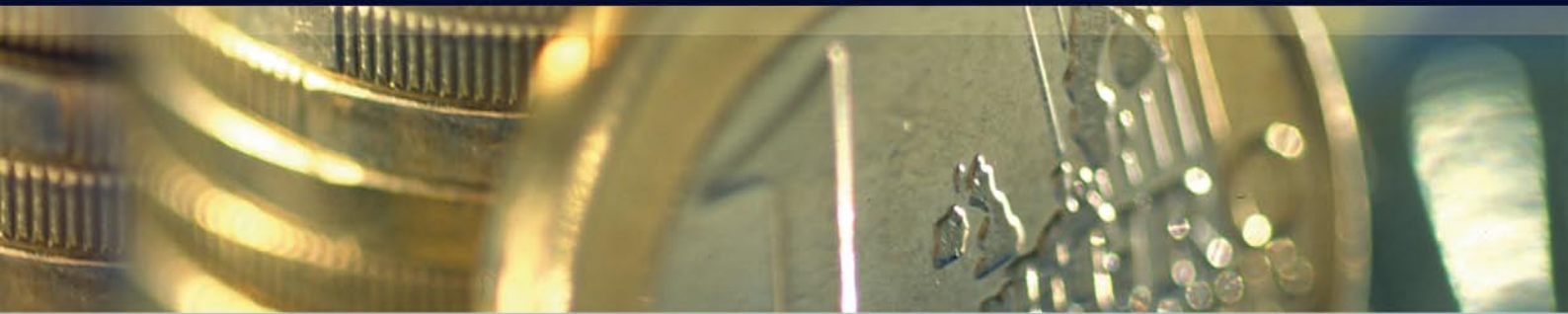


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The Evolution of Economic Governance in EMU

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EMU@10 Research

In May 2008, it will be ten years since the final decision to move to the third and final stage of Economic and Monetary Union (EMU), and the decision on which countries would be the first to introduce the euro. To mark this anniversary, the Commission is undertaking a strategic review of EMU. This paper constitutes part of the research that was either conducted or financed by the Commission as source material for the review.

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THE EVOLUTION OF ECONOMIC GOVERNANCE IN EMU*

by

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Abstract

EMU's unique economic governance structure was set up by the Maastricht Treaty to ensure the proper functioning of the economic and monetary union. A single monetary policy is entrusted with an independent central bank, a range of common policies is decided by the Council (notably the ECOFIN Council), and many other economic policies – notably fiscal and structural policies – remain in the hands of national actors. It was further shaped as events unfolded, priorities changed and new challenges emerged.

This paper examines the benefits of co-ordination in a stylised manner and how these benefits have shaped the co-ordination framework in EMU. It then discusses in detail the co-ordination experience in four areas that are particularly important for the functioning of EMU: (i) fiscal policy co-ordination under the Stability and Growth Pact (SGP); (ii) the co-ordination of structural policies under the Lisbon Strategy for Growth and Jobs; (iii) the representation and co-ordination of euro-area positions in international financial fora; and (iv) the co-ordination of macroeconomic statistics.

The thrust of the findings is that EMU's system of economic governance has, overall, proven fit for purpose. The current policy assignment to the institutions and instruments that govern the conduct of economic policy in EMU is sound, even though further progress is necessary in several areas, particularly as regards external representation.

* This paper is based on contributions prepared by Commission staff as background material for the report 'EMU@10: Successes and Challenges After 10 Years of Economic and Monetary Union,' *European Economy*, 2/2008, which was published by the European Commission on 7 May 2008.

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INTRODUCTION

EMU's unique economic governance structure was set up by the Maastricht Treaty to ensure the proper functioning of the economic and monetary union, where: (i) a single monetary policy is entrusted with an independent central bank, the European Central Bank (ECB); (ii) a range of common policies is decided by the Council (notably the ECOFIN Council); and (iii) many other economic policies – notably fiscal and structural policies – remain in the hands of national actors. It was further shaped as events unfolded, priorities changed and new challenges emerged. Notably, the enlargement of the euro area raised co-ordination issues that were not foreseen from the outset and led to modifications and different modes of implementation.

The ECOFIN Council is the natural body for decision-making at the EU level as concerns economic policies, because it ensures co-ordination between finance ministers. The latter are key actors in the euro area's system of governance because they are most directly involved in the functioning of EMU, and they have direct competence in areas that are more relevant for the functioning of EMU, such as fiscal policy, taxation and financial markets. The ECOFIN Council is also the forum for several key forms of economic governance in the EU, such as the Lisbon Strategy for Growth and Jobs or the Stability and Growth Pact (SGP).

Since not all EU Member States participate in the euro area, a separate body – the Eurogroup – has been created to deal with co-ordination at the euro area level. The Eurogroup consists of the ministers of Finance of the euro area Member States alongside with the Commissioner for Economic and Monetary Affairs and the President of the ECB. The Eurogroup has no role in the conduct of monetary policy, which is in the remit of the ECB. From the outset, the Eurogroup has had an informal status in the sense that it does not venture into voting on policy, but rather prepares such voting by the ECOFIN Council.

The role of the European Commission in this framework is two-pronged: (i) to pursue surveillance of economic policies that are in the remit of the ECOFIN Council and the Eurogroup, so as to facilitate its decision-making; and (ii) to initiate policy initiatives in the form of recommendations or proposals to the Council whenever it considers this to be appropriate and in line with the Treaty rules (the Commission's right of initiative).

The rationale of economic policy co-ordination in EMU is relatively clear-cut and relates to spillover effects across countries. Economic policy spillovers in EMU differ from those arising under flexible exchange rate arrangements. Members of EMU share a large amount of "club goods," including monetary stability, interest rates and the external exchange rate (Cohen and Wyplosz, 1999; Jacquet and Pisani-Ferry, 2000, von Hagen and Mundschenk, 2001). The existence of "club goods" raises an issue of free-riding behaviour, which manifests itself in an incentive to ignore fiscal spillovers (see, *e.g.*, Beetsma, 2001). In addition, the well functioning of a monetary union in part depends on: (i) the efficiency of intra-area adjustment in the absence of an internal exchange rate mechanism; and (ii) the ability to reach common positions in global macro-financial policy making and pursue them effectively (von Hagen and Mundschenk, 2002).

In the external field, the existence of a single monetary and exchange rate policy in the euro area (and of coordination frameworks in other key policy areas), the rising international role of the euro and the increasing relevance of euro area developments for

the world economy provide a strong rationale for the co-ordination of euro-area positions on international macroeconomic and financial matters.

Against this backdrop, the first section of this paper examines the benefits of co-ordination in a stylised manner and how those benefits have shaped the co-ordination framework in EMU. The subsequent sections then discuss in detail the co-ordination experience in four areas that are particularly important for the functioning of EMU: (i) fiscal policy co-ordination under the SGP; (ii) the co-ordination of structural policies under the Lisbon Strategy; (iii) the representation and co-ordination of euro-area positions in international financial fora; and (iv) the co-ordination of macroeconomic statistics. The co-ordination of financial market integration and development under the financial services action plan (FSAP) is not covered here. The interested reader may refer to European Commission (2007a), ECB (2007a, 2008) and Baltzer *et al.* (2008).

The thrust of the findings is that EMU's system of economic governance has, overall, proven fit for purpose. The current policy assignment to the institutions and instruments that govern the conduct of economic policy in EMU is sound, even though further progress is necessary in several areas, particularly as regards external representation.

1. BENEFITS OF CO-ORDINATION

In general terms, economic policy co-ordination in EMU has three dimensions which together have shaped the form co-ordination has taken: its rationale, timeframe and depth. Concerning the *first dimension*, there are three groups of rationales for co-ordination in an economic and monetary union: economic spillovers, learning and political spillovers, and external leverage.

- *Economic spillovers.* Fiscal and structural policies in each of the Member States affect the economic performance of other Member States, as well as the euro area as a whole. Such spillovers are typically more persistent in a monetary union than under a flexible exchange rate regime. Therefore, in a monetary union benefits are to be drawn from internalising those spill-over effects in setting both national policies and surveillance at the EU level.
- *Learning and political spillovers.* Common goal-setting and the frequent and regular exchange of countries' experiences in addressing these goals yield valuable information from which all Member States benefit. They may also help to overcome resistance to pursuing unpopular domestic reforms.
- *External leverage.* Co-ordination is needed also to enhance the relationships and dialogues with the outside world. 'Speaking with one voice' is a precondition for success. In turn, a drive for consensus may facilitate the co-ordination of policy-making among euro area Member States, *e.g.* in the Eurogroup.

The economic spillover effects have so far been the most important rationale for co-ordination in EMU. These spillovers comprise a complex set of channels:

- There are the classical adverse spillover effects stemming from *deficit bias* that have motivated the SGP. The SGP aims to stem both short-term and long-term spillover effects. The former relate to the tightening impact of government deficit bias onto the

monetary conditions (through both interest and exchange rates) facing other Member States. The latter concerns the adverse impact of deficit bias onto the growth potential of other Member States as their investment is squeezed.

- There are also spillover effects associated with (a lack or reversal of) structural policies to the extent that these improve the capacity of countries to *absorb asymmetric shocks* in the absence of intra-area exchange rates and given low labour mobility. The stronger nominal rigidities are, the bigger will be such spillover effects. Such behaviour is damaging not only for other Member States but also for the economic performance of the area as a whole.
- A related rationale for co-ordination stems from the need to address ‘*beggar-thy-neighbour*’ policies (internal devaluations) such as shifts in the tax mix towards VAT, which taxes imports and exempts exports, and (excessive) wage moderation and cuts in non-wage labour costs. Such policies clearly risk heightening tensions within the area. The risk of a joint *race to the bottom* of social policies can be thought of as falling in broadly the same category.

A *second dimension* to co-ordination concerns its *timeframe*. For example, co-ordination can either be used to speed up the transition to a more flexible and efficient market economy, or serve to better manage this economy once its new ‘steady state’ is attained. However, while conceptually clear, this distinction is much harder to make in practice and most existing co-ordination mechanisms contain elements of both. Specifically:

- In its initial guise the Lisbon Strategy for Growth and Jobs was primarily designed for the transition towards a best-practice market economy and, as such, intended to be phased out once this objective was realised. With the adoption of the integrated guidelines elements of the Lisbon Strategy, it has become akin to a permanent rather than a transitional device.
- Enlargement is, by its nature, a process limited in time (and space).
- The SGP should be seen as initially designed for the steady state, with some transition elements added later on. For example, the close-to-balance-or-in-surplus rule is intended to apply in equilibrium (*i.e.* in cyclically-adjusted terms) whereas the revised Pact contains more clauses regarding the path towards this objective in the transition period.
- The FSAP is aimed at fostering financial integration (a transition issue) but also puts a supervisory framework in place which is, or should be, designed for the steady state or fluctuations around it.

All co-ordination motivated by learning and benchmarking is, by its nature, transitional. But, obviously, in reality learning and benchmarking will always be useful even in a hypothetical steady state.

A *third dimension* of co-ordination is its *depth*, which relates to the degree to which it is constrained by the subsidiarity principle. In descending order of depth, four levels of mandates can be distinguished in EMU:

- *Centralisation*. Specifically, monetary policy is fully centralised as price and financial stability is considered to be a public good.

- *Positive co-ordination.* Positive co-ordination aims at gaining commitment in the pursuit of a common interest. This is, for instance, the case of mandating representations in multilateral fora such as the G7 or the IMF. The preventive arm of the SGP also falls in this category.
- *Negative co-ordination.* This form of co-ordination seeks to prevent or correct bad behaviour and kicks in only if there is evidence of such behaviour, the corrective arm of the SGP being a prime example.
- *Open co-ordination.* In some cases, the EU is mandated to stimulate reforms at national level (e.g. in the fields of the Lisbon Strategy). Open co-ordination is the softest form of co-ordination and mostly oriented towards learning spillover effects.

The predominant view prior to the creation of the euro was that – aside from centralised monetary policy – co-ordination should be light and restricted to negative co-ordination, *i.e.* to stem misbehaviour in the face of adverse spill-over effects, as opposed to positive co-ordination. Positive co-ordination has nevertheless gained prominence in EMU's governance structure, even if the scepticism about positive co-ordination has been growing as commitment proves difficult to enforce and the political cost of co-ordination high. Open co-ordination is restricted largely to the Lisbon Strategy, which originally went beyond the EMU governance structure (as it is a EU-wide process), but also gained prominence in EMU co-ordination. The latter reflects a growing recognition that Lisbon Strategy-related policies carry an EMU-specific dimension owing to the tight links between well-functioning markets and a smooth adjustment to country-specific shocks in the absence of intra-area exchange rates. By contrast, scepticism over the Lisbon Strategy as an EU process has been growing as the externalities were deemed to be small, *i.e.* there is perceived to be little common interest over and above the sum of the individual interests.

2. FISCAL POLICY CO-ORDINATION UNDER THE STABILITY AND GROWTH PACT

The key feature of the EMU policy framework with regard to public finance – and the one where it differs most from earlier blueprints for monetary union – is that fiscal policy remains fully decentralised in the hands of national governments, subject to rules on deficits and debt meant to ensure that it does not ‘overburden’ monetary policy.¹ Underlying this framework is a critical assessment of the role of fiscal policy, specifically concerning: (i) the stabilisation role of discretionary fiscal policy and the importance of cross-country fiscal spillovers, other than those potentially jeopardising price stability; and (ii) the willingness of Member States to give up freedom of choice on tax and expenditure perceived to be at the heart of national sovereignties and social models. The development of a consensus on the role of fiscal policy – with waning support for Keynesian activism – created the opportunity for moving ahead with the decentralised fiscal framework.

¹ Early blueprints for the monetary union such as the 1970 Werner Report and the 1977 MacDougall report all called for a Community budget as a prerequisite for monetary union. The Delors report of 1989, which provided the foundation of the Maastricht Treaty on economic and monetary policy, no longer called for such Community budget.

2.1. The run-up phase (1991-1998)

Mirroring the discussion on the role of fiscal policy and national competences, the shape of the EU fiscal governance framework has been subject to heated debates ever since the first blueprints for EMU were discussed.² The core of the debates is captured by the trade-off between allowing judgment and discretion to cope with complex economic interactions and unforeseen developments, on the one hand; and the need to retain the essence of a rules-based framework to address deficit bias and time-inconsistency³ and ensure enforcement and equal treatment, on the other. Over the years, the pendulum has swung in both directions at different times.

With a view to securing the benefits of union-wide financial stability, Member States in 1991 reached consensus on the design of a supranational fiscal policy co-ordination framework at the EU level. The rules were adapted to the institutional characteristics of EMU at the time and designed to encourage sound budgetary policies by the Member States, while allowing sufficient margins for national budgetary flexibility. Reference values for government deficit and debt were agreed at 3% and 60 % of GDP, respectively. A set of generic procedures was agreed and enshrined in the Treaty which could lead up to political and financial sanctions, in case a Member States over a longer period committed ‘gross errors’ in fiscal policy. The Maastricht Treaty entered into force on 1 November 1993. While the Treaty provisions made use of numerical targets and emphasised fiscal prudence and stability, they left a considerable room for judgement and interpretation.⁴

The numerical targets for deficit and debt and the Treaty rules and procedures were elementary in jumpstarting the process of budgetary retrenchment and guiding expectations. The EU fiscal framework encouraged Member States to take the necessary measures that allowed them to move towards more sustainable budgetary positions and debt levels.⁵

In the run-up to the introduction of the euro, some Member States voiced concerns that governments would backtrack on fiscal consolidation once the ‘carrot’ of EMU entry would no longer be available, with possible spillovers on other Member States via the common monetary policy. These worries led German Finance minister Theo Waigel to propose a ‘Stability Pact for Europe’ in the autumn of 1995. It called for virtual automaticity in the EU budgetary surveillance procedures, thus limiting the room for

² Dyson and Featherstone (1999) provide an overview of the events leading the Maastricht Treaty.

³ The debate on fiscal rules has strong similarities with the rules-versus-discretion literature on monetary policy that originated with Kydland and Prescott (1977)'s seminal paper on the time inconsistency of policy.

⁴ Italianer (1993) reflected the prevailing view at the time of the Treaty negotiations: “(...) *it is clear that the excessive deficit procedure is not a mechanistic procedure: the criteria or the judgement of the Commission are used to start a process which, after careful consideration of all the relevant aspects, may lead to the judgement that a Member State has an excessive deficit. Given the fact that, according to economic theory, an excessive deficit is difficult to define on the basis of strict criteria alone, this seems a balanced compromise.*” See also Buti (2006) for a reflection on the balance of judgement and rules in the budgetary framework.

⁵ Turrini and in't Veld (2005) estimate the reaction function of fiscal authorities to major macroeconomic variables, such as the cyclical position and the level of debt, for two different sub-periods: before and after the Maastricht Treaty. They find an important change in the behaviour of fiscal authorities, which put more weight on debt stabilisation after the start of phase II of EMU. They consider that the change resulted from the introduction of the EU fiscal framework.

judgment by the Commission and the Council. Automatic procedures leading to large financial sanctions for Member States that did not comply were to provide an important dissuasive effect, and hence an incentive for Member States to pursue more ambitious budgetary targets.

The key elements of the proposal eventually found broad acceptance throughout the EU and the basis for a Stability Pact was laid. After a year of further negotiations, political agreement on the SGP was reached in December 1996.⁶ The Stability and Growth Pact took effect in 1998 just before the euro was launched and complemented the Maastricht Treaty provisions on fiscal discipline.⁷ Its principal objective was to enforce fiscal discipline as a permanent feature of EMU by: (i) specifying the conditions for the application of the excessive deficit procedure (EDP) established by, but not elaborated in, the Treaty, including strict deadlines for the correction of excessive deficits; and (ii) imposing a medium-term budgetary objective of close-to-balance-or-in-surplus, which converted the 3% of GDP reference value from its then perceived status as a target into a ceiling; this ceiling could only be breached in exceptional cases. In order to allow for a consistent monitoring of the budgetary developments, the SGP required Member States to submit stability or convergence programmes with an annual frequency. These include the Member States' fiscal adjustment path towards their medium-term objective.

The original SGP relied on the clarity, simplicity and the uniformity of its rules.⁸ The logic was built on defining strict numerical rules, leaving as little room as possible for judgment when government deficits exceeded 3% of GDP. The corresponding price was a lack of flexibility, which was deemed worth paying for the sake of ensuring enforceability and equal treatment across time and among Member States. The quasi-automatic system⁹ was expected to impose upon Member States the need to internalise the 3%-of-GDP deficit limit in their national budgetary procedures. The threat of sanctions was assumed to have a dissuasive effect on countries that had not yet reached their medium-term budgetary objectives, motivating them to continue pursuing fiscal consolidation. The medium-term objective (MTO) of close-to-balance-or-in-surplus

⁶ See Stark (2001) and Costello (2001) for a description of the negotiations that led to the Stability and Growth Pact.

⁷ The SGP consists of two Council Regulations and a Resolution of the Amsterdam European Council. One regulation (Council Regulation (EC) N° 1466/97, OJ L 209, 2.8.1997, p. 1) established a requirement for Member States to achieve and maintain budgetary positions of 'close to balance or in surplus.' This would provide the necessary room for manoeuvre for cyclical stabilisation through the working of the automatic stabilisers without the 3% of GDP reference value for deficits being breached (see *e.g.* Buti and Sapir, 1998). Another regulation (Council Regulation (EC) N° 1467/97, OJ L 209, 2.8.1997, p. 6) aims at speeding up and clarifying the excessive deficit procedure as defined in the Treaty.

⁸ See *e.g.* Annet *et al.* (2005), and Buti and Giudice (2003) for an assessment of the design of the SGP.

⁹ Stark (2001) characterised the EDP in the SGP as "*a quasi-automatic system for imposing sanctions.*" Clear definitions of key provisions in the EDP curtailed the scope for judgement by the Commission and the Council. Moreover, until the 2004 ruling of the Court of Justice on the SGP proved otherwise, the perception was that once a procedure was launched, automatic and legally binding deadlines were imposed upon the Commission and Council to take decisions, preventing postponement of budgetary judgement.

together with the early-warning mechanism¹⁰ associated with it was further meant to anchor budgetary strategies to the pursuit of fiscal consolidation.

2.2. Tensions in the excessive deficit procedure (1999-2004)

This dissuasive effect turned out not to be as effective as foreseen. Short-termism in budgetary policies prevailed and the Pact proved ineffective in preventing expansionary policies in the years 1999 and 2000 when economic growth peaked.¹¹ The worsening of the underlying budgetary situation took its toll in later years.¹²

In the following years, consistent sizeable deviations from planned adjustment paths and a deterioration of the economic climate implied that the achievement of a budgetary position close-to-balance or in surplus became a moving target (see Graph 1). In subsequent stability and convergence programmes, the adjustment path gradually shifted and, on average, no progress was made. As a consequence, in the largely unanticipated protracted economic downturn that followed, government deficits rose again above the 3% of GDP reference value in several countries, notably in the largest Member States.¹³

¹⁰ As part of the preventive arm of the Pact, the Council monitors the implementation by Member States of the stability and convergence programmes with a view to identifying actual or expected significant divergences from the MTO, or the adjustment path towards it. When the Council identifies a significant divergence of the budgetary positions from its targets, it shall address a recommendation to the Member States concerned to take the necessary measures, with a view to giving an early warning in order to prevent the occurrence of an excessive deficit.

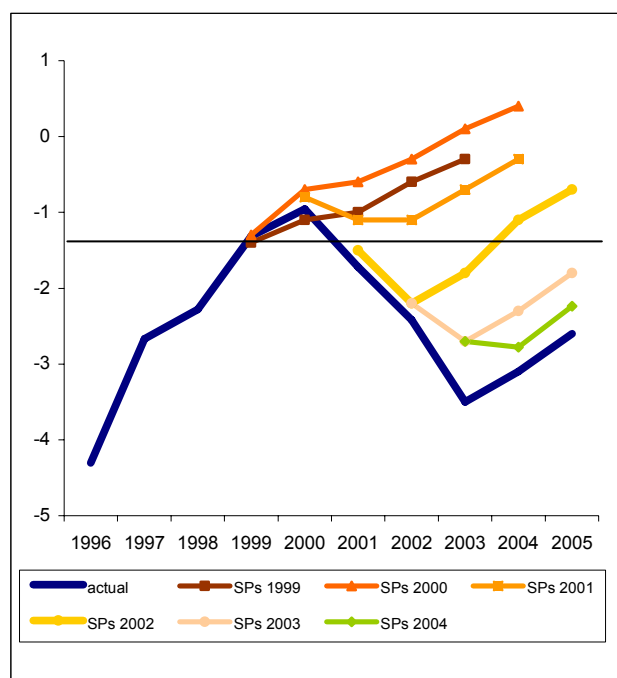
¹¹ Most EU countries ran highly pro-cyclical fiscal policies, especially during good times (Jaeger, 2001) and where political power was dispersed (Lane, 2003).

