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Expected and actual impact of EMU on growth, public finances and structural reforms in the euro area

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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

Other abbreviations:

ALMP	active labour market policy
BEPGs	Broad Economic Policy Guidelines
CAB	cyclically-adjusted balance
CABB	cyclically-adjusted budget balance
CAPB	cyclically-adjusted primary balance
ECB	European Central Bank
EDP	excessive deficit procedure
EGs	Employment Guidelines
EMI	European Monetary Institute
EMU	Economic and Monetary Union
EPC	Economic Policy Committee
EPL	employment protection legislation
ERM	Exchange Rate Mechanism
ESA	European System of Accounts
ESCB	European System of Central Banks
FSAP	Financial Services Action Plan
GDP	gross domestic product
GNI	gross national income
GNP	gross national product
ICT	information and communication technology
IG	Integrated Guidelines
IMF	International Monetary Fund
IT	information technology
MTO	medium-term (budgetary) objective
NRP	National Reform Programme
OCA	optimum currency area
OECD	Organization for Economic Co-operation and Development
PPS	purchasing power standards
RCAP	Risk Capital Action Plan
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. Prior to the introduction of the euro in 1999, it was expected that EMU would bring some important benefits for its members, i.e. it would ensure maintaining fiscal discipline within EMU and sound and sustainable public finances, play a role of a catalyst for structural reforms in the euro area, and – as a result – secure non-inflationary and sustainable economic growth conducive to employment creation. Today, 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 (including price stability). 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.

Sound public finances are essential for the proper functioning of EMU. After seven years of EMU, one can assess that budgetary developments in the euro-area countries were rather mixed – on the one hand, there were some remarkable consolidation efforts in the run-up to EMU and some significant improvements in nominal budgetary positions in the early years of EMU, but on the other hand, presently almost half of the euro-area countries exhibit general government deficits close to or above the reference value of 3% of GDP. Similarly, the current level of debt ratios in the euro area remains well above the 60% reference value of the Treaty and of the SGP. The overall situation of public finances should not be examined merely in the short- or medium-term perspective, but also over the (much) longer time horizon – especially taking into account the so-called ageing of populations which, according to various forecasts (Commission, IMF, OECD), may influence heavily public finances in the coming decades – if some necessary steps are not taken well in advance (i.e. today or in the nearest future).

There are opinions that the present disappointing growth performance in the euro area is mainly due to the lack of progress in carrying out and completing structural reforms of labour, product and capital markets in the Member States. In this context, it should be recalled that prior to the launch of EMU there was a wide debate concerning the question whether the single currency would act as a catalyst for structural reforms. The most spectacular impact of the introduction of the euro was observed in accelerating the process of integration of financial markets. There is also some evidence that EMU has had a positive impact on intra-euro-area trade and the single currency has raised the attractiveness of the euro area as a destination of foreign investments. With regard to the intensity of labour market reforms in the EU before and after the introduction of the euro, there are some opposing results of empirical research – both confirming and negating that labour market reforms have accelerated in the euro area since the launch of EMU.

JEL classification: E 62, E 66, G 10, J 00

Key words: EMU, the euro, euro area, growth, public finances, budget deficit, public debt, ageing of populations, structural reforms, labour/product/financial markets

The cut-off date: 31 August 2006

Introduction

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, i.e. it would ensure maintaining fiscal discipline within EMU and sound and sustainable public finances, play a role of a catalyst for structural reforms in the euro area, and – as a result – secure non-inflationary and sustainable economic growth conducive to employment creation. Today – after those seven years of the euro – it would be interesting to try to assess the actual impact of EMU on some key areas of the euro-area economy.

In this context, it should be emphasized at the very beginning that there are opinions of many economists that the above seven-year period seems to be enough to make only some preliminary assessments, and in order to draw convincing and reliable conclusions, much longer time horizon (perhaps even a generation) is required. This is related to, *inter alia*, public finances and structural reforms, in the case of which it is really difficult to assess the impact of EMU because of its relatively short existence so far. For that reason, the actual impact of EMU may not be fully apparent just some years after the introduction of the euro, but considerably later. Moreover, sometimes it is difficult to isolate the pure impact of EMU and distinguish it from the impact of some other influential phenomena – both internal ones from the EU's point of view (such as the completion of the Single Market) as well as external ones (such as technological change or globalization). Finally, in some cases (e.g. public finances), the impact of EMU should not be measured merely since the formal introduction of the euro, i.e. 1 January 1999, but some years before as well – taking into account the crucial moment in this regard was the ratification and putting into practice the Maastricht Treaty, stipulating the launch of EMU in some years. Despite the above limitations and uncertainties, it seems to be worth to try to make an assessment of the actual impact of EMU on some areas of the euro area economy – especially in the context of some expectations existing before the introduction of the euro.

The study, consisting of three parts, is organized as follows. In the first part there is a description of the overall performance of the euro-area economy (focusing on its growth performance) – presenting both some macroeconomic expectations and achievements related to EMU in this regard. The second chapter presents an expected (prior to the introduction of the euro) and actual impact of EMU on public finances in the euro area. This chapter deals with the three (classical) issues related to the situation of public finances in the euro area: budgetary positions, public debt, and budgetary impact of the ageing of populations. The third part is related to the ongoing debate on structural reforms – being not only a key challenge for the EU economy, but also a key aspect of the proper functioning of EMU. It presents some expectations and achievements concerning financial, product and labour markets in the euro area. The last part concludes.

As indicated in this study (as well as in some papers of other authors), when trying to find relevant solutions in order to contribute to improving the growth performance of the EU / 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 EU / euro area. For that reason, this study – dealing with some macroeconomic issues – is, to some extent, a complement of the previous study of the author on the actual and potential impact of EMU on economic and budgetary policies of the EU (Szeląg 2007).

1

EMU and the overall performance of the euro-area economy

1.1. Macroeconomic expectations vs. achievements related to EMU

Before the launch of EMU it was expected by many economists 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 (or almost eight) years of EMU – that the euro area proved to be really successful in achieving the goal of macroeconomic stability.

This success in ensuring macroeconomic stability within the euro area was due to **the stability-oriented framework of EMU** stipulated in the Treaty as well as **the extraordinary convergence in the run-up to EMU**. It is important that the economic convergence and macroeconomic stability achieved during the Stage Two of EMU (1994-1998) have also been maintained after the start of the Stage Three of EMU (since 1999 onwards). In this context, it is worth to mention some crucial macroeconomic indicators [Commission 2005x; 2006m]:

- first of all, **price stability**, i.e. **low and stable prices** – in order to meet the Maastricht criterion of price stability, the euro-area countries reduced their inflation level markedly in the 1990s (while in the first half of the 1990s the average rate of inflation stood at 3.5% in the euro area, in the second half of the 1990s it declined to 1.7%). In fact, just after the introduction of the euro (especially during the global slowdown of 2001-2003) inflation rates in the euro area were somewhat higher than the ECB definition of price stability (i.e. 2%); of course, it was not the effect of EMU, but of such factors as rising oil prices and depreciating exchange rate of the euro. Last year, rising energy and commodity prices again influenced to some extent the overall price level in the euro area and caused that annual HICP inflation in 2005 was 2.2% (slightly higher than the rate of 2.1% observed in the two preceding years). At the beginning of 2006 (especially in March) some international tensions over Iran's nuclear program resulted in some further tensions in oil and petrol markets, which might have a negative impact on the overall price level this and next year.[1] According to the most recent economic forecasts of the

[1] According to the Commission, the rise in oil prices during 2005 and early 2006 resulted not only from some geopolitical tensions and uncertainties (notably: Iraq and Iran), but also from rising demand in the USA, China and India, as well as some supply problems in the Middle East, Nigeria, Russia, and the Gulf of Mexico. These substantial and lasting increases in oil prices over the last two years have led to concerns about significant upward pressures on core inflation in the euro area. Moreover, in the Commission's opinion, rising oil prices

Commission (of May 2006), inflation in the euro area is projected to stabilize at 2.2% in the nearest future (i.e. 2006 and 2007). All in all, despite some shocks in the global economy, inflationary pressures remain under control of the ECB [ECB 2006a,b,c] and, in general, there are low and stable prices across the euro area (see: table 1.1);

- next, **very low and stable interest rates** – similarly as in the case of price stability, in order to meet the Maastricht criteria, the Member States decreased the level of **long-term interest rates** considerably in the 1990s (in the first half of the 1990s the average long-term interest rate stood at 9.1% in the euro-area countries, and in the second half of the 1990s it declined to 5.7%). After the introduction of the euro a further decrease has been observed since 2000 onwards, reaching finally the level of 3.4% in 2005. The present real long-term interest rates in the euro area are at their lowest levels for almost 30 years (since the second half of the 1970s). With reference to **short-term interest rates**, they were also reduced remarkably in the run-up to EMU – from 9.0% to 4.3% in the first and the second half of the 1990s respectively. After the launch of EMU, the downward trend in short-term interest rates (being identical for all the euro-area countries because of the single monetary policy) has been continued since 2000 onwards, leading finally to the level of 2.1-2.2% in 2004 and 2005. It should be noted that for almost two and a half years – from June 2003 until December 2005 – nominal interest rates of the ECB were not only at their lowest level during the existence of EMU, but even at the historically lowest levels for some 50 years (i.e. the vast majority of the whole post-war period);
- and finally, **the relatively stable (although rather far from the agreed objectives) situation of public finances** (for more details see: chapter 2) – in the run-up to EMU, keeping in mind the necessity to fulfil the Maastricht criteria on public finances, the vast majority of the Member States conducted some strong fiscal consolidation efforts and thereby remarkable improvements in their **budgetary positions** were recorded in almost all of them. Taking into account expectations of further budgetary consolidation it may seem disappointing that the Member States of the euro area failed to continue that process (despite the period of strong growth and favourable economic conditions). As a result, in the subsequent years, particularly during the recent global economic slowdown, the overall situation of public finances in the euro area deteriorated markedly and budget deficits grew rapidly (see: table 2.1). Following the peak of 3% of GDP in 2003, the overall level of the euro-area general government deficit started to decline. On the one hand, its present level (2.4% of GDP) is still higher than that of the second half of the 1990s (2.1% of GDP), but on the other, much lower that that of the first half of the 1990s (5.0% of GDP). It is also lower that the long-term average level in 1970-1990 (3.3% of GDP). In the case of **public debt** there were not so significant consolidation efforts and effects as in budget deficits in the Member States during the run-up to EMU. According to the most recent economic forecasts of the Commission (of May 2006), the debt ratio in the euro area – following the peak of 70.8% of GDP in 2005 – is projected to decline gradually in the subsequent years to 70.5% and 70.1% of GDP in 2006 and 2007 respectively (see: table 2.4). Its present level is, however, much higher than in the 1980s and at the beginning of the 1990s, but lower than in the second half of the 1990s.

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should not be regarded as a short-term anomaly because they are driven by many structural factors (including, *inter alia*, growing global demand for oil, lack of investment in oil exploration and production in recent years, etc). Therefore, oil prices are expected to remain as high as today at least for some time (higher than 60 USD a barrel in 2006 and 2007) [Commission 2005s; 2005z; 2006l]. *Notabene*, higher oil prices have an impact not only on inflation, but also on growth [see: Commission 2004g].

1.2. Growth performance in the euro area

Despite the above 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 [Commission 2006a-c]. According to the Commission, **the failure to translate achieved macroeconomic stability into sustained economic growth has caused considerable concern amongst policymakers** about the source of the growth problem and the policy measures required to improve economic performance. Overall, one of the main lessons from the first years of EMU is that, although the pursuit of macroeconomic stability is a precondition for sustainable growth,[2] there is no automatic mechanism for raising the economy's growth potential [Commission 2004j].

According to the ECB, a major reason of this disappointing growth performance in the euro area is the fact that labour productivity growth has been weak since the mid-1990s. And this is – together with high unemployment and the implications of the ageing of populations – the key economic problem that policymakers are currently facing in the euro area [Trichet 2006e]. Moreover, as it is assessed by the Commission, **the mixed growth performance of the euro area is not due to the failures of macroeconomic policy; the real reason is the lack of progress in carrying out and completing structural reforms of labour, product and capital markets**. Although some important reforms have been launched in many Member States, it is generally assessed that the overall pace of reforms is too slow. The recent Commission's estimates indicate that comprehensive labour and product market reforms in all the Member States could add almost ½ percentage point to the annual growth rate. Moreover, an additional ¼ percentage point could be added by increased investments in knowledge (as stipulated in the Lisbon Strategy). Finally, some effects of capital market integration should also make a positive contribution to potential growth. Therefore, comprehensive structural reforms in the EU Member States (covering labour and product markets, more investment in R&D and education) as well as the creation of the single market in financial services could raise the potential growth rate significantly – roughly from 2% to 3% [Almunia 2006]. This is really important, taking into account that there are opinions that **the lack of sufficient structural reform in Europe is a major cause of the gap in economic growth between Europe and the United States** [OECD 2005a; 2006a; see also: Trichet 2006d,h].

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-c]). It is projected 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: table 1.1).

[2] The importance of macroeconomic stability is emphasized not only by European, but also by American economists. For example, A.Greenspan stated last year: *"an environment of greater economic stability has been key to the impressive growth in the standards of living and economic welfare so evident in the United States"* [Greenspan 2005].

Table 1.1.
Recent economic forecasts for the euro area – as regards non-inflationary growth
(annual percentage changes unless otherwise stated)

a) main features of the Commission's Spring 2006 Forecasts for the euro area

	2002	2003	2004	2005	2006	2007
GDP	0.9	0.7	2.0	1.3	2.1	1.8
Consumption	0.9	1.0	1.5	1.3	1.7	1.4
Total investment	-2.0	0.9	2.3	2.2	4.2	2.4
Employment	0.7	0.3	0.6	0.7	0.9	0.8
Unemployment rate	8.3	8.7	8.9	8.6	8.4	8.2
Inflation (HICP)	2.3	2.1	2.1	2.2	2.2	2.2
Government balance (% of GDP) *	-2.5	-3.0	-2.8	-2.4	-2.4	-2.3
Government debt (% of GDP)	68.1	69.3	69.8	70.8	70.5	70.1
Current account balance (% of GDP)	0.8	0.4	0.5	0.1	-0.5	-0.3

* including proceeds relative to UMTS licences.

b) Eurosystem staff macroeconomic projections for the euro area *

	2004	2005	2006	2007
HICP	2.1	2.2	2.1 – 2.5	1.6 – 2.8
Real GDP	1.8	1.4	1.8 – 2.4	1.3 – 2.3
Private consumption	1.4	1.4	1.4 – 1.8	0.5 – 1.7
Government consumption	1.1	1.4	1.3– 2.3	0.7– 1.7
Gross fixed capital formation	1.6	2.5	2.3 – 4.5	1.6 – 4.8
Exports (goods and services)	6.1	4.1	5.2 – 8.0	3.3 – 6.5
Imports (goods and services)	6.3	5.0	5.3 – 8.7	2.8 – 6.2

* For each variable and horizon, ranges are based on the average absolute difference between the actual outcomes and past projections by euro area central banks. The projections for real GDP and its components refer to working-day-adjusted data. The projections for exports and imports include intra-euro area trade.

c) comparison of forecasts for the euro area – in relation to real GDP growth and HICP inflation

Institutions / forecasters	Date of release	GDP growth			HICP inflation		
		2005	2006	2007	2005	2006	2007
European Commission	May 2006	1.3	2.1	1.8	2.2	2.2	2.2
ECB	June 2006	1.4	1.8 – 2.4	1.3 – 2.3	2.2	2.1 – 2.5	1.6 – 2.8
IMF	April 2006	1.3	2.0	1.9	2.2	2.1	2.2
OECD	May 2006	1.4	2.2	2.1	2.2	2.1	2.0
Consensus Economics Forecasts	May 2006	1.4	2.1	1.8	2.2	2.1	2.1
ECB's Survey of Professional Forecasters	April 2006	1.3	2.1	1.9	2.2	2.1	2.1

Sources: 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]. World GDP growth exceeded 5% in 2004 – the fastest pace since the early 1970s. In 2006 – similarly like in 2005 – it is expected that average world GDP growth will remain at 4.6% [Commission 2006e,m]. In general, **growth in many regions of the world is**

projected to be much stronger than in the euro area over the forecast horizon (until the end of 2007). In particular, it is related to the United States and China – still regarded as the two main engines of global activity [ECB 2006e]. For example, in the United States, growth – supported by private consumption – remains healthy (3.5% in 2005), despite a temporary weakening because of some hurricane-related disruptions in the last quarter of 2005. But taking into account the large and growing current account deficit and general government deficit, the US growth seems to be rather unsustainable (it is expected to fall to 3.2% and 2.7% in 2006 and 2007 respectively). Moreover, in recent years the EU has started to loose ground vis-à-vis its other global competitors such as China and India which have been growing at substantially higher rates. In particular, the Chinese is growing rapidly – reaching the annual growth rate of 9.9% in 2005 (only marginally below the rate of 10.1% in 2004) and, according to the most recent forecasts, around 9.0-9.5% in 2006 and 2007. On average, the growth rates in Asia (excluding Japan) are projected to remain between 7% or 8% in 2006 and 2007 [Commission 2005c,x; 2006m]. Similarly, according to the IMF, China, India and Pakistan are expected to grow rapidly in 2006 and 2007 – at 9.0-9.5%, 7.0-7.3% and 6.3-6.4% respectively (compared to even higher rates by about 1 percentage point in 2004 and 2005) [IMF 2005d; 2006b].

In addition to the above analysis concerning the overall rates of GDP growth in the EU / euro area, it is worth to analyze the situation in terms of **GDP *per capita***. Over the past three decades, living standards in the EU-15 (measured by GDP *per capita* in purchasing power standards – PPS) used to remain at around 70% of the US level. After the recent enlargement, when the 10 new and much poorer Member States joined the EU, GDP *per capita* in the enlarged Union (EU-25) has declined to 65% of the US level (for the euro area this proportion remains at around 70%). Moreover, considering the first five or six years of the Lisbon Strategy, labour productivity growth in the EU (measured by GDP in PPS per person employed) was below that of the United States, which explains why – despite the substantial number of newly created jobs during that period of time (over 6.5 million) – EU GDP per capita has failed to catch up with that of the US [Commission 2006a-c]. In general, living standards in the EU remain well below those in the United States. But in particular, it should be noted that there are substantial differences in living standards between the Member States, e.g. GDP *per capita* in Luxembourg exceeds that of the United States, while GDP *per capita* in Poland and the Baltic States have not yet reached ⅓ of the US level.

As far as the new Member States are concerned, one more issue should be noted in the context of the overall growth performace in the EU. It should be emphasized that the new Member States generally enjoy growth rates well above those of the old Member States (EU-15) and contribute to an overall dynamism of the EU economy [Commission 2005a]. At the same time, however, it is necessary to remember that although growth in the new Member States has been considerably more dynamic in recent years (around 4.6%), their small economic weight causes that it is not clearly apparent in the overall growth rate observed in the whole EU (on average 1.9% during the first five years of the Lisbon Strategy) [Commission 2006a-c]. All in all, most academic studies suggest that **the EU enlargement is likely to contribute substantially to economic growth in the EU in the long term**. Although the degree of economic integration between the old and new Member States is already substantial (and it was even in the pre-accession phase), the enlargement is regarded to be likely to have some further integration effects – mainly by the extension of the Single Market, which has already intensified competition within the EU. And more intense

competition will over time contribute to a not negligible increase in the sustainable growth rate of the European economy [Issing 2005a]. It is important not only for the EU, but for the euro area as well, keeping in mind that the new Member States will join the euro area in the future. In this contex, it should be noted that some economic analyses suggest that **the adoption of the euro by the Central European countries could raise their GDP by an additional 20-25% over the long term** [Köhler 2004; Schadler *et al.* 2005].

With reference to the above considerations related to the overall growth performance of the euro area, it would be interesting to try to assess **the actual and potential impact of EMU and other phenomena on growth in the euro area**. It seems that the following three factors are of primary importance:

- the fiscal framework of EMU,
- structural reforms,
- the ageing of populations.

Taking into consideration the first factor, it should be assessed that the EMU fiscal framework – by changing the behaviour of fiscal authorities – has made a positive contribution in this respect. The Commission's analyses suggest that the budgetary convergence in the run-up to EMU laid the basis for better growth prospects for the euro area. In addition, the Commission argues that **without fiscal discipline introduced by the EMU fiscal framework potential growth would have been reduced compared with actual figures** [Commission 2004e].

Next, considering the potential impact of EMU in the future, it is worth to present some projections regarding **structural reforms and their awaited impact on growth in Europe** (keeping in mind that EMU was expected to play a role of a catalyst for structural reforms in the euro area). According to the Commission's estimates, product and labour market reforms in the second half of the 1990s resulted in an increase in annual GDP growth of almost ½ percentage point over the medium term [Commission 2002j].[3] As far as the future is concerned, the potential growth performance of the euro area may vary considerably, depending on progress concerning structural reforms:

- considering a **"status quo" scenario**, i.e. the lack of many structural reforms stipulated by the Lisbon Strategy, it is estimated that, relying on current trends, the potential growth rate of the European economy is expected to halve over the coming decades and reach **just over 1% of GDP per year** [Commission 2005d]. Thus far numerous reforms, which are the responsibility of the Member States, have not been achieved yet. And measures taken only at the European level are not enough to put the Lisbon Strategy on the right and satisfactory track [Commission 2004b]. Therefore, if structural reforms are not undertaken and conducted relatively soon, rather poor growth performance should be expected in the medium and long term in the EU (including the euro area);
- considering a **"structural reform" scenario**, i.e. an acceleration of Lisbon reforms resulting in increased knowledge investments, it is expected that the simultaneous and

[3] The Commission stated in it report: *"Labour and product market reforms, in combination with observed wage moderation, in the period 1996-2001, may have increased the level of potential output by 3-4% relative to a no-reform baseline path. This translates into an acceleration of annual output growth of a little less than ½ percentage point over a period of 7 to 8 years. Without reforms and moderate wage developments, average growth in the EU would have been around 2.2% instead of 2.6% over the 1996-2001 period. This would translate into 5-6 million fewer jobs in the EU and unemployment would have been 2 million higher"* [Commission 2002j].

integrated pursuit of reforms would cause **an increase in the GDP growth potential** of the EU of about **½ – ¾ percentage point** over the next 5 to 10 years [Commission 2004b]. Over a ten-year period, this would imply **an increase in the GDP level of up to 7% or 8%** (slightly below the IMF's estimates of the impact of product and labour market reforms, which show a 10% increase in the euro-area GDP level over the long term) [IMF 2003a; Commission 2005h].

According to the Commission, structural reforms need to be accelerated because *"the cost of a delay of 2-5 years in delivering on the Lisbon Strategy may be paramount to not having Lisbon at all"* [Commission 2005c].

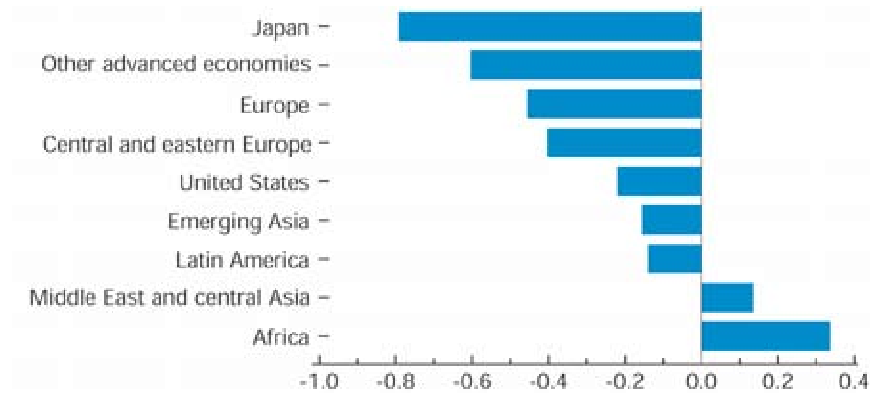
In addition to the above short-term growth forecasts for the euro area, it is worth to mention about some long-term projections as well – especially in the context of the ageing of populations, which is expected to influence seriously growth and public finances of the euro area in the future (see: section 2.3). In general, **it is projected that the ageing of populations will reduce growth in industrial countries**, beginning in the next decade in Japan (where growth is expected to be most severely affected) and then in the rest of other industrial countries by the middle of the XXI century. In contrast, it is expected that **developing countries** – taking into account that the relative size of their working-age populations increases – **will enjoy a "demographic dividend"** which should result in stronger growth over the next 20-30 years, before the ageing effects appear to be more evident [IMF 2004b; Batini, Callen, McKibbin 2006] (see: figure 1.1.a). Similarly, according to the recent projections of the Commission, potential GDP growth is projected to decline in the coming decades. For example, last year, the Commission stated that **if structural reforms are not carried out, the pure impact of ageing will reduce the EU potential growth rate significantly** – by almost half by 2040, from the present rate of 2-2¼% to around 1¼% [Commission 2005i,h]. At the beginning of this year (in January 2006), the Commission and the EPC confirmed that the annual average potential GDP growth rate of the old Member States (EU-15) would fall from 2.2% in the period 2004-2010 to 1.8% between 2011 and 2030, and to 1.3% in the period 2031-2050 (see: figure 1.1.b).[4] **In the euro-area countries** (such as Germany, Austria, Italy, Spain, Greece, and Portugal), **the rates of potential annual growth are projected to drop to only 1%** [Deroose 2006]. An even steeper decline is foreseen for the new Member States (EU-10), i.e. from 4.3% in the period 2004-2010 to 3% between 2011 and 2030, and to 0.9% in the period 2031-2050. This is not only due to some projected (unfavourable) demographic developments, but also owing to some underlying assumptions for these countries that over time – especially after successfully completing the convergence process – their productivity growth rates will come much closer to those of the old Member States [EPC / Commission 2006; Commission 2005z].

[4] In addition, the sources of economic growth will alter dramatically. Employment will make a positive contribution to growth up to 2010, become broadly neutral in the period 2011-2030, and turn significantly negative thereafter. Over time, labour productivity (due to progress of technology) will become the dominant, and in some countries the only, source of growth [Commission 2005z; EPC / Commission 2006; Deroose 2006].

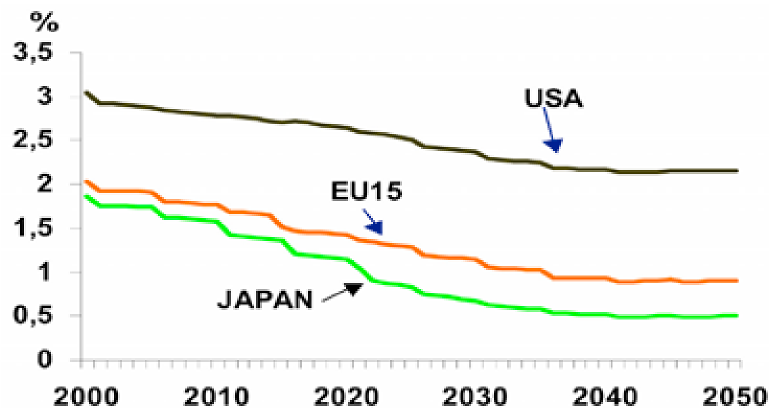
1

Figure 1.1.
Potential impact of the ageing of populations on growth (2000-2050)

a) impact on real GDP per capita growth (percentage points)



b) impact on potential growth rates



Sources: IMF 2004b; Commission 2005t.

Similarly, according to the recent OECD analyses, **the ageing of populations is likely to slow growth of GDP *per capita* in OECD countries (including the euro-area countries) in the long-term**. It is suggested that due to a growing share of inactive population, GDP *per capita* growth will tend to slow in most OECD economies in the XXI century. If social security and labour market policies remain unchanged, the following outcomes could be expected: while demographic developments will continue to sustain growth in the United States, ageing will tend to slow the expansion of GDP *per capita* in Japan, France and Germany. Relative to a situation with a stable age-structure of the population, the ageing-induced drag on GDP *per capita* in these countries will be on average -0.2 to -0.3 percentage point of growth *per annum* during the first half of the XXI century. As a result, ageing will tend to widen GDP *per capita* gaps relative to the United States by 2050 [Oliveira Martins *et al.* 2005].

In the context of the above projections, it is repeated by many economists that **the ageing of populations will have a serious impact on economic growth** and labour markets in the EU (and, **in particular, in the euro area**). In addition, some economists and officials draw attention that **it could also have some dramatic repercussions** for some other areas, such as the economic welfare of the EU citizens, for the functioning of the welfare state, and – last but not least – **for the overall operation of EMU** [Deroose 2006]. For that reason, and

assuming that ageing is largely predictable and thereby manageable, they formulate some policy conclusions allowing the EU / euro area to act in an efficient manner in order to mitigate some potential effects of ageing. These conclusions are the following:

- the EU needs to achieve, and then surpass, the goals it set for itself in the Lisbon strategy;
- economic / structural reforms work and many of the EU Member States have made some substantial progress in recent years;
- it is necessary for the EU to focus on education and investment in human capital formation.

It is argued that although the process of ageing is irreversible, its consequences are not. And, therefore, whether the EU will be able (or not) to cope with the economic and budgetary challenges of ageing, largely depends on its ability to implement well-designed and timely policy responses [Deroose 2006].

Summing up the above considerations, it should be noted that it is widely recognized that **the present (disappointing) growth performance of the euro area cannot be regarded as satisfactory and, therefore, a continuation of the current trend could result finally in undermining public confidence in the single currency.** In this context, it is often argued by many economists and institutions that this weak growth should be attributed to incomplete economic / structural reforms in the largest euro-area Member States (notably in Germany, France and Italy). In other words, low growth in the euro area is perceived as a result of some problems at the national level (i.e. policy failures in the Member States), but not at the European level (e.g. problems in economic governance of the euro area). Of course, the importance of domestic reforms is unquestionable,[5] but this is only part of the answer. Another part of the answer seems to be economic governance and policy making in the euro area, which also does matter in this regard [Pisani-Ferry 2006]. Therefore, **when trying to find relevant solutions in order to contribute to improving the growth performance of the EU / 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 EU / euro area**.[6]

[5] For example, it is argued that *"a reallocation of public spending towards education and research, as well as regulatory reforms of labour, product, and financial markets, are essential prerequisites to increasing productivity and thereby the growth potential of the euro area"* [Pisani-Ferry 2006].
[6] A detailed analysis of the present framework of economic governance and coordination within the EU / euro area was presented by the author in another working paper (see: Szeląg 2007).

