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End of previous Forum article

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Paradigm Shift in the Eurozone? The Market-Based Convergence Rationale

The economic rationale for the EMU was strikingly "neoliberal" from the start. By ruling out currency devaluations and tightly limiting the scope of macroeconomic policies, member states would have no option but to liberalise their labour markets and open up their product markets. The elimination of exchange rate fluctuations combined with greater price transparency would boost competition and trade among members. The creation of integrated and liquid capital markets would ensure a more efficient allocation of resources and reduce the cost of capital. A fully functioning Single Market would boost productivity and create greater prosperity. Although it was accepted that common monetary policy would initially lead to economic divergences among member states, these would quickly ease as the participating economies converged and became fully integrated.

The main economic form of convergence is convergence in real incomes. A monetary union is, in part, set up to achieve such income convergence: to facilitate economic integration and capital flows and to stabilise growth in previously volatile countries. Other forms of convergence concern inflation, interest rates, and structural or institutional policies. Different forms of convergence can be in conflict. For example, a less advanced economy that is catching up in terms of living standards will have higher inflation than the other countries in the monetary union as productivity and, thus, wages begin to catch up – and with them prices.

A monetary union does not need full income convergence or convergence on structural or institutional policies to function. In fact, there are two ways in which currency unions without income convergence can do so. First, they can implement transfers to poorer regions, like many monetary unions do, such as the US or even the UK and Italy. Such unions typically have strong national identities and a broad sense of solidarity; it is politically sustainable for capital and skills to be concentrated in particular areas and for large-scale transfers from richer to poorer regions to persist indefinitely over time. Second, countries can remain somewhat poorer indefinitely without transfers if the mechanisms and policies in the monetary union ensure economic stability in these countries – for example, if inflation and unemployment are kept in check, the business cycle is properly managed, and there is no build-up of unsustainable debt

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in the private or public sector. However, there are limits to this second form of divergence. The more divergent countries are, the less appropriate a single interest rate and single currency become, and the more difficult it will be to catch up. This is why income convergence, or at the very least no further divergence, should be a goal of eurozone economic policies.

There are three ways in which it was hoped the eurozone, as it was originally configured, would facilitate convergence among the participating member states. First, by increasing trade among member states and facilitating greater price transparency and competition, the euro would make it harder for governments to shield sectors or particular companies from competition. The integration of product markets and the development of cross-border supply chains would lead to a convergence in productivity growth rates, fostering economic convergence. Few eurozone politicians understood that by signing up to the euro, they were in effect agreeing to open up more of their economies to competition.

Second, because countries would no longer be free to devalue their currencies in the face of economic shock or loss of competitiveness brought on by excessive wage growth, governments would be forced to encourage labour mobility as well as labour market and wage flexibility in order to facilitate adjustment, thus converging on common labour market policies. The more flexible a country was, the less likely it would be to lose competitiveness. The strong emphasis on labour flexibility stemmed from the earlier literature on optimal currency areas.[1]

Third, a single currency would hasten the development of an integrated banking and financial market, reducing the cost of capital and ensuring a more efficient allocation of resources. This would facilitate cross-border investment and help under-capitalised countries catch up with wealthier ones. While some pointed to the potential risks of more integrated banking and financial markets, such as "hot" capital flows to booming regions,[2] current account imbalances within the currency union were generally considered no more of a threat than imbalances among US states or within EU member states.

How the macro setup complemented this neoliberal rationale

The macroeconomic setup of the eurozone complemented the market-based rationale for economic convergence. The governments that signed the Maastricht Treaty gave the European Central Bank (ECB) complete responsibility for price stability, rather than setting a pre-determined inflation target. Although the ECB amended its interpretation of price stability from "zero to two per cent" to "below, but close to two per cent" in 2003, this still leaves it with a more restrictive definition of price stability than any other major central bank. As discussed below, a diverse monetary union may need a higher inflation target and a broader mandate to facilitate internal adjustments.

The Stability and Growth Pact (SGP) aimed to provide a fiscal framework for participating countries. It stipulated that public sector deficits should be in balance over the economic cycle, that the deficit must not exceed three per cent of GDP (other than in exceptional circumstances), and that outstanding stocks of national debt should be kept under 60% of GDP. These inflexible rules would prevent member states from exploiting the lower interest rates to overspend, which would lead to excessive demand growth and higher inflation.

