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WHY THE EUROZONE CAN'T AGREE ON CONVERGENCE

AND HOW STRUCTURAL REFORMS CAN HELP

Anna auf dem Brinke | *Research Fellow at the Jacques Delors Institut - Berlin*

Henrik Enderlein | *Director of the Jacques Delors Institut - Berlin*

Jörg Haas | *Research Fellow at the Jacques Delors Institut - Berlin*

EXECUTIVE SUMMARY

It is common sense that the euro area needs more convergence to work as intended. At the same time, we lack a common definition. There are two important types of convergence that can both lead to a better functioning European Economic and Monetary Union: **real convergence** in living standards to foster social cohesion, and **cyclical convergence** to increase the fit of the European Central Bank's monetary policy.

"STRUCTURAL REFORMS CAN FOSTER CYCLICAL CONVERGENCE BUT WE HAVE TO CHOOSE THE RIGHT ONES"

Both types of convergence merit attention, yet real convergence is politically more demanding than cyclical convergence. The euro area, however, still needs urgent reform. We should therefore focus on cyclical convergence. Structural reforms can foster cyclical convergence but we have to choose the right ones.

Which structural reforms are best suited to increase cyclical convergence? This policy paper scans the long lists of structural reform recommendations and identifies those reforms that can best address the lack in business cycle synchronization. The three reform priorities are:

- **Facilitate competition through enhanced market entry and exit**, in particular in the service sector by opening up highly regulated professional services, and by working towards a digital single market
- **Increase labour market flexibility and fight dualism** by reducing the protection for insiders, and helping outsiders find back into the labour market
- **Boost investment in the private and public sector** by reducing regulatory uncertainty, forming public-private partnerships, and investing in education and infrastructure

The national reform context matters. All euro area members should work towards the integration of the single market. Countries with high unemployment rates should focus on labour market reforms. Countries with an investment gap should increase investment as far as fiscal space permits.

Structural reforms should be embedded in the "Draghi-Policy-Mix". Reform efforts should be accompanied by supply-side reforms, demand stimulus and a strengthening of the overarching political framework, as well as make use of the accommodative monetary policy stance of the European Central Bank.

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INTRODUCTION

Convergence in the euro area is like common sense: everybody agrees that we need more of it. Yet, the exact meaning of the word is as much a technical question as a matter of principle. Two kinds of convergence are often confused. For some, it means convergence in living standards, for which redistribution is probably unavoidable. Others aim for cyclical convergence, for which structural reforms and policy coordination are crucial.

These two types of convergence are different in nature. The goal to reach convergence in living standards (or "real" convergence) is inherently political; it requires a strong agreement across the currency union to put into place permanent transfers to align living standards. Today, Europe clearly lacks that political will. From an economic perspective, however, real convergence is of lesser importance for the proper functioning of the Economic and Monetary Union (EMU): currency unions with high discrepancies in living standards can function, as long as there is some alignment in the business cycles. Cyclical convergence, on the other hand, is crucial for the functioning of EMU. The single monetary policy cannot operate properly in a highly divergent "one size fits none" environment. This type of convergence doesn't require permanent one-directional transfers: rather, it needs strong market integration, including flexibility in the markets for goods, labour, and capital, and possibly also a cyclical stabilization component.

This policy paper argues that the political emphasis in the quest for more convergence should focus on cyclical convergence. It makes proposals how this can be achieved through structural reforms at the member state level. The policy paper thus complements our previous study on convergence that insisted on European steering and policy coordination.[1]

We proceed in three steps: First, we explain why the euro area cannot agree on convergence and argue that now is the time to focus on the structural side of the Economic and Monetary Union. Second, we offer explanations for the lack of cyclical convergence so far and show how divergence contributed to the crisis of the euro. Third, we present a priority-list of three areas of structural reform that we consider most urgent. Immediate action is required to reduce barriers to market entry, increase employment, and boost investment. We highlight how these reform recommendations have to be embedded in the right policy-mix and institutional set-up. In the last part, we conclude.

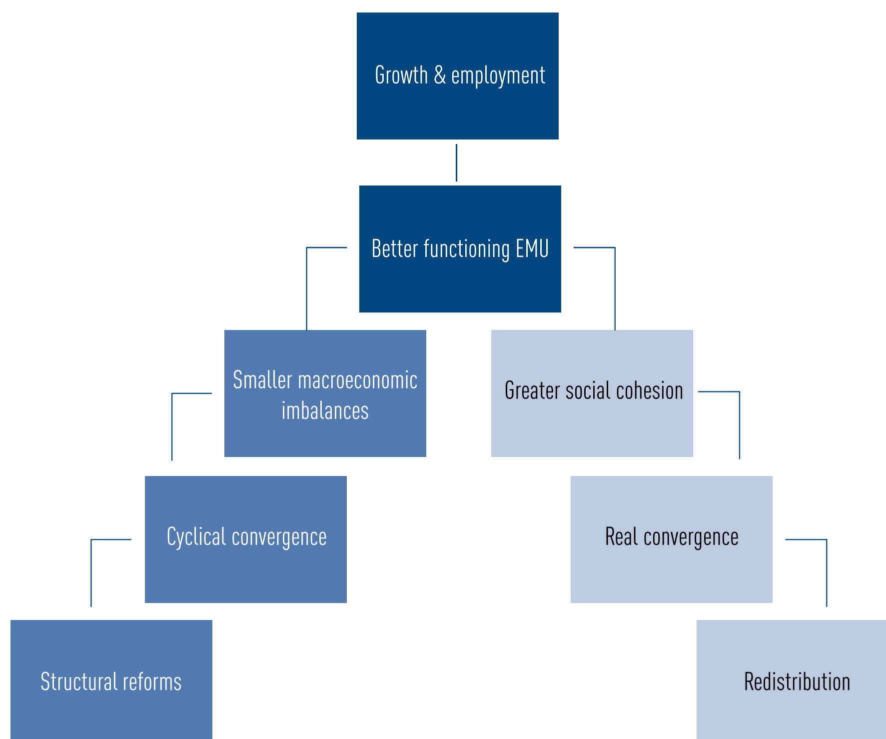
1. A. auf dem Brinke, H. Enderlein and J. Fritz-Vannahme, *What kind of convergence does the euro area need?*, Bertelsmann Stiftung and Jacques Delors Institut - Berlin, 2015.

