Jean-Claude Trichet: Two continents compared

Keynote address by Mr Jean-Claude Trichet, President of the European Central Bank, at the "ECB and its Watchers XIII" conference, Frankfurt am Main, 10 June 2011.

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Ladies and Gentlemen,

As always, it is a pleasure for me to open this conference today.

Four years ago at this gathering, I compared monetary policy in the euro area and in the United States. Today, I would also like to talk to you on the theme of "two continents compared". As we are all too well aware, much has happened on both sides of the Atlantic since 2007, and it is useful to take stock again. But this time, I would like to focus less on monetary policy and more on the wider economies of the two continents.

The crisis has exposed in both continents the issue of heterogeneity – a wide diversity of experience across different parts of the whole. As we will see, the economic fallout from the crisis and the ensuing recovery have shown considerable variation among the US states. And as we know, the same is true in the euro area, where some countries are a particular focus of attention.

But before turning to the issue of regional heterogeneity and the appropriate coordination of regional policies within an economic and monetary union (EMU), let me briefly take a bird's eye view of the euro area.

I. A bird's eye view of the euro area

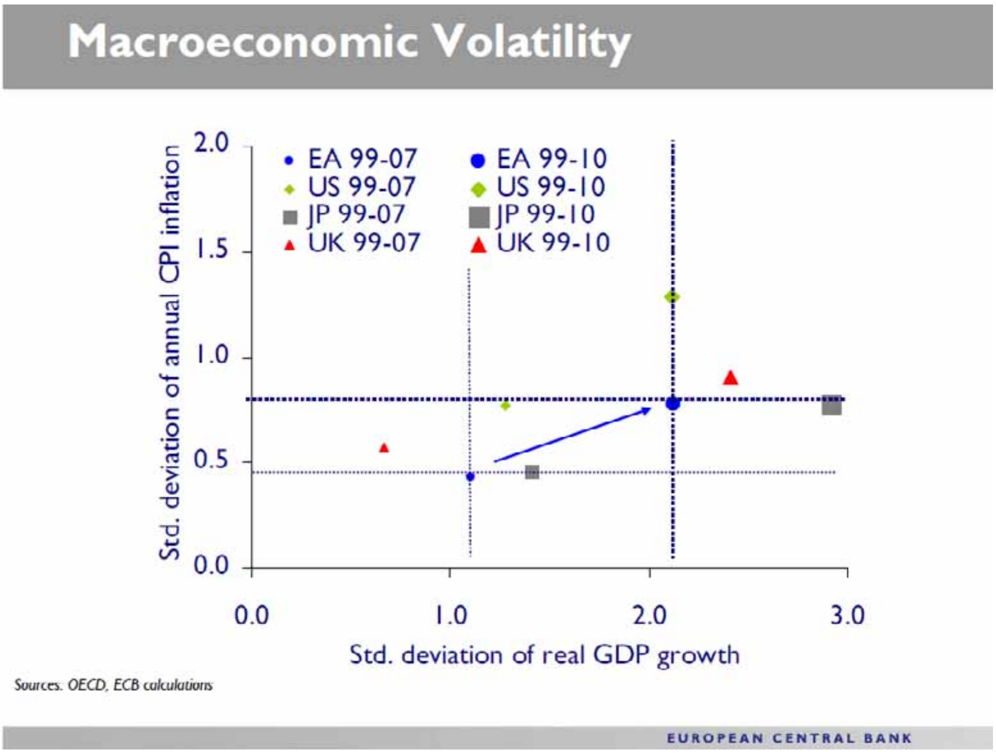
Speaking here four years ago I looked back at the ECB's monetary policy over the period 1999–2006. I showed a scatterplot of inflation volatility and output volatility for the euro area and other advanced countries.

Academic research suggests that there might be a trade-off between these two variables and that it is therefore difficult to have low inflation volatility and low output volatility at the same time. But what the chart showed was that the euro area scored well on both dimensions.

This seemed puzzling given that the euro area has quite rigid product and labour markets, at least compared with the United States. The higher degree of price and wage rigidity in the euro area would suggest that output volatility should be significantly larger in the euro area than in the more flexible US economy.

