Jean-Claude Trichet: Economic and financial integration in EMU and implications for monetary and economic policies

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the SUERF/UNICREDIT conference entitled "Governance and structure of European finance after EU enlargement", Frankfurt, 9 March 2005.

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Introduction

Ladies and gentlemen,

It is a great pleasure for me to give this keynote speech here today and to welcome you all to Frankfurt – the home of the ECB since 1998 and the euro since 1999. While serving the SUERF's aim of promoting contacts and discussions on monetary and financial issues, the topic of this conference covers the most crucial, and most rapidly changing, elements of present developments in the EU, namely i) the evolving composition of the EU and ultimately the euro area, ii) the prospects for European finance and finally, iii) issues of governance – and I am looking forward to hearing the results of today's discussions.

In 2003, I had the honour of speaking on the occasion of the 40th anniversary of the SUERF in Paris. I discussed the interplay between the degree of optimality of a currency area and the implementation of economic policies. Having made the move from Paris to Frankfurt shortly after, and having had enough time to appreciate the complex and fascinating mechanisms of EMU through another angle, I would like to return to the topic of economic and financial integration in Europe and its implications for economic and monetary policies.

Economic and monetary integration in the euro area

Political and economic rationale have taken turns in driving the European integration process with the aim of achieving peace, political reconciliation and economic prosperity. This has led to a very advanced stage of economic and financial integration in the EU, with the Single Market and the single currency as its most visible characteristics. This integration process is historically unique as it combines both supranational and intergovernmental elements between sovereign states in a way that challenges previous concepts and definitions. While integration in Europe could be seen partly as a regional process of the much wider global phenomenon of trade integration, visionary political leadership also played its role in accelerating the integration of the product, labour and capital markets. In the field of economics, theory and practical experience gained in the 1970s and 1980s led to a convergence of ideas and greater belief in the virtues of stability-oriented macroeconomic policies. As a result, we see less volatility in market variables such as interest rates and exchange rates.

The single currency and the Single Market in Europe are often discussed using the optimum currency area literature as a theoretical framework. The essential foundations of this literature were elaborated in studies by Mundell (1961), McKinnon (1963) and Kenen (1969) in the 1960s. The theory discusses the similarity of shocks affecting countries or regions in a monetary union and stresses the need for a high degree of trade and financial integration as well as similarity of economic structures. The greater the degree of similarity and integration in production and consumption structures, the lower the risks of asymmetric shocks or diverging developments that would necessitate a different monetary policy or changes in the exchange rate in order to avoid prolonged periods of unemployment. Of course, other adjustment mechanisms, such as a sufficient degree of price and wage flexibility as well as factor mobility, would need to compensate the loss of the exchange rate and an individual monetary policy in the event of diverging developments, and are thus stressed as necessary conditions for an optimum currency area.

While such considerations are true for any currency area, there have been specific concerns for Europe, as regards cross-border labour mobility (although this also applies within individual countries), labour and product market flexibility and a cross-border fiscal transfer mechanism. Let me say that I do not share the sometimes negative tone of this debate, mainly for two reasons; first, I believe the theory must be applied in a dynamic framework. Indeed, applying the theory at a specific point in time, there are few currency areas that fully live up to all the criteria of "optimality". My second reason, which is linked to my first, is that I believe the achievements, in terms of convergence and integration, have been significant in Europe and developments are going in the right direction. While accepting that more could, and should, be done to improve adjustment mechanisms, given that a significant number of countries still exhibit major product and labour market rigidities, it is my belief that the euro is helping individual countries to undertake reforms that are leading to an increasingly efficient currency area. Such reforms would also have been necessary in the light of the increasingly integrated and competitive world economy.

Let me highlight some of the most important achievements to date.

First, the process of nominal convergence in Europe has been truly impressive, especially seen from a historical perspective. In a sense, the EU has returned to the same macroeconomic stability that characterised the 1950s and the 1960s. Inflation in the euro area is well anchored to price stability according to our definition – below, and close to 2% - and price stability has become a common good for all European citizens, not just a subset of them. The dispersion of inflation rates has also been reduced. In 1992, the difference between the highest and the lowest inflation rate across the euro area countries was around 13.5 percentage points. Since 1999, it has been around 3.3 percentage points, which is admittedly higher than that observed within individual euro area countries, but of the same order of magnitude as that observed in, for example, the United States (where the average difference stood at 3.2 percentage points between 1999-2004 according to the survey of the 14 Metropolitan Statistical Areas).

