A H E M Wellink: Heterogeneity in Europe and the role of monetary policy

Opening address by Dr A H E M Wellink, President of the Nederlandsche Bank, at the CEPR/European Summer Institute conference, held in Amsterdam, on 15 September 2000.

*   *   *

Introduction

It is a pleasure to be here to give the opening address to this conference and to welcome you to Amsterdam. After only a couple of years, this annual conference has established a reputation for stimulating discussion on economic policy issues in Europe. This year's programme looks set to further enhance your reputation.

Issues of heterogeneity were the subject of much debate and analysis in the run-up to the introduction of the euro. The debate has continued since then, too, and this conference will no doubt provide fresh insights into the issue. Enlargement is also on the conference agenda. Obviously enlargement will have implications for current EU members, as well as for accession countries. Further, there are links between enlargement and heterogeneity.

This afternoon I would like to talk a little about heterogeneity in the euro area, and its implications for policymakers. I would also like to look forward and discuss these issues in the context of EU and EMU enlargement.

Heterogeneity

First, some thoughts about heterogeneity. We are used to thinking about heterogeneity mainly in terms of nation states. We focus on differences between countries. Of course, it is not only when discussing economic policies that we think about national differences. We also highlight differences in other areas – the Netherlands was a mass of colour from supporters of different countries earlier this summer during the European soccer championships. And, the Sydney Olympics provide an opportunity to celebrate national achievement, as well as individual sporting excellence.

Traditionally, monetary policy has also been conducted on a national basis, although European monetary policy did become more coordinated in the run-up to the introduction of the euro. Other economic policies have generally continued to be set on a national basis, although EU membership does impose some degree of consistency. Heterogeneity also occurs on other dimensions, such as between sectors of the economy. I will return to that point in a minute, but first want to make a couple of comments about country differences.

There have been many studies in recent years focussing on differences between euro area countries. And, while a few studies find evidence to the contrary, there appears to be a general consensus that business cycles have converged to some extent over the past decade or two. As a central banker, I am naturally interested in inflation differentials, and these are certainly lower now than they were 10 or 20 years ago. For example, inflation rates among current euro area members ranged from 21% in Italy to 5% in Germany in the last quarter of 1980. By the second quarter of this year the range was only 3½ percentage points.

Naturally, divergences do remain, and these reflect a number of factors. Some divergence is due to a process of convergence as countries catch up to euro area averages, the well-known Balassa-Samuelson effect. This effect explains how productivity growth during a catch-up process can result in higher inflation without undermining competitiveness. Country-specific policies, including fiscal policy and regulation, also result in divergences. Finally, countries have different industrial or sectoral concentrations. Differences in the economic performance of various sectors will therefore be reflected in cross-country divergences.

These factors are not going to disappear immediately, but may diminish as price and income levels converge and through continued deepening of the internal market. However, we cannot be sure how rapidly they will diminish, nor can we be certain what level of divergence will be normal in the long run. In addition, the process of convergence will not necessarily be continuous. For example, inflation differentials have widened a little over the last year or two, although they remain much smaller than they were a decade ago.

For small areas within a monetary union, a common monetary policy does have some specific implications. Small countries have little influence on the euro area inflation rate, which is a weighted average of national inflation rates. If inflation rates in those small countries diverge from the euro area average, that has relatively little impact on the overall monetary policy stance for the euro area. Consequently, it is possible for smaller countries to temporarily have growth rates and inflation rates that differ from those that would result from a national monetary policy aimed at maintaining price stability at the country level. Large countries could also be in this position. If inflation is well above the euro area average in one country, but below it in another, monetary policy may not contribute to narrowing the divergences. Where such divergences are not the result of catching-up processes, national economic cycles could potentially become more pronounced. Some euro area countries are arguably in this position now, or heading towards it. The Netherlands is one of those countries. Of course, such a deviation can also occur in the other direction, with inflation and output growth rates remaining lower for longer than would occur with a national monetary policy. This can lead to long-lasting social and economic costs if there are factors inhibiting a smooth adjustment process. I will return to this issue shortly.

As I mentioned earlier, heterogeneity occurs across several dimensions. In addition to country differences, there are also differences in economic performance between sectors in the economy. As the internal market continues to deepen, there may be fewer regulatory differences between countries and the Stability and Growth Pact constrains national fiscal policy. It seems likely that cross-country divergences will increasingly reflect exposures that countries have to various sectors. Thinking about heterogeneity at a sectoral level might therefore be more insightful for the euro area than focussing solely on cross-country comparisons.

Consider trends in inflation. The Eurosystem has defined price stability as a positive inflation rate below 2% over the medium term. The definition recognises the fact that at times inflation may temporarily move outside that target range. That is currently occurring as a result of higher oil prices - which are a kind of sectoral shock. The weak exchange rate is also contributing to higher prices. The most recent HICP inflation rate shows that euro area consumer prices increased by 2.4% in the year to July. Almost half of that increase is due to higher energy prices. Naturally, cross-country inflation differences remain, and are relevant. However, these cross-country differences are themselves affected by higher oil prices, reflecting the fact that energy intensity and energy taxation vary between countries. In the current circumstances, analysing relative price trends can help in assessing whether inflation is confined to specific sectors, or whether it is leading to more generalised inflation.

