Klaus Liebscher: Austria after 10 years of EU membership - a review from a central banking perspective

Speech by Dr Klaus Liebscher, Governor of the Austrian National Bank, at the Bulgarian National Bank, Sofia, 1 April 2005.

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Ladies and Gentlemen!

I greatly appreciate being invited to Sofia by Governor Iskrov. He and I have already had a fruitful exchange of views about Bulgaria's future membership in the European Union, the macroeconomic consequences of this step and its implications for the Bulgarian National Bank. It is now a great honor for me to address such a distinguished audience here today.

To begin, let me sketch the historical background leading up to this 10-year period.

Europe has changed dramatically over the last decades. Today's Europe is no longer characterized by "hot or cold" conflicts, but by peaceful coexistence and the mutual respect of nations. The EU has played a major role in this historic success.

Appeasement policies starting immediately after World War II in Western Europe resulted in the establishment of the European Coal and Steel Community in 1951 and in the foundation of the European Economic Community (EEC) in 1958. Since then, several enlargements of the European Community(EC), then the European Union (EU) and the establishment of the Single Market and Economic and Monetary Union (EMU) have been milestones in the European integration process. The latest – but not last – enlargement of the EU by 10 new member states in May 2004 has brought the definite end to the division of Europe into "East" and "West." Bulgaria's and Romania's EU accession treaties are scheduled to be signed on April 25 – in less than a month – and we hope to see Bulgaria and Romania join the EU by January 2007.

Austria recognized the benefits of active participation in European integration early on. In 1960, the country was among the founding members of the European Free Trade Association (EFTA). Then, in July 1989, Austria applied for EU membership. In 1994, Austria joined the European Economic Area (EEA) and finally, in 1995, it became a member of the EU. In the field of monetary integration, Austria belonged to the founding members of the euro area in 1999. Each of these events required substantial adjustments and modifications, all of which we were able to manage remarkably well.

The integration steps Austria took were based on the profound conviction among Austrian policymakers that Austria should be part of an integrated Europe, a Europe founded on fundamental values such as the respect for human rights and human dignity, freedom, democracy, equality, pluralism, tolerance and the rule of law.

I believe that the Austrian public always felt the same. The referendum on joining the EU in 1994 was backed by a very solid two-thirds majority. However, there have been periods of EU scepticism as well. The root causes for such scepticism are manifold. Sometimes they are vague and difficult to grasp, sometimes they are specific.

There is no ready-made solution to counteract bouts of EU scepticism. However, I consider it of the utmost importance that policymakers and opinion leaders do not tire of addressing the issues which are at the heart of such criticism and scepticism.

The entry into the EU and the participation in monetary union have visibly shaped the Austrian economy. The changeover to EU law and the intense cooperation and communication with EU institutions, together with the process of gradually getting used to the rules of the new and stiffer competition of a single market, have triggered extensive reforms, which have been in the genuine interest of Austria.

Accession to the EU generated considerable net welfare effects; that is, the cost of offsetting measures was more than compensated by welfare gains. Solid economic growth, a sound labor market, stable prices, moderate unit labor costs and high price competitiveness, the consolidation of public finances, growing attractiveness for foreign investors, the traditional monetary stability, and social peace have significantly increased Austria's international competitiveness. The growing integration of different economic areas and the increasing mobility of the production factor capital have shifted the focus of the economic debate on questions of competitiveness and advantages of business locations. Austria's attractiveness as a business location has substantially benefited from participation in the single market and in monetary union.

Let me cite an example: Before Austria joined the EU, competition policy was not one of the most sophisticated areas of the Austrian judicial and economic system, as deeply vested interests led to market segmentation and little competition in certain sectors, such as the food processing industry and utilities. EU membership was a deliberate decision of policymakers to facilitate structural changes that led among other things to greater efficiency, increased competitiveness and lower price increases in Austria.

