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Economic Developments in the Euro Area

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Introduction

2006 was characterized by increased economic growth for the Member States of the euro area in a world economy that continued to show strong growth, with an overall growth rate projected to be about 5 per cent of world Gross Domestic Product (GDP) (IMF, 2006). Whereas 2005 was dominated by the reform of the Stability and Growth Pact (SGP), in 2006 the pact played a very minor role due to the stronger economic outlook of countries of the euro area. Whether the revised SGP will 'bite' will only be tested in the years to come, most likely following a downturn in the economy.

The euro area's growth did not occur during a calm time, however. Oil prices continued to increase in the first half of 2006, reaching a peak in early August. A number of factors contributed to a sense of uneasiness about the world economy: continued uncertainty about the state of the United States' (US) economy, particularly its current account deficit and mounting public debt, a risk of a rapid cooling of its housing market and the onset of economic slowdown; continuing unrest in the Middle East and US foreign policy in the region; and continued strong growth of the economies of China and India. In 2006 there was a concern about rising inflation rates as a result of these developments and central banks (including the European Central Bank, ECB) responded by raising interest rates. In currency markets the real effective exchange rate of the euro strengthened by 2.8 per cent *vis-à-vis* other currencies as a whole, but appreciated more sharply against the US dollar (11 per cent) and the yen (9 per cent) (OECD, 2007, p. 56). The analysis of the Organisation for Economic Co-operation and Development (OECD) shows that the euro is close to its average of the 1990s and thus this appreciation for now should not be considered a problem for export competitiveness. As was the case in 2005, these developments came against the background of a euro area economy that was still not performing as strongly as those of non-euro area EU Member States (see Johnson, this volume) or other advanced industrialized societies (see Tables 1 and 2 below). The euro area economies, however, did perform considerably better than in previous years, although there was wide variation among the 12 Member States of the euro area.

This article looks at the economic developments in the euro area by highlighting a few core characteristics of the euro area as a whole and those of the largest five economies of the euro area (Germany, France, Italy, Spain and the Netherlands). Section I provides some key economic performance indicators. Section II examines the policy of the ECB and briefly discusses progress in the SGP, before reviewing the external dimension of the euro. Section III looks at the five selected countries. Section IV offers a reflection on the developments with Economic and Monetary Union (EMU) over the reviewed time period. Section V closes with a brief summary and outlook for 2007.

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

	2004	*2005*	*2006 projections*	*2007 projections*
World	5.3	4.9	5.1	4.9
Advanced economies	3.2	2.6	3.1	2.7
United States	3.9	3.2	3.4	2.9
Euro Area	2.1	1.3	2.4	2.0
Japan	2.3	2.6	2.7	2.1
United Kingdom	3.3	1.9	2.7	2.7
Canada	3.3	2.9	3.1	3.0
Other advanced economies	4.6	3.7	4.1	3.7
Central and eastern Europe	6.5	5.4	5.3	5.0
Commonwealth of Independent States	8.4	6.5	6.8	6.5
China	10.1	10.2	10.0	10.0
India	8.0	8.5	8.3	7.3
European Union	2.4	1.8	2.8	2.4

Source: IMF (2006, p. 2, Table 1.1).

Table 2: Annual Average % Change in GDP for the EU-15, 1992–2007

	1997–01	*2002*	*2003*	*2004*	*2005*	*2006 projected*	*2007 projected*
Euro Area Member States:							
Belgium	2.6	1.5	1.0	3.0	1.1	2.7	2.3
Germany	2.1	0.0	–0.2	1.2	0.9	2.4	1.2
Greece	4.0	3.8	4.8	4.7	3.7	3.8	3.7
Spain	4.4	2.7	3.0	3.2	3.5	3.8	3.4
France	3.0	1.0	1.1	2.3	1.2	2.2	2.3
Ireland	9.9	6.0	4.3	4.3	5.5	5.3	5.3
Italy	2.1	0.3	0.0	1.1	0.0	1.7	1.4
Luxembourg	6.3	3.8	1.3	3.6	4.0	5.5	4.5
Netherlands	3.7	0.1	0.3	2.0	1.5	3.0	2.9
Austria	2.6	0.9	1.1	2.4	2.0	3.1	2.6
Portugal	3.8	0.8	–1.1	1.2	0.4	1.2	1.5
Finland	4.6	1.6	1.8	4.4	2.9	4.9	3.0
Euro Area	1.9	0.9	0.7	2.0	1.3	2.6	2.1
Non-Euro Area Member States:							
Denmark	2.4	0.5	0.7	1.9	3.0	3.0	2.3
Sweden	3.2	2.0	1.7	3.76	2.7	4.0	3.3
UK	3.1	2.1	2.7	3.3	1.9	2.7	2.6
EU-25	2.9	1.2	1.3	2.4	1.7	2.8	2.4

Source: Commission (2006, p. 133, Table 1).

