Klaus Liebscher: Economic and Monetary Union (EMU) - an important pillar of stability for the International Financial System

Speech by Mr Klaus Liebscher, Governor of the Oesterreichische Nationalbank, at the symposium "The role of international institutions in globalisation", Centre for the Study of International Institutions CSI, Innsbruck, 16 November 2001.

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It was with great pleasure that I accepted the invitation to take part in the symposium on "The Role of International Institutions in Globalisation" and to deliver some thoughts about the Economic and Monetary Union and its role in the international financial system.

But first of all I would like to congratulate Dean Prof. Chen and Prof. Socher for their faculty initiatives to set up the "Centre for the Study of International Institutions". I strongly do hope that this new centre will contribute to a better understanding for the functioning as well as the need of international institutions like the IMF, the Worldbank, the BIS and others safeguarding the economic developments in a world of liberalisation and globalisation.

I really do wish you all the success needed for!

It has always been the duty of monetary authorities to secure both monetary and financial stability. Yet, issues of monetary and financial stability have moved up prominently on the agenda, due to the growth of financial services, both in volume and in depth, the financial crises of recent years or the terror attacks of September, 11. With the globalisation of capital flows the vulnerability of countries to financial crises has increased. International institutions, especially the IMF, have in recent years played an important role in crisis prevention and crisis management.

The crises in Asia and other regions have directed attention towards the phenomenon of financial contagion both from the side of politicians as well as academics. Through the global network of financial markets a crisis in one part of the world may quickly spread via a chain reaction to other places, with the potential to destabilise the global financial system. These crises have transformed the international agenda: At the global level plans for a new international financial architecture have abounded and the future role of institutions like the IMF and the World Bank has been widely and intensively debated. Prominent economists like Paul Krugman, Joseph Stiglitz, Stan Fischer, Barry Eichengreen and, of course the Meltzer Commission have formulated quite diverse and controversial proposals.

In this context I will focus my deliberations to the role of EMU and how the euro can provide for more stability for the International Financial System. EMU represents new opportunities and challenges for financial institutions and markets. Up to now, one can distinguish essentially between four types of stability effects which the euro's arrival has brought: exchange rate stability, price stability, financial stability and fiscal stability. To these four, let me add a fifth stability aspect given that EMU and the euro provide and will provide an anchor of stability for Central and Eastern European Accession Countries.

Exchange Rate Stability

First, exchange rate stability is directly related to the Single Market for goods and services, as well as development of financial markets in the European Union. The single currency has completely removed exchange rate risks for exporters and importers, debtors and creditors across the 12 countries of the euro area. Cross-border trade, investment and financial transactions are fostered and, in particular, small and medium-sized companies are encouraged to enter the euro area-wide markets. These developments increase competition, improve resource allocation and the investment climate and thus contribute to higher long-term potential growth in the euro area.

This - if I may say so - internal "exchange rate" stability aspect has often been overshadowed by the disproportionate interest in US dollar/euro exchange rate. The dollar/euro exchange rate movements have, in fact, been fully in line with the dollar's historical fluctuations vis-à-vis the European currencies prior to the introduction of the euro. More importantly, the weight of the fluctuating part in exchange rate "baskets" is, in all Member States, now much smaller than in the past.

For example, for Austria as a small open economy the external stability of the currency was of prime concern. With the introduction of the euro this has changed significantly because external trade is much less important for the euro area than it was for Austria.

Other than Austria which prior to the introduction of the euro followed a policy of tying its currency to the DEM, the Eurosystem does not have an exchange rate target. While Austria's stability oriented currency policy made sense for a small open economy, it would not be wise to try to maintain a fixed exchange rate between the international currencies in an era of globalisation of financial markets and full liberalisation of capital transfers.

