

The state of economic convergence in the Eurozone

Two decades of monetary union and economic governance

Clingendael Report

Adriaan Schout
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Executive Summary

What is the state of economic convergence in the euro area? And will the redefinition of the Stability and Growth Pact result in a more effective policy for achieving convergence? A common currency, together with the four freedoms, was assumed to lead to economic convergence. This Clingendael Report reviews the state of convergence in the euro area by focusing on nominal, real and institutional convergence. Despite a range of policy initiatives and monitoring systems, convergence has not been achieved neither in terms of monetary and economic performance nor of the quality of governance at the national level. Despite some major successes in convergence, welfare has continued to diverge in some countries and differences in debt levels have increased up to the point of threatening the - economic and political - coherence of the euro area. Public spending also varies considerably while higher public spending does not ensure higher growth levels. The paradoxical situation has arisen in which countries that (drastically) reduced debt levels performed better in terms of growth and reduction in unemployment.

Using comparative economic data for the more than 20 years since the introduction of euro, the Report among other things reaches the following conclusions:

- Upward convergence has been successful in among others Ireland and in East-European member states. These countries witnessed relatively high growth while debts were reduced. Portugal managed to bring down unemployment during the past years. Yet, a limited number of member states continue to struggle with debts, growth, and attracting investments.
- Trend analysis shows that European investment funds have failed to make a difference. Major benefactors of EU investment funds in Southern and Eastern Europe show diverging growth patterns. Ireland and East-European countries succeeded in terms of catch-up growth whereas Southern countries lagged behind. Further study is required to explain the differences in convergence and its relation to public investment.
- Contrary to the general impression that fiscal consolidation has hampered growth, we find that the countries that did cut expenditure also achieved relatively high growth levels, were able to attract investments, and managed to reduce unemployment. By implication, the notion of investment deficits in eurozone countries needs to be re-examined.

- Also in national federations with explicit stabilization mechanisms, such as the US and Germany, convergence is hard to achieve. Hence, it is probably more important to accept divergence while preventing that stability of the monetary union is undermined. Convergence is not a necessary condition for the economic stability of a monetary union as long as public debt levels do not cause negative external effects large enough to jeopardize the stability of the system.

In the conclusions we address the consequences for economic policy. Over two decades into the euro, the state of convergence – and the related political tensions – still is a liability to the integrity of the eurozone. The Report questions the effectiveness of further stimulating European investment and reopens the debate on the necessary path of fiscal consolidation. Moreover, in the negotiations on SGP reform the role of market forces needs to be put on the agenda. The institutionalized supervision in the EU, combined with suppression of market signals, offers one of the explanations for the differences in debt levels of states between the US and the euro area. Furthermore, quality of national institutions has been increasingly recognized as a key variable in explaining the relative economic performance of member states. Further research in the shape of empirical analysis is needed to identify which combination of national institutions in particular help to explain differences in economic performance.

These findings lead to further discussion on economic policy, including on how to move away from politicised hierarchical supervision to subsidiarity-based governance structures. Moreover, the instrumentation of the SGP is partly a balancing act. In the short run, economic and political pressures require active (national and EU) policies to counter asymmetric effects of shocks. Similarly, public investment may be needed in relation to, among others, energy infrastructure. Yet, longer-term performance and sustainability demand a balancing of short-term interventions with more painful governance decisions. There is a tension between short term needs and the long-term conditions for sustainability that needs to be clearly recognised in the governance regime. Finally, the Report questions the effectiveness of the SGP proposals as currently discussed for managing convergence.

While writing the Report, a range of important topics arose in discussions with experts and officials. Those familiar with the state of convergence may want to focus their attention on Annex II that summarises the points that emerged from the Report in the expert discussions.

1 Introduction

Has the EMU triggered convergence, is convergence a necessary condition for its stability, and has the literature progressed in finding the instruments to stimulate convergence? Convergence as understood here concerns the long-term development of compatible economic and institutional structures of member states. Absence of convergence creates the risk of negative spillovers across member states, such as differences in interest rates and related capital flows, demands for transfers, and reduced resilience when confronted with economic cycles and shocks.¹ Although a range of convergence trends is discussed below, labour productivity (or total factor productivity) has been identified as the most important aspect of convergence, even though the crises in the Euro area (EA) underlined that sustainable debt levels are no less important for resilience.

The challenges of convergence were well known at the start of the monetary union in 1992. However, given the relative stability of the EA until 2008, convergence received little attention. Projections of economic progress for all, strong and weak countries alike, were based on assumptions about trade facilitation following the creation of the internal market and on cost reductions as a result of monetary union. Mobility of labour, capital and goods and services would trigger convergence.

1 Diaz del Hoyo, J.-L. et al. (2017), *Real convergence in the euro area: a long term perspective*, ECB. [Real convergence in the euro area: a long-term perspective \(europa.eu\)](https://www.europa.eu).

Convergence became a theme following the Eurocrisis and triggered a stream of -often repetitive- assessments of convergence.² Upon being confronted with the next (covid-19) crisis, the EA had diverged rather than converged in essential respects. The covid crisis and the war in Ukraine sharpened the differences in economic and fiscal strengths.³ Lack of convergence has stimulated numerous debates on the monitoring of economic progress, on enforcement of debt rules, and on implementation of economic reforms in search of growth and fiscal discipline.⁴

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- 2 European Central Bank (2015), "Real convergence in the euro area: evidence, theory and policy implications", *Economic Bulletin*, Issue 5.
ECB (2016), *Convergence Report*, [Convergence Report, June 2016 \(europa.eu\)](#).
European Commission (2017), "Sustainable convergence in the euro area: A multi-dimensional process", *Quarterly Report on the Euro area*, Vol. 16/3. https://ec.europa.eu/info/sites/info/files/economyfinance/ip072_en_i_sustainable_convergence_euro_area.pdf.
Estrada, A., J. Gali and D. López-Salido (2013), "Patterns of Convergence and Divergence in the Euro area", *NBER, Working Paper*, No. 19561, Cambridge: National Bureau of Economic Research.
EEAG (2018), 'It's OK to Be Different: Policy Coordination and Economic Convergence', European Economic Advisory Group Report on the European Economy: *What now, With Whom, Where To – The Future of the EU*. Munich: CESifo.
Gros, D. (2018), *Convergence in the European Union: Inside and outside the euro Contribution to the Informal meeting of Economic and Financial Affairs Ministers Sofia, 27-28 April 2018*.
Franks, J., B. Barkbu, R. Blavy, W. Oman, H. Schoelermann (2018), *Economic Convergence in the Euro area: Coming Together or Drifting Apart?*, IMF Working Paper WP/18/10.
Tokarski, P. (2019), *Divergence and Diversity in the Euro area: The Case of Germany, France and Italy*, Berlin: SWP. [Divergence and Diversity in the Euro area. The Case of Germany, France and Italy \(swp-berlin.org\)](#)
- 3 A recent Commission report from November 2022 assesses that the effects of Covid19 on divergence were better managed than the effects of the great financial crisis. European Commission (2022), *Quarterly Report on the Euro area*, 21/3. [Quarterly Report on the Euro area \(QREA\), Vol. 21, No. 3 \(2022\) \(europa.eu\)](#)
However, it is doubtful whether Member States have equal (fiscal) space to cope with the effects of the war in Ukraine.
- 4 Among others Raad van State (2017), *Voorlichting over verbetering van de naleving van Europese afspraken en over de voor- en nadelen van verschillende opties voor de toekomst van de Economische en Monetaire Unie (EMU)*, Den Haag. *Voorlichting over verbetering van de naleving van Europese afspraken en over de voor- en nadelen van verschillende opties voor de toekomst van de Economische en Monetaire Unie (EMU)*. - Raad van State, [Voorlichting over de mogelijkheden om het Stabiliteits- en Groeipact te hervormen. - Raad van State](#)
Raad van State (2022), *Voorlichting over de mogelijkheden om het Stabiliteits- en Groeipact te hervormen*.

The aim of this project is to explore the current state of convergence and provide a basis for further discussion on the EMU toolbox. Discussions on EMU governance have reached the stage at which a more eclectic instrumentalization is being developed that includes more leeway for member states and offers financial incentives, while at the same time taking steps towards putting the quality of national institutions and their surveillance on the agenda ('conditionality').⁵ This review explores possibilities for deepening the convergence debate and the possibilities for steering convergence.

Discussions on economic governance mostly concern crisis-driven responses. Following Jean Monnet's idea that the EU develops through crises, some assume or hope that the EU is 'failing forward' with each crisis.⁶ However, debts have increased, convergence has not been achieved, and crisis measures have been unable to structurally stabilize the EA. This type of crisis management and tinkering with instrumentation has been reactive instead of diagnosing underlying long-term trends in economic growth.⁷ This critical insight, in fact, provides the methodological basis for this report: the notion that we should at the very least supplement the mechanism of policies triggered by crises with analyses based on what by now are over two decades of outcomes.

The overall approach in this project starts roughly from 'external convergence' (how has the EA performed compared to other OECD countries) and descends into the conditions in member states to identify diverging longer-term trends. At the present stage we have largely limited ourselves to the obvious starting point of analyzing divergence in welfare growth (economic terms: GDP per capita). Widening the scope to in-depth analyses of a wider set variables that matter to stability is required to arrive a more comprehensive diagnosis of weaknesses in the EA.

5 For example, the requirements imposed on member states in the Two- and Six-Pack and in the Fiscal Compact.

6 Jones, E., R.D. Kelemen & S. Meunier (2016). 'Failing Forward? The Euro Crisis and the Incomplete Nature of European Integration', *Comparative Political Studies*, 49/7: 10101034.

7 Instrumentation of EMU includes economic and monetary guidance mechanisms, and (increasingly) safety nets. Instruments have resulted from an incremental process resulting in SGP, Lisbon Process, Semester (and subsequent reforms of the Lisbon and Semester processes), ESM, ECB activities (such as OMT, PEPP, LTRO III, TPI), and RRF. In general, we see politicization of supervision as well as a search for positive stimulation combining ordoliberal sticks and Keynesian carrots.

Outline

The available reviews focus mainly on growth, catch-up growth, debt and public expenditure. Moreover, detailed policy comparisons between member states have been produced in large numbers and in great details among others by the ECB, IMF and OECD. A more recent trend in convergence research concerns the quality of national institutions. This Policy Brief follows the general themes in the literature. Section 2 presents the context of the debates on economic convergence in the EA. Types of convergence as discussed in the (European) literature are discussed in Section 3. Section 4 zooms in on the level and effectiveness of public expenditure and on public debt levels –the Achilles heel of a monetary union. Our closing section then takes some first steps in formulating policy recommendations against the background of the past decade of tinkering with economic governance aimed at convergence.

For those familiar with the debate on convergence and to contribute to the debate on the design of the SGP, Annex II summarises some of the points that emerged in discussions with experts and officials while writing the report and it formulates some potential policy inferences.

Caveats

Three caveats are in order. Firstly, given the multitude of variables involved and the varying quality of available data, mapping and correlating trends in economic and institutional convergence is an ambitious undertaking and more work needs to be done (see the suggestions below). Long-term databases in general and those on institutional differences in particular are far from homogeneous in terms of definitions and the extent of their observations, limiting the scope of analysis (see the list in Annex 1). Second, geopolitical convergence (differences in economic dependence and their effects on the resilience on the euro) are left out of consideration just as many other relevant policy areas have been left out of this analysis (e.g. the sustainability of pension systems, the extent to which climate change is addressed, or the extent to which governments have been able to pursue counter-cyclical policies). And thirdly, given the impact of the covid-19 crisis from 2020 and the war in Ukraine as of February 2022, it makes most sense, for the time being, to focus this study of convergence mainly on the period from 1999 to 2020.

2 Context: Convergence debate and current constraints

Convergence is important in a monetary union as countries can no longer devalue. The relevance of European devaluations prior to the emergence of the EA in 1999 is underlined by the fact that the Italian Lira devalued 13 times between 1979 and 1992 and was overvalued when it entered the EA. The restrictions of EMU create the necessity for countries to upgrade their external competitiveness through productivity, labour mobility or internal devaluation by means of reduced wage growth.⁸ Labour mobility in the EA has remained lower than that in the US⁹ and the hoped-for increase in internal EU trade turned out differently due to the fact that these trade-flows were already extensive and that the upswing in globalization diverted the growth of trade.¹⁰ Moreover, given the limited extent of risk sharing and the apparent return of shocks in a multipolar and economically more unstable world,

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- 8 During 2002-2008, unit labour costs of Southern member states increased markedly more than elsewhere in the EA. This initial overoptimistic wage development after 2000 was painfully compensated by wage moderation in Greece, Portugal and Spain (initially not in Italy). Schröder, Ch. (2021), *Lohnstückkosten im internationalen Vergleich*, IW-Trends 2/2021. [An International Comparison of Unit Labour Costs: A Heavy Burden on German Industry - German Economic Institute \(IW\) \(iwkoeln.de\)](#)
- 9 “[T]he level of mobility both between and within countries is low by international comparison” Riso, S. et al. (2014), *Labour mobility in the EU: Recent trends and policies*, Ireland: Eurofound. [Labour mobility in the EU: Recent trends and policies | Eurofound \(europa.eu\)](#). The European Commission publishes annual reports on intra-EU mobility.
- 10 Baldwin, R. (2006), *In or Out: Does it Matter? An Evidence-Based Analysis of the Euro's Trade Effect*, London: CEPR.
Chen, N., D. Novy (2021), *The impact of trade costs can be weak or strong – depending on how much countries trade*, VoxEU CEPR, [The impact of trade costs can be weak or strong – depending on how much countries trade | CEPR](#)

national adaptations within the EA are indispensable given the limited fiscal space some member states have left.¹¹

Four points elaborated below serve to put the debate on convergence in context:

- The way in which convergence was part of the debate up to the Maastricht Treaty
- The fundamental challenges of the EA in terms of growth and welfare
- The limited space that is left for the creation of a sustainable fiscal union
- A search for effective instruments that has shifted from rules and supervision to solidarity-based instruments combined with conditionality. This raises a number of questions: what kind of conditionality is useful, to what extent is the shift in instrumentation away from the No-Bail-Out and from austerity (reducing expenditures and increasing taxation) justified, and what additional instruments can be explored?

A – Origin of the convergence debate

The promise of EMU was that it would result in more macroeconomic stability – especially compared to the turmoil in the decade before EMU. Moreover, lower trade costs were assumed to increase growth and employment, lower interest rates, impose fiscal discipline and create an international currency that would strengthen the EU's geopolitical strength.¹² As underlined by the Italian search

11 In comparison, the EA has much less risk sharing compared to the USA where a great deal of risk sharing is organised through the capital markets and given the Federal budget. ECB (2018), *Risk sharing in the eurozone*, ECB: Monthly Bulletin, No. 3. For a critical assessment of the role of capital markets in the USA and the EU see Jones, E. (2016), 'Financial Markets Matter More than Fiscal Institutions for the Success of the Euro', *The International Spectator*, 51:4, 29-39, DOI: 10.1080/03932729.2016.1224699'.

