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Convergence and Shared Prosperity Have Always Been at the Heart of European Objectives

The European project has laid the foundations of a closer union among the people of Europe since the very beginning and, still today, remains resolved to ensure the economic and social progress of all.

The preamble of the Treaty of Rome (1957) says that the establishment of the European Union was intended to "strengthen the unity of [European] economies and to ensure their harmonious development by reducing the differences existing between the various regions and by mitigating the backwardness of the less favored regions" and to "direct their efforts to the essential purpose of constantly improving the living and working conditions of their peoples".

The improvement of the well-being of the European Union's people is one of the first aims of the European Union (Article 3 of the Treaty on European Union – TEU[1]). The means to achieve this goal are clearly described in Article 119 of the Treaty on the Functioning of the European Union (TFEU), in particular "the adoption of an economic policy which is based on the close coordination of Member States' economic policies" and "without prejudice to the objective of maintaining price stability, to support the general economic policies in the Union, in accordance with the principle of an open market economy with free competition"[2].

More recently, the European Commission's roadmap published in December 2017 pointed out that "one of the lessons learned from the crisis is that achieving convergence and building robust economic structures is crucial for the prosperity of the Union and, in particular, for the smooth functioning of the single currency". […] "The notions of convergence and integration are at the heart of the Economic Union. To achieve sustainable prosperity, Member States need to continue to focus on the necessary reforms to modernize their economies, make them more resilient to possible shocks and improve their growth prospects". […] "Going forward, the Union framework should continue to support a process of reforms for real convergence across the EU, both within the euro area and for countries on their way to joining the euro."

[1] *Article 3 TEU: 1. The Union's aim is to promote peace, its values and the well-being of its peoples. 2. The Union shall offer its citizens an area of freedom, security and justice without internal frontiers, in which the free movement of persons is ensured in conjunction with appropriate measures with respect to external border controls, asylum, immigration and the prevention and combating of crime.*

[2] *Article 119 TFEU: 1. For the purposes set out in Article 3 of the Treaty on European Union, the activities of the Member States and the Union shall include, as provided in the Treaties, the adoption of an economic policy which is based on the close coordination of Member States' economic policies, on the internal market and on the definition of common objectives, and conducted in accordance with the principle of an open market economy with free competition. Concurrently with the foregoing, and as provided in the Treaties and in accordance with the procedures set out therein, these activities shall include a single currency, the euro, and the definition and conduct of a single monetary policy and exchange-rate policy the primary objective of both of which shall be to maintain price stability and, without prejudice to this objective, to support the general economic policies in the Union, in accordance with the principle of an open market economy with free competition.*

Convergence is multifold

Convergence of per capita income levels[3] is not a prerequisite for a functioning monetary union per se. The convergence of economic structures is not required for a successful monetary union either.

However, countries need sufficiently flexible labor and product markets to adjust to shocks. If not, a heavier adjustment burden falls on the quantities (employment and output) – something we painfully felt during the crisis. This does not mean having identical product and labor markets but ensuring that factors can move to their most efficient use and be reallocated quickly. And, in any case, convergence and improvement of the living conditions is a decisive element for ownership of European citizens.

Real convergence is important for political cohesion within monetary union. It can help ensure that gains from monetary union are shared among Member States and thereby foster social cohesion. Divergences may fuel frustration and lead to resentment and political instability. During preparation of the Economic and Monetary union (EMU), nominal convergence criteria (e.g. inflation) took center stage.

General progress but high heterogeneity remains, especially after the 2008 crisis

