ON THE SIX YEARS OF THE OPERATION AND REGULATING OF EMU

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ABSTRACT:

The separation of the two elements of financial policy, the parting of fiscal and monetary policies in the decision-making system is one of the most unique features of the Economic and Monetary Union (EMU). Concerning fiscal policy, the Treaty of Maastricht and the Stability and Growth Pact (SGP) only contain equilibrium requirements. It is evident since 2002 that meeting the requirements of SGP has proved unachievable for a number of member-countries. Consequently, the most important challenge the Economic and Monetary Union faces these days is whether stability can be secured without strict fiscal regulations.

KEY WORDS: Economic and Monetary Union, fiscal policy, Stability and Growth Pact

SOBRE LOS SEIS AÑOS DE FUNCIONAMIENTO Y REGULACIÓN DE LA UEM

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SUMARIO:

La separación de los dos elementos de política financiera, la partida de políticas fiscales y monetarias en el sistema ejecutivo, es una de las características más particulares de la Unión Económica y Monetaria (UEM). Con respecto a la política fiscal, el Tratado de Maastricht y el Pacto de Estabilidad y Crecimiento (PEC) solamente contienen requisitos de equilibrio. Es evidente que desde 2002, los requisitos del PEC se han mostrado inalcanzables para muchos de los miembros de la UE. Consecuentemente, el reto más importante al que se enfrenta la Unión Económica y Monetaria en estos días es, si la estabilidad puede ser asegurada sin regulaciones fiscales estrictas.

PALABRAS CLAVES: Unión Económica y Monetaria, política fiscal, el Pacto de Estabilidad y Crecimiento

1. INTRODUCTORY REMARKS

The separation of the two elements of financial policy, the parting of fiscal and monetary policies in the decision-making system is one of the most unique features of the Economic and Monetary Union (EMU). While raising monetary policy to a supranational level, fiscal policies have remained in national supremacy, under the authority of national governments and parliaments. Concerning fiscal policy, the Treaty of Maastricht and the Stability and Growth Pact (SGP) only contain equilibrium requirements, *i.e.* the documents impose limits on current state-budget deficit and national debt. If a member-country of the euro area exceeded the reference value of current deficit it might even entail a fine.

Presumably, SGP regulations are so rigorous, above all, to deter EMU member-countries and their governments from violating deficit criteria. The regulators, according to their intentions, built such devices into SGP that prevent from the first the formation of excessive deficits. This is supported by the so-called early-warning system, too.

It is evident since 2002 that meeting the requirements of SGP has proved unachievable for a number of member-countries. Then it also follows from the foregoing that convergence criteria laid down in the Maastricht treaty, which are incumbent to guard the stability of the common currency, comprise an inadequate system of terms for reality.

Consequently, the most important challenge the Economic and Monetary Union faces these days is whether stability can be secured without strict fiscal regulations. Considering the challenges to the 12 member-countries of EMU posed by economic reform constraints and the age structure of their societies, it may even be assumed that the querying of fiscal stability is not the result of defective short-term budgetary or economic policy measures, but the whole of the euro area are being confronted with short or, perhaps, long-term fiscal policy difficulties.

In what follows, I will discuss the economic performance of EMU member-countries on the one hand, and the impracticability of SGP and its reform carried out in the spring of 2005 on the other.

2. ON THE ECONOMIC PERFORMANCE OF THE EURO-AREA COUNTRIES BETWEEN 1999 AND 2005

It seems as if after the turn of the Millennium public finances had switched over to a different trend. At the end of the 90s developed world “turned into surplus”. It all started with the US, then the majority of the EU15 followed suit and closed their financial years with a surplus. It was likely to be the ruling tendency in the developed world, and started to cause anxiety on the market of government securities.

It was 2000 the last “peace-time year”. By 2001 the US economy turned into a recession then the terror attack ensued on 11 September. The year 2003 already witnessed recovery in America, however, the whole era has been characterized by state-budget deficits, moreover, twin deficits. Thus, the age of surplus seems to have vanished. At any rate, it cannot be expected that in 2005 processes returning to those of the 90s would start.

Therefore, the question is whether such a growth will begin that is inevitably accompanied by budget deficit, and why if it will. Or there are only temporary hardships leading to this fiscal situation and as problems cease surplus will feature again the annual balance of public finances. This is especially true in the case of the US. It has to be emphasized, of course, that the idea of permanent surplus in the EU was triggered, not to a small extent, by the economic-policy success of the Clinton administration.

It is also a question if the tendency of growing deficit in the euro area will prove a lasting one.

2.1. The features of GDP growth and its components in the euro area and the USA

Between 2000 and 2005 recession and recovery were simultaneously present in the world economy. Nevertheless, it is unmistakably clear that the undisturbed economic growth of the 90s has not characterized the situation since 2000. As if those constituents of GDP growth in the 90s that yielded continuous development instead of a cyclical one in the US had disappeared. Naturally, growth rates in the euro area were lower than in the US even in the “happy” 90s. This situation remained typical in every segment of the period after 2000. It can be well illustrated by GDP data during the seven years between 1999 and 2005. (*Table 1*)

Table 1
GDP growth in the European Union and the United States
(as percentage of previous year)

