

INTERNATIONAL CENTRE FOR ECONOMIC RESEARCH



WORKING PAPER SERIES

George Irvin

THE IMPLOSION OF THE BRUSSELS ECONOMIC CONSENSUS

Working Paper No. 11 / 2005

The Implosion of the Brussels Economic Consensus

George Irvin

May 2005

Abstract.

Underlying the current political crisis of EU is a decade of cumulative malaise produced by low growth, high unemployment and welfare cuts. The poor economic record of the core Eurozone states is attributable neither to supply-side sclerosis nor top-heavy welfare, but rather to the ECB's obsession with inflation and the fiscal strait-jacket imposed by the Stability and Growth Pact (SGP), referred to here as 'Brussels Consensus' economics. The paper critically examines the SGP rules, argues that the 2005 SGP compromise reached at Luxembourg has not addressed the fundamental problem of Europe's asymmetric economic institutions, and proposes radical remedies.

Key Terms: Eurozone growth, unemployment, Maastricht, EIB, SGP rules, EU fiscal and monetary policy, neo-liberal Brussels consensus.

'It is not too farfetched to say that Europe chose never really to recover from the two worldwide oil-shock, anti-inflation recessions of the decade 1973 to 1982. Europe seems content to return to sustainable growth rates at lower and lower rates of utilization, without ever recapturing the ground lost in those recessions. With chronic double-digit unemployment rates in several members of the EU, the policy might be described as cutting out of the economy large fractions of the population, buying their acquiescence by welfare-state transfers, and then blaming the "structural" unemployment on the transfers. ... I am not enthralled by the recommendations I heard ... that the US follow the European example and gear monetary policy exclusively to price stability. This orientation of monetary policy has been very costly in Europe, and it is likely to be even more costly if it is enshrined as dogma by the Maastricht Treaty' (James Tobin 1994).¹

1 Introduction

The paper addresses a non-specialist audience on a subject about which there is a voluminous but often inaccessible professional literature. Underlying the current political crisis of EU---highlighted by the probable rejection of the Constitutional Treaty in France and/or The Netherlands--- is a decade of cumulative malaise produced by low growth, high unemployment and welfare cuts. The lamentable economic record of the core Eurozone states is attributable neither to supply-side sclerosis nor top-heavy welfare, but to the ECB's obsession with inflation and the fiscal strait-jacket imposed by the Stability and Growth Pact (SGP). Completion of the euro might have proceeded had a sensible macroeconomic framework been adopted. But the Maastricht-SGP institutional framework, the 'Brussels Consensus', is characterised by assigning all power to a central monetary authority, leaving fiscal balance to be achieved at state level by means of automatic stabilisers. Because the Eurozone is necessarily constrained by a one-size-fits all monetary policy, flexible and co-ordinated national fiscal policy is needed, ideally complemented by a central budget. Instead, the Eurozone got (and still has) the Stability and Growth Pact.

The paper starts with the basic data on the poor growth and employment performance of the core Eurozone states over the past decade, particularly since 2001, and describes the institutional setting and policy constraints. The underlying economic logic of the Maastricht arrangements is explored; in particular, the asymmetry between strong monetary governance assigned to the centre and weak fiscal authority granted the member-states. Section two asks whether an explanation is to be found in the changing historical circumstances and anti-Keynesian ideological climate of the two decades prior to Maastricht. In the third section, the SGP is critically dissected and alternative arrangements are examined. The fourth and final section argues that given the paucity

¹ Quoted in Bibow (2004: 1).

Component	1996-2000	2001	2002	2003	2004
GDP	2.7	1.7	1.0	0.8	2.3
<i>GDP Eurozone*</i>	<i>2.6</i>	<i>1.6</i>	<i>0.9</i>	<i>0.5</i>	<i>2.1</i>
Private Consumption	2.7	2.0	1.2	1.4	1.9
Government Consumption	1.7	2.5	3.2	1.9	1.9
Investment	4.3	0.4	-1.5	-0.1	2.9
Exports	7.8	2.9	1.6	0.6	7.0
Imports	8.3	1.3	1.1	2.4	6.9

Source: Eurostat (2005), *Real GDP Growth Rates*; Euro-memorandum Group (2004), p 6.

* Eurozone figures differ marginally from those of the EU-15; demand components refer to the EU-15.

of alternatives available in Brussels, nothing less than major surgery will suffice: this includes changing the statutes of the ECB, scrapping the SGP so enabling a more flexible response to shocks, and most importantly, setting in place a federal budget large enough to both promote integration and cohesion while serving as an instrument of Union-level fiscal policy.

1.1 Political and Economic Crisis

The EU has been plunged into a political crisis over the ratification of the Constitutional Treaty. Whatever the weight is given to factors such as the democratic deficit, the poverty of public discussion and the ‘national protest vote’ factor built into all referenda, at the root of this crisis is a decade of high unemployment and low growth in the core countries of the Eurozone. Table 1.1 shows the record for the EU-15.

In the mid-1990s, growth was constrained as countries tightened their budgets to meet the Maastricht convergence criteria as a condition for joining the euro. In 1999-2000, there was a slight spurt in growth, but this slowed with the world slump in 2001. Since the adoption of the Lisbon Strategy in 2000, average annual growth of the EU15 has been of the order of 1.5%, or half the value envisaged for the decade. Low investment has been the main factor slowing economic activity; for the first four years

of the new decade this rose by an average of less than 0.5% per year. Private and Government consumption have not been buoyant either, growing at around 2% per annum; enough to keep the EU moving forward, but not enough to rekindle investment growth. Exports, buoyed by growth in 2004, have grown at an average annual rate of just over 3%. Poor growth and persistent unemployment tend to be bedfellows. Average Eurozone unemployment in early 2005 stands at 8.8%, barely down on the 9% figure recorded in 2000.²

The Eurozone figures mask significant discrepancies between countries; good performance in countries like Ireland, Greece and Austria contrasts with the poor performance of the Eurozone's core countries. In 2003, Germany, France and Italy experienced several quarters of zero or negative growth, which together with very low inflation put these countries at risk of tipping into deflation. In 2004, French and Italian GDP growth was under 2% and German growth in the last quarter of 2004 was fractionally negative; in 2005 first quarter data for Italy shows it to be slipping into recession.

In 2003, the IMF³ reported that Germany, the locomotive of the EU economy, might soon join Japan in the deflation league.⁴ Since 2000, Germany's GDP growth rate has been barely positive while France and Italy have fared little better. Germany and Italy experienced negative growth in the final quarter of 2004. In the Eurozone since 2000, inflationary pressure has gradually declined. For 2004, the Eurozone annual inflation rate was 1.7%---and only 1.4% when food and energy prices are excluded.⁵ In 2003, in response to the Broad Economic Policy Guidelines (BEPG) issued by the Commission that year, UEAPME, the representative body of Europe's Small and Medium Size Enterprise issued an uncharacteristically strong warning:

UEAPME recognises the importance of stable prices for the economy and the efforts made by the ECB in the past to ensure this. However, high inflation rates are not the

² See OECD Quarterly National Accounts Database; 13 May 2005.

³ See IMF (2003).

⁴ See Paul Krugman 'Stating the Obvious' May 27, 2003; also The Economist, 'Of debt, deflation and denial' Oct. 10, 2002.

⁵ See OECD Consumer Price Index, 30 March 2005.

problem at the moment and we ask the ECB to use the room for an interest rate reduction for a more proactive approach towards the monetary environment: Low levels of demand (private consumption and investments), decreasing oil prices and the strong Euro are reducing the pressure on inflation. High inflation differentials between member states make it necessary to rethink the inflation targets in order to avoid the danger of deflation at the lower end of the scale. If deflation happens, monetary policy will lose most of its instruments, therefore, everything has to be done in order to avoid it from the start.⁶

1.2 Policy Responses

Over the 2001-2003 downswing the ECB cut rates from 4.75% to 2%, where the rate still stands today. In contrast the more pro-active Federal Reserve Bank (the US Central Bank or 'the Fed' for short) cut rates in the downswing from 6% to 1%.⁷ Moreover, the ECB has refused to budge despite evidence from the OECD that the Eurozone's monetary transmission mechanism is slower than in the US; ie, that a *more* proactive monetary policy is required in the Eurozone to achieve the same effect as in the US.⁸

The problem is not merely that the ECB is too cautious. Many economists consider the ECB's narrow focus on inflation as one reason for the stagnation in the Eurozone core states since 2001⁹. (By contrast, the US Fed focuses on getting the balance right between low inflation, low unemployment and growth.) Germany, France and Italy account for the greatest part of Eurozone output. While there is a certainly a case for looser monetary policy----particularly when core Eurozone states are at risk of deflation----monetary relaxation alone will not guarantee growth.

