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or slow real convergence?**

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Introduction

Along with the single market and monetary union, one of the fundamental aims (Article 2, TEU) of the European Union (EU) is to promote economic and social cohesion, an expression which is interpreted in Title XVII (Article 158, TEC) to mean ‘reducing disparities between the levels of development of the various regions and the backwardness of the least favoured regions or islands, including rural areas’. Clearly, this wording signals that a key element of ‘cohesion’ is the promotion of ‘convergence’ in the sense of reducing disparities in GDP per head: in other words, ‘real convergence’. Entry into stage 3 of EMU, that is full membership of the euro area, requires countries to pass the entirely different test of fulfilling the ‘nominal’ convergence criteria set out in the Maastricht Treaty. Real convergence means that poorer countries and regions should, by having relatively higher growth, catch-up with the richer, whereas nominal convergence has the more limited ambition of ensuring that a country’s fiscal and monetary position is compatible with the obligations of monetary union, irrespective of its growth rate.

The decision on whether or not to participate fully in monetary union, particularly for the new Member States that will accede to the EU in 2004, is one which will necessarily require a balancing of different considerations. On the one hand, as Leszek Balcerowicz explained in 2001¹, early ‘entry of the candidate countries into EMU would allow them to start reaping the related advantages (more price transparency, reduced transformation costs, stronger macroeconomic framework)’ as quickly as possible and would help to consolidate the momentum towards structural reforms. He also argues that setting a firm deadline is advantageous and that his reasoning is applicable to most of the new members. CEPS (2002) also supports early EMU entry for most of the new members on the grounds that a stable macroeconomic framework is an essential pre-condition for real convergence.

Opponents of early participation in EMU, on the other hand, are concerned that EMU will impose too rigid a macroeconomic policy framework on countries which are bound to face

¹ Speech to the 11th European Banking Congress in Frankfurt, 23 November 2001

turbulent times as they continue to restructure. The new members will have to cope with the demands of transition not only to a market economy, but also the EU single market (for a summary, see Landesmann and Richter, 2003). The core of this latter position is that a greater degree of flexibility will be required and that the capacity to adapt monetary conditions and alter the nominal exchange rate will be essential tools. There are also many factors to consider, as the evidence from the last forty years for the current members reviewed by Barry (2003) shows. The principal obstacles to convergence have been labour market rigidities (especially Ireland prior to 1973 and Spain during the 1980s), ill-judged macroeconomic policies (all the ‘cohesion countries’ from the mid-1970s to the late 1980s, and weaknesses in public administration).

The convergence challenges

For both the EU-15 and the new members, several convergence challenges will have to be confronted. Four very different (though possibly overlapping) types of convergence problem can be identified:

- *Lack of development* has meant that many parts of the enlarged EU are deficient in the dynamic sectors of activity that have supported economic advances. Such regions, typically, have large, often low-productivity, agricultural sectors and did not experience large-scale industrialisation. In much of Southern Europe, until quite recently, agriculture remained a dominant industry and there was relatively little industrialization. High ‘natural’ rates of labour force growth (that is, where the entry of youths into the labour market is substantially higher than the retirement of older workers) have traditionally characterized much of Southern Europe, as well as Ireland, and have led to a steady emigration working age individuals. Advances in agricultural productivity have meant that fewer workers can be supported by farming, with the result that in such regions there has been a drift of population towards urban centres. This pattern of a shakeout in agriculture is likely to be repeated in many of the new members from central and eastern Europe.
- *Peripherality, remoteness, or inaccessibility* are purely geographical disadvantages that amount to a permanent competitive disadvantage that is unlikely to be easily countered. Most of the currently designated ‘less-favoured’ regions are on the periphery of the EU, suggesting that this, in itself, is a significant reason for support. The notion of peripherality as a geographical one of distance from an economic ‘core’ implies that transport costs are the main obstacle, but it may be more accurate to analyze peripherality in terms of marginalization in a wider sense. It is also important to note that there are many relatively prosperous regions (the Prague region, Grampian in the UK, Uusimaa in Finland) in ostensibly remote locations, whereas some of the less-favoured regions, such as Hainaut in Belgium or the Saarland, could scarcely be more centrally located.