2

Public finances before and after the introduction of the euro

It should be emphasized that the assessment of EMU and its impact on some economic areas, such as public finances, is a very difficult task because of a number of reasons. First of all, EMU has been existing for more than seven (or less than eight) years only. While some economists state that it seems to be an enough period of time to make some preliminary assessments, some other observers argue that much longer time horizon (perhaps even a generation) is required in order to draw convincing and reliable conclusions. Moreover, it is argued that the Member States and market participants may have anticipated the launch of EMU (as it was announced many years before) and thereby adapted their behaviour accordingly, making it useless to regard the launch date (1 January 1999) as a real turning point or a structural break [Commission 2004j]. This is related to, for example, public finances in the Member States adopting the euro, which made remarkable consolidation efforts in the run-up to EMU. And that effect, although it occurred before the formal introduction of the euro, should be regarded as the actual impact of EMU (equally to the effects observed after 1 January 1999).

This chapter deals with the three (classical) issues related to the situation of public finances in the euro area:

- budgetary positions,
- public debt,
- budgetary impact of the ageing of populations.

Particular emphasis has been put on the expected and actual impact of EMU (and some other factors) on the Member States' budgetary policies and their effects in the past, present and future.

2.1. Budgetary positions

With reference to the first issue – general government positions (deficits/surpluses) – it should be noted that, as mentioned before, **the impact of EMU on budgetary developments in the euro area should not be measured merely since the formal introduction of the euro**, i.e. 1 January 1999, **but some years before as well** – taking into account the crucial moment in this regard was the ratification and putting into practice the Maastricht Treaty, stipulating the launch of EMU in some years. Therefore, the indirect (and even direct) impact of the introduction of the single currency on the situation of the EU's public finances was clearly visible during the Stage Two of EMU (1994-1998) as well as during the Stage Three of EMU (since 1999 onwards).

One of the most important tasks for the Member States during the Stage Two of EMU was to achieve a high degree of sustainable convergence, i.e. to fulfil the Maastricht convergence criteria – related to, *inter alia*, public finances. As it is known very well, in the case of public finances the Maastricht Treaty stipulates the achievement of the sustainability of the government financial position – referring to the following reference values: 3% for the ratio of the planned or actual government deficit to GDP at market prices; and 60% for the ratio of government debt to GDP at market prices.

Analyzing data on budgetary developments in the EU, it is clearly visible that in the mid-1990s, i.e. **in the run-up to EMU**, the vast majority of the Member States conducted **strong fiscal consolidation efforts** as a result of the necessity to fulfil the Maastricht convergence criteria. The average general government deficit of the euro area (or, more precisely, the group of countries belonging presently to the euro area) decreased by almost 3 percentage points of GDP during the Stage Two of EMU – from 5.1% of GDP in 1994 to 2.2% of GDP in 1998 (see: table 2.1 and figure 2.1). Similar improvements were also observed in cyclically-adjusted budget deficits at that time. It is remarkable that the above fiscal consolidation was undertaken and completed during the period of relatively weak economic performance (just after the 1992-93 crisis) characterized by negative output gaps (see: figure 2.2.a). Summing up, in the run-up to EMU, considerable improvements in budgetary positions were recorded in almost all the Member States, especially in those countries that had very high (even double-digit) deficits in the 1980s and at the beginning of the 1990s (e.g. Greece or Italy). In international terms, the overall budgetary situation of the euro area markedly improved in comparison with Japan, but it was still clearly worse than that of the United States (see: table 2.1 and figure 2.1.c).

Table 2.1.

General government deficit / surplus in the euro-area countries (1994-2007)*

% of GDP	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005[e]	2006[f]	2007[f]
Belgium	-4.9	-4.4	-3.8	-2.0	-0.8	-0.5	0.1	0.6	0.0	0.1	0.0	0.1	-0.3	-0.9
Germany	-2.3	-3.2	-3.3	-2.6	-2.2	-1.5	1.3	-2.8	-3.7	-4.0	-3.7	-3.3	-3.1	-2.5
Greece	-9.3	-10.2	-7.4	-6.6	-4.3	-3.4	-4.0	-4.9	-4.9	-5.8	-6.9	-4.5	-3.0	-3.6
Spain	n.a.	-6.5	-4.8	-3.1	-3.0	-1.1	-0.9	-0.5	-0.3	0.0	-0.1	1.1	0.9	0.4
France	-5.5	-5.5	-4.1	-3.0	-2.6	-1.7	-1.5	-1.5	-3.2	-4.2	-3.7	-2.9	-3.0	-3.1
Ireland	-2.0	-2.1	-0.1	1.1	2.4	2.5	4.4	0.8	-0.4	0.2	1.5	1.0	0.1	-0.4
Italy	-9.0	-7.4	-6.9	-2.6	-2.8	-1.7	-0.7	-3.1	-2.9	-3.4	-3.4	-4.1	-4.1	-4.5
Luxembourg	2.5	2.3	1.1	3.5	3.2	3.3	5.9	5.9	2.0	0.2	-1.1	-1.9	-1.8	-1.5
Netherlands	-3.3	-4.0	-1.7	-1.1	-0.7	0.6	2.1	-0.2	-2.0	-3.1	-1.9	-0.3	-1.2	-0.7
Austria	-4.9	-5.6	-3.9	-1.7	-2.3	-2.2	-1.5	0.0	-0.5	-1.5	-1.1	-1.5	-1.9	-1.4
Portugal	-7.3	-5.2	-4.5	-3.4	-3.0	-2.7	-2.9	-4.3	-2.9	-2.9	-3.2	-6.0	-5.0	-4.9
Finland	-6.7	-6.2	-3.5	-1.2	1.7	1.7	7.0	5.1	4.1	2.5	2.3	2.6	2.8	2.5
Euro area	**-5.1**	**-5.0**	**-4.2**	**-2.6**	**-2.2**	**-1.3**	**0.1**	**-1.8**	**-2.5**	**-3.0**	**-2.8**	**-2.4**	**-2.4**	**-2.3**
EU-25	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**-0.8**	**0.8**	**-1.3**	**-2.3**	**-3.0**	**-2.6**	**-2.3**	**-2.3**	**-2.2**
USA	**-3.6**	**-3.1**	**-2.2**	**-0.8**	**0.4**	**0.9**	**1.6**	**-0.4**	**-3.8**	**-5.0**	**-4.7**	**-3.8**	**-4.1**	**-4.4**
Japan	**-3.8**	**-4.7**	**-5.1**	**-3.8**	**-5.5**	**-7.5**	**-7.7**	**-6.4**	**-8.2**	**-8.0**	**-6.3**	**-6.5**	**-5.8**	**-5.4**

* Net lending (+) or net borrowing (-), general government (as a percentage of GDP); net lending (borrowing) includes one-off proceeds relative to UMTS licences; ESA 79 up to 1994, ESA 95 from 1995 onwards.

[e] estimates; [f] forecasts (spring 2006).

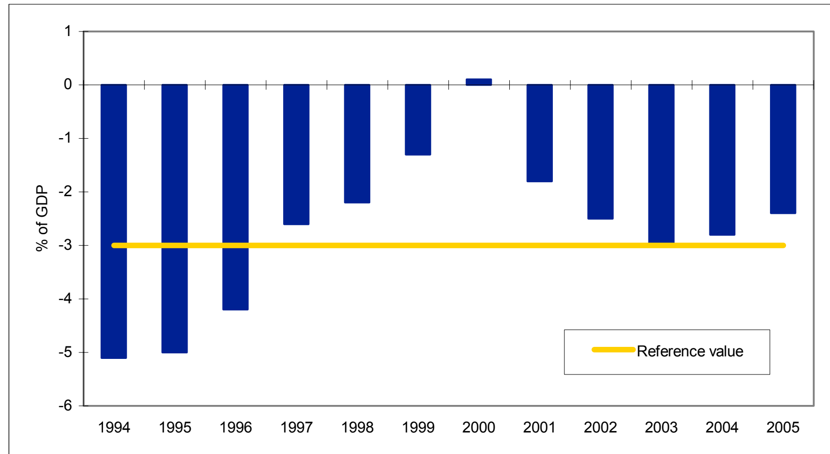
Source: Commission 2006m; Eurostat.

2

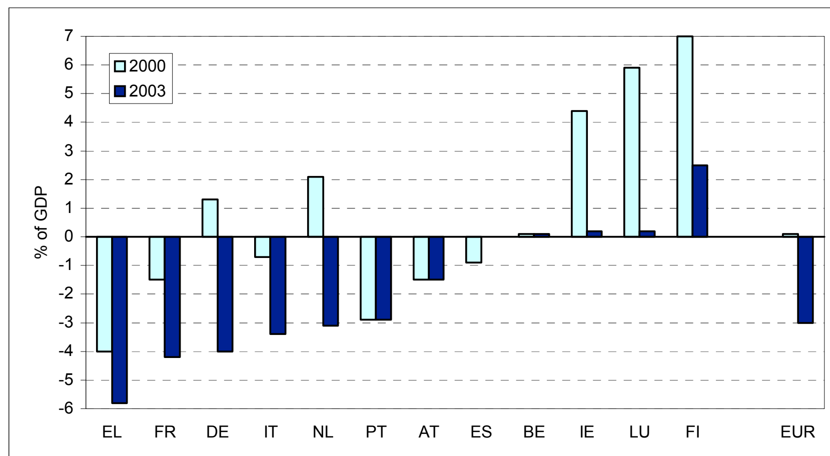
Figure 2.1.

General government deficit / surplus in the euro area (1994-2005)

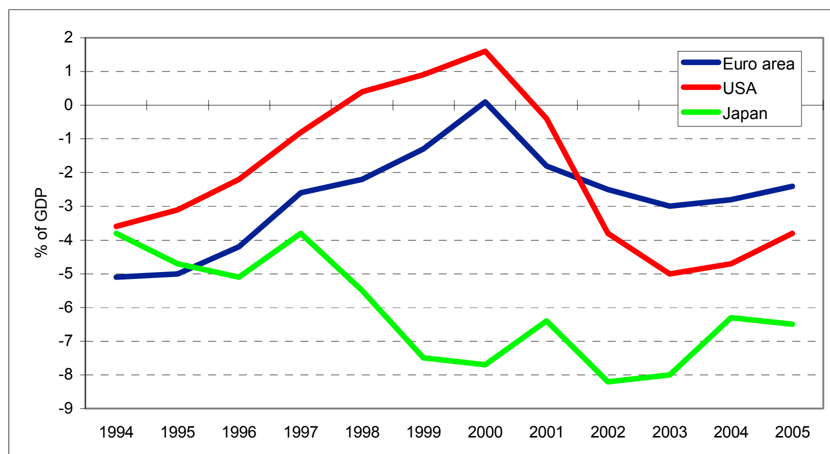
a) in relation to the reference value



b) performance of the euro-area countries



c) in relation to the United States and Japan



Source: own elaboration based on the Commission/Eurostat's data.

Before the introduction of the euro in 1999, expectations related to conducting fiscal policies in EMU were mixed and to some extent even contradictory with the needs at that time. On the one hand, there were opinions that after having secured participation in the euro area, (at least some of) the Member States – that had to achieve substantial budgetary consolidation in the mid-1990s – would loosen fiscal policies in EMU [Eichengreen, Wyplosz 1998a]. Moreover, it was argued that incentives to preserve fiscal discipline would be weaker after the goal of the euro-area membership had been achieved, especially taking into consideration expectations that interest-rate increases associated with expansionary fiscal policies in some countries would have partly spilled over to the other euro-area countries [Commission 2004j]. On the other hand, it was clear that – although some considerable budgetary efforts were made by the Member States in the run-up to EMU – **the need for further fiscal consolidation still existed at the start of EMU** (taking into account the fact that some of the Member States, including the largest ones, joined the euro area with budget deficits equal to or only slightly lower than the reference value of 3% of GDP, and thereby they were far from the objective of budgetary positions being "close to balance or in surplus" – as required by the SGP).

2

Budgetary developments in the early years of EMU were rather mixed:

- on the one hand, there were **significant improvements in nominal budgetary positions** over that period (more that 2 percentage points between 1998 and 2000; in 2000 even a small surplus was recorded in the euro area as a whole – see: table 2.1 and figures 2.1.a.b.c);
- on the other hand, the Member States of the euro area **failed to continue the earlier process of budgetary consolidation** – despite the period of strong growth and favourable economic conditions (1998-2000).

The former reflected some favourable factors which substantially increased budgetary revenues, such as the economic upswing and rising financial assets prices at the end of the 1990s, as well as – in 2000 – some extraordinary receipts from the allocations of mobile phone licences (UMTS). In cyclically-adjusted terms, however, the improvement in deficits was much smaller. The cyclically-adjusted budget balance (CABB) improved by 0.7 percentage point – from -2.0% to -1.3% of GDP between 1998 and 2000. At the same time, the cyclically-adjusted primary balance (CAPB), being at that time in surplus, improved by only 0.1 percentage point – from 2.7% to 2.8% of GDP [Commission 2001f]. Although there were some opinions that the overall stance of fiscal policy in the euro area (measured by the change in the CAPB) became somewhat expansionary, it was – in general – broadly neutral during the first two years of EMU.

In the subsequent years, especially **during the global economic slowdown (2001-2003), the overall situation of public finances in the euro area deteriorated markedly and budget deficits grew rapidly**. The aggregate budgetary position of the euro area shifted from a small surplus in 2000 (0.1% of GDP) to a large deficit in 2003 (-3,0% of GDP) (see: table 2.1 and figures 2.1.a.b). While the general government balance deteriorated each year, the cyclically-adjusted budget balance (CABB) remained almost unchanged over the period of the slowdown. Similarly, the cyclically-adjusted primary balance (CAPB), after some decline in 2002, stabilized and remained unchanged in the subsequent years (see: tables 2.2 and 2.3). The overall deterioration of the situation of public finances in the euro area was owing to a combination of the following factors:

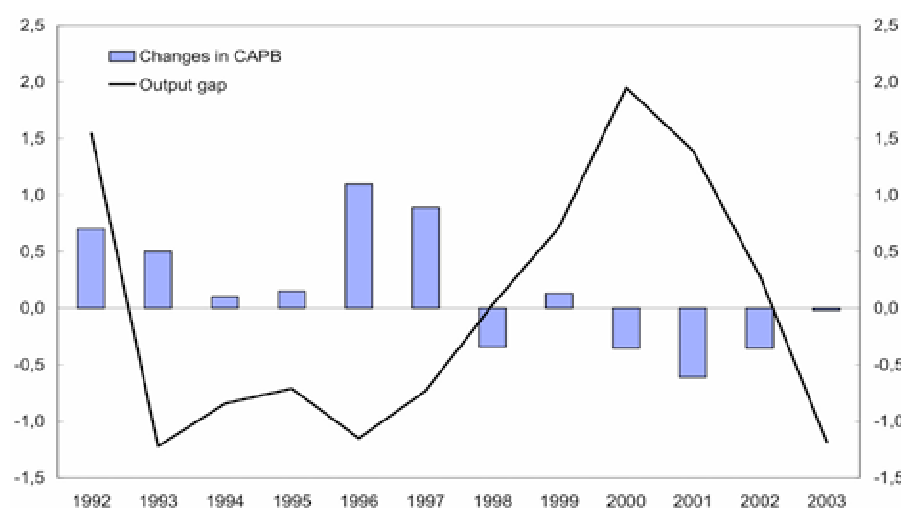
- the **economic cycle** (i.e. slow growth, poor economic performance and its persistence) was the main factor behind the deterioration in public finances over that period;
- part of the deterioration in public finances stemmed from a **discretionary loosening of fiscal policy**.

With reference to the former, as well as to the latter, it should be noted that there were some considerable differences across the Member States. In 2003, five countries of the euro area had their budgetary positions „close to balance or in surplus" (Finland, Ireland, Luxembourg, Belgium and Spain). Other countries, while "close to balance" in cyclically-adjusted terms, had small nominal deficits, indicating that in these countries **automatic stabilizers were left to work fully**. In contrast, two major countries of the euro area (Germany and France) had nominal deficits equal to or above 4% of GDP, being not only the result of weak economic growth, but also high cyclically-adjusted deficits before the slowdown. Generally, **in 2003, half of the euro-area countries recorded budget deficits close to or above the reference value of 3% of GDP** (also Greece, Italy, Netherlands, Portugal) (see: table 2.1). Almost all the Member States that had already sizeable nominal deficits further loosened their fiscal stances, while the Member States with small deficits or surpluses maintained broadly neutral stances. In general, those discretionary measures yielded **marginally expansionary fiscal policy** at the beginning of the slowdown (see: figure 2.2.b.c), but its impact on the economy was assessed as rather muted [Commission 2004j; 2005a].

It seems to be worth to mention that during the slowdown, since 2002 onwards, the overall budgetary situation of the euro area proved to be better not only in comparison with Japan, but – for the first time since the mid-1980s – better than the budgetary position of the United States, which has deteriorated considerably in recent years. This situation has been continuing until now (see: table 2.1 and figure 2.1.c).

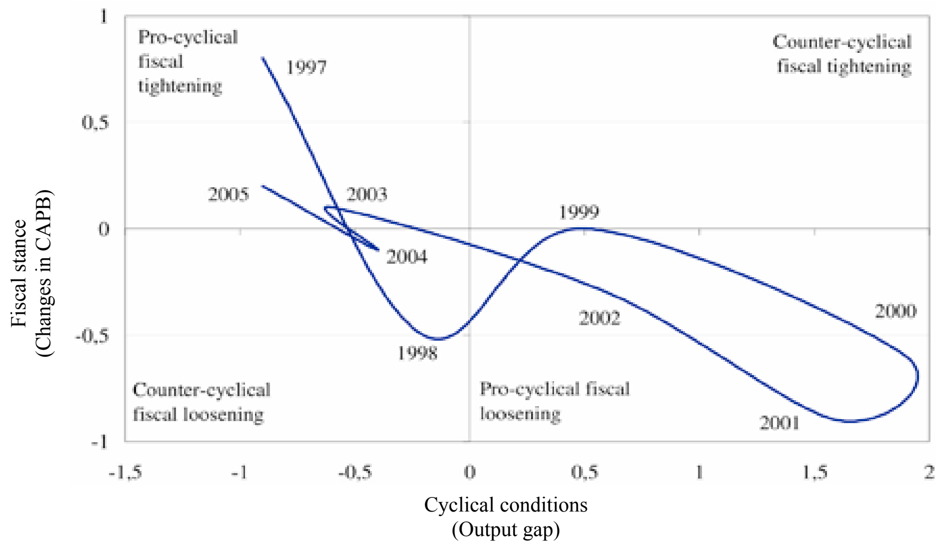
Figure 2.2.
Fiscal stance and cyclical conditions in the euro area and in the EU (1992-2007)

a) the euro area: longer-term perspective (1992-2003)

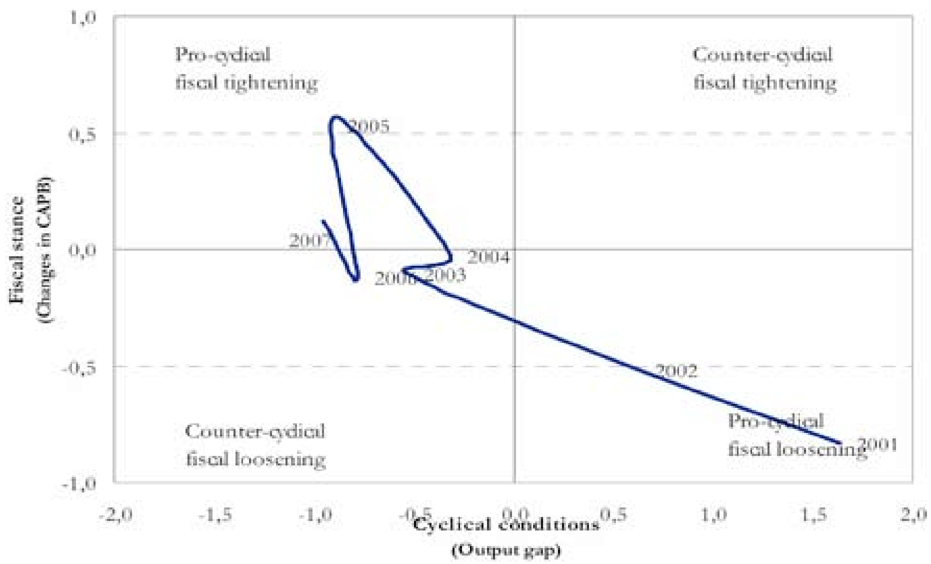


Note: The changes in the cyclically-adjusted primary balance (CAPB) are used as a proxy of the fiscal stance, while the size of the output gap proxies cyclical developments. A positive value for the fiscal stance represents a tightening of discretionary fiscal policies.

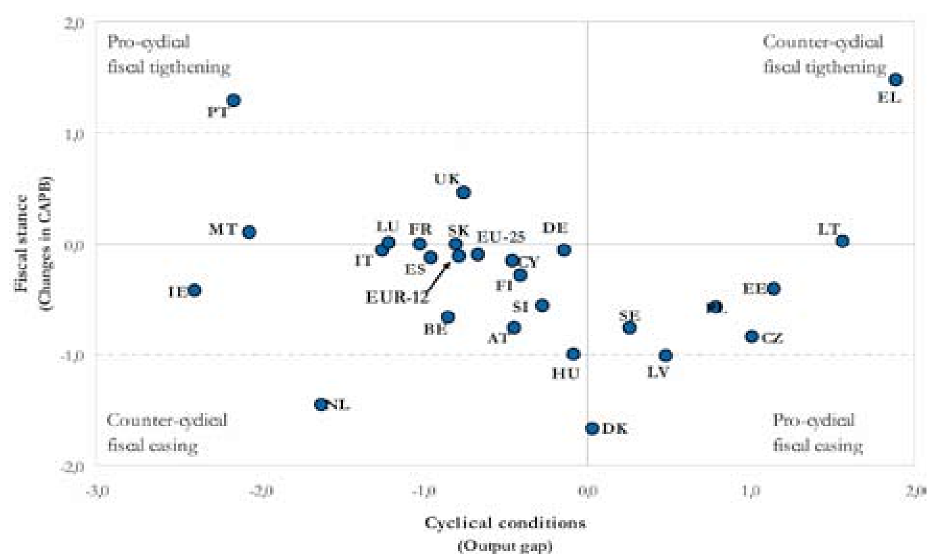
b) the euro area as a whole (1997-2005)



c) the euro area as a whole (2001-2007) – based on the Spring 2006 Forecasts



d) Member States of the EU (2006)



Note: Usually, annual changes of up to 0.5% of GDP are considered as broadly neutral.

Sources: Commission 2004j; 2005a; 2006m,s; Flores, Giudice, Turrini 2005; Pisani-Ferry 2006.

In 2004 – for the first time in recent years – **the overall budgetary situation of the euro area improved slightly**. In comparison with the previous year, the general government deficit fell by 0.2 percentage point and reached 2.8% of GDP. In cyclically-adjusted terms, relative to 2003, the deficit in the euro area remained unchanged at 0.5% of GDP (CAPB), or improved slightly – by 0.2 percentage point – reaching 2.6% of GDP (CABB). And **the overall stance of fiscal policy in the euro area was neutral** in 2004 (see: figure 2.2.b.c) – similarly as it was expected in the subsequent years. According to the Commission, the aggregate fiscal stance at that time resulted from quite diverse fiscal stances across the Member States, despite fairly similar cyclical developments (see: figure 2.2.d). For example, in 2004, some of the Member States (e.g. France and the Netherlands) ran somewhat pro-cyclical policies, reflecting their further consolidation efforts needed to fulfil the guideline on sound budgetary positions [Commission 2005a].

According to the recent Commission's economic forecasts (of both November 2005 and May 2006), in general, **the public finance outlook for the euro area as a whole seems to be essentially stable in the nearest future** (up to 2007 inclusive). The general government deficit in the euro area was 2.4% of GDP in 2005 – as compared to 2.9% of GDP in the autumn forecasts (it was due to lower-than-expected expenditures which more than offset lower revenues). Based on a "no-policy change" assumption,[7] the euro-area deficit – despite a stronger economic recovery – is not projected to improve but remain unchanged in 2006 and improve slightly in 2007 (2.3% of GDP). At the present moment, **still almost half of the euro-area countries exhibit general government deficits close to or above the reference value of 3% of GDP** (France, Germany, Greece, Italy and Portugal – ranging from 2.9% to 6.0% of GDP). But it is projected that they will be able to reduce those deficits

[7] The Spring 2006 and Autumn 2005 Forecasts – similarly like the previous Commission's forecasts – are based on a "no-policy change" assumption. It means that they incorporate the measures announced with the budgets for 2006, but do not include possible further measures for 2006 nor measures for 2007 beyond those resulting from decisions already made.

below the reference value by the end of 2007 (except for Portugal that are projected to reduce its deficit to 3.7% of GDP in 2007) [Commission 2006m; Council 2006a]. Overall, although the situation seems to be fairly stable in the forthcoming years, the problem of the existence of excessive deficits remains unsolved in many countries of the euro area. It continues to be a source of great concern and there is still the strong need to strengthen further consolidation efforts in the Member States concerned.

The **cyclically-adjusted budget balance** (CABB) in the euro area, relative to 2004, was reduced substantially last year (by 0.7 percentage point), and **is projected to remain stable over the period 2005-2007** (at 1.9-2.0% of GDP), **reflecting rather weak resilience of the budgetary consolidation process in recent years**. Similarly, the cyclically-adjusted primary balance (CAPB) is to be broadly stable at around 1.0-1.1% of GDP up to 2007 inclusive (see: tables 2.2 and 2.3). This extends further the period (since 2002 onwards) of little or no adjustment made in order to correct the underlying budgetary positions of the euro-area countries [Commission 2005x].[8] In spring 2006, the Commission stated that owing to the fact that the euro-area deficit is projected to remain unchanged in the coming years despite a stronger economic recovery, the cyclically-adjusted budget balance (CABB) is estimated to worsen slightly. In structural terms, i.e. net of cyclical factors and temporary measures, the budgetary situation in the euro area is expected to improve gradually over the forecast horizon, *inter alia* signalling a diminishing recourse to temporary measures [Commission 2006m]. More recently, in mid-June 2006, the Commission stated that **among the euro-area countries with higher cyclically-adjusted deficits, improvements over the entire projection period (2005-2007) were expected only in Germany and Portugal** (*notabene*, outside the euro area, most of the countries are expected to experience a worsening or no changes in their cyclically-adjusted deficits [Commission 2006s].

Table 2.2.
General government budgetary positions in the euro area (2001-2007)

% of GDP	2001*	2002*	2003	2004	2005[e]	2006[f]	2007[f]
Total revenues (1)	46.2	45.1	45.1	44.7	45.1	45.0	44.8
Total expenditures (2)	48.1	47.6	48.1	47.5	47.5	47.4	47.1
Actual balance (3) = (1)-(2)	**-1.8**	**-2.5**	**-3.0**	**-2.8**	**-2.4**	**-2.4**	**-2.3**
Interest expenditure (4)	3.9	3.5	3.3	3.1	3.0	3.0	3.0
Primary balance (5) = (3)+(4)	**2.0**	**1.0**	**0.3**	**0.3**	**0.6**	**0.6**	**0.6**
UMTS proceeds*	0.0	0.0	-	-	-	-	-
Cyclically-adjusted budget balance (6)	**-2.7**	**-2.8**	**-2.8**	**-2.6**	**-1.9**	**-2.0**	**-1.9**
Cyclically-adjusted primary balance (7) = (6)+(4)	**1.2**	**0.6**	**0.5**	**0.5**	**1.1**	**1.0**	**1.1**

* The primary balance includes one-off proceeds relative to UMTS licences. UMTS receipts as a % of GDP would be equal in 2001 to 0.2 for BE, 0.2 for DK, 0.5 for EL, 0.1 for FR, and 0.0 for the euro area. In 2002 they would be equal to 0.2 for IE and 0.0 for the euro area. The proceeds from UMTS licences are not included in the calculation of the cyclically-adjusted balances (CABB, CAPB).[9]

[e] estimates; [f] forecasts (spring 2006).

Source: Commission 2005x; 2005r; 2006s (adapted by the author).

[8] In this context, it should be noted that is some countries of the euro area, notably in Germany, there were some remarkable adjustments in recent years in order to correct the underlying budgetary positions, but their results were rather poor. In its country report on Germany (published in January 2006), the IMF stated: *"There is a fiscal puzzle in Germany: despite significant adjustment efforts by the government, the structural balance has not improved. Over the past three years, the efforts included deep reforms under the heading of "Agenda 2010," with cuts in pension, health, and unemployment benefits. In addition, tight management of public investment and the wage bill, and low interest rates on public debt helped contain spending. Nevertheless, the fiscal balance showed no signs of improvement, being stuck at around 3½ percent of GDP. This may have been due to a cyclical slump. But the structural balance, which accounts for the cycle, did not improve either."* [IMF 2006a].

[9] According to the Eurostat, the allocation of mobile phone licences (UMTS) had to be recorded in the general government account as expenditure with a negative sign at the moment the licence was sold. The cyclically-adjusted balances were calculated without taking into account those one-off proceeds [Commission 2001b,f].

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Table 2.3.
Budget balances in the euro-area countries (2003-2007)

% of GDP	Actual budget balance					Cyclically-adjusted budget balance					Cyclically-adjusted primary balance				
	2003	2004	2005[e]	2006[f]	2007[f]	2003	2004	2005[e]	2006[f]	2007[f]	2003	2004	2005[e]	2006[f]	2007[f]
Belgium	0.4	0.0	0.1	-0.3	-0.9	1.2	0.0	0.6	0.1	-0.3	6.5	4.8	4.9	4.3	3.6
Germany	-3.8	-3.7	-3.3	-3.1	-2.5	-3.2	-3.4	-3.0	-3.0	-2.3	-0.1	-0.6	-0.2	-0.2	0.5
Greece	-5.2	-6.9	-4.5	-3.0	-3.6	-5.7	-7.7	-5.3	-3.8	-4.4	0.1	-2.3	-0.3	1.1	0.6
Spain	0.3	-0.1	1.1	0.9	0.4	0.2	0.0	1.3	1.3	1.0	2.7	2.0	3.1	3.0	2.5
France	-4.2	-3.7	-2.9	-3.0	-3.1	-4.0	-3.6	-2.5	2.5	-2.5	-1.0	-1.0	0.1	0.1	0.2
Ireland	0.2	1.5	1.0	0.1	-0.4	0.2	1.4	1.5	1.1	0.8	1.5	2.6	2.7	2.3	2.0
Italy	-2.9	-3.4	-4.1	-4.1	-4.5	-2.6	-3.3	-3.4	-3.4	-3.8	2.7	1.4	1.2	1.1	0.9
Luxembourg	0.5	-1.1	-1.9	-1.8	-1.5	1.3	-0.5	-1.3	-1.3	-1.0	1.6	-0.3	-1.1	-1.1	-0.9
Netherlands	-3.2	-1.9	-0.3	-1.2	-0.7	-2.0	-0.9	1.0	-0.3	-0.2	0.9	1.7	3.5	2.1	2.1
Austria	-1.1	-1.1	-1.5	-1.9	-1.4	-0.8	-0.8	-1.0	-1.7	-1.2	2.3	2.0	1.7	1.0	1.4
Portugal	-2.9	-3.2	-6.0	-5.0	-4.9	-2.2	-2.7	-5.1	-4.0	-3.8	0.7	0.0	-2.4	-1.1	-0.7
Finland	2.5	2.3	2.6	2.8	2.5	3.2	2.5	3.2	3.0	2.7	5.2	4.0	4.7	4.4	4.1
Euro area	**-3.0**	**-2.8**	**-2.4**	**-2.4**	**-2.3**	**-2.8**	**-2.6**	**-1.9**	**-2.0**	**-1.9**	**0.5**	**0.5**	**1.1**	**1.0**	**1.1**

Note: excluding UMTS receipts for Ireland in 2002.

