

Jean-Claude Trichet: Economic management in a large currency zone like the euro area

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the Breakfast Policy Briefing at the European Policy Centre, Brussels, 8 October 2007.

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Ladies and Gentlemen,

It is a great honour and a pleasure to be invited to say a few words at your “Breakfast Policy Briefing”. I like an early start and greatly appreciate the opportunity to talk to such a distinguished and influential audience.

Not too long ago, a single currency in Europe would have been unthinkable for many observers. And yet, we are now approaching the tenth anniversary of the creation of the ECB and the launch of the euro. We have already achieved a great deal and overcome big challenges at a time when a lot was happening both worldwide and in Europe. Indeed, world growth has been very solid over the recent years. Competitive forces are reshaping global manufacturing, the financial landscape and the sharing of wealth. More and more countries have opened up their economies and are benefiting from greater prosperity.

Several of the benefits of the euro are already clearly visible, such as the deepening of trade and financial links between euro area countries and the greater resilience of the euro area to external shocks. Today I will discuss both of these accomplishments, and I will also touch on some of the challenges that we continue to face. For instance, there is presently a degree of diversity among euro area countries. What I intend to argue is that we have to consolidate the gains from the euro, seize global opportunities and reduce any future risk of divergence.

In my briefing this morning, I will provide you with a number of arguments concerning the need for a sound economic management in the euro area, which now comprises 13 countries and has 317 million inhabitants. Such economic management is an important tool in order to address the challenges we are facing. I will start by providing some of the reasoning behind the main principles of our economic management and will finish by looking at some areas of strength that we enjoy in this respect.

The reasoning behind a sound economic management: why is it needed?

Some diversity is a natural phenomenon in any vast currency area. Heterogeneity can originate from various sources, some of which have no direct link with monetary policy or a single currency. Causes may include country-specific demographic trends or catching-up in terms of living standards. There could also be differences in productivity growth, reflecting national differences in areas such as industry characteristics, investment in R&D and innovation.

Differences in the timing and extent of past structural reforms in euro area countries are also a source of diversity. To give you an example, the Netherlands undertook labour market reforms much earlier than the largest euro area countries. This enhanced its flexibility and increased its ability to adjust to a wide range of shocks. In some other countries, short-term shocks may have had more persistent effects on growth differentials owing to slow adjustment processes caused by the presence of structural rigidities.

Differences in fiscal policies and other national policies can also give rise to diverse economic situations. There is an additional source of diversity that may be working its way through the system. After the launch of the euro, some countries suddenly benefited from lower short and long-term interest rates, as well as easier access to more competitive credit markets. This encouraged the purchase of durable and non-durable goods, as well as

housing, albeit to differing extents in the various euro area countries. This was equivalent to a one-off shock immediately after the launch of the euro.

All in all, the degree of diversity observed in the euro area is not substantially different from that seen in the United States. And neither is it substantially different from that seen within the national borders of several large economies (such as Germany, Italy and Spain), which is a continuation of historical patterns.

Diversity in perspective

Diversity within the euro area should be put in perspective, and I shall now look at three main types of divergence. Whenever possible, I will compare the euro area with the United States, as the world's only other industrialised economy of a comparable size.

a) **Inflation dispersion in the euro area declined** considerably in the 1980s and 1990s and is now on a par with that of the United States. Impressive progress has been made, and inflation dispersion among euro area countries has broadly stabilised at a low level since the launch of the euro. To give you an example, the unweighted standard deviation of annual HICP inflation rates still stood at around 6 percentage points in late 1990, but this rate has broadly stabilised at around 1 percentage point since the launch of the euro. This dispersion level is similar to that of the 14 US metropolitan statistical areas (MSAs), but is somewhat higher than that of the four US census regions. Although such comparisons are subject to some well-known caveats, I would argue that inflation dispersion in the euro area has not been high by international standards.

One feature of euro area inflation differentials is their persistence over long periods of time; in this respect, the euro area differs from the United States. In other words, inflation in most euro area countries displays significant inertia. Most euro area countries exhibiting higher than average inflation rates in recent years have been in this position for at least a decade. Similar persistence is observed in low inflation countries. However, the good news is that we are now seeing signs of limited reversals of this trend. The inflation rates of some euro area countries have moved from being relatively high to being in line with – or even below – the euro area average. Of course, these corrections are welcome, but the point is that they have been fairly slow in coming.

