Research Fellowship Programme - Future of the EMU

Essay on Income convergence processes under the euro

Background

Catching up countries which adopted the euro at the time of its inception or shortly afterwards have experienced a mixed performance during the first decade of the single currency. During the decade to the global financial crisis, most of these countries (Portugal being the major exception) experienced some convergence in income per capita with the rest of the euro area. The income convergence process was facilitated by large inflows of foreign capital, mirrored in large and persistent current account deficits. In the euro area and the EU, and contrary to much of the rest of the world, capital tended to flow downhill over that period, i.e. from more advanced economies to less advanced ones. Nevertheless, with the hindsight of the crisis, it is now clear that the catching-up record under the early years of the euro was less solid than generally assumed a few years ago. Most convergence processes were associated with a comparatively sluggish productivity performance and the build up of large macroeconomic imbalances. The latter included various degrees of losses in competitiveness, private and public over-indebtedness and an excessive allocation of capital and labour resources to the non-tradable sector. These imbalances aggravated these economies' exposure to the crisis with fiscal consolidation and private sector deleveraging now weighing on the growth performance. Weak growth as a result of protracted adjustment processes in the years to come is likely to revert some of the convergence gains of the previous decade.

Aims of the essay and key questions to be tackled

The objective of this essay is to shed some light on income convergence processes under the euro with a view to better understanding why the record has so far been less successful than hoped. The work should also help designing policies that will minimise the risk of boom-bust cycles for new euro adopters with comparatively low income per capita. For that purpose, the essay should analyse in-depth the catching-up experiences of the first decade of the single currency, focusing in particular on the likely causes of a disappointing productivity record and of the emergence of large macroeconomic imbalances. The analysis should focus on early adopters of the euro but should also discuss whether risks of unsatisfactory convergence processes exist in Member Stats which have adopted the euro more recently. It should not necessarily be based on complex econometric modelling but should provide quantitative evidence of its main conclusions, including from sectoral data.

Important questions to be addressed include:

- What are the causes of a sluggish productivity observed in most catching up Member States in the first decade of the euro? To what extent is it related to an excessive allocation of capital and labour resources to the non-tradable sector?

- How has the sectoral structure of catching up economies evolved during the first decade of the euro? Has the modernisation of the industrial base been hampered by an excessive diversion of resource to the non-tradable sector.

- What are the main causes of the boom-bust cycles observed in catching-up Member States? Can these cycles be dampened and how? Have specific institutional features of these countries (e.g. labour market institutions, housing market regulations etc..) contributed to aggravate these cycles?

- What role has the euro played in the observed faults of the convergence processes? Are the risks of unbalanced convergence processes more likely in EMU?

- What lessons from past experience can be drawn for Member States which have joined the euro recently or plan to do so in the coming years? Should the conditions for euro adoption be reviewed to better address risks of boom-bust cycles? What is the best way to ensure that new euro entrants are well-prepared for smooth integration into the euro area, notably by minimising the risk of build up of imbalances and making sure that an appropriate adjustment capacity is in place?