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Summary

Over the last two decades, the emphasis in macroeconomic policy has shifted decisively to one that focuses on stability rather than active demand management. This was, arguably, needed to counter growing budget deficits and a propensity to inflation, but the chapter suggests that this policy position has been pushed too far. Too little attention to growth has adverse social consequences, because it entrenches high unemployment, leads to pressures to cut spending on social aims, and may lock countries into a vicious cycle. Although stability-orientated policies are rule-based and thus appear to be objective, the chapter points out that the policy approach does have distributive consequences, so that the normative dimension of stability cannot be ignored. Stability may be helpful for long-run growth and need not be incompatible with social solidarity, but it should be seen as part of a wider policy mix, not an end in itself.

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I. The problématique[1]

An extreme view in contemporary macroeconomics is that only actions on the supply-side (principally aimed at boosting productivity) can produce enduring growth, with the corollary that attempts to stimulate demand will inevitably back-fire. The polar opposite is the strongly Keynesian position that the demand side is crucial and that supply improvements will follow from stimulation of demand, rather than vice versa. The Keynesian view – despite the fact that it emerged from the policy failings that gave rise to the Great Depression of the inter-war years of the 20th century - fell into disrepute after the 1970s, because it was seen to have led to progressively higher inflation and growing imbalances. The perceived failings of Keynesian demand management, together with the huge costs that were incurred before and after the signing of the Maastricht Treaty to slay the demon of inflation and rein-in fiscal profligacy, have given rise to a policy model in which stability has become a core objective. Stability, in this sense, implies a long-term commitment to price stability and fiscal rectitude, and has ushered in a new orthodoxy inwhich macroeconomic policy is much more passive.

This new orthodoxy has, largely, become the model for macroeconomic policy-making that is written into the EU Treaties and which, downstream, dictates how the institutions, notably the European Central Bank (ECB), and the mechanisms of economic governance in the EU function. Indeed, the notion of active demand management has fallen into disrepute, and it can be argued that the policy model adopted for economic and monetary union (EMU) prevents any contestation of its tenets and severely constrains policy discretion (for an overview, see Buti, 2005). This constitutional position has been used to justify a monetary policy stance that is criticised for giving too much weight to price stability and not enough to the real economy, while fiscal policy has been subject to rules, including the Stability and Growth Pact (SGP) for euro area members, that are believed to deter expansionary policies..

An obvious reason for questioning this policy stance is the lacklustre economic performance of so many Member States, notably those usually considered to be the core of the EU integration project. There is also a sentiment that the US (and, to a lesser extent, the UK) has - notwithstanding the criticisms in the chapter in this volume by Block – been able to pursue economic growth more effectively because it has placed less weight on stability. This prompts doubts about whether stability has been overdone, to the neglect of growth. Here there is a marked divide. Stylising the ECB, its view tends to be that (price) stability is a necessary condition for growth and that any attempt to use monetary policy to deal with other policy objectives is doomed to failure. The alternative perspective is that monetary policy inevitably also affects the real economy and that this insight has been unreasonably overlooked in the EU, in contrast to the US where the Federal Reserve has a dual mandate to have regard to unemployment (that is, the real economy), as well as the price level.

Despite these constraints, calls for more active demand management are repeatedly heard. The European Trade Union Confederation (ETUC), for example, has been especially vocal in advocating more expansionary monetary policy (see Watt and Janssen, 2006), while in the debate leading up to the reform of the SGP in 2005, a suggested improvement canvassed by a number of Member States was that higher deficits should be allowed if they were associated with policies that brought long-term benefits.

[1] The research on which this paper draws is part of the Integrated Project ‘New Modes of Governance’ (www.eu-newgov.org), financially supported by the European Union under the 6th Framework programme (Contract No CIT1-CT-2004-506392)

There is, plainly, more to the European economic policy framework than macroeconomic management of the economy and the emphasis on stability. The single market is, for many commentators, what the EU is fundamentally about, while other forms of integration are regarded as either optional or superfluous, depending on the prejudices of the interlocutor. Despite the evidence that the French 'no' vote on the Treaty Establishing a Constitution for Europe was, at least in part, a reaction against the so-called 'neo-liberal' agenda that the single market is considered to epitomise, most discussions of the future of Europe regard the *acquis* of the single market as inviolable. Underlying this strong position is the equally strong belief that prosperity depends on competitive markets, so that actions that might compromise freedom of movement of goods, services, labour and capital will ultimately be self-defeating. In this view, to draw on two of the examples adduced in the introduction to this volume, the opposition from the Swedish trade union to Laval is misconceived, while the Opel workers in Bochum should understand that their country's prosperity – however implausible, even paradoxical, it may appear to the individuals concerned – depends on their vulnerability.

