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**Article**

## Divergences in EMU: Scope of the problem and policy options

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## **Divergences in EMU: Scope of the problem and policy options**

*Sebastian Dullien\**

### *Introduction*

Ten years after the introduction of the euro, the question of economic divergence has gained new prominence. While immediately after the introduction of the euro, skeptical voices about the young currency's sustainability fell silent, the debate first reemerged in the years after the bursting of the New-Economy-bubble in 2000. With Italy and Germany underperforming the rest of the euro-area in the recovery after 2001, think-tanks and investment banks debated whether economic divergence might in the end lead to a break-up of the currency union (Gros 2006, Munchau 2006, Prior-Wandesforde/Hacche 2005).

After shortly submerging in the years of robust economic growth in 2007 and 2008, the debate reemerged once again in early 2009 with rating agencies downgrading or putting on watch Ireland's, Portugal's and Spain's sovereign debt and interest rate spreads between euro-area countries widening to levels not observed since the start of EMU. Now, it is Spain, Ireland and Greece (which had outperformed the euro-area in prior years) which are seen as those at risk of leaving the currency union or being forced out of it by financial markets.

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The argument in both waves of the debate is roughly the same: It is argued that nominal divergences, mainly in wage costs, have led to an unsustainable position of overvaluation in some countries which leads to the loss of export market shares, high unemployment and permanently low economic growth. Since the real overvaluation might be perceived to be too painful to correct within the monetary union, at some point one of the countries might chose the seemingly easier way out and might leave EMU.

### *Harmful and beneficial divergences*

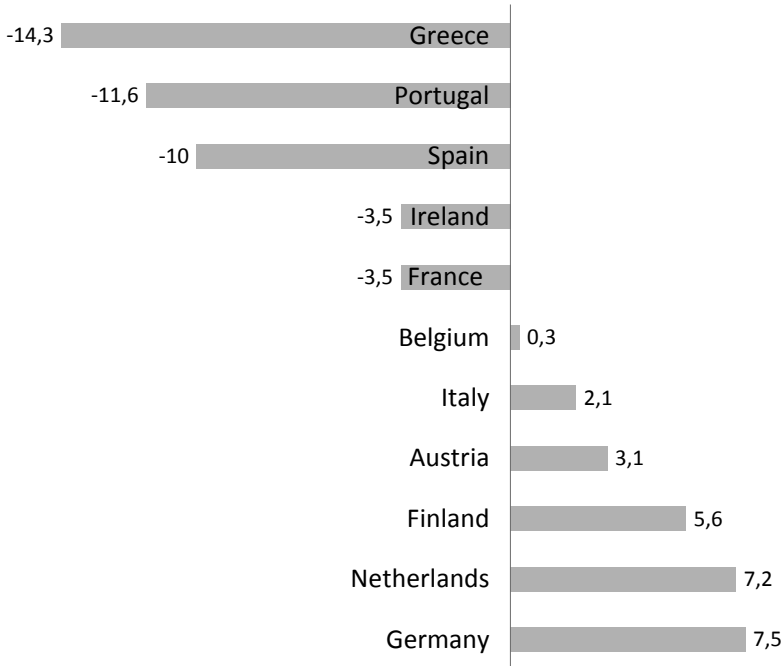
While it is undisputed that after the pre-EMU convergence until 1999, there has been a renewed nominal divergence (especially in consumer price inflation and unit labour cost increases) since the start of EMU, the interpretation has been less unanimous. While some economists have started early to argue that the divergences might cause trouble for the stability of EMU (i.e. Dullien/Schwarzer 2005, Gros 2006), others such as ECB (2005) have long argued that the divergences are not extraordinary for a currency union.

The divergence debate is usually focused around two connected issues: First, a gain or loss of competitiveness of single countries vis-à-vis the rest of the euro-area which is reflected both in a permanent divergence of consumer price inflation or in unit labour cost changes. Second, large external imbalances in the form of current account surpluses or deficits sometimes exceeding ten percent of GDP (see Figure 1 on the next page).

