Klaus Liebscher: The prerequisites and key challenges for participation in the euro area

Luncheon speech by Dr Klaus Liebscher, Governor of the Austrian National Bank, at a conference of the Austrian National Bank and the Joint Vienna Institute, held in Vienna, on 7 November 2000.

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Ladies and Gentlemen!

I am glad to have this opportunity to personally thank you for your participation and all speakers for their active involvement in this year's East-West Conference, which centers on topics that are crucial for the future economic development in the transition countries and, ultimately, for the people living in these countries. It is a pleasure for us to continue the tradition of offering our annual East-West Conferences as a platform and a meeting place for the debate on issues relevant to transition countries in order to help better answers to the challenges ahead to be developed.

Since the very inception of transformation, the Oesterreichische Nationalbank has had the unique opportunity to be an active partner for central banks in transition countries. At the same time, the Oesterreichische Nationalbank has been actively participating in another historic project, the realization of the European Economic and Monetary Union (EMU) and the introduction of the euro. The establishment of the euro as the single currency in 11 sovereign countries of the European Union at the beginning of 1999 was certainly not a purely economic move, but rather another very important political step in the process of European integration that began more than half a century ago.

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The creation of EMU can certainly be considered a success. Soon after transformation had begun, a common agreement was reached between the Member States of the European Union in the Treaty of Maastricht to build EMU. In the second half of the nineties, this decision markedly shaped economic and financial developments in the European Union, as it led to an impressive process of disinflation, to nominal and real convergence within the EU as well as to a process of consolidation of public finances.

Right from the start of Stage Three of EMU, a unified, deep and liquid euro area-wide money market was successfully established, and the area-wide market has displayed considerably less volatility than the 11 individual money markets before. Moreover, the euro has received widespread acceptance in the bond markets. To give but two figures, 30% of the outstanding volume of international debt securities were denominated in euro at the end of June 2000, and the euro-denominated issuance volume was roughly comparable to that in USD in the first quarter of 2000. Both sovereign and corporate borrowers are making use of the favorable financing conditions created by the introduction of the euro.

The EC Treaty established a clear institutional framework for the euro area's monetary policy. The President and the Vice President of the ECB plus the other four members of the ECB Executive Board and the Governors of the national central banks of the 11 countries participating in the euro area form the Governing Council of the ECB, which is responsible for monetary policy decisions. The Treaty enshrines the maintenance of price stability as the primary objective of monetary policy.

The Governing Council of the ECB has decided that price stability should be defined as a year-on-year increase in the Harmonized Index of Consumer Prices (HICP) for the euro area of below 2%, and that this objective has to be achieved over the medium term. If the Eurosystem's track record is measured against this clearly defined target, it can be stated that the objective of price stability has been reached, and I am convinced that it will be attained in the future, as well. With consumer prices in the euro area increasing by just 1.1% in 1999, inflation has come down to one of the lowest levels in the past 50 years.

During the course of this year, inflation increased to 2.2% year-on-year in the period January to September and to 2.8% year-on-year in the month of September, owing mainly to external factors. It is obvious that influences by the price development of raw materials, in particular oil, and by exchange rate developments cannot be remedied by monetary policy alone or even in the short term - and that is precisely one of the main reasons why our definition of price-stability relates to the medium term. Moreover, as it is imperative to contain upward pressure on prices in the medium term, the Governing Council of the ECB has gradually raised the interest rate on the main refinancing operations by a total of 2.25 percentage points to 4.75% since November 1999. These measures aim at avoiding second-round effects on wage-bargaining and price-setting at the national level and at fostering confidence in the maintenance of price stability over the medium term.

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The euro area is one large, relatively closed currency area which has replaced eleven smaller open currency areas, and the euro is one of the key currencies of the world. This explains why the Eurosystem has no exchange rate target. However, the development of the external value of the euro is taken into account in the Eurosystem's monetary policy strategy, which is based on two pillars. The first pillar consists in the analysis of the monetary developments, with an announced reference value for the growth of M3. The second pillar comprises the analysis of other economic and financial indicators which may signal inflationary risks, and the exchange rate is precisely one of these indicators.

