Jean-Claude Trichet: The process of European economic integration

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Fondation Jean Monnet pour l'Europe 2007, Lausanne, 21 September 2007.

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1. Introduction[1]

It is a great pleasure for me to be invited as a speaker to the Dialogue européen de la Fondation Jean Monnet pour l'Europe. Let me start by saying that we are today confronted with exciting challenges and unique historical developments. The enlargement of the European Union, currently including 27 countries and 494 million people with Romania and Bulgaria recently joining, is an exceptional endeavour. More historical developments can be observed in the euro area, which now comprises 13 countries and will expand to 15 in three months' time as we are joined by Cyprus and Malta.

It is a fact that economic integration has increased among the countries in the European Union. It is also true that further and deeper integration is needed and that the creation of the euro area, as well as EU enlargement and globalisation, highlights the need for flexible economies. In this sense, all policy-makers and social partners now have increased responsibilities. They must provide good management to ensure a well-functioning European Union characterised by flexibility, integrated labour, product and financial markets and disciplined fiscal policies.

This leads me to the issue I would like to address today, namely the process of European economic integration. First, I would like to share with you some stylised facts on the features of the European Union's and the euro area's economic integration process. Second, I would like to look at some ideas regarding economic adjustment processes, particularly in the euro area. Finally, I would like to talk about Europe in a global context.

2. Features of economic integration in the European Union

Allow me to briefly elaborate on four main features of the process of economic integration in the European Union, and the euro area in particular.

i) First, economic integration has been reflected in a marked increase in intra-euro area trade in goods and services. Let me provide you with some figures. Exports and imports of goods within the euro area increased from about 26% of GDP in 1998, the year before the adoption of the single currency, to around 32% in 2006. Intra-euro area exports and imports of services increased from about 5% of GDP in 1998 to almost 7% in 2006. The continued deepening of the Single Market will further facilitate trade in services. As this interdependence within the euro area becomes stronger, the euro area is also becoming a more open economy with increasing extra-euro area trade. Extra-euro area exports and imports of goods rose from about 24% of GDP in 1998 to around 33% in 2006. Over the same period, extra-euro area exports and imports of services increased from about 8% of GDP to almost 10%. These developments clearly show that we are not witnessing the creation of a "fortress Europe". On the contrary, European integration complements global integration.

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[1] I should like to thank Malin Andersson for her input into this speech, Klaus Masuch and Hans-Joachim Klöckers for their helpful comments, and Philippe Leclercq, Katherine Brandt and Antonio Afonso for their additional contributions.

ii) As a second feature, the introduction of the euro has contributed to financial integration which, in turn, improves the free movement of capital in the euro area. Financial integration enhances the efficiency of economic mechanisms, strengthens competition and raises the potential for stronger economic growth. For example, recent research by London Economics estimated the benefits of the integration of EU bond and equity markets to be around 1 percentage point of additional GDP growth over a ten-year period, or approximately €100 billion.[2] Financial integration is also crucial, as it enhances the smooth and effective transmission of the single monetary policy throughout the euro area. Despite some progress, further financial integration is particularly needed in a number of areas, including in retail banking.

iii) Labour mobility constitutes the third feature I should like to mention. Lack of openness in some countries increases risks of wage pressures as labour markets tighten. Available evidence suggests that, overall, cross-border labour mobility is still limited in most parts of the European Union and we still have regulatory barriers across the European Union, including the euro area in respect of labour from Slovenia. This is in clear contrast to the situation in the United States.

iv) As a fourth and final feature, the degree of synchronisation or co-movement between the different cyclical positions across the euro area countries increased since the beginning of the 1990s. In other words, a large number of euro area economies now share similar business cycles. In addition, current inflation and output growth differences among euro area countries are relatively limited compared with the past. The differences are also similar to those observed across regions or states within the United States.

