Employment, stability and efficiency

Strategic essentials of European economic policy

by

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The introduction of the euro is a powerful expression of the European Union’s common responsibility for economic policy and its ability to take decisions. The euro, however, is not the culmination of the European unification process, but rather the beginning of a new quality of economic-policy challenges. Under the regime of the euro the national economies will irreversibly grow together to form a single European economy.

Competition forces the players on the European markets to look for the best economic conditions. This must be supported politically. Furthermore, common responsibility for economic policy includes the strengthening of market forces through the removal of various impediments to trade. This will become even more evident under the regime of the euro. At the same time the adjustment process must not be distorted by widely differing country-specific rules.

But functioning markets and allocative efficiency are not necessarily sufficient to solve the most urgent problem of European economic policy, the reduction of unemployment. This requires a sound macroeconomic policy, i. e., a coordinated strategy of monetary, wage and fiscal policies.

Divergence and efficiency

Rational behaviour of companies and households may lead to inefficient structures in overall economic terms if the existing incentive systems are detriment to the conditions of a functioning single currency area. This fact has since long been agreed upon in the EU aid regime and generally in the single market philosophy. Further requirements must be fulfilled to prevent competitive distortions under the rule of the euro. In terms of economic policy, it is now also important to prevent the possibly significant allocative distortions that may be due to wages, taxes, social systems and environmental rules.

This does not mean the establishment of the harmonisation of country-specific rules as a separate objective of the Union. But it means to draw economic-policy conclusions due to the decision to introduce the euro. The transparency resulting from the euro and the fact that there are no longer any exchange risks generally lower the transaction costs in Euroland. As a consequence, politically determined conditions for economic activity become to a greater extent than so far significant aspects of allocative decisions. This can be a problem for the economy as a whole when individual tax rules, for example, become more important for investors than the results of market and business-site analyses. Such politically determined decisions always lead to prosperity losses. And if individual Member States think that they need to adopt similar rules as a consequence, this results in competition for "bad" practices within the Union without any perspective to improve the result for all participants. Finally, especially those countries that count in particular on this „business-site competition“ may believe that they must either request additional transfer payments from Brussels or restrict their supply of public goods. For possible temporary benefits thus a high price has to be paid in form of a higher degree of dependency from common political decisions or from future development opportunities.

In view of the common responsibility for economic policy, this sort of competition must be prevented. Therefore we need a minimum of coordination of framework conditions that are relevant for competition in Europe. Apart from a number of obvious cases, it cannot be said beforehand what this means in detail. Nobody can know today what dynamism will be triggered by the euro and which rules must some time in the future be regarded as "bad practice". It is to be expected in any case that the discrepancy between national autonomous decisions and the prerequisites for the functioning of EMU, i.e. between divergence and efficiency, will remain on the agenda of European economic policy. In this context, a European policy requires agreement that each individual Member State cannot benefit from the Economic and Monetary Union unless all benefit.

Competition among states?

The widespread idea that states also compete with each other is based on the same idea as mercantilism. These ideas saw a remarkable revival after the transition to flexible exchange rates and the prevalence of supply policy. An autonomous economic policy and progress with regard to employment policy through the improvement of the national export bases were hoped for. Economic policy was increasingly reduced to the creation of relative competitive advantages given the allegedly theoretic justification of „competition of systems“. The right core of this idea is the fact that policies must of course seek efficient control systems and should also learn from foreign experiences, i.e., the "best practice" of the other countries. If this leads to a rise in productivity, wages and generally incomes can of course rise quicker than otherwise.

But this „competition of systems“ is wrong and counterproductive if it takes place via real depreciations. In the case of constant (nominal) exchange rates or within a currency area, this means that competitive advantages are gained by refraining from exhausting one's economic possibilities, i.e. living „below one's means“. Wage increases below the productivity development are the most important strategic aspect of real depreciation. But real depreciations also take place when the tax burden is artificially lowered. This results in a reduction of the financing of state tasks and in the supply of public goods. Each strategy that aims at real depreciation is contrary to the idea of free trade. Within a single currency area, it is even destructive.

Competition is constructive among companies and states if it is a competition for the highest level of productivity. But it is destructive if it is competition in belt-tightening i.e., competition which aims simply at the reduction of costs by cutting expenditure without increasing the efficiency of the whole economic system. Competition cannot be efficient for the benefit of society unless the competitive conditions for companies are comparable and sufficiently stable. Competitive advantages must not be the result of the permissive adoption of framework conditions and of successful rent seeking. They must be the result of entrepreneurial efforts, i.e. the realisation of productivity gains by means of new products and methods which are produced under the „law of one price“ for all competitors, i.e. at equal prices of all purchased materials and services, (including labour) for all companies. A European economic government must create and secure the necessary framework. This comprises four central efficiency conditions.

