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EMU and economic policy

Introduction: 2003, a year of standstill

European economic and monetary union (EMU) went through a complete economic cycle during the period which saw the euro come into being. A revival of Europe's economic fortunes began at the end of 1996; it led to an boom phase lasting until the middle of 2000, before giving way to a slowdown and then a descent into sluggish growth. This was followed, from 2001 until autumn 2003, by disappointed hopes of an upswing and a brush with out-and-out recession. The mood changed during the fateful summer of 2002, under pressure from the stock exchange blues: having adjusted to a sharp but brief spell of activity, companies started to review their plans, with all the ensuing effects on investment and employment. Companies and governments realised belatedly that their management methods were reliant on the prospect of a rapid return to growth as from the second half of 2002. The wait proved costly. Finally, at the end of 2003, there were indications of a more definite recovery, driven on by international trade.

This cycle was political too: during its favourable phase, a large majority of European Union Member States were ruled by governments with social-democratic leanings. These administrations oversaw the final stages of the transition to the euro and experienced the opportunities and difficulties of macro-economic co-ordination within the new monetary area. Since then the European landscape has shifted markedly to the right. Although the political configuration was changing, uncertainties about a return to growth or the onset of a depression fuelled the controversy over economic policies. The difficulty of emerging from this morass put institutions and policies alike to the test.

The suspension of the procedures sanctioning excessive government deficits against Germany and France, at the end of 2003, opened up a void in European macro-economic regulation. Policy co-ordination had obviously failed, and the effects of the rules had become unpredictable. The French Finance Minister, Francis Mer, played down this situation, glossing over it as an adjustment that would allow for a "falling into step with the economic cycle" and deferring until 2005 a full-blown redefinition of new, more suitable rules (Mer, 2003). Other government leaders, as well as the Commission, viewed this renunciation of the rules of the game as a threat both to the credibility of EMU and to the success of structural reforms already underway (see for example Brinkhorst, 2003 and Solbes, 2003). At the same time as bringing proceedings before the Court of Justice, the Commission put forward its ideas for a reform of the Stability and Growth Pact (SGP). But this Commission's term of office is drawing to a close, and several governments would visibly prefer to deal with its successor over this matter. The European Trade Union Confederation (ETUC) issued a well-balanced opinion, pointing out the need for unambiguous rules on budget policy co-ordination and criticising the "pseudo-Keynesian" line taken by governments which augment public deficits through tax cuts whose effectiveness in consolidating the recovery is open to doubt. The ETUC, keen to turn this crisis to good effect, called for the establishment of co-ordination rules which are more sensible, more flexible and more plainly growth-oriented (ETUC, 2003).

This crisis over policy co-ordination under EMU inevitably raises questions of a "constitutional" nature. The SGP, adopted by the Amsterdam European Council in June 1997, comprises two European Council regulations, one on the excessive deficit procedure and another on surveillance (1466/97 and 1467/97), as well as a resolution passed by that same Council (17 June 1997) setting out the rules for implementing the Pact. The provisions of the Treaty itself are more general (Articles 98 to 104 of Title VII TEC on economic and monetary policy): in the final instance, they leave it up to the Council to describe certain countries' deficits as excessive and to decide on the resulting recommendations and penalties. One camp would like to see compliance with "the Treaty and the Pact taken together" (Solbes, 2003), while an opposing camp emphasises the distinction between

these two texts, whose status is not identical: the Treaty confers on the Council the responsibility for interpreting and implementing the Pact. From this point of view, the draft Constitution bequeathed by the Convention basically did not go beyond the *status quo*, which lends itself to conflicting readings.

This reappraisal of the rules on co-ordination comes at a moment when the European Union is facing up to events which will shape its future. The new Member States are joining a Union that has misgivings about the rules governing its operations. There was a certain apparent logic to the schedule set out for these countries: compliance with the Copenhagen criteria before acceding to the Union; compliance with the Maastricht criteria between the date of accession and the date when they would be eligible to join the euro zone; thereafter, participation in the joint implementation of the GSP. The crisis over the Pact belies the logic of this sequence and sows doubt about its suitability in enabling the new Member States to catch up in economic and social terms.

The Pact crisis has likewise impacted on the start of discussions about forthcoming Community budget plans for the years 2007-2013. Views are becoming even more polarised than they were during the negotiations which led to the compromise – in the form of the *status quo* – at the Berlin Council in 1999. France has now sided with the countries bent on freezing the size of the Community budget as a proportion of European GDP, thereby strictly curbing its zeal for redistribution: the Community budget should not be spared the stringency applied to national budgets. This tone was first set in October 2002 when, at the Brussels European Council, the French President consented to placing a real ceiling on CAP expenditure as from 2006. The other part of this proposal was that the same rigour be applied to the whole of the European budget, naturally including the allocation to the Structural Funds. The group of six countries (Austria, France, Germany, Netherlands, Sweden and United Kingdom) which, at the end of 2003, proposed freezing the European budget are lined up against the current and potential main beneficiaries from the Structural Funds.

National policy co-operation under EMU was at a standstill in early 2004, be it policy co-ordination with due regard for the specific circumstances of each country or the beginnings of budgetary

federalism represented by the Community budget. In our first section, this standstill will be placed in the context of cyclical developments in the European Union during the 1990s, especially the advent of the euro. The structural problems highlighted will be examined in section two.

1. An ongoing lack of co-operation

1.1 The euro: difficult gestation, successful birth

During the transition to monetary union, the European countries forged a common culture of price stability, which was necessary if the Union was to function. This process involved doggedly putting in place policies for competitive deflation and nominal convergence, in pursuit of common goals: low inflation, exchange-rate stability and a reduction of government deficits and debt. The Maastricht criteria set these goals in stone. Germany became the point of reference, the very embodiment of high standards of management. But this transition took on some sacrificial and contradictory characteristics:

- the competitive deflation policies in practice accepted growing unemployment as a – presumably transitory – cost for the success of these policies: unemployment helps to curb wages and prices; corporate adjustments, which require rationalisation and restructuring, must be made before competitive deflation can boost employment;
- similar policies in the countries participating in this process were no indicator of co-operation among them. Successful competitive deflation meant acquiring market shares – including from one's partners! Similarly, a given country's compliance with the budgetary convergence criteria was hampered by the restrictive effects of similar policies pursued by its neighbours. These tensions were exacerbated in the general climate of low growth during the early 1990s.

The shock of German unification heightened these tensions. In the absence of true political union, there could be no properly harmonised European approach to handling the consequences of unification. Thus the repercussions of reunification were managed by the markets, through a reconfiguration of capital movements, and by the Bundesbank, concerned about the inflationary risks of unification. The outcome was a

level, structure and volatility of interest rates that killed off European growth, in an international context of economic slowdown combined with a falling dollar. Its fall pitted the European currencies against one another until mid 1995. In autumn 1992 the European Monetary System (EMS) split into two camps: a strong currency camp where, in spite of some turbulence, currencies remained pegged to the Deutschmark; and a weak currency camp, consisting of countries subject to speculative pressure but also to objective constraints. The latter group allowed their currencies to depreciate sharply between 1992 and 1995 in order to ease the competitive and financial constraints affecting them. By so doing, these Mediterranean and Scandinavian countries, plus the United Kingdom, once again found competitive margins which enabled them more readily to manage budgetary convergence and compensate for deflation by introducing social pacts. The plan for a broad-based monetary union, once severely compromised, gradually recovered its credibility, even though this period left an indelible mark: distrust of the euro in the UK and Sweden can probably be laid at its door.

