OESTERREICHISCHE NATIONALBANK
EUROSYSTEM

Small countries in big unions – the Austrian experience

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“Small is beautiful.”

(Leopold Kohr, Austrian philosopher and economist)

“In turbulent financial waters it is better to be on a large, solid and steady ship rather than on a small vessel.”

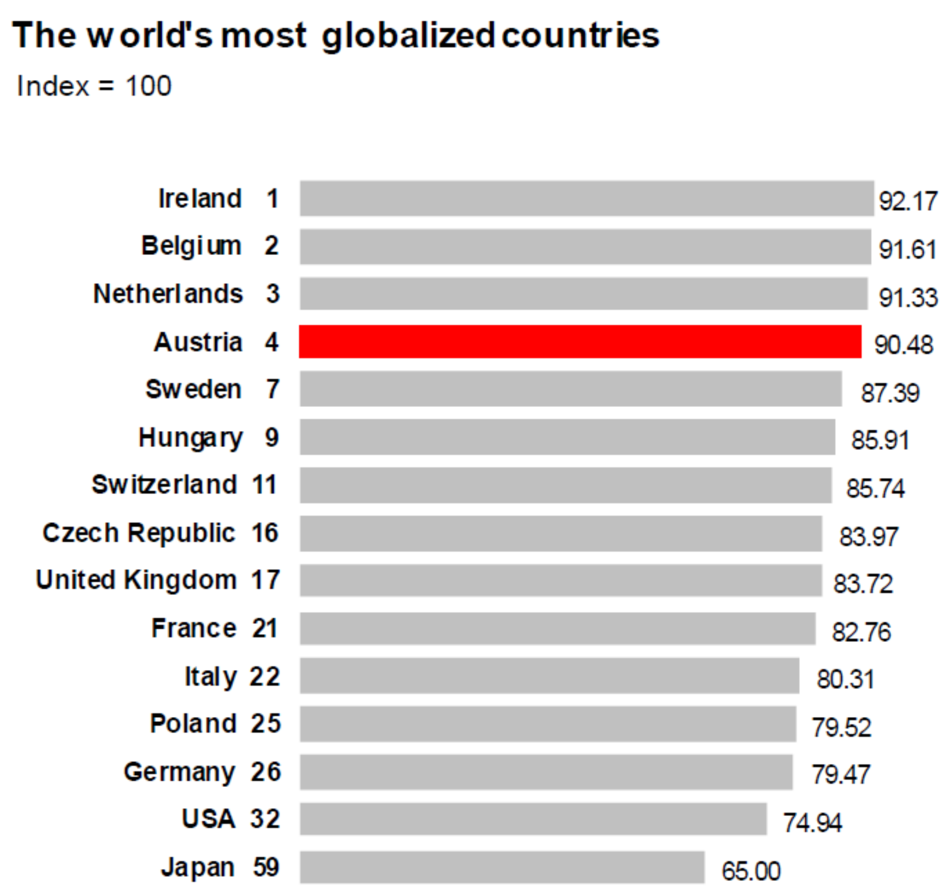
(Jean-Claude Trichet)

Outline

1. Austria's EU experience
2. Rationale for the common currency
3. The euro's past
4. The euro's present
5. The euro's future

Austria at a glance

- Fourth richest country in the EU (GDP per capita PPP 2014)
- Highly developed infrastructure
- Political stability – social partnership (low strike rate)
- Top rank in terms of hourly productivity
- Central location – bridge to Eastern and Southeastern Europe
- Austria is the fourth most globalized country



Source: KOF Index of Globalization 2014, ETH Zurich

Key figures of the Austrian economy

GDP 2014	EUR 324,26 billion
GDP per capita (2014)	EUR 38.540
GDP growth (2014)	0.4%
HICP inflation (Aug. 2015)	1%
Unemployment rate (July 2015)	5,8%
Government balance (2014, Maastricht)	-2.4%
Government debt (2014)	84.5%
Current account balance in % of GDP (2014)	0.8%
Export ratio (2014)	53.2%
Employment rate (2014)	78.4%

Milestones of Austrian EU membership

1960: EFTA membership

1989: Austria bids to join the EC

1995: Austria, Finland and Sweden join the EU

1997: Treaty of Amsterdam (Stability and Growth Pact)

