The crisis revisited: Will divergence tear the Eurozone apart?

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The significance of divergence

By early 2017, the euro crisis seems to have somewhat calmed down from its peak when it presented an existential threat to the European integration process, although challenges are still apparent, not least in the Italian banking sector, in Greece and in the full completion of Banking Union. Yet, despite unprecedented European policy development that would have been unthinkable before the crisis, there are still many unresolved structural issues, as noted, for example, in the Five Presidents' Report. One of these crucial issues is the continuing divergence within the Eurozone.

Divergence matters as it leads to an accumulation of imbalances within the Eurozone, making common (monetary) policy less effective. There are spill-over effects within the Eurozone, for example with respect to countries' fiscal stances that highlight the interdependence of Euro-area economies. Divergence also entails that some Eurozone countries are less resilient to exogenous shocks, necessitating assistance from others to prevent a catastrophic collapse. Finally, divergence, especially if it is addressed through painful adjustments such as internal devaluation, also can have political consequences, that could threaten the existence of the Euro by fuelling the rise of populists who advocate its abolishment as an easy way out of domestic problems.

To assess the importance of such divergence and what can be done to foster greater convergence, definitional clarity is important. In economic terms, convergence often refers to business cycle synchronization within an Optimum Currency Area. The less synchronized, the more there is a need for capital or labour flows to balance out activity or some form of equalization or transfer system. In addition, there is also absolute convergence in living standards, which requires higher growth rates in countries with a lower per capita GDP. However, while this might improve convergence between countries, there might be growing divergence within countries, even with higher growth if inequalities are increasing.

Convergence is also an economic policy concept, measured, by, for example, whether countries are converging to the same indicators and targets. This can be rules/legal based or it can be driven by market mechanisms. A convergence in applying the same rules and policies should not be seen as necessarily leading to the same economic outcomes, as this is highly dependent on the starting point and institutions of the country in question.

Current policy responses

While convergence is noted as a policy goal in the Five Presidents' Report, in reality there are few tools that effectively promote economic or policy convergence. The European Semester in its current form is not delivering convergence[2] and the economic recovery is still uneven, albeit with some positive signs in countries such as Spain and Ireland. While there has been some convergence on fiscal policy, there are few signs of consistent convergence on competitiveness or growth across all countries, nor a sustained and sustainable convergence on employment. Investment is too low across the Eurozone but critically low for countries which will need future investment-driven growth to restart the catch-up process.

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[2] 'Economic policy coordination in the euro area under the European Semester'; Fabian Zuleeg; European Parliament, November 2015

In part this is down to common policy failures, although other factors certainly also play a role, including policy decisions by individual countries. The reforms that have already been in the pipeline are slow in implementation and further reforms of the Eurozone are not on the cards. While the Commission is intending to make further proposals on EMU reform in the first half of 2017, following on from the publication of the White Paper[3], few expect that it will do much more than reiterate the reforms already noted in previous reports. At the heart of the problem lies significant policy divergence between member states and distrust in each other's willingness and (political or economic) capacity to implement the current framework, let alone any further steps. While some member states believe that responsibility lies, first-and-foremost, with national governments and that these need to deliver the agreed reforms, others believe that countries should have more flexibility to decide on their fiscal and structural reform stance, in line with their sovereignty, as well as more solidarity by those countries with stronger fiscal capacities. Each government is politically accountable to its own citizens, creating insufficient incentives to act cooperatively at EU level.

A pragmatic policy solution for a post-election era

One possible response to this policy dilemma is full political union. However, this is currently not on the cards[4]. It is also true that achieving higher convergence on the rules and legal targets alone is not a solution which addresses the underlying causes of divergence[5]. But it is also true that the Eurozone needs greater convergence both in policy and economic terms to make EMU sustainable for the long run. What is needed is a pragmatic first step that can rebuild trust, to meet the precondition for further, substantial reform in future.

Such reform must be driven by the two largest Eurozone economies, Germany and France. While all other countries also need to be involved, without these two there is no progress possible. But both face critical elections in 2017, so any possible solution can only be implemented after they have gone to the polls. But the current year is crucial to lay the foundations of such a solution which combines responsibility, flexibility and solidarity. The pillars of such a solution are:

- Fiscal flexibility but within a strict framework. This involves establishing a Golden Rule for public and social investment but with a clear definition and external assessment of what constitutes such investments. In return for more flexibility within this framework, stronger implantation of sanctions;

- Contractual reform contracts (Investment and Reform Compact), based on the CSRs, recognizing that growth-enhancing reforms often require investment, with funding conditional on demonstrated action, which could be built into the next Multi-annual Financial Framework; and

- For those countries within the Eurozone with insufficient fiscal space, a fiscal capacity that helps to underpin the contractual agreements mentioned above, with funding dependent on demonstrated reform implementation.

Such a reform package contains challenges but also opportunities for all Eurozone countries. It would increase economic and policy convergence, as well as strengthening the cohesiveness of the Eurozone, creating incentives for the pre-ins to join in future when they meet the conditions. It leaves significant decision-making at member state level, while creating and incentivizing cross-Eurozone cooperation. It is but a start of the reforms needed but a substantive step forward, benefitting from the potential

[3] 'White Paper on the Future of Europe: Reflections and scenarios for the EU27 by 2025'; European Commission, March 2017

[4] 'EU@60 - Countering a regressive and illiberal Europe'; Janis A. Emmanouilidis and Fabian Zuleeg; European Policy Centre, 13 October 2016

[5] 'Can the eurozone's economic governance combine political accountability, legitimacy and effectiveness?'; Fabian Zuleeg; in Redesigning European Monetary Union Governance in Light of the Eurozone Crisis; CIDOB 5/2015

window of opportunity post French and German elections. This will require a favorable, pro-European outcome of both elections and political will to compromise, driven by the recognition that more needs to be done to make EMU sustainable. The Eurozone, and indeed the EU, cannot afford to miss this unique chance to get the European integration project back on track. Otherwise, in the long run, the political consequences of sustained divergence will undermine the sustainability of the Eurozone itself, creating uncontrollable costs that all Eurozone members will have to pay.