These contradictions fuelled economic difficulties and social tensions in Europe in the mid 1990s. Hopes of a substantial recovery, generated by the burst of activity in 1994, were soon disappointed in 1995. Low consumer confidence – even when purchasing power was rising markedly – dampened consumer demand; companies became bogged down in a process of balance-sheet adjustments. The cautious behaviour that had contributed to the seriousness of the 1993 recession persisted. The economic situation remained lacklustre until the end of 1996. On the whole, labour struggles (in Italy, Belgium, the Netherlands and France) came to be dominated by the emergence of demands for economic security (IRES, 1995), translating the lack of confidence which undermined the European recovery of 1994-1995.

An upturn occurred in 1997. The European economy awoke to a sustained recovery stimulated by a favourable change in the international context, most notably a steady rise in the dollar after its low-point of mid 1995. This was an opportunity to reassert the credibility of plans for monetary union, in that a stronger dollar eased the strains between European currencies and brought about a general relaxation in the monetary constraints inhibiting European growth.

The appreciation of the dollar formed part of a sequence of developments whereby the US and European economies were out of step. The United States had been the driver of growth within the OECD ever since the 1980s, its growth outstripping and overtaking that of Europe. This lead benefited from the "benign neglect" of the US authorities as concerns exchange rates, enabling the US economy to profit from a falling or undervalued dollar (as was the case, with a few fluctuations, from 1985 to 1995). The United States, confident about its growth prospects, began to attract capital on a lasting basis. Foreign investors were motivated by the returns likely to be generated by this prospective growth. The attraction became even stronger in the 1990s, with the advent of the "new economy".

A configuration of this type does of course have its corrective factors: the attraction of the United States pushed the dollar upwards, contributing somewhat belatedly to an extension of growth in the direction of other economies, whose competitiveness thus increased. This factor worked very much in Europe's favour during the second half of the 1990s. Despite the gloom about the weak euro, the relaxation of exchange-rate constraints assisted the birth of the euro zone in 1999. "Market forces" determined parities between the currencies joining the euro zone; these parities were finally adopted as the conversion rates decided by governments (Fayolle and Mathieu, 1998; Couharde and Mazier, 2001).

This set of rates formed a scenario that was half way between the two extremes experienced during the 1990s: that of 1992, on the eve of the EMS crisis, when the parities derived from pegging to the Deutschmark placed unbearable strain on certain countries (in particular the Mediterranean economies, still catching up); and that of mid 1995, at the height of the crisis, when the distortion between the strong and weak currencies peaked. Entry into the euro zone took place at real parities that better reflected each country's individual constraints. These entry parities maintained an appreciable competitive margin in favour of the economies still catching up, while at the same time not intolerably overvaluing the strong currencies from the outset – although that phenomenon was not entirely absent. Thus the euro zone benefited at its inception from conditional viability. Since the markets now lent

credibility to the launch of the euro, and since the monetary authorities, their fears allayed, were more alive to the risk of deflation, the conditions were finally met for an across-the-board relaxation of interest rates in the short and long term. This relaxation was spectacular in the case of Italy and Spain, followed by Greece, with a disappearance of the risk premiums affecting them in comparison with German interest rates. This was a significant factor throughout Europe in freeing up growth capacity in the short term and making up lost ground in the longer term.

The favourable constellation thus presiding over the advent of the euro zone was partly circumstantial. US dynamism had a strong knock-on effect and, since it was accompanied by a rise in the dollar, its "displacement effect" on Europe – by acting as a magnet for capital – receded into the background. Yet the durability of this scenario was under threat from the scale of US external debt. Once international investors began to doubt the solidity of US performance, expectations as to the long-term value of the dollar were revised downwards, and the immediate rate of the dollar even more so, given the tendency of currency markets to overreact. The dollar started to weaken in this way in 2001; the process became more pronounced in 2003 (Baudchon, 2003).

1.2 The hopes and disappointments of a cycle

The favourable conditions in which the euro zone was founded helped point the policy mix in a more expansionist direction, postponing the latent conflict between the European Central Bank (ECB), the Commission and the national budgetary authorities – conflict which the ECB's statutes and the Stability Pact were in fact intended to contain. Until such time as the constraints on national budgets laid down in the Pact were triggered by the onset of an unfavourable economic climate, governments were able to effect a trade-off between budgetary measures to accompany the boom and a rapid reduction of deficits, with a view to balancing the public finances. With hindsight, the former option would not have seemed unreasonable if growth had been consolidated on a lasting basis.

However, the inauguration of the euro zone under favourable auspices fostered a damaging over-confidence, relieving governments of the duty to improve their co-ordination in a resolute and forward-looking manner. The arrangements for European economic governance accord priority to monetary policy objectives, subjecting them to far fewer constraints than budgetary policies. But the limits set for the latter are negative ones – what must not be done – without there being any direct incentives to engage in positive co-ordination, particularly in respect of expenditure guidelines. The procedure for synchronised presentation of multi-annual public finance programmes has remained formal and that of the Broad Economic Policy Guidelines (BEPGs) too inert to really stimulate any such positive co-operation, apart from the ritual appeal for structural reforms (Math, 2002). The community of governments has allowed the ECB, with its overview of the entire euro zone, to exert an excessive amount of dominance over the conduct of economic policy.

It is true that the window of opportunity opened up in this area was very soon closed. When Oskar Lafontaine was briefly Finance Minister in the Schröder government which came into office in autumn 1998, a more intense doctrine of co-operation sought to take hold. It entailed more active co-ordination of budgetary policies, the promotion of wage co-ordination to forestall competition based on wage deflation within the monetary union, and the definition of an exchange-rate policy setting out a balanced schedule of parities between the main currencies. However, although this last point was in conformity with the Treaties – whereby the European Council is responsible for fundamental exchange-rate strategy – it boiled down to curbing the ECB's room for manoeuvre, since the ECB would have had to take these parities into account when setting its intervention rates. This was one aspect of a conflict from which Oskar Lafontaine did not emerge victorious: he resigned in March 1999. The window had lasted a very short while (Dufresne, 2002). Lafontaine's proposals derived from an understandable attention to Germany's own interests – in particular to ensure German competitiveness, under threat from competitive adjustments in other European economies – but they had struck a chord in other countries, especially France.

Of course, from the Amsterdam and Luxembourg Councils in 1997 to that of Lisbon in 2000, the affirmation of the European Employment Strategy constituted a new and important element of Community activity. Employment was by now acknowledged to be a matter of common interest to the different countries. Confirmation of a growth phase helped the Strategy to take hold, by situating the objectives of employability and adaptability in a context of job creation and improvements in the quality of work.

