Conference on EMU and economic governance
Brussels, September 28, 2004
Session I: EMU after 5 years
Jean-Philippe Cotis
Chief Economist, OECD

First, I would like to express my gratitude for this invitation. It is a privilege to participate in this Roundtable on the basis of an excellent report from the Commission.

I find myself very much in agreement with this report. On the positive side, I certainly agree that:

- the launch of the euro went smoothly;
- monetary policy has generally been a success;
- and further economic integration has been achieved.

I also think that the report does a good job at identifying weak spots such as:

- a disappointing fiscal performance both from the point of view of long-term sustainability and conjunctural stabilization;
- a difficulty to cope with asymmetric shocks in a context of sluggish wages and low labour mobility;
- a lack of adequate progress in labour, product and financial market reforms.

Overall, *EMU after five years* is an evenly balanced report and I appreciate its guardedly positive tone.

Rather than paraphrasing this very good report what I would like to do this morning is to concentrate on what went wrong and needs to be addressed, sooner rather than later. I will deal mainly with structural and macro-structural issues through the prism of convergence both within and outside EMU.

I. Macroeconomic performance

The euro was launched amid very favourable economic conditions. Growth was above trend, inflation was low, unemployment was falling and nominal dispersion was at record low levels.

These positive developments continued for several years and misled some of us into declaring victory too soon. It was not fully appreciated maybe that macroeconomic stability over this period was a feature evident in virtually all other OECD economies, reflecting to a large extent the absence of major economic shocks.

In this context, it was felt that the worst was behind us and that the time had come to enjoy the fruits of past efforts. Such sentiment and 'reform fatigue' resulted in a missed window of opportunity to further advance structural reforms and fiscal consolidation. As a result the EMU did not prepare itself as well as it could have to cope with the next negative shock.

When it came about in late 2000, in the form of a collapse of ICT equipment in the US, prestigious officials told us that EMU would be nearly completely insulated! At first, in 2001, this prediction seemed to be sort of vindicated.

What was not expected, however, was the severity in which the negative effects were subsequently propagated throughout continental Europe. Leading to a protracted period of weakness, while other OECD non US economies resisted much better.

Even within the euro area the ramifications were diverse; with Germany posting a particularly dismal performance in terms of domestic demand. Compared with initial expectations EMU did not pass its first resilience test that well (Graph).

Forthcoming OECD work based on sophisticated techniques suggests that this specific lack of resilience reflects structural weaknesses rather than just muted macroeconomic policies.

Over the past decade, it seems that these OECD countries that enjoyed strong long-term growth also benefited from short-run resilience (Graph). So that, the same structural factors that contribute to long-run growth may also be at play in the short-run to help economies cope with adverse shocks.

Moving beyond fiscal issues, I already said that the conduct of monetary policy over the period was a success. But more should be done in terms of structural reforms to move towards an optimal monetary zone, in a loose sense.

Take for instance the dispersion of inflation within the euro area. Some dispersion is natural. But when it is large it may result in slow and painful adjustment in some regions of the monetary union. This seems to be the case in Italy, for example, where inflation has been frequently above the euro area rate, competitiveness has declined continuously and export market share has been falling sharply (Graph).

To a large extent the negative consequences of real appreciation on activity tends to be offset by a lower real interest rate. So that an inflation differential may not be detrimental to short-run growth.

Such a disparity in inflation rates may nonetheless artificially tilt the structure of economic activity away from the traded sector, which is often a source of technical progress and productivity increases.

These inflation differentials may stem in part from differential demand pressures, themselves originating at times from asymmetric transmission channels of monetary policy.

To give an example, work reported in the OECD's most recent Economic Survey of the euro area has found that monetary transmission through the housing channel may be stronger in euro countries with flexible mortgage markets than in economies where such financial products are less developed.

This conclusion offers another argument in support of a more integrated and effective financial market. Not only would it be beneficial in terms of strengthening competition in this sector and bolster the resilience of economies in the face of adverse circumstances, but it would also homogenize the impact of monetary policy within EMU.

