Jean-Claude Trichet: Governance and convergence – the state of play in the euro area

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the conference entitled "Euro zone – converging or drifting apart?", organised by the European Parliament (Committee of Economic and Monetary Affairs), Open Debate with National Parliaments, Brussels, 28 February 2007.

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Mesdames et Messieurs, Messieurs les Députés, permettez moi tout d'abord de remercier Mr Pervenche Berès de m'avoir invité à débattre sur un sujet particulièrement important, qui est le degré de convergence des économies de la zone Euro. C'est en effet un grand plaisir pour moi de partager avec vous et avec mes collègues et amis Jean Claude Juncker et Joaquin Almunia aujourd'hui quelques réflexions sur ce sujet.

Sehr geehrte Damen und Herren, sehr geehrte Abgeordnete, bevor ich beginne, möchte ich zuerst Frau Pervenche Berès danken für die Einladung und das Zustandekommen dieser sehr wichtigen offenen Debatte zum Stand der Konvergenz innerhalb des Eurogebiets. Es ist mir eine besondere Freude, mit Ihnen und meinen Kollegen Jean Claude Juncker und Joaquin Almunia einige Gedanken zu diesem Thema austauschen zu können.

Economic and Monetary Union and the creation of the euro area – a single economy with a single currency at the level of a continent – was, and still is, a formidable endeavour. Contradicting all those sceptical – academics, media and other observers – who had anticipated a failure, EMU has been a great success. For eight years we have successfully worked together in the euro area with a single monetary policy and a single currency. To those who claim that the euro has played against job creation, I would like to mention here two striking numbers: over the 8 years since the creation of the euro, the euro area created more than 12 million jobs; over the 8 years preceding the creation of the euro, less than 3 million jobs were created; of course I do not want to give the full credit of these job creations to the advent of the euro, but it is difficult to deny that EMU contributed to this achievement. With Slovenia joining the euro area, the latter is now embracing 13 countries and a population of around 317 million, a little bit larger than the population of the US. This story of success, however, requires a continuous effort from all of us, from the ECB, from the Commission, from the national authorities, from the Eurogroup and from you, members of European Parliament and of national parliaments, to continuously provide 'good' governance to the euro zone.

Before sharing with you some thoughts for the good governance of such a vast area, let me first provide you with our assessment and view on the current state of diversity in the euro area.

Stylised facts of growth differentials

Although I will focus on growth differentials and its related policy implications, let me briefly mention to you that in the case of inflation differentials, as you know, the current degree of dispersion across the euro area countries is historically low. Since 1999, inflation differentials across the euro area countries, measured by the unweighted measure of standard deviation, has been fluctuating around 1 percentage point, when at the beginning of the 1990s it was standing at around 6 percentage points. And last year, inflation dispersion reached a level of 0.7 percentage points. Moreover, the current degree of inflation dispersion among the euro area countries is practically the same as that seen in the US, in particular with the available data from 14 US Metropolitan Statistical Areas.

In the case of output growth, the current degree of differences in output growth across the euro area countries is neither large by historical standards nor by references to other relevant geographical areas. In fact, since 1999 – the start of the third stage of EMU – growth differentials have declined somewhat.

First, the dispersion of real GDP growth rates across the euro area countries, measured by the standard deviation in unweighted terms, has been fluctuating around a level of 2 percentage points, and has shown no apparent upward or downward trend over the past 35 years. However, since 1999, the degree of dispersion in annual average terms, also measured by the unweighted standard deviation, has declined among the euro area countries and in the last year is estimated to have declined further to slightly below 1.5 percentage points. Because sometimes the discussion focuses on the largest economies, let me mention that when looking at the four largest euro area economies, their growth differentials have been much lower, with a standard deviation fluctuating around a level of 1 percentage point.

Moreover, compared with other currency areas, the current degree of output growth dispersion within the euro area, measured by the standard deviation in unweighted terms, does not appear to be significantly different than that observed across regions or states within the United States. Across the 8 US regions, as defined by the US Bureau of Economic Analysis, the unweighted standard deviation has been fluctuating around 1.5 percentage points over the last years.

The second stylised fact that I would like to stress, which is relevant for the conduct of the single monetary policy of the ECB, is that the degree of synchronisation of business cycles across the euro area countries seems to have increased since the beginning of the 1990s. This finding holds for various measures of synchronisation applied to overall economic activity, for annual and quarterly data, as well as for various country groupings. Also last year, the strengthening of activity and the rebound in the euro area's real GDP growth was a very widely shared phenomenon across the various countries within the euro area.

And the third relevant stylised fact, related to the previous one, is that since the beginning of the 1990s the contribution to dispersion from the cyclical component of real GDP seems to have been relatively limited while most of the dispersion can be explained by differences in the trend component. In other words, differences of real GDP growth across the euro area countries since the beginning of the 1990s are largely due to trend growth differences.

