Jean-Claude Trichet: Economic integration in the euro area

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the 15th European Regional Conference of the Board of Governors, Tel Aviv University, Paris, 31 March 2006.

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Ladies and Gentlemen,

Dear Friends,

Thank you for inviting me here today, it's a great pleasure to be once again with the friends of the Tel Aviv University and among such a distinguished audience.

1. ***Introduction.*** As you know, the euro represents a unique endeavour in economic history: voluntarily creating an economic area with a single market and sharing a single currency among 12 national economies. Under the influence of the euro, many important developments are now taking place. I would like to share with you some thoughts on these developments and their implications.

My reflections are organised along four main lines. First, I argue that the euro pushes integration forwards. Second, I highlight some of the main benefits and costs of European economic and monetary integration. Third, I provide some snapshots of the diversity of euro area national economies, a natural phenomenon in a wide currency area. Fourth, I discuss the issue of the optimal economic management of the euro area.

2. ***First, the economic and financial environment of the euro area has changed and is still changing.*** The economies of euro area countries are becoming more interdependent as the euro acts as a catalyst, both directly and indirectly.

We have clear evidence of a significant increase in both ***intra- and extra-euro area trade in goods*** since the launch of the euro. ***Exports and imports of goods within the euro area*** increased from about 26.5% of GDP in 1998 to around 31% in 2005. This may be partly related to the introduction of the single currency and the increased price and cost transparency, which have promoted cross-border trade. Over the same period, ***exports and imports of goods with trading partners outside the euro area*** rose from about 24% of GDP to almost 30%. This is mainly due to more sustained growth in world GDP, an increase in global trade integration, and a very sizeable increase in trade with the ten new members of the European Union. All in all, these developments are noteworthy, given the already high degree of openness of the euro area countries, suggesting that we are not witnessing the creation of a "fortress Europe".

A less-known feature is that ***trade in services*** with partners inside and outside the euro area also increased as a percentage of GDP in recent years. Intra-euro exports and imports of services increased from about 5% of GDP in 1998 to around 6.5% in 2005. Proportionately, this represents a higher increase than extra-euro exports and imports of services, which increased from about 7.5% of GDP in 1998 to around 9% in 2005. Trade in services can rise much further when the single market for services is completed, particularly in the financial area.

Intra-euro area Foreign Direct Investments (FDIs) have grown considerably as well. They are now catching up with extra-euro area FDIs. Between 1994 and 2004, intra-euro area FDI stocks grew robustly from almost 14% of euro area GDP to around 24%. Extra-euro area outward FDI stocks have instead grown somewhat less rapidly since the introduction of the euro: i.e., from 22% to 30% of euro area GDP. Such FDIs – that also include Mergers and Acquisitions (M&A) activity – accumulate over time and contribute to the reshaping of Europe. If you allow me, this represents an investment of the euro area in itself!

The faster movement towards a single market in financial services is another example of the euro acting as a catalyst. I will give just a few examples. Last year, for the first time, the ECB published a set of indicators on the state of integration of euro area financial and banking markets. These indicators clearly show that the euro has been a catalyst, particularly in those market segments that are closer to the single monetary policy. For example the cross-sectional standard deviation of EONIA, EURIBOR and EUREPO lending rates across euro area countries plummeted to close to zero following the introduction of the euro and remained stable thereafter at around 1-2 basis points.

The euro corporate bond market has grown very significantly since 1999, and has the potential to grow even further, closing the gap with the US market. The outstanding volume of bonds issued by non-financial corporations of around €2.5 trillion in the United States is still three times larger than in the euro area. A gradual integration is also taking place in euro area equity markets. Stock prices across the euro area increasingly react to euro area-wide factors and news. Furthermore, the elimination of intra-euro area currency risk has reduced the "home bias" in the equity holdings of institutional investors, but the country effect is still quite important. Here there is potential for greater integration.

Cross-border interbank loans and holdings of securities are another area in which we have seen significant progress. At the end of 1997, securities issued by non-monetary financial institutions of another euro area country accounted for only 16% of the securities held by euro area monetary financial institutions (MFIs). This share has now reached almost 40%.

But integration in retail banking has been slow so far. Concentration in the banking sector has increased mostly due to domestic mergers. Cross-border banking mergers have only recently started to happen. In this respect, while a number of euro area banks have considerably expanded their interests outside the euro area in recent years, cross-border activity within the euro area, has remained limited. Only in recent quarters however, have we seen an increase. The continuation of this trend will result in an increase in the level of competition and efficiency in the euro area financial system.

