



Convergence and divergence in the euro area

Servaas DEROOSE

**Deputy Director-General
European Commission, DG Economic and Financial Affairs**

**21st Dubrovnik Economic Conference
8 June 2015**

Outline

- 1. What is the issue?**
- 2. Review of convergence trends in EA**
- 3. Looking ahead: EA – united in how much real divergence/heterogeneity?**

What is the issue?

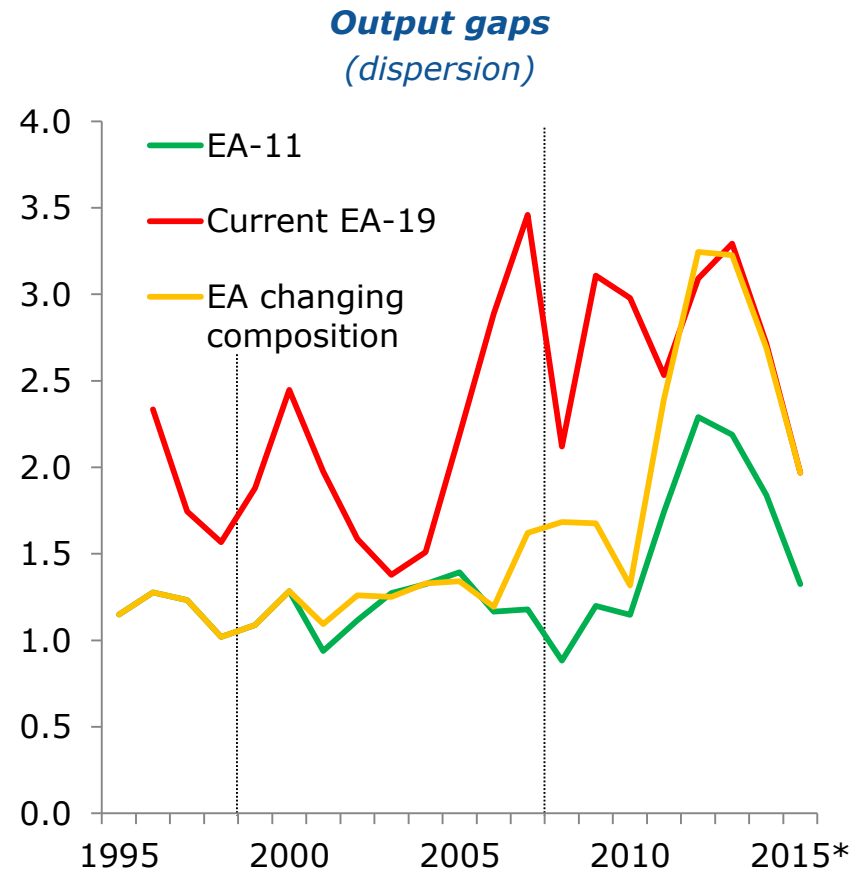
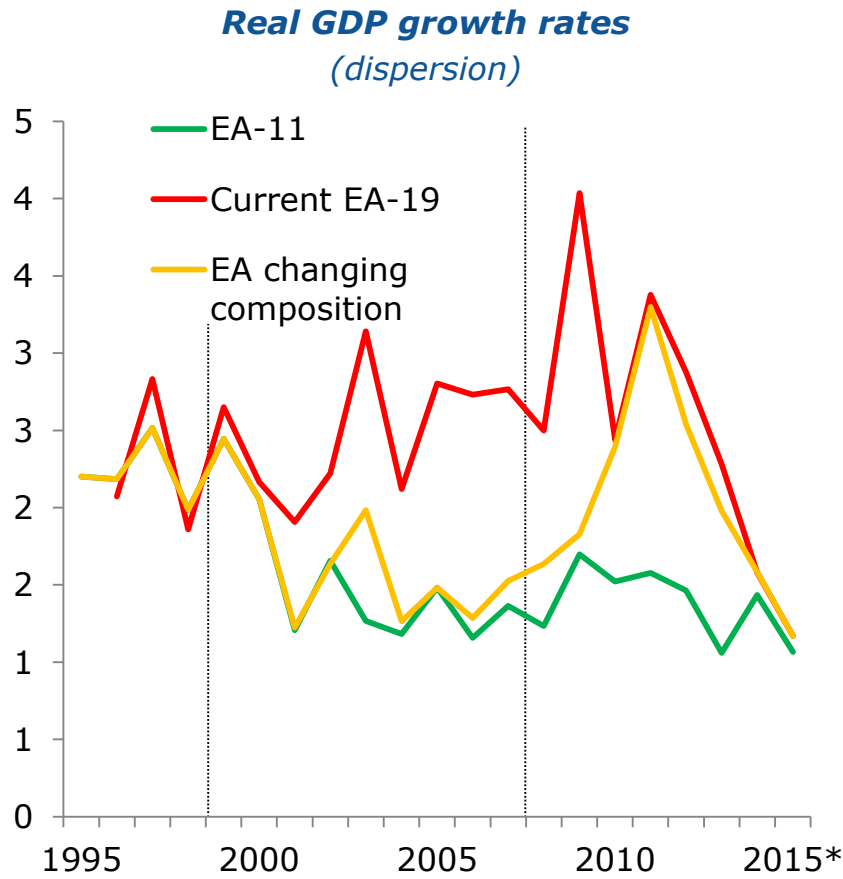
- **What type of convergence?**
 - OCA and the synchronisation of business cycles
 - Nominal convergence
 - Real convergence
- **Convergence to which frontier?**
- **Insufficient real convergence – would it be a problem?**
- **What policies/institutions to address the issue?**

EA: Towards an Optimum Currency Area (OCA)?

OCA criteria	Reached in		
	1999?	2007?	2015?
Synchronisation of business cycles ('OCA meta criterion')	Orange	Green	Orange
Trade integration	Orange	Green	Green
Inter-regional labour mobility	Red	Red	Orange
Wage flexibility	Red	Red	Orange
Mechanisms for fiscal transfers	Red	Red	Red
Financial integration	Red	Green	Orange
Political and institutional integration	Red	Red	Red