These findings point to the relevance of structural factors behind output growth differentials across the euro area countries over the last years, on which monetary policy, as you know, has no direct influence.

Policy considerations

Let me therefore now say a few words about the policy implications of these growth differentials, in other words what good governance means to us, in view of the vast size of the euro area.

But first of all, it is important to keep in mind that, in general, output growth differentials among countries or regions are a normal feature of monetary unions. They reflect various factors. For instance, differences in economic growth within the euro area partly reflect catching up of lower income economies. Specifically, this has been visible in the successful case of Ireland, a country whose level of per capita GDP rose from well below the euro area average, at the beginning of the 1990s, to significantly above the euro area average in recent years. A relatively strong increase in per capita GDP has also been seen in other economies, such as Greece and Spain over recent years.

Also, demographic factors can play a role in explaining differences in growth rates across countries. Demographic changes affect output growth, first, via the population growth rate and, second, via developments in the working age population, which is affected by changes in the age structure of the population. In particular, since the mid-1990s, output growth in Ireland, Spain and Luxembourg has been positively affected by demographic factors, partly reflecting immigration flows, while demographic factors have only made a marginal contribution to growth in Germany and Italy.

Furthermore, there can be temporary differences in output growth across countries reflecting, for instance, an equilibrating adjustment process in a monetary union following a shock. There is no need to be concerned about those differences, as such differences are economically justified, are needed and are observed within other currency areas. However, in some cases we need to be concerned. These cases are those when we see persistent differences in output growth which reflect inappropriate national economic policies, structural inefficiencies and rigidities or a malfunctioning adjustment mechanism in individual countries. These are the cases we should focus on as policy makers.

Monetary policy

We all know that the very existence of a single monetary policy and thereby a uniform policy interest rate across the euro area countries does not allow using monetary policy to influence output growth differentials across euro area countries. This makes it so important that only countries which have reached sustainable convergence participate in the euro area. The decisive contribution the ECB's single monetary policy makes to the smooth functioning of EMU is to maintain price stability – and be credible in the delivery of price stability in the future – in the euro area as a whole. Price stability is actually strongly requested by the European citizens according to various surveys and opinion polls and they attach utmost importance to the independence of the ECB in delivering such objective

Design of national policies

Addressing “unsatisfactory” output growth performances in individual countries must be tackled by properly designed national policies in the fiscal and structural domains. Policies have to focus notably on increasing the adjustment capacity of economies to shocks and, in the slower growth countries, on fostering productivity and labour utilisation while maintaining stable macroeconomic conditions.

Fiscal policy

In this respect, fiscal policy, under the responsibility of national authorities, can best help in EMU by being sustainable and medium-term oriented, in line with the orientations provided by the Stability and Growth Pact. The Stability and Growth Pact is the key element of fiscal governance in the euro area. It provides a clear and transparent framework for putting into operation the reference values set by the Maastricht Treaty, 3% of GDP for fiscal deficits and 60% of GDP for public debt. Ensuring sound fiscal positions is necessary in order to compensate for the absence of a significant federal budget at the level of Europe that could absorb asymmetric shocks and in order to prevent the negative impact of unbalanced national fiscal policies. In a monetary union, such incentives could even be reinforced as part of the burden induced by fiscal imbalances in one country is indeed borne by all other members. The full and consistent implementation of the Pact sets the right incentives for countries to achieve sound fiscal positions. And countries with fiscal imbalances should use the current favourable economic environment to achieve such sound position rapidly.

In particular, the Pact calls on Member States to bring budget balances to their so called medium-term budgetary objectives and maintain them at that level. These objectives are designed to ensure the sustainability of the debt burden while providing sufficient leeway for budgetary fluctuations over the business cycle without jeopardising fiscal soundness. This free operation of so-called automatic stabilisers contributes to smooth economic fluctuations by letting the budget react to changes in the business cycle. In this way fiscal policies contribute to economic stability and support strong and sustainable economic growth.

Fiscal policy can and should also help mitigate undesirable trend growth differentials through “high quality” expenditure and tax policies. In particular, high and inefficient public expenditure can put a brake on economic activity by imposing a high tax burden on the economy and channelling resources into unproductive uses. Public spending and tax systems need to become more efficient and growth-friendly to strengthen trend growth. Such reforms will also facilitate the adjustment of the economies in case of adverse shocks.

By contrast, the pursuit of “activist” fiscal policies to fine-tune the economic cycle entails significant risks: an ill-timed fiscal policy stance can be an important source of variability in the economy. It is thus desirable that governments, as a rule, abstain from discretionary fiscal policy aimed at fine-tuning the economic cycle. Especially in the current economic environment, it is important that governments prevent discretionary policy measures from contributing pro-cyclically to the business cycle.