While the boom was underway, from 1997 to 2000, employment and wages began to interact positively, allowing for a certain improvement in the wage component of added value and sustaining consumer demand on the part of employees. The diagnosis made in the Commission's *Employment in Europe* reports was that the labour market's structural state of health had improved and had become more responsive to the boom. Employment rates rose, above all as a result of the creation of full-time jobs, and the job-enrichment of growth was perceptible. A key role was played by job creation in service industries, especially hi-tech activities. Job creation was particularly dynamic in those services where potential demand evolves in parallel with real earnings growth. These structural developments appeared to consolidate the capacity of employment to withstand the slowdown, even though at the same time the upward trend in fixed-term contracts facilitated cyclical adjustment. In the Commission's view, these developments were evidence of the Lisbon spirit, i.e. the efforts of political and social players to co-ordinate with a view to consolidating growth and its quality job content within a "knowledge society".

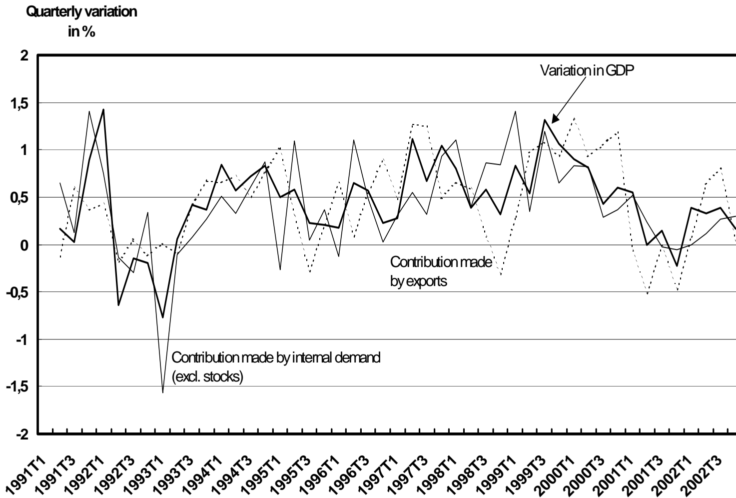
The job-enrichment of growth had a knock-on effect on wages, yet this resurgence in the purchasing power of pay remained only temporary. The relaxation of monetary policy helped the euro zone to get off to a good start, but its subsequent tightening was precipitate in the face of selective inflationary shocks affecting energy and food prices, occurring while unemployment was still at high levels. The ECB tightened the reins as from 2000, once these shocks began to have a negative effect on the purchasing power of pay. The combination of wage vulnerability and a tougher monetary line soon halted the boom. The slowdown in European internal demand, from mid 2000, predated the adverse

impact of external demand, which only kicked in during the course of 2001 (see graph 1). One justification for combating inflation is to protect the purchasing power of pay; that is not the argument which prevailed.

The monetary policy line followed by the ECB sanctioned an income distribution that was unfavourable to wages and contributed to the soft, capricious growth so typical of Europe. The way the ECB operated was to put on a display of preventing wage rises by counting on stronger growth, under the pretext of a threat of inflation. This acted by default as a wage norm: any increase in wages liable to affect the share-out of added value would be suspected of tipping the economy into an inflationary spiral. Wage restraint, i.e. keeping the progression in real incomes below productivity gains, remained the name of the game throughout the upswing (Janssen and Mermet, 2003) and was attenuated only by the effects of the boom on the labour market.

Wage restraint was naturally held up as the main cause of job creation. However, on the one hand, the decline in the euro until 2001 ensured that European prices were competitive and, on the other, the switch to the euro eliminated nominal currency devaluations between EU countries. The conditions therefore existed for embarking on a more resolute wage policy, coupled with fresh attention to the quality of work. Whereas the overall purchasing power of households grew significantly, a dominant role was often played by income from capital (for as long as the financial conditions permitted), social benefits and tax cuts. Prospective wage rises no longer benefited from "index-linking" to anticipated labour productivity gains; they were subject instead to uncertainty surrounding financial profitability, by now more directly reflected in wages as a result of management practices based on shareholder capitalism.

Graph 1: Contribution of components of demand to GDP growth in the euro zone



***Legend:** The contribution of each aspect of demand to GDP growth is the product of its variation rate multiplied by its share in GDP.*
***Source**: Eurostat*

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The persistent sluggishness of European internal demand largely contributed to the early downturn in growth, beginning in 2000, and then to the onset of stagnation. Companies, especially large multinational ones, incorporated this sluggishness into their strategies. The recovery in productive investment within the euro zone remained limited throughout the boom period of 1997-2000, despite its concentration in certain hi-tech sectors. The investment shortfall as compared with the United States worsened during the 1990s, so much so that European growth did not benefit to the same extent from the information technology boom. Many major European conglomerates bought up US assets, speculating on direct investment and external growth. The interrelation of the US and European stock exchanges grew stronger, and the European companies engaging in these strategies were caught unawares by the overall turn-around in the financial

markets from mid 2000 onwards. Even though they had not over-invested to the same extent as US firms, they were harder hit by the downturn in many cases and confronted by the need for time-consuming balance-sheet adjustments. Thus the effect of the prolonged stock market falls from 2000 onwards made itself felt on all households, even those of employees without share portfolios.

The fragility of European internal demand continued into 2003. A combination of factors prolonged the lacklustre performance: the deterioration in the labour market, renewed energy price rises, moves to correct corporate balance sheets and the wait-and-see attitude provoked by the geopolitical situation. Europe expected its recovery to come from an easing of the international situation, which would reduce energy prices, thereby contributing to an improvement in purchasing power and facilitating a revival of world trade. This is rather an acknowledgement of impotence for a regionally integrated zone whose dimensions might have been thought sufficient for it to go beyond the constraints affecting each Member State and exert a driving-force of its own. The recovery visible on the horizon at the end of 2003 was primarily driven by the upswing in international trade. It is now underway but, if internal demand once again fails to materialise, there is no guarantee that it will be consolidated.

1.3 The cost of incomplete political union

The implicit rule has been that the European Employment Strategy remains a subordinate part of the policy mix. The procedural adjustments made in order to dovetail the annual updates to the BEPGs with those to the Employment Strategy, as well as to incorporate the input made by macro-economic dialogue with the social partners, has created a cumbersome mechanism over which the Commission's economic departments and the Finance Ministers are still in overall control. Quality of work was the new watchword at one stage, but its definition did not include pay (Degryse and Pochet, 2002); indeed, it is difficult to detect the emergence of a wage system capable of consolidating internal demand in Europe. When the economy took a turn for the worse and all hope of a rapid recovery faded, the constraints of the macro-economic straitjacket – latent until then – made themselves felt. Wage restraint and job flexibility were then once

again given priority status by governments, while quality became a secondary goal. The main aim was to tailor employment to the new round of restructuring (IRES, 2002). There is no certainty that aligning the BEPGs and the employment guidelines for the first time in 2003, on an experimental basis, will be sufficient to give the Lisbon strategy second wind (on this point, see the article by Philippe Pochet in this volume). A good deal is at stake: is this a new opportunity for the social partners to influence the process or a final submission of the Employment Strategy to the current logic of the BEPGs?

