AFTER THE STABILITY & GROWTH PACT: CAN THE EURO CLUB STILL CALCULATE COMPARATIVE ADVANTAGE ?

WALTER GOLDSTEIN
Visiting Professor,
Center for European Studies, New York University

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The European Union celebrated a great achievement in the years following the signing of the Maastricht Treaty. The unification of monetary policy and national currencies among 12 of its 15 member states was smoothly executed and the formation of the ECB was hailed as a milestone of European integration. In the chronicles of European history, the creation of the EMU was a giant step in the evolution of a federal Union, and by law it can not be reversed........no matter how many economists object

In fact, at each stage of the process most were confident that that EMU could not be built and would never succeed. Eminent economists claimed that the eurozone could not meet the definition of an optimal currency area (OCA); and that if it ever tried to do so, it would fail at great cost. Even after they had been proven wrong, the critics insisted that though the EU states had somehow mastered the initial convergence criteria, the EMU would surely collapse (as the EMS had done in 1992-93) in the next storm to sweep though the world money markets.

The criticisms of the EMU came from Martin Feldstein, Fred Bergsten, Paul Krugman, leading financial columnists and a host of opponents in Britain and the U.S. They argued: (1) the ECB operated with a false dichotomy between fiscal and monetary policy; (2) it was not accountable to any democratic body; (3) it gave far too much of a priority to price stability rather than GDP growth; (4) and its excessive deflationary bias left no room for other objectives, such as raising employment and reducing steep regional or income inequalities. Three years after its inaugural, the ECB has done nothing to curb the rising unemployment (now at 8.4%), flagging growth (at less than 1%), and an inflation rate exceeding its minimal target of 2% (as measured by the Harmonized Index of Consumer Prices, the HICP).

As the course of a downturn in economic activity takes its toll, the balanced budget fixation of the ECB has deterred public and private sector borrowing for capital replenishment. It censured Ireland when it sported a fast growth record, and the UK for cutting taxes and raising expenditures. It refused to lower interest rates to boost the money supply, unlike the Fed which made 12 successive cuts in the federal funds rate to bring it to its lowest rate in 40 years. The ECB forfeited respect when it failed to intervene in the exchange markets as the euro lost 25% of its value against the dollar and the yen. The bank forfeited more credibility when the EU governments skirmished over the tenure of the ECB president, and when a sharp Franco-German rift over the ECB's discretionary power was settled by adding a dubious and contentious safeguard: the Stability and Growth Pact (SGP).

The outstanding euro critics disagreed keenly over a matter of historical interpretation. Had the Maastricht Treaty succeeded its initially in the 1990s because EU leaders were determined once and for all to cure the painful affliction of Euro-sclerosis and low growth ? Or were they moved by an elitist assumption that had won a wide following in Europe: that democratic regimes cannot hope to cure a terrible addiction to deficit financing unless some external force imposes a fiscal discipline on their querulous parliaments ? Bankers, Treasury and academic economists argued that the EMU had been designed to placate federalist ideologues, not bankers. They judged that the euro would never compete with the dollar and yen in the relentless skirmishing within the floating exchange regime of the G-3.

As expected, opposition to the EMU came first from public opinion; but that, unfortunately, rarely plays a significant role in debates over monetary policy in an any democracy. Massive majorities, especially in Germany, held that it was wrong to replace the strong DM with an unknown hybrid currency; and that the orthodox doctrines of the Bundesbank should not be subjected to an ECB packed with feckless red ink addicts. Mass opinion and most political parties expressed grave distrust of monetary unification, but the ECB was empanelled and went into action. A key agency within the Council, the Ecofin group of finance ministers, ignored the Commission's warning messages to Germany, France, Italy and Portugal that they were in breach of the 3% deficit limit set by the SGP. As a result, the ECB lost face and political support. It had sought to "warn" the offenders that they were obligated to balance their budgets, even if the SGP timing was wrong for the business cycle. The.Economist was prominent among the dissenters (Sept.28,2002 arguing that enforcement of the SGP edict was a "lousy policy" at a lousy time and could easily wreck havoc. "Ask Argentina"it added.

