# Mr Duisenberg discusses the challenges posed by economic divergences in the euro area: the consequences for economic policies

Speech delivered by Dr Willem F Duisenberg, President of the European Central Bank, at 'Nieuwspoort' in The Hague, Netherlands, on 5 November 1999.

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First, let me thank you for this rather special calendar for the year 2000. As you are undoubtedly aware, the President of the ECB has a very full schedule, not least in explaining the role of the Eurosystem and communicating its decisions to the general public (through the media). It is therefore a very suitable gift. It is also, however, if I may say so, a very symbolic gift. Next year marks the start of a new millennium. The introduction of the euro also marks the beginning of an important and historic step forward in European integration.

The introduction of the euro poses some new questions and challenges for the ECB and other economic policymakers in the euro area, and I would like to take this opportunity to deal with one particular issue which has been raised on a number of occasions in the past year - also here in the Netherlands - that is the challenges posed by economic divergences across regions or countries within the euro area.

## The single monetary policy and economic conditions in the euro area as a whole

The primary objective of the single monetary policy is to maintain price stability. The ECB has only one instrument at its disposal – short-term official interest rates - and can therefore only aim at one objective. This has been defined by the Governing Council as "a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%". The objective of price stability "is to be maintained over the medium term", emphasising that monetary policy needs to be forward-looking. But this definition also stresses the fact that the focus of the ECB is on price developments "in the euro area". In reaching its decisions on monetary policy, the Governing Council is concerned with economic conditions in the euro area *as a whole*, rather than specific regional or national developments.

It is sometimes said that while the single monetary policy may be "right" for the euro area as a whole, it is "wrong" for many individual countries within the area. I disagree with this view. First, it overlooks the fact that within a single currency area adjustment can occur via prices and wages. Second, it infers a very narrow perspective on the costs and benefits of a single monetary policy, in isolation from the broader arguments. These broader considerations can be assessed in my view, as being very clearly positive in the medium to long term for growth as well as employment. Nevertheless, an analysis of the causes of and policy responses to the differences across countries is useful.

## National differences will not entirely disappear

While monetary policy is determined by developments in the euro area as a whole, there will inevitably be some differences in the performances of individual countries and also regions within the euro area. Since the start of the year, the focus of attention in the media has rightly switched more towards looking at the euro area as a whole, but this also provides a natural benchmark against which to compare national developments. That is why some attention has been directed towards the differences that exist in some areas between euro area countries, particularly differences in economic growth and inflation rate differentials. The latter is true for the Netherlands, which currently has an inflation rate which is about 1 percentage point higher than that of the euro area.

There are a number of reasons why such differences will occur. These may broadly be considered under two headings. First, there are a number of reasons why, over relatively short periods of time, there may be clear differences in economic performances. Second, national rates of output growth and inflation may also differ within a single currency area over longer periods of time as a result of more structural factors.

**Short-term divergences among euro area countries**

Considering the short-term factors, with regard to price developments, there are various "country-specific" factors of a very temporary nature. Among these, government policies are perhaps the most obvious. These may lead to different price developments across countries within the Monetary Union in the short run via indirect tax changes, liberalisation measures and administrative price changes. These are generally not of the same magnitude and timing across countries.

Differences in growth and inflation may also occur over relatively short periods due to the occurrence of "asymmetric shocks" or differences in the responses to common shocks. A very clear example of such an asymmetric shock was German reunification.

Other shocks affect countries in a more or less similar fashion - for example, recent increases in oil prices have tended to lead to higher consumer prices in all euro area countries in the past few months. Shocks may affect countries in a diverse way due to different structures of the economy, patterns of trade and/or production for example. Evidence tends to suggest, however, that the industrial specialisation of the euro area countries is not one-sided, so that there is no risk of significant asymmetric effects. Moreover, the high degree of trade between euro area countries means that country- or region-specific developments tend to have significant spillover effects within the euro area.

Nevertheless, a common shock may have different consequences, depending on the precise institutional frameworks within the different countries. The possible so-called "second-round effects" of oil prices on wage and price developments may be considered to fall into this category.

Short-term or cyclical differences in demand pressures - though difficult to measure with precision - are an important cause of short-term variations in price increases. There is a relatively high degree of correlation in the cyclical developments of euro area countries over a longer time period, and recent differences in growth rates have not been particularly unusual. Nevertheless, different cyclical positions may lead to variations in price pressures.

**Longer-term factors leading to national differences**

Turning to the longer-term factors, the trend rate of growth may be higher in some countries due to the process of "catching-up" in terms of productivity and living standards with other euro area countries. It is likely that this has been happening in some euro area countries over the past few decades. In others, the trend rate of growth may be higher due to the fact that the economy is at a more advanced state of liberalisation and deregulation.

In terms of the current differences in inflation rates across euro area Member States, longer-term factors are important. It may first be noted that even if inflation rates for all individual goods were identical across countries, the overall rate of increase in consumer prices would differ because there are differences in tastes and preferences across countries and therefore the bundle of goods consumed, and thus the weights of the various goods in the overall price index, differs from country to country. This can also, of course, have consequences for short-term divergences in inflation rates across euro area countries.

The "catching-up" effect for countries whose living standards are rising towards the average euro area level also has consequences for inflation differentials. The convergence of productivity and living standards gives rise to differentials in inflation rates via the rate of increase of non-traded goods prices. Countries with higher levels of economic development tend to have higher prices of non-traded goods.

