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THE CANARY ISLANDS ECONOMY AND THE EFFECTS OF AN EXPANDED EUROPEAN UNION

I will try to synthesize the context of the Canarian economy, the generation of economic activity in this environment and the prevision about the effects on our small economy from the 5th expansion of the European Union (EU).

Economic activity is the manifestation of the relationship between economic agents: families or households, private and public businesses, the public sector, in their different levels of administration, and the rest of the world, given that we are part of an open global environment. This is what we always pretend to measure through aggregate variables, such as GDP, employment level and unemployment. From these we intend to capture the signals that are revealed through the actions and reactions that come about by these economic agents in the goods and services, financial and foreign exchange markets.

The presentation will expound at first on the economic situation in the Canary Islands with respect to the international economy and that of Spain and later expound on the expectations of the latest EU expansion.

1. INTERNATIONAL ENVIRONMENT

The signs of recuperation are not very clear in the principle economies of the world. The uncertainties of the last few years have slowed down growth expectations. For example, September 11th terrorist attack on the World Trade

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Centre, various highprofile business scandals, Iraq war, March 11\textsuperscript{th} terrorist attack in Madrid... The uncertainty of the geopolitical environment has passed, although with it there has been an increase in the possibilities of negative demand shocks which could lead to recessive situations and their consequent effects of deflation.

1.1. Monetary Policy

Not since the 1960’s have we seen monetary policy designed by the US Federal Reserve Bank and European Central Bank to have lowered their official or discount rate and, consequently, interest rates have achieved minimum historic levels. Having reduced their official rates, the Central Banks have articulated policies of more liquidity which then has led commercial banks and savings banks to have increased access to credit. This in turn has triggered the strengthening of the process of the “multiple expansion of deposits and credits”, typical of “advanced financial systems”.\textsuperscript{2} This increase in the monetary multiplier has translated into increased monetary supply (corresponding Monetary Aggregate M3).

This increase in monetary supply, liquidity, has been reflected in the bond market, by generating an increase demand for bonds. Thus prices for bonds have gone up and consequently a fall in effective market interest rates. Furthermore, monetary policy has been made under a context in which weakness in demand is forecasted, i.e. these negative demand shocks. Although, in this process there is limited manoeuvre left as monetary policy in the USA has put interest rates at 1% which is very near the level in which could endanger the stability of the financial system.\textsuperscript{3} During 2004, the official US interest rates have been ratcheted up to 2.25%, meanwhile the European Monetary Union has maintained its rate at 2%.

1.2. Fiscal Policy

In contrast, the implementation of fiscal policy by USA and by European Monetary Union has not been the same. The US economy has maintained a more relaxed fiscal policy, approving President Bush’s Fiscal Plan, while in Europe the dominant criterium, at least, until summer of 2003, has been to follow a restricted policy through the Stability and Growth Pact. This being reforms that reduce public spending in the present and future, which has generated an intense debate and sometimes bitter feud between countries that have achieved the fiscal policy.

\textsuperscript{2} Central Banks, Commercial Banks, Savings Banks.

\textsuperscript{3} Some authors identify this level at 0.75\%.
and those who haven’t. Furthermore, the continued maintenance of the restricted policy has encountered social opposition of various magnitudes in the European Monetary Union. Spain has maintained this criterion even though a change in government took place in 2004. With respect to the debates regarding the Stability and Growth Pact, it is important to note the possible negative consequences of the rupture of the criteria of fiscal and budgetary control by France, Germany, and Italy. This pact has brought good results in stability and generating confidence among many distinct, public or private, economic agents. This together with supply policy measures to propel flexibility and competition in the distinct goods and services markets as well as factor’s markets has been noted in the generation of economic activity and employment throughout the EU.

On the other hand, we must emphasise the pre-eminence of our market economic system as a mechanism to assign resources as well as, to be more precise, to point out the existence of problems characteristic of the system like: poverty, social exclusion, marginalization and instability. Furthermore, there is a wide margin of manoeuvrability from distinct Public Administrations, even under these tight constraints in the management of their respective budgets. Additionally, there is a certain responsibility that must be assumed by business leaders and unions in this respect. Without minimising social policies, the greatest possibilities of resolving the problems of poverty, marginalisation, social exclusion and instability, rest in the creation of employment and consequently, in the generation of economic activity in the short, medium and long term.