This chapter investigates whether stability is necessary for growth and on what terms. It starts by spelling out what is meant by stability, looking at how the EU evolved towards its present policy framework and discussing the implications. Section 3 focuses on the SGP and whether it is to blame for the current economic malaise in much of the EU, then section 4 widens the discussion of policy implications. The social consequences of the stability paradigm are discussed in section 5 and concluding comments complete the chapter.

II. What is meant by 'stability'?

Even if a focus on it is regarded as appropriate, what constitutes stability is open to interpretation. The strong preference for stable macroeconomic conditions can be seen by the frequency with which the word is used (positively) in key texts. Thus, in the preamble to the Treaty, the contracting parties resolve to pursue 'a single and stable currency', while Art. 4 TEC asserts the pre-eminence accorded to price stability in the conduct of monetary policy that is then fleshed out in the chapter on monetary policy (Art. 105 TEC). Art. 105 also emphasises financial stability, while Art. 111 stresses that exchange rate arrangements should be consistent with price stability. Other terms, such as 'sustainable' – notwithstanding its connection to environmental aims – and 'sound' (especially in relation to public finance) are also apt to be used in connection with an absence of volatility or risks of economic imbalance. For example, excessive deficits are linked in many official texts to the notion of sustainable public finances.

Some commentators argue that the particular configuration adopted for the euro area goes too far by specifying rules that are overly tight or misconceived (Buiter, 2006). There are two aspects to this: first, the legal framework can bind policy actors to such a degree that they have no discretion; and second, the actors themselves can interpret their mandate in a rigid manner that forgoes discretion. When this occurs, the risk is that social aims are paid less attention and that meeting the rule becomes an end in itself.

The example of the approach adopted by the ECB illustrates the dilemmas. As is well-known, the ECB's primary mandate, set out in Article 105 of the Treaty, is to assure price stability and, 'without prejudice to the objective of price stability' to support the general economic policies of the EU. In contrast to the monetary policy framework in the UK, price stability is not given a precise numerical target in the euro area and the ECB was able to specify its own 'reference value', a label chosen to avoid the impression that it is a target. In the UK, the target is symmetric with the Bank of England enjoined to aim for 2% plus or minus one percentage point. The ECB did not initially specify a lower bound, but subsequently issued the clarification that the 2% reference value meant close to 2%. Does all of this matter?

It can if it means that, especially when confronted with greater than normal uncertainty, monetary policy is kept tighter than it would otherwise be and the ECB errs on the side of caution in its decision-making, resulting in a dampening of demand. In addition, if inflation in a Member State is lower than the euro area average, the real interest rate will be higher and vice versa, yet the ECB is adamant that this phenomenon should not be its concern, since its mandate is to set policy for the euro area as a whole. This is not unreasonable, since it is what all other monetary authorities do, but can lead to perverse outcomes such as low or even negative real interest rates where the economy is booming and high rates where economic activity is stagnating.

A second aspect of stability to explore is what it means in the interplay between the Member State and EU levels of governance. In the euro area (as in any monetary union) there can only be one monetary policy with policy implemented through a single rate of interest. In a single polity, such an arrangement occasionally poses problems when there is regional imbalance that might warrant different rates, but on the whole it works. In the euro area, however, it is the Member State level which controls the levers of economic policy other than monetary policy, and it is national data that economic actors mainly take into account in decision-making. Wage negotiations, for example, are conducted in the national arena and it is national cost of living increases that tend to be used as benchmarks. Social priorities are determined within national, yet the supranational authorities with the biggest say over stability policies have no reason to take such social aims into account.

II.1 The evolution towards EMU

The road to monetary union in the EU was a long one and the arrangements for its economic governance have evolved considerably over the decades. The notion of the optimum currency area (OCA) was a key part of the intellectual impetus in early initiatives towards monetary integration and had some influence on the Werner (1970) report that produced a roadmap for a single currency to be achieved by 1980. That project was abandoned in the wake of the oil shocks of the 1970s, although a legacy was the European Monetary System launched in 1979 which provided for relatively stable exchange rates for a majority of EU members.