Since the start of EMU, some countries such as Spain or (after joining) Greece have permanently experienced consumer price inflation rates above the EMU average. Other countries such as Germany have permanently experienced inflation below the EMU average. As can be seen by looking at unit labour costs, this permanent divergence in consumer price inflation is not mainly due to diverging changes in indirect taxation or different weights of energy or other imported goods in the respective consumption baskets, but by an underlying trend of diverging unit labour costs in the economies in question. Consequently, one of the most often printed graph on divergences in EMU looks slightly like Figure 2 (on page 27) which plots the development of unit labour costs relative to the rest of EMU.<sup>1</sup> However, it is not a priori clear whether this divergence itself is yet a reason for concern. While the sceptics have long argued that this development reflects mainly differences in wage setting institutions or traditions, one could also argue that the differentials in unit labour cost growth is merely an adjustment towards long-run equilibrium. If a country has entered EMU at an undervalued exchange rate, above-average increases in unit labour costs over an extended period might just be the right thing to bring the country back to its long-run equilibrium. Similarly, if a country has entered EMU at an overvalued exchange rate, below-average unit labour cost growth would be warranted.

1 Figure 1 is an updated version of Figure 5 from Dullien/Fritsche (2007).

Figure 1: Current account balances (% of GDP)

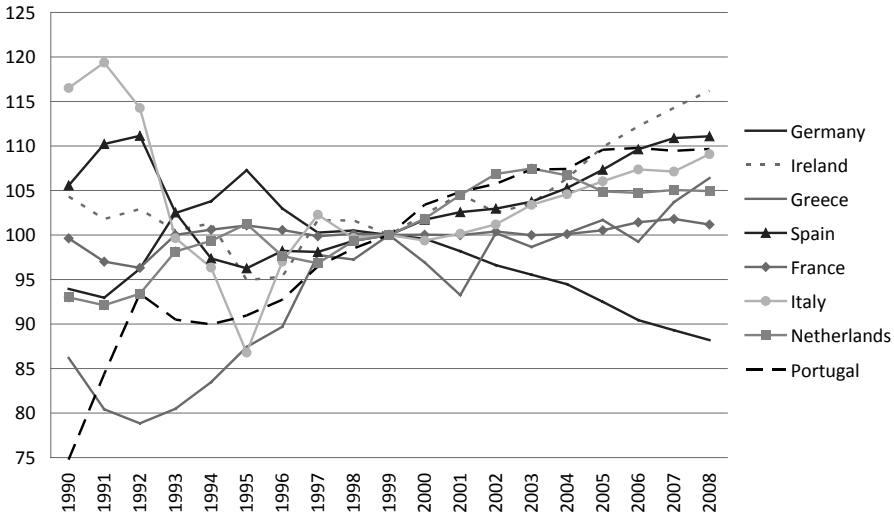


Source: ÖNB

Also, large current account imbalances are often defended by mainstream economists as a normal reflection of intertemporal consumption and savings decisions in countries with different levels of economic development. Ahearne et al. (2007) argue in an empirical study and in the neoclassical framework of international capital flows that the large current-account imbalances in the euro-area are a »sign of the proper functioning of the euro area rather than a sign of improper macro-economic management« (Ahearne et al. 2007: 33). According to them, lower income countries such as Portugal and Greece borrow from higher-income countries as the return on capital is higher in catching-up countries. Since investment in catching-up countries has a higher return than in mature economies, this process improves welfare in the monetary union.

The crucial question is thus: In how far are the divergences observed so far a sign for a permanent divergence and possibly single countries being stuck in a low-growth trap and in how far are they just a reflection of a process of real convergence towards a common long-term steady state or a correction of prior misalignments.