- *Loss of competitiveness* can arise for a variety of reasons, and can be especially hard to reverse if cumulative processes reinforce the initial loss. In Northern Europe, where the decline of agricultural employment occurred at an earlier stage, regional problems are associated mainly with the decline of staple industries, especially coal-mining, steel-making, textiles and shipbuilding, and it is apparent that the ‘sunrise’ industries, such as computer software or biotechnology, are drawn to different sorts of locations, often environmentally more attractive. For most of the regions affected by industrial decline, adjustment has proved to be slow and painful, instead of happening quickly as might be predicted by the more sanguine economic theories. Here too the reliance on ‘old’ industry and poor environmental conditions in regions of the new Member States are inauspicious.
- *The consequences of economic integration* can be pronounced where the dismantling of barriers, or a reconfiguration of the policy or regulatory frameworks may in themselves precipitate regional problems. The impact of integration can arise in a variety of ways, and are analysed notably in ‘new economic geography’ (NEG) approaches (Krugman and Venables, 1996; Puga, 1999). If integration tips the balance of industrial organisation in favour of economies of scale and scope, the effects may systematically affect a whole region, although the NEG analyses tend to have conflicting views on what the outcomes will be, depending on the assumptions made about labour mobility and wage flexibility. At a macroeconomic level, other mechanisms come into play. In particular, a changed macroeconomic policy mix may have an uneven regional incidence.

All four categories of regional problem are in evidence in the EU-15 at present. Eastern enlargement of the Union will, moreover, bring new demands on policy. EU policies to promote cohesion (through the Structural Funds and the Cohesion Fund) focus principally on enhancing the long-run competitiveness of weaker regions. Current eligibility rules distinguish between two classes of recipients: the lagging regions (those with a GDP per head relative to the EU of 75% or below (Objective 1 of the Structural Funds) and other regions facing socio-economic restructuring (Objective 2). Nearly all the regions in the former group have been slow to develop and tend to have above average proportions of primary industry. The Objective 2 regions, by contrast, have generally seen an erosion of competitiveness.

These questions about convergence point to a number of awkward trade-offs that need to be explored in considering the merits of quick accession to full EMU. The aim of this paper is to assess the issues raised by looking at the conceptual arguments and at the emerging evidence from the early years of the euro. Both are surprisingly inconclusive and the paper therefore also tries to explore the circumstances in which full monetary union is likely to be more

advantageous. The next section sets out the broad lines of the debate on the balance of effects of joining EMU rapidly. After a brief discussion of the record after five years of the euro, the paper concludes with a review of policy issues.

The impact of EMU

That EMU changes the economic environment, perhaps radically, is generally accepted and there is broad agreement on several of its expected effects. Equally, there are possible outcomes where neither theory nor evidence provides a solid basis for judgement and no easy way of reconciling the conflicting views. Three different categories of effects, all of which bear on real economy performance, can be delineated (see table 1). These are:

- *Macroeconomic changes* resulting from the new policy regime that alter the manner in which policy is conducted and require the country, first, to acclimatise then to develop new accommodations between policy actors and objectives. Thus, a general fall in interest rates (expected from the single currency) will favour (relatively) indebted countries regions. Curbs in public expenditure to meet the SGP may result in lower discretionary public spending.
- *Labour market transformations*. An important consideration in this context is the ease with which countries are likely to be able to render their labour markets more flexible. The difficulties in Germany in pushing forward labour market reforms may be in the limelight at the moment, but there is also evidence that there is a lack of adaptability on the part of lagging countries (Algoe and Alphametrics, 2002).
- *Induced effects on economic structure* that shape the longer-term competitive position of the economy by altering the competitive position of different areas and shaping supply-side developments.

In looking specifically at the challenges surrounding EMU facing the new members of the EU, three general questions arise. First, are stabilization and growth at odds with each other for any country contemplating whether to participate fully in EMU? Balcerowicz states that ‘we should not oppose nominal and real convergence. One should not assume there is an unavoidable conflict between the two.’ Equally, any such conflict may, above all, be a matter of timing: the medium- to longer-term benefits of stabilization may be uncontested, but if rapid transition is very costly, does it make sense?

Second, if EMU delivers its promise of higher growth in the medium- to long-term, will it benefit the richer parts of the Union at the expense of the poorer? In similar vein, will the advantages *within* countries be evenly spread or unbalanced? Third, is the particular institutional form of EMU – especially the fiscal rules that govern both the transition to stage 3 of EMU (the convergence criteria) and full participation (the Stability and Growth Pact) – likely to be an obstacle to successful economic development by the new members?

Stabilization effects

There is little dissent from the view that there are long-run benefits to be realized from the enhanced stability that will be achieved by full participation in EMU. Instead, the issues surrounding stabilization are more about the short- to medium-term effects. The expected gains in stabilization come about because full participation in EMU immediately confers on the country that joins commitment and credibility benefits that it would otherwise find it very difficult to achieve. It is generally accepted that these gains will have to be paid for in the transition to EMU and possibly beyond. The argument about transition costs is straightforward, if empirically contentious. Countries with inflation rates or fiscal ratios above the Maastricht thresholds will have to rein back the economy to attain the required macroeconomic balance and, in so doing, must expect to lose output growth. The extent of any output loss will depend on a range of influences, such as the magnitude of the adjustment that has to be made, the sequencing of different stages, whether it takes place in a generally buoyant or stagnating economic environment (both internally and among key trading partners) and the potential conflict that might be engendered in making the adjustment.

