Disparities in the euro area: a problem for European economic policy

Catherine Mathieu, Henri Sterdyniak

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Catherine Mathieu and Henri Sterdyniak (OFCE), Ewald Walterskirchen (WIFO)

Before the launch of the euro, the proponents of EMU thought that the introduction of a single currency would enhance growth and entail economic convergence within member states. This convergence would have facilitated policy coordination in the euro area. But since 1999 there have been instead increasing divergences in terms of GDP growth in the monetary union and economic policy answers have been unable to tackle these divergences.

From the very beginning, the EMU was strongly oriented towards price stabilisation and budget consolidation. The reduction of inflation rates and budget deficits in the euro area by about one half (from 1985/1995 to 1995/2005) was a success, besides the introduction of the euro. But the expected positive effects on GDP growth from stabilisation policies and the internal market did not turn up. Despite price convergence, the inflation rates remained higher in the South of Europe (mainly due to higher growth). Higher inflation rates in Spain and Greece did not result in lower growth through a loss in competitiveness, but in higher growth due to the effect of low real interest rates on housing and construction.

We intend to point out three issues. Disparities in growth, inflation and current account balances are a problem in the euro area. The current functioning of the euro area increases growth disparities between the Member States. It is not only domestic problems which could be improved by increasing flexibility in each country: it is the functioning of EMU that should be improved, especially in an enlarged euro area which will increase disparities further.

The euro area experienced robust growth between 1984 and 1991. Growth decelerated by 1.3 percentage points in the 1992-1998 period under the effects of the bad management of the reunification and the cost of the process to meet the Maastricht criteria in order to join the euro area (Table 1). The launch of the single currency did not enable the area to achieve more satisfactory growth. Euro area GDP growth has since 1992 been clearly lower than in the UK or the US, contrary to the situation prior to 1991. GDP growth accelerated in two countries: Ireland and Greece, and remained strong in Spain. The main losers were Germany, Italy, Portugal and the Netherlands.

Greece and Spain have been converging in terms of GDP per head (at PPP) but Portugal and Italy have been diverging downwards and Ireland upwards.

Many economists explain low growth in the euro area by low trend output in recent years. According to them, growth may only be increased by higher productivity (through more R&D and education investments), and by more ample labour supply (through immigration and longer working hours). But activity rates, unemployment rates, labour productivity and even population (immigration) depend on growth. Observed low trend growth cannot be said to be explained only by supply factors. For instance, a country may suffer from high real interest rates or low competitiveness or a sharp decline in housing prices which will induce low growth for many years.

Table 1. GDP Growth rates

	1985-1991	1992-1998	1999-2005	GDP per head 1998	GDP per head 2005
Euro area	**3.1**	**1.8**	**1.9**	**100.0**	**100.0**
Belgium	2.7	1.8	2.0	106.5	111.1
Germany	3.5	1.5	1.3	104.1	102.0
Greece	1.7	1.8	4.3	64.6	78.9
Spain	3.9	2.3	3.6	81.4	92.6
France	2.6	1.8	2.2	104.5	102.6
Ireland	4.0	7.2	6.5	106.9	130.4
Italy	2.9	1.3	1.2	105.2	97.8
Netherlands	3.6	2.7	1.7	113.7	116.7
Austria	3.1	2.2	2.0	112.9	115.5
Portugal	5.1	2.4	1.6	71.5	66.1
Finland	1.8	2.5	2.8	103.1	106.3
UK	**2.6**	**2.7**	**2.7**	**102.5**	**109.4**
US	**2.8**	**3.6**	**3.0**	**139.5**	**140.7**

Source: European Commission, own calculations.

With the same nominal interest rate, countries experienced different inflation and growth-corrected interest rates (table 2). The ECB monetary policy was particularly expansionary for Ireland, Greece and Spain, but restrictive for Germany. So firms and households in Ireland, Spain and Greece have had a strong incentive to borrow and to invest, which has induced strong domestic growth.

At the euro area level, the ECB monetary policy appears less growth-oriented than the Fed policy in good and in bad times. This implies that fiscal policies need to be more expansionary in the euro area in low growth periods.

Table 2. Real interest rates less GDP growth rates

	1992-1998	1999-2005
Euro area	**2.5**	**-0.6**
Belgium	1.6	-0.6
Germany	1.6	1.1
Greece	6.7	-3.3
Spain	2.1	-4.4
France	2.9	-0.5
Ireland	-3.5	-7.3
Italy	3.9	-0.6
Netherlands	0.9	–1.4
Austria	1.3	–0.4
Portugal	1.6	–1.7
Finland	1.3	–0.9
UK	**3.7**	**0.3**
US	**–0.1**	**–2.4**

Source: European Commission.