¹² Note that pro-cyclicality of budgetary policies was less apparent on the basis of real-time data than with hindsight of ex-post data as potential growth estimates have been substantially reduced. See notably Forni and Momigliano (2004), who suggest that part of the problems encountered in the implementation of the SGP could be attributed to misjudgements of cyclical conditions. Their results indicate that misjudgement of the size of the negative output gaps for the years 1999-2002 led to higher than projected deficit in 2003 in virtually all euro-area countries. See also Bernoth *et al.* (2008) and von Hagen and Wyplosz (2008).

¹³ Buti and Pench (2004) argue that the breakdown of enforcement mechanisms of the Pact is largely due to lack of compliance by the largest members of the euro area, while smaller countries have played, with some notable exceptions, by the book. They find that perception of a larger cost of consolidation, entrenched opposition to structural reforms, together with a lower weight to the external constraints may have all militated in discouraging large countries from behaving along the SGP rules in the early years of EMU.

Graph 1: Slipping fiscal targets in the euro area

General government budget balances (excluding UMTS) as projected in stability programmes (SP) (% of GDP)



Source: European Commission

Moreover, in many instances, attempts to comply with the 3%-of-GDP reference value created short-sightedness in the conduct of budgetary policy, notably via the implementation of one-off deficit-decreasing measures. This was already evident in the run-up to EMU when budgetary policies in the vicinity of the 3% deficit ceiling often revealed a preoccupation with cosmetic improvements. The SGP did not properly address the issue. On some occasions, the policies implemented by countries in excessive deficit cast doubts on their effective willingness and capacity to ensure the correction of the excessive deficits within deadlines. However, the tight procedures established in the SGP and the lack of flexibility to take account economic circumstances and factors outside the governments control also played a role in the difficult enforcement and the recourse to measures that did not improve the budgetary positions in a durable manner.¹⁴ Moreover, the reliability of EMU's key fiscal indicators for the EDP was put into question by a few episodes of large upward deficit revisions of the deficit outcomes.¹⁵

¹⁴ Koen and Van den Noord (2005) give an overview of accounting tricks and 'fiscal gimmickry' in the context of the SGP. See also Balassone *et al.* (2006 and 2007)

¹⁵ These revisions concerned mainly the 2001 deficit outcome in Italy and Portugal and the Greek government deficit and debt for several years. Discussing these episodes of deficit revisions, Balassone *et al.* (2007) argue that margins for opportunistic accounting mainly arise from two weak spots of EMU's deficit indicator: the identification of transactions in financial assets and the assessment of accrued revenue and expenditure. On the revisions of government deficit and debt statistics, see also Gordo and Nogueira Martins (2007).

2.3. Reforming the system within the SGP rules

Following the conclusions of the 2002 Barcelona European Council on the need to reinforce existing fiscal policy co-ordination mechanisms, the Commission adopted on 27 November 2002 five proposals to improve the interpretation of the SGP.¹⁶

Against the background of mixed budgetary performance since 1999 and emerging difficulties in the implementation of the rules, the Commission proposed:

- to establish medium-term budgetary objectives that take account of the economic cycle, *i.e.* measured in cyclically-adjusted terms and net of one-off measures;
- for countries that had not yet reached a budgetary position of ‘close to balance or in surplus,’ to achieve an annual improvement in the underlying budget position of at least 0.5% points of GDP;
- to avoid pro-cyclical policies in ‘good times’;
- to ensure the consistency between the Pact rules and the goals of the Lisbon Strategy, by allowing for small and temporary deviations from the underlying budgetary position of ‘close to balance or in surplus’ or the adjustment path to it; and
- to attach greater weight to the sustainability of public finances, including by making the Treaty’s debt criterion operational. Moreover, the Commission pointed to the need to take complementary measures in order to foster the overall fiscal and statistical governance.¹⁷

In March 2003, the ECOFIN Council endorsed in its report to the spring European Council¹⁸ most of the Commission proposals to improve the effective application of the SGP, yet agreed that there was no need for legal changes to the EU fiscal rules.¹⁹

Moreover, over the years, a number of gradual changes were introduced to the implementation of the SGP. Budgetary assessments evolved, driven by the experience accumulated with the operation of the EU fiscal framework and reflecting improvements in the analytical toolbox (*e.g.*, the use of budget balance measures adjusted for the cycle and the development of long-term sustainability indicators). Moreover, surveillance procedures in the stability and convergence programmes were streamlined and the programmes’ content was broadened to other areas, including structural reform, the quality of public finances and long-term sustainability issues in the context of ageing populations.

In addition to the difficulties with its implementation, the need to clarify and adjust the Pact was reinforced by some structural changes in the European economic and political

¹⁶ See Commission Communication on ‘Strengthening the Co-ordination of Budgetary Policies’ of 27 November 2002, COM (2002) 668 final. See also European Commission (2003: 47-55)

¹⁷ On the same day of adoption of the Communication on ‘Strengthening the Co-ordination of Budgetary Policies’ (see previous note), the Commission also adopted a Communication on ‘The Need and the Means to Upgrade the Quality of Budgetary Statistics’, (COM (2002) 670 final). See also European Commission (2003: 61-67).

¹⁸ ECOFIN Council report on ‘Strengthening the Coordination of Budgetary Policies’, 7 March 2003, 6877/03 (Press 61).

¹⁹ See European Commission (2003: 78-79).

environment. Since the negotiations of the SGP in 1996 and 1997, the issue of ageing populations had surfaced ever more prominently on the European economic and social agenda. Moreover, the issue of growth-enhancing policies received growing attention in the context of the Lisbon Strategy. The enlargement of the EU also implied that Member States were more diverse than before. The calls for reform of the Pact also continued to intensify the academic debate.²⁰

Despite these improvements, continuous difficulties in maintaining budgetary discipline and tensions in the application highlighted the need for further and more decisive progress to strengthen the Pact and its enforcement. The costs of the lack of flexibility and economic rationale of the rules and its effect on national ownership were higher than initially thought. This resulted in reduced enforceability, even though enforceability was considered the main advantage of the high degree of simplicity in the framework.

Table 1:

Main steps in the implementation of the fiscal surveillance in the EU²¹

September 1994	The Council decides that excessive deficits exist in Belgium, Denmark, Germany, Greece, Spain, France, Italy, the Netherlands, Portugal and United Kingdom, on the basis of the deficit (and in some cases, debt) outcomes for 1993, and adopts recommendations for the correction of the excessive deficits.
July 1995	The Council decides that excessive deficits exist in Austria, Sweden and Finland, on the basis of the deficit outcomes for 1994, and adopts recommendations for the correction of the excessive deficits. At the same time, the Council considers that the excessive deficit in Germany has been corrected and abrogates its 1994 decision on the existence of an excessive deficit in Germany.
June 1996	The Council decides that an excessive deficit exist in Germany, on the basis of the deficit outcome for 1995, and adopts a recommendation for the correction of the excessive deficit. At the same time, the Council considers that the excessive deficit in Denmark has been corrected and abrogates its 1994 decision on the existence of an excessive deficit in Denmark.
June 1997	The Council considers that the excessive deficits in the Netherlands and Finland have been corrected and abrogates its decisions of 1994 and 1995, respectively.
May 2008	The Council considers that the excessive deficits in the Belgium, Germany, Spain, France, Italy, Austria, Portugal, Sweden and the United Kingdom have been corrected and abrogates its decisions of 1994, 1995 (Sweden) and 1996 (Germany).
July 1998	Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies enters into force.
January 1999	Council Regulation (EC) No 1467/97 speeding up and clarifying the implementation of the excessive deficit procedure enters into force. SGP is fully operational.
December 1999	The Council considers that the excessive deficit in Greece has been corrected and abrogates its 1994 decision on the existence of an excessive deficit in Greece.

²⁰ Fischer *et al.* (2007) present a survey of reform proposals.

²¹ For documents concerning the implementation of the SGP, see: http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/index_en.htm?cs_mid=570

January 2002	The Commission recommends the Council to address an early warning to Germany and Portugal.
February 2002	The Council rejects the Commission's recommendation to give an early warning to Germany and Portugal. The countries' commitments not to breach the 3%-of-GDP threshold on the government deficit are considered to suffice.
November 2002	The Council decides that an excessive deficit exists in Portugal, on the basis of the government deficit outcome in 2001, and adopts a recommendation for the correction of the excessive deficit.
January 2003	The Council addresses an early warning to France. The Council decides that an excessive deficit exists in Germany, on the basis of the government deficit outcome in 2002, and adopts a recommendation for the correction of the excessive deficit.
June 2003	The Council decides that an excessive deficit exists in France, based on deficit outcome in 2002 and planned data for 2003, and adopts a recommendation for the correction of the excessive deficit.
November 2003	The Council does not step up the excessive deficit procedure vis-à-vis Germany and France, and decides instead to adopt conclusions addressing recommendations to these two Member States, while declaring the excessive deficit procedure in abeyance " <i>for the time being.</i> "
April 2004	The Commission recommends the Council to address an early warning to Italy. The Commission adopts a report on public finances in the United Kingdom (the first step in the excessive deficit procedure), but does not consider that an excessive deficit exists.
May 2004	The Council considers that the excessive deficit in Portugal has been corrected and abrogates its 2002 decision.
June 2004	The Council decides that an excessive deficit exists in the Netherlands, on the basis of deficit outcome in 2003, and adopts a recommendation for the correction of the excessive deficit.
July 2004	The Council decides that an excessive deficit exists in Greece, as well as in the following recently-acceded Member States: Hungary, Malta, Czech Republic, Cyprus, Slovakia and Poland, and adopts recommendations for the correction of the excessive deficits. The Council rejects the Commission's recommendation to give an early warning to Italy. The country's commitment to take measures for the government deficit not to breach the 3%-of-GDP threshold is considered to suffice. The European Court of Justice judgement annuls the November 2003 Council conclusions on France and Germany.
January 2005	The Council considers that Hungary was not complying with the recommendations of July 2004. The procedure is not stepped up since Hungary is not part of the euro area. A new recommendation is then adopted in March 2005.
February 2005	The Council considers that Greece did not comply with the recommendations of July 2004 and steps up procedure.
March 2005	The ECOFIN Council adopts a report on the revision of the SGP. The European Council endorses the report.

June 2005	The Council considers that the excessive deficit in the Netherlands has been corrected and abrogates its 2004 decision on the existence of and excessive deficit in the Netherlands.
July 2005	Regulations (EC) No 1055/2005 and 1056/2005 amending the Stability and Growth Pact enter into force. The Council decides that an excessive deficit exists in Italy, on the basis of 2003 and 2004 outcome.
September 2005	The Council decides that an excessive deficit exists in Portugal, on the basis of the planned deficit for 2005 in the stability programme.
November 2005	The Council considers that Hungary was not complying with the recommendations of March 2005. The procedure is not stepped up since Hungary is not part of the euro area. A new recommendation is then adopted in October 2006.
January 2006	The Council decides that an excessive deficit exists in the United Kingdom, on the basis of deficit outcomes for financial years 2003/2004 and 2004/2005.
March 2006	The Council steps up the excessive deficit procedure vis-à-vis Germany
July 2006	The Council considers that the excessive deficit in Cyprus has been corrected and abrogates its 2004 decision.
January 2007	The Council considers that the excessive deficit in France has been corrected and abrogates its 2003 decision.
June 2007	The Council considers that the excessive deficits in Germany, Greece and Malta have been corrected and abrogates its 2003 (Germany) and 2004 (Greece and Malta) decisions.
July 2007	The Council considers that the Czech Republic was not complying with the recommendations of July 2004. The procedure is not stepped up since the Czech Republic is not part of the euro area. A new recommendation is then adopted in October 2007.
October 2007	The Council considers that the excessive deficit in the United Kingdom has been corrected and abrogates its 2006 decision.
May 2008	The Commission proposes the Council to consider that the excessive deficits in Czech Republic, Italy, Portugal and Slovakia have been corrected and to abrogates the Council decisions of 2004 (Czech Rep. and Slovakia) and 2005 (Italy and Portugal). The Commission addresses a recommendation to France providing policy advice on economic and budgetary policy.

2.4. The 2005 reform of the SGP

The efforts to improve implementation had pushed the interpretation of the rules to the limit. Eventually, it was the tension and declining ownership in a strict EDP that triggered calls for a reform of the rules and their interpretation. In particular, the

ECOFIN Council decided, on 25 November 2003,²² not to endorse the Commission recommendations to step up the ongoing EDPs against France and Germany,²³ and addressed instead directly its own recommendations to the countries. The latter were subsequently annulled by the European Court of Justice.²⁴

De facto, the German and French EDPs were placed outside the SGP framework. Its strict rules were not applied by the Council and deadlines for decisions were not respected. Even though it annulled the Council conclusions on Germany and France, the Court's ruling of 13 July 2004 did not fundamentally change the situation, as it clarified that the Council could not be forced to take a decision against its will. If the procedures were to be left unchanged, the application of the EDP would likely become increasingly discretionary and would surpass the already stretched interpretation of the rules. While there was a need for more room for economic judgement in implementing the rules, the criteria and procedures for judgement needed to be clearly defined *ex ante*.

In this context, the Commission presented its Communication on "Strengthening Economic Governance and Clarifying the Implementation of the SGP"²⁵ on 3 September 2004. The Communication signalled a loss of credibility and ownership, a risk of discrimination in the application between large and small countries and institutional uncertainty. The Communication stressed that the objective was to enhance the economic underpinnings of the SGP framework and to strengthen its credibility, enforcement and national ownership.

The Communication took into account the implications of the ruling of the European Court of Justice that clarified the respective roles of the Commission and the Council in the application of the EU fiscal framework. The Commission considered several elements for strengthening the SGP: (i) placing more focus on debt and sustainability in the surveillance of budgetary positions; (ii) catering for protracted slowdown through the clause on exceptional circumstances; (iii) allowing for country-specific elements in the correction of excessive deficits (*i.e.* an appropriate adjustment path); (iv) allowing for more country-specific circumstances in defining the medium-term objectives of close-to-balance-or-in-surplus; and (v) ensuring earlier actions to correct inadequate budgetary developments.

At their extraordinary meeting of Sunday, 20 March 2005, the ECOFIN Council reached consensus on the reform of the Pact after several months of intense discussion. On 22 March 2005, the European Council endorsed the report of the ECOFIN Council entitled 'Improving the implementation of the Stability and Growth Pact'.²⁶ The fundamental

²² See Council Minutes of 25 November 2003, Council document ref. 14492/1/03 REV 1, available at: http://ec.europa.eu/economy_finance/publications/publication3217_en.pdf. See also European Commission (2004: 50-55).

²³ IP 03/1420 and IP 03/1560.

²⁴ Case C-27/04, Commission v. Council. (OJ C 228, 11.09.2004, p. 16; European Court reports 2004, p. I-06649.)

²⁵ COM(2004) 581 final. See also Deroose and Langedijk (2005) for a concise presentation of the reasons for reform. An alternative view focusing on effective and full application of the original SGP is presented by Annett *et al.* (2005).

²⁶ See Presidency Conclusion of the European Council of 22 and 23 March 2005 (Council document ref. 7619/05) and the ECOFIN Council report to the European Council of 21 March 2005 (Council document ref. 7423/05). See also 'Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes', in European Commission (2006b: 347-368).

rules remained unchanged. In particular, the ECOFIN report reconfirmed the agreement that the Treaty's reference values for government deficit and debt remain the anchor of the system. The 2005 ECOFIN Council report updated and complemented the SGP. It also recommended complementary measures for improving fiscal and statistical governance both at the national and the EU level. The SGP regulations were then formally amended by Council Regulations (EC) N° 1055/2005²⁷ and 1056/2005.²⁸

2.5. Institutions and procedures at the national level

The 2005 ECOFIN Council report recognises that modifications to the provisions of the Pact are not sufficient to ensure a meaningful improvement of their implementation. In order to solidly re-establish the credibility of the Pact and to strengthen the enforcement of budgetary discipline, it suggests that complementary measures are taken to enhance the institutional conditions for fiscal and statistical governance. The report contains a number of elements designed to increase the ownership of the Pact provisions, clarify the respective roles and responsibilities of the various actors involved, as well as measures to improve the quality and timeliness of statistical data, both at the national and the EU level.

The Report highlights the importance of national budgetary rules complementing Member States' commitments under the SGP at the EU level.²⁹ It suggests that national institutions could play a more prominent role in domestic budgetary surveillance, thereby underpinning and complementing the monitoring and surveillance procedures at EU level. A more effective mobilisation of the national public opinion is seen as a useful measure to strengthen national ownership and enhance enforcement.³⁰ With due respect to the subsidiarity principle, the Report suggests a greater involvement of national parliaments in the EU fiscal surveillance process. It invites national governments in particular to present to their national parliaments their stability or convergence programme and the respective Council opinions thereupon, and to discuss with the national parliaments the follow-up to recommendations in the context of early warnings and the excessive deficit procedure.

The enhanced economic rationale of the revised SGP framework was expected to increase ownership of the rules and facilitate agreement on recommendations that are always in the long-term interest of the country concerned. In this context, adequate

²⁷ OJ L 174, 7.7.2005, p.1.

²⁸ OJ L 174, 7.7.2005, p.5.

²⁹ Actually, the Maastricht Treaty already recognised the importance of national budgetary institutions and procedures in delivering sound budgetary policies when it called on Member States to “*ensure that national procedures in the budgetary area enable them to meet their obligations*” (Article 3 of the Protocol on the excessive deficit procedure).

³⁰ Depending on the characteristics, such national arrangements can address the deficit bias (i) in a direct way, through the imposition of effective constraints; or (ii) in an indirect way, through increasing reputation costs for unsound fiscal policies by raising public opinion awareness of the long-term consequences of bad policies. In this context, several authors provide convincing evidence that a comprehensive and well-defined budgetary process is effective for achieving a level of aggregate expenditure consistent with overall macroeconomic constraints and fiscal revenues. See for instance, European Commission (2005, 2006b and 2007b); Von Hagen and Harden (1994), Poterba and von Hagen (1999), Strauch and von Hagen (2000), Hallerberger *et al.* (2001) and Hallerberg (2004).

settings at national level can help addressing the deficit bias at its roots and, if properly designed, efficiently contribute to the conduct of sound fiscal policies.

The 2005 ECOFIN Council Report also recognises that the credibility and implementation of the fiscal framework relies crucially on the availability of timely and trustworthy fiscal data. Transparent budgetary statistics are also seen as instrumental to enable financial markets to better assess and distinguish the creditworthiness of the different Member States, thus providing an important signalling function for policy errors. In December 2004, the Commission had already presented three main lines of action towards a governance strategy for fiscal statistics.³¹ They included the further elaboration of the legal framework related to the reporting of fiscal data; the development of European standards for the institutional set-up of statistical authorities; and finally the provision of additional resources to enable the relevant Commission services to enhance their activity with respect to budgetary surveillance and the scrutiny of the quality of budgetary statistics. Section 5 below discusses in some more detail developments in the governance of macroeconomic statistics in EMU.

Box 1: The 2005 reform of the SGP

The revision of the SGP reaffirms the rules-based framework, especially the 3% of GDP deficit and 60% of GDP debt thresholds of the Treaty, whilst enhancing economic rationale and national ownership.

The following changes were introduced to the *preventive arm* of the Pact:

- *Medium-term budgetary objectives (MTOs)*: Rather than being uniformly set at close-to-balance or in surplus, the MTOs now are differentiated across countries. They can be revised when a major structural reform is implemented and, in any case, every four years. For euro area and ERM II Member States, the country-specific MTOs should be between -1% of GDP and balance or surplus.
- *Annual structural adjustment*: For countries in the euro area or the ERM II which have not achieved their MTO, the revised SGP requires an annual improvement of their structural balance by 0.5% points of GDP as a benchmark. This adjustment can be modulated depending on economic conditions. As well, the implementation of major structural reforms positively affecting long-term sustainability can be invoked to allow a temporary deviation from the adjustment path or from the MTO itself, provided that the deviation remains temporary and that an appropriate safety margin with respect to the deficit reference value is preserved. Special attention is to be paid to pension reforms introducing a mandatory, fully-funded pillar alongside a pay-as-you-go pillar, whereby the deviation should reflect the net budgetary cost.

The following changes were introduced to the *corrective arm* of the Pact:

- *Annual structural adjustment of countries in excessive deficit*: the annual adjustment should always be of at least 0.5% of GDP in structural terms.
- *Revision of deadlines in the EDP* can be granted if there are unexpected adverse economic events with major unfavourable consequences on government finances.
- *Re-definition of a 'severe downturn'*, which may lead the Council to consider that a deficit above 3% of GDP is not excessive. In the original SGP a 'severe downturn' consisted in a negative annual growth rate of GDP of at least 0.75%. Under the revised SGP, an economic downturn may be considered severe in case of a negative growth rate or accumulated loss of output during a protracted period of very low growth relative to potential.
- *Other relevant factors* may also be taken into account in assessing whether there is an excessive deficit if the general government deficit remains close to the reference value and its excess over the

³¹ See Commission Communication 'Towards a European Governance Strategy for Fiscal Statistics' of 22 December 2004, COM (2004) 832 final.

reference value is temporary. Special consideration is given to the implementation of systemic pension reforms. Specifically, the net cost of the reform to the publicly managed pillar is set against the deficit on a linear degressive scale for a period of five years, and this is taken into account also for the abrogation of the EDP provided the deficit has declined substantially and continuously and has come close to the reference value.³²

2.6. Experience with the reformed SGP to date

Since the SGP reform, the overall conditions of public finances have improved significantly in the EU. In 2006, the debt ratio came back on the declining trend that it had abandoned in 2003. In 2007, the government deficit ratio for the EU as a whole was the lowest for more than thirty years. These favourable developments reflect a broad-based economic recovery, but also consolidation efforts put in place in the framework of the reformed SGP.

