Jean-Claude Trichet: The challenges of economic and financial integration in the enlarged Europe

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the conference “Europe after the enlargement”, Center for Social and Economic Research (CASE), Warsaw, 9 April 2005.

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Ladies and gentlemen,

First of all I would like to thank the organisers for inviting me here and having the opportunity to share some thoughts with the participants of this very stimulating conference.

In the late 6th century BC, Heraclitus said that there is nothing permanent except change. This wisdom seems to be very obvious for citizens of the new Member States, given their rich and fascinating history, especially in the recent decades when rapid political, economic and social changes have been taking place. As recently as at the end of the 1980s – many countries in Central and Eastern Europe were still behind the iron curtain, with little political and economic freedom. Today, they are members of the European Union with established democracies and functioning market economies. In some years they are expected to become members of Economic and Monetary Union.

As we have just experienced the enlargement of the European Union and as we prepare for the future EMU enlargement, I would like to talk today about challenges for domestic economic policies ensuing from economic and financial integration in Europe. I would like to emphasise that these challenges are relevant both for current and prospective EMU members, though some particular characteristics of the new Member States add new dimensions to these challenges.

In my speech today, I will first briefly describe the state of economic integration in the enlarged Europe, recalling on this occasion the main theories on the optimality of a currency area. Then I will address the role that domestic economic policies must play in Economic and Monetary Union, focussing in particular on fiscal and structural policies.

Economic integration and the optimal currency area theory: policy implications

The economic integration in Europe has already quite some history. After establishing a single market in the early 1990s, the integration culminated in 1999 with the introduction of the euro in initially 11 EU Member States, which were joined by Greece in 2001, and with the conduct of a single monetary policy by the ECB. This ended the formal process of EMU integration for these countries, but not the underlying economic processes and adjustments as they are constantly evolving. The share of intra euro area trade of goods as a percentage of GDP increased for most of EMU countries and currently stands on average at around 38%. Recent years witnessed also impressive integration in financial market, in particular in money and government bond markets. At the same time, GDP growth among euro area countries continues to be closely correlated (with an average correlation coefficient close to 70% over the past 10 years). In addition, the inflation differential declined. The unweighted standard deviation for 12 euro area countries dropped from close to 6 percentage points at the beginning of the 1990s to around 1 percentage point in 1999-2004. The dispersion of annual inflation in the euro area is similar to that of the 14 US metropolitan statistical areas, which has hovered around 1 percentage point in recent years.

Impressive economic integration has also taken place between the 10 new Member States and the previous 15 EU Member States and the euro area. Aspirations of the new Member States to join the European Union and subsequently to enter the euro area served and still serve as a catalyst for far-reaching economic changes. The extent of already achieved economic integration of the 10 new members could be illustrated by several facts. Let me start with trade integration. The trade links among current EU members have increased considerably in recent years. The share of the new Member States in the euro area’s exports and imports doubled since 1995 and stands currently at around 10-11%. In the new Member States, exports and imports to the euro area accounts on average for around 40-50% of total goods trade. These shares are even larger if one takes into account trade with the non-participating EU Member States. Economic integration in Europe has also provided new opportunities for investment with a noticeable increase in capital flows in recent years. The asset share of foreign-owned banks in the new Member States increased enormously in recent years and now stands on average at 70%. Some empirical studies find an increasing synchronisation of business cycle among some new Member States and the euro area countries in recent years.[1] As economic integration has been increasing new Member States made a significant progress with nominal and real convergence. Discrepancies in average HICP inflation rates between the new Member States and the euro area dropped significantly from on 7.6 percentage points in 1997 to close to 1 percentage point in the last three years. Similar developments are evident for short-term and long-term interest rates – with the spreads falling on average to below 3 percentage points and above 1 percentage point, respectively. It should be also mentioned that although the new Member States made a headway in closing the GDP per capita gap versus the euro area in recent years, most of them still have a far way to go. In 2004 the gap ranged from around 25% for Cyprus to around 60% for Latvia.