The brevity of the upswing in Europe, from 1997 to 2000, coupled with the collective lapse of governments prevented this favourable period from being used to embark more resolutely on the road towards a European wage and social model. During the first few decades of Community integration, Social Europe was merely a "by-product" of the dominant economic side, intended to secure direct social gains as long as distortions of competition between Member States were averted. This contradiction deepened during the 1980s and 1990s. The goal of a Social Europe was held back by policies aimed at deflation and convergence, in spite of new social dialogue procedures and efforts towards cohesion: it was left up to each country to handle the social costs engendered by the transition to the single currency.

There was potential for a change in this situation once monetary union had been achieved: the positive linkage between economic policy and the response to employment needs encountered fewer obstacles at euro-zone level than in each country, individually facing its own constraints. The Union constituted an area where rules fostering social cohesion could emerge on a wider scale.

The recent cycle nonetheless shows how vulnerable aspirations of a Social Europe are to cyclical reversals. This vulnerability reveals the difficulty of turning the building of Europe into a plan for society, one which would overcome cyclical tensions rather than enduring them as though they merely resulted from exogenous shocks. Europe's capacity to build a political union – i.e. a common understanding about the social goals of the EU and rules enabling them to be attained – remains the key question in this regard. The putting-on-hold of the draft Constitution is part of this fundamental difficulty, following the

obstacle course that had to be tackled before social affairs were incorporated into the work of the Convention. The finalisation of the Constitution was an ideal opportunity to clarify at Community level the connection between economic and social affairs, previously established within nation-states. But the part of the draft Constitution devoted to policies is confined to a barely acceptable *status quo* that is hardly even faithful to the general commitments laid down in the text (from full employment to a social market economy). Should we, for want of a Constitution, content ourselves with a system of governance for public policies? If so, its instruments – such as the open method of co-ordination (OMC) and the social dialogue – would need some demonstrable normative powers, however weak (Freyssinet, 2003).

The report *An agenda for a growing Europe* (Sapir *et al.* 2003), written at the behest of the President of the European Commission by a group of independent experts chaired by André Sapir, appears to recognise these unsatisfactory circumstances. This report was prepared in parallel, but apparently unconnected, with the proceedings of the Convention. It focuses on the procedural coherence of European macro-economic governance and the rationality of its self-imposed rules. This line of thought leads the authors to recommend a scaling-down of Community fields of competence. They barely acknowledge the Community dimension of employment and social cohesion made explicit in the Treaty of Amsterdam. The report aims to be realistic: the Member States are not prepared to share too much competence with Community bodies, and the latter are not endowed with sufficient authority or resources to enable them successfully to exercise too many powers concurrently. It is proposed that the macro-economic functions performed at Community level should be performed more intelligently, in order to provide a stimulus for collective growth and for the less advanced countries to catch up. Employment and social cohesion are supposed to follow: it is up to Member States to ensure that they do.

At the risk of over-summarising, the Sapir report recommends a more sensible Maastricht Treaty in the macro-economic sphere but seems to scorn the input of the Amsterdam Treaty, followed up by the approach initiated at Lisbon. Whilst the macro-economic proposals are worthy of analysis, the acceptance of a distinction between economic and social

affairs constitutes a backward step. Economists are divided in this debate: Sinn (2003a) takes a more radical stance than the Sapir report, ruling out a Social Europe which, in his opinion, would result in a standardisation of wage and social norms that would undermine competitiveness and employment in the less advanced regions, hence provoking disruptive migratory flows. Bertola (2003), who in fact contributed to the Sapir report, points out in response that, whilst imperfections in the market need to be ironed out, Europe's social destiny cannot be abandoned solely to competition between national policies: economic and monetary integration must be matched by a co-ordination of certain components of social policy, so as to distribute fairly the benefits of integration.

This was in fact a problematical point in the Sapir report, which reveals the inegalitarian nature of the European upturn in the late 1990s: social cohesion, which benefited from job creation, was distorted by the drive to maximise financial assets. In the final analysis, this inegalitarian outcome proved to be an element of fragility rather than helping to consolidate growth. Consolidation of growth being the aim at Community level, responsibility for cohesion cannot simply be devolved to Member States. The dissociation between economic and social affairs accepted by the Sapir report has its procedural parallel: whereas the authors set little store by the constitutional process, nor do they have much faith in the virtues of the OMC, in view of the results achieved to date. This twofold scepticism leads them to advocate, for Community-wide competence, a method of governance which is shared between the Commission – endowed with additional responsibilities – and various independent agencies. The corresponding roles and instruments could then be allocated more satisfactorily: better institutional engineering should improve the consistency of Community decision-making, thereby preventing the promotion of the common good from being stymied by confusion and inertia leading to an injurious *status quo*. This depoliticisation of governance exposes the authors of the Sapir report to the charge of strengthening the technocratic bias of European integration (Le Cacheux and Sterdyniak, 2003). It plays down the embryonic participation represented by the invitation to the social partners to join in the OMC process. The fact that the OMC has thus far been limited in scope and a difficult learning

exercise – because of the governments' unwillingness to hand over any of the keys to the social partners – should not lead us to reject the contribution made by this attempt to diminish the democratic and social deficit in Europe.

2. Structural factors

2.1 Europe's America complex

The performance of the US economy is nowadays singled out as a benchmark for judging the situation in Europe. Indeed, the Sapir report devotes a good deal of space to this comparison, as a means of focusing the debate about reform of economic governance within the European Union.

There is nothing self-evident about comparing growth trends in different world economic zones, since no consensus exists about how to resolve the difficulties arising. Nevertheless, certain features seem to be sufficiently well established for their factual basis to withstand methodological diversity. The growth trend in Europe has been falling further and further behind that of the United States ever since the early 1980s, and upturns on this side of the Atlantic have remained too fleeting to reverse this hierarchy. This trend cannot be ascribed solely to the "new economy" bubble, which intoxicated the United States more than Europe. It has been a part of developments there for longer, and it resisted the selective shake-out of the new economy brought about by the cyclical downturn of 2001-2002. A cautious estimate would be that the pace of US growth exceeded its European counterpart by approximately one point (3 to 3.5% per year on average, compared with 2 to 2.5%).

This return to US leadership meant that Europe could not continue narrowing the gap in wealth per inhabitant with the United States – whether wealth be measured by per capita product or earnings. The catching-up process had been at the heart of the thirty-year boom following World War II; it ended before it had run its course. Detailed analysis reveals that Europe's intrinsic technical capacity to be as productive as the United States was not at issue: European labour productivity resumed its catch-up after the first oil crisis, despite wide

disparities from one country to another. The Sapir report provides some useful figures: in 1970, the US lead in terms of per capita earnings (30%) was linked solely to lower productivity in Europe; at the turn of the millennium it was identical in scale, allowing for statistical imprecision, but was divided into three roughly equivalent parts: one third for hourly productivity, a second for the number of hours worked, and a third for the rate of employment. Working life is managed very differently at its two ends: people in the United States start work sooner and go on for longer. And whilst hourly productivity is higher in certain European countries than in the United States, it leads us to work less. Yet, if the trend registered since the mid 1990s is borne out, the gap in hourly productivity between the United States and Europe is widening once again: a scissor-effect has been occurring over this period between hourly productivity gains which are accelerating in the US and slowing down in Europe, so much so that the former have outstripped the latter for the first time in several decades.