This would be particularly true during a period when the economy is subject to supply-side shocks, which are exerting simultaneously inflationary and recessionary influences. Yet surprisingly, and despite the negative supply-side shocks that had been hitting the euro area economy over the years up to 2007, the data suggested that both inflation volatility and output volatility in the euro area were lower than elsewhere.

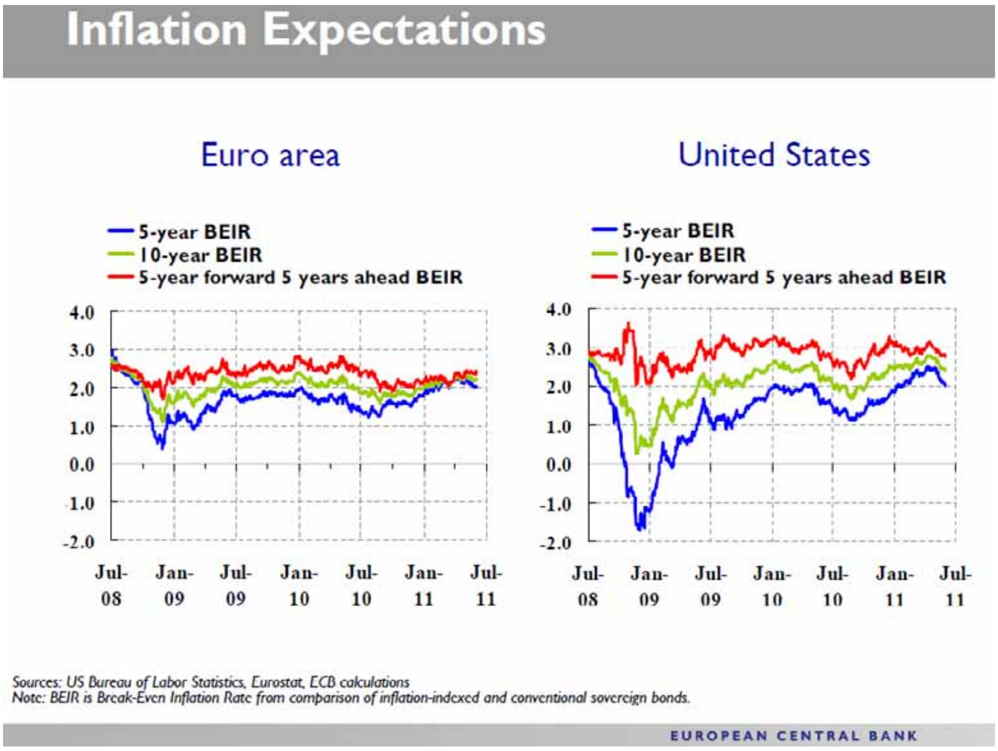
Has the crisis changed this picture?



Obviously, output volatility in the euro area is much higher when the crisis is included in the sample. But, remarkably, the euro area still scores well on both dimensions compared with other advanced countries.

So what is behind this apparent puzzle? How can nominal rigidities plus supply-side pressures not produce bad or worse macroeconomic outcomes?