The average (CPI) inflation rate fell from approximately 2.8% in the decade before EU membership to some 1.7% thereafter.[1] According to one economic study, EU membership has lowered inflation rates by some 0.3% to 0.5% and at the same time increased real GDP growth by some 0.3% to 0.8 % per annum in Austria, Finland and Sweden.[2]

A comparison by the Oesterreichische Nationalbank of Austria, Finland and Sweden, all of which have been EU Member States since 1995, and non-member Switzerland, concludes that productivity increases in Austria, Finland and Sweden have been nearly three times as high than those in Switzerland since 1995.[3]

Over the past decades, Austria has thus become a leading small, open economy in Europe. This positive economic performance is mirrored by GDP per capita figures, where Austria ranks third in the EU, right behind Luxembourg and Denmark. At 4.5%, the unemployment rate is the third-lowest in the EU.[4] Youth and long-term unemployment is also kept at comparatively low levels. The employment rate of 15- to 64-year olds, measured in terms of full employment, is one of the highest in Europe. Another often cited positive feature of the Austrian economy is the cooperative social climate, which has been fostered by the system of "social partnership." The dialogue between the social partners has facilitated the favorable development of unit labor costs, which, together with Germany's, have been the slowest-rising unit labor costs in the EU over the last decade. Thus, Austria augmented its share of EU exports to 3.4% by 2003 from 2.9% in 1995.

But Austria has benefited not only from EU membership and the Single Market, but also from the fall of the Iron Curtain in 1989 and from the transition and integration process in Central and Eastern Europe, including – as I always do when I refer to this region – Southeastern Europe. Foreign direct investment (FDI) in the region and bilateral trade intensified very significantly. In the case of Austria, bilateral trade with Central and Eastern Europe[5v] has tripled since 1993 in real terms. The respective data for Bulgaria and Austria reflect these developments: Austria's exports to Bulgaria more than tripled and imports from Bulgaria even quadrupled in real terms since 1993. In addition, Austrian investors are among the most important foreign direct investors in Bulgaria.

For instance, two of Austria's big financial players in the region, Bank Austria and Raiffeisen International, are active in Bulgaria through their subsidiaries ("HVB Bank Biochim" and "Hebrosbank" respectively "Raiffeisenbank (Bulgaria)").

Indeed, one particular success story is the Austrian financial sector, which seized the opportunity to enter the financial sector in Central and Eastern Europe by means of greenfield investments and by participating in the privatization processes. By entering these markets soon after they opened up, Austrian banks widened their home base, diversified their business portfolio and strengthened their profitability. The Financial System Stability Assessment (FSAP) finalized by the IMF last year confirms the robustness of Austria's banking system, not least due to the successful move into Central and Eastern Europe.

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1 Austria's (HICP) inflation rate has been consistently below the euro area rate.

2 Breuss, F. (2003), "Österreich, Finnland und Schweden in der EU – Wirtschaftliche Auswirkungen," WIFO-Monatsberichte7. Inflation: AT -0.32%; SF -0.32%; SW -0.52%. Real GDP growth: AT: +0.42%; SF +0.83%; SW +0,30%.

3 Pointner, W. (2005), "Drei Beitritte und ein Einzelfall" forthcoming in Geldpolitik & Wirtschaft 2/2005, OeNB.

4 At 4.5%, in January 2005 and on average in the year 2004, the unemployment in Austria is the third-lowest of the EU.

5 CEEC-10 (i.e. without CIS).

At the beginning of the transition period, the financial sectors in the transition economies were characterized by a low degree of financial intermediation, inefficiencies and instability. The strategic move of Austrian banks to Central and Eastern Europe not only benefited these banks, but contributed substantially to a stabilization of the banking systems in Central and Eastern Europe, accelerated the penetration of these economies with financial services and thereby contributed to the very positive development of this area.