	1999	2000	2001	2002	2003	2004F	2004	2005F[1]	2005F[2]	2006F
Germany	1.8	3.0	0.6	0.2	-0.1	1.8	1.6	1.1	0.8	0.9
France	3.0	3.4	2.1	0.6	0.5	2.3	2.3	2.2	1.5	1.9
Italy	1.6	2.9	1.7	0.4	0.4	1.1	1.1	1.6	0.1	1.0
Spain	4.0	4.3	2.7	2.0	2.4	2.8	2.7	3.0	3.4	3.2
The Netherlands	3.9	3.9	1.3	0.6	0.9	1.2	1.3	1.5	0.5	1.9
Belgium	2.7	4.1	0.8	0.7	1.1	2.3	2.7	2.3	1.4	2.2
Austria	2.8	3.4	0.7	1.4	0.7	1.4	2.2	2.1	1.7	2.1
Finland	4.0	5.7	0.6	2.3	2.0	2.7	3.4	2.6	1.8	3.3
Greece	3.4	4.1	4.1	3.9	4.3	4.0	3.9	3.0	3.3	3.2
Portugal	3.3	3.3	1.6	0.5	1.2	1.4	1.0	3.0	1.3	2.3
Ireland	9.8	9.0	5.7	6.1	3.7	4.2	4.7	4.5	4.0	4.5
Euro area	2.6	3.4	1.5	0.9	0.5	1.7	1.8	1.8	1.3	1.7
United Kingdom	2.3	3.1	2.1	1.8	2.2	3.5	3.1	2.8	1.8	2.0
Denmark	2.1	2.9	1.4	1.0	0.4	2.0	2.0	2.2	1.7	2.5
Sweden	3.9	3.5	1.0	2.1	1.6	2.8	3.5	2.4	2.2	2.9
USA	4.1	4.1	0.3	2.2	3.1	4.7	4.4	4.2	3.7	4.0

[1] Forecast July 2004
[2] Forecast October 2005
Source: Deutsche Bank: Ausblick: Globale Trends, September 2001; September 2003; July 2004; March, October 2005

There was only one single year, 2001, in the given period when the annual growth rate was lower in the US than in the euro area. Otherwise, American economic performance was significantly better than that of the euro area. From this point of view it is worth investigating the differences between forecast data and facts. In the case of the US the robust growth rate proved slightly more modest than predicted. However, disparity is conspicuous in favour of the US. Comparing the two forecasts for 2005 (made with a time lag), growth rates can be expected to slow down both in the euro area and the US. It seems that trends are similar but scales are rather different as American growth rates stay above four per cent while those of the euro area remain steadily below two per cent. When we compare the economic growths of EMU countries with the US then we only find four-per-cent rates in Ireland and Greece and sporadically three-per-cent rates in single years. Consequently, GDP growth in the euro area falls behind American performance overall as well as in particulars.

If the growth performance of the 12 member-countries is analyzed in itself then it becomes evident that Spanish, Greek and Irish GDP developments basically alter from German, French or Italian economic growth. One may establish that in the euro area also the catching-up process of the less-developed countries continues. According to data on the 2000s, Portuguese economy shows the worst performances among catching-up countries. It is one of the countries where the growth indicator was permanently low. By the year 2003 EMU's fortune reached its nadir: it was the lowest point of recession collectively and individually alike. In 2005 several of the twelve member-countries of EMU witnessed decreasing growth rates.

Surveying the growth performance of the twelve member countries, almost traditional differences are manifest among them. For instance, Finnish economic growth, though fluctuating, is well above the average of the other developed EMU member-countries. Likewise, the Irish economy will not return to the above-eight-per-cent growth rate of the 90s but frequently surpasses the four-per-cent level.

Glaringly bad results were produced by Germany in terms of growth performance following the year 2000. The trend of growth pace demonstrates that its economy has nearly run out of steam. Very low or even negative growth between 2001 and 2003 would not have posed a grave problem in itself if dynamic expansion had begun in 2004. Yet, examining data exposes that performance remained somewhat below the rate predicted by the prognosis for 2004. In addition, the difference between the values of the two prognoses for 2005 suggests that German economy will return to the situation before 2004, *i.e.* the practical absence of growth.

Looking at the French indicators it is striking at first that economic performance data in the medium term show better results than the German. There was no negative growth indicator in France between 2001 and 2005, and after the worst in 2003, the pace of expansion surpassed the two-per-cent level. Of course, it does not qualify a dynamic growth either, and it is evident that the rates exceeding three per cent in the 90s will hardly return. This economy has also lost from its dynamics, and in the long run at that.

The symptoms of “the German disease” may be found while looking at the Italian indicators with a by no means insignificant difference that growth never turned negative, and after the 2003 nadir it exceeded one per cent.

Those three developed EU member-counties that stay away from the monetary union have definitely performed better than the three big developed in EMU. Although the slowdown of growth pace in these three countries could also be experienced after 2000, the growth levels above two or even three per cent in certain years have been characteristic.

The sustainability of a relatively high GDP growth depends on how investors perform. (*Table 2*)

If one compares the respective data of the euro area and the US between 2001 and 2005 then it becomes clear that in the US investments foster dynamic GDP growth and in the euro area it is exactly the low rates of investment activity that result in a much more modest growth.

Table 2
Investment in the European Union and the United States
(as percentage of previous year)

	2001*	2002	2003	2004F	2004	2005F[1]	2005F[2]	2006F
Germany	-4.2	-6.7	-2.9	3.6	-0.9	2.7	-0.9	0.7
France	1.9	-1.4	-0.8	2.7	3.3	2.7	2.8	2.8
Italy	1.9	1.3	-2.1	-0.8	2.1	2.8	-1.3	1.3
Spain	3.3	1.0	3.0	3.1	4.6	4.1	6.1	4.1
The Netherlands	-0.1	-4.5	-3.4	0.5	1.6	3.4	1.2	3.5
Belgium	0.3	-2.2	2.0	1.5	4.3	3.3	4.9	3.4
Austria	-2.3	-2.8	3.1	1.8	3.8	3.2	1.8	3.3
Finland	3.9	-3.1	-2.3	2.4	4.5	3.7	-0.2	4.0
Greece	6.5	6.1	11.6	7.7	4.2	1.9	-1.0	4.0
Portugal	0.1	-5.2	-9.6	5.2	2.1	10.7	-1.4	1.9
Ireland	0.2	1.7	-5.3	2.5	5.0	4.5	5.7	6.0
Euro area	-0.1	-2.6	-1.2	2.3	1.7	3.2	1.1	2.8
United Kingdom	3.6	-1.0	2.6	5.1	5.9	4.4	3.4	3.8
Denmark	4.9	4.5	-2.9	4.3	4.6	3.4	-0.4	4.5
Sweden	-1.0	-3.0	-2.0	2.3	5.1	4.3	7.8	5.3
USA	-2.4	1.0	4.3	11.5	13.2	6.9	6.3	7.7

