Jean-Claude Trichet: The US economy, the euro area economy, and their central banks

Speech delivered by Mr Jean-Claude Trichet, President of the European Central Bank, at the award ceremony on the occasion of the "6. Karl Klasen Journalistenpreis", Hamburg, 7 December 2007.

* * *

Sehr geehrte Damen und Herren,

ich freue mich, heute Abend gemeinsam mit Ihnen diese festliche Atmosphäre genießen zu dürfen, und es ist mir eine Ehre, der Hauptredner der Verleihung dieses Journalistenpreises zu sein. Ich danke Ihnen, Herrn Kai-Jacob Klasen, herzlich für die Einladung und finde es bewegend, heute Abend im Rahmen dieser Veranstaltung Dr. Karl Klasen zu gedenken.

Die Stiftung, die diese Preisverleihung ausrichtet, hat sich das lobenswerte Ziel gesetzt, Journalisten zu Arbeiten über die deutsch-amerikanischen Beziehungen zu inspirieren, und zeichnet diejenigen aus, die sich durch ihre Beiträge um die Festigung der Bindungen zwischen Deutschland und den USA verdient gemacht haben. Was die Geldpolitik anbelangt, so stehen die transatlantischen Beziehungen nun im breiteren Kontext der Interaktionen zwischen dem Eurosystem und dem Federal Reserve System. In meiner Funktion als Präsident der Europäischen Zentralbank habe ich mich stets darum bemüht, die engen und freundschaftlichen Verbindungen zu unseren US amerikanischen Kollegen zu pflegen und zu stärken.

[Ladies and Gentlemen,

It is a pleasure for me to be here today in this festive atmosphere, and an honour to be the main speaker at this journalist award ceremony. I am very grateful, Mr Kai-Jacob Klasen, for your invitation, and I am moved to pay tribute tonight to the memory of Dr Karl Klasen.

The foundation hosting this ceremony has the commendable purpose of inspiring and rewarding journalists' works that strengthen German-American relationships. In the area of monetary policy, transatlantic relations are now written in the broader context of the interactions between the Eurosystem and the Federal Reserve System, and it has always been my aim, as President of the European Central Bank, to preserve and foster close and friendly relationships with our American counterpart.]

The goal of my talk today is to show that it is worth pursuing and extending this relationship. The euro area and the United States share some common external and internal experiences that justify the increasing cooperation that exists both at the policy and institutional levels. To convince you of this, I will first show that the United States and the euro area face a similar external environment and that their economic and financial connections have been reinforced in the context of globalisation. I will then argue that the monetary authorities of the United States and the euro area face common features due to a certain degree of internal diversity within such large economic areas. This is why sharing our thoughts and experiences always proves invaluable in our duty to ensure efficient monetary policy. In the last section of my talk, I will demonstrate how this interaction is facilitated by institutional cooperation and the development of personal contacts with our American colleagues.

Trade and financial integration: a shared external environment

The euro area and the United States are the largest economies in the world, hosting more than 600 million inhabitants and responsible for around 40% of world production. The preponderance of these two regions and their similar size naturally calls for parallels to be made. Viewed from outside, these two regions are large economic blocs that have led globalisation and the surge in world trade, financial flows and innovative ideas that has been getting stronger during the last few decades.

Trade openness

The euro area is the largest exporter in the world. Its extra-area exports amounted to €1.9 trillion last year, while US exports reached €1.1 trillion. Together, these two economies account for almost a third of world trade.

The euro area is a significantly open economy for its size. Its exports and imports of goods reached 33% of its own GDP in 2006, a figure to add to the rising importance of trade in services – around 10% of GDP. In 1998, euro area exports and imports only accounted for 24% of GDP, and trade in services for 8%. Trade openness of the euro area has therefore been reinforced since the advent of the euro. The United States is slightly less open, with trade in goods representing 22% of GDP and trade in services 6% of GDP. However, among euro area trade partners, the United States plays a central role. Indeed, around 15% of euro exports in goods goes to the United States. Looking at the other side of the Atlantic, American exports represent around 10% of our imports of goods. On balance, over the last few years, we have recorded a large trade surplus with the United States. Our goods exports exceeded our imports from the United States by more than USD 80 billion. In the services sector, where trade has been growing and continues to grow, our connection with the United States is even more important. 22% of our services exports goes to the United States and a quarter of our imports come from the United States. In particular, the export performance of our travel and transportation services is always outstanding.

