From High Hopes to Despair: The Missing Metric in the European Monetary Union

It all started out with high hopes. The idea was to build a united Europe that would enhance well-being all around. A sharing Europe that gave the continent's least developed countries an opportunity for fast-track convergence with the wealthiest countries. And lastly, a peaceful Europe—because the combined economic strength and weight of its members would ensure lasting cohesion.

In the first several years, those hopes appeared to be more than well-founded. When Spain joined the EU in the mid-1980's, the country's living standards lagged 25 percent behind the French-German average. Within less than fifteen years, the ensuing boom had lifted Spanish per capita income by 50 percent, making up for nearly half of the initial differential. Over that time span, massive foreign investment drove industrial expansion and exports quadrupled in volume, with 75 percent going to other EU Member States. The labor force also increased from 11 million to 15 million, while year after year, EU structural transfers, of which Spain has long been the leading recipient, helped the country gradually build up infrastructure to the level required to secure long-term growth.

Spain was clearly off to a flying start. From 1986 to 2000, GDP grew by an average of 4 percent a year. Just prior to Monetary Union, the country's balance of payments was roughly in balance. Spain managed to avoid exiting the EMS in 1992 and brought its exchange rate back on even keel. Inflation likewise fell to close to the rate in the other major European economies, and interest rates decreased considerably. And while fiscal deficits and government debt remained well above the limits set by the Maastricht Treaty, the efforts undertaken to get public spending under control inspired confidence in the country's ability to handle those problems as well. All in all, Spain looked like the ideal candidate for joining the single currency—in Maastricht terms at least. But that's precisely where the trouble lies. **None of the criteria in Europe's Stability and Growth Pact—deficit and debt levels, interest rate and inflation rate convergence, stable exchange rates—has anything to say about the one structural convergence criterion that is truly crucial for a monetary union to work, i.e., productivity. Although Germany had made productivity convergence between East and West Germany the cornerstone of its strategy to ensure a successful introduction of the Deutschmark in the Eastern *Länder,* and as such the main focus of Theo Weigel's speech at the time of reunification in 1990, there isn't a single mention of productivity in the Maastricht Treaty!**

The missing criterion

And yet the level of productivity in absolute terms is what determines the general price level in the various EU economies. If there is insufficient productivity convergence, prices are likely to create serious distortions in how capital is allocated across a region that lets people, goods and capital circulate freely but that no longer has the ability to adjust exchange rates. The inflow of capital into countries with low prices is an integral part of the European catch-up process and the goal of convergence in living standards across the Union. By accelerating the transfer of technology to the least advanced countries, capital inflows boost productivity, development, and growth in those economies. The logical outcome is general price level convergence. A country receiving such inflows will therefore grow faster for a while than its more advanced partners, and that faster growth calls for an appropriate monetary policy that implies higher interest rates than in the advanced countries. **It is vital for the monetary authorities to steer such countries all the way through the catch-up phase, abiding by what you might call the golden rule of all monetary policy—interest rates aligned with the nominal growth rate of each national economy.**

Hasty introduction of the single currency, and with it a monetary policy that by definition leaves no room for ad hoc adjustments, deprives catch-up countries of the monetary assistance they need and generates major economic imbalances. **This was the primary—and potentially fatal—mistake made by the EU on the road to monetary union. The current crisis is the direct outcome.**

Productivity in Spain had certainly gone up, but even so, just before the introduction of the euro, it was still 25 percent lower than in France and Germany, with a similar price differential also observable. What came next is easy enough to understand. During the catch-up phase, Spanish GDP growth averaged 3.5 percent a year in real terms and over 7 percent in nominal terms. This means interest rates should have been raised to roughly the same 7-percent average. Needless to say, that never happened. Between 2000 and 2008, the ECB held interest rates down to 3 percent on average, due in particular to the poor health of the German economy until the middle of the decade.
In a normal environment, such a sizeable gap between nominal growth and interest rates would have led to inflation. But with global industrial competition reaching new heights in the past decade, the main impact of this dysfunctional monetary policy was on asset prices, especially in real estate. The result was an uncommonly large bubble. When it burst in 2008, the damage was commensurate with the preceding expansion.

Let's hope this experience will become a textbook case so that a good grasp of what went wrong in the past can help us respond adequately to the present crisis. Spain, Portugal, Greece, and Ireland are all suffering from the same inadequacies in the European integration process. It is pointless to press them to improve their competitive position through adjustments whose deflationary consequences are bound to be devastating, particularly where there is only limited productive capacity and if nothing is done to consolidate it. As long as no structural development policy is introduced, the events to come will necessarily run counter to the initial aim of

integrating European economies through a race to the top. In the process, Europe will lose its *raison d'être.*

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