II. Convergence or divergence in economic performance?

The Commission's report rightly focuses on cyclical convergence across euro area countries, since this bears on how well shocks can be absorbed in a monetary union. And the Commission is able to report progress over the past five years. Let's not forget however long-term convergence in living standards across the regions and countries of the euro area. Indeed, it is an objective for economic union in its own right and enshrined in the Treaty (Article 158).

The OECD's latest Economic Survey of the euro area analysed in depth disparities across the union. It found, like the Commission did, that gains had been made, but more could be achieved.

Indeed, living standards differ widely across the euro area. Today real GDP per capita at the country level ranges from around two thirds of the euro area average to about 25 per cent above. And at the regional level the differences are even bigger, typically with the districts of the south much poorer than in the north. While these disparities have narrowed, especially at the country level over the past 10 years, income dispersion remains much larger in the euro area compared with regions in the US or Canada. There are also large disparities in euro area product and labour markets, which is indicative of high market segmentation and low geographic labour mobility.

This lack of improvement calls for further progress towards the completion of the single market. This means more action on the labour, product and financial market fronts.

An area where the EU has also failed to make progress is the degree of convergence in long-term growth relative to the US and other OECD economies. This sort of convergence was an important objective for the Lisbon Agenda. Looking back, however, to the past twenty years GDP per capita growth has been lacklustre. After a sustained period of catch-up to US levels, convergence in per capita output stalled in the 1980s, and during the 1990s it backtracked.

As a result of these trends, per capita incomes in 2002 were about 30 per cent lower in the euro area than in the United States. Looking ahead, if the gap in per capita incomes vis-à-vis the US is to narrow, it will be necessary not just to match US performance, but to exceed it. No large European economy has managed to do this for a sustained period in over two decades.

It is now well known that substantially lower labour utilization is the main cause of the widening gap in GDP per capita (Graph).[1] But still there does not appear to be a full consensus on why labour utilization has dropped. This is worrying as it weakens the prospect of gaining bi-partisan support for structural reform.

My concern is the frequency in which I hear the argument that there is nothing wrong a priori with different growth rates between the US and EU Member States because it reflects different societal choices such as a greater preference by Europeans for leisure. Even The Economist magazine[2] has recently sort of endorsed this view. Of course, individuals should feel free to choose between more consumption and more leisure. But we have to make sure that low rates of labour utilisation do not predominantly reflect public policies that are biased against labour and keeping people out of work.

---

[1] See, for example, OECD (2003), *The sources of economic growth*, Paris.
[2] See, Mirror, mirror on the wall in *The Economist* June 17 edition.

For example, at the OECD, we have documented distortions in pension and social transfer programmes that make it financially punishing for the so-called older workers to remain in the labour force until the statutory retirement age.[3] Our analysis shows how removing these disincentives could boost considerably the participation rate of the so-called older individuals (Graph). Should all OECD countries move towards actuarial neutrality, our simulations suggest that "older" persons in France, Belgium or the Netherlands may well want to work as long as a Swede or an American.[4]

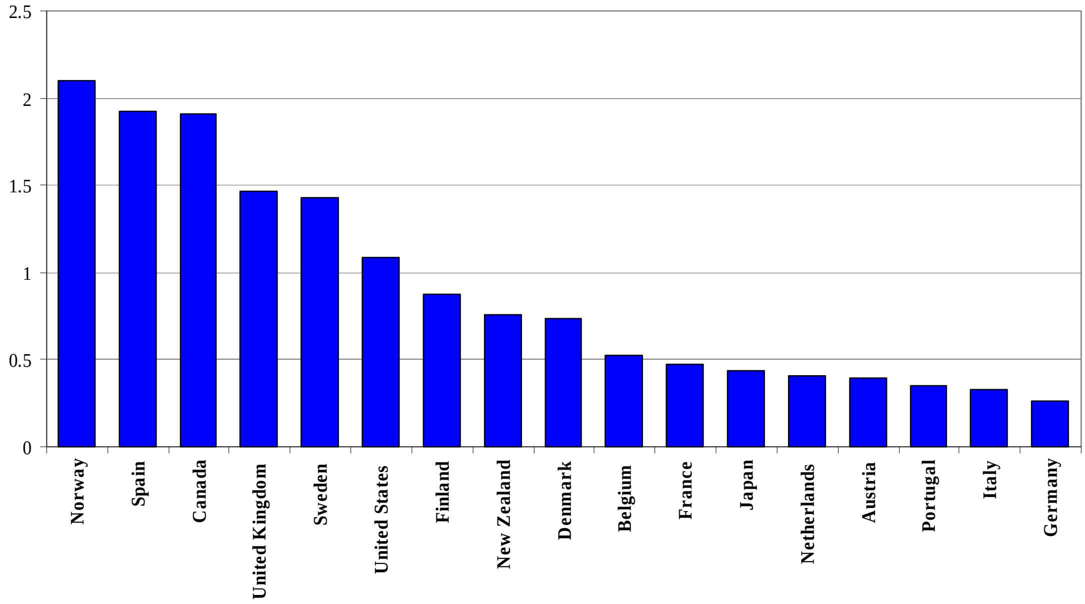
Europeans should also work at boosting productivity, which is impeded by a number of factors. Most importantly, product and capital markets are not open enough and therefore not integrated enough to generate the right kind of competitive pressures. There are still quite a number of obstacles to entrepreneurship in the EU (Graph).This lack of competitive pressures limits the scope for specialization, efficiency gains and productivity improvements.

