Jean-Claude Trichet: Economic integration and adjustment processes in the euro area

Speech by Jean-Claude Trichet, President of the European Central Bank, at the Wirtschaftstag 2007 as recipient of the "Ludwig Erhard Memorial Coin in Gold", Berlin, 13 June 2007.

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1. Introduction

Es ist mir eine große Ehre, als Ehrengast zu dieser Veranstaltung eingeladen zu sein und mit der Ludwig Erhard Gedenkmünze in Gold ausgezeichnet zu werden. Nicht nur Deutschland, sondern ganz Europa ist Ludwig Erhard zu Dank verpflichtet für seine mutige, auf den Prinzipien von freiem Wettbewerb, flexiblen Preisen und offenen Märkten beruhende Politik, und insbesondere für seine Ideen zum Konzept der Sozialen Marktwirtschaft. Er hat überdies auf die Bedeutung der Preisstabilität hingewiesen, welche er als menschliches Grundrecht aufgefasst hat.

[English version: It is a great honour for me to be invited as guest of honour and to receive the Ludwig Erhard Memorial Coin in Gold. Not only Germany but the whole of Europe is indebted to Ludwig Erhard for his courageous policies based on the principles of free competition, flexible prices and open markets, and above all for his ideas on the concept of the social market economy.[1] He also stressed the importance of price stability, which he considered to be a basic human right.]

We are today – thanks to the work of Ludwig Erhard – confronted with exciting challenges and a unique historical development. The creation of the euro area is an exceptional endeavour, now comprising 13 countries, with the entry of Slovenia, and 318 million people. I remember many critical voices anticipating a failure and claiming that it would be impossible to share a single monetary policy and a single currency.

Let me be clear from the very beginning: while there are still formidable challenges and we should not be complacent, Economic and Monetary Union (EMU) has been a great success. Some people claim that the euro and our focus on price stability have undermined job creation. I always put facts and figures first: over the eight years since the creation of the euro, employment in the euro area has risen by more than 12 million people. This can be compared with a rise of less than 3 million in the eight years preceding the adoption of the euro. Obviously, I do not intend to give all the credit for this impressive employment growth to the creation of the euro alone, but it is difficult to deny that the solid anchoring of price stability for all our vast continental economy has contributed to this achievement.

It is a fact that economic integration has increased among the euro area countries. However, it is also true that the creation of the euro area – like globalisation – highlights the need for flexible economies. I do not see this as a negative aspect. On the contrary, it is a positive implication. In this sense, EMU has increased the pressure on all policy-makers and also all social partners – and I stress the word "all". They must ensure a well-functioning euro area, by good management aimed at enhanced flexibility, integrated labour, product and financial markets and disciplined fiscal policies.

This leads me to the two main issues I would like to address this evening. First, I would like to share with you some stylised facts on the features of the euro area's economic integration process. Second, I will address the complex and important issue of how to ensure that economic adjustment

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[1] "A free economic order can only continue if and so long as the social life of the nation contains a maximum of freedom, of private initiative and of foresight. If, on the other hand, social policy aims at granting a man complete security from the hour of birth, and protecting him absolutely from the hazards of life, then it cannot be expected that people will develop that full measure of energy, effort, enterprise and other human virtues which are vital to the life and future of the nation, and which, moreover, are the prerequisites for a social market economy based on individual initiative. … It should not be denied that in modern industrialised countries even a good economic policy will have to be complemented by social policy measures. On the other hand it is true to say that every effective social aid will have to be based on an adequate and growing national income, which means an efficient economy. Thus it must be in the interests of every organic social policy to secure an expanding and sound economy, and to take care that the principles guiding this economy are maintained and extended." From: Ludwig Erhard, "Prosperity through Competition" (Wohlstand für alle), Chapter 12 "Welfare State – The Modern Delusion" (Versorgungsstaat – der moderne Wahn), London 1958.

mechanisms function properly in the euro area. Why are these topics so decisive, you may ask? Economic integration benefits consumers through lower prices and leads to increased employment. It is also crucial to enhancing the adjustment mechanism. This, in turn, helps to improve the ability of economies to cope with various events, with various "shocks" as we say in economics, so as to prevent a country or a region from entering into a long-lasting period of recession or overheating. These are very important issues because they are intrinsically linked to the welfare of our citizens and the continuing success of the euro area.

