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# Supermercantilism as a European Strategy: The Road to Stagnation

by Wolfgang Hager, Florence\*

**On the surface, Europe seems to be climbing out of the dreary post-1973 era, marked by anxiety, doubts, and shocks, to a new "1960s": economic growth, declining inflation, new consumer gadgets to enjoy. But the medium-term outlook is more disturbing than the euphoria engendered by a temporary economic upswing would suggest. While the general introduction of technologies matured in past decades seems to usher in a new era of creativeness in our economies, the overall economic policy context, expressly designed to foster such creativeness, bears the seeds of profound disequilibria.**

To understand the dilemma the European Community faces – and which has resulted in a radical and quite innovative medium-term economic and industrial strategy elaborated by the Commission (of which more below) – it is important to understand the main thrust of contemporary economic policies in the member states. In the early eighties these began to converge to exhibit a remarkable degree of similarity. If one were to look for a single label for these policies, one might choose "mercantilist austerity".

The basic premise of these policies is that traditional, short-term demand management of the kind which insured full employment, growth and a reasonable trade balance in the fifties and sixties is no longer possible.<sup>1</sup> The reasons given are sometimes theoretical. Keynes was wrong: government fiscal manipulation to "fine-tune" the economy cannot work, since workers, savers, and investors hold "rational expectations" which nullify the effects of such policies. Or they are empirical: Keynes cannot work, because the flexibility of our economies (e.g. the labour market, price system, etc.) is so reduced that any stimulus to economic activity does not create more output and employment, but simply drives up prices. Or they are more specific and practical: public deficits are too large and have to be cut; inflation must be brought down by restrictive policies; any stimulus to demand would merely suck in imports, deteriorating the balance of payments without creating employment (as proven in the early Mitterand boom).

Having agreed, for all these various reasons, that traditional short-term economic management is not

possible or desirable, European governments have resolutely shifted to medium-term, structural policies. All these policies, ultimately, are meant to favour investment. Investment, of course, was also the crucial policy variable for Keynes: if government stimulated demand, entrepreneurs would be moved to expand investment to meet this demand. But in the eighties, the rationale is quite different. Investment is not so much a means of increasing output in the short run, but of *modernising the capital stock*.

Such modernisation has assumed a central importance in policy thinking for several related reasons. One, a host of new technologies are now ready for industrial application. These range from the familiar micro-processor applications in new products and production processes (i.e. robotics), to less spectacular advances in materials technology (e.g. bonding), low-temperature chemistry (fermentation etc.) which is in turn related to the next great push for industrial innovation, i.e. genetic engineering and other forms of bio-technology. Without new investment these new possibilities for creating better, cheaper, and simply different new products cannot be realised. So far so good.

In contemporary policy thinking investment in this innovative, modernising sense has become the single, or at least dominant, instrument to regain the capacity for growth and full employment. In these macro-economic terms two rationales are usually advanced.

<sup>1</sup> These policies were never much in vogue in Italy, since the uneven structure of the economy (Mezzogiorno) made "aggregate demand management" less attractive than counter-cyclical public investment policies.

One is "domestic" and goes back to the theories of long-term cycles of economic growth discovered first by Kondratieff and developed by Schumpeter. They identified "long waves" of economic activity, twenty-thirty year periods of growth stimulated by new products and production techniques, followed by stagnation until a new bundle of innovation comes along. In this view we have exhausted the stimulus from traditional consumer goods (cars, washing machines, TVs, etc.) the markets for which are saturated. Rather than wait until presently feasible innovations create a new long-term upswing (by forcing entrepreneurs to make new investments, and by stimulating consumption through novel products, e.g. home computers), government policy should accelerate this process by creating favourable conditions for investment.

### **Adjustment to New Opportunities**

A second, much more powerful, rationale concerns international competitiveness. At its simplest the argument runs as follows: the basic, labour-intensive industrial processes have now been mastered by the Third World (and Eastern Europe). Adjustment to these new opportunities for the international division of labour requires the scrapping of such manufacturing facilities and new investment in activities where the advanced countries have a comparative advantage: specialised areas of traditional industries, e.g. special steels, high-fashion fabrics and clothing, advanced machine tools, special chemicals, etc. Trade adjustment also requires moving toward the high-technology spectrum of industry and services: telecommunications, aerospace, advanced engineering, etc.