There was little acknowledgement that flexible macroeconomic rules would be essential in the absence of currency flexibility. The need for symmetric adjustment was also ignored, i.e. after an economic shock or crisis, weak countries would need to be able to rely on robust demand from elsewhere in the currency union or risk being forced into deflation. This would require both expansionary fiscal and monetary policies across the eurozone as a whole. Nor was there much appreciation of the risks associated with national central banks losing their lender-of-last-resort function to banks and sovereigns, which meant they could no longer prevent self-fulfilling runs on banks and sovereigns.

In short, governments signed up to a currency union which reduced their scope to use macroeconomic policies to manage their economies. Furthermore, although many of these governments were quick to draw attention to the perils of neoliberalism, the currency union left them with little option but to liberalise their labour markets and open their economies to greater competition in an attempt to carve out the flexibility they lost through the absence of macroeconomic policy autonomy and exchange rate flexibility.

Why the old paradigm failed

The old paradigm of convergence suffered from several weaknesses. First, governments struggled to push

1 This began with R.A. Mundell: A Theory of Optimum Currency Areas, in: American Economic Review, Vol. 51, No. 4, 1961, pp. 657-665; for an overview, see F.P. Mongelli: "New" Views on the Optimum Currency Area Theory: What Is EMU Telling Us?, ECB Working Paper No. 138, 2002.

2 For example, the "Delors Report"; see J. Delors: Report on economic and monetary union in the European Community, Committee for the Study of Economic and Monetary Union, 17 April 1989.

through liberalising reforms, especially at a time when their economies were doing well on the back of low interest rates and capital inflows. Such reforms generally tend to be carried out during or after crises. Moreover, reforms are not unequivocally beneficial during crises or periods of weak economic growth, as the effects of labour market reforms are likely to be negative in the short run. Indeed, if the crisis is the result of an accumulation of debt, leading to a long period of deleveraging afterwards, some structural reforms might impede economic recovery, aggravating divergence.[3]

Second, encouraging flexibility, especially in labour markets, has more ambiguous effects in a monetary union than previously thought. Most models that show positive effects of downward wage flexibility do so because low wages lead to lower inflation, which in turn induces the central bank to cut interest rates and push down the value of the currency. If monetary policy is restricted, as in the case of a currency union, such beneficial effects of wage flexibility are weak.[4] The intuition is that wage reductions that do not generate an offsetting policy response, such as expansionary monetary or fiscal policy, subtract from overall demand.

Similarly, labour mobility out of depressed regions does not have unambiguously positive effects.[5] Workers migrating out of a depressed region provide a safety valve for the workers concerned (which is, of course, a positive) and deliver some short-term fiscal respite to the region by reducing the costs of unemployment benefits. However, such outmigration does not address the sources of the region's economic weakness.

The third problem is economic clustering. Economic clusters are based on increasing returns to scale and trade. With increasing trade openness (for example, because of the adoption of a common currency), countries specialise in areas in which they already have a large industry, because the larger the industry, the lower the costs. This is where the principle economic benefits of a currency union derive from: increased specialisation drives productivity growth and, with it, higher living standards. But rather than yielding economic convergence, such clustering could merely make countries less diversified. This increases economic efficiency, but greater dependence on one industry makes the country vulnerable to economic shocks (for example, changes in tastes and technology, as Finland learned with the decline of its large mobile phone producer Nokia).

The fourth and most important weakness of the old paradigm is destabilising capital flows. When an economy or sector grows rapidly, capital flows in to profit from the higher returns. But if the economy suffers an economic shock, capital is quick to retreat, forcing painful retrenchment. The removal of exchange rate risk inside the eurozone encouraged massive sums of capital to flow from slow-growing countries in the "core" to faster-growing countries in the "periphery" (where private investors thought the rates of return were higher). The influx of capital cut borrowing costs in the periphery, encouraging households, firms and governments to spend more than they earned. The resulting differences in inflation rates added fuel to the fire by lowering real interest rates further in the booming regions. The result was an explosion of current account imbalances inside the eurozone.

The rise in peripheral indebtedness would have mattered less if the capital had been productively invested. But much of it was wasted, financing real estate and consumption booms. Government profligacy was not to blame for the rise in peripheral indebtedness – indeed, Greece was the only country where this was the case. In Ireland and Spain, it was the private sector (particularly banks and households) that was to blame. In fact, in 2007, the Spanish and Irish governments looked more virtuous than Germany's: they had never broken the fiscal rules, had lower levels of public debt and ran budget surpluses.

