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Task Force on
Economic and Monetary Union

Briefing 41

Monetary Union: Convergence and Cohesion

Briefing drawn up by the Directorate-General for Research
Economic Affairs Division

The opinions expressed hereinafter are the author's own and do not necessarily reflect the position of the European Parliament

Economic and Monetary Union implies a single monetary policy, and a single short-term interest rate. In these circumstances, how far can funds from the EU Budget offset economic imbalances? Should Member States which have met the Maastricht convergence criteria still be receiving EU funding?

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Introduction

Several of the economic instruments currently available to EU governments in adjusting to external shocks or losses of relative competitivity will cease to exist within Economic and Monetary Union.

- ♦ The Single Currency will naturally make devaluation or revaluation of a national currency impossible.

- ♦ The European System of Central Banks will conduct a single monetary policy for the whole euro area, with a single structure of interest rates.

- ♦ The Stability and Growth Pact will set tight constraints on fiscal policy, as will the "no monetisation", "no privileged access to financial institutions" and "no bail-out" rules on deficit financing.

Part of the answer will lie in improving free movement and flexibility within the Single Market. But much will also depend upon the effectiveness of Community funding in offsetting economic disparities between countries and regions.

At the same time, such funding will be subject to two important constraints.

- ♦ The Edinburgh Summit of December 1992 put **a ceiling on the Community Budget**. Own resources cannot exceed 1.27% of GDP until at least 2006. Current budgetary projections for 2002-2006 envisage spending limited to 1.22% of GDP, with the remaining 0.5% constituting a contingency margin.

- ♦ **Six new Member States** are expected to join the EU between 2002 and 2006, including five central European countries with *per capita* GDPs well below the EU average. A further five currently even less prosperous countries may join not long afterwards.

The Structural and Cohesion Funds

The European Union currently has at its disposal five main budgetary[1] instruments to offset economic disparities between different parts of the Union.

The three Structural Funds

These exist to offset disparities between **regions**. They are:

♦ the *Social Fund,* created under Article 123 of the Treaty to

> *"improve employment opportunities for workers in the internal market"*, specifically by increasing *"their geographical and occupational mobility within the Community"* and by facilitating *"their adaptation to industrial change…"*

The main activities supported by the Fund are in the field of training and retraining.

♦ The *Regional Development Fund,* established

> "*to help redress the main regional imbalances in the Community through participation in the development and structural adjustment of regions whose development is lagging behind and in the conversion of declining industrial regions*" (Article 130c).

♦ The *Guidance* section of the *agricultural fund, FEOGA ("Fond européen d'orientation et de garantie agricole"),* established in 1962 under the general provisions of Article 43 on the Common Agricultural Policy.

These funds, originally created for separate purposes, were brought together to form a coherent regional development policy by a series of reforms after 1988 (see Article 130d of the Treaty). The Single European Act of of 1987 introduced a new Title V into the Treaty (which has now been renumbered Title XIV): "Economic and Social Cohesion". The overall objective was to

> "*aim at reducing disparities between the levels of development of the various regions and the backwardness of the least-favoured regions, including rural areas.*" (Article 130a).

The 1988 reforms, revised in 1993, clarified four principles for Structural Fund expenditure:

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[1] These are to be distinguished from loan funds from, for example, the European Investment Bank, although support for interest payments on such loans can be made from the Budget.

- ♦ *Concentration of spending on priority areas and sectors.* Objective 1 regions, given the highest priority, are defined as those with a *per capita* GDP below 75% of the EU average, and have covered Greece, Ireland and Portugal as a whole.

- ♦ *Partnership between the EU, the Member States and the regional/local authorities.* This has covered both the identification of projects and financing.

- ♦ *Integrated programming* to maximise the effect of spending from different sources.

- ♦ *Additionality* - that is, funding from the Community Budget must be additional to, rather than replace, expenditure from national or local sources.

The first programme ran from 1989-1993. In 1993 the decision was taken to double the sums available, and to concentrate the bulk of expenditure on Objective 1 regions during the 1993-1999 period. The remaining expenditure is targeted at special regional needs: for example, a new category of regions which have a very low population density was created as a result of the EU's 1995 enlargement.

The Cohesion Fund

The reforms of 1993 also established a new financial instrument, the Cohesion Fund,

> "*to provide a financial contribution to projects in the fields of environment and trans-European networks in the area of transport infrastructure*" (Article 130d).