The weakness of the euro in its early days could not be attributed to ECB inaction. The appreciation of the dollar was caused by soaring stock market prices in New York. Portfolio and FDI transfers rushed into dollar assets at the rate of billions of dollars a day. 40% of US government and 26% of corporate bonds were bought by overseas investors and the stock of FDI in the US exceeded one trillion dollars It was no wonder that the euro slipped from $1.17 to 83 cents; or that it came back again once the US boom went bust. It was obvious that the US had risked a "dash for growth", even while enormous debt piled up in public, corporate and personal accounts.......and then cutting interest rates by nearly 75% to stimulate consumer demand and capital investment. The liquidity and debt choices made by the Fed stood in stark contrast to the timid, restrictive targets of the ECB: 2% inflation (plus 60% national debt) shown by the HICP.

A critical problem emerged as stage two passed into three in the phasing in of the EMU: US productivity and GDP growth rates turned sharply upwards, along with US capital asset values, and the EU felt outmatched. EU companies rushed to acquire US competitors or off-shore subsidiaries, and they hired US banks and brokers to execute their profitable M&A with risk leveraged capital.Daimler bought Chrysler, Vivendi took over Seagram, BT and the Deutsche Bundespost bid for a horde of US dot coms, and bank LBOs morphed into a pandemic. A report of UNCTAD noted that mergers and acquisitions mounted 43% in 1999 alone, and that global M&A had climbed to $3 trillion. Much of it came from the EU ....until the major markets collectively collapsed.

Strikingly, while the euro lost 25% in its first two years, the ECB remained virtually inert. Its gestures to intervene in the forward markets failed, and its combined intervention with the US, Canada and Japan could not stop the euro's free fall. It had become clear that the ECB had been saddled with two critical defects at birth. First, the euro had been pegged from the outset at an excessive price and it could not correctit. Second, the ECB had been denied use of a critical authority. It could determine a common exchange rate and monetary policy, but it could not realistically forbid 12 nations to stop printing money /1/

Without regard for the post-2000 downturn the ECB set an M3 growth policy of 4.5% and an inflation target pegged too tightly and too long at 2%. Politically, the ECB had inherited none of the skills and independence once deployed by the Bundesbank. Tax and revenue decisions were decentralized to EU states and the ECB was too fearful to challenge their Finance ministers. The EU itself was limited to a budget of only 1% of its GDP and that afforded the Bank no financial leverage. The ECB could not rally markets or intervene decisively in forward exchange deals, nor could it imitate the rate-cutting bravado of the Fed. To alleviate political discord it wrote not one but two key objectives into its new charter, the Stability and Growth fiat. The SGP was supposed to enforce the law but no one in the Brussels hierarchies cared to invoke its ruthless penalties and anti-democratic sanction for a first time.

The EMU's problems have recently changed. The SGP rather than the ECB has become the focus of contention. As a safeguard against inflationary laxity, the guard is seen as more harmful than the original threat. Most member states fear that the SGP has impaired their GDP recovery. The ECB stands accused of ignoring the urgency of short term and counter-cyclical measures in its pursuit of long-term structural change. This is the wrong time, they insist, to depict Euroland as an optimal currency area (OCA). Its member nations shared little of the Bank's urgent drive to limit inflation and they were locked into divergent trends of red ink financing. Driven by constituents who faced unemployment they held little regard for a non-elective Bank.

Asymmetric shocks have begun to appear and four member states are already in default or hovering close to it. "One size fits all" remedies are clearly inappropriate. France and Germany angrily urge a short-term relaxing of the requirement to balance national accounts by 2004 (now 2006). Italy is hopelessly in excess of the 60% debt limit and Portugal reports a deficit of 4% of GDP. Member governments are divided. Those that withstood the downturn of the business cycle and deficit spending -- often because they are small, exporting economies -- have demanded that the SGP must be faithfully observed. Most of the big powers, including the two potential entrants (the UK and Sweden), have urged a temporary relaxing or suspension of the SGP but the Commission vehemently disagrees, claiming that any softening of the rules will impair the credibility of the EMU.

In the meantime there are two issues relating to enlargement that have not been resolved. First, few of the ten applicants have tried to meet the Maastricht criteria and the parameters of the exchange rate mechanism by voting for a stern austerity program. Second, even if they succeeded at great political cost to pursue a transition to a liberalized economy, they cannot ask to opt out of the EMU. Once in they will not be represented equally on the governing council of the ECB. They will be subject to the binding curbs of the ECB, Ecofin and the Commission in matters of the SGP's timing and constraints, but they might not be heard.