Monetary policy in the Eurozone is set centrally by the ECB. By contrast, fiscal policy is set both at EU level---the EU budget--- and, far more importantly, at the level of the individual member states. The EU budget is capped by the 1992 Maastricht Treaty at

⁶ UEAPME (Union Européenne de l'Artisanat et des Petites et Moyennes Entreprises) 'European Commission's proposal for the BEPG 2003 or shortcomings of Europe's economic policy; Position paper on Broad Economic Policy Guidelines 2003', Brussels, 3-6-03.

⁷ Since then the rate has risen to by steps to 2.75% (March 2005).

⁸ See Larry Elliot 'Brown needs to apply reverse thrust to Reagan theories' The Guardian, June 14, 2004.

⁹ Detailed evidence, including figures on the weakening of Eurozone domestic demand, is given in Bibow (2004). For a critical discussion of the SGP, see Arestis and Sawyer (2002, 2003).

1.24% of combined EU Gross National Income (GNI)¹⁰, while actual expenditure is slightly less (1% of GNI) and the bulk of the money goes on the Common Agricultural Policy (CAP) and structural funds. Moreover, the EU's annual budget must balance by law. This makes the central budget quite useless for counter-cyclical policy, the burden of adjustment falling entirely on fiscal policy in the member states.¹¹

Fiscal expenditure by the member states is constrained by the provisions of the Maastricht Treaty (Article 104.3) and the Stability and Growth Pact (SGP) of 1997. According to SGP rules, Eurozone states should not allow their budget deficit to rise above 3% other than in very exceptional circumstances; total public sector borrowing (PSB) should not exceed 60% of GDP and national authorities should aim at budgetary balance or surplus over the business cycle. The '3/60 rule' was enshrined in the Treaty as a target to be met for joining the euro. It was supplemented by the 1997 Stability and Growth Pact (SGP), making the rule permanent and enabling the Commission to take action against offending states.¹² In short, fiscal policy in the Eurozone is severely constrained at EU level by the size of the budget and the legal requirement that it must always balance; at member-state level, fiscal policy is constrained by the SPG.

Because fiscal policy is purely the responsibility of individual member states, the European Commission attempts to co-ordinate fiscal goals by means of the Broad Economic Policy Guidelines (BEPG). These were first issued in 2000; they are meant to provide a set of short- and medium-term policy goals for Eurozone countries and are revised periodically. Although the BEPG do stress worthy aims such as improving infrastructure, raising employment, investing in life-long education and improving social inclusion, the BEPG are no more than 'guidelines'.¹³ This leads to a double co-ordination failure. First, there is little co-ordination of fiscal policy between member-

¹⁰ When EMU was first discussed in the 1970s, the Chief Advisor to the Treasury, Sir Donald MacDougall, suggested the EU budget should be about 7% of combined GDP if it was to be used as an effective instrument in correcting the business cycle (MacDougall Report, 1977). The figure of 1.27% was fixed at the Berlin summit of 1999 for the perspective period 2000-2006. The GNI equivalent of this percentage is 1.24%.

¹¹ See Begg (2004).

¹² Determining whether a country has breached the rules is one of the functions of Ecofin, the Council of Economic and Finance Ministers of all EU member states. Full Ecofin meetings are usually preceded by a meeting of 'narrow' Ecofin; ie, its Eurozone members.

¹³ Sapir (2003), whose views on EU macroeconomic policy are quite different from those presented here, agrees that the BEPG and the 'open method' of co-ordination are very weak tools.

states; secondly, since the ECB is shielded by statute from consultation with member-state Governments, there is negligible co-ordination of monetary and fiscal policy.

It has been apparent since 2001 that, in the trough of a business cycle, budgetary deficits in the core countries would exceed 3%. In 2003, first Germany and then France and Italy were reprimanded by the European Commission; legal proceedings were started at the European Court of Justice (ECJ), which in 2004 threw the case back to the Council where a majority of members voted against sanctions. Given that the Maastricht Treaty and SGP are embedded in the Constitutional Treaty, it has become ever more necessary to come up with a 'workable' SGP or else drop any pretence of making it legally binding. At the time of writing, Finance Ministers of the EU-25 have reached a patch-up compromise over Luxemburg's very modest proposals for reforming the Pact. The ECB and many members of ECOFIN¹⁴, meanwhile, continue to oppose any relaxation of the SGP rules.

In short, economic policy in the Eurozone states is constrained today by a variety of rules and practices, sometimes referred to as the 'Brussels' consensus:

- A single monetary authority at EU level, the ECB, which is not pro-active, which focuses exclusively on inflation and whose discussions are not subject to public scrutiny;
- At member-state level, the Maastricht-SGP rules which cap public borrowing and keep fiscal policy too tight in a downturn and over the business cycle;
- a small and inflexible EU budget, nearly half the resources of which are committed to subsidising farmers via the Common Agricultural Policy (CAP);
- weak fiscal co-ordination between states, no co-ordination between monetary and fiscal policy and the absence of a long-term growth strategy;
- the belief that supply-side measures alone, ranging from flexible labour markets to higher R&D expenditure, will bring private investment-led growth.

¹⁴ ECOFIN is the acronym of the Economic and Finance Committee of the EU Commission; the Committee is made up of the member-states' Finance Ministers.

2 The Brussels Consensus and the economic asymmetry of the Union

The theoretical underpinnings of these arrangements, much influenced at design stage by the *Bundesbank*, are strictly orthodox---or neo-liberal to use the contemporary phrase. The Brussels Consensus¹⁵ has been aptly described as the application of the Washington Consensus to Europe, a set of principles emphasising, first, balanced budgets and price stability attainable through shrinking the size of the state; and secondly, structural reforms opening the economy to international competition. In the case of the EU, the institutional arrangements of the currency union are uniquely conservative. Power is concentrated in the hands of a fully independent central monetary authority; a Competition Commissioner enforces economic liberalisation; fiscal policy is left to the member-states and constrained by the SGP; and ‘accountability’ depends at union-level on a Parliament lacking the power either to shape the institutional arrangements of economic governance or to initiate policy.

The basis economic logic of the consensus can be summarised as follows. The ECB controls inflation at EU level through the interest rate instrument. (The ECB’s ‘two-pillar’ policy also includes a money supply target for M3, although this has recently been modified.) Inflation is targeted by statute to remain below 2%, a rate considered to be the irreducible ‘core rate’ of inflation. Equally, it is assumed that monetary policy has no long-term effect on the real economy. According to this reasoning, monetary policy cannot affect unemployment since this must settle at its ‘natural rate’, while monetary policy affects growth only indirectly by keeping inflation and thus inflationary expectations under control. Since there is only one goal (low inflation) and one instrument (the repo-rate), the ECB cannot have an exchange rate policy; ie, the underlying theory is that once the ‘core’ interest-rate is attained, the correct exchange rate will automatically be achieved by market forces.¹⁶

¹⁵ Excellent characterisations of the ‘Brussels Consensus’ appear in Tamborini (2004) and Fitoussi and Saraceno (2004); the latter refer to the Brussels-Frankfurt-Washington (BFW) Consensus.

¹⁶ Not only is such a view untenable theoretically since foreign exchange markets regularly overshoot, it means in practice that the ECB has adopted a policy of ‘benign neglect’ of the euro, allowing it to appreciate strongly against the US dollar. In this, the ECB accommodates the Bush administration’s ‘benign neglect’ of the dollar, justified on the grounds that the free market can be left to solve the US external account deficit.

Nevertheless, because of the one-size-fits-all nature of monetary policy in a monetary union, the monetary instrument must be complemented by fiscal policies tailored to meet the needs of member-states. Differences arise between member states because they are of differing size and strength or because their business cycles differ, or else because unpredictable outside shocks affect them in different ways (what economists call *asymmetric stochastic* shocks). But if asymmetric shocks are a potential problem, an even greater problem is that of member-states adopting discretionary fiscal policies.