This version of the story has, from an international perspective, strong collaborative aspects: the rich countries provide markets and growth opportunities for the developing countries while their standard of living rises due to the availability of cheap imported products and employment in high value-added fields of activity. I have argued in an earlier article for *INTERECONOMICS*<sup>2</sup> why I think this specialisation scenario is not feasible. Here it is enough to point out why all European countries feel a strong push, from below so to speak, to facilitate structural adjustment through increased, modernising investment.

### **Competition Among Advanced Countries**

The story becomes much less cooperative, and indeed highly conflictual, if we turn to the trading competition among the advanced countries themselves. All countries have discovered that a few high-technology products show very high growth rates

even while the rest of the economy stagnates. Most of these products – like computers or video-tapes – need world markets. The path to growth clearly lies in capturing as large a share of the world market as possible in these kinds of activity. Whoever is first on the market with a new product benefits from economies of scale, hence can lower prices to keep out competitors and/or make huge profits which enable them to finance new research and development and thus stay ahead in the race. IBM provides the best example; many others are offered by the Japanese consumer electronics industry.

Two pressures thus combine to make for a quasi-existential battle among the advanced countries for places in the high-technology league: the pressure from new competitors on mature industries; and the growth promise (or threat of economic stagnation) depending on securing market shares in high-growth activities.

If this were the whole story, mercantilist competition would perhaps be limited to industrial policies proper: subsidies to R&D, preferential financing for favoured industries, export promotion strategies (credits); protectionism, through technical standards and national procurement, to provide a secure home base for the attack on world markets, etc. All of this is, of course, taking place world-wide creating severe strains in the international trading system and posing the risk of world-wide overcapacity in the favoured activities: the transponder glut (communications satellites) is as large as the overcapacity in the world steel industry. On the other hand, as long as only a few identifiable industries are involved, an informal system of market-sharing, mutually tolerated protectionism, etc. could largely contain the damage. Such arrangements have after all long existed in telecommunications, civil aircraft, or nuclear reactors.

### **World Context of Competitive Deflation**

The really serious problems for the world economy and the European Community stem from the way macro-economic policy and its structural components are manipulated in an overall strategy of international competitiveness. Put at its simplest: all countries (with the temporary and crucial exception of the United States) practice austerity policies which depend for their ultimate success on demand created by others. The constellation makes for a world context of competitive deflation.

Taken for each country separately the economic recipe now quasi uniformly applied in Europe seems to make sense: in order to stimulate investment the costs

to businessmen must be reduced. This means wages growing more slowly than productivity (this also helps directly to improve international competitiveness), and reducing taxes on business. It also means reducing government deficits, since these are either financed via the money press, creating inflation, or via borrowing which reduces the capital available to productive investment and raises its price (crowding-out argument).

Thus the new policies for growth have a strong medium-term orientation: many years of declining wages relative to GNP; many years of steadily reducing government spending; many years of reducing money supply relative to nominal GNP so as to reduce inflation further. The result, it is hoped, will be steady gains in international competitiveness in simple cost terms (low wages and inflation) and more importantly, in structural

terms: higher profits and cheap capital will stimulate entrepreneurs to invest, thus incorporate technological progress in production technologies and final products, and hence take advantage of any growth of world trade that might occur.

### **Grave Drawbacks**

There are two grave drawbacks to this policy. The policies are not only non-Keynesian, but anti-Keynesian: two components of final demand, wages and government spending, are reduced in real terms not once for all, but over a period of years. For the total economy to grow, investment has to grow very fast for years, and/or exports must make up for the loss of domestic final demand. We can be sure of what happens in the sheltered sector of the economy, i.e. non-traded goods and services (home building), since these will be fully hit by the decline in domestic demand: investment will stagnate. As far as the export sector is concerned two conditions must be met for the hoped-for

<sup>2</sup> Cf. Wolfgang Hager: Free Trade Means Destabilisation, in: INTERECONOMICS, No 1/1984, p. 28 ff.

