

Discussion of “The Euro at Ten: Unfulfilled Threats and Unexpected Challenges”

by Mongelli and Wyplosz

Vítor Constâncio

Banco de Portugal

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A note of caution underlying the paper, this discussion and the Conference

- **The outcomes that we observe in the data result from the combination of the myriad of shocks, structures and policies in the euro area, and only a subset of these are (directly or indirectly) related to the introduction of the euro**
- **The absence of a counterfactual poses serious challenges to any assessment of the role of EMU in interpreting the data**

Outline of the discussion

- **Mongelli and Wyplosz (2008)'s set of unfulfilled threats and unexpected challenges**
- **Addressing in practice some of these threats and challenges: the case of adjustment of the Portuguese economy within the euro area**
- **Lessons for the future**

Mongelli and Wyplosz (2008)

- **The unfulfilled threats:**
 - The need for the ECB to earn credibility in the early years of the euro area
 - The destabilising effect of real interest rate movements (the “Walters Critique” v. the “Hume mechanism”)
 - The national bias towards running budget deficits
- **The unexpected challenges**
 - The criticism that the Eurosystem lacks transparency
 - The growing current account imbalances
 - The lack of responsiveness of real exchange rates in a monetary union

Mongelli and Wyplosz (2008)

- **The paper addresses comprehensively the performance and challenges facing the euro area throughout this decade**
- **The authors are careful in the survey of the literature and cautious in drawing their conclusions**
- **Nonetheless, some of the illustrations in the paper – in particular those based on bivariate relations between variables such as the current account and the REER or the current account and budget balances – are not really convincing**
- **Within the conservative uncertainty bands surrounding the authors' conclusions, I subscribe to most of them. Here, I would underline three of those conclusions.**

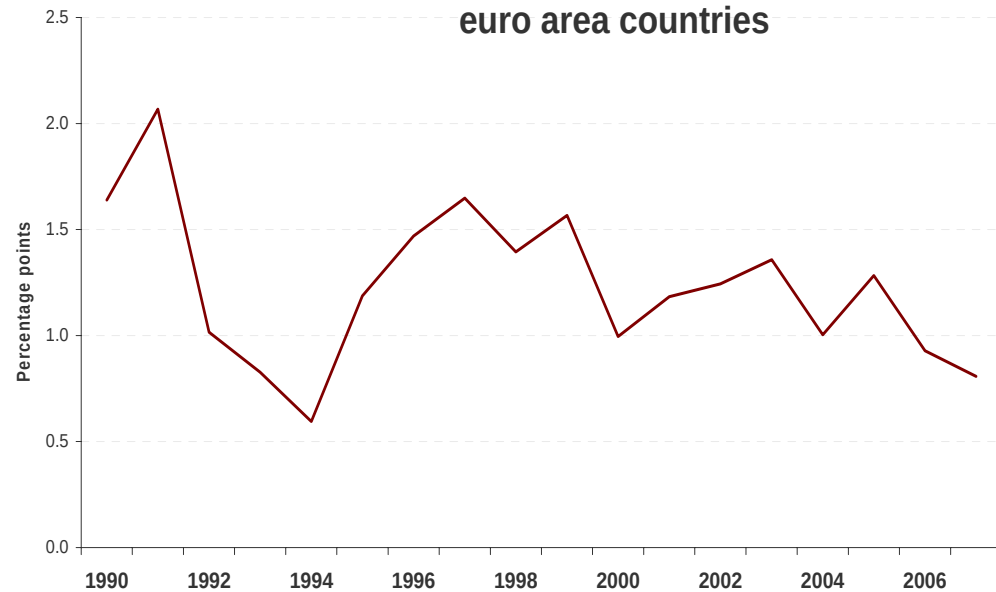
Mongelli and Wyplosz (2008)

- **GDP growth and inflation differentials in the euro area are at historical lows and synchronisation of the economic cycle has increased**
- **Adjustment mechanisms seem to work in the euro area**
- **The incentives surrounding the conduct of fiscal policy in a monetary union are very important**

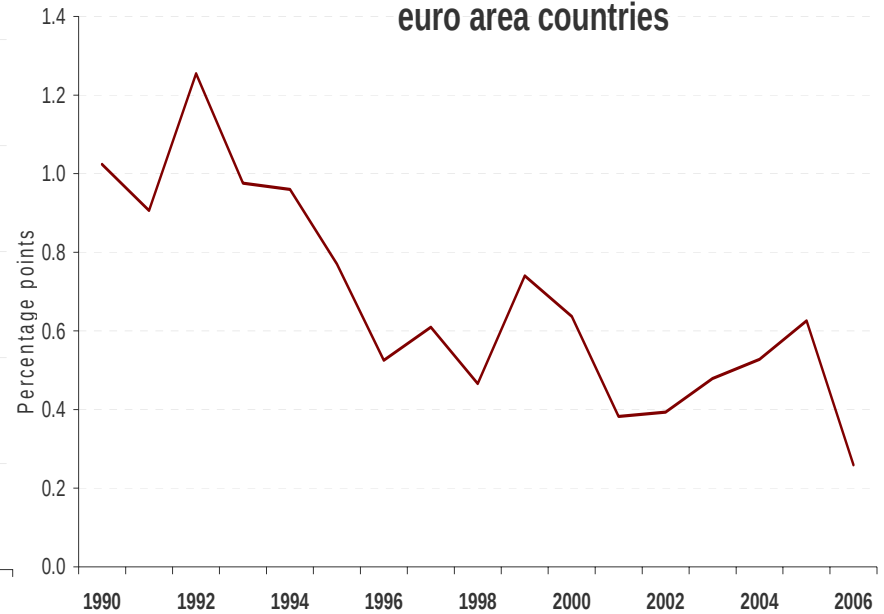
Mongelli and Wyplosz (2008)

- GDP growth differentials and dispersion of output gaps in the euro area have decreased**