Nevertheless, most euro area trade occurs with our European neighbours, and with Japan and China. This could suggest that the linkages between the United States and the euro area are of a secondary importance. However, this would underestimate the significance of the US economy because there are also indirect transmission channels. Indeed, the United States plays a broader role in the world economy, and there can be second-round effects that are not captured by the crude figures I have just presented.

These second-round effects include trade linkages, but also financial and confidence linkages. After the financial turmoil experienced this summer, it is becoming increasingly important to understand them.

The importance of financial openness

The United States, where the recent financial troubles originated, and the euro area are very open to financial flows. US external assets and liabilities exceeded USD 13 trillion in 2005, and the figure for the euro area is very similar. In percentage of GDP, US external assets represented 90 % of US GDP and US external liabilities amounted to 110 % of GDP in 2005. As regards the euro area in 2005 as well, external assets represented 124 % of euro area GDP and external liabilities reached 137 % of euro area GDP ; therefore, in relative terms, the euro area is financially more open that the United States.

European investors are also central players in American markets. As an example, the euro area stock of direct investment in the United States reached more than €600 billion at the end of 2006. Some industries are particularly present in the United States: the trade and the financial sector, of course, but also the chemical industries of France, Germany and the Netherlands have large investments at stake in the United States. The situation is fairly similar in the other direction, with around €630 billion from US firms being invested in the euro area, principally in the services industries of Belgium, Luxembourg and the Netherlands. The current levels of FDI flows show that these bilateral links will continue to strengthen in the future. Portfolio investments from the euro area to the United States are also of an impressive magnitude. The stock of US portfolio assets held by the euro area reached almost €1.5 trillion last year, this being about a third of European holdings worldwide. The euro and the US dollar are also the currencies of denomination of the majority of portfolio assets traded. More than three-quarters of portfolio assets worldwide are denominated in euro and in dollars, according to the available data.[1]

All in all, the United States and the euro area are large trade and financial partners. Arguably, the United States seems to have a greater impact on world business cycles, probably mainly because of the growing importance of financial channels in the transmission of macroeconomic shocks.

For both the United States and the euro area, trade and financial channels have, of course, direct consequences for monetary policy. For instance, the increase in imports from low-cost countries has ensured that import price inflation has remained contained. Import prices declined in the period 2001-2003 in the euro area and remained stable throughout the following years. However, commodity prices experienced higher levels of inflation as a result of the strong growth of emerging economies such as India and China. Globalisation can therefore have mixed effects on inflation. Finally, it has also been argued that both the United States and the euro area witnessed a loosening of the link between inflation and activity because of increased openness. This has important implications for monetary policy.

Diversity within large economic blocs – a common challenge for monetary policy

Although we have seen that the environment outside the euro area and the United States has gained importance, the internal economic situation remains a major focus of attention within central banks. Almost nine years after the euro changeover, euro area macroeconomic developments continue to mask some diversity across the euro area countries. Nonetheless, this diversity in terms of inflation and output growth is currently of approximately the same scale as in the United States.

More specifically, euro area inflation differentials have exhibited a strong decline in recent decades. Starting from an unweighted standard deviation of around 6 percentage points at the beginning of the 1990s, inflation dispersion has fallen to around only half a percentage point so far in 2007. More specifically, this year there has been an overall decline in inflation rates among traditional high-inflation countries compared with last year. However, since August, inflation rates in all countries have risen, probably as a result of higher oil and food prices. This implies that dispersion in the euro area is currently somewhat below inflation dispersion among the 14 US Metropolitan Statistical Areas, where it has fluctuated around 1 percentage point over the last two decades.

