Hans Georg Fabritius: The Euro-Arab economic dialogue

Keynote speech by Dr Hans Georg Fabritius, a Member of the Board of the Deutsche Bundesbank, at the International Arab Banking Summit 2005 - “The Euro-Arab Economic Dialogue”, Frankfurt/Main, 23 June 2005.

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Ladies and gentlemen

It is an honour and a pleasure to speak today at the International Arab Banking Summit here in Frankfurt.

I strongly welcome the organisers’ intention of enhancing future cooperation prospects between Europe and the Arab World.

Both regions are indeed engaged in a strategic economic partnership, which of course has a lot to do with the fact that Europe, like other developed economies, is oil-dependent.

Over the course of time trade relations between Europe and the Arab World have clearly intensified. For instance, German exports to the region increased by more than 10% last year. Although this is broadly in line with overall export growth in Germany, the strong increase occurred against broadly unfavourable exchange rate developments, given that the currencies of most Arab countries move in parallel with the US dollar.

Like trade in general, these developments have been to the benefit of both regions. A telling story of these mutual advantages is the fact that for Europe in general, and for Germany in particular, the dampening effects of the recent oil price shocks have been eased by a faster recycling of oil revenues in the oil producing countries.

This was made possible by increased foreign demand for European products in Arab countries. As imports from Europe play a much more important role for oil producing countries than imports from the United States, an oil price increase under unchanged trade structures leads to a demand shift in favour of Europe. To a certain degree, this is cushioning the adverse energy price effect.

Against this background closer trade links between Europe and the Arab world are highly welcome. This deserves our special attention for another reason: intensified trade relations also lead to a strengthening of financial relations. Therefore, I appreciate conferences like the one today and consider them an eminent effort to improve mutual understanding of the beneficial economic effects of further cooperation.

Although this example alone might suffice to steer us away from the one-sided view that the Arab economy is nothing more than an oil producing sector, it is undoubtedly worthwhile to take a closer look at the economic developments in the Arab world.

As I understand from the programme, the aim of today’s conference is just that – to take a closer look at these economic developments. I do not intend to deliver a broad based assessment of economic developments in the Arab economies but rather as an economist I will stick to the principle of comparative advantage and as a central banker I will concentrate on the issue of monetary integration. It is an issue that plays an important role in the current policy agenda in many countries on the Arab peninsula.

And it is an issue where I can draw on our own European experiences to exemplify the terms on which a European-Arab dialogue can be established.

The regional monetary integration initiative is, in my view, a quite astonishing development that does not get the attention it deserves. In fact, in economic terms, it is the second most important monetary integration initiative in the world economy.

With its plan to introduce a monetary union in 2010 the economies of the Gulf Cooperation Council (GCC) endeavour on a project that is surpassed only by the European monetary integration.

This development is of interest to Germany and Europe for a number of reasons. Firstly, the six GCC member countries Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates are by far the most important trading partners for Germany in the Arab World, accounting for nearly 55% of German exports to the Arab region in 2004.

Secondly, the debate about the benefits of monetary integration and the attempt to build regional currency blocks has become much more attractive since the successful launch of the single monetary policy in Europe. So Europe's experiences after over six years of the common currency might be of interest to those economies currently endeavouring into closer monetary and financial integration.

This, of course, is not to say that the example of the euro area can and should be uncritically carried over to other regions with different economic structure, cultural background and political systems.

Nevertheless, there are distinct pre-conditions necessary for the functioning of a currency union that are common to each and every project of closer monetary cooperation – even though the recognition of the empirical truth that a "one size fits all" approach is not doing justice to the many projects of regional economic and monetary cooperation throughout the globe.[1]

Thirdly, in that context the proper functioning of EMU has been questioned in some camps over recent weeks. In cases where this might have created some irritations in other parts of the world which are less familiar with what is going on in EMU some brief comments are necessary to put things in a proper perspective.

Please let me start with the latter point. Without any doubt, one of the major institutional changes in the international financial system in the last couple of years has been the move to European Monetary Union. The introduction of a common currency and common monetary policy among then eleven, now twelve, of the major industrialised countries of the world has been an economic endeavour unprecedented in economic history.

It certainly marks the most significant step in the process of European integration.

Currently, it seems to be a widely held belief that in the aftermath of the latest developments the tide is out for future significant integration steps.

But we all should keep in mind that from a broader historical perspective, European integration has never been a smooth, straight road towards closer cooperation. Instead, periods of ambitious progress were followed by periods of setbacks.

So, there is reason to believe that the undeniably difficult current situation for future European integration is itself creating the seeds for renewed initiatives and integration efforts. At least, this is what history in Europe teaches us.

But one thing is crystal clear. The visible tensions about the European constitution and the financing of the European Union by no means hamper the proper functioning of EMU. It is becoming more and more necessary to re-emphasise this point since some observers have argued to the contrary and doubted the sustainability of the current institutional framework for common monetary policy.