Weighted standard deviation of GDP growth in euro area countries



Weighted standard deviation of the output gap in euro area countries



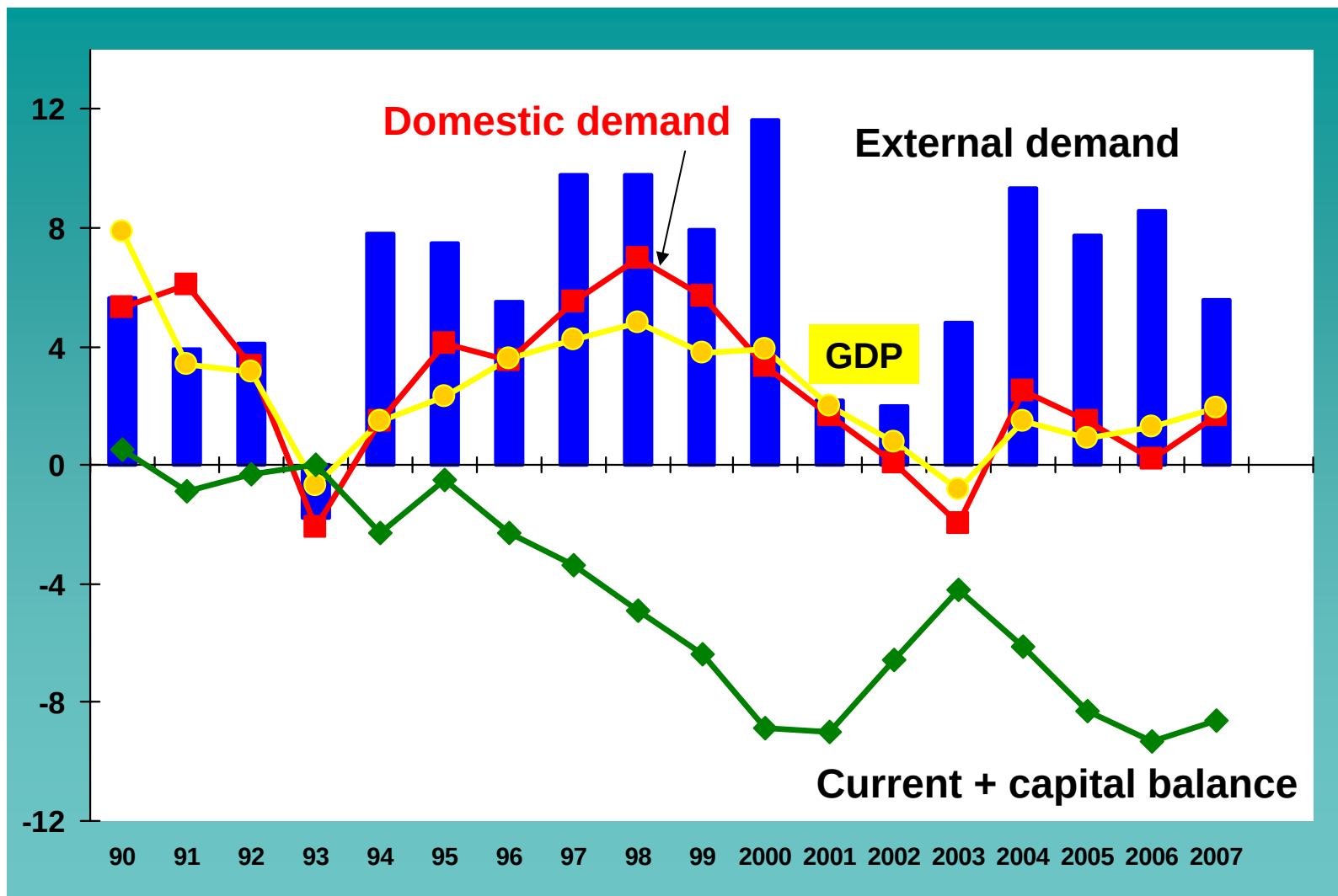
The Portuguese experience in the euro area

- **Portugal is a good example of the challenges identified in the paper.**
- **In fact, many of the incentive structures and mechanisms underlying the functioning of a monetary union can be observed in the Portuguese adjustment experience since 1995.**
- **The behaviour of the Portuguese economy in the past decade is a story of transition to a new regime and of adjustment to the rules of the game in a monetary union. After an initial boom came a marked slowdown**

Adjustment mechanisms in the euro area

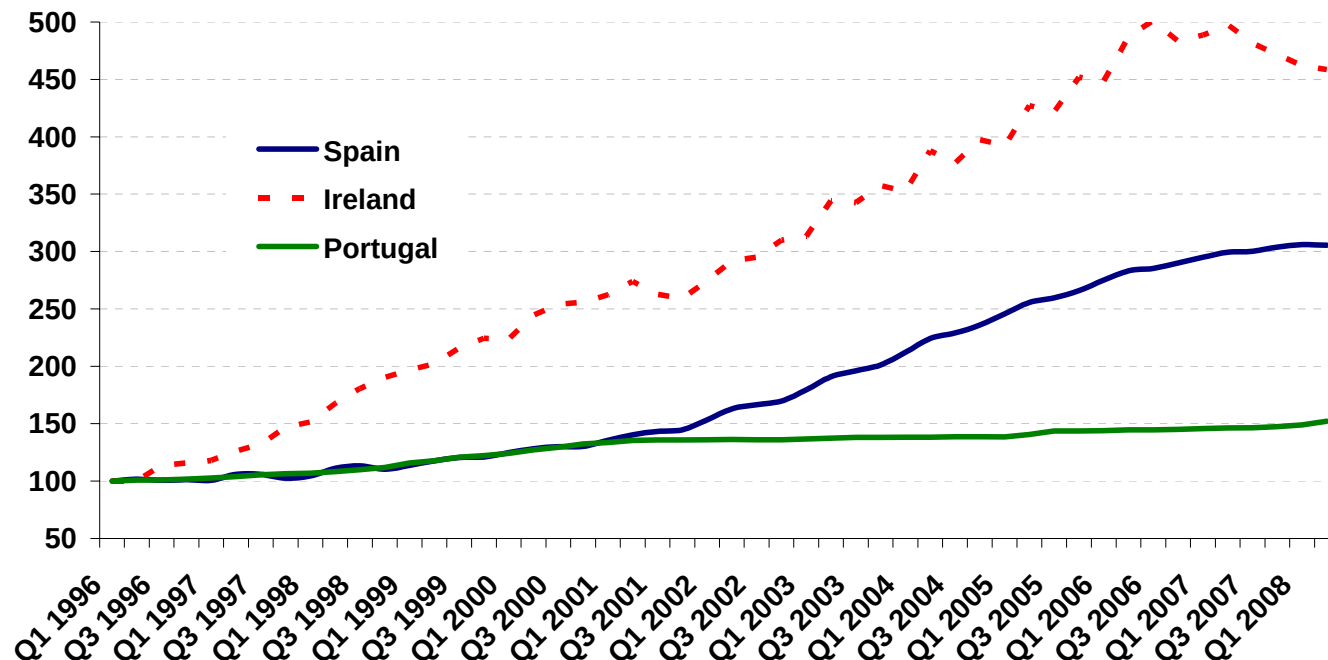
1. The role of fiscal policy
2. The real interest rate channel
3. The competitiveness channel
4. Risk-sharing, with a particular focus on the international financial markets and the financial system

- **Portuguese economy: from boom to recession and adjustment with slow recovery (until the recent turmoil...)**



- **Features worth noting of the boom period:**
 - The boom was relatively short
 - No bubble emerged in the property market
 - Fiscal policy was pro-cyclical
 - The interest rate channel played a significant role

House prices in Spain, Ireland and Portugal (1996Q1=100)