* European Commission : European Economy, January 2004
[1] Forecast July 2004
[2] Forecast October 2005
Source: Deutsche Bank: Ausblick: Globale Trends, July 2003; March 2004; March, October 2005

In the US the lowest verge of recession from the point of view of investments was 2001. Afterwards, no negative indicators can be found, and investments show dynamism that exceeds GDP growth. It is worth taking a good look at the prognosis for 2004 and facts. Forecasts predicted a growth well above ten per cent but facts surpassed even this level. It was well noticeable from GDP data that 2005 would be the year of slowing down. Keeping in mind all this, it is also worth having a look at the two prognoses of the US for 2005 made in two different periods. In spite of a decreasing GDP, the one made in March 2005 holds likely a better investment activity to unfold than the other made a year before. Thus, in the US, the space of this activity can be expected around ten per cent in 2005, too.

At the same time, the investment indicators of the euro area between 2001 and 2003 were negative. The prognosis for 2004 has finally shown growth, however, actual facts proved to be considerably lower. The March prognosis in 2004 predicted a decent dynamics for 2005 above three per cent, whereas the one in March 2005 reduced the expected rate considerably.

Similarly to GDP growth pace, investment activity in the twelve member-countries of EMU show considerable differences. Spanish and Greek investment indicators exemplify that the catching-up process in these countries are accompanied by modernization, for dynamic expansion of GDP is coupled with dynamic growth of investment. Irish investment data do not truly show good results between 2001 and 2003. The fall back in 2003 was conspicuous, although the pace of a five-per-cent growth or even higher than that seems to establish a more dynamic GDP growth. The difference between the 2004 prognosis and facts may indicate that, perhaps on a somewhat lower trajectory, the above-average Irish economic development resumed. Portuguese economy, on the other hand, indicates a different direction. In two consecutive years was the change in investment negative and, compared with forecast data, 2004 performance reached only less than half of what had been predicted. Therefore, the expected investment growth rate of more than ten per cent for 2005 was reduced to 2.9 per cent by the forecasters.

As in the case of GDP growth, the gravest concern can be expressed about Germany's performance in the field of investment activities. German investment data were negative in four successive years, *i.e.* between 2001 and 2004. The prognosis for 2004 has still predicted an expansion of 3.6 per cent but it also turned negative. Then the second forecast decreased the value to less than its half.

Both the growth and investment performances of France were better than those of the German economy. It was only two consecutive years when investment indicators were negative and 2004 facts surpassed all expectations. In spite of this, the 2005 prognosis in March predicted a slightly lower growth than the previous one did a year before. In any case, in 2005 an investment expansion well above two per cent will take shape in French economy.

In Italy investments produced negative growth pace only in 2003. Although the 2004 prognosis has still predicted a negative growth rate, actual data reached 2.1 per cent. Yet, the second 2005 prognosis has significantly reduced the probable level of investments compared with the one a year before. As if in 2005 investments were hardly increasing in the Italian economy.

Investment data also define GDP growth prospects following 2005. Consequently, the trends discussed foreshadow that the European Union will for a long time lag behind the United States. However, the scale of the backlog will vary according to the member-country concerned. The drawback of the three developed outsiders of EMU is more moderate than that of Germany, France or Italy. Catching up in Spain, Greece and Ireland continues, thus their disadvantage to the US will lessen. On the basis of investment indicators too, it is the German economic performance that seems to be the most serious problem as the growth of its backlog can be predicted of a larger-scale one than those of France or Italy.

Problems of economic growth also exert strong pressures on employment. Declining growth pace usually entails the rise of unemployment rates. (*Table 3*)

Table 3
Unemployment in the European Union and the United States
(as percentage of the employed)

	1999	2000	2001	2002	2003	2004F	2004	2005F[1]	2005F[2]	2006F
Germany	8.4	7.8	7.8	8.6	10.5	10.2	10.6	9.5	11.6	11.4
France	10.7	9.3	8.5	8.8	9.5	9.5	9.9	8.8	10.0	9.3
Italy	11.3	10.4	9.4	9.0	8.7	8.4	8.1	8.1	7.7	7.4
Spain	12.8	11.3	10.6	11.3	11.3	10.9	10.8	10.4	9.4	9.9
The Netherlands	3.2	2.9	2.5	2.7	3.8	4.8	4.7	2.1	4.8	4.6
Belgium	8.6	6.9	6.7	7.3	8.1	8.4	7.8	8.0	8.0	7.9
Austria	3.9	3.7	3.6	4.3	4.4	4.3	4.5	4.1	5.1	5.0
Finland	10.2	9.8	9.1	9.1	9.0	8.9	8.9	8.5	8.3	7.8
Greece	12.8	11.3	10.6	11.3	9.1	8.6	10.4	8.8	10.0	9.7
Portugal	4.5	4.1	4.1	5.1	6.4	6.7	6.7	5.4	7.2	7.1
Ireland	5.6	4.3	3.9	4.3	4.6	4.8	4.5	4.5	4.2	4.1
Euro area	8.7	7.8	7.4	7.7	8.8	8.8	8.8	8.5	8.7	8.3
United Kingdom	5.9	5.4	5.0	5.1	5.0	4.8	4.7	4.8	4.8	5.1
Denmark	4.3	4.4	4.3	4.6	6.1	6.2	6.4	5.5	5.8	5.4
Sweden	6.7	5.6	4.9	4.9	4.9	5.3	5.5	4.5	6.0	5.5
USA	4.2	4.0	4.8	5.8	6.0	5.4	5.5	5.0	5.1	4.7

[1] Forecast July 2004
[2] Forecast October 2005
Source: European Economy: Economic Forecasts, Spring 2004; Deutsche Bank : Ausblick – Globale Trends, March 2004; March, October 2005

Comparing American and euro-area data, it is apparent that in the six years between 1999 and 2004 unemployment rates in the US were lower than in the euro area. These rates in the euro area show relatively constant values as they never reach the nine-per-cent level and never fall below seven per cent. On the other hand, US data is not once less than four per cent as well as not once more than six per cent. However, a steady increase in unemployment can be observed over the six years. Thus, it can be declared that the state of employment in the euro area is worse than in the US.