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investment boom to materialise: profits and profit expectations must not only rise, but be better than in other countries. Otherwise what profits there are will simply be used for foreign investment, e.g. in low-wage countries. Secondly, there must be strong growth in the world economy, so that the growth of exports can compensate for the stagnation of sales in the domestic economy.

None of these assumptions are very plausible. Indeed, recent modelling by the Dutch planning office of that country's savage medium-term austerity policy produced the opposite of the intended result: instead of a surge of modernising investment there was stagnation. Whatever profits were realised by lower wages, taxes, and cheaper credits to industry (and due to depressed domestic demand profits would rise much less than intended) were used for foreign investment, even assuming reasonable world growth.

The trouble is that even that assumption is not likely to be fulfilled. Not only all European countries are conducting policies of budget consolidation and modernisation through austerity. Japan has also introduced an austerity budget; the large debtor countries of the Third World (and many small ones) are encouraged by the IMF to savagely cut internal demand (including investment on which European exports depend) and to increase exports, reducing Europe's share of world markets. In other words: everyone is relying on the growth of everyone else, while everyone is reducing the growth possibilities of everyone else.

### Disturbing International Outlook

This deflationary constellation would have already led to a deep world recession, were it not for the phenomenon of the United States. That country has been the intellectual and political leader of anti-Keynesian, supply-side policies: at home, in the OECD, and in the IMF. But its obsession with military strength has led it to pursue, via a huge defense budget, a strongly Keynesian policy of deficit spending. The predictably high US trade deficit (100 billion \$ forecast in 1984) has provided the rest of the world, and especially Europe, with an export-led growth opportunity which seemingly vindicates the austerity strategy. World trade is forecast to grow by 5 % in 1984. Fully half that growth consists of exports to the US.

This American boom, however, is not sustainable: the budget and trade deficits will have to be corrected; either protectionism or a sharp fall in the US dollar will stop the growth of European exports. Moreover, except for Great Britain, austerity policies have only recently been

introduced in most European countries: domestic demand is still relatively strong. And even the present boom has only stabilised unemployment at 30 million in the OECD area; it has not reduced it. Once the American market stops growing and the austerity measures in Europe take effect, the outlook is disturbing indeed.

### The EC Commission's Strategy

As stated earlier, the competitive modernisation and adjustment strategies pursued by the member states pose grave threats to the status quo of the Common Market. Members subsidise capital investment, R&D and other costs of advanced industries, undermining the fair competition basis of the Treaty of Rome. They practice modern forms of infant-industry protectionism against each other by manipulating the complex standards for modern products (e.g. health standards; technical specifications; inspection procedures) in ways which give an advantage to the home product. They tighten further, rather than liberalise, public procurement markets (almost one-fifth of all goods and services are purchased by public authorities). They encourage firms to enter into technological cooperation agreements with American or Japanese rivals, undercutting the opportunities for autonomously developed European technology.

The Commission has responded to these dangers by a medium-term economic and industrial strategy which seeks to "Europeanise" the goals and instruments underlying the national modernisation drives. This strategy, on the "macro-structural" level simply encourages the dominant national policy stance: consolidation of national budget deficits, lower wages, etc., intended to encourage investment and hence modernisation. It seeks to fulfil its "European" mandate by encouraging convergence among member states. Full convergence would imply equal, and low, inflation rates; and equally modern and adaptable industrial structures. It is in this context that its strong support for the Italian government's attempt to break the *scala mobile* must be seen.

But this is an area where the Commission advises rather than proposes concrete policies. For this we must look to the industrial policy opportunities offered by its competence in foreign trade, the internal market (including the control of subsidies and competition, the harmonisation of standards, tax rules, etc.) and, to a lesser extent, regional policy and other funds at the Commission's disposal. In addition, there is Euratom, with its changing emphasis from nuclear research to more general high-tech R&D.

