Klaus Liebscher: The euro – a contribution to international stability

Luncheon speech by Dr Klaus Liebscher, Governor of the Austrian National Bank, at the Metropolitan Club, New York, 16 April 2007.

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Ladies and Gentlemen!

It is a great pleasure and honor to have the opportunity today to talk in front of such a distinguished audience, in one of the most fascinating cities of the world. Financial markets have become global, yet I think New York and Wall Street will always remain synonyms for investors seeking returns, prosperity and new horizons.

Today, I would like to share with you one of Europe's most recent success stories, notably the story of our common currency, the euro. Recently, 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, was the birthday of the European Union, which today unites 490 million inhabitants and 27 countries.

The euro was introduced on January 1, 1999, and meanwhile, the euro and the Economic and Monetary Union (EMU) have entered their ninth year.

In today's euro area 317 million people in 13 countries (including Slovenia as the first of the new Member States to introduce the euro on January 1, 2007) benefit from a low inflation environment and stable inflation expectations, a high degree of confidence in their currency as well as a moderate level of interest rates – all elements of a favorable economic environment conducive to investment and business making.

Skeptics but also some advocates of Economic and Monetary Union once regarded the euro as "the world's largest economic policy experiment".[1] Well, although the introduction of the euro was an unparalleled project in European history, I certainly would not want to consider the euro a mere experiment. Launching the euro was, after all, a solidly founded and well prepared project, based on policymakers' firm conviction that the introduction of a single currency would entail ample benefits. Hence, I do not regard the euro as an experiment, but as a very wise and successful strategy.

Economic and Monetary Union has to be seen as one of our most important strategic responses to the chances and challenges in a globalized world.

The euro has fostered the European integration process; the euro has enhanced Europe's role in international economic policy circles; and the euro provides a sound basis for our businesses in a very competitive world.

The stability created by the euro already extends beyond the euro area: The non-euro area EU Member States, many Eastern European, Middle Eastern and African countries are positively affected by the euro as well. The euro is a key currency for monetary policy in many countries. In 2006, 25% of all official foreign exchange reserves worldwide were held in euro.

Since its introduction, the euro has become the second most widely used currency in the world. And in terms of banknotes and coins in circulation, the euro with 646 billion has already overtaken the US-Dollar.[2]

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[1] E.g. Richard Baldwin, Co-author of "The Economics of European Integration" (together with Charles Wyplosz).

[2] USD banknotes and coins: USD 810 bn = euro 615 bn (all data and the respective exchange rate by the end of 2006).

Moreover, the euro has proved to be a stabilizing influence not only for the European capital markets, but also for the international financial system, as was demonstrated after the shocking and very tragic events of September 11.

How did the euro establish itself that swiftly as an anchor of stability? To answer this question, monetary, fiscal and structural policies in the euro area have to be considered. Let me start with monetary policy.

The monetary policy framework of the European Central Bank (ECB) and the Eurosystem respectively, which includes the national central banks of the euro area, is based on central bank independence, transparency, accountability and an explicit mandate to maintain price stability.

The Eurosystem goes to great lengths to communicate the ECB's monetary policy strategy, the rationale for monetary policy decisions and our assessment of economic developments.

These communication efforts not only take the form of regular testimonies in the European and national Parliaments, periodic bulletins and speeches, but also take place in "real time": ECB President Jean-Claude Trichet explains the monetary policy decisions and the underlying reasoning in press conferences which take place immediately after Governing Council meetings and which provide "question and answer sessions" for journalists.

The ECB's monetary policy is based on a clearly defined monetary policy strategy aimed at fulfilling our primary mandate of price stability. This is defined as an inflation rate of below, but close to 2% over the medium term.

By and large we have maintained price stability since the introduction of the euro despite a difficult macroeconomic environment characterized by a high level of uncertainty and a series of adverse external and internal shocks:

Oil price developments accelerated inflation; at the same time events such as the burst of the equity bubble, geopolitical tensions and a decline in productivity dampened growth in the euro area.

