

Portugal, Italy, Spain, and Germany. The implications of a suboptimal currency area.

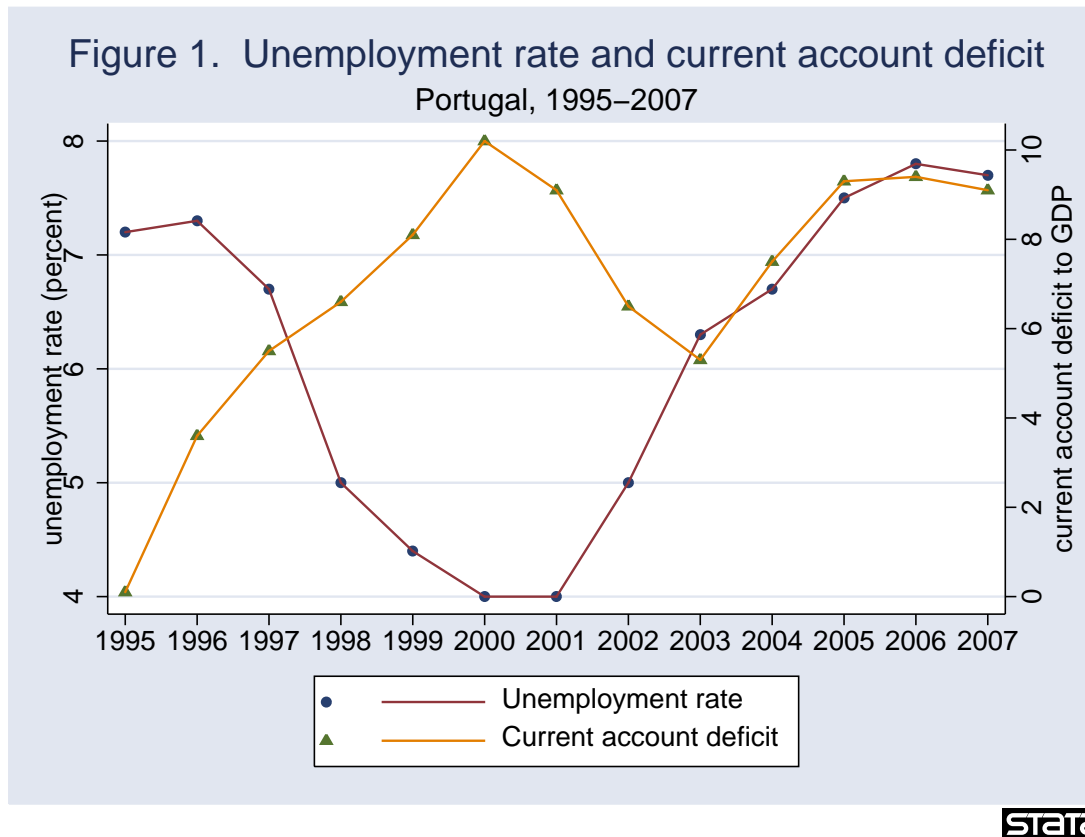
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WEL-MIT meeting, NYC, April 2006

- Started by looking at Portugal: Large current account deficit, high unemployment, low output growth.
- Realized that similar issues and mechanisms in Italy.
- Looking around: Soon to come in Spain.
- Clearly a structural problem: The old Mundell wisdom about optimal currency areas, with a vengeance:
- Small country-specific shocks: No.
- Labor mobility, or wage flexibility: No.
- Unlikely to change any time soon. So in all likelihood: Long, rotating, slumps.

- Look first at Portugal, and Italy.
- Then at Germany. Has gone through ten years of it, and is (probably) emerging.
- Draw lessons. No easy solution. More problems to come.

1. Portugal. The boom and the bust



The story of the boom.

