

BRIEFING PAPER

Macroeconomic Differences within the EMU

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Executive Summary

There are still many macroeconomic differences between EMU member countries. There is still no clear cut tendency for income per capita to converge and actual growth rates support this view. This is reflected in respective unemployment tendencies. One major reason for macroeconomic heterogeneity are persistent inflation differences rooting mainly in diverging wage developments. These imply significant changes of competitiveness that in the end could lead to a real depreciation race. Such a race implies deflationary effects. These should be fought in the first place by appropriate national fiscal policy and only when the race has started by monetary policy.

1. After the establishment of the currency union it was the general expectation that macroeconomic differences between member countries would shrink. This applies the foremost to the level of income per capita the most general measure of wealth. This indicator as all others too will be compared only among EU 12. Only these countries have been long enough members of the currency union to make a preliminary and basically descriptive assessment of the state of macroeconomic convergence. In particular it will be shown how macroeconomic reactions were during a phase of boom 1999/2000 and of the consecutive bust from 2001 to 2003. Furthermore one can see how fast these economies recovered after the economic slump. Looking at GDP per capita, that reflects the wealth differences, one sees that wealth convergence has not made much progress during the observed time span. One would expect countries being above average losing some of that advantage, whilst those being below average move closer to it. The contrary is for many the case. (Table 1)

	average 1999- 2004	1999	2000	2001	2002	2003	2004
Belgium	11,4	11,2	11,9	10,7	10,7	11,7	12,4
Germany	22,3	23,0	22,8	22,4	21,8	21,8	22,0
Greece	-55,0	-57,7	-56,9	-56,1	-54,9	-52,9	-51,7
Spain	-33,9	-34,7	-34,7	-34,1	-34,0	-33,0	-33,0
France	12,4	11,7	12,4	12,2	12,6	12,6	12,9
Ireland	12,7	3,1	7,9	11,2	15,0	18,4	20,1
Italy	-12,6	-12,8	-12,9	-11,7	-12,1	-12,6	-13,4
Luxembourg	110,6	101,0	109,9	108,3	110,2	114,6	119,1
Netherlands	11,5	13,3	12,9	12,2	10,7	10,2	10,0
Austria	24,8	25,5	25,2	23,9	23,8	25,2	25,4
Portugal	-52,8	-50,5	-50,5	-53,2	-53,4	-54,4	-54,5
Finland	16,7	13,8	15,3	14,6	16,5	18,9	21,1


¹ percent
Sources: Eurostat and IMK calculations



2. Most notably Luxemburg and Ireland have significantly extended there above average standing, to a lesser extent this applies to Finland, Belgium and France. Vice versa Portugal and Italy have lost ground in catching up to the average. The positive examples in terms of convergence are Greece and Spain that have diminished their distance to the average significantly and on the other side Germany and the Netherlands that have lost some of their advantage. Austria has kept its relative position more or less unchanged. Given these findings one cannot speak of a general tendency to wealth convergence. This

may be considered as no surprise since research has shown how lengthy these developments usually are (cf. Salla I Martin /Barro (1992), Blanchard/Katz (1993). The question is why on this shorter perspective resilience to convergence is so big. A look on other macroeconomic variables will reveal that there are some serious problems ahead for the EMU.

3. The expected kind of convergence should be accompanied by diverging growth rates. Those countries below average are supposed to grow above average and vice versa. As one could see growth rates of GDP basically mirror these convergence developments.¹ Those who have gained ground have done so because their growth rates were so high not because they may have lost population.²