Conditions for functioning markets

The introduction of the euro is the first and at the same time the most important condition for efficient markets. Exchange risks no longer exist in Euroland. The stabilisation of exchange rates as permanent task has definitely been abolished through a unique political decision. The necessary theoretical basis was the result of a difficult process, which was also overlapped by „political“ ideas. Many still regard the collapse of the Bretton Woods system as evidence of the impossibility to maintain fixed exchange rates. However, the expectations linked with flexible, market-determined currency systems have not at all been met.

The European governments have made such distortions impossible by deciding to introduce the euro. As a consequence, the industrial and political players are restricted to real economic adjustments. Thus the prevailing consensus on the inadequacy of changes in the value of money in time (inflation) to solve economic problems has been extended to analogous experiments regarding changes in the value of money in space (flexible exchange rates). On the basis of these results, Wicksell’s claim vis-à-vis monetary policy is unequivocal: „As currency is primarily a measure of value, it ought to be possible ... for a country to maintain that standard just as constant as, for instance, its standards of length, capacity or weight.“

This logic behind the euro cannot stop at the present borders of Euroland. For this reason, the enlargement of the European Union must right from the start take into account how the currencies of the potential acceding countries can be adjusted to the euro. The question of the exchange rates between the large currency zones as well as between them and the emerging markets is based on the same logic.

The second efficiency prerequisite has been fulfilled with the decision to introduce a single currency. The national money and capital markets have become European markets. Under the guidance of the ECB, they will result in uniform interest rates. Thus one of the most important factors of allocative decisions, the price of money and capital, is defined throughout Europe. Jevons’ law of indifference applies, one of the preconditions for allocative efficiency throughout the currency area is fulfilled.

The third precondition for efficient competition markets refers to the development of wages. In this context, the adjustment of the wage level upwards within the currency area cannot be the objective. Especially against the background of the German experiences after unification, such a wage-policy orientation must be avoided. But, on the other hand, an adjustment of the wage level via competition to the lowest level can and must also be avoided. In order to prevent both, inflationary and deflationary effects of wage policy, unit labour costs must be held constant in absolute and relative terms, i.e. in each country and thus also between the individual economies. This precondition is fulfilled when the development of wages follows the development of productivity. In a medium-term period this means that the productivity gains in the individual countries are used as the basis of wage policy, since the fundamental decisions that are relevant for the development of productivity are still taken within the national framework. However, the inflation rate will be a unique european phenomenon from now on. Therefore, the relevant productivity gains must be supplemented by an additional factor that is in line with the common inflation objective. In the very long term, the average productivity gain throughout the currency area together with the normative inflation rate may gradually become the orientation basis.

Catching-up processes of individual countries are not prevented by constant unit labour costs throughout the currency zone. But they are rightly based on the parameter that is the only source of growing prosperity and higher incomes, namely productivity gains. Successful competition of companies for higher productivity gains rather than the flight into various types of real depreciation, i.e. a beggar-thy-neighbour policy, is decisive for lasting catching-up processes of individual countries. Isolated strategies of moderate wage agreements and tax cuts provoke counterreactions, that is a wage-cut and tax-cut race, which finally results in deflation and the reduction of real income for all.

The Member States are directly responsible for the fourth precondition for efficient competition markets, that is tax systems, special tax rules, tax bases and tax rates. There is no doubt about the general problem of differing taxes. With regard to the functioning of the single market, the harmonisation of indirect taxes is, therefore, an „acquis communautaire“ laid down in the relevant treaties. Due to the euro, the direct taxes are increasingly gaining significance. There is probably agreement that allocative decisions dominated by tax divergencies can be as distorting as, for instance, aids. They are a burden on the efficiency of EMU and thus the prosperity level. Therefore they must be put on the political agenda of the Union. Analogous to the rule on indirect taxes in the EC Treaty, rules on direct taxes are also necessary. In its 1998/99 annual report, the German Council of Economic Experts in detail dealt with tax competition. According to the Council, the principles of transparency and equal treatment must be observed and it must be guaranteed that „the call for tax competition must not foster inadequate harmonisation efforts“. The aim is in fact not the harmonisation of direct taxes, but rather the prevention of „real depreciation“ via taxes. Social and environmental standards must be reconsidered against the background of the same objective.

The creation of the framework conditions for the European markets remains a permanent task of an „economic government“. The clearer the consensus on the general efficiency conditions of markets, the easier is the necessary coordination. National measures and rules also must be reviewed with regard to the question whether they fulfil the conditions for the functioning of EMU.

