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## Low growth and high unemployment in Europe - Causes and policy options

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# Low Growth and High Unemployment in Europe — Causes and Policy Options

by Klaus-Werner Schatz, Joachim Scheide and Peter Trapp

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- The stock market crash of October 1987 was not followed by the widely-feared recession in the world economy. Most forecasts have been revised upward again, and many are even more favorable than before the crash. This is also the case for Western European countries. However, beyond the very short run, there are serious cyclical risks.
- In the 1980s, the economic performance of Western European countries in terms of real GNP growth has been weaker than in previous decades, and unemployment is now more than twice as high as it was ten years ago. These developments are due to the poor performance of business investment. Rising labor costs have prevented employment and, hence, potential output from growing faster. This sharply contrasts with conditions in the United States and Japan.
- If the growth of potential output is to be increased, the rentability of investment and the flexibility in the labor market must be strengthened. As case studies for West Germany show, regulations, high minimum wages, wage costs and unemployment benefits have contributed to the long-term rise in unemployment. Therefore, demand stimulation will not induce faster growth and more employment. In the past 25 years, the acceptance of more inflation has not led to a lasting reduction of unemployment. Only a more market-oriented strategy can go to the root of the problem.
- An important prerequisite for a stable economic development is that monetary policy in industrial countries returns to a path compatible with price level stability. Monetary aggregates are still the most reliable anchor; alternative strategies for monetary policy — targeting interest rates, exchange rates or commodity prices — may well increase instability in industrial countries. Also, international coordination of macroeconomic policies is not necessary and may even be harmful if policymakers rely on wrong models. Given the failures of several attempts to coordinate (the locomotive strategy or the Louvre accord), industrial countries would fare better if they relied on sound policies at home rather than pointing toward mistakes of other countries.

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## I. The Present Situation and the Outlook

### 1. *Economic Development after the Crash: Has the Outlook Really Deteriorated?*

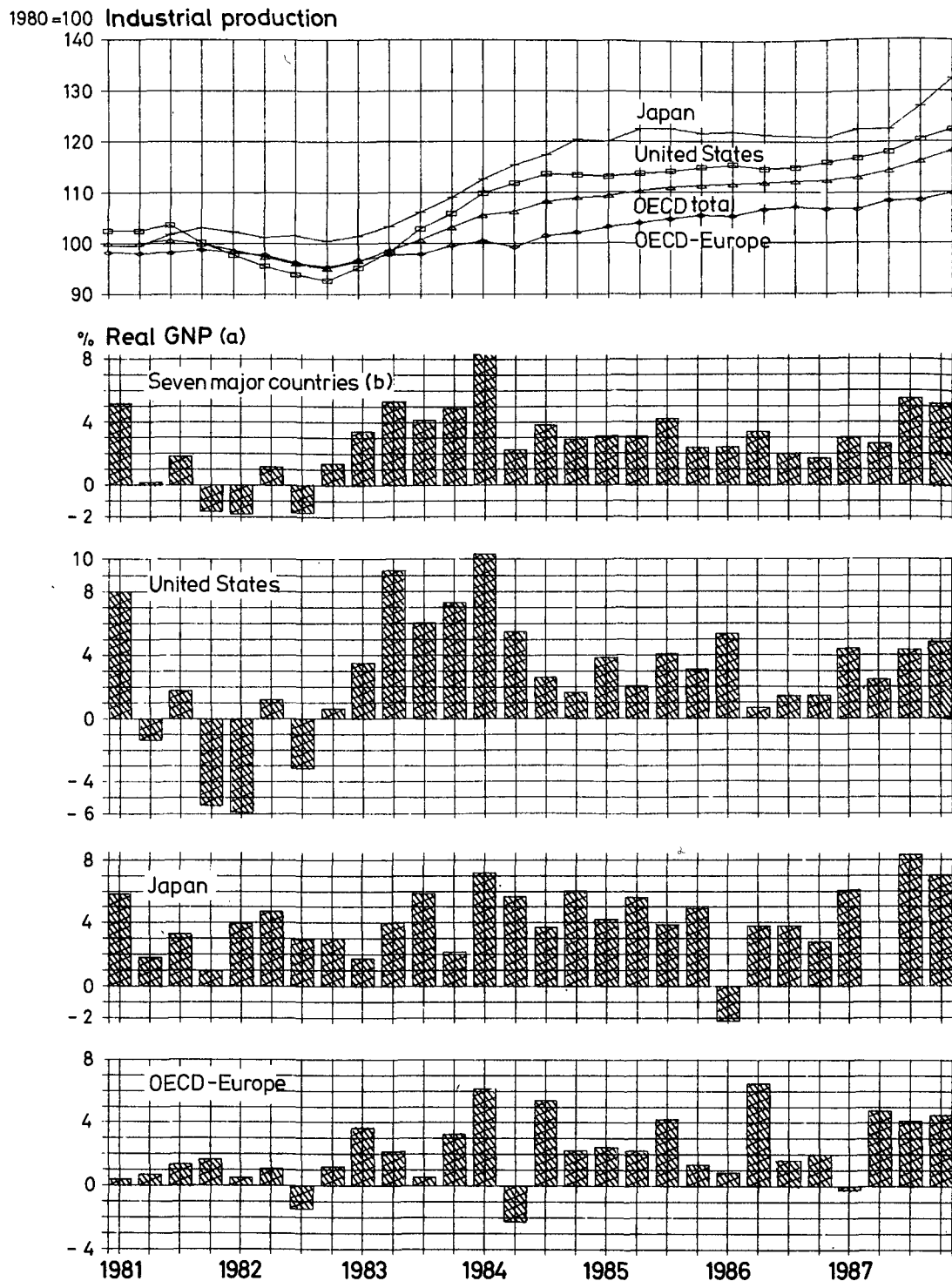
In spring 1988, it is obvious that the crash in the financial markets of October 1987 was not the beginning of the then widely-feared recession or even depression in the world economy. Industrial production has continued to expand (Graph 1), and overall demand has risen substantially. Above all, in contrast to the expectations of many observers, private consumption demand has not declined in the industrial countries. The United States are the only exception: private consumption and business investment decreased, and the expansion of domestic demand in the fourth quarter of 1987 was due to the increase of business inventories and to government purchases. Yet, the weakness was only partially affected by the crash. Both, consumption and investment behave very erratically from quarter to quarter. In addition, consumption started to decrease already in September, when car sales weakened after having been boosted by sales promotion actions in July and August. In recent months, private consumption has strengthened significantly. On the whole, the underlying upward tendency of economic activity seems to be basically unchanged in the industrial countries after the fall in stock prices. In 1987, gross national product (GNP) expanded in the industrial countries by 3 p.c., which is a bit more than in 1986 (2.7 p.c.). In Japan, the increase was almost 4 p.c., exceeding the expansion in 1986 by more than one percentage point (Table 1). In the United States and in Western Europe, GNP grew by 2.9 p.c. and 2.7 p.c. respectively, which are roughly the same increases as in 1986.

