

Foundering Stability Pact, Lisbon fiasco and constitution in danger: Is the EU heading for a political crisis?

- The loosening of the Stability Pact and the setbacks in the Lisbon process show that economic policy at the European Union level has become bogged down.
- National politicians have seized back the initiative from the European Commission.
- If the French referendum on the new constitution should lead to a No vote, the EU may find itself in an acute political crisis.

A stupid pact ...

In order for the euro zone's common monetary policy to work, individual nations need a fiscal policy that provides a certain freedom of movement yet ensures that the fiscal policy of the currency union as a whole does not become too expansive. The rules of the Stability Pact tried to fulfil both these goals – with mixed results. The Pact made the euro zone possible (without it, Germany would never have agreed to such a large currency union). The euro zone has also shown better structural balance in public finances than both the US and Japan.

But the currency union is far from achieving its target of balanced public finances. The largest euro zone countries have also repeatedly broken the rules of the Stability Pact. Romano Prodi, former President of the European Commission, explained this failure by saying that in its original form, the Pact was too “stupid”; its strict rule system caused it to lose political legitimacy in a number of member countries and it thus became too easy for various alliances in the European Council to defang the Pact.

For more than a year, there was a debate on how the Pact should be reformed. Two main alternatives were conceivable. *Either* tightening discipline by making the process even more legally binding and its sanctions tougher and more automatic. *Or* making the Pact more politically acceptable by making it “smarter”.

The Commission's proposal – unveiled this past winter – was based on the second alternative. The Commission maintained that the rule system of the Pact should be based more on structural budget deficits (keeping the economic cycle in mind) and that the level of central government debt should play a more prominent role. Thus, countries

with little such debt would enjoy more flexibility, while those with heavy debt would have less room to manoeuvre. Meanwhile the Commission wanted to impose more ambitious debt repayment requirements during economic boom years.

...that was loosened

The Council of the European Union did not accept the Commission's recommendation, but wanted to go considerably further in loosening the rule system. Both France and Germany demanded exemptions for a number of public expenditures when calculating budget deficits.

As a result of the Council's pre-Easter summit, Germany and France largely got what they wanted. The result is a Pact that is undoubtedly "smarter" – in the sense of being more sophisticated when it comes to calculating deficits and their causes – but also significantly looser and more negotiable, which in turn makes it less transparent.

- A long list of new exemption rules will lead to **significant loosening** of the Pact. In the future, breaching the budget deficit ceiling of 3 per cent of GDP will be permitted not only in the event of a recession (negative GDP growth) but also in the event of zero growth and in some case also weak positive growth. Pension reforms may be accepted as reasons for running deficits, and various expenditures may also be subtracted: development assistance, certain military operations, costs for the reunification of Europe (German reunification, structural fund expenditures), refugee reception and research expenditures. All of this opens the way for noisy squabbles on exactly what expenditures should be exempted and when. Furthermore, the Council said

that due consideration must be given to circumstances cited by the deficit-burdened country itself.

- The Council also agreed to **extend the deadline** for remedial action when a country has taken on large deficits. Now the guilty party will be given significantly more time before it must achieve its balance target. Assessment of penalties will take up to five years – which means in practice that they will not be used at all.

The politicians at the EU summit declared with one voice that now the Pact had been strengthened. This is not true. On the contrary, by approving exemptions and weakening the sanctions mechanism, the Council substantially loosened the Pact.

How dangerous?

Such a development may be dangerous for the currency union. No wonder the ECB is concerned and that its President, Jean-Claude Trichet, has sharply criticised the Council for its revision of the Pact.

So can we expect higher interest rates in the euro zone? At the moment, hardly. The loosening of the Stability Pact was expected and was largely priced into the market. And right now, unemployment is high while inflation is falling. Further ahead, however, more expansive budget policies may lead to higher interest rates. However, it is impossible to quantify this effect now – it will of course depend on *how much* fiscal discipline will slacken, and at what stage.

