Willem F Duisenberg: The euro as a catalyst for integration and competition in EMU

Speech by Dr Willem F Duisenberg, President of the European Central Bank, on the occasion of the 30th Economics Conference "Competition of Regions and Integration in EMU", Vienna, 13 June 2002.

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Ladies and Gentlemen,

Here in Vienna, exactly one hundred years ago, Joseph Schumpeter embarked upon his university studies at the School of Law and Political Science. He was a promising young student with ambitions in academics, politics and business. Already, at the age of 22, he had published his first works and would soon become one of the youngest holders of a doctorate, the youngest private teacher and the youngest professor in Austria.

Joseph Schumpeter has become known as one of the foremost representatives of the famous Austrian School of Economics. He has influenced economic thought, in particular, by introducing innovation as a source of economic dynamics. According to Schumpeter, economic development was a dynamic process, a disturbance of the economic status quo. The real challenge for capitalism, therefore, was to create and destroy economic structures in a process he called "creative destruction" This, he maintained, was the essence of economic development, a process defined by the implementation by the entrepreneur of new production combinations.

I believe that Schumpeter would be very interested in the topic I want to discuss today. My speech is about the euro as a catalyst for integration and competition in EMU, or, in other words, about economic growth and adjustment in the euro area. Both high, sustainable economic growth and the ability to adjust smoothly to changes in the economic environment require further economic integration and competition. This, in turn, is closely linked to the process of structural reform, which, to use Schumpeter's words, can be seen as a necessary precondition for a dynamic economic process, a disturbance of the economic status quo. The introduction of the euro acts as a catalyst for this dynamic process of structural change.

In my speech today I will address the following topics. I will first talk about the link between European integration and the euro, and then argue why an increasingly competitive and dynamic society raises the need for further structural reforms. However, reforms are also important for the smooth functioning of a monetary union, a point I will discuss next. Finally, I will assess the progress that has been made with the structural reforms in the euro area so far and discuss how the single currency has already benefited the euro area's economy, acting – as formulated in the title of my speech – as a catalyst for integration and competition.

A single currency for a single market

A natural starting point for my topic today is the adoption of the Single Market Programme in 1985, paving the way for the famous four "liberties" established in the European Treaties: the free movement of goods, services, labour and capital.

After the adoption of the Single Market Programme, it became increasingly clear that the potential of the internal market could not be fully exploited while the relatively high transaction costs linked to currency conversion and the uncertainties associated with exchange-rate fluctuations persisted. Indeed, the single currency should be seen as a necessary complement or, in fact, the crowning achievement of the Single Market.

That said, we have not reached the end of the development of the Single Market. Instead, I see the euro as facilitating further economic integration. For example, countries with the same currency tend to trade more with each other than they would with countries with different currencies. In addition, a single currency fosters the formation of a single financial system. By increasing price transparency, reducing transaction costs and fostering competition, the euro acts as a powerful catalyst to the economic integration process in the euro area. Last, but not least, our common currency is also a powerful symbol for all citizens of the euro area that integration has reached a new level. As we approach the first summer holiday season since the introduction of euro notes and coins, increasing numbers of people in Europe will, themselves, experience the practical advantages of a single currency.

The impetus the euro gives to economic integration and growth should not only be regarded as an opportunity for Europe, but also as a necessity in a world of innovation and globalisation. Over the last few decades, the world economy has become ever more integrated. We have witnessed a strong expansion of international trade and capital flows and an increase in competition. Behind these changes there are several underlying factors. Among the most important is rapid technological progress, leading to dramatic reductions in transportation costs and an unprecedented increase in information processing capabilities. Policy measures have also supported the globalisation trend, with the loosening of restrictions to trade and the liberalisation of capital movements.

This panorama shows that we live in a dynamic and competitive world, where the ability to innovate and adjust to changing economic circumstances has become even more important than before. In this respect, Schumpeter's thoughts haven't lost anything of their relevance. On the contrary; in a dynamic, ever-changing economic environment, entrepreneurs have to be all the more innovative and sensitive to new opportunities. The regulatory framework formed by the laws, rules and regulations that influence economic behaviour, should thus provide the right incentives for innovation, dynamism and economic growth.

