# Economic diversity on both sides of the Atlantic

**Speech by Jean-Claude Trichet, President of the ECB,
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Ladies and Gentlemen,

It is a great pleasure for me to speak to you here tonight.

The past few years have been a testing time for the economies of both the United States and Europe. We were faced with the worst financial and economic crisis since the Second World War. Still today – on both sides of the Atlantic – we are dealing with the consequences of the crisis – for economic growth, for employment and for government finances.

The crisis has also exposed the United States and Europe to a number of asymmetric shocks – in which different parts of our economies have had a wide diversity of experience. Some countries within the euro area are the particular focus of market attention at the moment as a result of their sovereign debt issues.

Some observers have been wondering how diversity can be dealt with in Europe's Economic and Monetary Union (EMU), what it means for monetary policy and whether the variations in economic conditions are aggravated by product and labour market rigidities. It has often been argued that economic diversity or heterogeneity is very significantly larger in Europe than in the United States.

We at the European Central Bank (ECB) have been looking closely at the degree of diversity in the two large, continental advanced economies on either side of the Atlantic. And some of the findings from this comparison are quite interesting. Because they show that economic diversity within the two currency areas is very similar in many ways. The analysis also shows that, in fact, in a large number of respects the two economies are similarly diverse.

I would like to share some of the key insights of this analysis with you tonight.

## I. Economic diversity in the euro area and the United States

The United States and Europe are often compared. This is quite natural. Americans and Europeans share a common cultural legacy. But our two economies, and I am speaking here of the economy of the euro area on our side, are also similar. Both are of similar size, in terms of population and in terms of economic output. Both have closely integrated financial and product markets. And both have a single currency.

Let me begin my comparison with an economic indicator that is particularly close to a central banker's heart: inflation. In historical terms, overall inflation has been low and stable in both the United States and the euro area since the late 1990s.

The ECB aims at an inflation rate of below, but close to, 2% over the medium term. Since the inception of the euro, the ECB has achieved that objective. Annual inflation in the euro area has been 1.97% on average over the first 12 years.

Importantly, the standard deviation in inflation across the members of the euro area has been around 1%. And it has remained broadly stable at similar levels to those observed in the US Metropolitan Statistical Areas. From that standpoint prices in the euro area are broadly homogenous and similar to those in the United States.

My second point of comparison is how diverse the United States and the euro area are in terms of economic growth. The results here are similar to that for inflation. First of all, the overall growth rates over the first twelve years of the euro were actually quite similar in the euro area to those in the US, once you adjust for differences in population growth. In both the euro area and the US, per capita growth was about 1% during 1999-2010. As concerns dispersion within the economies, before the crisis, the standard deviation of growth rates was around 2% in both the euro area and the United States. Dispersion rose somewhat during the crisis in both currency areas but remained broadly in line with pre-crisis patterns. [1]

Allow me to go one step further and compare the sources of this growth dispersion in the United States and the euro area. Both currency areas include regions that experienced a significant boom-and-bust cycle over the past decade. Both also contain regions that are facing significant structural challenges of a more long-term nature.

Let me start off with the United States. Here, several states experienced increases in house prices that outpaced the national average by a wide margin. The steep house price increases probably contributed to above average growth in these states, owing to strong positive contributions from real estate, construction and financial services.

Nevada, Arizona, Florida and California are good examples, where average growth between 1998 and 2006 exceeded that of most other states. The sharp fall in house prices in recent years turned boom into bust. These states experienced the harshest recession among the US states.

At the same time, some other US states have seen a long period of below average growth, particularly the former manufacturing powerhouses in the "Great Lakes" region. Structural shifts in the US economy towards services have gradually reduced the value added of manufacturing relative to GDP. In the decade before the financial crisis, growth rates in states with a high concentration of companies in manufacturing industries other than information and communications technology, such as Michigan and Ohio, were lower than in most other US states. Unsurprisingly, GDP growth in these regions remained below average during the crisis.

The euro area also contains examples of these two types of regions. On the one hand, some countries experienced asymmetric boom -and-bust cycles. Several euro area countries had higher than average growth in the pre-crisis years. For example, up to 2006, growth in Ireland was higher than in most other euro area economies, owing much to large increases in house prices.

On the other hand, a few euro area countries – Portugal for example – experienced growth below the euro area average in the decade preceding the crisis. This was typically a consequence of structural issues that could have been tackled earlier and with more determination.

