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Convergence and Divergence in the European Monetary Union

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Abstract

After the outbreak of the global financial crisis in 2008, macroeconomic disequilibria began to emerge and to grow within the eurozone. The original goal of real convergence which characterized and strengthened the European integration process has since been violated with increasing frequency, thus producing disappointment and the first signs of a legitimation crisis within the European Union. The convergence process which for a long time united the members of the European Union and later of the eurozone has recently been superseded increasingly by a divergence process which endangers the on-going European integration process. This paper describes and analyses this process, highlights new empirical evidence and draws some politico-economic implications.

Keywords: *convergence, divergence, EMU*

1. Convergence as an original goal of European integration

Convergence was an original goal of the European integration process; initially a hope, in time it became an expectation of the less wealthy member states and a demand from the acceding countries, respectively. Thus, it was a major goal of the European integration process from the beginning to reach an adjustment in institutions and in GNP per capita level among its member states. This was formulated in the preamble to the EC Treaty of 1957 as the aim to "strengthen the unity of [the] economies [of the member states] and to ensure their harmonious development by reducing the differences existing between the various regions and the backwardness of the less favoured". Later, in the preamble to the EU Treaty of 1992, the goal articulated was to "achieve the strengthening and the convergence of their economies". This expected development seemed to have the potential for manifestation in reality for a time, at least until the introduction of the monetary union and the advent of the "euro crisis" in the course of the global financial crisis. In the event it seems that through the construction of the monetary union a potential for destabilization has arisen that only becomes manifest when bigger shocks occur. In the beginning, optimistic expectations regarding a rapid convergence of the periphery countries still dominated (see Blanchard and Giavazzi 2002); these, fuelled by the interest rate adjustments in the first decade of this century, led to an imprudent minimum reform policy (to avoid the costs and pain of more fundamental reforms) in these countries. However, a sudden increase in divergent tendencies has occurred during the past five years leading to great disillusionment in the eurozone.

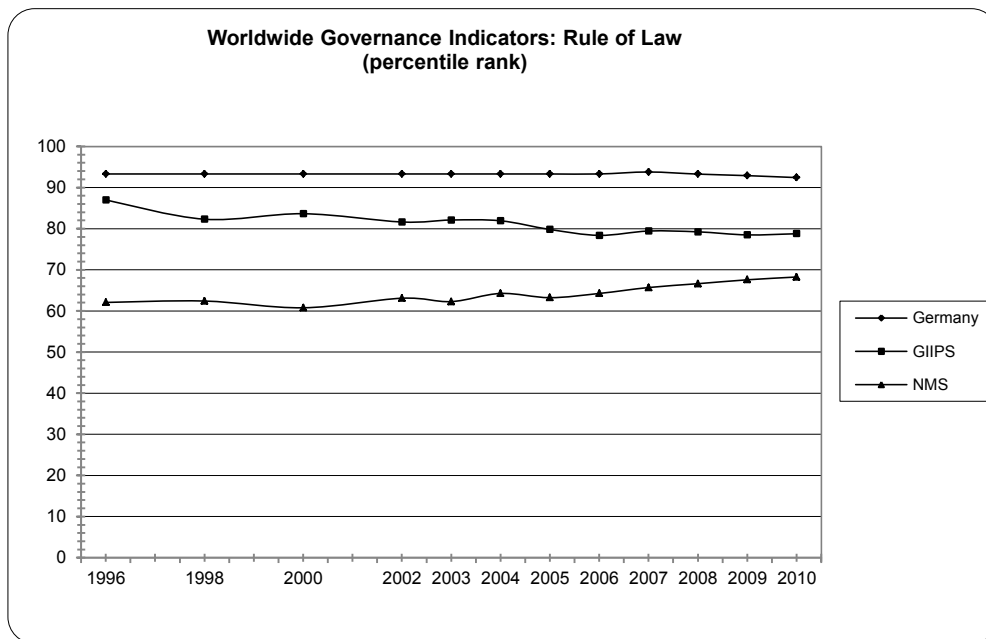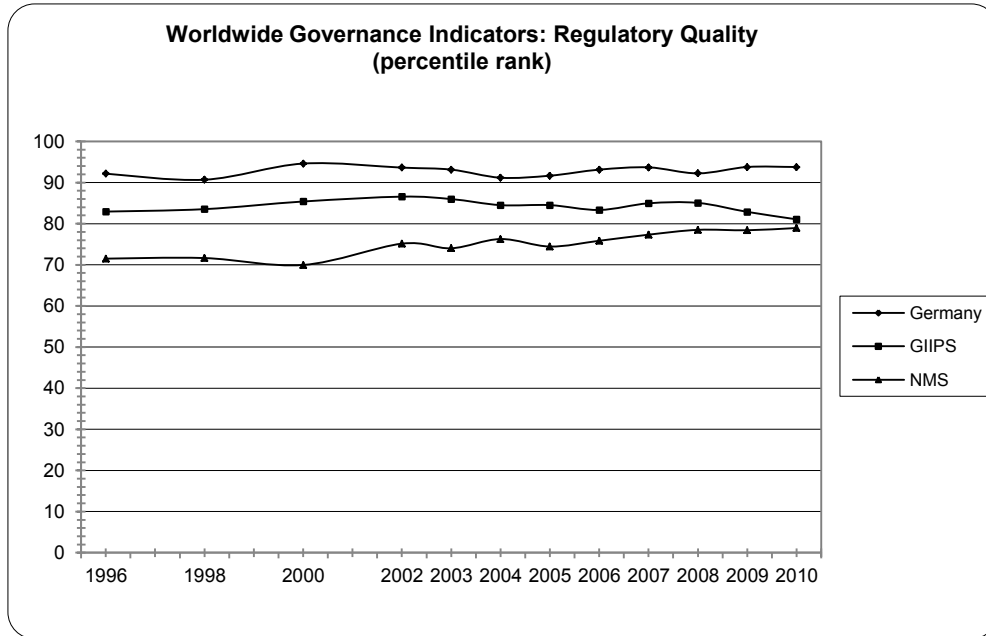## 2. Empirical results on convergence and divergence in the eurozone