The EU Heads of State and Government have recognised that, in order to improve the functioning of the Single Market and to enhance the economic growth potential of the EU, its regulatory framework has to be modernised and reforms are needed. Somewhat more than two years ago, the Lisbon European Council formulated a strategic goal for this decade, namely "to become the most competitive and dynamic knowledge-based economy in the world". The Lisbon strategy established a comprehensive reform agenda which aims to overcome existing fragmentation and inefficiencies in many different areas. This has provided a major political impetus for further progress in the field of structural reform that I very much welcome. The European Council aims to increase the potential GDP growth rate to around 3% per year, an objective which can only be achieved if steady progress on a broad range of reforms is made. Whether or not this objective is met hinges partly on the capacity to improve mobilisation of available labour resources. In this regard, one of the explicit objectives set at the Lisbon summit is to raise the EU-wide employment rate to 70% of the working age population by 2010.

In order to achieve the Lisbon objective, it is crucial that progress is systematically controlled and evaluated. In this context, the Broad Economic Policy Guidelines for the Member States and the Community play a particularly important role. This is the overall framework for the co-ordination of economic policies, in particular, those related to fiscal and structural policies. In order to fulfil this role, the Broad Economic Policy Guidelines have, in recent years, been enhanced in several ways. They have become more operational through the use of more concrete recommendations in both the general and country-specific parts. Moreover, within the overall process of policy co-ordination, increased emphasis is being placed on implementation. To this end, the European Commission has introduced a comprehensive implementation report that assesses the extent to which EU Member States have followed the policy recommendations. I fully support these changes.

As you know, the most recent Spring meeting of the European Council, the second "follow-up" meeting to Lisbon, took place in Barcelona earlier this year. The conclusions of the Barcelona Summit demonstrate that a strong political will and thorough preparation of the technical details are needed if the European Union is to meet the ambitious economic, social and environmental objectives that it set for itself at the Lisbon Summit. The successful introduction of the single currency is the best proof that these ingredients are indispensable. The main point now is that the relevant Council formations, the European Parliament and the Member States take the necessary steps to rigorously implement the structural reform agenda agreed in Lisbon and confirmed in Barcelona.

Why are structural reforms important?

Structural policies cover a wide range of areas and instruments. Among the most commonly discussed are microeconomic regulations implemented in product, labour and financial markets. Among other things, such regulations encompass competition policies, entry barriers, tax and benefit systems, state aid, employment protection rules, education and training, as well as incentives given to research and development. They are important for two main reasons since they enhance the economic growth potential and facilitate the adjustment to economic change. Let me say a few more words on these two reasons.

First, structural policies are just one of many factors determining the rate at which the economy can grow, although there are many other factors which influence the rate of economic growth. Some factors, such as changes in demand conditions, have temporary effects on economic growth, whereas others, such as the rate of growth of the working age population and capital stock, as well as the increase in productivity, have long-lasting effects. It is this latter type of factor, however, that determines the potential growth rate of an economy. These components, in particular the growth of employment and productivity, can be influenced by structural policies. Changes to tax and benefit systems, for example, can help to mobilise the unused labour potential in the economy by making it financially more attractive to accept a job. This could lead to a better use of the supply side potential of the economy. The third factor, productivity growth, can be influenced in several ways: by increasing competition, facilitating investment, encouraging enterprise and innovation and improving the workforce's skills. Structural policies have particular importance for monetary policy. They allow the economy to grow at a higher rate, on a sustained basis, without creating inflationary pressures.

However, structural reforms are not only important for economic growth, they also increase adaptability to economic shocks. Adaptability concerns the economy's ability to adapt and respond to changing economic conditions. It is the ability to shift resources from areas in recession to booming areas, something which is key to the successful functioning of a monetary union. Under EMU, member countries are unable to use country-specific monetary and exchange rate policies to address country-specific shocks. The adjustment to such economic fluctuations will therefore have to take place through other adjustment mechanisms. Without price and wage flexibility and mobility of production factors, economic shocks would lead to lower economic growth and higher unemployment. Let me say a few more words on the important role of these adjustment mechanisms in a monetary union.

The theory of optimal currency areas

Ever since the idea of EMU was launched, a discussion has ensued as to whether the whole or part of Europe would be an optimal currency area. The optimal currency area theory defines a set of mechanisms that might be set in motion when a participating country or region, in a monetary union, is hit by an asymmetric shock. First, adjustment to the shock might come from domestic price or wage changes, thereby altering the real exchange rate without changing the nominal exchange rate. Secondly, migration of production factors might act as an adjustment channel. These flows of labour and capital are facilitated by a high degree of economic and financial integration of the countries participating in the union.

