

IN-DEPTH ANALYSIS

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Convergence in EMU: What and How?

Euro Area Scrutiny



External authors:

Mathias Dolls, Clemens Fuest,
Carla Krolage, Florian Neumeier,
Daniel Stöhlker



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Convergence in the EMU: What and How?

Abstract

Convergence is one of the key goals of the European Union and has been at the centre of many recent debates. This paper strives to identify the types of convergence that are pivotal to the well-functioning of the euro area and discusses their role in the context of the EMU's governance framework. Evidence suggests that key economic indicators have converged for some member states before coming to a halt (or even diverge) with the onset of the global financial and euro area debt crises. As economic convergence depends mostly on the policies of the member states, we call for a strengthening of national responsibility for structural reforms. We discuss strengths and shortcomings of the recently proposed reform delivery tool and present our proposal of 'national convergence roadmaps'. We propose that member states can apply for resources from the European Structural and Investment Funds by committing to convergence targets and submitting reform plans in the context of the European Semester. If positively assessed by the European Commission and approved by the Council, the reform efforts could be financially rewarded – conditional on the potential for positive spill-overs, continuous implementation of the reforms and achievement of the convergence targets.

This document was requested by the European Parliament's Committee on Economic and Monetary Affairs.

AUTHORS

Mathias DOLLS
Clemens FUEST
Carla KROLAGE
Florian NEUMEIER
Daniel STÖHLKER

RESPONSIBLE ADMINISTRATOR

Martin Hradiský

LINGUISTIC VERSIONS

Original: EN

ABOUT THE EDITOR

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To contact Economic Governance Support Unit or to subscribe to its newsletter please write to:

Economic Governance Support Unit
European Parliament
B-1047 Brussels
E-mail: egov@ep.europa.eu

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EXECUTIVE SUMMARY

As required by its founding treaties, the European Union aims “at reducing disparities between the levels of development of the various regions and the backwardness of the least favoured regions”. Increasing convergence has been a target of many recent policy proposals at the European level. Against this background, this paper strives to identify the types of convergence that are pivotal to a well-functioning of the euro area and discusses them in the context of the EMU’s governance framework and of current policy proposals.

Focusing on real, nominal and cyclical convergence, the paper presents important indicators and discusses their development across time and countries. Evidence suggests that income, employment and other key economic indicators have converged for some groups of member states before coming to a halt (or even diverging) with the onset of the global financial and euro area debt crises.

The paper subsequently discusses which types of convergence are of particular importance for the well-functioning of the EMU. For once, a successful design and transmission of monetary policy is greatly facilitated if members of a currency union are at similar stages of their business cycles. Likewise, a certain degree of nominal convergence is crucial for a well-functioning of a monetary union, but full convergence would not be economically justified. Real convergence as such is not required for a functioning monetary union, but constitutes an important objective of the EMU by itself and may foster cohesion and political acceptance of the EMU.

In the existing institutional setup, economic convergence depends mostly on the policies of the member states. The European Semester policy coordination process aims to prevent unsustainable policies and raise awareness of the cross-border European implications of national policies. Implementation of the resulting country-specific recommendations, however, is politically challenging at the national level, where public debate and democratic control currently take place. Giving the European Union additional competences in areas where national economic policies generate considerable spill-overs can be helpful, but may blur responsibilities and allow national politicians to blame ‘Europe’ for unsatisfying results, even if these results are primarily caused by shortcomings of national policies and the failure to implement necessary reforms. The European Union can easily undermine trust in its own effectiveness if its cohesion and coordination initiatives are not equipped with efficient instruments needed to deliver results, and its policy recommendations often lack political ownership and legitimacy at the national level.

In this context, we assess the recently-proposed reform delivery tool, which aims to incentivise governments to conduct growth-enhancing structural reforms by means of fiscal transfers. Acknowledging the importance of national ownership, giving member states the opportunity to submit reform proposals, and requiring detailed implementation milestones all go in the right direction. However, the disbursement of funds should not only depend on the implementation of the agreed reforms, but also on achieving output convergence targets. Moreover, available resources should be used more effectively in promoting economic convergence.

We subsequently present our proposal of ‘national convergence roadmaps’ which serves as a blueprint for the reform delivery tool. Our proposal aims to strengthen the role of national responsibility for the convergence progress by giving member states the possibility to propose a convergence roadmap in the context of the European Semester, specifying structural reform plans and convergence targets. Convergence targets should be restricted to a small set of output convergence goals that allow for better policy-targeting and give more emphasis to policy-prioritisation. National convergence roadmaps would be assessed by the European Commission, while the Council would need to approve financial support of structural reforms which would depend on the potential for positive spillovers, continuous implementation of the reform package and achievement of the agreed convergence goals. Existing resources from the European Structural and Investment Funds should be used for this purpose. Restricting program eligibility to member states with below average per-capita GDP would ensure that resources are channelled towards those countries with the greatest need to catch up.

1. INTRODUCTION

The current debate on the economic and political development of the Economic and Monetary Union and the European Union as a whole devotes considerable attention to economic convergence of the member states. Economic convergence is usually defined as a process where a set of countries or regions becomes more similar in terms of income, wealth or employment levels, or where business cycles become more synchronized. Convergence may also refer to policies and institutions. While economic convergence is perceived to have progressed until 2008, the financial crisis and the ensuing sovereign debt crisis have put a halt on this trend (European Commission, 2017c). As described in the Commission's reflection paper on "Deepening the economic and monetary union", convergence processes between 1999 and 2007 were partly driven by auspicious credit conditions and capital flows towards member states with increasing current account deficits. In the shade of these favourable developments, a decline in competitiveness, growing inefficiencies in labour and product markets and sources of instability in the financial sector were not adequately captured by financial markets and public authorities. After the onset of the financial crisis, convergence trends reversed, hitting the least shock resistant countries the hardest (EEAG, 2018).

In the following years, economic convergence processes and possible policy instruments have attracted a lot of attention. In June 2015, the so-called Five President's Report (Juncker et al., 2015) outlined a plan for deepening the EMU. Highlighting the importance of economic cohesion and convergence, it suggested defining a set of commonly agreed convergence benchmarks. Compliance with these benchmarks would be a prerequisite for participating in a European shock absorption mechanism in the future.

Recently, many publications have further outlined concepts for measuring and achieving economic convergence. Amongst others, the European Parliament's resolution on a budgetary capacity for the euro area proposed the concept of a 'convergence code' (European Parliament, 2017b). This convergence code should encompass criteria related to taxation, the labour market, investment, productivity, social cohesion and good governance over a five-year period. A participation in a European fiscal capacity would require compliance with these criteria.

Likewise, the recent communication "Further Steps Towards Completing Europe's Economic and Monetary Union: A Roadmap" (European Commission, 2017a) specifies the steps the European Commission deems necessary for achieving this goal. It encompasses both a stronger financial union and an enhanced economic and fiscal union in addition to several measures intended to strengthen democratic accountability and effective governance in the EU. Examples of the latter include intensified discussions about the introduction of a European Monetary Fund and a European Minister of Economy and Finance.

Against this background, this paper strives to identify the types of convergence that are pivotal to a well-functioning of the euro area and discusses them in the context of the EMU's governance framework and of current policy proposals. Particular attention will be paid to the reform delivery tool, a recently proposed new budgetary instrument for incentivising structural reforms. We subsequently present our proposal of 'national convergence roadmaps' which serves as a blueprint for the reform delivery tool.

2. THE EMU'S RELEVANT ECONOMIC GOVERNANCE FRAMEWORK

In the aftermath of the financial crisis, numerous policy instruments have been introduced to monitor economic developments, increase macroeconomic stability, and foster convergence across member states. One key development is the European Semester, a cycle of economic policy coordination introduced in 2010. This instrument for preventive surveillance of member states' economic and fiscal policies aims to ensure sound and sustainable public finances, prevent excessive macroeconomic imbalances, support structural reforms and strengthen investment activities. Fiscal and economic policy is primarily a responsibility of the member states. The European Semester is a consultation and coordination process between member states and European institutions, following a specific timeline.

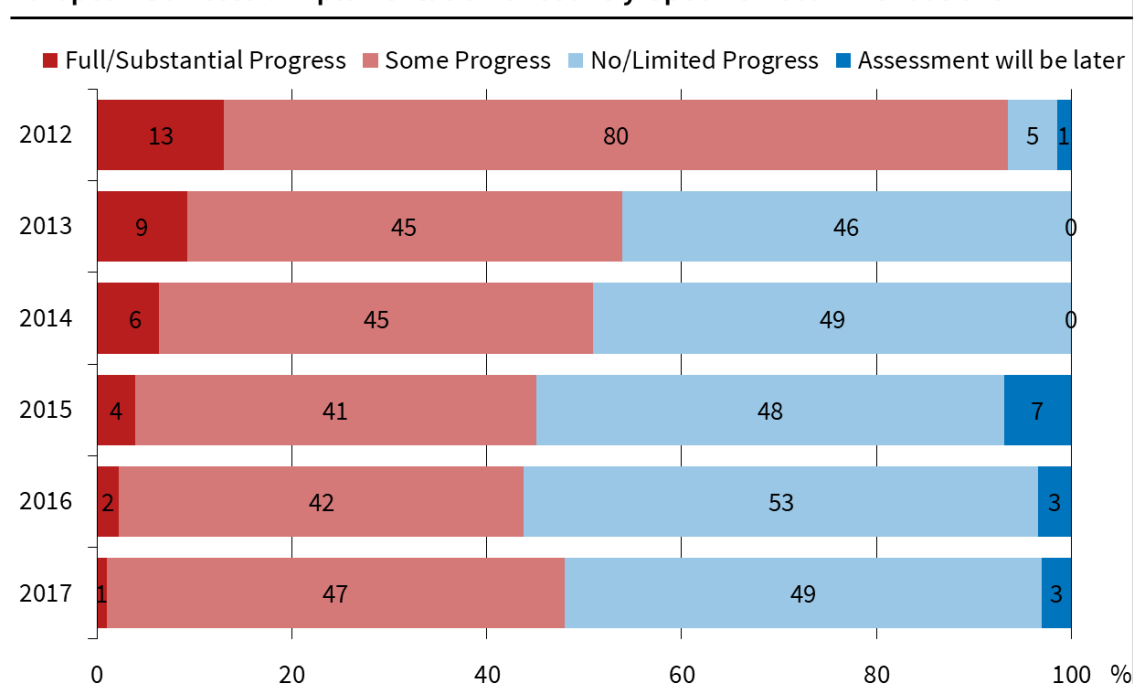
Within the context of the European Semester, a range of indicators is used. Notably, in its alert mechanism reports, the Commission uses a scoreboard of indicators within the framework of the Macroeconomic Imbalance Procedure. Assessing indicators pertaining to, amongst others, the labour market, trade, government debt and the characteristics of the private sector, these reports analyse potential macroeconomic imbalances in the EU countries' economies. Results are incorporated in the European Semester country reports for those countries that were subject to an in-depth review (IDR), based on the Alert Mechanism Report. A further role is played by the Europe 2020 agenda, which postulates key targets the EU should reach by 2020 with respect to employment and education, among others, for spurring sustainable growth and jobs.