Figure 2: Relative nominal unit labour costs (1999=100)



Source: AMECO Database

*Econometric analysis*

In order to differentiate harmful from beneficial divergences, one would first have to define which is the long term steady-state to which countries should converge. As production patterns differ, one cannot necessarily assume that the level of nominal unit labour costs should converge across EMU. Thus, one needs to look at different indicators. Dullien and Fritsche (2009) chose to compare the development of relative unit labour costs in EMU with those in other currency unions, namely the United States of America and the German Laender. In Dullien/Fritsche (2008), they have used the same data set to check for adjustment speed in relative unit labour costs. Collignon (2009) in contrast looks at the relative (adjusted) wage share in the EMU countries. A relative wage share above the EMU average signals lower profitability than in the rest of the union (and hence a lower degree of price competitiveness), a relative wage share below the EMU average a higher profitability. According to him, given similar production technologies and sectoral structures, these wage shares should in the long run converge.

All these approaches come to the same conclusion:<sup>2</sup> There have been cases of persistent unit labour cost increases which are beyond (both to the upside and downside) what one could assume to be standard in a well working currency union. Moreover, adjustment in EMU seems to be much slower than between US states and regions and between the

2 Note that due to the lack of long time series since the start of EMU, not all of the conclusions are statistically significant.

German Laender. All studies also quite easily point out the main culprits: Unit labour cost increases have been excessive in Spain, Greece and Portugal and have strongly deviated to the downside in Germany. Most of these studies interestingly also come to the conclusion that excessive unit labour cost increases have been much less of a problem in Italy than in the other Southern EMU members. This clearly contrasts with Italy having been the first target in the initial debate of a break-up of EMU.

### *Anecdotic evidence*

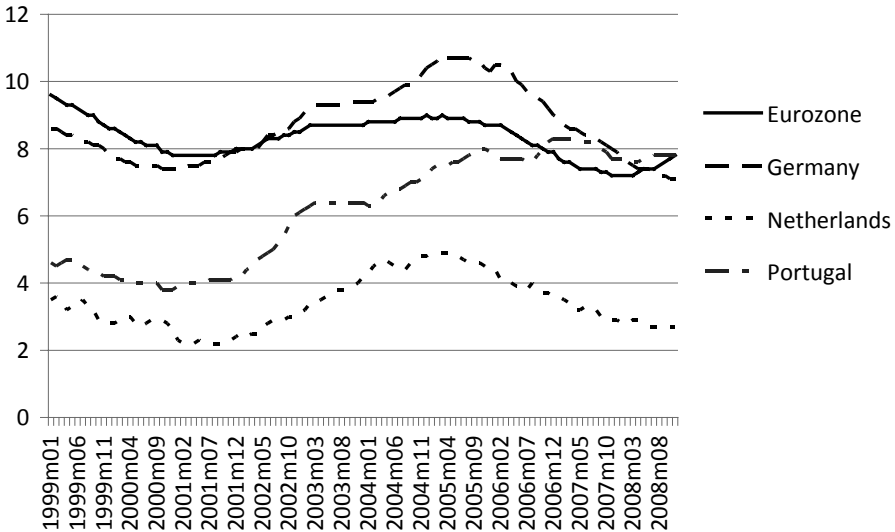
An alternative approach to looking at the statistical and econometric evidence is to analyse in a more qualitative way certain episodes of divergence in EMU and try to judge by the macroeconomic developments in the single countries in context with the development of the countries' competitiveness whether divergences help to reach a plausible long-term equilibrium or not. In the context of divergences, one would need to find a country which has come to the end of a cycle after which a correction of the unit labour cost deviation could have been expected but has failed to correct its misalignment.

Unfortunately, again, this exercise is seriously constrained by the short time-span since the beginning of EMU. At the time of writing, of the countries which have seen very strong upward divergences in unit labour costs in the first years of EMU, only very few have already experienced a time period in recession long enough to really expect them to see wage-moderating effects. Two very interesting cases, Spain and Ireland, have only entered recession in 2008 and any reaction in wages can sensibly only be expected in the years to come.