Looking beyond the numbers, the suspicion is as follows: if the European countries are putting more people into jobs, as they undertook to do at Lisbon, they are becoming less productive by mobilising a less efficient workforce which lacks the skills to cope with new technology. What is at issue here is Europe's capacity to employ broad swathes of its workforce in highly productive jobs (Gordon, 2003): how can we raise both the rate of employment and the productivity of the people who take up these jobs? It is a question of linking the European Employment Strategy with a proper industrial policy. What necessitates this linkage is quality of work, since quality lies at the interface between personal skills and development projects capable of bringing them to bear. Europe lags behind the United States in both of these senses, be it the relative weakness of expenditure on higher education and R&D or the difficulty of fostering a culture of entrepreneurship able to spread the implementation and use of new technologies right across the economy.

When cyclical developments are taken into account, the US advance becomes all the more evident. Upswings in Europe have for the past twenty years been belated, low-key and short-lived compared with those in the United States. Recessions can be brutal in the US, and empirical

analysis shows that the US economy is more cyclical, if what we mean by that is a propensity for lengthy booms alternating with out-and-out recessions. Such cycles are compatible with relatively regular prolonged growth, a characteristic of the United States rather than Europe. Variations in Europe tend to be less extreme, and a quick succession of bursts of activity and relapses clouds the horizon for all concerned. Whereas US growth and its fluctuations basically bow to the intensity and pace of capital accumulation, European growth suffers the unpredictable repercussions of more volatile inventory behaviour (Bentoglio *et al.,* 2001 and 2002). European recoveries prompted by the replenishment of stocks do not always lead to a resumption of productive investment, a necessary next step on the road to a true upturn. If the monetary authorities react to the first signs of tension by taking a precipitately tough line, without distinguishing sufficiently between a technical rebound of uncertain outcome and a full-blown boom, they could jeopardise the consolidation of that boom.

The mediocrity and faintheartedness of European growth are interrelated. The repeated mood-swings of European growth dissuade companies from embarking on long-term ventures or encourage them to relocate to what are deemed more attractive locations. The interaction of conservative economic policies – i.e. ones whose rules are predicated on prolonging the mediocre performance of past growth, which is explicitly the case of ECB policy – and corporate strategies which build the deficiencies of European growth into their forecasting ultimately means that the slump in Europe becomes self-perpetuating.

The dynamics in the US and Europe are contrasting but not independent. “Schumpeterian” growth in the United States absorbs surplus European savings, but the financial dependence of the US economy is a sign of both strength and vulnerability. The US only incurs debt for as long as foreign investors anticipate a high yield on their investments and have faith in US solvency. These investors have been attracted since the early 1980s by the opportunities afforded by restructuring and liberalisation in the US economy. Meanwhile, the pragmatic policy of the Federal Reserve, helping to maintain growth that is structurally accompanied by an external deficit, assists in spurring on the world economy. By going into debt, the United States ensures

that the dollars whose circulation fuels international business networks will flow back home. The United States, having become the “debtor of last resort”, plays the role of engine-house continually driving forward world growth, despite the shortcomings of creditor regions (OPEC, then Germany and Japan) and emerging borrower countries.

The lead country no longer is a well-defined, stable boundary, which would progress slowly enough for other countries to be able to catch up within the foreseeable future. Yet, as a result of demographic growth fed by a sustained inflow of immigrants, combined with technological creativeness, it pushes back this boundary and distances itself from its pursuers. It takes on the paradoxical form of a “developing lead economy”, which at one and the same time propels forward and dominates its partners. If its indebtedness, which reflects the strength of its attraction to others, were to turn into a weakness because international investors lost faith, the deflationary forces unleashed could take a dramatic turn – given that there is no immediate substitute for US leadership. The world economy is excessively dependent on US dynamism these days, but it is never easy to shake off such dependence. Recent economic developments reveal a degree of hesitancy: since 2001, the US balance of payments gap has been closed much less by direct investment than by portfolio and short-term investment. Capital movements changed direction in 2003, pushing the euro upwards until it exceeded the rate against the dollar that prevailed at its launch.

The 1990s cycle in the United States was fundamentally associated with wide fluctuations in capital accumulation, fed by growing yields from new technology and by competition to obtain potential clients. The resulting over-investment contributed to the downturn. But household consumption and property investment acted as a bulwark against recession: the capacity of the US financial system to manage massive household debt – by renegotiating loans and converting the value of the housing stock into liquid assets – helped to sustain consumer expenditure.

Yet the originality of the 1990s lies more in a particular conjunction of factors underpinning the boom than in these factors themselves: taken in isolation, they can be detected in other cyclical episodes. During the latest upswing, US inflation was contained on account of several

factors: the competitive liberalisation of markets, a widespread fall in costs prompted by new technology, recourse to immigration which provided low-wage labour, the rise in the dollar (from 1995 to 2001), and so the list goes on. Labour productivity gains during the second part of the boom, between 1995 and 2001, rose by between 0.5% and 1% per year more than the foregoing long-term trend. The acceleration seems to be almost equally attributable to the effect of substituting capital for labour and to that of improving the overall productivity of the factors of production. This set of circumstances enabled the Federal Reserve to be more relaxed about engaging in fine-tuning the economy, so as to help maintain the boom without being hampered by significant inflationary strains. This accommodating attitude did not prevent the risk of over-investment in activities centred on new technology from materialising – but that is nothing new in US history. Monetary policy has little control over the incentives generated by competition, nor over the temptations for managers and analysts to overly extrapolate the associated returns, to the extent of convincing shareholders that these are unchanging norms certain to stand the test of time.

The combination of factors characterising the last US cycle is nonetheless singular enough to generate considerable uncertainty: the lasting effects of investment in sectors which produce and use new technology are still open to question; the scale of job cuts made by US companies during the slowdown indicates that high productivity gains are still being made. The recovery of 2003 stemmed primarily from such gains, rather than from job creation. The joint capacity of the financial system and households to fine-tune consumer indebtedness is likewise subject to doubt. Finally, if the next upturn in the US economy is partially attributable to a military build-up, will that prove as attractive to foreign investors as did the peaceful activities of the internet bubble?