Having mentioned some positive effects for Austria, one has to concede that big changes rarely only create winners. Even though Austria had been a highly developed country with strong trade links in Europe, our entry in the Single Market entailed adjustment costs and significant changes for some. A powerful process of structural consolidation manifested itself, among other things, in a temporarily very high number of insolvencies. This became visible to some extent even at an aggregated level, foremost in our current account balance, which deteriorated temporarily from close to balance to a deficit of some 2% of GDP from 1994 to 1996. Notwithstanding this development, on balance, the decision to join the EU was without a doubt beneficial for Austria as a whole, not only in the medium and long run, but even in the short run.

To what extent can our experience be relevant to Central and Eastern Europe?

Basically, European integration was conceived as a project aimed at ensuring peace, stability and prosperity in Europe. This aim is not restricted to Western Europe only. The most recent and forthcoming enlargement of the European Union should be seen as the realization of the EU's longer-term objective of providing a framework for political stability and economic progress throughout Europe.

But I am afraid that we have sometimes become very selective in our perception of Central and Eastern Europe. We tend to take note only of certain developments and give some well-meant advice. And sometimes I have the impression that we easily fail to appreciate the enormous progress that has already been made in most of the – let me say "former" – transition countries, especially in those which are most advanced in reforms and transformation. However, the latest enlargement of May 2004, as well as the forthcoming enlargement with Bulgaria and Romania, is the well-deserved confirmation of the impressive progress these countries have made. Let me congratulate you on these major achievements!

Having said this, there is a consistent need for economic reform in all societies. While the reforms which can be characterized as transition-specific sooner or later come to an end, other reforms will never be complete, and the need for further adjustments will always arise. Constant reform efforts are the key to achieving a path of sustainable high real growth. Maintaining a faster pace of average real growth than in the European Union is a minimum requirement for keeping the catching-up process going in Central and Eastern Europe. We all need and benefit from this catching-up process, both in Europe as a whole and at the global level, as we cannot afford to let the gap between rich and poor countries persist or become wider.

Notwithstanding the progress made so far, a balanced and consistent policy mix will be of crucial importance also for Central and Eastern Europe in its catching-up and integration efforts. Let me focus on two aspects of this policy mix:

First, 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 nonexistent when transition started some 15 years ago, have to be strengthened further. As you are well aware, the main tasks are bank privatization, making possible the entry of foreign banks, the development of a sound credit culture, the transformation of banks into efficient financial intermediaries and the privatization of corporates. Reforming economic structures and institutional arrangements will, in turn, often imply additional fiscal expenditures. Therefore, it is all the more important to push ahead with fiscal reform to ensure adequate room for maneuver for these additional outlays. Furthermore, this exemplifies the importance of a well-balanced policy mix, in particular a good balance between structural and fiscal policies.

Second, 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.

From a central banking perspective, Austria's EU membership did imply major changes de jure, which de facto, in the case of the Oesterreichische Nationalbank, were rather minor. In particular, the monetary policy strategy of the Oesterreichische Nationalbank had been price stability oriented ever since the country's dramatic experience with hyperinflation after World War I. Hence, joining the EU and being one of the founding members of the euro area changed very little in terms of the monetary policy orientation.

The Maastricht Treaty of 1991 set out the criteria for membership in the Economic and Monetary Union, clearly stipulated that EMU would have to start by 1999 at the latest and specified that EMU would be stability oriented, particularly in terms of low inflation and sound public finances. In 1994–95 not everybody believed that EMU actually would fly by 1999, but we at the Oesterreichische Nationalbank had already started to prepare for this historic event. And this was a wise and foresighted decision.

One of the most important issues we had to handle when we were preparing to join the EU concerned the entry of our currency, the Austrian schilling, into the old ERM. At the time, our exchange rate policy for about two decades had been to have a very narrow peg to the Deutsche mark, because Austria was a small, open economy whose most important trading partner was Germany and because the Deutsche Bundesbank pursued a price stability-oriented monetary policy strategy. Over time, this exchange rate strategy gained very high credibility inside and outside Austria, not least because the Austrian schilling was one of the very few currencies to weather the exchange rate turbulences of 1992 and 1993 which ultimately resulted in the ejection of the pound sterling and the Italian lira from the ERM and the widening of the ERM bands from ±2¼% to ±15%.