Heijdra M. et al. (2018), *A more stable EMU does not require a central fiscal capacity*, VoxEU [A more stable EMU does not require a central fiscal capacity | CEPR](#).

12 Commission of the European Communities (1990), *One market, one money: An evaluation of the potential benefits and costs of forming an economic and monetary union*, European Economy, No. 44. http://ec.europa.eu/economy_finance/publications/pages/publication7454_en.pdf. For a discussion see Gros, D. (2017), *One Market, One Money – A Mistaken Argument (post factum)?* Ceps: Policy Insights, No 2017/05. According to Gros, the argument ran the other way around: One money would force the creation of a more integrated market.

for *vincolo esterno*¹³, EMU was a voluntary way for governments to tie their political hands to the mast.¹⁴ Convergence was a core theme at the start of the introduction of the euro. The debate around 1990 on the phasing of monetary unification centered on the question of whether real convergence should first be achieved before embarking upon monetary unification (the ‘Krönungs’ theory), or whether monetary union should be introduced with convergence from equilibrating market forces (interest rates). This debate was cut-short by the introduction of the date of 1999 in the Maastricht Treaty at the initiative of prime minister Andreotti from Italy and French president Mitterrand. As a result, real convergence largely lost its sense of urgency while the role of nominal convergence (of debt, inflation and deficits) remained limited to the conditions for entry and the SGP introduced in 1997.¹⁵ The exact role of convergence has been a bone of political content from the beginning.

B – Welfare growth as a fundamental challenge

In the more than two decades of its existence, average growth in the EA (GDP and GDP per head) has fallen behind that in most OECD countries, including those with a comparable level of income per head and a resultant growth potential (lack of external convergence, see Figure 1a). Even though the difference in growth rates may appear limited, over time, this amounts to a sizeable loss in real terms. Since 1999, welfare gains in the US and the group of countries for which Angus Maddison invented the term ‘western offshoots’ (USA, Canada, Australia, New Zealand) were 9 - 11 percentage points higher.¹⁶ Moreover, the economic resilience in public sector investment in the US (Figure 20) allowed it to be markedly faster in recovering after the 2008 crisis (although at the expense of a sharp initial increase in unemployment but followed

13 The paradox in the search for long term *vincolo esterno* is that Italy aimed at replacing market control by European control. Sottillotta, C.E. (2020). ‘Vincolo esterno or Muddling Through? Italy.’ In: Morlino, L., Sottillotta, C. (eds) *The Politics of the Eurozone Crisis in Southern Europe*. Palgrave Macmillan.

14 Giavazzi, F., M. Pagano (1988), “The advantage of tying one’s hands”, *European Economic Review*, 32: 1055–1082.

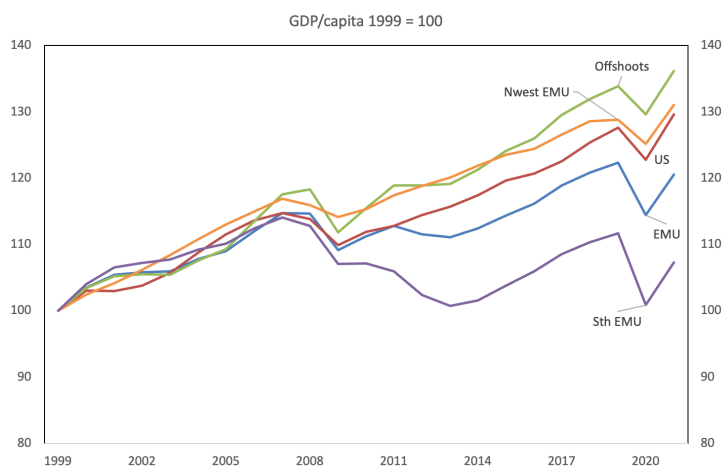
15 Cabral, A.J. (2001), ‘Main Aspects of the Working of the SGP, in: Brunila, A., Buti, M., Franco, D. (eds), *The Stability and Growth Pact*, London: Palgrave Macmillan.

16 Maddison, A. (2006), *The world economy*, OECD. [Development Centre Studies : The World Economy \(oclc.org\)](https://www.oecd.org/development/studies/the-world-economy/).

by a faster pace in employment creation).¹⁷ Cumulative differences relative to emerging economies were of course much larger, in the case of GDP ranging from 22 points (relative to Brazil) to some 250 for India and 490 for China.

The trends also show a lack of internal convergence (Figure 1b). Southern EMU suffered from low growth compared to European countries in the East and North. One sign of the stronger growth in North and East are the current account surpluses vis-à-vis the South. To move beyond overall GDP figures, Figure 2 zooms in on the purchasing power in specific EU member states. Growth in terms of prosperity and employment is important for the political coherence of the eurozone, for trust in the euro, and for trust in the ECB (see figure 3). This serves to underline that ultimately the euro is a political project and with doubts about coherence and trust, “the euro’s future is by no means secure”.¹⁸

Figure 1a External convergence - overall GDP growth per capita (1999-2021)



Source: Ameco. Northwest EMU = NI, B, Ger, Fr, Lux, Fin, Ir, Baltics (weighted figures, hence very limited influence of fast Baltic catch-up growth for EA as a whole).

17 In the US there was only a recession (two or more consecutive quarters of negative growth) between Q3 2008 and Q2 2009 (12 months). At the level of the G20, the contraction was even limited to the three quarters between Q3 2008 and Q1 2009 (seasonally adjusted). In the Netherlands, but also elsewhere in Europe, the recession lasted considerably longer. In the Dutch case from Q2 2008 to Q2 2013, with interruptions between Q3 2009 and Q1 2011, and in Q2 2012 (OECD and Eurostat).

18 Blyth and Tilford, ‘How the Eurozone Might Split’, *Foreign Affairs*, January 2018.

Figure 1b Internal convergence – overall GDP growth per capita (1999-2021)

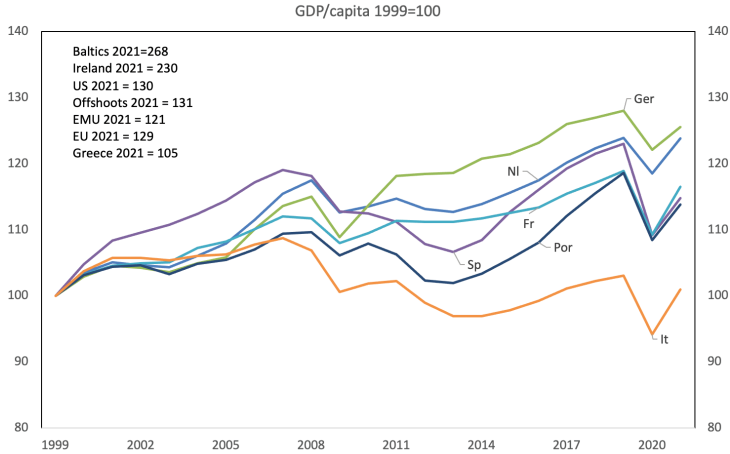
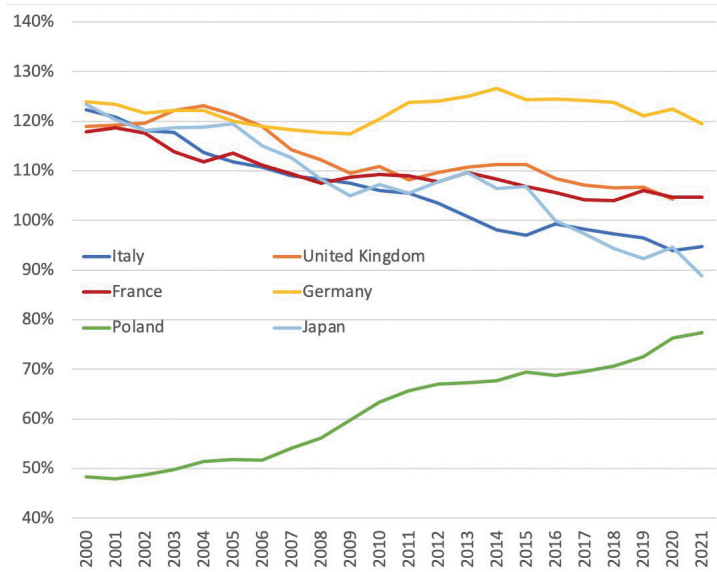
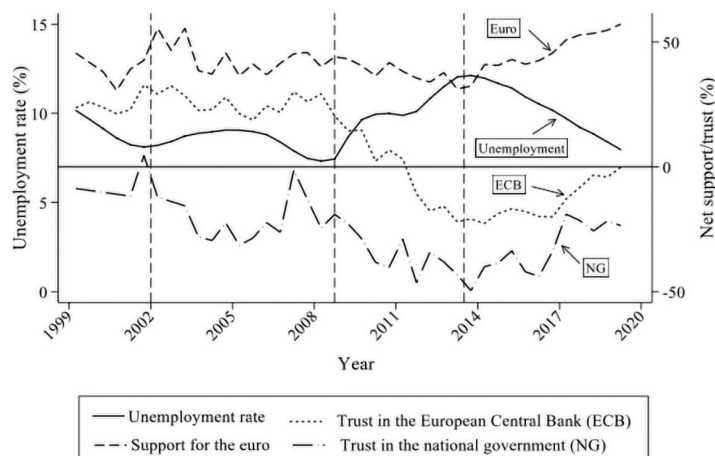


Figure 2 PPP-adjusted GDP per capita (as a share of the EU27 average)



Source: Statistics | Eurostat (europa.eu)

Figure 3 Net support for the euro, net trust in the ECB and the national government and the unemployment rate, average for the euro area¹⁹



C – Limited fiscal space

There has been a constant discussion about creating a fiscal capacity, or even a fiscal union, to address problems with convergence. These discussions are based on alleged ‘design flaws’.²⁰ However, given the longer-term trend in the build-up of fully-fledged welfare states from the 1960s onwards, the promises to pay for these under the current regime of much lower growth and the already high levels of public debt in a number of EA members²¹, there is little space left for increased spending at EU level – unless the fiscal union substitutes national tasks and budgets. Currently, the higher cost of energy – and the effect that this is likely to have on industrial competitiveness of the EA – adds to the forces determining

19 Jonung, L., F. Roth (2019), *Public support for the euro and trust in the ECB: The first two decades, Public support for the euro and trust in the ECB: The first two decades* | CEPR

20 De Grauwe, P. (2011) *Governance of a Fragile Eurozone*, Brussels: CEPS Working Documents. For a discussion of design flaws see Schout, A. (2018), ‘The EMU has no design flaws’, in: Schout, A. and W. Zweers (2018) (eds), *State of the Union 2018: towards better European integration*, The Hague: Clingendael. <https://www.clingendael.org/pub/2018/clingendael-state-of-the-union-2018/4-the-emu-has-no-design-flaws/>

21 Streeck, W. (2013), *The Politics of Public Debt Neoliberalism, Capitalist Development, and the Restructuring of the State*, Köln: Max-Planck-Institut für Gesellschaftsforschung, Discussion Paper 13/7.

fiscal constraints. Particularly, those countries with the highest public expenditure will have to bring their levels of national taxation and expenditure down to create fiscal space for a European fiscal capacity. The paradox in the debate is that countries most in favour of a fiscal union have to first implement the biggest cuts in their national welfare state. Hence, given the difficulties in implementing massive cuts, strengthening the eurozone has to happen at the national level through identification of obstacles to growth.

D – Search for conditionality, but what type of conditionality?

The foundations of economic governance in the EA are changing. The earlier trend in the Lisbon process and EU semester towards, at times, ever increasing detailed controls has made way for focusing on national budgets over the medium-term and national ownership for reforms. Moreover, the emphasis on rules and supervision has shifted towards financial support (solidarity) combined with conditionality (solidity). It is now more or less agreed (although apparently less so within the ECB) that countries eligible for support have to accept conditionality. The question however is: how to define useful reforms? The analysis of long-term convergence here may help to identify key variables, trends, and lessons from experience.

3 Types of convergence

There is no agreement in the literature on essential convergence indicators.²² Yet, with monetary controls over inflation delegated to the ECB, three variables are key in most analyses of the EA: 1) debt (public and private) as it influences the resilience of any monetary union, 2) growth as a basis for investment, fairness and debt consolidation, and 3) high and persistent unemployment because it forms a threat to political stability. One could argue that high debt ('divergent fiscal policies') is the most serious threat to a monetary union as it erodes trust from financial markets in national governments and hence influences expectations on net returns and results in interest rate differences. Moreover, debt erodes mutual trust between governments. Curtailment of debt requires that members of the EMU convergence their policy preferences and behaviour towards the common goal of monetary union (comparable to adaptation of political choices to the rules of the games under the golden standard).²³

Within the remit defined by these key variables, debates on convergence have progressed along a number of lines. Over time, we see a shift in political and academic attention from nominal (government debt as targeted by the SGP) to real convergence indicators (Lisbon Process, EU Semester). Failure to achieve nominal convergence was recognized as being closely related to not "getting the policies right".²⁴ A second shift resulted somewhat later with the growing attention for the quality of socio-economic institutions to understand the successes and failures to implement and supervise policy

22 The possible lists of types of convergence that can be deducted from the literature is long and also moves into socio-economic or ecological types of convergence. Auf dem Brinke, A., H. Enderlein, and J. Fritz-Vannahme (2015), *What kind of convergence does the euro area need?*, Bertelsmann Stiftung and Jacques Delors Institut – Berlin.

23 Jonung, L., & M. Bordo (2000), *Lessons for EMU from the History of Monetary Unions*. Lund: IEA Readings 50.

24 Baldwin, R., V. Vihriälä (2017), *Globalisation may soon accelerate again – time to get domestic policies right*, VoxEU.org. [Globalisation may soon accelerate again – time to get domestic policies right | CEPR](#). Getting its policies right, Finland has grown faster than its peers over two waves of globalization – despite substantial setbacks.

and institutional reforms (Fiscal Compact, institutions of IFIs and NPBs²⁵, the Two and Six Packs).²⁶ Convergence is not just a matter of getting policies right but also of getting institutions right. In relation to national institutions, from a large-scale research project explaining differences in factor productivity, a range of institutions can be deduced that help to explain the differences in economic performance (including the functioning of capital markets, vigilance of national banking supervision, centralized or decentralized wage bargaining systems, competitiveness watchdogs, education systems, labour market support mechanisms).²⁷

For our purposes, we distinguish between three broad categories of economic convergence: nominal, real and institutional convergence. Subsequently, these can be linked to specific economic indicators ('Achievements'), and a toolbox can be identified to exert influence on these variables. Table 1 summarizes the main categories of convergence and the related policy tools.

25 European Commission (2017), *Independent Fiscal Institutions in the EU Member States*, DG Ecfm: Discussion Paper 067.

Council Recommendation of 20 September 2016 on the establishment of National Productivity Boards OJ C 349, 24.9.2016.