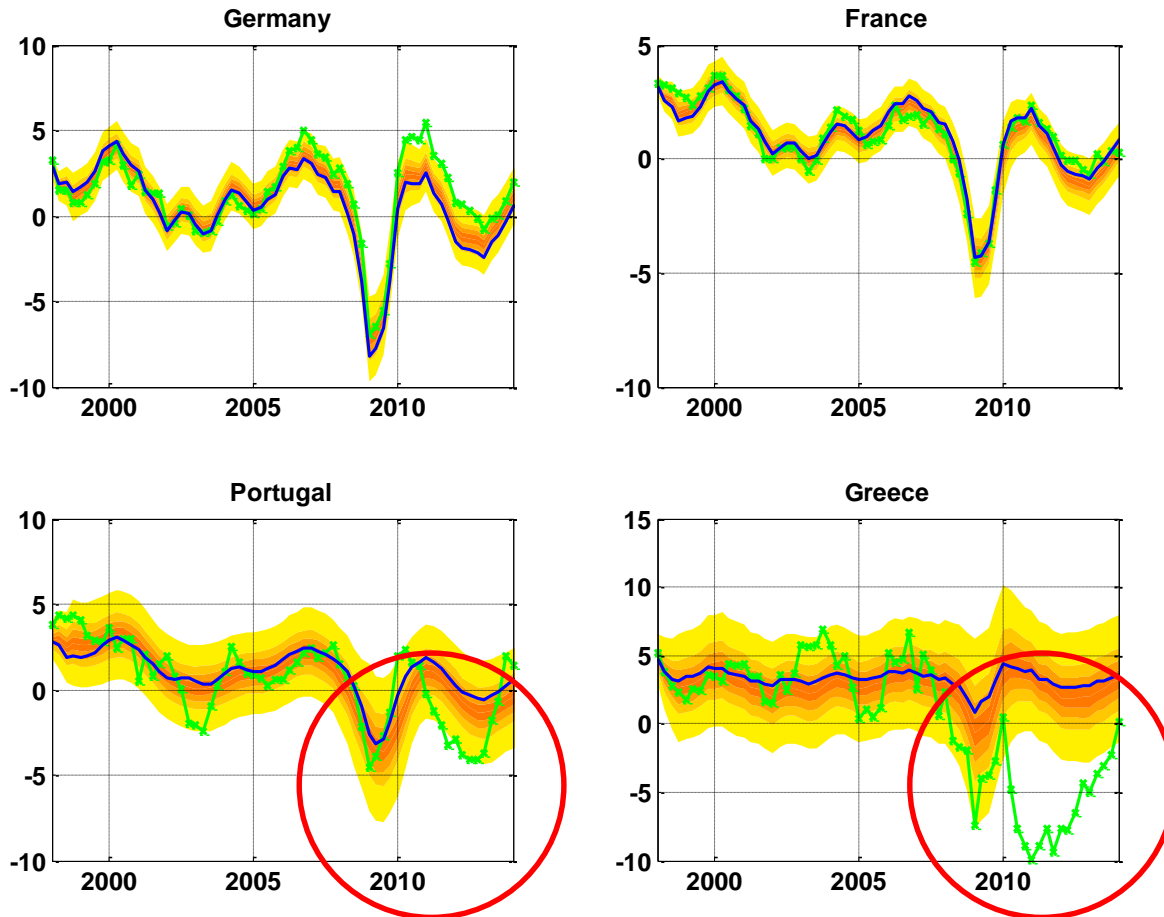
Note: Green / orange / red stand for 'fulfilled' / 'partly fulfilled' / 'not fulfilled'.

While difference in real GDP growth returned to pre-crisis levels, cyclical differences remain high in the euro area



Note: Dispersion measured as an unweighted standard deviation.

Heterogenous propagation of common shocks

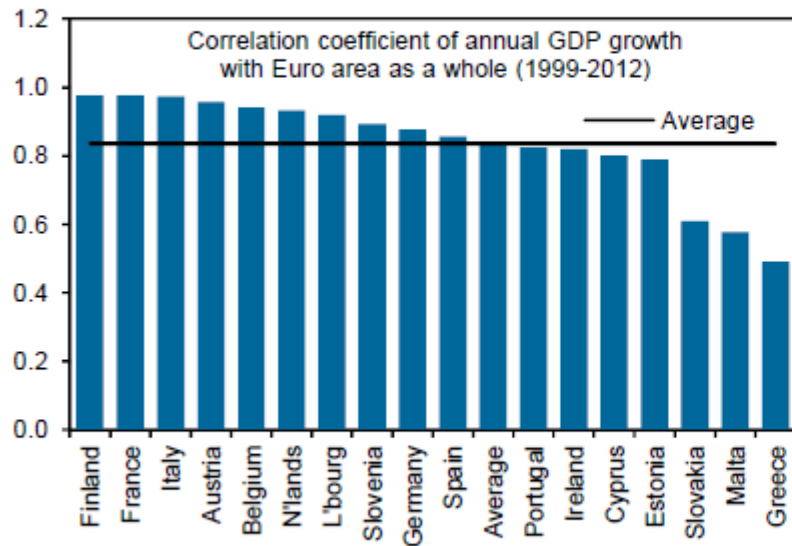


Note: Charts show the findings of a BVAR model conditional on the observed EA-12 GDP per capita. Shades of orange/yellow show the distribution of the conditional forecasts of a BVAR model in levels, excluding the lower and higher 5% quantiles. Solid blue line: the median of the distribution of the conditional forecasts in the BVAR in differences. Green line : actual values.

Source: European Commission (2015): Business cycle synchronisation in the euro area, Quarterly Report on the Euro Area, forthcoming.

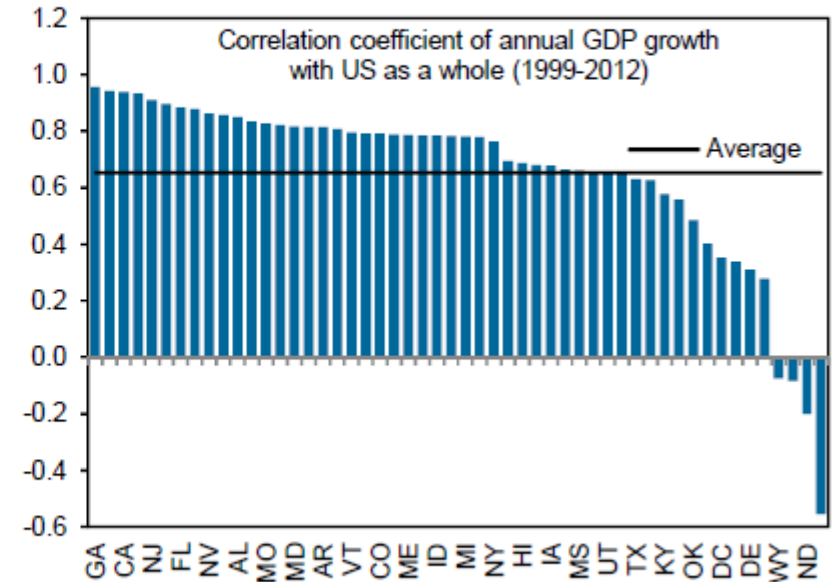
Euro area growth correlations are uneven, but no less than among US states

Exhibit 1: Correlations of growth between Euro members and the Euro area as a whole over the 1999-2012 period are higher than...



