



OESTERREICHISCHE NATIONALBANK
EUROSYSTEM

Ewald Nowotny
Governor
Oesterreichische Nationalbank

Vienna, November 26, 2018

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Conference on European Economic Integration (CEEI) 2018

How to finance cohesion in Europe?

Opening remarks

Ladies and gentlemen,

Welcome to this year's Conference on European Economic Integration in Vienna. Let me particularly welcome several distinguished guests:

- Austria's Finance Minister Hartwig Löger
- Benoît Cœuré, Member of the Executive Board of the ECB
- My governor colleagues
 - o Anita Angelovska Bezhoska from Macedonia
 - o Mugur Isărescu from Romania and
 - o Dimitar Radev from Bulgaria
- Also, Anthanasios Orphanides, the former Governor of the Central Bank of Cyprus.

As every year, the CEEI is designed to advance our thinking about economic challenges in Europe, with a special focus on Central, Eastern and Southeastern Europe (CESEE). This year we put the spotlight on public and private funds that help EU Member States align their economic performance and thus stick

together. After all, cohesion and convergence form the cornerstone of European integration. The EU Treaty states in Article 3 that the EU (quote) “shall promote economic, social and territorial cohesion, and solidarity among Member States.” Already the Treaty’s Preamble refers to the resolution of the signatories (quote) “to achieve the strengthening and the convergence of their economies and to establish an economic and monetary union including (...) a single and stable currency.”¹

When we talk about monetary integration, convergence – which implies a narrowing of countries’ economic indicators – is not only an objective but also a condition. Here, the so-called Maastricht criteria immediately spring to mind. They first and foremost refer to inflation, interest rates and public deficits. These are nominal convergence criteria. But, when we have the theory of an optimal currency area in mind, real convergence is equally important. When it comes to catching up with per capita income levels, real convergence is de facto a political condition for cohesion. In terms of business cycle synchronization, real convergence reduces the probability of asymmetric economic shocks. In the event of such shocks, which would affect only some countries of a currency union, the central bank of that currency union would face a dilemma: its centralized monetary policy would not fit all members. But then another type of convergence – structural convergence – helps smooth the impact of idiosyncratic shocks. That is, flexible prices and costs as well as the mobility of labor and capital assume the role that exchange rates would play outside a currency union. There is a tradeoff between real and structural convergence: the more diverse the economic performance of regions in a currency area is, the more flexible their adjustment mechanism needs to be.²

The good news is that the business cycles of the euro area countries have become more similar.³ Also, structural reforms in crisis-ridden countries have

¹ https://www.ecb.europa.eu/ecb/legal/pdf/oj_c_2016_202_full_en_txt.pdf

² https://www.dnb.nl/binaries/serie2003-20_tcm46-147349.pdf

³ Campos, N., J. Fidrmuc and I. Korhonen. 2017. Business cycle synchronisation in a currency union: Taking stock of the evidence. Bank of Finland Discussion Paper 28/2017.

supposedly improved their adaptive capacity and resilience. The bad news is, however, that the gap in income levels has widened rather than narrowed due to the financial crisis. In CESEE, the catching-up process only paused during the crisis years and continued thereafter – albeit at a slower pace than before and benefitting people unevenly. Small wonder that populism has been on the rise and has become a source of disintegrative tendencies.

Hence there is a need to foster convergence and cohesion through public and private investment in vulnerable regions. Fortunately, we can look back on periods of successful catching-up: to quote the World Bank “the EU has become the modern world’s greatest ‘convergence machine’.”⁴ The EU’s regional or cohesion policies were instrumental to that development. It is, however, also true that these policies need an upgrading. For them to be more effective, the EU should target its funds more specifically to skills and innovation and disadvantaged regions – and seek synergies with private investment flows. At the same time, recipient countries should increase their absorption capacity. Finally, with a view to sustainable development, “blended” funding that combines credit, grants, expertise and advice is the way to go.

In the next two days, we will elaborate on these issues. Let me quickly run through the program: representing Austria’s EU Presidency with the motto “A Europe that protects,” Finance Minister Hartwig Löger is going to kick off the CEEI by giving his welcome address. Austria’s Presidency aims at “a stable and strong euro area,” and its economic policies focus “on the completion of banking union and the setting-up of a capital markets union.”⁵ Additionally, the Austrian Presidency targets fair and efficient taxation and hopes to reach a compromise on a digital tax by the end of the year.

After that, ECB Executive Board Member Benoît Cœuré will give a keynote lecture on our conference theme – financing economic and social cohesion. At

⁴ <https://www.worldbank.org/en/region/eca/publication/europe-growing-united>

⁵ BMF. 2018. Loeger chairs ECOFIN meeting for Austria for the first time. https://english.bmf.gv.at/carousel/Loeger_chairs_ECOFIN_first_time_.html.

this point, please allow me to say a few words about monetary policy. The Governing Council of the ECB has already announced its intention to end its asset purchase program, subject to the outlook for medium-term price stability. To my mind, the normalization of the Eurosystem's monetary policy, which also includes raising interest rates poses little risk to financial stability. Given a reasonably robust economic recovery, a well-communicated and predictable exit might even benefit the health of insurance companies, pension funds and banks by improving net interest margins. The alternative – market interest rates that stay very low for a long time – might even impair financial stability.

The subsequent central bank governors' panel will touch on the role that independent monetary policy plays in economic catching-up outside of the euro area. Two of the countries represented are in the middle of a vigorous boom that has been driven by domestic demand and helped by solid EU fund absorption. Interestingly, the two countries follow different exchange rate regimes, with the Romanian leu freely floating and the Bulgarian lev pegged to the euro. The Macedonian denar is effectively stabilized, with the euro serving as anchor. The country has just recovered from a recent recession caused by political instability. The panelists will probably also discuss the right timing of their countries' monetary and economic integration. I am looking forward to my colleagues' insights.