In parallel, the consolidation of public finances that took place in the 1990s was as impressive as it was necessary, ending the continuous increase in public debt that had taken place since the 1970s. In this regard, the convergence criteria for joining EMU played a crucial role in supporting the consolidation efforts. However, since the start of EMU, compliance with the 3% and 60% budgetary reference values has diminished. Further fiscal discipline is called for, in the light of the challenges of an ageing population and in order to facilitate the efficient functioning of automatic stabilisers.

Reflecting the achievements in terms of inflation and public finances, long-term interest rates have also tended to converge downwards and are now more stable. This, combined with the total removal of any exchange rate volatility in the single currency area, has markedly reduced their potentially disturbing impact on individual countries. This is very different from the situation in the early 1990s, when financial market turbulence heavily affected our continent. Without the single currency, recent major shocks, such as the stock market correction in 2000 and the terrorist attacks on 11 September 2001, would have triggered major instability in European economies and financial markets. A remarkable sign of the success of EMU, in my mind, is that long-term inflation expectations have been well anchored to price stability since the first days of the euro and of the ECB, and that the cost of long-term capital, including mortgage credit, has converged towards the best performers in terms of credibility and low interest rates, therefore offering an environment highly favourable to economic growth. These are indeed results that could never have been achieved without the euro.

The positive results for nominal convergence and stability have also been shared by other EU Member States, and, supported by the convergence criteria, are indeed serving as strong incentives for Member States aiming to join the euro area.

As outlined in the theory, real convergence is equally essential for the smooth functioning of a currency area. Real convergence usually refers to the degree of trade and financial integration, the similarity of economic structures and business cycles, the flexibility of prices and wages, and labour and capital mobility. Trade integration is well-advanced and trade flows within the euro area have increased sizeably since the introduction of the euro, suggesting that the elimination of transaction costs and uncertainties related to exchange rates have indeed enhanced cross-border price transparency and trade opportunities as expected. While trade within the euro area has increased markedly, it is interesting to note that trade with countries outside the euro area has also increased, raising the export share to almost 20% of GDP in 2003, from around 17% in 1997 (a similar development is recorded for imports), compared with around 10% in the United States and Japan. An important factor is the rising trade with the new EU Member States, which has increased trade integration within the enlarged EU. The share of total euro area exports to the new Member States was less than 9% on average during the second half of the 1990s, but it has now risen to more than 11%.

Similarly, the integration of financial markets is well advanced in the euro area, facilitating the efficient allocation of savings to the most profitable investment opportunities and allowing market participants to partly diversify away the risk of asymmetric shocks.[1] The euro has visibly accelerated integration, particularly in the money market. In addition, the measures adopted under the Financial Services Action Plan (FSAP) have significantly enhanced the integration of the government bond market, and to a lesser extent the corporate bond market. However, in the retail area, especially in the banking sector, market segmentation remains rather strong. Cross-border loans from euro area banks to the private non-financial sector remain below 5% of total loans, and there is persistent dispersion in the levels of financial institutions' interest rates across countries, at least in some instrument categories; in this regard, the ECB strongly supports the efforts aimed at creating a Single European Payment Area.

In terms of economic structures, euro area countries show a high degree of similarity, with well diversified production and consumption structures that should reduce the risks of asymmetrical disturbances. Financial structures are also very homogeneous across countries, implying that the transmission channels of monetary policy to the real economy can work in a comparable and predictable way across countries.[2]

A series of studies have revealed the similarity of monetary policy transmission channels, with the interest rate channel playing the prominent role in all countries and the bank credit channel a less predominant role.[3] National financial structures, however, still continue to exhibit significant differences. For instance, the role of debt securities and shares in financing the private sector and the types of vehicles (pension, insurance and mutual funds) used to manage the long-term savings and pensions of households are markedly different across countries.

As a result of the high degree of trade, particularly intra-industry, and financial integration, as well as the high degree of convergence of macroeconomic policies in the euro area, the business cycles tend to be significantly synchronised. Cross-correlations of business cycles (in particular industrial output) have been quite high between the larger euro area countries[4] over the past decade, although business cycles have also tended to be more synchronised across the world. Moreover, the dispersion of real GDP growth rates in the euro area has remained very close to its historical average, suggesting the absence of any major asymmetric shocks. As differences in GDP growth rates partly reflect differences in potential growth rates, and consequently differences in the successful implementation of structural reforms, the dispersion also indicates the scope for countries with low growth to achieve higher growth rates. It is important to note that even if there have been no major asymmetric shocks, diverging developments may have arisen from the transmission of common shocks, implying that adjustment mechanisms, working via external competitiveness or automatic fiscal stabilisers, are still necessary.