The expectations for economic recovery and confidence among economic agents are occurring at a faster rate then forecasted at the end of 2003. In the USA, it seems that the long-awaited recovery has been confirmed. This is tied to fiscal expansion, pulled by rising internal demand and the depreciation of the dollar, which in turn has increased external demand. Furthermore, investment has responded slowly and the American authorities are making a strong effort to sustain consumption and favour exports.

The recuperation in the world economy will continue depending on the growth of the American economy which has been supported by low interest rates, fiscal expansion and the depreciation of the dollar. Closing 2003 with 3.1%, the signals confirm, which was previously pointed out by Professor J. Donges, that the world economy is on the right track with expectations of 4% in the USA, 6% South East Asia, 8% China and 8% in India for 2004.

Confirming these expectations, in the medium term, it seems that the criterion of the principle latent problem in the US economy, i.e. the shortage of national savings, have been loosened. This being derived from a previous context of deceleration as private savings had barely increased and public savings had decreased as a consequence of fiscal expansion. What it had

4 Greater than expected.
generated is that the American economy had increased its dependence on foreign savings, amplifying their trade deficit, greater than 5% GDP, which constitutes as well a latent risk factor not only for the USA.

There persists a certain disappointment in Europe with regard to the low level of economic growth. In 2003, growth in Europe was 0.4% GDP, almost 1/8th of the American growth. Negative demand shocks, overinvestment in technology, losses derived from investments in USA and the appreciation of the Euro have put the brakes on the recuperation. Furthermore, the economy hasn’t received as much support from monetary and fiscal policies. The previsions for EU growth for 2005 are expected to be 1.5%\(^5\), similar to the levels of 2004. This is in contrast to a relative improvement in the international economy and a certain recuperation in consumer and business confidence. Therefore we have “a recovery but still little growth”. As stated by Professor Donges, “Spain has done what it could do, growing more than the average of all EU countries. But even with this, it couldn’t implant this on the rest of the EU. This is especially due to the brakes put on by the German economy through policies that have increased an already costly welfare state.”

We are, therefore in an environment of moderate growth, where interest rates have been maintained at their historic minimums. During 2004, the interest rate increases have been very modest, only in function of the necessity to correct recovery of actual liquidity and neutralise their possible inflationary effects.

2. SPANISH ENVIRONMENT

In terms of GDP growth the Spanish economy has fared much better than the EU average. Spain’s growth rate was 2.4% in 2003, 0.4% more than 2002, interrupting the deceleration phase initiated in 2000, although this phase of deceleration is continuing for the EU as a whole. In 2004, the growth rate in Spain should advance even more to 2.8%\(^6\). Consequently, the vitality of the Spanish economy during 2003 and 2004 has been developing much better than the European economy as a whole.\(^7\)

\(^{5}\) Although we have to check for the effects of the EU expansion.

\(^{6}\) Forecasted by INE and Funcas.

\(^{7}\) See the article presented in the conference sited above by Juan Iranzo that clearly states the underlying challenges of Globalization, European Economic Union, EU expansion, Aging of the population and immigration, Reforming and Revising Institutions of the EU, Sustainable Development, Supply Crisis (not demand) and concluding the importance of orthodox economic policy which leads to a flexible and stable path.
The increase in GDP has been supported by:

Minimum interest rates without significant increases over the short term. This has motivated a continuous recovery in capital investment by businesses (due to the low real cost of capital). This minimum demanded yield for investment projects together with the greater growth perspectives in Spain in comparison with the rest of the EU combined, allows for a forecast of consolidation in the recuperation in capital expenditures around the 2003 average growth of 3%. As for construction spending, it will increase by 2.9%, less than the last 4 years in which this type of investment grew much more than GDP. This reveals a process of adjustment that will continue in 2004 as a consequence of less construction investment for civil infrastructure by the AA.PP. (Public Administration) and less demand pressure for new housing due to their elevated prices.

With an impulse from the reform of the personal tax code on household disposable income, internal domestic spending has increased. This reform will increase household income by 3000 million Euros in 2003 and 600 million more for 2004. Consumer spending grew 2.5% in 2003 and similar to this in 2004. Thus, it is clear that the driving force in the evolution of household consumption has been the effect of the tax code reform, interest rates and the return from fixed assets in the creation of financial wealth compensating for the negative impact from the equity markets.

