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978-0-521-86700-9 - The External Dimension of the Euro Area: Assessing the Linkages

Edited by Filippo di Mauro and Robert Anderton

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## The External Dimension of the Euro Area

Although still relatively closed, the euro area economy is nevertheless subject to a broad range of economic impacts originating from outside its borders. This book aims to improve our understanding of how, and to what extent, such external developments affect the euro area. Using a broad range of methodologies and techniques, chapters analyse the various channels that connect the euro area to its external environment; most notably trade, capital flows and other international macroeconomic linkages. The result is that the interaction between the euro area and its 'external dimension' is shown to be complex and wide-ranging. With contributions from both academics and professionals, this volume will be an invaluable source of information for researchers and policy makers concerned with the interaction between regional European integration and globalisation.

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## Preface

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Although relatively closed in comparison with the individual constituent countries, the euro area economy is subject to a broad range of economic impacts originating from outside its borders, by an extent which remains significant. At the ECB we are well aware of the international linkages of the euro area and in 2004, we hosted a workshop on ‘The Importance of the External Dimension for the Euro Area: Trade, Capital Flows and International Macroeconomic Linkages’. Drawing partly from that workshop and using the most recent research, the book edited by di Mauro and Anderton aims at providing an overall understanding of how and to what extent external developments affect the euro area. Using a broad range of methodologies and techniques, the chapters bring together the latest information and results regarding the various channels connecting the euro area to its external environment, most notably the trade, capital flows and other international macroeconomic linkages.

The work is ambitious as it attempts to tackle a number of complex, overarching issues: how good are standard openness measures to ascertain the impact of trade developments on the euro area economy; what are the most relevant economic linkages between the euro area and the rest of the world; what are the channels and mechanisms by which the euro area is influenced by external developments and how are they changing through time; and what can we say regarding claims that there has been an increase in the international synchronisation of economic cycles?

While most of the replies remain work in progress, still a number of results are in my opinion worth mentioning. First, there are significant indicators of an increase in the synchronisation of economic cycles across the major countries of the world since the mid-1990s which seems to be associated with the growth in international economic linkages resulting from globalisation. However, these linkages and mechanisms are not straightforward and the impact on the euro area of external shocks can differ quite considerably depending on the specific nature of the shock. For example, the apparent recent rise in the international synchronisation of cycles may be partly due to the global nature of the ICT shock

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which led to the downturn in early 2000, but the nature of future external disturbances may be more idiosyncratic or country-specific and, therefore, may not have such a significant impact on the euro area. Second, the explosive growth of FDI since the mid-1990s represents a key mechanism by which globalisation seems to have increased economic spillovers across borders and continents by creating additional channels for the international transmission of shocks. Third, given the greater openness of the euro area compared to the USA and Japan, international trade still remains one of the most important sources of external shocks for the euro area. Finally, financial shocks such as equity price movements play an important role as a channel for external shocks, while the speed with which financial shocks are transmitted across the globe is much faster than shocks to output.

All in all, the comprehensive information contained in this book regarding the euro area's response to external shocks is important to the ECB for the conduct of monetary policy. In particular, external shocks affect the broad set of economic and financial indicators which are analysed under the *economic analysis* pillar of the ECB's monetary policy strategy. As shown in the various chapters, policy makers should be aware that real and financial market linkages between the euro area and the rest of the world may be changing over time both in number and magnitude, with globalisation being likely to be one important driving force behind such changes. Overall, the conclusion is that the 'external dimension' of the euro area has a complex impact on its economic developments. Moreover, increasingly important factors that are common to other economies, such as globalisation, are compounded by the fact that the euro area is a new and still rapidly transforming entity – by virtue of its own economic and financial integration in progress – and therefore many European and global structural changes are at play contemporaneously.

Against the background of larger and deeper global interconnections, the call for increasing the flexibility of the euro area economy becomes even more urgent. In rapidly changing markets and with new world players entering the scene, only timely and flexible responses can ensure a smooth absorption of external shocks. In this context, the continuation of structural reforms in the labour and product markets in the euro area countries is essential. This in turn will also encourage a better and more sustainable utilisation of human and capital resources, while enhancing the euro area's growth potential in an increasingly integrated world economy where the process of globalisation shows no signs of abating.

*Jean-Claude Trichet*

President of the European Central Bank