The decline in inflation differentials has been impressive. At the beginning of the 1990s, the dispersion in inflation rates across the euro area countries was, on average, around 6 percentage points (standard deviation measured in unweighted terms). Last year, the inflation dispersion was only 0.7 percentage point. As to real GDP growth rates across the euro area countries, the dispersion, measured in terms of standard deviations, has been fluctuating around a level of 2 percentage points over the past few decades, with no apparent upward or downward trend.

While some differences are temporary, others are of a more persistent nature. Let me stress that the sustained differences in economic growth or inflation rates between some euro area countries are absolutely normal in a monetary union, to the extent that they are related to catching-up phenomena. However, it is also true that persistent differentials which reflect structural rigidities are a concern. I will address this issue later.

In sum, there is evidence of stronger economic integration among the countries in the European Union. The adoption of the euro has particularly contributed to this development by reducing information costs, enhancing price transparency and eliminating exchange rate risk between countries in the euro area. In this manner, the euro acted as a catalyst for the Single Market, within which goods, services, people and capital are to move freely. Nonetheless, a lot remains to be done, for instance, in order to increase services trade and labour mobility and to reduce structural rigidities.

3. Economic integration and adjustment processes in the euro area

Let me now turn to adjustment processes whose smooth functioning is important in all EU countries but particularly in the euro area. Why is an efficient adjustment mechanism particularly important in the euro area? In a monetary union where national monetary and

[2] London Economics, "Quantification of the macroeconomic impact of integration of EU financial markets", report to the European Commission, 2002.

exchange rate policies are no longer available options, it is important to make sure that other mechanisms of adjustment to shocks function properly. This is needed to avoid a situation whereby a country or a region, for instance after experiencing a specific event or asymmetric shock, enters either into a period of protracted low growth and higher unemployment, or into a long period of overheating.

There are many factors that can improve the resilience of the euro area economies to adverse shocks. But before addressing this issue, let me stress that the ECB's single monetary policy contributes to the proper functioning of adjustment mechanisms within the euro area by ensuring price stability, i.e. by anchoring price stability in economic agents' decisions. I believe that this is a very important contribution. In other words, the social partners, when agreeing on wage increases, and also national authorities, when preparing their budgets or designing policies in their fields of responsibility, should be, and, as a matter of fact, are fully confident that we, at the ECB and in the Eurosystem, will deliver price stability.

Turning to other factors, well-designed structural reforms that enhance competition and foster flexibility in product and labour markets are particularly relevant for the proper functioning of the euro area.

In this context, the Lisbon strategy is a fundamental and ambitious programme to draw Europe's attention to the urgency of structural reforms. Such reforms will improve long-term growth prospects. They do so by affecting positively labour participation and by improving productivity growth through the promotion of innovation and technological change. In recent years, we have already seen the benefits of a number of structural reforms, with the creation of about 13 million new jobs since 1999.

Economic flexibility can be promoted by removing the institutional barriers to flexible wage and price-setting mechanisms. Specifically, in a monetary union, most of the adjustment has to take place through national labour markets. Therefore, wage setting should appropriately reflect the different situations of sectors, of firms and of overall labour market conditions. Let me stress that social partners share responsibility for ensuring that wage settlements fully take into account the need to reduce unemployment and to enhance labour market access and employment. Moreover, governments should also be aware of the way in which wage setting for public servants can serve as a role model for the private sector. And social partners need to take into account the different conditions at the firm and sectoral level, internalising the repercussions of wage settlements on competitiveness and thus employment at their company and in their industry, sector or region. Sufficient wage differentiation would improve employment opportunities for less skilled workers and in regions or sectors with high unemployment. In this respect, it is clear that excessive wage regulations are undermining job creation, in particular for young and less qualified workers, as well as for all those who face problems entering the labour market.

The proper functioning of adjustment through labour markets also requires the completion of the Single Market. In particular, all existing barriers to labour mobility within the EU and notably within the euro area must be removed.

As to product markets, let me stress that it is also essential that the Single Market be deepened, particularly in services and network industries. Greater cross-border competition and a deeper integration of markets across all EU countries would contribute to lower prices and higher real wages. It would also enhance price flexibility, and thereby the adjustment processes in the individual countries.