There is another forbidding prospect that the EMU will have to manage: the old-age time bomb ticking across Euroland. By mid-century the proportion of citizens over 60 or unwilling to work will exceed 30% or 35% of the 400 million population. Unless non-EU immigrants are recruited to enlarge the work force, and to contribute handsomely with pay-as-you-go taxes, the ratio of workers to retirees will sink far below the equilibrium point of an insurance payout Since medical and pension disbursements will rise in an aging population, welfare benefits will either have to go unfunded or payments will be severely cut. And of course fiscal surpluses will vanish for ever. /2/

Demographic projections for the next 20 or even 35 years are fairly certain but the capacities of member nations to reconstruct policy priorities are not. Logically the SGP is therefore doubly threatening. It forbids the use of counter-cyclical expenditures and monetary "stabilizers" in the short term to stimulate lagging demand and to rebuild capital stocks. But in the longer term it cannot cope with the structural and demographic dilemmas that the EU must eventually master. The president of the Commission (Prof Prodi) insists that the SGP is "stupid" but he has neither the authority nor the consensus to suppress it.

A careful study sponsored by the Commission (2003) lists the criticisms that have been made against the SGP: "It reduces budgetary flexibility, works asymmetrically, does not sanction politically-motivated fiscal policies, discourages public investment ....and by focusing on short term commitments, disregards long term sustainability" The study notes that it is difficult for a "golden rule" of SGP compliance to be enforced when there are great differences in the burden of national debt and pension liabilities. If the Commission acts as an enforcer of orthodox financing it could add a hefty risk premium to state borrowing at the point in the business cycle when it would do the most harm. The authors conclude that rules are necessary and that no alternatives are available, so the SGP will have to be firmly preserved (and technically improved). /3/

This finding unfortunately does not cope with the basic problem. The unifying of exchange rates, monetary policy, inflation limits, and deficit spending for 15 or 25 states is never likely to reach an optimal condition. Worse, the effort could be destructive and costly. If the basic measurements of comparative advantage (CA) across the EMU states were ever to become blurred, member states would discover anew how steeply they varied in capacities and national priorities. Their economic recovery could falter if they could no longer gauge their own and their neighbors' CA. Forcing a uniform SGP on highly differing states competing for price and productivity advantages could bring confusion.

CALCULATING COMPARATIVE ADVANTAGE

The concept of comparative advantage was first articulated by David Ricardo as a defense of free trade (against the Corn Laws) and as a rejection of Britain's mercantilism. He suggested that an open calculus of factor costs should guide the composition and direction of world trade --- as in the exchanges between labor and food intensive economies. His implied "laws" of CA were later refined by Hecksher-Olin, Leontief and contemporary theorists with a view to the equalizing of a One Factor Price in world trade. It was never simple to specify where CA was empirically located or how compliance could best be measured. Too many variables intersect for a precise fix to be made. For a start, the productivity of labor and comparisons of factor costs are usually stated in fluctuating currency values. Since the dollar varied by nearly 40% against the DM or the yen between 1971 and 1991, none can be used as a steady yardstick. Nor could the errors magnified by sudden changes in currency exchanges be removed by turning to another measure, the calculation of national PPP. There has never been an exact accounting of GDP, on an absolute or a per capita basis, and hence efforts to estimate PPP remain open to criticism /4/

It is conventionally assumed that adjustments will be made just before CA turns negative. Since labor is the most significant of factor costs, real wages will have to be reduced or labor mobility encouraged if export markets are lost. Alternatively, currencies will be devalued or interest rates modified to ease the course of a business cycle. The greatest flexibility will be achieved, it is argued, if a regime of floating exchange rates is accompanied by an advanced degree of free trade. Governments should therefore abandon all disruptive activities, trade protection, manipulating of exchange rates and *dirigiste* intervention. Market driven demand and supply schedules will then prevail, as neo-classical economics assumes, and price signals will surely be followed.

Naturally infringements will always occur and many of them are now acceptable. Economists explain that deviations from 'perfect competition' are necessary and even desirable, even if they do infringe on CA The deviations include the protection of infant industries, the subsidizing of "national champions" (in many cases, statist monopolies), the legalizing of strategic oligopoly equilibria (as in the oil or telecom industries), and the sheltering of airlines and defense firms desperately seeking economies of scale. As adjustments to CA, these infringements are justified as a public good, as Airbus and Boeing have long maintained.