All in all, I would happily endorse this quote from the Commission's report 'The implementation of reforms identified as part of the Lisbon strategy is perhaps the most important economic policy challenge now facing the euro area'.

I fully agree and support the tactic of committing to specific objectives. To be effective, however, these objectives need to avoid setting the bar too high. As it is likely to be more a source of discouragement than encouragement to reform. This was a weakness of the Lisbon Agenda. The 3% target growth for GDP, the huge increases in employment rates that were set for some countries for 2010 were somewhat unrealistic and backfired. At some stage ambitious but realistic targets will have to be decided on again.

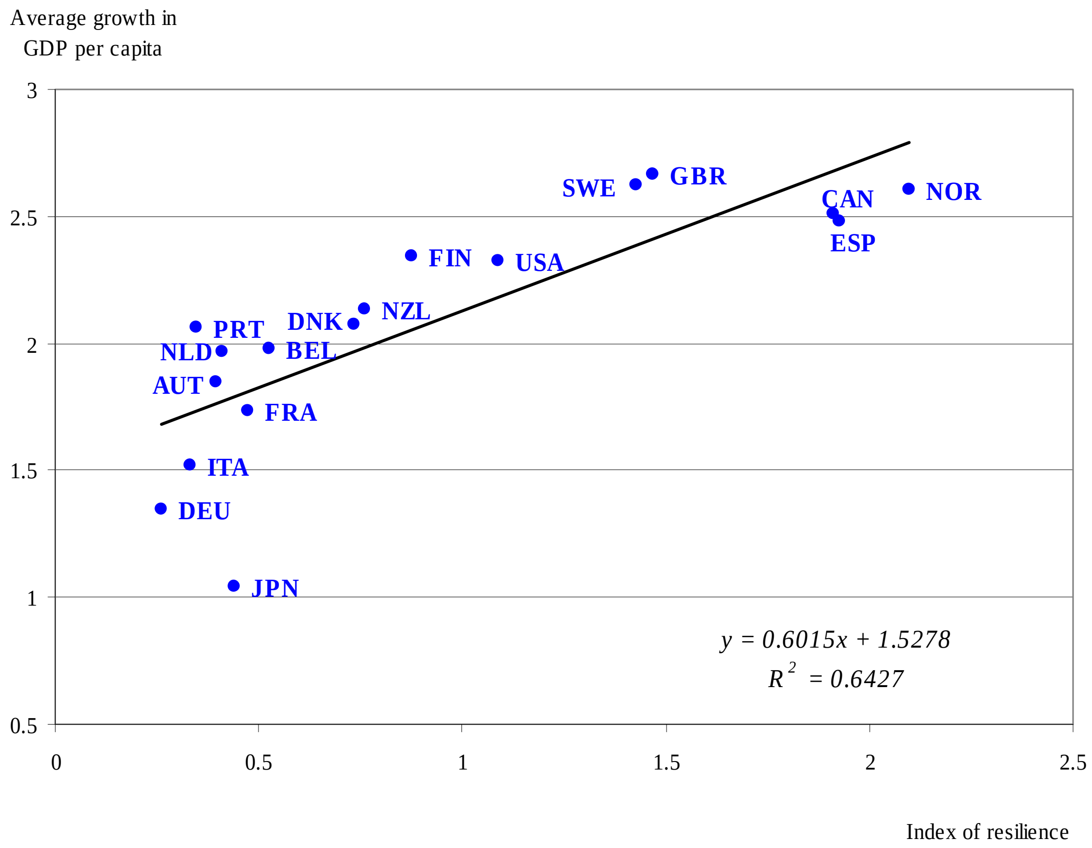
[3] See Duval, R (2003), "The retirement effects of old-age pension systems and other social transfer programmes in OECD countries", *OECD Economics Department Working Paper*, No. 370.
[4] See Jaumotte, J. (2003), 'Female labour force participation: past trends and main determinants in OECD countries", *OECD Economics Department Working Papers*, No. 376.