Another important market-based mechanism that can help to attenuate the impact of shocks in a country or region is well-integrated financial markets and readily available opportunities for the diversification of financial asset portfolios. This would reduce the dependence of households' saving and spending decisions on economic and financial developments in their country or region. This mechanism is known as the "credit and risk-sharing channels". In essence, it means that consumption is less dependent on movements in national output, first because consumers can borrow from international financial institutions which are active at the level of the euro area, and second because the financial wealth of households is less dependent on local conditions thanks to an internationally well diversified portfolio allocation. Moreover, more integrated financial markets give rise to greater competition, resulting in more favourable financing conditions for consumers and firms. To provide you with some figures, in the United States, over the period 1963-90, capital markets smoothed out 39% of the shocks to gross state product (the equivalent to GDP), the credit channel smoothed out 23% and the federal government, through the fiscal channel, 13%. Around 25% of the shocks were not smoothed out. Hence, financial markets and financial institutions contributed 62% to the absorption of idiosyncratic state shocks. We therefore see from the US example that the financial channel can be much more important than the fiscal channel. This is an additional reason for speeding up financial integration in Europe.[3] According to a more recent study, the level of integration in the euro area has been increasing, although it remains modest. It was found that in the countries that now make up the euro area (excluding Luxembourg), capital markets smoothed out about 10% of the country-specific shocks to GDP between 1993 and 2000.[4]

National authorities can also make a substantial contribution to ensuring the proper functioning of adjustment mechanisms within the European Union by conducting well-designed fiscal policy. The best contribution fiscal policy can make to the proper functioning of the euro area is by being disciplined and medium-term oriented, fully in line with the orientations provided by the Stability and Growth Pact. Moreover, improving the quality of public finances can enhance business and growth conditions, while at the same time allowing a reduction in overall public spending at the national level. Indeed, available evidence points to the existence of significant inefficiencies in public spending both in the EU and in OECD countries. In other words, it would seem that public spending could be substantially reduced without a detrimental impact on the volume of output. Additionally, a more efficient public administration would also allow the indirect costs of public sector inefficiency, linked to financing through inappropriate taxation regimes, to be reduced.

Let me finally mention the important issue of competitiveness. One of the most important market-based adjustment mechanisms in a monetary union works via changes in competitiveness. In the euro area, persistent losses in relative cost competitiveness necessarily translate, in the medium term, into a period of below-average growth and an abnormal level of unemployment. According to recent figures, the difference in the cumulated growth of unit labour costs for the total economy between the euro area countries with the largest and the smallest cost increases, respectively, was between 20% and 25% in the period 1998-2006.

In sum, structural reforms in the labour, product and financial markets together with sound fiscal policies are crucial to enable smooth adjustment processes in the European Union and particularly in the euro area. At the same time, differences in price competitiveness and in unit labour costs across the euro area economies need to be closely monitored, as they may imply major adjustments in the countries concerned in the years ahead.

4. Europe in a global context

Economic integration and smooth adjustment processes are clear prerequisites for the efficient functioning of the European Union. All the more so because Europe is regularly

[3] See P. Asdrubali, B. Sorensen and O. Yosha, “Channels of interstate risk sharing: United States 1963-1990”, Quarterly Journal of Economics Vol. 111, 1996.

[4] See S. Kalemli-Ozcan, B. Sorensen and O. Yosha, “Asymmetric shocks and risk sharing in a monetary union: Updated evidence and policy implications for Europe”, CEPR Discussion Paper No. 4463.

confronted with various adverse events or shocks, for instance in the context of globalisation, which translates in particular into greater interdependence between our economies through an increase in cross-border transactions of goods, labour and capital. Let me briefly elaborate on this aspect.

Globalisation is triggering major transformations all over the world, not only in Europe. For instance, globalisation has undeniably had an impact on the inflation process.

