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# Western Europe: Hard Decisions Ahead

Economic forecasts for the current year for the Western industrial countries have become less favourable in the course of recent months. The increase in real gross domestic product compared to 1995 is now mainly estimated at about 2%, roughly half a percentage point lower than in previous estimates. This revision reflects in particular the lower rate for Western Europe, where the increase in production - at a probable  $1\frac{1}{4}$  to  $1\frac{1}{2}\%$  - remains one percentage point behind earlier forecasts. The less favourable estimate of growth in Western Europe is not so much an expression of a deterioration of general economic prospects, however. It is, rather, a reflection of the trend in the course of the winter six months, which was less favourable than had previously been expected but which is regarded as being only a brief "growth pause". It is expected that there will be a return - from the lower starting-point - to an upwardly directed trend with production expanding at a similar speed to that in the "old" forecasts. This is demonstrated especially in the expected growth rate for 1997 of 2 to  $2\frac{1}{2}\%$ .

The unexpectedly strong slowing down of the upswing in Western Europe was mainly the result of changes in interest rates and exchange rates. On the one hand, the considerable increase in long-term interest rates in 1994 contributed to the levelling-off of demand. On the other hand, exchange rate turbulencies in the first third of 1995 caused dampening effects as well. These were partly a consequence of the renewed appreciation of the European currencies vis-à-vis the dollar. Partly they resulted from the considerable "realignments" among Western European currencies, not least because of uncertainties about the further course of economic policy. Furthermore, reactions and effects were not symmetric. For instance, the worsening of the competitive position in countries with revalued currencies took effect more rapidly than the impulses emanating from lower interest rates.

The expectation that a new upward trend will make itself felt in Western Europe this year is based above all on the relatively favourable general conditions. Capital market interest rates already fell again markedly last year and monetary policy is in many cases likely to have an expansionary effect. In addition, exchange rates have returned to relations which can be regarded, taking fundamental aspects into account, as close to a normalisation.

The fiscal policy situation is less favourable, however. The "explosive" increase in public debt in relation to gross domestic product in most of the Western European countries - and in North America - up to the beginning of the present decade to a level previously unequalled in peacetime placed increasing pressure on many governments to reduce their budget deficit. As a result, taxes were often increased and expenditure cut in recent years.

Consolidation policy can, in contrast to the fears not only of many politicians, be relatively "painless". Precisely this experience has again been confirmed in the USA in recent years. The US budget deficit was reduced to an extent significantly beyond that which was caused by the business cycle. The resulting loss of demand, which usually plays a major role in the scepticism with which the potential effects are judged, did not have any visible dampening effect on economic trends. The demand effect was not only overcompensated by the impulses emanating from other policy areas, particularly monetary policy. The consolidation itself apparently also had a stimulating effect on the economy via various channels, even if these lagged behind the demand effect. One major transmission mechanism was the reduction in interest rates which resulted from the government's lower consumption of national savings. There was, moreover, a positive influence on the expectations of the private sector.

Nevertheless, the question poses itself for many Western European countries whether the forced consolidation of public finances, such as would be required for the monetary union planned for 1999, is justifiable from the point of view of trade-cycle policy in a phase of weak economic activity such as the present one. In order to achieve the fiscal criteria agreed upon in the Treaty of Maastricht, or at least to approach their achievement, next year the cyclically based slower rise in revenue and the more rapid increase in public expenditure which would be necessary from the point of view of trade-cycle policy could not be accepted. This would, however, involve the risk that the contractionary demand effects, which dominate at first, would place an additional burden on the economic climate and thus counteract the desired effect.

The forced reduction of budget deficits with "unpleasant" consequences for the economy and employment also involves the risk of reducing the acceptance of a common European currency. All the more so, as the austerity programmes often particularly affect social expenditure. Yet cuts in the social safety net, although they are always unpopular, are necessary in any case in order to put a brake on this expenditure with its particularly strong tendency to expand.

Yet even if the economy recovers as expected, employment prospects will remain gloomy. Under these conditions, unemployment will hardly decline. At a good 11% of the labour force it is roughly twice as high as in the USA. Weaker economic trends in Western Europe in recent years have clearly accentuated these differences, but this should not blind us to the fact that the core of the Western European employment problem is not a cyclical one. The increase in unemployment to its present high level is, rather, the result of a long-term process. The considerable difference in employment between the USA and Western Europe is not based, for example, on a more favourable demographic trend or on a stronger increase in employment participation in the USA. It is, rather, the very much greater vigour of employment expansion in the USA which has played a prominent role. While national production increased in both regions in the last twenty years by an annual average of 2½%, the number of employed in the USA rose by a total of about 40%, whereas in Western Europe the gain was not even 10%; in the one and a half decades previously the discrepancy was similar.

When there is a lack of jobs the question as to the quality of the employment opportunities available is really secondary. Yet in Western Europe the American "job wonder" is often discredited with a reference to the fact that, above all, jobs demanding low levels of qualification and with low pay have been created. In contrast to this biased opinion, however, the pay for almost two thirds of the jobs created in recent years was above the average hourly wage. Even though this proportion may be less favourable in the long run, the job-intensive growth in the USA is an indication of an environment more conducive to employment than that in Western Europe.

Trends in labour costs undoubtedly play an important role for the expansion of employment. In the USA, real average hourly wages have fallen distinctly since the beginning of the eighties, in contrast to the situation in Western Europe. The greater flexibility on the labour market, due among other things to a comparatively high degree of both job mobility and geographical mobility on the part of the labour force, but also to the lower level of social safeguards, had an additional effect in favour of employment. European governments are not prepared to accept a "hire-and-fire culture". Their capacity for maintaining their closely woven social safety nets has sunk markedly, however, in view of the above-average expansion of social expenditure in recent decades, of the considerable increases in taxes and social insurance contributions which have resulted mainly from this expansion, and of the high rate of government expenditure in relation to GDP this has caused. The question is for how much longer Europeans will be able to afford their present social standards.

*Günter Weinert*