Certainly, countries that have to travel a long way to achieve nominal convergence might be expected to have to forgo more growth to attain a stabilized economy than those which only have to make minor adjustments. There are also significant risk of instability from early membership of ERM II (Pelkmans and Hobza, 2002), a system that requires a fair degree of nominal convergence to be generally beneficial for its participants, but could prove to be damaging if exchange rates tend to diverge. As Landesmann and Richter (2003) note, several of the CEECs have suffered ‘major exchange rate crises which entailed exchange rate realignments (Czech Republic 1997, Slovak Republic 1999; see also the realignment in Poland 2002, etc.).’ They therefore contend that joining EMU swiftly could necessitate the over-riding of other macroeconomic policies while at the same time slowing structural reforms. Both could result in heavy costs in terms of output foregone. They also point to the fact that one potential adjustment mechanism – migration – will be even weaker than it is at present in EU-15 because of the

agreement on a seven year transitional period. A further important element in the macroeconomic assessment of early EMU entry is whether capital flows are likely to have a destabilizing impact. In this regard, the free capital movement that characterizes all current and new EU members means that there is limited scope for dealing with destabilizing capital flows.²

But it can be argued, just as persuasively, that if the pursuit of EMU constitutes a shift from 'bad' to 'good' policy, then the process may well be unambiguously beneficial. A question to pose is, therefore, whether the pre-EMU policy regime was one that favoured growth or, instead, had had a debilitating effect. For example, the Greek economy appeared to pick-up from the mid-1990s onwards as the macroeconomic excesses of the previous decade were replaced by more sensible policies. Ireland, too, rapidly saw benefits as the large deficits and high debt of the decade before were brought under control from the late 1980s onwards. Indeed, the transformation of Irish macroeconomic policy in the late 1980s is regarded as one of the foundations of that country's subsequent spectacular growth (Barry et al, 1999). By contrast, both the French and Italian economies seemed to lose dynamism during the 1980s and 1990s, first through targeting the exchange rate in order to stay in the exchange rate mechanism of the EMS, then in making the further adjustment to EMU. It is, perhaps, salient that the small open economies have, on the whole, found it easier to adjust than their larger peers. EMU can also act as an external benchmark cum incentive for policy improvement and there is evidence that it contributed to the recasting of policy in Greece (with results that can be regarded as positive for growth) and Italy (though with, thus far, less encouraging outcomes).

Once in EMU, a country has to adapt to a policy regime that is radically different. In particular, it has to recognize that the ECB will deliver price stability and that resort to inflation as an adjustment mechanism, or to calling on the central bank to print money to finance expenditure are no longer options. Adjustment to shocks, symmetric or asymmetric, will require the creation of room for manoeuvre in fiscal policy, while also obliging the supply-side to assume a greater share of any burden. Consequently, the fiscal authorities will have to adapt and labour market actors to recognize that monetary policy can no longer accommodate inflationary pay deals.

Inter-territorial disparities

Even if EMU does fulfil the expectation of its supporters that it will facilitate stable growth in the EU as a whole, there is no guarantee that the resulting growth will be balanced, whether among Member States or regions. Yet there is by no means a consensus in the literature on how

² Here again, the implication is that full EMU participation would be beneficial compared with ERM II, so that it is the transition that is the risky, and potentially costly, phase.

the furthering of economic integration by monetary union will affect disparities. In the Delors report (1989: paragraph 29) that paved the way for the euro, the fear was expressed that 'historical experience suggests, however, that in the absence of countervailing policies, the overall impact on peripheral regions could be negative.' This statement echoed concerns expressed in the Padoa-Schioppa report (1987) and led directly to the acceptance that there should be some sort of compensatory policy to assure cohesion. The thrust of much of the new economic geography analysis as applied to European integration is that integration does indeed favour core areas at the expense of the periphery. But the outcome will be the result of a balancing of different effects (succinctly summarized in Krugman, 1998) which can only sensibly be assessed empirically.

An alternative view is that EMU will provide a stimulus to the less competitive countries and regions that will enable them to make a leap forward, the implication being that separate currencies have acted as a barrier to economic development. Possible explanations for advance include the overcoming of inhibitions on factor movements that have prevented optimal allocation of resources, especially investment flows, and the negative effects of markets fragmented in a way that has slowed innovation and the exploitation of economies of scale. The recently published 'Sapir' report notes that 'growth may have a negative effect on cohesion if market forces lead to a widening of the income gaps between regions or between individuals. In the case of economic convergence between regions there is little evidence of such effects and, on the contrary, lagging regions have provided a boost to overall EU growth' (CEC, 2003b: 2). The same report also states that although redistributive policies have helped to assure social cohesion, they may have done so 'at the expense of lower incentives for growth' (CEC, 2003b: 3). The inference to draw is, perhaps, that EMU provides a new setting within which the detailed policy choices made by the acceding country are what matter, rather than the overall impact of monetary union.