Indicator of resilience for the recent downturn in a number of OECD countries [1]



1. The indicator of resilience is measured as the ratio of the cumulative output gap in the first half of a downturn to the cumulative gap in the second half. The ratio is then divided by the square-root of the average gap over the whole period so as to adjust for the severity of recessions.
Source: OECD

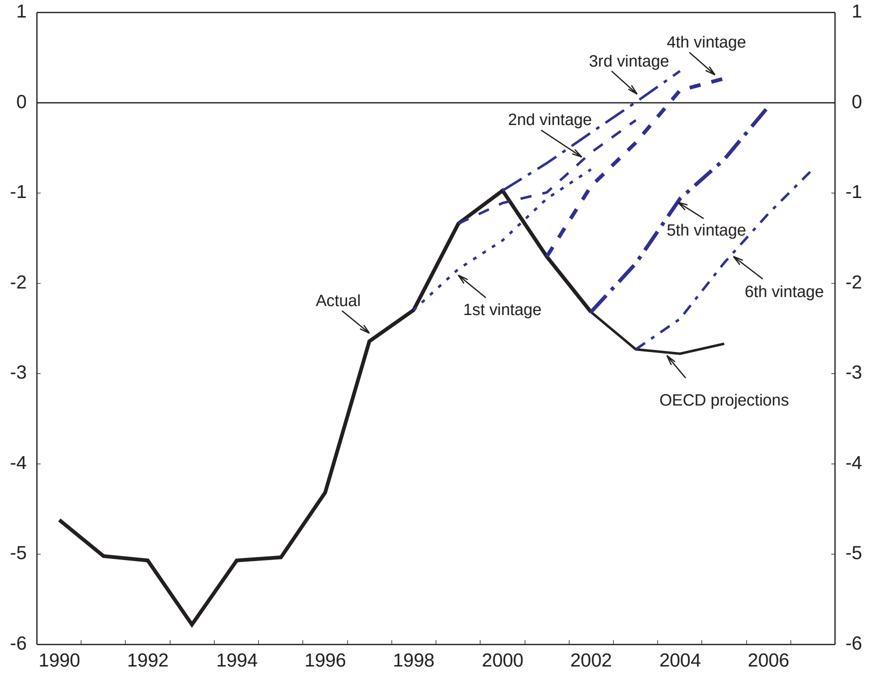
Resilience and average growth in GDP per capita over the past 10 years