Both macro-economic and structural issues will need to be addressed in order for Europe to overcome its America complex:

- EMU cannot easily exist without a doctrine concerning the euro/dollar exchange rate, so as to secure the external conditions for its growth and to draw conclusions for the operation of its monetary policy. This is a politically sensitive area since, although the general thrust of exchange-rate policy is a matter for the

Council, the ECB does not wish to sacrifice its independence. The ECB explained its reading of the texts at a very early stage (ECB, 1999): the European Council should intervene only in exceptional circumstances;

- how can quality jobs be a factor of growth in Europe, a source of innovation and productivity? They cannot do so in isolation from development projects in the industrial and tertiary sectors. The idea of major public works made a comeback in 2003: the Lisbon strategy is to be given second wind by promoting trans-European networks with backing from suitable financial mechanisms. These projects can lend added substance to the European area; above all, however, they must give succour to Europe's capacity for initiative in the fields of training, research and trade. A unified market is not sufficient on its own to unleash growth, which also calls for government action and financial mechanisms to underpin the creation of quality jobs. This connection between employment policy and growth efforts was neglected by the Sapir report.

2.2 The difficulty of managing divergence

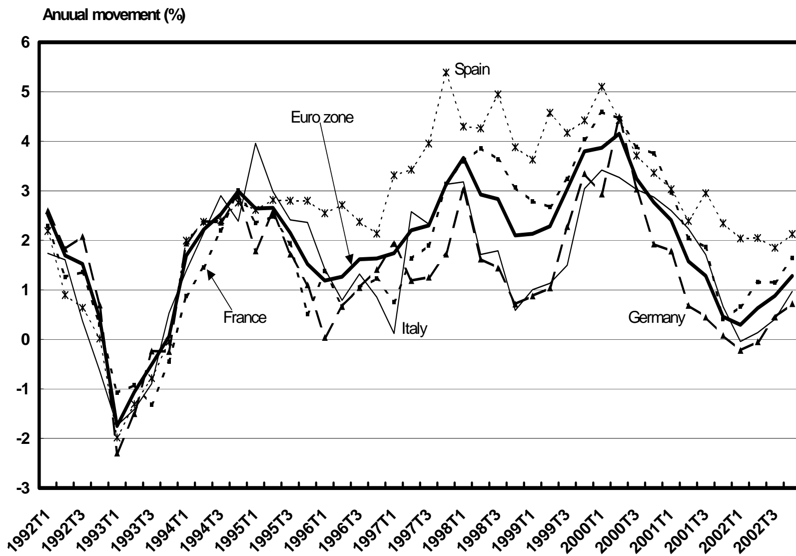
It was surprising to see a resurgence of large disparities in growth performance in the years following the establishment of the euro zone: these disparities were more pronounced than during the early 1990s when all the EU countries experienced recession simultaneously in spite of their divergences during the EMS crisis (see graph 2). The cyclical movement of the euro zone is still a long way from being identical in all Member States, in that it is not triggered by stimuli which affect them all simultaneously and in the same manner. A number of studies conclude that each of the national economies is affected to the tune of at least 50% by factors other than common European economic developments (Fayolle and Lemoine, 2002). Although these disparities bear the hallmark of earlier monetary rifts, mainly between "Germanic" and "Latin" countries, and although monetary unification should in essence attenuate them, any such reduction is hard to detect at present.

Be that as it may, to interpret the persistence of these disparities solely as a sign of inadequate cohesion in the euro zone would be precipitate. Varied phenomena are involved. During the 1990s, several factors

contributed to a more pronounced cyclical convergence among European countries: integration of the single market and an intensification of intra-European trade; an alignment of consumer and investor behaviour; and the "enforced" convergence of government policies. Not all of these factors are equally irreversible: under monetary union, following the discipline inherent in the transition period, policy co-ordination can in fact authorise more subtle national trade-offs; the apparent uniformity of the exchange-rate constraint can mask differential vulnerability to international competition. Effective co-ordination does not consist in denying these differences but in managing them, so as better to steer collective growth.

In practice, the mismatches in economic cycles interfere with a long-term dynamic governing the goal of economic and social cohesion that the European Union has set itself. The Union remains an area where unequal development and catching-up processes are very much in evidence. This still applies to the fifteen EU Member States – within which the countries "lagging behind" have indisputably made up ground over the past twenty years, albeit with variable intensity and regularity from one country to another – and more especially if we look at the regional level, where inequalities of development still persist in spite of the Structural Funds. It will apply all the more after the accession of the new Member States from Central and Eastern Europe: inequality and catching-up are not residual issues.

Graph 2: Rates of growth in European GDPs



Source: Eurostat.

Successful catching-up in socio-economic terms entails above all a proportionate, controlled catching-up of wages. If this happens too rapidly, it will hamper the competitiveness of the country where it takes place, especially if that country subjects itself to binding exchange-rate discipline, something that most definitely does apply under monetary union. If wages fail to catch up adequately, the more advanced partners, confronted by a loss of market share and the threat of relocations, resent what they regard as "dumping". A happy medium is not easy to achieve, and a country which tries to catch up in the face of excessive constraints is heading for trouble: the EMS crisis of 1992-1993 was partly linked to such competitive strains. Spain and Portugal, for example, suffered these strains throughout their catching-up process, even though the two countries responded quite differently: Portugal opted to curb the catching-up of wages, enabling itself to retain a strong competitive edge in highly competitive sectors such as textiles; Spain

caught up more rapidly but Spanish industry, undergoing modernisation, was unable to absorb the full inflow of labour coming from traditional sectors in decline. For a country that is catching up while carrying out extensive intersectoral restructuring, the trade-off between jobs and wages can be painful if growth in the entity to which it belongs is modest. That is also the reason why Germany's weak growth is a common problem for Europe: it encourages countries which are catching up to play the wage-dumping card, so as to free up employment-friendly competitive margins. The new East European Member States may well be tempted to follow this course of action.

The move to monetary union was not neutral with respect to catching up. Entry into the euro zone abolished the specific risk premiums which increased the interest rates charged to Spanish, Portuguese or Greek debtors in comparison with German ones. Having rid themselves of these premiums, those countries can more easily attract investors at the cost of severe competitive pressure on the lead country, which no longer enjoys the advantage of low relative financial costs. Differential growth rates within the euro zone corroborate this scenario. This pressure – exerted by competitors having largely made up for their initial productivity shortfall, bowed to the discipline of competitive deflation and liberalised their labour markets to a high degree – is contributing to Germany's structural difficulties: the pupils are taking revenge on their master.

The competitiveness of the German model, based on specialisation in classic capital goods, depended on a certain type of international growth. While the OECD countries were catching up with the US technological head-start by means of intensive capital growth, Germany derived maximum benefit from its specialisation. Its exports were very elastic to the expansion of its partners, which prompted a high degree of investment. German industry imposed its products and prices on international markets. The structural slowdown of growth in the OECD countries and the more immaterial nature of investment altered the German economy's position on the international scene. At the same time, the eastern *Länder* have not yet managed to escape the fate of the *Mezzogiorno:* it is proving difficult to establish a proper industrial base there. Labour productivity in the eastern *Länder* rapidly rose from a

third of that of the western *Länder* to 60%, between 1991 and 1995, but since then it has stagnated at this relative level (Sinn, 2003b).