1. Why Europe can't agree on convergence

During the last fifteen years, the differences between euro area economies have become more pronounced.[2] There is agreement that this trend must be stopped, and that only more convergence will allow the monetary union to work as intended. However, it seems impossible for EU member states to agree on specific measures to promote convergence. How can we explain this paradox?

The answer relates to the two different concepts of convergence depict in figure 1. Real convergence from redistribution is mainly an item on the political agenda in the crisis countries, based on a *solidarity view* of how EMU should function. Many of the non-crisis countries look at the matter from a perspective of cyclical convergence. They adopt a *stability view* of convergence. Since their objectives are identical only in name, they disagree on the required policy-action. This is where a significant part in the disagreement over convergence policies arises.

FIGURE 1 ► The structural and redistributive sides of convergence



Source: Authors' representation.

The figure suggests that both channels can contribute to a better functioning EMU and thus to higher growth and employment. Proponents of the stability view argue that EMU is still threatened by macroeconomic imbalances. Only if countries are economically as similar as possible can the euro truly work. The solidarity view is more concerned with social imbalances. Proponents of that view argue that a better functioning EMU needs greater social cohesion in order to maintain political support for the euro. This in turn requires real convergence, defined as a closing the gap in living standards. The introduction of a common currency had been expected to help in this regard, but has not been able to live up to the high expectations until today. In order to increase social cohesion, the euro area would therefore need to actively redistribute income.

2. E.g. European Central Bank, "Real Convergence in the Euro Area: Evidence, Theory and Policy Implications", *Economic Bulletin* Issue No. 5: 30-45, 2015.

„ IMPROVING THE STRUCTURAL CHANNELS REQUIRES STRUCTURAL REFORMS AT THE NATIONAL LEVEL"

This divide into the structural and redistributive side of convergence in the euro area demonstrates how policy-makers agree on the overall objective, yet disagree on the best strategy to move on. Improving the structural channels requires structural reforms at the national level. Fostering convergence via redistribution implies transfers from one euro area country to another.

Both types of convergence are important and merit attention. But we argue that the left-hand side of the graph (the structural reform channel towards cyclical convergence) is currently the more important one. From an economic perspective, it's a "must-have" in EMU.

Redistributive policies at the euro area or European level might be required for reasons of political stability or indeed straightforward solidarity considerations to alleviate poverty or social inequality in Europe. That solidarity part, however, looks currently neither politically feasible, nor is it as urgently required as higher cyclical convergence. In the spirit of the subsidiarity logic to create "as much additional integration as strictly needed for the stability of the euro as necessary, but as little as possible", we argue that the structural channel towards cyclical convergence is the one on which the euro-area should concentrate today.

2. How cyclical convergence works (or doesn't)

What is cyclical convergence? Cyclical convergence refers to business cycle convergence. Business cycles are fluctuations in aggregate economic activity. They are typically closely tracked by the inflation rate. During booms inflation increases, during recessions it decreases. Business cycle synchronisation occurs when countries move simultaneously through upswings and downswings.

Cyclical convergence is important for the functioning of the common currency because the the European Central Bank (ECB) sets only one interest rate based on the weighted average inflation rate in the euro area. Its mandate is to keep inflation at just below 2 percent. During an upswing it increases the interest rate to avoid overheating the economy. During a downswing the ECB decreases the interest rate to stimulate the economy and increase economic activity again.

With perfectly synchronised business cycles, the ECB can run a monetary policy that is equally suitable and stabilising for all euro area economies.[3] However, in the absence of cyclical convergence, the interest rate will be too low for countries in an upswing and too high for countries in a downturn. It thereby reinforces booms and depressions.

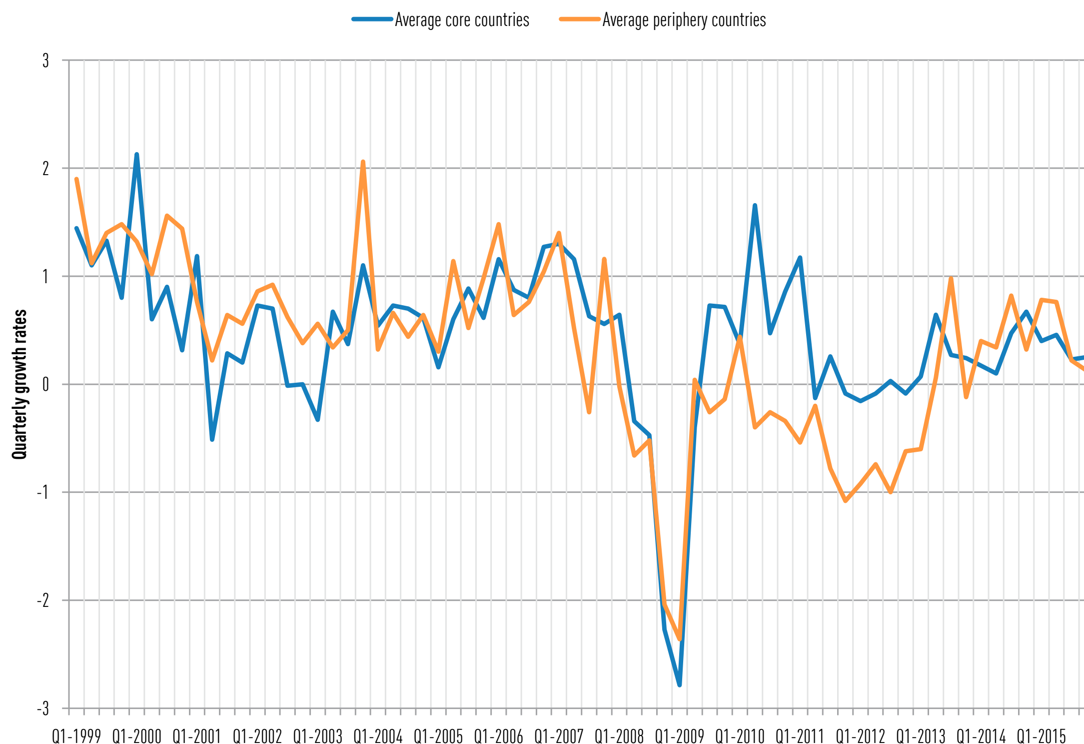
3. H. Enderlein, *One Size Fits None*, Central Banking XVI, no. 1: 24–28, 2005.

