The Role of Cohesion Policy in the Decision to Adhere to the Euro Area

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Abstract. *The fulfillment of the nominal convergence criteria by a certain member country of the EU constitutes a necessary, albeit not sufficient condition to adhere to a monetary union. Essential are the progresses in the process of real convergence, because these are, in a large measure, able to ensure a growth in the economy's flexibility and a higher concordance of business cycles. The adoption of the sole currency implies, beforehand, finding other methods of economical adjustment, as a consequence of the renunciation of the internal monetary policy. Some of these can be the result of structural fund allocation through cohesion policy. Thus, Romania's decision to adhere to the euro zone in 2014, after it would have been able to access the Community's financial assistance in the 2007-2013 period, is explained.*

Key words: euro area; Cohesion policy; optimum currency area; economic convergence/divergence; urban agglomeration

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The objectives of Cohesion policy

The European process of economic integration did not generate a uniform allocation of benefits, under the conditions that member countries had different initial levels of development. The adoption of a EU cohesion policy was necessary to support countries/regions with gaps in development. Its objective is to reduce inequality between EU regions, through a better usage of their respective economical and human potentials, in order to achieve a real convergence. This process has both internal (as a result of internal policy being promoted, in accord with common policies) and Community's (through cohesion policy) sources. Both generate a structural transformation of economy, contributing, through it, to the stimulation of the economic growth process and to the faster recovery of discrepancies in income (figure 1).

In the European model, cohesion policy constitutes the communitarian instrument through which the process of economic convergence is supported. This results in both a better accumulation of production factors and an improvement of their productivity (as in a higher rate of growth), and an economic modernization of the benefiting countries (regions).

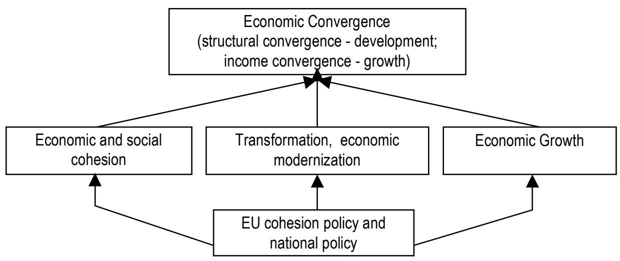

Figure 1. *The sources of economic convergence*

The allocation of structural funds is meant to unblock the engine of development in regions that benefit them. However, lacking some absorbing effects at a regional level, development disparities can persist. Thus, it is explained why discrepancies between EU regions have maintained relatively constant, while those from within the member states have even increased. Regions with a reduced level of development within the EU-15 are characterized by a reduced growth in the total productivity of their production factors (of the efficiency in their utilization, lacking an improved education and technology), through the existence of a high unemployment rate and continued relatively high numbers in agriculture. An additional challenge for internal cohesion of the EU has been the enlargement program, which has lead to an increase in income inequality within the communitarian space. Thus, the difference between the development level of 10% of the population in the most prosperous regions and the same percentage of inhabitants of the poorest regions has grown more than 2 times, compared to the existing situation in the European Union with 15 member states.

For the 2007-2013 period, EU's cohesion policy was reformed in order to better comply with the objectives set at Lisbon and Göteborg (competitive economy based on knowledge, technological research and development, sustainable development, employment). The financial means with which the economic and social cohesion policy is implemented are Structural Funds (The European Fund for Regional Development and the European Social Fund), and the Cohesion Fund, for which the objectives are:

- *European Regional Development Fund* (ERDF) finances technological research and development, innovation and enterprising, protecting the environment, tourism, creation of and informational society, of SMEs.
- *European Social Fund* (ESF) contributes to increasing the adaptability of labour force and firms, increasing access to the labour market, prevention of unemployment, prolonging the active life through participation in life-learning programs.
- *Cohesion Fund* (CF) finances mainly, projects in the fields of environment protection and trans-European transport networks.

