Klaus Liebscher: The euro area and the challenges of enlargement

Speech by Dr Klaus Liebscher, Governor of the Austrian National Bank, at the European Lawyer Conference "Advising Clients in an Expanded Europe", Vienna, 29 April 2004.

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Ladies and Gentlemen,

It is a pleasure for me to be with you today. My contribution will focus on two milestones of European integration: the enlargement of the European Union (EU) and the establishment of a monetary union within the EU. As Austria's central bank, the Oesterreichische Nationalbank, has largely contributed to both forms of integration, I am pleased to share with you some of my views.

Over the last half century, Europe has followed an impressive path of voluntary integration of nations. In parallel to the successive deepening of Economic integration, the European Union has been gradually enlarged. At present, we are at the threshold of a further historic enlargement stage. On Saturday, ten countries - five Central European and three Baltic countries as well as two Mediterranean islands - will join the European Union, expanding the EU's population by 20%.

This enlargement round is not only the most important one to date in terms of scale, diversity and economic growth potential, but also - as Commissioner Verheugen once put it - the best prepared in the history of the European Union. I would like to state very clearly that we highly welcome the acceding countries' joining the European Union. After the fall of the "iron curtain" 15 years ago, the Central and Eastern European countries have undergone an impressive and successful, if often painful, process of transformation and we see their joining our Union as a well-deserved step of historic dimensions.

The forthcoming enlargement of the European Union comes at a moment when the euro area sees increasing signs of a gradual recovery in economic activity. While growth has been relatively modest so far, both external and domestic factors give reason to expect a strengthening of the recovery through 2004 and beyond. On the external side, all recent indications confirm that global economic growth in 2004 will be robust and broadly based across different regions of the world. On the domestic side, the conditions for a recovery in private demand are in place and there have been signs over recent months of a pick-up in investment. The positive growth outlook is supported by a favourable outlook for price stability in the euro area. While over the short term, inflation may show some volatility reflecting temporary factors, inflation rates are expected to remain in line with the Eurosystem's definition of price stability of below[, but close to] 2% over the medium term. Neither wage developments nor inflation expectations are to date considered a major risk to this assessment.

Economic and trade integration in Europe has proven a fruitful co-operation for all involved parties. The current EU member states experienced deepened trade integration, a speeding up of the convergence process of income levels, and better access to a broader knowledge pool. Intensified peer pressure increased incentives to stick to sound macroeconomic policies and to implement overdue structural reforms. All these factors contributed to a stable and favourable economic environment, even though many challenges still remain to be tackled.

Now, on the eve of EU enlargement, it is time to look ahead. I am convinced that all involved parties are going to benefit from this further integration in Europe. The new Member States will certainly gain most from their new status, but also the current EU Member States, especially those with strong trade links towards the enlargement area as for example Austria, will also experience positive effects. While there may be initial adjustment costs in some sensitive areas these costs should be of a temporary nature and will be outweighed by far by the positive long-term effects, related to trade creation, increased competition and intensified foreign direct investment flows. Actually, in this respect one does not even have to look to the future; a considerable part of the expected benefits has become reality even today. The European agreements eliminated trade barriers already in the second half of the 1990s, causing imports from Central and Eastern European countries to the EU to double in the first five years. Supported by intensified trade, the stabilization of expectations and the decrease in interest rates, the acceding countries experienced a GDP growth rate of 3.6% in 2003, well above the euro area average.

Since January 1, 1999, when eleven EU member states entered the third stage of Economic and Monetary Union (EMU) by adopting the common currency, the euro has gained international importance. Further to its role in trade and financial markets, where it has been well received, the euro has asserted itself as an important official reserve currency and as an anchor in exchange rate regimes in many non-euro area countries.

Increased price transparency, lower interest rates and transaction costs, and the import of stability and credibility are only some of the manifold benefits of the euro. I would, however, like to stress one specific aspect of monetary integration that proved most relevant for the success of EMU in Europe: Through the irrevocable fixing of exchange rates countries are no longer exposed to harmful intra-European exchange rate tensions and are also better protected from negative external shocks. Indeed, major global developments in recent years, like the bursting of the equity bubble, the repercussions of the terrorist attacks and the substantial depreciation of the U.S. dollar might otherwise have led to phases of instability within the European economy. Yet EMU provided a stable framework for weathering these turbulences.

