Can EMU accession by the NMS disrupt the eurozone?

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- Some ESCB officials have argued that real convergence is necessary for NMS to join EMU
- Real GDP has little in itself to do with price stability - if it did, inflation would have been lower in the 1970s than in the 1870s
- One argument has been that rapid growth means that NMS are likely to have inflation rates of up to 2% higher than the current EMU (H-B-S effect and shift in demand to non-tradeable services)

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- So, it is argued, in order to avoid higher inflation in the whole zone, monetary policy will need to be tightened, leading to even lower growth and maybe deflation in SGCs - is there any merit in this argument?
- This is mistaken for a number of reasons:

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- NMS constitute about 6% EMU GDP together, so that even if their inflation were the full 2% higher, this would add 0.1% to EMU inflation.
- **Any** uneven growth within a monetary union will have the same effect - if France and Italy increased trend growth by 50%, and this raised their inflation by a quarter, this would add 0.2% to the HICP.
- Does this mean that faster growth in France and Italy should be discouraged? This might be taking harmonization a bit too far.

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- **Most important**, higher productivity growth in the tradeable goods sector in the whole of the monetary union in the face of an unchanged, stability oriented, monetary policy, which is defined as:
  - M/Y = constant
  - will lead to nominal appreciation of the euro, because:
    - tradeables prices must remain constant in world currency (USD) terms (we assume non-differentiated tradeables, i.e. no EMU pricing power for tradeables);
    - non-tradeables prices within the EMU rise as a result of growth, and
    - average prices have to remain stable because of the monetary policy stance.
- The result of this nominal appreciation of the euro is falling domestic (euro denominated) tradeables prices.

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- If only part of the union experiences tradeables sector growth, then the contribution of “growth inflation” in these regions to union-wide inflation is proportional to the share of the growing regions in the GDP of the whole union.
- But so is nominal euro appreciation, which therefore still balances the higher inflation these regions bring about, so once again there is no overall inflationary effect on the union as a whole.

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- What is the effect of such regionally unbalanced growth on slow growing countries in the union? If they have flexible labour markets, it is exclusively positive:
  - nominal wages decline in the traded goods sector to ensure constant competitiveness (real wages remaining constant), while demand for tradeables from the fast growing country increases (if intra-union transactions costs are lower than those in world trade), increasing the SGC's income;
  - in the non-traded sector demand will also increase slightly as income in the traded sectors increases.
  - neither the SGC nor the union as a whole will suffer from higher inflation.

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- What happens to the SGC if it has inflexible labour markets? In that case:
  - it will loose employment and output in tradeables, except for those tradeables which are exported to the FGC and which are protected by low intra-union transactions costs;
  - it may gain some output and employment in non-tradeables if aggregate real incomes in tradeables rise;
  - these losses can be avoided by productivity growth which is a fairly small fraction of that in the FGC;
  - still no inflation anywhere.

Conclusions

- Catch-up by new member states entering the eurozone, or a growth acceleration by some incumbents, poses **no threat whatsoever in terms of higher inflation** in the union.
- It may cause **unemployment** in slow growing countries, but **only** because of their inflexible labour markets.
- The solution is not to exclude fast growers, but to **reform slow growers.**

Can EMU entry slow down catch-up in the NMS themselves?

- Monetary policy may be pro-cyclical in young democracies with populist politics and low human capital at the central bank.
- Exchange rate fluctuations may have more to do with emerging market contagion than the smoothing of real asymmetric shocks.
- The convergence time frame is 18-36 years, not a period in which macro fine tuning is likely to be decisive.
- On the other hand, eliminating emerging market contagion and importing a strong anti-inflationary (and we hope a fiscal responsibilty framework as well) will certainly make a higher level of capital inflow safe and maybe encourage domestic savings, tending to **increase** the long term growth rate.