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# **REAL AND NOMINAL CONVERGENCE IN THE EUROPEAN UNION**

## **WHICH TYPE OF CRISES IS BEST FOR CONVERGENCE?**



## **THE OPTIMISTIC VIEW:**

**CONVERGENCE WILL BE A GRADUAL PROCESS WHERE THE NEW MEMBER STATES IN THE EAST EVENTUALLY WILL “CATCH-UP” WITH THE OLD MEMBER STATES IN THE WEST.**



**THE NEW MEMBER STATES WILL TURN TO MATURE ECONOMIES FOLLOWING A SMOOTH PATH SIMILAR TO THAT OF SOME EMERGING ECONOMIES IN THE PERIPHERY OF EUROPE IN THE FIRST PERIOD OF GLOBALIZATION – THAT IS DURING THE CLASSICAL GOLD STANDARD BEFORE 1914.**

**THE CASE OF THE SCANDINAVIAN COUNTRIES – COLONIES LIKE CANADA AND AUSTRALIA.**

**THIS IS AN “EQUILIBRIUM STORY”.**



**I WILL FOCUS ON THE RISKS – OR CHALLENGES - OF FINANCIAL CRISES.**

**A “DISEQUILIBRIUM STORY” BASED ON THE EVIDENCE FROM FINANCIAL CRISES FROM THE 1990S (THE SECOND PERIOD OF GLOBALIZATION) AS WELL AS FROM THE FIRST PERIOD OF GLOBALIZATION.**



**MY STARTING POINT:**

**THE HISTORICAL EVIDENCE SUGGESTS THAT ANY COUNTRY GOING THROUGH A RAPID TRANSFORMATION IS LIKELY TO FACE CRISIS.**

**WE HAVE SEEN IT IN THE PAST. AND WE WILL SEE IT IN THE FUTURE.**

**CHINA AND INDIA WILL FACE CRISES.**



## **LESSONS FROM FINANCIAL HISTORY**

**LESSON 1. EMERGING ECONOMIES ARE LIKELY TO EXPERIENCE FINANCIAL CRISES  
(MEXICO, ARGENTINA, BRAZIL, ASIA, RUSSIA)**

**LESSON 2. ECONOMIES THAT LIBERALIZE THEIR FINANCIAL SYSTEM ARE LIKELY TO EXPERIENCE FINANCIAL CRISES (FINLAND, SWEDEN, THE ERM-CRISIS)**

