

Convergence in the euro area - what's the evidence?

Economic convergence is regarded as an important pre-requisite for countries forming a monetary union. In a single currency area nations no longer exercise autonomy over monetary policy, instead a 'one size fits all' rate is applied and there is a perfectly fixed exchange rate between countries. A country which is at a different part of the economic cycle as the rest of the currency union therefore faces a sub-optimal monetary policy regime and an incentive to reintroduce its own domestic monetary policy.

The Maastricht Treaty defined convergence criteria on inflation, interest rates and budget deficits for the European nations adopting the euro. Strictly speaking though, convergence criteria are not a pre-requisite for the operation of a single currency, although they do help at the outset. In fact, the Maastricht condition puts the cart before the horse, for one of the main predictions of a single currency is that there will be convergence in output across the euro area.

This arises because a single currency strengthens trade links between member countries. Firstly, if all goods and services are expressed in the same currency then consumers find it easier to make international price comparisons, i.e. the costs of search are much lower. Secondly, and perhaps more importantly, a single currency removes the transactions costs of dealing in different currencies that might otherwise create an impediment to trade.

There are now two ways in which cyclical convergence might arise. Directly, nations with strong domestic demand are likely to run trade deficits with the rest of the currency union whereas nations with weak domestic demand are more prone to run trade surpluses. Therefore, external demand via net-trade acts to synchronise business cycles. Indirectly, inflation is likely to be higher in countries that are growing strongly rather than where growth is sluggish. Although the nominal exchange rate is de facto fixed, differences in inflation rates allows the real exchange rate to vary. Strongly growing countries will face a real appreciation, and weakly growing countries a real depreciation. The competitiveness effects, again through net-trade, will generate convergence.

So, how does the record on convergence stand up? From figure 1 there is some evidence on convergence, but it appears that this has arisen because most nations have exhibited poor growth in recent years. Only Finland, France and Spain have performed better in EMU than during the decade before. The countries that have grown strongly, Ireland, Greece and Luxembourg are relatively small economies, and unlikely to impose strong external effects on the others.

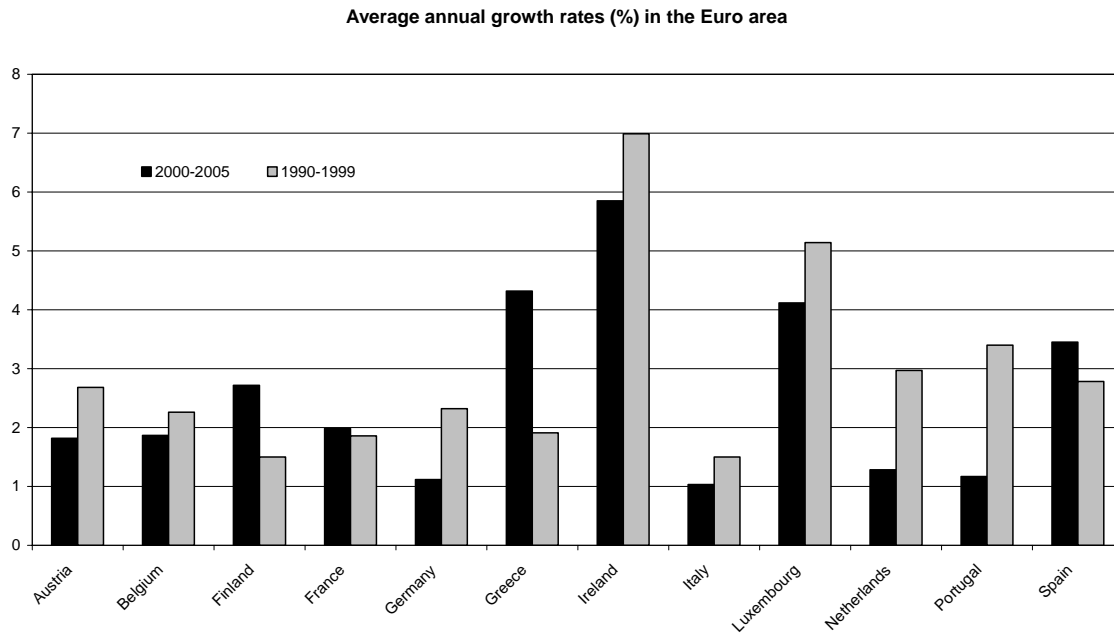


Figure 1: Source- IMF World Economic Outlook database

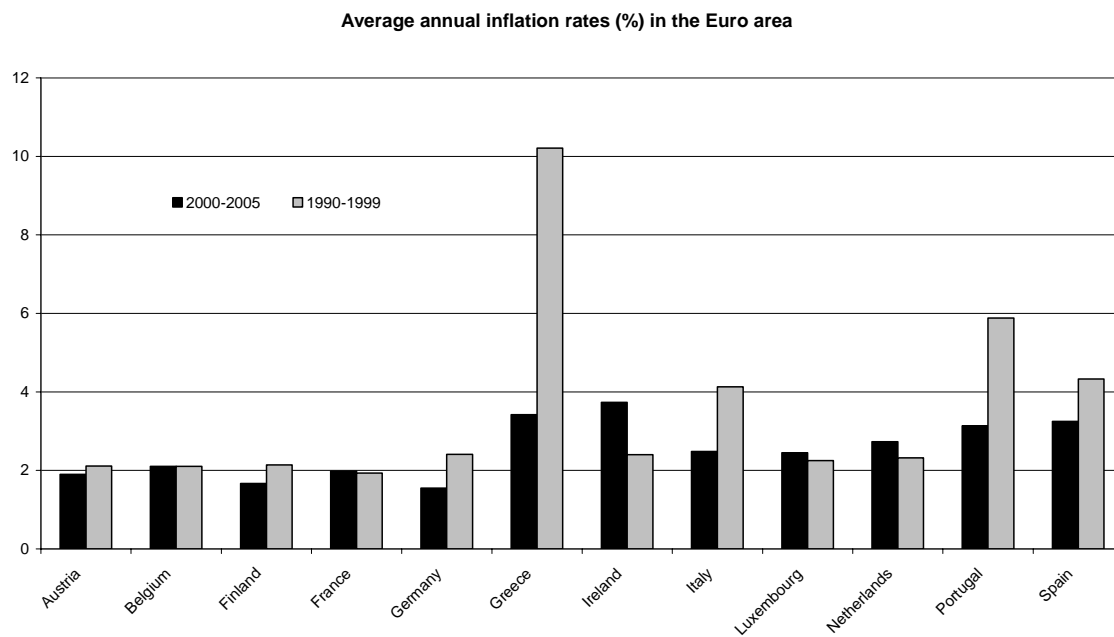


Figure 2: Source- IMF World Economic Outlook database

The evidence on inflation convergence (figure 2) is much stronger, with countries with historically high rates of inflation converging towards the rest of Europe. There are two ways in which this might arise. First, a single currency by reducing search and transaction costs makes European goods markets potentially more competitive - which holds down price increases. However, more likely the ECB has introduced a more credible monetary policy regime than existed prior to the euro membership in certain high inflation countries such as Greece and Portugal.