If we look at the cost side, the factors generating inflation differentials are, in most countries, primarily domestic rather than external. In particular, we have witnessed sustained divergence in wage developments across the euro area and smaller differences in labour productivity growth. These differences in the growth of labour costs have been the main sources of persistence in inflation differentials. Various reasons can be suggested for this. Varying levels of wage rigidity across the euro area, changes in profit margins, imperfect competition and associated price rigidities across countries all affect labour costs and contribute to inflation differentials.

If we look at product groups, price dispersion has been greater in the area of services, mostly owing to the dispersion observed in wage developments across countries. By contrast, inflation dispersion has been relatively low for tradable non-energy industrial goods, with greater competition in tradable goods being the main reason for this. Products with relatively volatile prices (such as energy and both processed and unprocessed food) have, on the other hand, shown high levels of dispersion across countries in terms of price changes.

To sum up, a significant degree of diversity does exist among the national economies of the euro area in terms of inflation and cost developments. This diversity is of the order of magnitude of what is observed in the United States. But the persistence of inflation differentials is the main problem to the extent that it reflects structural rigidities or a lack of competition. It has to be corrected at the level of the economies concerned in order not to see their relative competitiveness fall for too long.

b) **Output growth differentials in the euro area have remained broadly stable** since the early 1970s. The average dispersion of annual real GDP growth over the period between 1999 and 2006 (measured as unweighted standard deviation) was around 2 percentage points. This figure is close to the average dispersion of real growth rates since the 1980s. By comparison, if we look across all 50 US states, the dispersion of real growth has averaged approximately 2.5 percentage points over the last 15 years. When the United States is divided into the eight statistical regions, the average dispersion is around 1.5 percentage points.

One important issue of concern, however, is the fact that within the euro area there is also a relatively high degree of persistence regarding output growth differentials. This is less the case in the United States. However, taking the United States for comparison only helps up to a certain point. On the one hand, the US economy is more flexible than the euro area, which means that the effects of asymmetric shocks can be absorbed more easily and more quickly. On the other hand, the United States exhibits stronger regional specialisation than the euro area, making its regions more susceptible to specific asymmetric shocks.

Let me now turn to the two main drivers of growth differentials for the euro area: differentials in cycles and differentials in trends. Differentials in cycles have steadily declined since the early 1990s. There is also evidence of a stronger common euro area cycle accounting for a large part of the business cycle fluctuations across euro area countries. Since 1999 several shocks have spread in similar ways across euro area countries. For example, the euro area has successfully weathered a number of shocks, including the bursting of the dotcom bubble, the ripple effects of the terrorist attacks of 11 September, the surge in global commodity prices – particularly energy prices – and the persistence of sizeable global imbalances. The high degree of synchronisation in the business cycles of euro area countries is a feature unique to the euro area. This suggests that EU integration and the launch of the euro – rather than global forces – have led to smaller differences in output gaps among euro area countries.

The picture for the second driver of dispersion – i.e., differentials in trends – shows lasting differences, with a gradual increase in trend growth dispersion. This picture also differs across euro area countries, some of which persistently exhibit trend output growth either above or below the euro area average. It is here that the various sources of diversity that I have just mentioned play a role.

To sum up, first there is evidence of a stronger common euro area cycle. Second, the differences observed in trend growth – which are not due to the single monetary policy or the euro – have important implications. Macroeconomic policies have a limited role in addressing such differences in trend growth. Indeed, structural reforms by national authorities as well as sound fiscal policies are the primary means of dealing with such differences.

c) **Changes in cost and price competitiveness** mainly reflect changes in relative unit labour costs and persistent inflation differentials. These demonstrate that there is significant leeway for influencing relative competitiveness, even in the absence of nominal exchange rate adjustments. To give you an idea of the magnitude of this leeway, looking at the cumulative growth of unit labour costs for the economy as a whole between 1999 and 2006, the difference between the countries with the largest increases and those with the smallest increases was around 20-25%. This is an important phenomenon, and a close examination of the driving factors is therefore required.

Germany, for example, has seen moderate growth in unit labour costs over an extended period, leading to a correction of the losses in competitiveness which arose in the aftermath of German reunification. This correction – and the corresponding sustained period of relatively low inflation – is of course fully justified and most welcome. It also shows that adjustment mechanisms in the euro area work. A higher degree of wage flexibility would help to accelerate such desirable adjustment processes.

At the other extreme, some countries are to some extent catching up with others' higher living standards and may, therefore, be experiencing some temporary differences in relative cost competitiveness, reflecting movement towards a new equilibrium. Some other sources of persistent inflation differentials may, however, not be justifiable – for example differentials attributable to insufficient flexibility. In some economies, the combination of weak labour productivity growth and strong increases in nominal wages and salaries over a sustained period inevitably results in a significant loss of relative competitiveness.

