BEF 2004, summary session 3 (by Klaus Wälde)

This session focused on real and nominal convergence in the European Union. The general theme was whether lessons could be learned from the past experience in EU15 and whether these lessons are useful and can be applied when new member states have joined. The general view about convergence prospects was optimistic, even though some warnings were given.

An introduction to this session was given by the session chair, Steven Kaempfer (EBRD). After presenting various benefits for the new member states (reforms, more stability and catching up), he pointed out that unemployment in many of these countries is rising. There is also a large regional dispersion of unemployment. According to him, this can be understood, as usually, by not sufficiently high mobility and maybe not enough wage adjustment. He also added that more crossborder mobility of labour is desirable. Concerning nominal aspects, he pointed out that many challenges concerning the Maastrich criteria remain to be tackled and solved.

Val Koromzay (OECD) gave the first presentation on “Cyclical Convergence and Divergence in the Euro Area”. He analysed why member states do not necessarily exhibit convergence of various macroeconomic variables. He presented simulation results from a model that allow to understand diverging features as the result of asymmetric shocks or as asymmetric reactions to common shocks. Reactions to common shocks can be asymmetric because of e.g. different trade structures (in the case of the Euro dollar exchange rate shock) or differences in institutional setups, where one aspect highlighted by the presenter was the housing market.

The second presentation by Paolo Sestito (Italian Ministry of Labour) focused on convergence and non-convergence between and within EU countries. The starting point is the observation of an increasing inequality in regional GDP per capita within EU member states. This within inequality drives overall inequality in the European Union to a large and increasing extent. This fact is surprising if one believes in estimates in the literature on convergence speeds of 2%, driven basically by diminishing returns to reproducible assets. It is less surprising, when locally increasing returns and cumulative R&D processes are believed to play a role as well. Interesting conclusions for regional policy were drawn and recommended to be taken into account.

John Fitz Gerald (Economic and Social Research Institute, Dublin) focused on the four poorest member states of EU15 and analysed their convergence process towards the EU average. While Ireland had the fastest catch-up process, Spain and Portugal were somewhat slower. Convergence in the case of Greece was much less pronounced. The author warns that a "one-model-fits-all" strategy will not work. He claims, however, that free trade, an open and competitive economy, investment in human capital and an adequate infrastructure are key elements for economic prosperity. For new member states, the adjustment and convergence process will have to be longer and maybe related to higher adjustment costs (e.g. unemployment) than for these four countries. Flexible labour markets, investment in human capital and investment in infrastructure, however, will be crucial also for new member states.

Vitor Constancio (Bank of Portugal) posed the question what policies new member states should apply in order to optimise their speed of convergence. He started his presentation by claiming that high degree of trade integration, synchronisation of economic cycles and good adjustment mechanisms conditions for successful integration. Certain risks of integration were highlighted: inflation might go up too quickly and real interest rates might be misaligned. Large capital inflows bear some risk as well. A possible overheating can be counterbalanced by appropriate policies such as counter-cyclical fiscal policy, and good and prudential supervision.

These individual presentations were followed by a policy panel, consisting of Vitor Gaspar (ECB), Michael Landesmann (Institute for International Economic Studies, Vienna) and Lars Jonung (European Commission, ECFIN). Interventions by panel members stressed the importance of sound and stability oriented policies for a sustainable growth and convergence. The Balassa-Samuelson effect was discussed in some detail. An intervention with novel views stressed that any adjustment process will probably imply crises. This has been seen in the past and it will likely happen in the future again. It could therefore be argued that the best policy can do is to avoid the most costly crisis.