Let me now turn to theoretical considerations and refer to the optimum currency area theory. Debates about the optimality of a common currency area intensified with the envisaged establishment of Economic and Monetary Union in Europe. More recently similar discussions have been triggered by prospects of EMU enlargement by the new Member States. Let me focus on selected issues that in my opinion are of the essence in this debate. First, let me stress the fact that the traditional theoretical arguments based on the optimum currency area theory pioneered by Mundell (1961), McKinnon (1963), and Kenen (1969)[2] dealt primarily with the preconditions and possible costs of a currency union and not so much with the benefits. According to the optimum currency area theory, homogenous countries in terms of this economic structure should experience less asymmetric shocks than heterogeneous countries. This, in turn, suggests that the costs of abandoning independent monetary policy in a group of homogeneous countries are low, therefore supporting the creation of a monetary union.

The traditional optimum currency area theory has been challenged by endogeneity arguments. Pioneering this strand of optimum currency area theory Frankel and Rose (1998)[3] suggested that international trade patterns and business cycle correlations are endogenous to monetary integration. In other words, a country is more suited to join a monetary union ex post than ex ante as monetary unions boost trade which leads to more symmetric business cycles. Consequently, too much fixation on historical patterns of shocks and movement of business cycles could be misleading.

Another related new strand of intellectual debate shifted the focus to the benefits of monetary integration. More specially, it stressed the importance of risk sharing in the analysis of the positive effects of participation in a monetary union in case of heterogeneous economies and the positive implications of monetary integration on the level of trade and output.[4] These new insights suggest that the beneficial effects of financial and trade integration on the level of output could be larger than previously expected.

The key lesson we can draw from the theoretical debates about the optimality of a currency area is that the net benefits of a monetary union can be very significant and may well increase over time. Moreover, the benefits of monetary integration depend strongly on national economic policies.

Domestic economic policies in EMU

Membership in a monetary union has important implications for domestic economic policies. In the euro area monetary and exchange rate policies are no longer available to correct for country-specific imbalances and monetary authorities are primarily responsible for area-wide price stability. This is the key channel via which monetary policy contributes to long-run growth. Other conditions which are

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[1] Z. Darvas and G. Szapary (2004), “Business Cycles Synchronization in the Enlarged EU: Comovement in the New and Old Members”, MNB Working Paper, No. 1/2004, February

[2] R.A. Mundell (1961), “A theory of optimum currency areas”, American Economic Review, Vol. 51, 509-17; R. McKinnon (1963), “Optimum currency areas”, American Economic Review, Vol. 53, September, 717-725; P. Kenen (1969), “The Theory of Optimum Currency Areas: An Eclectic View”, in Mundell, R. and A. K. Swoboda (eds.), Monetary Problems of the International Economy, University of Chicago Press, 41-60.

[3] F. Frankel and A. Rose (1998), “The Endogeneity of the Optimum Currency Area Criteria”, Economic Journal, Vol. 108, 1009-1025.

[4] 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; A.K. Rose and E. van Wincoop (2001), “National Money as a barrier to trade: the real case for currency unions”, American Economic Review (Papers and Proceedings), May, 386-390.

equally necessary to ensure high and sustainable long-term growth and prosperity lie beyond the purview of monetary policy. They depend on sound fiscal policy and comprehensive structural reforms. These policies, in my opinion, are among the most powerful policy tools for addressing and preventing problems that may arise within a currency area.

The need for structural reforms and sound fiscal policies – two mutually reinforcing strategies – is not limited to members of a monetary union, but it applies to all countries. Flexible markets are a universal need in an open, science- and technology-driven, highly competitive and rapidly changing global economic environment. This also implies that the general call for structural reforms and sound fiscal policy is required in the euro area countries as well as the new Member States. However, in the latter case, consistent and stability-oriented domestic economic policies are essential not only for successful monetary integration but also for taking full advantage of the benefits of EU membership and for the catching-up process in per-capita income levels.

Now let me speak in more detail about domestic fiscal policy and structural policies concerning financial, labour and product markets.

