OESTERREICHISCHE NATIONALBANK

Stabilität und Sicherheit.

Eurosystem, Monetary Policy and European Integration

Conference on “EMU Governance and Euro Changeover: Slovenia on the Path to the Adoption of the Euro”

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Outline

- The **historical roadmap** of European (monetary) integration
- The Eurosystem: **stability architecture** and monetary policy framework
- The **strategy of enlargement**: 3 steps to the euro
- **Policy challenges**: convergence - monetary policy - cash changeover
- **Policy conclusions**(?)

European (economic) integration

History = ongoing process of **deepening** and **enlargement** of the EU

Start	Today	Future
EC (European Communities) narrowly focused cooperation (raw materials)	EMU (Economic and Monetary Union)	Constitution (?) Political Union?
Founded by 6 member states in 1952	Comprising 25 countries and 460 million citizens	2 acceding countries (Bulgaria, Rumania) 2 candidate countries (Turkey, Croatia) More potential candidate countries

A “logical roadmap“ of regional integration

Balassa-sequencing (1962)

- From **free trade area** to
- **customs union** to
- **internal market** to
- **currency union**
- Incentives for further political integration – **political union**?

3 stages of monetary integration

Stage 1 Completion of the Internal Market	**Stage 2** Enhanced economic and monetary co-operation	**Stage 3** The Changeover
1990–1993	**1994–1998**	**1999–2002**
Integration of financial markets and liberalisation of capital movements 1992: Maastricht treaty → provisions on EMU 1992/93: EMS crisis	1994: European Monetary Institute – Independence of NCBs – Co-ordination of monetary and fiscal policy 1996: Stability and Growth Pact 1998: ECB established 11 initial euro area members determined	Irrevocable fixing of exchange rates Introduction of the euro as non-cash currency Single monetary policy by ESCB 2002: Cash changeover coins and banknotes

The euro area’s stability architecture

Prosperity

1st Pillar	2nd Pillar	3rd Pillar
Monetary stability	**Sound public finances**	**Dynamic Structural policies**
Independent ECB • stable currency • low inflation rates	Stability and Growth Pact • Discipline • Sustainability	EU-Lisbon Agenda • Flexibility • Innovation • Competitive-ness

Monetary stability: a reminder

The primary objective:

Article 105(1) of the Treaty

- "*The primary objective of the* [Eurosystem] *shall be to maintain price stability*".
- "*Without prejudice to the objective of price stability, the* [Eurosystem] *shall support the general economic policies in the Community*".

Monetary policy strategy of the Eurosystem

The quantitative definition of price stability

Economic analysis

Identify short to medium-term risks to price stability

Analysis of shocks

Projections

Cross-check

Monetary analysis

Assess medium to long-term trends in inflation

Wide range of monetary indicators

Monetary policy strategy characteristics

- ✓ Forward-looking
- ✓ Medium-term orientation
- ✓ Focus on area-wide developments
- ✓ Overall assessment instead of mechanical reaction
- ✓ Stability orientation

Why a monetary strategy?

- Build confidence, stabilize expectations
- Transparency, communication
- Systematic framework for organizing economic information
- Historical experience, tradition

The real world: monetary policy under uncertainty

– Data uncertainty (revisions)
– Model and forecast uncertainty
– Economic shocks (type, extent, permanent or temporary, effects)
– Effect of interest rate changes (how large? how quick?)
– Divergent signals from indicators under review
– No “simple rules”
– Tendency toward “gradual” interest rate changes

Who benefits from a common currency?

