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EUROPEAN ECONOMIC PERSPECTIVES

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European Economic Perspectives

Politics, Divergent Growth and the Euro

The rejection of the European Constitution by voters in France and the Netherlands has raised legitimate question marks about support for further European integration and encouraged speculation that the euro might eventually break apart. We believe the costs involved in such a move are huge and that it remains only a remote possibility. Moreover, it is one which, if it were to happen, would probably play out over an extended period of years. Nonetheless, divergent economic performance within the euro area is set to continue and is likely to feed this speculation.

Nominal Growth Divergence

Speculation about the eventual demise of the single currency is likely to be spurred on by the simple fact that several countries appear to have been losers from European monetary integration. This is obvious from a simple comparison of nominal GDP growth for the main euro-area countries since the formation of the euro in 1999. Over the last six years, nominal GDP growth has averaged 4.0% for the euro area as a whole but has varied from 1.9% in Germany to 8.0% in Spain and 11.2% in Ireland **(Display 1)**.

There are many reasons why economic performance can diverge. The euro-area countries are at different stages of economic development and have different economic structures, so it is natural for them to grow at very different rates. Moreover, in Germany's case, many of its current problems can be traced back to the competitiveness lost during reunification in the early 1990s. However, even allowing for this it is hard to avoid the conclusion that the monetary union is exacerbating the situation.

The European Central Bank (ECB) sets monetary policy on the basis of economic conditions in the euro area as a whole. This makes it impossible to set interest rates at the appropriate level for all euro-area countries. Even worse, interest rates tend to be too high for low growth/low inflation countries such as Germany and too low for high growth/high inflation countries such as Spain. Prior to monetary union, Germany had the lowest real interest rates in the euro area; today it has the highest **(Display 2)**.

By contrast, monetary union has resulted in very low interest rates in Spain, and this has provided a huge boost to economic growth and asset prices **(Display 3)**. In addition, strong nominal growth and low rates have eliminated the budget deficit, allowing Spain to ease fiscal policy and cushion the economy from weaker growth. In Germany, low nominal growth has put upward pressure on the budget deficit and forced a pro-cyclical tightening of fiscal policy.

Trying to satisfy the competing aims of Germany and Spain with a single interest and exchange rate is an impossible task. Germany needs lower interest rates and a weaker exchange rate, while Spain needs higher rates and a stronger currency. Faced with this dilemma, the ECB continues to focus solely on the euro-area aggregate, but this intensifies the problem of weak nominal growth in Germany and continues to fuel asset-price inflation in Spain.

Against this backdrop, it is tempting to conclude that the single currency is unsustainable in its present form. However, it is important to bear in mind the huge costs inherent in leaving the monetary union. Nor would it be a universal panacea. Germany would still face structural barriers to growth and Italy would face a crippling increase in debt-servicing costs. For Italy, life within the single currency would have to be extremely grim to make leaving a viable option.

In coming weeks we will focus on circumstances in individual euro-area countries. This will help us gain fresh insights into the pros and cons of euro-area membership. While we believe the barriers to exit are huge and that a break-up of the single currency is unlikely, the near-term outlook will be dominated by unsettling political news, weak economic data and more evidence of Italy's deteriorating fiscal position. As a result, markets will continue to question the

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euro's sustainability, leaving it vulnerable to further setbacks.

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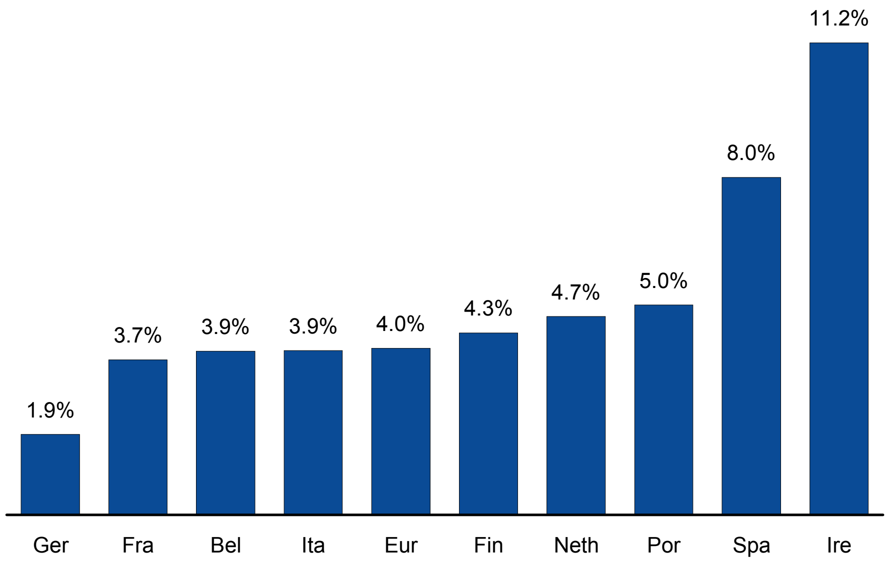
Display 1: Nominal GDP Growth Has Varied Widely in the Euro Area
Average Annual Nominal GDP Growth, 1999–2004