See also OECD (2014), *Recommendation on Principles for Independent Fiscal Institutions*, [Recommendation on Principles for Independent Fiscal Institutions – OECD](#).

26 Wyplosz, Ch. (2008), *Fiscal policy councils: Unlovable or just unloved?*, *Swedish Economic Policy Review*, 15: 173-192.

Wyplosz, Ch. (2012), *Fiscal rules: Theoretical issues and historical experience*, Washington: National Bureau of Economic Research, Working Paper, <http://www.nber.org/papers/w17884>.

Wyplosz, Charles (2018) "Fiscal Councils and Fiscal Rules: Complements or Substitutes?" in: R. Beetsma and X. Debrun (eds), *Independent Fiscal Councils: Watchdogs or Lapdogs?* London: CEPR.

Žuk, P., Savelin L. (2018), *Real convergence in central, eastern and south-eastern Europe*, ECB: Occasional Paper Series No. 212.

27 Claeys, G., M. Le Mouel, and G. Sgaravatti (2022), *The low productivity of European Firms: how can policies enhance the allocation of resources?*, Bruegel: Working Paper 06/2022.

Table 1 Types of convergence & toolbox

| Types of Convergence | Achievements | Policies & Policy Tools |
|----------------------|--|--|
| Nominal | Macro indicators: Budget deficit, Public debt, Inflation, Interest rates | Accession criteria, SGP |
| Real | GDP and GDP per capita, Unemployment, Productivity growth, REER | Lisbon and EU Semester addressing a range of policy fields: Fit labour markets, Investment levels, R&D spending, Taxation, national and European investment programmes, etc. |
| Institutional | Supervision, societal processes, effectiveness of legal systems, quality of government (tax systems, transparency, etc.), social norms/trust | Fiscal Compact, RRF and other funds, supervisory mechanisms, peer pressure |

A – Nominal convergence

Nominal convergence concerns macro-economic indicators such as (public) debt, budget deficits, inflation, interest rates and real exchange rates. For the EA, the core nominal targets are defined by the Maastricht criteria and SGP as agreed in 1997 (60% public debt, 3% deficit, stable interest rate and inflation). The original emphasis on nominal criteria was swiftly regarded as insufficient and the need for some sort of combination of nominal, policy, institutional and ideational convergence was recognized.²⁸ The initial concerns were mainly related to consequences of external shocks and budget discipline (see German Finance minister Waigel's efforts to create the SGP from 1997). With decentralized fiscal and economic policies, and idiosyncratic credit risks on government bonds, the nominal Maastricht criteria were bound to be insufficient. Furthermore, the set-up was criticized for limiting the room for automatic stabilizers.²⁹

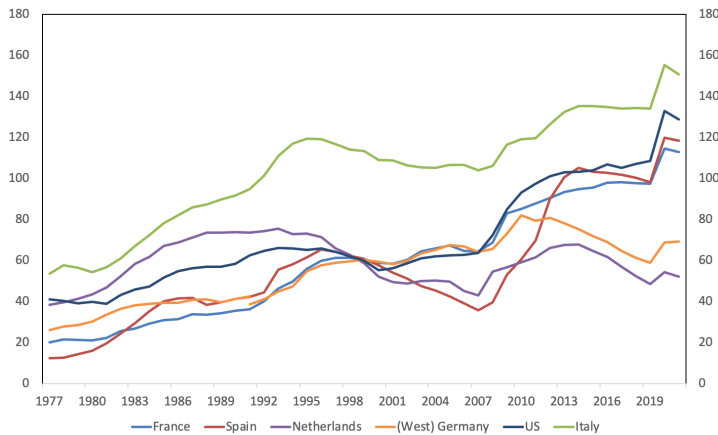
28 Emerson, M., D. Gros, A. Italianer, J. Pisani-Ferry and H. Reichenbach (1992), *One Market, One Money: An Evaluation of the Potential Benefits and Costs of Forming an Economic and Monetary Union*, Oxford: Oxford University Press. See also Farkas, B. (2016), *Models of Capitalism in the European Union. Post-crisis Perspectives*, Basingstoke: Palgrave Macmillan.

29 Buiter, W. (2006), 'The 'Sense and Nonsense of Maastricht' Revisited: What Have We Learnt about Stabilization in EMU?', *Journal of Common Market Studies*, Vol. 44.4, pp. 687-710.

Debt levels

Nominal convergence fared well until the Great Financial Crisis. Since 2008, however, these convergence criteria have not been met and public debt levels have widened. The effect of the 60% criteriuma for joining and the divergence in terms of public debt after 2008 can be seen in Figure 4. It illustrates the varied development of debt levels and the divergence in bringing debts down after 2012. Germany and The Netherlands reduced their public debt to around 60% of GDP, whereas in other countries the 60% public debt target remained out of reach. Debt levels have not only been high, but the effects of fiscal policy also varied between the member states. Worrying trends have related to difficulties with monitoring and enforcement (a problem that has been known for quite some time³⁰), depletion of fiscal buffers, and procyclicality of fiscal policies.³¹ Debt is not just a simple isolated fact but is part of governmental responses to crises in search of stability and growth and, hence, of convergence. Section 4 initiates the discussion on the extent to which public spending, debt and (European) investments policy have contributed to growth.

Figure 4 Public debt (1977-2021)



Source: Ameco.

30 Eyraud, L., and T. Wu (2015), *Playing by the Rules: Reforming Fiscal Governance in Europe*, IMF Working Paper, No. 15/67.

31 Grootjes, B., J. de Haan (2022) 'Procyclicality of fiscal policy in European Union countries', *Journal of International Money and Finance*, <https://reader.elsevier.com/reader/sd/pii/S0261560620302321?token=30A53CB47034247FC2AA9588B629919A0E83AF27C6D0624ADC446003F6786311D19AE63D1FD5C1F2D9F7483A25C42F6&originRegion=eu-west-1&originCreation=2022110103913>.

B – Real economic convergence

Upward real convergence concerns the trend in long-term development of economic wealth. Real convergence covers variables as wide as growth in GDP per capita, purchasing power, working conditions and employment figures. At a particular point, the Lisbon process involved some 300 indicators. One major reason for introducing the euro was to stimulate growth. Contrary to expectations, despite remarkable catch-up growth (or ‘ β -convergence’)³² in the East, no North-South catch-up growth occurred, and the ‘old’ eurozone countries diverged.³³ Theoretically, Southern countries should grow above the EA average (‘catch-up growth’³⁴) and structural funds were designed to support catch-up growth.³⁵ In 2017, the European Commission concluded that: “The convergence trends of the single currency’s first years have proven partly illusory.”³⁶ Figure 1 above already showed the extent to which the GDP per capita in the EA failed to keep up with the offshoot countries (external convergence). In more detail, Figure 5 below presents the ongoing diversity in growth within the EZ (internal convergence). It shows that after initial upward convergence (with a prominent role for Spain), divergence had set in already before the economic and financial crisis of 2008. The trend lines also show the extent to which the difference between two big countries, Germany and Italy, has been widening.

32 Catch-up growth: at a low level of public expenditure in less developed countries, public investments (e.g. in infrastructure or education) make more of a differences to productivity growth compared to investments in developed countries. Barro, R., X. Sala-i-Martin (1995), *Economic Growth*, McGraw-Hill.

33 Gros, D. (2018). *Convergence in the European Union: Inside and outside the Euro*, Brussels: CEPS. Franks, J. et al, 2018. *Economic Convergence in the Euro area: Coming Together or Drifting Apart?*, Working Paper International Monetary Fund, Washington: IMF.

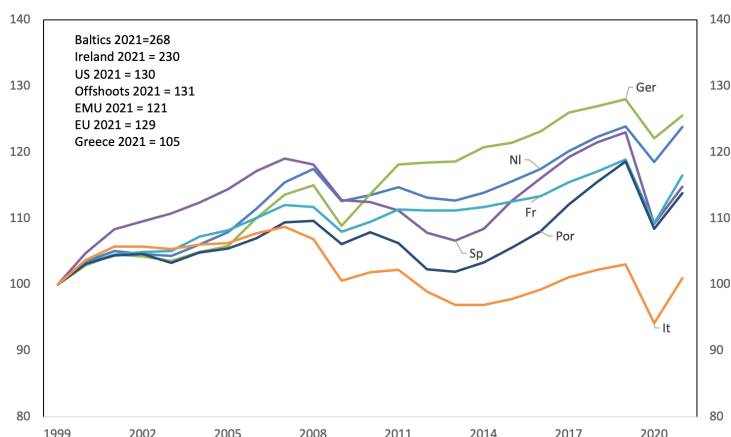
Miron, D., Holobuic, A.-M. (2020), ‘Multi-speed Europe? An Analysis of the Real Convergence within the European Union’, *Economies of the Balkan and Eastern European Countries*, KnE Social Sciences: 96--106. DOI 10.18502/kss.v4i1.15980.

34 Finland would deserve special attention given that it has outperformed other countries while showing uneven growth figures and location in the periphery of the EU.

35 Emerson et al.

36 European Commission (2017), *Reflection paper deepening of the economic and monetary union*, [reflection-paper-emu_en.pdf \(europa.eu\)](https://ec.europa.eu/economy_finance/wp-content/uploads/2017/06/reflection-paper-emu_en.pdf).

Figure 5 Growth per capita 1999-2021 (selected countries, 1999=100)



Source: Ameco

Before the financial crisis, the inflow of capital in southern EA member states failed to produce catch-up growth. Investment flows were concentrated in bank loans, sovereign debt and real estate, which, contrary to foreign direct investment, has a limited effect on productivity growth. Even in the years that preceded the 2008 crisis divergence had set in, only to become more pronounced up to the end of the Eurocrisis in 2013. Since then, limited reconvergence has occurred for Spain and Portugal while Italian and Greek income levels fell between 2007 and 2013.³⁷ The cumulative effect has been that over the course of its existence the EA as a whole has diverged. Put differently, both in terms of factor flows and income convergence, the EU has not progressed towards an Optimal Currency Area (OCA).³⁸ As such, these developments are not so important for the resilience of the EA as long as debt levels ensure national buffers against external shocks and internal shifts in competitiveness.

Part of the low growth in Southern EU countries stems from continued investments in economic sectors with low contributions to total factor productivity (see Figure 6). Part of this misallocation in low growth sectors

37 Greek income per head peaked in 2007 at 34 percent above that for 1999. In 2013 this was down to -1 percent, recovering to plus 5 percent in 2019.

38 Frydrieh, J., S. Burian (2017), 'OCA indexes and convergence process in Europe, *Scientific Annals of Economics and Business*, 64/2: 187-197.

resulted from the decrease in interest rates after the creation of the euro and the opening of capital markets. Most countries suffered from misallocation in sectors with low returns but the effects differed due to varying sizes and strengths of economic sectors between member states, and due to specific regulatory qualities in the member states such as insolvency regimes.³⁹ Moreover, such influences appear to persist. For example, Poland currently is a higher growth-country but it falls behind in economic innovation⁴⁰ as well as in important institutional indicators. Hence its continued catch-up growth is not ensured even though its quality of government indicator has surpassed the level of Italy.⁴¹

The final type of real convergence to discuss here relates to economic interconnectedness. Germany has a relatively highly (globally) interconnected supply chain. The eastern EU in turn is strongly intertwined with the German economy. Southern economies instead depend more strongly on domestic consumption.⁴² The differences in interconnectedness (or, along the same line: energy structures) serve to underline that divergence per se need not be a bad idea. Differences can also contribute to distribution of risks, increasing scope for learning and tailoring policies to national welfare functions.

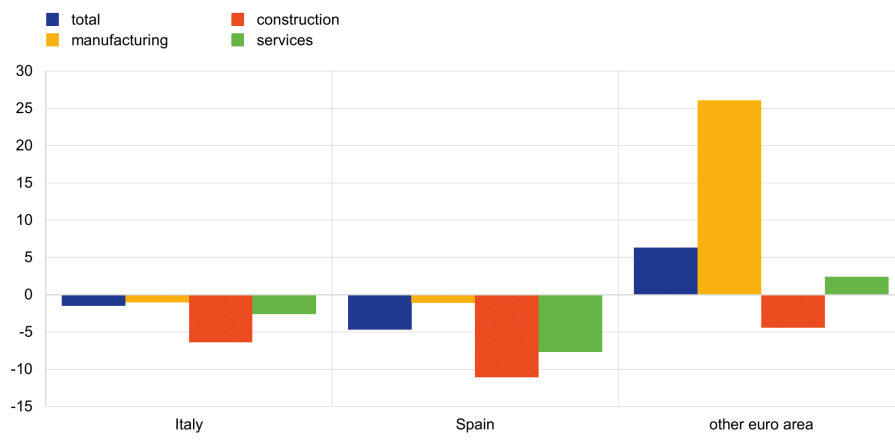
39 Gamberoni, E., Giordano, C., Lopez-Garcia, P. (2016), *Capital and labour (mis)allocation in the euro area: some stylized facts and determinants*, ECB: Working Paper Series, No 1981. [Capital and labour \(mis\)allocation in the euro area: some stylized facts and determinants \(europa.eu\)](#)

40 European Commission: *European Innovation Scoreboard 2022 and Regional Innovation Scoreboard 2021*, [EIS 2022 - RIS 2021 | Research and Innovation \(europa.eu\)](#)

41 ICRG indicator 2019: Poland (0.694), Italy (0,569). In comparison: Spain (0,722), Portugal (0,75), NL (0,944). ICRG Indicator of Quality of Government. [QoG World Map \(gu.se\)](#)

42 Blyth and Tilford (2018).

Figure 6 Cumulative TFP growth in main economic sectors in the period 1999-2007 (Percentages)



Source: European Commission.

Notes: No data are available for Greece and Portugal. "Other EA" refers to Belgium, Germany, France, the Netherlands, Austria and Finland. The 2007 value for Belgium is extrapolated from 2006. Aggregates are unweighted. "Total" also includes other sectors, such as agriculture and mining, electricity, transport, and financial intermediation.

Source: Hoyo et al.

Real effective exchange rate (REER)

Whereas the ECB managed to keep inflation relatively constant until the end of 2021, the real effective exchange rate between the member states of the EA has been a challenge from the introduction of the euro onwards. Exchange rate stability was one of the Maastricht criteria for joining but disappeared from the radar when the euro was introduced. The REER is influenced by wage differences, differences in productivity growth and internal inflation differences (relevant in relation to e.g. Greece, Ireland, Spain and Portugal between 1999-2007). Basically, strong countries benefitted from the euro, given their economic strength, the absence of a correction in their exchange rates and resultant trade surpluses, whereas less competitive countries incurred trade deficits and appreciated in relative terms.⁴³

43 Perotti, E., O. Soons (2020). 'The euro: A transfer union from the start', VoxEU.org. [The euro: A transfer union from the start | CEPR](#)

Figure 7a shows the evolution of the REER⁴⁴ in EA Member States that adopted the Euro before 2001 between 1999 and 2016. Figure 7b offers the figures for the EU-27 between 2015 and 2019. The Figures show the relative devaluation of Germany and the appreciation of Spain.⁴⁵ The graphs show a pattern of diverging competitiveness that is linked to fixed exchange rates because less competitive economies see their costs and productivity being locked in. Propped up by positive current accounts and in the absence of a correction mechanism, this situation results in beneficial exchange rates for strong countries and has resulted in one of the core arguments in the euro debate for internal transfers.⁴⁶

An important factor behind the trends in REER are labour costs. Prices go up and down relatively fast, but wages fluctuate more slowly. Hence, the importance of national labour market institutions and wage bargaining systems.⁴⁷ Institutions are much harder to adapt than prices so that REER patterns are difficult to reconfigure. The gradual increase in differences in figures 5a-b reflects the challenges in terms of economic reforms.