In addition to this, the theory of optimal currency areas has also something to say on the similarity of shocks affecting countries or regions in a monetary union. In this respect, the degree of trade and financial integration are often considered. Trade and financial integration may tend to lead to more similar economic developments in the respective countries or regions in a monetary union, reducing the likelihood of asymmetric shocks and increasing the economies' abilities to adjust to these shocks.

So far the theory, let me now move on to the practice. I will now focus on two adjustment mechanisms: price-wage flexibility and factor mobility. A host of empirical studies on these mechanisms has been undertaken for the euro area. How well does the euro area measure up against these two criteria?

Price and wage flexibility

There is broad agreement that price flexibility is low across euro area countries in comparison with the United States. In the euro area, price flexibility for goods and services is hampered by trade barriers, continuing state aid to several sectors and, more generally, a lack of competition in sectors that have been dominated by monopolies or state owned enterprises.

Low wage flexibility is also an important factor behind the lack of price flexibility in the euro area. Many studies indicate that in comparison with the United States, real wages are relatively inflexible in Europe. More specifically, I mean that the downward responsiveness of real wages to the level of unemployment is more limited in Europe than in the US. There are, however, notable differences across countries in the euro area.

Let me also mention the potential links between the flexibility of product and labour markets. Reforms in one area are likely to have effects across markets. For example, reforms leading to more flexible product markets might improve the performance of the labour market. If regulations on setting up a business are loosened, employment creation is also likely to increase. Similarly, labour market reforms might also have an impact on product markets. For example, labour market reforms may improve the extent to which differences in skills or productivity are reflected in wage differentials, which could affect prices. More generally, more flexible labour markets allow companies to adjust to economic changes with greater ease.

Factor mobility

Let me now turn to the second adjustment mechanism, the mobility of factors of production. Changes in price levels, in product and labour markets, can also be triggered by a migration of factors of production. If a country or region is affected by a negative output shock and markets do not clear instantaneously, unemployment will rise. Workers will, therefore, tend to migrate to other regions. The same might be true for capital: if a negative output shock made capital obsolete and reduced profitability, investors would tend to move their funds to other regions. This adjustment mechanism has two limitations. First, the migration of labour and capital involves transaction costs. Moreover, it is doubtful whether this mechanism is very efficient when a country or region is hit by a temporary shock. Therefore, factor mobility seems a suitable adjustment mechanism only in case of a permanent shock and if prices or wages are rigid.

Several studies have found that labour mobility within the United States is two to three times higher than in Europe. This result is confirmed by the persistence of regional unemployment differences in Europe.

Overall, it can be concluded from empirical studies that the degree of wage-price flexibility and factor mobility is relatively limited in the euro area. The lack of adjustment mechanisms in the euro area should, however, not be exaggerated. Euro area countries are highly integrated both in terms of trade and financially. As I have just explained, a high degree of trade and financial integration may lead to more similar economic developments across euro area countries.

In addition, the optimal currency area properties are likely to evolve over time. The irrevocable fixing of exchange rates and the introduction of the single currency may lead to a convergence in the production and export structures of economies in the euro area, thereby reducing the risk of future asymmetric shocks. This argument is often referred to as the "endogeneity" of the optimal currency area hypothesis. Hence, according to the endogeneity literature, the euro area could gradually become more of an optimal currency area, after the introduction of the euro. More generally, it has to be borne in mind that all empirical studies on whether the countries that have entered the euro area constitute an optimal currency area are based on historical data. These data refer to regimes with flexible or fixed-but-adjustable exchange rates. In short, the regime shift to a monetary union may have an impact on economic structures and may alter some of the conclusions drawn on the basis of these historical data.

Progress made with structural reforms in the euro area

Some people say that central bankers are professional sceptics whose job it is to point to economic risks and weaknesses. Having listened to me so far, I can imagine that you may find some degree of truth in this. Let me tell you, however, that the euro area has recently seen many changes and innovations that go in the right direction. And I am pleased to be able to tell you that many of these changes are directly, or indirectly, related to the euro. Let us have a closer look at three areas of change: financial markets, product markets and labour markets.

Financial markets

The first area I want to discuss are financial markets. There is ample evidence that financial markets have some way to go before national demarcation lines will effectively disappear. Henceforth, there is still a significant potential for further financial market integration in the euro area. Financial market integration has been driven by global developments, such as advances in information technology, falling communication costs and standardisation of products. It has also been supported by European Commission initiatives.