Upon entering the European Union, the ten new member states also become members of the Economic and Monetary Union. While they will not yet take part in EMU to the full extent, as they cannot adopt the euro immediately, they are already required to observe a number of obligations embodied in the stability architecture of EMU: They generally have to bring into line their economic and monetary policies with the overall goals of EMU. Their central banks will be represented in the General Council of the ECB, which supports the ECB in its advisory and coordinating functions. The new member states will participate in the coordination of economic and monetary policies and in the multilateral fiscal surveillance. Moreover, they shall treat exchange rate policies as a matter of common interest, as the functioning of the single market must not be weakened by real exchange rate misalignments or excessive nominal exchange rate fluctuations.

From the point of view of a country that already enjoys the benefits of the common currency, it is essential that the next step of European integration, the adoption of the euro in the acceding countries, is as well prepared as all past integration steps. I am convinced that each of the new EU Member States is a good potential candidate for the single monetary policy as defined by the economic theory on optimal currency areas: They can all be characterized as open economies with strong economic linkages with the euro area, a steadily increasing degree of business cycle synchronization with the euro area and a high level of flexibility to adjust to new economic circumstances.

While in general most of the advantages of monetary integration will increase with the scale of the euro area, it is crucial that countries are sufficiently prepared for this intensified integration before they adopt the euro. The Treaty with its convergence criteria provides the appropriate framework to assess whether a country shows a record of stability-oriented monetary and fiscal policy and therefore can be regarded as ready for monetary integration. Let me at this point recall some of the convergence criteria to evaluate where the group of new EU Member States stands at the moment.

A key convergence criterion is a high degree of price stability. A low level of inflation is a precondition for the provision of a favorable growth environment. The group of new EU Member States has shown an impressive record of disinflation with inflation in some cases dropping from more than 20% in the mid-1990s to levels consistent with price stability in recent months. While we certainly welcome this disinflation trend it should be born in mind that it is related to the current central policy focus on inflation reduction as well as to past appreciations of the currencies and that is hardly sustainable to the full extent for the near future. The continuing income convergence process as well as the deregulation of administered prices will put inflation back onto the list of national policy challenges.

Another criterion requires the sustainability of the government financial position as expressed by the deficit and debt ratios to GDP. Only a stability-oriented fiscal policy allows the countries of a monetary union to fully profit from one of the major benefits of monetary integration: a low level of risk premia and therefore interest rates. Fiscal discipline will be one of the major challenges for the coming years as many acceding countries recently experienced difficulties in sticking to previously announced deficit targets. Let me at this stage emphasize the commitment of the Eurosystem to the achievement of sound budgetary positions. Recent developments in some euro area countries give reason for concern and underline the importance of using the expected upward phase of the cycle to eliminate imbalances over the coming years. All countries would benefit from the strengthening of the sustainability of their public finances.

The exchange rate criterion requires formal participation in the Exchange Rate Mechanism (ERM) for at least two years with no devaluations and without severe tensions. ERM II is designed to provide for flexibility and adjustability as well as for enough stability to help anchor expectations. In this view, participation in ERM II should contribute to real and nominal convergence. To ensure a smooth participation in ERM II it is essential that major policy adjustments are undertaken prior to participation in the mechanism and that a credible fiscal consolidation path is being followed. Exchange rate policies within ERM II have to be in line with the general policy framework: with monetary, fiscal and structural policies.

Overall I'd like to emphasize the importance of considering the time period between EU enlargement and the adoption of the euro in the new EU Member States as an essential test period to assess the stability of their policies and their readiness for this next integration step. The speed of further monetary integration must not compromise its quality. Consequently, there will also be no uniform appropriate strategy concerning participation in the exchange rate mechanism and the adoption of the euro due to differences in the economic situation, the history and background of exchange rate and monetary policies.

Decisions have to be taken in accordance with the legal foundations on a case-by-case basis, and, simultaneously, equal treatment between new and current EU Member States must be ensured throughout the whole process. The acceding countries are in the midst of an integration and catching-up process, and their equilibrium exchange rates will be subject to gradual changes and shocks over time. Therefore, any premature euro area participation has to be avoided. An enlargement of the monetary union by well prepared countries will be a benefit for all member states and will continue the success story of European integration.

Ladies and Gentlemen,

From my point of view, it is vital for the new member countries to keep attaining strong but sustainable real economic growth that permits their income-per-capita levels to gradually approach the average income level in the present EU member countries. Therefore, economic policies of the new member countries and any further steps in monetary integration should be oriented towards achieving sustainable real and nominal convergence, as both convergence processes are complementary to each other and should be pursued in parallel.

Let me conclude with expressing my conviction that the enlargement of the European Union and the economic and monetary integration of the acceding countries will not only strengthen the role of the European Union as a global player in the long term, but also make a sustainable contribution to stability, peace and welfare in Europe. Therefore, I am looking forward to this new era that lies in front of us, characterized by a larger number of Member States and, in terms of ideas, by an even larger potential of human beings.