Germany's strong competitiveness resulting in a stable REER is due to its institutional strengths partly originating from decentralised wage bargaining (industry and enterprise level) and flexible labour markets, as well as from globalized – low cost – supply chains keeping (labour) costs low and productivity

44 REER measures the cost-structures of countries (e.g. on the basis of hourly wage rates, etc.) and indicates whether a country is over- or undervalued. A decrease in REER implies an increase in competitiveness.

For details on methodologies and trend analysis (1998-2015) see: EU Commission (2022), *Real Effective Exchange Rates: a comparison of the data published by the European Commission (DG ECFIN) with data published by other international institutions (ECB, OECD, IMF and BIS)*, [What is the price and cost competitiveness report? \(europa.eu\)](https://ec.europa.eu/economy_finance/real-effective-exchange-rates).

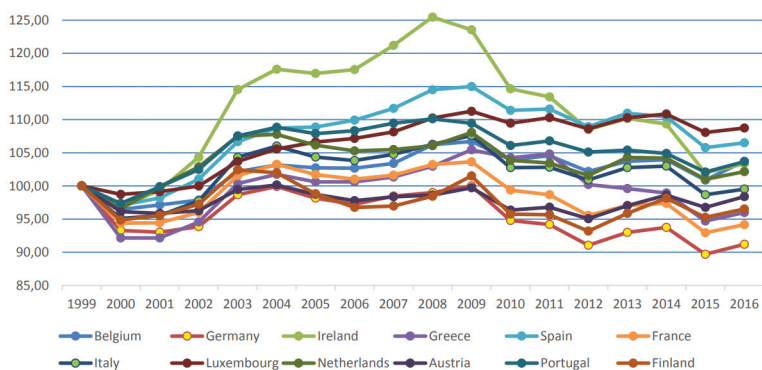
45 EP (2017), *The Real Effective Exchange Rate in Euro area Member States*, Economic Governance Support Unit. [The Real Effective Exchange Rate in Euro area Member States \(europa.eu\)](https://ec.europa.eu/economy_finance/real-effective-exchange-rate-in-euro-area-member-states)

46 For example, Perotti and Soons (2019) summarize that countries with relatively more manufacturing will find it more difficult to reduce costs – particularly if national institutions are weak – and that solidarity is in order given that member states differ and as a result have idiosyncratic REER developments (compare the redistribution in the USA through the federal budget). Perotti, E C, and O Soons (2019), "The Political Economy of a Diverse Monetary Union", CEPR: discussion paper 13987.

47 Aglio D. and F. Di Mauro (2020), *Decentralisation of collective bargaining: A path to productivity?*, Microprod Deliverable, D4.7. [1 \(microprod.eu\)](https://microprod.eu/).

growth high.⁴⁸ France lacks Germany’s international interconnectedness, especially with China and other Asian economies (which, in turn, explains its more limited sensitivity to global economic ups and downs). Figures 7a-b also show remarkable gains in the competitiveness of Ireland after 2008 and the worrying position of Spain. Overall, the differences in competitiveness have tended to widen, even though some countries show upward convergence due to structural reforms (Portugal, Greece, Ireland). The dynamics in real exchange rates during recent years for the EU27 (2015-2019) is presented in Figure 7b. It shows some remarkable recent losses in competitiveness in Germany and the Baltics.⁴⁹ Monetary unions are inherently confronted with internal exchange rate fluctuations. Swings in convergence and divergence are generally accepted by markets but persistent divergence creates structural imbalances in terms of debt and competitiveness.

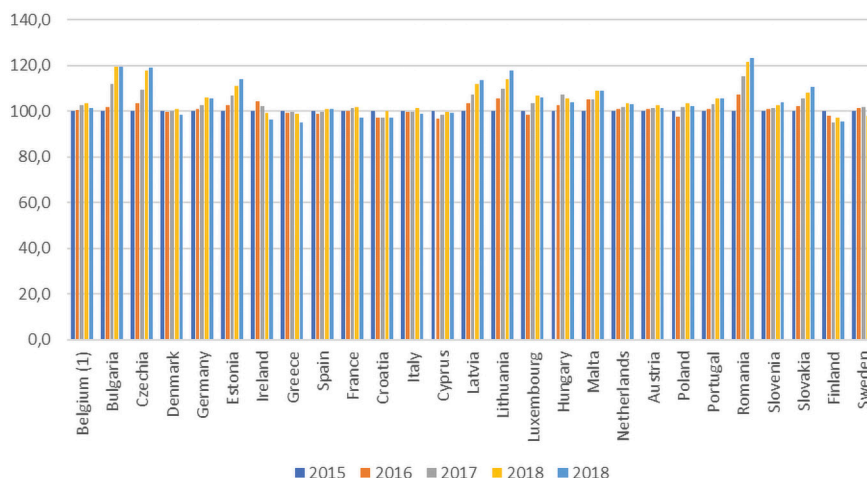
Figure 7a REER (1999-2016)



48 The result of Germany’s growth and export model has been its large current account surplus. Although the argument is often made that higher wages would fair vis-à-vis European trading countries and result in more imports, higher wages may as well result in higher savings (Tokarski 2019 17).

49 The strength of the Baltics matches the progress made in improving regulatory quality and control of corruption (Worldbank governance indicators).

Figure 7b REER (2015-2019)



Source: Ameco.

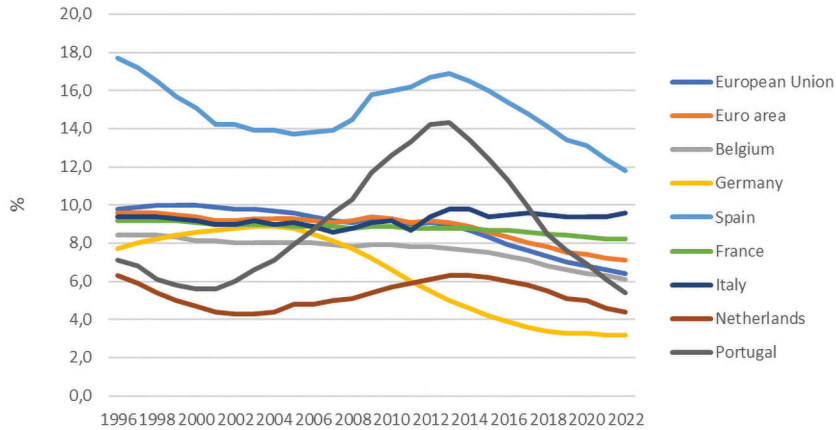
Unemployment

Growth figures are closely related to levels of unemployment. Differences range from stable but relatively high levels of unemployment to remarkable reductions in unemployment over the past years. Countries with large government sectors tend to show less variation over economic cycles: France, Belgium, Italy.⁵⁰ The Baltics display a gradual downward trend although the overall percentages have to be seen in the context of their high level of intra-EU labour mobility.⁵¹ The unemployment rates (Figure 8) show the extent to which selected countries were able to pick up growth after 2012. The comparison between Spain and Portugal in particular is of interest. Starting from a similar level, unemployment in Portugal dropped below 6% (following cut-backs and reforms during the Costa government), but remained twice as high in Spain.

50 EEAG (2018).

51 European Commission, 2019 Annual report on intra-EU labour mobility, Brussels, <https://ec.europa.eu/social/main.jsp?catId=738&furtherPubs=yes&langId=en&pubId=8242>.

Figure 8 Unemployment rates in selected European countries



Source: Ameco (NAWRU).

C – Policy, legal or input convergence

Policies to discuss in relation to convergence are many, as can also be seen from the width of the Lisbon and Semester exercises. Member states have selected their own policy priorities – generally in line with traditional patterns related to geographical location, sectoral specialization⁵², administrative cultures, etc. Education, for example, has been one of the important contributions to Finnish growth in combination with a favorable social welfare system⁵³ whereas Ireland relied heavily on a favorable tax system. Evidently, therefore, policy differences have persisted as also underlined by differences in the quality of market regulation, the implementation of Semester recommendations⁵⁴, the ease of doing business, control of corruption, reduction in CO2, etc.

52 Germany and Austria are relatively strong in manufacturing whereas Hungary and Slovenia are oriented towards services.

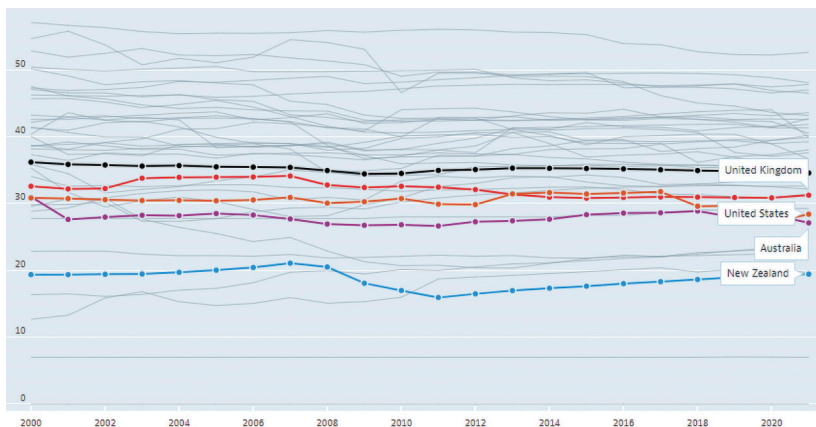
53 Baldwin, R., V. Vihriälä (2017), *Globalisation may soon accelerate again – time to get domestic policies right*, VoxEU.org. [Globalisation may soon accelerate again – time to get domestic policies right | CEPR](https://voxeu.org/article/globalisation-may-soon-accelerate-again-time-to-get-domestic-policies-right).

54 EU Court of Auditors (2020), *The European Semester – Country Specific Recommendations address important issues but need better implementation*, [European Semester – Country Recommendations need better implementation \(europa.eu\)](https://ec.europa.eu/economy_finance/en/the-european-semester-country-specific-recommendations-address-important-issues-but-need-better-implementation).

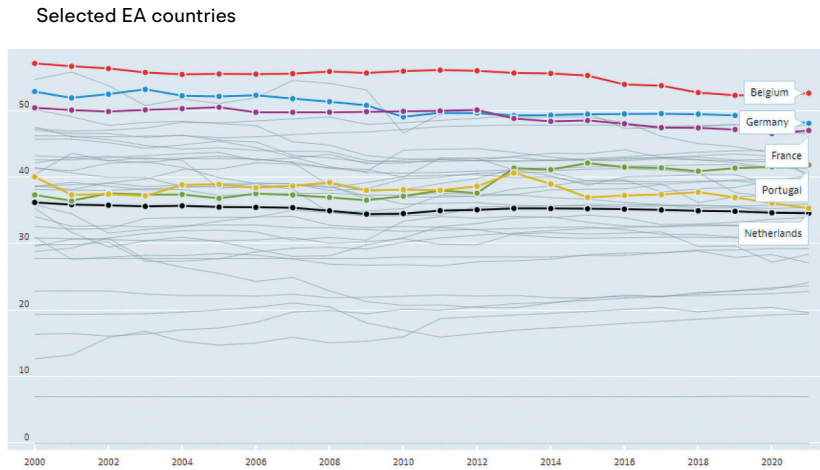
Given vested interests and traditions, national policies take time to reform. This is not the place to review convergence in all policy areas, although some of the more prominent aspects deserve being highlighted. Education and labour markets institutions have remained characterized by major differences between member states -the latter especially with regard to the flexibility of contracts and pay. As regards taxation, the wedge between capital and labour has somewhat converged between OECD countries although the differences have remained marked (displaying the stickiness of national traditions). As shown in Figure 9, the tax wedge of the non-EU offshoot countries is well below the OECD average whereas EA countries are well above the OECD average (black line: around 34% on average). Belgium (52,6% in 2020), France, Italy (not shown) and Germany with the highest levels of taxation on income. Portugal made a deliberate attempt to follow the Semester advice and reduce the tax wedge. New Zealand has the lowest tax on income (19,4%).

Figure 9 Tax wedge OECD countries (% of labour cost, 2000-2021)⁵⁵

Offspring: Australia, Canada, New Zealand, USA



55 Tax - Tax wedge - OECD Data

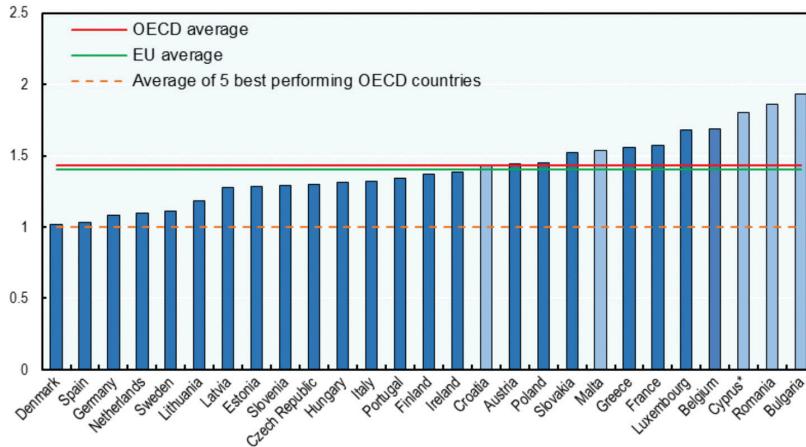


Source: OECD data

In terms of market regulation (Figure 10), most EU countries score well below the OECD average in terms of regulatory quality (indicating a higher ranking – less regulated markets). These figures affect the functioning of the internal market and, hence, growth and convergence. The assessments of this OECD index are now part of the national reform plans under the RRF. The best performing OECD countries are UK, Denmark, Spain, Germany and The Netherlands (Figure 10). Bulgaria, France and Luxemburg are falling behind in regulatory competitiveness.⁵⁶ The countries that are in particular in need of addressing their regulatory competitiveness are also those that fall behind in the implementation of semester recommendations (as does Italy).

56 <https://www.oecd.org/economy/reform/OECD-PMR-Economy-Wide-Indicator-values-2018.xlsx>. See also rankings in this list for Simplification of Regulations, Administrative Burden on start-ups, and Barriers to Trade and Investment.