Although this is not stated in the Treaty, the establishment of the Fund was directly linked to the Maastricht programme for Economic and Monetary Union. In order to qualify for participation in the Single Currency, Member States were required to reduce their budget deficits below the 3% reference level, and to reduce the overall level of public debt towards the 60% reference level. At the same time, the cuts in public expenditure required to achieve these objectives could have severely reduced the level of essential public investment in the poorer EU Member States. Cohesion Fund money was intended to offset this reduction, so promoting not only *nominal* convergence (inflation and interest rates, deficits and debt levels) but also *real* convergence (*per capita* GDP, employment, etc.) within EMU.

To qualify for Cohesion funding, Member States:

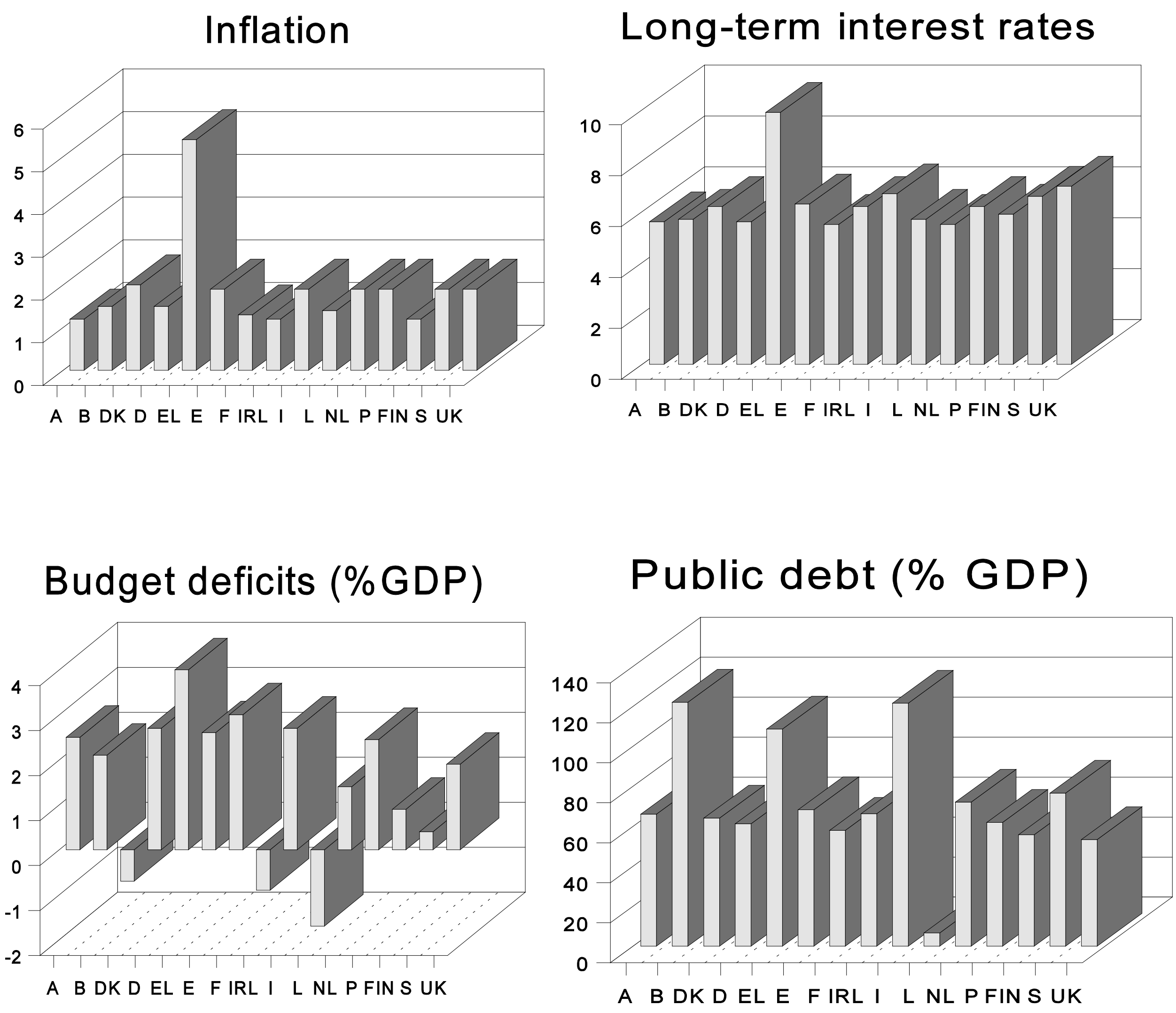
- had to have a *per capita* GDP under 90% of the Community average; and

- were required to put in place - and adhere to - a programme of action designed to meet the EMU convergence requirements.

