Oesterreichische Nationalbank
Eurosystem

# Workshops

Proceedings of OeNB Workshops

# *From Bretton Woods to the Euro – Austria on the Road to European Integration*

*In Memoriam Karl Waldbrunner 1906–1980*
*First Vice President of the Oesterreichische Nationalbank*

November 29, 2006

No. 11

# Editorial

On November 29, 2006 the Oesterreichische Nationalbank (OeNB) organized a symposium to commemorate the centenary of its former Vice President Dipl. Ing. Karl Waldbrunner. As one of the leading economic policy makers of the Social Democratic Party (SPÖ) Karl Waldbrunner played a key role in Austrian economic policy for decades. He was elected member of the National Council in 1945 and served until 1971. He took his first cabinet post in 1945. Karl Waldbrunner was involved in the currency reform of 1947 and headed an important ministry from 1949 to 1962: the Ministry of Traffic and Public Companies (from 1956 Ministry of Traffic and Electricity) formed an integral part of the Austria development strategy of an export led economic growth process. From 1972 to 1980, he held the office of the First Vice President of the Oesterreichische Nationalbank. Within the Social Democratic Party (SPÖ) he played a leading role from 1945 to 1974 as a member of the highest party committee of the SPÖ (Parteivorstand).

The topic *"From Bretton Woods to the Euro – Austria on the Road to European Integration"* was chosen, because Waldbrunner's term coincided with the emergence of Austria's stability oriented so called "hard currency policy" (Hartwährungspolitik). This volume consists of the papers presented at the symposium and the summary of a panel discussion on "Handlungsspielräume nationaler Wirtschaftspolitik in einer globalisierten Welt" ("The Room for Maneuver of National Economic Policy in a Globalized World"). The symposium was held in German and so are most of the contributions to the present volume. However, to serve our international audience, the editorial contains English summaries of all contributions and the introductory paper by Mooslechner, Schmitz and Schuberth presents a broad overview of the evolution of Austrian monetary policy from 1969 to 1999 in English, too.

The literature on the hard currency policy is very rich, although mostly confined to Austria. The term hard currency policy refers to an exchange rate peg with respect to stable foreign currencies combined with the implicit guideline of stabilizing or appreciating the real effective rate. Its evolution commenced in 1971 but the term was used for the first time in the OeNB's Annual Report in 1978.

During the balance of payments crisis in the late 1970s the hard currency policy was faced with criticism from the representatives of the exposed sector and from government officials. Albrecht and Pech (1979) – who both worked at the Bank – launch a defence. They argue that a depreciation would not solve the balance of payments problem due to a low elasticity of imports and exports with respect to exchange rates. They shift the burden of adjustment to the incomes policy in the exposed sector. Also Haberler (1979) assesses the exchange rate policy as a success because he considers it a restrictive policy approach that worked to bring inflation down. His explanations for this success rest on the credit control agreements and on the cooperation and moderation of the trade unions. However, in his writing during the balance of payments crisis, he also emphasizes that a bit of "belt-tightening" (i.e. low real wage increases) would be necessary to cope with the external imbalance.

Dorn (1979) criticizes the hard currency policy from 1971 to 1979 as an approach without stable rules. The structure of the peg changed, as currencies were dropped from and added to the so called "indicator" (a basket of currencies that served as benchmark for the schilling's external value). The schilling's external value fluctuated with respect to the German mark. He calls for clear rules for the exchange rate policy that were to be announced ex-ante for a prespecified period of time. Handler (1980) and Socher (1980) are among the early academic critics of the approach. Their critique focuses on the consequences of the narrowing of the basket to the German mark by 1976. They recommend a switch back to a basket of foreign currencies. Socher stresses that the policies of the Social Partners and the government were too expansive to be consistent with the target. The large balance of payments deficit was unsustainable and demonstrated that the hard currency policy was not successful.

After the successful reduction of the balance of payments deficit Handler (1983 and 1989) changes his view and provides a positive assessment. His studies present the most comprehensive ones on the hard currency policy. He argues that the hard currency policy is intimately tied to the tradition of the consensus orientation of economic policy in Austria, which is based on the Social Partnership. An exchange rate policy that aims at low imported inflation is interpreted as precondition for a wage policy that is stability and output oriented. This combination leads to an increase in international competitiveness, despite – or even due to – a hard currency policy. Androsch (1985) reports that the Trade Union Federation and the Chamber of Labor supported the hard currency policy already in 1975. They argued that it would reduce imported inflation. At the same time, they recognized the importance of an accommodating incomes policy and the cooperation of the Social Partners, the government and the OeNB in maintaining international competitiveness. The representatives of the employers (Association of Austrian Industrialists, the Chamber of Commerce and the Chamber of Agriculture) took a much more critical stance. They feared that the exposed sector would suffer from the increases in the real effective exchange rate. After the appreciation in July 1976, they focused more on calling for moderate wage demands by the Trade Union Federation. They also called for a broadening of the exchange rate orientation from the German mark peg to a basket of currencies. Androsch concludes that the success of the hard currency policy was due to the moderate wage demands by the representatives of organized labor which helped to keep the growth of the unit labor costs in line with the German ones. The exchange rate peg also served to accelerate structural change in the Austrian economy.