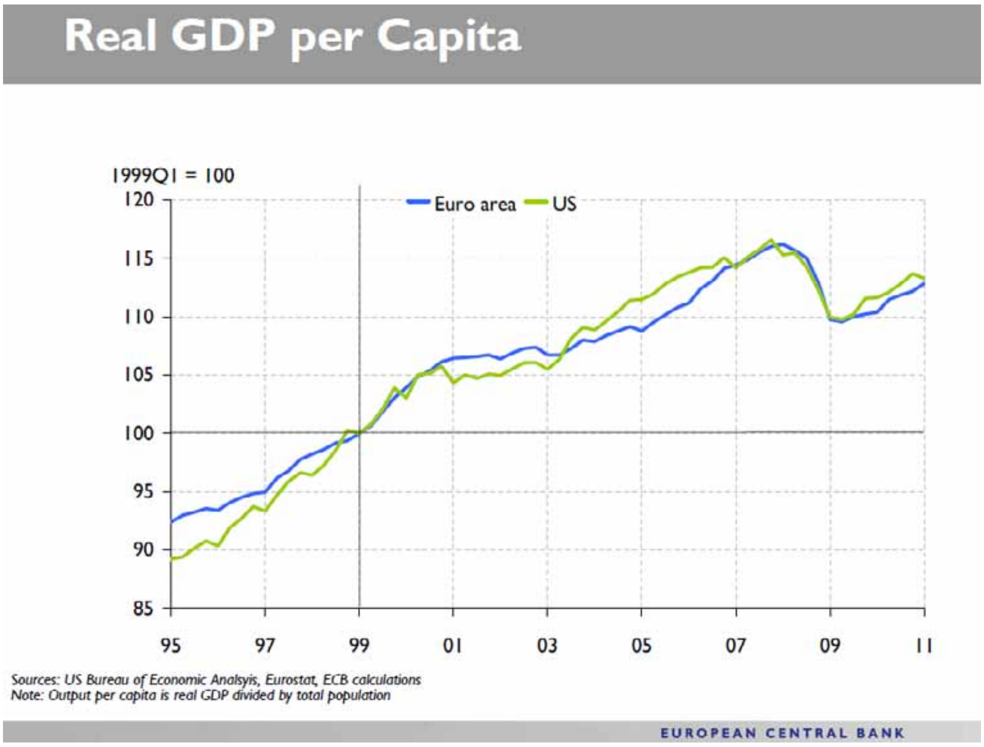
As I explained in detail four years ago, I believe that the strong anchoring of inflation expectations in the euro area is the key to understanding these developments.



Inflation expectations have remained solidly anchored in line with our definition of price stability throughout the crisis. There was no materialisation of a deflation risk. This has enormously facilitated our task, especially during the period of economic freefall in the winter of 2008/09.

Other indicators corroborate the finding that at the aggregate level the euro has been a remarkable success:

- Annual inflation over the first 12 years of EMU has been 1.97% on average. This outcome is fully in line with our aim of keeping inflation below, but close to 2% over the medium-term. What is equally noticeable is that it is a better result, in terms of price stability, than in the euro area Member States over the last 50 years.
- Real output per capita has grown at a similar pace in the euro area than in the United States, which – in terms of economic dynamism – remains the benchmark for the advanced countries.



- Employment growth in the euro area has been strong over the past 12 years. More than 14 million jobs have been created since the introduction of the euro, compared with 8 million in the United States.
- Finally, public finances in the euro area as a whole are sound. As elsewhere, the financial crisis has left its mark on government deficit and debt in the euro area. Yet, the fiscal deficit in the euro area on aggregate for this year is estimated at less than one half of that in the United States and Japan. Recent forecasts indicate that the euro area as a whole is on track to bring the deficit to GDP ratio below the 3% reference value by 2013 and to stop the adverse debt dynamics caused by the financial crisis.

Of course, there is absolutely no reason for complacency in the euro area. Much more remains to be done, especially in terms of employment creation, reduction of the level of unemployment and enhancement of Europe’s growth potential.

But, we should recognise that the euro has acted in many areas as a catalyst for structural change. If euro area member states take up the challenge of adjusting, there is every reason to be confident about the future.