I. Economic Developments in the Euro Area: Main Economic Indicators

Economic Growth

In September, the International Monetary Fund (IMF) reported that the average rate of economic growth for advanced economies in the year 2006 was projected to be 3.1 per cent, which is up a little from 2.6 per cent the year before (IMF, 2006, p. 2). As was the case in previous years, the euro area, however, continued to perform less well than the advanced economies as a whole, performing particularly badly in 2005 but recovering in 2006 (see Table 1). The recovery in the euro area in 2006 closed the performance gap with other leading nations, such as the US and Japan, albeit not quite catching up (see Table 1). Furthermore, even the EU as a whole performed better than the euro area.

In January 2007 the OECD concluded that recovery has finally taken hold of the euro area. It estimated euro area GDP growth for 2006 at 2.6 per cent, compared to considerably weaker growth in previous years, namely 1.5 per cent in 2005 and 1.7 per cent in 2004 (OECD, 2007, p. 25, Table 1.3).

In 2006 some of the euro area economies that had performed particularly poorly in 2005, such as Germany and Italy, picked up. The *European Economy* autumn forecast (Commission, 2006) estimated the GDP growth in 2006 for Germany at 1.7 per cent and France at 3.1 per cent. EU-15 countries that are not part of the euro area did a little better than the average of the euro area countries (2.6 per cent). For example, growth in the United Kingdom (UK) was estimated at 2.7 per cent, Denmark at 3.2 per cent and Sweden at 3.4 per cent. Table 2 sets out the European Commission's latest estimates of GDP growth in the euro area plus Denmark, Sweden and the UK and the forecast for 2007.

Employment

The employment situation in the euro area also continued to improve, as had been the case in 2004 and 2005. Stronger than expected economic growth throughout 2006 contributed importantly to the improved employment performance and forecast. The forecasted figures for 2006 suggest that the euro area's employment performance is catching up to that of the other countries of the EU-25. Table 3 shows that the average unemployment in the euro area is now the same as that of the EU-25. Note the continuing buoyancy of Ireland, but also the strong performance of Austria and the Netherlands. High unemployment still exists in Belgium, Germany, Greece and France, although the situation in Germany has improved markedly compared to last year.

Inflation

Looking at the Harmonized Index of Consumer Prices, we find that inflation rates in the euro area countries have, on average, stayed more or less the same over the past three years. The performances of individual countries, however, continue to diverge a little, with the same countries being the high and low inflation performers as in 2005. The average inflation rate of the euro area countries in 2006 was 2.2 per cent, with a maximum of 3.6 per cent (Spain) and a minimum of 1.3 per cent (Finland) (see Table 4).

If we compare the inflation performance of the euro area countries with those in the rest of the EU we find that inflation rates still diverged between the euro area Member States and the three EU-15 'outs' and the new Member States, although the average inflation rate for the EU-27 was close to that of the euro area (see Table 4). Much discussed in 2006 was the decision by the European Commission and the ECB not to allow Lithuania to join the euro area in 2007 as it missed the inflation criterion by less than 0.1 per cent, whereas Slovenia was allowed in (see Johnson this issue).

Table 3: Percentage of the Civilian Labour Force Unemployed in the EU-15, 1992–2006

	1997–2001	*2002*	*2003*	*2004*	*2005*	*2006 projected*	*2007 projected*
Euro Area Member States:							
Belgium	8.1	7.5	8.2	8.4	8.4	8.6	8.5
Germany	8.1	8.2	9.0	9.5	9.5	8.9	8.4
Greece	11.0	10.3	9.7	10.5	9.8	9.3	8.9
Spain	13.1	11.1	11.1	10.7	9.2	8.1	7.9
France	10.1	8.9	9.5	9.7	9.6	9.3	8.9
Ireland	6.3	4.5	4.7	4.5	4.3	4.3	4.5
Italy	10.5	8.6	8.4	8.0	7.7	7.1	7.0
Luxembourg	2.4	24.5	4.7	5.1	4.5	4.6	4.4
Netherlands	3.4	2.8	3.7	4.6	4.7	3.9	3.0
Austria	4.0	4.2	4.3	4.8	5.2	5.1	5.1
Portugal	4.9	5.0	6.3	6.7	7.6	7.6	7.7
Finland	10.6	9.1	9.0	8.8	8.4	7.7	7.4
Euro Area	10.6	9.1	9.0	8.8	8.4	7.7	7.4
Non-Euro Area Member States:							
Denmark	4.8	4.6	5.4	5.5	4.8	3.8	3.5
Sweden	7.1	4.9	5.6	6.3	7.8	7.3	7.4
UK	5.8	5.1	4.9	4.7	5.7	5.3	5.0
EU-25	9.1	8.8	9.0	9.1	8.8	8.0	7.6

Source: Commission (2006, p. 146, Table 28).