Optimal Currency Area (OCA) theory:

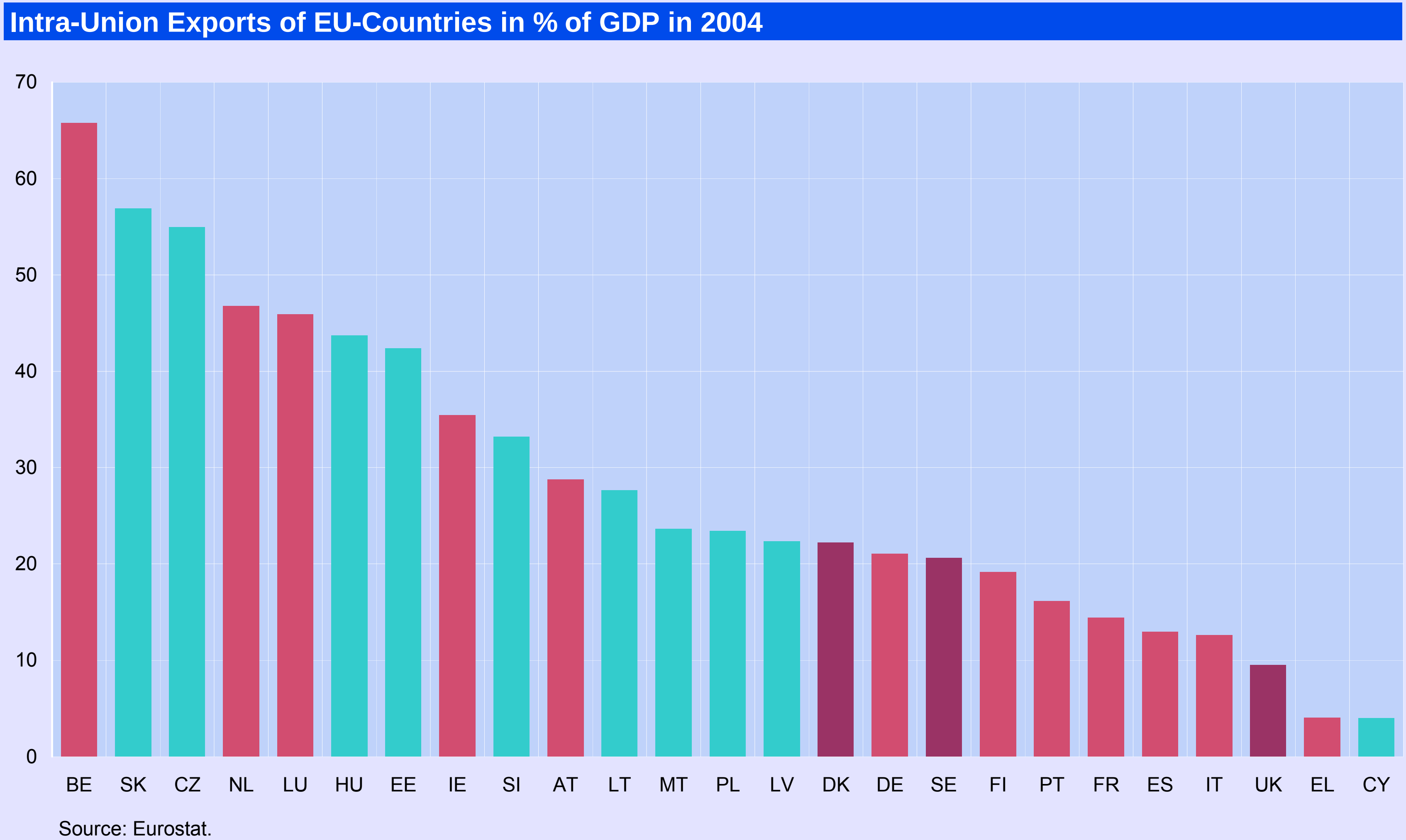
(Mundell, McKinnon, Kenen)

