Toward the First Decade of Economic and Monetary Union – Summary of the 36th Economics Conference

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The 36th Economics Conference hosted by the Oesterreichische Nationalbank (OeNB) on April 28 and 29, 2008, was dedicated to looking back on the first ten years of the euro and ahead to future challenges for Economic and Monetary Union (EMU). With contributions invited from both economic policymakers and academics, the conference was designed to foster an objective and informed debate on this significant chapter in recent economic history. The OeNB succeeded in bringing together high-ranking representatives of central banks, international and national policymakers as well as representatives of the business community and of academia.

The Euro: The Right Response to Globalization

In his opening speech, *Klaus Liebscher, Governor of the OeNB,* underlined that introducing the euro had been the right move for Europe in response to mounting globalization; just as joining EMU as a founding member had been the right thing to do, and a very important step, for Austria. With the Great Inflation of the 1970s in mind, policymakers had granted the Eurosystem a high degree of independence and a clear statutory mandate to maintain price stability as its primary objective when designing the new monetary constitution for Europe. Hovering slightly above 2%, euro area inflation had consequently been persistently low from the start of monetary union despite a number of price shocks. The success of EMU was not a given, though; making EMU work also required efforts in other areas of economic policy. A smooth functioning of monetary union was above all dependent on stringent fiscal policies and dynamic structural reforms. Governor Liebscher attributed the favorable macroeconomic developments in the first decade of EMU precisely to the euro and the Eurosystem's stability-oriented monetary policy. All countries participating in monetary union had benefited from the euro, and Austria in particular judging from the considerable welfare gains. Austria had been able to substantially improve its competitiveness, as reflected in robust GDP growth and a positive growth gap of roughly ½ percentage point against the euro area average in recent years. The euro had, indeed, given a fresh impetus to Austria's internationalization. Furthermore, the enlargement of the EU, and of the euro area, had been and continued to be most important for Austria as well. Governor Liebscher reiterated that the Eurosystem was open to further members, subject to the principle of equal treatment with the current euro area members when it came to assessing whether prospective members had met the convergence criteria. Recent inflation developments had forcefully driven home the message that monetary and economic policymakers needed to remain watchful of underlying inflation trends. Contrary to some predictions of an end to inflation, recent developments had emphasized the continued need for vigilance. The OeNB was proud to contribute to the success of EMU.

Call for Reforming EU Economic Policymaking Structures and Strengthening the Social Agenda

In his opening address ("The Euro in an Enlarged EU – An Austrian Perspective"), *Alfred Gusenbauer, Chancellor of the Federal Republic of Austria,* confirmed that the euro was working effectively and had asserted itself well as an international currency. Credit for this internationally acknowledged success story was due above all to the ECB – whom the chancellor congratulated on its tenth anniversary – and the national central banks (NCBs). Gusenbauer presented five propositions: *First,* the European Social Model should be included in the Lisbon reform agenda. *Second,* notwithstanding some progress, economic policy coordination would need to be enhanced further. Above all, it would take a framework to design economic stimulus packages in concerted action if required. *Third,* the euro exchange rate should not be the responsibility of central banks alone; there was a broader need for closer monitoring and coordination. *Fourth,* the external representation of the euro area should be improved, and the international financial architecture should be reinforced. Policymakers should consider establishing a global regulatory body – a world financial organization – within the framework of the Bretton Woods institutions. *Finally,* the chancellor called for the introduction of a tax on financial transactions. He concluded with a plea for resolute action in policymaking, based on bold vision. Getting European citizens to accept the EU more wholeheartedly called for renewed political confidence in Europe.

Acclaim for the ECB's Stability-Orientation – Need for Open Markets and Low Inflation