Within a euro zone wracked by these strains, the danger of excessive wage competition comes from the countries that are catching up, tempted by dumping, but also from wealthy countries whose competitiveness is under threat, tempted by wage deflation. If either group resorts to action, the modest collective growth will once again fan the flames of competitive tension.

The protagonists in building Europe are well aware of these risks. References to the so-called Balassa-Samuelson effect, named after its authors, have returned to the economic policy debate. This effect justifies the maintenance of higher inflation rates in countries catching up, until such time as they have finished doing so. The Balassa-Samuelson effect is founded on a greatly simplified model of wage catch-up, which sets out to encapsulate certain key long-term features: wage levels in sectors (mainly industrial) exposed to international competition catch up with those in the lead countries. These wage levels become possible and justifiable in those sectors because productivity gradually catches up with modernisation; they then spill over into protected sectors (services, construction, etc.) due to the functioning of the national labour market. However, since there is less potential for catching up in these sectors (the productivity of a hairdresser, a waiter or a bricklayer is thought to vary little from one country to another), the relative price for these activities goes up and the cost of a haircut becomes as expensive in Lisbon as in Paris. Hence the normal difference in inflation rates. When the trade unions explore European wage co-ordination taking account of national and/or sectoral patterns of productivity to align wage claims, they are seeking a co-ordination model founded on this type of reasoning (Pochet, 2000 and 2002). The ECB, for its part, wonders how compatible the Balassa-Samuelson effect is with its monetary strategy: if the effect is significant, the average inflation target in Europe should not be seen as perfectly uniform. That is no doubt one of the reasons why, in May 2003, the Board of Governors described its action as an attempt to maintain inflation in the vicinity of the 2% per annum target, rather than at a markedly lower level.

The "upward" absorption of development differentials could act as an engine for growth in Europe, given the social and environmental needs of regions lagging behind. Outlook scenarios looking at the conditions for a successful enlargement to take in the Central and Eastern European countries demonstrate this possibility; and its plausibility is likewise corroborated by the reasonably good resilience to the 2001-2002 slowdown in Spain and Greece, as well as in the future East European Member States. Today, however, the mediocrity of performance in Europe is influenced more by Germany's very weak growth than by the relative dynamism of countries catching up. The sluggishness of the lead country weighs more heavily than the dynamism of outsiders and is contaminating Europe as a whole.

The German question is of interest to all Europeans, since its handling will affect Europe's collective destiny. Germany is finding it difficult to abide by the typical rules of the social market economy in the face of a competitive unification of the European area. It is suffering a backlash from the liberal adaptation of its partners to the macro-economic disciplines inspired largely by itself. This contradiction, palpable on the eve of monetary union, faded during the ensuing growth phase; it is reappearing now in tough economic times. The Schröder government's scheduled reforms of the labour market and social protection ("Agenda 2010") are provoking loud protests from the trade unions. What has altered is Germany's specificity, even though that was partly what previously made the Deutschmark function as a monetary linchpin: Germany used to be known for its superior material and cultural recognition of the input of wage labour, especially in industry. The resonance between economic stability and a strong DM used to be at the core of the internal consensus about the virtues of the German model and its external power of attraction.

This is a major paradox of the euro zone: once the euro was up and running, competitive deflation policies were expected to be replaced by policies promoting growth – except that Germany's leaders are tempted by competitive deflation. This temptation is making companies go all-out to adjust their balance sheets and costs. Germany's unemployment rate is "falling into line" by converging with the European average.

Today's Europe is a long way from the German social contract. Nevertheless, a positive gloss can be put on the question confronting Europeans due to the shortcomings of the German model: how can companies come together in a European production network so as to compensate for the weakness of the German industrial power? How can European growth be driven not by an elusive engine but by a well-balanced catching-up of regions and countries? How can the risk of competitive deflation be averted through wage co-ordination that involves the social partners and has a real impact on bargaining?

2.3 Macro-economic governance

The tribulations of European macro-economic governance are not merely a short-term economic accident, caused by unforeseeable events; they raise questions about the capacity of rules-based governance to promote growth. Such governance has taken hold with monetary union. Often these rules are justified more in terms of governments' reputations than by their responsibility to public opinion. If the rules are badly designed, they can contribute to a descent into ineffective, weak growth (Fitoussi and Le Cacheux, 2003). The degeneration of rules into dogma then triggers a revolt: if the rules preclude any appropriate adjustments, adjustments will be enforced brutally, amidst conflict, as was illustrated in 2003.

Even though the financial epicentre of the 2001-2002 downturn was situated in the United States, the European Union suffered longer-lasting repercussions and did not benefit from the recovery. Whereas the US government acted with resolute pragmatism, the European authorities were hidebound by a retrograde mechanism (the Maastricht criteria were geared to the transition to monetary union and calmly extrapolated the strong but fleeting growth of the late 1980s) and by distrust between the EU institutions and governments.

A pertinent appraisal of the ECB's actions must be put clearly into context. If one measures the ECB's responsiveness to ***variations*** in unemployment and inflation, which is on a par with the earlier conduct of the Bundesbank and with that of the Federal Reserve in similar circumstances, there is nothing self-evident about its uniquely restrictive inclinations. These are however more palpable if we look at ECB

responsiveness to higher ***levels*** of unemployment and lower ***levels*** of inflation, structurally, than in the United States: a tight monetary policy is less acceptable in such a context, where full employment is still far away. The ECB is supposed to assess the risk of inflation in the medium term, but its anxieties about the slippage in inflation forecasts are leading it to narrow its assessment horizons. In practice it assesses the risk of inflation more based on snapshot observations of inflation (sensitive to one-off rises in food or energy prices) than according to underlying inflation which is more indicative of medium-term trends. Its responsiveness is asymmetrical: vigilant in the face of calculated risks of inflation, but somewhat inert when it comes to the danger of deflation, convinced that – after all – inflation is never far off. It is rigid about taking account of cyclical dips and inconsistent in the decisions it takes by way of a response. The US Federal Reserve, by contrast, takes a gradual approach which could be defined as a long-term capability to determine and implement a resolute, progressive and persistent short-term interest-rate policy: this approach might initially take financial operators by surprise, but it moves their expectations and hence impacts on their business activity, causing them to share the diagnosis of the central bank (Creel and Fayolle, 2002).

Until the beginning of 2003, the ECB strenuously defended its "two-pillar" strategy: the medium-term money supply as the growth norm and a judicious appraisal of the risk of inflation. Nonetheless, throughout 2002 and in early 2003, the increase in the M3 money supply in the euro zone – affected by the reallocation of portfolios towards less risky liquid assets – far exceeded the norm of 4.5% per annum, imperturbably renewed every year by the ECB: it hovered around 7%. This overrun slowed down the monetary relaxation finally allowed by the ECB at the end of 2002. But it did reveal the obsolete nature of a "monetarist" norm that was supposed to prevail for an indeterminate medium term but was repeatedly disrupted by cyclical blips. This became so apparent that the Board of Governors decided on 8 May 2003 to relegate the money supply norm to the rank of second pillar. This norm does however incorporate an unchanged extrapolation of the growth trend in Europe, modestly situated at between 2% and 2.5% per annum, and the inflation risk is assessed in the light of this conservative extrapolation. Until autumn 2002, the ECB's passivity over

the risk of recession was predicated on the idea that – now that recovery could be expected fairly soon – inflation was a more pressing danger than the lack of a recovery. The ECB is more alive to the risk of inflation in countries where business activity is holding up and where companies are returning to profitability by raising prices than it is to the risk of deflation in Germany, which is more sensitive than small, open countries to the weakness of internal demand. Admittedly, it is difficult for the ECB to differentiate between risks because it is responsible for regulating the zone, but there is no harm in allowing for different levels of flexibility in budgetary policies.