[e] estimates; [f] forecasts (spring 2006).

Source: Commission 2005x; 2005r; 2006s (adapted by the author).

Summing up the above considerations related to budgetary performance during the pre-EMU period as well as the seven-year existence of the single currency, there are several findings regarding **the expected and actual impact of EMU on budgetary developments in the euro area**. It should be noted that, firstly, those findings are generally mixed, and secondly, due to the relatively short period of the EMU existence – conclusions are not definitive. Nevertheless, taking into account expectations before the introduction of the euro, as well as the outlined above budgetary performance since 1999 until now, it would be possible to indicate some preliminary findings:

- first of all, **progress towards the achievement of the commonly agreed targets is not satisfactory** (or even disappointing to some extent). In fact, taking into consideration both internal and external factors as well as positive and negative elements, **the overall assessment is mixed**. On the one (positive) side, some Member States (mainly small countries) have been able to achieve and maintain their budgetary positions being “close to balance or in surplus” (in line with the SGP). Moreover, for some years (since 2002 onwards) the euro area has recorded lower general government deficits in comparison with both the United States and Japan. But on the other (negative) side, the overall levels of budget deficits, in both nominal and cyclically-adjusted terms, have risen since 2000 onwards and stabilized presently at a relatively high level, i.e. only slightly below the 3% ceiling (reference value). At the present moment, the majority of the euro-area countries are rather far from the objective of budgetary positions being “close to balance or in surplus” – still almost half of them display general government deficits close to or above the reference value of 3% of GDP (of which Germany and France – the “core” countries of EMU). It should be noted that **the present problem with high deficits in the euro area is a direct consequence of the failure to run sound fiscal policies by (some of) the Member States and make further budgetary consolidation in the so-called “good times”, i.e. in the early years of EMU** when economic conditions were very favourable;

- in some cases, budgetary targets were not matched because they based on rather optimistic assumptions on future growth prospects (particularly, but not only, in the election periods). Such a general tendency to base budgetary projections on **overly optimistic growth assumptions** has been observed in many Member States in recent years. It has inevitably led *ex post* to missing their budgetary targets again and again [Larch, Salto 2003; Commission 2004j; Strauch *et al.* 2004; Buti 2006];[10]
- as mentioned above, prior to the introduction of the euro there were some opinions that after joining the euro area some Member States – which had to achieve significant budgetary consolidation in the pre-EMU period in order to fulfil the convergence criteria – would loosen their fiscal policies in EMU. Moreover, some observers expected that the introduction of the EU fiscal framework would lead to less counter-cyclical, or more pro-cyclical, fiscal policies in EMU. The above **expectations about a substantial loosening of fiscal policies in EMU, as well as their more pro-cyclical character, have proved to be generally unfounded**. Although in some years certain countries of the euro area ran somewhat pro-cyclical policies,[11] the overall fiscal stance was (with some small exceptions) broadly neutral since the launch of EMU. Moreover, some recent research suggests that after 1992 fiscal policy in the euro area became on average more counter-cyclical [Galí, Perotti 2003]. This is consistent with the view that in the pre-EMU period, counter-cyclical fiscal policies in the Member States were the exception rather than the rule [Buti, Sapir 1998];
- according to some institutions and organizations (e.g. Commission, OECD), there is quite clear evidence that **the original commitment to pursue budgetary consolidation has diminished over time**. This weakening in the political commitment towards the commonly agreed budgetary goals in the SGP may be at least partly explained by a **reorientation of government budgetary priorities**. Some years after the successful introduction of the euro, several governments of the euro-area countries (even those with the sizeable deficits – like Germany, France or Italy) pay less attention to the goal of budgetary consolidation (that was the top priority in the pre-EMU period), and instead concentrate on other budgetary objectives, e.g. tax reforms and redirecting government spending towards programmes considered more favourable to growth and employment creation [Commission 2001d; Oliveira Martins *et al.* 2005];
- there is evidence that **the EU fiscal framework has influenced the behaviour of fiscal authorities in the euro area**. Some research conducted in recent years have indicated that after the introduction of the euro – and the parallel introduction of the new fiscal framework – **fiscal authorities became more concerned about the need to run low budget deficits** [von Hagen *et al*. 2001; Mélitz 2002; Ballabriga, Martinez-Mongay 2002]. The most recent analyses show that the introduction of the SGP reduced the probability of breaching the deficit reference value of 3% of GDP [Hughes Hallett *et al.*

[10] In this context, it should be noted that there are some authors [Buti 2006] indicating that the European Commission suggested that Stability Programmes should be based on macroeconomic assumptions provided by the Commission. This proposal would allow addressing the above-mentioned problem of overly optimistic growth assumptions and budgetary projections. But the Council decided that the Member States would be still free to use their own assumptions (although they have to give detailed explanations of any – especially significant – divergences from the Commission forecasts). Moreover, there are also some authors who advocate for maintaining independent national forecasts [Larch, Jonung 2004].

[11] The overall fiscal stance after the introduction of the euro has not differed markedly from that observed during the past decades when discretionary fiscal policy has tended to be pro-cyclical, mainly on the revenue side, being tighter during cyclical downturns and looser during upturns. In general, the governments of the Member States make stronger fiscal consolidation in downturns than in upturns because during the former it is easier to be conducted and more justifiable than in the latter. The reason is the fact that spending increases in the context of high budget deficits raise more concerns about the sustainability of public finances and may be perceived more negatively by the public (the voters) than doing so when the budget displays a surplus or only a small deficit [Commission 2004m].

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2004]. Some other analyses indicate that over the 1994-2003 period **the euro-area budget deficits would have been higher** (up to 1 percentage point per year) **in the absence of the EMU fiscal framework** [Commission 2004e];

- it was often argued before the introduction of the euro that the SGP's "philosophy" of **allowing automatic stabilizers to operate fully during economic slowdowns around a broadly balanced budget** could work in a "steady-state" situation, but problems could emerge during the transition process towards budget positions of "close to balance or in surplus" – taking into account that many Member States joined the euro area with budget deficits only slightly lower that the reference value (3% of GDP). It was confirmed in practice. Generally, the smaller Member States completed the transition to budgetary positions of "close to balance or in surplus" (during the slowdown those countries, while close to balance in cyclically-adjusted terms, had small nominal deficits, indicating that automatic stabilizers in these countries were left to work fully). On the contrary, most of the large euro-area countries failed to improve their underlying budget positions. The failure to do so over some past years means that **the euro area continues to be faced with the same budgetary challenge like at the start of EMU, i.e. allowing the full operation of automatic stabilizers during economic downturns while respecting the SGP budgetary requirements** [Commission 2004j].

2.2. Public debt (government debt)

In the run-up to EMU, i.e. during the Stage Two of EMU (1994-1998), the overall economic performance of the group of countries belonging presently to the euro area was mixed. First, there was a sharp rise of the level of public debt, and then it was started to decline slightly (since 1997 onwards). But this overall decrease was very small (just 0.5 percentage point between 1997 and 1998) and the average level of the public debt ratio (gross government debt to GDP) stood well above the reference value, i.e. at about 73% of GDP at the start of EMU on 1 January 1999. As it is visible very well, **in the run-up to EMU there were not so significant consolidation efforts and effects in public debt as in budget deficit in the Member States**. But it seems to be natural because of some reasons. First of all, at the beginning of the 1990s, many Member States had quite high levels of debt-to-GDP ratios and it was clear that during only a few years (between the entry into force of the Maastricht Treaty and the launch of EMU) it would be impossible for them to reduce those ratios substantially – especially below the 60% reference value in order to meet the convergence criteria. Moreover, the Member States were aware that in such cases it would be possible to apply some specific provisions of the Treaty, stipulating that compliance with budgetary discipline may be assessed positively also in the case when the ratio of government debt to GDP exceeds the reference value, but the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace (Article 104(6)). In such a situation, **the Member States had neither sufficient incentives nor enough strong motivation to enact more efforts and achieve better results in their debt-to-GDP ratios**. It was confirmed in March 1998 in the Convergence Reports of both the European Commission and the European Monetary Institute (EMI), which recommended – directly or indirectly – potential participants of the euro area.[12]

[12] In its Convergence Report (1998) the European Commission stated: *"While the government debt ratio was below the 60% of GDP reference value in 1997 in only four Member States (...), almost all the other Member States with higher debt ratios have succeeded in reversing the earlier upward trend. (...) In the current year, 1998, falls in the debt ratio are expected in all the Member States where the ratio is above the reference value. Conditions are in place for a sustained decline in debt ratios in future years."* Similarly, the European Monetary Institute assessed convergence progress in public debt: *"For the first time during the 1990s, the debt-to-GDP ratio for the EU as a whole declined in 1997. (...) However, the average debt ratio still stands at 72.1% of GDP and is*

During the first years of EMU, the downward trend of debt ratios was being continued until 2002 when the average debt ratio of the euro area reached the lowest level so far, i.e. 68.1% of GDP. **Since then the above tendency has reversed** and the euro-area ratio has been rising steadily in recent years – reaching 70.8% of GDP last year (see: table 2.4 and figure 2.3.a). At the present moment, the majority of the euro-area members (7 out of 12 countries) have their debt-to-GDP ratios above the 60% reference value. Among those countries, there are some Member States (Greece, Italy and Belgium) with debt ratios at more or less 100% of GDP. Comparing figures for 2000 and 2003 (see: table 2.4 and figure 2.3.b), it is apparent that during the recent slowdown some Member States were able to reduce their debt ratios (*inter alia*, the above most indebted countries), while debt ratios of the others (e.g. Germany, France and Portugal) deteriorated significantly (by about 5-6 percentage points of GDP). The average euro-area debt ratio remained almost unchanged over the period. It is worth to mention that during seven years of EMU **the most spectacular improvements** related to the level of the debt-to-GDP ratio were made by Belgium, Spain and Ireland – **by some 20-25 percentage points** in all the cases (from about 117% to 93%, from 63% to 43% and from 53% to 28% of GDP respectively between end-1998 and end-2005; and some further declines are projected in the forthcoming years – see: table 2.4). It should be noted that there are considerable differences across the euro area as regards the level of debt ratios – ranging from almost 6% in Luxembourg to 106-107% in Greece and Italy (see: figure 2.3.b). At the same time, it should also be noted that are also some negative examples, e.g. Portugal, where the debt ratio is projected to increase by some 20 percentage points between 1999 and 2007 – from about 51% to almost 71% of GDP).

In **international terms**, analyzing data for the Stages Two and Three of EMU (since 1994 to date), one can easily conclude that at the beginning of that period the situation of the euro area countries, the United States and Japan was broadly similar (all they had their debt-to-GDP ratios at about 70-80% level). Over the period, the situation in the euro area deteriorated slightly (by about 3 percentage points), while it improved clearly in the United States (by almost 10 percentage points). In the case of Japan, the ratio grew enormously rapidly over that period – from about 80% of GDP in 1994 to almost 160% of GDP in 2005; today the difference between debt ratios of the euro area and Japan amounts to about 90 percentage points (see: table 2.4 and figure 2.3.c).

According to the most recent Commission's economic forecasts (of May 2006), **the upward trend in the debt ratio of the euro area (observed since 2003) is expected to reverse during the forecast period (i.e. until 2007)**, although it was not expected in the previous Commission's forecasts (of November 2005). Following the peak of 70.8% of GDP in 2005, the debt ratio in the euro area is projected to decline gradually in the subsequent years to 70.5% and 70.1% of GDP in 2006 and 2007 respectively. In the Commission's opinion, the projected revival of economic activity is unlikely to outweigh the downward trend in the primary budget surplus in 2005 and beyond. In particular, with reference to the individual Member States, the euro-area countries with the highest debt ratios (except for Italy) are projected to reduce it further over the forecast period. Conversely, in the Member States with the highest general government deficits (Germany, France and Portugal) a further increase in the debt ratio is expected to take place up to 2007 inclusive [Commission 2005x; 2006m].

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much higher in three Member States. In addition, the decline in deficit ratios below the reference value and the fall in debt ratios in many countries have only recently been realized. (...) Overall, progress in reducing fiscal deficit and debt ratios has generally accelerated." The Commission stated that the 11 Member States (Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, the Netherlands, Austria, Portugal and Finland) fulfilled the convergence criteria and recommended them to join the euro area on 1 January 1999. Similar findings were in the EMI Convergence Report [see: Commission 1998a; EMI 1998].

Table 2.4.
Government debt in the euro-area countries (1994-2007)*

% of GDP	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005[e]	2006[f]	2007[f]
Belgium	131.5	129.7	126.9	122.2	117.0	113.6	107.7	106.3	103.2	98.5	94.7	93.3	89.9	87.0
Germany	48.0	55.5	58.4	59.6	59.8	60.2	59.2	58.8	60.3	63.8	65.5	67.7	68.9	69.2
Greece	107.9	108.7	111.3	114.0	112.4	112.3	111.6	113.2	110.7	107.8	108.5	107.5	105.0	102.1
Spain	59.8	62.5	66.7	65.3	63.2	61.6	59.2	55.6	52.5	48.9	46.4	43.2	40.0	37.9
France	48.9	55.1	57.6	58.5	58.7	58.3	56.7	56.2	58.2	62.4	64.4	66.8	66.9	67.0
Ireland	88.6	81.0	72.4	63.6	53.0	48.1	37.8	35.3	32.1	31.1	29.4	27.6	27.2	27.0
Italy	121.5	121.2	120.6	118.1	114.9	113.7	109.2	108.7	105.5	104.2	103.8	106.4	107.4	107.7
Luxembourg	5.5	5.8	6.3	6.4	6.2	5.6	5.3	6.5	6.5	6.3	6.6	6.2	7.9	8.2
Netherlands	73.3	74.0	72.1	67.0	64.0	60.5	53.6	50.7	50.5	51.9	52.6	52.9	51.2	50.3
Austria	63.4	67.9	67.6	63.8	64.2	66.5	65.8	66.1	66.0	64.4	63.6	62.9	62.4	61.6
Portugal	59.0	61.0	59.9	56.1	52.2	51.4	50.4	52.9	55.5	57.0	58.7	63.9	68.4	70.6
Finland	57.4	56.5	56.7	53.6	48.2	46.7	44.3	43.3	41.3	44.3	44.3	41.1	39.7	38.3
Euro area	**67.6**	**72.2**	**73.9**	**73.5**	**73.0**	**71.7**	**69.2**	**68.3**	**68.1**	**69.3**	**69.8**	**70.8**	**70.5**	**70.1**
EU-25	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**66.4**	**65.8**	**61.9**	**61.1**	**60.5**	**62.0**	**62.4**	**63.4**	**63.2**	**62.9**
USA	**74.6**	**74.2**	**73.4**	**70.9**	**67.7**	**64.5**	**58.5**	**58.4**	**60.6**	**64.2**	**64.8**	**65.0**	**66.0**	**67.1**
Japan	**79.7**	**87.1**	**93.9**	**100.3**	**112.2**	**128.8**	**136.8**	**145.0**	**152.0**	**156.3**	**157.3**	**158.9**	**161.1**	**162.4**

* General government gross debt (as a percentage of GDP) – as defined in the Council Regulation 3605/93; ESA 95 from 1996 onwards.

[e] estimates; [f] forecasts (spring 2006).

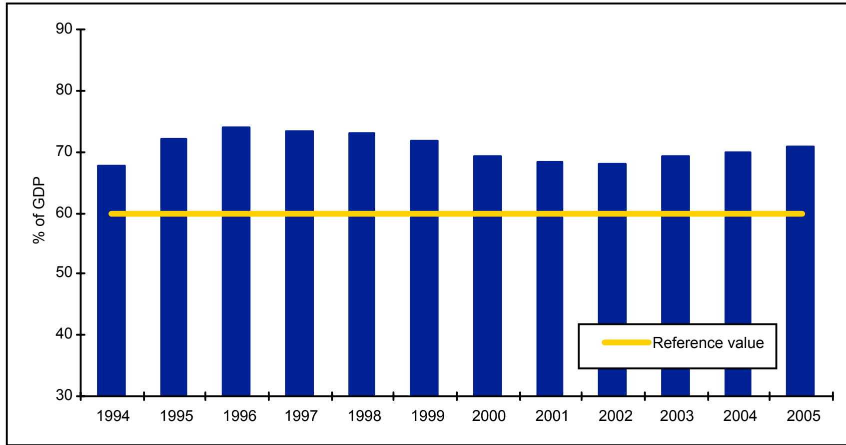
Source: Commission 2006m; Eurostat.

Summing up, the above considerations indicate that – similarly as in the case of budget deficits – the findings concerning both previous and current debt developments in the euro area, i.e. before and after the launch of EMU (and its actual and potential impact in this regard), are rather mixed and not definitive. They are the following:

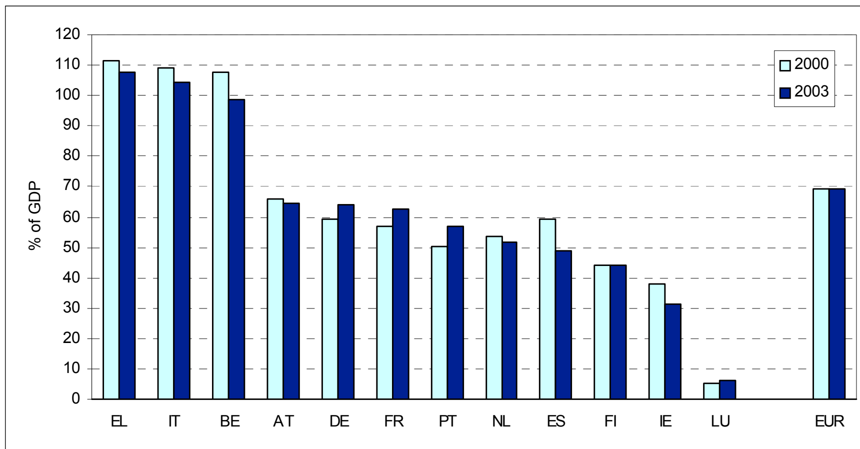
- **the overall assessment of the achievements related public debt in the euro area is mixed**. As indicated before, since the beginning of the Stage Two of EMU to date the overall situation regarding debt ratios deteriorated slightly in the euro area (by about 3 percentage points). Moreover, it should be noted that presently the average debt ratio of the euro area is (as it has been for many years before) much higher than the analogous ratio for the entire EU – by some 7 percentage points). It looks quite disappointing that **the average level of the euro-area debt ratio remains**, **and it has remained all the time** (both in pre-EMU period as well after the launch of EMU), **well above the reference value of the Treaty and of the SGP**. On the other hand, it is much more optimistic that some Member States (especially the most indebted ones) were able to reduce significantly their levels of public debt both before and after the introduction of the euro;

Figure 2.3.
Government debt in the euro area (1994-2005)

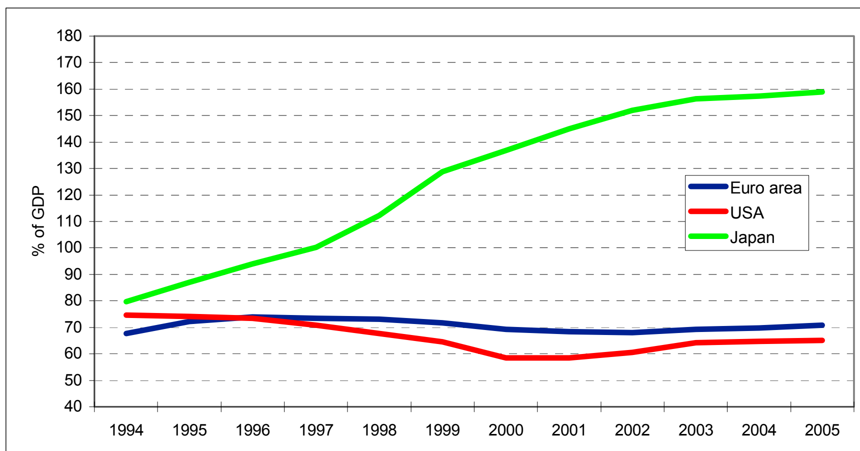
a) in relation to the reference value



b) performance of the euro-area countries



c) in relation to the United States and Japan



Source: own elaboration based on the Commission/Eurostat's data.

- as mentioned before, the SGP fiscal framework, although often criticized, has contributed positively to the overall situation of public finances in the euro area because **in the absence of the EU fiscal framework** primary budget deficits for the euro area would have been higher over the 1994-2003 period (see: section 2.1) and, as a result, this would have led to a sizeable build-up of **the euro-area government debt which would have been higher** (by about 8 percentage points of GDP) by 2003 [Commission 2004e];
- EMU has played a positive role in the context of sound public finances by exerting pressure on the Member States (particularly those belonging to the euro area) to respect some specific provisions related to the required level of public debt (the Treaty, the SGP). Although the existing provisions have been relatively good in exerting pressure (within the process of multilateral surveillance), it was necessary to improve at least some of them (mainly the SGP regulations) by **placing more focus on public debt in the surveillance of budgetary positions** – as proposed by the Commission in 2004 and by the Council and the European Council in 2005. According to the Commission, the increased focus on debt developments would complement continued rigorous attention to deficit developments. As regards the debt criterion, in the Commission's opinion, the SGP could clarify the basis on which the Treaty provision of a "satisfactory pace" of debt reduction should be assessed. In defining a required rate of debt reduction some specific needs should be taken into account – especially the need to ensure prudent debt ratios before the impact of ageing takes place fully and to consider country-specific initial debt levels and potential growth conditions [Commission 2004k]. At the present moment, it is of utmost importance that the new rules on public debt, commonly agreed in spring 2005, must be effectively enforced and respected by all the Member States in the future;
- the current level of debt ratios in the euro area should be a matter of serious concern. **Although the present levels of public debt of the euro-area countries** – even combined with high nominal budget deficits and rather weak growth – **do not pose an imminent threat to the sustainability of public finances in the short or medium term, such a risk could emerge in the longer perspective** (see: section 2.3). In the Commission's opinion, the fact that risk premia on government debt have not changed despite breaches of the SGP requirements illustrates that financial markets still retain confidence in the capacity of governments to address budgetary problems and to ensure that unsustainable positions will not emerge in the future. However, this market confidence can shift very quickly and a risk to the sustainability of public finances can emerge in the future – unless the Member States intensify their efforts in the forthcoming years and achieve substantial improvements in their government positions [Commission 2004j];
- with reference to the above issue – i.e. financial markets confidence – it should be noted that the so-called **"disciplining role of financial markets" has decreased after the introduction of the euro**. It is argued that in the euro-area countries with high general government deficits and high public debt ratios (e.g. in Greece or Italy) there are also relatively high interest rates (higher than the average long-term rate for the euro area). It seems that in the case of some Member States of the euro area higher interest rates do not reflect adequately some increased risks attributed to such (highly indebted) countries. Therefore, one can assess that financial markets do not fulfil their disciplining

role properly and do not create incentives for the Member States to improve their public finances;[13]

- all in all, some **further (and more effective than so far) efforts aimed at decreasing debt ratios should be enacted in some of the euro-area Member States**. Perhaps a bit optimistic factor may be the fact that the present upward trend in the debt ratio of the euro area is expected to stabilize and even decline slightly in the forthcoming years, while growth is projected to accelerate and stabilize at the same time (one can see this as a turning point and a starting date of the reversed trend in the subsequent years).

2.3. Long-term sustainability of public finances [14]

The overall situation of public finances should not be examined merely in the short- or medium-term perspective. It should also be assessed over the (much) longer time horizon – especially taking into account that the main threat of the XXI century to economic growth and public finances is **the ageing of populations**. For many years it has been forecasted by various institutions and organizations (OECD, IMF, Commission) that the numbers of elderly people will increase rapidly in the coming decades, due to increasing longevity (life expectancy), the retirement of the post-war baby boom generations, low fertility rates, as well as projected rather slow growth of the labour force. According to the latest EPC's and Commission's projections (of January 2006), the total population of the Union (EU-25) will shrink marginally (from 457 to 454 million) between 2004 and 2050. Much more important is from an economic point of view are some serious (or even dramatic) changes in the age structure of the population (see: figure 2.4). In the period 2010-2050, the population of working age (15 to 64) is projected to fall by 48 million (or 16%). In contrast, the number of elderly people (aged 65+) will rise sharply – by 58 million (or 77%) during the above period of time. As a result, the old-age dependency ratio[15] is projected to double, reaching 51-53% in 2050[16] (in other words, Europe will go gradually from having four working-age people for every elderly citizen presently to a proportion of two to one by 2050) [OECD 2001; Commission 2005z; EPC / Commission 2006; Deroose 2006]. With reference to other countries, it is assessed that, for example, the dependency ratio in the United States will double by 2075 [Lee 2001]. The above trends related to the ageing of populations imply not only higher dependency ratios, but also an increased debt burden, higher real interest rates and lower potential output unless action is taken now to safeguard the long-term sustainability of the EU economy [Commission 2005i]. In general, it is assessed that the EU (and the euro area in particular) has much more of an ageing problem than the United States

[13] It should be noted that some proposals to enforce the disciplining role of financial markets have been suggested and considered. They have related to, *inter alia*, the use of capital adequacy rules, arrangements for joint issuance of euro-area government debt and the eligibility and pricing mechanism of collateral used by the Eurosystem, etc. However, some possible regulatory or administrative measures to increase the scope for market pressure have been regarded as unnecessary or unjustified. Moreover, some other potential measures (notably those encouraging investor discrimination between euro-area bonds on the basis of non-compliance with the EU budgetary requirements) have been perceived as introducing distortions elsewhere in the economic and financial system and thereby rejected [Commission 2003a].

[14] There is not a common definition of "long-term sustainability of public finances" in the literature. For that reason, the EU institutions (the Commission and the Council) have adopted their own pragmatic definition of a sustainable public finance position. This definition is used in the assessment by the Commission and the Council whether – on the basis of current policies and projected budgetary trends – the EU Member States will: (i) meet the government's intertemporal budget constraint so that the discounted value of future government revenues matches the discounted value of its future expenditures and the level of outstanding debt; (ii) continue to comply with the budgetary requirements of EMU, and in particular, the Treaty provision to keep debt levels below the reference value of 60% of GDP [Commission 2006s].

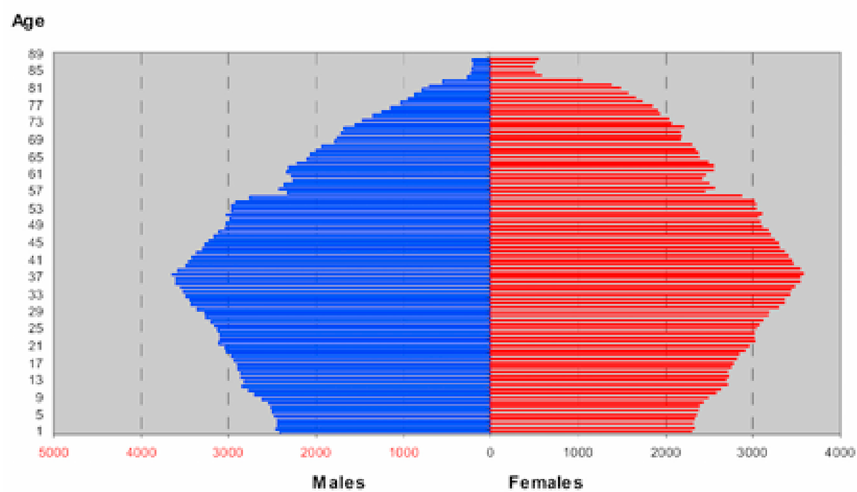
[15] The dependency ratio (the ratio of the elderly to working-age population) is calculated as the population aged 65 and over divided by the population aged 15 to 64.

[16] The population over 65 years compared to the working-age population will increase gradually – from 25% in 2002 to 30% in 2015, 40% in 2030 and more that 50% in 2050 [Commission 2005c].

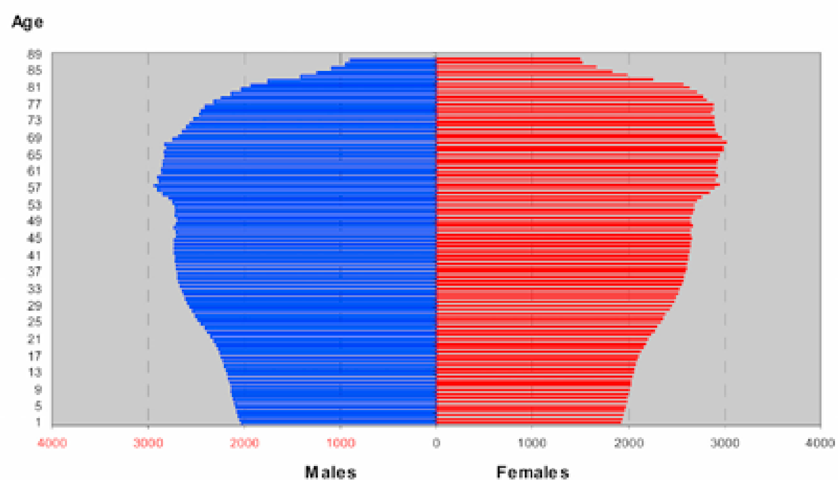
and thereby the EU Member States should adopt a more prudent budgetary course [Commission 2004j].