For the new Member States, business cycles are less correlated within the group and with the euro area, showing also higher output variability. While this partly reflects the profound structural changes and reforms that have taken place, it may also reflect the fact that these countries are rather small and specialised. As trade integration and foreign direct investment flows into these countries continue, there is reason to believe that the level of synchronisation will increase. As a matter of fact, there has been a marked increase in investment flows towards the 10 new Member States in recent years.

Certainly, the euro area also lacks some properties that would make countries and regions more resistant to economic disturbances and improve performance in terms of GDP growth and employment, in particular a high degree of wage and price flexibility and labour market mobility. Some have also argued that the sustainability of EMU hinges on the existence of a cross-country fiscal transfer mechanism to absorb regional shocks. Most of these issues are not unique to the euro area

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1 See A. Atkeson and T. Bayoumi (1993), Do Private Markets Insure Against Regional Shocks in a Common Currency Area? Evidence from the US, Open Economies Review 4, 303-324 or P. Asdrubali, B. E. Sörensen, and O. Yosha (1996), Channels of interstate risk sharing: United States 1963-1990, Quarterly Journal of Economics, November, 1081-1110.

2 As illustrated for example in the "Report on financial structures" published by the European Central Bank in 2002 or in the "Financial Integration Monitor" published by the European Commission in 2004.

3 See I. Angeloni, A. K. Kashyap and B. Mojon (2003), Monetary policy transmission in the euro area, a study by the Eurosystem Monetary Transmission Network.

4 Correlation coefficient of around 0.9 (based on de-trended GDP series) between Germany, France and Italy during the period 1993-2003.

but are relevant in a majority of EU countries and I would like to return to them a bit later when the discussion turns to challenges for structural policies.

Specialisation and agglomeration within the euro area

Having discussed the current situation of the euro area as an optimum currency area, it is also important to discuss where EMU might be heading. The dynamics that have been set in motion are indeed likely to lead to further changes and challenges. As we have seen, the Single Market and the single currency have mainly affected trade and financial integration through changes in the competitive conditions of the markets. Easier market entry, reduced cross-border transaction costs and increased price transparency should increase the competitive pressures, to the benefit of consumers in terms of greater product diversification and lower prices. In response to this, the strategic behaviour of firms may change and lead to structural changes in terms of economies of scale, industry concentration and location. An interesting issue is how European integration will affect specialisation and the division of labour between Member States, especially since a higher degree of specialisation might imply greater vulnerability to asymmetric shocks.

In economic theory, two strands of thinking have emerged. The first, supported by Paul Krugman (1991) and the new economic geography models, suggests that as trade barriers (e.g. transport and transaction costs) are reduced, opportunities for economies of scale and specialisation in production where countries have a comparative advantage would increase. Consequently, countries' production structures would become less diversified and thus increasingly vulnerable to asymmetric shocks while business cycles could become less synchronised. An opposing view, developed by Frankel and Rose (1997), states that European integration would instead lead to greater intra-industry trade integration and more similar economic structures and business cycles through the convergence of factor endowments and technology and reduced exchange rate variability, which tends to weaken intra-industry trade. This view even implies that countries could satisfy the optimum currency area properties ex post rather than ex ante (the "endogeneity of OCA" argument).

Although the timespan since the start of the EMU is too short for any strong empirical conclusions, evidence based on long-term trends of European integration gives some support to both views, leaving it fairly open as to where we might be heading. According to an overview published by the European Commission[5], there have so far only been modest changes in the pattern of industrial concentration and geographical specialisation within the euro area.

While production specialisation has gradually increased since the 1970s, export specialisation appears to have decreased, which could be partly explained by the increased importance of intra-industry trade. Similarly, a study of sectoral specialisation carried out by the European System of Central Banks[6] in 2004 found the production structure of euro area countries to be relatively similar, more homogeneous than in the United States, and relatively stable over time. An overall view of the effects of EMU on specialisation is consequently still difficult to obtain.

A few other developments could shed further light on the issue. A host of studies have highlighted agglomeration or clustering effects, suggesting that in high-value industries, an environment generating positive externalities, such as dense networks of sub-contractors, the presence of competitors and informal links with complementary businesses, the supply of qualified labour and investment capital, the proximity of research capacity and other services, is increasingly important. Such agglomeration of production factors could indeed increase specialisation and reduce cross-border trade within industries. At the same time, the growing economic role of services, which are less prone to specialisation and trade, needs to be taken into account.