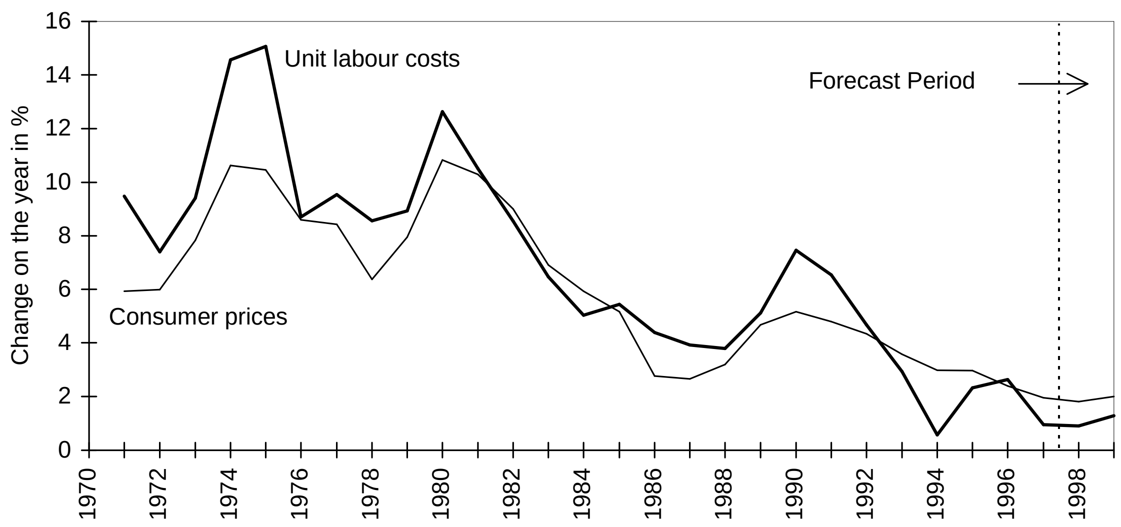
More employment through wage and fiscal policies?

A framework of conditions for the European markets that is characterised by competition in the euro zone and political action is the basis for allocative efficiency and high productivity gains. For a long time the idea that this is roughly the task of economic policy prevailed among those responsible at the national and European levels. Laissez faire was the motto: Reduce the distortions on the markets that are due to state rules, create functioning markets and guarantee a stable money! This message of economic liberalism from the 17th century, which, paradoxally, is in principle contrary to mercantilism, saw a revival in the supply policies of the 70s and the 80s. Its message is not wrong, but it is only half of the truth. After a quarter of a century that saw unemployment rising at intervals, the belief that efficient markets automatically result in full employment of all resources has begun to waver.

There is a lack of 18 million jobs in Europe. They cannot be created by means of export surpluses. The European Union must solve its employment problem in a different way. Supply policy that aims at high productivity gains cannot be the solution as well. Productivity gains which do not induce higher real income and thus higher demand will even lead to the shedding of labour. Many citizens in Europe have been confronted with experiences of the rationalisation of production processes in the last few years. Therefore, many have come to the wrong conclusion that productivity gains are the reason for unemployment and redistribution of work is the only solution. Such ideas are, paradoxically again, the result of a policy that promised more employment through greater productivity gains.

Wage policy too cannot shoulder the full burden of the responsibility for employment. Wage increases that considerably exceed the overall economic productivity development have an inflationary effect and rightly call for restrictive monetary policy. This leads to a stabilisation crisis with inevitable negative reactions with regard to the supply of jobs. But the employment level is also jeopardised by rises in nominal wages that are below the overall productivity gain. Falling unit labour costs are the main reason for deflationary processes. The Great Depression at the beginning of the thirties is a deterring example. As soon as investors and consumers expect falling prices, demand is dwindling. The present economic situation in Japan shows how difficult it is to return to a cyclical recovery in such a constellation. For this reason, wage policy, contrary to the neo-classical approach, is not only an inadequate, but even a dangerous instrument of employment policy. Wage policy can and must stabilise costs and prices as the following graph demonstrates. It cannot do any more.

Unit labour costs and consumer prices in Europe[1]



[1] EU 15; weighted with 1996 nominal GDP on U.S. dollar bases at 1995 exchange rates.
Souces: OECD, research institute calculations, research institute forecasts for 1998 and 1999

In the Keynesian tradition, an important employment-policy role is often attributed to financial policy. In this context, people fail to see that for Keynes deficit spending is the ultima ratio only in case the monetary policy has been made full use of and interest rates tend towards zero. In this situation, a public spending programme to boost effective demand and to reverse expectations is in fact the only thing that remains to be done. But the European economy has not yet reached this stage. Monetary policy can still be used for employment purposes. Therefore financial policy does not yet have to leave its consolidation path.