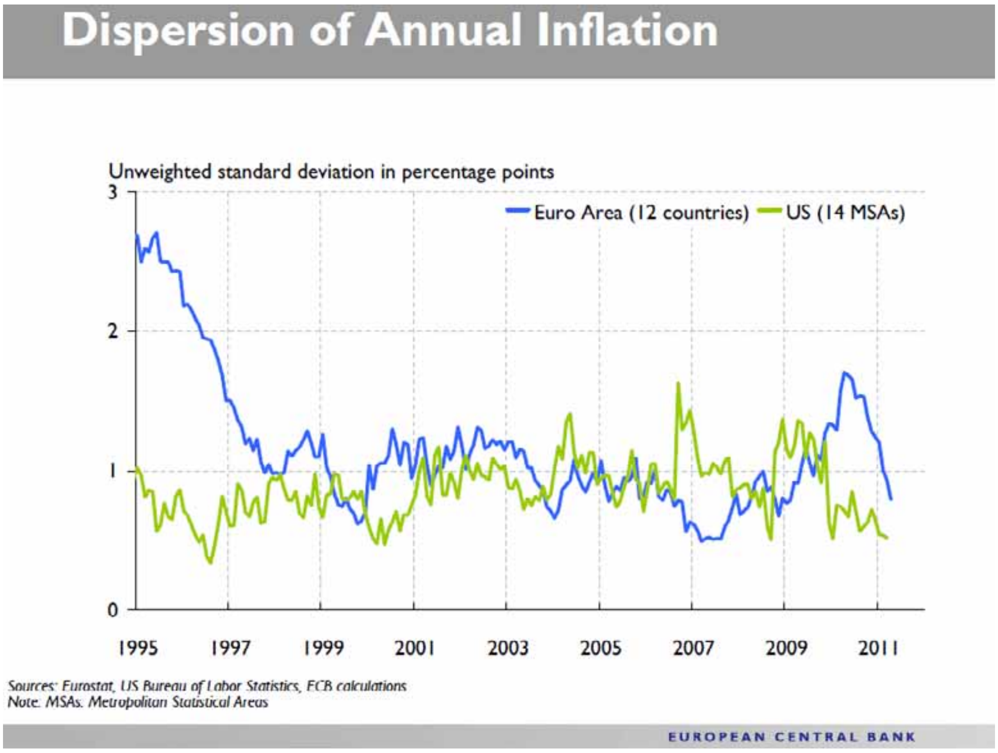
II. Heterogeneity in the euro area and the United States

So much for the bird's eye view. Let me now zoom in on the regional dimension and focus on heterogeneity within EMU compared with the United States.

You may argue that the bird's eye view is misleading. The US economy may be more homogeneous than the economy of the euro area. In other words, aggregate economic data may hide the variance in economic performance across regions within a monetary union.

Looking more closely at the regional dispersion across US regions and euro area economies suggests otherwise. In fact, the dispersion of many of the key indicators is similar.

Let me start off with the inflation indicator. Before the crisis, the dispersion of HICP inflation in euro area countries had remained broadly stable since the late 1990s, at a level similar to the 14 US Metropolitan Statistical Areas. During the crisis we saw a temporary increase in inflation dispersion in the euro area but this has been reversed over the past 12 months.



The picture is similar for the dispersion of GDP growth. Before the crisis the dispersion of growth rates was around 2%, in both the euro area and the United States. Dispersion rose somewhat during the crisis in both currency areas but remained broadly in line with pre-crisis patterns overall.[1]

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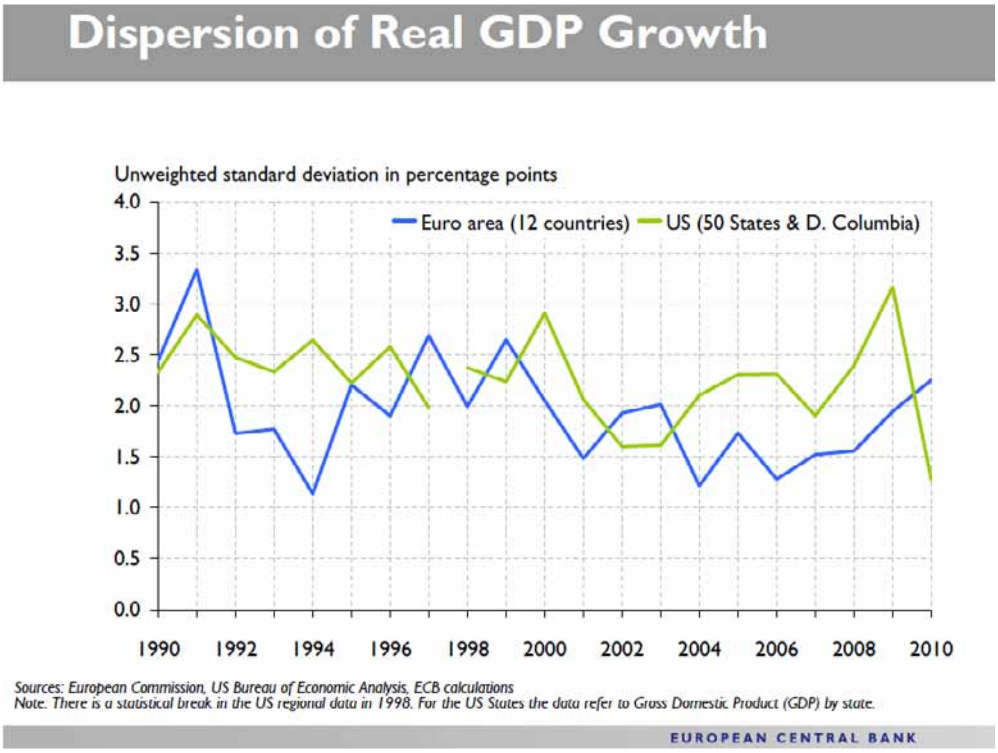
[1] The 2010 data for US regions are provisional estimates published by the Bureau of Economic Analysis on 7 June 2011.



