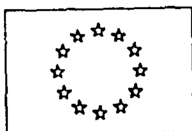

COMMISSION OF THE EUROPEAN COMMUNITIES

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Reinforcement of convergence in Stage 3 of EMU

Study requested during the informal Ecofin meeting in Verona

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I. Introduction and conclusions

On the initiative of the French Minister for Economic Affairs and Finance, Mr Arthuis, a number of suggestions were put forward at the informal Ecofin Council meeting in Verona on 12 and 13 April aimed at "reinforcing convergence and combating currency fluctuations". They were put forward within the framework of the move to the third stage of Economic and Monetary Union and the relation between participating Member States (the "ins") on the one hand, and the not yet participating Member States and Member States with an opt-out possibility (the "pre-ins") on the other.

Mr Arthuis proposed first that a way be found of ensuring "that countries whose currencies depreciated did not receive larger payments from the Structural Funds as a result of conversion into national currency. Consideration might be given, for example, to reprogramming payments to such countries on the basis of changes in the real exchange rate."

Mr Arthuis further proposed that "a link be established between payments from the Structural Funds and macroeconomic policies pursued in the Member States. In the run-up to Economic and Monetary Union, the solidarity obligation and the Union budget should take account of the efforts made to achieve convergence. It might thus be possible to proceed on the basis of the arrangements already introduced for the payment of aid from the Cohesion Fund, which can be suspended in the event of non-compliance with the individual recommendations addressed to each Member State with an excessive government deficit."

The Commission agreed to study these ideas, as well as the other suggestions made at the same informal Council meeting. As regards the latter, the Commission will present its contributions in due time for the European Council in Dublin, in accordance with the requests from the European Council in Madrid and Florence. Enhanced convergence is an essential element of the relationship between the ins and the pre-ins. In addition, Article 109 M of the Treaty states that the provision "each Member State shall treat its exchange-rate policy as a matter of common interest" applies to Member States with a derogation in the third stage.

Ensuring a durable and harmonious growth process within a well functioning internal market requires that Member States respect the objective of economic convergence. A policy framework that fosters budgetary discipline could contribute to preventing disruptive economic effects from movements in exchange rates between the euro and the currencies of the "pre-ins". However, proposals aimed at modulating the Structural Funds have to be seen in the light of the following constraints:

- It would be impossible to modify the Structural Funds' regulations before the end of 1999 or change the operation of the Community budget before the third stage of EMU.

A change in the current Structural Funds' regulations would not only require unanimity but would also run counter to the principle of legitimate expectations for all the on-going programmes.

- The Commission will put forward a communication on the future financial framework for the period after 1999 after the conclusion of the IGC. Individual elements of this package will not in any case be considered before that date in order not to prejudge the overall consistency and coherence of the package.
- The use of the ECU in the Structural Funds is part of the "acquis communautaire". It would be wholly inappropriate, in view of the changeover to the euro, to introduce increased use of national currencies through complex mechanisms in the Community budget. Moreover, given the intention of non-participating Member States to join as soon as possible, an effort to introduce such mechanisms would be disproportionate compared to the fact that they would be temporary.
- The introduction of the euro as the single currency will reduce the existing exchange rate risk for the Community budget. It would therefore be inappropriate to introduce new mechanisms, such as modulating payments on the basis of fluctuations in nominal exchange rates, which by themselves would imply a further exchange rate risk for the Community budget.
- Finally, it should be borne in mind that no new criteria for entry into stage 3 of EMU should be established.

Further technical considerations are provided in the following two chapters of this working document, of which the main conclusions are:

- As for the proposal to link appropriations from Structural Funds to the evolution of real exchange rates, it is not an efficient approach to achieving its objectives. Sanctions on real depreciations regardless of their reasons might punish countries that stabilized their economies. Nominal depreciations are not always or exclusively due to loose economic policies. In all cases, arbitrary technical choices on measuring the evolution of exchange rates and on alternatives of implementation would have to be taken that might lead to significantly different results. Finally, further decisions would have to be taken regarding countries with appreciating currencies and the extent to which payments to countries with depreciating currencies would have to be reduced.
- The objective of the Structural Funds to foster economic and social cohesion is broader than the objective of nominal convergence. As for the proposal to introduce macro-economic conditionality for the Structural Funds, it is found that their medium- and long-term character would not be properly reflected in the existing mechanism of conditionality in the Cohesion Fund. Furthermore, given the size of the Structural Funds, a suspension could have disproportionate effects across Member States or when made independent of the size of the excessive deficit, with the serious risk of leading to adverse effects on the catching-up process. Furthermore, there would be important practical problems to be solved given the principle of programming which implies a certain continuity in Community support. Finally, main beneficiaries of the Structural Funds are regions and certain social groups (e.g. unemployed) that must not be penalized.

