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Economic Policy in EMU: Community Framework and National Strategies

- focus on Greece -

Theodoros S. Papaspyrou

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Theodoros S. Papaspyrou [#]

ABSTRACT

The objective of this paper is to analyse key aspects of economic policy in EMU taking into account the basic components of the Community framework, namely (i) the internal market, (ii) common fiscal rules and provisions for economic policy co-ordination, and (iii) the single monetary policy. The paper argues that EMU provides a framework favourable to economic activity provided EMU advantages are fully exploited and disadvantages minimized. An optimal use of available policy instruments is necessary by individual member states in order to take advantage of the framework of stability provided by EMU and take an active role in the European and international division of labour.

Keywords: Community Framework; EMU; Member States national policies

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[#] Mr Papaspyrou is Adviser at the Bank of Greece and former official of the European Commission, DG for Economic and Financial Affairs.

Correspondence: Theodoros S. Papaspyrou, Bank of Greece, 21 E. Venizelos Avenue, 102 50 Athens, Greece, TPAPASPYROU@bankofgreece.gr

Economic Policy in EMU: Community Framework and National Strategies – focus on Greece

1. Introduction

The objective of this paper is to analyse key aspects of economic policy in EMU[1] taking into account the basic components of the Community framework, namely (i) the internal market, (ii) common fiscal rules and provisions for economic policy co-ordination, and (iii) the single monetary policy. The basic elements of the EMU framework are analysed in annex 1.

In section 2 the paper reviews the main economic trends in the euro area in recent years and the main policy challenges. It analyses subsequently, in section 3, the policy response, at Community level, to the challenges posed by the slow pace of reform, the need to ensure sustainability of the recent economic recovery and enhance the growth potential of the euro area economy. Initiatives at Community level include the re-launch of the Lisbon strategy, the reform of the Stability and Growth Pact and improvements in economic governance in the EU, and actions to complete the Internal Market such as the adoption of the services directive.

In section 4 the paper examines the implications of EMU for economic policy at national level, notably the effect of the loss of the exchange rate instrument and the common interest rate policy. Key issues related to fiscal policy and structural reforms are also examined, with special focus on Greece's fiscal adjustment effort and long-term sustainability of public finances. In the same section, the importance for Greece of the rapid development of its neighbouring Balkan countries is briefly reviewed.

In section 5 the main advantages and disadvantages of EMU are identified and their impact on the design of economic policy and the introduction of structural reforms is analysed. Some preliminary evidence is also supplied on the dynamics of adjustment in EMU.

In the final section the paper concludes that EMU provides a framework favourable to economic activity provided EMU advantages are fully exploited and disadvantages minimized. An optimal use of available policy instruments is necessary by individual member states in order to take advantage of the framework of stability provided by EMU and take an active role in the European and international division of labour.

2. Euro area: Economic trends and policy challenges

2.1. Economic trends

The dominant feature of economic trends in the euro area in the period 2001-2005 has been the very modest growth performance and relatively high unemployment rate. This has justifiably been a matter of serious concern and asked for appropriate policy response.

[1] EMU stands for Economic and Monetary Union. A plausible question may arise: what is the difference between EMU and the euro area? Formally, the euro area is simply the sum of EU member states that have reached the third stage of EMU and have adopted the euro. In practice, most people associate the term "euro area" with the single monetary policy conducted by the ECB, i.e. the "M" of EMU.

Indeed, after an outstanding performance in 2000, when real GDP growth rate in the euro area reached 3.7%, there was a prolonged economic slowdown in subsequent years and despite a tentative recovery in 2004, growth rates remained very modest, averaging 1.3% per annum during 2001-2005. Economic developments and prospects are currently better for 2006 and 2007, as real GDP growth rates for the euro area is estimated at 2.6% for 2006 and 2.3% for 2007, according to the latest economic forecasts (IMF). However remains to be seen whether the current recovery will be sustainable.

The average unemployment rate in the euro area at an estimated 8.6% of labour force in 2005 (and slightly below 8% in 2006) is much higher than, for example, in the USA (below 5%), although important differences do exist among euro area countries[2].

Table 1. Key economic indicators, 2001-2005 average

	EU-15	Euro-area	USA	Japan
GDP growth rate (volume, annual %)	1.5	1.3	2.5	1.4
Unemployment rate (% of labour force)	7.7	8.4	5.4	4.9
GDP per capita (2004, USA=100)	72	71	100	74

Source: Eurostat

The failure to translate remarkable macroeconomic stability into sustained economic growth raised concerns amongst policymakers about the sources of the growth problem and the policy measures that are required to reinvigorate economic activity in the euro area. Productivity trends are of particular concern. In the euro area, average productivity growth (measured in terms of output per hour worked), after growing on average by about 2.5% from 1980 to 1995, declined to just above 1.5% in the period 1995-2000 and further to just above 1.0% on average in the period 2000-2004. By contrast in the US, growth in productivity per hour worked, after averaging just below 1.5% from 1980 to 1995, rose to an average of just below 2% in the period 1995-2000 and to just below 3% over the period 2000-2004. There seems to be robust evidence that slower productivity growth in the euro area since the mid-1990s reflects both less capital deepening and lower growth in total factor productivity. The latter may be explained in part by differences in the production and diffusion of information and communication technology.

Fiscal adjustment in the euro area in recent years has been inadequate, as the average general government deficit for the euro area in 2006 remained higher than in 1999, the year the third stage of EMU commenced. The still high government deficits can, to a large extent, be attributed to the prolonged economic slowdown, until 2005, although they also reflect a relaxation in the pace of fiscal consolidation in several member states -- notably large countries -- after their intensive effort to comply with the Maastricht convergence criteria. For example, there was inadequate fiscal adjustment in 2000, when real GDP growth in the euro area was significantly higher than potential output. Because of the inadequate fiscal adjustment in good times, fiscal policy was not able to play fully its anti-cyclical role, mitigating the economic slowdown, without exceeding the deficit limits (3% of GDP) required by the Treaty.

[2] It should be noted, however, that there was considerable employment creation in the euro area in the period 1999-2006 (see Quarterly Report on the Euro Area, EC, DG ECFIN, No 1, 2007).

A principal lesson of the first years of EMU is that, although the pursuit of macroeconomic stability is a precondition for sustainable growth, there is no automatic mechanism for raising the economy's growth potential[3]. Most analysts, including international institutions (IMF, OECD) and Community bodies, agree that the modest growth performance of the euro area was due to a lack of adequate progress in structural reform in product, labour and capital markets. Even though a number of reforms have been set in motion in several member states, the overall pace of reform is too slow.

Several estimates indicate that comprehensive product and labour market reforms could add almost half a percentage point to the annual growth rate. An additional quarter of a percentage point could come from the increased investment in knowledge foreseen in the Lisbon Strategy. The effects of capital market integration could further add to potential growth. Comprehensive reforms, covering product and labour markets, more investment in R&D and education and the creation of a single market in financial services could thus raise potential growth from 2% to 3% (see Almunia, 2006).

A number of reforms have been set in motion at Community level and in member states in recent years. At Community level, there was the re-launch of the Lisbon agenda, the reform of the Stability and Growth Pact and a number of other initiatives (see below).

There is evidence that reform and adjustment effort started to pay dividends. There is, however, uncertainty about the duration of the recovery taking into account past experience of short-lived recoveries. The right lessons must be drawn from this experience in order to ensure a sustainable recovery in the Euro area economy. Tackling the root causes of slow growth via the implementation of reforms identified in the Lisbon strategy is perhaps the most important economic policy challenge now facing the EU and the euro area in particular.

2.2. Monetary developments

In contrast to economic policy, where responsibility lies principally with national governments (subject to common Community rules a far as budgetary policy is concerned), the issue is different concerning monetary policy as a new institution, the European Central Bank, was assigned the exclusive responsibility of ensuring price stability.

Key questions concerning monetary policy in the euro area after eight years of operation are (i) whether the ECB rose to the challenge of defining and implementing an effective monetary policy for the euro area as a whole and (ii) whether the primary objective of price stability was successfully achieved and whether monetary policy was adjusted in an appropriate manner in line with economic conditions (See European Commission, 2004a). On the first one, despite the numerous uncertainties and the undertaking of a task without historical precedence, the ECB succeeded in developing a monetary policy strategy reflecting the experience of the most successful central banks in Europe. Regarding the second question, although inflation has been above the ECB's definition of price stability over most of the past eight years, this mainly reflects the series of one-off price shocks that the euro area was subjected to in that period. The ECB has remained focused on achieving price stability over the medium term, and resisted the temptation to raise rates in response to one-off shocks when the risk of second round effects was very limited. Inflation expectations have remained both stable and close to the ECB's price stability definition.

[3] See European Commission, (2004a).

Low inflation and stable inflation expectations have been also reflected in historically low nominal and real interest rates in the euro area.

Even critics of some aspects of ECB's monetary policy, agree that ECB performed remarkably in issuing a stable currency for 310 million people under circumstances without historic precedence. There are, however, several dissenting voices among academics and other observers on ECB's monetary policy stance who argue that the ECB must not be overly obsessed with inflation risks when evidence shows that the policy priority in the euro area is rather the support of deficient internal demand and less the fight against perceived inflation risks. For example, Bofinger (2004) while praising ECB for its established reputation ("…there is no doubt that since 1999 ECB has been very successful in implementing the common monetary policy and establishing a high reputation as a stability oriented central bank"), he is critical on other aspects of its policy arguing that in addition to a comprehensive reform of the Stability and Growth Pact, the overall macroeconomic philosophy of the ECB needs a thorough re-examination (Further analysis on the implications of the single monetary policy for individual member states is presented in section 4, below).

2.3. Other developments and global trends

A major event in the European Union in recent years was the enlargement by which ten new member states joined the EU on the 1st May 2004.

Slovenia joined the euro area from 1 January 2007, as it fulfilled the required convergence criteria. Seven of the new member states have already become members of the Exchange Rate Mechanism (ERM II), in preparation of their participation in the euro area, once the convergence criteria foreseen in the treaty are fulfilled.

On the global scene, a noteworthy development in recent years, affecting also the European economy, has been the sharp rise in the price of oil, from about $ 25 the barrel in 2002, to an average $ 37.5 in 2004 and further to $ 54 in 2005 (a rise by 44% compared to 2004). The average 2006 price of oil is estimated at about $65 per barrel.

On the positive side, there was the recovery of the world economy in 2004, when it reached a growth rate of 5.3%, the highest rate for 25 years, and the still high growth rates in 2005 and 2006 around 5%, despite the adverse impact of high oil prices. Growth prospects are also good for 2007.

3. Response at Community level to key policy challenges

The review of the main economic trends in the EU in the preceding section showed that European policy makers will have to act decisively in order to address the important challenges faced by the European economy and enhance its growth potential.

There was, over the past two years, a series of initiatives whose aim was to enhance the dynamism of the European economy. The achievement of such an objective relies also on the sound fundamentals of the EU economies, including the prevailing price stability and stable inflation expectations, the still low nominal and real interest rates, sound financial systems and the lack of significant external and domestic macroeconomic imbalances. The most important initiatives are described below.

3.1. Re-launch of the Lisbon Strategy

The mid-term review of the Lisbon strategy[4] that took place during the first half of 2005 concluded that its main weakness was poor implementation of reforms by member states. The implementation of reforms has not been fast enough and has not been comprehensive, particularly in the larger member states. Therefore, the re-launched Lisbon strategy attempts to improve implementation by increasing national ownership of the reform process, better focusing the strategy and simplifying its governance. According to the Conclusions of the European Council of March 2005 *"…it is essential to relaunch the Lisbon Strategy and re-focus priorities on growth and employment…placing the main emphasis on knowledge, innovation[5] and the optimisation of the human capital*". In the field of R&D, the overall objective of 3% of GDP investment spending by 2010 was maintained, with an adequate split between private and public investment (R & D spending in the EU was 1.9% of GDP on average during 2000-2003 compared to 2.6% of GDP in the US and 3.1% of GDP in Japan). It also needs to fight red tape, remove obstacles to the mobility of workers and develop better regulation[6].

In order to fill the existing gap between higher education, research and innovation in Europe, the European Commission, in a Communication[7], proposed the creation of a European Institute of Technology. After an initial favourable view of the European Council, a formal Commission proposal for a Regulation establishing the Institute was made in October 2006.

The endeavour to enhance and step up the implementation of reforms must be shared by all if it is to be successful. Therefore, the renewed strategy creates the conditions for a new partnership with the member states, based on a clearer distribution of tasks and responsibilities.

The major innovation of the renewed Lisbon strategy was the decision to prepare National Reform Programmes in which member states, governments, parliaments and social partners should identify the main challenges they are facing and outline the reform measures they deem appropriate for addressing them. A key aspect of the NRF is the capacity of member states to learn from each other experiences. This should make member states actively involved and increase support for government initiatives.

3.2. Reform of SGP and Improvement in Economic Governance

3.2.1. Reform of the Stability and Growth Pact

The Stability and Growth Pact was established in 1997 in order to improve economic policy coordination within EMU and ensure budgetary discipline and sustainable growth. One of SGP's cornerstones is that Member States should seek to achieve budgetary positions close to balance or in surplus over the economic cycle, as this would allow automatic stabilizers to operate freely without the risk of breaching the reference value of 3% of GDP for the fiscal deficit.

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[4] The Lisbon Strategy was initiated in 2000 and was re-launched in 2005.

[5] In September 2006 the European Commission proposed ten priority actions to achieve a broad-based innovation strategy for the European Union (EC/MEMO/06/325, 13 September 2006).

[6] See Bank of Greece (2005b) for an analysis of the re-launched Lisbon Strategy.

[7] Communication from the Commission to the European Council, 8.6.2006, COM(2006) 276 final.

However, budgetary developments in recent years, mainly the high government deficits in several member states and the failure of EU fiscal rules and mechanisms to correct such imbalances, have led to the decision to amend some of the Pact's rules.

A reform of the SGP was, indeed, introduced in 2005 in order to take more into account economic realities faced by member states, improve economic and fiscal policy coordination and economic governance in the EU and the euro area. The reformed Pact, which acquires more flexibility while keeping its rigour, is expected to contribute to the sustainability of public finances and, also, reinforce its contribution to growth and jobs. The new Pact preserves the EU's fundamental fiscal rules for keeping budget deficits below 3% of GDP. At the same time it leaves more room for economic judgment in the application of these rules so as to better reflect the economic heterogeneity of the 25 member states. It gives, for instance, more time to correct imbalances, takes into account the level of government debt and adjusts accordingly the medium term fiscal target or be stricter when considering one-off measures.

Most observers agree that the amendments concerning the preventive arm of the pact (i.e. to prevent excessive deficits from occurring in the first place) and the improvement of economic governance in the EU are steps in the right direction. However, reservations have been expressed as to the amendments referring to the Pact's corrective arm (i.e. correction of excessive deficits) and its ability to ensure fiscal discipline. Most analysts seem to agree with ECB's view that a rigorous and consistent implementation of the reformed Pact is of utmost importance for the credibility of EU fiscal rules (for details on the reform of the SGP see Bank of Greece, 2005b).

3.2.2. Strengthening national ownership of the fiscal framework

The ECOFIN Council in its report on "Improving the implementation of the Stability and Growth Pact" stressed the importance of improving economic governance and strengthening national ownership of the fiscal framework. To this end, the Council called for

- close and constructive cooperation among member states, the Commission and the Council in the process of economic and fiscal surveillance in order to guarantee certainty and effectiveness to the SGP rules
- national institutional bodies to assume a more prominent role in budgetary surveillance, so as to strengthen national ownership of the fiscal rules and objectives
- continuity with respect to the budgetary targets endorsed by the Council, as well as description of the specific policies and measures for their achievement, in case of change of government
- presentation of stability/convergence programmes and Council opinions thereon to national parliaments
- member states to affirm their commitment to produce reliable statistical data, in view of the great importance of fiscal statistics. [8]

Given that this ECOFIN Council report was endorsed by the European Council and forms part of the new Stability and Growth Pact, the above proposals are already part of the Pact.

[8] Provisions for the improvement in the quality of fiscal data are included in Council Regulation (EC) No 2103/2005 of 12 December 2005 amending Regulation 3605/93 "as regards the quality of statistical data in the context of the excessive deficit procedure", OJ L 337/1, 22.12.2005.

Box A: Policy co-ordination in EMU

Several official Community documents talk about the need for economic policy co-ordination or co-ordination of economic and budgetary policies at euro area level. However, there is no reference in these texts to co-ordination of economic and monetary policies. This may appear surprising as coordination of economic, notably fiscal, and monetary policies is a very common issue when monetary policy is exercised at national level.

An explanation of the absence of reference to economic and monetary policy co-ordination at euro area level can be found in the independence of the ECB and the desire of other Community institutions to respect, and be seen as respecting, this independence. Therefore, the Council and the European Commission are reluctant to discuss this issue in order to avoid being perceived as interfering with ECB's independence (although there have been a few cases of eurogroup ministers arguing about the need for closer co-operation with the ECB on economic issues of common interest).

On its part, the ECB has been more explicit on this issue, through comments and speeches of members of its governing council, arguing that any ex-ante co-ordination of economic and monetary policies is both undesirable, being incompatible with the ECB's independence, and ineffective. Otmar Issing, member of the ECB's governing council until May 2006, justified this view arguing that with an independent central bank and its stability-oriented strategy, the euro area has a highly predictable monetary policy (Issing, 2005). As a consequence, there is no ambiguity as to how monetary policy will respond to economic, including fiscal, developments: it will respond to the extent that they pose risks to price stability.

