Jean-Claude Trichet: The process of European economic and financial integration

Keynote speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Journalist Symposium "Konvent für Deutschland", Berlin, 5 December 2007.

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1. Introduction[1]

Es ist mir eine große Ehre, als Gastredner zu diesem Journalisten-Symposium in Berlin geladen zu sein, um über die wirtschaftliche und finanzielle Integration in Europa zu sprechen. Der Gedanke ist nicht neu. Bereits als der Vertrag von Rom vor einem halben Jahrhundert unterzeichnet wurde, stand der freie grenzüberschreitende Verkehr von Waren, Dienstleistungen, Kapital und Personen im Mittelpunkt der Bemühungen der innereuropäischen Politik, die schließlich zum europäischen Binnenmarkt führen sollten.

[It is a great pleasure for me to be invited as a guest speaker to this Journalist Symposium in Berlin to talk about European economic and financial integration. The idea of financial and economic integration is not new. Even at the time the Treaty of Rome was signed, half a century ago, the prime focus of intra-European policies was on facilitating the free flow of goods, services, capital and people across national frontiers, an initiative which was to become the Single Market.]

If you will allow me, I will now continue in English.

Today, the European Union comprises 27 countries and a population totalling 494 million people, with Romania and Bulgaria joining in January of this year. The impressive enlargement of the EU has gone hand in hand with the successful creation of Economic and Monetary Union among 13 of the EU countries and 317 million citizens. The 13 will become 15 in January of next year, when Cyprus and Malta join the euro area, adding another 1 million people to the population of the euro area.

However, Europe still needs to make progress to fully reap the benefits from the euro. In this respect, achieving the objective of the "Konvent für Deutschland", which is to enhance the ability to make reforms in Germany, is urgently needed. This brings me to the issue I should like to address today, namely that of European economic and financial integration. First, I should like to share with you some facts on the process of economic and financial integration in Europe. Second, I should like to talk about economic adjustment processes. Smooth adjustment processes are further enhanced by economic and financial integration and are crucial for the proper functioning of the European economies.

2. Economic and financial integration in Europe

Allow me now to elaborate on three aspects of economic integration in Europe, namely trade, labour mobility and business cycle synchronisation.

i) First, economic integration has been reflected in a marked increase in intra-euro area trade in goods and services. Let me mention some figures. The share of exports and imports of goods in terms of GDP within the euro area increased by 6 percentage points between 1998 and 2006, to stand at around 32% of GDP. The

[1] I should like to thank Malin Andersson for her input into this speech, Klaus Masuch and Hans-Joachim Klöckers for their helpful comments, as well as Katherine Brandt, Annalisa Ferrando, Arne Gieseck, Matthew Hart, Christophe Kamps and Andrea Lüske for their additional contributions.

share of intra-euro area exports and imports of services increased by about 2 percentage points in this period, to almost 7% of GDP.

As trade integration within the euro area becomes stronger, the region is also becoming more open to the outside world. The share of extra-euro area exports and imports of goods rose by about 9 percentage points between 1998 and 2006, to around 33% of GDP. Over the same period, the share of extra-euro area exports and imports of services increased by about 2 percentage points, to almost 10% of GDP. German extra-euro area trade contributed particularly strongly to these developments, increasing from 31% of German GDP in 1998 to 51% in 2006. German trade is a good example of the fact that the euro area is an open economy and not a "fortress Europe". By comparison, in the United States, exports and imports of goods are lower, representing about 22% of GDP and trade in services 6% in 2006.

ii) A second aspect of the process of economic integration is the degree of synchronisation or co-movement between different cyclical positions across the euro area countries. This degree of synchronisation has increased since the beginning of the 1990s. In other words, a large number of euro area economies now share similar business cycles.

In addition, the decline in inflation differentials across the euro area countries has been impressive in recent years. The level of dispersion is currently at a lower level than that among 14 US Metropolitan Statistical Areas.[2] Dispersion in real GDP growth rates across the euro area countries has been fluctuating around a level similar to the one observed in output growth across regions within the United States.[3]

iii) Labour mobility within the EU constitutes a third aspect of economic integration that I should like to mention. Labour mobility offers additional choices to workers. It can dampen the effects from country-specific shocks and decrease the risks of wage pressures as labour markets tighten. Available evidence suggests that, overall, cross-border labour mobility is still limited within the European Union with regulatory barriers still existing, even within the euro area itself with respect to labour from Slovenia, for example. Germany belongs to the countries which currently prevent labour mobility from some EU countries. This comes at a time when many companies are reporting problems in finding properly skilled labour. For instance, the German industry currently reports very significant shortages of labour, according to a survey by the European Commission.