The role of monetary policy

Overcoming mass unemployment in Europe cannot succeed with outdated economic-policy patterns. The supply-policy strategy is able to raise labour productivity, but it cannot expand the volume of labour. Wage policy can stabilise demand and secure the value of money from the cost side. But its use as employment-policy instrument only results in inflationary or deflationary developments. Financial policy can directly shift purchasing power from the private sector to the public sector and vice versa. But in the short term it does not create higher employment. Deficit financing of public expenditure also is no means to sustainably reduce unemployment. Altogether the contribution of financial policy is restricted to the free play of automatic stabilisers and the short-term prevention of demand slumps. The latter may be necessary especially due to the impact of monetary policy.

The stabilisation-policy risks of wage policy, on the one hand, and the employment-policy limits of financial policy, on the other hand, inevitably raise the question which room of manoeuvre monetary policy has. The creation of money is an exogenous political act. Monetary policy, unlike fiscal policy, is not faced with the problem of „counterfinancing“. It can give impetus to additional investments without having to fear the contractionary effects on the money, capital and commodity markets. The power of monetary policy over the price of money, the central allocation mechanism in modern economies, inevitably results in responsibility for investment and thus employment.

Political action is, needless to say, oriented towards the shaping of the future. Objectives need to be reached. This does not mean, especially with regard to employment policy, securing the status quo, but rather overcoming it by creating adequate conditions. A monetary policy which, for instance, is based on the growth of the current growth rate of production potential under conditions of high unemployment cannot fulfil this task. It is basically retrogressive in so far as it aims at financing a growth rate of the production potential that reflects i.a. the creation of unemployment in the past. As according to Schumpeters theory of economic development monetary conditions are the driving force behind economic development, the relevant questions are: How much does the production potential have to grow so that employment rises considerably in the medium term? And which monetary conditions are necessary to achieve this potential growth. In Schumpeters theory economic development is not only a question of the monetary alimentation of the process of development, but of its creation by adequate monetary conditions.

Nobody can predict which growth rates such a policy can achieve and how large the production potential will be in the medium term. We cannot know the economic dynamism and the potential production. Economic policy can rely on model statements (Hayek), that is on theoretically secured interrelations, which also can be proved empirically. Monetary policy has no additional basis. But the uncertainty about the production potential should not lead to a backward looking orientation of monetary-policy and the establishment of the present trend of the potential growth as an adequate standard. A retrogressive monetary policy is not able to assume responsibility for future developments and prevents other policy areas to take over this responsibility.

Coordination of the macro-policy

The existing consensus on the common responsibility for economic policy is a necessary, but not a sufficient precondition for the success of employment policy and the securing of price stability. Coordination means process management. However, the objective of coordination and the underlying strategic concept is often not clear. A wrong policy approach cannot be corrected by means of coordination. On the contrary. Procyclical fiscal policy on the basis of theoretical patterns that are disputed in macroeconomic terms may even deteriorate the employment crisis. For this reason, each economic-policy coordination must be preceded by a discussion of the economic interrelations, i.e. of employment theory. This task must not be simply delegated to science. Politicians must participate in the process of forming an opinion and accelerate it with critical questions.

As far as the consensus on theoretical positions and problem diagnoses is concerned, considerable progress has been made recently. Convergence exists with regard to basic economic-policy ideas. Thus a basis for coordinated economic-policy strategies has been created.

In summary, the following essentials of a European economic policy must be pointed out::

- Impediments and distorting state incentives that hinder competition on the European markets must be removed. This task is even more very urgent after the launch of the euro. It would, however, be an illusion to believe that it can ever be regarded as fulfilled. The dynamism of the markets, on the one hand, and the understanding that sufficiently harmonised framework conditions raise prosperity, on the other hand, will in the future as in the past remain the driving forces behind convergence and integration.

- Budgetary policies of the Member States must credibly be oriented towards medium-term consolidation. This is not in contradiction to the free play of automatic stabilisers. Industry must be able to rely on the fact that financial policy does not destabilise economic slumps through procyclical expenditure cuts.

- Wage policy plays a central role in terms of stabilisation policy. It must prevent both inflationary and deflationary potentials with wage rises within the framework of the overall economic productivity trend. It is the stabilisation anchor within EMU.

- Under these conditions, i.e. with a clear consolidation strategy of public households and slightly rising unit labour costs that are in line with the inflationary objective, the way is paved for a new monetary policy that gives an impetus to investments and does not jeopardise the stability objective at the same time.