Institutional factors

The recent controversies surrounding the SGP have prompted searching questions about whether the current policy framework is appropriate. The EMU policy regime combines a specific philosophy of economic policy, a novel distribution of responsibility between the national and supranational levels of economic governance, and a reconfiguration of policy instruments and targets. It is easy to forget just how profound the change is. In addition, because of political imperatives that have resulted in a delicate balance of power between Member States and the supranational level, EMU has also had to establish means of co-ordinating a

range of national policies. A key question in this regard is whether what might be called the Artis-Buti policy framework³ goes far enough in assigning policy roles. In this conceptualisation - to simplify greatly - monetary policy (and hence the ECB) plays the primary role in responding to symmetric shocks to the euro area economy, while fiscal policy provides the means to deal with national differentiation. A related, but separate question is whether national inflation rates matter and thus whether anyone should lose sleep if they diverge, provided the overall euro area rate is on track. Criticisms centre on the SGP, but go further (Pisani-Ferry, 2002).

If the SGP is problematic for growth in EU-15, what about the new members? For Buiter and Grafe (2003: 2), the answer is clearcut: 'both the Stability and Growth Pact and the Broad Economic Policy Guidelines currently in place are ill-designed to address the economic realities of countries that differ significantly from the current EU average as regards their expected future inflation rates and real GDP growth rates, and their inherited stocks of environmental and public sector capital.' The same authors (Buiter and Grafe, 2002) nevertheless believe that the new members should accede to EMU at the earliest possible opportunity, arguing that the benefits of a correct 'fiscal financial programme' are paramount. But the implication is that the fiscal rules may well water-down the potential benefits. The dilemma here is that EMU is a package deal which includes fiscal rectitude, yet the new members (and indeed countries such as the UK which have neglected public investment) have obvious needs for enhancement of infrastructure and other forms of public capital.

The timing of EMU effects

In thinking about monetary union, a number of phases can be envisaged for different effects. The first is nominal convergence which, in the EMU model, has had to take place prior to joining the currency. Second, there is assimilation to the resulting new regime. Then follow the medium- to longer-term real economy effects described in the second and third segments of table 1.

The nominal convergence phase has proved to be a testing one for many countries, because the obligation to 'consolidate' public finances tends to mean a combination of tax increases and public spending cuts that dampen demand. In the EU as a whole, public spending fell by some seven percentage points between 1995 and 2002, with most of the change matched by a fall in

³ See, for example the model developed in Artis and Buti (2000) and some of the contributions to Brunila et al. (2001) and Buti et al. (2002).

public deficits. There are circumstances in which the holy grail of an expansionary fiscal contraction can be achieved, especially if fiscal restraint permits a markedly looser monetary policy, but the consensus is that most Member States lost potential output during the 1990s as they struggled to meet the Maastricht criteria.

Another major issue is the price level. In all the new member states, these are well below EU-15 levels: according to a recent report by the OECD (2003), the price level in the accession countries, measured in 2001, was just 51% of the EU-15 level. The lowest recorded level was the Slovak Republic at 39%; the figure for Hungary was 46%, for Poland 56% and for Slovenia 65%; while Cyprus topped the list at 85%. One potentially disruptive factor is the so-called Balassa-Samuelson effect which arises because productivity in the tradable sector of the economy rises more rapidly than in the rest of the economy, but relative wages do not adjust. If the effect is substantial, measured inflation will be higher, but the competitiveness of the tradables sector will be scarcely affected. But, by causing a real exchange rate appreciation there may be problems in maintaining the combination of stable nominal exchange rates and low inflation required for EMU accession. Again, the rules and economic common sense risk being at odds.

To bring these together, a useful analytic device for looking at the impact of the single currency is the j-curve, traditionally employed to assess devaluations – see figure 1. If the country does not accede to full EMU, it might be expected to maintain a steady rate of growth, but to forgo the boost to growth that arises from greater macroeconomic stability. When the decision is taken to seek full participation in EMU, the process of nominal convergence may cause initial dislocations that result in a loss of performance – this is captured in the chart in the period A-B, and the downward movement along the j-curve. It can be argued that this was true for several EU-15 countries during the 1990s. Subsequently, however, the benefits of stabilisation manifest themselves in a better trajectory for performance: this is the upward slope of the j-curve⁴. The length of the period B-C will depend on how quickly the country adapts to the new macroeconomic regime. One of the challenges of joining EMU is to optimize the shape of the j-curve. An ideal policy will have little or no initial loss of performance, a short wait until

⁴ As applied to devaluation, the j-curve approach analyses the response of the trade balance. It posits an initial ‘terms of trade loss’ giving rise to a worsening trade balance, but a subsequent improvement as increased price competitiveness boosts exports. The difficulty with devaluation, however, is that it risks higher inflation that leads to a further loss of competitiveness. There is no reason to expect such a third phase from full participation in EMU unless there are longer-term incompatibilities between the monetary conditions under EMU and those that the economy needs.

improvements kick-in and a steep upturn. The one to be avoided will have such severe short-term costs that it is politically awkward. Figure 2 illustrates these extreme cases.

