Convergence in the euro area: cycling up and down

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1. How to get more convergence in four steps

While convergence in the euro area has slowly improved since 2009 in some areas such as competitiveness and public deficits, it has stagnated in others, in particular (youth) unemployment.[2] In this short essay, I offer four analytical steps of how to get more convergence (summed up in chart 1) and describe where we are today.

Step 1: Objectives

Since there are different kinds of convergence, agreeing on the objectives is the first crucial step. Broadly speaking, two objectives have mattered most for the euro area: improving the functioning of the common currency and letting everyone benefit from economic success. While some may prioritize one over the other, both objectives are important.

Step 2: Definitions

The second step is to agree on common definitions for both objectives.[3] Cyclical convergence is needed to reduce harmful imbalances in the euro area and ensure that the common monetary policy can work. Cyclical convergence indicators include, among others, growth rates and inflation rates. In the absence of cyclical convergence, the interest rate of the central bank may be either too high, suppressing a recovery and growth rates, or too low, allowing economies to overheat. For everyone to enjoy the benefits of integration, real convergence is necessary. It is most commonly defined as convergence in GDP per capita. It is also closely linked to social cohesion which includes a wider range of indicators including inequality measures.

Step 3: Instruments

In a third step, one has to agree on the instruments. To increase cyclical convergence the euro area needs some kind of shock absorption mechanisms. Different ideas are already on the table.[4] In addition, the euro area countries need structural reforms to increase potential output and the adjustment capacity to asymmetric shocks. Real convergence may require a different set of instruments, among them more investment (both public and private), and stronger institutions that distribute growth gains.

Step 4: Enforcement

If one were to agree on the instruments, the crucial question is how to get there. There are essentially two strategies. The first is to improve the set of rules for the euro area and ensure that they are

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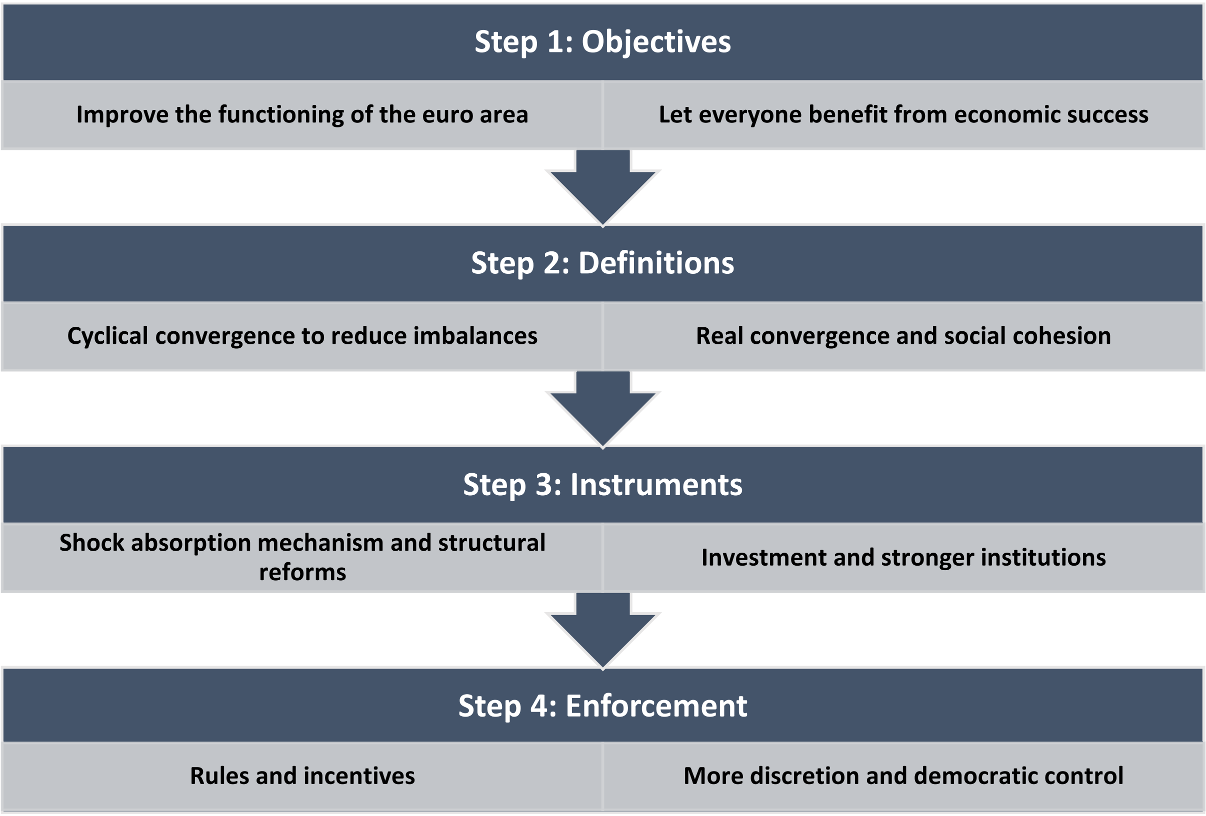
[2] Compare A. auf dem Brinke, H. Enderlein and J. Fritz-Vannahme, What kind of convergence does the euro area need?, Gütersloh: Bertelsmann Stiftung and Jacques Delors Institut – Berlin, 2015.

