Lucas Papademos: What effects is EMU having on the euro area and its member countries (opening remarks)

Opening remarks by Mr Lucas Papademos, Vice-President of the European Central Bank, at the ECB Workshop "What effects is EMU having on the euro area and its member countries?", Frankfurt, 16 June 2005.

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Introduction

When the ECB started organising this workshop a year ago, we thought that addressing the question of the workshop's title would provide a necessary stocktaking and useful analysis of the effects of EMU on the euro area and its member countries, 6½ years after the introduction of the single currency. Recent developments and debates have shown that the impact of EMU on the euro area countries is a very topical issue indeed. Officials, economists and commentators have sought to analyse the pertinent issues and tried to answer the question of this conference. And some of them have come to conclusions which my colleagues in the Governing Council have called "absurd", "nonsensical" or implying "economic suicide" – and rightly so. This debate has sometimes risked being fairly long on polemics and rather short on arguments. With this workshop, to which I would like to welcome you all, we can bring to this discussion some solid facts, sound arguments and a better understanding of the manifold issues involved.

The debate on these issues has often been couched in terms of two key concepts, "convergence" and "heterogeneity" (which do, however, need clearer definitions), and the relationship between the two. On the one hand, further integration of labour, product and capital markets can be expected to reduce economic heterogeneity within the euro area. On the other hand, some degree of heterogeneity can be expected to remain and, indeed, it can be considered a natural feature of any monetary union. These propositions raise several important questions, for example:

- What kind of convergence processes has EMU set in motion?
- To what extent has EMU-induced convergence moderated economic heterogeneity within the euro area?
- What are the causes and consequences of sometimes sizeable and in some cases persistent inflation and output growth divergences across different euro area countries, in a macroeconomic environment shaped by the ECB's monetary policy, which aims to preserve price stability for the euro area as a whole?

These questions, which will be addressed in this workshop, relate to diverse but interrelated issues, such as trade integration, business cycle synchronisation, financial integration, structural reforms in product and labour markets, as well as inflation persistence and inflation differentials. I believe that the quality of the papers to be presented and the impressive group of discussants, chairpersons and panellists will contribute to fruitful debates.

Looking at the titles of the various sessions of the workshop, I would like to share some thoughts with you on three specific topics. The first relates to the consequences of market integration for trade. The second, "closer to home" for a central banker, concerns inflation and output divergences across euro area countries and their implications for policy. The third pertains to the role of the euro in fostering reforms in product, labour and financial markets.

The implications of the integration of goods, services and financial markets for trade

The first topic – the effects of market integration on trade – is particularly interesting, as it raises a number of issues which sometimes seem to lead to puzzling results. First, the conclusions about what we should expect as the trade effects of deeper integration are, in part, ambiguous – think, for example, of the effects of specialisation. Increased competition achieved by deregulation and the completion of the single market, as well as cross-border price transparency due to the single currency, may foster higher sectoral or industry-specific specialisation. Greater sectoral specialisation, as well as increased financial integration, should lead to increases in trade flows within the euro area. At the same time, however, if increased integration were to lead to more similar economic structures and business cycles, this could weaken trade flows within the euro area.

But even if the expected effects of integration are not as ambiguous, appearing instead to be rather straightforward, the evidence available thus far seems not to fully conform with the expectations. Take, for example, the significant progress that has been made in the 1990s regarding product market reforms, which had positive effects on the integration and the degree of competition in goods and services markets in the euro area. One could expect that easing regulations and fostering competition would lead to higher labour productivity growth in the industries concerned, as has happened, for example, in the telecommunications sector. Yet, over the past decade the euro area as a whole has experienced a decline in trend labour productivity growth.

A number of other effects of integration on trade should also be looked at: for instance, whether labour regulations and taxation that hamper technological innovation could lead to a decline in exports within the euro area, as well as resulting in lower exports from the euro area to the rest of the world. As regards the latter effect, it appears that the product composition of euro area exports might involve risks for the future export performance of the euro area, if the under-specialisation in fast-growing high-tech sectors is not adequately addressed. Richard Baldwin's paper offers a very useful and comprehensive treatment of the issues related to the euro's trade effects. And what he found – or did not find – should certainly provide fertile ground for a fruitful discussion in the first session.

Inflation and growth divergences in the euro area and policy implications

The existence of divergences in growth rates and inflation in the euro area, and the associated challenges posed for economic policy in general, and the single monetary policy in particular, are issues that have been debated extensively and intensively since the creation of the euro. They have again been at the centre of public debate in recent months, partly as a result of the performance of the euro area economies over the past few quarters, and partly as a result of uncertainties and concerns deriving from the ratification process for the Constitutional Treaty. In this context, doubts have even been raised about the sustainability of the single currency. There are four key questions that should be addressed regarding this matter:

- Are growth and inflation divergences a real problem in a monetary union?
- And, if so, how serious is the problem for the euro area?
- Are these divergences likely to get worse or likely to be self-correcting?
- What can be done to reduce these divergences and at the same time foster higher growth for the euro area as a whole?

It is worth recalling that growth and inflation divergences between member countries are a natural, inevitable phenomenon in any large monetary union, as evidenced by the experience of a long-established one, the United States. And, in general, they may reflect both structural and conjunctural factors that affect differently the monetary union's countries or regions. Differences in economic structures and/or in market adjustment mechanisms across member countries imply that common or global shocks and common policies will have different effects on their economies. Moreover, growth and inflation differentials may also reflect the impact of asymmetric shocks, fiscal policies and diverging productivity and wage developments. Whether such divergences create problems for the performance and functioning of a monetary union depends on their causes, size and persistence.