Source: Eurostat, National Statistics Offices, Goldman Sachs Global Investment Research

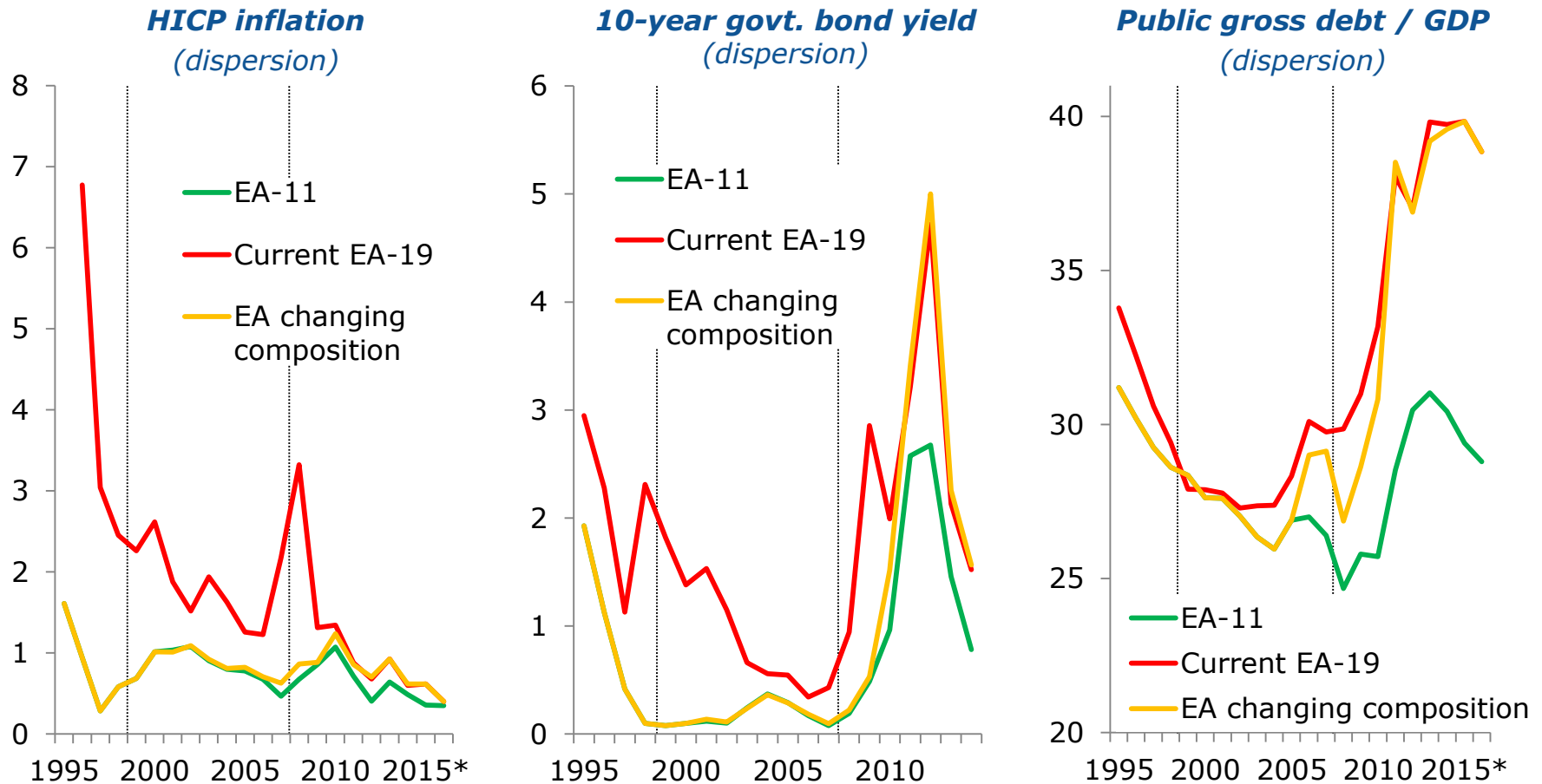
Exhibit 2: ...the correlations of growth between US states and the US as a whole over the same period



Source: US BEA, Goldman Sachs Global Investment Research

Source: Goldman Sachs (2014): What makes a monetary union work?, Global Economics Paper: 224.

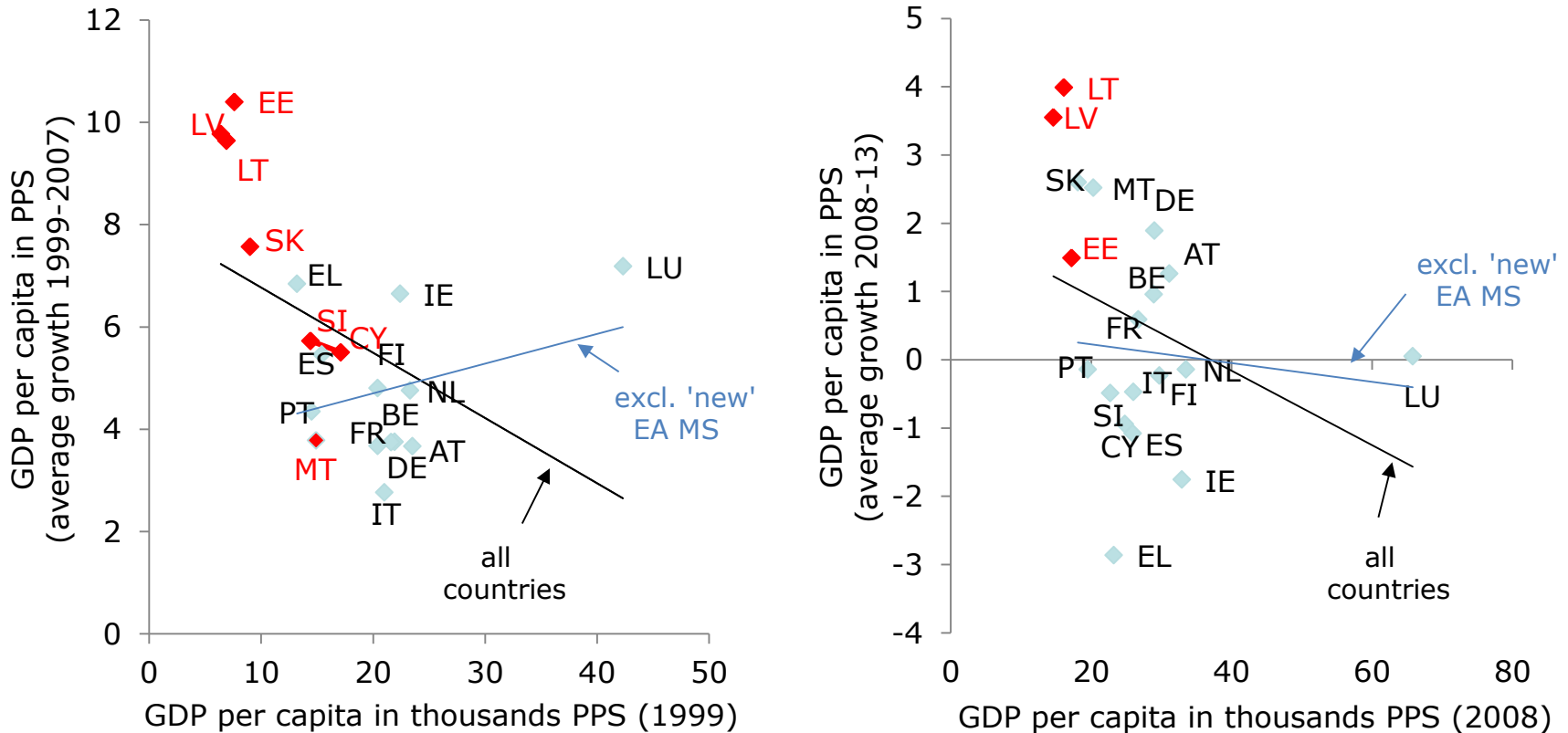
Strong nominal convergence pre-EMU; limited further progress due to weak market pressure and policy complacency



Note: Dispersion measured as an unweighted standard deviation. "*" indicates projected values. HICP inflation measured as y-o-y growth rate of the HICP index. 10-year nominal gov. bond yield. Public gross debt in line with EDP definition based on ESA 2010. Source: Ameco.

