MACROECONOMIC DIFFERENTIALS AND ADJUSTMENT IN THE EURO AREA

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In a monetary union such as the Euro Area, monetary policy can only address common shocks. Adjustment to asymmetric shocks – country specific shocks or common shocks which affect countries in different ways – cannot take place through monetary policy, nominal interest rates or exchange rates but must take place through other mechanisms. Theory suggests four main channels through which equilibrium can be restored:

a) market-driven price and output adjustment;
b) policy induced fiscal adjustment;
c) risk-sharing against country-specific shocks through fiscal transfers and financial integration; and
d) labour mobility.

In a recent article**, Iulia Siedschlag explored the factors underlying macroeconomic differentials (such as differences in output growth rates and inflation), the sources and transmission of shocks and the adjustment process in the Euro Area. A clear understanding of these issues is important to economic policy in the European Economic and Monetary Union (EMU). The paper analysed macroeconomic differentials and the adjustment in the Euro Area over the period 1999-2007. In particular it addressed the following questions: What do we know about macroeconomic differentials in the Euro Area? Are they temporary or persistent? What factors underlie them? What is the likelihood of asymmetric shocks in the Euro Area and what are their main transmission channels? What policy issues related to the macroeconomic adjustment in the EMU are most important at this stage?

Output growth differentials across the euro area countries were mainly explained by underlying trend growth differentials while the cyclical components of growth rates have become more synchronised. In particular, differences in real GDP growth reflect primarily differences in supply conditions such as demographic and labour supply developments, and long-

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term labour productivity trends. Inflation differentials reflected changes in relative prices and were driven mainly by country specific factors. On average, growth in wages per employee played a stronger role in explaining differences in unit labour costs growth than differential labour productivity growth.

Price and output differentials in the Euro Area have triggered adjustment through two channels: the real interest rate channel and the competitiveness channel. Divergent real interest rates and real exchange rates have had uneven effects on domestic and external demand. In particular, in countries with positive output growth differentials with respect to the Euro Area such as Ireland and Spain, real interest rates lower than the Euro Area average have added to demand pressures and contributed to housing market booms. Conversely, real interest rates higher than the Euro Area average have further depressed domestic demand in countries with output growth below the Euro Area average, in particular Germany and Austria.

Real exchange rate adjustment has led to changes in external demand and export performance in the Euro Area. Over the period 1999-2005, competitiveness gains have led to export growth in particular in Germany, Austria, Belgium and Luxembourg, while competitiveness losses have affected negatively export growth in Italy, Portugal and Spain. Significantly in Ireland, Finland, and the Netherlands export growth has remained above the Euro Area average despite their real exchange rate appreciation. These divergent developments in export growth performance may be explained by the product composition of exports. Due to their specialisation in low-tech products which are sensitive to price competitiveness, Italy, Portugal and Spain have been negatively affected by export competition from low cost countries, in particular China, while exports of Ireland and Finland are concentrated in high-tech industries which are less sensitive to competition from low-wage countries.

EMU has fostered intra-Euro Area trade integration in particular intra-industry trade which in turn has contributed to business cycle synchronisation. However, because of differences in patterns of trade, financial linkages and industrial specialisation there remains the possibility of asymmetric shocks – country specific shocks or idiosyncratic effects of common shocks across the Euro Area countries.

Financial integration can act as an adjustment mechanism to country-specific shocks by smoothing consumption over time through cross-border portfolio diversification. Furthermore, financial integration plays an important role in the transmission of the common monetary policy. Recent research suggests that the euro has fostered financial integration in the Euro Area. However, the level of risk sharing through financial integration in the Euro Area is still relatively low as wealth effects on consumption are weak in the member countries in particular in the short run. Global equity price shocks have a stronger effect in the Euro Area with most of the spillovers originating in the US. There is also evidence indicating that households react more strongly to capital losses in comparison to capital gains. This asymmetry is likely to influence the marginal propensity to consume out of wealth.

The effectiveness of fiscal policy as a stabilisation tool remains to be proven. Model-based simulations suggest that discretionary fiscal policy is more effective in large countries while, due to import leakages, it is limited in small open economies. More open economies, with a high share of intra-Euro Area trade are likely to benefit more from a Euro Area wide fiscal expansion. A combination of highly mobile capital and relatively low labour mobility within the Euro Area is likely to increase adjustment costs to asymmetric shocks.

Overall, the adoption of the single currency was assessed as successful. However, the resilience of the Euro Area countries to major asymmetric shocks has not yet been fully tested.

** Iulia Siedschlag, 2008, "Macroeconomic Differentials and Adjustment in the Euro Area", *SUERF Studies,* 2008/3, Vienna: The European Money and Finance Forum.