Based on the Stability and Growth Pact's economic governance rules, EU member states are also required to submit stability and convergence programmes, where the former applies to EMU members and the latter to non-EMU members. Convergence programmes also include information on the conduct of national monetary policy. Both programmes encompass fiscal plans for the upcoming three years, also specifying the underlying assumptions on economic variables such as growth and inflation as well as a description of policy measures to achieve the programme's objectives. These plans are assessed by the Commission prior to and after implementation and are compared with other institutions' forecasts.

In addition, five European Structural and Investment Funds aim to support sustainable and inclusive economic development and cohesion across all EU member states. Designed as investment vehicles in line with the Europe 2020 strategy, they target five main areas: employment, education, innovation, climate change and energy, and poverty and social exclusion. In total, their budget encompasses EUR 460 billion for the period 2014-2020.

Following the Five Presidents' Report (Juncker et al., 2015), the European Pillar of Social Rights was launched in 2017. Focusing on three main themes – equal opportunities and access to the labour market, fair working conditions, and social protection and inclusion – the Social Pillar contains 20 principles aiming at increasing inclusiveness and fairness of economic and social outcomes.

While the number of initiatives has increased over the last years, their impact has been limited so far. In particular, the European Semester's country-specific recommendations' track record has exhibited limited success (EEAG, 2018).

Figure 1**European Semester: Implementation of Country-Specific Recommendations**

Source: European Commission. Based on EEAG (2018), Figure 4.23.

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As shown in Figure 1, a substantial share of the recommendations is not implemented. In 2017, the European Commission ascertained ‘full/substantial progress’ for only 1% and ‘some progress’ for 47% of the country-specific recommendations, while there was ‘no/limited progress’ reported for almost half of all recommendations. Potential reasons for the poor implementation record could be that recommendations do not sufficiently focus on policies with strong spill-overs (Ragot, 2017), or do not inherit sufficient national ownership (Alcidi & Gros, 2017). These weaknesses have been acknowledged by the European Commission which now aims at strengthening the role of the European Semester as a platform for intensified exchange and dialogue with a clearer focus on the euro area dimension (European Commission, 2017c).

One major issue with the current governance framework of the EU’s initiatives to foster convergence and improve policy coordination is the sheer multitude of programmes and indicators that exist in parallel. This may estrange the European procedures from the political and economic debate in member states (EEAG, 2018). Instead of adding more convergence indicators to the existing mix, we propose to reduce the set of relevant indicators to a smaller number and to focus on key convergence indicators only. These indicators are presented in the next section.

3. TYPES OF CONVERGENCE

When assessing economic convergence, it is important to distinguish between input and outcome convergence. Input convergence refers to policy parameters such as regulations or institutional quality, whereas outcome convergence encompasses economic outcomes such as employment, GDP per capita, or the income distribution. While input convergence requires similar policy choices, convergence in outcomes can be attained despite differing policies or institutional settings across countries.

The debate on convergence raises several important questions. For example, should convergence across EU member states be considered as an aim in its own right?¹ And to what extent is convergence a prerequisite for achieving other aims, such as economic efficiency or political stability?

While the European Union's Treaties emphasize that economic convergence constitutes an objective of the EU by itself, some types of convergence clearly play a central role in ensuring the smooth functioning of the Economic and Monetary Union (EMU). This report strives to assess which types of convergence are most central for a well-functioning of the EMU, mainly focusing on key indicators of outcome convergence. Outcome convergence encompasses convergence processes in real, nominal and cyclical terms. Amongst others, real convergence addresses convergence in income levels and living standards. Nominal convergence covers nominal indicators such as interest rates and inflation rates. Nominal convergence has played a prominent role since the Treaty of Maastricht, and the fulfilment of certain nominal convergence criteria is a prerequisite for becoming a Euro member. As exchange rate adjustments are not possible in the Eurozone, nominal convergence is of considerable importance. Cyclical convergence focuses on the synchronicity of business cycles across member states and likewise plays an important role.

3.1 Real convergence

Two widely-employed concepts for real convergence are β -convergence and σ -convergence (Barro & Sala-i-Martin, 1995). The concept of β -convergence sets growth rates in relation to a country's initial income level. Convergence is attained when initially poorer countries grow faster than richer countries, reducing income disparities over time. This catching-up process is typically measured in terms of PPP-adjusted per capita GDP. On the other hand, σ -convergence refers to a reduction in the dispersion of income levels across countries. This process can be measured by calculating the coefficient of variation across countries over time.

3.1.1 Income convergence

Per capita GDP constitutes one of the most widely used convergence indicators. According to standard neoclassical growth theory (Solow, 1956), countries converge to a so-called steady state GDP in the long run, and permanent growth is only achievable through technological progress. Countries starting out farther from their equilibrium initially experience higher growth rates, resulting in a catching-up process of poorer countries.

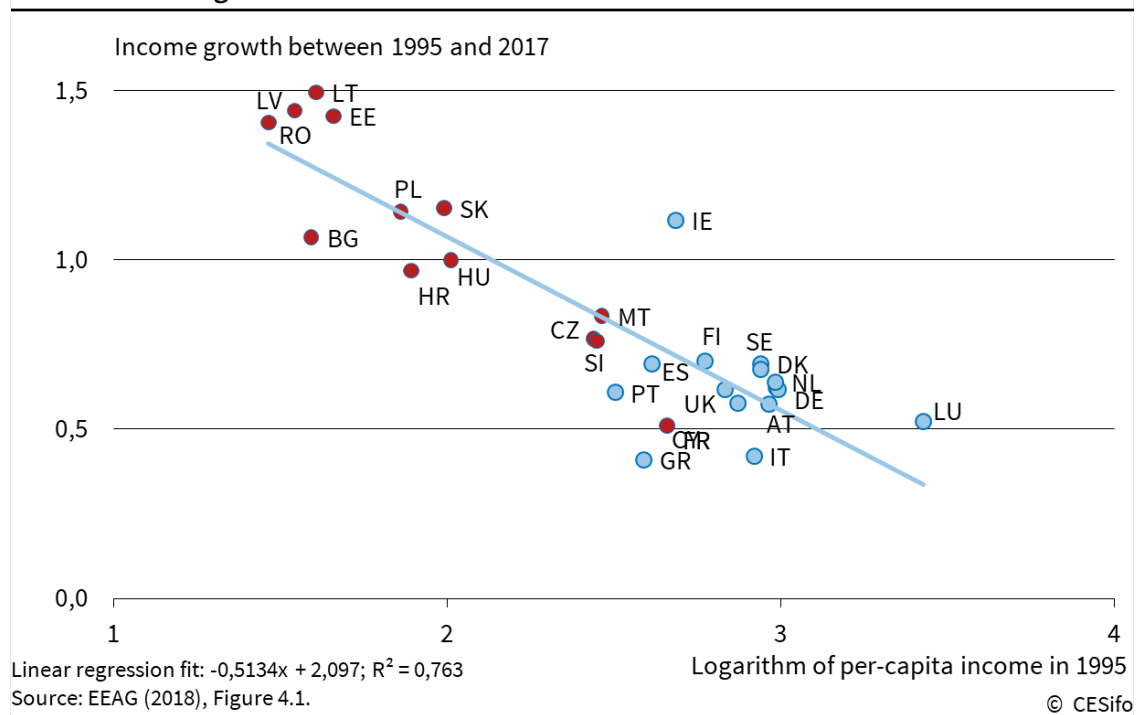
¹ In this paper, we focus on convergence across member states, not regions. Convergence among regions within member states is a different issue. The principle of subsidiarity suggests that assuring convergence within countries should primarily be a responsibility of the member states.

Two opposing hypotheses have been made with regard to income convergence in the EMU. On the one hand, it has been argued that the EMU's lower trade barriers and reduced exchange rate risk could increase capital flows to economies in the catching-up process (Blanchard & Giavazzi, 2002). This would increase economic growth and investment in these countries, thereby leading to a higher degree of income convergence. On the other hand, the EMU might also exert an adverse effect on income convergence as economic integration could facilitate a concentration of economic activity in more prosperous areas (de la Dehasa & Krugman, 1992).