If member states were left entirely free to pursue their own fiscal policy---so the orthodox account goes--- they would spend freely, spreading inflation and leaving others to foot the bill; ie, they would become ‘free-riders’. The centre must impose discipline in the form of a Pact. The SGP restriction on the budget deficit---that it cannot exceed 3% and must balance over the cycle---serves two aims. First, in the short-to-medium term, it constrains member-states to a fiscal stance that leaves no room for discretion; ie, macroeconomic balance over the cycle is governed entirely by the action of automatic stabilisers. (It is the orthodox view that because of the nature of fiscal lags, discretionary fiscal policy is often pro-cyclical and thus best abandoned.) Secondly, in the longer-term, the zero budget balance requirement ensures that the size of public debt falls to zero; in other words, that the state---because it can neither borrow nor print money, and is gradually compelled by tax competition to lower taxes---is forced to contract. Equally, this division of labour between the ECB monetary giant and the member-state fiscal dwarves ensured a unique ‘well-behaved’ policy environment in which growth can take place.

In the world described above, unemployment cannot arise because of deficient demand (Keynes’s central hypothesis). Rather, insofar as the ‘natural’ rate¹⁷ of unemployment is exceeded, unemployment arises either because inflationary expectations lead to unrealistic wage demands or else because wage markets are ‘inflexible’; ie, wage bargains are too strongly influenced by trade union bargaining at national or regional level. In consequence, much of the debate about the Eurozone’s poor performance has concentrated on structural obstacles to the smooth functioning of the free market;

¹⁷ This ‘natural rate’ is usually called the Non-Accelerating Inflation Rate of Unemployment’ (NAIRU). Orthodox theory posits that although actual unemployment may temporarily differ, in the long term unemployment must settle at NAIRU.

notably, labour market rigidities, a welfare regime that discourages work, burdensome taxes on enterprise and so on.

According to the orthodox theory, such problems are all different faces of the same coin; they can be cured by a prolonged period of unemployment that dampens inflationary expectations and weakens trade unions. A corollary is that unemployment may also arise because of excessive charges borne by employers leading to a loss of 'international competitiveness'; however, this too is curable since contracting the state removes the need for such costs. If one completes this picture with trade liberalisation (already achieved), services liberalisation (nearly achieved), a competition Commissioner to ensure the liquidation of public monopolies such as power and railways, longer working hours, lower pensions and so on, then in the words of one commentator "the European Union appears as the neo-liberals' ideal world".¹⁸

For ordinary mortals, though, this world turns out to be one of unemployment and very low growth in the core states---hardly a world designed to foster the knowledge economy, sustainable growth and social cohesion envisaged in Lisbon 2000. Since the institutions of the European Union were not very democratic to begin with, prolonged unemployment and growing pressure to prune the state, cut welfare, privatise pensions and so on invariably lead to a crisis of legitimacy. This is the crisis Europe faces today. In short, although creation of the euro may be symbolic of the rise of an alternative model to that of US capitalism, the completion of EMU is unfinished and unbalanced; without substantial modification, the economic foundation of Europe cannot sustain the European Social Model.¹⁹

¹⁸ See EPOC (2005) Chap 3, p 17 (prepared by Malcolm Sawyer).

¹⁹ A number of recent books, somewhat prematurely, have painted the European model in glowing terms relative to the US variant of capitalism; see for example Haseler (2004), Rifkin (2004).

2.1 Why was Maastricht so conservative?

It is important to distinguish between the advantages of the euro, and the disadvantages of the Eurozone's economic architecture. Creating a common currency not merely reduces transactions costs, making cross-border dealings more transparent and facilitating economies of scale; crucially, a single currency protects the Eurozone from speculative attack by increasingly powerful financial markets. This is a considerable accomplishment. By contrast, because of the 'bankers' orthodoxy' inherent in the Maastricht-SGP rules, the full advantages of the euro cannot be realised.

The Maastricht economic rules were first conceived in the late 1980s at a time when the world was emerging from a period of serious inflation and the ratio of public debt to GDP in many EU countries had grown alarmingly. With hindsight, it is perhaps understandable that the Treaty's drafters---including the French socialist, Jacques Delors----should have been so cautious. Public finances in most of the then 12 member-states had deteriorated; in the early 1980s, countries such as Belgium, Greece, Italy and Ireland had public debt stocks in excess of 100% of GDP and current budget deficits as high as 10% of GDP. This issue was particularly sensitive in Germany, a country with a powerful Central Bank with a strong record of prudential monetary management. Broadly speaking, Germany and the financially stable northern European countries were concerned that their southern European neighbours might continue to run 'unsustainable' budget deficits for which they, the richer countries, might have to pay.

Secondly, economic ideology of the day was still strongly affected by the anti-Keynesian climate of Thatcher-Reagan years and by the belief that economic management should rely on rules-based monetary policy applied by independent central banks.²⁰ Governments' sole concern---so ran the Washington-inspired orthodoxy---should be to 'get prices right'; discretionary fiscal policy was strongly discouraged and the monetarist doctrine of the Chicago School had gained worldwide

²⁰ For a succinct summarisation of the 'New Consensus Macroeconomics', see Arestis and Sawyer (2003). Particularly apt is the notion that "the essence of Say's Law holds, namely, that effective demand does not play an independent role in the (long-term) determination of the level of economic activity, and adjusts to underpin the supply-side determined level of economic activity (which itself corresponds to NAIRU). Shocks to the level of demand can be met by variations in the rate of interest to ensure that inflation does not develop (if unemployment falls below NAIRU)." (p 3.)

influence. The drafters of the Maastricht Treaty were not necessarily monetarists, but like all bankers they believed in ‘sound money’.

Thirdly, for two decades policy makers have been obsessed with maintaining the confidence of powerful international financial markets. This first became apparent in 1982 when the newly elected Mitterrand Government tried to use Keynesian measures to reflate the French economy, thus precipitating a run on the franc. Subsequently, France focussed on keeping its currency strong; the *franc fort* policy. Delors himself had been Finance Minister at the time; more than most, he recognised the potential havoc that could result from losing the confidence of financial markets.

The year in which the Maastricht Treaty was signed, 1992, was also a year of chaos in the foreign exchange markets. Currency traders judged that public finances in some countries were overstretched, that inflation might result and therefore that those currencies were vulnerable. The Italian lira was vulnerable because government borrowing was thought far too high; whether the French could bring down their (far smaller) deficit was uncertain. Sterling was vulnerable because it was thought to have joined the Exchange Rate Mechanism (ERM) at too high an exchange rate.

In Britain, the memory of ‘Black Wednesday’ in September 1992 still rankles: over three days and at a cost to the Bank of England of nearly £10b in reserves, hedge-fund speculators forced sterling out of the ERM and Norman Lamont out of office. The franc and the lira also came under attack. France managed a successful exchange rate adjustment while staying within the ERM and Italy, although forced to devalue, managed to rejoin the ERM’s outer band. The crucial point is that the restrictive Maastricht rules were designed at least in part to assuage financial markets and manage an effective---if unnecessarily lengthy--- transition towards the adoption of a common currency in January 1999.

In Germany, a folk memory of inflation was coupled with a particular attachment to the *Deutschmark* as a symbol of national recovery. In the post-war context, the stability of the new currency was identified with the miracle years. In the words of one writer, a precondition to entry into the euro was:

‘... to ensure at very least that the new currency is ‘as hard as’ the Mark, by insisting that the institutional arrangements for EMU are identical to those applying for the Mark: independent bank, stability culture, Frankfurt Headquarters... Embracing the euro is thus seen not as an enthusiastic strategy for economic advancement, but rather as a collective price to be paid for economic re-unifications.’²¹

From 1993 until 1999, the Exchange Rate Mechanism (ERM) kept Europe’s currencies together with reasonable success. But the separate currencies were still vulnerable to speculative attack. Once the currencies locked together to form the euro on 1 January 1999, the risk of financial attack effectively ceased. This is because the euro, like the dollar, is so widely used that a successful financial attack---eg, one forcing a significant devaluation in the short term---cannot be mounted.²² Nevertheless, this point was ignored when adopting the SGP. Politicians and functionaries have continued to follow the same orthodox strictures. This vital point about the euro---that stability does not derive from any simple notion of ‘fiscal rectitude’---is almost entirely absent from public discourse. It is perhaps not surprising that so many Europeans should agree that balancing the books keeps the currency strong. Few politicians dare challenge what seems a commonsense principle of household budgeting. Yet as every first-year economics student learns, while the annual budget of the local baker or grocer needs to balance, that of Government does not, particularly when the economy is in the doldrums and unemployment is high.

