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It ain`t broken but it has to be fixed

- Maria Lorca

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***European Union Miami Analysis* (EUMA)** is a by-weekly service of analytical essays on current, trend setting issues and developing news about the European Union.

These short papers (between 2,000 and 2,500 words in length) will be produced by the Miami-Florida European Union Center of Excellence (a partnership of the University of Miami and Florida International University) as an outreach service for the academic, business and diplomatic communities.

Among the topics to be included in the series, the following are suggested:

- The collapse of the Constitution and its rescue
- The British presidency of the EU
- Turkey: prospects of membership
- Impact of the German elections on the EU
- The budget impasse
- Immigration crisis and cultural challenges
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- The Common Agricultural Policy and other public subsidies
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These topics form part of the pressing agenda of the EU and represent the multifaceted and complex nature of the European integration process. These short papers also seek to highlight the internal and external dynamics which influence the workings of the EU and its relationship with the rest the world.

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Introduction

The Stability and Growth Pact (SGP) adopted by the European Council in its June 1997 Amsterdam meeting is an agreement by European Union member states related to their conduct of fiscal policy to facilitate and maintain economic and monetary union. It basically consists of enforcement policies of mutual surveillance of fiscal positions and of an excessive deficit[1]. By 1990s the convergence was real and the achievement on the part of the member states of the so-called Maastricht Convergence Criteria[2]**,** art. 121.1 of the EC Treaty, was a requirement for all those member states adopting the euro; that is, the so-called stage 3. However, the German Finance Minister Theo Waigel was concerned that some EU States might make a one time effort to meet the convergence criteria to qualify for the euro after which they will revert to high levels of borrowing and endanger the stability of the new currency; based on this believe the ¨stability and growth pact¨ was created.[3]

The Stability and Growth Pact is nowadays one of the most important policies for the Directorate General for Economic and Financial Affairs**,** with Commissioner Joaquín Almunia[4], since the Directorate states that "(t)he Stability and Growth Pact (SGP) is the answer to concerns on the continuation of budgetary discipline in Economic and Monetary Union (EMU)"[5]. The Treaty thoroughly explains that the SGP has several well developed elements that ought to be respected or penalties will be imposed upon those EU countries not complying with theses requirements[6]:

- EU countries have to commit themselves to "medium-term" budgets that are "close to balance or in surplus". EU countries have to submit annual programs specifying medium term budgetary objectives; so, there will be a track record for the Council and/or the public to examine a country's compliance with the terms in the Pact. Countries in the Euro-zone that run "excessive deficits" will be subject to financial penalties.

- Deficits are "excessive" if they exceed 3% of GDP, unless they occur under "exceptional" circumstances.

- Public debt must be lower than 60% of GDP or approaching this value

- And Consumer Price Index measuring the inflation rate must not exceed 2%.

[1]Matthew B. Canzoneri and Behzad T. Diba. The Stability and Growth Pact Revisited: A Delicate Balance or an Albatross? http://www.georgetown.edu/faculty/canzonem/Stability_Pact.PDF

[2]Zalcova, Zuzana. European Monetarian Union. http://www.csis.org/eaac/EMU_overview.pdf#search='maastricht%20convergence%20criteria'

[3] Van Oudenaren, John. Uniting Europe: European Integration and the Post-Cold War World. Lanham and Oxford: Rowman and Littelfiled Publ., Inc., 1999

[4] Europa, Getaway to the European Union. Economic and Financial Affairs DG. *Directory Chart*, 7 October 2005. http://europa.eu.int/comm/dgs/economy_finance/organisation/ecfin_org_chart_en.pdf

[5]European Commission for Economic and Monetary affairs. The Stability and Growth Pact. http://europa.eu.int/comm/economy_finance/about/activities/sgp/sgp_en.htm

[6] Resolution of the European Council on the Stability and Growth Pact. http://www.eurotreaties.com/stabilitygrowth.pdf

The SGP is a very important and necessary pact since its main idea is to prevent governments from running loose fiscal policies at the expense of other euro-area countries. Still, it has been strongly criticized for being insufficiently flexible[7], and even the President of the European Commission, Romano Prodi, stated "I know very well that the stability pact is stupid, like all decisions which are rigid [8]". Hence, in March 2005, the EU Council relaxed the rules to respond to these criticisms and to make the pact more enforceable and flexible. But, the main real weakness is that the pact has lost all credibility since penalties have not been enforced against countries, such as France and Germany, that are breaking the pact's requirements; countries which ironically were the biggest promoters of the SGP when it was created[9]. The SGP is of such importance for the economic development and well being of Europe that even the Union of Industrial and Employers' Confederations of Europe (UNICE) was calling on EU member states to maintain a strong commitment to the Stability and Growth Pact and on the European Commission to be firm and rigorous in its interpretation of the rules[10].