The euro area economy is far less open than the economies of the individual euro area countries. This tends to limit the impact of external economic developments and in particular of exchange rates and external prices on domestic euro area prices. Thus, the exchange rate channel of monetary policy transmission is less important for a large, relatively closed currency area, like the euro area, than for small open economies. However, as statistics show, the euro area is still more open than the United States. In 2000, exports of goods and services represented 19,1 %, whereas imports represented 18,7 % of the euro area's GDP. This is more than the United States with a ratio of 10,7 % for exports and 14,4 % for imports.

In such an environment, only a stability oriented and credible economic policy can contribute to sustainable and economically viable exchange rates. Of course, exchange rate developments cannot be ignored – the second pillar of the monetary policy strategy of the Eurosystem also contains information from the foreign exchange markets. Long-lasting and identifiable deviations from estimated "equilibrium" exchange rates can have very negative consequences for an economy such as a massive misallocation of resources. But so far, regrettably, there is no clear consensus in the economic literature on how to calculate equilibrium exchange rates. Given this and the general observation that we still move within the framework of what has happened over the past 30 years, the importance of the external exchange rate stability is somewhat overstated.

It has also to be emphasised that the tragic events of September, 11 did not inject any turbulence into currency markets but the euro/dollar exchange rate continued to trade around its previous level. Hence, even though it may be too soon to make a firm statement but the very existence of the euro as well as the actions taken by the Eurosystem in conjunction with the Federal Reserve System are likely to have stabilised markets.

Price Stability

Second, as to price stability, most analysts agree that the monetary policy decisions of the ECB Governing Council have been appropriate. Since the beginning of EMU, the euro-area has achieved low inflation and expectations thereof and thus interest rates have been low. The Governing Council has made its decisions on the basis of its primary goal, price stability. It is worthwhile to restate the mandate of the Eurosystem. The primary objective of the Eurosystem, as the Treaty of the European Union defines it, is to maintain price stability in the euro area.

The Governing Council of the ECB has defined price stability as "year-on-year increases in the HICP for the euro area of below 2%". Furthermore, it was made clear from the outset that price stability should be maintained over the medium term. By unambiguously assigning the primary objective of price stability to an independent central bank, the Treaty recognises that focusing monetary policy on the maintenance of price stability in the euro area ensures that monetary policy will make the best possible contribution to improving economic prospects.

This view is rooted in the fact, supported by practical experience and empirical evidence, that the benefits of price stability for growth are substantial. Without putting forward all the arguments, the maintenance of price stability helps to allocate resources efficiently both across uses and across time. Inflation causes economic agents to confuse transitory with permanent price changes, and therefore distorts their decision-making process. In evaluating investment opportunities, firms need to have confidence in the signals conveyed by relative price changes, and to discriminate between relative price adjustments and general changes in the overall price level. This process is facilitated in a situation of overall price stability. Price stability therefore improves the transparency of the relative price mechanism and can promote an adequate environment to increasing the growth potential of the euro area economy. Moreover, as experience has shown, stable prices minimise the inflation risk premium, thereby lowering long-term interest rates and helping to stimulate investment and growth.

In order to maintain price stability, the Eurosystem has designed a monetary policy strategy wherein risks to price stability are assessed on the basis of two pillars. The first pillar assigns a prominent role to monetary developments. The second pillar is a broadly based assessment of a wide range of other economic and financial indicators. This all-encompassing and systematic approach guarantees that the Governing Council of the ECB takes into consideration all relevant pieces of information when assessing the outlook for price stability in the medium term.

The Eurosystem´s two-pillar monetary policy strategy was particularly chosen to cater for a period of transition and uncertainty. The two-pillar strategy allows us - and indeed compels us - to follow closely and systematically a wide range of monetary, economic and financial indicators which may give indications on future inflation and economic developments at large. It easily accommodates the advisable shift in the relative weight attached to various variables.

What is more, the two-pillar strategy does not pretend the existence of certainty and stable economic relationships where there are in reality no such things. In this sense, it is a very honest strategy. To be transparent to the public, though, it requires special communication efforts by the Eurosystem.