Public Finances

Public finances in the EU stabilized somewhat during 2006, mostly because of better growth performance. As a result, the budget deficit as a percentage of GDP improved in most Member States. Average deficit in the euro area in 2006 is projected to be 2.0 per cent, down from 2.4 per cent in 2005. The only two countries still above the 3.0 per cent threshold in 2006 were Italy and Portugal (see Table 5).

II. Developments Surrounding the Stability and Growth Pact

Last year's review discussed in some detail the 2005 reform of the Stability and Growth Pact (SGP) and what its main aim was, namely to serve as a disciplining mechanism once Member States were in the third stage of EMU (Verdun, 2006). In a nutshell, the SGP aims to ensure that Member States keep their fiscal policies under control once in EMU. The 2005 reform made the original SGP rules less mechanical so as to include more scope for

Table 4: Harmonized Consumer Price Index (Annual % Change)

	2000	*2001*	*2002*	*2003*	*2004*	*2005*	*Projected 2006*
Belgium	2.68	2.44	1.55	1.51	1.86	2.53	2.34
Bulgaria	10.32	7.36	5.81	2.35	6.15	6.04	7.42
Czech Republic	3.95	4.54	1.43	–0.07	2.55	1.60	2.09
Denmark	2.71	2.30	2.38	1.98	0.90	1.70	1.85
Germany	1.40	1.90	1.35	1.03	1.79	1.92	1.78
Estonia	3.94	5.62	3.59	1.39	3.03	4.11	4.44
Ireland	5.25	3.99	4.72	4.00	2.30	2.18	2.70
Greece	2.90	3.65	3.92	3.44	3.03	3.48	3.31
Spain	3.48	2.83	3.59	3.10	3.05	3.38	3.56
France	1.83	1.78	1.94	2.17	2.34	1.90	1.91
Italy	2.58	2.32	2.61	2.81	2.27	2.21	2.22
Cyprus	4.86	1.98	2.79	3.96	1.90	2.04	2.25
Latvia	2.64	2.52	1.95	2.94	6.19	6.90	6.57
Lithuania	1.08	1.55	0.34	–1.08	1.16	2.66	3.79
Luxembourg	3.78	2.40	2.06	2.54	3.23	3.76	2.96
Hungary	9.96	9.08	5.24	4.68	6.77	3.48	4.03
Malta	3.04	2.51	2.61	1.94	2.73	2.53	2.58
Netherlands	2.34	5.11	3.87	2.24	1.38	1.50	1.65
Austria	1.96	2.29	1.70	1.30	1.95	2.11	1.69
Poland	10.08	5.31	1.95	0.71	3.59	2.18	1.27
Portugal	2.80	4.41	3.68	3.26	2.51	2.13	3.04
Romania	45.68	34.47	22.52	15.27	11.89	9.07	6.61
Slovenia	8.95	8.56	7.46	5.69	3.66	2.46	2.54
Slovakia	12.20	7.16	3.50	8.43	7.47	2.80	4.26
Finland	2.94	2.67	2.01	1.30	0.14	0.77	1.27
Sweden	1.30	2.67	1.93	2.34	1.02	0.82	1.50
United Kingdom	0.79	1.24	1.26	1.36	1.34	2.06	2.33
Euro Area[a]	2.12	2.36	2.26	2.08	2.14	2.18	2.18
EU-27	3.46	3.20	2.54	2.14	2.27	2.28	2.30
EU-25[b]	2.44	2.49	2.13	1.95	2.14	2.16	2.20
EU-15[c]	1.90	2.19	2.08	1.96	1.96	2.14	2.19

Notes: [a] Euro area with 12 countries; [b] Former EU-25; [c] Former EU-15.
Source: Commission (2007b).

economic judgement and consideration of country-specific conditions. Many observers have pointed to the flexibility of the reformed SGP and have questioned whether it will still have the disciplining effect it originally was aimed to have (Buiter, 2006; Buti, 2006; Calmfors, 2005; Heipertz and Verdun, 2006; Šabić, 2006).

In 2006 the countries that were still judged by the Commission and Council as having excessive deficits (above 3 per cent of GDP) were Germany, Greece,

Table 5: Net Lending (+) or Net Borrowing (–) of General Government as a Share of GDP in EU-15, 1992–2008