To sum up, changes in relative cost competitiveness provide much more room for manoeuvre than was foreseen prior to the launch of the euro. In several euro area countries, wage formation is still linked to indexation mechanisms or is influenced by the public sector. This limits the ability to respond to shocks. Structural reforms and the liberalisation of product and labour markets can and must contribute to significant increases in flexibility.

The need for sound economic management

The economic management of the euro area should reflect the increasing interdependence of its economies and should ensure that excessive differentials in inflation, growth and competitiveness are addressed. Let me now stress the importance of four guiding principles in this respect: first, the rigorous implementation of the Stability and Growth Pact; second, the full completion of the single market, including the area of services and financial services; third, the implementation of structural reforms in all markets; and fourth, the need to monitor carefully at country level the evolution of unit labour costs and competitiveness indicators in general.

a) **The first principle** is the rigorous implementation of the Stability and Growth Pact as a prerequisite for sound fiscal policies. There are several reasons for supporting sound fiscal policies. They are, for instance, needed to reduce the risk of fiscal policy spillovers, both into monetary policy and across countries more generally. They are also needed to enhance flexibility and adaptability. Sound fiscal policies create the necessary conditions for flexibility, which cushions the effects of the economic cycle through the functioning of automatic stabilisers. Sound fiscal policies also ensure proper incentives. The tax and benefit system should avoid major distortions that would affect incentives to work, save, invest and innovate, thereby making fiscal policy more efficient and growth-friendly. Moreover, the public sector also functions as a role model, for example as regards wages or administrative prices. The behaviour of the public sector can, for instance, make social partners more aware of the trade-off between higher salaries and job creation. Furthermore, population ageing in most industrialised economies – and a significant increase in the old-age dependency ratio and higher healthcare and long-term care expenditures – will exert growing pressure on public finances. Sound fiscal policies will need to make provisions for the effects from population ageing.

b) **The second principle** pertains to the full completion of the single market. This will enhance not only competition and efficiency, but also adjustment mechanisms in the event of adverse shocks. We still have significant progress to make in this domain, despite the fact that the single market was the goal of the founding fathers of the European Union as set out in the Treaty of Rome and despite the fact that this 50-year endeavour was very strongly reaffirmed 20 years ago with the Single European Act. We still have a lot of work to do in this area.

According to the OECD, product market regulation remains high in several euro area countries, and the level of such regulation in the euro area as a whole is considered significantly higher than in the United States. Let me also mention the fact that the services sector, which represents 70% of euro area GDP, is far from being fully integrated as an effective single market. We attach enormous importance to the full integration of financial markets, particularly because these play a decisive role in shock absorption and adjustment dynamics in a large single currency area. Concerning cross-border labour mobility, empirical

evidence suggests that it is still low in the euro area – both across countries and within countries – due to several formal barriers across the euro area. This is in clear contrast to the situation in the United States where labour mobility is considerable and greatly contributes to the adjustment process. Hence, more needs to be undertaken to enhance labour mobility in Europe including by removing the remaining barriers and by undertaking structural reforms to which I now turn.

c) **The third principle** is the need to monitor closely the implementation of structural reforms. Earlier I referred to some factors commonly contributing to inflation and growth differentials, such as the detrimental role played by pervasive price and wage rigidities, excessive labour market regulation and the imperfect competition observed in several important sectors of the euro area economies. This has been well known for quite some time. However, there is a lot at stake here and action is urgently needed.

Put simply, all euro area countries could benefit from structural reform, although the extent differs from country to country. Reforms are essential in order to raise factor productivity and potential output, to create new jobs, to achieve lower prices and higher real incomes, and to increase the resilience and flexibility of the economy. The need for reform is clearly signalled by the fact that the euro area's potential output growth appears to have moved to the lower bound of its previously estimated range of 2-2.5%.

