NATIONAL BANK OF POLAND
WORKING PAPER
No. 39

Actual and potential impact of EMU on economic and budgetary policies of the EU

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Warsaw, January 2007

The views expressed in this study are personal opinions of the author and should not be attributed to any institution. Some parts of the study are based on the author's Ph.D. thesis as well as some articles, working papers and drafts prepared or published in recent years [see bibliography: Szeląg 2001-2006]. The starting point for the elaboration of this study was the author's speech held at the 18th Annual European Finance Convention (Palermo, Palazzo dei Normanni, 2-3 December 2004).

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Design:

Oliwka s.c.

Layout and print:

NBP Printshop

Published by:

National Bank of Poland
Department of Information and Public Relations
00-919 Warszawa, 11/21 Świętokrzyska Street
phone: +48 22 653 23 35, fax +48 22 653 13 21

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Abbreviations

Member States of the euro area (as of 2006):

BE	Belgium
DE	Germany
EL	Greece
ES	Spain
FR	France
IE	Ireland
IT	Italy
LU	Luxembourg
NL	Netherlands
AT	Austria
PT	Portugal
FI	Finland

Member States not belonging to the euro area (as of 2006):

- new Member States:

CZ	Czech Republic
EE	Estonia
CY	Cyprus
LV	Latvia
LT	Lithuania
HU	Hungary
MT	Malta
PL	Poland
SI	Slovenia
SK	Slovakia

- others:

DK	Denmark
SE	Sweden
UK	United Kingdom

Other countries or groups of countries (as of 2006):

EU-25, EU	European Union (consisting of 25 Member States)
EU-15	old Member States (15 Member States belonging to the EU before 1 May 2004)
EU-12	euro area (consisting of 12 Member States)
EU-10	new Member States (10 Member States that joined the EU on 1 May 2004)
JP	Japan
US, USA	United States of America

ERM 2 currencies (as of 2006):

EUR	euro
DKK	Danish krone
CYP	Cyprus pound
EEK	Estonian kroon
LVL	Latvian lats
LTL	Lithuanian litas
MTL	Maltese lira
SIT	Slovenian tolar
SKK	Slovak koruna

Other abbreviations:

ATM	automatic teller machine
BEPGs	Broad Economic Policy Guidelines
CAB	cyclically-adjusted balance
CABB	cyclically-adjusted budget balance
CAPB	cyclically-adjusted primary balance
CAP	Common Agricultural Policy
CECs	Central European countries
CLP	Community Lisbon Programme
ECB	European Central Bank
EDP	excessive deficit procedure
EEP	European Employment Pact
EES	European Employment Strategy
EGs	Employment Guidelines

EMU	Economic and Monetary Union
EPC	Economic Policy Committee
ERM	Exchange Rate Mechanism
ESA	European System of Accounts
ESCB	European System of Central Banks
GDP	gross domestic product
GNI	gross national income
GNP	gross national product
ICT	information and communication technology
IG	Integrated Guidelines
IT	information technology
IMF	International Monetary Fund
IMS	Internal Market Strategy
JER	Joint Employment Report
MTO	medium-term (budgetary) objective
NAP	National Action Plan
NRP	National Reform Programme
OCA	optimum currency area
OECD	Organization for Economic Co-operation and Development
OMC	open method of coordination
QMV	qualified majority voting
R&D	research and development
SGP	Stability and Growth Pact
SMEs	small and medium-sized enterprises
SMP	Single Market Programme
UMTS	Universal Mobile Telecommunications System

Abstract

EMU and the euro have been existing for more than seven (almost eight) years. As it is known, EMU – and in particular the proper functioning of the single currency – requires the appropriate policy mix. But there is the significant macroeconomic and institutional imbalance within the euro area stemming from the coexistence of the single (centralized) monetary policy and nationally-oriented (decentralized) economic policies that are merely coordinated. Besides the EU economic coordination process and the policy mix have many other serious weaknesses. For that reason, in recent years there have been numerous proposals of the strengthening the economic policy coordination within the EU, which could be implemented in the nearest or a bit later future. They were related to improving coordination of economic, employment and budgetary policies within the EU or the euro area (including the Stability and Growth Pact – reformed in 2005). But those proposals and reform seem to be more or less enough to resolve some current problems, but they do not propose the complex and ultimate framework of economic policy within EMU in the long-term perspective.

For that reason, at the present moment the EU still needs a serious debate on its future. The debate on the future of the EU started in 2000 – just a year after the introduction of the euro. After some years it might seem that the debate was over and the necessary solutions were found and adopted in the Constitutional Treaty. But following the last year's events (of May and June 2005) – related to the rejection of the Constitution for Europe and initial non-agreement on the Financial Perspective 2007-2013 – the debate on the future of the EU was reopen. Taking into account this crisis situation within the EU as well as the fact that the previous economic and political solutions have not been regarded as effective, it is worth to consider (or reconsider) some potential solutions that could be implemented in the EU in the longer future. For example, in the case of potential economic reforms, it would be interesting to consider whether the idea of the single economic/budgetary policy in the euro area is feasible (and desirable) in the long run. On the one hand, this idea is an extremely sensitive and controversial issue and there is strong opposition related to such a vision in the EU. But on the other hand, it seems to be very logical and natural because the logic and cumulative character of the integration process indicate that the evolution from the coordination of national economic and budgetary policies to the single economic/budgetary policy (coexisting together with the single monetary policy) seems to be an inevitable consequence of EMU in the longer term.

In general, this study argues that EMU will have a serious impact on the further integration process within the EU, exerting in the course of time stronger and stronger pressure on its deepening – in both political and economic spheres (e.g. by complementing a monetary union with a political union).

JEL classification: E 61, E 62, H 20, H 41, H 50, H 77

Key words: EMU, the euro, policy coordination, policy mix, economic policy, fiscal/budgetary policy, fiscal federalism, federation, political union

The cut-off date: 31 August 2006

Introduction

At the present moment – some years after the introduction of the single currency and the recent enlargement – the European Union (EU) experiences an extraordinary moment in its history, because on the one hand, the EU must face some new challenges resulting, *inter alia*, from more and more advanced integration, and on the other, the existing measures seem to be no longer sufficient to achieve these goals. Therefore, a turning point seems to be forthcoming. In this context, this paper is going to indicate that the establishment and existence of Economic and Monetary Union (EMU) and the single currency will have serious impact on the future of the EU and the further process of European integration. In the course of time EMU and the euro will exert stronger and stronger pressure on deepening this process – in both economic and political spheres. Some more or less visible symptoms of this impact are observed even today.

The study is focused particularly on some economic (including budgetary) aspects of European integration. The objective of this paper is analyzing and assessing a potential medium- and longer-term impact of the introduction of the euro on economic and budgetary policies of the EU or, at least, of the euro area (although finally all the EU Member States are expected to join the euro area). The basis for such an assessment is the present situation because the potential future impact is expected to be a continuation of the actual influence of EMU and the euro on the EU's policies. For that reason, in this study there is a comprehensive overview of the current debate on improving policy coordination within the EU (and, in particular, in the euro area). On this basis it is possible to consider some potential economic and political solutions for the EU – not only in the short term, but also in the medium and even long term.

The study, consisting of five parts, is organized as follows. In the first part there is a brief outline of the present framework of coordination of national economic policies within the EU and the euro area (including the indication of the main weaknesses of this framework), as well as some effects of the coordination framework and the policy mix on the euro-area economy. The second chapter concerns some recent (short- and medium-term) proposals to strengthen coordination of economic policies within the EU. In the third part of the study, particular emphasis has been put on strengthening coordination of budgetary policies as well as the implementation of the Stability and Growth Pact (including the recent reform of the Pact). The fourth chapter presents some political, economic and budgetary issues being the subject of the debate on the EU's future, including the relatively recent events connected with the Constitutional Treaty and the next Financial Perspective, as well as – last but not least – the perspectives of the enlargement of the euro area (being an important element of the general debate on the EU's and EMU's future). Finally, some potential future (long-term)

evolutions from coordination of national economic and budgetary policies to the single economic/budgetary policy in the EU, as well as the usefulness of fiscal federalism (in the context of, *inter alia*, the theories of optimum currency areas), are being discussed in the fifth part of the study. The last part concludes.

The main goals of this study are the following:

- to make a review of the economic literature related to the analyzed subject;
- to make a review of the relevant documents of the EU institutions (mainly the European Commission, the ECB, the European Council, etc.), as well as some international institutions and organizations (such as the IMF or the OECD);
- to propose some potential solutions for the euro area / EMU, which could be potentially considered in the future.

This paper should be regarded as a contribution to the ongoing debate on the future of the EU (and EMU as well) by indicating both some new ideas as well as some forgotten ones that perhaps could be reconsidered once again (if not today, at least in the longer perspective).

1

Present framework of coordination of national economic policies within the EU and the euro area

Without any doubts EMU is a very ambitious and – taking into account its scale and complexity – an unique and unprecedented project in economic history of the world. It represents a significant economic, political and institutional achievement of the EU. There are even opinions that EMU constitutes the most important change in the global economic system since the collapse of the Bretton Woods system in the early 1970s [Commission 2004j]. The successful launch of the single European currency on 1 January 1999, and the subsequent introduction of euro notes and coins on 1 January 2002, caused that the euro – called sometimes "a currency without a state" [Issing 2006a] – has become a tangible reality in 12 countries with a total population of more than 300 million people and accounting for about one-sixth of global output.

EMU is also a unique undertaking because of its macroeconomic framework. The euro area is the only region in the world combining the centralized conduct of common monetary policy with independent fiscal and other economic policies operated by individual countries. This situation is sometimes labelled the coexistence of one "monetary giant" with many "fiscal dwarfs" [Tamborini 2002]. While the single monetary policy is oriented towards a union-wide objective (the maintenance of price stability), the other policy areas – including fiscal and structural policies – are mostly aimed at specific national targets. Against this background, calls for strengthened macroeconomic policy coordination have caused the perception that the single monetary policy placed constraints on national economic policies. It is argued that those constraints could be mitigated by setting the other national instruments of economic policy in a coordinated manner in order to achieve macroeconomic outcomes favourable to national policymakers, while at the same time respecting their important anti-cyclical role [Issing 2000].

According to the Treaty[1] – after the significant amendments made by the so-called Maastricht Treaty[2] – the Member States shall conduct their economic policies with a view to contributing to the achievement of the objectives of the Community, but at the same time they should regard their economic policies as a matter of common concern and coordinate

[1] Terms "the Treaty" or "the EC Treaty" refer to the original Treaty of Rome (as amended by subsequent Treaties). The Treaty of Rome (officially the Treaty establishing the European Economic Community) was signed on 25 March 1957 in Rome and entered into force on 1 January 1958. It was amended several times by new Treaties, e.g. the Maastricht Treaty (of 1992), the Amsterdam Treaty (of 1997), the Nice Treaty (of 2000). The Maastricht Treaty changed the name of the Treaty of Rome (by removing the adjective "Economic"). As a result, the Treaty is presently called the Treaty establishing the European Community (or the EC Treaty).

[2] The Maastricht Treaty (officially the Treaty on European Union) was signed on 7 February 1992 in Maastricht and, after the ratification process, entered into force on 1 November 1993. Its main results were the establishment of the EU and EMU. The Maastricht Treaty introduced a new chapter on economic and monetary issues into the EC Treaty (Title VII – Economic and monetary policy – Articles 98-124).

them within the Council (Articles 98 and 99). As far as monetary policy is concerned, defining and implementing the monetary policy of the Community is one the basic tasks to be carried out by the ESCB with a view to maintain price stability as its primary objective (however, without prejudice to this primary objective, the ESCB should also support general economic policies in the Community) (Article 105). In other words, **monetary policy in the euro area is centralized and formulated at the supranational level** (by the ECB), while **economic policies – including budgetary and structural policies – are decentralized, i.e. formulated and implemented at the national levels** (by the governments of the Member States). However, economic policies are **coordinated** by some Community institutions, namely the EU Council and the European Commission).

The above institutional set-up for the euro area – consisting of both centralized monetary policy (formulated in Frankfurt am Main) and decentralized but coordinated economic and budgetary policies (in Brussels) is sometimes labelled the **"Brussles-Frankfurt consensus"** [De Grauwe 2006a,b]. It means that there is a general agreement among the main EU institutions (the ECB, the Council and the Commission) that the present institutional set-up in the euro area is appropriate and thereby there is no need to change it in the foreseeable future (i.e. in the short or medium term).

Last but not least, prior to some further considerations about macroeconomic and institutional issues within EMU, it should be noted that, as it is known, the euro area – as a monetary union – is potentially exposed to so-called **asymmetric shocks**, i.e. economic shocks hitting negatively only some parts of a currency area or a monetary union. Before the introduction of the euro there were some diverging or even contradictory opinions on the probability of asymmetric shocks (and, in consequence, the neccessity to have relevant adjustment capacity).[3] In fact, the euro area, similarly like the EU, has been so far subject to some economic shocks,[4] but it has not experienced truly asymmetric shocks. Nevertheless, it still remains one of the greatest challenges for EMU – affecting actually and potentially its institutional and macroeconomic arrangements. Moreover, there are even some opinions that, in terms of the future risks, some serious asymmetric shocks, e.g. a severe economic downturn or financial crisis in one (or some) of the Member States of the euro area, would be the proving ground for the political viability of EMU [Lane 2006].

1.1. Main instruments of economic coordination in the EU

In mid-December 1997 – a little bit more than a year before the introduction of the euro – the European Council adopted the resolution on economic policy coordination in the Stage Three

[3] On the one hand, some economists argued that the likelihood of asymmetric shocks would diminish in EMU because stronger economic integration between the euro-area countries would result in more correlated business cycles within the euro area. They indicated that there was empirical evidence (thirty years of data from twenty industrialized countries) confirming a strong positive relationship between the degree of bilateral trade intensity and the cross-country bilateral correlation of business cycle activities [Frankel, Rose 1998]. On the other hand, some economists argued that the process of economic integration, and notably the expansion of interregional trade as a result of EMU, would lead to greater local or regional specialization and concentration of production, which might cause that some regions of the euro area become more vulnerable and prone to idiosyncratic (industry-specific or sectoral) shocks and, in consequence, various region-specific crises and recessions within the euro area would be more likely to occur than before [Krugman 1991; 1993]. Such a phenomenon could potentially result from lower trading costs under EMU leading to greater industrial specialization and concentration along geographical borders. In practice, however, there is little evidence for increased specialization so far [OECD 2004a] and, as it is argued by some authors, trade integration effects may dominate, leading to greater dispersion rather than concentration of economic shocks in the euro area [Duval, Elmeskov 2005; 2006].

[4] The euro area has already been subject to some symmetric shocks in its relatively short history (since the announcement of its composition in May 1998), i.e. the Asian financial crisis (1997-1998), the oil price hikes (2000 and 2005), and the global economic slowdown (2001-2003). The oil price hikes were supply shocks, while the other two were demand shocks [see e.g. Buti, Sapir 2002; Commission 2004j].

of EMU [European Council 1997d]. It adopted the resolution in order to demonstrate a formal commitment to respecting the Treaty provisions in terms of surveillance and coordination of economic policies, and to reinforce coordination in practice both between the Member States which would share the single currency (by, *inter alia*, setting up an informal EuroGroup) and between those countries and the Member States which would not participate in EMU from the very beginning. The European Council – taking into account that the euro-area Member States would share the single monetary and exchange rate policy, while the other aspects of economic policy would remain national issues – stated that **to the extent that national economic developments would influence monetary conditions in the euro area, closer Community surveillance and coordination of economic policies among the euro-area Member States would be necessary**. All the Member States (including those remaining outside the euro area) should be included in the process of economic policy coordination because all of them participate in the Single Market and may also participate in the new exchange rate mechanism (ERM 2). According to the European Council, enhanced coordination and surveillance should cover the following areas:

- macroeconomic developments in the Member States and the development of the exchange rate for the euro;
- budgetary positions and policies;
- structural policies in labour, product and services markets, as well as cost and price trends.

Last but not least, the European Council underlined that coordination of economic policies must adhere to the principle of subsidiarity stipulated in the Treaty.

Practical implementation of the Treaty provisions related to economic policy has resulted in setting some specific **coordination instruments, procedures and processes** being applied presently in the EU and in the euro area. They are the following:

- the **Broad Economic Policy Guidelines** – for both the Community as a whole as well as for the particular Member States (related mainly to macroeconomic and structural policies);
- the **Stability and Growth Pact** – related to coordination of budgetary policies of the Member States;
- the **Luxembourg process** (known also as the European Employment Strategy) – concerning coordination of employment policies and labour market reforms;
- the **Cardiff process** – regarding structural reforms of product, services and capital markets;
- the **Cologne process** – establishing the so-called Macroeconomic Dialogue on interactions between fiscal policy, monetary policy and wage developments.

The Broad Economic Policy Guidelines (BEPGs) are regarded as the central element of the coordination process in the EU (see: figure 1.1.a). They were introduced to the EC Treaty in 1993 with the fundamental amendments made by the Maastricht Treaty. According to the amended EC Treaty, the Member States shall conduct their economic policies with a view to contributing to the achievement of the objectives of the Community (Article 98) and they shall also regard their economic policies as a matter of common concern and shall coordinate them within the Council (Article 99). The first BEPGs were adopted at the end of 1993 – just after the entry into force of the Maastricht Treaty and before the beginning of the

Stage Two of EMU. Since the very beginning the key objective of the BEPGs has always been achieving strong and sustained non-inflationary growth and a high level of employment (indicated in Article 2 of the EC Treaty) – by setting a comprehensive strategy which, contrary to any other policy coordination instrument, combined both sound macroeconomic policies and structural reforms. The original BEPGs used to consist of two main parts:

- first part containing **general guidelines for the Community** as a whole;
- the second part containig **country-specific recommendations for the individual Member States** according to their specific situations (in 2003, specific recommendations were addressed not only to the Member States, but also to the euro area as a single entity; in 2004, the new Member States were also incorpotated into that part of the BEPGs).

The overall structure and content of the BEPGs was amended last year because of the adoption of the so-called Integrated Guidelines (see: further part of this section and section 2.3).

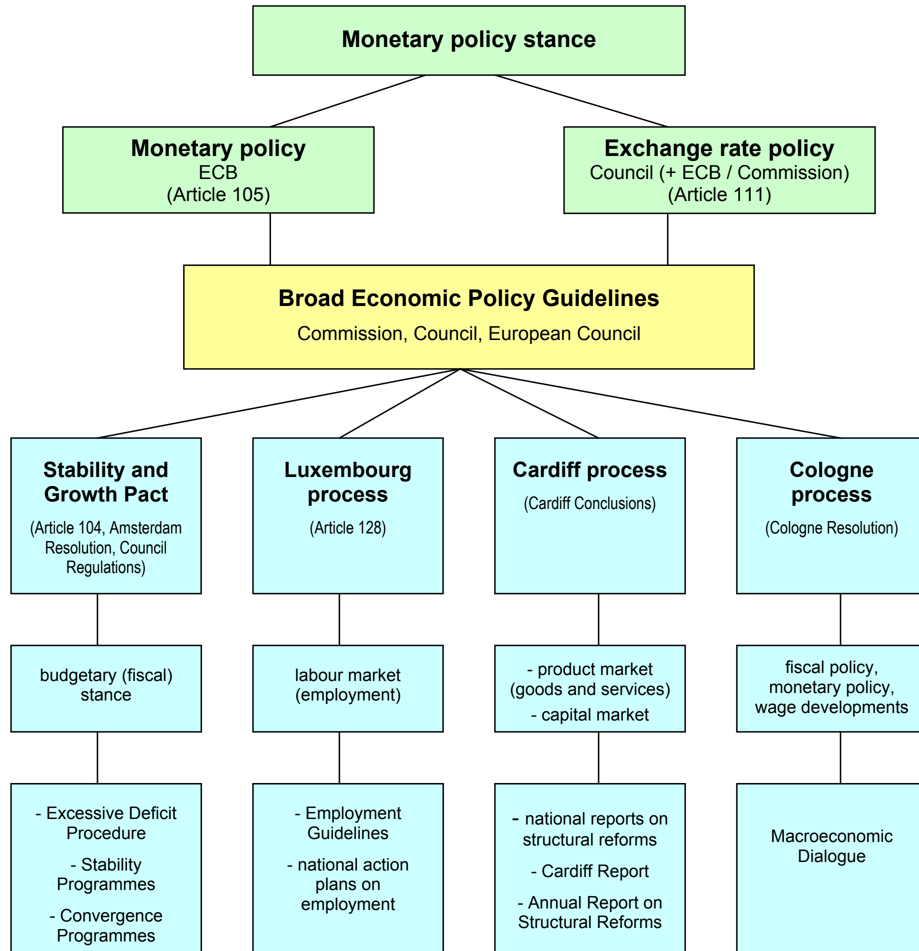
The original BEPGs – although quite extensive – have been regarded as a coordination tool of a rather general nature, but their recommendations are further developed by more specialized procedures (such as the Stability and Growth Pact as well as the Luxembourg, Cardiff and Cologne processes), which, of course, need to be consistent with the BEPGs). Taking into account the above fact that the BEPGs provide general guidance and build on these specialized procedures, the latter are timed with a view to ensure that the BEPGs stand at the start and at end of the **annual coordination cycle** (see: figure 1.1.b). The annual BEPGs procedure is sometimes divided into two phases, i.e. a preparatory phase (lasting from autumn to spring and resulting in the Commission's recommendation) and a finalizing phase (completed by the adoption of the final policy document by the Council in summer) [Commission 2002e]. The BEPGs are usually adopted in early summer (at the end of June or at the beginning of July) in order to leave a sufficient period of time for governments and thereby allow them to take into account the Council's recommendations during their autumn works on national budgets for the next year.

The BEPGs are politically but not legally binding. Compliance is voluntary and based on peer pressure. In fact, no sanctions for non-compliance are stipulated. In practice, when economic policy of a given Member State is not consistent with the BEPGs and it could jeopardize the proper functioning of EMU, the only possibility for the Council is to issue a recommendation to the (non-compliant) Member State concerned and, if deemed necessary, decide to make it public. For that reason, strict and regular monitoring of the implementation of these recommendations by the Member States is indispensable in order to ensure the overall effectiveness of the BEPGs as a tool of multilateral surveillance. The first annual Implementation Report was related to the 1999 BEPGs; since then such reports have been continuously prepared by the Commission every year (in January 2006 this report was incorporated into the the Annual Progress Report – see: section 2.3).

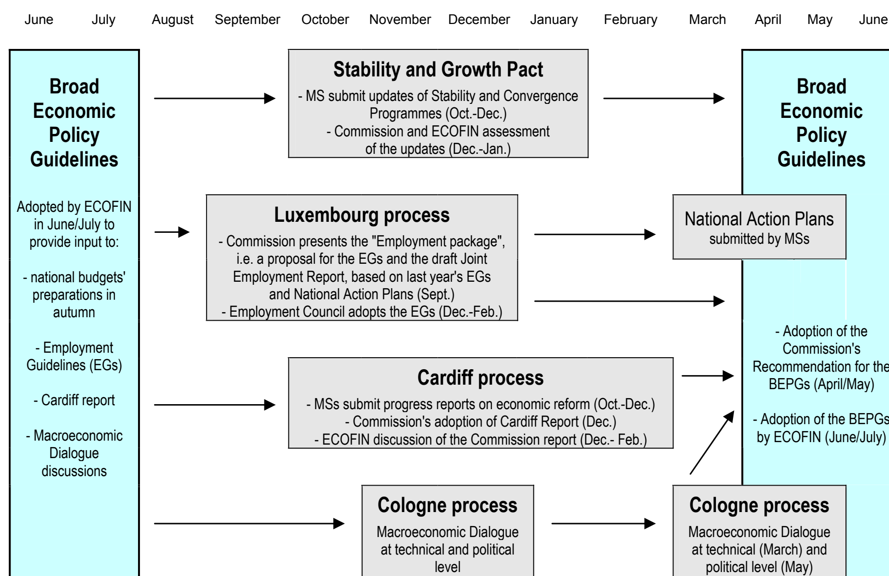
1

Figure 1.1.
Economic policy coordination in the EU (and in the euro area)

a) economic policy coordination (including the dialogue with the ECB)



b) original annual economic policy coordination cycle



Source: Commission 2002e (adapted by the author).

Full employment has always been one of the key Community's goals. It was stipulated in the Treaty of Rome, but particularly in the mid-1990s – when the EU experienced the highest rates of unemployment – the EU leaders focused very strongly on this issue. At the so-called Luxembourg Jobs Summit (in November 1997), just after the inclusion of the new chapter on employment into the Treaty,[5] the European Council launched the **European Employment Strategy** (EES) – also known as the **Luxembourg process** – aimed at strengthening coordination of national employment policies and significant reduction of unemployment at the European level. The EES has established a framework for multilateral surveillance to encourage the Member States to establish effective policies, in particular a joint annual report on employment and employment guidelines. It consituted a basis for the National Action Plans (NAPs) prepared by the Member States, and the Council's recommendations to the Member States. One of the main objectives of the EES is to involve the Member States in a series of common targets, focused on the following **four pillars**:

- improving **employability –** of which especially tackling youth unemployment and preventing long-term unemployment, monitoring of the unemployed by offering them a new start in the field of training or employment, modernizing education and training systems, easing the transition from school to work, etc.;
- developing **entrepreneurship** – of which establishing clear, stable and predictable rules concerning starting up and running businesses, simplifying administrative procedures and reducing other burdens on small and medium-sized enterprises (SMEs); reducing some costs for enterprises, e.g. those related to hiring additional workers; facilitating self-employment and setting up microenterprises; reducing tax burdens on employment;
- encouraging **adaptability** – of which modernizing work organization and flexibility of working arrangements; putting in place more adaptable forms of contracts; removing

[5] The Treaty of Amsterdam, signed on 2 October 1997 in Amsterdam, introduced a new chapter on employment into the EC Treaty (Title VIII – Employment policy – Articles 125-130). The Amsterdam Treaty, after the ratification process, entered into force on 1 May 1999.

fiscal barriers and mobilization of state aid policies on upgrading the labour force; creating sustainable jobs and efficiently functioning labour markets;

- ensuring **equal opportunities** – of which combating the gender gap and supporting the increased employment of women, by implementing policies on career breaks, parental leave, part-time work, and good quality care for children, as well as facilitating return to work, in particular for women [European Council 1997c].

Finally, it should be added that the above-mentioned new chapter on employment has envisaged the establisment of the **Employment Committee** (which replaced the Employment and Labour Market Committee). According to Article 130 of the Treaty, the new committee has advisory status and its main role is promoting coordination of employment and labour market policies of the Member States.

In June 1998, the European Council at its meeting in Cardiff stated that economic policy should focus on promoting growth and employment, as well as on securing macroeconomic stability and efficient labour, product (goods and services) and capital markets. The European Council welcomed the decision of the Council to establish a light procedure – called the **Cardiff process** – under which the Member States and the Commission would produce **reports on product and capital markets** (within their areas of competences). The European Council also welcomed the Commission's initiative to prepare a report on structural issues and policies drawing on some materials for consideration prepared by the ECOFIN Council as well as the other Council formations [European Council 1998]. Therefore, two reports have been envisaged:

- the so-called "Cardiff I" report – presenting the overall functioning of product and capital markets in the Member States;
- the so-called "Cardiff II" report – drawing on the Member States' progress reports and their NAPs on employment. The Cardiff II report emphasizes the role of **structural reforms** in fostering growth and employment and the need to consider the interaction between various aspects of structural reforms and macroeconomic policies. On the one hand, the Member States are urged to achieve coherence between reforms of various markets, and on the other hand, between reforms in labour markets and public finances [European Foundation 2005].

It was decided that the above procedure would fully respect the principle of subsidiarity, help exchange best practices and information already available in the national employment plans and some other existing reports [European Council 1998].

In June 1999, the European Council at its meeting in Cologne established the so-called **Macroeconomic Dialogue**, i.e. a specific form of discussion between the ECB, the Council, the Commission and the European social partners.[6] It is related to monetary and budgetary policies, as well as wage developments. The main objective of the **Cologne process** is encouraging an informal and unfettered dialogue between all the parties involved in macroeconomic policy and strengthening their confidence – in order to encourage effectivelly

[6] The term "European social partners" is being used to refer to those organizations at the EU level, which are engaged in the so-called European social dialogue (according to Article 139(1) of the Treaty). It usually refers to the Union of Industrial and Employers' Confederations of Europe (UNICE), the European Centre of Enterprises with Public Participation and of Enterprises of General Economic Interest (CEEP), and the European Trade Union Confederation (ETUC). They play a central role in tripartite concentration at the EU level ('Tripartite Social Summit for Growth and Employment' formally established in March 2003). They are also the organizations that negotiated the first European social dialogue agreement and signed European cross-sectoral agreements. The dominant position of the UNICE, CEEP and ETUC in the European social dialogue is being contested by some other social partner organisations [European Foundation 2005].

growth and job creation. Delegates and experts from the above-mentioned institutions participate in two kinds of sessions which constitute this dialogue – i.e. either in a technical (expert) session or in a political (high-level) one. The autonomy of the parties is fully respected and their discussions are confidential. The process is not binding for its participants and thereby no formal conclusions and reports are being prepared and published (each party is responsible for reporting back to its own constituency) [European Foundation 2005].

At the same time, the European Council in Cologne confirmed that higher employment continued to be one of the EU's top objectives and, therefore, it decided to establish the so-called **European Employment Pact** (EEP) aimed at a sustainable reduction of unemployment [European Council 1999a]. The EEP is regarded as a comprehensive overall approach bringing together all employment policy measures of the EU. The Cologne European Council endorsed the following three pillars of the Pact:

- further development and better implementation of the coordinated employment strategy to improve the efficiency of labour markets by improving the four pillars of the EES, i.e. employability, entrepreneurship, adaptability of enterprises and their employees, and equal opportunities for men and women (Luxembourg process);
- comprehensive structural reforms and modernization in order to improve the innovative capacity and efficiency of labour market as well as product and capital markets (Cardiff process);
- coordination of economic policy and improvement of mutually supportive interaction between wage developments and monetary and budgetary policies through the so-called macroeconomic dialogue aimed at preserving a non-inflationary growth dynamic (Cologne process).

As it has already been mentioned, the overall structure and content of the BEPGs was amended last year because of the adoption of the so-called **Integrated Guidelines for growth and jobs – for the period of 2005-2008** (see also: section 2.3). In recognition of the fact that macroeconomic, microeconomic and employment policies are closely connected and mutually strengthening, the Integrated Guidelines has been presented in one comprehensive document consisting of two main parts:

- **Part 1 – the Broad Economic Policy Guidelines**;
- **Part 2 – the Employment Guidelines**.

As we can see, the Integrated Guidelines consist of two existing before documents. In order to ensure appropriate consistency between both parties, cross-references have been made between relevant guidelines in Part 1 and Part 2.

The first part includes the Commission's recommendation on the BEPGs, applicable to all the Member States and to the Community (similarly as before). It reflects the new start of the Lisbon Strategy (see: section 1.3) and concentrates on a contribution of economic policies to higher growth and more jobs. At the same time it provides guidance on macroeconomic and microeconomic policies (see: box 1.1) and, accordingly, it is divided into two sections:

- Section A – **macroeconomic policies for growth and jobs** (including measures aimed at ensuring the dynamic and well-functioning euro area);
- Section B – **microeconomic reforms to raise Europe's growth potential** (dealing with such issues as making Europe a more attractive place to invest and work, boosting knowledge and innovation for growth, etc.).

In this context, the Commission has emphasized some strong links and feedback between structural reforms macroeconomic policies. In its opinion, growth and stability-oriented macroeconomic policies are the most important preconditions for achieving the potential benefits of structural reform. Equally, structural reforms can contribute to stable macroeconomic policies by making markets more efficient and thereby exerting downward pressures on prices and increasing the economy's resilience to shocks [Commission 2005i].

The second part of the Integrated Guidelines includes the proposal for a Council decision on the Employment Guidelines – setting out the overall employment objectives and priorities for action for the EU and its Member States (see: box 1.1). It concentrates on a contribution of employment policies to creating more and better jobs (as defined by the new Lisbon Strategy), as well as to raising employment and productivity growth, and to strengthening social cohesion. According to the Commission, employment policies should go hand-in-hand with reforms in product, services and financial markets, and interact positively with growth and employment-oriented macroeconomic policies [Commission 2005i].

Box 1.1.
Integrated Guidelines for growth and jobs (2005-2008)

Macroeconomic guidelines

(1) to secure economic stability;
(2) to safeguard economic sustainability;
(3) to promote an efficient allocation of resources;
(4) to promote greater coherence between macroeconomic and structural policies;
(5) to ensure that wage developments contribute to macroeconomic stability and growth;
(6) to contribute to dynamic and well-functioning EMU;

Microeconomic guidelines

(7) to extend and deepen the Internal Market;
(8) to ensure open and competitive markets;
(9) to create a more attractive business environment;
(10) to promote a more entrepreneurial culture and create a supportive environment for small and medium enterprises (SMEs);
(11) to expand and improve European infrastructure and complete agreed priority cross-border projects;
(12) to increase and improve investment in research and development (R&D);
(13) to facilitate innovation and the take up of information and communication technologies (ICT);
(14) to encourage the sustainable use of resources and strengthen the synergies between environmental protection and growth;
(15) to contribute to a strong industrial base;

Employment guidelines

(16) to implement employment policies aimed at achieving full employment, improving quality and productivity at work, and strengthening social and territorial cohesion;
(17) to promote a lifecycle approach to work;
(18) to ensure inclusive labour markets for job-seekers and disadvantaged people;
(19) to improve matching of labour market needs;
(20) to promote flexibility combined with employment security and reduce labour market segmentation;
(21) to ensure employment-friendly wage and other labour cost developments;
(22) to expand and improve investment in human capital;
(23) to adapt education and training systems in response to new competence requirements.

Source: Commission 2005i.

1.2. Stability and Growth Pact

The Stability and Growth Pact (SGP) is commonly interpreted as a major building block of EMU's architecture [Buti 2006]. Some authors argue even that the Pact *"must rank as one of the most remarkable pieces of policy coordination in world history. Its construction makes it in some respects comparable to the founding of the Bretton Woods system"* [Artis 2002].

In fact, the Pact is a unique coordination instrument of the EU. As mentioned before, the above instruments are politically but not legally binding for the Member States. The only exception is **the SGP** that is **both politically and legally binding**. The original SGP, established in 1997, consisted of the following elements:

- Resolution of the European Council on the Stability and Growth Pact of 17 June 1997 [European Council 1997b];
- Council Regulations 1466/97 and 1467/97 of 7 July 1997 [Council 1997a,b].

Those provisions – that fully entered into force on 1 January 1999 when the euro was introduced – strenghtened the relevat provisions of the Treaty on budgetary discipline, i.e. Articles 99 and 104 on multilateral surveillance and the excessive deficit procedure (EDP) respectively. In 2005, the above regulations were amended by Regulations 1055/2005 and 1056/2005 respectively. They were adopted by the Council on 27 June 2005 and entered into force on 27 July 2005 [Council 2005b,c]. Referring to these regulations, it is generally accepted that the SGP consists of the so-called two arms. The **preventive arm** is related to strengthening surveillance of budgetary positions and coordination of economic policies (including the medium-term objectives – MTOs), the adjustment paths, etc.). And the **corrective arm** is related to speeding up and clarifying the implementation of the EDP of the Treaty.

In principle, the Member States shall comply with **budgetary discipline** by respecting two **criteria**: a deficit-to-GDP ratio and a debt-to-GDP ratio not exceeding a reference value of **3%** and **60%** respectively, as defined in the Protocol on the excessive deficit procedure annexed to the Treaty. In practice, however, since the launch of EMU the attention has been paid particularly to the reference value for general government defict. It should be noted that the above reference values (of 3% and 60% of GDP) are both in the Treaty and in the Pact. But while the Treaty establishes some entry conditions for the Member States to join the euro area, the SGP aims to make budgetary discipline a permanent feature of EMU [Buti 2006].

The principal purpose of the SGP is **to ensure and maintain fiscal discipline within EMU**. Safeguarding sound government finances as a means to strengthening conditions for price stability and for strong and sustainable growth conducive to employment creation. It was also recognized that the loss of the exchange rate instrument in EMU would imply a greater role for automatic fiscal stabilizers at the national level to help economies adjust to asymmetric shocks [Commission 2006f]. The role of automatic stabilizers is part of the debate on the conduct of fiscal policy in EMU – suggesting either a more active use of fiscal policy in the euro area or its limitation to enabling the full operation of automatic stabilizers (see: section 1.5).

Under provisions of the SGP, the Member States are obliged to respect **the medium-term budgetary objective of positions "close to balance or in surplus"** (set out in their Stability or Convergence Programmes). The adherence to those MTOs allows the Member States to deal with normal cyclical fluctuations while keeping their general government

deficits below 3% of GDP (in normal circumstances deficits above this reference value are regarded as "excessive" unless the excess is considered as "exceptional and temporary"). According to the Regulation 1467/97, **the deficit excess** over the reference value of 3% of GDP shall be considered **"exceptional and temporary"**, when resulting from an unusual event outside the control of the Member State concerned and which has a major impact on the financial position of the general government, or when resulting from a severe economic downturn. According to the original provisions of the Regulation 1467/97, a **"severe economic downturn"** was defined as an annual fall of real GDP of at least 2%. But according to the recently amended provisions (Regulation 1056/2005), it refers to a negative growth rate (even lower than 2% of GDP annually) or the accumulated loss of output during a protracted period of positive - but very low - growth (see: section 3.2).

According to some authors, the reference value of 3% of GDP for triggering the excessive deficit procedure should be regarded as a "hard ceiling", breaking of which would activate "a quasi-automatic mechanism" for imposing sanctions [Stark 2001; Buti 2006]. As stipulated in the Regulation 1466/97, in the case of a significant divergence of the budgetary position of a given Member State from the MTO, or the adjustment path towards it, the Council – on the basis of a recommendation from the Commission – shall issue an **"early warning"** to this Member State in order to prevent the occurrence of an excessive deficit. Next, according to the Regulation 1467/97, if the Council decides on the existence of an excessive deficit in a given Member State, it should launch the EDP by making a **recommendation** to this Member State and establishing relevant deadlines for effective action to be taken in order to improve its budgetary situation. If the Member State concerned fails to do so, the Council should make a decision to impose some stronger (pecuniary) **sanctions**:

- first of all, a non-interest-bearing deposit is required as a rule. The amount of the first deposit shall comprise a fixed component equal to 0,2% of GDP, and a variable component equal to the size of the deficit (one tenth of the difference between the deficit as a percentage of GDP in the preceding year and the reference value of 3% of GDP);
- next, each following year the Council may decide to intensify the sanctions by requiring an additional deposit, but an annual deposit may not exceed the upper limit of 0,5% of GDP;
- finally, a deposit should be as a rule converted into a fine, if after two years the excessive deficit has not been corrected.

In this context, it should be noted that although the excessive deficit procedure shall apply to all the Member States, the above sanctions may be imposed on the euro-area countries only. At the same time it should be noted that it is possible to impose some financial sanctions on the Member States not belonging to the euro area – by the limitation of their access to the Cohesion and Structural Funds.

1.3. Lisbon Strategy

The Lisbon Strategy (also known as the Lisbon Agenda or Lisbon Process) is an action/development plan for the EU. It was outlined by the Lisbon European Council in March 2000, which articulated a new strategic goal for the EU for the present decade (2000-2010), namely: *"to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social*

cohesion". According to the European Council, achieving this strategic goal required an overall strategy aimed at the following issues [European Council 2000a]:

- preparing the transition to the so-called **knowledge-based economy and society** by better policies for the information society and research and development (R&D), stepping up the process of **structural reform** for competitiveness and innovation, and completing the Single Market;
- modernizing the **European social model**, investing in people and combating social exclusion;
- sustaining the healthy economic outlook and favourable growth prospects by applying an **appropriate macroeconomic policy mix** in the EU.

The Lisbon European Council announced not only the above new strategic goal, but also the so-called "open method of coordination" as the principal instrument through which this goal was to be achieved (see: section 2.1). Some other means were also specified: social dialogue, Structural Funds, programmes and research to underpin policy initiatives, etc. In this context, it is indicated that the unlimited scope of this new (open) method of coordination as a key instrument for achieving the Lisbon Strategy contrasts with the restricted scope of legislation and social dialogue [European Foundation 2005].

As we can see, the above goals of the Lisbon Strategy were extremely ambitious. In this context, it should be explained that they were adopted in the period of a very good macroeconomic climate and promising economic prospects. The Lisbon European Council stated that **the Union was experiencing at that time its best macroeconomic outlook for a generation**. Moreover, the Single Market was almost completed and was bringing some tangible benefits for consumers and businesses. And the euro was successfully introduced and – according to the European Council – it was started delivering the expected benefits for the European economy. Finally, the forthcoming enlargement would create some new opportunities for growth and employment [European Council 2000a]. Undoubtedly, **the successful introduction of the single currency – just a year before the European Council's meeting in Lisbon – provided the EU leaders with fresh impetus and optimism related to the EU's future** (it was expected that the euro and EMU would create relevant macroeconomic conditions for sustainable and non-inflationary growth in the euro area over the medium and long term). In this context, one can state that **the Lisbon Strategy is an "indirect effect" of EMU**; it is likely that without the successful introduction of the single currency (and some other factors), the Lisbon Strategy would have not been adopted. All in all, against the above background – especially a very favourable macroeconomic outlook and the successful introduction of the euro – the Lisbon European Council adopted the ambitious strategic goals for the forthcoming decade, based on a broad agenda of structural reforms in labour, product and financial markets.[7]

[7] A similar approach has been adopted in this study, i.e. confirming the above statement that the Lisbon Strategy is an "indirect effect" of EMU. For that reason, the Lisbon Strategy (and especially structural reforms – being of utmost importance for the proper functioning of the euro area) will by analyzed in detail in the subsequent parts of the paper.

1

Table 1.1.
The main targets of the Lisbon Strategy – progress in the Member States (as of January 2005)

Lisbon Strategy	Target	Target year	Reference year [1]	EU 15 average	EU-15: target achieved	EU 25 average	EU-25: target achieved
Employment							
Overall employment rate	67%	2005	2003	64.4%	7	63.0%	8
Overall employment rate	70%	2010	2003	64.4%	4	63.0%	4
Female employment rate	57%	2005	2003	56.1%	9	55.1%	14
Female employment rate	60%	2010	2003	56.1%	7	55.1%	8
Employment rate for workers aged 55-64	50%	2010	2003	41.7%	4	40.2%	6
Increase in average effectif retirement age	by 5 years to EU average 65	2010	2003	61.4	0	61	0
Available childcare for pre-school children over three	90%	2010	2004	n.a.	4	n.a.	n.a.
Available childcare for children under three	33%	2010	2004	n.a.	2	n.a.	n.a.
Research, Innovation, ICT and Education							
R&D spending/GDP	3%	2010	2003	1.99%	2	1.93%	2
Business participation in R&D spending	2/3	2010	2003	56.0%	3	55.4%	3
All schools with internet connection	100%	2002	2002	93.0%	1	n.a.	n.a.
All teachers to have training in digital skills	100%	2003	2002	56.8%	0	n.a.	n.a.
Internet penetration in households	30%	2002	2004	47.0%	12	44%	15
eGovernment: basic services online	100%	2002	2003	45.0%	0	n.a.	n.a.
Upper secondary attainment of young people (20-24 years old)	85%	2010	2004	73.5%	3	76.4%	8
Maths, science and technology graduates	15%	2010	2002	3.9%	1	4.4%	2
Economic Reform							
Transposition rate of internal market directives	98.50%	2002	2004	97.0%	1	96.3%	2
2 years timelimit for transposition of internal market directives	0 directives	2002	2004	n.a.	3	n.a.	3
Open electricity markets for customers	100%	2007	2004	90.0%	9	87.0%	9
Open gas markets for customers	100%	2007	2004	94.0%	7	88.0%	7
Cross-border energy transmission capacity relative to installed production capacity	10%	2005	2003	n.a.	10	n.a.	19*
Social Cohesion							
Low achieving 15 year olds in reading literacy	-20%	2010	2003	9.7%	0	2.2%	2
Early school leavers	10%	2010	2004	18.0%	5	15.9%	9
Participation in life long learning, % of adulst 25-64	12.5%	2010	2004	10.1%	6	9.4%	
Environment/Sustainable Development							
Visible progress at reducing greenhouse gas emissions	Reach EU average of 92% of the 1990 level	2008-2012	2002, 1990=100	97.1%	3 respect national targets	91.0%	10 respect national targets
Contribution of electricity produced from renewable energy sources to gross electricity consumption	Reach EU-15 average of 22% and EU-25 average of 21%	2010	2002	15.2%	4 respect national targets	14.2%	4 respect national targets

[1] if data not available for reference year, earlier data has been taken for some of the Member States.