The revival of plans for EMU in the late 1980s was politically driven yet, although there was renewed intellectual interest in OCA, its reasoning effectively played no role in the construction of EMU (Wyplosz, 2006). It can be argued that, instead, the 'project' was pushed forward because the political circumstances of the period (notably a Commission in the ascendancy under Delors) made it feasible to do so, although there is a widespread perception that monetary union represents a logical culmination of economic integration. In this logic, independent monetary policy is either not possible for Mundell's 'holy trinity' reasons[2], or becomes a potential barrier to free movement of goods, services and capital, if not labour. While the European Monetary System that pre-dated the euro partly resolved the inconsistency problem, it did so in a manner that eschewed some of the benefits of full monetary union and was also seen politically as imposing German preferences on other countries.

[2] This is that with free capital movement, it is not possible simultaneously also to have fixed exchange rates and independent monetary policy. Padoa-Schioppa, similarly, refers to the inconsistent quartet, adding free and extensive trade flows to the trinity

In the period preceding the agreement of Maastricht Treaty, there had been an extended debate about the transition to monetary union, with the two camps labelled 'economists' – who favoured a long period of convergence before full monetary union - and 'monetarists' - who argued that economic agents would rapidly adapt their behaviour to the new monetary regime, a corollary of which is that their history would have only a marginal bearing on how they conducted themselves under EMU. An irony of the labelling is that the economists' view was most heartily endorsed by central bankers, while the monetarist approach was espoused by academic economists of diverse persuasions. The logic of the latter position was that a 'big bang' move to EMU would be the most attractive route, partly because it would avoid the potential damage to the real economy from an extended period of restraint aimed at achieving the required limits for the nominal indicators. In other words, the threat of macroeconomic instability as a result of monetary integration was greatly exaggerated, according to the monetarist camp.

In the event, as Wyplosz (2006) argues, the economists probably won the battle for the EMU policy framework and rules, notably through the imposition of convergence criteria that focused on nominal indicators (price convergence and fiscal restraint) rather than whether or not the countries coming together were an optimal combination according to OCA principles. Yet it may have been an incomplete victory insofar as the monetarist view prevailed in the implementation of the rules, with many countries acceding in the first wave, despite not fulfilling the convergence criteria, and subsequently reneging on their SGP commitments. Nevertheless, the convergence period is recognised to have been associated with a relatively weak economic performance by the majority of the current euro area members, though proving causality is not easy. Since this nominal convergence was, at least in part, about promoting stability, the implication is that economic performance was compromised by the focus on stability. However, neither camp had much reason to consider social solidarity, with the implication that the social consequences were seen as a second order issue.

The other side of the coin is that the achievement of stability can become a platform for improved long-run economic performance and it can be argued that the whole EMU construction would make little sense if it did not embrace such a prospect. Rather than stability being an end in itself, it would be an element in the economic governance package, a (probably) necessary condition, but not a sufficient one. The key challenge then becomes one of going beyond stability to achieve the real aims of economic policy, that is improving living standards and an equitable distribution of society's resources.

II.2 Stability and economic adjustment

It follows from this discussion that the term 'stability' has to be interpreted with caution because an inappropriate interpretation can result in poor policy choices. From a social perspective, it is also important to note that once fiscal and monetary policy are orientated towards stability, pressures associated with adjustment of the economy fall on other policy areas. Different policy levers have to be pulled and their effects may differ from those that applied for Member States. Certain levers of policy that governments have relied on will lose their effectiveness, while others will need to evolve to play a more extensive role in economic management. Changes of this sort inevitably have distributive consequences, yet there has been little recognition that EMU has many normative dimensions.