The macroeconomic record of the euro

With the euro having now been in place for close to five years and a fair degree of consensus on macroeconomic projections for 2004, there is now enough information to attempt a provisional assessment of its initial macroeconomic effects. In terms of growth, the outcome is, perhaps, surprising: the core countries, other than Luxembourg have performed relatively poorly, while the periphery (with the exception of Portugal) has prospered, as can be seen from figure 3. Moreover, the difficulties confronting Germany, Italy and France have become more pronounced since the downturn of 2001, and the Netherlands has seen a marked reversal of the dynamism it exhibited in the late 1990s. These trends go a long way to explain the tensions that have arisen in relation to the Stability and Growth Pact.

However, although six years has to be seen as more than a temporary phenomenon, the apparently favourable impact of EMU on several peripheral countries may well be the result of factors other than the single currency. Among the reasons for the disparate performances of the euro area economies since 1999, four deserve particular attention. First, there is the gain in credibility that accrues to countries that had previously faced an interest rate surcharge because of fears about long-term inflation. This would have benefited, primarily, the Southern Member States. Second, debt service has become much cheaper as countries have benefited from falling national debt stocks and lower coupon rates. As a result, the shackles on fiscal policy in these countries have been relaxed. Third, by managing to maintain growth above the EU average, the faster growing countries have avoided the fiscal squeeze that has affected Germany and France, generating a virtuous circle effect. A fourth effect stems from the parities at which countries fixed their currencies to the euro. By common consent, Germany has had a rate which has been relatively uncompetitive whereas other countries – notably Ireland and Spain – may, perhaps, have had a competitive advantage. For the core economies, especially Germany and Italy, structural problems are often cited as an explanation for the difficulties besetting them. It is, though, easy to forget that these structural challenges are of long standing and cannot be directly associated with the euro.

In Ireland's case especially (also in Portugal), a further effect has been rapid asset price inflation manifesting itself, above all, in the property market, while elsewhere strains have emerged on the current account of the balance of payments. EMU has, in short, been accompanied by signs

of macroeconomic imbalance, although only in Portugal has this been translated into a fiscal position incompatible with the SGP.⁵ Indeed, there is more than a little irony in the growing problems that Germany and France have in conforming to the Pact at a time when the majority of the supposedly more vulnerable countries have been doing well. The underlying question, however, is whether the temporary benefits will subsequently be reversed. In practice the answer will depend on the degree to which the economies themselves adapt.

Policy implications and conclusions

The early years of the euro have, in several respects, confounded the fears about divergence and give some support to those who argue that EMU will foster more rapid real convergence. But the jury remains out, if only because so many of the supply side indicators remain tilted against the poorer parts of EU-15 (Begg, 2003). By inference, the same conclusion would be drawn about the new members.

When the ten new members join the Union in 2004, cohesion will be high on the agenda in at least two key respects. A first question is how quickly countries acceding to the EU should seek to embrace full monetary union. Three options can be delineated:

- Entry into stage 3 of EMU as rapidly as possible, i.e. a form of big bang
- An extended period in ERM II to assist acclimatisation, but with the corollary that monetary policy would remain with the Member State
- Retaining flexibility in the exchange rate in order to deal with possible shocks or problems associated with transition both to EU membership and more comprehensive market economy structures.

Devereux (2003) models the second and third options and shows that in most respects, the ERM option is the least attractive for reasons that are well-rehearsed in the literature. Being part of ERM only partly captures the benefits of the fixed exchange rate, notably forgoing the credibility gains that would arise from full participation in EMU, leaving the currency (and the economy) vulnerable. Retaining exchange rate flexibility would, according to Devereux's simulations, make it easier to ensure efficient adjustment to cyclical and structural shocks. Full participation in EMU, keeping the transitional ERM II stage to a minimum, may however be better.

⁵ In any case, Portugal has shown that it can exercise the political will to rein in the deficit

Second, the advent of the new members will prompt a rethinking of both the nature of cohesion policies and which regions should be eligible for them. How direct Community assistance to lagging regions is reformed will be a key part of this rethinking, but questions also arise about striking a balance between cohesion and catch-up, the role of domestic policy in fostering change, and the appropriate pace of progress towards full adoption of the European social model. In this regard, a specific challenge will be how to respond – if at all – to any widening of regional disparities within the new members. There is already evidence from some countries that capital-regions have gained most from the post-communist transition, and the experience of Portugal, Ireland and Greece suggests that market forces have favoured agglomeration at the expense of the most backward regions. Will there be enough ‘trickle-down’ to make such internal divergence palatable?