Table 2: Differentials¹ in annual growth rates in relation to the euro area average							
	average 1999- 2004	1999	2000	2001	2002	2003	2004
Belgium	0,2	0,4	0,2	-1,0	0,0	0,6	0,9
Germany	-0,6	-0,8	-0,5	-0,5	-0,7	-0,7	-0,4
Greece	2,2	0,6	0,8	2,6	2,9	4,0	2,2
Spain	1,5	1,4	0,7	1,8	1,8	2,2	1,1
France	0,3	0,5	0,4	0,4	0,3	0,1	0,3
Ireland	4,9	7,9	5,5	4,5	5,2	3,7	2,5
Italy	-0,6	-1,1	-0,7	0,1	-0,5	-0,4	-0,8
Luxembourg	2,7	5,0	5,3	-0,2	1,6	2,2	2,5
Netherlands	-0,2	1,2	-0,2	-0,3	-0,8	-0,8	-0,3
Austria	0,1	0,5	-0,3	-0,9	0,1	0,7	0,4
Portugal	-1,1	1,1	0,1	-4,5	-0,5	-1,8	-1,0
Finland	1,0	0,6	1,3	-0,7	1,3	1,7	1,6
¹ percentage points							
Average Absolute							
Difference							
	1,28	1,76	1,33	1,46	1,31	1,58	1,17
Sources: Eurostat and IMK calculations							
							

Portugal, Italy, Germany and the Netherlands are those countries that have grown less than the EMU average. Two of these were above average with respect to wealth two below average. Hence this performance seems not to be very closely linked to their respective wealth position. The same consequently applies to those countries showing the highest growth rates. Ireland, Luxemburg, Finland and France were already above average, Greece and Spain were not. If anything, these findings would speak in favour of increasing

¹ The other variable being the slowly moving population growth.


² That this not just a theoretical case is shown in the case of East Germany where convergence to West Germany is only achieved by a decreasing population. This phenomenon is called negative convergence.

returns to wealth and thus for divergence. Interestingly some countries show persistence in their growth performance i.e. they always deviate from average in the same direction. In the positive sense they showed since 1999 a permanently higher than average growth. This is the case for Ireland, Greece, and Spain and to a lesser extent for France. On the other side only Germany constantly grew less than EMU average. The overall differences of growth rates seem to be fairly constant over time. There is no clear cut trend.

4. The third macroeconomic indicator is unemployment. These figures reflect the growth performance and the initial employment situation in the respective countries.

	average 1999-2004	1999	2000	2001	2002	2003	2004
Belgium	-1,0	-0,6	-1,3	-1,2	-1,0	-0,7	-1,1
Germany	-0,3	-1,3	-1,0	-0,5	-0,1	0,3	0,6
Greece	2,2	2,8	3,1	2,9	2,0	1,0	1,6
Spain	3,0	3,7	3,2	2,9	3,2	2,8	2,1
France	0,8	2,6	1,9	1,0	0,7	0,5	0,2
Ireland	-4,0	-3,6	-3,9	-4,0	-4,0	-4,1	-4,4
Italy	0,7	1,7	1,9	1,2	0,3	-0,3	-0,9
Luxembourg	-5,5	-6,8	-5,9	-5,8	-5,5	-5,0	-4,1
Netherlands	-5,3	-6,0	-5,4	-5,7	-5,5	-5,0	-4,3
Austria	-4,5	-5,3	-4,5	-4,3	-4,1	-4,4	-4,1
Portugal	-3,4	-4,7	-4,1	-3,9	-3,3	-2,4	-2,2
Finland	0,8	1,0	1,6	1,2	0,8	0,3	-0,1

¹ percentage points
Sources: Eurostat and IMK calculations



Interestingly there seems to be a weak tendency for convergence. With the exception of Ireland that succeeded in reducing its unemployment ever further below the average the other countries have moved closer to the average. This is in particular the case for Germany where unemployment was slightly below average in 1999 and is now slightly above. Against the backdrop of its better growth performance Finland made the opposite movement. A special case is Italy despite the poor growth record the employment development was rather positive. The reason for this special there have been tax incentive for a rapid built up of employment. This measure led to very low productivity growth and it remains to be seen whether the effect is lasting.

5. What are the driving forces behind these heterogeneous performances? Three of the high performer (Ireland, Spain and Greece) were heavily subsidised by the EU. So one can attribute the success partly to an EU policy of cohesion. But

more important is the interest rate advantages all these countries have faced. In due course of monetary convergence when relatively high inflation in most of these countries receded real interest rates converged the low level previously only achieved in Germany with its long tradition of price stability. Lower real interest rates are beneficiary for investment and consumption and tend to spur domestic demand what could be observed all the countries mentioned. Real interest rate convergence at the same time partly explains why growth in Germany could be expected to be relatively weak. Simply because Germany acted as monetary anchor and thus did not have the advantage of lower interest rates. They basically stayed at the same level as before monetary union. While this reasoning explains some of the growth differences there must be other forces at work. This can be shown by the case of Italy. Italy also had the interest rate advantage, even to a very significant extent. Nevertheless its growth performance is with the minor exception of one year well below average.

