

THE EUROPEAN ECONOMY

EC4027: Lecture I

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This lecture introduces students to the central problem of the EU: concurrent, yet different, visions of modus vivendi. We will discuss the role of the EU's institutions in creating a homogenous-seeming presence amongst member states, and yet being accountable to none of them. We will discuss the formation of major EU institutions, and reflect on the relationship between economic growth, and European integration.

ON August 11, 2010, economist Paul Romer¹ wrote of Greece that

[a]n achingly slow recovery from the financial crisis could threaten the foundations of Greek society. To avoid this, the people of Greece should reach out to the EU – not for more loans or for budget supervision but for assurance that new efforts to root out corruption and civil service inefficiency will be politically neutral. By working with the EU, Greece can quickly build the kind of strong, honest, and efficient state that can lead the country out of the crisis.

Romer's idea is to infuse Greece's corrupt institutions with the credibility and good governance structures of the EU. The idea was warmly received, and may even be acted upon. Currently there are calls for 'fiscal councils' to monitor budgetary policies within the EU's member states, to ensure fiscal coordination. The thinking goes that fiscal policy during normal times must be sufficiently counter-cyclical to enable aggressive fiscal intervention in the event of a major negative shock. A fiscal, as well as monetary, union, must be built. The solution is to set up independent fiscal councils in Eurozone member countries. The idea, again, is that the EU's core institutions know better, that the economic crisis within the EU will act as a spur to move possibly recalcitrant member states toward fiscal consolidation and coordination.

The preeminent notion of fiscal discipline mainly reflects the economic interests of Germany, a country that in recent years has witnessed strong gains in competitiveness and has managed to maintain a large external surplus in 2010 without compromising its fiscal discipline (the debt ratio is currently at 79.6% and the primary budget at -3.5% of GDP). While German output fell by almost 5% between 2009 and 2010, the unemployment rate has fallen. GDP growth has rebounded in recent months in Germany. Contrast the 'core' of Europe's economy with the 'periphery': the Greek economy shrank for a seventh quarter, sending the yield premium investors demand to hold the country's 10-year bonds rather than German bonds (bunds) to the highest since the European Union announced a 750 billion-euro package for the region's

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¹Paul Romer, Cutting the corruption tax: A way out for Greece, *VoxEU.org*, August 11, 2010, <http://www.voxeu.org/index.php?q=node/5394>.

Country	Adjustment (% GDP)
Austria	-0.9
Belgium	-0.05
France	-0.05
Germany	-0.03
Hungary	-0.02
Greece	-0.11
Ireland	-0.03
Italy	-0.02
Netherlands	-0.02
Portugal	-0.07
Slovakia	-0.03
Spain	-0.08
Switzerland	-0.01
Hungary	-0.02
UK	-0.06

Table: Budget cuts (% GDP) for 2010–15 in Europe. Source: CESINFO DICE, Medium Term Fiscal Consolidation Plans. See <http://tinyurl.com/2ubg5bf>. Note Ireland's budget cuts were pre-2010 and aren't included.

most indebted nations. Germany's recent explosive GDP growth in the face of a large fiscal retrenchment can be contrasted with the planned fiscal contractions of other EU member states, as the table to the right shows.

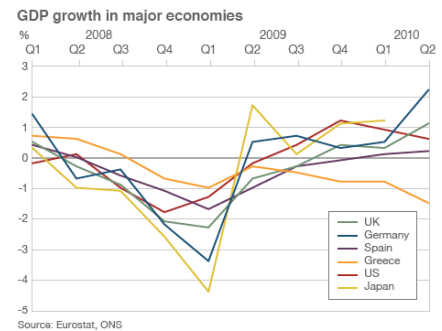
Contrast Romer's statement with the outlook of philosopher Jurgen Habermas², who feels that a policy of graduated integration between member states over decades is the only possible solution to the lack of public participation in the European project, which Habermas regards as fundamentally undemocratic. In fact, Habermas believes the EU is a Utopian project, with undemocratic under- and over-tones. The only solution Habermas sees is multiple referenda by each member state, with various 'speeds of integration' being chosen. For Habermas, Romer's solution, meritorious though it might be, would just be more of the same: an erosion of sovereign power by a supervening (and supranational) bureaucratic agency. The unifying institutions of the EU are at work here, but, Habermas might argue, it is to *impose*, rather than to evolve, a solution, to the problem of Greek corruption in public life. The very real question of whose interests are served in any policy mix—the EU or the member state—becomes apparent in seeking a remedy to the problem of Greek corruption. Greek corruption is an EU problem, because Greece is an EU member state, and the consequences for Greece's default would be felt EU-wide. Yet does that imply that the solution to Greece's problems is to be found at EU level?

