Current EMU Divergence: Lessons for an Enlarged EMU

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Divergence within the euro area

- Divergence in various indicators, such as:
  - GDP growth; Inflation; Current account balance; House price developments; Credit growth; Real effective exchange rate developments; Export performance; ... and crisis response

- Divergence is not ‘bad’ in itself: some divergence is even warranted in a heterogeneous monetary union

- However, persistently low growth performance, the build up of vulnerabilities, and large volatility in response to a crisis are undesirable

- Prospective euro area applicants should learn from the lessons of current euro area member states
Outline

1. Pre-crisis period: lessons from the divergence within the euro area

2. Crisis: different responses across euro area member states

3. EMU divergence lessons for euro area entry criteria

4. Some closing thoughts
Divergent growth trends after euro area entry

GDP per capita at PPP (US=100), 1950-2014

2009-2014 forecasts are from the October 2009 World Economic Outlook of the IMF
Divergent inflation rates after euro area entry

Annual inflation, 1995-2010

2009-2010 forecasts are from the October 2009 World Economic Outlook of the IMF
Divergent CA developments after euro area entry

Current account balance (% GDP), 1970-2014

2009-2014 forecasts are from the October 2009 World Economic Outlook of the IMF
Divergent property price developments after euro area entry

Real house prices (change in % - 1999-2007)

Divergent credit developments after euro area entry

Credit to the private sector (% GDP), 1995-2009
Divergent ULC real exchange rate and export developments after euro area entry

Cumulative change from 1999 to 2010

The end points of the curves denote 2010

2009 and 2010 forecasts are from the DG ECFIN October 2009 forecast
Sectoral developments in ULC: Divergence across countries and sectors
2000Q1-2009Q1
1. EMU divergence lessons: adjustment within the euro area can be painful

- Some countries fared well within the euro area, while others lagged behind.

- Nominal interest rate convergence: countries with higher inflation (e.g. Greece, Ireland, Spain, Portugal) faced low real interest rates, while countries with low inflation (e.g. Germany) faced high real interest rates.

- Some countries (e.g. Portugal, Germany) probably joined the euro with an overvalued real exchange rate: Portugal has even lost competitiveness further while Germany gained due to wage restraints.

- The damaging effects of divergences call for painful corrective adjustment in member states that have marred by a loss of competitiveness.
1. EMU divergence lessons: adjustment within the euro area can be painful

- The ‘competitiveness channel’ needs to be strengthened by fostering wage and price flexibility
- Enhanced surveillance
- Macro-prudential supervision
- Regulation to alleviate bubbles
- Counter-cyclical fiscal policies
- Education/Innovation to help moving up in the value chain

Lesson for future CESEE euro area applicants that are most likely to face problems similar to those of Ireland and Spain: difficult, though not impossible, to manage a catching-up economy in a monetary union
Crisis response of output: Not really related to trend growth

2009-2014 forecasts are from the October 2009 World Economic Outlook of the IMF
Crisis response of unemployment: Sharp increases in some countries

2009-2011 forecasts are from the October 2009 DG ECFIN forecast
General government balance before and after the crisis: Large differences
General government gross debt before and after the crisis: Large differences
Crisis response of government default risk: sharp contrast between euro area members and non-euro area NMS (despite differences in debt)

Credit default swap on 5-year government bonds
2 January 2008 – 6 November 2009
Non euro-area CEEs pay a much higher price for the same level of government debt.
Credit default swap vs. net external debt

Non euro-area CEEs pay a much higher price for the same level of net external debt of the country.
2. Crisis lessons

- Euro area countries: vulnerable and more export dependent countries suffered more (similarly in CESEE)
- Being inside the euro area helps
  - Credibility effect
  - ECB facilities at a time of drying-up of money markets
- The period of capital abundance may be over and countries within the euro area may have better positions in acquiring foreign capital with consequences on investment and growth
3. EMU divergence lessons for euro area entry criteria

- The criteria was set up to measure a “high degree of sustainable convergence”

- It has been a rule rather than the exception that euro-area members have violated the entry criteria since becoming members, both before the crisis and currently
The percentages are calculated from the actual euro-area member states in each year (and the first eleven members before 1999). A country is considered to meet the debt criterion if either the debt/GDP ratio is below 60 percent or, if above, then projecting the average change in debt/GDP ratio of the latest three years twenty years ahead will lead to a ratio below 60 percent. Three percent is used for the budget deficit criterion.
3. EMU divergence lessons for euro area entry criteria

- The large number of violations after euro-area entry suggests that the criteria are inadequate for judging "high degree of sustainable convergence".

- This fundamentally calls into question both the economic and moral foundations of the future application of the current entry criteria.

Other reasons to reform the criteria:

- The criteria have been applied “flexible” in the past.
  - E.g. Italy, Belgium and Greece were allowed to join with debt levels above 100% of GDP; Italy, Finland and Slovenia did not spend the minimum two-year period in the exchange rate mechanism before the examination; The exchange rate of the Slovak koruna appreciated by about 25% in the final two years

- Keeping the same rules in an expanded EU violates the equal treatment principle, because the inflation criterion became tougher by the expansion of the EU from 15 to 27 members.
3. EMU divergence lessons for euro area entry criteria

All criteria should be related to the euro-area average:

- All prospective applicant countries are highly integrated into the euro area, and hence what happens inside matters a lot for those outside.

- It would abolish the peculiar possibility that non-euro-area countries or very small countries with which the applicant has virtually no trade may affect the criteria.

- It would alleviate the asymmetry of letting the automatic stabilisers run and helping the economy with discretionary stimulus in euro-area countries while doing the painful opposite of this in applicant countries during a crisis.

- It would remove the property that most countries can join only in good times.

- As countries in the euro area are declared to have achieved "a high degree of sustainable convergence", the convergence of applicant countries towards the euro-area average seems a natural requirement.
Is there a way to reform the criteria without a formal Treaty change?

- Yes. The EU treaty itself specifies an obligation on the Council to lay down the details of the convergence criteria and the excessive deficit procedure.

- “The Council shall, acting unanimously on a proposal from the Commission and after consulting the European Parliament, the ECB as the case may be, and the Economic and Financial Committee, adopt appropriate provisions to lay down the details of the convergence criteria referred to in Article 140(1) of the said Treaty, which shall then replace this Protocol.” (Article 6 of Protocol 13 of the EU Treaty)

- Two decades after the designing of the criteria and one decade since the launch of the euro it is time to reform the criteria and to strengthen their economic rationale.
4. Some closing thoughts

- Main EMU divergence lesson: difficult, though not impossible, to manage economic catching-up in a monetary union
- For some CEE countries the flexible exchange rate (when supported by credible macroeconomic policies) served well both before and during the crisis
- For these countries the additional credibility effect of joining the euro area should be weighted against the benefits of the floating rate and the risk of repeating the examples of Spain or Portugal
- Baltics – very different circumstances
- The decision whether to apply for euro area membership should be given to the applicants. To facilitate this, it is time to reform the euro area entry criteria and to strengthen their economic rationale.
Thank you for your attention

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