Countries will profit more from joining a currency area

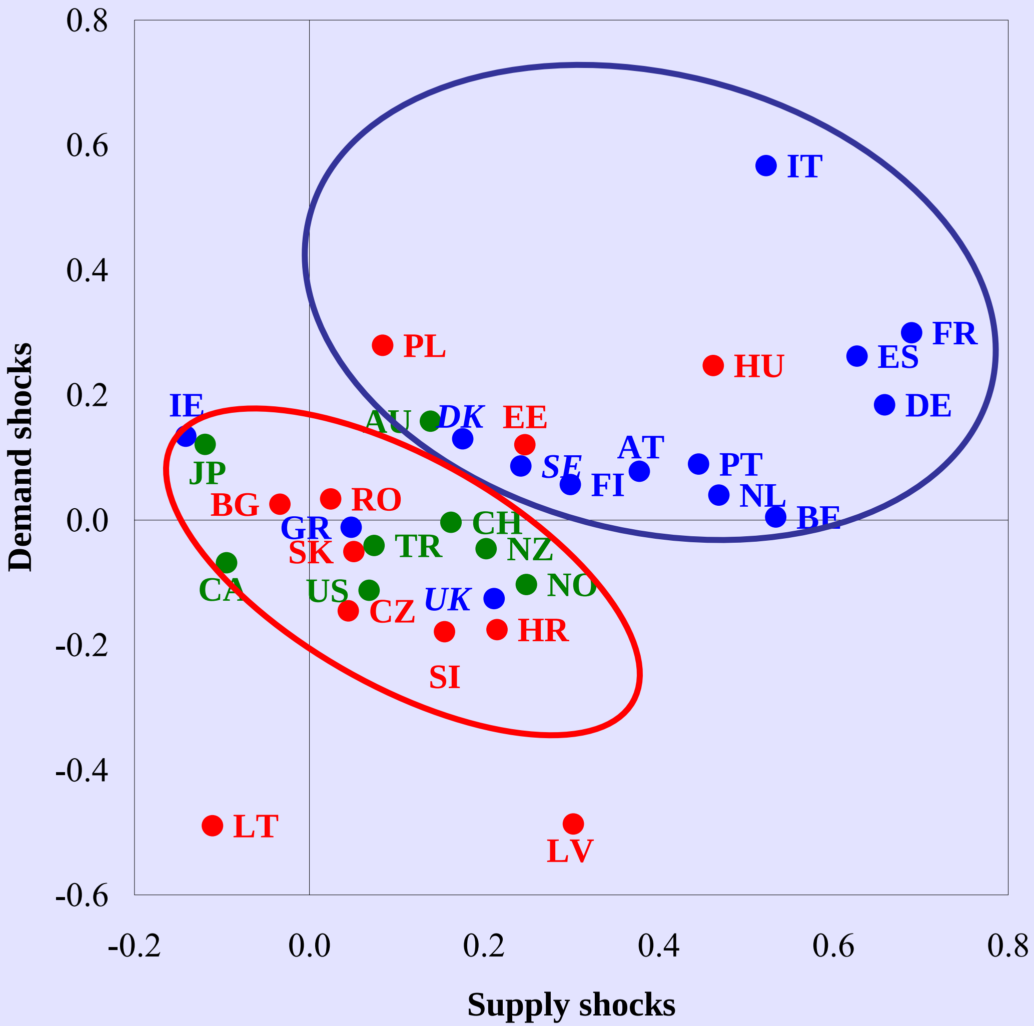
- the more **open** they are,
- the closer the **trade links** are,
- the higher the **degree of business cycle synchronization** is
- the more **flexible** the economy is (labor and capital mobility, wage and price flexibility)

Meta criterion: similarity of shocks and the quality of policy responses to shocks.