Also Socher (1992), who was an early critic of the hard currency policy, provides a positive assessment later on. He argues that the emergence of the particular exchange rate target was the result of a learning process that encompassed the OeNB but also the government (fiscal policy) and the Social Partners (incomes policy). It took from 1969 to 1983. The foundation for the policy's success was the – almost unique – consensus among the main policy institutions that is also reflected in the National Banking Act of 1955. He stresses the important role of the Trade Union Federation which not only adapted their incomes policy to the exchange rate target but also influenced the Socialist single party government during the 1970s to subordinate its fiscal policy to the hard currency policy. Hochreiter and Winckler (1995) conclude as well that the hard currency policy was a success. They suggested two approaches to the discussion concerning its reasons: the optimum currency theory and the theory of the time consistency of economic policy. They argue that Austria was not part of an optimum currency area with Germany at the beginning of the 1970s, but that it became one as a consequence of the hard currency policy. They interpret Austria's exchange rate policy after 1971 as a "straightforward and credible rule […] observed and understood by the public" (p. 1010). The policy created the conditions for its success by a rule based approach to monetary policy that was well understood by the Austrian public. The Bank convinced the Social Partners and the government to subordinate their policies to the exchange rate target. The Social Partners did so effectively and the real wage flexibility played an important role in absorbing asymmetric shocks.

Glück, Proske and Tatom (1992) present empirical evidence of the coordination of the Austrian monetary policy with Germany's for the period after 1979. In fact, Austrian monetary aggregates (M1 and M3), the inflation rate, and short-term interest rates "exhibit strong unidirectional causality from Germany to Austria in the 1980s." (p. 24). The authors suggest that this kind of "policy coordination" explains the success of the Austrian hard currency policy in establishing credibility and in delivering internal and external price stability. Schubert and Theurl (1995) highlight that Austria' s exchange rate policy after the end of the Bretton Woods system was a "move into uncharted waters" (p. 51) but that it was substantially facilitated by the solid economic fundamentals of the late 1960s and early 1970s. They argue that the hard currency policy after 1979 was successful because it helped to stabilize inflation expectations – both within Austria's incomes policy network and on international financial markets – by contributing to the credibility of the stability orientation of the OeNB. Guger (1998) discusses the hard currency policy in a broader macro-economic framework. His analysis assumes the allocation of economic policy objectives to policy instruments as given: fiscal and monetary policy were assigned the objective of demand and employment stability, exchange rate policy that of price stability, and incomes policy that of balance of payments equilibrium. As the room for maneuver diminished after 1979, the main contribution of the hard currency policy was its positive impact on the growth rate of labor productivity. However, a prerequisite for the feasibility of this strategy was that the Social Partners followed a long-term incomes policy which took into account the macroeconomic situation. This in turn was possible only because the Social Partners were strongly integrated in a national economic strategy. Dueker and Fischer (2000) abstract from the idiosyncrasies of the Austrian economic policy network, objectives, and instruments and reduce their analysis of the hard currency policy to two mechanistic “rules”: one inflation rule that states that Austria’s inflation rate should be close to Germany’s; one interest rate rule that governs the response of the Austrian short-term interest rate in the face of deviations of the Austrian inflation rate from the target level. Their results show that the “Austrian inflation target was essentially indistinguishable from Germany’s” (p. 2) and the OeNB increased the short-term interest rate more than necessary (i.e. implied by their interest rate rule) if the domestic inflation rate increased above Germany’s. That “over reaction” underpinned the credibility of the hard currency policy.

Pech (2002) stresses that a moderate incomes policy was more likely in a climate of low and stable inflation. The hard currency policy aimed at such a climate from the beginning through its impact on imported prices and on inflation expectations. He conjectures that an accommodating incomes policy could already be expected in the early 1970s given the institutional set-up of incomes policy in Austria, the Social Partnership. When financial markets became more integrated and capital accounts increasingly liberalized, the OeNB’s perseverance during the critical phase of the balance of payments deficit in the second half of the 1970s paid off. The credibility that the hard currency policy had acquired during that period was important for its success in the 1980s and 1990s.