Convergence: the record

The statistics for 1997, and the projections for 1998 and beyond, indicate that the convergence of *nominal* factors required for the establishment of EMU has taken place in every case except that of Greece. The budget deficits of the other fourteen Member States (whether they intend to join the Single Currency or not) are below 3% of GDP. Inflation and interest rates have converged at historically low levels.

Chart 1: Nominal convergence of EU Member States, 1997



Disparities between countries.

A similar convergence of *real* economic factors, however, has not yet occurred.

Four Member States - Spain, Portugal, Greece and Ireland - were in 1993 identified as having a level of ***per capita* GDP** below 90% of the EU average, and have therefore been in receipt of Cohesion funding. Just over half of the 15,500 billion ECU to date has been spent in Spain, with the rest being divided roughly evenly between the other three.

Before the establishment of the Fund, these economies were already improving their relative position. Between 1983 and 1993 their *per capita* GDP rose from two-thirds to three-quarters of the EU average. Since then the trend has continued, though unevenly. Ireland has dramatically improved its position as a result of a very high economic growth rate, reaching 90% of the EU average by 1995, and the average itself by 1998. Greece, by contrast, has only now reached the two-thirds figure.

At the other end of the spectrum, four Member States have a *per capita* GDP over 10% higher than the EU average: Austria, Belgium, Denmark and Luxembourg. Germany, France, Italy and the Netherlands are also above average; the UK is almost exactly on it; and Sweden and Finland are marginally below. The result is a spread of some 40 percentage points about the average between the richest Member State, Luxembourg, and the poorest, Greece.

Chart 2: *Per capita* GDP of EU Member States, 1997 (ECU ,000)

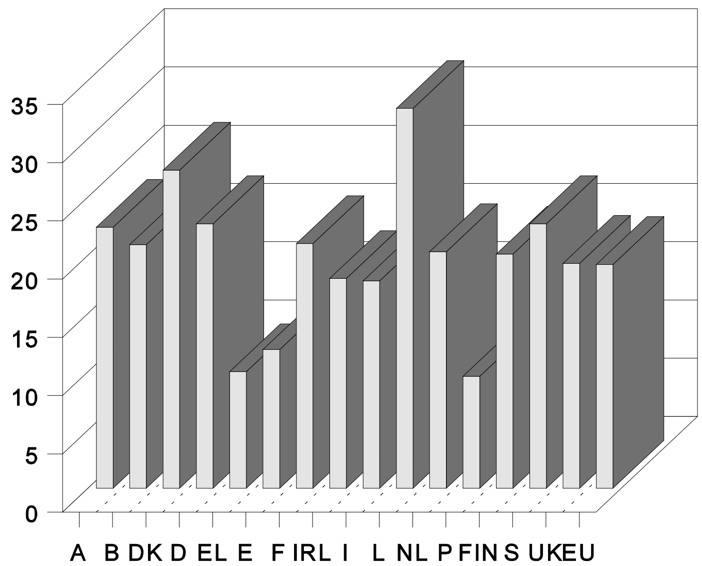
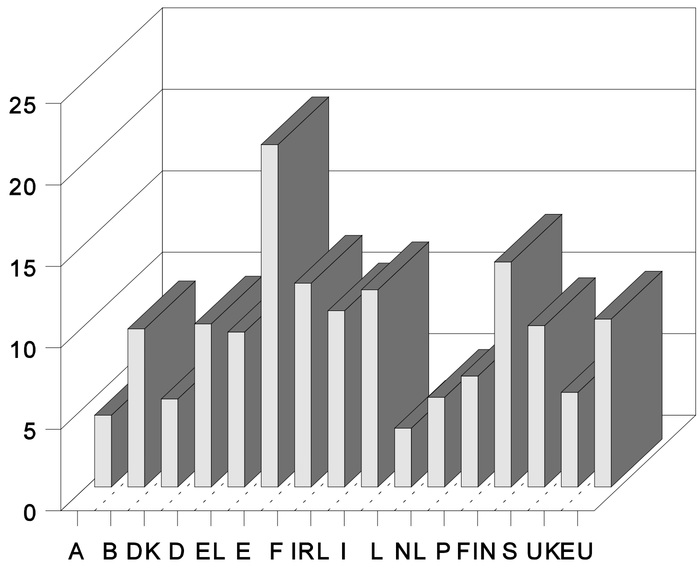