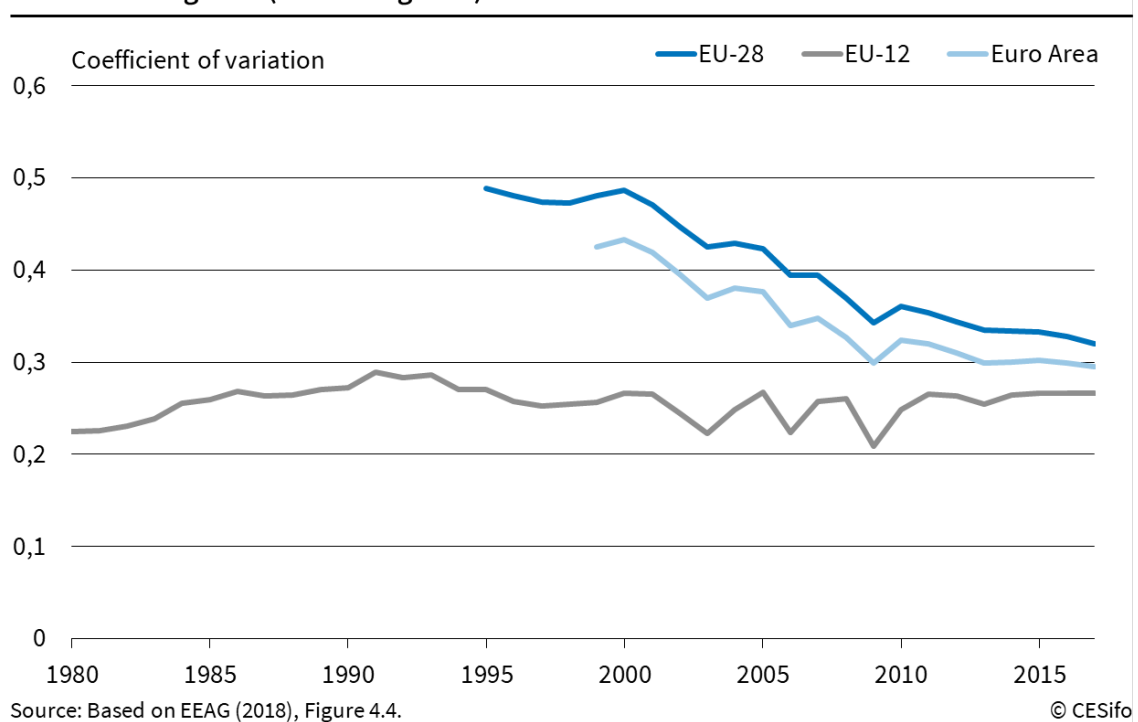
Figure 2 shows β -convergence in per capita income amongst the EU-28 countries, plotting 1995 per capita income on the horizontal axis and income growth since 1995 on the vertical axis. As evidenced by the figure, EU member states have witnessed a catching-up process in line with economic theory. Since the mid-1990s, countries with an initially low per capita income have exhibited substantially larger growth rates than countries with a much higher initial income level. Overall, this has resulted in converging income levels across EU countries. Yet, this process is almost entirely driven by Eastern European member states' catching up with the EU-15. In contrast, there is no indication for convergence amongst the EU-15.² Within this group, a substantial variety does persist. For example, Ireland has experienced much larger growth than Italy and Greece, even though the three countries had similar incomes levels in 1995.³

² Throughout the text, we refer to the EU-12, EU-15 and EU-28. The EU-12 includes Belgium (BE), Denmark (DK), France (FR), Germany (DE), Greece (EL), Ireland (IE), Italy (IT), Luxembourg (LU), Netherlands (NL), Portugal (PT), Spain (ES) and United Kingdom (UK). The EU-15 includes the EU-12 plus Austria (AT), Finland (FI) and Sweden (SE). The EU-28 includes the EU-15 plus Bulgaria (BG), Croatia (HR), Cyprus (CY), Czech Republic (CZ), Estonia (EE), Hungary (HU), Latvia (LV), Lithuania (LT), Malta (MT), Poland (PL), Romania (RO), Slovakia (SK) and Slovenia (SI).

³ Note that higher average growth in Ireland is to some extent due to one-off factors leading to a very large growth rate in 2015.

Figure 2**Income Convergence between 1995 and 2017 for EU-28**

Results for σ -convergence are in accordance with these findings (Figure 3). While the coefficient of variation in per capita incomes has decreased over time among the EU-28 and the euro area member states (EA-19), no such development is observed for the EU-12.

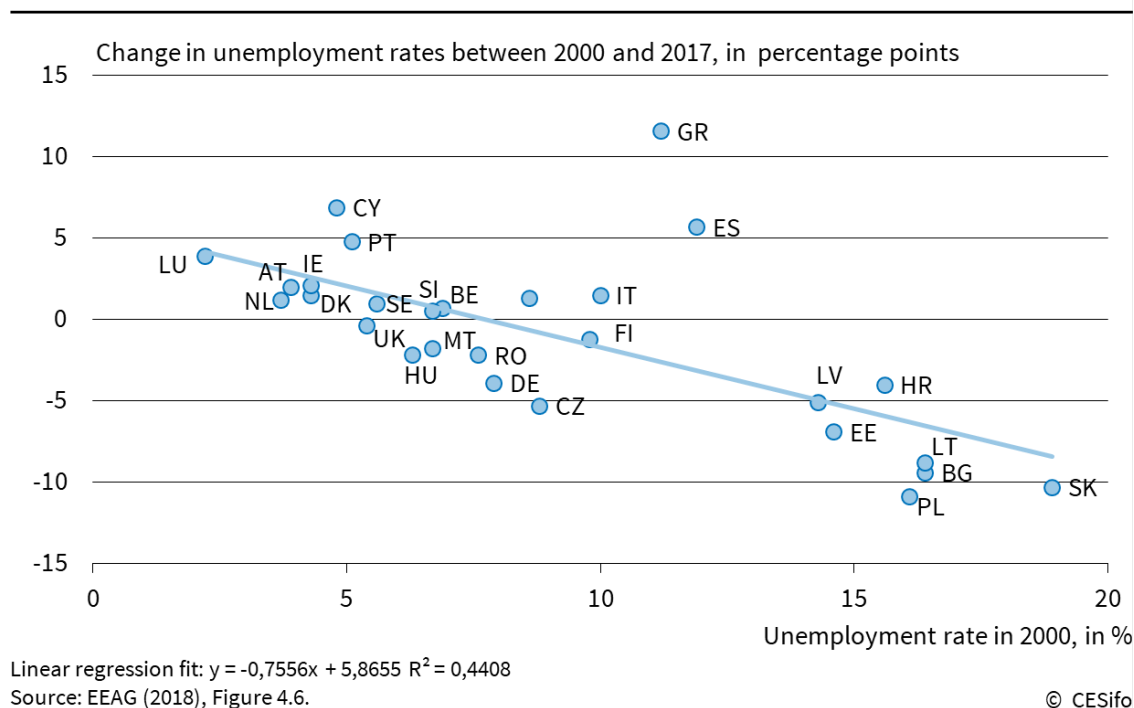
Figure 3**Income Divergence (σ -Convergence)**

3.1.2 Labour market convergence

Figure 4 shows that countries with high initial unemployment rates in 2000 have experienced the largest declines in their national unemployment rates, suggesting that convergence in unemployment rates across the EU-28 does seem to be present.

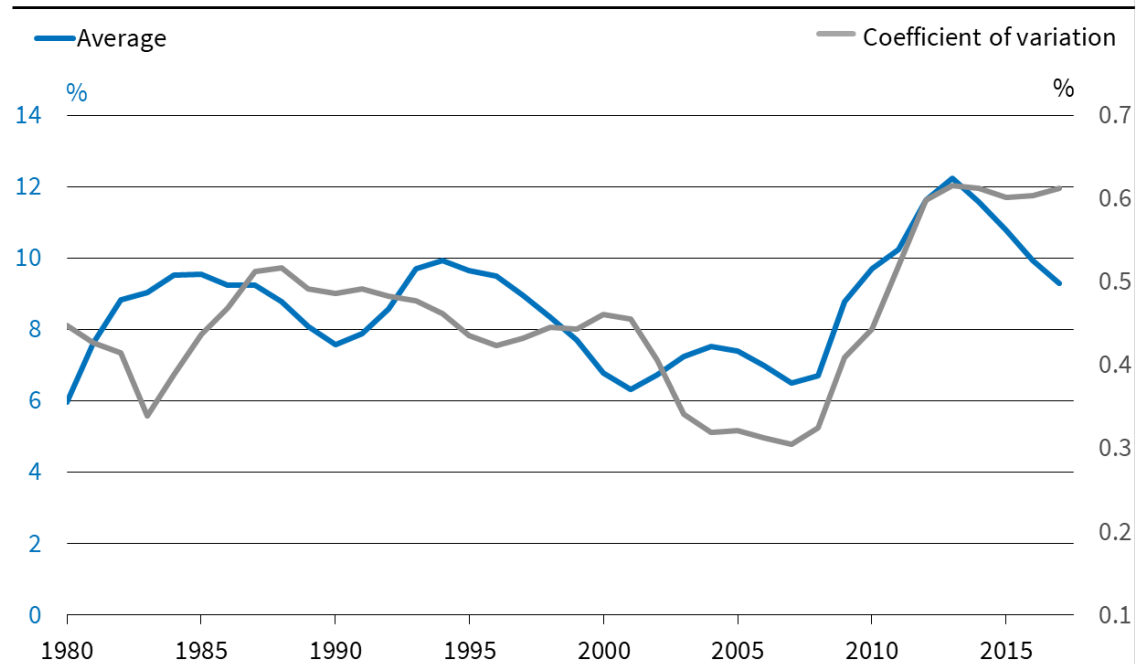
Figure 4

β -Convergence in Unemployment Rates between 2000 and 2017 for EU-28



However, as in the case of income convergence, this development is mainly driven by declining unemployment rates in Eastern European member states which have seen declines in their national unemployment rates of up to ten percentage points since 2000. If the same regression line without the Eastern European countries was drawn, the line would be flat or even upward sloping, indicating that labour market adjustments are not sufficiently strong enough to offset persistent differences across countries in unemployment rates.