As regards economic efficiency, increased specialisation offers sizeable gains in terms of innovation, productivity and higher potential growth rates. These trends are apparent worldwide, as shown by the fast accumulation of capital and know-how in the new Member States and similar developments in Asia. In the EU, the promotion of a knowledge-based economy and the clustering of more diversified but complementary competencies could further advance innovation, agglomeration effects and economic dynamism.

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5 European Commission (2004), "EMU after 5 years: an assessment".

6 ECB (2004), "Sectoral specialisation in the EU – a macroeconomic perspective", Occasional Paper No. 19.

If Europe were to evolve gradually into more specialised regions, one could argue that economic cycles and developments could become more divergent across the area, creating challenges for economic policies. However, increased specialisation is likely to operate at regional rather than national level. Consequently, it may pose a challenge for regional policy at national or EU level, rather than weighing on the "optimality" of the currency area. Such problems of diversity across regions are well known in most currency areas. The best model for a dynamic Europe may be one of regional diversity, with comparative advantages determining the regional specialisation, rather than centralisation of capital and labour in only a few areas which would put greater demands on labour mobility and possibly lead to greater polarisation across regions. Let me now discuss some policy implications.

Implications for monetary and economic policies

In Europe, the question as to how economic policies should be conducted in a diversified currency area has been at the centre of the policy debate since the launch of the single currency. By entering the monetary union, individual countries renounce the possibilities of an independent monetary policy and variations in the nominal exchange rates within the area. This affects the ability of individual members to respond to economic shocks that are specific to individual countries or regions or that result in diverging developments. What can then the single monetary policy and economic policies do to avoid the risks of shocks that give rise to diverging developments?

Monetary policy

The ECB/Eurosystem has a mandate to maintain price stability in the euro area as a whole. Our monetary policy focuses on this overriding objective, thus providing a nominal anchor to the euro area economy. All our internal work, our analysis and assessment of economic information, our policy discussions and policy decisions are clearly directed at this aim. I am deeply convinced that this is the best contribution that monetary policy can give to the welfare of the euro area. Attributing additional roles to monetary policy, such as that of directly aiming to reduce divergences across sectors or regions in the euro area, would overburden monetary policy with objectives that it cannot deliver and to the detriment of its primary role.

Having said that, does this mean that we ignore sectoral, regional or country-specific information? Not necessarily. First, the ECB and the Eurosystem devote a large effort in gathering and analysing disaggregated evidence, and we intend to do this even more in the future. But, I should stress that our efforts in this regard are made with the clear idea that such disaggregated analysis helps us to have a better understanding of the aggregate area-wide picture, taking into account all the complex linkages between the euro area regions and countries. To the extent that price formation processes might be different across economies, it is useful for monetary policy to consider the size, persistence and determinants of inflation differentials when assessing the area-wide inflation dynamics. Furthermore, in our communication with the public, the explanations of the monetary policy decisions are framed in terms of the area-wide assessment. We see this practice not only to be in line with our mandate but also instrumental in fostering public awareness of the euro area as a new entity.

Second, as part of the evaluation of our monetary policy strategy in May 2003, the ECB also took into consideration the implications of persistent inflation differentials across countries when reviewing the area-wide inflation objective. From the analysis of the available evidence in this regard, we concluded that our aim of maintaining the euro area inflation rate below, and close to 2% also provides a sufficient safety margin for avoiding that individual countries might have to structurally operate at negative inflation rates. Finally, the ECB pursues its objective with a medium-term orientation. This means that we can tailor our monetary policy response by taking into account the nature and the persistence of economic shocks, and ensures flexibility for individual economies or sectors to adjust gradually also in the face of asymmetric shocks.

Fiscal policies

In EMU, fiscal policy is potentially useful in responding to economic fluctuations, as it is an instrument in the hands of the national governments and thus can be tailored to macroeconomic developments that are specific to the country. However, given the considerable time lags, discretionary fiscal measures are not well suited to fine-tuning in the short run.

The free operation of automatic stabilisers can help to cushion economic upswings and downturns. In this way, government spending and revenues can absorb part of the deviation from the structural economic growth path. Creating the conditions for an appropriate play of automatic stabilisers was one of the considerations in drawing up the Stability and Growth Pact. If governments, on average, have a budgetary position close to balance or in surplus over the business cycle, this normally should authorise to let automatic stabilisers operate without the deficit exceeding the 3% of GDP reference value. Consequently, concerns about fiscal stabilisation are combined with the need for fiscal sustainability.