**THE NEW MEMBER STATES ARE EMERGING ECONOMIES GOING THROUGH A PERIOD OF LIBERALIZATION. THE RISKS ARE HIGH.**



## **THE POLICY PERSPECTIVE:**

### **THE “MENU” OF FINANCIAL CRISES.**

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**A. CURRENCY CRISES**

**B. BANKING CRISES**

**C. TWIN CRISES (A + B)**

**D. DEBT CRISES**

**E. OTHER FINANCIAL CRISES (STOCK MARKET  
CRISES ETC)**

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**THE POLICY QUESTION:**

**WHICH TYPE OF FINANCIAL CRISES IS THE “BEST”  
ONE FOR THE MEMBER STATES?**

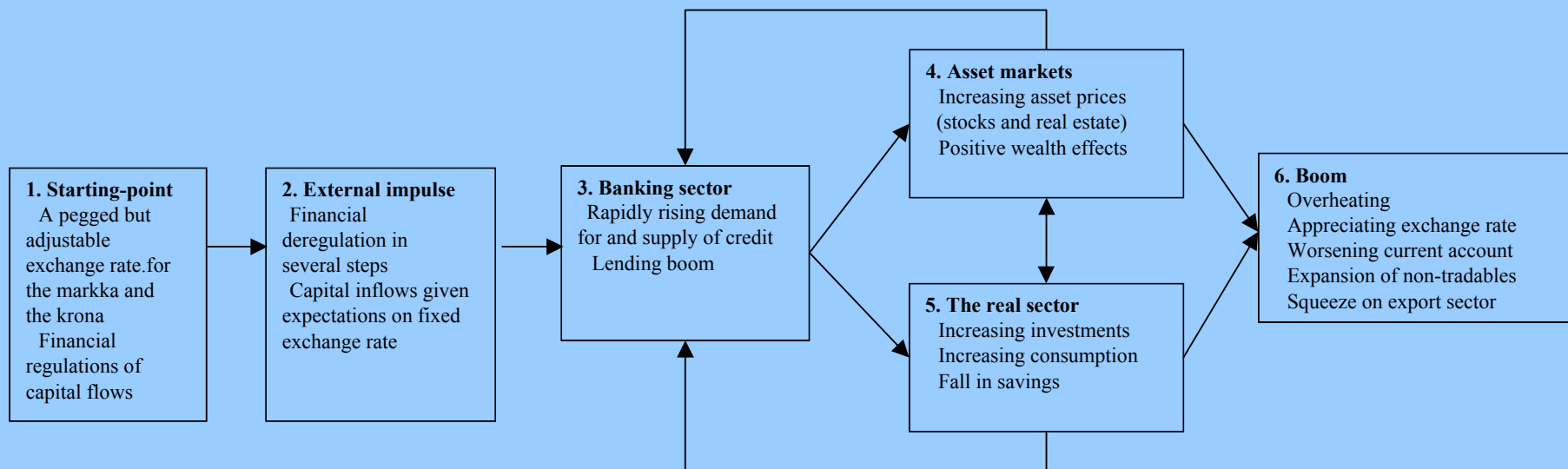
**BY NOW WE HAVE A COMMON “STYLIZED” PICTURE  
OF THE PROCESS OF FINANCIAL CRISES IN THE  
1990S**