II. Linking appropriations from the Structural Funds to the evolution of the real exchange rate

1. The present situation

At present, overall budgetary appropriations for the Structural Funds are expressed and contracted in ECU terms. The use of the ECU in the Structural Funds and its modalities as established by Article 12 and Annex II of Regulation (EEC) No 2081/93 of 20 July 1993 (Framework Regulation) and by Articles 21 and 22 of Regulation (EEC) No 2082/93 of 20 July 1993 (Coordination Regulation) are part of the "acquis communautaire". It is the result of intense efforts towards increased Community integration.

All other things being equal a nominal depreciation will raise a Member State's potential appropriations expressed in national currency. For on-going programmes and projects, Community co-financing assistance would in principle not exceed the initially fixed share of the costs actually incurred in national currency for the set of measures. A depreciation will, however, create an unused margin in ECU that is determined by the size of the depreciation itself and the extent to which the depreciation increases costs of projects and influences other macroeconomic variables. Where this occurred in the past, this unused margin has often been employed to increase co-financing ratios for projects, in particular at the end of the programming periods, in order to prevent a loss of appropriations.

Any modification of the present regulations, which will require unanimity in the Council as regards the Framework Regulation and qualified majority as regards the Coordination Regulation, would have to consider several economic, technical and symmetry/equity aspects.

2. Economic considerations

Real currency depreciation can be caused by a decline in the relative level of prices/costs and/or by a nominal depreciation.

A *decline in the relative level of prices or costs* is in normal circumstances an indication of the success of policies aiming at the reduction of inflation or unit labour costs. In Ireland, for instance, there has been no nominal depreciation of the Irish pound relative to the other Union currencies between 1987 and the first quarter of 1996 (see table 1). Nevertheless, the real effective exchange rate based on unit labour costs in the manufacturing sector declined by more than 32% due to a rise in productivity in Irish manufacturing. A modulation of the Structural Funds should avoid punishing Member States that have had success in reducing unit labour costs. It would thus be necessary to ensure that only those countries would be concerned whose currencies had also depreciated in nominal terms and to take into account the causes for a real depreciation in each case.

Nominal depreciations do not always occur because of a deficient macroeconomic policy in the country concerned. It can be due to speculation based on the market's perception of political instability or to other short-term and less quantifiable factors such as, for example, self-fulfilling market expectations or developments outside the European Union (including fluctuations in the value of the US dollar). Even if inadequate macroeconomic policies warrant a currency's depreciation, markets tend to overshoot and the resulting (larger than necessary) depreciation will be corrected in due time. The Italian lira, after an initial depreciation of 23% as from mid 1992 to mid 1994, depreciated further by 12% against the other European currencies between February and April 1995. This nominal depreciation

was followed by a correction between April and September 1995 when the lira appreciated by 11%. Nominal depreciations are thus not necessarily and exclusively policy-induced and can be mitigated in due time.

In addition, the suggested modulation of Structural Funds' spending on the basis of currency fluctuations, however, would risk making the "pre-ins" participating in the currency arrangement reluctant to devalue their currency, even if such a devaluation were justified by fundamentals and in the common interest of the Union Member States. Thus, a direct link between monetary and structural policies would be created.

3. Technical considerations

Several technical issues concerning the measurement of the evolution of exchange rates would need to be resolved, such as the currencies of reference and the period of reference. In addition, a deflator has to be chosen for the calculation of real exchange rates. Finally, alternatives to modulate payments on the basis of fluctuations in the nominal exchange rate would also involve several problems. These technical choices are by nature arbitrary and will lead to significantly different results.

First, it would be necessary to define *the currency or currencies of reference*, against which the depreciation would be measured. The broadest possible measure would be the effective exchange rate relative to the industrial countries (both inside and outside the European Union). A second option would be the effective exchange rate relative to the European Union as a whole. A third and more narrow option would be to use the bilateral exchange rate against the euro. The first two measures are generally not that different in terms of outcome. Since 1987, the Irish pound, for example, has depreciated in real terms by 32% relative to both the industrial countries and the European Union as a whole. Choosing the third option, however, could have major implications. As an indication, the real bilateral exchange rate of the Irish pound against the German mark has decreased by 41% since 1987.