Enlargement is bound to require major changes in the way in which structural operations are conducted and difficult questions arise about how to deal with the accession of so many regions with low per capita GDP. As a backdrop to the discussion, the following points are worth noting:⁶

- There seems little disposition to change one of the key features of the Structural Funds, which is that regions with a GDP per head, measured in PPS (purchasing power standards, which correct for price level differences between countries), below 75% of the EU average are classified as Objective 1 (lagging behind) and entitled to the highest level of Community support.
- Because the accession of the ten new members due to enter in 2004 implies an increase of almost 20% in the population of the EU, but barely 4% in GDP measured in current euros, the average GDP per capita of the EU will fall by about 10 percentage points.
- Nearly all the regions of the ten new Member States will be below the revised 75% threshold for Objective 1 status calibrated on EU-25, but the majority of the EU-15 regions currently classified as Objective 1 will be lifted above it by what has become known as the statistical effect. Yet the absolute prosperity of the latter group will be unchanged.
- At present all the richer Member States continue to receive some allocations from the Structural Funds under Objective 2 (which mainly targets regions facing industrial decline and undiversified rural areas) or Objective 3 (designed for labour market interventions, mainly to deal with unemployment, anywhere in the Union).
- Following accession, the number of Member States that are net contributors to the Community budget can be expected to increase. Despite the arrival of so many new

⁶ See Commission (2001, 2003a and 2003b), Begg (2003), Boldrin and Canova (2003) and Hallet (2002).

members who might be expected to support a higher budget, the fact that the budget requires unanimity means that it is highly unlikely that the current ceiling of 1.27% of EU GDP will be increased.

- The maximum level of support for any region is to be capped at 4% of its GDP, a figure set to ensure that the capacity of an economy to absorb the resources is not exceeded.
- Evidence on the effectiveness of the Structural Funds is patchy and, in some respects inconclusive. Some authors, such as Cappelen et al. (2003) find that the cumulative effect of cohesion policies has been positive, whereas others, such as Boldrin and Canova (2001) are quite scathing, while Hallet (2002) pleads for a more subtle assessment.
- Doubts have also been raised about the orientation of policy, especially an excessive focus on infrastructure, leading to the criticism that there are insufficient efforts to institute a comprehensive development framework (Barry, 2003).

Cohesion policy consequently faces a number of dilemmas. First, it will have to provide for a larger Objective 1 population while also satisfying the Member States and regions that currently receive support. Second, there are awkward questions about whether all Member States, or just the lagging countries, should be eligible for aid. Third, there are many questions about the focus and administration of structural policies. A key recommendation of the Sapir report is 'that EU convergence policy should concentrate on low-income countries rather than low-income regions, and that eligibility for access to EU assistance should be reviewed at the end of each programming period. In addition, convergence funds allocated to low-income countries should focus on two areas: (1) institution building, and (2) investment in human and physical capital, leaving beneficiaries free to decide how to allocate resources across different national projects' (CEC, 2003b: 6)

Although the costs of extending the EU's structural operations to the new members is surprisingly low at present, it could rise to become more contentious for a reason that has received little attention. If (as they would be expected to do, not least because of the Balassa-Samuelson effect) price *levels* in the accession countries start to rise, the cost to the EU budget of a transfer amounting to 4% of GDP will also rise. A simple exercise shows what is at stake (table 2). In 2000, the aggregate GDP of the ten CEEC countries, measured in euros, was 395 billion, just 4.4% the aggregate of the EU-15 and the CEEC-10 current GDP. In PPS terms, the GDP per head was more than twice as high at 9.6% (yielding a per capita figure of 38%) and can be used as a measure of the potential for price convergence. The last line of the table shows the cost of a transfer of 4% of GDP based on the current price level and the price level if full convergence occurs (as measured by using the PPS values). The effect would be to increase the

cost of structural operations in the CEECs from a very manageable 0.18% of EU GDP to a much more demanding 0.38%. Although this is manifestly a simplistic calculation, it should be noted that the two figures differ purely because of a nominal change, and thus imply no *real* convergence, yet the impact would be to make a politically awkward hole in the EU budget.