On the other hand, if the fiscal starting position is not particularly solid when an economic downturn sets in, there may come a point where budget deficits become excessive. In such cases, automatic stabilisers can no longer operate without creating problems of sustainability, and undermining confidence in the longer-term soundness of public finances with an immediate negative effect on the behaviour of all economic agents.

This is why the ECB and its Governing Council have the same analysis since the beginning of the discussions on the Stability and Growth Pact. Namely, strongly recommending to preserve the integrity of the corrective arm of the Pact, with the nominal anchor of 3% and the excessive deficit procedure, and to improve and make more effective the preventive arm of the Pact.

Structural policies

Turning now to structural policies, in my opinion, they contain the most powerful policy tools for addressing and preventing problems that may arise in a currency area, as well as in individual countries and regions. Why? Because they can influence the speed with which market forces can operate and provide lasting adjustment after an economic shock. In this regard, two mechanisms are particularly relevant to the euro area economy; the mobility of factors of production and the flexibility of price and wage setting. Either of these mechanisms would need to react in order to achieve a sustainable adjustment to economic disturbances.

I have already discussed the striking feature of financial integration in the euro area, where there is a continuous increase in cross-border financial and capital flows. This creates an increasingly effective risk-sharing mechanism against regional divergences in the euro area over time. The labour factor, on the other hand, shows little mobility across border and regions, either because of institutional and administrative factors or because of flawed price signals, or both, thereby negatively affecting an efficient allocation of productive resources.

In the labour markets, governments and social partners face major challenges in finding the right balance between social considerations and individual incentives that maximise economic welfare. Areas of particular interest are, for example, the social transfer systems, employment protection laws and the wage setting mechanisms, including wage indexation. Equally important are policies supporting the creation of new businesses and housing policies that do not hinder labour mobility, e.g. through rent subsidies or high transaction costs. In most countries, there has been some progress with labour market reform over the past decade, leading to a small reduction in structural unemployment. Nevertheless, labour market flexibility needs to be enhanced further, especially in view of the large number of people who are wastefully underemployed or unemployed in Europe, resulting in individual difficulties and welfare losses to society.

In the goods and services markets, further steps in reforming and liberalising markets would improve the efficiency of price signals, resulting in reduced inflation persistence and a speedier adjustment mechanism to shocks. Services markets in the euro area hold a particularly great potential to benefit from greater cross-border competition, especially as this sector is likely to have a sizeable impact on employment given its high labour content.

That is why the Eurosystem strongly supports the Lisbon process and shares the views expressed by the former Dutch Prime Minister Wim Kok in his recent mid-term assessment of the Lisbon agenda.

Concluding remarks

Let me now briefly say a few words in conclusion,

- In terms of macroeconomic stability, the euro area and the new enlarged EU are committed to a stability-oriented framework that provides the best conditions for sustainable economic growth and employment. The results of the euro area in terms of nominal and real convergence are impressive and compares well to the criteria for an optimum currency area. The euro has played an important role in these achievements and will continue to do so.

- In terms of what may lie ahead, a process of change has been set in motion. The internal market and the single currency, combined with structural changes in the world economy, are changing economic conditions at a rapid pace. Ultimately, this may lead to a higher degree of economic diversity and regional specialisation, which, provided that it is led by market forces, should enhance the economic welfare of the area as a whole. Issues related to the redistribution between more advanced and lagging regions may pose a challenge for regional policies at national and EU level.
- Automatic fiscal stabilisers can contribute to economic stability via their smoothing impact on aggregate demand. Given the lack of a cross-border central fiscal transfer mechanism, it is vital that these stabilisers are able to operate freely. This calls for renewed efforts to return to sound fiscal positions, as those we saw in the run-up to Monetary Union.
- In terms of structural policies, measures have been taken in the euro area countries to increase the flexibility of labour and product markets, with positive results and further benefits to come. While sometimes implying short-term costs from uncertainty, especially when the measures are not implemented in a resolute fashion, in a longer perspective, the positive impact of well-designed structural reforms on growth and on job creation is very significant. A resolute pursuit of the implementation of these reforms is desirable and the mid-term review of the Lisbon agenda offers an important opportunity for stepping up the pace of reform. While boosting the growth potential and employment, which is badly needed in many countries, more flexible economies would also accelerate the adjustment mechanisms to shocks, thereby increasing the resilience to economic shocks of the euro area as a whole. In the present global economic environment, marked by a significant acceleration of the pace of structural changes, this resilience is more important than ever.