Unfortunately, according to Professor Franz-Christoph Zeitler—member of the Executive Board of the Deutsche Bundesbank—almost half of the countries in the euro area have either exceeded last year the 3% deficit ceiling specified by the Treaty or are in danger of exceeding that threshold in 2006. Furthermore, six of the ten economies which joined the EU last year have deficits of 3% or more and have run "excessive" deficits under the pact definition for some years now, yet the EU Council has not applied sanctions against them[11] (see graphs below).

Nevertheless, the Commission has been working very hard to adjust and impose the SGP requirements. The Council of Minister has adopted modifications on two Regulations that underpinned the SGP and has completed the reform process that was launched by the Commission in September 2004 and culminated on March 2005[12]. Despite these modifications, it seemed that the SGP had been effectively suspended through the reluctance of France and Germany to effectively accept and implement these recommendations of the ECB and the Commission to manage their budget deficits below 3% of GDP Euro zone[13]. It appeared that until the Treaty establishing the Constitution has been signed, it is unlikely that a replacement Pact will be agreed on and an agreement reached. However, the importance of the pact and the willingness of EU countries to endlessly work toward a successful EU exist, and on October 5th 2005, the Ministers of Economics of the EU with the agreement of France and Germany came to terms to thoroughly reform the SGP and move forward[14]. This agreement showed that once again**,** the European Union is ready to comply with its mission of civilization[15] and become a very powerful economic and social union; unfortunately, the rest of the paper will demonstrate, and show in graphs, that

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[7] Razin, Assaff and Efraim Sadka. The Stability and Growth Pact as an Impediment to Privatizing Social Security. The NBER Webpage. 2 October 2005. http://papers.nber.org/papers/w9278.pdf .

[8]Michael Keaney. EU Stability and Growth Pact: Prodi Speaks Out. http://archives.econ.utah.edu/archives/a-list/2002w42/msg00111.htm..4 October 2005

[9] Katinka Barysch. A Pact for Stability and Growth. The CER Website. Octuber 2003. The Center for European Reforms. 6 October 2005. http://www.cer.org.uk/pdf/policybrief_stabilityandgrowth_oct03.pdf

[10] Infobase Europe. UNICE Calls For Stability and Growth Pact Rules to be Applied. 2 October 2005. http://www.ibeurope.com/Database/6000/6070.htm#6076

[11] Zeitler, Chrisph, What Remains of the Stability and Growth Pact? 2 October 2005. http://www.bundesbank.de/download/presse/reden/2005/20050826zeitler_en.pdf

[12]Infobase Europe. Commission Welcome Final Adoption of Reforms to Stability and Growth Pact. 2 October 2005. http://www.ibeurope.com/Records/8500/8538.htm

Infobase Europe. European Parliament Call For Changes In Stability and Growth Pact Reform Proposals. 2 October 2005. http://www.ibeurope.com/Records/8400/8457.htm

[13] Benoit, Bertrand. *Assertive Berlin Keeps up Bere-Knuckle Statnce*. Financial Times, Wednesday October 5, 2005.