Comparable figures on labour mobility for the EU and the United States are difficult to obtain and any such figures should be interpreted very cautiously. Still, in the United States, geographical labour mobility appears to be far higher.

Let me now turn to financial integration in Europe. The introduction of the euro has contributed to intra-European financial integration which, in turn, has facilitated the free

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[2] At the beginning of the 1990s, the dispersion in inflation rates across the countries, which now belong to the euro area, was, on average, around 6 percentage points (standard deviation measured in unweighted terms). So far this year, the inflation dispersion was only 0.5 percentage point. Dispersion among 14 US Metropolitan Statistical Areas has moved around 1 percentage point over the past two decades. Dispersion in real GDP growth rates across the euro area countries has been fluctuating around a level of 2 percentage points over the past few decades.

[3] It should be stressed that while some differences are temporary, others are more persistent. Sustained differences in economic growth or inflation rates between some euro area countries are 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.

movement of capital in the euro area. Financial integration strengthens competition and raises the potential for stronger non-inflationary economic growth.[4] It also improves the smooth and effective transmission of the single monetary policy throughout the euro area.

Financial integration also helps financial systems to channel funds from those economic agents that have a surplus of savings to those with a shortage; in particular, it enables agents to effectively trade, hedge, diversify and pool risks. As a result, there is a better sharing and diversification of risk.

According to academic research, 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%.[5] 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. In a more recent study, it was found that the situation in the euro area countries has begun to converge towards that of the United States as inter-euro area country capital flows increase. It was found that in what would become the euro area countries (excluding Luxembourg), capital markets would have smoothed out about 10% of the country-specific shocks to GDP between 1993 and 2000.[6]

A set of indicators, published by the ECB, points to an increasing degree of integration of euro area financial and banking markets since 1999.[7] Moreover, the size of capital markets – in terms of the ratio of the total value of stock, bond and loan markets to GDP – has increased substantially since 1999, and has the potential to grow even further, as seen from a comparison with the United States. In the period 1995-99, it was 177% of GDP in the euro area and 279% in the United States; in 2005-06 it had increased to 256% in the euro area, and 353% of GDP in the United States. In Germany this ratio rose from 202% to 229% of GDP.

Integration in retail banking, by contrast, has been slow so far. There are still significant differences in bank deposit and lending interest rates across euro area countries. In the euro area, the cross-country dispersion is higher than the intra-regional dispersion of the same rates in the United States.[8]

This notwithstanding, overall there is evidence of growing economic and financial integration among the countries of the European Union. The adoption of the euro has contributed to this development by reducing information costs, enhancing price transparency and eliminating exchange rate risk between countries in the euro area. Nonetheless, in some fields, a lot

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4 A research study conducted by London Economics estimated the benefits of the integration of European bonds and equity markets to be around 1% of additional GDP over a ten-year period. London Economics, 2002, "Quantification of the macroeconomic impact of integration of EU financial markets", Report to the European Commission. See also "EU Productivity and Competitiveness: an Industry Perspective. Can Europe Resume the Catching-up Process?" by Mary O'Mahony and Bart Van Ark, European Communities, 2003, for a comparison of the financial sector contribution to annual labour productivity growth in the United States and the euro area.

5 See P. Asdrubali, B. Sørensen and O. Yosha, 1996, "Channels of interstate risk sharing: United States 1963-1990", Quarterly Journal of Economics Vol. 111.

6 See S. Kalemli-Ozcan, B. Sørensen and O. Yosha, 2004, "Asymmetric shocks and risk sharing in a monetary union: Updated evidence and policy implications for Europe", CEPR Discussion Paper No. 4463.

7 "Financial integration in Europe", ECB, 2007.

8 C. Kok-Sørensen and T. Werner, 2006, "Bank interest rate pass-through in the euro area; a cross-country comparison", ECB Working Paper No. 580.

remains to be done, for example, that of increasing intra-euro area labour mobility and financial integration in retail banking.

