An EU Agenda for Reform not Business as Usual

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Boldly pursuing business-as-usual

Hailed by one commentator as "bold", the speech to the EU parliament by Commission president Jean-Claude Juncker would more accurately qualify as shifting deckchairs on the Titanic in anticipation of its rendezvous with an iceberg. The bold proposals in question were modest in number and more modest in content. The two would-be headline grabbers were expansion of the EU Infrastructure Investment Plan and an EU joint military force.

The first involves enlarging the investment programme that began in 2014 and extending it to 2022. If realized the "doubling" of investments would increase annual expenditure by slightly over €30 billion, considerably less than the German government alone spends annually for public investment. Because the programme involves a combination of public and private funds with no mechanism to ensure the latter part, the qualifier "if realized" is necessary.

A joint military force has been under discussion for decades, made concrete in the early 2000s with the creation of the European Defence Agency. The Treaty of Lisbon formalized arrangements with the EU Common Security and Defence Policy. Mr Juncker's bold wrinkle on existing policy is to include cooperation on border controls. The likelihood of agreement on this proposal seems low given past objections by member governments, most vigorous by Greece and Hungary.

Given the decidedly re-tread nature of Mr Juncker's boldness, hopes for decisive action at the summit in Bratislava were not high. In the space of a week Mr Juncker and his summitry colleagues went from "existential crisis" to "initiating discussion". The already narrow proposals by Mr Juncker were rendered paper-thin by Donald Tusk who omitted the investment part (yet another president, this one of the European Council).

Once in Bratislava the EU leaders seemed content to engage in a collective invocation of "I'm alright, Jack", or the all-purpose advice of *Mad Magazine*'s Alfred E. Neuman, "what, me worry?" Were it the case that the meeting in the Slovak capital wished to engage in serious reform of the EU Treaties, the salient issues present themselves clearly.

Reform the EU Trading System

The European Union began as a trading group who purpose was to integrate national economies, first in the coal and steel sectors. It represented a project in regional cooperation not competition. Facilitating a sustainable external sector is central to the success of any trading arrangement, the necessary basis for maintaining and extending economic and political integration.

Since the introduction of the euro and its adoption by more members, the European Union has unambiguously failed to facilitate external sustainability. On the contrary, external imbalance across countries has increased. The chart below shows the current account balances of 27 EU countries (all but the exit-bound United Kingdom). It reveals a trading block in which mercantilist competition has replaced cooperative and open trade.

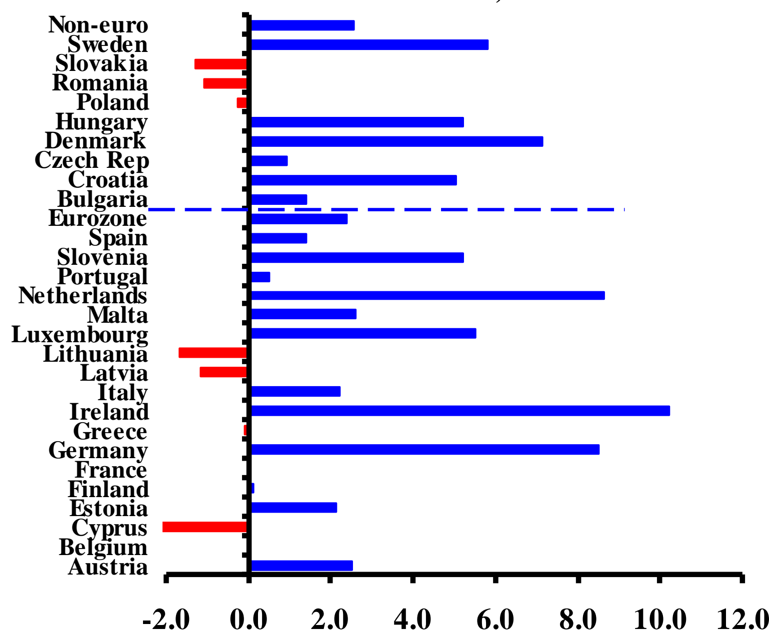
While no country shows an unsustainable deficit, the surpluses of at least six are unsustainable (Ireland, Germany, Netherlands, Denmark, Sweden and Slovenia). Without exception the most important component of the current account for EU members is the trade balance. It follows that a current account surplus implies a trade surplus, which in turn implies that domestic expenditure is less than domestic production (i.e., positive net exports).