A related point concerns ‘rules and discretion’. The decline in Keynesian economics has been accompanied by the belief that politicians should have as little discretion as possible in setting fiscal and monetary policy; in economists’ jargon, that policy should be ‘rules-determined’. A corollary of this view is that ‘discretionary’ policy leads to fluctuations and macro-economic instability, which in turn reduces growth. The particular lesson drawn is that national counter-cyclical policy can be left to ‘automatic stabilisers’; ie, during a recession tax receipts fall more than government expenditure, enabling consumers to spend more and the economy to grow. The general lesson drawn, not surprisingly, is that reducing the size of the public sector will ease

²¹ See Leaman (2001), p 20; Leaman further observes (p 64) in the years leading up to Germany’s great hyper-inflation of 1922-23, the average annual borrowing requirement was 75%---in contrast to the 3% limit imposed by the Maastricht Treaty.

²² Of course if markets sense that the currency is overvalued then, in the absence of Central Bank intervention, markets can gradually force it downward.

the strain on public finances and therefore improve stability and growth. Such views are widely accepted not just on the political centre-right but increasingly on the centre-left and across much of the economics profession.²³

2.2 Back to Pre-Keynesian Economics?

Keynesian economics was not suddenly invalidated by the rise of Thatcher-Reagan monetarism of the 1980s. Indeed, it seems ironic that some of the most ardent practitioners of Keynesian policies today are to be found in the United States and Japan. A key plank in George W Bush's strategy to revive the US economy in the wake of the 'bust bubble' depression of 2001 was a huge tax cut designed to boost consumer spending and rekindle growth. The package may have been badly designed, but its sheer size seems to have done the trick. Equally, the Japanese were converted to Keynesian deficit spending in the mid-1990s when it became apparent that lowering interest rates to zero was insufficient to spur private investment. By 2003, Japan's budget deficit was 6.5% of GDP, higher than that of the United States.

Keynes's fundamental point was not about 'pump priming' or even 'fine tuning', but rather about the role of the state in undertaking long-term investment designed to boost productivity and keep growth expectations buoyant. Such was the case during Europe's Marshall plan recovery, which gave rise to the *wirtschaftswunder* and the *trente glorieuses*. The European growth record of the 1950s and 60s was not merely---or even primarily---a matter of 'catching up'; rather, Europe grew because in its core countries, large investments were made not just in manufacturing but in social and economic infrastructure, as reflected in the growth of Europe's public sector share from under 30% in 1950 to roughly 40% two decades later. By contrast, in Britain in the mid-1970s, long-term investment lagged behind that of its continental neighbours, public infrastructure began a long decline and manufacturing investment stagnated.

Nor was average annual inflation of 3-4% in the industrialised countries a problem in the 1950s and 1960s: indeed, mild inflation had generally been considered an inducement to growth since it reduced companies' (and Governments') liabilities. But

²³ See for example Fatas, A and A Milhov (2003) for the case against fiscal discretion; there is a large and growing economics literature about the 'size of government', efficiency and growth. For an orthodox view by two leading economists at the EC in Brussels, see Martinez-Mongay and Sekkat (2004).

following dollar devaluation and the oil shock of 1973---and again in 1979--- the West's industrial growth faltered and inflation rose. Arguably, had Lyndon Johnson not attempted to finance both his 'Great Society' programmes and the Vietnam War without raising taxes, Nixon's 'benign neglect' of the dollar, the crisis and dollar devaluation of 1971 and the ensuing collapse of fixed exchange rates might have been avoided.²⁴

This aside on economic history is vital to understanding Europe's woes. Today, the US administration has once again adopted a policy of 'benign neglect' of the dollar, just as it did in the 1970s. Over the past two years the dollar has been allowed to depreciate by nearly 50% against the euro. Because most of the major trading countries in Asia have maintained a peg to the dollar (or at least remained close), the brunt of trade adjustment has fallen on the Eurozone. The ECB, too, appears to be following a policy of 'benign neglect'. There has been little attempt to counter euro appreciation; instead, the ECB continues to focus exclusively on its inflationary remit. The irony is that the euro was intended to protect Europe against the reluctance of the US to follow responsible policies.

For nearly two decades after the Bretton Woods Conference of 1944, floating exchange rates had been unpopular because of their association with the competitive devaluations of the inter-war years. As William Keegan has observed:

Benign neglect of the dollar in the 1970s was a major factor behind the decision by West German Chancellor Helmut Schmidt and French President Valery Giscard d'Estaing to construct 'a zone of monetary stability in Europe'. This led to the European Monetary System (more popularly known as the exchange rate mechanism) in 1979, without which the Great Leap Forward to the European single currency (1999) would almost certainly not have taken place.²⁵

Economic theory tells us that under a floating exchange rate regime, monetary policy becomes more powerful than (Keynesian) fiscal policy---a principle dear to the heart

²⁴ First, there was a realignment of exchange rates against the dollar under the 'Smithsonian Agreement' of 1971; this was followed by the shift to a floating exchange rate system in 1973.

²⁵ See William Keegan, 'Shock as Continent cut adrift by Snow' *The Observer*, November 21, 2004.

of most bankers and Treasury officials. But this principle alone does not explain the ascendancy of monetarism in the 1970s and 1980s.

In the early 1970s, as inflation soared and workers attempted to defend their real wage position, economic growth faltered and social unrest grew. In 1976, following a run on sterling which forced Britain's Labour Government into the arms of the IMF, Jim Callahan had famously repudiated Keynesianism by declaring that no government could 'spend its way out of recession'. The recession of the late 1970s was one of the factors explaining why Jimmy Carter lost power in the US while, in Britain, Callahan's government faced the 'winter of discontent'. The new decade saw radically conservative governments come to power in both countries with a similar agenda: to reduce trade union power and shrink the size of the state.

Other European countries appeared to resist Thatcherite policies for a time, but their Central Banks reacted to the oil shocks by applying the monetary brakes and squeezing credit. As is now obvious, the Keynesian tradition---so influential in the US and Britain after the war---was intellectually less well-rooted in 'continental' Europe where pro-growth, pro-union traditions were more anchored in the politics of the post-war settlement. This was particularly true in Germany where 'global steering' (as Keynesian demand management was called) was not introduced until 1967 when the SPD became senior partner in a coalition government and passed the Stability and Growth Act.²⁶ Keynesian policies were largely abandoned when fixed exchange rates broke down in the early 1970s. Ironically, the name of the Act was borrowed 30 years later for a decidedly anti-Keynesian Pact.

²⁶ Fritz Schäffer, the West German Federal finance minister from 1949 to 1957, explicitly rejected the notion of Keynesian deficit financing. 'Global Steering' was enshrined in the West German 'Stability and Growth Act' of 1967 (*Gesetz zur Förderung der Stabilität und des Wachstums der Wirtschaft*); See Tim Congdon (2004) 'Will the EU's Constitution rescue its Currency' *EU Constitutional Briefing Paper No 6*, London: The Bruges Group.

2.3 The Rise of the ‘Washington Consensus’

A further shock to the world economy occurred when, within weeks of the 1979 oil crisis, an interest rate rise engineered by the Paul Volcker at the US Fed sent world interest rates soaring. The interest-rate spike set off a chain of events, including the Mexican debt default of 1981, which tipped much of Latin America and Africa into recession and resulted in an unserviceable debt burden. Just when poor countries found themselves facing huge interest repayments, international credit for these countries dried up, thus forcing them into IMF receivership. The IMF mantra of ‘deregulation, deflation and devaluation’ became the basis for what would be known a decade later as the Washington Consensus.

The Thatcher-Reagan governments, aided by the IMF, helped spread not just the gospel of monetarism, but of ‘supply side’ economics: the notion that more can be accomplished by allowing free-market forces to discipline workers and removing barriers to entrepreneurship than by Keynesian-style demand management. Although the intellectual basis of this doctrine was always suspect---indeed, George H W Bush famously referred to it as ‘voodoo economics’---supply-side economics gained widespread currency, not least in amongst some of the proponents of the Third Way in the US and Britain.