Let me briefly mention that the ECB and the Eurosystem are actively involved in several joint initiatives. The launch of TARGET2 – the new payment platform for the financial system – is planned for the end of 2007. We are participating in the Short-Term European Paper (STEP) initiative to promote the convergence of standards and practices prevailing in the European short-term securities markets. We are also working with the European Commission on the Green Paper on Mortgage Credit in the EU. This segment of the banking and retail markets has an outstanding volume of more than €4 trillion in residential mortgage debt in the EU, corresponding to around 40% of EU GDP. Euro area mortgage markets are not yet fully integrated, and I see here great potential for further integration.

I would also like to see further progress in creating more flexible labour and product markets. Movements in this area have been slower than we expected. I will come back to this issue later on.

All in all, the economic and financial environment is steadily changing: euro area countries are becoming even more interdependent than they were at the start of EMU. We all have a bigger stake in each other and are increasingly inter-reliant.

The ECB and the Eurosystem pay close attention to these effects of the euro. Last June we held a workshop to explore developments in all areas. I can only repeat here what I said at the end of that workshop, namely: ***"All my experience tells me that in such a rapidly changing world, where the progress of sciences and technology, the globalisation process and the very profound structural changes in Europe are simultaneous, we have to be humble in front of facts and figures and be ready to take [them] on board."***

3. ***My second observation is that the single currency has fostered changes in the economic and financial environment that are beneficial.*** The single currency has created lower transaction costs and increased price and cost transparency on top of the Single Market Programme, thus fostering competition in the area of tradable goods and services, and promoting trade. Indeed, there are benefits from deeper trade in goods and services. Increasing intra-euro FDIs and M&As allow companies based in Europe to obtain higher returns.

The Eurosystem – with the ECB at its centre – has built a successful monetary framework. This includes a clear monetary policy strategy to deliver our primary objective – price stability – and an efficient payment system. As a result, expected inflation levels are low, in line with our definition of price stability. This has allowed for nominal and real interest rates standing at historically low levels, thus creating favourable conditions for sustained economic growth and job creation.

Currently, nominal and real interest rates are at historically low levels. In most euro area countries, lower real interest rates existed only back in the 1970s, when financial captivity preceded financial liberalisation. But these rates were "too low" to maintain price stability in these countries. The main achievement which we see at present is low nominal and real rates consistent with stable inflation, due to the credibility of the ECB in solidly anchoring long-term inflation expectations.

The euro area has become more resilient. As a whole, we find less volatility because the cyclical component of output growth is more synchronised and some previously idiosyncratic national economic policies have disappeared. A relevant factor for some euro area member countries is that the risk of possible speculative attacks on national currencies has been removed.

Clearly, there are also general economic benefits arising from more financial integration in the euro area. I will mention a few. Financial integration fosters financial development and the modernisation of the financial system and, ultimately, economic growth. Some of our studies and some analyses by the EU Commission claim that the potential gains from the financial integration of European bond and equity markets in terms of additional GDP growth amount to around 1% over a ten-year period.

Thanks to greater financial integration, economic agents can invest more easily in any part of the euro area and thereby spread the risk of potential local shocks impacting on income and consumption. The potential benefits of this are enormous. To the extent that euro area investors are assigning a higher weight to portfolio investment in euro area countries – and banking integration increases as well – risk-sharing in the euro area increases: a very important shock absorber.

I will give you a comparison. A few years ago Sorensen and Yosha showed in a research paper that the US capital markets smoothes 39% of the shocks to gross state product, credit markets 23% and the federal government 13%. 25% of the shock is not smoothed. Hence, in the United States, financial markets and financial institutions contribute by 62%, to the absorption of state idiosyncratic shocks. The effect is about five times more important than the federal budget. While in Europe the supranational budget plays a different role, we expect European financial markets to move in this direction.

Furthermore, by making markets deeper and more liquid, financial integration creates economies of scale and increases the supply of funds for investment opportunities. The integration process fosters competition, the expansion of markets and intermediation, thereby complementing and leading to further financial development. Financial development, in turn, leads to lower intermediation costs and a more efficient allocation of capital. Allocating resources to the most productive investment opportunities ultimately increases the potential for greater and more sustainable non-inflationary economic growth.

