Further Integrating Euro Area Economies: Some Reflections

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A *preamble.* The creation of an economic area with a single market and 12 national economies now sharing a single currency – the euro – has been a unique endeavour in economic history. Other countries will follow in adopting the euro in the future. This has set in motion several new developments to which we need to pay close attention.

But we should also not forget that the euro was introduced only in 1999 (with banknotes and coins following three years later). As such, its full effects may take some more time to unfold. Experience also shows that in such a rapidly changing world, where the progress of science and technology, the globalisation process and the very profound structural and institutional changes in Europe are taking place simultaneously, we have to be humble before facts and figures and be ready to take them on board.

My reflections are organised along five main lines. *First,* I will list some reasons why the euro is setting in motion some developments that were not there before. *Second,* I will argue that actually the euro is already fostering such developments and integration in many areas. *Third,* I will highlight some of the main benefits and consequences of European economic and monetary integration. *Fourth,* I will provide some snapshots of the diversity of euro area national economies, a natural phenomenon in a wide currency area. And *finally,* I will discuss the issue of the optimal economic management of the euro area.

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First reflection, why should the euro bring countries closer together?

What is so special about a monetary union among countries that are ready for this leap forward?

We know that by moving from several national currencies to a single currency, some pecuniary costs disappear or at least decline. The introduction of the euro has therefore contributed to reducing trading costs both directly and indirectly: e.g. by removing exchange rate risks and the cost of currency hedging among the pre-euro legacy currencies. Information costs have been reduced as well. The euro is also enhancing price transparency and discouraging price discrimination: this is helping to reduce market segmentation and is fostering competition. Hence, the euro is acting as a catalyst for the Single Market Programme.

But there is more to it. The euro is rendering this single market irrevocable. A single currency among partner countries, some of which already started integrating in the 1950s, is seen as "a much more serious and durable commitment" than other monetary arrangements between countries.[1] It precludes future competitive devaluation, facilitates foreign direct investment and the building of long-term relationships. Producers may be more willing to undertake large fixed costs associated with exporting to other partner countries of the currency area. One single currency is more efficient than multiple currencies in performing the roles of a medium of exchange and unit of account. As a result, a single currency promotes convergence in social conventions with potentially far-reaching legal, contractual and accounting implications.[2]

The euro is also rendering more obvious the need to intensify structural reforms, such as those fostered and monitored in particular by the European Commission, the OECD and that we strongly support ourselves. Reforms span product and labour markets, and as regards financial integration the measures listed in the Financial Services Action Plan (FSAP), the launch of TARGET2, the establishment of the Single Euro Payment Area (SEPA), the initiatives to further integration in the Mortgage Credit Market in the EU, and others. This is in fact vital to enhance the success of EMU.

[1] See, among others, Engel and Rogers, "European Product Market Integration After the Euro", Economic Policy, July 2004, 347–384, and McCallum, "National Borders Matter: Canada-US Regional Trade Patterns", American Economic Review 85 (3), 1995, 615–623. For a description of the European process of integration see Mongelli, F.P., E. Dorrucci, and I. Agur, "What does European institutional integration tell us about trade integration?", ECB Occasional Paper Series no 40, 2005.

[2] Garcia-Herrero, Gaspar, Hoogduin, Morgan and Winkler, "Introduction of volume with Conference Proceedings", in *Why Price Stability,* First ECB Central Banking Conference, European Central Bank, 2001.

Hence, the euro is contributing to the removal of "borders". These are broadly intended to include the former legacy currencies, but also national procedures, rules and conventions, plus many other obstacles and hindrances to economic and financial integration. *To what extent are we starting to see these effects?*

Let me now illustrate, and it is my second point, how the economic and financial environment of the euro area has changed, and will continue to change

More and more research studies and analyses on the effects of the euro are being conducted. The effects observed are generally beneficial and euro area economies are becoming more interdependent.[3]

We have clear evidence of a significant increase in both *intra and extra-euro area trade in goods* since the launch of the euro.[4] *Exports and imports of goods within the euro area* increased from about 26.5 percent of GDP in 1998 to around 31 percent in 2005. This may be partly related to the introduction of the single currency and the increased price and cost transparency, which have promoted cross-border trade. Over the same period, *exports and imports of goods with trading partners outside the euro area* rose from about 24 percent of GDP to almost 30 percent. This is mainly due to more sustained growth in world GDP, an increase in global trade integration, and a very sizeable increase in trade with the ten new Member States of the European Union. All in all, these developments are particularly noteworthy given the already high degree of openness of the euro area countries, suggesting that we are not witnessing the creation of a "fortress Europe" but that the European integration is perfectly complementary with the global integration.