Issing argued further that a stability- oriented monetary policy will take fiscal policy measures into account in its analysis. Yet, there cannot be a commitment to an automatic or even ex-ante monetary policy reaction in response to fiscal consolidation policies or structural reforms: "*……Given the absence of credible enforcement mechanisms, ex-ante co-ordination between monetary and fiscal policies are unlikely to be successful. In addition, ex-ante coordination tends to blur the fundamental responsibilities for the respective economic actors and may even increase uncertainty about the general policy framework……a clear distinction of responsibilities between monetary and fiscal actors is consistent with implicit policy co-ordination between authorities. A single monetary policy that is committed to maintaining price stability in the euro area will by itself facilitate "appropriate" economic outcomes in the Member States. If national fiscal authorities correctly perceive the behaviour of the single monetary policy they will take actions that would likely lead to implicitly "coordinated" policy outcomes ex post."*

According to Issing, an open exchange of views and information between individual policy actors - without any commitment or mandate to take and implement joint decisions - will assist the overall outcome, if it manages to improve the understanding of the objectives and responsibilities of the respective policy areas and does not dilute accountability.

3.2.3. EU's Integrated Guidelines for Growth and Jobs[9]

The Broad Economic Policy Guidelines (BEPGs) have been the main instrument for coordinating economic policies within the EU, in application of Article 99 of the Treaty stating that "Member States shall regard their economic policies as a matter of common concern add shall coordinate them".

The European Council of March 2005 decided to simplify the BEPGs and make them more focused on the crucial problems faced by the EU. The European Council decided further

[9] For details on this issue see Bank of Greece, Interim Monetary Policy Report, Appendix: "EU's integrated guidelines for growth and jobs", October 2005.

that the BEPGs will be merged with Employment Guidelines to form the Integrated Guidelines for Growth and Jobs.

The Integrated Guidelines adopted on 16-17 June 2005 set two main priorities: (α) enhancing Europe's potential for job creation and (β) accelerating productivity growth. Emphasis was also given to the need for sound macroeconomic policies that will foster market confidence in the stability of the European economy and lay the foundations for dealing with future demographic problems.

3.2.4. New working methods for the Eurogroup

At the Informal Ecofin in Scheveningen, on 10 September 2004, finance ministers of the euro area countries have unanimously agreed on new working methods for the Eurogroup. There was also broad agreement among ministers that the efficiency and effectiveness of the Eurogroup can be improved and that policy coordination can be strengthened. Ministers therefore agreed to the following.

There was unanimity on the principle of creating a stable presidency of the eurogroup for a period of two years as the embodiment of the strengthened policy coordination and the enhancement of the continuity within the Eurogroup. The Eurogroup president will be selected on the basis of skills and experience, irrespective of nationality and giving equal treatment of candidates from all member states[10].

Jean Claude Juncker, prime minister and finance minister of Luxembourg was chosen as the first Eurogroup president from 1 January 2005 for a period of two years[11]. The vice president of the Eurogroup will always be the acting Ecofin president, provided he/she belongs to the Eurogroup.

*3.3. **Clarification of monetary policy targets***

Following concerns expressed in the press, the academia and in official circles about the worldwide risk of deflation, notably in view of the persistent deflation phenomenon in Japan and elsewhere, the ECB proceeded in 2003 to a clarification of its monetary policy strategy to, precisely, take into account these concerns.

In a statement on 8 May 2003 the Governing Council of the ECB[12] confirmed the definition of price stability announced in 1998 but added that the pursuit of price stability will aim to maintain inflation below but close to 2%. The communiqué added that the clarification underlined the ECB's commitment to provide a sufficient safety margin to guard against the risks of deflation and it also addressed the issue of the possible presence of a measurement bias in the HICP and the implications of inflation differentials within the euro area.

The Governing Council, in the announcement of 8 may, confirmed that its monetary decisions will continue to be based on a comprehensive analysis of the risks to price stability. The ECB announced also that the economic analysis will serve as the principal basis for analyzing monetary conditions and that the money supply measures will serve to cross-check, from a medium to long-term perspective, the results of the economic analysis.

[10] The draft Treaty on European Constitution foresees some further enhancement of eurogroup duties.
[11] In September 2006, the mandate of J-C. Juncker was renewed for two more years.
[12] See ECB, Monthly Bulletin, May 2003.

3.4. Completing the Internal Market

3.4.1. *Market services*

There is growing recognition of the importance of a smoothly functioning internal market for Europe's economic and social future. The greatest potential for more growth and more innovation exists in the area of services, which has so far been largely untouched by internal market policies. A wide range of legal and administrative barriers inhibit direct cross-border trade in services and make it unnecessarily difficult, if not impossible, to set up permanent establishment in one member state to operate as a true European service provider. There has been little market integration and not enough competition, with the result that productivity growth has been held back (EC, Internal Market Report, 2005).

The removal of these internal market obstacles is essential for the EU economy to raise its growth potential and for its companies to become more competitive on global markets. The services covered by Services Directive account for more than 50% of EU GDP and an even greater share of employment, so the potential gains in terms of growth and job creation are huge. A recent study by the Netherlands Bureau for Economic Policy Analysis (2006) estimated that full implementation of the services directive – i.e. including the country of origin principle[13] – would increase European GDP by 0.3% (lower bound) to 0.7% (upper bound). When the directive is applied without the country of origin principle, GDP increases by 0.2% and 0.4% respectively.

A substantially modified version of the initial Commission proposal for Services Directive obtained a positive vote in the European Parliament on 15 February 2006. Following this development, the Commission prepared a new proposal based on EP's modifications, on which there was a political agreement by the EU Council of Ministers on 29 May 2006. The services directive was finally adopted in December 2006[14]. Member States will have to transpose the directive into their national legislation within three years.

3.4.2. *Financial integration*

Financial services and financial integration had been the subject of particular interest on the part of Community institutions, national authorities and the business community. In September 2005 the ECB (2005a) published, for the first time, a series of indicators regarding the state of integration of the euro area financial and banking markets. The main findings were as follows:

While the euro has undoubtedly acted as a catalyst for financial integration in general, it is true that the degree of integration differs from market segment to market segment, with integration being more advanced in those segments that are closer to the single monetary policy, notably the money market. There, was achieved almost complete integration, thanks to, among other things, the establishment of the pan-European payment infrastructure, the TARGET system[15].

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[13] The "country of origin principle" implies that a service provider who operates legally in one member state, can trade its services in other member states without having to comply with further rules – save for a few explicitly named exemptions – in those host member states.

[14] Directive 2006/123/EC of the European Parliament and the Council on services in the internal market, OJ L 376/36, 27.12.2006.

[15] Payments are the oil in the wheels of the Internal Market and it is of major importance that those wheels run smoothly and safely. The objective is a Single Payment Area, in which citizens and businesses can make

Bond market integration has also progressed significantly. Government bond yields have converged considerably and are now driven mainly by euro area-wide shocks and news. The euro area corporate bond market has grown considerably in recent years and is also fairly integrated, in the sense that the country of issuance is only of marginal importance in explaining yield differentials.

The integration of equity markets in Europe is a slow and more laborious process of overcoming fragmentation. That said there are encouraging signs of an increasing degree of integration, such as the substantial decrease in the "home bias" in the equity holdings of investment and pension funds, and a more homogenous reaction of equity prices across the euro area to monetary policy signals.

The pace of integration in the banking sector has been uneven. Integration is well advanced in wholesale and capital-related activities, while it is lagging behind in retail markets. This partly reflects differences in the nature of competition in these segments. Proximity to clients, bank-customer relationships and access to information play a key role in retail banking, while they are less crucial for investment banking and for corporate banking aimed at large companies. However, lack of integration stems also from differing national regulatory arrangements, practices and product characteristics.

All in all, monetary union has been highly beneficial for euro area financial markets, although improvements can still be made, if the deep, liquid and unified US financial markets are taken as a benchmark. The euro area still has some way to go, especially as regards the integration of equity markets, the establishment of common legal and regulatory framework, and the consolidation of the banking sector.

3.4.3. *Taxation*

Other initiatives concerning the Internal Market include a number of actions undertaken by the Commission in order to improve the situation in the area of taxation in the EU. Some proposals were approved by the Council and are part of Community law while others are still the subject of deliberation:

The Council adopted on 12 December 2005 a directive extending until the end of 2010 the minimum standard rate of value added tax at 15%. The directive maintained the minimum standard rate for a period long enough to cover the ongoing strategy to simplify and modernize current EU legislation on VAT[16]. The proposal for an extension of the reduced VAT rates on a number of products and labour intensive services was approved by the Council on 14.2.2006.

Another important initiative concerns Commission' proposal for a harmonisation of the tax base for taxing corporate income. It was felt that by harmonising the tax base (and not tax rates) European companies will be helped as it would reduce the administrative burden associated with the existence of diverse tax bases.

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cross-border payments as easily, safely and efficiently as they can within their own countries and subject to identical charges. Important current initiatives in this area include the recent Commission proposal for a Directive on payment services (PSD) which will remove the legal barriers to the creation of a Single Euro Payments Area. On 27.3.2007 the ECOFIN Council adopted a general approach on a compromise text for the PSD which will be subsequently considered by the European Parliament.

[16] The initial minimum vat rate of 15% was set by directive 77/388/EEC.

3.4.4. *Competition policy*

The Commission's exclusive powers on competition issues bring also a specific responsibility to examine how the system can be improved in search of better competitiveness. Three priorities have been set by the European Commission, in 2004, in this area: (i) a comprehensive reform of the State Aid rules, (ii) effective enforcement and modernization of the anti-trust and merger rules, and (iii) a proactive competition policy to complement competition rules[17].

The re-launched Lisbon Strategy makes specific reference to an active competition policy which should be accompanied by a reduction in the general level of state aid, accompanied, however, but a re-deployment of aid in favour of support for certain horizontal activities such as research and innovation and the optimisation of human capital. The Commission proposed to increase the scope for compatible aid – including innovative start-ups and innovation clusters as well as new rules on risk capital aid.

An effort has also been made in recent years so that the task of policing anti-competitive behaviour and handling complaints to be better shared by the national competition authorities and the Commission linked through the European Competition Network.

*3.5. **Other initiatives: a European Globalisation Adjustment Fund***

The European Commission, taking into account criticism that it remained insensitive to the effects of restructuring and extensive job losses arising from trade liberalisation measures, gave on 1 March 2006 details about its proposal for the creation of a European Globalisation Adjustment Fund. The fund aims at helping workers made redundant due to changing global trade patterns reintegrate into the labour market. The proposal was endorsed, in principle, at the December 2005 European Council, where there was general agreement among European leaders on the need to address the adverse effects of changing trade patterns on workers. It was finally adopted in December 2006[18].

The fund will provide up to € 500 million each year, in 2006 prices. Its operations will start as soon as the new regulation governing the creation and operation of the fund is in force.

On analytical grounds the proposal seems, in principle, justified as the theory of international trade shows that the net gains from trade outweigh the losses and the welfare economics suggest that it is fair that gainers compensate the losers. The proposal tries to invent a mechanism in order to make this principle operational. However, critics of the proposal see it rather as a bureaucratic mechanism providing no much help to the need for economic adjustment (see EurActiv.com, 2005).

4. National economic policy in EMU: focus on Greece

4.1. Recent economic trends

As was already noted in section 2 of this paper, the economic performance of most euro area countries, notably the larger economies, has been very modest in the first half of this decade, both compared with their estimated growth potential and in comparison with the performance of other advanced economies. For example, during 2001-2005, the annual average growth rates of real GDP was 0.7% in Germany, 0.8% in Italy and 1.6% in France,

[17] See Kroes (2006)

[18] Regulation (EC) No 1927/2006 of 20 December 2006, OJ L 406/1, 30.12.2006

compared with 2.6% in the US and 2.3% in the UK. A notable feature of this comparative performance has been the faster recovery of the US economy from the slowdown in 2001, when real GDP growth rate was as low as 0.8%, to as high as 4.2% in 2004 and 3.5% in 2005. In contrast to this, the economic slowdown was prolonged over a longer period of time in most euro area economies, as initial signs of recovery proved repeatedly illusory, although the 2006-2007 recovery seems more promising.

There were, however, some bright spots in this sombre picture. Economic developments in a number of small economies and also in one large economy, Spain, have been above the euro area average. For example, average annual growth rates of real GDP during 2001-2005 was 5.1% in Ireland, 4.2% in Greece, 3.1% in Spain and 2.2% in Finland. Even concerning the unemployment rate, an area where the general picture in the euro area is unsatisfactory, some member states, notably small to medium economies, succeeded in reducing unemployment to very low levels. Examples are Luxembourg, Austria, Ireland and the Netherlands where the unemployment rate was between 4.3%-5.5% of the labour force in 2005.

Fiscal adjustment has, also, been unequal among member states, combining cases of remarkable fiscal consolidation with others with persistently high deficits. For example, four euro area countries registered government budgetary positions in surplus or in balance in 2005[19] while five others are subject to the excessive deficit procedure[20].

In annex 2 are presented the main elements of the economic performance and economic policies in a number member states. This examination supplied a useful input in the analysis of the implications of the EMU framework for national economic policy and the identification of advantages and disadvantages of EMU for the design of economic policy at national level.

As was already noted in section 2 above, there was a strong recovery in the euro area in 2006 and prospects are good for its continuation over the short-term.

4.2. Implications of EMU for economic policy at national level

One of the consequences of joining EMU is the loss of the exchange rate as a policy instrument for individual member states. Also, policy interest rates are decided by the ECB's governing council for the whole euro area and, therefore, this policy instrument is not anymore at the disposal of national authorities.

Although these two issues are different in the sense that the interest rate instrument is not lost but delegated to the ECB, while the exchange rate is practically lost as a policy instrument even at the level of the euro area (as the formation of an exchange rate policy vis-à-vis third countries has become extremely cumbersome[21]) the fact is that neither instrument can be used by individual member states.

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[19] These were, Finland, Spain and Ireland with surpluses of 1.8%, 1.0% and 0.3% of GDP, respectively, and Belgium with balanced budgetary position.

[20] These countries are: France, Germany, Greece, Italy and Portugal

[21] According to Article 111 of the EC Treaty, agreements concerning exchange rate policy with non-Community countries may be concluded by the Council on a recommendation from the Commission and after consulting the ECB.

4.2.1. *The loss of the exchange rate instrument*

The loss of the possibility to devalue and regain lost competitiveness is generally considered as depriving EMU countries from an important policy instrument. A first step in evaluating the implications of this loss is to examine developments in international price competitiveness and export performance of member states which in the past made repeated recourse to devaluation in order to regain lost competitiveness and, on the other hand, of member states whose currencies had as a rule been revalued.

Italy, Greece, Spain and France are examples of economies whose currencies experienced devaluations in order to recover lost competitiveness and Germany the typical case of country with an appreciating currency.

It emerges form relevant studies (ECB, 2005) that in cumulative terms, since the start of the Stage three of EMU in January 1999, Germany has steadily gained export market shares, in contrast to the sizeable losses seen in Italy and, to a lesser extent, in France.

The ability of German firms to compete better in the area of capital intensive products, for which there is a strong demand from the EU New Member States and from many Asian economies together with moderate labour cost growth over this period, partly explain the positive export developments in Germany since 1998. In France, adverse non-price competitiveness factors, such as relatively subdued growth in R&D investment and specialization on consumer goods that may respond less to dynamic foreign demand, may have played an unfavourable role while, in fact, export price competitiveness has evolved rather similarly to that seen in Germany.

In the case of *Spain*, the lagged cumulative impact of deteriorating export price competitiveness since 2000 appears to mostly explain the recent losses in export market shares. In Italy, a clear correlation appears between losses of competitiveness and losses of export market shares. Although no detailed reference is made to Greece in the above study, available data (EC, Price and cost competitiveness, third quarter of 2006) indicate that losses of price competitiveness have been significant, though lower that those in Italy and Spain (concerning Spain, only as far as total economy indicator is concerned).

Table 2. Real effective exchange rate (unit labour costs) relative to IC34

	Total economy				**Manufacturing**			
	GR	**E**	**I**	**DE**	**GR**	**E**	**I**	**DE**
1999	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
2006 (Q3)	108.2	111.5	112.2	92.1	123.1	118.3	130.0	87.5

Source: EC, DG ECFIN, Price and cost competitiveness, third quarter of 2006

Although the loss of price competitiveness indicated in the above cases would suggest that the exchange rate instrument could have been used, in the absence of the euro, to restore competitiveness, there are important counter-arguments to this view:

(i) It is well known that devaluations are not sufficient, by themselves, to obtain lasting effects, unless accompanied by supporting measures, notably appropriate wage policy and structural reforms in order to contain costs and improve competitiveness of internationally traded goods and services. Therefore, the focus must, in any case, be on implementing the right policies in the first place and not on devaluations

(ii) Moreover, it is argued that a hard currency policy is beneficial in the long- term to the economy concerned, as it forces economic agents to contain costs and be more productive and innovative in order to preserve competitiveness and market shares[22]

(iii) Finally, an aspect which must be taken into account when discussing the potential use of the exchange rate instrument in the EU is the extent to which currency devaluations could be used within a framework of increasingly integrated economies of the EU. Even in the absence of the single currency, it would have been increasingly difficult to resort to currency devaluations. In fact, recourse to currency devaluations by members of the EU before the creation of the euro area was the source of tensions and acrimonious accusations about "competitive devaluations" which put at risk the very existence of the single European market.

The policy conclusion from the above analysis is that exchange rate changes are not a substitute for appropriate policies to contain production costs and improve international competitiveness. Probably more importantly, the loss of export market share in the case of some member states - that occurred also in periods where the exchange rate instrument was available- suggests that a more dynamic approach is necessary in enhancing competitiveness, involving the upgrading of education, research and human capital and differentiating the composition of exports. The implementation of the renewed Lisbon strategy would help advancing towards this direction.

4.2.2. The single monetary policy

The single monetary policy implies a uniform interest rate set by the ECB for the whole euro area. Market interest rates in individual member states may, of course, differ depending on local competitive conditions and the credit-worthiness of the borrower. However, it is true that in general interest rates in the euro area in recent years have been historically low (see Table 3), a development attributed both to global trends in interest rates but also to low inflation in the euro area and to the credibility of the ECB reflected in stable inflation expectations.