Going one step further, investigation of the sources of this growth dispersion in the US and euro area economies reveals parallels even in the root causes of dispersion in economic performance. Both currency areas comprise regions that experienced a significant boom and bust cycle over the past decade. Both also contain regions that are facing significant structural challenges of a more long-term nature.

In the United States, for example, Nevada, Arizona, Florida and California experienced increases in house prices that outpaced the national average by a wide margin. The steep house price increases probably contributed to above average growth in these states, owing to strong positive contributions from real estate, construction and financial services. These sectors all saw their share in terms of value added to GDP increase at the national level during the years of the housing boom.

But at the same time, some US states, particularly the former manufacturing powerhouses in the "Great Lakes" region, have seen a long episode of below average growth. Below average performance of the region – and particularly weaker growth rates in the states of Michigan and Ohio – are related to strong reliance on manufacturing. Structural shifts in the US economy towards services have gradually reduced the value added of manufacturing relative to GDP, with implications for areas with a high concentration of companies in manufacturing industries other than information and communications technology.

The sharp fall in house prices in Florida and the south-western US states turned boom into bust. These states experienced the harshest recession among the US states.

But GDP growth in the "Great Lakes" region, which was below average before the crisis, also remained below average during the crisis.

Note that the states with the best economic performance in the United States during the crisis – among them, Wyoming and Alaska – have benefited from their dependence on mining.

Similarly, in the euro area some countries experienced asymmetric boom-and-bust cycles. Several euro area countries had higher than average growth in the pre-crisis years. In Ireland

and Spain particularly, a large part of this growth can be ascribed to increases in housing prices.

Other countries in Europe – Portugal, for example – have experienced growth persistently below the euro area average for the past decade due to structural issues that could have been tackled with more determination.

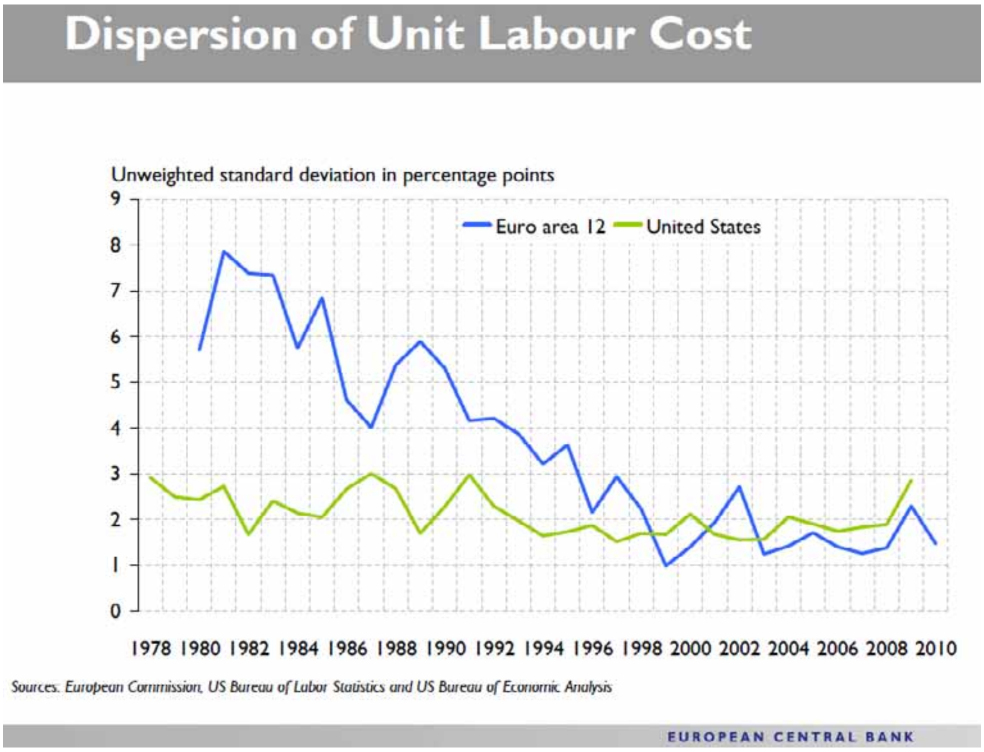
Just a few years ago, this group of countries included Germany – then labelled, totally wrongly, the "sick man of Europe". Yet Germany is now an example of how big the dividends of reform can be if structural adjustment is made a strategic priority and implemented with sufficient patience.