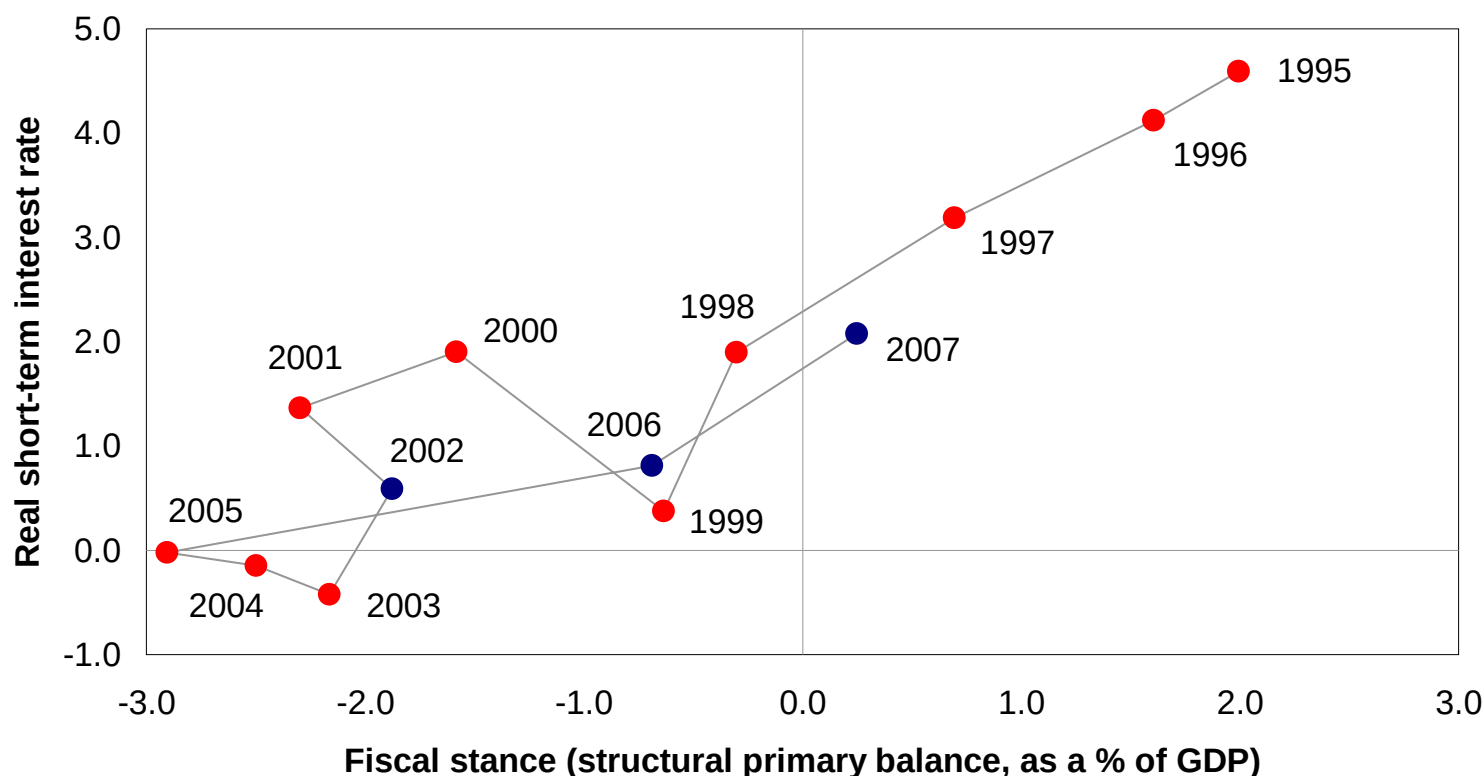


- **The sudden stop: After 2000 there was a sharp adjustment to a protracted period of lower trend GDP growth**
 - **The role of shocks: the early 00s were characterised by a deceleration of the Portuguese main trading partners and significant oil price shocks**
 - **The role of expectations' formation: the prospects of monetary unification triggered a rational intertemporal response of bringing forward consumption and investment decisions; the subsequent revision of potential growth led to a reversal in those trends. The emergence of the budget crisis of 2001 led to a collapse of expectations and of domestic demand**
 - **The Portuguese economy did not seize up fully the technological improvements that prevailed since the 90s, given its relatively low level of human capital.**
 - **The intensification of the globalization process led to significant changes in the revealed comparative advantage of the Portuguese economy. The transition to these new comparative advantages was hampered by the existence of several rigidity factors in the economy.**

1. The role of fiscal policy

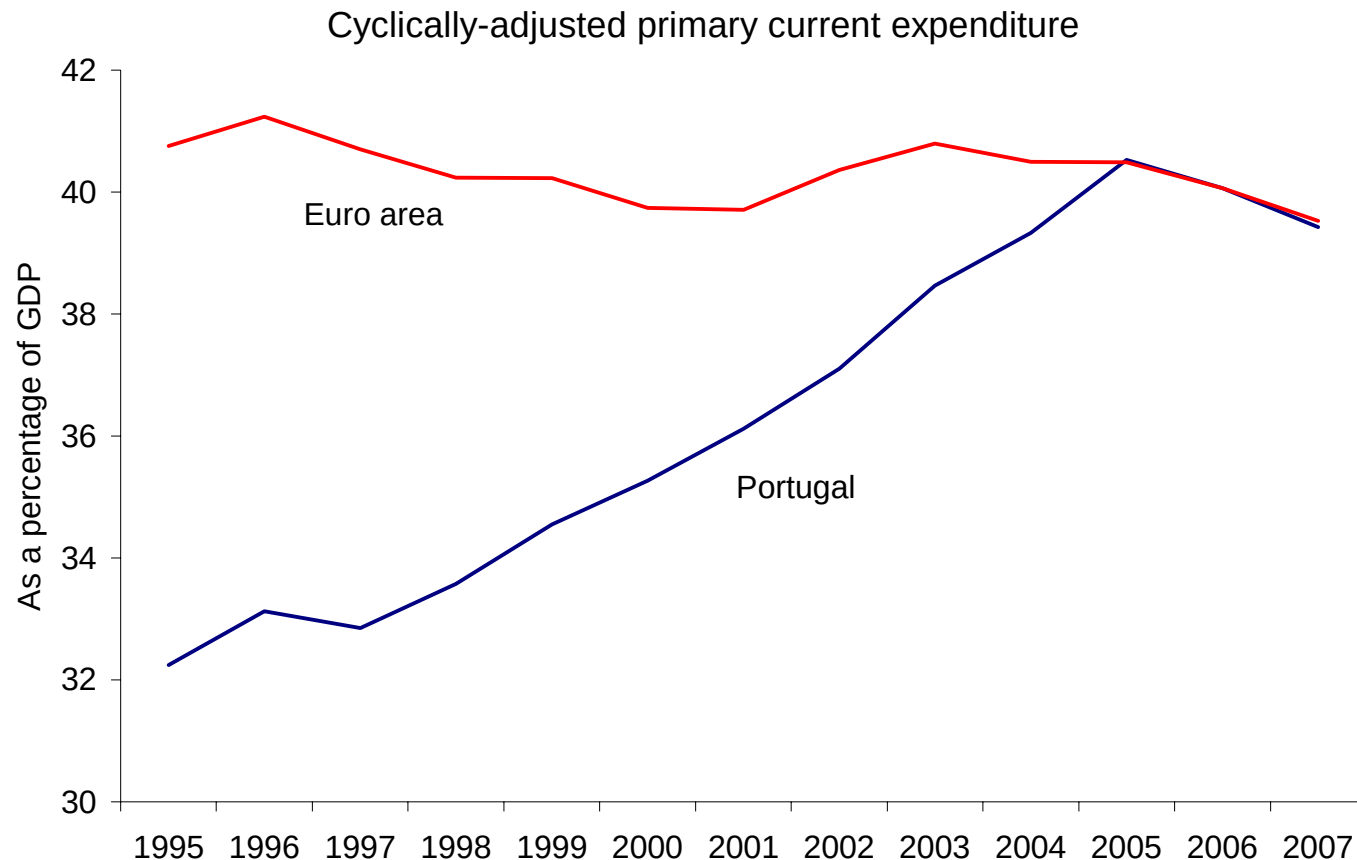
- Before the introduction of the euro and until 2005:
(i) pro-cyclical (this behaviour exacerbated expectations concerning trend growth during the late 90s and contributed to the sharp reversion of expectations in the early 00s)