Indeed, creditor countries were partly to blame. The export-led growth in countries like Germany and the Netherlands was structurally reliant on rising indebtedness abroad. Moreover, the conduits for the capital that flowed from core to periphery were banks, and these were more highly leveraged in countries like Germany, the Netherlands and Belgium than they were in the periphery. The eurozone crisis is as much a tale of excess bank leverage and poor risk management in the core as of excess consumption and wasteful investment in the periphery.

The missing cyclical policy

If the eurozone had been a fully fledged fiscal union, economic divergence would not have led to such a protracted economic crisis. The currency union's aggregate public debt and deficit ratios were no worse than those of the US. But the eurozone is not a fiscal union, which is why economic imbalances between members of the eurozone matter in a way that those between US states do not. And

3 See J. Andrés, Ó. Arce, C. Thomas: Structural reforms in a debt overhang, in; Journal of Monetary Economics, Vol. 88, 2017, pp. 15-34.

4 J. Galí, T. Monacelli: Understanding the Gains from Wage Flexibility: The Exchange Rate Connection, in: American Economic Review, Vol. 106, No. 12, 2016, pp. 3829-3868.

5 E. Fahri, I. Werning: Labor Mobility Within Currency Unions, NBER Working Paper No. 20105, 2014.

it explains why individual US states do not face sovereign debt crises and protracted economic slumps, while some eurozone members do, since unlike US states, they did not assume joint liability for rescuing banks.

Many eurozone policymakers continue to assert that the crisis is not one of the eurozone structure itself, but rather of errant behaviour within it. In this interpretation, neither the eurozone design nor the behaviour of the "virtuous" members in the core was at fault. If countries had not broken the rules and let their "competitiveness" deteriorate, these policymakers argue, the participating economies would not have diverged economically and the eurozone would never have run into trouble. The way to ensure confidence (and convergence) is to enforce the rules rigorously.

This interpretation is not all wrong: Greece did grossly mismanage its public finances, and Spain could have run larger fiscal surpluses in an effort to prevent economic overheating. But it ignores that the rules failed to prescribe the countercyclical policies necessary in a monetary union; that adhering to them did little to contain capital flows; and that the rules were not fit for purpose in the ensuing crisis, as they helped reinforce the downturn in hard-hit economies, thus aggravating divergence. Furthermore, the interpretation fails to acknowledge how the absence of fiscal integration exacerbated financial vulnerabilities and made the crisis harder to resolve. The hallmark of fiscal integration is some kind of mutualisation – a greater pooling of budgetary resources, joint debt issuance, a common backstop to the banking system, and so on. Tighter rules are not so much a path to mutualisation as an attempt to prevent it from happening.

Inflexible and pro-cyclical fiscal rules were not the only macroeconomic policy rules that aggravated divergence. The ECB's inflation target of "less than but close to two per cent" and the absence of any mandate to ensure an adequate level of economic activity is strikingly restrictive for a currency union as heterogeneous as the eurozone. It increases the risk that interest rates will be raised in response to temporary shocks – such as higher oil prices – that do not threaten medium-term price stability. Furthermore, excessively low inflation leaves little room for adjustment within the currency union. Countries that cut their wage costs in order to improve their "competitiveness" risk deflation (and debt traps) if prices across the eurozone are barely rising. Moreover, if several countries lower wages simultaneously, this leads to a lack of overall demand, which is risky in a monetary union, as the weakest countries are then easily forced into deflation. Finally, a currency union needs a lender of last resort even more urgently than countries with their own currencies. Runs on banks' deposits or wholesale funding as well as massive government bond sell-offs have mostly local effects and can severely exacerbate an economic downturn in a particular member state – and hence divergence. Without a lender of last resort, such runs are very hard to stop, and without macroeconomic tools such as monetary or fiscal policy, the economic effects are hard to contain.

The old eurozone paradigm

The euro was supposed to boost economic growth across the currency union, especially in its weaker member states. It was also meant to strengthen public finances and, hence, the sustainability of welfare states. Initially, there was convergence in the eurozone. Real interest rates fell sharply in the poorer member states, attracting large inflows of capital from the northern core of the currency union. But the financial crisis reversed this pattern, due to the sudden stop to capital inflows. Real interest rates are now higher in economically weak states such as Greece and Italy, where inflation is very weak, and lower in economically strong countries like Germany, where inflation is higher.