In particular, in so far as the strengthening of the USD against the euro has contributed to the recent acceleration of inflation in the euro area, it is certainly a reason for concern which has to be addressed adequately. Looking at the main underlying causes, the high rate of domestically based real growth in the United States seems to have been one of the main underlying factors of that strength. However, it is also important to bear in mind the historic dimension of the euro area as a common European project, and the adequate approach to evaluating the exchange rate of the euro against the USD is certainly a long-term one.

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How can we turn the current expansion in the euro area into a prolonged period of non-inflationary growth? There is no doubt that this is a challenge for both society as a whole and policymakers. What it takes is people who are prepared to act as entrepreneurs and are willing to take risks. What it takes are policymakers who set incentives and push for continuous economic reform and adjustment. Existing regulations have to be checked continuously in terms of their adequacy, and adaptations have to be introduced as timely as possible, while paying due attention to social needs. In particular, it is important that the current economic expansion should be used to enhance the fiscal consolidation.

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How does this experience translate to countries in transition? What is the relevance of this experience for them ?

Obviously, there is a consistent need of economic reform in all societies. While those reforms which can be characterized as transition-specific will sooner or later come to an end, "completing transition" - the theme of this conference - should not be mistaken as "completing reforms", as reforms will never be complete and the need for further adjustments will always arise again.

Constant reform efforts are the key to achieve a path of sustainable high real growth. Maintaining a faster pace of average real growth than in the European Union is a minimum condition for keeping the catching-up process going in the transition economies. We all need and benefit from this catching-up process, both in Europe as a whole and on a global level, as we cannot afford the persistence or even widening of the existing gaps between poor and rich countries. Moreover, a balanced and consistent policy-mix will be of crucial importance also for the transition countries in their catching-up and integration efforts. In that respect, I am glad that this conference provides an excellent opportunity to review the policy challenges the transition economies face in the most important fields of economic policy.

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Let me briefly touch these fields, which range from microeconomic reforms over macroeconomic policies to integration policies.

Firstly, structural reforms are the key to long-term success. Existing productive capacities have to be reshaped, and new ones have to be built, above all in the service sector. In particular, financial services, which were practically non-existent when transition started a decade ago, have to be strengthened further. Developing structures and institutions of financial intermediation is the prerequisite for ensuring the high level of productive real investment necessary for high real GDP growth. More broadly, structural convergence is a conditio sine qua non for successful transition and it is an indispensable basis for sustainable macroeconomic stability.

Secondly, in the field of macroeconomic policies, I would like to underline the importance of formulating and implementing stability-oriented, sustainable and consistent fiscal and monetary policies. To keep the accession process manageable even now that the Union is negotiating with a comparatively large number of countries, it will be essential to key the pace of negotiations as objectively as possible to the further progress of the candidate countries toward fulfilling the conditions for EU membership.

This involves two aspects: first, the speed of enlargement must not compromise its quality, and second, differences between the countries in the two former groups of candidates must be taken into consideration if there is a factual reason to do so. An overly ambitious approach which is not adequately underpinned by developments in the real economy may lead to losses in credibility or even turn out to be counterproductive to stability and to the long-term catching-up process. From my point of view, it is clear that adequately designed stability-oriented policies facilitate structural change. In that way, prudent efforts towards stabilization and structural change can reinforce each other and will foster the catching-up process.

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Turning to monetary policy, I am convinced that a sound stance and conduct can best be achieved if the central bank is fully independent. Central bank independence - ie institutional, personal and financial independence - is a basic building block any country that intends to join the European Union has to put in place. Moreover, I am sure that price stability should be regarded as the primary objective of monetary policy in transition countries, as well. However, in most transition countries that objective can only be defined in concrete terms by taking into account the specific characteristics of the transition process and, in particular, the fact that structural convergence is a longer-term process as well. While steering a clear course towards disinflation, a cautious approach to monetary policy, especially in setting explicit targets, is called for.

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The Central and Eastern European countries which are involved in accession negotiations with the European Union are confronted with the basic question of how Economic and Monetary Union features in the overall context of enlargement. As far as we can judge today, we see the economic and monetary policy integration of the candidate countries proceeding in three steps. In a first step, the candidates will accede to the European Union, then they will participate in the ERM II, the exchange rate mechanism of the Union, and finally, they will introduce the euro as their national currency.