2.1. Cyclical divergence in EMU

The most common measures for cyclical convergence are quarterly data on GDP (sometimes decomposed into production, investment and consumption) and credit cycles.[4] One simplified way to look at cyclical divergence in the euro area is to group countries into two groups: the geographic core (Austria, Belgium, Finland, France, Germany, Luxembourg, and the Netherlands) and the geographic periphery (Greece, Ireland, Italy, Portugal, and Spain). Figure 2 shows fluctuations in the average quarterly GDP growth rate for these two groups.

In the early years of EMU, the core experienced on average lower growth rates than the periphery. There was some synchronisation in the mid-2000s, and all countries went into a deep recession in 2009. In the wake of the crisis from 2010-2011, the core countries recovered faster, while the periphery countries experienced a prolonged recession. Since then the two country groups have seen low and more similar growth rates.

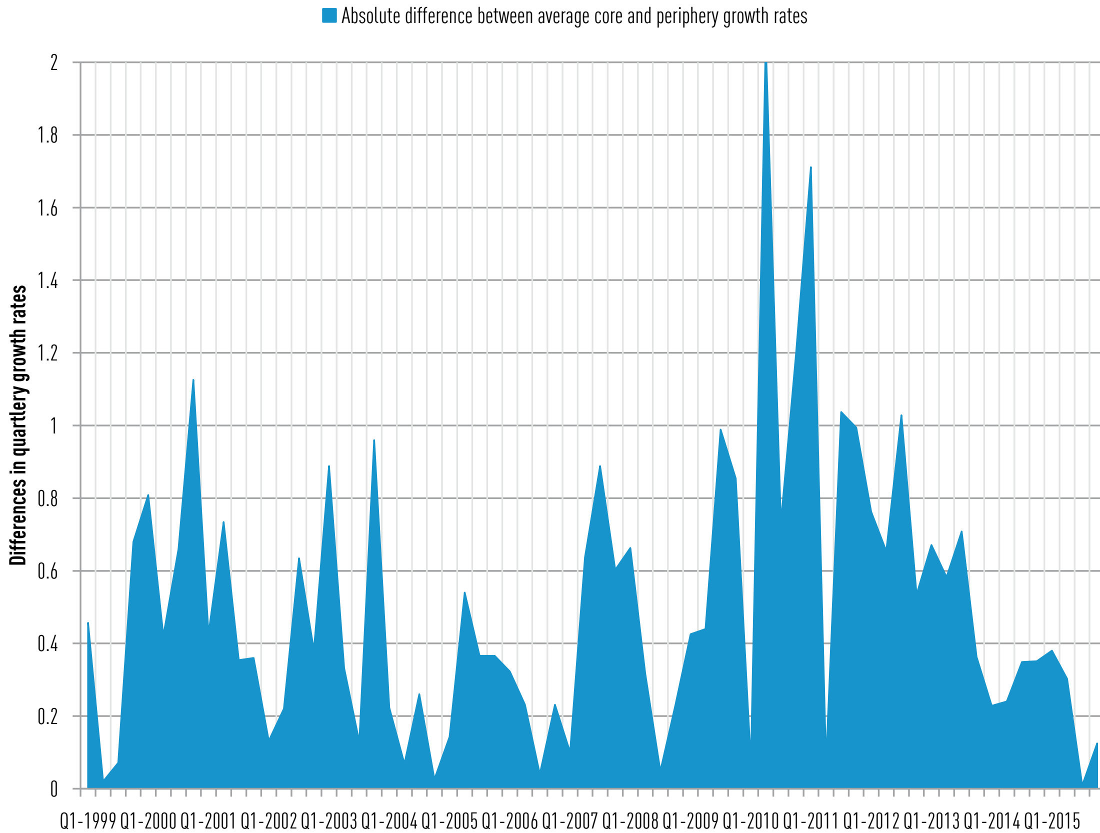
FIGURE 2 ► Quarterly growth rates in core and periphery countries of the euro area



Note: Figure shows unweighted average for selected euro area member states in the geographic core (Austria, Belgium, Finland, France, Germany, Luxembourg, and Netherlands) and periphery (Greece, Ireland, Italy, Portugal, and Spain). Source: OECD stats, authors' calculation.

4. J. de Haan, R. Inklaar and R. Jong-A-Pin, "Will business cycles in the euro area converge? A critical survey of empirical research", *Journal of Economic Survey* 22(2): 243-273, 2007.

FIGURE 3 ► Difference in growth rates between the geographic core and periphery in the euro area



Note: Figure shows the absolute difference between the unweighted average of quarterly growth rates for selected euro area member states in the geographic core (Austria, Belgium, Finland, France, Germany, Luxembourg, and Netherlands) and the periphery (Greece, Ireland, Italy, Portugal, and Spain). Source: OECD stats, authors' calculation.

Figure 3 elaborates these points: It shows the absolute difference between the average quarterly growth rates for the same two country groups. Just looking at the spikes, one can observe that there was some business cycle convergence until 2007, then the differences increased again. There was a two percent difference in quarterly growth rates in 2010. Since then, differences have shrunk. Until 2015, the descriptive statistics show no evidence of business cycle convergence.

> "EMU HAS NOT INCREASED BUSINESS CYCLE CONVERGENCE SIGNIFICANTLY"

The empirical literature on business cycle convergence also suggests that EMU has not increased business cycle convergence significantly:[5] Countries which already had similar levels of GDP per capita in the 1970s have experienced similar business cycle movements throughout the decades. The core group of rather homogenous countries has consisted of Germany, France, Belgium and the Netherlands. The other group is more heterogeneous and there has been no common trend: Some countries have caught-up, others have not.