There are significant differences among the unemployment data of the twelve member-countries of EMU. It can also be founded that there are no functional connections between levels of development and employment difficulties. Unemployment rates above ten per cent feature the Greek and Spanish economies. Rates as high as these also occur, though not frequently, in France, Italy and Germany. Levels often exceeding eight per cent characterize Belgium and Finland. In contrast with these countries, unemployment rates in the Netherlands, Austria and Ireland generally do not surpass the five-per-cent level. In sum, member-countries' employment difficulties are rather various.

The trend of increasing unemployment, prevailing in the United States between 1999 and 2003, did not feature the countries in the euro area indeed. Afterwards, the rise of unemployment rates is characteristic neither to the US nor to most of the EMU members. However, it is distinctively present in Germany. Bad growth performances are also manifest in high unemployment permanently above the ten-per-cent level.

Considering the growth rates of GDP and investment activity as well as unemployment data, it is little wonder that the British, the Danish and the Swedish do not feel an urgent necessity to accede to the euro area.

When assessing these economic performances from the point of view of SGP then it becomes evident that it is Germany at the first place that has to face the consequences of violating the pact. Of course, by no means can the situation in France or Italy be labelled as satisfactory. It is also notable that how badly performs the Portuguese economy and how far it lags behind Spain or Greece according to growth and investment indicators.

2.2. Financial performance in the euro area and the United States

The financial performance of EMU can be judged, above all, on the basis of the developments of state-budget deficit and inflation. The comparison with the US is justified because both macroeconomic indicators depend on the changing frameworks of the world economy. In this case the most important external variable is the price of oil.

It is worth underlining repeatedly that American economic performance made popular and proved feasible the pursuing of fiscal policies with surplus in the European Union. At the end of the 90s a number of experts definitely hoped that once a set of countries succeeded in closing the budgetary year with surplus for a longer period, then it would become the ruling trend all over Europe.

Nonetheless, the beginning of this decade seems to contradict this prophecy. Nearly everything appears to have hanged that applied to state-budget trends formerly. Budget deficit has become a world phenomenon. The obedience to the rules of the Stability and Growth Pact is not in the least suitable to endure the situation which has changed for an indefinitely long time.

Of course it can also be raised as a question, whether countries of the euro area have enough scope of movement at all that allows them to run their public sectors with – if not a surplus but – a modest deficit.

Where lasting growth problems are present, it is generally true that creating financial stability proves more difficult, especially in the fiscal grounds. However, a presumption can be put the other way round. If state activities fostering innovation in a catching-up country decrease, or even cease, to meet the criteria imposed by the pact then it may have growth-limiting effects. As it had frequently happened, cause and effect are simultaneously present in the economy and essentially explain why is breaking out of distressing circumstances is so hard to do.

The economic attitude toward growth and investment in recession usually establishes the emerging growth potential prevalent following the cycle. The American example calls attention to the fact that investments to modernize in recession shorten the period itself on the one hand, and create a new growth trajectory for the economy after the period on the other.

In recent decades the European market-economy model has not shown any inclination to apply the means of "escape by renewing". Developments at the beginning of the 2000s in the EU confirm the above statement. Nevertheless, there are a number of differences between the performances of the 15 old member-countries and their companies. At the same time, another statement can be risked. Differences between the EU15 never reach such an extent that any member-country would rather resemble the US.

It is worth examining the rates of annual inflation in the period discussed. (*Table 4*)

Table 4

Inflation in the European Union and the United Sates

(as percentage of previous year)

	1999	2000	2001	2002	2003	2004F	2004	2005F[1]	2005F[2]	2006F
Germany	0.7	2.1	1.9	1.3	1.1	1.8	1.8	1.3	2.0	2.0
France	0.6	1.8	1.8	1.2	2.2	2.1	2.3	1.3	1.9	1.9
Italy	1.7	2.6	2.3	2.6	2.8	2.2	2.3	1.9	2.2	2.2
Spain	2.2	3.5	2.8	3.6	3.1	3.0	2.9	2.4	3.4	3.3
The Netherlands	2.2	2.5	5.1	3.9	2.2	1.4	1.1	0.9	1.4	-2.1
Belgium	1.1	2.7	2.4	1.6	1.5	1.8	1.7	1.6	2.6	2.0
Austria	0.5	2.0	2.3	1.7	1.3	1.7	2.0	1.5	2.2	2.0
Finland	1.3	2.9	2.7	2.0	1.3	0.2	0.1	1.2	0.8	1.7
Greece	2.1	2.9	3.7	3.9	3.4	3.7	3.0	2.9	3.6	3.4
Portugal	2.2	2.8	4.4	3.7	3.3	2.5	2.5	2.3	2.1	2.3
Ireland	2.5	5.3	4.0	4.7	4.0	2.4	2.3	2.8	2.1	2.9
Euro area	1.1	2.3	2.3	2.3	2.1	2.1	2.1	1.6	2.2	1.9
United Kingdom	1.6	2.9	1.8	1.3	1.4	1.5	1.3	1.9	2.1	2.0
Denmark	2.5	3.0	2.3	2.4	2.0	1.3	2.0	2.0	1.7	2.1
Sweden	0.3	1.3	2.8	2.6	2.3	1.0	0.9	1.8	0.7	1.7
USA	2.2	3.4	2.8	1.6	2.3	2.6	2.7	2.6	3.5	3.0

[1] Forecast July 2004
[2] Forecast October 2005
Source: Deutsche Bank: Ausblick: Globale Trends, September 2001; September 2003; July 2004; March, October 2005

Annual inflation rate in the euro area was lower than in the US during the seven-year period introduced in the table. In the two time-series the rate exceeded the tree-per-cent level only once, which labels the environments as definitely good. The period was characterized by a moderate inflation in recession, in recovery or beside high oil prices alike. The ambition of the European Central Bank (ECB), ever since it has been established, was to have annual harmonized price index around the two-per-cent level or, preferably, below that. It is apparent that during the three years with the highest rate of price rise, between 2000 and 2003, inflation exceeded two per cent only slightly. It is notable that the fact equals the prognosis for 2004. In the US a higher rate of inflation appeared by 2004 and actual data somewhat surpassed the prognosis made in the previous year. For 2005, prognoses predict values below the two-per-cent level in the euro area and around two and a half per cent in the US. There seems to have occurred a higher inflation in the US. Of course, one must not forget about the substantial differences between growth rates.