Countries have varied in the way they have approached fiscal stabilisation, with some preferring to cut spending, while others have used tax increases to improve their budgetary positions. Equally, EMU has resulted in a significant windfall improvement in public finances because of lower nominal interest rates. This is especially true for the formerly more inflation prone euro area members which had (and continue to have) relatively large stocks of public debt, such as Greece and Italy. The windfall gain in Italy, for example, was over 5% of GDP, halving the debt service charge the country faced in the mid-1990s. This windfall could, potentially, have been used for social purposes, but seems instead to have been used instead to consolidate public finances

An important institutional dimension of stability that is prone to be overlooked is whether and, if so, how monetary policy actors co-ordinate their policies with other institutional actors involved in macroeconomic management. There are different aspects of this issue to consider. First, the pursuit of stability is associated with rule-based policy making and it can be argued that this not only restricts political discretion in macroeconomic management, but also leads, in the context of EMU, to a new balance of power. A simple observation is that a single monetary authority (the ECB) is confronted today by 13 independent fiscal authorities and even more balkanised responsibilities for structural policy. Moreover, the indications are that central bank governors have evolved towards a common view of policy imperatives, irrespective of the Member State they 'represent' on the ECB's Governing Council, the key decision-making body for monetary policy in the euro area. This tends to confer a strong bias in policy-making towards stability objectives.

The EMU macroeconomic framework means that when economic adjustment is required, it is in the labour market that it has to occur, at least to a greater degree than hitherto (Ardy et al., 2006). Social protection budgets are also likely to come under scrutiny, if only because governments have to make hard choices in order to conform to the fiscal rules. This will tend to call into question notions of social solidarity and engender an expectation that social protection systems have to become part of the economic management toolkit, rather than instruments of re-distribution.

The upshot is that both public expenditure on social policies and the regulatory aspects of social models will be affected by the stability focus in all EU countries, with clear implications for norms underpinning those models. Yet, economic integration and the changing nature of production call for social responses. Indeed, as Atkinson (2004) points out, the globalisation that took place at the start of the 20th century was associated with the emergence of the welfare state, precisely because change brought forth a demand that means be found to protect the losers. This may be especially complicated for the recently acceded members of the EU from central and eastern Europe. In most of the these countries, growth has benefited from a combination of stability and processes leading to economic convergence, with social solidarity put on the back burner, the message from which is that it is more important to increase the size of the cake than to worry about how the slices are distributed. There may, though, be social demands that need to be accommodated precisely because the catch-up/convergence process has negative consequences for certain groups.

II.3 What is the empirical record on stability?

So far, the ECB has, by and large, delivered what it was asked to do, namely price stability, ironically despite consistently failing to meet its self-imposed target for growth in the money supply. In fact, with a few exceptions (for example, Bibow, 2006) the consensus seems to be that the ECB has not been unduly severe in the priority it has given to stability. Thus, Wyplosz (2006) argues that the Eurosystem has been wise in its policy decisions and has not slavishly followed what its own statements indicated it might. Principles and action have diverged. But the EMU governance system in aggregate has conspicuously not achieved the improved economic performance that was promised. Criticisms focus on the choice of monetary policy strategy (which some believe to be behind the state of the art), the overly rigid application of the SGP, the incoherence of supply-side policies and the wider shortcomings of the economic governance system.

Clearly, the EU has seen a strong convergence in inflation rates that reflects the priorities set for monetary policy both inside and outside the euro area, and the data show that inflation is now low across the EU and shows few signs of any resurgence. Volatility in the real economy has also declined, though towards steadier but lower growth rates. Whether this is because of the governance changes adopted with the aim of assuring stability (and not just in the euro area), the pressures of international competition or behavioural changes in societies that recognise that inflation is ultimately pernicious, is an unresolved research question. But in other respects the EU economy shows signs of increased imbalance that are not so obviously compatible with stability. Significant imbalances have emerged between euro area members, with large trade surpluses in Germany and the Netherlands, and burgeoning deficits in Spain and Portugal.

Despite some improvement in 2006, unemployment remains doggedly high in several Member States. According to Blanchard (2005) many explanations of unemployment in the EU are unconvincing and struggle to explain differences among countries. The received view that a wedge between labour costs and wages is to blame is specifically shown to be implausible. What is undeniable is that the EU as whole, despite achieving productivity levels close to those of the US, lags a long way behind in terms of GDP per head, adjusted for purchasing power. Arithmetically, the principal explanation is the significantly lower hours worked, but as Gordon (2006: 44) observes, 'but then the questions begin'. He reviews the evidence for whether the explanation is a preference for leisure, the effects of high taxes on labour, an overly generous welfare state or the effects of union power in restricting hours worked. Gordon finds the first of these explanations to be the most powerful, but also notes that the drift towards flexibility in Europe has reduced some of the gap in recent years. Another plausible explanation is the 'ETUC' one that stability has simply been overdone. It may well be the case that a whole policy emphasis has been created to fight a war against an enemy (inflation) that has long since disarmed.