The effect of the crisis on the different euro area economies follows a similar pattern to those of comparable US states. The countries in the euro area that have been hit hardest are those in which either large asset-bubble driven imbalances unwound or structural problems were left unaddressed before the crisis. More specifically, Ireland and Greece, in particular, remained in recession in 2010.

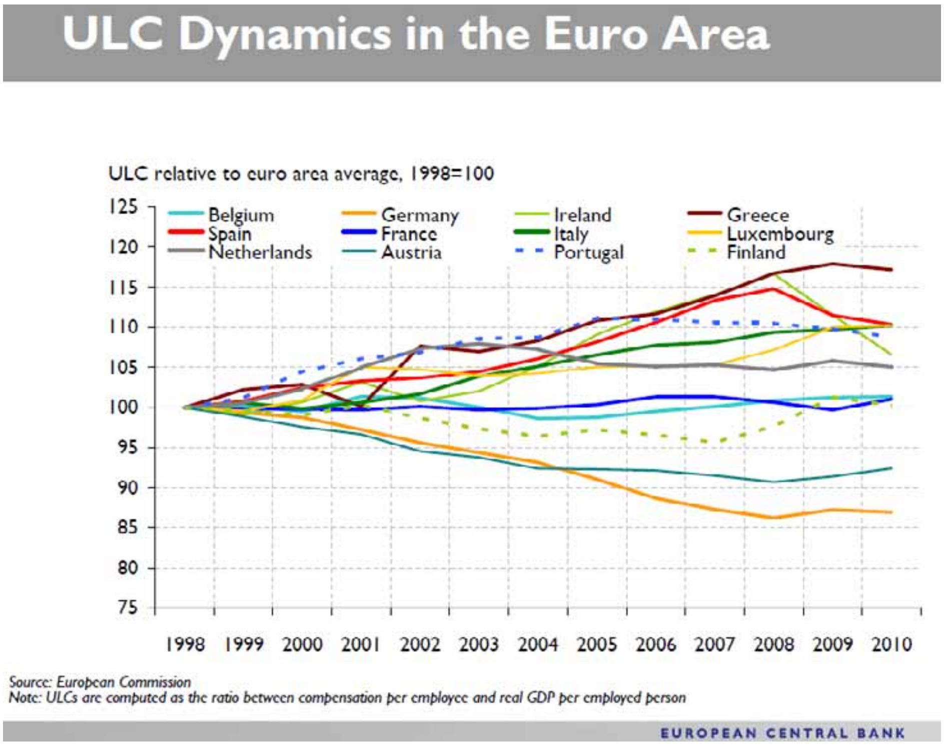
Those countries that have yet to implement more far reaching structural reforms also have relatively low growth prospects after the crisis.

These relatively low growth rates are linked to a deterioration of competitiveness, driven, for example, by persistent above average unit labour costs.

