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Incomplete convergence and latent risks – the euro area in the 2000s

The economic policy makers creating the euro area were well aware that several critical conditions had not been met at the start of the single currency: there were significant differences across the member countries in terms of the level of development and competitiveness, the mobility of labor force was low and, in the absence of own exchange rates, flexible wages, adequate room for fiscal manoeuvre and a risk-sharing mechanism at euro area level, **there was no policy toolkit set of instruments which could have helped to provide appropriate support to countries facing the crisis within the area.**

Why, then, could the single currency be adopted ahead of time? The answer is simple: the prevailing thinking at that time was that once the euro started, the countries of the zone would converge, and the establishment of monetary union would itself be a catalyst of this process. Even on the eve of the GFC, in 2008, many European political leaders considered the 10 years since the creation of the euro as a major success and addressed the potentials risks only marginally.

In certain areas, certain economies began to converge indeed. During the decade following the adoption of the euro, business cycles of euro-area members became synchronized, and some periphery countries, e.g. Spain, Greece or Ireland, managed to show much higher growth than core countries and Germany in particular. But the headline growth figures revealed that **convergence was incomplete even during „peacetime"**: the Portuguese and Italian economies had already been lagging behind.

In the case of the Maastricht criteria, the picture was quite mixed too: although at that time almost all countries adhered to the 3 per cent government deficit threshold (in retrospect, it is an interesting exception that, together with Greece and France, Germany ran a persistently higher deficit in the 2000s), the considerable differences between the individual debt ratios barely narrowed.

The convergence of long-term yields has largely been achieved by the time the euro was launched, which continued further slightly by 2007. **In terms of inflation, however, the picture was less positive:** while inflation rates in the core countries remained below the Maastricht criterion almost throughout the entire period, in the periphery they exceeded the target level almost constantly. The marginal differences between yields, combined with the much larger gaps between inflation rates, **resulted in significantly lower real interest rates in the periphery countries than in the core countries.**

Faced with shrinking profit margins, the European banking sector was eager to take the opportunity to provide cheap financing to the private and government sectors of the periphery countries by making use of the favorable conditions, triggering a rapid wave of indebtedness. All this planted the seeds of the next crisis: **in the background, strong divergence began to build up in equilibrium indicators not addressed by the Maastricht criteria.**

Significant **differences** were observed in the **dynamics of corporate and retail indebtedness and in developments of saving rates. Current account balances diverged**: core countries accumulated higher surpluses while the periphery countries saw their deficits surge. Exacerbating the situation, a large part of borrowings was used to finance property development projects, which led to a marked divergence in property prices and the emergence of asset price bubbles.

Only a smaller part of the sources was used to finance productive investments and so the differences in the competitiveness and labor productivity of individual countries persisted**. Moreover, only modest progress was made in the labor market**: although by 2007 unemployment rates had fallen in most of the countries, there was relatively little convergence in employment levels and labor mobility remained very low.

Overall, although there was some degree of convergence in output levels across euro area economies, the partial catching up of the periphery has led to a **significant divergence of the equilibrium indicators.** In the meantime, no steps were taken towards establishing the necessary institutional conditions; by 2008 no risk-sharing mechanism had been set up that could effectively address emerging problems when needed. All this apparently did not cause a problem during the economic expansion. But **as the enormous burden of the crisis continued to weigh down on the euro area, the building of the monetary union began to crack…**