	1997–2001	*2002*	*2003*	*2004*	*2005*	*2006 projected*	*2007 projected*	*2008 projected*
Euro Area Member States:								
Belgium	–0.5	0.0	0.0	–2.3	–2.3	–0.2	–0.5	–0.5
Germany	–1.6	–3.7	–4.0	–3.7	–3.2	–2.3	–1.6	–1.2
Greece	–4.7	–5.2	–6.1	–7.8	–5.2	–2.6	–2.6	–2.4
Spain	–1.8	–0.3	0.0	–0.2	1.1	1.5	1.1	0.9
France	–2.1	–3.2	–4.2	–3.7	–2.9	–2.7	–2.6	–2.2
Ireland	2.3	–0.4	0.3	1.5	1.1	1.2	0.9	0.4
Italy	–2.2	–2.9	–3.5	–3.4	–4.1	–4.7	–2.9	–3.1
Luxembourg	4.5	2.1	0.3	–1.1	–1.0	–1.5	–0.5	–0.3
Netherlands	0.0	–2.0	–3.1	–1.8	–0.3	0.0	0.1	0.3
Austria	–1.5	–0.5	–1.6	–1.2	–1.5	–1.3	–1.2	–1.0
Portugal	–3.3	–2.9	–2.9	–3.2	–6.0	–4.6	–4.0	–3.9
Finland	2.8	4.1	2.5	2.3	2.7	2.9	2.9	2.9
Euro Area		–2.5	–3.1	–2.8	–2.4	–2.0	–1.5	–1.3
Non-euro Area Member States:								
Denmark	1.8	1.2	1.1	2.7	4.9	4.0	4.3	4.2
Sweden	2.2	–0.2	0.1	1.8	3.0	2.8	2.4	2.5
UK	0.8	–1.7	–3.3	–3.2	–3.3	–2.9	–2.8	–2.5
EU-25		–2.3	–3.0	–2.7	–2.3	–2.0	–1.6	–1.4

Source: Commission (2006, p. 151, Table 37).

Italy and Portugal. Although Germany's and Greece's deficits are forecast to have fallen below the 3 per cent threshold by the end of 2006, the other two are still above the threshold. Italy has until 2007 to correct its excessive deficit, while Portugal has until 2008 (Commission, 2007a).

Leaving these four countries aside, the other EU Member States are not reducing their levels of public debt as one might expect in a year of improved economic performance. Instead, the OECD survey of the euro area shows that public debt in EU Member States is projected to stay high, albeit declining somewhat during the period 2005–10 (OECD, 2007, p. 95, Table 3.1).

Some of the challenges that the Member States are facing include ageing populations (thereby higher pressures on pensions and healthcare in the future) and non-demographic pressures on health care services (such as increasing technological progress and an increase in desire for healthcare services related to an increase in wealth). In other words, Member States will need to account for these pressures in the present in order to maintain responsible public debt and budgetary deficit positions in the future.

It is clear, however, that Member States have not put in the effort that is needed to avoid difficulties in the future. The SGP did not have an effect in this regard during 2006 in part because economic growth enabled countries to keep their deficits below the 3 per cent without taking action, even though Member States are supposed to keep their budget deficits 'close to balance or in surplus' in the medium term (the 'medium term objective', MTO). Although some Member States – such as Belgium, Finland, Ireland, the Netherlands and Spain – have already reached their MTOs, others are either not targeting that objective or are not doing so successfully (OECD, 2007, p. 99 and Table 3.3).

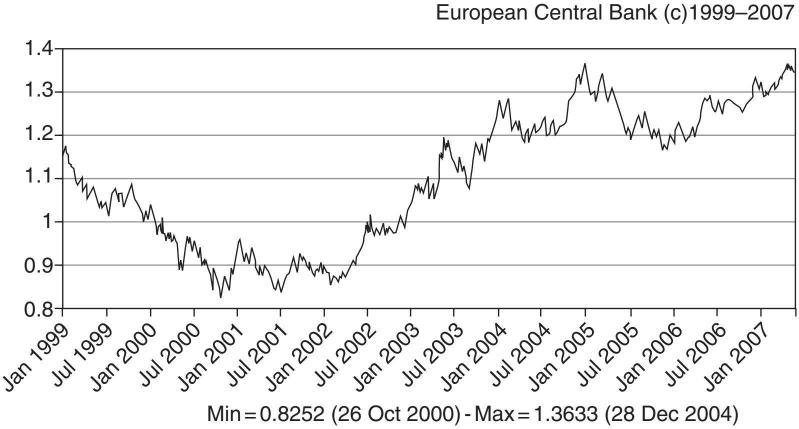
III. Policies of the European Central Bank

The Governing Council of the ECB sets the key interest rates for the euro area. Since its creation, the ECB has taken the euro area as a whole as its reference point. In determining policy the Member States' economies are weighted proportionally to their economic size in the euro area economy. There were no changes in policy by the ECB in 2006 (for a general discussion of ECB policy see Verdun, 2006). During 2006 the ECB raised interest rates five times, each time by 25 basis points (from 1.25 per cent on 6 December 2005 to 2.50 per cent on 13 December 2006). This increase in interest rates is unprecedented for the ECB. As was discussed in last year's review (Verdun, 2006), when the ECB raised its interest rates in December 2005 it was the first time it had done so since 2003. The ECB has typically not been responsive to outside pressures. It has usually kept its interest rates unchanged when commentators were pointing to weak economic growth or the value of the euro (either over or undervaluation). These interest rate increases in 2006 were a response to a threat of increasing inflation, driven primarily by higher prices for energy and raw commodities. Despite the sharp increases, the ECB's interest rate at the end of 2006 was still 100 basis points (i.e. 1 per cent) lower than that of the US Federal Reserve.

