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Eurozone Economics, Enlargement and the Maastricht Rules

At least four things have happened this year (2004) of key importance to the European Union. The draft Constitution, which was not ratified last December, has been renegotiated under the Irish Presidency to include various British red lines. Second, last April, in response to an anti-EU campaign largely promoted by the tabloid press, Tony Blair did a U-turn on holding a referendum. Third, in May, a new round of enlargement took place; the EU-15 became the EU-25. Fourth, in June, the European Parliamentary elections were marked by a large protest vote. In this piece we examine the relationship between the election results, the enlargement and, more generally, the dismal trajectory of Eurozone macro-economic policy. The salient argument is that low growth is leading to an erosion of welfare provision, in turn reducing social cohesion and increasing political instability; the threat is to both the accession states and to the core members.

We shall not discuss the relative merits of the new constitution here---in my view far from satisfactory, but better than nothing. The results of the European Parliamentary election, although predicted by most pundits, produced a shock throughout Europe. In the UK, the size of the UKIP vote seems certain to shift the Tories from Euro-scepticism to outright EU-rejection. In almost all EU countries, a low turnout was the rule and the popular vote swung strongly against the ruling party---although not necessarily against the EU. In the Central European accession states, turnout was negligible and centre-right parties gained. EU citizens are angry. Mainly, they are angry at national governments ---whether in France, Britain or Germany---because these have cut back on social benefits and pensions, squeezed public services and largely ignored growing income inequality. Europeans' frustration has spilled over into the arena of Euro-elections where national politicians squabble endlessly and a protest vote is seen by most citizens as 'costless'. In short, the electoral wake up call sent to Brussels is about trouble at home, a call which if unheeded could cost the EU its constitution as well.

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To a considerable degree, low growth and high unemployment at the core of the Eurozone have helped fuel public resentment, although in the public eye these are seen as national rather than EU-induced problems. True, Britain's aggregate growth and employment figures look better than those of the Eurozone, but swathes of privatisation, growing income disparities and a deregulated labour market have resulted in greater insecurity. Social safety nets are weaker in Britain that in the core Eurozone states and relative deprivation is far greater. In France and Italy, as one might expect, the Euro protest vote went to the Left; in Germany and the UK where 'social-democratic' parties are in power it has gone to the right.

What makes Britain a special case is not just its geographical and historical detachment from mainland Europe. We live in a country where an imperial national mythology with a growing xenophobic tinge is recycled endlessly by a largely US-controlled popular press. Although Thatcherism was succeeded by a New Labour commitment to 'modernisation', it is now clear that Blair agenda has to modernise Thatcherism rather than social democracy. Over seven years, Blair's promise that Britain would 'take its place in Europe' has become an empty phrase; New Labour no longer considers the European heartland sufficiently modern to merit emulation. The core Eurozone is now dismissed as 'old Europe', its economies comatose and its politicians treacherous. The Blair-Brown economic model---with its reliance on rules-driven monetary policy, its obsession with subjecting the public sector to market disciplines and proxy market regulation, and its love affair with an entrepreneurial culture supported by private-public partnerships and a flexible labour market---is in almost every sense part of the neo-liberal project, as refined and widely disseminated over two decades by the World Bank and the IMF. In the words of one commentator, New Labour is now the party of 'lower case' euro-scepticism.

How is all this relevant to story below which looks at the accession process and the financial orthodoxy of Maastricht? An obvious point of departure is the grafting of 'new Europe' onto the old. The accession states are largely drawn from the former Eastern Bloc where forty years of communist rule anaesthetised two generations to any vision of a progressive future lying between Soviet Sputnik fantasies and a Hollywood-style free market. A few Eastern European communist parties have re-

branded themselves social democrats, but it is the anti-communist right which has made most of the running. While the current enlargement may be greeted in Brussels as the re-establishment of Europe's pre-war frontiers, in reality it greatly complicates the EU's political and ideological cohesion.

The original EU was crucially shaped by Western Europe's post-war settlement: the European political class, in return for the expansion of workers' political representation and economic rights, accepted to remain firmly in the Western camp. Both symbolically and in reality, US neo-conservative discourse on the 'new Europe' represents the rejection of that settlement, proposing instead a vision of the universal triumph of market values, or what Phillip Bobbit has termed the 'market state.' In short, the accession countries will dilute the 'social-market' tradition of the EU-15.