The urgent need for structural reforms was highlighted by the Lisbon agenda of 2000, which represents a fundamental and ambitious programme to draw Europe's attention to the major areas where changes are required. However, the modest and uneven implementation of the Lisbon agenda to date has clearly shown how difficult it is to achieve reforms in practice. More recently, the Lisbon agenda has been refocused in the direction of growth and employment. Various attainable objectives have been set in order to enhance the flexibility and adaptability of labour markets, to raise competition in markets for goods and services, to increase employment, to promote innovation, and to strengthen growth and employment rates in all participating countries. The need for structural reforms and liberalisation also applies to financial markets. In fact, further financial integration has the potential to 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 in order to identify with greater accuracy the areas where the reform challenges are most urgent. As I have already explained, a successful reform programme is particularly important for the euro area countries.

d) **The fourth principle** is the need to monitor unit labour costs and national competitiveness indicators to prevent or correct abnormal deviations where necessary. We would expect some dispersion and differentials among euro area countries. As I have already mentioned, in such a vast area there will always be some diversity, as in the United States. Countries catching up in terms of GDP per capita and price levels are always likely to have stronger output growth and higher inflation. Diversity may also extend to correcting past excesses in terms of overall cost and price competitiveness, particularly in the tradable goods and services markets. In such situations, national governments and social partners need to take action to address excessive wage developments and to strengthen productivity growth, so that unit labour costs in those economies increase less rapidly than the euro area average.

To sum up, the economic management of the euro area requires a combination of appropriate monetary and fiscal policies, as well as structural reforms and the liberalisation of product and labour markets, in order not only to foster economic stability and growth, but also to reduce the impact of adverse shocks or facilitate the adjustment of the economy thereafter. The attentive monitoring of economic and financial developments – and changes in competitiveness in particular – must be an integral part of this economic management. The

public's understanding and acceptance of these elements is also crucial. Consequently more needs to be done for information purposes.

Three areas of strength

There are three main areas of strength that can be seen in euro area countries since the launch of the euro. These support the economic management that I have just discussed.

a) **The first is the success** of the monetary policy of the ECB and the Eurosystem. The ECB and the euro have been credible from day one. Inflation expectations – even looking far into the future – are well anchored and it is crucial for paving the way for sustainable growth and job creation.

b) **The second element of strength** is the fact that the launch of the euro has coincided with a remarkable deepening of financial integration. The financial landscape has already changed enormously in most market segments. Well-integrated financial markets and diversified portfolios reduce the extent to which firms' and households' saving and spending decisions are dependent on economic and financial developments in a specific country, region or sector. As a result, credit and risk-sharing channels are increasingly helping to attenuate the impact of shocks in a specific euro area country or sector. This financial market-based mechanism essentially means that consumption does not need to follow movements in regional output. There are two reasons for this: first, consumers can borrow from abroad; and second, their financial wealth is less dependent on local conditions thanks to well-diversified international portfolio allocation. This also gives rise to greater competition, resulting in more favourable financing conditions for consumers and firms.

In this regard, there is a very interesting study looking at the United States that I like to cite. According to this study, the US capital markets smooth out 39% of shocks to gross state product (equivalent to our GDP), the credit channel smooths out 23% of such shocks, and the federal budget smooths out 13%. 25% of the shock is not smoothed out. Thus, according to this study, financial markets and financial institutions absorb 62% of idiosyncratic shocks in the United States: an effect much larger than that of the federal budget. The euro area is moving in this direction, and I am sure that financial market-based risk-sharing will become increasingly important over the coming years.

c) **The third area of strength** is the fact that the euro area as a whole has become more resilient to external developments than its individual member countries ever were before the launch of the euro. National economic policies have become better coordinated, and of course the risk of possible speculative attacks on national currencies has been removed. Not so long ago, the impact of movements of the US Dollar vis-à-vis major European currencies was significantly aggravated by big tensions inside the Exchange Rate Mechanism namely between the currencies that have now merged to form the euro. This can no longer happen. This increasing resilience is illustrated by the fact that the major shocks of the last ten years have not played a significant role in the dispersion of output growth and have not contributed to economic divergence.

Ladies and gentlemen, let me now conclude.

Although there is still some persistent diversity across euro area countries, a stronger common euro area cycle can now be observed. A sound economic management should reflect the increasing interdependence of euro area economies and ensure that excessive differentials in inflation, growth and competitiveness are addressed.

Four guiding principles should be heeded in order to ensure a sound economic management of the euro area as a whole: rigorous implementation of the Stability and Growth Pact; the completion of the single market; the implementation of the structural reforms in the Lisbon

agenda; and the need to monitor carefully at country level the evolution of unit labour costs and competitiveness indicators in general.

We have to consider that the euro has already brought a number of benefits, including price stability, favourable medium and long-term interest rates, and a remarkable degree of resilience in a complex international environment. These achievements make a significant contribution to ensuring sound economic management, but national economies also need to adapt and further liberalise their economies.

Thank you for your attention.

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