A main policy initiative that has contributed to financial market integration is the Financial Services Action Plan. EU Heads of State and Government have agreed to implement the Financial Services

Action Plan by 2005, at the latest, and to achieve fully integrated risk-capital and securities markets by 2003. The groundwork for the latter was prepared by a Committee of Wise Men called the Lamfalussy Group. On wholesale markets, measures to facilitate raising capital on an EU-wide basis, through common rules concerning prospectuses, is targeted for adoption in 2002. In addition, legislative proposals on financial statements for listed companies and a common legal framework for a single market for securities and derivatives are close to being adopted. We, at the ECB, fully support these initiatives. I would like to stress, however, that the successful and timely implementation of the Financial Services Action Plan will be very difficult without the continuing commitment of the Member States.

The integration of financial markets would not only facilitate cross-border capital flows towards their most productive uses, but it could also serve as a catalyst for structural reform in other markets. For example, the impact of product market reforms, aimed at easing the restrictions on creating a business, are likely to be reinforced if a well-functioning risk capital market, which efficiently channels the necessary funds from investors to beginning entrepreneurs, is in place.

The euro has made a spectacular impact on financial markets in the euro area. Concrete examples of its impact are the integration of the money market, the explosive growth of the euro-denominated corporate debt market and a wave of consolidation among intermediaries and exchanges. These are very fundamental changes. The surge of euro-denominated corporate debt, for example, has helped to finance the wave of mergers and acquisitions in the European corporate sector and shows how a larger and deeper single financial market can help to strengthen Europe's competitiveness.

Product markets

Let me now turn to product markets. The pace of liberalisation has differed considerably across countries and sectors in the euro area, leaving ample room for further reforms. Whereas the integration of goods markets is relatively advanced, shortcomings still exist with regard to the integration of service industries. Most of the barriers to integration in the service sector appear to be due to national regulations, for example administrative procedures for setting up subsidiaries in other euro area countries. Regulatory barriers along these lines reduce competition in services, thus keeping prices above the level that would be expected in a fully integrated market.

More progress has been made with regard to the integration of goods markets and regulatory reforms in network industries. Here too, positive macroeconomic effects can be discerned. Owing to an increased number of competitors, prices in some network industries, such telecommunications, have started to decline, in particular in those industries and countries which liberalised earlier. The initiatives in the telecommunication sector show how reforms that succeed in increasing competition in previously sheltered sectors considerably enhance productivity and lower prices. As network industries provide inputs to the rest of the economy, this may also increase the rate at which the economy can grow without creating inflationary pressure. Nevertheless, an important unfinished agenda remains to be tackled in almost all network industries. In order to reap the full economic benefits, it is important that reforms in network industries are accompanied by an appropriate regulatory framework which ensures non-discriminatory access to the bottleneck infrastructure and more generally, a "level playing field" for all market participants. The quality of the regulatory framework has a considerable impact on the extent to which potential price falls due to structural reforms in network industries will be achieved.

Another instrument available to reduce distortions to competition is state aid policy. State aid subsidies weaken the incentives for companies to improve their efficiency, enabling the less efficient to survive at the expense of the more efficient. Although there are still substantial differences between euro area countries, the overall trend is towards a reduction in state aid levels. Another positive development is that the transparency of state aid policies has improved as a result of the publication of a new state aid register and a state aid scoreboard by the European Commission.

The impact of the euro on these processes, which has led to more competition, cannot be overestimated and goes far beyond the mere abolition of intra-European exchange rates and the introduction of common notes and coins. The single currency opens up the euro area product markets further and will be a major impetus to competition and integration by increasing the transparency of prices across borders. Investment will also benefit as euro area companies no longer have to insure against exchange rate movements within the euro area and there are indeed indications that direct investment into the euro area has strongly increased since the start of EMU. Overall, the euro will give new impetus to the initiatives taken in the 1980s to establish a truly integrated internal market.

Labour markets

Progress with labour market reforms has become evident from the increase in employment-intensive growth in the euro area. It is very interesting to note that job creation has held up reasonably well over recent years. During the first three years of EMU, some 6 million jobs have been created in the euro area versus 3.5 million in the US. The unemployment rate in the euro area has declined from almost 11% in 1997 to slightly more than 8% in 2001 (which is still too high). On the supply side, the employment rate, particularly in the case of women, has increased considerably, along with the proportion of part-time jobs and temporary contracts in total employment. Euro area average participation rates are, nevertheless, still below those of the US or the Scandinavian countries.