Second, when considering currency fluctuations, one needs to decide on a *starting point*. The choice of reference period is important, but also arbitrary. Recent Commission studies used 1987 as reference period. However, this should not be seen as implying that exchange rates prevailing in this reference period were in equilibrium. Rather, the stability of exchange rates throughout the period 1987 to 1992 seemed to indicate that the rates of the Louvre Accord of January 1987 were appropriate and that at this time an international balance was struck. In other words, imbalances slowly began to build up thereafter and 1987 could be considered as a suitable basis for analysis. However, what would seem to be an appropriate choice for the European Union as a whole would not necessarily be the best choice for each individual Member state. The importance of the choice of reference period can best be illustrated by another example.

In the first quarter of 1996, the real effective exchange rate[1] of the Spanish peseta showed an 8½% increase compared to 1987 (see table 1). Compared with the third quarter of 1992[2], however, the peseta's real exchange rate had declined by 14%.

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1. Real effective exchange rate relative to the European Union as a whole based on unit labour costs in manufacturing.
2. The third quarter of 1992 marks the beginning of the ERM crises of 1992 and 1993.

Third, a decision would have to be taken on *the price or cost deflator to be used* to transform nominal exchange rates into real rates. In order to provide a comprehensive assessment of a country's price and cost competitiveness within the European Union, the Commission normally considers the following five deflators: (1) the Consumer Price Index (CPI); (2) the GDP deflator; (3) the price deflator of exports of goods and services; (4) unit labour costs in the economy as a whole; and (5) unit labour costs in manufacturing. This last deflator is most commonly used in the analysis of international cost competitiveness, as a large part of international trade is trade in manufacturing products. However, which deflator would be the most suitable for the purpose of modulating Structural Funds' spending in the Member States is not immediately clear. The choice to be made will have considerable implications as can be illustrated by the example of Ireland: while the real exchange rate of the Irish pound based on unit labour costs in manufacturing has declined by 32% since 1987, the real exchange rate based on the CPI has declined by 8% only.

Finally, the possibility to *modulate payments on the basis of fluctuations in the nominal exchange rate* would also involve several technical problems, including those mentioned above such as reference currency and starting point. It should also be taken into account that no mechanism should be introduced which would increase the currency risk for the Community budget.

If the overall envelope for the Financial Perspectives period were to be defined as the sum of the annual appropriations expressed in national currency and calculated at the exchange rate prevailing at the beginning of the financial perspectives period, currency changes would no longer have an effect on the nominal national currency equivalent. Although such a modulation would probably provide the right incentives not to depreciate, it would also cause a continuous reduction in payments expressed in euro to some of the most lagging and least competitive regions of the Union: for instance, the nominal effective exchange rate of the Greek drachma declined by more than 47% between 1987 and the first quarter of 1996, while during the same period the real effective exchange rate of the drachma rose by 25%, implying a 25% reduction in the cost competitiveness (see table 1). Moreover, currency changes would be reflected in the Community budget via a lower (depreciation) or higher (appreciation) euro equivalent which would involve additional risks for the Community budget.

In addition, it would implicitly be assumed that the exchange rates prevailing at the beginning of the financial perspectives period were not misaligned. No distinction would be made whether a depreciation/appreciation is policy-induced or not. Nor would the issue of excessive fluctuations during the financial perspectives period be explicitly addressed or that of unintended changes, in real terms, of spending on Structural Funds. In addition, double accounting in the Community budget would run counter to the efforts to introduce the Euro in the widest context and as fast as possible.

The introduction of a "double ceiling" both in euro and in national currency terms would eliminate the currency risk, but introduce further complications and not solve any of the other problems. Neither would a CAP-like system of agri-monetary adjustments to Structural Fund appropriations be appropriate in view of the irrelevance of its underlying logic for the case at hand and its prohibitively complicated nature.

4. Symmetry/equity considerations

While the proposal is clear about the consequences of a real currency depreciation (i.e. a decline in the allocation of the Structural Funds to the country concerned), it does not mention what should happen in case of a real currency appreciation. The rationale of a rise in payments to countries with an appreciating currency can be questioned. Depending on the composition of "ins" and "pre-ins", the total of Structural Funds' payments to all Member States together would vary with the fluctuations in currency markets and could cause a significant change in total Structural Funds' expenditures. The suggested re-programming would thus imply the need for an appropriate budgetary adjustment mechanism for the Structural Funds.

If the only objective is to avoid giving a depreciating country an advantage in terms of increased payments in national currency, it should be taken into account that most projects require imports from other Member States and a depreciation will thus induce a rise in expenditure expressed in national currency. In order to avoid a real cut-back in investment and a disruption of long-term planning, the real depreciation would only have to be partially reflected in a decline of the Structural Funds' spending for this country.

