Chart in focus

EMU: Money's tight in Southern Europe

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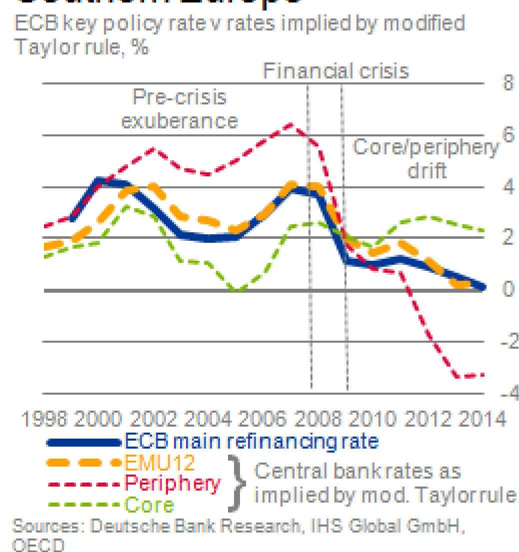
It is the classical dilemma of any currency union that a single monetary policy cannot possibly be appropriate for everybody if members are at very different stages of the business cycle. To get a feel for the scale of monetary (mis-)alignment, we calculate central bank rates as implied by a modified Taylor rule.* For the euro area as a whole, this rate (the yellow dotted line) is fairly close to the actual main refinancing rate set by the ECB. This suggests that monetary conditions have on average been quite fitting. However, the picture changes when looking at individual regions.



Naturally, the regions of interest are what is commonly referred to as core EMU (e.g. Germany, the Netherlands and Finland) and the periphery (Italy, Spain, Greece, Ireland, and Portugal). As illustrated in the chart, the monetary needs of the core and the periphery as implied by the Taylor rule have been very different throughout the history of EMU. Currently, monetary conditions appear to be too lax in the core but too tight in the periphery.

This form of misalignment is a destabilising force on EMU because it tends to exacerbate differences in business cycles, thus putting more strain on fiscal and macro-prudential policy. Moreover, monetary misalignment often breeds future problems. Before the financial crisis, monetary conditions were too generous in the periphery, contributing to an unsustainable credit boom, rising public and private debt and inflated real estate prices. This made the post-crisis hangover even more painful.

Of course, the Taylor rule is only a rough guide to central bank rates. One of its key drivers, the output or unemployment gap, is only known in hindsight and not in real time. Moreover, the rule does not take into account unconventional monetary policies, such as quantitative easing. It also ignores that in times of crisis lack of access to credit is often more important than the level of interest rates. Yet, despite these caveats, it seems fair to say that monetary policy in EMU needs to strike a delicate balance.

*The Taylor rule is a guide for setting key central bank rates proposed by John B. Taylor and others in 1993. The modified rule used here calculates the appropriate central bank rate based on core inflation rates and the unemployment gap (giving both equal weights) for each country.

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