In the absence of direct and overt subsidies (prohibited in the EU), wage repression provides the basis for export surpluses. A policy framework for export surpluses is simultaneously a wage suppression framework. This is not a politically sustainable growth strategy as the February election in Ireland and the success of *Podemos* in Spain demonstrate. The two presidents Juncker and Tusk decry the rise of what they call populism as an existential threat to the European Union. They fail to recognize the growing current account surpluses are the symptom of the underlying cause of voter disaffection, stagnant personal incomes.

The EU-wide solution to the neo-mercantilism of current account surpluses is simple and straight-forward, a fiscal stimulus that would reduce external imbalances by increasing imports. Complementary policies would reduce the substantial cross-country variability: 1) effective sanctions against countries with excessive surpluses; 2) re-design and re-allocate the EU Infrastructure Investment Plan to lower production and transport costs in trade deficit countries; and 3) an effective intra-EU clearing system for trade imbalances (as suggested by Thomas Mayer, former chief economist of Deutsche Bank).

The necessary reform would create an EU equivalent of the 1944 proposal of J M Keynes for an international clearing union, but much easier to implement because the common currency exists.

27 EU Countries Current Account Balance, share of GDP



2015

Source: Eurostat

Re-write the Fiscal Rules

The sustainability of the European Union requires complete re-writing of the treaty-based fiscal rules, from "convergence criteria" to the Treaty on Stability, Coordination and Governance ("Fiscal Pact"). These rules generate macroeconomic instability, reflect technical incompetence, and come from political ideology not economics.

They cause macroeconomic instability because they are pro-cyclical in economic down-turns; i.e., they tend to turn recessions into depressions. Recessions result in falling public revenue due to the income elastic nature of personal and business taxes, while some expenditures automatically rise (for example, unemployment payments). The Fiscal Pact's deficit rules require national governments to depress demand, lower expenditure or higher tax rates, when the economic problem is insufficient demand.

The rules are technically incompetent because they specify inappropriate measures of the fiscal balance (overall when it should be the primary balance) and the public debt (gross when it should be net). The neoliberal ideology of the rules manifests itself in the narrow approach to "competitiveness", predilection to policies that deregulate markets (especially the labour market), and the bias for a small public sector.

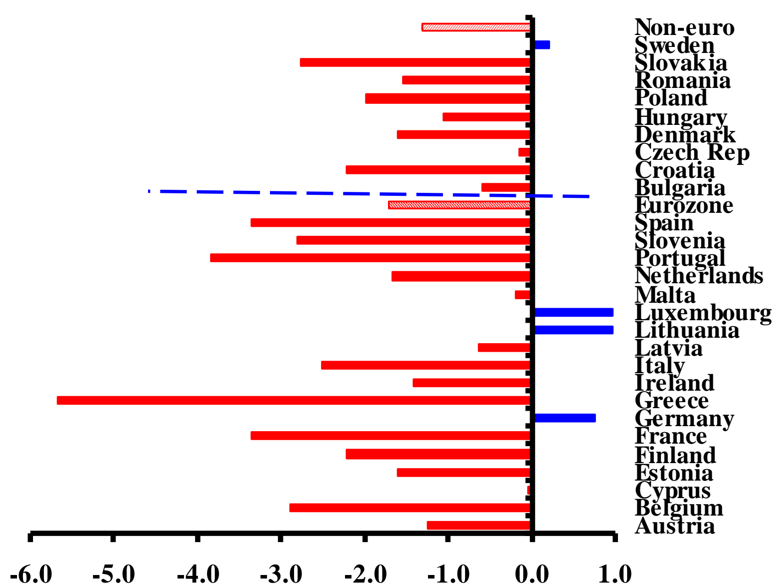
Perhaps the most damning criticism of the fiscal rules is failure to achieve their most important goal, deficit reduction. The chart below shows the overall fiscal balance of 27 member countries for the four quarters ending March 2016. Of the 27 countries 23 had negative fiscal balances (and six in excess of the infamous Maastricht 3% of GDP). If we omit Germany in 2016 the other EU countries combined for a population of 420 million; 407 million lived in countries with fiscal deficits.