5. D. Giannone, M. Lenza, and L. Reichlin, "Business cycles in the euro area", *ECB Working Paper Series* No. 1010, 2009.

The results are similar for the aftermath of the crisis.[6] There is a strong interdependence among some euro area countries which is picked up by common factors that can explain up to half of the variation in national GDP: Germany and France, for instance, had a strong co-movement of business cycles, while Spain has remained on a different trajectory after the crisis.

This absence of business cycle convergence has two important implications: First, it shows that EMU governance, including the Maastricht criteria and the Stability and Growth Pact, has not been successful in bringing about business cycle convergence. Second, ECB monetary policy is likely to cause even larger divergence by exacerbating booms and recessions. In terms of business cycles, EMU has not gotten closer to the optimal currency area requirements.

2.2. Why divergence is costly and who paid the bill

Why did business cycles not move more in tandem? The main reason is that the economic union is still far from being complete. Before the euro was introduced, its proponents hoped that synchronisation would occur quasi-automatically via the increased trade flows that a common currency would trigger.[7] A country that grows strongly normally also experiences higher inflation. In a fully integrated economic area, the higher costs will render goods and services less competitive. Falling demand will then bring growth and inflation back to the euro area average. This is called the real exchange rate channel of adjustment.

However, the euro area turned out to be an only partially integrated economic area. While capital moves freely, numerous obstacles to the trade in goods and services persist.[8] As a result, some sectors barely competed with foreign goods. The euro area split into a high-growth, high-inflation area with countries such as Spain and Ireland and a low-growth, low-inflation area around Germany. The competitiveness of the former group deteriorated due to increasing prices and wages, but the economies did not adjust and slow down. Domestic demand made up for stagnating exports.

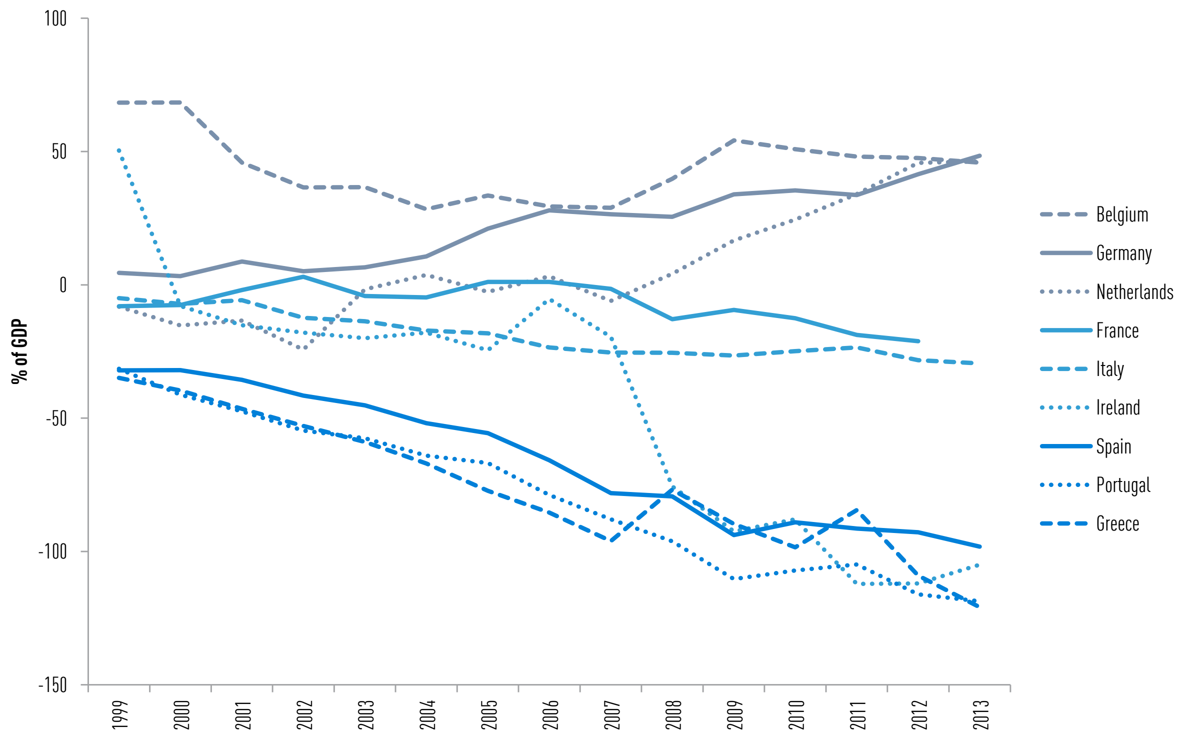
A decisive and coordinated countercyclical fiscal policy might have been able to bring business cycles back into sync. Indeed, the architects of the euro had been aware of the need for economic policy coordination.[9] But their tools turned out to be blunt: The European Treaties provided for *Broad Economic Policy Guidelines* and oblige countries to regard their economic policies as a "matter of common concern" (Art. 121 TFEU), but failed to generate policy coordination. When in 2001, the Commission reproached Ireland for cutting taxes in the face of an overheating economy, the Irish government reacted "quite relaxed."[10]

The other key instrument, the *Stability and Growth Pact,* was supposed to limit public deficits. However, it did not meaningfully coordinate fiscal policy as it had an asymmetric focus on the deficit side, but could not exert pressure on countries in an upswing. Furthermore, France and Germany demonstrated in 2003 that the Commission was unable to even enforce the deficit-side of the rules against determined resistance from core member states.[11]

The combination of insufficient market integration and weak economic policy coordination undermined the synchronisation of business cycles. The ECB's unitary interest rate amplified the effects. Ultimately, lacking convergence resulted in unsustainable macroeconomic imbalances. The competitiveness loss of the GIIPS economies (Greece, Ireland, Italy, Portugal and Spain) vis-à-vis low-inflation economies in the euro area was reflected in current account deficits and growing private debt (see figure 4).