IV. External Dimension of the Euro

The euro gained considerably in value against other major currencies during 2006. Even though the euro had been deemed by the media to have been overvalued in 2004 and to a lesser extent 2005, in 2006 (see Figure 1) there was less emphasis on the euro being overvalued, but concern focused on the decline of the US dollar. The concern was that a sharp decline in the US dollar might undermine the competitiveness of the euro area economy. Towards the

Figure 1: US–Euro Exchange Rates January 1999 – January 2007



Source: European Central Bank.

end of 2006 the depreciation of the Japanese yen emerged as another concern. In addition to the height of the exchange rate, there was concern about the euro's volatility. During 2006 it fluctuated between roughly \$1.20 and \$1.30, for example. However, if put in historical perspective the euro (or in the past the Deutschmark) exchange rate *vis-à-vis* the US has often fluctuated this much or more.

Given the appreciation of the euro throughout 2006, the ECB came under some pressure to act. The ECB, however, considers the value of the euro only insofar as it might contribute to inflation. Ministers of Finance of the EU are the ones responsible for setting any exchange rate regime. To date the euro has been freely floating. In other words, although the mandate of the ECB is to secure price stability (defined as 2 per cent inflation) and it has also to consider the overall economic performance of the EU, the ECB has not targeted the exchange rate in 2006. However, the President of the ECB, Jean-Claude Trichet, signed a G-7 Communiqué in Singapore stating that 'Excess volatility and disorderly movements in exchange rates are undesirable for economic growth' (Trichet, 2006). This statement suggests that the ECB might consider interventions in the exchange rate in the future.

V. Developments in Selected Member States of the Euro Area

Since EMU is an asymmetrical monetary union (Verdun, 1996), with a strong central authority responsible for monetary policy whereas fiscal policy is conducted decentrally by national governments, more than in any other monetary union, its success depends on the economic performance of Member States. Some of the criticisms of the euro area have been that its economic growth has lagged behind, in particular that of the largest countries (Germany, France and Italy). The performance of the larger Member States is important as the ECB sets monetary policy based on a weighted average of the economies of the euro area and the largest economies weigh the most. Let us now turn to a discussion of some economic developments in the largest five Member States of the euro area and assess what the differences in performances are of these countries on a number of characteristics, such as growth, investment, employment, public finances, inflation and the forecast for the next year.

Germany

Economic growth in Germany in 2006 was stronger than expected. Measured as annual percentage of change at previous year prices, 2005 saw only 0.9 per cent growth compared to a projected 2.4 per cent in 2006 (Commission, 2006, p. 58). Exports were seen to be the main driver, although the German government's announcement that it would increase value-added tax (VAT) from 16 to 19 per cent on 1 January 2007 caused consumption to be brought forward to 2006. The football World Cup during the summer also generated growth, in particular through its effect on the service sector.

The consumer confidence index, an indicator of how likely consumers are to make larger purchases, went up very strongly in 2006 (Commission, 2006, p. 56). Overall investment was also up, with investment in the housing sector getting a boost in advance of the 2007 VAT increase and some policy changes, such as subsidies on energy-saving construction measures, that offered stimuli in this sector. Corporate investment was encouraged by some depreciation rules that would be valid only until the end of 2007.

Employment was up in Germany in 2006 in terms both of number of people employed and number of hours worked. Although in past years Germany has seen a strong increase in so-called 'flexible jobs', in 2006 growth occurred in more traditional jobs; for the first time in years there was even an increase in jobs subject to social insurance contributions.

Having had problems since 2002, public finances in Germany finally did better in 2006. The fall in the government budget deficit to 2.3 per cent of GDP in 2006 was due to increased revenue (mostly via direct taxes) from increased economic activity. The government is keeping general government expenditure under control. As total expenditure grew by 0.8 per cent (spring projection) in 2006, the unexpectedly high GDP growth reduced expenditure as a share of GDP by one percentage point. At the same time, the improved employment situation reduced the amount needed to pay unemployment insurance. The budget deficit is forecast to fall further in 2007 to 1.6 per cent of GDP (see Table 5), in part because of the increase in VAT on 1 January 2007. Public debt is forecast to remain roughly unchanged (67.9 per cent of GDP in 2005 to 67.7 per cent of GDP in 2008).

