Klaus Liebscher: EMU and globalization – chances and challenges

Speech by Dr Klaus Liebscher, Governor of the Austrian National Bank, at the Central Council of ELEC, Vienna, 1 June 2007.

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Ladies and Gentlemen!

It is both a privilege and a pleasure for me to address this distinguished audience on the topic "EMU and Globalization – Chances and Challenges".

European Monetary Union (EMU) and the euro, which seemed to be very ambitious projects of European integration some decades ago, meanwhile have become a remarkable contribution both to the stability and the international competitiveness of the European Union, and in particular of the euro area. One of the success factors of this milestone of European integration was the strong political will to follow the "stability architecture of EMU", which rests on three pillars: a monetary policy oriented to price stability, a fiscal policy geared towards sound public finances (Stability and Growth Pact) and structural policies designed to foster competitiveness and sustainable economic growth (Lisbon Agenda). So far, EMU and the euro can be seen as one of the EU's most important strategic responses to the chances and challenges of a globalized world.

Earlier this year, we celebrated the 50th anniversary of the Treaty of Rome, which established the European Economic Community (EEC). The day the Treaty was signed, March 25, 1957, is considered the birthday of the European Union, which today unites around 490 million people in 27 countries. And in today's euro area, about 317 million people in 13 countries benefit from a low inflation environment and stable inflation expectations, a high degree of confidence in their currency and moderate interest rates – all elements of a favorable economic environment conducive to investment and business.

Since 1999, we have experienced a number of important shocks to the global economy, such as the Y2K challenge, substantial oil price increases, the ups and downs of the euro exchange rate, the boom and the burst of the equity market bubble, global imbalances and the clouds of war and terrorism. Amidst all of this, the Governing Council of the European Central Bank (ECB) has guided inflation expectations in a manner consistent with price stability and thus provided a reliable anchor for the euro-area economy, while the euro has sheltered euro area financial markets against those shocks.

Not least because of the growing international use of the euro, the stability culture formed by the single currency has already bestowed positive benefits on the non-euro area EU Member States and many Eastern European, Middle Eastern and African countries. Meanwhile, nearly one-third of all international debt securities are denominated in euro, and the euro accounts for about 25% of global foreign exchange reserves. Since its introduction, the euro has become the second most widely used currency in the world. Moreover, with 646 billion banknotes and coins in circulation, the euro has already overtaken the US dollar.[1]

In a global perspective the EU and the euro area are unique. No other model of supra-national cooperation or agreement has achieved such a high level of integration. In the classification of the IMF, the euro area is the 3rd largest economic area in the world in terms of real GDP (15%), after the US (20%) and developing Asia (27%).

Moreover, following a few years of economic sluggishness, the euro area is now becoming an ever larger player in the global economy, thereby contributing to an urgently needed

[1] USD banknotes and coins: USD 810 bn = EUR 615 bn (all data and the exchange rate at end-2006).

rebalancing in global economic growth. Economic activity, in fact, accelerated to 2.7% last year, and since the start of Monetary Union real GDP growth has averaged 2.1%. The ECB staff projections from March 2007 see growth ranging between 2.1% and 2.9% in 2007 and between 1.9% and 2.9% in 2008.

Unemployment has declined significantly, from 9% in 1999 to 7.2% (March 2007), a development which is particularly welcome. 12 million new jobs have been created since 1999.

On average, inflation has stood at 2.1% since the start of EMU, which shows that inflation expectations are firmly anchored. Hence, price stability has created a favorable environment for investment and growth in the euro area. Concerning the outlook for prices, the ECB staff projects annual inflation to average between 1.5% and 2.1% this year and between 1.4% and 2.6% in 2008.

Risks to the medium-term outlook for price stability remain on the upside, relating in particular to stronger than currently expected wage developments in a context of ongoing robust growth in employment and economic activity. Given the vigorous monetary and credit growth in an environment of already ample liquidity, the Governing Council of the ECB will continue to be strongly vigilant in order to ensure that risks to price stability over the medium term do not materialize.

A price stability-oriented monetary policy is a necessary precondition for sustainable dynamic growth and employment, but it is by no means the only precondition. Monetary policy needs to be supported by sound public finances, ambitious structural reforms and a competitive economic framework.

It is important to understand that unsustainable fiscal policies may put the entire euro area at risk. For instance, higher risk premiums in response to unsustainable policies in one Member State could spill over to other euro-area countries. Euro-area membership thus also means compliance with a stringent regulatory framework, the Stability and Growth Pact.

We are aware that structural improvements are only part of the reason for the current improvement in euro-area fiscal balances, from -1.6% in 2006 to an expected -1.0% in 2007. Thus, it is essential that any budgetary leeway granted by the current favorable economic environment be used for lasting budgetary consolidation in order to prepare for challenges such as population ageing and to create room to maneuver for future economic downturns.

In addition, structural polices are needed to ensure that countries can flexibly react to asymmetric shocks, as the single monetary regime makes adjustments to asymmetric shocks a painful and drawn-out process.

In 2000 the European Council adopted the Lisbon Agenda. In broad terms, the Lisbon strategy aims to "make Europe, by 2010, the most competitive and the most dynamic knowledge-based economy in the world". In 2005, after the mid-term review, European policymakers renewed their commitment to the ambitious goals. Even though a number of Member States have achieved significant progress in several areas, much remains to be done. This includes more effective and efficient investment in knowledge and innovation and making labor and product markets more flexible. At the end of the day, only dynamic economies can sustain modernized yet generous welfare systems in Europe.

This brings me to further challenges facing the EMU in the years to come, most notably the further enlargement of the euro area and the EU.