Austria decided to join the ERM on January 9, 1995, as soon as possible after entering the EU, without changing its narrow peg strategy against the Deutsche mark. The ERM countries gave us a warm welcome, not only because of our impressive exchange rate track record. Let me relate to you what made Austria's "hard" peg exchange rate strategy so successful and indeed is essential to make any viable fixed-peg exchange rate regime a success.

The underlying, interdependent factors are:

1. stable institutions;
2. a compelling economic policy strategy and policy mix, with straightforward, credible rules that are understood and observed by all players;
3. the firm understanding and the credibility that macroeconomic policy, in particular fiscal and wage policies, will be adjusted whenever necessary; and
4. sound economic fundamentals.

In general, I would caution a simple transfer of conclusions from one country's experience to any other country. However, I absolutely believe that these principles play a vital role in any fixed exchange rate regime, including currency boards, such as Bulgaria's arrangement.

In respect to monetary policy, I am also convinced that a sound stance and conduct can best be achieved if the central bank is fully independent. 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.

Functional independence is tantamount to having a clear primary objective, which has to be reflected in a country's central bank legislation. Moreover, great importance should be attached to responsibility, accountability and transparency as a counterpart of independence.

I am convinced that price stability should be regarded as the primary objective of monetary policy in transition countries, too. Actually, all EU member countries are obliged by the Treaty to pursue price stability as a target, even though there is no legal requirement for a national central bank outside the euro area to pursue price stability as its primary target. However, before adoption of the euro, changes in respect to price stability as the primary objective are required as part of the legal convergence, which will be examined in the convergence reports by the Commission and the ECB.

Progress in bringing inflation down can be accomplished through a variety of monetary and exchange rate frameworks that can be classified into three groups: 1) euro-based currency boards (such as Bulgaria's arrangement); 2) pegs or managed floating with the euro as the anchor currency; and 3) free floating.

Having said this, an overly ambitious monetary 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. In my view, it is clear that adequately designed stability-oriented policies facilitate structural change. They support the mutual reinforcement of prudent efforts toward stabilization and structural change, which will foster the catching-up process.

As you know, the monetary integration of Bulgaria and other accession countries is scheduled to proceed in three stages:

- in stage 1, they join the EU;
- in the second stage, the new Member States participate in ERM II for at least two years without severe tensions; and
- in the third stage, after the sustainable fulfillment of all the convergence criteria, the new Member States adopt the euro.

Actually, the institutional monetary integration process already starts somewhat before a country joins the EU: Following the signing of the Accession Treaty, the Governors of the acceding country central banks attend the meetings of the General Council of the ECB as observers, and the acceding countries' central bank experts have observer status in the committees of the ESCB whenever these meet in ESCB composition.

This principle already applied to Austria in 1994 – at a time at which the EMI, the forerunner of the ECB, existed, and it will apply to Bulgaria from April 25, 2005. National central banks outside the euro area in the ESCB framework as well as in inside the euro area in the Eurosystem have vital tasks in the preparation and implementation of the decisions taken by the decision-making bodies of the ESCB and of the Eurosystem.

Upon joining the EU, i.e. in the first stage of the integration process, Bulgaria will participate in Economic and Monetary Union with the status of a "country with a derogation." This means that Bulgaria cannot join the euro area immediately, but that it has already committed to joining the euro area at a later stage.

In the second stage of monetary integration, participation in ERM II does not require the fulfillment of formal criteria. However, successful participation in ERM II requires that major policy adjustments are undertaken before joining the mechanism. It also requires utmost vigilance in keeping the economy on a sound performance path after joining the ERM II. Three of the 10 new Member States – Estonia, Lithuania and Slovenia– have joined ERM II in the meantime. They are participating with standard fluctuation bands of ±15%. Nevertheless, Estonia and Lithuania have kept their currency boards as a unilateral commitment.