Figure 10 Product Market Regulatory (PMR) indicator scores for EU countries



OECD figures 2022.⁵⁷ (0=most, 6=least competition friendly)

Lastly, a relatively recent European Parliament study argues in favour of paying greater attention to social convergence.⁵⁸ Buffers to dampen the social consequences of economic shocks and cyclical swings, according to this study, would contribute to the resilience of the eurozone.⁵⁹ It makes the same, rather more doubtful, claim in relation to mutual compensating for trade surpluses/deficits.

57 https://www.oecd.org/economy/reform/final_assessment_of_the_recovery_and_resilience_plan_2022.pdf

58 Creel, J. (2018), *Euro area Scrutiny*, European Parliament: Economic Governance Support Unit, PE 614.504.

59 On national differences and transformations in social policy systems, see Vandenbroucke, F., C. Luigjes (2016), *Institutional moral hazard in the multi-tiered regulation of unemployment and social assistance benefits and activation. A summary of eight country case studies*, Brussel: Centre for European Policy Studies.
Vandenbroucke, F. (2016), *Automatic Stabilizers for the Euro area and the European Social Model*, Notre Europe Institut Jacques Delors.

D – Cyclical convergence

Convergence in terms of economic cycles is important because disparities in terms of timing and amplitude complicate the coordination of fiscal responses and the one-size-fits-all interest rate of the ECB. Moreover, disparities may gradually lead to divergence in REER. Cyclical convergence is a threat in economic unions because countries specialize and, hence, will respond differently to economic swings and shocks.⁶⁰

Thus far business cycles in the EA have displayed a high degree of synchronization in movement.⁶¹ However, although dampened both by the ECB's monetary policy and the Commission's fiscal policy (RRF, Sure), what has been painfully clear is that the *amplitude* of shocks and cycles varies considerably between EA countries. Moreover, growth and employment figures show correlated variations in the speed of bouncing back.

Differences in the amplitude of cycles and speed of economic recovery form a risk in terms of the monetary policy response, as cycles trigger 'one-size-fits-none' policy – hence the insistence on equal interest rates that was at the heart of the conditions for joining the EA. From its inception, the EA was assumed to foster efficiencies gains, among other things, through the liberalization of capital markets.⁶² Yet, countries have had to deal with bubbles and exacerbated downturns for weaker countries complicating governance responses. Hence, the eurozone has become more susceptible to a widening of the amplitude of economic swings.⁶³ The in and out flow of capital (savings and investments) also implies that there is a *financial* cycle (and particularly high in relation to Greece, Spain and Portugal). Hence, given the absence of exchange rate adjustments and national monetary policies, maintaining trust in public finances has become a key challenge for governments.⁶⁴

60 Krugman PR (1991), 'Increasing returns and economic geography'. *Journal of Political Economy*, 99: 483–499

61 IMF 2017; EEAG 2018. For non-EA member states see ECB (2022) *Convergence Report, Convergence Report, June 2022 (europa.eu)*.

62 Delors Report (1989), *Report on economic and monetary union in the European Community*, European Council: Committee for the Study of Economic and Monetary Union.

63 Franks et al. 2018 (IMF).

64 Grauwe, P. de, Y. Ji (2014), *Disappearing government bond spreads in the eurozone – Back to normal?*, CEPS: Working Documents.

E – Club convergence

Assessments of convergence may be carried out at different levels: geopolitical comparisons (EU, US, China), international regions of comparable countries ('clubs'), individual country comparisons, and subnational regions. As regards intra-EA clubs, the Baltics have converged upwards whereas the South has fallen behind. However, even though some categorization can be helpful (e.g. post-revolution countries share specific transition challenges: Portugal, Spain, Greece) identifying clubs does not do justice to individual countries.⁶⁵ More detail on the comparative growth performance between North, East and Southern EU is offered in Figure 11. By plotting the average rate of growth (in GDP per head) against the initial level of income for a wider sample of OECD countries between 1999 and 2019, it places the growth performance for each of these in the context of beta convergence (poorer countries grow relatively faster than rich countries, see above). Although the overall distribution of data points fits this pattern, within the EU we do see catch-up growth in the east but not in the south.⁶⁶ Compared to catch-up countries elsewhere in the world, countries below the dotted line in Figure 11 perform below their potential as determined by their initial level of income. Given the expectation of a catch-up effect, growth has been disappointing in Italy (0,1% p.a.) and Greece (0,3% p.a.). Portugal and Spain were sluggish but recovered better after 2012.

By 2017, half of the eastern EU states had caught up with Greece and Portugal in terms of GDP per capita. Only the Baltics are located above the dotted line of the overall pattern, signaling a strong catch-up.⁶⁷ Remarkable differences can be seen in terms of growth between countries. Greece, Italy and Ireland started at more or less comparable levels of GDP per capita in the early 1990s. Of these, Ireland developed into one of the most prosperous countries in the EA, whereas both southern countries barely expanded at all in the course of two decades. The fundamental problems and painful reforms in the Baltics, as well as their

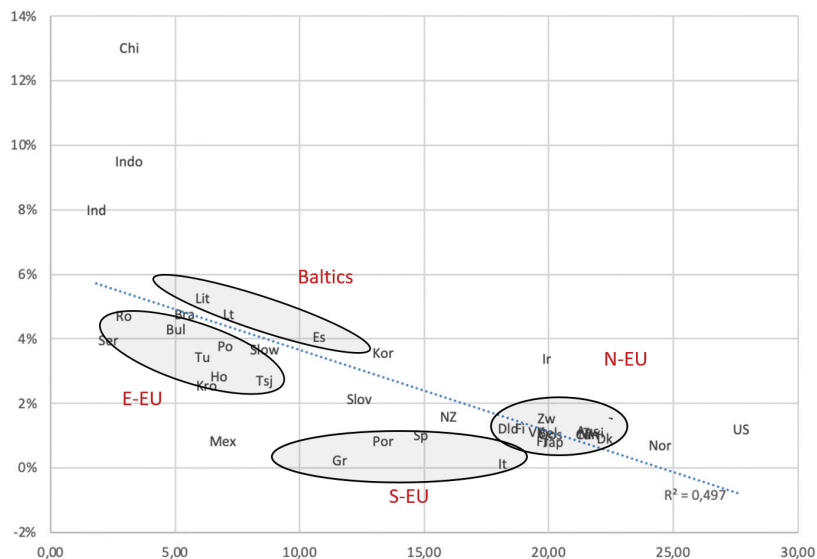
65 Kassim and Schout (2022).

66 Žuk, P., Savelin L. (2018) *Real convergence in central, eastern and south-eastern Europe*, ECB: Occasional Paper Series No. 212.

67 More detailed analysis is required to map the dynamics of countries over time. Lessons from past convergence such as from the case of Italy, that first showed impressive progress until 1980 and subsequently showed low growth performance, may be relevant to assess the resilience of the current catch-up growth in East-European countries.

remarkable performance, were not on the radar screen during the economic crisis when most political attention was devoted to the crisis countries.⁶⁸

Figure 12 Catch-up growth in GDP per capita (1999-2019)



Source: Ameco. Y-Axis: average annual growth in % GDP. X-Axis: average income per capita (in 1999).

Rather than focusing on strong or weak countries, Tokarski (2019) takes a different look and examines convergence between Germany, France and Italy as not only the core of the EA, but with each also being too big to save by the ESM. These three countries differ so profoundly in growth potential and debt levels, and the differences are also so persistent that Tokarski raises the question of how to cope with major differences rather than pursuing convergence. Stabilizing of, in particular, Italy but also of France, demands first of all a national political climate favorable to reform and efficient national institutions. In addition, stabilization demands European monetary support and a larger ESM. Key for Tokarski is to ensure social support for the EA. However, doubts are possible

68 One of the major disputes in the eurozone has concerned the tension between core and periphery. Perotti, E., O. Soons (2020). 'The euro: A transfer union from the start', VoxEU.org. [The euro: A transfer union from the start](https://www.voxeu.org/en/feature/the-euro-a-transfer-union-from-the-start) | CEPR

whether his recipe of an expanded ESM and of transfers will be effective as well as politically supported. Moreover, as discussed below, the financial and monetary support may well have stalled reforms. Furthermore, the problem with a focus on the big three is that it leaves the experience out of consideration of countries that have converged.

A particular form of club convergence relates to countries with comparable economic governance models.⁶⁹ The traditional difference in the EU is between France and Germany. France generally prefers Keynesian policy, a bias towards inflation, and an active role for the state in industrial policy while Germany focusses on rule-based governance, orientation towards a strong currency, and personal responsibility. Italy, being divided between the center and strong regions, has a more incapacitated view on the role of the state and a love-hate relation with technocratic governance.⁷⁰

As regards the European narrative, Italy tends to share the French view of economic governance, including the preferences for expanding the EU budget and for a politicization of the ECB. This is in line with the formal European model and is shared by big Southern member states (Italy, France and Spain) but is not warmly supported by most (mostly smaller) Northern EU member states.⁷¹ The Baltics and Ireland for instance had a clear preference for wanting to belong to the North and not to be seen as a “demandeur” (Irish foreign minister Fitzgerald in 1975).

F – Institutional (or structural) convergence

The EMU started with little more than a static definition of accession criteria. The Lisbon economic benchmarking process and the EU Semester met with limited successes. Currently, the quality of national institutions is increasingly

69 Brunnermeier, M., H. James, J.-P. Landau (2016), *The Euro and the Battle of Ideas*, Princeton: Princeton University Press.

Johnston, A., A. Regan (2016), “European Monetary Integration and the Incompatibility of National Varieties of Capitalism”, *JCMS*, 54/2: 318–36.

70 Munchau, W., (2022), ‘By appointment’, [EuroIntelligence](#) 25 October.

71 Kassim and Schout (2023)

recognized as the most important convergence factor.⁷² The quality of government, the judicial system, and regulation and supervision as well of national traditions define “the rules of the game in a society”.⁷³ A recent ECB report refers to the quality of national institutions as “the key precondition for real convergence”.⁷⁴ The Five Presidents’ Report (2015) identifies institutional quality as the “process towards more resilient economic structures”. However,

72 See the discussion on “strong forces” behind productivity growth persistent significant explanatory value: “the establishment of certain basic social institutions such as a stable state and the rule of law” (social capabilities). Wolff, E. (2014), *Productivity Convergence - Theory and Evidence*, Cambridge: Cambridge University Press.

Hall R., Jones C.I. (1999), ‘Why Do Some Countries Produce so Much More Output per Worker?’, *Quarterly Journal of Economics*, 114: 83-116.

Rodrik D., Subramanian A., Trebbi, F. (2004), ‘Institutions rule: the primacy of institutions over geography and integration in economic development’, *Journal of Economic Growth*, 9: 131-165.

Rodrik, D. (2011), *Unconditional convergence*, NBER Working Paper No 17546.

Acemoglu, D., J. Robinson (2012), *Why Nations Fail: The Origins of Power, Prosperity, and Poverty*, new York: Crown Publishing.

del Hoyo, D., J. Luis, E. Dorrucci, F. Heinz, S. Muzikarova (2017), *Real convergence in the euro area: A long-term perspective*, European Central Bank: Occasional Papers, No. 203.

Masuch, K., E. Moshhammer, B. Pierluigi (2016), *Institutions and growth in Europe*, CEPS Working Document No 421.

World Economic Forum (2015), *The Case for Trade and Competitiveness. Global Agenda Councils on Competitiveness and Trade and FDI*, Geneva. http://www3.weforum.org/docs/WEF_GAC_Competitiveness_2105.pdf

The World Bank (2022), *Business enabling environment (BEE) – concept note*. [BEE-Pre-Concept-Note---Feb-8-2022.pdf \(worldbank.org\)](https://www.worldbank.org/~/media/external/otherpublications/2022/02/bee-pre-concept-note---feb-8-2022.pdf)

73 North, D.C. and Thomas, R.P. (1973), *The rise of the western world: a new economic history*, Cambridge UK: Cambridge University Press.

See also North, D. (1990), *Institutions, Institutional Change and Economic Performance*, Cambridge: CUP.

74 Hoyo et al. Identifying national institutions as key does not imply that also high quality European institutions are required for recommendations and supervision.

See also Buti, M., A. Turrini (2015), ‘Three waves of convergence. Can Eurozone countries start growing together again?’, *VoxEU*, 17 April.

Dorrucci, E., Ioannou, D., Mongelli, F., A.Terzi (2015), ‘The four unions ‘PIE’ on the Monetary Union ‘CHERRY’: A new index of European Institutional Integration, Occasional Paper Series, No 160, ECB. [The Four Unions ‘PIE’ on the Monetary Union ‘CHERRY’: A New Index of European Institutional Integration by Ettore Dorrucci, Demosthenes Ioannou, Francesco Paolo Mongelli, Alessio Terzi :: SSRN](https://www.ecb.europa.eu/press/pr/2015/04/150401_01_en.html). Interestingly, this paper focusses mainly on European institutions without mentioning (the quality of) national institutions or the importance of the interaction between national and EU institutions.

as with policy convergence, the toolbox for strengthening and supervising institutional quality has so far been underexplored.

Assessments of the importance of institutional resilience do exist. In well-developed markets with established legal systems and high levels of openness, prices will fluctuate quickly and thus contribute to incentives to innovate⁷⁵ and converge.⁷⁶ However, wages tend to adapt more sluggishly⁷⁷ than product market prices, and the speed of wage adjustment depends on the design of the labour market institutions (centralized, sectoral or decentralized wage bargaining).⁷⁸ Similarly, there is some evidence that countries with a tradition of independent fiscal institutions tend to have more stable budget plans and, as a corollary, lower debts.⁷⁹ Fiscal institutions help to create transparency regarding debt levels which reduce debt bias (a political tendency towards underestimating the dangers of increasing debts).⁸⁰ Furthermore, small and open countries tend to have institutions that are more strongly geared to coordinated adaptation in response to external shocks – what Peter Katzenstein referred to as ‘democratic

75 Griffith R., Harrison R., Van Reenen J. (2007), How Special is the Special Relationship? Using the Impact of US R&D Spillovers on UK Firms as a Test of Technology Sourcing, *American Economic Review*, 96(5): 1859–75.

76 Bloom N., Schankerman M., Van Reenen J. (2007), *Identifying Technology Spillovers and Product Market Rivalry*, NBER Working Paper 13060.

77 Pettinger, T., (2012), Improvements in eurozone competitiveness, [Improvements in Eurozone Competitiveness - Economics Help](#).

For a nuanced assessment of wage-productivity gap given the multitude of other factors at play, see: Schneemelcher, P., Ph. Ständer (2018), *Wage-Productivity Gap – Four Tales from the Eurozone*, Berlin: Jacques Delors Institut. [productivity.pdf \(delorscentre.eu\)](#)

78 Guerrazzi, W. (2021), *Wage bargaining as an optimal control problem: a dynamic version of the efficient bargaining mode*, *Decisions in Economics and Finance* (2021) 44:359–374. <https://doi.org/10.1007/s10203-021-00326-x>.

For a critical assessment of the role of centralized or decentralized wage bargaining, see Baccaro, L., Tobe, T. (2021), *Reassessing the role of wages in the Eurozone*, LSE: blogpost, [Reassessing the role of wages in the Eurozone | EUROPP \(lse.ac.uk\)](#).

