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The Scope for a European Economic Policy Initiative

Almost ten years ago, Jacques H. Drèze and Edmond Malinvaud published an article on „Growth and Employment: The Scope for a European Initiative“[1]1) which was aimed at shaking up economists in Europe to engage actively in the design of macro-economic policy in Europe.

The paper began with the observation of almost twenty years (as of 1994) of underutilisation of resources at a time of unfilled needs. In 1994 the (standardised) unemployment rate of European Union member countries had peaked at 10.5 percent of the labour force.

With unusual personal emphasis, Drèze and Malinvaud advocated a coordinated European growth initiative. Their plea was for a synthesis of measures, among which a decrease of the real interest rates, an exemption of social security contribution for minimum wages, a CO_2 tax, targeted investment programs on the national as well as on the EU level, a streamlining of welfare programs, a coordinated withholding tax on interest income and wage moderation played the most important role.

Since 1994 the unemployment rate in the EU fell to 7.4 percent in 2001. To a great extent this was the effect of higher growth rates in the period 1997 to 2001 (+2,6 percent per annum) than in the period between 1990 und 1996 (+1.5 percent per annum). The decrease of reported unemployment partly reflects lower participation rates in certain sectors and a reduced increase in labour productivity.

For the period 2001 to 2003, a growth rate of just 1 percent per annum can be assumed. Europe is confronted at the end of spring 2003 with the prospect of a third year (after 2001 and 2002) of growth significantly below potential and with only a vague hope for a „hesitant and unbalanced global recovery“ (EU Commission, spring forecasts 2003) starting towards the end of the year at best.

There are considerable risks of a worsening situation: if economic activities in the United States were to fade or if European domestic demand were to be depressed by more cautious or more pessimistic views of households, companies, capital markets and financial institutions. The mood of the latter could be spoiled e.g. by the urgent restrictive measures taken by many

[1] European Economic Review 38 (1994), p. 489-504. This paper was a condensed version of a position paper collectively prepared by 13 leading European economists.

governments at the moment in order to better balance their budgets or by a continued revaluation of the € against the $.

It would therefore be a sort of positive surprise if - according to the spring forecasts of the EU Commission - the unemployment rate in 2003 would only be 0.5 percentage points up from 2002 (or + 0.8 percentage points respectively up from its lowest level in 2001) and remain stable at that level in 2004. Perhaps this could be explained by assuming that, in the meanwhile, the European growth path of PO is much lower than it was in the mid nineties. But if that is the case, we should not seek comfort in that argument.

I therefore would advocate discussing the strategic elements of a new European initiative.

European economic policy according to the Broad Economic Policy Guidelines (BEPG)

What is the answer of official European economic policy makers to that prospect and to the risk of a worsening situation?

The answer is can be found in the BEPG, presented by the Commission to the Council in May 2003 - and in regular notifications issued by the European Central Bank which intentionally lack transparency and explicitness.

The BEPG strategies consist of a number of key elements:

1. „*To ensure an annual improvement in the cyclically-adjusted budgetary position of at least 0.5 percent, while avoiding policies that counteract the full and symmetric play of automatic stabilisers over the cycle*" (Italics by BEPG). Whoever knows what exactly the cycle is. This is an attempt to re-interpret the Stability and Growth Pact (SGP) provisions that have practically and politically collapsed under the impact of a more or less symmetric contraction of domestic demand developments in most EMU countries since 2001.

2. Next, social partners are addressed to: „*Ensure that nominal wage increases are consistent with price stability and productivity gains*." For the time being this would be akin to distributing the pelt of the bear before it is shot. The main concern of the BEPG in the field of income policy seems to be possible wage claims expected in the case that the (vaguely hoped for) cyclical upswing should materialise. If it does, priority should be given - again, according to the BEPG - to a restoration of profit margins.