Thus, we have basically three countries for which we can already make an evaluation whether the economy has the necessary adjustment capability to correct divergences in its competitiveness position again: The Netherlands, Portugal and Germany. The Netherlands found itself in a position of overvaluation and recession after the new economy boom and a national real estate boom up to the year 2003. Portugal's boom (which was correlated with an above-average increase in nominal unit labour costs) ended in 2001. Hence, one should have seen a correction of the unit labour cost overvaluation by now in both countries. Germany's long period of stagnation turned into a strong upswing in late 2005 with growth rates exceeding those in the rest of EMU. Here, after years of downward deviation in unit labour costs, for a well-working labour market, one would have expected unit labour costs to increase again to correct the position of undervaluation.

Looking at the macroeconomic data for these three countries does not yield an optimistic conclusion for the adjustment capability in EMU. In Portugal, the recession of 2001 – 2002 and the subsequent low growth has led to a strong increase of unemployment from 3.9 percent in 2001 to 8.3 percent in 2007 (see Figure 3). However, unit labour cost increases have been very slow to moderate. According to unit labour cost data from the EU Commission, the competitive position has continued to deteriorate until 2005 and has remained constant since. Yet, the continuously large current account deficit of around ten percent of GDP while domestic demand growth remains rather weak hints at a significant overvaluation.

Figure 3: Unemployment rates in selected EMU countries



Source: Eurostat

In Germany, the upswing after 2005 has cut unemployment from 10.8 percent in 2005 to 7.1 percent at the end of 2008. Yet, even this strong performance in the labour market did not yield a fundamental change in Germany's undervaluation. Up until 2008, competitiveness has even continued to improve, with unit labour cost increases in Germany below that in the rest of EMU even though the German labour market performance has been much stronger than in the monetary union on average.

The only country in which the correction from a position of overvaluation seems to have worked smoothly is the Netherlands which has managed to improve its competitive position from 2003 until 2008 again. Unemployment in the Netherlands climbed from 2.2 percent in 2001 to almost 5 percent in 2005 before it started to drop below 3 percent again.

Thus, among these three countries, only the labour market of the Netherlands shows the wage reaction necessary for a smooth working of EMU. In Portugal and Germany, in contrast, labour markets do not show the wage flexibility necessary for a smooth working of EMU: In Portugal, wage increases do not seem to react sufficiently *downwards* once unemployment increases. In Germany, wage increases do not seem to react sufficiently *upwards* once unemployment falls.

Looking at single country cases also sheds doubts on the interpretation of current account positions in EMU as normal intertemporal investment decisions, there are two problems with this view: If the capital import (and thus the current account deficit) of the Southern EMU countries had been a consequence of higher returns in the wake of a catching-up growth process, it should have gone hand in hand with an increase in the share of investment in capital goods. Moreover, with per-capita-incomes approaching that of the

rest of EMU, the amount of capital imported should have decreased. Yet, if one looks into details of the national accounts of the countries in question, this is not the case. Portugal's share of investment in equipment relative to GDP dropped below the EMU average in 2005, yet the current account deficit remained in the magnitude of ten percent. For Spain, the huge current account deficit persisted even after the country came close to the EMU average in per-capita GDP.

### *Policy options*

Given the results above, the question is in how far macroeconomic policy instruments could be employed in order to correct the imbalances. Monetary policy as an instrument is ruled out as since the beginning of EMU, all countries in the monetary union are faced with the same interest rate. Fiscal policies might in contrast in principle be employed in order to alleviate economic divergences. In a standard Keynesian model, national contractionary fiscal policies would be used in times of an idiosyncratic national boom to dampen demand. In an ideal world, this would prevent the economy from running into bottlenecks and overheating and hence prevent excessive wage increases. Expansionary fiscal policies would in contrast be used in order to prevent a prolonged crisis which would lead to an excessive improvement of competitiveness. Many proposals for a more centralized fiscal policy in EMU such as the ideas of using the EU budget in order to stabilize national business cycles by speeding up or postponing spending on infrastructure (Dullien/Schwarzer 2009) or an E(M)U unemployment insurance (Dullien 2008) or the more traditional idea of a European transfer fund (Pisani-Ferry et al. 1993) would go into this direction.