1999: Monetary union starts with 11 countries

2002: Euro cash is issued

2004: EU is enlarged to include 8 CESEE countries, Malta and Cyprus

2005: Treaty of Lisbon signed

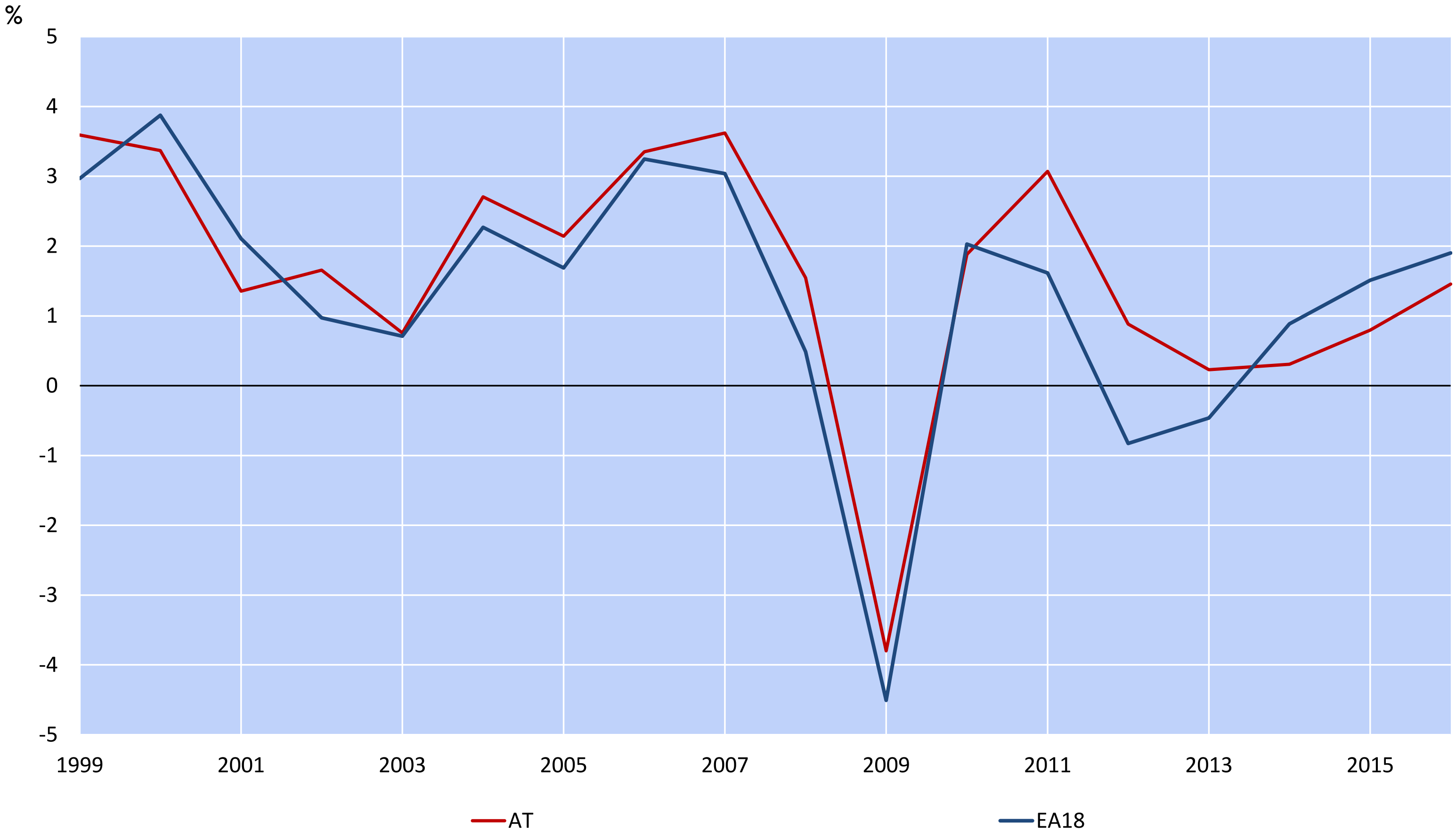
Austria benefits from EU integration

- **Exports to EU-26 have risen 2½-fold since accession. More than 70% of Austria's foreign trade with other other EU countries.**
- **Foreign direct investment (FDI) to Austria rose almost six-fold. In turn, the CESEE countries have attracted more than 50% of Austria's FDI since 2001.**

- **Annual increase of real GDP of 0.6pp with 14,000 new jobs every year compared to non-accession (Breuss 2010)**
- **Complete integration bonus (opening of Eastern Europe in 1989, Austria's EU accession, EMU membership and EU enlargement starting in 2004 deliver an integration bonus of 0.9 pp real GDP growth and 20,000 jobs per year (Breuss 2010).**
- **Austria ranks third in terms of benefits of the EU single market, with an average annual gain of EUR 280 per capita (Bertelsmann Foundation 2014)**

Austria outperformed the euro area

Real GDP growth



Source: European Commission (AMECO).

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2. Rationale for the common currency

Benefits:

- Exchange rate stability
- Low interest rates
- Low transaction costs
- Price transparency, competition
- Completion of the common market
- Europe's increasing role in the international financial system
- Political integration, European "identity"

Costs:

- No national monetary and exchange rate policy in case of asymmetric shocks
- Divergence creates tensions
- Without a genuine Economic and Monetary Union (EMU), central bank may overstretch its mandate

Optimal currency area theory

R. Mundell (1961), McKinnon (1963), Kenen (1969):

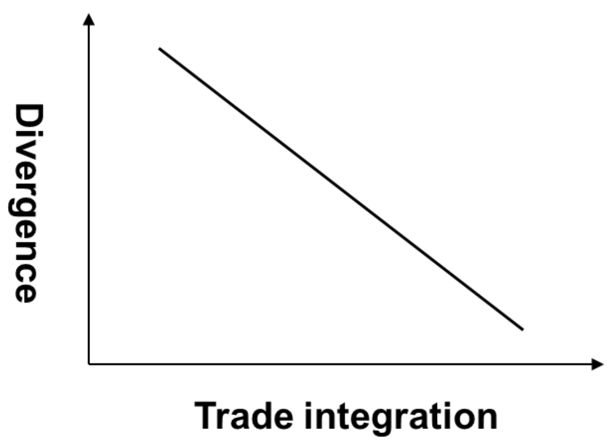
1. **Countries benefit from a common currency**
    - **the opener they are,**
    - **the closer their trade relations,**
    - **the more synchronized their business cycles,**
    - **the more flexible their economy (wages and prices),**
    - **the more mobile economic factors are (labor and capital).**

2. **Politics can help "optimize"**
    - **fiscal discipline (Stability and Growth Pact – SGP)**
    - **economic policy coordination (e.g. investment plan)**
    - **common institutions (e.g. ESM, Banking Union)**

(Currency) integration → convergence or divergence?

