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Economic Developments in the Euro Area

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Introduction

The year 2005 was characterized by turmoil for the Member States of the euro area. The Stability and Growth Pact (SGP) was revised at the March European Council. By June the French and Dutch had voted down in a referendum the draft Treaty establishing a Constitution for Europe. In the autumn spiking oil prices, following the hurricane season (in particular Hurricane Katrina that hit the American city of New Orleans), led to concerns about stifling the prospects of a precarious recovery of the euro area economy and those of others. In December the European Central Bank (ECB) raised its interest rate by 25 basis points – changing its rate for the first time since 2003. These developments came against the background of a seemingly poorly performing euro economy (compared to others) and the mid-term review of the Lisbon agenda (see Howarth in this issue).

Reflections on the performance of the euro area economy come amidst mounting speculation about whether the United States' (US) current account deficit and indebtedness are sustainable in the long run, and what implications any corrections might have on the relationship between the euro and the dollar. In addition, during 2005 the economies of China and India gained further in strength, suggesting that for the foreseeable future the world will be characterized by multiple poles of economic strength.

This review looks at the economic development in the euro area by highlighting a few core characteristics and discusses some policy areas more closely.

The first section provides some key economic performance indicators. The second discusses developments surrounding the SGP, particularly the March reform. Next, the review examines the policy of the ECB, before reviewing the external dimension of the euro. It closes with a brief summary and outlook for 2006.

I. Main Economic Indicators

In September, the International Monetary Fund (IMF) reported that the average rate of *economic growth* for advanced economies in the years 2004 and 2005 remained largely unchanged, from the previous forecast, at respectively 3.3 per cent and 2.5 per cent annual change of gross domestic product (GDP) (IMF, 2005; see also Table 1). The euro area, however, continues to show a weaker than average performance compared to the advanced economies as a whole (lagging behind by about 1 per cent, i.e. 2.0 per cent (2004) and 1.2 per cent (2005)). Not surprisingly, the euro area performed worse with regard to other leading nations. For example, GDP in the United States was 4.2 per cent (2004) and 3.5 per cent (2005), and even Japan, which had experienced slow growth in the previous decade, stood at 2.7 per cent (2004) and 2.0 per cent (2005). Furthermore, even the EU as a whole performed better than the euro area, 2.5 per cent (2004) and 1.6 per cent (2005).

Table 1: Overview of World Economic Outlook Projections in Annual % Change

			Projections	
	2003	*2004*	*2005*	*2006*
World output	4.0	5.1	4.3	4.3
Advanced economies	1.9	3.3	2.5	2.7
United States	2.7	4.2	3.5	3.3
Euro area	0.7	2.0	1.2	1.8
Japan	1.4	2.7	2.0	2.0
United Kingdom	2.5	3.2	1.9	2.2
Canada	2.0	2.9	2.9	3.9
Other advance economies	2.5	4.4	3.2	3.9
Central and eastern Europe	4.6	6.5	4.3	4.6
Commonwealth of Independent States	7.9	8.4	6.0	5.7
China	9.5	9.5	9.0	8.2
India	7.4	7.3	7.1	6.3
European Union	1.3	2.5	1.6	2.1

Source: IMF (2005).

In December the Organization for Economic Co-operation and Development (OECD) estimated euro area GDP growth for 2005 at only 1.4 per cent, compared with 3.6 per cent for the US, 2.4 per cent for Japan and 3.0 per cent for Canada (OECD, 2005). As was the case last year (Grimwade, 2005, p. 183) the large economies of the euro area were still underperforming (Germany and Italy) or not performing much above the average (France). The OECD estimated the growth in GDP at market prices in 2005 for Germany at 1.1 per cent, France 1.6 per cent, and Italy even as low as 0.2 per cent. The countries in the EU-15 not part of the euro area did a little better. For example, growth in the United Kingdom (UK) was estimated at 1.7 per cent, Denmark at 3.0 per cent and Sweden at 2.4 per cent of GDP at market prices. Table 2 sets out the latest estimates of the European Commission for GDP growth in the euro area plus Denmark, Sweden and the UK and the forecast for 2006.