However, the harder question is in how far fiscal policy could be used in times in which the single countries' competitive positions already have diverged and policy makers want to support the return towards a long-run steady state. Looking at the cases described above, the actual scope for fiscal policy seems limited. In the case of Portugal described above, an already contractionary fiscal policy over the past years which brought the government deficit back down from 6.1 percent of GDP in 2005 to a little more than two percent in 2008 has not been able to bring unit labour costs down relative to the rest of EMU. For Germany, even the strong upswing after 2005 with a fall of the number of registered unemployed by about two million did not manage to lead to a turn-around in the unit labour cost trends. Here, it is hard to imagine a fiscal stimulus package large enough to turn around the wage trend.

Thus, in order to correct pathological developments in countries such as Portugal or Germany (and possibly Spain in the downturn which started in 2008), there seems to be no other option than to get the government involved in wage setting and correct the trends which have led to the persistent divergences in EMU.<sup>3</sup> For countries such as Spain and Portugal, this would probably first require to get rid of inflation indexation in wage con-

3 Collignon (2009) proposes reforming the macroeconomic dialogue in a way that it becomes more prominent and discussing wage increases more prominently in this dialogue as an alternative approach which – given that national wage setters really followed the recommendations – might have a similar effect.



tracts. Second, the government should think about incentives for the social partners for wage freezes over several years. A possibility could be to give temporary tax incentives for such wage contracts. Finally, measures to boost country-wide productivity increases should be taken to improve competitiveness.

For a country like Germany which has the problem of insufficient wage increases and excessive gains of competitiveness, the measures to be taken would have to be slightly more heterodox. The focus should be on getting nominal wage increases up again which would have to be done in a way which does not overly hurt the profit situation of the German corporate sector. A part of the strategy would have to be a turnaround in the public sector wage setting towards real wage increases over several years. Even though the German public sector is not very large in international comparison, it is probably large enough to have a signaling function for the rest of the economy. Second, one should think about temporary tax-breaks for companies which increase permanently the wages of their workers.

### *Conclusion*

In conclusion, one can say that with the boom having ended in countries such as Spain and Ireland, it becomes increasingly hard to deny that the divergence in unit labour cost trends over the past years or the growing current account imbalances within the euro-area are pathological. Given the current economic situation in Ireland and Spain, it is now difficult to continue arguing that the good growth performance of the past years has been a consequence of good microeconomic reforms in these countries. Instead, the boom now looks something which has been closely related to the divergence in unit labour costs trend in EMU: A national construction boom in these countries seems to have fuelled above-average wage increases which again allowed for a stronger increase in real estate prices. Now, these countries are faced with a very painful correction, of which we do not know yet whether national labour markets have the adjustment capability for. Even if doom scenarios of a break-up of EMU might be exaggerated, this development should alert European policy makers: At the very least, those divergences are set to create regions in EMU which are permanently trapped in growth-traps. This runs diametrically against the goal of creating similar living standards across the EU. Policy makers should thus put the issue high on their agenda. The longer one waits, the harder will it get to correct the divergences already accumulated.

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## East European capitalism – What went wrong?

*Dorothee Bohle\**

### *Introduction*

Not all that long ago, the East European newcomers to the European Union (EU) were considered economic miracles which successfully weathered the storms of transformation from socialism, and were ready to settle on stable democratic capitalist development paths. It was even assumed that these countries, toughened by the experience of repeated crises in the 1990s and backed by EU-entry requirements, had developed regulations and institutions that would prove resistant to the current global crisis. Things have turned out otherwise. Almost all new EU member states have accumulated major economic imbalances, and are boarding on steep recessions. Two countries – Hungary and Latvia – had already to turn to the International Monetary Fund (IMF) in order to defend their currencies and keep their economies afloat. Other countries of the region are prone to follow. The crisis in

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