OESTERREICHISCHE NATIONALBANK
EUROSYSTEM

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SPEECH

Vienna, November 16, 2009

Check against delivery!

"The Euro's Contribution to Economic Stability in CESEE"

Opening Remarks CEEI 2009

Ladies and gentlemen!

It is a great pleasure for me to welcome you at the annual Conference on European Economic Integration. The Oesterreichische Nationalbank has been hosting this event for many years, offering a forum for lively debates between distinguished panelists from national and international institutions, politics, banking and academia. I am glad that such a sizable number of participants and speakers show great interest in this year's conference theme. As you all know we are currently witnessing turbulent and challenging times, which, to an extraordinary degree, are characterized by volatility and uncertainty. Against this backdrop, this year's conference is devoted to the **euro's contribution to economic stability in Central Eastern and Southeastern European countries**.

The conference theme goes well with **two anniversaries we are celebrating this year**:

- the fall of the Iron Curtain and
- the introduction of the euro.

Ladies and gentlemen, the fall of the Iron Curtain was, clearly, a milestone in the process of European integration. Twenty years ago, the breakup of what we knew as the "eastern bloc" ended the long-lasting division of Europe. This initiated a successful process of integration, which culminated in the 2004 and 2007 enlargement rounds of the European Union.

At least since then, cooperation and integration have been an integral part of our day-to-day European reality, a major element of our European identity.[1]

[1] OeNB (2009): Foreword, FEEI special issue: "20 years of East-West Integration – Hopes and Achievements".

Publisher and editor:
Oesterreichische Nationalbank
Communications Division
Editor in chief: Günther Thonabauer
Otto-Wagner-Platz 3, 1010 Vienna, PO Box 61

The OeNB took the 20th anniversary of the opening up of Central and Eastern Europe as an occasion to publish a special issue of its quarterly Focus on European Economic Integration. It is a great pleasure for me to announce the presentation of **this special issue tonight**. Key experts, who accompanied the Eastern European economies through the transition process, have contributed to this publication and will be with us this evening to exchange their – very personal – views and experiences on the most important topics concerning East-West integration.

Let me now turn to another milestone of European integration, which has traditionally been more the focus of a central bank: the euro. Now it was a bit more than ten years ago, on January 1, 1999, that eleven EU Member States adopted the single currency. Against the background of the economic crisis and this year's anniversary, it seems to be the right time to discuss and reflect the euro's development both from a European perspective and from a global angle. To start with, I would like to note that in the early stages of its existence, the euro was under heavy criticism. The well-known argument of proponents of the optimum currency area (OCA) paradigm associates the costs of joining a monetary union with the loss of domestic monetary policy. A currency union becomes costly if business cycles of individual countries are not synchronized highly enough. In the absence of country-specific monetary policies, an idiosyncratic shock cannot be absorbed through the real exchange rate but has to be digested via other channels:

- flexible wages,
- fiscal transfers and
- mobile factors of production.[2]

However this argument is very static. Joining a currency area leads to a boost in trade and hence to a convergence of business cycles. Moreover, in the current environment, the question of how costly idiosyncratic shocks can become are of minor importance. The crisis is a shock that has affected all economies. The past ten years have shown that the introduction of a single currency ensured price stability and spurred trade flows over the region.

To put it in the words of Richard Baldwin[3] *"Most of the trade effect literature treats currency unions as magic wand. The only question is: How big is the magic?"*[4] Although there is no consensus about the magnitude of the trade effect triggered by the creation of the currency union, estimates point to a significant increase in trade and foreign direct investment within the euro area.[5] The rise in trade also went hand in hand with a surge in

[2] OeNB (2009), The Euro – A Stability Anchor in Turbulent Times, Ewald Nowotny, OeNB Governor, Bologna, 10.9.2009.

[3] Exact citation of Baldwin's statement: *"Most of the Rose effect literature treats currency unions as magic wands – one touch and intra-currency-union trade flows rise between 5% and 1400%. The only question is: How big is the magic?"*

[4] Baldwin, R. E. (2006): "The Euro's Trade Effect." Working Paper Series 594, European Central Bank.

[5] European Commission (2008): "EMU@10: Successes and challenges after ten years of Economic and Monetary Union", European Economy 2/2008.

employment and a significantly lower price level than in the 1970s and 1980s. Therefore we can say that confidence in the euro is as large as confidence in its most stable predecessors used to be.

Let me elaborate a little bit more on the current international role of the euro and its prospects for the medium term. In the 10 years of its existence, the euro has not only been a great success for its member states but has also continuously enhanced its international role. With the entry of Slovakia in January 2009, the euro area currently comprises 16 member states, with a total population of more than 330 million.[6] This compares with a U.S. population of 304.5 million in 2008. Another important determinant is economic activity. While in 2008, the **euro area's GDP** at purchasing power was still below that of the U.S.A., economic activity in the **European Union** exceeded that of the U.S.A. In other words, 2008 figures demonstrate that the potential euro area of the future outpaced the U.S.A. in terms of economic activity.