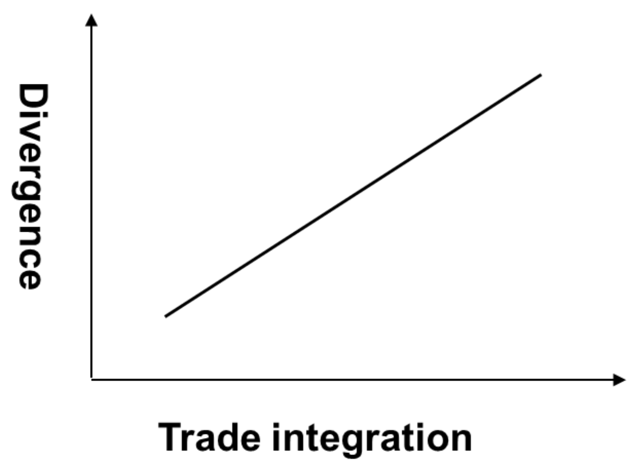
Optimists (European Commission, 1998):

- Trade in the EU (intra-industry)
- Demand shocks hit all countries at once
- Integration leads to similar economic structure



Pessimists (Paul Krugman):

- Free trade → economies of scale and concentration of production
- Demand shocks hit individual countries (and products)
- Integration leads to asymmetric shocks



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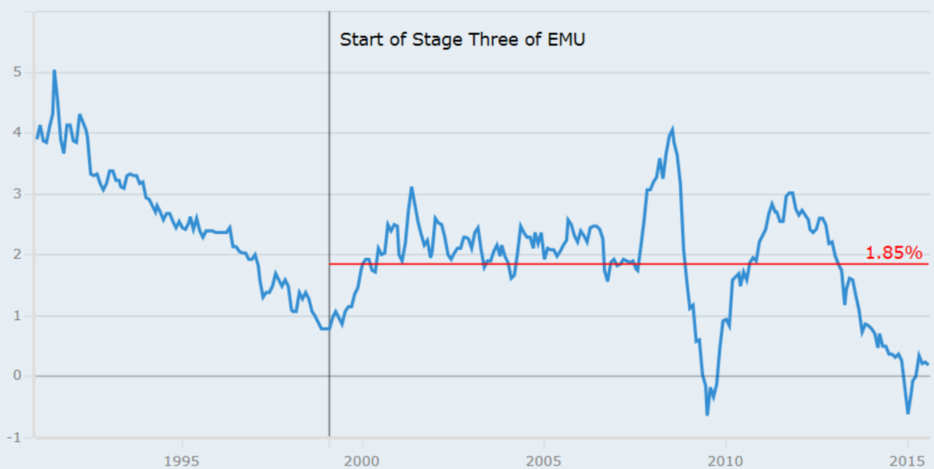
The euro until 2007: a success story

Inflation moderate despite of oil price explosion

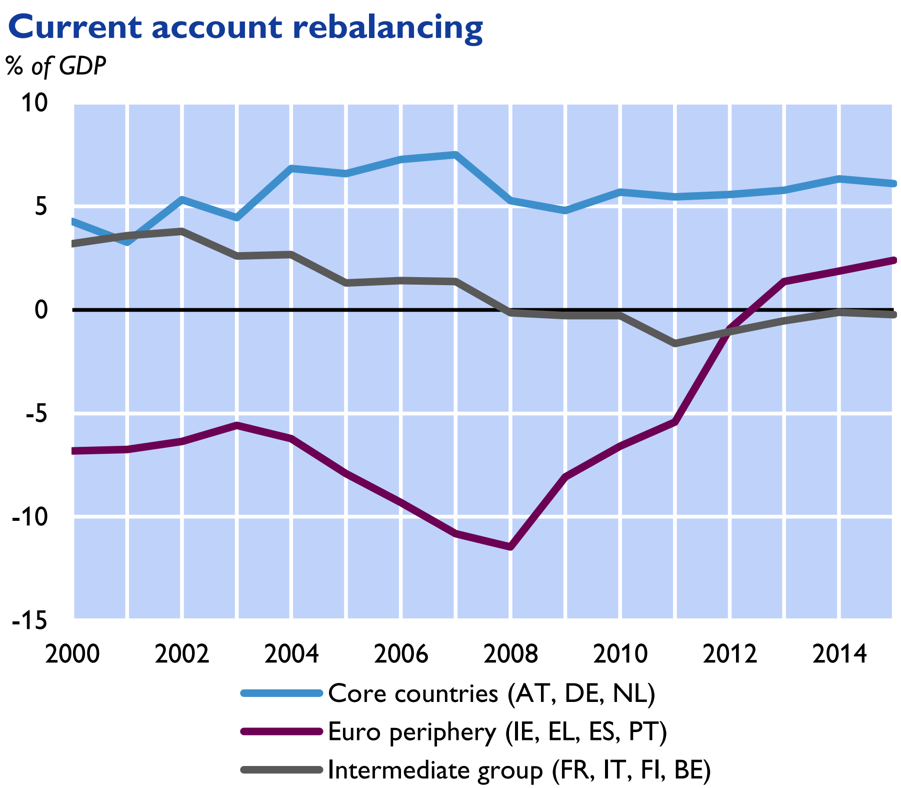
Inflation in the euro area (annual percentage changes, non-seasonally adjusted)



Source: Eurostat. Data prior to 1996 are estimated on the basis of non-harmonised national Consumer Price Indices (CPIs). Average inflation since 1999.