Inflation in Germany has been lower than in other euro area countries and at 1.8 per cent was slightly lower in 2006 than in 2005. Although Germany is a large economy that has the greatest impact on the policies of the ECB, this does not mean that euro area interest rates exactly reflect economic conditions in Germany. In 2006, as in the recent past, inflation in Germany would have merited a lower interest rate than that set by the ECB. As a consequence, German economic growth has occurred despite a relatively tight monetary policy.

The economic forecast for Germany in 2007 is favourable. The planned VAT increase will cause inflation to increase slightly, which will mean that the ECB's monetary policy will be more appropriate for the Germany economy, although inflation is forecast to come down again in 2008. GDP and employment growth are also forecast to continue to grow in 2007. According to the Commission's (2006, p. 58) annual forecast, unemployment is projected to come down to 8.4 per cent in 2007 (from 8.9 in 2006). Last but not least, Germany's public finances seem finally to have improved and are forecast to stay below the SGP's 3 per cent reference value in 2007.

France

As in Germany, economic growth in France in 2006 was stronger than expected and significantly higher than the year before. Measured as annual percentage of change at previous year prices, 2005 only saw 1.2 per cent growth, whereas 2006 was projected to be at 2.2 per cent (Commission, 2006, p. 668). Increased domestic demand was the main driver of this increased growth, although exports also improved. Strong import growth, however, meant that the contribution of net exports to growth was close to neutral (in 2005 it had been negative).

Investment in the French housing sector also got a boost following the implementation of new mortgage financing conditions. Investments by companies were also strong. In part corporate expenditures reflect the economic cycle; an increase in economic growth following a period of weak growth causes companies to invest to replace their equipment.

The employment situation in France in 2006 also showed improvement and finally employment levels began to catch up to those of the other EU

Member States. In 2005 job creation was about 0.2 per cent, whereas the projected increase in jobs in 2006 was 0.8 per cent. Similarly, whereas the rate of unemployment was 9.7 per cent in 2005, the forecast for 2006 was 9.3 per cent, with further reductions envisaged in the years to come.

Having famously had problems since 2002, public finances in France started to improve in 2005. The budget deficit fell to 2.9 per cent of GDP, with a further decline projected to be at 2.7 per cent of GDP in 2006 (see Table 5). Most of the reduction in the budget deficit was due to stronger economic growth (that is, improved revenues and reduced expenditures). The increase in revenue was largely due to strong consumption growth and thus higher revenue collected through indirect taxes. In addition, increased corporate profits led to higher corporate tax revenue and increased employment contributed to more revenue collected through income taxes. In terms of expenditure, the cost of healthcare fell as a result of reforms. In addition to these improvements related to the economic cycle, the French government also relied on some one-off measures (Commission, 2006, p. 67). The public debt to GDP ratio is forecast to fall slightly from 66.6 per cent of GDP in 2005 to 64.7 per cent in 2006 and 63.9 in 2007.

Inflation in France has been steady and marginally lower than in other euro area countries. Inflation in 2006 was projected to be 2.0 per cent, compared to 1.9 per cent in 2005 and is expected to fall to 1.8 per cent in 2007. Because inflation in France is close to the average of that of the euro area as a whole, the ECB's interest rate policy is appropriate for France.

The economic forecast for France for 2007 is favourable. After years of sluggish domestic demand, it is expected that the next years will be better largely because of strong demand, especially private consumption (Commission, 2006, p. 66). Inflation should stay stable at just below 2 per cent. Being so close to the projected average inflation rate of euro area Member States will mean that ECB monetary policy will be 'just right' for France. GDP and employment growth are also forecast to continue in 2007. According to the Commission's autumn annual forecast, France's unemployment rate, although still relatively high compared to other EU Member States, is projected to come down to 9.0 per cent in 2007 from 9.3 in 2006 (Commission, 2006, p. 58). Finally, France's budget deficit seems to have stabilized at just below the SGP's 3.0 per cent threshold. It is forecast to be at 2.6 per cent in 2007 and 2.2 per cent in 2008.

Italy

As in Germany and France, economic growth in Italy in 2006 was stronger than expected and markedly better than in previous years. Measured as annual percentage of change at constant prices, the economy stagnated in 2003 and 2005 (0.0 per cent in both years) and grew only slowly in 2004 (1.1 per cent), whereas for 2006 growth was projected again to be 1.7 per cent (Commission, 2006, p. 73). As in France, increased domestic demand was the main driver. Following from the increased growth in the euro area and the rest of the EU, Italian exports picked up, but they seem not to have grown as much as could be expected if keeping in pace with increased demands in their export markets. The problem is, that with relatively high prices and wages, Italy is not as competitive as its neighbouring countries (Commission, 2006, p. 36).

The employment situation in Italy has improved in 2006 (Commission, 2006, p. 35). Italy recorded one of the stronger rates of job creation in the euro area in 2006, with employment increasing by 1.3 per cent. Some of these jobs are related to net immigration and there has been strong growth in so-called 'flexible jobs'. Unemployment also went down from 8.0 per cent in 2004 to 7.7 per cent in 2005 and is projected to have been 7.1 per cent in 2006. It is forecast to stay at roughly that level in the coming years (Commission, 2006, p. 73).