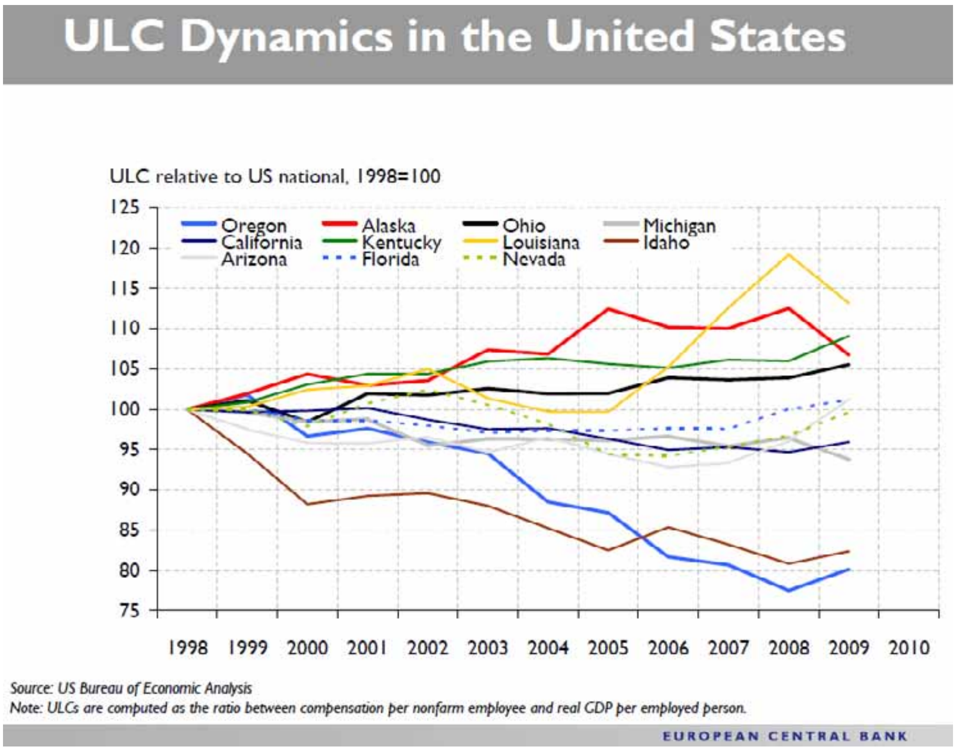
Ahead of EMU, unit labour costs converged in the euro area. What is more – disregarding the most recent countries to join the euro area – dispersion both ahead of the crisis and during the crisis was very similar in the euro area and the United States.



At the same time, it is worth noting that both currency areas include regions with persistently above or below average unit labour cost growth. Again leaving aside the most recent countries to join the euro area, here, Greece, Portugal and Ireland, in particular, have lost competitiveness vis-à-vis their main trading partners in the euro area. Germany, in contrast, has been able to lower relative unit labour costs over the same period of time.



Similar persistent losses and gains in competitiveness are also observed in the United States. Some states have experienced large or persistent increases in unit labour costs, currently exceeding the national average by as much as 20%. Other states, on the other hand, have been gaining competitiveness vis-à-vis the national average over the past decade.



In summary, these results suggest that those who are questioning the viability of the euro area as a single currency area on the grounds of economic heterogeneity are misguided. Over the past 12 years, heterogeneity in the euro area and the United States has been broadly similar.

This should, however, be no reason for any complacency in the euro area.

As the crisis has taught us, persistent losses in competitiveness on the part of individual members in a currency union lead to a build-up of external and internal imbalances. When these unravel, the cost for the affected economies can be very large. They can also have spillover effects on other members of the currency union.

In any union, an economic governance framework is needed to prevent developments in an individual member state endangering the smooth functioning of the union. But for EMU, the economic governance framework devised in the 1990s has not been correctly implemented and, in any case, has proved too weak during the crisis. The crisis has exposed a clear need for strong reform. As I speak today the reform debate is still in progress, and in the last part of my remarks today, I would like to talk briefly about the present reform of economic governance in the euro area.

