Peter Mooslechner
Executive Director
Oesterreichische Nationalbank

Convergence in EMU and CESEE: Where Do We Stand Twenty and Thirty Years after Departure?[1]

Interestingly enough and not much noted, the Treaty on European Union (TEU) doesn't talk about convergence but of cohesion, using cohesion in a very broad sense – including social cohesion, solidarity and even territorial cohesion. Annexed to the Treaty are the famous well-known convergence criteria and there is also the Protocol on economic and social cohesion, which deals specifically with cohesion financing. Against this background it comes as no surprise that even in a rather narrow economic sense the term convergence can mean many different things, and that its meaning has changed considerably over time.

Twenty years after the establishment of the European Central Bank and almost thirty years after the fall of the "iron curtain" a serious "stocktaking" regarding convergence seems not only necessary but also possible, covering both monetary union and the development of the CESEE region over the last decades. When talking about the concept and the underlying economic development and its assessment, a first important step would be to clarify what type of convergence one has in mind.

"Babylon" or Do we know what are we talking about?

From both perspectives – EMU and CESEE – convergence is a very difficult term to be used in an analytical or policy context. In many cases the debate starts from very different starting points with regard to the prior (and often unrevealed) understanding of what is meant by convergence and, at the same time, with regard to the real importance of convergence in the context of (European) integration. As Krastev (2018) has shown, this diversity can in particular be explained by the specific situation in Europe after the opening-up of Eastern Europe and by the specific focus on differences in standards of living created thereby.

Even from a rather narrow economic point of view, convergence is used – to give a few examples only – with the meaning of (i) income convergence, (ii) nominal convergence, (iii) real convergence, (iv) price convergence, (v) beta convergence (= catching-up), (vi) sigma convergence (= variation; e.g. in GDP per capita) and in many other meanings – even very prominently in the sense of business cycle synchronization.

But when the EU Treaty speaks of "cohesion" it does so less about business cycle synchronization but mostly about income convergence, social fairness and even solidarity, addressing social and distributional objectives mainly. The wording used regarding cohesion in Article 3 TEU and in the Protocol on economic and social cohesion is as follows:

"The Union shall promote economic, social and territorial cohesion, and solidarity among Member States…." and *"Stating their belief that progress towards Economic and Monetary Union will contribute to the economic growth of all Member States… the European Investment Bank should continue to devote the majority of its resources to the*

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promotion of economic and social cohesion…"

In fact, income convergence between the original euro area countries was high and increasing before the introduction of the euro (not least because of the so-called "Maastricht effect"). After the introduction of the euro convergence stagnated, and it has become markedly divergent since the crisis of 2008/2009. Euro area countries which joined EMU some time after its start show a better performance, mainly because they experienced some fundamental catching-up process in parallel. Related to this, convergence of regions is another important and often neglected aspect of convergence. Due to OECD figures, regional GDP per capita disparities have declined over time in the majority of EU countries and there is convergence both at the country and regional level (OECD, 2018). As expected, business cycle synchronization has accelerated significantly since the introduction of the euro, with synchronization across European countries increasing by 50% after 1999 and at an even more pronounced rate in the euro area countries. (Campos et al., 2017)

But there are many more perspectives to look at when trying to understand the many facets of convergence. Convergence in the EU and euro area is widely understood as the approximation of poorer Member States to richer ones in terms of "economic and social performance," most commonly measured by GDP per capita. In the growth literature the rationale behind "convergence" is the expected tendency for countries to grow faster the lower their GDP per capita at the starting point is. Such "real convergence" (i.e. narrowing differences in terms of per capita GDP, relative endowments of productive factor prices) is what neo-classical growth theory predicts (Buti and Turrini, 2015).

Beta convergence measures the process of catching-up and the tendency for low-income countries or regions to grow faster than high-income ones. Catching-up is characterized by a negative relationship between the growth rate of GDP per capita (in purchasing parity terms) and the initial level of GDP per capita. In fact, there is a clear pattern of catching-up in the EU, with low-income regions having grown faster, on average, than high-income ones.

Different from that, sigma convergence is captured by a lower dispersion of the income distribution, typically measured as the coefficient of variation of GDP per capita. If the cross-sectional dispersion falls over time, there is sigma convergence for economies in the sample. There has been convergence among regions in Europe in the past decade, although convergences has since somewhat stalled because of the crisis. Last but not least, while the single market contributed to rising price convergence between countries, price dispersion within countries remains significantly higher than in the U.S.A. (OECD, 2018). At the same time, there was a global trend to "divergence" observable in parallel, the only significant exceptions in Europe being the Visegrad and Western Balkan countries. Even in the U.S.A. there is divergence of per capita incomes between states observable since the 1990s. In contrast, states converged in GDP per capita before the 1990s, and the gap between poor and rich narrowed as a trend (Ganong and Shoag, 2016).