Degree of openness of EU countries



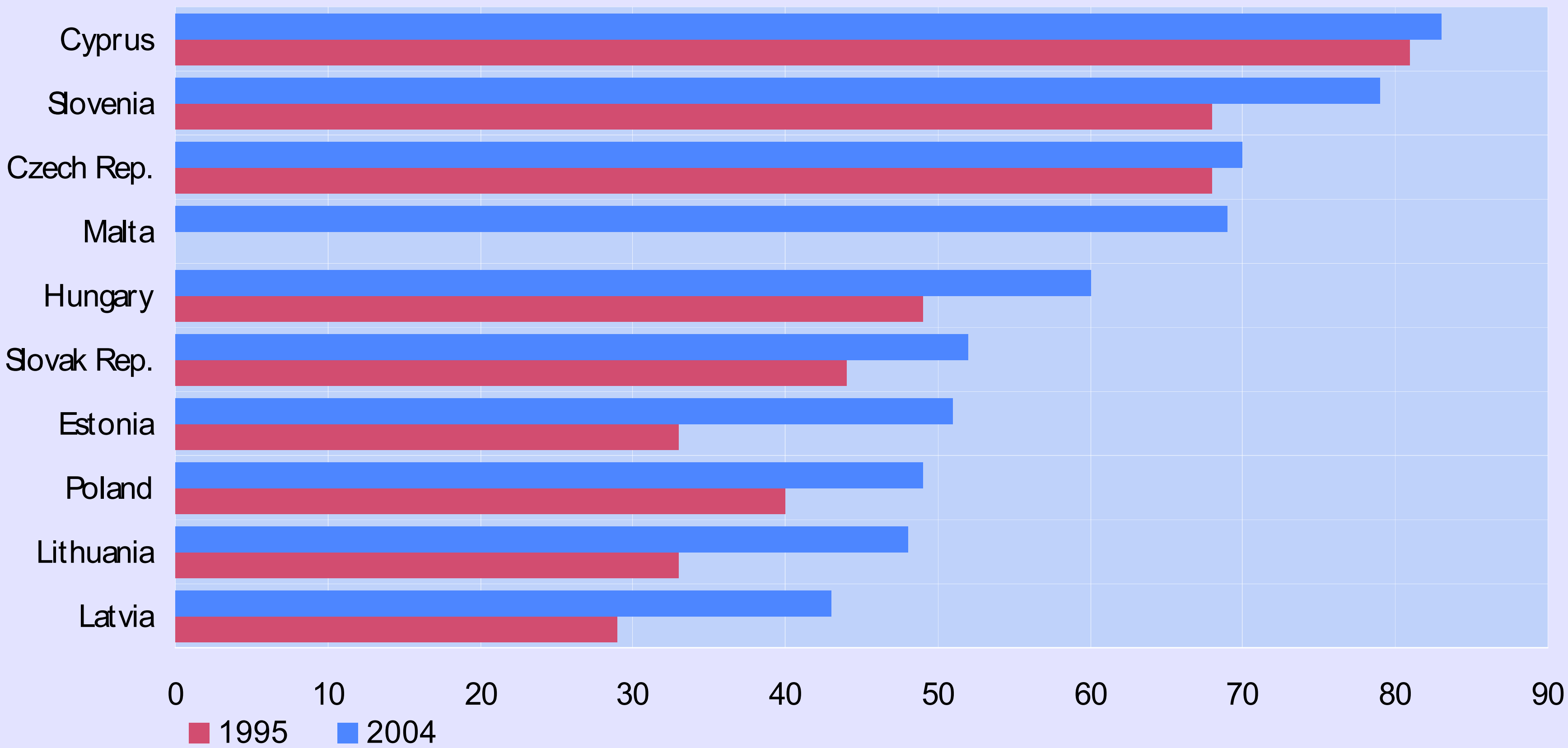
Synchronization of business cycles



Fidrmuc & Korhonen (2003): Similarity of supply and demand shocks between the euro area and the CEECs

Income levels converging

Per-capita income in % of the EU-25 average (at PPP)



Source: Eurostat.