2. Features of economic integration in the euro area

Allow me to briefly elaborate on five main features of the process of economic integration in the euro area.

The first three are related to the completion of the Single Market, i.e. the integration of goods, services, capital and labour markets across the euro area countries.

i) As to the first feature, 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 common 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 full achievement of a single market for services should further facilitate trade in services.[2] As this interdependence within the euro area becomes stronger, the euro area is also becoming a more open economy. 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.[3]

ii) As a second feature, the introduction of the euro has also contributed to financial integration which, in turn, improves the free movement of capital in the euro area. First, financial integration raises the potential for stronger, non-inflationary 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.[4] Second, a well-integrated financial system is, of course, also crucial for the conduct of the single monetary policy, as it enhances the smooth and effective transmission of monetary policy throughout the euro area. Generally, financial integration is more advanced in those market segments that are closer to the single monetary policy, especially the money market.[5] However, as I have stressed on several occasions, further financial integration is particularly needed in a number of areas, including in retail banking.

iii) Turning to labour mobility, which constitutes the third feature I would like to mention, available evidence suggests that, overall, cross-border labour mobility is still low in the euro area. And we still have formal barriers to labour mobility across the euro area. This is in clear contrast to the situation in the United States.[6]

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2 See Task Force of the Monetary Policy Committee of the European System of Central Banks "Competition, productivity and prices in the euro area services sector", ECB Occasional Paper No 44, 2006.

3 See R. Baldwin "The euro's trade effects" ECB Working Paper No 594, 2006.

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

5 See "Financial Integration in Europe", ECB, March 2007.

6 Although the data available refer mostly to the 15 earliest members of the European Union, the EU15, they are still illustrative of the situation in the euro area. In 2000 only 0.1% of the total EU15 population (or around 225,000 people) moved their official residence between two Member States. Furthermore, only a small proportion of individuals – 0.4% of the EU15 population – were known to commute across borders to work, and half of this amount was to a non EU15 country. In the United States, geographical labour mobility appears to be far higher. Evidence suggests that around 5.9% of the total US population moved their residence between US states in 1999. See F. F. Heinz and M. Ward-Warmedinger, "Cross-

iv) As a fourth feature, economic integration and convergence is also reflected in the fact that current inflation and output growth differences among euro area countries are relatively limited by historical standards. The differences also appear to be similar to those observed across regions or states within the United States.[7]

I understand that some observers may like to create headline news from the differences in economic growth or inflation between some euro area countries in a specific quarter or year. But let me stress that it is absolutely normal in a monetary union, such as the euro area, for economic developments to differ across individual regions. This is also the case among regions in the United States. Why is it normal? First, differences in growth rates and inflation may be related to catching-up phenomena. A region which is relatively underdeveloped would, if not hindered by bad economic policies, be expected to grow at a rate above the currency area average and thus, over time, reach an income per capita level similar to the currency area as a whole. This process is highly welcome. Second, there are countries that are more advanced, in terms of structural reforms, than others and have therefore a higher growth potential. Third, a country or region might also be exposed to country or region-specific shocks. This specific shock may cause a growth or inflation differential, which is also normal in any monetary union. However, it is also true that persistent differentials which reflect structural rigidities are a concern. I will address this issue later.[8]

v) Equally relevant for the conduct of the single monetary policy of the ECB is the fifth and final feature of economic integration I would like to mention to you. The degree of synchronisation or co-movement between the different cyclical positions across the euro area countries seems to have increased since the beginning of the 1990s. In other words, a large number of euro area economies now share similar business cycles.[9]