Table 3. Long-term interest rates (10-year Government Bond yields)

	1999	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Euro-area	4.7	5.4	5.0	4.9	4.1	4.1	3.4	3.9
USA	5.6	6.0	5.0	4.6	4.0	4.3	4.3	4.8
Japan	1.8	1.8	1.3	1.3	1.0	1.5	1.4	1.7
UK	5.0	5.3	5.0	4.9	4.6	4.9	4.5	4.5

Source: ECB and European Commission (DG ECFIN)

Regardless of the current level of interest rates in the euro area compared to those prevailing in the past and in other economic regions, there seem to exist two sources of costs for individual member states from the transfer of responsibility for interest rate decisions to the ECB (see Thygesen, 2003):

(i) ECB's interest rate may not correspond to the stabilisation needs of each member state due to lack of synchronisation of national macroeconomic variables, and

[22] This was, in particular, the prevailing view in Germany after the second world war and one of the pylons of the export-based German economic miracle.

(ii) Transmission mechanisms of monetary policy may be sufficiently different among member states to create divergence in macroeconomic performance even if the stabilisation challenges faced by the participants are broadly similar.

Available evidence suggests that ECB's monetary policy has been supportive of economic activity in individual member states. However, it is a different question (not addressed in this paper) whether the-one-size-fits all monetary policy has been optimal (see Honohan, 2005).

- Some analysts report evidence of a more synchronized economic cycle in EMU during the first years of its operation. For example, according to Hericourt (2005), monetary integration supported and strengthened business cycles and inflation convergence among the euro zone countries
- Other economists, however, argue that there is no conclusive evidence on increased business cycle synchronisation following EMU creation. Moreover, to the lack of synchronization, they add the worrying factor of growth differentials among EMU member countries, notably between Germany and Italy on the one (the weak) hand and several dynamic small member states on the other, with France being somewhere in-between (see, for example, Gros, 2006)
- In a recent review of the issue of cyclical synchronization within the euro area, the economists of DG ECFIN of the EC concluded that although measures of cyclical synchronisation have recently sent somewhat conflicting signals, the analysis suggests that member states' business cycles have remained closely aligned in the past few years[23]
- Hayo (2006), in his paper "Is European Monetary Policy Appropriate for the EMU Member Countries"[24] found that for almost all EMU member countries, with the exception of Germany[25], euro area interest rates tend to be below the national target interest rates, even after explicitly accounting for a lower real interest rate in the EMU period. He argued that the gain in terms of lower interest rates is a result of the high credibility imported by becoming a member of EMU
- Regarding Ireland and Finland, Honohan (2005) argued that Ireland's experience suggest little loss from the abandonment of an autonomous currency, while Salo (2006) reports that the general perception in Finland is that common monetary policy has been reasonably appropriate for the Finnish economy (see annex 2 for case studies of Ireland and Finland)
- In Austria, according to Gnan, Kwapil and Laderama (2005), both monetary conditions indices as well as Taylor rules suggest that the monetary conditions have turned more expansionary under EMU than in the four years preceding the start of EMU. Also inflation and real GDP growth in Austria and in the euro areas have become more closely synchronized

[23] "Cyclical synchronization within the euro area: what do recent data tell us?", DG ECFIN, Quarterly Report on the euro area, II/2006. The study found also that the dispersion of member states' output gaps has remained at historical lows, although some measures of business cycle correlation have pointed to a possible de-synchronisation in a few member states (Belgium, Greece, Finland and Spain) which, however, reflects temporary and minor shifts in cycles which are inevitable in EMU.

[24] Paper presented in the Workshop 'The Travails of the Eurozone", Heriot Watt University, March 2006. The methodology adopted by Hayo consists in estimating long run Taylor rules for the last 20 years before the formation of EMU and deriving long-run target rates which are employed in the simulation of counterfactual interest rate paths over the time period January 1999 to December 2004 and then compared to actual short-term interest rates in the euro area.

[25] Other research (ECB) concludes that ECB interest rates have been lower also compared to Bundesbank's.

- For a number of member states (Greece, Portugal and Spain) which experienced a sharp fall in interest rates due to their convergence with those prevailing in the rest of the euro area countries, there was a big increase in credit expansion and a boost in economic activity following interest rate convergence.

Policy conclusions: the relatively short period of the operation of EMU makes premature a definitive assessment of the implications for individual member states of the delegation of interest rate policy to the ECB. It is true, however, that some rather sizeable effects have been noted in a number of member states, notably in those countries where interest rate convergence was significant. These effects seem nevertheless to be of a transitory character (although the transition may last several years) and they created some delicate problems of adjustment. In general, ECB's nominal and real interest rates have been lower in most euro area countries compared to their probable level in the absence of EMU[26]. This suggests that the single monetary policy has been supportive to economic activity in the euro area.

Box B: How Independent is Monetary Policy in EU countries outside the euro area since its creation in 1999?

A criticism often addressed to EMU is that the "one-size-fits-all' monetary policy may not be appropriate for every single member state. Staying outside the euro area, the argument goes, countries could retain their independent monetary policy.

Regardless of the analytical and practical relevance of the argument, it is interesting to see whether EU member states outside the euro area follow, indeed, an independent monetary policy (the analysis here is limited to the three member states, DK, SW and the UK, which stayed outside the euro area from its creation in 1999).

It is interesting to note that Denmark, a country which enjoys an opt out clause regarding the adoption of the euro, is member of the exchange rate mechanism (ERM II) a fact implying that this member state has de facto pegged its exchange rate with the euro and its monetary policy decisions follow closely those of the ECB.

Sweden, although is not subject to an opt-out clause similar to those applying to Denmark and the UK, is not yet member of ERM II and follows a more independent monetary policy. However, even in the case of Sweden there is a strong correlation between ECB's and central bank of Sweden's monetary policy decisions. For example, between December 2005 and October 2006 both the ECB and the Riksbank raised their respective policy interest rates five times by 25 basis points each time (in four cases, ECB's decisions preceded those of the Riksbank and in one case, in March 2006, the Riksbank decision preceded that of the ECB by one day).

The UK, on the other hand, follows a more independent monetary policy while its exchange rate follows a free floating regime. However, even in the case of the UK, there was some "convergence" between the ECB and the bank of England in that the inflation target for the latter was modified in December 2003 to 2% (based on CPI inflation) instead of 2.5.% (based on PRIX inflation) previously.

With regard to both the loss of the exchange rate instrument and the transfer of the interest rate instrument to the ECB, we do not know enough about the dynamics of economic adjustment, which could be generated in the euro area as a whole and in individual member states[27] (some preliminary evidence of economic adjustment is presented in section 5

[26] This does not necessarily imply that interest rates have been optimal in each case.

[27] The dynamics of economic adjustment may be linked with the phenomenon of the endogeneity of optimum currency areas (see Tavlas, 2004).

below). As a consequence, we can make the rather uncontroversial assumption that the loss of the exchange rate instrument and the delegation of the interest rate instrument to the ECB would entail some limitation of available policy instruments at national level. Such limitation will have to be addressed by appropriate adaptations and enhanced effectiveness of remaining policy instruments at the disposal of national governments

Euro area's single monetary policy, despite the criticisms it is receiving, it is popular enough (or influential enough) so that other monetary authorities in the EU follow ECB's monetary policy decisions or at least co-ordinate their monetary policies with that of the ECB. Box B provides some evidence of this.

4.3. Fiscal Policy: adjustment, stabilization and growth

In contrast to the exchange rate and monetary policy aspects of EMU analysed above, fiscal policy remains at the core of member states' competences, subject of course to common EU fiscal rules. The objective of EU's budgetary rules is that member states achieve fiscal positions close to balance or in surplus and let automatic stabilisers play freely over the economic cycle.

There is significant convergence of views of academics and policymakers that fiscal policy is more effective, and much less subject to adverse side-effects, through the operation of automatic stabilizers, as opposed to discretionary fiscal policy[28]. Given the large tax and benefit systems in Europe, relying mainly on automatic stabilization would allow a relatively high degree of cyclical smoothing, while avoiding pitfalls of fiscal activism (see Buti and van den Noord, 2004)

As common EU fiscal rules concern the government balance and debt as percentage of GDP and do not enter into issues referring to the size of the public sector or to expenditure policy and the tax system[29], there is a wide scope for national policies in the area of fiscal policy.

- Indeed, an important challenge for member states is how to achieve an optimal use of fiscal policy in the EMU environment. One direction of reflection is the functioning of automatic stabilisers and how it can be improved. For example, there are demand and supply side aspects of automatic stabilisers, which should be examined in each case.
- Also, consideration should be given to assessing specific fiscal instruments on the basis of a number of criteria e.g. maximizing the effect on activity, minimizing lags and contributing to the attainment of wider policy objective such as efficiency and equity.[30]

As government expenditure accounts for 47% of GDP, on average, in the euro area, it is evident the importance of the optimal use of this huge amount of resources for enhancing productivity and competitiveness of euro area economies. The need for an optimal use of public funds is even more pressing if account is taken of the requirement to respect Community fiscal rules and, also, the limited margin to raise tax rates in an environment of integrated markets and international tax competition. For example, the key objective of the Lisbon Strategy of allocating more budgetary resources to innovation and research and

[28] Typical pitfalls of discretionary fiscal policy are model uncertainty, risks of pro-cyclical behaviour due to implementation delays and irreversibility of spending decisions.

[29] Except in areas where there are commonly agreed Community rules as, for example, those concerning VAT rates.

[30] See "Fiscal stabilization and EMU, a discussion paper, HM Treasury, 2003.

upgrading the education systems requires that public finances are reformed so that adequate resources become available for these purposes.

Ensuring the long-term sustainability and enhancing the quality of public finances are important steps in the effort towards both fiscal consolidation and the optimal use of budgetary resources. The focus on long-term fiscal sustainability is justified by the reality of population ageing and the needed reforms in order to avoid shifting on future generations of the budgetary burden arising from the support of the social security system. Attention on the quality of public finances emerged from the necessity to extract maximum benefit from alternative uses of funds out of limited budgetary resources. Quality covers both expenditure and revenue, but the focus here is on government expenditure, as the analysis of the revenue side would require a thorough review of tax systems and tax policy which lies beyond the scope of the paper.

In the following paragraphs the issues of budgetary adjustment, long-term sustainability and quality of public finances are examined in more detail, focusing in particular on Greece.

4.3.1. Fiscal adjustment in member states and the euro area

Fiscal adjustment in the euro area since the start of the Third Stage of EMU is generally considered as inadequate in terms of the requirements of the treaty and the stability and growth pact and the policy objectives set at Community and national level[31]. In 2006, the euro area budget deficit, estimated at 2% of GDP, remained at a higher level compared to 1999 (1.3% of GDP), the year the monetary union commenced. The euro area primary balance has actually deteriorated by about 2 percentage points of GDP since 1999, while the primary expenditure ratio is broadly unchanged over this period[32]. The decline in the euro area debt ratio has been minimal, to 69.4% of GDP in 2006 from 71.8% in 1999.

- The budgetary stance of the euro area as a whole since the start of the Third Stage of EMU was largely determined by fiscal developments in large countries. There was, indeed, a significant deterioration in the fiscal position in Germany, France and Italy in the period under review which resulted in the general government deficits exceeding the 3% of GDP threshold and the activation of the excessive deficit procedure against the countries concerned.[33] There was also in the same period a significant deterioration in the cyclically undusted fiscal position in Germany and Italy and a less important deterioration in France.
- In contrast to the situation in large countries, several smaller countries managed to reach balanced budgetary positions and even budgetary surpluses: For example, Belgium reached budgetary equilibrium in 2000 (even a small surplus of 0.1% of GDP), Austria in 2001 and Spain in 2003, while Ireland and Finland registered budgetary surpluses already in 1997 and 1998 respectively. These member states were then in a position to let fiscal stabilizers work, mitigating thus the effects of the prolonged economic slowdown after 2000, without breaching the 3% deficit threshold.

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[31] It is recalled that the 1999 Broad Economic Policy Guidelines of the EU Council recommended that Member States achieve budgetary positions of close to balance or in surplus no later than by the end of 2002.

[32] This points to the fact that the "premium" of declining interest payments in recent years has been "spent" on tax cuts rather than fiscal consolidation.

[33] Under the excessive deficit procedure have also been placed Greece and Portugal as well as other five EU member states, not members of the euro area (situation in December 2006).

- Among smaller countries, significant was the deterioration of the fiscal position in Portugal, from 2.8% of GDP in 1999 to an estimated 4.6% of GDP in 2006. In cyclically adjusted terms the deterioration of the fiscal position was limited, from 3.5% of GDP in 1999 to 3.7% in 2006 after having reached a peak of 5.1% of GDP in 2005.

4.3.2. Fiscal adjustment in Greece

As was the case with the rest of EU member states willing to form an economic and monetary union by the end of the 1990s, Greece mobilized all energies in order to comply with the convergence criteria and qualify for euro area membership. Although not among the first wave of countries which participated in the euro area from 1.1.1999, Greece managed to join the rest two years later, on 1st January 2001. That was an undeniable success, given the "distance" Greece had to cover in order to fulfill the convergence criteria and the difficulties involved - for example risks of speculative attack on the currency in the last critical months - inherent in such a "single-country" convergence effort[34].

As was seen above, following euro area membership there was a relaxation, at a varying degree, of fiscal adjustment effort in several EU member states, as there was a sort of "fiscal fatigue" after the intensive consolidation effort to meet the Maastricht fiscal criteria. However, the relaxation was relatively more pronounced in Greece if account is taken of the robust GDP growth rates compared to weak economic activity in most euro area members and its implications more serious than elsewhere, given the very high government debt and the elevated debt servicing costs as percent of GDP.

Since the start of this decade, there was in Greece a small improvement in the nominal deficit, which passed from 3.4% of GDP in 1999 to an estimated 2.6% of GDP in 2006, after having peaked at 7.8% of GDP in 2004. However, the cyclically adjusted deficit -- which measures changes in the fiscal stance -- marked a clear deterioration, rising from 1.3% of GDP in 1999 to an estimated 3.3% of GDP in 2006. Moreover, the relaxation of Greece's fiscal adjustment effort was accompanied by frequent and extensive revisions of the general government data in recent years involving significant increases in the deficit and debt figures as percent of GDP[35].

Concerning Greece's fiscal adjustment strategy, available data indicate that the savings from the decline in interest expenditure, by almost 4 percentage points of GDP between 1999 and 2006, were mainly "absorbed" by a reduction of total revenue as percent of GDP (by 3.8 points) with limited contribution to the reduction of the government deficit ratio (which was reduced only by 0.8% of GDP between 1999 and 2006). The primary balance (i.e. general government balance excluding interest payments) is estimated to having returned to a surplus of 2% of GDP in 2006, after recording primary deficits during 2003-2005. It is clear that a sustained fiscal consolidation and debt reduction strategy should rely on a high enough primary surplus in the years to come. It should be noted in this respect that the total revenue ratio is quite low in Greece (41.6% of GDP in 2005) compared with the euro area average (45.1% of GDP). Taking into account that the average tax rates in

[34] See T.Papaspyrou (2004) "EMU strategies: lessons from past experience in view of EU enlargement".

[35] For details see "Fiscal data revisions and fiscal developments" in Bank of Greece, Interim Monetary Policy Report, October 2004.

Greece are, overall, above the euro area average, it ensues that there is in Greece a serious problem of tax evasion that needs to be tackled[36].

Table 4. General Government debt (as % of GDP)

	1995	1999	2000	2001	2002	2003	2004	2005
Greece	108.7	112.3	111.6	113.2	110.7	107.8	108.5	107.5
Belgium	129.7	113.6	107. 7	106.3	103.2	98.5	94.7	93.3
Italy	121.2	113.7	109.7	108.7	105.5	104.2	103.8	106.4
Ireland	81.0	48.1	37.8	35.3	32.1	31.1	29.4	27.6

Source: European Economy, Statistical Annex, autumn 2006

Probably a clearer picture, than looking at the budget deficits[37], of the fiscal adjustment effort in Greece can be obtained by examining government debt ratio figures since the start of the Third Stage of EMU, in comparison with those of three other high-debt euro area members: Ireland, Belgium and Italy.

It emerges from Table 4 that in Greece the government debt ratio registered a modest decline by less than 5 percentage points between 1999 and 2005 to a still very high figure of 107.5% at the end of 2005[38]. During the same period Ireland managed to reduce its government debt ratio by 20.5 percentage points from 48.1% of GDP to 27.5% of GDP[39]. Even more remarkable was the decline in the debt ratio in Belgium, by about 20 percentage points (from 113.6% of GDP in 1999 to 93.3% in 2005), taking into account the

[36] The general government total revenue ratio in Greece would fall even further on the basis of the revised national accounts data.

[37] According to the latest data confirmed by Eurostat in autumn 2006, the general government deficit in Greece was 5.2% of GDP in 2005, 7.8% in 2004, 6.1% in 2003 and 5.2% in 2002. In principle, the annual data for government deficits/surpluses must be reflected in the outstanding amount of government debt. However, according to established statistical rules, certain operations are registered directly in the government debt (either increasing or decreasing the debt) without passing through the government balance. In certain cases (e.g. privatization revenue) the result of the operations are correctly, according to Eurostat rules, recorded directly in the debt figures (i.e. decreasing the debt ratio) without affecting the government balance. However, certain operations may be incorrectly recorded directly in the debt and not, also, in the government balance. This implies an adjustment in the accounts once the Eurostat corrects the records. Eurostat has become more vigilant in recent years and phenomena of incorrect recordings are less numerous. However, creative accounting by Member States seems to be still alive (see, for example, an interview of Commissioner Almunia, in the Financial Times of 6 October 2005).

[38] In September 2006, the Ministry of Economy and Finance announced that the National Statistical Service of Greece proceeded, according to EU rules, to a revision of national accounts data and a change in the base year to 2000. The revision, which amounts to an upward adjustment of the GDP of the order of 25%, will imply a significant downward adjustment of the government deficit and debt ratios (bringing government debt down to around 85% of GDP - it should be noted that until the revised data are validated by Eurostat, EU multilateral and budgetary surveillance will be effected on the basis of the unrevised data). However, the argument about the limited budgetary adjustment remains valid, as the government debt ratio, although lower by more than twenty percentage points of GDP with the revised data, would be little changed in the period 1995-2005, on the plausible assumption that the size of GDP revision in the period 1995-1999 would be similar to that in 2000-2005 (if anything, the reduction of the debt ratio between 2000 and 2005 is smaller with the revised data (3.4 percentage points, compared to 4.1 pp with the unrevised data).