EU enlargement and the way towards the euro

Process in three steps:

1. EU membership
2. Participation in the exchange rate mechanism (ERM II) for at least two years (with no devaluation and without severe tensions)
3. Adoption of the euro after fulfillment of convergence criteria

The convergence criteria require

- Stability-oriented monetary and fiscal policies plus flexibility in policies and structures

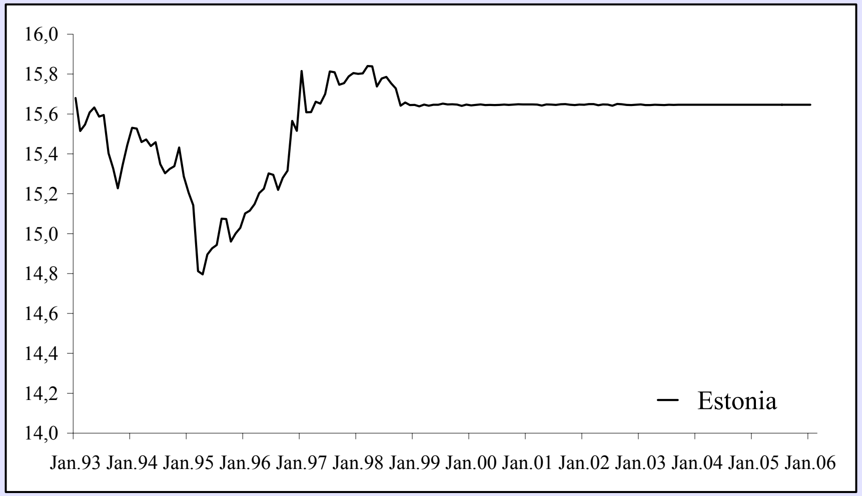
1st step: Accession to E(M)U

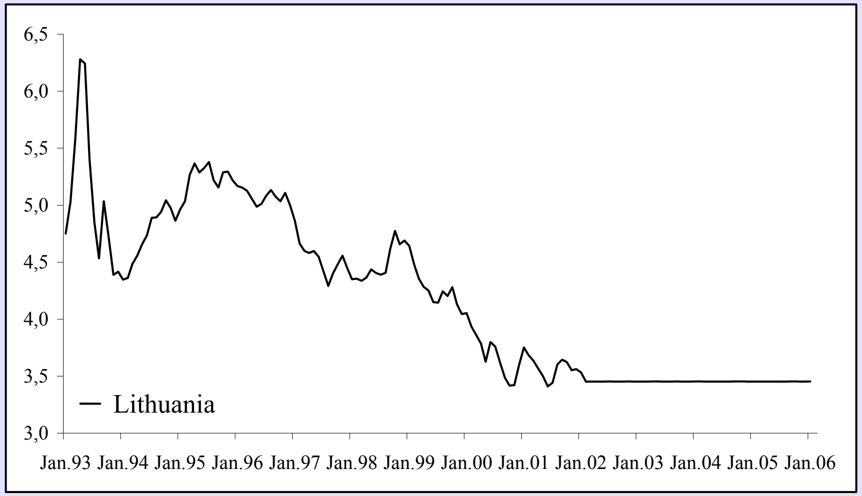
- Central banks represented in the General Council of the ECB
- **Treat exchange rate policies as a matter of common interest** so that internal market is not disturbed by foreign exchange policies (no competitive devaluation)
- Bring economic and monetary policies into line with the overall goals of EMU
- Participate in the **coordination of economic policy**
- Participate in the multilateral fiscal surveillance, convergence programs