III. Conditionality and the Structural Funds

1. The legal situation regarding the Structural Funds

Article 130a of the EC Treaty stipulates that "in order to promote its overall harmonious development, the Community shall develop and pursue its actions leading to the strengthening of its economic and social cohesion. In particular, the Community shall 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 130b assigns to the Structural Funds the task of supporting the achievement of this objective of strengthening economic and social cohesion.

Within this framework, the regulations laying down the tasks, priority objectives and organizational arrangements of the Structural Funds were adopted in 1993 on the basis of the conclusions of the Edinburgh European Council in December 1992, which had set the financial perspective in ECU for the period from 1993 to 1999 and the main guidelines for structural measures, in particular the fact that "the basic principles laid down in 1988 (concentration, programming, partnership and additionality) should continue to guide the implementation of the Structural Funds". These provisions relating to the Structural Funds will remain in force until 31 December 1999.

The introduction of conditionality would therefore necessitate amendments to the framework Regulation and even to the other regulations involved. According to Article 130d of the Treaty, the Council would have to act unanimously on a proposal from the Commission after obtaining the assent of the European Parliament and after consulting the Economic and Social Committee and the Committee of the Regions.

A proposal to introduce a fifth basic principle for the operation of the Structural Funds could prove difficult to negotiate within a framework requiring unanimity. This would also entail the risk of reopening discussions on other provisions, particularly those relating to additionality.

Furthermore, a re-examination of the basic principles underlying the existing legislation and the introduction of a new principle governing the operation of the Structural Funds would be contrary to the conclusions of the Edinburgh European Council and would be incompatible with the principle of legitimate expectations (non-retroactivity).

2. Main implications

Independently of the legal implications, the introduction of conditionality for the Structural Funds should be assessed from the viewpoint of the macroeconomic consequences and in relation to the objectives and functioning of the Funds.

(a) Economic consequences

The conditionality proposed raises the question of the link between the convergence criteria and structural policy. The aim of the proposed conditionality is to encourage nominal convergence, and in particular budgetary discipline, which is a precondition of lasting growth in addition to providing a means of access to the third stage of EMU.

This objective would be pursued by adding to the budgetary discipline rules (excessive deficit procedure) a dissuasive effect in that national authorities would be anxious to avoid the suspension of payments from the Structural Funds.

Structural policies aim primarily to promote medium- and long-term development with a view to increasing the lasting growth potential of economies in difficulty. They thereby contribute to the continuity of the corresponding investment measures. In all the Member States, and particularly those covered to a large extent by Objective 1, Community structural resources have a structuring impact on national, regional and local public expenditure.

Consequently, their medium- and long-term character would not be properly reflected in the existing mechanism of conditionality in the Cohesion Fund.

However, there is no incompatibility between national development and budgetary convergence. Both theoretical studies and developments experienced by, for example, Ireland bear witness to this. The aim of the "pre-in" countries is to move to EMU as quickly as possible, largely by means of an appropriate national budgetary strategy. This strategy can only reinforce the effectiveness of the Structural Funds.

For some Member States - the main beneficiaries of the Funds - conditionality would have a more substantial impact than in the case of the Cohesion Fund, whose resources are relatively marginal (less than 10% of the Structural Funds). Thus, for some countries, the combined effect of reductions in both the Structural Funds and the national public expenditure earmarked for co-financing them could have a macroeconomic impact on growth, and therefore on the catching-up process, that would be all the more significant the greater such reductions were.

If it were to be applied, a reduction in the Structural Funds' financial contribution to a commitment programmed on a multiannual basis would result either in the abandonment of the planned programmes or in increased burdens for central government or even the regions concerned. Such a situation could well lead to a reduction in the public expenditure earmarked for development. The financial weight of the Structural Funds in the economies in question varies widely from one case to another. There could be a marked imbalance between the excessive budget deficit in question and the economic and social consequences

stemming from the suspension of the Community structural transfer payments. Such a suspension might well lead the Member State concerned towards a less than optimum reallocation - or even to one that ran counter to the necessary adjustment objectives - of budgetary resources in terms of economic efficiency (passive grants).

(b) The objectives and functioning of the Structural Funds

Conditionality, as currently applicable to the Cohesion Fund, should be assessed in relation to the objectives and operational arrangements of the Structural Funds.