As a result, capital and skilled labour are now concentrating in the currency union's richer regions. But whereas in the United States or Germany, the negative impact of such concentration is cushioned by fiscal transfers among the states or regions (through, for example, federal unemployment benefits and tax systems), there are no such mechanisms in the eurozone. The eurozone's fiscal rules left governments too little scope to boost public spending to ameliorate the economic crisis. This worsened the recession, which in turn raised the burden of public debt. Rising debt undermined confidence in struggling member states' banks, which were backstopped by national governments rather than by the currency union collectively. Consequently, these enfeebled banks undermined confidence in the sovereign finances of their home market – resulting in the so-called "doom loop".

The ECB was unable to act as a lender of last resort to either banks or governments. It also allowed inflation to fall too low, resulting in higher real interest rates in struggling member states. This was partly due to the ECB's excessively low inflation target but also due to the fact that it misread the economy, downplaying the risks of deflation and overplaying the risk of inflation.

Finally, the currency union lacked an integrated financial system. As a result, losses incurred during the crisis in one economy were not shared across the currency union. The financial cost of cleaning up the crisis fell squarely on the taxpayers of the debtor countries, forcing them to engage in fiscal austerity.

The potential for a new paradigm

In debates about the future of the eurozone, most accept that continued divergence in economic fortunes between member states is politically corrosive for the European project. But there is as yet no agreement on the instruments that could bring about less divergence, let alone convergence. While the inherent forces for divergence in a monetary union are strong, the inherent forces for convergence have proved largely elusive, at least so far. To counteract divergence, the eurozone needs both cyclical and structural policies.

Structural policies

By structural policies, we mean all policies that are unrelated to those directly affecting the business or financial cycle, although clearly there are overlaps. First, countries need to be able to adapt quickly to changing economic circumstances because there are no monetary cushions, such as devaluation, to help economies manage shocks. The old paradigm acknowledged this but put too much focus on labour market flexibility and mobility. Other policies are more important to ensure an economy is flexible and resilient. Countries need to be able to move economic resources to other, faster-growing sectors. In order to do that, these sectors need to be open to new entrants; firms need access to funding and new investment needs to be encouraged, especially in times when traditional sectors are struggling. Since economic shifts often happen in the context of crises, banks need to be able to extend lending even when their loan books have taken a hit. Dealing swiftly with non-performing loans and having an effective insolvency regime is crucial for ensuring that funding is available to fast-growing, high productivity sectors. Some of these elements are emerging as a new paradigm – for example, the European institutions are putting a strong emphasis on completing the banking union and making progress on creating a capital markets union. But the public focus tends to ignore structural and financial policies in favour of labour market flexibility and "competitiveness".

Second, the extent to which the euro fosters specialisation, which in turn could increase vulnerability to economic shocks, is unclear. There is some evidence that broad clusters can also improve the resilience of an economy,[6] but if narrow clustering makes economies more vulnerable, then countries need to diversify their economies. They also need to re-double their efforts to promote convergence through other economic policy channels. This aspect is largely absent from the eurozone debate.

The third set of structural policies concerns (non-cyclical) current account deficits and surpluses. Modest current account imbalances are a natural phenomenon in a monetary union with countries at different stages of development. But they can also signal underlying structural problems – in both deficit and surplus countries. Unaddressed, such excessive imbalances can sow the seeds of the next crisis, as surplus countries depress demand and send capital flows to deficit countries, which in turn run the risk of overheating.

While there are many sources of current account surpluses and deficits, two context-specific policies stand out. First, wage growth needs to rise in line with productivity growth. Second, fiscal policy in surplus countries must ensure that demand shortfalls are at least partially compensated through increased public investment and incentives for private investment; at the same time, fiscal policy in deficit countries must not exacerbate overheating but rather act countercyclically, beyond what was seen in Spain.

It is hard to envisage an institutionalised way to make this happen, considering that nation-states remain sovereign in the eurozone. As Keynes once quipped, the process of adjustment is compulsory for the debtor and voluntary for the creditor. The European macroeconomic imbalances procedure is largely a paper tiger and in any case allows current account surpluses of six per cent of GDP but deficits of just three per cent before a warning is triggered. A clearing union, along the lines of the Keynes Plan of the 1940s, is politically out of the question. Thus, there are two remaining options: first, re-shape the debate in surplus countries, and second, re-emphasise strongly countercyclical fiscal and regulatory policies, to which we turn next.