Schneemelcher, P., Ph. Ständer (2018), *Wage-Productivity Gap – Four Tales from the Eurozone*, Berlin: Jacques Delors Institut. [productivity.pdf \(delorscentre.eu\)](#)

79 Wyplosz (2018).

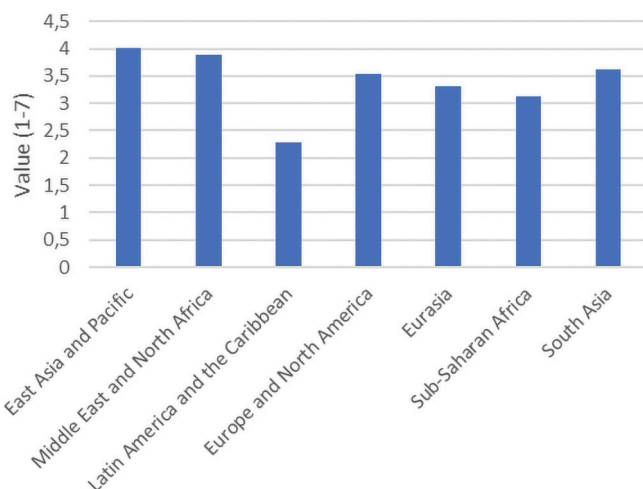
Masuch, K., E. Moshhammer, B. Pierluigi (2016), *Institutions, Public Debt and Growth in Europe*, ECB Working Paper Series, no. 1963.

See also Hallerberg, M., G. Wolff (2006), *Fiscal Institutions, Fiscal Policy and Sovereign Risk Premia*, *Bundesbank Series: Discussion Paper No. 35*.

80 Eichengreen, B. (2007) *The breakup of the Euro area*, Cambridge: NBER.

corporatism'.⁸¹ Countries with high quality institutions are able to allocate funds more effectively (see Figures 13-14) with the result that public spending in transport, education and ICT systems are better geared towards strengthening the national investment climate.⁸² A study of 'strength of national finance ministers' reveals that Belgium, for example, suffers from a weak embedding of the budget process in the national governments.⁸³

Figure 13 Efficiency public spending of geopolitical blocks (scale 1-7)



Data: OECD.

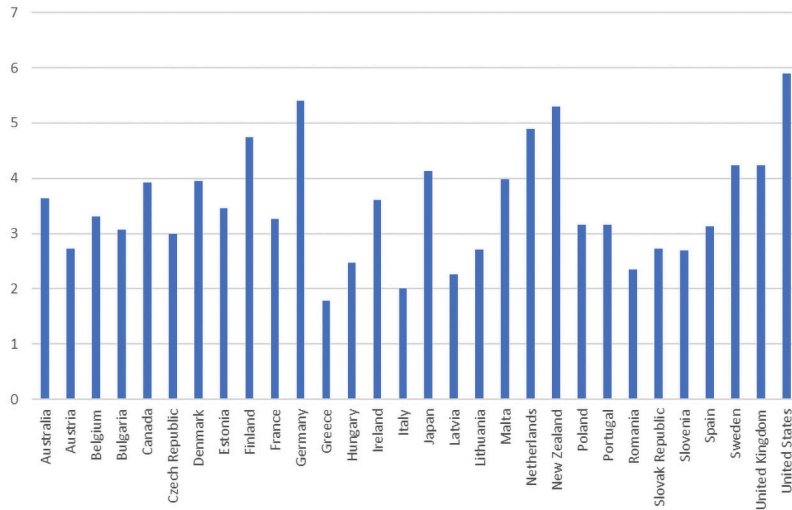
81 Katzenstein, P. (1985), *Small States in World Markets: Industrial Policy in Europe*. Ithaca: Cornell University Press.

82 Nifo, A., G. Vecchione (2015), 'Measuring Institutional Quality in Italy', *Rivista economica del Mezzogiorno*, 1-2: 157-182

83 Eichengreen (2006).

See also 'Sjacheren met de begroting: dat is wat premier Alexander De Croo de voorbije dagen heeft gedaan', *De Tijd*, November 2022. [Sjacheren met de begroting: dat is wat premier Alexander De Croo de voorbije dagen heeft gedaan](https://www.knack.be/nieuws/politiek/sjacheren-met-de-begroting-dat-is-wat-premier-alexander-de-croo-de-voorbije-dagen-heeft-gedaan) (knack.be)

Figure 14 Efficiency of public spending of EU countries (scale 1-7)



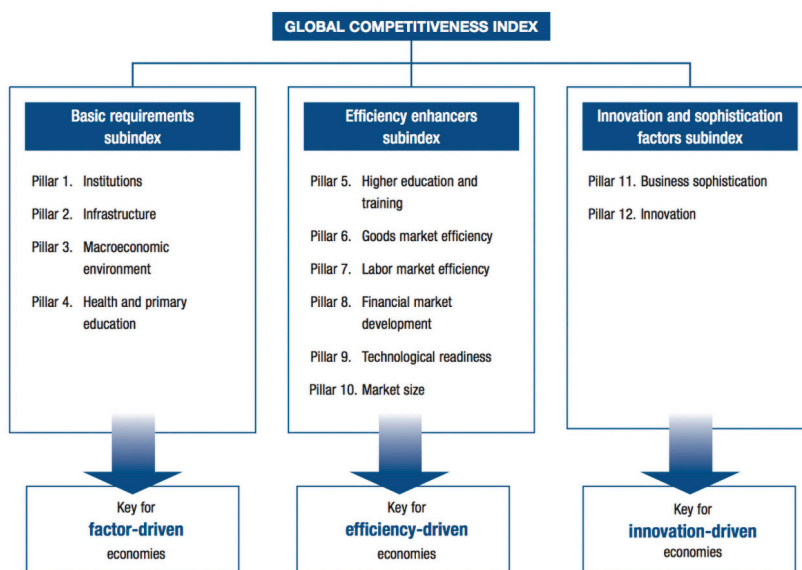
Data: OECD.

Spurred by the work of economic historians such as Douglas North, political economists like Alberto Alesina and others in the fields of New Institutional Economics and Public Choice theory, have developed an extensive literature documenting the influence of political, judicial and economic institutions on distributional aspects of welfare growth. In the past two decades there have been efforts on the part of the World Bank and other international bodies to build databases containing comparative evidence on such structures. Figure 14 gives an overview of the 11 categories to assess the competitiveness of nations as developed by the World Economic Forum. Annex 1 offers a list (not exhaustive) of organizations that produce broad or more focused rankings of institutional quality.

Despite the growing attention for capacities of national and regional governments, the analysis of institutional influences needs further elaboration in relation to EA convergence. The importance of this observation is underlined by the fact that the available data raises questions about whether the quality of national institutions in the EA has actually diverged and about the importance of specific institutions. Correlations show that countries that are able to reform and update their competitiveness also appear to be able to adapt their economic

institutions.⁸⁴ At the same time, there is a dynamic aspect to the divergence observed, as the quality of governance in some member states develops more slowly than it does in others. What are the mechanisms behind institutional change and to what extent does or could EU governance play a role?

Figure 14 Categories in the WEF Global Competitiveness Index



Source: WEF (2014).⁸⁵

84 Schout, A., A. van Riel (2020), 'De houdbaarheid van de euro ligt bij de lidstaten', ESB, 6 augustus, <https://esb.nu/esb/20060302/de-houdbaarheid-van-de-euro-ligt-bij-de-lidstaten..>
Pettri and Soons (2019).

85 World Economic Forum (2014), 'The Global Competitiveness Report 2014-2015', Geneva. http://www3.weforum.org/docs/WEF_GlobalCompetitivenessReport_2014-15.pdf

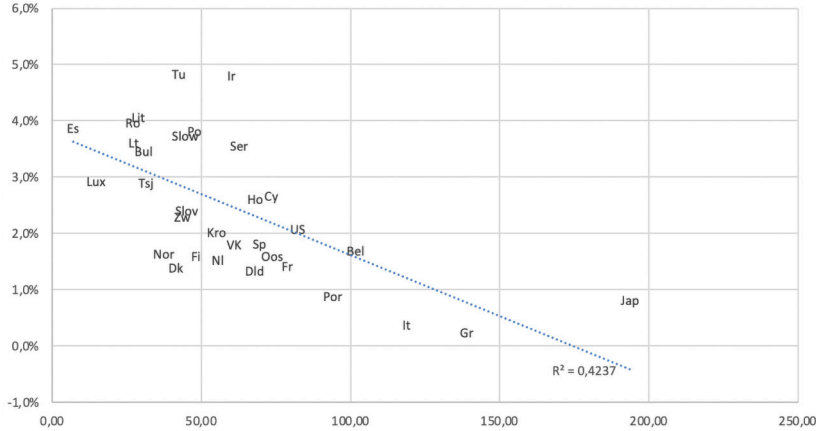
4 Analysis of public expenditure and debt

Section 3.b discussed the lack of nominal convergence. Given the dangers of high debt for the resilience of a monetary union, this section addresses the question regarding some of the effects of high levels of public spending and debt on growth. The tentative conclusions below raise doubts about the beneficial effects of higher public spending and the usefulness of EU financial assistance programs over the longer term, given that trend growth has failed to converge.

Figure 15 indicates that over the 1999 to 2019 period, countries with lower public debt levels performed better in terms of growth and those with a higher debt burden had a lower rate of economic expansion, especially at the higher end of the scale. Thus, Italy and Greece show high debts and low growth, whereas Ireland and the Baltics combined severe fiscal consolidation with high growth levels. This also qualifies the effectiveness and need for EU investment funds over a longer horizon. As Daniel Gros from CEPS concluded, the relation between debt and growth suggests that countries that drastically reduced debt levels managed to grow because they attracted outside investment.⁸⁶ This indicates that the political debate on investment deficits in the EA and the need for EU investment funds (such as the Juncker fund), are likely to have underestimated the potential of market forces while overstating the expectations of (mutual) debt and public expenditures.

⁸⁶ Gros, D. (2014) *Investment as the key to recovery in the euro area?*, Brussels: Ceps. See also O. Jorda, M. Schularick, A. Taylor (2016), *Macrofinancial History and the New Business Cycle Facts*, NBER Macroeconomics Annual Conference — Cambridge, April 14–16.

Figure 15 Growth in GDP (Y-axis) and public debt (X-Axis) ('Reinhart and Rogoff effect'⁸⁷(1999-2021)



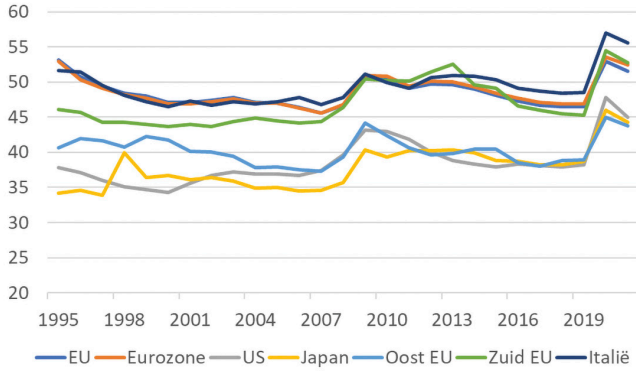
Source: Ameco, own calculations.

A – Trends in public expenditure and debt

Government expenditures show – by and large – parallel developments due to cyclical convergence, while levels remain tied to national political preferences (hence convergence in trends but not in levels). The EU trends are partly also in tune with international peers such as Japan and the US (Figure 16). The different levels of total public sector spending for OECD is presented in Table 2. France has the highest level: in 2020 no less than 61,4% of GDP was redistributed through the public sector. This share in France is likely to rise even further due to the energy crisis and the weakened parliamentary position of president Macron, forcing him to placate (among others on pension age which will remain at 62). Depending on the lifespan and actions of the Meloni government, we may see the same trend in Italy which has been supported by the ECB through its programmes to buy government bonds. Other countries, such as Germany, keep a long-term preference for maintaining public sector spending around 45% of the size of the economy.

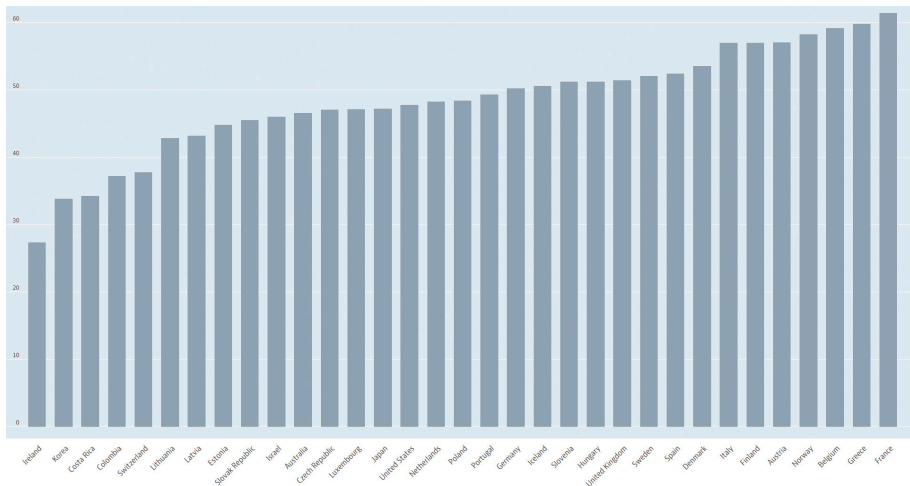
87 Reinhart, C., K. Rogoff (2010), 'Growth in a Time of Debt'. *American Economic Review*, 100: 573-578.

Figure 16 Total government expenditure (% GDP, less interest expenditure)



Source: Ameco.

Table 2 General government public spending (total % GDP, 2020)



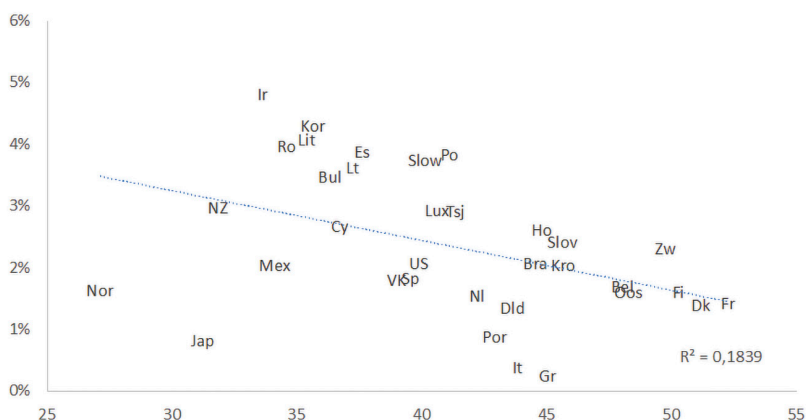
Source: OECD.