Thus far, empirical studies have shown a non-linear tendency towards convergence. As a general trend, institutional–structural convergence could only be observed before accession to the European Monetary Union (EMU). After accession to the EMU, institutional–structural convergence appears to have slowed down or even turned to divergence in some countries (particularly in those with emerging markets). However, these studies have also shown that there has been a clear alignment of GNI per capita and the fulfilling of some Maastricht criteria in a majority of the E(M)U member countries. In contrast, there was real divergence with respect to institutional and structural alignment in some of the GIIPS countries (Greece, Ireland, Italy, Portugal, Spain) after accession to the EMU. Interpreted in the context of optimum currency area (OCA) theory, this indicates that the GNI per capita convergence tendency is also likely not to be sustainable (in the sense of an endogenous convergence process). The hitherto alignment of GNI per capita (and the fulfilling of some Maastricht convergence criteria) seems to have been possible only against the background of unconditional financial aid and non-credible commitments.

This has partly been observed in previous studies (see, e.g. Christodoulakis 2009, Marelli and Signorelli 2010, Raileanu Szeles 2011)[1] and has received further support in recent studies (Wagner 2013, Breitkreuz and Wagner 2013).

Figure 1 Some Governance Indicators

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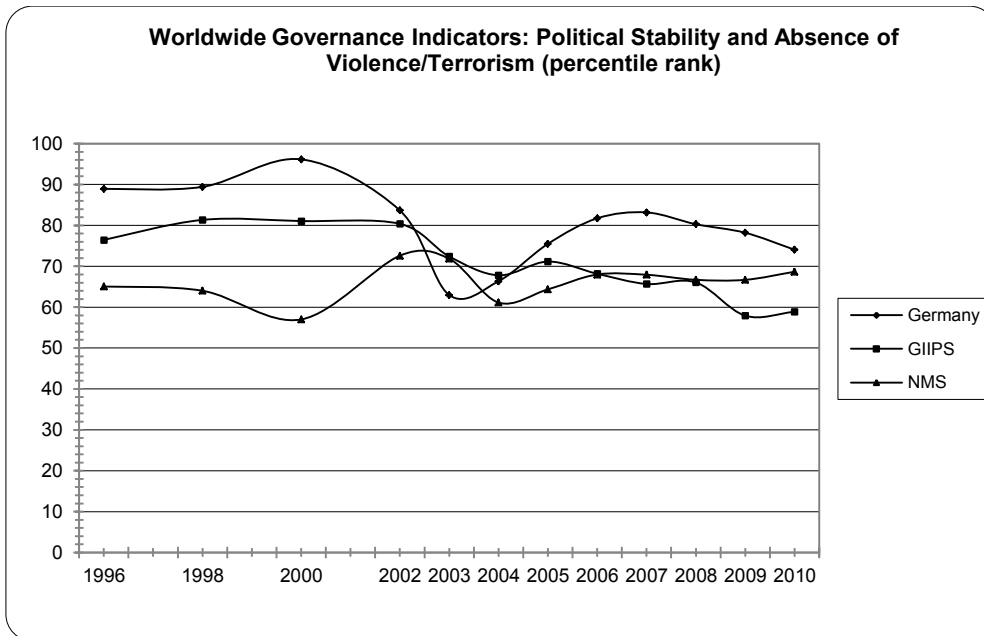
[1] For a brief description of these studies see Wagner (2013).

**Worldwide Governance Indicators: Regulatory Quality
(percentile rank)**

**Worldwide Governance Indicators: Rule of Law
(percentile rank)**

Datasource: World Bank, Worldwide Governance Indicators
NMS = New Member States (= the East European countries which acceded the European Union (EU) in 2003)
Figure 1 is taken from Wagner (2013)

In a dynamic panel data model, Breitkreuz and Wagner (2013) investigate the speed of institutional convergence induced by European integration. They find an overall positive effect of a prospective EU membership, and a smaller effect of the preparation for the euro. However they find no indication for institutional convergence or divergence as soon as Member States introduce the euro.

3. Disequilibria and international policy coordination in the eurozone

The reason for the recent GNI per capita divergence and institutional divergence lies, in part at least, in the existence of continuing macroeconomic disequilibria within the eurozone. Apart from growth divergence, we have recently seen significant differences in debt ratios, reputation levels and interest rates across the member countries of the eurozone (see Table 1).