Source: Commission 2005h.

Unfortunately, **in the subsequent years the overall macroeconomic situation in the world – and thereby in Europe as well – deteriorated considerably** (partly due to normal cyclical fluctuations and partly as a result of growing uncertainty and geopolitical tensions, particularly after the events of 11 September 2001 in the United States[8]). Real GDP growth dropped significantly, reached historically lower levels and maintained at those levels for some years (especially in Europe or, more precisely, in th euro area). For that reason, many structural reforms were postponed because they had been found difficult to implement in such a poor macroeconomic environment. In consequence, many targets of the Lisbon

[8] For a more detailed analysis on economic consequences of terrorism and assessment of the global economic outlook and policies following the terrorist attacks of 11 September 2001, see e.g.: IMF 2001; OECD 2002.

Strategy became much more challenging and harder to reach. In fact, at the moment many of the Lisbon targets are not expected to be reached by its time horizon (i.e. until 2010).

At the beginning of 2005, **five years after the launch of the Lisbon Strategy, its results seemed to be rather disappointing** because the European economy has failed to deliver the expected sound performance in terms of growth, employment and productivity, investment in R&D, etc. (see: table 1.1). To some extent the poor economic performance of the EU was the result of some cyclical slowdowns at both the global and European levels, but at the same time the slow pace of structural reforms has also hampered economic growth [Commission 2005h; 2006e]. For that reason, at the beginning of February 2005, the European Commission presented **a new strategy for the EU in order to revitalize the Lisbon Strategy** [Commission 2005b,d,e; Barroso 2005]. It was necessary because – according to the EU leaders, Community institutions and many external observers – five years after its launch the Lisbon Strategy was not expected to be able to meet its original (extremely ambitious) objectives. Although some observers suggested to abandon those ambitious goals, the Commission did not agree with them because – in its opinion – the challenges were even more urgent in the face of the ageing of populations and global competition.[9] Accordingly, the Commission – making its mid-term review of the Lisbon Strategy – decided to focus on actions to be taken rather than targets to be achieved. The deadline of 2010 as well as the objectives concerning various employment rates have no longer been put forward as priorities [Commission 2006f]. Policy priorities have been refocused on growth and employment. For that reason, the Commission stated in its report to the Spring European Council [Commission 2005d] that the crucial policy measures of the renewed Lisbon Strategy should focus on the following three main areas:

- making Europe a more attractive place to invest and work (by, *inter alia*, deepening the Single Market and ensuring open and competitive markets inside and outside Europe);
- boosting knowledge and innovation – as the heart of European growth (by, *inter alia*, investing more in R&D, ICT, etc.);
- creating more and better jobs (by, *inter alia*, investing more in human capital through better education and skills).

Within each area the Commission set out a concrete action programme for the EU and its Member States to generate sustained economic growth (3% of GDP) and more and better jobs (over 6 million jobs by 2010) [Commission 2005e].

Some months later, the Spring European Council in Brussels (in March 2005) confirmed the Commission's opinion and endorsed the renewed Lisbon Strategy. According to the European Council, it was crucial to relaunch the Lisbon Strategy without delay and refocus priorities on growth and employment because *"Europe must renew the basis of its competitiveness, increase its growth potential and its productivity and strengthen social cohesion, placing the main emphasis on knowledge, innovation and the optimisation of human capital. Given the challenges to be met, there is a high price to pay for delayed or incomplete reforms, as is borne out by the gulf between Europe's growth potential and that of its economic partners. Urgent action is therefore called for"* [European Council 2005a].

[9] Some months earlier, in November 2004, the need for urgent action was confirmed by the report from the High Level Group chaired by W.Kok. In the report there was the folowing statement: *"The Lisbon Strategy is even more urgent today as the growth gap with North America and Asia has widened, while Europe must meet the combined challenges of low population growth and ageing. Time is running out and there can be no room for complacency. Better implementation is needed to make up for lost time."* [Kok *et al.* 2004].

One of the most important elements of the relaunched Lisbon Strategy was redesigning its governance structure to specify more clearly the respective tasks, competences and responsibilities at both the national and Community levels – as maximum advantages, economies of scale and synergies can only be achieved if national reforms are complemented by relevant actions at the Community level [Commission 2005q]. The Integrated Guidelines endorsed by the European Council (June 2005) constituted a basis for the Member States' national programmes for growth and jobs – the so-called **National Reform Programmes** (NRP), which had a positive impact on the Member States' national ownership of the revamped Lisbon Strategy [EPC 2005; 2006]. The European Council also invited the Commission to present – as a counterpart to the national programmes – the so-called **Community Lisbon Programme** (CLP), covering all actions at the Community level [Commission 2005q]. This programme follows the structure of the Integrated Guidelines for growth and jobs (macroeconomic, microeconomic and employment policies) and falls under the same priority areas as the relaunched Lisbon Strategy (boosting knowledge and innovation for growth, making Europe a more attractive place to invest and work, creating more and better jobs). In order to achieve these goals, the Commission is going to concentrate on a number of key actions and measures with high value-added.[10] Progress related to both the NRPs and the CLP is reviewed in the single EU Annual Progress Report (see: section 2.3).

The first Annual Progress Report on the Lisbon Strategy – prepared on the basis of the NRPs submitted by the Member States in October 2005 – was released by the European Commission in January 2006 [Commission 2006a]. In this report, the Commission identified **four priority action areas in the context of the renewed Lisbon Strategy**, and then proposed that all the EU leaders, which would meet at the Spring Summit in Brussels (in March 2006), should commit to implement these measures. The European Council endorsed the above Commission's proposal and agreed on the following specific areas for priority action to be implemented by the end of 2007 [European Council 2006a]:

(1) investing more in knowledge and innovation;

(2) unlocking business potential (especially of SMEs);

(3) increasing employment opportunities for priority categories;

(4) Energy Policy for Europe (guaranteeing a secure and sustainable energy supply).

The above priority areas are practically indentical with those proposed a bit earlier by the Commission which stated that after the relaunch of the Lisbon Strategy in 2005, now – in 2006 – the EU must focus on delivery. In other words – as it was stated by the Commission President – "it is time to move up a gear" [Barroso 2006]. The above-mentioned priorities were also confirmed in June 2006 by the European Council that welcomed the Commission's and Member States' intention to pursue vigorously the Lisbon Strategy and ensure the good functioning of EMU [European Council 2006b].

Finally, it should be noted that there are clear links between the Lisbon Strategy and EMU. As it is known, **the proper functioning of EMU requires, *inter alia*, flexible labour,**

[10] There are, in particular, eight key actions and measures: (i) the support of knowledge and innovation in Europe; (ii) the reform of the state aid policy; (iii) the improvement and simplification of the regulatory framework in which business operates; (iv) the completion of the Internal Market for services; (v) the completion of an ambitious agreement in the Doha round; (vi) the removal of obstacles to physical, labour and academic mobility; (vii) the development of a common approach to economic migration; and (viii) the support of efforts to deal with the social consequences of economic restructuring. The full list of measures of the Community Lisbon Programme is annexed to the Commission Communication in this regard [Commission 2005q].

product and financial markets because members of the euro area have lost their independence in monetary and exchange rate policies (which are important adjustment mechanisms in the case of asymmetric shocks). And **the Lisbon Strategy calls for structural reforms aimed at more flexible labour, product and financial markets**. As it is argued by the ECB, it would be easier for the Member States to implement structural reforms in a stable macroeconomic environment within which such reforms and microeconomic policies could fully exploit their welfare enhancing effects. For that reason, the ECB (and its single monetary policy) supports continuously and contributes to the implementation of the Lisbon Strategy by maintaining price stability and promoting financial stability and, in consequence, contributing to a stable macroeconomic environment within the euro area. Price stability – being a crucial factor fostering non-inflationary and sustainable growth as well as supporting employment and social cohesion – is thereby the most important contribution of the single monetary policy to the Lisbon Strategy, supporting the latter in achieving its targets. Similarly, structural reforms in labour, product and financial markets improve the environment in which the stability-oriented monetary policy of the euro area is conducted [Issing 2004b]. The above arguments indicate that **EMU (with its single monetary policy) and the Lisbon Strategy (with its call for structural reforms) should not be regarded as two different and separate things**. On the contrary, as they are closely connected and mutually supporting, the Lisbon Strategy and EMU should be analyzed in parallel (especially their impact on each other).

Last but not least, it should be indicated that **there are some links not only between EMU and the Lisbon Strategy, but also between them and the EU budget**. Last year the European Commission stated that the debate on the new financial framework for the EU (Financial Perspective 2007-2013) had to reflect Lisbon ambitions by supporting Lisbon priorities within the future EU budget [Commission 2005d]. The European Council was of the same opinion, stating that the Financial Perspective 2007-2013 would have to provide the EU with adequate funds to carry through the Union's policies in general, including these policies that contribute to the achievement of the Lisbon priorities [European Council 2005a] (see: section 4.3).

1.4. Main weaknesses of the EU’s economic coordination and governance

As we can see, on the one hand, the EU strategic goals remain still really ambitious and, therefore, achieving those goals requires an overall strategy aimed at, *inter alia*, sustaining the healthy economic outlook and favourable growth prospects by applying the appropriate macroeconomic policy mix (as stated in Lisbon). But on the other hand, **the EU’s economic coordination process and the policy mix have many serious weaknesses**.

In July 2003, the following weaknesses of the EU’s coordination process were identified in the Sapir Report:

- first, an **inappropriate distribution of responsibilities between the Commission and the Council** in the enforcement of fiscal rules – in the current setting, the Council is entrusted with both policy and surveillance functions. The Commission is also entrusted with the latter, but it has no sufficient legal means to perform surveillance in an authoritative way because its warnings and recommendations have to be endorsed by the Council;

- second, **weak "political ownership"** of the EU economic coordination process by the Member States, which undermines the effectiveness of the coordination procedures – one of the reasons is the fact that there is no alignment between the European coordination process and national budgetary processes;
- third, **the coexistence within a single institutional setting of both the Member States that have adopted the euro and those that have not done it** – such an arrangement was sensible as long as the vast majority of the EU Member States were also members of the euro area, but it is not sufficient in the enlarged Union where more than half of the EU members will not belong to the euro area for some time. It may result in the lack of transparency, inefficiency and even confusion.

As stated in the report, macroeconomic policy coordination is envisaged in the Treaty as a key feature of EMU, yet weaknesses in its current institutional set-up do not favour an effective process of coordination [Sapir *et al.* 2003].

It seems that in order to complete the above list of weaknesses (or to make it more precise) the following ones should be added as well:

- first of all, the present coordination processes are largely **politically but not legally binding**. As mentioned above, the only exception is the Stability and Growth Pact that is both politically and legally binding and stipulates various sanctions for non-compliance, eventually even really painful. But for many (particularly recent) years the SGP has often been criticized and there has been observed a growing number of proposals to amend and reform the original rules of the Pact;
- next, the serious problem is the **decision-making weakness of the ECOFIN Council** which is the key institution in the EU's coordination process of economic policies. The Council's weakness, being a result of its highly politicized nature, is clearly visible in some crucial decisions that have an obvious political motivation. Sometimes it may be regarded as a violation of the commonly agreed rules (see: the Council's decision of 25 November 2003 [Council 2003c] and the ruling of the Court of Justice of 13 July 2004 [Court of Justice 2004]; see also: box 1.2). Such behaviour undermines the credibility of the whole coordination process and raises doubts about its functioning in the future;
- and finally, the **significant macroeconomic and institutional imbalance within the euro area** resulting from the above-mentioned coexistence of the single (centralized) monetary policy and nationally-oriented (decentralized) economic policies that are merely coordinated. The institutional imbalance is a result of the fact that the ECB has no real counterpart responsible for the whole economic (and particularly budgetary) policy in the EU, or at least, within the euro area. The only institutions fully responsible for fiscal policies are the governments of the euro-area countries, which are nationally-oriented, while there is a genuine need to ensure sufficient fiscal discipline in the euro area as a whole. Such a situation causes the persistent risk of "free riding" behaviour of some national governments – especially in the case of conflicting national and Community interests. And the short- or medium-term lack of fiscal discipline may jeopardize the long-term sustainability of public finances. In order to reduce the potential risk of "free riding", national fiscal policies are coordinated, but it may be insufficient because of the partisan implementation of fiscal rules at the Community level (what was experienced by the euro area in 2003 – just a few years after the launch of EMU). It

constitutes a basis for actual and potential tensions within such a partly centralized and partly decentralized macroeconomic framework and, in consequence, creates the above-mentioned macroeconomic imbalance (from the point of view of the euro area as a whole).

Box 1.2.
Judgment of the Court of Justice:
Commission of the European Communities vs. Council of the European Union

In this judgment the Court of Justice clarifies the powers of the Commission and the Council relating to the excessive deficit procedure (...).

- ***Background to the case***

The Council decided, on a recommendation from the Commission, that **excessive deficits existed in France and in Germany**. It adopted two recommendations setting those two Member States a deadline for adoption of the measures recommended for correcting their excessive deficit.

After expiry of the deadlines, the Commission recommended to the Council that it adopt decisions establishing that neither France nor Germany had taken adequate measures to reduce their deficit in response to the Council's recommendations. The Commission also recommended the Council to give the two Member States concerned notice to take measures to reduce their deficit.

On **25 November 2003** the Council voted on the Commission's recommendations for decisions, but did not achieve the required majority. On the same day the Council adopted, in respect of each of the two Member States concerned, essentially similar conclusions stating that it had decided **to hold the excessive deficit procedures in abeyance with regard to France and Germany** and addressing recommendations to them for correcting the excessive deficit in the light of the commitments made by each of them.

On 27 January 2004 the Commission brought an action before the Court of Justice challenging (i) the Council's failure to adopt the decisions recommended by the Commission and (ii) the conclusions adopted by the Council.

- ***The claim seeking annulment of the Council's failure to adopt, despite the Commission's recommendations, decisions establishing that neither France nor Germany had taken adequate measures to reduce their deficits and decisions giving notice to each of those two Member States***

The Court (...) finds that failure by the Council to adopt the decisions recommended by the Commission does not constitute an act challengeable by an action for annulment and it declares this part of the action to be inadmissible.

- ***The claim seeking annulment of the conclusions adopted by the Council in so far as they contain decisions to hold in abeyance the excessive deficit procedures with regard to France and Germany and decisions modifying the recommendations previously made by the Council to those two Member States for correction of their excessive deficits***

The Court accepts that the action is admissible in so far as it is directed against the conclusions, on the ground that they are intended to have legal effects: they hold the ongoing excessive deficit procedures in abeyance and modify the recommendations previously adopted by the Council.

The Court then states that the Council has a discretion in this field, as it can modify the measure recommended by the Commission on the basis of a different assessment of the economic data, of the measures to be taken and of the timetable to be met by the Member State concerned.

However, **the Council cannot depart from the rules laid down by the Treaty or those which it set for itself in Regulation 1467/97**. (...) the Court observes that where the Council has adopted such recommendations, it cannot modify them without being prompted again by the Commission, which has a right of initiative in the excessive deficit procedure.

The Court accordingly annulled the Council's conclusions of 25 November 2003.

Source: Court of Justice 2004.

According to some authors [Jacquet, Pisani-Ferry 2001], the undeniable efforts undertaken so far (related to economic policy coordination) have not succeeded in creating a genuine "culture of coordination" in the euro area. As a result, **national governments do not find**

sufficient incentives to conceive of national economic policies as issues of common interest, not even as a basis for the exchange of information and consultation. The commonly agreed coordination instruments (Luxembourg, Cardiff, Cologne processes) are regarded as imperfect because **the procedures are too complex to be operationally transparent**. The SGP and its associated provisions do not constitute a sufficient set of principles and procedures to organize economic policies in a proper manner within the euro area. In particular, there is the absence of a jointly elaborated and shared economic philosophy (such a philosophy should appear e.g. in the BEPGs). As a consequence, **the directions of the overall policy mix remains uncertain**. Observers and markets may get the impression that the policy mix results from political and diplomatic games rather than from a consistent and active conception of the role of economic policy. Such a level of uncertainty may involve some potential costs that should not be underestimated, inevitably influencing market expectations [see also: Gros *et al.* 2000].

Similarly, more recently, some authors confirm that there is a deep problem of governance in the euro area and its present institutional framework is weak. In this context they indicate the following problems [De Grauwe 2006a,b]:

- **imbalance between the scope of competences and responsibilities** – stemming from the fact that some important instruments of macroeconomic policy (related not only to monetary policy, but also to government deficits and debt) have been transferred to the supranational (European) level, while political accountability for decisions made in these areas (notably in the latter) has been maintained at the national level. This is a source of various tensions between national governments and the EU institutions (see: section 3.1);
- **lack of some important solutions contributing to the sustainability of EMU**. First, some large areas of economic policies remain in the competences of the Member States, i.e. their national governments, and this may create asymmetric shocks (mainly those of a political origin[11]) undermining the sustainability of EMU. Second, there is no system of budgetary redistribution in the euro area, which would compensate its members hit by a negative economic shock (such a redistributive system could be a crucial tool creating an “allegiance” to EMU, which in turn would be important to maintain its sustainability);
- **incomplete economic governance of the euro area** – due to the lack of a “central European government” which would be necessary to complement macroeconomic management of the euro area (being, at the present moment, entrusted almost exclusively to the ECB). It is argued that such a “central European government” would be the only EU institution that could fully back the ECB and its absence is perceived as a serious flaw in the present euro-area governance framework, which has to be fixed in the future.

With reference to these issues, it is argued the above-mentioned weaknesses of the present institutional design in the euro area is apparent both in the case of monetary and fiscal policies (the recent is, however, out of the scope of this study and, therefore, only the latter will be analyzed in more detail). In the case of coordination of fiscal policies within the euro area, the SGP – regarded as the key element of governance of fiscal policies in EMU – is indicated as an instrument built on a weak institutional foundation. This is due to the above-mentioned imbalance between the scope of competences and responsibilities resulting in

[11] The often cited example of such an asymmetric shock was the unilateral decision of the French government (of February 1998; with effect of January 2000) to shorten the length of a working week in France from 39 to 35 hours (in order to cope with high unemployment by forcing employers to hire additional workers).

some (potentially permanent) tensions and conflicts between the Member States and the EU institutions. This situation, in particular the lack of political accountability of the EU institutions (e.g. the Commission) in contrast to national governments, causes that the SGP seems to be rather a fragile and unsustainable institutional construction. For all those reasons, it is argued by some authors that **the above problems related to governance in the euro area call for further steps towards a political union**[12] **because without it the euro area and EMU are at risk** [De Grauwe 2006b]. Therefore, it is worth to analyze this proposal in detail in further chapters of this study (especially in the two last ones).

1.5. Policy mix in the euro area

As it is known, EMU – and in particular the proper functioning of the single currency – requires the appropriate policy mix within the euro area. In the Maastricht Treaty there are some specific provisions related to economic and monetary policies. According to them, monetary policy is formulated for the whole euro area at the Community level – by the supranational and independent institution, i.e. the ECB – as **the single monetary policy**. On the contrary, there is **no single economic policy** within the euro area, but economic policies are decentralized and remain within the competences of the Member States (those policies are, however, coordinated by some EU institutions – see: sections 1.1 and 1.2). On the one hand, such decentralization was regarded as an advantage and it was argued before the introduction of the euro that individual countries would be able to adapt fiscal and structural policies to their own specific situations and problems. But on the one hand, it was indicated that **it would complicate the task of achieving the appropriate policy mix at the euro-area level** because inadequate national policies – through their implications for the single monetary policy and the exchange rate for the euro – would inevitably have some spillover effects on other countries[13] [McDonald, Świderski, Knot 1998].

In general, it was always expected by many economists that **the policy mix in the euro area should be aimed at sustainable and non-inflationary economic growth**. For that reason, they have called for a policy mix combining sound budgets, responsible wage trends and corresponding monetary conditions [Commission 2002e]. At the same time many economists doubted whether the macroeconomic policy framework of EMU would be appropriate to achieve the above target. It was often argued that in the early years of EMU the ECB would conduct **overly restrictive monetary policy** in order to build its credibility. And it could be even exacerbated by the **overly restrictive and rigid fiscal rules** stipulated by the SGP. On the contrary, other economists argued that EMU would be characterized by a **looser fiscal stance** – as a result of the fiscal adjustment fatigue during the pre-EMU period in order to meet the convergence criteria [Commission 2004j].

Even prior to the launch of EMU there were no doubts that a sound macroeconomic policy framework is a key factor to achieve and maintain sustainable and non-inflationary growth in the long term. But there were some doubts about **the appropriate (inappropriate)**

[12] It should be noted that there is not a common definition of the term "political union" in the literature. According to a popular definition, a political union is a type of state which is composed of some smaller states/countries; the individual states/countries have a common (supranational) government and the union is recognized internationally as a single political entity [Wikipedia 2006]. Such a general definition – indicating the above internal and external features of a political union – has been adopted for the purposes of this study. For more details about the process of European political unification, political economy of European monetary integration, connections between a monetary and political union, etc. – see e.g.: Eichengreen 1997; Eichengreen, Frieden 2000; Wallace, Wallace, Pollack 2005.
[13] For an overview of some actual and potential economic spillover effects and policy coordination in the euro area, see: Weyerstrass *et al.* 2006.

combination of fiscal and monetary policy that would ensure reaching that goal. The importance of the proper policy mix was quite obvious given the strong mutual interactions between monetary and fiscal policies as well as their impact on growth and welfare (confirmed by many empirical analyses and research). In particular, some recent studies have confirmed the highly damaging effect of inflation on long-term growth (even with moderate rates of inflation), as well as the harmful impact of higher inflation volatility on welfare [see e.g. Camba-Mendez, Garcia, Rodriguez-Palenzuela 2003]. There is also some empirical evidence confirming that unsustainable public deficits could damage growth by crowding out private investments [Fatás *et al.* 2003; Rzońca, Ciżkowicz 2005]. The lack of fiscal discipline can also jeopardize the effectiveness of monetary policy and lead to higher risk premia in interest rates, which in turn may have a negative impact on investments [Trichet 2006a]. Not only the lack of fiscal discipline, but also tight monetary policy – aimed at a reduction of inflation – can lead to crowding out private investments. In this context, it should be noted that relatively tight fiscal policy (characterized by decreasing government expenditures) would allow achieving a reduction in inflation without any significant tightening of monetary policy (and thereby it would reduce the scale of the crowding-out effect). For that reason, such a policy mix – i.e. relatively tight fiscal policy combined with moderately tight monetary policy – is regarded as more beneficial for long-term economic growth (in comparison with a policy mix characterized by an expansionary fiscal stance, which is regarded as a non-optimal one) [Borowski *et al.* 2004].

More recently, in mid-June 2006, it was explained in the Commission's *"Public finances in EMU – 2006"* what should be regarded as an **"appropriate policy mix"**. According to the Commission, an appropriate policy mix can be defined as ***"a combination of monetary and fiscal policies that ensures price stability and keeps economic activity close to its potential level"***. In this context, in the Commission's opinion – given that in the euro area monetary policy is centralized and fiscal policies are decentralized – it is of utmost importance to assess both the aggregate fiscal stance at the euro-area level and national fiscal stances. Namely, the aggregate fiscal stance affects the policy mix at the euro-area level and, therefore, this is one of the most important elements to be considered by the ECB when formulating the single monetary policy for the euro area [Commission 2006s].

In addition to the above discussion on the appropriate combination of fiscal and monetary policy, there was also **the debate on the conduct of fiscal policy in EMU**. On the one hand, some economists – taking into account the loss of independence in the conduct of monetary and exchange rate policies – called for a **more active use of fiscal policy** in the euro area in order to correct country-specific macroeconomic imbalances. According to the European Commission, better stabilization at the national level – by limiting inflationary or deflationary pressures – could have some positive spillover effects at the euro-area level by facilitating the primary objective of the ECB aimed at marinating price stability, as inflation in the euro area would be less volatile [Commission 2004j]. On the other hand, some authors argued that the active use of fiscal policy should be avoided [Auerbach 2002]. In particular, it was indicated that there was the risk of "free riding" at the national level and inappropriate fiscal policies – especially if carried out simultaneously by many countries – could increase uncertainty about its overall effect on the policy mix and, in consequence, it could prompt countervailing action by the ECB. Moreover, taking into account that trade in EMU was likely to increase, it was expected that it might reduce the effectiveness of (discretionary) domestic fiscal policy. For those reasons, in opinions of many economists, **fiscal policy should be**

limited to enabling the full operation of automatic stabilizers. But there were some doubts related to the effectiveness of automatic stabilization – e.g. whether they would always be helpful in stabilizing the economy and whether they would be sufficient in the case of strong asymmetric shocks.[14] All in all, automatic stabilizers – which are roughly twice as large in the euro area compared to the United States – lessen considerably the need for discretionary policy in EMU [Commission 2004j].

Making an overall assessment of the policy mix in the euro area, it would be useful to present briefly its evolution since the launch of EMU. In 1999, **EMU started with the policy mix consisted of still tight fiscal policy** (similarly like in the run-up to EMU) **and relatively loose monetary policy** (because of countinuously favourable macroeconomic conditions). In general, during the first six years of EMU, monetary policy was more or less loose, except for 2000 when the ECB decided several times to increase interest rates because of the unfavourable combination of the depreciation of the euro exchange rate and rising oil prices. At the same time, fiscal policies of the Member States started to become more and more loose as a delayed result of the consolidation fatigue in the run-up to EMU. Fiscal policy of the euro area eased from 1999 to 2001 while the degree of easing was reduced in 2002 and 2003 [Commission 2003f]. Some fiscal tightening started to be observed in 2003 and 2004 when public finances in the largest euro-area economies (namely Germany and France) were expected to deteriorate significantly. In those years, the overall euro-area fiscal stance (measured by changes in CAPB) was broadly neutral. **In 2005, fiscal policy became much tighter** (see: figure 1.2.a). It seems to be quite understandable, taking into account that since spring 2005, the Commission and the Council took actions concerning the excessive deficit procedure in relation to six Member States. This fiscal stance is expected to be remained this year as well, keeping in mind that since January 2006 twelve Member States, of which five euro-area countries, are subject to the EDP. Similarly as in the case of fiscal policy, **the monetary stance started to be tighter in 2005** – especially after increasing interest rates by the ECB in December 2005 (after maintaing them unchanged for almost two and a half years). In the first half of 2006 there were some signs of a slight monetary tightening – particularly after further increasing interest rates by the ECB in March and June 2006. In general, **the present policy mix of the euro area – in contrast to the previous situation – is expected to shift from the broadly neutral stance in recent years to some policy tightening (notably in fiscal policy) in the nearest future**. Similar developments are observed at the national level, despite some obvious differences between the Member States. In recent years (2004 and 2005), the overall fiscal stance of the euro area has been expected to be, on average, broadly neutral (see: figure 1.2.b), although some fiscal tightening was projected or expected in some countries with high deficits, i.e. in Germany, France, Greece, Portugal, Italy, and the Netherlands.[15] In 2006, these projections and expectations seem to be still valid in most of those cases, particularly in relation to Germany, taking into account that in March 2006 – on the Commission's recommendation to step up the excessive deficit procedure on Germany – the Council decided to give notice to this

[14] According to the European Commission, the effect of automatic stabilizers largely depends on the type of shocks hitting the economy. For example, empirical evidence shows that automatic stabilizers are quite effective in the case of shocks to private consumption, while they are less effective in the case of shocks to investment or external demand [van den Noord 2000; Commission 2001d; Commission 2004j].

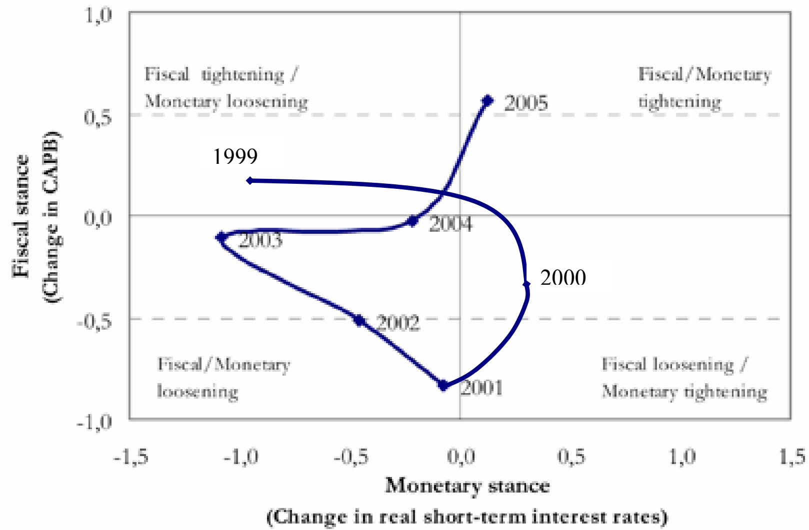
[15] In this context, it is worth to mention that the euro-area members with larger deficits tend to have a more pro-cyclical stance both in "good times" and in "bad times"; since the launch of EMU in 1999, this has been especially pronounced in "good times" [Commission 2004m].

country to bring its deficit below 3% of GDP by 2007 at the latest[16] [Council 2006a,b; Commission 2006g,s]. This notice to Germany was assessed by the ECB as *"the step that the Council failed to take a couple of years ago and the spark which ignited the debate leading up to the Pact reform"* [González-Páramo 2006].

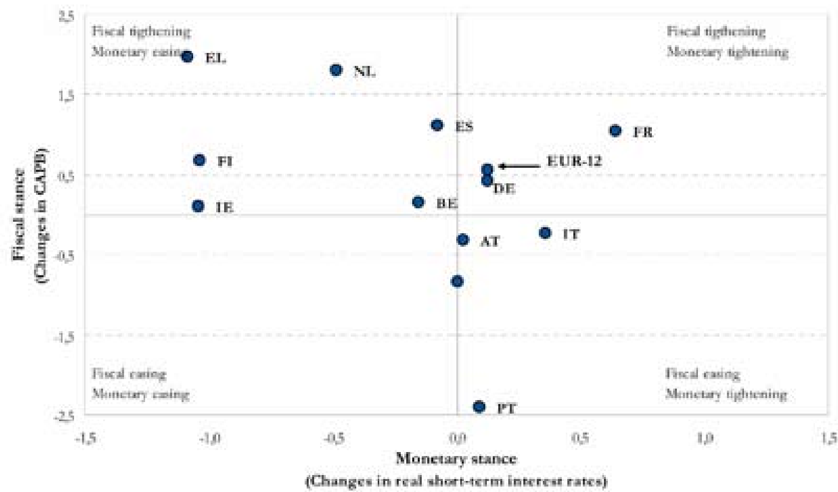
1

Figure 1.2.
Policy mix in the euro area

a) the euro area as a whole (1999-2005)



b) Member States of the euro area (2005)



Sources: Commission 2005a,r; 2006m,s; figure a) adapted by the author.

In general, some years after the introduction of the euro, it was assessed that **the macroeconomic policy framework (policy mix) in the euro area** – aimed at maintaining low and stable inflation and preventing unsustainable deficits and debt – **seemed to be appropriate to ensure sustained and non-inflationary growth.** Since the very beginning of EMU the single monetary policy has taken into account the fiscal policy stance as a very important factor contributing to overall price stability and fiscal policies have contributed to

[16] According to the Council decision, in 2006 and 2007, Germany shall ensure a cumulative improvement in its cyclically-adjusted balance net of one-off and temporary measures of at least 1 percentage point [Council 2006b].

maintaining overall macroeconomic stability. Moreover, the euro-area policy mix was assessed positively because of the existence of an efficient assignment of policy objectives and instruments, clear division of responsibilities, open exchange of views and information between policy actors, which could facilitate mutual understanding each other [Duisenberg 2003]. Although the above assessment was made some years ago, it seems to remain valid at the present moment as well. However, some authors argued that the macroeconomic policy mix in the euro area had been very restrictive since the launch of EMU and based on a "new monetarist" approach to economic policy. Instead, they proposed an alternative "post-Keynesian" approach which – contrary to the strict assignment of macroeconomic goals to the macroeconomic policy actors and their instruments in the above "new monetarist" approach – would require the coordination of monetary, fiscal and wage policies in order to achieve growth, high employment and price stability [Hein, Truger 2004].

Taking into account the above argumentation, as well as keeping in mind that it was always expected by many economists that the policy mix in the euro area should be aimed at sustainable and non-inflationary economic growth, it is worth to look at some key indicators in the euro area – notably economic growth. Before the launch of EMU it was expected that the introduction of the euro would be a "remedy" for relatively poor economic performance during some past decades (i.e. in the 1970s, the 1980s, and most of the 1990s), when most of the Member States experienced serious output losses and high unemployment as a result of an unstable macroeconomic environment (characterized by high inflation, high interest rates and unsustainable public finances). It was expected that under EMU the euro area would be able to address the above weaknesses not only by improving economic efficiency in the euro area, but also by providing greater macroeconomic stability [Commission 2004j]. In this context, it is possible to assess – even after only seven years of EMU – **that the euro area proved to be really successful in the achievement of the goal of macroeconomic stability**. Despite those achievements in terms of macroeconomic stability, **the growth performance of the euro area has been rather disappointing in recent years**. Although real GDP growth in the euro area accelerated in the second half of the 1990s, peaking at 3.5% in 2000 (the highest rate of the whole decade), in the subsequent years the euro area experienced a protracted slowdown in economic activity – falling to less than 1% in 2002 and 2003 – despite a continuously stable macroeconomic environment (while the United States recorded quite strong growth at the same time). Overall, since the launch of the Lisbon Strategy in 2000, the average growth rate in the euro area amounted to 1.8% annually, lagging behind its main competitors in the world [see e.g.: IMF 2002a,b; 2003a,b; 2004a,b; OECD 2002; 2003b; 2004b]. As far as the present situation is concerned, according to the recent Commission's economic forecasts (of November 2005 and May 2006), after having reached an annual average rate of 2% in 2004, growth of the euro area was more subdued last year (estimated at 1.3%), but it is expected to return to potential since 2006 onwards (the potential growth rate of the European economy is currently estimated to be around 2.0% [Commission 2006a]). It is projected by the Commission to reach 2.1% in 2006 and 1.8% in 2007 (what is broadly in line with the recent projections of the ECB, IMF and OECD – see: Commission 2005x; 2006m; IMF 2006b; OECD 2006b; ECB 2005h; 2006g). The main factors behind the outlook include, *inter alia*, the accommodative macroeconomic policy mix, an acceleration in domestic demand and investment, benign financial conditions, an improved outlook in Germany, a robust global environment, etc. [Commission 2005x; 2006m; IMF 2006a; OECD 2006a].[17]

[17] A more detailed analysis of the overall growth performance in the euro area was presented by the author in another working paper (see: Szeląg 2007).

Finally, it should be noted that the launch of EMU has reinforced the discussion on policy coordination within the euro area. In particular, the single monetary policy has logically stimulated **the debate about policy mix coordination at the euro-area level** [Vijselaar 2000]. It was particularly important in the context of the parallel existence of decentralized fiscal and structural policies in the EU (and in the euro area as well). Sometimes – especially before the introduction of the euro – there were some opinions in the economic literature that the right policy mix could only be achieved through **more active coordination of fiscal and monetary policies** [Bayer, Katterl, Wieser 1998]. On the contrary, with regard to the policy mix, it was argued that **monetary and fiscal policies should (or even must) be functionally separated** for many reasons and there would be some clear gains from such a separation. In the context of economic policy making, it was suggested that undisputed links and interactions between monetary, fiscal and structural policies were not sufficient reasons to call for close coordination of those policies at the euro-area level. Instead, it would be a good reason for policymakers to exchange necessary information. Such a dialogue between the main actors of the policy mix (monetary and fiscal authorities as well as the social partners) could improve overall decision-making by preventing policy decisions to be made in isolation, and thereby it would generate more support for the eventual decisions made. Therefore, it was concluded that the lightest forms of coordination (exchange of information and analyses, macroeconomic policy dialogue, etc.) seemed to be a maximum sort of coordination between monetary and fiscal policies [Vijselaar 2000]. Similarly, the ECB stated some years ago that **there could not be any scope for an active coordination of fiscal and monetary policies**. Such active coordination would be ineffective given the incapacity of both monetary and fiscal policymakers to fine tune economic developments, as well as because of the absence of credible enforcement mechanisms. Therefore, there should not be any commitments to an automatic or even *ex ante* monetary policy reaction in response to fiscal policies or structural reforms. Such formal commitments to *ex ante* coordination between those policies might potentially blur the responsibilities of monetary and fiscal authorities, reduce their incentives to pursue their objectives as well as increase uncertainty about the general policy framework. In the ECB's opinion, the economic outcome of such coordination would be probably worse than the conduct of monetary and fiscal policies within the existing institutional set-up because only the latter would be able to ensure genuine accountability [Duisenberg 2003; Issing 2002; 2005b].

Summing up, the overall assessment of the policy mix in the euro area seems to be quite positive, although the unique combination of the single (centralized) monetary policy and decentralized economic policies may seem to be imperfect and perhaps even ineffective. One can state that the above-mentioned list of weaknesses of the present coordination framework (see: section 1.4) confirms this judgement. Of course, even this seems to be true to some extent, it does not mean that the policy mix in the euro area is completely wrong. This is obviously not true. In order to assess whether the euro-area policy mix has proved to be successful, it would be necessary to examine the overall performance of the euro-area economy, especially in terms of growth and inflation – keeping in mind that the policy mix in the euro area has always been expected to be aimed at sustainable and non-inflationary economic growth.

2

Recent (short- and medium-term) proposals to strengthen coordination of economic policies within the EU

Looking back on the experience of more than seven years of the existence of EMU and the euro, it is clearly visible that the EU's economic and budgetary governance has ensured overall macroeconomic stability in the EU (and, in particular, in the euro area), contributed to non-inflationary growth and impressive budgetary consolidation in the period preceding the introduction of the euro, etc. But even some European officials acknowledge that not only achievements but also problems have been experienced during this seven-year period (especially in implementing the EU fiscal framework) and it is necessary to strengthen economic and budgetary coordination to capitalize on the advantages of EMU and the euro [Regling 2004].

Taking into account the above, in recent years some experts and institutions have made numerous proposals to strengthen economic policy coordination within the EU, which could be implemented in the nearest or a bit later future (in the short or medium term). Those proposals have been announced mainly by the European Commission, but representatives of another institutions, research institutes and universities have also taken part in **the debate on amendments concerning the EU's economic policy**. They have made their proposals mainly since 2001 onwards (practically until now). It seems it is not a coincidence that this debate has been developed considerably in recent years, because it is directly connected with some significant events and phenomena of both positive and negative natures:

- the introduction of the euro and the start of conducting the single monetary policy in the euro area (1999) – it seems that both of them have already forced and further will force greater discipline and cohesion of national economic and budgetary policies of the Member States belonging to the common currency area;
- the global economic slowdown (2001-2003) – and much weaker and fragile recovery observed in the euro area (and in the whole EU) in comparison with some other developed regions of the world (particularly the United States);[18]
- the completion of accession negotiations (2002) and hence the forthcoming enlargement of the EU (2004) – the much larger number of the Member States and the fact that the new members are much less developed than the present ones will further complicate the

[18] In this context, it is worth to mention that this weaker recovery observed in the euro area in recent years confirms the overall characteristics of the euro-area cycle in the longer perspective (since the 1970s to date). There are some recent studies, comparing the characteristics of the economic cycle of the euro area with that of the United States, which have found that *"the two cycles are driven by a common world shock, but that the propagation of the shock differs across the two areas: the euro area lags the US and its cycle is more persistent, but less volatile. Low growth, persistence of shocks and low volatility are common characteristics of the euro area and the gap with respect to the US has been stable over the last thirty years"* [Giannone, Reichlin 2005; 2006].

whole economic coordination process (especially after the enlargement of the euro area in some time).

The above proposals has concerned both general economic policy as well as some specific kinds of economic policy, such as employment policy or budgetary policy.

2.1. New open method of coordination

Taking into account the above instruments of economic coordination within the EU (see: sections 1.1 and 1.2), it seems that there is a sufficient number of the coordination tools available for the EU and its Member States. It was confirmed by the European Council in Lisbon (March 2000), which stated that **no new coordination process was needed** because the existing ones – i.e. the BEPGs and the Luxembourg, Cardiff and Cologne – offered the necessary instruments, provided they were simplified and better coordinated. It was also proposed that those improvements would be underpinned by a stronger guiding and coordinating role for the European Council to ensure more coherent strategic direction and effective monitoring of progress towards the newly adopted goals of the Lisbon Strategy. Implementing this strategy was expected to be achieved not only by improving the existing coordination processes, but also by introducing the so-called **new open method of coordination** (OMC). According to the Lisbon European Council, this method, which is designed to help the Member States develop their own policies, should involve the following elements:

- adopting – at the EU level – **policy goals and guidelines** for the whole EU as well as specific short-, medium- and long-term timetables for achieving the goals;
- establishing – in order to compare best practices – both quantitative and qualitative **indicators and benchmarks** which would be, on the one hand, based on the world's best results in a given area, and on the other, tailored to the needs of the various Member States and sectors;
- translating the above EU guidelines into **national and regional policies** by setting specific targets and adopting relevant measures;
- periodic **monitoring** of results and **evaluation** of achieved progress.

The Lisbon European Council proposed the OMC as a **fully decentralized approach** which would be applied in line with the principle of subsidiarity – with an active participation and a relevant division of competences between the EU, its Member States, the regional and local levels, as well as the social partners and civil society [European Council 2000a]. Therefore, it is largely implemented by the Member States and supervised by the Council and the Commission. This decentralized nature of the OMC confirms the thesis that this method is sometimes perceived as a reaction to the EU's economic integration in the 1990s, which reduced the Member States' options in a given area (e.g. employment policy). Therefore, taking into account that the Member States were usually reluctant to delegate more powers to the European institutions, the OMC was designed as an alternative to the existing EU modes of governance [European Foundation 2005].

The OMC is a form of **soft law** of the EU (i.e. non-binding for the Member States) and its crucial tool is **peer review**. The OMC is aimed at spreading **best practices** and achieving **greater convergence** towards the EU strategic goals. Although the so-called "Employment title" of the EC Treaty (introduced by the Treaty of Amsterdam in 1997 – see: section 1.1) is regarded as the original model of the OMC, this method is not limited to this area only, but it

is being applied to other **policy areas**, such as research and development (R&D), education, social protection and inclusion, pensions, enterprise policy and immigration. In general, the OMC was devised as a tool in policy areas which remains a priority for national governments and offered an alternative to the Treaty rules on the “enhanced cooperation” [Hodson, Maher 2001; Eckardt 2005; European Foundation 2005].