It is also worth scrutinizing inflation in the twelve member-countries separately since harmonized price index is a weighted average. If we take the inflation rates of the three big developed EMU member-countries it shows clearly that a conspicuously low consumer price growth features German economy. Neither consolidated data nor a single prognosis reach the two-per-cent level in 1999 and 2000. From the point of view of the ECB Germany can be considered as the ideal country. When analyzing France, one finds low inflationary values too, although the rise of consumer prices surpassed two per cent. In case of Italy data show a country more prone to inflation. It can well be seen that inflation remained above two per cent and approached the tree-per-cent level once. The fourth big country of EMU, Spain belongs to the catching-up countries. There are no data below two per cent, and inflation exceeded the three-per-cent level in the year 2000 and 2002 both. Dutch inflationary trends deserve attention on the basis of the magnitude of GDP. In the Netherlands a decreasing trend has been prevailing since 2002. Dutch economy deserves attention not merely owing to the foregoing. It is Dutch economic policy, besides the German, that can be referred to as the stronghold of rigorous financial policy.

The Greek inflationary indicators are remarkably high from the ECB standpoint. Consumer price indices steadily stayed over three per cent. Similar trend features Portugal too, with the difference of a falling rate below three per cent from 2004. Ireland belongs to the countries with outstanding inflation, where perhaps the highest rate of the whole period could be observed with a peak of 5.3 per cent in 2000. Irish inflation has also been reducing significantly since 2004. In his case, though, it is worth noting that GDP growth pace has decreased, too.

According to the inflationary indicators between 1999 and 2004, it can be declared that the new currency, the euro proved to be a stable currency. In countries where people lived with modest inflation the new currency has not caused disappointment. In countries where the inhabitants had had to accustom to a relatively high inflation the appearance of the common currency triggered the slowing down of price rise. It is also a fact, however, that the introduction of the euro as cash in 2002 disillusioned people to a certain extent for the prices of ordinary consumer goods used daily rose significantly in the wake of exchange tricks.

It is hard to deduce from the inflationary data of the period between 2000 and 2004 for the forthcoming years of this decade, since oil prices may play an increasingly important role in domestic inflation. The price of oil lingers around 55 USD per barrel and there is nothing to indicate a decrease. Moreover, a further increase is far from inconceivable. Typically, at the beginning of the year the oil-price-rise trend was underestimated. This trend worth surveying. (*Table 5*)

Table 5
Oil prices. Forecasts and facts

(USD/barrel)

1999		2000		2001		2002		2003		2004	
F*	F**	F*	F**	F*	F**	F*	F**	F*	F**	F*	F**
12.5	25.0	18.5	28.5	24.5	25.0	20.0	25.0	23.0	28.5	25.0	40.0

* Forecast July 2004
** Forecast October 2005
Source: Deutsche Bank: Ausblick: Globale Trends, March 2004; March 2005

Looking at the data, it unambiguously shows that forecasts failed to predict even a single unexpected change of price at any year beginning. It might as well be said that high oil price "bursts open the door on" the market actors all of a sudden. It is also clear from the table that a drastic price increase ensued in 2004, which projects that the demand for oil will stabilize prices on a high level. Therefore, it is worth emphasizing that the low trend of inflation observed since 2003 in the euro area is far from certain to remain unchanged. The kinds of tasks that this inflationary trend will set ECB are interesting questions of the future.

In terms of financial performance, it is extremely important how successful fiscal policy has proved to be. (*Table 6*)

Table 6
Budget balance in the European Union and the United States
(as percentage of GDP)

	1999	2000	2001	2002	2003	2004F	2004	2005F[1]	2005F[2]	2006F
Germany	-1.6	1.2	-2.8	-3.5	-3.9	-3.6	-3.7	-2.9	-3.9	-3.8
France	-1.6	-1.3	-1.5	-3.2	-4.1	-3.8	-3.7	-3.3	-3.1	-3.1
Italy	-1.8	-0.3	-2.6	-2.3	-2.4	-2.6	-3.0	-2.6	-4.1	-4.0
Spain	-1.1	-0.3	-0.1	-1.9	-3.0	-2.9	-2.9	-2.5	0.3	0.3
The Netherlands	0.4	2.2	0.1	-1.9	-3.0	-2.9	-2.9	-2.5	-1.8	-2.1
Belgium	-0.6	0.1	0.4	0.1	0.2	0.0	-0.1	-0.2	-0.4	-0.7
Austria	-2.2	-1.1	0.3	-0.2	-1.1	-0.8	-1.3	-1.4	-2.1	-1.9
Finland	1.9	6.9	5.1	4.3	2.3	1.6	2.1	2.1	1.5	1.6
Greece	-1.8	-1.1	-1.4	-1.4	-5.1	-1.6	-6.1	-1.5	-3.8	-3.1
Portugal	-2.1	-1.5	-4.2	-2.7	-2.8	-2.8	-2.9	-2.8	-6.0	-4.6
Ireland	2.3	4.5	1.1	-0.2	-0.4	-1.1	0.9	-1.5	-1.1	-0.8
Euro area	-1.3	0.3	-1.6	-2.3	-2.7	-2.7	-2.9	-2.4	-2.8	-2.9
United Kingdom	1.2	2.0	0.0	-2.2	-3.4	-3.1	-3.0	-2.9	-3.3	-2.9
Denmark	3.1	2.8	3.1	1.7	1.5	2.0	1.7	2.7	2.8	3.0
Sweden	1.7	4.1	4.5	0.0	0.7	1.0	0.8	1.5	1.1	1.3
USA	1.3	2.4	1.3	-1.5	-3.4	-4.5	-3.5	-3.2	-2.7	-3.3

