Dr. Liebscher talks about European Economic and Monetary Union – Chances and Challenges for Europe

Address by the Governor of the Oesterreichische Nationalbank, Dr. Klaus Liebscher, to the Eurogiro Central and Eastern European Conference at the SAS Palais Hotel in Vienna on 9 April, 1999

Ladies and gentlemen,

It is a great pleasure for me to share a few thoughts with you on the chances and challenges for Europe that arise from European Economic and Monetary Union. As you may know, the Oesterreichische Nationalbank has a long tradition of close co-operation with Central and Eastern European countries and central banks. It is therefore quite natural - for historical, geographical and economic reasons - that, within the newly established European System of Central Banks, the OeNB sees itself as a kind of interface between the ESCB, on the one hand, and Central and Eastern European countries and central banks, on the other. This is particularly relevant at the present juncture: EU accession negotiations with Central and Eastern European countries are in full swing. The ESCB needs to build up expertise on the prospective new EU member countries. At the same time, Central and Eastern European candidate countries might benefit from the OeNB's practical experience with its own – still quite recent - accession to the EU and its integration into the euro area and the ESCB. All those who have been following EU politics, EU economic developments and the establishment of Economic and Monetary Union, know that there are, indeed, many chances and challenges arising from EMU, which could easily provide material for discussion for a whole series of conferences.

Let me therefore focus on just four areas which I believe might be of particular interest to you. The first area concerns the Eurosystem's monetary policy. The second area deals with the economic impact of EMU on the euro area and the interplay between the Eurosystem's monetary policy and the other areas of economic policy. The third area relates to the chances and challenges EMU holds for banks. The fourth area, finally, concerns the consequences of EMU for Central and Eastern European countries in their process towards EU accession.

The Eurosystem's monetary policy

1. Let me start with the Eurosystem's monetary policy. As you know, the Eurosystem, i.e. the European Central Bank (ECB) and the national central banks which take part in the euro area, has

taken over responsibility for the euro area's monetary policy as of January 1, 1999. Roughly a decade of intensive preparations among EU central bankers led up to this historic step. The Maastricht Treaty establishes a clear and transparent institutional framework for the euro area's monetary policy. The Eurosystem is structured as a federal system: Monetary policy decisions are taken jointly at the bi-weekly meetings of the ECB Governing Council in Frankfurt, where the ECB President, Vice-President, the other four members of the ECB Executive Board and the governors of the euro area's 11 national central banks participate, each with one vote. The Eurosystem is assigned exclusive responsibility to design and implement the euro area's monetary policy with the primary objective of maintaining price stability. In doing so, the system is independent from political interference and influence. Without prejudice to its primary objective, the Eurosystem supports the broad economic objectives as laid down in Article 3 of the Maastricht Treaty, which include, among other things, growth and employment. By establishing this clear hierarchy between objectives, the Treaty legislator acknowledged that the best contribution monetary policy can make to economic growth and employment in the medium and long run is to maintain price stability.

What does the primary objective of "price stability" mean in concrete terms? With a view to providing a firm anchor to inflation expectations and facilitating public assessment of the Eurosystem's monetary policy performance, the ECB Governing Council has announced a quantitative definition of its objective. Price stability has been defined as a year-on-year increase in the Harmonized Index of Consumer Prices (HICP) of less than 2%, measured on the euro-area-wide average. Furthermore, the Governing Council clarified that price stability is to be maintained over a medium-term horizon. Thus, the possibility of short-term fluctuations generated by causes outside the Eurosystem's influence has been taken into account. Finally, it is noteworthy that the ECB Council also regards *de*flation, i.e. a sustained fall in prices, as *in*compatible with price stability. The current annual rate of inflation in the euro area of 0.8% is fully consistent with the ECB's definition of price stability.

The ESCB's strategy to achieve its objectives rests on two pillars: First, money is assigned a prominent role. Therefore, a reference value for the annual growth of M3 is announced. This reflects the generally agreed notion that, in the medium and long run, "inflation is always and everywhere a monetary phenomenon." The ECB Governing Council has set the reference value for M3 growth at 4.5%. However, we do not react to any deviations in a "mechanistic" way. Only if a deviation is found to signal threats to price stability, will the Eurosystem take monetary policy measures. The second pillar is a broadly-based assessment of the outlook for price developments, on the basis of a wide range of financial and other economic indicators, including economic forecasts. To implement its monetary policy, the Eurosystem uses a full range of state-of-the-art, market-based monetary policy instruments. The operational framework comprises minimum reserves, open market operations and standing facilities. Open market operations are the main instrument to steer interest rates, manage liquidity and signal the monetary policy stance. The two standing facilities – the marginal lending facility and the deposit facility – are open to counterparties on their own initiative. Accordingly, they usually form a corridor for euro area overnight money market rates. I should also like to say a few words on a subject which is particularly topical at this conference: payment systems. As you know, the Eurosystem set up a European payments system – TARGET – to ensure the integration of the various money markets and the emergence of a single interbank interest rate. TARGET links all the national large-value payments systems in the EU. Except for some initial "teething problems" arising from the necessity for commercial banks and central banks to adapt to the new system and environment, TARGET has functioned well overall and has contributed substantially to the rapid integration of the euro money market.