There are many opinions about the OMC in the economic literature in recent years. On the one hand, it is argued that **the OMC is not only a new but also an effective policy-making instrument**. But on the other hand, some authors raise **doubts about both claims**. For example, it is possible to make a comparison of soft law policy coordination in some international organizations, i.e. the EES (which was the first use of the OMC), the BEPGS, the OECD Economic Surveys, and the IMF Article IV Consultations. Based on expert interviews, it is argued that these procedures are forms of multilateral surveillance that do not differ significantly. Accordingly, it does not support the above claims about the OMC’s novelty. As far as effectiveness is concerned, it is argued that effective problem solving is not necessarily the dominant objective of soft law because governments tend to select some voluntarist procedures mainly to secure their own scope of competencies rather than to realize commonly agreed goals [Schäfer 2004].

There are also some more critical opinions about the OMC. First of all, it is considered whether there is **the single method** or there are **several methods** in place. The reason for such a consideration is the fact that the OMC varies significantly across policy areas. Although there are some similarities across policy areas, such elements as benchmarking, peer review and learning mean different things in the case of different policies. Policymakers make usually reference to the OMC as legitimizing discourse, but *de facto* they deal with different mechanisms and logics. Some processes are of a political nature, while others are governed according to expertise and bureaucratic goals. As a result, one could not refer to the method, but rather to different policy practices, i.e. ‘lighter’ and ‘harder’ versions of the OMC. Moreover, rather **limited results and achievements of the OMC** has often been criticized. The following issues are indicated as rather disappointing: the lack of bottom-up participation, limited cross-national and bottom-up learning, limitations in the current use of benchmarking, etc. Participation is only one dimension of the whole issue of legitimacy, accountability and democratization of the new method, which is regarded as the biggest challenge for the OMC. Despite the above critical opinions, it is assessed that the OMC has considerable potential for better governance in the EU, but the effort to exploit this potential has just begun and must be continued [Radaelli 2003].

2.2. Strengthening economic policy coordination within the euro area

The first concrete proposals to strengthen economic policy coordination within the euro area appeared relatively soon after the introduction of the euro, i.e. in 2000 and 2001. Some experts [e.g. Jacquet, Pisani-Ferry 2001] argued that the introduction of the euro reinforced the need to implement the kind of economic policy coordination that the governments of the Member States had committed themselves to support. In their opinion, despite the fact that some progress had been made, current procedures did not provide a satisfactory response to that need and, as a consequence, Europe’s future economic growth was accordingly at risk. In response, they proposed some **institutional guidelines** which should provide an operational answer to the current questions:

- elaboration of an **economic policy philosophy** (economic policy charter) by the euro-area members, i.e. a set of principles going beyond mere procedures and criteria[19];
- more transparency and predictability in economic policy;
- transforming the EuroGroup into a collective executive body (it should evolve into a true **Eurozone Economic Policy Council**[20]);
- closer interaction between EU procedures and national decisions;
- more effective external representation of the euro area (ECB / EuroGroup)[21] and genuine exchange rate policy (the EuroGroup should make exchange rate decisions by qualified majority);
- monetary strategy for the enlargement.

The above policy suggestions presented varying degrees of institutional difficulty. Some of the above proposals could be implemented at once, without any modification of the current text of the Treaty, while others would require minimal reforms, and sometimes would demand potentially deeper changes in the existing Treaties [Jacquet, Pisani-Ferry 2001].

The first formal proposal of the EU institutions to strengthen economic policy coordination within the euro area was made by the European Commission in February 2001 [Commission 2001a]. In its communication, the Commission proposed some more effective coordination instruments, focusing particularly on the **more efficient functioning of the EuroGroup** (an informal but important body in the euro area) and strengthening its position by increasing its competences and certain (gradual) formalization of its operational framework. Moreover, the Commission proposed **to institutionalize the dialogue between different actors of the policy mix within the euro area** – by frequent and regular meetings between the President of the ECB, the President of the EuroGroup and the representative of the Commission in the ECB Governing Council (within a framework of strict confidentiality and with respect for the independence of all parties – similarly as in the case of the Macroeconomic Dialogue within the Cologne process). The common position on issues of particular relevance to EMU would be presented by the above “triumvirate” and it would be valid not only internally (i.e. within the euro area), but also externally (e.g. at the IMF, G-7) – in order to ensure **the single representation of the euro area in the international forums**.

Next year, in May and December 2002, the Commission published two other communications [Commission 2002b,i]. In those documents the Commission recalled the fact that the euro and EMU had widely been recognized as a great success and the EU must be able to use this achievement as the basis for its economic development. But in order to function properly the single currency has needed (and still needs) sound performance of overall economic policy within a monetary union (especially in the context of the enlargement of the EU and then, at a later stage, of the euro area as well).

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[19] According to the proponents, the formulation of such principles should not be left to negotiation, since they would then result from various trade-offs and concessions, but it should rather be entrusted to a group of higly qualified experts and professionals. The Commission and the ECB should also be involved in this process.

[20] According to the proponents, in such a Council decision-makers – the EU Ministers of Finance/Economy and, as a frequent guest, the President of the ECB – would decide on the appropriate strategies for dealing with structural problems or responding to economic and financial shocks, agree relevant policy orientations, define a sustainable growth strategy for the euro area. This Council should be able to adopt some economic policy documents (especially those related to the euro-area economy and its economic policy).

[21] According to one proposal, the EuroGroup should appoint its vice-president who would always come from the euro-area country belonging to the G-7, and would have the authority to talk on international monetary issues on behalf of all the euro-area Ministers of Finance/Economy. This vice-presidency would rotate between the three EMU countries, being also G-7 members, and in tandem with their EU presidencies. Another (alternative) proposal stipulated the nomination of the so-called “Mr. Euro”, who could be the chairman of the Economic and Financial Committee [Gros *et al.* 2000; Jacquet, Pisani-Ferry 2001].

In the Commission's opinion, it is essential to have a central body responsible for coordination of economic policies within the euro area, articulation of its common interest, maintaining credibility and cohesiveness of the single economic area, etc. This role should be entrusted to the Commission and its role in the economic coordination process must be strengthened. The BEPGs, opinions on the Stability and Convergence Programmes and the SGP's "**early warnings**" should not be drafted on the basis of the Commission's recommendations (like presently), but rather on the Commission's proposals. It is important because the Council may depart from a recommendation by qualified majority; and in the case of a proposal it could depart only by unanimity. In the future, however, **qualified majority voting** (QMV) must become the single procedural rule within the Council in the overall decision-making process related to economic policy because it no longer makes sense to apply unanimity e.g. to fiscal and social affairs within the Single Market with the single currency. The Commission also suggested setting up an **"ECOFIN Council for the euro area"** or an **"ECOFIN euro-area Council"**. It would consist of the Ministers of Finance/Economy from the euro-area countries only, who would be able to take part in the EU decision-making process concerning economic policy within the euro area. Finally, the Commission drew attention to **the external representation of the euro area**, suggesting that it could be a single body representing the euro area in the case of all relevant international issues (economic, monetary and financial ones). The Commission invited the European Convention to try to seek a pragmatic solution in this context (see: section 4.2).

Some of the above solutions were confirmed and recommended in July 2003 in the Sapir Report. According to the authors of the report, a **euro-area Council** should be established and entrusted with all non-monetary policy decisions pertaining to the operation of the euro area (for example, the euro-area BEPGs, macroeconomic policy recommendations to the euro-area Member States, exchange rate policy, etc.). It would also be given the right to adapt rules that are relevant only for the euro-area members, while preserving the rights of the Member States not participating in the single currency. The **high-level dialogue** between the euro-area Council and the ECB needs to be upgraded via regular informal meetings between the President of the euro-area Council, the relevant Commissioner and the President of the ECB. The objective of such a dialogue would not be to coordinate *ex ante* monetary and fiscal policies, but to have an exchange of views on the assessment of the economic situation and policy challenges [Sapir *et al.* 2003]. The above proposals would address one of the indicated weaknesses of the current coordination process – related to the coexistence within a single institutional setting of both the Member States that have adopted the euro and those that have not done it (see: section 1.2).

2.3. Streamlining the annual economic and employment policy coordination cycles

Some years after the launch of EMU some observers started to claim that the current coordination framework provided by the Luxembourg process (established in 1997), as well as some other coordination mechanisms, should be redesigned. In their opinions, coordination efforts should not focus mainly on simple policy indicators (as stipulated by the open method of coordination), but rather on the broad effects of reforms for welfare outcomes as well as on potential cross-country spillovers. And mechanisms should be introduced for monitoring implementation of reforms rather than simply legislation and preventing reversal of reform efforts [Bertola, Boeri 2001]. Moreover, there were opinions

that the overall coordination process should not have merely a short-term dimension. And the existing coordination processes – as stated by the Lisbon European Council – should be better coordinated (see: section 2.1). The European Council at its meetings in Lisbon (March 2000) and in Goeteborg (June 2001), setting strategic objectives for the present decade, made a decisive shift to a more medium-term approach to policy making. Next, the European Council in Barcelona (March 2002) urged the Council and the Commission to streamline and synchronize the relevant policy coordination processes, stating that the focus must be on action for implementation, rather than on the annual elaboration of guidelines [European Council 2002a].

In response, the Commission published in September 2002 its communication on streamlining the annual economic and employment policy cycles [Commission 2002f]. In that document the Commission proposed **a better streamlined policy coordination cycle which could be achieved within the current Treaty framework** and contribute to, *inter alia*, enhancing the efficiency of policy coordination by securing a better follow-up of implementation, improving coherence and complementarity between the various processes and instruments, fostering a wider-shared commitment and ownership, increasing the transparency, intelligibility, visibility and impact of the policy coordination cycle. To that end, the Commission suggested to **streamline the existing processes around a few key points in the year**:

- preparation of the Spring European Council;
- the Spring European Council (a defining moment in the annual policy coordination cycle);
- Commission's proposals for new guidelines and recommendations;
- adoption of new guidelines and recommendations (by the June European Council);
- concentration of an implementation review in the last quarter of the year.

In this context, it should be noted that the Commission proposed that both **the BEPGs and the EGs would be presented at the same time as a "package"**. In its opinion, the proposed synchronization of the start of both processes (by the simultaneous Commission's presentation of their inputs and their subsequent discussion in relevant bodies) would be likely to contribute to the coherence of the guidelines package. Moreover, the Commission also proposed in its communication **to put more emphasis on the medium-term orientation of the economic and employment policy strategy**. It would help provide some policy guidelines and recommendations with stability as well as avoid giving the impression that the policy strategy is incomplete and needs permanent re-definition, etc. According to the Commission, the BEPGs and the EGs would keep their annual character, but in principle, they would be fully reviewed once every 3 years. In the intermediary years changes to the BEPGs and to the EGs should be avoided, if possible. And the timeframe of those 3-year periods should be preferably adjusted to the deadline of the Lisbon Strategy, i.e. 2010.[22] Similar solutions were also proposed in relation to the other coordination processes, e.g. the Cradiff process or the Internal Market Strategy (IMS).

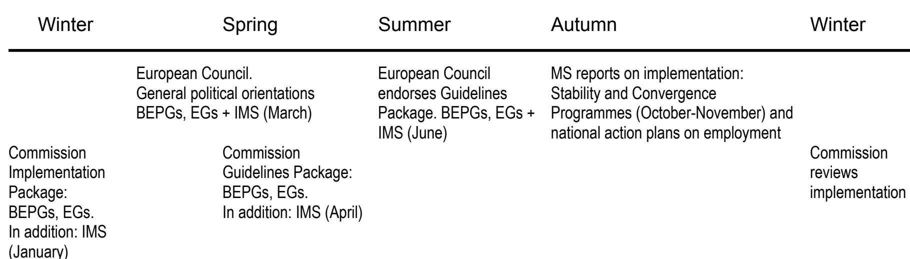
Taking into account the above assumptions, in April 2003 the Commission – for the first time – issued on the same day its recommendation on the BEPGs and its proposal on the EGs [Commission 2003b,c]. Both documents were scheduled for the **period of 2003-2005** and **for the first time they covered a period of three consecutive years in order to**

[22] Today this seems to be not necessary because – as mentioned before – the deadline of 2010 is no longer regarded as a priority for the renewed Lisbon Strategy (see: section 1.3).

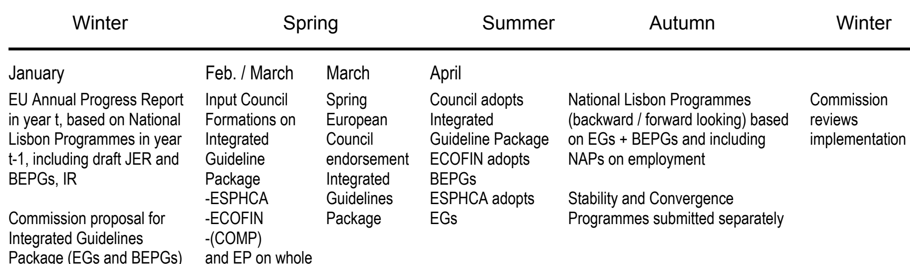
rationalize and synchronize the process of coordinating economic and employment policies (see: figure 2.1.a). In June and July 2003, after the discussion within the European Council in Thessaloniki [European Council 2003b], the Council adopted the relevant recommendation and decision on the BEPGs and the EGs respectively [Council 2003a,b].

Figure 2.1.
The "old" and "new" cycles of economic and employment coordination

a) previous coordination cycle (2003-2005)



b) new coordination cycle (2005-2008)



Source: Commission 2005f.

Last year the next important step forward was made, i.e. the new **Integrated Guidelines for 2005-2008** were adopted by the Council in mid-July 2005 [Council 2005d,e] (see also: section 1.1). They were prepared and adopted in accordance with the request from the Spring European Council [European Council 2005a] and having regard the Commission's recommendation/decision on the BEPGs and the EGs published together in mid-April 2005 [Commission 2005i] as well as the discussion by the European Council in mid-June 2005 [European Council 2005b]. The Integrated Guidelines, proposed by the Commission last year, brought together for the first time the BEPGs and the EGs in **one single and comprehensive document**. According to the Commission, consistency of this new (redesigned) guidelines has been reinforced by incorporating both texts into one and the same document, thus making it possible to present to the UE and its Member States a clear strategic vision of the challenges facing Europe in the macroeconomic, microeconomic and employment fields [Commission 2005i]. The Integrated Guidelines set out the appropriate responses to these challenges, i.e. relatively weak growth performance and insufficient job creation in the EU – reflecting thereby the new start of the Lisbon Strategy by refocusing on growth and employment in Europe.

The adoption of the Integrated Guidelines in mid-year is the beginning of a **new three-year coordination cycle** (see: figure 2.1.b). They are to serve as a basis for the preparation of

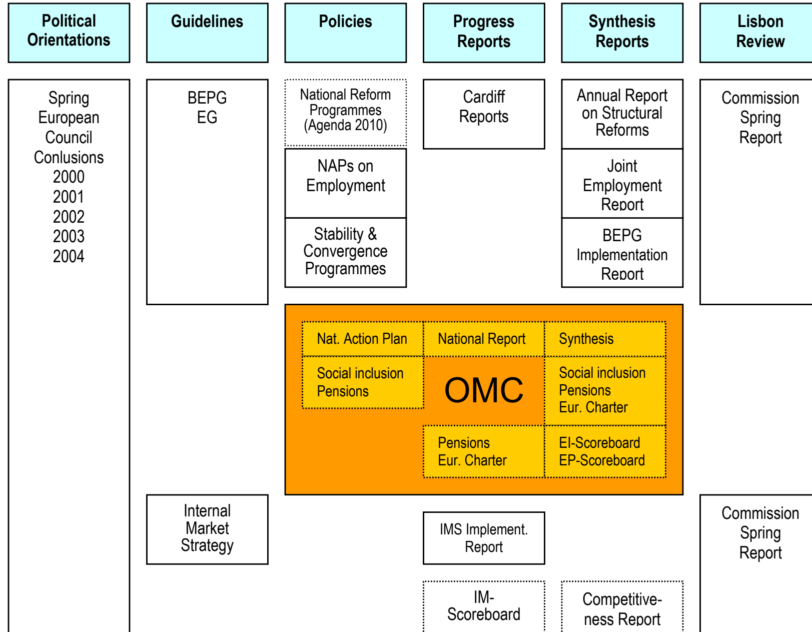
the national reform programmes which the Member States are asked to present in autumn every year over the coordination cycle. In order to simplyfy the coordination process it was necessary to **streamline reporting at the EU and national levels** – resulting in fewer and less complex reports. For that reason, since the very beginning of the relaunched Lisbon Strategy it has been expected that – similarly like the guidelines – all the existing national reports (relevant to the Lisbon Strategy) would be incorporated into a **single summary document** – the **National Reform Programme** (or the National Lisbon Programme). It was related to, *inter alia*, national reports on employment, national reports on structural reform (Cardiff reports), sectoral implementation reports (which are covered by the open method of coordination), strategic plans concerning the Structural and Cohesion Funds, etc. On the basis of the above streamlined National Lisbon/Reform Programmes, the Commission is to assess progress achieved by the Member States and summarize it in its EU Annual Progress/Strategic Report.[23] Such an integrated report is to be drawn up in January and submitted to the Spring European Council (the first one was prepared in January 2006). Therefore, **at the EU level – similarly like at the national level – there is only one report on progress towards the objectives of the Lisbon Strategy** (see: figure 2.2.b). According to the Commission, this is an important element of simplifying the coordination process. Moreover, a unified and integrated report at the level of the European Council would allow political ownership to be taken at the highest level [Commission 2005f].

As mentioned before, the first **Annual Progress Report** on the Lisbon Strategy was released by the European Commission in January 2006. It consisted of three main elements. First, the Report provided an analysis of the 25 new National Reform Programmes submitted by the Member States in October 2005. Second, it identified the strengths in different national programmes with a view to promoting the exchange of good ideas. Third, it highlighted areas where there were shortcomings and proposed concrete actions at the EU and national levels to deal with them [Commission 2006a]. The next Annual Progress Report will be published in 2007. And the EU Strategic Report of 2008 will mark the start of the next three-year coordination cycle (2008-2011).

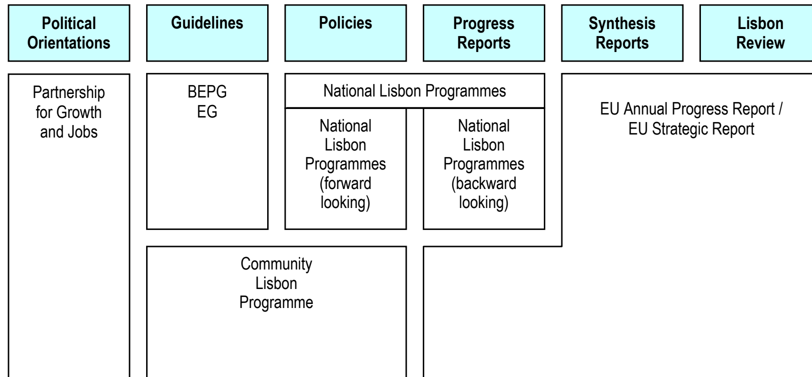
[23] In the first two years of the three-year economic and employment coordination cycle the Integrated Report will be called the EU Annual Progress Report (“light” review). In the third year it will be called the EU Strategic Report (“in-depth” review). In this report, the Commission would also make proposals for amending the BEPGs and/or the EGs, if necessary. As far as the present coordination cycle (2005-2008) is concerned, a “light” review has been planned to be undertaken in 2006 and 2007, and an “in-depth” review in 2008 [Commission 2005i,f].

Figure 2.2.
Simplification of the coordination process under the Lisbon Strategy

a) original Lisbon coordination process



b) simplified Lisbon coordination process



Source: Commission 2005f.

3

Strengthening coordination of budgetary policies and the implementation of the Stability and Growth Pact

As it is known, sound public finances are essential for the proper functioning of EMU. For that reason, the issue of utmost importance is coordination of budgetary policies. After almost eight years of practical experience related to the Stability and Growth Pact under EMU there are both **significant achievements and successes** (especially its contribution to overall macroeconomic stability in the EU and within the euro area), but also **some important weaknesses**. According to the critics, the original SGP reduced budgetary flexibility and hampered automatic stabilizers, worked asymmetrically and focused mechanistically on an arbitrary level of nominal deficits, did not sanction politically-motivated fiscal policies, disregarded the aggregate fiscal stance of the euro area, focused on short-term commitments and hence disregarded the long-term sustainability, discouraged structural reforms and public investments, created some tensions and conflicts between the Member States and the EU institutions, etc. [see e.g. Eichengreen, Wyplosz 1998a,b; Andersen, Dogonowski 1999; Owen, Cole 1999; Balassone, Franco 2001; Ballabriga, Martinez-Mongay 2002; Buti 2002; von Hagen 2002; Buti, Eijffinger, Franco 2003; De Grauwe 2006b].

At the same time, it should be noted that, according to some authors, a lot of the academic criticism related to the SGP was exaggerated. For example, it was argued even in the early years of EMU that the original Pact was considerably more flexible than its critics suggested, but it had not been sufficiently communicated to the public (and the lack of communication was attributed to the political purpose of the SGP in the late 1990s, when it was principally ‘sold’ as a solid and hard (and thereby perceived as rigid) guarantee for fiscal discipline in the euro area – in order to make EMU more acceptable to rather sceptical public opinion in some Member States, notably Germany. In general, the SGP was regarded as “not the best but better than nothing” [Heipertz 2003; Szeląg 2003a]. Nevertheless, taking into account the above criticism, numerous proposals on relevant changes of the SGP were raised and considered in the early years of EMU.

3.1. Proposals of strengthening the EU fiscal framework

First of all, there have been some proposals of **internal adjustments** which generally would be possible under the current EU legal framework (maybe with some small amendments). In this context the following proposals have been discussed [Buti, Eijffinger, Franco 2003; Eijffinger 2004]:

- **a country-by-country articulation of the medium-term budgetary objective** – to avoid excessive uniformity between countries with different levels of public debt, different public investment needs, different business cycle volatility, different automatic stabilizers, etc.;
- **improving transparency in current and perspective fiscal accounts** – to exclude or limit the role of creative accounting, one-off and temporary (cash-raising) measures[24] in meeting short-term budgetary targets (instead of real implementation of necessary structural reforms). It was argued several times that the EU's fiscal rules suffered from various weaknesses in reporting: in some cases the Stability and Convergence Programmes have been biased by projections which have proven to be too optimistic because of too favourable assessments of the Member States' structural fiscal positions and the use of one-off measures and creative accounting (see: table 3.1 and figure 3.1) [OECD 2005a; Commission 2006s];
- **tackling misbehaviour in "good times"** – with two possible solutions. First, to use the „early warning" procedure of the SGP not only in "bad times" when deficits approach the ceiling of 3% of GDP, but also in "good times" when a significant divergence from targets is detected.[25] Second, to establish the so-called **"rainy-day funds"**, i.e. reserve funds that could be replenished in recovery and used during economic slowdowns to buffer the effects of unexpected negative events and cyclical downturns, as it is in several US states and Canadian provinces;[26]
- **non-partisan implementation of the rules** – sanctions for non-compliance with the SGP should be imposed by the Council on the basis of a proposal (not a recommendation) from the Commission.

With reference to the last issue, it was indicated in the Sapir Report that the Commission had not been given the legal means to perform surveillance in an authoritative way because its warnings and recommendations had to be endorsed by the Council. Therefore, under the current EMU setting, the enforcement of fiscal rules risked being partisan: national authorities were supposed to apply the rules to themselves and hence have incentives for collusion and horse-trading. According to the authors of the report, in order to move to non-partisan enforcement, it was necessary to distinguish between **three types of decisions in the implementation of the SGP**:

- "technical" assessments on compliance with the rules;
- "political" decisions on how to prevent or correct an excessive deficit, and, in the latter case, at what speed;
- application of sanctions.

The Commission should be entrusted with the implementation of decisions which mainly implies detection of compliance with the rules. It should be entitled not only to issue "early warnings", but also to determine whether an excessive deficit exists in a given Member

[24] Some examples of one-off and temporary measures are e.g. the sales of non-financial assets; receipts of auctions of publicly owned licenses; short-term emergency costs emerging from natural disasters; tax amnesties; revenues resulting from the transfers of pension obligations [Council 2005f].

[25] There is not a common operational definition of "good" and "bad" times in the literature. However, in most analyses, "good (bad) times" correspond to periods of positive (negative) output gap. Alternatively, they could be identified in the following way: "good times" as periods in which the output gap is both positive and rising and, symmetrically, and "bad times" as periods with negative and falling output gaps [Commission 2006s].

[26] In the 1990s, many US states set aside so-called "rainy-day funds", i.e. reserve accounts funded during the recent economic expansion in order to be the first line of defense against the pressures that declining revenues and rising need for public services might place on state budgets during a recession [Zahradnik, Johnson 2002]. A concept of rainy-day funds was discussed in the literature mainly in relation to the United States [Kopits, Symanski 1998; Knight, Levinson 1999], but there are also some papers related to the EU in this regard [Buti, Eijffinger, Franco 2003; Sapir *et al*. 2003; Buti 2006]. In practice, however, the only EU Member State that has set up a fiscal rule with effects similar to those of rainy-day funds is Finland [Commission 2006s].

State. The Council should take final responsibility on the other two types of decisions whose political nature is evident [Sapir *et al*. 2003]. Such a solution would adequately address one of the indicated weaknesses of the current coordination process – related to an inappropriate distribution of responsibilities between the Commission and the Council in the enforcement of fiscal rules (see: section 1.4).

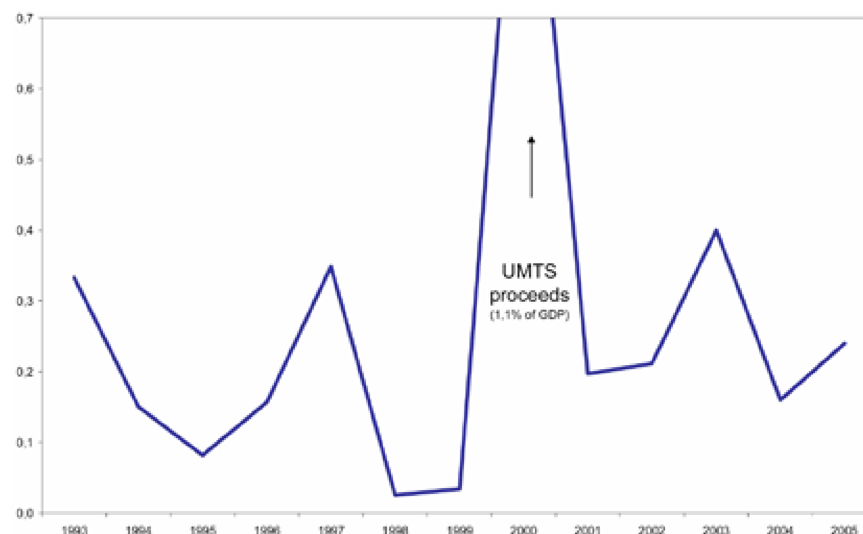
Table 3.1.
One-off "creative accounting" operations and reclassifications affecting the fiscal balance in the euro area (1993-2003; as % of GDP) *

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Belgium	0.4	0.2		0.9					0.3	0.2	1.9
Germany					0.2						
Greece	3.7	0.5	1.7	1.3	2.8	1.9	1.8	3.4	2.6	3.4	2.8
Spain	1.3		0.4	0.4	0.4						
France		0.2		0.3	0.5		0.1				
Ireland	0.4			0.5	0.4			0.4	0.4	0.7	
Italy	0.9	0.6	0.7	0.4	1.4				0.7	0.9	1.7
Luxembourg									1.8		
Netherlands	1.1	1.1	0.9	0.4	0.1						
Austria	0.1	0.5	0.5		0.1			0.3			
Portugal		0.7	1.0		0.5	0.2			0.6	1.7	2.3

* Abstracting from UMTS license receipts, operations amounting to less than 0.1% of GDP and one-offs that temporarily worsen rather than improve the recorded fiscal position.

Source: Koen, van den Noord 2005.

Figure 3.1.
One-off and temporary measures in the euro area (1993-2005; as % of GDP)



Source: Commission 2006s.

There have been also some proposals suggesting more **far-reaching solutions** which would require relevant amendments (sometimes really significant or even fundamental) in the existing Treaties:

- establishing at the national levels new highly independent bodies – the so-called **Fiscal Policy Committees** [Wyplosz 2002], similar to Monetary Policy Councils in the EU

central banks before the introduction of the euro. The role of the FPC would be setting short- and medium-term budgetary targets for a given Member State as well as endorsing the budgetary bill. It was also suggested to create independent national **Fiscal Auditing Boards** [Sapir *et al*. 2003] that would have no policy role, but they would be entrusted with the mission to provide: (i) an independent auditing of budgetary forecasts for the current year; (ii) an independent evaluation of the budgetary impact of policy decisions; and (iii) an independent assessment of the implications of different economic assumptions. Finally, it was recommended to establish an **Economic Policy Council** which would consist of the Ministers of Finance/Economy (or their direct representatives), who would make fiscal policy recommendations to the euro-area Member States [von Hagen 1999];

- **setting a target for the euro area as a whole** and then sharing it between the Member States. According to the so-called "system of tradable budget deficit permits", having set an aggregate target for the euro area and an initial distribution of "deficit permits", the euro-area countries could be allowed to 'trade' ('buy' and 'sell') their permits/shares with the other euro-area countries [Casella 2001; Buti, Eijffinger, Franco 2003];
- shifting from the excessive deficit procedure to the **Debt Sustainability Pact** [Pisani-Ferry 2002]. It would be allowed for those countries with the level of public debt below 50% of GDP to exempt from the standard EDP and sanctions. They would have greater flexibility in the short-term;
- defining an **index of institutional reforms** with one point each for reform of budgetary arrangements, reform of public pension schemes, and reform of labour markets and unemployment insurance. Countries receiving a maximum score for successful reforms (three points) would be exempt from the SGP's numerical guidelines, as it is suggested that they would not be prone to chronic deficits. Other countries would still be subject to the relevant warnings, sanctions and fines [Eichengreen 2004].

As we can see, the above proposals are really interesting and intellectually challenging, but also – at least some of them – seem to be more or less controversial. Moreover, there could be a problem with their feasibility because sometimes they require serious amendments in the Treaty and in the SGP, some limitations of national governments' power in the area of budgetary policy, etc. For those reasons, they have not enough political or social support to be implemented. And finally, none of the above proposals provides with the complex approach to the budgetary policy in the euro area.

It does not mean that there are no proposals indicatig the complex approach in this respect. In fact, there are some such proposals suggesting e.g. **shifting some budgetary power (related to spending and taxation) from the national to supranational (European) level**. These proposals are aimed at overcoming some current and potential tensions and conflicts between the Member States and the EU institutions because of an inappropriate division of their competences and responsibilities. This is due to the fact that national budgetary spending and taxation remain in the exclusive competences of national governments and parliaments (this confirms both democratic legitimacy and political responsibility of their budgetary decisions before their electorate). On the contrary, there is neither such democratic legitimacy nor political responsibility in the case of the EU institutions coordinatig fiscal policies in the euro area. For example, the Commission is empowered to launch the

excessive deficit procedure which is likely to influence national budgets of the Member States (by forcing their governments to cut spending and/or increase taxes), but it takes no political responsibility for results caused by its decisions. The only institutions which could be judged by voters are national governments, but it should be noted that they might punished for the decisions being not their own. Such a situation is naturally perceived as a potential source of conflicts between the governments of the Member States and the EU institutions – which were experienced in the past (in November 2003) and are likely to occur again in the future. It is assessed that *"this problem will continue to exist as long as the nation-states maintain their sovereignty over spending and taxation, and as long as those who decide about spending and taxation are made accountable for decisions before a national electorate"* [De Grauwe 2006b]. One of the potential solutions in this regard would be **a "central European government" with power in relation to spending and taxation – being independent of national governments, but politically accountable for its budgetary decisions**. Although this proposal provides with the complex approach to the budgetary policy in the euro area, it is as controversial as the above-mentioned far-reaching solutions and, therefore, very problematic in terms of its feasibility in the foreseeable future (it could only be considered in the longer-term).

Not only external observers, but also the EU institutions (especially the European Commission), have acknowledged the need to improve the present framework for budgetary coordination. It was confirmed in November 2002 in the Commission's communication on strengthening coordination of budgetary policies in the euro area [Commission 2002g]. Its proposals aimed at increasing a positive contribution of sound and sustainable public finances to growth and employment in line with the Lisbon Strategy. First of all, the Commission presented in the communication some proposals **to improve the interpretation of the SGP**:

- establishing budgetary objectives that take into account the economic cycle;
- transitional arrangements for countries with excessive deficits (an annual improvement in the underlying budget position of at least 0.5% of GDP each year);
- avoiding pro-cyclical budgetary policies in "good times" (i.e. running nominal surpluses when economic conditions are favourable);
- sustainability of public finances should become a core policy objective (greater weight attached to government debt ratios in the budgetary surveillance process).

Moreover, in order **to strengthen the implementation of the SGP**, the Commission proposed the following four-point programme:

- the solemn political commitment of the Commission, the Council and the Member States to implement the SGP (expressed in a special resolution);
- upgrading the analysis of economic and budgetary polices [Commission 2002h];
- more effective enforcement procedures – e.g. empowering the Commission to issue "early warnings" directly to the Member States without recourse to the Council's approval;
- better communication through openness and transparency, i.e. reliable and timely information on the budgetary commitments of the Member States and on how the SGP is being implemented.

Last but not least, it should be noted that one of the most heavily criticized features of the EU's fiscal framework was the fact that **the budgetary targets** (in particular, the reference values for deficits and debt) were set **in nominal terms** and thereby did not take into account the impact of economic conditions on budget balances. But it should be noted that since the launch of EMU considerable progress has been made in order to formally include the impact of the economic cycle into the assessment of the Member States' budgetary positions, as well as develop more comparable indicators across the Member States on **cyclically-adjusted budget deficits** (CAB or CABB – cyclically-adjusted (budget) balance; CABB – cyclically-adjusted budget balance) [Commission 2004j; Flores, Giudice, Turrini 2005]. It was in line with some international standards in this regard. As it is argued by not only European but also American economists and officials (including the President of the United States), given the fact that the size of the budget deficit depends not only on policy decisions, but also on the overall state of the economy, economists tend and prefer to use the terms "structural deficit" or "cyclically-corrected deficit" to assess the stance and direction of fiscal policy. And they define the structural deficit as *"the deficit that would result if the economy were operating at or near its potential output level"* [Clinton 1995]. In other words, the structural deficit is a hypotetical/potential measure indicating what the size of the deficit would be if actual/real output (measured by GDP) were equal to potential output (assuming full employment). According to some Asian economists, the structural deficit is *"a measure of what the government deficit would be under existing tax and spending rules, if GDP were at its "natural" (or mid-cycle) level"*, i.e. neither in an upswing nor in a downturn [Lau 2001]. The above American and Asian definitions of the the structural deficit (sometimes labelled the full-employment deficit, mid-cycle deficit, etc.) seem to be universal and thereby apply to the European economy as well. In general, the reason for computing the structural (cyclically-adjusted) budget deficit is willingness to capture the pure effects of policy making, and – at the same time – filter out and exclude the impact of cyclical economic fluctuations (effects of the business cycle) on the budgetary situation of a given country and the size of its deficit.

In the EU, one of the most important changes towards calculating structural (cyclically-adjusted) deficits was made in 2001, when the revised *Code of conduct* was adopted [Council 2001]. It clarified the role to be played by cyclically-adjusted budget balances during assessing whether the Member States achieved (or not) their budgetary objectives set down in the Stability and Convergence Programmes. As a result of those changes, the situation today is mixed: **while the reference values / budgetary targets are established in nominal terms, the achievement of the "close to balance or in surplus" objective of the SGP is being assessed in relation to the economic cycle (i.e. by identifying the cyclically-adjusted positions).** Similarly, the *Code of conduct* – after its recent revision in autumn 2005 – confirmed that the medium-term budgetary objective should be defined in cyclically-adjusted terms, net one-off and other temporary measures (i.e. measures having some transitory budgetary effects that do not lead to a sustained change in the intertemporal budgetary position) [Council 2005f].[27] The above clarifications are perceived as being helpful

[27] There is a broad consensus in academic and policy-making circles as regards the importance of taking into account the underlying budgetary positions during the decision-making process, but at the same time there is no such a consensus related to the practical calculation methods which should be used in this regard, i.e. in order to calculate the cyclically-adjusted balance (CAB). The European Commission argues that in an ideal world (with sufficient information on all budgetary developments and policy measures) it would be possible to use some direct calculation methods, i.e. adjust each budget item directly to reflect their "true" structural position. But, as it is known very well, in the real world information of such high quality is usually not available and, accordingly, some indirect calculation methods must be used, i.e. the cyclical and structural budgetary components are inferred from the covariation of government revenues and expenditures with output fluctuations. Assuming that the actual budget balance (B) is the sum of the structural (B_s) and cyclical (B_c) budgetary components, the cyclical component is calculated by subtracting the estimated structural component of government revenues and expenditures from their actual levels ($B_c = B - B_s$); and the structural component is calculated from actual

in improving the assessment of the Member States' budgetary positions under the SGP, and ensuring that it goes well beyond the simple verification of compliance with the agreed nominal targets [Commission 2004j; Flores, Giudice, Turrini 2005].

As we can see, there were many proposals to amend more or less the original framework of budgetary coordination within the euro area, particularly the SGP. But what the press and some officials called the reform of the SGP, the Commission tended to see it as an evolution rather than a reform [Almunia 2004]. According to the Commission, there was no need to change the whole EU fiscal coordination framework because only its certain parts need to be changed over time – in line with changing economic circumstances (e.g. the enlargement of the EU, consisting presently of 25 countries and characterized by considerable economic heterogeneity and diversity). Therefore, when discussing the modification of the SGP, it was advisable to enhance the original framework while safeguarding its successful elements [Deroose, Langedijk 2005].

It seems it was the right approach. In the short-term the SGP should be generally maintained in its original form, of course, with some necessary internal adjustments, but without any radical changes. First of all, it is easy to criticize, but not so easy to propose feasible and acceptable solutions – so the question arises: is there presently a real alternative for the SGP (which would be able to replace it at all)? Next, it is necessary to remember the SGP is the result of a political compromise and it would be really difficult (if possible at all) to reach a new compromise on budgetary coordination within the EU (or the euro area) in the foreseeable future. Finally, any radical changes of the SGP – after only some years of EMU – would get the impression that the EU's fiscal rules are volatile. For that reason, at the present moment such proposals seem to be extremely problematic from a political point of view. However, they could be reconsidered in the longer term [Szeląg 2004b; 2005; 2006b].

3.2. Reform of the Stability and Growth Pact

A turning point of coordination of budgetary policies within the EU (or rather within the euro area) was the decision of the ECOFIN Council made on 25 November 2003 [Council 2003c]. Before that Council's meeting, the Commission recommended the Council to adopt decisions that neither France nor Germany had taken adequate measures to reduce their deficits in response to the earlier Council's recommendations, and – consequently – use relevant sanctions against those Member States at that stage of the excessive deficit procedure, i.e. to give them notice in order to take measures to reduce their deficits. But **the Council – contrary to the Commission's recommendations – decided to hold in abeyance the implementation of the provisions of the EDP and not to use any sanctions against France and Germany despite the fact that both countries had clearly breached the reference value of 3% of GDP**. If the Council had decided to use at that time even some "light sanctions" (such as notices), it could have been forced to use "harder sanctions" (eventually pecuniary ones) at a later stage. But – as it is argued by some authors – *"the*

government revenues and expenditures, adjusted proportionally according to the ratio of potential to actual output and the assumed built-in elasticities [van den Noord 2000]. In other words, the structural budget balance or the cyclically-adjusted balance (CAB) is computed as the actual budget balance adjusted by the cyclical budgetary component (CAB = B – B_c), where the latter is estimated as the GDP output gap (G), i.e. the percentage difference between actual and potential output, times budget sensitivity to the output gap (α). Hence, CAB = B – α*G. It should be noted that the European Commission uses the values of budget sensitivities which are based on budget elasticities estimated by the OECD, i.e. percentage changes in budget items associated with percentage changes in GDP [Commission 2004j; Flores, Giudice, Turrini 2005].

experience of the early years of EMU showed that the Council was not prepared to use the "nuclear option" of pecuniary sanctions, especially vis-à-vis large countries" [Buti 2006].

In the Commission's opinion, included formally into the ECOFIN Council's conclusions of 25 November 2003, the above rejection by the Council's of the Commission's recommendations was made without giving the adequate explanation. The Commission **deeply regreted that the Council had not followed the spirit and the rules of the Treaty and the SGP** because only a rule-based system could guarantee that commitments were enforced and that all the Member States were treated equally. Similarly, the ECB Governing Council deeply regreted the Council's decision and shared the above views of the Commission. In the ECB's opinion, published on the same day, the conclusions adopted by the ECOFIN Council carried serious dangers because the failure to go along with the rules and procedures foreseen in the SGP risked **undermining the credibility of the institutional framework and the confidence in sound public finances of the Member States across the euro area** [ECB 2003a].

The European Commission, acting as "the guardian of the Treaty", decided to challenge the matter before the court to clarify the institutional set-up and the procedure. On 27 January 2004 the Commission brought an action before the Court of Justice challenging, *inter alia*, the conclusions adopted by the Council on 25 November 2003. In its judgement, published on 13 July 2004, **the Court of Justice** stated that the Council could not depart from the rules laid down by the Treaty or those which it set for itself in the SGP (Regulation 1467/97) and accordingly **annulled the Council's conclusions of 25 November 2003** [Court of Justice 2004] (see: box 1.2).

A little bit earlier, at the end of June 2004, the Brussels European Council adopted the Declaration on the Stability and Growth Pact [European Council 2004c]. Then the European Commission presented two communications on strengthening economic governance and clarifying the implementation of the SGP – in June and September 2004 [Commission 2004e,k]. Both Commission's communications, but especially the latter, contained some proposals on **the future set-up and functioning of the EU fiscal framework – adjusted to the enlarged EU** consisting of the 25 Member States. As stated by the Commission, the aim of its proposals was not to increase the rigidity or flexibility of the current rules, but rather to make them more effective. In this context, the Commission considered several elements for strengthening the SGP:

- **placing more focus on public debt and sustainability in the surveillance of budgetary positions** because it is as important as general government deficit performance for overall soundness of public finances. The SGP could clarify the basis on which the Treaty provision of a "satisfactory pace of debt reduction" should be assessed – by defining such a "satisfactory pace" which would ensure reaching by the Member States prudent debt ratios within a reasonable period of time. The annual assessment of debt developments could be made against this reference rate of reduction, but taking also into account country-specific growth conditions (i.e. in "bad times" when growth is below its potential a slower pace of debt reduction would be required, while in "good times" when growth is above its potential a faster pace of debt reduction would be applied). Moreover, in defining a required rate of debt reduction it would be necessary to take into account the need to ensure prudent debt ratios before the impact of ageing populations takes place fully;

- **more country-specific circumstances in defining the medium-term budgetary objectives** (MTOs) – the uniform approach to all countries (“one-size-fits-all”) should no longer be applied taking into account significant economic diversification and heterogeneity of the 25 Member States. Moreover, the MTOs should be differentiated among the Member States depending on their current debt levels and projected developments in the medium and long term (i.e. the higher the debt level, the MTO would have to be more stringent – „close to balance or in surplus”). In addition, some “other relevant factors” should be taken into account during the assessment of the deviation from the MTO or the path to achieve it (e.g. such factors as potential economic growth, inflation, the existing implicit liabilities related to the ageing of populations, the impact of structural reforms, the need for additional net investment, etc.);
- **considering economic circumstances and developments in the implementation of the excessive deficit procedure** (EDP). First, it would be necessary to regard prolonged periods of sluggish growth (i.e. slow but still positive) as the “exceptional circumstances clause” (presently the SGP limits this clause only to cases of negative growth or its substantial drop, i.e. an annual fall of real GDP of at least 2%). Second, it would be justifiable to allow for applying some country-specific elements in the enforcement of the correction of excessive deficits (the adjustment path). In determining a relevant adjustment path, the SGP should better take into account some economic conditions and the fundamentals of the Member States breaching the 3% budgetary ceiling, and thereby the pace of adjustment could differ across countries. In any case, it would be essential to set a maximum time limit for the Member States to correct their excessive deficits and there should be no waivers for bad policies. Moreover, the existing deadlines for exercising surveillance should be reconsidered in order to make them more coherent with the national budgetary processes;
- **ensuring earlier actions to correct inadequate budgetary developments** – thanks to the capacity of the Commission to issue “early warnings” directly to the Member States[28] – not only in “bad times” (when deficits approach the 3% reference value), but also in “good times” (when deficits are not necessarily close to the 3% ceiling, but some significant divergences from structural targets are detected). Moreover, the SGP should reaffirm the commitment of the Member States to conduct symmetric fiscal policies over the economic cycle in order to prepare for the ageing of populations, create sufficient room for dealing with economic downturns and ensure an adequate policy mix over the cycle.