Wilhelm Molterer, Vice Chancellor and Finance Minister of the Republic of Austria, praised the euro as an anchor of stability-oriented policymaking in Europe. The euro required member states to strive for greater coherence of their economic policies. Looking ahead, Molterer singled out six issues: *First,* he called for a clear commitment to the ECB's stability policy, to its price stability objective and to its independence. Putting any of those principles in question would be the wrong conclusion from the current financial turmoil. *Second,* market liberalization rather than protectionism was the right response to the slowing of the economy – above all also with regard to labor market issues. *Third,* to successfully combat inflation, competitiveness and deregulation needed to be enhanced further. *Fourth,* there was a need for tax relief measures, above all for a reduction of the tax rates on labor – without jeopardizing fiscal discipline, though, because fiscal discipline was of the essence for stability-oriented policymaking. *Fifth,* the power to innovate had to be strengthened. Molterer showed concern about the mounting unwillingness to embrace change in the EU and in Austria. *Sixth,* global markets needed global rules, which is where the IMF had an important role to play. At the same time, so as not to paralyze financial markets they must not be overregulated. The Vice Chancellor called EMU a success story that was without a true alternative, which had helped turn Europe into a reliable and key anchor of global stability, and he concluded with congratulations on the good functioning of the ECB.

The Eurosystem Works Smoothly, Is Efficient in Crisis, and Has Fast Achieved a High Degree of Credibility

Jean-Claude Trichet, President of the ECB, addressed the track record of the ECB and on the challenges lying ahead for the Eurosystem. He noted that the ECB had rapidly become a mature institution, and that the Governing Council of the ECB was working smoothly and efficiently. Good and efficient cooperation among the ECB and the NCBs in numerous committees and working groups was highly significant for the achievement of shared Eurosystem decisions. This close and professional interaction had also been critical for the good start of EMU and for the smooth changeover to the euro. Over the years, the Eurosystem had established a high degree of credibility, having successfully withstood such tests as the bursting of the Dot-com Bubble or the terrorist attacks of September 11, 2001. The progressive integration of new members into the euro area had worked well. Thus, inflation had remained in a tight vicinity of 2% over the past ten years. By the time the financial turmoil hit in mid-2007, the Eurosystem had repeatedly been warning against such developments. When those risks materialized, the ECB reacted immediately with a sequence of fine-tuning operations, in order to keep the very short-term money market rates close to the main refinancing rate and to contain spreads in the longer-term segments of the market. President Trichet stressed that those liquidity operations had not changed the monetary policy stance of the Eurosystem – which remained anchored on maintaining price stability over the medium term. It was after all beyond the power of money market operations to eliminate the underlying causes of the tensions. The recent developments had shown that the ECB had adopted the right monetary policy stance: flexible action guided by a steady and unwavering compass.

The ECB Fulfills Its Stability Mandate; Combating Inflation Is a Social Policy Measure

Jean-Claude Juncker, President of the Eurogroup, shared his views on "EMU and EU Policymaking – Intelligent Design or Learning by Doing?" He addressed the astonishing difficulty of successfully communicating the euro's manifold advantages and the numerous benefits of EU integration and EU enlargement to the general public: After all, the euro had entailed remarkable savings in transaction costs, intra-European exchange rate tension had been eliminated, fiscal rules had managed to bring fiscal deficits down considerably, inflation had dropped significantly, and the interest rate level had fallen visibly below pre-EMU levels. Despite some progress with reform, major anti-reformist forces remained in Europe that would make key structural reforms unpopular. Juncker argued that counterinflationary measures were in fact social policy measures, since the socially marginalized suffered most from high inflation. The ECB had succeeded in fulfilling its price stability mandate and in anchoring inflation expectations at low levels, thus justifying the confidence placed in it. Yet combating inflation was not an issue for the ECB alone; wage settlements needed to be kept in line with productivity growth.

The EU's Economic Policymaking Structures Reflect What Is Politically Feasible

Coordinating European economic policies was a tall order according to Eurogroup president Juncker. While the negotiations on the Treaty of Maastricht had been informed by a consensus on a single monetary policy, the policy frameworks for a single economic policy were found to differ too strongly. Therefore, the responsibility for economic policy had remained with the Member States – subject to a variety of coordination mechanisms. Despite the lack of consensus on a uniform perspective among the members of the Eurogroup, there was still a need to exert a high degree of verbal discipline in communicating national policies, which is why the Eurogroup had started to negotiate "terms of reference" on central issues. While this "weak form" of economic policy coordination was not ideal, it reflected the political reality of Europe today.

World Economy and Euro Area Economy to Decouple from U.S. Economy?