The EMU however introduced a novel form of distortion but at a macro-economic level. Twelve once sovereign states were bound inextricably in a common exchange rate, a unified monetary policy, and a tightly limited discretion for fiscal stimulus. If an asymmetric shock should ever occur, due to some external or sudden upheaval, the victim country could resort (in theory) to only one escape. Since it could no longer devalue the currency, boost its money supply, resort to trade protection, subsidize its exports or relapse into a deficit easing, it would face just one option: to retrench its factor prices, either by cutting wages and benefits or by restricting unproductive output and employment. Such theoretical conclusions would never be politically popular, of course, but they are held by some members of the EU to be an indispensable weapon in the drive to integrate a regional market bedeviled with low GDP growth and a cyclical downturn.

A thoughtful analysis of CA was provided by Michael E.Porter (1990). He surveyed ten leading trading nations to compare their labor costs, interest rates, exchange rates and economies of scale and found that most conventional indicators were badly flawed. First, if CA is correlated with cheap and abundant labor, or with ample natural resources, for example, it would be an error to view Germany, Switzerland and Japan as top performers. Second, competitive economies are supposed to be especially well run, but such exemplars as Italy and South Korea were saddled with large deficits and punishing interest rates. Third, the managing of labor or capital is often effective in certain industries but awful in other sectors (as Japan's banks now reveal.) Porter then adds: "The only meaningful concept /of CA/ at the national level is productivity...... is the value of output produced by a unit of labor or capital........A nation's standard of living depends on the capacity of its companies to achieve high levels of productivity, and to increase productivity over time". But he warns that classical theory has been changed in recent times by the onset of a globalized revolution of competition and the unprecedented power of technology /5/.

MEASURING CA WITHIN THE EU.EONOMIES

The measurement of labor productivity and GDP within the EU is not well established. Limited data surveys have been published by Eurostat, the Commission, OECD, the IMF, the US/BLS and The Economist. Most tabulations hasten to warn that FX rates keep changing and PPP estimates are just that. For instance, a summary given in Euroactiv (5/12/01) compared the candidate countries with the EU 15 in 1998-99. Most of the candidates in Eastern Europe recorded labor productivity and remuneration at roughly 30% of the EU average, though the Czechs came in at 60% and the Slovenes at 70%. This roughly compared to the spread in per capita GDP and PPP. Naturally, productivity and remuneration for labor differed between various sectors, ranging from agriculture to financial services, but the distinctive gap between the poor and the rich was consistent if not accurate.

The debate over productivity and CA focuses not so much on the new candidates but on the EU itself. First, it appears that the CA of Europe declined as the euro appreciated on forward markets by 20%. In fact the rise of the euro effectively negated the interest rate cuts that the ECB had so tardily decided Second, the unifying of exchange and interest rates once again blurred the distinction between the more and the less efficient states in Euroland. The only viable indicators now are those measuring unemployment, raw output and fiscal deficits (and the latter would disappear if the SGP ever curtailed state subsidized funding and budget overruns). Cross-border transactions have multiplied with the advent of the euro. Intra-mural capital flows have increased within the EU as multi-national firms exchange component parts and servicing contracts. The leveraged funding of FDI has brought an Enron sophistry to national accounting. The intra-EU packaging of intermediary and unfinished goods, service contracts, derivatives and hedged investments have become too difficult to count. And so too has CA.

Three extensive papers were published in 2001–2002 that focus on these problems. Daniel Gros and his colleagues at the Centre for European Policy Studies in Brussels wrote on "Fiscal and Monetary Policy for a Low-Speed Europe". Adair Turner, a vice chairman of Merrill Lynch, printed his lecture at LSE on "What's Wrong with Europe's Economy ?" And last, Michael Burda of Humboldt University wrote on "European Labour Markets and the Euro"for ENEPRI, the European Network of Economic Policy Research Institutes /6/. The data provided is too rich and varied to be quickly summarized but a few central points must be noted.

