I. OVERVIEW

TABLE OF CONTENTS

OVERVIEW

1. Economic and monetary union in the early years: achievements and adjustment challenges

The introduction of the euro has been a decisive success. International confidence in the currency has been strong, and the euro has changed the face of global capital markets. The economy of the euro area has weathered successfully the common shocks experienced by its members since 1999 – including the bursting of the dotcom bubble, the September 11 events, the surge in global commodity prices, and the persistence of wide global imbalances. Indeed, monetary union eliminated, by its nature, the currency turmoil which, in earlier decades, all too frequently engulfed its members at times of international financial stress. Domestically, meanwhile, the adoption of the euro has been associated with an extended period of price stability: the low level of inflation and inflationary expectations testify to the credibility of the common monetary policy. Overall, policy coordination has led to a reduced number of policy-induced shocks at national level, usually smaller in size and impact. Thus a number of concerns raised in the period leading to monetary union have proved unfounded.

While some Member States have fully enjoyed the benefits of belonging to the currency union, notably by experiencing high growth rates, growth performance on average in the euro area – and particularly in the largest economies – has been disappointing. Concerns about growth performance, it should be noted, long pre-date the adoption of the euro, and recent experience has led to a reinvigoration of the Lisbon Strategy to foster a sustained acceleration of economic growth across the European Union. However, in relation to the functioning of monetary union, it is particularly important to understand one aspect of this experience better. This is the marked and persistent divergence of growth and inflation among euro-area economies.

One example of such divergences in economic performance is the protracted period of slow growth and low inflation in Germany, from 2001 onwards, which contrasts with a prolonged period of high growth and more rapid inflation in Ireland and Spain. Some divergences, including this one, partly reflect the process of economic catching up underway in certain euro-area members. But even within the latter group, there have been marked differences over an extended period. Most strikingly, since 1990 Ireland has achieved particularly rapid real convergence, which has led to living standards above the euro-area average since 1997. On the other hand, Portugal experienced a stalling of real convergence after 2000.

There is a question of what factors lay behind such divergences. Do they reflect mainly strong country-specific developments, tied to a combination of one-off effects – German unification, interest rate declines in the initial run-up to the euro, or the stresses of real convergence in some members? Are they related to long-standing issues about progress in enhancing the flexibility of markets, the mobility of labour, or the adequacy of fiscal stabilisers – many of which had been identified in the debate that took place during the years when monetary union was being designed? Or could they signal challenges that had not been anticipated in the functioning of the euro area – for instance: unexpected interactions between growth, prices and fiscal positions; inter-country spillovers; or unexpectedly strong financial market dynamics? Answering these questions may shed light on the functioning of monetary union.

This Review focuses on these divergences in economic performance, and it does so by using a range of analytical techniques to explore the dynamics of adjustment in the euro area. The focus is essentially on adjustment at the macroeconomic level, in terms of short- to medium-term influences on growth, employment, inflation, real exchange rates and current account imbalances. The goal is to identify possible policy lessons that can help assure an increasingly efficient functioning of the euro area in the period ahead. This could be relevant in three respects: to understand how adjustment challenges in its members can best be addressed; to ensure that future members benefit from these lessons of experience; and to safeguard the euro area's continuing resilience in the event of future global stress

2. The nature of the adjustment process

A starting point in this analysis is the process through which economies adjust to country-specific economic disturbances, at the macroeconomic level, under monetary union. This can be illustrated by an economy that experiences a stronger cyclical boom than the rest of the euro area – because of a specific shock or the economy's response to a common shock. Experience in the Netherlands during 1997 to 2005 is a helpful example, because developments in this case do not involve issues about economic catching up. As the economy entered a strong boom, the cyclical situation became tighter than the euro-area average, and thus to some degree out of line with common monetary conditions. Inflation started to accelerate, leading to overheating of the economy.

There is a complicating factor, inherent to some degree in all monetary unions. National real interest rates tend initially to fall as inflation accelerates in a boom (and conversely in a slowdown). This channel may tend to amplify swings in output and inflation. Indeed, measured on a backward-looking basis, real interest rates have fallen during the booms in euro-area members. Real interest rates at the national level can thus affect the adjustment path in a perverse (i.e. pro-cyclical) direction.