The explanations for this job-rich growth lie in structural changes in the labour market and wage moderation. Government policies have generally improved labour market performance in euro area countries. A number of countries have lowered marginal tax rates in order to make their tax systems more employment-friendly. Many countries have targeted tax cuts at the lower end of the labour market in particular. These measures have contributed to a higher demand for low-skilled workers. Nevertheless, marginal tax rates still remain high in some countries. Some progress has also been made with the introduction of part-time or more flexible working contracts and practices.

In addition to government policies, there are signs of a gradual change in labour market behaviour related to the wage formation process. Discipline seems to have improved in that field over the past decade. Such a change, resulting from lower inflation expectations, is important. Furthermore, there seems to be a growing awareness that, in a single currency environment, the price increases and loss of competitiveness generated by excessive wage settlements cannot be compensated by an exchange rate depreciation and may directly result in a loss of jobs.

Looking ahead, it is crucial that social partners continue to adhere to moderate wage developments, since this is one of the prerequisites in fostering employment and maintaining a favourable outlook for price stability in the medium term. In this respect, there is some cause for concern with regard to ongoing wage negotiations.

The wage formation process also seems to have undergone changes. In a majority of euro area countries, there are signs of a gradual trend towards more decentralised bargaining and more flexibility at lower bargaining levels. This seems to happen, mostly informally, through clauses that allow firms to deviate from the sectoral or central wage agreements according to the financial situation of the firm or sector. This is encouraging. The outcomes of wage bargaining should allow not only for appropriate wage developments in the overall economy, but also for adequate wage differentiation across sectors, regions and firms. This will make it easier to account for local conditions, such as unemployment, productivity or profitability differentials across sectors, regions and firms.

In short, labour market reforms have, in general, been going in the right direction in recent years and the benefits of these positive developments are clear. However, progress has been rather uneven across countries and areas. In many areas important reforms have not yet got off the ground. For instance, few changes have been made regarding employment protection policies in euro area countries, which remain amongst the strictest in the industrial countries. Furthermore, in almost all euro area countries, reforms targeting unemployment benefit systems have only made slow progress. At the same time, significant mismatches between labour demand and supply are still present along a number of dimensions. All this shows that large structural problems remain and need to be solved.

What needs to be done to speed up labour market reforms? This is a difficult question, not least because the euro area labour markets are still very heterogeneous. Each country should identify the root causes of its labour market deficiencies and implement appropriate corrective measures. However, there are some areas of reform that apply to many, if not all, euro area countries. Improved job mediation, education and training, to mention just a few examples, all help towards making the matching process more efficient. In addition, euro area countries need to ensure that tax and benefit systems make work pay. Reforms to tax and benefit systems should increase work incentives, profitability and competitiveness and consequently labour supply and demand. At the same time, it is important to ensure that tax-benefit reforms are undertaken without jeopardising the long-term sustainability of public finances.

Conclusion

Ladies and Gentlemen. Joseph Schumpeter taught us that economic development consists of the continuous introduction of new combinations of products and means of production. He taught us that this process involves the incessant mutation of the economic structure from within, destroying the old and creating a new. In today's dynamic, ever-changing economic environment, entrepreneurs have to be all the more innovative and sensitive to new opportunities. The regulatory framework has to be designed in such a way that it allows this to happen by providing the right incentives for innovation, dynamism and economic growth.

Today's dynamic society also requires an increased ability of markets to adjust smoothly to changing economic circumstances. This is all the more true of a monetary union, where member countries are no longer able to use country-specific monetary and exchange rate policies to address country-specific shocks. In such an environment, other adjustment mechanisms are needed such as price and wage flexibility and factor mobility. Structural reforms can contribute to a better functioning of these adjustment mechanisms by fostering integration and competition. The relationship between integration, competition and the single currency works in both directions. The euro itself has already contributed to more integration and competition and will continue to do so in the future. Its impact is most clearly visible in financial markets, where a single money market has been created and a deep, liquid bond market has encouraged a surge in debt issuance by the corporate sector. In product markets, the euro has an important impact on the cross-border transparency of prices, acting as a catalyst for trade. Finally, with regard to labour markets, the wage formation process shows signs of increased flexibility and labour market reforms are starting to go in the right direction. Overall, the single currency contributes forcefully to more integration and competition, acting as a powerful driver for the further enhancement of the Single Market and creating an environment which – I am sure – Schumpeter would have enjoyed.

Thank you very much for your attention.