Who should care about divergence within EMU?

Brussels Economic Forum, 31 May 2007

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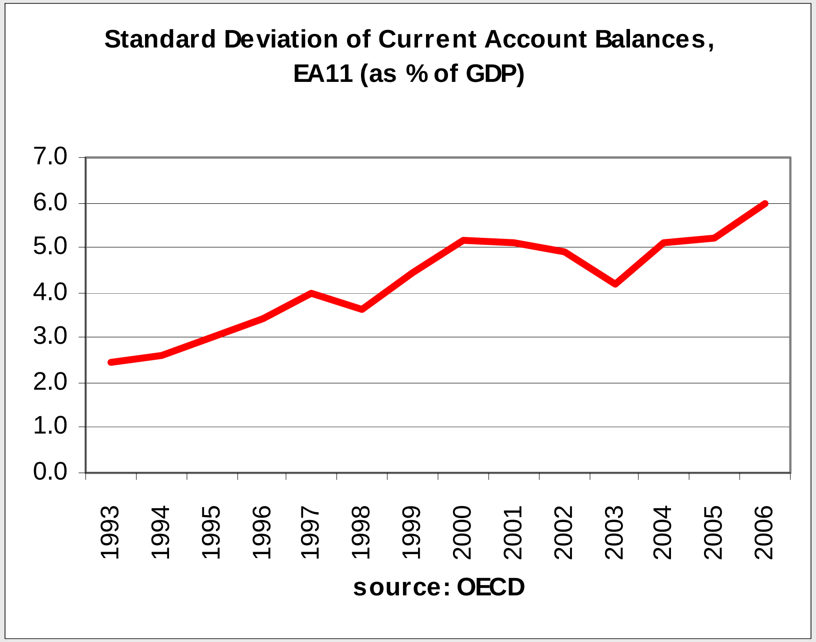
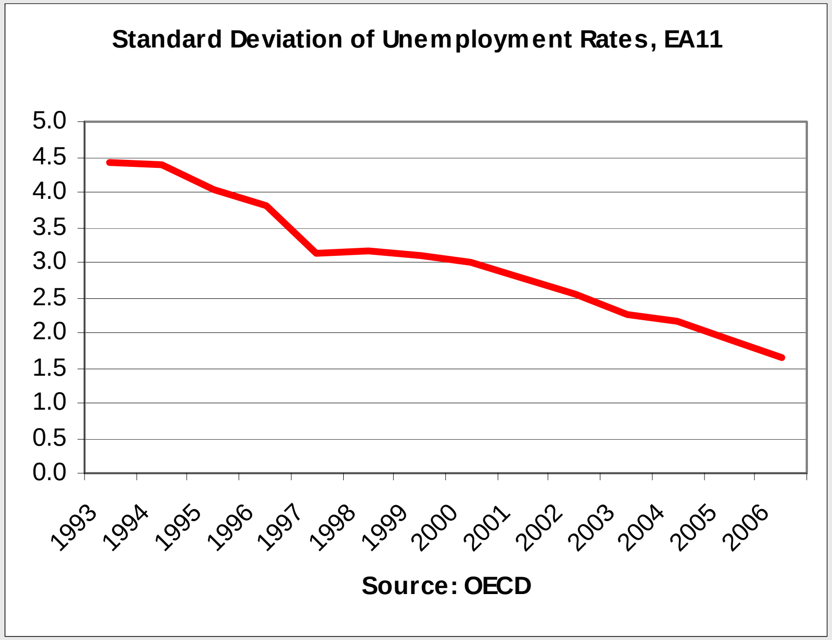
The issue

- **Since 2005, new concern about divergence of:**
  - Inflation
  - Growth
  - Current accounts
- **Is it justified?**
- **If so, who should care about divergence?**
  - Governments?
  - Eurogroup?
  - ECB?
- **What could be done?**