In addition to the above proposals, the Commission suggested reinforcing some existing links between the BEPGs, the SGP and the national budgetary processes, as well as strengthening the role of the Stability and Convergence Programmes. Last but not least, it confirmed that the two nominal anchors, i.e. the reference values of 3% and 60% of GDP (for general government deficits and public debt respectively), would remain unchanged, being a basis for multilateral surveillance.

Following the above Commission’s communication of September 2004, the Council started to work in order to make concrete proposals for a **reform of the Stability and Growth Pact**. The ECOFIN Council prepared and submitted to the Spring European Council in Brussels its

[28] In this context, the Commission recalled that there were similar provisions in the new Constitutional Treaty, i.e. direct issuing “early warnings” by the Commission as well as the Council’s decisions launching the EDP based on the Commission’s proposals rather than recommendations. In the Commission’s opinion, those provisions would strengthen the system of economic governance and clarify the complementary roles of the Commission and the Council [Commission 2004k]. As it is known, the Constitutional Treaty could only enter into force after its ratification by all the Member States, but in May/June 2005 the new Treaty was rejected in the referendums in France and in the Netherlands, and the whole ratification process was suspended (see: section 4.2).

report of 20 March 2005 *"Improving the implementation of the Stability and Growth Pact"* [Council 2005a]. In this report, endorsed by the European Council [European Council 2005a], there were numerous proposals how to strengthen the effectiveness of the Pact – both in its preventive and corrective arms.

With reference to the **preventive arm of the Pact**, the Council has made some proposals related to:[29]

- **definition of the medium-term budgetary objective** (MTO), i.e. budgetary positions of "close to balance or in surplus" – it should be differentiated for the individual Member States taking into account the increased economic and budgetary heterogeneity within the EU consisting of the 25 Member States, e.g. their different situations concerning potential growth, debt ratios, risks to the sustainability of public finances connected with prospective demographic changes, etc. (with reference to the latter, the Member States should also take into account implicit liabilities related to increasing expenditures connected with the ageing of populations). Although the MTOs should be differentiated for the individual Member States, they have to ensure sufficient margins in order to safeguard the reference value of -3% of GDP. Therefore, according to the Council, the range for the country-specific MTOs for the Member States belonging to the euro area or participating in the ERM 2 should be – in cyclically-adjusted terms, net of one-off and temporary measures – between a deficit of 1% of GDP (in the case of low debt / high potential growth countries) and a balance/surplus (in the case of high debt / low potential growth countries);

- **adjustment path to the medium-term objective** – in order to reach gradually the medium-term budgetary objective, achieve a more symmetrical approach to fiscal policy over the cycle, and avoid pro-cyclical policies, the Member States should commit themselves to consolidate public finances in "good times" (e.g. by the use of unexpected extra revenues for deficit and debt reduction). Thanks to such an enhanced budgetary discipline during economic recovery they would be able to create a necessary room to accommodate a deterioration of their budgetary situation during economic downturns. In order to reach their MTOs, the Member States belonging to the euro area or participating in the ERM 2 should pursue an annual adjustment of 0.5% of GDP as a benchmark (in cyclically-adjusted terms, net of one-offs and other temporary measures);[30]
- **taking into account structural reforms** – in order to enhance a growth-oriented dimension of the Pact, structural reforms should be taken into account when defining the adjustment path to the MTO (but it is restricted only to major reforms with direct long-term cost-saving effects; other reforms will not be taken into account). A detailed cost-benefit analysis of such major reforms (from a budgetary point of view) should be provided in the updated Stability or Convergence Programmes of the Member States. Therefore, in the case of structural reforms entailing significant frontloaded costs, deviations from the MTO are allowed, but only under strictly defined conditions [Buti 2006].

[29] For a more detailed overview, see: Commission 2006s (Part II.2. *Making the revised Stability and Growth Pact operational – the preventive arm*).
[30] It should be noted that in March 2005 both the Council and the European Council proposed that the Member States that did not follow the required adjustment paths to their MTOs would explain the reasons for the deviation in their annual updates of the Stability and Convergence Programmes. The Commission would issue "policy advices" to encourage the Member States to stick to their adjustment paths. Such policy advices would be replaced by "early warnings" in accordance with the Constitutional Treaty as soon as it becomes applicable [Council 2005a; European Council 2005a]. But, as mentioned before, in May/June 2005 the new Treaty was rejected in France and in the Netherlands (see: section 4.2).

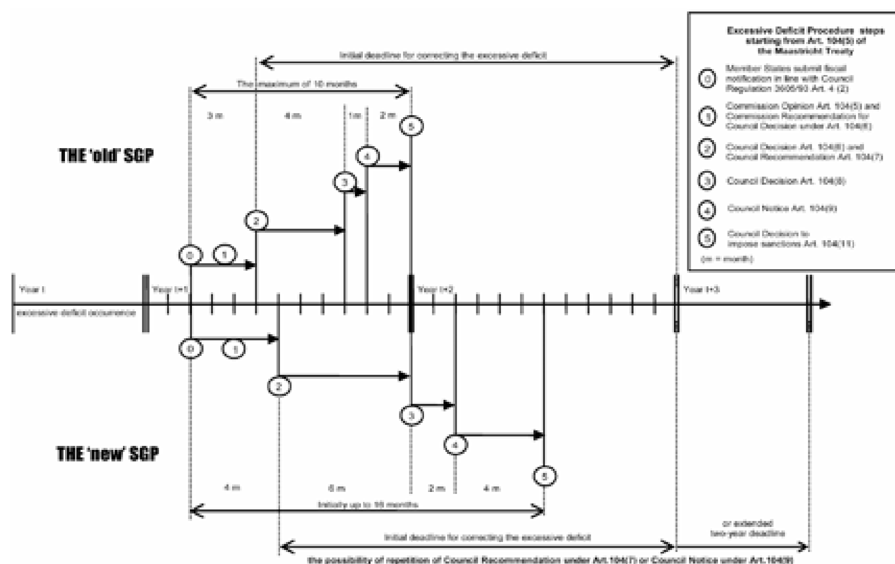
And with reference to the **corrective arm of the Pact**, the Council has made some proposals related to:[31]

- **the reference values** – the reference values of 3% and 60% of GDP have been strongly reaffirmed as the nominal anchors of monitoring and assessing developments of general government deficits and public debt in the Member States;
- **an excess of the deficit over the reference value** – taking into account that the previous definition of a "severe economic downturn" (in principle, an annual fall of real GDP of at least 2%) had been often criticized as too restrictive, it was decided to re-define it by considering as "exceptional and temporary" an excess over the reference value, resulting from a negative growth rate (even lower than 2% of GDP annually) or from the accumulated loss of output during a protracted period of positive - but very low - growth relative to its potential. Moreover, it was necessary to clarify the framework to take into account "all other relevant factors"[32] that might cause the excess over the reference value. In this context, the Commission underlines that – according to the revised SGP – "other relevant factors" can be taken into account when deciding on the existence of an excessive deficit only if the excess of the deficit over 3% of GDP is temporary and the deficit remains close to the reference value [Commission 2006s];
- **taking into account systemic pension reforms** – the Commission and the Council, in all budgetary assessments in the framework of the excessive deficit procedure, will give due consideration to the implementation of such reforms, e.g. when assessing whether the excessive deficit has been corrected, they will assess and consider both deficit figures as well as the net cost of those reforms;
- **extending deadlines of the excessive deficit procedure** – it was decided that several deadlines stipulated in the EDP should be extended – e.g. the deadline for adoption of a decision concerning the existence of an excessive deficit (from 3 to 4 months) or the deadline for taking effective actions by a given Member State following the Council's recommendation to correct the excessive deficit (from 4 to 6 months). Moreover, the initial deadline for correcting an excessive deficit could be set one year later, i.e. the second year after its identification and thus normally the third year after its occurrence (see: figure 3.1). And the deadlines for correcting the excessive deficit could be revised and extended if unexpected adverse economic events with major unfavourable budgetary effects occur during the EDP.

[31] For a more detailed overview, see: Commission 2006s (Part II.3. *Making the revised Stability and Growth Pact operational – the corrective arm*).

[32] The list of such "relevant factors" is really long and includes such factors as, *inter alia*, potential growth, cyclical conditions, the implementation of Lisbon reforms and policies fostering R&D and innovation, fiscal consolidation efforts in "good times", debt sustainability, public investment and the overall quality of public finances, budgetary efforts towards increasing or maintaining at a high level financial contributions to fostering international solidarity and to achieving European policy goals, notably the unification of Europe, etc.

Figure 3.2.
The “old” and “new” deadlines of the excessive deficit procedure



Source: Commission 2005r.

At the time of the ECOFIN Council’s submission of the above report to the European Council, on 21 March 2005, the ECB Governing Council expressed its opinion about the proposed changes to the SGP. As regards the preventive arm of the Pact, the ECB regarded the proposals as being generally in line with the planned strengthening the SGP. But at the same time, the ECB expressed its serious concern about the proposed amendments to the corrective arm of the Pact, because it must be avoided the situation that changes in the corrective arm could undermine confidence in the fiscal framework of the EU and the sustainability of public finances in the euro-area Member States [ECB 2005a]. Although it was not stated explicitly, it seems that the ECB was mainly concerned by the provisions related to the extension of the EDP deadlines as well as the possible interpretation of “other relevant factors” because they could potentially reduce transparency of the SGP and undermine its rules-based character, and thereby constituting the ground for some collusive and partisan actions within the Council (as it took place in November 2003).

Despite the above opinion of the ECB, the European Council – during its meeting of 22-23 March 2005 – endorsed the ECOFIN Council’s report concerning proposals for a reform of the SGP. In the Presidency Conclusions, the European Council invited the Commission to bring forward rapidly **proposals for amending the Regulations 1466/97 and 1467/97** in accordance with the ECOFIN Council report. The Commission’s proposals of amendments, released at the end of April 2005 [Commission 2005k,l], expressed the Council’s preference for keeping changes to those regulations to a minimum. For that reason, only some amendments mainly of a technical nature were introduced to the Regulation 1466/97 (e.g. the extension of the deadlines for examination of the Stability and Convergence Programmes by the Council). In the case of the Regulation 1467/97, it was proposed to introduce only four changes explicitly requested by the Council report, in particular those concerning the definition of a “severe economic downturn”, the definition and role of “other relevant factors”, the extension of the deadlines for taking action in the context of the EDP, and to allow the repetition of some steps in the procedure (recommendations, notices). The amendments to

(in the form of the Regulations 1055/2005 and 1056/2005 respectively) and entered into force a month later, i.e. on 27 July 2005 [Council 2005b,c]. And the new *Code of conduct*, whcih replaced the previous one of 2001, was endorsed by the ECOFIN Council of 11 October 2005 [Council 2005f].

Of course, the 2005 reform of the SGP was not limited to the above-mentioned amendments only. The scope of the agreement was much broader and included also some fundamental issues, such as taking into account **systemic pension reforms** (introducing a multi-pillar system including a mandatory fully-funded pillar). According to the agreement, the Commission and the Council should consider – within the EDP – the net cost of pension reforms. Consideration to the net cost of the reform should be given for the initial 5 years after a Member State has introduced a mandatory fully-funded system, or 5 years after 2004 for those Member States that have already introduced such a system (e.g. Poland introduced its pension reform in 1999). It is to be regressive, i.e. during a period of five years, consideration will be given to 100%, 80%, 60%, 40% and 20% of the net cost of the reform to the publicly managed pillar [Council 2005a]. Although the above agreement on pension reforms means the significant change in relation to the previous framework, it was decided not to include it into the amended regulations of the SGP; instead, the Commission was to revise the Code of Conduct setting out how the above rules should be implemented. In this context, the Commission explained, *inter alia*, that the above provisions imply that, when considering whether a deficit above 3% of GDP is excessive, the net cost of systemic pension reforms should be considered only if the government deficit is close to the reference value. In other cases, i.e. when a deficit is above but not close to 3% of GDP, these provisions do not apply – even if the excess of the deficit over the Treaty reference value was due to the pension reform costs [Commission 2006s].

In general, it was agreed that the SGP should take into account **structural reforms**. As it is known, structural reforms are of utmost importance for the EU economy and the EU's economic policy. But it is not easy to underatke and conduct such reforms in general (because of strong social resistance and political costs), and in particular for the Member States obliged to meet the SGP objective, i.e. to keep budgets „close to balance or in surplus". Before the reforem of the SGP, it was often criticized for not taking properly into consideration a trade-off between the short- and long-term budgetary effects of structural reforms [e.g. Eichengreen, Wyplosz 1998a]. As it is argued, **the implementation of structural reforms may lead to a short-term deterioration of the budgetary position** of a given country and, therefore, it may not be in line with the SGP rules (being even subject to some sanctions stemming from the EDP). But on the other hand, **structural reforms contribute clearly to the improvement and sustainability of public finances in the long term**. It is particularly important in relation to the ageing of populations and some future budgetary burdens connected with this phenomenon (the so-called "hidden costs for national budgets"), which must be addressed in Europe as soon as possible.

Taking into account the above logic, it seems to be clear that before the reform of the SGP the Member States had to make a choice between implementing structural reforms and preventing their budgetary positions from a serious deterioration (and, in turn, receiving an "excessive deficit" status). In other words, the Member States had no incentives to underatke such reforms. But in this context, everyone can agree that a country that has implemented

necessary structural reforms (resulting in a temporary higher budget deficit) could not be "punished" for such a decision by the rigid rules of the Pact. And the recent reform of the SGP not only eliminates this "punishment", but also creates some incentives for the Member States to implement the necessary reforms. It seems that for the first time the Pact has not only "sticks", but also "carrots". But it seems that more "carrots" would be needed to encourage the Member States to conduct more structural reforms that are necessary for they economies and indirectly for the EU economy as a whole. Therefore, the decision concerning costs of structural reforms was a step in the right direction, but further steps in this direction would be needed too (and they should be taken urgently).

The overall assessment of the 2005 reform of the SGP was mixed. On the one hand, there were some **positive opinions**. For example, the Commission stressed that the SGP reform had reached the right balance between economic rationale and simplicity, as well as between maintaining the rigorous application of the rules-based system and allowing more room for assessment and judgement. And that some initial experiences with the revised Pact has been encouraging and suggested a renewed sense of national ownership of the EU fiscal framework [Almunia 2006]. Moreover, both the Commission and the European Council – keeping in mind that sound macroeconomic conditions are essential to underpin the efforts in favour of growth and employment – stated that the recent amendments to the SGP should further stabilize the EU economy and enable the Member States to play a full role in creating conditions for long-term growth [Commission 2005d; European Council 2005a]. According to the last year's economic survey of the euro area elaborated by the OECD, the amended EU's fiscal rules have been praised for, *inter alia*, their increased flexibility in the implementation and medium- or even long-term orientation. In particular, it was emphasized that both the interpretation of the "exceptional circumstances" and "relevant factors" clauses, as well as the adjustment path towards compliance with the rules, would bring more flexibility. Moreover, focusing not only on budget deficits, but giving also greater weight to public debt, long-term sustainability and structural reforms was welcome because it meant that the interpretation and implementation of the SGP was increasingly concentrating on the longer term [OECD 2005a].

On the other hand, however, the reform of the SGP got also a **sceptical reception**. Some authors – even those traditionally critical of the old Pact – have not presented entirely positive but rather mixed opinions about the new (reformed) SGP. On the one hand, they appreciated a better balance between fiscal discipline and flexibility, but on the other, they regarded the reformed Pact as excessively vulnerable and prone to various opportunistic interpretations as well as having failed to tackle the real reasons (root causes) of fiscal imbalances within the euro area [Coeuré, Pisani-Ferry 2005]. It is also still criticized that there is a "hard" 3% ceiling for the deficit-to-GDP ratio, but there are no legal instruments to enforce the "close to balance or in surplus" rule which is essential to provide the necessary room for manoeuvre during economic downturns [OECD 2005a]. Many observers criticized the revised SGP as a "watering down" of the rules [González-Páramo 2006], and some authors even argued that – taking into account a lot of exceptions related to the application of the 3% budgetary ceiling as well as the greater discretion left to the Council within the EDP – the Pact became, *de facto,* dead [Buiter 2005; Calmfors 2005].

The above opinions about the last year's reform of the SGP were formulated, in general, more or less directly after that reform, when there was no practical experience with the newly

agreed EU fiscal rules. For that reason, it worth to mention the Commission's opinion of mid-June 2006, i.e. after the first year of the revised Pact. According to the Commission, **the first-year experience with the revised SGP is rather positive – notably in relation to the corrective arm of the Pact**. In this context, the Commission indicated the following issues: improving economic rationale of decisions and recommendations in the EDP, remaining the SGP as a rules-based system, setting more realistic deadlines for correcting the excessive deficits, recommending some significant structural efforts, devoting more attention to debt levels and developments, establishing a better economic dialogue between the Commission, the Council and the Member States, etc. At the same time, the Commission articulated **some concerns related to the implementation of the preventive arm of the Pact**. In its opinion, country-specific MTOs reflect economic fundamentals and national strategies, but planned fiscal efforts to achieve the objectives are not always sufficiently ambitious (for example, they fall short of the 0.5% benchmark in 2006). Moreover, despite clear improvements, some questions remain on the credibility of the medium-term budgetary adjustments planned by some Member States. Taking into account this mixed assessment, the Commission identified some **challenges ahead** concerning the new EU fiscal framework, i.e.: (i) ensuring that the spirit of the reform is followed during "good times"; (ii) increasing focus on the sustainability of government finances; (iii) improving statistical governance; (iv) ensuring better synergies between fiscal policy and growth; (v) supporting fiscal rules and institutions at the national level. Summing up – in the Commission's opinion – *"the 2005 reform strengthened the SGP and reaffirmed its core role in the budgetary coordination process as an instrument which contributes to achieving a high degree of macroeconomic stability, an essential condition for sustained economic and employment growth, as recognized by the Integrated Guidelines"* [Commission 2006r].

Some authors have assessed the reformed SGP against the set of specific **criteria for an optimal framework of fiscal rules**. Such a set of eight criteria was published just after the adoption of the SGP and before the launch of EMU [Kopits, Symanski 1998]. According to the authors, fiscal rules should be well-defined, transparent, simple, flexible, adequate to final goal, enforceable (credible), consistent, and supportive of structural reforms. Some years after the introduction of the euro, other economists assessed the SGP against the above set of criteria [Buti, Eijffinger, Franco 2003]. They concluded that the EU fiscal rules appeared to fare relatively well against those criteria; their strongest point was simplicity while their weakest aspects concerned enforceability as well as supporting structural reforms (see: table 3.2). It is also possible to assess the impact of the 2005 reform of the SGP on the fulfilment of the above criteria. In general, the analysis suggests that **the reform has resulted in a broadly balanced set of the new fiscal rules in the EU**. The score has deteriorated in relation to those criteria on which the SGP scored high in the previous assessment concerning the original Pact. The new provisions are less well-defined, less transparent and more complex. In the case of the other criteria, where the previous ratings were generally less positive, the assessment has improved (see: table 3.2). In this context, it should be underlined – and repeated after the Commission – that the interpretation of results of the above comparative assessment of the new EU fiscal rules against the criteria for optimal rules must be taken with care. Although such an assessment could be regarded as a useful indication of the quality and direction of various changes and reforms, it cannot be concluded that the new EU fiscal rules are simply "better" or "worse" than the rules existing before the 2005 reform of the SGP [Commission 2005r].

Table 3.2.
The EU fiscal rules against the criteria of optimal fiscal rules

Criteria of optimal fiscal rules (1998) [a]	**Assessment 2003** [b]	**Assessment 2005** [c]
	Original EU fiscal rules (before the 2005 SGP reform)	Impact of the 2005 SGP reform on fulfilment of the criteria
Well-defined: no ambiguous definitions, competence divisions or escape clauses	++	(-)
Transparent: data reporting and data analysis according to the same rules / procedures; no interpretation problems	++	(-)
Simple: rules being easily understandable and observable	+++	(-)
Flexible: allow for capturing of the impact of important influences not captured in the framework, making its application less mechanistic	++	(+)
Adequate to final goal: rules should be not too broad nor too narrow; legal instruments should be capable of obtaining the goal	++	(+)
Enforceable / credible: rules should be credible; application impartial; susceptible to subjective pressures	+	(+) [d]
Consistent: internally and with other policy objectives	++	(+)
Supportive of structural reforms: rules should take into account the importance of structural reforms for the economy	+	(+)

[a] Criteria elaborated by: Kopits, Symanski 1998.
[b] Assessment made by: Buti, Eijffinger, Franco 2003: +++ very good, ++ good, + fair.
[c] Assessment made by: Commission 2005r: (+) improvement, (-) deterioration.
[d] Assessment of the enforceability/credibility of the rules compared to the situation existing after November 2003.

Sources: Kopits, Symanski 1998; Buti, Eijffinger, Franco 2003; Commission 2005r.

Some other authors have assessed the reform of the SGP in relation to some areas that any effective reform of the Pact should tackle, i.e.: (a) overcoming excessive uniformity, (b) improving transparency, (c) correcting pro-cyclicality, and (d) strengthening enforcement. Those issues were raising by some authors during the debate on the SGP reform [Buti, Eijffinger, Franco 2005]. After the reform, the renewed SGP has been assessed on the basis on these criteria (see: table 3.3). The overall assessment is the following [Buti 2006]:

- with reference to the first issue – **overcoming excessive uniformity** – the reformed SGP has introduced some elements of country-specificity in both the preventive and the corrective arm of the Pact (for example, in the reformed Pact the articulation of the MTO has been extended to other dimensions than the cyclical component of the budget balance (as previously), e.g. different situations of the Member States regarding potential growth, debt ratios, risks to the sustainability of public finances, etc.);
- next, as far as **improving transparency** is concerned, the picture is mixed. On the one hand, the renewed SGP includes some provisions leading to improved transparency as well as the quality and availability of fiscal indicators (by requiring high-quality, timely and reliable fiscal statistics). But on the other hand, it has also some elements that could negatively affect an unambiguous assessment of compliance with the rules (i.e. blurring this assessment because of too long list of "other relevant factors");
- next, referring to **correcting pro-cyclicality**, the reformed Pact is explicitly aimed at achieving this goal by, *inter alia*, emphasizing the importance of producing reliable macroeconomic forecasts, the commitment to step up fiscal consolidation in "good times", relaxing the "exceptionality clause", making the timing of the excessive deficit correction a function of the existing cyclical conditions, stipulating the possibility to repeat steps of the procedure in the case of adverse economic shocks, etc.;

- and finally, in relation to **strengthening enforcement**, the picture is mixed again because the renewed SGP includes both some provisions that will strengthen enforcement and others that could potentially weaken it. As far as national ownership is concerned, the new (amended) provisions of the Pact related to governance – especially the involvement of national parliaments – are assessed as going generally in the right direction, but being too modest. But at the same time, the new Pact does not stipulate any significant changes in voting and procedural arrangements, which would strengthen the role of the Commission in the enforcement process.

With reference to those areas where the picture is mixed – i.e. improving transparency and strengthening enforcement – it is indicated that there is a serious risk that misusing some provisions (particularly those related to the interpretation of "other relevant factors") could work against efficient enforcement of the new fiscal rules by reducing transparency and increasing the possibility of collusion in the Council [Buti 2006]. In this context, and in particular keeping in mind the previous partisan implementation of the SGP rules by the Council (in November 2003), it should be noted that the new fiscal rules must be applied much more rigorously than before. Otherwise, **if the Council decided again for such partisan and collusive actions, it would undermine both the credibility of the EU fiscal framework and public confidence in itself**. In such a situation, the Council would be regarded as an institution which first calls for some reforms, and then – when these reforms are agreed – it breaks the rules that it has just endorsed. And the Council must be aware that presently, after the reform of the SGP, all its decisions regarding enforcement will be monitored more strictly and carefully than previously.

Table 3.3.
Assessment of the reformed EU fiscal framework (after the 2005 reform of the SGP)

2005 SGP reform	Overcoming excessive uniformity	Improving transparency	Correcting pro-cyclicality	Strengthening enforcement
I. Governance				
Stability programme for the legislature		(+)		
Involvement of national Parliament				(+)
Reliable forecasts		(+)		(+)
Better statistical governance		+		+
II. Preventive arm				
Medium-term objectives	+ +	–		
Adjustment path	+		+	
Structural reforms	+	–		–
III. Corrective arm				
Exceptional circumstances	+		+	
"All other relevant factors"	+	– –		– –
Systemic pension reforms	+			–
Debt and sustainability	+	–	+	
Repeatability of steps	+	–	+	–
Overall assessment	**+**	**– / +**	**+**	**– / +**

Legend: + improvement; + + strong improvement; (+) improvement if effectively implemented at the national level
– deterioration; – – strong deterioration

Source: Buti 2006.

Although the 2005 reform of the SGP introduced several proposals made by both the EU institutions and external observers concerning the EU fiscal framework, **there are still many suggestions how to improve further the Pact, which have not been included and could**

be potentially considered in the future. Many of them are related to the original Commission's proposal [Commission 2004k] that was the basis for the 2005 reform of the SGP. It is related, for example, to:

– defining (quantifying) a required minimum rate of debt reduction for the Member States with very high debt ratios – notably taking into account that the Council, similarly like the Commission, called for a stronger weight to be given to public debt;

– the possibility to use the „early warning" procedure of the SGP, not only in "bad times", but also in "good times" (the Council did not accept that suggestion last year, although before it stipulated that the Commission should have the possibility to issue "policy advices" in this regard);

– a stronger role of the Commission in the enforcement process, its greater independence from the Council in the EDP (e.g. by issuing "early warnings" directly by the Commission without recourse to the Council's approval).

With reference to this last issue, it is assessed that the reformed Pact has not introduced any major changes in the procedural and voting arrangements because – as it is indicated by some economists – the Council was evidently not prepared to strengthen the authority and competences of the Commission in the Community's interest of the credibility of the EU's fiscal rules [Buti 2006]. Moreover, it has also not been accepted to establish the so-called "rainy-day funds" (that would be used in times of economic downturns and replenished during upturns, and thereby could improve incentives for prudent fiscal behaviour in "good times"), what was called for by some external observers [Kopits, Symanski 1998; Knight, Levinson 1999; Zahradnik, Johnson 2002; Buti, Eijffinger, Franco 2003; Sapir *et al*. 2003; Buti 2006] (see: scetion 3.1). But according to the Commission, the setting up of rainy-day funds would have a clear stabilizing impact on the gross debt, but at the same time it would not have any direct stabilizing impact on budget balances [Commission 2006s].

Box 3.1.
Rainy-day funds – a brief description

So-called "rainy-day funds" (alternatively referred to as "extra-budgetary stabilization funds") are instruments designed to prevent pro-cyclical behaviour of fiscal policy. The principle underlying the working of rainy-day funds is the following: in "good times" government revenues are more abundant, and part of these extra revenues is used to accumulate financial assets in the fund. Conversely, during "bad times" fund assets are decumulated.

In practice, many conditions have to be met in order to ensure that rainy-day funds function properly:

(i) the circumstances and modalities under which reserves could be accumulated and withdrawn need to be clarified *ex-ante*, monitorable, and enforceable. This requires, *inter alia*, a non-ambiguous definition of "good" and "bad" times, clear provisions on the modalities for the accumulation of assets in the fund, clear rules governing the use of the assets in the fund, etc.;

(ii) the notion of good times used for the working of the fund should be both easily made operational and useful for the purpose of output stabilization;

(iii) it is necessary to prevent the risk that the accumulation of assets in "good times" in the fund occurs *via* additional borrowing;

(iv) the amount of resources moved in and out rainy-day funds need to be sufficiently large in order to have a relevant impact on the fiscal stance. This may require determining some accumulation thresholds that guarantee a significant impact on the fiscal stance. An alternative approach could be to define some minimum requirements for asset accumulation as percentages of the cyclical component of the budget (or of the difference between expected and realized revenues).

Source: Commission 2006s.

As already mentioned, this is the right approach that in the short- or medium-term the SGP should be generally maintained in its original form with some necessary internal adjustments, but without any radical changes. It seems that **the 2005 reform of the SGP should contribute to improving the SGP and coordination of budgetary policies within the EU in the coming years**. The crucial factor of success will be political will of the Member States (constituting the Council) to implement the new rules rigorously and avoid any partisan or collusive actions. But the question is: **will this amended budgetary framework be sufficient in the longer perspective as well?** It seems that in the longer term coordination of economic (budgetary) policies will not be as effective as the single monetary policy within the euro area (and finally within the EU). It seems to be quite likely that stronger and stronger tensions between these two forms of macropolicies will occur over time – as a result of the coexistence of both centralized and decentralized policies within the single macroeconomic framework. Therefore, coordination of national economic policies may not be the best solution for the euro area characterized by the single monetary policy conducted at the supranational level. At the same time, the lack of relevant reforms of the fiscal framework of EMU (much deeper than the present one) may cause growing problems in the functioning of the euro area as a whole and consequently aggravate the overall economic situation of its Member States. And this constitutes the ground for the discussion about the future framework of the EU's economic policy. Of course, such a discussion is part of a broader debate on the EU's future.

4

The debate on the future of the EU and the euro area – political, economic and budgetary issues

The debate on the future of the EU started in 2000 – just a year after one of the greatest events in the EU's history, i.e. the introduction of the single currency – the euro. At the beginning the debate had an informal character (in the form of subsequent speeches of the EU leaders), and then a much more formal nature (in the special European forums). A starting point was May 2000 and the famous speech of Minister Fischer in Berlin. After some years it might seem that the debate was over and the necessary solutions were found. But following the events of May and June 2005 – related to the ratification of the Constitution for Europe and the non-agreement on the EU budget for the next Financial Perspective 2007-2013 – the debate on the future of the EU was reopen and launched once again. Last but not least, it should be highlighted that a very important element of the overall debate on the future of the EU is the debate of the euro-area enlargement which is expected in the coming years.

4.1. The European Union – federation or confederation?

As stated above the debate on the EU's future was started and prompted by the speech of Joschka Fischer, German Minister of Foreign Affairs (at that time), held at the Humboldt University in Berlin in May 2000 [Fischer 2000]. In his speech he indicated two main challenges for the EU in the coming decade, i.e. (i) the enlargement of the EU and (ii) integrating the new Member States into the EU structures without substantially deteriorating the Union's capacity for action. And it was kept in mind that what was related to the EU was also related to EMU because the new Member States were expected to join the euro area some years after their accession to the EU.

According to Fischer, the need to address properly the above problems is undoubtedly the biggest challenge facing the Union since its establishment. But in his opinion, there is the following answer to these problems: **the transition from a union of states to a European Federation**, something Robert Schuman and Jean Monnet demanded 50-60 years ago. To this end it is indispensable to complete political integration (especially in the situation when economic and monetary integration is expected to be almost completed in some years – with the accession of the new Member States to the euro area). Under a full political union it would be possible to organize the Union similarly to some existing federations – with a federal structure of government (central, regional and local authorities) and truly federal institutions, i.e. a real European Parliament (consisting of two chambers) and a **European government** – institutions which really do exercise legislative and executive power within the

Federation. According to Fischer, there are two main options for the European executive or government, i.e. (i) developing the European Council into the European government, or (ii) taking the existing Commission structure as a starting point (in this case one can opt for the direct election of the President with far-reaching executive power). The establishment of the above European government would allow the future European Federation to speak with one voice in the international forums on behalf of all its Member States. The outlined above federal structure (European Federation) will have to be based on a **constituent treaty** (European Constitution) – similarly like in the other existing federal states [Fischer 2000].

The above considerations lead inevitably to the conclusion that the above-outlined vision of the European Federation would imply **the necessity to transfer some further national competences and sovereignty to the European level**. Of course, this is a natural consequence of deepening the integration process. And deeper integration is indispensable if members of a union want to achieve better progress and more benefits from their political and economic cooperation. In this context, it should be stated as clearly as possible (and it was done in the Fischer's speech several times) that **a vision of the European Federation will mean neither the abolition of the nation states nor replacing them by the newly created European superstructures**. Such a concept, ignoring the present reality, would be seen as an artificial one and therefore rejected by the EU citizens [see e.g. Szeląg 2001a; 2006a]. Everyone can easily agree that *"it is important to allow an evolutionary process, which is open to further steps of integration, yet safeguards what is already in place and working well, and which assigns competencies to nation states or even regions as appropriate"* [Issing 2006a].

With reference to the above considerations, there is the following fundamental question in Fischer's speech: can this vision of the Federation be achieved through the existing method of integration? If not, it would be necessary to find another methods. One of such methods could be the so-called **"closer cooperation"** envisaged in both the Amsterdam and Nice Treaties. This method is very useful in the situation when some members of a union want to achieve further integration progress in some areas while some others are not ready to do it or simply do not want deeper integration (as it was in the case of EMU or Schengen). It is of utmost importance that the "closer cooperation" should not be understood mistakenly as the end of integration or full integration, but as a tool to achieve this goal. Moreover, it cannot be merely "an exclusive club" of selected countries, but it must be always open to all others wanting to join it at any stage of integration. Such a group of the Member States, cooperating each other more closely than others, would be a **"centre of gravity"** within the Union and play a role of the driving force for the completion of political integration leading finally to the establishment of the future Federation [Fischer 2000]. It seems to be a rational idea that – as proposed by Fischer and before by Helmut Schmidt and Valery Giscard d'Estaing – the role of such a "centre of gravity" within the EU should be entrusted rather to the EuroGroup (previously called the Euro-11 or Euro-12) than just to the six founding states. It is justified because the creation and existence of the euro area (i.e. economic and monetary union) has resulted in exerting pressure to complete political integration in the EU (i.e. to establish a political union as well).

At the turn of April and May 2001 Chancellor Gerhard Schroeder proposed **a federal model for the future EU** (similarly like Minister Fischer proposed the European Federation a year before), raising again the question whether the EU should move to a full political union or not

[see e.g. Kieffer 2001]. Some weeks later, at the end of May 2001, Lionel Jospin, French Prime Minister, presented in Paris his vision related to the future of the enlarged EU [Jospin 2001]. First and foremost, Jospin **rejected the idea to transform the EU into the European Federation** as proposed by German politicians. In his opinion the nation states (not supranational institutions) should have the central role in the decision-making process in the EU. Therefore, the EU should remain a community of nation states, i.e. a "union" of more or less integrated countries rather than a "true federation". But at the same time Jospin supported surprisingly the idea of the so-called **"Federation of Nation States"** – the term originally coined by Jacques Delors, former President of the European Commission (although he was aware that parallel rejecting and supporting "the federalist idea" may be misleading for external observers, as well as the concept of the "Federation of Nation States" might seem ambiguous from a legal point of view). It seems that Jospin – for greater clarity – should have used the term **"confederation" instead of "federation"** in this regard.[33]

The real federation would require strong supranational institutions with real legislative and executive power. But Jospin stated that **the present European institutional system** – based on the triangle of the Commission, the Council and the European Parliament – **should be maintained in the future**, although it would be necessary to amend it to some extent. Although Jospin was against establishing the strong executive authority at the top (federal) level of the potential European Federation (or the Federation of Nation States), he suggested to establish an **economic government of the euro area**. In his opinion the single currency has given the EU much-appreciated stability. To balance the structure of the Union, the EU needs the above economic government of the euro area. Moreover, coordination of economic policies must be considerably enhanced. Each Member State should consult its counterparts and give careful consideration to their recommendations before making decisions which have a major impact on the euro area as a whole. It is advisable to set up a **short-term economic action fund** to which each Member State would be eligible in order to support any member country suffering from the effects of world economic turbulences [Jospin 2001]. The above economic government could help the euro-area countries unify their representation in the international forums and thereby to speak Europe (i.e. its most integrated part) with one voice in the world.

With regard to the "closer cooperation" as a potential method of integration for some (the most advanced) countries within the Union/Federation, Jospin stated, on the one hand, that a two-speed Europe would not be an acceptable proposition, but on the other, that the **"enhanced cooperation" mechanism could be applied in such areas as economic coordination in conjunction with the euro**, but also in such areas as health care and arms.

With reference to some other economic – or more precisely socio-economic and budgetary – issues, Jospin stated that economic cohesion must serve social solidarity because that was what citizens were calling for. Taking into account that since the adoption of the Lisbon

[33] According to a popular definition, the term "**federation**" means a specific kind of the state consisting of a number of more or less autonomous and self-governing regions (referred to as "states", "provinces", "lands", etc.) united by a central ("federal") government. The form of government or constitutional structures applied in a federation is known as federalism**.** In a federation, the self-governing status of the component states are typically constitutionally entrenched and may not be altered by a unilateral decision of the central government. In contrast, the term "**confederation**" means an association of sovereign states, usually created by a treaty, but often later adopting a common constitution. Confederations tend to be established for dealing with some critical issues, such as defence, foreign affairs, foreign trade, and a common currency (possibly with the central government being required to provide support for all members). In modern political terms, the term "confederation" is usually limited to a permanent union of sovereign states for common actions in relation to other states [Wikipedia 2006].

Strategy the EU has focused mainly on growth and employment, he traditionally referred in his speech to the European social agenda, insisting on the adoption of a **European social treaty** and suggesting a social dialogue with trade unions at the European level. Moreover, Jospin strongly supported **combating "tax dumping"** as one of the most urgent priorities. In his opinion, it was not acceptable for certain Member States to practice unfair tax competition in order to attract international investments and offshore headquarters of European groups (it was a clear allusion to the United Kingdom and Ireland with their low tax rates). Ultimately, he also postulated that **the corporate tax system as a whole should be harmonized**. Finally, Jospin called several times for "more Europe", i.e. setting up some common European undertakings that would bring benefits to all the Member States, but could be carried out at the European level only – e.g. a true European Research Area, Common Law Area, European Judicial Area, etc. But at the same time he did not mention any sources of financing these undertakings (e.g. the EU budget, national budgets, other sources). Last but not least, Jospin favoured the idea to elaborate and adopt a **European Constitution** [Jospin 2001].

At the end of May 2001, on the very next day after Jospin's speech, British Prime Minister Tony Blair presented his position in the context of the future of the EU. He rejected some crucial elements of both German and French visions of Europe. First, taking into account the traditional and well known British antipathy to the federalist idea, Blair **opposed the German proposal of more federal Europe (European Federation)**. In his vision, Europe should not be a federal superstate submerging national identity, but a union of nations working and cooperating closely together. Second, he **rejected the French proposal to harmonize taxes across Europe**. But at the same time he stated that unfair tax competition is a matter preventing the Single Market working properly. Therefore, in his opinion unfair tax competition should not be used as an argument for tax harmonization within the EU.

At the end of November 2001, some days after the above speech of Prime Minister Blair, **France and Germany adopted the Joint Declaration on the main priorities of Europe**, in which they stated: *"The economic challenges facing Europe have increased and they require convincing responses. On 1 January 2002 the introduction of euro notes and coins will be the epilogue to the historic process of the creation of a European currency. Thanks to the euro, the Union has a broader and more stable economic basis, even in times of instability in the world economy. The single currency strengthens Europe's ability to make its voice heard more strongly in the international monetary chorus.* ***The euro makes it necessary to have greater economic and social solidarity in Europe.*** *To this end, and in addition to the common policies that already exist and that will have to be pursued and intensified, such as, for example, coordination of economic policies of the Member States, our two countries consider it important to make progress in the following areas:* ***greater coordination of economic policies of the Member States, harmonization of taxation, especially taxation of enterprises,*** *establishment of a genuine single financial market"* [France and Germany 2001]. And the crucial point in the historic process of European integration would be the **European Constitution** – the idea supported by both Germany and France.

Finally, in mid-December 2001 – about two weeks before the €-day – the Laeken European Council adopted the **Declaration on the future of the European Union** (the so-called **Laeken Declaration**). In that document the EU leaders recalled the most significant economic achievements of European integration, such as a genuine Single Market and the

single currency that was added in 1999 (and in 2002 the euro was introduced into circulation and became the day-to-day reality for more than 300 million of the EU citizens). The leaders were also aware of the challenges facing the EU – both within and beyond its borders. The Laeken Declaration also considered some potential actions towards the **Constitution for Europe** – being a response to the present and future European challenges. With reference to that problem, the EU leaders decided at the end of 2001 to convene the **Convention** composed of the main parties involved in the debate on the future of the EU [European Council 2001c,d] (see: section 4.2).

Summing up the above considerations, the debate on the future of the EU and EMU, and in particular some links between a monetary and political union, is still open and unconcluded. There are two main (contrasting) views or visions in this respect. According to the first one, **the present degree of political unification within the EU is sufficient to guarantee the long-term survival of EMU** (in other words, the euro area will be able to survive even if the EU does not become over time a federal state like the United States. But according to some other views, **a monetary union cannot survive in the long term without a strong political union among the Member States**. It is argued that this vision seems to have history on its side because monetary unions that were not supported by strong political unions have not survived [De Grauwe 2006b]. At the moment, the first of the above visions is dominant, having status of the day-to-day reality in the EU. But considering some potential developments in the EU over the longer perspective, driven (at least to some extent) by the launch and functioning of EMU, it seems to be interesting (or even necessary) to explore in more detail the second of the above visions, emphasizing some links between a monetary and political union. In this context, it would be helpful in analyzing not only some theoretical assumptions, but also some practical steps taken in recent years.

4.2. The European Convention and the Constitutional Treaty

Following the Laeken Declaration (see: the previous section), the **European Convention** was established to institutionalize the debate on the future of the EU. The main task of the Convention, chaired by Valery Giscard d'Estaing, former President of France, was to prepare the draft of the Treaty establishing a Constitution for Europe. The Convention started its works in February 2002. The whole works of the Convention were divided between 11 Working Groups on some specific areas. One of them was the Working Group VI on Economic Governance which presented its report in autumn 2002 [Convention 2002a]. In its report the Working Group recommended **to maintain the current roles and responsibilities for the policy mix**, i.e. the exclusive competences of the EU in the case of monetary policy within the euro area (exercised by the ECB) while the competences of the Member States in the case of their economic policies. It was also proposed to maintain the present framework of the BEPGs, the SGP as well as taxation affairs (although there were also some opinions expressing the need to change them).