During the 1999-2005 period, the adjusted wage share in GDP decreased in 8 of the euro area member states (table 3). From 2000 to 2005, real compensation per workers increased only by 0.35 % by year in Germany, 0.5% in Austria and in Italy, 0.6% in Belgium, when it increased by 1.3% in France, 1.5% in the Netherlands, 2.5 % in the UK. Restoring profitability and improving competitiveness through pressure on wages has become an important strategy for firms in many countries, especially in Germany. This boosted exports but put a drag on private consumption in these countries, thus dampening demand in the whole euro area.

Table 3. Adjusted wage share in GDP

	1998/2005
Euro area	**-1.5**
Belgium	-1.3
Germany	-1.6
Greece	-4.3
Spain	-5.0
France	-0.7
Ireland	-2.8
Italy	-0.7
Netherlands	0.5
Austria	-5.8
Portugal	3.3
Finland	1.9
UK	**3.1**
US	**-0.9**

Source: European Commission.

In this non-cooperative game, the winners were Germany and Austria (table 4) which succeeded to sustain GDP growth by a positive contribution of net exports (by around half percentage point of GDP each year). The losers were Spain (0.7 percentage point per year), and France (0.7). But low growth of domestic demand in Germany, Austria and the Netherlands negatively affected growth in the whole euro area.

Table 4. GDP and domestic demand growth rates. 1999-2005

	GDP	**Domestic demand**
Euro Area	**1.9**	**2.0**
Belgium	2.0	2.2
Germany	1.3	0.8
Greece	4.3	4.2
Spain	3.6	4.3
France	2.2	2.9
Ireland	6.5	6.4
Italy	1.2	1.6
Netherlands	1.7	1.3
Austria	2.0	1.4
Portugal	1.6	1.6
Finland	2.8	3.3
UK	**2.7**	**3.1**
US	**3.0**	**3.6**

Source: European Commission.

Globally, the euro area lost competitiveness between 1998 and 2005, mainly due to the effect of the appreciation of the euro vis-à-vis the US dollar. However a weaker exchange rate would be needed to help lowering the high unemployment rate in the euro area. Exchange rates entry levels in the monetary union were not appropriate for all countries (Germany or Italy, for instance). Under a fixed nominal exchange rate and rigid inflation rates, persistent misalignment periods follow, which induces restrictive wage policies. Since 1998, Ireland, Austria and Germany have succeeded in gaining competitiveness vis-à-vis Southern European countries. Since devaluation is not possible any more for a member country of the euro area, cuts in real wages are the only option left, which is long and painful, since it depresses both domestic demand and euro area demand unless corrective measures are taken at the European level.

The more visible result is a high disequilibrium in current account balances in 2005 (Table 5): Germany and the Netherlands run large external surpluses while Spain, Greece and Portugal run large deficits. Does the divergence in external account deficits reflect an equilibrium phenomenon (the savings of the older industrial countries being invested in younger and more profitable member states) or a disequilibrium (European savings being wasted in Southern countries in non-profitable investment such as housing)? These imbalances cannot be considered as equilibria as economic agents are not subject to the same real interest rates. The logic is that Spain, Greece and Portugal will have to undertake restrictive policies in order to restore their current account, but this would have a negative impact on euro area growth. We would need to define a strategy comprehending euro depreciation, low interest rates, higher wages in some countries like Germany and restrictive policies in some others.

Greece, Spain and Portugal have very low national saving rates, which is unusual for countries in strong growth periods. It means that part of their growth will benefit foreign owners. From another point of view, we can see that Greece, Spain, the UK and the US have high growth and very low national and household saving rates. On the contrary, Belgium, Germany, Austria and France suffer from too high saving rates. So, the euro area must avoid increasing its private households' savings rate. On the contrary, a low saving rate is needed for high growth and low public debts.

Table 5. External positions

	Competitiveness*	Current account balances, % of GDP**	National savings rate/net households savings rate **%**
Euro area	**92**	**0.2/-0.6**	**20.6/n.a.**
Belgium	94	2.3/-2.8	23.7/6.2
Germany	109	3.9/4.6	22.1/10.7
Greece	86	-9.2/-5.7	15.8/na
Spain	88	-7.4/-6.2	16.9/5.4
France	99	-1.2/-3.5	19.9/11.6
Ireland	117	-1.0/-1.9	25.5/na
Italy	84	-1.1/-3.0	20.5/9.5
Netherlands	87	7.6/4.6	24.0/5.7
Austria	120	2.9/3.7	22.7/9.5
Portugal	86	-9.5/-2.2	15.7/4.9
Finland	97	2.4/-3.3	19.0/na
UK	**95**	**-2.6/-2.1**	**15.4/0.0**
US	**110**	**-6.3/-5.0**	**14.5/-0.4**

*2005/1997(=100); ** 2005/change from 1998 to 2005.
Source: European Commission.