The happy side of divergence

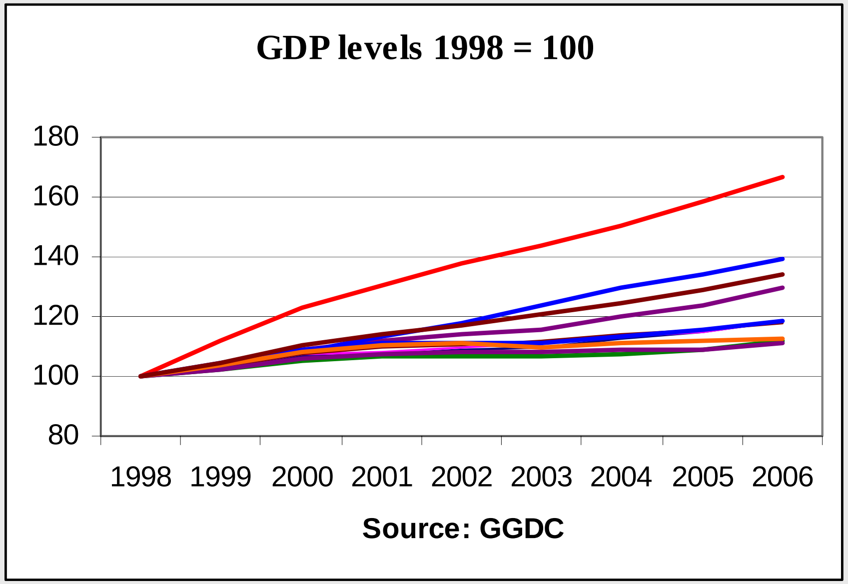
- **Current account divergence…**
- **…and unemployment convergence**

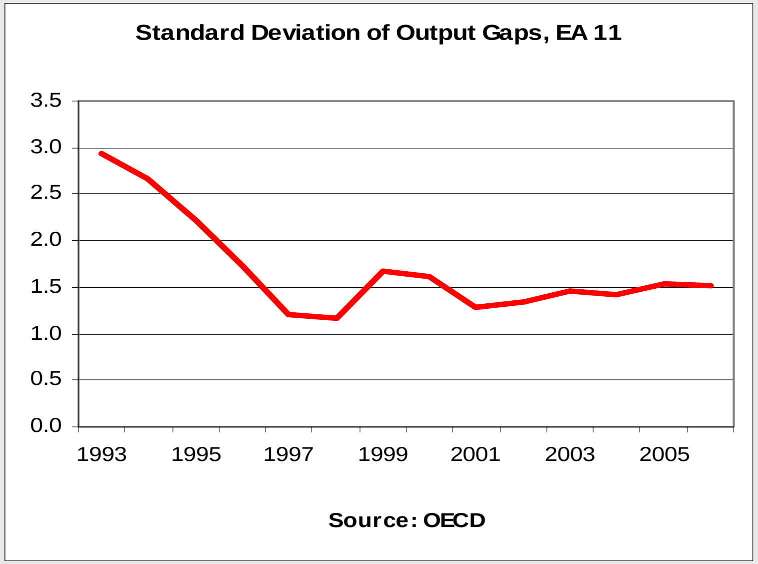




The happy side (contd..)

- Different growth performance..
- ..But a common cycle





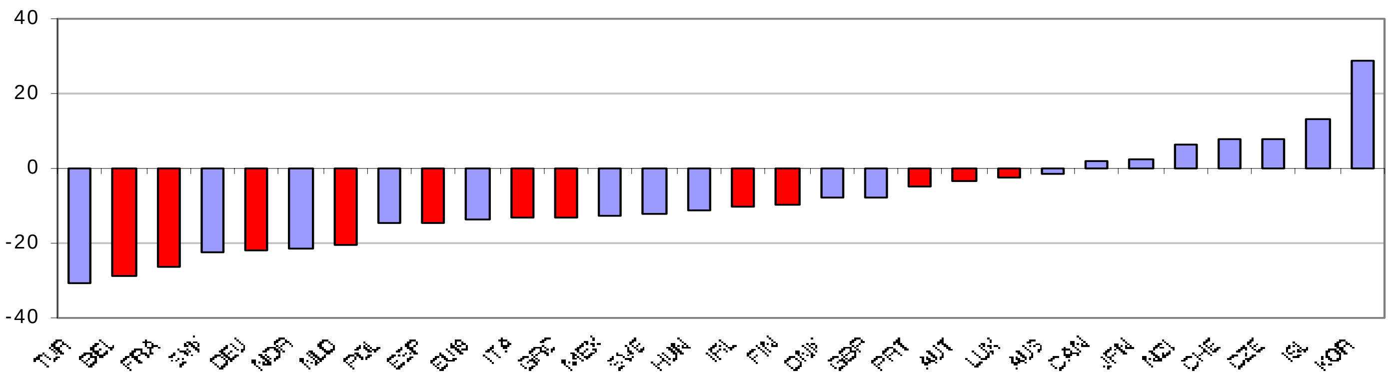
What those data remind us

- **EMU is not about making all countries' performance converge**
- **It is about creating a common stability framework where:**
  - Countries can unleash their growth potentials
  - Good policies are rewarded
  - Catching up can take place (hopefully faster)
  - Temporary shocks can be smoothed out
- **Those evolutions imply divergence in growth / real wages / inflation / current account performance**

When is divergence a problem? For whom?