What of Maastricht, then? Should the Stability and Growth Pact (SGP) be enforced, re-negotiated or simply allowed to fade away? Will enlargement bring new dynamism to Europe's economies or, *per contra*, will its budgetary cost slow us down? Will the ten new members 'catch up' like Spain and Portugal or will the income gap between the rich and poor countries grow? Should the new countries join the euro immediately, or should they be asked to adhere to an extended timetable of convergence?

In a piece in *Soundings 24* last year, I argued that despite the shortcomings of Maastricht, Britain should join the euro. The argument set out here is that because of continued Eurozone stagnation and of the recent round of enlargement, the macro-economic rules of Maastricht and the Stability and Growth Pact (SGP) require fundamental change. The costs of Maastricht-style economics have become unacceptably high. I do not believe, however, that Britain should reject the euro, and certainly not that it should withdraw from the European project. The notion--- advanced by sections of the left--- that Britain can or should 'go it alone' is pure illusion. Economically, Europe's capitalism is far gentler that the rapacious US variety; politically, Europe still offers the only reasonable alternative available to American global hegemony. European social-democracy may not be 'socialism', but it offers the only alternative model available; without it, the European socialist tradition perishes. Nevertheless, as long as the Eurozone continues to stagnate

economically, the pressure to cut budgets and reduce labour costs will grow and EU social democracy will founder.

The Current Round of Accession is Different

The current round of accession is quite unlike those of 1995 (Austria, Finland, Sweden) or 1986 (Portugal, Spain). Broadly, the current accession means that the EU's population has grown by 20% but it's combined GDP by only 9%. The accession countries are poorer----their per capita GDP is only half that of the EU-15. While the new round will double Europe's farm population; it is estimated that by 2013 Brussels will need to find an extra € 5bn per annum to subsidise agriculture in the new states---an effort which (hopefully) may finally kill off the Common Agricultural Policy.

Although extra spending is foreseen on accession countries' infrastructure in the Commission's financial perspectives, it falls far short of what is needed to achieve rapid modernisation. According to the rosiest forecasts prepared by The Economist Intelligence Unit in London, Polish living standards will take nearly 60 years to catch up to the average of the EU-15.[1] How long will it take the Baltic States to catch up---where living standards are only one-third of the EU-15 average?

Eight of the ten accession states are from the former Eastern Bloc, the so-called 'new Europeans' first identified by Donald Rumsfeld. Although there is much enthusiasm for joining, there is also much legitimate concern. After all, these countries were promised a glorious future upon abandoning the Soviet Bloc 15 years ago. Instead, the transition to the market economy proved traumatic; per capita income fell precipitously and unemployment surged. Since 1995, the trend has in most countries has sharply reversed. But it is only today that Poland, Hungary and the Czech Republic---the largest accession economies---are at last returning to their 1989 level of per capital income.

Understandably, these countries do not want to be placed once more under stringent IMF-style tutelage. Nevertheless, that is what the Maastricht rules require. To join the

[1] See The Economist (2004).

Eurozone---as all new EU entrants are committed to do---strict targets must be met with respect to each country's budget deficit, level of indebtedness, level of inflation, exchange-rate regime and so on. Most recently, both Hungary and Poland have experienced serious pain in attempting to tighten their belts. This has led some economists, most prominently France's Charles Wyplosz, to call for a change in the rules lest the central and eastern European lest these countries be forced into a new recession.[2]

Should New Members rush to join the Eurozone?

Within a few days of accession, Cyprus, Estonia, Lithuania and Slovenia announced plans to join the euro by late 2007. Brussels is not keen, arguing that only by spending many years within the new Exchange Rate Mechanism (ERM 2) will countries converge sufficiently with the Eurozone to qualify for membership. Is this a sensible argument?

According to Berkeley's Barry Eichengreen, it is not![3] Prolonged membership of the ERM only increases the probability of a currency suffering a speculative attack---the sort that Britain experienced in 1992. Eichengreen's alternative is called the 'Nike strategy': ie, if you want to join the euro, just do it! Hungary, for example, has experienced several serious and destabilising currency fluctuations since 2001. Like sunburn, the best way to avoid speculative attack is to minimise exposure.

