Professor Axel A Weber
President
of the Deutsche Bundesbank

State and Challenges of the European Integration

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– Check against delivery –

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I am honoured to give a keynote speech at this 10th anniversary event of the conference on "Banking and Finance in the Baltics". The governors of the Baltic Central Banks and we meet regularly as members of the General Council. The General Council contributes to the ECB's advisory and coordination work and is helping to prepare for the future enlargement of the euro area. I welcome this conference as a further opportunity for us to become better acquainted with each other and to learn more about the financial system in the Baltic states.

Today, in reviewing "European Integration – its status and challenges", I shall focus on the state of convergence as was documented last Wednesday in the Convergence Report of the ECB. However, I would like to start by pointing out some key characteristics which distinguish the EU economy from other major economies. These key characteristics help to interpret the performance of EMU in what have now been almost six years since the introduction of the euro. The future of monetary union will depend, not least, on a successful and sustained process of convergence in the new member states. In reviewing the status of nominal and real convergence, I shall go in greater depth into the topic of financial markets, and I shall conclude with a list of the main challenges facing the Baltic states as well as in the euro area.

Within the "big three" economies of the EU, USA and Japan, the EU economy (EU-25) leads in terms of population and GDP. However, it is lagging behind in terms of GDP per capita and the gap is widening. The inner diversity in terms of wealth within the EU, even within the EU-15, is more pronounced than the differences that exist between the EU and the USA. The EU has the most open economy, though statistically openness has shrunk a little with the accession of the new member states. This is due to the fact that the new member states' share of intra-EU trade is higher than their share of extra-EU trade. And the EU displays a more balanced export/import ratio than the US (large deficit) and Japan (large surplus).

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The gap in GDP per capita against the USA of roughly 50 per cent is explained by lower labour productivity and a lower labour force participation rate. Within the EU-15, labour productivity is at its lowest in some of the southern countries (Spain, Portugal and Greece), whereas the labour force participation rate is particularly low in Italy, Belgium, France, the Netherlands and Germany. Moreover, EU GDP suffers from a comparatively high level of unemployment. Economic indicators prove that the low participation rate is not predominantly voluntary in terms of its causes. A significantly higher degree of regulation and mostly centralised wage bargaining procedures have created underperforming labour markets in the EU. In contrast, high R&D expenditure and the rapid diffusion of technology create high productivity growth in the USA.

Another striking difference is the role of government. In the EU, government expenditure as a percentage of GDP is as high as 48 per cent, which is one and a half times the US figure. Having such a large share of economic activity which is exempt from competition obviously produces significant slack and inefficiency. Furthermore, intense bureaucracy poses an additional burden on businesses. The gross debt of general government is rising overall in the “big three” economies, with the record figure in Japan being as high as 134.6 per cent. Financial structures differ in terms of the degree of intermediation. The EU is half way between banking-dominated Japan and the capital-market-oriented USA.

Turning to the performance of the European Monetary Union (EMU), I would like to underline the outstanding performance of the young Eurosystem in safeguarding price stability. The ambitious objective of an annual increase of the Harmonised Index of Consumer Prices (HICP) below two per cent over the medium term, but close to two per cent, has roughly been achieved. This definition of price stability was reiterated and clarified in the May 2003 review of the ECB’s monetary policy strategy. The two per cent threshold

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allows for persistent inflation differences as well as asymmetrical shocks and provides a safety margin against the risk of deflation. Since 1999, the average HICP increase has been close to two per cent. The actual rate for September was 2.1 per cent. The observed inflation differentials have decreased over time and remain at a low level comparable to that in the USA. Indicators such as the core inflation rate has been below two per cent since mid-2002, and the long-term inflation expectations as displayed by the consensus forecast are also below two per cent. Therefore, the Eurosystem can rightly claim to have achieved substantial credibility. Its stability performance is the clear reflection of a successful monetary policy.

However, stability is an ongoing task. Challenges to price stability result from a high degree of inflation persistence despite the large output gap and despite the appreciation of the euro. The reasons for inflation persistence may lie in indirect taxes and administered prices, in food and energy price shocks, in significant price inertia caused by downward-inflexible wages and service prices responding slowly to a downturn. Therefore, vigilance continues to be warranted.

The sustained performance of monetary policy is being supported by the increasing synchronisation of business cycles as well as deeper and better integrated financial markets. This holds true especially for wholesale banking and unsecured money markets as well as bond and equity markets. Integration leads to declining funding costs, improved investment opportunities, narrower margins and lower overall transaction costs. EMU has stimulated more cross-border mergers, has made price comparisons easier, and thus intensified competition. Issues for concern are the fact that there is still a low degree of labour mobility and the existence of some nationally segmented markets, mostly in services. The ongoing integration of product and financial markets and the coordination of fiscal policies, if pursued, will help to reduce long-lasting cyclical divergence.