- **Inferior performance is fundamentally a problem for national governments if it results from e.g.:**
  - Low labour utilisation (see below)
  - Low productivity gains
  - Low migration inflows
- **Issue for the euro area is only one of incentives to reform**

Labour utilisation, 2005 (gap vis-à-vis the US)



Source: OECD

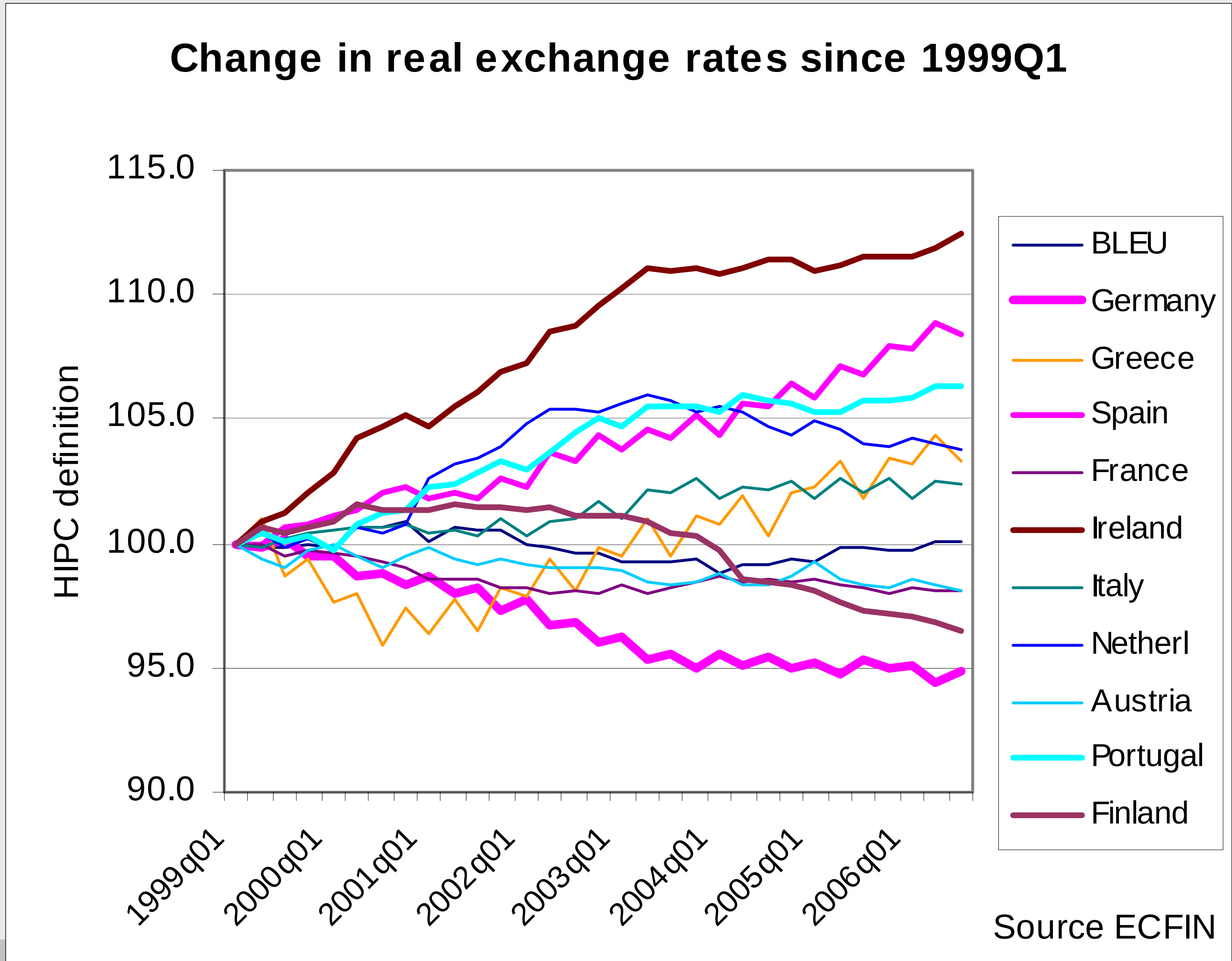
Potential problems for the euro area

- **If divergence "risks jeopardising the proper functioning of economic and monetary union" (Art. 99)**
- **Possibilities:**
  - Divergent optimum interest rates → Disagreements over monetary policy
  - Divergent real exchange rates