At least over the longer run, this variation in levels of public expenditures show little correlation with growth (cf. the fit of the trendline in Figure 17). The developed countries hover around the 1-2% growth mark irrespective of the level of government expenditure. Combining public sector spending and unemployment suggests that a bigger size of the government in itself does

not stimulate growth or employment. Yet, a bigger government does help in cushioning cyclical developments, albeit at a higher level of unemployment and delayed bouncing back in terms of investments (Figure 18). This suggests that there is little in terms of a positive connection between size of the government and growth. This lack of correlation is also in line with Martin Wolf’s recent conclusion in the Financial Times that there is no direct unequivocal relation between taxation, government expenditure and growth (Figure 19).

In other words, debt as such matters little, as long it is not consistently high.⁸⁸ The effectiveness depends on how the money is spent and on the quality of the national institutions involved. We may assume that high public spending and debt levels may have a better chance to contribute to growth in countries where the institutional quality is high. France has high levels of public spending and debt, but the efficiency of spending is low (Figure 14). Given the multitude of factors involved, more detailed research is required to interconnect public sector indicators to growth. For example, also spending on (and quality of) education, R&D⁸⁹, public infrastructure, income equality, all influence the link between government spending and growth.

Figure 17 GDP growth versus public expenditure (averages, 1999-2019)

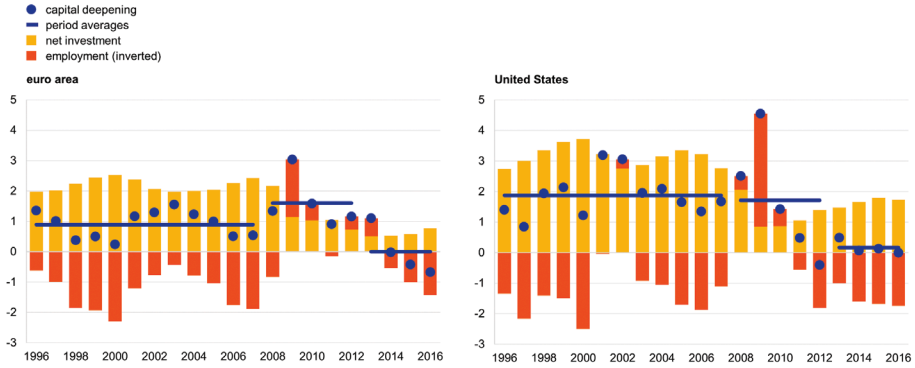


Source: Ameco, own calculations.

88 For a more detailed discussion see: Heimberger, Ph. (2022), ‘Do public debt levels reduce public growth?’, *Journal of Economic Surveys*, 2022:1-29.

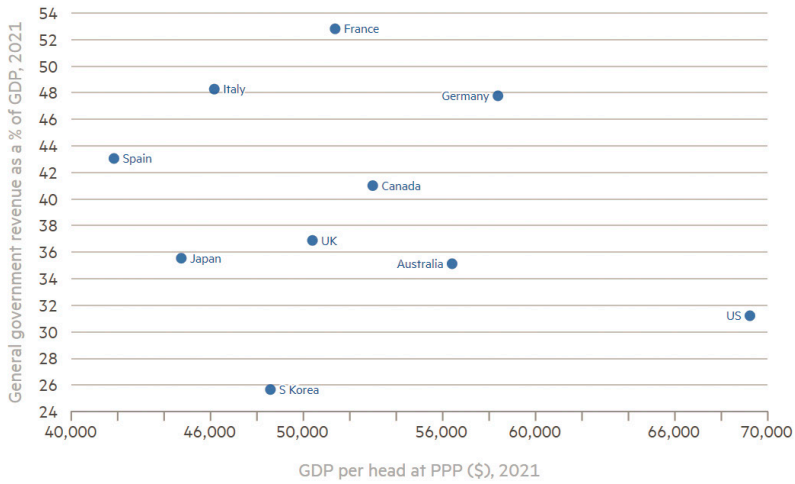
89 A brief analysis of R&D spending shows for example that France and Germany rank higher on R&D spending compared to The Netherlands. Yet The Netherlands is ranked as Innovation Leader.

Figure 18 Resilience investments EZ – USA (capital deepening 1996-2016)



Source: Hoyo et al.

Figure 19 Growth and government revenue

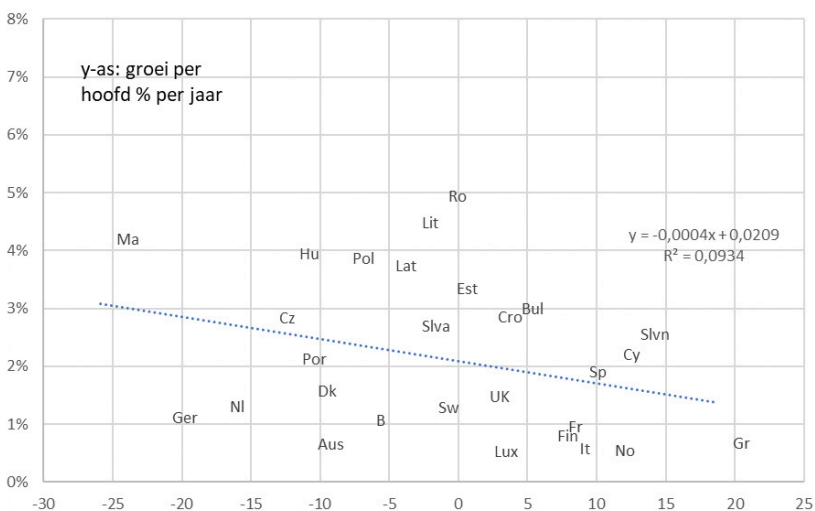


Source: Financial Times.⁹⁰

90 [The economic consequences of Liz Truss | Financial Times \(ft.com\)](#)

The above figures and tables show that for a broad range of debt levels up to approximately 80%, differences do not affect growth. Countries with persistently higher levels, however, tend to face significantly higher sovereign risk premia and have difficulties in debt servicing, and are especially vulnerable to external shocks. Moreover, it seems plausible that high levels also indicate that essential reforms have been postponed. More insight in the relation between debt and growth is offered in Figure 21 showing that there is little relation between size of austerity and growth. Cuts have had little impact on growth, just as deficits did not seem to have paid off in terms of growth in the longer run. For example, growth in Portugal was slightly larger compared to Spain although the Spanish public debt grew while debts were reduced in Portugal.

Figure 20 Growth and cuts in public debt levels (2012-1999)



Source: Ameco. Y-Axis: average growth per year. X-Axis: cutbacks in public debt (in %GDP).

B – Implications for the EU’s regional and structural funds

Have EU funds been supportive in developing (catch-up) growth? There is broad agreement in the literature on the effects on growth of the *acquis* and of joining the internal market. Yet the effects of the economic importance of EU funds have received critical assessments. The literature concludes mixed or limited

contributions of the funds. This doubt about effectiveness is supported by the analysis of long-term trends in the Sections above. Growth in the South remained sluggish despite the funds whereas the East benefited from catch-up growth although this mainly comes from joining the internal market. Hence, with a view to the longterm trends, the EU funds have offered little added value.

The explanations for the mixed and disappointing findings are various. On the positive side, particularly the methodology of funds can be beneficial for capacity building. On the downside, investing in countries with poor institutions entails risks or have counterproductive effects if corruption is strengthened.⁹¹ As in the discussion on the role of public sector spending and debt, the quality of national institutions are probably more important than EU funding. For details on the contributions of the EEAG Report (2018).

91 Breidenbach, P., T. Mitze, and C. M. Schmidt (2016), "EU Structural Funds and Regional Income Convergence – A Sobering Experience", *Ruhr Economic Papers*. No. 608.
Mungiu-Pippidi, A. (2018) *Europe's burden - Promoting good governance across borders*, Cambridge University Press.

5 Conclusions: The state of convergence in the eurozone

This Clingendael Report offers insights into three sets of questions: What is the state of convergence in the euro area? To what exact extent is convergence of importance? And, given elaborate yet largely ineffective earlier attempts to stabilize the eurozone, what further steps can be devised to manage the tensions related to convergence?

The state of convergence

Divergence is a fact of economic life. Countries differ in many ways: with respect to their economic specialization, energy dependencies, geographic location, history, and other factors. Moreover, the dynamics of economic development and shocks are bound to have an asymmetric impact. As a corollary, interest rates and real exchange rates (REER) will vary. If divergence remains limited (particularly with regard to public debt), many of its forms are not problematic to economic interdependencies. Markets, financial and otherwise, are able to absorb such dynamics.

However, a sustained lack of convergence in critical economic outcomes has been a topic of concern and debate ever since the conception of EMU onwards. The evidence on the drift of convergence from the first two decades of EMU is mixed. We find selective progress in convergence, for example in economic cycles, but also diverging performance in terms of growth, employment and public debt in a limited number of countries. Although visible even before 2008, levels of divergence have gathered pace since the financial crisis. The covid pandemic also resulted in higher debt levels and it is possible that the effects of the Ukraine war will reinforce doubts about the sustainability of diverging fiscal positions and differences in inflation.

As regards real convergence (GDP growth per capita), we see catch-up growth in Eastern-European countries, whereas Southern European member states have fallen behind. This is not only the case in absolute terms, which is the common

observation, but even more so relative to their growth potentials, given that their starting points in terms of income per head was below the EA average (Figure 12).

While acknowledging the differences in growth performance between North, East and South, it is also clear that countries can adapt. A wide range of countries have at times been both good as well as weak performers. Within the wider EU, countries that ran into difficulties but managed to reform themselves include the UK, Sweden, Germany, Ireland, the Baltic countries, and The Netherlands. Currently, Portugal is doing well in reducing unemployment. Despite its cuts in public debt after 2015, the Portuguese government brought down unemployment to a much larger extent than Spain. So far, Italy (third-largest economy in the euro area) has been the main country posing continued challenges in terms of divergence.

The differences between growth patterns in the East and South are well known. Our assessment adds the question whether real convergence in East European countries will continue, since this will require shifts in sectoral composition as well as improvements in national institutions. More research is required to examine whether current indicators of national strengths in East European countries put them on the trajectory of Italy or that of Ireland. Italy also experienced catch-up growth before the 1980s but subsequently stagnated, whereas Ireland succeeded in weathering three crises successfully.

In terms of nominal convergence, some countries have maintained sustainable debt levels or have reduced their debts – in some cases even drastically. Yet, the overall debt level in the EA has increased, from an average of 72 percent of GDP in 1999, to 86 percent just prior to the covid pandemic and 97 percent in 2021. The analysis shows that from a longer-term perspective, moderate levels of debt within the EA have had no discernable influence on growth. However, high debt levels such as those maintained by Greece and Italy are unsustainable without further European fiscal support or hedging by the ECB. France, Spain and Belgium are among the countries that require both national and European decision makers to be vigilant with regard to debt levels and budget deficits. Critical debt levels for these countries depend on the trust they continue to enjoy on financial markets. This assessment of sovereign risk will be based on national and EU financial obligations, growth potential, primary balances, and the term structure of debts. Importantly, we see countries that did reduce their debts yet outpace average EU growth. The relations between austerity and growth, as well

as between austerity and sustained investments, thus warrant further attention.⁹² Similarly, the question needs to be addressed why reform packages worked well in some, but not in other countries. Ingredients of these explanations are likely to include the ability to implement reforms and to provide political leadership, and the quality of national institutions and the independence of national supervisory authorities.

Consensus has emerged on the notion that the primary responsibility for convergence lies at the national level. Awareness has grown that the quality of national institutions is key to ensuring economic growth and the quality of fiscal policies. Progress has been made on gathering the necessary data at the European level but more work is needed to identify critical institutional capacities and on the role of multilevel institutional surveillance as part of Euro area governance.

Is convergence important?

Convergence helps to make a monetary union resilient. Yet, history shows that monetary unions do not fall apart unless confronted with deep flaws and profound external shocks (such as wars). Debt convergence is not an immediate requirement for a monetary union as long as this does not result in destabilizing effects from elevated sovereign risk. Markets are able to cope with reasonable and temporal divergencies. What matters are national buffers and the trust of financial markets that primary surpluses will be realized and a credible path towards sustainable debt is followed, even if competitiveness levels do not converge. Differences in economic structures and cycles will always exist, but countries that structurally lock themselves out of access to the international bond market threaten the economic fabric of the monetary union, since they have to rely on collective securities and transfers. Differences in debt levels can be sustained within some margins and for some time.

Politically, economic divergence is more of a problem, as differences in unemployment and abilities to respond to economic and external shocks threaten support for the EA and erode mutual trust. In times of crisis, countries with an

92 Alesina, A., C. Favero, F. Giavazzi (2019), *Austerity, When it works and when it doesn't*, Princeton University Press.

incapacitating debt-overhang lack the means to address economic challenges, and thus have to resort to demands for solidarity. When persistent, this will trigger discussions about the role of the ESM and conditionality and will foster uneasiness in countries that did bring down debt. The past decades have shown that (severe) external shocks are more part of reality than was anticipated at the start of the monetary union. Hence, economic convergence is important to ensure sustained commitment. In the end, the euro is a political project.

Governing convergence

The lack of nominal, real and institutional convergence will remain one of the major challenges for the eurozone. Although the risks of a heterogeneous membership were well known when the monetary union was created, little serious thought was given to the question of how to ensure convergence once the monetary union was underway, other than through a predefined set of criteria for accession. The Stability and Growth Pact conceived in 1997 was quickly perceived to be a fair-weather arrangement.⁹³

In terms of governance, a first conclusion is that the years of experimenting with the SGP have not been effective in stabilizing the EA despite the creation of a range of policy instruments. There has been an ongoing discussion on deeper integration to address alleged design flaws by creating a European fiscal capacity. As the analysis has shown, the creation of a meaningful fiscal capacity at the level of the EU raises questions regarding overall shares of public spending and regarding multilevel debt levels. Moreover, downward convergence in national public spending from present levels seems unavoidable to ensure an economic sustainable balance between the market and the government sector. Politically, a realistic chance of approval of any distributional key of a European fiscal capacity will demand a (painful) reconsideration of the allocation of public spending at the national level.

Parallel to the debate on a fiscal capacity, there have been policy initiatives to coordinate economic policies, such as the Lisbon Process, the EU Semester and more recently the RRF budget. Yet, a trend change towards convergence has

93 Verdun, A. (2013), 'The Monetary Union', in: Schout, A., J. Rood (eds) *The Netherlands as an EU member state: a normal partner at last?*, Portland: Eleven International Publishing.

not been achieved. Neither the introduction of the euro itself nor subsequent experimenting with governance tools have been able to foster convergence. Recently, the increase in debt levels following external shocks and the uneven way in which members have been responding, combined with existing debt overhangs, has put renewed pressure on the convergence debate, with new policy options being explored - including greater national ownership for debt targets and financial incentives.