Real convergence: Catching-up process mostly driven by 'new' euro area Member States

GDP per capita (in PPS) before and after the start of the financial crisis

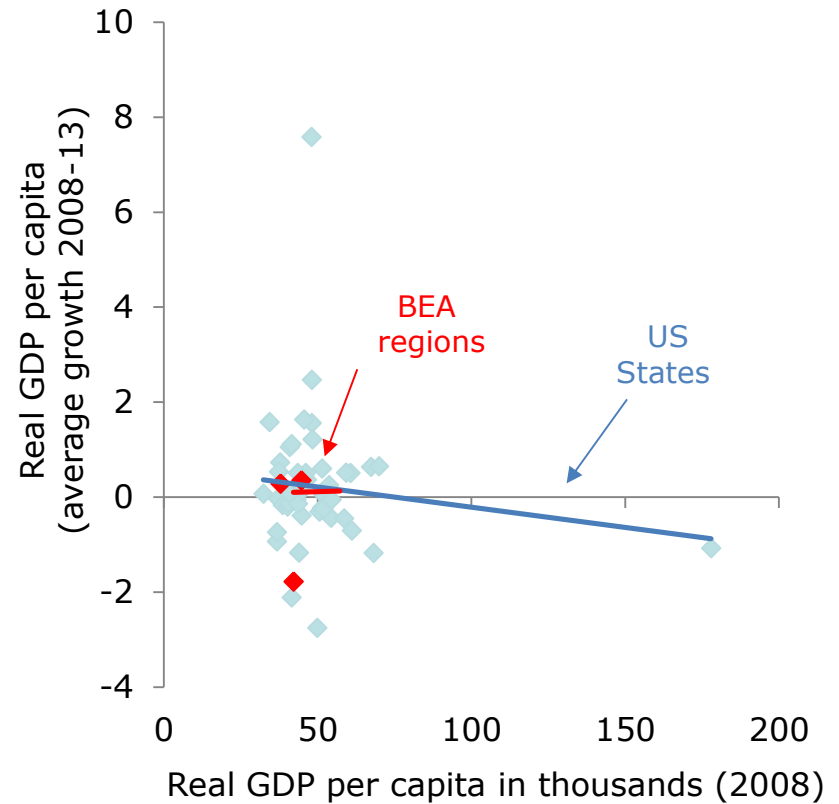
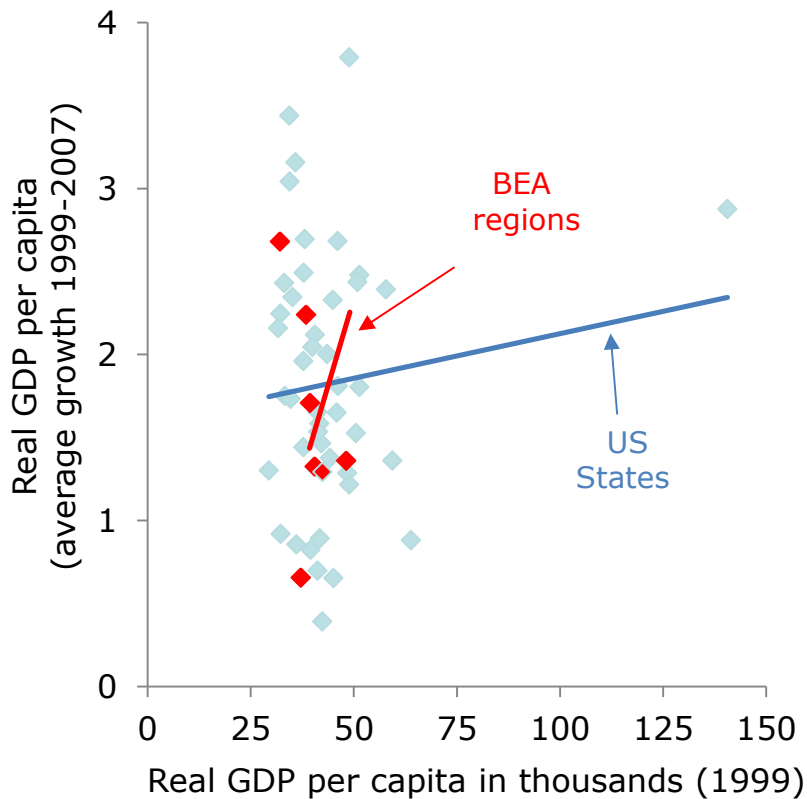


Note: Countries which were in 1999 (left chart) and in 2008 (right chart) not members of the euro area are highlighted in red. The black regression line is based on the full sample of countries, the blue one excludes the 'new' euro area Member States, which are highlighted in red.

Source: Eurostat.