The increased co-movement of business cycles across the euro area economies has resulted from a continuous process of integration. The move from several currencies to a single currency has meant the elimination of exchange rate risk between countries in the euro area. The euro has also reduced information costs and has enhanced price transparency. This, in turn, has fostered competition and market integration. In this way, the adoption of the euro has acted as a catalyst for the Single Market, within which goods, services, people and capital are to move freely. Ludwig Erhard said

" A free market can only be said to exist […] if and as long as free performance competition and free price formation are the motor and means of steering the economy."[10]

In sum, there is evidence of stronger economic integration among the euro area countries. Evidence of the completion of the Single Market looks promising, especially the rise in intra-euro area trade and integration in the money market. Business cycles have become more synchronised. This is an encouragement to continue to work actively to enhance integration, notably in the provision of services, in labour mobility and in the integration in some segments of the financial markets. A lot of homework remains to be done in the euro area.

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border labour mobility within an enlarged EU", ECB Occasional Paper No 52, 2006. See also "Action plan for skills and mobility", European Commission, 2002.

7 The decline in inflation differentials has been impressive. At the beginning of the 1990s, the difference 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 differential was only 0.7 percentage point. Moreover, the current degree of inflation dispersion among the euro area countries is practically the same as that seen in the United States. As to real GDP growth rates across the euro area countries, the difference has been fluctuating around a level of 2 percentage points over the past few decades, with no apparent upward or downward trend. Since 1999, however, it has declined from 2.8 percentage points in that year to close to 1.5 percentage points last year. Again, the growth dispersion within the euro area is virtually the same as across the eight US regions defined by the US Bureau of Economic Analysis.

8 On output growth differentials see the article entitled "Output growth differentials in the euro area: sources and implications", in the April 2007 issue of the ECB's Monthly Bulletin, and N. Benalal, J. L. Diaz del Hoyo, B. Pierluigi and N. Vidalis, "Output growth differentials across the euro area countries: some stylised facts", ECB Occasional Paper No 45, 2006. On inflation differentials, see the article entitled "Monetary policy and inflation differentials in a heterogeneous currency area", in the May 2005 issue of the ECB's Monthly Bulletin.

9 See D. Giannone and L. Reichlin (2006), "Trends and cycles in the euro area: how much heterogeneity and should we worry about it?", ECB Working Paper No 595.

10 From: Ludwig Erhard, "Die Ziele des Gesetzes gegen Wettbewerbsbeschränkungen" (speech to the German Bundestag on 24 March 1955), in Ludwig Erhard, Deutsche Wirtschaftspolitik, Düsseldorf, 1962.

3. Adjustment processes in the euro area

Economic integration is a clear prerequisite for the smooth functioning of the euro area. All the more because the euro area is continuously confronted with adverse events or shocks, for instance in the fields of global competition or energy price developments. In addition, individual euro area economies or regions may be affected by specific sectoral developments, for example in real estate markets. It is therefore important to make sure that adjustment mechanisms function efficiently.

Why is an efficient adjustment mechanism important in the euro area? As national monetary and exchange rate policies are no longer available options, it is important to make sure that other mechanisms of adjustment to shocks function properly within the euro area. This is needed to avoid a situation where a country or a region, after suffering a specific or asymmetric shock, enters either into a period of protracted low growth and high unemployment, or in 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. On this issue, Ludwig Erhard said that

" It is a great mistake for a people, or a State, to believe that it can introduce and pursue an inflationary policy, yet insure itself against the results. This is to try to lift oneself by one's own bootlaces. On the contrary, it is essential to concentrate all efforts to prevent an inflation […]".[11]

And let me add that the best way of anchoring price stability in economic agents' decisions is through an independent and accountable central bank. German history provides the best possible example of this.