Edward P. Lazear, Chairman of the Council of Economic Advisers (U.S.A), sketched a not so pessimistic picture of current economic developments in the U.S.A. as the debate in the media or some forecasts would imply. Lazear stressed that the U.S.A. was not experiencing another Great Depression, and most probably not even a recession. The economy was growing, and the unemployment rate continued to be low at a level of just a little above 5%. He was positive that the fiscal stimulus package approved in February 2008 was going to boost the economy in the second half of the year. Real estate prices had peaked already in 2006, long before the onset of financial market turbulence. The latter had triggered a rapid adjustment of risk premia on asset-backed securities, and many people had lost their jobs as a result of the troubles in the financial sector. Yet on balance, the tightening of credit standards need not necessarily have adverse effects, even though investment had been dampened. Unlike in the past ten years, U.S. output growth was benefiting from the robust global economy in 2007, above all from the momentum in emerging markets. Ultimately, Lazear did not see the global economy or the EU economy decoupling from the U.S. economy for the U.S.A. were too big an economic power and had too many ties with the rest of the world.

Klaus Liebscher Prize Awarded to German and Austrian Researchers

Following the morning session, the Klaus Liebscher Prize for excellent scientific papers on European monetary union or European integration issues was awarded for the fourth time. This year's winners were *Kerstin Gerlach, University of Mannheim,* who received the prize for her paper on the economic policy theory of international financial integration; as well as *Silvia Rocha-Akis* and *Aleksandra Riedl,* both *Vienna University of Economics and Business Administration,* who received the prize for a joint paper on the theory and empirics of tax competition in Europe. *Executive Director Josef Christl* introduced the prize winners and their papers, while *President Herbert Schimetschek* recalled the history and intentions of the Klaus Liebscher Prize. Following two short presentations of the papers by the winners themselves, the prizes were awarded by *Executive Director Christl* and *Governor Liebscher.*

Fruitful Dialogue between Economic Scientists and Policymakers in the First Decade of EMU

Charles Wyplosz, Graduate Institute of International Studies (Geneva), assessed the first decade of EMU: "What Have Academics Learned from the Experience of EMU? What Has EMU Learned from Academics?" From a political perspective, monetary union had followed from the EU's Single Market by sheer necessity: Capital liberalization and fixed exchange rates were simply not compatible with independent monetary policies of the individual nation states. In the academic debate, monetary union had mostly been discussed against the background of the theory of optimum currency areas (OCA theory), yet it had taken a while for OCA criteria to be acknowledged in the political debate as well. In contrast, with regard to the Stability and Growth Pact, politicians had moved ahead and had designed such a pact before the academic debate had actually gotten fully underway. The political rationale had been to avoid, first, the monetization of public deficits through central bank financing and, second, national deviations from fiscal discipline. While those arguments had been acknowledged in principle in the academic debate, the actual design of the Stability and Growth Pact had been subject to much controversy among academics. The major points of criticism were that the exceptional circumstances under which debt and deficit thresholds may be exceeded had been defined too narrowly, and that the pact did not distinguish between different purposes of debt usage. Some but not all of those points of criticism had been taken up by politicians. Furthermore, academics often also criticized the ECB's two-pillar strategy. De facto experience with EMU in the first ten years had repeatedly shown that the ECB's monetary policy was broadly in line with current developments in theory, and that this debate much rather had the character of a discussion of principles. According to Wyplosz, politicians and academics had indeed displayed an ability to learn from each other. With regard to EMU, politicians invariably moved faster than academics, but the dialogue had been intensified, and the integration of the two areas had strongly deepened and improved, not least as a result of the great research efforts made by the central banks themselves.

Effects of Monetary Union Have Materialized as Expected; Looking Ahead to Guaranteeing the Future of the Euro

The subsequent panel discussion dealt with various substantial aspects of EMU, such as enlargement, financial integration, the impact of EMU on trade, and guaranteeing the sustainability of the euro.

Mathilde Maurel, Université Paris 1, tackled EMU enlargement issues, above all the need to bridge the gap between the criterion on price stability that candidates have to meet as a prerequisite for EMU accession and the strong output growth fueled by the catching-up process, which raises inflationary pressures. She discussed the possibility of and the rationale for adjusting the convergence criteria to the specific situation of the catching-up countries. From Maurel's point of view the accession criteria were endogenous and would thus be fulfilled upon the introduction of the euro. Therefore she did not consider an early enlargement of EMU to pose a risk for monetary union and its goals.