The study, by Gros, compares CA in the US and the EU with rather aggregate indicators of inflation and interest rates. The main concern is with flagging productivity in the services and IT sectors (especially compared to the US) since the fabled "lack of labour market reforms...........and IT investment cannot tell the full story" about the poor competitiveness of the EU. The divergence from the US is consistent While much of Europe saw negative growth in labor productivity and capital deepening, the US scored well on both counts. The study tries to separate the structural from cyclical causes of decline and to assess the value of cross-border activity, but not much headway in made to identify divergent CA across the EU. It resorts to a simple arithmetic of employment cost estimates in a similar manner to that used by The Economist (Nov.16, 2002). In 2001, Greece and Portugal reported wage and benefit costs 35% below the US and France, and 60% below Japan. But what meaning should be read into the 8% differential between France and Germany and into the vast gap between the EU and India or China ?

The second study, by Adair, insists that the divergence with the US can be explained by distinguishing the data for GDP growth per capita from that of absolute GDP growth. He argues that the US population is increasing in size and staying younger than the EU, and that it chooses to work 18% more hours at relatively less remuneration (especially given social benefits). Europeans choose to retire early, to stay out of work longer, and to show a strong utility preference for leisure over work in the pursuit of prosperity. Hence the US might enjoy a 40% rise in absolute

GDP (over the last 15 years) but not in the productivity if the labor total is divided by the number of people employed and the hours they worked. Adair concludes: the US aggregate figure "is not a sign of inferior economic performance" but reflects a trade-off between acquiring riches in the US and leisure in the EU. Furthermore, the EU estimates output per hours worked in the whole economy, including the public sector and the output of part-time workers (as in France where there is a work-sharing 35-hour week). This variance in cost data, leisure values, and social benefits, tend to distort assessments of comparability /7/.

Michael Burda limits his analysis to the likely consequences of product and capital market integration across the EU. He forecasts that labor market imperfections and cost distortions will be diluted by rising forces of competition, but his chief focus is on their impact on business cycle volatility. He notes that Robert Mundell had anticipated that an OCA would bring a synchronous effect to business cycle timing; and that a greater mobility of labor and capital would emerge as internal exchange rates lost importance. Burda looks at the slowing increase in hourly pay and benefit totals between 1961 and 1996, suggesting that there was an "inwardization" of costs and wages. But he does not say whether intra-EU calculations of CA can be made once the EMU unifies all monetary and interest decisions /8/.

The latest details to be published (The Economist, Mar 22, 2003) once again contrast the raw data for the US and the EU. The most recent growth in GDP was 2.9% in the US and 1.3% in the EU Retail sales grew at 4.3% in the US and unemployment stood at 5.8%, while the EU lagged far behind. US productivity grew at an average of 3% in the 1990s, but the EU saw less than 2%. All of these US strengths disappear when it is noted that the US runs a negative balance of $500B on its trade balance as against a $98B surplus in the EU; and that the trade-weighted dollar declined by 20% while the euro appreciated nearly 20%. Of course, the euro appreciation will harm the EU's export trade, but not greatly. Nearly 80% of the EU's trade is done internally so that price distortion will be limited. But it is not a healthy sign that the EU tends to a 'fortress Europe' pursuit of intramural exchanges.

Three years ago the 2000 EU summit at Lisbon determined that "it would create the most competitive economy in the world by 2010". It resolved to create 20 million more jobs and to execute a raft of structural reforms. The gross data show how far the EU states have failed to fulfill the project. But beyond this there is a missing factor in the calculations in that the *relative* failure of each state remains difficult to quantify. There is no agreed calculus of CA between the agrarian, the high debt, or the top exporting nations of the EU .The Germans command almost twice as much in current GDP, export earnings, employment totals and capital investment as the other eleven members of Euroland put together. But it also runs a much greater deficit and a faltering rate of productivity growth. So the question stands: where should Germany properly stand in the rankings of Europe's competition for comparative advantage; and how should an investor appraise its prospects against those of a neighbor ?

It is still too early in the history of the EMU to gather adequate performance data or to test hypotheses regarding the costs and benefits resulting from this vast project in regional integration. Previous attempts were made (Cecchini 1987) to gauge the added value that might be won by integrating a Single European Market but the estimates proved to be unrealistic /9/.