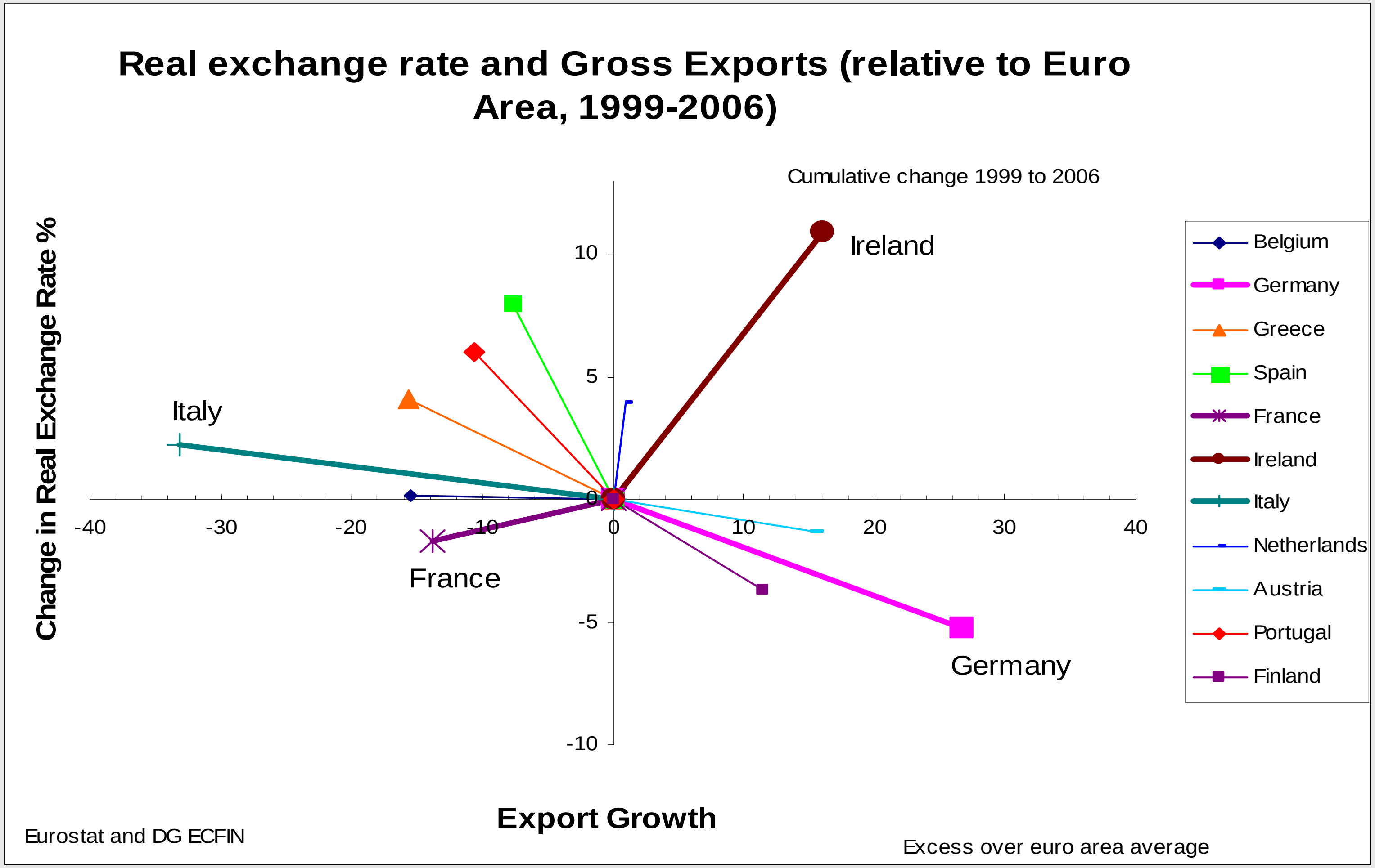
  → disagreements over exchange rate policy

  → potential spill-overs on trade / single market / competition policy
  - At the limit contagion effects of exit (or threat to exit)
  - Threats to financial stability