No clear real convergence trend across US States / regions either

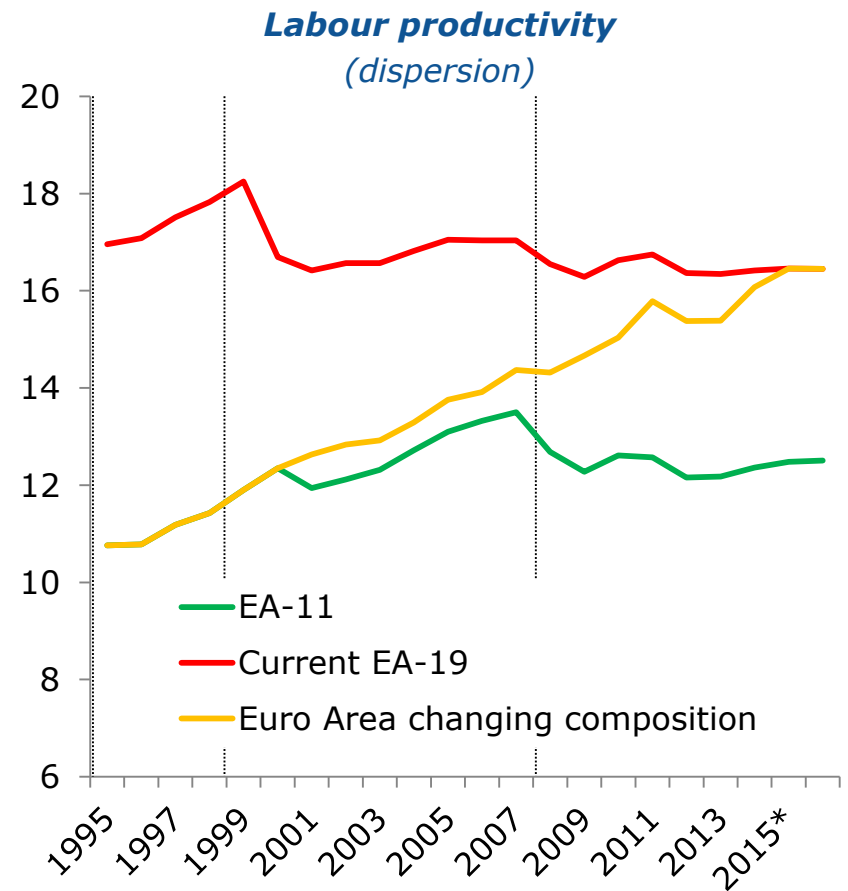
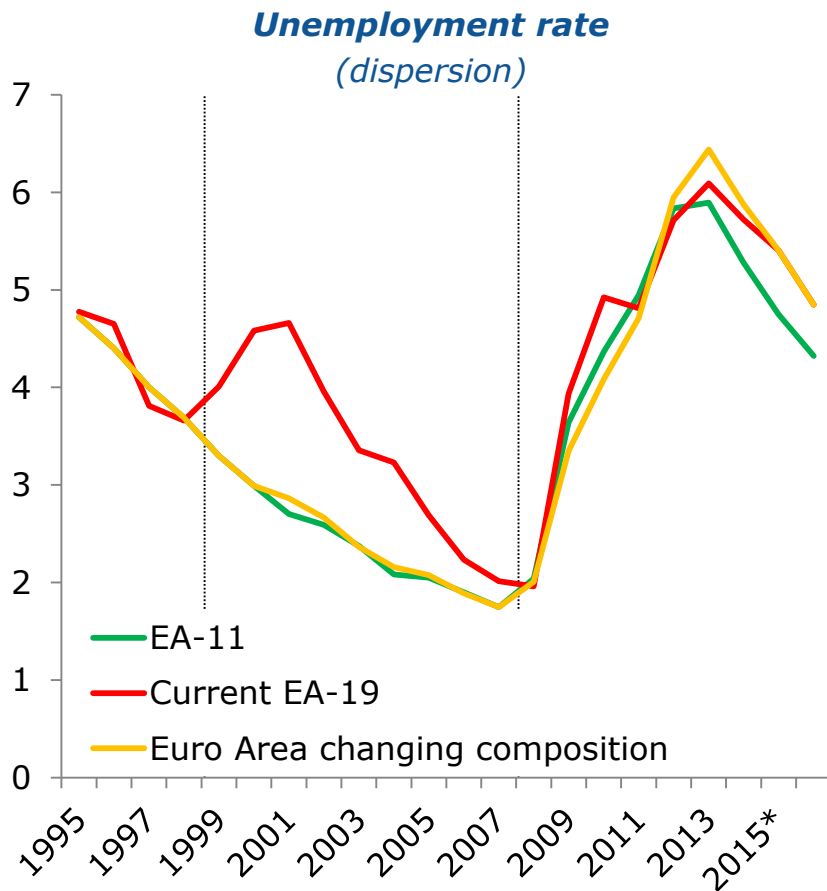
Real GDP per capita before and after the start of the financial crisis



Note: Blue entries relate to U.S. States, red entries to BEA regions. Real GDP per capita in thousand USD.

Source: U.S. Department of Commerce. Bureau of Economic Analysis (BEA).

While unemployment rates converged prior to the crisis, there is no sign of productivity convergence

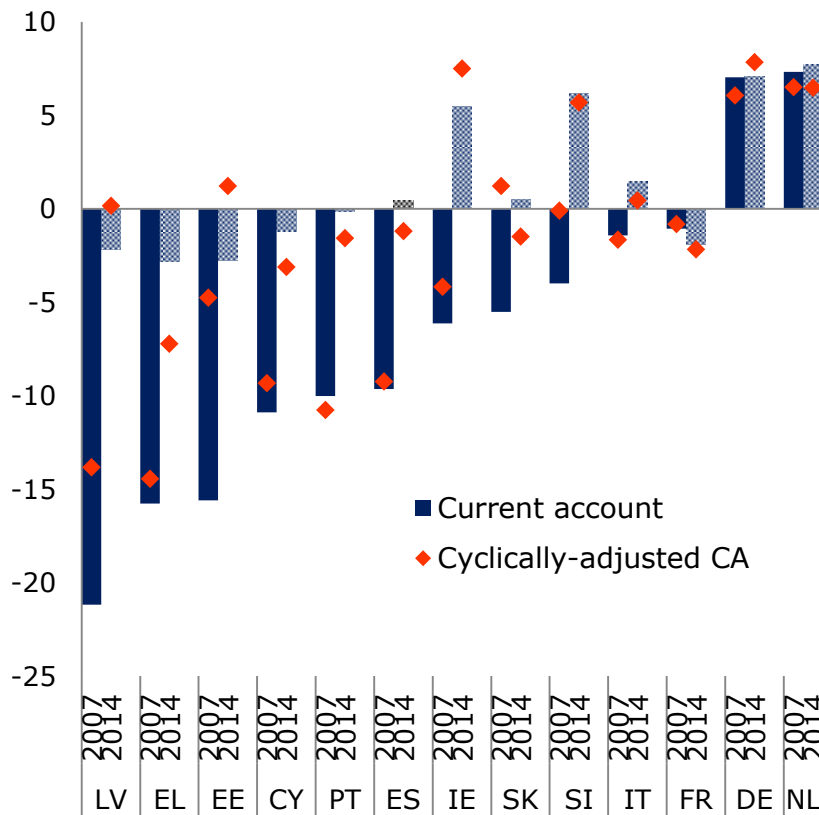


Note: Dispersion measured as an unweighted standard deviation. Total unemployment rate in line with Eurostat definition. Labour productivity measured as GDP at 2010 reference levels per hour worked. "*" indicates projected values.

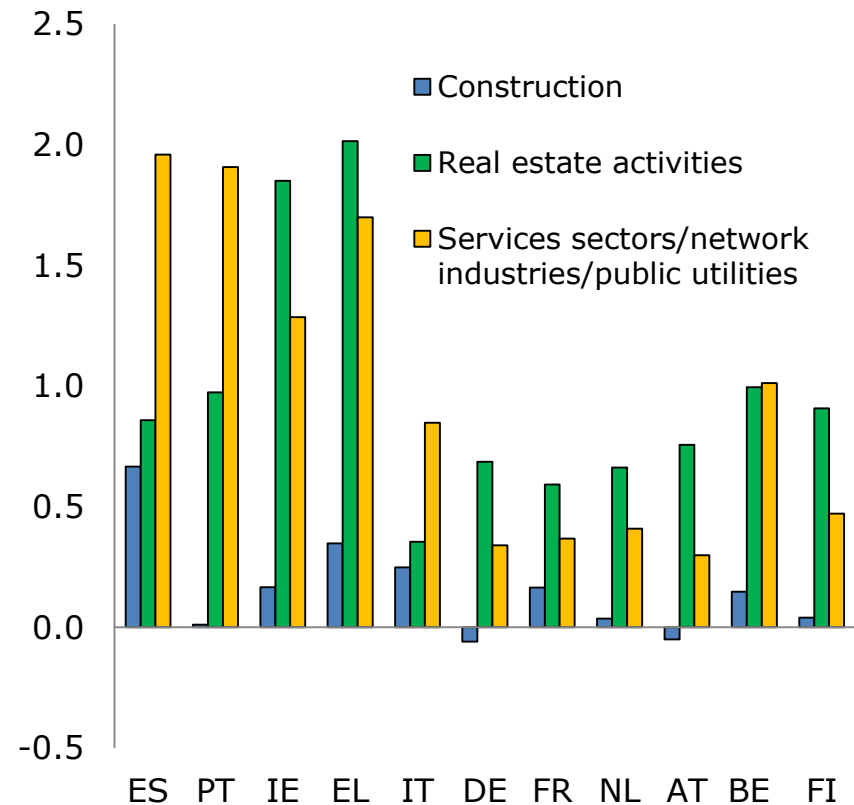
Source: Ameco.