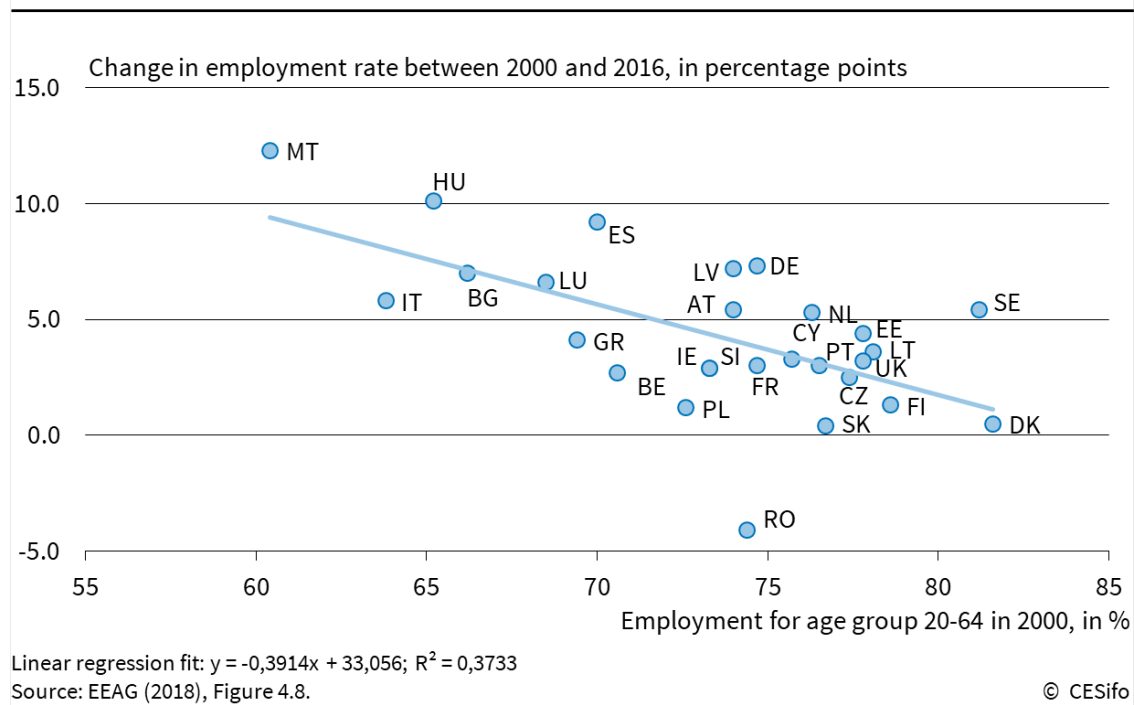
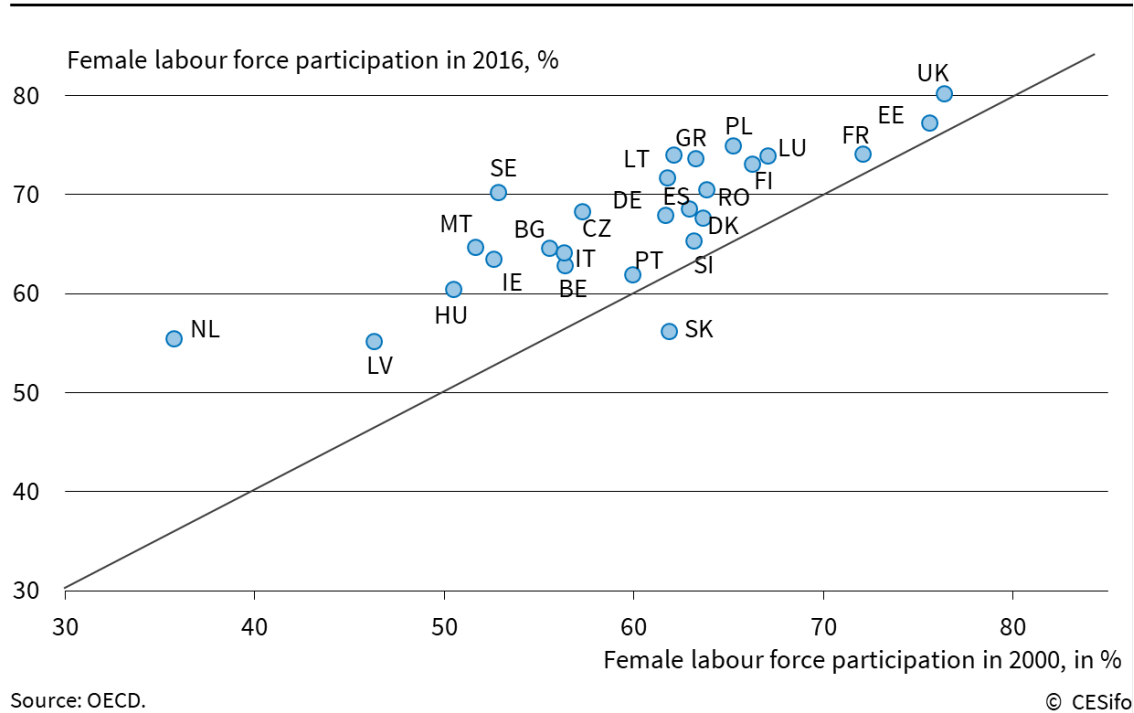
Worryingly, the convergence process has come to a halt since the outbreak of the financial and economic crisis. Following the crisis, unemployment rates have surged in several member states, especially in Greece and Spain, leading to a more pronounced dispersion in unemployment rates across the EU-12, as illustrated in Figure 5. Even though overall unemployment has slightly declined since the peak of the crisis in 2012/13, large heterogeneities persist.

Figure 5**Unemployment Rate across EU-12**

Source: Based on EEAG (2018), Figure 4.7.

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Other important dimensions that characterize the functioning of the labour market are female labour market participation and employment rates in general. Figure 6 indicates that employment rates have risen in virtually all countries since 2000, with only the exception of Romania. Increases in employment rates can be attributed to increased female labour market participation (Figure 7) as well as several reforms of early retirement schemes that have fostered old-age employment rates (EEAG, 2018).

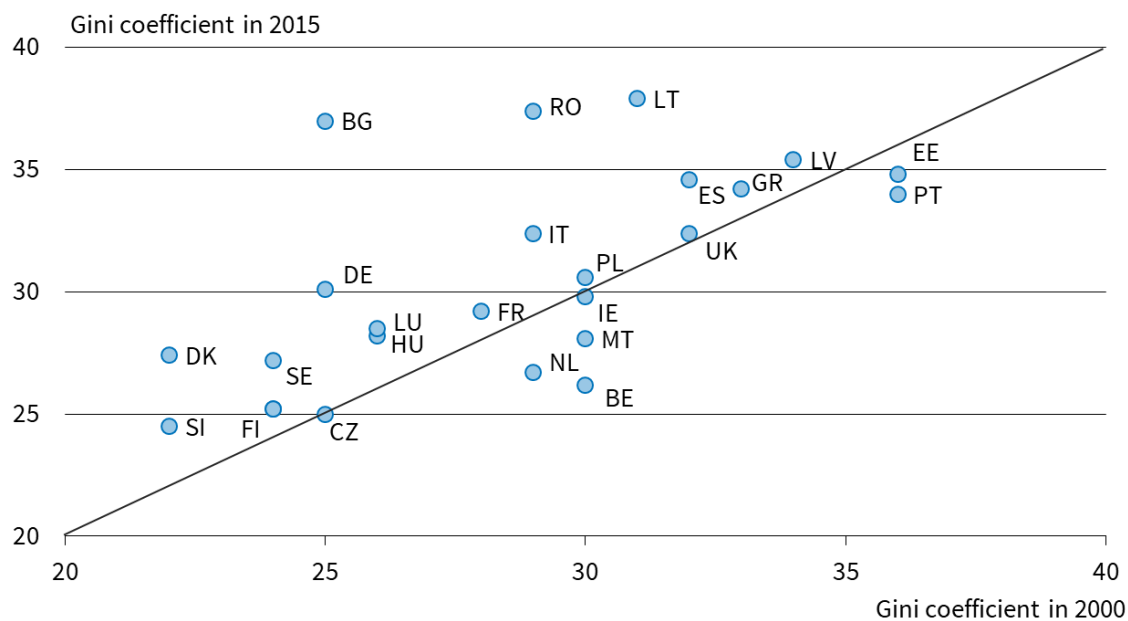
Figure 6 **β -Convergence in Employment Rates between 2000 and 2016 for EU-28****Figure 7****Female Labour Force Participation for EU-28**

3.1.3 Convergence in inequality

In the majority of EU member states, inequality measured by the Gini coefficient has been rising over the period 2000-15 (Figure 8). Notable exceptions are Belgium, the Netherlands, and to a smaller extent also Portugal and Malta. Some countries have experienced pronounced increases in inequality, in particular Bulgaria, Romania, and Lithuania.

Figure 8

Gini Coefficients in 2000 and 2015 for EU-28



Note: Gini coefficient based on equivalised disposable income (SILC-survey).

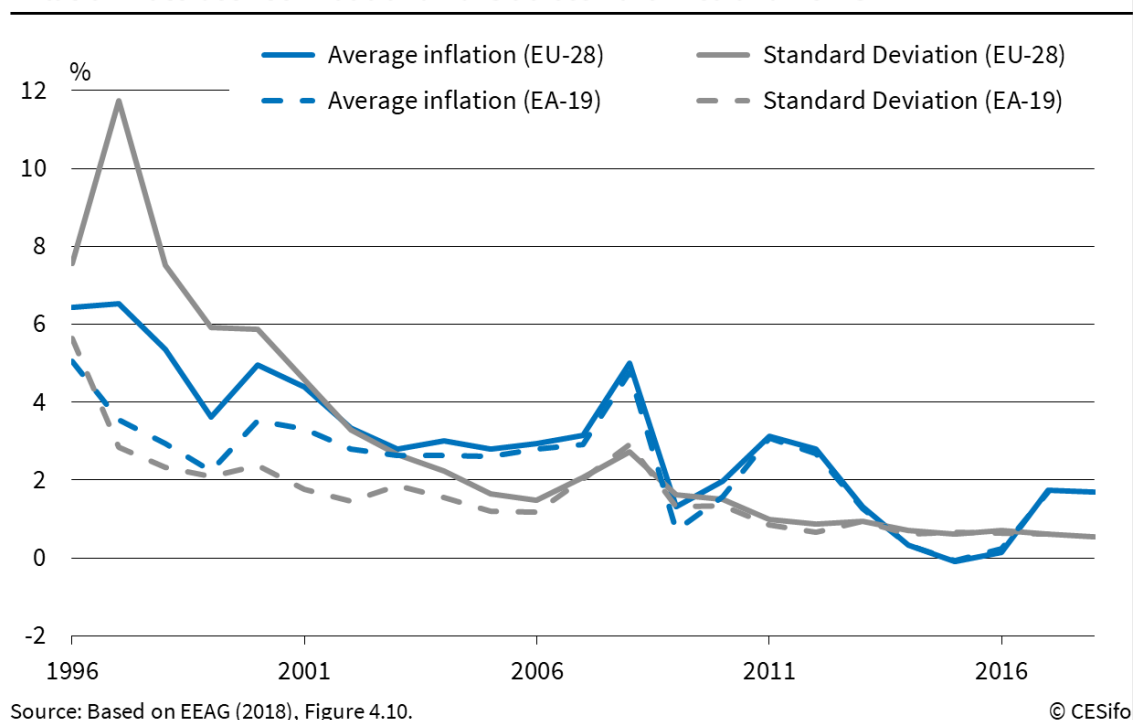
Source: EEAG (2018), Figure 4.11.