Figure 2.4.
Projected changes in the size and age structure of the EU-25 population

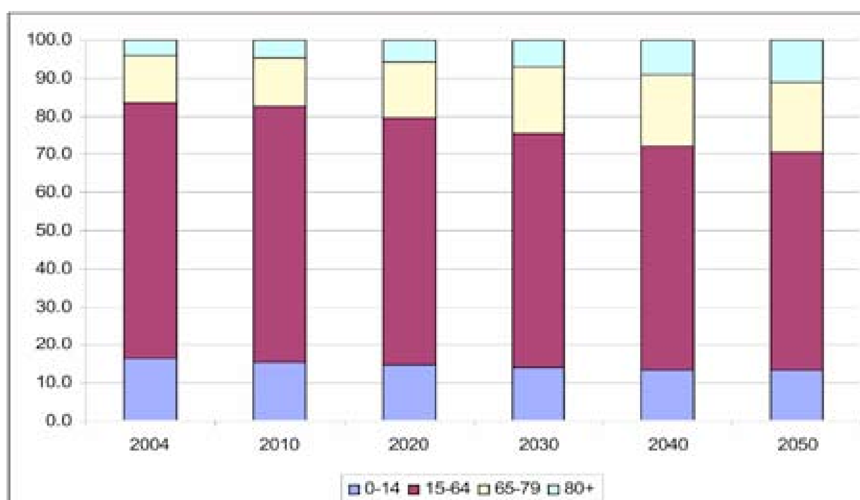
a) actual situation in 2004



b) potential situation in 2050



c) changing age structure



Source: Commission 2005z; EPC / Commission 2006; Commission 2006s.

As we can see, the size and age-profile of the EU population is likely to change significantly in the coming decades. It will influence heavily the overall situation and sustainability of the EU public finances in the long term. According to the OECD, about 40-60% of total public spending in its member countries is sensitive to the age structure [OECD 2001]. As a result – as indicated by, *inter alia*, the European Commission and the Economic Policy Committee – the ageing of populations will lead to a **substantial increase in public spending.** In 2003, this effect was assessed **between 3 and 7 percentage points of GDP in most of the Member States by 2050, if no corrective action is taken** (under the so-called "no policy change" scenario). As of the beginning of 2006, it is expected that overall age-related public spending in the old Member States (EU-15), as well as **in the euro area** (EU-12), will increase by about **4 percentage points of GDP** between 2004 and 2050 (and even between 5 and 10 percentage points in seven countries of the euro area, but not in the largest ones – Germany, France and Italy – where a total increase is projected to be between 1.5 and 3 percentage points). And in the case of the new Member States (EU-10), an increase in public spending is projected to amount around 1.5 percentage points of GDP (however, excluding Poland, age-related spending in the new Member States would rise by more than 5 percentage points).[17] Most of the projected increase in public spending will be on **pensions, health care and long-term care**. In most countries, the expected budgetary impact of ageing will start about 2010, and the largest increase is projected to take place between 2020 and 2035 or 2040 [EPC / Commission 2006; Bogaert 2006] (some years ago it was assessed between 2010 and 2030 – see: EPC 2003).

The projected demographic changes, with the old-age dependency ratio doubling over the coming decades, have caused growing concerns regarding the long-term sustainability of public finances in the EU. **Since 1999, i.e. the very beginning after the introduction of the euro, the Commission has started to include an examination of the sustainability of**

[17] This apparently low budgetary impact of the ageing of population in the new Member States is primarily due to the projected sharp decline in public pension spending in Poland, which – similarly like in some other new Member States – is to some extent the result of the switch from public to private funded pension schemes in these countries. In the case of Poland a significant decrease in total public spending is expected between now and 2050 – by about 6.7% of GDP [EPC / Commission 2006].

public finances into the existing EU framework for surveillance of the Member States' economic and budgetary policies. Similarly, the Economic Policy Committee – prompted by the launch of the euro – established the Working Group on Ageing Populations to examine the economic and budgetary consequences of ageing, which led to the publication of age-related expenditure projections in 2001, 2003 and 2006 [EPC 2001; EPC 2003; EPC / Commission 2006]. It was in line with the later conclusions of the Spring European Councils in Stockholm and Barcelona (March 2001 and 2002 respectively).[18] Moreover, the previous Spring European Council (March 2005) emphasized the necessity to focus on the long-term sustainability of public finances in the context of the reform of the SGP.[19] Some time later, the Commission – elaborating its recommendations on the BEPGs and the EGs – has taken into account not only the time horizon of the new Integrated Guidelines (2005-2008), but much longer perspectives (even 2040-2050) connected with the ageing of Europe's populations. According to the Commission, **the EU must be prepared for these trends because over time they would put an enormous strain on public finances and labour supply and could significantly affect its outlook for growth and employment**. Therefore, the ageing of populations poses some serious risks to the long-term sustainability of the EU economy. In the Commission's and the Council's opinions, in order to address the projected costs of ageing and potential economic implications, the Member States should implement **the agreed three-pronged approach**, consisting of:

- a much faster pace of debt reduction (requiring governments to achieve and sustain balanced budgetary positions over the economic cycle);
- measures to raise employment rates and productivity;
- appropriate reforms of pension and health care systems.

The above approach was included into the Integrated Guidelines for 2005-2008 [Commission 2005i]. And more recently, in March 2006, it was reaffirmed by the Spring European Council [European Council 2006a].

Since 2001, the Commission has been monitoring long-term budgetary trends by including an examination of the sustainability of public finances as part of the overall assessment of the Stability and Convergence Programmes. An initial assessment was carried out on the basis of the 2001 updates of the Stability and Convergence Programmes, with using an approach and indicators developed by the EPC [EPC 2001]. Last year, in autumn 2005, the Commission – based on the 2004 updates of the Stability and Convergence Programmes, and drawing on the above-mentioned EPC report of 2003 [EPC 2003] – projected some **potential changes in the underlying budget balance**[20] **and debt ratios until 2050**. As expected, and in line with the previous findings of the EPC, age-related budgetary expenditures are projected to increase substantially over this time horizon. Moreover, the Commission analyzed a potential **evolution of public debt up to 2050** under two different scenarios – a "baseline scenario" and a "2004 position scenario".[21] The projections were the following [Commission 2004j; 2005r]:

[18] The European Council in Stockholm (March 2001) stated that *"the Council should regularly review the long-term sustainability of public finances, including the expected strains caused by the demographic changes ahead. This should be done both under the Guidelines [BEPGs] and in the context of the Stability and Convergence Programmes*". Next, the European Council in Barcelona (March 2002) invited the Council "*to continue to examine the long-term sustainability of public finances as part of its annual surveillance exercise, particularly in the light of the budgetary challenges of ageing*" [European Council 2001a; 2002a].

[19] The European Council in Brussels (March 2005) stated, *inter alia*, that *"in making the proposals for a reform of the Stability and Growth Pact, the Council gave due consideration (...) to safeguard the sustainability of public finances in the long run (...) and to avoid imposing excessive burdens on future generations"* [European Council 2005a].

[20] The underlying budget balance is calculated as net off the cyclical component and any one-off measures.

[21] The "baseline scenario" assumes that the Member States will be able to achieve their budgetary and debt targets set down in the Stability and Convergence Programmes – by the final year of the 2004 updates (for most of the Member States this is 2008). On the contrary, the "2004 position scenario" assumes that no budgetary

- under a “baseline scenario” (“programme scenario”) it was projected that over the next two decades (or a bit more) public debt levels would decrease – as a result of achieving and maintaining budget positions “close to balance or in surplus”. After that, around 2025 (or a bit later), the trend would start to reverse – as a result of the budgetary impact of ageing; the most substantial increase of public debt is expected in most of the EU Member States between 2030 and 2050. It was projected that around 2040 the average debt-to-GDP ratio of the EU would reach the 60% reference value (in the euro area it would be even sooner, taking into account that the most indebted Member States of the EU – Italy, Greece and Belgium – belonged to the euro area);
- under a “2004 position scenario” (“no-policy change scenario”) it was projected that over the nearest decade public debt levels would remain relatively stable, but after that (around 2015) it was expected to rise rapidly – as a result of the failure to achieve and maintain balanced budgetary positions before the impact of ageing. Under that scenario neither the EU nor the euro area would be able to decrease its average debt level below the 60% reference value. On the contrary, it was projected that about 2050 the average debt-to-GDP ratio of the EU would reach 180% of GDP, i.e. three times higher that the reference value (and even much more than the present debt level in Japan).

In spring 2006, the Commission – on the basis of the 2005/2006 updates of the Stability and Convergence Programmes – made a similar assessment of the long-term sustainability of public finances, as previously, under two different scenarios [Commission 2006s]:

- a “baseline scenario” or “programme scenario” (which usually assumes some fiscal consolidation actions) – it is projected that the initial budgetary positions of the Member States at the end of the programme periods (2008 or 2009) will be still too weak, implying that their public finances are on an unsustainable path in about a quarter of these countries even before considering the budgetary impact of ageing. As expected in many previous projections, some **age-related expenditures are projected to rise significantly in the years to 2050** (**notably pension, health-care and long-term care expenditures** are of the highest concern for the long-term sustainability of public finances in the EU). The Commission’s assessment confirms that around 2025 (or a bit earlier) public debt levels will start to rise and **the most substantial increase of public debt is expected in most of the EU Member States between 2030 and 2050** (see: figure 2.5). It is projected that, under a “programme scenario”, the average debt-to-GDP ratio of the EU will reach the 60% reference value around 2036 (as opposed to 2040 previously);
- a “2005 position scenario” (“no-policy change scenario”) – according to the Commission, the initial budgetary position (the current structural primary balance[22] and the current level of debt) was not sufficiently strong in 2005 to avoid unsustainable public finances even before considering the budgetary impact of ageing in about half of the Member States. It confirms the previous projections that **around 2050 – if no corrective action is taken in advance – the average debt-to-GDP ratio of the EU would exceed 180% of GDP**. And in the case of some countries of the euro area, projected debt ratios could reach much higher levels in 2050 – e.g. about 450% of GDP in Greece or 520% of GDP in Portugal (see: table 2.5). By the way, there are also some threats of unsustainable public finances

consolidation will be achieved over the above period of time, i.e. the underlying budget balances and the debt ratios will be the same in both 2004 and 2008.

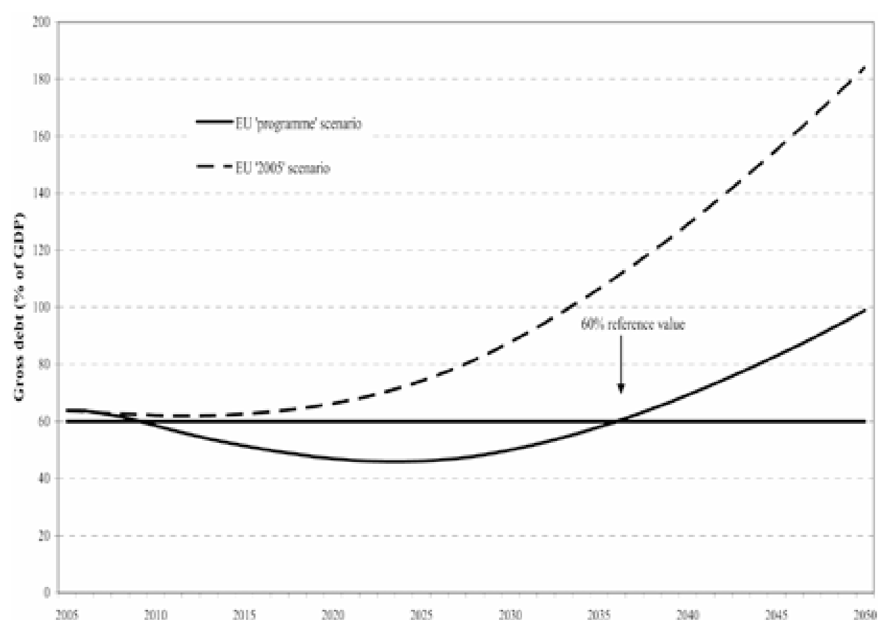
[22] The structural primary balance equals the cyclically-adjusted primary balance (CAPB) net of possible one-offs and temporary measures relative to GDP [Commission 2006s].

in the new Member States which in some time are to join the euro area (e.g. the projected debt ratios of almost 290% of GDP in Slovenia or 320% of GDP in the Czech Republic).

In conclusion, the Commission reiterated that *“one way to cope with the budgetary implications of ageing is to run and maintain sound public finances”*. In order to illustrate the size of the required budgetary positions of the Member States, the Commission introduced the so-called required primary balance (RPB), i.e. an indicator that would be required over the medium term to ensure sustainability over the long term (see: table 2.6). Analyzing the required primary balances (calculated under the “2005 scenario”) – especially in comparison with the structural primary balances in 2005 as well as at the end of the programme periods – it is necessary to agree with the Commission that *“indeed, high-debt countries need to keep large primary surpluses for an extended period of time, which may be hard to achieve in practice in view of competing budgetary pressures”* [Commission 2006s]. One can even state that it is simply impossible – keeping in mind some recent developments in public finances in the EU. But on the other hand, one can also remind that in some extraordinary periods of time (e.g. in the run-up to EMU) the EU Member States were able to achieve some remarkable results in fiscal consolidation.

Figure 2.5.

Potential public debt developments in the EU (projected up to 2050)



Source: Commission 2006s (see also: Commission 2005r).

Table 2.5.

Projected evolution of debt levels in the euro area up to 2050 (in % of GDP)

Member States of the euro area	2005	Programme scenario			2005 scenario		
		2010	2030	2050	2010	2030	2050
Belgium	94.3	75.3	36.1	63.5	73.4	33.6	60.2
Germany	67.3	65.6	57.9	99.4	73.6	116.2	232.4
Greece	107.9	91.0	122.0	346.0	96.9	165.2	451.3
Spain	43.1	31.5	9.6	95.8	25.7	-13.5	42.6
France	65.8	61.1	64.2	121.2	69.2	132.8	269.9
Ireland	28.0	24.6	36.7	156.2	13.6	7.9	100.4
Italy	108.5	99.1	51.4	30.7	108.9	127.6	208.9
Luxembourg	6.4	8.9	20.9	109.7	11.5	56.1	179.1
Netherlands	54.4	50.0	88.6	218.1	44.2	67.8	177.7
Austria	63.4	54.9	15.0	-21.2	58.9	54.9	67.5
Portugal	65.5	64.4	89.2	262.5	76.3	195.4	517.4
Finland	42.7	37.3	38.8	117.3	23.7	7.9	61.6

Source: Commission 2006s (based on the 2005/2006 updates of the Stability and Convergence Programmes).

Table 2.6.

The structural primary balance and the required primary balance in the euro area

Member States of the euro area	Structural primary balance		Required primary balance
	2005	end of programme	
Belgium	4.3	4.3	5.6
Germany	0.0	1.9	3.4
Greece	0.4	2.0	9.2
Spain	3.0	2.3	5.0
France	-0.6	2.0	4.1
Ireland	2.3	1.4	6.9
Italy	0.8	3.5	2.9
Luxembourg	-1.3	0.4	6.6
Netherlands	2.6	2.0	5.5
Austria	1.4	2.9	1.6
Portugal	-2.2	1.9	7.8
Finland	3.8	3.2	4.5

Source: Commission 2006s (based on the 2005/2006 updates of the Stability and Convergence Programmes).

Of course, **the long-term sustainability of public finances is important for all the EU Member States** because their unsustainable positions of public finances could have some negative spillovers on the other Member States. But it should be indicated that this issue is particularly important for the euro area because sound and sustainable public finances are essential for the proper functioning of EMU in the long run. According to the Commission, last year nine of the EU Member States exhibited various risks of the long-term sustainability and five of them (Belgium, Germany, Greece, France and Italy – all belonging to the euro area) had more serious problems. In spring 2006, however, the Commission stated that there was a large variation in the degree of risks that the Member States were facing and where

they mainly came from. On this basis it assessed that six countries were at high risk, ten at medium risk and nine at low risk; and this Commission's opinion was generally (with some small exceptions) confirmed by the Council (see: table 2.7). **The euro-area countries were classified - in general - as medium-risk countries, but some of them** (Greece and Portugal) **as high-risk ones** (similarly like Slovenia which is to join the euro area at the beginning of 2007) [Commission 2006s; Council 2006a].

2

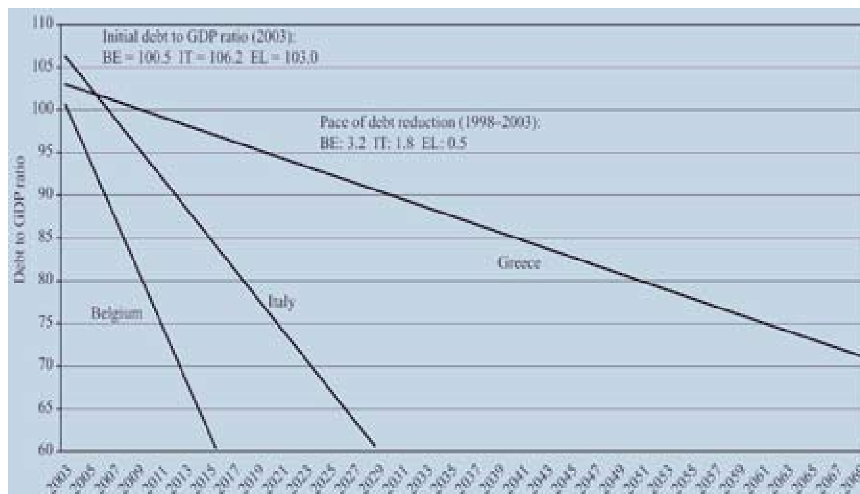
Table 2.7.
Overall classification of the Member States' risks to their public finances sustainability

Risk category	Euro-area Member States	Non-euro-area Member States
Low	Austria, Finland	Denmark, Estonia, Latvia, Lithuania, Poland, Slovakia, Sweden
Medium	Belgium, Germany, Spain, France, Ireland, Italy, Luxembourg, Netherlands	Malta, United Kingdom
High	Greece, Portugal	Czech Republic, Cyprus, Hungary, Slovenia

Source: Own elaboration based on: Commission 2006s.

The level of the debt-to-GDP ratio is presently a source of concern in at least three countries (Belgium, Greece and Italy). In order to reduce their public debt towards 60% before the impact of ageing takes place, these countries – in the Commission's opinion – have to run sustained high primary surpluses (above 4% of GDP) during the next 10 to 15 years (and even more in the case of Greece) (see: figure 2.6). However, as mentioned before, such budgetary targets seem to be overly ambitious and one can say that they are doubtful. In the case of the other euro-area countries mentioned above (Germany and France), a source of concern is not the very high level of their debt-to-GDP ratios, but rather its recent upward trend (being the result of their budgetary deterioration during the slowdown), which pushed public debt up, breaching the reference value in 2002-2003 and remaining clearly above 60% of GDP to date. In this context, however, it should be noted that **some of the euro-area countries (including the largest ones) have implemented certain structural reforms in recent years – in order to strengthen the sustainability of public finances** (for example, Germany, France and Italy reformed their pension systems and France also reformed its health-care system). The implementation of such structural reforms is a very important aspect of the long-term sustainability of public finances because it helps ensure that sound budgetary positions would be maintained in the longer term [Commission 2005r; 2006s].

Figure 2.6.
Long-term projections of public debt reduction in the most indebted Member States of the euro area



Source: Commission 2004e.

In the context of the above considerations related to the long-term sustainability of public finances in the EU (and in the euro area), it is possible to draw some conclusions:

- one can state that there are no direct links between EMU and the ageing of populations. Even if this is true, it must emphasized that there are some clear indirect links between them. First of all, **the EU and its Member States have been much more focused on the sustainability of public finances after the launch of EMU**, under which the overall quality of public finances has become much more important than previously (before EMU). Next, the ageing of populations may have a significant impact especially on public finances (government deficits and debt). And – what is widely recognized – sound public finances are of utmost importance for the proper functioning of EMU. And finally, the ageing of populations is particularly important in the case of the nine Member States, of which the majority belong to the euro area – namely the most indebted countries (Italy, Greece, Belgium) and those with high deficits (France, Germany). Therefore, **the sustainability of public finances seems to be a bigger problem for the euro area rather than for the EU**;
- **the ageing of populations is a much bigger problem for the euro area than for the United States**. For that reason, the euro-area countries should adopt much more prudent budgetary measures. In particular, they should implement the agreed three-pronged approach, including a much faster debt reduction, measures to raise employment rates, and relevant reforms of their pension and healthcare systems [Commission 2004j];
- as mentioned before, the levels of current deficits do not pose an imminent risk to the sustainability of public finances, but this threat could easily materialize unless countries achieve significant improvements in their underlying budget positions over the coming years. But – as it may be concluded from the Commission's analyses and research – there is a serious concern regarding the achievement of budgetary consolidation in the medium-term for most of the Member States. **If the assumed fiscal consolidation is not achieved in the medium-term by (some of) the Member States, the projected debt**

dynamics would worsen considerably in the long-term. It underlines the importance of strengthening the fiscal positions sooner rather than later (the sooner, the better) [Commission 2004j; 2005r].

* * *

Overall, the assessment of the impact of EMU on fiscal policy and the budgetary performance of the euro-area countries is mixed. Undoubtedly, the introduction of the euro – resulting in running the single monetary policy within the euro area and the parallel introduction of the new fiscal framework (SGP) – has brought many positive contributions to coordination of budgetary (fiscal) policies and the overall quality of public finances in both the EU and the euro area. But there are still some (serious) problems and the need for further fiscal consolidation – that existed at the launch of the single currency – is still evident after more than seven (or almost eight) years of EMU.

3

Structural reforms and market integration before and after the introduction of the euro

In the case of structural reforms[23] – similarly like in the case of public finances – it is really difficult to assess the impact of EMU because of its relatively short existence so far (only seven years). For that reason, the actual impact of EMU – as a catalyst for structural reforms – may not be fully apparent just some years after the introduction of the euro, but considerably later. Therefore, at this stage it is impossible to draw firm conclusions that there is no impact of EMU on structural reforms (or that the observed impact is the definitive one). Moreover, sometimes it seems to be difficult to isolate the pure impact of EMU and distinguish it from the impact of some other influential phenomena – both internal ones from the EU's point of view (such as the completion of the Single Market) as well as external ones (such as technological change or globalization) [see e.g. Issing 2006b]. Nevertheless, keeping in mind that structural reforms are of utmost importance for the proper functioning of EMU, it is worth to analyze some structural reforms in labour, product and financial markets before and after the introduction of the euro, and try to assess their actual and potential impact of the euro-area economy.

It is often argued that structural reforms are one of the most important points of the EU economic agenda. This is true presently, similarly as it was in the past – especially in the run-up to EMU. Before the introduction of the euro there was a wide debate concerning the question **whether the single currency would act as a catalyst for structural reforms**. During the debate there were even opinions that a critical factor in the success or failure of EMU would be whether the advent of a single currency would provide an impetus for further structural reforms within the euro area [Commission 2004j].

As it is known today, as well as before the launch of EMU, the euro area is a monetary union, but at the same time it is not an optimum currency area (OCA). Being a monetary union, the euro area is potentially exposed to so-called asymmetric shocks. In the case of such shocks, the OCA theory stipulates the following **adjustment mechanisms**: (i) **labour mobility**, (ii) **price and wage flexibility**, and (iii) macroeconomic / fiscal policy. According to the OCA theory, if a given country or region of a monetary union is hit by an asymmetric shock,

[23] There are various definitions of "structural reforms". According to the European Commission [Commission 2005r], the term "reform" is being used with reference to different types of policy interventions (labour market reforms, tax reforms, pension reforms, health sector reforms, trade reforms, etc.), which are expected to have a long-lasting impact. The adjective "structural" is added to indicate that the policy interventions are aimed at affecting the economy in its structure, e.g. changing the functioning of markets (reforms in product or factor markets) or modifying the working of public institutions (pension or health care reforms). In this working paper structural reforms are related mainly to reforms in product and labour markets.

wages/prices may fall and/or the labour force may move to other regions (not hit by the shock). In such a case, the economic, social and political costs of adjustment are much lower in comparison with a situation where adjustments take the form of growing unemployment and/or recession.

Prior to the launch of EMU many economists – taking into account the lack of adjustment capacity in several countries of the euro area because of their rigid product and labour markets, low cross-border labour mobility and the absence of a central fiscal authority in the euro area – indicated that it could lead to the emergence of some large and persistent macroeconomic imbalances which could result in protracted periods of slow growth and high levels of unemployment in some countries or regions of the euro area. It seemed to be likely in a monetary union consisting of a group of countries with significantly different economic structures and not fully synchronized business cycles. For that reason – and keeping in mind that there was no political will to establish more supranational institutions for EMU (e.g. a central fiscal authority) – it was argued that **the only possibility within EMU was to reform product and labour markets and make them (much) more flexible**.[24] First of all, some economists expected that by reinforcing the integration process of product and labour markets, EMU could reduce the likelihood of asymmetric shocks inside the euro area and strengthen adjustment capacity in the case of such shocks [Commission 2004j]. Moreover, it was (and still is) argued that structural reforms – which would result in greater competition in product, labour and capital markets – had been found to generate positive macroeconomic effects in the form of higher productivity and employment and lower unemployment [Weyerstrass *et al.* 2006]. Therefore, **the strong need to intensify structural reforms in the euro area** has emerged before the introduction of the euro.

Moreover, it should be added that some authors argued that **not only asymmetric shocks, but even entirely symmetric shocks could be problematic for the euro area** – especially in the early years of EMU. In their opinion, in the case of symmetric shocks, the overall situation could be aggravated (and more difficult to be overcome) if some uncoordinated actions or "free riding" behaviour take place in response to such shocks. In general, both asymmetric and symmetric shocks would be potentially challenging, taking into account that some adjustment mechanisms are no longer available in the euro area, while some others are not yet fully mature [Buti, Sapir 2002]. This confirms again the need to have in place both coordinated mechanisms, procedures and policies for crisis management, as well as relevant economic adjustment mechanisms (such as flexible markets which could be achieved through conducting some structural reforms).

Although the need to reform product and labour markets was clearly evident, there were arguments that EMU might both strengthen and weaken structural reform. On the one hand, it was argued that there were some **reasons to expect more structural reforms after the introduction of the single currency** (and the single monetary policy):

[24] The importance of market flexibility is still underlined by leading economists not only in Europe, but also in other developed economies, such as the United States. For example, A.Greenspan stated in one of his speeches last year: *"Flexibility is most readily achieved by fostering an environment of maximum competition. A key element in creating this environment is flexible labor markets. Many working people, regrettably, equate labor market flexibility with job insecurity. Despite that perception, flexible labor policies appear to promote job creation, not destroy it. (...) The net effect, to the surprise of most, has been what appears to be a decline in the structural unemployment rate in the United States. Protectionism in all its guises, both domestic and international, does not contribute to the welfare of American workers. (...) I trust that we have learned durable lessons about the benefits of fostering and preserving a flexible economy. That flexibility has been the product of the economic dynamism of our workers and firms that was unleashed, in part, by the efforts of policymakers to remove rigidities and promote competition. Although the business cycle has not disappeared, flexibility has made the economy more resilient to shocks and more stable overall during the past couple of decades"* [Greenspan 2005].

- as mentioned above, under EMU such macroeconomic adjustment instruments as monetary policy or exchange rate policy are no longer available for individual countries to respond to asymmetric shocks. Hence, the euro-area countries should have **stronger incentives** to undertake structural reforms leading to more efficient and flexible labour and product (goods and services) markets – in order to have some market-based adjustment instruments to such shocks. It is often argued that in some specific circumstances, e.g. in the absence of significant labour mobility, **there is no alternative** for governments and they have to adopt some necessary reforms (the so-called TINA argument) [Bean 1998];
- as it is argued by some economists, if market interactions deliver sub-optimally low levels of employment and economic activity, and nominal wages are rigid in the short term, then monetary authorities are *ex post* tempted to engage in expansionary monetary policy. If such behaviour is rationally expected by wage- and price-setters then inflation will be *ex ante* so high as to discourage further increases. The resulting equilibrium combines low levels of activity (or high unemployment) and high inflation. To correct this unsatisfactory state of affairs, the standard prescription is that low activity levels and excessive real wage aspirations should be targeted by appropriate structural reforms [Bertola, Boeri 2001];
- moreover, EMU may stimulate structural reforms because of greater transparency caused by the single currency, which may expose more clearly **the costs of structural rigidities** as reflected in relative prices. In addition, greater transparency and reduced trading costs should increase product-market competition, thereby reducing the size of product-market rents in the euro area. As a result, with less rent to be captured, the resistance to reforms of structural policies that enable such capturing may become smaller [Duval, Elmeskov 2005; 2006].

On the one hand, despite the above arguments, it was suggested that **it should be expected to observe less structural reforms under EMU**:

- taking into account that EMU would lead to increased transparency and competition in markets, this might induce a **greater demand for protection** in the sheltered sectors and could thus hinder the process of structural reforms [Commission 2004j];
- the **up-front costs of structural reforms** may be larger in the euro area because of a certain degree of restriction on the use of fiscal policy under EMU [Bean 1998; Duval, Elmeskov 2005; 2006]. As it was expected before the introduction of the euro, the fiscal framework of EMU (the SGP) might constrain the use of fiscal policy to accommodate structural reforms. And, as it is known, such accommodation is easier for countries which undertake reforms from a position of “close to balance or in surplus” as stipulated by the SGP (but it was obvious before the launch of EMU that many of the Member States would join the euro area with rather significant deficits – only slightly below the reference value).

In addition to the above pre-EMU expectations about the potential impact of the single currency on structural policies, it should be noted that today’s expectations about these reforms in the euro area are to some extent similar, and to some extent different. On the one hand, it is still repeated that in order to limit cyclical divergence and enhance the effectiveness of the adjustment mechanisms, some further progress with structural reforms and budgetary consolidation are both essential [Commission 2004f]. On the other hand, it is

argued currently – especially after the recent economic slowdown – that **structural reforms are necessary** not only to increase flexibility of European markets (in order to cushion potential asymmetric shocks), but also **to raise overall Europe's growth potential**. Reforms in product and labour markets are perceived as the fundamentals for relaunching the EU growth potential in accordance with the Lisbon Strategy. In other words, structural reforms in labour and goods markets should (or even must) be undertaken as the key element of a comprehensive strategy for improving growth, employment and investment prospects in Europe [Issing 2000]. But there are still many opinions – expressed, for example, in the recent Commission's Annual Progress Report on Growth and Jobs (of January 2006) – that **comprehensive structural reforms in labour, product, services and capital markets are particularly important for the euro area to increase its adjustment capacity** (for example, better functioning product and labour markets could help limit inflationary pressures in the case of positive demand shocks). Moreover, the Commission argues that *"in the view of the persistence of growth differences across some euro-area Member States structural reforms are necessary to boost the responsiveness of the economy through changes in prices (the so-called competitiveness adjustment mechanism)"* [Commission 2006a-c].

3.1. Integration and reforms of financial and product markets

In general, EMU has accelerated economic integration between the euro-area countries. One of the most widely expected effects of the single currency was complementing the Single Market and fully exploiting its huge potential. The European Commission stated in its famous study *"One market, one money"* [Commission 1990] that EMU should be regarded as a complement to the Single Market Programme (SMP) and it would strengthen some potential gains from the SMP, contributing consequently to improved market efficiency and higher growth. According to the study, this should bring a number of **benefits of EMU regarding product market integration**:

- direct benefits arising from savings on transactions and hedging costs (around 0.5% of GDP);
- indirect benefits of the elimination of exchange rate uncertainty, i.e. its positive impact on trade, cross-border investments and capital flows within the euro area;
- further benefits of the overall reduction in uncertainty under EMU, i.e. its positive impact on decisions concerning domestic investments.