With the prospects of entry into the Euro

- A dramatic reduction in nominal interest rates, from 16% in 1992 to 4% in 2001, and real interest rates (6% to zero).
- Widely held expectations of faster convergence, and higher income.
- Leading to a consumption boom, facilitated by financial integration and access to euro-borrowing.
- Leading to a decrease in unemployment, from 7.2% in 1995 to 4% in 2001. Sustained nominal wage growth, despite poor productivity growth.
- Leading to a steady overvaluation vis a vis euro partners: using ULC, by 15% from 1995 to 2001.
- Leading to an increase in the current account deficit from 0% in 1995 to 10% in 2000.

Macroeconomic evolutions, 1995-2001

	1995	1996	1997	1998	1999	2000	2001
GDP growth	4.3	3.6	4.2	4.7	3.9	3.8	2.0
(relative to euro)	1.9	2.1	1.5	1.9	1.1	0.0	0.1
Unemployment rate	7.2	7.3	6.7	5.0	4.4	4.0	4.0
Current account	-0.1	-3.6	-5.5	-6.6	-8.1	-10.2	-9.1
Household saving	13.6	11.8	10.3	9.9	8.6	10.9	11.9
Budget surplus	-5.3	-4.6	-3.4	-3.0	-2.8	-2.9	-4.3
Primary surplus (cycl adj)	1.9	1.3	0.8	-0.4	-0.7	-1.6	-2.3
Nominal wage growth	6.7	9.0	3.8	4.3	4.0	6.9	5.2
Productivity growth	5.8	3.6	2.4	2.6	3.1	1.8	0.3
Unit labor cost growth	1.0	5.4	1.3	1.8	0.9	5.1	4.9
(relative to euro)	-0.7	4.8	1.8	1.4	0.2	4.0	2.7

The story of the bust

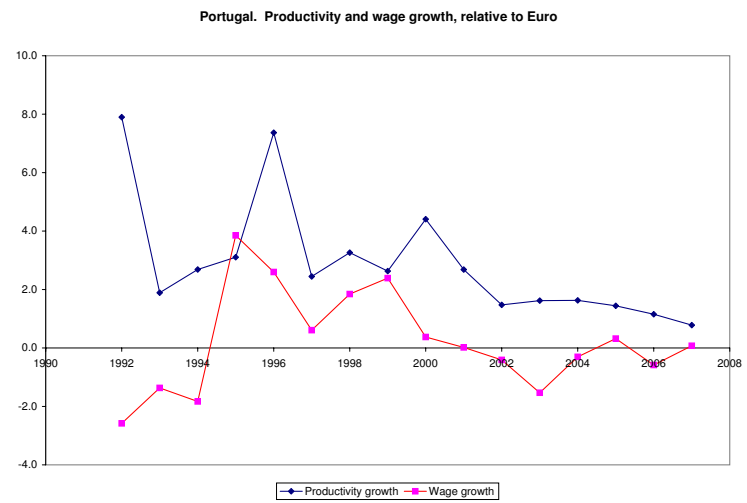
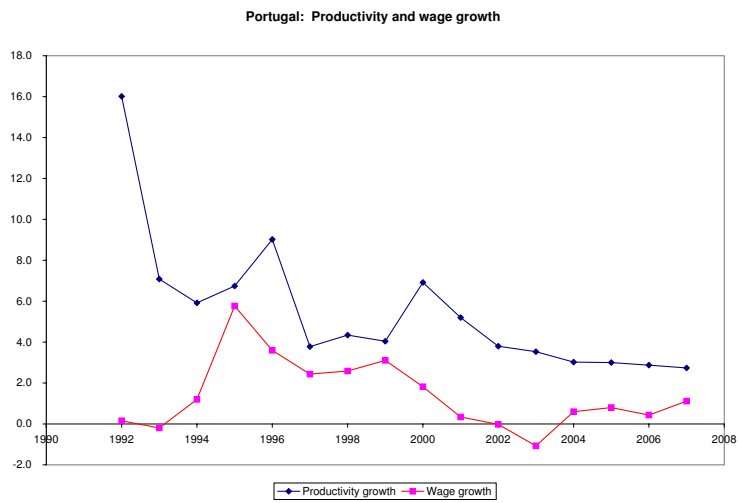
- 2.3% cumulative output growth since 2002. Unemployment back at 7.8%.
- Higher productivity growth has not materialized. Just the opposite: 0.7% cumulative productivity growth since 2002.
- Private saving has increased, leading to a decrease in demand.
- Nominal wage growth has decreased a little, but much less than productivity growth.
- The overvaluation has gotten worse. By another 10% relative to euro area since 2002 (using ULC)
- The current account deficit is still at 10% despite the slump. And it is now associated with a large fiscal deficit, 6% in 2005.