Contrast, yet again, the views of Romer and Habermas with the central tenet of the EU: increased integration between nations reduces the probability they will make war on one another³. This is a one-way proposition, easily tested. It is a fact that no nation has gone to war with another since the EU began in the late 1940s. The EU is an economic solution to a political problem: how can Europe avoid another destructive war? The tools of economic liberalization are various, but can be grouped according to reductions in

Barriers to trade in goods and services, barriers to trade of productive factors like capital and labour, bans on cooperative behaviour between firms, universities, and nations, and of course coordinated government behaviour, especially with regard to policy coordination.

The EU⁴ was constituted in 1957 under the auspices of the Treaty of Rome, which established principles of free trade in goods, common trade policies, prohibition of state aid, the prosecution of anti-competitive behaviour, and reductions in distortionary taxes. The Treaty also made inroads to allowing trading in services, labour and capital market integrations, and putative exchange rate coordination. Common regional, agricultural, and taxation policies were also mooted. From the Treaty of Rome in 1957 through to the Treaty of Lisbon in 2009, the increase in economic integration of capital, labour, and goods and services markets has continued apace, though highly correlated with rates of overall economic growth in the Eurozone. Periods of prosperity

²Jurgen Habermas, *Europe :The Faltering Project*, London: Polity Books, 2009, pp. 78–105.



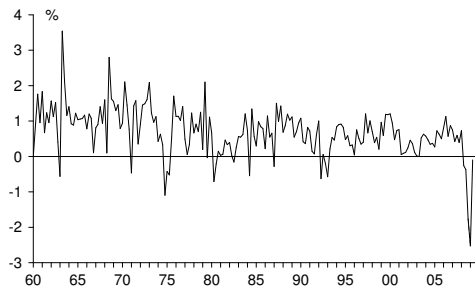
GDP Growth in the EU Today. Source: Eurostat.

³Barry Eichengreen. *The European Economy since 1945*, Cambridge, MA: MIT Press, 2007, Chapter 2, especially.

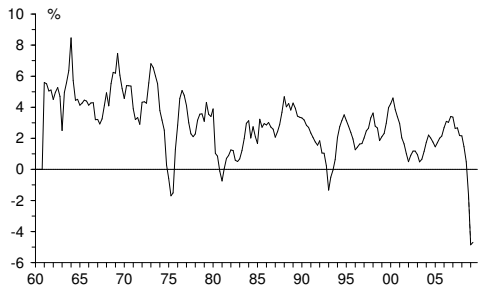
⁴Throughout these notes I'll use the acronym 'EU' to refer, variously, to the European Economic Community (EEC), the European Community (EC), and the European Union (EU). For much more on the Treaty of Rome and subsequent treaties, see www.ena.lu/.

are, of course, linked with periods of GDP Growth, as the figures below show, but they are also linked with periods where economic integration increases. When things go well, in other words, we get increased economic integration.

Quarter on quarter



On year ago



Figures above: Quarterly GDP growth, Euro area, 1960–2009.
Source: OECD.

The EU is a Utopian experiment in trying to answer the basic questions economics is built to answer: is continual economic integration growth enhancing? Are the rich getting richer and the poor getting poorer, or will the income levels of EU member countries converge as a consequence of integration? Who benefits more from the introduction of new member states--the new member states themselves, or the 'core' economies? Ultimately, whose agenda is served?