Persistent inflation differentials and changes in real exchange rates



Real Exchange Rates vs. Export Performance



The wider evidence

- **Entry shocks have had lasting consequences**
  - Portugal still undergoing adjustment
  - Slow correction of initial misalignments (Germany)
- **New sources of divergence**
  - Real effects of trade shocks
  - Wages developments in non-tradable sector unrelated to productivity growth
  - Divergence in real estate prices fuelling wealth effects, construction boom/ bust cycles (Spain)
- **Adjustment through competitiveness channel remains painfully slow**

Policy implications (1): Structural dimensions

- **Need to prevent the build-up of excessive real appreciation through**
  - Better responsiveness to disequilibria
  - Integration of sheltered markets
  - Stronger adjustment mechanisms
- **Paradox is that euro area lagging behind on single market, product market regulation**
- **Role for governments**
- **Role for EU/Eurogroup**
  - Reform and integration programme
  - Incentives to reforms

Policy implications (2): The case for surveillance

- **Regime preservation calls for surveillance of national performance**
- **Non-budgetary risks were overlooked in early years of EMU, but "It's all fiscal" assumption is complacent**
  - Compliance with 3% limit doesn't avoid divergence (Portugal 2000)
  - Fiscal rectitude does not prevent financial crises (Sweden 1992)
  - But fiscal stance can be geared to avoiding divergence build-up
- **Therefore need for:**
  - Analysis, "ruthless truth-telling", early warnings by Commission
  - Possibility of giving mandate to Eurogroup president to initiate dialogue with national authorities
  - Political consensus for issuing non-SGP related recommendations under Art. 99 (legal instrument)

Policy implications (3): Implications for candidate countries

- **For countries starting from very different initial conditions, agility matters more than nominal entry criteria**
- **Narrow interpretation of the inflation criterion is misguided**

