Klaus Liebscher: A stable euro for a strong Europe

Panel statement by Dr Klaus Liebscher, Governor of the Austrian National Bank, at the European Banking & Financial Forum, Prague, 25 March 2003.

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It is a great pleasure for me to participate once again in the European Banking & Financial Forum here in Prague and I congratulate the organizers for the interesting topics they have chosen this year.

I would like to focus my deliberations on the state of the economy, on the stability-oriented framework of EMU, including the need for further reforms required to enhance the euro area's noninflationary growth potential, and - last but not least - on the EU enlargement process.

The Governing Council of the ECB decided on March 6 to reduce the key interest rate by 25 basis points to 2½%. This decision was taken in the light of an improved outlook for price stability, owing in part to the appreciation of the euro and the subdued pace of economic growth in the euro area. The latter must be seen in the context of increased geopolitical risks over a protracted period of time, which once again led to higher oil prices. Additionally, a fundamental downward correction of companies' profit expectations as well as increasing pessimism on the part of consumers and investors have substantially dampened demand and depressed stock prices in the industrial world. However, apart from these unfavourable shocks, some structural inefficiencies have also been holding back the euro area economy.

Forecasting the future is notoriously difficult - even more so under the current geopolitical conditions. Heightened volatility in oil markets, for instance, makes it more problematic than usual to assess short-term inflation developments. However, on the assumption that geopolitical tensions will decrease over time, more fundamental factors should dominate price developments in the euro area. The significant appreciation of the euro over the past year, which will feed through to the economy via lower import and producer prices, subdued economic activity and somewhat more modest wage settlements should dampen inflation in the medium term. If oil prices moderate, as indicated by futures, inflation rates in the euro area will most likely fall below 2% in the course of 2003 and should remain at levels in line with price stability thereafter.

Against this background, interest rates in the euro area have fallen to very low levels, both in nominal and real terms. On the basis of currently available information, this policy stance, while contributing to the preservation of price stability over the medium term, somewhat counterbalances the multiple factors which currently have an adverse effect on economic activity.

In the current environment of heightened uncertainty, stability has become an even more precious asset. As is well known, the Eurosystem's primary objective is to maintain price stability over the medium term, since price stability unambiguously represents a precondition for sustainable economic growth and rising employment in the long run. Moreover, in times of severe tension, it is of the utmost importance that policymakers do not lose sight of their primary responsibility, so as to reduce uncertainty and strengthen confidence. Consequently, the Governing Council of the ECB stands ready to act if necessary. And financial markets can rely on the provision of sufficient liquidity even under exceptional circumstances, as was demonstrated in the past.

As to military action in Iraq, the impact of this confrontation on the global economy can vary significantly in scope and size, depending on the extent and duration of the conflict. It is therefore not possible at this juncture to conclusively assess the short and medium-term implications for the euro area.

The euro area has established itself as a stable monetary anchor in the global economy. That notwithstanding, one has to acknowledge that much remains to be done.

The Stability and Growth Pact obliges euro area 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 in the course of a business cycle. Sound budgetary positions not only create enough leeway for automatic stabilizers to take full effect over the cycle, they contribute to reducing the debt-to-GDP ratio and consequently the interest burden for governments, increase investors' confidence in the euro area and therefore keep interest rates lower than they would otherwise be. Moreover, demographic developments make it imperative to bring public finances into structural balance or surplus. Even though in most countries the current fiscal policy stance, as envisaged in the updated stability programs, strikes a reasonable balance between letting automatic stabilizers operate and seeking further consolidation where needed, some countries' current consolidation plans lack ambition, particularly over the medium run, once the current slump has in all likelihood been overcome. It is necessary that all euro area countries live up to their obligations in full. Fiscal policy must be part of a comprehensive and growth-oriented strategy, focusing - as a rule - on restraining the volume and on improving the structure of public expenditures.

The euro area economy is held back not only by current geopolitical tensions, but also by frictions in labor and product markets. Structural reforms in these areas are of utmost importance to increase the flexibility of the economy, thereby improving its resilience against detrimental shocks and raising the euro area's noninflationary growth potential. Policymakers are well aware of this assessment.

However, the lack of clear and decisive progress in implementing structural reforms weighs on confidence. It is high time to reassure business, investors and consumers by delivering overdue structural reforms. Such measures must be geared towards more flexible labor markets and higher labor participation rates, the full implementation of the EU single market, free and sound competition along with further cutbacks in state aid, and consumer-friendly retail market regulations. This would enhance productivity, thereby making the euro area more attractive for domestic and international investment, it would promote economic activity and raise the noninflationary growth potential of the euro area, and it would enhance employment, thus boosting consumer confidence and private consumption. Indeed, it is up to us to set in motion such a *virtuous circle*!

The policy program of the newly elected Austrian government includes several important measures to foster Austria´s attractiveness for business and investors. Starting out from a small budget deficit of 0.6% in 2002, the government´s fiscal policy stance foresees some cyclically motivated widening of the deficit to 1.3% this year. Looking ahead, the government intends to make significant tax cuts. The cutback of the share of government in the Austrian economy is appropriate and in line with international endeavors to improve the quality of public finances. The tax cuts should be accompanied one for one by expenditure cuts so as to ensure that a balanced budget is achieved over the cycle.

Where do Central and Eastern European countries enter this picture? It is my conviction that this historic reunification of Europe will mutually strengthen today's accession countries and the EU. Having said this, challenging tasks lie ahead. First and foremost, we will have to provide stability in a broad sense: political stability, macroeconomic stability, financial market stability and price stability. The framework which is in place provides for such broadly based stability. Thus, enlargement will encourage growth and employment in a wider Europe.

Economic and monetary integration of the accession countries will proceed in three stages: first, the acceding countries will join the EU in May 2004, second, the new Member States will participate in ERM II, the exchange rate mechanism of the EU, for at least two years, and third, after the sustainable fulfilment of all the convergence criteria laid down in the Treaty, the new Member States will adopt the euro.

Throughout the process leading to the introduction of the euro, the new Member States' economic situations and their policy strategies will have to be assessed on a case-by-case basis. The role of ERM II in this process, first, is to help participating Member States orient their policies to stability and to foster economic convergence. Second, participation in ERM II without severe tensions for at least two years is one of the convergence criteria.

Finally, entry into the euro area will be based on the sustainable fulfilment of the Maastricht convergence criteria. These criteria will be applied to future euro area entrants in the same way they applied to euro area countries. It may take quite a while before new Member States will be in a position to fully participate in EMU. A fair share of realism is called for to avoid disappointment. In the long run, such an equitable and strict procedure will be to the advantage of all Member States of the European Union.

In concluding, I would like to reiterate that in many respects, the euro has proved to be a driving force for Europe's continued political integration and economic reforms. The euro is regarded as an important token of identity for a modern, dynamic and open Europe.

The euro provides a stable anchor in unfortunately not so stable times. But the euro can only shield us from external shocks within limits. Even though the euro has already triggered considerable fiscal and structural reforms, we must not relinquish our endeavors to make the euro area economy more efficient and productive.