A lesser-known feature is that *trade in services* with partners inside and outside the euro area has also increased as a percentage of GDP in recent years. Intra-euro area exports and imports of services increased from about 5 percent of GDP in 1998 to around 6.5 percent in 2005. Proportionately, this represents a slightly higher increase than extra-euro area exports and imports of services, which increased from about 7.5 percent of GDP in 1998 to around 9.5 percent in 2005. Trade in services can rise much further when the single market for services is completed. We are perhaps already seeing the first signs of this process: over the last three years the growth of the euro area's international trade in financial services has surpassed the growth in all other sectors of services. Moreover, intra-euro area trade in financial services grew almost as rapidly as extra-euro area trade. Other dynamic sectors on the intra-trade side were computer and information services as well as communication services.

Intra-euro area Foreign Direct Investments (FDIs) have grown considerably as well. They are now catching up with extra-euro area FDIs. Between 1998 and 2004, total FDIs grew by about 180 percent in nominal terms while cumulated total FDIs now account for around 24 percent of euro area GDP. Intra-euro area FDIs grew instead by over 240 percent and now account for a little less than half total FDIs. Such FDIs – which also include mergers and acquisitions (M&A) activity – accumulate over time and contribute to reshaping Europe.

The faster movement towards a single market in financial services is another example of the euro acting as a catalyst. Here I will give just a few examples. Last year, for the first time, the ECB published a set of indicators on the state of integration of euro area financial and banking markets. These indicators clearly show that the euro has been a remarkable catalyst, particularly in market segments closer to the single monetary policy.

For example, the cross-country standard deviation of EONIA – i.e. overnight – and EURIBOR – i.e. one-month and 12-month – lending rates among euro area countries plummeted to close to zero following the introduction of the euro, and since early 1999 this standard deviation has remained low at only 1 to 2 basis points. Just to give for comparison some figures from the time before Monetary Union, let me mention that in January 1998, i.e. one year before the start of Monetary Union, the indicator for the EONIA lending rates stood higher than 130 basis points and the indicators for the EURIBOR lending rates stood at more than 100 basis points for the one-month maturity, and at around 50 basis points for the 12-month rates.

The euro corporate bond market has grown very significantly since 1999, and has the potential to grow even further. The outstanding volume of bonds issued by non-financial corporations of around €2.5 trillion in the United States is still three times larger than in the euro area (while the respective GDPs are comparable). A rapid integration is also taking place in euro area equity markets. Stock prices across the euro area increasingly react to euro area-wide factors and news. Furthermore, the elimination of intra-euro area currency risk and, most importantly, the reduction of direct and indirect costs for cross-border portfolio transactions has reduced the "home bias" in the equity holdings

[3] In June 2005, the ECB held a workshop on *"What effects is EMU having on the euro area and its member countries?"* The workshop was organised in five areas: 1) trade integration; 2) business cycle synchronisation, economic specialisation and risk sharing; 3) financial integration; 4) structural reforms in product and labour markets; and 5) inflation persistence. All proceedings are now available in the ECB Working Paper Series: see nos 594 to 599.

[4] See Baldwin, "The euro's trade effects", ECB Working Paper Series no 554, 2006, and Anderton, di Mauro, and Moneta, "Understanding the impact of the external dimension of the euro area: trade, capital flows and other macroeconomic linkages", ECB Occasional paper no 12, 2004.

of institutional investors. A simple inspection of the data reveals that European countries increased their holdings of euro area international assets (as a share of their total international portfolio). Over the 1997-2003 period, the share of intra-euro area allocation increased markedly by 10 percentage points for equity portfolios and by almost 25 percentage points for fixed income portfolios. There is nevertheless potential for greater integration particularly in the equity market.[5]

Cross-border interbank loans and holdings of securities are another area in which we have seen significant progress. At the end of 1997, securities issued by non-monetary financial institutions of another euro area country accounted for only 16 percent of the securities held by euro area monetary financial institutions (MFIs). This share has now reached almost 40 percent.