The experience with the implementation of the EDP after the reform has overall been positive. A weakening of implementation, as feared by media and other commentators³³ did not materialise. In fact, since the SGP reform, all government deficits in excess of 3% of GDP have been considered excessive, triggering the respective procedure, confirming that the SGP remains a rules-based framework. The Commission reports prepared in accordance with Treaty Article 104(3) adopted since the reform contained a comprehensive assessment of all relevant factors, ensuring that decisions and recommendations reflected a comprehensive assessment of the budgetary developments in the context of the economic conditions prevailing in the country concerned.³⁴

The additional room for judgement in the EDP has been applied to set realistic deadlines for Member States to correct their excessive deficits, while ensuring that significant fiscal efforts would be made. The Council recommendations and notices issued since the reform have always specified the required structural fiscal effort, which excluded one-off and temporary effects on the budget balances. Despite extended deadlines in some case in which the excess over the reference value was very high, the required fiscal effort in structural terms was, on average, higher after the 2005 reform than before³⁵ Moreover, for the first time, the Council adopted notices in accordance with Treaty Article 104(9)³⁶

³² On the SGP provisions on systemic pension reforms, see European Commission (2007b: 112-118).

³³ Some commentators argued that, given the host of exceptions to the 3%-of-GDP rule, and the greater discretion left to the Council, the Pact was, *de facto*, dead (notably Buiters, 2005 and Calmfors, 2005). Even those traditionally critical of the old SGP, while appreciating the better balance between fiscal discipline and flexibility, viewed the reformed Pact, as excessively prone to opportunistic interpretations and as having failed to tackle the root causes of fiscal imbalances (Coeuré and Pisani-Ferry, 2005). Buti *et al* (2005) and Buti (2006) discuss the SGP reform and its main criticisms.

³⁴ See European Commission (2006b: 93-98).

³⁵ Notably, in the 2005 Council recommendations under Article 104(7) to Portugal and Italy, which extended the deadlines for the correction of the excessive deficits were granted, while the required annual improvement of the structural balance (by 0.9% and 0.6% points of GDP, respectively) that is higher than 0.5% points that had been required in previous cases (see http://ec.europa.eu/economy_finance/publications/publication3510_en.pdf and http://ec.europa.eu/economy_finance/publications/publication3492_en.pdf).

³⁶ The notices adopted by the Council according to Article 104(9) of the Treaty are the last step in the procedure before imposing financial sanctions, and are themselves a significant political sanction.

in the cases of Germany³⁷ and Greece,³⁸ setting a precedent and strengthening the credibility of the full set of instruments under the SGP.

In spite of these encouraging developments, recent experiences also highlight a number of issues that need to be addressed in order to secure these accomplishments and in particular to make sure that Member States make rapid progress towards achieving sustainable budgetary positions in order to be prepared for the budgetary impact of ageing populations. Moreover, in a number of countries, the decline of the structural budget deficit recorded in recent years significantly benefited from better-than-expected tax revenues,³⁹ which were partly used to offset slippages on the expenditure side of the budget.

Overall, the current situation and outlook corroborate the conclusion that, while the corrective arm of the Pact has regained credibility and effectiveness following the SGP reform of 2005, the situation is less clear for what concerns the preventive arm of the Pact. In this context, the Commission adopted, in 2007, a Communication on “Ensuring the Effectiveness of the Preventive Arm of the SGP,”⁴⁰ including a number of proposals to strengthen the implementation within the reformed SGP framework. With a view to strengthening the results and the impact of the review, the Eurogroup considered at its meeting of 24 November 2006, that the mid-term budgetary review (MTBR)⁴¹ should be improved so as to become a genuine *ex ante* political debate on the fiscal stance both in the euro area as a whole and the individual Member States with a strong forward-looking dimension.⁴²

2.7. Developments in budgetary surveillance

In the run-up to the creation of the euro in 1999, all EU Member States committed to regularly submitting medium-term programmes, convergence programmes for non-euro countries and stability programmes for euro countries. These programmes are a requirement under the SGP, and since 1998 all EU Member States have submitted updates yearly.⁴³

From the outset, the content of the programmes have varied, in terms of the variables included, the length of the forecasting period and the focus and degree of thoroughness of the qualitative analyses. Since 1998, the content of the programmes has been codified in a code of conduct endorsed by the Council. The code of conduct was revised in 2001

³⁷ Council Decision 2006/344/EC (OJ L 126 , 13.05.2006, p. 20).

³⁸ Council Decision 2005/441/EC (OJ L 153, 16.6.2005, p. 29).

³⁹ See, for example, Martinez Mongay *et al.* (2007).

⁴⁰ COM(2007) 316 final. See also European Commission (2007b).

⁴¹ The Council report of March 2005 underpinning the 2005 reform of the SGP states that the Eurogroup should discuss, at least once a year before the summer, a horizontal assessment of national budgetary developments and their implications for the euro area as a whole. The Eurogroup discussion in the context of the MTBR improves the link between the national budgetary process and the co-ordination exercise.

⁴² This should address the issue that the Council Opinions on the Member States’ stability and convergence programmes are delivered long after the relevant debate in the national parliaments, undermining the effectiveness of the peer review process. Ministers can refer to the written text of reference summarising the main conclusions of the MTBR discussion in the subsequent steps of budgetary surveillance and coordination as well as in the national debate, enhancing peer support and peer pressure for sound fiscal policies.

⁴³ Before the adoption of the SGP, most Member States also used to prepare convergence programmes, although with a less regular frequency (there were not annual updates) and in a less formal manner.

to streamline and thus facilitate the assessments and improve the comparability of the programmes. After the 2005 reform of the SGP, another revision specified the new provisions and incorporated developments in the SGP implementation.⁴⁴

Widening coverage of the programmes

The coverage of the programmes has progressively been widened to include the new concerns of budgetary policy and, in particular, the budgetary challenges posed by ageing populations. Since 2002 the programmes include up-to-date projections of the impact of ageing populations on, notably pension and healthcare spending. The quality of public finances also has taken an increasingly prominent place in the programmes and in the respective Council opinions. The broader scope of the stability and convergence programmes, including structural reform and the quality of public finances, increased the importance of ensuring the integration of the SGP with the Broad Economic Policy Guidelines (or BEPG; see section 3.2), through a proper coverage in the programmes of all issues with budgetary implications.

The assessment of the stability programmes has been evolving over the past years. This has partly reflected improvements in the analytical toolbox in budgetary surveillance (notably the use of budget balance measures adjusted for the cycle and the development of long-term sustainability indicators), and has partly been driven by the experience accumulated with the operation of the EU fiscal framework. Overall, the scope of the assessment has broadened: the number of factors taken into account in assessing fiscal plans has expanded. This tendency is likely to continue in the coming years, as a result of the increased focus on long-term public finance developments (*e.g.*, the impact of pension reforms), fiscal governance (*e.g.*, the working of national budgetary institutions) and the quality of public finances.⁴⁵

Streamlined procedures to enhance effective coordination

The submission and assessment of the first sets of stability and convergence programmes was scattered over time towards the end of each year. Submission of programs used to take place between mid-September to January each year. The ECOFIN Council recognised already in 1999 in a report to the Helsinki European Council that the ‘*effectiveness of the budgetary and economic surveillance procedure will be enhanced by [...] a commitment to submit the annual updates of the programmes at the same time as, or shortly after, the adoption of annual budget proposals or of medium-term budgetary strategy documents foreseen by national procedure*’. A common deadline for the submission of the programs of 1 December was agreed in the 2001 code of conduct.

Still, the arrangements for budgetary coordination in the SGP framework imply that the programmes are examined by the Commission and the other Member States only after national budgets are submitted to (and in some cases approved by) national parliaments. With the Council opinions often delivered long after the relevant debates in national parliaments, these cannot be taken into account in the budget law, undermining the effectiveness of the peer review process.

⁴⁴ See ‘Specifications on the implementation of the Stability and Growth Pact and Guidelines on the format and content of Stability and Convergence Programmes’, in European Commission (2006b:347-368).

⁴⁵ On the quality of public finances, see Deroose and Kastrop (*eds.*) (2008).

Evolving tools for the implementation of the SGP rules

Fiscal surveillance complements the simple and transparent reference values of the EU fiscal framework and serves as a basis for using the room for economic judgement that is given by the Treaty to the European Commission in operating the system. The tools for fiscal surveillance have broadened significantly in recent years. Assessments in the context of the SGP are now based on a range of fiscal indicators that account for different aspects of fiscal policy behaviour.

Of particular importance was the trend to increasingly focus on structural budgetary developments. This allowed a better assessment of the soundness of the underlying budgetary position. And, when assessing compliance with consolidation requirements, it abstracted from factors outside the control of the government, providing a fairer assessment of efforts.

The cyclically-adjusted budget balances (CAB) were first introduced in the surveillance framework in the Council opinions on the 2001 stability and convergence programmes. It addressed weaknesses in the surveillance based on nominal balances which had surfaced during the boom of the late 1990s and 2000.⁴⁶ Further refinements, addressing temporary effects other than of a cyclical nature on the key indicator for measuring the fiscal effort, have been introduced formally or are implicitly considered in the assessment of budgetary discipline. All such refinements come with specific additional uncertainties and require discretionary choices in a context of uncertainty on the choice of economic models and increase the complexity of the framework.

A number of Member States made consistent use of deficit-reducing one-off and temporary measures, in some cases with the objective of complying with the requirements of the SGP. This hampered adequate fiscal surveillance of durable fiscal consolidations. Following the introduction of structural balances – which exclude temporary and one-off measures from the CABs – in fiscal surveillance after the 2005 SGP reform, the occurrence of one-off and temporary measures declined dramatically.

Despite its sophistication, the structural balance remains subject to flaws. For instance, *ex post* revisions in potential growth often lead to significant revisions in the structural balance. Atypical developments in tax revenues which are not captured by the cyclical adjustment also affect the measure.⁴⁷ Moreover, growth-composition effects may also affect tax revenue movements.

Strengthening the economic rationale of the MTOs

A much debated issue in the early years of EMU related to the medium-term targets of Member States consistent with the close-to-balance-or-in-surplus rule of the pact. In the early years, the MTOs were set primarily to ensure a sufficient safety margin vis-à-vis

⁴⁶ Fiscal surveillance based on nominal balances favoured pro-cyclical policies and unfair judgement of fiscal efforts when disappointing growth led to failure to comply with requirements, even if the government implemented all required measures. To overcome these undesired effects of growth on the indicator that was used for identifying policy errors, the CAB became the main diagnostic tool.

⁴⁷ Windfall tax revenues have inflated the measured fiscal effort in 2004, 2005 and 2006 in many countries. And in the period before, low revenues and downward revisions in potential growth have played a role in, for example, the German and Dutch fiscal performance. See Langedijk and Larch (2007) on the impact on fiscal surveillance of *ex post* revisions of potential growth.

the 3% of GDP reference value for the budget deficit in order to let the automatic stabilisers fully operate in a cyclical downturn. Therefore, the MTOs were nothing more than minimum benchmarks.⁴⁸ To this end, a broadly balanced budget in cyclically-adjusted terms was required for most countries. For countries with large automatic stabilisers, a structural surplus of the order of 1% of GDP over the cycle was deemed adequate. Subsequently, a common MTO of a deficit-to-GDP ratio of ½% in cyclically-adjusted terms was applied to all Member States.

Since 2005, the MTOs – as agreed in the 2005 reform of the Pact – are set by each country individually in their stability and convergence programmes, and assessed by the Council. They are defined on the basis of the current government debt ratios and long-term potential growth rates, while the overall objective of achieving a budgetary position close-to-balance or in surplus remains. They may not be set lower than a deficit of 1% of GDP and must provide an adequate safety margin against vis-à-vis the 3% of GDP reference value. Once criteria and modalities for the assessment of implicit liabilities are established and agreed by the Council, the definition of the MTO will be reviewed with a view to reflecting such implicit liabilities more explicitly in the medium-term objective.⁴⁹

3. CO-ORDINATION OF STRUCTURAL POLICIES

The importance given to structural reforms in EMU's governance framework is embedded in the conviction that macroeconomic policies can help provide the conditions of economic stability but cannot, on their own, ensure a fully efficient functioning of the euro area. The weight of the growth and adjustment challenge in the euro area contrasts with the absence of strong forms of policy co-ordination in the area of structural policies. On the one hand, the prevalence of soft forms of policy co-ordination is basically consistent with the observation that most structural reforms generate only minor cross-country economic spill over.⁵⁰ On the other hand, the emergence of a euro area economy has transformed the way in which economic policies interact also in the area of structural policies. Due to the fixed exchange rates and the higher degree of economic integration, the benefits from reforms are higher in EMU, but so are the costs of non-reforms.

Against this background, Section 3.1 elaborates on the specific reform needs in EMU arising from the sharing of a common currency. Section 3.2 then describes how governance procedures in the area of structural policies have evolved over time. For assessing the efficiency of the governance of structural policies, several academic studies approached the question whether EMU has increased the pace of reforms. Section 3.3 reviews the available evidence and complements it with a new series of empirical estimates, using alternative data sources.

⁴⁸ See Artis and Buti (2000) for a discussion on the role of the MTO and the minimal benchmarks.

⁴⁹ The code of conduct of 2005 specifies the criteria for setting the MTO. On the concept of implicit liabilities, see Buti and Nogueira Martins (2006). On the different alternatives for taking into account implicit liabilities in the determination of MTOs, see European Commission (2007b: 81-85).

⁵⁰ See, for example, Everaets and Schuele (2006), Everaets (2007).

3.1. The evolution of reform needs in EMU

Within the context of European economic integration, EMU has been widely regarded as the macroeconomic complement to the Single Market Programme. Especially in the public debates prior to the actual introduction of the euro, the focus was on the nominal convergence criteria, the risk to price stability and effects of remaining cyclical differences, indicating that the scope of EMU was primarily of macroeconomic nature.

Even before the launch of the single currency, economists stressed that a good economic performance in the euro area would rely on well-functioning markets and therefore EMU would need to be accompanied by progress with structural reforms. For example, in European Commission (1997) high mark-ups and price stickiness on product markets as well as high unemployment and widespread real wage rigidities were identified as obstacles to an efficient functioning of the single currency area. The analysis further recognised that EMU would contribute little to resolving them and further progress with structural reforms would be needed to arrive at better functioning product and labour markets. Since market structures were considered not sufficiently flexible to shoulder the higher adjustment burden in EMU, the single currency was hoped to produce incentives for governments to undertake structural reform in the pursuit of market flexibility. This argument has become known as TINA (*'there is no alternative'*).

The academic debate on reform needs in the newly created economic entity has been strongly influenced by the theory of optimum currency areas (OCA). In case of idiosyncratic shocks, the irrevocably fixing of bilateral nominal exchange rates entails that the short-term adjustment burden is shifted to product and labour markets.⁵¹ Therefore, policy reforms that aim at improving adjustment through both factor quantities and prices were considered essential. In view of larger adjustment costs in case of quantity adjustment, and the possibility that factor adjustment may even intensify the impact of some shocks, adjustment through prices was the favoured option, with enhanced competition and less regulation on product markets, more flexible wages as well as further financial market integration being regarded as essential means. The analysis in the European Commission (2006c) on economic adjustment in EMU largely confirmed the earlier policy diagnosis. Existing frictions and rigidities have hampered adjustment and led to divergences in economic performance across Member States to become entrenched. Price stickiness, wage rigidities, incomplete integration of retail financial markets and lack of fiscal leeway were highlighted as underlying obstacles to a more efficient adjustment in EMU, which policies would need to address.

Economic developments in the first decade after the introduction of the euro broadened the discussion on reform needs. While in the very early years the euro area weathered the economic consequences of financial turmoil in East Asia and Russia 1998/99, suggesting that resilience to shocks was better than expected, and recorded a buoyant expansion of both economic activity and employment in 2000, the assessment radically changed after 2001.⁵² Growth rates turned dismal and economic rebounds have become short-lived, being interrupted by adverse shocks acting on a global scale. Average annual real GDP per capita growth in 2001-2005 was a mere 0.8%, falling considerably short to the 2.1% registered in the US over the same period. The low growth potential of the euro area became particularly evident in a further decline in productivity growth. Indeed, hourly

⁵¹ See, for example, De Grauwe (1997), Pissarides (1997).

⁵² See European Commission (2002a).

labour productivity growth dipped to 0.4% in 2004. European Commission calculations of total factor productivity (TFP) growth in 2001-2005 yielded a rate of 0.2% on average 2001-2005. Whereas the pace of job creation was similar to the one in the US, high unemployment and low employment rates suggested a large potential for improvement. In consequence, the focus of reform debates shifted towards the need to conduct growth-enhancing structural reforms to improve both labour utilisation and productivity growth. Although EMU was not a cause of the weak growth performance, and some, especially smaller, Member States benefited from a strong growth performance, low adjustment capacity in several euro-area Member States limited the scope to accrue the full benefits from technical progress and globalisation.

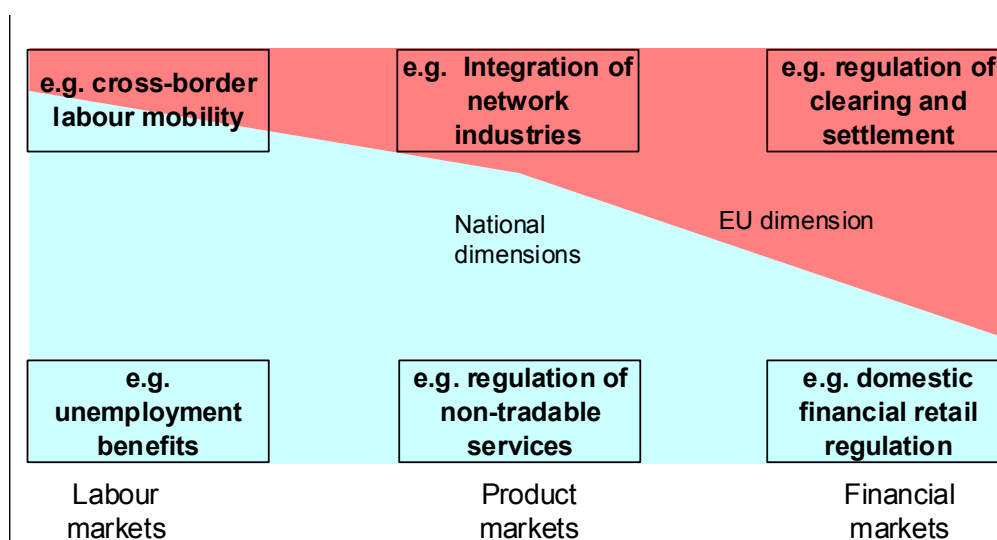
A further strand of the euro-area reform debate that has gained in prominence over the last years embraces the economic consequences of ageing populations. Increased knowledge about the budgetary impact of ageing populations added a further motivation to the quest for budgetary consolidation. Moreover, it made it evident that the long-term sustainability of public finances depended on reforms to pension and health care systems. Though the issue of ageing is not limited to the euro area, it can be noted that a number of euro-area Member States undertook reforms to pensions, health and social systems. The political and social tensions accompanying these reforms in some Member States seem to have had adverse effects on both political capital and the electorates' acceptance of further reforms.

3.2. The governance of structural policies in the EU

3.2.1. EU co-ordination procedures in the field of structural reforms

From an institutional perspective, structural policies encompass a broad range of microeconomic policies, which are customarily divided into policies that affect labour markets, product markets and financial markets. Some policy areas are cross-cutting, for example taxation, education and social security systems, whereas several sector-specific policies such as agriculture, external trade are normally considered separate from the field of structural policies. The mix of Member States' and EU's activity differs considerably across market segments, with only little competences at EU level for labour market regulation and much wider scope for financial market integration (see Graph 2). Broadly speaking, Member States are in charge of the design of national institutions and framework conditions that govern private agents' economic activity. The EU level becomes important for all aspects of cross-border relevance, covering intended moves to generate a single market as well as the avoidance of negative externalities from rules or economic activity in one Member State on welfare in other Member States.

Graph 2: Policy assignment across areas of structural reforms



Although largely remaining in the remit of the Member States, Article 99(1) of the Treaty indicates that Member States should “*regard their economic policies as a matter of common concern and shall coordinate them within the Council*”. In practice, differences in responsibilities across market segments and policy areas impact on how coordination of structural reforms can take place. Consequently different EU coordination procedures have been in place already prior to the launch of the euro.⁵³

- The central role in the coordination of economic policies has been assigned by the Treaty’s Article 99(2) to the Broad Economic Policy Guidelines (BEPGs). The BEPGs were introduced with the Treaty of Maastricht and a first vintage of the BEPGs was adopted already in 1993, that is, before Stage 2 of EMU started, in the form of a short 4-page document with general guidelines. Following the European Councils of Amsterdam and Luxembourg of 1997, the BEPGs became more concrete and detailed on policies. Motivated by the launch of the euro, a new section was added that complemented the Community wide guidelines with country-specific recommendations in 1999 and, in order to monitor policy responses, the Commission issued the first Implementation Report in 2000. Since then, the issuance of country-specific recommendations and the monitoring of their implementation have become a recurrent feature in the coordination cycle.
- Article 125 of the Treaty calls specifically for a coordinated strategy for employment and Article 128 provides the legal basis for employment guidelines. The special European Council meeting in Luxembourg in November 1997 decided to apply the Article 128, which was a novelty of the Amsterdam Treaty. This was the starting point for the so-called Luxembourg process, under which Member States remained responsible for their employment policies, but were obliged to consider employment as a matter of common concern and coordinated policies to be consistent with the BEPGs. Policies are not imposed; the process largely builds on achieving policy consensus, monitoring and a willingness to adjust to peer pressure.

⁵³ European Commission (2002d) reviews the EU coordination procedures prior to 2002.

- Following the Cardiff European Council in June 1998, a specific reporting system called the Cardiff process was set up, including annual reports by Member States on reforms in products and capital markets and a Commission report on the Community product and capital markets. The Cardiff process did not lead to policy guidelines, but aimed at advancing reform through monitoring, analysis and the creation of peer pressure. The reports were used as input for the structural part of the BEPGs Implementation Report and by the Economic Policy Committee in its work on economic reforms, which focused on identifying shortcomings in structural policies and highlighting best practices.