Numerous channels have been identified in economic theory through which globalisation can influence the level of prices. Without doubt, globalisation and the associated rise in world trade have contributed to import price moderation,[5] notably in the manufacturing sector, which is primarily due to increased imports from low-cost countries. Furthermore, the widespread opening-up of emerging countries and of almost all former centrally planned economies has significantly increased the labour pool available, leading to dampening pressures on labour costs, especially for unskilled labour. Globalisation can also exert pressure conducive to lower inflation more indirectly, as increasing international competition may have limited the pricing power of domestic corporations. However, at the same time, the sudden emergence of fast-growing economies in the global economy is exerting upward pressure on prices for energy and raw material prices.[6]

Regardless of the intensive research currently pursued in particular in academia, at central banks and at various international institutions, there still remains significant uncertainty about the aggregate role and impact of globalisation. Even though the net effect of these counterbalancing forces is mostly believed to have contributed towards reducing inflation, whether and how long this disinflationary effect will last in the future remains an open question.

Ultimately, globalisation is an opportunity, not a threat. Globalisation provides much-needed solutions. For instance, it may allow increased labour inflows to the euro area, which, in certain sectors, would help to reduce bottlenecks in labour markets and hence ease wage pressures. In addition, globalisation may supply external capital in exchange of know-how. As a matter of fact, the euro area has become an attractive place for foreign direct investment (FDI). A breakdown of extra-euro area liabilities indeed reveals that inward FDI amounts to more than 27% of euro area GDP, against 22.5% for the United States. The euro area has received, proportionally to GDP, a similar amount of FDI as China, 27.3% for both economies, according to IMF statistics. A rising amount of FDI comes from the so-called BRIC group – including Brazil, Russia, India and China.

In fact, contrary to what such protectionist thinking would suggest, EU integration and the adoption of the euro seem to make Europe fitter for globalisation. The single currency has supported the development and diversification of exports in the euro area countries, as mentioned earlier. The euro has also made a significant contribution to the process of opening up euro area financial markets. On the assets side, stocks of euro area assets held abroad have increased from less than 87% of GDP in 1999 to over 124% in 2005. On the liabilities side, the increase was also very substantial, from around 92% of GDP to 137%. The rise has actually been much less pronounced for the United States during the same period: US assets grew from 80% of GDP in 1999 to 90% today, and US liabilities increased from 91% to 110% of GDP. In other words, the euro area and the United States held roughly

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5 See Box 13 in the June 2007 issue of the Monthly Bulletin entitled “Is the downward impact of globalisation on import prices waning”.

6 Furthermore, there are also other factors – independent of globalisation – that can help to explain the decline in global inflation, such as the rapid technological progress and structural reforms that both have helped to increase the growth potential of the economies and thus to facilitate price stability, greater budgetary discipline and finally “better” monetary policy, that have resulted in an enhanced credibility of central banks.

comparable assets and liabilities in 1999, but the euro area witnessed a more substantial increase since the start of Economic and Monetary Union.

Finally, globalisation puts emphasis on the need for further reforms to raise the ability of Europe to adjust to the major changes taking place in the global environment. The implementation of such reforms should raise flexibility and lower the adjustment costs for European firms and workers facing the globalisation process. Raising competitiveness is the main condition for making globalisation a success for the European citizens.

5. Conclusion

Ladies and gentlemen, let me conclude. The successful creation of the euro area and further economic integration within Europe has gone hand in hand with the integration of Europe within the global economy. In no way are we creating a “fortress Europe”. This is not our objective and is not in our interests. It is crucial to promote further economic integration and to enhance flexibility of the European economies. This would also enhance adjustment processes in Europe. As regards monetary policy, Europe can count on the European Central Bank and the Eurosystem to be faithful to their primary objective and solidly anchor inflation expectations in the euro area. As regards the elements of policy that do not depend on the central bank, I have touched on three crucial areas: disciplined fiscal policies, fully in line with the Stability and Growth Pact; structural reform policies, fully in line with the Lisbon Agenda and the completion of the Single Market; and appropriate monitoring of the relative cost competitiveness indicators.

Thank you very much for your attention.