No treatment of monetary policy is complete without some remarks on the reverse side of monetary policy: exchange rate policy. The euro area is a fairly closed economic area, with foreign trade representing just above one tenth of GDP. Thus, the euro area should be less concerned with international exchange rate fluctuations than its individual participating countries were hitherto. Given its economic strength and the depth of its financial markets, the euro will, over time, become an important international currency. The importance of the euro area and its economic policies is fully recognized at the international level, as is evidenced by the rapid integration of ECB representatives in the various fora responsible for international policy co-ordination. The challenge will be to use this new influence and power wisely, and to withstand the temptation to distract from unpleasant domestic economic policy requirements through misplaced activism at the international level.

The economic impact of EMU on the euro area

2. This leads me to the second area, the economic impact of EMU on the euro area and the interplay between the Eurosystem's monetary policy and the other areas of economic policy. In the short run, EMU means substantial costs - one only has to think of all the activities related to the changeover weekend at the start of this year and the forthcoming replacement of banknotes and coins. At the macro level, there were also the unpleasant short-term effects of disinflation and fiscal consolidation required in many member states to qualify for participation in the monetary union. Note, however, that these measures would in any case have been necessary, with or without EMU.

Furthermore, I should like to emphasize that these short-term efforts are a necessary - and profitable - investment into Europe's political and economic future. The benefits of sound fiscal and monetary policies are already today reflected in the historically low level of inflation throughout the Union, in low interest rates and in stable exchange rates. All these factors are, in the long run, conducive to growth and employment. The stabilizing impact of EMU was to be felt well ahead of its inception. Just think of the virtual absence of negative spill-over effects from the international emerging market crises on EU financial and exchange markets. Contrary to the early 1990s, the EU is now generally recognized as a safe-haven of stability, steadiness and economic reliability. The strong convergence, observed in the run-up to EMU, of short and long-term interest rates to the levels of the most stable EU currencies has contributed to monetary conditions favorable for growth and employment. Real interest rates in the euro area are now considerably below their average levels observed over the past decade.

While the benefits of EMU are quite obvious even in the short run, the real dividends from monetary union are yet to come. The positive "shock" that EMU implies for our economies' productive capacity will propel European long-term growth, allowing higher real growth and employment, while maintaining price stability. The monetary discipline exemplified by the independent ESCB's credible monetary policy will fundamentally alter European agents' price and wage setting behavior and thus contribute to the necessary structural reforms in factor markets. Price transparency will be dramatically enhanced through the introduction of a single unit of account for the entire area, thus giving an additional boost to the deepening of the single market. The creation of a single store of value and the conduct of a single monetary policy operating in a unified European money market will lead to the creation of large and deep European bond and stock markets, providing cheaper access to funds and a greater variety of liquid investment opportunities. The rules of the Stability and Growth Pact will ensure that sound fiscal policies are pursued and that Member States' public finances are put back on a sustainable path.

Let me emphasize the importance of two fields of economic policy other than monetary policy for the realization of EMU's full benefits: fiscal policy, and wage and labor market policies. As regards fiscal policy, strict adherence to the prescriptions of the Stability and Growth Pact – in particular the requirement to achieve zero or positive fiscal balances over the cycle – is of vital importance for the monetary union to work smoothly and yield its full benefits. It is true that the euro area economies have undergone an impressive process of cyclical synchronization during the 1990s. Nevertheless, in an uncertain world full of unexpected events asymmetric shocks can never be ruled out. Balanced budgets over the business cycle ensure that automatic stabilizers can operate freely in the face of shocks and thus buffer, at the national level, de-synchronized cyclical fluctuations, which the single monetary policy – by definition – can no longer provide for. Strict adherence to the Stability and Growth Pact also allows an optimal policy mix between monetary and fiscal policies. In this way, the Pact contributes to laying the groundwork for continued broad public support for the EMU project.