6. F. Ferroni and B. Klaus, "Euro area business cycles in turbulent times: convergence or decoupling?", *ECB Working Paper Series* No 1819, June 2015.
7. J. A. Frankel and A. K. Rose, "The endogeneity of the optimum currency area criteria", *NBER Working Paper* 5700, 1996.
8. E.g. European Economic and Social Committee, Obstacles to the European single market, 2012.
9. Committee for the Study of Economic and Monetary Union, *Report on economic and monetary union in the European Community (Delors report)*, 1989.
10. BBC News, "EC attacks Irish budget", 2001.
11. H. James, "The history of European economic and monetay union", in: *Routledge Handbook of the Economics of European Integration*, edited by H. Badinger and V. Nitsch, pp. 22-37, 2015.

FIGURE 4 ► **Net investment position of selected euro area countries from 1999- 2009**



Source: Eurostat, authors' calculations.

In Greece, this was exacerbated by excessive public spending. Cheap credit provided by overly optimistic lenders made it possible to maintain this situation for a time, but high public and private indebtedness left the GIIPS very vulnerable to disruptions of the inflow of capital. This proved nearly fatal for the euro area when the financial crisis of 2008 struck and severely constrained external financing.

The costs of the resulting chain reaction are well-known. Although it would be too simplistic to claim that the euro crisis was caused only by lacking cyclical convergence and the resulting debt imbalances, there can be no doubt that they played a central role.[12] Even today, the heterogeneous growth rates of euro area economies are hindering crisis management. The ECB has little political support for running a decisive countercyclical monetary policy as long as some parts of the euro area are in crisis while others are growing.

12. R. Baldwin and F. Giavazzi (eds), *The Eurozone Crisis. A Consensus View of the Causes and a Few Possible Solutions*, CEPR Press, 2015. H. Enderlein, J. Fritz-Vannahme, and J. Haas, *Repair and Prepare: Strengthening Europe's Economies after the Crisis*, Bertelsmann Stiftung and Jacques Delors Institut – Berlin, 2015.

2.3. What the crisis has taught us about convergence

Once divergence has occurred it is difficult and costly to correct. For instance, if competitiveness deteriorates in one country over a decade as it did in Ireland, Greece, Spain or Italy, countries can only devalue internally. Wages have to be cut significantly over years, which weakens demand and increases inequality. The high unemployment and poverty figures in Spain and other countries show how costly the clearly needed successful reforms can be, even in the short-term.

"IMBALANCES HAVE PUSHED CRISIS COUNTRIES IN A CATCH-22 SITUATION"

Imbalances have pushed crisis countries in a catch-22 situation, in which they have to choose between reforms that are economically required but politically difficult to implement, and continuing on an economically unsustainable trajectory. The lesson is that the adjustment of imbalances must occur at a much earlier stage before those differences become too large.

The reduction of cyclical imbalances in the euro area has two effects. First, it reduces the likelihood of another crisis triggered by divergence. Secondly, it also has the positive effect that, by increasing the fit of the ECB's interest rate for a larger number of euro area members, this interest rate would much less amplify the imbalances.

Since the coordination of fiscal policy in the euro area has so far been largely unsuccessful, efforts to promote convergence need to focus on the economic foundations of EMU, namely on the real exchange rate channel. Structural reforms can help in this regard. The ECB describes the following channels:[13] Labour market and product market reforms have effects on wages and prices. Labour market reforms that reduce the reservation wage, generally lead to wage moderation. This in turns increases competitiveness, which fuels the demand for labour and leads to employment increases. Product market reforms such as lowering the barriers to entry and increasing competition reduce the profit mark-up for firms. Prices fall. Real wages increase and stimulate demand. In the new equilibrium there is higher demand, higher output and higher employment. To the extent that wages and prices react to the market, the real exchange rate channel in the euro area is strengthened.

Structural reforms have played a key role in euro area politics for two reasons: First, they reduce divergence after asymmetric shocks and thereby make the Eurozone more resilient. Second, they can be part of a pro-growth strategy by increasing potential output. Structural reforms address rigidities in the product and labour market which hamper the price adjustment mechanism in the euro area. Relative price adjustment in turn reduces imbalances and foster cyclical convergence. This double dividend has been stressed repeatedly by the OECD, the International Monetary Fund, the European Commission, and the ECB.

3. Finding the best structural reforms for cyclical convergence

The list of possible structural reforms to enhance convergence is long. But there are two main insights from the literature. First, it is important to note that many structural reforms have short- to medium-term transitional costs. For instance, lowering barriers to market entry will drive some incumbent firms out of the market. Employees from these firms will have to find new jobs. It can take several years before the positive effect of structural reforms is fully translated into economic growth. Therefore, it is often suggested to approach labour and product market reforms in a coordinated manner, and accompanied by a supportive fiscal context. The empirical evidence suggests that joint implementation yields the largest effect in terms of GDP growth in the euro area.[14]