- ECB mandate accomplished: inflation below, but close to, 2% over the medium term
- Convergence in GDP/capita (poor countries grow faster)
- Unemployment fell everywhere
- Moderate consolidation of public households
- Public debt fell
- Trade and FDI increased
- Interest rates low (market failure?)

Competitiveness gap developed in the euro area

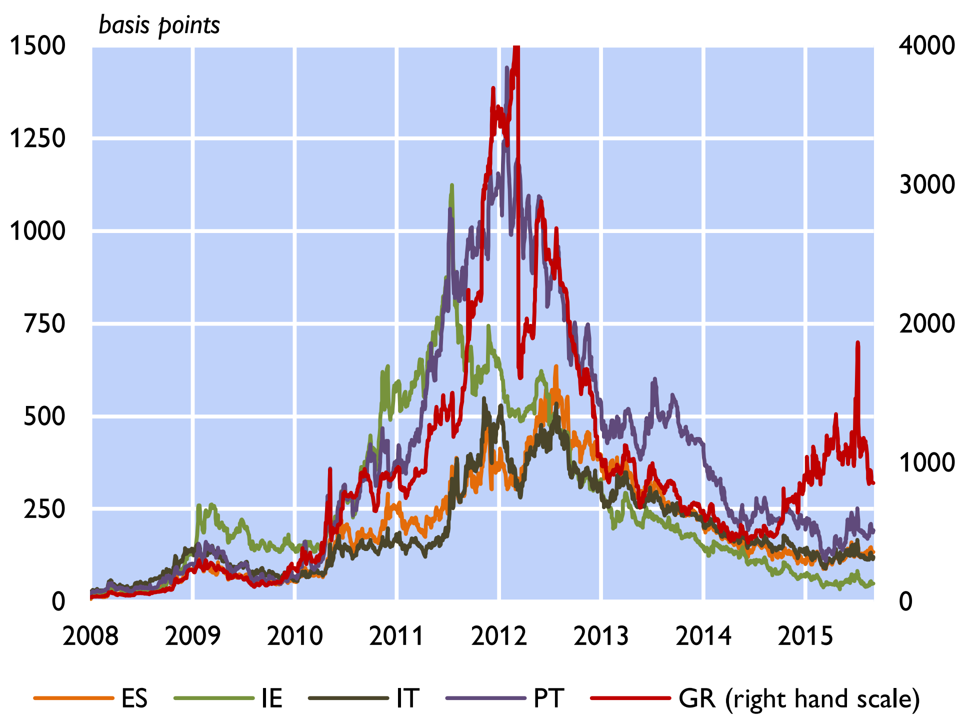


Source: European Commission.

- **Demand and unit labor costs rose faster in euro area periphery countries**
- **Current account deficits in ES, GR, PT and IT accumulated**
- **Current account surpluses in DE, NL and AT**
- **Growth of housing bubbles (in ES and IE)**
- **Bank loans to households exploded**
- **Growth of public debt (GR)**

From financial crisis to sovereign crises

Spread of ten-year government bonds vis-à-vis Germany



Source: ECB.

- **2007 U.S. subprime crisis**
- **2008 collapse of Lehman Brothers**
- **Great Recession (global)**
- **Recovery program and bank bailouts – public debt rose**
- **ECB no lender of last resort for Member States (vs. Fed)**
- **Risk of government insolvency – interest rates rose (vicious circle)**
- **As of mid-2012: ECB has calmed financial markets (Draghi: “Whatever it takes”)**

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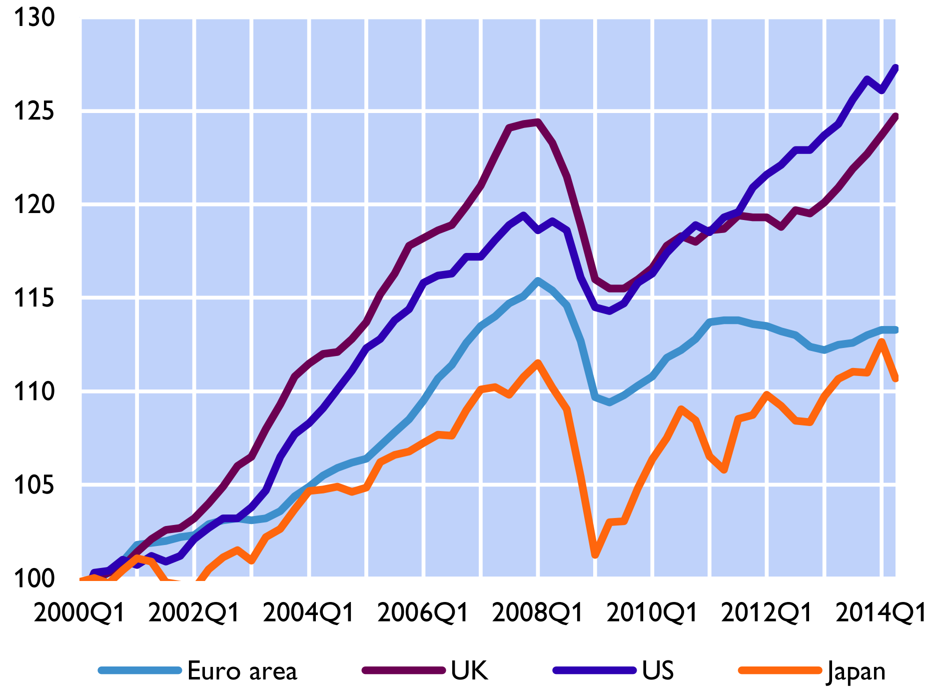
4. The euro's present: economic situation in euro area