These divergent developments in inflation and growth, as well as asymmetric effects of these shocks across countries posed challenges, especially for a new central bank.

Given such an environment of constant economic uncertainties and challenges, the European Central Bank has put a monetary policy strategy in place that is based on a comprehensive analysis of economic and monetary developments. That means that the Governing Council cross-checks the information gained from economic analysis with all available evidence from a wide range of monetary, credit and asset market indicators.

Looking back, this monetary strategy has served us very well, despite some inherent volatility between money demand and inflation: Since 2004, private lending and money aggregates have grown in parallel and at accelerated speed. This was an early indication of the current economic upswing, which most other data did not signal until much later.

Indeed, the ECB's monetary policy strategy contributed to the timely and highly warranted adjustment of the ECB's monetary policy stance, with the first interest rate increase in December 2005, which was to ensure that risks to price stability over the medium term do not materialize. Having said this, we are aware that strong money and credit growth may also signal the build-up of financial imbalances and potential price bubbles in asset markets, as could be indicated, for instance, by significant housing price increases in some regions in the euro area.

Despite the negative factors mentioned before inflation stood at only 2.2% in 2006. On average, inflation has come to 2.1% since the start of EMU, which shows that inflation expectations have been firmly anchored. Hence, price stability has created a favorable environment for investments and the euro area's growth performance.

Indeed, economic activity accelerated to 2.8% last year, and since the start of Monetary Union real GDP growth has amounted to 2.1% on average. Unemployment has declined significantly, dropping from 9% in 1999 to 7.3% recently, a development which is particularly welcome. 12 million new jobs were created since 1999.

The ECB staff projections foresee growth in a range between 2.1% and 2.9% in 2007 and between 1.9% and 2.9% in 2008. In the opinion of the ECB's Governing Council, the risks surrounding this favorable outlook for economic growth are broadly balanced over the short term. However, looking at longer time horizons, risks may lie mainly on the downside. The main risks relate to the possibility of a renewed increase in oil prices, fears of a rise in protectionist pressures and concerns about possible disorderly developments owing to global imbalances.

Concerning the outlook for prices, last year's volatility in energy prices will lead to significant base effects, affecting the profile of annual inflation rates in a slightly U-shaped way. The ECB staff projections from March 2007 foresee annual inflation averaging between 1.5% and 2.1% this year and between 1.4% and 2.6% in 2008.

Given these projections and the credible price stability commitment of the ECB, long-term inflation expectations according to professional forecasters continue to be firmly anchored at just below 2%.

Having said this, upside risks to price stability remain and relate foremost to higher wage claims, and of course the oil price. Given the favourable economic environment, our monetary policy continues to be on the accommodative side, with the key ECB interest rates moderate, money and credit growth vigorous, and liquidity in the euro area ample by all plausible measures.

Therefore, looking ahead, acting in a firm and timely manner to ensure price stability in the medium term is warranted. Indeed, it is essential to ensure that risks to price stability over the medium term do not materialise.

A price stability-orientated 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. While monetary policy in the euro area is firmly vested in a supranational body – the ECB – fiscal and structural policies remain the responsibility of national governments.

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. Hence, membership in the euro area also means compliance with a stringent regulatory framework, the Stability and Growth Pact.

We are aware that the present improvement of fiscal balances in the euro area, from -2.4% in 2005 to an expected -1.6% in 2006[3], is only partly driven by structural improvements.

Thus, it is essential that any budgetary leeway emerging from the currently very favorable economic environment is used for lasting budgetary consolidation in order to prepare for challenges such as population ageing and to create room to maneuver for future economic weaknesses.

Monetary policy needs to be supported by sound public finances and, apart from that, by ambitious structural reforms and a competitive economic framework, to enable the euro area to fully reap the benefits of the common currency. Structural polices need to ensure that

[3] Forecast for 2006 by the IMF, WEO Spring 2007.

countries can flexibly react to asymmetric shocks, as the common monetary regime makes adjustments to asymmetric shocks a painful and tedious process.