Structural reforms

It is in the area of structural reforms where national policies can make the most significant contribution to facilitating the working of adjustment mechanisms in individual countries and to improving long-term growth and employment prospects as well as to addressing undesirable growth underperformance in some countries. In this regard, the Lisbon process has raised the awareness among European countries that structural reforms are decisive for remaining competitive in an increasingly global economic environment. The Integrated Guidelines outlining reform and policy priorities as well as the setting-up of National Reform Programmes are suitable instruments to lead the way to a well-functioning internal market as well as to better functioning national markets. In this respect, we appreciate the inclusion of a special euro area fiche into the Integrated Guidelines, highlighting the particular reform necessities of countries that participate in the euro area.

Let me briefly elaborate in more detail on these important issues.

First, the focus must be on structural reforms enhancing economic flexibility. This should help to better absorb shocks and thereby improve the working of adjustment mechanisms in individual countries. In the context of EMU with a single monetary policy, the later the necessary national policy measures are taken to make the economies more flexible, the larger the potential costs can be in case of adverse shocks.

How to enhance economic flexibility? There are many factors that may help to increase flexibility within the euro area. First, the Single Market needs to be completed in order to stimulate price flexibility by fostering competition and open product markets, e.g. in the services and network industries. This requires that existing barriers to labour and capital mobility within the euro area are removed. In this respect, measures aimed at protecting domestic industries or employees against competition are only counterproductive as they delay the necessary adjustment. Now that Slovenia has entered it the euro area, it is decisive that its labour force is granted full access to the labour markets of all euro area countries. As I have already stressed in several occasions, it is abnormal that there are labour restrictions as regards Slovenian workers in a number of economies that are members of the euro area.

Economic flexibility can also be promoted by removing the institutional barriers to flexible price and wage setting mechanisms, in particular by easing product market regulations and employment protection legislation.

Specifically, as regards wage setting, nominal and real wages should adjust to help absorb shocks. Wage setting must reflect firms' different situations rather than being defined homogenously across sectors or countries independently of the local conditions to the risk of a higher level of unemployment. It is consequently of particular importance for all countries to achieve a high degree of wage flexibility in order to improve the ability of their labour markets to adjust to such shocks.

Secondly, national policies should aim at improving long-term growth prospects by, on the one hand, affecting positively labour utilisation and, on the other, improving labour productivity growth.

Structural policies can increase labour utilisation by addressing labour supply incentives that are inherent in tax and benefit systems. High average and marginal tax rates and high unemployment benefits impact negatively on the incentives to engage in paid employment or on the choice of the number of hours to work. Early retirement policies also have a significant negative effect on labour supply and, hence, on the participation and employment rates.

Growth in labour productivity should be supported by policies that aim at promoting innovation and technological change. For that purpose, policies should focus on allowing the efficient functioning of entrepreneurial activities, removing for instance entry restrictions and improving labour market adaptability.

Speaking in front of elected representatives, I know that the successful implementation of structural reforms requires constant explanations and well targeted communication in order to convince the citizens about their beneficial effects on growth and job creations; I fully understand the difficulty of this task and can only encourage all responsible parties in these communication efforts.

Conclusion

I am fully aware that this is indeed a very demanding list of tasks. But this is in our view the only way ahead. There is indeed enormous work to be done by all of us. And I would like to stress "by all of us". We have, the Eurosystem, the European Commission, the national governments, and the European and national Parliaments, a shared responsibility in ensuring a smooth functioning of EMU, by improving the integration and flexibility of its markets. Some differences in economic performances across countries or regions have existed and will continue to exist in the future, as it is the case in the US and in other any areas.

317 millions d'Européens ont décidé de partager aujourd'hui un destin en commun. La monnaie unique n'est pas seulement une formidable réussite et le symbole puissant de l'unité de l'Europe dans un monde en voie de transformation rapide. La monnaie unique nous réunit plus profondément, plus intimement que le débat public européen ne le suggère parfois. 13 pays aujourd'hui et 25 pays demain ou après-demain ont décidé d'unir leur destin. Ces 25 démocraties ont démocratiquement approuvé les dispositions qui les unissent. Ces dispositions ne sont pas inscrites sur un chiffon de

papier. Elles sont inscrites dans un traité international qui engage tous ceux qui l'ont ratifié au terme d'un processus exemplaire. Mes collègues du Directoire, du Conseil des Gouverneurs et moi-même, nous mesurons pleinement la confiance et l'honneur qui nous ont été faits de définir et mettre en oeuvre la politique monétaire de l'euro, en toute indépendance, pour assurer la stabilité des prix conformément au Traité. C'est ce double sentiment de confiance et de responsabilité qui nous anime.