3. **„Monetary authorities should pursue price stability."** A truism! The BEPG at most venture, if they really intend to venture anything, to add (omitting bold-faced type) „that, subject to this being achieved, monetary policy should support the general economic policies".

The ECB for its part has possibly been emitting - if some Frankfurturologues are right - signals indicating the preparation for a possible cut of the central interest rate. A more determined step than the last cut, however, is advocated by many independent voices. It could be justified by waning inflationary threats of the Iraq war and by the risk of a further strengthening of the € against the $.

4. **„Economic reforms to raise Europe's growth potential"**. Of course! It cannot be denied that this advice is not only appropriate but also potentially powerful. To achieve a higher growth potential of the EU is indeed key to the solution of most macro-economic impasses national governments are confronted with. Questionable is whether „Lisbon" and the „European Employment Strategy" are sufficient instruments to underpin that difficult task.

This set of economic policy advice was derived from internal considerations of the Commission services as well as from political considerations at the levels of the Commission and the Council. The former - the Commission services – is not to be blamed for an inadequate approach towards imminent problems. Their review of the European economy in 2002 represents a fine piece of economic policy analysis, consisting of political conclusions drawn from the empirical evidence.

The European public has become familiar with the particular way of publishing these conclusions through the BEPG. It is hard to avoid being reminded of the promulgation of Vatican documents.

These Guidelines are - surprisingly - rarely discussed among independent or academic economists. Of course, there are some exemptions, e.g. Paul de Grauwe, Jürgen von Hagen or Paul Krugman, to name just a few. Somewhat disappointingly (to me), the conclusions of the recent spring forecast issued by the 6 leading German institutes – to whom I would ascribe a crucial role in this matter as stagnation in Germany is one of the central questions - seem to fall in line with the official European policy mainstream, while - rightly - criticising faltering policy reform attempts of the German government.

To make myself clear: I do not intend to question the wisdom of the above prescriptions in themselves. It goes without saying that formulations of that sort always have good points in their favour.

However I strongly feel that they are seriously insufficient in just the same way as similar views expressed by European policy institutions have proven insufficient - if not unrealistic - in the recent past.

It is time for a new initiative of non-partisan economists

Since 1994 many important framework conditions have changed. I mention only some of the most important:

- The establishment of EMU.

The Euro and the common monetary policy offer, no doubt, the potential for improving macro-economic conditions (e.g. internal exchange rate stability, higher efficiency of capital markets). There are, however, some problematic features caused by asymmetric developments and the specific formulation of the tasks and the practice of the ECB).

- The forthcoming enlargement of the EU.

This project leaves - even after the signing of the treaties - many questions and opportunities open, not least matters of economic policy. The conditions of the approach of new members towards EMU need to be clarified, a very tricky problem that cannot be solved satisfactorily by forcing them to sign the SGP.

- The issue of population ageing.

This has finally become a matter of highest priority in almost all EU countries. It deserves more attention than it received in 1994. Reform efforts have ideally to be of a very comprehensive nature. They have to assess the macro-economic conditions, e.g. possible side-effects demand higher attention than they were paid in 1994. And, again in this matter, European coordination could expand national options.

- The global situation.

Now the option of any tripartite coordination between Europe, Japan and the USA seems to be without any substance. But, at the same time, the global situation implies higher risks than as seen in 1994.

Some other elements of the synthesis of Drèze and Malinvaud still are left to be installed into the construction of a European initiative.

Core elements of a new strategy

The following aspects seem most basic to me:

1) It is simply not sufficient to wait and see for an upswing.

The vague hope for an upswing at some point in time in the not too distant future is mainly derived - according to the BEPG - from

- increased external demand - hopefully from the USA, though the Euro rate will dampen that unavoidably,

- favourable macro-economic conditions as specified in a lower inflation rate, the limited playing of automatic stabilizers in state budgets and (perhaps) an interest rate reduction by the ECB (hopefully more distinct than the latter and hopefully before the summer),

- some positive achievements of structural reforms which obviously cannot be of major importance in the short run.