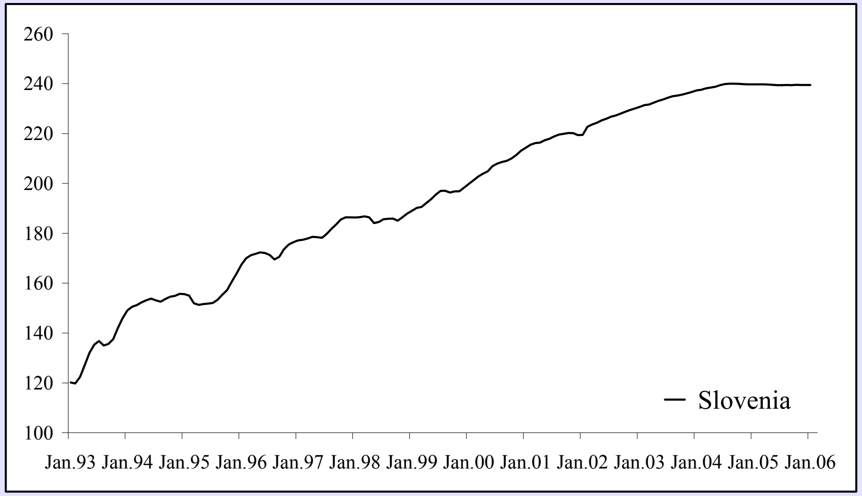
2nd step: ERM II

- Features of ERM II:
  - **Fixed parity** with respect to euro, standard width of ±15%
  - Interventions within the bands and at the edges of the band
  - Intervention in principle automatic and unlimited, however suspension allowed if in conflict with price stability
- Aims of ERM II:
  - Helps orientate **policy towards stability**
  - Promotion of real and nominal convergence
  - Shields unjustified pressure on the foreign exchange market
- Accession to ERM II at any time
  - Needs agreement concerning band widths and fixed parity
  - Possibility of **unilateral commitment** to a more narrow band