As for trading reform the necessary changes to the fiscal rules are simple and straight-forward: 1) make the rules counter-cyclical; 2) apply the technically appropriate measures and definitions for deficits and debt; and 3) change the rules to be ideologically neutral. The only serious difficulty that arises is how to facilitate adjustment in countries with unsustainable deficits.

Practical guidelines for the technical solution to unsustainable deficits, guidelines that should have guided US policy towards Greece, are 1) treat deficits as structural imbalances not a profligate sins; and 2) deficit reduction is far easier in a growing economy that in a stagnant or contracting one.

To summarize the needed reform in a phrase, end austerity and its ideological biases.

27 EU Countries Fiscal Balance, share of GDP 2015Q2-2016Q1



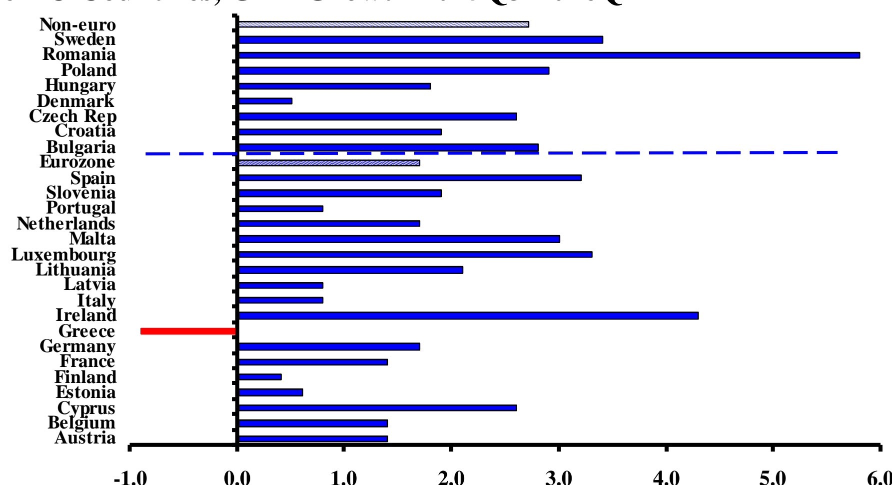
Source: Eurostat

Stop Fostering Stagnation

The problems of persistent trade imbalances and use of austerity policies in response to fiscal deficits have made the European Union perhaps the slowest growing region in the world during this decade.

The chart below shows how slow that has been during the 12 months ending in June 2016. Eight years after the global financial crisis 13 of the 18 euro zone countries grew at an annual rate of less than 2 percent. By contrast, only three of the nine non-euro countries fell below 2% (3 of 10 if Britain were included), suggesting that the currency step towards "ever closer union" fostered lower not higher growth. We should expect this because the Commission can more vigorously enforce the fiscal rules on the euro countries.

26 EU Countries, GDP Growth 2015Q3-2016Q2



Source: Eurostat
Note: No statistics for Slovakia.

Reform Priorities

The last chart should not be interpreted as evidence for an end to the common currency system (as Stiglitz seems to suggest in his new book). First, the mainstream parties in all the large countries as well as some of the insurgent parties (Podemos, for example) are committed to maintaining the single currency. A successful reform programme must maintain the single currency, even facilitate more members.

Second, the euro is not the barrier to growth and equity in the European Union, trade and fiscal policies are. The end of neo-mercantilism by design and implementation of an effective clearing mechanism for intra-EU trade, plus fiscal transfers to finance reductions in production costs would change the current wage-depressing trade regime into a growth enhancing external policy. Simultaneous reforms of the fiscal rules to render them ideologically neutral would foster policy diversity rather than the current one-size-fits-all austerity regime.

The countries of the Union are different. Trade and fiscal policies should accept those differences. Closer union in Europe should not mean every country with the same policies any more than it does for the 50 states that make up the United States of America.

Further integration, or “ever closer union”, is not the solution to problems; it will be the consequence of resolving problems. The introduction of the euro clearly demonstrates that further integration on top of unresolved problems reinforces rather than resolves those problems. By doing so it makes further integration politically remote.