One further factor seems to have played a role in securing the victory of Europe’s ‘sound money’ polices, notably, the success of Clinton’s deficit reduction programme after 1992. Deficit reduction is merely another name for orthodox public finance. It became a policy aim of the Clinton administration largely because of the relative power of Wall Street and the Treasury. Anybody who doubts the power of the Treasury (Ministry of Finance) and Central Bankers to determine economic policy in Washington, London or Berlin should study the influence of Alan Greenspan on the first Clinton Administration or of the *Bundesbank* on the drafting of the Maastricht Treaty and the SGP.²⁷

What is surprising about deficit reduction in the US under Clinton is that instead of leading to lower growth, it appeared to increase it, thus causing government revenue to

²⁷ On the US see Stiglitz (2003); on the UK see Keegan (2004); on Germany see Leaman (2001).

rise more quickly than expenditure and producing budget surplus---hailed by some as Clinton's greatest achievement. It can be argued that by lowering long-term bond yields, deficit-reduction fomented growth by forcing US banks to expand credit to the private sector.²⁸ The point is simply that in the 1990s, while some economists questioned the wisdom of Maastricht and the SGP, supporters of Maastricht could point out that deficit reduction in the United States had been accompanied by a decade of strong growth. And if one claimed that US deficit reduction could not be said to explain US growth, the retort was that neither could EU deficit reduction be said to explain EU stagnation. The answer, in broad terms, is that while deficit reduction in the early Clinton years took place against the background of an economy buoyed by accelerating growth of high technology and a bullish stock market, financial stringency in Europe appears to have fed upon---and contributed to---pessimism about growth. But let us return to the Maastricht story.

3 What's wrong with Maastricht and the SGP?

Germany, France and Italy are the key countries that have been unable to live within the narrow confines of the much-debated SGP. Attempts by the Commission in 2001 and 2002 to make marginal adjustments to the SGP proved unsuccessful. The EC's Financial Affairs Commissioner, Joaquín Almunia, admitted as much by calling in Autumn 2004 for proposals that would 'clarify' the SGP and allow member states to run budget deficits in excess of 3% when experiencing a prolonged period of sluggish growth. A compromise solution defining 'exceptional circumstances' was agreed in March 2005, but the basic rules remained fundamentally unchanged. Below are eight inter-related criticisms of Maastricht and the Stability and Growth Pact (SGP).²⁹

- a) **The 2% ECB inflation ceiling is too low:** Aside from the fact that the ECB's mandate is too restrictive, its 2% inflation ceiling is too low, particularly since the ECB aims to keep inflation in the range 0-2%. As argued in an influential paper by Akerloff, Dickens and Perry (1996) and again in Wyplosz (2002), very low inflation reduces wage market flexibility and thus economic efficiency. Because money wages are generally inflexible downwards, under

²⁸ An excellent discussion of the matter appears in the early chapters of Stiglitz (2003).

²⁹ There are various critiques of the SGP; see for example Wyplosz (2002).

conditions of very low inflation, wage differentials cannot adjust to sectoral or regional differences in productivity growth.

- b) The numbers are arbitrary:** The 3% budget deficit and 60% public borrowing figures are arbitrary limits. These figures are not underpinned by any economic logic; rather, they represent a conservative ‘guess’ of what limits the financial markets would accept in the early 1990s.³⁰ This argument has been made by a number of authors; eg, Buitter *et al*, 1993. In 2004 the US trade deficit was 5.3% of GDP; in Japan the 2003 deficit was over 8% and the stock of public sector borrowing represented over 80% of GDP---but in neither of these countries is a dangerous acceleration in inflation likely. Indeed, Japan in 2005 is still struggling to escape deflation; ie, falling prices.
- c) Budgetary limits are no longer necessary:** The rationale for Maastricht was to reassure financial markets and minimise the risk of speculative attack on EU currencies in the run-up to EMU, particularly the weaker ones: eg, lira, peseta, drachma etc. Once the single currency was in place, the risk disappeared. Since there is only one central bank, no Eurozone country can cause inflation by printing money to finance a budget deficit.³¹ As gattempted curbs on Germany or France.
- d) The budget deficit is not clearly defined:** The drafters of the Treaty make no distinction between ‘headline’ and ‘structural’ budget deficits (the latter netted of cyclical components), or the current and capital budget. The ‘basic’ deficit, that net of interest payments, is not mentioned. It is unclear whether Maastricht is compatible with a ‘golden rule’; ie, maintaining structural budget balance while borrowing for public investment. Because of its vagueness, the Treaty’s provisions are nearly impossible to interpret in a court of law.

³⁰ In fact, the 3% deficit limit was arrived at by assuming that anything above a 60% ratio of debt to GDP was unsustainable and that the nominal rate of growth of GDP at the peak of the cycle would be 5%; hence if inflation were assumed to be 2%, the real rate of growth would finance a 3% deficit and public debt would be sustainable. Besides being arbitrary, this logic says nothing about why the budget should be in balance over the cycle as a whole.

³¹ In the bad old days, the Treasury could ‘monetise’ a budget deficit by selling Treasury paper to the Central Bank, in effect much the same as ‘printing money’.

e) Attaining budget balance over the cycle is deflationary: The (implicit) provision that a member state's budget should balance over the cycle is strongly deflationary. Given a deficit limit of 3% in the downswing, to achieve a balanced budget over the cycle implies running a 3% surplus or more in the upswing. Where public non-discretionary investment is included in the budget, this would imply large cuts in expenditure in the good years, over and above 'automatic stabiliser' cuts. Moreover, under a budget balance rule and with monetisation (printing money) ruled out, there appears to be no provision for expansion of the monetary base to correspond with real growth. Even the staunchest Friedmanite would blanch.

f) Budget balance is not a policy variable: First-year economics students will recognise the 'three balance' identity: namely, the sum of the domestic private savings gap and the domestic public savings gap (ie, the budget deficit) must equal the external current account deficit, or:

$$(S-I) + (T-G) = (X-M)$$

As Godley and Izurieta (2004) point out, the budget (T-G) can only cycle around zero as required by the SGP if the sum of the other two balances also cycles around zero. Take a simple example. Assuming a zero output gap, if Germany normally achieves a private savings surplus (S-I) greater than its current account balance (X-M), it must run a budget deficit.³² This conclusion follows irrespective of Government's fiscal stance. Proponents of the SGP ignore this basic economic logic.

g) The SGP implies reducing public debt to zero: According to Maastricht and the SGP, public indebtedness should not exceed 60% of any country's GDP and the budget should be in balance over the business cycle as a whole. There are two problems here. First, it is unclear whether the debts ratio refers to gross or net debt.³³ Secondly, the '3/60' rule is logically inconsistent. As noted by De Grauw (2003) amongst others, if the target budget deficit over the cycle is zero,

³² Another way of reading this is that given the constraint on Germany's budget deficit (T-G)* and its traditionally large private savings surplus (S-I), it must run a current account surplus (X-M); ie, that the German export-led-growth model is 'forced' by keeping deliberately maintaining an output gap and constraining domestic demand.

³³ Net debt is defined as Government's total liabilities minus total assets.

then public sector debt in the long term must fall to zero.³⁴ This follows from the assumption that no new debt is incurred over the business cycle and old debt gradually matures and is repaid.

h) Only the stock of debt matters: As many economists have pointed out, the object of the Maastricht and SGP exercise was to prevent member states accumulating high and unserviceable indebtedness, thus creating a problem of moral hazard since the ECB might be forced to monetise one country's debt at the cost of inflation to all member-states. The correct answer would be to monitor member states' indebtedness and its sustainability, the latter depending on whether the nominal interest rate was higher than the nominal rate of growth. The Centre for Economic Policy Reform in London has suggested that the SGP be replaced by a 'Sustainability Council' at EU-level whose function would be to monitor indebtedness.³⁵

3.1 Replacing Maastricht and the SGP by a Golden Rule

An option widely promoted by Britain's current Chancellor, Gordon Brown, is to model a fiscal and monetary policy on that pursued by the Treasury and the Bank of England. On this logic, the SGP would follow the UK Treasury's 'Golden Rule'. The Rule calls for structural budgetary balance over the cycle. Public borrowing is allowed only for Government capital expenditure, and public indebtedness is capped at 60%. Like the ECB, the Bank of England's Monetary Policy Committee (MPC) has a 2% inflation target.³⁶ Unlike the ECB, however, the MPC's inflation target is 'symmetrical'; ie, if inflation falls below the target level, monetary policy must be eased. Britain uses monetary rather than fiscal fine-tuning of the economy and, as the above suggests, the policy is 'rules-driven'. Although the budget is required to balance over the cycle, there is no fixed limit on the size of the deficit during a recession.

³⁴ This is because the steady state relationship between debt and the debt ratio (the share of public sector borrowing in GDP) is given by $d = b.gY$ where: d is the long-term deficit as a share of GDP; b is the long-term debt share in GDP and gY is the nominal growth rate of GDP. Rearranging, we get $b = d/gY$ --or that provided the long term deficit (d) is some very small number close to zero, b (the warranted PSB ratio) must be close to zero.

³⁵ See CEPR (2003).

³⁶ Prior to the adoption of the HIPC measure of inflation in 2003, the inflation target was 2.5%.