[1] Forecast July 2004
[2] Forecast October 2005
Source: Deutsche Bank: Ausblick: Globale Trends, October 2002; September 2003; March 2004; March, October 2005; Europäische Wirtschaft : Beiheft A, October/November 2001

If we set out from the respective data of the US it can clearly be seen that in 2002, after three years of surplus, the American budget turned into deficit, which has been growing since then. It is noticeable that the 2004 data shows a one-per-cent smaller deficit than forecast. However, it is also noticeable that, according to the prognosis, by 2005 deficit will decrease somewhat. It seems very likely to happen as Deutsche Bank predicted the same a year before and in March 2005. In sum, it can be said that the Bush administration appears to be reluctant to increase the level of indebtedness.

When we compare the aggregate data of EMU to that of the US then it can be seen that neither fact nor forecast surpasses the three-per-cent level in the euro area as a whole. From this point of view, EMU demonstrates a more balanced policy than the US. On the other hand, it is equally true that between 1999 and 2001 there was only one year when aggregate budgetary data showed surplus. Data from the euro area are calling attention to the fact, too, that in 2002 aggregate deficit exceeded the two-per-cent limit and it has stayed there, moreover, shows a significant growth. It is interesting to compare the two actual 2004 data with the forecast ones because as long as the American fact shows smaller deficit than forecast data the relation in case of the euro area is the other way round. It may explain that the March forecast made in 2005 predicts a bigger aggregate deficit than the one in the previous year. It looks as if the aggregate budget deficit of EMU drew closer to that of the US. Whatever the case may be, one fact is certain. After 2002, budget deficit features both in the United States and in the euro area instead of surplus.

The development of budget deficits deserves to be surveyed by country. If we analyze the three big developed countries, it is conspicuous that since 2002 both German and French public accounts close with deficits higher than three per cent. In case of Germany it is interesting to compare forecast data with facts. The latter, though not in large measures, reflect more substantial deficit than planned. The crucial problem is the year 2005. From the two prognoses made with a one-year time lag, one may be allowed to extrapolate a German budget deficit higher than three per cent of GDP in 2005, too. In March 2004, there was still a faint hope that deficit would, even if slightly, fall below the “magical” three per cent. Knowing growth and investment data today, one may declare the target to be unattainable.

Since 2002 budget deficit in France has been and will probably remain higher than three per cent. However, there is a remarkable difference compared with Germany. The 2004 data is lower than forecast and the second prognosis for 2005 contain data more moderate than the one a year before. Thus, expectations toward French economy are either more realistic or, what is rather likely, growth performance is better and anticipated to improve.

In any case, on the basis of their budgetary performances neither country of the tandem is interested in creating a kind of rigorous, let alone unambiguous, regulation of the Stability and Growth Pact in the long run.

Turning to Italy, the fiscal situation simultaneously seems better and continuously deteriorating. Although budget never closed with a surplus during the seven-year-long period, deficit only reached three per cent in 2004 for the first time. It is noteworthy that forecast for 2004 was more favourable. The same tendency can be observed when comparing the two prognoses made for 2005 with a one-year time lag. The one in March 2005 predicted a deficit level as high as 3.6 per cent of GDP. Consequently, one may risk such a statement that all of the tree big developed countries will violate the reference value of three per cent in 2005.

The Netherlands, as a relatively small developed country, had always been the embodiment of rigorous fiscal policy. In 2003 Dutch public-accounts deficit surpassed the three-per-cent limit measured against GDP. However, it was successfully reduced below the limit in 2004 and the trend will continue in 2005, too. It deserves attention at the same time that the 2005 forecast predicts a slackening pace of deficit reduction.

From among the catching-up countries, it is Portugal to be in the most endangered position. In 2001 deficit was over four per cent of GDP, and according to the 2005 prognosis made in March 2005 it will exceed the three-per-cent level again. It was the year 2003 when deficit reached the reference level in Spain but starting from 2004 economic policy managed to lessen it somewhat. Compared to Germany and France, it seems that in the two countries of the Iberian Peninsula there is a more substantial scope of action for economic policy to set bounds to the scale of current deficit. It is worth establishing that the budgetary situation of the catching-up countries with less developed social-welfare systems is permanently easier than it is in the big developed countries.

From 2001 to 2004 data relating to Greek current deficit did not reflect real degrees. It was Karamanlis who exposed the “make up” put on the budget by his predecessor when coming to power in 2004. The 2004 six per cent of deficit measured to GDP was not an outstanding data but the first real data after a long time. Thus, it must be said about Greece that its fiscal policy was lastingly characterized by a deficit above three per cent. From a fiscal point of view the country was not prepared to be a member of the euro area in any single year. Merely to remind, it is worth noting that Greece had not been among the founder-countries of EMU but were able to enter in 2001 as the result of a two-year consolidation programme supervised by the European Commission. The mechanism that features the two countries of the Iberian Peninsula does not at all apply to Greece. Notably, that undeveloped social-welfare system entails more manageable public accounts. Greece evidently cannot cease running an expansive fiscal policy even after acceding to the euro area.

It is also worthy to risk the statement that there are significant differences between individual EMU member-countries in terms of the capabilities of their governments for undertaking responsibility for a crisis situation before the public. In 2001, owing to a more than four-per-cent current deficit the government was forced to resign in Portugal. But the idea of inventive accounting to conceal deficit never occurred. There are countries among the twelve members of EMU where the deficit measured as percentage of GDP is traditionally low. It is, for instance, Austria or Belgium. The latter is notable on account of a bigger national debt than annual GDP. Thus, in Belgium, one may witness a change of trend in fiscal policy.