The dispersion in real GDP growth rates, measured in terms of the unweighted standard deviation, has been moving around a level of 2 percentage points over the past few decades, with no apparent upward or downward trend. This is similar to the dispersion witnessed in output growth across regions within the United States.

The persistence of macroeconomic developments in the euro area

A key feature of the observed economic diversity is the persistence of macroeconomic developments across euro area countries. For example, the difference in the cumulated growth of real GDP between the two euro area countries with the largest and the smallest output increases, respectively, was more than 50 percentage points in the period 1998-2006. The situation was similar across US states. Furthermore, the equivalent accumulated spread between the two euro area countries with the lowest and highest inflation rates was almost 20 percentage points and in unit labour costs for the total economy between 20 and 25

[1] CPIS data, IMF, 2005.

percentage points over the same period. In the United States, the spread in CPI inflation between the two Metropolitan Areas with the lowest and highest inflation rates was slightly lower, at around 18% for the same period.

In the euro area, in addition to the decline in dispersion of inflation, activity and labour cost developments, another key feature is that business cycles are converging and output gap fluctuations are becoming more similar across countries. This feature is not apparent in the United States, where the dispersion of cycles and of trend GDP growth, seem to explain roughly equal parts of growth dispersion between states. For instance, last year, the acceleration in activity and the rebound in the euro area's real GDP growth was a widely shared phenomenon across the various euro area member countries. Hence, registered growth dispersion across the euro area countries seems to be mainly explained by differences in trend output growth, rather than cyclical developments, a feature I would like to reflect more on.

Differences in trend output growth in the euro area

The differences in trend output growth in the euro area might reveal structural factors that are a normal feature in a monetary union. Differences in trend output growth may, for instance, reflect diverse initial conditions and catching-up processes in some countries. For example, in recent years, per capita income in Ireland has risen from a level well below that of the euro area in the early 1990s to a level well above. In the early 1990s the GDP per capita of Ireland represented 75 % of the average of what were to become the first 12 euro area countries. Last year, the level in Ireland was about 30% above the euro area level. Moreover, a country may experience an equilibrating adjustment process following a shock. Diversity stemming from these factors is also economically justified, needed and observed within other currency areas. In an environment of high adjustment capacity, such divergences can be interpreted as a desirable equilibrating mechanism, contributing to sustainable convergence among euro area countries.

However, in some cases, persistent macroeconomic differentials may reflect inappropriate national policies, structural inefficiencies and rigidities or a malfunctioning adjustment mechanism in individual euro area countries. Differentials resulting from such factors may be detrimental to the dynamics of economic activity and employment. These are sources of macroeconomic differentials that policy-makers should be concerned about and where measures should be taken at the national level in order to increase economic flexibility.

The importance of the functioning of product, labour and financial markets

Starting with monetary policy, the single monetary policy with a uniform policy interest rate for the euro area countries cannot, as you know, directly influence diversity in output growth or inflation across the euro area countries. This emphasises the importance of only those countries that have reached sustainable convergence – as prescribed in the Maastricht criteria – participating in the euro area.

Well-designed structural policies – undertaken at the national level – should be implemented to enhance flexibility in product and labour markets and thereby increase the adjustment capacity of economies. Such reforms should aim to enhance productivity growth and labour utilisation while maintaining stable macroeconomnic conditions. In this context, the Lisbon strategy is a fundamental and ambitious programme to draw our attention to the urgency of such structural reforms. The United States, where cross-state labour is higher, could also be considered to be a role model for Europe.

Speaking to an audience of journalists and business executives, I am well aware of the hard task you are confronted with – that of conveying the message about the beneficial effects of reforms in growth and job creation. In this context, it is essential to understand and communicate that the medium to long-term benefits of structural reforms will significantly reward the initial investment. I can only encourage all responsible parties in these communication efforts.