Turning to other factors which are particularly relevant for the proper functioning of the euro area, well-designed structural reforms that enhance flexibility in product and labour markets are crucial. This is helping to better absorb shocks and thereby improve the working of adjustment mechanisms in individual countries, regions or sectors.

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 would improve long-term growth prospects in the euro area by, on the one hand, affecting positively labour participation and, on the other hand, improving labour productivity growth through the promotion of innovation and technological change. Needless to say, the responsibility for the implementation of reforms is in the hands of national governments, of Parliaments and of social partners. We know very well that structural reforms may face both resistance from economic agents and different sensitivities in public opinion. This is why it is extremely important to communicate the fact that the medium to long-term benefits of structural reforms will significantly outweigh any short-term cost. We therefore strongly support governments in their implementation of structural reforms and we consider our duty to stress and explain their benefits.

What factors may help to increase flexibility within the euro area? Economic flexibility can be promoted by removing the institutional barriers to flexible wage and price-setting mechanisms. If wages and prices are flexible enough and be able to adjust to the changes in the economic conditions, then this will help to avoid unwelcome fluctuations in unemployment.

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 governments and social partners share responsibility for ensuring that wage determination sufficiently takes into account labour market conditions and does not jeopardise competitiveness and employment. Governments should also be aware that wage setting in the public sector can serve as a role model for the private sector. And social partners need to take into account

[11] From Ludwig Erhard "Prosperity through Competition" (Wohlstand für alle), Chapter 12 "Welfare State – The Modern Delusion" (Versorgungsstaat – der moderne Wahn), London 1958.

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.[12] Sufficient wage differentiation would 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 market.

Allow me to mention also that corporate governance should ensure that executive board remuneration is properly set, in line with the performance of the board members and conditions at the respective company.

As seen in the German case, the period of adjustment can be painful, but reforms and unit labour cost moderation is paying off and contribute to robust growth and impressive economic records, like the one currently observed in Germany. I remember some observers arguing that much stronger wage increases were needed for higher growth. The recent evidence does not confirm this view. As seen in Germany since last year, past moderation of unit labour costs has very significantly contributed to declining unemployment and higher growth. The competitiveness gained by the German economy was an important prerequisite for sustainable job creation and sound and long-lasting growth.

The proper functioning of adjustments through labour markets also requires the completion of the Single Market. In particular, all existing barriers to labour mobility within the euro area – in particular as regards Slovenians – must be removed.

As to product markets, let me stress that it is essential that the Single Market must be fully completed, 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.[13]

Another important market-based mechanism in a monetary union that can help to attenuate the impact of shocks in a country or region is well-integrated financial markets and readily available opportunities for portfolio diversification. Well-integrated financial markets and diversified portfolios reduce the dependence of firms' and households' saving and spending decisions on economic and financial developments in a specific country, region or sector. This mechanism is known as the "credit and risk-sharing channels". In essence, it means that consumption does not need to follow movements in regional output, first because consumers can borrow abroad and second because their financial wealth is less dependant on local conditions thanks to an internationally well diversified portfolio allocation.[14] Moreover, more integrated financial markets give rise to greater competition, resulting in more favourable financing conditions for consumers and firms.

This mechanism is more important in the United States than among the euro area countries. However, recent evidence shows that the degree of risk-sharing across euro area countries has increased since the 1990s.[15]

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12 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, 2, 1997, pp. 89-141.

13 As an example, fully integrated markets across countries mean that a country which is under-utilising its capacity can more easily absorb some of the excess demand from overheating countries. Regional differentials in capacity utilisation would then not persist for a lengthy period and would not be associated with high and persistent unemployment in the region or country facing a lack of demand.

