Klaus Liebscher: Monetary integration and EU enlargement

Speech by Dr Klaus Liebscher, Governor of the Austrian National Bank, at the Vienna International Summer University, Vienna, 26 July 2002.

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Ladies and Gentlemen,

It was with great pleasure that I accepted the invitation to participate in the Vienna International Summer University 2002, and I would like to congratulate the organizers on the well-chosen topic.

One of my colleagues from an Eastern European country once remarked that delivering speeches was an easy task for central bankers. They could always stick to three items: First, inflation is too high. Second, interest rates are too low. Third, if anything goes wrong, blame the minister of finance.

Well, although I might be tempted to concentrate on these issues, I would like to focus my speech on two broader issues, namely on the principles which are essential for the Third Stage of Economic and Monetary Union (EMU) and on how we can pass on our experience to countries in transition and, above all, to countries which have applied for EU membership.

Since January 1st of this year, more than 300 million European citizens have been using the same new euro banknotes and coins for their daily transactions. The high speed of the changeover and the enthusiastic reception of the new currency units in all 12 euro area countries has been remarkable. It represents a big leap forward in the process of European integration, which now finds a visible expression in the daily life of its citizens. Every coin and every banknote bear the map of Europe. The citizens literally carry Europe in their hands.

The idea of a common currency based on sound economic policies is proving attractive beyond the borders of the euro area. I am not only referring to the Central and Eastern European accession countries, which show a keen desire to participate in the "success story" of the euro, but especially to the three EU countries that have not yet adopted the common currency - Great Britain, Denmark and Sweden. I am convinced that they will not want to be on the sidelines for long. According to opinion polls, popular support for the euro has increased significantly in these countries after the physical introduction of the currency.

However, it is important to stress that the euro was not created overnight, but rather in a demanding process of convergence that took many years to complete. The first ideas for a European monetary union came up in the late 1960s. However, the terms and conditions for such a challenging project were not yet mature - neither in political nor in economic terms. Thus, only in the late 1980s new progress was made that led to the Treaty of Maastricht more than 10 years ago (on February 7, 1992). The exact timetable and the name for the new currency were determined by the heads of state at the end of 1995. Finally, the euro was introduced to financial markets in 1999, and three years later at the retail level as a physical currency.

As a result of these decisions, and in order to get in shape for the proposed monetary union, the member countries embarked on a remarkable process of economic convergence. Fiscal policy was tightened, inflation declined to low single digits, and the legal systems were brought in line.

The creation of EMU was a careful process that built on international best practices, and on a large body of economic research. It was of utmost importance to ensure the trust of the markets in as large and diverse a geographical area as the euro area.

Thus, in order to foster the market´s trust in "monetary stability," the Eurosystem was built around the principle of price stability. Its framework was laid down in international treaties and enjoys constitutional status in all member countries.

Of its many features, I would like to stress the following five principles, which I consider essential for the success of EMU:

1) Independence of the central bank

First of all, the Treaty of Maastricht has endowed the European System of Central Banks (ESCB) with a very high degree of political independence. This came as a recognition of the empirical evidence that good inflation performance around the world is linked to central bank independence. While the economic profession had started to subscribe to this view a long time ago, the issue was more contentious at the political level. The European monetary union comprises countries with very different macroeconomic policy traditions. In some countries, the objective of price stability was subordinate to other economic goals, and often the financing needs of the state dominated monetary policy. This was not the case in a second group of countries, where price stability ranked high in the eyes of the public, and legal systems set barriers to fiscal incursions into the central bank. The last decade saw a remarkable convergence around this second, stability-oriented approach, which is fully reflected in the design of the ESCB.

The Governing Council of the ECB is the central decision-making body of the independent Eurosystem. It brings together the 6 members of the Executive Board of the ECB and the 12 governors of the national central banks currently participating in monetary union. The Governing Council normally takes decisions with a simple majority according to the principle "one member, one vote." In other words, all the members of the Governing Council are on an equal footing irrespective of the size of their country, which reflects a key principle of the Maastricht Treaty.

Decentralization is at the root of the Eurosystem, i.e. strategic decisions are taken in the Governing Council. They are then implemented decentrally by the central banks of the Eurosystem. The OeNB thus remains a national institution which, however, also fulfills tasks at the European level.

2) Clear Priority: Price Stability

According to the Treaty of Maastricht, the Eurosystem´s primary objective is to maintain price stability and, by that, the purchasing power of more than 300 million people. The Treaty leaves no doubt about this priority, even as it retains operational flexibility in the choice of the instruments of monetary control. The emphasis on price stability is important, since it reduces uncertainty and sends a clear signal to the markets.