Let me make very clear that fulfillment of the Maastricht convergence criteria is ***not*** a prerequisite for membership in the European Union. Still, a reasonable degree of macroeconomic prudence is essential in the run-up to EU accession, as stability-oriented policies facilitate structural change and foster the catching-up process in Central and Eastern Europe.

In this context, it is important to underline that there are no institutional constraints on exchange rate policies during the preaccession period. Any exchange rate regime is feasible during this stage, provided that it contributes to and is embedded in an overall set of policies that is sound and effectively geared toward stability. What really matters is not the exchange rate regime as such, but the consistency and soundness of the policy mix as a whole. Experience shows that stability-oriented policies underpinned by wide-ranging structural reforms contribute substantially to limiting exchange rate variability.

Not only institutional and legal aspects as well as the principle of equal treatment, but also economic considerations strongly suggest the step-by-step procedure I have sketched out. Adopting the euro too early could place severe strains on such countries' economies, and perhaps even trigger substantial and lasting disturbances. Such a course of action would be in the interest neither of the current euro area members, nor of future members of the euro area.

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A number of Central and Eastern European transition countries have already achieved a high degree of trade and financial integration with the European Union and have reached quite close convergence with these countries. As a next step, this economic integration has to be deepened and complemented by institutional integration. Finally, the efforts of these countries to become members of the European Union will further enhance their integration into the world economy.

Personally, I am convinced that both the economic preparations during the preaccession period as well as the accession itself will boost structural reforms and developments, thus reinforcing the dynamic structural adjustments that we have witnessed as a consequence of transformation in general and trade liberalization under the Europe agreements (ie the EU association agreements) in particular. Companies seem to have started already to take into account the perspective of EU enlargement for their investment decisions. Moreover, the adoption of the acquis communautaire and the process of institution-building for an effective implementation of this acquis will harmonize and improve the institutional and legal setup in these countries.

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Before concluding, let me come back to an important issue I already touched briefly - central bank independence. What does the European Union mean by "central bank independence"? Basically, it is independence from other authorities, in particular political authorities, in the conduct of monetary policy and, more broadly, in the performance of all the tasks that are related to the ESCB, the European System of Central Banks, in which the central banks of all EU Member States participate. Central bank independence is essential for the credibility of the European System of Central Banks and for the effective conduct of a stability-oriented monetary policy. Independence has three main dimensions - the institutional, the personal and the financial dimension.

- ***Institutional independence*** primarily means that central banks are prohibited from seeking or taking instructions from Community institutions or bodies, from any government of a Member State or from any other body. Likewise, rights of third parties to approve, suspend, annul or defer central bank decisions on ESCB-related tasks are incompatible with the EU Treaty. The same is true of any rights to censor such decisions on legal grounds.

- ***Personal independence*** is about ensuring tenure for members of the ESCB's decision-making bodies by minimum terms of office and giving protection against arbitrary dismissal. To make this latter aspect more concrete, a central bank governor may be relieved from office only if he or she no longer fulfills the conditions required for the performance of his or her duties or if he or she has been guilty of serious misconduct, with the possibility of appeal to the European Court of Justice.
- ***Financial independence***, in essence, denotes that central banks have to be in a position to avail themselves of the appropriate means to ensure that they can properly fulfill their ESCB-related tasks.

Those applicant countries which engaged in accession talks with the European Union in 1998 already dealt, in detail, with the issue of central bank independence during the membership negotiations last fall, when the chapter "Economic and Monetary Union" was on the agenda. Progress in the candidate countries on this issue is being monitored very closely by the European Union at large and by the European System of Central Banks in particular.

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Let me draw the conclusion that the key challenge facing the applicant countries in the next few years, consists in strengthening their market economies and their competitiveness by firmly pushing ahead with structural reform and by subsequently adopting the Community acquis in the process. Only on this basis will the EU candidate countries from Central and Eastern Europe be able to attain durable and sustainable macroeconomic stability, and only by taking these steps will they ultimately be able to fulfill, in a lasting manner, the prerequisites for participation in the euro area.

Thank you very much for your attention.