14 Moving from a pay-as-you-go to a capital-based pension system would contribute to improve portfolio diversification.

15 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 to speed up financial integration in Europe. See P. Asdrubali, B. Sorensen and O. Yosha, "Channels of interstate risk sharing: United States 1963-1990", Quarterly Journal of Economics Vol. 111, 1996. In a more recent study, it was found that the euro area situation has begun to converge towards the situation of the United States and that there is already modest but non-negligible insurance through inter-state capital flows. It was found that in the euro area (excluding Luxembourg), capital markets would have smoothed out about 10% of the country-specific shocks to GDP between 1993 and 2000. See S. Kalemli-Ozcan, B. Sorensen and O. Yosha,

National authorities can make a substantial contribution to ensuring a proper functioning of adjustment mechanisms within the euro area. Not only can they improve the flexibility and integration of labour, product, including services, and financial markets, but they can also conduct 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 provided by the Stability and Growth Pact. Moreover fiscal policy can and should also help mitigate undesirable trend growth differentials through "high quality" expenditure and tax policies. In particular, high and inefficient public expenditure can put a brake on economic activity by imposing a high tax burden on the economy and channelling resources into unproductive uses.

Let me take the opportunity to stress that the Governing Council of the ECB welcomes the recent commitment by the euro area finance ministers at the Eurogroup meeting here in Berlin on 20April. All euro area finance ministers then committed to making full use of the current economic growth and better than expected tax revenues to pursue sound fiscal policies and to avoid procyclical policies in line with the provisions of the Stability and Growth Pact.

In the view of the Governing Council, this requires a rigorous implementation of 2007 budgets, the avoidance of expenditure overruns and the allocation of unexpected extra revenues to deficit and debt reduction. For 2008, countries with remaining fiscal imbalances are expected to pursue more ambitious than currently planned budgetary targets. This would allow euro area countries not only to meet their commitments but also to 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 active and younger generations.

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.[16] Simply put, competitiveness is the ability of an economy to compete in international markets. This ability to compete is usually assessed on the basis of various measures of cost and price competitiveness[17], complemented by accounting for some "non-price" factors, such as the quality and the technological content of the goods produced.

Economic adjustment via the competitiveness channel works as follows. Assume, for example, that a country or a sector in a monetary union experiences an increase in demand that drives its output above long-term sustainable production. This will lead to inflationary pressures in this country or sector, in particular a rise in wages and other domestic costs. As a result, competitiveness will gradually deteriorate over time, reducing demand for goods or services produced by this country or sector. This decline in demand will tend to restore output to its potential level and to dampen previous inflationary pressures.

Differences in price and cost competitiveness are observed between the various regions and states of any vast economy of the size of the euro area or of the United States. The competitiveness channel plays a permanent role in the adjustment. It is particularly justifiable, economically, when any particular economy has to cope with a demand shock, whether positive or negative, as in the previous example. Such differences are also a normal phenomenon when any particular economy is in the process of 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, developments in price competitiveness and unit labour cost competitiveness across the euro area economies need to be closely monitored. Persistent losses in relative cost competitiveness, for instance, can also relate to a number of structural rigidities leading to inertia in price and wage formation. If and when such phenomena are identified, it is important for all parties

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"Asymmetric shocks and risk sharing in a monetary union: Updated evidence and policy implications for Europe", CEPR Discussion Paper No 4463.

16 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.

17 The ECB has recently 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.

concerned – the private sector, social partners, the national public authorities – to be as lucid as possible in their own decision-making, to avoid relative losses of competitiveness that would not be economically justified and to minimise therefore possible unwelcome future adjustment through the competitiveness channel.

M. Chairman, 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 success since the Treaty of Rome was signed half a century ago. 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 to our 318 million fellow citizens. This is a pre-requisite for sustainable growth and job creation. As regards the other elements of policy that 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 program and the achievement of the Single Market; and appropriate monitoring of the relative cost competitiveness indicators in the euro area.

Ludwig Erhard was a pioneer in understanding the utmost importance of price stability, of free and flexible markets and of competition for social and economic progress and job creation. We are also indebted to him for his thoughts and leadership that left a clear mark on the later negotiations for the preparations for Economic and Monetary Union. I am greatly honoured to receive the Ludwig Erhard Memorial Coin in Gold.