By all means, the two-pillar strategy is in my firm conviction clearly superior – particularly at the present juncture of considerable model uncertainty – to any mechanical rule-based approaches. The latter are usually taylored to specific views of how the economy operates and are therefore less likely to perform well in periods where these views might have to be adapted. Monetary policy rules usually derive their policy recommendations from a very narrow set of economic indicators only. In many cases they rest heavily on the output gap and the equilibrium real interest rate, which, as I have pointed out, are potentially very unreliable concepts at the present juncture.

Financial Stability

Third, the financial stability of the euro area has been enhanced by the single currency; the latest developments have provided indisputable proof of this.

Generally, the implementation of monetary policy in the euro area has proved highly efficient. The Eurosystem has successfully introduced a market-oriented, modern and flexible operational framework. The money market has clearly benefited from this in its refinancing operations. Short-term interest rates have totally converged and the money market within the euro area has become fully integrated. As a result, we have an efficient and liquid euro money market, and banks benefit from the conformity of market conditions.

The euro money market has widely used daily reference indices for interest rates, notably EONIA for overnight transactions and EURIBOR for transactions with longer maturities. These euro area indices were swiftly accepted on the market and form a common basis for pricing. Market participants are now able to manage their day-to-day funds in an efficient manner, incurring relatively low costs.

The rapid integration of the euro area's money market was also supported by the developments in the payment systems infrastructure, above all the establishment of the TARGET system operated by the ESCB, which links the national real-time gross-settlement systems with the ECB's Payment Mechanism. The smooth functioning of the settlement of cross-border payments allows banks to trade safely throughout the euro area. Therefore the money market has gained a clear cross-border orientation, and some large banks have started to act as "money center" banks, based on a euro area-wide scope of activity.

The broadening of the market and the increasing share of cross-border transactions have had a positive impact on the provision of liquidity: The wider euro area money market can now absorb liquidity shortages more easily than before, as banks can borrow more readily from foreign institutions or vice versa.

When the terrorist attacks in the United States triggered some threats to the short-term functioning of the global financial market in the very beginning, the mere existence of the single currency and the consequent integration and deepening of the euro area financial markets contributed to financial stability not only in Europe. In addition, in the days following the attacks, the Eurosystem was able to react quickly and efficiently and succeeded in stabilising the markets and creating confidence in their functioning. The Eurosystem’s decision to immediately provide extra liquidity in euro, and in co-operation with the US Federal Reserve System and the euro area national central banks, in dollars, contributed to the rapid return to normal of the euro area as well as international markets.

The euro area is not an island and global developments do affect the euro area economy of course. Hence, one of the requirements of a globalised world is a frequent exchange of information and views among policy-makers. The Eurosystem currently participates in the meetings of international organisations, such as the International Monetary Fund (IMF), the Organisation for Economic Co-operation and Development (OECD) and the Bank for International Settlements (BIS), and different fora, such as the G7 and G10. These exchanges are important to better understand economic developments and to fully analyse the spill-over effects in the economy arising from different policies.

In a longer term context, the launch of the single currency and the establishment of a strong monetary policy player on the global scene have contributed to the efforts to enhance co-operation in the regulation and supervision of financial market institutions, as well as in the oversight of payment and settlement systems, both at the European and the global level.

Fiscal Stability

The fourth stability-related aspect in the euro area is the discipline of fiscal policies. The macroeconomic policies pursued in the euro area at present are, on the whole, more conducive to price stability, fiscal prudence and structural changes than at any time in the 1970s, 1980s or early 1990s. The convergence criteria to the third stage of Economic and Monetary Union have already been important in ensuring a stable environment.

They have also set a kind of standard beyond the euro area, above all in the EU Member States which have not yet adopted the euro, but also in the 12 candidate countries actively negotiating for membership of the European Union. In addition, the institutional set-up and different permanent procedures within the European Union aim to promote further the stability-oriented policies.

The multilateral surveillance and the Stability and Growth Pact are important tools here. The fact that the developments of all Member States' public finances are continuously scrutinised in detail by the ECOFIN Council implies peer pressure and shared responsibility.