The pace of employment growth increased in 2003, with 484,700 new jobs created, which is the principle pillar of disposable household income. This growth in employment has surpassed expectations. Additionally, limited increases in salary have been maintained due to either reduced productivity gains or for controlling inflation. With this information the deceleration in employment growth from the second half of 2002 has been interrupted. Thus, this has contributed to a reduction in unemployment rate from 11.4% in 2002 to 11.2%, absorbing some of the increase in the labour force.

Improving growth in 2004 hasn’t been easy neither will it be for 2005 as the effects of the tax reform from the anterior government have waned. Although, excluding their relative importance, the economy has taken advantage of the effects of the reform in financing for local communities with the modification of the IME (local business tax). On the other hand, over the medium term, the forecast is for moderate increases in interest rates, which has already taken place in the American economy. In order to maintain growth, it will require a consolidation of the international economy that creates greater external demand. This will not be the only way for Spain to grow, as internal demand could continue responding thanks to the excellent performance of the Spanish economy over the

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8 Other aspects regarding the uncertainties of its effects would come from the reform of the Ley General Tributaria (General Tax Law) that took effect in July 2004 and the Ley General Presupuestaria (The General Budget) approved by the parliament in December 2003.
last few years, in which there is an accumulation of private savings and a deficit that is under control based on maintaining the criteria of the Stability Pact.

This combination between the protagonists of internal and external demand in economic growth in 2004 is significant. Depositing excessive confidence on the impulse of net worldwide demand was extremely risky; and as such, Spain’s price competitiveness with respect to the EU has been reduced. Several reasons cited for this are: productivity gains were less than other EU partners and in turn our partners applied multiple efforts to strengthen competition in their markets, which reveals that in Spain the markets for goods, services and labour reflect an oligopoly market power structure. On the other hand with respect to international commerce, Spain has been affected by the appreciation of its currency, the euro, against the dollar. All of which decreases its real trade balance and competitiveness in the marketplace. Thus, it is more difficult to export and easier to import, which furthermore conditions improvement on the expectation of greater external demand for the next financial year.

2.1. Prices and Salaries

Inflation has settled down and the perspectives stabilised. The liquid monetary policies only can be sustained if the basic objective of economic policy, such as inflation, is controlled. The IPC\(^9\) increased 2.6% in 2003, 9 decimals less than 2002 and in 2004 it was 2.4%. Favouring these improvements is the inexistence of the “rounding effect” from the changeover from pesetas to the euro and in addition in 2003 there wasn’t any increase in special taxes (as it was in 2002).

On the other hand, the evolution of our exchange rate, with an 18% appreciation of the euro against the dollar, has facilitated a decrease in inflation on imported products (logically the price in dollars for raw materials had increased, but not in euro terms or as in some cases even decreased in price). The price of petroleum had increased with respect to 2002, after surprisingly falling behind the conclusion of the Iraq war. In spite of this, this increase, as you will see, was more than compensated by the appreciation of the euro.

The inflation differential with respect to the EU, around 1%, has maintained stable during 2004. The existing difficulties in reducing this gap can be found in the following: a) in the greater increase in salaries per worker in Spain not compensated by more productivity or control of profit margins and/or b) by the existence of inefficient markets of oligopoly power structure (both in the goods and services market – prices higher than competitive markets- as well as the labour market – salaries higher than competitive markets).

\(^9\) The index Armonizado de Precios al Consumo IPCA (Harmonised Consumer Price Index) was 2.7%.
3. CANARY ISLANDS ECONOMY