GDP 2000Q1 - 2014Q2

Index, 2000 = 100



Source: Eurostat, national sources.

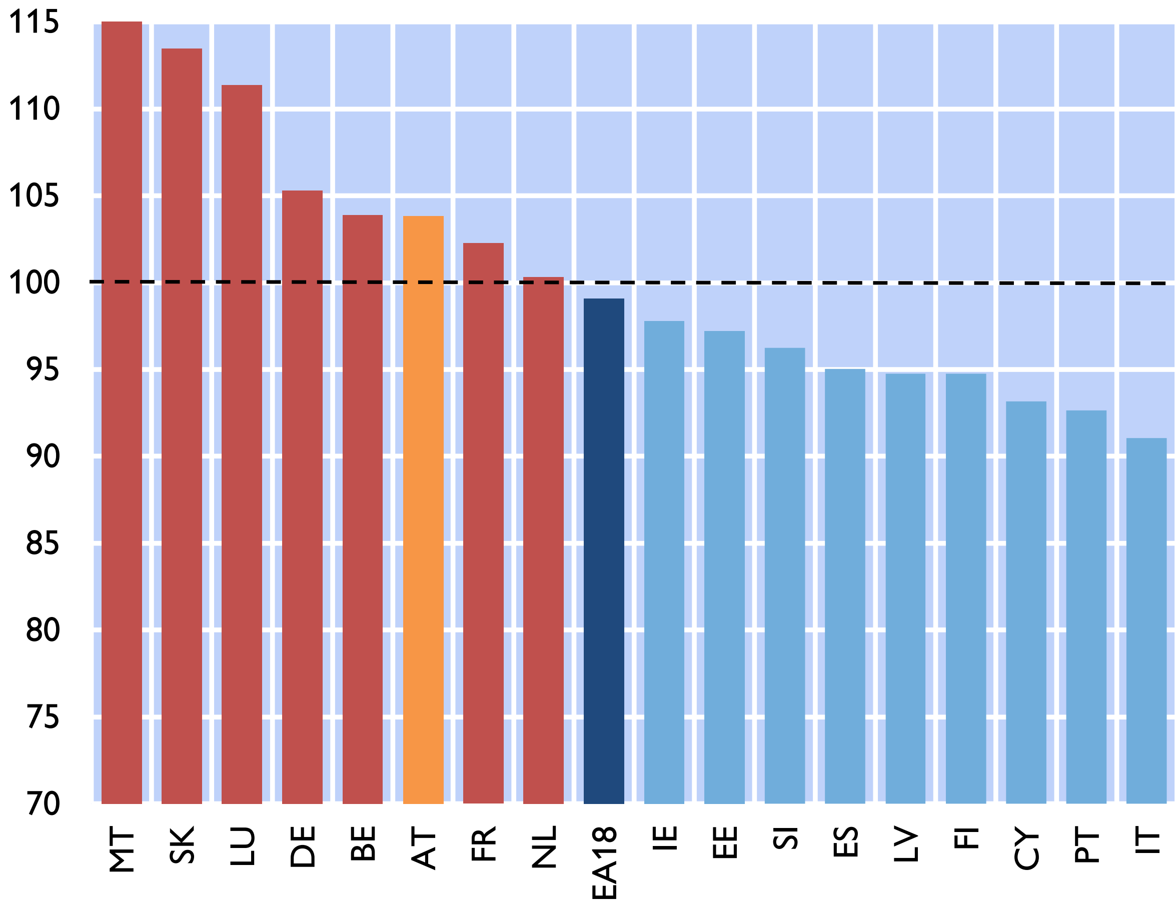
Crisis reveals EMU deficiencies

- **Euro area double-dip recession**
  - **Fiscal consolidation (essential for periphery but suboptimal for euro area as a whole)**
  - **Less aggressive monetary policy**
  - **Structural problems: reduced flexibility**
  - **Uncertainty because of exit fears**
  - **Complex decision making**

→ Governance reform is necessary

Euro area economic performance still below pre-crisis level

Real GDP 2014 in the euro area (2007=100)



Source: Eurostat.