There is another side to the 4% ceiling which also warrants mention, which is that if crudely applied, it will have a perverse distributive effect. Richer recipients, especially if they have a higher price level will, receive proportionately much more. This can again be illustrated using 2000 data, this time looking at the per capita cost to the EU budget of a transfer of 4% of GDP to each of the CEECs. From this calculation it can be seen (table 3) that the biggest per capita cost to the EU budget would be for the two most prosperous accession countries (Slovenia and the Czech Republic) and the smallest the two poorest (Bulgaria and Romania). If parts of the richer countries such as the Czech Republic are excluded (notably the booming Prague region), the per capita transfer would fall accordingly, but to put the estimates for the richer accession countries in perspective, they are of similar orders of magnitude to the current transfers to Greece and Portugal and hence by no means unrealistic. The dilemma here is that the 4% limit has been set to reflect what any receiving nation can reasonably absorb and to this degree makes sense, especially if it is recognised that much of the expenditure would fall on the construction sector. Equally, if the money is used to purchase goods and services from abroad at world, rather than indigenous output at domestic prices, the least well-off will be penalised by the mechanical operation of the 4% rule. This, plainly, is a thorny issue.

A specific challenge will be how to respond – if at all – to any widening of regional disparities within the new Member States. There is already evidence from some countries that capital-rich regions have gained most from the post-communist transition, and the experience of Portugal, Ireland and Greece suggests that market forces have favoured agglomeration at the expense of the most backward regions. Moreover, it is often the case that the return on investment in, for instance, R&D will be higher in more competitive regions, raising questions about how active policy should be elsewhere (see, for example, Rodríguez-Pose, 2001). To the extent that growth is fuelled by the performance of leading regions, competitiveness imperatives would caution against countervailing policy. But will this be politically acceptable?

There is, therefore, much to sort out about real convergence and it is clear that reaching convincing conclusions is not easy. It may be that asking how rapidly to seek full participation in EMU is not the question that should be posed. Rather, attention needs to focus on whether the overall mix of policies and economic conditions will be conducive to comfortable membership

of the euro area, including adequate real convergence. In part, this concerns the nominal variables, but judging by the EU-15 experience, it is also important to emphasise different aspects of the 'E' in EMU – that is the real economy. Key issues include labour market conditions, administrative capacity and the approach to public investment. Efficient use also has to be made of support policies such as the Structural Funds, notably ensuring that they dovetail well with indigenous policies as in Ireland (see FitzGerald, 1998).

In conclusion, real convergence is a dimension of EMU that has received insufficient attention, yet it is also one for which neither theory nor empirical evidence provide altogether convincing answers. For countries contemplating full participation in EMU, the real test is not so much *whether* EMU will result in convergence as *how* to ensure that it does. The trick, in short, is to flatten the dip in the j-curve and to ensure that the upswing phase is sustained.

Table 1 The Impact of EMU on Cohesion

MECHANISM	EFFECT	INCIDENCE & IMPACT ON COHESION
Macroeconomic shifts, of which:	Change to the new policy regime recasts established policy signals and rules	Affects all Members of EMU, but spatial impact uncertain; depends on willingness and capacity to adapt
Acclimatisation in the short-term to new policy settings	Low nominal interest rate; impact on asset prices; but disparities in real rates	Previously inflation-prone regions face overheating. Thus far, positive for less prosperous areas, but increases prospect of macroeconomic imbalances
Adoption of stability-orientated macro policy approach	Alters government and financial market behaviour	Most pronounced for those who have to change most, with need for policy learning; risks from Balassa- Samuelson effect for countries with least developed service sectors.
Labour market and transformations of it, of which:	More of the burden of adjustment falls on labour market	Creates problems for least flexible regions. Could aggravate unemployment in weaker regions
Systems for wage-setting	Influence wage flexibility & scope for short-term adjustment	Potentially damaging for areas with rigid systems and engenders problems of social cohesion (insiders and outsiders)
Geographical, sectoral and occupational mobility	Affects medium-term scope for labour market adaptability to deal with competitiveness problems	Induced pressures from migration; could lead to brain drain (gain). Possibility of aggravated imbalances within countries
Regulatory setting and institutions underpinning labour market	Shapes long-term potential for adjustment through supply-side	Adverse for less developed economies that lack training provision, especially where de facto regulation is pronounced.
Induced effects on economic structure	Market opening accelerates pace of restructuring	Potential threat to least competitive regions Likely to widen disparities
Regional industrial specialisation	Mix of centripetal and centrifugal 'NEG' consequences	Initially favours core regions; but creates opportunities for low cost areas Ambivalent overall
Concentration of financial services	Lowers intermediation margins; enhances pool of liquidity and supply of risk capital	Regions with weak financial sectors lose activity Ambivalent overall

Note: Reproduced from Begg (2003).