The main conclusion in the literature is that the hard currency policy was an economic success which can be explained by the consensus orientation of the Austrian Social Partnership. (Only Glück, Proske and Tatom (1992) as well as Dueker and Fischer (2000) offer more mechanistic interpretations of the hard currency policy based on policy coordination with Germany that neglects the true problems of a peg: What are the real costs of maintaining the peg and to what extent are they politically sustainable?) The contributions to this volume add to that literature. First, it is argued that the complex set of instruments that was employed in implementing the peg attenuated the potential negative side-effects and distribution conflicts associated with nominal pegs in other countries. Second, the gradual approach to the liberalization of the financial sector and to the liberalization of the capital account played in important role in explaining the successful economic performance associated with the peg, because they helped to avoid financial crises which had caused large losses in terms of real GDP in many other countries with pegs. Third, the German mark peg is compared to another episode of a hard currency policy that caused high costs in terms of real GDP growth, employment and political instability. Here it is argued that in addition to the important role of the Social Partnership two other factors were important to explain the success of the hard currency policy: the good initial position of the Austrian economy around 1970 and the integrationist strategy associated with the hard currency policy. Fourth, the question emerges why the political integration into the European Union was so contested despite the broad consensus concerning the economic development strategy and the integrationist approach of the hard currency policy. Here it is argued that foreign policy considerations (rather than ideological or economic ones) impeded Austria's membership in the European Union until 1995.

In their introductory paper *Mooslechner*, *Schmitz* and *Schuberth (OeNB)* provide the wider context in which the papers of the workshop are integrated. They start with placing the OeNB in the context of the Austrian economic policy network after World War II (WW II). Then they provide a chronology of the OeNB's exchange rate policy from 1969 to 1999 with the objective to reconstruct the evolution of the German mark peg after the collapse of the Bretton Woods system. Was the evolutionary process (from the "indicator"-based exchange rate target to the German mark peg) driven by changing policy strategies or simply by a changing environment? In section three, they present evidence on the OeNB's motivation for the exchange rate policy over the period 1969 to 1999. They find evidence for the hypothesis that the evolution of the exchange rate target form the "indicator" to the German mark peg was driven by a changing environment rather than a changing policy strategy. Throughout that period the Bank adhered to its legal objective, despite recurring pressure from the exposed sector, but one foreign currency in the "indicator" after another proved to be an inadequate component of a nominal anchor to reach the legal objectives. In their final section, they turn to the question how the Austrian exchange rate target acquired credibility? They show that the OeNB employed a large and complex set of instruments to implement the target that helped to avoid some of the costs associated with it. Especially until the mid-1980s they helped to attenuate the negative side-effects of the hard currency policy. This helped to avoid seriously testing the consensus orientation of the Austrian economic policy network by exchange rate crises.

In his paper, *Ewald Nowotny (BAWAG P.S.K.)* addresses four issues. In the first section, he provides a brief overview of the Austrian economic history after WW II until the adoption of the euro. The main conclusions he draws are that the Austrian export-led growth strategy until the collapse of the Bretton Woods system period built on the strategic under-valuation of the schilling. After that the hard currency policy constitutes a fundamental shift: the choice of a nominal anchor with low inflation led to a low inflation rate, but also to real effective appreciations. In addition to monetary policy objectives (importing stability) this strategy followed structural ones.

In the second section, Nowotny analyzes the performance of the Austrian economy relative to that of France, Germany, Italy, Japan, the United Kingdom and the U.S.A. after 1970. The exercise rests on the comparison of the long-term evolution of four indicators (GDP-per-capita growth rates, inflation rates, unemployment rates and the growth of public debt). He concludes that the Austrian performance was very convincing in international comparison. In the third section, Nowotny discusses a theoretical foundation of the hard currency policy put forth in the 1970s: the Scandinavian Model of Inflation. In the fourth section, Nowotny raises an issue that has received little attention in the debate about the hard currency policy so far: many economies with exchange rate targets experienced financial crises since the collapse of the Bretton Woods system. How could Austria avoid that fate? He argues that the gradual and step-wise approach to the liberalization of the capital account and of the financial system helped to maintain financial stability.

*Hansjörg Klausinger (Vienna University of Economics and Business Administration)* discusses two episodes of Austrian monetary policy in the context of the history of economic thought over the 20$^{th}$ century. He distinguishes two broad categories of theoretical foundations: "classical" approaches that assume monetary policy as exogenous and place the burden of adjustment on real wage and price flexibility and "Keynesian" approaches that assume nominal wages and prices as given and place the burden of adjustment on monetary policy.

The conceptual framework rests on the "impossible trinity", which states that out of three policy objectives only two can be reached simultaneously: on the one hand, fixed exchange rates and capital mobility are incompatible with an autonomous domestic monetary policy. On the other hand, the latter can lead to exchange rate fluctuations, if combined with capital mobility.