Even though a number of Member States have achieved significant progress in several areas, much remains to be done. Necessary measures include more effective and efficient investment in knowledge and innovation, as well as promoting the flexibility of labor and product markets in order to unlock business potential. At the end of the day, only dynamic economies can sustain modernized, but still generous welfare systems in Europe.

This brings me to another part of Europe, the new Member States of Central and Eastern Europe. They have succeeded in transforming their economies from centrally planned systems to market economies. Substantial progress has been achieved in the areas of property rights, 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 serves as an anchor of monetary stability in the region, often directly, for instance in the framework of the European Exchange Rate Mechanism ERM II. Currently, six countries of the 12 new Member States participate in the exchange rate mechanism ERM II: Estonia, Cyprus, Latvia, Lithuania, Malta, and Slovakia.

All Member States of the EU, with the exception of Denmark and the United Kingdom, are to adopt the euro, once they fulfill the Maastricht convergence criteria in a sustainable way, as laid down in the EU Treaty.

In line with this procedure, Slovenia joined the euro area as its 13th member 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. Both institutions will publish their convergence reports in May. Based on these reports, the ECOFIN Council (i.e. the EU Ministers of Finance) will take a final decision in July, after having consulted with the European Parliament and after a discussion of the matter by the European Council (i.e. the Heads of State and Government) in June. In case of a positive decision, both countries would adopt the single currency by the beginning of 2008.

Even though the new EU Member States of Central and Eastern Europe account for only some 6% of GDP within the EU, one cannot neglect their positive effects on the rest of the European Union. Central and Eastern Europe is the most dynamic region in the EU – both in terms of economic growth and in terms of reform speed. During their catching-up-process, the new Member States will further gain in importance and may turn into a driving force of the European economy.

As a result of the dismantling of trade barriers, trade links with the new EU Member States have gradually intensified. The former EU-15 countries are not only the most important trading partners for the new Members States but also account for three quarters of their total FDI stock. This is particularly true for the banking sector, in which foreign-owned banks have gained an average market share of around 70%.

I expect the very positive dynamics in Central and Eastern Europe to continue. For the three EU members Czech Republic, Hungary and Poland, and also for Russia, the staff of our Bank forecasts annual real GDP growth to range between 5% in the Czech Republic, 6% in Poland and 6 ½% in Russia, while economic activity in Hungary is expected to slow down to less than 3% this year, as necessary austerity measures take effect.

For 2008, our staff expects some growth acceleration for Hungary, and some moderation in the other countries mentioned. In the long run, the leveling off of EU accession-related and catching-up effects may dampen growth, but the general growth prospects remain favorable.

Austrian companies in general, and Austrian banks in particular, identified market opportunities in Central and Eastern Europe at a relatively early stage and have established a considerable presence in the region by now. With an average market share in banking sector assets of almost 25%, Austria's banks are market leaders in Central and Eastern Europe.[4] More than one-third of the profits of the six largest Austrian banks already come from this region.

As Austrian banks 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.

Let me conclude by getting back from Austria's focal point of interest, Central and Eastern Europe, to New York's focal point of interest: the world economy.

The increasing globalization of the world economy, with new players emerging on the world stage, has contributed to the very impressive expansion of the world economy in the recent past. Yet, this dynamic growth has also spurred economic challenges, such as strongly rising commodity prices and significant current account imbalances. Recently, global growth appears to be somewhat more even-footed, as growth in Japan and the euro area has been picking up.

The economic upswing recorded in the euro area can be attributed, at least partly, to improved economic structures and is based on the stability-orientated framework of EMU. The ECB and the Eurosystem respectively, will continue to support economic growth in the euro area by vigorously pursuing price stability. Following this approach also guarantees that the euro can contribute most effectively to international stability.

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