[39] More impressive was the reduction of the government debt ratio in Ireland between 1995 and 2000, by about 43 percentage points, a performance made possible by the double digit GDP growth rates in Ireland in the 1990s. The contrast with the very limited reduction of government debt ratio in Greece in the same period is sharp: in ten years, the Greek government debt ratio declined by only one percentage point, although this summary performance conceals a reduction by about two percentage points between 1997 and 1999 (which allowed euro area qualification), a deterioration in 2001 and a rather slow decline thereafter.

rather modest GDP growth rates in that country[40]. In annex 2 the main ingredients of Belgium's successful fiscal consolidation and debt reduction strategy are examined. The essence of Belgium's strategy was coherent fiscal consolidation and debt reduction policies based on strict expenditure rules and supported by well-designed and functioning institutions.

It should be noted that recent estimates and forecasts[41] point to a faster decline in Greece's government debt ratio in 2006 to 104.1% of GDP and further, to 91.3% of GDP, in 2009 (see also below projections of the updated stability programme of Greece, 2006-2009).

An area where considerable progress was made in Greece, over the last ten years, concerns the management of government debt which resulted in reduced borrowing costs for the state.

The above analysis shows that fiscal adjustment and the long-term sustainability of public finances must be key policy priorities in Greece. The following subsection examines key aspects of this issue, notably those linked to Community rules and the reformed Stability and Growth Pact. A related issue is the quality of public finances, which is linked both to fiscal adjustment and sustainability and to the overall competitiveness of the economy.

4.3.3. Budgetary adjustment in the updated stability programme of Greece

(i) Updated stability and growth[42] programme, 2005-2008

In the updated stability programme of Greece, 2005-2008, the deficit of the general government sector is projected to decline to 1.7% of GDP in 2008 from an estimated deficit of 5.2% of GDP in 2005, while the government debt ratio is projected to fall by more than 10 percentage points, from an estimated 107.9% of GDP in 2005 to 96.8% of GDP in 2008. The main projections of the updated programme are included in Table 5.

Table 5. Greece: projections of the stability and growth programme, 2005-2008

% of GDP	Projection	2004	2005	2006	2007	2008	2009
Real GDP (% change)	Dec 2005	4.7	3.6	3.8	3.8	4.0	
	Dec 2006		3.7	4.0	3.9	4.0	4.1
General Govt Balance	Dec 2005	-6.6	-4.3	-2.6	-2.3	-1.7	
	Dec 2006		-5.2	-2.6	-2.4	-1.8	-1.2
Cyclically adjusted GGB	Dec 2005	-7.8	-5.5	-4.4	-3.5	-3.0	
	Dec 2006		-5.6	-3.4	-2.7	-2.2	-1.6
GG Primary balance	Dec 2005	-0.9	0.9	2.3	2.4	2.8	
	Dec 2006		-0.4	2.0	2.0	2.4	2.9
General Govt Debt	Dec 2005	109.3	109.3	107.9	104.8	101.1	96.8
	Dec 2006		107.5	104.1	100.1	95.9	91.3

Source: Ministry of Economy and Finance, December 2005 and December 2006.

[40] It is noted that in 1995, Belgium was the country with the highest government debt ratio in the EU: 129.7% of GDP, followed by Italy, 121.2% of GDP and Greece, 108.7% of GDP.

[41] European Commission, autumn 2006 economic forecasts.

[42] According to the relevant EU Council Regulation, Member States having adopted the euro must submit stability programmes, updated annually. Greece decided to name these programmes as "stability and growth programmes". Although this initiative may have some justification in that it corresponds to the Stability and Growth Pact, it represents an innovation that the Commission has chosen not to contest.

In its Opinion of 24 march 2006 on the Greek stability programme, the ECOFIN Council *"welcomed the efforts undertaken so far and the priority given by the government to a permanent reduction of the deficit and noted that, overall, the programme is consistent with the correction of the excessive deficit by 2006"*, but added *"subject to a full implementation of the envisaged adjustment and conditional on the effects on the planned deficits of possible further statistical revisions of budgetary data"*.

This qualified approval implies both that the programme must be applied rigorously and, also, that even better results than the projected ones should be sought as a margin for unfavourable statistical adjustments. In regard to the excessive deficit procedure, the Council invited Greece to *"implement the necessary permanent measures leading to the correction of the excessive deficit by 2006 at the latest"*.

Box C: procedures for the abrogation of the excessive deficit in Greece

The procedures for the abrogation by the Council of its decision on the existence of excessive deficits (ED) have become more rigorous following cases, in the past, of sharp deterioration of budgetary situations shortly after the ED situation had been abrogated and, also, following the provisions of the reformed Pact which give more weight on the sustainability issue.

In the case of Greece the ED situation must (see Council decision above) be corrected by 2006 at the latest. This implies that the Commission will be in a position to verify whether the ED has been corrected in April 2007, on the basis of Eurostat's validation of data reported by member states in the context of ED procedures.

Assuming that the data for 2006 indicate that the government deficit in Greece does not exceed 3% of GDP, the decisive element for a Commission recommendation for the abrogation of the ED decision will be the Commission forecasts of May 2007 concerning government deficits for 2007 and beyond. Commission's budgetary forecasts will take into account, among other elements, the Greek budget for 2007 and measures supportive of the budget projections.

It is recalled in this respect that the Report of the Council of March 2005 on "Improving the implementation of the SGP" (which is an integral part of the reformed SGP) makes specific reference to the importance of Commission forecasts in assessing the reliability of macroeconomic and budgetary projections of stability programmes.

(ii) Updated stability and growth programme 2006-2009

On 22 December 2006 the Minister of Economy and Finance presented the updated Stability and Growth Programme of Greece 2006-2009. The programme was based on upwardly revised general government data for 2005 (to 5.2% of GDP instead of 4.3% of GDP in the 2005-2008 update of the stability programme) but kept unchanged the estimated deficit for 2006 at 2.6% of GDP (see Table 5).

In its Opinion of 27.2.2007 on the updated stability programme the Council shifts the focus from short-term fiscal adjustment to more medium to long-term fiscal sustainability: "….*in view of the very high level of debt and the projected increase in age-related expenditure*", Greece is invited to "…*improve the long-term sustainability of public finances by achieving the Medium Term Objective, controlling public pension and healthcare expenditure and resolutely implementing ambitious reforms*".

4.3.4. Fiscal adjustment in the light of new SGP rules

Regarding fiscal adjustment, Community rules have set the broad framework for action in order to comply with the requirement to avoid excessive government deficits and, further, to achieve -- over the cycle -- a fiscal position close to balance or in surplus.

Key issues concerning fiscal adjustment are the pace at which the government deficit will be reduced, and finally eliminated, and the fiscal adjustment strategy, i.e. how the elimination of the deficit (and reduction of government debt) will be achieved. Another important issue is how to ensure that fiscal adjustment programmes, once agreed, will be effectively implemented.

We have seen, in section 3 above, that the EU has reviewed and tightened its surveillance of economic and budgetary issues and invited member states to collaborate in that effort by improving their own internal procedures and economic governance. The existence of appropriate rules, procedures and institutions at national level will ensure the respect of the agreed fiscal adjustment programmes and contribute also to improving the quality of public finances, an issue analysed below. Regarding fiscal adjustment, Community rules have set the broad framework for action in order to comply with the requirement to avoid excessive deficits and, further, to achieve over the cycle a fiscal position close to balance or in surplus. We have seen above that the reformed Stability and Growth Pact (Pact) takes more into account the economic situation and prospects of a member state and its reform programme in order to determine the objective to be attained and the pace of the adjustment effort.

Specifically, the elements of the reformed Pact most directly concerning high debt countries which are also subject to the excessive deficit procedure[43] include:

- A minimum fiscal adjustment effort of 0.5% of GDP per year in the cyclically-adjusted balance is required for member states which are subject to the excessive deficit procedure (EDP), i.e, those with general government deficit above 3% of GDP. This minimum effort must not include temporary or one-off measures.
- Particular attention will be paid by the Council to reducing government debt ratio at a satisfactory pace, thereby contributing to the long-term sustainability of public finances. For countries above the reference value of 60% of GDP, the Council shall formulate recommendations on the debt dynamics in its opinions on the stability and convergence programmes. In practice, this means that situations of declining deficits and inadequately declining (and, more so, rising) debt ratios will not be acceptable, unless adequate justification is provided.
- Another important aspect concerns the deadlines for the correction of an excessive deficit. The reformed Pact gives the possibility to extend the period to two years, compared to one year before the revision. In case of special circumstances, the initial deadline for correcting an excessive deficit would be set, as a rule, one year later, i.e. the second year after its identification and thus normally the third year after its occurrence.
- Following cases of significant revision of budgetary data in recent years, statistical surveillance of fiscal data has been enhanced both by strengthening the monitoring role of the Eurostat and by efforts to upgrade the professional competence and scientific independence of national statistical services. Although the efficacy of the new changes will have to be tested in the length of time, it is clear that a closer look at budgetary data will be paid in the future by Commission services.

[43] For example, Greece and Italy among euro area countries fall currently (Dec 2006) into that category.

Implicit liabilities (related to increasing expenditures in the light of ageing populations) should be taken into account, as soon as criteria and modalities for doing so are appropriately established and agreed by the Council. Available experience indicates that realistic economic and budgetary objectives, expenditure rules and appropriate fiscal institutions are decisive elements of effective economic governance at national level.

4.3.5. Long-term sustainability of public finances

The long-term sustainability of public finances usually requires, in addition to short term fiscal adjustment, structural reforms with lasting effects on public finances. Fiscal sustainability is of particular importance for Greece given its high fiscal deficits and the very high government debt ratio, taking also into account demographic trends and the budgetary cost of pension and health care systems. The Ecofin Council, the European Commission as well as international institutions such the IMF and the OECD, have underlined the need for action in order to ensure the sustainability of the public finances in Greece.

The Ecofin, in its opinion, of 14 March 2006 on the updated stability programme of Greece 2005-2008[44] was noting that *"…with regard to the sustainability of public finances, Greece appears to be at high risk on grounds of the projected costs of ageing populations. The debt ratio is currently the highest in the EU, and is projected to remain at very high levels throughout the projection period up to 2050. It is therefore necessary to implement rigorously the planned consolidation of public finances over the medium-term and to further strengthen the budgetary position in order to reduce risks to public finance sustainability. At the same time, the projected increase of government expenditure, notably on pensions, over the projection period is expected to put a high burden on public finances"* concluding that "*Greece should control public pension expenditure and resolutely implement the approved pension reforms and carry out structural reform to ensure the long term sustainability of public finances*".

Similar remarks with regard to long-term sustainability of public finances were included in Commission's assessment of Greece National Reform Programme[45] and in its report on "The long-term sustainability of public finances in the European Union" (October 2006)[46].

Monitoring the likely trends of public finances is of paramount importance to preventing the burden of public debt from becoming unsustainable. It should be noted in this respect that fiscal surveillance of long-term sustainability entails a high degree of uncertainty as the results may differ according to assumptions on future trends of demographic developments (mainly growth conditions) and budgetary development of age-related expenditures. Also,

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[44] OJ C 82 p. 1, 5.4.2006.

[45] The European Commission, in its assessment of Greece's National Reform Programme, dated 25.1.2006, noted that "*….Greece did not present a comprehensive strategy for reforming the pension system to improve adequacy and sustainability"*, and further, that, "*except for in the banking sector, the National Reform Programme important measures -- such as reforms of early retirement, reform of pay-as you-go system or the development of the second pillar --, are postponed to a future social agreement, with an imprecise calendar*". Similar remarks were included in Council's opinion on Greece's Stability and Growth Programme.

[46] The report, referring to Greece, notes: "*although projections for pension expenditure are not available for Greece in the 2006 Ageing Report, according to the latest available information from the 2002 updated Greek stability programme, a significant increase in pension expenditure as a share of GDP is projected over the long-term", and concludes: "…Overall, Greece appears to be at high risk with regard to the sustainability of public finances".*

sustainability depends on the impact of structural reforms that may affect either the potential growth rate or the budgetary profile of certain expenditure categories.

In the reformed Stability and Growth Pact, sustainability is at the core of budgetary surveillance. References to sustainability exist in several provisions of the Pact:

(i) in the requirement that a Council opinion on sustainability is formulated on the annual update of the stability or convergence programmes,

(ii) the definition of the medium-term objective for a member State budgetary position will take account of the Commission and Council assessment on the sustainability risks,

(iii) if a member state introduces major reforms that have direct long-term budgetary saving, for example a reform of the pension system, then a deviation from the medium-term objective or the adjustment path toward it may be allowed,

(iv) in applying the excessive deficit procedure, the net cost of pension reforms that introduces a mandatory fully-funded pillar will be considered carefully, as such reforms involve a short-term budgetary cost while the long-term impact is positive, and

(v) there will be increased focus on the debt criterion set down in the Treaty. In particular, Member States with high debt-to-GDP ratios should make greater efforts to reduce them rapidly, thus contributing to the sustainability of the public finances.

It should be noted that the long-term sustainability of public finances is not only a matter of budgetary discipline, which is of course indispensable, but also a matter of economic and employment growth. This is the reason why any credible strategy in this regard must incorporate policies dealing with fiscal, financial, employment, health care and pension systems. It is useful to look at ways member states have tackled this important and sensitive issue. There are several interesting and pragmatic solutions, both institutional (e,g, the Ageing Fund introduced in Belgium, see annex 2) as well as operational ones.

According to the European Commission, while the budgetary impact of ageing populations is a concern for all EU Member States, the EU aggregates mask considerable variety. There is a large variation across the EU in the degree of risks and where they mainly come from. Overall among the 25 Member States of the EU six countries are assessed to be at high risk, ten at medium risk and nine at low risk, which overall confirms the assessments of the stability and convergence programmes carried out in the early months of 2006. The main characteristics of the sustainability challenges they face can be summarized as follows: The high risk group of countries which comprises two euro area members, Greece and Portugal as well as Czech Republic, Cyprus and Hungary, is characterized by a very significant rise in age-related expenditure over the long-term, underlining that measures aimed at curbing them will prove strictly necessary. Moreover the Czech Republic, Greece, Cyprus, Hungary and Portugal have large deficits and some of them also a high level of debt, in particular in Greece. Budgetary consolidation is as well necessary and urgent in order for these countries to reduce risks to public finance sustainability.

4.3.6. The quality of public finances

In recent years, in support of budgetary adjustment and fiscal sustainability, the concept of "quality of public finances" has gained in importance in the economic policy debate, at national and EU levels, on how fiscal policy can contribute to more growth and employment[47].

The huge amount of economic resources absorbed and managed by the public sector gives a measure of the difference an improved quality in public finances would make for the overall performance of the economy. In Greece, the problem is more acute, as the quality of public finances is, according to all available evidence, far from satisfactory[48]. As a consequence, it can be safely argued that the outcome of the competitiveness game for Greece would depend to a large extent on improving the situation in this area[49].

Generally accepted definitions of quality of public finances are not available. A broad concept of quality would include the allocation of resources and the efficient and effective use of those resources in relation to identified strategic priorities. The Lisbon Strategy defines sustainable growth, full employment, social cohesion and competitiveness, as strategic priorities.

In recent years, a number of reports have been prepared by EU institutions in connection to the quality of public finances. In European Commission's reports on "Public Finances in EMU" in 2004 and in 2005, analytical, methodological and policy aspects of the issue of the quality of public finances were examined. The methodology adopted by Commission's reports is to examine the link between the composition of public expenditure and revenue and long-term growth.

It emerged from reports and case studies that those countries that have been at the forefront of institutional reform, by introducing national expenditure rules and performance budgeting schemes within a medium-term framework, have better managed to redirect public spending towards their national expenditure priorities and to protect these targeted items during periods of fiscal consolidation. Therefore, appropriate and effective budgetary institutions appear to be a key factor in facilitating the implementation of medium-term policy objectives, which are relevant not only for raising the quality of public budgets but also for helping maintain fiscal discipline.

Several Member States have introduced medium-term frameworks for expenditure control and reforms to the budgetary process that aim at achieving priorities in the most efficient and effective way by linking public expenditure to policy outcomes (performance budgeting). The analysis shows that, in countries with more effective control of public expenditure, fiscal consolidation in the run-up to EMU has been mainly based on containing expenditure, rather than on raising revenues, thereby contributing to a better long-run growth performance. Overall, this analysis implies that the allocation of resources and the monitoring of action undertaken to pursue identified priorities should have a greater role in the analysis and conduct of fiscal policy[50].

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[47] However, while the EU fiscal framework lays down the principles and procedures for achieving fiscal sustainability, the principles for improving the quality of public finances have not yet been integrated in a systematic way within the framework of EU policies.

[48] For example, according to the 2005 World Competitiveness Report, issued by the World Economic Forum, that weak area of Greece's overall competitiveness picture is the public sector as enterprises face difficulties related to bureaucracy, tax regulation, labour market legislation and corruption. Greece's comparative ranking was 51, among 104 countries, regarding the Global Competitiveness Index and 37, regarding Growth Competitiveness Index. The ranking regarding sub-indexes of the latter was as follows: 38, Technology Index, 44, Public Institutions Index and 31, Macroeconomic Environment Index.

[49] The IMF (2006) argues that strengthening international competitiveness will require further reforms to product and labour markets, including by improving public administration.

[50] A proper design and implementation of medium-term expenditure frameworks and progress in cost-benefit analysis and performance budgeting would help to improve both the control and allocation of existing funds.

In 2005, the issue of quality of public finances found its place in two policy documents of the Council: Ecofin's report to the March 2005 European Council on "Improving the implementation of the Stability and Growth Pact" includes specific references to the overall quality of public finances and the implementation of policies in the context of the Lisbon agenda, as elements to be taken into account when assessing budgetary developments in the EU.