Prior to the launch of EMU it was commonly expected that the impact of the introduction of the euro on product markets would materialize through the following channels: lower transaction costs, exchange rate stability and greater price transparency. As a result, it should intensify competition within the euro area. Those factors were also expected to have a positive effect on financial markets.

3.1.1. Financial markets

Not only today, but even some decades ago, it was argued by some economists that a high degree of financial integration was one of the most conducive issues for the sustainability of a monetary union. It was expected that financial integration, together with developed and sound financial markets, could help mitigate some effects of asymmetric shocks by facilitating cross-border capital flows [Scitovsky 1966; Ingram 1973; Mundell 1973]. The

importance of financial integration has also been recognized by the so-called "new" OCA theory. Financial integration is often seen to include the similarity of financial structures, institutions and legislation, taking into account that similar structural features – including the financing pattern of private enterprises (i.e. a share of bank loans to total liabilities) and households (i.e. a share of mortgage payments to total payments) – are seen to increase the effectiveness by which monetary policy is being transmitted to the real economy. Therefore, it is expected that financial integration will contribute to the better functioning of a monetary union. In this context, it should be noted that prior to the introduction of the euro financial integration was often perceived as essential for the euro area to ensure a comparable implementation of the single monetary policy within EMU [Mongelli 2002; Backé, Thimann *et al.* 2003]. And even today, many years after the launch of the single currency, progress in European financial integration (for which the euro has acted as a major catalyst) – together with the single monetary policy – are regarded as two main successes of EMU [Trichet 2006g]. Moreover, it is also argued that financial markets can play an important role in promoting sound public finances in EMU (by disciplining governments to avoid excessive borrowing and placing their debt on unsustainable trajectories) [Commission 2003a].[25]

The most spectacular impact of the introduction of the euro was observed in accelerating the process of integration of financial markets (thanks to eliminating exchange rate risks in financial flows, enhancing transparency and competition in the provision of financial services, increasing the size and liquidity of financial markets, etc.). In 2000, shortly after the launch of EMU, the European Council in Lisbon stated that efficient and transparent financial markets would foster growth and employment by better allocation of capital and reducing costs. Such markets play a crucial role in supporting entrepreneurship, promoting access to and use of new technologies, etc. In addition, efficient risk-capital markets play a major role in innovative high-growth SMEs and the creation of new and sustainable jobs. Therefore, it was argued that in order to exploit the full potential of the euro, it was essential to push forward the integration process of financial markets in the EU [European Council 2000a]. A few years later – referring to particular segments of financial markets – some researchers reported **an overall increase in the process of integration of both equity and euro-area bond markets since the introduction of the euro** (although this integration has been found to be very advanced in the case of all euro-area government bond markets, while equity markets seem to lag behind; and progress in this regard is limited mainly to some large economies of the euro area). Moreover, it is worth to add that there is increasing integration across some large EU economies and the United States, while some small EU countries and Japan remain generally very little integrated with other countries [Cappiello *et al.* 2006; see also: Hartmann *et al.* 2005]. Similarly, the IMF stated that EMU had fostered a deeper, more liquid, complete, and increasingly integrated government bond market. In its opinion, monetary union undid the segmentation that former national currencies of the euro-area countries created in sovereign debt markets, introducing direct competition for an increasingly international pool of investors [IMF 2005c].

Some time ago, after five years of the existence of EMU, the European Commission – keeping in mind that financial markets are regarded as a necessary ingredient (or even a basis) of the proper functioning of contemporary economies – stated that **financial**

[25] It should be noted, however, that according to the Commission, in the context of EMU financial markets could only react powerfully when budget deficits and public debt reach some unacceptable levels, i.e. levels which would be well above those considering appropriate to support the single monetary policy in delivering a stable macroeconomic environment [Commission 2003a].

integration is not an objective in itself; it is rather a means to raise the EU's growth potential through a more efficient allocation of resources, lower cost of capital and transaction costs, exploitation of economies of scale, increased investment and higher productivity [Commission 2004j; Almunia 2005]. Similar opinions were also expressed by some other international institutions, such as the IMF or the ECB. According to the former, financial integration is crucial to support higher and better balanced economic growth, permit a more efficient distribution of risks, and enhance the effectiveness of monetary policy [IMF 2005b]. And in opinion of the latter, there is evidence in the empirical literature confirming that economic growth is linked with a degree of development and the structure of the financial system because *"financial integration is a key factor in the development of the financial system, which, in turn, increases the potential for greater and more sustainable non-inflationary economic growth"* [Trichet 2006a,b]. Moreover, **completing the single market in financial services is a crucial part of the Lisbon economic reform process** [Commission 2005q,m]. In addition, it is argued that the euro has contributed both directly and indirectly to the process of financial integration in Europe [Almunia 2005]. In this context, it should be noted that **the single currency and integration of financial markets are mutually supported**. It is confirmed by, on the one hand, a positive contribution of the euro to the process of financial integration, and on the other, a similar contribution of a fully integrated EU financial market to making the euro one of the most stable and leading international currencies [ECB 1999; 2001; 2002b; 2003c; 2005i];[26] in fact, the second currency in all major segments of international financial markets [Commission 2005w].

Since the very beginning of the existence of the single currency there were some initiatives aimed at undertaking **specific measures for improving (in other words: reforming) the single market in financial services**. In March 2000, the Lisbon European Council stated that in order to accelerate completion of the single market for financial services, the following steps should be taken: ensuring full implementation of the *Risk Capital Action Plan* (RCAP) by 2003 and the *Financial Services Action Plan* (FSAP) by 2005. A very important issue was also the so-called Lamfalussy process introduced in 2001 (see: box 3.1). All those measures have given a strong impetus to the creation of legal and regulatory frameworks for integrated financial markets, convergence of supervisory practices, and the Memorandum of Understanding on cooperation between the banking supervisors, central banks and finance ministries of the EU in financial crisis situations (which entered into force on 1 July 2005) has been another step forward [IMF 2005b; ECB 2005c]. Despite these significant achievements, reforming efforts have to be continued. For that reason, in December 2005 the European Commission presented its new financial services strategy for the next five years – the so-called *White Paper on Financial Services Policy 2005-2010*. According to the Commission, the EU financial services industry (banking, insurance, securities, asset management) still has strong untapped economic and employment growth potential. The retail Internal Market is still far from being completed. One of the major structural economic challenges of the EU – its huge pension deficit – needs to be financed. Better functioning risk-capital markets are needed to promote new and innovative firms and raise economic growth. Last but not least, taking into account that the EU markets are overregulated, it is of utmost importance to ensure better regulation and proper regulatory and supervisory structures [Commission 2005y; see also: Trichet 2006f].

[26] 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].

Box 3.1.
Integration of financial markets in the EU: key measures

- **Risk Capital Action Plan** (1998)

The RCAP was adopted in March 1998. It was designed to promote coordinated actions aimed at stimulating the development of risk-capital markets which – by providing financing to companies (e.g. SMEs) – played a crucial role in business start-ups and their further development, and thereby in job creation, within the EU. The Commission identified some key barriers to the creation of risk-capital markets (such as market fragmentation, institutional, regulatory, tax, cultural barriers, etc.) and proposed to remove them at both Community and national levels. During 1998-2003 some significant progress regarding the RCAP implementation was achieved (the regulatory framework improved markedly, but tax issues remained the weakest point). The gap between the EU and the US concerning the development of risk-capital markets was cut by half since 2000.

- **Financial Services Action Plan** (1999)

The FSAP was adopted in May 1999. It was a driving force of the process of integration of European financial markets during 1999-2005. It consisted of more than 40 specific legal measures (mainly directives and recommendations) for improving the single market in financial services and harmonizing the Member States' rules related to banking, insurance, securities, pensions, mortgages, etc. The FSAP was designed to achieve three strategic objectives, i.e. (1) establishing the single market in wholesale financial services; (2) making retail markets open and secure; and (3) strengthening the rules on prudential supervision. By the end of 2005, almost all of the FSAP measures have been adopted and implemented.

- **Lamfalussy process** (2001)

The Lamfalussy process was proposed in February 2001 by the Committee of Wise Men (chaired by A.Lamfalussy, former President of the European Monetary Institute). The Committee suggested that the European regulatory and supervisory process should be conducted via a four-level approach:

- Level 1: framework legislation adopted in co-decision (between the Council and the European Parliament – following the Commission's proposal), focusing on the core political principles;
- Level 2: implementing measures to fill in the details of the "level-1" legislation subject to precise constraints fixed in that legislation (and establishing some new European committees[27]);
- Level 3: day-to-day cooperation by national supervisors and regulators[28] to ensure consistent implementation and enforcement;
- Level 4: strengthened and more effective enforcement of the Community law (by more vigorous actions of the Commission and the Member States).

The Lamfalussy process was initially related to securities markets only, but then it has been extended to some other sectors as well; today it is applied in the banking, insurance and occupational pensions, securities and UCITS sectors.[29]

- **White Paper on Financial Services Policy 2005-2010** (2005)

In December 2005 the European Commission presented its new financial services strategy for the next five years (2005-2010). Although significant progress has been made through the successful completion of the FSAP, the Commission has concluded that the EU financial services industry (banking, insurance, securities, asset management) still has strong untapped economic and employment growth potential. The Commission's new strategy explores the best ways to effectively deliver further benefits of financial integration to industry and consumers alike. It is related to five priorities: (1) to dynamically consolidate progress and ensure sound implementation and enforcement of existing rules; (2) to drive through the better regulation principles into policy making; (3) to enhance supervisory convergence; (4) to create more competition between service providers, especially those active in retail markets; and (5) to expand the EU's external influence in globalizing capital markets.

Sources: Commission 1998b; Commission 1999; Lamfalussy *et al.* 2001; Commission 2005n,y; 2006e.

[27] Representatives of national governments cooperate within the following level-2 committees: European Banking Committee (EBC); European Insurance and Occupational Pensions Committee (EIOPC); European Securities Committee (ESC).
[28] Representatives of national supervisors and regulators cooperate within the following level-3 committees: Committee of European Banking Supervisors (CEBS); Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS); Committee of European Securities Regulators (CESR).
[29] In March 2006 the Inter-institutional Monitoring Group published its first interim report on the Lamfalussy Process [Åkerholm *et al.* 2006]. In the report, based on evidence given by the stakeholders closely involved in this process and market participants, the Group has stated that there is general and strong support for the Lamfalussy approach, but at the same time it has identified a number of unresolved questions and uncertainties surrounding the procedure, which remains a "learning-by-doing process" [Commission 2006k]. Therefore, the process should be continuously monitored and, if necessary, periodically improved.

3.1.2. Product and service markets

It was widely anticipated prior to the introduction of the euro that EMU would have a significant impact on **intra-euro-area trade** (resulting in some empirical studies just after the introduction of the euro).[30] It was often argued that EMU would foster greater trade among its Member States because of the elimination of exchange rate uncertainty between them, lower transactions costs, enhanced competition through greater transparency, etc. The gains in intra-area trade do not appear to occur at the expense of extra-area trade, i.e. EMU seems to have rather trade-creating than trade-diverting effects [Faruqee 2004].

And indeed, as it is confirmed by some recent research, there is some evidence that **EMU has had a positive impact on intra-euro-area trade** – although the findings of various studies vary considerably (estimating the euro effect on trade between 3% and 50% depending on the studies considered). For example, one of the recent studies states that EMU has boosted trade among the euro-area countries by roughly 10% (on average) during the existence of the euro (although the trade gains from the single currency have not been evenly distributed among the Member States – see: figure 3.1.a) [Faruqee 2004]. Other studies indicate that the impact of the euro on bilateral trade in goods within the euro area may be even larger – i.e. an increase between 5% and 20% [Micco, Stein, Ordoñez 2003], between 7% and 18% [Commission 2003d], between 8% and 15% [Flam, Nordstrom 2003], etc (see: figure 3.1.b). There are also some opinions that the euro effect on trade is not as large as commonly thought because there is an upward bias in existing estimates and after making relevant corrections the estimated EMU impact on trade shrinks to 3% [Bun, Klaassen 2003; 2004]. Some other authors indicate so-called consensus estimates suggesting that the euro has already boosted intra-euro area trade by 5% to 10% [Baldwin 2005; 2006].[31] The above figures – up to around 20-25% – should be interpreted as the short- or medium-term effects of EMU. But there are also some much higher estimates of the dynamic effects of EMU on trade integration – reaching 29% [Barr, Breedon, Miles 2003], 38% [Bun, Klaassen 2002], or even 50% [HM Treasury 2003b]. And these figures should be regarded as the long-term effects of EMU. Overall, the main conclusion emerging from the recent empirical studies is that although EMU has already had a sizeable impact on intra-euro-area trade flows, this effect does not seem to have reached its maximum yet, and thereby **the impact of EMU on trade is likely to increase further in the coming years** [Commission 2003d; 2004j; Faruqee 2004]. Moreover, some authors find a significant and positive impact, indicating that third countries tend to trade up to 27% more with the euro-area countries since the creation of EMU [Baldwin, Skudelny, Taglioni 2005].

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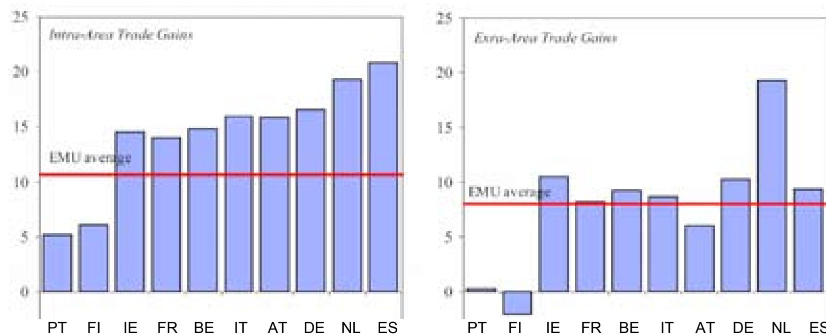
[30] The trade effects of monetary unions (considering both EMU and non-EMU currency unions) is often labelled the “Rose effect” – after the famous empirical study [Rose 2000], which found that currency unions tended to have a huge impact on trade and could increase bilateral trade flows substantially (even by about 200% according to some of estimates of that study). The above study started a great debate on what would be the real effects of the single currency (or common currencies in general) on international trade and. The above study received a lot of comments and critiques – mostly suggesting that initial Rose’s estimates were too high and should be (considerably) shrunk [Nitsch 2001, 2002; Bun, Klaassen 2003; 2004]. And, indeed, the next studies found that the so-called “Rose effect” is much smaller, but still quite large. For example, some authors concluded that the average currency union effect was below 60%, although their estimates were not significantly different from zero [Tenreyro 2001]. Similarly, some other authors estimated that effect up to 70%, e.g. between 15% and 66% [Persson 2001] or between 21% and 43% [Rose 2001] (the former was based on the original Rose’s data set, while the latter on a much larger one). For more details, see: Baldwin 2005; 2006.

[31] According to the ECB, exports and imports of goods within the euro area increased by less that 5 percentage points – from about 26.5% of GDP in 1998 to around 31% in 2005. Over the same period, exports and imports of goods with trading partners outside the euro area rose by about 6 percentage points – from about 24% of GDP to almost 30%. In the ECB’s opinion, the former may be partly related to the introduction of the single currency and the increased price and cost transparency, which have promoted cross-border trade. And the latter is mainly because of more sustained growth in world GDP, an increase in global trade integration, and a very sizeable increase in trade with the ten new Member States of the EU (particularly due to a high degree of openness of the euro-area countries) [Trichet 2006i].

The above estimates have affected the debate in non-EMU countries, particularly in the United Kingdom, on whether to join the euro area (*notabene*, this debate has also been conducted outside Europe, e.g. in the United States [see e.g. Micco, Stein, Ordoñez 2002]). It should be recalled that the potential impact of the euro-area membership on trade is directly or indirectly related to some of the UK government's five economic tests[32] – being preconditions for joining EMU.[33] For that reason, in 2003 the UK government focused on the assessment to extent which UK trade with the euro area might be increased through the British participation in EMU and, in consequence, what would be the potential impact it could have on UK output and income in the long term. It was concluded that a reasonable range for the potential increase in UK trade with the euro area resulting from the UK's membership of EMU would be between 5% and 50%, without any trade diversion from the non-euro area (the upper estimate appeared closer to the more likely outcome in the long term). It was assessed that with the above increase in trade with the euro area, it suggested that EMU membership could potentially increase the long-term level of output *per capita* in the UK by between 4.5% and 9.25% (depending on the assumption made) in the long-term period, i.e. about 30 years [HM Treasury 2003b].

Figure 3.1.
Trade effects of the introduction of the euro

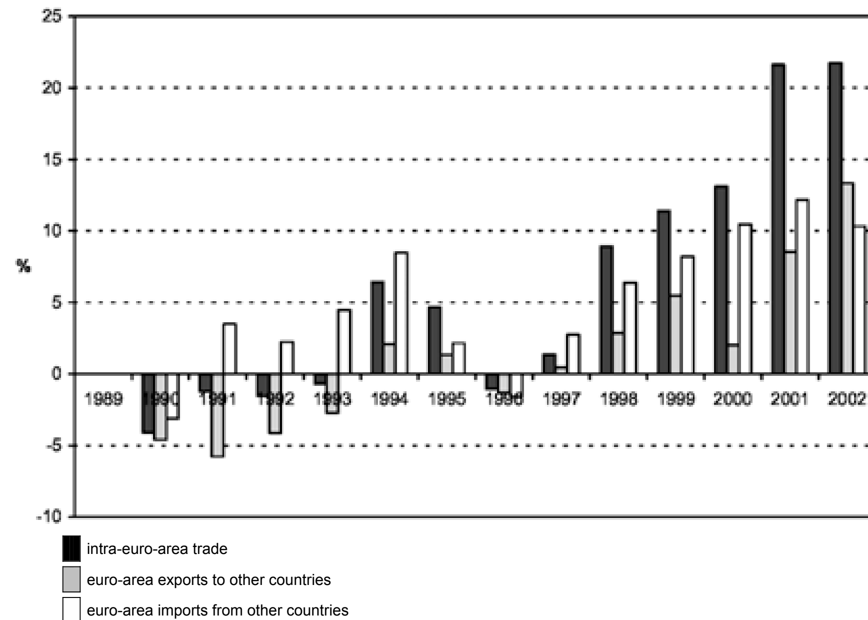
a) trade creation versus trade diversion under EMU (in %)



[32] The **five economic tests** are the criteria defined in 1997 by G.Brown, the UK Chancellor of the Exchequer. Those tests are the basis to make an assessment whether joining the euro area would be beneficial for the UK. The tests are the following: **(i) convergence** (are business cycles and economic structures compatible so that we and others could live comfortably with euro interest rates on a permanent basis?); **(ii) flexibility** (if problems emerge is there sufficient flexibility to deal with them?); **(iii) investment** (would joining EMU create better conditions for firms making long-term decisions to invest in Britain?); **(iv) financial services** (what impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets?); and **(v) growth, stability and employment** (in summary, would joining EMU promote higher growth, stability and a lasting increase in jobs?). If the above tests are met, it will be possible for the UK government to put the issue before the British people in a referendum in order to make a final decision on joining the euro area [HM Treasury 1997].

[33] The UK government's study *"EMU and trade"* was most relevant to the assessment of the fifth economic tests for EMU entry, i.e. the growth, stability and jobs test. It was also relevant in assessing the first and third economic tests, i.e. the convergence test and the investment test respectively [HM Treasury 2003b].

b) dynamics of intra- and extra-euro-area trade (1990-2002)



Sources: top panels: Faruqee 2004; bottom panel: Flam, Nordstrom 2003; Baldwin 2005; 2006.

Before the introduction of the euro, it was also expected that the impact of EMU on **foreign direct investment** (FDI) would be positive as well. Monetary integration may affect FDI through various channels. First, EMU is regarded as an area of significant macroeconomic and political stability. And, as it is known, the greater economic and political uncertainty, the higher probability that potential investors will wait before entering a given country/market. Moreover, monetary integration could strengthen foreign investments because it bring numerous advantages, such as eliminating exchange rate volatility, reducing transaction costs, increasing price transparency, etc. Therefore, the single currency could foster FDI since it makes comparison of international costs and price decisions easier [de Sousa, Lochard 2006; Dixit, Pyndick 1994; Bénassy-Quéré *et al.* 2001].

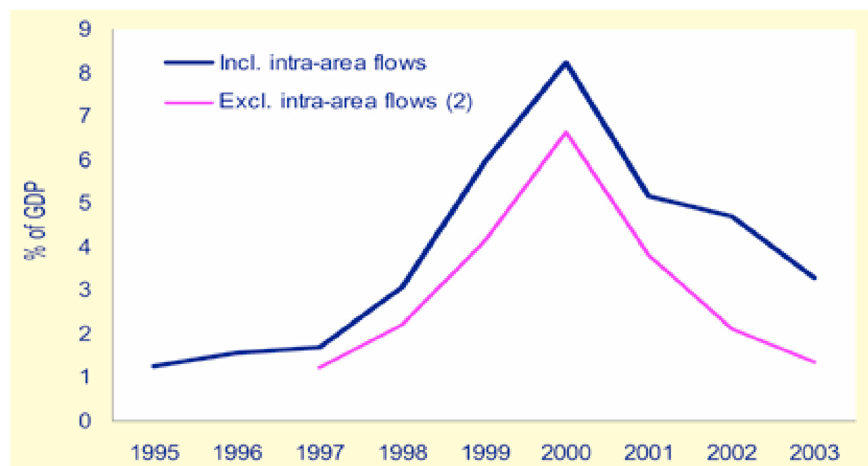
The above expectations have materialized. There is a common view that **the single currency has raised the attractiveness of the euro area as a destination of foreign investments**. According to the recent empirical studies (researching outward bilateral FDI of more than 20 OECD countries during the 20-year period of 1982-2002), monetary integration plays an important role for stimulating intra-EMU FDI. The authors of this study find that the single currency has affected positively the decision of the euro-area members to invest inside and outside the euro area. Their estimates suggest that **the adoption of the euro has increased intra-euro-area FDI significantly** – the euro has increased intra-EMU FDI stocks by about 26% in the first four years of its adoption; this effect is even larger for FDI flows (increased by 42% in comparison to FDIs among non-EMU countries). However, the authors of this study do not find strong evidence that the introduction of the single currency has attracted more FDI from non-euro members [de Sousa, Lochard 2006]. According to some other authors (analyzing FDI inflows of 60 countries in 1995-2002), EMU has raised annual FDI inflows by more than 33% [Economist Intelligence Unit 2004].

In the 1970s, the 1980s, and the 1990s, overall FDI activity (the average of inflows and outflows relative to GDP) was broadly similar in both the euro-area countries and the world economy. A very sharp increase was observed just before and after the introduction of the euro (see: figure 3.2). Euro-area FDI flows increased from 1.5% to 8% of GDP over the period 1996-2000 (at the same time there was a much lower increase - from 1.2% to 3% of GDP - in the rest of the world). Since 2001 onwards global (including European) FDI activity has experienced a sharp decline, but it has been more moderate at the euro-area level than at the world level. **The present level of FDI flows of the euro-area countries remains considerably above the level recorded prior to EMU.** According to the Commission, this is owing to relatively **strong intra-euro-area FDI activity**,[34] suggesting that the euro has given impetus to cross-border ownership and production in the euro area. In consequence, the business cycles of the euro-area countries should become more synchronous, similarly to the effects from rising trade integration [Commission 2004q]. And the more synchronized business cycles, the less likely asymmetric shocks in the euro area.

It is sometimes argued that the above positive impact of the euro on FDI may encourage some of non-EMU countries – namely the United Kingdom (one of the biggest beneficiaries of FDI in the world[35]) – to join the euro area in the future. Such opinions are usually based on evidence that **the share of non-EMU countries in total inward investment into the EU has decreased sharply since the introduction of the euro**, falling from 37% to 11% between 1998 and 2002 [Commission 2004j]. Some authors, analyzing the fall of FDI into the United Kingdom in recent years, suggest that it may be a consequence of not adopting the euro [Barr, Breedon, Miles 2003]. The UK government also acknowledges that there is evidence that the UK's share of inward investment from outside the EU has fallen relative to the other EU members since the introduction of the euro. However, it also emphasizes that FDI flows have been affected by many factors in recent years and it is therefore difficult to detect with confidence a specific EMU effect in this respect [HM Treasury 2003c]. There are also some opinions and evidence that exchange rate uncertainty between both the euro and the sterling against the US dollar has a strong negative effect on FDI and influences location decisions of American firms in the euro area (in particular, there is evidence that, as exchange rates become perfectly correlated, US firms tend to divert their investment from the euro area to the UK) [Barrell, Gottschalk, Hall 2004]. Therefore, it may not be an incentive for the United Kingdom to adopt the euro. But in its recent review of the five economic tests (of June 2003), the UK government concluded that a successfully operating EMU and the UK's membership of the euro area would boost FDI over the longer term. And the longer its membership of the euro area is delayed, the longer some potential gains in terms of increased inward investment are postponed [HM Treasury 2003a].

[34] For example, in 2003 total euro-area FDI inflows were more than 3% of GDP compared to the level of extra-area FDI inflows of slightly above 1% of GDP [Commission 2004q].
[35] For example, in 2004, the United States was the biggest recipient of FDI, followed by the United Kingdom and China [Commission 2005w].

Figure 3.2.
FDI flows in the euro-area Member States (1995-2003) (1)



(1) Average of FDI abroad and foreign FDI in the economy
(2) Data only available from 1997

Source: Commission 2004q.

As regards product market reforms, the integration process has caused **an increase of the level of competition in European product markets**. In particular, the above effects of EMU on trade and FDI have led to a visible change in competitive conditions within the euro area. According to the European Commission, the single currency and the Single Market – by eliminating exchange rate uncertainty and several trade barriers – have facilitated market entry by new firms and the introduction of new products into the EU markets. As a result of increased inter-brand competition, profit margins started to decline after 1999. Similarly, the next effect of EMU – higher transparency of price differences between the euro-area countries (especially since 2002 onwards, i.e. after putting euro notes and coins into circulation – made it more difficult for multinational enterprises to segment national markets geographically and maintain profit margins. Therefore, product market integration – by changing competitive conditions – has lead to increasing allocative efficiency. Moreover, as the Commission argues, it is expected that increased competition and a possible subsequent decline in profit margins may force firms to make some greater efforts to reduce production costs or implement strategies to regain market power – by e.g. increasing product differentiation. But product differentiation requires **investment in research and development** and advertising [Commission 2004j]. In this context, it should be noted that spending on R&D represents presently about 2% of GDP on average in the euro area (similarly like in the EU as a whole). And taking into account that its increase in recent years has been small, it seems to be unlikely – at the current pace – that the Barcelona target of 3% of GDP[36] will be reached in the coming years [Regling 2004b].

Increased competition and investment in R&D are also required to **stimulate productivity growth**. Not only the theoretical literature on competition and growth indicates that increased competition may enhance incentives for enterprises to innovate or increase their efficiency in

[36] In March 2002 the European Council in Barcelona stated: *"In order to close the gap between the EU and its major competitors, there must be a significant boost of the overall R&D and innovation effort in the Union, with a particular emphasis on frontier technologies. The European Council therefore agrees that overall spending on R&D and innovation in the Union should be increased with the aim of approaching 3% of GDP by 2010. Two-thirds of this new investment should come from the private sector"* [European Council 2002a].

research. Some researchers find that those product market reforms in the EU, which were associated with the Single Market Programme (SMP), lead to an increase in product market competition in affected countries and industries. And, in turn, increased competition led to increased R&D investment in manufacturing industries. Finally, increased R&D investment led to faster total factor productivity growth in manufacturing industries [Griffith, Harrison, Simpson 2006].

Although the introduction of the euro has caused many positive effects for European product markets (leading to changes in competitive conditions and raising overall competition in goods and services markets), there are still some **factors restricting to some extent market mechanisms (including free competition)**. Barriers existing within the Internal Market hit services harder than goods, as providing services is usually more complex regulated in comparison with providing goods. In July 2002, the Commission identified in its report **several barriers to the Internal Market for services**, i.e. numerous difficulties perceived as obstacles by the providers and users of services. There were both legal barriers (i.e. difficulties relating to: the establishment of service providers, using inputs necessary for providing service, promotion, distribution and selling of services, after-sale phase) as well as non-legal ones (e.g. the lack of information, cultural/language barriers) [Commission 2002d]. This is extremely important for the EU economy taking into account that in modern economies **services generate about 70% of GDP and employment** and thereby offer considerable potential for growth and job creation. For that reason, in March 2004 the Commission proposed the **draft directive on services in the Internal Market** – the so-called Services Directive [Commission 2004d]. The objective of the Services Directive is **opening up services markets across Europe** by eliminating two main obstacles related to (i) the freedom of establishment for service providers and to (ii) the free movement of services between the Member States. It should ensure the legal certainty for both providers and recipients of services, which they need to exercise these two fundamental freedoms stipulated in the Treaty. In February 2006, after two years of work, the draft Services Directive (revised to some extent), was adopted by the European Parliament and in June 2006 the European Council welcomed the agreement reached in the Council on the Services Directive and called for a swift conclusion of the legislative process [European Council 2006b]. Although the legislative process has not been completed yet, the decisions made so far on opening up the EU market in services – thanks to the Services Directive – are assessed as a big step forward which may bring some significant benefits to consumers and producers (equal to about 30 billion EUR), as well as to the EU economy – by boosting economic growth (by 0.6% of GDP), creating more new jobs (up to 600 000 in the medium term), and ensuring a better position to compete with some booming services markets, notably in China and India [European Parliament 2006; EPC 2005b; 2006]. Indeed, it should be regarded as a real turning point for the EU (and for the euro area as well) because only fully open and competitive product market (in both goods and services) is able to exploit the full potential the Single Market supported by the single currency.

Another serious problem is related to so-called **overregulation of product markets** in the EU (and especially in some Member States of the euro area). In principle, the adoption of regulations is aimed at improving the functioning of markets. But a number and scope of regulations must be properly balanced. Otherwise, if there are too much regulations in place, and they are too extensive, it may be (and usually it is indeed) harmful for market mechanisms and burdensome for market participants; in consequence, it may affect

negatively competitive conditions, resource allocation or productive efficiency. There are a lot of types of regulations: they can be inward-oriented or outward-oriented, economy-wide or industry-specific, economic or administrative, etc. (see: box 3.2). Regulations may cause, for example, state control over business firms, raise barriers to entrepreneurial activity or raise barriers to international trade and investment. The latter seems to be less relevant for the euro area (because of the above-mentioned positive effects of EMU on trade and FDI), but the others remain a serious problem for the EU (and particularly for some EMU members). For that reason, taking into account the problem of overregulation in Europe, the need to reform product markets is apparent in some of the Member States.