The new Member States to date have succeeded in transforming their economies from centrally planned systems to market economies. Substantial progress has been achieved in the areas of property rights and privatization as well as capital and trade liberalization. As these countries have anchored their institutional structures to the EU, they are viewed as increasingly secure places for investing and doing business in general. Moreover, the euro anchors monetary stability in the region, often directly, for instance through the European

Exchange Rate Mechanism ERM II. Currently, six of the 12 new Member States are members of ERM II: Cyprus, Estonia, Latvia, Lithuania, Malta, and Slovakia.

Full monetary integration will be the ultimate goal of all new Member States depending on their progress of sustainable convergence. However, the application of the convergence criteria for the new Member States must not be more, but also no less strict than for the current euro area countries. Moreover, when adopting the euro, quality must not be compromised for the sake of speed.

Slovenia became the 13th member of the euro area at the beginning of this year. In February 2007, Malta and Cyprus submitted their requests for convergence assessment by the ECB and the European Commission. If given approval by the European Council, both countries would adopt the single currency at the beginning of 2008.

The anchoring effect of the euro also applies to many other countries located in the neighborhood of the euro area. Tightening financial and institutional links is an integral part of the EU's Stabilization and Association process with the countries of the Western Balkans.

The merits of the process are assessed regularly. Bulgaria and Romania joined the EU on1 January 2007, with some more countries to follow in the future.

As a small open economy, Austria is highly exposed to the changing global economy and globalization. Open economies face greater challenges than less open economies in adjusting to a more integrated world and to the greater exposure to real and financial volatility that comes with integration. Large capital flows can complicate the task of achieving sustainable growth, low inflation and financial stability. Austria has never shied away from the challenges of globalization. Not in the period prior to EU and EMU membership, when Austria followed a fixed exchange rate regime, which became a role model coined as stability-oriented exchange rate policy, nor later on when the euro replaced the Austrian Schilling.

All in all, we can safely say today that Austria's EU membership has contributed not only to solid economic growth, a significant consolidation of public finances and price stability, but also to structural changes which have securing Austria's position in a highly competitive environment. Thus, over the past decades, Austria has become a leading small open economy in Europe. This achievement is borne out by GDP per capita figures which place Austria third in the euro area, right behind Luxembourg and Ireland in 2006. Austria's goods exports-to-GDP ratio grew from about 24% in 1995 to 43% in 2006 (goods and services exports-to-GDP ratio: 58% in 2006), and foreign direct investment has increased from 5% to 23% of GDP in 2005. In addition, average (CPI) inflation fell from approximately 2.7% in the decade before EU membership to some 1.7% thereafter and, at 4.8% in 2006, the unemployment rate is one of the lowest in the EU, also due to a successful "social partnership". The employment rate of 15-64-year olds is one of the highest in Europe.

Austria benefited not only from EU membership and the Single Market, but also from the fall of the Iron Curtain in 1989 and from the transition and integration process in Central and Eastern Europe, including Southeastern Europe. FDI in the region and bilateral trade have intensified very markedly. Bilateral trade with Central and Eastern Europe has tripled since 1993 in real terms.

Austrian companies in general, and Austrian banks in particular, were quick to identify market opportunities in Central, Eastern and Southeastern Europe and have established a considerable presence. With an average market share in banking sector assets of almost 25%, Austria's banks are among market leaders in this region.[2] More than one-third of the profits of the six largest Austrian banks already come from this region. As Austrian banks

[2] Central, Eastern and Southeastern Europe, excluding CIS countries.

continue to move into the southeast and east, their exposure is broadly diversified, which is intended to contain risks. At the same time, the Austrian authorities closely monitor potential challenges involved. Stress tests indicate that the banks' exposure is manageable and potential contagion effects on Austrian banks should be very limited.

Having mentioned some positive effects for Austria, we must concede that big changes rarely only create winners. In balance, however, EMU and the euro have undoubtedly shielded the Austrian economy well from possible adverse effects of globalization. Moreover, backsliding into protectionism would be like traveling back in time.

From the narrow focus, let me again widen the perspective to the world economy.

The increasing emergence of new players on the globalized stage has contributed to the very impressive recent expansion of the world economy. Yet, this dynamic growth has also created economic challenges, such as surging commodity prices and significant current account imbalances. Recently, global growth appears to have become somewhat more even-footed, as growth in Japan and the euro area has been picking up.

The economic upswing in the euro area can be attributed at least in part to improved economic structures and is based on the stability-oriented framework of EMU. The Governing Council of the ECB will continue to support this upswing by acting vigorously to maintain price stability.

Moreover, the international competitiveness of the euro area has to be improved. With structural reforms still ahead, the euro area economy seems vulnerable to an abrupt unwinding of global imbalances in the US and Asia. Today, there is large consensus in Europe that lower growth in the EU is largely structural in nature. In order to improve its position in the global economy, we have to work on reducing growth differentials, in particular vis-à-vis the US. We should respond with policies designed to use opportunities of globalization, particularly to increase productivity and growth, while minimizing unavoidable adjustment costs. The right answer to globalization and international competition is therefore to continue and intensify the structural reform process. Standstill would be detrimental.

In this context, let me mention the moribund Doha round, which has even cast doubt on the future of the World Trade Organization (WTO). Although calls for protectionist measures to counter the increasing competition from Asian economies should be taken seriously, I stand on the side of free trade and believe that protectionist pressures need to be firmly resisted.

There is no doubt that globalization has worked well for the people of Europe. After nearly nine years of experience, Economic and Monetary Union and the euro have proven to be Europe's most forceful strategic responses in a changing global economy. It is said that: "Change is inevitable; growth is optional." In a globalized world, Europe has chosen to grow.