Philip Lane, Trinity College Dublin, first showed that the elimination of intra-European exchange rate risks had considerably boosted the integration of the interbank market and of the money market. Likewise, EMU was an asset for formerly national stock markets, and it had fueled FDI flows between the euro area countries and driven up bond market issuance substantially. At the same time, major catching-up needs remained in the retail segment, but the outlook for integration was bright in this area as well. In a second step, Lane discussed the macroeconomic implications of financial integration. Although enhanced integration had made risk allocation more efficient within EMU, other forces had acted in a countervailing fashion. In the long term, EMU would benefit from greater financial integration.

Cross-checking the positive effects of EMU on trade anticipated and broadly discussed ex ante, *Andrew K. Rose, University of California (Berkeley),* summarized conventional wisdom on the quantitative effects of EMU on trade that had actually materialized, based on a systematic review of the empirical literature of the past ten years. His key finding was that EMU had caused trade to grow by at least 9% and probably by as much as 21%, and that this effect was likely to intensify over time. In addition, the growing interlinkage of trade increased the coherence of business cycles, thus preparing the ground for an optimum currency area; yet the empirical evidence was limited so far, given the lack of long data series.

Next, *Charles A. E. Goodhart, London School of Economics,* posed the question "Is the Euro Sustainable?" and discussed four scenarios that could possibly threaten the existence of EMU: The first scenario was Germany exiting from EMU because it was being pushed to deliver inflationary policies. As a *second* scenario, he described the possibility of a number of Eurogroup finance ministers bringing pressure to bear on the ECB to drop its anti-inflationary policy. As a *third* critical scenario he mentioned an anti-euro party carrying the majority of popular votes. A *fourth* scenario might be a feedback effect stemming from widening and mutually reinforcing interest rate differentials that caused weaker Member States to feel the costs of EMU membership more strongly. According to Goodhart, the euro might indeed become unsustainable if those effects were all to materialize at the same time. However, he considered such a turn of events to be highly unlikely; and the probability of such a result might be reduced further as the political union deepened and as the labor markets became more flexible.

Banking Supervision: Basel II Supports Adjustment to New Challenges

Arnout H. E. M. Wellink, President of De Nederlandsche Bank and Chairman of the Basel Committee on Banking Supervision, explored the issue of "Banking Supervision in the Euro Area: Experiences, Challenges and Prospects." He considered three developments to be instrumental: Banks had become increasingly market-dependent, had increasingly embarked on international operations, and the banking sector had become more concentrated. President Wellink explained how the new Basel II Accord, which had been fully implemented in the EU in the form of the Capital Requirements Directive only since early 2008, might facilitate adjustment to those developments: Above all, Basel II raised the risk sensitivity in capital adequacy calculations, made off balance sheet exposures subject to regulatory capital charges as well, and enhanced the disclosure of banks' securitization activities. President Wellink rejected criticism leveled against the procyclicality of the new Capital Requirements Directive and – addressing lessons learned from the recent financial turmoil – stressed that the Basel Committee stood ready to make the necessary adjustments to the framework. Looking ahead, Wellink highlighted the challenges for banking supervisors following from the internationalization of the banking industry. He was in support of continuing to build on the existing institutional structures but skeptical about the creation of a pan-European supervisory structure in the near term. With regard to ensuring an effective interplay between supervisors and central banks, President Wellink considered it difficult to draw a line, in practice, in a modern financial system between the responsibility for systemic stability and that for prudential supervision. Effective cooperation between supervisors and central banks required close and continuous information sharing. Important synergies created by combining prudential supervision tasks and the responsibility for financial stability reinforced the arguments for bringing both responsibilities as closely together as possible.