Also, in the Broad Economic Policy Guidelines (BEPGs) 2005-2008, Member States are asked to direct the composition of public spending towards growth-enhancing items, adapt tax structures to strengthen growth potential and assess properly the relationship between public spending and the achievement of policy objectives.

The European Council, in March 2006, underlined the need *"to further improve the efficiency and effectiveness of public spending and taxes in order to enhance the quality of public finances and foster growth and employment enhancing activities…"*[51].

More recently, in October 2006, the Ecofin in its conclusions on a report by the European Commission and the Economic Policy Committee underlined the important role that national fiscal rules and institutions can play in the attainment of sound budgetary positions and invited member states to provide relevant information on their national fiscal frameworks in the forthcoming stability and convergence programmes. The Ecofin invited also the Commission to develop further in co-operation with the Economic and Financial Committee and the Economic Policy Committee its analysis of the quality of public finances, including the efficiency and composition of public expenditure, and to provide an overview of the implementation of the existing rules based on the 2007 updates of the stability and convergence programmes.

4.4. Structural policies – implementing the Lisbon Agenda

4.4.1. The role of structural reforms as a policy instrument

Structural policies, together with fiscal policy, are the main policy instruments in the hands of national authorities in the EMU environment. Structural reforms, in particular, are

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A starting point focuses on the link between fiscal policy and long-term growth, notably by examining the composition of expenditure and revenue and long-term growth. The major difficulties that empirical studies have encountered concern the distinction between "productive" and "unproductive" expenditure. Although there is a certain degree of agreement that a few categories of public expenditure can quite safely be included among "productive" public expenditure because they are directly aimed at productivity improvements (e.g. R&D, education and infrastructure investment) there is no consensus among researchers concerning the impact of most expenditure items on long-term growth and its timing. This lack of consensus is reflected by the fact that available estimates of "productive" expenditure in the EU range between 5% and 44% of total public expenditure In the light of these difficulties, the analysis of the composition of public expenditure across EU countries focuses on what the changes in the compositions have been and what factors drive these changes. Generally, over the last decade social protection and health care expenditure increased their share in total expenditure, while total expenditure expressed as a share of GDP has gone down. This suggests that the main drivers of expenditure re-composition over the medium-long term are related to underlying upward pressures such as those resulting from ageing and that any framework for the definition of strategic expenditure priorities must take such long-term trends into account.

[51] In December 2005, the EU Economic Policy Committee in a report to the Ecofin Council analysed the links between public finances and long-term growth, focusing on the expenditure side of the subject, dealing in particular with three aspects: a) investigating the role of budgetary institutions in identifying the implementing expenditure priorities, b) analysing and monitoring trends in the composition of public expenditure, and c) measuring the efficiency of public expenditure.

important in facilitating adjustment -- also by increasing the effectiveness of the single monetary policy -- and enhancing economic efficiency and performance.

- Structural policies contain the most powerful policy tools for addressing and preventing problems that may arise in a currency area, as well as individual countries and regions, because they can influence the speed with which market forces can operate and provide lasting adjustment after an economic shock. In this regard, two mechanisms are particularly relevant to the euro area economy: the mobility of factors of production and the flexibility of price and wage setting. Either of these mechanisms would need to react in order to achieve a sustainable adjustment to economic disturbances (seeTrichet, 2005).
- At the Lisbon council the EU has launched its comprehensive strategy of reforms as an important precondition to become the most competitive and dynamic knowledge based economy in the world. To reach this goal, the Lisbon strategy put heavy weight on structural reforms, notably on product, labour and financial markets in the EU member states. The introduction of EMU has likely reinforced the need of structural reforms, as monetary policy or nominal exchange rate adjustments are no longer available for individual countries to respond to asymmetric shocks. Due to trade integration for example, specialization patterns of the member states may have become more important, implying that the probability for asymmetric shocks could increase. In the absence of substantial migration flows into the prosperous regions, appropriate reforms could strengthen market-based adjustment processes. Restrictions on the use of fiscal policy constrain the use of this instrument unless a country starts from a position of a budget surplus (see Dreger, 2007).

Structural reforms concern all areas of public policy. For example, measures to enhance the long-term sustainability of public finances examined in the previous section have a structural character. We have seen that structural reforms are taken explicitly into account in the reformed stability and growth pact, in the assessment of fiscal adjustment and the sustainability of public finances.

4.4.2. Progress in implementing the Lisbon Agenda

<u>(i) At the EU level</u>

The latest European Commission annual assessment[52] of National Reform Programmes arrived to the following summary conclusions:

- Progress over the last year has in general been good towards boosting R&D and innovation, improving regulation and enhancing the business environment, especially for SMEs
- Weak competition in many markets, especially in network services including energy, continues to hold Europe back.
- In labour markets, measures have been taken. Employment is up and unemployment down. The growing consensus in favour of the "flexicurity" approach to labour market reform is a very positive development. But it has yet to be fully translated into action. The EU is not moving fast enough to tackle the twin problems of inflexible labour markets that hold back competitiveness and of the "segmentation" between workers on permanent contracts with high employment protection and those working on fixed-term contracts, with little or no security or chance of obtaining it.

[52] European Commission: "Working for growth and jobs – A year of delivery", 12 December 2006.

Box D: Reform of product markets: focus on competition and innovation

Product (and services) market reforms are directly related to the single market and European integration. The reason why the issue of competition deserves particular attention is because its impact on productivity and competitiveness is significant: both theoretical work and practical evidence indicate that competition is fundamental for innovation and productivity growth. There are analysts who even argue that product market reforms which create conditions of free competition are the most important. For example, William W. Lewis (2004) in his book "The power of productivity" argues that

"Undistorted competition in the product market makes economies healthy. That's why product market distortions are much more important than labour. Most economic analysis ends up attributing most of the differences in economic performance to differences in labor and capital markets. This conclusion is incorrect. Differences in competition in product markets are much more important. Policies governing competition in the product markets are as important as macroeconomic policies".

Although the above view about the overwhelming importance of product market reform and competition may seem too strong, it is recalled (see section 3, above, and annex 1) that free competition lies at the foundation of the Internal Market and product market reforms have been a pillar of economic policy in the EU. Starting with the removal of trade barriers between 1958 and 1968, measures to open up markets to competition have been pursued with the implementation of the Single Market Programme by the end of 1992 and today product market reforms remain a key element of the Lisbon Strategy and the Broad Guidelines of Economic Policy.

In a study on product market reform and productivity, G.Nicodeme and J-B. Sauner-Leroy[53] found that although product market reforms may have a direct impact on the cost of doing business, most of their effects actually translate into productivity increases through three transmission channels which depend heavily on the competition effects that product market reforms unleash by means of opening up markets to domestic and foreign competitors, removing hurdles to business activities and leveling the playing field among businesses. Competition immediately puts pressure on the economic rents and creates incentives to companies to both reallocate (allocative efficiency) and use (productive efficiency) their resources in the most efficient way. Those changes that are internal to the firm drive capital and labour productivity increases. In addition, competition plays an essential role in enhancing dynamic efficiency through creative destruction. Although the relationship is of non-linear nature and depends on the type of the industries and on the technological gap, competition generally forces competitors to innovate. This in turn raises productivity growth in the long-term.

In practice, however, there are interactions and synergies between labour and product market reforms. Labour market reforms should go hand in hand with structural reforms resulting in enhanced competition in goods and services markets[54]. There are significant productivity gains to be reaped in Europe by removing the considerable barriers to competition that still remain at the national and EU levels.

In addition to the above view, it may be of interest to see also how the implementation of the Lisbon agenda is assessed by a body outside the EU institutions. The World Economic Forum in its "Lisbon Review 2006" published in December 2006 makes a comparison of the EU with the US and East Asia on the basis of eight dimension and sub-dimensions. The comparison shows that the US outperforms the EU average in all areas except for

[53] G. Nicodeme and J-B. Sauner-Leroy, "Product market reforms and productivity: a review of the theoretical and empirical literature on the transmission channels", European Economy, No 218, December 2004.
[54] See Papademos (2005).

telecommunications and modernizing social protection, while the East Asian economies outperforms the EU average in all dimensions except – just barely – for financial services and sustainable development. On average, the greatest gaps between the EU's performance and those of the US and East Asia is in the development of an information society, innovation and R&D and enterprise environment.

<u>(ii) In Greece</u>

The European Commission, assessing Greece's 2006 update of the National Reform Programme, concluded that *"Greece is moving ahead relatively strongly in the macro-economic area, whereas progress in implementation of the micro-economic and employment reforms is still insufficient. There is limited policy response to commitments made in the 2006 Spring European Council. Regarding governance, better coordination and stringer ownership among administrative levels is needed"*. Among the strengths of the Greek NRP and its implementation were the good progress made on the consolidation of public finances and promising signs of progress were also noted on improving public resource allocation, improving the business environment, R&D and innovation, Information and Telecommunications technology and education and training.

Against the above background the Commission recommended that Greece (i) ensures the continuation of fiscal consolidation and debt reduction (ii) modernize its public administration by building up efficient regulatory, control and enforcement capacities, including through upgrading skills, in order to ensure effective use of Structural Funds, (iii) modernize employment protection including legislation, reduce the tax wedge on labour, and strengthen active labour policies to foster flexibility and security in the labour market and transform undeclared work into formal employment, and (iv) increase investment.

4.5. Geography matters: Greece and the dynamic development of SE Europe

When Portugal ceased, at the start of this decade, to be a star performer of the EU, many observers were predicting that Greece would follow a similar orbit as Portugal's, experiencing very modest growth rates after the euphoria of the second half of the 1990s[55].

Greece escaped, so far, this oracle and managed to maintain high GDP growth rates in the drive to EMU and after EMU membership. Also, recent studies indicate that Greece's potential output lies above 3%[56]. Comparative figures of potential output calculations are supplied in Table 6.[57]

[55] It is recalled that in Portugal real GDP growth rates averaged 4% during 1996-2000, before falling to about 0.6% on average during 2001-2005.

[56] Of course, there are risks of some deceleration of economic activity in Greece when credit growth rates would come down to more sustainable levels. Also, projections for potential output for the period 2006-2010 suggest that growth rates are diminishing. Therefore, the need to keep alive the reform momentum should never be forgotten.

[57] It is specified in the study by Denis *et al* that since the estimates of potential output are used for budgetary surveillance purposes, a prudent approach was taken regarding the assessment of future evolution of potential growth in the EU

Table 6. Potential growth (annual % change)

	EA	Greece	Ireland	Spain	Portugal
2005	1.8	3.5	6.1	3.6	1.1
1996-2000	2.2	3.1	8.1	3.1	2.8
2001-2005	1.9	3.6	6.4	3.6	1.6
2006-2010	1.9	3.0	4.9	2.5	1.4

Source: Denis C., Grenouilleau D., Mc Morrow K. and Roger W. (2006), Calculating Potential Growth and Output Gaps, European Economy Economic Papers 247 (March)

What many analysts probably missed was that Greece is located in a more challenging, but at the same time much more dynamic area in the South-Eastern Europe and Eastern Mediterranean. As political stability is being established in the Balkans (EU membership, for some, and prospect for EU membership for the rest of the countries of the region,[58] helps a lot) the catching up process is gaining momentum in the region and Greece has been an active player in this process.[59]

Statistical data confirm the economic dynamism and positive prospects of the economies of the region[60] and the rising commercial and investment links of Greece with them. Greece's economic linkages with the Balkan countries have developed significantly in the past ten years or so and are expected to develop further in the years to come, as the prospects for stability and economic growth in the region are improved.

About 17% of Greek total exports are destined to the Balkan countries (excluding Turkey). The value of Greece's exports to these countries were multiplied by twenty between 1990 and 2004, rising from €102 million to €2074 million, accounting for about 17% of total exports. Imports from the above countries during the same period increased from €151 in 1990 to €1313 in 2004. As a consequence, the trade balance with the Balkan countries passed from a deficit of €49 million in 1990 to a surplus of € 761 millions in 2004. The value of the Greek exports to Bulgaria reached 779 million in 2004, accounting for 6.4% of total Greek exports and that of imports 464 million i.e. 1.1% of the total. Exports to Romania, the second most important export market in the Balkans, reached 383 million and imports 504 million in 2004.

Commercial transactions between Greece and Turkey also increased significantly in the past decade. Greek exports to Turkey were multiplied by five in current prices and reached 750 million euros in 2005, while imports from Turkey increased by six times in the same period and reached 956 million euros. However, both exports and imports to and from Turkey remain relatively low as percent of total Greek exports and imports (5.4% and 2.2% respectively) a fact implying that there is scope for further development of these transactions.

Greece has also become one of the biggest investors in the Balkans, as countries in the area gradually build market economies. Increasing numbers of Greek companies have

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[58] The situation of the Balkan countries regarding accession to the EU is as follows: Bulgaria and Romania are, from 1.1.2007, members of the EU. According to EU terminology, Croatia, the Former Yugoslav Republic of Macedonia and Turkey are "candidate countries", while Albania, Bosnia and Herzegovina, Serbia, including Kosovo, and Montenegro are "potential candidate countries".

[59] Also, according to intergovernmental agreements, Greece could play a key role in the transfer of Russian and Central Asian oil and gas to Western Europe.

[60] Real GDP growth in 2006 was 6% in Bulgaria and 7.2% in Romania and around 5% in the rest of the Balkan countries and their economic prospects remain positive, according to forecasts of international institutions.

developed activity in the region attracted by the size of the market and by the potential for growth. Total Greek investment in the region are estimated at over $7,0 bn (however, more recent estimates suggest that total Greek investment in the Balkans are much higher, i.e. of the order of 12 billion euros)[61].

Greece's large banks pursued the expansion of their activities to the Balkans and the broader region of South-Eastern Europe through acquisitions and the establishment of branches. The five largest Greek banks have invested in the countries of South-Eastern Europe funds exceeding € 2 billion, employing 16.000 persons in a network of about 960 branches (see Mantzounis, 2005)[62] and their market share was close to 20% in most of these countries at the end of 2005. Of course, such an expansion involves also important challenges inherent in an environment of dynamic and fast moving economies. Provided that such challenges and risks are properly assessed, the active presence of Greek banks in the region is a positive development. It is noted that the business activity of Greek banks in the region is already contributing significantly to their profitability and is expected to do that at a higher scale in the future.

Greek manufacturing companies are expected to lead the investment drive as they seek to lower costs and expand their markets. The strategic aim of the bigger Greek companies is to become key regional players in specific sectors. Greece is also expected to become leading provider of financial services as Greek-owned banks expand their branch networks and offer new products to small and medium-sized businesses and retail clients.

Greece is expected to benefit from increasing ties – trade, investment, tourism – with the fast growing neighbouring countries and has every interest in preserving and developing further such relations.

Prospects for further development of economic relations of Greece with the Balkan countries are bright. It is expected that the process for political and institutional stability and economic reform already under way will advance steadily and rapidly in those countries of the region where difficulties and uncertainties are still present. An important element of stability and positive developments is the prospect of integration of all countries of the region into the European Union. The EU encourages such a prospect through a series of initiatives including financial support through specific projects.

4.6. Main findings from country-specific experiences

The main findings from the examination of economic performance and reform progress in member states in the first half of this decade can be summarized as follows:

1. Slow progress towards reform has been a feature of the EU and the euro area economies, although exceptions to this phenomenon were noted. It is expected that the re-launch of the Lisbon Strategy will provide the needed impulse to accelerate reform effort.
2. Economic performance of large economies has been much worse than that of most small countries.
3. Reform inertia was greater in large countries, a development which may partly explain their modest economic performance.

[61] See, interview of K. Michalos, President of the Greek Chamber of Industry and Commerce to the daily "Eleftherotypia", 27.12.2006.

[62] These figures should certainly be adjusted upwards as there were important new acquisitions by Greek banks.

4. Countries which traditionally had shown strong export performance, such as Germany, continued to perform well in this area in the EMU environment.
5. Countries which used to rely on currency adjustments (depreciation) such as Italy, Greece, Spain and Portugal have been loosing price competitiveness and export market shares in EMU. Despite this adverse development, some of these countries (Greece, Spain) exhibited strong overall macroeconomic performance.
6. Exchange rate changes are not a substitute for appropriate policies to enhance productivity, contain production costs and improve international competitiveness.
7. There is not, as yet, conclusive evidence on whether the one-size fits all monetary policy is appropriate for each national situation, although ECB’s nominal and real interest rates have been lower in most euro area countries compared to their probable level in the absence of EMU, a phenomenon attributed to ECB’s credibility.
8. Countries in which interest rates have fallen substantially as a result of interest rate convergence, experienced also a sustained credit expansion (this may partly explain the strong GDP growth in Greece and Spain noted above)
9. Member states with reform/technology-oriented policies (e.g. Ireland, Nordic countries) have been experiencing good economic performance.
10. Member States which maintained sound public finances (in terms of both low government debt ratio and budgetary position close to balance or in surplus) achieved, also, high GDP growth rates.

5. Advantages and disadvantages of EMU and optimal national strategy

EMU, with the centralized monetary policy and the decentralized economic and fiscal policies, subject to common Community rules, has created an environment which requires a reconsideration of policy making at national level. It emerges from a review of the main themes in policy discussion on EMU that focalization on the loss of the exchange rate instrument, and the assumed shortcomings of the one-size-fits-all monetary policy, overshadows important positive aspects of EMU as well as disadvantages other than those generally assumed.

5.1. Advantages and disadvantages

5.1.1. Advantages

- An important advantage of EMU is the protection it provides to its members against exchange rate pressures and balance of payments crises and their implications for interest rates and economic policy in general. These aspects can be more clearly seen if account is taken of past cases of exchange rate and balance of payments crises accompanied by destabilizing capital movements involving even large and economically advanced countries[63].
- A measurable effect of the EMU is the low interest rates enjoyed by member states, notably those with high inflation and weak currency history, compared with the pre-EMU situation, as a result of the disappearance of the exchange rate risk and, in general, the low risk premia associated with euro area membership.