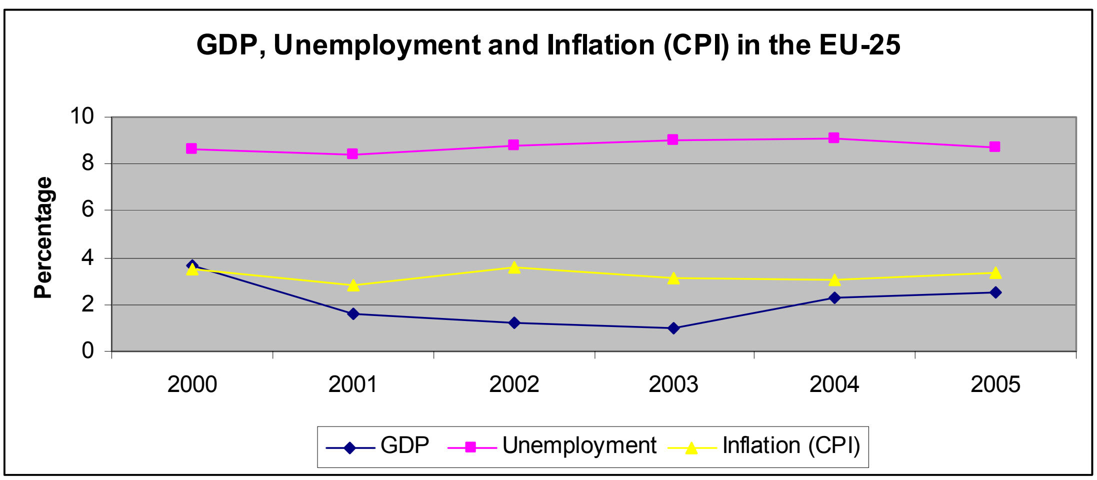
[14] El País. *Acuerdo a la medida de Francia y Alemania.*7 October 2005. http://www.elpais.es/afondo/tema.html?id=111

[15] Hobsson, J.A. Imperialism. The University of Michigan Press, Ann Arbor Paperback, 1965

most countries of the EU-25 are not meeting the standards, leaving this fundamental pillar for the fiscal stability of the EU on the air.

How are the EU Members Doing?

According to the Commission's spring economic forecasts, published on May 8th, 2006, economic growth measured by the GDP in the EU-25 was projected to improve from an average of 2.3% in 2005 to close to 2.5% on average for 2006. This economic growth impulse will be based on a robust increase in investment, continued strong world growth, and an improved economic outlook in Germany. Furthermore, the EU as a whole is expected to create 3.5 million new jobs over the period 2006-07, after nearly 3 million in the previous two years, which is expected to reduce unemployment from a peak of more than 9% in 2004 to an expected 8% in 2007 in the EU-25. However**,** Consumer Price Index—measuring inflation— remains difficult to control, and on average while in 2001, 2002 and 2003 it was kept under the 2% rate benchmark, in year 2004 and 2005 it was above this requirement. In this case, an analysis of GDP growth and unemployment rate shows that as GDP was decreasing in 2001, 2002 and 2203, unemployment was rising as well; furthermore, in 2004 and 2005 GDP started to increase and unemployment started to decrease. However, this macroeconomic relationship has nothing to do with the famous Okun´s Law since according to this theory an increase of the economic growth rate by 3 percent (above the normal rate) was expected to reduce the unemployment rate by 1 percentage point, which is not the case now—in the sixties and seventies the relationship between GDP growth and unemployment was clear and undisputed. Furthermore, the macroeconomic theory belief is that high unemployment is related to low aggregate demand, and low aggregate demand puts downward pressure on prices, which is not the case in our analysis either.