Table 1: „Imbalances" within the Euro area 2011

	GDP growth	Unemployment rate	Government debt	Fiscal deficit	Long-term interest rate	Current account balance
Belgium	1,8	7,2	97,8	-3,7	4,23	-1,4
	(-1,2)	*(1,3)*	*(17,3)*	*(-2,9)*	*(1,6)*	*(-7,1)*
Germany	3,0	5,9	80,5	-0,8	2,61	5,7
	(0,0)	*(0,0)*	*(0,0)*	*(0,0)*	*(0,0)*	*(0,0)*
Estonia	8,3	12,5	6,1	1,1	n.a.*	2,1
	(5,3)	*(6,6)*	*(-74,4)*	*(1,9)*		*(-3,6)*
Ireland	1,4	14,7	106,4	-13,4	9,6	1,1
	(-1,6)	*(8,8)*	*(25,9)*	*(-12,6)*	*(7,0)*	*(-4,6)*
Greece	-7,1	17,7	170,6	-9,4	15,75	-9,9
	(-10,1)	*(11,8)*	*(90,1)*	*(-8,6)*	*(13,1)*	*(-15,6)*
Spain	0,4	21,7	69,3	-9,4	5,44	-3,5
	(-2,6)	*(15,8)*	*(-11,2)*	*(-8,6)*	*(2,8)*	*(-9,2)*
France	1,7	9,6	86,0	-5,2	3,32	-2,0
	(-1,3)	*(3,7)*	*(5,5)*	*(-4,4)*	*(0,7)*	*(-7,7)*
Italy	0,4	8,4	120,8	-3,9	5,42	-3,1
	(-2,6)	*(2,5)*	*(40,3)*	*(-3,1)*	*(2,8)*	*(-8,8)*
Cyprus	0,5	7,9	71,1	-6,3	5,79	-4,7
	(-2,5)	*(2,0)*	*(-9,4)*	*(-5,5)*	*(3,2)*	*(-10,4)*
Luxembourg	1,7	4,8	18,3	-0,3	2,92	7,1
	(-1,3)	*(-1,1)*	*(-62,2)*	*(0,5)*	*(0,3)*	*(1,4)*
Malta	1,7	6,5	70,3	-2,7	4,49	-0,3
	(-1,3)	*(0,6)*	*(-10,2)*	*(-1,9)*	*(1,9)*	*(-6,0)*
Netherlands	1,0	4,4	65,5	-4,5	2,99	9,7
	(-2,0)	*(-1,5)*	*(-15,0)*	*(-3,7)*	*(0,4)*	*(4,0)*
Austria	2,7	4,2	72,4	-2,5	3,32	0,6
	(-0,3)	*(-1,7)*	*(-8,1)*	*(-1,7)*	*(0,7)*	*(-5,1)*
Portugal	-1,6	12,9	108,0	-4,4	10,24	-7,0
	(-4,6)	*(7,0)*	*(27,5)*	*(-3,6)*	*(7,6)*	*(-12,7)*
Slovenia	0,6	8,2	46,9	-6,4	4,97	0,0
	(-2,4)	*(2,3)*	*(-33,6)*	*(-5,6)*	*(2,4)*	*(-5,7)*
Slovakia	3,2	13,6	43,3	-4,9	4,45	-2,1
	(0,2)	*(7,7)*	*(-37,2)*	*(-4,1)*	*(1,8)*	*(-7,8)*
Finland	2,8	7,8	49,0	-0,6	3,01	-1,6
	(-0,2)	*(1,9)*	*(-31,5)*	*(0,2)*	*(0,4)*	*(-7,3)*

Source: Eurostat. Deviation from Germany in parentheses.

*There are no Estonian sovereign debt securities that comply with the definition of long-term interest rates for convergence purposes. No suitable proxy indicator has been identified. (ECB)

How did these "disequilibria", in particular the debt crisis in the eurozone, arise? The trigger was that today's "crisis countries" in the eurozone (the GIIPS countries in particular) profited in the beginning from the entrance into the eurozone in that they could enjoy strong interest rate reductions in the course of the levelling of (country-specific bankruptcy) risk premiums within the eurozone. They used these interest rate reductions mainly to expand their consumption and other less productive investment spending (particularly in the housing sector). This, for a while, produced an economic boom and induced the governments and enterprises of these countries to accept generous wage increases and welfare gifts. The consequence of such behaviour was a decline in international competitiveness, the negative effects of which were manifested after the outbreak of the global financial crisis. In order to save the banking system in these countries, government debt had to be increased significantly. Simultaneously, the interest burden again rose drastically due to the fact that the risk premiums (spreads) for government bonds increased, so that these countries were eventually brought to the brink of insolvency. This was used by finance investors as an opportunity to speculate against the continuance of these countries in the eurozone (supported by the grading of these countries by the rating agencies). As a result, however, their interest burden increased still further. This led to the actual insolvency of some of these countries. The formal insolvency of these countries could only be avoided by huge warrants from the other eurozone member countries as well as by financial aid from the International Monetary Fund (IMF) and the European Central Bank (ECB). It was important that the private markets from the outset did not believe in the binding nature of the no bailout clause, nor in the bite of the Stability and Growth Pact. This led to the levelling of government bond spreads from 1995 to 2008 (see Figure 2), reflecting the mistrust of the binding nature of the no bailout clause.