Cyclical policy

The old paradigm largely ignored the cyclical components of convergence, such as the long business cycles in a monetary union, the importance of countercyclical policies, the potentially destabilising effects of cyclical capital flows and the role of the financial system in driving divergence. The result was the divergence and crisis that the eurozone has witnessed.

Business and financial cycles can be longer in the individual countries of a monetary union, with long-lasting

6 See M. Delgado, M.E. Porter, S. Stern: The Resilience of Clusters: Evidence from the Great Recession, mimeo, 2015.

effects, if not properly managed. The reason is that monetary policy is not tailored to an individual country, and as such, inflation rates can diverge. This serves to reinforce the business cycle, e.g. as higher inflation drives down real interest rates, fuelling the boom. Outside of a monetary union, rising interest rates and an appreciating currency would contain the boom, and vice versa.

That does not mean that inflation rates should be equal across all countries in a monetary union, nor that all current accounts should be in balance. A convergence process on the incomes of countries at different economic levels requires modest current account deficits in poorer countries as capital flows into them. In addition, the convergence process requires somewhat higher inflation rates in these countries: As their productivity catches up, higher wage growth in tradable sectors extends to non-tradable sectors, which drives up inflation. But policy needs to ensure that such necessary divergence in current account positions and inflation rates does not translate into excessive capital flows and overheating.

The first key element is countercyclical policy. Countries that are catching up need to pursue countercyclical policies in order to prevent overheating on the back of capital inflows. Countries in recessions or going through low-growth periods need to act countercyclically, too, as unemployment will otherwise become long-term unemployment, which can erode human capital and lead to permanently higher unemployment (hysteresis). Depressing domestic wage growth and investment in one country will lead to the export of so much capital that it could destabilise the rest of the eurozone.

Countercyclical policy has both national and eurozone-wide dimensions, as well as fiscal and financial regulation dimensions. At a national level, countries need to pursue strong countercyclical fiscal and regulatory policies. The current fiscal rules are still mainly focused on deficit and debt reduction. To the extent to which the rules contain a countercyclical element, it is to let automatic stabilisers – such as income taxes and welfare spending – work. However, these automatic stabilisers are not strong enough in the eurozone, and there have been calls to strengthen them.[7] For example, eurozone countries could introduce automatic tax credits to companies or automatic transfers to local governments for investment during a downturn. Unemployment benefits could also be extended in times of recession, to be automatically reduced when the economy returns to normal.

In addition to strengthening these stabilisers, more will be needed to make fiscal policy in the eurozone the countercyclical force it needs to be. Rules are unlikely to ever be able to capture the complexity of fiscal policymaking in a monetary union. Just as central banks are independent institutions with an economic mandate, fiscal policy – as far as it concerns countercyclical policy – could be governed by a similar type of institution, such as strong fiscal councils, with a mandate to ensure countercyclical policy.

National governments, including highly indebted ones, need the fiscal space to conduct these strongly countercyclical policies. One way to ensure that is to move some national countercyclical policies to the eurozone level, i.e. via a eurozone budget for national fiscal support or common unemployment insurance. A eurozone budget would increase spending in a member state going through a downturn, thereby helping its government avoid having to cut spending pro-cyclically. A eurozone unemployment insurance scheme would work in a similar way: when an economy is performing strongly, it would be a net contributor into the unemployment insurance system, and the reverse when times were bad. Such proposals would keep national fiscal policy and rules largely untouched while ensuring that national policy is more countercyclical. This does not need to be the start of a transfer union, as many in creditor countries fear, as the schemes could be designed to avoid fiscal transfers. For example, they could be structured so that member states only receive support to cope with the costs of cyclical unemployment and would sum to zero over the business cycle as a whole. But they would help member states deal with the effects of asymmetric shocks, such as falling demand for a product or service that a member state specialises in or a sudden change in credit conditions and withdrawal of capital from a particular member state.

The main countercyclical force in the eurozone is monetary policy. Monetary policy needs to be sufficiently aggressive to contain booms and recessions alike. A symmetrical inflation target is crucial, such that deviations in either direction are avoided, and hence economic divergence is contained. An inflation target higher than two per cent would make it much easier for a member state to hold its inflation rate (and wage growth) below the eurozone average without risking economic stagnation and deflation. A target that also included unemployment or growth, such as the US Fed's dual mandate, would further help to limit economic divergence by allowing temporary deviation from the inflation target to aid re-employment of workers.