Macroeconomic policy stance



1. The role of fiscal policy

- **Before the introduction of the euro and until 2005:**
 - (ii) **Unsustainable growth of primary expenditure (including the pension system)**



1. The role of fiscal policy

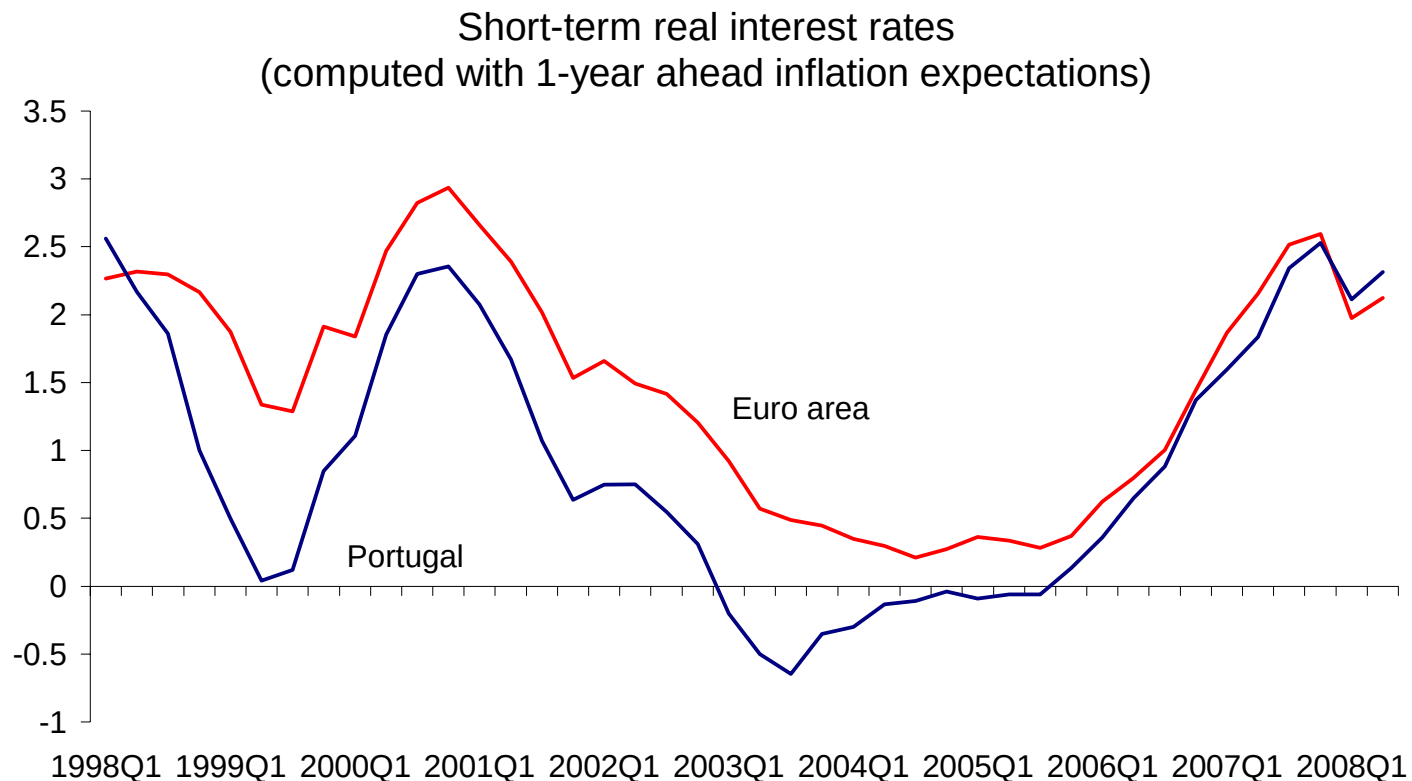
- What happened in 2005?
 - New government supported by single-party majority in the Parliament
 - Broad public support for budgetary action, with the budget deficit reaching over 6 per cent of GDP in 2005
 - The revised Stability and Growth Pact offered an agreed multilateral framework to support the consolidation effort and to rationalize fiscal measures aimed at sustainability

Adjustment mechanisms in the euro area

1. The role of fiscal policy
2. The real interest rate channel
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4. Risk-sharing, with a particular focus on the international financial markets and the financial system

2. The real interest rate channel

- **The Portuguese economy observed slightly lower real interest rates throughout the decade. But the gap was not growing throughout this period (actually, inflation was below the euro area levels in 2008). The real interest rate differential contributed to foster growth in Portugal vis-à-vis the euro area and thus contributed to approximate the respective rates of growth.**