Figure 2 EMU convergence criterion bond yield spreads vis-à-vis Germany (EA12)
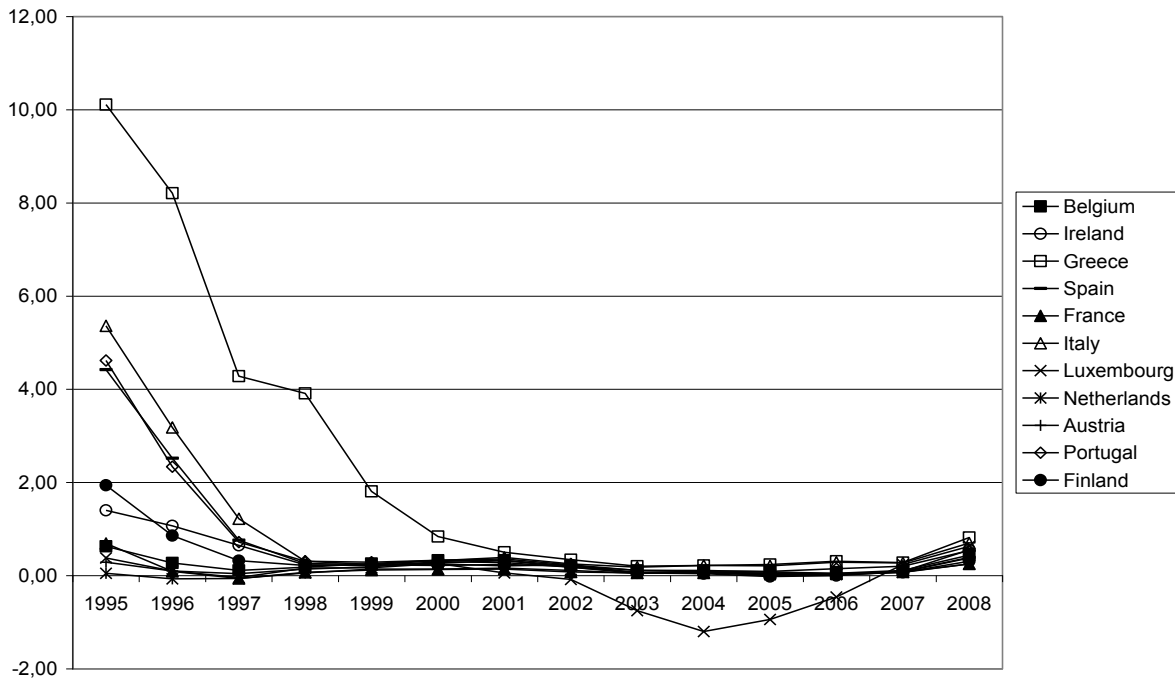
Data source: Eurostat

Figure 2, which is taken from Wagner (2013), shows that the spreads of government bonds among the euro area member countries began to level out from the mid-1990s. The reason for this early levelling was the so-called "halo" effect, i.e. the effect of the early announcement regarding the participating countries.

But it also reflected doubts concerning the endogeneity hypothesis. This endogeneity hypothesis claimed that due to the mere fact that a country enters the euro area, this country would be encouraged or pressured to adjust its institutions closer to those of the incumbents. Consequently, the process of entry and membership into a monetary union should produce the incentive to conduct structural reforms.

This was and is definitely the case after entry into the EU, when the new EU members intend to join the euro area (this is what they are expected to do). To prepare for this, they have a strong incentive to reform their structures and align their institutions. However, this incentive reduces or even stops after these countries enter the euro area, as new EMU members cannot be forced out. Hence, the expectation that with the early inclusion of emerging market economies (of the 1990s) like Greece, Portugal or Spain into the EMU these countries would institutionally and structurally converge more rapidly towards the core euro area proved wrong… For instance, entry into the EMU does not appear to have sped up either labor market reforms or governance reforms in these countries.[2] (Wagner 2013, p. 208)

Which dangers are associated with this apparent non-occurrence of a sustained endogenous convergence process in the eurozone? The biggest danger is the breakdown of the EMU. This would stop the – decades long – implementation of the European integration process and endanger the associated convergence and peace process in Europe. Even the isolation and exclusion of single member countries would produce new political instabilities in Europe and might lead to contagious effects for other member countries. This is the reason that the other eurozone members have so far undertaken costly financial strains in order to avoid such a worst case scenario.