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A rather disappointing aspect of performance is the widening income gap of some member countries compared with leading OECD countries. It has to be admitted that the expectations of EMU boosting trend growth by abandoning the exchange rate risk and enhancing integration have not yet been fulfilled. GDP growth has been below potential growth for some years and the economy has recovered only slowly from recent shocks. Domestic demand has been persistently weak and trend growth in the EMU has been weakened owing to the disappointing performance of the German economy. Structural reforms are necessary to enhance trend growth. This relates, in particular, to labour markets. Labour is continuously underutilised and EMU is suffering from low non-inflationary growth and a high non-accelerating inflation rate of unemployment (NAIRU).

In terms of stability, the performance of public finances is even worse. In 2004, six out of 12 countries have breached the three per cent threshold (for the public deficit as a percentage of GDP). Rising gross debt and large structural deficits are among the features that raise doubts about the governments' willingness to pursue a policy of fiscal prudence. We witnessed notably shrinking deficits in the run-up to EMU, but consolidation stalled thereafter. Many EU member states eased their fiscal policy in the economic upswing of 1999-2000 and did not leave enough room for the automatic stabilisers in the following downturn. The rationale for the Stability and Growth Pact (SGP) still holds. If implemented appropriately, it avoids conflicts between monetary and fiscal policy, provides room for the automatic stabilisers and prepares fiscal policy for mastering the future. Considering the projected costs of demographic change, fiscal sustainability requires fiscal positions close to balance or in surplus.

The state of convergence depends, not least, on structural diversity within the enlarged EU economy. The accession of ten countries in May 2004 brought about a significant increase

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in institutional and structural diversity. The production structure differs particularly in terms of employment and the difference is even more pronounced within the industry/services sectors than between them. Enlargement will have an upward impact on real GDP growth, the degree of competition, the unemployment rate and labour mobility. It will have a downward impact on GDP per capita, employment and labour force participation (particularly for male persons and the aged), the public debt ratio, the average tax and regulations burden, the level of financial intermediation and the degree of openness of the union. The changes, however, will tend to be limited owing to the small size of the economy of the new member states, which contribute less than five per cent to the EU-25 economy. In comparison, Spain and Portugal together accounted for more than eight per cent of EU GDP at the time of their entry (1986). The corresponding figure for Austria, Finland and Sweden was seven per cent in 1995.

The rationale behind the requirement of convergence, the state of which is to be assessed every other year by the ECB, is that participation in the euro area depends on membership being conducive to the maintenance of price stability and the viability of EMU. The convergence criteria are a coherent and integrated package and all of the criteria have to be satisfied. The criteria have to be met on the basis of current data. However, the assessment hinges on the quality and integrity of the underlying statistics. And recent developments underline the necessity to provide for the independence, integrity and accountability of statistical offices.

Judging nominal convergence, one must recognise that the new member states have made considerable progress over the past few years. However, they still have a long way to go to finally qualify for membership in EMU. The exchange rate criterion cannot possibly be met by any country yet. Estonia and Lithuania have been participating in ERM II since 28 June 2004 on the basis of a unilateral commitment. Latvia has an inflation rate of 4.9 per cent

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(over the 12 months ending in August 2004), which is far above the reference value. However, the three Baltic states meet all other nominal convergence criteria, although they face considerable challenges that will have to be dealt with in coming years. The inflation rates will probably be put under upward pressure by the Balassa-Samuelson effect owing to the catching-up process and by the continued adjustment of administered prices to market-determined levels. All the Baltic states already have a relatively large public sector in comparison with countries that have a similar level of per capita income. Their low but rising public debt is mostly in foreign currency (predominantly euro) and they will undergo even more rapid demographic change than the euro area with a resulting rising dependency ratio. Macroeconomic instabilities may also result from high unemployment, which is largely structural. The high credit growth and the high growing unit labour costs also deserve attention since the sustainability of the convergence process hinges on both a sound starting position and sound policies pursued thereafter.

I would like to add a few words on the exchange rate criterion. A currency board is not a substitute for participation in ERM II. The treaty makes provision for joining ERM II and adopting the euro after fulfilling the convergence criteria. Exchange rate stability is subordinated to price stability. Problems which arise from currency boards are that the central rate may not be market-based and that the national central banks lack experience of national monetary policy. ERM II lends credibility owing to the implied protection of the Eurosystem. However, vulnerabilities for the new member states remain. These vulnerabilities stem mainly from high credit growth, the large debt in foreign currencies, the deficit on current account and the rapid worsening of their international investment position. Therefore, in dealing with exchange rate risks, new member states should be keen on sound public finances, stable financial systems and macroeconomic stability.