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3.2 Nominal convergence

3.2.1 Convergence in inflation rates

A well-functioning monetary policy requires at least a certain degree of convergence in inflation rates as large inflation differences are notoriously difficult to deal with (Franks et al., 2018). Figure 9 displays the average inflation rate as well as its standard deviation for the EU-28 and for euro area member states (EA-19). Over the period 1995-2015, average inflation and its standard deviation have been smaller among euro area member states. It is noteworthy, however, that difference between the EU-28 and the euro area have vanished in recent years, which can be partially attributed to a general decline in overall inflation rates in the recent past.

Figure 9**Inflation Rate between 1996 and 2018 across Euro Area and EU-28****3.2.2 Convergence in interest rates**

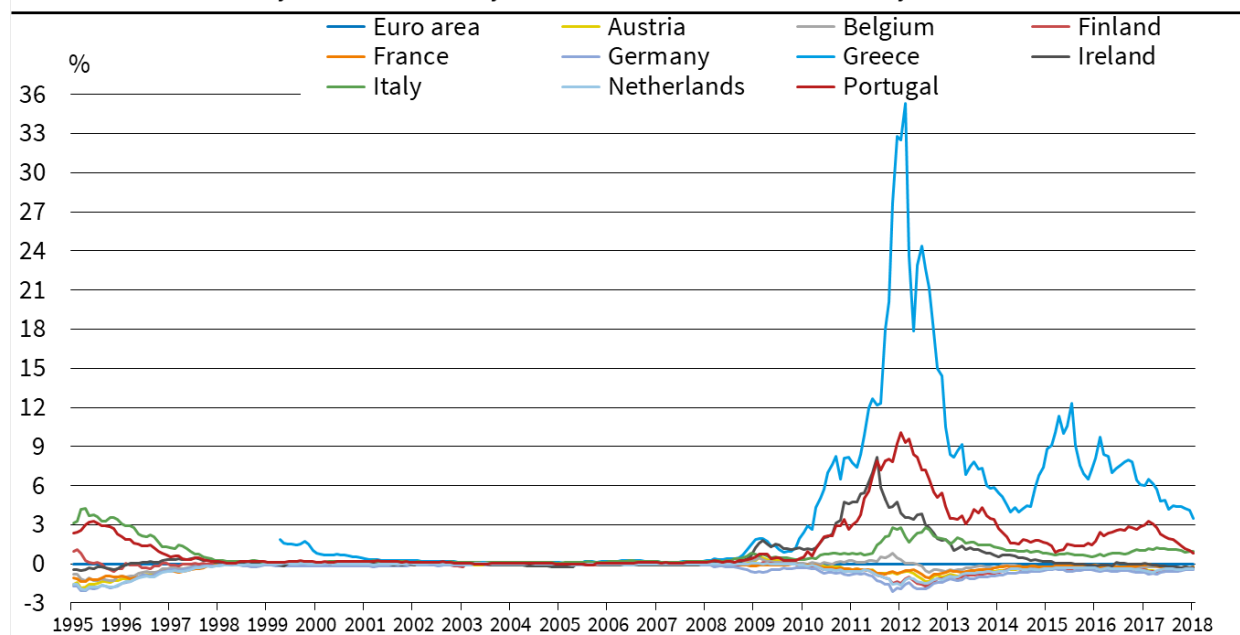
Government bond interest differentials have played a prominent role in the discussion on Eurozone developments after spreads shot up during the financial crisis. Figure 10 presents the evolution of long-term government bond yields of selected euro area countries since 1995. With a synthetic euro area bond as a benchmark, the figure shows the spread of a country's interest rate over the Euro Area average.

The years leading up to the Euro introduction saw a convergence in government bond interest rates, with the rates of formerly high-interest countries such as Italy, Portugal and Greece declining to the level of countries with relatively low rates. Assuming that euro area sovereigns are unlikely to default, capital markets largely stopped distinguishing credit risks between EMU governments (EEAG, 2018). In the wake of the financial crisis, this development reversed and markets repriced sovereign default risks. Spreads of countries that used to have the highest interest rates in the 1990s shot up to very high levels. In recent years, spreads have become smaller again primarily due to the ECB's expansive monetary policy as well as an improving economic outlook in the respective member states.

Arguably, neither a full convergence of sovereign interest rates nor an overly wide spread is desirable. As sovereign credit risks differ and fiscal policies are decentralized across the Eurozone, a full convergence would not be desirable and should not be expected (Franks et al., 2018). Hence, interest rates should always be assessed in the context of the respective economy's underlying fundamentals.

Figure 10**Regional Disparities in Government Bond Yields in the Euro Area**

Differences between 10-year national and synthetic euro area benchmark bond yields

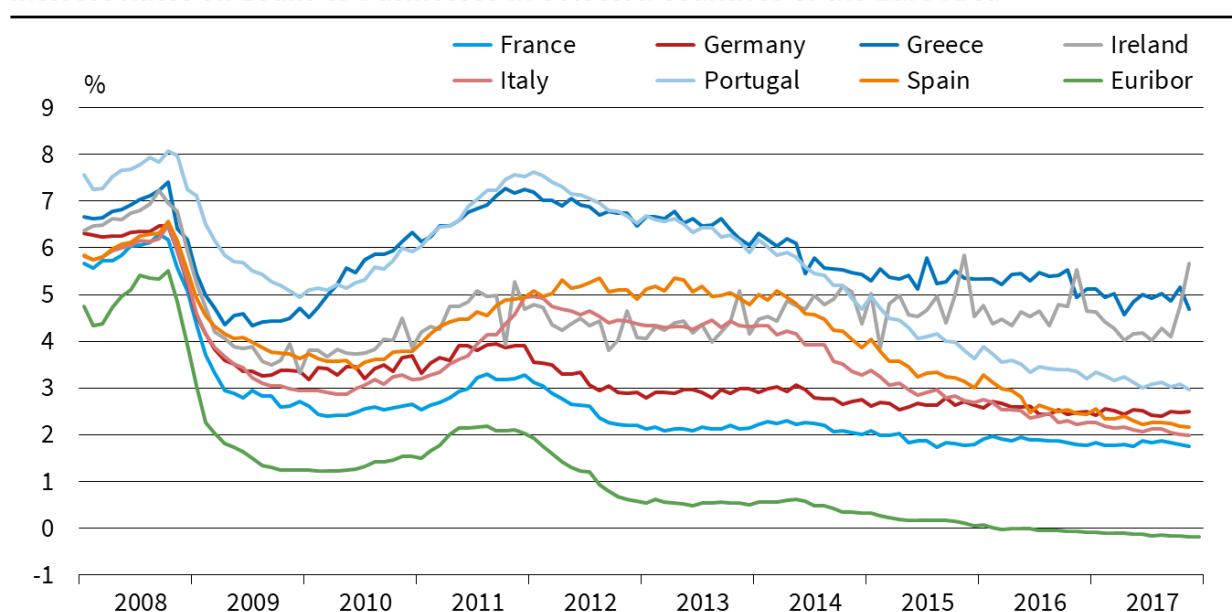


Source: Datastream; last accessed on 27 January 2018. Based on EEAG (2018), Figure 1.21.

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In addition to sovereign interest rates, interest rates to businesses carry a large importance for the well-functioning of the private sector. Since the outburst of the recent economic and financial crisis, the ECB has been conducting expansionary monetary policy, injecting a considerable amount of liquidity into the market. While financial sector interest rates plummeted to a low and even negative level, interest rates on loans to businesses have not followed that trajectory.

Figure 11 displays interest rates on loans to businesses in selected EMU countries. The Euro Interbank Offered Rate (Euribor), which captures average interest rates at which Eurozone banks lend unsecured funds to other banks, indicates interest rates for lending within the financial sector. As shown by Figure 11, trajectories differ between countries. While interest rates to Portuguese, Spanish and Italian businesses have fallen quite substantially in recent years, developments are less pronounced for Ireland and Greece. The large gaps between private sector and interbank lending rates raise the question of whether monetary policy is transmitted to businesses. At the same time, a certain degree of differences in interest rates is natural as business structures and general economic circumstances may differ across countries.

Figure 11**Interest Rates on Loans to Businesses in Selected Countries of the Euro Area^a**

^a New loans to non-financial corporates up to one million euros using floating rates or up to 1 year initial rate fixation. The Euribor rate is based on secured interbank loans with a maturity of one year.

Source: EEAG (2018), Figure 1.18.

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3.3 Cyclical convergence

Referring to a synchronization of business cycles, cyclical convergence is of central importance to monetary policy and to the design of fiscal institutions at the European level. More precisely, cyclical convergence means that business cycles are at the same stage across countries, with booms and busts occurring at roughly the same time. As postulated by the optimum currency area theory (Mundell, 1961), countries with asynchronous business cycles would have diverging optimal monetary policies, leaving them worse off under a common monetary policy. Highly asynchronous business cycles impede a well-targeted monetary policy within a currency area, as some countries may need a less restrictive monetary policy than others. In consequence, it is helpful for monetary policy if business cycles across EMU countries achieve a sufficiently high level of convergence.

Moreover, the degree of business cycle asymmetries is also essential for the effectiveness of the currently discussed fiscal stabilization mechanisms at the European level. Such a stabilization function at the European level would be destined to alleviate the effects of asymmetric shocks. This could possibly take the form of a European unemployment insurance scheme, a European investment protection scheme, or a 'rainy day fund' (European Commission, 2017c). Assessing to what degree shocks are asymmetric is important for the design of such a stability function.