Actual and projected macroeconomic evolutions, 2001-2007

	2001	2002	2003	2004	2005	2006	2007
GDP growth	2.0	0.5	-1.2	1.2	0.8	1.0	1.8
(relative to euro)	0.1	-0.4	-2.0	-0.6	-0.7	-1.1	-0.3
Unemployment rate	4.0	5.0	6.3	6.7	7.5	7.8	7.7
Current account	-9.1	-6.5	-5.3	-7.5	-9.3	-9.4	-9.1
Household saving	11.9	11.5	11.4	11.8	11.7	11.7	11.7
Budget surplus	-4.3	-2.8	-2.9	-3.0	-6.0	-4.9	-4.6
Primary surplus (cycl adj)	-2.3	0.0	1.3	1.2	-1.1	0.2	0.4
Nominal wage growth	5.2	3.8	3.5	3.0	3.0	2.9	2.7
Productivity growth	0.3	0.0	-1.1	0.6	0.8	0.4	1.1
Unit labor cost growth	4.9	3.8	4.6	2.4	2.2	2.5	1.6
(relative to euro)	2.7	1.9	3.2	1.9	1.1	1.8	0.7

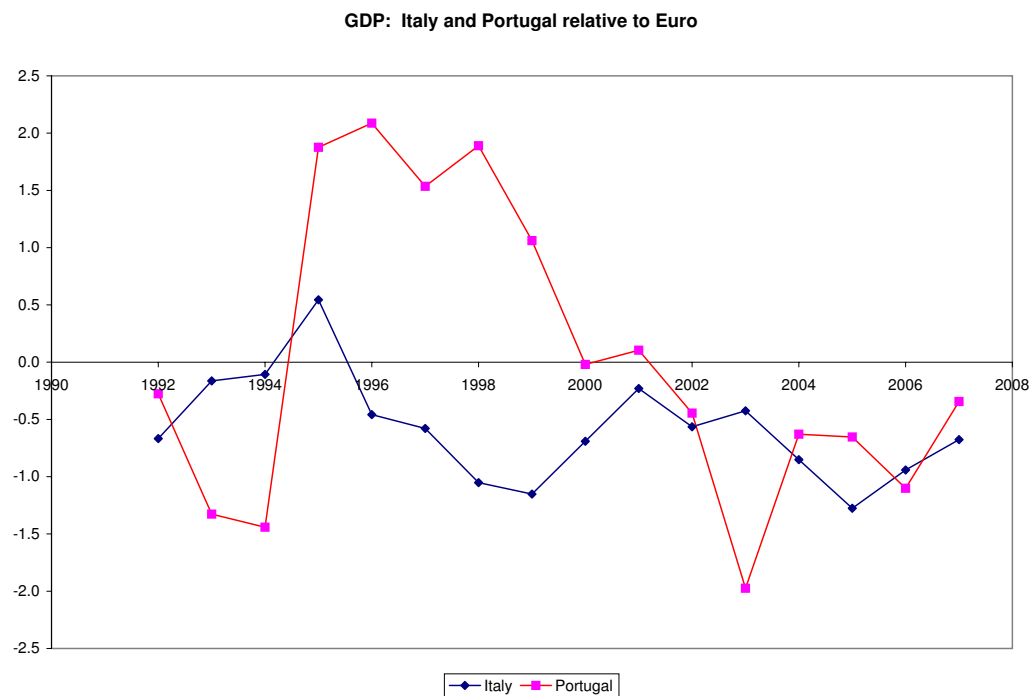
The prospects. Slow and painful adjustment.

