The future of the Economic and Monetary Union to 2025 and beyond: the need for convergence

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Abstract
As set forth in the Maastricht Treaty, the objective of establishing the Economic and Monetary Union (EMU) was based mainly on the need to achieve nominal convergence. However, the global economic and financial crisis has since proved that the EMU architecture is not solid enough. Therefore, EU institutions and member states have developed and started to implement plans for the completion of the EMU. The main focus of these plans up to 2025 is on institutional and regulatory reform. However, more attention should be paid to other types of convergence: real convergence, social convergence, financial convergence, cyclical convergence and structural convergence. This would lead to sustainable and strong all-round convergence in the EMU. This article outlines recommendations for the completion and sustainable maintenance of the EMU, concentrating on social, financial and cyclical convergence.

Keywords
Convergence, EMU reforms, Euro area, Future of Europe

Introduction
The architecture of the Economic and Monetary Union (EMU) was designed in relatively stable economic conditions. The EU’s leaders love to make comparisons between the EMU and a common house (Juncker et al. 2015, 4). They knew from the beginning that this house was not complete and that it would be difficult for a supranational
monetary union to function merely through the coordination of economic policies, without a stable fiscal, financial and more developed political union.

The recent ‘storm’ (the last global economic and financial crisis) demonstrated in a much clearer way that this ‘house’ (the EMU) is indeed not finished. Therefore, major ‘repairs’ (reforms) have been started to complete the ‘roof’ and to make the ‘walls’ and ‘insulation’ much more solid. However, these changes focus mainly on institutional and regulatory reforms. Some of the measures aim to achieve different types of sustainable convergence among the member states, including real, cyclical, structural, social and financial convergence.

The start of the UK’s withdrawal from the EU—that is, the Brexit process—provoked another debate in the EU on what the future of Europe should look like, at least by 2025. The withdrawal of the second-largest EU economy raises many questions—one of which is how to structure the EMU in a future EU27 where only about 15% of the gross domestic product will be produced in non-euro-area member states. Therefore, the European Commission has launched a profound and intense debate about the future of the EU, including the future of the EMU.

This paper will first outline the main building blocks of the EMU reforms so far. Then it will briefly present some of the key concepts of convergence and how they should be tackled at the EU level. Finally, some conclusions and a summary of the recommendations will be provided. This article argues that attention should be paid not only to EMU institutional and regulatory reforms but, in order for the EMU to be sustainable to 2025 and beyond, also to achieving real, social, financial, cyclical and structural convergence. This paper will focus specifically on social, financial and cyclical convergence.

Reforms to complete the EMU

Many years ago, a Bulgarian writer wrote a famous crime novel titled, There Is Nothing Better Than Bad Weather. If one prefers just sunshine and does not agree with this concept, it may be worth looking at the trigger for the last round of EMU reforms. The storm that was produced by the last global economic and financial crisis damaged the unfinished architecture of the EMU but did not destroy it. On the contrary, it showed in a much clearer way where the problems are, and where there is a need for the reform, repair and completion of the architecture.

One of the first results of the reforms was the introduction of the European Semester and the Macroeconomic Imbalance Procedure (MIP). As part of the framework for these mechanisms and procedures the EU provides concrete recommendations for individual member states, outlining the main policy areas where national reform measures are needed.

The presidents of the EU institutions, led by the president of the European Council, presented their ideas for EMU reform in late 2012 in the so-called Four Presidents’
The report aimed to foster integrated financial, budgetary and economic policy reforms, as well as enhanced democratic legitimacy and accountability in the EMU. In late 2012 the European Commission also outlined its vision for EMU reform, focusing on some more medium- and long-term measures (European Commission 2012).

The next strategic paper that outlined the need for EMU reform was the Five Presidents’ Report published in June 2015. In addition to the president of the European Council, the president of the European Commission, the president of the Eurogroup and the president of the European Central Bank, the co-authors of this report included the president of the European Parliament. In a further difference from the Four Presidents’ Report, the lead this time was taken by the president of the European Commission. The main focus of the suggested reforms was the completion of economic, fiscal, financial and political union (Juncker et al. 2015).