At the Lisbon European Council in 2000, the EU set itself the new strategic goal of becoming “*the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion.*” Structural reforms in budgetary institutions, product and labour markets were considered key in accomplishing this. In terms of governance, the Lisbon process aimed at better coordinating the existing processes and introduced the "open method of coordination". Since then, the Spring European Council meeting has been devoted to economic issues, seeking coherence among policies and providing guidance for the elaboration of the BEPGs. The open method of coordination involved the setting of EU-wide goals, establishing of benchmarks and indicators, periodic monitoring, evaluation and peer review. By favouring mutual learning, Member States should be helped to improve their policies.

A mid-term review of the Lisbon process took place in 2005, following a critical evaluation of its effectiveness undertaken by a high-level group led by the Dutch former Prime Minister Wim Kok. To some extent, it marked a watershed in the design of the coordination processes. A first change concerned a narrowing down of the economic priorities towards growth and jobs, which implied a stronger focus on those economic reforms that target labour utilisation and productivity. Hitherto, the Lisbon agenda became also known as Lisbon Strategy for Growth and Jobs. BEPGs and Employment Guidelines became merged into the Integrated Guidelines, leading to a further streamlining of underlying procedures. The re-launch of the Lisbon Strategy involved a downgrading of the tools of benchmarking and peer pressure, which were seen as having been less effective in stimulating Member States' reform commitments than expected. Instead, the role of Member States in the process was strengthened. They were obliged to define their policy priorities in National Reform Programmes and to report on their implementation reforms in annual reports. This aimed at improving the ownership of Member States of the reform process. In parallel, the Commission has provided a Community Lisbon programme that lists activities to be conducted at EU level. Table 2 gives an overview of the interplay of guidelines, reform programmes, assessment of progress with reforms and recommendations currently in place.

Table 2: Key dates and procedures in the re-launched Lisbon Strategy

Spring 2005	Upon proposal of the Commission, the Council adopted the Integrated Guidelines 2005-2008, which combine the broad economic policy guidelines and the employment guidelines.
Autumn 2005	Each Member State produced a three year strategic plan, its national reform programme (NRP), which defined the main national challenges to be overcome to achieve the Lisbon objectives, as well as the policies designed to address those challenges.
January 2006	The Commission assessed the NRPs in view of identifying whether the challenges addressed by the Member States match with the individual reform needs. It included a euro-area fiche that summarised the economic challenges and reform commitments identified by the euro-area Member States.
Autumn 2006	The NRP was followed by Member States' Implementation Reports (IR) that showed where progress had been made to meet Member States' own reform strategies. The Commission submitted a Community Lisbon programme that reported on progress with policy measures at the Community level.
December 2006	In its 2006 Annual Progress Report, the Commission highlights what it considers to be the strengths and weaknesses of reform in each Member State. A separate assessment was produced for the euro area, the so-called euro-area fiche, comparing the progress with reforms in the NRPs with the area-specific reform needs. The concluding section of the Commission's assessment included specific policy recommendations that cover those areas where weaknesses need to be tackled with the highest priority. These conclusions and recommendations were addressed to each Member State and to the euro area.
Spring 2007	The concluding sections of the Commission's assessment have been discussed by the Council in view of adopting a Council Recommendation on the 2007 BEPGs (Art. 99(2)) and the Employment Guidelines (Art 128(4)) addressed at each Member State and, concerning the euro area fiche, the euro-area Member States. They were adopted by the Council in March 2007.
Autumn 2007	A second vintage of Member States' Implementation Reports (IR) showed where progress had been made to meet Member States' own reform strategies. Voluntarily, most Member States also submitted reporting tables to the Commission that listed reform measures in a systematic manner. The Commission submitted a revised Community Lisbon programme.
December 2007	In its 2007 Annual Progress Report, the Commission evaluated reform progress in each Member State and the euro area. The concluding section of the Commission's assessment was used to update the recommendations addressed to Member States and to the euro area. The Commission proposed to leave the Integrated Guidelines 2008-10 materially unchanged.
Spring 2008	The concluding sections of the Commission's assessment have been discussed by the Council in view of adopting a Council Recommendation on the recommendations addressed at each Member State and, concerning the euro area fiche, the euro-area Member States. The recommendations and the Integrated Guidelines 2008-2010 were adopted by the Council in March 2008.

Note: The Commission's assessments are in the public domain, having been published as its Annual Progress Report (APR), http://ec.europa.eu/growthandjobs/european-dimension/200712-annual-progress-report/index_en.htm.

3.2.2. *The evolving euro-area dimension in the coordination of structural reforms*

The procedures that govern the coordination of structural policies apply to the EU as a whole. No separate procedures for the euro area have evolved. While the Eurogroup has recurrently discussed structural reforms in the euro area, the discussions have remained informal. They nevertheless contributed to a political consensus among euro-area Member States on both the need for structural reforms and the advantage of coordinating reforms. In this context, the conclusions of the spring 2006 European Council are worth noting: *“The European Council recognises the special importance of enhanced structural reforms in Member States of the euro area and stresses the necessity of effective policy coordination within this areas, i.a. as a requirement to more effectively deal with asymmetric developments within the monetary union.”*

Despite the absence of specific coordination procedures for euro-area Member States, the euro-area dimension has gained in importance over time within the existing procedures, most notably in the BEPGs and Lisbon Strategy. For example, references to structural reform needs in the euro area have become more prominent in the texts of the BEPGs. Initially they remained fairly general, referring to a need to step up structural reform in view of a low growth potential and a lack of resilience. Over time, the treatment of the euro area in the BEPGs and later Integrated Guidelines has become more in-depth and specific, culminating so far in the adoption of specific recommendations to the euro-area Member States. The chronology below demonstrates the increased prominence of the euro-area dimension since 1999.

- The 1999 BEPGs, in its general part, describe the policy-mix in the euro area as consisting of four elements. These are next to fiscal policy, monetary policy and wage bargaining, *“a commitment from the Member States to press ahead with front-loaded, coherent and comprehensive reforms with a view to enhancing the adaptability and efficiency of product, capital and labour markets”* (Council Recommendation of 12 July 1999).⁵⁴
- The 2001 BEPGs included, for the first time, a reference to the euro area dimension in the country-specific policy guidelines addressed to the euro-area Member States. However, this referred only to budgetary policy and not to the recommendations on structural policies (Council Recommendation of 15 June 2001).⁵⁵
- The BEPGs for the period 2003-05 included for the first time, specific recommendations to the euro area. Five recommendations were addressed to policy actors at national level related to the policy-mix, fiscal positions, inflation differences, external representation and governance of structural reforms. The latter one asked Member States to *“improve the efficiency of existing coordination procedures in the area of structural reforms that aim at strengthening the euro area’s growth potential and resilience to shocks”* (Council Recommendation of 25 June 2003).⁵⁶
- The Integrated Guidelines for the 2005-2008 period, which were merged with the Employment Guidelines, included a specific chapter on a *“dynamic and well*

⁵⁴ OJ L 217, 17.8.1999, p.34.

⁵⁵ OJ L 179, 2.7.2001, p.1.

⁵⁶ OJ L 195, 01.08.2003, p. 1.

functioning euro area” that culminates in a recommendation to Member States to “ensure better co-ordination of their economic and budgetary policies.” Guideline No 6 made four more detailed points of which the third one requests to “press forward with structural reforms” (Council Recommendation of 28 June 2005).⁵⁷

- In the 2007 update of the Integrated Guidelines, the Council issued four specific recommendations to the euro-area Member States, which they should consider together with their specific country recommendations. They concern: (1) budgetary consolidation; (2) the quality of public finances; (3) competition in services and financial market integration; and (4) labour market flexibility and security, wages and labour mobility (Council Recommendation of 27 March 2007).^{58,59}
- In the reporting tables that accompanied their 2007 Implementation Reports, the euro-area Member States earmarked almost 300 policy measures that address the euro-area recommendations, meaning that Member States understand that their implementation would have an effect on the issues raised by the four recommendations. Table 3 reveals that about a third of the measures were attributed to the three broad areas of public finance (recommendations 1 + 2), microeconomics (recommendation 3) and employment (recommendation 4). Only few countries and measures targeted financial market integration. More than two third of the measures were classified as already in place and a further 20% as recently put in place. Less than 10% were listed as forthcoming measures.

Table 3: Distribution of policy measures allocated to the euro-area recommendations in the 2007 countries' reporting tables

	Rec. 1	Rec. 2	Rec. 3		Rec. 4	
	Budgetary consolidation	Quality of public finances	Service competition	Financial markets	Employment	Sum
BE	0	0	1	0	6	7
DE	3	5	1	3	3	15
IE		7	7	1	4	19
EL	1	10	10	0	10	31
ES	4	6	5	4	8	27
FR	na	"1"	na	na	na	na
IT	2	1	9	0	0	12
LU	0	0	3	0	17	20
CY	"3"	"2"	"4"	"0"	"5"	"14"
MT	1	3	2	0	1	7
NL	1	0	1	0	11	13
AT	3	8	10	3	13	37
PT	6	16	17	1	2	42
SI	0	1	8	0	4	13
FI	0	25	0	0	14	39
Share/sum	7.6%	23.6%	28.0%	3.9%	36.9%	296

Note: France did not submit a reporting table. Cyprus did not earmark measures in response to the euro area recommendations in its reporting table. In this case, the allocation of measures to the euro area recommendation was based on the author's judgement. The share was calculated as a weighted average in order to reduce distortions arising from the large variation of measures in Member States.

⁵⁷ OJ L 205, 6.8.2005, p.28.

⁵⁸ OJ L 92, 3.4.2007, p. 23.

⁵⁹ See European Commission (2007c) for a detailed analysis of the recommendations' motivation.

The adoption of specific recommendations to the euro area Member States to address structural reform gaps did not only imply greater political visibility of reform needs in the individual countries. It also made clear that there is an euro area-specific structural reform agenda to be pursued. For example, the euro-area recommendations target the strengthening of adjustment capacity in the euro area, encompassing the fiscal room for manoeuvre, wage rigidities, price stickiness, efficiency of financial adjustment and the reallocation between the tradable and the non-tradable sector. These are euro-area specific issues that go beyond the “traditional” Lisbon agenda for higher growth and more jobs, since they deal with mechanisms to adjust more efficiently within the euro-area in the absence of internal exchange rate adjustment and with a single monetary policy.

The formulation of euro-area specific recommendations in the Integrated Guidelines affects the governance of structural reform in the euro area in several ways. Importantly, they help to internalise euro-area priorities into Member States’ domestic reform priorities. The lack of adjustment capacity does not naturally emerge as an obvious problem to the public. Deterioration in competitiveness and the policy challenges following thereof tend to be discussed in the media with reference to globalisation rather than to adjustment in the euro area. Also, economic overheating is not necessarily seen as a policy challenge by the public. Moreover, the fact that the euro-area recommendations have become much more precise than in earlier BEPGs may contribute to public awareness of reform needs. It is, for example, evident that measures to improve financial integration are rarely discussed by the wider public other than in special situations. Similarly, the benefits of more integrated and more competitive service markets for adjustment in the euro area have hardly played a role in the controversy surrounding the service directive several years ago.

3.3. A tentative evaluation of the progress with structural reforms in EMU

Despite the rising attention to euro-area issues on the EU’s structural reform agenda, there still appears to be a rather loose link between euro-area reform needs and concrete reform undertakings in Member States. Absent a valid counterfactual, it is difficult to either refute or confirm whether the gradual strengthening of coordination procedures have had a material impact on structural reform endeavours. Rather than trying to assess the effectiveness of the governance framework, this section therefore seeks to analyse whether reform progress has been different in Member States that adopted the euro than in countries outside EMU. For this purpose, this section reviews first the theoretical arguments brought forward in the academic literature, then lists the available evidence and finally presents a new set of empirical estimates.

3.3.1. Have incentives to undertake reforms changed with EMU? Theoretical conjectures

A number of theoretical papers, prior to and since 1999, addressed the question of whether and how EMU would affect incentives to undertake reforms. An important aspect was whether higher reform needs generate incentives for reforms. Other facets relate to the impact of the changed macroeconomic environment, i.e. with monetary policy conducted by the ECB for the euro area as a whole and budgetary policy being subject to the rules of the SGP.

Most academic contributions analysed the question of whether higher costs of non-reforms in EMU have actually fostered or impeded policy makers’ incentives to

implement reforms with respect to labour market reforms, assuming that high unemployment and wage rigidities were an Achilles heel to the success of EMU. Some authors, for example Bean (1998), argued that the increased need for market efficiency and flexibility in EMU would create strong incentives for policy makers to undertake reforms simply because TINA (“there is no alternative”).⁶⁰ More competition on product markets as the result of increased price transparency and lower transaction costs in intra-area trade would yield a higher elasticity of labour demand with respect to real wages, squeeze rents and increase the responsiveness of wage bargaining to conditions on competitors' markets.⁶¹ Stronger competition, greater mobility of capital and labour in EMU, accelerated structural change and higher variability of employment have been highlighted in the economic literature as factors that raise the costs of non-reforms and therewith, *ceteris paribus*, encourage reform efforts.⁶²

However, it has also been reasoned that opposite effects may emerge. If EMU leads to higher labour market risk, it would raise the demand for social protection policies, rather than for flexibility-enhancing reforms. That is, the higher cost of economic distortions might not result in reforms that aim at more market flexibility.⁶³ A further effect could arise from the increased economic integration under EMU. The stronger the degree of integration, the higher could be the cross-country spill over of reforms and, in consequence, reforming countries could accrue smaller benefits from reforms being in EMU than outside of it.

As regards the impact of the changed monetary environment on reform incentives, the literature has so far remained inconclusive.⁶⁴ On the one hand, EMU was expected to reduce the credibility problem of monetary policy, *i.e.* by reducing both the inflation bias and equilibrium unemployment in Barro-Gordon type credibility models. The existence of a national inflation bias would lead an inefficient national labour market to cause both higher structural unemployment and higher inflation compared to a situation in a monetary union. In a monetary union, inflation is determined by conditions in the euro-area aggregate and not by national unemployment. Thus, the costs of an inefficient labour market are lower and, with stability-oriented macroeconomic policies, the urgency of reforms would be smaller. On the other hand, the costs of non-reforms increased with EMU because monetary policy cannot accommodate asymmetric shocks anymore. This gives rise to a precautionary motive of reforms. The same argument has, however, also been used to explain why reform efforts in EMU might slowdown. Since monetary policy is conducted for the euro area as a whole, governments cannot count on any deflationary effects of reforms being compensated for by accommodative monetary policy.⁶⁵ Saint-Paul and Bentolila (2000) considered this latter effect to have a decisive influence on the incentive to conduct large-scale labour market reforms, reasoning that this would create a “case for coordination of labour market reforms across European

⁶⁰ Some optimism with respect to the influence of adjustment needs in EMU on policy incentives to raise wage flexibility is already visible in the study “One Market, One Money” by the European Commission (1990).

⁶¹ See Andersen (2003), Nickell (1999), Bertola and Boeri (2002). On the other hand, Burda (1999) argued that the move to EMU must not necessarily increase competition. A countervailing factor was that large firms may have more monopolistic power in price setting due to being active in an enlarged economic entity with a degree of openness comparable to that of the USA.

⁶² See, for example, Calmfors (2001).

⁶³ This has been argued by Saint-Paul and Bentolila (2000) and Bertola and Boeri (2002).

⁶⁴ For a survey on the interaction between reform incentives and monetary policy, see Leiner-Killinger *et al.* (2007).

⁶⁵ See Calmfors (1998), Bean (1998), Berthold and Fehn (1999) and Saint-Paul and Bentolila (2000).

countries” in order to allow the ECB to complement structural reforms with accommodative monetary policy.

Concerning the impact of EMU's fiscal policy framework on reform incentives, positions are also divided. Most analyses start from the assumption that structural policy is fiscally costly, for example, because reforms cause distributive effects. Thus, financial constraints hamper reform incentives.⁶⁶ A sound fiscal position and additional spending are regarded as being conducive to structural reforms because they allow overcoming reform resistance from the likely losers of reforms by financially compensating them. This hypothesis is in line with the observation by Debrun and Annett (2004) that labour market reforms in the euro area had been discouraged by the little leeway available for fiscal manoeuvre. It is difficult to square this with the claim in IMF (2004) that reforms in EMU seem to have taken place primarily in bad times whereas Anglo-Saxon countries reformed economic structures in good times. While the prevalence of crisis as a supportive factor to reforms is consensual in the economic literature,⁶⁷ reforms in bad times are more likely to conflict with budgetary consolidation in EMU due to the limits set by the SGP.⁶⁸

3.3.2. *Does EMU lead to more reforms? Findings in the empirical literature*

One reason for the difficulty of resolving the issue of whether the pace of structural reforms has accelerated or slowed down since the introduction of the euro is that the concept of a structural reform is vague and difficult to translate into measurable quantities. A number of institutions, including the European Commission, have assembled data on individual reform measures (see Table 3). The drawback of the first approach is that reforms are normally very specific and thus difficult to compare across countries. Often the observations inform merely about reform events and the user needs to classify the information. This makes it difficult to derive data series that can be used in empirical research. Moreover, coverage is often limited to few countries and a relatively short time horizon. The alternative consists in using compiled indicators that capture regulatory institutions, the changes of which can be interpreted as due to reforms. Almost all the studies mentioned below therefore use these institutional indicators as proxies of reforms. The most common data used is the one established by the IMF on the basis of the indicators compiled by Nickell/Nuniata and the OECD. The drawback of these institutional indicators is that the weight with which different features of institutions are aggregated, is *ad hoc* and uniform across countries, even though the different features may have a different role in different social environments. Often the translation of reform measures into indicators relies on country expertise, which may attach different weights to different institutional features. Other points of criticism relate to their dependence on the theoretical priors of those that establish them and the loss of information due to their aggregate nature.⁶⁹

⁶⁶ This point was modelled by Beetsma and Debrun (2003).

⁶⁷ For the role of crisis in fostering reforms, see for example Rodrik (1996), Drazen and Easterly (2001), Duval (2005), Høj *et al.* (2006).

⁶⁸ This is somewhat contrary to the position in Debrun and Pisani-Ferry (2006), who argue that reforms in good times are more likely to conflict with budgetary consolidation because policy makers have to decide on how to allocate their political capital.

⁶⁹ For a critical evaluation of reform indicators, see Campos and Horváth (2006), who focus on indicators of labour market institutions, and Ochel (2006), Arpaia and Mourre (2005), Crafts (2006) and Schiantareli (2005), who focus on product market indicators.

Two approaches have been used in the economic literature to assess the impact of EMU on the pace of structural reforms based on these aggregate indicators. The first consists in comparing the amount of reforms before and after 1999, i.e. when the euro was introduced. The problem with this approach is that the reform pace might have changed over time independent from EMU, which may distort the picture unless relevant controls are introduced to capture these other factors. The second approach compares the pace of reforms in euro-area countries with a control group of countries outside the euro area. This may give a biased picture if the reform needs are different across country groups, but appropriate controls can again be introduced. Most studies combine both approaches by pooling time series over a sample of countries.

From the available studies emerges that EMU has had no significant impact on the pace of overall reforms, be it positive or negative, although with results varying across reform areas and countries.⁷⁰ Duval and Elmeskov (2006) see no acceleration of reforms in EMU and Duval (2006) even a slowdown in reforms in 1999-2004 relative to 1994-1998. Bertola and Boeri (2002) detect stronger reform efforts for non-employment benefits and employment protection legislation (EPL). Their result is confirmed in European Commission (2006c) using the same data source. The number of reforms was higher in 1999-2002 than in 1994-1998 in the areas of income replacement benefits, EPL and migration, but not in the area of pensions. European Commission (2006c) found reform intensity to have been higher in six countries in the period after 1999 than before (Germany, Spain, France, Italy, Netherlands and Portugal). This differs from the assessment in Debrun and Annett (2004), who note stronger reform effort in only three euro-area countries (Germany, Spain and Italy).⁷¹

Assessing progress in the euro area against a control group of other OECD countries, Van Poeck and Borghijs (2001) find that, in the 1990s, EMU countries undertook fewer labour market reforms than non-EMU countries. A more nuanced picture emerges from Duval (2005), who finds that euro-area countries implemented more reforms than other OECD countries in both 1994-1998 and 1999-2004, but fewer than non-euro-area EU countries. Debrun and Annett (2004), for a panel of 17 OECD countries over the period 1975-1998, find that EU Membership fostered reforms, which they interpret in that EU helped to overcome domestic reform resistance. However, while EU membership had a positive effect on incentives to conduct labour market reforms, being in the ERM with narrow fluctuation bands had a significantly negative effect on labour market reforms.⁷²

⁷⁰ When EMU is considered to have begun with the start of phase II in 1994, rather than with the introduction of the euro (phase III) in 1999, there was an increase in the frequency of product market reforms and pension reforms compared to 1990-93 (Deroose and Turrini, (2005) and of labour market reforms compared to 1971-1993 (Buti *et al.*, 2007).

⁷¹ The difference is likely due to a different method for combining marginal and structural reforms in both studies. European Commission (2006c) reports the numbers of both marginal and substantial reforms. Annet and Debrun (2004) weigh substantial reforms three times higher than marginal reforms. Moreover, they concentrate on the years 2000-2002, *i.e.* since the launch of the Lisbon Strategy, compared to the period 1999-2002 in European Commission (2006c).

⁷² The IMF WEO indicators for product and labour market reforms were used in this exercise.

Table 4:

Reform data

Source	Record	Coverage			Special features
		areas	geographic	time	
Rodolfo de Benedetti foundation reform data base	Description of reform events	EPL, employment benefits, pensions, migration	14 EU countries	1985-2005	Distinguishes marginal and structural and direction of reform
Bertelsmann foundation International reform monitor	Description and assessment of reforms	Pensions, and social security health care, labour market, industrial relations	10 EU countries	1997-2004	Analysis from research institutes located in countries concerned. Discontinued.
ECFIN LABREF	Description of reform events	8 labour market areas	25 EU countries	2000-2006	Accessible on DG ECFIN website
ECFIN MICREF	Description of reform events	7 product market areas	27 EU countries	2004-2006	Will be made public in summer 2008
EU Implementation reports (BEPGs, NRPs)	Assessment of measures that address reform priorities	Public finances, product markets, labour markets, Capital markets (partly)	All EU countries	2000-2005	Reports on policy measures that address EU recommendations to MS
OECD regulation indicators	Index of product market regulation	7 networks	21 OECD countries	1985-2003	
	Index of labour market regulation	7 policy areas	OECD countries	1994-2004	
Frazer indicators of economic liberty	Assessment of tightness of regulation	10 policy areas with various sub-indicators	165 countries (123 countries for older vintages)	5 yr intervals 1970-2000, annual 1995-2007	(Change in methodology 2005 backcast to 1995)
Nickell Nunziata data base	Indicators of labour market institutions	Employment protection, Labour union density	20 OECD countries	1960-1995	
IMW WEO indicators of structural reforms	Summarises OECD and Nickell/Nunziata data	Financial sector, labour market, product market, tax, trade	20 industrial countries	1975-2000	

Source: European Commission.