- Fiscal policy: not available, not useful
- Improvement in competitiveness? How much? How to achieve it?
- Improvements in productivity growth. In tradables? FDI gone East.
Room for reform in non-tradables. Indirectly useful. But difficult to do with high unemployment.
- Low nominal wage growth. The difficulty of nominal wage cuts.



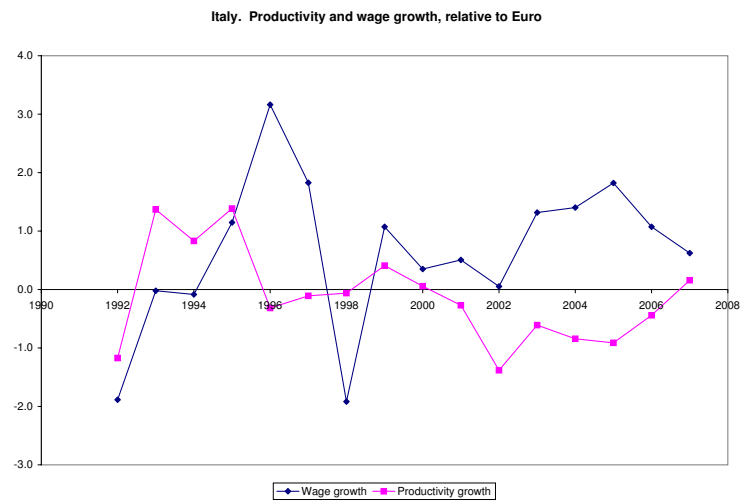
Productivity and wage growth; Absolute and relative to the euro area

2. Italy. A slow deterioration



No boom-bust. Just slow growth.

- On the surface. Not so bad. Decrease in unemployment from 11% in 1995 to 7.5%. Small current account deficit, about 2%.
- But very low growth, and a problem of competitiveness.
- Very low productivity growth. Cumulative 9.3% since 1995. relative to the euro: -3%
- Low, but still higher nominal wage growth. Steady loss of competitiveness. Using ULC: An appreciation of 15% vis a vis Euro area.
- Loss of competitiveness partly offset by low import growth. So limited deterioration of current account balance.



Productivity and wage growth; Absolute and relative to the euro area

1. Looking more closely: Why the very low productivity growth?

- Regulation, and low competition in non-tradable sector. Some numbers. (Costs of financial services: 1996=100. December 2004: Italy 175. France 130. Germany 115).
- Looking at productivity growth by sector suggests indeed a major difference between Italy and, say, Germany.