Whether a ‘Golden Rule’ approach provides a genuine alternative model to the SGP is arguable. For one thing, the fiscal corset is only slightly looser—the budget must still balance over the cycle. The only advantage of UK-style monetary policy lies in the symmetrical nature of inflation target and the provision that the Chancellor can borrow to finance investment. Britain has been fortunate in that aggregate demand has remained high over the cycle, in part because of increased Government investment, but mainly because of buoyant private consumption. By contrast, in the core Eurozone countries, consumers have reacted to the threat of a downturn by increasing domestic private saving. Britain’s consumer spending is driven by several factors, which do not figure in the rest of the EU. One is that UK mortgages are tied to short-term interest rates---in contrast to the German *pfandbrief* or long-term mortgage bond; another is the widespread (and deregulated) use of credit cards.³⁷ Many economists in Britain doubt that the continued expansion of household indebtedness underlying the growth of consumption demand is sustainable.³⁸

Equally important, the ‘independence’ of the Bank of England from impure thought is more apparent than real since the MPC (Monetary Policy Committee) includes economists and financial experts, some of whom are known to have reflected on how best to achieve the right balance between growth, low inflation and full unemployment. The Bank of England’s *de facto* policy targets are broader than the ECB, so that the Golden Rule’s *de jure* adoption would be insufficient.

In short, although UK macroeconomic arrangements may seem preferable, how much of Britain’s success can be credited to the policies of the Treasury and the Bank of England is debatable. UK growth has thrived on buoyant consumer demand, a sea of consumer credit underwritten by steadily rising asset prices and foreign direct investment (FDI) into London’s financial services sector, now larger than manufacturing. The UK model cannot be exported; Britain looks more like Switzerland every day---independent, prosperous and smugly content to live on other people’s savings.

³⁷ According to Adams (2004), Britain accounts for 75% of total credit card debt in the EU. See Adams, T (2004) ‘Give Me Some Credit’ London: The Observer, 18 April 2004.

³⁸ According to Alex Izurieta of the Judge Institute in Cambridge, in 2004 the UK flow of net lending as a percentage of personal income reached an unprecedented level of 17%; he considers a sustainable level to be 5%, implying a fall in net lending equivalent to 12% of disposable income. If this fall happened quickly, it would trigger a severe recession. See Godley and Izurieta (2004).

3.2 The SGP and Enlargement

The recent accession places further pressure on the Union's economic arrangements; the EU acquired ten new members in mid-2004. Expansion was greeted with much fanfare, even if doubts remain in some quarters about its wisdom. Setting aside geopolitical factors, the economic benefits to the core states of enlargement are ready access to a wider market and to cheap skilled labour. The other potential benefit is that high 'catch-up' growth will foster more growth in the core Eurozone, particularly since the new accession states are important trading partners for the core countries. The main costs are extra pressure on the structural funds and agricultural subsidies in the EU budget on the one hand, and on the other the danger that low rates of corporate taxation will draw firms towards the periphery, thus prolonging stagnation in the core states.³⁹

Another difficulty is that the large accession countries---Poland, Hungary and the Czech Republic---have high unemployment and budget deficits, although most accession states have a low level of public indebtedness. In order to join the Eurozone, as they must, these countries have to fall into line with the 3% budget deficit rule of Maastricht and the SGP. As Charles Wyplosz (2003) has argued, the application of deflationary policies over a period of several years could bring about a severe recession in the Eurozone's newest members. Equally, the new entrants---particularly the ex-Eastern bloc countries---all need finance to modernise their economic infrastructure. The Sapir Report (2003) recommended, *inter alia*, scrapping the Common Agricultural Policy and redirecting EU budgetary resources to this end; the Report was largely ignored.

Enlargement will continue to raise serious questions both for new members and for old. For the new states, a period of prolonged membership of the new Exchange Rate Mechanism (ERM 2) in order to gain Eurozone entry may prove very costly if tight Maastricht-style budgetary controls are imposed. By contrast, if ERM membership conditions are relaxed, the accession states may repeat the success of earlier lower-

³⁹ The popular argument that core states 'lose' because of investment migration wrongly assumes a zero-sum game outcome. After all, a large flow of US investment towards Europe in the post-war period was reflected in increased transatlantic trade, making the US richer, not poorer.

income entrants like Spain, Portugal and Ireland. All have achieved rapid ‘catch-up’ growth. Income levels in Spain and Portugal have risen towards the EU-15 average; Ireland’s is now well above the average.

4 A paucity of prescriptions in Brussels

When one looks around for remedies, the prescriptions on hand are hardly encouraging. Although a few Finance Ministers are breaking ranks, ECOFIN appears to believe that sooner or later ‘financial discipline’ will create a suitable climate for investment and growth. The Brussels consensus is increasingly seen to rest on little more than a quasi-mystical belief in sound money, akin to the economic philosophy of Herbert Hoover in the 1920s.

Various suggestions have been made about how the ECB might be reformed.⁴⁰ But while it is true that its anti-inflationary remit is absurdly narrow, monetary policy alone cannot jump-start the Eurozone economy. The first reason is that the ECB’s interest rate is already close to zero in real terms. Because most gross fixed capital formation (investment) is relatively unresponsive to interest rates, cheap money alone cannot cure a recession. As Keynes famously argued, using interest rate policy in a recession is like pushing on a piece of string. A further problem is that monetary policy is subject to notoriously long and variable lags, one of the rare points on which on which Monetarists and Keynesians agree. Moreover, there is evidence that the lags are longer in the EU than in the USA; in short, using monetary policy as a central instrument of policy under current conditions in the EU is deeply problematic.⁴¹

Nor can exchange rate policy alone do the trick, even if the euro stops rising against the dollar. This is not merely because management of the euro (at least downward) is seen as falling outside the ECB’s remit. Ironically, Europeans savings have helped the US run huge twin deficits and pursue a policy of benign neglect of the dollar, spurring US investment and growth. Unlike the US and Britain, Eurozone households are net savers and its governments practise restraint. Because the euro has appreciated by

⁴⁰ See for example Fitoussi and Creel (2002).

⁴¹ See Larry Elliot ‘Brown needs to apply reverse thrust to Reagan theories’ *The Guardian*, June 14, 2004.

nearly 50% in two years while major Asian currencies have remained informally pegged to the dollar, the Eurozone bears the cost of an adjustment the US is unwilling to make. Fundamentally, dollar adjustment can only take place if US resources are transferred from consumption into export-orientated investment; ie, if US consumers tighten their belts. But if US consumers are to consume less, Eurozone consumers (and others) must consume more to prevent world demand from contracting.

Assuming that the political will to adjust exists in the US---an heroic assumption⁴²--- adjustment will take time, caution and co-operation lest it set off a new US recession. Meanwhile, Europe is left largely alone to shoulder the burden. It is unlikely Asia will accept revaluation. First, Japan has suffered nearly 15 years of stagnation. Secondly, China is still a poor country and has no intention of reducing its export-led growth to accommodate the rich, still less of conceding to the sabre-rattling demands of the US Senate.⁴³ Ironically perhaps, one way for the EU to engineer a fall in the euro is by engaging in just the sort of ‘fiscal irresponsibility’ financial markets fear; ie, underwriting a long-term investment programme to create jobs such as that advanced in the Delors White Paper (EC, 1993), agreed at the Essen summit in 1994 but largely abandoned as being too expensive.

Does the Lisbon agenda provide a solution? There is much that is positive and important about the Lisbon (2000) process, not the least as set out in Wim Kok’s (2004) report. The goals are well known, and for the most part admirable. It is crucial that the EU should stress quality of life factors including the environment, sustainable development, high levels of education and lifetime learning. Europe cannot become ‘competitive’ in areas in promoting low ‘flexible’ wages; on the contrary, its comparative advantage lies in reproducing a highly educated workforce, productive precisely because of its social entitlements. Lisbon correctly promotes more employment (ie, less involuntary unemployment), greater labour mobility through better education, more portable pensions and so on.

⁴² It has been argued that the external deficit of the United States could likely rise to perhaps 10% of GDP towards the end of the decade. See Godley, W and A Izurieta (2004) ‘Deficits Which Need a Global Solution’, *Financial Times*, 2 December 2004.

⁴³ See ‘US and EU turn up the heat on China’, *International Herald Tribune*, May 18, 2005.

While Lisbon goals are integral to social Europe, they do not add up to a growth strategy. The causality is more likely to run in the opposite direction. Only by pursuing a Delors-style macroeconomic strategy focussed on investment-driven growth can the Lisbon goals be realised. Unfortunately, macroeconomics is absent from the Kok report; only two paragraphs are devoted to the subject.