The following analysis focuses on two main indicators for assessing cyclical convergence in Euro Area countries: Gross domestic product (GDP) and the unemployment rate.⁴ GDP and unemployment are driven by both a structural trend (i.e. the 'natural' level of GDP and unemployment) as well as by

⁴ This section draws on Alcidi et al. (2017).

business cycle up- and downswings (i.e. the output and unemployment gap). In this study we employ the Baxter-King filter (Baxter & King, 1999) to decompose the respective time series into a trend component, a business cycle component and irregular disturbances. The extracted cyclical component is then used to assess the extent of cyclical convergence.

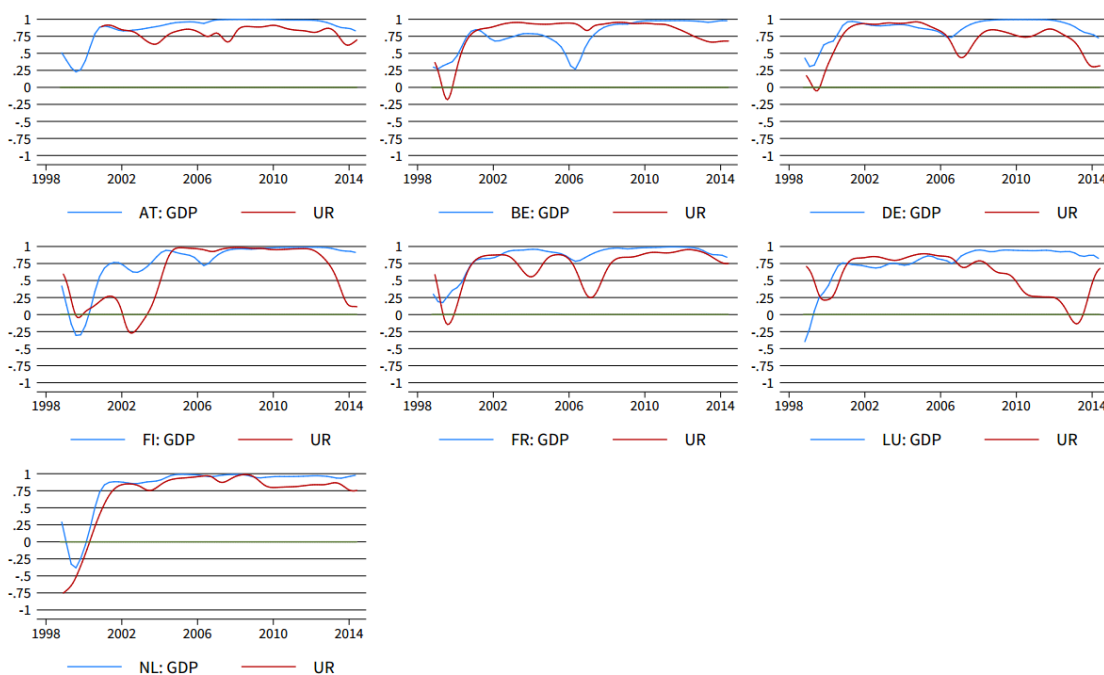
Developments in cyclical components are benchmarked against average developments in the EA-12. The latter consists of aggregate GDP or unemployment rates across the EA-12 countries with the exception of the country it is compared with.

To assess changes in correlations over time, we evaluate correlations between each respective country's cyclical component and the EA-12 average across 5-year rolling windows. In Figure 12 - Figure 14, x-axes indicate the end of the respective timeframe. For example, the correlation coefficient of January 2014 refers to the correlation between the respective country's unemployment rate or log GDP and the EA-12 aggregate between February 2009 and January 2014. High correlation coefficients indicate a large degree of synchronicity.

As shown in the figures, correlations tend to be rather high, in particular in the years since the introduction of the common Euro currency. On average, correlations in GDP exceed those in unemployment rates. Correlations tend to be highest across the core member states, and have in recent years reached high levels as well in the new member states. Developments in Greece, on the other hand, seem out of sync.

Figure 12

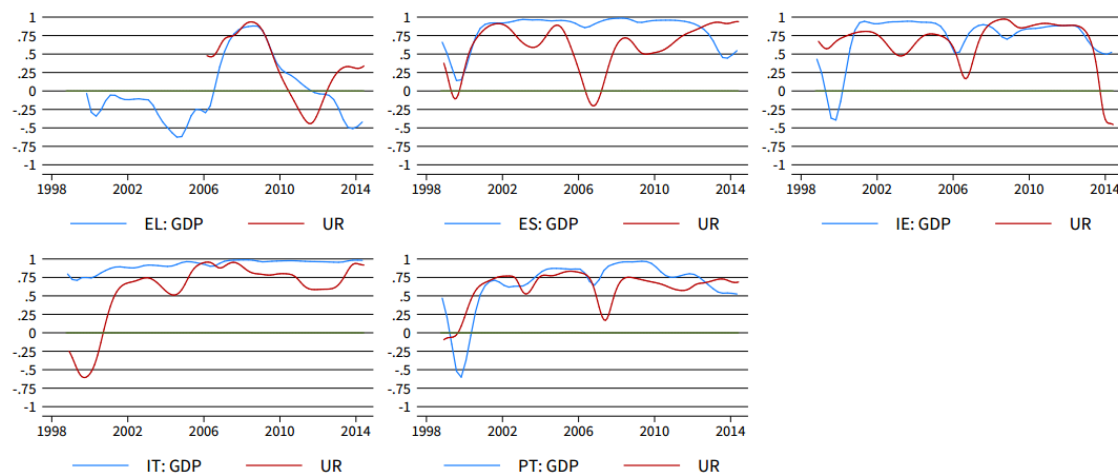
Core Member States: Correlations with EA-12 Cyclical Component
5-year rolling windows



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Source: Own calculations based on OECD Economic Outlook.

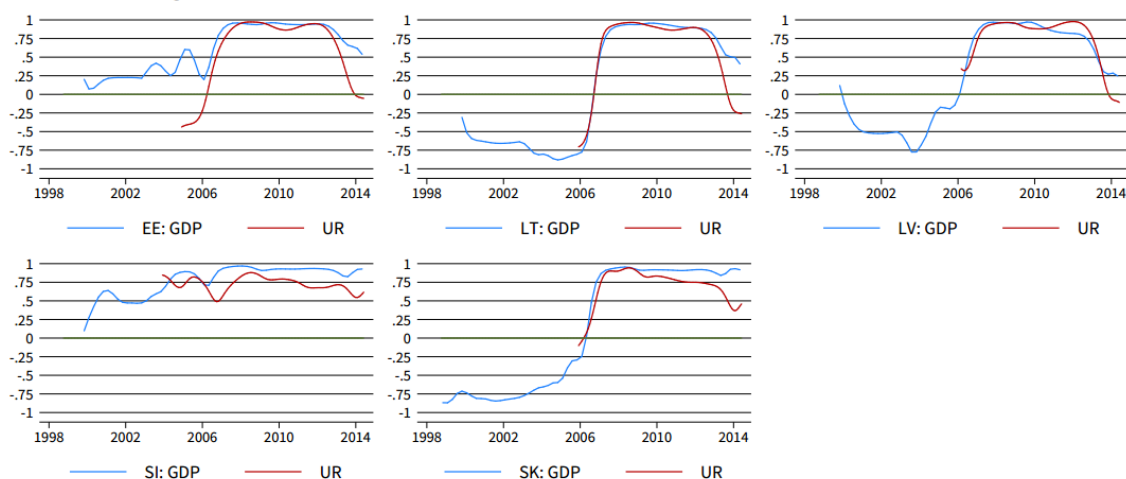
Figure 13
Peripheral Member States: Correlations with EA-12 Cyclical Component
5-year rolling windows



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Source: Own calculations based on OECD Economic Outlook.

Figure 14
New Member States: Cyclical Correlations with EA-12 Cyclical Component
5-year rolling windows



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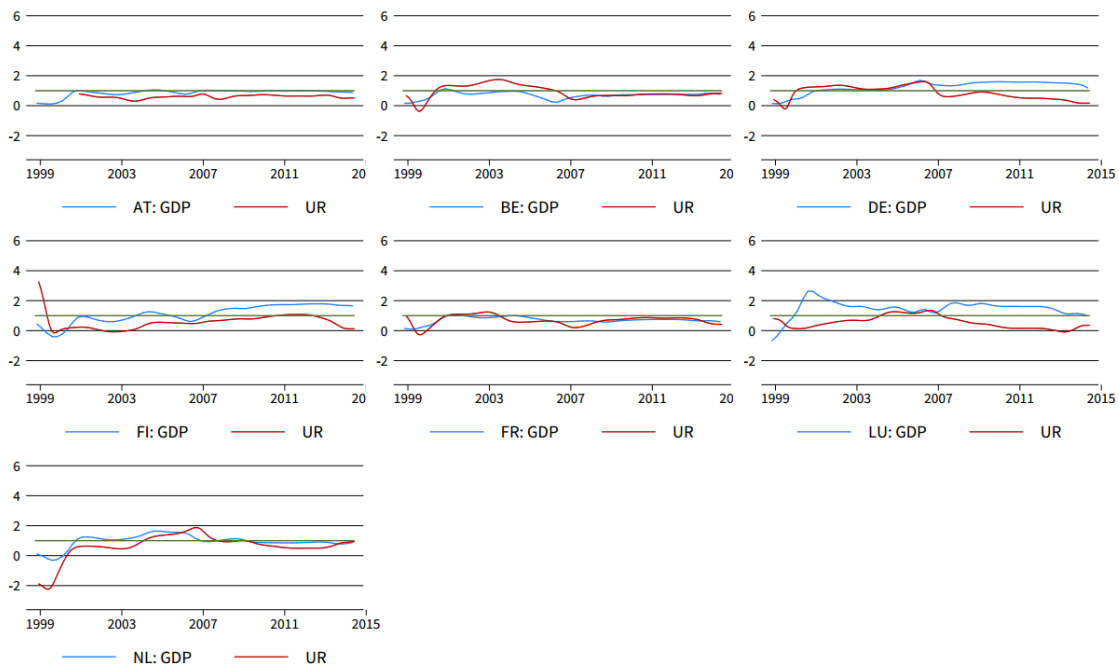
Source: Own calculations based on Eurostat, Latvian Central Statistics Bureau and OECD Economic Outlook.