In the absence of national monetary policy, or the use of other instruments, the adjustment process that brings cyclical conditions back in line with the euro-area average in such cases is a loss of national competitiveness, which tempers the boom. This is indeed what occurred in the Netherlands between 2001 and 2004. The reverse occurs, of course, at times of country-specific cyclical weakness. This equilibrating process, operating through the "competitiveness channel", should be dominant over the medium term and should assure a dynamically stable adjustment process under monetary union.

This means that the scale and duration of divergences in growth and inflation among euro-area members, following country-specific shocks, will depend importantly on two sets of factors. First, they will depend on the nature and scale of the specific shocks and trends. Second, they will reflect the relative strength of the competitiveness and real interest rate channels in shaping the profile of adjustment. Several types of shock are explored in the Review. German unification exemplifies a major country-specific shock, with clear spillovers to neighbouring economies. Other familiar instances have been the fall in interest rates as some countries approached euro adoption, or the impact of tourism and migration on the housing market. Such events that trigger cyclical divergences are thus a key focus in this study: they include also productivity shocks in different sectors of the economy, and the relaxation of credit constraints as financial integration deepens.

There is significant scope for national policies to influence the adjustment process through the fiscal stance and, over the medium-term, structural policies. It is therefore important to understand how, as adjustment in the euro area evolved, it was affected by the interaction of policy initiatives with adjustment through market channels such as wages and prices. A better understanding of this process in the early years of monetary union can provide valuable lessons to enhance the functioning of the euro area in the future.

3. The approach to analysis in this study

To explore the dynamic nature of adjustment among euro-area economies, the Review is organised as follows:

- It first sets the stage by recalling how adjustment in the euro area was expected to function in the run-up to its creation in 1999 (Chapter II: Objectives, expectations and current issues).
- Area-wide economic trends in the early years of monetary union are then reviewed to assess how consumption, investment, inflation and financial market performance have evolved under monetary union (Chapter III: Economic developments and adjustment).
- This is followed, in turn, by an investigation of how the competitiveness and real interest rate channels of adjustment have worked, and a discussion of the impact of fiscal policies as well as labour, product and financial market reforms (Chapter IV: Market adjustment – the competitiveness channel; Chapter V: Market adjustment – the real interest rates channel; and Chapter VI: Policy-based adjustment).
- This leads to an integrated assessment of adjustment experience: an econometric model identifies how key factors have interacted, and selected country case studies draw on this in exploring economic developments and policy experience (Chapter VII: Country adjustment experience).
- The final section of the study considers opportunities and challenges facing euro-area policy-makers – focusing on routes to enhancing adjustment dynamics, including during real convergence (Chapter VIII: Adjustment and surveillance issues).

The study draws on a range of analytical techniques to explore the working of the euro-area economy. These include time series analysis and modelling, and six country case studies that seek to identify interactions between market developments and policy design in the spirit of a surveillance analysis.

4. Main findings about adjustment experience

The key conclusion of the Review is that, over the medium term, the adjustment process in the euro area is indeed dynamically stable, because changes in competitiveness dominate the process of adjustment following country-specific shocks. But this channel can operate slowly, and it is not exempt from some overshooting. The analysis stresses that the real interest rate channel is complex to analyse: backward-looking measures based on consumer prices fail to capture expectations, which are anchored by the credibility of the ECB's monetary policy; and economic agents face different sets of prices, capital costs and time horizons. The Review finds that pro-cyclical changes in real interest rates are somewhat less important than previously thought in explaining divergences in growth and inflation. By contrast, country-specific shocks – including developments in risk premia, credit constraints, and productivity in traded and non-traded goods – are powerful explanatory factors.

An important message about the adjustment process is that the interaction of several factors in a country can prove strong and mutually-reinforcing. In Spain, for example, several factors came together to shift demand towards non-traded goods, and specifically housing: a fall in risk premia, a relaxation of credit constraints on households, migration and demographics. This kind of effect – and specifically in residential investment – is evident in several economies: it is particularly instructive, because the empirical review of area-wide trends highlights the behaviour of investment – notably residential investment – as an important source of growth divergences. It emerges here as driven quite strongly by one-off factors and real economic changes, but often acting in combination.