Sound fiscal policy first

In EMU, fiscal policy largely remains a national competency and may be used for coping with country-specific conditions. This characteristic has to be noted with cautious, however, given that the past experience of most countries shows that the use of discretionary fiscal policy for short-term demand management is extremely difficult to implement successfully. This stems from considerable time lags involved in implementing fiscal measures. Nevertheless, a fiscal policy can have a positive effect on the economy via the “so called” automatic stabilisers. A proper functioning of automatic stabilisers requires sound fiscal policy. This issue is currently of a significant relevance given that many EU members exhibit considerable fiscal imbalances. In 2004, both some EMU Member States (Germany, Greece, the Netherlands and France) and six new Member States (the Czech Republic, Cyprus, Hungary, Malta, Poland and Slovakia) were in an excessive deficit situation. Although, the new Member States have generally lower debt ratios than the euro area countries, they have two additional incentives to lower their government budget deficits. First, the failure to fulfil fiscal Maastricht criteria could derail the entry to EMU. Second, reasonably sound public finances are crucial for an effective and exhaustive use of structural EU funds.

At this point let me make a few remarks on the Stability and Growth Pact. Since the very beginning of the discussion on the reform of the Pact, the ECB has strongly recommended preservation of 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 implementation of the preventive arm of the Pact.

It has always been our position. After the decision of the Council of Ministers on 21 March we said that “it is imperative that Member States, the European Commission, and the Council of the European Union implement the revised framework in a rigorous manner, conducive to prudent fiscal policies. And I said last Thursday, on behalf of the Governing Council, that it is now “essential that the European Commission and the ECOFIN Council strictly enforce the new agreement on the implementation of the Pact so as to restore the framework’s credibility”.

Now let me turn to the long-term role of fiscal policy. A fiscal policy that is set according to rules adds to macroeconomic stability by providing economic agents with expectations of a predictable economic environment. This reduces uncertainty and promotes longer-term decision-making, notably investment decisions, and economic growth. Furthermore, it is important to keep in mind that fiscal policy can also promote growth and employment via appropriate adjustments of the level and composition of government taxes and expenditures. Reducing inefficient public spending can for example help to finance tax cuts. Furthermore, public expenditures can be redirected towards productivity-enhancing physical and human capital accumulation rather than, for instance, the provision of subsidies for declining industries. This seems especially relevant for the new Member Stats. These arguments demonstrate a clear and important link between fiscal and structural reforms.

Financial reforms are a major challenge in the new Member States

Starting with financial markets, structural reforms in this area should aim at facilitating a more effective allocation of savings toward the most rewarding investment opportunities and at the same time at securing financial stability. The pace of recent reforms in the European Union, and in particular the euro area, has been impressive. They have contributed to a continuous increase in cross-border financial and capital flows and in turn created an increasingly effective risk-sharing mechanism against regional divergences in the euro area.

New Member States have also been participating in and benefiting from financial integration in the European Union. One particular aspect of financial markets' reforms and development in these countries, related to the catching-up process, deserves attention. Real convergence is expected to have sizeable effects on the financial sectors that may not always be easy to manage. The process of catching-up will lead to financial deepening and a strong expansion of the balance sheets of financial institutions. In this context, two effects will be operating in parallel: the deepening of financial intermediation and development of capital markets to levels that are comparable with those of countries with similar income levels, and a further increase in the relevance of non-bank financial intermediaries such as pension funds or life insurance companies in the financial sector, as these are still underrepresented when compared to the previous EU Member States. As a result of these two factors, financial sector assets and liabilities are expected to expand substantially in most of the new Member States over the next two decades. Similarly, a strong development should be expected with regard to the insurance and pension fund sector and to the evolving bond and stock markets in the new Member States. Against this background, a key policy challenge in the new Member States is to ensure robust and stable development of financial markets with an important role for supervisory bodies.