The European Commission’s White Paper from March 2017 aimed to highlight five possible scenarios for the future of Europe (European Commission 2017f). The EMU was presented in light of these five scenarios and its development was explained in the framework of the realisation of each individual scenario. The White Paper was accompanied by five additional sectoral reflection papers that aimed to provide more detailed discussion on topics such as globalisation, EU finances and budget, defence policy and the social dimension of Europe. The fifth paper was dedicated to the development of the EMU to 2025 (European Commission 2017b). It develops further the ideas of the Five Presidents’ Report and other strategic papers related to the EMU. The reflection paper on the EMU also offers several new or reframed ideas.

Another important milestone for the reform of the EMU was the 6 December 2017 package of measures announced by the European Commission. This package included the Communication on Further Steps Towards Completing the EMU, together with some legislative proposals and other documents. Some of the main elements of the reforms in the package relate to the transformation of the European Stability Mechanism, the completion of the Banking Union, and measures relating to an economic and fiscal union, as well as plans for better accountability and more effective governance in the EMU (European Commission 2017a).

The Commission proposal for a new Multiannual Financial Framework from spring 2018 also contains draft reform measures that would enforce the functioning of the EMU if accepted by the Council and the European Parliament:

- A Reform Support Programme would support priority reforms in all EU member states, with an overall planned budget of €25 billion for the period 2021–7. It would comprise three elements: a tool to provide financial support for reforms, an instrument providing technical expertise and a convergence facility to help member states that are on their way to joining the euro.
A European Investment Stabilisation Function, which is intended to help with stabilising public investment levels and facilitating rapid economic recovery in cases of significant economic shocks both in euro-area member states and in those states participating in the European Exchange Rate Mechanism (European Commission 2018).

These Commission proposals have already received criticism from researchers as insufficient and limited in their possible impact (Claeys 2018). However, in June 2018 France and Germany agreed to work on a budget for the euro area. They proposed a euro-area budget ‘within the framework of the European Union to promote competitiveness, convergence and stabilisation in the euro area, starting in 2021’ (France, Ministry for the Economy and Finance 2018, 4). The Franco-German roadmap for the euro area also contains concrete proposals for European Stability Mechanism reforms as well as the establishment of a European Unemployment Stabilisation Fund that would be used to secure the social safety net and supplement national unemployment schemes in the euro area. None of these ideas is completely new, but it is the first time that any have been endorsed by leading EU member states in an official statement. The challenge now is to define a concrete design for these proposals and persuade the other member states to support these reforms.

All current EMU reforms and plans focus mainly on institutional and regulatory reforms, with some limited plans for how to foster the different types of convergence. This article provides some thoughts on three types of convergence: social, financial and cyclical. This does not mean that the importance of real, nominal, structural and other forms of convergence, which are extensively discussed in the literature, is underestimated by the author. The recommendations below are focused on the selected three types of convergence as these have been explored to a lesser extent in the current literature and have only recently become a topic for research in relation to the reform and completion of the EMU.

Social convergence

The establishment of the EMU was expected to lead to greater prosperity and social inclusion in the participating member states. However this did not prove to be the case in the years after the introduction of the euro. The last economic and financial crisis only helped to increase social divergence in the EU. For example, there has been a divergence in the ratio of the total income received by the 20% of the population with the highest income compared to the 20% of the population with the lowest income (European Commission 2017d, 15).

This situation provoked further scepticism among the public regarding the EMU and the single currency after the crisis. However, support for the euro has increased since the economic recovery and the emergence of growth in recent years (European Commission 2017e, 6).
This social divergence also increased the influence of Eurosceptic political parties, with the departure of their countries from the euro area openly being promoted by some of them, such as the former French National Front (Front national), now renamed National Rally (Rassemblement national) (France 24 2017). In order to increase the resilience and stability of the EMU it is not only necessary to maintain political support for the single currency among the major non-Eurosceptic political parties but also to increase support for it among the EU’s citizens. In order to achieve this, greater social inclusion and convergence is needed in the EMU.