Box 2: The linkage between fiscal policy and structural reforms – the empirical evidence

Few studies have so far approached the linkage between budgetary consolidation and reform incentives empirically. When analysing the impact of aggregate indicators of reform intensity on budgetary figures, the estimates in Deroose and Turrini (2005) suggested that while reforms had been associated with deteriorating budgetary positions, the magnitude was rather small. In general, it was found that the budgetary consequences of reforms depended very much on the specific reform undertaken. Labour market reforms seem to be associated with a budgetary deterioration in the order of few decimal points of GDP, while estimates for other kind of reforms yielded insignificant coefficients. There was, for instance, no clear direction in the relation between pension reform and fiscal consolidation. The empirical estimates in IMF (2004) also found that budgetary consolidation is a significantly negative determinant of labour market reforms and tax reforms, but not significant for product market, financial and tax reforms.

Heinemann (2006), Duval (2006), Duval and Elmeskov (2006) and Høj *et al.* (2006) analysed fiscal positions as a determinant of reform intensities. While the former detected a weak relationship between reform indicators and budgetary consolidation, pointing to no general trade-off between both, the estimates in the latter three suggest that a sound fiscal position increases the likelihood of reforms in line with the compensating-the-losers hypothesis. The possibility of a positive effect of fiscal discipline on labour market reforms emerges from the empirical analysis in Buti *et al.* (2007), which compares the likelihood of reforms in 1993-1998 with those prior to the introduction of the Maastricht constraints. The estimates suggest that the EU fiscal framework has affected positively the probability of labour market reforms.

More relevant when it comes to a possible application to the EMU fiscal framework than budgetary positions is budgetary consolidation. This is typically measured by a change in the fiscal surplus net of cyclical influences. This determinant was found to reduce the likelihood of reforms in Høj *et al.* (2006) and Duval (2006), but turned out to be insignificant in the comparable set up in Duval and Elmeskov (2006). The estimates in Buti *et al.* (2008) find that reforms taking place in periods of fiscal consolidation do not have a significant impact on governments' election chances. Thus, there is only weak support for a negative association of overall structural reform with fiscal consolidation.

3.3.3. A crosscheck

The overall picture seems to be that being inside of EMU, or the launch of the single currency itself, has not been a stimulus for structural reform – which is a concern in view of the stronger reform needs of the euro area. It appears therefore useful to crosscheck this finding with alternative sets of reform indicators. Two approaches have been pursued.

Table 5:

Recommendations and implementation scores in the Broad Economic Policy Guidelines 2000-2005

	EA12	Non-EA control group (DK, SE, UK)	Top 3 EA performers	standard deviation EU15
Number of recommendations	22.8	15	14.3	6.7
- Labour market	10.3	5.3	4.3	4.5
- Product market	12.4	9.7	10	2.6
Implementation score*	1.4	1.7	1.6	0.2
- Labour market	1.3	1.7	1.5	0.3
- Product market	1.4	1.6	1.6	0.2

* score encompasses 0 (no measures) via 1 (partial, limited), 2 (in progress) and 3 (complete)

Source: European Commission.

The first approach is to analyse whether euro-area countries fared better or worse than non-euro-area countries in terms of respecting the recommendations addressed to them by the EU under the BEPGs – the Treaty-based tool for policy co-ordination. The BEPGs provide the basis for the European Council, upon proposal by the European Commission,

to issue recommendations for economic reform in the EU countries (see above). Every year the European Commission assesses progress in the Member countries with the implementation of policies to address these recommendations. Though the assessment is mainly of qualitative nature, progress with each recommendation has been classified in four categories (3 = complete, 2 = in progress/partial, 1 = limited, 0 = none). Scores are computed in the policy areas of product markets and labour markets coded.⁷³ The data set comprises the period 2000-2005, with annual recommendations and implementation reports available from 2000 to 2002 and multi-annual recommendations available for the 2003-2005 period. This yields four observations per country.

The upper panel in Table 5 compares the average scores of the 12 euro-area Member States with those of the three countries that have not joined the euro area. Over the period reviewed, there were more recommendations addressed to the average euro-area Member State than to the average other country, suggesting that EMU Member States were considered to have higher reform needs. No systematic difference emerges for the three non-EMU countries in comparison with the three best countries in the euro area in terms of number of recommendations issued. Differences in the follow up to the recommendations between EMU and non-EMU countries are shown in the lower panel of Table 6. The average score for all EMU countries was about one standard deviation worse than for the three out countries. Moreover, the score in each of the three out countries is higher than the euro-area average, although again the three best performers in the euro area had only a slightly smaller score than the three non-EMU countries.

While the latter findings point to a negative impact of EMU membership on the structural reform efforts, it is well possible that this effect is driven by a negative correlation between the number of recommendations and the policy effort devoted to each recommendation. Such a negative correlation is plausible – if governments have limited political capital and administrative capacity to reform, their average achievement will decline with the number of targets. The estimates in Table 6 show, however, that the correlation of structural reform with membership in EMU remains negative even if controls are introduced for the number of recommendations and the size of the economy.⁷⁴

The results reported in Table 6 also suggest that the size of the economy has a positive impact on reform scores, which contradicts the widely held belief that small countries in the euro area are more active reformers.⁷⁵ However, more detailed analysis suggests that the significance of the positive coefficient is due to the relatively low scores in the assessment for Ireland and Luxembourg.

⁷³ Other policy areas covered by the BEPGs were fiscal policy and, in some years, capital markets. Recommendations on social security, including pension reforms were included in this exercise as labour-market reforms and those on the knowledge-based economy as product-market reforms.

⁷⁴ However, the small number of observations and especially the fact that only three countries outside the euro area are included in the panel warrants caution in interpreting the results. For example, when Greece is considered a non-EMU country before 2002, the EMU effect is no longer significant in the third estimate.

⁷⁵ Duval and Elmeskov (2006), for example, yield a significantly positive impact of a "small-country dummy" on the probability of reforms.

Table 6:

Determinants of structural reform scores based on BEPGs

	Constant	No	Size	EMU
1. Average 2000-2003/05	1.56 (0.16)*** R ² = 0.76	-0.02 (0.005)*** Obs. = 15	0.07 (0.02)***	-0.20 (0.08)**
2. Individual years	1.46 (0.25)*** R ² = 0.23	-0.07 (0.03)** Obs. = 60	0.09 (0.04)**	-0.20 (0.12)
3. Individual years with year fixed effects	1.43 (0.22)*** R ² = 0.42	-0.05 (0.03)** Obs. = 60	0.08 (0.03)**	-0.22 (0.11)**

No - Number of recommendations. Size - GDP in PPS (average 1999-2005). EMU - dummy for EMU Member States. OLS estimate, standard errors in brackets. *, **, *** significance at 10, 5, 1% level, respectively.

Source: European Commission.

The second approach is to check progress with reforms based on reform proxies for a larger group of industrialised countries. Table 7 summarise the results of estimations from different time periods and indicators established by the Fraser Institute, the OECD and Eurostat. For all indicators, the change in the indicator is regressed on its starting position and a euro-area dummy. When both Central and Eastern European Countries (CEEC) countries and other OECD countries are included, a further dummy is introduced for the former as transition countries are expected to portray a different reform pace than other countries.

Fraser indices describe the degree of economic liberty as the aggregate of sub-indicators in 10 different areas.⁷⁶ A high level of the indicator signals a more lenient stance of structural policy. While the indicator is available for 122 countries, the panel was restricted to 36 industrial countries. For the aggregate Fraser indicator as well as for most of the subcomponents shown below, the euro-area variable shows up significantly and negatively, suggesting that membership in the euro area has slowed down liberalisation. However, the share of the cross-country variation in changes of "economic freedom" explained through this estimate is in some cases very small, especially in the sub-period 2000-2004. In contrast to other studies,⁷⁷ the starting position is not significantly negative in any of the estimates. That is, the estimate does not provide evidence of convergence.

⁷⁶ For a description of the construction of the index of economic freedom, see Beach and Kane (2007).

⁷⁷ The initial level is for example significantly negative in the estimates provided by Belke *et al* (2005), which show a positive correlation between changes in the Fraser index and a fixed exchange rate regime. Belke *et al.* control for the starting level, inflation, growth, openness, policy constraints and government changes. Their panel consists of 178 countries over the period 1970-2000.

Table 7:

Determinants of structural reform scores based on alternative sources

A. Changes in Fraser indicators of economic freedom								
	1995-2004				2000-2004			
	Euro	CEEC	Level	R2	Euro	CEEC	Level	R2
Fraser index	- *	+ *	-	0.69	-*	+*	+	0.79
- Government size	- *	+	-	0.35	- *	-	+	0.19
- Legal system	-	-	-	0.05	-	+	-	0.04
- Labour market regul.	- *	+	-	0.22	+	-		0.01
- Business regulation	- *	-	-	0.47	- *	+	-	0.53
B. Changes in OECD deregulation indices								
	1995-2003				2000-2003			
	Euro	CEEC	Level	R2	Euro	CEEC	Level	R2
Product market.	+		+ *	0.56	+		+ *	0.61
- Airlines	+		+	0.17	+		+ *	0.28
- Telecom	+ *		+ *	0.91	+		+ *	0.47
- Electricity	+		+*	0.48	+		+ *	0.47
- Gas	+		+*	0.31	+		+	0.38
- Post	+		+*	0.40	+		+ *	0.68
- Rail	-		+ *	0.44	+		-	0.02
- Road	-		+	0.17	-		+	0.09
EPL (1998-03)	+	-	+ *	0.22				
GRR	- *		+ *	0.50	- *		+ *	0.42
LTU (2001-04)					-	-	+ *	0.39
C. Change in Eurostat structural indicators								
	Period	Coverage	Euro	CEEC	Level	R2		
Tax wedge on low wage earners	2000-2005	REU+6	+*		-	0.35		
Unemployment trap	2001-2005	REU+5	+*		+	0.15		
Low wage trap	2001-2005	REU+5	+		+	0.12		
Spending on education	1995-2001	REU+5	-*		-*	0.38		
Life-long learning	2001-2005	REU+4	-		+	0.30		
Average exit age	2001-2005	REU+3	- *		-	0.23		

Level is the initial level in 1995 and 2000, respectively. Periods are determined by data availability. A +/- means that the factor has a positive/negative impact on deregulation. A * indicates significance at 5% level. For the Fraser indicators, the non-EMU group consists of the remaining EU countries plus Australia, Canada, Iceland, Japan, South Korea, Mexico, New Zealand, Norway, Switzerland, US. For the OECD product market indicators, the control group are the non-EMU EU-15 countries plus Australia, Canada, Japan, New Zealand, Norway, Switzerland and the US. EPL - employment protection legislation index. GRR - gross replacement rates, i.e. summary measure of benefit entitlements. LTU - net replacement rate of long-term unemployed. Life-long learning is share of participants. REU+X means all other countries of the EU-25 plus x non-EU countries.

Source: European Commission.

According to the estimates on the basis of the OECD regulatory indices (Panel B), the starting position of regulation has a significant impact on the pace of product market deregulation with the expected negative sign. Euro-area membership has a positive impact on structural reform. Although it is insignificant in most cases, this result dismisses other findings that membership in the euro area slowed down progress with reforms. The results reported in Panel C, with varying compositions of control groups, show that euro-area Member States progressed more in some areas and less in others.

To sum up, the assessment of whether the single currency led to less or more progress with structural reforms depends largely on the data source used. OECD and Eurostat data

do not replicate the negative impact of the single currency emerging from the BEPGs and Fraser indicators. Obviously, the small size of the control groups constitutes a severe handicap, and no sweeping conclusions can be drawn. Even so, from the findings can be safely inferred that there is no overwhelming evidence of the ‘TINA’ argument that giving up of the exchange rate and interest rate instruments in EMU would spontaneously produce incentives for structural reform so as to heighten the flexibility of markets in the pursuit of alternative adjustment mechanisms. There is no evidence that this has occurred, which is of concern given the sizable reform needs.

3.4. Interim conclusions

The pace of structural reform in the euro area has not accelerated despite evident reform needs and has also not been outstanding in comparison with countries in which monetary policy and exchange rates are able to support adjustment to changing economic circumstances. Over the years, the European Commission’s progress reports on the Lisbon commitments or the implementation reports of BEPG recommendations have consistently spotted a persistent implementation gap between reform needs and adopted policy measures. The euro-area dimension in the governance framework of structural policy has gradually gained in importance and has become more specific. Importantly, the adoption of specific recommendations addressed to the euro-area Member States now help to internalise euro-area priorities – notably the need for flexible and effective adjustment of prices and wages in the absence of internal exchange rates – into Member States’ reform priorities.

4. EXTERNAL COORDINATION AND REPRESENTATION

Another key area of coordination for which EMU has created both new opportunities and new challenges is international macroeconomic and financial matters. The creation of a single monetary and exchange rate policy, the emergence of the euro as a key international currency and the important weight of the euro area in the world economy have increased the need for euro-area countries to coordinate their positions and on international matters, exposing the deficiencies of the current arrangements. While the Treaty established a sound exchange rate policy framework, the representation of the euro area in multilateral financial fora remains fragmented and, despite significant progress to strengthen coordination, the euro area is often unable to speak with a single voice in them. As emphasized by several observers,⁷⁸ this causes the euro area to punch in the global arena below its economic and financial weight.

4.1. The institutional set-up for euro exchange rate policy

The main instruments for exchange rate policy in the euro area are established by the Treaty (Article 111). It covers the possibility of entering a system of fixed exchange rates with countries outside the EU, as well as the formulation of general orientations for exchange rate policy.⁷⁹ Formal agreements require a unanimous decision by the Council, following a proposal by the ECB or the Commission and consultation of the European

⁷⁸ See, for example, Bini-Smaghi (2004 and 2006a) and Sapir (2007).

⁷⁹ Cf. the overview in Kutos (2001).

Parliament. The formulation of general orientations for exchange rate policy is generally understood to cover informal agreements with partners outside the euro area, as well as unilateral position-taking by the euro area. Here, the Council acts with qualified majority, either on a recommendation from the ECB, or on a recommendation from the Commission and after consulting the ECB. The Eurosystem (the system of national central banks of the euro area and the ECB), which holds the euro area's foreign exchange reserves, is the sole institution responsible for carrying out interventions. As an additional safeguard for the independence of the ECB, exchange rate policy, and in particular general orientations, may not jeopardise the primary objective of price stability.

The Treaty framework has been fleshed out by the Resolution adopted by the Luxembourg Council of 12-13 December 1997.⁸⁰ It states that exchange rates are, in general, the outcome of all other economic policies and limits the formulation of exchange-rate orientations to exceptional circumstances, such as clear misalignment. Moreover, the Resolution called on the ECOFIN Council to regularly monitor the euro exchange rate, taking into account a wide range of economic data and assessing whether exchange rate developments are consistent with the underlying economic situation. The deliberations by the ECOFIN Council (*de facto* the Eurogroup) are prepared by the Economic and Financial Committee (*de facto* the Eurogroup working group), which bases its discussions on analytical input provided by the Commission services.

The Treaty provisions on exchange rate policy have been criticised by academics and practitioners for their lack of clarity.⁸¹ In practice, the rules governing the conduct of euro exchange rate policy have largely evolved in an informal manner. The instruments provided by the Treaty have never been used for the purpose of exchange rate policy so far. The regular exchange-rate surveillance at the Eurogroup results in "terms of reference" on the exchange rate of the euro against the major currencies and in agreed language for the participation of the Eurogroup President in the discussion on exchange rates at the G7 meetings of finance ministers and central bank governors. Even when preparing the ground for the foreign exchange interventions in the autumn of 2000, the Eurogroup used its *communiqué* to comment on the exchange rates rather than adopting general orientations on the basis of Article 111. The ECB has also occasionally issued written statements and press releases on the euro exchange rate.

The interdependence of exchange rate and other economic policies has given rise to an arrangement where the president of the ECB attends the meetings of the Eurogroup, and the Eurogroup president as well as the Commissioner for Economic and Monetary Affairs are invited as observers to the meetings of the ECB Governing Council.⁸² A pragmatic approach is also followed for the IMF missions in preparation of the so-called

⁸⁰ OJ C 35, 02.02.1998, p. 1.

⁸¹ See e.g., IMF (2001) and Lastra (2006).

⁸² A careful institutional balance is needed because exchange rate policy is an area in which both finance ministries and central banks have an interest but where their mandates differ. On the one hand, central banks, which are held accountable for price stability, tend to interpret exchange rate developments mainly in light of their direct and indirect impact on prices. They also have an interest in ensuring that exchange rate policies do not undermine the pursuit of price stability (cf. e.g. Fisher, 1994). On the other hand, finance ministers are appointed to conduct economic policies in general. They tend to see exchange rate developments more in terms of their implications for trade and output. However, where the policy assignment gives the central bank the primary objective of price stability, it would be illogical to jeopardise its work through an inconsistent exchange rate policy.

Article-IV consultations on the euro area, where – despite the euro area itself not being a member of the IMF – IMF staff meets with the ECB, the Commission and the Eurogroup working group.

While some ambiguities remain, the practical conduct of exchange rate policy in the euro area has not encountered major problems. The interventions in September and November 2000 to stem the depreciation of the euro demonstrate that effective action is possible. The coordinated interventions in September 2000 followed an agreement at Eurogroup level, after which the Eurosystem carried the interventions out together with G7 partners. In November 2000, the Eurosystem intervened unilaterally, without another specific agreement at Eurogroup level (based on the “green light” to intervene provided by the Eurogroup in September). In their public statements after the episodes of intervention, members of both the Eurogroup and the Eurosystem tended to emphasise their own role in preparing the decision to intervene.⁸³

A challenge the Eurogroup is facing is to develop a common view on exchange rate issues that is the precondition for conducting an exchange rate policy, and to stick to the agreed view in external communication. The lack of transparency often perceived by third countries’ authorities is compounded by the fact that the views of ministers in the Eurogroup do not always converge. This has, on occasions, led to a lack of consistency in their public statements.⁸⁴ As discussed below, there is also a need to simplify the very complex arrangements for the external representation of the euro area. While the ECB is represented in most key multilateral fora, the “economic side” is divided between the Eurogroup presidency, the ECOFIN Council presidency, the Commission and individual Member States, which sometimes makes it harder for the euro area to convey a consistent view on exchange rate issues.⁸⁵

Recently some improvements were made, though. The decision in 2005 to appoint the Eurogroup president for a term of two years⁸⁶ and his enlarged participation in G7 meetings has increased the transparency of euro-area external representation. In the IMF-led multilateral consultations on global current account imbalances, in which exchange rate developments also played a role, a different setup has emerged, where the presidency of the Eurogroup, the ECB and the Commission jointly represented the euro area. In a bilateral dialogue with China in November 2007, this approach was repeated at the highest level, with a troika constituted by the Eurogroup President, the President of the ECB and the Commissioner for Economic and Monetary Affairs represented the euro area.

4.2. Key developments in external representation since 1998

Reflecting the need to respond to the institutional challenges raised by the international dimension of EMU, Article 111 of the Treaty foresaw procedures not only covering, as

⁸³ Henning (2006).

⁸⁴ See Bini-Smaghi (2007a and 2007b) for a general discussion. A concrete example was provided in the margins of the Eurogroup meeting of 8 October 2007, where French Minister of Economy and Finance Lagarde noted the group’s “*collective concern*” about the euro’s strength, whereas the German Finance minister Steinbrück insisted that he “*preferred a strong euro*” and Dutch Finance Minister Bos said that “*the whole idea of monetary union was to make a strong euro.*”

⁸⁵ On this point, see also Pisany-Ferry *et al.* (2008).

⁸⁶ Article 2 of the Protocol (N° 14) on the Eurogroup annexed to the Lisbon Treaty formalises the election of a Eurogroup President for 2½ years.

noted, exchange rate policy and exchange rate arrangements with third countries but, more generally, the position taking and external representation of the euro area on issues of particular relevance for EMU. The Council was identified as the main policy actor and the Commission was given the right of initiative (to be shared, as noted, with the ECB on exchange rate policy matters).⁸⁷

Attempts to formalise the external representation of the EU/euro area on financial and monetary matters have not made much progress, however. A proposal to that effect was made by the Commission in 1998 under Article 111(4) of the Treaty, but was not considered by the Council. Nonetheless, at the end of that year, the Vienna European Council agreed on a number of measures aimed at helping the euro area speak with a single voice on issues of particular relevance for EMU. Regarding the IMF, it called on the ECB to be given observer status at the IMF board. It also called on the representative of the Member State holding the euro area presidency, assisted by a representative of the Commission, to represent the views of the EU/euro area on EMU-related issues.⁸⁸ Regarding the G-7 Finance, the Council called on the president of the ECOFIN Council (or if the president is not from a euro area country, the president of the Eurogroup), assisted by the Commission, to participate in G-7 meetings. The Vienna Council also encouraged the timely preparation and presentation of common EU positions in international fora on EMU-related issues. On matters that do not belong to Community competence, it recognised that pragmatic solutions for the external representation (including, where appropriate, the use of common understandings) should be developed.

The Vienna conclusions have been partially implemented. In 1999, the ECB was granted observer status at the IMF board, where it participates on issues of particular relevance for EMU (notably global surveillance, exchange rate matters and the Article-IV consultations for the euro area).

As discussed in the following section, there has also been significant (though insufficient) progress with the representation through the EU presidency of common positions of EU/euro area countries on issues of particular relevance to EMU. Also, since 2005, both the president of the Eurogroup and the president of the ECB fully participate in the G-7 meetings. The participation of the president of the Eurogroup in G-7 meetings, and more generally, the euro area's capacity to speak with a single voice on economic, monetary and financial matters on the international stage has been facilitated by the Eurogroup's decision to appoint a two-year president, which helps to ensure continuity.

In October 2006, the ECOFIN Council ministers agreed additional measures on external representation, most of which have yet to be implemented (in some cases reflecting opposition from non-EU partners). The ministers asked for a more pro-active EU approach in multilateral fora and a more effective euro area presidency presence in the G-7 and the G-20. They called for the full participation of the Commission in the G-7 in all agenda items within its competences, in the G-20 (alongside the Council presidency and the ECB in the delegation representing the EU) and in the Financial Stability Forum (FSF) as an observer.⁸⁹ They also agreed on a number of measures to enhance EU

⁸⁷ See European Commission (2004): 131.