Our two-pillar monetary policy strategy allows us - and compels us - to follow closely and systematically a wide range of monetary, economic and financial indicators which point to possible risks of future inflation. After more than three years of EMU we can observe that the Governing Council of the ECB has to date performed very well in safeguarding price stability. In addition to the elimination of exchange rate fluctuations among the former currencies of the euro area, price stability has been the main contribution of EMU to sustained long-run growth, employment creation and better standards of living.

3) Fiscal Discipline

In order to ensure stability, the institutional framework of EMU extends beyond monetary policy. A key ingredient is the Stability and Growth Pact, which intends to promote sound fiscal policies at the level of individual member countries. Fiscal discipline plays a crucial role in keeping pressure off monetary policy. As a last resort, unsustainable debt burdens would always be monetized. Economic history has shown time and again that monetary policy cannot be truly independent if fiscal policy is not sound.

True price stability can only be ensured if budgets are broadly balanced over the medium term. This policy will reduce the ratio of public debt to GDP over time and keep real interest rates low. It encourages the "crowding in" of private investment and frees resources for the most productive sectors that are the engines of economic growth.

Finally, the progressive ageing of the population will result in a considerable burden on future budgets. Intense strain on Europe´s pension systems will start to be felt in this decade still. On this matter, time is not on our side, and the possible size of the problem calls for precautionary actions already today. Fiscal prudence is thus not an end in itself, but also an investment into the well-being of the current working population and of our children.

It is important to note that all euro area countries must honor the commitments made to achieve budgets close to balance or in surplus by 2003/2004. Fiscal targets have to embody sufficiently ambitious structural consolidation efforts and have to be based on realistic growth assumptions. Any weakening of the elements of the Stability and Growth Pact would raise concerns about the credibility of EMU and could erode the confidence in the stability-oriented policy framework of the euro area.

4) Structural Policies

Structural reform is the third pillar of success for Europe's monetary union, especially in the longer term. Structural reform is needed both for its indirect effects on monetary policy via the budget, and for the direct impact it has on the competitiveness of the euro area.

Competitiveness includes increasing the flexibility of the labor market, creating a more efficient tax system that encourages job creation, and reducing the overall tax burden on the economy. The process of coordinating structural reform in member countries, which was started by the European Council of Lisbon and continued by the Council of Barcelona this March, must be strengthened and deepened. The European Single Market needs to be completed and extended to public utilities by opening them up to international competition.

The introduction of the euro has increased transparency for consumers who can now easily compare prices across countries. Thus, monetary union is contributing to the pressure for accelerating structural reform. People are beginning to wonder why large price differentials still exist, and markets will find ways to erode them. However, where price differentials are the result of regulatory impediments to trade, people will start to question the regulations and press for change. The introduction of the euro will give new impetus to eliminating obstacles to the Single Market. Structural reform - and European integration in general - may become more of a "bottom-up" process that is driven by the citizens of Europe, as opposed to the "top-down" process it has been so far and which is driven by experts and politicians.

5) Public involvement

This leads me to the fifth and last pillar of success for monetary union, the high degree of public awareness. The deliberate transparency of EMU institutions fosters close involvement of the citizens. The Treaty of Maastricht has imposed extensive reporting requirements on the ECB and on member countries in order to ensure transparency and accountability. The ECB itself goes to great lenghts to keep the public at large well informed. Monetary policy decisions are explained in press conferences at least once month. A large collection of economic data is provided to the interested public in the "Monthly Bulletin" and in corresponding publications of national central banks. The ECB reports in regular hearings to the European Parliament. Finally, it is integrated closely into the decision-making structures of the EU, as the president of the ECB is a member of the Ecofin Council, and the Ecofin president participates in the meetings of the Governing Council of the ECB. In sum, the ECB is probably one of the most transparent central banks worldwide.

Both the policy of deliberate transparency and the broad popular support for European integration have helped making the physical introduction of the new currency remarkably smooth. The public was well-prepared for the euro changeover and has greeted the new banknotes and coins with more enthusiasm than anyone anticipated.

Beyond EMU - Further Political Integration and Enlargement

EMU represents a milestone in European integration, a key step in completing the Single European Market. Of course, competition is most pronounced within EMU itself. Monetary union guarantees that the Single Market can utilize the full potential of its economic power on the basis of a stable common currency and that the growing pressure of international competition on Europe is buffered.

The deepening of the European Union which accompanies EMU and the euro is therefore not simply the most suitable response to internationalization and globalization, but also a bulwark against any maneuvers to reverse liberalization in Europe. Deepening European integration is crucial especially for small open economies, no matter whether they are already Member States like Austria or accession countries.

By introducing the euro, European economic policymakers have assumed the responsibility for both exploiting the opportunities and addressing the challenges this move represents for the EU and for Europe as a whole.