EU economic policy simply cannot restrict itself to encouraging members to do their homework of consolidating budgets. It has to play an important, necessary and more active role in coordinating national attempts at overcoming depressionary mechanisms that are threatening given the atmosphere of a serious post-boom hangover.

2) National governments are caught in a sort of prisoners' dilemma which prevents them from giving fiscal policy stimulus.

Some governments have announced unilaterally to envisage giving priority to domestic demand conditions over meeting the SGP targets, however defined. Frankly, without denying the basic point for commitments by EMU participants to sound fiscal policy, Romano Prodi's labelling its design as being stupid appealed to me very much. (In an expert's opinion given to the Austrian Minister of Finance in 1996, WIFO argued that the provisions in the then SGP draft could eventually lead to exactly the discussion that arose in 2002.)

Of course, especially small economies risk severe imbalances of public finances and the current external account as the result of attempts at giving short-term fiscal stimulus. Most probably they would be left with higher deficits but rather limited employment effects.

It seems to me that the most urgent element of a European impulse policy indeed would be a coordinated extra-budget stimulus in favour of infrastructure and, even more, of human capital investments. The task is „to find ways of *stimulating investments without falling back too much on national budgets for funding*" (italics by Drèze-Malinvaud). It is not impossible indeed to think of such programmes in the wake of EU enlargement, given the fact that most trans-European networks still show bottle-necks at the precise location where the Iron Curtain collapsed almost 14 years ago.

3) The BEPG do not address the employment problem of the less qualified persons in an adequate way, who in all European countries are the bulk of the unemployed. Whereas the 2002 Economic Report correctly addresses the tax wedge on low-paid workers as a crucial issue, the BEPG implicitly advocates lowering wages („allow them to better reflect productivity“).

There is still, 10 years after Drèze-Malinvaud, ample room for a coordinated initiative on the European level to reduce the wedge between private and social labour costs.

Some attempts by the EU Commission in this direction (including reduced VAT for specific services) seem to have been discouraged since by Ministers of Finance, against all theoretical wisdom and empirical evidence. Of course that could mean to take the proposal of a coordinated CO_2 emission tax seriously.

4) The topic of pension reform is high on the agenda of most European governments between the North Cape and Crete. There are certainly many national features of the existing system to be approached in a very specific way. But the general orientation of the reform steps could profit from some European coordination:

- There are probable short-term effects on the final demand that could cause the recent business outlook to deteriorate (further?).
- For the strategic design of reforms, there are obvious interactions among pension reform with employment as well as taxation or capital market considerations: They could be improved by coordination on a European level.
- More generally I am convinced that reforming the welfare state is - besides these obvious interactions - the test of the existence of a European model of society invoked in the preamble of the draft text of the Constitution of the European Union.

5) Such a strategy would have to discuss the role of the ECB in the course of macro-economic events since 2001. There are obvious points for revision, e.g. the obsolete orientation at the variations of M3, or the wisdom of an inflation rate tolerance at 2 percent, which now proves to be one of the serious impediments to a revival of economic activities in Germany.

6) Most of these strategic elements of European Economic Policy could be doomed to failure if they will not be based on an ambitious European growth strategy. The Lisbon process was the result of precisely this consideration. However, apart from its targets being somewhat scattered, not forming a

comprehensive model, their implementation is poor due to an asymmetry of political commitment between the SGP and "Lisbon". Therefore the overall restrictive stance of budgetary policy limited public efforts to expand and to upgrade education, research and infrastructure systems in many European countries. The disappointing performance of the EU economies in recent years is not least the outcome of lower investment into these sectors as compared with the US.

I feel - as Jacques Drèze and Edmond Malinvaud did almost 10 years ago -

that these problems and related issues are „fundamental enough to call for an active participation of academic economists who should not leave entirely the task to policy makers".