There is no guarantee that the accession states will find membership of the EU a magic potion to remedy all economic ills; indeed, the opposite seems more likely. According to projections recently published by the *Centre Economique de l'Université de Paris Nord*[4]*,* while adhesion may prove a blessing for the more advanced countries enabling them to achieve Spanish-style transformation, others may fall even further behind the EU-15. Unless measured are taken to reduce vulnerability to speculative attack, a prolonged transition to the euro could prove more painful than staying out altogether.

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[2] See Wyplosz (2003).
[3] See Eichengreen (2000)
[4] See Dupuch, S, Jennequin, H and El Mouhoub Mouhoud (2004).

True, some of these problems might be avoided were the core members of the Eurozone more understanding and more generous. But overly tight fiscal and monetary policies have nearly paralysed the economies of Germany, France and Italy. Under conditions of economic stagnation, EU generosity is in short supply. A radical reformulation of macro-policy in the core Eurozone countries appears urgently required if the EU-15 and the ten accession countries are to prosper together.

It's Time to Rewrite the Eurozone's Economic Rules

At a meeting of the G7 group in April 2004 the new President of the European Central Bank (ECB), Jean-Claude Trichet, was assailed by the German and French Finance Ministers, Hans Eicher and Nicolas Sarkosy, for failing to ease its lending rate in order to stimulate EU growth and employment. Average Eurozone unemployment currently (summer 2004) stands at 8.8% and, despite calls for monetary relaxation during the past year. Over the current downswing the ECB has cut rates from 4.75% to 2%; in contrast the more pro-active US Fed has cut rates from 6% to 1%. 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!

Not only is the ECB too cautious, but also most economists consider the ECB's narrow focus on inflation---in contrast to the US Fed's focus on inflation, employment and growth--- as one major reason for the stagnation in the Eurozone core states since 2001. Germany, France and Italy account for the greatest part of Eurozone output. However, while there is a certainly a case for looser monetary policy----particularly last year when core Eurozone states came perilously close to deflation---monetary relaxation alone will not guarantee growth. A necessary condition for achieving Eurozone growth is that broad macro-policy must change.

Some argue that wage market flexibility is essential for securing EU 'competitiveness'. We do not pursue the labour flexibility argument here; suffice is to say that an important study by Schmitt *et al* (2001) suggests there is little empirical evidence to support this view. Supply side rigidities do not appear to be nearly as

important as inadequate aggregate demand in explaining the Eurozone's inability to increase income and employment.

Eurozone monetary policy is set centrally by the ECB. By contrast, fiscal policy is set both at EU level---the EU budget--- and, most importantly, at the level of the individual member states. The EU budget is capped by the Maastricht Treaty at 1.24% of combined EU Gross National Income (GNI)[5], 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. This makes the central budget a very weak counter-cyclical instrument. Fiscal expenditure by member states is constrained by the budgetary provisions of the Maastricht Treaty (Article 104.3). According to rules, Eurozone states should not exceed a budget deficit of 3% other than in very exceptional circumstances, that total public sector borrowing (PSB) should not exceed 60% of GDP and that national authorities should aim at budgetary balance or surplus over the business cycle. The '3/60 rule' is enshrined in the Treaty and supplemented by the 1996 SGP enabling the Commission to take action against offending states.[6] In short, expansionary fiscal policy in the Eurozone is severely constrained at EU level by the size of the EU budget and at member-state level by the SPG.

A further twist in this story involves the 'debate' between large and small Eurozone countries. It has been apparent for several years that, in the trough of a business cycle, the core countries would run budgetary deficits of more than 3%. First Germany, then France and now Italy have been reprimanded by the European Commission (EC) and legal proceedings are currently under way at the European Court of Justice (ECJ). Smaller countries such as The Netherlands, Austria and Portugal, which have cut spending drastically to stay within the limits, have strongly criticised the core countries for their profligacy. It should be added that several of most vocal critics of rule breaking are members of right-wing governments ideologically committed to slashing social expenditure: namely, the Dutch Finance Minister, Gerrit Zalm and the Austrian Finance Minister, Karl-Heinz Grasser.

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[5] Interestingly, when EMU was first discussed in the 1970s, the Chief Advisor to the Treasury, Sir Donald MacDougall, suggested the budget should be about 5% of combined GNI.
[6] 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, Eurozone members.