All in all, there is no doubt that sharing the euro has been beneficial for all euro area countries. The 313 million people in the euro area and, more generally, the 460 million European Union citizens expect such economic benefits.

4. ***My third observation concerns the level of diversity*** among the euro area national economies. I will present some snapshots of diversity from several angles. First, I will analyse the evolution and dispersion of inflation, as well as indicators of growth differentials, competitiveness and unit labour costs. I will compare and contrast the euro area with the other major industrialised continental economy, the United States.

4.a *Inflation dispersion in the euro area has considerably declined*, and it is on par with the level found in the United States. Inflation dispersion among euro area countries declined in the 1980s and 1990s and has broadly stabilised since the inception of the euro. The progress made was very impressive. The unweighted standard deviation of annual HICP inflation rates was still around 6 percentage points in late 1990. It has declined to 1 percentage point since the launch of the euro, a level at which it broadly stabilised. This dispersion level is similar to that of the 14 US Metropolitan Statistical Areas (MSAs), but somewhat higher than for the four US census regions. Although such comparisons are subject to some well-known caveats, it can be argued that inflation dispersion in the euro area has not been high by international standards.

One significant feature of euro area inflation differentials is their persistence. Inflation in most member countries displays significant inertia. Many countries below, or above, the euro area average inflation rates in recent years have remained in this position on average for at least a decade. Such widespread persistence of inflation differentials over long periods does not occur in the United States. We now see signs of limited reversals: some euro area countries with relatively high inflation rates have moved down to, or even below, the euro area average. Overall, these corrections are welcome, but the point is that they have been quite slow. While some wage or inflation differentials are justified – and prove that monetary union promotes adjustments – there is a need to better understand the reasons for this apparent sluggish adjustment process.

If I look at the *cost side,* in most countries, domestic factors dominate external factors in generating inflation differentials. In particular, we have witnessed a sustained divergence of wage developments across the euro area, and narrower differences in labour productivity growth. As a result, differentials in the growth of unit labour costs have been persistent. This suggests a link with differing wage rigidities across the euro area. However, changes in profit margins also contributed to inflation differentials. Imperfect competition and associated price rigidities across countries may also have been a factor in explaining inflation differentials.

If I look at *product groups*, there has been a relatively higher price dispersion in the area of services. This is probably associated with the dispersion in services wage developments. By contrast, inflation dispersion was relatively low for tradeable goods. Then, of course, products with relatively volatile price developments (energy, unprocessed food and processed food) also showed a high dispersion of price changes across countries.

Hence, there is a certain degree of structural diversity in inflation and cost developments among euro area national economies. A portion of this diversity is undesirable and, if uncorrected, may engender negative effects and externalities for the euro area as a whole. We can conclude that, while differing wage and price rigidities play an important role, increased competition, particularly in the services sector, is very welcome to the extent that it has a dampening effect on inflation differentials.

4.b *The second snapshot of diversity in the euro area concerns growth dispersion.* Growth dispersion in the euro area has been broadly stable since the early 1970s. Between 1999 and 2005 no signs of increased divergence emerged. The average dispersion of annual real GDP growth (measured as the unweighted standard deviation) was around 2 percentage points. This is very close to the average dispersion of real growth rates since the 1980s. By comparison, the dispersion of real growth across the 50 US states fluctuated around an average of 2½ percentage points over the last 15 years, while the average dispersion of the real growth rates was around 1½ percentage points across the eight US statistical regions.

There is also a relatively high degree of persistence of output growth differentials within the euro area. A certain degree of persistence of growth differentials is also found in the United States. However, to take the United States as a benchmark is useful only up to a certain point. On the one hand, the US economy is known to be more flexible than the euro area (and thus effects of asymmetric shocks should be absorbed more easily and faster). On the other hand, the United States exhibits stronger regional specialisation than the euro area, making its regions more subject to specific asymmetric shocks.

It is useful to distinguish between the developments of dispersion and the issue of business cycle synchronisation. Dispersion in real GDP growth rates across the euro area countries reflects two main factors: dispersion of cycles and dispersion of trends. Using the production function approach, the dispersion of cycles, that are often addressed as output gaps, has steadily declined since the early 1990s from about 2 percentage points to 1 percentage point. Instead, since the beginning of the 1990s we witness more lasting differences in trend growth that rose from about 1.2 percentage points to about 1.7 percentage points in the late 1990s and then started declining. Some euro area countries persistently exhibit trend output growth either above or below the euro area average.