**WE HAVE EMPIRICAL MEASURES OF THE COST OF  
CRISES, DEPTH AND RECOVERY TIME, FREQUENCY  
ETC.**



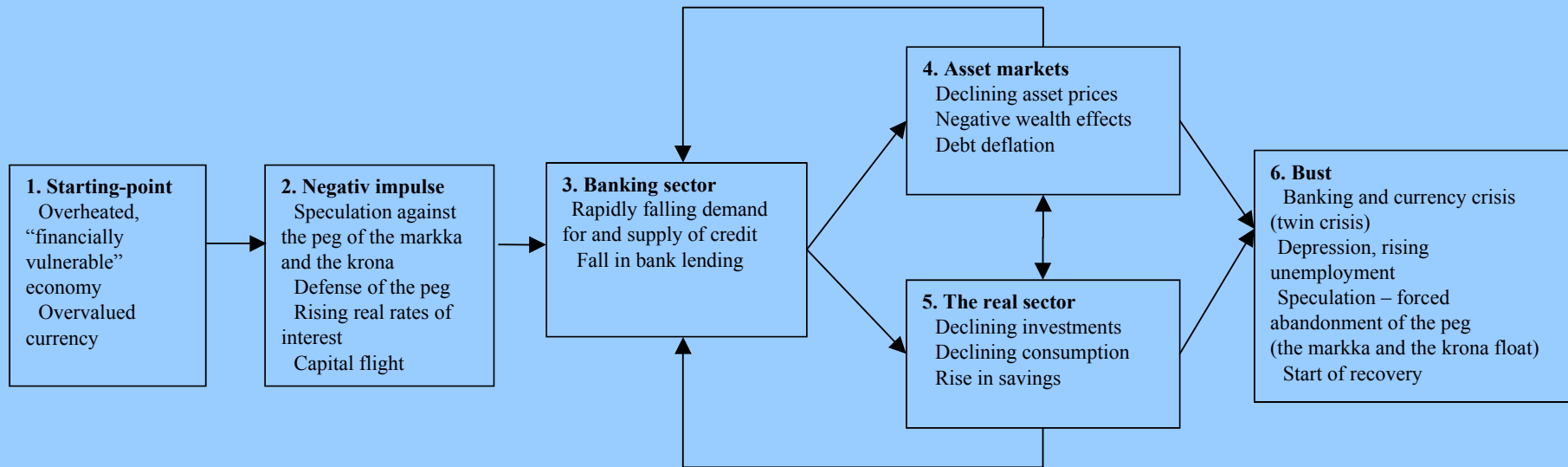


# Boom phase





# Bust phase





**WHICH TYPE OF CRISES SHOULD WE AVOID?