Wage and price setting behaviour influences the efficiency of the adjustment process, taken together with underlying trends in productivity. Quite significant differences existed in the extent to which wages responded to changes in national output gaps, and in particular the emergence of cyclical slack. Italy, the Netherlands and Portugal, for example, experienced sluggish wage adjustment at times of weak activity. Recent surveys show that prices in the euro area change relatively infrequently. Prices of services are especially sticky, which is an indication of a lack of competition in services markets. Only 20% of the price changes in services are price declines, as opposed to 40% in other product markets. Also, in some cases productivity growth has played a rather modest role in facilitating real exchange rate depreciation. Thus adjustment through changes in competitiveness could be slow, resulting in a less efficient process and wider economic divergences. There are risks that wage and price dynamics could cause some overshooting in country-specific booms and downturns.

The analysis suggests that policies may need to help ensure that overshooting is dampened and problematic spillover effects are contained, including by avoiding a pro-cyclical fiscal stance or rapidly addressing undue developments at the sectoral or microeconomic level. In particular, further structural reforms are needed to increase the responsiveness of domestic prices to shocks. Even though the gap with the US has narrowed, euro-area product markets remain highly regulated. The creation of a more integrated and competitive Internal Market, particularly in services, should help ensure that prices adjust more rapidly to changing supply and demand conditions. During the period 1999-2006, a number of Internal Market directives and regulatory reforms aimed at opening up markets to competition were adopted and competition policy rules were revised according to economic principles. Nevertheless, sectoral enquiries show that effective competition in sectors that have been legally opened up to competition is still limited. A more effective implementation of agreed reform measures and a more ambitious reform programme are therefore essential to speed up the process of price adjustment in product markets. Similar action is required in labour markets, where progress with reforms has been steady but slow.

The analysis also points to a more prominent role for financial markets in the inter-country adjustment process than was anticipated. During the first few years of the euro area, there has been an overall sizeable reduction of interest rates in the euro area as a result of the credibility of the set-up concerning the conduct of monetary policy. Coming on top of this trend, the decline of risk premia and the easing of credit constraints in countries, which had experienced substantial differences with respect to the average situation in other countries, before the adoption of the euro, opened up new economic opportunities, including scope for higher household borrowing and growth in the non-traded goods sector, and notably in housing. With a good investment climate and an adequate supply of human skills, there was scope for capital to flow strongly to the traded goods sector also (as in Ireland). Productivity growth could then underpin income gains, competitiveness, and contribute to the servicing of external liabilities, though this was a demanding set of conditions to have in place. But the influence of financial markets was not always benign in terms of a swift and linear adjustment process. Asset markets tended to boom as real interest rates declined, so that wealth effects could amplify the "perverse" real interest effects noted above, thus widening swings in output and inflation.

The study highlights that key gains from financial integration are yet to be fully tapped. It appears that cross-border asset holdings are beginning to contribute to the smoothing of incomes at times of adjustment stress, but there is great potential for this process to strengthen. Evidence from the United States also points to the scope for greater integration in, and securitisation of, national mortgage markets in order to dampen downswings in localised real estate cycles.

The experience with fiscal policy in the adjustment process is also reviewed. One feature of interest is the association of periods of real effective appreciation in euro-area economies with strong revenue performance – since both are likely to occur during country-specific booms. During such upswings, reflecting strong internal demand, it was easy to overestimate the underlying strength of revenues, which were boosted temporarily by a consumption-rich composition of GDP and, in some cases, asset market booms. There was also a tendency to revise potential growth up too sharply, and to factor it into wage agreements and budgetary projections. This sowed the seeds of boom-bust dynamics. These effects, in combination, can be observed in the Netherlands in the period until 2004; and they are a reason for continuing vigilance in Spain. Conversely, fiscal consolidation during country-specific downswings – induced by weak internal demand – proved very arduous, even where nominal expenditure growth was well-contained, as was the case in Germany.

Partly as a result of these factors, there is evidence during the early years of monetary union of a failure to accelerate fiscal consolidation in good times. And, as a corollary, fiscal flexibility in a number of cases was not sufficiently available to buffer economic activity during the downswing. It becomes crucial to focus on the composition of growth in the assessment of cyclical conditions.