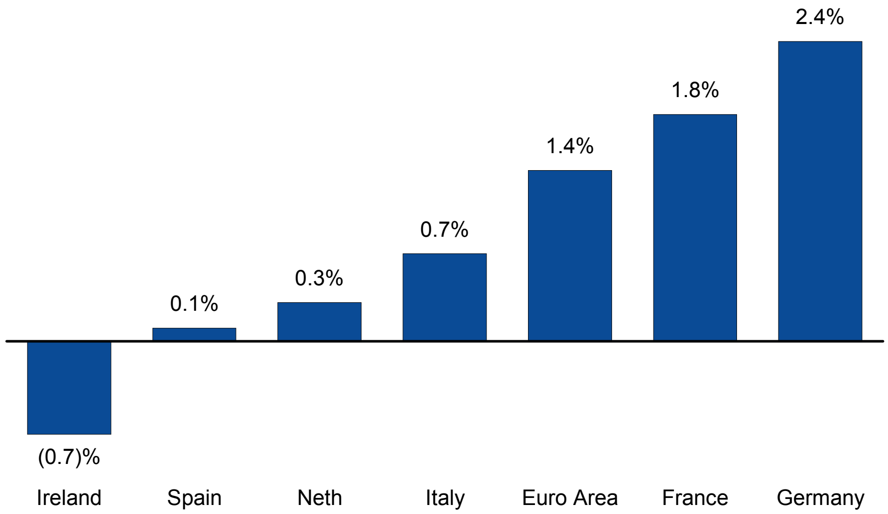


Source: Haver Analytics and Alliance Capital Fixed Income: June 3, 2005

Nominal GDP growth has varied widely in the euro area since 1999. Germany has been the worst-performing country, with nominal growth of just 1.9%. Spain and Ireland have been the best-performing countries, with nominal growth of 8.0% and 11.2%, respectively.

Display 2: Monetary Policy Is Tightest in Germany

Average Real Short-Term Interest Rate, 1999–2004

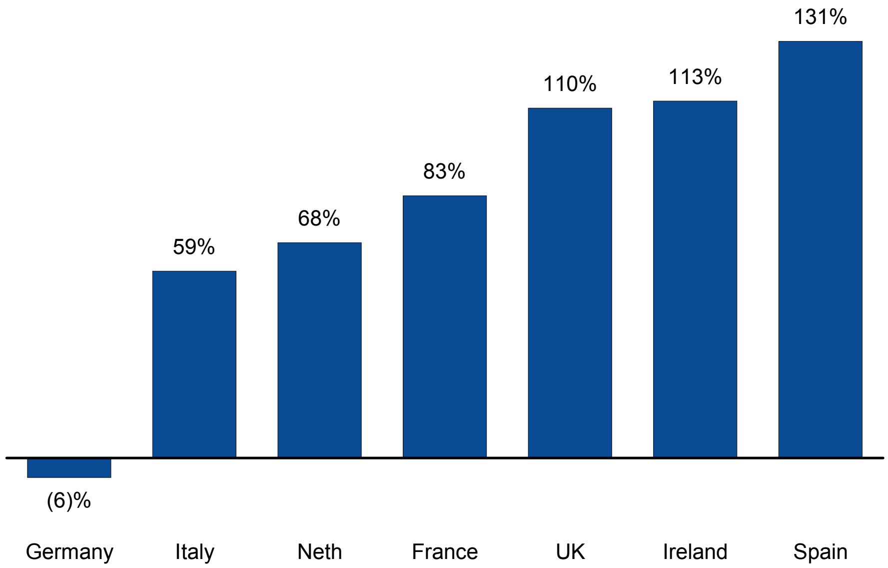


ECB refinancing rate deflated by the GDP deflator for each country.

Source: Haver Analytics and Alliance Capital Fixed Income: June 3, 2005

Historically, Germany has had the lowest real interest rates in Europe. However, by virtue of its lower inflation, Germany now has the highest real interest rates in the euro area. Ireland and Spain have been the main beneficiaries.

Display 3: House Price Growth Has Varied Massively
Change in House Prices, 1999–2004



Source: Bank for International Settlements, Royal Institute of Chartered Surveyors and Alliance Capital Fixed Income: June 3, 2005

The results of this perverse effect are plain to see. While German house prices continue to stagnate, house prices have risen sharply in Spain and Ireland, even outstripping the UK. So while the single currency delivers low nominal growth to Germany, it continues to fuel asset-price inflation in Spain.

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