A full analysis of how the Maastricht rules came into being would require a long digression; suffice it to suggest a few simple reasons. First, the rules were fist 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. 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. Government's sole concern---so ran the Washington inspired orthodoxy---should be to 'get prices right'; discretionary fiscal policy was strongly discouraged. Thirdly, for two decades policy makers have been obsessed with maintaining the confidence of financial markets. This first became apparent in 1982 when the newly elected Mitterand Government attempted to use Keynesian measures to reflate the French economy, thus precipitating a run on the Franc. In Britain, the memory of 'Black Wednesday' in 1992 still rankles: over three days and at a cost to the Bank of England of nearly £10bn in reserves, foreign exchange speculators forced sterling out of the Exchange Rate mechanism (ERM) and forced the Chancellor out of office. The restrictive Maastricht rules were at least in part designed to assuage financial markets and manage an effective (if unnecessarily lengthy) transition towards EMU, the adoption of a common currency.

To resume, economic policy in the Eurozone states is constrained today by a variety of factors:

- An ECB which is not pro-active, which focuses on a narrow inflation target and whose discussions are not subject to public scrutiny;
- The Maastricht-SGP rules which caps public borrowing and keeps fiscal policy too tight in a downturn and over the business cycle;
- Agreement amongst the EU-15 that EU budget expenditure should be caped at its present level of roughly 1% of combined EU GNI;
- A curious row between large and small countries about 'breaking the rules'.

It is against this background that the EU has acquired ten new members. The expansion on 1 May 2004 was greeted with much fanfare, but there is considerable scepticism amongst the EU-15 about this latest enlargement. Setting aside geo-political factors, the economic benefits to the core states of enlargement are ready access to a wider market and to cheap skilled labour. The main costs are extra pressure on the structural funds and agricultural subsidies in the EU budget together with the danger that low rates of corporate taxation will draw firms towards the periphery, thus prolonging stagnation in the core states.[7]

But the key problem about the current round of expansion is that the large accession---Poland, Hungary and the Czech Republic---have high unemployment and high budget deficits. In order to join the Eurozone, as they must, these countries must 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.

What's wrong with Maastricht?

Germany, France and most recently Italy are the key countries which 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 have proved unsuccessful. Although the European Commission is taking Germany and France to court over rule breaking, it is clear that the SGP is nearly defunct---despite claims to the contrary by the incoming Financial Affairs Commissioner, Joaquín Almunia. Before discussing alternatives, it will be useful to review the flawed economic logic of the Maastricht Treaty in more detail.[8]

1) **The 2% ECB inflation target too low**: Aside from the fact that the ECB's mandate is too restrictive, its 2% inflation target is far too low. As argued in an influential paper by Ackerloff, Dickens and Perry (1996) and again by Wyplosz (2001), very low inflation reduces wage market flexibility and thus economic efficiency. Because money wages are generally inflexible

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[7] The argument that core states 'lose' because of investment migration implicitly assumes a zero-sum game situation, an erroneous assumption. After all, a large a flow of US investment towards Europe in the post-war period was reflected in increased transatlantic trade, making the US richer, not poorer.
[8] A detailed critique of the SGP is Wyplosz (2002).

downwards, under conditions of very low inflation wage differentials cannot adjust where productivity growth is higher in some sectors than in others.

2) **Arbitrary numerology**: 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. This argument has been made by a number of authors; eg, Buiter *et al*, 1993. The US currently runs a deficit of over 5% 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 serious acceleration in inflation foreseen. Indeed, Japan is still struggling to escape deflation!

3) **Budgetary limits are no longer necessary:** The rationale for Maastricht was to reassure financial markets and minimise the risk of speculative attack on weak currencies (eg, lira, peseta, drachma) in the run-up to Economic and Monetary Union (EMU). Now that the single currency is in place, there is no such risk. Nor can Eurozone countries cause inflation by monetising their budget deficits. As Paul Krugman (1994) pointed out years ago, the US Treasury has no reason impose budget curbs on New York or California and the same logic holds for EC curbs on Germany or France.