Klausinger discusses the solutions of the "impossible trinity" under the Austrian experiences with the Gold Standard after WW I and the schilling exchange rate target after the collapse of the Bretton Woods system, respectively. What was the solution of the "impossible trinity" under the two episodes? What was the specific order of precedence between monetary policy and incomes policy? What were the potential conflicts of interest between long-term and short-term (monetary) policy objectives?

The discussion of the theoretical foundations of the first episode is based on the example of the Austrian School of Economics. It argued that the economy tends towards a welfare maximizing equilibrium if markets are liberalized. Monetary policy cannot improve upon such an outcome. On the contrary, it can only destabilize the economy. The optimal monetary order ensures the constancy of the money supply. The Gold Standard does not meet this criterion, but is preferred to alternatives, because it ensures the stability of exchange rates and de-politizes monetary policy which reduces its destabilizing effects. This monetary order solves the "impossible trinity" by abandoning the autonomy of monetary policy. Monetary policy dominates incomes policy in as far as the latter has to ensure price and wage flexibility to balance external imbalances. The long-term policy objectives dominate short-term policy objectives. Austria's economic performance under the Gold Standard after WW I was weak by international comparison. Klausinger argues that this was due to the bad initial situation of the Austrian economy in 1922, the low intensity of competition in Austria, and the lack of an institutional framework that ensured the consensual solution of conflicts of interest over the distribution of income.

The second episode – the hard currency policy after the collapse of the Bretton Woods system to the adoption of the euro – had similar characteristics as the Gold Standard after WW I. Especially after 1979, it combined capital mobility and stable exchange rates (vis-à-vis the German mark) with forgoing the autonomy of monetary policy. Again monetary policy took precedence over incomes policy and long-term policy goals dominated short-term ones. However, this time the approach turned out to be a success. Klausinger offers four explanations: first, the initial conditions were very good; second, the hard currency strategy was an integration strategy which implied an increasing intensity of competition; third, the OeNB did not attempt to follow autonomous monetary policy after 1979. In combination with the decreasing room for maneuver for fiscal policy this left incomes policy as the sole mechanism of adjustment. Fourth, incomes policy proved to cope well with this challenge. Klausinger explains this success by the centralized, corporatist institutional framework of wage setting.

Despite the broad consensus regarding Austria's economic development strategy, the conservatives and the socialists were deeply divided concerning the question of European integration. In his paper, *Oliver Rathkolb (Ludwig Boltzmann Institute for European History and Public Sphere)* provides an overview over the debate within the Social Democratic Party concerning European (economic) integration from 1945 to 1972.

Immediately after WW II, two camps dominated the debate: the first favored European integration as a visionary "socialist alternative" to both Stalinism and Anglo-American capitalism; the second emphasized the full sovereignty of Austria. Due to the immediate foreign policy objective to negotiate the pullout of the Allied troops the second camp dominated the SPÖ's foreign policy. European integration did not feature prominently on the party's agenda. Membership in the United Nations was considered more important and more realistic than the participation in the political process of European integration.

After the State Treaty of 1955, the debate took a new turn. The economic motives of European integration gained more importance. The pro-integrationist views in the SPÖ were voiced mostly by its economists, including Karl Waldbrunner. Many of them were affiliated with one of the institutions of the

Social Partners, which shared a pro-integrationist view early on. The skeptics were led by the party's foreign policy expert Bruno Kreisky. His argument was that Austria's full membership of the European Economic Community (EEC) would be in conflict with Austria's obligations in the State Treaty of 1955. In particular, Austria's neutrality would prohibit the country from joining the EEC. The first negotiations between Austria and the EEC concerning an association sparked protests from the U.S.A. and from the U.S.S.R.. Rathkolb emphasizes that within the SPÖ, foreign policy concerns outweighed the economic considerations of the Trade Union Federation and the Chamber of Labor.

Emerging from the debate was the SPÖ's position that Austria should seek a free trade agreement with other non-members and with the EEC. However, the first single party government (formed by the Conservative Party, ÖVP) resumed negotiations with the EEC in the late 1960s with the objective of a full membership. These encountered resistance from the U.S.S.R., France, and Italy. As a consequence, the government switched to a more realistic integration strategy towards a free trade agreement. This was concluded under the first socialist single party government in 1972 when Austria joined the European Free Trade Association (EFTA).

The volume concludes with a summary of the panel discussion on "The Room for Maneuver of National Economic Policy in a Globalized World". The panelists – politicians, central bankers, and economists – attempt to draw policy implications to address current issues from their experience with Austrian economic policy from the collapse of the Bretton Woods system to the adoption of the euro.

The editors gratefully acknowledge the excellent editorial assistance by Rita Schwarz and the outstanding research assistance by Ernst Glatzer, Wolfgang Harrer, Ronald Heinz and Beate Resch.

Peter Mooslechner
Stefan W. Schmitz
Helene Schuberth

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