Table 1 - Real GNP and Domestic Demand in Industrial Countries, 1985, 1986, and 1987

	GNP			Domestic demand		
	1985	1986	1987	1985	1986	1987
United States	3.0	2.9	2.9	3.6	3.9	2.5
Japan	4.9	2.4	4.2	4.0	4.0	5.1
Western Europe	2.6	2.6	2.7	2.4	4.0	3.7

Source: OECD [b; c]; own estimates.

Graph 1 - Industrial Production and GNP in OECD-Countries, 1981-1987



(a) Percentage changes from previous period at annual rates. - (b) United States, Japan, Canada, West Germany, France, United Kingdom, Italy.

Source: OECD [b; c]; own estimates.

## *2. The Shifts between Domestic and External Demand Continue*

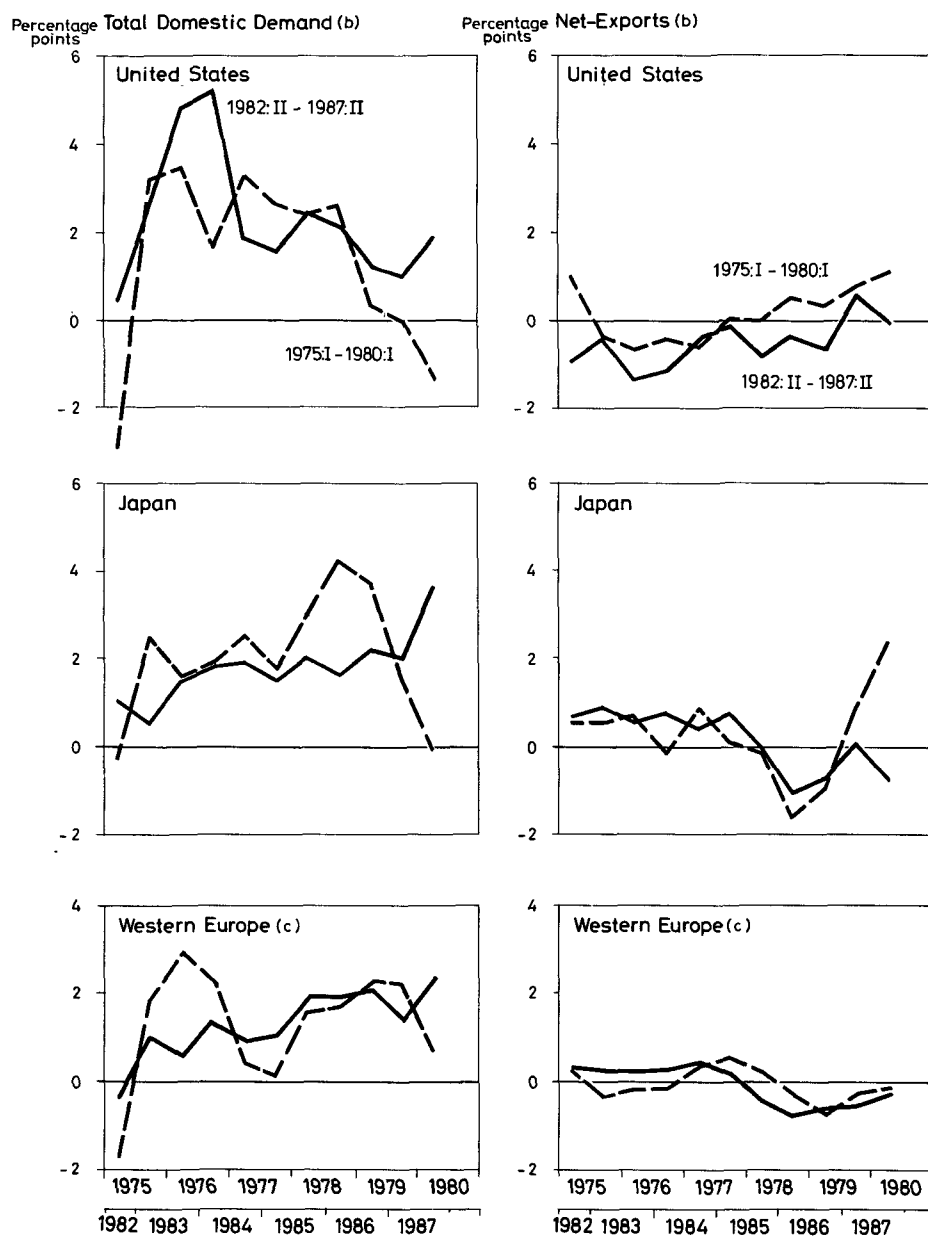
In the United States, the shift from domestic to external demand continued during 1987. Higher interest rates dampened the expansion of domestic demand, and, together with a lower exchange rate of the US dollar, they reduced the increase of imports. Private consumption rose by only half the increase which would be observed in 1986. Business investment that had been cut by 10 p.c. one year earlier expanded slightly as profit expectations improved because of the lower dollar and lower real wages. For the first time in the current upswing, exports grew substantially faster than imports. The reduction of the import surplus accounted for roughly half a percentage point of the expansion of GNP and thus made up for the lower increase of domestic demand.