Adjustment mechanisms in the euro area

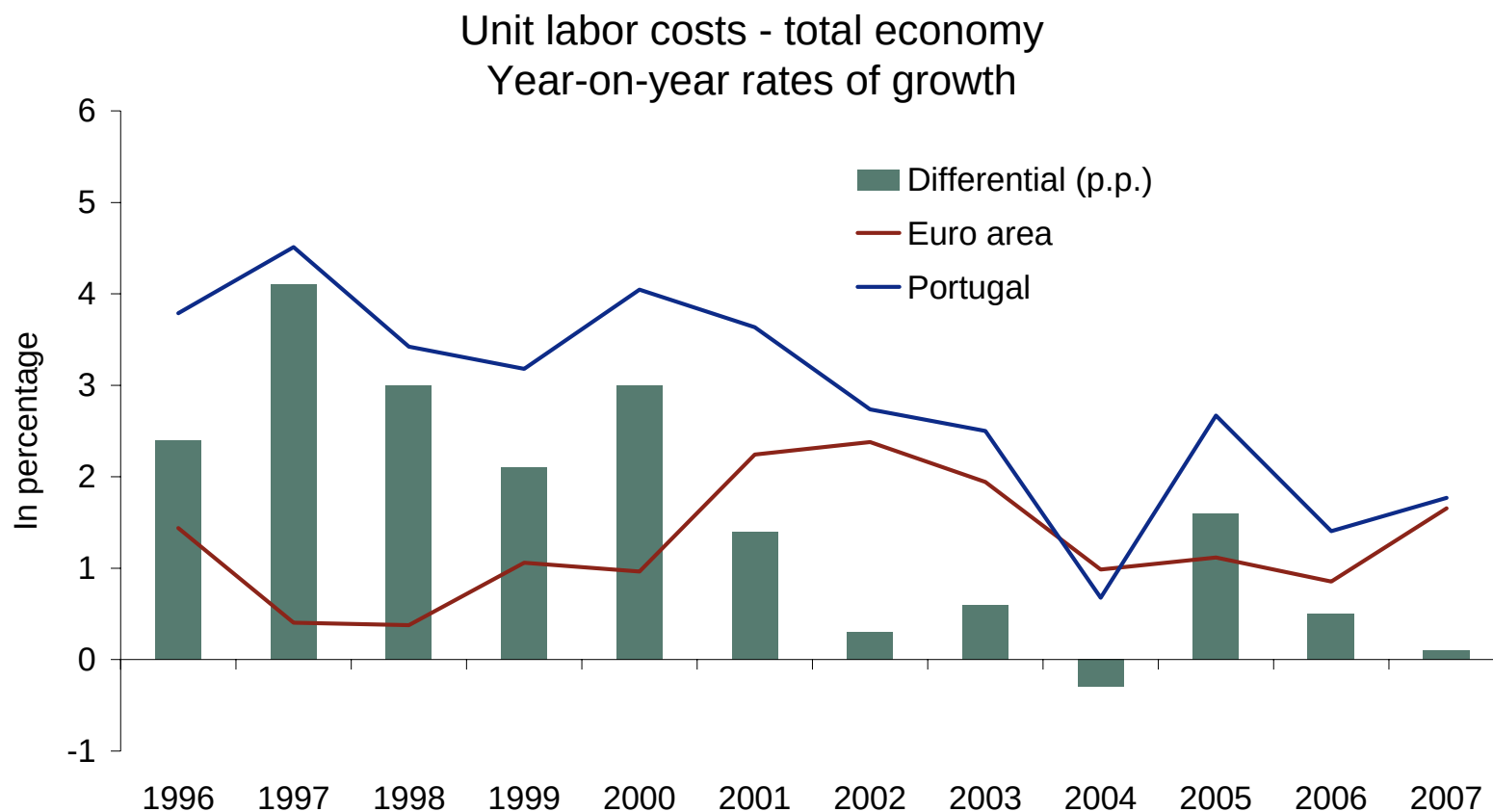
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3. The competitiveness channel

- **The competitiveness channel is typically interpreted as an equilibrating mechanism in a monetary union (countries with higher inflation and strong growth become less competitive, which reduces external demand for home produced goods and increases import penetration, reducing the initial growth differential)**
- **General equilibrium simulations suggest the competitiveness channel tends to build up slowly but is dominant in the long-run**
- **In Portugal, there was significant real appreciation at the beginning of the 90's but the dynamics of inflation and unit labour costs broadly converged to the euro area levels in the early 00s**

3. The competitiveness channel

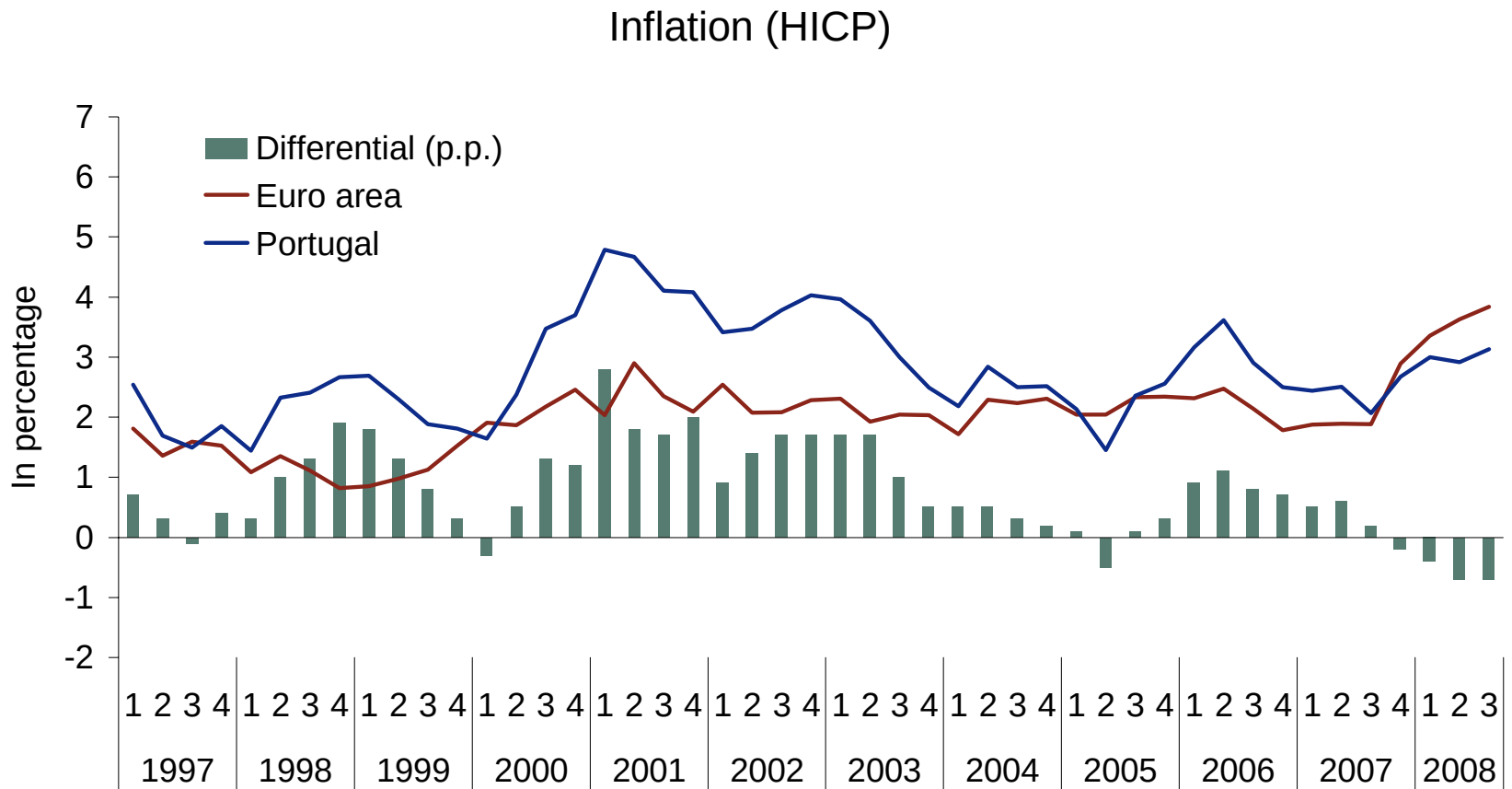
- ULC growth approached the euro area dynamics around 2002/03