As was mentioned earlier, Italy was one of those countries that ran an excessive deficit in 2006, despite the government's significant efforts to bring it below the 3 per cent SGP threshold. An important reason for the disappointing budgetary situation in 2006 was related to a recent European Court of Justice ruling that allows companies to claim VAT refunds for company cars, which has had a considerable impact on Italian public finances, estimated to be the equivalent of 1 per cent of GDP (Commission, 2006, pp. 41 and 72). Nevertheless the forecast for 2007 is that the deficit will drop just below 3 per cent of GDP. The public debt to GDP ratio is forecast to increase slightly to 107 per cent in 2006, compared to 104.3 per cent in 2003, 103.9 per cent in 2004 and 106.6 per cent in 2005. In 2007 and 2008, however, the debt as a proportion of GDP is forecast to come down gradually (Commission, 2006, p. 73).

Inflation in Italy over the past few years has been around 2.3 per cent and is expected to go down to 2.0 per cent in 2007 and 1.9 per cent in 2008. Italy, like France, has an inflation rate that is close to the average of that of the euro area as a whole. As a consequence, the ECB's interest rate policy is appropriate for Italy as far as price stability is concerned.

The economic forecast for Italy for 2007 is quite favourable. Domestic demand is on the rise and is expected to continue to be positive in the coming years, albeit at a slower pace than in 2006 (Commission, 2006, p. 71). Inflation is forecast to come down slightly to 2.0 per cent in 2007 and 1.9 per cent in 2008. GDP is forecast to grow by 1.4 per cent in both 2007 and 2008. Job creation is not expected to be as strong as in 2006, but is still positive (forecast to be 0.5 per cent in both 2007 and 2008). According to the Commission's annual forecasts, unemployment is projected to come down to 7.0 per cent in both 2007 and 2008 (Commission, 2006, p. 73).

Spain

Growth in Spain was faster than in most Member States of the euro area. Measured as annual percentage of change at previous year prices, 2005 saw 3.5 per cent growth, whereas 2006 is projected to be at 3.8 per cent, well above the euro area average (Commission, 2006, p. 65). Again, increased domestic demand was an important driver. In Spain net exports are contributing negatively to growth but less so than in 2005 (Commission, 2006, p. 63). With strong job creation and easy monetary conditions, Spain is benefiting from the strong economic performance.

The employment situation in Spain is still looking very good, confirming a remarkable success story. A country that had double digit unemployment in the 1990s now serves as an example of job creation and low unemployment. Employment increased again in Spain in 2006. In 2005 the job creation rate was about 3.1 per cent, whereas the projected increase in jobs for 2006 was 3.2 per cent. Similarly, whereas the rate of unemployment had been 9.2 per cent in 2005, the forecast for 2006 was 8.1 per cent, with further reductions envisaged in the years to come (to 7.9 per cent and 7.4 per cent in 2007 and 2008, respectively).

Spain has not had problems meeting the SGP deficit criteria. In 2005 Spain ran a budget surplus equivalent to 1.5 per cent of GDP and it was projected to be even larger (1.9 per cent) in 2006 (see Table 5).

Inflation in Spain has been steady and tended to be a little higher than that in other euro area countries. Inflation in 2006 was projected to be at 3.6 per cent, compared to 3.4 per cent in 2005 and projected to come down to 2.8 per cent in 2007. In 2006, as in the recent past, the inflation rate in Spain is the second highest in the euro area as a whole. Thus the interest rate policy of the ECB is not ideal for Spain.

For Spain the economic forecast for 2007 is once again favourable. Growth in 2007 and 2008 is expected to be similar to, but not quite as high, as was projected for 2006 (Commission, 2006, p. 65). Inflation will gradually come down to about 2.8 and 2.7 per cent in 2007 and 2008, respectively. With Spain growing faster in terms of both GDP and employment and with an overall higher inflation than the euro area average, ECB monetary policy is rather too loose for Spain.

The Netherlands

After three years of economic decline, the Dutch economy began to recover in 2005 and economic growth accelerated in 2006. Measured as an annual percentage change at the previous year's prices, 2005 saw 3.5 per cent growth, whereas growth in 2006 was projected to have been at 3.8 per cent, well above the euro area average (Commission, 2006, p. 65). Domestic demand is an important driver in the Netherlands, with private consumption doing a lot of 'catching up'. Exports also grew but as imports grew at a similar pace, the impact of net exports remained unchanged (Commission, 2006, p. 86).