But integration in retail banking has been slow so far. Consolidation in the banking sector has taken place mostly as a result of domestic mergers whereas cross-border banking mergers have started to happen only over the recent years. In this respect, whereas a number of euro area banks have considerably expanded their interests outside the euro area, cross-border activity within the euro area has remained relatively limited, though it is gaining importance. The continuation of this trend is expected to result in an increase in the level of competition and efficiency in the euro area financial system.

Let me briefly mention that the ECB and the Eurosystem are actively involved in several initiatives that help fostering financial integration. First, the launch of TARGET2 – the new payment platform for the financial system – is planned for the end of 2007. Furthermore, we are participating in the Short-Term European Paper (STEP) initiative to promote the convergence of better market standards and practices prevailing in the European short-term securities markets, whereby Euribor ACI and Euribor FBE formally adopted the STEP Market Convention just recently at the beginning of June. End of last year, we also provided a contribution to the European Commission on the Green Paper on Mortgage Credit in the EU, an important segment of the banking and retail markets that has an outstanding volume of more than €4 trillion in residential mortgage debt in the EU, corresponding to around 40 percent of EU GDP. Euro area mortgage markets are not yet fully integrated, and I see here great potential for further integration. Last but not least, there is also the Single Euro Payments Area (SEPA) project that aims at integrating the market for retail payment services.

Let me finally stress how important it would be to speed up progress in creating more flexible labour and product markets. Advances in this area have been uneven across countries and as a whole too slow.[6] I will come back to this issue later on.

All in all, however, euro area countries are becoming more interdependent than they were at the start of EMU. Simply put, we all have a bigger stake in each other. *What are some of the direct and indirect implications from sharing the euro?*

My third reflection is that the single currency has been largely beneficial.

There are benefits of intense trade in goods and services. By increasing intra-euro area FDIs and M&As, companies in Europe are able to re-allocate their capital in a more efficient manner.

The Eurosystem – with the ECB at its heart – has built a successful monetary framework. This includes a clear monetary policy strategy to deliver our primary objective, price stability, an effective framework for the operational conduct of monetary policy, and an efficient payment system. As a result, expected inflation levels have remained in line with our definition of price stability. This has allowed nominal and real medium and long term market interest rates to contribute to favourable conditions for sustained economic growth and job creation.

The euro area has become more resilient. As a whole, we find less dispersion because the cyclical component of output growth is more synchronised. Since the start of EMU dispersion in annual average real GDP growth rates across the twelve euro area countries, measured by the unweighted standard deviation, has declined from a level of 2 percentage points, around which it has fluctuated since the

[5] A more sophisticated analysis based on an international portfolio choice model reaches the same conclusion (see De Santis and Gérard, "Financial integration, international portfolio choice and the European Monetary Union", ECB Working Paper Series, no 626, 2006.). EMU has enhanced regional financial integration in the euro area in both the equity and bond markets. There is evidence of active trading among euro area Member States, with euro area investors assigning a higher weight to portfolio investment in euro area countries. Over the period 1997–2001, the average increase in weights – on top of the world average portfolio weight increase in euro area assets – amounts to 12.7 percentage points for equity holdings and 22.4 percentage points for bond and note holdings.

[6] See Duval and Elmeskov, "The effects of EMU on structural reforms in labour and product markets", ECB Working Paper series no 557, 2006, and Blanchard and Giavazzi, "Macroeconomic effects of regulation and deregulation in goods and labor Markets", Quarterly Journal of Economics, August, 118(3), 2003, 879–907.

[7] See Giannone and Reichlin, "Trends and cycles in the euro area: how much heterogeneity and should we worry about it?", ECB Working Paper series no 555, 2006, Benalal, Diaz del Hoyo, Pierluigi and Vidalis, "Output growth differentials across the euro area countries: some stylised facts", ECB Occasional Paper Series no 45, 2006, and ECB, "Sectoral specialisation in the EU: a macroeconomic perspective", ECB Occasional Paper no 19, 2004.

