Franz-Christoph Zeitler: Global competition – what makes Europe competitive?

Panel contribution by Professor Franz-Christoph Zeitler, Vice-President of the Deutsche Bundesbank, at the Conference dedicated to the 15th anniversary of the re-introduction of the Estonian kroon, at the Bank of Estonia, Tallinn, 23 May 2007.

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1 Introduction

The previous speakers have already (and rightly) highlighted **Europe's ongoing need for structural reforms**. In order to fully use the benefits of globalisation, it seems obvious to me to increase the **flexibility of our labour and product markets**.

However, I would like to focus on a slightly different issue today:

- To what extent has monetary union enhanced economic performance
- and thereby helped to improve the competitiveness of its member states?

I shall start with an overview of the entire euro-area and then move on to consider the case of Germany.

2 The international role of the Euro

Despite being considered as a bold experiment by some sceptics, **European monetary union (EMU) has lived up to our expectations**.

In particular, the Euro has gained the same level of **monetary stability** and confidence as the most stable of its prerunner currencies: The average inflation from 1999 to 2006 in the euro-area was 2.05 %, only slightly above our definition of price stability. This is below the long-run average inflation rate of the Deutsche Mark, which was 2.8 %, although this higher figure is partly owed to the more difficult international environment for example in the 1970s.

Moreover and in addition to price stability, the Euro plays an important role as an **international currency** and in the **international trade**. Today, it's **second only to the USD**.

Firstly, the share of the Euro in **official foreign exchange reserves** has increased from 18% in 1999 to almost 26% in 2006.

Even if one has to take into account the exchange rate developments and the build-up of foreign reserves of the Asian countries in that time span, the rising share of the Euro as an reserve currency mirrors a high degree of third party confidence in the currency union.

Secondly, as for international debt securities, the stock of **international debt securities** in Euro rose from 19% in 1999 to 32% in 2006.

This developments reflect the growing depth and liquidity of euro-area financial markets – a feature that has been heavily promoted by the common currency acting as a catalyst for the EU's single market programme.

As financial markets and economic development are closely linked, broadening demand of Euro spills over to international trade of goods, too. In most EMU countries, more than 50% of extra-euro-area exports of goods are invoiced in Euro. In Germany, the ratio is even higher than 60%.

3 Trade effects of the Euro

The crucial question beyond this abstract figures is: "Does the Euro really helps to foster economic prosperity and growth?" Or does the opposite holds true as some politicians sometimes use the Euro and its exchange rate as a lightning rod? Let me mention two channels to back my hypothesis that the Euro supports economic prosperity: Firstly, trade within the EUM and secondly beyond the EMU-borders.

First channel: Adopting the Euro reinforces the **positive impetus of the EU's common market**. The introduction of the common currency has eliminated currency risk within the euro area. Moreover, it has reduced trade costs and improved price transparency for its member states.

Before turning to an empiric prove, one caveat: The impact of the single currency should not be reduced to one single date, e.g. 1999. In fact, one has to take into account the whole process of convergence during the 1990s in the run-up to the monetary union.

Empirical literature states that the Euro has probably boosted intra-eurozone trade by around **5 to 15%** so far.[1] And indeed, German exports of goods within the euro area grew from 12% of GDP in 1988 to 16.5% in 2006, with an interim downswing to 8.5 % in 1993 which was mainly caused by the German re-unification. So it is safe to say that the Euro has played its part in the increase of intra-EMU-trade.

Second channel: Trade between EMU-members and other countries. The growing international importance of the Euro spills over to extra-EMU-trade, too. The high and world-wide confidence in the monetary union supports the international trade of firms which are located in its member countries. To support the argument I would like to remind you of the 50 % figure of extra-euro-area exports invoiced in Euro.

This enumeration, incomplete as it may be, clearly shows that the adoption of the Euro has had a **positive impact** on the EMU's macroeconomic performance.

4 Competitive advantages of the German economy

Let me now turn to my last point: EMU membership comprises handing over monetary policy (including nominal exchange rate adjustment) to the Eurosystem. Does this impede as sometimes, mainly during election campaigns argued, a country's ability **to adjust to asymmetric shocks?**

The case of Germany helps to answer this question.

In the past years Germany has made it from the bottom of the euro area growth table to a good positioning in the EMU growth chart. Why is this?

The growth gap during much of that time was notably. Average growth in the years 2001 to 2005 added up to only 0.6 % p.a., which is clearly below Germanys potential growth rate of 1 ½ % p.a..

This slow growth and the unsatisfactory placement in the European growth chart was partly the result of other economies catching up economically and of the stimuli generated by interest rate convergence in some member states during the run-up to EMU. Domestic problems caused the main part of the subdued growth, however. Among other things the very quick catching-up of wages in the eastern part of Germany and structural weaknesses in the **labour market** led to a weak domestic demand and economic performance.

It was only gradually that the German economy emerged from this difficult situation.

Firstly, the adjustment was supported by the fact that price dynamics in Germany have been more moderate than in most other EMU countries.

On average the German HICP was 1 %-point lower than the average HICP of the other member states of the monetary union. This led to a cumulated price advantage of 8.5 % since 1999.

Measured in terms of unit labour costs, German industry gained an advantage of 15 % since 1999.

At this point one sidestep: It's sometimes argued that higher inflation rates support growth because lower real interest rates foster investment activities. This is wrong for two reasons: Firstly, if calculating real interest rates, one has to consider inflation **expectations** which are not considerably lower in Germany than in other countries of the monetary union. Secondly, and this is a much stronger argument, the case of Germany shows that **modest price dynamics** support competitiveness within a monetary union and therefore foster sustainable growth.

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[1] OECD, economic survey, euro area, 2007, p. 31.

Secondly, beyond or parallel to the stability performance deep and sometimes painful restructuring effort of the industry was necessary during the process of catching up. This include modest wage developments and strong cost saving and restructuring efforts in the last ten years.

Thirdly, the legislator launched overdue structural reforms. Among other things the system of unemployment benefits as well as the pension scheme was reformed. Furthermore, from 2008 on a revised enterprise taxation will be valid.

I don't want to keep secret, that there is still some way to go, however. Just to mention one or two examples: Some 25 % of the new jobs in Germany are temporary, whereas only 4 % of the labour force stock is temp-work. This shows the need for further amendments of the labour market flexibility. Another example is the German deficit. From my point of view we are right now in a good position to go for a balanced budget and we are still a good way off.

5 Concluding remarks

Let me conclude: A monetary union does not automatically lead to a high decree of competitiveness and good economic performance, but the remove of the "veil of exchange rate" puts the finger on the root of the matter, i.e. the structural weaknesses of a country.

Taking all this together, **Germany is a classic example** of how market-related adjustments can work and be effective under the rules of a monetary union.