III. The Stability and Growth Pact: villain or scapegoat?

Many commentators believe that much of the malaise confronting the EU economy, especially that of the euro area, is self-inflicted, with the fiscal policy framework singled out for the most blame. Others argue just as forcefully that there is nothing wrong with the framework and that it is the lack of budgetary discipline over many years that is at the root of many of the EU's economic difficulties. These perspectives are not necessarily incompatible. There is broad agreement that the fiscal laxity that characterised the 1980s and early 1990s was not sustainable (Allsopp and Artis, 2003) and that fiscal 'consolidation'[3] had to occur. Given that it is never easy to effect such a consolidation, the correction was always going to be painful, irrespective of the Maastricht convergence criteria.

However, the Stability and Growth Pact is significantly more demanding than the Maastricht criteria because it calls on euro area members not only to prevent deficits exceeding 3% of GDP in any year, but also to aim for a fiscal position 'close to balance or in surplus' over the medium-term. The latter implies a gradual decline in national debt, because if the deficit is below the rate of nominal growth of GDP, the debt to GDP ratio will fall, and is justified on two grounds. First, the margin between 'balance' (or surplus) in periods in which the econ-

[3] An expression coined to place a positive spin on expenditure cuts and/or tax increases

omy is on trend and the 3% deficit limit is intended to provide leeway for the automatic stabilisers to function in a downturn. In the absence of such a margin - as Germany, France and others have found to their dismay - the deficit can quickly jump above the limit, prompting demands to retrench further in a way that, because is pro-cyclical, risks amplifying the downturn (Begg et al., 2004). Second, all EU economies face a growth in long-term commitments to pensions and health-care expenditure which argues for a building up today of public assets from which to fund these future commitments.

The fiscal problems, particularly with the incidence of the SGP, can thus be portrayed partly as a tension between short-, medium- and long-term aims. While the SGP functioned fairly well in the early years of the euro, it ran into problems as the economies of key Member States slipped into recession in 2001, prompting repeated calls for relaxation of the Pact. To a considerable extent it is in the three largest euro area countries that the conflict between stability and growth is most evident. An inference is that Germany, Italy and (less so) France are in a sort of Catch-22 in which, if only they had been able to create space for fiscal policy to work, it would have helped them to solve many of their adjustment problems. The reformulation of the Pact in 2005 has, in fact, been widely interpreted as just such a relaxation, although it might be more accurate to view the changes as a (limited) restoration of political input into fiscal policy. For Gros (2005 and 2006) this re-orientation is to be regretted, since it is seen as allowing policy-makers to be less disciplined in a way that will weaken long-term stability, while Buiter (2006) argues that the SGP is effectively dead.

The debate around reform of the SGP turned in part on the doubtful logic of applying the same rule for all Member States. Plainly, a highly indebted country is in a much more precarious fiscal position than one with little debt and while the latter can comfortably deal with a temporarily larger deficit, the former would risk a funding crisis. Equally salient is the underlying economic position. The Maastricht convergence criteria of 3% public deficit and 60% public debt could be regarded as a consistent with stable public finances so long as nominal[4] GDP growth was greater than or equal to 5%, roughly the average values for these variables at the time the criteria were announced. The increase in the nominal stock of government debt resulting from the 3% deficit is offset by the increase in the nominal value of GDP with the result that the debt to GDP ratio remained constant. Thus from a starting position of a debt stock of 60% of year 1 GDP, the debt stock would increase from 60 to 63 as a result of there being a 3% deficit, but GDP – the denominator of the ratio - would rise from 100 to 105. 63/105 is still 60%, and is therefore stable.

However, when nominal GDP growth is lower (as is the case at present for several euro area countries), whether because of slow growth in real GDP or lower inflation, the deficit consistent with maintaining a stable debt ratio also has to be lower. To maintain a debt ratio of 60% when nominal growth is 3% (made up, say, of 1.2% inflation and 1.8% real GDP growth), the annual deficit would have to be limited to just under 2%; any higher a deficit and the debt will tend to increase. If, in addition, the country in question has to provide for future pension claims, it will have to target a progressive improvement in the debt position, implying a smaller deficit (or even a surplus) than would otherwise be required for immediate debt stabilisation.