6. The missing forces become clearer when looking at inflation differences

Table 4

Table 1 Differentials in annual HICP inflation in relation to the euro area average							
(percentage points)							
	1999-2004 average	1999	2000	2001	2002	2003	2004
Belgium	-0.1	0.0	0.6	0.1	-0.7	-0.6	-0.3
Germany	-0.7	-0.5	-0.7	-0.4	-0.9	-1.0	-0.4
Greece	1.2	1.0	0.8	1.3	1.7	1.4	0.9
Spain	1.0	1.1	1.4	0.5	1.3	1.0	0.9
France	-0.2	-0.6	-0.3	-0.6	-0.3	0.1	0.2
Ireland	1.8	1.3	3.2	1.6	2.5	1.9	0.2
Italy	0.4	0.5	0.5	0.0	0.3	0.7	0.1
Luxembourg	0.5	-0.1	1.7	0.1	-0.2	0.5	1.1
Netherlands	0.8	0.9	0.2	2.8	1.6	0.2	-0.8
Austria	-0.4	-0.6	-0.1	0.0	-0.6	-0.8	-0.2
Portugal	1.1	1.0	0.7	2.1	1.4	1.2	0.4
Finland	-0.3	0.2	0.8	0.3	-0.2	-0.8	-2.0

Sources: Eurostat and ECB calculations.

The ECB has calculated them and there was an astonishing result. There were significant and persistent deviations from the EMU average. That there are differences should not be a matter of great concern, since there may be good reasons for it. The relative price of products produced in one specific country may change or the business cycle may be different. However all these reasons should lead to temporary deviations only, but they should not be persistent. How unusual this kind of phenomena are, shows a comparison with the US, a well established currency union. During the same time period deviations in major regions of the US were quite smaller and not persistent, although the US faced the same shocks as Europe. That shows the US economy has dealt with the

shock with respect to inflation in a much less heterogeneous manner than the Euro area.

	1999-2004	1999	2000	2001	2002	2003	2004
Northeast urban	0,3	-0,1	0,0	-0,1	0,5	0,5	0,8
Midwest urban	-0,2	-0,1	0,0	-0,1	-0,4	-0,4	-0,3
South urban	-0,2	-0,2	-0,2	-0,2	-0,3	0,0	-0,2
West urban	0,2	0,5	0,1	0,9	0,3	-0,2	-0,4

¹percentage points
Source: U.S. Bureau of Labor Statistics

What are the forces behind these persistent inflation differences. The ECB has shown in its Monthly Bulletin of May this year that labour costs development play a major role in that. Especially for Germany but also for Austria strong wage restraint has caused inflation to be always lower than in the other EMU countries. On the other hand wages are the driving force behind persistently higher inflation rates in Spain and Portugal. In Italy it was mainly low productivity that also provoked relatively high unit labour costs. In Ireland instead high profits hinting a buoyant economic dynamics seems to be the main reason.