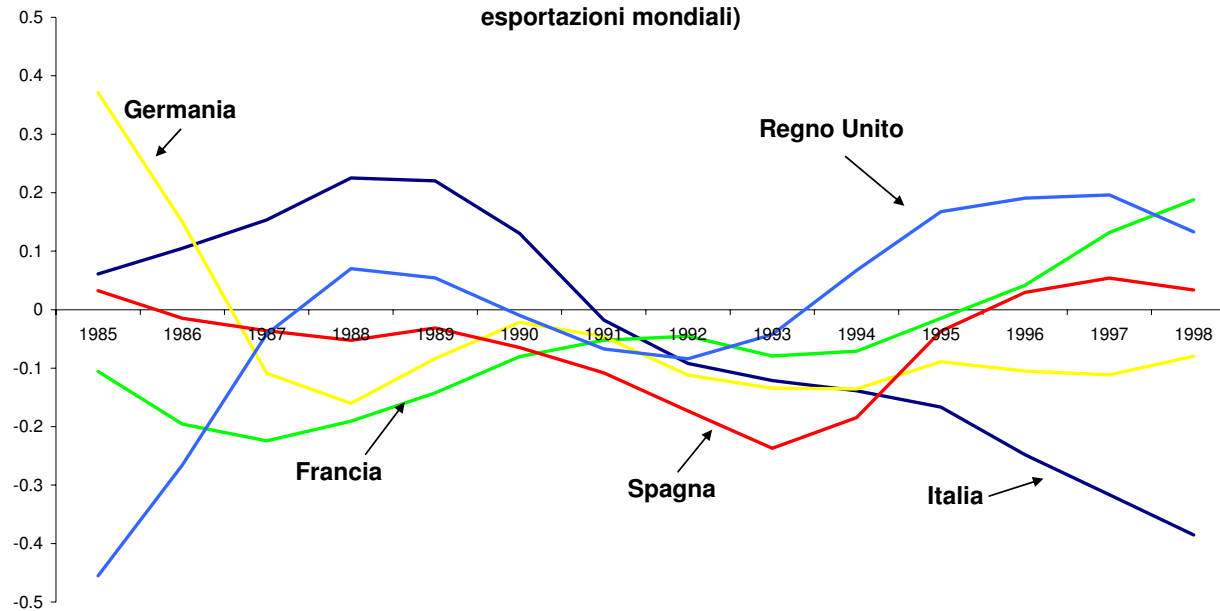
Hourly productivity growth

	Overall	Contribution from		
		Manufacturing	Services	(Non ICT services)
1981-95				
Germany	2.3	0.8	1.0	(0.4)
Italy	2.2	1.0	0.9	(0.4)
1996-2000				
Germany	2.0	0.4	1.2	(0.3)
Italy	0.7	0.2	0.1	(-0.5)

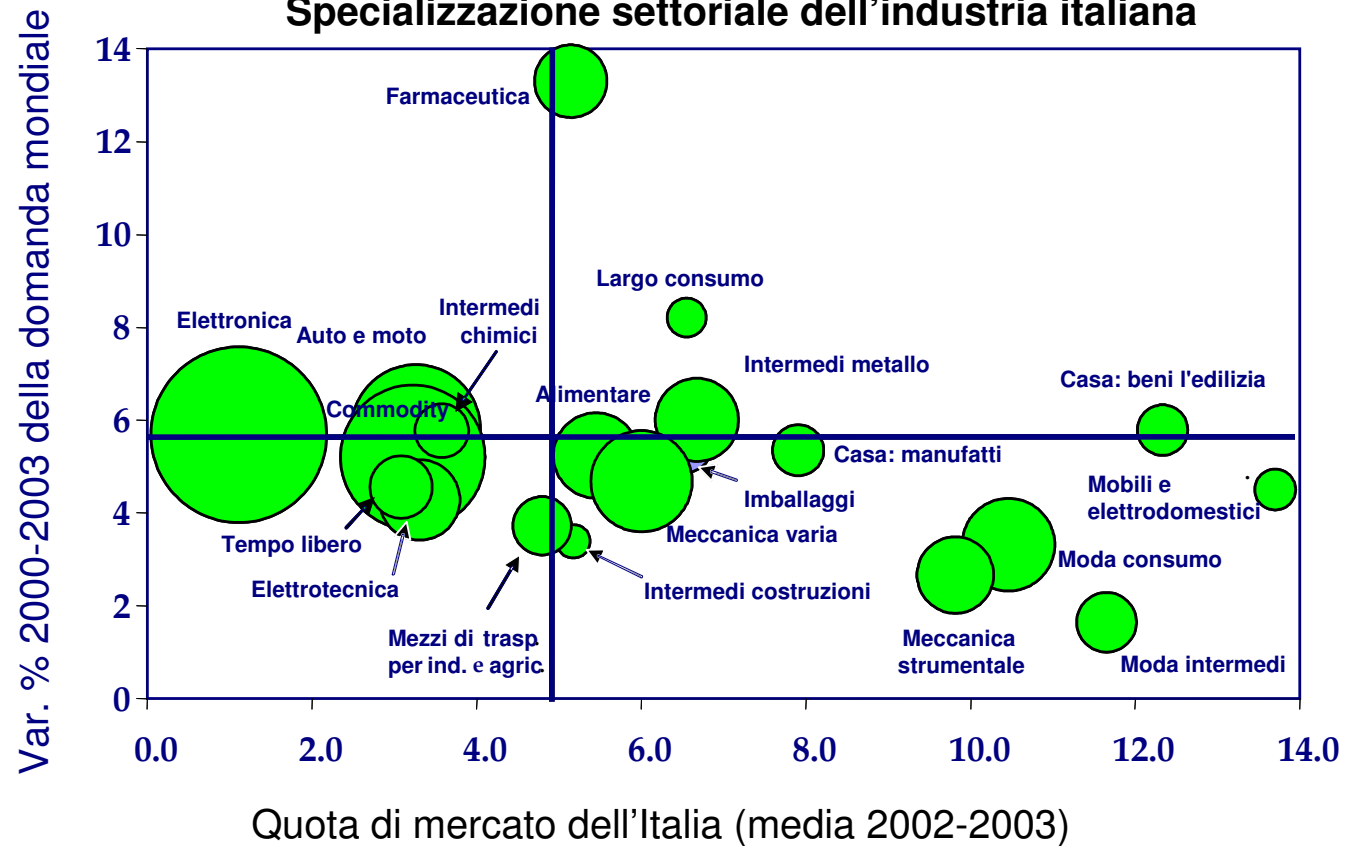
2. The composition of exports.