[63] It is recalled that even advanced countries such as France, Italy and the UK were hit in the past by capital outflows, balance of payments crises and pressure on the currency which led to currency devaluations. Less economically advanced countries experienced such situations much more often.

- EMU facilitated intra-euro area trade: according to available evidence the euro probably did already boost intra-euro area trade by something five to ten percent on average (see Baldwin, 2006).
- Moreover, precisely because it provides a framework of stability, EMU gives its member countries the possibility to design strategies and policy measures with a medium to long-term horizon without the often destabilizing pressure of financial markets and capital movements on the balance of payments and the exchange rate. This is a valuable, and often underestimated, aspect of EMU that deserves to be evaluated carefully. If this aspect is combined with the financial support and guidance provided by EU programmes and mechanisms, a more clear view can be gained of the advantages offered by the Community framework to member states' forming and implementing their economic and financial policies.

The above aspects related to euro area membership and the single monetary policy should not be examined in isolation but within the framework of other EU policies already in place, or further developed, which form a set of rules affecting national policy making. As we have seen above, such rules and decisions concern the completion of the Internal Market and the common trade policy. These Community rules and mechanisms should not be perceived as constraints imposed by the EU – as is often the case in most, if not all, member states – as they are the result of intense consultations and decisions by the majority (unanimously for taxation issues) of member states in the relevant Council configurations. This Community framework is often the best ally of governments in order to take difficult decisions, which may adversely affect certain groups, but are nevertheless to the overall benefit of the economy.

5.1.2. Disadvantages

A probably serious disadvantage of EMU, revealed by its operation, is, perhaps paradoxically, linked to the above mentioned protection it offers to its members. Because of the "shield" it provides against external monetary shocks and pressure on the currency, EMU exerts a "tranquiliser effect", as member states do not feel the need to act and introduce the necessary reforms in order to cope with a deteriorating situation. We have noted above the tendency of delayed adjustment and reform in the area of public finances following entry into the euro area, but it applies also in other areas. This tendency may delay the necessary adjustments and aggravate the situation. The huge current account deficits in some euro area countries, which would have been unsustainable outside a currency union, are indicative of the effects of the EMU "shield" but also, probably, of a deteriorating economic disequilibrium.

Table 7. Current account deficit (as % of GDP)

	1997	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**
Greece	2.1	3.5	5.7	8.2	9.2	9.7	10.0	9.5	9.2
Spain	0.1	1.3	2.8	3.8	4.3	3.8	4.0	5.9	7.5
Portugal	6.4	7.4	9.1	10.3	10.5	8.2	6.5	7.8	9.5

Source: European Economy, Statistical Annex, November 2006.

The existence of a "tranquiliser effect" may be surprising, as one could have reasonably expected that EMU would mobilise the reform zeal of member countries in order to cope with the intensifying competition of the internal market. This expectation has even taken a code name, TINA, standing for There Is No Alternative to structural reforms, taking into account the loss of exchange rate instrument already mentioned. However, recent research seems to confirm the tendency to postpone reforms, at least for larger members of EMU. For example, R. Duval and J. Elmeskov (2005) show that large member states are even less inclined to introduce the necessary reforms in EMU compared to smaller, more open economies (see Box E).

In the introduction of this paper, reference was made to *constraints* to economic policy implied by the Community framework. What is meant by this term is the need for national policymakers to take account of commonly agreed rules such as free movement of goods, services and capital, trade agreements with third countries minimum vat rates etc. The fact that these constraints limit (by definition) the margin of action of national authorities does not imply that they are harmful. On the contrary, their existence ensures the smooth functioning of the internal market and EMU and avert recourse to restrictive practices (e.g. imposition of import restrictions) which may alleviate temporarily the extent of a problem but can be harmful in the medium to long term.

Box E: is there a reform inertia in EMU?

R.Duval and J.Elmeskov argued that large, more closed member states of EMU are less inclined than smaller, open economies to introduce reforms and relate this finding to the role of monetary policy regime. Their methodology is as follows: they examine the impact of monetary policy autonomy (or absence thereof, as is the case of EMU member countries) on structural reform and deduct conclusions on EMU. They argue that the results concerning the influence of monetary autonomy and country size can be rationalized within a framework where structural reform is expected to create slack resources in economies. In small open economies such slack is more quickly taken up through changes in net trade and incentives to undertake structural reform are therefore stronger. In larger, more closed economies, by contrast, net trade is less powerful as a mechanism for taking up slack. Hence, such economies are more reliant on accommodation through monetary policy when they undertake structural reform and when exchange-rate arrangements, like EMU, exclude such accommodation they undertake less reform.

If the above finding is added to the conclusion of this paper that the protection provided by EMU to large and small member states alike against exchange rate and balance of payments pressures render them less inclined to undertake reforms, then the case of a tendency towards reform inertia is strengthened. Moreover, the fact that the Lisbon Strategy was initiated, in the first place, and was deemed necessary to be re-launched as the pace of reforms was judged inadequate, provides evidence that there is not enough natural momentum in the system to introduce structural reforms. To the same direction seems to work the low sensitivity of financial markets to high government debt, as reflected in the very low spreads between government securities of high debt and low debt euro area countries vis-à-vis German government debt (see Wyplosz, 2006): it constitutes a disincentive to fiscal adjustment and reform.

The policy conclusion from the above is that mechanisms of reform initiatives must be put in place both at Community level, such as the Lisbon Strategy, but also at national level.

5.2. Ingredients of a national economic strategy

The design of a strategy for growth and stability at national level should take into account the main elements of EMU, and their implications for policy analysed above, as well as the international environment. This means a need to:

(i) Take advantage of the protection and stability offered by EMU to design appropriate medium-term policies without the pressure from foreign exchange and financial markets,
(ii) Ensure sound public finances and long-term fiscal sustainability while paying particular attention to the quality of public finances,
(iii) Avoid the inertia owed to the "tranquiliser effect" and the "large country" effect mentioned above and implement the necessary reforms with determination and consistency,
(iv) Shift focus on "microeconomics" aimed at improving the performance of the economy and enhancing its productive potential in the medium to long term,
(v) Prepare the economy to meet the challenge of globalization.

5.2.1. Optimal use of available policy instruments

The guiding principle for conducting economic policy at national level must be the optimal use of available policy instruments and resources. Although optimality should guide public policy action under any circumstances, it is even more necessary in EMU, as fewer policy instruments require that the use of existing instruments and resources to be more effective[64]. Moreover, pressure on available budgetary resources, as a result of the need to reduce the tax burden and enhance the attractiveness of national economies to foreign capital and their overall competitiveness, make the optimal use of limited resources even more pressing.

The content to be given to the optimality principle in each case is a real challenge in the uncharted territory of economic and monetary union. The renewed Lisbon strategy and other Community mechanisms provide the general policy framework. In particular, the Broad Economic Policy Guidelines and Employment Guidelines, now combined in the Integrated Guidelines, as well as Council opinions on stability programmes provide recommendations on economic and budgetary issues.

The economic, fiscal and financial strategies to be adopted, the method to be followed and the concrete policy measures to be taken is a national responsibility and should be adapted to the specific national situation and needs.

5.2.2. Focus on structural reforms and the micro-economy

Structural reform is an issue that transcends all five elements enumerated above and deserves some further comments. First of all, a key requirement of the theory of optimal currency areas is that economies should be structurally sound to make monetary unification beneficial. Furthermore, the notion of microeconomics is related to structural reforms, in the sense of ensuring that reforms must be relevant and economically sound. The focus on microeconomics involves also an orientation of both academic thinking and policy debate towards the need for microeconomic foundation of policies and projects.

In practice, the "microeconomic" approach to EMU should cover issues such as:

- How to enhance competition in goods and services markets

[64] According to Garganas (2005) "Although some reforms have been implemented since the start of EMU, the euro area is still not an optimum currency area in the traditional sense. This is the reason that it is important that national labour market policies enhance flexibility at the national and regional levels. Structural policies should also aim at improving the efficiency of the wage and price setting mechanism to reduce the persistence of inflation divergence"

- The quality of public finance and optimal taxation
- Regulation and supervision of financial and non-financial services
- The right incentives in order to promote research and innovation

Even a preliminary exploration of these issues gives of measure of the difficulties involved in the design and implementation of the right institutions and policies. Although successful models of institutions and policies exist in the EU and around the world, their successful transposition in each national framework remains an important challenge.

5.3. The dynamics of adjustment in EMU: some preliminary evidence[65]

The dynamics of economic adjustment in EMU is still an uncharted territory as the operation of EMU so far is too short in order to draw definitive conclusions. However, some interesting developments have been already identified.

Euro area countries try to maintain and improve the international competitiveness of their production by containing costs, notably labour costs. A characteristic of the EMU environment has been wage moderation, a phenomenon that prevailed in practically every member state[66]. It should be noted that wage moderation was present already before the introduction of the euro, as the process of EMU appeared irreversible and social partners were aware of the risks for economic activity and employment of competitiveness losses. It may be interesting to note that wage moderation is a common feature of both traded and non-traded goods sectors[67]. An explanation of this phenomenon may be sought in the fact that in EMU, the inability to regain competitiveness though exchange rate adjustments, combined with the intensified international competition in the form of increased low-cost imports, have kept import prices low (except oil and other commodities prices) putting thus a downward pressure on wages in the traded goods sectors. It seems that in a sort of Reverse Balassa-Samuelson effect[68], this development exerted also a downward pressure on wages in non-traded sectors, through the supply of excess labour from the import-hit sectors.

However, control of wage and non-wage production costs is a necessary but not sufficient condition for successful participation in the European and international division of labour as available evidence indicates[69]. This is the reason why member states, while trying to contain their production costs, are also attempting to identify sustainable comparative advantages. Although the mechanisms of economic adjustment in EMU are not yet known, there are signs indicating that the adjustment process is in progress and may take different

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[65] Economic adjustment in Emu has been described in the literature as falling either in the "competitiveness channel" or in the "real interest rate channel" (see e.g. "European Economy", November 2006, EC, Brussels). Such an approach has, indeed, analytical merits although it may not fully reflect the complexity of the adjustment process.

[66] Data on nominal compensation per employee (annual percentage change) in EUR-12 show the following picture: 1991-2000: 3.8%, 2001-2007: 2.4%. Data on real compensation per employee gives a similar picture: 1991-2000: 1.1%, 2001-2007: 0.4% (2006 and 2007: forecasts). Source: European Commission, European Economy, spring 2006, statistical appendix)

[67] See for example data on compensation per employee in various sectors in DG Ecfin's AMECO data base

[68] It is recalled that the Balassa-Samuelson effect essentially implies that high wage growth in the (high productivity) traded-goods sector is transmitted to the (low productivity) non-traded sectors, a development resulting in higher inflation than in the absence of such a phenomenon

[69] According to a recent study (ECB, 2007) the correlation between changes in export market share and relative export prices is not particularly strong, suggesting that other determinants, such as non-price competitiveness, the different sectoral specialization across countries and the different ways of adjusting to globalisation also influence export market shares.

forms and paths in each country. In *Finland*, for example, priority has been given to technology and innovation paths, without neglecting cost competitiveness. In *Spain*, despite the relatively high real GDP growth, an intense discussion is underway in the country, and concerns have been expressed, about the reasons for the very modest rates of productivity growth and about the appropriate policy response to this phenomenon. Concerns have been also expressed on the excessive reliance of economic activity on the construction sector.

Another noteworthy development is the unexpectedly high growth rates of *Greece*'s exports in recent years despite the cumulative loss of price competitiveness noted above[70]. For example, the growth rates of Greece's exports of goods and services (volume) increased by an average of 7% in 2004 and 2005 and are forecast (by the EC) to grow by about 6% per year in 2006 and 2007. In value terms, Greece's exports of goods increased by 13.1% in 2005 and by 13.8% in 2006, according to provisional data of the Bank of Greece. Although it is premature to draw definitive conclusions, this development may reflect the working of an adjustment process by which losses of price competitiveness may be partly offset by improvements in non-price factors such as product differentiation, reorientation of export destinations (towards high growth emerging markets) and marketing efforts. This development must not, however, lead to the underestimation of the importance of containing production costs and preserving price competitiveness which must be a constant objective.

Portugal is facing the difficult challenge of unwinding the accumulated domestic and external imbalances while enhancing the competitiveness and the growth potential of the economy. Short term growth prospects remain, however, modest with real GDP projections of around 1% in 2006 and 2007. According to Portugal's national reform programme in order to strengthen fiscal consolidation and foster economic growth a few policy areas are identified, the majority concentrating on the micro-economic area, including public administration reform, competitiveness and entrepreuneurship and R& D and innovation. *Germany* represents the clearest example of a paradoxical situation of bright external cost competitiveness and export performance combined with weak domestic demand and very modest real GDP growth. Although the macroeconomic prospects have improved in 2006 and prospects are reasonably good for 2007, the weakness of domestic demand makes the sustainability of economic recovery uncertain. On the positive side, implementation of economic reforms and the improvement of employment situation are expected to support private consumption even with continued wage moderation, while good export performance will boost also business confidence and investment spending.

Concerns about loss of competitiveness and weak economic performance in *Italy* have been often expressed in recent years and are also reported in annex 2 of this paper. Although the facts indicate, indeed, an important, cumulative loss of price competitiveness in Italy, a more careful look at the data shows some positive (or less negative) developments. For example, growth rates of unit labour costs, after having peak at 4.3% per year in 2003 slowed down to about 2.5% on average in the following three years and are projected to decelerate to 1.9% and 1.6% in 2007 and 2008 respectively according to autumn 2006 Economic Forecasts of the European Commission. Italy's loss of export markets share, although still important, is also diminishing, while its current account deficit remained modest, estimated 1.4% of GDP in 2006. The above elements may suggest that economic adjustment may have been underway also in Italy within the EMU framework.

[70] According to the IMF, the surprising strength of Greek goods exports, despite several years of eroding cost competitiveness, reflects partly the pickup in export markets (IMF, Greece-2006 Article IV Consultation, October 20, 2006). See also Thomopoulos (2006) for an explanation of recent Greek export performance.

6. Concluding remarks

A key feature of economic developments in the euro area in the most part of the current decade has been a weak economic performance accompanied by relatively high unemployment rates in a framework of slow pace of structural reforms. Some exceptions to this sombre picture did not change much the general trend. A recovery of economic activity in the euro area in 2006 and in 2007 may indicate the starting point of a positive trend if it is supported by the right policies[71].

The unfavourable trends during the first half of the current decade have naturally been a matter of concern for European policymakers who have been seeking appropriate responses to these challenges. There have been, indeed, some major initiatives at Community level, notably the re-launch of the Lisbon Strategy for growth and employment, the reform of the Stability and Growth Pact and efforts to improve co-ordination of economic policies. Also, the adoption of the Services Directive in December 2006 was an important development in completing the internal market which is crucial for economic activity and job creation. On its part, the ECB ensured that inflation and inflation expectations remain low in the euro area, contributing thus to an environment favourable for economic activity.

However, economic policy in EMU is primarily a matter for each member state to decide. This paper argues that EMU provides favourable conditions in which member states can design and implement their economic policies. The main advantage of EMU is that it provides protection from risks of balance of payments crises and pressures on the exchange rate that allows the design and implementation of policies with a medium to long term horizon, in an environment of price stability and low interest rates. Member states can also rely on financial support and advice from the Community in their effort to achieve real convergence.

There is, however, a "snake" in EMU's "paradise". This is not, as is generally believed, the loss of the exchange rate instrument, whose effectiveness was anyway questionable in the absence of accompanying measures, or the single monetary policy, but a reform inertia emanating from the very same protection EMU provides against external monetary risks evoked above. Such protection, while broadly beneficial, generates also a tendency to delay the necessary adjustments. Reform inertia has been greater in large countries, a development which may partly explain their modest economic performance. It was precisely this slow reform progress that led the European Council to re-launch the Lisbon Strategy whose aim is to accelerate structural reforms and enhance the dynamism of the European economy.

It emerged from the analysis in the paper, based also on the experience of member states, that the competitiveness concept is not limited to cost indicators but reflects the situation in the whole economy. For example, available research indicates that the deterioration of competitiveness and export performance in some member states has not only to do with relatively high costs of domestic production but also with the low quality of public services and the slow pace of structural reforms.

Given the importance of sound public finances for the proper functioning of EMU and for the overall competitiveness of the economies of member states, the paper examined fiscal adjustment and reform in a number of member states, with focus on Greece. It emerged from the analysis that fiscal adjustment and reform should be a high policy priority in

[71] It is recalled that since the start of this decade there had been a number of short-lived recoveries in Europe.

member states in order to ensure sustainability and quality of public finances and in particular in Greece, taking account of its very high government debt ratio and the low quality of public services. The competitiveness game in EMU will, to a large extent, be played on the capacity to make significant and rapid progress in this direction. It is certainly not by chance that EU member states with reform and technology-oriented policies, sound public finances and efficient public sector (e.g. Ireland and the Nordic countries), have been also experiencing better economic performance and low rates of unemployment.

In conclusion, two major lessons can be drawn from the analysis developed in this paper concerning economic policy in EMU: (i) The existence of a reform inertia requires that a constant effort must be made, at both Community and national level, to maintain the reform momentum, (ii) In view of the loss of some policy instruments, national authorities should make an optimal use of available policy instruments, notably fiscal and structural policies, and institutions.

There are signs indicating that the adjustment process is underway in EMU and may take different forms and paths in each country. Economic policy must create the right conditions for facilitating adjustment so that member states take maximum advantage of the opportunities of the integrated European market and the stability offered by the euro.

Annex 1. The Community institutional and policy framework

General aspects

The Community framework comprises the broad principles guiding the action of Community institutions and EU member states and the more detailed provisions and rules governing the functioning of the internal market, economic policy coordination and the single monetary policy.

Key objectives[72] of the European Union and of Community Institutions are *economic growth*, to be achieved through the completion of the internal market, the coordination of economic policies and the conduct of the single monetary policy and *solidarity*, pursued through the implementation of policies aimed at supporting regional development, improving basic infrastructure and supporting agricultural activities and income.