Overall, there was a process of upward convergence ahead of the crisis 2008/2009, which then reversed into divergence because of the crisis, followed by a return to convergence, at least partly, very recently. But more importantly, Buti and Turrini (2015) argue that euro area convergence has never really stopped but just changed its nature,

such that the current face of convergence is different from that of the past. They characterize today's convergence as neither nominal nor real; convergence nowadays is now predominantly "structural" in their view.

At the same time, structural convergence presents a necessary basis for renewed real convergence. The first decade of EMU showed that structural convergence is not automatically a by-product of nominal and real convergence achieved, as had been expected. Today, many structural reforms implemented during and because of the crisis may be responsible for higher potential convergence in terms of structural convergence. This is underlined by most recent data pointing to an acceleration of growth and employment in most euro area countries in the periphery as well. The easing of bond market tensions, the reduced fragmentation of financial markets and fewer fiscal austerity needs in (previously) distressed countries can be seen as contributing factors to these developments.

But whether these developments will be sufficient in a sustainable sense can be questioned because of underlying special determinants: (i) Much of the structural convergence observed is linked to the contraction in the non-tradable sector in periphery countries. More ambitious reforms and supportive policy frameworks are still needed to improve competitiveness in export markets. (ii) There is a possible trade-off between export-driven growth strategy and price competitiveness gains. (iii) To achieve sustainable convergence will only be possible with building a credible institutional framework and with creating a corresponding climate of social trust and an investment friendly business climate.

Doubtful evidence, lost recipes?

With the benefit of hindsight – and obviously very much complicated by the recent experience since the crisis started in 2008/2009 – the policy measures and recipes for successful convergence have become less clear. This is in particular true compared to the text-book-based view and advice dominant at the beginning of these convergence processes (European Council, 1989; Emerson et al., 1992; Barro et al., 1992; Sala-i-Martin, 1996). Even the importance of areas contributing to convergence, ranging from fiscal developments and business synchronization to governance and institution building has become more difficult to rank compared to past experience. To a large extent this increased "policy uncertainty" or "recipe uncertainty" regarding convergence is related to the significant changes in the institutional design of the EU because of the crisis, for example concerning banking supervision or the fiscal framework.

Against this background, there is an obvious need for stocktaking on the empirical convergence evidence, as well as for a qualified analytical assessment of the effectiveness of convergence recipes. However, the analytical sequence in dealing with European convergence issues has to be structured along three crucial questions:

- What were the convergence expectations and objectives at the beginning of EMU and at the opening-up of CESEE?
- Where do we stand today compared to these starting points and what has been achieved?
- What are the convergence perspectives for the medium-term future and what are the related policy challenges and needs?

From a European integration point of view, a first policy priority should be to make convergence towards more resilient economic structures more binding. This could be achieved or at least fostered by politically agreeing on a set of common high-level standards that could be defined in EU legislation – including inter alia sovereignty over policies of common concern as well as a strengthening of decision-making at euro area level. This will either need to involve further harmonization in some areas or finding better country-specific solutions in others. In this context it is undisputed that the famous Copenhagen criteria of 1993 – enshrined in European law since the Amsterdam treaty of 1997 – still constitute the basic political, economic and legislative criteria of membership in the European Union. At the same time it is necessary to accept also that the situation has changed and developed further over the last 25 years and that, as a consequence, a much broader set of criteria is held relevant for assessing progress toward convergence today – and even the focus within the spectrum of relevant issues might have shifted.

This becomes visible for example when comparing past and recent convergence reports, which are still the most encompassing analytical instrument in assessing progress toward convergence and in identifying further convergence needs. All seven EU Member States under review in the recent 2018 convergence reports have made progress with regard to compliance with – traditional – convergence criteria. But there is no country fulfilling all obligations laid down in the Treaty, including legal convergence criteria and, in particular, institutional requests. As sustainable convergence is now seen as the overriding condition for successful adoption of the euro, countries which want to adopt the euro should be able to demonstrate the sustainability of their convergence process as early as when they consider applying for ERM II membership. The treatment of Bulgaria in its 2018 attempt to join ERM II is a telling example in this respect, putting sustainability as well as banking union into the centre (Council of the European Union, 2018). No doubt, to achieve good grades in an evaluation regarding sustainability has become more complicated over time and today refers to a much broader set of issues and criteria than at the time of the Maastricht treaty, mainly because of the crisis experience of the last decade.