Behind the slowdown: exports an increasingly wrong specialization

Fig 11 Un modello di specializzazione obsoleto?
(correlazione fra indici settoriali dei vantaggi comparati e crescita settoriale delle esportazioni mondiali)



IL MODELLO DI SPECIALIZZAZIONE: Specializzazione settoriale dell'industria italiana



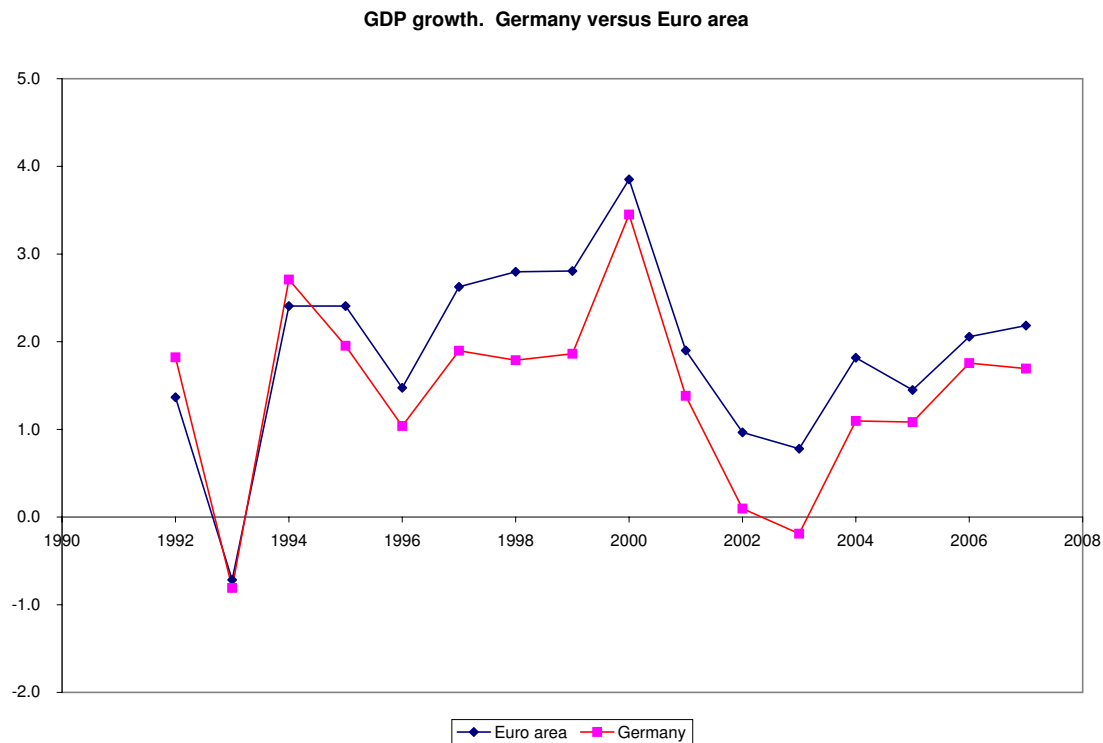
Nota: la dimensione del cerchio indica il peso del settore sul commercio mondiale
Fonte: Banca Intesa - Prometeia.