Thank You For Your Attention

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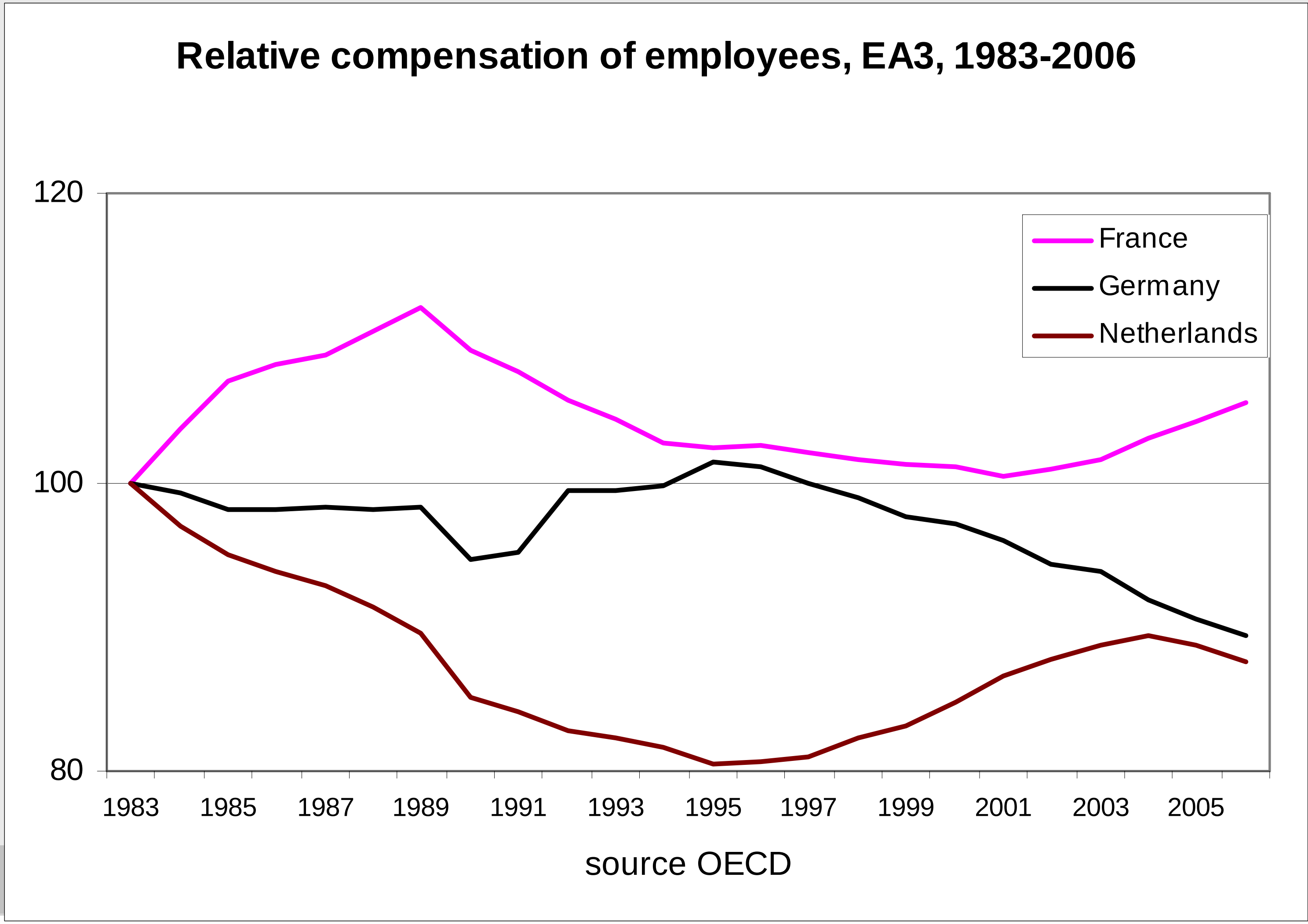