The analysis of Community's directions suggests that financial assistance has positive effects on economic growth at a regional and national level. Cohesion Policy influences all of its sources, contributing to the growth of capital accumulation (through the birth of new firms), of the degree of employment (in concordance with the objectives set by the Lisbon Strategy) and the efficiency with which the production factors are used (education, innovation, reduction of transaction costs). The estimates of the European Commission emphasize an increase in national GDP by 10% as a result of the allocation of financial resources towards the less developed countries of the EU, between the years 2007 and 2013.

Beyond the immediate effects of aggregate demand (income rises in the beneficiary regions), decisive become those on aggregate supply, on a long time. Thus, the modernization of the infrastructure, the rise of education levels as well as subsidies of research and development activities permit the increase of potential growth in of the economy (as in potential GDP). In these conditions, shock absorption on the demand or the structural sides will be faster in the countries/regions that benefit from structural and cohesion funds. It results that from cohesion policy, the convergence of business cycles of a economy within the euro zone can rise, consequently increasing the benefits of adopting a single currency.

The criteria for an optimal currency area. The impact of the Cohesion policy

In the decision to participate in a monetary union, a country must take into account both the benefits and the costs of renunciation of the exchange rates and its own monetary policy. All the economies that consider they will have superior benefits form an optimum currency area. The theory with the same name is based on the hypothesis that using an exchange course would constitute a solution to neutralize the shocks that affect a national economy. Thus, the devaluation of national currency contributes to increased competitiveness in exports and the reduction of unemployment rates from a certain economy. However, if unemployment is of a structural nature, then the instrument of the exchange course would not have an effect.

Among the basic criteria based on which the opportunity of adhering to a monetary area, I will study the following:

a) The degree of openness of an economy. The more this is, the more the benefits rise (the risk of commercial transactions falls), and costs are reduced, because the effectiveness of using the exchange course drops in case the national economy will be affected in a greater measure by external shocks;

b) The economy's flexibility, which presumes a faster elimination of the influence of the shocks that affect it. If it rises, then the instrument of exchange courses can be dropped, as an adjustment mechanism;

c) The convergence of business cycles, which is influenced by the economy's structure and the nature of the promoted macro-economical policies. The more synchronized the business cycles are, the less asymmetrical the results will be, in common monetary policy, and the benefits of adopting a common currency rise.

The three criteria are in a permanent state of interaction. Thus, although an economy with a divergent business cycle with the euro area should not adhere to it, nevertheless, the increase in the degree of openness could increase the benefits of the renunciation of its own currency. In the graphic below, I have represented the OCA_1 (optimum currency area) line for which the costs generated by the divergence are equal with the benefits. The zone situated to the right of it is specific to the situation in which the benefits are higher than the costs. Another criteria on – that of the economy's flexibility – will permit a faster adjustment of asymmetric shocks (caused by divergence), even if the degree of economic openness is low. Consequently, the OCA line will move towards the left (from OCA_1 to OCA_2), increasing the gap that outlines an optimum currency area.

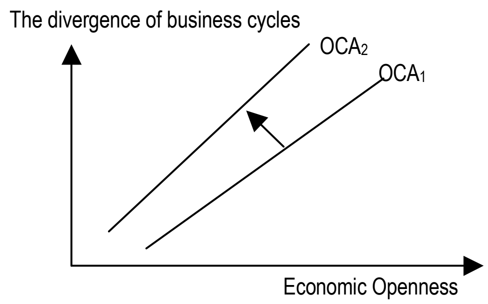

Figure 2. *The effects of greater economic flexibility*

Through the chosen objectives, cohesion policy influences the criteria of defining of an optimum monetary area, increasing the benefits of adhering to the euro area. Thus, the allocation of structural funds to less developed countries contributes to:

a) The increase of aggregate demand and growth potential, which allows the elimination of the effects of conjectural and structural shocks. The optimum currency area theory is based on the hypothesis that a federal fiscal system exists, in which economies in expansion will transfer fiscal revenues to those in recession, to compensate losses of wealth caused by a high unemployment rate. The European Union's Budget is not built for that, but the funds allocated through the cohesion policy have such a role, because they are addressed to the economies that are at a lower level of development;

b) The reduction of transaction costs, as a result of the improvement of infrastructure and communication, which will increase the degree of openness of the respective economy (under the conditions of intensified commercial exchanges);