3. Adjustment processes in the euro area

Economic and financial integration are prerequisites for the smooth functioning of the euro area. In a monetary union like the euro area, where regional monetary and exchange rate policies are no longer available options, it is important to ensure that market adjustment mechanisms function properly. Such mechanisms are needed in order to prevent a country or region, after experiencing a country-specific shock, from entering 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. In this context, the ECB's monetary policy contributes to the proper functioning of adjustment mechanisms within the euro area by ensuring price stability, by being credible in ensuring price stability and therefore by anchoring such price stability in economic agents' expectations and decisions. This anchoring of expectations is important for enabling market participants to set suitable prices. And let me add that the best way to anchor inflation expectations is through an independent and accountable central bank. German history provides the best possible example of this.

Well-designed structural policies that enhance flexibility in product and labour markets are crucial for absorbing shocks more effectively. Needless to say, the responsibility for the implementation of such policies is in the hands of national governments, of parliaments, and of social partners.

In this context, the Lisbon strategy is a fundamental and ambitious programme designed to draw Europe's attention to the urgency of structural reforms. Such reforms improve long-term growth prospects in the euro area by, on the one hand, positively affecting labour participation and, on the other, improving labour productivity growth through the promotion of innovation and technological change. We know very well that structural reforms often face both resistance from economic agents and sensitivities in public opinion. Therefore, it is essential to understand and communicate that the medium to long-term benefits of structural reforms will significantly outweigh any short-term cost. The ECB therefore strongly supports governments in their implementation of structural reforms. For instance, in Germany, the labour market reforms, implemented a few years ago, have significantly contributed to job creation, lower unemployment and the recent economic upswing. It is essential that those results are not jeopardised by interrupting or even reversing the reform process. Unemployment in Germany is still high and further reforms are required to better utilise the labour potential here in this country.

More specifically, on the labour market, economic flexibility can be promoted by removing the institutional barriers to flexible wage and price-setting mechanisms. Let me stress that governments and social partners share responsibility for ensuring that wage determination appropriately takes into account labour market conditions at the industrial, sectoral and regional level and does not jeopardise competitiveness and employment.[9] Governments should be aware that wage setting in the public sector very often serves as a role model for the private sector. Moreover, sufficient wage differentiation is needed to improve employment opportunities for less skilled workers and in regions or sectors with high unemployment. In this respect, 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

[9] See, for example, the analysis of the role of wage developments in the 1970s in explaining European unemployment in O. Blanchard, "The medium run", Brookings Papers on Economic Activity, No. 2, 1997, pp. 89-141.

market. In particular, setting minimum wages at levels which are not in line with productivity reduces the employment chances of less skilled workers and of the unemployed.

As seen in Germany following unification, the period of adjustment can be painful, but reforms and unit labour cost moderation are finally paying off and they are contributing to robust growth. I remember some observers arguing several years ago that much stronger wage increases were needed in Germany for higher growth. The recent evidence does not confirm this view. On the contrary, the increased competitiveness seen in the German economy – thanks to moderate unit labour cost developments – has been an important prerequisite for the very strong job creation observed in recent years.

Not only in Germany, but also in the euro area as a whole, employment growth has been impressive in the eight and a half years since the euro changeover. Employment growth amounts to 14.9 million persons in the euro area, as opposed to only 3.8 million in the previous eight and a half years.

Reforms are also needed in product markets. Let me first stress the importance of fully completing the Single Market, particularly in services and network industries. A deeper integration of markets would stimulate price flexibility by fostering competition and open product markets. Greater cross-border competition and the integration of markets across the euro area countries would contribute to lower prices. It could also enhance the adjustment processes in the individual countries in the event of asymmetric shocks or differing cyclical developments.

It is also important to promote further financial market integration and the development of readily available opportunities for portfolio diversification. This would help to attenuate the impact of country-specific shocks, as I mentioned earlier.

National authorities can make a substantial contribution to ensuring the proper functioning of adjustment mechanisms within the euro area by conducting a well-designed fiscal policy. As I have stressed on many occasions, the best contribution fiscal policy can make to the proper functioning of the euro area is by being sustainable and medium-term oriented, fully in line with the orientations of the Stability and Growth Pact. Moreover, fiscal policy can and should also focus on increasing the effectiveness and efficiency of the public sector itself through high quality expenditure and tax policies. Large and inefficient public sectors are putting a brake on growth by imposing a high tax burden on the economy and channelling resources into unproductive uses.