In contrast to the United States, Western Europe and Japan's domestic demand was supporting the economic expansion in 1987, its increase exceeded GNP growth substantially. In both regions, the central banks conducted decisively expansionary monetary policies, and in Japan government expenditure programs also stimulated demand. While in Europe private consumption continued to increase at roughly the rate as in the previous year, in Japan it expanded significantly faster since the increase in employment and in real wages together with substantial tax cuts led to a more rapid rise of disposable income of private households. In Western Europe, it was mainly private consumption which supported the increase of production, whereas in Japan residential as well as nonresidential investment accelerated, partly because of improved profit expectations, partly because of lower interest rates and higher incomes.

Because of the strong domestic demand and the appreciation of their currencies, imports of the European countries and of Japan rose more rapidly than exports. For Japan and West Germany, a significant reduction of the current account surplus can be predicted; in a number of Western European countries (e.g., the United Kingdom, France and Italy), the current account is now in deficit.

In the United States and in Western Europe, as well as in Japan, the current upswing started with a recovery of domestic demand (Graph 2). In the course of the upswing, domestic demand in Japan and in Western Europe supported the expansion more and more, while in the United States, after peaking in 1984, its contribution to GNP growth declined. In contrast to widely accepted opinions, the

Graph 2 - Contribution of Domestic Demand and Net-Exports to GNP-Growth, 1975-1987 (a)



(a) Change in total domestic demand and net-exports in percent of previous period's real GNP. -  
 (b) Constant prices, seasonally adjusted. - (c) Second half 1987 estimated.

Source: OECD [c]; own estimates.

upswing in Japan and Western Europe was not due above all to strong export over import growth. Up to 1986, net exports never contributed more than one percentage point to GNP growth in Japan, and in Western Europe even barely more than half a percentage point. In 1986 and in 1987, net exports even dampened the increase of GNP. For the United States, the numbers seem to suggest that re-



ducing domestic absorption is inevitable for lowering the current account deficit. When total domestic demand rose rapidly in 1983, net exports immediately worsened, and they improved in the second half of 1984 and in 1985, when domestic absorption increased less. Also, in the following years, the changes in the expansion rate of internal demand are clearly reflected in the net-export performance of the United States.

The strong increases of domestic demand and of imports compared to exports in the initial years of the upswing in the United States did not contribute very strongly to the expansion in Japan and Western Europe; as the graph shows, net exports of Japan and Western Europe remained fairly stable. They turned from supporting GNP growth to dampening it when internal demand in Japan and the European countries tended to increase faster. Of course, the strong fall of the dollar since the beginning of 1985 may have strengthened these developments, but it seems not to have been decisive in this respect. The current upswing is supported by the same factors as the previous upswing.

All these observations suggest that GNP expansion in Japan and Western Europe will not be dampened if the United States want to cut their current account deficit through faster export and slower import expansion. In order to assure that the upswing continues, it is important, however, that they can maintain or speed up the increase of domestic demand by measures that improve the prospects for long-term growth. Given the experiences, this will also mean faster import than export growth, and rapid reductions of current account surpluses or, in a number of countries, increasing deficits. Most central banks and governments, however, tend to be mercantilist, preferring surpluses over deficits, as the present discussion and the experiences at the end of the 1970s exhibit. At that time, a number of central banks initially reduced money supply growth and raised interest rates not for fears of increasing inflation, but in order to stem against the reduction of the current account surplus.

### *3. The Forecasts: Are There Risks of Recession?*

Practically all available forecasts suggest that the recovery in Western Europe will continue. Compared to the predictions published in last October - i.e., the fore-

casts right before the crash - there is no significant downward revision. In several cases, the 1987 GNP growth was higher than forecast; obviously, the latter part of 1987 was a surprise to many observers. This is true for individual countries (Table 2), but also for the forecasts of world trade and GNP in the whole OECD area. Yet, most institutions still forecast slightly lower growth rates of GNP for this year than for 1987, and the deceleration is very pronounced for the United Kingdom and Spain, where the increase in GNP was exceptionally high. In recent months, we have generally been able to observe the tendency to revise the forecasts upward also for this year, because 1988 started surprisingly well in most countries. For example, in the recent joint economic report of the five leading institutes in West Germany a 2 p.c. increase of real GNP is forecast as opposed to 1.5 p.c. right after the crash.