From a **micro perspective**, the use of the single currency outside the euro area is most prominent in its neighboring countries, where strong cultural and political ties exist. Today's afternoon session will provide some insight into the use of the euro in the CESEE region, featuring the presentation of the main findings of the Euro Survey carried out by the OeNB.[7] They show that the dissemination of euro cash holdings is strong in some (potential) candidate countries (the Former Yugoslav Republic of Macedonia, Serbia, Albania and Croatia). This highlights the perception of the euro as an anchor of stability and underscores its important role as an international means of payment and store of value.

However, euroization can also be accompanied by certain risks, especially if financial markets are still to deepen. Foreign currency loans to households (predominantly denominated in euro) are substantial in some countries. Without euro area membership, balance sheet effects can seriously jeopardize households' ability to pay back their debt, which, ultimately, may feed through to the real economy.

At its 10th anniversary the euro has been tested by **a severe global financial and economic crisis**. The worlds' worst recession since the 1930s poses a wide range of macroeconomic and political challenges for all affected economies and is putting the single currency to the test. Rising spreads between German covered bonds and bonds of other euro area countries as well as diverging credit default swaps (CDS) on government bonds within the euro area are a major concern. Still, Nobel Prize Winner Milton Friedman's prophecy that *"when the global economy hits a real bump, Europe's internal contradictions will tear (the euro) apart"* proved wrong. Quite on the contrary, it is the euro

[6] ECB (2009), Statistics Pocket Book, www.ecb.int/pub/pdf/stapobo/spb200910en.pdf.

[7] Dvorsky, Scheiber, Stix (2009), CESEE Households amid the Financial Crisis: Euro Survey Shows Darkened Economic Sentiment and Changes in Savings Behavior, FEEI 4/2009, OeNB.

that functions as an anchor of stability and helps weathering the storms of the crisis. Still, there are some challenges ahead.

In its early stage, the crisis had been confined to advanced economies. Local and foreign banks in Central Eastern and Southeastern European economies held only a negligible amount of so-called toxic assets. These innovative financial products and excessive risk taking put major banks under serious stress and brought into question their business model. A post-crisis business model should therefore emphasize the importance of diversification of profit and funding sources, with the latter being most reliably provided by deposits. Also, for Austrian banks holding a major stake in the CESEE region, adaptations in their business models will be needed. This will concern the dynamics of granting loans and in particular, the risks of foreign currency lending must be adequately taken into account.

With the collapse of the investment bank Lehman Brothers, the crisis reached the CESEE economies during late 2008 and started to fully feed through to the real economy in early 2009. That said, the crisis turned from a financial market crisis into a broad economic crisis throughout the region. The global loss of confidence and the slump in demand for exports almost interrupted the convergence process of the catching-up economies.

What followed were falling stock prices, increasing risk premia on bonds and – in some cases – a downward rally of currencies.

Since the crisis has severely hit the real economy of the region, the question arises how long it will take to bring the economies back to the growth track experienced in the last decade. Put differently, when will catching up to the euro area continue to take place at a fast rate? It is worth mentioning that there are several characteristics shared by most CESEE countries: their high growth rates have been accompanied by

- strong credit growth
- remarkably high foreign capital inflows and
- widening current account deficits.

Whereas global imbalances have been one of the focal points of policymakers over the last years, **imbalances have widened also within the euro area**. Since the launch of the euro in 1999, the euro area has experienced significant divergence in the external economic positions of its member states. Two groups of economies emerged: surplus countries and deficit countries, with the two CESEE countries that have already introduced the euro falling by large into the second category. The determinants of the trend of divergence in competitiveness and current accounts are manifold. Changes in price competitiveness can reflect

- convergence in the price level of tradable goods,
- the Balassa-Samuelson effects and
- the response to cyclical differences between euro area countries.[8]

It is possible that the euro has amplified the divergence trend in current accounts since it grants better access to international capital markets for catching-up member states and hence allows running larger trade deficits. The imbalances might be attributed to

- domestic demand pressures,
- surging private and external debt and
- the inefficient use of foreign capital (e.g. housing booms).

Adjusting imbalances remains a serious challenge particularly within Economic and Monetary Union.[9] Whereas the global crisis has dampened growth dynamics and lowered potential output of both advanced and catching-up economies, it has accelerated the adjustment of imbalances. To a large part, this adjustment is achieved through the trade channel, with demand for imported goods decreasing more strongly than demand for exports of the CESEE region. That said, it remains key to understand the determinants of these imbalances, while close monitoring remains essential in the near future.

It is one of the key objectives of this year's conference to elaborate on the **euro's role as a shelter**, a term which has become en vogue during late 2008 and mid-2009. The last two years provide ample evidence that the euro has been an anchor of stability throughout the CESEE region. This is closely linked to the highly effective measures the ECB has taken to support the functioning of financial markets. The launch of international financing packages for some countries of the region (among them Hungary and Romania), increasing confidence and an improvement in the global risk appetite have contributed to **a recent easing in financial market strains**. We all hope that this is not only a "recent easing" but that the economies will recover from the crisis quickly. However, "coming back to normality" also bears the risk of missing chances. It is important to take the opportunity the crisis offers and bear in mind the lessons we have learned so far: enhanced regulation, coordination and transparency will ensure a sustainable long-term functioning of financial markets and help prevent such a global downturn in the future.