Table 2 Potential cost of transfers to CEECs if price convergence occurs

All data for 2000	Current price GDP (billion euros)	GDP based on PPS per head (billion euros)
1. GDP of the ten CEE countries	394.9	906.5
2. EU-15 GDP	8523.9	8523.9
3. Total EU-25 GDP	8918.8	9430.4
4. Cost of 4% transfer (4% of row 1)	16.0	36.3
5. Transfer as % of EU-25 GDP (Row 4 as % of row 3)	0.18	0.38

Source: author's calculations from Eurostat data

Table 3 The likely payments to accession countries

Accession Country	Current GDP (b. euros)	Population (millions)	Cost of 4% transfer (b. euros)	Per capita cost to EU (euros)	GDP per head (EU-15=100)
Bulgaria	13.0	8.211	0.52	63	28
Czech Republic	55.0	10.283	2.20	214	59
Estonia	5.5	1.444	0.22	152	38
Hungary	50.3	10.068	2.01	200	51
Lithuania	12.2	3.700	0.45	122	33
Latvia	7.8	2.432	0.31	127	30
Poland	171.0	38.654	6.84	177	40
Romania	40.0	22.458	1.6	71	23
Slovenia	19.5	1.986	0.84	393	69
Slovakia	20.9	5.395	0.78	156	48

Source: author's calculations from Eurostat data

Figure 1 The euro membership 'J'-curve
(trajectory of the economy)

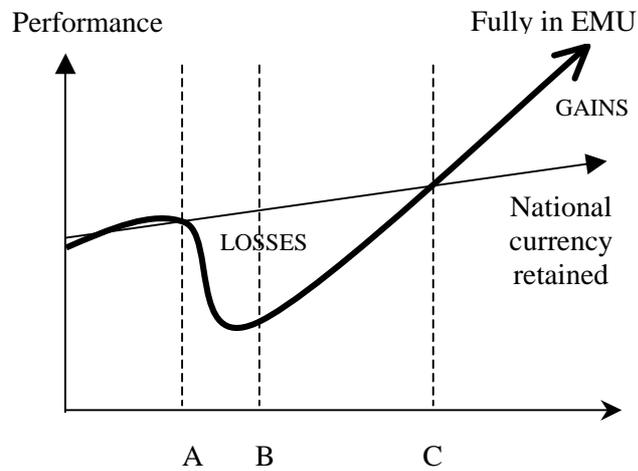


Figure 2 The euro membership 'J'-curve
(trajectory of the economy)

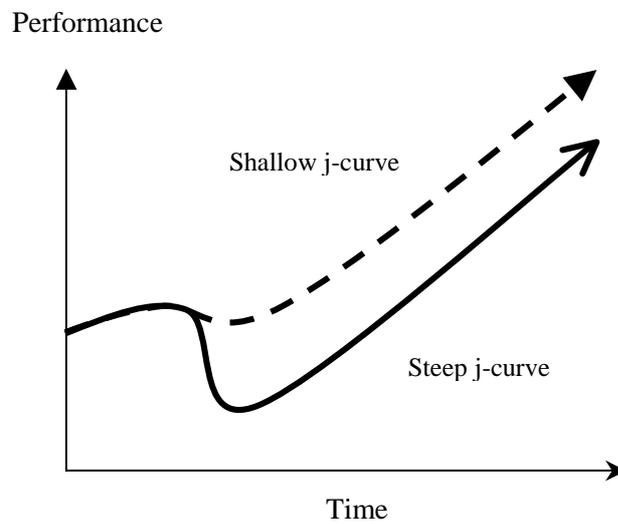
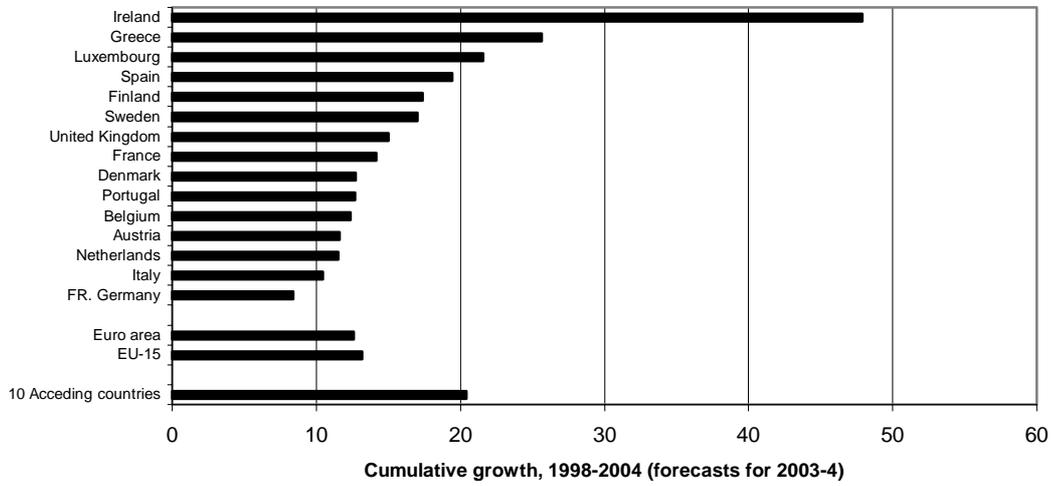


Figure 3

Growth of EU economies since the advent of the euro



Source: European Commission AMECO database (April 2003 version)

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