Moreover, some Member States, as well as representatives of the European Commission [Convention 2002b], presented in the Convention their proposals on how to improve coordination of economic policies within the euro area. In particular, the French-German contribution on economic governance [Convention 2002d] should be noted. In their common document France and Germany stated that the existence of the euro, the experience of economic coordination since 1997, and the expected entrance of a quite large number of

new members in the EU, underlined the need to strengthen European economic governance, particularly in the euro area. In this context, France and Germany expressed their common views on the following issues:

- recognizing the EuroGroup in a Protocol annexed to the Treaty (but still as an informal forum for the dialogue with the ECB);
- improving coordination of economic policies – but without disrupting the balance of the existing institutional triangle (Commission – Council – European Parliament);
- a broader use of qualified majority voting for tax issues directly related to the Internal Market, double taxation, harmonization of turnover taxes and excise duties, etc.;
- the single representation of the euro area in the international financial institutions (such as the IMF).

The above French-German contribution on economic governance was submitted to the Convention in December 2002. Practically at the same time, the President of the Convention submitted to the Copenhagen European Council his report on progress made by the Convention [Convention 2002c]. The report presented similar issues to those presented above and contributed by France and Germany, the Commission, and the Working Group.

The Treaty establishing a Constitution for Europe was presented as a draft by the President of the Convention at the meeting of the European Council in Thessaloniki in June 2003 [Convention 2003; European Council 2003b]. Then it was adopted by the Brussels European Council in June 2004, signed in October 2004 in Rome and published in the Official Journal of the EU [European Council 2004b,d]. In order to enter into force, the Constitutional Treaty must be ratified by all the EU Member States (see: further part of this section).

In relation to the policy mix within the EU, i.e. formulation and implementation of monetary and economic policies, **the Constitutional Treaty stipulates to maintain *status quo***. On the one hand, monetary policy for the Member States whose currency is the euro has been placed among areas of the exclusive competences of the EU (Article I-13). **The single monetary policy for the euro area is still to be formulated at the supranational level** by the ECB Governing Council and implemented by the ECB Executive Board which shall give the necessary instructions to the national central banks of the euro area (constituting together with the ECB the so-called Eurosystem, officially recognized in the Constitution). On the other hand, the Constitutional Treaty stipulates that **the Member States shall coordinate their economic and employment policies within the EU**. The Council shall adopt broad guidelines for economic policies, while the EU shall define guidelines for employment policies. The EU may also take initiatives to ensure coordination of social policies of the Member States (Articles I-12 and I-15).

According to Article III-179 of the Constitutional Treaty, the Broad Economic Policy Guidelines (BEPGs) for the Member States and the Union are still to be formulated by the Council on a recommendation from the Commission. If economic policy of a given Member State is not consistent with the BEPGs or it could jeopardize the proper functioning of EMU, the Commission may address a "warning" to such a Member State. The Council, on a proposal from the Commission, shall decide whether an excessive deficit exists. Making the above decisions the Council shall act by qualified majority, i.e. at least 55% of the Member

States (excluding the Member State concerned) and 65% of the population of the participating Member States (i.e. those belonging to the euro area).

The Constitutional Treaty includes some **specific provisions which shall apply to those Member States whose currency is the euro** (Articles III-194 to 196). For example, when setting economic policy guidelines for the euro-area countries, only representatives of the participating Member States are allowed to take part in voting. There are also some provisions related to the EuroGroup which is formally recognized in the Protocol annexed to the Treaty (the President of the EuroGroup is to be elected for two and a half years by the majority of the euro-area Member States). Finally, in order to secure the euro's place in the international monetary system, the Council, on a proposal from the Commission and after consulting the ECB, shall adopt common positions on matters of particular interest for EMU in the competent international financial institutions and conferences. Under the same procedure the Council may adopt appropriate measures to ensure the single/unified representation in the above international forums. In those cases also only the Member States of the euro area are allowed to take part in voting (by qualified majority: 55% of the Member States an 65% of the EU's population – known also as "double mojority"). Finally, it is worth to mention that, according to Article III-198, the Council – before the adoption of its decision concerning the abrogation of a derogation – should act having received, *inter alia*, a recommendation of the euro-area Member States (adopted by them by qualified majority). It means that not only the EU institutions, but also the euro-area members would co-decide whether a given country staying outside the euro area could adopt the single currency or not.

The Constitutional Treaty is regarded by many experts a milestone in the history of European integration. But – due to the lack of political will – there is neither a real turning point nor significant progress of the EU's coordination process of economic policies in the provisions of the new Treaty. In this area the Treaty maintains *status quo* in both the EU's macroeconomic and institutional frameworks.

At the same time it must be noted that the Constitutional Treaty is too complicated and not transparent for many people. The EU citizens seem to be exhausted by more and more sophisticated forms of European integation which are – in their opinion – not fully effective (in this context, some authors refer to the so-called "integration fatigue" in Europe – see e.g. De Grauwe 2006a,b). It was confirmed very clearly (and very painfully for the EU) at the end of **May 2005** when the **French citizens rejected in the referendum the Constitutional Treaty** (55% votes against, 45% votes in favour). Some days later, at the beginning of **June 2005**, **the Treaty was also rejected in the referendum in the Netherlands** (63% votes against, 37% votes in favour).[34] As it is known, the Treaty – to enter into force – must be ratified (either by national parliaments or in referendums) by all the 25 Member States. Those socio-political events, resulting in some uncertainty about the future of European integration (including the future of the euro area and the single currency), had not only political consequences (e.g. the resignation of the French Prime Minister, proposals to suspend the ratification process for some time), but also clear economic repercussions (e.g. the lowest exchange rate of the euro against other currencies, notably the US dollar, for several

[34] In mid-July 2005 the Constitutional Treaty was accepted in the referendum in Luxembourg, but it could not change an overall bad impression made by the referendums in France and in the Netherlands. In general, since June 2005 further five Member States have ratified the Constitutional Treaty (bringing the total number of ratifications to fifteen), eight Member States have still to complete their ratification processes (one of which has recently launched the procedure to that effect), and two Member States – France and the Netherlands – have been unable to ratify the new Treaty [European Council 2006b].

months). After the rejection of the Constitutional Treaty in France and the Netherlands it was decided to introduce the so-called **"reflection period"** in order to enable the EU to assess some concerns and worries of some Member States and their citizens expressed during the ratification process [European Council 2005b,c]. In June 2006, the EU leaders decided that the Presidency would present a report to the European Council in the first half of 2007, based on extensive consultations with the Member States. Then this report will be examined by the European Council and the results of this examination will serve as the basis for further decisions on how to continue the reform process. It was decided that the necessary steps in this context should be taken during the second half of 2008 at the latest [European Council 2006b].

Of course, the negative results of the referendums in France and in the Netherlands must not necesarilly mean the end of the Constitutional Treaty because, for example, in June 1992 the Maastricht Treaty was also rejected for the first time in the Danish referendum, but it was adopted in the second referendum in May 1993. And without the ratification of the Maastricht Treaty it would be impossible to establish EMU, introduce the euro, and start the single monetary policy for the euro area.

It seems it should not be judged from the results of the French and Dutch referendums that the Europeans are totally against European integration. Of course, this is not the truth. The EU citizens are in favour of various forms of integration (especially economic one) provided this integration is understandable for them and brings them some clear (measurable) benefits. In the case of economic integration ordinary people usually understand and know very little (or almost nothing) about coordination of the EU's economic policies. But they seem to understand of feel quite clearly that this approach must be wrong because of the relatively weak performance of the EU economy (growth, unemployment, etc.) in comparison with some other regions of the world (e.g. the United States or China). Simply speaking: people need dynamic economy and jobs, not economic coordination instruments and strategies. And by rejecting the Constitutional Treaty, the EU citizens decided to recall that the EU should be much closer their citizens than it is today.

Taking into account the above considerations, one can say that maybe in the future it would be a right approach **to make the present framework of the EU's economic policy more simplified and transparent**. It seems that such a framework would be more understandable to people and therefore more acceptable as well. It would also be more transparent for markets and should have positive impact on the whole EU economy. For example, some years ago the single monetary policy was a novum in the Maastricht Treaty, but at the same time it was a relatively clear, transparent and understandable concept with the credible institutional framework (the ECB / ESCB) and clear objectives (to maintain price stability). And, as a reslut, people finally voted for the Treaty as well as the new monetary framework was accepted by markets. Perhaps a similar solution is needed for the EU's economic policy. It should be a matter of the EU-wide debate of the Union's future. If not, there will be continuous ambiguity and uncertainty about the direction of European integration and, therefore, similar crisis situations (as recently in France and in the Netherlands) may appear in the future again and again, having a negative impact not only on the political situation of the Union, but also on the economic one (e.g. the exchange rate of the euro, the overall performance of the EU economy, etc.).

4.3. The EU budget and the Financial Perspectives

The debate of the Union's future is related not only to political issues, but it has also clear economic or budgetary dimensions. In general, analyzing the present and potential future designs of the Union, it is necessary to consider whether in the longer term (i) the EU would remain a similar political and economic structure as presently (with rather a small central budget at the Community level), or maybe (ii) the EU - or the euro area - would evolve gradually from the present form to a stricter federal structure (with a true federal budget), provided political integration would be deepened significantly and thereby a full political union would complement a monetary union.

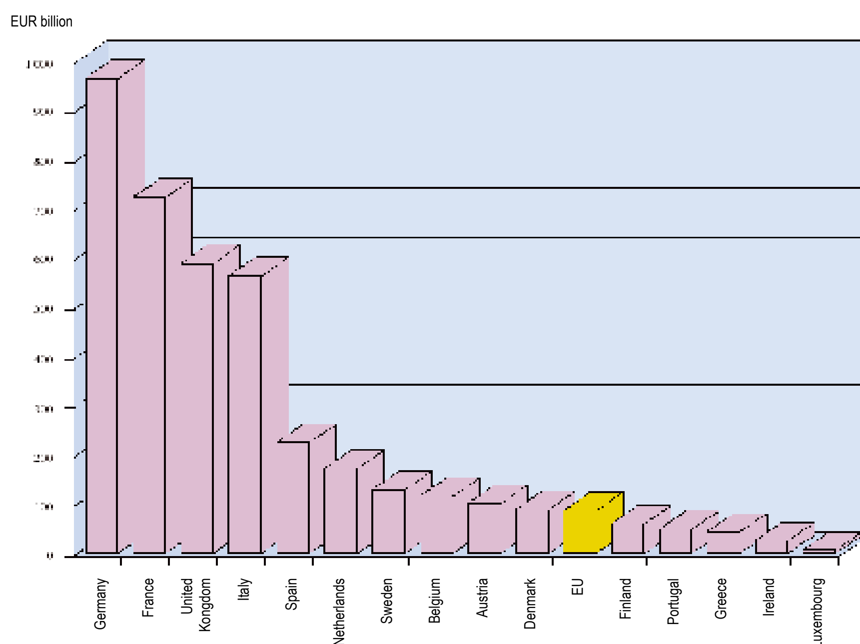
Moreover – abstracting from the above longer-term considerations and focusing on more medium- or short-term issues – it should be indicated that there are some links not only between EMU and the Lisbon Strategy (see: section 1.3), but also between them and the EU budget. In recent years the European Commission has stated several times that the debate on the financial framework for the EU (Financial Perspective 2007-2013) had to reflect Lisbon ambitions by supporting Lisbon priorities within the future EU budget. The new financial framework should also be in favour of growth and employment – which are crucial factors for the proper functioning of the EU economy as well as EMU, and at the same time necessary conditions to exploit fully the potential of the Single Market supported by the single currency. Similarly, the Spring European Council stated last year that the Financial Perspective 2007-2013 would have to provide the EU with adequate funds to conduct the Union's policies, including those policies that contribute to the achievement of the Lisbon priorities [European Council 2005a].

For the above reasons, it seems to be useful to analyze the EU budgetary framework, its present situation and future prespectives in the context of the debate on the Union's future which will affect not only the existing political structure of the EU, but also general economic policy and development within the EU (and the euro area as well).

The current EU budget

At the beginning, it is worth to recall briefly some basic facts about the EU budget. As it is known, **the general budget of the EU is very small – particularly in relation to its economic potential**. The size of the budget – being the result of a minimum compromise between the Member States – is a very sensitive political issue. In 1999 it was decided that the ceiling of own resources would be "frozen" and remained at the previous level of 1.27 % of EU GNP in the period of 2000-2006. The EU budget is small not only in relation to the EU's economic potential, but also in relation to the budget sizes of the individual Member States. While national budgets, on average, amount to around 45-50% of national income, the EU budget is only slightly over 1% of EU gross national income (GNI). The present level of expenditures of the EU budget (about 90-120 billion EUR per year in the current financial framework) is comparable to the expenditure levels of the smaller Member States (like Denmark or Austria) and at the same time much lower than those of the biggest countries (the UK, France, Italy) and about 10-times lower than budgetary expenditures in Germany (see: figure 4.1).

Figure 4.1.
The EU budget vs. national budgets of the Member States (expenditures in 2000)



Source: European Communities 2000.

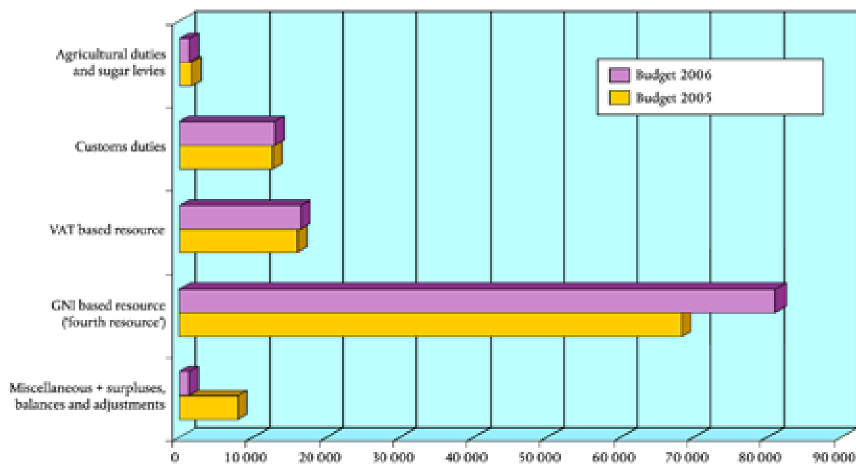
With regard to the **revenue side**, the EU budget is entirely financed by the following **own resources**: (1) duties established within the framework of the Common Agricultural Policy (CAP); (2) customs duties (the former and the latter are "traditional own resources"); (3) the application of a uniform rate to the harmonized VAT assessment base (VAT resource); (4) the application of a rate to the sum of all the Member States' GNIs (the so-called "fourth resource" or GNI-based resource); (5) other revenues (e.g. income tax paid by officials, fines imposed on firms by the Union, late interest payments, etc.). The so-called "fourth resource" is the dominant type of revenues in the EU budget – ammounting currently to more than 70% of total revenues (see: table 4.1 and figure 4.2). In 2000, the Council's decision on the new own resources system (with taking effect from 2002) stipulated that no new own resources – that could potentially allow the EU to increase its budget – would be introduced [Council 2000a]. At the present moment **the EU has no power to create or levy taxes**, but it is quite active in the process of coordination and harmonization of taxation within the Single Market in order to ensure its efficient functioning (see: section 5.2).

Table 4.1.
The structure of revenues of the EU general budget (in 2005 and 2006)

Type of revenue	Budget 2005		Budget 2006	
	EUR million	%	EUR million	%
1. Agricultural duties and sugar levies	1 913,20	1,8 %	1 319,70	1,2 %
2. Customs duties	12 030,80	11,4 %	12 905,40	11,5 %
3. VAT based resource	15 556,05	14,7 %	15 884,32	14,2 %
4. GNI-based resource ('fourth resource')	68 884,10	65,2 %	80 562,50	72,0 %
5. Miscellaneous + surpluses, balances and adjustments	7 299,90	6,9 %	1 297,69	1,2 %
Total	**105 684,05**	**100,0 %**	**111 969,61**	**100,0 %**

Source: Commission 2006b.

Figure 4.2.
The structure of revenues of the EU general budget (in 2005 and 2006)



Source: Commission 2006b.

As far as **budgetary expenditures** are concerned, the following areas are financed by the EU general budget: agriculture, structural operations, internal policies (notably research and technological development), external action, administration, pre-accession strategy, etc. Two **major (dominant) categories of expenditures are agriculture** (Common Agricultural Policy) **and structural operations** (Structural Funds / Cohesion Fund) – amounting to about 46% and 32% of total expenditures respectively (see: table 4.2. and figure 4.3). The other budgetary categories, especially those which are particularly important for the achievement of the Lisbon priorities, are much smaller (about 5% of total expenditures) and seem to be underdeveloped in comparison with the dominant categories of the EU budget. For example, analyzing in detail appropriations for commitments in the section "Internal policies" within the 2006 budgetary framework, it is apparent that, in fact, there are some increases in comparison with the previous year, but generally the main categories crucial for the Lisbon Strategy are still relatively small in the overall EU budget, e.g. research – about 3% of total commitment appropriations, information society and media – more than 1%, education and culture – less than 1%, etc. At the same time, it is clearly stated that *"the emphasis is on measures (…) contributing to the Lisbon strategy"* in the 2006 budgetary framework [Commission 2006b]. In general, considering the three main functions of the budget (allocation, redistribution and stabilization), there is no doubt that presently the EU budget fulfils mainly redistributive function – via structural operations.

According to the Treaty, revenues and expenditures shown in **the EU budget shall be in balance each year** (Article 268). It means that, in principle, it is prohibited for the EU budget to be ended with a deficit or a surplus in a given financial year. This is confirmed by the new financial regulation applicable to the general budget of the EU [Council 2002a], which replaced the old one of the late 1970s [Council 1977]. The scope of this new regulation is restricted to stating some basic rules and broad principles governing the EU budget. There are, *inter alia*, the principles of universality and equilibrium. The principle of universality means that total budget revenues must cover total budget expenditures. And according to the principle of equilibrium, budget revenues and payment appropriations must be in balance, as **the EU is not authorized to raise loans in order to cover its expenditures**.

For that reason, the budgetary balance from each financial year is entered into the budget of the following financial year as a revenue (in the case of a surplus) or a payment appropriation (in the case of a deficit) [Commission 2006f].

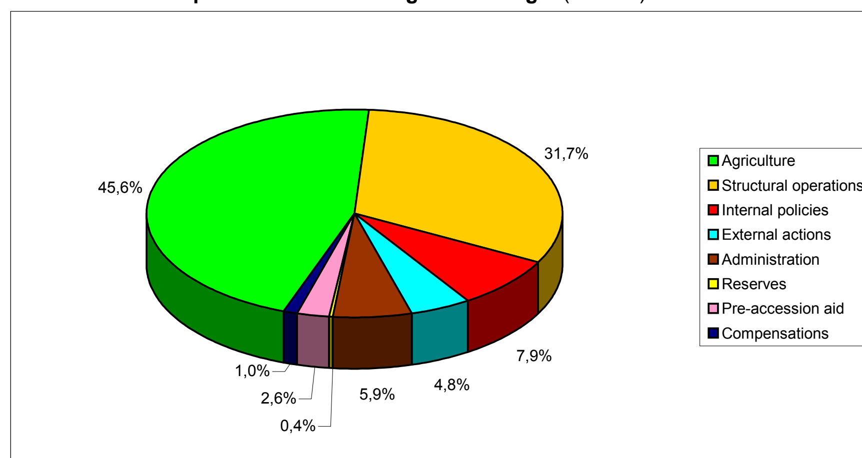
Table 4.2.
The structure of expenditures of the EU general budget (Financial Perspective 2000-2006; selected years)

(in million EUR, at current prices)

Appropriations for commitments	2000	2003	2006
1. AGRICULTURE	41 738	47 378	52 618
- Agricultural expenditures (excluding rural development)	37 352	42 680	44 847
- Rural development and supporting measures	4 386	4 698	7 771
2. STRUCTURAL OPERATIONS	32 678	33 968	44 617
- Structural Funds	30 019	31 129	38 523
- Cohesion Fund	2 659	2 839	6 094
3. INTERNAL POLICIES	6 031	6 796	9 385
4. EXTERNAL ACTIONS	4 627	4 972	5 269
5. ADMINISTRATION	4 638	5 211	6 528
6. RESERVES	906	434	458
7. PRE-ACCESSION AID	3 174	3 386	3 566
8. COMPENSATIONS	-	-	1 074
Total appropriations for commitments	**93 792**	**102 145**	**123 515**
Total appropriations for payments	**91 322**	**102 767**	**119 112**
Ceiling, appropriations for payments as % of GNI (ESA 95)	1,07 %	1,11 %	1,08 %
Margin for unforeseen expenditures	0,17 %	0,13 %	0,16 %
Own resources ceiling	**1,24 %**	**1,24 %**	**1,24 %**

Source: Commission 2006b.

Figure 4.3.
The structure of expenditures of the EU general budget (in 2006)



Source: Commission 2006b.

The EU budget for each financial year is part of a broder budgetary package, the so-called **financial perspective** (multi-annual framework determining the maximum amount of expenditures in the EU annual budget). In principle, financial perspectives are set in order to promote and strengthen overall budgetary discipline of the EU budget, provide stability for annual budgets, enable a long-term planning related to the main EU priorities, as well as – what is important for the individual Member States (especially the main net contributors) – keep the total increase in budgetary expenditures under control. Thus far there were three

financial perspectives for the following periods of time: 1988-1992 (Delors I), 1993-1999 (Delors II) and 2000-2006 (Agenda 2000).

New financial framework (2007-2013)

Taking into account that the current financial framework expires at the end of 2006 and the new budget should be put into practice at the beginning of 2007, the European Commission presented its budgetary proposals well in advance – about two and a half years (or even more) before the start of the next financial framework. First of all, in February 2004 the Commission presented its communication on the **new financial framework for the enlarged EU** for the period 2007-2013 [Commission 2004c]. It was a political project for the EU to indicate the key challenges facing Europe and its citizens in the coming years. Its objective was, on the one hand, to launch a forward-looking debate on the EU's goals and policy challenges, and on the other, on the tools (budgetary means) required to make these goals a reality. Some monts later, in July 2004, the Commission presented its next communication on the **new Financial Perspective 2007-2013** [Commission 2004g] as well as the working document related to the interinstitutional agreement on budgetary discipline and improvement of the budgetary procedure [Commission 2004h]. Those documents proposed a set of detailed measures and actions; they were also accompanied by relevant legislative proposals and intended to serve as a basis for the negotiations between the Council, the European Parliament, and the Commission. In its communications the Commission proposed that the EU should concentrate its efforts on the following **priorities**:

- promoting sustainable development, i.e. completing the Single Market and mobilizing various policies – economic, social and environmental – to that end (in order to achieve greater competitiveness and cohesion within the EU);
- giving meaning to the concept of the EU citizenship by completing the area of freedom, justice and security and ensuring access to basic public goods and services;
- promoting a coherent role for Europe as a global partner.

As we can see, the EU is going to achieve many ambitious goals (e.g. relaunched Lisbon Strategy). It also has to fulfil some large-scale commitments from the past (e.g. the CAP). Moreover, the EU is to take on some new tasks at the EU level (e.g. in the area of freedom, security and justice to deal with new security threats and crises). In order to achieve all those goals it is indispensable to have appropriate funds for action. Of course, one can say that there are many EU instruments where little or no funding is required. It is true, but at the same time many EU policies must be accompanied by financial resources (sometimes really substantial) if they are to be effective. And the Commission is right stating that **to expect more Europe for less money is simply unrealistic**; new policy areas at the EU level imply new financial requirements. Otherwise, without sufficient financial resources, this will remain an empty promise [Commission 2004g; Prodi 2004].

Taking into account the above considerations, the Commission stated that **the significance of the identified future challenges would justify and even require a very substantial increase of financing capabilities at the EU level**. Thus the Commission proposed substantial increases in expenditures in certain policy areas for the period of 2007-2013. But at the same time, the Commission was fully aware that – due to the existence of some budgetary ceilings – the above challenges could be accommodated by a combination of

shifts in the balance between different spending priorities, careful costing, and **only a limited increase in the current size of the EU budget**. A credible (and feasible in the present reality) plan to meet the EU's needs could be drawn up only within current budgetary discipline, represented by the overall own resources' ceiling of **1.24% of EU GNI** (gross national income). For that reason, in order to respect this ceiling, it would be necessary to make a rebalancing of the budget, that would allow space for the new priorities. A significant proportion of the EU's resources would focus on the objectives such as competitiveness for growth and employment (16%) and Europe as a global partner (7%) [Commission 2004c].

Although in its proposal the Commission suggested a potential increase in the current size of the EU budget, some of the Member States would like to go in the opposite direction and to decrease the size of the budget to around or even below 1% of EU GNI. In the Commission's opinion, that approach is fundamentally flawed [Prodi 2004]; **cutting the budget ceiling down to below 1% of GNI would be unrealistic**. First of all, setting a 1% ceiling would mean **a huge financial cut** – amounting to almost 20% of the Commission's proposal for 2007-2013 (about 200 billion EUR over the period). And this financial cut could be put into practice in 2007, i.e. in the same year that two new countries (Bulgaria and Romania) are to join the EU.[35] Moreover, if the budgetary resources are less than in the current period, it would be impossible for the EU to meet all its commitments. A 1% ceiling could only be achieved by **abandoning some major commitments already made by the Member States**. In this context, according to the Commission, the EU would face the following choice:

- to preserve exiting policies like the CAP and structural/cohesion policies in the present form without any changes; or
- to reopen the deal on CAP financing (and thereby on the CAP reform) as well as on the fundamentals of cohesion policy.

To make a choice in such a situation seems to be an extremely difficult task because both options involve some negative consequences. Choosing the first option would preserve the dominance of the CAP and structural/cohesion policies in the EU budget. It would also mean sacrificing many of the Lisbon Strategy targets or some new priorities. Choosing the second option would unleash a storm of protests from a lot of the Member States. It would mean opening a debate on the re-nationalization of the CAP, and on the need for EU-wide cohesion policy [Commission 2005o].

The outlined situation was not helpful to reach a compromise that should have been found by mid-2005. First of all, there was a clear time pressure[36] – a factor that could result merely in

[35] In May 2006, in its recent monitoring report on the state of preparedness of Bulgaria and Romania for their membership of the EU, the European Commission recalled that the conditions of their accession were agreed in the Accession Treaty signed in April 2005 between the 25 EU Member States and Bulgaria and Romania. According to the Accession Treaty, both countries will join the EU on 1 January 2007 (unless the Council decides, upon a recommendation from the Commission, to postpone the accession of either country until 2008). In the Commission's opinion, both Bulgaria and Romania have already made significant progress in transforming their political and economic systems into functioning democracies and market economies. Nevertheless, there are still many areas requiring some further improvements (clearly indicated by the Commission in its report). In this context, the Commission informed in May 2006 that it would report once again on Bulgaria's and Romania's progress in addressing those outstanding issues (no later than in early October 2006) and on this basis it would consider whether the date of their accession to the EU on 1 January 2007 could be maintained [Commission 2006p]. It was confirmed by the European Council (June 2006) which stated, on the one hand, that *"it is the Union's common objective to welcome Bulgaria and Romania in January 2007 as members of the Union if they are ready"*, but on the other hand, it called on both countries *"to rigorously step up their efforts to tackle decisively and without delay the remaining issues of concern as mentioned in the Commission's May 2006 report"* [European Council 2006b].

[36] The EU Member States were fully aware that a compromise on the Financial Perspective 2007-2013 should be reached about 12-18 months before the beginning of the new financial framework (in mid-2005). The European Commission indicated clearly potential negative consequences – of political, technical (procedural) and budgetary nature – as a result of a late or non-agreement on the new financial framework. In particular, the Commission warned that it would send a signal that the enlarged EU is not working properly, cannot respect its commitments

agreeing some provisional solutions, but not strategic and multi-annual ones. Next, there was **the lack of an agreement between the Member States not only in some details, but generally in many fundamental issues** (e.g. the CAP reform and future spending on agriculture). Finally, the procedure for adopting the EU's financial perspectives was driven by narrow national calculations of self-interest, bolstered by **unanimity voting**. Sometimes – or perhaps quite often – it might seem that **national interests** were more important for the Member States than Community interest. As a result, the successive budgets were more the expression of different deals and attempts by national governments to claw back in receipts as much of their contribution as possible than a coherent set of measures aimed at pursuing the EU's objectives [Sapir *et al.* 2003]. But not this time. While **some of the Member States (e.g. France) wanted to maintain budgetary *status quo*** (especially in relation to substantial spending on agriculture), **the other Member States (e.g. the United Kingdom) called for a more rational structure of the EU budget in the future** (lower spending on agriculture, higher spending on pro-growth and solidarity priorities).

Despite efforts and priorities of the Luxembourg Presidency (in the first half of 2005), **the European Council failed in June 2005 to find a budgetary compromise on the Financial Perspective 2007-2013** [European Council 2005d].[37] Many observers stated that Europe finds itself in a deep crisis. The failure was regarded as a result of the rigid position of the United Kingdom that did not want to accept the new financial framework without starting a process which could lead to a more rational EU budget in the future (i.e. with much lower spending on the CAP than presently). According to the UK Prime Minister, the EU budget should be a modern one and must reflect the present reality, including new challenges and priorities. But a modern budget for Europe is not one that ten years from now would still mean spending 40% of its total amount on the CAP.[38] In Blair's opinion, the Sapir Report, published by the European Commission in 2003, set out in clear detail what a modern European budget would look like. Therefore, the EU should put it into practice [Blair 2005]. The subsequent British Presidency (in the second half of 2005) announced that it would seek a consensus on a **general review of the EU budgetary structure and priorities** (and important part of a budget review would be the CAP reform) [UK Presidency 2005]. Finally, **in December 2005, the European Council reached an agreement on the Financial Perspective 2007-2013** as set out by the Council [European Council 2005e; Council 2005g]. As it was expected, the annual structure of the EU budget will be similar to the present one in the coming years. But at the same time it was announced that *"the European Council (…) invites the Commission to undertake a full, wide ranging review covering all aspects of EU spending, including the CAP, and of resources, including the UK rebate, to report in 2008-2009. On the basis of such a review, the European Council can take decisions on all the subjects covered by the review. The review will also be taken into account in the preparatory work on the following Financial Perspective"* [Council 2005g]. Let's hope that the initiated changes will prove to be irreversible and the recently agreed financial framework will have a

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(especially to the new Member States as regards cohesion policy); it would also have negative consequences on the ratification of the Constitution, undermine the relaunch of the Lisbon Strategy and create a climate of uncertainty around attempts to boost the European economy [Commission 2005p].

[37] The Luxembourg Presidency had three priorities. First, it wanted to reform the Stability and Growth Pact (and it was achieved in March 2005). Next, it intended to give new impetus to the Lisbon Strategy (it was also achieved in March 2005 and the Integrated Guidelines were adopted for the first time in the EU's history in June 2005). Finally, it hoped to reach an agreement on the new EU Financial Perspective for 2007-2013 – but that priority failed in mid-June 2005 (two weeks after the French and Dutch referendums on the Constitutional Treaty).

[38] The British call for a more rational budget was not the first one in the EU. In autumn 2004, Michaele Schreyer, Member of the European Commission responsible for the budget, stated in his speech about the financial framework for 2007-2013: *"I would still ask if such a budget structure, where about 45% goes to one sector (agriculture) is forward looking. It quite clearly isn't. It will not be possible – also not at the European level – to rise to the challenges of the future with the structures of the past"* [Schreyer 2004].

transitional character. If so, the successive frameworks (from 2014 onwards) will have to be substantially amended according to the reformed provisions and adjusted to the needs of the enlarged Union consisting of almost 30 Member States and intending to play a leading role in the world.

Acording to the above-mentioned Sapir Report, **the EU budget – in its present form – is a historical relic**. Its expenditures, revenues and procedures are all inconsistent with the present and future state of European integration. Almost half of its spending is directed to supporting the sector whose economic significance is declining (i.e. agriculture), while convergence policy is not focused on activities it should support. Besides, more than 90% of the EU budget is financed via national contributions linked to the national treasuries, rather than from taxes levied on the EU-wide fiscal bases. According to the authors of the report, the EU budget should focus on spending on those economic and social areas where it is best able to make a contribution to growth and solidarity in Europe. And, in their opinion, this implies a **radical restructuring of the EU budget** to support the growth agenda in line with the Lisbon objectives. It could be achieved by maintaing the overall size of the EU budget at the present level (about 1% of EU GDP) and – at the same time – regrouping its spending into some new instruments or funds [Sapir *et al.* 2003]:

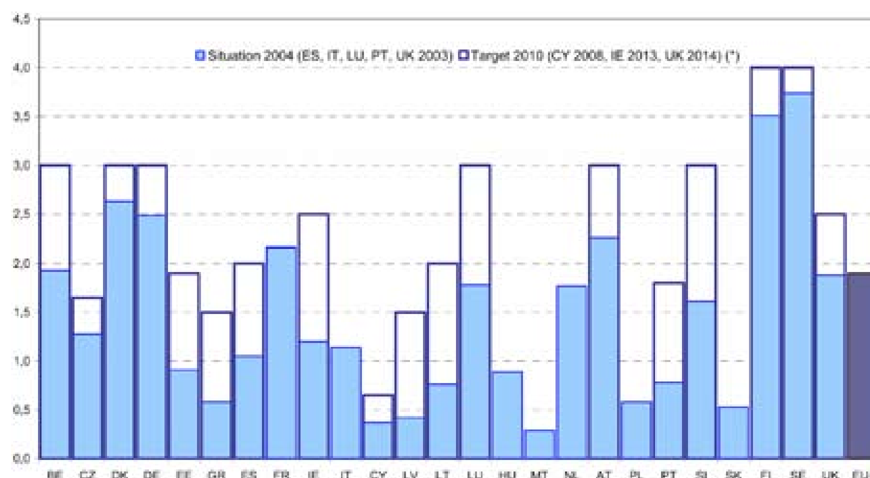
- a **growth fund** (about 45% of the budget) – including expenditures for research and development (R&D), education, training and infrastructure; resources for growth should be allocated on a competitive basis;
- a **convergence fund** (about 35% of the budget) – including mainly financial assistance for low-income countries to support their catching-up processes; resources for convergence should be allocated to countries on the basis of their income level;
- an **economic restructuring fund** (about 20% of the budget) – including generally aid to the agricultural sector and aid to displaced workers; resources for restructuring should be allocated to individuals anywhere in the EU based on their economic circumstances.

The above (potential) structure of the EU budget implies **a very sizeable (or even sharp) reduction in the amount devoted to agriculture**. The proposed shift away from traditional expenditures (such as the CAP) means of course a radical step away from the present situation, but it is indispensable and justifiable. According to the authors of the report, if the Union is serious and determined to achieve growth and solidarity in enlarged Europe, **the EU budgetary framework should move away from the present inertia and be radically restructured**. Such restructuring would enable the budget to play a more clearly defined role in achieving the Union's 2010 objectives [Sapir *et al.* 2003]. For example, if **spending on R&D are part of the biggest fund of the restructured EU budget**, it would be more likely that the Barcelona target of 3% of GDP for R&D spending (of which ⅔ should be financed by the private sector and ⅓ by the public sector) will be reached in the future – although surely beyond the Lisbon horizon.

It is worth to analyze this issue briefly because **knowledge and innovation are regarded as the engines of sustainable growth** in the EU (and in the euro area as well). At the present moment spending on R&D in the EU and in the euro area amounts to 1.9% of GDP (see: figure 4.4), of which public expenditures on R&D have stabilized at about 0.7-0.8% of GDP in recent years. This European indicator of 1.9% of GDP (which has remained unchanged since 1999 in the case of both the EU and the euro area) is compared to around 2.7% of GDP in the United States and 3.1% of GDP in Japan. The gap between the US and the EU amounts

currently to about 120 billion EUR per year. In principle, the main contribution to spending on R&D should come from the private sector. But in order to achieve this goal it is necessary to increase public spending as well, and thereby strengthening the leverage effect of public R&D investment on private R&D investment. The EU needs also to step up its **investment in higher education** [Commission 2005j]. It should be aimed at devoting at least 2% of GDP to higher education by 2010 – taking into account that the EU spends currently only 1.28% of GDP compared to 3.25% in the United States (the gap is mainly due to greater private funding in the US). Too low investment in education is one of the reasons resulting in the fact that today Europe has not a sufficient number of scientists and researchers (about 5 per 1000 workforce compared to 9-10 per 1000 in the US and Japan) and, moreover, it is rather weak in translating results of research and knowledge into innovative (unique, high-value, high-quality) products and services that could boost competitiveness; in contrast, this capacity has emerged as the most important competitive asset of the United States [Porter, van Opstal 2001]. In order to compete internationally, the EU (or the euro area) has to deliver the above-mentioned **innovative products and services**, i.e. some attractive products and services that people from practically all over the world would like to purchase. This issue has been recently raised by the Commissioner responsible for Information Society and Media, who emphasized the crucial role of ICT in productivity growth and stated that the future developments of the whole EU economy would depend on progress in that area. In this context, she recalled that at the moment Europe still lagged behind its major competitors in investing in ICT (not only the US and Japan, but also China, Korea and Asia in general). Therefore, it is essential that the share of ICT (in the 7th Framework Programme) would not be reduced in the recently agreed Community budget for 2007-2013, but even increased (if possible) because **ICT should have the budget that reflects its key role for the economy.** It is important that the increase of Community funding for ICT research should be also matched by a higher share for research in the budgets of the Member States [Reding 2006]. For that reason – in order to reduce the innovation gap between the EU and its main competitors and ensure good prospects of the development of the EU (and euro-area) economy – there is the real need for a far-reaching reform of the European innovation system, a new impetus to the European ICT research and innovation agenda, as well as focused and coordinated actions in this regard [Commission 2006a; Reding 2006]. The above approach was confirmed by the recent Spring European Council (March 2006), which also supported the establishment of some new institutions for R&D/ICT, such as the European Institute for Technology and the European Research Council [European Council 2006a].

Figure 4.4.
Gross domestic spending on R&D in the EU Member States (as % of GDP)



* DK >3%; IE as % of GNP (not GDP); NL aim at a "top 5" position.

Source: Commission 2006a.

With reference to the second major expenditure category of the present EU budget – the Structural and Cohesion Funds and policies – the European Commission, relaunching the Lisbon Strategy at the beginning of 2005, stated that **it is necessary to reform both the role of the Structural Funds and the EU cohesion policy.** In its opinion, the EU will contribute to the Lisbon objective of more and better jobs by mobilizing its expenditure policies. The next generation of the Structural Funds (including those for rural development) will be reshaped with this in mind – focusing on how it can help deliver growth and jobs at the local level [Commission 2005d]. Similarly, in its recent Annual Progress Report on Growth and Jobs (of January 2006), the Commission stated that in order to foster competitiveness, regional cohesion and benefit SMEs, **it is necessary to spend a significantly greater share of the Structural Funds on research and development, innovation, as well as information and communication technologies** [Commission 2006a]. Some time later, it was also confirmed by the Commissioners responsible for Regional Policy as well as for Science and Research. According to the recent, although currently there are some Structural Funds investments in research and innovation,[39] these areas will be one of the top priorities for the Structural Funds in the future – as one of the three overarching Community strategic guidelines is *"improving knowledge and innovation for growth"*, which sets out investment priorities in such areas as R&D, innovation and enterprise, ICT, and financial engineering. And, in general, regional policy should act as a catalyst for innovation through its support for innovative approaches [Hübner 2006a,b]. And the latter recalled that at the end of 2005 the EU leaders reached an agreement on the Community budget for the period 2007-2013, but – in his opinion – that agreement did not match the level of ambition that was set out in the original Commission's proposals (especially in relation to those areas best capable of

[39] The support of the Structural Funds for research, technological development and innovation (RTDI) amounts at the present moment to 10.5 billion EUR in the form of grants. About 97% of this support is made through the European Regional Development Fund (ERDF). Around 8% of total ERDF resources are invested into research and innovation. The support of the Structural Funds for RTDI falls into four types of activity: (i) research projects based in universities and research institutes receive about 26% of total RTDI investment (some 2.7 billion EUR); (ii) research and innovation infrastructure (public facilities, but also technology transfer centres and incubators) receives slightly over 25% of the total (about 2.8 billion EUR); (iii) innovation and technology transfer and setting up networks and partnerships between businesses and/or research centres receives about 37% of the total (some 3.6 billion EUR); (iv) training for researchers (co-financed by the ESF) receives about 3% of the total (around 350 million EUR). This type of project is supported through the European Social Fund (ESF) [Commission 2006c].

currently to about 120 billion EUR per year. In principle, the main contribution to spending on R&D should come from the private sector. But in order to achieve this goal it is necessary to increase public spending as well, and thereby strengthening the leverage effect of public R&D investment on private R&D investment. The EU needs also to step up its **investment in higher education** [Commission 2005j]. It should be aimed at devoting at least 2% of GDP to higher education by 2010 – taking into account that the EU spends currently only 1.28% of GDP compared to 3.25% in the United States (the gap is mainly due to greater private funding in the US). Too low investment in education is one of the reasons resulting in the fact that today Europe has not a sufficient number of scientists and researchers (about 5 per 1000 workforce compared to 9-10 per 1000 in the US and Japan) and, moreover, it is rather weak in translating results of research and knowledge into innovative (unique, high-value, high-quality) products and services that could boost competitiveness; in contrast, this capacity has emerged as the most important competitive asset of the United States [Porter, van Opstal 2001].

In order to compete internationally, the EU (or the euro area) has to deliver the above-mentioned **innovative products and services**, i.e. some attractive products and services that people from practically all over the world would like to purchase. This issue has been recently raised by the Commissioner responsible for Information Society and Media, who emphasized the crucial role of ICT in productivity growth and stated that the future developments of the whole EU economy would depend on progress in that area. In this context, she recalled that at the moment Europe still lagged behind its major competitors in investing in ICT (not only the US and Japan, but also China, Korea and Asia in general). Therefore, it is essential that the share of ICT (in the 7th Framework Programme) would not be reduced in the recently agreed Community budget for 2007-2013, but even increased (if possible) because **ICT should have the budget that reflects its key role for the economy.** It is important that the increase of Community funding for ICT research should be also matched by a higher share for research in the budgets of the Member States [Reding 2006]. For that reason – in order to reduce the innovation gap between the EU and its main competitors and ensure good prospects of the development of the EU (and euro-area) economy – there is the real need for a far-reaching reform of the European innovation system, a new impetus to the European ICT research and innovation agenda, as well as focused and coordinated actions in this regard [Commission 2006a; Reding 2006]. The above approach was confirmed by the recent Spring European Council (March 2006), which also supported the establishment of some new institutions for R&D/ICT, such as the European Institute for Technology and the European Research Council [European Council 2006a].

Member States are potential members of the euro area – provided they will fulfil the necessary conditions. Finally, in comparison with the euro-area countries, the new Member States exhibit some fundamental economic differences which reflect their economic history. As it is known, most of these countries (excluding Cyprus and Malta) have experienced the transformation process from centrally planned to market economies during the 1990s. They have some considerable achievements in terms of macroeconomic stabilization, but at the same time they are still significantly underdeveloped in comparison with the mature economies of the old EU Member States. It is confirmed by the fact that the recent accession of the 10 new Member States has not changed significantly the overall economic features of the EU. In fact, the population of the Community has increased by about 20%, but the economic weight of the enlarged EU has increased by only 5%, reflecting the lower level of GDP in the new Member States [Commission 2004j; ECB 2004b].

The debate on the future enlargement of the euro area started quite early – some years before the enlargement of the EU (and just after the launch of EMU in 1999).[41] At the beginning, there were considerations related to a way and timing of the adoption of the euro by the EU candidate countries, mainly the Central European countries (CECs), which at that time were expected to become the new Member States of the EU in some years. In this context, it is worth to mention about **the debate on two opposite concepts concerning the adoption of the single currency – a gradual (multi-stage) process of the introduction of the euro vs. unilateral euroization**.