Box 3.2.
Types of product market regulations

According to some OECD publications, product market regulations can be classified into various regulatory domains on the basis of some specific criteria:

Orientation. Regulations can be **inward-oriented or outward-oriented**, depending on whether they are directed at domestic or foreign operators. Inward-oriented policies are subdivided according to two different criteria – so-called "thematic" and "functional" ones (see: below).

Scope. Regulations can be **economy-wide** or **industry-specific**. Economy-wide regulations are defined as regulations that affect all or most sectors of the economy equally (such as administrative burdens), while industry-specific regulations concern only particular activities or markets (such as price controls or limitations on the number of competitors in a given sector/industry).

Type of restriction. Regulations can be divided into some "thematic" domains indicating the main channels through which regulation may restrict market mechanisms:

- **state control over business enterprises**: this domain is related to, *inter alia*, the overall size of the public enterprise sector; the existence and extent of special rights over business enterprises; legislative control over public enterprises; the existence of price controls in competitive industries; and the use of command and control regulations (both economy-wide or industry-specific ones);
- **barriers to entrepreneurship**: this domain is related to, *inter alia*, the features of the licensing and permit system; the communication and simplification of the rules and procedures; administrative burdens on start-ups of firms; the scope of legal barriers to entry; and the existence of antitrust exemptions for public enterprises or government-mandated behaviour;
- **barriers to international trade and investment**: this domain is related to, *inter alia*, barriers to share-ownership for non-resident operators (both economy-wide and industry-specific ones); discriminatory procedures in international trade and competition policies; regulatory barriers to trade; and tariffs.

Function. Regulations can be **economic** or **administrative**. Administrative regulation includes reporting, information and application procedures and burdens on start-ups, implied by both economy-wide and industry-specific requirements. Economic regulation includes all other provisions (such as state control, legal barriers to competition and barriers to trade and investment).

Source: Boylaud, Nicoletti, Scarpetta 2000.

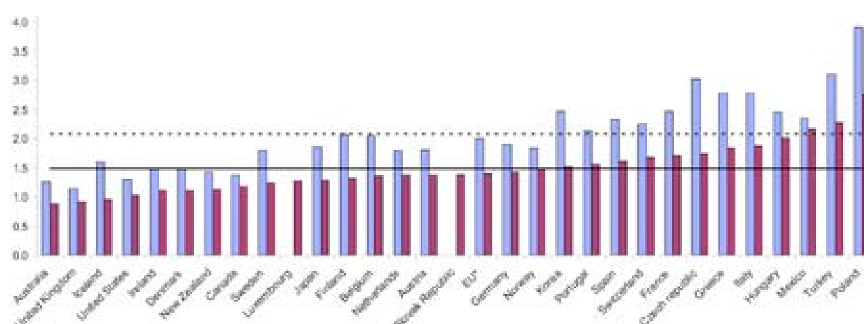
According to the OECD, in the past two decades (i.e. the 1980s and the 1990s), as well as in recent years, an increasing number of countries has reformed their regulatory environments in product markets. In many of them, this reform process was partly driven by comparisons with policies implemented and results obtained by some other countries. Such comparative studies were conducted and published both before and after the introduction of the euro – as of 1998 [Boylaud, Nicoletti, Scarpetta 2000] and 2003 [Conway, Janod, Nicoletti 2005]. Such international comparisons are not favourable for the EU Member States (especially for some members of the euro area). Analyzing all OECD countries, it is clear that the regulatory environment is the friendliest to competition in relatively liberal countries, such as Australia, the United Kingdom, Iceland and the United States. By contrast, **the most restrictive regulatory environment has been found in some Member States of the euro area (Italy, Greece, France and Spain)**, as well as in some new members of the EU (Poland, Czech

Republic, Hungary) and some of the EU candidate countries (Turkey); the only non-European country among the most restrictive ones is Mexico (see: figure 3.3.a).

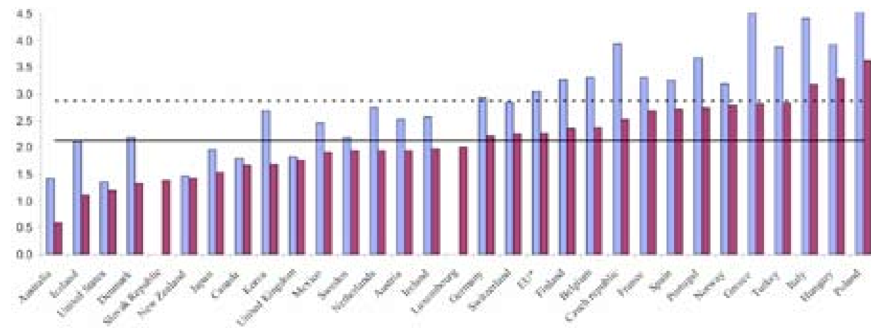
But it should be noted that those countries that were estimated to have had relatively restrictive product market regulations before EMU (in 1998), have recorded – in most cases – a relatively large improvement in overall product market regulation; **for most of those countries reforms of product market regulations since 1998 has led to substantial improvements** in all three of the broad policy domains, i.e. state control, barriers to entrepreneurial activity and barriers to trade and investment (see: figure 3.3.b-d). For the euro-area countries the most relevant are the first two issues. In general, countries differ much more in the degree of state control than in the extent of barriers to entrepreneurship. In particular, state control – which was generally relatively pervasive in 1998 – has been reduced substantially. In any case, this reflects the removal of price controls and reductions in the extent of direct government control over firms (the latter except for France and Spain). With regard to progress in reducing barriers to entrepreneurship, it is worth to mention that Italy, France and Spain – which were estimated as having some of the most restrictive barriers to entrepreneurship in 1998 – have made substantial progress after the introduction of the euro. It was driven predominantly by substantial reductions in administrative burdens on start-ups of firms [Conway, Janod, Nicoletti 2005]. Of course, the above achievements are very important as they are steps in the right direction, but some **further progress is still needed** – not only in the above most restrictive countries, but also in those that have been classified as the “middle of the road” countries, such as e.g. Germany which have made significant progress in reduction of barriers to entrepreneurship as a result of lower administrative burdens, but the main problem is still overregulation related to product licensing and approvals as well as the length of procedures to product admissions [Langhammer 2004].

Figure 3.3.
Indicators of product market regulation (1998 vs. 2003)

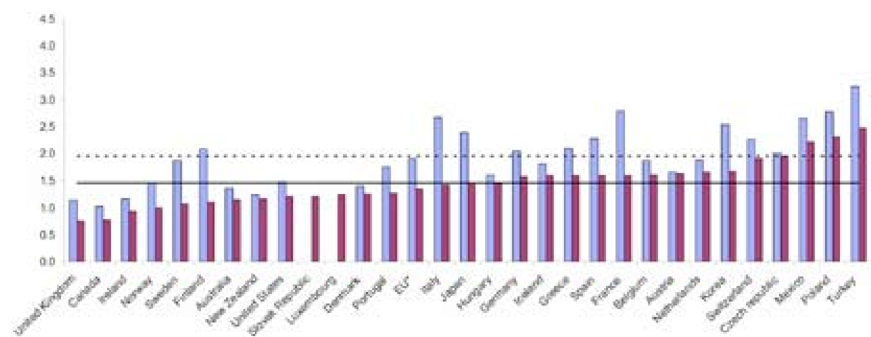
a) overall product market regulation



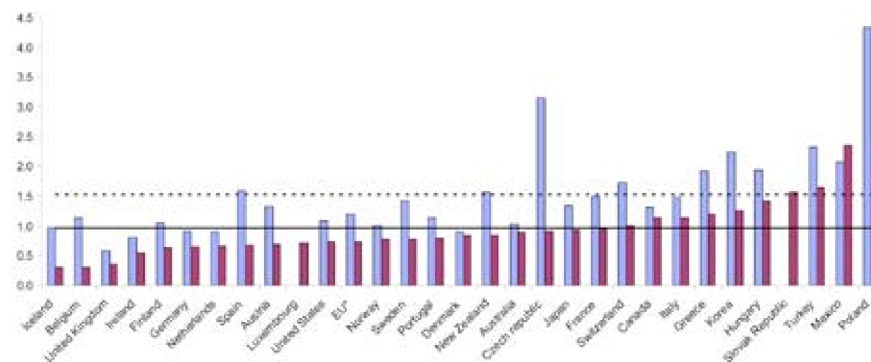
b) state control



c) barriers to entrepreneurship



d) barriers to trade and investment



Legend: 1998 2003 - - - - 1998 average —— 2003 average (sorted by 2003 values)
The scale of indicators is 0-6 - from the least to the most restrictive of competition
EU = EU-15 (simple average)

Source: Conway, Janod, Nicoletti 2005.

The above situation has not changed significantly to date. European product markets are still overregulated. For that reason, just after the launch of EMU – as well as in the subsequent years – it was suggested that countries with tight economic regulations and burdensome administrative procedures on business enterprises should carry out reforms which would cause **a simplification of administrative procedures and a reduction in administrative burdens**, and in consequence enhancing their positive effects on product market competition [Boylaud, Nicoletti, Scarpetta 2000; Conway, Janod, Nicoletti 2005]. It is worth to mention that there are opinions that a less burdensome administrative environment may make it

easier to reform economic regulations that must be endorsed and implemented by national and/or local administrations. In this case, the administrative simplification may constitute a pre-condition for reforms in some other areas [OECD 2003a]. Moreover, it could have **a positive impact on economic growth**. According to some recent studies, a reduction of 25% in administrative burdens in the EU would lead to a real GDP level increase of 1% and 1.4% in the short and long term respectively [Tang, Verveij 2004; Commission 2005h].

In this context, it is worth to mention that in October 2005 the European Commission proposed the **new simplification initiative** – taking into account that **better regulation** not only make day-to-day life easier for enterprises and citizens, but it is also crucial to generate more growth and employment in Europe. The objective of this initiative is **promoting better regulation and cutting unnecessary overregulation and "red tape" on all levels**. The Commission has proposed to scrap, modify or codify more than 1400 legal acts across all policy areas over three years. It is intended to tackle the most heavily regulated sectors (such as waste, cars or constructions) and address the main day-to-day problems of small business (such as cumbersome statistical form-filling or customs procedures). As further areas for simplification are identified, the programme will be expanded. The Commission argues that better regulation (including simplification of legislation) is essential for improving competitiveness and conditions for more growth and jobs, as it will reduce excessive administrative burdens for companies and hence their costs, making them more competitive, providing with incentives to create new jobs, removing obstacles to adaptability and innovation, etc. But it must be underlined that this simplification initiative can only tackle overregulation at the European level and it is regarded as a catalyst to start a chain reaction in the Member States which have to undertake and carry out **the lion's share of the simplification process at the national level**. Otherwise, the Commission's efforts will fail [Verheugen 2005; Commission 2005u; Commission 2006a-c].

In its recent Annual Progress Report on Growth and Jobs (of January 2006), the Commission identified some stages of progress in achieving better/simplified regulation, starting developing better regulation awareness, strategy and tools, and ending in monitoring progress, evaluating results, exchanging best practices with the other Member States, launching new initiatives, etc. [Commission 2006a-c]. In order to drive this simplification process forward, the Commission established in February 2006 a new high-level group of national regulatory experts who would advise the Commission on its general strategy to simplify and improve European legislation as well as facilitate the development of better regulation measures at both the EU and national levels (in other words: to cut "red tape" on all levels) [Commission 2006i]. Finally, the Spring European Council (March 2006) emphasized the importance of creating a more favourable business environment (including a regulatory environment that is simple, transparent and easy to apply) – especially for small and medium-sized enterprises (SMEs), being the backbone of the European economy and playing a crucial role in creating both growth and jobs in Europe [European Council 2006a]. And the recent European Council (in June 2006) – noting that some Member States have already set their national **targets for reducing administrative burdens by 25%** – was convinced that it should be possible to set similar targets at the European level and invited the Commission to make appropriate proposals by early 2007 in time for the Spring European Council [European Council 2006b].

European product markets suffer not only from overregulation and excessive administrative burdens for business, but also from **relatively high taxes** across the EU (except for the United Kingdom and Ireland). In comparison with main economic competitors of the EU, i.e. the United States and Japan, it is obvious that tax rates in Europe are still quite high. It should be noted that **lower taxes and tax system reforms could play an important role in fostering medium-term economic growth** (it is important in the context of the ambitious goal of the renewed Lisbon Strategy, i.e. achieving growth rates around 3% per year). It is argued that tax reforms – aimed at reducing tax burdens on production factors and changing the composition of taxes – would help achieve this goal. A reduction in tax burdens normally results into improved incentives and then into higher potential output. In particular, investors and entrepreneurs benefit from lower taxes which enhance the dynamism of the economy. Moreover, lower taxes can also increase the pool of savings available for investment. Therefore, higher expected business profits would lead to increased investment in physical capital or R&D, and then – via an endogenous growth mechanism – to higher potential growth [Commission 2005r]. It should also be noted that lower taxes may bring positive effects not only to product markets, but also to labour markets – as it usually leads to a higher quantity and quality of labour and capital, which increase the potential growth rate of the economy. In these ways, lowering taxes can contribute to solving two of the most pressing economic problems facing both the EU and the euro area: relatively low potential economic growth and high unemployment [Duisenberg 2001]. In this context, it is worth to mention that the two large economies of the euro area, i.e. Germany and Italy, have implemented their tax reforms in recent years (in 2001 and 2004 respectively).

Summing up the above considerations on various aspects of product and services markets in the context of EMU, it should be noted that the competitive and well functioning Internal Market is particularly important for the euro area as a whole – taking into account that it could enhance its capacity to adjust smoothly to asymmetric shocks [Commission 2006a-c]. It is especially important in the case of the Single Market complemented by the single currency – with no other adjustment instruments, such as independent monetary or exchange rate policies.

3.2. Labour market reforms and performance

The potential impact of EMU on labour markets was widely discussed long before the introduction of the euro. Prior to the launch of the single currency, it was broadly expected that [Commission 2004j; De Grauwe 1992; 2000; 2005]:

- the smooth functioning of EMU would require sufficiently flexible labour markets (i.e. much more flexible than in the pre-EMU period) because only such markets would allow for adjusting to economic (notably asymmetric) shocks;
- assuming that the euro area might require a higher degree of labour market flexibility, EMU would encourage and accelerate structural reforms of labour markets in order to increase their flexibility and efficiency;
- increased flexibility and efficiency of labour markets would cause their better performance, and this would contribute to the proper functioning of EMU because with lower levels of unemployment it would be easier for governments and central banks to conduct fiscal and monetary policy respectively;

- EMU might lead to some convergence in labour market policies and institutions among the Member States in order to limit the scope for asymmetric transmission of symmetric shocks.

Of course, there were very different views and opinions among economists – both before and after the introduction of the euro – related to the potential impact of EMU on structural reforms in labour markets. Some observers were more optimistic and agreed with the above theses, while other experts were more sceptical about whether EMU would lead to acceleration in the pace of labour market reforms.

In order to assess whether the above expectations and assumptions (or, at least, some of them) have actually been materialized, it would be useful to analyze the following issues: the overall labour market performance in the EU, intensity of labour market reforms in EMU, present labour market flexibility in the euro area, etc.

3.2.1. Labour market performance in the EU

During the 1960s and 1970s unemployment was not regarded as a problem for the European economy (the average unemployment rate stood at 2.2% and 4.0% respectively). In the 1980s it grew markedly (8.0%) and in the mid-1990s it reached the level of 10-11% in the EU. That unacceptable level of unemployment caused that the issue of employment, or rather combating unemployment, became one the most important problem of the EU economy. In response to that challenge, the EU leaders decided to arrange the extraordinary meeting of the European Council in Luxembourg (in November 1997), which was entirely focused on the issue of employment [European Council 1997]. It was a starting point of the so-called Luxemburg process (known also as the European Employment Strategy) aimed at coordination of employment policies and labour market reforms.

The years just before and after the introduction of the euro (until the recent global slowdown) were a period of very favourable macroeconomic conditions and it was reflected in labour market performance reaping the benefits of earlier labour market reforms in the EU. Employment growth rose to 1.8% in 1998-2001 in the euro area and thereby reduced the rate of unemployment from 10.8% in 1997 to 7.9% in 2001 (i.e. close to the average level of the 1980s). Obviously, significant part of the improvement was of a temporary (cyclical) nature, but – and it was more optimistic – some small reduction in structural unemployment was observed as well (reflected in the decline of long-term unemployment and youth unemployment). Therefore, the above decline in unemployment appeared to be more than just a cyclical phenomenon. Keeping in mind the overall upswing in the global (and European) economy, the EU leaders adopted in March 2000 the Lisbon Strategy, setting – as part of that strategy – specific **employment targets**[37] for 2010 [European Council 2000a]. A year later in Stockholm (in March 2001), those final targets were supplemented by some intermediate targets [European Council 2001a]. All in all, the agreed targets were the following:

[37] The main employment target is related to **the overall employment rate**, defined as employed persons aged 15-64 as a share of the total population of the same age group. The additional employment targets are related to **the female employment rate**, calculated by dividing the number of women aged 15-64 in employment by the total female population of the same age group, as well as to **the employment rate of older workers**, measured by the number of employed persons aged 55-64 as a share of the total population of the same age group. As of the beginning of 2006, among the 25 Member States of the EU, 18 countries have set national targets regarding the overall employment rate, 15 countries – for the female employment rate, and 11 countries – for the employment rate of older workers [Commission 2006a-c].

- **the overall employment rate** of as close as possible to **70% by 2010** (and 67% by 2005);
- **the female employment rate** of more than **60% by 2010** and 57% by 2005;
- **the employment rate for older workers** of **50% by 2010** (with no intermediate target).

The above targets seem to be really ambitious. But in spring 2000, keeping in mind favourable macroeconomic conditions (not only strong GDP growth, but also high employment growth), as well as other significant successes of the EU (the smooth launch of the euro in the preceding year), the prospects for the EU economy seemed to be really optimistic and the overall target of 70% and other targets were regarded as being not very difficult to be reached.

In the subsequent years, however, **the fulfilment of the Lisbon and Stockholm employment targets appeared (much) more challenging**. It was connected with the global economic slowdown (2001-2003), the negative impact of which on employment was observed in 2002 and 2003, when the average rate of employment growth in the euro area dropped to 0.7% and 0.3% respectively. As a result, the average euro-area rate of unemployment started to increase steadily – from 7.9% in 2001 to 8.9% in 2004. According to the latest Commission's economic forecasts (of May 2006), it is expected that employment growth in the euro area will be stronger in the coming years (0.8-0.9% over the forecast period) and the rate of unemployment will start to decline gradually – from 8.6% in 2005 to 8.2% in 2007 (see: table 3.1). Similarly, labour productivity trends are expected to improve slightly in the euro area. After a relatively strong decline in labour productivity growth last year, it is projected to improve and reach 1.2% in 2006 (up from 0.7% in 2005). However, this level of productivity of the euro area is still much lower in comparison with the analogous levels of the United States and Japan (standing at about 1.8-2.1% at the present moment and in the coming years) [Commission 2004o; 2005x; 2006m].[38]

Table 3.1.
Selected labour market indicators for the euro area (in comparison with the EU, the US and Japan)

	1961-1970	1971-1980	1981-1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005[e]	2006[f]	2007[f]
Unemployment (as a percentage of civilian labour force)																				
EU-12	2.3	4.2	8.5	7.8	8.2	10.1	10.7	10.5	10.7	10.6	10.1	9.2	8.2	7.9	8.3	8.7	8.9	8.6	8.4	8.2
EU-25	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	10.4	10.4	10.1	9.4	9.1	8.6	8.4	8.8	9.0	9.1	8.7	8.5	8.2
US	4.8	6.4	7.1	6.7	7.4	6.8	6.1	5.6	5.4	4.9	4.5	4.2	4.0	4.8	5.8	6.0	5.5	5.1	4.8	5.1
Japan	1.3	1.8	2.5	2.1	2.2	2.5	2.9	3.1	3.4	3.4	4.1	4.7	4.7	5.0	5.4	5.3	4.7	4.4	4.3	4.3
Employment (annual percentage changes)																				
EU-12	0.3	0.3	0.7	1.3	-0.9	-1.6	-0.3	0.7	0.5	0.9	1.9	2.0	2.4	1.5	0.7	0.3	0.6	0.7	0.9	0.8
EU-25	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	0.6	1.0	1.5	1.1	1.7	1.0	0.4	0.3	0.6	0.8	0.9	0.8
US	2.0	2.1	1.7	-1.0	0.1	1.8	2.3	1.9	1.7	2.2	2.4	2.2	2.2	0.0	-0.3	0.9	1.1	1.8	1.4	0.6
Japan	1.4	0.8	0.9	2.0	1.1	0.4	0.1	0.1	0.4	1.0	-0.7	-0.8	-0.1	-0.6	-1.4	-0.3	0.2	0.4	0.4	0.3
Labour productivity (real GDP per occupied person; annual percentage changes)																				
EU-12	3.2			1.8					1.2					0.4	0.3	0.4	1.5	0.7	1.2	1.0
EU-25	n.a.			n.a.					1.7					0.9	0.8	0.9	1.8	0.8	1.4	1.3
US	1.6			1.4					2.0					0.7	1.9	1.8	3.1	1.7	1.8	2.1
Japan	5.1			0.7					1.0					1.0	1.5	2.1	2.1	2.3	2.4	2.0

[e] estimates; [f] forecasts (spring 2006).

Source: own elaboration based on: Commission 2006m.

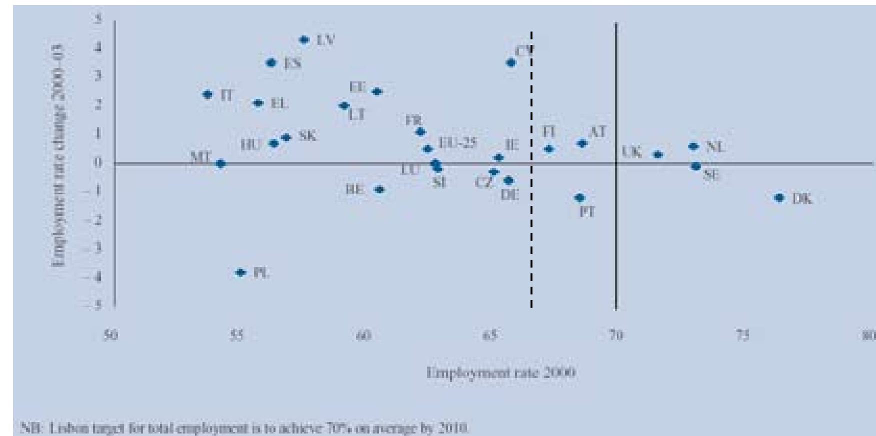
[38] The above figures confirm some longer-term trends in the euro area and the United States. During the period 1996-2005, labour productivity growth (per hour worked) was 1.3% in the euro area – compared to 2.3% in the US. In this context, it is worth to mention that the euro area experienced a slowdown in labour productivity growth (per hour worked) around 2000, with productivity growth declining from 2.0% in 1996-2000 to 0.8% in 2000-2005 (compared with rates of 2.0% and 2.6%, respectively, in the US) [Trichet 2006c].

With reference to the Lisbon and Stockholm employment targets, the present achievements are not satisfactory or even disappointing. According to the Eurostat, in the period of 1999-2004, **the overall employment rate** for the EU rose, on average, by 1.4 percentage points, from 61.9% in 1999 to **63.3%** in 2004 (therefore, it was clear that the intermediate target of 67% would not be achieved by the end of 2005). As far as **the female employment rate** is concerned, in the above period it increased, on average, by 2.8 percentage points – from 52.9% to **55.7%** in 2004 (similarly, the intermediate 2005 target of 57% has been missed). Finally, **the employment rate of older workers** (aged 55-64) – that has been increased by 4.8 percentage points since 1999 – amounted to **41.0%** in 2004 (compared to 36.2% in 1999). Comparing the actual figures to the Lisbon and Stockholm targets, it is apparent that the best results have been achieved in the case of the female employment rate, and the worst – regarding the older workers employment rate (although there was the biggest progress in the case of the latter). It should be noted that the rise in the overall employment rate was (again) driven by women (0.7 percentage point) and older people (0.8 percentage point) [Commission 2006a-c]. It is worth to mention that **the analogous figures for the euro area are apparently lower, i.e. 63.0%, 54.5% and 38.6% for the overall / female / older workers employment rates respectively** (compared to 60.4%, 50.1% and 33.9% in 1999). All in all, only few Member States have already met the Lisbon employment targets, of which mainly the three outside the euro area – the United Kingdom, Denmark and Sweden (see: figure 3.4).

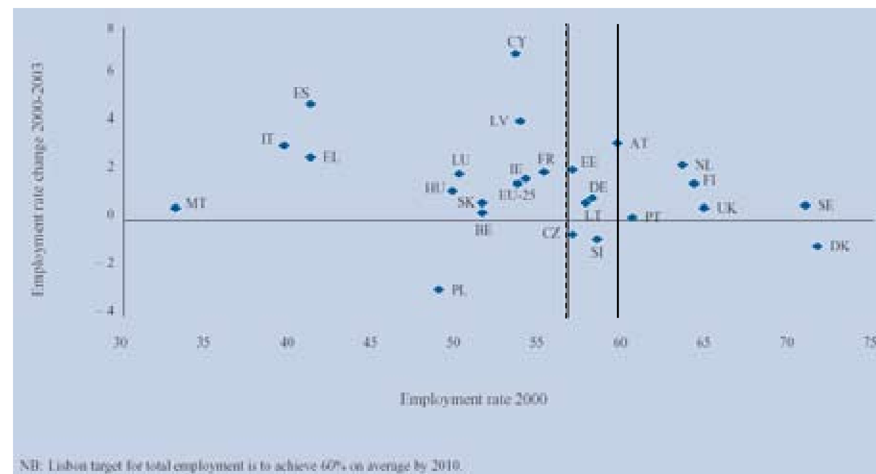
As we can see, roughly **halfway through the period of the Lisbon Strategy, the EU is failing to reach the employment targets**. Moreover, **all the above employment targets (and especially the last one) remain still far from the final targets to be achieved by 2010** (i.e. 70%, 60% and 50% respectively). As it is assessed by the European Commission, with five years to go until the end of 2010, the required annual rate of employment growth (to reach the 70% target) would be 1.5%, i.e. well above the long-term average of about 0.5% since 1970. Furthermore, breaking the labour force down by age and gender, it is clear that the lion's share of the increase would have to come from younger people (who at the same time are encouraged to stay longer in education), women (who have already made a substantial contribution) and older workers (who are still encouraged to retire early in some countries). Overall, after five years of the Lisbon Strategy, the employment targets are not only regarded as considerably more challenging than at its start, but simply as unattainable by the assumed time horizon. Therefore, although it is very likely that the 2010 employment targets will be missed, **the pace of labour market reforms must be accelerated in order to ensure that the Lisbon targets would not to be missed by a large margin** [Commission 2005a].

Figure 3.4.
Progress towards the Lisbon and Stockholm employment targets

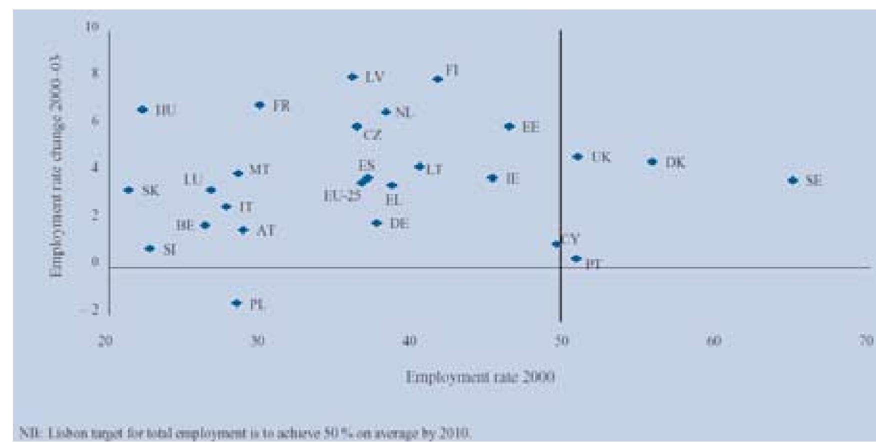
a) total employment rate



b) female employment rate



c) older workers employment rate



Source: Commission 2005a.

Although the recent downturn had a clear negative impact on the overall employment performance in the EU (and in the euro area), the failure to meet the intermediate Lisbon employment targets in 2005, as well as disappointing progress towards the final Lisbon targets of 2010, cannot be fully explained by cyclical factors only. Many Member States still display the symptoms of **severe and chronic structural problems** in their labour markets. In this context, one of the most important problems in the EU (and in the euro area as well) is relatively **low labour-force participation** in certain groups, especially **women** and **older working-age people**. The structural nature of this problem is also reflected by relatively high **long-term unemployment** (more than 1 year) and **youth unemployment** (people under 25 years). For example, it is worth to mention that the rate of the latter still exceeds 20% in half of the euro-area countries, even though some efforts to improve employability have been focused on this group.[39] Finally, high unemployment – with rates approaching or exceeding 9% in all of the large euro-area countries as well as in some smaller ones – remains a serious concern too [Commission 2004j]. Fortunately, labour market conditions in the EU (and in the euro area) are expected to improve (resulting in about 6 million new jobs in 2005-2007 stemming from the projected rise in economic growth – see: section 1.2). As a result, as mentioned before, it is expected that the unemployment rate will decline from 8.6% in 2005 to 8.2% in 2007 [Commission 2006a-c; 2006m].