After the launch of EMU, capital flowed towards lower productivity economies, but largely to less productive sectors

Actual current account levels
(2007 and 2014, % of GDP)



Decomposition of growth in capital services by sector
(avg. annual contributions 1999-07)

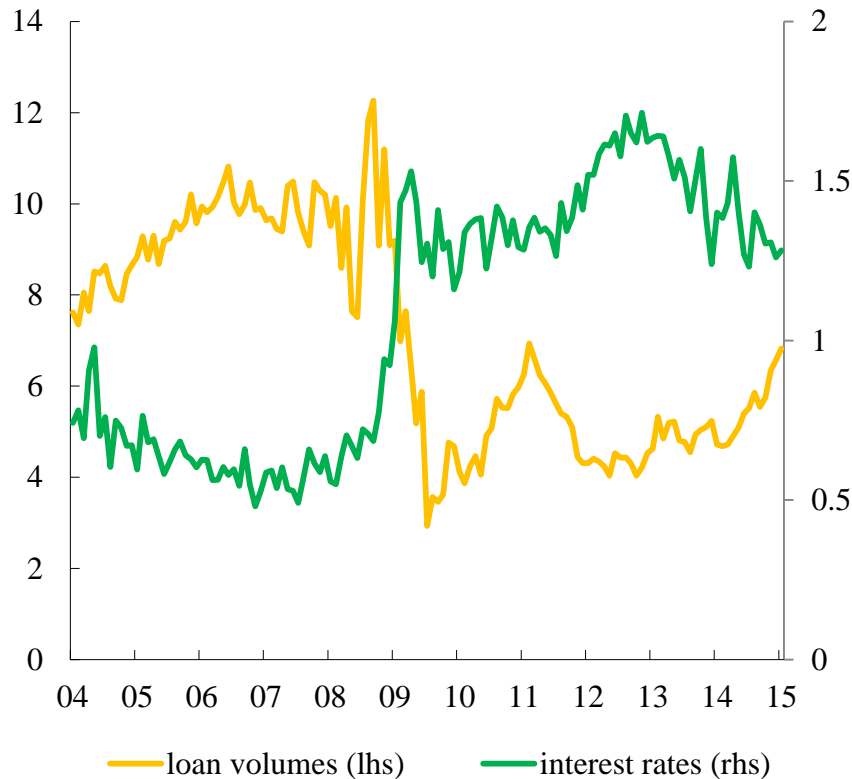


Source: European Commission (2013): *External rebalancing in the euro area: progress made and what remains to be*, Quarterly Report on the Euro Area, 13(4), p. 30.

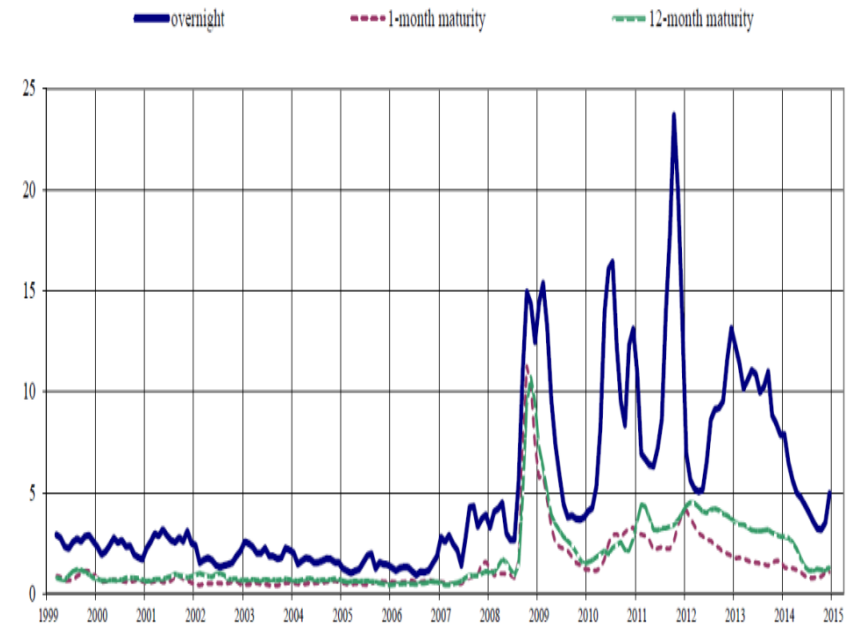
Source: European Commission (2013): *Catching-up processes in the euro area*, Quarterly Report on the Euro Area, 12(1), p. 10.

Financial fragmentation hampered the adjustment process, but has declined in the recent years

Interest rates on loans to non-financial corporations (dispersion)



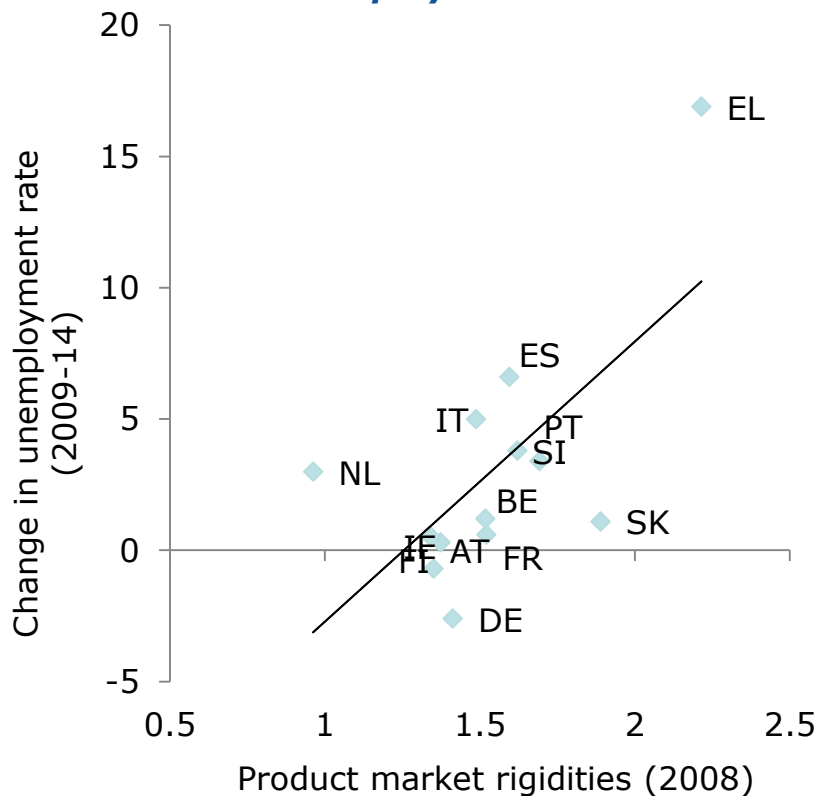
Cross-country dispersion of unsecured interbank lending rates, by maturity (b.p.)