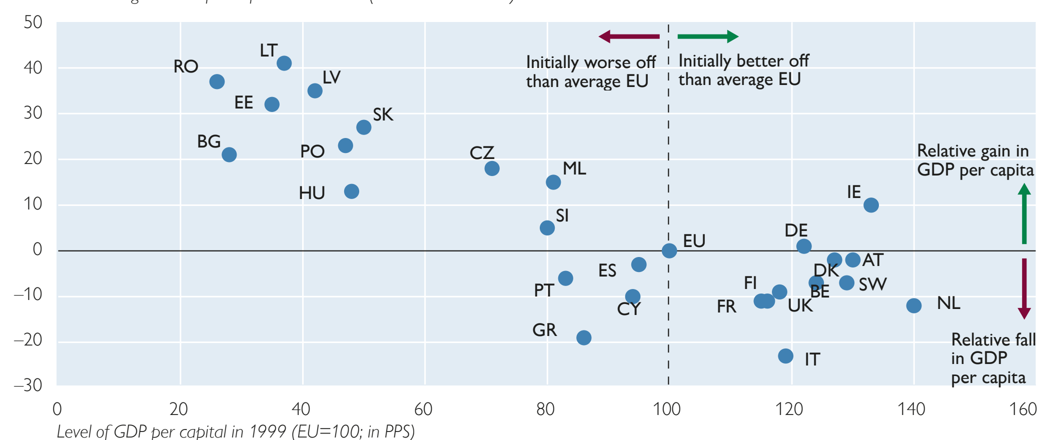
The inspiring idea behind EU and EMU was that the removal of barriers would produce capital flows towards catching-up economies, thereby boosting investment and economic growth. Hence, it was expected, not only that all European countries would grow but that less favored countries would benefit from the impetus coming from the most favored ones. Looking at the figures, and starting at the introduction of the euro, all countries have indeed experienced growth in GDP per capita. In addition, some degree of real convergence has definitely taken place in the most recent EU Member States.

In particular, Lithuania, Estonia, Latvia, Romania and Slovakia have achieved the largest degree of convergence among EU countries so far (top of the top-left quadrant in chart 1),

Chart 1

EU Convergence: where do we stand now ?

Cumulative change in GDP per capita 1999–2017 (EU normalized to 0)



Source: ECB.

[3] *"Real convergence" is then defined as real GDP per capita of lower income economies catching up with those of higher income economies on a durable basis.*

followed by other countries in the Central and Eastern Europe region[4]. While they were among the poorest countries in 1999, they cumulated growth points that allowed them to achieve substantial GDP per capita gains relative to the EU average.

More problematically, in contrast with initial expectations that the euro would act as a catalyst of faster real convergence, little convergence, if any, has taken place over the period 2000–2017 among the older Members States (EU-12). In fact, a stocktaking exercise may appear quite bleak: low-income early euro adopters (e. g. Spain, Greece) have increased their income gap with the average, which means that not only they are still below the European average, as they were in 1999, but their relative income gap has deteriorated (bottom-left quadrant in chart 1). Italy, initially a higher-income country (above EU-12 average), has registered the highest relative fall in GDP per capita (lowest part of the bottom-right quadrant in chart 1, i.e. the relative fall in the level of GDP per capita was much stronger than in any other EU Member States).

Of course, the global financial crisis explains a lot: before the crisis, there was faster growth in Spain or in Greece than in the rest of the euro area but this catching-up process rapidly reversed after the crisis (with a recession or at best a stagnation). The persistent underperformance of growth in some euro area countries limited the performance of the whole area. Transfers arising from the EU budget (cohesion funds, struc-

tural funds and the common agricultural policy) also contributed to the increased prosperity of some Member States.

The crisis hit an uncompleted European Union

We knew a complete EMU implied more integration. This situation was not unanticipated. Ever since the early steps of EMU, many have warned that it was at risk of being suboptimal and unbalanced. In the 1970s, the Werner report advocated an autonomous budget, a decisional center for economic policy, accountable to a parliament elected by popular vote and the coordination of social partners. The 1989 Delors report required proper convergence before entering EMU, rules to control national budgets and common resources to increase transfers – a topic that carried no taboo at the time. Between 1994 and 1999 the structural and cohesion funds of the EU were doubled to reach almost a third of the total EU budget. The 1993 White Paper on Growth, Competitiveness, and Employment advocated

[4] *Some evidence for the positive effect of EU membership on relatively low-income countries, largely thanks to a greater degree of economic integration, can be found in a number of economic papers. E.g. Crespo Cuaresma, J., D. Ritzberger-Grünwald and M. A. Silgoner. 2008. Growth convergence and EU membership. In: Applied Economics 40(5). 643–656. One cannot ignore that an additional factor lies, more simply, in the "natural" catching-up of these economies, i.e. their greater scope for accumulation of capital, labor shifting out of the agricultural sector, and productivity gains.*

a sweeping program of infrastructure of Europe-wide interest based on a European funding.