Source: OECD

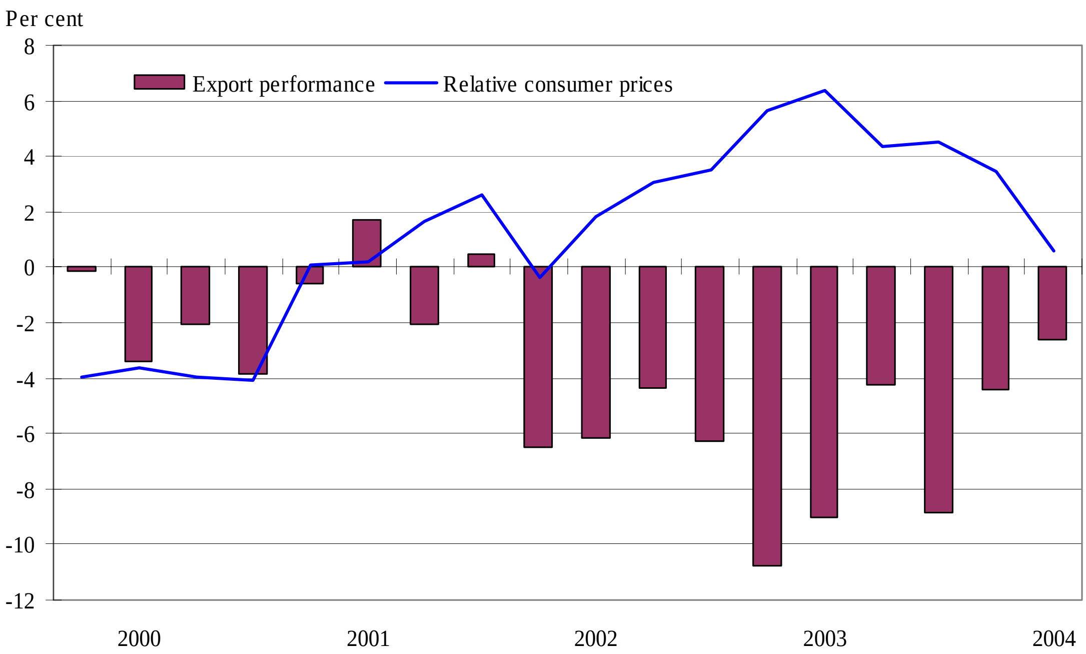
Fiscal targets have been missed repeatedly [1]

General government balance in the euro area as a percentage of GDP [2]



1. The various vintages of the Stability Programmes were released over the following periods: 1st 1998/99, 2nd 1999/2000, 3rd 2000/01, 4th 2001/02, 5th 2002/03, 6th 2003/04.
2. Excluding UMTS licence proceeds.
Sources : European Commission/Eurostat and OECD.

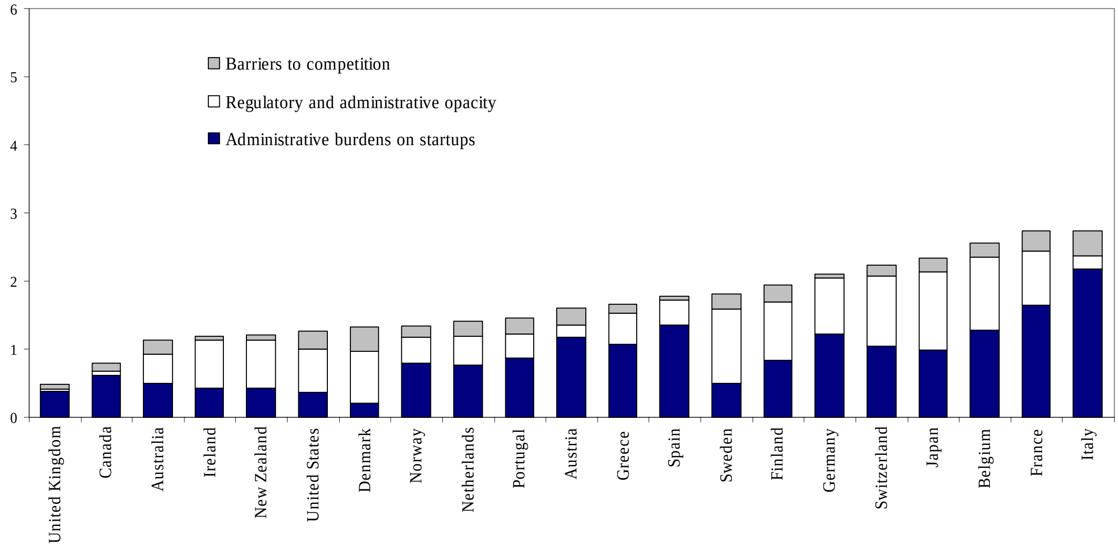
Italian competitiveness has deteriorated [1]



1. Year-on-year percentage changes.

Source: OECD.

