

## Jean-Claude Trichet: The process of European economic and financial integration

Speech by Jean-Claude Trichet, President of the European Central Bank, at the opening session at the conference “EMU Governance and Euro Changeover: Malta on the path to the euro”, Valletta, 1 October 2007.

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Ladies and Gentlemen,

It is a great honour and pleasure for me to be invited to offer some remarks at this conference organised by the National Euro Changeover Committee and the Central Bank of Malta, just three months before Malta adopts the euro on 1 January 2008. This will signify a great milestone in Malta’s history, especially since Malta only joined the European Union (EU) almost four years ago, on 1 May 2004.

You can be proud of Malta’s successful convergence process. In fact, we are very pleased about the fruitful cooperation between the European Central Bank (ECB) and the Central Bank of Malta in the preparations for the changeover, be it at the technical level or through the participation of Governor Bonello as observer in the Governing Council since last July. Preparations for EU membership and the adoption of the euro have spurred a broad-based reform process, which has led to the restructuring of the public enterprise sector and the liberalisation of the trade regime. These reforms have helped Malta to gradually reduce inflation and significantly shrink the fiscal deficit. Moreover, the exchange rate of the Maltese lira has been maintained at the central rate since the currency joined ERM II in May 2005, and long-term interest rates have declined.

The adoption of the euro should not mark the end of this structural reform process. In order to reap the full benefits of euro adoption and to ensure sustainable convergence, this process should continue. This will involve noticeably reducing Malta’s high debt ratio, maintaining moderate wage developments that take fully into account labour productivity growth, and fostering labour participation.

As you know, economic and monetary integration between countries with somewhat different characteristics and levels of development requires careful preparation. However, you have already reached this stage and your planning for the introduction of the euro is almost complete.

Looking ahead the adoption of the euro will enhance your integration with all EU partners. Let me now offer two brief remarks in this respect: first about some of the effects that the euro has already had on euro area countries, and second about the functioning of the euro area and its greater resilience vis-à-vis external events.

### 1. **My first remark is that the euro is providing a positive impetus in the euro area economy.**

The economic and financial environment of the euro area is changing in many ways and the euro is having a beneficial impact. Euro area economies are gradually becoming more interdependent, as evidenced by the following facts:

- a. There is clear evidence of a significant **increase in both intra- and extra-euro area trade** in goods since the launch of the euro. Exports and imports of goods within the euro area rose from about 26% of GDP in 1998 to around 32% in 2006, and intra-euro area exports and imports of services increased from about 5% to almost 7% of GDP over the same period. The introduction of the single currency, as well as greater price and cost transparency, have promoted cross-border trade. The

completion of a single market for services will also further facilitate trade in services. In addition, the rate of increase in extra-euro area exports and imports exceeded that in intra-euro area trade, rising from about 24% of GDP in 1998 to almost 33% in 2006. Over the same period, extra-euro area exports and imports of services grew from about 8% of GDP to almost 10%. External factors, such as more sustained growth in world GDP than in euro area GDP, rising global trade integration and a sizeable increase in trade with the new EU Member States, are also playing an important role.

- b. Another area I would like to mention is foreign direct investment (FDI), which also includes merger and acquisition (M&A) activity. FDI accumulates over time and thus makes an important contribution to reshaping Europe. **Intra-euro area FDI has grown** considerably and is catching up with extra-euro area FDI. Between 1994 and 2004, the stock of intra-euro area FDI grew from almost 14% of euro area GDP to around 24%. On the other hand, the stock of extra-euro area outward FDI have grown somewhat less rapidly over the same period, rising from 22% to 30% of euro area GDP. In particular, EMU has been associated with a sharp increase in cross-border M&As of the manufacturing sector among euro area countries. Conversely, the service industry has thus far benefited less from European financial integration. This also illustrates that more has to be done to remove the existing barriers to trade in services.
- c. **The euro is acting as a catalyst towards a single market in financial services.** To illustrate this, I will give you just a few examples based on a set of ECB indicators on the level of integration in euro area financial and banking markets.
- Since the introduction of the euro, the **cross-country standard deviation of interest rates in the interbank money market has plummeted**. Back in January 1998, one year before the launch of the single currency, this deviation stood at more than 130 basis points for overnight rates, at over 100 basis points for one-month maturities, and at around 50 basis points for 12-month rates. Since January 1999, however, these differences have rarely exceeded one or two basis points.
  - Furthermore, there is significant evidence that **euro area corporations are taking advantage of the possibility to appeal to a broader universe of investors** in order to raise funds. As a result, the euro corporate bond market has grown significantly since 1999, and has the potential to grow even further, judged by a comparison with the US. In 1999, the outstanding volume of bonds issued by non-financial corporations was just 3.9% of GDP in the euro area and 24.3% in the US; in 2006 it has increased to 12.5% but the US market is still one and a half times larger than in the euro area (21.1%).
  - Between 1997 and 2005 euro area residents doubled their **holdings of equity issued in another euro area country** – as a share of their total portfolio of shares issued in their own country and elsewhere in the euro area – to reach 29%. Instead, the share of euro area equity assets held outside the euro area remains much lower and increased only slightly. Hence, since the launch of the euro there has been a portfolio reallocation from holdings of domestic equities to holdings of equities issued elsewhere within the euro area.
  - The **share of long-term debt securities** issued in the euro area and held by residents of other euro area countries has risen markedly. Euro area cross border holdings of long-term debt securities have risen from slightly above 10% in 1997 to nearly 60% in 2005.