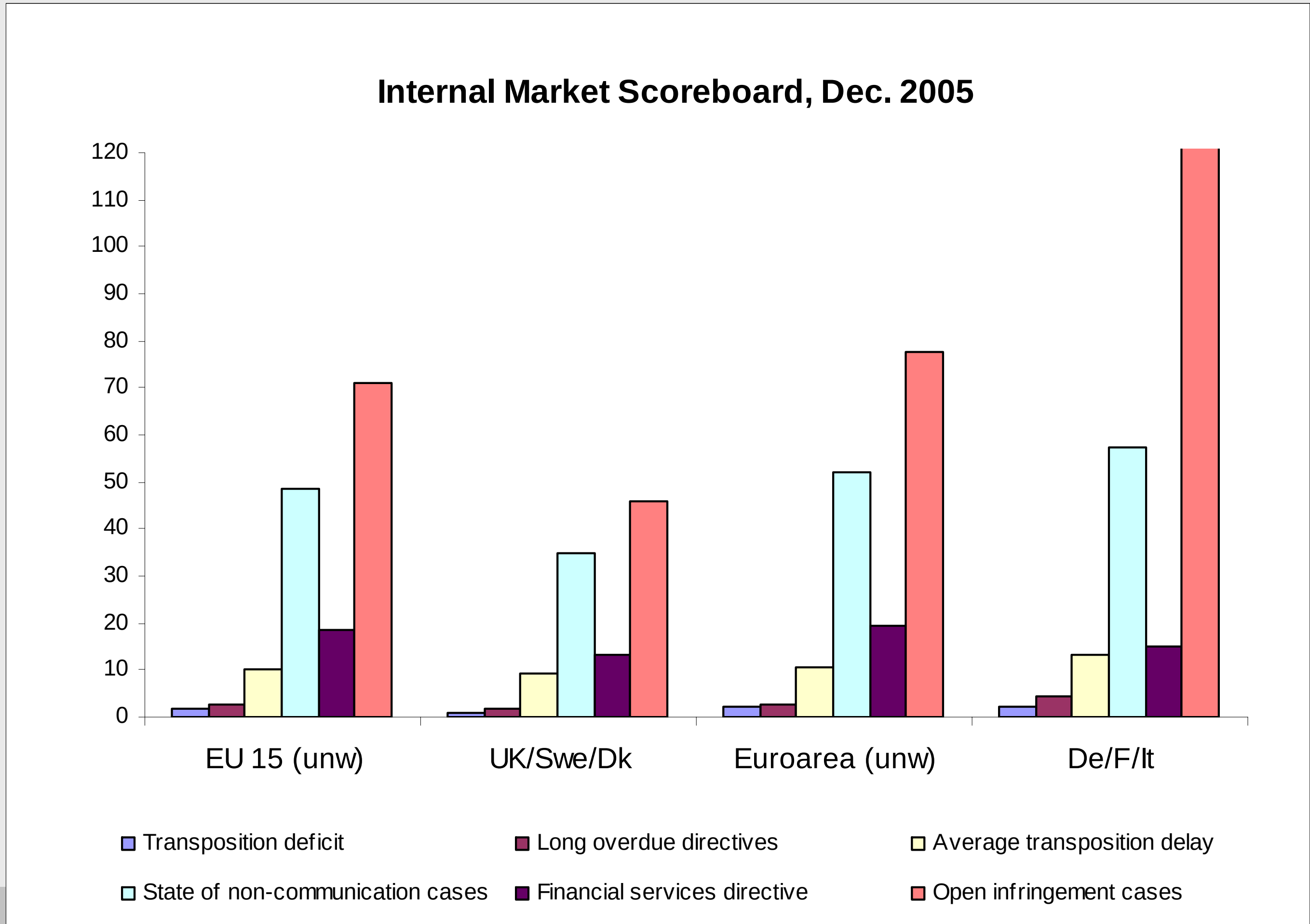
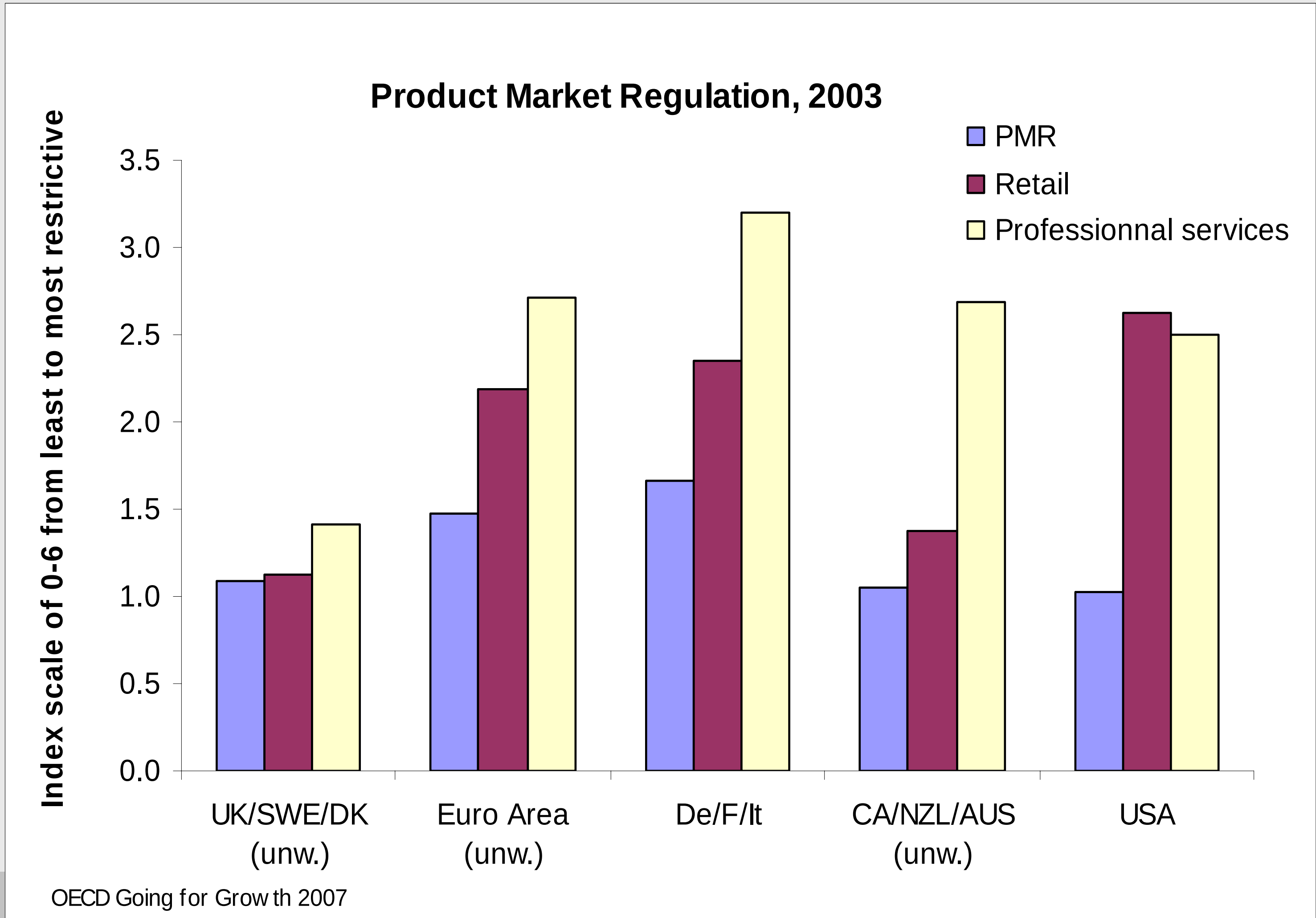
Germany/France/Netherlands: Evidence of long real exchange rate cycles