Source: Eurostat, INE and Banco de Portugal.

3. The competitiveness channel

- As well as inflation...



Source: Eurostat.

3. The competitiveness channel

- **In spite of this adjustment in prices and ULCs the magnitude of adjustment was not sharp. This may have been influenced by the relatively high degree of downward nominal wage rigidity in Portugal, in the context of a protracted period of low inflation/low growth, which may have limited the responsiveness of wages to the unemployment rate.**
- **It may also have been due to the financial integration of the Portuguese economy, which allowed a sharing of risk with the euro area and the rest of the world.**

Adjustment mechanisms in the euro area

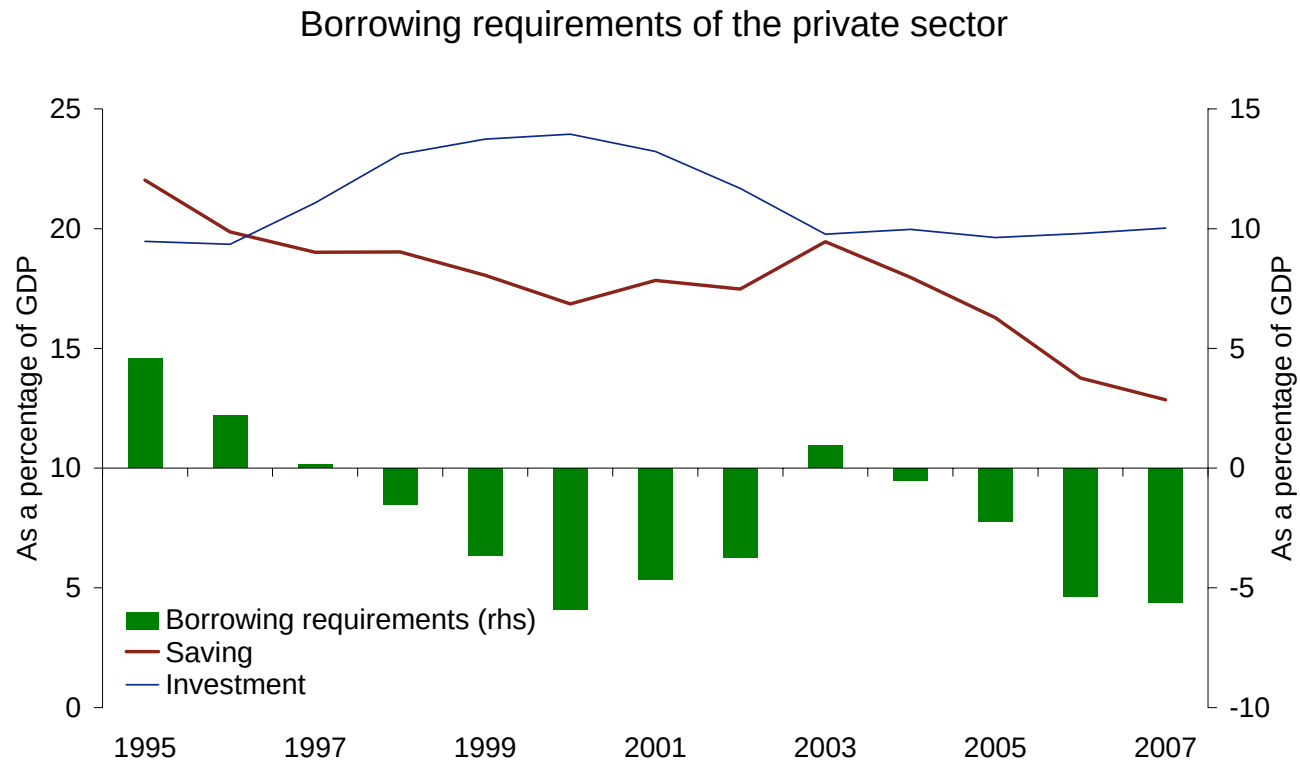
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4. Risk sharing

- **Risk sharing allows agents to smooth temporary and idiosyncratic shocks to their income and wealth**
- **The financial integration of the Portuguese economy, fostered by the participation in the euro area, increased the indebtedness of the non-financial private sector, namely allowing the possibility to smooth household consumption**
- **The banking system played a crucial role in these dynamics, namely through the recourse to financing in international markets and by adapting the credit products offered to the private sector**