Table 2: Annual Average % Change in GDP at 1995 Prices for the EU-15, 1991–2006

	1991–2000	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*
Euro area Member States:							
Belgium	2.1	1.0	1.5	0.9	2.6	1.4	2.1
Germany	2.1	1.2	0.1	–0.2	1.6	0.8	1.2
Greece	2.3	4.6	3.8	4.6	4.7	3.5	3.4
Spain	2.8	3.5	2.7	3.0	3.1	3.4	3.2
France	2.1	2.1	1.2	0.8	2.3	1.5	1.8
Ireland	7.1	6.2	6.1	4.4	4.5	4.4	4.8
Italy	1.6	1.8	0.4	0.3	1.2	0.2	1.5
Luxembourg	5.5	1.5	2.5	2.9	4.5	4.2	4.4
Netherlands	2.9	1.4	0.1	–0.1	1.7	0.5	2.0
Austria	2.6	0.8	1.0	1.4	2.4	1.7	1.9
Portugal	2.9	2.0	0.5	–1.2	1.2	0.4	0.8
Finland	1.8	1.0	2.2	2.4	3.6	1.9	3.5
Euro area	2.2	1.9	0.9	0.7	2.1	1.3	1.9
Non-euro area Member States of the EU-15:							
Denmark	2.6	0.7	0.5	0.6	2.1	2.7	2.3
Sweden	2.0	1.0	2.0	1.5	3.6	2.5	3.0
UK	2.5	2.2	2.0	2.5	3.2	1.6	2.3
EU-15	2.2	1.9	1.1	1.1	2.3	1.4	2.0

Source: Commission (2005a).

The *employment* situation also continued to improve, as had been the case in 2004. Stronger economic growth, in particular in the latter part of 2005, contributed significantly to the improved employment performance and forecast. Table 3 again shows stronger employment performance for the non-euro area Member States than those in the euro area. In the case of employment, the trend is even stronger than with regard to GDP growth. Again the difference is caused mostly (but not only) by poor performance of the larger Member States. Note the continuing buoyancy of Ireland, but also the strong performance of Austria and the Netherlands. High unemployment still exists in Germany, France, Spain and Greece. The situation in Germany looks to improve slightly next year.

Looking at the harmonized index of consumer prices, we find that *inflation rates* in the countries of the euro area continue to diverge a little, but still remain low (the average at about 2.3 per cent with the maximum at just over 3.7 per

Table 3: % Share of the Civilian Labour Force Unemployed in the EU-15, 1991–2006

	1991–2000	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*
Euro area Member States:							
Belgium	8.5	6.7	7.3	8.0	7.9	8.0	7.9
Germany	7.7	7.4	8.2	9.0	9.5	9.5	9.3
Greece	9.5	10.8	10.3	9.7	10.5	10.4	10.0
Spain	16.0	10.8	11.5	11.5	11.0	9.2	8.5
France	10.7	8.4	8.9	9.5	9.6	9.6	9.3
Ireland	11.1	3.8	4.3	4.6	4.5	4.3	4.4
Italy	10.4	9.1	8.6	8.4	8.0	7.7	7.6
Luxembourg	2.5	2.1	2.8	3.7	4.8	5.3	5.6
Netherlands	5.1	2.2	2.8	3.7	4.6	5.1	4.9
Austria	3.9	3.6	4.2	4.3	4.8	5.0	5.0
Portugal	5.6	4.0	5.0	6.3	6.7	7.4	7.7
Finland	12.5	9.1	9.1	9.0	8.8	8.4	7.8
Euro Area	9.6	7.9	8.3	8.7	8.9	8.6	8.4
Non-euro area Member States of the EU-15:							
Denmark	6.6	4.3	4.6	5.6	5.4	4.6	4.2
Sweden	7.6	4.9	4.9	5.6	6.3	6.8	5.9
UK	7.9	5.0	5.1	4.9	4.7	4.6	4.9
EU-15	9.2	7.2	7.6	7.9	8.1	7.9	7.7

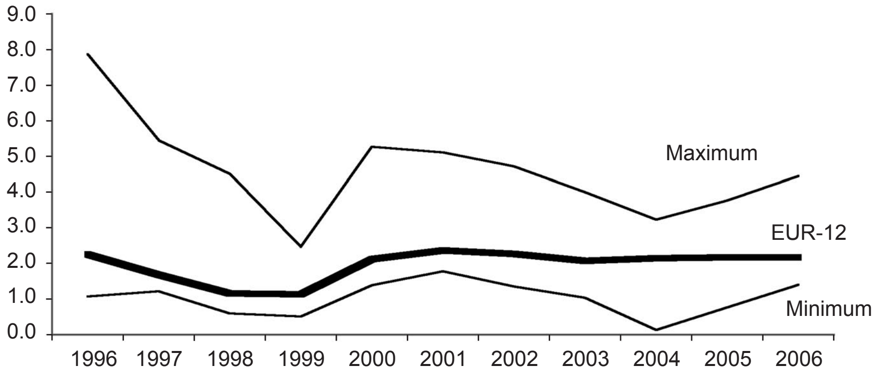
Source: Commission (2005a).