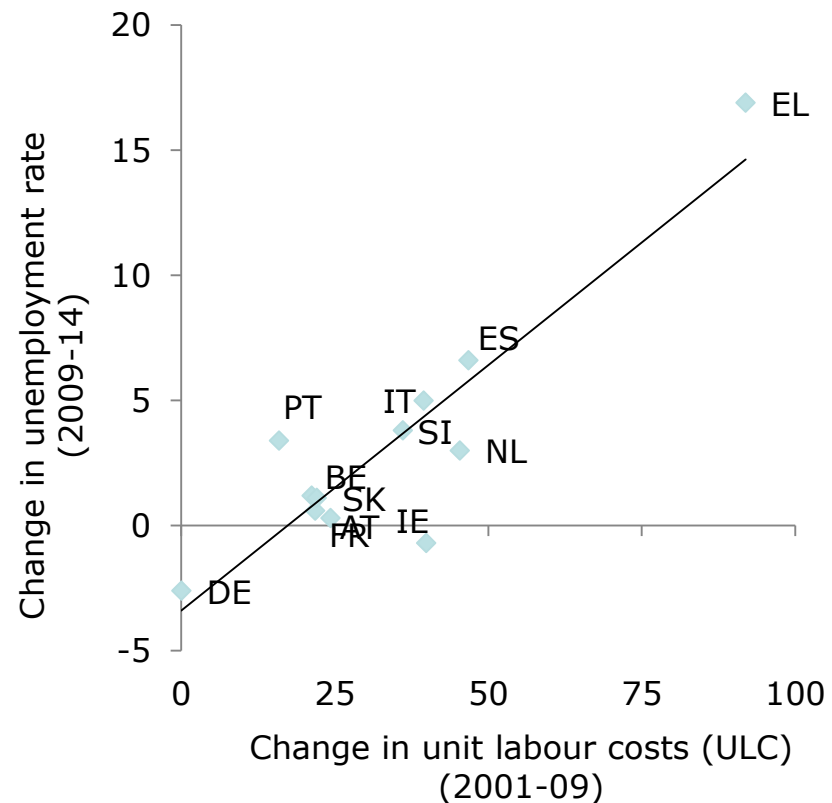
Source: ECB.

Labour and product market rigidities contributed to the non-sustainable real convergence process

Product market rigidities and unemployment rate



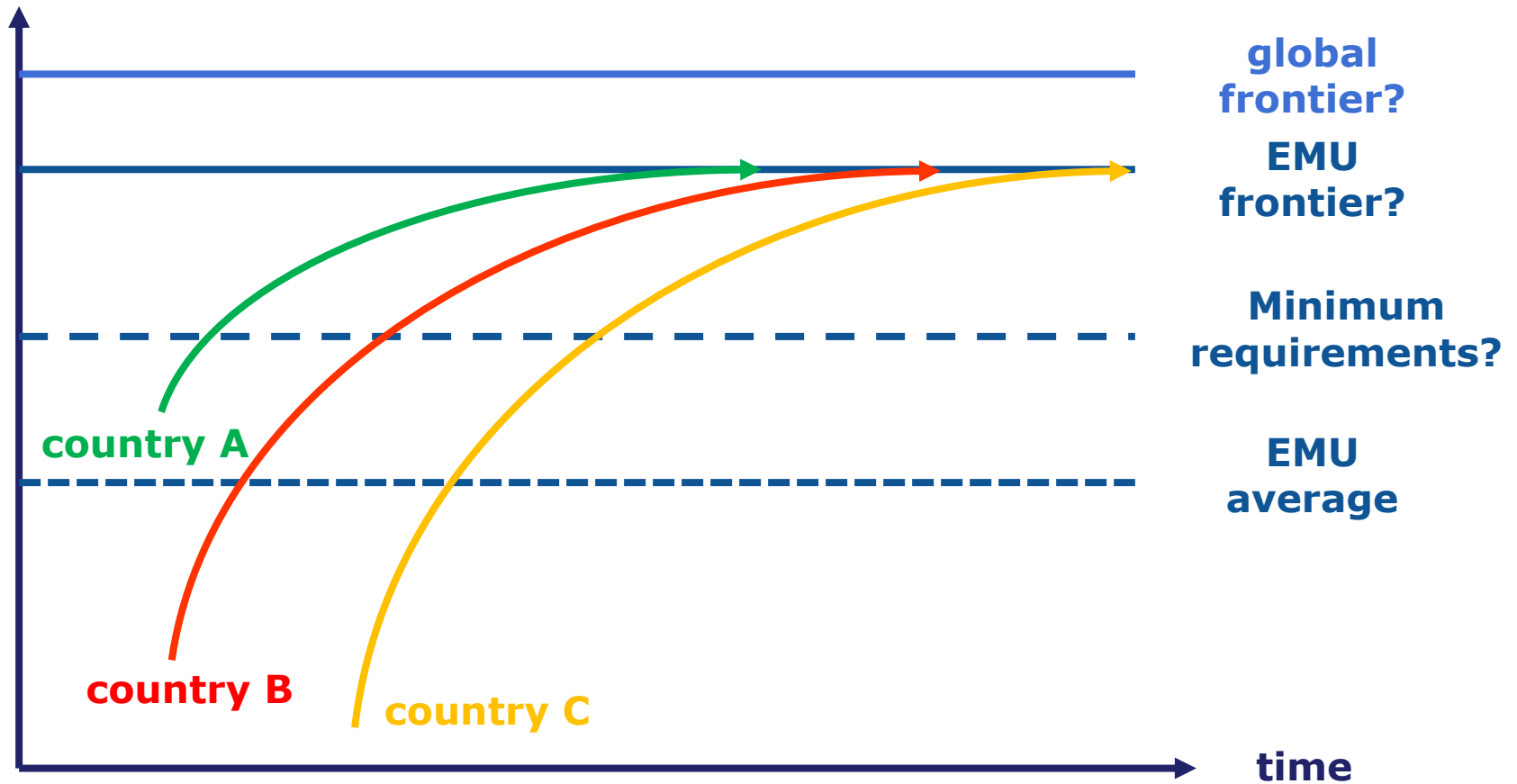
Changes in ULC and unemployment rate



Source: All indicators taken from Ameco except for the product market rigidity measure, which comes from the OECD.

Convergence to which frontier?

Indicator of
convergence



Insufficient real convergence: a problem?