An indispensable prerequisite for sustainable convergence nowadays is macroeconomic stability, understood in a very broad sense. It's no longer the fulfilment of certain quantitative single criteria alone which counts, the assessment depends on a certain track record and the proven robustness of successful policies also. In this sense, the European fiscal framework has been reformed in order to incentivize the improvement of fiscal positions in good times and to reinforce convergence towards a sustainable debt level. Most of the countries under review have made progress in addressing macroeconomic imbalances in their economy, with the newly introduced macroeconomic imbalances procedure (MIP) as an explicit recognition of the importance of this aspect from a forward-looking sustainability-oriented perspective. In addition, countries must have well-functioning product and labor markets, which is essential for coping with macroeconomic shocks. Moreover, appropriate macroprudential policies need to be in place to prevent especially the build-up of macrofinancial imbalances, such as excessive asset price increases or credit boom-bust cycles. Last but not least, for convergence to be

sustainable, an encompassing sound and functioning institutional framework must be in place, with banking supervision and sound financial structures as a central challenge stemming from the crisis experience.

Successful "Deepening of EMU" demands much more than (simple) structural reforms…

Structural reforms will play a crucial role in successful EMU deepening in all countries. But there is no one-size fits all policy framework. The optimal set of structural policies for an economy depends on many idiosyncratic factors, ranging from its historical record and its appropriate institutional setup to its level of development and/or geographical location. In any case, reforms must go beyond simple flexibility-enhancing measures, towards targeted productivity-enhancing instruments. In reality, the success of reforms depends very much on the design, timing and sequencing of the reform process. Even if cross-border spillovers justify the involvement of the EU in structural reforms of Member States, reform ownership at the national level based on broad social consensus is essential for effectiveness.

Perhaps the most recent and important consequence from the actual crisis experience in this respect is an appropriate framework for banking supervision and the resolution of financial institutions, in view of the establishment of European banking union and the Single Supervisory Mechanism (SSM). In addition, greater convergence of capital market regimes would enhance cross-border capital flows by removing undue differences in regulatory practices and by improving consistent enforcement, as it is addressed in the capital markets union initiative of the European Commission.

At the German-French Head of State's meeting at Schloss Meseberg near Berlin on June 19, 2018, French President Macron and German Chancellor Merkel agreed on a number of important elements set to shape the future of Europe. Concerning EMU, they are committed to promote competition and stabilization, with the ESM, banking union and capital markets union as well as a common euro area budget seen as key steps of a roadmap for deepening EMU. It has to be seen to what an extent this agreement will lead to a focused and broadly accepted strategy towards more encompassing convergence policies in European political reality.

This leads to the fundamental question, namely why it is at all important to fight divergence and to create convergence. Some "realists" think countries "should simply live their divergence" but they forget that this is and will be followed by a divergence of national political cycles. Today's political reality shows that this is a breeding ground for populism, which in the end endangers European integration, EMU and economic development.

Although for the CESEE region relative growth performance always has to be understood as a combination of convergence and catching-up, the Central and Eastern European EU Member States have enjoyed robust growth over the past couple of years, and this trend has even strengthened recently. With annual growth rates close to or even above 4%, their economic convergence with Western Europe gained momentum in 2017.

Convergence in terms of per capita GDP levels in CESEE is a long-term process. Overall, per capita GDP levels in the CESEE economies have been approximating those of the 'old' EU Member States. However, the pace of convergence, which was quite rapid before the outbreak of the global financial

crisis, has since slowed. This slowdown has been particularly visible in the more developed EU CESEE countries. Forward looking simulations show (Zuk et al., 2018) that by 2026 no country in the region will have caught up with average EU-28 levels. Per capita GDP in the Czech Republic will exceed 90% of the EU-28 level, whereas in Poland and Hungary it will not reach 80%. For most of the CESEE region, a halving of the current gap to the EU-28 in terms of average per capita GDP will take almost 25 years.

Challenges for future convergence in CESEE reside in an adverse impact of population ageing, institutional quality, innovative production, reinvigoration of investment and ensuring its sustainability and weak productivity growth. In general, the transformation of Central and Eastern European economies from centrally planned towards open market economies has been inherently interlinked with their integration into the EU. The desire to join the EU worked as a major force for economic reform, in particular over the first decade after the opening-up of Eastern Europe. This not only improved the efficiency of resource allocation but also made EU membership a plausible political outcome, a mood which seems to have deteriorated more recently. However, the positive climate that rapid growth and convergence created has hidden deeply seated problems of weak institutions and slow social progress, while substantial capital inflows led to resource misallocation in the economy. The speed, sustainability, and equity of future convergence will depend on further renewed efforts.