Chart 3: Unemployment rates in EU Member States (%), 1997



The situation in relation to **unemployment** is more varied, and does not entirely correlate either with GDP growth or with *per capita* GDP. Thus Ireland, which has enjoyed the fastest economic growth in the EU for a number of years, nevertheless has an unemployment rate above the EU average. Spain, which has had an economic growth rate second only to that of Ireland, has the highest unemployment rate in the EU, at *double* the average. Portugal, by contrast, has enjoyed economic growth similar to that of Spain, but has an unemployment rate only *half* the average. Similar disparities can be observed among the richer EU Member States. Belgium, France and Germany have rates of unemployment of over 10%, Denmark, the Netherlands and the UK of only 5 - 6%. Whereas cyclical factors can provide some of the explanation (as in the case of the UK), structural differences appear to be more significant (as in the case of Denmark and the Netherlands).

Disparities between regions

Though the Cohesion Fund itself is related to national statistics, these nevertheless give a highly misleading picture of the extent to which standards of living throughout the EU have converged. When the statistics are aggregated at regional rather than Member State level, three facts stand out clearly:

- The disparities between different regions *within* Member States are substantially greater than the differences between the Member States themselves. For example, the *per capita* GDP in the Northern Italian regions is between 120% and 130% of the EU average, whereas that in the Southern regions is only between 60% and 90%.

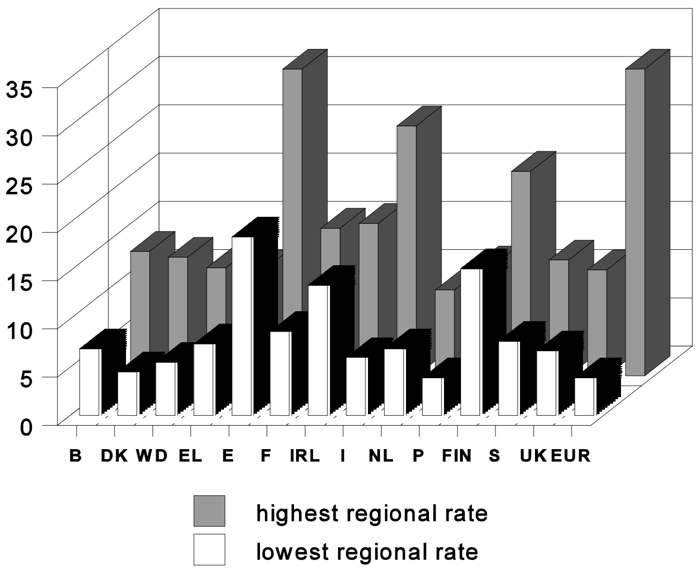
♦ The differences in standard of living between the poorest and richest regions within *the EU as a whole* are also substantially greater than the differences between Member States. The richest German *Land*, Hambourg, has a *per capita* GDP four times that of the poorest region in Portugal, Alentejo. The ten worst-hit regions have unemployment rates of over 25%, whereas the ten best have rates below 4%.

♦ Though the standard of living in all regions has of course risen, it is also apparent that no convergence has taken place. In the decade 1983-93 the 25 richest regions increased their *per capita* GDP by about 140% of the EU average, the poorest regions by only a little above 50% of the average. The unemployment gap, moreover, has been widening: rates in the low-unemployment regions have been falling, those in the high-unemployment regions rising.

A number of explanations can be advanced for this increase in disparity between regions. Labour mobility between regions is low, even within the same Member State. At the same time, regional specialisation is aggravating the impact of changes in demand for particular goods or services.

"Asymmetric shocks seem to be becoming a regional phenomenon rather than national".[2]

Chart 4: Regional disparities in unemployment in the EU (1995)



[2] Professor José-Maria Estaban in evidence to the European Parliament's Committee on Econonic and Monetary Affairs and Industrial Policy, 17th March 1998.

Taken as whole, the EU has also shown a pattern of disparity between “core” and “peripheral” areas: for example, the *per capita* GDP of all the Mediterranean regions is below the EU average, whereas that of a zone comprising the North of Italy, Austria and Southern Germany is above average.