Table 2 - Comparison of the Forecasts (a) for the Six Largest Economies in Western Europe

	Fall 1987				Spring 1988			
	real GNP		consumer prices		real GNP		consumer prices	
	1987	1988	1987	1988	1987	1988	1987	1988
West Germany	1.7	2.1	0.5	1.9	1.7	2.0	0.2	1.1
France	1.4	1.8	3.3	3.0	2.1	1.7	3.1	2.4
Italy	2.8	2.3	4.6	5.4	2.7	2.3	4.7	4.9
United Kingdom	3.3	2.6	3.6	4.2	4.7	3.0	3.2	4.5
Spain	4.3	3.8	5.3	4.0	5.2	4.0	5.3	4.0
Netherlands	1.8	1.0	-0.5	0.8	2.5	1.5	0	1.0
(a) Average of the forecasts for the respective countries by members of the A.I.E.C.E.								

There also seems to be more optimism with respect to inflation; i.e., many forecasts now point to lower inflation rates - in terms of the CPI - than half a year ago. This certainly has to do with the renewed weakness of oil prices: while in October, most institutes expected an increase in 1988, the outlook is now for a lower average of this year's oil prices.

The rather low inflation forecasts indicate, too, that cyclical tensions are not considered to be very likely in the course of 1988. The recovery will continue in its sixth year, but the growth rates are still quite low if compared to previous up-swings, especially for most countries in Western Europe, where the upward trend

of overall output became increasingly flatter since the early 1970s, and where unemployment is now more than twice as high as it was in the second half of the 1970s.

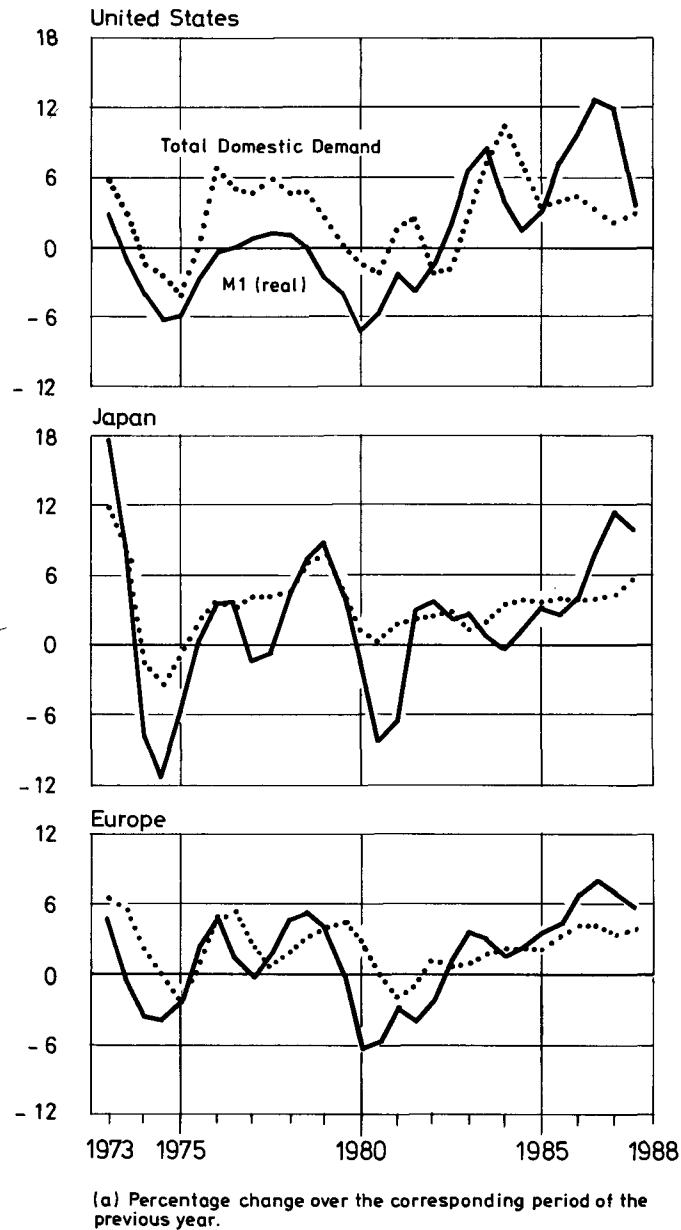
## II. Slow Growth Ahead: Is the Weakness Cyclical or Is It Supply-Determined?

In spring 1988, the conditions for a continuation of the upswing are viewed to be favorable. The following reasoning concerning economic policy and economic development in the industrial countries seems to be most plausible: demand is stimulated by expansionary monetary policies (Graph 3); and since January 1988, the exchange rate of the US dollar which had fallen after the crash in the stock markets has stabilized again. For the United States, it is important that exports will continue to rise much faster than imports reflecting the adjustment after the decline of the dollar. The acceleration of inflation, which most countries have experienced since the end of 1986 or in the course of 1987, slowed after the crash in the financial markets. As inflation rates are remaining low at present, monetary policies are likely to continue the expansionary course for the months to come. Therefore, the upswing will continue through 1988. Yet, while a recession is improbable in the remainder of the year because demand will continue to expand rapidly, there are no signs for a shift in economic policy, particularly in Europe, which could promise faster increases in potential output and therefore higher growth rates in the medium run.