4) **The Budget Deficit is not clearly defined**: The drafters of the Maastricht Treaty appeared to have no idea of the difference between 'headline' and 'structural' budget deficits (the latter netted of cyclical components). Nor was there any clear provision of how public investment is to be financed. Because of its vagueness, the Treaty's provisions are nearly impossible to interpret in a court of law.

5) **Attaining budget balance over the cycle is deflationary**: The (implicit) provision that member states' budgets 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 in the upswing. Where public non-discretionary investment is included in the budget, this

would imply large cuts in current expenditure in the good years, over and above 'automatic stabiliser' cuts. Such cuts would almost certainly fall on transfer payments such as health, education and pension provisions.

6) **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. As a recent paper by Godley and Izurieta (2004) point out, if over time both the domestic private savings gap and the external account deficit cycle around (say) 2%, so too must the budget deficit. The budget can only cycle around zero (as required by the SGP) if the sum of the other two balances also cycles around zero. This conclusion follows *irrespective* of Government's fiscal stance. This simple piece of logic seems to have been largely ignored by both sides in the Maastricht debate.

7) **Implicit 0% Public Debt**: 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 cycle as a whole. There are two problems here. First, it is unclear whether the debts ratio refers to gross or net debt.[9] Secondly, the '3/60' rule is logically inconsistent. As pointed out by De Grauw (2003) amongst others, if the target budget deficit over the cycle is zero, then public sector debt must ultimately fall to zero. This is because the steady state relationship between debt and the debt ratio[10] is given by $d = by$ where: d is the % long term deficit; b is the long-term debt share in GDP and y is the nominal growth rate of GDP. Rearranging we get $b = d/y$---or that as long as the long term deficit is some very small number close to zero, b (the warranted PSB ratio) must be close to zero. Curiously, this highly conservative result appears to have gone unnoticed in the SGP debate. It is possible this condition was accepted as a means of forcing some countries to reduce their PSB ratio before EMU. However, once the PSB ratio is 60% or lower, the rule no longer makes sense.

[9] Net debt is defined as Government's total liabilities minus total assets.
[10] The 'debt ratio' is the share of Public Sector Borrowing (PSB) in GDP.

Replacing Maastricht and the SGP

Once the deep flaws in the economics of the Maastricht Treaty and SGP become apparent, the question is how to change it. Below we discuss a number of alternatives. These can be considered singly or in combination.

A fist option is to do nothing; ie, to let the SGP die quietly. This seems the most likely outcome of the current legal proceedings against offending members may be just this: the member states' case rests on the argument that while the Commission may recommend policy, it has no legal authority to dictate national economic policy. If this legal argument succeeds, the SGP will indeed be dead. Such a decision would leave member states in a position adopt an expansionary fiscal stance if they so desire. Since no state can print money, there is no danger of inflation.

Two arguments are invoked against such a policy, however. First, the growth of long term public debt might force up interest rates and cause some crowding out of private investment; and more seriously, a return to high levels of public debt might place the ECB under great pressure to print money. Such a scenario, although debated amongst the specialists, seems unlikely. Secondly, to the degree that the core countries adopted a strongly expansionary fiscal stance and accepted a high debt ratio, international financial markets might 'loose confidence' and move against the euro. However, since the euro is currently overvalued---and since fiscal expansion is urgently required to boost growth---it is difficult to fault this option.

A complementary option is to reshape the ECB, making it more publicly accountable and insisting that, like the US Fed, it consider explicitly the trade-offs between inflation, employment and growth. Looser monetary policy under current circumstances is certainly desirable. Nor is it inconsistent with adopting a looser fiscal stance. However, it is likely that any attempt to change the statutes of the ECB would meet strong resistance---not merely from bankers, but from the Commission. In short, while changing the statutes of the ECB is desirable, it is unlikely to find the necessary support, particularly at a time when member states are concerned with reforming the SGP. Over the longer term, as the orthodoxy of the ECB comes under growing pressure from member-states, it is likely that its stance will change---indeed, it should

be noted that the preamble of the EU's draft constitution speaks of full-employment as a goal, echoing the Amsterdam Treaty of 1996.

An option widely promoted by Britain's 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 the PSB ratio is capped at 60%. It should be recalled that, like the ECB, the Bank of England's Monetary Policy Committee targets a 2% inflation target. The only difference is that the 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'.