After a good start, euro area economies have not converged as envisaged

In the first years of its existence, the euro contributed noticeably to economic convergence in the euro area (European Commission, 2008), against a favorable global background called "The Great Moderation" by Ben Bernanke (2004). With the benefit of hindsight, it looks like that part of the convergence gains achieved over this period were due to less frequent and less pronounced country-specific shocks. However, these smooth developments were masking the build-up of unsustainable imbalances and mispricing of sovereign risk. As a result, the economic convergence achieved early in the euro's existence was reversed during the crisis period until the overall economic recovery stopped and has since partly reversed this tendency (Franks et al., 2018).

If one looks more closely into some of the several dimensions of convergence the picture that emerges is at least somewhat mixed:

- Nominal convergence of inflation and interest rates largely took place in the run-up to the establishment of the euro, then temporarily reversed and has since been re-established, although at (or because of?) a historically unusual low level of inflation and interest rates.
- Real convergence has been a rare phenomenon among the original euro member countries (European Central Bank, 2015). In particular, GDP growth and productivity growth have not reduced income disparities between richer and poorer countries, while there was some convergence of unemployment rates.
- There has been significant convergence among those countries who joined the euro later on.
- The synchronization of the timing of business cycles has improved, but the amplitude of those cycles has diverged because of asymmetric shocks and specific national developments.
- The synchronization of financial cycles diverged during the pre-crisis boom, but has since been re-established. Also regarding financial cycles the amplitude again has become more uneven (Cesa-Bianchi, 2015; Praet, 2014).
- Last but not least, it is interesting to note that German cycles have become more delinked from the rest of the euro area. Significant capital flows, build-up imbalances, emerging systemic risk as well as resource misallocation and therefore productivity divergence and divergence in competitiveness in parts of EMU contributed to this development.

An additional important issue, which became very prominent not least because of the crisis experience and politically driven disintegration tendencies, is how to tackle the core-periphery issue. Campos and Macchiarelli (2018) try to overcome the simplistic core-periphery perspective and propose a new framework to identify sets of European countries. They show the recent emergence of three clusters: a set of six core countries (Austria, Belgium, Germany, France, Italy and the Netherlands), a mixed set of (intermediate) countries (Greece, Denmark, Sweden, Spain and the UK) and a set of deep-rooted periphery countries (Finland, Ireland, Norway, Portugal and Switzerland) – clusters which seem to reflect the crisis experience as well as the political and economic integration status (or integration willingness?) of European countries. In the same vein Demertzis et al. (2018) propose a hybrid "European integration by differentiation" governance framework for the EU, consisting of a "barebones EU base" and a "top-up Europe of clubs."

Integration: A story of (high) expectations and (deep) disappointments

The current assessment and understanding of convergence seems to be driven very much by expectations. Expectations of "dis-equilibria" are nowadays very prominent and impactful in many economic areas, especially in financial markets. They are characterized by a high degree of instability and they are the source of all kinds of uncertainty as well as "disappointments" by economic agents. It seems that there is a very similar type of problem regarding EU, EMU and CESEE integration. As expectations were very high – perhaps unreasonably high and far reaching – at the start of EMU and at the opening-up of Eastern Europe, the substantial progress achieved since then tends to be experienced negatively by the people, because these expectations – in some cases even wide-ranging political promises – were not (and could not be) completely met.

- Regarding EMU, the theory-based expectation that monetary integration will automatically lead to quick and complete cross-country convergence turned out to be more complicated in reality – and in any case to take much longer as envisaged.
- Regarding CESEE, the expectation that catching-up to Western GDP-per-capita levels will be a quick, smooth and common process for the region did not materialize.

EMU was expected to foster greater macroeconomic stability, prosperity and convergence. It succeeded in estab-

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lishing a credible monetary policy framework and deepened financial integration, but governments failed to exercise sufficiently coordinated fiscal policies and to agree on a joint implementation of targeted and adequate institutional reforms. In the wake of the financial crisis 2008/2009, the euro area crisis has severely tested the stability of the euro area and uncovered dangerous tendencies of economic divergence, but monetary policy has been successful in retaining the existing integration status and a sustained convergence of inflation towards the inflation target avoiding deflation (IMF, 2017; OECD, 2018).