More specifically, on the labour market, economic flexibility can be promoted by removing the institutional barriers to flexible wage and price-setting mechanisms. Let me stress that social partners share responsibility for ensuring that wage determination appropriately takes into account productivity and labour market conditions at the industrial, sectoral and regional level and does not jeopardise competitiveness or employment. And one should also take into account the fact that wage setting in the public sector often serves as a role model for the private sector. In addition, early retirement policies have a significant negative impact on labour supply and, hence, on the participation and employment rate. In the context of wage setting, sufficient wage differentiation is needed to improve employment opportunities for less-skilled workers and in regions or sectors with high unemployment.

Reforms are also needed in product markets. Let me stress the importance of fully completing the Single Market, particularly in services and network industries. A deeper integration of markets would stimulate price flexibility by fostering competition and open product markets. This requires that existing barriers to labour and capital mobility within the euro area be removed. Greater cross-border competition and the integration of markets across the euro area countries would contribute to lower prices, an area in which Europe may again find an interesting benchmark in the United States. These reforms could also enhance adjustment processes in individual countries in the event of asymmetric shocks or differing cyclical developments.

National authorities can make a substantial contribution, not only by implementing sound structural policies, but also by ensuring a proper functioning of adjustment mechanisms within the euro area and by implementing well-designed fiscal policies. Here, I would like to repeat that the best contribution fiscal policy can make to the proper functioning of the euro area is to be 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 focus on increasing effectiveness and efficiency of the public sector itself through “high quality” expenditure and tax policies. Large and inefficient public sectors can put the brakes on economic activity by imposing a high tax burden on the economy and channelling resources into unproductive uses. There, speaking in Germany, I have to mention that Germany itself has been exemplary in containing overall public spending as a proportion of GDP over the last years despite many challenges and a difficult environment. In 2007 the Commission estimates that public spendings will represent 43.8 % of GDP, which is 4.3 percentage points less than in 1999.

Cooperation between the two major monetary authorities

I hope I have by now convinced you that the monetary authorities in the United States and the euro area face challenges that are similar. Internally, diversity in these large areas is of the same magnitude, although possibly not of the same nature. Externally, both regions count on a large external sector, with significant bilateral linkages. Similar experiences naturally call for close working relations. This interaction has become particularly intense since the advent of the euro and the setting up of the European Central Bank and of the Eurosystem, but at the same time builds on a long-standing history of central bank multilateral cooperation in various international institutions and fora, including the Bank for International Settlements since the 1930s, the International Monetary Fund since the mid-1940s, the G10 since the 1960s, the G7 since the mid-1970s and, more recently, the Financial Stability Forum and the Group of Twenty.

Contacts with the Federal Reserve

These international organisations provide an excellent opportunity for the Federal Reserve Chairman and myself, for the members of the Boards as well as for the staff of both the Fed and the ECB/Eurosystem, to meet very regularly. To give you some idea of the level of contact we have, I can say that Ben and I meet, through the G7, the G10, the G20, the IMF and BIS meetings, probably a little more than once a month on average. In addition, Mr Bernanke and I jointly participate in a number of international conferences.

Indeed, through our regular meetings, Ben and I have built up a very close working relationship, a climate of mutual trust, and a platform for direct and quick contact in special circumstances that would require urgent communication.

Why is this important? The purpose of our contact is not the coordination of our monetary policies. This would be incompatible with the orientation of our policies towards our respective domestic objectives. Rather, the benefit of our close contact lies in the in-depth exchange of information and views on recent economic developments, on the monetary, financial and economic outlook in our respective economies, and on the policy challenges ahead. This includes, as I discussed before, trade and financial linkages between our two economies, directly or via other economies. Sharing first-hand knowledge on the world outlook and on how we see our respective domestic economies influencing and being influenced by the global outlook is extremely important in today's globalised economy.

On very rare occasions in the past, our close working relationship has also permitted to work out swift action. A prime example of this is the decision the ECB took in the very afternoon of the day of the terrorist attacks on 11 September 2001.