Some authors recommended that the new Member States should join the euro area as soon as possible, suggesting even a unilateral adoption of the euro prior to the EU accession – so-called "euroization" or **"unilateral euroization"** [Rostowski 1999; Bratkowski, Rostowski 2000; 2001; Rostowski 2001]. Having based on the existing concepts (e.g. "dollarization"), they modified them for the EU candidate countries, of which the biggest one – Poland. They proposed to replace the Polish currency (the zloty) by the euro as quickly as possible – not only before joining the euro area, but even before Poland's membership in the EU (preferably, with the acceptance of the EU). According to the authors, zloty cash in circulation and in bank vaults would be replaced by euro notes and coins which could be bought with large international reserves of Poland. At the same time, all zloty-denominated bank deposits, private contracts, wages and tax obligations would be redenominated into euro using the "conversion rate" chosen by the Polish Government [Bratkowski, Rostowski 2001]. In their opinion, unilateral euroization would be very beneficial for Poland (and some other CECs) from an economic point of view because of, *inter alia*, a reduction in short-term interest, savings in government expenditures, accelerated economic growth, etc. Other authors considered some economic costs and benefits of euroization as well as proposed to introduce the euro as a parallel currency in the accession countries [Buiter and Grafe 2001; 2002].

On the other hand, some other authors stated that – after a detailed analysis of the economic effects of unilateral euroization – **the often cited benefits of euroization seemed to be**

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[41] Some authors indicate that the concept of the early introduction of the euro was raised for the first time by J.Drnovsek, Slovenian Prime Minister, who stated in December 1996 that Slovenia would do its best to join EMU as soon as possible, perhaps even before its full membership in the EU. But in the subsequent years the debate on "euroization" remained rather subdued (or was even faded out at all) – until early 1999, when C.Menem, former President of Argentina, launched the debate on "dollarization" in Latin America. And shortly after that, some similar proposals (concerning "euroization") were announced in some countries of Central and Eastern Europe, e.g. Poland and Estonia [Backé, Wójcik 2002]. The most active debate on euroization took place in 2000 and 2001. After that it has gradually faded out again.

much less clear than they would appear to be at first sight, while the costs and risks would be really considerable [Wójcik 2000; 2001]. For example, it was indicated that unilateral euroization would involve giving up seignorage income as well as the central bank's function of the lender of last resort [Haussmann 2001; Begg *et al.* 2001]. Moreover, some authors argued that unilateral euroization involved various economic costs, which would not arise in the case of full participation in EMU according to the standard rules. In the worst scenario, unilateral euroization might even render the fulfilment of the Maastricht convergence criteria more difficult or costly than some alternative monetary regimes [Backé, Wójcik 2002]. As a result, the strategy of unilateral euroization would involved a serious risk that the date of official EMU entry would be highly uncertain and probably much delayed [Gomułka 2001]. Last but not least, some authors argued that **unilateral euroization – although technically feasible – was politically unacceptable** because practically all the EU institutions (Commission, ECB, ECOFIN Council, European Council), as well as some of the Member States, strongly opposed that concept; therefore, the idea of euroization should be abandoned and **the standard (gradual) approach** should be applied – divided into some successive stages (phases), such as: a pre-accession period, membership of the EU, participation in the ERM 2, and finally – full participation in EMU, i.e. the adoption of the euro [Szeląg 2001b; Wójcik 2001].

The political unacceptability of unilateral euroization was clearly confirmed by the main institutions of the EU. For example, the Commission indicated in its report prepared for the ECOFIN Council (of November 2000) that the concept of euroization is incompatible with the Community law, the existing rules of the negotiation process and the economic rationale of the EU accession. Moreover, in the Commission's opinion, there was no possibility of a unilateral adoption of the currency of another currency area [Commission 2000b]. Similarly, in November 2000, the ECOFIN Council stated in its conclusions that *"it should be made clear that any unilateral adoption of the single currency by means of "euroization" would run counter to the underlying economic reasoning of EMU in the Treaty, which foresees the eventual adoption of the euro as the endpoint of a structured convergence process within a multilateral framework. Therefore, unilateral "euroization" would not be a way to circumvent the stages foreseen by the Treaty for the adoption of the euro"* [Council 2000b]. The ECOFIN Council's report was submitted to the European Council in Nice (in December 2000), which confirmed that all exchange rate strategies of the EU candidate countries, aimed at the final adoption of the euro, would have to stipulate their participation in the exchange rate mechanism after the accession to the EU [European Council 2000b]. Finally, the ECB – similarly like the ECOFIN Council – stated that euroization would not be a commendable procedure for the candidate countries to adopt the euro because it would invalidate the underlying economic reasoning of EMU, which had foreseen the eventual adoption of the euro as the endpoint of the convergence process within a multilateral framework. Therefore, given its Treaty mandate and responsibilities, the ECB was not in a position to enter into any agreement to support euroizing countries [ECB 2000b].

After the above debate of 2000-2001 it was clear that the introduction of the euro in the new Member States would be conducted in a similar way as it had been in the case of the other euro-area countries (which adopted the single currency in 1999 and 2001). It was confirmed that – in line with the Treaty provisions – the adoption of the euro by the new Member States had to be understood as a complex and multilateral (not unilateral) process, spread over time and segmented into some successive stages. Moreover, it had to be regarded as a

structured convergence process conducted upon the fulfilment of certain conditions – the so-called Maastricht convergence criteria (of both economic and legal natures). Although practically all observers agreed with such an approach, **some economists started another debate: are the convergence criteria suitable for the new Member States?** The debate was related mainly to the following criteria: price stability and exchange rate stability.

With reference to the criterion of **price stability**, some economists indicated that the new Member States tended to experience **higher inflation rates** than most of the euro-area countries. One of the most popular and frequently cited explanation of this phenomenon is the so-called **Balassa-Samuelson effect** [Balassa 1964; Samuelson 1964]. According to the Balassa-Samuelson hypothesis, there is higher overall inflation in catching-up countries than in more mature economies (e.g. those of the euro area) because of higher productivity growth differentials between tradables and non-tradables sectors in these (catching-up) countries.[42] The size of the Balassa-Samuelson effects in the new Member States is estimated by various authors and according to more or less different methods. In general, it is assessed that productivity differentials can explain, on average, between 0.2 and 2.0 percentage points of differences in annual inflation between (some of) the Central European countries vis-à-vis the euro area [Mihaljek, Klau 2003; see also: Szapáry 2000; Buiter, Grafe 2002; von Hagen, Zhou 2003]. There are, however, quite significant differences in estimates among various authors; in some cases the Balassa-Samuelson effects is regarded as insignificant or rather low (between roughly 0 and 1 percentage point) [De Broeck, Sløk 2001; Coricelli, Jazbec 2001; Égert 2002; Arratibel, Rodriguez-Palenzuela, Thimann 2002], while in some other cases – considerably higher (even 2 to 4 percentage points) [Kovács, Simon 1998; Rother 2000; Halpern, Wyplosz 2001; Fischer 2002]. All in all, the above estimates suggest that differences in productivity growth between the new Member States and the euro-area countries are unlikely to widen sufficiently to become a determining factor in the ability of the former to meet the Maastricht inflation criterion [Mihaljek, Klau 2003].

Taking into account the above argumentation, some economists called for either **the amendment of the inflation criterion or its different interpretation in relation to the new Member States.** For example, it is argued by some authors that the price stability criterion regarding inflation should be adapted to the fact that EMU now exists. Its original interpretation was understandable at the moment of the launch EMU, but it no longer makes sense to apply this criterion after the enlargement of the EU. The larger the number of the Member States, the higher the probability that the three best-performing countries will have extremely low inflation rates (and they might not even belong to the euro area[43]). Therefore, it is suggested that the basis for calculating the maximum allowable inflation rate for the candidates for the euro area should be modified by referring to "at most 1.5 percentage points above the average of the euro area" (and not to "the three best-performing Member States in terms of price stability"). This would allow the candidates to join the euro area without having to artificially depress demand because the 1.5-percentage-point margin

[42] In a hypothetical catching-up economy, consisting of two sectors – (i) tradables and (ii) non-tradables (usually services), prices in the tradables sector tend to adjust over time to those of a country being its main trading partner (this adjustment is based on the current exchange rate). Because of the catching-up process, productivity growth in the tradables sector of such a country should be higher in comparison with its more mature trading partner. Hence, it would be possible to increase wages in the tradables sector without losing competitiveness. But it should be noted that it is likely that this increase of wages could spill over to the non-tradables sector where productivity growth is lower. As a result, prices in the non-tradables sector are likely to increase as well, resulting in picking up the overall inflation rate in a catching-up country. And it is likely that this increase in inflation would be higher than the one in its more mature trading partner [Commission 2004j].

[43] For example, in the recent Convergence Reports (of May 2006), the three best-performing Member States in terms of price stability were Sweden, Finland and Poland, i.e. two countries staying outside the euro area.

roughly corresponds to estimates of the Balassa-Samuelson effect [Szapáry 2000; Gros 2004]. At the same time, some other authors argue that **changes to the current convergence criteria are neither economically necessary nor politically justifiable**. One reason is that the Treaty is a solid and comprehensive foundation for the enlargement process (of both the EU and the euro area). There are both clearly defined procedures and economically founded requirements that must meet at different stages of the integration process. Another reason is the universal rule of equal treatment, according to which the same rules which were applied to the current members should be applied to the new entrants [König 2001]. Finally – taking into account, *inter alia*, the latter argument that the old and new Member States should be equally treated – the Maastricht convergence criteria (including that of price stability) have not been amended.

With reference to the criterion of **exchange rate stability**, it was quite unclear what should be understood by the term "standard fluctuation band" within the new exchange rate mechanism (ERM 2) – which was established by the European Council in order to link the currencies of the EU Member States staying outside the euro area to the euro [European Council 1997a]. And **what fluctuation band (a wide or narrow one) should be applied in order to fulfil the exchange rate criterion**? It was unclear because the original participants of the ERM 2 applied different fluctuation bands, i.e. **±15%** and **±2.25%** around the central rate (Greece and Denmark respectively).[44] According to the ECB, the ERM 2 is a multilateral arrangement of fixed but adjustable exchange rates with the central rate and the standard fluctuation bands of ±15% around the central rate. Nevertheless, some narrower fluctuation bands may be adopted at the request of the Member State concerned.[45] Such decisions should be made on a "case-by-case" basis and would be regarded as exceptional – as they were in the past – taking into account that the standard band is appropriate for the Member States which are engaged in the convergence process. Therefore, multilaterally agreed narrow bands could only be considered at a very advanced stage of convergence, as it was in the case of Denmark [ECB 2003b]. In this context, it should be noted that a few years ago the Commission stated that merely respecting the ±15% fluctuation band would not be sufficient to meet the Maastricht exchange rate criterion [Commission 2003g]. Those contradictory positions could be (and were indeed) confusing for the new Member States – especially taking into account that both the Commission and the ECB were empowered by the Treaty to prepare the Convergence Reports. Finally, in order to solve this problem, it is suggested to use an **asymmetric fluctuation band**, i.e. a band with an upper margin of +15% and a lower margin of -2.25% (taking into account that some or even most of the CECs' currencies tended to appreciate against the euro). According to some authors, this asymmetry stems from the reading of the criterion on exchange rate stability, according to

[44] Moreover, before the ERM crisis in 1993, the prevailing ±2.25% fluctuation bands provided a basis for the interpretation of the criterion on exchange rate stability, i.e. a given currency was regarded as meeting the criterion if its bilateral nominal exchange rates vis-à-vis the other currencies participating in the ERM were kept within a tunnel of 4.5% around the central parity without severe tensions. But the above-mentioned ERM crisis entailed the necessity to widen the fluctuation bands to ±15%. On the one hand, that decision allowed the ERM to survive, but on the other, it faced a lot of critical opinions (as exchange rate fluctuations of 30% around the central parity seemed to be unable to ensure exchange rate stability). Moreover, the interpretation of the exchange rate criterion became less clear than before. As a result, the provision concerning *"the normal fluctuation margins (…) without severe tensions"* has given rise to alternative but not necessarily conflicting practices when interpreting the criterion [Égert, Kierzenkowski 2003].

[45] According to the IMF, potential participants of the ERM 2 may opt for a narrow fluctuation band (e.g. ±2.25%) because of many reasons. First, participants of the ERM 2 may be uncertain about both the Commission's and the ECB's interpretations of the criterion on exchange rate stability and thereby wish to aim for an outcome that will almost certainly be accepted by these institutions as consistent with stability. Second, it may be expected by participants of the ERM 2 that they could enhance the credibility of their parity and, therefore, limit or minimize some upward pressures on their final conversion rate by constraining the market rate within the narrow band. Third, participants of the ERM 2 may be highly confident about the strength of their supporting policies and decide to apply a narrow band arragement because it is administratively easier, but substantively similar to a hard peg [Schadler *et al.* 2005].

which *"the Member State shall not have devalued its currency's bilateral central rate against any other Member State's currency on its own initiative"*; by contrast, the criterion is largely silent on the re-valuation of the central parity [Égert, Kierzenkowski 2003]. Surprisingly, such an approach (assuming the application of an asymmetric fluctuation band) was suggested even earlier by the Commission in its Convergence Report 2000, where it stated that *"a distinction would be drawn between movements above the 2.25% upper margin and movements below the 2.25% lower margin, with only the latter potentially indicating severe tensions within the ERM 2"* [Commission 2000a].

According to the IMF, the discretion afforded the ECB and the Commission in interpreting the fulfilment of the Maastricht criterion on exchange rate stability, as well as the previous participants' experiences in both the ERM and ERM 2, resulted in **a great debate about what the exchange rate criterion really required**. First of all, as mentioned above, how much exchange rate volatility would be consistent with this criterion? Next, would a two-year participation in the ERM 2 be obligatory? Next, would the ECB marginal interventions be a major source of support for the CECs' currencies within the ERM 2? And finally, would the use of capital controls be completely prohibited in the ERM 2 (taking into account that the EU accession required full liberalization of capital accounts)? [Schadler *et al.* 2005]. In particular, the mandatory length of participation (minimum two years before the examination) was often criticized by the new Member States that intended to stay in the ERM 2 as short as possible – no more that two years (and preferably much shorter, if possible) – because of possible speculation attacks against their currencies and thereby possible exchange rate instability. But according to the EU institutions, e.g. the ECB, the length of participation in the ERM 2 should be assessed in terms of what could be most helpful in accompanying the convergence process, rather than in relation to the required minimum period of two years. Thus, in some cases, the new Member States may be interested in prolonging their participation in the ERM 2 while further convergence takes place – as there are no restrictions on the length of stay beyond the minimum period [Solans 2002; ECB 2003b]. It is also argued that the ERM 2 should not be regarded as a mere "waiting room" before the adoption of the euro, but rather as a "testing room" [Papademos 2004; Issing 2005a]. In the ECB's opinion, the ERM 2 is particularly useful for the catching-up economies (such as the new Member States) because of a number of reasons. First, it can foster policy discipline towards stability, i.e. by requiring the adoption of a consistent monetary and economic policy framework, it can help establish a stable macroeconomic environment and, moreover, it can also act as a catalyst for structural reforms. Second, the ERM 2 can enhance policy credibility and help guide expectations because the central parity of a given currency vis-à-vis the euro provides guidance to foreign exchange markets and investors; in turn, it should contribute to greater exchange rate stability. Moreover, by anchoring inflation expectations, the ERM 2 participation can also speed up the process of disinflation and reduce overall inflation volatility in a given country. But – as it is underlined by the ECB – although the ERM 2 can be helpful in stabilizing expectations if sound policies are in place, no exchange rate mechanism can replace good policies [Issing 2005a].

As it is known very well, according to the Treaty, the new Member States are obliged to fulfil the Maastricht convergence criteria – i.e. to achieve a high degree of sustainable convergence (in order to ensure the smooth functioning of EMU). This is related to two kinds of convergence: (i) **legal convergence**, i.e. compatibility of national legislation with the Treaty and the ESCB/ECB Statute, and (ii) **nominal convergence**, i.e. fulfilment of some

macroeconomic criteria based on monetary and fiscal indicators, such as inflation (price stability), long-term interest rates, public finances quality (budget deficits and public debt), and exchange rate stability. Therefore, it would be necessary to analyze their recent **macroeconomic performance** against the reference values (as in the 2004 Convergence Reports [Commission 2004n; ECB 2004d]). Moreover, it seems to be interesting to compare it with the analogous performance of the euro-area countries.

As far as **price stability** is concerned, all the new Member States have made remarkable progress in bringing their high and volatile inflation rates down to low levels (mainly owing to exchange rate and monetary policy frameworks, which have taken a clear anti-inflation stance). As of the end of 2003, some months before the enlargement of the EU, the average level of consumer price inflation in those countries reached 2.1% (which corresponded to the euro-area average at that time), but inflation rates varied significantly between the new Member States and ranged from –1.1% in Lithuania to 8.5% in Slovakia (Lithuania, similarly like the Czech Republic experienced deflation in 2003). As of the end of 2005, the average rate of inflation increased slightly in the new Member States and reached 2.3% (similarly like in the euro area) and ranged from 1.7% in the Czech Republic to 6.8% in Latvia (no country experienced deflation last year).

Together with the above progress in disinflation, there has been impressive convergence of **long-term interest rates** in the new Member States in recent years. For example, in 2000 the highest long-term interest rates were in Poland and Estonia (11.8% and 10.5% respectively) and in the run-up to the EU they were significantly reduced – by roughly half in both cases (to 5.8% and 5.3% respectively). According to the Commission, the fall in long-term interest rates in these countries has been fostered by positive market sentiment and the decline in risk premiums triggered by the prospect of their accession to the EU [Commission 2004j]. Despite that progress, just before the enlargement of the EU, the average rate for the new Member States (5.3% in 2003) was still clearly higher than the corresponding rate of the euro area at that time (4.1%). After the enlargement a further reduction in the average level of long-term interest rates has been observed in both the new Member States (4.4%) and in the euro area (3.3%).

Turning to **public finances**, consisting of both general government deficits/surpluses and government debt, the picture is mixed. Before the EU enlargement, for the new Member States as a whole, the average **general government deficit** amounted to 5.7% of GDP in 2003 (in comparison with 4.9% of GDP in 2002), well above the euro-area average (2.5% and 3% of GDP in 2002 and 2003 respectively). But it should be noted that there were some significant differences between some countries, e.g. Estonia posted a surplus of 2.6% of GDP, while other countries had general government deficits ranging from 1.2% of GDP in Latvia and Lithuania to 10.4% of GDP in Hungary and 12.5% of GDP in the Czech Republic. As assessed by the Commission, the fiscal position of the new Member States deteriorated due to various factors, e.g. because of the loosening of fiscal policy (Poland), slippages (Czech Republic, Hungary), and the inclusion of state guarantees (Czech Republic, Malta). Moreover, in most of the new Member States, general government deficits seem to be primarily of a structural nature [Commission 2004j]. According to the recent Commission's forecasts (of May 2006), there is a clear improvement in fiscal consolidation in the new Member States (the average general government deficit amounted to 2% of GDP as of the end of 2005 – compared to 2.4% of GDP in the euro area). But it necessary to keep in mind

that at the present moment half of the new Member States (namely the Czech Republic, Cyprus, Hungary, Malta, Poland and Slovakia) are still the subject of the excessive deficit procedure – as a result of the Council's decisions and recommendations of 5 and 6 July 2004 respectively [Council 2004a,b].

In contrast to general government deficits, public debt levels are relatively low in the new Member States. Prior to the EU enlargement, their aggregate **government debt** ratio reached 42.2% of GDP in 2003, well below the euro-area average of 70.4% of GDP. At the present moment this situation looks very similar. As of the end of 2005, the lowest level of public debt was noted in Estonia and Latvia (5.1% and 12.8% of GDP respectively). The only countries with debt ratios above 60% of GDP were the smallest ones – Cyprus and Malta. Although public debt levels are generally low, some countries (such as the Czech Republic, Malta and Poland) have experienced in recent years certain developments in their debt dynamics that – in the Commission's opinion – may constitute a threat for the sustainability of their public finances in the future [Commission 2004j].

Finally, as far as **exchange rate stability** is concerned, progress is uneven across the new Member States. The first group of countries – Estonia, Lithuania and Slovenia – joined the ERM 2 and started to stabilize their currencies (kroon, litas and tolar respectively) against the euro with effect from 28 June 2004. The next group of the new Member States – Cyprus, Latvia and Malta – included their currencies (pound, lats and lira respectively) into the ERM 2 with effect from 2 May 2005. The most recent participant of the ERM 2 is Slovakia which has stabilized its currency (koruna) against the euro since 28 November 2005 [ECB 2004c; 2005b,f]. All those countries stabilize their currencies in the ERM 2 within the wide fluctuation band, i.e. ±15% around the central parity (similarly like Greece in 1999-2000, but in contrast to Denmark – see: table 4.3). Taking into account the Treaty requirement to particpate in the ERM 2 for a period of at least two years prior to the convergence examination without severe tensions (in particular without a devaluation against the euro), it would be possible for the above first group of the new Member States participating in the ERM 2 to fulfil the exchange rate criterion in June 2006.

Table 4.3.

Participants, central parities and fluctuation bands of the ERM 2
(from 28 November 2005 onwards)

Country and currency	Central rates / fluctuation bands	1 EUR =
Denmark Danish krone (DKK)	Upper rate (+2.25%)	7.62824
	Central rate	**7.46038**
	Lower rate (-2.25%)	7.29252
Estonia Estonian kroon (EEK)	Upper rate (+15%)	17.9936
	Central rate	**15.6466**
	Lower rate (-15%)	13.2996
Cyprus Cyprus pound (CYP)	Upper rate (+15%)	0.673065
	Central rate	**0.585274**
	Lower rate (-15%)	0.497483
Latvia Latvian lats (LVL)	Upper rate (+15%)	0.808225
	Central rate	**0.702804**
	Lower rate (-15%)	0.597383
Lithuania Lithuanian litas (LTL)	Upper rate (+15%)	3.97072
	Central rate	**3.45280**
	Lower rate (-15%)	2.93488
Malta Maltese lira (MTL)	Upper rate (+15%)	0.493695
	Central rate	**0.429300**
	Lower rate (-15%)	0.364905
Slovenia Slovenian tolar (SIT)	Upper rate (+15%)	275.586
	Central rate	**239.640**
	Lower rate (-15%)	203.694
Slovakia Slovak koruna (SKK)	Upper rate (+15%)	44.2233
	Central rate	**38.4550**
	Lower rate (-15%)	32.6868

Source: ECB 2005g.

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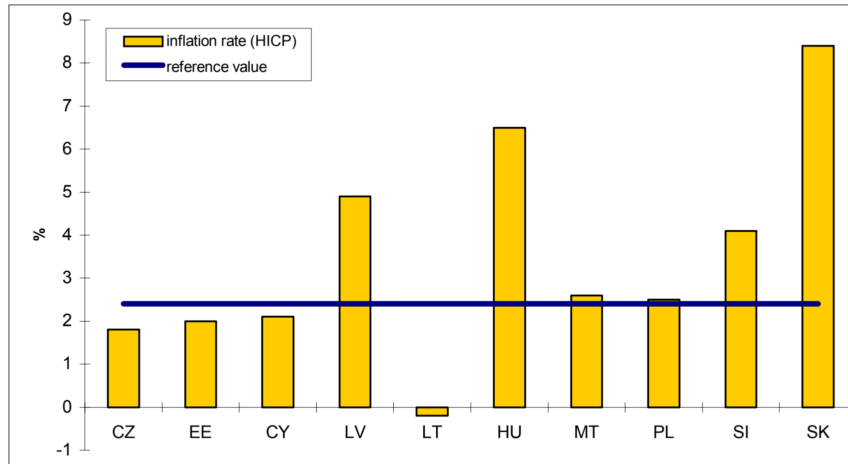
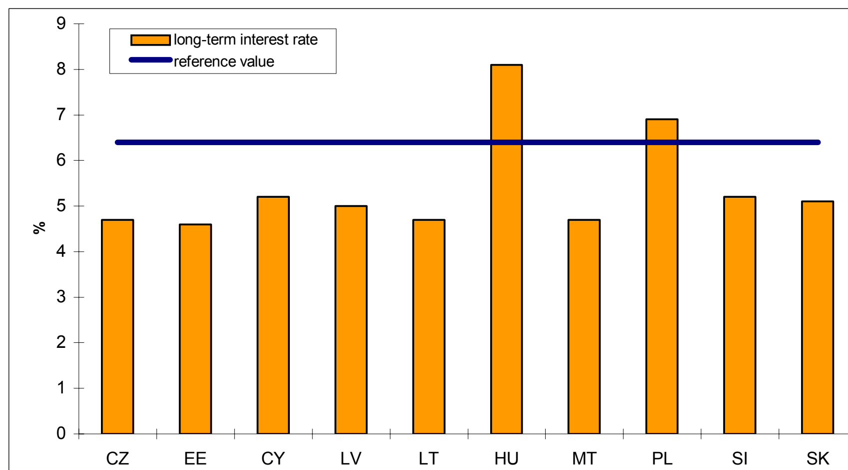
Figure 4.5.
Fulfilment of the convergence criteria in the new Member States

a) price stability (August 2004)



b) long-term interest rates (August 2004)



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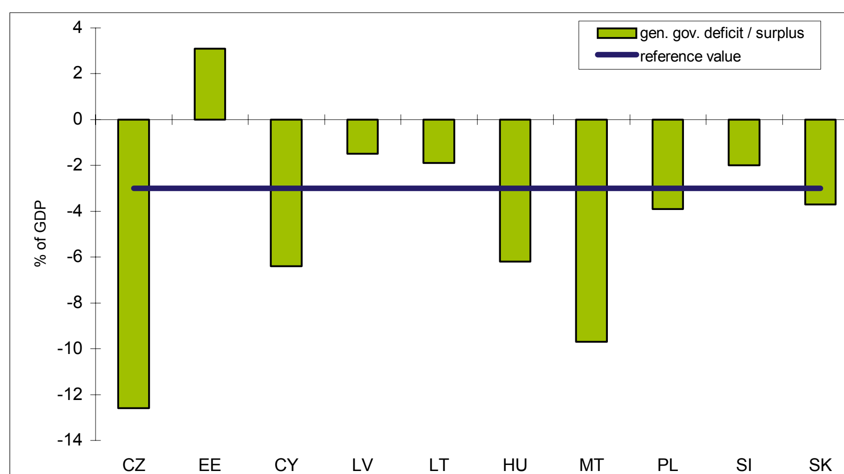
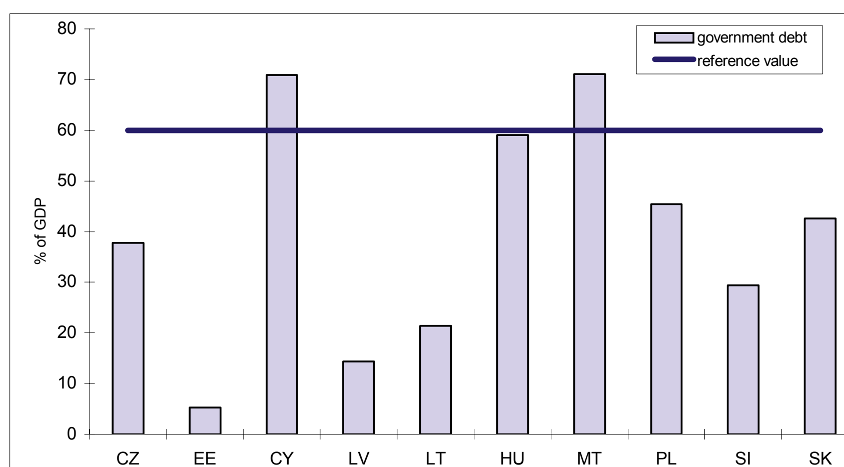
c) general government deficit / surplus (2003)



d) governmnet debt (2003)



Source: own elaboration based on: Commission 2004n; ECB 2004d.

For the first time, progress of the new Member States related to their fulfiling the convergence criteria was assessed in the **Convergence Reports 2004**, published in October 2004 (some months after the enlargement of the EU). Those reports covered the following eleven Member States with derogations: the ten newly acceded countries (Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia, and Slovakia) as well as Sweden (which – contrary to the UK and Denmark – has no "opt-out" clause).[46] Progress was different depending on a given criterion and a country concerned (see: box 4.1 and table 4.4). For example, none of the above countries has fulfilled the criterion concerning the legal compatibility, while the vast majority of them have met the criterion of long-term interest rates. Sweden has fulfilled almost all the economic criteria, while Poland has fulfilled none of

[46] The United Kingdom and Denmark have "opt-out" arrangements stipulated in the Treaty (Article 4 of the Protocol on certain provisions related to Denmark and Article 10(a) of the Protocol on certain provisions related to the UK). In consequence, they have a special status in comparison with the rest of the Member States as regards the adoption of the single currency. In 2004, neither the UK nor Denmark were examined by the Commission and the ECB in their Convergence Reports because they had not indicated their willingness to join the euro area.

them. All in all, in the light of their assessments, both the Commission and the ECB have concluded that there should be no change in the status of all the assessed countries (being “the Member States with a derogation”) and, accordingly, **none of the examined Member States should be recommended to join the euro area** and adopt the single currency [Commission 2004n; ECB 2004d].

Table 4.4.
Fulfilment of the convergence criteria in the new Member States
(as assessed in the 2004 Convergence Reports)

	Legal compatibility	Price stability		Government budgetary positions			Exchange rate stability	Long-term interest rates	
Reference values	--	2.4%		-3% and 60% of GDP [a]			2 years in ERM 2	6.4%	
Czech Rep.	no	1.8	yes	-12.6	37.8	no	no	4.7	yes
Estonia	no	2.0	yes	3.1	5.3	yes	no	(4.6) [b]	--
Cyprus	no	2.1	yes	-6.4	70.9	no	no	5.2	yes
Latvia	no	4.9	no	-1.5	14.4	yes	no	5.0	yes
Lithuania	no	-0.2	yes	-1.9	21.4	yes	no	4.7	yes
Hungary	no	6.5	no	-6.2	59.1	no	no	8.1	no
Malta	no	2.6	no	-9.7	71.1	no	no	4.7	yes
Poland	no	2.5	no	-3.9	45.4	no	no	6.9	no
Slovenia	no	4.1	no	-2.0	29.4	yes	no	5.2	yes
Slovakia	no	8.4	no	-3.7	42.6	no	no	5.1	yes
Sweden	no	1.3	yes	0.3	52.0	yes	no	4.7	yes

[a] -3% of GDP – general government deficit (positive value = general government surplus); 60% of GDP – government debt.

[b] Due to the absence of a harmonized benchmark long-term government bond or comparable security, an interest rate indicator has been identified, based on bank lending rates.

Source: own elaboration based on: Commission 2004n; ECB 2004d.

Box 4.1.
Convergence Report 2004 (extract):
Overview of compatibility of legislation and achievement of economic convergence

The content of the reports prepared by the Commission and the ECB is governed by Article 121(1) of the Treaty, which requires that the reports include an examination of (i) the compatibility of national legislation with the Treaty as well as with the ESCB and of the ECB. The reports must also examine whether a high degree of sustainable convergence has been achieved, by reference to the four convergence criteria relating to (ii) price stability, (iii) government budgetary positions, (iv) exchange rate stability and (v) long-term interest rates as well as a number of additional factors (...).

(i) compatibility of national legislation

Compatibility of national legislation, including the statutes of the national central banks, with Articles 108 and 109 of the Treaty and the Statute of the ESCB/ECB must be ensured. As far as the new Member States are concerned, the independence of their respective national central banks and the latter’s compliance with the ESCB’s objectives have been taken care of as part of the pre-accession requirements. However, in order to ensure the full integration of the different national central banks into the ESCB before the Member States concerned join the euro area, incompatibilities need to be resolved in the legislation of all countries.

(ii) price stability

The assessment of the price stability criterion is based on the observance of an average inflation rate over a period of one year before the examination, that does not exceed by more than 1.5 percentage points that of, at most, the three best-performing Member States in terms of price stability. The reference value was calculated to be 2.4% in August 2004, with Finland, Denmark and Sweden as the three best-performing Member States. Of the eleven Member States analyzed in this report, five fulfil this criterion, namely the Czech Republic, Estonia, Cyprus, Lithuania and Sweden.

(iii) government budgetary positions

The criterion on government budgetary positions is linked to the decisions made in accordance with the excessive deficit procedure in Article 104 of the Treaty. At present, five of the eleven Member

States examined are not the subject of a Council decision under Article 104(6) on the existence of an excessive deficit, namely Estonia, Latvia, Lithuania, Slovenia and Sweden, which therefore fulfil the criterion.

(iv) exchange rate stability

The exchange rate criterion requires the observance of the normal fluctuation margins of the exchange rate mechanism (ERM II) for at least two years without severe tensions. On 28 June 2004, the Estonian kroon, Lithuanian litas and Slovenian tolar joined ERM II. The Czech koruna, Hungarian forint, Cyprus pound, Latvian lats, Maltese lira, Polish zloty, Slovak koruna and Swedish krona have not yet joined ERM II. While the three currencies participating in ERM II since 28 June 2004 have been stable vis-à-vis the euro, no country examined has participated in ERM II for the required period. None of the eleven Member States fulfils the exchange rate criterion.

(v) long-term interest rates

The long-term interest rate criterion is based on the observance, over a period of one year before the examination, of an average nominal interest rate that does not exceed by more than 2 percentage points that of, at most, the three best-performing Member States in terms of price stability. The reference value was calculated to be 6.4% in August 2004. Long-term interest rates were below the reference value in the Czech Republic, Cyprus, Latvia, Lithuania, Malta, Slovenia, Slovakia and Sweden. These eight Member States were found to meet the interest rate criterion. For Estonia, where no long-term government bonds or comparable securities are available, there are no reasons to conclude that Estonia would not fulfil the interest rate criterion.

Source: Commission 2004n.

As we can see, progress towards meeting the convergence criteria is varying significantly among the new Member States. These countries differ considerably not only in nominal, but also in real and structural terms, as well as they adopt and conduct very different monetary and exchange rate policies and strategies. For that reason, it is obvious that this diversity of economic situations and policy strategies causes that there is no single path towards the euro area for new members and they should be assessed on a "case-by-case" basis [Papademos 2004]. It is reflected in their national plans related to the potential dates of joining the euro area. At the moment, taking into account the so-called **target dates of the planned adoption of the euro**, countries staying outside the euro area (including both the new and old Member States) could be divided into four groups [Commission 2005v; 2006t]:

- the Member States that are going to adopt the euro as soon as possible (in **2007 or 2008**), i.e. Estonia, Lithuania and Slovenia (participating in the ERM 2 since June 2004) as well as Cyprus, Latvia and Malta (participating in the ERM 2 since May 2005);
- the Member States that will be able to adopt the euro in a longer perspective (not earlier that **2009 or 2010**), i.e. Slovakia, the Czech Republic and Hungary (not participating in the ERM 2 with the exception of Slovakia which has participated in the ERM 2 since November 2005);
- the Member States that have set **no target dates** of the planned adoption of the euro, i.e. Poland and Sweden (not participating in the ERM 2);
- the Member States that have **no precise plans** related to the adoption of the euro, i.e. Denmark and the United Kingdom (both having an "opt-out" clause).

The above **target dates mean not only joining the euro area, but at the same time the introduction of euro notes and coins into circulation**. The vast majority of the new Member States prefer to adopt the single currency applying the "big bang" scenario rather than the Madrid scenario involving a transitional period. As it is known, for practical and logistical reasons, the current euro-area countries introduced the **transitional period** of 3 years between the adoption of the euro as their currency (1 January 1999), and the

introduction of euro cash (1 January 2002).[47] It was the so-called **Madrid scenario**. Some years later it was assessed that the transitional period of 3 years was too long and, in consequence, some momentum was lost after 1999 and the use of the "scriptural" euro was rather limited during the transitional period. Taking into account those experiences, it is not advisable for the future euro-area entrants to apply a long transitional period. The main reason is related to the fact that euro banknotes and coins have existed for many years and most citizens in the new Member States are already familiar with them. Moreover, the size and extent of the necessary preparations to the euro changeover will be much limited than previously because most of the new Member States are much smaller in comparison with the present members of the euro area. The main alternative is the so-called **"big bang" scenario in which the date of joining the euro area coincides with the cash changeover date (€-day)**, i.e. the date of the introduction of euro banknotes and coins into circulation in a given country. This approach has a number of advantages (if well prepared, it can ensure the rapid and smooth transition), but there are also some disadvantages (e.g. it reduces the period available for the public and private sectors, and citizens generally, to prepare for the changeover) [Commission 2004p]. In this context, the Commission and the Council agreed that it should be possible for the Member States, if they want, to benefit from a special form of the above scenario, i.e. a **"big bang" scenario combined with a "phasing-out" period** (of maximum 1 year). During this period of time it would be possible to continue to make reference to the national currency unit in some new legal instruments, notably those concerning pecuniary amounts and rights, e.g. invoices, price catalogues, price displays, order forms, cheques, transfer forms, letters of credit, accounting, sales contracts, etc. [Schäfer 2006]. It would give economic actors in such countries more time to adapt to the introduction of the euro and therefore ease the transition). This option – similarly like the above two options – was included into the recently amended regulation on the introduction of the euro, which was adopted at the end of December 2005 and entered into force in January 2006 [Council 1998; 2005h]. But at the moment the new Member States are rather not interested in applying this special form of the "big bang" scenario combined with a "phasing-out" period.

It should be noted that **the national changeover plans – notably those assuming the most rapid joining the euro area – can experience some difficulties regarding their implementation**. As it is known, the introduction of the single currency is not only related to the fulfilment of the convergence criteria, but also to many practical preparations regarding the introduction of euro notes and coins into circulation (such as production of notes and coins, their frontloading and sub-frontloading, preparation of ATMs, IT systems, etc.). It requires a relevant time span between the decision of the Council on the abrogation of the derogation and the so-called €-day (similarly as it was in the case of Greece: the Council's decision – June 2000 (after the positive assessment in the Commission's and the ECB's Convergence Reports of May 2000); and the €-day – 1 January 2001). An analogous scenario was assumed in the case of some new Member States (Estonia, Lithuania and Slovenia). They expected that the Convergence Reports 2006 would be prepared by the Commission and the ECB in June 2006 (the Commission indicated 12 June 2006 as a potential date in this regard) in order to allow the Council for abrogating the derogation(s) and setting the irrevocable conversion rate(s) in mid-2006. In such a scenario these Member States would have about half a year to complete all the necessary preparations (what seems to be a sufficient period of time in the case of small countries) and join the euro area on 1

[47] In the case of Greece this period was limited to 1 year because it joined the euro area on 1 January 2001.

January 2007. But in the first quarter of 2006 the Commission stated that it intended to prepare its Convergence Report in October 2006 (instead of June 2006). The official reason was the fact the previous Convergence Reports had been published in October 2006 and the Treaty requires preparing these reports at least once every two years (or at the request of a Member State with a derogation). And this means that the necessary Council decisions could be taken not earlier that in October or November 2006 – only one or two months before the planned €-day. Of course, it will complicate and delay the whole process (making it impossible – at least for some of the above-mentioned countries – to join the euro area on 1 January 2007).

It was confirmed in spring 2006. Taking into account the above attitude of the Commission, as well as the fact that the Treaty requires assessing the fulfilment of the criteria for full participation in EMU by the Member States with a derogation not only at least every two years, but also at the request of any of these Member States, the Slovenian and Lithuanian authorities asked the Commission and the ECB (on 2 and 16 March respectively) to assess whether these countries met the necessary conditions for adopting the euro. The third country of those planning the most rapid adoption of the euro – Estonia – has not asked the EU institutions to assess its readiness to join the euro area.[48] Two months later, in mid-May 2006, both institutions released their Convergence Reports 2006 [Commission 2006n,o; ECB 2006d]. The Commission concluded that Slovenia fulfilled all the convergence criteria[49] and achieved “a high degree of sustainable economic convergence” with the other euro-area members (see: table 4.5). Therefore, the Commission recommended **Slovenia to join the euro area on 1 January 2007**. In the case of Lithuania, the Commission stated that it met all the convergence criteria except the one on price stability. At the time of assessment (in March 2006), the average rate of 12-month inflation in Lithuania (2.7%) stood slightly above the reference value (2.6%). Moreover, it was expected to rise gradually until the end of the year (to 3.5%). For that reason, the Commission concluded that, at the present stage, there should be **no change in Lithuania’s status as the Member State with a derogation**. The final decisions were taken in June and July 2006. First, in mid-June 2006, the European Council welcomed the Commission's proposal that Slovenia should adopt the euro on 1 January 2007 [European Council 2006b]. And then, in mid-July 2006, the ECOFIN Council adopted a decision allowing Slovenia to adopt the euro as its currency as from 1 January 2007, and – at the same time – a regulation fixing a permanent conversion rate between the Slovenian tolar and the euro (amending the Regulation 2866/98 accordingly).[50] It means about six months to prepare for the changeover (as Slovenia has chosen a “big bang”

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[48] It was likely due to relatively high inflation in Estonia in recent years and expecting that it would be assessed as non-compliance with the criterion on price stability. In May 2006, when the Convergence Reports on Lithuania and Slovenia were published, the Estonian authorities announced that it had set a new target date for the adoption of the euro, i.e. 1 January 2008 (instead of 1 January 2007). In their opinion, it seemed to be the date by which Estonia would be able to meet the only problematic criterion – related to price stability. It should be, however, noted that according to the most recent economic forecasts of the Bank of Estonia (of end-April 2006), the inflation rate in Estonia is expected to decline to 3.6% in 2006 and to 3.0% in 2007, but in 2008 it will accelerate back to 3.7%. In such a situation – in opinion of the Estonian central bank – meeting the Maastricht inflation criterion may become possible in the first half of 2007, when the inflation rate will reach its lowest level [Bank of Estonia 2006]. It seems to be rather a risky strategy taking into account that the convergnece criteria should be fulfilled on a permanent (and not just one-off) basis. One can doubt whether the fulfilment of the inflation criterion would be in this case in line with the necessity to achieve “a high degree of sustainable economic convergence” (as required by the Treaty).

[49] In fact, the Slovenian tolar – similarly like the Lithuanian litas – has participated in the ERM 2 since 28 June 2004 and, therefore, at the time of assessment (in spring 2006) its participation in this mechanism was a bit shorter than two years (as required by the Treaty). However, keeping in mind that the final decisions in both cases (Slovenia and Lithuania) will be taken by the ECOFIN Council on 11 July 2006, it was possible to assume that the currencies of these countries will have participated for over two years in the ERM 2 by the time of this decision. Moreover, since the beginning their participation in the mechanism, both the tolar and the litas have remained stable and close to their central rates. Thus, as of the end of June 2006, the criterion on exchange rate stability will have been fulfilled in both cases (Slovenia and Lithuania).

[50] The permanent (irrevocable) conversion rate was set at 239.64 Slovenian tolars to the euro, which corresponded to the current central rate of the tolar within the ERM 2.

scenario, the adoption of the euro in this country will occur at the same time as the issuing of euro notes and coins) [Council 2006c].

Table 4.5.
Fulfilment of the convergence criteria in Lithuania and Slovenia
(as assessed in the 2006 Convergence Reports)

	Legal compatibility	Price stability		Government budgetary positions			Exchange rate stability	Long-term interest rates	
Reference values	--	2.6%		-3% and 60% of GDP [a]			2 years in ERM 2	5.9%	
Lithuania	yes	2.7	no	-0.5	18.7	yes	yes	3.7	yes
Slovenia	yes	2.3	yes	-1.8	29.1	yes	yes	3.8	yes

[a] -3% of GDP – general government deficit (a positive value means general government surplus); 60% of GDP – government debt.

[b] Due to the absence of a harmonized benchmark long-term government bond or comparable security, an interest rate indicator has been identified, based on bank lending rates.