c) The improvement of education and increase of qualified labour force, which permit a faster adaptability of workers for rapid changes of technology;

d) The increase of the attractivity of the zones that benefit from assistance, which will contribute to the creating of new SMEs and the increase of new jobs. In an economy characterized by a more flexible job market, the aggregate supply on a long term will rise faster, diminishing structural unemployment. The efficiency of the stimulation policies of the supply becomes essential within the framework of the euro area, because the management of aggregate demand is limited by the existence of a common monetary policy and the restrictive provisions of the Stability and Growth Pact;

e) The modernization of agriculture and the stimulation of development in the regions that are confronting an industrial decline. Thus, a structural transformation process of these economies takes place, through the increase in the importance of services, which will, in turn, lead to the increase of structural convergence in the countries with the euro area and, implicity, the degree of synchronization with their respective business cycles.

The impact of the cohesion policy on the balance of costs and benefits of adopting the euro currency is summarized in the figure below. Community's financial assistance determines both a reduction of the divergence of the business cycle with the euro area, and an increase in the degree of economical openness, influencing positively the flexibility of the beneficiary economy.

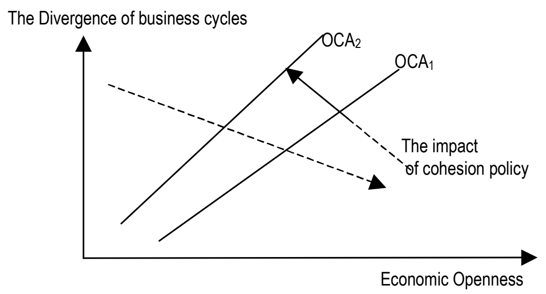

Figure 3. *The impact of cohesion policy within OCA*

Cohesion policy - the gap between objectives and achievements

Beyond the selected objectives, cohesion policy has proven, up until now, a weak capacity of supporting the development of regions with gaps in income or of a structural nature. The positive effects of financial assistance have only been temporary, and for two reasons. The first refers to the lack of coordination of Community's projects with other local policies, at a regional level, and the second refers to the existence of a national structure of the center-periphery type, which has led to a concentration of benefits towards urban agglomerations. Both suggest that the allocation of structural funds to regions with a gap in development constitutes only a necessary condition, but not sufficient for the achievement of a sustainable economic growth. On the contrary, the effect, on a medium term, can be the impoverishment of those regions.

The first example represents the projects that are meant to improve the infrastructure between a better developed region (the center) and a less developed one (the periphery). This determines a temporary growth in aggregate demand in the peripheral region (as a result of increased incomes), on the duration of the project. Lacking other training effects in the peripheral region (improvement of the business system, growth of qualification of the labour force, emergence of SMEs), firms that already exist will prefer the central region, because of the bigger commodity market. As a result, the development potential of the periphery will decrease.

These consequences are made obvious in the below graph, based on the "aggregate demand - aggregate supply" (AD-AS model). I have presumed a perfect elasticity on the short run aggregate suply (SRAS), because the periphery is characterized by a high unemployment rate and by an unexploited production capacity. Community's financial assistance determines a growth in aggregate demand (from AD_0 to AD_1), accompanied by a growth in the region GDP. The tendency to reduce transaction costs at the same time with the ending of the project could generate the return of aggregate demand to its initial level, as well as the delocalization of firms from the periphery to another region in which income is higher.

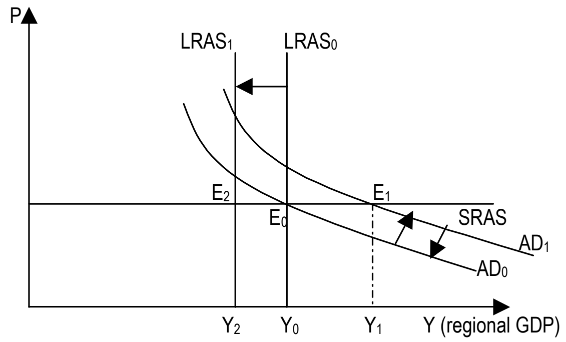

Figure 4. *The effects of Community's financial assistance in accordance with AD-AS model*

The long-run stability is not situated at the E_0 point, but at the E_2, because the placement of assets towards the better developed region determines a reduction of potential production towards the peripheral region (a drop in long-run aggregate supply - LRAS).