4.1 Radical Surgery: the ECB

It should be clear from the above that tinkering with economic institutions of the EU is insufficient. This is true not merely because the basic architecture is lopsided, but also because Eurozone growth is needed to make resources available to the faster integration of the accession countries as well as to offset the potential deflationary threat to world trade posed by the US current account deficit. In short, even were current economic arrangements not threatened by the EU's political crisis, serious surgery would be needed.

The first criticism of the ECB is that its anti-inflationary remit is too narrow, a view shared by many economists. If the sole objective of the ECB is low inflation, this means the sole objective of EU-wide macroeconomic policy is inflation targeting. The objectives of monetary policy should surely be derived from the wider considerations. A fundamental requirement would be to require the ECB to balance the goals of growth, full employment and low inflation---as does the US Federal Reserve Bank. This can be done either by statute, or by changing the composition of the ECB's policy-making Board. For example, the Bank of England's Monetary Policy Committee (MPC) includes various independent advisors---including notable academics---and membership rotates at regular intervals. Although the MPC does not have as wide a remit as its US equivalent, it clearly does take wider policy goals into account.

The pursuit of multiple objectives by the ECB logically implies multiplying the policy instruments at its disposal. Thus, fiscal and exchange rate policies are required; since the ECB policy instruments are limited, it should logically co-ordinate its policies with member-states to achieve some balanced set of macro policies. Constitutionally, however, the ECB is required to operate in complete independence from member-

states, or even from ECOFIN, the European Commission's monthly meeting of Finance Ministers.

A closely related matter is the ECB's lack of accountability. Unlike the Fed or the Bank of England, the ECB Governing Council does not publish its minutes nor is any record available of members' voting record. This means that while the European Parliament can debate monetary matters, it has no means of establishing how and why the ECB reaches its conclusions. To a degree, this is mitigated by the fact that the ECB President now addresses the European Parliament and gives monthly press conferences. But the secretive nature of the ECB does little to reinforce its authority; rather the perceived lack of democratic accountability detracts from its legitimacy. In the absence of an EU level fiscal authority to act as a counterbalance, the ECB is arguably more autonomous than the US Fed or even the *Bundesbank* before EMU.

The constitutional requirement that national governments must not influence the ECB both reinforces the view of that body's perceived lack of democratic accountability, while making it nearly impossible to co-ordinate EU-level monetary policy with state-level fiscal policy. At the same time, there is evidence that the Central Bank governors sitting on the Governing Council do vote according to the interests of the member-states they represent rather than determining EU-wide interest.⁴⁴ If the evidence is correct, then the political justification collapses for maintaining a Chinese wall between the ECB, member-states and Parliament. There is no economic justification for this wall other than in a world of highly orthodox theory.

4.2 Even More Radical Surgery for Fiscal Policy

In contrast to the Sapir Report (2003) or the Kok Report (2004), the view advanced here is that the SGP should be scrapped. The institutional arrangements shaping EU macro-policy require major surgery. This is hardly surprising given the theoretical perspectives set out above. First, national fiscal policies should be designed as far as possible to achieve the economic objectives of national governments rather than set artificial limits on national deficits. In the words of Malcolm Sawyer, removing the fiscal strait-jacket imposed on member-states 'by no means preclude[s] some co-ordination of national fiscal policies as such co-ordination should enhance, rather than

⁴⁴ The evidence from a study by Meade and Sheet (2001) is quoted in Arestis and Sawyer (2002).

detract from, the use of national fiscal policies.⁴⁵ Nor does it preclude the counter-cyclical use of an expanded EU budget. What it does ensure is that national fiscal policy could be used more effectively to address problems not addressed by a unitary monetary policy.

Two examples will help illustrate the need for flexible fiscal policy at national level. First, let us suppose that Ireland is experiencing rapid growth with 4% inflation and Germany is in recession with 0% inflation while the EU-wide rate of interest is 2%. This would mean that high-growth Ireland faced a negative real interest rate, while low-growth Germany faced a positive one; macroeconomic correction requires Ireland and Germany to apply quite different fiscal policies rather than merely to assume that a correction will be achieved through the operation of automatic stabilisers. Secondly, there is evidence that the link between GDP growth and the budget position varies considerably between member states. Buti et al (1997) find that a 1% slowdown in economic growth would raise member-states' budget deficit by 0.5% on average, but by up to 0.9% in the case of The Netherlands and Spain.⁴⁶ If a given slowdown in growth has a different impact on the budget of individual member-states—say, because of differing employment effects and hence a differing impact on expenditure and receipts---the imposition of a common fiscal constraint makes no sense. What does make sense is to replace the SGP with appropriate institutional arrangements for monitoring the size of member-states' indebtedness; ie, establishing a Sustainability Council along the lines described above.

Assuming the SGP is abolished, the problem of poor fiscal co-ordination amongst core states remains. The Broad Economic Policy Guidelines are wholly inadequate; some EU-level fiscal authority is required. Several authors⁴⁷ have proposed setting up a European Stabilisation Fund (ESF) which, broadly speaking, would resemble an IMF facility. The fund, possibly administered by the European Investment Bank (EIB)---would be financed by borrowing on the international market; loans would be disbursed in the event of a serious economic downturn, whether in one or several member-states. Each state would be required to draw up a contingency plan for its use in recession,

⁴⁵ See EPOC (2005) Chap 3, p 4 (prepared by Malcolm Sawyer).

⁴⁶ See Buti et al quoted in EPOC (2005), Chap 3, p 4.

⁴⁷ See for example the 'rainy day fund' proposed in Sapir (2003); and the proposals in the EPOC Report (2005).

and equally to draw up a plan to offset overheating; these would allow rapid reaction to excessive expansion or contraction by an amount equivalent to up to 2% of the member-state's GDP. In principle, the ESF would supplement---and substantially strengthen---the operation of automatic stabilisers at national level. The activation of the ESF would be subject to the approval of ECOFIN.

The EIB should equally be used to promote long-term public investment at EU level; the accelerated development of common infrastructure as envisaged by Delors White Paper (1993) in such areas as telecommunications, transport and research as a vital part of Europe.⁴⁸ Doubtless, this can be done in part through private investment, and common standards assured by means of a regulatory authority. Or, once again, it can be done through the EIB, thus avoiding excessive reliance on Private Financial Initiatives (PFIs) and Public Private Partnerships (PPPs) under which current capital costs are taken off-budget only to reappear as expensive handouts to industry in future. Nobody will quarrel with the greater use of the EIB to promote ecologically sustainable development, whether in the form of renewable energy generation, environmental clean-up or the restructuring of transport systems. Sustainable development---and the supporting research required---features as an agenda item in almost every European summit, and progress here has been one of the genuine success stories of Europe.

A major restructuring of EU economic institutions would enable a variety of other questions to be addressed. One example is the setting of common standards of social welfare and cohesion policies in defence of the European Social Model. While recognising that quite different 'welfare models' exist in the EU, certain minimum levels of welfare achievement should be defined and extended---for instance in the areas of social security, workers' protection, education and health. Agreement might be reached between member states on spending a certain proportion of GDP on welfare. Equally, some degree of tax harmonisation is called for 'to recover the room for manoeuvre within national expenditure policies which many member states have lost during the last two decades due to increasing pressure on taxes and to tax

⁴⁸ For a good discussion of this matter see Holland (2005).

competition amongst member states.⁴⁹ While full tax harmonisation is unrealistic and unnecessary, initiatives in this area would include a common centralised system for the calculation of VAT based on national accounts; a pan-EU system of dividend withholding tax for non-EU residents; the harmonisation of corporation tax throughout the EU⁵⁰ (though not of personal taxation); and the introduction of EU-wide energy taxes, starting with aircraft fuel.

The most important fiscal reform would be the establishment of a Federal EU budget as envisaged in the MacDougall Report (1977). MacDougall's target, it may be recalled, was of the order of 5-7% of combined EU GDP, large enough to be used as an instrument of counter cyclical fiscal policy but much smaller in comparison to the US Federal Budget which represents some 25% of US GDP. An EU Federal Budget is necessary not just to mobilise the resources necessary to strengthen pan-European investment, underwrite the European Social Model and intensify activity in the areas of security and development aid. Crucially, a Federal Budget is needed to redress the asymmetry between centralised monetary and decentralised fiscal policy described above.