The second field of crucial importance is the situation on European labor markets. The high level of unemployment is the single most important economic and social problem in the European Union. There is wide agreement that European unemployment is largely structural, i.e. it cannot be remedied through expansionary monetary and/or fiscal policies. The euro makes the significant wage differentials which exist within the euro area immediately transparent. Annual wage increases also become directly comparable. There is a risk that differentials in wage levels and growth rates which are justified – and even necessary – due to productivity differentials, might be leveled out. This would severely damage competitiveness in the less productive regions and companies in the euro area. Since in the monetary union, by definition, the safety valve of a nominal exchange rate depreciation against the partner countries is no longer available, such losses in competitiveness would cause unemployment or migration. Trade unions and enterprises should therefore orient their stances in wage negotiations on productivity and its development over time. Consequently, wage formation should be decentralized. National economic policy makers should, in turn, take up the challenge of making labor cheaper by reducing non-wage labor costs. At a more general level, the creation of sustainable employment on a large scale will require fundamental changes to an economic environment which currently hampers private initiative, entrepreneurship and flexibility in the EU.

The effects of EMU on European banks and financial markets

3. Let me now turn to the third area that I want to address, namely the effects of EMU on European banks and financial markets. The tasks of the Eurosystem include, inter alia, to contribute to the smooth conduct of banking and financial market supervision. In this context, the Eurosystem published a report in February of this year on the possible effects of EMU on the EU banking systems in the medium and long term as well as on banks' responses to the challenge so far. The main finding of this report is that EMU will likely act as a catalyst, reinforcing already prevailing trends. In particular, EMU will reinforce the need to reduce excess capacities and exert pressure on profits. It will furthermore favor internationalization and geographical diversification, also outside the euro area, and provide an additional impetus for conglomeration as well as mergers and acquisitions. As a result, overall competition in banking will in all likelihood mount considerably. Let me elaborate a bit on these findings. EMU affects banking activities in various ways. Most obviously, banks lose their intra-euro area foreign exchange business. Banks may be expected to compensate this loss of revenue through other activities. They might increase their money and securities market activities, benefiting from the deeper and more liquid euro financial markets. The reduction of Government debt, owing to fiscal consolidation, might boost private sector securities issues, thus opening new business opportunities for banks. At the same time, the larger euro financial market might imply stronger competition and lower margins in this business area; it will, furthermore, reinforce the trend towards disintermediation, implying a relative shrinkage in banks' traditional business segments. However, in the long run, the adjustment process triggered by these challenges should make European banks stronger and fitter, while benefiting customers through increased competition. In addition, the stable monetary environment, ensured by the Eurosystem, should generally benefit banks' business. For Central and Eastern European banks this overall development means that they will face a streamlined, competitive EU banking system, well experienced in surviving in the competitive environment of the euro area.

The chances and challenges of EMU for Central and Eastern Europe

I am turning now to the final issue: the chances and challenges that EMU holds for Central and Eastern European countries in their process towards EU accession. The creation of the euro will affect Central and Eastern European economies through three main channels. First, it should, through its positive medium and long-run impact on euro area growth, boost demand for imports from Central and Eastern European countries, and thus spur growth. The creation of a zone of stability in Europe should undoubtedly have positive spillover effects on the Central and Eastern European countries closely associated with the European Union. Second, euro area interest and exchange rate developments will be critical determinants of the external economic environment of Central and Eastern European countries. The decline of long-term interest rates in Western Europe will reduce the interest servicing costs of CEECs which hold sizeable foreign debt denominated in Western European currencies or which intend to tap the euro credit and bond markets. Finally, the above-mentioned structural changes that EMU brings about in euro area financial sectors, will also affect CEECs. The creation of the euro area might have an impact on both FDI and portfolio investment flows from the euro area countries to CEECs. However, the direction and size of such possible changes are uncertain and will depend, inter alia, on how attractive the investment opportunities and macroeconomic framework conditions in CEECs are. The advent of the euro also has implications for macroeconomic policies in the CEECs. The creation of EMU further accentuates the need for sound and consistent macroeconomic policies. Stability-oriented policies are not only a general prerequisite for EU accession. Healthy macroeconomic policies will become ever more important in the years to come, as the CEECs will gradually remove the existing restrictions on capital movements. Tackling the existing structural problems in fiscal policy will be instrumental in assuring and further reinforcing the sustainability of the consolidation achieved so far. Reducing inflation to low single-digit levels and keeping it there will also be a major challenge in the advanced CEECs. The creation of the euro has already affected the exchange rate regimes of the countries in Central and Eastern Europe. The CEECs are following a wide variety of monetary and exchange-rate strategies, ranging from free floating to currency boards, and involving, more recently, inflation targeting policies. In the countries with some form of exchange rate targeting, which is the vast majority of CEECs, the start of monetary union has prompted both technical adjustments and, in some cases, also changes of substance. At the technical level, the euro has replaced the Deutsche Mark (and, in some cases, also other European currencies) as the anchor or reference currency. In terms of substance, some countries took the opportunity at the start of EMU to increase the weight of the European component at the expense of the U.S. dollar in their reference basket. Furthermore, it can be expected that, over time, CEECs will increase their use of the euro both in transactions and as a reserve asset. Finally, in a long-run perspective, all the countries that seek to join the European Union will have to organize their transition from the present exchange rate regime to full participation in monetary union. This will be a major challenge. Experience tells us that – even though exchange rate policy is a common concern - the exchange rate must be adapted to the economic conditions of each specific country and to its authorities' policy commitments. As the example of South-East Asia and other emerging markets has again demonstrated, a premature adoption of an overly rigid fixed exchange rate regime by transition countries is fraught with risks. Therefore, the countries of Central and Eastern Europe will have to adopt a gradual, step-by-step policy of approaching the definitive commitment EMU requires. Thus, as regards a possible ERM II membership of selected Eastern European countries, one has to keep in mind that the ERM II has been set up as a sort of "training ground" for EU member countries not yet ready to adopt a single currency. With its rather wide fluctuation margins of ±15%, it will not cause very tight constraint. However, this system forms part of the institutional architecture of the European Union and as such is intended for and consequently restricted to EU members. After all, it also entails, inter alia, intervention commitments on the side of the European Central Bank. Once the most advanced CEECs have joined the European Union, participation in the ERM II will be a relevant option for them until their economies will be ready to join the monetary union on a sustainable basis. The built-in flexibility of the ERM II could be very helpful. It allows for a gradual reduction in the fluctuation margins. In the meantime, many of the rules of EMU, like the prohibition of government financing by the central bank, the independence of central banks from any political interference or the clear stability-oriented mandate of the central bank, can serve as benchmarks for the CEEC countries. I am well aware that considerable progress has already been made on this path in several countries but some work still remains to be done. EMU can work as a catalyst in this respect, speeding up the necessary political decisions within CEECs and helping the respective central banks. A crucial point on the path towards EU and EMU-membership is the development of a "*stability culture*", i.e. the wide-ranging consensus within a country that the principal and most important task of monetary policy is to ensure price stability - a necessary condition for sustainable growth and hence for the catching-up process. This primacy of stability has to be recognized and accepted by all relevant political forces, which in turn calls for the respective central banks to do a lot of explaining and convincing - a process that has to start as early as possible. Without such a consensus, a successful integration into the Union, and even more so into the euro area, cannot or at least is very difficult to be achieved. Therefore, this "convergence of minds" is just as important as the other formal convergence criteria. Thus, membership in the euro area will be a rather long-term perspective for the transition countries as the successful and sustainable adoption of a single currency will require more preparation than the fulfillment of the well-known (nominal) convergence criteria. It will be in the interest of the accession countries themselves to join monetary union well prepared.