Countries that joined ERM II on June 28, 2004







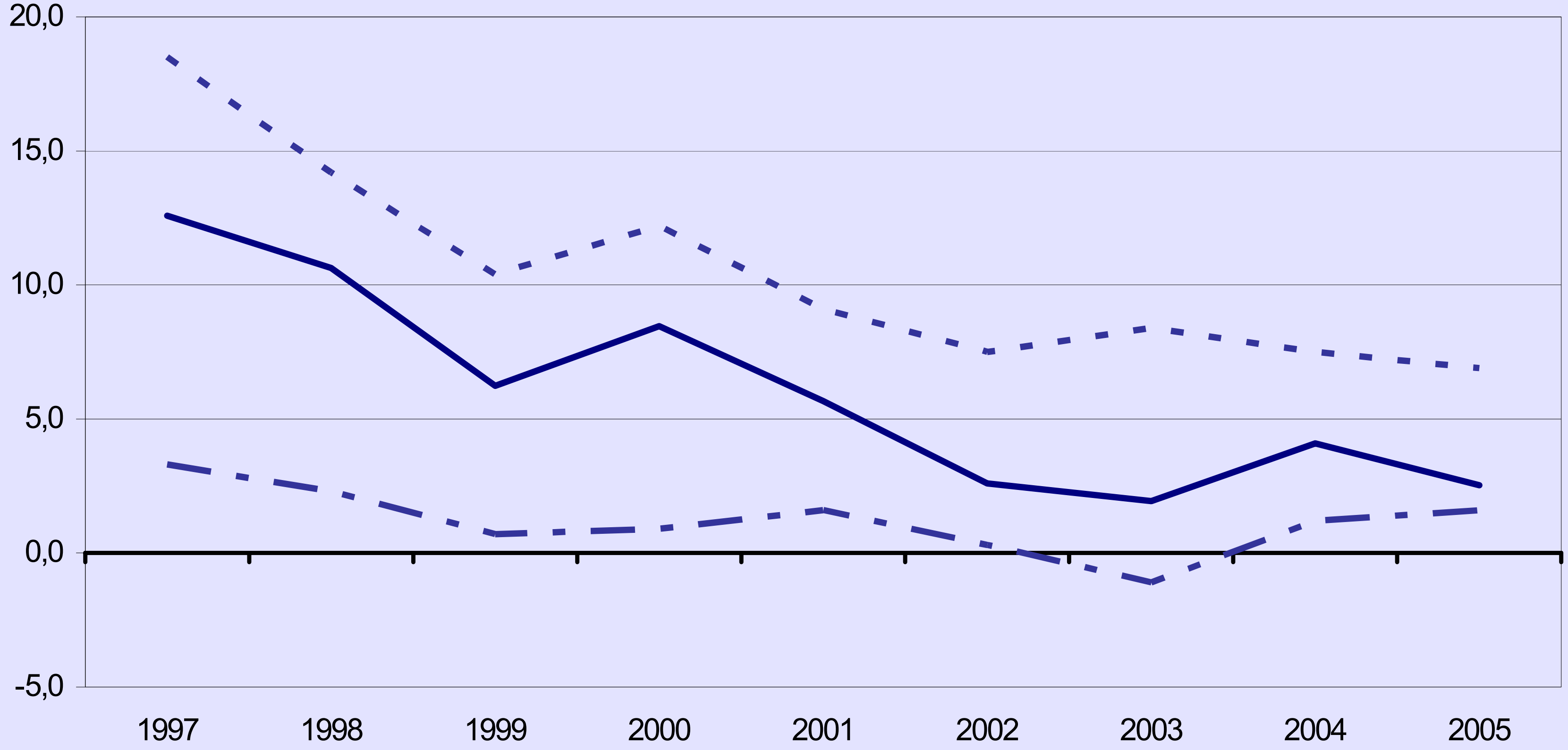
3rd step: The euro adoption

- Euro adoption only after **fulfillment of Convergence Criteria**:
  - High degree of price stability
  - Sound public finances
  - Successful participation in ERM II
  - Low long-term interest rates
  - Independence of national central banks
- **Sustainable nominal convergence**
- **Equal treatment** principle
- **„Soft criteria“:** integration of the markets, unit labor costs, current account deficits

Price stability criterion

Lowest, highest and average HICP inflation
in the new Member States

(y-o-y changes, Eurostat country weights)



Source. Eurostat, Own calculations.

Challenges for monetary policy

- **Real convergence and high GDP growth**
  - Increase inflation pressure (Balassa-Samuelson effect)
  - Credit-boom (credit risk, risk of overheating of the economy)
- **Budget and current account deficits**
  - Pressure on official foreign reserves and debt levels
  - Impact on interest rate, price and exchange rate developments
- **Monetary integration process (ERM II, adoption of Eurosystem monetary policy strategy)**

The macroeconomic policy trilemma

- Policy makers in open economies face the **"impossible trinity"** of pursuing three typically desirable, yet contradictory objectives (Mundell):
  - Stabilizing the exchange rate
  - Enjoying free international capital mobility
  - Employing independent monetary policy for domestic goals

→ ***Countries at earlier stage of development face the challenge to bring in line domestic development goals and monetary integration***

Economic impact of the cash changeover

- **Impact on Inflation**
  - In general initial **downward pressure on inflation**:
    - increased price transparency should enhance competition
    - consumer associations intensify price checks
    - the use of dual pricing makes any price rises more transparent
    - ECOFIN and ECB recommend that governments shall round their prices, taxes and fees in favor of the general public
  - **Costs** borne by banks/retailers may be passed on to consumers
- **Impact on economic activity**
  - A proportion of the costs of changeover represents increase in activity (e.g. investment in new systems)
  - Risk that output is adversely affected, if changeover not smooth

Some policy conclusions

- Importance of creating a **robust policy framework**, which delivers macroeconomic adjustment as well as a microeconomic setting providing for structural flexibility needed to cope with external shocks and/or structural changes.
- The **national orientation of macroeconomic policy** will become more limited.
- Most important economic policy question: likelihood and nature of **possible asymmetric shocks**.
- **Integration** always bears the risk to come **as a kind of shock**, asking for more structural adjustment and flexibility.
- **„Perceived controllability“** as the main factor in reaching a high degree of credibility in macroeconomic policy.