

Weinert, Günter

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Western Europe in Need of Structural Reform

Demand and production in the world economy continue to show a clear upward trend. The developing and newly industrialized countries and the Central European transition countries are maintaining their high rates of growth. In the industrialized countries the expansion has become more uniform in the individual regions with the renewed marked recovery in Western Europe. In their spring report, the major German economic research institutes forecast real growth rates of gross domestic product for this year in Japan, Western Europe and the USA which are close to one another at 2 to 2½%. The cyclical position of these regions continues to differ considerably, however. In the USA capacity utilization is high while in the other regions it is mostly below the normal rate. The labour market situation differs accordingly: while unemployment in the USA has kept to a very low level for some time now, about one in ten in the labour force in Western Europe is jobless; this high level is mainly due to structural causes, however.

The resurgent expansion in the industrialized countries is largely a consequence of a further improvement in general monetary conditions, which in a number of cases have been very favourable for some time. Long-term interest rates have dropped to a very low mark. Another factor in Western European countries, where the central banks lowered their rates further last year, and in Japan, was the correction of their exchange rates vis-à-vis the US dollar, which until spring 1995 had been far overvalued in terms of international competitiveness. The gain in competitiveness compared to suppliers from the dollar area has contributed to a marked increase in exports, especially from Western Europe, and has again considerably improved the earnings situation for manufacturers of internationally traded goods.

All this has, however, as yet hardly induced a faster increase in domestic demand. For the most part, private household demand and public demand have remained modest. Demand for residential building has also remained weak in most countries despite low interest rates. The key to the reticence of private households, despite the considerable accumulation of wealth thanks above all to the marked rise in share values, is the unchanged gloomy income expectations in the face of high unemployment, which will not decline appreciably this year, either.

On the other hand, businesses' propensity to invest is hardly weaker than in earlier, similar phases of the business cycle. This is all the more remarkable as the relatively pronounced real appreciations and depreciations in this decade have certainly loosened the links between exchange-rate shifts and responses by the real economy. Enterprises can be expected to have catered for the larger exchange-rate fluctuations in their investment plans with higher risk premiums. These are unlikely to be reduced again unless there is growing confidence in the durability of present exchange rates.

This is unlikely, however, in the leadup to the planned European Monetary Union, at least in the immediate future. No-one knows for certain which countries are going to qualify for

the start; a deferment cannot be ruled out, either. Depending on the arrangements made in connection with the one decision or the other, turbulence on the financial and foreign exchange markets is just as possible as widespread calm.

The continuingly sluggish upward trend in Western Europe is often construed as the result of ongoing efforts by many governments to cut back their budget deficits drastically. In fact the total government expenditure surplus will decline considerably more this year than last. This is largely a result of favourable cyclical trends, however. Structural deficits, i.e. deficits adjusted for cyclical influences, will not as a whole be reduced more strongly this year than last taking into account the lower interest rate burden due to the marked fall in interest rates, according to budget estimates to date in the countries of the European Union. Consolidation efforts had become more vigorous last year, when a tangible recovery took place, though this was export-driven. Furthermore, the statistical drop in the deficits is exaggerated because it is in part the outcome of dubious accountancy and valuation methods.

However, should, as is variously to be feared, additional measures be taken to raise public revenue and/or reduce public spending this year in order to satisfy "completely" the reference value for aggregate government deficit and thus to qualify for the planned European Monetary Union, this is likely to put an additional damper on the economy. This in turn would thwart the foreseeable, albeit only slight, improvement on the labour market to the further detriment of EMU acceptance. In several countries resorting to further creative bookkeeping to meet the strictly interpreted fiscal reference value is being considered. Even if this does not directly have a dampening effect on the economy, it would certainly undermine confidence in the stability of the future euro.

Furthermore, with attention concentrated on meeting the Maastricht fiscal reference value, growth policy continues to be neglected. Opportunities for raising the relatively flat potential curve in continental Europe lie in particular in the rolling back of high government expenditure and overall tax ratios while at the same time stemming spending in the social sector, in making the labour market more flexible and in cutting back the relatively dense thicket of regulatory constraints in many fields. The "internal" opening of markets, which has just tentatively begun in a number of countries, intensifies – in the same way as an external opening – competition and stimulates the development of new products and production methods. Experience in Anglo-Saxon countries, and especially in the United Kingdom itself, confirms the "virtuous circle" of a stronger increase in production and productivity combined with a lower rise in prices to which market reforms and favourable supply conditions lead. This is an important reason for the lasting growth achievements and positive employment trends there. Conversely, the high rates of unemployment in continental Europe, which are not primarily attributable to cyclical factors, clearly point to a sizable reform backlog.

At the macroeconomic policy level, this need for adjustment cannot be "played over" by loosening the monetary reins for example, as some demand, at least not for long. This holds all the more as experience shows that faster growth fuelled by monetary means, if it comes about at all, usually eases the pressure, and seemingly the inclination of economic policymakers, to implement structural reforms. This is not the way to achieve any sustainable rise in growth. The essential role of economic policy is to allow sustained expansion and thus facilitate structural reform. The main way to achieve a steeper growth path, however, is through market economy reforms; at the same time this could reduce the substitution of labour by capital. In order to bring the high unemployment in continental Europe lastingly down to a distinctly lower level, to halve it for example, reforms which foster competitiveness on the goods and factor markets are essential.

Günter Weinert