Jean-Claude Trichet: Building Europe in a globalised world

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1. Introduction[1]

It is a great pleasure for me to be invited to Harvard University to talk about a key issue: how can Europe best adapt to a globalised world? Let me start by saying that the idea of the European Union and the concept of the single currency originated about 50 years ago. They resulted from a desire of European nations to create conditions for lasting peace and prosperity after the two devastating wars of the first half of the 20th century. Initially, the prime focus of intra-European policies was on how to facilitate the free flow of goods, services, capital and people across national frontiers, an initiative which was to become the Single Market. Serving as a role model in the creation of such a genuine common market in Europe was the unified market of the United States.

Today, the EU is considerably larger than it was all those years ago. It comprises 27 European countries and a population totalling 494 million people, with Romania and Bulgaria joining in January this year. 13 of these countries are members of the Economic and Monetary Union (i.e. the euro area with its 317 million inhabitants) and have introduced the euro. The 13 will become 15 in January next year, when Cyprus and Malta join. Importantly, the impressive enlargement of the EU and the successful creation of the euro area have gone hand in hand with Europe’s integration into the global economy. Globalisation provides great opportunities for flexible economies. However, Europe still needs to make progress in this field in order to fully gain from globalisation.

This brings me to the issue I would like to address today, namely the building of Europe in a globalised world. First, I would like to share with you some thoughts on Europe in a global context. Second, I would like to provide some facts on the process of economic and financial integration in Europe and – as a comparison – the United States. Finally, I would like to talk about how globalisation influences European macroeconomic policies.

2. Europe and globalisation

Globalisation has indeed increased significantly over the last couple of decades. Let me first present some figures on the degree of global openness. Thereafter, I would like to provide some examples of the impact of globalisation, especially on Europe’s economies.

Global trade openness – measured as world exports and imports of goods and services as a share of world GDP – has practically doubled over the last 20 years. In 1986 it accounted for 34% of world GDP; in 2006 the figure was 61%. A key factor has been the increase in trade in intermediate goods and services as a result of the rising internationalisation of production processes.

Financial systems have also been deeply affected by globalisation. The share of gross international asset holdings in world GDP – which provides a measure of financial openness

[1] I should like to thank Malin Andersson, Annalisa Ferrando, Martin Heipertz, Keith Kuester and Samu Kurri for their input into this speech, Nick Vidalis and Hans-Joachim Klöckers for their helpful comments, and David Clarke for his additional contributions.

– has grown eightfold over the last 25 years and now stands at more than 130% of world GDP.

Globalisation is triggering major transformations all over the world, not only in Europe. For instance, globalisation has had an impact on inflation.

Economic theory has identified numerous channels through which globalisation can influence price developments. Without doubt, globalisation and the associated rise in world trade have contributed to import price moderation[2], notably in the manufacturing sector, which is primarily due to increased imports from low-cost countries. Furthermore, the widespread opening-up of emerging countries and of almost all former centrally planned economies has significantly increased the labour pool available, leading to dampening pressures on labour costs, especially for unskilled labour.[3] Globalisation can also exert indirect downward pressure on inflation, as increasing international competition may limit the pricing power of domestic corporations. However, at the same time, the sudden emergence of fast-growing economies in the global economy is exerting very significant upward pressures on commodity prices. This has been particularly visible since 2003. In addition, the prices of certain agricultural products have also risen recently.

Despite intensive research, there remains significant uncertainty about the overall role and impact of globalisation. Even though the net effect of these counterbalancing forces is mostly believed to have reduced the level and volatility of inflation, how long this disinflationary effect will last remains an open question. Still, in view of the much lower price levels of the economies in emerging markets, they are expected to increase their market shares in the developed economies, which in turn will help to contain import price pressures there.

Ultimately, globalisation is an opportunity, not a threat. Globalisation fosters economic prosperity and raises living standards. It may facilitate increased labour inflows to the euro area, which, in certain sectors, would help to reduce bottlenecks in labour markets and hence ease wage pressures. Meanwhile, resources are allocated to the most profitable activities across the world. In addition, globalisation helps to intensify the exchange of investment capital for know-how between regions. As a matter of fact, the euro area has become an attractive place for foreign direct investment (FDI). IMF statistics reveal that FDI into the euro area amounts to more than 30% of euro area GDP, whereas the comparable figure for the US is 16%.

In sum, increasing globalisation leads to structural changes that are sometimes difficult to quantify. Developed economies need to be sufficiently flexible in order to absorb these structural changes smoothly. Overall, however, these developments should be seen as increasing economic prosperity as they improve the international allocation of resources. In addition to globalisation, European countries are facing the challenge of integration in their product, labour and financial markets. I will turn to these issues now.