### *1. Long-Term Development of Capacity, Output, and Employment*

While in the short run the change of GNP depends on the development of demand, the growth of potential output is determined by supply-side factors, as they become manifest in the increase of investment and the number of new jobs. In the industrial countries together, gross private nonresidential fixed capital formation which determines the growth of technical production capacities increased somewhat

Graph 3 - Money and Total Domestic Expenditures, 1973-1987 (a)



Source: OECD [b; c]; own estimates.

less in the years 1982-1987 than in the previous upswing (1975-1980). Between the regions, however, substantial differences exist (Table 3):

- In the United States, capital formation had grown by 35 p.c. in the years 1975-1980 and, hence, significantly faster than in the industrial countries on average; in the present upswing it grew by 22 p.c., which is below average.

Table 3 - Percentage Increase in Business Investment, Gross National Product, Employment, and Unemployment Rates in Industrial Countries, 1975-1980 and 1982-1987

	1975-1980	1982-1987
Business Investment (a)		
Industrial Countries	28	26
United States	35	22
Japan	28	46
Western Europe	20	20
Gross National Product		
Industrial Countries	18	18
United States	18	21
Japan	28	21
Western Europe	16	13
Employment		
Industrial Countries	6	6
United States	16	13
Japan	6	6
Western Europe	1	2
Unemployment Rate (b)		
Industrial Countries	5.2	7.8
United States	6.6	7.4
Japan	2.1	2.7
Western Europe	5.6	10.7
(a) Gross private nonresidential fixed capital formation. - (b) Standardized unemployment rate, OECD definition; average rates in the years 1976-1980 and 1983-1987.		

Source: OECD [c]; own calculations and estimates.

- In Western Europe, the increase was relatively low in both upswings compared to other regions; yet, there are important exceptions in the present upswing namely the United Kingdom, Spain, and Denmark.
- In Japan, capital formation attained the average increase of the industrial countries in the second half of the 1970s. In the present upswing, however, investment in Japan has outperformed that in the other countries by far.

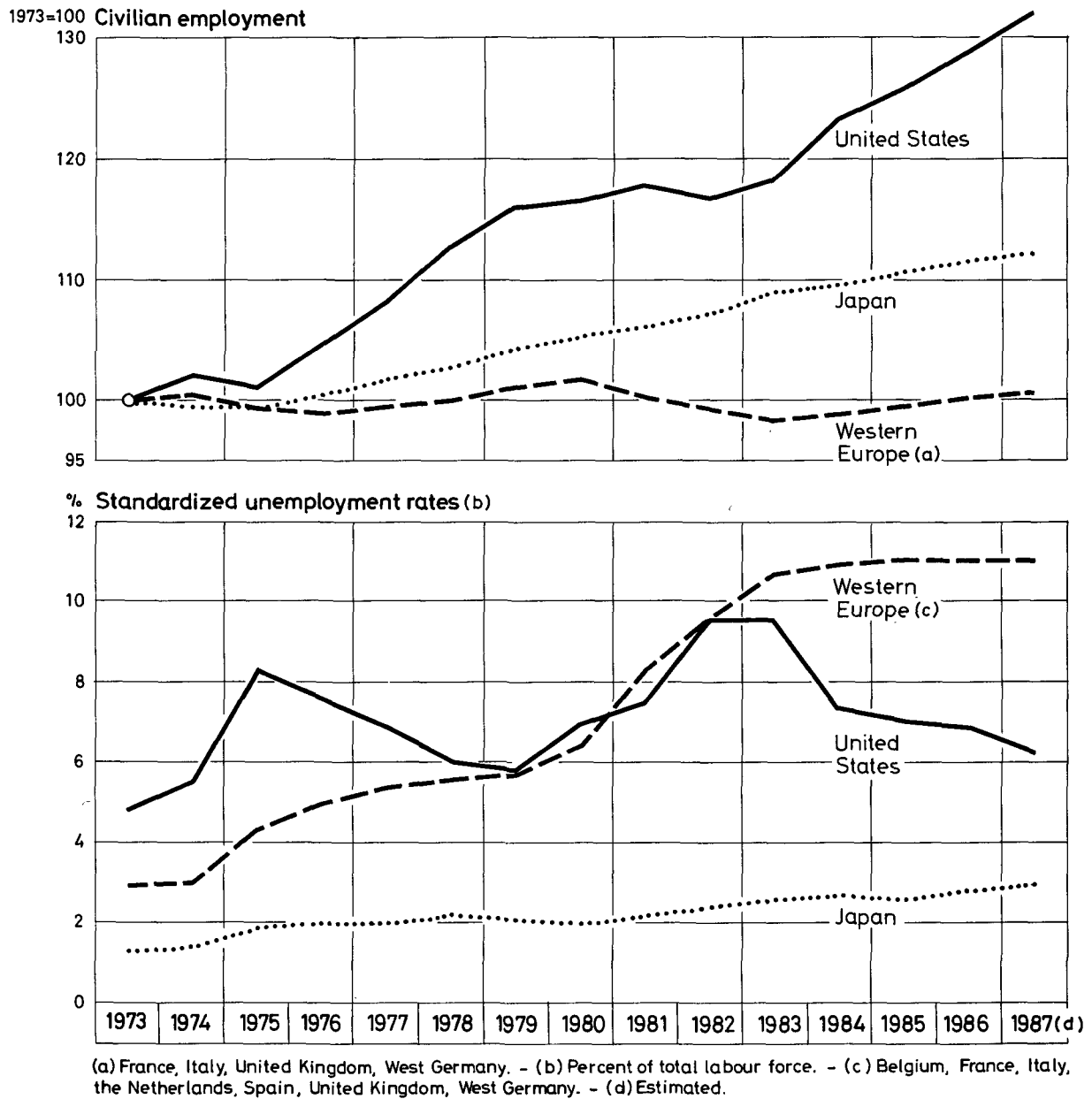
The numbers seem to suggest that the Japanese economy was the most dynamic with respect to the response to the challenges posed by competition from newly industrialized countries, new technologies, and other determinants of structural change in the world economy.