However, the distinction between “core” and “periphery” should not be taken too far. Some of the highest growth rates in the EU have recently been achieved by the “Atlantic” states, Ireland and Portugal. The “peripheral” countries of Finland, Ireland and Portugal has similarly made the most spectacular progress in meeting the Maastricht convergence criteria, while “core” countries like France and Germany have experienced difficulties.

The Budgetary Context: Agenda 2000

With the prospect of the EU's enlargement by a further six Member States early in the next century, the Commission published a programme of far-reaching policy reforms in July 1997: "Agenda 2000". This proposed major changes to the structure and financing of regional, social and agricultural funding.

Detailed legislative texts implementing these proposals have now been published. The Financial Perspective for 2000-2006 retains the 1.27% of GNP ceiling on EU "own resources"; but envisages major changes within the envelope. Whereas spending on agriculture would rise by 1.9% a year to 51.6 billion ECU in 2006, that on normal structural operations would *fall* by 1.4% a year to 32.47 billion ECU. Expenditure would, however, rise on both agricultural and structural operations related to accession, reaching 17.61 billion ECU in 2006.

Structural Fund reform

Within this financial envelope, a major reform of the Structural Funds themselves is also planned, with the objective of concentrating spending on the poorest areas.

- Instead of the current seven categories of Regional Fund objective, there would only be three: *Objective 1*, still defined as regions with a *per capita* GDP lower than 75% of the average; *Objective 2*, covering industrial, rural, urban and fishing areas in economic decline, and, in particular, with high rates of unemployment; and *Objective 3*, focusing on improvements to the labour market through retraining, etc. and linked to Social Fund spending.

- *Objective 1* regions would be redefined, so that the coverage fell from 25% of the EU's population to 20%. The whole of Ireland, for example, would lose Objective 1 status. There would, however, be a six- to seven-year phase-out period.

- *Objective 2* spending would also be more concentrated, with coverage falling from 26% to 18% of the EU population.

- The net effect would be to reduce the overall coverage of regions eligible for support from 51% of the EU population to between 35% and 40%.

In the case of the Cohesion Fund, the current ceiling of 0.46% of EU GNP would remain, with a limit on transfers to any one country of 4% of GDP.

The Impact of Enlargement

The *per capita* GDP of the states currently seeking EU membership is, together, only about 30% of the EU average. That of the largest, Poland, is only just above this level, at 31%. Enlargement will therefore result in a significant drop in the EU's average *per capita* GDP.

All four previous additions to the original six EEC countries have, in fact, resulted in such a fall. That which would result from enlargement to the eleven current applicants, however, would be substantially greater than on previous occasions - a fall nearly three times as great as that resulting, for example, from the Greek/Iberian enlargement in the early 1980s. (see Table 1)

Table 1. Impact of successive EU enlargements on *per capita* GDP

	Increase in population (%)	*Increase in total GDP (%)*	*Change in per capita GDP (%)*	*Average per capita GDP (EUR 6 = 100)*
EUR 9/EUR 6	32	29	- 3	97
EUR 12/EUR 9	22	15	- 6	91
EUR 15/EUR 12	11	8	- 3	89
EUR 26/EUR 15	34	9	- 16	75

Source: Agenda 2000.

At the same time, the existing EU is facing economic problems of its own. Over the period 1991-96, unemployment rose steadily, exceeding a rate of 10% to reach a total of 18 million.

Enlargement therefore poses the problem of reconciling three potentially conflicting objectives:

♦ integrating the new Member States into the EU economy;

♦ improving - or at the very least preventing any relative deterioration in - the position of the poorest countries and regions in the existing EU; and

♦ maintaining the agreed ceiling on EU spending.

The 2000-2006 spending plans envisage that 30% of the Structural Funds will be devoted to enlargement. A third of the extra money will come from the savings resulting from reform (see above); the other two-thirds from a projected 2.5% annual rate of economic growth in the existing EU Member States, and a 4% rate in those acceding.