4. Risk sharing

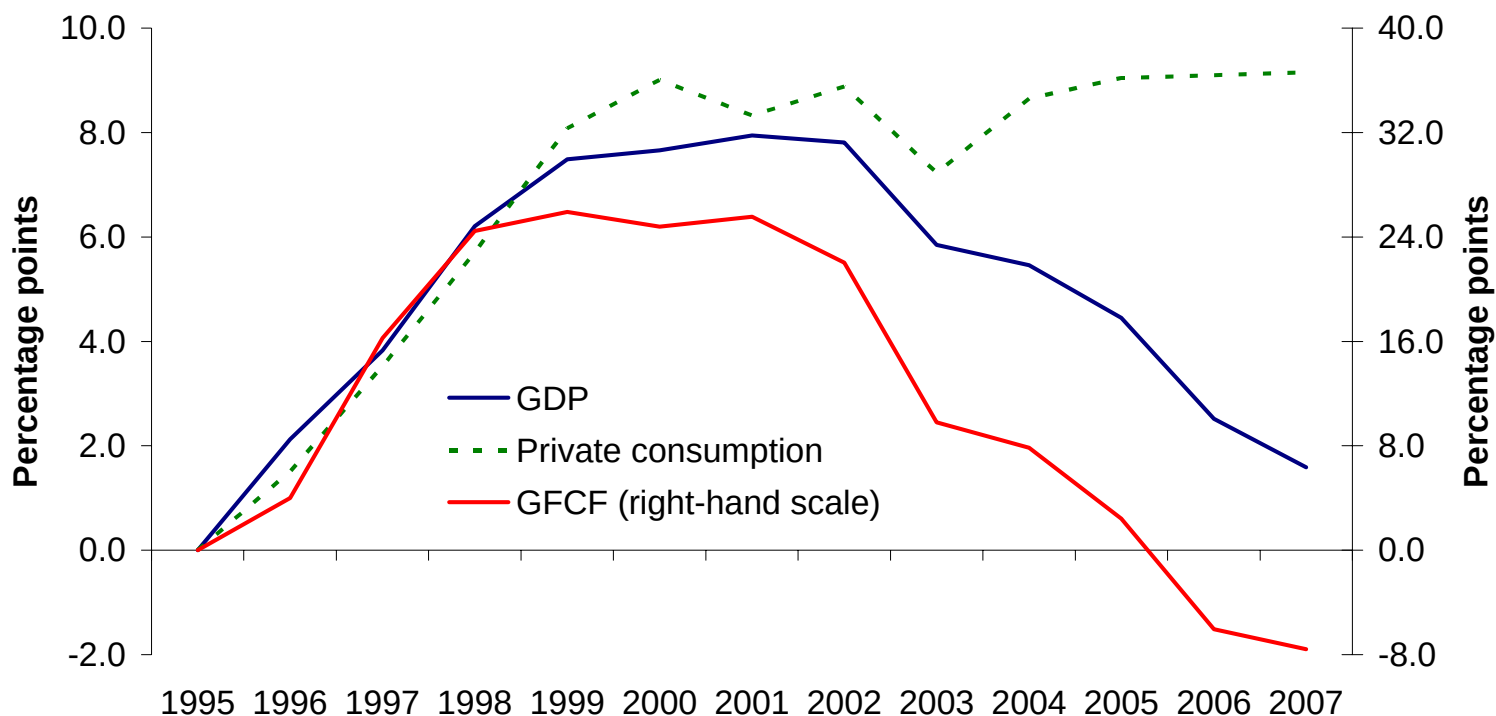
- Financial integration sustains significant mismatches between domestic supply and demand. The behaviour of the Portuguese economy after 2003 illustrates this pattern, with the maintenance of a downward trend in the private sector's saving rate and a broad stabilization of the investment rate. Over these years Portuguese banks ensured the channelling of funds from international investors to finance consumption and investment of the non-financial private sector.



4. Risk sharing

- **Relative to the euro area, there was a significant smoothing of consumption expenditures by households in recent years, in contrast with the behaviour of investment.**

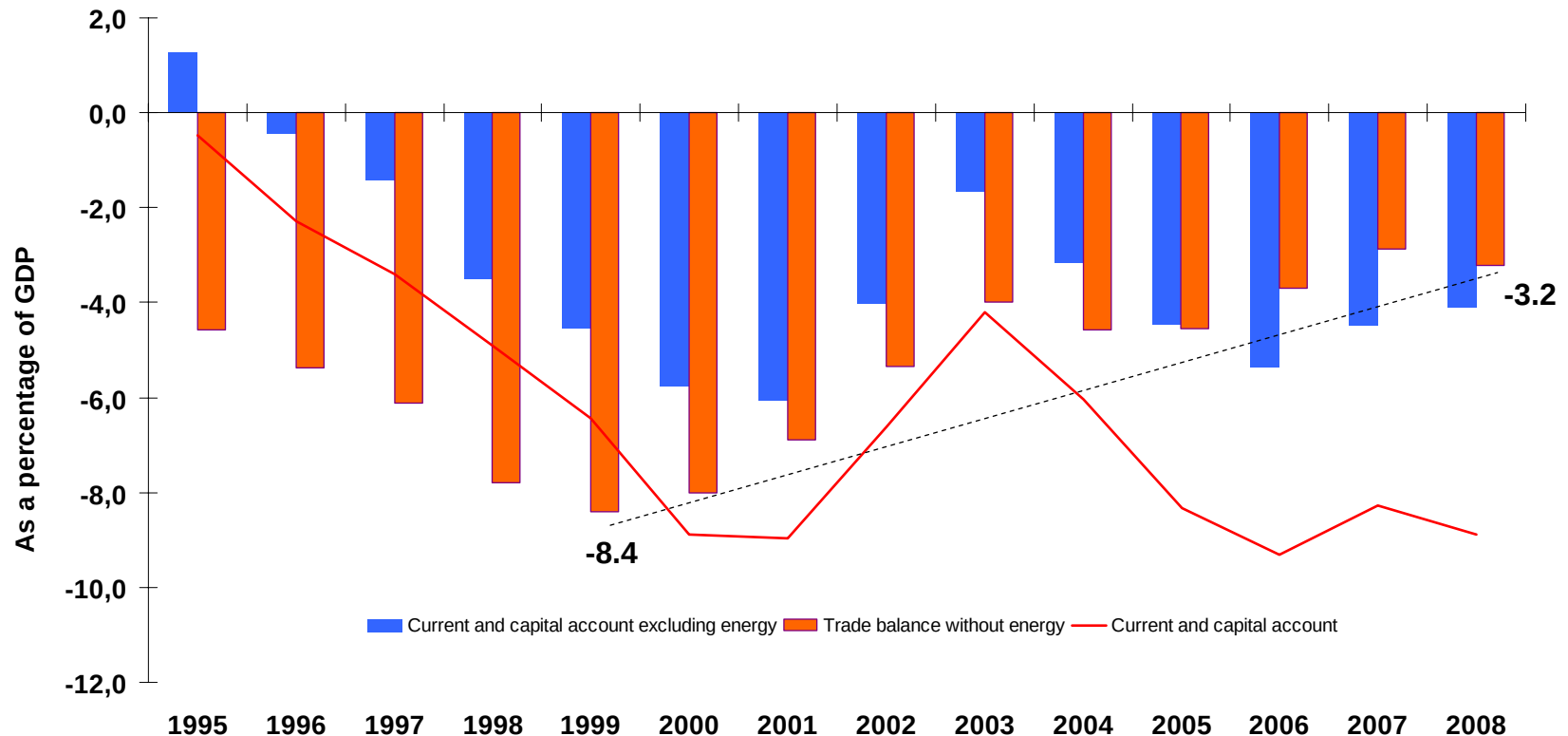
Portugal vis-à-vis the euro area
Cumulated growth differences