Whether a 'Golden Rule' approach provides a genuine alternative model to the SGP is arguable. For one thing, the fiscal corset is only marginally looser and the only advantage of UK-style monetary policy lies in the symmetrical nature of its core rule. More importantly, aggregate demand in Britain has remained high over the cycle, unlike the core Eurozone countries where 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.[11]

The key argument against the 'golden rule' is analytical. As outlined above, the budget deficit is identically equal the sum of the private financial surplus plus the external balance, and since neither the private financial surplus nor the external balance can be directly controlled by Government, it follows that the Golden Rule is unworkable. Without delving into the question of whether the UK's burden of consumer debt---partly covered by the increased value of consumer housing assets---

[11] According to Adams (2004), Britain accounts for 75% of total credit card debt in the EU.

proves sustainable in the coming years,[12] one can conclude that although a shift to a 'Golden Rule' style SGP might be an improvement on current arrangements, such a shift is unlikely to jump-start the core Eurozone economies.

A further interesting 'EIB option' is set out in Holland (2005). Echoing a strong pro-employment tradition in the EU going back to the 'Essen Strategy' (1993) and the Amsterdam Treaty (1996), it is argued that while in the 1980s and 1990s national models of the welfare state and social investment were destabilised by foreign exchange speculation, today the situation has changed. The strength of the Euro enables new Keynesian-style policies to be pursued in order to enhance the European social model. The funding of health, education and social investment costs can in part be transferred to the European Investment Bank (EIB), thus releasing national budgets to fund more labour intensity in the social sphere.

The crucial point here is that because most Eurozone countries do not treat EIB borrowing as part of their public sector debt, the Maastricht rules can easily be circumvented by shifting much investment off national budget and using EIB funds. However, it remains unclear whether the EIB as presently constituted could (or would) make such funds available in a timely and sufficient manner. This option, which has been overlooked or simply overshadowed by the Maastricht and SGP debate, does clearly merit serious attention.

Two further options should be considered: that of replacing the SGP by a 'Sustainability Council', and that of using the EU budget as a counter-cyclical tool.

The notion of creating a Sustainability Council (SC) comes from the Centre for Economic Policy Reform in London (CEPR, 2004). Membership of the SC would be based on a nomination process run by the European Parliament. The SC's brief would be to monitor the growth and sustainability of long-term debt, not budget deficits. In the words of its authors, the SC would replace "rigid rules by a judgemental assessment of the fiscal assessment and outlook of each euro-area member state. This

[12] According to Alex Izurieta of the Judge Institute at Cambridge, in the UK the flow of net lending as a percentage of personal income has reached unprecedented level of 17%; a sustainable level would be 5% an thus a fall in net lending equivalent 12% of disposable income could trigger a severe recession. See Godley & Izurita (2004).

makes room for more flexible fiscal policies in the short run." Hence the SC would not infringe national sovereignty on fiscal matters; its authority would be advisory and derive from its democratic mandate.

The SC idea is doubtless a good one. By focussing on the sustainability of long-term indebtedness rather than on the short-term budget deficit, it (correctly) allows low debt countries to run higher deficits. However, it also assumes that Eurozone states benefit from strong automatic stabilizers over the cycle, or at least from sensible discretionary fiscal policies.

The use of the EU budget for counter cyclical purposes, although desirable in principle, is constrained chiefly by its small size and relative inflexibility. It has been suggested in some quarters that the budget should be doubled from the current 1% to 2% of combined EU Gross National Income (Euro-Memorandum Group, 2003). Because the current 1% budget is largely hypothecated for the CAP and structural funds, it is clear that the current budget leaves little room for discretionary counter-cyclical policy (Begg, 2004).

Nevertheless, there are two obvious problems with the 'Memorandum' proposal. First, large-scale spending on public works[13] may be desirable, but it is would only achieve the necessary reflationary effect if directed at relatively quick-yielding projects with strong multiplier effects in the core economies.[14] Second, because many unemployed workers already benefit from transfer payments, shifting them from the dole to public employment might provide insufficient stimulus; it would seem more important (as in the Polder model of the mid-1990s) to focus on integrating workers into the EAP, for example by greatly increasing the supply of (and benefits from) part time employment. Finally, however desirable it may be to increase EU investment spending on social and economic infrastructure, at present such a proposal would be opposed by all core Eurozone countries. The likely chances of its implementation seem quite low.