A figure of 5% of combined GDP could be achieved by making member-states' contributions a progressive percentage of their GDP and incrementing contributions in stages---say, by 0.5% per annum between the present and 2012. Obviously, funding this level of expenditure will require radical changes on the revenue side. The current system comprises the original or 'first own resources' (revenues from the common external tariff plus agricultural levies representing some 10-15% of the budget); the lion's share comes from member-states' VAT-based consumption revenue as well as their contributions from GDP. At present, VAT-based claims are inter-regionally regressive, placing a greater proportional burden on poorer member-states where consumption accounts for a larger share of GDP than in richer states. GDP-based claims, known as the 'fourth resource', account for just under half of total revenue; these claims are neither regressive nor progressive. Existing arrangements could be

⁴⁹ EPOC (2005), chap 16, p 6; the call for tax harmonisation is hardly new; the Ruding Report to the Commission in 1992 called for corporation tax to be set uniformly at 30%.

⁵⁰ It has been suggested that a multi-tier corporation tax be adopted according to a country's per capita income level; see EPOC (2005), chap 16. A 'withholding tax' for income from capital earned by non-residents exists in the USA and is being adopted by the EU.

replaced using a unified GDP-based revenue raising system based on a progressive tax schedule, a variant of the ‘modulation coefficients’ based GDP contribution proposed by Spain in 1998.⁵¹

Finally the EU, like the US Federal Government, should be allowed to borrow. This would entail the abrogation of Articles 268 and 269 of the Maastricht Treaty requiring the annual EU budget to balance and to be financed entirely from ‘own resources’. EU-level deficit finance would be justified in two cases; notably, where long-maturation investment was required in research or infrastructure on an EU-wide basis whose beneficiaries would be future generations; and secondly, where such finance was required for EU-wide stabilisation; ie, for a European Stabilisation Fund as described above.

4.3 Relevance for a Social Europe

To resume, many people---particularly on the left---think of Maastricht and EMU as incompatible with Keynesian-style public spending. Precisely the opposite is true. It is because Europe does now have a world currency that it is protected from speculative attack; this is the main reason why Keynesian-style policies can be made to work, despite globalisation. Equally, the single currency obviates the need for policing current budget deficits. Unfortunately, at precisely the time expansionary fiscal policies have become possible and vital in the EU, political opinion has swung rightward and fiscal orthodoxy has become entrenched.

Europe is nearly as prosperous as the US---in some ways more so---but its growth rate has fallen and unemployment has increased. Economic stagnation in the Eurozone is now more than a decade long. The Japanese experience is instructive about how great a fiscal and monetary effort is required to overcome ‘deflationary expectations’. The Eurozone remains dangerously vulnerable to this malady; it certainly cannot afford the cost in terms of economic output foregone---not to mention the political costs---of failing to act.

⁵¹ In order to raise revenue equivalent to 5% of combined EU GDP, the EPOC Report calculates that country-specific progressive tax rates (proportional to per capita GDP) would range between 0.95% of GDP for Latvia to 5.25% for Italy and 11.35% for Luxembourg. See EPOC Report (2005), chap 16, Table 18.1.

Calling for a more pro-active Central Bank and making marginal adjustments to the SGP of the sort agreed in 2005 are mere window-dressing. Implementing the social agenda of Lisbon is necessary and desirable, but attaining the Lisbon goals will be as much the effect as the cause of faster growth, and such a goal is incompatible with the EU's current economic institutional design. The cost of low growth and high unemployment has not been confined to the economic sphere; the evidence of its political impact is everywhere. The roots of this political backlash are complex, but few will doubt that the politics of a high-growth Europe with jobs for all would dispel the gloom on offer. Achieving high growth and low unemployment calls for radical surgery. Growth with equity is no pipe dream; today, it is crucial to making the Union work.

References.

- Akerloff G, Dickens W and G Perry (1996) 'Low Inflation or No Inflation: Should the Federal Reserve Pursue Complete Price Stability?' *Brookings Papers on Economic Activity* 1996:1 Washington DC: The Brookings Institution
- Arestis, P and M Sawyer (2002) 'The euro, public expenditure and taxation' *Working Paper No 357*, The Levy Economics Institute: Annandale-on-Hudson, NY
- Arestis, P and M Sawyer (2003) 'Macroeconomic Policies of the Economic Monetary Union: Theoretical Underpinnings and Challenges' *Working Paper No 385*, The Levy Economics Institute: Annandale-on-Hudson, NY
- Begg, I (2004) 'EU Budget: Common Future or Stuck in the Past?' London: Centre for European Reform, *Briefing Note*, 19 February 2004.
- Bibow, J (2004) 'Assessing the ECB's Performance since the Global Slowdown: A Structural Policy Bias Coming Home to Roost?' *Working Paper 409*, The Levy Economics Institute: Annandale-on-Hudson, NY
- Buiter, W, Corsetti G and N. Roubini (1993) 'Excessive Deficits: Sense and Nonsense in the Treaty of Maastricht' *Economic Policy*, 1993
- Buti, M Franco, D and H Ongena (1997) *Budgetary Policies during Recessions: Retrospective Application of the 'Stability and Growth Pact' to the Post-War Period*, Brussels: European Commission.
- CEPR (2003) 'Stability and Growth in Europe: Towards a Better Pact' *Monitoring European Integration* 13: London: *Centre for Economic Policy Research*, 4 December 2003.
- De Grauwe, P (2003) 'The SGP in need of Reform' Dept. of Economics, University of Louvain.
- EPOC Report (2005) 'Economic Policy Coordination for Full-employment and Social Cohesion in Europe'; *forthcoming*; see <www.epoc.ini-bremen.de>
- Euro-memorandum Group (2004) 'Beyond Lisbon; economic and social policy orientations and constitutional cornerstones for the European Social Model' *10th Workshop*, Brussels, September 26-28,2004.
- European Commission (1993) *Growth Competitiveness and Employment* (Delors White Paper). Luxembourg: OOEPEC
- Fatas, A and A Milhov (2003) 'The Case for Restricting Fiscal Policy Discretion' *Quarterly Journal of Economics*, 4, 1419-1448.

- Fitoussi, J-P and F Saraceno (2004) 'The Brussels-Frankfurt-Washington Consensus Old and New Tradeoffs in Economics' Paris: (OFCE) *Observatoire Français des Conjonctures Economiques* N° 2004-02, February.
- Fitoussi, J-P and J Creel (2002) 'How to reform the European Central Bank' London: The Centre for European Reform.
- Godley, W and A Izurieta (2004) 'Balances, Imbalances and Fiscal Targets: a new Cambridge View' Cambridge Endowment for Research and Finance; Judge Institute, Cambridge.
- Haseler, S (2004) *Super-State: The New Europe and its Challenge to America* London: Tauris.
- Holland, S (2005) *Europe in Question---and what to do about it* London: Routledge. (forthcoming).
- IMF (2003) 'Deflation: determinants, risks and policy option', IMF, Washington DC, 30 June 2003.
- Keegan, W (2004) *The Prudence of Mr Gordon Brown* London: Wiley.
- Kok, W (2004) 'Facing the challenge; the Lisbon strategy for growth and employment' Report from High Level Group chaired by Wim Kok. European Commission.
- Krugman, P (1994) *Peddling Prosperity* New York: Norton.
- Leaman, J (2001) *The Bundesbank Myth: Towards a Critique of Central Bank Independence* London: Palgrave.
- MacDougall Report (1977) *Report of the Study Group on the Role of Public Finance in European Integration*, Brussels: European Commission, April 1977.
- Martinez-Mongay, C and K Sekkat (2004) 'The Trade-off between efficiency and macro-economic stabilisation in Europe' *Working Paper No 05.04RS, DULBAE*, Université Libre de Bruxelles.
- Rifkin, J (2004) *The European Dream*: Cambridge UK: Polity Press.
- Sapir, A et al (2003) *An Agenda for a growing Europe: making the EU economic system deliver* London: Oxford University Press.
- Stiglitz, J (2003) *The Roaring Nineties* London: Penguin Books.
- Tamborini R. (2004), "The "Brussels consensus" on macroeconomic stabilization policies in the EMU. A critical assessment", forthcoming in *Governing EMU Political, economic, historical and legal aspects*, edited by F. Torres, Proceedings of the 1st EUI Alumni Conference, EUI, Florence, October 2003.

Wyplosz, C (2002) 'The Stability Pact Meets its Fate' *Paper prepared for the 'Euro Group 50' Meeting*, Paris, 27 November 2002.

Wyplosz, C (2003) 'Do not impose a currency crisis on Europe' *Financial Times*, June 16, 2003.