Conversely, for rapidly growing economies, including those in the recently acceded Member States, rapid real growth and above average inflation rates combine to give nominal growth

[4] That is, GDP at current prices. The increase in this variable is the combination of increases in prices and increases in the real output of the economy

rates substantially above 5% in several cases. For these countries, the budgetary arithmetic is more favourable from the perspective of debt stabilisation, since they can maintain the debt ratio with a higher current deficit. As an illustration, a country with a debt stock of 50% of GDP, real growth of around 5% and inflation of around 3% would have nominal GDP growth of about 8%, and could maintain the stock of debt stable with an annual deficit of 4% of GDP. Higher deficits might well make sense for countries seeking rapid economic development and requiring higher levels of public investment for this purpose, while also seeking to re-structure social protection.

IV. The consequences for economic policy-making

In some respects, the policy framework obtains widespread support. Stable prices are valued as a public good in their own right and are generally regarded as preferable to inflation because they confer greater certainty on economic life. Sound public finances offer citizens more coherent economic governance and diminish the risks of excessive cyclical volatility, again valued as a public good. The trouble, though, often lies in the detail. Commonly used price indices typically overstate true inflation by an uncertain margin, because they struggle to accommodate quality improvements in goods and services, and they tend systematically to under-represent newer products which account for growing shares of consumer demand. As a result, measured inflation of 1-2% may, in fact, constitute price stability, so that when monetary policy targets a figure of 2%, an under-shoot may imply deflation.

Deflation, in turn, carries its own risks by taking economies that have established means of living with low levels of inflation into what De Grauwe (2003) describes as the *terra incognita* of falling prices. In wage setting, for example, negotiators become accustomed to factoring-in an element of compensation for the previous year's inflation, thereby distinguishing between cost-of-living increases and increases that reflect workers obtaining a share of productivity gains. Indexing of social protection benefits has much the same purpose. With deflation, however, the reverse applies since a stable wage becomes a real increase in spending power, and if the company paying that wage is faced with cutting prices to stay competitive, it may be caught between a rock and a hard-place.

Another facet of the policy framework is where the balance of power lies in policy-making, an issue that has several dimensions to it. It has been argued that monetary union has altered the balance between fiscal and monetary policy in favour of the latter (Canzonieri et al., 2001), making the ECB a more dominant institution in economic policy-making than the national central banks had been in most countries prior to EMU[5]. To the extent that central bankers have a distinctive view of the world, this tends to entrench a preference for price stability. Second, in a number of countries, the social partners have been marginalised in economic management, while in others they never had much in the first place. The relative decline in influence not only of national governments (and, within them, of 'social' minsters relative to finance ministers), but also of social partners is the flip-side of this accretion of power to the ECB, although the dominance of the Bundesbank during the last few years of the European Monetary System, suggests that it predates full EMU.

The EU is by no means unique in giving greater weight to rules-based policy making and eroding the input of different interests, but the change is more striking when compared to the corporatist traditions of the likes of Germany, Austria and the Benelux countries. The balance

5 Germany was always an exception given the political weight of, and broad popular support for the Bundesbank.

of power is also reflected in the evolving character of accountability arrangements, with central bankers judged more in terms of output legitimacy - that is, what they deliver, to adopt the distinction suggested by Scharpf (1999) – than whether they are directly accountable to an electorate. A corollary of this shift is that rules rather than political judgements/discretion have become more prominent, and that political power has shifted away from electorates because they can less easily tell their governments what fiscal policy they want when the policy is subject to judiciable rules. A further dimension to the balance of power is between geographical units, although here the trends are less easy to assess. The European level has gained in some respects, but Member States have flexed their muscles. Some Member States have seen their relative power increase – certainly this is argued for the smaller states which were, under the European Monetary System, simply policy-takers.

These shifts in power have implications for the balance of economic and social policy objectives that, in turn, impinge upon social solidarity. Stability is not just a means to an end (higher growth), but may also have non-negligible distributive effects. For example, it may be more conducive to the interests of savers than borrowers, favouring richer segments of society. 'Consolidation' of public finances tends to be associated with diminished levels of public services, while increased taxes on consumer spending rather than incomes typically have a regressive impact. There are, therefore, norms embedded in the stability focus, with the implications that it is not just a technical choice about how best to manage the economy.