Solidarity is basically exercised through the EU budget which amounts to about 100 billion euros per year, or slightly above 1% of EU Gross National Income. Concerning medium-term financial perspectives, which will determine the amount to be spent through the EU budget during 2007-2013, an agreement has been reached by the heads of state and government at the European Council summit of London, in December 2005[73]. This agreement, which was also approved by the European Parliament, determines the amounts to be received by less prosperous countries of the Union in order to support their effort towards real convergence.

The Internal Market and the Common Trade Policy

At the basis of the *internal market* are the four freedoms enshrined in the Treaty, i.e. free movement of persons, goods, services and capital. The deadline for the completion of the internal market was the year 1992 and, indeed, by that date most barriers to the four freedoms were removed. For example, freedom of capital movements by July 1990[74] was a necessary condition for entering the second stage of EMU and advancing towards monetary union as foreseen in the Maastricht Treaty. However, in some key areas, as in services, the single market is far from being a reality. However, the adoption of the Services Directive (see section 3 of this paper) was a major step forward.

Of particular importance both for the completion of the internal market and the implementation of the single monetary policy is financial integration, a concept which includes integration of banking and capital markets and the development of an efficient, safe and competitive payments system in the EU and the euro area.

In addition to financial integration, the focus in this paper is on a number of key aspects of the internal market which are central for European economic integration and particularly important for economic performance and economic policy at national level. These are competition policy, taxation and common trade policy.

[72] As reflected in Article 2 of the Treaty on European Union and Articles 2 and 4 of the Treaty establishing the European Community.

[73] According to the agreement, 862.4 billion euros, corresponding to 1,045% of EU GNI, will be allocated during 2007-2013 in order to realize the objectives of the EU. The amount allocated to Greece was 20.1 billion euros. For details on the agreement see Bank of Greece, Annual Report for 2005, April 2006, Box: “Prospects for transfers from the EU during 2007-2013”.

[74] Complete liberalisation of capital movements was realised in 1992 in Spain, Ireland and Portugal and in 1994 in Greece.

Competition policy

Competition policy, which aims at creating a level playing field for all companies operating in the EU, is the cornerstone of the internal market and a key driver for delivering an attractive environment for growth and jobs. It is a well-established fact that the existence of competitive business conditions sustains and promotes competitiveness, productivity and growth, in global and regional markets, as well as at national level.

It is noteworthy that the competences of the European Commission are very extensive in this domain and subject only to rulings of the European Court of Justice. The most important way in which competition policy can contribute to competitiveness is through the tool of state aid control.

Taxation

In the EU, responsibility for tax policy mainly lies with the member states. However, member states face two important constraints in their capacity to adjust tax rates and, in general, to form their tax policy:

Firstly, some harmonization has been achieved in the EU in the area of indirect taxes because they affect the free movement of goods and freedom to provide services[75]. There is a EU-wide minimum value added tax rate of 15% and decisions for lower vat rates for certain products and services require unanimous decisions[76]. As a consequence, the capacity of member states to adjust their indirect taxes is subject to serious constraints.

Secondly, because of tax competition in the increasingly integrated European market, but also due to pressures coming from globalization, governments have to take into account very seriously external factors before raising tax rates. This consideration concerns mainly mobile tax bases, for example tax rates on savings (e.g. tax rates on bank deposits, bonds and equity investments) but also less mobile tax bases to the extent that tax differentials become sizeable.

Financial integration

In a fully integrated financial market, institutions, investors, and services should be able to move freely around the EU, without restrictions other than complying with common prudential and investor protection rules.

European and international financial integration affects the three major components of the financial system, namely the financial markets, the related market infrastructures, and the financial institutions. Financial integration is a key factor in the development and modernization of the financial system, which in turn leads to a more efficient allocation of capital and an increased potential for economic growth. An integrated financial market is an important driver for improving economic growth and productivity in all sectors of the economy.

Furthermore, a well-integrated financial system in Europe is essential for the implementation of monetary policy as it enhances the smooth and effective transmission of monetary policy impulses throughout the euro area.

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[75] Article 93 of the Treaty calls for harmonization of turnover taxes, excise duties and other forms of indirect taxes. No such harmonization is required for direct taxes. However, efforts for some approximation also in the field of direct taxation have been made in certain cases. Moreover, irrespective of specific provisions about tax harmonization, Article 90 of the EC Treaty prohibits any tax discrimination which would, directly or indirectly, give an advantage to national products over products from other member states.

[76] Temporarily reduced vat rates have been agreed for a number of labour-intensive services.

Finally, financial integration will progressively strengthen the stability of the financial system, provided that the financial integration process involving structural transformation of the financial system is closely monitored. Cross-border banking broadens and deepens financial markets and increases liquidity and risk sharing.

Common trade policy

Trade policy forms one of the main pillars of the European Union's relations with the rest of the world. Its purpose is to promote the interests of the European Community and covers all the main aspects of trade in goods and services as well as key aspects of intellectual property, investment and competition.

The European Union's 25 members represent 7% of the world's population, but they account for more than a fifth of global imports and exports. The EU is the first exporter of goods and services and the first investor abroad. It is evident, therefore, that Europe has more to gain by expanding its exports of goods and services than by adopting a protectionist stance (Mandelson, 2005).

Although the gains from trade are well documented, trade openness exposes economic sectors to international competition and are bound to be sectors that will come under pressure. However, international trade agreements imply that governments cannot take protective measures which would amount to raising barriers to free movement of goods. It is, as a consequence, obvious that a coherent strategy is required in order to cope with severe sectoral problems arising from the removal of trade barriers and globalization while respecting the World Trade Organization rules and agreements.

Economic and Monetary Policy in EMU

The 1st of January 1999 marked the effective beginning of the third stage of economic and monetary union. This implied (i) a single monetary policy managed by the Eurosystem, which consists of the European Central Bank (ECB) and the national central banks of the euro area, (ii) introduction of the euro as the single currency of the participating countries (on financial markets from 1.1.1999 and in coins and notes on 1 January 2002) and (iii) in terms of economic policy, increased convergence of policies, with reinforced multilateral surveillance and an obligation of the euro area member states to avoid excessive government deficits.

Economic policy

According to the Treaty, member states will conduct their economic policies so as to contribute to the achievement of the Community's objectives. Economic policies are regarded as an issue of common interest and will be coordinated at Community level. To this end, broad economic policy guidelines will be proposed by the Commission and adopted by the Council on the basis of the conclusions of the European Council.

The Council will regularly undertake an overall assessment (multilateral surveillance) of economic policies and, where appropriate, will address recommendations to any member state whose economic policies do not appear to be consistent with the broad guidelines.

As regards budgetary policy, member states are obliged to avoid excessive government deficits[77]. The Stability and Growth Pact also requires participating member states, under normal circumstances, to maintain a balanced budget or a surplus and to present once a year

[77] Article 104 of the EC Treaty. It is noted that member-states of the EU which are not members of the euro area shall endeavour to avoid excessive government deficits.

stability programmes (convergence programmes for member states not participating in the euro area). In order to encourage member states to respect budgetary commitments, the Council may impose sanctions on those which do not comply with their obligations to avoid excessive deficits. Sanctions may be much more severe for members of the euro area than for non-members, as sound public finances are considered crucial for the proper functioning of EMU.

It should be noted that the economic policy provisions of the treaty[78] concern, in principle, all countries, both members of the euro area and non-members. Where certain provisions do not apply to non-members of the euro area (for example concerning sanctions for non-correction of excessive deficits) this is stated explicitly as an exception. It is also of interest to note that EMU is considered by the Community legislator as the "normal" state of affairs. This can be seen from the fact that provisions concerning exclusively non-members of the euro area are included in a section of the Treaty titled "transitional provisions" revealing the provisional character of the situation[79].

Monetary policy

The Treaty[80] makes provisions for *"…the definition and conduct of a single monetary policy and exchange rate policy, the primary objective of which shall be to maintain price stability…"* and specifies[81] how the implementation of this monetary policy will be effected and by which institution.

The body which has responsibility for defining and implementing the monetary policy for the euro area is the European System of Central Banks (ESCB), or briefly "The Eurosystem"[82], composed of the Executive Board of the ECB and Governors of central banks of member states participating in the euro area.

The ECB and national central banks are independent and may under no circumstances seek or take instructions from Community institutions and bodies, governments of member states or any other bodies[83].

An aspect which is worth noting, as it is consistent with the internal market principles analysed above, is that the activities of member states and Community institutions, including monetary policy and related activities undertaken by the ESCB, must be conducted "…*in accordance with the principle of an open market economy with free competition"*.[84]

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[78] Articles 98 to 104 of the EC Treaty

[79] Of course, the fact that certain member states have obtained an opt-out clause from participating in the euro area imply that such a situation may last for (very) long.

[80] Article 4 of the EC Treaty.

[81] In Articles 105 to 111 of the EC Treaty

[82] The term "Eurosystem" is commonly used to describe the ECB plus the national central banks of member states participating in the euro area (in distinction to the European System of Central Banks, ESCB, which is a term explicitly mentioned in the Treaty and comprising central banks of all EU member states. In the Draft Constitution the term "Eurosystem" has been officially introduced.

[83] Article 108 of the EC Treaty.

[84] Article 4(2) of the EC Treaty.

Annex 2: Economic trends and policy issues in selected member states

The review of the key features of the growth pattern in selected member states could provide useful insights on successful and less successful policies and economic performances in EMU. As monetary union is only several years old it is too early to take definite views about the dynamic process of economic adjustment in EMU. However, the study of the different country experiences suggests that there are policies which will lead to a better result under most circumstances. Also, given the limited budgetary resources available for government action, because of the fiscal rules and because of the tax competition in the globalised economy, priorities have to be set and an optimal use of such resources must be made. The study of successful policies in each member state is a key aspect of the Lisbon Strategy and of the integrated guidelines of economic policy.

Greece: the challenge of reform and real convergence

In a possible taxonomy of EU member states in relation to reform progress and economic performance, Greece could be ranked in the category "slow reform – high GDP growth" category compared to, for example, Portugal which could be ranked in the "slow reform – low growth" category or to Ireland's "fast reform – high growth" one. The qualification of slow reform for Greece (and Portugal) is of course a summary assessment but not arbitrary as it reflects detailed assessments by international institutions and other entities, although the reform performance is currently improving in both countries. Regarding macroeconomic performance, Greece has consistently achieved much higher real GDP growth rates than most EU and euro area countries during the last ten years. Greece's average real GDP growth rate was 3.4% in the period 1995-2000 and 4.2% during 2001-2005[85].

The apparent paradox of slow reform/high growth combination could be resolved if account is taken of a number of special factors which supported economic activity in Greece: (i) significant inflow of EU funds, (ii), low interest rates as a result of convergence to euro area rates combined with expansionary fiscal policy and (iii) the effect of preparation for the Olympic Games of 2004. To these factors must be added the geographical location of Greece (see below).

The diverging macroeconomic performance between Greece and Portugal since the start of this decade has attracted much attention as both countries exhibited similarities in their macroeconomic performance and some other features during the 1990s. When Portugal ceased, at the start of this decade, to be a star performer in the EU, many observers were predicting that Greece would follow an orbit similar to that of Portugal which experienced very modest growth rates after the euphoria of the second half of the 1990s[86]. While there have been similarities between Greece and Portugal (both countries are benefiting from sizeable inflow of EU funds and from lower interest rates), several factors seem to have contributed to Greece's better performance. In addition to the activity-boosting effect of the preparation for the Olympic Games of 2004 (which is an ad hoc factor), Greece is also benefiting from the fact that it is located in a probably more challenging but, at the same time, more economically dynamic area in the South-Eastern Europe and Eastern Mediterranean. As political stability is being established in the Balkans (EU membership for some and prospect of EU membership for the

[85] Indicative average real GDP growth rates were as follows: during 1996-2000: Ireland: 9.7%, Spain: 4.1%, Greece: 3.4%, Belgium: 2.7%, Italy: 1.9%, Euro area: 2.7% and during 2001-2005: Ireland: 5.1%, Greece: 4.2%, Spain: 3.1, Belgium: 1.5%, Italy: 0.8%, Euro area: 1.5%.

[86] It is recalled that in Portugal real GDP growth rates averaged 4% during 1996-2000, before falling to about 0.6% on average during 2001-2005.

rest of the countries of the region helps a lot) the catching up process is gaining momentum in the region and Greece has been an active player in this process, notably as exporter of goods and services. Greece has also become one of the biggest investors in the Balkans, as countries in the area gradually build market economies. Increasing numbers of Greek companies have developed activity in the region attracted by the size of the market – about 50 million people – and by the potential for growth. Total Greek investment in the region is estimated (in 2005) at over $7 billion. As we have seen above, Greek biggest banks all have operations across the region. Also, available evidence[87] indicates that macroeconomic and financial imbalances in Portugal had been accumulated earlier and become very high. In particular households' indebtedness in Portugal is much higher than in Greece. The current account deficit was very high already in 1997 and reached 10% of GDP in 2000. As the correction process for these imbalances has started to unwind, its adverse effects on economic activity has been significant. However, despite these differences[88], the Portuguese example suggests that complacency is a bad advisor, and care must be paid in Greece to orientate economic policies towards enhancing the competitiveness of the economy and its capacity of the economy to overcome external and domestic shocks.

Risks of deceleration of economic activity in Greece do exist as credit growth rates would come down to more sustainable levels and the positive influence of other factors diminish. Moreover, despite the above favourable factors, the structural weaknesses of the Greek economy are still significant: consistently higher inflation than the euro area which is eroding international competitiveness, high current account deficit, low inflow of foreign direct investment (though increasing recently), and, as was already noted above, still high fiscal deficit and a very high government debt ratio. Therefore, economic policy centered on adjustment and structural reform is necessary so that the present favourable growth momentum acquires more sustainable characteristics. The recommendations and advice of international (EU, IMF, OECD etc) and national institutions (e.g. Bank of Greece) all converge to the need for adjustment and reform in the labour, product and services markets so that Greece enhances its competitiveness and performance of its economy.

What is probably not always obvious are the specific policies, the method and the role of institutions in this process. The example of successful economic policies in some member states presented in this annex show that, regardless of the particular situation and economic structure of each country, there is a core of policies which remain indispensable in all circumstances: these include a constant reform effort oriented towards innovation, technology and improvement of human capital, sound public finances and efficient public administration, and an attitude of transparency and openness to the rest of the world.

These policy objectives are to a large extent reflected in the renewed Lisbon Strategy agreed at the European Council in March 2005, which member states are committed to implement through their national reform programmes. As was noted also in the main text of this paper, fiscal adjustment and the long term sustainability of public finances are of paramount importance for Greece. In a sense, the very high public debt and the Community requirements derived from the Treaty and from the provisions of the stability and growth pact make easier

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[87] Recent research by the National Bank of Greece (2006) underlines the significant differences in the orientation of exports and the size of macroeconomic, financial and fiscal imbalances between Greece and Portugal. The study indicates that Greece's orientation of exports has shifted to the more fast-growing markets of SE Europe, while 80% of Portugal's exports are oriented to the EU. Also, households indebtedness in Greece at about 37% of GDP is among the lowest in the euro area, while the corresponding ratio for Portugal is 80% of GDP and it was already 60% of GDP in 2000. The study argues, also, that more significant progress towards fiscal adjustment has been achieved in Greece compared to Portugal's.

[88] It should be noted that regarding public finances, although the general government deficit in Portugal is presently higher than Greece's, its government debt ratio, at about 64% of GDP, is much lower than that in Greece, 107.5% of GDP (2005 data).

for Greece to set the priorities for policy action among competing tasks. A decisive action in the area of public finances will serve all key objectives: enhancing the competitiveness of the Greek economy, support real convergence and comply with the requirements of the Treaty and the Stability and Growth Pact.

Portugal and Spain: similarities and differences in economic policies and economic performance[89]

The comparative review of economic trends in Spain and Portugal may help identifying similarities in their growth pattern during the 1990's as well as factors explaining diverging performance in recent years.

Since the late nineties, Portugal and Spain have shared a number of economic features associated with accession to EMU and the convergence process. Strong anti-inflationary commitment, coupled with structural reform, underpinned the credibility of policies in a setting of economic expansion. GDP grew in both countries by more than 3.5% annually. Rising income expectations linked to the run-up to the euro, together with supply-side developments in financial markets supported a very strong momentum in private consumption and investment, in particular construction. Although real estate was the main target of credit boom, consumer credit also grew rapidly, from a low base. A decline in saving and rising private indebtedness were evident.

Both economies experienced adverse cost developments in this phase. In Spain there was a positive inflation differential relative to the euro area, apparently due to higher mark-ups in sheltered sectors, in a context of wage moderation. In Portugal wage increases in excess of productivity gains occurred in a tight labour market. Unit labour costs, which rose at 1% annually in the euro area, rose by close to 4% annually in Portugal and nearly 2.5% in Spain.

One differentiating aspect lay in exchange rate policies during the run-up to the euro. While Spain experienced depreciation until 1995, Portugal supported an appreciating currency. In fact, Portugal was almost the only country in the current euro area whose real effective exchange rate did not depreciate in the second half of the nineties. The result was a worse external competitiveness position in Portugal than in Spain. Consequently, the external balances performed differently in the two countries. In 2000, Portugal registered a peak current account deficit of above 10% of GDP, the highest in the euro area, and the state's net lending worsened to some 9% of GDP from a situation of close to balance in 1995. In Spain, during the 1995-1998 high growth period, a balanced position on the current account was registered coupled with a net lending position of the nation of 1% of GDP.