It is especially worth talking about fiscal policy in case of Ireland. In those three years when the US concluded the budget with surplus the same phenomena could be observed in Ireland, too. From 2002 Irish budget turned into deficit, however, in 2004 it showed a surplus again, which has definitely not been predicted by forecasts. Consequently, according to the 2005 prognosis made in 2004 current deficit would reach a higher level in Ireland than according to the one made in March 2005. It is an Irish peculiarity that following 2002 it is not the budget deficit but the equilibrium of payments that features the country, although with minor waverings. An enviable situation it is with fast growth and low current deficit. Of course, inflationary indicators are far from being similarly good.

In sum, it can be declared that none of the twelve member-countries of the euro area shows satisfying growth and investment rates accompanied by low inflation and balanced budget in international comparison. The countries with better growth indicators are the catching-up ones, at the first place, where either inflation or the degree of budget deficit falls short from what is allowed. Moreover, it also happens that both financial indicators exceed the acceptable level.

Perhaps the statement may be risked that the gravest concern of current-budget-deficit developments is caused in Germany, nevertheless, trends in France or Italy are not comforting, too. In these big developed countries, and especially in Germany, the annual rate of inflation is low. Due to their statistical weight, harmonized consumer price index will linger around two per cent. The purchasing power of euro within EMU proves to be extremely stable. From the viewpoint of the success of the currency, this has an outstanding importance. Thus, it can be established after all that in the first six or seven years the economic performance of the twelve member-countries of EMU from the point of view of the stability of currency rates has not caused major problems. It is true, even if the prescriptions of the Stability and Growth Pact have appeared to be impracticable and led to hazardous situations solved in ways that brought doubts, over a not too long span of time.

It is worthy to raise such a question that whether fiscal trends will change until 2010 and zero-balance or surplus budgets will “come into fashion” again. It is also a justifiable question if there will be any member-countries in EMU that characteristically close their public accounts with surplus, with deficit or even with a deficit beyond the permissible level. At present, these questions cannot be truly answered, yet. Nonetheless, one thing can be laid down. Notably, it is conceivable that in the US and within the EU in Ireland, Denmark and Sweden, irrespective of business cycles, change will be featured by a controllable budgetary balance. In this context, of course, the temporary formation of deficits cannot be excluded. It is notable that three of the four countries in this circle are non-members of the euro area. If, after certain considerations, we include Great Britain the number of countries running a successful fiscal policy outside the euro area grows further. Is it possible that the pact is such a shackle that deprives the countries in the euro area of the necessary scope of action to run successful fiscal policies? Not likely. It seems more probable that by the beginning of the 2000s certain “incriminated” countries lost their chances of economic growth due to postponed reforms.

3. THE TRANSFORMATION OF THE STABILITY AND GROWTH PACT

3.1 On the fiscal-policy situation in spring 2005

In spring 2005, the revised form of SGP came finally into existence. SGP, accepted as a supplement of the Amsterdam Treaty, has already been diluted somewhat compared with the original German proposals. However, the fine extending to 0.2 per cent of GDP has remained as a real threat in the pact for all those EMU member-countries that violate the three-per-cent limit of deficit.

Since 2002 the pact has been violated permanently. If rules had seriously been taken into consideration, it should have entailed fines. It did not happen. From this moment it could even have been said that the validity of SGP was suspended. However, it was not the case. The representatives of France and Germany have succeeded in having the members of the ECOFIN council agreed that these two countries, where the regulations of SGP could lastingly be met, should not be punished.

The question naturally emerges, if infringement of the three-per-cent reference level had not happened on the French and German sides would any other EMU member-country “producing” excessive budget deficit have gained an exemption? We will never learn that for the pact itself has been transformed.

However, it is worth referring that Greece, having acceded to the euro area in 2001, continuously infringed the three-per-cent reference value. With the help of inventive accounting it could manage to hide it up until 2005.

In connection of the foregoing, an interesting situation has occurred. If France and Germany were exempted by the Council from paying a fine then Greece could not have been fined for similar reasons. To be more precise, Greece could only be punished for concealing the real state of affairs.

Based on all the above, such a presumption does not seem unfounded that for violating fiscal-policy regulations a fine can hardly be imposed on a country, not even when EU laws would otherwise create the possibility, let alone the necessity, to do so.

One of the strangest peculiarities of the Economic and Monetary Union is that while monetary policy has been governed on a supranational level for six years now, the fiscal policy of the twelve EMU member-countries are essentially being pursued within the frameworks of national parliaments. Considering this peculiarity, the question can rightly be raised even after the first six years. If national governments are responsible for the revenue and expenditure sides of the budget alike, then what real role may the European Commission play with the excessive-deficit procedure? As long as 40 to 55 per cent of GDP is reallocated by national budgets in EMU member-countries real responsibility should naturally be taken by the national governments.

This strange contradiction of competences does not carry any tensions till the criteria of the pact can be met. Nevertheless, when either globalization or age-structure changes pose lasting challenges, then the current budget balance exceeds the reference value steadily. In this case, the European Commission is the responsible to confront with the situation emerged as the guard of Community law while member-countries have to search the solution within their national boundaries, which frequently differ from the recommendations of the Commission. It is true even if the therapy was confirmed by ECOFIN.

In this situation another conclusion may be risked. The demand for staying below the three-per-cent limit of budget deficit will not remain “engraved in stone” and will become gradually more virtual. The problem is further aggravated by the fact that it is only the minority of the EU25 that belongs to EMU. Consequently, newer and newer countries will intend to accede and will probably accomplish joining to the euro area. Until their entrance, Maastricht criteria are compulsory for them. It would be rather curious if they had been forced to meet more rigorous criteria before accession on the fiscal side than after they became members of EMU.