For the time being attention must turn to the clash of economic principles. One one side the SGP represents the notion that unification can be profitably enforced if this heterodox group of states can be pulled into line, even on the brink of a recession. One the other side there is marginal utility analysis, holding that measurable distinctions can be drawn between high and low productivity nations. The first assumes that there is a strength in numbers; sovereign states, no matter how much they disagree, can be integrated into a unit big enough to dominate markets and realize economies of scale. The second position holds that states' performance can still be measured at a macro-economic level, even if key national indicators are missing. Both sides agree that market forces will eventually distinguish between the winners and losers any way, so why not pre-empt them ? Unfortunately, as in all such macro judgments, there are no quick conclusions to be drawn.........other than to keep collecting data.

REFERENCES

1. There is a disagreement over the unified price level at which the euro was first unveiled. One estimate held that the first $1.17 price was exorbitant; had it appeared below $1.00 it would have helped EU exports weather the global downturn. In the ten years leading up to the euro, the average deficit in the EU stood at over 4% and national debt at 77%. Hence it was foolish to hope that the Maasticht criteria could easily be met, or that the old DM could survive at $1.80 as it merged into the euro. Today pressure is exerted by Germany for the ECB to reverse course. Inflation and over-heating are in no way as persistent in the German economy as in several EMU partners; hence it urges a relaxing of the SGP and of the high repo rates kept by a hyper-cautious ECB to restrain growth.

2. See a useful analysis of two recent reports on the EU's aging populations issued by the UN and the EU Commission: Martin Wolfe, " Is Europe becoming a dying continent ?", Financial Times, March 5, 2003. Given the EU's extremely low birth rates, median age levels could climb sharply (to 48); Italy's population (among others) could fall in 2050 by 22%; and the ratio of employed to dependent persons in several nations could move from 4 to 1 to nearly 2 to 1. If that occurred, the Commission forecast that the EU's share of GWP might fall from 18% to10%; while the US (with a growing population and youth curve) might raise its share from 23% to 26%.

3. European Commission: "Revisiting the SGP; grand design or internal adjustment ?". Economic Papers. No.180, Jan. 2003.

4. The calculation of PPP is often hotly contested. China, with 1.3 billion people, balks at converting its supposed GDP at 8.3 renminbi to $1, claiming that its total GDP simply cannot total $1 trillion. But the World Bank multiplies China's per capita PPP (to its dismay) to an aggregate of $4 trillion, or nearly 40% greater than that of Japan.

5. Porter adds a key point (The Competitive Advantage of Nations, New York: Free Press, 1990): "Defining national competitiveness as achieving a trade surplus or balanced trade per se is inappropriate. The expansion of exports because of low wages and a weak currency... may bring trade into balance or surplus but lowers the nation' standard of living. Competitiveness also does not mean jobs. It's the type of jobs.....that is decisive for economic prosperity".

6. Daniel Gros et.al., 4th Annual Report of the CEPS macro-economic group, 2002 (www.ceps.be). Adair Turner, the Queen's Prize lecture, LSE Research Lab, Feb 5th, 2003 (www.LSE.ac.uk). Michael Burda, Working paper No.4, 2001. (www.ENEPRI.org).

7. Adair writes that the high cost of taxes and welfare benefits in Germany should not be exaggerated. Sweden and Finland are also costly but they have kept employment and output above the level of the UK, where labor costs 30% less. By contrast, however, public pension spending comes to only 4% of GDP in the UK (and US) but 12% in Germany and France.

8. A wealth of data is provided by the Bureau of Labor Statistics on hourly compensation for workers in manufacturing industries in 29 countries and the US for the last 25 years (www.bls.gov.fls). In 2000 dollars with the US at 100, Germany stood at 122, Holland at 114 and Japan at 112. Frequent fluctuations in the value of the dollar and the US current account distort any attempt to read CA into these figures. See also the contribution of Martin Rhodes, "Globalization, Welfare States, and Employment: Is there a European 'third way' ?", in Nancy Bermeo (ed), Unemployment in the New Europe (New York: Cambridge Univ. Press, 2000)

9. Following the passage of the Single European Act in 1986, a team headed by Dr. Cecchini estimated that a full scale EU integration could raise total GDP by the startling sum of 7%. The reasons for his exorbitant estimate were reviewed by the present author in "Europe After Maastricht", Foreign Affairs (vol 71, No.5), Winter 1992.