As a second step, we compare the cyclical components' amplitudes to the EA-12 aggregate. Following Belke et al. (2016) as well as De Grauwe and Ji (2016), we regress the cyclical component of national GDP and unemployment on the EA-12 cycle. Figure 15 - Figure 17 plot the resulting β -coefficients of these regressions over time, using 5-year rolling windows. A coefficient of one indicates that the national business cycle's magnitude equals the aggregate EA-12 cycle's magnitude; coefficients larger than one indicate comparatively larger up- and downswings. Negative coefficients occur once correlations are negative.

While the core member states exhibit rather similar magnitudes around one, fluctuations are much larger in the new member states. Just as correlations of cyclical unemployment differed more than correlations in GDP, national labour markets display a larger degree of heterogeneity in their sensitivity to common employment shocks.

Figure 15

Core Member States: Betas of Cyclical Component Regressed on EA-12 5-year rolling windows

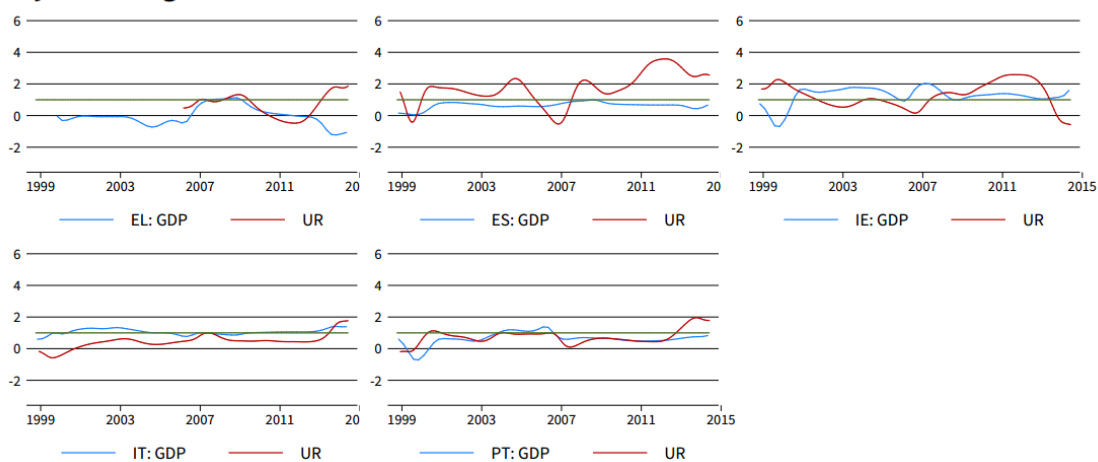


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Source: Own calculations based on OECD Economic Outlook.

Figure 16

Peripheral Member States: Betas of Cyclical Component Regressed on EA-12 5-year rolling windows

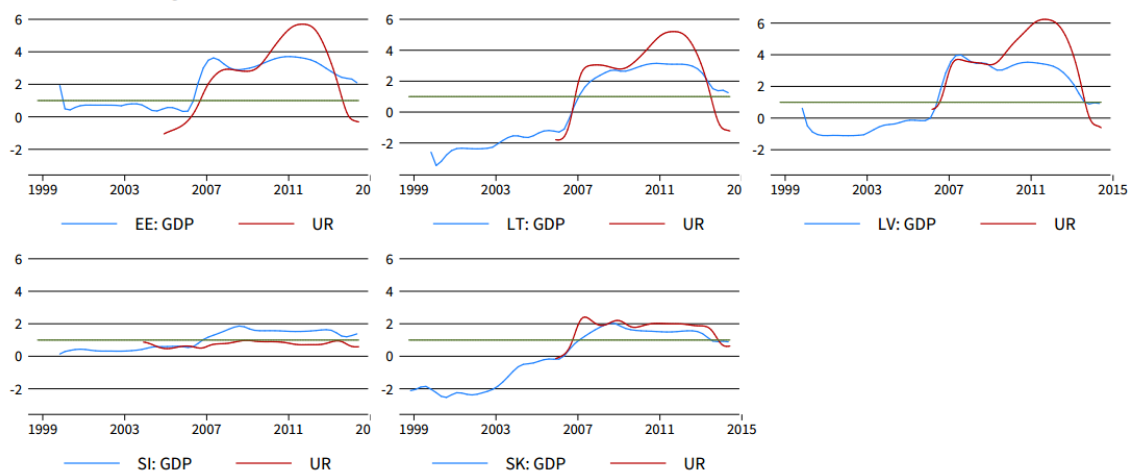


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Source: Own calculations based on OECD Economic Outlook.

Figure 17

**New Member States: Betas of Cyclical Component Regressed on EA-12
5-year rolling windows**



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Source: Own calculations based on Eurostat, Latvian Central Statistics Bureau and OECD Economic Outlook.

4. WHICH TYPES OF CONVERGENCE ARE PARTICULARLY RELEVANT FOR THE FUNCTIONING OF THE EMU?

Overall, we think that cyclical convergence carries a high importance for ensuring a well-functioning of the EMU. A successful design and transmission of monetary policy requires that the member states of a currency area are at similar stages of their business cycle.

Real convergence as such is not required for a functioning monetary union (Franks et al, 2018). If business cycles are synchronized, monetary policy and macroeconomic stabilization may still function in the presence of persisting cross-country income and labour market differences. However, real convergence constitutes an important economic objective of the EMU by itself (European Commission, 2017c). Convergence is also of high relevance for the cohesion of the monetary union: The perception that benefits of the EMU are equally shared increases political acceptance of the EMU and raises social cohesion (Franks et al., 2018). Also, income convergence can help alleviate concerns that the EMU carries the risk of developing into a transfer union. In turn, this might facilitate implementing currently discussed common insurance mechanisms at the European level to alleviate macroeconomic shocks and increase stabilization.

Likewise, a certain degree of nominal convergence is crucial for the well-functioning of a monetary union (Franks et al., 2018). Large inflation differentials could not easily be addressed within a monetary union that cannot resort to country-specific monetary policies. At the same time, a certain discrepancy in national inflation rates may be required for adjusting real exchange rates.⁵ Similarly, as mentioned above, some differences in sovereign interest rates are also desirable as they reflect differences in credit risk.

While the policy debate often postulates the importance of input convergence (see e.g. European Parliament, 2017a), it is not clear whether input convergence is always needed or even desirable. Individuals in different European member states may have differing preferences regarding the design of their country's institutional setting. At the same time, many different policy options may equally ensure achieving certain outcomes as well as a high level of competitiveness, leaving leeway for member states to design institutions in accordance with their citizens' preferences. Also, differing social systems and institutions may reflect or even give rise to comparative advantages. For example, countries with flexible labour markets and a rather generous unemployment insurance system may benefit from specializing in industries with large fluctuations in demand and production, while countries with strict employment protection regulations and less comprehensive unemployment insurance systems may have a competitive advantage for industries subject to less fluctuations (EEAG, 2018). We hence are in favour of focusing on output convergence, leaving the choice of inputs for reaching the corresponding convergence levels at the discretion of the respective member states.

⁵ In a monetary union, competitiveness gaps between countries cannot be compensated by nominal exchange rate adjustments, but by flexible prices leading to adjustments in the real exchange rate.

5. THE EUROPEAN COMMISSION PROPOSAL FOR A REFORM DELIVERY TOOL

5.1 Outline of the Tool

In its roadmap for further institutional reforms in the EMU published in December 2017, the European Commission has proposed a “reform delivery tool” to support structural reforms in the member states (European Commission 2017a,b). The key elements of the proposal are as follows. In a pilot phase from 2018-2020, member states can use some of their European Structural and Investment Funds performance reserve (set up in Articles 20-22 of the Common Provisions Regulation for cohesion policy) to support structural reforms instead of projects. There are no additional funds involved as these would be taken from member states’ existing 2014-2020 European Structural and Investment Funds. In addition, the European Commission proposes to double the budget of the Structural Reform Support Programme such that it would amount to EUR 300 million for the period 2017-2020. With these funds, the Commission offers technical assistance to the member states for the design and implementation of reforms.

The new reform delivery tool would be established together with a follow-up programme to the Structural Reform Support Programme under the post-2020 Multiannual Financial Framework. The reform delivery tool would then be equipped with its own budgetary endowment which would be separate and in addition to the European Structural and Investment Funds.

The Commission proposes the following procedure for the reform delivery tool:

- Member states can apply for funding by committing to implement structural reforms addressing structural weaknesses of the economy identified in the context of the policy dialogue of the European Semester. Member states agree with the Commission on a multiannual reform commitment package which would include a set of reform measures, milestones for implementation and a calendar for completion within a maximum period of three years.
- A peer review process shall ensure that an assessment by the Commission as well as successful policies in other member states (‘best practice’) are to be taken into account in the development of reform proposals.
- The reform delivery tool would provide financial support in particular for those reforms that aim to strengthen the resilience of domestic economies and that are expected to have positive spill-over effects on other member states.
- Progress in reform implementation would be reported by the member states through the National Reform Programmes and regularly monitored by the European Commission through the Annual Country reports of the Commission’s services as part of the European Semester.
- Financial support would be granted by the Commission once the Member State has fully implemented the reform commitment.

5.2 Assessment of the Commission proposal

The basic idea of the proposed reform delivery tool is to incentivise governments to conduct growth-enhancing structural reforms by means of fiscal transfers. In some dimensions, it resembles the Convergence and Competitiveness Instrument proposed by the European Commission in 2013 that did not find political backing by the member states (European Commission, 2013; Steinbach, 2016). Such an instrument would need to be carefully designed in order to avoid adverse effects. First, one might ask why member states do not pursue reforms that are in their own interest. If fiscal transfers are paid as a reward for reforms that would have been implemented anyway, such an instrument would

lead to windfall gains, put an unnecessary burden on taxpayers and hence be inefficient. Second, there is a concern that the reform delivery tool could cause moral hazard. This would be the case, for instance, if reform efforts are delayed until governments become eligible for financial support through the reform delivery tool. Third, at the national level reforms may be more difficult to implement if they are perceived as being imposed from the outside or as giving in to pressure exerted by the EU.