With the statistical data from the Contabilidad Regional del INE (Regional Accounting from the National Statistical Office), the Canary Islands grew at 1.9% in 2002, 9 decimals below 2001 and one decimal lower than the national average. Meanwhile for 2003, growth stood at 1.5%, a difference from the improvement that Spain made as a whole from 2 to 2.4%. This level of positive growth is the lowest since 1996, and as such, continuing the downward direction in growth. The reason for this is owed to the decrease in the service's market and in construction which hasn’t been fully compensated by an increase in energy and public service activity. The economy in the islands has been influenced by the international crisis, the impact in the airline sector from the September 11th terrorist attacks, and in essence uncertainty in the geopolitical environment. The international passenger traffic in the Canary Islands' Airports was reduced by 4.3% and national traffic had increased by 1.4%. Reaching 20 million passengers in 2002 and 2003, meanwhile in 2001 it was 20.5 million. The slower economic activity in Germany and Europe, given its relevance for tourism in the Canary Islands, reduced the amount of tourists from that region which in turn affected a great number of local economic activities. These effects were somewhat mitigated by the increase in tourists from the mainland and Britain, which is experiencing, as well as that of Spain, greater growth than the EU average (about 1.7% and 0.5% respectively). Improving European confidence seems to be farther away from the scenario as the indicator of tourist activity by ISTAC, is once again showing a deceleration in the service sector, although the latest data for 2004 seems to show improvement.

By economic sectors, during 2002, the construction sector continued to be the most dynamic at 4%. Even though, a process of deceleration has continued (in 1999 it reached 18%). Industry showed a slight increase (3.1%) primarily due to the pace of development in energy production. Agriculture continued showing stagnation at 1.1%, but due to the limited role it has in GDP, the primary and secondary sectors only amount to 11%, this only added 2 decimals to the growth rate. In 2003 the behaviour of both of these sectors has been relatively stable as a consequence of weakness in demand. Construction (−1%) is showing signs of exhaustion from the positive demand “shocks” derived from the lower interest

10 This growth factor must be acknowledged as data not finalised although this is the forecasted level. See the presentation by José Carlos Francisco Díaz in the conferences already cited.

11 This represents in Canary Islands 60% of all economic activity.

12 A very interesting approximation that complements the standard profile of the productive structure was made in the presentation of Manuel Navarro Ibáñez in the cited conferences, which puts emphasis on the natural aspects of the New Economy.
rates and the tax code reform, as well as the effects of the end of an election cycle.

The trade sector in the Canary Islands is similar to that of domestic demand, which is at this point less dynamic. Imports from abroad have been reduced by 11.5% and imports from the mainland have increased by 5.2%. Remember that 70% of all imports to Canary Islands are provided for by the Spanish mainland. Exports to the rest of Spain grew 39%, which compensates significantly from the fall in exports to EU and the rest of the world (−12.5% and −3.5% respectively). As well, note that 54% of Canary Islands’ exports are directed towards the peninsula.

The labour market shows a positive profile of the Canary Islands’ economy. True, it has decelerated with respect to years past, but growth still reached 4.2% in the first quarter of 2003. This has broken the slowdown in the process of growth in the number of people employed and together with a strong increase in people actively looking for work has put unemployment at 11.5%. This is somewhat greater than the national average, but one must note that the activity rate in the Canary Islands is greater than the peninsula (60% vs. 54% respectively). This reflects the growth in population and their incidence in labour terms.

Lastly, we characterise the Canary Islands as a region with less inflation than that of the rest of Spain, even though this favourable difference has been reduced recently. What stands out is that the hotel sector shows price increases (3.4%) continuously greater than other products or sectors. This is relevant given the relative importance of the hotel sector in that of services as a whole. On the other hand, this behaviour profile of prices in the hotel sector is apparent, and somewhat more accentuated, in the nation as a whole. Revealing in both cases that the adjustment in prices is related to the evolution in demand, certainly with weaker growth prices this should stabilise, but still this is insufficient.

We can conclude that the expectations for 2005 present us with great uncertainty, above all, for a small, open economy such as the Canary Islands. To be precise, what is needed is, a recuperation in the European economy, a better international environment and a correct and coordinated institutional strategy, led by local and community politicians in order to take advantage of the recovery in the tourist sector.14

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13 This is in value terms (−0.5%) for the appreciation of the Euro.
14 See the intervention by Adán Martín Menis, presidente de gobierno de la Communidad Autónoma de Canarias, (President of the Autonomous Government of the Canary Islands), at the opening of the conferences cited before in which among many interesting aspects, he emphasised the importance of shaping strategies on leadership capacity in the tourist sector and promoting business-risk decisions thru support from distinct institutions and administrations. Furthermore, he stressed the need for continuous renovation of lodging infrastructure (maintenance), the adoption of the new tendencies in the markets, Public-Private ventures, the necessity of a new focus with
3.1. The effects of the EU expansion on the Canarian Economy

The Canarian economy represents 81% of GDP per capita of the EU; almost double that of the average of the newly integrated states in 2004 (45%) yet, on average, 20% below that of the EU community. The effects are outlined below:

1. Workers’ expectations for higher salaries and benefits in the actual EU, in virtue of being able to move about freely, suggest a migratory influx towards the EU-15. But we are not dealing with a very large population in the Canary Islands and besides, the distribution of such migratory flows will be spread out among the 15 countries of the UE. Furthermore, the majority of these migrants will flow towards countries closest to their origins. With respect to migratory influx, it is not foreseen that the Canary Islands will receive an intense influx of these new citizens of the European Union.