EU response to the crisis: much has been accomplished

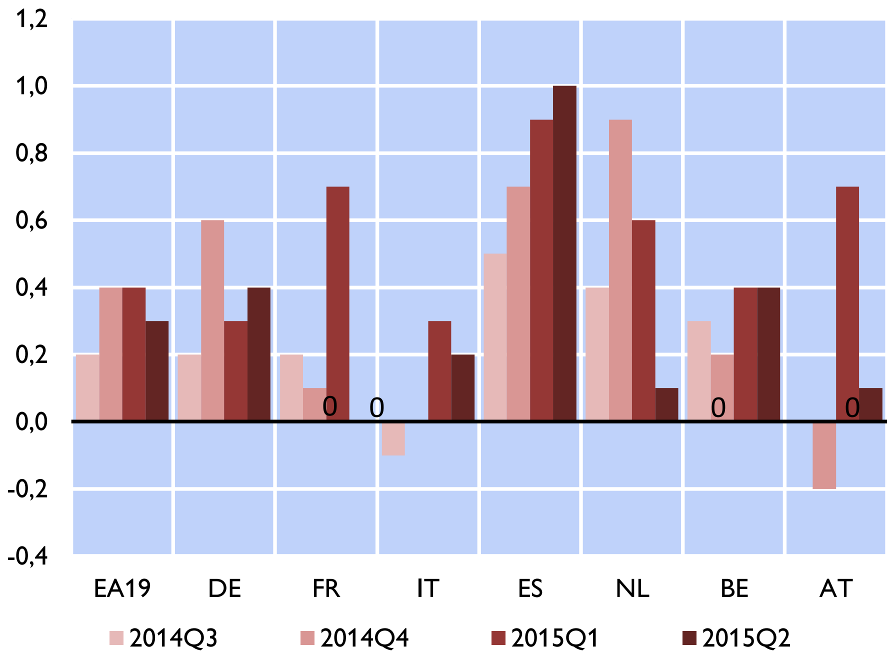
Emergency measures	Financial markets	Fiscal policy	Structural policy
Ad-hoc **assistance**	European Systemic Risk Board (ESRB) → **macroprudential supervision**	Stability and Growth Pact 3.0 • Expenditure rules • Debt criteria	**Excessive Imbalance Procedures** (EIP) • "Scoreboard" macro economic indicators • Preventive and corrective arm
ESM (European Stability Mechanism)	**Banking Union** • Single supervision (ECB) • Single resolution • Harmonized deposit guarantees	**"Fiscal pact"** (TSGE)	
	European System of Financial Supervision (EFSF) • Banking authority (EBA) • Security authority (ESMA) • Insurance authority (EOIPA) →**microprudential supervision**	**European Semester**	
OMT(ECB announces unlimited purchase program option)	Financial market regulation (Basel III, mutual funds, rating agencies)	More **duty to inform** **European Commission** (six-pack & two-pack)	**Investment plan** + Capital Markets Union **EU 2020** Growth strategy

Slow economic recovery in the euro area supported by monetary policy, low oil prices and the exchange rate

Spanish growth in the lead (after severe recession)

Real GDP growth in the euro area

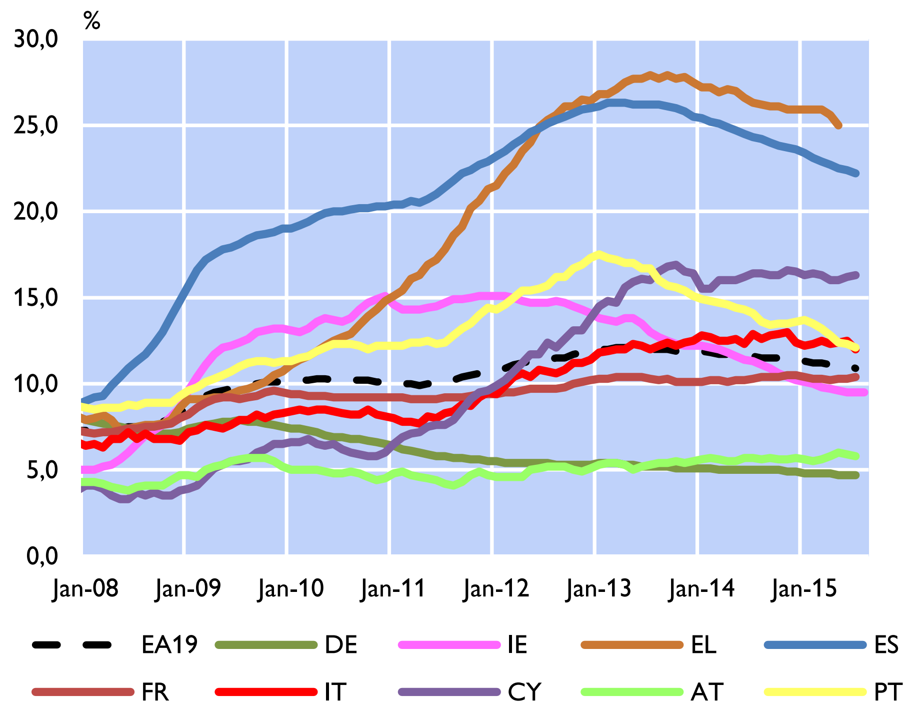
quarter-on-quarter changes in % (saisonally and working day-adjusted)



Source: Eurostat.