3.2 On the transformed pact

In March 2005 the council of ECOFIN revised SGP, opening up the possibility for the member-countries of the euro area that considering certain economic and economy-policy factors they may “virtualize” the actual magnitude of current deficit.[1]

During the Luxembourg presidency, the council of ECOFIN, led by Jean-Claude Junker, was set the task to create such “flexible” regulations in the pact that allow EMU member-countries to consider hardships arising from actual economic situations. Six such changes were made in the text of the pact meant to promote this cause. Summing up shortly, these are the following:

- There is an opportunity to exceed temporarily the three-per-cent reference limit even if structural reforms are being carried out in a country or other “relevant factors” emerge. These are: research; European political goals; international solidarity; investment projects; pension reform; consolidation packages; outstandingly high EU contribution.
- Excessive deficit may be tolerated if economy stagnates for a longer time or growth is “very weak”.
- The one year prescribed for the liquidation of deficit may supplemented by another one in case of specially hard conditions and deadline may also be postponed in case of appreciable efforts to liquidate deficit or in time of slow business cycles.
- The four-month deadline for implementing recommendations had been raised to six month.
- The mid-term budget target of reaching balanced or surplus budgets has also been modified according to the following: beside low indebtedness and high

[1] Conseil Europeen – Bruxelles 22 & 23 mars 2005. (DOC/05/1) II. Supplelment pp. 21–38.

growth potential deficit may reach one per cent, otherwise it should be zero or turn into a surplus.

* Under the circumstances of a favourable economic climate boosting savings and reducing indebtedness should be pursued, with 0.5 per cent of GDP and without introducing single measures to reach those aims; unexpected access incomes should be used for reducing debts and the system of early warning should also be applied.

The list of the six points proves conclusively that the Council have tried to proceed with thorough carefulness in applying the "dilution" techniques. The target of balanced public accounts had not been abandoned. However, especially on the basis of the opportunities presented under the first point, the council has essentially "virtualized" the magnitude of current deficit that should be declared according to SGP prescriptions. For research, investment, European goals are all items that can be applied with relative flexibility. Moreover, there are wordings that can entirely be interpreted flexibly. Such is, for instance, the outstandingly high EU contribution under point one. In the second point the concept of bad economic environment has become completely vague compared to the original pact. On the basis of all the foregoing it can be predicted that there will be long debates between the finance ministers of individual countries and the EU Commissioner responsible for fiscal policy about the magnitude of deficit when the scope of action of member-countries considerably widen as the result of slackening the pact. Thus, even the vision can be sketched when it will depend on the bargaining power of a member-country how it can utilize the possibilities offered by the new SGP.[2] The fact that the prospective German chancellor might define the deadline of deficit liquidation points out that Germany has pledged itself to fulfil the criteria set by the pact but reserves the right to decide on the deadline. On the bases of the above, the statement can be risked that the influence of the European Commission via the early-warning system on national fiscal policies will lessen according to the rules of the revised pact and, at the same time, member-country competence will grow. It may as well be said that this is the constellation that match actual power and responsibility relations.

Such a financial integration where fiscal and monetary competences were separated to a degree as in the euro area has never existed in the world economy. Therefore, it cannot be foretold whether the revised pact will harm the stability of euro and its world economic role, or not.

In its monthly report,[3] the European Central Bank has also discussed the revised form of SGP. It formulates a concept in its conclusion which holds out much hope for the application of rigorous future fiscal policy. It is worth quoting the last sentences from the ECB statement. "The reform of the SGP creates an opportunity for renewed commitment to the conduct and enforcement of sound fiscal policies that meet both shorter and longer-term budgetary challenges. A rigorous and consistent implementation of the revised rules is needed to underpin the credibility of the EU fiscal framework and confidence in prudent fiscal policies."

[2] In a TV debate between Gerhard Schröder and Angela Merkel held before the extraordinary German parliamentary election in the autumn 2005, the prospective chancellor said, among other things, that she would do everything in her power to make Germany reach the less than three-per-cent reference value of budgetary balance by 2008.

[3] Die Reform des Stabilitäts- und Wachstumspakts, *EZB Monatsbericht*, August 2005, pp. 63–80.

There are no appreciable data yet on how the slackening of the pact will affect fiscal discipline within the euro area. It may be assumed, perhaps, that under the circumstances of a globalized world economy market forces themselves will drive all actors to run strict, balance-seeking fiscal policies. Thus, even such a hope could be expressed that there will be no possibility in the euro area to slacken fiscal policy in the near future.

Of course, the cause which led to the revision of the pact in 2005 still exists. In several EMU member-countries, due to globalization and changing age structure the overall reform of public accounts is urgently needed. The reform in a few countries has already started. It cannot be said, however, that developments toward balanced budgets occurred. On the other hand, it is manifest that the reform does not find support in the whole of society, moreover, it makes such social discontent that may easily cause political crises.

Consequently, the statement does not seem to be unfounded that it is the uncertain economic situation that can be discovered in the transformation of SGP. And this uncertainty will prevail in the foreseeable future. Therefore, fiscal performances will be determined and motivated basically by the advance of this somewhat dubious reform process, even until the welfare state will transform into a service state.

As in the present, the future stability and the world-economic role of the euro will depend on the economic performance of the euro area. In this performance the scale of harmonized consumer price index has an enormous significance. It seems that in the short run the price index will fall closer to three per cent than to the prescribed two-per-cent level set by ECB. If this trend proves to be lasting, it is obvious that ECB will have to adjust this historically low basic rate in the direction of increase. It is a curious question how member-countries will react to a possible rate rise in the light of sluggish business cycles.

The independence of ECB will truly be put to a test these days. If it passes the test, it may significantly contribute to the stability of euro and the strengthening of its world-economic role. Irrespective of the pact, this may exert in itself a substantial influence on the future of euro.

So, to sum up, it can be established that after the first six years of the euro the next four may serve with various surprises. However, even such a development may take shape after the first decade that will improve the role of euro in the world economy. Since the elements of uncertainty are not only present in the economies of the euro area but in the other dominating regions of the world economy, too.

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