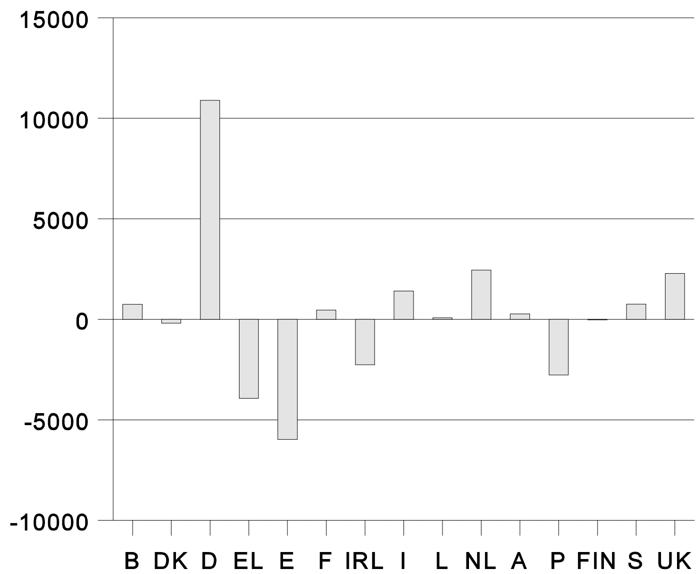
The pattern of net contributions

The problem of reconciling the need for structural spending with budgetary constraint is complicated by the pattern of payments into, and receipts from, the EU budget. This results in some two-thirds of net contributions being made by Germany - despite the fact that between 1991 and 1995, Germany spent some 330 billion ECU on economic reconstruction in the relatively poor East German *Länder*.

For example, some 30% of the funds for agricultural and structural spending come from German taxpayers; but only 14.8% of the spending is made in Germany. In the case of France, the two figures are in balance; while Spain contributes about 6.5% and receives about 15.5%. The second largest net contributor is the Netherlands, which makes the highest contributions of all in relation to population. The third largest net contributor is the UK.

Such statistics help explain why Germany - supported by the Netherlands and the UK - oppose any further expansion of the EU Budget.

Chart 5: Net contributions to (+) receipts from (-) the EU Budget (1996)
(ECU *m.*)



Sources: Commission, Court of Auditors

A further complicating factor is the special position of the UK. At the beginning of the 1980s, the imbalance between the UK's relative wealth and its relative net payments into the budget resulted in the creation of a mechanism for special budgetary rebates[3], without which the UK's net payments would possibly be doubled.

Voices are now being been raised both for a re-negotiation of this special rebate mechanism, and for some similar arrangement in relation to the German and Dutch net contributions.

Finally, German Finance Minister Theo Waigel among others has also raised the question of whether those Member States which have attained the necessary convergence to join the Single Currency in January 1999 - that is, Ireland, Spain and Portugal - should now continue to benefit from special EU funding.

[3] Sometimes called "Maggie's money" after the then British Prime Minister, Margaret Thatcher.

Conclusions

As the European Union moves into the final phase of Economic and Monetary Union, the pattern of convergence between Member States' economies is not clear-cut. At the same time, the budgetary situation is also complex. A number of conclusions can nevertheless be drawn.

- **Nominal factors** show a high degree of convergence, except in the case of public debt, where Belgium and Italy still have a debt/GDP ratio double the 60% reference level.

- **Some real convergence between Member States** has clearly taken place as *per capita* GDP in the poorer countries has risen - in the case of Ireland at a very rapid rate. But the situation in relation to unemployment is less satisfactory, and not entirely correlated with GDP.

- **Real convergence between *EU regions*** has hardly occurred at all, either in terms of *per capita* GDP or unemployment.

- Only one Member State hitherto in receipt of Cohesion Fund money has converged both in nominal and real terms: that is, **Ireland**. A second Member State, **Greece,** has so far converged neither in nominal nor in real terms. **Portugal** and **Spain** have converged in nominal terms, but not yet in real terms - in the latter case unemployment shows particular disparity.

- The purpose of the **Cohesion Fund** was in part to offset cuts in public expenditure made by the poorer Member States in order to meet the Maastricht fiscal criteria, so preventing a widening of real economic disparities. These fiscal criteria, however, will continue to apply within the Monetary Union, re-enforced by the Stability and Growth Pact. Hence, as long as the real economic disparities exist, the logic of Cohesion funding remains.

- Since the most serious economic disparities are between regions rather than Member States, the case for continued **Structural Fund** transfers is unaffected by Member States' meeting the nominal Maastricht convergence criteria.

- The fact that the most significant economic disparities are between regions - often within the same existing currency area - and not between countries, indicates that the ability to **vary exchange rates** is an adjustment instrument of limited value. Its loss following adoption of the Single Currency is therefore unlikely to disadvantage the poorer Member States.

- The ability of the EU to **fund enlargement** within the agreed budgetary ceiling will depend upon meeting a sustained 2.5% annual growth target within the existing Member States.

- Pressures to change the **relative net contributions** by Member States into the EU budget must also be taken into account.