- By contrast, **integration in retail banking has been slow so far**, although it has picked up in the last two years. With some notable exceptions, much of the consolidation in the banking sector has been the result of domestic mergers; only in the last couple of years have cross-border banking mergers started to take place. In this respect, a number of euro area banks have considerably expanded their interests outside the euro area. However, cross-border activity within the euro area is still relatively limited, even though it is gaining in importance: a trend gradually increasing the level of competition and efficiency in the financial system.
- Further work is needed in order to achieve the goal of a single market for financial services. To this end, the **ECB and the Eurosystem are actively involved in several initiatives** that help foster financial integration, including: the launch of TARGET2, the new payment platform for the financial system, which is planned for the end of 2007; the European Commission's Green Paper on Mortgage Credit in the EU. The mortgage credit market is an important segment of the banking and retail markets, with an outstanding volume of more than €4 trillion in the EU, which corresponds to around 40% of EU GDP. Euro area mortgage markets are not yet fully integrated, and I believe there is great potential for further integration in this respect; and the Single Euro Payments Area (SEPA) project, the aim of which is to integrate the market for retail payment services.

**To sum up**, these examples clearly show that the euro is having a remarkable impact, particularly on the financial market segments that are more directly affected by the single currency and monetary policy, such as fixed-income markets. Hence, interdependence within the euro area is becoming stronger.

## **2. My second remark is about the actual functioning of EMU.**

Before the launch of the euro, some experts feared that a single monetary policy would not suit a group of countries that were still diverse. But, after nearly a decade, the euro area has proved to be a success. The degree of synchronisation of business cycles across euro area countries has grown since the 1990s and remains high. There is evidence of a stronger common euro area cycle that accounts for a large part of the business cycle fluctuations.

- a. Furthermore, however favourable the previously mentioned statistics are, they cannot fully capture the fact that the euro area has become more resilient to external developments than its individual member countries ever were before the launch of the euro. National economic policies have become better coordinated and the intra-European impact of external exchange rate turbulences has been of course totally removed.
- b. Let me give you some specific examples of this increasing resilience: since 1999, the euro area has successfully weathered several common shocks, including the bursting of the dotcom bubble, the ripple effects of the terrorist attacks in the United States on 11 September 2001, the surge in global commodity prices and energy prices in particular, and the persistence of sizeable global imbalances. These shocks were very significant and evidence shows that they spread in similar ways across euro area countries. They have not played an important role in the dispersion of output growth and they have not contributed to economic divergence.
- c. Furthermore, we are currently witnessing a significant market correction with a reappraisal of risk, and episodes of high volatility and turbulences on various markets having threatened in particular the normal functioning of the money market. Through our liquidity operations in the recent period, the ECB and the Eurosystem

took the appropriate decisions to help ensuring the orderly functioning of the money market. I am proud of the capacity we showed to judge correctly the situation of the market and to act decisively and rapidly when needed.

**3. Ladies and Gentlemen, this now brings me to the final part of my remarks.**

As we have seen, the economic and financial environment is changing and euro area countries are gradually becoming more integrated and mutually interdependent. The effects of EMU have been beneficial, in line with the expectations of the 317 million people in the euro area and, more generally, the 494 million citizens of the EU. The euro area is experiencing low inflation and low macroeconomic volatility, both in historical terms and compared with other single currency areas, such as the United States. Let me remind you that over the eight and a half years since the creation of the euro, employment in the euro area has risen by almost 15 million people, compared with a rise of around 3 million in the eight and a half years preceding the adoption of the euro.

European integration complements global integration. We are also reaping the benefits of a highly credible monetary policy strategy that is anchoring long-term inflation expectations at low levels. Several concerns that preceded the launch of the euro have successfully been dispelled. The euro area is now more resilient than its individual countries were before the launch of the euro.

The fact that the euro area is now a very large economic area is accompanied progressively by a change in mentality. We need to think in terms of economic developments in the euro area as a whole, not just in our home countries. This has also implied a different type of economic management to the one used prior to 1999, including the peers' surveillance of fiscal policies as called by the Stability and Growth Pact. We are also well aware that more must be done in several areas, such as raising the flexibility and adaptability of the individual euro area economies and paying close attention to cost competitiveness in the various economies. The achievements of EMU and our monetary policy support the reforms that are urgently needed in many countries.

We look forward to welcoming you wholeheartedly into the euro area. Thank you very much for your attention.