3. Economic and financial integration in Europe and a comparison with the United States

In a monetary union, economic and financial integration is crucial as it ensures smooth adjustment processes to economic shocks. In a monetary union like the United States or the

[2] See Box 13 in the June 2007 issue of the ECB Monthly Bulletin entitled “Is the downward impact of globalisation on import prices waning?”

[3] There are, however, other factors – independent of globalisation – that can help to explain the decline in global inflation, such as rapid technological progress and structural reforms. These factors have helped to increase the growth potential of economies and thus to facilitate price stability. Moreover, greater budgetary discipline and “better” monetary policy that enhances the credibility of central banks have probably also contributed.

euro area, where regional monetary and exchange rate policies are options that are no longer available, it is important to make sure that other shock adjustment mechanisms function properly. Such mechanisms are needed in order to prevent a country or region from entering into a period of protracted low growth and higher unemployment, or into a long period of overheating, after experiencing a country-specific shock.

Allow me, now, to elaborate on four main features of economic and financial integration in Europe, namely trade, financial integration, labour mobility and business cycle synchronisation. I will also compare these features with those in the United States, in order to illustrate some of Europe's achievements and remaining challenges.

i) First, economic integration has been reflected in a marked increase in intra-euro area trade in goods and services. Let me mention some figures. The share of exports and imports of goods in terms of GDP within the euro area increased by 6 percentage points between 1998, the year before the adoption of the euro, and 2006, when it amounted to around 32% of GDP. The share of intra-euro area exports and imports of services increased by about 2 percentage points from 1998 to 2006, to almost 7% of GDP.

As trade integration within the euro area becomes stronger, the region is also becoming a more open economy to the outside world. The share of extra-euro area exports and imports of goods rose by about 9 percentage points between 1998 and 2006, to around 33% of GDP. Over the same period, the share of extra-euro area exports and imports of services increased by about 2 percentage points, to almost 10% of GDP. These developments clearly show that we are not witnessing the creation of a "fortress Europe". On the contrary, the euro area is a more open economy than the other two G3 economies, the United States and Japan. In the United States, exports and imports of goods represented about 22% of GDP and trade in services 6% in 2006. The corresponding figures for Japan were 27% and 6%.

ii) As a second feature, the introduction of the euro has contributed to intra-European financial integration which, in turn, improves the free movement of capital in the euro area. Financial integration enhances the efficiency of economic mechanisms, strengthens competition and raises the potential for stronger non-inflationary economic growth.[4] Financial integration also improves the smooth and effective transmission of the single monetary policy throughout the euro area. More precisely, financial integration helps financial systems to channel funds from those economic agents that have a surplus of savings to those with a shortage; in particular, it enables agents to effectively trade, hedge, diversify and pool risks. As a result, there is a better sharing and diversification of risk. In the US, 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%.[5] 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

[4] A research study conducted by London Economics a few years ago estimated the benefits of the integration of European bonds and equity markets to be around 1% of additional GDP over a ten-year period. London Economics, 2002, "Quantification of the macroeconomic impact of integration of EU financial markets", Report to the European Commission. See also "EU Productivity and Competitiveness: an Industry Perspective. Can Europe Resume the Catching-up Process?" by Mary O'Mahony and Bart Van Ark, European Communities, 2003, for a comparison of the financial sector contribution to annual labour productivity growth in the US and the euro area.

[5] See P. Asdrubali, B. Sorensen and O. Yosha, 1996, "Channels of interstate risk sharing: United States 1963-1990", Quarterly Journal of Economics Vol. 111.

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. 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.[6]

A set of indicators published by the ECB also points to an increasing degree of integration of euro area financial and banking markets.[7] For instance, there is significant evidence that euro area corporations are taking advantage of the possibility to raise funds. As a result, the euro corporate bond market has grown significantly since 1999, and has the potential to grow even further, judged by a comparison with the US. In 1999, the outstanding volume of bonds issued by non-financial corporations was just 3.9% of GDP in the euro area and 24.3% in the US; by 2006 it had increased to 12.5%, but relative to GDP the US corporate bond market is still one and a half times larger than that of the euro area.

Integration in retail banking, by contrast, has been slow so far, although it has picked up in the last two years. There are still differences in bank deposit and lending interest rates across euro area countries, whose cross-country dispersion is higher than the intra-regional dispersion of the same rates in the US.[8] However, a number of indicators point to increasing cross-border banking activities in the euro area, such as the growing cross-border share in the financial holdings of banks as well as cross-border mergers and acquisitions.