1970s, to 1.5 percentage points in 2005.[7] National economic policies have become better coordinated, and in the case of monetary policy it has even been completely merged. A relevant factor for some euro area member countries is that the risk of possible speculative attacks on national currencies has been removed. Not so long ago, in the pre-EMU past, the impact of movements by the Deutsch Mark against the US dollar was often aggravated by similar movements against euro legacy currencies: this can no longer happen.

Clearly, there are also general economic benefits arising from more financial integration in the euro area. I will mention a few here.[8] Financial integration fosters financial development, the modernisation of the financial system and, ultimately, economic growth. Some of our studies and a number of analyses by the European Commission claim that the potential gains from the financial integration of European bond and equity markets in terms of additional real GDP growth amount to around 1 percent over a ten-year period.

Thanks to greater financial integration, economic agents can invest more easily in any part of the euro area and thereby spread the risk of potential local shocks having an impact on income and consumption. The potential benefits of this are very significant. As euro area investors assign more weight to portfolio investment in euro area countries – and banking integration grows as well – risk-sharing in the euro area increases. This is a very important shock absorber.

I will give you a comparison. A few years ago some researchers showed that the US *capital markets* smoothes 39 percent of the shocks to gross state product (that is equivalent to our GDP), 23 percent to *credit institutions* and 13 percent to the *federal government.*[9] 25 percent of the shock is not smoothed. Hence, in the United States, financial markets and financial institutions contribute 62 percent to the absorption of state idiosyncratic shocks. The effect is substantially higher than the effect of the federal budget. While in Europe the supranational budget plays a different role, we expect European financial markets to move in this direction.

Furthermore, by making markets deeper and more liquid, financial integration creates economies of scale and increases the supply of funds for investment opportunities. The integration process fosters competition, the expansion of markets and intermediation, thereby complementing and leading to further financial development. Financial development, in turn, leads to lower intermediation costs and a more efficient allocation of capital. Allocating resources to the most productive investment opportunities ultimately increases the potential for greater and more sustainable non-inflationary economic growth.

All in all, there is no doubt that sharing the euro has been beneficial for all euro area countries. The 313 million people in the euro area and, more generally, the 460 million European Union citizens expect such economic benefits. At the same time the euro area is now a very large economic area which requires a new type of economic management than we were used to prior to 1999. We need to think in terms of economic developments in the euro area as a whole, in our home country and in euro area-partner countries. This requires an enormous change in mentality, but it is indispensible for the success of EMU.

My fourth reflection concerns the level of diversity within the euro area.

Let me provide you only a few snapshots of the evolution and dispersion of inflation, as well as indicators of growth differentials, competitiveness and unit labour costs. Whenever possible, I like to compare and contrast the euro area with the other major industrialised continental economy, the United States.

I would like to stress that monitoring economic developments and understanding what lies behind diversities is an important aspect of the new economic management that I referred to above.

a) *Inflation dispersion in the euro area declined considerably* in the 1980s and 1990s, and is on a par with the level found in the United States. Inflation dispersion among euro area countries has broadly stabilised at a low level since the beginning of the euro. The progress made has been very impressive. The unweighted standard deviation of annual HICP inflation rates was still around 6 percentage points in late 1990. It has dropped to 1 percentage point since the launch of the euro, a level at which it broadly stabilised. This dispersion level is similar to that of the 14 US Metropolitan Statistical Areas (MSAs) but somewhat higher than for the four US census regions. Although such comparisons are subject to some well-known caveats, it can be argued that inflation dispersion in the euro area has not been high by international standards.[10]

[8] See Cappiello, Hördahl, Kadareja, and Manganelli, "The Impact of the euro on financial markets", ECB Working Paper series no 556, 2006, and Baele, Ferrando, Hördahl, Krylova, and Monnet, "Measuring financial integration in the euro area", ECB Occasional Paper no 14, April 2004.
[9] Asdrubali, Sorensen and Yosha, "Channels of Interstate Risk Sharing: United States 1963–1990", Quarterly Journal of Economics, CXI, November 1996, 1081–1110.