Way out?

- Same recommendations as for Portugal (with more balance between external and internal demand).
- Higher productivity growth, especially in non-tradables.
- Lower nominal wage growth (But why has it remained so high relative to productivity?)
- Likely slow and painful.

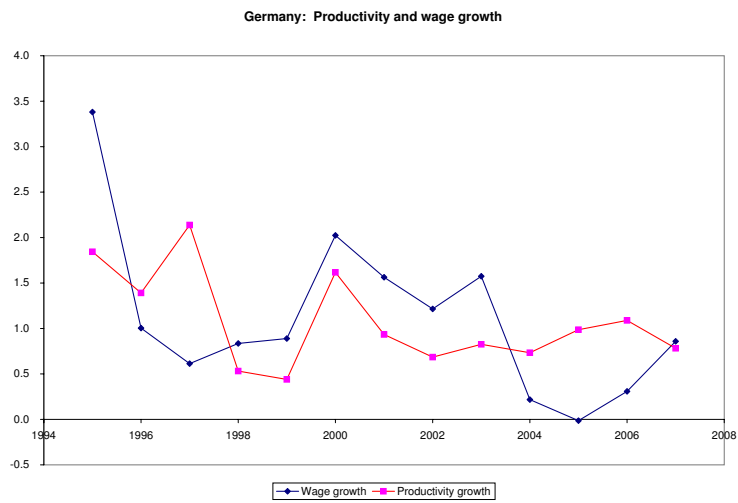
3. How Germany has done it (if it has)

A long period of low growth, after the reunification boom.



Behind the scene: A long, but (probably) successful competitive disinflation.

- The reunification boom, followed by overvaluation and low internal demand. But since 1995:
- Very low nominal wage growth. Cumulative wage growth since 1995 10% below Euro average.
- Decent productivity growth. Cumulative productivity growth 1.7% above Euro average.
- So steady improvement in competitiveness. Increase in external demand, and improvement in the current account.
- Internal demand still lagging. Large profit margins, and investment likely to increase. Consumption: Reforms and precautionary saving.



Productivity and wage growth; Absolute and relative to the euro area

Lessons and forecasts

- Country-specific shocks. Likely to continue.
- In the best of cases, slow and painful adjustment
- Portugal and Italy may not be the best of cases:
- Increases in productivity in non-tradables: Difficult politically, and uncertain effects on competitiveness.
- Negative nominal wage growth? Difficult to achieve.
- Ideal solution: Aggressive wage adjustments (not through unemployment, but national agreements), together with fiscal policy adjustments (Difficult starting from large deficits).
- Next on the list. Spain. Growth so far driven by internal demand. Steady appreciation. Current account deficit of 10%.

- Will countries be tempted to get out of the Euro? (Northern League, Wolfgang Munchau)
- Governments: Probably not. The costs of unilateral exits are likely to be very high.
- May however be forced by markets. Positive probability would lead to massive outflows and bank runs. Unless the ECB plays lender of last resort, not easy to handle.
- Leave these issues to the discussion by Nouriel Roubini.