Which policy strategies are available to minimize these dangers? The central message of the recent euro crisis is that the disequilibria, if they are first allowed to grow excessively, become impossible to solve on a national basis but can only be addressed commonly through international policy coordination. This is partly due to the loss of the currency devaluation instrument. That is, in the case of the EMU, 17 countries must – under serious time pressure – agree upon a solution which is acceptable to all members in the hope that this solution can stabilize the euro system.

The policy alternatives currently available to stabilize the euro system can briefly be described as follows:
    A Continuous or repeated financial aid
    B Hard debt restructuring in some crisis countries

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[2] In particular, the "New OCA Theory" emphasized the endogeneity of cyclical correlations with respect to the decision to join a monetary union (cf. Frankel and Rose 1997; Frankel 2005; see also de Grauwe and
Mongelli 2005). However, others have emphasized the endogeneity of structural and institutional convergence in a broader sense (see Wagner 2012).

C Exit or "declassing" of single countries from a currency union
D Soft debt restructuring (with voluntary contributions from private finance investors)

Alternative A gives the political decision agents more time (to conduct reforms), but does not solve the problem of over-indebtedness (or insolvency). This extends (in the case of strong over-indebtedness) also to alternative D. Theoretically, alternatives B and C could solve the problem of over-indebtedness transitionally, but only if they are accompanied by comprehensive, rapid reform steps in the crisis countries. In other words, just because only a common solution (international policy coordination) can stabilize the euro system does not mean that the individual countries in crisis do not have to implement profound and painful national reforms. In particular, this is about austerity measures and even more importantly about institutional reforms with regard to improving conditions in terms of location and raising international competitiveness. These reforms can be implemented by the respective countries voluntarily or under pressure from those which provide assistance (for example, via the conditionalities of IMF lending).

Regarding the above policy alternatives, it has to be considered that any alternative is associated with partly incalculable costs,[3] which have to be contrasted with the likely benefits. These costs include above all negative incentive effects, such as the triggering of moral-hazard behaviour, or contagious effects (spillovers) to other countries. Such fears are at the root of, for example, the refusal of policy alternatives B and C by the ECB.

4. Politico-economic considerations

In Wagner (2013), I found that, over a certain period of time (before and after entry into the EMU), convergence occurred, as indeed empirical evidence has proved. However, as soon as a large-scale global crisis arrived, convergence stopped and instead divergence occurred. The question is how long this divergence process will continue. As argued in the paper, the reason for this reversal was, among other things, construction failures within the EMU.

(T)hese construction failures meant that sanction mechanisms regarding violations were never anticipated to be strong. Therefore, private markets did not expect the "no bailout" to be binding, and this resulted in a leveling of interest rates (due to a reduction of spreads) among heterogeneous member countries before and after the date of entry into the EMU. Lower interest rates (cheap credit) were used by some of the emerging new member countries to raise their consumption expenditure and to produce excessive credit booms, thus creating inflation pressures and an asset price bubble. When this bubble burst, these countries were left with significant debts and deficits (together with rising interest rates due to again-rising spreads, as soon as the financial markets recognized that an easy bailout was not possible). This eventually produced economic divergence *and* political tensions between the poorer emerging and the richer member countries with growing bailout demands against richer member countries; thus, the legitimacy of the EMU was also reduced in donor countries. (Wagner 2013, p. 214)

This construction failure implies an erroneous incentive mechanism for accession countries, meaning that before entrance into E(M)U the incentives to follow the rules are strong, whereas

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[3] This is due to the fact that here we have a hitherto very rare event (a so-called "black swan"), for which there is almost no past experience on which we could build.

after entrance the incentive to undertake further reform slows down. This has been strengthened by the globalization or integration process over the past two decades. Under such strong global integration conditions, a currency union converts to a kind of "community of fate" in which even small countries, by behaving as freeloaders, can "blackmail" other countries since they can cause systemic contagion effects for the union and the world economy as a whole. Not to have foreseen or not to have established effective sanction mechanisms against a delay in necessary adaptation reforms is a second construction failure of the EU Treaty for which the then governments have to answer.

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