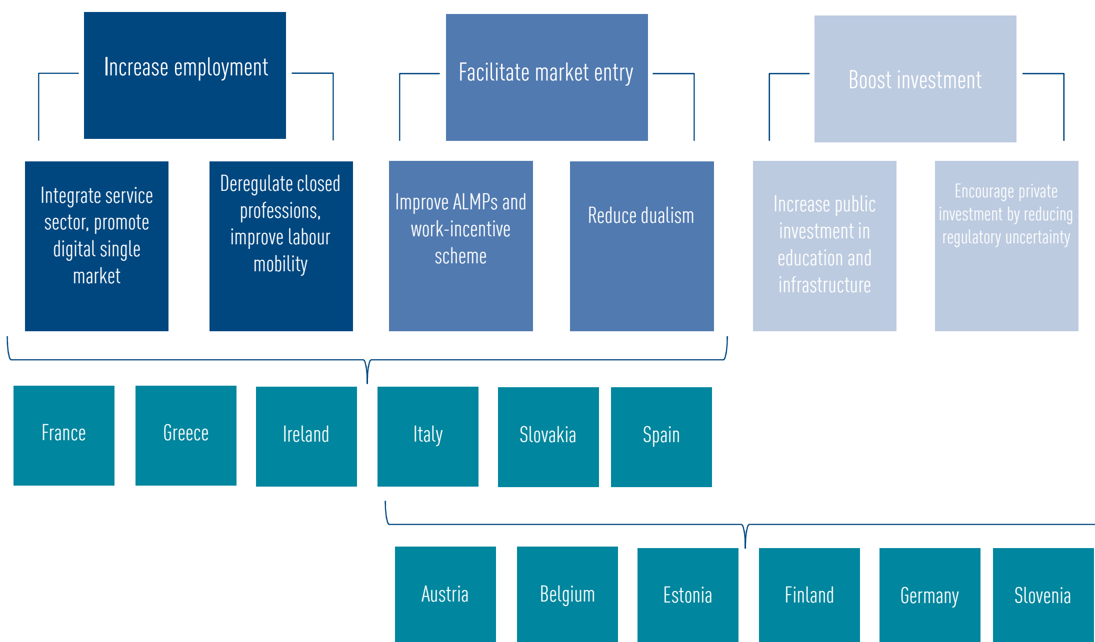
13. ECB, *Economic Bulletin*, Issue 2, 2015.
14. D. Andersen, B. Barkbu, L. Lusinyan, and D. Muir, "Assessing the Gains from Structural Reforms for Jobs and Growth"; in: *Jobs and Growth: Supporting the European Recovery*, IMF 2014.

Second, and related to the same logic, sequencing of reforms is important: Product market reforms should generally precede labour market reforms.[15] The theoretical explanation of this logic is well-known: If structural reforms in the labour market prompt the natural rate of unemployment to fall, then the short-run unemployment rate can be higher than the natural one, leading to wage adjustment in the labour market: in other words, wages will fall. If the product market is deregulated prior to the labour market, falling prices lead to lower mark-ups and wage cuts. As new firms enter the market, workers can move from less efficient firms to more competitive firms. The fall in wages is countered by a fall in prices. In the new equilibrium, real wages do not have to be lower. In fact, they can increase because of a more efficient and productive allocation of resources.

3.1. Three reform priorities for cyclical convergence

Looking at the long lists of recommendations from ECB[16] and OECD[17], we can identify three core areas that are especially promising for the euro area that are summed up in figure 5. It also shows for which countries the reforms are most relevant.

FIGURE 5 ► **Structural reform priorities for cyclical convergence in the euro area**



Source: authors' compilation

1. Facilitating competition through enhanced market entry and exit

Many European economies suffer from a lack of competition within and across national markets. Two areas stand out in particular: First the services sector which is still suffering from high barriers to entry within countries, but also across countries. The service sector accounts for over 70 percent of GDP in the EU, yet only around 20 percent of it is traded across borders.[18] While certain services are non-tradable, the 20 percent

15. O. Blanchard and F. Giavazzi, "Macroeconomic Effects of Regulation and Deregulation in Goods and Labour Markets", *Quarterly Journal of Economics* 118(3): 879-907, August 2003.
16. ECB, "Progress with structural reforms across the euro area and their possible impact", *Economic Bulleting* Issue 2, 2015.
17. See among the country-specific "Better Policies" Series also: OECD, "Economic Challenges and Policy Recommendations for the Euro area", *Better Policies Series*, February 2014.
18. Enderlein, Henrik, Peter Bofinger, Laurence Boone, Paul De Grauwe, Jean-Claude Piris, Jean Pisani-Ferry, Maria João Rodrigues, André Sapir, and António Vitorino. "Completing the Euro. A Road Map towards Fiscal Union in Europe (Report of the 'Tommaso Padoa-Schioppa Group')". Jacques Delors Institute *Studies & Reports*, No. 92, 2012.

number is far too low and leads to spatially isolated economies that have a tendency to cyclically diverge rather than converge.

An effort therefore needs to be put on opening up highly regulated professional services. Here, barriers to entry hinder competition in the EU, while sheltered professions can reap the benefits of almost monopolistic structures. Some reform work has already been done[19], but a lot still needs to be achieved. The Monti Report[20] of 2010 spells out the obstacles that have to be tackled and there has been too little decisive action since then. Enderlein and Pisani-Ferry have suggested specific reform options for France and Germany in 2014.[21]

> "A DIGITAL SINGLE MARKET WOULD GO A LONG WAY IN SYNCHRONISING BUSINESS CYCLES"

The second area that could play a key role in fostering cyclical convergence is the digital sector.[22] Currently, a fragmented regulatory landscape makes it costly for European firms to expand into other EU countries, a problem that is especially relevant for new market entrants. This state of affairs is deplorable for two reasons. First, it hinders the spread of innovation and consequently stymies growth. Second, it inhibits the exchange of goods and services. A digital single market would go a long way in synchronising business cycles. The spread of business models such as e-commerce and online platforms for services would open up sectors of the economy that were previously sheltered from competition.[23]

Addressing these topics will be politically difficult, but it pays a double dividend:[24] it increases both growth and stability in the euro area, in particular by strengthening the adjustment capacity via the real exchange rate channel. Because reforms have to be sequenced to minimise transition costs, these product market reforms should be implemented first.

2. Increasing labour market flexibility

The increase of employment is one of the most pressing concerns in Europe. In most crisis countries high youth and long-term unemployment have already led to the emergence of a lost generation. While labour-market flexibility is an often used and abused buzz-word, it should not be put aside. There is a need in most euro-area countries to significantly improve the adjustment capacity of labour markets to the business cycle.

> "MANY EUROPEAN LABOUR MARKETS SUFFER FROM DUALISM IN LABOUR MARKETS THAT IS NOT ONLY ECONOMICALLY INEFFICIENT BUT ALSO SOCIALLY UNFAIR"

The theoretical argument is straightforward: Many European labour markets suffer from dualism in labour markets that is not only economically inefficient but also socially unfair. Research shows that insiders at the core of the labour market enjoy high levels of security and stability, while those at the fringes have to cope with high turnover rates and instability.[25] During the crisis, insiders have been relatively sheltered. Outsiders have been disproportionally hit and job creation has been coupled with a proliferation of short-term contracts.[26] Protection for insiders has to be reduced at the same time as outsiders receive more help to find back into the labour market.