The Governing Council of the ECB has been stressing for some time that countries that operate a euro-based currency board deemed to be sustainable might not be required to go through a double regime shift, i.e. floating the currency within ERM II only to repeg it to the euro at a later stage. We have been pointing out as well that any currency board regime will be assessed on a case-by-case basis and that a common accord on the central parity against the euro will have to be reached.

The Maastricht criteria will be applied to future euro area entrants just as they were applied to euro area countries: Not more, but certainly not less stringently. It may take a while before new Member States are in a position to fully participate in EMU.

A fair share of realism is called for to avoid disappointment. In the long run, such an equitable and strict procedure will be to the advantage of all Member States of the EU.

My own institution, the Oesterreichische Nationalbank, has been an active partner for central banks in Central, Eastern and Southeastern Europe 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 the 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. At another, multilateral level, the Oesterreichische Nationalbank, the Austrian Ministry of Finance and the IMF are the Primary members of the Joint Vienna Institute (JVI). Since 1992, Bulgarian participation in courses and seminars offered at the JVI has been high and very active.

Of course, the Oesterreichische Nationalbank would be pleased to consider any further requests for technical cooperation by the respective Bulgarian authorities, for instance in the form of tailor-made study visits and consultations.

After touching on the implications of our experience for the monetary integration of the new Member States, I would like to return to my original topic, Austria after 10 years of EU membership. Here one event clearly stands out: the introduction of the euro in 1999. The introduction of the single currency was a major success for Austria, the euro area and from a global perspective. Let me mention just a few aspects of this success:

The integration of money and capital markets in the euro area has lowered cross-border barriers, has increased the depth and breadth of financial markets and has thereby boosted their efficiency. Market integration has also led to the convergence of long-term interest rates toward the rates of the best performers. All this and in particular the single currency have improved the resilience against financial market crises, such as heightened exchange rate and interest rate volatility, which had beset us all too often before 1999.

Turning to monetary policy, the independence of the Eurosystem and its primary objective of maintaining price stability over the medium term have become a global standard. Price stability unambiguously represents a precondition for sustainable economic growth and rising employment in the medium run. Not only has the euro helped to lower inflation rates in Member States, but the euro area itself has become a stable monetary anchor in the global economy.

The aim of the Eurosystem to maintain inflation rates close to but below 2% over the medium term is widely accepted. With inflation averaging 2% since the start of EMU, we have by and large achieved this goal, despite quadrupling oil prices and a difficult macroeconomic environment. On top of this, monetary policy with historically low interest rates has taken on its share of the burden in supporting economic activity and employment.

The public and the markets can trust that the Governing Council remains firmly committed to deliver on its mandate of maintaining price stability.

With respect to fiscal policy, the EU Treaty and the Stability and Growth Pact oblige euro area member states to achieve budgetary positions close to balance or in surplus, in order to provide a safety margin to the 3 % deficit limit. However, the fiscal track record of the euro area is mixed. In the early years of EMU, the Stability and Growth Pact led to an end of ever-rising debt ratios. Since then, fiscal discipline has regrettably deteriorated in some Member States, which cannot be explained by weak economic growth alone.

The Governing Council of the ECB is seriously concerned about the recent changes to the Stability and Growth Pact. We must prevent changes in the corrective arm from undermining confidence in the fiscal framework of the European Union and the sustainability of public finances in the euro area Member States.

Sound fiscal policies and a monetary policy geared to price stability are fundamental for the success of Economic and Monetary Union. They are prerequisites for macroeconomic stability, growth and cohesion in the euro area. It is imperative that Member States, the European Commission and the Council of the European Union implement the revised framework in a rigorous and consistent manner conducive to prudent fiscal policies. More than ever, in the present circumstances, it is essential that all parties concerned fulfill their respective responsibilities.