Increasing competition together with this shared responsibility has also strengthened the incentives to improve the efficiency and viability of public sector, labour markets and pension system structures.

At present, there are no major imbalances in the euro area which would require long-term adjustment. Economic policies in the euro area as a whole remain geared towards price stability, the objectives of the Stability and Growth Pact, wage moderation and structural reform. Further positive effects on economic growth should stem from the impact of tax reductions in several member countries and from the fact that financing conditions are favourable.

Thus, while it is natural for an economic slowdown to have adverse effects on Member States' budgets, it is important that especially those countries with a budget position still not close to balance or in surplus and/or with high public debt-to-GDP ratios adhere to their medium-term consolidation plans. The current slowdown should not substantially change the scope for reaching the medium-term commitments they made under the Stability and Growth Pact and in the context of their stability programmes. A medium-term perspective and continuous consolidation are essential for the conduct of fiscal policy in all euro area countries. This would give a firm signal to investors and consumers, thereby supporting confidence and contributing to a recovery.

While it may be perceived as more difficult to advance in these areas in an environment of weaker economic activity, the need to properly address rigidities should be much more obvious now than at times of buoyant growth. The current weakness should therefore be taken as a challenge to be met by stepping up reforms rather than allowing efforts to abate.

Stability Anchor

Finally, let me turn to the fifth stability aspect. EMU and the euro are an anchor for stability for Central and Eastern European Countries (CEECs), among them several applicants for EU accession.

A more detailed analysis shows that the euro has become particularly important as a unit of account in international goods and service trade in the CEECs. Moreover, the euro is likely to play an ever larger role on the Central and Eastern European forex markets. The same is true of the euro as an investment and issuing currency for private users in the CEECs and, in the longer term, for pricing of goods and on the stock exchange.

Even today, the euro is a key currency for Central and Eastern Europe. In most of the CEECs' monetary policy strategies, exchange rates play a vital role and, wherever they are not a formal or informal intermediate target, they are at least a key monetary policy indicator. In nearly all cases it is the euro upon which the CEECs' currencies are oriented, or to which they are formally linked.

European integration will only be truly successful if it reaches out to the whole of Europe. It is the concept of stability orientation that urges us to complete European unification. If we manage the enlargement process successfully, this will also be conducive to our endeavor to guarantee stability for the whole euro area. Such a mutual improvement is desirable in a very broad sense: political stability, financial market stability, macroeconomic and – in the particular interest of the Eurosystem – price stability.

There is no doubt that enlargement will encourage stability, growth and employment in a wider Europe. There is a consensus that the accession countries will reap substantial growth and employment benefits from their membership in the European Union. Still, let me also add a word of caution in this context: It may take quite a while before new entrants will be in a position to fully harvest these benefits. A fair share of realism is called for to avoid disappointment.

The countries of Central and Eastern Europe have made successful and impressive progress on their way to EU membership. Yet more remains to be done. Sustainable monetary, fiscal and structural policy reforms are of prime importance in this context, as they help to establish the required real convergence with the European Union – a precondition for smooth accession to the EU. These reforms comprise, for example, sustainable low rates of inflation, sound public finances, stable currencies, flexible labor markets and efficient financial markets.

Finally, the Central and Eastern European countries involved in accession negotiations will be confronted with the basic question of how Economic and Monetary Union features in the overall context of enlargement. As far as we can judge today, we see the economic and monetary policy integration of the candidate countries proceeding in three steps: In a first step, the candidates will accede to the European Union, then they will participate in ERM II, the exchange rate mechanism of the Union, and in a last step, they will introduce the euro as their national currency.

Let me point out very clearly that the fulfillment of the Maastricht convergence criteria is not a prerequisite for membership in the European Union. But, of course, this does not mean that the convergence criteria are wholly unimportant for the accession countries today. While they may not represent criteria with which to judge a country's readiness for Europe, they may be signposts for stability-oriented policies, which of course must be devised in line with the particular situation the countries are in. To fulfill the convergence criteria is a necessary condition for participation in EMU. Future candidate countries for EMU must, as the current members have done, fulfill the convergence criteria of the treaty, not more but also not less.