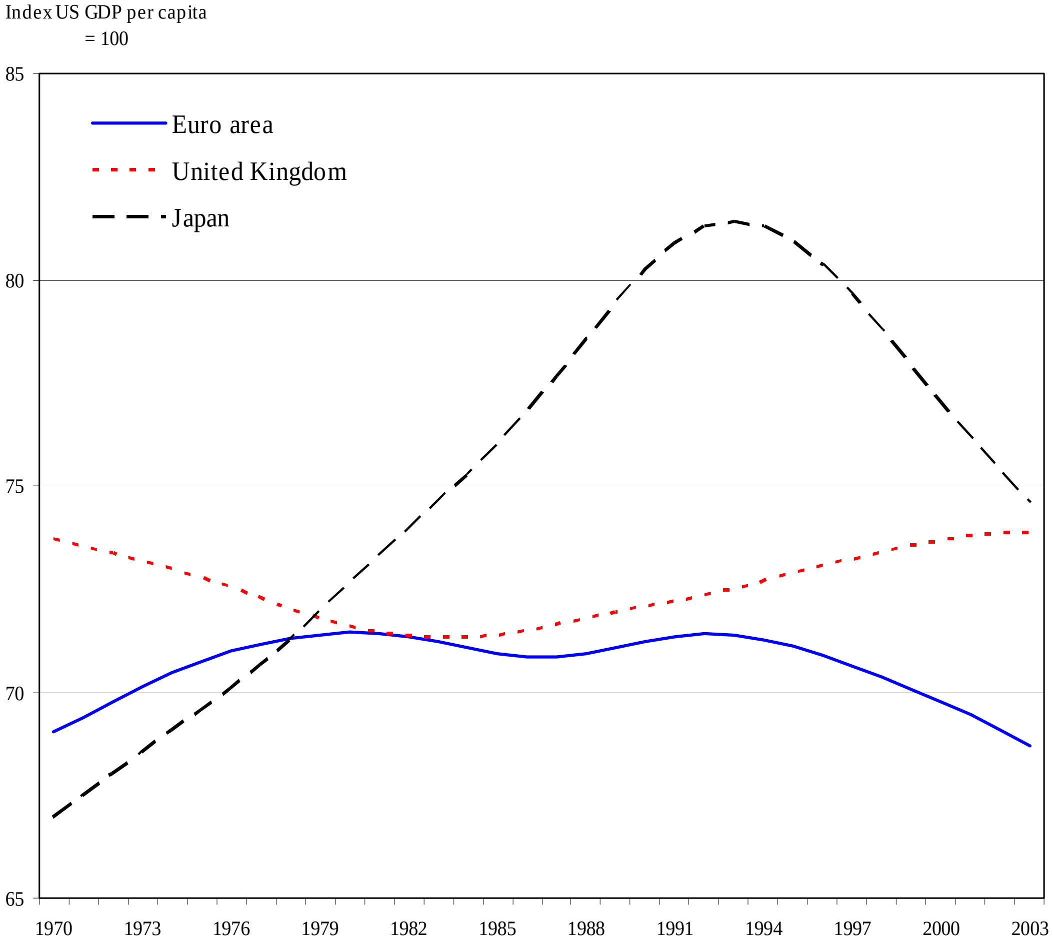
Barriers to entrepreneurship in euro area countries are high[1]



1. The scale of indicators is 0-6, from least to most restrictive.

Source: Nicoletti, et all (1999), "Summary indicators of product market regulation with an extension to employment protection legislation," OECD Economic Working Papers no. 226.