4. Risk sharing

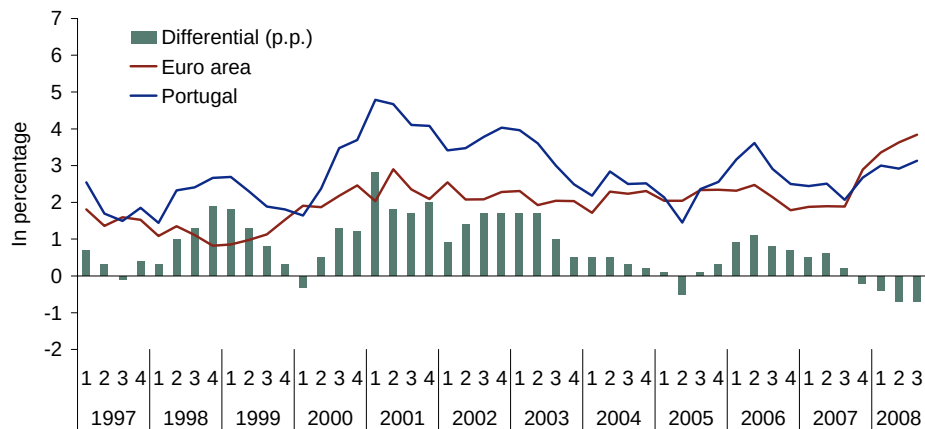
- **These very favourable international financing conditions were reflected in favourable financing conditions of the private sector. This allowed the smoothing of expenditures even in the face of the unprecedented oil price shocks observed in the 00s**

**Trade, Current and capital accounts
(with and without energy)**



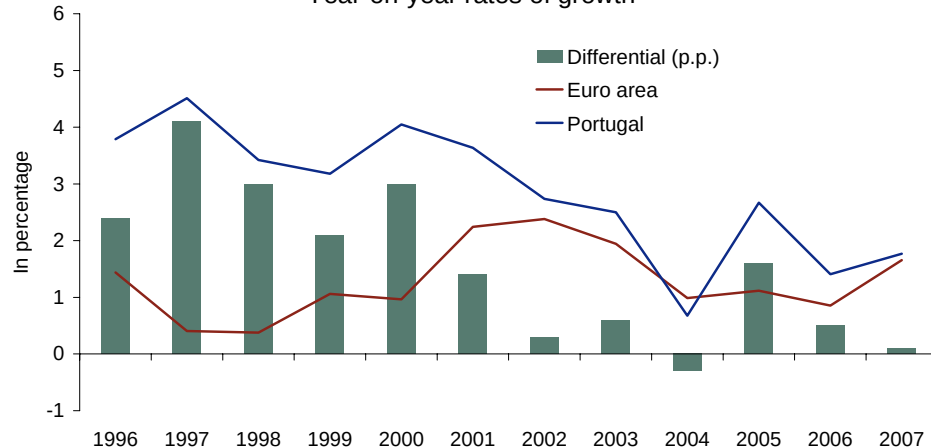
PORTUGUESE ECONOMY: FROM BOOM TO ADJUSTMENT

Inflation (HICP)



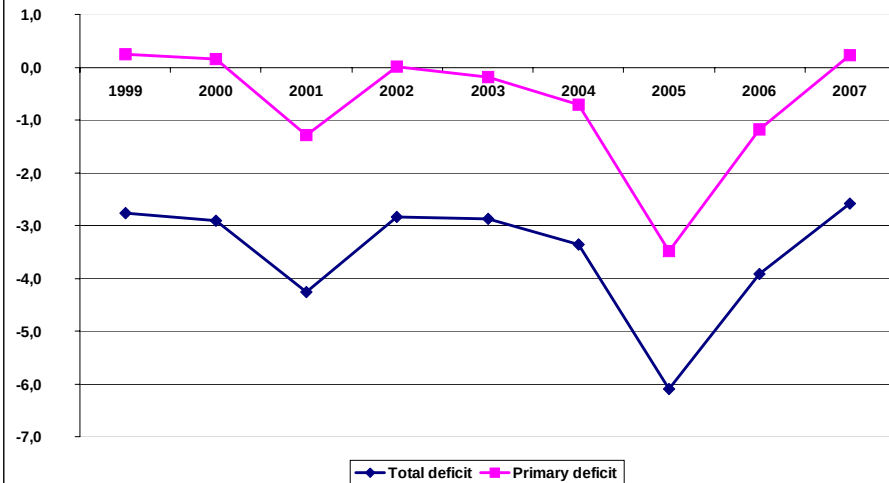
Source: Eurostat.

Unit labor costs - total economy
Year-on-year rates of growth

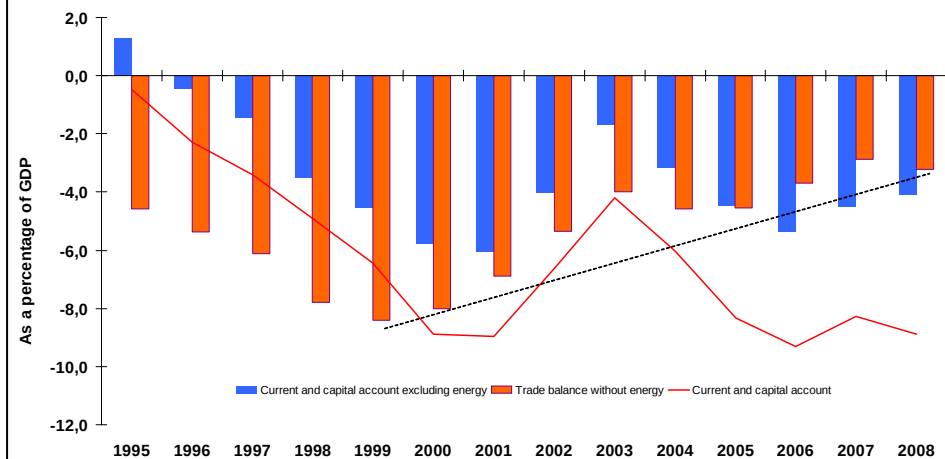


Source: Eurostat, INE and Banco de Portugal.

Budget deficit



Trade, Current and capital accounts
(with and without energy)



Lessons from the Portuguese case

- **A tale of gradual adjustment of the economy in the euro area: all channels and adjustment mechanism played a role**
 - In the Portuguese case, the real interest rate and the competitiveness channels seem to have favoured a gradual adjustment of the economy. This conclusion must always be evaluated taking into account the interplay between shocks, structures and policies in each country. Moreover, any conclusion must take into account the impact of other broad structural trends – not directly related to the euro – that may influence the adjustment of the economy.
 - The SGP delivered a framework that eventually allowed the right incentives to be delivered to the authorities
 - Financial integration allowed increased risk sharing of the economy and prolonged the adjustment process
- **Importance of learning the rules of the game in advance**
 - Permanent anti-cyclical use of Fiscal Policy to absorb shocks coming from fluctuations of external demand or capital inflows.
 - Realistic wage behaviour to avoid excessive real appreciation in terms of relative Unit Labour Costs.
 - Strong prudential supervision of the banking sector, taking seriously financial stability risks
 - Implement structural and institutional reforms to ensure flexible and competitive markets.