⁸⁸ See the Presidency Conclusions of the European Council Meeting of Vienna, 11-12 December 1998.

⁸⁹ The G-20 was established by the G-7 in the wake of the financial crises of 1997-98 to provide a wider forum for informal dialogue on the international financial architecture and other global economic and financial issues. It includes the G-7 countries, 12 systemically important emerging market economies, the EU (represented by the ECOFIN Council presidency and the President of the ECB), the IMF and

coordination at the IMF, including the election every two years of an EU executive director to represent EU positions at the IMF and the appointment of a Commission official in the office of a euro-area executive director. Finally, they underlined the importance of deepening EU coordination also at the World Bank.

At their October 2006 meeting, the ECOFIN Council also agreed that the move to *a single euro-area chair at the IMF* is a longer-term issue, while noting that it raises a number of difficult political and technical questions (among them the necessary change in the IMF's Articles of Agreement). The Ministers left, however, the window open for such a possibility, pointing out that if a political decision is made to move closer to a single seat, modalities for designating the common executive director, organising its constituency and coordinating instructions should be found.

There has also been some progress with *the recognition of the euro area as a key entity for surveillance and a key interlocutor by multilateral institutions*. In particular, the IMF and the OECD have extended their multilateral surveillance activity to include the euro area. The IMF conducts annual consultations with the euro area in the context of the so-called Article-IV procedure. The OECD, for its part, has included the euro area in the regular assessments of member economies conducted by its Economic Development and Review Committee (EDRC).⁹⁰ Both exercises provide key input for the bi-annual multilateral surveillance and forecasts of these institutions. In addition, the euro area (represented by the Euro Working Group, the Commission and the ECB) participated as such, together with China, Japan, Saudi Arabia and the United States, in the multilateral consultations on global imbalances organised by the IMF between 2006 and 2007.

Table 8 summarises the current status of external representation of euro area countries and euro area and EU common institutions in the main international fora.

(cont.)

the World Bank. The FSF was established by the G-7 in 1999 to help assess vulnerabilities in the international financial system and propose appropriate regulatory and policy responses. It includes 26 representatives from the financial regulatory and supervisory authorities of the G-7 countries, Australia, Hong-Kong, the Netherlands, Singapore and Switzerland, as well as 15 representatives from international financial institutions, the ECB, and certain standard-setting, supervisory and regulatory associations.

⁹⁰ Since 2007, these euro-area reviews by the EDRC have been conducted on a biennial basis, alternating with a review of EU-27 policies, which focuses on the structural aspects of Community policies

Table 8:

External representation of the euro area: an overview

	Eurogroup Presidency	EU Presidency	European Central Bank	European Commission	Euro-area Member States*
OECD	Participation in EDRC's examination of the euro area	Participation in the EDRC's examination of EU-27 policies	Participation in EDRC, Economic Policy Committee, and Committee on Financial Markets	Participation, on behalf of the European Community, in all committees and Ministerial Council Meetings	12
IMF Executive Board		EU or euro-area position represented by the EURIMF Chairman	Observer status		15
IMF's International Monetary and Financial Committee		Full participation, depending on the constituency agreement	Observer status	Observer status	6/7
World Bank Executive Board					15
Development Committee of the World Bank		Full participation, depending on the constituency agreement		Observer status	6
Financial Stability Forum			Full participation		4
G-7 Finance Ministers	Full attendance		Full attendance	Partial attendance; not fully involved in preparatory work	3
G-8 Finance Ministers		Full participation	Full participation	Full Participation	3
G-20 Finance Ministers		Full participation; but not eligible to hold G-20 Presidency	Full participation	Part of the EU Presidency delegation in G-20 Deputies meetings	3

Source: Commission services.

Notes: EDRC stands for Economic Development and Review Committee.

4.3. Progress with EU coordination

At the informal ECOFIN Council meetings of Oviedo and Copenhagen in 2002, an informal model of coordination was agreed to facilitate the flow of information and the adoption of common positions at the IMF board on a list of issues. The main committees of the ECOFIN Council and Eurogroup, called respectively the Economic and Financial Committee (EFC) and the Eurogroup Working Group (EWG), regularly elaborate common positions and understandings ahead of key international meetings, on issues ranging from exchange rate and important country matters to the reform of the international financial architecture. For example, the EFC discusses and agrees on statements of the EU presidency for the spring and annual meetings of the IMF, while the EWG prepares the intervention of the president of the Eurogroup at G-7 meetings. The efforts to increasingly speak with a single voice in international meetings have also been reflected in the regular practice of the President of the Eurogroup, the president of the

ECB and the Commissioner for Economic and Monetary Affairs to hold joint press conferences following G-7 meetings.

The coordination of EU positions at the IMF board of directors has been facilitated by the creation of specialised committees in Brussels and Washington. Since 1998, the EU representatives at the IMF board meet on a weekly basis to exchange information on, and where appropriate adopt common approaches to, key issues. This coordination group, known as the EURIMF, also includes the ECB observer at the IMF board and a representative of the Commission. Moreover, in 2000, the EFC created the so-called Subcommittee on IMF and Related Issues (SCIMF), which includes representatives from the ministries of Finance and central banks of the 27 EU countries, the ECB and the Commission. It meets approximately on a monthly basis in Brussels to discuss and develop common positions on key IMF issues. Documents agreed by the SCIMF and endorsed by the EFC are then submitted to the EURIMF as the basis for common positions.

Since June 2007, as agreed by the ECOFIN Council in October 2006, the EURIMF appoints a two-year chairman to facilitate the representation of EU/euro area positions at the IMF board and in contacts with IMF management. The EURIMF chairman conveys these positions in the board in different ways depending on the topic or degree of consensus achieved. The strongest form of coordination is the so-called common written statement (also known as common “gray”), which precludes other EU chairs from issuing separate written statements. This is normally used for issues exclusively related to euro area common policy such as the Article-IV consultations on the euro area, multilateral consultations on global imbalances and exchange rate issues. Other, weaker forms of coordination are the “EURIMF presidency statement” (used, for example, for Article-IV consultations on EU Member States), which allows other EU chairs to issue separate statements provided that they do not contradict the common elements of the Presidency statement, and “joint statements,” co-signed only by the EU chairs wishing to do so.

In the case of the World Bank, there is no coordination mechanism in Brussels to prepare board meetings. This partly reflects the fact that, in contrast with the existence of a single monetary and exchange rate policy in the euro area, the EU does not have a unified development policy. Although there is a consensus on the basic principles for aid, and the EU-budget and European Development Fund provide substantial development assistance, most development aid is provided by Member States in bilateral manner. However, and like in the IMF, the EU representatives at the World Bank board do meet regularly in Washington to coordinate positions. Their weekly meetings, which are also attended by the Commission representatives, often result in joint positions on the board or, more rarely, Development Committee topics. In recent years, they have adopted about 70 common positions on a wide range of issues. There is also an increasing dialogue and cooperation on World Bank issues between the EU executive directors and the Commission, including the provision by the Commission of analytical input for key Board discussions and the organisation of annual visits of EU executive directors to Brussels. The importance of EU countries as donors, and in particular as contributors to the International Development Association (IDA) and the World Bank Trust Funds (see Table 9), and their large aggregate voting power at the World Bank, means that EU countries also have a strong mutual interest in coordinating positions at the World Bank.

Table 9

Contributions to World Bank Trust Funds¹ and IDA²

	Contributions (%)		
	Trust Funds	IDA	IBRD voting shares
EU 27	59.5	55.5	28.6
Low Income	0.1	0.0	8.7
Lower Middle Income	0.1	0.7	15.4
Upper Middle Income	0.3	0.8	13.0
High Income	89.9	98.5	62.9
United States	15.1	16.1	16.4

Sources: World Bank Trust Funds Annual Reports and World Bank website.

1) Average of total contributions to Trust Funds for 2004-06: US\$4,35 bn;

2) Total IDA14 pledges 2006-08: US\$17.65 bn.

4.4. A still fragmented representation

Despite the efforts made by euro area countries in recent years to speak with a more cohesive voice on international financial matters, Europe's external representation in international financial fora remains fragmented, reducing the actual influence of the euro area in them.

First, the representation of euro area/EU countries in *the Bretton Woods institutions* (the IMF and the World Bank) remains dispersed among a large number of constituencies (see Table 10 for the IMF). Moreover, some of them are mixed-constituencies that include non-euro area and even non-EU countries. This fragmented representation would require a strong coordination to be effective. However, and despite the steps in that direction described above, Europe's coordination at the IMF is insufficiently developed. Not only do the topics on which coordination takes place remain limited, but there have also been occasional problems to fully translate the common lines agreed in Brussels into the statements of EU executive directors in Washington.

All this explains why, despite the large aggregate voting share and large number of chairs EU countries have at the Bretton Woods institutions, the EU is seen as less influential in them than the US, which has however a quota about half the EU's aggregate quota. EU countries hold together 32.4% of the actual quotas of the IMF,⁹¹ and exert some influence, by way of leading mixed country constituencies, on an additional 12% of the votes. They also have 6 to 8 executive directors (of a total of 24) and 7 to 9 alternate executive directors. The situation at the World Bank is similar. Insufficient coordination means that the EU's actual voting power is well below its aggregate voting share. At the same time, however, there is a growing perception among other countries that Europe is

⁹¹ Each IMF member country is assigned an *actual quota*, denominated in SDRs, that is broadly based on its relative position in the world economy. The actual quota is based on a *calculated quota*, which is mathematically determined based on a country's GDP, trade openness, export variability and official reserves. Actual quotas may differ from calculated quotas, reflecting political considerations in the allocation of actual quotas or a failure of actual quotas to catch-up with developments in a country's relative economic position. Actual quotas determine a member's capital subscription, its voting share, and the amount of financial assistance it can obtain from the Fund. At its spring meeting of 2008, the IMF's International Monetary and Financial Committee endorsed a proposal of quota reform that modifies the definition of the quota formula but preserves the above-mentioned principles. The reform also implies a reduction in the EU's aggregate actual quota to about 31%. See IMF (2008). For the debate that preceded this quota reform, see Skala *et al.* (2007).

over-represented in these institutions, in terms of both seats and aggregate voting power.⁹²

Table 10
Constituencies in the IMF (as of 13 February 2008)

Country holding chairs	Other EU countries in the constituency	Total voting share of constituency (%)	Total voting share of EU countries (%)
Single country constituencies:			
United States		16,79	
Japan		6,02	
Germany		5,88	5,88
France		4,86	4,86
UK		4,86	4,86
China		3,66	
Saudi Arabia		3,17	
Russia		2,7	
Mixed constituencies including EU countries:			
Belgium	Austria, Czech Republic, Hungary, Luxembourg, Slovak Republic, Slovenia	5,15	2,15
The Netherlands	Bulgaria, Cyprus, Romania	4,76	0,85
Venezuela (1)	Spain	4,45	1,39
Italy	Greece, Malta, Portugal	4,11	0,75
Canada	Ireland	3,64	0,39
Sweden (2)	Denmark, Estonia, Finland, Latvia, Lithuania	3,44	1,52
Switzerland	Poland	2,79	0,63

Notes:

(¹) Chair rotates between Spain, Mexico and Venezuela

(²) Chair rotates between Denmark, Finland Sweden and Norway

Source: IMF.

Concerning the “G groups” and other key multilateral financial fora such as the FSF, only a few large euro-area/EU countries are represented, while the presence of the EU or euro area institutions in them remains inadequate. In the G-7, for example, EU institutions are partly excluded from the preparatory meetings at deputy or “deputy deputy” level and the Commission only participates in certain issues of the agenda of the ministerial meetings, being often excluded from issues in which it has Community competence and expertise (e.g., trade, financial market issues, development cooperation and global imbalances). The Commission is also excluded from the G-20 ministerial meetings and, despite its role in financial regulatory issues, from the FSF.⁹³ The partial exclusion of Community institutions from these fora prevents them in some cases from having more meaningful discussions and reaching agreements on certain issues as part of the relevant players are excluded.

The representation of the EU and the euro area at the OECD is also far from optimal. Only 19 EU countries are currently members of the OECD, with three new euro area countries (Cyprus, Malta and Slovenia) remaining outside this institution. While the EU, represented by the Commission, enjoys a special status with practically all membership

⁹² See Boyer and Truman (2005), Adams (2006), Bergsten (2006) and Truman (2006).

⁹³ At their summit of 29 January 2008 in London, the European G-7 countries reiterated the wish to see the Commission participate as observer in the FSF. However, this proposal has yet to be agreed by the other members of the G-7.

rights and obligations,⁹⁴ it does not have the right to vote. And, despite the existence of some coordination infrastructure in Brussels (mainly through the so-called ‘133 Committee,’ which however deals only with some of the issues addressed by the Paris-based organisation), coordination among the EU countries that are OECD members often leaves to be desired.

2.5 Rationale and options for consolidating external representation

EMU has strengthened the case for the euro area to speak with a single voice in international economic and financial matters for several reasons. First, the existence of a single monetary and exchange rate policy, and of coordination frameworks for other policies, makes it natural and efficient for the euro area to have a common voice in global macroeconomic surveillance fora such as the IMF and the G-7. Second, although the emergence of the euro as an international currency is expected to bring net benefits to the euro area over the medium term, it has also increased the risks for the euro area and its global responsibilities.⁹⁵ For example, by increasing the substitutability between euro-denominated and dollar-denominated assets, it increases the exposure of the euro area to disruptive international portfolio shifts. Third, EMU is making economic developments and policies increasingly relevant for world macroeconomic and financial stability,⁹⁶ further underlining the euro area’s growing global responsibilities. The trend towards globalisation, particularly in the financial field, tends to amplify these changes.

A consolidated representation of the euro area in international fora would strengthen the euro area’s negotiating power and could increase its gains from international policy coordination. The EU common external trade policy demonstrates the advantages in terms of bargaining power and influence of speaking with a single voice. A consolidated external representation of the euro area could also reduce the transaction costs associated with international co-ordination (because the number of actors involved would be reduced) and increase the interest of other key partners to coordinate with the euro area.⁹⁷ This could facilitate international policy coordination, potentially bringing benefits for the world as a whole. In this respect, it should also be noted that many of Europe’s partners increasingly regard the euro area/EU as a single entity and find it more efficient to deal with it through a single interlocutor.

Long-term trends in the world economy, and in particular the rise of emerging market economies (notably in Asia), will tend to reduce the weight and influence of the euro area in international financial institutions and fora, providing an additional case for the amalgamation of euro area representation in them as a way of maintaining influence. Thus, for example, long-term growth projections undertaken by Bertoldi *et al.* (2008) suggest that the aggregate calculated quota share of the euro area in the IMF could decline from 23% in early 2008 to 2001 by 2020 and to 12% by 2050. Bénassy-Quéré *et al.* (2007) also project a significant decline in the euro area’s quota share in the IMF the period up to 2030. Long-term projections also suggest that the G-7, and in particular its European members, will continue to lose share in the world economy, weakening its relevance as a global economic steering committee.

⁹⁴ The Community is not obliged to contribute to the OECD’s main budget, although it finances many OECD projects via voluntary contributions.

⁹⁵ See European Commission (2008), chapter III-3.

⁹⁶ See Döhring and Temprano-Arroyo (2008).

⁹⁷ For an elaboration of these points, see European Commission (1990).

These trends will not only strengthen the case for euro area consolidation but will also provide an opportunity for doing so, since they will increase the pressure for an ambitious overhaul of the international financial architecture. In fact, the move towards a more consolidated external representation of the euro area/EU should facilitate the reform of the international financial architecture by freeing space for emerging and developing countries.

The general arguments for a consolidation of euro area (or EU) representation in multilateral fora therefore seem strong. The remainder of this section looks in more detail at the case and options for European consolidation at the Bretton Woods institutions and at the G groups.

The Bretton Woods institutions

In recent years, a number of economists and policy makers have argued that the existence of a single monetary and exchange rate policy provides a strong argument for creating a single euro area/EU chair at *the IMF*.⁹⁸ For some authors (Ahearne and Eichengreen, 2007), the homogeneity of preferences on macroeconomic and monetary issues among EU countries (and not just euro area countries) is such that it may warrant even a consolidation of the representation in the IMF of all EU countries. However, the argument for a single EU chair seems weaker.

Recent research suggests that the euro area could increase its actual voting power in the IMF by consolidating representation even if its aggregate voting share declines. Thus, by applying voting power analysis Leech (2004) and Leech and Leech (2005) and Bini-Smaghi (2006b) show that the actual voting power of the EU/euro area is significantly below its aggregate voting share while that of the USA exceeds its voting share.⁹⁹ More recent analysis by the Commission staff confirms these findings, also suggesting that the euro area/EU could gain actual voting power with a partial regrouping of its constituencies.¹⁰⁰

A full consolidation of euro (or EU) constituencies would probably require amending the IMF's Articles of Agreement since they limit the size of elected constituencies to 9% of the total votes and do not foresee the joint membership of a group of countries.¹⁰¹ More importantly, the objective of having a single chair at the IMF has so far not received sufficient political support from euro area countries. In particular, some euro countries that find themselves in a privileged situation, holding the chair or the alternate executive director position of their constituencies, may fear a loss of influence from a consolidation of chairs. Some feel that, despite the existence of a common monetary and exchange rate policy, their participation in the IMF should remain in the realm of their national foreign economic policy.

Given the political obstacles to full consolidation of European representation at the IMF, intermediate steps implying the regrouping of euro area countries into a few constituencies have been proposed. This would make it easier for the euro area to speak

⁹⁸ Bini-Smaghi (2004, 2006a and 2006b), Truman (2006) and Pisani-Ferry *et al.* (2008).

⁹⁹ An actual voting power index is defined as the probability a shareholder has of being able to change the outcome of a vote by joining or withdrawing from possible coalitions with other voters. A voter's power is measured as the fraction of all swing votes that he could cast.

¹⁰⁰ See Bertoldi *et al.* (2008).

¹⁰¹ On the legal implications of adopting a single chair at the IMF, see Mahieu, *et al.* (2003).

with a single voice while already freeing some seats for emerging and developing countries.¹⁰² This incremental approach would also give euro area countries time to further develop their infrastructure for the coordination of positions at the IMF. In this vein, Truman (2006), for example, has proposed a consolidation of EU representation in three stages: in a first step, non-EU countries in EU-led constituencies would join other constituencies and EU countries in non-EU majority constituencies would join EU-led constituencies; in subsequent steps, EU constituencies could be consolidated gradually until a single EU constituency is formed. While Truman's proposal would end-up with a single EU chair, a single euro area seat may prove a more realistic long-term objective.

For as long as EU development policy remains fragmented, the case for a consolidation of *European representation in the World Bank* will seem weaker than in the IMF. While some economists find the segmentation of EU development policy hard to justify on economic grounds and have called for the pooling together of Community and Member States aid budgets,¹⁰³ it may still be a long time before this happens. As noted above, however, the important role played by EU countries and the Community budget as donors has made them interested in coordinating their positions at the World Bank, and this may pave the way for some form of consolidation in the future. Moreover, while there is no statutory link between the governance structures of the World Bank and the IMF (other than the fact that World Bank shareholders must also be members of the IMF), the World Bank has de facto tended to emulate the IMF quota structure. This may put pressure on EU countries to reconsider also their representation at the World Bank, though not necessarily by following the approach that might be chosen at the IMF.

The "G groups"

In the case of the "G groups," there have also been proposals aimed at reforming them by consolidating European representation, while allowing the entry of some systemically important emerging market economies. This partly reflects the recognition that, given the gradually declining relative collective weight of the G-7 economies, this group needs to be replaced by a more relevant global steering committee.

Three basic reform options have been put forward. One would imply collapsing the G-7 into either a G-4, comprising the United States, China, Japan and the euro area, or a G-5 including also the UK (Ahearne and Eichengreen, 2007). A second option would be to expand the existing G-7 to major emerging market economies (basically the so-called BRICS¹⁰⁴ but possibly also Mexico and Saudi Arabia). A variant, proposed by King (2005), would expand the G-7 to add emerging market economies on a rotational basis depending on the issues to be addressed, in a system of variable geometry. Finally, a third option would build on the existing G-20 but would consolidate EU participation by dropping the four individual EU members, creating instead a G-16 (Bergsten, 2006).

¹⁰² Certain partial regroupings of euro area constituencies may also require an amendment of IMF's Articles of Agreement for two reasons. First, because they may breach the 9% of total votes limit on the size of elected constituencies. And second, because the Articles of Agreement foresee that the five executive directors with the largest quotas (which currently include France, Germany and the UK) should each have a permanent ("appointed") executive director.

¹⁰³ See, for example, Coeuré and Pisani-Ferry (2007).

¹⁰⁴ The term BRICS stands for Brazil, Russia, India, China and South Africa. These countries already are normally invited to participate in the outreach sessions of G-7 Finance meetings, while Russia is a full member of the G-8 summit process including the G-8 Finance Ministers meetings.

All the reform proposals under consideration have in common that, with the emergence of new systemically important players, existing steering committees such as the G-7/8 do not adequately represent some of the countries that are crucial for addressing collective action and coordination problems such as the adjustment of global imbalances or energy issues. The absence of key players also reduces the room for horse-trading between different policy areas, thus limiting the capacity of these groups to reach meaningful agreements, and induces a loss of the legitimacy of these fora.¹⁰⁵

For some economists, the G-20 is too large and unwieldy. For others, a core group such as the G-4/G-5 would be too small to be representative. As Bergsten (2006) stresses, in reforming the “G-groups” structure, an appropriate balance should be found between legitimacy and relevance (which argues for including more countries) and efficiency of decision-making (which argues for keeping the total membership small). An ideal “G-group” should be sufficiently representative to encompass all the relevant players for the main issues to be discussed and should ensure, if possible, a good geographical and cultural balance.

The consolidation of European representation would help to form a “G group” that is both efficient and has a wide coverage of relevant players. It would entail replacing the currently fragmented and incomplete representation by individual euro area (or EU) countries by a unified representation by common euro area (or EU) institutions. So far, however, there has not been sufficient support for this type of reform among either European or other members of G-7.