Fiscal policy is always effective but in an area with many medium-size countries, each country may hesitate to use it because the favourable impacts will be shared with trading partners and hence will be relatively weak at the domestic level. The smaller the country, the more it is tempting to use competitive policy instead of demand policy. This lack of coordination is harmful for the area as a whole. There is too much competition and not enough cooperation. So coordination needs to be organized. Looking at the last recession (table 6), it appears that fiscal policies were not used to support growth in the euro area as strongly as in the UK or in the US. The SGP was a corset for fiscal policies, even if public finances are more sustainable in the euro area than in the US, UK or Japan (table 7). European countries do not need fiscal adjustments, but European rules put a too strong weight on public deficits relative to growth issues.

Table 6. Fiscal impulses, 2000/2005

Percentage of GDP	2000/2005
Euro Area	**0.7**
Belgium	0.8
Germany	0.6
Greece	4.2
Spain	-1.2
France	0.6
Ireland	2.8
Italy	2.9
Netherlands	0.0
Austria	-1.7
Portugal	0.1
Finland	4.7
UK	**4.7**
US	**5.4**

Source: OECD.

Table 7. Public finances sustainability in 2006

Percentage point of GDP	Structural balance	Output gap	Limit for gov. balance*
US	*-3.7*	*0.6*	*-3.0/-3.3*
Japan	*-5.3*	*0.5*	*-1.0/-3.0*
Germany	-2.1	-1.7	-1.7/-2.7
France	-2.1	-1.7	-1.8/-2.8
Italy	-3.6	-1.3	-1.9/-4.3
Portugal	-2.8	-4.1	-2.3/-4.0
Greece	-3.5	1.2	-3.3/-7.0
UK	*-3.1*	*-0.8*	*-2.0/-2.5*

Note: The limit for the government balance is calculated under two alternative assumptions: a strict assumption where the level of desired debt is either the current level or 50% of GDP (for countries where debts exceed this limit); a more favourable assumption where the level of desired debt corresponds to the observed level or 50% of the GDP (where debts are below this limit). Moreover, it is considered that the structural balance contains discretionary measures for an amount of GDP corresponding to 25% of the output gap, if the latter is negative. Public finances are unsustainable if the public deficit is higher than the limit, even under the favourable calculation. This is the case for the countries in italics.
Source: OECD, own calculations.

The EU has so far been unable to organise a satisfactory coordination of economic policies. Many European economists or institutions refer to a Walrasian myth: if each economy was fully flexible (prices, wages, workers), there would be no need for economic policy and hence no need for coordination. But as the US example shows, even a flexible economy needs economic policy.

Increasing labour market flexibility is not the *panacea*. Contrary to the current mainstream opinion, wage flexibility is not the solution to all demand shocks since it may dampen further an already low demand and increase uncertainties.

European countries should avoid higher international labour mobility as an objective. Governments cannot ask their unemployed workers to find a job abroad. This would be neither a solution nor an objective.

We cannot expect that financial integration will dramatically reduce disparities in the euro area. The impact of cross-border portfolio diversification on consumption is very small, if it exists at all. Only few richer people own foreign assets.

The euro area is not an optimum currency area (OCA) and perhaps an OCA can never exist between different countries. The problem is: How to organise the use of economic policy instruments in the euro area in order to respond to various shocks or structural differences?

The absence of coordination in both fiscal, wage and social policies enables profitable non-cooperative strategies to be initiated first by smaller countries and followed by bigger ones. These tensions are exacerbated by insufficient macroeconomic growth at the euro area level and by the difficulties for the European Social Model to cope with globalisation. Many countries are tempted by tax competition, in particular by cuts in corporate taxation. Several NMS have also introduced a flat tax or strongly cut social security benefits. Europe needs to progress towards economic integration in order to cope with macroeconomic imbalances but this requires agreeing on tax coordination and on the social model.

The existing monetary framework and the SGP fiscal framework cannot handle these divergences, especially because there are no satisfactory criteria in terms of domestic inflation, external account deficits or private debts. The question is all the more relevant in the prospect of new member states joining the euro area. This will increase disparities in a euro area, where old member states are already unable to deal with current disparities. This leads European institutions to be tempted to postpone any enlargement.

How to address this challenge? Three main options are possible:

- An economic policy decided at the area level, but the euro area lacks democratic institutions. There is no consensus in the area on how to deal with different domestic situations.
- A better co-ordination *au coup par coup,* but will it be sufficient?
- Introducing more adequate policy rules in a European framework, oriented towards growth and taking disparities into account: some countries must have higher inflation, because they are in a catching-up process; some countries may run public deficits because they have high saving rates, some countries could be asked to introduce taxes in order to avoid too high accumulation of private debt; euro depreciation could be considered as more relevant than national competitive policies,... This coordination would have to be piloted by the Eurogroup Council. But this would require an evolution in economic policy thinking.