[13] Such spending was first mooted in the early 1980s by Jacques Delors; the call was repeated against in 2003 by the Italian Finance Minister, Giulio Tremonti.
[14] It is sometimes argued that the massive increase in defence spending under George W Bush 'kick-started' the US economy; yet defence spending has a relatively low multiplier effect and so a shift of resources away from private consumption to public investment might provide almost no stimulus to the economy.

Conclusions

The recent Euro-election results suggest there is growing disaffection throughout the EU with national ruling parties which have failed to deliver on their promise of higher growth and employment while cutting welfare benefits and weakening labour market protection. Such disaffection is not confined to the immediate issues of economic policy as the rise of the right---most notably in Britain and France---demonstrates. Weakened social provision leads to weakened social cohesion and growing susceptibility to xenophobic populism.

The round of EU enlargement on 1 May 2004 resulting in 25 member states raises 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. For the old states, particularly those of the EU 'core', it is evident that continued low growth and high unemployment cannot be attributed entirely---or even mainly---to 'labour market rigidities' and other supply-side constraints.

The 1992 Maastricht Treaty rules constrain both monetary and fiscal policy in the Eurozone. The ECB is insufficiently proactive and targets only inflation; it targets too low an inflation rate and it does so in a non-symmetrical manner. As concerns fiscal policy, following EMU in 1999 the SGP became redundant. For the reasons set out in detail above, it is clear that the SGP and Maastricht rules are intellectually indefensible

While it is clear that reforming the ECB is desirable in order to make it---like the Fed---more accountable and focussed on a broader set of targets, the political prospects of this happening are poor. The UK would like to see a much milder reform, notably, the adoption of a 'symmetrical' inflation target. In current circumstances this is probably the best that can be hoped for. In any event, the reform of monetary policy alone cannot move the EU towards higher growth. In essence, the EU needs to adopt a strongly expansionary fiscal stance.

At the time of writing, the European Commission's (EC) interpretation of the Maastricht fiscal rules as enshrined in the SGP is the subject of legal dispute. If as seems probable the case brought by the EC against the offending countries fails, the SGP will be scrapped. Whether a new scheme takes its place or whether member states are allowed to set their own fiscal and public borrowing targets unhampered by the EC is still unclear.

If the SGP is to be amended rather than merely scrapped, various proposals have been advanced for its reform. These range from letting it die to adopting the UK Treasury's 'golden rule', or even to setting up a 'Stability Council' appointed by the EU Parliament and charged solely with monitoring sustainable levels of public indebtedness amongst the member states. The full repatriation of budgetary policy to members without oversight, we have argued, is probably too lax an arrangement; money markets are unlikely to view with favour the absence of any budgetary supervision in the Eurozone. On the other hand, adopting the Treasury approach, however successful this has proved Britain, is probably overly restrictive since British growth is largely driven by factors having little to do with the Treasury. Creating a Stability Council would have the advantage leaving members to expand their budgets while focusing on the long-term sustainability of public debt; its adoption would constitute a clear break with Maastricht.

The best solution might be to combine the Stability Council with the counter-cyclical use the EU budget. The problem is that the budget as it stands is too small and too hypothecated to be used effectively for this purpose. Doubling the size of the current budget, desirable as this might be, is unlikely to prove acceptable to any of the core states as long as public finance continues to be under strain. Beyond this, there remains the further option of shifting part of the burden of financing national education, health and infrastructure investment to the EIB. Because EIB borrowing is not counted as public sector debt in most Eurozone countries, such an option would appear well worth pursuing.

In general, while changed fiscal and monetary arrangements are important for the economic health of the Eurozone, such changes may be insufficient for ensuring long-

term growth. Like Japan, Europe's stagnation has produced a low-growth mentality; what one might call 'deflationary expectations'. Like Japan, too, it may take years of easy credit and fiscal pump priming to overcome the inertia of low growth.

The latest round of EU enlargement has brought these issues to the fore. Quite apart from the constitutional changes needed to avoid political gridlock, enlargement poses clear issues of economic policy. What seems sure is that unless enlargement is accompanied by radical reform designed to bring higher economic growth and reasonably full employment, the 'social Europe' at the heart of the EU project may be fatally compromised.

ENDS

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