Table 6

	Final demand deflator			GDP deflator				Unit labour costs		
	Total change in %	Contribution to change		Total change in %	Contribution to change			Total change in %	Contribution to change	
		Domestic costs	Import costs ¹⁾		Unit labour costs	Gross operating surplus	Net indirect taxes		Compensation per employee	Inverse labour productivity
	1 = 2+3	2	3	4 = 5+6+7	5	6	7	8 = 9+10	9	10
	Average annual growth in percentage points, unless otherwise indicated									
Euro area	1.8	1.0	0.8	2.0	1.1	0.6	0.2	1.9	2.6	-0.7
	Deviation from the euro area average ²⁾									
Belgium	0.1	-0.4	0.5	-0.4	0.1	-0.4	-0.1	0.1	0.5	-0.4
Germany	-1.0	-1.0	-0.1	-1.2	-0.7	-0.5	0.0	-1.1	-1.0	-0.1
Greece	1.5	1.4	0.1	1.5	0.2	1.0	0.3	0.4	3.5	-3.1
Spain	1.5	1.2	0.3	1.8	0.7	0.8	0.3	1.1	1.2	0.0
France	-0.7	-0.3	-0.4	-0.6	-0.2	-0.2	-0.2	-0.2	-0.2	0.0
Ireland	1.3	1.2	0.1	2.4	0.0	2.0	0.3	0.4	3.5	-3.0
Italy	0.8	0.8	0.0	0.5	0.3	0.2	-0.1	0.7	0.0	0.8
Luxembourg	0.3	-0.4	0.7	0.3	0.7	-0.6	0.2	1.4	3.3	-1.9
Netherlands	0.8	0.6	0.3	1.4	1.2	-0.1	0.3	1.9	1.5	0.4
Austria	-0.6	-0.6	0.0	-0.6	-0.8	0.4	-0.2	-1.4	-0.9	-0.5
Portugal	1.0	1.3	-0.3	1.6	2.0	-0.9	0.5	2.9	2.7	0.2
Finland	-0.8	-0.4	-0.4	-0.8	-0.2	-0.5	-0.1	-0.2	0.5	-0.7

Sources: European Commission, Eurostat and ECB calculations.
1) At the country level, import costs refer to intra and extra-euro area imports.
2) The figures in the table can be interpreted as follows: in the case of Belgium, for instance, the average annual change in the final demand deflator over the period 1999-2003 was 0.1 percentage point higher than in the euro area as a whole. The contribution from average import cost changes to the observed differential in final demand inflation was 0.5 percentage point, whereas the contribution of domestic costs was -0.4 percentage point.

7. Such a persistent inflation difference within a currency union has two major impacts. First of all it constitutes a significant change of real exchange rates. It means there is a real depreciation of an economy with persistent low inflation against the other members of the currency union. Therefore competitiveness of that economy rises accordingly. Germany has gained according different measures between four and

nine percent in competitiveness since 1999.³ This puts German exporters into a much better position and soaring German exports prove this. Economies with relatively high inflation rates instead appreciate in real terms. Their exports will suffer. One can see this already in the case of Spain, Italy and even France. Given that the German economy has been lagging behind in terms of growth such a boost to exports seems desirable at the first glance. On the other hand a persistently lower inflation within a currency union with equal nominal interest rates means that an economy faces high real interest rates. Those depress domestic investment and consumption. For an economy with the size of Germany that has a significant domestic market, the overall effect is negative. For small economies like Austria this would be different. Spain on the contrary benefits from such a constellation. For the currency union as a whole, these tendencies create in the longer run severe problems.

8. If these trends continue Germany will not pick up in growth despite the real depreciation that continues to increase German competitiveness. Its growth and inflation differentials persist. However, the export performance of other countries starts to suffer and their economic activity loses steam. The probable reaction will be a wage and price restraint also in these economies in order to regain competitiveness. Then the race for real depreciation has started. Some indications of such a development are already in place. Current accounts of Spain, Italy and France are deteriorating and real wages on EMU average decrease. In the end there exists the danger of deflation. This is a symmetrical situation compared to the seventies and eighties when nominal depreciation races were quite common among European countries leading then to high inflation rates. These situations have been mastered not at least by the currency union. But what is the remedy against a deflationary race?

9. In the first line fiscal policy is requested to counteract asymmetrical developments. Hence German fiscal policy should be much looser than Spanish fiscal policy. The German economy would get an internal boost leading to higher growth speeding up wages and prices and ending real depreciation in due time, while the Spanish economy would be dampened by more restrictive fiscal stance. The Stability and Growth Pact (SGP) has prevented up to now that Fiscal policy could take this role especially in the country with low growth and accordingly high public

³ Cf IMK –Report 1/2005.

deficits. If this first line of defence cannot be hold, it remains only monetary policy to prevent deflation. But it has to react swift and significant in order to be successful. In particular it has to be on the alert already to detect the beginning of a depreciation race as early as possible. The present impression is that the ECB is not yet aware of these imminent dangers. That could prove detrimental in case of a too late reaction.