[10] ECB (2003) "Inflation differentials in the euro area: potential causes and policy implications," ECB report released on 16 September 2003. ECB (2005) "Monetary policy and inflation differentials in a heterogeneous currency area", article in the ECB Monthly Bulletin of May 2005.

A feature of euro area *inflation differentials* is their persistence. Inflation in most member countries displays significant inertia. Many countries below, or above, the euro area average inflation rates in recent years have remained in this position for at least a decade on average. Such widespread persistence of inflation differentials over long periods does not occur in the United States. And we are now seeing signs of limited reversals: some euro area countries with relatively high inflation rates have moved down to, or even below, the euro area average. Overall, these corrections are welcome, but the point is that they have been quite slow in coming. Whereas some wage or inflation differentials are justified – and prove that monetary union promotes adjustments – there is a need to better understand the reasons for this apparent sluggish adjustment process.

If we look at the *cost side,* in most countries domestic factors dominate external factors in generating inflation differentials. In particular, we have witnessed a sustained divergence of wage developments across the euro area, and narrower differences in labour productivity growth. These differentials in the growth of unit labour costs have been the main sources of persistence. This suggests a link with differing levels of wage rigidities across the euro area. However, changes in profit margins have also contributed to inflation differentials. Furthermore, imperfect competition and associated price rigidities across countries may also have been a factor.

If we look at *product groups,* there has been a relatively higher price dispersion in the area of services. This is probably associated with the dispersion in wage developments in the services sector. By contrast, inflation dispersion has been relatively low for tradable non-energy industrial goods. Then, of course, products with relatively volatile price developments (such as energy, unprocessed food and processed food) has also shown a high dispersion of price changes across countries.

Hence, there is a certain degree of structural diversity in inflation and cost developments among euro area national economies. This is undesirable if it reflects misaligned policies and structural rigidities or a lack of competition. If uncorrected, over time, it may engender negative effects and externalities for the euro area as a whole.

b) *The second snapshot of diversity in the euro area concerns growth dispersion.* Growth dispersion in the euro area has been broadly stable since the early 1970s. Between 1999 and 2005 there were no signs of increased divergence. The average dispersion of annual real GDP growth (measured as the unweighted standard deviation) was around 2 percentage points. This is very close to the average dispersion of real growth rates since the 1980s. By comparison, the dispersion of real growth across the 50 US States has fluctuated around an average of 2 1/2 percentage points over the last 15 years, while the average dispersion of the real growth rates was around 1 1/2 percentage points across the eight US statistical regions.

There is also a relatively high degree of persistence of output growth differentials within the euro area. A certain degree of persistence of growth differentials is also found in the United States. However, to take the United States as a benchmark is useful only up to a certain point. On the one hand, the US economy is known to be more flexible than the euro area (and thus effects of asymmetric shocks should be absorbed more easily and faster). On the other hand, the United States exhibits stronger regional specialisation than the euro area, making its regions more subject to specific asymmetric shocks.

It is useful to distinguish between the main drivers of dispersion. Dispersion in real GDP growth rates across the euro area countries reflects two main factors: dispersion of cycles and dispersion of trends.

The dispersion of cycles has steadily declined since the early 1990s from about 2 percentage points to 1 percentage point. In this regard, the *degree of synchronisation* of business cycles across euro area countries seems to have increased since the early 1990s. This holds true for various measures of synchronisation applied to overall activity and to the cyclical component, for annual and quarterly data as well as for various country groupings. In particular, the degree of correlation appears currently to be at a historical high. These two features are unique to the euro area.[11]

This may indicate that EU integration and, more recently, EMU – as opposed to global forces – have led to smaller differences in output gaps and an increase in the synchronisation of business cycles across the euro area countries.

Instead, since the beginning of the 1990s we witness more lasting differences in trend growth, which rose from about 1.2 percentage points to about 1.7 percentage points in the late 1990s before starting to decline. Some euro area countries persistently exhibit trend output growth either above or below the euro area average.[12]

Differences in trend growth among euro area countries can be explained by various structural factors, including to some

[11] No increase in the contribution from trend growth differences and no increase in synchronisation have been detected for a subset of 12 non-euro area OECD countries.