Ladies and gentlemen, let me summarize by extracting three key messages:

First, EMU took off very well. Both on the European and national levels, the relevant authorities and the private sector did their homework in the preparatory work. The Eurosystem and its monetary policy are well on track. The euro area's important role in the world economy is reflected in the recognition shown by various international fora. Rules for sound national fiscal policies are in place. Nevertheless there are important challenges: Governments need to reinforce their consolidation efforts to create the leeway necessary to counteract future shocks and recessions. The unacceptably high European unemployment rates need to be reduced sharply by clear-cut labor market reforms and responsible wage developments, which take into account productivity developments and international competitiveness. The dialogue between the Eurosystem and other policy makers needs to be intensified, while recognizing each others' exclusive responsibilities. In this respect, we are just at the beginning of a learning process. I am confident that, over time, informal fora, which have worked well elsewhere, will also evolve at the European level. Central and Eastern European governments and central banks will face a highly complex set of economic policy co-ordination mechanisms when entering the Union and, at a later stage, the euro area. They will need to gradually build up the institutional knowledge to move efficiently in this environment.

The second key message is that EMU is a major regime shift for European financial markets and a challenge for banks. The recent wave of mergers, strategic alliances and cooperation agreements among banks and stock exchanges is testimony to the fact that institutions are taking up the challenge. However, I believe it is fair to say that we have by far not reached the end of this important restructuring process, much more is yet to come. Eastern European banking systems will be faced with very strong and experienced competitors upon entry into the Union.

The third message is that EMU increases the European Union's political and economic potential. Thus, entering the EU becomes ever more attractive. However, this also means that the benchmark for becoming fully integrated into all aspects of the Union – including participation in the euro area – has shifted one important step higher. Catching up by the candidate countries to the point where participation in EMU is mutually beneficial for them and for the euro area is a formidable task and can only be achieved over the longer term. As the EU's process towards EMU itself has shown, such a task can only be achieved step-by-step, bit-by-bit, through persistent work and effort. To conclude, let me illustrate this with a little anecdote: In the late 1980s, when the idea of EMU was taking shape, European Commission officials were sent to special time management training courses dealing with the issue of "How to eat an elephant." The simple strategy presented there was: piece by piece. Apparently, this strategy worked out for EMU; I have no doubt it can work as well for Central and Eastern European countries' accession to the EU and their eventual participation in the euro area.