cent (Spain) and the minimum at 1.1 per cent (Finland) (Commission, 2005a; see also Figure 1). Inflation in the euro area peaked in September of 2005 (2.6 per cent) in response to the higher oil prices in the wake of Hurricane Katrina, but came down nicely (2.5 per cent in October, 2.4 per cent in November, 2.2 per cent in December 2005 (Eurostat, 2006)).

If we compare the inflation performance with those in the rest of the EU we find that inflation is still diverging among both euro area Member States, the three 'outs' and the new Member States (see Table 4). Inflation in the non-euro area Scandinavian states is low. Those that experienced high inflation rates in 2005 are new Member States eager to join the euro (Estonia and Latvia), but also Greece and Spain, with the latter experiencing higher than average growth rates (on the policies towards EMU of the new Member States, see Johnson in this volume).

Turning to *public finances*, the situation in the EU seemed to have stabilized somewhat. In particular the deficit situation was subject to considerable scrutiny in 2005, because of the reforms in the SGP. Compared to the situation in 2004 in which the average deficit in the euro area was 2.5 per cent, the situation in 2005 had worsened mostly because of the performance of a small group of countries. With the weighted average deficit at 3.0 per cent, it is clear that some members are above the threshold, and in some cases by quite a margin. Greece continued to be a concern with its deficit at 5.7 per cent. Germany and France were also still above the 3.0 ceiling and were both estimated by the Commission by the end of 2005 to be hitting 4.1 per cent, albeit on a downward trend (see Table 5). However, all other Member States are closer to the

Figure 1: Inflation in the Euro Area



Source: Commission (2006).