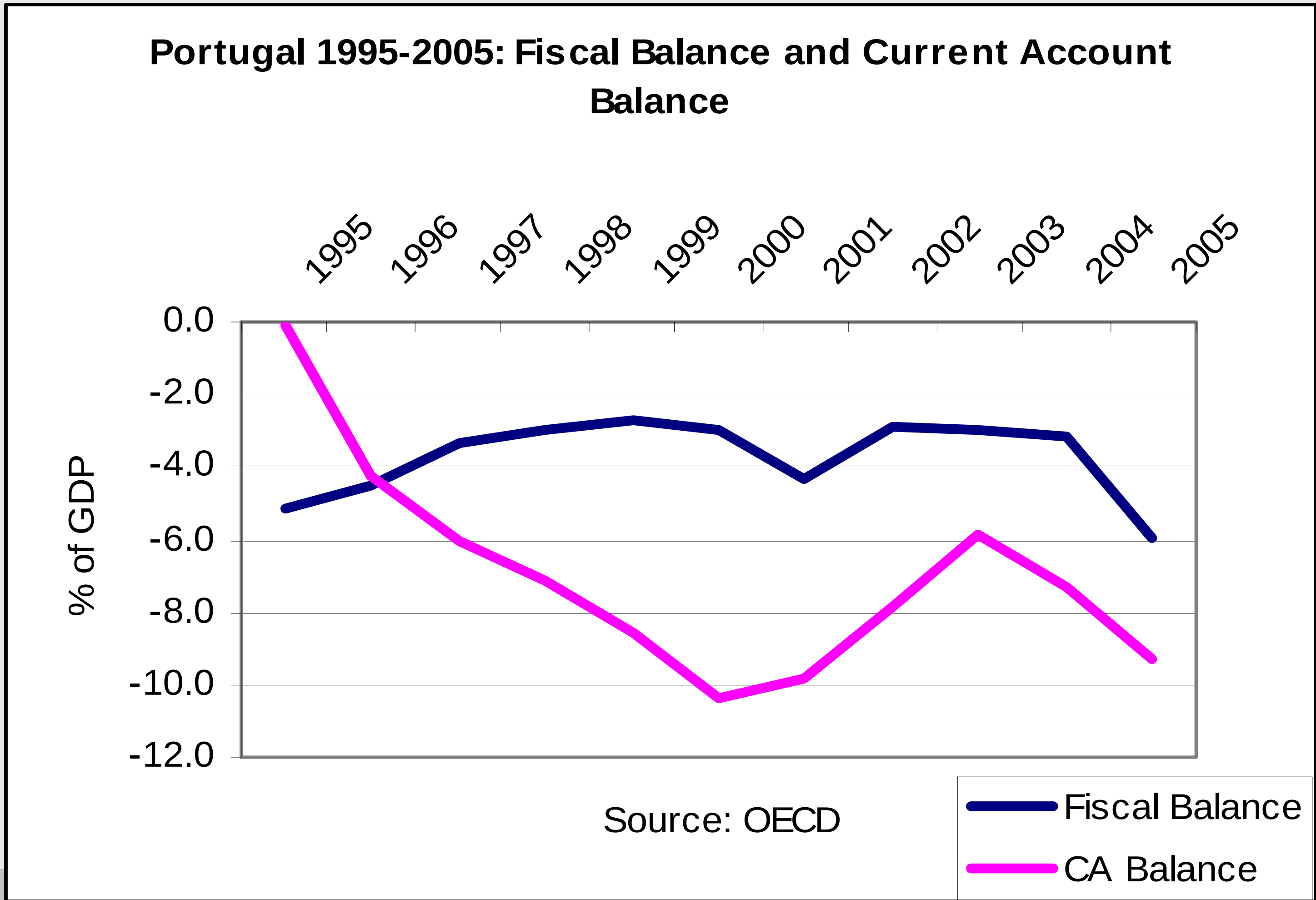
Delays in implementation of internal market



Product market regulation



Portugal: CA deficit unrelated to budget



Sweden 1990s: Fiscal restraint did not stop the credit bubble