In the light of the debate at the start of EMU this crisis experience came as a surprise, as the discussion at that time mainly focused on convergence. The Maastricht criteria essentially singled out nominal convergence (such as convergence in interest rates and inflation rates). The objective was not only to create a single currency but also a stable currency. It was expected that a single currency would give strong incentives to carry out structural reforms to compensate for the loss of monetary policy as a national stabilization tool (Buti and Turrini, 2015; Banerji et al., 2015).

U.S. economists, for different reasons and based on rather different arguments, pointed to the risks of this undertaking. For example, Krugman (1993) concluded that "…EMU will not be a bad thing, but … the combination of 1992 and EMU will tend to produce some new stabilization problems at the regional level." Martin Feldstein (1992) went even further: "… the European Community should abandon its plans for monetary union."

Is it still the case and valid that EU integration – in its different forms – can be seen as a convergence engine? In fact, the European Union has been the modern world's greatest "convergence machine" since its foundation more than 60 years ago (The World Bank, 2017), propelling poorer new Member States to become middle- to high-income economies and to delivering to its citizens some of the highest living standards and lowest levels of income inequality in the world against the background of completely devastated economies and societies after WW II. Today, however, at a markedly higher income level, Europe is increasingly recognizing that convergence is not automatic.

Contrary to its nominal policy focus in preparation for EMU, the academic debate – based on optimal currency area theory – has emphasized the extent also to which real convergence was sufficiently advanced to make the economies of the countries in EMU sufficiently synchronized. Within monetary union, the lost mechanism of exchange rate adjustments created the need for another (set of) adjustment mechanism(s) to deal with asymmetric shocks – and the need to introduce common structural improvements to the integration region.

Another optimal currency area theory-based integration aspect is the role of risk-sharing mechanisms. Given the still existing lack of fiscal risk sharing in EMU, this role has been more or less explicitly delegated to financial markets solely. This is one reason also why the EU's capital markets union initiative – launched in 2014 – is so important to provide businesses with a greater choice of funding, to offer new opportunities for private investors across Member States, thereby making the entire financial system more resilient (Buti and Turrini, 2015). In a similar way, EU enlargement was surrounded by the debate on the possible tensions between nominal and real convergence and the related difficulties encountered by accession countries in respecting Maastricht criteria because of their catching-up properties (the famous Balassa-Samuelson effect).

Instead of conclusions: Four core questions to concentrate on

Instead of drawing curtailed conclusions on the complex question of convergence let me end by simply stating four questions which would need more detailed analysis to make progress regarding a better understanding of this difficult topic:

In what areas is convergence most needed for a well-functioning EMU?

Euro area member states differ significantly in economic structure. Broad consensus about socioeconomic convergence seems necessary to guarantee the stability of the euro area, but not in all its dimensions to the same degree. Any binding rule has to take note of the principle of subsidiarity. The crisis experience has revealed that exaggerated convergence demand puts the whole euro area to test and can/will create unwanted side effects and even larger imbalances. How to identify the appropriate degree of convergence is perhaps the most urgent requirement to be addressed (auf dem Brinke et al., 2015).

What role for convergence in the social field?

Better-integrated and more flexible labor markets as well as deeper financial market integration are widely seen as the basic prerequisites to increase the resilience of EMU. But how much socioeconomic convergence and/or minimum standards are really necessary and reliable without putting the integration process at stake? Given existing European cultural diversity it seems neither possible nor meaningful to make Europe similar to the U.S.A. or any other specific role model.

How to achieve convergence: laws, carrots or sticks?

Common sustainable economic policies are in the best interest of all euro area member states. No question, cautious coordination of national policies is necessary in an integration context, as national policies in the end influence the functioning of the entire area. Up to now, limited implementation of the commonly agreed policies turned out to be an increasing political weakness of the integration efforts in an enlarging EU. A common understanding of collective challenges and a greater readiness to agree on common objectives would enable all countries to converge faster and produce a better outcome. Incentive-based enforcement mechanisms to complement the already extended framework of existing rules – as suggested, for example, in the Five Presidents' Report (see in particular European Commission, 2016) – would be a positive way to achieve more agreeable convergence standards.

What do we know about all the other factors influencing our readiness to live convergence?

Much more research efforts and understanding is definitely needed on all the prospective many other factors, which obviously not only have an impact on convergence but seem to have risen markedly in their influence on and relevance for people's acceptance of integration and convergence – such as globalization, technical progress or migration to name three recently very prominent factors only.

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