Table 4: Harmonized Consumer Price Index, Annual % Change

	1991	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*
Belgium	N/a	2.25	2.49	2.39	1.27	1.78	1.50	0.91	1.13	2.68	2.44	1.55	1.51	1.86	2.53	2.60
Czech Rep.	N/a	N/a	N/a	N/a	N/a	9.09	8.01	9.69	1.81	3.94	4.55	1.42	–0.06	2.56	1.58	2.90
Denmark	2.16	1.95	0.91	1.81	2.05	2.08	1.96	1.29	2.06	2.73	2.26	2.42	1.96	0.92	1.70	2.00
Germany	N/a	N/a	N/a	N/a	N/a	1.21	1.53	0.60	0.64	1.39	1.90	1.36	1.04	1.78	1.94	1.64
Estonia	N/a	N/a	N/a	N/a	N/a	19.80	9.27	8.79	3.10	3.94	5.62	3.59	1.39	3.03	4.11	3.30
Greece	N/a	N/a	N/a	N/a	8.90	7.87	5.46	4.51	2.16	2.88	3.66	3.92	3.46	3.01	3.49	3.10
Spain	N/a	N/a	4.87	4.63	4.58	3.56	1.87	1.77	2.23	3.48	2.83	3.59	3.10	3.05	3.38	3.27
France	3.40	2.42	2.21	1.74	1.79	2.08	1.28	0.67	0.56	1.83	1.78	1.94	2.17	2.34	1.90	2.09
Ireland	N/a	N/a	N/a	N/a	2.80	2.15	1.26	2.13	2.46	5.27	3.98	4.72	4.00	2.31	2.18	2.50
Italy	6.22	4.98	4.51	4.17	5.39	3.98	1.90	1.97	1.65	2.60	2.33	2.60	2.82	2.26	2.20	2.13
Cyprus	N/a	N/a	N/a	N/a	N/a	N/a	3.32	2.34	1.14	4.86	1.98	2.79	3.96	1.90	2.04	2.10
Latvia	N/a	N/a	N/a	N/a	N/a	N/a	8.06	4.29	2.13	2.64	2.53	1.95	2.94	6.19	6.90	6.00
Lithuania	N/a	N/a	N/a	N/a	N/a	24.70	10.27	5.39	1.46	1.07	1.55	0.34	–1.08	1.17	2.66	2.80
Luxembourg	N/a	N/a	N/a	N/a	N/a	1.16	1.38	0.97	1.02	3.78	2.40	2.06	2.54	3.23	3.76	4.45
Hungary	N/a	N/a	N/a	N/a	N/a	23.49	18.46	14.22	9.97	9.96	9.08	5.24	4.68	6.77	3.49	2.00
Malta	N/a	N/a	N/a	N/a	N/a	N/a	3.92	3.70	2.29	3.04	2.51	2.61	1.94	2.72	2.53	2.60
Netherlands	3.16	2.83	1.62	2.14	1.38	1.43	1.86	1.78	2.03	2.34	5.11	3.87	2.24	1.38	1.50	2.04
Austria	3.08	3.48	3.16	2.70	1.62	1.78	1.16	0.82	0.51	1.96	2.30	1.70	1.30	1.95	2.11	2.10
Poland	N/a	N/a	N/a	N/a	N/a	N/a	14.97	11.79	7.18	10.08	5.33	1.94	0.70	3.60	2.17	2.30
Portugal	11.43	8.86	5.93	4.97	3.97	2.93	1.89	2.22	2.17	2.80	4.41	3.68	3.26	2.51	2.13	2.70
Slovenia	N/a	N/a	N/a	N/a	N/a	9.91	8.34	7.91	6.12	8.95	8.56	7.46	5.69	3.66	2.46	2.50
Slovakia	N/a	N/a	N/a	N/a	N/a	5.78	6.00	6.69	10.45	12.20	7.16	3.50	8.43	7.47	2.80	3.60
Finland	4.54	3.25	3.33	1.61	0.40	1.07	1.22	1.34	1.32	2.94	2.67	2.01	1.30	0.14	0.77	1.40
Sweden	8.74	1.30	4.81	2.88	2.70	0.96	1.81	1.03	0.54	1.30	2.67	1.93	2.34	1.02	0.82	1.36
UK	7.54	4.24	2.53	1.98	2.73	2.49	1.81	1.56	1.35	0.80	1.22	1.27	1.36	1.34	2.05	2.22
EUR-12	4.32	3.77	3.38	2.83	2.55	2.25	1.68	1.16	1.13	2.12	2.36	2.27	2.08	2.14	2.17	2.16
EU-25	N/a	3.97	3.43	2.84	2.98	3.07	2.57	2.10	1.60	2.44	2.52	2.12	1.94	2.15	2.16	2.22
EUR-15	5.17	4.05	3.43	2.80	2.78	2.42	1.71	1.31	1.16	1.91	2.20	2.08	1.95	1.95	2.14	2.18

Source: Commission (2006).

Table 5: Net Lending (+) or Net Borrowing (-) as a % of GDP in EU-15, 1991–2006

	1996–2000	*2001*	*2002*	*2003*	*2004*	*2005*	*2006*
Euro area Member States:							
Belgium	–1.4	–0.5	0.1	0.6	0.0	0.1	0.0
Germany	–1.7	–1.5	1.3	–2.9	–3.8	–4.1	–3.7
Greece	–5.2	–3.4	–4.1	–6.1	–4.9	–5.7	–6.6
Spain	–2.6	–1.2	–0.9	–0.5	–0.3	0.0	–0.1
France	–2.6	–1.7	–1.4	–1.5	–3.2	–4.1	–3.7
Ireland	2.1	2.5	4.4	0.8	–0.4	0.2	1.4
Italy	–3.0	–1.7	–0.8	–3.2	–2.7	–3.2	–3.2
Luxembourg	3.6	3.5	6.1	6.5	2.1	0.2	–1.2
Netherlands	–0.2	0.6	2.1	–0.2	–2.0	–3.2	–2.1
Austria	–2.3	–2.2	–1.5	0.1	–0.4	–1.2	–1.0
Portugal	–3.3	–2.7	–2.9	–4.2	–2.8	–2.9	–3.0
Finland	1.3	2.2	7.1	5.2	4.3	2.5	2.1
Euro area	–5.1	–1.3	0.1	–1.8	–2.5	–3.0	–2.7
Non-euro area Member States of the EU15:							
Denmark	1.2	2.3	3.3	2.6	1.4	1.2	2.9
Sweden	1.2	2.5	5.1	2.5	–0.3	0.2	1.6
UK	–0.3	1.0	3.8	0.7	–1.7	–3.3	–3.2
EU-15	–1.6	–0.7	1.0	–1.2	–2.2	–2.9	–2.6

Source: Commission (2005a).

