Ewald Nowotny: The future of European integration – some economic perspectives

Opening remarks by Prof Dr Ewald Nowotny, Governor of the Central Bank of the Republic of Austria, at the 39th OeNB (Austrian National Bank) Annual Economic Conference on "The Future of European Integration: Some Economic Perspectives", Vienna, 23 May 2011.

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Ladies and gentlemen,

I am very pleased to welcome you to the 39th Economics Conference of the Oesterreichische Nationalbank here in Vienna.

I am proud that we have once again managed to prepare a ***highly interesting program*** featuring distinguished speakers and discussants from different backgrounds in academia, policy-making and policy-commentating who have in common a vital interest in economic issues. I should like to thank all of them in advance for coming to Vienna and for contributing to this year's Economics Conference. I would also like to take the opportunity to thank the staff members of the OeNB for their great efforts in organizing this event.

My particular welcome goes to Federal Minister ***Rudolf Hundstorfer***, who will address the participants of this year's conference as our first speaker. I am very honored to welcome ***Olli Rehn***, Commissioner for Economic and Monetary Affairs of the European Commission, who will join us today. I am also very grateful that ***Lorenzo Bini Smaghi***, Member of the Executive Board of the European Central Bank, has found the time to be with us today. Lorenzo Bini Smaghi is not only a dear colleague of mine on the Governing Council of the European Central Bank, he has also been one of the most eloquent commentators on the future of the European project over the last few months. Thank you very much for joining us today.

Finally, I would like to add that I am very glad to see such a densely packed audience here today. This confirms that this year's conference topic – "The Future of European Integration" – strikes a chord with many people from different walks of life. As you all know, a conference of this size is not arranged within a couple of days. In fact, the ***lags of transmission*** between a decision and its visibility, which are well known from monetary policy*making*, are also present in organizing a monetary policy *conference*. Sometimes a topic that appears to be timely and urgent in the planning phase of a conference has lost some of its appeal by the time the event actually takes place. This year, however, it was almost the exact opposite. When we first thought about a possible topic for the 2011 Economics Conference last fall, we did not expect – and could not have expected – how significant and intensively debated this very topic would be in May. The debt crises and institutional reforms we have observed over the recent months have moved the topic of the future path of integration to the top of both the European and the international agenda. I am therefore looking very much forward to our discussions, which promise to be lively and – hopefully – also fruitful.

Ladies and gentlemen,

From its beginning, ***Europe*** has been characterized ***by alternating periods of integration and disintegration***. This, however, is not to say that every step toward more integration has to be followed by a step in the opposite direction. Historical progress does not follow such a simple pattern. In the sixty-six years since the end of ***World War II***, a model of European integration has developed which is – for the first time – neither based on strategic alliances nor on involuntary association. The connections between countries have become closer and closer over the years, even though this process has not been linear but has had its ups and downs, its "speed-ups and slow-downs" so to say. Every setback, however, was typically followed by a further leap forward. If the picture of circular movements is at all accurate, one should think of European integration not as a wavelike process but rather as a spiral stair where each cycle is accompanied by an upward movement.

In recognizing this pattern, I do not wish to diminish the challenges we are facing today. Nor do I wish to suggest that it will be easy to find the right answers to these challenges. We have heard many different assessments of the causes and underlying mechanisms of the current situation and equally many proposals, suggestions and solution strategies. Politicians, economists and commentators are in disagreement on many of the issues currently at stake. It is rather telling that this disparity of positions is also reflected in the public opinion and in noneconomic newspaper articles. Two well-known German-speaking authors, for example, recently expressed their views on the European project – and they have come to almost diametrically opposed conclusions. While one of them talks about the "Gentle Monster Brussels," the other praises the qualification and dedication of its bureaucracy.

In light of the already existing multitude of opinions, let me offer just some brief observations on our current situation and on a possible way forward. Let me start by saying that I see a "***double heterogeneity***" as one of the main causes of our present constellation: a heterogeneity of national economic developments and a heterogeneity of supranational institutions. Let me begin with the latter – the ***heterogeneity of institutions***. On the one hand, a majority of EU countries have handed over the responsibility for monetary policy to an independent supranational institution: the European Central Bank. On the other hand, there is economic policy, which still is – in large part – the responsibility of the individual Member States. This set-up follows from the subsidiarity principle, which aims to respect and support local policy decisions wherever they are reasonable. We have had to realize, however, that it is often not easy to specify the optimal level of policymaking. The lack of more centralized economic governance is especially noticeable when the second heterogeneity – the one between countries – becomes visible, as has been the case in the recent past.

Cross-country heterogeneity is, in the first place, a structural phenomenon. Individual countries have reached different stages in their economic development; they are specialized in different areas of economic production; they are characterized by different sets of institutions and they have different preferences regarding the reach of the market and role of the welfare state. While these structural differences reflect national histories, national institutions and national preferences, they are nonetheless not a strictly national affair. They are not, because the idiosyncratic situation in one Member State can easily spill over to other countries and to the EU as a whole. A fiscal crisis typically only breaks out at the end of a longer process of unhealthy and unsustainable development, although budgetary distress is sometimes – but not always – visible earlier on.