V. The social consequences of the pre-eminence of stability

The links between the macro-economy and the social situation are many and diverse. Most obviously, slow growth tends to be associated with rising and/or persistent unemployment, increased demands on social protection systems, and resistance to structural change. A vicious cycle can be triggered with a stable, but distinctly sub-optimal equilibrium, sometimes captured in the notion of an 'equilibrium' at a relatively high level of unemployment – the so called non-accelerating inflation rate of unemployment (NAIRU). In this sense, stability and social progress would appear to be in conflict. These problems should not be exaggerated, but nor can they be wholly ignored as they have real economy consequences which, in turn, affect social objectives.

There are also links from other major trends, such as shifts in inequality (which has tended to increase in OECD countries – see Förster and Mira d'Ercole, 2005), demographic trends that alter the share of the dependent population and the overall impact of welfare regimes on economic dynamism. There is some suggestion that high public spending has a deleterious effect on growth, although the empirical evidence is mixed and as Gatti and Glyn (2006: 304) note: 'the jury is still out, and certainly the case for systematic detrimental effects of social spending on growth has not been convincingly demonstrated'.

How much social can be 'afforded' in today's world is an issue that is manifestly part of the debate on the links between stability and social policy. Many authors (see, for example, Tanzi, 2002) have argued that the EU's current high levels of social spending, the corresponding rates of taxation and the degree to which the state's regulatory interventions promote social cohesion will all be called into question by deeper economic integration. The implication is that a stable economy can only be achieved when the share of the public sector in the economy is reduced. He suggests that more social risks will have to be assumed by private provision, for which the state would then have a supervisory role, instead of being the principal provider of protection. Yet despite the frequency with which it is foretold, the 'race-to-the-bottom' in social policy remains conspicuous by its absence. For example, at a macroeconomic level, the proportion of GDP spent on social protection has been remarkably stable in the EU for many years at around 27%. Certainly, there have been re-orientations within social protection budgets, with more resources devoted to activation and less of an emphasis on solidarity as such (or, at least, notions of solidarity that make no concession to social protection as a productive factor), but this trend can be attributed more to a search for higher quality of public spending than as a denial of social aims – see also the chapter by Andersson in this volume.

Nevertheless, a link from stability-orientated macroeconomic polices to social policies cannot be denied. The nature of adjustment problems varies. Financing of social spending relies on buoyant tax yields and these yields have been reduced by relative stagnation, and there is also some suggestion that more open markets and intense competition limit the scope for corporate taxation. There is also a high income elasticity of social spending as societies devote a growing proportion of resources to social aims. This effect is reinforced, on the one hand, by the fact that many social services (such as care or health provision) have limited scope for productivity gains, as a result of which their costs rise relative to other goods and services. On the other hand, demographic changes add to the proportion of the dependent population. While this is not the place to dwell on the these trends, the important point is that they add to the challenges of stabilisation at the same time as engendering new demands. It may be that there are asymmetric effects of long-run processes such as globalisation and demographic change on public spending and on taxation, with the latter squeezed by a range of factors, such as e-commerce, capital mobility and the imperative to attract investment. However, this point should not be exaggerated as it is belied by the resilience of corporate tax yields.

V.1 The German problem

In the early years of full EMU the Member States that had the best economic performances were not those that many, conditioned to regard Germany and the neighbouring smaller countries of what was regarded as the D-Mark zone as the most likely winners and the 'periphery' as the probable losers, would have expected. Germany in particular has performed poorly in the early years of EMU, suggesting a possible conflict between stability and growth. It is, therefore, interesting to ask whether the fate of the Opel workers might be explicable by this policy orientation. Germany arguably entered monetary union with a high exchange rate and has sought to boost its competitive position by holding down wages, even to the extent of nominal wage cuts in some sectors. In contrast, Italy has allowed nominal wages to increase, eroding its competitive position and, almost certainly, creating a future problem

Part of the explanation for German performance is, almost paradoxically, that Germany (especially) did not really have to adjust its economy to conform to the exigencies of monetary union, notably by changing policies to meet the Maastricht convergence criteria. Yet because monetary policy in the euro area, by definition, is now a one-size-fits-all one set to reflect conditions in the area as a whole, if conditions in an individual country diverge from the euro area average, the country has to adjust by other means. Even Germany is only one third of the euro area in economic weight and, because its economy has been the least dynamic in the euro area, it has had to use other policies to deal with its new circumstances. Moreover, the low inflation in Germany has meant that the euro area interest rate has been higher in real terms than for partner countries, in some of which it has, on occasion, been negative. This effect should not be exaggerated in that nominal interest rates since the advent of the euro have not exceeded 4.5% and for much of the time have remained at just 2%, a rate that could be regarded as close to a minimum one[6].