From an economic perspective, one rationale for incentivising structural reforms is that some reforms create positive externalities for other member states, or conversely negative externalities if the reform is not implemented, which are not fully internalised by governments (Grüner, 2013). Without financial support, governments might abstain from conducting such reforms. Moreover, some structural reforms might not be pursued because of their short-term economic and political costs, while the gains materialise only in the long-run (Banerji et al.; 2015; Marrazzo and Terzi, 2017).

Against this background, the Commission proposal of the reform delivery tool contains some aspects which go in the right direction. First, it is important to acknowledge that national ownership of reforms is essential for their successful implementation. The proposal aims to secure national ownership by giving member states themselves the opportunity to submit reform proposals within the scope of the European Semester framework. This is preferable to an approach where the European Commission is asked to propose reform programs to the member states. Second, member states are required to detail milestones for implementation and a calendar for completion in their reform commitment packages. Ideally, these provisions should induce member states to pursue reform efforts with the necessary degree of commitment as failure to reach targets would have to be explained by the member states. Third, the proposed peer review process should support the process of learning from successful policies implemented by other member states.

However, two provisions in the Commission proposal should be viewed with scepticism. First, it is debatable why the reform delivery tool should be endowed with separate budgetary resources under the post-2020 Multiannual Financial Framework in addition to the existing European Structural and Investment Funds. The available evidence on the effectiveness of the EU's cohesion policy in promoting economic convergence suggests that its contribution to overall growth and convergence is limited (EEAG, 2018). Structural reforms could be more effective, in particular if they have a larger impact on productivity growth in countries with lower initial productivity levels (Banerji et al., 2017). The pilot phase provision suggesting that financial support of structural reforms is to be paid out of existing funds from the European Structural and Investment Funds should therefore be maintained also under the post-2020 Multiannual Financial Framework. Second, the disbursement of funds should not only depend on the implementation of the agreed reforms, but also on achieving output convergence targets. This creates clear incentives for countries to pursue general economic, fiscal and social policies which support convergence strategies funded with EU support. In addition, experience shows that successful, but unpopular reforms are sometimes reversed by new governments, even if this comes with efficiency losses in the long run. Moreover, the existing fiscal governance framework already provides some inbuilt flexibility in support for fiscal reforms so that governments can bear potential short-term costs of structural reforms. Therefore, such a provision would incentivise a more long-term commitment to structural reforms and growth enhancing economic policies.

6. A NEW PROPOSAL: NATIONAL CONVERGENCE ROADMAPS

Since the member states are primarily responsible for economic, fiscal and social policies, instruments at the disposal of the European institutions for achieving output convergence are rather limited. At the same time, economic divergence and unsatisfactory economic developments in individual member states are often portrayed as reflecting policy errors or broken promises of the EU, in particular by national policy makers trying to divert attention from policy failures at the national level. We therefore think that the responsibility for making satisfying progress with respect to key convergence targets needs to be rebalanced between the member states and the EU. Specifically, we propose a mechanism where member states agree on convergence targets laid out in convergence roadmaps, which also specify how and over what time horizon these jointly agreed country-specific targets should be achieved. Our proposal aims to strengthen the role of national responsibility for the convergence progress.

6.1 Convergence targets

Convergence targets should be limited to a relatively small set of output related convergence indicators. First, focusing on a substantially smaller list of targets ensures that the importance of those targets and their relative priority over other goals is not blurred by a multitude of different goals. Moreover, we think that this allows for more focused and more effective policy-targeting. Second, restricting the list to output convergence targets gives member states more flexibility when deciding about the most suitable and nationally preferred way to converge to these goals in terms of policy instruments chosen. For example, countries that have relatively less political stability or worse functioning institutions should not be deprived of their right to set lower corporate tax rates to offset such characteristics and still to improve their attractiveness for businesses in the longer run.

We propose that convergence targets should be specified by two indicators of real convergence: per capita income and unemployment. The convergence targets should reflect the concept of β -convergence implying that the potential of structural reforms to promote economic growth is higher the lower the initial level of income per capita.⁶ In its convergence roadmap, the applying member state would have to underpin its targets with sound economic ex-ante analysis quantifying the expected impact of the structural reforms on potential output growth, per capita income and unemployment.⁷ The impact analysis would then be scrutinized by the European Commission.

Importantly, convergence targets should refer to the structural component of income per capita and unemployment, respectively, rather than actual income and unemployment.⁸ They would thus be independent of the economy's current position in the business cycle and it would be ruled out that failure to reach convergence targets is driven by business cycle shocks or achieving targets is only due

⁶ Some contributions have found that income gaps between high- and low-income countries shrink by 2% per year on average (e.g., Sala-i-Martin, 1996). However, the academic literature has not reached a consensus on structural parameters such as the rate of convergence (Islam, 2013).

⁷ See e.g. ECB (2015) and the references therein.

⁸ The estimation of structural income per capita and unemployment could be based on the ECOFIN's 'approved production function methodology' as well as the corresponding estimates and forecasts of the non-accelerating wage rate of unemployment (NAWRU).

to a transitory boom. In addition, the focus on structural income/unemployment would minimize the risk that member states resort to fiscal stimuli that do not have a long-term effect on the economy.

Including cyclical indicators to the list of convergence targets is not advisable for at least two reasons. First, as highlighted in Section 3.3, business cycle fluctuations are already highly synchronized across EMU member states. Second, cyclical fluctuations are typically driven by exogenous shocks that are beyond the control of a member state's government. Moreover, their timing and severity can hardly be anticipated.⁹ Nominal indicators should also not be included in the list of convergence targets. National inflation and interest rates are influenced by the common monetary policy, and rules regarding public debt and fiscal deficits are already part of the Stability and Growth Pact.

6.2 Assessment and approval of national convergence roadmaps

Our proposed mechanism would be best implemented in the context of the cross-country reviewing process of the European Semester that should be used as a platform for member states for effective exchange and continuous interaction throughout the cycle. After having agreed on key convergence targets, we propose that countries detail what we call a convergence roadmap, listing the proposed policy measures that – according to the countries themselves – allow to reach those targets within a realistic time horizon (which could be also subject to discussions). Those policy proposals should be flexible enough to allow countries to pick those measures ‘for their roadmap’ that are most suitable to country-specific economic circumstances as well as political preferences. But they should also be detailed enough to make progress measurable, including milestones with intermediate objectives. Having said this, it would be useful to integrate this mechanism into the framework of the European Semester as member states should learn through interacting with other countries from ‘best practices’ and seek continuous guidance from the Commission, without receiving binding recommendations, though.

After thoroughly assessing each country's convergence roadmap, the European Commission would ask the Council for approval. The Council would decide, on the basis of agreed criteria, which of the proposed measures have most promise for reaching the agreed convergence targets and which of them have spillover effects across borders. The approval of the Council would be necessary to grant financial support.¹⁰ Giving the Council the decision-making power is coherent as the financial support for structural reforms would be conditional on positive spillovers (see below).

If a member state misses its convergence targets, it would need to provide a thorough justification which would then be assessed by the European Commission. In case the failure to comply with the convergence target is due to unexpected events beyond the control of the member state's government, an extension of the time horizon to achieve the target could be granted.¹¹ The same procedure as with the adoption of the initial convergence roadmap would apply. The extension

⁹ As pointed out by Alcidi et al. (2017), the most promising way to increase national shock absorption capacities and to facilitate resilience against macroeconomic shocks is to promote capital market integration within the E(M)U, which requires joint efforts at the European level.

¹⁰ See the Commission proposal on the Convergence and Competitiveness Instrument which also includes an obligatory approval of the Council (European Commission, 2013).

¹¹ The Brexit and its expected adverse impact on the Irish economy might serve as an example for such an event which is beyond the control of a member state.

proposed by the European Commission would need to be approved by the Council. In case the failure to achieve the agreed convergence target is in the responsibility of the member state – e.g., the proposed reforms were not implemented or counteracting measures were adapted – financial support would not be granted.

6.3 Financial resources, conditions for financial support and program eligibility

No additional financial resources would need to be activated for this initiative. Instead, we recommend that available resources from the European Structural and Investment Funds, where a substantial share of the total program remains unused each year, should be rededicated. Financial support would depend on the potential for positive spillovers, continuous implementation of the reform package and the achievement of the convergence targets. This implies that only those structural reforms which are expected to have a direct and measurable impact on the two convergence indicators specified above would qualify for financial support.¹² Funds should be paid in tranches after important milestones have been achieved in order to incentivise member states to fully implement their convergence roadmaps. Restricting program eligibility to member states with below average per-capita income would ensure that resources are channelled towards those countries with the highest need to catch up and to those with limited capabilities of financing reforms themselves. Moreover, member states that are in an ESM-programme would not be eligible to apply for financial support as those member states already receive financial assistance conditional on the implementation of policy measures.

We think that this refinement of the reviewing process within the European Semester would not only meet the frequently raised criticism of Commission proposals being insufficiently tailored to individual countries and their specific circumstances. Our proposal of national convergence roadmaps also reflects the fact that ensuring progress towards convergence targets is primarily a responsibility of the individual member states, not of the EU or European institutions and bodies like the European Commission and the Eurogroup. The EU can assist, offer a productive dialogue and is willing to support successful convergence policies. More responsibility by national policy makers, together with a smaller list of targets, would focus public attention and increase both pressure and incentives for national stakeholders 'to deliver'. It would then be much more difficult to blame the EU for lack of economic convergence.

¹² Arguably, in an economically-integrated currency area such as the euro area any growth-stimulating structural reforms should have positive spillovers to other member states. Conversely, reforms without quantifiable spillover effects, for example judiciary reforms, would not qualify for financial support.

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