3.0 per cent ceiling, although the Italian deficit performance started to attract attention again in early 2006. The situation on the deficits was the key subject of the reforms of the SGP discussed in detail below.

II. Reform of the Stability and Growth Pact

The Stability and Growth Pact (SGP) was created in 1997 to serve as a disciplining mechanism once Member States were in the third stage of EMU (Heipertz and Verdun, 2004, 2005). The SGP[1] specifies the fiscal policy framework set out in Article 104 of the Treaty Establishing the European Community (TEC).

[1] The legal text of the SGP consists of (1) Resolution of the European Council on the Stability and Growth Pact (OJ 1997, C 236/1); (2) Council Regulation No. 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies (OJ 1997, L 209/1 as amended by Council Regulation 1055/105 of 27 June 2005); and (3) Council Regulation No. 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure (OJ L 209/6 as amended by Council Regulation 1056/2005).

Since the start of stage three of EMU on 1 January 1999, attention has been paid to how the SGP would be implemented. In the 2001 and 2002 so-called 'early warnings' were given, and the excessive deficit procedure was started against some Member States such as Portugal, Germany and France, that were running deficits in excess of 3 per cent of GDP. These Member States were supposed to correct the excessive deficits within a year, which Portugal did, but Germany and France did not. In 2003 the Commission proposed that the next step of disciplinary action, which envisages the imposition of sanctions, be taken against France and Germany, but the Council of Ministers of Economic and Financial Affairs (Ecofin) decided on 25 November 2003 not to adopt the Commission proposal. Instead, it decided that application of the SGP in the cases of France and Germany be interrupted. This decision effectively put the excessive deficit procedure for these two countries into limbo.

The Commission challenged Ecofin's decision before the European Court of Justice (ECJ). In July 2004 the ECJ ruled that the Council indeed *had the right* not to adopt the Commission's proposal, but it *could not* adopt provisions on its own without a proposal by the Commission (see Dougan, 2005, pp. 93–5). In the light of the resulting difficult political situation, it was considered necessary to review the SGP, which eventually happened in the spring of 2005.

Critics had been making the case that the SGP was too rigid. It put too much emphasis on the needs of the euro area to be protected against free-riding behaviour of some Member States, which happens if they run excessive deficits, at the expense of allowing Member States the flexibility and autonomy to take fiscal measures aimed at stabilizing their domestic economies. These observers became more vocal in 2003–04 and argued that the SGP should be relaxed (Enderlein, 2004). The principles of the SGP, however, are firmly embedded in the Treaty on European Union, and the SGP provisions in a sense are merely a clarification of the provisions in the Treaty. Hence, it was not a feasible option to abandon the SGP altogether, but rather to make sure that a reformed SGP would make for better compliance and greater sensitivity to some of the Member States' difficulties.

A review of the SGP was initiated in September 2004 and was concluded in the spring of 2005 and the final regulations were adopted in June 2005 (Almunia, 2005). The preventive arm of the SGP has been strengthened by making the rules more differentiated and focused on the medium term. The new provisions seek to pay proper attention to the fundamentals of fiscal sustainability when setting budgetary objectives. More attention will be paid to the debt level than was the case before. In the future, the medium-term budgetary objective of a Member State will be determined by its current debt ratio and potential economic growth. This means in practice that Member States with a combination of low debt and high potential economic growth should be allowed to run a small deficit over the medium term, whereas those with high debt and low potential growth will have to keep a balanced budget or a surplus. The preventive arm of the SGP is further strengthened by the Member States' commitment actively to consolidate public finances under favourable economic conditions. Furthermore, it has been envisaged that the Commission may act and give 'policy advice' if this consolidation does not occur often enough.

The revised SGP includes provisions that seek to facilitate the choices of Member States that are considering going through major structural reforms. The new SGP allows Member States to be given more flexibility if major structural reforms have direct long-term cost-saving effects and verifiably improve fiscal sustainability. In this way, the new rules have tried to encourage the Lisbon agenda reforms, whilst still aiming at fiscal discipline. The timing of some corrective measures has also been extended. The one-year deadline for the correction of an excessive deficit has been extended by an additional year, as it is very difficult to correct a deficit within only one year.

