Summary for non-specialists
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# Policy Coordination, Convergence, and the Rise and Crisis of EMU Imbalances

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During the euro's first decade, the financial imbalances eased by adoption of the single currency were plausibly driven not only by capital flows towards initially capital-poor countries, but also by expectations that tighter market integration would accelerate the institutional and productivity convergence promised by the European integration process. Before the crisis, however, productivity failed to converge within the euro area. In countries with initially lower income and increasing international liabilities, total factor productivity and institutional quality indicators both declined. And so did personal income inequality, in sharp contrast to the increasing trend observed in other countries as a plausible consequence of tighter economic integration's pressure on uncoordinated policy choices to privilege competitiveness over distributional objectives.

At the start of the unprecedented single currency experiment, expected convergence rates were not easy to estimate on past data. It could be hoped that adoption of a common and sensible legal and policy framework and elimination of market barriers would foster productivity convergence not only through technological knowledge flows but also, and more importantly, through adoption of institutional features that support efficient use of each country's resources. In principle, competitiveness concerns may be stronger when adoption of a single currency removes devaluation escape routes to temporarily better competitiveness. In practice, adoption of a single currency (but not of a common policy framework in many other policy areas) did not foster convergence of productivity and institutions. But it certainly did foster financial market integration and, to the extent that convergence was expected, eased accumulation of international imbalances, possibly relaxing competitiveness concerns in peripheral countries.

The imbalances that would have been sustainable if productivity growth had materialized are problematic in the context of a crisis which, while partly triggered by the asymmetric impact within Europe of global financial shocks, is compounded by revision of the convergence implications of economic and monetary integration. During the crisis, international assets and liabilities did not effectively smooth country-specific shocks, notably because imperfect integration of the banking system proved unable to pool and diversify default risk. And, in sharp contrast to the role performed within Nations by taxes and transfers, the absence of fiscal risk-sharing instruments implied disorderly adjustment and divergent disposable income developments across European Union member countries.

The paper's reasoning and evidence indicate that the current euro area crisis is rooted in the weakness or absence of the expected cross-country convergence, in the asymmetric implications of the global economic and financial crisis, and in the inability or unwillingness on the part of markets and governments to share the resulting unforeseen losses. They cast doubt on the sustainability of the current configuration of the European integration process, suggesting that a robust and coherent process of European market and policy integration would require supranational implementation of the behavioral constraints and contingent redistribution

schemes that traditionally operate within National socio-economic systems, and have been weakened in recent experience by uncoordinated policy competition.

While such hitherto missing features of the European policy framework might have avoided the current crisis, revised perceptions of economic integration's promises and pitfalls may self-fulfilling trigger a breakdown of the integration process itself. The euro area was unable to control macroeconomic fiscal policies and refrained from coordinating social or employment policies, relying on systems competition to achieve convergence and on financial markets to redistribute resources across countries and over time. This configuration proved inadequate to sustain the imbalances that can be justified by expected institutional developments, but need to be supported by coordination and monitoring of those developments. Within Nations, limitation of individual freedom of choice is accepted as a condition for participation in financial markets and welfare schemes. At the European Union level, a sustainable framework should ensure that National policies foster institutional and productivity convergence, and make the resulting limitation of policy sovereignty a condition for participation in orderly risk-sharing and redistribution mechanisms in the face of unexpected shocks. Unfortunately, formidable political commitment and technical implementation problems would need to be solved on the way towards such a robust and coherent European system of economic policies.