Firstly, the Cohesion Fund was set up as a means of facilitating the budgetary adjustments necessary for the least prosperous national economies of the Union to participate in EMU. That is why macroeconomic conditionality, but not additionality, applies to that Fund. The Structural Funds have the much wider aim of promoting the overall development of regions in difficulty by establishing the conditions necessary for their long-term development. They therefore provide assistance in the three key fields of development, namely economic infractructures, the improvement of human resources and the productive sector. They consequently have structuring effects, especially as they have acquired significant macroeconomic importance for those Member States widely eligible for Objective 1 assistance.

The Cohesion Fund, through its support for the financing of transport infrastructures and environmental projects alone, constitutes funding that is additional to the Structural Funds. However, any suspension of such funding under the conditionality clause would not - owing to the relatively marginal resource allocation - have a macroeconomic impact that would undermine the adjustment efforts of the economies in question. Furthermore, as no cases of suspension have occurred in practice, the actual functioning of the Cohesion Fund's conditionality is based on very limited experience, and it would be premature to consider that such experience could be extrapolated generally.

Secondly, the Cohesion Fund concerns the Member States (eligibility at national level), whereas the Structural Funds apply to the development and conversion of regional economies with problems and to the reinforcement of measures designed to benefit either specifically targetted groups or certain active labour and human resource policies. Applying the conditionality introduced for the Cohesion Fund would have the effect of linking all the Community structural support for the regions and the development of human resources to strict national budgetary discipline.

It could prove difficult to explain to regions eligible for Structural Fund assistance, which in some cases contribute themselves to the development budget and play a substantial part in mobilizing regional and local agents, that the Community transfer payments being made to implement programmes are being halted for reasons which are very largely or totally unrelated to them.

The question of the appropriateness of such a link would arise particularly for industrial regions in decline (Objective 2), the other rural areas in difficulty (Objective 5b) and the very thinly populated northern areas (Objective 6). In most cases, these are small or thinly populated areas that are unrelated to national budgetary discipline. The same applies to Objectives 3, 4 and 5a.

Furthermore, it would be difficult to imagine limiting application of conditionality solely to regions eligible for Objective 1 assistance. Such a limitation would have the effect of freeing a number of the most prosperous Member States from this requirement (Denmark, Luxembourg, Sweden and Finland), while the least prosperous would potentially be the most affected by conditionality, and indeed on two counts (Cohesion Fund and Structural Funds) in the case of the cohesion countries.

At all events, the penalties linked to conditionality should not apply to those Structural Funds which cofinance regional and local spending.

Conditionality and additionality may not be compatible. It is necessary to encourage nominal convergence because budgetary consolidation and monetary stability are prerequisites for medium- and long-term development. At the same time, however, the regional development process, being a condition for sustained development for which additionality constitutes a necessary guarantee, cannot be called into question.

Finally, the programming principle implies continuity of Community support, which is incompatible with an interruption of financial support.

Table 1: Nominal effective exchange rate[1] and cost competitiveness[2]

CHANGE %	96Q1/1987		96Q1/92Q3		96Q1/95Q2	
	Nominal Effective Exchange Rate	Cost Competitiveness	Nominal Effective Exchange Rate	Cost Competitiveness	Nominal Effective Exchange Rate	Cost Competitiveness
BLEU	12.6	7.6	9.1	8.7	-2.4	-3.7
DENMARK	12.7	10.7	10.9	13.8	-1.6	0.1
GERMANY	17.6	17.9	13.6	14.0	-3.4	-3.9
GREECE	-47.4	25.0	-15.7	11.7	-4.3	-2.2
SPAIN	-7.1	8.5	-14.7	-14.0	1.9	1.3
FRANCE	13.9	-0.6	12.2	8.5	0.0	0.2
IRELAND	0.6	-32.4	-1.9	-16.9	-0.1	-5.3
ITALY	-26.4	-19.5	-22.8	-23.2	9.9	9.7
NETHERLANDS	12.6	-2.2	9.9	6.3	-2.1	-2.3
AUSTRIA	11.4	-3.5	8.9	6.3	-2.3	-4.0
PORTUGAL	-14.2	20.3	-7.4	1.4	-0.8	-2.5
FINLAND	-9.2	-16.1	2.9	1.3	-3.3	-0.8
SWEDEN	-13.9	-9.2	-13.6	-19.5	11.2	10.0
UK	-15.6	-9.1	-12.5	-7.0	-2.0	0.4

Source: DG II-D-4 FX

1. The nominal effective exchange rate allows comparison of the evolution of each Member State's exchange rate with those of other Member States.
2. Real effective exchange rate based on unit labour costs in the manufacturing sector. The minus sign indicates an improvement in cost competitiveness.