In this respect, we welcome the efforts of the German government to reduce the regulatory burden further. In addition, the latest fiscal developments in Germany have been encouraging. For the first time since German reunification, the general government is expected to record a balanced budget, after having recorded a deficit above the Maastricht Treaty’s threshold of 3% of GDP over the period from 2002 to 2005. While partly based on revenue-increasing measures, such as the increase in the standard VAT rate at the beginning of the year, the success with fiscal consolidation can also be significantly attributed to expenditure restraint. Indeed, the share of government expenditure to GDP has dropped by 4½ percentage points over the past four years, reaching a level considerably lower than the euro area average. At the current juncture, it is important that the government stay on course, maintaining moderate expenditure growth while strengthening the incentives to work and invest. If policies continue on the path of structural expenditure restraint and lasting improvement in fiscal balances, Germany could become a fiscal role model in the euro area and would be well prepared for fiscal challenges in the short and long run.

It is particularly important that countries prepare themselves for less favourable economic conditions and the rising fiscal burden, in the longer run, associated with population ageing. In this context, the gradual increase of the pension age in Germany is an important step in the right direction. It will help to reduce the large ageing-related fiscal burden on the younger and active generations.

Let me finally mention the crucial issue of competitiveness, which is one of the most important market-based adjustment mechanisms in a monetary union.[10] Competitiveness is usually assessed on the basis of various measures of cost and price competitiveness[11], complemented by accounting for some "non-price" factors, such as the quality and the technological content of the goods produced.

A special feature of competitiveness differentials in the euro area is their persistence. Over the period between 1999 and 2006 there is a difference of up to around 25 percentage points between the euro area countries with the lowest and highest cumulative growth rates for unit labour costs for the economy as a whole. Germany and Austria belong to the first group of countries, while Ireland, Portugal and Greece belong to the second. Persistent differences in competitiveness may be a normal phenomenon when an economy is in the process of sustainable catching-up, leading to a higher level of per capita income, or whenever an economy has to cope with structural changes or past shocks of any nature that would be reflected in a new relative price equilibrium.

That being said, persistent losses in relative cost competitiveness can also relate, for instance, to a number of structural rigidities leading to inertia in price and wage formation. They may be worrying signals for an economy, indicating a need for caution. Hence, developments in price and cost competitiveness across the euro area economies need to be closely monitored.

It is important for all parties concerned – the private sector, social partners, the national public authorities – to contribute to flexibility in prices and wages. In this manner, economically unjustified losses of competitiveness would be avoided and the risk of possibly protracted adjustment costs through the competitiveness channel minimised.

4. Conclusion

Ladies and gentlemen, let me conclude. The single currency and Economic and Monetary Union have been an impressive and remarkable success, perhaps Europe's most remarkable since the Treaty of Rome was signed. It is up to all of us to consolidate this great success and ensure that it is reinforced in the years to come. As regards monetary policy, Europe can count on the European Central Bank and the Eurosystem to be faithful to its primary mandate and to deliver price stability in the medium run to our 317 million fellow citizens. As regards other policy areas, which do not depend on the central bank, let me stress the three areas where sound policies are absolutely of the essence: sound fiscal policies, fully in line with the Stability and Growth Pact; structural reform policies, fully in line with the Lisbon strategy and the achievement of the Single Market; and last but not least appropriate monitoring of the relative cost competitiveness indicators in the euro area.

It is encouraging to see that past reforms have contributed to job creation and reduced unemployment. It is important that governments continue in this direction and do not reverse past reforms just at the point when they are starting to bear fruit.

Thank you very much for your attention.

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[10] See, for an extensive discussion of adjustment mechanisms, "The EU economy 2006 review: adjustment dynamics in the euro area – experiences and challenges", European Commission, 2006 and F. P. Mongelli and J. L. Vega, "What effects is EMU having on the euro area and its member countries? An overview", ECB Working Paper No. 599, 2006.

[11] In 2007, the ECB started to publish price competitiveness measures, the Harmonised Competitiveness Indicators (HCIs). See the box entitled, "The introduction of harmonised competitiveness indicators for euro area countries", in the February 2007 issue of the ECB's Monthly Bulletin.