Related to this, the degree of **synchronisation** of business cycles across euro area countries seems to have increased since the early 1990s. This finding holds true for various measures of synchronisation applied to overall activity and to the cyclical component, for annual and quarterly data as well as for various country groupings. In particular, the degree of correlation appears currently to be at a historical high.

These two features are unique to the euro area. No increase in the contribution from trend growth differences and no increase in synchronisation have been detected for a subset of 12 non-euro area OECD countries. This may indicate that EU integration and more recently EMU – as opposed to global forces – have led to smaller differences in output gaps and an increase in the synchronisation of business cycles across the euro area countries.

Differences in trend growth among euro area countries, can be explained by various structural factors, including to some extent demographic trends and catching up with others in terms of the standard of living. Differences in the timing and extent of past structural reforms in euro area countries are likely to have played a significant role. For example, the Netherlands and Spain have undertaken labour market reforms earlier than the largest euro area country. As a result, diverse long-term trends in labour productivity and employment growth have been observed. More in general, the degree of economic flexibility could be a factor explaining trend growth differences. In some countries, short-term shocks may have had more persistent effects on growth differentials, due to slow adjustment processes in the presence of structural rigidities.

The increasing weight of differences in trend growth, and the lower weight of dispersion in business cycles has important implications. Macroeconomic policies can only partly address this dispersion while structural reforms can more fully address them.

4.c *My third snapshot of diversity concerns the rapidity with which relative changes in cost and price competitiveness are occurring.* These movements mainly reflect changes in unit labour costs and inflation differentials. They demonstrate that there is much leeway for loosing, or gaining, competitiveness even in the absence of exchange rate adjustment: more leeway than was foreseen prior to the launch of the euro. Let me give you an order of magnitude. Between 1999 and 2005 the difference in the cumulated growth of unit labour costs for the total economy between the "highest inflation" and the "lowest inflation" countries was about 20–25%.

This is an important phenomenon that calls for a deep understanding of the factors driving it. I will touch upon a few developments:

Unit labour costs are increasing at a relatively fast pace in those euro area economies which started at a significantly lower price and cost level. In most cases this phenomenon is driven by the Balassa-Samuelson effect, which occurs when there is a catching-up to higher living standards, and is generally acceptable, as it reflects the movement to a new equilibrium;

Germany has seen very moderate growth in unit labour cost over an extended period, leading to a correction of the losses in competitiveness as a result of German reunification. This correction and the related sustained period of relatively low inflation is, of course, fully justified and perfectly welcome. It also shows that adjustment mechanisms in EMU do work. A high degree of wage flexibility would contribute to speeding-up such welcome adjustment processes;

Some other sources of diversity are not economically justified. They might be partly attributable to insufficient flexibility; in such economies corrections must be made. For example in some economies wage increases have exceeded the weak labour productivity growth rates for a sustained period, leading to a progressive deterioration of their competitiveness. Furthermore, in several euro area countries there exists a phenomenon of hysteresis in wage formation (for example due to indexation mechanisms) and in price formation in general, limiting the responsiveness to shocks.

5. My fourth observation concerns the optimal economic management of the euro area. I will now stress the importance of three "guiding principles" that must guide the economic management of the euro area: strict adherence to the Stability and Growth Pact, close monitoring of the implementation of the structural reforms called for by the Lisbon agenda, and close attention to the indicators of relative competitiveness inside the euro area. Such economic management aims to exploit all the benefits deriving from a single currency, given the fact that countries no longer have national monetary policy tools to resort to.

5.a A rigorous implementation of the Stability and Growth Pact. There are several reasons for clear fiscal rules in a monetary union such as those embodied in the Stability and Growth Pact, including: correcting the "deficit bias" of fiscal policy, and preventing spillovers from fiscal policies to monetary policy. I have made these reasons clear on numerous occasions. Euro area countries need to maintain budgetary positions that are close to balance or in surplus over the medium term and to reduce public debt to a low and sustainable level.

But the subject of my speech today is the economic integration of the euro area, so I would like to mention three other reasons for supporting sound fiscal policies: first, the need to reduce the risk of fiscal policy externalities; second, the need to gain flexibility and adaptability; and third, the importance of ensuring proper incentives. Sound fiscal policies allow flexibility, which cushions the effects of the economic cycle through the working of automatic stabilisers. Additionally, sound fiscal policies create room for domestic economic management going beyond compliance with the Stability and Growth Pact and, say, pursue the desired tax and spending policies. Furthermore, the tax and benefit system should avoid major distortions to incentives to work, save, invest and innovate. This creates conditions which are conducive to stability and sustainable growth. Ireland is one of the very clear examples of such a virtuous process inside the euro area.