7 See M. Buti, V. Gaspar: Designing fiscal policy for steady, enduring growth, VoxEU, 10 December 2015, available at https://voxeu.org/article/fiscal-policy-enduring-growth; and International Monetary Fund: Fiscal Monitor. Now Is the Time: Fiscal Policies for Sustainable Growth, Chapter 2, April 2015, pp. 21-36.

Fiscal policy has a role to play if the central bank struggles to maintain its target inflation rates. To achieve this, national fiscal policies could be coordinated to make sure the aggregate fiscal stance is appropriate. Alternatively, a common eurozone budget could be set up to spend in times of severe downturns. This would be a limited step toward fiscal integration. Suggestions include capital contributions into a fund that can issue bonds, common eurozone taxes that could go into a eurozone budget, and the pooling of central bank profits in a common eurozone budget, with payouts to be triggered by the ECB when the central bank needs support to revive the economy.

Countercyclical regulatory policy concerns the management of capital flows. Capital can flow freely within the EU, so there is limited capacity for countries to restrict inflows. One possibility is for countries to tax incoming funds, as Brazil did in the aftermath of the global financial crisis in 2008-09. But there are ways to contain bank leverage and domestic credit creation during boom times, which in turn could help stem excessive capital inflows. Such "macroprudential policies" are underdeveloped everywhere, but they are more important in the eurozone than elsewhere. The problem with such policies is that they are rarely triggered in time and generally not aggressive enough, as politicians fear it will be unpopular to rein in a boom. Moreover, such policies may not be enough to stem capital flows in the EU. More research is required, and countries need to isolate macroprudential policy sufficiently from short-term political meddling.

The second key element to ensure convergence is to prevent self-fulfilling panics in which investors in banks or sovereign debt have doubts about solvency. The eurozone crisis was triggered by fears that some countries' membership in the common currency was unsustainable. These fears led to the withdrawal of funds from hard-hit countries, including from banks and sovereign bonds, which in turn did make the countries' membership unsustainable. This was not inevitable. Eurozone policies could have prevented panic by making sure banks were liquid, that there was no run on government bonds and that fiscal deficits were temporarily funded so that governments were not forced to tighten fiscal policy in the teeth of a downturn.

The eurozone has belatedly implemented policies to ensure that self-fulfilling runs are prevented, but this arrangement is not as stable as the current economic recovery suggests. The ECB's role as lender of last resort to banks is still largely an implicit political deal rather than an explicit part of its mandate and is subject to political decisions at the eurozone level (such as on debt sustainability). Moreover, deposit insurance is still largely a domestic affair, which means that in times of stress, banks may still be subject to deposit flight. There is still no common European safe asset, and the ties between banks and their home sovereign remain strong.

A different kind of policy, popular in Germany, would be to allow high-debt countries in a crisis to restructure their debts, ensuring a fresh start for the country and thus limiting economic divergence. The downsides of this approach are that it could foster economic divergence if interest rates increase for high-debt, low-growth countries such as Italy, if banks still hold substantial amounts of public debt from their "home" sovereign or if the threat of restructuring leads to periodic runs on government bonds. Another problem is that the country in question would not be able to implement countercyclical policies in a crisis unless there were considerable external funds available to bridge the funding gap. In other words, there would have to be many other policies and safety nets in place for such an approach to foster convergence. As a last resort, public debt restructuring needs to be an option. But as a general rule, this risks destabilising the union and would encourage countries to try to self-insure by running budget and current account surpluses, which could destabilise the world economy.

A new paradigm?

There was always a gap between what the majority of economists – including those at international institutions such as the IMF or OECD – thought the eurozone needed, and what the member states of the currency union were able to agree upon amongst themselves. The international consensus was always that the eurozone required some kind of fiscal union as well as an activist central bank. Contrary to much of the thinking within the eurozone, there was also a general international consensus that, in the absence of fiscal transfers, large current account imbalances within the eurozone would pose a risk to the stability of the eurozone. The international consensus aligned more closely with the eurozone view that its members needed to embrace a high degree of labour market flexibility and improve labour mobility in order to cope with the strictures of eurozone membership, as well as in advocating monetary policy rather than fiscal policy as the more effective macroeconomic tool to manage demand in an economy. The international and eurozone assessments also aligned in downplaying or ignoring the financial sector, financial flows and the rise of private debt as a destabilising force in a monetary union.