Taken together, labour market, financial and fiscal factors in each euro-area economy had the potential to interact in ways that could have accelerated efficient adjustment. By contrast, it is evident that they can also have mutually-reinforcing pro-cyclical effects – amplifying swings in output and inflation and stretching out the adjustment process. Slower adjustment is not necessarily less desirable if it involves less output sacrifice and lower social costs. But the concern here is that a problematic interaction of policy and market forces could increase adjustment challenges. Experience in the Netherlands illustrates this risk. Pro-cyclical developments in the financial markets, wages and the fiscal stance proved mutually-reinforcing. This suggests that, even after many years of de facto monetary union (considering also the long period of exchange rate stability within the so-called "DM area"), economic agents and policy-makers had not fully internalised dynamic risks in the adjustment process.

The study also sheds light on experience with nominal and real convergence, and accelerated financial sector integration, under the euro. Several findings deserve highlighting:

- During nominal convergence, interest rates fell significantly in some cases, providing a stimulus to activity; but countries differed widely in the extent to which they used this opportunity to achieve a durable acceleration of fiscal consolidation – with experience in Italy and Portugal being particularly cautionary in this regard.
- During real convergence – i.e., economic catching up – conditions varied significantly across countries as regards the attractiveness of investment in the traded goods sector. Ireland is the most striking case of strong inflows of investment to this sector. This triggered productivity growth in tradeables that helped to preserve competitiveness, reducing the need for later adjustment in the real exchange rate, in spite of stronger inflationary dynamics reflecting the catching up in living standards.
- During accelerated financial integration, as borrowing constraints on households were eased, there were major differences in supply response in the housing market, and hence in experience with asset price inflation. The strong supply response in Portugal meant that the subsequent economic slowdown was not accompanied by the bursting of an asset price bubble. However, the scale of housing booms in countries such as Spain may raise some questions of efficiency in the allocation of foreign and domestic savings at times when real interest rates were falling or low.

Finally, recent experience also confirms that spillover effects within the euro area can be sizeable. The scope for such spillovers is well-recognised in the case of fiscal policies, and they can also arise if inefficient functioning of labour markets slows the adjustment process. Moreover, strong housing investment across several large euro-area economies affects other members through demand effects (the shift to non-traded goods) and, simultaneously, through the resulting tightening of monetary conditions across the area.

The issues emerging from this analysis, it is recognised, do not map one-to-one with those highlighted in the academic and policy debate that took place in the run-up to creation of the monetary union. Some concerns that had been raised before the introduction of the euro did not materialise. Questions about economic flexibility and fiscal room for manoeuvre proved very relevant to recent adjustment experience. On the other hand, the impact of policy and market interactions, of cross-country spillovers and of financial market dynamics looms larger than anticipated.

5. Issues for policy consideration

This analysis of adjustment experience in the early years of monetary union sheds some light on opportunities and challenges for policy-makers, and on the scope for further "learning" about this environment by other economic agents. There is significant scope for national policies to respond to shocks in the short run, and major scope to enhance adjustment capacity over time. Given spillover effects, moreover, the benefits from effective policy co-ordination among euro-area members are heightened; and the interaction between macroeconomic and structural policy becomes of stronger common concern

Among the policy actions that can have immediate effect, three issues from recent experience deserve particular attention.

- First, to ensure that fiscal policy does not retard adjustment to country-specific shocks, thus magnifying divergences in economic activity. This requires strong focus on the underlying development of budget balances supported by careful analysis. First, country-specific booms – particularly those originating in the non-traded goods sector – can lead to over-optimism about the underlying fiscal position. Second, the flexibility of fiscal policy in the event of shocks can be improved by consolidation in "good times." This also helps to dampen the appreciation of real exchange rates and to offset the impact of positive wealth effects on consumption during country-specific booms. Where risks exist of real exchange rate overshooting, a careful approach to fiscal management is particularly important: for example, a pro-cyclical stance could aggravate such risks. Third, where shocks are permanent, the efficient operation of tax and benefit systems, rather than cyclical stabilisation, is the key to fostering the necessary resource reallocation.
- Second, to ensure that the social partners have appropriate information about adjustment challenges and the implications of different lines of action. It seems particularly important to analyse whether current wage and price developments are benign in terms of adjustment needs. Along with fiscal policy, well-adapted wage- and price-setting – closely reflecting productivity developments also in relation to the rest of the euro area – the potential for overshooting in intra-euro-area real exchange rates is a key concern.
- Third, in the field of policy co-ordination at EU level, including in the Eurogroup, to develop a shared understanding of wage, price and competitiveness trends, as well as interactions between developments in the real economy and fiscal adjustment goals. The scope for addressing inter-country spillovers deserves close attention in this connection.