In this sense, the US economy presumably has performed worse than the other countries, as its investment record exhibits. Yet, despite similar low rates of capital formation, the US economy surpassed the Western European economies by far with respect to the increase in real GNP. The reason is that employment increased significantly faster than in Europe (Table 3). This enabled the US economy to expand the growth of potential output and of GNP beyond the rates of growth of technical capacities which are determined by capital formation. In addition, labor productivity grew markedly in the United States in the current upswing, one reason presumably being the increasing shortage of labor, whereas productivity had practically stagnated in the previous upswing. Since the beginning of the present upswing, employment has risen by 13 p.c., lately the unemployment rate was as low as it was in 1974. The labor-force participation rate has risen again (by 2 points to 66 p.c.) - mainly due to the higher participation of women - although less than in the second half of the 1970s, when the rate was only 61 p.c. at the beginning of the upswing.

The US example reveals that slow capital formation must neither mean unemployment nor restrict the growth of output; what is important is that the supply of labor is elastic. At the same time, it shows, however, that real labor costs must decrease, as they did in the United States, if high employment levels are to be achieved and if insufficient capital formation does not allow for a more rapid increase in labor productivity. In Western Europe, in the current upswing, investment grew by less than in the United States, and employment increased by only 2 p.c. (compared to 13 p.c.), and unemployment remained at levels exceeding those in the United States and in Japan by far (Table 3 and Graph 4).

In Japan, unemployment has rather steadily increased since the beginning of the 1970s and doubled up to 1987, as measured by the unemployment rate. Yet, neither in the recession of 1974/75 nor in that at the beginning of the 1980s did the unemployment rate rise as dramatically as it did in the other industrial countries, in particular in Western Europe. With roughly 2.8 p.c. at present, the unemployment rate is also significantly lower than the industrial countries' average of 8.2 p.c. or the Western European average of 11 p.c. Together with the high rates of capital formation, the observations suggest that Japan has been and presumably will be able to achieve rapid increases in potential output by making use of its financial and human resources.

Graph 4 - Employment and Unemployment in the United States, Japan, and Western Europe, 1973-1987



Source: OECD [a, December 1987]; own calculations and estimates.

## 2. Capacity Utilization: Have We Reached the Level of 1979/80?

Despite only moderate increases of production, business surveys for most European countries reveal that at present the degree of capacity utilization in manufacturing is as high as it had been at the 1979/80 peak. For the European Community (EC)

as a whole, surveys published by the Commission of the EC even show that the utilization rate has surpassed the rate at the turn of the decade (Table 4). Hence, bottlenecks to further production increases exist in many industries. Presumably, the degrees of capacity utilization are not only high in manufacturing, but come close to the 1979/80 levels in the European economies in general (see, e.g., the case for West Germany in Graph 5). Capital formation increased at the same low pace in the present and in the previous upswing (Table 3). The growth of output was slightly lower in the 1980s, yet labor productivity advances were lower in the 1980s than in the 1970s. Together with the poor employment record, this means that there is little scope for faster expansion. This can only be achieved if the growth rates of capacities and of employment can be substantially raised. There are idle labor resources which are not utilized because of too high labor costs, because of labor laws which prevent the dismissal of labor and, hence, its hiring, and because of numerous other barriers which hinder faster increases of employment (see also Section III.2 below). As improvements toward more flexibility in the labor market are hardly discernible, and as there are no signs for faster capital formation, the growth of potential output will remain low. Hence, what becomes manifest in slow GNP expansion and high unemployment is basically a medium-term problem on the supply side.

Table 4 - Capacity Utilization in Manufacturing Industry: Survey Results, 1973-1988 (rates in percent)