Historic Experiment of EMU Has Been a Success, but Major Challenges Remain

Hans Tietmeyer, Former President of the Deutsche Bundesbank, explored "Economic and Monetary Union from a Historial Perspective," looking back to when the very idea was first voiced in 1961, and ahead to future challenges. Making EMU happen had been the result of a protracted and at times controversial convergence process merging divergent economic and monetary conceptual frameworks. The decisive breakthrough had been made possible by the efforts of outstanding politicians; at the same time historic framework conditions – the Single Market, the fall of the Iron Curtain and German reunification – had provided crucial incentives to realize the EMU project. Notwithstanding the heterogeneous background of the key players and central banks involved, the Eurosystem had been successful in fast establishing its credentials. The key foundation for the Eurosystem's credibility was its tried and tested independence from political influence, which was particularly important and remarkable given the system's diverse background. Tietmeyer stressed that, so far, the catalytic power of the euro with regard to deepening economic union had been limited: It had not been possible to fully implement the Stability and Growth Pact, the Lisbon process was yet to bring substantial progress, and the integration of labor markets was as yet highly rudimentary. More analytical transparency and a stronger role for the European Commission might move reform along. According to Tietmeyer, monetary union did not presuppose uniform political conditions, but the latter must not distort competitive conditions in the long run – a social union that reinforced rigidities rather than weakening them was not compatible with a monetary union. EMU was such an important milestone in history that failure or turning the clock back was out of the question. Referring to the enlargement of the euro area, the former Bundesbank president observed that the convergence criteria had been applied almost too loosely so far. Current inflation was – still – astonishingly low. Yet the inflation-dampening impact of globalization was vanishing. Finally, the ECB had been implementing better monetary policies than the U.S. Federal Reserve System, but it might have moved faster to raise key interest rates on occasion.

Austria's Hard Currency Policy Continued with EMU and the Euro

A panel discussion among economic policymakers on "Austria and EMU" concluded the conference. *Christine Marek, State Secretary in the Federal Ministry of Economics and Labour,* saw the stability-oriented policy of the Eurosystem as a continuation of Austria's hard currency policy. EMU had strengthened the European economy and supported macroeconomic developments. The euro was a strong reserve currency, and financial markets in the euro area were powerful. The ECB had a proven track record in fulfilling its price stability mandate, which Marek supported wholeheartedly. Yet currently high inflation rates were a cause for concern; it was important not to set off a wage-price spiral. Austria had benefited from EMU above all through enhanced integration into the world economy and the resulting boost for output and employment growth. The Treaty of Lisbon was important for making cooperation among the EU-27 more efficient, for bringing the EU closer to its citizens, and thus for the future evolution of the EU.

Keeping Up the Reform Momentum in Economic Policymaking in Austria Is Essential

Markus Beyrer, Secretary General of the Federation of Austrian Industry, stressed that being competitive as a location was even more important in a currency union. While Austria was doing quite well in international location rankings, there had, however, been signs of reform fatigue lately, which is why efforts to maintain Austria's attractiveness as a business location would have to be intensified. The ECB was on the right track in steadily implementing its stability policy, although doing so was not always easy in the short term. The important thing for economic policymaking was to aim at sustainability – and in this respect rules were helpful. In the field of monetary policy, Europe had bid farewell to activist reaction patterns motivated by short-term goals, instead taking its cue from the Deutsche Bundesbank as the best practice model. Beyrer noted that, in monetary policy matters, Austria had a much longer track record in sustainability than in fiscal policy matters. EMU had triggered a fiscal policy turnaround in Austria – initially out of short-term considerations with a view to being among the founding members of EMU. With the reform of its budget system law, Austria was on the right track, but the envisaged efforts would not suffice to overcome the major spending blocks looming ahead. The thing to do was to move from a spending-oriented revenue policy to revenue-oriented spending. Open issues included above all the latest softening of the pension reform, the health care reform, the administrative reform and the Austrian Stability Pact. Generally speaking, fiscal policy would need a stringent framework similar to that established for monetary policy. Opening the Austrian labor market only gradually to the Eastern European EU citizens was a major mistake of Austrian economic policy. If Austria wanted to excel in bringing companies to set up their headquarters here, it would at the same time have to be open to skilled workers from abroad.

Euro Helps Avoid the Disadvantages of a World without the Euro

Georg Kovarik, Chief Economist of the Austrian Trade Union Federation, emphasized that EMU had brought Austria more stability and security in times of financial turmoil. The main advantage of EMU was that it spared us the disadvantages we would have without it. Wages were growing more slowly now. While the past few years had undoubtedly been marked by economic recovery, numerous people did not see themselves as benefiting from growth. Even employer associations had been criticizing the ECB of wielding too restrictive a policy more recently. The economy was expected to slow down soon, among other things because the euro exchange rate was too high. While inflation was somewhat above 3%, core inflation was only somewhat above 2%. As inflation was internationally driven by commodity price increases, a high-interest policy was not the right instrument to contain inflation. The EU would benefit from a better coordination of policies among central banks, social partners and governments. The macroeconomic dialogue of the EU was in urgent need of reform. With regard to the gradual opening of the Austrian labor market to Eastern European workers, Kovarik argued that the market was already open to skilled workers. The immediate opening of the labor market in the United Kingdom and in Ireland had also had undesired consequences, such as a brain drain in Eastern Europe. Austria's citizens would not understand the rationale for a more rapid liberalization.