However, this line of argument simply neglects the empirical facts.

The Eurosystem's common monetary policy has delivered price stability and also well anchored long-term inflation expectations at a level consistent with the definition of price stability.

The achievements of the single European monetary policy is deeply rooted in a few characteristics. Among those, a clear objective and the supranational perspective in the decision-making process are key. In my eyes, these defining elements are central not only to the European project but also for other possible monetary integration efforts.

Well anchored, low inflation expectations have allowed us to deliver price stability under historically low nominal interest rates. This result is advantageous to all member countries involved in EMU. It has promoted economic welfare for countries with a formerly less pronounced stability culture and the elimination of intra-EMU exchange rate volatility has benefited all member states with both improved trade links and a deeper and more liquid financial market.

Just to remind us of the facts, even conservative estimates of the trade inducing effect of EMU lie in a range of around 10% of trade volumes or equivalent to roughly 1% of euro area GDP.

Moreover, the functioning of EMU is clearly visible in the growing international role of the euro. The euro's role as a reserve and invoicing currency and its relevance as an issuing currency on the

[1] The ECB provides a useful survey of the multitude of approaches to regional economic cooperation in the world economy (ECB Monthly Bulletin 10/2004).

international bond market is confirming this judgment. It is important to emphasise that the internationalisation of the euro reflects a market driven process and is no goal of the common monetary policy. Thus, the acceptance of the euro in international markets is even more reassuring.

Despite these overall achievements, some have recently cast their doubts on the future of monetary integration in Europe in the face of heterogeneous developments at the level of member states.

And here I can only repeat myself. This line of argument neglects the basic empirical facts. The divergence in national inflation rates and output growth rates has not increased with EMU. Nominal convergence has not lead to real divergence and the heterogeneity within EMU is by no means significantly larger than in a well-established monetary union, ie the United States.

And it should be borne in mind – and this is one of the important lessons for countries engaging in a monetary union – that there are several national adjustment mechanisms to deal with idiosyncratic developments in a monetary union. These range from labour mobility, to flexible prices and wages to intra-union shifts in competitiveness.

Arguably, the most favourable condition for a monetary union would be a far reaching structural homogeneity of participating countries. But some instances of heterogeneity can realistically never be dismissed, and should not be. Otherwise the fruits of specialisation, comparative advantages and interregional risk-sharing cannot be earned in full. Thus, what is of the essence is that the member states forming a monetary union have a clear awareness of the “rules of the game”.

Ladies and gentlemen,

with regard to the important GCC initiative, these issues are highly relevant. Currently, due to oil production there is a high degree of structural similarity between the GCC economies. But differences in the amount of oil reserves will mean that economic heterogeneity will certainly increase in the future.

The structural homogeneity of GCC countries has been accompanied by significant monetary convergence. Widely unnoticed these countries have managed intra-regional exchange rate stability, low inflation rates and co-moving interest rates in a narrow range.

Fiscal convergence seems to lack behind the developments at the monetary frontier. And here, too, EMU experience shows the necessity to agree on a common framework for the conduct of fiscal policies.

Ladies and Gentlemen,

one characteristic feature of the Arab world is the low degree of regional trade links. Intra-regional trade accounts for only 8% of the total trade of Middle Eastern and Northern African countries.[2] This differs markedly with Europe.

In the light of these figures one might feel tempted to ask why, on a conference like this, I am devoting so much attention to regional integration efforts. The reason is – and once again I refer to the European experience – that regional cooperation does not imply increased intra-regional trade at the cost of less trade with countries outside the region.

EMU has not resulted in so-called trade divergence effects. In other words, developing a closer regional integration in the Arab world seems to be an important prerequisite to strengthen economic links between Arab countries and Europe, too.

These will include product as well as financial markets. It will have consequences for the banking business and it will shape the way in which the future economic dialogue between Europe and the Arab world is framed.

Looking over the programme of this conference all these topics will be discussed in greater detail in the various workshop sessions and plenary rounds. I am confident that the broad programme framework will mean that the conference results will meet everyone’s expectations.

The current global economic conditions are well suited to enhance economic cooperation between Europe and the Arab world. Under the surface of oil market developments, which absorb so much

[2] Regional and monetary integration in the member states of the Gulf Cooperation Council (GCC), forthcoming ECB Occasional Paper.

public attention in Europe, when it comes to economic debates about the partnership between Europe and the Arab world there are interesting ongoing developments in Arab countries which, in my view, do not get the attention they rightly deserve.

Economic cooperation in a region where economic fortune has all too often been hampered by regional tensions and conflicts should be a central concern for all of us in Europe. I am glad that conferences like today's are shaping our understanding of the vital importance of economic partnerships between both regions.