The EU as Utopian Project

[John Gray here.]

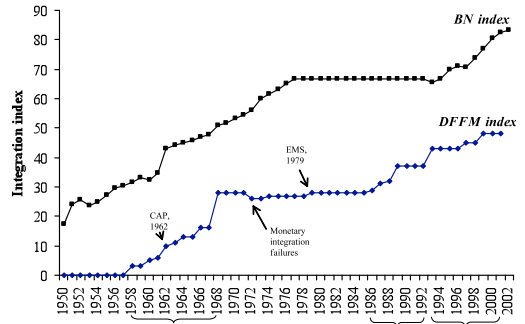


Figure above: Stages of economic integration.
Source: Baldwin and Wyplosz, *The Economics of European Integration*, McGraw-Hill, 3rd Edition, 2009.

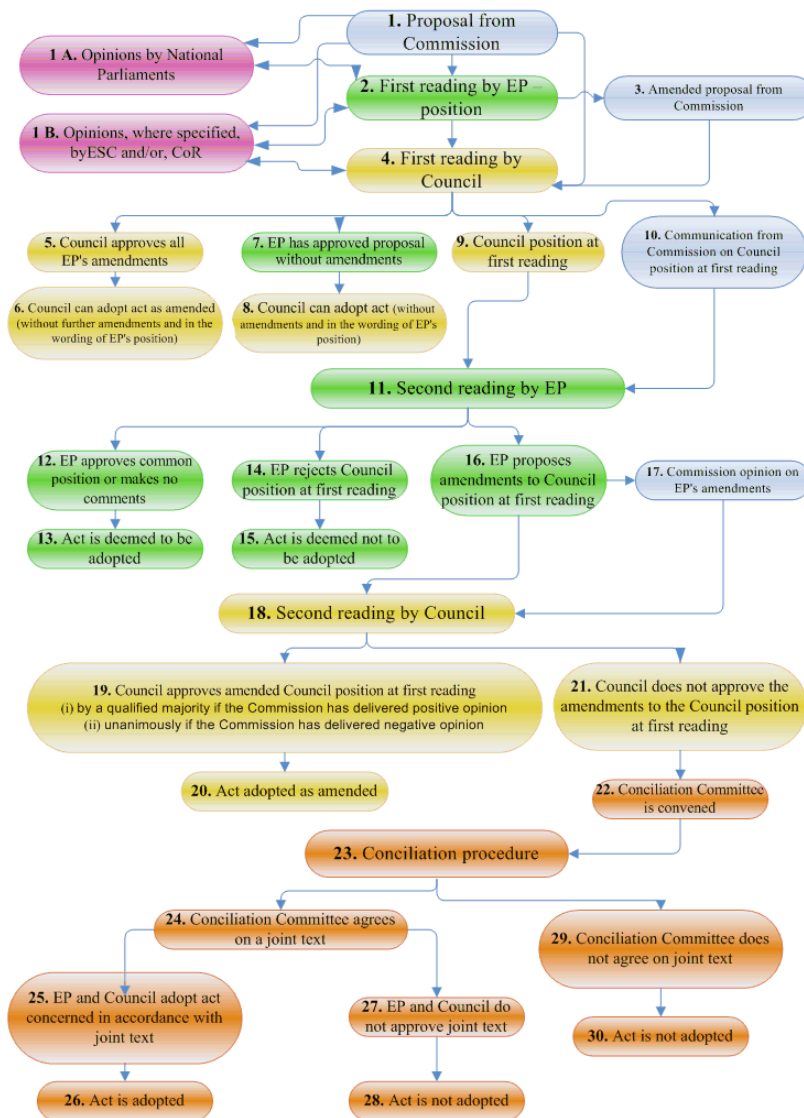


Figure. Byzantine decision-making structures within the EU. Source: Europa, details at http://europa.eu/institutions/decision-making/index_en.htm.