The labour market in Canary Islands shows a more positive profile in occupation and unemployment than the average of the newly incorporated countries, although it has a less favourable profile when compared with the rest of Spain and the actual EU. With respect to productivity and labour costs, the Canary Islands are relatively well situated with productivity around the EU and Spain average and with competitive labour costs.

We should note that salary levels (18.5%) and labour costs (4.2€/hour) in the new member states are very low when compared to Spain as a whole (63.3%) and that of the Canary Islands (53%), respectively. Problems of industrial relocations for cost advantages will not be a problem for the Canary Islands. This is so because of the limited weight of this sector in the economy of the Canary Islands and for its distance geographically. Nevertheless, the com-

heterogeneous solutions for the 7 islands, the importance of boosting the Common Canary Islands’ Market and the fact that it is an extreme, outlying region of the EU, and the need to create objectives for its position (Ultra periphery Region –RUP–), the pursuit of sustainable development, the dilemma of quality of life vs. income, system of public assistance, the desire to overcome the restricted framework of 1.15% of the European GDP dedicated for financial assistance and bring it to 1.24%, the improvement in infrastructure, the connection of the Canary Islands with the exterior, the consideration of the Canary Islands as a platform of tri-continents (connecting Central and South America, Africa and Europe), the potential of public services in conjunction with the State, the theme of excess tourist populations and the situation derived from irregular immigration. Aspects in the same way that José Carlos Mauricio, Consejero de Economía y Hacienda de la Comunidad Autónoma de Canarias (Councillor of Economics and Tax for the Canary Islands’ Government), spoke about in his closing speech at the cited conference.


The preceding EU responds to the reference index of 100%.

The 5th expansion of the EU was carried out on 1st May 2004 with the inclusion of Cyprus, Slovakia, Slovenia, Estonia, Hungry, Lithuania, Malta, Poland and Czech Republic.
petitiveness and the productivity of the Canary Islands require greater use of human capital (training). In this sense, surprisingly these new countries have a great advantage if you compare their education level, on average 64% of the population have secondary education vs. Spain’s and the Canary Islands’ 19%. In spite of this disadvantage, Canary Islands will have relatively less problems than the newer countries to transform their workers into skilled labourers, because those countries lack sufficient labour experience in market oriented businesses.

With respect to migratory flows, the number of immigrants from these regions of approximate adhesion will not even reach 1% of the total flow of immigrants that will arrive in the Canary Islands. The adhesion will produce a greater number of these immigrants, albeit in a small way, but this will dwarf in comparison to other populations of origin (Central and South America, Morocco and other surrounding countries and Sub Saharan Africa).

2. The immense weight of the tourist sector of the Canary Islands’ Economy contrasts with the productive structure in these new countries, in which the industrial sector dominates. Of the 10 countries, only Malta and especially Cyprus have a similar productive structure as the Canary Islands. These two countries could be considered as possible direct competitors of the Canary Islands. In difference to the predominant role tourism plays in the productive structure in the Canary Islands, this sector isn’t, nor much less, the base of their economic structure in these new countries, even though they receive many visitors, especially Poland, Hungary and Czech Republic. Nevertheless, these markets are not substitutes for the Canary Islands’ Tourist Market. Even though, it is possible to attribute a common market with Cyprus and Malta, but this would be on a much smaller scale as they do not receive nearly the number of visitors as the Canary Islands.

3. With regard to the external sector, the distinct productive structure between the 2 economic environments (Canary Islands and the majority of these new countries), the enlargement should be mutually advantageous. Exports from the Canary Islands to these countries are extremely small, almost testimonial, and imports are very limited. Nevertheless, after the expansion there could be a certain commercial stimulus.