Another example refers to the allocation of structural funds for increasing the level of professional training in the population able to work from the less developed regions. In no infrastructure conditions (water, sewage, roads, telecommunications), jobs will not be created, so the tendency to migrate towards better developed regions will grow. The effect might seem paradoxical from the cohesion policy objectives point of view. Although the allocation of EU financial assistance increases the qualification of labour force and its maintenance in the periphery regions, however, the effect could be that of stimulation of migration (being better qualified, they can obtain better incomes in better developed regions).

The spatial agglomeration of activities constitutes a factor of economic growth, permitting the stimulation of the accumulation of other production factors, but it does not lead to the realization of cohesion (as in attenuating regional inequality). The agglomeration phenomena create a tension between efficiency (quick economic growth) and equity (economic cohesion). Higher economic growth from one region (generated by agglomeration) attracts other economic activities to that area (the potential of its commodity market) which will accentuate the spatial agglomeration process. This one is self sustained by the vertical integration of firms, faster communication of technological externalities, as well as the migration of workers to this region.

When competition is high, agglomeration can reduce its dimensions, through the migration of some firms to the peripheral regions. However, this does not generate reduction of inequalities, as long as activities in these regions are characterized by a lower added value.

How does the existence of aglommerations influence the transition to euro?

For a country in a process of reduction of gaps in income, like Romania, economic growth is propelled by a few poles at a national level. These are, in fact, the great urban agglomerations that attract the majority of direct foreign investors and superiorly qualified labour force. It will be a national economic convergence, under the conditions that internal regional disparities will accentuate. The manifestation of a national structure of a central-periphery type might delay the adoption of Euro, if the weight in the GDP of the less developed regions is important. In this situation, the national economy will be characterized by a high degree of structural divergence (a high contribution of agriculture and a relatively reduced one from the services in these regions), which will decrease the degree of convergence with the business cycles of the Euro-zone.

The solution is the emergence (existence) of some regional growth poles, which will, in turn, influence positively the convergence of both income and structure. These agglomerations generate training effects at regional levels, by attracting foreign capital and labour force from the underdeveloped regions, thus reducing the rate of unemployment. The process of structural adjustment of these regions will be faster, and the rate of economic growth will be higher.

Up until now, cohesion policy has not contributed to the stimulation of development of underdeveloped regions, but it has, indirectly, generated a concentration of benefits for the agglomerations. To eliminate the compromise between growth and cohesion, the structural funds should be given to the regions close to the center (in the form of concentric circles, in waves, towards the exterior), which will stimulate the emergence of new poles of economic growth. European experience shows that isolated zones which benefit from structural funds have had only temporary boosts (regions like Mezzogiorno, Andalusia, Easter Germany lands etc.).

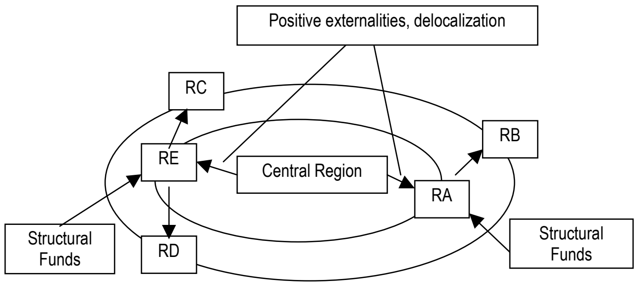

Figure 5. *The allocation of structural funds, in the form of concentric circles*

In the above figure I have proposed the allocation of structural funds towards the RA and RE regions, in close proximity of the central region. These will benefit from positive center's externalities, from the delocalization of firms from the agglomeration, and EU structural assistance. The respective regions can become growth poles and will exert a positive influence over the regions in close proximity to them (RC, RB and RD). By promoting a cohesion policy strategy like this one, there will be an increase in the numbers of regional growth poles, which will reduce the risks of adopting the euro in the respective economy.

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