The employment situation in the Netherlands has improved with the economic recovery. In 2005 and 2006 the Netherlands was among the countries with the lowest rates of unemployment of the euro area countries; 4.7 per cent in 2005, dropping to 3.9 per cent in 2006 (Commission, 2006, p. 87). Although there was no increase in new jobs in 2005, 2006 is thought to have seen growth, with an increase in new jobs of 1.6 per cent. Although growth has accelerated and jobs have been created, there has been no sign of a considerable wage increase. The implication is that the productivity of Dutch labour has gone up.

The Netherlands has performed admirably lately with regarded to the SGP's budget deficit criterion. Whereas it was considered to have an excessive deficit in 2003, the Netherlands was in surplus in 2006 (see Table 5), a very rapid turnaround.

Inflation in the Netherlands has been dropping since the early 2000s, falling to 1.5 per cent in 2005, but is expected to have increased to 1.6 per cent in 2006 and is forecast to continue to increase gradually to 2.3 per cent in 2008. Thus, in 2006, as in the recent past, inflation in the Netherlands has been low. With the forecast gradual increase, however, one could conclude that the interest rate policy of the ECB is fine for the Netherlands.

The 2007 economic forecast for the Netherlands is positive. Since the recovery finally took hold in 2005, private consumption is back and productivity growth appears strong as well (Commission, 2006, p. 36). Overall, the Netherlands is doing very well indeed.

VI. An Assessment of Economic and Monetary Union in 2006

EMU has done well in 2006. After a number of years of speculation about whether it was good for the Member States, criticisms of EMU were much less frequent in 2006. In part this improved perception of EMU is due to the improvement of the economic performance of the larger economies of the euro area (in particular Germany's). In recent years the economic performances of the countries in the euro area have been compared unfavourably to those Member States that stayed out; in fact it was argued that those who stayed outside EMU were faring better. Such comments were much rarer in 2006.

The reality is that, on average compared to the period prior to 1999, EMU enables the euro area countries to benefit from the lower cost of borrowing money (i.e. better financial circumstances, in particular low interest rates, low inflation and easy access to money). Other benefits of EMU are the ease in comparing price levels which should promote trade and investment into the euro area. Finally, the dynamic effects of EMU are such that other imperfections of market integration, such as shortcomings in the integration of financial services, are now coming to the surface and are being discussed. This year was characterized by an overall acceptance of EMU, rather than any major reflection on whether EMU's institutional design needs any adjustment. The only major institutional change was the accession of Slovenia (see Johnson, this volume).

Conclusion

The economic developments in the euro area countries during 2006 were overwhelmingly positive. The concerns about the lack of economic growth in the euro area that dominated 2005 have withered away. The differences between the 'ins' and the 'outs' did not get larger and the larger economies in the euro area made clear improvements. Moreover, although the euro area Member States' economies still perform differently, the differences among them are not very large and are shrinking. Some larger Member States that performed worse in earlier years are now experiencing stronger economic growth.

EMU as a whole seems to enjoy the support of citizens in the EU. The year 2006 saw no major discussion of the institutional structure. Criticism of the Stability and Growth Pact was subdued in 2006, in part because the improved economic performances meant that its restrictions bit less. The commitment of the euro area countries to EMU and the SGP still seems strong, but a clear assessment of that commitment can be made only after their economies have been tested by a recession.

The ECB has been very active in 2006 changing interest rates in response to increasing inflationary pressures. Yet interest rates in the euro area are still considerably lower than elsewhere, notably the United States.

The outlook for the euro area economy in 2007 is good. It is likely that economic growth in 2007 will be slightly weaker than 2006, but the prospect is that countries will still experience strong economic growth, improvement in job creation and drops in unemployment. The countries in the euro area may look ahead to another good year.

Key Readings

Buiter (2006) argues that old criticisms of the Stability and Growth Pact survive intact, but emphasizes two further features. First, the Pact imposes constraints on national fiscal autonomy, but there are no clear cross-border externalities that warrant debt and deficit limits. Second, the Pact cannot address E(M)U-wide stabilization and the fiscal-monetary policy mix.

El-Agraa's (2007) textbook is designed for readers from all disciplines studying the EU, its economics and policies and the effects of economic integration. It offers an overview of economic policies and principles (including chapters on theories of economic and on monetary integration) and touches on various policy-making areas. It is among the most useful textbooks for those mainly interested in the economics of the EU (for a discussion of De Grauwe 2005, see last year's review).

Puetter (2006) is the first study on the work of the Eurogroup – monthly informal meetings between euro area Finance Ministers, the Commission and the European Central Bank. It examines how this group of senior decision-makers shapes European economic governance through a routinized informal policy dialogue. It shows how an understanding of the interplay of formal provisions and informal processes is pivotal to the analysis of euro area governance.

Torres *et al.* (2006) explore issues of economic and political governance in the European Economic and Monetary Union. Combining the perspectives of economics, law, political science and historical research, it provides an up-to-date analysis of the development of the Eurozone and assesses the prospects for the economic and political sustainability of the euro.

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