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The second important area of convergence is legal convergence. This concerns the guarantee of central bank independence, the requirement of price stability as the primary objective and legal integration of the NCBs into the Eurosystem. Central bank independence is to be achieved in functional, institutional, personal and financial terms. Such legal convergence is still to be achieved for all new member states. Incompatibilities persist and the NCBs have not yet been integrated into the Eurosystem.

Besides nominal and legal convergence, the degree of real convergence is important. It covers such topics as a similar level of per capita income, business cycle synchronisation, the degree of trade and financial integration, factor mobility as displayed in wage and price flexibility and the risk of asymmetric shocks and capacity to absorb them.

The degree of real convergencedepends, not least, on the degree of structural convergence that has been achieved. I would like focus on financial systems, as well as the integration of trade and foreign direct investment. Any judgement of how far new member states are integrated into the financial system of the EU has to take into account the overall low degree of financial penetration in the new member states. A substantial deepening of financial systems is to be expected. For instance, the average household in the Baltic states has financial assets of about E 3,000 euro at its disposal. The corresponding figure for the EU-9 (euro area excluding Ireland, Greece and Luxembourg) is as much as E 116,000. The low level of households'financial assets reflects the overall lower level of wealth per capita and is, of course, a legacy of communism, a slow transition and considerable instability over many years. In addition, households in the Baltic states hold an above-average share of liquid assets (in cash and transferable deposits). This may be due to habit persistence after the high inflation rates in the 1990s and the currently still low level of banking penetration.

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In terms of the size of the banking sector, the Baltic states are far below the level of Spain, Portugal and Greece at the time of their accession to the EU. Since financial sectors in the euro area change rapidly, new members need to catch up with a moving target. Their financial sectors are not yet fully developed in terms of market segments or instruments. Their capital markets only play a marginal role. The normal sequence is to create strong banks and market players and then develop liquid capital markets. The wider spreads on capital markets in the Baltic states are due to lower efficiency, lower liquidity and structural impediments. However, the Baltic states are ahead in terms of the provision of services by cross-border operators and in terms of foreign ownership, which is more than three times the figure for the euro area. Therefore, they enjoy comparatively strong financial integration with the EU and quite EU-compatible financial legislation and regulation.

Trade integration was largely achieved prior to EU accession owing to the opening-up of markets. This trade integration also substitutes partially for migration. Germany is the most important trading partner in the EU-15 for the new member states. About 40 per cent of EU exports to the new member states are of German origin. And German imports from the new member states are as high as for the rest of EU-15. Ten per cent of all German imports stem from the new member states. Gravity models show that imports from Germany into the new member states are far higher than the figure that might be expected. This can be explained by the leading role of German foreign direct investment as well as the conformity of the structure of German export goods with that of import demand in the new member states.

The impressive level of foreign direct investment has also supported integration. The three Baltic states have accumulated a large negative net international investment position in the space of only a few years. Direct investment has had other positive effects such as a transfer of capital and knowledge, increased competition and higher productivity. Foreign

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direct investment can be expected to slow down after the end of the privatisation process. However, investment conditions in the Baltic states are remarkably good, such as moderate taxes, an investment-friendly tax legislation, and low labour costs (per hour and per unit). These conditions and the higher growth rates are important pull factors for investors.

Summing up , I would like to point out that we have a good prospect of dealing successfully with the growing diversity of the EU economy after enlargement if monetary, fiscal and economic policy fulfil their respective tasks. The performance of the EMU economies is to be improved: Non-inflationary growth must be enhanced and inflation persistence should be tackled by structural reforms in order to foster price and wage flexibility. The heavy burden of public finances should be reduced. The euro area member countries must adhere to the Stability and Growth Pact. Moreover, for the sake of sustainable stability, we must face the fiscal costs of demographic change. In the long-term, a reduction of government's share in GDP is likely to increase potential growth. Focusing on the new member states, the harmonisation of business cycles and the integration of financial markets must be promoted. A remarkable degree of convergence has already been achieved. Further steps are needed to ensure that fiscal policy is compatible with price stability at low levels of interest rates. In terms of fiscal policy I hope that the continuing fiscal laxity and reluctance to undertake structural reforms in the current euro area will not undermine the fiscal discipline in the hitherto successful new member states. Finally, some new EU member states need to complete the disinflation process to successfully participate in ERM II, which is designed as a real test of sustained and sustainable convergence.

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