The efficiency of adjustment dynamics within the euro area can also be enhanced by an acceleration of progress in structural policies, the effects of which are felt only in the medium term.

- First, shifts in countries' competitiveness positions reflect both wage and productivity developments. Experience illustrates how productivity growth can enhance the efficiency of adjustment – especially by reducing reliance on extended periods of low nominal wage growth. Thus, reforms to boost productivity are of key importance.
- Second, the efficient working of labour and product markets can clearly contribute to the adjustment process, and here the apparently low responsiveness of costs in some economies to the emergence of cyclical slack is a key point of concern. This needs to be understood in the context of each country's market institutions and frameworks, in order to highlight ways in which the welfare costs of slow adjustment can be reduced.
- Third, at the level of the euro area, financial integration is key: rising cross-country asset holdings can smooth incomes during adjustment, while retail market integration can dampen credit shocks and foster new investment. These effects are especially valuable in a monetary union without a large federal budget or strong labour mobility.
- Fourth, monetary union itself may have subtly affected the nature of systemic risk – with different profiles in economic adjustment, fewer market crises, greater financing ease, a dampening of market signals to policy-makers, and the interaction of complex real interest rate environments with asset markets. These changes need to be internalised by financial market institutions, and their supervisors, with particular alertness to distortions or failures of governance that could foster pro-cyclical market behaviour.

Policy priorities along these lines can help foster more efficient adjustment to country-specific shocks, minimise output losses, and reduce risks of financial sector stress. They would help to improve adjustment to common shocks. Moreover, the structural policy priorities identified here would typically contribute also to raising potential growth rates – by fostering higher productivity, improving the efficiency of labour and product markets, and unlocking the gains from deeper financial integration for investment and regional specialisation. Potential growth, indeed, can benefit to the extent that the euro-area economy experiences an increasingly efficient adjustment process and assures a yet more stable setting for investment.

These priorities, indeed, map very clearly on to key elements in areas where the European Union has established policies and strategies. The reformed Stability and Growth Pact lays an emphasis on consolidation in "good times" that appears even more warranted in light of the discussion above about fiscal elasticities and risks of inadvertent pro-cyclicality. It also builds explicit links between fiscal policy and structural reforms. The Lisbon Strategy highlights structural reform priorities such as stimulating market entry and getting people into work, which are promising in terms of efficient adjustment as well as growth. The findings of this study further underscore the crucial contribution of well-targeted reforms in a setting of monetary union. A dynamic Internal Market contributes to adjustment in the euro area through two channels: first, by creating a more competitive business environment it ensures that companies adjust their prices to reflect changing supply and demand conditions; and second, by facilitating the movement of resources towards more dynamic firms, sectors or regions. Sufficiently strong competition in product markets also helps to ensure that wage moderation and productivity gains are reflected in lower price levels. Financial market integration, moreover, is a core objective at the EU level; and the discussion in this study lends added emphasis to the steadily growing role that this can play, over time, in improving the quality of adjustment in those Member States that participate in the euro area. In addition, the findings of this Review with regard to interactions across countries, and spillover effects, confirm the importance of achieving a shared understanding of adjustment challenges, which is a pre-requisite for effective governance of the euro area.

Understanding and improving the functioning of economic and monetary union is important to allow all Member States of the EU take full advantage of the potential benefits of the currency union. This means achieving and sustaining higher rates of growth in the euro area, while preserving the stability of prices and of the exchange rate. Thanks to the deep integration of the euro area within the EU, higher growth and stability therein would have positive effects for all Member States of the European Union. Improving the functioning of economic and monetary union can also help to reinforce support for joining the euro area in those non-participating Member States, where doubts subsist as to the effective benefits of joining the euro area. Finally, learning lessons from the first few years of the euro area will contribute to facilitating a smooth entry of those Member States that are in the process of joining the euro area, starting with the accession of Slovenia and continuing with the other countries over the coming years. These Member States, as has been the experience of many euro-area countries during the first years of the euro area, would most probably undergo significant real adjustment in their economy, even after having achieved the nominal convergence necessary to adopt the euro. Continuing the effort of understanding which policies are necessary to address this continuous adjustment, and which errors to avoid, will certainly be a major contribution towards facilitating a smoother integration of EU economies within the monetary union.