On the budgetary side, the Stability Pact came to grief over a scenario – albeit not uncommon in recent European history – for which it had not made provision: a slowdown that did not conform to the exceptional circumstances entitling a country temporarily to operate a government deficit in excess of the 3% GNP threshold (an exceptional recession, resulting in a significant fall in GDP for a given year) but sufficiently persistent (almost three years) to take government deficits close to or beyond the critical threshold. The Pact is intended to be precise, but since its precision is not exhaustive, the rules it lays down may be ill-suited to unforeseen circumstances. Formal compliance with the Pact inhibits budgetary action against a decline into prolonged weak growth, whereas the deficit in a given year registers the cumulative impact of several years of low growth. Attempting to reduce that deficit over a short time-span contributes to prolonging this state of affairs. In 2002, budgetary policies were calibrated on the idea that the slowdown would be brief and they would soon be able to revert to the goal of balancing public finances. In case the slowdown were to last longer than anticipated – which is what happened – pro-cyclical policies were decided in advance. These lengthened the slowdown rather than countering it.

The German and French governments, more sensitive than smaller countries to the slump in domestic demand, were confronted in late 2002 with the reality of an abortive recovery; they protested against a Community mechanism which they now deemed unsuitable. This rebellion led the Commission to propose a slightly more generous timetable for the elimination of deficits (2006) and a target for gradually

reducing structural deficits (0.5% per annum). This adjustment was ultimately not enough to satisfy everyone. The suspension of the GSP procedures against Germany and France testifies to profound doubts about the very essence of macro-economic governance.

It has become plain that the European arrangements – the BEPGs and the national multi-annual public finance programmes – are ill-suited to contextualising budgetary policy: they result in formal programming which is more about stringency than it is about good planning. These arrangements are unable to take account of the point in the cycle, at risk of suddenly being caught unawares and making one-off opportunist adjustments. A single cycle was sufficient for the GSP to fail, whereas it had been supposed to help ensure consistency of economic policies in a medium/long-term perspective. The Sapir report was therefore right to draw attention to what is really at stake, namely the sustainability of the budgetary policies and of government debt. De Grauwe (2003) underscores the rudimentary nature of the GSP in this respect. On the one hand, the Pact is less explicit than the Maastricht criteria as to the critical threshold for government debt: this threshold was conventionally set by the Treaty at a uniform 60% of GDP, in view of the average figure prevailing in Europe in the late 1980s; in order to create a broad euro zone, formal compliance with this criterion had to be slackened, since it was achieved by only a small minority (including the United Kingdom!). On the other hand, in actual fact the Pact adopts a uniform criterion of zero long-term debt by demanding that governments balance their budgets in the medium term: this reduction from 60% to 0% constitutes "*a considerable change which went almost unnoticed when the Pact was signed*" (De Grauwe, 2003: 11).

To heavily indebted countries, the immediate reason for cutting debt was to ensure that they passed the test for admission to the euro zone. Now that the euro zone is in place, it is intended to last for ever. A permanent system of sustainable budgetary policies, providing a common framework for both new and existing Member States, now needs to be defined and established. Equating such policies simply with the gradual elimination of government debt would place a drastic structural constraint on public investment, since it would have to be funded out of current taxation: the potential for growth would be

unlikely to rise. The sustainability of government debt cannot be assessed independently of the prospects for growth and the impact of budgetary policies on these prospects: the "productive quality" of government revenue and expenditure is a live issue, and growth is not immune to government action.

The implementation of a viable process of budget policy surveillance is contingent on agreement between governments and Community institutions about determining sustainable public debt trajectories (perhaps laying down different targets from one country to another, depending on their inherent characteristics). The Sapir report calls for the Commission to assume greater responsibility in this process, in order to improve the capacity to predict and react, while giving the European Council responsibility in the final instance for making recommendations and imposing sanctions. But any such development would presuppose a consensus on the assessment criteria themselves.

Multilateral surveillance could thus apply to compliance with long-term debt targets and could evaluate deficits according to their compatibility with these targets (which is what the United Kingdom does quite happily, although it has just been rebuked by none other than the IMF). Attention should be focused on primary structural deficits (i.e. excluding interest payments and cyclical effects), so as to gauge the discretionary scope of the existing budgetary authorities (interest payments reflect both a cumulation of past deficits and the then interest rates). Burden-sharing between the ECB and the budgetary authorities needs to be better thought through. Co-ordination among the institutions handling the instruments of the policy mix should be based on a shared understanding of growth prospects and sustainable public debt trajectories, which has not been the case until now: the 3% European growth rate deemed feasible and desirable by the governments in Lisbon is significantly beyond the potential growth range estimated by the Central Bank (2 to 2.5%). The counterpart of more judicious budget policy surveillance is a demand for greater accountability on the part of the ECB, both upstream – when it has to justify its decisions publicly – and downstream – when their impact is assessed. An inflation target policy, whereby the Bank justifies its decisions in terms of the gap between its inflation forecast and a

reasonable medium-term target, lends itself better to this more responsible exercise of independence, since the ECB's case can then be compared with other forecasts put forward in public debate.

Conclusion

At the end of 2003, the European constitutional process was deadlocked, at least temporarily. The temptation to make the best of things could act as an incentive to press ahead with making European governance more sophisticated from a technocratic point of view. Yet the tough lesson to be drawn from recent cyclical troubles may well be that Europe will be hard pressed to do any better without a more effective reconciliation between the fundamental constitutional process and pragmatic improvements in governance. The former is needed so as to clarify the European citizens' political preferences and to define rules for democratic participation that are better suited to endowing the social dialogue with normative powers (a process initiated by the Maastricht Treaty with its Social Protocol). The latter is needed in order to heighten the effectiveness of decision-making rules concerning common or shared policies (a vast area where the draft Treaty bequeathed by the Convention broadly contents itself with a rather unsustainable *status quo*).

One fascinating aspect of the crisis in European macro-economic governance is this: the Europeans do not yet know how to draw on the full potential offered by their single currency. Beyond the speeches, the Community institutions and national governments collectively remain hostages to a conservative method of building Europe. This method has difficulty in accepting that the transition to the euro constitutes a full-blown structural change, one which gives Europe the potential in monetary terms to break with the sacrificial trajectory of the 1980s and 1990s – on condition that the institutional, political and social players can find a means of co-operation which is sadly lacking at present.

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