Clearly, detailed proposals on changes to labour and employment policies need to take into account the specific national context, but the goal to create more labour market flexibility should be a pan-European one. Increasing flexibility in the labour market helps not only to prevent the insider-outsider problem (and thus alleviates social inequality), but also contributes to a much better passing-through of price-signals across

19. A. Thum-Thysen and E. Canton, "Estimation of service sector mark-ups determined by structural reform indicators", *European Commission Economic Papers* 745, April 2015.
20. M. Monti, *A New Strategy for the Single Market, Report to the President of the European Commission*, Milan, May 2010.
21. H. Enderlein and J. Pisani-Ferry, *Reforms, Investment and Growth: An Agenda for France, Germany and Europe*, Report to Sigmar Gabriel and Emmanuel Macron, German and French ministers for the economy, November 2014.
22. P.-J. Dittrich, "A deepened Single Market for labour and digital innovation. Proposals for a higher factor mobility in the EU", *Policy Paper No. 164*, Jacques Delors Institut – Berlin, May 2016.
23. M. Scott, "Could the Internet Do What the Euro Couldn't?", *New York Times*, 26 February 2016.
24. See also: A. auf dem Brinke, K. Gnath, and J. Haas, "Growth and the euro area stability: The double dividend of a deepened European single market for services", *Background Note*, Jacques Delors Institut – Berlin and Bertelsmann Stiftung, 26 June 2015.
25. E.g. B. Palier and K. Thelen, "Institutionalising dualism: Complementarities and change in France and Germany", *Politics & Society* 38 (1): 119-148, March 2010.
26. OECD, "The 2012 labour market reform in Spain: A preliminary assessment", *Better Policies for Better Lives*, 2013.

countries and thus has the potential to lead to increases in the internal adjustment capacity within the euro area. This would reduce divergence and make future imbalances within the euro area less likely.

3. Boosting investment

Europe suffers from a gap in public and private investment. There are three ways to respond to this challenge:

> "A LACK OF PRIVATE INVESTMENT IS GENERALLY ALWAYS A SIGNAL OF UNCERTAINTY OR A LACK OF TRUST IN REGULATION"

The first aspect is regulatory. A lack of private investment is generally always a signal of uncertainty or a lack of trust in regulation. As long as there is uncertainty about regulation in core investment markets such as energy or digital, investment rates are likely to remain low. Many private companies have to deal with regulatory uncertainty due to very different legal frameworks and tax systems. This hampers in particular investment in new energy networks and digital technology. Reforms leading to more predictable patterns in such diverse but narrow fields such as recognition of medication, energy subsidies, data protection regimes, rules on fees for network utilization in telecommunications etc. can have a major impact on investment.[27]

The second aspect relates to the mobilization of private investments in combination with public investments. Public-private partnerships can be successful as long as they are legally well embedded and allow combining specific knowledge from the private sector with public interest orientation of the public sector. Also, the public component can take over a certain share of the risk in project financing (subsidized interest rates do not help in the current interest rate environment). Higher costs from public private partnerships should not be seen as problematic per-se: as long as both the quantity and quality of investment and project implementation is improved, the mark-up on the costs can be socially justified.

The third aspect relates to public investment only. This is mainly relevant for countries that do have some fiscal space. Renewing the capital stock and increasing human capital is important to sustain the on-going recovery and to keep especially those countries that have weathered the crisis relatively well on a positive growth trajectory.

In short, all euro area countries can still improve their output gap and contribute to cyclical convergence in the euro area, thereby increasing the fit of the ECB's monetary policy and reducing harmful imbalances within the euro area. Structural reforms are the key to improving cyclical convergence in the euro area. However, they can only fulfil their true potential in an adequate context. In order to minimise social and economic disruption, they require careful sequencing and support from other policy areas.

3.2. What reforms were implemented and did they work?

The reform record in the euro area is mixed. Generally, reform activity in the euro area improved rapidly from 2009 onwards as persisting high debt levels and financial market pressure added to the sense of urgency although the rigidities were also well known before the crisis. Higher potential output can be expected in the next five to ten years from recent reform efforts. At the same time, since 2013 the reform efforts have slowed-down markedly in the euro area (and indeed in most OECD countries).[28]

Structural reforms are notoriously difficult to implement because of a strong status quo bias:[29] The winners of reforms tend to be dispersed among the labour market outsiders while the losers tend to be labour market

27. H. Enderlein and J. Pisani-Ferry, *Reforms, Investment and Growth: An Agenda for France, Germany and Europe*, Report to Sigmar Gabriel and Emmanuel Macron, German and French ministers for the economy, November 2014.
28. OECD, *Structural Reforms in Europe, Achievements and Homework*, "Better Policies" Series, April 2015.
29. R. Fernandez and D. Rodrik, "Resistance to Reform: Status Quo Bias in the Presence of Individual-Specific Uncertainty", *The American Economic Review* 81(5): 1146-1155, 1991.

insiders and are concentrated.[30] In addition, structural reforms can create costs and many of them require a primary deficit.[31] Previous research on this is also confirmed by the recent Spanish labour market reform experience.[32] Still, many countries and in particular Greece, Ireland, Spain and Portugal, have implemented a number of far-reaching structural reforms. A survey of all reforms in the euro area by the OECD[33] found that these reform efforts were overall concentrated on taxes, product and labour market policies, education, pensions, and public spending.

3.3. How to embed structural reforms

Some argue that an economic crisis helps the implementation of structural reforms. In this view, fighting a recession with accommodative monetary policy is likely counterproductive as it diminishes the perceived urgency of problems. This is called the 'super Walters' effect:[34] low real interest rate during a boom can discourage policy-makers from implementing reforms.[35] But while the argument may hold true for the reform willingness of policy-makers, it does not take into account that broad public support for reform is also needed.