Source: own elaboration based on: Commission 2006n,o; ECB 2006d.

The above events seem to confirm that at the present moment **there is neither positive political climate nor political will to enlarge the euro area very rapidly**. Recently, especially last and this year, there was a growing number of opinions that **the enlargement of the euro area in 2007 would be premature** (maybe with the exception of Slovenia which is richer than some of the present members of the euro area, such as Portugal). For example, in January 2006, the Bundesbank analyzed the structures and developments of the current accounts in the central and eastern EU Member States and their potential impact of foreign investments and joining EMU. In its report, the Bundesbank referred to the fact that most of the eight new Member States from central and eastern Europe posted **large current account deficits** over the past few years, which were mainly associated with the economic catching-up process. This phenomenon – together with a real appreciation of their currencies (which accompany the catching-up process and hamper a reduction in current account deficits) – could negatively influence some investment, saving and consumption decisions. In this context, the Bundesbank stated that *"the Eurosystem requirement for a sufficient degree of real convergence to be achieved prior to accession to European monetary union is therefore also justified given the effects on the current account situation. Joining the euro area too early would make it difficult to set an adequate conversion rate. With imperfect price flexibility, a misvaluation could expand the current account positions in Europe and give rise to matching adjustment costs"* [Bundesbank 2006].

Some commentators – referring to the above-mentioned plans of Estonia, Lithuania and Slovenia to join the euro area in 2007– state that the existing debates in the EU about the enlargemnent of the euro area (discussing e.g. the inflation criterion and the Balassa-Samuelson efect) should be regarded as not fully honest, or even dishonest, because the inflation rates of the above countries (especially Estonia and Lithuania) pose no economic problem at all – neither for themselves nor for the rest of the euro area. **The real reason why Estonia and Lithuania should not adopt the euro in the near future is the fact that they are still to poor and their economies are not flexible enough.** And *"one of the main economic lessons from EMU is that one should not join a monetary union, unless the economy is sufficiently flexible"* [Munchau 2006]. But the author complaints that this issue is not raised by the EU institutions (Commission, ECB) in their official reports. Only a few reports, e.g. the above Bundesbank's report (of January 2006), indicate the potential risks

connected with too early adoption of the single currency by some countries (of which the most important risk is the choice of wrong conversion rate). On the other hand, some economists argue that **Estonia and Lithuania could fare well in the euro area** [Mody, Rosenberg 2006]. They do not neglect the importance of factor and product market flexibility for success in a monetary union, but in their opinion, it seems to be the wrong conclusion that low *per capita* incomes imply inflexibility because, in fact, both Estonia and Lithuania have rather flexible economies (in many cases much more flexible than some richer countries of the euro area). The above economists agree that it would be dangerous to join the euro area at an overvalued exchange rate, but they underline that this risk is the same for all countries (i.e. there is not a bigger risk for poor countries than for rich ones). With reference to large current account deficits, indicated by the Bundesbank, they argue that large deficits can be a sign of overvaluation, but at the same time it can also be a sign of large investment inflows as a result of capital scarcity, relatively high rates of return and – last but not least – flexible economic structures. And for such countries (having flexible economic structures and strong fiscal policies) closer trade and financial integration within the euro area could result in hastening catching up and thereby real convergence. Therefore, the latter (real income and productivity convergence) should not be regarded as a prerequisite for joining the euro area, but – on the contrary – as a result of adopting the euro (as it was in the case of Ireland).[51]

In general, during the above debate on the enlargement of the euro area, there were two main positions concerning the enlargement of the euro area – to some extent complementing each other, and to some extent contradictory. On the one hand, in recent years it has been stated repeatedly that the principle of equal treatment was still valid and applicable, and thereby some comparable situations and cases would be treated in a comparable manner, both across countries and over time [Papademos 2004; Issing 2005a]. On the other hand, it was more and more frequently argued by some observers that the new Member States should not be assessed entirely on the basis of the Maastricht criteria (as it was in the case of the current euro-area members) because they ignore **the problem of real convergence and the so-called real economy**, i.e. income, productivity, jobs, wages, business cycle correlations, trade, etc. [Frankel 2005; Munchau 2006]. EMU is a learning-by-doing process, and it has been learnt that **nominal convergence was proved to be not enough to assess a given country's suitability and readiness to adopt the euro**. For that reason, and keeping in mind that the Treaty explicitly requires "a high degree of sustainable convergence" as a condition of the euro-area membership, there should be a broader economic assessment of the potential candidates in relation to their effective and lasting ability to participate in the single currency area [Ahearne, Pisani-Ferry 2006].

Similarly, in opinion of some European institutions (e.g. the Commission or the ECB), expectations related to the timing of the introduction of the euro in the new Member States should be based not only on their progress in achieving nominal convergence (including their filfilment of the Maastricht criteria), but also should take into account some economic factors, including **real convergence**, i.e. catching up to the EU income levels (GDP *per capita*) and

[51] Similar argumentation was presented just before the introduction of the euro in 1999. According to some economists, some countries may seem to be rather poor candidates for the euro area (examining their historical data), but EMU entry may increase substantially their integration and economic links with the euro-area members (resulting eventually in much more correlated business cycles). And this confirms that such countries are more likely to satisfy the necessary criteria to join EMU rather *ex post* than *ex ante*" [Frankel, Rose 1998]. Today it is still argued by some economists that intensified trade between the new and old Member States (including the euro-area countries) will not only enhance the openess of the former (and thereby make them a better fit for EMU), but also raise their income growth [Frankel 2005].

adjusting real economic structures to those existing (prevailing) in the euro area. In this context, the ECB argues that although the Treaty does not stipulate a direct assessment of real convergence (e.g. in terms of a country's GDP *per capita*), *"there is another notion of real convergence that relates to the adjustment of economic structures and institutions, be it in labour or product markets, or with regard to administrative capacity and judicial efficiency"*. According to the ECB, such a concept of real convergence – sometimes labelled **"institutional" or "structural" convergence** – plays a key role in determining the overall economic performance of a given Member State and it has an impact on the achievement and sustainability of nominal convergence. Therefore, nominal and real convergences are interdependent processes reinforcing each other [Papademos 2006].

Of course, real convergence is usually related to income levels (measured by GDP *per capita*). In this context, it is argued that the new Member States – in order to close their income-per-capita gap with the present members of the euro area – need to:

- raise labour productivity;
- increase employment rates.

With reference to the former, average labour productivity of the new Member States amounts to just above half of that of the EU-15 (only the smallest ones – Cyprus, Malta and Slovenia – display labour productivity levels above the lowest productivity level among the old Member States). According to the Commission, the differences in labour productivity among the new Member States reflect to some (large) extent their income-per-capita differences relative to the EU-15 [Commission 2004j]. With reference to the latter, the average employment rate of the new Member States is well below the EU average (which is *notabene* relatively low compared to the Lisbon targets); only the above-mentioned smallest countries have employment rates above the euro-area average.

Real convergence is regarded as an important factor of monetary integration within the EU, but at the same time its importance should not be overestimated. As it is argued, convergence of economic structures is not sufficient to guarantee that the economies of the new Member States will perform successfully and benefit from their future membership in the euro area. But, at the same time, it should be noted that real convergence decreases the likelihood of asymmetric shocks [Issing 2005a]. Although there is no doubt regarding the importance of real convergence, it is argued that the level of real GDP *per capita* should not be itself a criterion for joining EMU. The deciding question should be whether countries characterized by some significant divergences in comparison with the euro-area members have taken (or not) the necessary measures to limit (minimize) some potential risks associated with their participation in the euro area – e.g. whether they conduct prudent macroeconomic polices and carried out microeconomic (structural) reforms – in order to avoid some (potentially painful) adjustments after joining the euro area [Ahearne, Pisani-Ferry 2006]. All in all, taking into account the above argumentation related to real convergence, it is worth to analyze briefly some **structural characteristics** of the new Member States regarding their economies and markets [Backé, Thimann *et al.* 2003; Commission 2004j; 2006q]:

- **the overall structure of the economy** – the transition process in the central and eastern European countries has led to a significant increase in the size of the private sector as well as to large shifts in the sectoral composition of GDP and employment (from agriculture and industry to services). Nevertheless, agriculture is still a much more

important sector of the economy in the new Member States than in the euro-area countries. In the former, the average share of employment in agriculture is more than three times higher than in the EU. And the share of value added of agriculture is almost twice as high as that of the euro area. Accordingly, the share of value added and employment in services (being a determinant of modern economies) is apparently lower in comparison with both the EU and the euro area. It confirms that, in general, the economies of the newly acceded countries have more obsolete structures compared to those of the old Member States;

- **labour markets** – practically since the very beginning of the transition to the market economy, most of the new Member States have experienced a sharp decline in employment and, at the same time, rapid increases in unemployment. The average unemployment rate in the new Member States is almost twice as high as that of the euro area. It is assessed that unemployment in the new Member States is mostly a structural problem rather than a cyclical one – what is confirmed by **the persistence of high levels of unemployment** in some of them (especially high rates of long-term unemployment, youth unemployment, and unemployment among low-skilled workers – in comparison with the euro-area members). The structural nature of unemployment in the new Member States is also confirmed by its **concentration in some regions or groups** in most of these countries – what is explained by rather low occupational and interregional labour mobility in these countries.[52] The smooth functioning of labour markets in the new Member States is hampered by some significant **structural rigidities**, such as relatively high tax burdens on labour, generous social benefits, easy access to early retirement and disability schemes, etc.;
- **product markets** – with the transition to the market economy, these markets have undergone some major structural changes, in particular through such processes as enterprise restructuring and privatization. In most of the new Member States, the privatization process is almost completed. But in some of them (e.g. Poland) it is still far from being completed and the public sector remains relatively large; and restructuring the agricultural sector remains one of the key challenges too. Moreover, there is still substantial state aid in some of the new Member States – distorting competition in their product and service markets (which is still relatively weak in most of them in comparison with the EU) and, in turn, having a negative impact on the smooth functioning of the whole economy. In most new members, the structural changes of their economies have been stimulated by large FDI inflows (mainly from the EU);
- **financial markets** – these markets have also experienced some considerable changes since the beginning of the transition process, but they still lag behind the old Member States in terms of stock market capitalization, liquidity, financial intermediation, etc. (with reference to the latter, only the smallest EU members – Cyprus and Malta – have

[52] It should be added that cross-border labour mobility between the old and new Member States is also limited by some transitional arrangements agreed during the accession negotiations. Those agreements were negotiated because some of the old Member States had afraided of serious disturbances in their labour markets after the enlargement of the EU – due to expected mass inflows of workers from the new Member States. The transitional agreements, which apply to the new Member States with the exception of Cyprus and Malta, may restrict their citizens' access to labour markets of the old Member States for maximum 7 years – according to the so-called "2+3+2" rule. Since 1 May 2004, only the United Kingdom, Ireland and Sweden have opened their labour markets for workers from the new Member States. In spring 2006, almost two years after the enlargement of the EU, the Commission examined the situation and invited the other Member States to open their labour markets. Since 1 May 2006 some of the Member States – Spain, Portugal, Greece and Finland – have opened their labour markets entirely. At the same time, some other Member States (especially Germany and Austria) decided not to open their labour markets at the present moment – although the economic rationale for maintaining restrictions on the free movement of workers after the date of accession is much weaker than often assumed before (see e.g. Commission 2006q). After the next three years, the remaining Member States which still restrict access to their labour markets will be again invited to open them – from 1 May 2009 onwards. Finally, on 1 May 2011 all restrictions will be removed and thereby all labour markets will be open for all the EU citizens.

reached a level comparable with the euro-area average). The financial sectors of the new Member States are characterized by the apparent dominance of banks and rather little-developed capital markets. A further characteristic of their financial systems is substantial foreign ownership, which can be observed in all market segments, but mostly in the banking sector.[53] Overall, despite the above differences, the degree of financial integration between the new Member States and the euro area seems to be relatively high – *inter alia*, in terms of the similarity of their financial structures and institutions, as well as their supervisory and regulatory frameworks (which contribute to greater financial stability). As it is often argued, the experience of the present euro-area members suggests that the eventual adoption of the euro will further boost financial integration, increase the homogeneity of structures and the efficiency of banks and capital markets;

In general – taking into account the existing macroeconomic and structural characteristics of the recently acceded countries – it is necessary to indicate that there are some significant **challenges facing the new Member States on their road to the adoption of the euro**. As it is often argued, in order to ensure a successful participation in the euro area, it is required, *inter alia*, to reduce the susceptibility of a given country to asymmetric shocks and enhance its adjustment capacity for absorbing such shocks – given the absence of such instruments as independent monetary and exchange rate policies. In this context, the following issues are regarded as especially important [Commission 2004j]:

4

- **synchronization of the business cycles with the euro area** – it should be strong between the members of EMU because only in such a case it could reduce the likelihood of asymmetric shocks within the euro area. As it was argued even before the introduction of the euro, participation in a monetary union may result in more intensified trade between its members and, in turn, in more correlated business cycles. And, indeed, EMU is characterized by a very high degree of cyclical convergence / synchronization between the participating Member States.[54] Empirical evidence suggests that the GDP growth rates of the new Member States are becoming increasingly correlated with those of the euro area. In this context, however, some economists indicate that the so-called **shock symmetry** between a given country and a monetary union is likely to change after joining that union (in practice, the euro area). For that reason, while some of the new Member States exhibit already a really high degree of shock symmetry with the euro area (and thereby they seem to be ready to join the euro area), some others might benefit from waiting for some time (e.g. five years) when their vulnerability to asymmetric shocks diminishes (or shock symmetry increases) [Frankel 2005];
- **fiscal policy** – it will play a key role in stabilizing the economy in both before and after the adoption of the single currency. Therefore, one of the crucial tasks should be creating sufficient budgetary room for manoeuvre in the case of unpredictable shocks. In

[53] Foreign investors are mostly from the EU and in many of the new Member States they are owners of more than 80% of the total banking assets (this is well above the average share of cross-border ownership in the EU). On the one hand, it is argued by some of the EU institutions (e.g. the Commission) that a high degree of foreign ownership contributes to the overall stability of the banking sectors. On the other, a very high share of foreign capital in the economy (and, in particular, in the financial sector) is the basis of political and social complaints in some of the new Member States (e.g. in the largest one – Poland).

[54] According to the Commission, cyclical synchronization between the euro-area Member States decreased shortly after the mid-1990s, but renewed with a moderate upward trend after 2000 and then – some years after the introduction of the euro – reached the highest level in the past two decades. This cyclical convergence is largely an EMU-specific factor rather than a reflection of the emergence of a global business cycle. The following forces have contributed to the greater synchronization between the euro-area members' business cycles since the launch of EMU: product and financial market integration as well as convergence of macroeconomic policies within the euro area. Taking into account that EMU is a major driving force of economic integration, it is expected to foster cyclical convergence/synchronization further in the coming years [Commission 2004f].

order to attain this goal, it will be necessary to implement public finance reforms, continue fiscal consolidation, avoid high deficits, etc. – taking into account higher cyclical volatility of the new Member States in comparison with the present euro-area members;

- **wage and price flexibility** – despite the fact that the new Member States compare relatively well with the euro-area countries concerning wage flexibility, there is still sizeable scope for increasing price flexibility. In this respect, it seems to be essential for them to strengthen competition in their product markets (by e.g. further progress with privatization, better enforcement of competition rules, reducing regulatory burdens on business, etc). Overall, improving the adaptability of the new members to potential (unforeseen) shocks will require some fundamental structural reforms strengthening the resilience of their economies.

Moreover, one more challenge should be emphasized. Some authors argue that the new Member States, upon their accession to the euro area, might be confronted with excessive aggregate demand dynamics due to declining short-term nominal and real interest rates (possibly leading to inflationary pressures), as well as with the loss of export competitiveness (resulting in current account imbalances). With reference to the former, inflationary pressures and rising price levels could encourage wage developments which, if not matched by productivity growth, would lead to higher unit labour costs in the tradables sector. As a result of wage pressures in setting buoyant domestic demand, spurred by low (or even negative) real interest rates, the new Member States could potentially experience **the loss of competitiveness after joining the euro area**. Therefore, on the one hand, participation in a monetary union would ease the external financing constraints, but on the other, widening of **external imbalances** could lead to building up external debt that might be unsustainable in the longer term [Backé, Thimann *et al.* 2003]. In this context, it is worth to mention that fiscal policy can also play a vital role in maintaining external sustainability. As mentioned before, some of the new Member States have relatively high current account deficits. Thus far it has been justified by the catching-up process because such economies require investments exceeding domestically available savings. And, in countries exhibiting high current account deficits, fiscal policy can play a crucial role by keeping their imbalances between investments and savings on a sustainable level [Issing 2005a]. This confirms the above statement that sound public finances and appropriate fiscal policies in the new Member States will play a key role in stabilizing their economies – not only in the run-up to the adoption of the euro, but also beyond this time horizon.

5

Potential future (long-term) evolution from coordination of national economic policies to the single economic policy in the EU

As we can see from the previous chapters, the introduction of the euro has influenced the EU's economic policy almost from the very beginning of the launch of EMU. And it seems that in the course of time the impact of the single currency will be even stronger. The proposals so far and the results of improving and strengthening coordination of economic and budgetary policies within the EU or the euro area (presented in chapters 2 and 3) seem to be more or less enough to resolve some current problems, but they rather do not propose the complex and ultimate framework of economic policy within EMU in the long-term perspective.

Having regard the establishment of EMU – resulting in the introduction of the single currency and the formulation of the single monetary policy – some further ideas have been raised from time to time. They have indicated that consequently the single economic (and budgetary) policy should also be considered to be applied in the EU (or, at least, in the euro area). On the one hand, the above idea seems to be very logical and natural, but on the other, it is an extremely sensitive and controversial issue. It is fully understandable and justifiable because of the fact that economic policy, and especially the budgetary competences of the Member States, are regarded as an indication of their national sovereignty. Therefore, there is strong opposition related to a vision of the single economic/budgetary policy in the EU. It is natural because not long ago some Member States have resigned another part of their sovereignty – in the area of monetary and exchange rate policies. Undoubtedly, such a situation will remain unchanged in the coming years. Nevertheless, it is worth to consider whether the above idea of the single economic/budgetary policy is feasible (and desirable) in the longer-term.

5.1. Economic policy in the euro area – coordination or centralization?

The economic literature provides usually the following **rationales for economic policy coordination**. On a conceptual side, the calls for international policy coordination are based on the idea that individual (national) policies, which influence one another, should take into account one another's objectives and actions [Issing 2000]. First of all, coordination is regarded as a means of supplying public goods which decentralized actions are unlikely to produce. Next, **economic spillovers** between countries are very important, and the consequent relevance of coordination in assessing **economic policy externalities**.[55] Finally,

[55] In this context, it should be noted that many different types of spillovers can be distinguished in the euro area, e.g. external vs. internal spillovers, shock vs. policy-induced spillovers, direct vs. indirect spillovers, positive vs. negative spillovers, etc. Moreover, there are also several channels of spillovers from fiscal policies and structural reforms in the euro area, e.g. output channel, price channel, interest rate and exchange rate channel, government debt channel, structural reform channel, etc. For more details, see: Weyerstrass *et al.* 2006.

the need for coordination increases with the degree of economic interdependence between countries [Jacquet, Pisani-Ferry 2001; see also: Thygesen 1992; Masson 2000].

In the context of European economic and monetary integration, the issue of policy coordination is often addressed in terms of the institutional framework, i.e. the question arises whether decisions about a given policy instrument should be taken at the central level (the Community level) or should be decentralized (at the national, regional or local levels). Some authors argue that **the larger cross-border externalities associated with decentralized policy actions, the stronger the case for shifting decision-making powers to a higher level of government, possibly even to a supranational institution** being able to internalize all externalities and deliver more efficient policies. This is especially important for EMU because in a monetary union, irresponsible policies conducted by the individual Member States may negatively affect the overall economic performance of the other members. These negative consequences of irresponsible policies ("free riding") could be avoided by some coordinated actions. Hence, **all national policies generating substantial cross-border spillovers could be – to some extent – subject of policy coordination or centralization at the supranational level** [Beetsma, Debrun, Klaassen 2001; Weyerstrass *et al.* 2006]. For example, such decisions as that of the French government (of 1998) to shorten the length of the working week in France (from 39 to 35 hours), which was equivalent to a negative supply shock in France and had obvious implications for the other Member States as well as for the euro area as a whole (affecting aggregate output in the euro area and, in turn, the conduct of the single monetary policy by the ECB), should be – in some opinions – a matter of common concern, and thereby should not be allowed to be decided by individual countries without consultation with the other euro-area members [De Grauwe 2006a,b].

In Europe, **coordination of economic policies is regarded as a proper and desirable tool of cooperation within the EU and EMU**. It is characterized by a certain degree of advanced intergovernmental cooperation and a limitation of national prerogatives (because of some commonly agreed rules which must be applied). But at the same time it provides the Member States with the possibility to control the whole process. And this is regarded as a principal advantage of coordination. Policy coordination is also desirable because it seems that it involves practically no costs or only some small costs for participating countries.

Last but not least, it is sometimes argued that **improved policy coordination would reduce the frequency and scale of policy shocks**, and over time economic integration between some countries could further reduce **the likelihood of asymmetric shocks** or, at least, enhance their capacity to adjust smoothly to such shocks. It seems to be primarily important for the euro-area countries, because before the introduction of the euro many economists and observers had argued that EMU lacked the appropriate adjustment tools needed to respond to economic shocks, especially if the Member States were hit asymmetrically [Commission 2004j].

But more detailed analysis indicates that **policy coordination is relatively costly**. It is related mainly to substantial monitoring costs. Moreover, the coordination process seems to be extremely time-consuming and sometimes also not transparent. In any case, existing empirical research – although they differ in results to some extent – indicate generally that benefits from international policy coordination are usually rather limited [Ghosh, Masson

1994]. Moreover, the gains from coordination become smaller rather than larger as countries become more integrated [Obstfeld, Rogoff 2002]. In addition, there are some **serious practical problems and limitations** concerning policy coordination [Issing 2000]:

- first of all, coordination of individual policy areas may create serious problems related to gathering and analyzing all necessary information in a timely and effective manner. In consequence, there are often some decision-making delays in the case of coordinated policy making;
- next, policy coordination among many individual countries or institutions (policymakers) may result in confusing responsibilities, distorting incentives, reducing accountability of individual policymakers. It is argued that in the worst case scenario, if it is assumed that everyone is regarded as being responsible for everything, in practice no one will take responsibility for anything;
- and finally, the calls for policy coordination seem to ignore the political-economy context of practical policy making. For that reason, the implementation of coordinated policy decisions in the jurisdictions of some individual policymakers may suffer from a lack of relevant enforcement mechanisms which would help prevent “free riding” behaviour of some national policymakers.

With reference to the above argumentation, concluding generally that coordination is not a highly efficient form of decision-making and conducting a given policy, it is worth to consider whether **centralization of economic policy** within the euro area would be (or not) an appropriate alternative for coordination. Centralization – by definition – eliminates the vast majority of shortcomings attributed to coordination, such as time-consuming, inefficiency, lacking transparency, etc. In the case of policy centralization there are both a clear division of roles and assigning the responsibility for decisions. The decision-making process is shifted from a national level to a supranational one and decisions (made usually by majority voting) are directly binding for participating countries. Of course, centralization of economic policy means not necessarily full centralization of all existing functions by a central decision-making authority (government). **In principle, such a framework would be centralized, but to some extend it could (and should) be decentralized**; some functions would be left to a lower level of government (similarly as it is in the existing federal states).

The idea to create a European central decision-making body in the area of economic policy is not a new one. The so-called **Werner Plan** [Commission 1970] – stipulating the launch of a monetary union and the introduction of the single currency in the Community by 1980 – postulated to establish not only a “Community system for the central banks”,[56] but also a **“decision-making centre for economic policy”**. As a result, it meant shifting from policy coordination to the implementation of common economic and monetary policy. At the end of the previous decade, just before the introduction of the euro, some experts of the IMF[57] argued that adopting a European common currency represented a decisive step for the participating Member States towards closer integration and more centralized policy, despite different preferences among countries, might become not only possible, but necessary in the longer run, resulting eventually in the creation of a **“central fiscal authority” for EMU** [Cangiano, Mottu 1998]. Some years later, in 2001, German Minister Fischer proposed to

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[56] It is worth to mention that some proposals toward a supranational monetary system were made even some years earlier, in the second half of the 1960s [see e.g. Kenen 1967].
[57] Although the authors were the IMF’s employees, the views expressed by them in the IMF publications were their own and did not necessarily represent those of the Fund.

establish a **"strong European executive authority"** and French Prime Minister Jospin – an **"economic government for the euro area"** (see: section 4.1). And according to the European Commission, this is a natural situation at the national level in the EU Member States where governments and national parliaments have formal roles and clear division of responsibilities in relation to the formulation and implementation economic policy. Therefore, a similar situation should also be observed at the European level but there are neither a "central economic government" nor a formal role of the European Parliament in the process of economic coordination in the EU (or, at least, in the euro area) [Commission 2002b]. This idea has not been forgotten and even today, as mentioned before, there are some proposals to establish – after achieving a sufficient degree of political unification within the euro area – a **"central European government" with real power related to budgetary spending and taxation**, which would be independent of national governments and could complement macroeconomic management of the euro area (at the moment entrusted almost exclusively to the ECB) [De Grauwe 2006a].

It seems that the establishment of the above-mentioned supranational "economic government" or "central fiscal authority" could bring **numerous benefits for the euro area** [Szeląg 2003g; 2004a,b]:

- ending the present significant macroeconomic imbalance between centralized monetary policy and decentralized economic / budgetary policies within EMU (connected with the lack of sufficient fiscal discipline, the persistent risk of "free riding" behaviour of national governments, the partisan implementation of fiscal rules at the Community level, etc.);
- creating a real counterpart for the ECB and hence ending the present institutional imbalance within EMU;
- ensuring macroeconomic stabilization on the entire territory of the euro area (especially in the case of asymmetric shocks within a monetary union);
- eliminating excessive and harmful tax competition between the Member States ;
- ensuring the real (single) representation of the euro area in the international forums.

At the same time, however, it should be underlined that the above visions regarding a "central fiscal authority" or "economic government" for the euro area will only materialize, if **a sufficient degree of advanced political integration within EMU** is achieved, i.e. a real **political union** between the euro-area members. There are some proposals how such a political union should look like. According to some authors, it should consist of the following elements [De Grauwe 2006b]:

- first, a certain degree of "**budgetary union**", stipulating some discretionary power related to spending and taxation for a "European executive" (central European government), backed by its full democratic accountability. It would allow setting up a **system of fiscal transfers providing some insurance system against asymmetric shocks** within the euro area. Both issues would require to increase significantly the EU general budget – well beyond its present level of about 1% of GDP;
- second, **increased institutionalized coordination of a number of economic policy instruments** which have (or could have) some macroeconomic consequences for the other euro-area members (e.g. in such areas as social policies, wage formation, etc.). However, the need to coordinate does not mean that these areas should be fully

centralized; it rather implies that the spillover effects of decisions in these areas should be internalized within EMU;

- third, **significantly improved political accountability of the EU institutions** making currently major macroeconomic decisions (including the ECB).

In general, it is argued that a political union reduces the risk of asymmetric shocks – especially those having a political origin. Moreover, some of the above elements of a political union, e.g. a system of fiscal transfers, cause that member countries perceive their adherence to this union as being less costly than in the absence of such a system [De Grauwe 2006a,b]. This is true provided that this transfer system has a temporary character (i.e. it is used only in the case of asymmetric shocks); otherwise, if this system becomes a system permanent transfers from richer to poorer regions, it is likely to be perceived by the former that their membership in such a union is relatively costly.

As mentioned before, a "central European government", being the result of a political union within the euro area, could contribute significantly to the real (single) representation of the euro area in the international forums. It seems it is worth to say some words about this issue. The euro area is collectively the second world economic and trading power and the euro – since its introduction in 1999 – has been the second most important international currency [ECB 1999; 2001; 2002b; 2003c; 2005i][58]. The euro is also perceived as a stabilizer in the international economic and monetary system [Mundell, Clesse 2000]. However, the EU is not reaping all possible benefits at the international level, because **the question of international representation for the euro area remains *de facto* unsettled** [Commission 2002i]. In contrast to some unitary or even federal countries, the EU does not carry out international economic relations according to a single template; depending on the policy area, competences for external relations belong to (i) the EU, (ii) its Member States, or (iii) they are shared between both of them [Coeuré, Pisani-Ferry 2003]. The clear examples are, *inter alia*, representation of the EU / euro area in the IMF or G-7.[59] For that reason, there are some proposals to unify this representation by e.g. establishing a single/consolidated seat of the EU/euro area in the IMF [Bini Smaghi 2005; 2005].[60] It should be regarded as the first step in this (right) direction and then, in turn, similar solutions should be adopted in the case of some other international forums.

It is of utmost importance for the EU to ensure that the euro area "speaks with one voice" at the international level. **As long as the euro area is perceived as a group of more or less integrated countries, its importance will be assessed – at least to some extent – on the basis of the importance of its individual Member States**. It is frequently claimed by some authors that it weakens the EU's negotiating position makes as well as make the EU less able to play an active role in international discussions and economic relations, because of its

[58] It is worth to mention that even in the new Member States, still staying outside the euro area, there is wide consensus (on average, 74% of their citizens) that the euro is a truly international currency like the US dollar or the Japanese yen [Commission 2006t].

[59] For example, during the G-7 meetings on finance matters, the EU is represented by several persons (who participate fully or partly in these meetings), i.e. the Commissioner for economic and financial affairs, the Minister of Finance of the country holding the EU Presidency, the Ministers of Finance of the four EU Member States (Germany, France, Italy and the UK), as well as the President of the ECB.

[60] Some authors argue that although some substantial coordination concerning international representation of the EU / euro area already takes place (particularly on issues related to the euro area and the single monetary and exchange rate policy), the current institutional set-up, whereby the Member States of the EU / euro area are spread in several member groups (constituencies) of the IMF, undermines its effectiveness. For that reason, a more consolidated EU / euro area representation could raise Europe's voting power (especially that of the smaller Member States, but without reducing that of the bigger ones), as well as facilitate overall coalition-building and majority-finding in the IMF Executive Board. Moreover, the single EU / euro area constituency would enable the Member States to have a strong impact on the IMF's activity and policies, potentially as strong as that of the United States [Bini Smaghi 2005; 2005]. Therefore, it would be advantageous to both the IMF and the EU / euro area.

status of an “accidental player”, i.e. one which, depending on its internal arrangements or the lack of them, is sometimes at the table and sometimes off the table. [Coeuré, Pisani-Ferry 2003; Pisani-Ferry 2005]. There are even some views that the EU will not be able to play its role as a global partner in the future and, therefore, a tripolar world will exist in some decades (e.g. in 2050), in which the three powers would be the United States, China and India [Virmani 2005]. But dismissing the perspective that the EU would also be one of the economic powers in the future world is criticized and rejected by some other authors [Pisani-Ferry 2005]. All in all, Europe should take into account the emergence of some new economic powers with really huge and growing potential (such as China and India), and response adequately to this challenge. One of such responses could be its unified representation in international relations. **In the future, when the euro area starts to be regarded as a genuine single economic entity (speaking “with one voice” to the rest of the world), its importance at the international level will increase significantly and become adequate to its spectacular economic potential.** In other words, at the moment the EU (similarly as the euro area) is labelled the “economic giant” and the “political dwarf” in international relations. And ensuring a genuine representation of the euro area in the international forums would be a very important (but not the only) condition allowing it to become the “economic and political giant” (comparable to the United States). It would be in line with one of the key present priorities of the EU, i.e. promoting a coherent role for Europe as a global partner (what is indicated, *inter alia*, in the Financial Perspective 2007-2013 – see: section 4.3).

Coming back to **the idea to create a “central authority for economic policy” in the euro area**, it seems to be rather **a longer-term vision**. Some authors argue that *“the recent no votes concerning the European Constitution signal that there is a strong “integration fatigue” in the EU today, making it unlikely that significant progress in political unification can be made. This will continue to make the eurozone fragile regime. In the long run, however, there can be little doubt: without further steps towards political union the eurozone has little chance of survival”* [De Grauwe 2006b]. In other words, the long-term success (or even survival) of the euro area and EMU depends on continuing (or even accelerating) the process of political unification in Europe, which seems to be rather long-lasting.

Nevertheless, it does not mean that there is nothing to do in the shorter perspective (i.e. in the short or medium term). Fore example, some recent initiatives should be supported, such as reinforcing the EuroGroup. It makes some progress, although there are opinions that neither the ECOFIN Council nor the EuroGroup would be able to play the role of a real “economic government” or “central fiscal authority” in the EU. It should also be noted that – thinking of such a supranational authority for decision-making on economic policy – one can consider that it is absolutely necessary to establish a new institution. Not necessarily, because it might be created on the basis of some existing structures, e.g. the European Commission, the competences of which related to economic policy could be gradually extended over time. And the Commission seems to be a proper candidate to perform this function because for many years it has been perceived (unofficially) as an “embryo” of the future European government.

In the economic literature there are some concrete proposals in this regard. For example, it is suggested that **the European executive, presumably based on the European Commission’s structures, would formulate the aggregate fiscal stance for the EU (or**

for the euro area) – after consulting the EuroGroup (acting as a special subcommittee of the Council). The proposed ceilings for the EU aggregate public revenues and expenditures would have to be approved by the ECOFIN Council and the (reformed) European Parliament. Within this general framework, national governments would be allowed to define their local budget positions (the coherence between their individual choices would be ensured by bilateral bargaining and a stabilization fund allowing for side payments in the bargaining process). This would guarantee the execution of the agreed aggregate stance. It should be remembered, however, that the need for a democratic ratification of the proposed aggregate fiscal position by the European Parliament and the (ECOFIN) Council would require a democratic cross-border dialogue about policy objectives, which is necessary to reach an agreement and consensus. The ECB could then optimize the policy mix at a given European collective preference point by setting its official interest rates for the euro area at the appropriate level [Collignon 2001]. In this context, it would be advisable to consider whether the above-mentioned institutions – as designed today – are prepared for the above roles. While the Commission seems to be prepared relatively well and for many years has been (unofficially) seen as a prototype of the future EU executive or government, in contrast, the European Parliament – perceived by most people as an artificial institution with unclear competences and no real power – does not seem to be properly prepared for the above role. Therefore, it should not be considered in such debates unless it is redesigned thoroughly (but a detailed analysis in this regard goes beyond the scope of this study).

5.2. The single budgetary policy in the euro area – real vision or utopia?

With reference to coordination of budgetary policies in the EU (or, more precisely, within the euro area), there are some opposite views among economists and observers. On the one hand, some authors argue that **the present European framework for fiscal coordination has been practically completed and, therefore, there is no need for further coordination of fiscal policies** at the aggregate level. In their opinion, the SGP provides sufficient insurance against overly expansionary fiscal policies, which seems to be the most important issue for EMU. Moreover, the SGP was designed, *inter alia*, to create room to let automatic stabilizers operate fully at the national level. Nonetheless, there might be some circumstances that justify and warrant common action, but this would be in some special cases only. Therefore, fiscal policy coordination could take place exclusively on an *ad hoc* basis [Vijselaar 2000]. On the other hand, however, there are opinions that **the need for coordination of national fiscal policies is still strong** (or perhaps stronger than before) **because it arises from the ongoing need for a clear and well-defined aggregate fiscal policy stance** (that could ensure its coherence with the aggregate stance of the single monetary policy). In this context, it would be necessary to consider the potential costs of uncertainty regarding the direction of the policy mix in the euro area if such a stance is not defined [Jacquet, Pisani-Ferry 2001]. At the moment there is no such an aggregate fiscal policy stance in the euro area as a whole. The SGP is a tool to contain “free riding”, but it gives no guidance about the coherent policy mix. This is regarded as a major gap in the Europe's institutional set-up. For that reason, some authors propose institutional reforms of European economic policy making with an objective to give aggregate fiscal policy a certain degree of coherence allowing the optimal and sustainable policy mix [Collignon 2001].

Taking into account the above argumentation – in particular the need to ensure a coherent policy mix and an aggregate fiscal policy stance in the euro area – there are some concepts

whether **the single budgetary policy (or even the single economic policy) could be a potential solution for the euro area in the future**. With regard to this idea, it would be necessary to analyze some potential consequences of the single economic/budgetary policy for the EU, and especially for its budget. It is obvious that – as a result – it would mean **a serious increase of both the role and the size of the EU budget**. In such a case some national budgetary competences should be shifted to the Community level and the EU competence in this area should be extended on both the revenue and expenditure sides. In this context it is necessary to consider some fundamental issues [Szeląg 2003d,f,g; 2004b]:

- is there the need to establish in the future a centre of decision-making for economic/budgetary policy in the euro area (discussed in the previous section) and what is its probability in the foreseeable future?
- is it desirable and feasible in the future to increase significantly the size and the role of the EU budget (on both the revenue and expenditure sides)?
- is broad tax harmonization across the EU and/or the introduction of a EU-wide tax or taxes desirable and feasible?
- what additional areas could be potentially financed from the EU central budget in the future (if increased sufficiently)?

As mentioned before, the general budget of the EU is very small – notably in relation to its economic potential. Although the EU budget amounts presently to only 1.27% of EU GNP (or 1.24% of EU GNI in the next financial framework), some of the Member States would like to decrease the size of the budget to around 1% of GNI (despite some new priorities of the EU have emerged in recent years). But in the Commission's opinion such a ceiling would not be sufficient because it is simply impossible to have "more Europe for less money" (see: section 4.3). In any case, one can say that in the near (foreseeable) future – as it was in the past – the EU budget will remain as small as today. This is the result of the informally agreed practice that almost always the successive negotiations to renew the financial frameworks followed the line of least resistance, which consists of modifying, at the margin only, the financial allocations of the previous period. But **instead of being merely a reflection of the past, the EU budget should be a crucial – and much more active than today – measure to support achieving the current and future economic objectives of the Union**. It must, therefore, be sufficiently flexible to permit some (serious) redeployments according to the new priorities of the EU [Sapir *et al.* 2003].

Taking into account the above considerations, it should be indicated that many **new priorities of the EU** have already been identified in recent years. And these new priorities are generally accepted by many experts and institutions as well as public opinion. For that reason, there have been some **proposals to increase the EU budget** in recent years. As mentioned above, in 2004, the Commission stated that the significance of the identified future challenges would justify and even require a very substantial increase of financing capabilities at the EU level. But at the same time the Commission was fully aware that in the present reality only a limited increase of the current size of the EU budget is feasible [Commission 2004c]. Similarly, in 2003, it was stated in the Sapir Report that the EU budgetary framework should be radically restructured. One can suppose that this "radical restructuring" means not only the change of the budgetary structure of expenditures and revenues, but also the size of the EU budget. But, on the contrary, it was stated in the report that it was outside its scope to examine whether the current size of the EU budget (the

ceiling of 1.27 % of EU GNP) would be sufficient for financing policies beyond narrow economic and social issues, such as policy towards neighbours, foreign and defence policy, development aid, justice and home affairs, or those economic policies with a dominant external dimension, such as trade policy [Sapir *et al.* 2003]. Although there is no direct answer to this question in the report, it seems quite easy to conclude that **satisfactory financing not only current tasks, but also many new areas and priorities, requires a clear increase of the EU budget (as well as a radical redefintion of its structure)**. This confirm the Commission's opinion that it is simply impossible to expect more activity of the Union in some new important areas without additional financial means. The deep reform of the EU budget (related to both its structure and size) is the only way for the EU to achieve its economic and social goals, face the future challenges, as well as play properly its role of a global partner.

The idea to increase significantly the EU general budget is not a new one. In the so-called **McDougall Report** [Commission 1977], there was a proposal to increase the role of public finances in the process of European integration and hence the size of the Community budget. The report assumed **a gradual – but substantial – increase of the Community budget**, but with substantial effects at the subsequent stages, leading finally to the budget comparable with those in some federal countries:

- a "pre-federal" budget – about 2-2.5% of GDP of the Community;
- an "early-federal" budget – about 5-7% of GDP of the Community;
- a "federal" budget – about 20-25% of GDP of the Community.

The McDougall Report was a far-reaching vision which could not become a reality because of the lack of political will of the Member States. Even today **there is no political will** to put into practice such a vision. Taking into account the present discussion on the Financial Perspective 2007-2013, there is no chance to change the EU budget size significantly in this period of time (perhaps it will be possible to change – more or less substantially – the structure of the budget). A potential increase of the EU budget – allowing to achieve at least the above "pre-federal" size of the budget – would be possible not earlier than in one of the next financial perspectives, i.e. 2014-2018 or 2019-2023.[61] It would require some significant **deepening political integration** within the EU in the coming decades and a gradual evolution of the EU towards a more **federal structure**.

Some authors argue that the McDougall Report highlighted the theoretical arguments in the context of the sustainability of a monetary union (concluding that a substantial increase in centralized funding would be required to deal with asymmetric shocks in EMU). The report had a lasting impact on some opinion in the Union, leading to ambitions to increase the size of the EU budget considerably. But the subsequent works on a monetary union suggested that EMU could be successful with a much lower central budget, as long as there was a sufficient degree of flexibility in national fiscal policies [Mayhew 2004]. This seems to be a controversial thesis, taking into account the recent global economic slowdown (2001-2003) and much slower recovery observed in the euro area in comparison with some other regions of the world. Relatively slow growth and high unemployment in recent years do not confirm that the EU policy mix is a fully appropriate and successful solution. And the last year's non-

[61] The Commission suggested that from 2013 onwards the financial perspectives should be established for periods of five years (instead of seven-year periods so far). It would be better adjusted to the institutional framework and timetable because both the Commission and the Parliament have five-year terms [Commission 2004i].

agreement on the Financial Perspective 2007-2013, that was painfully experienced in June 2005, does not confirm that also this issue – the EU budget – is solved successfully.

Moreover, the introduction of the euro has created a totally new situation for both budgetary and economic policies of the EU. The SGP has restricted flexibility of national fiscal policies to prevent irresponsible actions ("free riding") at the national level. Besides, as it is argued by some authors, **monetary policy has effectively been delegated to the ECB (at the supranational level), but at the same time no progress has been made towards a true federal budget**. On the contrary, it was explicitly decided that the current EU budget would not be increased as a result of EMU. Therefore, the introduction of the euro requires to experiment with a new approach, closer to intergovernmentalism than to the traditional Community method or the federalist idea. And – in their opinion – common economic policy could only emerge on the basis of coordinated (or, more appropriately, coherent) actions between independent actors, some of which (the ECB) are federal institutions while the others (national governments) are not. As mentioned before, the need for coordination of national fiscal policies and the single monetary policy arises from the need to have a clearly defined aggregate policy stance in the euro area as a whole [Jacquet, Pisani-Ferry 2001]. And defining such an aggregate fiscal policy stance would allow the ECB to set, in response, interest rates at the appropriate level. In consequence, it would allow optimizing the overall policy mix in the euro area [Collignon 2001]. Of course, if the single economic / budgetary policy would emerge indeed (as postulated above), coordination of national fiscal policies of the Member States (relying on their national budgets) would have to be only a transitional solution in the euro area. Without any doubts, even in the case of the single economic / fiscal policy, the ECB and monetary policy would remain fully independent – similarly like the above-mentioned "economic government" or "central fiscal authority" in the euro area. Although there would be no formal coordination between monetary and fiscal policies, there would be still the need for coherent actions between these two principal sources of macroeconomic power. And, of course, real progress towards a federal budget would have to be made.

In the context of the above considerations, it is necessary to emphasize that **a potential increase of the size of the EU general budget** is not the only objective and it **should be accompanied by a parallel increase of the role of the budget – on both the expenditure and revenue sides** – in order to make a vision of the single budgetary policy in the euro area reasonable and sensible.