An initial test is likely as early as next year. The Commission predicts that Italy's budget deficit will climb from 3.6 per cent of GDP this year to 4.6 per cent in 2006, well above Italy's own forecasts. The reasons are slow growth plus a number of cosmetic

one-off measures in the Italian budget. The political situation in Italy – a parliamentary election due no later than the spring of 2006 in a situation where the government is suffering repeated defeats in regional elections – will lead to further risks of more expansive fiscal policy. The stage is thus set for a new showdown between the Commission and the Council.

It should be pointed out here that the Pact itself, with its figures and goals, is actually not the essential issue. The previous version of the Pact – the “stupid” one – of course had figures and goals that were carved in stone. That did not prevent the largest euro zone countries from breaking it. The figures in the Pact are thus less important than one might think. Political will is what determines the future.

Nations have taken back power

Thus in itself, the significance of watering down the Pact should not be exaggerated. More ominous is the political process that led to the loosening of the Pact, and the fact that it is also behind political failures in other – more important – areas.

What the euro zone, squeezed between the US and Asia and suffering from permanent high unemployment, needs most of all is structural reforms: More flexible labour markets, reforms to boost employment and incentives to work, better education etc.

The “Lisbon process” – aimed at turning the EU into the world’s most competitive, dynamic knowledge-based economy by 2010 – has not yielded the desired results. On the contrary, in economic terms the EU has fallen even further behind the US in recent years. There are two reasons behind this fiasco. Firstly, other difficult matters – eastward enlargement, the introduction of

the euro and the work on the constitution – have required most of the energy at the EU level. Secondly, the EU has no supranational decision making power on issues crucial to growth. The power over structural reforms lies at the national level.

The Commission’s attempts to motivate national politicians to embrace the Lisbon strategy took the form of an intricate system of goals and indicators that would lead to rankings of the various countries’ growth measures and potential. A kind of peer pressure would thus drive each country to implement the necessary reforms.

But this method has not worked. Due to political compromises, the number of targets and indicators was far too big. In practice, each government has thus been able to point to some indicators on which it has performed well and say nothing about those on which its results have been poor.

And now that the Commission has tried to make the Lisbon process more efficient by reducing the number of goals and indicators, it has encountered loud protests saying that social and environmental goals are being neglected – despite the fact that even after a stricter “prioritisation” the number of indicators is still well above 100. The directive on services, part of the Lisbon process, has been sent back to the Commission for new compromises.

Both the Lisbon process and the handling of the Stability Pact illustrate an ongoing trend in the EU: A movement from supranational regulation to political negotiations between nations. The Council – in practice the governments of (the largest) member countries – have seized power from the Commission.

Those who feared that EU integration would give more power to the bureaucrats

in Brussels thus have reason to celebrate; today collaboration (and horse-trading) between national governments is in the driver's seat. Instead, those who hoped that "Brussels" could pursue a dynamic policy to bring about faster European growth and sound state finances have reason to be worried – and self-critical. Developments show that supranational proclamations and rigid rule systems without support at the national level do not work; they require national politicians who will assume wholehearted responsibility.

A political crisis is brewing

The conflict between "European" and "national" interests may burst out into an acute political crisis during the coming year, if any EU member country should refuse to ratify the new constitution. The enlarged EU would then be forced to live with the Treaty of Nice, which is an exceptionally unsuitable platform for today's enlarged 25-member union. One major problem with Nice (which the proposed constitution has tried to eliminate) is that it allows blocking minorities and, in practice, makes majority decisions impossible in numerous fields.

One reason why the other EU heads of government allowed French President Jacques Chirac to lead the attack against the Stability Pact and the Lisbon process was his ar-

gument that otherwise the French would say No to the constitution, thereby throwing the EU into a constitutional crisis.

But despite the willingness of other leaders to accommodate this, the No side now leads the opinion polls in the run-up to the French referendum on May 29. Should France vote No, the task of ratifying the new constitution will come to a screeching halt. There is consequently a major risk that the conflicts built into the Treaty of Nice will break out again. More concretely: Germany and France are once again likely to try to create alliances – often directed against new members, the Nordic countries and the United Kingdom – aimed at blocking the modernisation of the union. The negotiations on Turkish membership would be interrupted.

What would be left is a single market and a central bank – but without clear rules for a functioning system of fiscal policy coordination or the Stability Pact, without a common growth strategy, and without a functioning system for decision making in the enlarged European Union.

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