**

**COST OF CRISES LITERATURE DEVELOPED  
RECENTLY GIVES SOME RECOMMENDATIONS**

**THE EVIDENCE FROM IMF, BORDO, EICHENGREEN  
AND OTHERS**



**Figure 1. Crisis Frequency**  
(per cent probability per year)

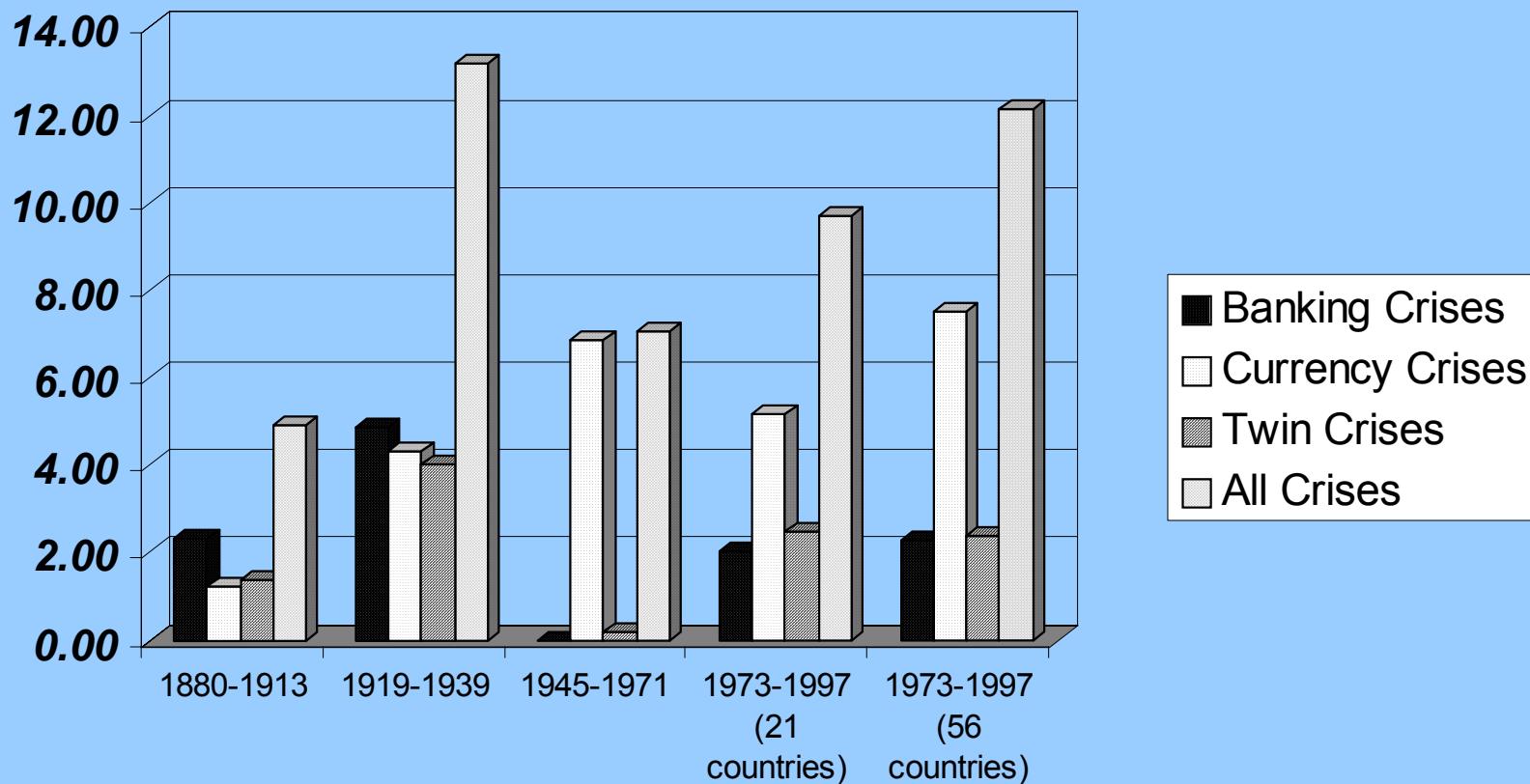
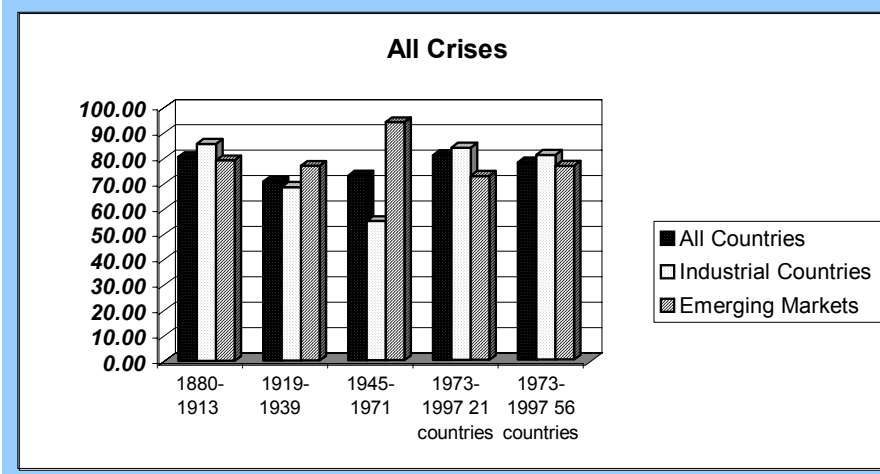
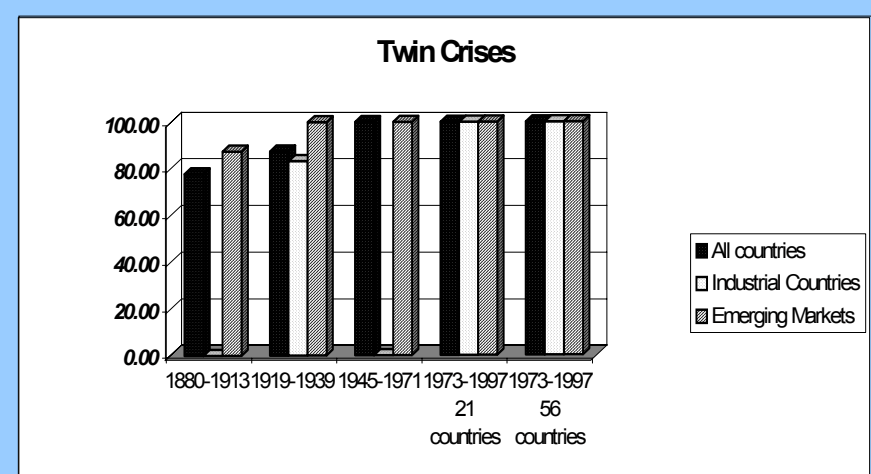
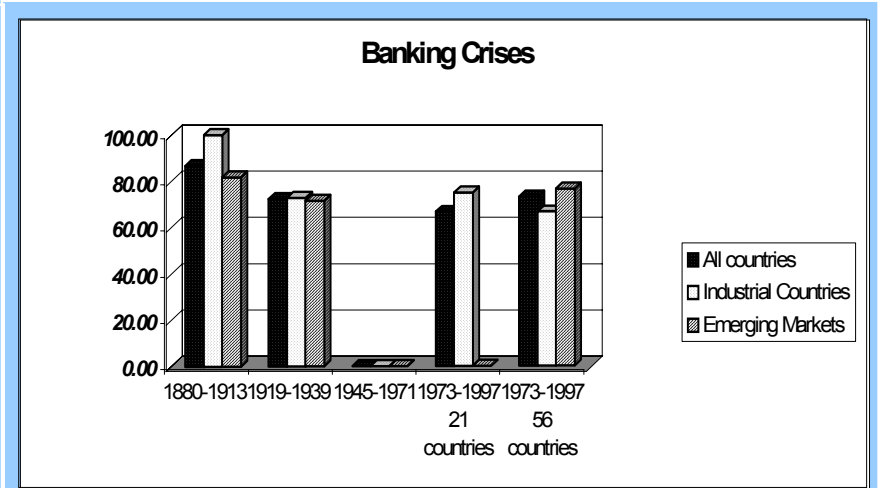
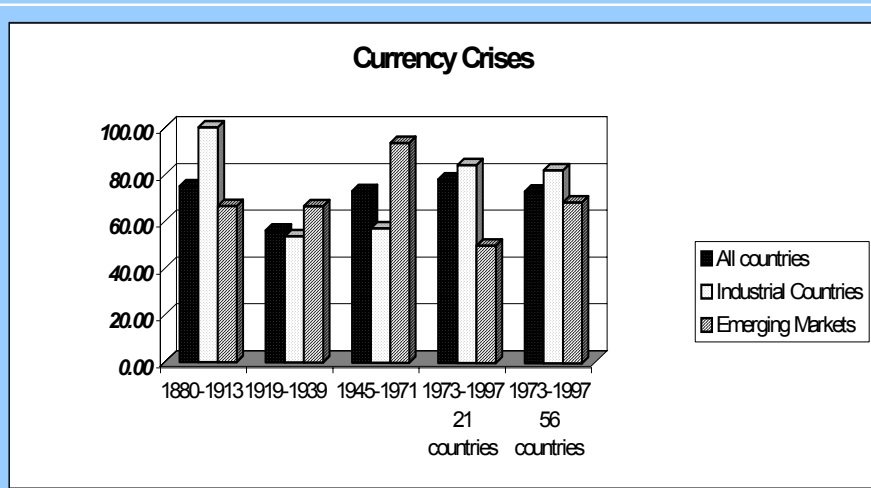