Unemployment shrinks (but remains high)

Unemployment rate in the euro area



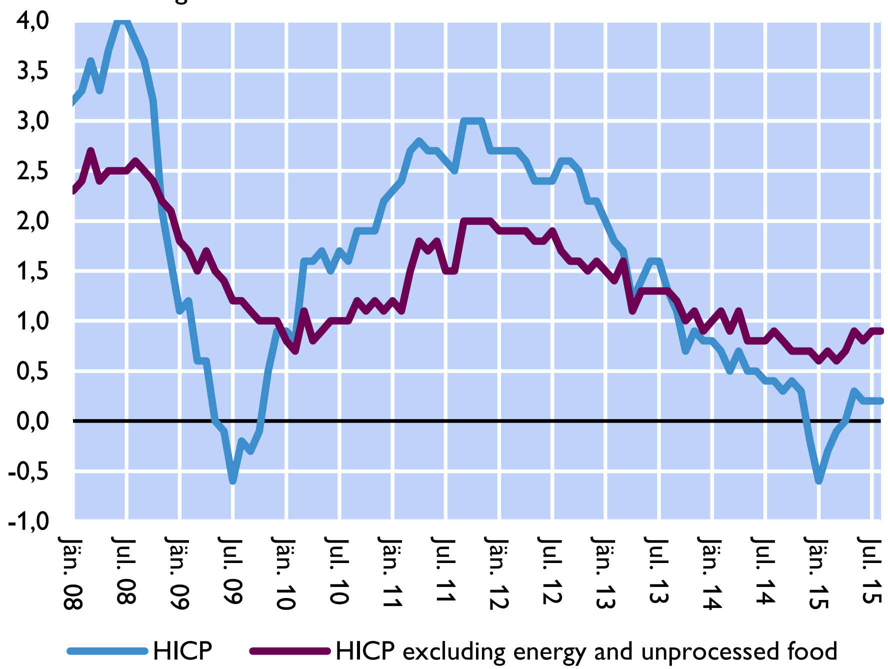
Source: Eurostat.

ECB fights deflation risk

Inflation very low

Euro area inflation and core inflation

annual % change

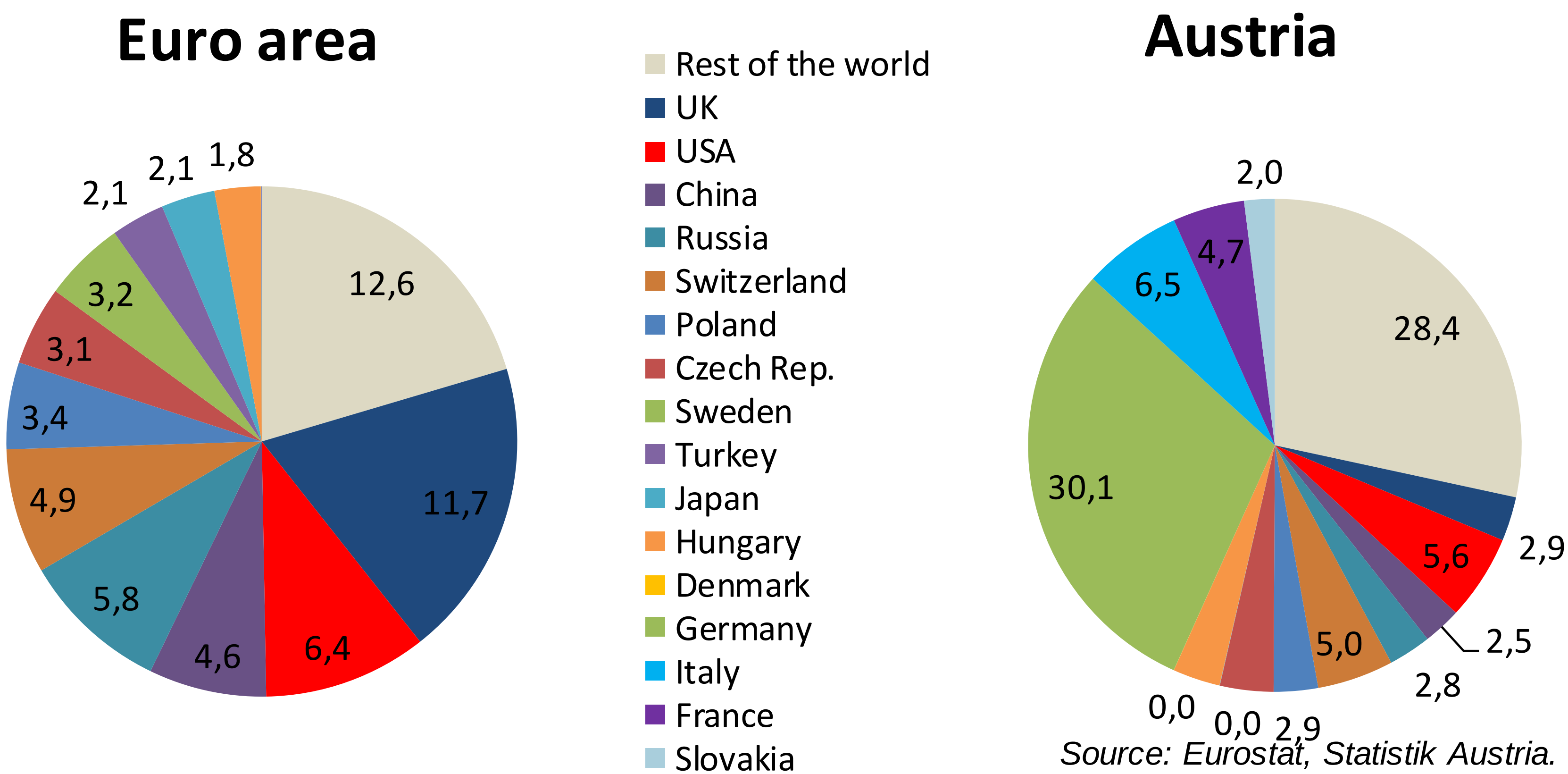


Source: Eurostat.