Higher living standards mostly reflect high productivity in the traded goods sectors but, given integrated national labour markets, wages are generally higher in the economy as a whole and although the scope for productivity gains may be more limited in the non-traded sectors of the economy, a general rise in wages tends to lead to higher relative prices in the non-traded to traded goods sectors. The euro area countries undergoing this catch-up process will, therefore, in general have higher inflation.

As an ultimately temporary but nevertheless protracted phenomenon, there is also an ongoing process of convergence of prices of individual goods. Price differences across countries will tend to be reduced for goods and services which are widely traded across national boundaries as a result of increasing integration of the single market. The introduction of the euro can, of course, be expected only to intensify this process through increased price transparency and the elimination of exchange rate risk.

**Are national differences a cause of concern?**

Are differences in growth and inflation among euro area countries a matter of concern? In terms of growth, there are no indications that the differences are particularly large or unusual. Harmonised prices data do not exist over a longer time period, but available national figures point to the fact that differences are much smaller than they were in some other periods in the past. For example, in the early 1990s, the differences between the highest and lowest inflation rates were of the order of magnitude of over 10 percentage points. Thus, a more stable price environment in the euro area as a whole has also been accompanied by a considerable degree of narrowing in inflation rate differentials. The move to a single currency and the introduction of the euro are based on the success of this convergence process towards low inflation rates in all participating countries. It may be recalled that the achievement of a high degree of price stability is one of the convergence criteria established in the Treaty to be used to assess whether countries have fulfilled their obligations regarding participation in Monetary Union. However, this does not mean that after countries have joined the Monetary Union they will - at all times - have the same rate of inflation.

To put the current differences in inflation in the euro area into context, it is useful to compare developments in the euro area with variations in inflation in the United States, a large single currency area which has been established for a long period of time and which is highly integrated in terms of labour and product markets. Analysis of data for price developments in various US cities over the past suggests not only that significant inflation differences occur within a monetary union, but also that they are at least as great as those currently prevailing between euro area countries. Thus, recent divergences in the euro area are by no means unusual. A further feature of the US data is that the observed divergences in inflation rates among these cities, although persistent, are not permanent. There is a tendency for price levels in individual cities to converge back towards their initial levels relative to the national average. It can be assumed that similar adjustment processes would also operate in the euro area.

**The role of other economic policies**

Differences in economic developments between countries within the euro area do not, therefore, always warrant an economic policy response. Action may, however, be necessary. For instance, when developments diverging from those in other countries threaten to trigger painful adjustment processes in the form of increasing unemployment. This can be avoided. If action is required it must be taken through other, national economic policies, in particular wage developments and fiscal policy. As said before, “Frankfurt” has no role to play in this area.

As regards labour and product market developments, it is important, also for this reason, to reduce as far as possible existing rigidities, so as to allow wages and prices to adjust. This is as important for countries which are performing above the euro area average as for those whose economies are performing below the average. In circumstances where, for example, the economy is weaker than the euro area - and where monetary policy may be regarded as too tight - a high degree of flexibility is required in order to avoid significant increases in unemployment. Should, for example, the economy be growing strongly and unemployment be falling more rapidly than in the euro area, a more flexible labour market could help to contain the upward pressures on prices that could emerge sooner than in the euro area as a whole. The current recovery in the euro area provides a good opportunity to initiate new policies designed to improve the functioning of markets. The Netherlands has shown that this can bring about positive results. Although inactivity still remains high, the rate of unemployment is now one of the lowest in the euro area. It would be a good thing if the Netherlands could show that the dialectics of progress do not apply in this case.

It is also necessary for fiscal policy to play its part. The Stability and Growth Pact is sometimes seen as constraining the role of fiscal authorities, but this is a misconception. The Pact is required in order to ensure that responsible fiscal policies are pursued by all participating Member States. In the longer term, an unbalanced fiscal policy has a negative effect on economic efficiency and on price developments. It increases the strains on the monetary policy and, in a monetary union, there may be significant adverse spillover effects on other euro area countries. An institutional framework that guarantees sound government finances is an important contribution to macroeconomic stability and is conducive to sustained output growth and employment. It also helps to underpin the monetary policy.

The implementation of the Stability and Growth Pact provides sufficient scope in the medium term for a stabilising role for fiscal policy in Monetary Union. While, on the one hand, an unbalanced fiscal position creates difficulties for the economy concerned, if the government debt level is reduced to a reasonable level and fiscal deficits are close to zero or in surplus, this creates room for manoeuvre in economic downturns for fiscal policy to act as an automatic stabiliser. But this should then also apply if the ecomony grows rapidly or inflation is relatively high. Windfalls occurring in such cases should then lead to lower deficits. Of course, in making this remark I am not addressing one country in particular. Fortunately, however, the Dutch language gives me the opportunity to say: “If the shoe fits, wear it”.

## Concluding remarks

To summarise, national differences in growth and inflation observed in the euro area in the recent past do not appear to be unusual either in a longer-term perspective, nor compared with that which has been seen in the United States. Looking into the future, it is of course difficult to predict how these differences may evolve. The experience of the United States suggests that they will not disappear completely. The further development of the single market is likely to lead to some sources of divergence becoming less significant, while others may become more important. Divergences across countries will be monitored closely by the ECB but, given that monetary policy is geared towards maintaining price stability in the euro area as a whole, this means that other economic policies are required in circumstances where country or regional developments differ significantly, or over too long a period of time, from area-wide developments. In particular, this means that wage developments, backed by structural reform in labour and product markets, have a significant role to play while fiscal policy, within the framework of the Stability and Growth Pact, must also make a significant contribution.