The single currency holds out the promise of fostering European integration in areas far beyond monetary union. Of course, this chance also implies that there are many questions about how far political and institutional integration is to progress. The events of the next few years may well provide us with the answers to these questions.

What is certain, however, is that EMU is a harbinger of political union within Europe - as history shows, national territories and currency areas are, as a rule, identical. For this reason it is fundamentally important that national interests be overcome in favor of a single European policy and that the Member States step up their cooperation on a common foreign and security policy as well as an internal security policy.

I therefore welcome the EU's special constitutional convention. The assembled politicians and officials have the task of proposing a concept for the EU which will match our continental dimension and the requirements of the 21st century. I acknowledge that this convention is a bold experiment in consultative democracy.

However, we need to define what kind of institutional arrangements will be prerequisite to meet our aspirations, what kind of society and what kind of economy we want to build. I also do not think that the real question is about federalism versus national sovereignty. The EU is federal already. It divides power between different levels of authority.

The questions now are about the most effective and legitimate way to divide that power, so that national sovereignty is preserved within an integrated system. If these questions can be resolved, Europe will earn the voice it seeks on the world stage.

This, however, does not mean that we have to give up our national identities. Their roots go very deep, and it is absolutely in the European Union's best interest to preserve specific national and regional cultural traits. "Unity through diversity" is certainly an advantage Europe has compared to other regions and economic areas.

I am therefore confident that - if we succeed in tapping the creative and problem-solving potential of Europe's diversity to work on reaching common goals - Europe and its countries face a bright future.

Ladies and Gentlemen,

After having EMU implemented successfully, the current major challenge which Europe faces is certainly the enlargement of European Union. This integration project is just as impressive and far-sighted as EMU, and it also holds out enormous opportunities - as well as challenges that must not be underestimated.

The process of integration has given Western Europe a period of political and economic stability not known before in its history. I am therefore deeply convinced that the enlargement of the Union will be to the advantage of all countries on the continent, especially Austria, and will be regarded as a great step in the history of Europe in the years to come.

Accession negotiations began in 1998 and are now being conducted with a total of 12 candidate countries. The progress of the talks is encouraging, and many applicant countries have made striking efforts to get their economies in shape for membership in the EU.

With regards to the monetary aspects of integration, at present a three-step procedure is envisaged:

In a first step, the country becomes a new member of the European Union and adopts the body of community law. This includes laws that guarantee the independence of the central bank and prohibit monetary financing of government deficits. Also, international capital flows have to be fully liberalized. Upon accession, the new member countries will join EMU with the status of "countries with a derogation" and their central banks will become part of the European System of Central Banks (ESCB). A second step is the participation in the so-called Exchange Rate Mechanism II, ERM II for short. This implies maintaining a stable exchange rate within a band of +/-15 percent vis-à-vis the euro. Successful participation in the ERM II band for at least two years is required before the country can introduce the euro. The mechanism serves as a trial period to determine how well the economy copes with the loss of exchange rate flexibility and monetary independence. The third and last step before the integration of the central bank into the Eurosystem is a strict and sustained adherence to the Maastricht criteria for economic convergence, especially price stability, sound fiscal policies and low long-term interest rates.

The European Commission and the ECB are monitoring progress closely. The criteria will be applied equally and fairly to all candidate countries, and there will be no discrimination between old and new members of monetary union. Convergence criteria serve as an instrument to ensure sustainable and stability-oriented policies in the long run. Speed must not come at the expense of quality in this process, in the interest of both the candidate countries and the present members of EMU.

Independently of the process of EU enlargement, the euro has become a currency of reference for many countries in the region and beyond. Almost all candidate countries already use the euro in one way or another as their monetary anchor. At present, the accession countries are following a variety of exchange rate strategies, covering the full spectrum from currency boards to free floats. Their monetary strategies differ widely, too, as they use inflation targets, exchange rate targets and targets for monetary aggregates. Even countries that are not among the group of membership candidates have adopted a close monetary arrangement with the euro. In some cases, the euro has replaced an existing peg to the Deutsche mark or the French franc, as for instance in the countries of the Western and Central African Monetary Union. In other cases, especially in the Balkans, the euro has been unilaterally adopted as legal tender. Overall, the euro has become the monetary anchor for about 50 countries all around the world.

Ladies and Gentlemen!

Having outlined this general institutional framework, let me now turn to some more specific issues and challenges that accession countries face on their way to euro.

Although a lot has been achieved, accession countries will still need to further advance the process of bringing down inflation rates, while not delaying the much needed relative price adjustments within the economy. Such price adjustments are part of the transition process and of structural real convergence and will typically entail inflation rates that may, for some time, range above those prevailing in the euro area. Hence, accession countries are well advised to properly sequence the disinflation path toward the Maastricht criteria and in some cases delayed entry into the euro area could be an optimal policy choice.