The public sector also has a "role model" function, for example concerning public wages and/or administrative prices. Its behaviour can make the social partners more aware of the trade-off between higher salaries and job creation.

While a sound fiscal policy is in a country's own interest, it is very much in the interest of the euro area as well. An inappropriate fiscal policy in one country directly affects the other countries as the impact on interest rates is no longer confined to one country but spreads across the euro area.

5.b The close monitoring of the implementation of structural reforms. Earlier, I referred to some common denominators behind inflation and growth differentials: the detrimental role of pervasive price and wage rigidities, excessive labour market regulations, and of imperfect competition in several important sectors of the euro area economies. We have known this for quite a long time. A lot is at stake here, and there is an urgent need for action.

Why? All euro area countries need structural reforms, although to different degrees. Reforms are essential to raise factor productivity and potential output, to create new jobs and achieve lower prices and higher real incomes. The need for reforms is signalled very clearly by the fact that euro area potential output growth seems to have moved to the lower bound of its previously estimated range of 2–2.5% and that, in addition, euro area real GDP per capita is still about 70% of that in the United States. Furthermore, reforms are also needed to increase the resilience and the flexibility of the economy.

The Lisbon agenda of 2000 was, and is, a fundamental and ambitious programme to draw Europe's attention to the urgency of structural reforms. It identified everything that needs to be changed. However, the modest and uneven implementation so far has clearly shown how difficult reforms are. More recently, the Lisbon agenda has been refocused towards growth and employment. Diverse feasible goals were set in order to enhance, among other things, the flexibility and adaptability of labour markets, to raise competition in the markets for goods and services, to increase employment, promote innovation and strengthen growth and employment in each participating country. The need for structural reforms and liberalisation applies also to financial markets. In fact, further financial integration has the potential to greatly foster economic growth.

Governments are paying greater attention to the implementation of reforms. We appreciate this renewed impetus, which has now resulted in the more focused Partnership for Growth and Jobs and in the structural reform commitments of the National Reform Programmes. We also need to reinforce the benchmarking of good performance to better identify where the reform challenges are most urgent. As I have explained above, a successful reform programme is of particular importance for euro area countries.

5.c It is necessary to monitor unit labour costs and national competitiveness indicators to prevent or correct, if necessary, abnormal deviations. We would expect some dispersion and differentials among euro area countries: in the long and very long term, several parameters characterising their economies are bound to fluctuate around some average of the euro area as a whole. Put more clearly, there will always be some diversity as in other monetary unions, including the US. In particular, this should be the case for countries catching-up in terms of GDP per capita and price levels and would thus show faster output growth and inflation. For some economies, the observed diversity may go beyond the completion of the "catching-up" process. This should be the case for corrections of past excesses in terms of overall cost and price competitiveness, particularly in the tradable goods and services markets, triggered by the proper functioning of the market mechanism.

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Ladies and gentlemen, dear friends, to conclude, several developments are already evident, while some others are still latent. Please remember that the euro was introduced as a single scriptural currency only in 1999, and as a physical currency three years later: hence, things are still unfolding and it will take time for the full effects of the euro to become apparent. The economic and financial environment is changing and the euro is operating as a catalyst – both directly and indirectly – in many areas. Euro area countries are becoming more interdependent. All in all, I see mainly beneficial effects resulting from the launch of the euro. However, some more hard work is needed to improve the flexibility and adaptability of the euro area economies. The implementation of the structural reforms is essential in order to enhance growth potential for the euro area as a whole, and to facilitate and speed up the endogenous corrections of deviations of economic parameters, including competitiveness indicators.

Against this favourable background, we need to monitor and understand the factors behind the diversities among euro area countries: if they were to persist unchecked they could accumulate over time. These developments, and the underlying factors, need to be discussed by euro area policymakers and appropriate corrective measures have to be taken to ensure a smooth functioning of the euro area in the coming years.

Given the global and open environment in which we live, this hard work would have been needed in any case. The euro has brought low inflation, low medium and long-term interest rates, and much stability to the euro area as a whole: three achievements that lend support to these urgently needed reforms.

I thank you for your attention.