No further delay with labour markets reforms

Regarding labour markets, a major challenge for structural reforms is to find the right balance between social considerations and individual incentives that maximise economic welfare. Areas of particular interest are 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. From the monetary policy point of view it is also important that labour market reforms facilitate wage adjustments that reflect more closely regional and sectoral productivity differences.

Although labour markets in the EU are very heterogeneous many old and new Member States face severe problems. In many countries employment rates are low by international standards and in some cases even falling. There has been some progress with labour market reform over the past decade, however, 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. A main focus should be put on the groups that face particular challenges when trying to enter the labour market, such as women, the youngest and oldest age groups and the lowest educated. In the new Member States there is a particular need to address skill mismatches, the limited domestic labour mobility, and to constantly upgrade human capital. Throughout the enlarged European Union the labour market performance can be considerably improved, what calls for an immediate action that must reflect the characteristics of national labour markets.

Fostering competition in product markets does pay off

Turning to product market reforms, their key role should be to enhance innovation, ensure an efficient allocation of resources, and create business-friendly environment. In recent years, much headway has been made in the European Union regarding integration and the level of competition in product markets.

In light of empirical research[5] and the current stage of product market reforms in the new Member States, some of them could gain significantly thanks to further regulatory reforms that include a

[5] N. Giuseppe and S. Scarpetta (2003), "Regulation, productivity and growth: OECD evidence", OECD Working Paper, No 347, January

sustained reduction in state aid, and more generally state involvement in the economy – particularly if it constitutes economically questionable ad hoc and sector-specific measures.

This will help to smooth the restructuring process in product markets by promoting the entry of new players and to reduce the tax burden. Fostering competition in product markets should also have a positive effect on price developments.[6]

Effective reforms means comprehensive reforms

Finishing the discussion about the right domestic policies in a monetary union and beyond, I would like to stress the need for a comprehensive approach to structural and fiscal reforms as opposed to piecemeal measures. There is evidence that structural reforms are mutually reinforcing and essential for bringing welfare improvements. A removal of a bottle-neck in one market is not usually sufficient for achieving a flexible and smoothly working economy. The positive interactions with structural and fiscal reforms are also numerous. For instance, labour market reforms should go hand in hand with product market reforms and reforms of the pension and health care system. Such reforms are not only needed to reduce non-wage labour costs and increase incentives for job creation but also to ensure the sustainability of the social security systems and lower the burden for public finances.

Conclusions

Ladies and gentlemen, sound and responsible domestic economic policies are a universal requirement in a competitive and constantly changing world, and participation in a currency union makes it even more important. Given that in Economic and Monetary Union the main aim of the single monetary policy is price stability at the euro-area wide level and given that bilateral exchange rate adjustments are by definition no longer possible, the main responsibility for the domestic economic management falls on fiscal and structural policies. This in particular involves conducting a sound and credible fiscal policy that fosters long-term expectations as well as supports an efficient public sector and active implementation of structural reforms. The structural reforms should foster the flexibility of labour and product markets, encourage innovation activities, ensure smooth functioning of financial markets, and create business-friendly environment. I would like to stress again that the integration process and the need for economic reforms do not end with EMU membership. The success of EMU depends on member states' ability to adapt to a changing global environment and solve domestic problems.

Let me conclude by expressing my confidence in the process of European integration, my confidence in the positive consequences of enlargement. I am convinced, and this conviction is reinforced by academic research, that enlargement will not only bring additional dynamism and growth to the ten newcomers, in speeding up their catching-up exercise, but will also contribute – positively and significantly to growth in the previous fifteen members. The pessimism that we observe in some sectors of the public opinion are not founded. Let us all together take advantage of the additional dynamism that Poland and the nine other new members are bringing to the European Union. Let us not forget that before the entry of Spain and Portugal we had the same gloomy sentiment in the public of the then previous "10". After the "10" had become "12" that sentiment dissipated progressively in the face of all what Spain and Portugal had contributed to the "12"

Thank very much for your attention.

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[6] M. Przybyla and M. Roma, "Does product market competition reduce inflation? Evidence from EU countries and sectors", ECB Working Paper, No. 453.