Cross-country differences are nowadays clearly reflected in almost any macroeconomic and financial time series, starting from interest rate spreads to economic forecasts. In fact, the signals coming from the ***most recent forecasts for the European Union*** are quite positive and the first quarter of 2011 has shown improvements that were larger than expected. The outlook for the global economy has also improved, and this synchronicity might lead to further positive reinforcement effects for the European economy. One cannot exclude the possibility of a slowdown in recovery, but I think that the risks of an L-shaped or a W-shaped development have decreased. The picture is particularly encouraging for Germany and for a number of smaller, export-oriented countries, while some peripheral countries are lagging behind, both in terms of GDP growth rates and of unemployment rates. Although this divergence is of course worrisome, we should not immobilize ourselves by focusing on the problematic cases alone. If we do, we might forget that *on average* the performance of the EU economy was good – both during and after the crisis. The flexible way in which many countries reacted to the unexpected events was certainly facilitated by the past progress of European integration, which was accompanied by structural progress and an intensification of trade. The remaining divergence in economic development, however, is in my view a clear mandate to further reduce the institutional heterogeneity of economic governance.

In order to shape the new institutional landscape in the best possible way, it is useful to look back for a moment and analyze the trends and conditions that made a crisis of this size possible. A correct account of the crisis period is not only important for economic historians. It is even more important for today's policymakers as it enables them to identify the main weaknesses and to tackle them in an adequate way. In many respects the chronology of the recent contraction has followed the prototypical ***sequence of events*** characteristic for severe financial crises. The main preconditions were a number of slowly emerging disequilibriums on the real side of the economy, accompanied by suboptimal behavior and regulation in the financial sector. These real factors include, for example, the global imbalances that led to the "paradox" financial flows from emerging to advanced economies. This caused a relative abundance of available funds in the advanced economies, which was further amplified by a rapidly growing financial industry and a period of rather low global interest rates. These elements, among others, contributed to an increase in household indebtedness and to low private savings rates. The financial sector, on the other hand, was eager to satisfy the demand for apparently safe assets by designing and selling exotic products. At the same time, one could observe a deterioration of lending standards, excessive leverage ratios and the extension of management contracts that favored short-term behavior and excessive risk-taking. In the financial crisis, all of these factors worked together to cause a massive fall in asset prices, a wave of fire sales and an almost complete breakdown of the interbank market. These turmoils in the financial market then led to a loss of confidence in the real sector and a plunge in production and trade. The shockwaves finally reached the fiscal sector and have led to a – sometimes huge – increase in deficits and in public debt. This was particularly true for countries which had recorded large imbalances before the crisis and which, in addition, had structural problems to struggle with. Often, these were problems that had been present for some time but had remained hidden in the periods of easy money, credit booms and increasing indebtedness.

This short and necessarily sketchy and incomplete account suggests that there have been ***weaknesses and failures in at least four areas of economic governance***: the governance of the financial sector, of national economic structures, cross-country balances and fiscal policies. We need reforms in all four of these areas. This is important to stress since the events of the recent months have put fiscal problems and the role of the government to the fore. It goes without saying that national and supranational bodies did not work in the most efficient way before and during the crisis and that it is necessary to improve their functioning. On the other hand, however, this is only one field that calls for reform efforts.

Ladies and gentlemen,

We have already seen some reform progress over recent months. I do not need to give you a detailed account of all the ***institutional adaptations and innovations*** which have been put into place recently or which are scheduled to be implemented in the near future. First, because most of you will have followed these events closely and second, because I am sure that we will hear much more about them in the course of this conference. I just want to mention some of the innovations that are related to all four areas that I identified before as the crucial targets of reform: the modification of the Stability and Growth Pact (to allow for a higher degree of automatism of – and a stricter adherence to – the rules); the Euro Plus Pact, which will improve the coordination of national economic policies and help identify macroeconomic imbalances; the set-up of new supervisory authorities for securities, banking and insurance; and the establishment of the European Systemic Risk Board and the European Stability Mechanism to monitor macrofinancial stability and manage future sovereign debt crises. At the same time we have also seen that some countries have tackled their own specific structural deficiencies to be better able to cope with the current crisis and with future economic shocks.

The biggest challenge for this new institutional architecture is to implement improvements in monitoring and coordination with respect to ***fiscal policy and macroeconomic imbalances***. In both fields we will have to find rules and regulations to help us decide when a country's budgetary or macroeconomic development looks sustainable and when it seems to be on the wrong track. But this task of identifying fiscal or macroeconomic imbalances is inherently difficult. In most cases it is not possible to draw a clear line between the states of insolvency and illiquidity or between a macroeconomic divergence that is just the consequence of a catching-up process and one that is the sign of an alarming disequilibrium process.

In this context, I see a ***number of guiding principles*** that could be useful in defining a new structure of European economic governance.

First, we tend to be particularly alerted if we see balances in the red, if we see minus signs, negative numbers and apparent deficits. As a consequence, most reform activities normally concentrate on the bad times and on deficit countries. But we should not forget that the fiscal crisis has become so severe because most countries did not manage to restructure and improve their budgets during the good times of rather high growth. As it is much easier to implement far-reaching reforms when the general economic outlook is positive, we should put much ***more emphasis on appropriate anticyclical policies during periods of upswing***.

Second, given the uncharted territory that we are currently exploring and the many uncertainties concerning the functioning and the effects of each institutional reform, it is probably wise to take a ***gradualist approach*** and to gradually add new elements to the already existing and functioning structures.

Third, apart from establishing a new institutional architecture, we also have to accomplish the more immediate task of reducing debt levels and securing the sustainability of public finances. Given the exceptional nature of the current crisis, it is necessary to think carefully about a reasonable and balanced reform package to be able to ***distribute the costs of the crisis*** in an equitable manner.

Ladies and gentlemen,

Coming to the end of my remarks, I would like to emphasize that we also need to ***improve – and maybe regain acceptance*** for – our unique and precious European project. I am confident that European integration will proceed despite the difficulties that we have faced over the past years. I look forward to having a day and a half with you to discuss the future of Europe from a multitude of perspectives. I hope you will find our Economics Conference a useful and an insightful event.