[12] See Benalal, Diaz del Hoyo, Pierluigi and Vidalis, "Output growth differentials across the euro area countries: some stylised facts", ECB Occasional Paper Series no 45, 2006.

extent demographic trends and catching up in terms of the standard of living. Differences in the timing and extent of past structural reforms in euro area countries are likely to have played a significant role. For example, the Netherlands have undertaken labour market reforms earlier than the largest euro area countries. As a result, diverse long-term trends in labour productivity and employment growth have been observed. More generally, the degree of economic flexibility could be a factor explaining trend growth differences. In some countries, short-term shocks may have had more persistent effects on growth differentials due to slow adjustment processes in the presence of structural rigidities.

The increasing weight of differences in trend growth and the lower weight of dispersion in business cycles has important implications. Macroeconomic policies can only partly address this dispersion, whereas structural reforms can address it more fully.

c) *My third snapshot of diversity concerns the rapidity with which relative changes in cost and price competitiveness are occurring.* These movements mainly reflect changes in relative unit labour costs and inflation differentials. They demonstrate that there is significant leeway for losing, or gaining, competitiveness, even in the absence of exchange rate adjustment: more leeway than was foreseen prior to the launch of the euro. Let me give you an order of magnitude. Between 1999 and 2005 the difference in the cumulated growth of unit labour costs for the total economy between the "highest increase" and "lowest increase" countries was about 20 to 25 percent.

This is an important phenomenon that requires an understanding of the factors driving it. I will touch upon a few related developments:

- Unit labour costs are increasing at a relatively fast pace in those euro area economies which started at significantly lower price and cost levels. In most, but not all, cases this phenomenon is driven by the Balassa-Samuelson effect, which occurs when there is a catching-up to higher living standards, and is thus generally acceptable, as it reflects the movement to a new equilibrium.
- Germany has seen very moderate growth in unit labour costs over an extended period, leading to a correction of the losses in competitiveness which arose in the aftermath of German reunification. This correction and the related sustained period of relatively low inflation is, of course, fully justified and perfectly welcome. It also shows that adjustment mechanisms in EMU do work. A high degree of wage flexibility would help to accelerate such welcome adjustment processes.
- However, the persistence of growth and inflation differentials also show that some other sources of diversity are not economically justified. They might be partly attributable to insufficient flexibility; in such economies corrections must be made. For example, in some economies the combination of weak labour productivity growth and of strong nominal increases of wages and salaries for a sustained period might lead to a progressive deterioration of their competitiveness. Furthermore, in several euro area countries there exists specificities in wage formation (for example due to indexation mechanisms or due to the influence of the public sector) and in price formation in general. This limits the responsiveness to shocks.

My final reflection concerns the optimal economic management of the euro area

The economic management of the euro area needs to reflect the increasing interdependence of euro area economies and ensure that the above-mentioned diversity can be addressed. I will now stress the importance of three "guiding principles" for this.

a) *The first principle is a rigorous implementation of the Stability and Growth Pact.* There are several reasons for clear fiscal rules in a monetary union, such as those embodied in the Stability and Growth Pact, including correcting the "deficit bias" of fiscal policy and preventing spillovers from fiscal policies to monetary policy. I have made these reasons clear on numerous occasions. Euro area countries need to maintain budgetary positions that are close to balance or in surplus over the medium term. They also need to reduce public debt to a low and sustainable level.

But the subject of my speech today is the economic integration of the euro area, so *I would like to mention a few other reasons for supporting sound fiscal policies.* First, the need to reduce the risk of fiscal policy externalities; additionally, the need to gain flexibility and adaptability; and finally, the importance of ensuring proper incentives. Sound fiscal policies allow for flexibility, which cushions the effects of the economic cycle through the working of automatic stabilisers. Additionally, sound fiscal policies create room for domestic economic management, say, to pursue the desired tax and spending policies. Furthermore, the tax and benefit system should avoid major distortions affecting incentives to work, save, invest and innovate. This creates conditions conducive to stability and sustainable growth. Ireland is one very clear example of such a virtuous process inside the euro area.

