



**EUROPEAN CENTRAL BANK**  
EUROSYSTEM

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*COURTESY TRANSLATION*

Mario DRAGHI  
President

Mr Marco Valli and Mr Marco Zanni  
Members of the European Parliament  
European Parliament  
60, rue Wiertz  
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Frankfurt, 18 January 2017

L/MD/17/33

**Re: Your letter (QZ-119)**

Honourable Members of the European Parliament, dear Mr Valli and Mr Zanni,

Thank you for your letter, which was passed on to me by Mr Roberto Gualtieri, Chairman of the Committee on Economic and Monetary Affairs, accompanied by a cover letter dated 8 December 2016.

Inflation differentials are a common feature in large and diverse economies. A uniform rate of inflation across regions within a currency area is neither required nor prevalent. In the United States, for example, inflation rates have also tended to vary visibly across major metropolitan areas.<sup>1</sup> Inflation rates differ across a currency area as regions typically specialise in different types of economic activity and are affected differently by economic and political events accordingly, often leading to temporary disparities in inflation. As such, temporary inflation differentials are part of the economic adjustment process and not normally a matter of concern.

In the euro area, however, inflation differentials have tended to be sizeable and more persistent, reflecting a build-up of economic imbalances. Persistent inflation differentials can lead to differing financial conditions (as measured by real interest rates, for example) thereby reinforcing existing economic or financial imbalances and obstructing the smooth transmission of monetary policy into financing conditions for households and firms. These types of persistent inflation differentials may become a source of vulnerability. They can

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<sup>1</sup> See, for example, slide 2 of the speech by P Praet, 2012, Heterogeneity in a monetary union: What have we learned?, available at [http://www.ecb.europa.eu/press/key/date/2012/html/sp120615\\_1.en.html](http://www.ecb.europa.eu/press/key/date/2012/html/sp120615_1.en.html).

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undermine the competitiveness of individual countries, thereby depressing both employment and growth. Indeed, until some years ago inflation differentials contributed to major relative cost and price imbalances within the euro area. Although we have seen some correction in recent years, we expect significant temporary inflation differentials to still be needed over the coming years to correct past imbalances.

In terms of underlying causes, it is not the single monetary policy that drives imbalances related to the persistent inflation differentials, and a differentiated monetary policy would not be an appropriate remedy for them either. Instead, they typically result from structural features of economic institutions at national level. For instance, inflation rates may diverge for long stretches of time if some countries in a currency area adopt very rigid or asymmetric wage-setting processes that hinder price or cost adjustments to changing economic circumstances, while others permit greater flexibility. The ensuing economic imbalances may be further accentuated by pronounced and persistent cross-country differences in productivity growth, potentially expanding the wedge in unit-labour costs.

Yours sincerely,

[signed]

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