Since 2003 there have been numerous cases of opening an excessive deficit procedure against Member States. Some, such as the Netherlands, had been opened and were closed. By the end of 2005 procedures were ongoing in at least five euro area countries: Greece, France, Germany, Italy and Portugal (second time). The new SGP gives them a little more time. In some circumstances that should enable them to argue why they need more room for manœuvre. Nevertheless it is expected that it will still be difficult for these countries to bring down their deficits or to argue for a prolonged period of deficits exceeding the reference value of 3 per cent of GDP.

III. Policies of the European Central Bank

The ECB sets the monetary policy for the entire euro area. Since its creation, the ECB has taken the euro area as a whole as its reference point. In determining policy, the Member State economies are weighted proportionally to their economic size in the euro area economy. The ECB has typically kept interest rates unchanged even when commentators have pointed to weak economic growth (and argued that the ECB should reduce rates), or called on the ECB to increase interest rates to increase the value of the euro, as was the case in 2002. In 2005 there was not that much pressure on the ECB regarding the value of the euro, compared to earlier years, even though there was still pressure on the ECB to lower rates (or not increase rates) in order to improve the prospects of economic growth. The ECB did not respond to these demands.

Even though the ECB values proportionally the Member States' economies in determining its policy, the effect of the single interest rate has been divergent. In some countries, such as Ireland, the ECB's interest rate was generally seen as too low. In others, such as Germany, the interest rate was seen as too high. Nevertheless, as we saw in 2004, economic growth and inflation rates were not wildly out of sync with one another (see Table 2 above).

In 2004 and during almost all of 2005 the ECB kept rates unchanged. Only on 1 December 2005 did it increase interest rates by 25 basis points (a second 25 basis point increase occurred on 2 March 2006). As a result, the key interest rate in the euro area in April 2006 is 2.5 per cent compared to a primary credit rate of 5.25 in the US.

The ECB has focused on pursuing monetary policy with a view only to maintaining price stability. It has unilaterally explained that price stability means maintaining inflation at or below 2 per cent over the medium term. It has refused to deal with matters related to economic growth, employment, or economic activity more generally, or the costs associated with keeping interest rates relatively high to secure low inflation. Instead it focuses merely on low inflation, arguing that low inflation ultimately leads to growth (Trichet, 2006).

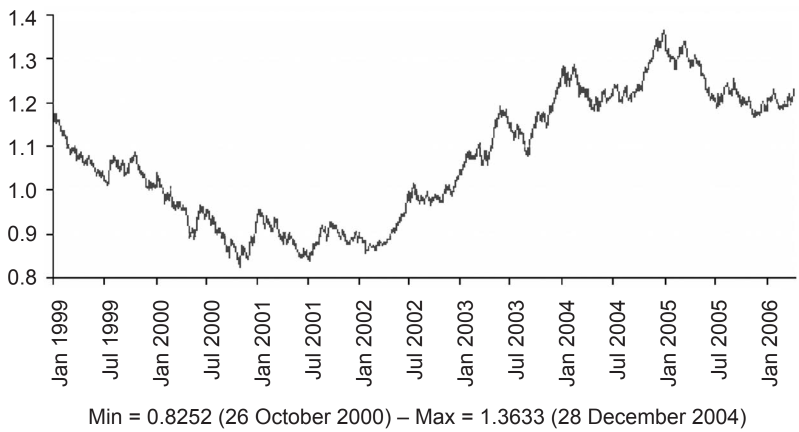
IV. External Dimension of the Euro

The most immediate external dimension of the euro concerns those EU Member States that wish to join EMU. Along with having to meet the SGP targets, the EMU aspirants must join the exchange rate mechanism (ERM)-II, under which their currencies have to stay within 15 per cent (plus or minus) of the agreed parity for two years. The new Member States are working on meeting those criteria, just as euro area Member States did before joining EMU (see Johnson in this volume).

The euro lost considerable value against other major currencies during 2005. At the beginning of 2005 there were real concerns, carried over from 2004, that the euro was overvalued and was disrupting the competitiveness of the euro area economy. As the year progressed and the euro fell, however, these concerns became less vocal. Towards the end of 2005, the concern was less with the euro than with whether the US dollar could be facing a major depreciation in value.