The public perception of Community industrial policies is one of coping with crisis industries: steel, shipbuilding, textiles, petrochemicals, etc. In these areas the Commission is forced to act to bring a minimum of order into sectors where the market has been heavily distorted by governments. But these are not the industries which are central to the Commission's industrial policy programme.

### **Need for Rapid Technology Diffusion**

The real concern is with overall competitiveness of Community manufactures in world markets, and especially with the strength of technology-intensive sectors. The Commission is among those who argue loudest that the European Community is dangerously slipping behind the US and Japan in computers, biotechnology, machine tools, telecommunications, etc. Moreover, as mentioned above, modern technology is transforming production technology and product design in virtually all traditional sectors (e.g. cars designed, made, and controlled by computers). According to the Commission, only a radical programme of rapid diffusion of technology throughout the economy can prevent Europe from losing out in world markets.

To achieve this aim the Commission has developed proposals in very diverse policy areas. These range from encouraging "applied R&D" in informatics through the "Esprit" programme; the provision of a public (European) infrastructure for data transmission and storage (Euronet, etc.); an ambitious collaborative R&D effort in biotechnology; encouragement for the formation of venture capital institutions throughout Europe; reforms in patent, tax, and competition laws to encourage innovation and technological cooperation; encouragement of flexible and shorter working time, plus retraining schemes, to reduce worker resistance to the introduction of new technology; infant industry protectionism and much else besides.

### **Creation of a European Industrial Space**

The new slogan is: the "creation of a European industrial space". This involves a renewed attack on internal barriers to trade in the not-so-common market, including the harmonisation, or mutual recognition, of technical standards and the mutual opening of public procurement markets, especially in sensitive high-technology fields like telecommunications. As a counterpart, the Commission has cautiously adopted the French argument that such internal liberalisation must be matched by external protectionism: the notion of "Community preference" is to be extended from the area of customs tariffs to – potentially much more

effective – non-tariff areas, e.g. standards and public procurement. One of the many unsolved problems with this approach is the extent to which EFTA countries (with whom the EEC has free trade agreements) will be included or excluded from Community preference.

Put differently, the Commission's strategy, faced with the nationalistic tendencies implicit in the current modernisation drives of the member states, is to develop a supernationalism on the European level. It has sound arguments on its side. No single European country has a sufficiently large market, and a sufficiently diversified and complete range of technology, to cost-effectively produce world-class technology in the future. The fragmentation of markets and national R&D efforts must stop. On the other hand, Europe has a unique socio-industrial context, some of it hostile to innovation and industrial modernisation, which requires specifically European responses. If any more time is lost, Europe will lose its technological autonomy and become a mere sub-contractor to American and Japanese companies. Moreover, without technological autonomy, given US restrictions, major foreign policy objectives pursued via East-West trade will be compromised.

### **Austerity Approach the Major Flaw**

The major flaw in the Commission's strategy is that it takes as its starting-point the austerity approach to investment-led modernisation.<sup>3</sup> A policy which is doubtful when practiced by a single member state becomes many times more dangerous when practiced by a whole continent. Even the most spectacular growth of the world economy, and the most successful participation in such growth by a technologically revitalised Community, cannot offset the cumulatively depressing effects of generalised austerity policies. Here lies a major opportunity for Europe to prove, in very concrete and immediate terms, the advantage of belonging to a larger unit: policies of economic stabilisation are possible for Western Europe as a whole, even though they are not possible for any single country. Without paying more attention to growth in the short term, present plans for growth in the long term, i.e. export-led growth, will be disappointed. Investment will stagnate, the capital stock will age rather than be rejuvenated, and unemployment will reach new records. The Commission's strategy is tailor-made for a small country, designed to exploit the world economy. In many respects the Commission's plans for a modernised Europe are bold. It must now add an essential ingredient: think big.

<sup>3</sup> Cf. Fifth Medium-Term Economic Policy Programme, in: European Economy, No. 9, July 1981.