It is also worth to consider one more important issue, i.e. **labour productivity growth** in the EU (and in the euro area as well). In general – as it is argued by the Commission in its recent Annual Progress Report on Growth and Jobs (of January 2006) – since the mid-1990s, there has been observed in the EU a relative decline in productivity growth in comparison with the United States.[40] Average labour productivity growth in the EU (in terms of GDP per person employed) was 1.9% in 2004; it was an improvement in relation to the previous three years, but not a major improvement with respect to its overall sluggish performance since the mid-1990s. The above figure still compares unfavourably with Japan (2.5%) and the United States (3.3%). The disparity is less explicit looking at productivity growth in terms of GDP per hour worked (e.g. in 2004, European growth amounted to 2.5%, similarly like in Japan, but the gap in relation to the United States still remained quite significant). In the case of the euro area, hourly productivity rose 1.2% annually between 1999 and 2003 and displayed a declining trend. According to the Commission, the deteriorating labour productivity performance of the EU is the result of such factors as, for example, too slow technological progress, too low investment per employee, etc. However, **European labour productivity growth has started to accelerate in recent years**. It can be attributed to the present upswing in the business cycle, but also to some other (more structural) factors, such as e.g. the delayed impact of investments in ICT, outsourcing, etc. In general, it is expected that an increase in productivity, combined with wage moderation, should help the EU maintain its

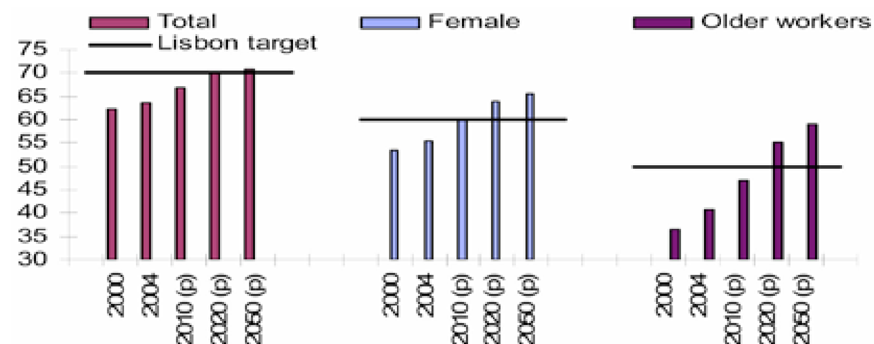
[39] Last year, the Spring European Council (March 2005) adopted the European Youth Pact as one of the instruments to attain the Lisbon goals related to growth and jobs. The Youth Pact is aimed at improving education, training, mobility, employment and social inclusion of young people, as well as enabling them, and in particular young women, to combine working and family life. This year, the Spring European Council (March 2006) stated that further progress is needed as regards the implementation of the European Pact for Youth and encouraged the Member States to reinforce links between policies on education, training, employment, social inclusion and mobility.

[40] It is argued that the rapid growth of production in the sector of information and communication technology (ICT), as well as the widespread use of such technologies by the other sectors, have caused its growing importance during the course of the 1990s and resulted in the fact that ICT had become a major driving force of productivity developments since the late 1990s. In the euro area ICT has contributed positively to productivity since the mid-1990s, but this contribution has been much lower in comparison with the United States where growth in labour productivity accelerated throughout the 1990s (in contrast, in Europe, after more than a decade of relative stability, trend in labour productivity growth started to decelerate in the first half of the 1990s and some time later, for the first time in decades, productivity growth in the euro area became lower than in the USA). According to the Commission, the observed deceleration of productivity growth in the euro area is particularly due to a slower diffusion of ICT and difficulties in exploiting its full benefits, as well as reflects, *inter alia*, the combination of a downward trend in non-ICT investment rates and a slowdown of technical progress [Commission 2003h].

competitive position in the global economy. Taking the above arguments into account, the Commission indicated in its Annual Progress Report that there is **the need to boost labour productivity (through an attractive business environment, R&D and innovation) as well as increase employment and participation rates**; and at the same time it noted with some satisfaction that this is reflected in the comprehensive and mostly forward looking National Reform Programmes of the Member States belonging to the euro area [Commission 2006a-c].

Finally, it seems to be interesting to consider the achievement of the Lisbon employment targets over the longer time horizon – in the context of the ageing of populations – because the projected demographic changes are expected to have a major impact on labour market developments. In this context, it should be underlined that **attaining the Lisbon employment targets, even if not on time, will temporarily cushion the economic effects of the ageing of populations**.[41] According to the latest labour force projections of the EPC and the Commission (of January 2006), the overall employment rate is expected to rise to 67% in 2010 and to reach the 70% Lisbon target in 2020 (see: figure 3.5). The projected increase is to be mainly due to higher female employment rates, which are projected to reach the 60% Lisbon target in 2010 and then rise gradually to almost 65% by 2025 (as older women with low employment rates retire and are successively replaced by younger women). But the strongest projected increase is expected in the case of the employment rate of older workers – by almost 20 percentage points over the next 20 years (i.e. from about 40% today to 59% in 2025). This is well above the 50% Lisbon target, which is to be reached by 2013. About half of this significant increase is owing to some positive effects of already implemented pension reforms, which is perceived as a good illustration of the potential benefits of structural reform [Commission 2005z; EPC / Commission 2006]. It should be noted that the above projections are related to the EU as a whole (EU-25) and, of course, there are very uneven developments across the Member States. For example, **while the old members (EU-15) are projected to meet the overall Lisbon target by 2015, the euro area would only do so by 2035, and the new Member States (EU-10) – which in some time will join the euro area – are not expected to reach the 70% target by 2050.** The situation is even more heterogeneous when one looks at the individual Member States [Deroose 2006].

Figure 3.5.
Projected employment rates and Lisbon targets in the EU



(p) means projected figures; actual figures are given for 2000 and 2004.

Source: Commission 2005z; EPC / Commission 2006.

[41] The total number of persons employed is projected to increase up to 2017, but after 2017, the demographic effect of ageing is to outweigh this effect. The ageing effect will dominate from 2018 onwards, and both the size of the working-age population and the number of persons employed will be on a steady downward trajectory [Commission 2005z; EPC / Commission 2006; Deroose 2006].

3.2.2. Intensity of labour market reforms in EMU

The above considerations, notably the mentioned above severe and chronic structural problems in European labour markets, confirm **the urgent need to undertake some serious structural reforms of labour markets in the EU (that seems to be even more urgent in the euro area)**. But this is not a new situation. This is a similar situation to that of the mid-1990s when the overall rate of unemployment was really high and, what seemed to be even more important, structural unemployment also remained relatively high and almost unchanged.

In this context it would be interesting to analyze the intensity of labour market reforms in the EU before and after the introduction of the euro. And, on this basis, it would be possible to assess what was the impact of the launch of EMU on structural reforms. There are some empirical research studies on this issue in recent years, but their conclusions are diverging and sometimes even contradictory. The opposing results between various authors may be explained by the application of different analytical methods and the scope of analyses (i.e. coverage of reforms).

On the one hand, there are some analyses suggesting that **labour market reforms have accelerated in the euro area during the 1990s and they have become relatively more frequent in EMU countries** (in comparison with the non-euro-area Member States),[42] and many of the euro-area countries have reduced welfare system generosity and deregulated labour markets [Bertola, Boeri 2001]. According to the authors, in order to exploit fully the advantages of economic and monetary integration, the institutional structure of labour market (and other markets as well) needs to be revised extensively in the euro area. It is crucial to prevent the euro-area economies from retaining unsuitable institutions in this new (much more competitive) environment in labour and product markets (created by EMU). Moreover, further labour market reforms may be needed in the future to maintain and reinforce the momentum of European economic integration.

On the other hand, there are some research papers concluding that **the euro-area countries, on average, have carried out no more reform than countries outside EMU** and there have been no links between progress on reforms and the initial level of unemployment [van Poeck, Borghijs 2001]. According to the authors, despite improving labour market conditions during the early years of EMU, a number of the euro-area countries still suffered from high and persistent unemployment. It could therefore be expected that labour market reforms would be a priority task for them. Moreover, the new constraints associated with the single monetary policy only increased the pressure for reform. But – as confirmed by some empirical analyses – the thesis that countries with higher unemployment rates carry out more labour market reforms is generally true, but not for the Member States belonging to EMU. Therefore, in the authors' opinion, it may be a risky strategy to rely on the introduction of the euro as a trigger for labour market reforms. According to them, the need and incentives to undertake reforms may be related to the overall deterioration of macroeconomic conditions rather than to EMU.

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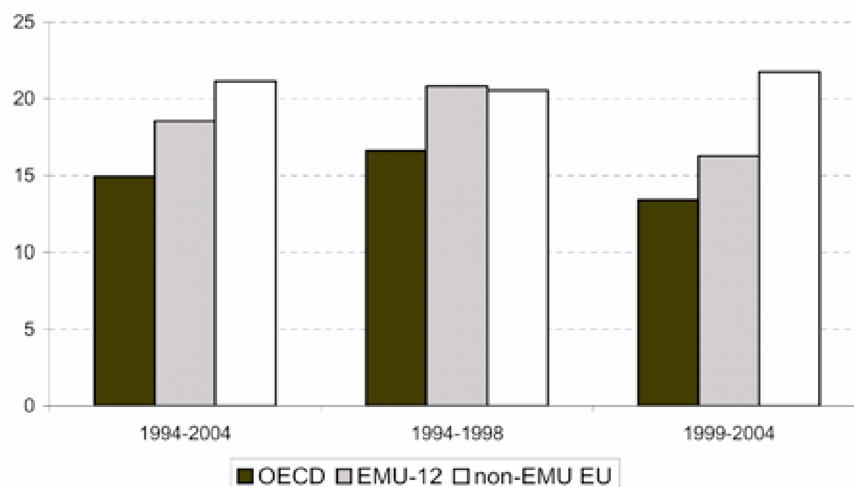
[42] This was a similar situation to that of the past, which had indicated that countries belonging to the DM-area did not experience a stasis in structural reforms, but in many areas actually carried out more reforms than the countries outside the (quasi)-monetary union [Bertola, Boeri, Nicoletti 2001].

Similar conclusions can be drawn from the most recent research too. For example, the OECD carried out last year a thorough assessment of recent labour market reforms [Brandt, Burniaux, Duval 2005], and on the basis of this analysis some other research was elaborated [Duval, Elmeskov 2005; 2006]. The latter concerns labour market reforms, especially their intensity and timing over the 10-year period of 1994-2004 (divided into two sub-periods – both before and after the introduction of the euro: 1994-1998 and 1999-2004).[43] Results of this research indicate that, on average, the propensity to carry out labour market reforms was greater in the EU than in other OECD countries during the above period. Within the EU, the overall reform intensity appeared to be marginally lower in the euro-area Member States in comparison with other countries (Denmark, Sweden, United Kingdom). And within EMU, reforms in small countries were more intensive and more radical than in large ones. According to the authors, **the advent of EMU did not seem to coincide with an acceleration of reforms**. This is confirmed by the fact that in the pre-EMU period (1994-1998) there was observed a quite high average reform intensity in the euro-area countries; and in the subsequent period, i.e. after the launch of EMU in 1999, it was considerably lower (see: figure 3.6). During the second period (1999-2004) there were much less reforms in such countries as Italy, France and Spain (at the same time no such a clear deceleration was observed in the non-EMU Member States and in other OECD countries). This lower intensity of reforms after the launch of EMU is most likely related to the limited political capital of some governments after some painful fiscal adjustments in the run-up to EMU All in all, the authors argue that one can not rule out that the fairly high reform intensity observed in EMU countries before the introduction of the euro was itself fostered by expectations related to EMU [Duval, Elmeskov 2005; 2006].

Figure 3.6.
Intensity and timing of labour market reforms in EU, EMU and OECD countries (1994-2004)



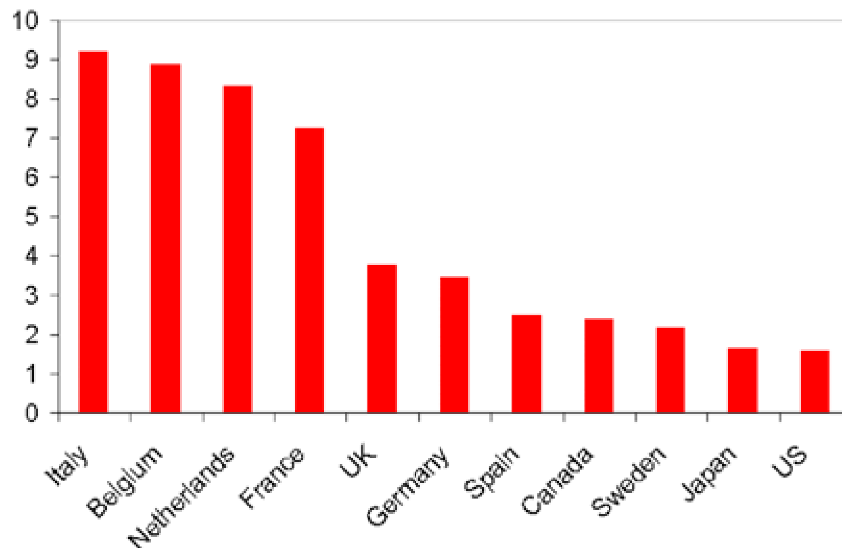
Source: Duval, Elmeskov 2005; 2006; Brandt, Burniaux, Duval 2005.

[43] All policy measures implemented over the period 1994-2004 have been evaluated in relation to the following areas: active labour market policies (ALMP), taxes and social security contributions, employment protection legislation (EPL), unemployment benefit systems, wage formation and industrial relations, working-time flexibility and part-time work, old-age pension systems and early retirement schemes.

The European Commission has drawn similar conclusions. In its opinion, at the present moment (some years after the introduction of the euro) it is clear that the advent of the euro has not led to any noticeable acceleration in the pace of labour market reforms (as many experts had hoped for), and the relatively slow and steady pace of reforms evident before the launch of the euro has continued in EMU as well. But, **although the introduction of the euro has not been a catalyst for structural reforms, the effects of EMU on market integration and reforms are likely to become more apparent over time** [Commission 2004j]. It seems to be likely, taking into account slower growth and poorer labour market performance of the euro area in comparison with the whole EU and, therefore, the greater need to undertake structural reforms in this regard. They are also necessary to make a positive long-term contribution to the sustainability of public finances, the quality of which is of utmost importance in EMU.

Although the overall picture regarding structural reforms in EMU is rather disappointing so far, there are some more optimistic signs related to labour market reforms in EMU. According to the Commission, during the early years of EMU reforms were concentrated mainly in somewhat **easier areas**, such as active labour market policies, cuts in tax burdens on labour, education and training measures, strategies for lifelong learning, etc. – of which, especially decreasing tax burdens on labour seems to be very important, keeping in mind that this kind of taxation is really high in the EU (notably in some of the euro-area countries – see: figure 3.7) and there is a strong relationship between tax on work and a share of older workers out of the labour force, what is important in the context of the projected impact of ageing on public finances and labour markets [Wise 2006]. Of course, these are steps in the right direction, but in order to achieve real progress, it is indispensable to conduct reforms in some **more politically difficult areas**, such as reforms of wage bargaining, benefit systems and employment protection laws. Although actual progress has been very little so far in those areas, in recent years (mainly in 2003 and 2004) there have been some **signs of emerging political will in a number of the euro-area countries** (including the large ones, such as Germany and Italy) **to tackle some of more difficult reforms** [Commission 2004j]. One can state that this is perhaps a turning point because – after the lack of political capital in the early years of EMU (as a result of the adjustment fatigue in the run-up to EMU) – the euro-area governments have just started to gain necessary political capital to undertake and conduct more ambitious labour market reforms than so far. However, some relatively recent events in France, i.e. the mass protests and demonstrations of March 2006, showed that it was not – and it will not be – an easy task (see: further part of this subsection).

Figure 3.7.
Sum of tax rates on work (from early retirement age to 69)



Source: Wise 2006.

3.2.3. Labour market flexibility in the euro area

With reference to the above considerations related to the overall intensity of labour market reforms in EMU, in both easier and more politically difficult areas, it should be noted that especially the latter are necessary to achieve a sufficient degree of **labour market flexibility**,[44] which is required to ensure the smooth functioning of EMU (and, in particular, improve its adjustment capacity in the case of asymmetric shocks). In the context of EMU, labour market flexibility may refer to overall wage flexibility (a degree of decentralization of wage bargaining) as well as geographical or occupational labour mobility.

First of all, as it is known very well, **geographical labour mobility between the euro-area countries is low** (much lower than between the US states). Taking into account such issues as language and cultural differences, and socio-psychological and economic factors,[45] one can expect that in the future it will remain as low as today. It should be added that there is **low labour mobility not only between the Member States of the euro area, but also between various regions within the same country**. According to the OECD, with the exception of some areas where economic integration is relatively substantial, labour mobility in the euro area is really low. Some peripheral regions in the EU, having a high proportion of the least mobile and low skilled workers, exhibit stubbornly high unemployment rates.[46] At

[44] There are many definitions and meanings of the term “labour market flexibility”. In general, this is related mainly to wage flexibility and geographical labour mobility. But at the same, time there are many other types of this flexibility, e.g. occupational mobility, job-search in general, numerical flexibility, functional flexibility and flexible working conditions, entry and exit of firms, etc.

[45] According to the recent survey of the Commission (Eurobarometer), which interviewed about 24,000 of the EU citizens about mobility issues (in September 2005), people often cited the same reasons as being conducive and adverse to moving abroad in order to find a job or live. The key reasons were often the following: (i) learning a new language or (ii) culture – around 30% and 20% respectively of those wanting to move; and 50% and 20% respectively of those perceiving those factors as potential difficulties. Moreover, the main reasons cited not to move abroad were: losing touch with family and friends, losing valuable support such as childcare or care for the elderly people, and being happy where they are already [Commission 2006d].

[46] This situation was confirmed by the European Commission in its recent Annual Progress Report on Growth and Jobs (of January 2006). According to this report, regional employment and unemployment disparities remain

least a partial explanation of the persistence of regional differences in employment and unemployment within the EU is low interregional and (*a fortiori*) cross-country mobility of workers, while wage developments are often not in line with local labour market conditions [OECD 2000; 2004a]. According to the European Commission, reasons for this may include wage equalisation across regions (meaning employees have incentives to remain in relatively unproductive areas), benefit systems (meaning the jobless may not have strong incentives to seek work elsewhere), housing market rigidities and the role of the local family in providing social security. Some of these reasons may suggest that the present degree of mobility is sub-optimal [Commission 2004j].

It is argued by the Commission that mobility between the euro-area countries would help smooth the functioning of EMU, substituting partly for wage adjustments, but it should not be expected to play a decisive role. Moreover, geographical mobility alone may do little to offset sectoral shocks that affect all regions in which the sector in question is present. For that reason, it is expected that **occupational mobility** (i.e. capacity or willingness of workers to change their jobs and shift from one economic activity to another) **will be much more important in the euro area** as a potential adjustment instrument. The growing role of this kind of mobility has been observed in recent years and decades, notably during economic downturns [see e.g. Heckman 2002]. But it must be kept in mind that although occupational mobility seems to be a key type of flexibility in the euro area, it cannot substitute all other kinds of flexibility, e.g. wage flexibility (but it should be mentioned that in the case of sector-specific shocks, wage flexibility can only marginally substitute for occupational mobility, i.e. the need to shift some human resources to the other sectors).

The significance of labour mobility, being always a very important issue for Europe, has been clearly emphasized more recently, as **the year 2006 has been designated the European Year for Workers' Mobility**. In its recent survey about mobility issues (Eurobarometer), the European Commission found that there were much more Europeans seeing the benefits of mobility (46%) in comparison with those seeing it negatively (11%).[47] But at the same time, the Commission confirmed in its survey that Europeans are rather neither geographically nor occupationally mobile. Only around 2% of Europeans in working age live in the EU Member State other than their country of origin (and this is a proportion largely unchanged for the last 30 years). About 33% of the EU citizens have moved for some time from their home countries or regions and they are satisfied with the move, but some 70% of Europeans have no intention to move abroad in the near future. As far as occupationally mobility is concerned, the average job duration is 10.6 years in the EU (while in the United States this is 6.5 years); moreover, around 36% of European employees have been working in their professions for more than 10 years (in the same place) [Commission 2006d].

With reference to overall **wage flexibility** (including a degree of decentralization of wage bargaining), it is also well known that **European labour markets are relatively rigid** in this respect. The lack of this kind of flexibility in the EU (and in the euro area as well) is reflected by the lack of wage differentiation between regions within the same country (despite very different productivity levels). This explains the phenomenon of persistent regional unemployment in some Member States (and thereby significant disparities in unemployment

widespread in the EU, with very high unemployment rates in many regions. Moreover, regions with low levels of employment are usually the ones with lower productivity levels [Commission 2006a-c].

[47] In general, mobility is really important to Europeans; when asked what Europe represents for them, 53% of the EU citizens answered "freedom to travel and work in the EU". This came above "the euro" (44%) and "peace" (36%) [Commission 2006d].

rates between their regions). Some observers were afraid that under EMU this situation might be replicated at the EU level. But it must be stated very clearly that although EMU may yet lead to increased coordination of wage bargaining, it is not expected to lead to wage equalization across the Member States with widely varying productivity [Commission 2004j].

In the context of labour market flexibility, it should be noted that at the beginning of 2006 both the European Commission and the European Council strongly advocated for the so-called concept of **"flexicurity", i.e. an approach balancing market flexibility and social security** [Commission 2006a-c; European Council 2006a]. In their opinion, this concept is a proper response to the needs of both employers and workers in rapidly changing labour markets (similarly like the adaptability of workers and enterprises, which is still neglected by the Member States). The concept of "flexicurity" combines sufficiently flexible work contracts with effective policies being able to ensure adequate social insurance, supporting labour market transitions, lifelong learning, etc. According to the Commission, there are conditions for a good combination of flexibility and security in some countries – both belonging to the euro area (Netherlands) and staying outside (Denmark) [see e.g. Castanheira *et al.* 2006]. But in the other Member States, especially in the large euro-area countries (notably France), the new labour legislation aimed at introducing more flexible work contracts for young people (proposed recently by the French government),[48] caused a lot of controversy and **strong and mass protests of students and trade unions across France** (including strikes, demonstrations, university occupations, etc.), which lasted many weeks **in March 2006** and involved between 1 to 2.5 million people (according to various estimates). Those mass street protest were against the potential loss of some labour rights and privileges existing so far, and being perceived as part of the overall social security system. The above events and civil unrests in France show, on the one hand, how much the Member States are afraid of such structural reforms (of labour and other markets), and on the other, how much they need those necessary (but unpopular) reforms. It is related mainly to the largest and least flexible economies of the euro area.

Finally, in international terms, **labour market flexibility in Europe (including the euro area)**, similarly like in Japan, **is much lower in comparison with the United States**. The relatively inflexible labour markets are, in consequence, more costly. According to American economists, businesses in Europe and Japan face higher costs of displacing workers and reallocating the labour force to more productive uses. On the contrary, in the United States labour displacement and reallocation are more readily countenanced by both law and culture. The lower costs of dismissing workers, entailing less potential costs of hiring, have resulted in a considerable decline in the US unemployment rate in recent years. Moreover, labour market inflexibility is regarded as a reason causing that some economic developments (e.g. new technologies) have not the same impact in Europe or Japan as they did in the United States. American businesses and workers appear to benefit more from these developments than their European or Japanese counterparts, although the latter also participate in inventions and innovations, but they are able to exploit them relatively slowly because of their inflexible labour markets [Greenspan 2000; Issing 2000].

[48] The First Job Contract (*Contract première embauche*) would make it easier for employers to dismiss young workers (under 26 years old) – practically without any reason or notice, within their first two years of employment. According to the proponents of the First Job Contract, the introduction of the act would be favourable for young people because it could result in their larger employment than today (and, in consequence, reduce the overall unemployment rate). But the opponents argued that it would result in threatening job security of younger people (especially those graduating from schools and universities and entering labour market for the first time).

3.3. Structural reforms – a key challenge for the EU economy

In general, one can state that the EU coordination framework looks quite good and the recent improvements have made it even better (see: Szeląg 2007). But the problem is another – of a much more fundamental nature – i.e. **the well developed and sophisticated coordination framework in the EU is based on rather weak foundation because of the lack of significant structural reforms in many Member States**. Therefore, the EU economy as a whole is structurally obsolete, becoming over time less flexible, less dynamic and less competitive in comparison with some other economies of the world – not only the United States, but also some rapidly growing Asian economies such as China or India. Although the economic potential of the EU (or the euro area) is really huge, it is still not fully benefited by the EU and its Member States.

Taking into account the above argumentation, one can ask: if the need to undertake and carry out necessary reforms is so evident, why there is such little progress in this respect (in both the EU and the euro area)? One of the possible explanations is widely recognized **strong resistance to economic reforms**. In the economic literature there are several reasons why reforms could be blocked or delayed [see e.g. Commission 2005r; Drazen 2000; Rodrik 1996]. The main reasons are the following:

- strong and effective lobbying in the policy-making process – it is connected with the fact that usually (or almost always) reforms cause some losses to particular groups in the society (so-called "reform losers") and for that reason such groups undertake various organized forms of resistance to reforms in order to prevent themselves from experiencing the expected losses;
- uncertain reform payoffs at the individual level (when people are uncertain about whether they will benefit personally from a given reform or not) as well as uncertain division of reform payoffs between various social groups (when it is expected that some groups, so-called "reforms winners", will benefit from reforms significantly more than others);
- uneven distribution of reform pay-offs over time – this is a typical situation because reforms usually involve some costs in the short term, while their gains materialize in the long term (and thereby people are sure that their situation will worsen, but at the same time they are not sure whether they will experience improving their situation as a result of reforms);
- uncertainty whether undertaking a given type of reforms is really necessary – when policymakers (e.g. governments) are not sure whether a particular problem (e.g. high unemployment) requires reforms (e.g. in labour markets) or is rather caused by some adverse cyclical conditions. In such a situation, policymakers tend to delay or postpone any action arguing that they have to obtain new information to make a proper decision about the necessity of undertaking reforms.

Of course, as it is often argued, resistance to reforms is quite understandable, and should be taken into account by policymakers. It would be dangerous, however, to accept such resistance passively, or yield to pressures for reforms meant to patch the shortcomings of existing institutions without adapting them to the new structural needs [Bertola, Boeri 2001].

In order to overcome (at least to some extent) potential public resistance, it is necessary for governments to gain some **social and political support for reforms**. Of course, there is no one universal strategy in this regard because the successful strategy depends on many factors, e.g. the specific characteristics of a given sector expected to be reformed, the economic and political situation of the country where the reform is debated and planned to be introduced, etc. (in other words: no "one-size-fits-all" policy recommendation could be drawn). Nevertheless, it is necessary to remember that political support cannot be of a one-off or temporary nature, but it must be stable and sustained during the whole period of implementing reforms (in order to avoid a situation that some serious reform measures aimed at liberalizing some markets would be started and initially implemented, and then (at a later stage) overturned or abandoned [Castanheira *et al.* 2006].

Indeed, resistance to serious (and inevitably painful) structural reforms is usually really strong, especially in European societies of the so-called welfare states. Some relatively recent events in France, i.e. the mass social protests and demonstrations of March 2006 (see: section 3.2.2), are the best examples in this regard. And it is seriously taken into account by both national and European leaders and policymakers. Nevertheless, **the need for structural reforms is repeated all the time – notably by the EU institutions**. For many years various institutions of the EU have urged the Member States to implement some necessary reforms, but their **progress and results remain limited** in many areas.

For example, in its report on the implementation of the 2003-2005 BEPGs, the European Commission stated that those guidelines outlined the EU medium-term economic policy strategy with particular attention to a contribution that economic policies could make to reaching the Lisbon strategic goal. The key element of this strategy is primarily growth- and stability-oriented macroeconomic policies, but at the same time economic reforms to raise Europe's growth potential. In this context, the Commission indicated very clearly in its report that **the recent or current economic problems** – either external (the 2001-2003 global economic slowdown) or internal ones (the present need to consolidate public finances) – **could not be an excuse for the Member States to postpone necessary reforms** [Commission 2004a]. On the contrary, in its recent Annual Progress Report on the Lisbon Strategy (of January 2006), the Commission clearly indicated that after the relaunch of the Lisbon Strategy last year, the EU must focus currently on delivery and implementation, and thus it is necessary to speed up structural reforms (in other words: "it is time to move up a gear" [Barroso 2006]). Moreover, in this report the Commission emphasized the importance of developing **a coherent overall strategy of reforms**, fully taking into account the interrelationships between macroeconomic, microeconomic (structural) and employment policies. The reason is their actual and potential impact on the economy. As it is argued by the Commission, while macroeconomic policies could provide conditions conducive to growth and job creation, structural reforms would be more directly aimed at raising productivity and employment, and for that reason it is important for this above-mentioned overall reform strategy to be coherent, with reforms in one area supporting those in another one [Commission 2006a-c].

Similarly, the Economic Policy Committee – in its recent reports on structural reforms and the national reform programmes (of January and November 2005) – assessed that **there had been some progress with structural reforms in recent years** (e.g. in 2004), **but much more urgency was still needed with their implementation**. In its opinion, Europe cannot

afford to lose precious time and, therefore, a relatively rapid start with reform implementation could provide the EU with stronger and healthier economies of its Member States and would see strong players developing, growing and prospering in relevant economic sectors [EPC 2005a,b]. Moreover, in January 2005, the EPC identified seven key areas[49] pivotal for refocusing on the core goals of the Lisbon Strategy – higher growth and employment. In particular, **the need for urgent and intensified labour market reforms emerged as a particularly important issue**. Further, the EPC stressed that also all measures aimed at reforming product, labour and capital markets must be consistent with the overarching objective of fiscal sustainability. And in November 2005 – when assessing the National Reform Programmes submitted by the Member States in October 2005 – the EPC stated that the Member States had identified in their National Reform Programmes (NRPs) five key challenges at the present moment[50] and formulated policies to enhance competition, but only a few countries identified improving competition as a key (and thus urgent) challenge. On the contrary, the recent Spring European Council stated that **further structural reforms would be required in order to increase the EU's competitiveness** and sustain growth, and – in consequence – to contribute to an increase in living standards and the creation of new jobs [European Council 2006a].

The European Central Bank has also repeatedly argued in favour of structural reforms to improve the potential for higher economic growth in the euro area. For example, in May and June 2005 (some months after the relaunch of the Lisbon Strategy), the ECB Governing Council suggested that **the continuation and completion of structural reforms would be of utmost importance as it could be vital for Europe's ability to respond to the challenges arising from an ongoing deepening in the global division of labour, the fast process of technological change and the ageing of populations.** According to the ECB, over recent years uncertainties about the structural reform agenda in some countries of the euro area have undermined to some extent the confidence of consumers and entrepreneurs. For that reason, only a clear commitment to implementing the reforms and the explanation of their benefits could help reduce such uncertainties and thereby make a considerable contribution to improving the economic outlook for the euro area. In mid-2005 the ECB stated that it believed that the new Lisbon Strategy's governance would provide fresh impetus to structural reforms in Europe [ECB 2005d,e]. In this context – and referring to structural reforms – the ECB Governing Council welcomed at the beginning of this year the ECOFIN Council's conclusions (of 6 December 2005) on the Lisbon National Reform Programmes and the intended responses to the challenges of globalization.[51] In its opinion, Europe would significantly benefit from more flexible labour and product markets – especially if it would like to speed up the necessary (and thereby urgent) changeover from contracting to expanding activities and minimize potential adjustment costs [ECB 2006a].

