# Convergence: Are the Eurozone countries too different?

The Eurozone countries are economically different. The crisis has rendered some of these differences more acute and this could destabilize the currency union. The Eurozone countries therefore need to agree on which type of convergence is most important to them and the best way to achieve it. In what areas should they converge? What differences could or should remain? And what policy instruments are required to achieve this?

JACQUES DELORS INSTITUT BERLIN | BertelsmannStiftung

# Why is the lack of convergence in the Eurozone a problem?

**Economic differences in the Eurozone can be problematic for two reasons:** First, a common monetary policy requires similar price developments so that the European Central Bank's (ECB) interest rate suits all the countries in question. Second, the trust that consumers and the markets place in the European project depends on the euro's success. Convergence is therefore not only an economic but a political issue.

**From the start of the common currency, there has been too little convergence in the Eurozone.** Already in the first decade, inflation rates varied greatly: German inflation, for example, was well below the average, while in Spain it was well above it. So, the ECB's interest rate was too high for Germany and too low for Spain. In addition, economic cycles were not synchronized: Spain's economic development clearly fell out of sync with that of the others.

**The financial and economic crisis heightened key differences.** While Greece, Italy and Spain suffer from high unemployment, the jobless rate in Germany is lower than it has been for a long time. There remain significant differences in living standards: Greece's gross domestic product (GDP) per capita is around 30 percent below the EU average, while in the Netherlands it is approximately 30 percent higher.

**Economic imbalances in the Eurozone are hard to correct,** as a comparison with the USA demonstrates: unlike the US federal government, the EU has only a small budget and cannot reduce imbalances between the states through welfare benefits, for example. Furthermore, the EU's Single Market is less integrated than its American counterpart: worker mobility is low. The EU therefore cannot rely on the currency union alone – it requires an economic union.

**Convergence**
Convergence is when economic conditions, ranging from productivity to living standards, get closer. The economic structures of the countries strongly influence the extent to which living standards may or may not converge.

**Economic cycle**
The average length of an economic cycle from boom to recession is approximately five years. If the phases in the different euro countries fall out of sync, the ECB must react to upswings and downturns at the same time.

*"The notion of convergence is at the heart of our Economic Union: convergence between Member States towards the highest levels of prosperity; and convergence within European societies, to nurture our unique European model."*

Jean-Claude Juncker, President of the European Commission,
in the Five Presidents' Report on 22 June 2015

*"Without reforms […] it is not possible to fight unemployment. Everything must come together: government support and economic reforms. Then Europe has the chance to fulfil its promise of prosperity."*

Angela Merkel, German Chancellor,
in a government statement on 23 November 2016

# How far is the currency union already an economic one?

**From the outset, the Eurozone was created as an economic union as well.** Three elements are especially important for economic convergence:

**First, the common currency is underpinned by regulations.** The Stability and Growth Pact aims to prevent individual countries from borrowing too much money, thus endangering the sustainability of their national debt and – in the long term – the Eurozone's stability as a whole. A member state's deficit may not exceed three percent of GDP and its debt may not surpass the 60 percent mark. Public debt, however, has burst this limit almost everywhere. To prevent any future accumulation of debt on this scale, the requirements have become even stricter and now include a debt brake that has to be anchored in the national constitution.

**Second, the EU budget plays an important role for convergence.** The convergence of living standards has become increasingly important in the distribution of spending. For the period between 2014 and 2020, the EU has a budget of around 638 billion euro. During this period, it will allocate more than a quarter of this to specific measures for education and training, better working conditions and the fight against poverty.

**Third, new convergence instruments were introduced after the crisis,** including the so-called ➔ Macroeconomic Imbalance Procedure. As well as monitoring budget deficits and debt, other indicators are now also watched carefully so that imbalances can be recognized and corrected earlier. Country-specific recommendations are intended to advance national ➔ structural reforms and generate more convergence.

**Despite these efforts, differences between the countries persist.** Owing to continuingly high levels of debt, structural reforms are the only way for many Eurozone countries to revive their economies. But it is proving difficult to enact such reforms.

**Macroeconomic Imbalance Procedure**
14 indicators are now monitored by the European Commission, including public and private debt, long-term unemployment and house price development. If dangerous imbalances accumulate, a country receives recommendations for reform. These must be implemented by the Eurozone countries on pain of sanctions.

**Structural reforms**
Reforms which impact upon the organization of markets and the state may lead to greater growth and convergence. The European Commission regularly devises country-specific recommendations. These aim, inter alia, at raising the employment rate, introducing more competition in individual sectors and improving credit conditions for companies.

*"[W]e need a fully-fledged EU-policy on youth. While we have been able to steadily decrease youth unemployment since it reached its peak in 2013, divergences remain huge in EU Member States."*

Martin Schulz, President of the European Parliament,
in a speech to the European Council on 15 December 2016

*"There are many understandable political reasons to delay structural reform, but there are few good economic ones. The cost of delay is simply too high."*

Mario Draghi, ECB President,
at the Brussels Economic Forum on 9 June 2016

EUROPA briefing

# CONVERGENCE

## A look ahead

### SCENARIO 1
## Doing nothing

If Eurozone countries prioritize their independent room for manoeuvre, differences between them will remain. Economic policy will continue to be anchored rather nationally. Each country can pursue the economic policy that it thinks suits it best. So no active coordination takes place and any convergence is simply a by-product of economic integration.