EMU Skeptics Have Been Proved Wrong

Bernhard Felderer, Director of the Institute for Advanced Studies, recalled that according to OCA theory, the optimum currency area was defined such that EMU should never have been created in the first place. Yet so far putting the cart before the horse had, indeed, been very successful. Contrary to critics' predictions, EMU had entailed a sustained and broad convergence of interest rates at low levels – benefiting also the hard currency block countries originally united in the European Monetary System. The predicted current account problems had not materialized, by and large. Moreover, EMU had led to a marked improvement of fiscal balances. General government debt had gone down across the board, with some countries having made particularly great progress. Yield spreads between government bonds had also narrowed considerably. While the smaller euro area countries had been better at coping with the pressures arising from globalization, there was an urgent need for swift reform also in the larger countries. Last but not least there was a need to reconsider the size and the role of government, and to reduce the tax burden on labor.

Euro Has Entailed Numerous and Major Advantages for Austria; Intensified Competition Has Contained Inflation

Karl Aiginger, Director of the Austrian Institute of Economic Research, argued that EMU had pushed up growth by 1.7% in five years, or by 0.3 percentage points each year. Thanks to EMU, inflation volatility had been generally reduced to the low German level, and growth and unemployment were subject to less uncertainty these days. The Austrian economy had again been outperforming the euro area economy in recent years, and the current account was now firmly in surplus. Since Austria's participation in EMU, the domestic inflation rate had been significantly lower than in the decade before. As was to be expected, Austria's unemployment rate had become more closely aligned with that of the EU. Austria had turned from a technology taker to a frontier economy, and had risen to the opportunity of its changing geo-economic position. In the next ten years, migration, climate change, income and wealth issues as well as the aging of society would dominate the debate. Aiginger argued that the economic momentum of Austria's neighbors, the catching-up potential and the size of the BRIC countries (Brazil, Russia, India and China) and a controlled flexibilization of the labor market were offering opportunities. In the public sector it was important to check objectively whether the private sector might not be in a position to provide some services in a better way and at a better price. The currently high inflation rates were to be seen against the backdrop of the ample liquidity supply worldwide; commodity price increases were being passed on to end products, and there was not enough competition in the energy sector. This was the hour of competition policy; fiscal policy and monetary policy were not in a position to contribute much to combating inflation under the current circumstances.

It Takes More Reforms to Keep Up the Success of the Euro

Josef Christl, Executive Director and Member of the Governing Board of the OeNB, identified a broad consensus on the success of the euro, as evidenced by numerous before-EMU and after-EMU comparisons of economic indicators. Monetary union had also contributed substantially to the completion of the Single Market. Price transparency had increased, transaction costs had gone back, and competition had been stimulated. Thus, monetary union had delivered exactly as promised. Christl argued that the past few months in particular had highlighted the monetary union's role as a protective shield against turmoil and shocks. EMU had amply proved to be a stability anchor for the European economy and for the EU. At the same time, Europe had gained in visibility worldwide with the euro. The results presented at the conference justified the introduction of a single currency in Europe, and they also justified the confidence in the future of EMU and were biding well also for the success of further enlargements of the euro area. The ECB was contributing to the integration of the European economy by enhancing transparency and by making monetary policy more predictable. The ECB had swiftly asserted itself as a credible guarantor of stability. Yet challenges remained, including above all the divergent development of unit labor costs. Here, politicians were called upon to take the necessary action for change. For a flexible and competitive European economy, it was necessary to implement the Lisbon agenda as soon as possible, and to start thinking about the post-Lisbon process. In the realm of fiscal policy, it was important to strengthen the preventive arm of the Stability and Growth Pact. The EU required more effective institutional structures: Vis-à-vis the rest of the world, the significant and growing role of the euro would need to be matched by a more active role of Europe in international forums.