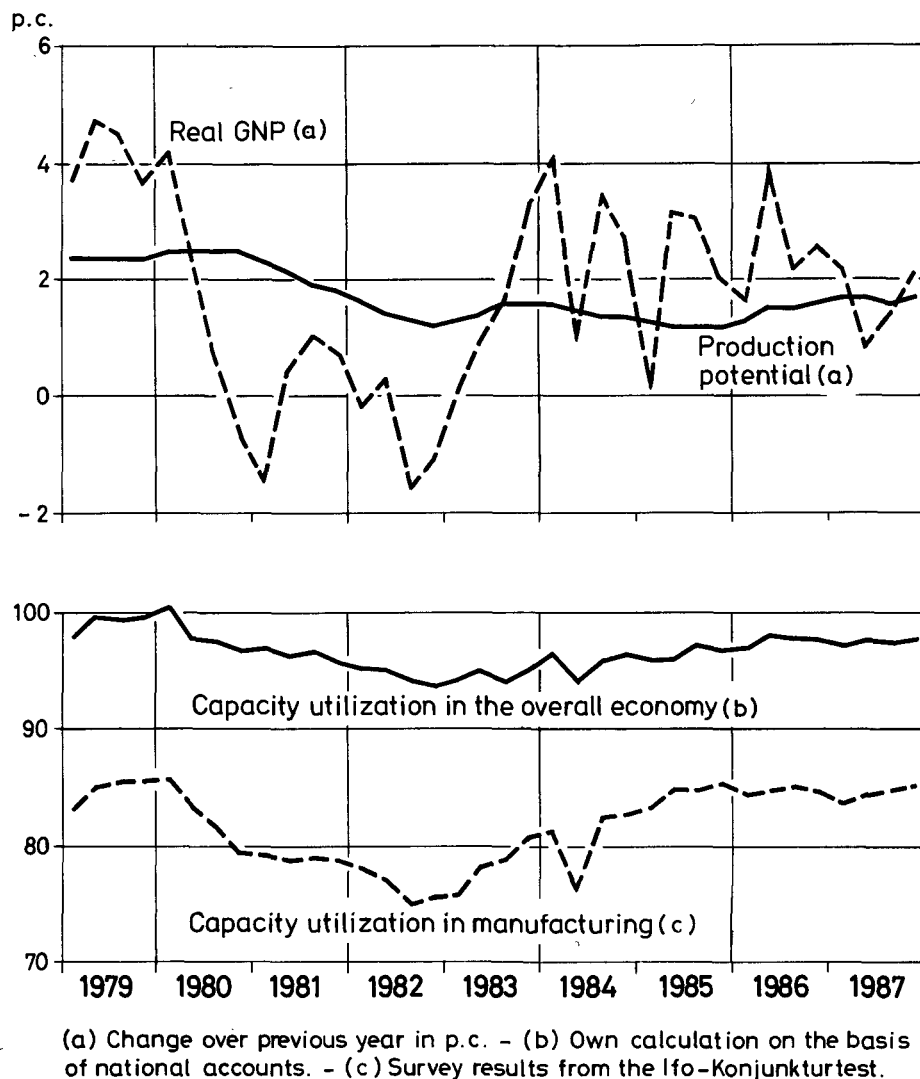
	Peak 1973	Trough 1975	Peak 1979/80	Trough 1982/83	1986	1987	January 1988
West Germany	88.1	74.8	86.0	75.3	84.7	83.5	84.1
France	87.8	76.6	85.3	81.1	83.3	83.5	85.0
Italy	78.8	68.0	77.3	69.1	75.2	76.7	77.6
United Kingdom	90.6	75.5	87.6	73.0	85.1	87.5	92.6
Netherlands	86.0	76.0	83.0	75.8	83.4	83.0	83.5
Belgium	85.4	70.4	79.1	74.4	79.4	77.9	78.5
Europe	86.4	75.0	83.9	76.4	82.2	82.5	84.2

Source: Commission of the European Communities [1988, p. 2].

In the United States, it will become increasingly difficult to raise the labor force participation rate further and to reduce unemployment. Hence, the growth of employment will be more and more limited by the demographically-determined supply of labor which expands at an annual rate of about 1.5 p.c. Therefore, bottlenecks



Graph 5 - Economic Activity in West Germany, 1979-1987



Source: Statistisches Bundesamt [var. issues]; Ifo-Institut [var. issues]; own calculations and estimates.

in the labor market may restrict future growth in the US economy to rates lower than in the average of the present upswing unless investment increases significantly faster than it has done hitherto, which would allow more productivity growth. In 1986 and 1987 taken together, business investment even stagnated. Yet, recently there have been some indications for more rapid capital formation. In contrast to Western Europe and the United States, capital formation in Japan has significantly accelerated in the 1980s as compared with the second half of the 1970s, although the country exported capital to the rest of the world, running a huge current account surplus.

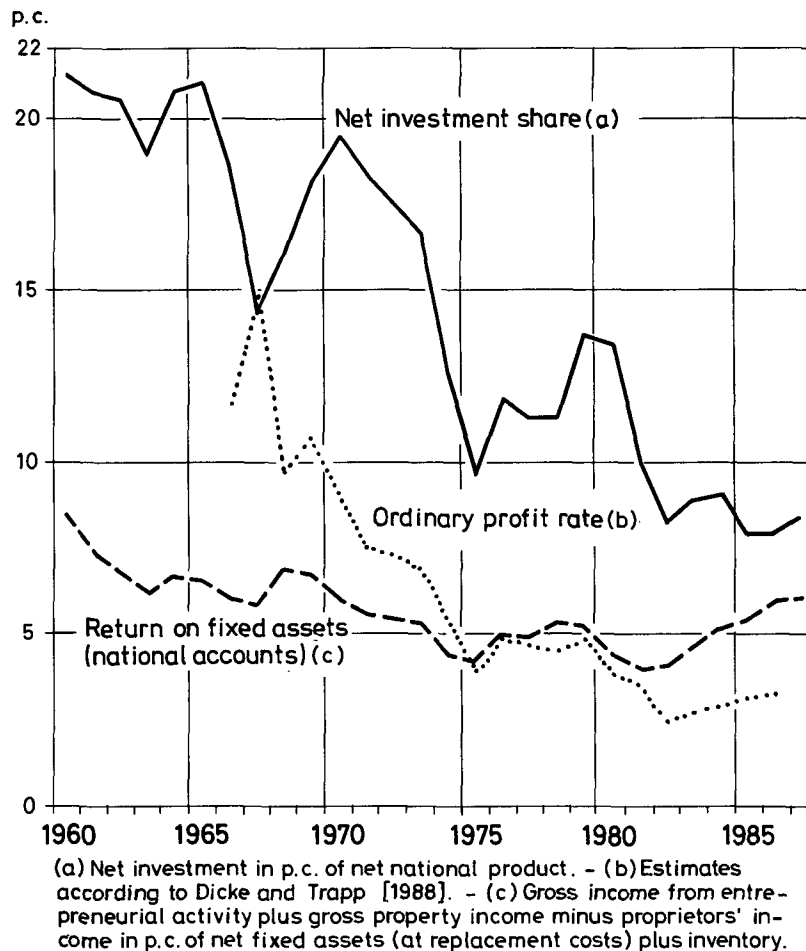
The assigned positive contribution from trade surpluses to GNP growth stems from a mechanical interpretation of national income accounts statistics as does the perception that deficits dampen growth. Running a trade deficit simply means that countries are able to absorb more resources than otherwise and that, by capital imports, domestic investment can increase faster than domestic saving. If the United States want to utilize less real and financial resources from abroad, Western Europe and Japan, which are important suppliers, should seize the opportunity of absorbing the resources instead and of raising the growth rate of their production capacities. At present, however, it seems that only Japan is prepared to meet the opportunities which are offered.