Internationally, there is now more scepticism regarding the reliance on monetary policy to stabilise demand. The IMF and others are calling for more activist fiscal policies.

There is also a lively debate about the optimum degree of central bank independence, as well as over the appropriate level of inflation to target and, indeed, over whether inflation is the appropriate target to begin with; some argue that nominal GDP would be preferable. Similarly, with wage growth remaining stubbornly low and continuing to lag behind that of productivity growth in most OECD states, the merits of untrammelled labour market flexibility are under scrutiny in a way they were not a decade ago, as are the macroeconomic imbalances and the threat they could pose to economic stability. There is also now a better understanding that the sequencing of structural reforms is crucial: reforms that depress economic activity should not be undertaken in the teeth of a downturn. Finally, the attitude towards public debt has evolved, as it is now unclear whether the previous wisdom favouring low levels of public debt still applies in a world of near-zero interest rates. Internationally, the new paradigm is still under construction, but it is clearly visible in the debate.

Within the eurozone, however, there is little to suggest a paradigm shift. The EU banking union is a significant step forward, though it is a long way from completion. In some areas, such as the need for a European safe asset or common deposit insurance, countries disagree so fundamentally that it seems unlikely at this stage that such ideas will ever see the light of day. There is lukewarm support for a capital markets union, but it would require a degree of political integration, for example in the areas of insolvency regimes and business taxation, which is currently not achievable. It is also questionable whether the creation of a capital markets union would be enough to foster the cross-country investments that would help to promote macroeconomic stability and convergence.

The European Commission is certainly showing flexibility regarding fiscal deficits and is trying to implement the rules with an eye to the economic situations of the countries facing difficulties, but there is little sign of a broader re-think. The eurozone member states may agree to create a eurozone finance minister, but he or she will be largely symbolic. They may also agree to establish a small unemployment insurance scheme, but there is little chance that they will reach agreement on the creation of a common deposit insurance scheme, let alone any mutualisation of debt or even a more flexible fiscal regime. Indeed, the risk is that the current cyclical upturn in activity in the eurozone emboldens adherents of the original paradigm and makes it harder for supporters of a new paradigm to convince policymakers and the public that the eurozone remains a fragile construct vulnerable to the next economic downturn.

Agenda

How to bring about economic convergence is still a controversial topic. In order to shape the debate about a new paradigm, we highlight several issues here that still need to be explored in detail and others that need to play a more prominent role in the public debate.

1. *Labour market flexibility and wage costs: how important are they for convergence?*

One of the key concepts in discussions of convergence is competitiveness, which is often simplified to "relative wage costs". As a result, labour market and wage flexibility is one of the cornerstones of eurozone reforms, often with the implicit goal of structural convergence toward a common model for labour markets. But both theoretical and empirical evidence cast doubts on how important such flexibility really is for macroeconomic stability, and hence convergence – especially in a currency union, where wage cost reductions are less effective in stimulating employment because of the absence of any offsetting monetary policy stimulus. There has been some recent high-profile critical academic research,[8] but more research needs to be done that is tailored to monetary unions and convergence. For example, what are the wider implications of wage flexibility if such flexibility also drives current account surpluses and hence divergence elsewhere? And does migration leave some regions starved for qualified workers, hence contributing to divergence rather than convergence?

2. *A broader understanding of competitiveness*

A related issue concerns how the concept of competitiveness can be broadened to encompass productivity growth, innovation and similar aspects. Both the Competitiveness Research Network (CompNet) and international think tanks such as the World Economic Forum have already broadened the scope of the concept, but more needs to be done to advance the understanding that structural reforms to foster convergence are not just about wage costs and labour flexibility. Such a research agenda should also comprise the political and economic ramifications of convergence to one (export-driven) growth model, instead of allowing many different economic models to thrive.

8 J. Galí, T. Monacelli, op. cit.; E. Fahri, I. Werning, op. cit.; S. Bhattarai, G. Eggertsson, R. Schoenle: Is Increased Price Flexibility Stabilizing? Redux, NBER Working Paper No. 19886, 2014.