Economic argument

Heterogeneity can be costly, but it can be overcome by appropriate adjustment mechanisms

Reduce heterogeneity by reinforcing single market integration, risk-sharing financial market integration and cross-border labour mobility, whilst allowing for system competition and national idiosyncracies

Ensure adequate **adjustment mechanisms** which make heterogeneous economies resilient to shocks (asymmetric/common) and respond effectively to internal and external imbalances

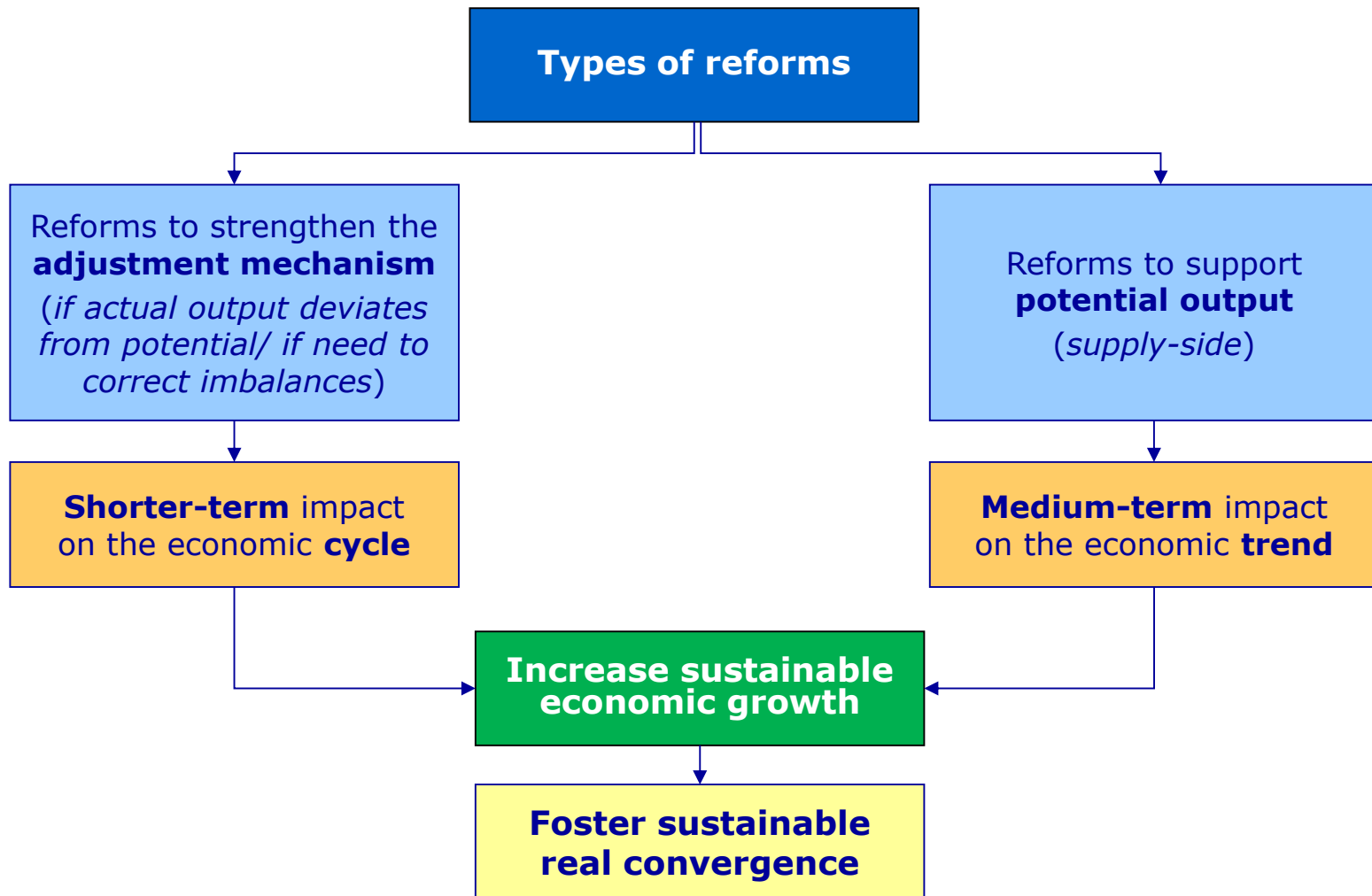
Political- economy argument

A monetary union of heterogeneous economies depends on political cohesion and identity

Monetary unions with heterogeneous economies can be sustainable as long as a **certain degree of political cohesion and identity** exists, e.g. US, Belgium, Germany

If political cohesion is defined in terms of **convergence of economic welfare levels and in the absence of large transfers**, the sustainability of heterogeneous monetary unions is less clear.

How to strengthen efficient functioning of EMU?



EMU policy priorities have evolved over time

	Adjustment mechanism	Potential output (supply side)
EMU in 1999	Limited emphasis	Minimum harmonisation approach <ul style="list-style-type: none"> • Single Market (<i>acquis communautaire</i>) • Exceptions: (direct) taxation, labour and social compact, education, health
Institutional reforms in EMU since 2011	Macroeconomic Imbalance Procedure (MIP) <ul style="list-style-type: none"> • Avoid excessive internal and external imbalances • Still allows for a variety of country-specific settings Banking and Capital Market Union	Limited emphasis

Which policy priorities to make EMU work?

	Adjustment mechanism	Potential output (supply side)
Future EMU	<ul style="list-style-type: none">• Strengthen national adjustment and shock-absorption capacities by pursuing rigorous reforms in product and labour markets, including removing barriers to labour mobility• Promote sustainable financial integration and reduce fragmentation by completing Banking Union• Diversify corporate funding sources by implementing Capital Market Union• Assure full play of strong fiscal automatic stabilisers by creating national fiscal buffers and adequate aggregate EA fiscal stance, aligned with the monetary stance (policy mix)• Prevent harmful imbalances by consistent monitoring and corrective action (MIP/EIP)	<ul style="list-style-type: none">• Prioritise the removal of medium-term bottlenecks to potential growth in the European Semester process• Exploit the full potential of the Single Market as a key instrument to foster growth and convergence, with a focus on services and the digital economy• Boost productive investment to support the sustainability of long-term growth• Re-kindle catching-up convergence with a focus on Member States where catching-up has stalled

Which governance for genuine EMU?

Deepening EMU governance

Future EMU

- **Centralise or de-centralise EMU governance?**
 - Establish an EMU Treasury/Debt Management Office, with EA-wide taxing and borrowing powers?
 - Or, de-centralise fiscal responsibility by re-instating the no-bailout clause, in conjunction with a EA sovereign insolvency framework?
- **Move from a rules-based to an institutions-based approach?**
 - Develop institutions with appropriate mandates within which they can act flexibly?
- **Develop a limited EA fiscal capacity** in the form of EU Unemployment Insurance scheme or EA Emergency Facility?
- **Introduce systemic stress-testing of national security systems** to establish adequate floors and minimum efficiency standards for social safety nets?
- **Create independent Productivity Councils** at the national level to monitor trends in competitiveness , productivity and convergence?
- **Monitor and benchmark national shock absorption and adjustment capacities?**
- **Establish minimum requirements for structural reforms?**
 - Labour markets, e.g. full portability of pension rights and enhanced recognition of qualifications
 - Product markets, e.g. strengthening national competition authorities