In terms of fiscal transfers, obviously in the US there are inter-regional transfers which add to the degree of integration, while transfers in the euro area are almost exclusively domestic and not cross-border.

iii) Labour mobility constitutes the third feature of integration that I would like to mention. Labour mobility may dampen the effects from country-specific shocks or decrease the risks of wage pressures as labour markets tighten. Comparable figures on labour mobility for the euro area and the US are difficult to obtain and any such figures should be interpreted very carefully. Available evidence suggests that, overall, cross-border labour mobility is still limited in most parts of the European Union with regulatory barriers still existing, and even within the euro area with respect to labour from Slovenia. Linguistic, cultural, legal and other differences between countries and the costs involved in moving residence also play a role.[9] In the period 2000-2005 only 0.1% of the working-age population of the then EU 15 Member States moved away from their country of origin to another country in the EU. Furthermore, only a small proportion of individuals – 0.4% of the EU's working-age population – commuted across a national border to work. In the US, geographical labour mobility appears to be far higher. Evidence suggests that

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[6] See S. Kalemli-Ozcan, B. Sorensen and O. Yosha, 2004, "Asymmetric shocks and risk sharing in a monetary union: Updated evidence and policy implications for Europe", CEPR Discussion Paper No 4463.

[7] "Financial integration in Europe", ECB, 2007.

[8] C. Kok-Sorensen and T. Werner, 2006, "Bank interest rate pass-through in the euro area; a cross-country comparison", ECB Working Paper No 580.

[9] See Blanchard O., L.F. Kats, 1992, "Regional evolutions", Brooking Papers on Economic Activity, and Obstfeld M., G. Peri, 1998, "Regional Nonadjustment and Fiscal Policy: Lessons for EMU", NBER Working Paper 6431, as references.

around 3.1% of the country's total working-age population moved from one state to another each year between 2000 and 2005.[10]

iv) A fourth and final feature of the process of economic and financial integration is the degree of synchronisation or co-movement between different cyclical positions across the euro area countries. This degree of synchronisation has increased since the beginning of the 1990s. In other words, a large number of euro area economies now share similar business cycles.

In addition, current inflation and output growth differentials between euro area countries are relatively limited compared with the past. Indeed, the decline in inflation differentials across the euro area countries has been impressive in recent years. At the beginning of the 1990s, the dispersion in inflation rates across the countries which now belong to the euro area was, on average, around 6 percentage points (standard deviation measured in unweighted terms). Last year, the inflation dispersion was only 0.7 percentage point. This implies that dispersion in the euro area is currently broadly in line with inflation dispersion among the 14 US Metropolitan Statistical Areas, where it has fluctuated around 1% in the last two decades. Dispersion in real GDP growth rates (standard deviation measured in unweighted terms) across the euro area countries has been fluctuating around a level of 2 percentage points over the past few decades. This is similar to the dispersion observed in output growth across regions within the United States.[11] Still, with a view to further enlargements of the euro area, these issues need to be kept in mind. For the proper functioning of the single monetary policy in Europe all participating countries are required to display high degrees of convergence with each other and to do this on a sustainable basis. In all enlargement decisions for the euro area, we refer to some clearly defined "convergence criteria" and apply them in a very strict manner. We did so in the past and will do so in the future.

In sum, there is evidence of growing economic and financial integration among the countries of the European Union. The adoption of the euro has particularly contributed to this development by reducing information costs, enhancing price transparency and eliminating exchange rate risk between countries in the euro area. Nonetheless, in some fields, Europe is lagging behind the US and a lot remains to be done, for instance, in order to increase labour mobility and financial integration in retail banking. Progress in these fields is clearly needed in order to adapt to a globalised world.

4. How globalisation influences European macroeconomic policies

As I claimed earlier, globalisation and integration brings clear benefits to the economy. At the same time, however, European policy-makers need to ensure that Europe quickly adapts to a globalised world.

Globalisation increases the pressure on national policy-makers to implement reforms and to pursue structural policies that enhance competition and foster flexibility in product and labour markets. In fact, globalisation brings opportunities for flexible economies but penalises rigid

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[10] Data on the US and the EU stem from the "Economic Survey of the European Union" published on 20 September, OECD, 2007. For a discussion on labour mobility see also F. F. Heinz and M. Ward-Warmedinger, "Cross-border labour mobility within an enlarged EU", 2006, ECB Occasional Paper No 52, and "Action plan for skills and mobility", European Commission, 2002.

[11] It should be stressed that while some differences are temporary, others are more persistent. Sustained differences in economic growth or inflation rates between some euro area countries are normal in a monetary union, to the extent that they are related to catching-up phenomena. However, it is also true that persistent differentials which reflect structural rigidities are a concern.

ones. In many euro area countries, structural reforms have been too slow to facilitate the reallocation of resources to their most productive uses and to foster labour productivity growth and technological progress. The implementation of structural reforms is envisaged under a wide-ranging programme for economic, social and environmental reform in the EU, a programme known as the Lisbon strategy. In particular, Member States are required to reduce tax burdens on low-wage earners, to bring wage developments into line with productivity, to raise the skill level of the workforce as well as to adopt active ageing strategies to encourage older workers to stay in the workforce. This strategy should increase the flexibility of, and lower the adjustment costs for, European firms and workers confronted with globalisation. Improving competitiveness is the main condition for making globalisation a success for the citizens of Europe.