Session 1 will focus on cohesion within and between countries in the euro area. It will also refer to the significant progress that has been made so far in deepening EMU and improving the resilience of the euro area economy. Of course, there is enough room for improvement in terms of both risk sharing and risk reduction: This applies to the fiscal backstop for the Single Resolution Fund that has already been agreed on and is provided by the reinforced European Stability Mechanism and to a European Deposit Insurance System that is still under negotiation. Further progress toward a rudimentary fiscal union would be provided by the Commission's proposals for a Reform Support Program that would cover the short-term costs of domestic structural reforms, and a European Investment Stabilization Function that would help maintain

investment levels in the event of large asymmetric shocks.⁶ Apart from that, the Eurogroup is debating other options for a euro area budget, including a European unemployment insurance fund for cases of severe economic crises.⁷ Reaching an agreement on all of these institutional innovations requires a minimum of mutual trust. Compliance with existing rules is certainly an essential ingredient for building confidence.

Session 2 will review the actual and potential role of the EU budget in fostering cohesion. The European Commission has presented its proposal for the next Multiannual Financial Framework, trying to match ambitions with resources. The plan would include a rule of law mechanism to ensure sound financial management as well as more investment in research, migration, border control and defense, partly financed through reallocation and also through an increase of the EU's own resources.

The dinner speech will be held by Frank Elderson of De Nederlandsche Bank. Frank is also the chair of the newly founded Central Banks and Supervisors Network for Greening the Financial System, in which the Oesterreichische Nationalbank also participates. This network raises awareness not only of the financial risks posed by climate change and related policies, but also of the huge opportunities that the transition toward a low-carbon economy offers to finance and the economy.

Tomorrow morning, Professor Jeffrey Sachs from Columbia University will give a video-streamed keynote lecture on 'Strengthening economic convergence in Europe.' He is one of the most influential living economists, who is well known for his advisory role in the transition of Poland and Russia toward market economies, and more recently for his efforts to promote sustainable development and climate change policies.

⁶ http://europa.eu/rapid/press-release_MEMO-18-3621_en.htm

⁷ <http://www.consilium.europa.eu/en/press/press-releases/2018/06/22/remarks-by-m-centeno-following-the-eurogroup-meeting-of-21-june-2018/>

Session 3 will revolve around ‘Industrial policy and investment.’ We certainly do not advocate the old-style industrial policy of ‘picking the winner’ and distorting competition. New industrial policy does not rely on market restrictions – it fosters skills, innovation and (digital) infrastructure instead, as for instance the European Commission strategy for a smart, innovative and sustainable industry does. In practice, these strategies center on soft measures such as cluster policies, investment promotion or green growth. This session will also discuss the size of the investment gap in CESEE and how to close it.

This leads us to Session 4, which will focus on how to improve host countries’ investment environment. Structural reforms come to mind here, yet already 60 years ago, Fritz Machlup, a disciple of the Austrian School of Economics, stated that “Structure, I am afraid, is often a weasel word used to avoid commitment to a definite and clear thought.”⁸ To avoid that trap, we need more precise policy prescription relevant in CESEE countries, including transparency, coherent regulation, and capital market deepening.

Finally, our business panel on ‘Corporate investment across EU borders’ brings together representatives of companies with diverse experience in outgoing foreign direct investment. They will reveal their motivation, difficulties and strategies.

Ladies and gentlemen,

2018 marks at least two important anniversaries worth mentioning at this conference. First, 100 years ago, several successor states of the Habsburg empire were founded in the CESEE region, including the First Republic of Austria was established. Too few people believed then that the new small state would be able to survive. So, it took another reboot to learn that small open economies can provide an even higher quality of life and social security for their citizens. Unlike the interwar period, the development of the Second Republic

⁸ Machlup, F. (1958). Structure and Structural Change: Weaselwords and Jargon. *Zeitschrift Für Nationalökonomie / Journal of Economics*, 18(3), 280-298. Retrieved from <http://www.jstor.org/stable/41795928>

of Austria was embedded in a process of international cooperation and European economic integration, which culminated into EU membership. Democratic integration into something bigger turned out to be the more sustainable and more promising political and economic concept.

Second, ten years ago, Lehman Brothers collapsed, and the global financial system was on the brink of falling apart. Today, we can truly say that all the efforts undertaken to prevent the worst from happening have succeeded in the end. Initially, coordinated monetary and fiscal expansion on a global scale was instrumental in avoiding an economic meltdown of the kind experienced during the Great Depression in the 1930s. Later, reforming the micro- and macroprudential regulatory frameworks helped fix the financial system. Having established much larger capital and liquidity buffers as a result, banks now have significantly reduced the risks in their balance sheets. In Europe, new emergency funds, centralized banking supervision and resolution as well as more stringent procedures to deal with fiscal and macroeconomic imbalances addressed critical weaknesses of Economic and Monetary Union. Yet, there is no reason for complacency. High global debt, large global imbalances, a weaker post-crisis growth path, pending monetary policy normalization and remaining EMU imperfections pose challenges that will have to be tackled. To say nothing of the political risks exemplified by Brexit, recent trade tensions and populism that jeopardizes the European project and multilateral cooperation in urgent global matters. Hence, there are many challenges ahead.

Let me now give the floor to Minister Löger; dear Hartwig, the floor is yours.