The stance of *fiscal policy* differed markedly in the two countries. In Spain, balancing the public finances was a key tenet of policy. Adjustment was based on reduction in the current expenditure (e.g. civil service salaries were frozen in 1994 and 1997) and a restructuring of revenues, including a full reform of the personal income taxation. Moreover, the government promoted an important privatization policy. Gross debt, and the debt service burden, continued to fall. Spain reached a position of budgetary balance in 2001, which was maintained during the following years. This consolidation effort allowed policy to work as a stabilization instrument. Despite a fall in private saving, national saving was maintained. Fiscal policy in Portugal, by contrast, amplified the effects of easy monetary and financial conditions over the second half of the nineties. Current primary expenditure was kept on a clearly expansive path until 2001, mainly reflecting higher pay and number in the public service and also non-cash social transfers. Strong revenue growth resulting from lively domestic demand, together with falling

[89] This annex draws on the analysis in "Financial imbalances on the road to EMU: lessons from Portugal and Spain" Public Finances in EMU, 2005, EC.

interest expenditure, provided sufficient margin to meet the Maastricht requirements. With no fiscal offset to private sector developments, the national savings rate gradually declined.

In Portugal, after a period of strong credit growth, high indebtedness and rising interest rates triggered a sharp re-assessment by private sector agents amid a more gloomy growth outlook. Household consumption decelerated and the savings arte started to increase. Almost simultaneously, corporations started boosting their savings rates as well. The strongest effects were felt in 2003, the year in which Portugal went into a recession, as real GDP fell by 1.1% on account of a shrinking domestic demand. After 2001, Portugal registered improvement in its external imbalance. But the loose fiscal stance pushed Portugal into a situation of excessive deficit in 2001

In Spain, as budgetary adjustment has been relatively intense since 1995, there was no need to tighten policy at a tine of sluggish growth. Still, private sector imbalances have left some legacy in terms of economic vulnerability. Easy monetary and financial conditions have continued to stimulate household spending. The sharp rise in housing prices in Spain (they doubled in real terms between 1997 and 2004) raises concerns about their sustainability and the potential impact of an abrupt adjustment. Some analysts are, however, reassuring suggesting that the annual financial effort to service mortgages remained broadly constant between 1997 and 2004. As a result, rising housing prices have not had any significant impact on households' purchasing power.

Despite the relatively high real GDP growth rates, an issue of concern and heated debate in Span is the low productivity growth of the economy. Indeed, economic growth over the last ten years was based mainly on increases in employment as productivity growth has been very modest. The composition of economic growth in recent years, based mainly on construction and low-value added services, is advanced as one reason of the low productivity growth but the debate continuous.

Italy: symptoms and causes of weak economic performance[90]

The search for explanations for the weak performance of the Italian economy in the 1990s, a trend that continued and sharpened in recent years, may lead to a better understanding of the dynamics of economic adjustment in EMU, operating in the broader context of an increasingly globalised economy, and to policy lessons for Italy and for other member states with similar, even if less acute, problems.

The Italian economy has shown weak growth even since the beginning of the 1990s. More recently it has developed two particularly striking, interlinked symptoms: a discouraging performance by exports and the longest stagnation of output in the tradable goods sector in post-war history. In contrast to previous episodes of weak growth, the current difficulties are not caused by supply shocks such as excessive wage increases. On the contrary, the dismal export performance has fallen within a period of wage moderation, and, since the late 1990s, of buoyant employment growth. The persistent loss of export market shares would seem to chiefly result from the unfavourable product specialisation of the Italian economy – more recently coupled with a marked slowdown in productivity growth which has largely offset the achievements of wage moderation. The productivity slowdown resulted from two factors: (i) the weakness of manufacturing output in combination with (ii) atypically resilient employment growth since the late 1990s. On the aggregate, the productivity slowdown entailed an increase

[90] This section draws on M. Larch's article "Stuck in a rut? Italy's weak export performance and unfavourable product specialization", ECFIN country focus, 12.5.2005 and on K. Church's article on "Does Italy's plight threaten European Monetary Union?", Economic Outlook, Bank of England Commission Report, July 2005.

in real unit labour costs, including in the manufacturing sector, which in turn affected Italy's cost competitiveness as measured by the real effective exchange rate.

Comparatively low inflows of foreign direct investment seems to have contributed to Italy's weak economic performance, as FDI is a potentially powerful determinant of technology diffusion, specialisation and a driver of economic growth. In addition to its comparatively low levels of FDI, recent inward FDI in Italy is also characterised by a low and decreasing share in high technology industries. However, cost competitiveness is not the only and, according to a number of studies, not even the most important reason for Italy's weak export performance. Indeed, Italy seems to be losing export market share even in times of stable real effective exchange rates.

Italy's product specialization has not significantly changed over past decades in reaction to global economic developments. Italian industry remains strong in traditional, low-skilled labour-intensive sectors for which global demand is growing below average. The inertia is generally attributed to a number of structural factors which are hampering change, including low levels of R&D investment, low human capital, low competition – issues that fall within the remit of the Lisbon strategy.

Towards the end of the 1990s, after more than five years of weak economic growth, it was felt that a large part of the problem was due to the overlap of a number of temporary factors such as fiscal consolidation, exchange rate movements and the policy mix. However, as the growth malaise dragged on and even worsened during the following five years the assessment changed. There is now a broad consensus that Italy is suffering from a series of mutually reinforcing structural shortcomings affecting its foreign sales and more generally its overall growth performance. Remedy should focus on education and skills, innovation, research and development, more competition and better regulations. The renewed Lisbon strategy launched at the 2005 Spring European Council provides the right setting in which to tackle the Italian economy's structural challenges.

While much of the emphasis when talking about competitiveness is rightly placed on trade, it is worth mentioning another factor that may be important and also impacts on competitiveness: a problematic public sector. Inefficiency in the public sector needs to be addressed in order to raise competitiveness. This is not related to the budget deficit per se – in fact Italy is running a primary surplus anyway – but it is a question of productivity in the public sector and the trend in prices for services such as utilities, health care etc.

Finland: some lessons from a Nordic economic model[91]

The case of Finland is interesting as it represents a country having experienced not very long ago a severe recession due to the collapse of its trade with the ex-Soviet Union but managed to recover quickly, stabilize its economy, restructure its production and exports and become a founding member of the euro area.

The Finnish economy exhibits a number of strengths but also faces a number of challenges. The strengths include a stable society, a strong tradition for the rule of law and a well-educated population. An important challenge is the relatively high unemployment rate. Real GDP growth rates passed from an average of -0.9% during 1991-95, to 4.7% in 1996-00 and 2.3% in 2001-2005. The unemployment rate was 8.4% in 2005 and declined to 7.7% in June 2006.

In many respects Finland represents a successful example of a "knowledge economy" in Lisbon Strategy's language, in which human capital plays a central role. However, not long ago, in the

[91] This section draws on M. Maivali' "Structural unemployment: a blot on the Finnish success story", ECFIN, Country Focus, and S. Salo's "Finland – From a crisis to a successful member of the EU and EMU", seminar at Narodowy Bank Polski, 21 April 2006.

early 1990s Finland drifted into the worst economic crisis seen in any western market economy. The sources of the crisis were external. With the collapse and disintegration of the Soviet Union, Finnish exports to Russia dropped rapidly. Meanwhile, the global forest industry was in recession and the level of international interest rates high. Finnish GDP declined by more than 10% in the early years of the 1990s and unemployment rose close to 20%. The recession led to a banking crisis. Getting through the crisis was largely aided by the state's decision to provide guarantees for all banks. The economic and human losses caused by the crisis were extensive. On the other hand, the crisis prompted basic improvements in structures of the economy. These improvements have been of vital importance for Finland's fairly favourable performance over the last ten years.

As a member of economic and monetary union, the focus of Finland's economic policy is on fiscal and incomes policies. As far as incomes policy is concerned, comprehensive incomes policy agreements have been continued, with duly moderate wage hikes; on the other hand, the Finnish cost level has risen faster that the euro area average. Since Finland's adoption of the euro, fiscal policy has been marked by fiscal discipline. Finnish general government finances have been in surplus all the time. Central government finances have remained close to balance, despite sizeable tax cuts. The local government deficit is small. The share of public expenditure to GDP has been falling gradually, and their level is clearly lower than in Sweden and Denmark.

When it comes to internationalization and globalization, Finland has adopted an open market approach. Within the EU, Finland has been opposed to various attempts at building internal and external barriers to trade, starting from the conviction that globalization is an inevitable challenge and that the countries quickest to adapt to it will also, in the long run, reap the greatest benefits from it. A case in point is Nokia, which has benefited decisively from domestic and global liberalization.

The success story of Finland after the recession is largely due to the economy bouncing back by successfully embracing the opportunities of globalization. The jobs lost during the recession were substituted with new ones, albeit often in other sectors, and with a time lag, markedly different features and other skill requirements than those lost. In very broad terms, jobs in construction, manufacturing of consumer goods and agriculture were replaced by employment in business services, social services and electronics manufacturing. The situation in Finland therefore confirms the theory that international trade and capital movements should entail net gains for the economy as a whole. The global open economy was an important ingredient enabling Nokia's phenomenal rise to become a world leader in telecommunications equipment. Economic recovery was largely based on rapid growth in industrial production and exports, which also added to industrial employment.

This success has come by no coincidence. Finland has systematically been ranked highest in cross-country comparisons on the competitiveness of the economy and its human capital. The quality of the Finnish educational system is highly rated in the OECD's programme for international student assessment rankings. Finland is in a relatively good position to compete in the global division of labour with its high level of human capital. The structural shift towards jobs with higher human capital content is beneficial for the Finnish economy as a whole

While the Finnish economy as a whole has coped well with the structural changes, the extensive adjustments in the economy apparently led to a rise in structural unemployment due to adjustment lags. The present stabilization of Finnish unemployment at rather high levels in spite of favourable overall demand seems to confirm this. While many features of the Finnish labour market institutions are well-designed and well-funded, the stalling of unemployment in recent years points to deficiencies which have to be addressed. Further reductions in unemployment will depend crucially on taking steps to eliminate features encouraging unemployment among older workers and to improve employment opportunities among the low-skilled employees.

All in all, the Finnish EU and EMU membership seems to have fulfilled most of its promises and most of the fears have not materialized. There is a very broad consensus among Finnish economists and policymakers that the stability of the economy is now much better than it used to be in the past, and that the policy trade-offs are much more favourable now. The general perception in Finland is that common monetary policy has been reasonably appropriate for the Finnish economy. The problem of asymmetric (i.e. country-specific) shocks has not at all been at the forefront in Finnish economic policy. Actually, it seems that economic cycle in Finland has recently become more synchronized with the euro area countries although the amplitude of the cycle in Finland in larger.

Ireland: is there a recipe for its economic "miracle"?[92]

The paradox with the successful story of the Irish economy over the last fifteen or so years is that it is so remarkable that few believe that it can be copied. Although there may be some truth in this statement, the Irish example provides useful elements which could, at least, inspire policymakers in other economies.

Some basic figures should give the essence of Ireland's achievements: real GDP growth rates reached double digits in the 1990's to slow to more sustainable levels of around 5% since the start of this decade. As a result, GDP per capita in Ireland climbed from 88.8% of EU15 in 1995 to 127.9% in 2005.

According to Cech and Macdonald (2004), who cite research of several authors, Ireland's massive catch-up in the 1990's benefited from a wide array of important, often interconnected, features:

- **macroeconomic stability and institutional quality**: the fiscal correction of the late 1980's was a necessary precondition for an economic turnaround. In addition, the falling interest rates up to the launch of the euro gave Ireland an additional monetary stimulus. Ireland also scored high on most of the subjective indicators of political stability and institutional quality
- **EU internal market and membership of the euro**: Ireland benefited from increased openness, as the country's attractiveness for foreign direct investment inflows were boosted by the launch of the EU internal market. During the 1990s, the requirements for joining the euro area acted as an external anchor to help macroeconomic stability. Since then, EMU has continued to provide an external incentive for macroeconomic discipline.
- **Wage competitiveness**: Ireland put in place a series of national agreements from the late 1980s onwards that ensured a high degree of support from all stakeholders in the economy. These resulted in industrial peace and wage moderation. Progress in fiscal consolidation also allowed the authorities to trade off tax reductions for moderate pay increases.
- **EU funds**: Transfers from EU funds, also in the light of fiscal consolidation, helped to finance a resumption of public capital spending and helped to improve public sector efficiency.
- **Educated and abundant workforce**: Ireland's population has been growing strongly since the early 1990s and the country had been investing heavily in education since as far back as the 1960s, producing a supply of skilled labour ready to meet the needs of the incoming FDI.

[92] This section draws on Z. Cech and J. Macdonald paper "The "Celtic Tiger" learns to purr, ECFIN country focus, 19.11.2004 and on P. Honohan and A. Leddin paper "Ireland in EMU: more shocks, less insulation?", October 7, 2005

- **Industrial policies**: Industrial policies played a key role in Ireland's, success. In order for growth to be generated in Ireland it had to become competitive in internationally-traded sectors, where its low corporation tax strategy and other measures to promote FDI played a crucial role.

Regarding Ireland' performance in EMU, we have seen above that the extraordinary growth of the economy in the 1990s, mainly due to the favourable external environment and the sizeable pool of available labour at that time, has given its place to more sustainable growth rates. Therefore, by most measures the Irish economy continues to perform well in EMU, and better than most, if not all member states. Closer examination of things point, however, to some particular challenges. Honohan, for example, argues that the experience in EMU has been an unalloyed success for Ireland if account is taken of its GDP growth rates, unemployment rate, BOP current account balance and even inflation, although it averaged 3.7% per annum. However, he expressed more concerns about the adjustment mechanisms. Examining Ireland's performance during the first seven years of EMU, Honohan asked whether

- exogenous shocks hitting the Irish economy are larger in EMU, and
- how have the economy's endogenous responses to shocks changed as a result of the regime changed.

His conclusion on shocks is that these have not on balance increased by much. While neither interest rate nor exchange rate movements have been helpful for internal macroeconomic stability in Ireland since EMU began, this dimension seems on balance no worse than it was before EMU began. To have an independent monetary and exchange rate policy does not mean that it will be used in an optimal manner. Ireland's practical experience in this regard suggests little loss from the abandonment of an autonomous currency.

On the other hand, the initial fall in interest rates unleashed a long-lived property price and construction-led boom which, interacting with long-standing migration forces, has allowed the economy on aggregate to survive -for the present- a relatively severe loss of labour competitiveness. This may help explain why losses of wage competitiveness have not yet been followed by a downturn in employment as has been feared for several years now. As this positive force finally weakens, period of labour market weakness cannot be ruled out.

Another key question was whether, with EU enlargement, the highly open Irish economy would face further potential challenges, as some of the new EU member states are likely to pose a threat by diverting FDI inflows away from Ireland. Many new member states are attempting to put in place similar policies to those of Ireland, including low-corporation-tax strategies. It is argued on this issue that the Irish case was a mixture of different factors at different times, with the country having also some specific features which might not be available to the EU new member states. Ireland has also the advantage of a core labour force in sophisticated tradable services sectors and in the information technology sector, which require skilled labour and, further, FDI flows into the new member states are likely rather to complement the Irish production networks. Therefore the main challenge for the economic policy continues to be maintaining competitiveness and addressing the structural bottlenecks that arise.

Belgium: the importance of rules and institutions in fiscal adjustment[93]

In section 5 of this paper was examined the significant budgetary adjustment in Belgium over the last ten years, notably the decline in the government debt ratio by about 37 percentage

[93] The section draws on a number of sources including Belgium's stability programmes and ECOFIN opinions on them, IMF's 2005 Article IV Consultations on Belgium and EC Public Finances in EMU publications.

points, from about 130% of GDP in 1995 to 93% of GDP in 2005 and the budgetary position in balance or in surplus in the last five years. Current plans are to reduce the government debt ratio to 60% of GDP by 2015. This achievement is all the more remarkable as GDP growth rates over the said period were rather modest. It is also interesting to note that Belgium is the only high debt country of the EU that has not been subject to the excessive deficit procedure. The examination of the fiscal adjustment in Belgium indicate that there have been three key elements behind the successful fiscal adjustment so far:

(i) a clear, broad and strong political commitment to eliminate fiscal deficits and reduce rapidly the huge government debt so that budgetary resources are freed for other policy priorities of higher economic and social value

(ii) a clear and coherent fiscal consolidation strategy based on high primary (i.e. excluding interest payments) surpluses and transparent quantitative rules on expenditure grow

(iii) credible institutions, such as the High Finance Council, whose role is consultative, but nevertheless central, on the formulation and implementation of the budgetary effort of each sub-sector of the general government sector.

The broad political commitment towards fiscal adjustment and debt reduction was forged following the excesses of the1980s and early 1990s which led to a budget deficit of close to 8% of GDP in 1992 and the government debt ratio to 133.4% of GDP (the highest in the Community) in 1993.High primary surpluses for a long series of years (around 5% of GDP, on average, per year during 1995-2005) was a central factor to the fiscal consolidation strategy. Such high primary surpluses were made possible through the implementation of strict rules, for example by limiting the primary expenditure increase in real terms for the federal government and the social security to 1.5% per year. On an operational level, there was a tight control of expenditures in order to respect the budgetary projections.

The role of the *High Finance Council* (HFC) has been important in the success of the fiscal adjustment. The HFC essentially formulates independent views on the fiscal outlook, assesses the budget proposals of the various levels of government in Belgium (Regions and Communities), monitors the execution of the budget and issues warnings in case of non-compliance by any counter-party in the budgetary agreement. Although the role of the Council has become crucial in the specific federal institutional structure of Belgium, and it may not be easily transposed elsewhere, it provides nevertheless an example of the useful role of independent, highly-respected consultative and technical bodies. The HFC is chaired by the minister of finance (who has no vote in Council's proposals) and is composed of representatives of the central bank, the ministries of finance and budget, of communities-regions and of independent experts.

Noteworthy initiative in order to prepare for the budgetary consequences of the ageing of population was the creation of the *Ageing Fund* in 2001 whose objective is to accumulate reserves in order to finance additional pension expenditures between 2010 and 2030. No expenditure will be made by the Fund before 2010. Moreover, any expenditure after that date will be subject to the requirement that the government debt ratio is lower than 60% of GDP. At the end of September 2005, the Ageing Fund reserves totalled € 12.391,5 million.

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