The objectives of nominal and real convergence should be pursued in parallel. Progress in nominal and real convergence will imply an orderly closing of the gap between the accession countries and the euro area economy, both in terms of per capita income and price levels. In order to reinforce each other, nominal and real convergence paths must be properly sequenced and mutually balanced. A fast-track move toward full nominal convergence and, in particular, toward complete monetary convergence could prove counterproductive in the pre-accession period.

An important element of structural real convergence is further development of financial services structures, which were practically non-existent when transition started a decade ago. The main tasks are bank privatization, the development of a sound credit culture and the transformation of banks into efficient and competitive financial intermediaries. The three pillars of a functioning banking system are high-quality corporate governance of banks, market discipline in accordance with best-practice standards and efficient banking supervision. Especially in transition economies, it makes sense to locate banking supervision with the central banks, at least for the time being, as central banks have the necessary funds to perform this task, have established their reputations and are already concerned with systemic risk issues.

The strict implementation of EU Treaty obligations, in particular those concerning the independent status of central banks, will be of fundamental importance. Institutional, personal and financial independence are constitutive elements of central bank independence which are not an end in themselves but are instrumental in attaining functional independence. All the accession countries have either revised their central bank acts in the past few years or are amending them so as to meet the EU requirements. So far, progress has been considerable. In addition to the revision of the respective central bank statutes, it is also important to ensure that the revised laws are indeed fully implemented and that central bank independence is not only ensured formally but also respected in the day-to-day conduct of policy. The process of adjusting the central bank statutes has not been smooth in all cases. More recently, the parliaments in Hungary and Poland have discussed or introduced amendments to their respective central bank statutes that could de facto limit the degree of central bank independence. The passage of amendments that, in substance, weaken central banks in their pursuit of price stability would cause serious concerns in the accession process. Moreover, great importance should be attached to responsibility, accountability and transparency as a counterpart of independence. To sum up: The accession countries have made remarkable progress over the past few years in macroeconomic stabilization. The prospect of EU accession and - thereafter - adoption of the euro has already served as an anchor for all policy areas concerned. Nevertheless a crucial point on the path toward EU and EMU membership is the development of a "stability culture," i.e. reaching a broad 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 accpted 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 be achieved or will be very difficult, to say the least. Therefore, this "convergence of minds" is just as important as the other formal convergence criteria.

Finally, I would like to mention that future membership of accession countries' central banks in the ESCB and the Eurosystem requires not only a strengthening of central banking policies, but also significant technical preparation, for instance, of payment and securities settlement systems, in the field of statistics, and IT.

Ladies and Gentlemen!

Let me stress that I welcome the conclusions of the Seville European Council meeting which renewed the commitment of the European Union as well as of the individual Member States to the enlargement process. The institutional reform work within the European Union is approaching a stage which makes the Union ready for enlargement. I am pleased to hear that Denmark, now holding the EU presidency, has the firm intention to continue this process and to tackle some of the core issues during the second half of 2002.

My own institution, the Osterreichische Nationalbank has been an active partner for central banks in transition countries since the very start of transition. Initially, our contribution to institutional development consisted in technical assistance. Gradually, this has evolved into technical cooperation and finally into working relationships. By now, these relationships have become integrated in joint efforts of the whole European System of Central Banks. Being a member of this system, my bank has complemented its bilateral relations by actively promoting a dialogue between the Eurosystem and the central banks of the accession countries. In addition, I would like to point out that those of you who are interested in getting more information about all these issues may consult the most recent editions of the "Focus on Austria" as well as the "Focus on Transition" of the Oesterreichische Nationalbank, whose general theme ties in with the topic of this year's Vienna International Summer University. Both publications provide a number of interesting and high-quality papers related different aspects of EU enlargement.

Conclusion

In concluding, I would like to reiterate that EMU and the euro are in many respects Europe's strategic response to global competition and the associated challenges it poses. EMU underpins Europe's role in the world and strengthens the position of our economy in the face of growing international competition.

EMU triggered not only monetary convergence, but also the real convergence of our economies. Structural reforms geared toward efficient and flexible product, capital and labor markets, as well as sounder fiscal policies have made our economies more shock-resilient and will ultimately increase our non-inflationary growth potential.

This positive and stabilizing influence is not only felt within the euro area, but also in the countries that have close ties to the euro area, such as the countries currently conducting accession negotiations with the EU. Thus, with the euro as a stable anchor, EMU creates a zone of stability that is even larger than the euro area itself. In this way, the euro is a catalyst for the future political and economic integration of Europe.

Thank you for your attention!