A second example is the decisions we took to help stabilising money market conditions during the financial market turmoil of last summer. Here again, close contact with the Fed proved extremely useful in sharing information on the financial conditions and central bank actions in our respective economies.

The close contact I have with the Chairman is, as you see, only the tip of the "iceberg". Our two institutions collaborate closely at all possible levels, involving Board members, management and staff. Across various domains of central banking, we have set up joint platforms for the regular exchange of information. In the field of economic research, we have set up the International Research Forum on Monetary Policy to discuss theoretical and empirical aspects of monetary policy. So far, four conferences have been organised, and a fifth one is scheduled for June 2008. In the area of payment and settlement systems and infrastructure, we have organised a number of joint conferences, for instance in April 2006 on central counterparty clearing, as well as regular meetings with the Federal Reserve Board. Even in an area such as education, we have undertaken joint work, for example at the conference on the Role of Central Banks in Economic and Personal Finance Education in Poland in 2006, organised by Narodowy Bank Polski, the Federal Reserve Bank of New York and the ECB.

Our ties are also facilitated by geographic proximity. You may be surprised to hear me mention geographic proximity, given that the centres of the Eurosystem and Federal Reserve System are in Frankfurt and Washington respectively. However, the ECB maintains a permanent representative office at the IMF, only a few streets away from the Federal Reserve Board in Washington. Though liaison with the Federal Reserve is not its main raison d'être, this office is another channel for closer contact and interaction.

Staff members of the two central banks also participate regularly in conferences organised by the other institution. For instance, so far in 2007, over ten staff members of the ECB, the Federal Reserve Board and the Federal Reserve District Banks have presented their research work in seminars and conferences organised by one of these institutions. Staff members also regularly visit the other central bank, spending several days discussing research work or technical issues. On some occasions, these stays even run over several months. Since 2003, six ECB staff members have spent a total of 40 months at the Federal Reserve Board and District Banks as part of the ECB's External Work Experience programme. And I do not mention here the many many relationships that are established between the national central banks of the Eurosystem and the Federal Reserve System.

Conclusion

Ladies and gentlemen, allow me to conclude.

The euro area and the United States are large economic blocs which are, at the same time, largely open to world markets. The last decades, in particular, have witnessed a tightening of the trade and financial linkages and the bilateral relationships between the United States and the euro area have been reinforced. As a result, central banks worldwide, and in particular the Federal Reserve and the Eurosystem, always keep an eye on partners' economic, monetary and financial developments. The ECB and the Federal Reserve System have many opportunities to share their experience and technical expertise, whether through discussions within international meetings or in informal ways through conferences, staff visits, personal contacts of all nature, including confident personal relationships at the level of Chairmen. I would also like to point to one example of cooperation that might look unusual. Last year, we had one case of cooperation in the domain of culture and arts, as the Federal Reserve exhibited a remarkable set of the art works of its collection at the premises of the ECB in Frankfurt. This art exhibition was another symbolic illustration of our close cross-Atlantic ties, in which tonight's journalist prize ceremony also plays a part. I have always been convinced that a very strong relationship between both sides of the Atlantic is essential for the stability and continued prosperity of our respective continents but also for the continuing stability and prosperity of the global economy itself. This is today particularly true in a period of immense opportunities and of significant challenges.

Thank you very much for your attention.

References

Bayoumi T. and A. Swiston (2007), Foreign Entanglements: Estimating the Source and Size of Spillovers Across Industrial Countries, IMF Working Paper 07/182.

Calza A. and S. Dées (2007), The Euro Area in the Global Economy: Its Sensitivity to the International Environment and Its Influence on Global Economic Developments, in Di Mauro and Anderton (eds.), The External Dimension of the Euro Area: Assessing the Linkages, Cambridge: Cambridge University Press.

Di Mauro F., L.V. Smith, S. Dées and M. H. Pesaran (2007), Exploring the international linkages of the euro area: a global VAR analysis, Journal of Applied Econometrics, vol. 22(1), pages 1-38.