[49] The reform priorities identified by the ECP were the following: (1) realizing the knowledge society and boosting innovation; (2) keeping the commitments to the Internal Market; (3) creating the right climate for entrepreneurs, (4) building labour market for higher employment and stronger social cohesion; (5) working towards the environmentally sustainable future, (6) ensuring the long-term sustainability and quality of public finances; and (7) enhancing external openness [EPC 2005a].
[50] The challenges identified by the Member States were the following: (1) labour market performance, (2) the sustainability and quality of public finances, (3) performance in R&D and innovation, (4) the climate for business and enterprises, and (5) education and training [EPC 2005b; 2006].
[51] The above responses to the challenges of globalization are based on some market-economy mechanisms. But it is worth to mention that there is also some other (more "social") response of the EU to these challenges – in the form of the so-called European Globalization Fund. In its communication of October 2005, the Commission highlighted numerous benefits of more open trade, but also underlined the need to help those people who experience some negative consequences of globalization, notably through losing their jobs [Commission 2005t]. In this context, President Barroso proposed to establish the European Globalization Fund (providing up to 500 million EUR each year) which would provide a European response to those adjusting to the consequences of globalization – acting as a sign of solidarity from those who benefit from open trade to those who face the sudden shocks of job losses. The proposal was endorsed in December 2005 by the European Council [European Council 2005c] and the Commission's objective is that the Fund be operational from 1 January 2007 [Commission 2006h].

For that reason, in June 2006, the ECB reiterated its call for the implementation of firm measures to ensure open, competitive and well-functioning product and labour markets. In its opinion, structural reforms of those markets could bring numerous benefits for the Member States as well as for the euro area as a whole, such as **fostering an attractive environment for investment and innovation, increasing flexibility in wages and prices, enhancing the resilience of the euro-area economy to external shocks, smoothening the functioning of adjustment mechanisms in the euro area** (and, in turn, facilitating the conduct of the single monetary policy), etc. In contrast, the lack of such reforms would maintain some remaining rigidities (e.g. low productivity growth or indexation of nominal wages to prices) – which, in some Member States, contribute to wage developments leading to relatively high inflationary pressure, high and persistent unit labour cost growth, losses in competitiveness, etc. In general – according to the ECB – **a comprehensive set of structural reforms is essential to strengthen the foundations for sustained growth in output and employment across the euro area, as well as in order to underpin the ongoing economic recovery** [ECB 2006f; see also: Trichet 2006d,h].

Some of the above issues raised by the ECB have been recently confirmed by the Spring European Council. In its opinion, the two main drivers for structural reforms will be preparing for the ageing of populations and the ambition to reap the full benefits of globalization. The European Council has also recognized the special importance of enhanced structural reforms in the euro-area countries and stressed the necessity of effective policy coordination within this area (as a precondition for more effective dealing with asymmetric economic developments within EMU) [European Council 2006a].

Some months later, at the end of May 2006, the IMF stated in the concluding statement of its mission on euro-area policies that many structural reforms were undertaken over the past decade in the euro-area countries (e.g. labour markets and wage setting have become more prudent and flexible, some product and services markets have been liberalized, pension reforms have effected major improvements in fiscal sustainability, etc.), but clearly, there is a need for more reforms in the euro area. The IMF emphasized the importance of implementing **consistent, complementary and mutually reinforcing packages of fiscal and structural policies which could be sustained over the long term**. In this context, some recent euro-area policy initiatives on both the fiscal and structural sides look quite promising, but – in the IMF's opinion – major challenges need to be faced if decisive progress is to be expected. Moreover, the IMF stated that *"the underlying rigidities* [as a result of insufficient structural reforms in the euro area] *are widely viewed as contributing to the sustained divergences in intra-area growth trends and imbalances – divergences that have contributed to concerns about the entry of new members even though some of these seem well-positioned to instill a new dynamic to the euro area"* [IMF 2006c].[52]

Most of the above problems were reflected in the new **Integrated Guidelines** for 2005-2008 – adopted in June 2005 by the European Council on the basis of the Commission's recommendations. In the Commission's opinion, comprehensive reforms in product and labour markets constitute an integral part of this approach. The Commission is fully aware that **the costs of implementation of all necessary reforms may be really significant**, because they are often socially painful and thereby politically unpopular. But at the same

[52] It was a clear allusion to the debate on the euro-area enlargement at the beginning of 2006, when some economists of the IMF [Mody, Rosenberg 2006] argued that Estonia and Lithuania – having rather flexible economies (or even more flexible than some euro-area members) – could fare well in the euro area.

time, it points out very clearly that **the costs of inaction** (although it is difficult to measure them precisely given the heterogeneity of reforms) **may remain substantial as well** [Commission 2005i]. According to the ECB, a key factor in this context (i.e. social fears about reforms) is effective – and thereby – successful communication that convinces the public of the benefits of reforms. It is important to explain to the general public that these reforms will gradually but progressively deliver higher growth and lead to more job creation, and that, as a result, European societies will be better off [ECB 2005d].

It is sometimes argued that the implementation of structural reforms in the euro area involves problems of collective actions. In this context, the question arises **whether the implementation of structural reforms should be coordinated or not**. On the one hand, there are opinions that coordination of structural policies is unnecessary because economic and social reforms benefit a reforming country and thereby penalize these countries that do not implement them. Therefore, there is no need to have additional incentives [Jacquet, Pisani-Ferry 2001]. There are also views that coordination in the field of structural and tax policies should be an exception rather than a rule – as it has to be dealt with on the basis of a "case-to-case" scenario because the optimal form of coordination differs from case to case [Vijselaar 2000].

In the case of structural reforms there are no effective coordination tools at the EU level (the non-binding Luxembourg and Cardiff processes cannot be regarded as such tools). According to some authors, the above problem of collective actions related to the implementation of structural reforms – in the absence of coordination – would give rise to a dilemma possibly leading to inaction (the so-called "prisoners' dilemma"). The dilemma is that for structural reforms to deliver an acceptable pay-off in the form of lower interest rates, a sufficient number of countries (especially the large ones) have to make a clear commitment to reform. But given the short-term costs involved, some of these countries may be reluctant to undertake structural reform because they are not convinced that other countries will follow suit [Jacquet, Pisani-Ferry 2001]. If so, it potentially could have a really positive impact on the other Member States because such competitive structural reforms could in return increase pressure for the imposition of supranational "minimum standards" for structural policies, possibly shifting the quest for both rent-seeking and structural reform to the level of the euro area. But **a more coordinated approach to structural reforms may be more complicated than it seems to be at first sight** – taking into account that *"the Member States have widely different starting points as regards structural policy settings and therefore different needs in terms of reforms"* [Duval, Elmeskov 2005; 2006].

On the other hand, however, there are some views that coordination of structural reforms at the EU level could play an important role in overcoming opposition by national lobbies, but it should take into account the historical heterogeneity of market structures and policies within the EU [Bertola, Boeri 2001]. Besides, keeping in mind that EMU has weakened incentives for structural reforms in the larger Member States, **a more coordinated approach to structural reforms may seem to be desirable** because it could enable greater monetary accommodation and thereby increase incentives for undertaking reforms by the Member States [Duval, Elmeskov 2005; 2006].

The above statement that a more coordinated approach to structural reforms would be desirable in the euro area has been confirmed more recently by some researchers. They

elaborated a model to allow making an assessment of results in terms of welfare gains or losses for some potential approaches (scenarios) related to structural reforms and budgetary consolidation in the euro area. Those scenarios assumed that, for example, all the euro-area countries (or only some of them – mainly the largest ones) would conduct coordinated structural reforms only (or budgetary consolidation only) or both structural reforms and budgetary consolidation in the entire euro area. The main result of this welfare analysis is that **the optimal approach to coordination is the one in which all the euro-area members would pursue coordinated structural reforms and budgetary consolidation** (scenario 5 – see: table 3.2). According to the authors of this analysis, the implication is that there is a strong positive spillover between structural reforms and stability-oriented macroeconomic policies to ensure greater flexibility in product, labour and capital markets. There is also some empirical evidence of a **strong positive cross-country spillover from coordination** and, for that reason, the individual euro-area countries would enjoy much higher welfare gains from coordinated structural reforms and budgetary consolidation than in the case in which they would pursue these policies in an uncoordinated way and isolation. In the case of the latter, if reforms were undertaken in just one individual country or a in very limited number of the Member States, some negative spillover effects might occur in the euro area because such isolated actions would be likely to improve competitiveness of a given country (or a small group of countries) at the expense of the other Member States [Weyerstrass *et al.* 2006.].

3

Table 3.2.
Potential welfare effects of coordinated/uncoordinated structural reforms and/or budgetary consolidation in the euro area (GDP target)

	Scenario 1	Scenario 2	Scenario 3	Scenario 4	Scenario 5
Germany	9.65	3.09	8.92	14.28	20.29
Austria	8.20	3.28	0.23	1.43	18.93
Italy	17.26	4.15	0.59	2.29	34.69
France	8.59	3.66	0.18	2.45	21.61
Rest of the euro area	8.95	2.58	0.12	1.49	19.02
Total euro area	**52.66**	**16.76**	**10.03**	**21.95**	**114.54**

Note: Positive figures denote welfare gains, negative figures welfare losses.

Scenario 1	coordinated structural reforms for the entire euro area
Scenario 2	coordinated budgetary consolidation in the entire euro area
Scenario 3	structural reforms in one large Member State (Germany) and budgetary consolidation in another (Italy)
Scenario 4	simultaneous structural reforms and budgetary consolidation in one large Member State (Germany)
Scenario 5	coordinated structural reforms and budgetary consolidation in the entire euro area

Source: Weyerstrass *et al.* 2006.

The above question regarding coordination of structural reforms should be considered mainly in the context of EMU because there are some direct links between such reforms and public finances. For that reason it would be interesting to analyze **the impact of EMU (and the EU economic coordination framework) on the frequency and probability of structural reforms**. According to the European Commission, which investigated empirically this issue last year, the following conclusions could be drawn [Commission 2005r]:

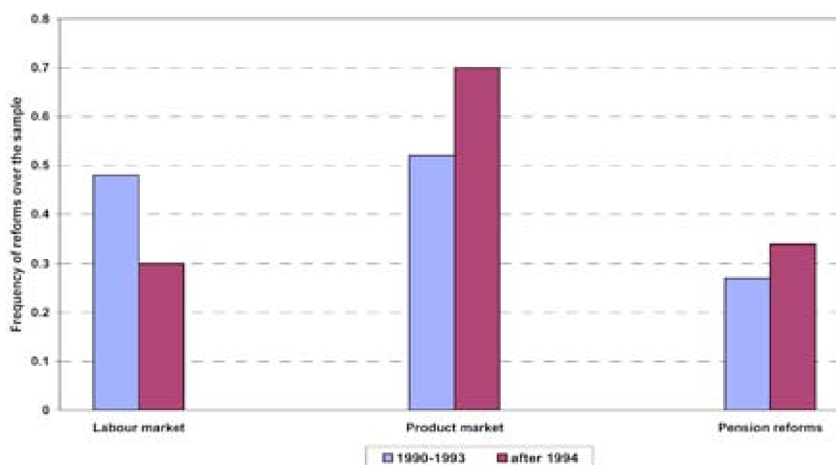
- there is no systematic evidence that after the introduction of the EU fiscal framework (which has corresponded in some Member States to their consolidation efforts in the run-up to EMU and with a subsequent prudent budgetary strategy) reforms became less frequent: while this seems true for labour market reforms, the opposite result has been obtained for product market and pension reforms (see: figure 3.8). It means that the

introduction of the EU fiscal framework – being the direct effect of EMU – did not have any significant impact on the frequency of structural reforms;

- the present rules of the EU fiscal framework (which requires keeping balanced budgetary positions and lower public debt levels) may have some positive impact on the probability of structural reforms. According to the Commission's empirical analysis, in the case of product market reforms, there is some evidence that low deficits (more room in budgets to accommodate possible budgetary costs of reforms) contribute to increasing the probability of reforms. Furthermore, for both labour and product market reforms, high public debt (implying some stronger needs to put to an end unsustainable trends in public finances) increase the probability of reforms;
- expectations that reforms are less frequent in these years when budgetary consolidation takes place are not strongly supported by the data: product market and pension reforms are actually more frequent in these years;
- it is very difficult (if possible at all) to indicate the pure impact of EMU on structural reforms. First, it is difficult to separate the direct effects of EMU from the effects of some processes connected with economic and monetary integration in Europe, e.g. the Single Market Program, the European Employment Strategy, or the Cardiff process, which have already had (or could potentially have) a positive impact on product or labour market reforms. Second, it is also difficult to distinguish the effects of EMU on labour or product markets from some other driving forces of a more global nature (e.g. globalization, liberalization, technological change, etc.), which have a major impact on the structure of economies and markets, work organization, etc.

Overall, it should be underlined that even after more than seven (almost eight) years it is still too early to draw firm conclusions about the impact of EMU on product and labour markets. First, the time span is too short and the data set is too limited because EMU is a very recent phenomenon. The existence of EMU provides too few observations for proper econometric analysis or statistical testing on the basis of available data. Second, the impact of structural reforms on labour or product market performance usually occurs with a significant delay and it may take many years for some of the expected effects to materialize [Commission 2004j; Duval, Elmeskov 2005; 2006].

Figure 3.8.
Frequency of structural reforms before and after the Stage Two of EMU



Source: Commission 2005r.

However, it should be emphasized that there are not only some direct links between structural reforms and public finances, but also **a close linkage and a clear feedback between structural reforms and economic policies**. According to the Commission, the role of sound macroeconomic policies is to provide appropriate conditions for growth and employment, but ultimately structural reforms play a key role in promoting efficient markets and well-designed public interventions that determine sustainable growth in output and welfare. And **a failure on (part of) structural policies could undermine macroeconomic stability**, thus a key feature of the Member States' overall economic strategy should be ensuring that they have a consistent set of structural policies supporting the macroeconomic framework and *vice versa* [Commission 2005i]. The EPC fully shares the view that a macroeconomic framework supportive of stability and growth is indispensable. Governments will reap the full benefits of structural reforms in terms of growth and employment only in an appropriate macroeconomic environment. At the same time successful structural reforms enhance the effectiveness of macroeconomic policies, ensuring long-lasting growth and the long-term sustainability of public finances [EPC 2005a].

In the Commission's opinion, the macroeconomic framework of EMU has performed quite well since the introduction of the euro. However, while **macroeconomic policies** have a role to play in supporting and sustaining a recovery in growth, they **cannot act as a substitute for essential structural reforms in goods, services and labour markets,** which are necessary in order to raise potential growth rates (as well as to improve the capacity of the euro area to emerge more rapidly from future downturns). Structural reforms aimed at raising potential growth rates and improving market flexibility are necessary to maximize the possible gains of the single currency. However, one of the main lessons from the past seven (almost eight) years is that EMU itself is not sufficient to generate these reforms, and thereby a radical shift in attitudes leading to concrete action is indispensable. In this context, it is evident that the euro-area countries will face a considerable number of challenges in the coming years. And **one of the most important economic policy challenges facing presently the euro area is undoubtedly tackling the causes of slow growth via the implementation of structural reforms** identified as part of the Lisbon Strategy. In other words, the challenge now is to reinforce 'E' in EMU through economic reform (assuming that 'M' is strong enough) [Commission 2004j].

Considering various macroeconomic links (e.g. between structural reforms and public finances or economic policies), it should be noted that there is also a relatively strong **relationship between labour and product market policies**. According to some analyses of the OECD, restrictive regulatory environments in product markets tend to be associated with restrictive employment protection policies (see: figure 3.9). It seems that this correlation supports the idea that policies in these two areas are politically complementary. For that reason, it has been argued for many years that the above strong correlation between regulatory regimes in product and labour markets could cause that regulatory reform in only one market would be less effective than simultaneous reform in those two markets [Boylaud, Nicoletti, Scarpetta 2000; Conway, Janod, Nicoletti 2005]. These opinions are in line with some empirical findings. According to the IMF, there is evidence that **reforms in one particular sector of the economy are quite often accompanied by reforms in some other sectors**. In several advanced countries, labour and product market reforms as well as tax reforms occurred broadly at the same time [IMF 2004a]. This is also confirmed by some other authors who indicate that there is some tentative evidence that product market

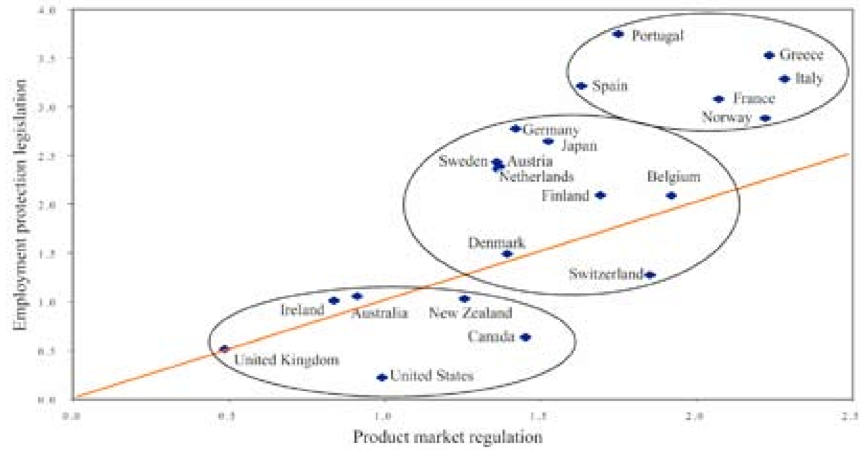
deregulation could pave the way for subsequent labour market reforms because several countries which have undertaken labour market reforms since 1999 had also deregulated their product markets beforehand. In their opinion, if such a political economy mechanism were to hold, EMU could ultimately facilitate the implementation of labour market reforms *via* its effects on economic integration and product market competition [Duval, Elmeskov 2005; 2006]. Moreover, according to the European Commission, there is not only a strong correlation between some sectors/markets or types or reforms (e.g. product, labour, tax ones), but also between countries. In its opinion, **reforms in a given country are more likely if other countries have already carried out reforms in the same sector** or they are in the process of carrying it out [Commission 2005r]. One can suppose that starting reforms in one country might potentially cause a chain reaction in other countries as well.

Some authors argue that there is empirical evidence (based on OECD countries in the period 1990-2004) that lower product and labour market regulation foster employment growth, including through some **sizable interaction effects**. In their opinion, the employment effects are the largest when deregulation includes both product and labour markets [Berger, Danninger 2006]. At the same time, some other authors call into question **policy complementarity in the case of labour and product market reforms**. In their opinion, joint deregulation policies could have conflicting effects on aggregate employment in a given country. And they argue that this could explain why the EU Member States engaged in some large-scale deregulating reforms have not experienced, as it was expected, substantial increases in their aggregate employment levels [Amable, Gatti 2006].

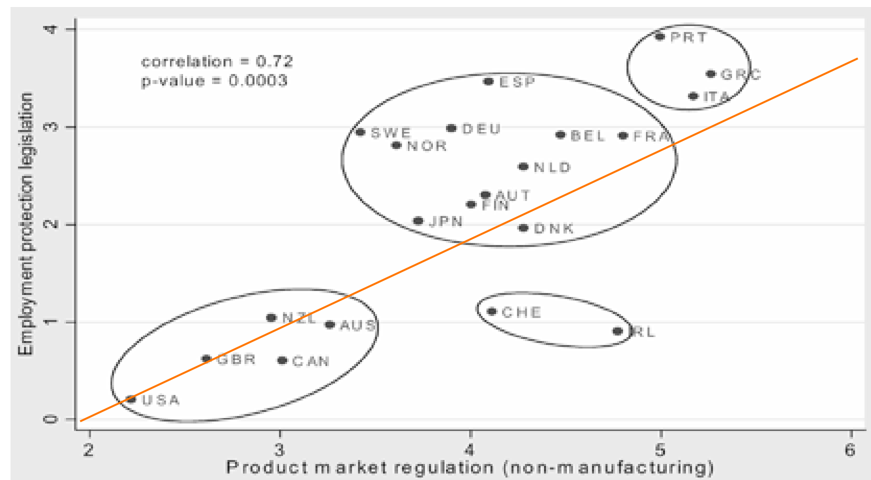
Taking into account that structural reforms tend to be mutually reinforcing, there are opinions that it is therefore crucial to implement reforms in all areas and in all the Member States of the EU [Regling 2004b]. **The need to implement structural reforms is especially important for the Member States of the euro area because they are usually regarded as countries with relatively (or even highly) restrictive product and labour market policies and regulations** (see: figure 3.9). Some countries of the euro area – such as Italy and Greece – have been always classified as the most restrictive states regardless of the adopted method, time span or indicators. Many other members of the euro area – including the largest economies such as Germany, France and Spain – also remain well above the EU or OECD average. In this context, it is necessary to remember that in restrictive labour markets employment rates are usually lower than in more liberal ones, similarly as in restrictive product markets competition and potential growth are usually limited. And this is clearly in opposition to the most important objectives of the Lisbon Strategy for this decade (and beyond as well).

Figure 3.9.
Labour and product market policies in OECD countries

a) summary indicators as of 1998



b) summary indicators – long-term average (1981-2002)

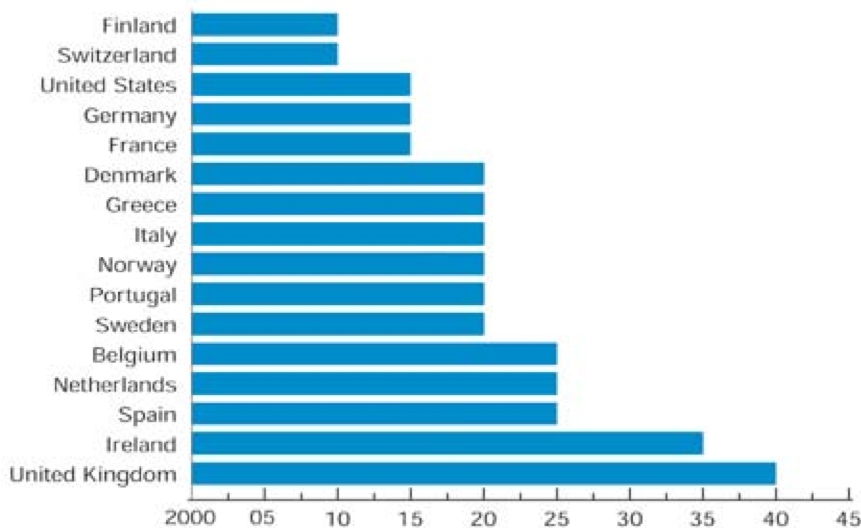


Note: the scale is 0-6 - from the least to the most restrictive.

Sources: Boylaud, Nicoletti, Scarpetta 2000; Langhammer 2004; Nicoletti, Scarpetta 2005.

Last but not least, it should be emphasized that **the ageing of populations has not only economic and social dimensions, but also a clear political context**. As it is known, one of the most important structural reforms is pension reform. And, as indicated by the IMF, an important factor for pension reforms is the fact that demographic changes – by increasing the political weight of older persons who may have the most to lose in the case of pension reform – are actually likely to make the implementation of such reforms increasingly difficult over time. In many countries – including the Member States of the EU and the euro area – the elderly (i.e. people over 50 years of age) may soon represent the majority of active voters (see: figure 3.10), making it harder and harder to implement pension reforms (because such reforms could adversely affect them) [IMF 2004b].

Figure 3.10.
Older people as the majority of voters in selected countries *



* year in which voters aged 50 and older comprise at least 50.1% of all voters

Source: IMF 2004b.

As we can see, the need for structural reforms is repeated almost all the time within the EU. And what is the result? Although there is a broad consensus that structural reforms are needed and urgent in the EU (and, in particular, in the euro area), and there are various instruments available at the national and Community levels, the EU's growth remains rather weak, unemployment rates are generally quite high, labour markets seem to be as rigid as before, there are still many social transfers deteriorating public finances, etc. Indeed, the above picture is not optimistic. On the one hand, the EU has in its disposal many sophisticated instruments, but on the other, it is not able to use them fully effectively in order to achieve satisfactory economic performance. As it has already been mentioned above, the well developed coordination framework in the EU (even strengthened and streamlined in recent years) is still based on rather fragile foundations because of the lack of significant structural reforms in many Member States. Therefore, one can say that **without structural reforms** – using an architectural metaphor – **the EU (similarly as the euro area) resembles a huge building** (i.e. the large economy of the EU or the euro area as a whole plus a large number of regulations, instruments, strategies, etc.) **constructed on an extensive but a swampy ground** (i.e. obsolete economic structures of many of the Member States constituting the EU or the euro area). For that reason, **the priority task is without any doubts to drain the slushy ground.** In this context, the potential solution seems to be a "small steps" approach, i.e. gradual implementation of structural reforms. If there is no conditions for more decisive and concrete actions (e.g. due to strong social resistance), such an approach may allow for some progress. It seems to be a better approach than inaction because in such a situation – when nothing is done – (serious) reforms are eventually driven by a (deep) crisis. There is empirical evidence that reforms tend to follow periods of crisis [Rodrik 1996; Drazen 2000; Duval, Elmeskov 2005; 2006; Commission 2005r]. But taking into account that structural reforms have been postponed for many years in the past, they have to be not only undertaken, but even accelerated in the (near) future.

Concluding remarks

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 benefits for its members, i.e. it would ensure maintaining fiscal discipline within EMU and, in turn, sound and sustainable public finances (being essential for the proper functioning of a monetary union), it would play a role of a catalyst for structural reforms in the euro area, and – as a result – it would secure non-inflationary and sustainable economic growth conducive to employment creation. 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).

And what is the result? In 2006, after seven 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 (including price stability, i.e. low and stable prices in the euro area). 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 of labour, product and capital markets in the Member States. This is regarded as one of the most important problems of the euro area, but another one is the quality of its public finances.

As mentioned above, sound public finances are essential for the proper functioning of EMU because of, *inter alia*, their positive contribution to overall macroeconomic stability in the euro area. Today, after more than seven or almost eight years of EMU, one can assess that budgetary developments in the euro-area countries were rather mixed – on the one hand, there were some remarkable consolidation efforts in the run-up to EMU and some significant improvements in nominal budgetary positions in the early years of EMU, but on the other hand, the Member States of the euro area failed to continue the earlier process of budgetary consolidation. And the present problem with high deficits in the euro area is regarded as a consequence of the failure to run sound fiscal policies by (some of) the Member States and make further budgetary consolidation in the early years of EMU when economic conditions were very favourable (before the recent global economic slowdown). As far as public debt is concerned, the downward trend of debt ratios was being continued during the first years of EMU and then it has reversed and the euro-area ratio has been rising steadily in recent

years (remaining well above the reference value of the Treaty and of the SGP). The current level of debt ratios in the euro area should be a matter of serious concern. Although the present levels of public debt of the euro-area countries – even combined with high nominal budget deficits and rather weak growth – do not pose an imminent threat to the sustainability of public finances in the short or medium term, such a risk could emerge in the longer perspective. It should be noted, however, that – according to some opinions – in the absence of the EU fiscal framework (introduced as a result of EMU), both the euro-area government deficit and debt ratios – perceived as quite high at the present moment – would have been higher than today. Therefore, this is a positive result of EMU on public finances.

The overall situation of public finances should not be examined merely in the short- or medium-term perspective, but also over the (much) longer time horizon – especially taking into account the so-called ageing of populations. According to various economic forecasts (Commission, IMF, OECD), it may influence heavily public finances in the coming decades – if some necessary steps are not taken well in advance (i.e. today or in the nearest future). It is projected that a substantial increase in some age-related public spending (on pensions, health care and long-term care) could put an enormous strain on public finances over time. And the euro area (similarly like the whole EU) must be prepared for these trends; otherwise, it could significantly affect its outlook for growth and employment. For that reason, since the launch of EMU in 1999, the Commission has started to include an examination of the sustainability of public finances into the existing EU framework for surveillance of the Member States' economic and budgetary policies. It seems to be not a coincidence and this increased focus on the quality of public finances in the euro area (in short, medium and long term) should also be regarded a positive result of EMU.

As mentioned above, there are opinions that the present 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 of labour, product and capital markets in the Member States. In this context, it should be recalled that prior to the launch of EMU there was a wide debate concerning the question whether the single currency would act as a catalyst for structural reforms. Many economists – taking into account the lack of adjustment capacity in several countries of the euro area because of their rigid product and labour markets, low cross-border labour mobility and the absence of a central fiscal authority in the euro area – indicated that it could lead to the emergence of some significant macroeconomic imbalances which could result in protracted periods of slow growth and high unemployment in some countries or regions of the euro area. It was also expected that EMU – via structural reforms – could reduce the likelihood of asymmetric shocks inside the euro area and strengthen adjustment capacity in the case of such shocks. Therefore, the strong need to intensify structural reforms in the euro area has emerged before the introduction of the euro.

The most spectacular impact of the introduction of the euro – in line with some earlier expectations – was observed in accelerating the process of integration of financial markets (thanks to eliminating exchange rate risks in financial flows, enhancing transparency and competition in the provision of financial services, increasing the size and liquidity of financial markets, etc.). It was also widely anticipated before the introduction of the euro that EMU would have a significant impact on intra-euro-area trade – because of the elimination of exchange rate uncertainty between the euro-area members, lower transactions costs, enhanced competition through greater transparency, etc. And indeed, there is some

evidence that EMU has had a positive impact on intra-euro-area trade and, moreover, it is expected that the impact of EMU on trade is likely to increase further in the coming years. Prior to the introduction of the euro it was also expected that the impact of EMU on foreign direct investments in the euro area – regarded as an area of significant macroeconomic and political stability – would be positive as well. Again, those expectations have materialized; there is a common view that the single currency has raised the attractiveness of the euro area as a destination of foreign investments. With regard to the intensity of labour market reforms in the EU before and after the introduction of the euro, there are some opposing results of empirical research – on the one hand, there are some analyses suggesting that labour market reforms have accelerated in the euro area during the 1990s and they have become relatively more frequent in EMU countries, but on the other hand, there are some research concluding that the euro-area countries have carried out no more reform than countries outside EMU and thereby the advent of EMU did not seem to coincide with an acceleration of structural reforms. All studies, however, taking into account some severe and chronic structural problems in European labour markets, confirm the urgent need to undertake some serious structural reforms of labour markets in the EU (that seems to be even more urgent in the euro area).

Finally, as mentioned at the beginning of this study, it should be repeated that in the case of structural reforms – similarly like in the case of public finances – it is really difficult to assess the impact of EMU because of its relatively short existence so far (only seven years). For that reason, the actual impact of EMU may not be fully apparent just some years after the introduction of the euro, but considerably later. Moreover, sometimes it is difficult to isolate the pure impact of EMU and distinguish it from the impact of some other influential phenomena (such as the completion of the Single Market, technological change or globalization). Finally, in some cases (e.g. public finances), the impact of EMU should not be measured merely since the formal introduction of the euro, i.e. 1 January 1999, but some years before as well – during the run-up to EMU.

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