As for fiscal policies, in the global economy, capital and labour mobility puts pressure on tax bases. Rather than a "race to the bottom", with only tax rates reduced, we begin to see tax reforms that make a country more "competitive" and more attractive for investment and human capital. On the expenditure side, the influence of globalisation appears to be more limited. We should expect a tendency towards smaller but more efficient budgets, with "higher-quality" public spending. This implies, for example, more emphasis on "tomorrow" – i.e. investment and education (also for older workers) – and less on "yesterday" – e.g. less money spent on unemployment benefit for unskilled workers or on large and inefficient public administrations. On this issue, the debate has only started in the European Council of Ministers of the EU Member States (ECOFIN). In this respect, a number of important moves towards structural reforms are also currently under discussion in the ECOFIN to make the public sector more efficient. Finally, in a globalised world, the soundness of public finances becomes ever more important. The links between financial markets are growing closer and all governments must ensure the sustainability of their fiscal positions. In this context, the ECB calls upon the Member States of the EU to comply fully with the Stability and Growth Pact, an agreement which aims to ensure that they conduct prudent fiscal policies.

Globalisation changes the environment also for monetary policy-making. As I mentioned earlier, globalisation intensifies global competition – for example by reducing the pricing power of firms – and necessitates adjustments to relative prices. In the presence of nominal rigidities, changes in relative prices and the pricing power of firms can affect inflation in the short run. But even in the long run, when all adjustment processes have come to an end, globalisation is likely to affect the transmission of economic shocks to inflation.

Let me give you an example to illustrate the effects of globalisation on the transmission of shocks. I will consider the case of a shock to production costs, e.g. due to high wage pressures in one country. Increased competition implies reduced pricing power of firms. In response to increases in costs, competitive forces may prevent individual firms from adjusting prices by as much as in a low-competition environment. As a consequence, shocks to production costs might have a smaller effect on domestic inflation than what we are seeing today but a larger effect on output and employment.

In Europe, this implies a very important message to the social partners, notably trade unions and employers' organisations. Excessive wage agreements in a highly competitive environment have much higher costs in terms of growth and employment than they had in the past. Social partners in Europe seem to have understood this, as inflationary pressure coming from labour costs has been much lower in recent years than in previous decades. This, in turn, has led to significant employment gains in Europe, now amounting to 14.9 million new jobs created since the euro was introduced, compared with only 3 million jobs in the 8½ years before its launch. This gives us hope that the structural reforms which have been implemented in recent years have helped to create jobs.

But we cannot simply assume that these trends will continue. Therefore, the pursuit of price stability will remain a demanding task. Central banks will need to carefully monitor the changes to the structure of the economy and to the behaviour of economic agents brought about by globalisation.

How should monetary policy respond to the effects of globalisation on inflation? I would like to stress that globalisation does not affect the central role, the capability and overriding responsibility of central banks to preserve price stability.[12] In the long run, when adjustment processes are over, globalisation will affect real quantities only. After all, whatever the influences being exerted in the context of globalisation, the basic tenet of monetary policy remains: in the long run, inflation is a monetary phenomenon. Globalisation can at times mean fairly rapid changes in relative prices. In such an environment, I would argue that a credible commitment to maintaining price stability is essential. Most importantly, such a commitment helps consumers and firms to accept changes in relative prices while the aggregate price level is largely unaffected. Central banks should not prevent efficient changes in relative prices triggered by a move towards a new equilibrium due to globalisation, but they are well advised to prevent significant second-round effects from spreading to other parts of the economy.

5. Conclusion

Ladies and gentlemen, let me conclude. Economic integration within Europe has gone hand in hand with Europe's integration into the global economy. These forces call for structural adjustment in order to fully grasp the opportunities they provide. To this end, we should make our markets even more flexible and promote further economic and financial integration in Europe's economies. At the same time, we need to have fiscal policies which are disciplined, in line with the objective of reaching balanced or surplus budgets over the medium term. Finally, monetary policy-makers need to carefully monitor the ongoing structural changes globalisation brings about. In this context, monetary policy has to ensure that inflation expectations are well anchored, which means a strong commitment to pursuing price stability. Thank you very much for your attention.

[12] See, e.g., M. Woodford (2007), "Globalization and Monetary Control", NBER Working Paper 13329.