Figure 5. Crises with Output Losses - Percentage of Total





**CHOOSE A CRISIS THAT ARE HAVE SHORT  
RECOVERY TIME:**

**AVOID LONG CRISES – AVOID DEPRESSIONS  
(HIGH COSTS IN TERMS OF FOREGONE OUTPUT  
LONG RECOVERY TIMES)**

**THE POLITICAL ECONOMY OF CRISES HAS  
IMPORTANT LESSONS**



**Q: WHICH MARKET SHOULD TAKE THE ADJUSTMENT?**

**A: THOSE WITH A MINIMUM OF NOMINAL RIGIDITIES – THUS WITH RAPID ADJUSTMENT.**

**FINANCIAL MARKETS (RAPID CLEARING)**

**CURRENCY MARKETS**

**ASSET MARKETS (CREDIT AND CAPITAL MARKETS)**

**LABOR MARKETS (SLOW ADJUSTMENT – CLEARING)**



**SKILLFUL POLICY-MAKERS SHOULD PICK:**

**GOOD CRISES - RAPID AND SHORT ONES – BY USING  
FINANCIAL MARKETS**

**CURRENCY CRISIS AND BANKING CRISIS**

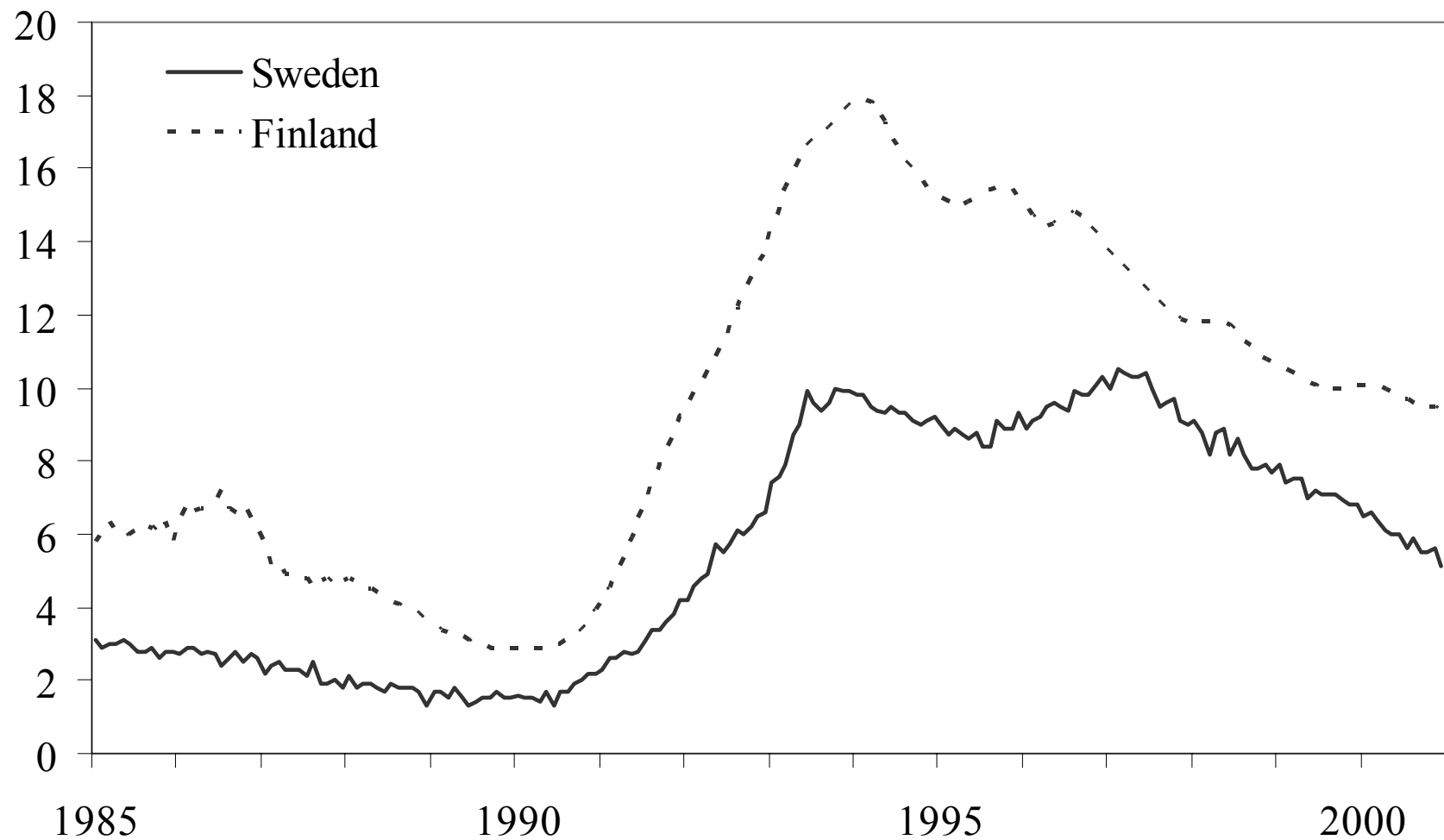
**AVOID BAD CRISES – TWIN CRISES, LABOR MARKET  
CRISIS AND DEPRESSIONS**

**LOOK AT FINLAND AND SWEDEN IN THE 1990s**





## Unemployment rate in Finland and Sweden.





**THE CHOICE OF EXCHANGE RATE REGIME.**

**LESSON: NEVER DEFEND A PEGGED BUT  
ADJUSTABLE RATE.**

**THE BIPOLAR VIEW: EITHER A FLOATING  
EXCHANGE RATE OR AN IRREVOCABLY FIXED  
RATE. THE MIDDLE GROUND – THE PEGGED RATE –  
HAS DISAPPEARED.**

**THE EXCHANGE RATE IS THE MOST IMPORTANT  
PRICE IN A SMALL OPEN ECONOMY – IT SHOULD BE  
USED WISELY**



**DO THE NEW MEMBER STATES HAVE TO WALK THE  
VIA DOLOROSA OF FINANCIAL CRISES?**

**NOT NECESSARILY – BUT THE RISKS ARE GREAT.**



**LET ME END WITH AN OPTIMISTIC TONE:**

**FINANCIAL CRISES ARE ASSOCIATED WITH OUTPUT LOSSES.**

**BUT THERE ARE LONG RUN BENEFITS. FINANCIAL CRISES ARE FOLLOWED BY RAPID GROWTH. THIS HOLDS FOR MANY COUNTRIES THAT HAVE GONE THROUGH CRISES**

**WHICH IS THE FASTEST ROUTE TO MATURITY: FINANCIAL STABILITY OR FINANCIAL CRISIS.**

**THE FUTURE CONVERGENCE PROCESS OF THE MEMBER STATES MAY TELL US?**