This scenario is challenging for the ECB, however, as national differences could become even bigger. If a country grows faster than the Eurozone average, the ECB's interest rate will be too low and cannot prevent that country's economy from overheating: more and more capital flows into it, wages and prices increase, and competitiveness worsens. If, by contrast, a country grows significantly more slowly, an excessively high base rate will delay and could even jeopardise its economic recovery.

This scenario therefore brings with it the risk of not only an economic but a political crisis: new economic imbalances might arise while an effective monetary policy will be impossible if the inflation rates of the individual countries continue to diverge.

### SCENARIO 2
## A federal Europe

The federal solution is based on a stronger EU with more risk and sovereignty sharing. The member states coordinate their economic policies through a mixture of incentives, sanctions and financial and fiscal transfers.

This scenario would entail a sufficient level of convergence in the Eurozone. A larger common budget makes up for some of the imbalances. Member states are responsible for their own debts but issues such as high unemployment may be mitigated by transfer payments. The completion of the Single Market, banking union and capital market union is on the agenda. If the EU takes on a higher degree of responsibility for economic policy, it must democratically legitimize this and create the necessary instruments, for example by appointing a European Finance Minister.

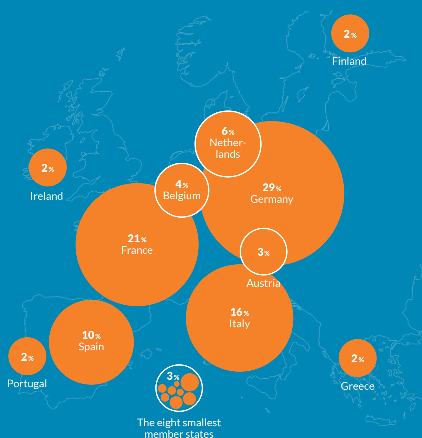
That said, the EU is still a long way from being a federation. A federal Europe means striving towards an "ever closer union", as outlined in the preamble to the European Treaties. However, such a solution seems unlikely for now. Hardly any nations are prepared to accept fundamental reforms and a further transfer of powers to the European authorities.

### SCENARIO 3
## Compromise

Many member states are aware that doing nothing could lead to another crisis. However, the grand European project does not enjoy the backing of a political majority. Many reforms have been proposed, but they remain controversial. For example, further extending the Single Market has been met with concerns that market liberalization will put pressure on wages and ultimately fail to adequately protect individual investment in education. For some, policy instruments to combat recession, such as a European Unemployment Insurance, are vital but are seen by others as leading to a transfer union in which "free-riding" becomes a long-term issue.

One quid pro quo might be a promising compromise: countries that successfully implement reform recommendations gain access to compensation mechanisms to help them overcome crises. However, such a solution poses the threat that each national government will implement a part of its own agenda but the euro will ultimately remain unstable. A successful compromise must therefore offer more than the sum of individual interests.

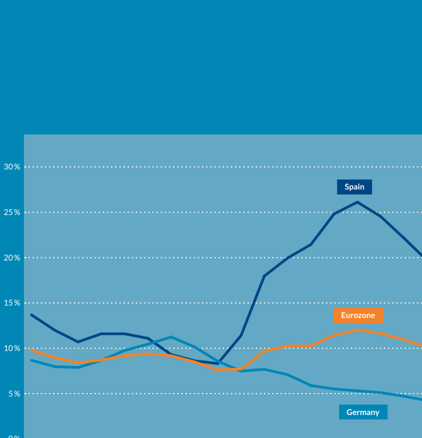
### FACT #1
**Distribution of economic power in the Eurozone**
Share of Eurozone GDP by euro-area member state




340 million people – more than the population of the USA – live in the Eurozone. The four largest economies in the Eurozone generate more than three quarters of its GDP. It is therefore particularly important that these four agree on which economic policy to pursue.

Source: Eurostat, author's calculations.

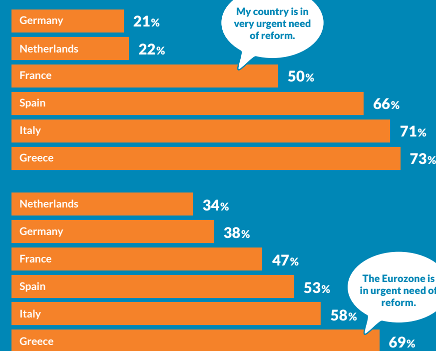
### FACT #2
**From convergence to greater divergence in unemployment**
Unemployment rate as a percentage




The economic and social divergence within the Eurozone is particularly reflected in the large differences in unemployment. Young people in Italy, Greece and Spain are especially affected, with youth unemployment levels reaching between 40 and 50 percent. On the whole, however, unemployment in the euro-area countries has been continually falling since 2013.

Source: Eurostat.

### FACT #3
**What Europeans think about reforms**




Other survey answers include "It would help, but it's not necessary", "It is not in need of reform" and "I don't know".

Source: eupinions, Bertelsmann Stiftung, author's calculations. The data were collected in the spring of 2016. Number of respondents = 10 992.

*"The crisis has shown that a lack of convergence damages all euro-area countries economically and politically. It is therefore not hard to see why contributing to convergence is not only in the European but also in the national interest. No country makes economic policy for itself alone. This is particularly true for the Eurozone."*


Dr. Anna auf dem Brinke
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EUROPA briefing

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