Klaus Liebscher: The European monetary union and the euro - a contribution to international stability

Welcome address by Dr Klaus Liebscher, Governor of the Austrian National Bank, at the Academic Ceremony - Awarding of the Academic Degree of Master of Laws, Vienna, 10 October 2005.

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Ladies and Gentlemen,

It is a great pleasure for me to welcome all of you in the OeNB and to participate in your Academic Ceremony of awarding the Academic Degree of Master of Laws. Not only do I personally consider the Postgraduate Program in International Tax Law of the Vienna University of Economics and Business Administration as one of the centrepieces of post gradual education, but due to its uniqueness and international orientation, it became a worldwide renowned and exclusive program offering ample opportunities to its graduates. My sincere congratulations to you, the graduates!

In this context I would also like to thank the Vienna University of Economics and Business Administration for its never ceasing enthusiasm to develop and further an outstanding education for its graduates – the core for the future, not only in Austria but also in all the countries its graduates will find their vocation. I am pleased to say that, not only as the Governor of the OeNB but also in my function as Deputy Chairman of the University Board of the Vienna University of Economics and Business Administration.

The year 2005 is for you but also for Austria a memorable one. We are celebrating the 60th anniversary of the Second Republic, the 50th anniversary of the Austrian State Treaty and independence as well as ten years of EU membership. Especially the ten years of EU membership have marked the landscape decisively. The momentum supplied by the driving forces of the European integration was impressive. Already, the Single European Market had aimed at removing obstacles to the free movement of goods, services, people and capital in Europe. The next step along the road of political and economic integration was 1999 the creation of European Monetary Union (EMU) and the introduction of the euro. Together with the enlargement of the European Union in 2004 to now 25 Member States we can look back on a remarkable development.

In Austria EU membership contributed not only to solid economic growth, to a significant consolidation of public finances and to price stability, but also to structural changes securing Austria its position in a competitive environment. A number of reforms would have to come about anyway but EU membership was a catalyst for many of them. Let me mention here the tax reform as well as the improvements undertaken in the pension-, health- and administrative systems. Measured by GDP per capita figures, Austria now ranks third in the EU right behind Luxembourg and Denmark. The goods exports-to-GDP ratio in Austria grew from 24% in 1995 to 38% in 2004 and foreign direct investments increased in recent years from 12% to 22% of GDP. In addition, the average (CPI) inflation rate fell from approximately 2.8% in the decade before EU membership to some 1.7% thereafter and at 5.1%, the unemployment rate is one of the lowest in the EU. Just recently Austria's reform efforts were cited as a positive example by the IMF and the OECD in the course of their annual consultations on the Austrian economy.

As others have already observed, the euro was a quantum leap in the direction of creating an economic area without internal frontiers. EMU marked the end of a Europe fragmented by monetary differences as the euro became the single currency of more than 300 million people with an economic weight roughly equal to the USA. The euro quickly turned into the second most widely used currency and is now a key currency for the monetary policies of many countries. As for its important international dimension, the stabilizing influence of the euro on the international financial system was already successfully demonstrated after the tragic events of September 11, 2001.

Given the size and the economic clout of the euro area it came as no surprise that EMU actually generated a zone of stability that is even larger than the euro area itself. This can be seen most distinctly in those countries closest to the euro area such as the new Member States of the EU and the countries currently conducting accession negotiations with the European Union. The stabilizing effects of the euro, however, go beyond providing an anchor in the exchange rate regimes of the new Member States. Since they have to implement the convergence criteria foreseen by the Treaty on the

European Union in order to ultimately adopt the euro, this has so far led to an impressive record of macroeconomic stability as well as exchange rate stability on their way to EMU.

The firm commitment of the euro system – as the European Central Bank and the 12 National Central Banks from the Member States of the euro area are called – to pursuing price stability as its main objective remains a key factor behind market confidence in the euro as a global and stable currency. Since the euro system became responsible for monetary policy in 1999, the primary objective of maintaining price stability has been successfully pursued. Inflation volatility has stabilized – the average inflation rate being around 2% over the past years – in spite of major inflationary shocks and although oil prices have quadrupled and the economic environment is difficult right now, inflation expectations still remain low. This reflects the high confidence of the public as well as the financial markets in the euro.

However, in the light of ample liquidity and very low interest rates in the euro area, strong vigilance with regard to upside risks to price stability is warranted.

The success story of EMU is based on the efficient interaction of three pillars: a stability oriented monetary policy, sustainable sound public finances and dynamic structural policies. In short, these three pillars are the foundation of economic stability and growth, hence fostering unity and peace in the euro area.