[3] A. auf dem Brinke, H. Enderlein and J. Haas, "Why the Eurozone can't agree on convergence and how structural reforms can help", Policy Paper No. 165, Jacques Delors Institut – Berlin, 24 May 2016.

[4] See H. Enderlein, E. Letta et al., Repair and Prepare: Growth and the Euro after Brexit, Gütersloh, Berlin, Paris: Bertelsmann Stiftung, Jacques Delors Institut – Berlin and Jacques Delors Institute in Paris, 2016.

properly enforced through incentives, which could also be rewards rather than penalties. The second strategy would be to give the European Commission more (political) leeway and to add new layers of democratic control, such as a Eurozone parliament.[5]

Chart 1: Four steps to more convergence in the euro area



Source: Author based on earlier work.

2. What is the state of the convergence process?

So far the strategies for more convergence in the euro area have cycled a few times through all four steps. Here I just provide a short overview of the three most important rounds so far:

In the Maastricht Treaty, convergence was defined in terms of price stability and sustainability of public finances. The objective was to prepare countries for giving up monetary policy. The instruments were up to the national governments. The strategy for enforcement was reward: adoption of the euro as the new currency.

The Stability and Growth Pact (SGP) defined convergence in terms of public finances. The objective was to prevent inflationary spill-overs. Governments were free to choose the instruments to control their budget. The strategy for enforcement was close monitoring and policy recommendations and the excessive deficit produce, which may ultimately lead to a fine (although it has never been enforced).

The third round started with the introduction of the Macroeconomic Imbalance Procedure (MIP). The objective was to prevent a building up of imbalances over years. The MIP monitors a range of indicators (14 at the moment) to detect external and internal imbalances and correct them if needed. As an instrument it is at same time more flexible and encompassing but also more difficult to interpret than the rules in the SGP. In terms of enforcement, the MIP is integrated into the European Semester and accompanied by constant reviews, recommendations, and monitoring.

[5] V. Kreilinger and M. Larhant, "Does the Eurozone need a Parliament?", Policy Paper No. 176, Jacques Delors Institut – Berlin, 14 November 2016.

The Five Presidents' report sets out a new process for convergence.[6] Here, convergence is one ingredient towards the objective to complete the Economic and Monetary Union. According to the report we are back at step two: Countries should agree on new benchmarks that can be legally enforced some time after June 2017. Only then can the euro area revisit instruments and enforcement mechanisms again. For now the European Commission aims to continue monitoring and issuing recommendations. It suggests that convergence efforts could be awarded with participation in a shock absorption mechanism.[7]

[6] J.-C. Juncker et al., Completing Europe's Economic and Monetary Union, Brussels. European Commission, 22 June 2015.
[7] Compare H. Enderlein and J. Fritz-Vannahme, Repair and Prepare: Strengthening Europe's Economies after the Crisis, Gütersloh: Bertelsmann Stiftung and Jacques Delors Institut – Berlin, 2014.