Fiscal policy must be part of a comprehensive and growth-oriented strategy, focusing – as a rule – on restraining the volume and on improving the structure of public expenditures. Excessive deficits for a protracted period of time – like those we are witnessing in some euro area member states – obviously do not promote economic growth but rather depress the confidence of investors, entrepreneurs and consumers. On the other hand, the top performing countries in the euro area in terms of recent budget balances, all have been proving that sound fiscal policies and productive economic structures actually contribute to positive economic developments.

I sincerely hope that the new Member States and accession countries do not draw misguided conclusions from the latest adaptations to the Stability and Growth Pact. It is of utmost importance to recognize that potentially lax fiscal policies in the new and future EU Member States carry the high risk of triggering detrimental convergence expectations, which would bring about significant “divergence costs” in financial markets and economic performance.

This brings me to an – at least as formidable – challenge, which relates to the low potential growth in the euro area. In 2000, the European Council adopted the Lisbon Agenda with the bold aim of making the EU the most dynamic economic area by 2010. Even though there have been structural reforms and successes in several areas und some countries, economic growth has remained disappointing. Due to long time lags, it is possible that the beneficial effects of some already implemented reforms are still to kick in. However, it is obvious that the progress of most Member States has been insufficient.

To make the EU more dynamic, the implementation of structural reforms has to be stepped up and many partially implemented reforms have to be fully put into practice, in order to provide the framework in which competitive enterprises and qualified human capital can prosper and create wealth. Such reforms should be aimed at increasing labor utilization as well as boosting labor productivity, for instance by increasing flexibility, improving education and technological diffusion as well as promoting innovation.

Indeed, recent challenges from the new Member States, e.g. in terms of attracting foreign direct investment, have raised the urgency for Western Europe to adapt its structures in order to boost competitiveness. These spillover effects are welcome eventually, as they accelerate structural change, which promotes economic growth. At the end of the day, only dynamic economies can sustain modernized, but still generous social systems in Europe.

The integration process in Europe will mutually strengthen the EU and its current and future Member States. Bulgaria and the other countries from Central and Eastern Europe certainly stand to gain most from the related catching-up and convergence process. But the EU-15 Member States, especially those with strong trade links to this area, for example Austria, will experience positive effects as well.

While there may be adjustment costs in some sensitive areas, not only for the EU-15 but also for the new EU Member States, these costs should be of a temporary nature and will be outweighed by far by the positive effects related to intensified foreign direct investment flows, trade creation and increased competition. Actually, we do not have to rely on vague projections anymore: a considerable part of the once expected benefits has already become a reality. Supported by intensified trade, the stabilization of expectations and the decrease in interest rates, Bulgaria and the new EU Member States are experiencing an impressive catching-up process, with economic growth rates significantly above those of the euro area.

In concluding, Austria joined the EU more than a decade ago. Naturally, our honeymoon did not last for the entire decade. However, it is fair to say that Austria's first 10 years in the EU have been an impressive success, certainly for us, and I believe for the EU as well. The economic data give us an unambiguous verdict.

Having said this, the EU is not only about markets, trade, profits and losses. The EU is much more than that: The EU is the most important and successful peace project Europe has ever seen. Visionaries like Winston Churchill, Robert Schuman and Jean Monnet were needed to outline how to overcome deeply vested, ingrained divisions within Europe.

Today, the EU not only comprises countries from the western part of Europe, but also free and democratic countries from Central and Eastern Europe. Bulgaria is at the threshold of joining the EU. Some 15 years ago, such a development appeared highly unrealistic. Again, visionaries as well as the will of the people were needed to translate this project into reality.

This success reminds us not to lose sight of our long-term goals and visions despite short-term distractions and the concerns of our daily work. No matter whether they relate to a peaceful world, a prosperous and dynamic Europe, or the establishment of vibrant cultural ties across the European regions and peoples.

Thank you very much for your attention!