From an overall perspective, I clearly welcome the European Union's plans for enlargement, as enlargement will help extend the zone of stability in Europe, strengthen Europe's international competitive position and will thus contribute substantially to prosperity, security and peace in the long term.

September 11th and their implications for monetary policy and international co-operation

In his well-known address to the American Economic Association in 1968, Milton Friedman[1] stated that: “The first and most important lesson that history teaches us about what monetary policy can do...is that monetary policy can prevent money from being a major source of economic disturbance. The Great Contraction might not have occurred at all, and if it had, it would have been far less severe, if the monetary authority had avoided mistakes.”

The terror attacks in New York and Washington on September 11th had immediate repercussions across the world, in particular in financial markets. In dealing with the immediate impact, the Eurosystem acted both in close co-operation with the Federal Reserve and on its own. The world’s leading central banks took prompt action to alleviate the ensuing liquidity crunch by providing markets with liquidity and subsequently cutting interest rates to prevent market crashes. They have thus acted as mature players that successfully forestalled crisis and injected confidence into battered markets.

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1 Milton Friedman (1968), „The Role of Monetary Policy“, American Economic Review, vol. 58, no.1.

Are any general lessons to be drawn from this experience? Will concerted policy actions among central banks be more frequent in the future? It may sound confusing but such joint actions should be restricted to truly exceptional circumstances and extreme events. In addition, any such concerted action must be consistent with the principles of sound monetary policy. Even in exceptional circumstances, the euro area's monetary policy must always remain clearly focused on the mandate of the Eurosystem and its primary objective of maintaining price stability in the domestic economy. What may differ in such circumstances, however, is the time profile of the appropriate policy actions best serving that objective and the degree of co-operation among central banks in coming to a common understanding of the situation in the case of an emergency.

Without doubt, central banks can make an important contribution to limiting the international economic consequences that an extreme event like the September terrorist attacks may entail. However, apart from the immediate tasks of central banks in terms of ensuring the continued functioning of markets and of payment systems, the main contribution of central banks remains what it always has been: the maintenance of price stability. Confidence in the maintenance of price stability is the foundation for the effective functioning of a market economy.

Fostering trust and confidence in lasting price stability become not less but more important in the wake of extreme events and in the presence of unusual uncertainty. This remains the best contribution that monetary policy can make to securing a solid basis for growth and "domestic" as well as international stability.

Asking monetary policy to do more or to serve other purposes, risks creating illusions about what monetary policy can do. As it has been aptly put by the Governor of the Bank of England, Sir Eddie George, in a recent speech: "It is important that the limitations of monetary policy - what it can and what it can't hope to achieve - are clearly understood. Otherwise expectations are likely to be disappointed, and disappointed expectations may lead to building pressure for alternative policy actions, which may not in the event be in our longer-term economic interest."

This view on what monetary policy can do - and more important what it cannot do - is basically shared by all major central banks. Based on this "common understanding", central banks are thus likely to come to very similar conclusions on the appropriate course of policy given the respective mandates and prevailing conditions in the respective economies. Concerted actions should not come into conflict with the mandates and monetary policy strategies pursued by the participating central banks. Otherwise co-operation could lead to increased uncertainty about the future course of policy and compromise longer-term stability.

This lesson also seems to stem from historical experience. On the whole, since the end of Bretton Woods efforts at policy co-ordination have been confined to addressing specific unusual circumstances such as severe currency misalignments.

Conclusion

In concluding and summing up my remarks, I strongly believe that the best contribution that a large economy like the euro area can make to the international financial system is to ensure macroeconomic stability "at home" by pursuing policies which lead to sustainable non-inflationary growth in the euro area. Given the size of the economy of the euro area, a stability-oriented policy will help to create a favourable environment conductive to non-inflationary growth at the global level.