The public sector also has a "role model" function, for example, concerning public wages and/or administrative

prices. Its behaviour can make the social partners more aware of the trade-off between higher salaries and job creation.

Although a sound fiscal policy is in a country's own interests, it is very much in the interests of the euro area as well. An inappropriate fiscal policy in one country directly affects other countries, as the impact on interest rates is no longer confined to one country but spreads across the euro area.

b) *The second principle is a close monitoring of the implementation of structural reforms.* Earlier, I referred to some common denominators behind inflation and growth differentials: the detrimental role of pervasive price and wage rigidities, excessive labour market regulations, and imperfect competition in several important sectors of the euro area economies. We have known this for quite some time. A lot is at stake here, and there is an urgent need for action.

Why? All euro area countries need structural reforms, although to different degrees. Reforms are essential to raise factor productivity and potential output, to create new jobs and to achieve lower prices and higher real incomes. The need for reforms is clearly signalled by the fact that euro area potential output growth seems to have moved to the lower bound of its previously estimated range of 2 to 2.5 percent. In addition, euro area real GDP per capita is still about 70 percent of that in the United States. Furthermore, reforms are also needed to increase the resilience and flexibility of the economy.

The Lisbon agenda of 2000 was, and is, a fundamental and ambitious programme to draw Europe's attention to the urgency of structural reforms. It identified all major areas which need to be changed. However, the modest and uneven implementation so far has clearly shown how difficult reforms are. More recently, the Lisbon agenda has been refocused towards growth and employment. Various feasible goals were set in order to enhance, among other things, the flexibility and adaptability of labour markets; raise competition in the markets for goods and services; increase employment; promote innovation; and strengthen growth and employment rates in each participating country. The need for structural reforms and liberalisation also applies to financial markets. In fact, further financial integration has the potential to greatly foster economic growth.

Governments are paying greater attention to the implementation of reforms. We appreciate this renewed impetus, which has now resulted in the more focused Partnership for Growth and Jobs and in the structural reform commitments of the national reform programmes. We also need to reinforce the benchmarking of good performance to better identify where the reform challenges are most urgent. As I have explained above, a successful reform programme is of particular importance for euro area countries.

c) *The third principle is the need to monitor unit labour costs and national competitiveness indicators* to prevent or correct, if necessary, abnormal deviations. We would expect some dispersion and differentials among euro area countries: in the long and very long term, several parameters characterising their economies are bound to fluctuate around some average of the euro area as a whole. Put more clearly, there will always be some diversity as in other vast continental economies with a single currency like the United States. In particular, this should be the case for countries catching up in terms of GDP per capita and price levels and would thus show faster output growth and inflation. For some economies, the observed diversity may go beyond the completion of the "catching-up" process. This should be the case for corrections of past excesses in terms of overall cost and price competitiveness, particularly in the tradable goods and services markets.

In such situations, national governments and social partners need to take action to address excessive wage developments and strengthen productivity growth in order for unit labour costs in those economies to increase less rapidly than the average of the euro area.

The economic and financial environment is changing and euro area countries are becoming progressively more interdependent. Several potential concerns preceding the launch of the euro have been dispelled. At the same time, more must be done to increase the flexibility and adaptability of euro area economies. Structural reforms are essential to facilitate and speed up the endogenous corrections of deviations of economic parameters. Reforms will also enhance growth potential for the euro area as a whole as well as reinforcing its resilience in the case of shocks.

We also need to monitor and fully understand the factors behind the persistence of diversities among euro area countries: this persistence is in some cases fully justified. In other cases it has to be corrected in order to avoid the accumulation of differences over time. This is particularly true as regards the cost competitiveness indicators. Euro area policy-makers need to discuss the underlying factors and the necessary corrective measures in the appropriate institutional fora: this should ensure a smooth functioning of the euro area in the coming years.

In such a rapidly changing world, with many simultaneous developments brought about by the progress of science and technology, the globalisation process and the profound changes in Europe – which have been the subject of my reflections – this hard work would have been in any case necessary. The euro has brought price stability, favourable medium and long-term interest rates, and a remarkable degree of resilience in a complex environment marked by shocks, three achievements that lend support to these urgently needed structural reforms.