Social convergence among EU member states has been reported as having been weakened in the years after the establishment of the euro area (European Commission 2017d, 15). This is particularly true in the founding member states of the EMU. Poverty rates and social exclusion indicators have also not improved in the last decade. There are new social challenges being caused by globalisation and the introduction of new technologies. These problems and challenges have become so pressing that in order to ensure the future of Europe up to 2025 the European Commission has placed a special focus on this social dimension. As already mentioned, one of the five reflection papers that accompanied the March 2017 White Paper was dedicated specifically to the social dimension of Europe (European Commission 2017c).

It is not possible to establish a fully fledged social union in the EMU as there are different social models across the various euro-area member states. However, some recommendations can be highlighted as ways to achieve greater social convergence. These recommendations include:

- The need to create a list of more targeted social standards. Such standards were developed as part of the Europe 2020 strategy and the MIP but they need to be further developed and detailed.

- The possibility of introducing legal requirements that would limit the investment of EU money to only those member states that complete the reforms and measures needed to meet these social standards.

- A focus on further implementing the recently established 20 key principles in the framework of the European Pillar of Social Rights.

- An increase in national and EU funding for meeting social standards.

- The stimulation of cooperation and exchange of best practices among member states in the social area.

- The enhancement of current EU requirements in relation to labour mobility, and health and safety at work.

- The development of measures that will deal with the challenges and opportunities that are provided by the digital market and digital society.
• Stimulation of a dialogue with social partners and the further engagement of civil society with EU reforms, including in relation to deepening and completing the EMU.

The majority of these recommendations are presented in the European Commission’s Reflection Paper on the Social Dimension of Europe. The challenge now is how to implement this wide variety of actions and measures. Social convergence is necessary in order to streamline social inclusion and prosperity in the EMU. Greater social convergence will also facilitate public support for EMU reforms, as well as greater real and cyclical convergence among the member states.

Financial convergence

Financial convergence or the convergence of financial cycles is one of the types of convergence that has not been analysed in detail before. This type of convergence is also important in light of achieving a sustainable and resilient EMU. So far, financial services have been regulated and developed within the framework of the efforts to finalise the EU’s internal market. The last global economic and financial crisis also changed how the convergence of financial cycles is dealt with. It proved that the financial sector, instead of being the financial intermediary for the real economy, could also create problems that could lead to major economic recession if financial crises are not prevented and tackled properly.

Financial cycles are not easy to measure, partly because the concept is new, but also because it is difficult to select the relevant financial indicators from those available and because there is not sufficient data available as yet (European Commission 2017d, 17). However, more attention should be paid to financial cycle synchronisation in the EMU as financial cycles and crises may also affect real, nominal, cyclical, social and other types of convergence. The level of synchronisation of the member states’ financial cycles fell in the first years after the introduction of the euro but then rose again in the wake of the last crisis. However, similar to the synchronisation of business cycles, the major challenge in the euro area is caused by the large disparities in amplitudes across national financial cycles (Franks et al. 2018, 15–17).

There are several recommendations that should be highlighted in relation to streamlining the synchronisation of financial cycles. One possible measure is to further develop and implement the monitoring of financial indicators in the MIP. Currently there is only one headline financial indicator in this procedure, that is, the year-on-year changes in total financial sector liabilities, with a threshold of 16.5% at which such a procedure is triggered. Although this is an important and summarising indicator, more developed and detailed financial indicators would ensure a safer and more prudent financial cycle environment. Possible indicators in the banking area that might be included in the MIP as headline or auxiliary indicators are those that are currently elaborated in relation to the efforts to enforce risk-reduction measures in the EU banking sector.
Another measure that would improve financial cycle convergence in the EU is the finalisation of the institutional structure of the Financial Union. The financial services area is one of the areas of convergence where there is a clear connection between institutional reforms and greater convergence within the EMU. The EU Banking Union is a unique example of a developed supranational supervision and resolution mechanism in a multilateral economic and monetary union. However, it has still not been completely finalised and the EU is currently discussing measures for its completion, including the adoption of a legal framework for the establishment of the European Deposit Insurance Scheme. Completing the Banking Union will enhance financial stability in the euro area and will also lead to greater convergence in the EMU. The link between the institutional structure of the Banking Union and greater convergence can be ascertained from the current literature (Gros 2018, 5–6).