There is a high level of consensus on the need for a European capital market to ensure that risks are more widely shared between private sector players. More contested are the deepening of monetary and fiscal policy on the part of the ECB and the European Commission. Although the need to contain risks of speculations on public debts is widely accepted, there is little agreement on whether risk management should demand more European governance or a greater reliance on markets.⁹⁴ Moreover, sharing risks on debts has remained highly contested.⁹⁵

The conclusion as regards the instrumentation to support convergence is first of all that the responsibility for sound fiscal and economic policies lies primarily with the national governments. Most countries have been able to – more or less – manage adequate levels of convergence. Secondly, rules and supervision have not resulted in the ownership required to address structural deficiencies in the functioning of economies and of the underlying institutions. Thirdly, the effects of the RRF (financial stimulus combined with conditionality) are as yet unclear, but it is hard to imagine that reforms can be subsidized on a permanent basis. It will also be difficult to prevent conflicts between its European policy objectives and national priorities. Finally, European and national investment programs have not led to observable differences in terms of catch-up growth. On the whole, institutions rather than active policies seem to matter most.

To conclude, there are three interconnected approaches that could be pursued. First, the fact that the role of market forces thus far has been suppressed rather than relied upon could be reconsidered. The role of risk sharing via capital markets in the US is larger than it is in the EU. Second, the importance

94 *Consistent paths towards a stable and resilient European economy*, Kamerstuk, 30-06-2021.

[Consistent paths towards a stable and resilient European economy | Kamerstuk | Rijksoverheid.nl](#)

95 Relevant in this context is for instance the extent of household wealth and the potential for its taxation in the case of the Italian debt overhang. See OECD statics on net worth households.

[Household accounts - Household net worth - OECD Data](#).

of national institutions is now widely recognized, but the linkages between national institutions, successful implementation of reform policies, and economic convergence need to be examined in more detail. This should contribute to better incorporating institutional reforms in conditionality requirements. At present, in spite of a large general literature on institutional effects, research with an institutional focus that pertains to the EA, is sketchy. This may require that the EU develops its own set of institutional indicators based on long term trend analysis of economic performance. The list in Annex I shows a selection of indicators that are currently available as part of datasets maintained by different organizations. This list has not yet resulted in a set of variables able to explain trends in EU member states, nor in an agreed set of indicators that is of relevance to EU and EA policies. Finally, on the basis of these linkages, country studies could offer insights into why some countries struggled to recover after the financial crisis, how top performers developed into laggards, whether austerity proved to be effective, what policies were pursued and which institutional reforms contributed to reforms and growth. At this point in the development of the euro area and of economic governance the convergence debate requires new input.

Annex I – Institutional quality indices

The list of public sector quality indicators below is far from complete and does not list sector specific indicators (related to among others education, regulatory quality and meritocracy)⁹⁶, or health care and pension systems.

- European Commission
 - [European Quality of Government Index 2021 – Regional Policy – European Commission \(europa.eu\)](#) Although this index focusses on regions, it also offers country averages⁹⁷
- Atlas of complexity index (Harvard)
- Global Innovation Index (Inseed)
- The OECD has various indices
- IMD: World Competitiveness Index
- WEF: World Economic Forum
- GII: Global Innovation index
- HDI: Human Development Index
- Sustainable Governance Indicators [SGI 2022 | Sustainable Governance Indicators \(sgi-network.org\)](#)
- World happiness report (VN)
- OECD has several assessments and indices (e.g. trust in government, Better Life Index, rankings of impact assessments, anti corruption and integrity)⁹⁸
- IMF

96 Charron, N., N. Harring, V. Lapuente (2021), 'Trust, regulation, and redistribution why some governments overregulate and under-redistribute', *Regulation & Governance*, 15: 3–16. [Trust, regulation, and redistribution why some governments overregulate and under-redistribute \(oclc.org\)](#).

Charron, N., N. Harring, V. Lapuente (2016), 'Measuring Meritocracy in the Public Sector in Europe: a New National and Sub-National Indicator', *European Journal on Criminal Policy and Research*, 22: 499–523.

97 European Commission (2021), *Sub-national Quality of Government in EU Member States, 2021_4_Charron_Lapuente_Bauhr.pdf (gu.se)*.

98 For an overview, see OECD, *Government at a Glance 2021*, <https://www.oecd-ilibrary.org/docserver/1c258f55-en.pdf?expires=1667727634&id=id&accname=guest&checksum=9DF7F67DC19F42BCC06A42BCC21874A0>.

- World Bank
 - [Worldwide Governance Indicators | DataBank \(worldbank.org\)](#)
- Millennium Challenge Cooperation. [Country Scorecards \(mcc.gov\)](#)
- University of Gothenburg, Quality of Government (QoG) Institute. [QoG World Map \(gu.se\)](#)
- The World Justice Project [World Justice Project | Advancing the rule of law worldwide](#)
- Freedom house [Countries and Territories | Freedom House](#)
 - For example, the Nations in Transit project [Nations in Transit | Freedom House](#)
- Transparency International Corruption Overview

Annex II – Convergence: Discussion Note

To contribute to the debate on the design of the Stability and Growth Pact (SGP), this Note complements our Clingendael Report on convergence. It summarises some of the points that emerged in discussions with experts and officials while writing the report and it formulates policy inferences. It also aims to highlight questions for further research.

How much convergence does a monetary union need?

A fundamental requirement for any monetary union is that actions of its member states do not have negative external effects large enough to jeopardize the stability of the system. High debt levels constitute a principal threat, especially so in the case of the Eurozone where there is as yet no banking union and banks have a relatively strong exposure to national public debt. Convergence in itself is not a necessary condition for the economic stability of the monetary union as long as public debt levels do not create problems for other members of the monetary union. In the US, differences between states have remained pronounced and some, such as Alabama and Puerto Rico, have lagged behind in many respects. Within Europe the same holds for, among others, parts of the German federation. Lack of upward convergence has persisted in the US and Germany despite federal fiscal systems, explicit redistributions and related buffers (compare the lack of convergence in spite of the EU investment funds; see the Clingendael Report).

Hence, within certain limits, a lack of upward convergence in growth and debt levels need not be a problem. However, given that convergence problems tend to be persistent, the question is how to prevent these causing economic and political problems for the monetary union and for individual member states. In the US, the explicit absence of a cushioning of debt overhangs, in combination with a disciplining reliance on market forces, and various forms of fiscal capacity seem to have helped to contain the effects of divergence. These three components offer a framework for a monetary union in which negative external effects of the behaviour of individual countries are contained. Yet, it needs to be taken into account that the no-bail out (and hence market pressure) in the US is more pronounced than in the EU. The stability in the US suggests that the

euro area needs a restoration of market forces combined with a banking union and a minimum shock absorption mechanism. This would however also require credible commitment from member states and subsidiarity-based independent supervision to ensure commitments to reform and mutual trust.

The state of convergence in the Euro area

In terms of economic outcomes, we find both convergence and divergence. On the positive side, the record of EMU over the past two decades shows that countries are able to reform, turning troubled economies into performers. Convergence is possible. For the time being, only Italy has been a cause of major concern throughout the existence of the eurozone, mainly as a result of its debt overhang and its status as being 'too-big-to-either-fail-or-save'. Painful as this was for all actors involved, the situation in Greece was easier to contain.

In political terms, economic divergence in the eurozone has led to tensions between member states with regard to solidarity and, hence, has led to policy programs based on conditionality. In the US, such political tensions between States are less pronounced due to the combination of acceptance of a greater role of market forces and federal support to alleviate political tensions. Such a combination is not a guiding principle in the current debate on SGP reforms.

How important is a fiscal capacity?

Its utility as a means of dampening the effects of shocks notwithstanding, the comparison with the US shows that the contribution of a fiscal capacity to long-term growth should not be overstated. This fits the discussion in the Report on the limited effectiveness of European investment funds with regard to growth.

Given the absence of such an effect in national federations such as Germany, Canada or the US and within the EU itself, it is reasonable to conclude that there is no unambiguous relation between public spending and convergence. Several explanations have been reviewed (see the Clingendael Report), such as the timing of interventions in the phase in the economic cycle, crowding out of private sector investment, rent-seeking politicisation of projects, inefficient public institutions, hampering implementation of projects, and corruption.

Why focus on the quality of governance and institutions?

Following the largely ineffective contributions from nominal accession criteria and that of policy convergence instruments such as Lisbon process, targeting the quality of national institutions has now been recognised as a core component in

economic governance. However, there is no consensus in the literature on what combination of economic, judicial and governmental institutions constitutes the minimum (or optimum) in fostering convergence.

The Clingendael Report presents compounded and specific indices of the quality of national governance that are available as statistical data. However, these only cover a part of the wide array of institutional variables that matter. On the one hand, institutions can refer to specific bodies, practices and procedures. Examples include the independence of essential bodies such as courts, the central bank, statistical bodies, land registry, corruption control offices, anti-trust authorities, the Ombudsman, the size and staffing of independent fiscal institutions and national productivity boards. Similarly, ‘institutions’ may refer to policy fields such as education and pension systems, and the security of property ownership. Measures of relevant institutions can also be more generic, such as the share of SMEs without professional management (compare the professional management culture in German and family-based Italian SMEs), or the nature of wage bargaining. Institutions can even be more abstract, as for instance in the notion of high and low trust societies.⁹⁹ At a more detailed level, institutional quality with regard to public administration also relates to the design of national governance systems: rules for transparency, impact assessment procedures in policy making, design of the independence and transparency of monitoring and enforcement bodies, etcetera. The quality of institutions influences the governability of a (federal) country and the political culture. Belgium, for example, at the federal level only has a junior minister for finance so that public finance is largely in the hands of the Prime Minister (thus internalizing other interests as well). It is the entire spectrum of institutions that, over time, shapes economic and political and economic expectations.¹⁰⁰

The impact of institutions can be assessed by analysing correlations between economic performance along different dimensions with measures of the quality of institutions such as those developed and used in country analyses by the World Bank. However, policy conclusions drawn on the basis of such exercises are politically sensitive and assessment institutional quality touches on the limitations of EU governance as respect for national administrative traditions

99 Schout, A. (2021), *Europese integratie en Europese samenwerking: als meer van hetzelfde niet werkt*, Radboud University/Institute Clingendael. [Oratie prof. dr. Adriaan Schout - Europa: 'Best Mogelijk' | Clingendael](#)

100 Rankings of mutual trust between EU member states however are rare.

is embedded in the Treaty. In practice, the assessment of national productivity boards by the EU Commission for instance is limited to a legal box-ticking exercise (listing whether such a board has been created irrespective of size, independence, funding, and role in political decision making). Even though institutional analysis did become part of policy debates following, among others, the conditionality of ESM assistance.

National institutions constitute a political consensus that has been solidified over time and are therefore resistant to change. Countries with more established institutions are probably harder to change due to vested interests and entrenched cultural patterns. Given the profound embedding in national systems, national reforms have to be defined and monitored primarily at the national level, with an active involvement of national consultative bodies and parliaments.

Research questions and issues for discussion

Research on the following topics would be a useful contribution to the convergence debate and to discussions on the reform of the SGP from the perspective of policy goals in the longer term:

- Scandinavian countries tend to have political decision making separated from independent bodies implementing and assessing policies. Research is needed to see to what extent this type of Nordic arrangement explains differences in competitiveness with other EU member states. This type of research would offer a useful addition to the discussions about the SGP that will most likely continue after 2024.
- Why has fiscal consolidation worked in some countries, but not in others? Similarly, to what extent can differences in private sector and foreign direct investments be linked to the quality of institutions? Moreover, can different forms of fiscal consolidation (whether these are on the side of income or expenditure) explain differences in convergence? Further research is needed into the longer term effects of fiscal consolidation on the performance of individual member states since the financial crisis. It seems that Italy in particular has opted for an increase in taxation, whereas countries that achieved greater convergence mostly reduced expenditure.
- The politicization of the Commission threatens to erode the effectiveness of European governance and the level of trust in EU institutions. A further politicization of European supervision may also have a lasting negative influence on the quality of national systems of policy making and multilevel enforcement. Member states are expected to have their own national socio-economic institutions and their independence may be eroded if these are

embedded in politicized European networks. Looking at the developments in national and European enforcement, the question needs to be asked what kind of governance model is emerging. What is the subsidiarity-based distribution of tasks in monitoring and enforcement between national and EU bodies and -institutions (Commission, ESM, ECB and newly created governance structures)? How are quality and independence guaranteed at both levels? Is a consensus emerging regarding a multilevel enforcement system?

- How to increase the quality of institutions in weaker countries? Little progress has been made in terms of strengthening national institutions and multilevel networks.¹⁰¹ Greater attention for instrumentation is in order. One important topic for further study concerns the role of market forces as a tool for putting pressure on continuous adaptation of essential institutions. Moreover, the case of multilevel border control provides insight into the ways in which peer review has contributed to strengthening mutual and multilevel adaptations.¹⁰²

Refocussing the SGP

In terms of finding an effective set of instruments and procedures for the SGP as a means to support convergence leads to four points for discussion emerge:

- Greater attention to fiscal consolidation is required. As discussed in the Clingendael Report, fiscal consolidation may have been more effective at achieving growth and sustainable public spending than is currently acknowledged in the SGP negotiations. Fiscal consolidation has two essential dimensions, limiting expenditure and increasing taxation. Limiting expenditures seems to have been most effective in the eurozone. Moreover, the effects of consolidation are conditional on institutional forces in implementation, on the trust markets have in a government, and on the existing debt levels (the 'Reinhardt and Rogoff effect').
- The effectiveness of EU investment funds and the role public investments in terms of convergence.
- As a result of successive reforms of the SGP, and of ECB policy, market forces in fiscal policy have been subdued. This financial repression is not sustainable.

101 See Schout, A., A. van Riel (2020), 'De houdbaarheid van de euro ligt bij de lidstaten', ESB, 6 augustus, <https://esb.nu/esb/20060302/de-houdbaarheid-van-de-euro-ligt-bij-de-lidstaten>.

102 Schout, A., I. Blankesteyn (2020) *Diagnosing enforcement of EU border control*, Clingendael Clingendael Report, 2020. <https://www.clingendael.org/publication/diagnosing-enforcement-eu-border-control>

It not only warehouses risks in a way that forms a tax on all investors and savers in the Euro area, but also crowds-out private investors. Rejuvenation of the market mechanism also relates to the historical development of capital markets in the EU and of the interrelation between banks and governments.

- These points also speak to the way in which the interpretation of the no-bail out has evolved. The no-bail out clause was intended to ensure that responsibility for debt levels would remain squarely in the hands of the member states. In many ways, this position was comparable to the limits on debt levels of the States the US.

These questions and points for discussion will help to clarify the role of subsidiarity, to identify ways of separating politics and implementation, and to more accurately specify short term and long term policy objectives and conditionalities. The instrumentation of the SGP is partly a balancing act. In the short run, economic and political pressures require active policies to counter asymmetric effects of shocks, both at the national level and that of the Euro area as a whole. Similarly, public investments may be needed in relation to, among others, energy infrastructure. Yet longer-term performance and sustainability demand a balancing of such interventions with more painful governance decisions. Hence, our final question: will the renewed SGP trigger convergence where this thus far has remained problematic?