The surge in investor confidence we currently see in the markets can be partially attributed to the adapted monetary policy of the ECB. This helped ensure stability in the markets, not only within but also beyond the borders of the euro area. The ECB reacted promptly to the challenges brought about by the crisis, taking both traditional and unconvential measures. Along with other major central banks, the ECB gradually cut interest rates; they are now at historically low levels – the lowest since the ECB's

[8] European Commission (2009): "Quarterly report on the euro area – March 2009".
[9] Arghyrou, M.G. and Chortareas G. (2006): "Real exchange rates and current account imbalances in the Euro-area".

establishment. Liquidity provided through unconventional measures aimed at ensuring that policy rate cuts are effectively passed on to the economy.

These instruments also made it possible to provide stimuli to the economy when interest rates are already very low. In addition the ECB signed swap agreements to provide European central banks outside the euro area with euro funding.[10]

2009 will undoubtedly enter the textbooks as the year dominated by the biggest economic crisis seen in decades. Certainly it will also be remembered as a year in which strong and coordinated policy efforts were undertaken to shield the real economy, financial markets and banking sectors around the globe from the most adverse effects of the global downturn. As a case in point I would like to point out the Vienna Initiative, which was launched in early 2009 to avoid uncoordinated national crisis responses. A key element of the multi-institutional forum is the commitment of major banks to maintaining their exposure to the CESEE region. Containing financial outflows is important to regain financial stability. In times of crisis, this is a strong sign and complies with the long-term investment perspective of the – mostly Austrian – banks operating in the region. No doubt, a decade ago, a lack of coordination would have resulted in national interests prevailing, which would have made it nearly impossible to quickly and efficiently counter the crisis.

The measures taken are only one side of the coin when it comes to discuss the euro's role as a shelter. It is plain to see that EU membership alone has stabilized the region. It boosted access to international financial markets and enhanced the provisioning of indirect support to local banks. **Membership in monetary union** would have further increased access to liquidity during the crisis and provided shelter against speculative currency attacks. Moreover, the longer-term benefits of monetary union include

- lower transaction costs,
- increased competition and consequently lower profit margins,
- stronger financial market integration and
- a credible monetary policy target towards price stability.

Capital flows have enabled the financing of current accounts and have been an important ingredient of the CESEE growth model so far. However, whether in or outside the euro area, some CESEE countries will have to adjust their growth model in order to render their internal and external imbalances more sustainable. Higher returns attracted capital inflows from Western Europe but in light of the crisis, one was tempted to ask whether this source of financing would dry up.

This leads me to the question of whether **rapid euro adoption** is reasonable for CESEE countries. During the crisis a relatively short-lived debate evolved whether countries outside the euro area should be allowed to join monetary union immediately. This would have meant to abolish – or temporarily suspend – the convergence criteria

[10] C.f. footnote 1.

laid down in the Maastricht Treaty. In this respect, ERM II is an important instrument to stabilize acceding countries' exchange rate and guarantees a smooth transition from a national to the single currency. It is important to note that the convergence criteria are key determinants of the sustainability of the fixed exchange rate implied by adopting the euro.

While entering the euro area is obligatory for almost all EU members, choosing the right moment is a demanding task. There are several factors that affect the decision:

- the mobility of capital and labor and
- the flexibility of domestic wages

are essential factors for gauging the readiness of a country to join monetary union. Besides that, one should bear in mind the Maastricht criteria, in particular

- convergence in prices,
- a focus on long-term interest rates and
- fiscal stability.

Against the backdrop of the current crisis, the discussion is revolving around the fiscal stance of countries. The decline in growth rates has put serious pressures on the budget and fiscal positions in the region. It is therefore a challenge to manage the trade-off between providing support to those hit hardest by the crisis and correcting fiscal imbalances to ensure sustainability and to qualify for EMU.[11] Let me emphasize that the CESEE region is very heterogeneous and their achievements with respect to the particular factors mentioned before vary from country to country. Hence the timing of euro adoption remains a country-specific task and should be decided on a case-by-case basis.

Let me conclude and stress that European integration is closely linked to the creation of the Economic and Monetary Union, which ultimately led to the birth of the single currency. Having successfully weathered the storms of the worst financial and economic crisis of postwar history, the euro has been and will continue to be an important anchor of European integration. This conference demonstrates readiness to open a discussion about the various dimensions of the euro's role in general and in the light of the current crisis in particular. Views from countries that have not yet introduced the euro will supplement those of euro area members on the issue of the euro's contribution to economic stability. I am looking very much forward to hearing, discussing and learning from the opinions of policymakers, bankers and academics over the next two days.

It is now a great pleasure for me to welcome our first keynote speaker, Joaquín Almunia, EU Commissioner for Economic and Monetary Affairs.

Mr. Almunia, the floor is yours!

[11] Backé, P. (2009): „The Monetary Integration of Central and Eastern European EU Member States: Achievements and Prospects" in the FEEI special issue: "20 years of East-West Integration- Hopes and Achievements", OeNB.