Monetary easing

- **Standard policy: interest rates at record low**
- **Nonstandard measures**
  - **Generous bank liquidity**
  - **Purchasing programs: mainly sovereign bonds**
    - **EUR 60 billion per month at least until September 2016**
    - **Balance sheet still smaller than U.S. (Fed), Japan or U.K. (BoE)**
  - **Aim:**
    - ➢ **anchor expectations**
    - ➢ **inflation below, but close to, 2% over the medium term**

Euro area shares in exports to the ten major trading partners (2013) in % of its total exports



Source: Eurostat, Statistik Austria.

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5. The euro’s future

- **Today the euro is the official means of payment for more than 330 million people in 19 Member States.**

- **The euro offers protection against global crises, especially for small countries.**
- **The euro is one of the most important currencies in the world.**
- **The euro strengthens the EU's role as global player.**
- **The euro prompts reforms.**

- **Crisis in the euro area ➜ push for European integration**

€xit is no option: everybody would lose

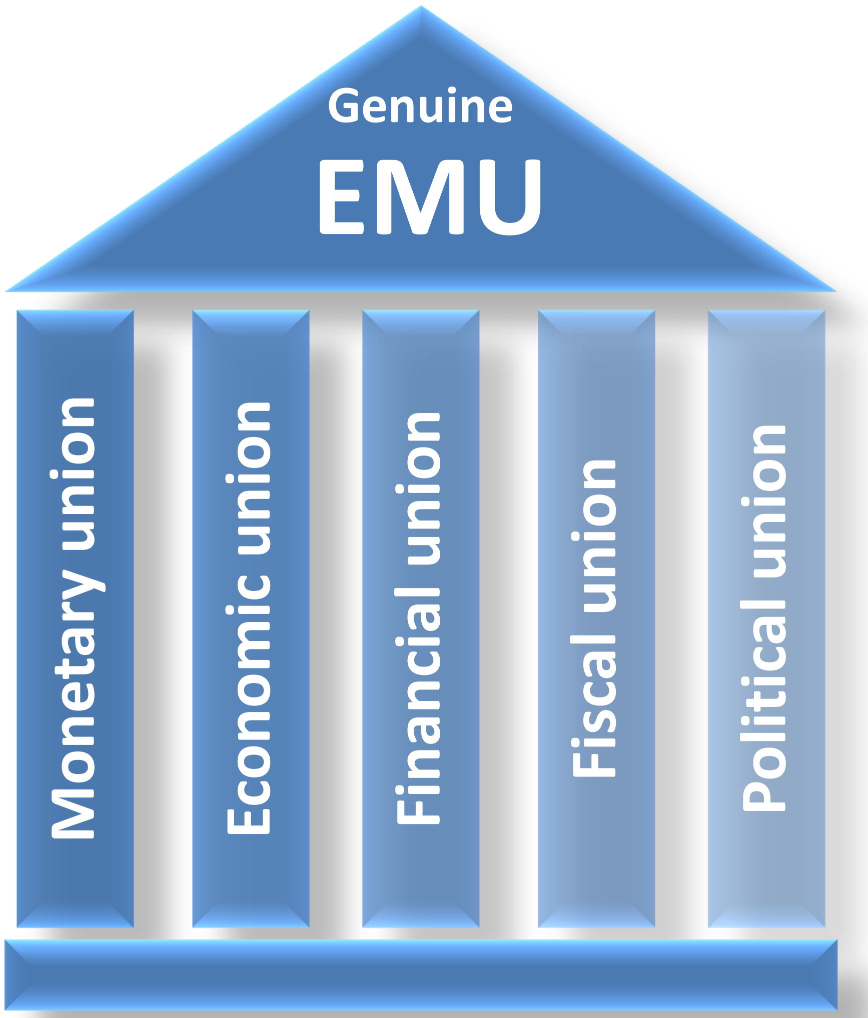
Risks for the country concerned:

- Exchange rate weakness makes foreign debt more expensive (private and government debt)
- Capital flight
- Capital controls further destroy confidence
- Less foreign investments
- Less, not more, competitiveness in the long run
- Unemployment and poverty continue to rise

Risks for the euro area:

- Contagion
- De facto a system of fixed exchange rates but no monetary union anymore
- Speculators are encouraged: Who is next?
- Self-fulfilling prophecy

Five Presidents' Report: Completing EMU



1st stage (until 2017)

- **Competitiveness authorities**
- **Strengthened implementation of the Macroeconomic Imbalance Procedure**
- **European Semester simplified**
- **Complete banking union**
- **Launch capital markets union**
- **European Fiscal Board**
- **Control by EU Parliament**
- **Intergovernmental treaties in EU law**

2nd stage (until 2025)

- **Macro stabilization function**
- **Treasury for the euro area**