Implications for policy

So we have heterogeneity across several dimensions. What does that mean for policy, and why should policy makers be concerned about divergences? Let me focus on price divergences. In a market economy, relative prices play an important role. And, relative prices include not only the prices of different goods and services within a country, but also the prices of the same goods and services in different countries. These relative price changes provide the signals to ensure that changes in preferences or technology flow through to changes in resource allocation. In theory, therefore, relative price movements are welfare enhancing and not something that we should be concerned about. In practice, the world is not so simple and markets are not perfectly competitive. Relative price movements do not always occur freely, and adjustments to changes in preferences or technology can be costly.

Monetary policy cannot and should not influence relative prices within the euro area to offset divergences between sectors or countries. Those relative prices are determined by real factors. Instead,

the best contribution that monetary policy can make to society's welfare is to stabilise the general euro area price level. That reduces the noise in relative price changes, and therefore improves the workings of the price mechanism.

Nonetheless, central bankers do monitor divergences. Why do we monitor divergences if there is nothing we can do about them? First, our knowledge of the monetary transmission mechanism is incomplete. Information about the various parts of the economy, including divergences, adds to our knowledge of the economy as a whole. We are particularly conscious of this in the euro area where we are still in the process of developing and enhancing indicators for the euro area as a whole. The second reason for our interest is that regional or sectoral differences in economic performance can provide early signals of area-wide developments, as US experience has shown.

If monetary policy cannot and should not react to divergences, what about other policy areas? As I mentioned earlier, allowing relative price changes to occur is often the best approach, so that resources are allocated to their most effective uses. Accordingly, structural reforms that allow the relative price mechanism to operate are generally sensible. And, hearing central bankers call for structural reforms is nothing new! My colleagues and I on the ECB Governing Council have been regularly calling for further structural reform. For example, labour market reform that stimulates the movement of labour around the euro area is likely to reduce euro area unemployment overall, as well as reducing disparity in prices, wages and unemployment rates between regions. Central bankers in other countries make similar points.

Another approach would be to use fiscal policy to try and dampen national divergences. However, given the planning and implementation lags, it is not easy to use fiscal policy in a counter-cyclical manner. In addition, the main objective of fiscal policy is not normally to reduce cross-country or cross-sector divergences. Even though fiscal policy is normally formulated within a multi-year framework, elements of discretion remain. Any discretion should be used to reduce, rather than increase, cross-country divergences in inflation. Fiscal policy should also be in a sustainable position so that automatic stabilisers can operate fully. At times it may even be appropriate for fiscal policy to seek to offset divergences. It is certainly the case that there is little to be gained from discretionary pro-cyclical policies. Rather, economic cycles could become more pronounced, resulting in costly adjustment taking place in downturns.

The point I made earlier about small countries is relevant here. Euro area monetary policy is not significantly influenced by the inflation rate of a small country. It is therefore important for small countries to have the flexibility in other policy areas to offset inflation. Of course, large countries would also gain if they undertook structural reform and avoided pro-cyclical fiscal policy. And there could be times when it is appropriate for large countries to use national policies to offset divergences. I would merely make the point that the costs of not being flexible might be greater for small countries in the event of a downturn.

Monetary policy after enlargement

I would also like to briefly discuss how these issues apply to enlargement. First, the points made regarding small countries currently in the euro area apply with even greater force to accession countries. Given the relative size of accession countries, monetary policy for the enlarged euro area will be little influenced by their inflation rates. Accession countries are in general less converged in real terms than the initial EMU members were when monetary union began. This is true when measured on the basis of GDP per capita, and when adjustments are made for differences in purchasing power. Real convergence may therefore take a considerable period of time. Ongoing convergence, EU membership, and eventually adoption of the euro, could all result in economic shocks that mean monetary policy requirements in an accession country differ from those in the euro area as a whole. Given these factors, the extent of the difference in monetary policy requirements could be greater or more protracted than is the case for small countries currently in EMU. To minimise the economic and social impact of divergences, it is important that accession countries have flexible economies, sound financial systems, a solid fiscal position, and a well-developed institutional framework. Arguably, accession will therefore have greater consequences for countries now than was

the case previously, in the sense that they are less converged in real and institutional terms than initial EMU members. A cautious approach to the adoption of the euro therefore appears appropriate, as premature adoption could prove costly.

Second, monetary policy within the EMU will continue to focus on area-wide conditions. Obviously, that area will be larger following enlargement. One of the important issues for us will be to ensure that the indicators we use in our monetary policy deliberations are based on developments across the enlarged area. Our data requirements will expand accordingly. We will also need to learn how the monetary policy transmission mechanism works across the new area. I expect that the national central banks from the accession countries will have an important role to play here in helping us understand the workings of the enlarged euro area.

Conclusion

Despite having given some warnings about the consequences of divergences, I would like to conclude on an optimistic note. Yes there are differences within the euro area. But the differences do not create problems for euro area monetary policy. The overall gains from membership certainly outweigh the costs. I am confident the same will apply for accession countries. What the divergences do teach us is that other policies must play their part if we are to maximise the gains from a common monetary policy. That is particularly important for small countries.

Thank you for your attention. I would like to repeat my welcome to you, and wish you well for the remainder of the conference. I am sure that it will be both stimulating and fruitful.