A further problem that Germany faced once in the euro area is that it entered with a budgetary position that only just met the Maastricht criteria, and its debt was rising. As such it was vulnerable to a downturn in the economy and its subsequent struggle to keep within the constraints of the Stability and Growth Pact is largely attributable to the lack of adjustment during the 1990s. Germany's solution has been to try to hold down nominal wages as a means of reinforcing its international competitiveness and achieving export-led growth. At one level, testified to by the burgeoning trade surplus, this approach has been highly successful. Its drawback, though, is that the squeeze on nominal wages has had an adverse effect on domestic demand, especially from consumption. This effect has, arguably, been exacerbated by the high level of unemployment in Germany which has made consumers more cautious and thus inclined to save for precautionary reasons. With limited room for manoeuvre in fiscal policy, the German position had become a vicious cycle as stagnant domestic demand prevented any reduction in unemployment, further undermining consumer confidence. The inference to draw is that a stability orientation may not have been responsible for the problems that Germany faces, but may have complicated the search for an effective response.

VI. Concluding comments

Over the last twenty years, economic policy-making in the EU has increasingly focused on stability. As a reaction to what went before, this switch was probably needed, but it is also timely to ask whether too much attention has been devoted to stability and, more pointedly, whether it has been to the detriment of growth. This question is easily confused with one about whether reform is needed. There are diverging views on whether growth can be facilitated by more expansionary macroeconomic policy, but it would be fair to say that a faster growing economy finds it easier to restructure if only for the straightforward arithmetic reason that it will be updating its capital stock more rapidly as a result of higher growth. Equally, countries that delay structural reforms can find themselves caught in a vicious cycle of slow growth and hesitant reform. In the latter case, social policies tend to come in for criticism and may be financially squeezed.

The benevolence of the single market became part of the conventional wisdom about the EU in the 1990s, a status in which it has been joined latterly by the linked belief in the virtues of 'sound' macroeconomic policy. The EU, however, also has complementary forms of economic governance that could allow more flexibility in conducting policy, notably the 'Lisbon' partnership for growth and employment (re-launched in 2005), with its twenty-four integrated guidelines to orientate Member State policies. However, these 'softer' instruments, because they have the status only of recommendations, tend to have limited influence on national policies. Yet it is through these other channels that greater scope for policy choices are more likely to arise, given the autonomy of Member States in so much of economic policy-making. There is, therefore uncertainty about whether the arrangements for the macroeconomic governance of the EU economy are suitably balanced. Moreover, the 2005 re-launch of Lisbon

[6] The Fed cut nominal rates to just 1.25% in responding to the downturn of the US economy in 2000 and the Bank of Japan adopted a zero interest rate policy in its attempts to deal with the crisis in the economy that arose from the severe banking problems of the 1990s. But it can be argued that, at 2%, the euro area interest rate will not deter consumers from taking on debt or businesses from investing. Lower rates might have a valuable psychological impact on markets, but the central bank also has to be aware of the need to keep a little flexibility in reserve for more extreme problems.

seemed to play down the commitment to social cohesion that was at on of the pillars of the original Lisbon strategy, implying that economic imperatives matter more.

It can also be argued that the constraints and weaknesses of EU economic governance stand in the way of improvements in policy-making. Consequently new approaches could offer a different way forward. These might include a more fully-fledged form of *gouvernement économique* or variants on closer co-operation among the willing in economic policy-making, designed to counter these constraints and weaknesses. Stability, carefully and properly pursued, may contribute to economic growth, but it does not guarantee it and should not be seen as an end in itself. Stability could also be associated with distributive shifts, but the reasons for these have to be sought in deeper shifts in norms and political preferences, rather than the macroeconomic policy stance. The implication is that although a diminution of solidarity may be occurring, stability is not necessarily to blame, nor is it inevitably incompatible with socially progressive aims.

VII. References

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