What are the facts about the relative macroeconomic performances of euro area member countries? And what is the diagnosis about the causal factors and the underlying processes that explain them? I would like to point out two interesting facts that are contrary to popular perceptions. The first is that during the first six years since the creation of the euro, the growth and inflation differentials observed between member countries have not been greater than those recorded in the 25 years before the establishment of EMU. On the contrary, according to some measures, the dispersion in growth rates has recently reached a historically low level. The second fact is that both growth and inflation differentials in the euro area since the introduction of the euro have been broadly of the same order of magnitude as the corresponding differentials observed across regions and metropolitan areas in the United States. These facts would seem to suggest that, at least on the basis of size, the heterogeneity observed in the macroeconomic performance of euro area member countries is not exceptional and thus need not be a cause of alarm.

Nevertheless, there are certain other developments that suggest caution and point to the need for a deeper and more comprehensive analysis. One such development relates to the significant and persistent divergences in measures of competitiveness between member countries. The diverging competitiveness is a consequence of various factors and policies as well as of market adjustment mechanisms, which in some cases reflect rigidities in labour markets and the low degree of integration and competition in certain product markets, particularly for services. The persistence of these developments suggests that adjustment mechanisms are functioning slowly and that self-equilibrating forces are not sufficiently strong. The extent and the cumulative effects of differences in competitiveness between some euro area countries raise concerns about their impact on growth. In addition, other factors – some exogenous, such as competitive pressures resulting from globalisation, and some internal, influencing consumer sentiment – affect economic activity and tend to compound the adverse effects of the erosion of competitiveness in some countries or partly offset the benefits from the increased competitiveness attained in other countries.

A better understanding of the factors and processes that determine economic fluctuations, inflation persistence and competitiveness developments across the euro area countries will contribute to the diagnosis of the present situation and the assessment of future trends. Two papers in this workshop provide insights and useful results to this end. The extent of synchronisation of economic activity in Europe is examined in the paper by Domenico Giannone and Lucrezia Reichlin, which evaluates long-run tendencies and cyclical fluctuations. Different growth trends may be due to different patterns of specialisation, which can be desirable within the monetary union provided that countries can share risk through capital market integration. This study and other recent research show that European financial integration has resulted in increasing opportunities to share risk. The paper by Ignazio Angeloni, Luc Aucremanne and Matteo Ciccarelli concentrates on determinants of inflation dynamics in different euro area countries, notably the evidence on the price-setting behaviour of firms and on factors explaining inflation persistence. A thorough analysis of aggregate inflation dynamics and of the inertia characterising core inflation is of direct relevance to the formulation of monetary policy and also contributes to the diagnosis of the causes of growth fluctuations and of the high unemployment in Europe.

One general conclusion that emerges from the papers prepared for this workshop is that the divergences observed in the euro area are fundamentally the consequence of structural and not of conjunctural factors – even if current divergences may also have been influenced to a certain extent by conjunctural events. The policy implication of this general diagnosis is that more economic reforms are needed to address the structural impediments to growth and the causes of growth and inflation divergences. Of course, structural reforms are not always easy to implement, they may be politically costly, and their positive effects may not be immediately visible – which makes it difficult to communicate them and convince the public at large about their benefits. Nevertheless, only the implementation of appropriate economic reforms can address effectively and permanently the root causes of the euro area's economic problems. Consequently, the focus of the public debate should be how to speed up the reform process and its beneficial effects and thus strengthen consumer and business confidence.

The role of the euro in fostering reforms in product, labour and financial markets

Has the euro been of help in pushing the reform agenda? At the time of the launch of the single currency, some observers had seen the euro as a "reform whip" that, together with the completion of the single market, would push in the direction of increased competition, higher productivity growth and greater market flexibility, which are essential for the smooth functioning of monetary union. After all, in a single currency area, the adjustment of domestic imbalances cannot be corrected by exchange rate policy any longer, but rather has to take place via prices and costs. The paper by Romain Duval and Jørgen Elmeskov, which will be discussed tomorrow, will provide empirical evidence about the determinants of the pace of the reform process. Our own ECB research, presented in the paper by Lorenzo Cappiello, Philipp Hartmann, Peter Hördahl, Arjan Kadareja and Simone Manganelli, will dwell on the impact of the euro on the integration of European financial markets, notably the equity and bond markets. This stock-taking exercise and associated analysis should also assist in identifying where, precisely, structural changes are most urgently needed and how to make the necessary reforms a success.

Concluding remarks

The introduction of the euro and the conduct of the single monetary policy have established an environment of price stability in the euro area. The ECB's monetary policy has acquired credibility and has succeeded in anchoring long-term inflation expectations to price stability, thereby exerting a moderating influence on price and wage-setting behaviour. Both short-term interest rates and long-term bond yields are at historically low levels in nominal and real terms. But, as we know, price stability and favourable financing conditions establish necessary but not sufficient conditions for sustainable growth. There is still some way to go in terms of the implementation of the necessary structural reforms that will result in faster and durable growth in the euro area, through higher productivity growth, increased labour utilisation, and improved competitiveness in the global economy. Which brings me to a final reflection, opening up a broader perspective.

The issues to be discussed in this workshop should also be seen against the background of globalisation. The forces and dynamics of globalisation influence economic developments in the euro area (for instance through pressures on firms' cost structures) and also have an impact on the integration process that has been triggered by the euro. Of course, it is not easy to disentangle the effects of globalisation on the European integration process from those which stem from the creation of the single currency. However, both processes call for mechanisms that facilitate the economy's efficient adjustment so as to cope with the challenges of a constantly changing environment for firms, consumers and policy-makers. All of which reinforces the urgency to pursue the structural reform agenda in the euro area in a determined and systematic manner. With this wider-ranging reflection, I conclude. Once again, welcome to this ECB workshop. I can rationally predict that it will be a very productive and enriching one.