3. *Countercyclical policy in high-debt countries: effects on debt sustainability*

The discussions around a common European budget or unemployment insurance are a response to the high debt levels and strict fiscal rules in Europe. If countries had plenty of fiscal room and were not constrained by the common debt rules, they could spend countercyclically to contain divergence. Does the absence of a significant joint fiscal capacity condemn poorer or highly indebted economies to underperformance – and hence the eurozone to divergence? Current research suggests that even high-debt countries should enact countercyclical policies.[9] This research could be further developed and more forcefully articulated in the public debate.

4. *Automatic stabilisers: how to strengthen them, and which ones are most effective?*

Automatic (fiscal) stabilisers are a potentially very effective tool, economically and politically, for eurozone stabilisation. Renewed academic interest in automatic stabilisers has led to insights that they could help avoid economic divergence by forcing fiscal policy to act countercyclically without time lags or short-term political involvement.[10] But more work is needed to understand their effects in a monetary union and to strengthen and broaden the scope of potential stabilisers in the eurozone, such as varying tax rates automatically across the economic cycle or automatically boosting local public investment in economic downturns.[11]

5. *Optimal inflation target for a diverse monetary union*

To facilitate adjustment after an economic shock, a sufficient level of demand (from abroad) is crucial. Those countries that are doing well need to mildly overheat in order to foster this demand. While there is some debate about a joint eurozone fiscal capacity to help the ECB manage demand effectively, there is not enough discussion about a changed mandate for the ECB. It is not even clear that two per cent inflation is the optimal target, considering how diverse the eurozone still is. Should the US and the eurozone share the same inflation target, despite their considerable differences?

6. *Managing capital flows in a monetary union*

To promote economic convergence, capital needs to flow to less developed regions – but in amounts and in a manner that drives prosperity and long-term economic growth, not speculative bubbles. More research is needed on how capital flows inside the EU can be managed to that end, on the effects of macroprudential policy in a monetary union and on the effect of the global financial cycle on countries in the eurozone.[12] Should eurozone countries be allowed to tax short-term capital inflows? Should macroprudential policies be set by independent institutions?

7. *Capital markets and banking union*

To prevent divergence in a downturn and help cushion economic shocks, capital markets and banks both need to be integrated and assets diversified across eurozone member states. This was part of the original literature on optimal currency unions, but it needs to take centre stage again. Capital markets could be an especially important vehicle for promoting economic convergence by facilitating risk-sharing across regions and countries, but deep integration would be required to stabilise economic fluctuations. Such integration would include banking regulation, the diversification of banks' portfolios – including their sovereign bond portfolios – and the creation of a eurozone safe asset.

8. *Do economic clusters and specialisation increase vulnerability and divergence?*

As a monetary union leads to more trade and capital flows, we should see the increased clustering of economic sectors in certain regions. Does that help or hinder economic convergence in the eurozone, and does it increase the vulnerability of regions if specific clusters take a hit? Are clusters that contain firms from across the supply chain and of various levels of sophistication less vulnerable to shocks than clusters comprising particular links in an international supply chain? The purpose of the euro was to facilitate trade and specialisation, but the question here is whether that means the eurozone needs to work harder to prevent divergence through other policy measures.

9 See e.g. A.J. Auerbach, Y. Gorodnichenko: Fiscal Stimulus and Fiscal Sustainability, NBER Working Paper No. 23789, 2017.

10 See e.g. A. McKay, R. Reis: The Role of Automatic Stabilizers in the U.S. Business Cycle, in: Econometrica, Vol. 84, No. 1, 2016, pp. 141-194; A. McKay, R. Reis: Optimal Automatic Stabilizers, NBER Working Paper No. 22359, 2016; and M. Buti, V. Gaspar, op. cit.

11 This is along the lines of recommendations in International Monetary Fund, op. cit.

12 See H. Rey: Dilemma not Trilemma: The Global Financial Cycle and Monetary Policy Independence, NBER Working Paper No. 21162, 2015.

9. *What happens if the eurozone does not implement policies for increased convergence, and how will countries react?*

If there is no mechanism to ensure economic stability and convergence in the eurozone, countries will start to draw their own conclusions and act accordingly. The drive to make labour markets more flexible and the focus on cost competitiveness has already led many countries to adopt export-led strategies that generate current account surpluses. In addition, countries might try to build up buffers of fiscal and foreign assets to be better able to withstand shocks. What will be the effect on the eurozone – and on the world economy?