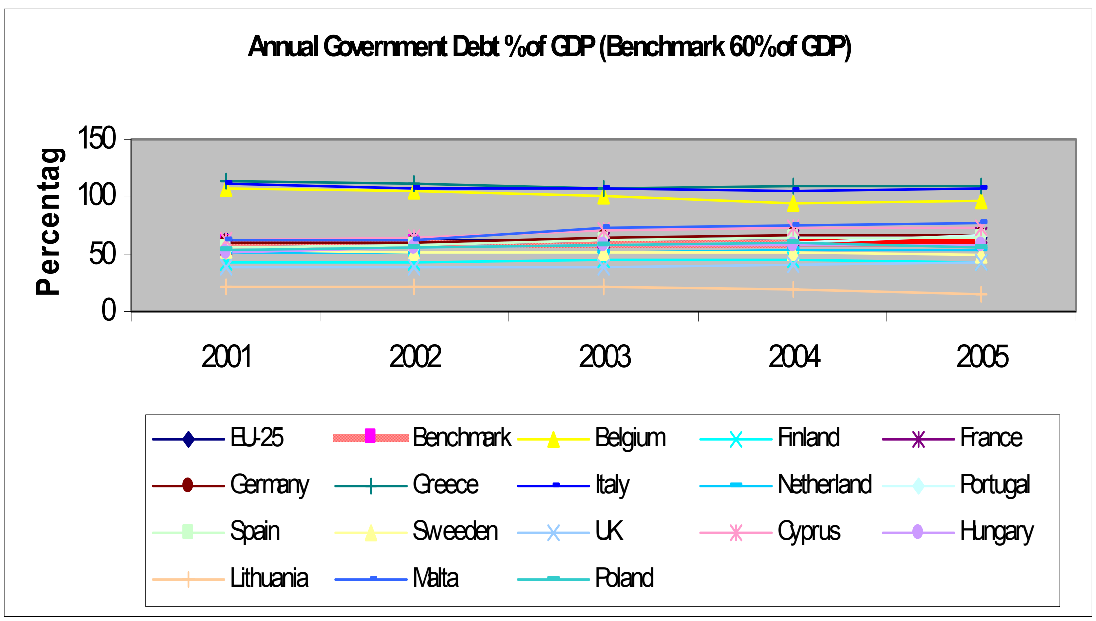


DataSource:Eurostat:Unemployment:http://epp.eurostat.ec.europa.eu/portal/page?_pageid=1996,39140985&_dad=portal&_schema=PORTAL&screen=detailref&language=en&product=STRIND_EMPLOI&root=STRIND_EMPLOI/emploi/em071CPI:http://epp.eurostat.ec.europa.eu/portal/page?_pageid=1996,45323734&_dad=portal&_schema=PORTAL&screen=welcomeref&open=/&product=EUROIND_CP&depth=2GDP:http://epp.eurostat.ec.europa.eu/portal/page?_pageid=1996,45323734&_dad=portal&_schema=PORTAL&screen=welcomeref&open=/&product=EUROIND_NA&depth=2

This revival of growth in the EU-25 is expected to be supported by a vibrant global outlook since world growth is expected to reach 4.6% in 2006, but it will fail to 4.3% in 2007. In particular, growth in the United States is easing however will stay at around 3% over the forecast horizon, and Asia**,** excluding Japan, is expected to grow at an impressive rate of more than 7.5%.

Japan—leaving behind a five-year deflation period—is expected to grow at 2.8% this year and 2.4% in 2007. However, for the European Union, as well as for the rest of the world, the biggest near-term risk lies with the oil markets. The very low spare capacities make markets extremely vulnerable to actual and potential supply disruptions. As the current high oil prices contain a significant risk premium due to geopolitical tensions, the oil price assumption of the forecast ($68.9 per barrel on average for 2006 and $71 per barrel for 2007) is subject to a considerable risk, both on the upside and downside.[16] In this sense, Alan Greenspan told the US Senate foreign relations committee that crude markets were now so tight that the slightest supply disruption could prompt big oil price rises. However, while for the EU the oil market situation is worrisome, "the US economy –according to Alan Greenspan- has been able to absorb the huge impact of rising oil prices with little consequences to date because it has become far ore flexible over the part three decades, owing to deregulation and globalisation."[17]

According to the Growth and Stability pact, certain benchmarks cannot be breached in order to follow economy and financial sustainability with the objective of aiming at a proper balance between fiscal discipline and the macroeconomic stabilization role of fiscal policy. In summary, the financial and economic criterions to follow are not to surpass a budget deficit of 3 percent of gross domestic product, maintain public debt below 60 percent of GDP, and an inflation rate under a 2%. For instance, regarding the maintenance of public/government debt below 60% of GDP, the chart shows that very few countries are complying with this requisite; in fact, all the countries studied in this paper—except from Finland, Netherlands, Portugal, Sweden, UK, Hungary, Lithuania, and Poland— surpassed the benchmark impose by the EU.