The EU’s financial sector is still dominated by the banking sector. However, the measures in sectors such as capital markets and insurance services should also stimulate further financial cycle synchronisation in the EMU. The measures being implemented to establish the EU’s Capital Markets Union are therefore actions in the right direction.

**Cyclical convergence**

Cyclical convergence received even less attention during the establishment of the euro area. However, in recent years EU institutions and literature have devoted much more attention to it. Cyclical convergence happens when countries are in the same stage of the business cycle. This can be measured by the gross domestic product growth rates on a quarterly basis or by another indicator. As the European Commission has recognised, achieving cyclical convergence is important for the EMU because following a single monetary policy is harder and possibly less effective when countries are at very different stages of the economic cycle. When they are cyclically divergent some member states will need more restrictive or expansionary policy stances than others (European Commission 2017b).

The current figures show that there was some business cycle synchronisation after the introduction of the euro. However, the amplitudes of their business cycles have since started to diverge among euro-area member states (Franks et al. 2018, 15), especially since the onset of the economic and financial crisis.

Some recent research has shown that cyclical convergence may even be more important for EMU sustainability than real convergence. It has also highlighted that business cycle convergence can be achieved through structural reforms. These possible structural reforms could be outlined as recommendations for stimulating greater cyclical convergence. Some of the reforms include the improvement of competition in the EU’s internal market, including through enhanced market entry and exit conditions; boosting investments in the private and public sectors; and increasing labour market flexibility (Brinke et al. 2016, 1).
Conclusions

EMU reforms aim to complete the construction of the euro area, with the goal of establishing a more sustainable and resilient EMU by 2025. The EMU was created in the late twentieth century based on nominal convergence criteria. The EU has now begun to place more focus on real and structural convergence. Recently EU institutions and research organisations have also started to focus their efforts on social, financial and cyclical convergence too.

Social convergence is an important pillar of current EMU reforms. However, much more work is needed to establish a proper list of social standards, to make a link between these standards and EU financing, to implement key principles in the social area, to enhance cooperation among member states in this area, to better prepare for the challenges of the digital era and so on. One cannot expect sustained and improving public support for the euro if social conditions and convergence are not further developed.

The convergence of financial cycles could be enforced in the EU through measures such as the inclusion of new and more detailed headline and auxiliary indicators in the MIP, the institutional development and completion of the Banking Union, and the finalisation of the Financial Union. The latter should be achieved through actions that aim to foster the growth of non-banking financial services in the EU, such as capital markets and insurance sector services. The establishment and development of the Capital Markets Union is a step in the right direction.

Business cycle convergence is also of great importance for the resilience of the EMU. To streamline this, the member states should conduct more targeted structural reforms, including in the areas of competition, private and public investment, and the flexibility of the labour markets.

Institutional and regulatory reforms need to be achieved in order to make the EMU more stable by 2025. However, if this stability is to be sustained beyond 2025, further convergence must be achieved among the EMU member states, including in the social, financial and cyclical areas.

Notes

1. Some of these reforms include the establishment of new institutions and mechanisms, such as the European Stability Mechanism and the Banking Union; new fiscal capacities; and major regulatory reforms, such as those in the financial services area. It should be stressed that some of the institutional reforms will also stimulate greater convergence in the EMU. Some examples are provided in the text below.

2. This paper is focused on three types of convergence: social, financial and cyclical. However, it should be stressed that the measures in relation to real convergence (including income and productivity convergence), nominal convergence (including further enhancement of measures to preserve fiscal stability), structural convergence and other types of convergence should be also achieved and streamlined.
3. The bank risk-reduction measures are also perceived as a prerequisite for risk-sharing advancement in the EU’s Banking Union. The risk-reduction indicators that are currently under discussion in the banking sector are capital ratio, leverage ratio, liquidity coverage ratio, net stable funding ratio, indicators related to the minimum requirements for eligible liabilities and non-performing loan indicators. Other measures that are being debated relating to bank risk reduction are improved organisation in the anti-money-laundering area and insolvency procedures in the banking sector, among others.

4. The Financial Union was introduced as a concept in the 2015 Five Presidents’ Report. Currently this concept comprises the completion of the Banking Union and the development of the Capital Markets Union.

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