All in all, however, some encouraging structural reforms notwithstanding, the high degree of monetary stability achieved stands in contrast to the as yet insufficient flexibility and dynamism of some euro area economies. The latter phenomenon explains why the success of EMU has not been accompanied by higher real growth.

This brings me to the importance of sustaining sound public finances. Sound fiscal policies are fundamental to the success of economic and monetary union and they are prerequisites for macroeconomic stability, growth and cohesion in the euro area.

In the mid to late 1990s, euro area Member States made considerable progress in consolidating their fiscal positions as they sought to meet the convergence criteria for adoption of the euro. Since 1999, however, fiscal performance has been rather mixed. Initially a relatively favourable economic environment masked this development, but in the context of the economic slowdown that began in 2001, fiscal balances soon deteriorated. At the same time the rules and procedures of the Stability and Growth Pact were not always implemented in a rigorous manner. Presently six out of twelve euro area Member States are subject to excessive deficit procedures and only a small number of Member States has succeeded in achieving and maintaining close to balance or in surplus budgetary positions. This increasing reluctance to follow agreed rules and procedures eroded confidence in the EU fiscal framework and intensified criticisms of the Stability and Growth Pact that have been voiced ever since its inception.

Against this background, political agreement was reached in March 2005 on the reform of the Stability and Growth Pact. I will not deny that I am seriously concerned about the weakening of the Stability and Growth Pact and its implications on the future development of public finances and the confidence in the fiscal framework. The implementation of excessive deficit procedures and fiscal surveillance in the coming months will now serve as a test of the new framework’s effectiveness and renewed progress towards achieving sound medium-term budgetary positions. Let me emphasize, that it should be of the highest priority, especially if combined with a comprehensive economic reform strategy!

With a view to the third pillar, EU policy makers are well aware of the importance of structural reforms and they did commit to action when the European Council adopted the Lisbon strategy five years ago. Some encouraging structural reforms notwithstanding – let me mention here as examples the liberalisation of the electricity market and the progress in pension and labour market reforms – the Lisbon strategy fell short of its initial goals.

Even if we consider the time lag between the implementation of reforms and their taking the intended effects, the increase in potential growth was disappointing. In addition it has obviously proven difficult to communicate the benefits of long-term growth effects of structural reforms to the general public. Social and economic progress often entails significant changes in the life of individuals, with risks as well as benefits. These legitimate worries need to be taken seriously and addressed appropriately.

As a new start for the Lisbon strategy, in spring 2005 the European Commission presented the “Community Lisbon Programme” focusing on two principal tasks – delivering stronger, lasting growth and more and better jobs. The idea is to modernise our economy in order to secure the European social model in the face of increasingly global markets, technological change, environmental pressures, and an ageing population – a difficult challenge ! But we need to invest more in the young people, education, research and innovation. We also need to further open markets, to invest in modern infrastructure and to take the necessary steps to develop a skilled and entrepreneurial workforce. Some of the policy actions will take time to show visible effects, others will deliver early benefits. In all cases they must be approached with a strong sense of urgency and collective responsibility of all the Member States of the European Union.

Due to the recent enlargement of the EU the necessity of ongoing structural reforms became more stringent also for the old Member States. Moreover, the new Member States demonstrated in many areas that even unpopular reforms, like pension reforms, can be accomplished when tackled right. Increased competition from within and the will to further the competitiveness of the EU as a whole are surely very nice side effects of the enlargement and an incentive to take the revival of the Lisbon strategy seriously.

Although EMU represents a highly successful achievement it cannot be considered as the end-point of the European integration process.Apart from the necessity to successfully maintain and foster stability and growth, Europemust also meet the challenge of the recent geographic expansion of ten new Member States, which is of immense historical magnitude. The Maastricht Treaty was negotiated by 12 countries. We are now 25, and virtually already 27. Hence, in Europe a unique “vertical” economic and political transformation and a geographic “horizontal” expansion of an immense significance are intertwined. The need to accommodate and integrate 458 million European fellow citizens will certainly keep us on our toes.

I consider it also part of the ongoing process that we will be faced with difficult moments from time to time, the European Constitution being one example. In my opinion a temporary setback on the way to a more comprehensive European Union will in no way stop the process. It might just sharpen our awareness for striving to strike the right balance between widening and deepening the EU, as integration is the driving force for securing peace and welfare in Europe, also for the next generations.

With my renewed congratulations and the best wishes for your personal future, I thank you for your attention.