Just a few years ago, this group of countries included Germany, then labelled completely wrongly the "sick man of Europe". Yet Germany is now an example of how big the dividends of reform can be if structural adjustment is made a strategic priority and implemented with sufficient patience.

In short, the effects of the crisis on the different economies in the euro area follow a similar pattern to those in the United States. The countries in the euro area that have been hit hardest are those in which either large asset-bubble driven imbalances unwound or structural problems were left unaddressed before the crisis. More specifically, Ireland and Greece, in particular, remained in recession in 2010.

Those countries that have yet to implement more far reaching structural reforms also have relatively low growth prospects after the crisis. These relatively low growth rates are linked to a deterioration of competitiveness, driven by persistent losses in relative competitiveness, for example by above average increases in relative labour costs.

Again, this problem is not isolated to the euro area. Disregarding the most recent countries to join the euro area, dispersion of unit labour costs is similar in the euro area and the United States, both before and during the crisis.

It is worth noting that both currency areas include regions with persistently above or below average unit labour cost growth. Again leaving aside the most recent countries to join the euro area, Greece, Portugal and Ireland, in particular, have lost competitiveness vis-à-vis their main trading partners in the euro area. Germany, in contrast, has been able to lower relative unit labour costs.

There have been similar persistent losses and gains in competitiveness in the United States. Some states have experienced large or persistent increases in unit labour costs, currently exceeding the national average by as much as 20%. Other states have been gaining competitiveness vis-à-vis the national average over the past decade.

In summary, economic heterogeneity in the euro area and the United States has been broadly similar on a number of measures over the past 12 years.

## II. Economic governance in the euro area

But the crisis has shown us that this should be no reason for any complacency in the euro area. Persistent losses in competitiveness on the part of individual members in a currency union lead to a build-up of external and internal imbalances. When these unravel, the cost for the affected economies can be large. They can also have spillover effects on other members of the currency union.

In any union, an economic governance framework is needed to prevent developments in an individual member state endangering the smooth functioning of the union. This is particularly true in a currency union that – in contrast to the United States – does not have a large federal budget to balance severe asymmetric developments.

For EMU, the economic governance framework devised in the 1990s has not been correctly implemented and, in any case, has proved too weak during the crisis.

As I speak today, the reform debate is still in progress. Allow me to take a few more minutes to outline the reforms required to make Europe's institutions of economic governance commensurate with monetary union.

As you may know, the ECB takes the strong view that there is the need for more speed and automaticity in the sanctioning mechanism. This is particularly true for the Stability and Growth Pact, the EU's framework for fiscal governance. But it is also the case for the broader framework for macroeconomic policy surveillance. The experience of recent months has vividly demonstrated the importance of a timely correction of internal and external imbalances.

But faster and more automatic sanctions alone will not be enough. The enforcement tools will also need to be made more effective. The macroeconomic surveillance framework, in particular, needs to provide clear incentives for sound policies in the member states by imposing financial sanctions at an early stage. This also means that there should be no room for discretion in the implementation of the surveillance framework.

At the same time, requirements on fiscal and other macroeconomic policies should be more ambitious. To ensure that none of the euro area members are left behind, they have to bring national policies in line with membership of a currency union.

Finally, the implementation of sound fiscal and macroeconomic policies is best ensured if these are solidly anchored at the national level. An effective way of achieving this is to implement strong national budgetary frameworks in the members of the euro area.

## III. Conclusion

Let me conclude. The European Union and the Euro area on one side of the Atlantic, the United States on the other side not only share the common heritage of their culture and their nature of advanced economies. They are not only of similar size. Our economies are also showing remarkable resemblance in their diversity – among the 50 states on this side of the Atlantic and among the 17 euro area members on the other side. This is true for both the euro area and the United States before the crisis and also in their reaction to the asymmetric shocks during the crisis.

Therefore we have a common challenge. That of governing, in the best fashion possible, very large and similarly diversified economies as regards the economic features of member countries and states. This is naturally done in the US through the federal institutional framework.

We Europeans need to reform our economic governance framework, as I have briefly outlined here tonight. Here, we would do well to heed the words of Alexander Hamilton, a founding father of America's economic and political union,. Just as Hamilton once called to his fellow Americans, we Europeans should call on our leaders to "learn to think (more) continentally".

Thank you for your attention.