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18 We assume that the obligation to study to at least this level now in Spain will correct this disadvantage.
19 Remember that of the 10 countries only Cyprus has a greater GDP per capita (86%) than Spain and the Canary Islands.
20 Excluding the effect of tourism, the exports from the Canary Islands are concentrated in food, tobacco and raw materials (derived from refining petroleum) of very limited importance in the commercial trade of these countries, as their commercial trade is predominately in manufactured goods and machinery.
4. In the Canary Islands the percentage of investment of GDP (27.7%) is significantly greater than the European average (19.9%) and is somewhat greater than the newly adopted countries (25.5%). Yet these countries have received a greater portion of direct foreign investment (4.9%) and Europe (3.8%) compared to Canary Islands (3.4%) and (0.7%) respectively. The registry regarding investment in the Canary Islands shows as well that investment is above Spain’s as a whole (26.3%). One point that stands out is the important role Canary Islands business owner’s play in their investment decisions or employing capital. This greater percentage weight of GDP has occurred even when the reception of foreign capital has been inferior to that received by similar environments, may it be EU, Spain or the newly incorporated countries. Concretely, Spain has received direct foreign investment of 11% and from Europe 7.6%, which is much more than what has been received in the Canary Islands. Behind this signal of business confidence is the effect derived from the Reserva para Inversiones de Canarias (RIC) (Canary Investment Reserve). This aspect is of vital importance that requires good management and coordination.

5. Another aspect to note is the impact of European Funds. Canary Islands has maintained its status as an objective 1 region until 2006, which in turn has enabled it to receive 402 million Euros per year. The 10 countries that have just integrated into the EU in 2004 have also received these funds, totalling 7,242 millions of Euros per year. The EU is responding in this way, logically to their objective of creating a better economic and social cohesion thru these measures.

In short, we can conclude that the relative importance of the direct effects in the Canary Islands due to the 5th expansion of the EU is quite limited. Nevertheless, there will be some “induced effects” that should be considered.

With respect to the integration of the new countries in the EU, it obviously will have a statistical reflection, this being a lower average in income level. However, the threshold of 75% has already been surpassed by the Canary Islands’ economy several years back. In my judgement, there is a great sense of satisfaction for having achieved real and nominal convergence with the rest of EU. It is true with this; the Canary Islands will be out of the criteria for Objective 1 regional status. This aspect must be assumed coherently as a point of solidarity. Therefore, from this new situation or relative position we should act accordingly and appeal to be recognised as an “Ultra Periphery Region” of the EU.

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21 See Sosvilla Rivero Simón (2003). The results of the evaluation of the assistance doming from EU in the period of 1989–2006 compared to the situation without those funds, “we can affirm that the total effect would be a difference in real GDP growth rate of 0.78% per year during 1988–2006. With regard to the labour market, it is estimated that the full effect of the investments and assistance from the European Funds have generated, on average from 1989–2006 7,000 employees more than if no European Funds were employed. This has translated in an average reduction of unemployment by 0.73% during this same period”.

22 Spain as a whole received 6,438.7 million € per year.
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GOSPODARKA WYSP KANARYJSKICH:
SKUTKI ROZSZERZENIA UNII EUROPEJSKIEJ

Celem autora artykułu jest przedstawienie sytuacji gospodarczej Wysp Kanaryjskich na tle Hiszpanii, krajów Unii Europejskiej, a także Stanów Zjednoczonych.

Atak terrorystyczny na World Trade Centre, skandale w zakresie księgowości kreatywnej, wojna w Iraku, atak w Madrycie – to tylko niektóre sytuacje, które bezpośrednio wpłynęły na spowolnienie tempa wzrostu gospodarczego na świecie. Rozważając tę sytuację szczegółowo autor skupia się na polityce monetarnej oraz finansowej, która dominowała po 11 września.

Polityka finansowa Unii Europejskiej i Stanów Zjednoczonych różni się zasadniczo. Unia prowadzi politykę systematycznego ograniczania wydatków publicznych poprzez tzw. pakt stabilnego wzrostu, co spotyka się ze sprzeciwem krajów członkowskich, szczególnie wśród
nowych członków Unii. Stany Zjednoczone opowiadają się raczej za liberalną polityką w zakresie finansów publicznych, co jest realizowane poprzez plan finansowy prezydenta Busha.