As far as **budgetary expenditures** are concerned, the three main functions of the budget are usually being discussed – allocation, redistribution and stabilization. As mentioned in the previous chapter (section 4.3), at the present moment **the EU budget fulfils mainly the redistributive function** – via the Structural Funds and the Cohesion Fund (about 35% of total expenditures). But the effects of the redistribution – measured as a reduction in the differential of regional / national income *per capita* – are rather limited in the EU in comparison with some other countries. According to some empirical studies of the previous decade, the redistributive effects of the EU Structural / Cohesion Funds were estimated at about 2.5%, whereas the interregional transfers of the German federal budget reduced regional disparities by 5.2% [Costello 1993a], and even much more in some other federal countries like the United States or Canada [Bayoumi, Masson 1995; Obstfeld, Peri 1998].

The other functions – allocation and stabilization – are fulfilled by the EU budget to a small extent, although macroeconomic stabilization is one of the key factors in designing a monetary union. In unitary states, both functions are usually fulfilled by the central budget (reflecting – more or less – the collective preferences of voters). In federal states, it is necessary to distinguish between different government functions. The allocative function of fiscal or structural policies has not to be necessarily performed at the highest (federal) level and thereby it is often reduced to the regional level. Therefore – considering the case of the EU (or the euro area) – intergovernmental cooperation is appropriate for these functions. But with reference to the stabilization function, only the central (federal) authority is in a position to internalize all (of almost all) externalities of regional policies. Macroeconomic externalities are the key reason explaining why fiscal federalism always assigns the stabilization function of fiscal policy to the central (federal) government agency [Collignon 2001].

In the euro area, however, this is not the case. As the EU (or the euro area) is not a federation, the stabilization function in EMU has not been assigned to the Community level, but – similarly like the allocative function – it is still subject to intergovernmental cooperation (despite some key differences between those functions). As it is argued, **the absence of the sizeable central (federal-like) budget in the euro area implies that no budgetary policy aimed at stabilizing the business cycle in EMU is available at the European level** [De Grauwe 2006a,b]. Macroeconomic stabilization within EMU may be pursued by means of centralized monetary policy as well as national fiscal policies. But, according to the popular idea, the ECB should cope with union-wide shocks while the governments of the Member States should stabilize domestic shocks is not always the most efficient assignment choice, and it is inconsistent with the imposition of the SGP fiscal deficit ceiling on the Member States [Tamborini 2002]. At the same time, however, it is also argued that – according to he monetarist theory – the central bank cannot do much to stabilize the economy. Similarly, according to the real business cycle theory, assuming that the sources of economic cycles are shocks in technology and changes in preferences – there is very little the central bank can do about these movements [De Grauwe 2006a,b].

It seems that **some existing externalities of national policies, as well as some spillover effects from economic integration, would require shifting the stabilization function from the national to supranational level**. Otherwise, if national fiscal authorities fail to internalize these externalities and spillover effects of their policies, it may eventually result in the failure of the whole process of fiscal policy coordination [Gatti, van Wijnbergen 2000]. Of course, eventual **assigning the stabilization function to the Community level would imply a serious increase of the EU budget** in order to allow this redesigned budget to fulfil properly its increased functions.

Thus far the following areas have been financed by the EU general budget: agriculture, structural operations, internal policies (especially research and technological development), external action, administration, pre-accession strategy, etc. And considering the future situation, notably the question what areas could be potentially financed by the EU central budget (if increased substantially), it would be useful to identify so-called **EU-wide public goods**. In this context, there are some opinions which seem to be partially opposite and partially convergent. On the one hand, it is argued that most public goods are of a regional nature and, for that reason, their provision would be better addressed at the national or

regional levels rather than at the EU (supranational) level [Costello 1993b; von Hagen 1993]. On the other hand, there are also some arguments that **with the establishment of EMU and the introduction of the single currency, the spatial characteristics of public goods are likely to change over time**. Given the growing unity between the Member States of the euro area because of their stronger and stronger economic, monetary and political integration, the spatial incidence of public goods may widen, preferences may become more uniform, and hence some **new European public goods may emerge**. The provision of such goods should be centralized or very closely coordinated, regulated and supported by financial transfers [Cangiano, Mottu 1998; Commission 1993a]. There are numerous European public goods and services which have already been identified: defence, security, foreign policy, environment protection, energy, higher education, research and development (R&D), telecommunications, transportation, etc. [CEPR 1993; Masson 2000]. It is also argued that the most obvious examples of economic public goods are the preservation of the Single Market and stability in financial markets within the euro area. In macroeconomic terms, fiscal discipline also became a sort of European public goods during the transition to EMU [Jacquet, Pisani-Ferry 2001]. Summing up, due to the principle of subsidiarity, the case for EU-wide fiscal policy must rely on the existence of externalities or distortions which cannot be captured at the national level [Masson 2000].

In order to decide whether a given area should be financed from the national or European level, it is necessary to assess **the effectiveness and efficiency of both kinds of spending – national and supranational (European) ones**. In the Commission's opinion – that is undoubtedly right – the Union's common objectives can only be met effectivelly through a partnership between the national and European levels. On the one hand, financing from national budgets can bring some huge benefits to citizens, but on the other, **there are some limitations to the effectiveness of national public spending; some gaps are left which only the Union (and its budget) can fill**. In order to reach its objectives, the Treaty – from the very outset – assigned a central role to fully-fledged common policies such as competition, trade, transport, agriculture and fisheries, and more recently EMU. As far as efficiency is concerned, the Commission is of opinion that the EU's actions can also be justified on value-for-money grounds, i.e. one euro spent at the EU level can offer more than one euro at the national level. In addition, **uncoordinated spending at the national level to reach common European objectives is simply a waste of money**. In any case, considering the above criteria of effectiveness and efficiency, there are clear cases where the EU's action is the only way to get results to create missing links, avoid fragmentation, and realize the potential of a border-free Europe. There are also some cases where the EU offers better value for money because externalities can be addressed, resources or expertise can be pooled, and actions can be better coordinated [Commission 2004g].

Taking into account the above argumentation, the Commission points out that complex cross-border action can only be properly handled at the EU level because of the mismatch of costs and benefits (costs are borne solely by governments financing a given action, while economic and financial returns are shared across borders, often Europe-wide) as well as the lack of synergy between objectives and actions (objectives are agreed at the EU level, and their delivery commits the EU and its Member States to act). In this context, the Commission gives many examples of **areas that should be financed at the supranational – Community – level** [Commission 2004g]:

- first of all, the existence of the Single Market automatically requires the EU's actions on **public health, food safety and consumer protection**. It is necessary to address the needs of the EU citizens' interests (one of the core Union's objectives), but in all these areas, actions are indispensable at the European level;
- next, **education and training** is crucial for the Lisbon target to establish the knowledge-based economy and information society, but the potential EU-wide gains in this area are limited by low mobility within the Union; and mobility can only be effectively handled at the EU level;
- similarly, **research and development (R&D)** on the scale of the EU can offer better value for money than nationally-funded research because – in the Commission's opinion – as the complexity of research and the critical financial mass required increases, no Member State acting in isolation can create the minimal, critical mass. The economies of scale offered at the EU level become more significant and the benefits of linking specialists across borders more clear;
- the next area – development of effective **infrastructure** – is a crucial point for each economy; notably for the European economy which will become more and more integrated over time and for which the costs of poor infrastructure (especially in the new Member States) would be really substantial for the EU. Allocating resources at the European level is the only way to redress the natural preference for directing national spending which start and finish within national boundaries. It could also help some less developed EU economies improve their infrastructure what would be beneficial for the other Member States as well;
- another areas of utmost importance – **fight against organized crime and terrorism** (as well as **immigration and asylum policy**) – have a clear cross-border dimension and can no longer be met adequately by national administrations acting alone. A series of unpredictable events, such as the terrorist attacks in Madrid (March 2004) and in London (July 2005), raised public concern and expectations for action at the EU level (in this context, it is necessary to remember about the removal of internal borders within the EU and the need to strengthen checks on external borders – in order to ensure security and safety of the EU citizens);
- finally, it is obvious that **external relationas and operations** have clear externalities and justify intervention at the EU level. The EU's action makes the collective external effort more coherent, more than the sum of the parts, financing measures to make development aid more effective to ensure that individual efforts do not overlap.

The changes advocated on the expenditure side of the EU budget require a parallel (and – what is equally important – consistent) changes on **the revenue side (taxes)**. As mentioned before (see: section 4.3), at the moment the EU budget is wholly financed by the so-called own resources (traditional own resources, VAT resource, GNP resource, other revenues). About 90% of the EU budget's revenues are being financed by national contributions. Presently **the EU has no power to create or levy taxes**, but it is quite active in the process of **coordination and harmonization of taxation** within the Single Market in order to ensure its efficient functioning [Bolkestein 2001a,b, 2002]. It is related especially to **indirect taxes**. The Treaty calls for harmonization of turnover taxes, excise duties and other forms of indirect taxation (Article 93). And there is quite substantial progress in this area, notably in the case of VAT and excise duties which have been harmonized to the greatest extend (achieving

also a partial alignment in the rates of these two types of taxation among the euro-area countries). In the case of **direct taxes**, the Treaty does not specifically call for their harmonization, but only for the approximation of laws in those areas where they affect free movement of goods and freedom to provide services (Article 94). Nevertheless, there are some visible effects of this voluntary harmonization of direct taxes, mainly in the area of company taxation [Commission 2001e; 2003e]. In the case of personal income taxes, they are and will remain in the sole responsibility of the Member States and their coordination at the EU level may only become necessary to prevent cross-border discrimination or obstacles to the exercise of the Single Market's freedoms [Commission 2001c].

As mentioned above, at the present moment the EU has no power to create or levy taxes. But sometimes there are proposals to introduce some forms of **EU-wide taxes**. The most popular suggestion is to create a EU-wide environmental tax (eco-tax). It seems to be justifiable because environment protection and its externalities have clearly international dimension. Besides national eco-taxes are generally not popular and underdeveloped in the Member States because of harmful tax competition within the EU [Spahn 1993; Tanzi 1996; OECD 1998a]. Some experts, e.g. the authors of the Sapir Report, advocate that **the relative weight of national contributions to the EU budget should be reduced in favour of revenue sources with a clear EU dimension**. According to those experts, *"the overt character of national contributions, which have a very clear link to the national treasuries and no link to EU-wide tax bases, feeds the tendency of national governments to focus the debate on the net balance or juste retour issue, thus preventing an economically rational allocation of the EU budget. To redress this situation, the EU should target those sources of revenues that have a clear EU dimension rather than those with an obvious national label. Revenues directly accruing (partially or totally) to the EU budget might be either related to an EU policy so that they cannot meaningfully be reapportioned nationally or might have a very mobile tax base within the EU.*[62] *Further economic integration is likely only to increase the number of sources of revenues that have a clear EU dimension and that could therefore directly accrue to the EU budget"* [Sapir *et al.* 2003].

Finally, it is worth to say some words about the above-mentioned issue – **harmful tax competition**. In general, this is one of the effects of the process of globalization (see: box 5.1). In particular – with reference to the EU or the euro area – harmful tax competition is the result of the existence of several national tax system within the Single Market and, for that reason, it cannot be resolved at the national level. Moreover, it seems that this problem has been accelerated since the introduction of the single currency and it will be growing in the future. It would be better addressed at the supranational level – by one of the EU institutions (e.g. the Commission or the Council) with the support of the Member States,[63] or – in a longer perspective – by the above-mentioned "EU central fiscal authority" which could also

[62] An example of the former would be the seignorage earned from issuing euro banknotes. Some examples of the latter would be e.g. capital income taxes, stock exchanges taxes. The size of the EU budget is so small that even a partial allocation to the EU budget of any of these possible taxes would suffice to cover the financing needs [Sapir *et al.* 2003].

[63] The work on preventing and combating harmful tax competition has been carried out not only within the OECD, but also in the EU. On 1 December 1997 the Council adopted the so-called "tax package", i.e. a package of three measures to tackle harmful tax competition including (i) a code of conduct for company taxation, (ii) key elements on taxation of savings, and (iii) agreement on the need to eliminate withholding taxes on cross-border interest and royalty payments between companies. The main purposes of the package were the following: tackling harmful tax competition, eliminating some distortions in the Single Market, preventing excessive losses of tax revenues, helping reverse the trend of increasing labour taxation, making taxation systems more employment-friendly. The code of conduct identified some potentially harmful measures (e.g. tax measures which provide for a significantly lower effective level of taxation, including zero taxation, than those which generally apply in a given Member State). It also included the commitment not to introduce any new harmful tax regimes and to rollback existing regimes [Commission 2006f; OECD 1998a].

be empowered to create and levy EU-wide taxes as well as collect tax revenues. Although there are some arguments to centralize tax revenue collection (e.g. economies of scale, avoiding excessive tax competition), it is argued that full centralization would not be a perfect solution even in federal countries and some taxation power should remain decentralized [Tanzi, Zee 1998]. With reference to some previous arguments concerning different government functions, given the decentralized incidence of the allocative aspects of fiscal policy, collective choices on many aspects of government revenues and expenditures must remain on the regional / national level. In the case of the EU (or the euro area) this logic would imply delegating the stabilization function to the European level, but leaving implementation to national governments [Collignon 2001].

Box 5.1.
Harmful tax competition and practices

In 1998 the OECD published its report on harmful tax competition. In that report there were, *inter alia*, the following statements and findings:

The accelerating process of globalization of trade and investment has fundamentally changed the relationship among domestic tax systems. The removal of non-tax barriers to international commerce and investment and the resulting integration of national economies have greatly increased the potential impact that domestic tax policies can have on other economies. Globalization and the increased mobility of capital has also promoted the development of capital and financial markets and has encouraged countries to reduce tax barriers to capital flows and to modernize their tax systems to reflect these developments. Many of these reforms have also addressed the need to adapt tax systems to this new global environment.

Harmful tax practices (such as e.g. tax havens, harmful preferential tax regimes, etc.) can affect the location of financial and other service activities, erode the tax bases of other countries, distort trade and investment patterns and undermine the fairness, neutrality and broad social acceptance of tax systems generally. Such harmful tax competition diminishes global welfare and undermines taxpayer confidence in the integrity of tax systems.

Tax havens or harmful preferential tax regimes that drive the effective tax rate levied on income from the mobile activities significantly below rates in other countries have the potential to cause harm by:

- distorting financial and, indirectly, real investment flows;
- undermining the integrity and fairness of tax structures;
- discouraging compliance by all taxpayers;
- re-shaping the desired level and mix of taxes and public spending;
- causing undesired shifts of part of tax burdens to less mobile tax bases, such as labour, property and consumption; and
- increasing the administrative costs and compliance burdens on tax authorities and taxpayers.

If such practices have all of these negative effects, they are harmful. However, in other cases, for example if only some of these effects are present, the degree of harm will range along a spectrum and thus the process of identifying harmful tax practices involves a balancing of factors. If the spillover effects of particular tax practices are so substantial that they are concluded to be poaching other countries' tax bases, such practices would be doubtlessly labelled "harmful tax competition".

Globalization and intensified competition among firms in the global marketplace has had and continues to have many positive effects. However, the fact that tax competition may lead to the proliferation of harmful tax practices and the adverse consequences which results show that governments must take measures (including intensifying their international cooperation) to protect their tax bases and avoid the world-wide reduction in welfare caused by tax-induced distortions in capital and financial flows.

Source: OECD 1998a.

Taking into account the above considerations, it should be stated that a vision of the single budgetary policy in the euro area depends on many conditions. It is not enough to increase both the size and the role of the EU central budget (in relation to both revenues and expenditures), but it would also be necessary to make **some other fundamental changes** concerning the present characteristics of the EU general budget [Szeląg 2003d,e; 2004b]:

- to abandon the present rule stipulating that revenues and expenditures shown in the budget shall be in balance for each financial year (and hence to permit for either a surplus or a deficit);
- to provide the EU – or, more precisely, the EU central fiscal authority – with the right to borrow relevant financial means to finance its budget deficit (but, of course, with the prohibition of borrowing from the central banks).

And last but not least, it is necessary to state very clearly that in order to make a vision of the single budgetary policy within the euro area a reality in the future, **the absolutely indispensable thing is political will of the Member States**. Unfortunately, presently there are neither political will nor social support nor readiness of the Member States to transfer their further competences of utmost importance from the national level to the Community one. For that reason, **a concept of the single economic / budgetary policy seems to be a relatively far-reaching vision**. Although there are some opinions that the institutional set-up for supranational fiscal policy would be desirable at an early stage of EMU [Buchanan, Musgrave 1999], it seems to be more likely that the rationale for common fiscal policy may be considerably stronger in ten or twenty years since the introduction of the single currency and the single monetary policy [Masson 2000].

5.3. Economic and Monetary Union vs. fiscal federalism

A starting point for considerations regarding fiscal federalism should start with the reference to the theories on **optimum currency areas** (OCA).[64] Some pioneer OCA theories were developed in the 1960s[65] [Mundell 1961; McKinnon 1963; Kenen 1969] and then regularly complemented by some other authors – especially during the 1970s (see: table 5.1). Those theories are often reffered to as the “classical OCA theories” (those of the 1960s) and the “new OCA theories” developed in the subsequent years and decades [see e.g. Tavlas 1993]. All in all, the OCA theories have been developed for over 40 years and they are sometimes divided into some phases, such as the pioneering phase (from the early 1960s to the early 1970s), the reconciliation phase (during the 1970s), the reassessment phase (during the 1980s and the early 1990s), and the empirical phase (from the mid-1980s to date) [Mongelli 2002].

[64] The “optimum currency area” (OCA) can be defined as a specific form of a “currency area”, i.e. a geographic area of the single currency or several currencies whose exchange rates are irrevocably pegged each other and can fluctuate only in unison against the rest of the world. The “optimality” of such a currency area is being assessed in terms of several OCA properties (see: table 7.1), including mobility of labour and other factors of production, price and wage flexibility, economic openness, diversification of production, similarity in inflation rates, fiscal and political integration [see e.g. Mongelli 2002].
[65] It should be noted that some interesting insights in this regard were made already in some earlier elaborations of the 1950s (see: Friedman 1953; Meade 1957; Scitovsky 1958). However, they were not always in line (but sometimes in contrast with some further OCA theories.

Table 5.1.
Review of the theories on optimum currency areas (OCA)

Authors	Conditions / features of an optimum currency area
Mundell (1961, 1963) Ingram (1962) Corden (1972)	Mobility of production factors – mainly goegraphical mobility of the labour force: • internal mobility of factors • lack of external mobility of factors. Mobility of some other production factors (e.g. capital).
Mundell (1961)	Flexibility of prices and wages
McKinnon (1963)	Openess of the economy (measured by international trade with other countries): • large – fixed exchange rate • small – floating exchange rate. Size of the currency area: • large – floating exchange rate • small – fixed exchange rate. Mobility of production factors (goegraphical and interindustrial).
Kenen (1969)	Diversification of production: • large – fixed exchange rate • small – floating exchange rate. Mobility of production factors (goegraphical, interindustrial and professional).
Snider (1967) Kenen (1969) Grubel (1970)	Centralization of monetary policy (full) and fiscal policy (full or partial) – i.e. shifting policy formulation form the national to supranational level.
Fleming (1971)	Similarity in inflation rates
Scitovsky (1966) Ingram (1962, 1973) Corden (1972) Mundell (1973) McKinnon 2001	Integration of financial markets
Grubel (1970) Corden (1972) Mundell (1973) Ishiyama (1975) Tower, Willet (1976) DeGrauwe (2000)	Analysis of the benefits and costs connected with the establishment of an optimum currency area (monetary union). Analysis of welfare in comparison with the situation before the establishment of a common currency area (monetary union).
Bayoumi, Eichengreen (1993) Frankel (2000)	Business cycle correlation / correlation of various economic shocks (shock symmetry).
Snider (1967) Mintz (1970) Haberler (1970) Cohen (1992, 1993) De Grauwe (2000, 2005, 2006a,b)	Political factors, political will, political integration, etc.

Source: own eleboration.

According to the OCA theories, many **specific conditions (criteria)** should be fulfilled in order to regard a given currency area or a monetary union as an “optimum currency area”. The most important conditions are the following: factor (labour) mobility, price and wage flexibility, openess of the economy, size of the currency area, production diversification, economic integration and convergence, integration of financial markets, centralization of monetary and fiscal policies, political integration, etc. (see: table 5.1). However, even before the launch of EMU, some authors argued that a mere examination of historical data – in order to find out whether a given country or countries fulfilled the necessary criteria or not – might give a misleading picture of this country’s suitability for its entry into a monetary union,

since **the OCA criteria are endogenous**[66] [Frankel, Rose 1998]. Moreover, it should also be noted that – according to the OCA theory – the members of a monetary union can form an optimal currency area not only if they fulfil all (or the vast majority) of the above conditions, but also if, at the same time, **the benefits of a monetary union exceed the costs** [De Grauwe 2000; 2005]. In such a situation, member countries have no incentives to leave such a monetary union. This is particularly important for EMU, taking into account that there is a fundamental difference between the United States (as a monetary union) and the euro area because the US federal government has in its disposal relevant power to prevent any state from seceding from the monetary union and there is no similar (supranational) institution in the EU which could prevent a Member State of the euro area from seceding. Therefore, the euro-area members have to perceive continuously their membership in EMU as being in their national interest [De Grauwe 2006a,b].

One of the key aspects of the OCA theories are **potential economic shocks** that could hit negatively (part of) a currency area or a monetary union. Such shocks may be symmetric (if a given shock affects all countries of a currency area / monetary union in a similar or the same way) or asymmetric (if it affects various parts – countries, regions, sectors, etc. – of a currency area / monetary union in a different way and to a different extent). There are also a lot of other types of economic shocks depending on their nature (demand or supply shocks), effects (negative or positive shocks), origin (external / exogenous or internal / policy-induced shocks), duration (temporary / cyclical or permanent / structural shocks), etc. [see e.g. Pauer 1996]. The OCA theories focus mainly on so-called **asymmetric shocks** (e.g. country-specific / regional / sectoral shocks). Therefore, it is necessary for members of a monetary union to have in their disposal relevant adjustemnt instruments to cushion (neutralize) asymmentric shocks. But in a currency area/monetary union – characterized by the existence of the single (common) currency in its member countries – such instruments as monetary and exchange rate policies are no longer available for individual countries. Therefore, taking into account the above limitations, the OCA theories stipulate that the following **adjustment mechanisms** could be potentially used in the case of asymmetric shocks:

- labour mobility,
- price and wage flexibility,
- macroeconomic (fiscal) policy.

As it is known, **the euro area is a monetary union, but at the same time it is not an optimum currency area**. The euro area – similarly like the whole EU – does not fulfil some important OCA criteria, especially those related to labour mobility as well as price and wage flexibility. As a monetary union, the euro area is potentially exposed to so-called asymmetric shocks that could hit negatively only some regions of a monetary union while not affecting other regions. In this context, the following question arises: which of the adjustment mechanisms could be (effectivelly) used in the case of asymmetric shocks within the euro area? Empirical evidence confirms that labour mobility is not a key adjustment mechanism in the EU and in the euro area [Decressin, Fatás 1995; Obstfeld, Peri 1998; OECD 1999; HM Treasury 2003]. Moreover, product and labour markets of the Union are characterized by substantial price and wage rigidity. And for that reason – due to prevailing price and wage

[66] It is often argued that some countries fulfilling some criteria (e.g. displaying close links in international trade and high business cycle correlations) are more likely to form an optimum currency area (OCA). It is related to an OCA in general, and to EMU in particular. The authors of the theory of the OCA criteria endogeneity argue that *"some countries may appear, on the basis of historical data, to be poor candidates for EMU entry. But EMU entry per se, for whatever reason, may provide a substantial impetus for trade expansion; this in turn may result in more highly correlated business cycles. That is, a country is more likely to satisfy the criteria for entry into a currency union ex post than ex ante"* [Frankel, Rose 1998].

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rigidities in the EU and in the euro area – adjustments based on competitiveness can be slow and involve costly over/undershooting [Commission 2004f]. Therefore, it seems that **the euro area would not be able to use effectivelly either labour mobility or price and wage flexibility to absorb the negative effects of asymmetric shocks**. And keeping in mind that under EMU individual countries of the euro area have no longer the possibility to use such instruments as monetary or exchange rate policies, the only possibility for them seems to be macroeconomic (fiscal) policy. It is related to both fiscal policies of the individual Member States being part of a monetary union, as well as to the (potential) single fiscal policy formulated for the entire monetary union. In the case of the latter it would be possible to direct some **budgetary transfers to regions/countries affected by an asymmetric shock**.

The systems of interregional budgetary transfers are typical for the federal countries (such as the United States, Canada, Germany) being monetary unions as well. The main function of the federal budgets of those countries is to ensure overall macroeconomic stabilization of the economy. And **the efficiency of fiscal transfers in providing macroeconomic stability** is often being measured by the percentage of the negative effects of asymmetric shocks that could be absorbed thanks to transfers from the central budget (see: table 5.2). In Europe that issue was disscused for the first time in the late 1970s in the so-called MacDougall Report on the role of public finances in European integration [Commission 1977], which argued that federal systems would be able to reduce significantly diffeneces in regional income and compensate around 28-32% of the overall effects of saymmetric shocks (but the report did not distinguish between the stabilization and redistributive roles of the federal budget). The vast majority of research on **the effectiveness of federal budgets (systems) in absorbing potential effects of asymmetric shocks** were conducted and published in the 1990s. Initially, some authors estimate the stabilizing (and sometimes also redistributive) effects of the US and Canadian budgets for even 30-40% [Sala-i-Martin, Sachs 1991; Bayoumi, Masson 1995]. But some other authors – analyzing separately stabilizing and redistributive functions of the budget – indicated that the stabilization effect of the federal budget is much lower, i.e. around 10-15% on average in the United States and somewhat higher in Canada [von Hagen 1991; Goodhart, Smith 1993; Obstfeld, Peri 1998; Mélitz, Zumer 1998; 2002]. Although results of various empirical studies were sometimes clearly different, it should be acknowledged that the degree of stabilization which could be provided by the federal budget is really considerable or even impressive – especially in comparison with the stabilization and redistributive effects of the present EU budget, estimated between 0.5% and 3% [Sala-i-Martin, Sachs 1991; Costello 1993a; Bayoumi, Masson 1995].

Table 5.2.
Effectiveness of federal budgets in absorbing potential effects of asymmetric shocks

Authors	United States		Canada		Germany		United Kingdom		France		Italy	
	R	S	R	S	R	S	R	S	R	S	R	S
MacDougall / Commission (1977)	28		32		29				54		47	
Sala-i-Martin, Sachs (1991)	33-40											
von Hagen (1991)	30-47	9-10										
Goodhardt, Smith (1993)	15	13	13-24	12-24			21	21-34				
Masson, Taylor (1993)				24								
Pisani-Ferry *et al*. (1993)		17				33-42				37		
Atkeson, Bayoumi (1993)		7										
Gros, Jones (1993)		4-14										
Bayoumi, Masson (1995)	7-22	7-30	39	14-17								
Asdrubali *et al*. (1996)		13										
Sørensen, Yosha (1997)		15										
Athanasoulis, van Wincorp (1997)	20	10										
Obsfeld, Peri (1998)	19	10	53	13							8	3
Mėlitz, Zumer (1998, 2002)	16	12-20	18	14			26-29	21	38	19-40		
Fatás (1998)		11				10		13		6		12
von Hagen *et al*. (1999)					0	0,03						
Decressin (1999)											30-35	20-30

R – redistributive function, S – stabilizing function.

Sources: Pacheco 2000; Zumer 1998; 2002; Kletzer, von Hagen 2000; Vigneault 2002.

Taking into account the above argumentation regarding the relatively high effectiveness of federal budgets and interregional fiscal transfers in absorbing potential effects of asymmetric shocks, there were some proposals in the 1990s to establish the so-called **"European fiscal transfer schemes"** [Pacheco 2000]. One of the first and the most famous proposals suggested to create a "European stabilization mechanism" – possibly in two variants, i.e. a "full stabilization mechanism" (to deal with all asymmetric shocks) and a "limited stabilization mechanism" (activated only in the case of large shocks exceeding the agreed level) [Italianer, Vanheukelen 1993]. In the subsequent years – between 1993 (entry into force of the Maastricht Treaty stipulating EMU) and 1999 (the introduction of the euro) – there were further proposals to establish some similar federal fiscal schemes in the EU, for example: a "shock absorption mechanism" [Mélitz, Vori 1993], a "temporary and asymmetric shock absorption mechanism" [Hammond, von Hagen 1995], a "EU stabilisation instrument" [European Parliament 1998a,b], or a "temporary financial transfers mechanism" [Economic and Social Committee 1999]. Moreover, as mentioned before (see: section 4.1), it was proposed to set up a "short-term economic action fund" in order to support any Member State suffering from the effects of world economic turbulences [Jospin 2001].

The main argument in favour of the above mechanisms of interregional budgetary transfers is to provide countries belonging to EMU with **insurance against asymmetric shocks** and hence to ensure **macroeconomic stabilization**. Moreover, as mentioned before, the existence of such a system of fiscal transfers, might cause that the euro-area members would perceive their **participation in EMU** as **less costly** in comparison with staying outside EMU (when they would have to neutralize asymmetric shocks themselves – without any financial support from abroad). However, there are also some counter-arguments which suggest that the costs of implementing such a system would be higher than the benefits, there would be large cross-country differences regarding the potential benefits for the particular Member States, the amount of interregional insurance/stabilization provided by the

current national systems is more than half of a hypothetical European fiscal federation [Fatás 1998]. Besides it is often argued that such an effective **"shock absorption mechanism" could be establish only in a country having the federal structure.** And the euro area is not a federal state or superstate.

As it is known, **federal countries** and their authorities (governments) are usually organized on a three-level basis:

- central (federal) level – i.e. countries, unions, federations;
- regional (national, provincial) level – e.g. states, provinces, lands, etc.
- local (territorial) level – e.g. counties, boroughs, cities, towns, etc.

The outlined above standard organization of federal countries is also related to their budgetary (fiscal) framework – the so-called **fiscal federalism** [see e.g. Oates 1972; 1991]. Fiscal federalism is defined as a subfield of public finance that addresses the vertical structure of the public sector and explores the roles of the different levels of government and the ways in which they relate to one another through such instruments as intergovernmental grants [Oates 1999]. Fiscal federalism emphasizes to the coexistence of multiple levels of government and to their interactions, notably on the financial side [Tommasi 2001]. According to a popular definition, fiscal federalism is understood as the system of transfer payments or grants by which the federal government shares its revenues with the lower levels of government [Wikipedia 2006].[67]

As mentioned before (see: sections 4.3 and 5.2), there are **three main budgetary functions – stabilization, redistribution and allocation** – that should be performed by governments. In the case of fiscal federalism it is possible that different government functions can be provided at different levels; it allows to achieve the most efficient and optimal delivery of goods and services. Functions related to macroeconomic stabilization (e.g. price stability, employment policy, economic growth and development, etc.) are usually assigned to the central/federal government (although some authors argued for assigning some of those functions, e.g. related to infrastructure and economic development, to mid-level governments [Rivlin 1992; Peterson 1995]). As far as distribution and redistribution is concerned, this is generally treated as a mix of federal and regional responsibility. Finally, functions related to allocation are usually carried out by all the levels of government; functions with a clear local dimension (e.g. public security, fire or emergency services) need to be provided locally, but functions with wider spillover effects (e.g. environment protection, interregional or international transport networks) should be shifted – at least to some extent – to a higher level of government (or shared by various levels of government).

Of course, neither the EU nor the euro area is a federation, although there are some federal institutional arrangements in the EU, such as the ESCB or the Eurosystem.[68] But **being fully aware that at the present moment the EU and its budgetary system are not organized as those in federal countries, it seems to be worth to consider whether such a solution**

[67] It should be noted that although federalism pays its attention on how power is distributed between authorities of different levels of government, i.e. public entities, but a very important source of power is also private sector and economic interests of its entities.
[68] In this context, it is worth to mention that some authors perceive EMU as a federal bargain adopted by the EU in order to provide its Member States with a remedy against the volatility of the international economy – because all of them agreed that only federal-like economic and political arrangements would ensure economic and political stability [McKay 1999]. But some other authors criticize the EU for the discrepancy between its federalist rhetoric and non-federalist (intergovernmental) actions, i.e. between its ideological aspirations and contemporary political reality (stating even that the post-war federalist heritage of the European Community has become discredited by contemporary politicians) [Burgess 2000].

would be advisable for the Union (or, at least, for the euro area) in the future. The Commission indicates that the delivery of some key agreed objectives requires synergy between actions and expenditure decisions at **the EU, national and regional levels** (the Lisbon Strategy or external EU action are good illustrations of this problem). By complementing and stimulating national efforts to promote economic development, the Union can improve the efficiency of national actions and demonstrate EU-wide solidarity [Commission 2004g]. Similarly, the Sapir Report – along with changes in expenditures and revenues of the EU budget – recommended also changes in budgetary procedures, including the devolution of some responsibility for budget execution to actors other than the Commission, i.e. to relevant **local, national or EU actors** [Sapir *et al.* 2003]. In fact, in the above documents there is no official call to organize the EU budgetary system as those in federal countries, but the above-mentioned division of responsibility seems to confirm that such a model would be rational (and perhaps even desirable) for the EU – or for the euro area – in the future. In the literature, however, there are such voices; for example, some authors call for an important change in the present institutional and economic organization of the EU – towards a model of largely decentralized federalism [Alves 2004], i.e. with some functions attributed to all (local, national and supranational) levels. One can say that those official and unofficial opinions and calls are the first steps in the right direction – towards fiscal federalism within the Community.

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As far as the EU budgetary system is concerned, it should be noted that there are opinions that the approach taken by the EU on EMU fiscal rules is stricter than the solutions adopted in some federally structured countries [Balassone, Franco 2001]. But according to some other opinions, given the current level of political integration, conditions for a federal system of public finances do not seem to exist presently in the EU; in the future, however, if the single currency increases the taste for political integration towards a fully-fledged federal structure, a different and more efficient system of public finances could be devised [Buti, Eijffinger, Franco 2003]. Therefore, there is no doubt that **it would be possible only if political integration in the EU is deepened significantly and then – under a full political union – the EU would evolve gradually to a federal structure, introducing its fiscal federalism as well**. In this context, it is worth to quote the recent opinion of the former Member of the ECB Governing Council: *"On the final stage of the integration process, the steady state of political union in Europe, one can only speculate. None of the examples of history, be they a federation of states or a union of nations, can serve as a blueprint for shaping political union. The EU has always been, and will remain, a unique undertaking for which there are no models that can easily be adopted."* [Issing 2006a]. Even if the latter is true that "there are no models that can easily be adopted" in the EU or in the euro area, it does not mean that it is not worth to put some successful achievements (e.g. federal structures) as references for the EU or, more importantly, for the euro area and EMU. It should also be noted that federations of states are not merely "examples of history", but our day-to-day reality in many regions of the contemporary world.

Summing up, it should be stated that, in general, federations have proved their value as successful structures functioning in various regions of the world, including the most developed ones – for example, America (United States, Canada), Europe (Germany, Switzerland) or Australia. This is a simple, transparent and – last but not least – effective solution in terms of political, social and economic dimensions. The federal structure is relevant for a different number of states or countries, e.g. 16 lands in Germany or even 50

states in the United States (thus it seems to be suitable for the EU of about 30 Member States as well). Of course, within the EU (or the European Federation) the nation states would still exist and retain a much larger role than the lands in Germany or the states in the United States. Therefore, it seems it could be workable within the EU (transformed over time into a federation).

Concluding remarks

EMU is not just another stage in the process of European integration – similar to the previous ones. The establishment and existence of EMU, and the introduction of the euro, is undoubtedly one of the greatest integration achievements so far (or perhaps the greatest one). EMU will have a serious impact on the further integration process within the EU, exerting in the course of time stronger and stronger pressure on its deepening – in both political and economic spheres (e.g. by complementing a monetary union with a political union). In other words, it will affect the EU's future. Although EMU seems to be limited to the euro area only, it will influence all the Member States of the EU.

As it is known, EMU and the euro have been existing for more than seven (almost eight) years. Prior to the introduction of the euro in 1999, it was expected that EMU would bring some important economic benefits for its members. Today, after almost eight years of EMU, the overall performance of the euro-area economy is rather mixed. On the one hand, there are some important successes, such as providing greater macroeconomic stability within EMU, but on the other, there are also some significant problems in the euro area, such as its disappointing growth performance in recent years, high and persistent unemployment, relatively high budget deficit and public debt ratios, etc. There are opinions that this disappointing performance of the euro area in terms of growth and job creation is mainly due to the lack of progress in carrying out and completing structural reforms in the Member States. This seems to be true, but at the same time this is only part of the picture. Therefore, when trying to find relevant solutions in order to contribute to improving the growth performance of the euro area, it is necessary to propose not only undertaking and conducting structural reforms by the Member States, as well as consolidating their public finances, but also reviewing the present framework of economic governance and coordination within the euro area (*notabene*, the same is related to the EU as well).

With reference to the latter, i.e. economic governance and coordination of economic / budgetary policies within the euro area, it is apparent that there are many serious weaknesses concerning the present economic framework. For that reason, it would be desirable to reform or change this framework in order to make it more conducive to conducting more efficient economic policy in the euro area. The term "more efficient economic policy" means such a policy framework that would be successful not only in ensuring a stability-oriented macroeconomic environment within the euro area, but also in effective translating this macroeconomic stability into relatively strong, sustainable and non-inflationary growth and creating more and better jobs (i.e. primary objectives of both the Treaty and the Lisbon Strategy). Such an economic policy framework should be able to internalize some (or preferably all) externalities of regional/national policies and spillover

effects from economic integration, ensure macroeconomic stabilization for the whole euro area (notably in the case of asymmetric shocks), contribute to the coherent and optimal policy mix by determining the aggregate economic (and fiscal) policy stance in relation to the single monetary policy, etc.

In this context, especially as regards a more or less profound reform of the present framework for economic and budgetary policies, there are some proposals of both a short- or medium-term character, as well as of a longer-term nature (including the single economic/budgetary policy instead of coordination of economic policies within the euro area). But, at the same time, it must be emphasized that in this regard – particularly in relation to those long-term and far-reaching proposals – the absolutely indispensable thing is political will of the Member States. And at the present moment there is neither political will nor social support for such far-reaching visions of the future Union, including the establishment of "the European superstate" and/or "the European superinstitutions". On the contrary, there is strong opposition in this respect in some Member States. Nevertheless, despite this present adverse climate for proposing some profound reforms in the EU, it is worth to consider whether they would be useful (and desirable) in the longer perspective.

At the moment, there is also some "integration fatigue" in the EU (including the euro area). It was confirmed by, *inter alia*, some last year's events (of May and June 2005), i.e. the rejection of the Constitutional Treaty in the referendums in France and in the Netherlands, as well as the initial non-agreement concerning the EU budget for the Financial Perspective 2007-2013. One can say that those events suggest that the EU citizens and politicians are clearly against further deepening of European integration. Moreover, it could be concluded that the Union has found itself into a deep crisis and there is serious uncertainty about the future of the EU and European integration, including the single currency. But on the other hand, it is possible to make an opposite conclusion: the EU citizens and politicians decided to indicate that the EU – as it stands today (i.e. being too complicated, not transparent and not effective) – could no longer be acceptable. For that reason, it is necessary to conduct serious reforms and find a new formula of the Union in the future. In this context, the last year's crisis situation (not fully solved to date) is not a bad thing, but rather a good one for the EU – taking into account that such a crisis situation is always the opportunity to make more brave and landmark decisions than in another situation, i.e. relative stabilization (as it has been experienced so far). It is obvious that without such a clear crisis the EU leaders would have no incentives to change anything in the existing economic and financial framework of the Union – including its present budgetary rules despite the fact that those rules are obsolete, inconsistent with the present reality and the future challenges and objectives of the EU. As a result, there would be no progress and the EU would remain into stagnation. Therefore, the recent crisis could be a real turning point for the EU and would involve some long awaited decisions and reforms (maybe not today, but in some time – the sooner, the better).

At the present moment the EU needs a serious debate on its future. The debate on the future of the EU started in 2000 – just a year after one of the greatest events its history, i.e. the introduction of the single currency – the euro. There were some far-reaching visions of the future EU – transformed over time into the European Federation – but in the period of relative political and economic stabilization those visions were criticized and rejected. After some years it might seem that the debate was over and the necessary solutions were found and

adopted in the Constitutional Treaty. But following the above-mentioned events of May and June 2005 – the rejection of the Constitution for Europe and the initial non-agreement on the next Financial Perspective – the debate on the EU's future was reopen and launched once again. For example, the proposed review of the EU budgetary rules should be a starting point and part of a broader economic and political debate on the EU's future. One of the crucial elements of this debate is also the future of the euro area and EMU (including its macroeconomic and institutional characteristics).

In the context of potential economic changes within the EU, it should be noted that in the longer perspective – especially considering the future enlargement(s) of both the EU and the euro area (which are to start already in 2007 in both cases) – it seems to be impossible to maintain the present macroeconomic imbalance within the euro area characterized by the existence of the single supranational monetary policy and, at the same time, many national economic / fiscal policies being merely coordinated. Such a partly centralized and partly decentralized macroeconomic framework is connected – actually or potentially – with some negative phenomena, such as the persistent risk of "free riding" behaviour of national governments or the partisan implementation of fiscal rules at the Community level. The Stability and Growth Pact, even after its reform of 2005, does not seem to be able to prevent all such phenomena. In consequence, this results in the lack of fiscal discipline in the euro area, which is necessary for the single monetary policy (moreover, as it is known, sound public finances are necessary for the proper functioning of EMU). It seems that the above situation will inevitably lead to serious tensions between monetary and fiscal policies. In this context, it should be noted that the logic and cumulative character of the integration process indicate that the evolution from coordination of national economic and budgetary policies to the single economic/budgetary policy (coexisting together with the single monetary policy) seems to be an inevitable consequence of EMU in the longer term. Of course, it would require the EU to evolve from the present form to a stricter federal structure, as well as a serious increase of the role and size of the Community budget, and the establishment of an "economic government" or a "central fiscal authority" in the EU (or, at least, in the euro area). Such a centre would be a counterpart for the ECB and could ensure the real representation of the euro area in the international forums.

Conducting within the EU much more efficient economic policy than presently is important not only because of the introduction of the euro and the forthcoming enlargements of the EU and the euro area, but also taking into account the EU strategic goal adopted in the Lisbon Strategy (which is – as argued in this study – an "indirect effect" of EMU because it is likely that without the successful introduction of the single currency and some other factors, the Lisbon Strategy would have not been adopted). Although the original (extremely ambitious) Lisbon goal was partly abandoned in 2005, when the Lisbon Strategy was relaunched, its present goals – to generate sustained economic growth and more and better jobs – still remain very ambitious. But it seems that it will be really difficult for the EU to achieve these goals, having regard, *inter alia*, the recent global economic slowdown which proved to be a much more severe economic problem for the EU (and the euro area) in comparison with some other regions of the world. But without the effective macroeconomic policy mix (in particular coherent and mutually supporting economic and monetary policies) it seems to be simply unrealistic – not only within the time horizon of the Lisbon Strategy, but even (much) later. Therefore, the EU adopting such ambitious goals (as those of the Lisbon Strategy 2000-2010 and the new Financial Perspective 2007-2013) should also think about some

practical measures to achieve them. In particular, it is related to the above-mentioned profound reform of economic policy (including budgetary policy) because its coordination – which has been more or less sufficient so far – seems to be rather a temporary, but not a definitive, solution for the EU (and particularly for the euro area).

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