4.5. Bilateral macroeconomic dialogues with strategic partners

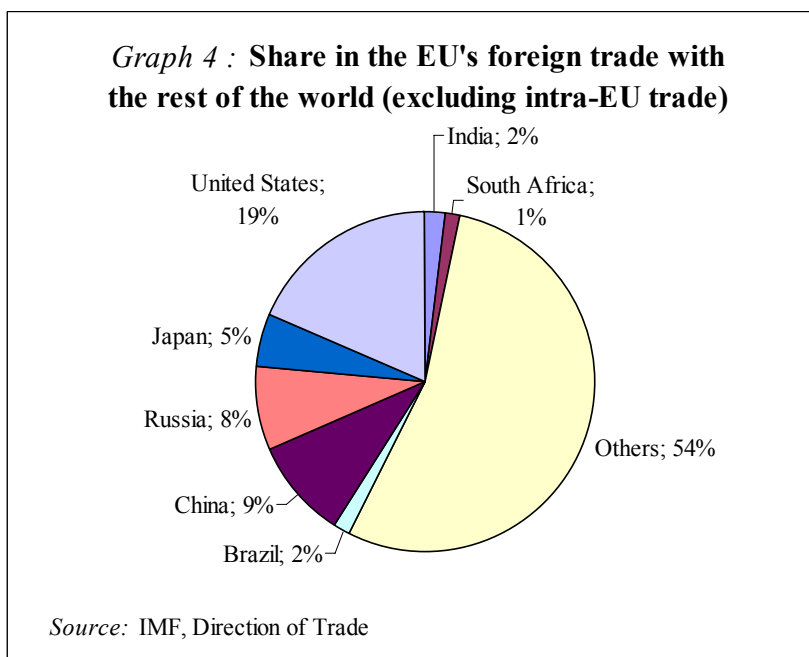
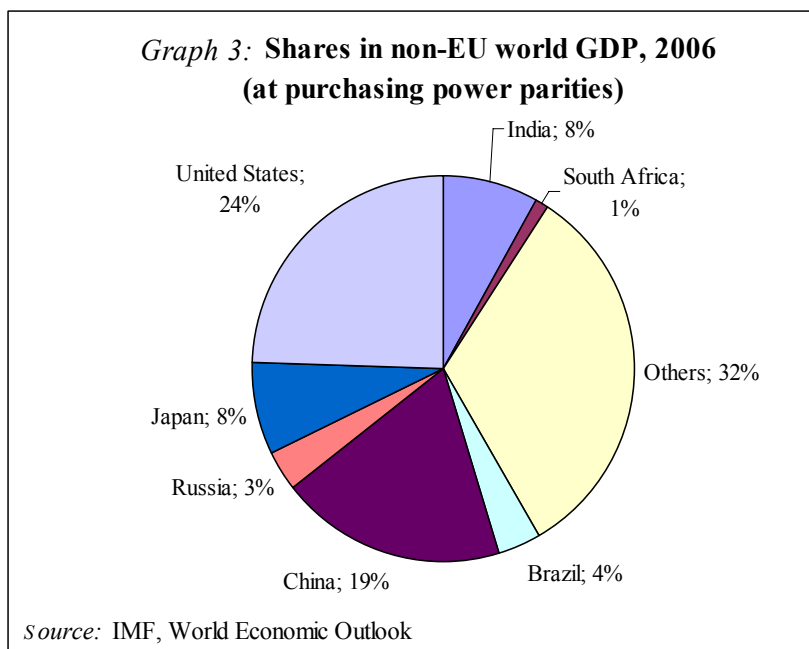
The same factors that call for improving the EU/euro area’s external representation in multilateral financial fora also argue in favour of strengthening its bilateral macroeconomic dialogues with key economic partners. Over the last 20 years, the EU has developed regular dialogues on macroeconomic and financial issues with a significant number of countries and regions, both at high level and at technical level. With the exception of the troika dialogue with China, these dialogues are held by the EU rather than the euro area.¹⁰⁶

From a global surveillance point of view, the focus of the high-level dialogues is being put on a limited number of strategic partners, namely, Brazil, China, India, Japan, Russia, South Africa, and the United States. These countries together account for nearly 70% of non-EU world GDP measured at purchasing power parities and for 46% of EU trade with third countries (see Graphs 3 and 4). With China, India, Japan, and Russia, annual dialogues on macroeconomic matters are already taking place, in most cases jointly with financial regulatory dialogues. Similar dialogues with Brazil and South Africa are being

¹⁰⁵ It has also been argued that the increasing ineffectiveness and lack of legitimacy of the G-7 as global economic steering committee has contributed to the weakening of the IMF because the G-7 has traditionally been an important engine for new initiatives taken by the IMF (Bergsten, 2006). According to this view, restoring the effectiveness of the G groups or, alternatively, creating an effective steering committee for the IMF (King, 2004; Thimann *et al.*, 2007) is therefore a prerequisite for a more effective IMF.

¹⁰⁶ The discussion below does not cover the dialogues with the countries that are formally candidates for EU membership (currently Croatia, the former Yugoslav Republic of Macedonia and Turkey) or potential candidates (Albania, Bosnia and Herzegovina, Montenegro and Serbia, including Kosovo under UN 1244), since they have a different institutional and political framework and somewhat different objectives.

considered. With the US, priority has been given to the financial regulatory cooperation, including in the context of the new Framework for Advancing Transatlantic Economic Integration,¹⁰⁷ while discussions on macroeconomic issues have not been formalised, and generally take place in the margins of the multilateral fora. With all these countries, the EU has also agreed to establish strategic partnerships, which imply an intensified cooperation and dialogue on political and economic matters, including the regular organisation of heads of State's summits and other high-level meetings.



¹⁰⁷ At the EU-US Summit of 30 April 2007, both parties agreed to engage into a closer regulatory dialogue on trade, financial markets, investment and intellectual property rights. The summit established a Transatlantic Economic Council at ministerial level to guide and oversee the implementation of the measures envisaged in the framework agreed at the summit.

These bilateral dialogues with strategic countries normally take place, on the EU side, at the level of director general/deputy minister but are in some cases upgraded to ministerial level. The ECB is invited to participate in the dialogues and is often represented by a board member. In the case of China, and as already noted, a bilateral dialogue with a euro area troika including the President of the Eurogroup, the President of the ECB and the Commissioner for Economic and Monetary Affairs, was organised in November 2007. It has also been agreed to explore ways to enhance the dialogue with China on a more permanent basis.¹⁰⁸

The EU also conducts macroeconomic and financial dialogues at high level with certain regions or country groupings. In particular, EU Finance ministers meet regularly with their Asian partners under the so-called Asia-Europe Meetings (ASEM),¹⁰⁹ with the EFTA countries¹¹⁰ and with the Mediterranean countries.¹¹¹ The macroeconomic dialogue with the Latin American countries has been limited and occasional (for example, *ad hoc* meetings with ministers of finance of the Mercosur countries).¹¹² With the Gulf Cooperation Council countries, the dialogue on macroeconomic matters has so far remained mostly of a technical and sporadic nature.

In choosing the countries or regions with which the Community wants to develop high-level bilateral macroeconomic dialogues, the following criteria have been emphasized: (i) the importance of those partners in the world economy; (ii) their political influence in international economic and financial matters, for example through their participation in multilateral institutions and fora; (iii) the importance of the EU's political, institutional and economic relations with them; and (iv) the need to maintain certain geographical balance.

The dialogues cover three main types of issues: (i) *global issues* that are salient in the discussions taking place in the multilateral financial fora (e.g., global imbalances, IMF/World Bank reform, financial globalisation, energy efficiency and security, development financing); (ii) *regional issues* of interest to both parties or in which the EU's experience is relevant (e.g., financial and monetary integration with the Asian, Mercosur and GCC partners); and (iii) key *bilateral issues*, including macroeconomic policy challenges, structural reform strategies, EIB lending, and the impact of free trade agreements between the EU and the country or region in question.

These dialogues provide a useful complement to the discussions conducted in the multilateral fora. They improve the mutual understanding of economic developments and policies and facilitate the resolution of contentious issues and the exchange of experiences. They can also help the EU/euro area agree on common lines with its key

¹⁰⁸ The US and China have also decided to strengthen their bilateral economic dialogue. In 2006, they established a six-monthly Strategic Economic Dialogue at ministerial level, which covers, in addition to macroeconomic and financial issues, other areas such as energy and the environment.

¹⁰⁹ The ASEM include representatives from the 27 EU countries, the Commission, China, India, Japan, Pakistan, South Korea, Mongolia, seven Asian countries that are members of the ASEAN (Brunei-Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam) and the ASEAN Secretariat.

¹¹⁰ Iceland, Liechtenstein, Norway and Switzerland.

¹¹¹ The meetings with Mediterranean partners, launched in 2005 under the so-called Barcelona EuroMed process, involve the following 10 Mediterranean countries: Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Palestinian Authority, Syria, Tunisia and Turkey.

¹¹² The Mercosur countries include Argentina, Brazil, Paraguay and Uruguay. Venezuela has applied for full membership.

partners on prominent policy issues discussed in the multilateral fora and, in some cases can compensate for the insufficient progress achieved at the multilateral level. For example, during 2006-07, the euro area usefully complemented its participation in the IMF-led multilateral consultations on global imbalances with bilateral discussions on the matter with some of the multilateral consultation partners. These bilateral talks on global imbalances were fully consistent with, and provided additional support to, the agreed multilateral strategy.

5. HIGH-QUALITY STATISTICS FOR EMU

The proper functioning of EMU, effective surveillance and co-ordination of economic policies and, more generally, the running of modern-day democracies requires a comprehensive information system to provide policy-makers with the data on which to base their decisions. Timely statistics are a prerequisite for an effective assessment of the economic situation and prospects. As Alexander Lamfalussy argued, “*nothing is more important for monetary policy than good statistics*” (EMI, 1996); and his case can be extended to other macroeconomic policies. Moreover, the private sector also uses these statistics, and in turn drives markets.

In 1998, the EU Member States already had a long experience in the compilation of macroeconomic statistics, but the quality of those data varied considerably. Several initiatives had been taken since the adoption of the Maastricht Treaty in 1992 to promote the co-operation among compilers of macroeconomic data, and improve statistics.¹¹³ Among the most important statistical legislation adopted or prepared in the run-up to the euro were: (i) the adoption of the European System of National and Regional Accounts (ESA95) and its transmission programme of national accounts data;¹¹⁴ (ii) a series of regulations on the compilation of harmonised indices on consumer prices (HICP);¹¹⁵ (iii) the regulation governing the reporting of government deficit and debt data for the purpose of the excessive deficit procedure;¹¹⁶ (iv) the regulation on short-term economic statistics,¹¹⁷ and (v) a regulation on the organisation of a labour force sample survey in the EU.¹¹⁸

However, in the inaugural meeting of the Eurogroup (known at the time as the Euro-11 group) on 4 June 1998, Ministers drew attention to important gaps in the available euro-area statistics that needed to be addressed urgently. In response, the EU’s Monetary Committee prepared a report on statistical requirement in stage three of EMU, which was

¹¹³ On earlier experiences of co-operation on macroeconomic statistics in the run-up to the monetary union, see van Wijk (2001) and Bull (2004).

¹¹⁴ ESA95 was adopted by Council Regulation (EC) N° 2223/96 (OJ L 310, 30.11.1996, p.1). ESA95 replaced the ESA, second edition of 1979. ESA95 was amended, complemented and clarified on several occasions, and its transmission programme was also strengthened since 1996.

¹¹⁵ See notably Council Regulation (EC) N° 2494/95 (OJ L 257, 27.10.1995, p. 1), which was then followed by a series of implementing acts.

¹¹⁶ Council Regulation (EC) N°3605/93 (OJ L 332, 31.12.1993, p. 7).

¹¹⁷ Council Regulation (EC) N° 1165/98 (OJ L 162, 5.6.1998, p.1).

¹¹⁸ Council Regulation (EC) N° 577/98 (OJ L 77, 14.3.1998, p. 3).

There were also several initiatives by the ECB and its predecessor the European Monetary Institute (such as guidelines and compilation guides) on money and banking statistics, which are not further discussed in this section (see Bull, 2004).

endorsed by the ECOFIN Council in January 1999. The report identified five priority areas: (i) quarterly national accounts; (ii) statistics on public finances; (iii) labour market statistics; (iv) short-term business statistics and (v) balance of payments and trade.

An Action plan on EMU Statistics was endorsed by the ECOFIN Council in September 2000. The Action Plan identified the statistical areas and the Member State where urgent progress had to be made. Focus concentrated on the above mentioned statistics and actions were subsequently directed towards improving timeliness and coverage and to improve or set up the necessary legal framework.

The Action Plan boosted the development of short-term economic statistics in the euro area but quickly faced the limit represented by the late availability of statistics for some Member States. The Action Plan, although very substantial, was not enough to match the US and best practices worldwide. A list of more focussed infra-annual macro-economic indicators, the so-called Principal European Economic Indicators (or PEEIs), has therefore been set up in 2003.¹¹⁹ PEEIs had more challenging target release dates for the euro area indicators, different quality objectives and milestones. The accent shifted from efforts for Member States to efforts towards the release of European aggregates. The PEEI approach innovated the way of deriving European short-term indicators, asking for strong and efficient co-ordination of statistical information and compilation practices at European level.

In a process driven by the main institutional users, the Commission and the ECB, and starting from a benchmarking exercise with the US (Öberg, 2001), the PEEIs project characterised the most recent years of short-term economic statistics in the euro area. Table 11 lists the principal European economic indicators and indicates the timeliness of each variable in 1998, 2001 and 2007, as well as the targets established by the European Commission.¹²⁰

5.1. Developments in timeliness, availability and coverage of key statistics

5.1.1. HICP

The harmonized index of consumer prices (HICP) is one of the most important and mediatic macroeconomic statistics for the euro area: it has a decisive impact on monetary policy geared toward price stability. It is also a convergence criterion on the basis of which new members of the monetary union are chosen. Over the last few years, the HICP confirmed its accuracy as an inflation measure and its role as a reference indicator for measuring price developments (Eurostat, 2004).

Several actions to improve timeliness (see Graph 5), coverage and availability of inflation measures have been undertaken. Improved timeliness of HICP published by national statistical institutes and Eurostat and improved coverage of the euro-area flash estimates – now encompassing above 95% of euro area total consumption expenditure – successfully supported the inflation measurement strategy set up at the EU level. This strategy, aimed at strengthening comparability and accuracy, relies on the continuous co-

¹¹⁹ Joint Report of the Council and the Commission on Eurozone statistics and indicators, 18 February 2003.

¹²⁰ Communication to the European Parliament and the Council: ‘Towards Improved Methodologies for Eurozone Statistics and Indicators’, COM (2002) 661.

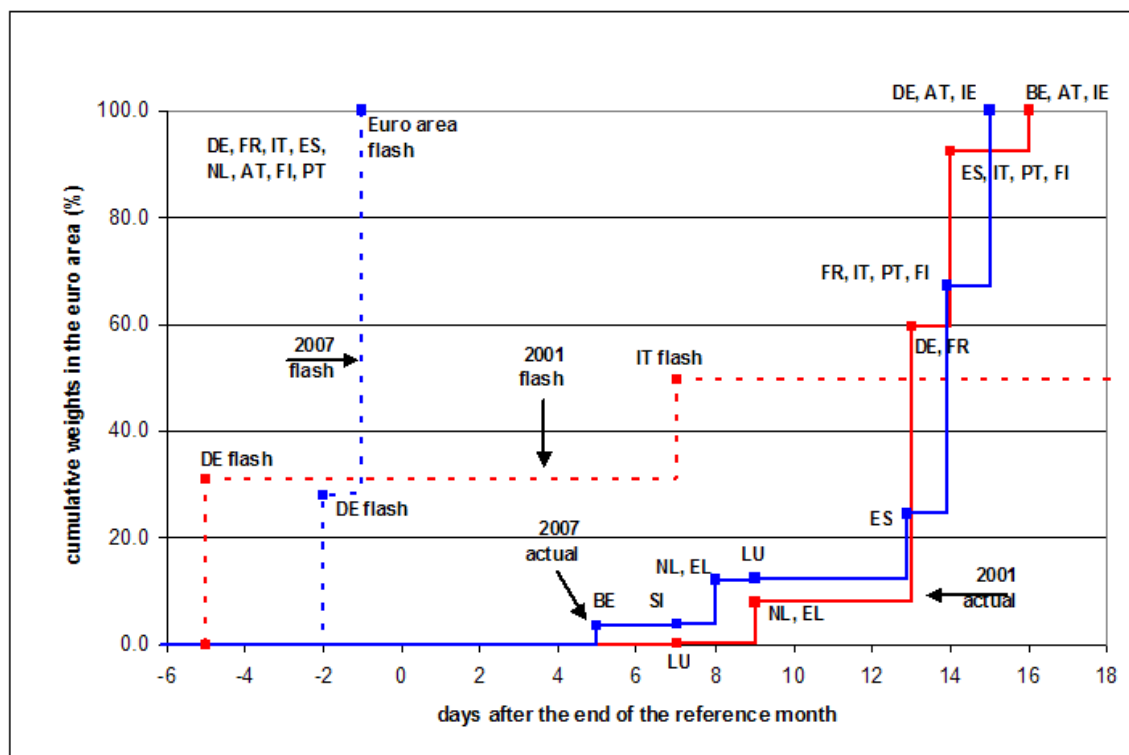
operation between Eurostat and national statistical institutes to speed up methodological developments, including quality adjustments, consumer expenditure on owner-occupied housing; as well as to promote transparency, comparability and credibility of price statistics. Currently, the compilation of the HICP in the euro area consists in observing around 1.7 million prices in more than 180 thousand shops of nearly one thousand towns and cities; those prices concern around 700 representative goods and services (ECB, 2007b).

Table 11

Timeliness of economic indicators	Euro area timeliness (days)			Target in Commission (2002b)
	2007	2001	1998	
Set 1: Consumer Price Indicators				
1.1. Harmonised Consumer Price Index: flash estimate	0 (~96.5% EA)	2	-	0
1.2. Harmonised Consumer Price Index: actual indices	14 (100%)	17	30	17
Set 2: Quarterly National Accounts				
	45*			
2.1. Quarterly National Accounts: First GDP estimate	(~95% EA, ~87% EU)	-	-	45
	61			
2.2. Quarterly National Accounts: GDP release with more breakdowns	(~97% EA, ~94% EU)	70-120	70	60
	121			
2.3. Quarterly National Accounts: Household and Company Accounts	(90% EA, 88%EU)	-	-	90
	99 (120 EU)			
2.4. Quarterly National Accounts: Government Finance Statistics	(100%)	-	-	90
Set 3: Short-term business Indicators				
3.1 Industrial production index	42 (~93%)	48	-	40
3.2 Industrial output price index for domestic markets	33 (~96%)	35	-	35
	53			
3.3 Industrial new orders index	(~97%)	-	-	50 (40)
	[44]			
3.4 Industrial import price index	48	-	-	45
	(~95%)			
3.5 Production in construction	30	75	-	45
	(~99%)			
3.6 Turnover index for retail trade and repair	60	60	-	28
	(~87%)			
3.7 Turnover index for other services	-	-	-	60
3.8 Corporate output price index for services	-	-	-	60
Set 4: Labour Market Indicators				
	32			
4.1 Unemployment rate (monthly)	(~81% EA, 78% EU)	34	-	30
	75			
4.2 Job vacancy rate (quarterly)	(67% EA, 78% EU)	-	-	45
	73			
4.3 Employment (quarterly)	(~85% EA, ~75% EU)	-	-	45
	75			
4.4 Labour cost index (quarterly)	(78% EA, 82% EU)	90	-	70
Set 5: External Trade Indicators				
5.1 External trade balance: intra- and extra-MU; intra- and extra-EU	48	51	-	46

Source: European Commission.

Graph 5:
Release of flash estimates and actual indices of HICP (2001 and 2007)



Source: Eurostat.

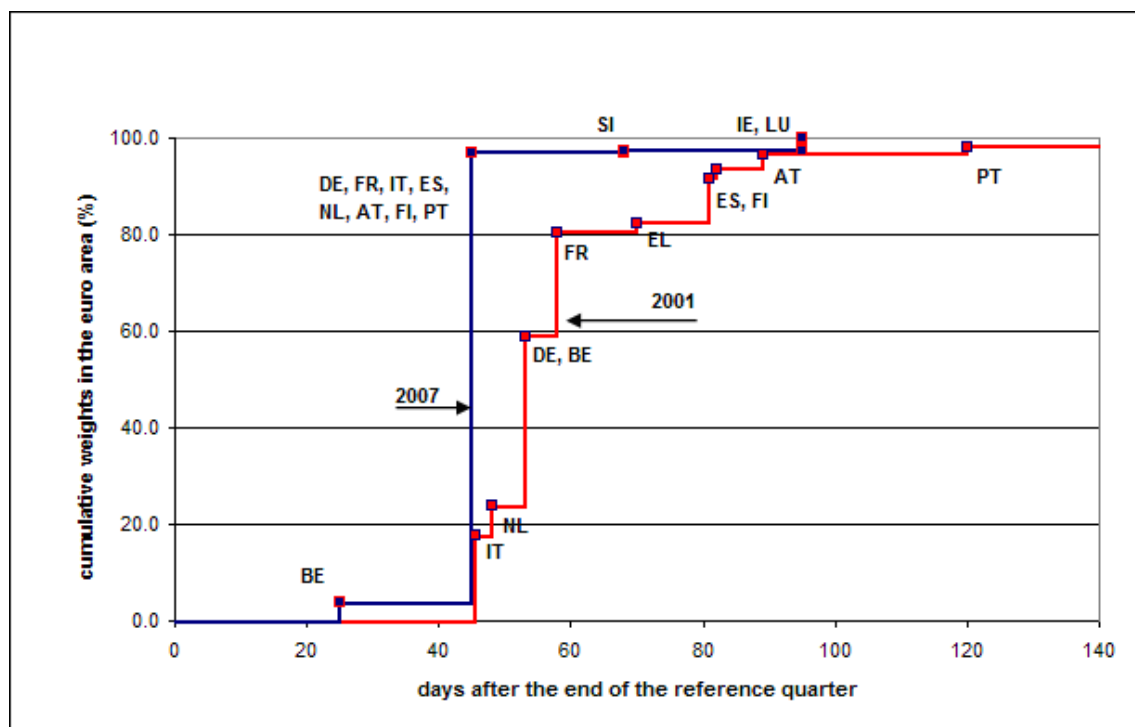
However, since the changeover to the euro-denominated banknotes and coins, perceived inflation, as derived from surveys, has shown persistent deviations from officially measured HICP in several Member States.¹²¹ These differences may jeopardise confidence and trust of European citizens in the euro as a whole and in the quality of the HICP in particular, which has potentially widespread consequences. For this reason, the challenge for the coming years in this area is an active and coordinated communication on different concepts of inflation and on their measurement to raise awareness among European citizens of factual developments and, ultimately, to mitigate the gap between perceived and measured inflation.