After the strong catching-up of the 2000s, the crisis both stopped and differentiated the growth of new Members States – especially those whose initial standard of living was low – and created the beginning of divergence among the core countries. An explanatory factor lies in the widening of macroeconomic imbalances among European economies.

Urgent actions were taken to weather the crisis

Several measures were taken to deal with the financial crisis: a monetary policy response (decrease in policy interest rates, non-standard measures, etc.), macroprudential measures, new regulations, new tools (the Single Rulebook), new

Chart 2

Emergency responses to the crisis

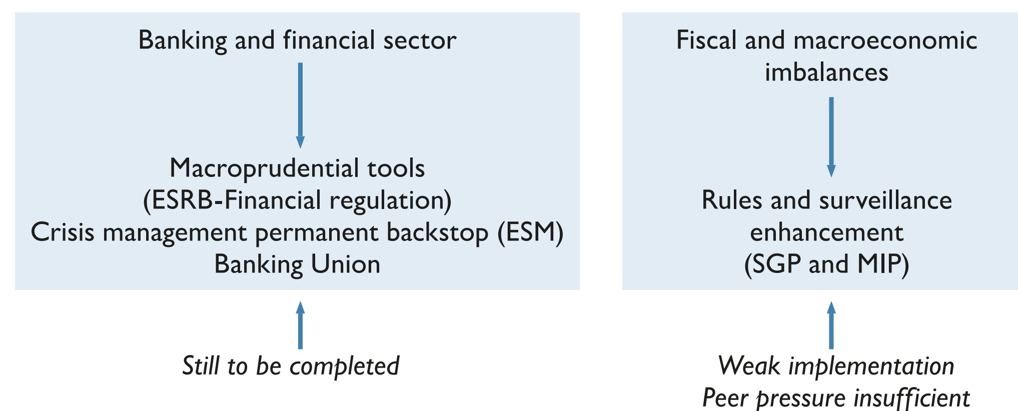
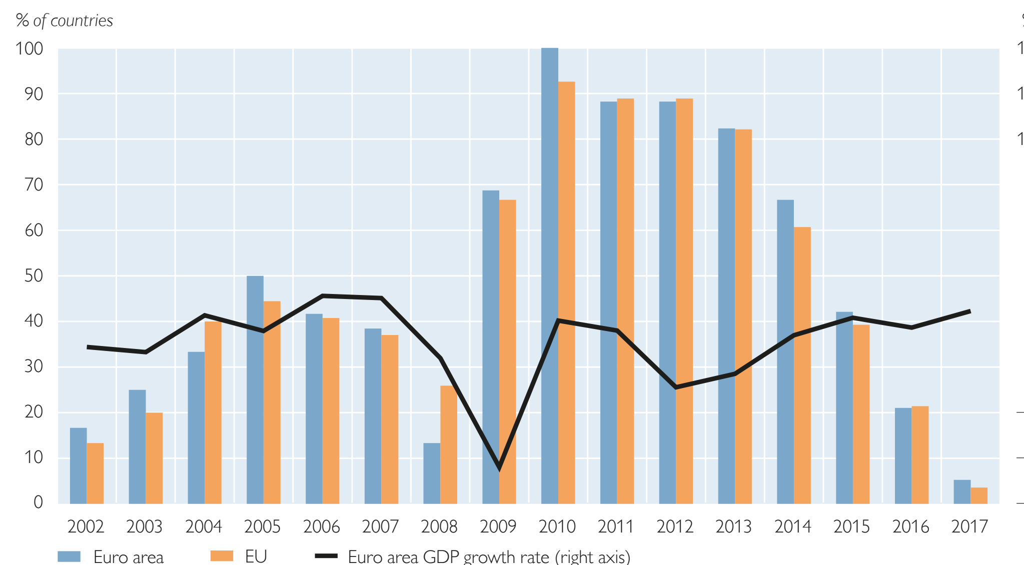


Chart 3

Stability and Growth Pact: Countries in Excessive Deficit Procedure



Source: Eurostat.

institutions (like the European Stability Mechanism – ESM), etc. The banking union both protects financial stability and deepens financial integration in the EU. It is a considerable step forward compared with the pre-crisis situation but needs to be completed. Steps were also taken to change the rules. As a response to the absence of policy tools to prevent the build-up of macroeconomic imbalances prior to 2008, the Macroeconomic Imbalance Procedure (MIP) was created within the European Semester six-pack in 2012.