III. Economic governance in the euro area

The euro is the only major currency not issued by a single sovereign state, but by a union of states.

The Treaties specify a clear division of responsibilities between European and national policy-makers within EMU. On the one hand, monetary policy is inherently indivisible, and in the euro area it is thus conducted at the supranational level by the ECB. On the other hand, fiscal policies remain largely the competence of national governments.

Today's reform of the governance framework has to take the current constitutional framework as a given. For the foreseeable future we have to empower the institutional arrangements that are already in place to the point at which they can really and durably inspire confidence.

The economic governance framework has been incorrectly implemented and, more importantly, has proven to be insufficiently binding whilst lacking appropriate comprehensiveness.

The requirements for a very significant reinforcement of the fiscal surveillance of the Stability and Growth Pact and for the creation of a new surveillance of competitive indicators and macroeconomic policy have been discussed widely.

As you know, the ECB takes the strong view that there is the need for more speed and automaticity in the sanctioning mechanism, particularly in the Stability and Growth Pact, but also in the broader macroeconomic policy surveillance framework. The experience of the past months has vividly demonstrated the importance of a timely correction of internal and external imbalances.

Beyond faster and more automatic sanctions, the enforcement tools also need to be more effective. The macroeconomic surveillance framework, in particular, needs to provide clear incentives by imposing financial sanctions already at an early stage. This also means that there should be no room for discretion in the implementation of the surveillance framework.

At the same time, requirements on fiscal and other macroeconomic policies should be more ambitious. To ensure that none of the euro area countries are left behind, they have to bring national policies in line with the membership to a currency union.

The implementation of sound fiscal and macroeconomic policies is best ensured if these are solidly anchoring at national level. An effective way of achieving this is to implement strong national budgetary frameworks in the euro area Member States.

Another important area of reform, at the global level, is the reform of financial governance.

I have to say that on financial reform we have made more rapid progress. As you know, we have drawn up a set of more stringent banking regulations, more ambitious capital requirements to absorb losses, improving coverage and reducing the risk of excessive borrowing. The countercyclical capital buffers are designed to reduce pro-cyclicality.

At the same time, the supervision of financial institutions, financial markets and market infrastructure has been tightened, and the organisational structure of financial oversight has been overhauled. The European System Risk Board and the European Supervisory Authorities – the three new authorities created for the European banking sector, insurance and occupational pensions, and capital markets – have taken up their work at the beginning of this year. The ESRB is in the process of developing the tools necessary to warn and, if appropriate, make recommendations as regards systemic risk. And the ESAs will allow closer monitoring of the interrelationships in the financial system of the European Union.

- But much remains to be done. Most importantly, we need to ensure the full implementation of the envisioned reforms. In addition, key areas where work is still in progress – not only at the European, but also at global level – include: the treatment of systemically important financial institutions; the mechanism of bank crisis management and resolution; oversight of the shadow banking system; and – very importantly – the further regulation and oversight of financial markets and their functioning.

IV. Conclusion

Let me conclude. The euro area as a whole has witnessed an unprecedented degree of price stability since its inception more than 12 years ago. This has been accompanied by economic performance in terms of growth per capita and job creation that compares positively with other large advanced economies.

It is also remarkable that there is convincing evidence that the euro area and the United States of America have similar features in terms of diversity of the economies that are part of these vast continents: member countries on this side of the Atlantic and the States on the other side. This is documented, in particular, as regards asymmetric inflation, asymmetric growth developments and even in terms of somewhat persistent asymmetric gains and losses of competitiveness.

Therefore, it is important to redress a common belief which is unfounded, in my opinion, namely that the euro area as a whole is significantly more heterogeneous economically, with more dispersion and higher levels of standard deviation of a number of important indicators than the US.

But what remains true is that governing these very vast and equally diverse economies with a single currency is more of a challenge in a union of sovereign states than in a political federation. That is the reason why the European Central Bank is stressing tirelessly the necessity of strongly reinforcing the euro area economic governance. The economic policy of each member of the euro area has to be aligned with the requirements of EMU. As Alexander Hamilton said two hundred years ago: we should ourselves “learn to think (more) continentally”.