5.1.2. Quarterly national accounts

Quarterly national accounts represent one of the main sources for monitoring the main macroeconomic developments. Moreover, the accounting framework that underlies the production of national accounts helps to ensure coherence among a number of derived indicators, such as the real and nominal GDP growth rates, saving and investment ratios and external trade indicators (Eurostat, 1999). Ambitious targets in terms of timeliness were fixed firstly in the EMU statistics action plan and then as part of the PEEIs.

¹²¹ On the discrepancy between inflation measured and perceived, see Döhring and Mordonu (2007).

Graph 6:
Release of the first estimate of real GDP growth (2001 and 2007)



Source: Eurostat.

Major progress has been achieved in this field. This includes: (i) the regular release of the flash estimates of the euro area GDP at t+45 days after the end of the quarter, together with a co-ordination of the release calendar among the euro area Member States; (ii) progressively moving the release of the main components of GDP (according to output and expenditure) to t+62 days, as currently available;¹²² (iii) the progressive extension of the coverage of the main aggregates; and (iv) the first release in June 2007 of the quarterly euro area sector financial and non-financial accounts. Graph 6 illustrates the improvement in the timeliness of the publication of the first estimate of real GDP growth rates in the euro area countries. Moreover, the improvement in timeliness has not led to a reduction in reliability; the first outcome for quarterly accounts for the euro area statistics have generally shown a very small or no bias and subsequent revisions have been very modest and comparable with those of the US and Japan (Branchi *et al.*, 2007).

Underpinning those developments, a legal and methodological framework has been set up in recent years to support and harmonise the compilation of quarterly accounts. This included changes in the ESA95 regulation, including a revised transmission programme; common rules and guidelines for seasonal adjustment; methodological progress such as the measurement of financial intermediation services indirectly measured (FISIM), the introduction of chain-linked volume measures both for annual and quarterly data; as well as coordinated releases including the publication of GDP flash estimates.

The first publication of European quarterly sector accounts in June 2007 was a major milestone for the European statistical system. Economic actors now have comprehensive

¹²² In early 1999, the regular first releases of the euro area GDP took place after 75 days, with a coverage of 77% of the area.

information on the transactions of households, non-financial corporations, financial corporations and the government, but also on the interactions between these sectors and the rest of the world. This will allow them to better understand and to follow more closely the behaviour of economic agents. The euro area sectoral accounts comprise financial and non-financial data, thereby allowing an integrated analysis of non-financial transactions (such as investment) and the related financial transactions (such as the issuance of debt). The euro area accounts also include consistent financial balance sheets, thus allowing quarterly changes in the financial wealth of each euro area sector to be better integrated into business cycle analysis.

Yet, in spite of these achievements, challenges have still to be faced in terms of extending the coverage, ensuring reliability, further improving timeliness and communication, promoting best practices, and enhancing the coordination of national accounts with other short-term statistics, including common release and revision policies.

5.1.3. *Public finance statistics*

When considering developments in relation to public finance statistics over the last decade, it is useful to distinguish annual from quarterly data. The distinction makes sense since annual public finance statistics – in particular the annual government deficit and debt – constitute the foundation of the SGP. Quarterly public finance statistics are of utmost importance for a timely assessment of macroeconomic and fiscal developments in each Member State and in the euro area as a whole, yet they are not relevant for the formal implementation of the Pact. However, discussing developments in annual and quarterly public finance statistics as two different topics is somewhat artificial. The two sets of data refer to the same phenomena, they are consistent with each other, and progress in quarterly statistics has beneficial consequences for the quality of annual statistics and vice-versa.¹²³

Annual public finance statistics have a specific importance in EMU. They are the numerical foundation of the SGP and they constitute one of the convergence criteria which contribute to the decision on Member States joining the monetary union – experience has shown that they are among the most decisive criteria. Moreover, there is a need to closely monitor developments and planned changes in government finance, given the impact that demographic changes will have on government accounts in future.¹²⁴

At the moment the monetary union was created, all EU Member States published timely statistics for the annual government deficit and debt. In contrast with other macroeconomic statistics, the main challenges have not been the availability or timeliness of government finance statistics,¹²⁵ but their reliability and potential manipulation for political purposes. When the ECOFIN Council concluded on 2 June 2004 that the compilation of fiscal statistics “*must not be vulnerable to political and*

¹²³ European Commission (2003, in particular II.4; and 2007b, in particular II.2.4) and ECB (2004).

¹²⁴ European Commission (2006a). Statistics on pension entitlements are currently being prepared, see European Commission (2007b, in particular II.2.3)

¹²⁵ All Member States used to report to the Commission their government deficit and debt data twice a year (March and September) since 1994. However, until 2000, when ESA95 became the relevant accounting standard, there was no regular and mandatory transmission of detailed revenue and expenditure accounts. Since 2006, the transmission of government deficit, debt, revenue and expenditure takes place in April (with data being revised in October).

electoral cycles,” it was not simply making an abstract statement, but reacting to concrete episodes in a few Member States.

The concerns in relation to annual public finance statistics can be divided in three categories. First, for a number of Member States, the government deficit and debt numbers have been subject to large revisions. Either because of lack of resources or expertise or because of data manipulation for political purposes, those revisions were detrimental for the credibility of the SGP and of European statistics in general. Second, the implementation of the SGP might have given incentives for Member States to implement one-off transactions, to organise expenditure in such a way that it is not recorded as deficit-increasing, or more generally to enter into what some authors have summarised as fiscal gimmicks or creative accounting.¹²⁶ A third issue was on the accuracy and bias of official forecasts of government deficit;¹²⁷ although the latter is a quite relevant issue, one should note that there is a crucial distinction between actual data – i.e. statistics for a past period, which are compiled by statisticians – and projections, notably those published by national governments with some normative content.

The reply to those preoccupations took place in two fronts: statistical and analytical. The authority of Eurostat in scrutinising and validating the government accounts published by the national statistical authorities was clarified and strengthened; a number of initiatives were taken to improve the transparency of government accounts.¹²⁸ The change in the institutional framework on the reporting of fiscal data and their validation by Eurostat should be understood as an integral part of the reform of the SGP of 2005. The increased scrutiny of data compiled by national authorities seems to have already led to an upgrade in their quality over the last years,¹²⁹ though practice shows that a definitive assessment on the quality of statistics is not possible before several years have elapsed. This tighter scrutiny has not only led to identify errors earlier, but might have increased the political costs and reduced the incentives for policy makers to enter into a number of fiscal gimmicks.

From the analytical side, the reformed Pact contains provisions establishing that one-off measures should be netted out when assessing the Member States’ fiscal efforts. This has reduced incentives for Member States to organise large one-off deficit decreasing in specific moments of the implementation of the Pact.¹³⁰ Moreover, the plausibility of forecasts provided by Member States in their medium-term budgetary plans acquired a more central role in the assessment of stability and convergence programmes carried out by the Commission.

Quarterly government accounts. This was an area where the EU statisticians had less experience by 1998. Only one country – the United Kingdom – used to routinely publish

¹²⁶ On the political incentives in relation to government finance statistics, see Milesi-Ferretti (2003), Koen and van den Noord (2006), von Hagen and Wolff (2006), and Buti *et al.* (2007). On the revisions of government finance statistics, see Balassone *et al.* (2006 and 2007). and Gordo and Nogueira Martins (2007).

¹²⁷ See for example, Jonung and Larch (2006), Brück and Stephan (2006) and Pina and Venes (2007).

¹²⁸ These initiatives started in 2002, when the Commission (2002c) proposed and the Council adopted a code of best practice on the compilation and reporting of data in the context of the excessive deficit procedure. Much of the initiatives contained in that code then acquired force of law with the adoption of Council Regulation (EC) N° 2103/2005 (OJ L 337, 22.12..2005, p. 1).

¹²⁹ Eurostat (2007a).

¹³⁰ Kiss (2007).

quarterly statistics according to ESA.¹³¹ Other countries published quarterly or even monthly public finance indicators based on domestic definitions that were neither harmonised nor comparable. Most domestic definitions of infra-annual public finance indicators used to be narrow in terms of sector, covering only central government, rather than general government, and with methodological basis that differ from ESA: often cash-based and not properly distinguishing financial from non-financial transactions.¹³² Moreover, there was a clear perception that the lead times to compile and publish these figures would be long.

The compilation of public finance statistics has evolved slowly on a step-by-step basis. Member States started by compiling quarterly data on taxes, social contributions and a very small fraction of expenditure in mid 2000.¹³³ All Member States are now compiling and publishing these data on a routine basis. The compilation of a complete expenditure and revenue account, thus leading to a quarterly deficit, started in mid 2003.¹³⁴ Data are now available for most Member States in a timely manner. However, a few Member States, notably Germany and France, compile their data and transmit them to Eurostat under embargo. As a result, while these data are used by Eurostat to produce euro area and EU aggregates, they cannot be used in the assessment of infra annual developments in the two larger economies of the EU.¹³⁵ The compilation of government debt with a quarterly frequency started at the end of 2004.¹³⁶ Quarterly fiscal data are now regularly published for all Member States. Finally, the production of quarterly government financial accounts and quarterly financial balance sheets started in mid 2004.¹³⁷ Data initially available did not cover the whole government sector, and although coverage has expanded, several Member States are not yet publishing complete quarterly financial accounts and balance sheets.

Infra-annual data on government finance can give early signals on fiscal policy developments, thus allowing analysts to better understand the underlying developments, and policy makers to better calibrate the implementation of their budgets. However, quarterly public finance data are intrinsically more volatile than annual data and subject to larger revisions. Therefore, their compilation and use for economic analysis remains a challenge.¹³⁸

5.1.4. Labour market statistics

Cross-country comparisons of the labour market and of labour cost required a major effort in the European Statistical System to ensure the availability of measures for productivity and competitiveness analysis, as well as the possibility to catch specific phenomena like shifts in the composition of the labour force, in the industrial structure, shifts towards overtime and part-time and the impact of labour policies.

¹³¹ Note, however, that the UK used to publish quarterly statistics for the public sector, and not for general government.

¹³² However, it is possible to extract useful information from those non-harmonised monthly figures. See, for example, Pérez (2007).

¹³³ Commission Regulation (EC) N° 264/2000 (OJ L 29, 4.2.2000, p. 4).

¹³⁴ Regulation (EC) N° 1221/2002 of the European Parliament and of the Council (OJ L 179, 9.7.2002, p.1).

¹³⁵ See European Commission (2007b, notably section II.2.4).

¹³⁶ Council Regulation (EC) No 1222/2004 (OJ L 233, 2.7.2004, p. 1).

¹³⁷ Regulation (EC) No 501/2004 of the European Parliament and of the Council (OJ L 81, 19.3.2004, p. 1).

¹³⁸ On the quality of quarterly public finance statistics, see Eurostat (2006 and 2007b).

The answer by European statisticians to these requirements was a step-by-step approach: the necessary infrastructure, including legislation, has been prepared and implemented so to assure the availability of a continuous quarterly labour force survey,¹³⁹ to strengthen the compilation of the labour cost index,¹⁴⁰ to improve quality and timeliness of unemployment and employment data and to reinforce the links between labour market statistics and national accounts. In parallel, the basis for the methodology of compilation underwent a review aimed to harmonise and reinforce key concepts underlying the compilation of these statistics, for example, the definition of hours worked and the harmonisation of the labour cost index. Finally, users' needs translated into initiatives undertaken to set up new indicators, like the quarterly job vacancy rate.

Nevertheless, labour market statistics are still lagging beyond other areas and further efforts are still required to meet the PEEI targets, notably: the release at t+45 days after the reference quarter for employment; the adoption and implementation of the regulation on job vacancy statistics; enhancing the availability and coverage of annual and infra-annual national accounts employment statistics. These targets become even more urgent in the context of monitoring and drive forward the Lisbon Strategy.

The research project EU KLEMS¹⁴¹ is an attempt to cover these needs focusing on the analysis of productivity and growth accounting in the EU at the industry level. Its aim is to provide measures of economic growth, productivity change, employment creation by skill level, capital formation by type of capital good and technological change for all EU Member States, for European aggregates (e.g. euro area) as well as for the United States, Japan and Canada. The integration of the EU KLEMS research project on the work of statistical offices is one of the challenges for the future.

5.1.5. *Short-term business statistics*

Short-term business indicators are essential for assessing developments in the economy, notably its position in the cycle. Progress in the last decade was remarkable for short-term statistics in the euro area: the above-mentioned regulation on short-term statistics and its amendment¹⁴², which reflected the action plan requirements, improved both timeliness and coverage of the indicators. Notably, the index of production for construction became monthly since 2007, the timeliness of the release of the industrial production index has considerably improved, approaching the t+40 target, and several services indicators are now available (such as the turnover index for other services) or will be released soon (e.g. service producer prices).

Besides coverage and timeliness, actions have been taken in recent years to compile a set of short-term business indicators suited for users' needs and matching quality requirements. Harmonisation of concepts, of methodology (e.g. seasonal adjustment), and sharing best practices contributed to the overall improvement in this area.

¹³⁹ Regulation (EC) No 1991/2002 of the European Parliament and of the Council (OJ L 308, 9.11.2002, p. 1).

¹⁴⁰ Regulation (EC) No 450/2003 of the European Parliament and Council (OJ L 69, 13.3.2003).

¹⁴¹ EU KLEMS stands for EU level analysis of capital (K), labour (L), energy (E), materials (M) and service (S) inputs. See Koszerek *et al.* (2007).

¹⁴² Regulation (EC) No 1158/2005 of the European Parliament and Council (OJ L 191, 22.7.2005).

A major challenge for the coming years is the coordination and the integration of the changeover to the new industry classification.¹⁴³ The implementation of this major methodological revision in short-term statistics requires that utmost attention be given to a well coordinated approach as regards timing, coverage and back-casting of sufficient length. In addition, coordination should be ensured with other domains that rely on short-term business statistics, like quarterly national accounts.

5.1.6. Balance of payments and external trade statistics

The creation of the EU single market and the associated measures of administrative simplification of trade declarations taken at the beginning of the nineties led to a significant deterioration in the availability of basic data for trade and balance of payments statistics, notably for intra-EU trade. Statistics for international transactions became increasingly difficult to produce with regard to coverage and regional allocations. Furthermore, the increasing complexity of financial market activity as well as globalisation added further concerns to the collection of sound external trade and balance of payments statistics.¹⁴⁴ At the same time, the more globalisation progresses, the more interest there is in balance of payments and related statistics (Viñals, 2004).

The close cooperation between the European Statistical System and the ECB in recent years contributed to manage the above mentioned changes. The new regulations on balance of payments, international trade in services and foreign direct investment¹⁴⁵ and on foreign affiliates trade (FATS),¹⁴⁶ together with the improvement of timeliness of external trade statistics, new legislation on Extrastat (i.e. statistics on trade in goods of EU Member States with non-EU Member States) and a systematic analysis of discrepancies among trade statistics between countries are steps to improve the quality of those data. However, the increase in the reporting threshold for payments within the EU and the need to simplify Intrastat (i.e. statistics on intra-EU exports and imports) so as to reduce the administrative burden on enterprises raise other challenges for the coming years and will require alternative approaches in the compilation of data.

5.2. Governance issues

In order to fulfil their role, official statistics must be produced and disseminated according to common standards guaranteeing compliance with the principles of impartiality, reliability, objectivity, scientific independence, cost-effectiveness and statistical confidentiality. At the same time, in the last decade, the role of European statistics become increasingly important in the context of the EMU, the Lisbon Strategy, the integrated guidelines for growth and jobs, to monitor and review the implementation of other key policy initiatives at European level such as the sustainable development strategy, or even the common immigration and asylum policy, etc. Statistics of good quality, but also the framework to produce them, are therefore a necessity for the EU.

¹⁴³ The so called NACE rev. 2.

¹⁴⁴ For an overview on the European experience in the compilation of balance of payments, see Israel and Sánchez Muñoz (2007). See also Damia and Picón Aguilar (2006) for an analysis of their quality.

¹⁴⁵ Regulation (EC) N° 184/2005 of the European Parliament and the Council (OJ L 35, 8.2.2005, p. 23).

¹⁴⁶ Regulation (EC) No 716/2007 of the European Parliament and of the Council (OJ L 171, 29.6.2007, p. 17).

Reflecting these concerns the national statistical institutes and Eurostat put forward a European Statistics Code of Practice.¹⁴⁷ The Code has the dual purpose of improving trust and confidence in statistical authorities by proposing certain institutional and organisational arrangements, and reinforcing the quality of the statistics by promoting the application of best international statistical principles, methods and practices. The Code consists of 15 principles that mirror to a large extent the United Nations' Fundamental Principles of Official Statistics. The principles are organised in three groups on institutional environment, statistical processes and outputs. The monitoring of the Code implementation includes self assessments and regular peer reviews. Moreover, in 2008, the European Parliament and the Council established a European Statistical Governance Advisory Board,¹⁴⁸ with the mission of providing an independent overview of the European Statistical System regarding the implementation of the Code. The board will also be complemented by a European Statistical Advisory Committee,¹⁴⁹ which will gather users of statistics, such as the scientific community, social partners and the civil society, and institutional users. It will play an important role in ensuring that user requirements as well as the response burden on information providers and producers are taken into account in developing the European statistical policy (Bohatá, 2007).

¹⁴⁷ The European Statistics Code of Practice was adopted by the Statistical Programme Committee on 27 February 2005 and promulgated in the Commission Recommendation of 25 May 2005 on the independence, integrity and accountability of the national and Community statistical authorities (COM (2005) 217).

¹⁴⁸ Decision No 235/2008/EC of the European Parliament and of the Council (OJ L 73 15.3.2008, p. 17).

¹⁴⁹ Decision No 234/2008/EC of the European Parliament and of the Council. (OJ L 73 15.3.2008, p. 13).

6. CONCLUDING REMARKS

The governance structure in EMU builds on a strong tradition of subsidiarity, which leaves policy responsibilities to the Member States wherever this is feasible. It has clearly contributed to promoting a common understanding among euro-area policy makers on the importance of sound public finances and flexible product, labour and capital markets for the smooth functioning of EMU. Even so, EMU governance has also suffered from a deficit of political and national ownership, which has resulted in a reluctance of some Member States to translate this common understanding of policy challenges into policy making at home. Based on this experience decisive steps to improve the situation were taken in 2005, with a reform of the SGP, the revamping of the Lisbon Strategy for Growth and Jobs, the appointment of the President of the Eurogroup for a term of two years and the adoption of an European Statistics Code of Practice.

The dissuasive effect of the fiscal governance set-up embodied in the SGP initially turned out not to be as effective as foreseen. Deviations of the fiscal position from the agreed adjustment paths were sizeable and attempts to comply with the 3%-of-GDP reference value for budget deficits in some cases led to a preoccupation with cosmetic improvements. In March 2005, a reform of the SGP was adopted by the ECOFIN Council. Concerning the preventive arm of the Pact; it introduced the possibility of adopting medium term budgetary objectives that are better tailored to country-specific considerations along with some flexibility in the pace of achieving this objective in light of a country's structural reform efforts (notably pension reform). Concerning the corrective or dissuasive arm, the economic circumstances that could lead to a waiver of the excessive deficit procedure were reinterpreted and clarified. The implementation of the corrective arm now runs much smoother, although further progress looks desirable concerning the preventive arm.

Structural reform has remained largely in the remit of the Member States, but the need for enhanced reforms in the euro area has been widely accepted from the outset. Article 99 of the Treaty requires Member States to “*regard their economic policies as a matter of common concern and shall coordinate them within the Council.*” This has led to references to the euro-area dimension in the broad economic policy guidelines (BEPGs) to which the Treaty has assigned a central role in the coordination of economic policies. This coordination has remained subject to the open method of coordination under the Lisbon Strategy for Growth and Jobs which is oriented towards learning effects, benchmarking and peer pressure. A critical report by a high-level experts group led by the Dutch former Prime Minister Wim Kok in 2004 was followed up by a re-launch of the Lisbon Strategy in 2005, including tighter priority setting and improved governance of the process through a clearer division of responsibilities at the EU and national levels. Importantly, the adoption of specific recommendations addressed to the euro-area Member States now help to internalise euro-area priorities – notably the need for flexible and effective adjustment of prices and wages in the absence of internal exchange rates – into Member States’ structural reform priorities.

In the external area of EMU governance, progress has been significant but there is still much room for improvement. The Treaty defined carefully the arrangements for the conduct of exchange rate policy, including the procedures for the conclusion of formal exchange rate agreements with third countries, and the practical conduct of exchange rate policy has not encountered major problems. This and other areas of external EMU policy, however, continue to suffer from the complexity of the euro area’s representation

in multilateral fora, which makes it harder for it to speak with a single voice on global matters. Although important steps have been taken since EMU was launched to strengthen the coordination of euro area positions and the role of common euro area or EU institutions in such fora, the external representation of the euro area remains fragmented. This prevents the euro area from playing an international role commensurate with its global economic and financial weight.

At the same time, the emergence of new key players in the world economy has increased the need to reform the governance of the international financial architecture and the pressure on the euro area to consolidate its external representation. Both things could go hand in hand. European consolidation could help multilateral institutions enhance the voice of emerging and developing countries, thus contributing to restore their legitimacy and relevance. At the same time, it would allow the euro area to gain influence in these institutions by being able to speak with a single voice. There is also scope for using the bilateral macroeconomic dialogues with strategic countries more effectively to convey a common European voice to the world.

Finally, the proper functioning of EMU requires a comprehensive information system to provide the statistical data on which to base surveillance, coordination and policy decisions. An action plan on EMU Statistics was endorsed by the ECOFIN Council in September 2000 which identified the statistical areas where progress was urgent. This boosted the development of high-frequency statistics, but the result still does not match the US or best practices worldwide. This concern led to the European Statistics Code of Practice in 2005, mirroring the United Nations' Fundamental Principles of Official Statistics. From it emerged also a new statistical governance structure involving the relevant European institutions along with the scientific community, social partners and the institutional users of statistics.

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