Real per capita GDP relative to the United States

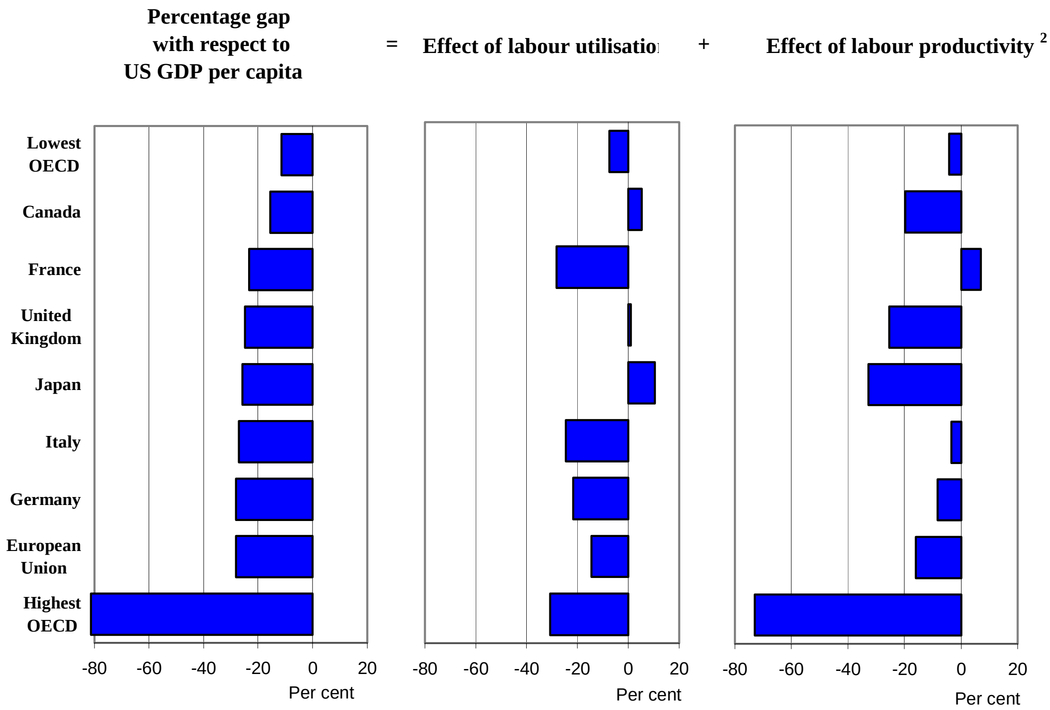


1. The trend is calculated using a Hodrick-Prescott filter (smoothing parameter set to 100) over a period which includes projections through 2010.

Source: OECD Annual National Accounts.

Differences in labour utilisation continue to be important in explaining differences in GDP per capita

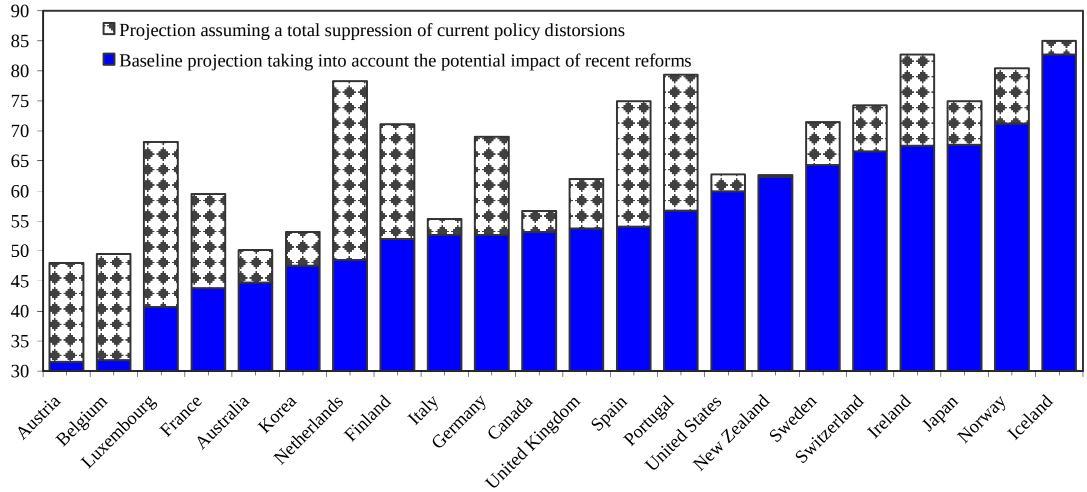
Percentage point differences in trend , PPP-based, GDP per capita with respect to the United States, 2002



1. Labour resource utilisation is measured as total number of hours worked divided by population.
2. Labour productivity is measured as GDP per hour worked.
Source: OECD.

Removing implicit taxes on older workers would raise participation

Potential impact of pension reforms on labour force participation of older workers (projected labour force participation rates of the 55-64 age group in 2025 under different scenarios)



Source: OECD.