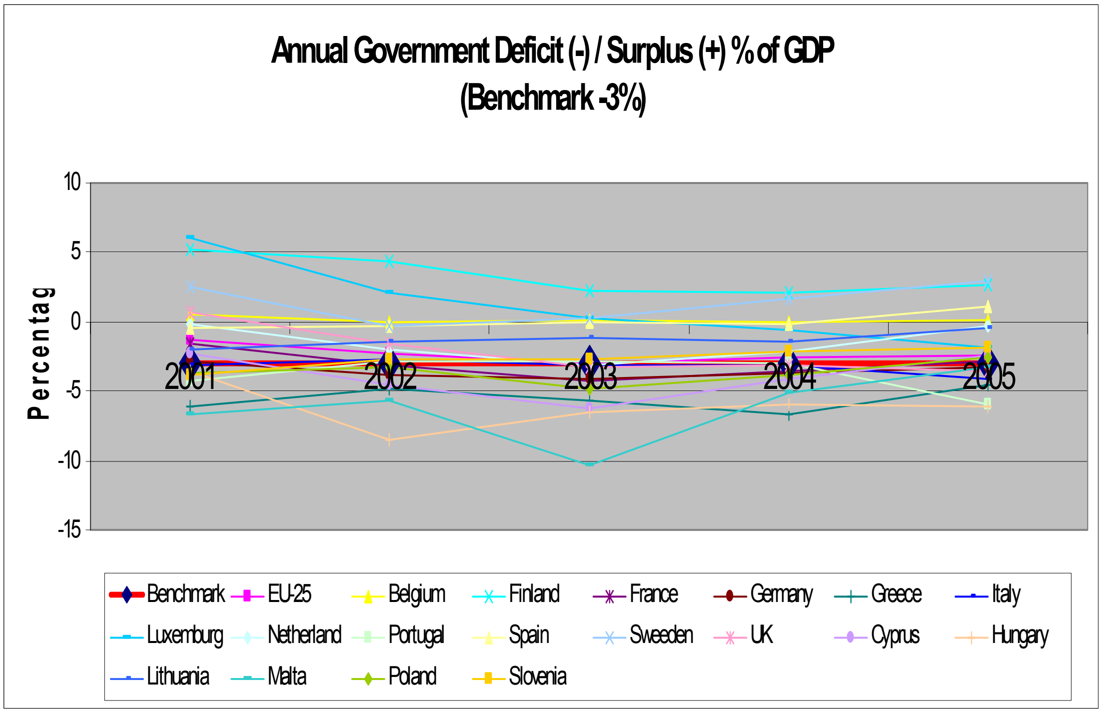


Data Source: Eurostat: **http://epp.eurostat.cec.eu.int/pls/portal/docs/PAGE/PGP_PRD_CAT_PREREL/PGE_CAT_PREREL_YEAR_2005/PGE_CAT_PREREL_YEAR_2005_MONTH_09/2-26092005-EN-AP.PDF**

[16] Directorate General for Economic and Financial Affairs. "Commission spring economic forecasts 2006-2007" http://europa.eu/rapid/pressReleasesAction.do?reference=IP/06/588&format=HTML&aged=0&language=EN&guiLanguage=en

[17] Kliment, A., and Edward Alden. « Former Fed chief warns on tight oil supply » Financial Times, Thursday June 8, 2006. p.2

At the same time, a thorough analysis of the second criteria—the government deficit should not exceed the reference value of 3% of GDP—shows that in the EU-25 this rate has improved from 2003 peak of -3% to -2.5% in 2005; however, a detailed analysis of some member states shows that for instance in 2003 more than half of those countries did not comply with the -3% government deficit of GDP and surpassed this benchmark, while in 2005 the number of countries that broke this level has been tremendously reduced although those still breaking the benchmark are mostly the new member states.



Data Source: Eurostat
http://epp.eurostat.cec.eu.int/pls/portal/docs/PAGE/PGP_PRD_CAT_PREREL/PGE_CAT_PREREL_YEAR_2005/PGE_CAT_PREREL_YEAR_2005_MONTH_06/2-16062005-EN-AP.PDFhttp://ec.europa.eu/economy_finance/publications/european_economy/2006/statannex0106_en.pdf

In detail, this graph shows that within the EU-15 both Germany and France have been consistently breaching the benchmark since 2002; furthermore, of the ten new members, countries such as Cyprus, Hungary, Malta, Poland, Slovakia, Czech Republic, have been also breaking this rule since 2002.

Conclusion

This analysis shows that Germany together with France— the main instigators of the pact, which have been stuck in recession or stagnation for the past three years – have been breaching since 2002 the keystones of the Stability and Growth Pact. The problem is that these countries were not punished which, some argue makes sense since imposing financial penalties when they're already mired in economic problems makes little sense. However, this undermines the main spirit of the pact: to enforce budgetary discipline among the countries—using or joining the euro— to avoid jeopardizing economic growth of the EU-25. Furthermore, this rift could threaten other common policies and EU projects such as the EU constitution, where the balance of power between big and small states is already a contentious issue. Finally, if France and Germany do not face any penalties, there are not backgrounds to oblige any member state to comply with the Growth and Stability Pact which could jeopardize the financial, economic and fiscal stability of the EU-25.