Maastricht inflation criterion should not be seen as an immediate requirement for the EU-entry, but rather as an objective of central banks during the period of ERM II participation. But to stick to it and it's definition as formulated in the Maastricht Treaty is a MUST.

The Eurosystem's policy position that nominal and real convergence should be pursued in parallel and that accession countries should strive to achieve price stability in the medium term is very sensible.

Over the past few years, there has been significant diversity in the monetary policy and exchange rate strategies of accession countries. Over this period, the euro has become the main reference currency for most of these countries, including those operating managed floating regimes. In the pre-accession phase, the consistency of the exchange rate strategy with other macroeconomic policies and objectives will take precedence over the choice whether to reduce existing exchange rate flexibility. However, a certain degree of exchange rate orientation toward the euro would be in line with further economic and financial integration and would also be consistent with the prospect of ERM II entry. ERM II arrangements should not necessarily be seen as a „waiting room" prior to the adoption of the euro, but as a flexible framework for the achievement of further convergence.

In particular, real convergence can help promote both economic cohesion within EMU and integration between member states, thereby supporting efforts to minimize the risk and the effects of asymmetric shocks.

Ladies and gentlemen,

This morning the discussions focused on the role of the financial sector. This sector is predestined to provide a key contribution to speeding up real convergence in accession countries. Significant progress has been made over the past years in rehabilitating banking sectors and encouraging foreign ownership. The latter has also contributed to greater microeconomic integration with the EU. But financial sectors are still relatively small and some segments are underdeveloped. Creating conditions for the sound expansion of the intermediating role of the banking sector remains fundamental to promote the efficient use of capital and sustained growth. Progress in corporate governance and the enhancement of the legal frameworks that support the banking sector would also be conducive to achieving the macroeconomic objectives of the accession countries.

Looking ahead to an enlarged European Union, it will be even more important in the future than today to keep up the momentum of existing convergence processes and to promote them further. Nominal as well as real convergence are key ingredients of regional and social cohesion and thus, stability, in our Union and the euro area. I am looking forward to the final session this afternoon, which will deal with some of these issues.

Ladies and Gentlemen,

We will not be immune to adverse shocks in the future. However, based on the stable architecture of EMU, I am confident that sound policies will continue to keep the euro area a robust shock absorber and the euro a stable anchor. Prudent accession and enlargement policies will enhance the position of the European Union and add to the importance of the euro worldwide, reinforcing it as a major and stable cornerstone of the international monetary system.

This will, however, require perseverance of structural reform efforts in various fields within the European Union, as well as sound convergence strategies and policies on the part of accession candidates. Together we provide our strategic response to rising global competition and our common contribution to global stability.

Thank you very much for your attention.