The value of the euro remains an issue of much discussion as it has fluctuated quite considerably in value. Following its introduction at $1.17 it fell to $0.825 on 26 October 2000. Between summer 2001 and late 2004 it rose, peaking at $1.36 on 28 December 2004. In 2005 the euro was initially still quite high at around $1.30, but roughly stabilized around $1.20 (see Figure 2). Even though significant currency fluctuations occurred in the mid- to late-1980s, fluctuations of this magnitude (one could say of 30 per cent in the first few years) led to considerable concern about the external value of the euro.

Figure: US–Euro Exchange Rates January 1999–January 2006



Source: European Central Bank.

During 2005, however, the fluctuation *vis-à-vis* the US dollar was more in the 10 per cent range, which is much more common. Indeed the relevance of currency fluctuations depends largely on the size of the import/export sector of the euro area economy with the countries outside that area. Consequently, as the Member States of the euro area trade considerably more with each other than those outside the euro area, the effect of a high or low euro may not in fact be as influential on the economy as the symbolism of the fluctuation.

V. EU Politics in 2005 and the Dutch and French Referendums

The rejection of the Treaty establishing a Constitution for Europe in referendums in France and the Netherlands pointed to the symbolic role of the euro in domestic politics (on the referendums, see Taggart in this volume). The referendums are interesting for developments in the euro area in a number of ways. First, the euro figured in the 'no' campaigns of both countries. In the Netherlands the 'expensive euro' was used as an argument. In France the left-of-centre parties argued that the EU was synonymous with neo-liberalism (or 'Anglo-Saxon' market mechanisms). Moreover, in Italy in spring 2005, some argued that Italy should leave the euro area. These statements were mostly received with some ridicule as it was quickly pointed out that the Italian government would have to pay much more to service its large debt (over 100 per cent GDP) if it had to borrow in the marketplace without the support of the other EU Member States.

Conclusion

The euro area experienced a year of slow economic growth amidst a global economy that was picking up speed. The main issue of 2005 was how to get the euro economy back on track. With the provisions in the Treaty requiring that deficits be capped at 3 per cent of GDP, backed up by the SGP in case countries were to exceed those ceilings, the remaining strategies to encourage growth were reduced largely to adopting microeconomic reforms. This is especially the case for those countries that face the need to reform pensions or healthcare in the light of demographic changes. Thus the reforms on which governments are embarking now are likely to start to have an impact only in the years to come. The 2005 reforms of the SGP focused on permitting greater flexibility in the application of the SGP's rules for those Member States embarking on these kinds of reform.

The reform of the SGP had become necessary following the November 2003 Council decision and the 2004 ECJ ruling that found the Council conclusions illegal. It is as yet unclear what the impact of the revised SGP will have on the governance of EMU.

During 2005 the ECB pursued monetary policy very much in line with what it had done in the first years of its existence. It strongly signalled its commitment to price stability by leaving interest rates largely unchanged throughout 2005, with the exception of December 2005 when it raised its rate in response to the inflationary pressures resulting mainly from higher fuel prices.

The outlook for 2006 is that it is generally believed that the economy is picking up, even in the larger economies of the euro area. The ECB's policies are – predictably – still predominantly focused on containing inflation. In its statement in April the ECB signalled a possible increase in interest rates foreseen for July. All in all the euro area economies are seeking ways to increase their economic growth. Those countries with excessive deficits have been given some more flexibility under the SGP, but it still has some teeth. How the reformed SGP is applied will be something to watch in 2006.

Key Readings

Commission (2005b) offers an oversight of the EU economy until October 2005 and gives a balanced view of the challenges and opportunities that have faced the EU in 2005 and those that lie ahead. This particular issue is devoted to 'globalization'.

de Grauwe (2005) offers an overview of the issues related to EMU from an economic perspective, providing various models and analytical tools to study the issues at stake in the creation of EMU.

Hosli (2005) provides a brief overview of the history and policies of EMU, the structure of the ECB and the role of the euro in the international system.

Howarth and Loedel (2005) give a general introduction to the ECB's history, design, organization and governance. It offers various theoretical approaches to the ECB, a review of national perspectives on central bank independence and accountability. It also reviews its first years of operation.

OECD (2005) offers an oversight of the economic situation and the policies of the euro area to 13 June 2005.

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