Although most structural reforms have to be implemented at the national level, the European Union should play a much more active role in promoting and coordinating them. A tool to this end is the European Semester, which was introduced in 2010. During the European Semester, the European Commission analyses the fiscal and structural reform policies of the Member States and gives policy recommendations. In addition to the European Semester, a number of new budgetary measures including the Six Pack and the Two Pack, as well as the Fiscal Compact were added to ensure better coordination and monitoring of fiscal policies.

The European Commission monitors a range of macroeconomic indicators in thescoreboard of the Macroeconomic Imbalance Procedure (MIP).[36] It includes measures for the public sector balance, external balance, competitiveness, and internal balance as well as labour market indicators. The MIP should help to detect imbalances as well as provide data for country-specific recommendations by the European Commission also with regards to structural reforms.

However, there clearly is not enough leverage at the European level to trigger and steer national structural reforms. This is acknowledged in both the Four Presidents' Report of 2012[37] and the Five Presidents' Report of 2015.[38] The Four Presidents' Report argues that structural reforms are necessary for convergence of the euro area member states, which in turn supports shock absorption mechanisms such as the European Stability Mechanism (ESM).

Therefore, structural reform recommendations are part of the country-specific recommendations and are binding for euro area members (and voluntary for the other EU members). The Five Presidents' Report proposed new national institutions, the Competitiveness Authorities, which are supposed to assess whether wages are rising in line with productivity growth, compare possible wage deviations with trading partners, and monitor and evaluate structural reforms.

Supply-side reforms can help the EMU work more smoothly and raise growth rates in the medium term. But their short-term political and economic costs can be considerable if they are implemented in a low-demand environment. Moreover, they will not lower unemployment in the short run, which may add to the problem of hysteresis.[39]

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36. Eurostat collects the newest live data here.
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39. OECD, *Going for Growth*, 2016.

"STRUCTURAL REFORMS NEED TO FORM PART OF A JOINT EFFORT INCLUDING SUPPLY-SIDE REFORMS, DEMAND-SIDE POLICIES AND A STRENGTHENING OF THE OVERARCHING POLITICAL FRAMEWORK"

Therefore, structural reforms need to form part of a joint effort including supply-side reforms, demand-side policies and a strengthening of the overarching political framework. This has been coined the "Draghi Policy Mix", alluding to the view by ECB President Mario Draghi that Europe needs to make use of the favourable context of accommodating monetary policy to engage in structural reforms while pushing forward the European integration agenda.[40]

In this view, monetary policy is already playing its part. The ECB has adopted a very accommodative stance in light of low growth and inflation. But the fiscal stance of the euro area is still neutral, and was contractionary until recently. Even though this is understandable and in some cases necessary given high public debt levels, it is damaging for economic recovery. Countries that currently could spend more, such as Germany, are already growing, while stagnating countries have no fiscal space left. A lack of trust between European governments has so far thwarted attempts to coordinate a common fiscal stance.

The challenge is to ensure that any additional spending will not be used merely for current consumption but for investment that raises future output and lowers the overall debt burden. Building on the experiences with the Juncker Plan, a European investment budget might become an effective tool.[41] The German idea of reform contracts, under which progress on structural reforms would be rewarded with financial assistance, also deserves a second chance. Another option would be EU-level structural councils that monitor progress.[42]

These measures need to be complemented by a stable political framework. Long-term growth and investment depend on investors' expectations about the future. As long as EMU is unfinished, the future of the euro area periphery countries remains unclear, which will weigh on their economic prospects. The euro area will need to improve its capacity to prevent and manage economic crises. It needs to arrive at a compromise that ensures effective risk-sharing in exchange for sovereignty-sharing.

This could include, for example, a European Monetary Fund (EMF). The EMF would allow countries to issue a limited amount of debt guaranteed by all euro area members, but they would gradually have to cede budgetary sovereignty in return. Just as important as increased resilience would be a stronger democratic legitimacy of euro area economic policy. For this reason, an EMF should be headed by a European finance minister under direct democratic control from national parliaments, the European Parliament, or a mix of both.[43]

As part of the Draghi Policy Mix, structural reforms could make a decisive contribution to EMU stability by improving business cycle convergence and raising growth rates. However, we should not lose sight of their limitations. For example, no matter how flexible and integrated the euro area economies become, they will never become identical, and neither should they. Specialisation and cultural features are natural and desirable and often go hand in hand with comparative advantages.

But they also imply that each economy will experience idiosyncratic shocks. Consequently, business cycles are unlikely to ever converge completely. In order to prevent new imbalances from arising, EMU will likely need an institutionalised stabilisation mechanism. This could take the form of a shock insurance based on macroeconomic indicators such as the output gap, or it could be a European unemployment insurance. It is possible to construct these stabilisers in a way that minimises redistribution.[44] Well-functioning capital markets and widespread cross-ownership could also contribute to ensuring that macroeconomic shocks are distributed evenly over the euro area, as they do in the US.

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CONCLUSION

By now it is common sense that the euro area needs more convergence. Growing imbalances in the euro area have been very costly and continue to undermine the stability of the euro. Yet, the euro area has failed to agree on new convergence goals. This paper explains the apparent paradox: Most Northern European countries want cyclical convergence first, while those in Southern Europe are more concerned about real convergence.

This paper has taken a pragmatic approach. If there is no political will to engage in further redistribution, let us fix the structural divergence to improve the functioning of the euro area. To this end, countries in the euro area have to implement structural reforms. This paper has presented a short and clear list of structural reform priorities that can foster (if not only but also) cyclical convergence. They fall into three categories: facilitating market entry, increasing employment, and boosting investment.

While structural reforms have the potential to help create a more stable and prosperous euro area, they need to be embedded in a policy-mix that stresses the importance of supply-side policies but supports it with fiscal and monetary policy to bolster the demand side, and with reforms to EMU's political-institutional framework, that render the governance of the common currency more effective and accountable.

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Hertie School
of Governance

Pariser Platz 6, D – 10117 Berlin
19 rue de Milan, F – 75009 Paris
office@delorsinstitut.de
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