Some sort of fiscal convergence appeared over time. In 2017 there is only one country left in Excessive Deficit Procedure (EDP) (see chart 3). However, this instrument failed to avoid procyclical policies during the crisis. Besides, the correction of macroeconomic imbalances is slow and insufficient. The current system based on peer pressure, asymmetric incentives, and possible – but never applied – sanctions does not lead to reform implementation (see chart 4).

What next? Avenues for improvement

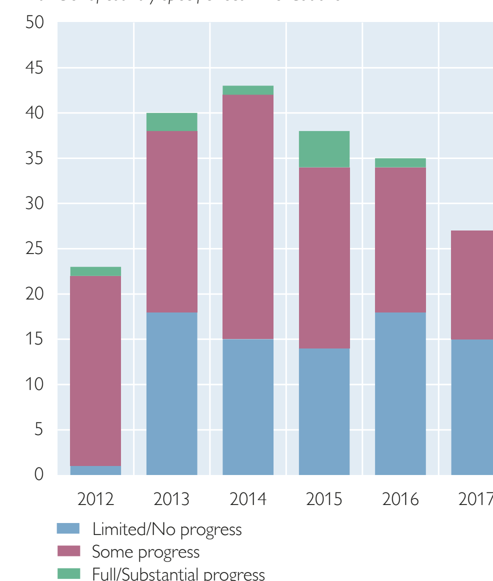
Within the current framework, there are multiple layers of rules but no proper mechanism for enforcement when rules are not respected. One suggestion might be to apply the rule of law. The Court of Justice is at least partly excluded from having the role of judicial control (Art 126 (10) TFEU on budgetary discipline). Without enforcement procedures, the single market would certainly not be what it is.

A way was found to compensate the lack of legal enforcement with the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, signed in 2012 as an intergovernmental tool which has been transposed into national constitutions.

Chart 4

Macroeconomic Imbalance Procedure

Number of country specific recommendations



Source: Eurostat.

A budget not in line with a country's European commitments could thus be invalidated by the national supervisory authorities (Constitutional Court most often). Unfortunately, the requirements related to macroeconomic imbalances, which are key for convergence, are not part of this intergovernmental treaty. Although the Commission is supposed to enforce them, they were neglected.

Boost potential growth

National structural reforms are needed to boost employment and growth in all Member States and they will have even more impact if they take into account the objectives set for the entire union in a collective and coordinated way.

These reforms should favor policies with cross-country effects that can enhance rebalancing within the EU and the euro area. They should also foster real sustainable convergence between European economies, in particular by improving labor and capital mobility, improving education and labor

skills and stimulating investment and innovation.

Create the right conditions for investment and innovation: finance the real economy

On this particular issue, a "financing union for investment and innovation", which would better channel money towards innovation such as digital or energy transition technologies, is a promising option. The aim of such a financing union is to better steer the 400 billion EUR savings surplus in the EU towards productive investment, in particular by shoring up equity, which is key for an innovation economy and for boosting potential growth. This union should bring together existing initiatives, and as a priority, the Capital Markets Union, but also the banking union and the Juncker investment plan.

Conclusions

Reforms can be very painful in the short-run but they do pay off in the longer run. Of course, one has to be wary of reforms made under the pressure of markets and are to a certain extent countercyclical (GR, IT). Yet, looking at the last two decades, we have proof that sound economic structures have benefited the countries that implemented reforms. We know that structural reforms boost growth and create employment.

Sharing a common currency is about sharing risks. It means sharing a vision, an endeavor, a destiny, and about building a bold and lasting relationship. This is about delivering on a pledge, as Helmut Kohl did when he promised his mother her grandson would not die in a war between European states. The denial of rules and risk-taking generates mistrust – it does not foster convergence.