### *3. Investment Weakness: What Are the Reasons?*

Although business profits have improved noticeably in most European countries since 1983, investment spending has remained disappointingly sluggish and has hampered the increase of employment. Some observers have argued that the low propensity to invest is due to insufficient demand. However, as has been shown above, demand has recovered over recent years and overall capacity utilization in most countries is close to the peak levels of 1979/80.

Since profit opportunities provide the main incentive to invest in new capacities, it seems worthwhile to analyze what contributed to the improvement of profits in recent years. One observation is that while the profit shares (in GNP) have returned to the high levels prevailing in the early 1970s, the profit rates - total profits in relation to capital at replacement costs - have hardly increased or have even declined. This is partly due to the pronounced increase in capital output ratios in the 1970s. The most striking feature is, however, that revenues not earned by domestic production activity but by financial investment and direct investment abroad has increased strongly. The development of profits in West Germany gives an outstanding example of this trend [Dicke, Trapp, 1987]. Whereas profits earned by production activity (ordinary profits) accounted for two thirds of total profits in the sixties, they contributed only roughly a quarter in the mid-1980s (Graph 6). Profits earned in production have even declined in absolute terms whereas "neutral yields" (interest revenues and extraordinary revenues) have quadrupled and are now a main source of company income. This process started in

Graph 6 - Investment Activity and Return on Fixed Assets in West Germany, 1960-1987



Source: Statistisches Bundesamt [var. issues]; Deutsche Bundesbank [var. issues]; Dicke, Trapp [1987].

the early 1970s and has continued up to the first half of the 1980s. In 1982, the ordinary profit share attained a low point, but has increased somewhat since then. As cyclical factors have contributed to the turnaround, it is too early to judge whether the increase will be permanent.

The decline of ordinary profits is not in contradiction to the hausse at the stock exchange from 1983 to 1986. Share prices reflect the expected earnings capacity of companies as a whole and not only the profitability of domestic production. In fact, while there was a lasting and marked decline in the ordinary profit rate, the gross profit rate remained at a fairly high level. This indicates that companies, on average, have successfully invested in financial assets and in existing or new production capacities abroad. Thus, low ordinary profits should not be considered as

being a problem of individual companies but rather as a problem of the national economy as a whole. They reflect that West Germany as a production location has become less attractive to firms. The ratio between the ordinary profit rate and the real rate of return on financial assets which was clearly above unity in the 1960s and early 1970s, fell rapidly and was even below unity in the first half of the 1980s. This change in profitability has left its mark on the investment behavior of firms. The share of net fixed capital in total assets declined from 38 p.c. in the 1960s to 28 p.c. in the mid-1980s; the share of financial assets rose correspondingly. Similar trends in company earnings are reported for other European countries. These developments explain why net corporate investment was extremely subdued in recent years.

#### *4. Has Inflation Bottomed Out? The Limits to Demand Stimulation*

Since the short period of accelerated price increases in the first half of 1987, inflation rates in industrial countries have stabilized at relatively low levels. The absence of noticeable inflationary pressures at the beginning of the sixth year of the upswing has led to the conclusion that there is ample scope for additional demand stimulation. The fact, however, that inflation rates are still down does not mean that inflation is out. In the past, the lag in the effect of expansionary policies has been long and variable. In the course of the present upswing, the fall of the price of oil and of other raw materials, relatively low wage increases, and fierce competition have helped to extend the period of relatively low inflation. However, the increase in capacity utilization indicates that supply has not been expanded at the same rate as demand. Therefore, the danger that inflation will accelerate if monetary policy remains expansionary is not only a remote possibility but a very acute threat. It is true that in some countries financial deregulation has increased the demand for money. But a shift in the demand for money does not imply that the relation between money supply and price level is no longer existent and that a permanently high rate of monetary expansion will do no harm to price level stability. The pronounced increase of domestic demand in Germany, for example, shows that the economy responds in the traditional way to the acceleration of money supply growth. A continuation of the expansionary stance will probably add to the inflationary pressures which are already in the pipeline.

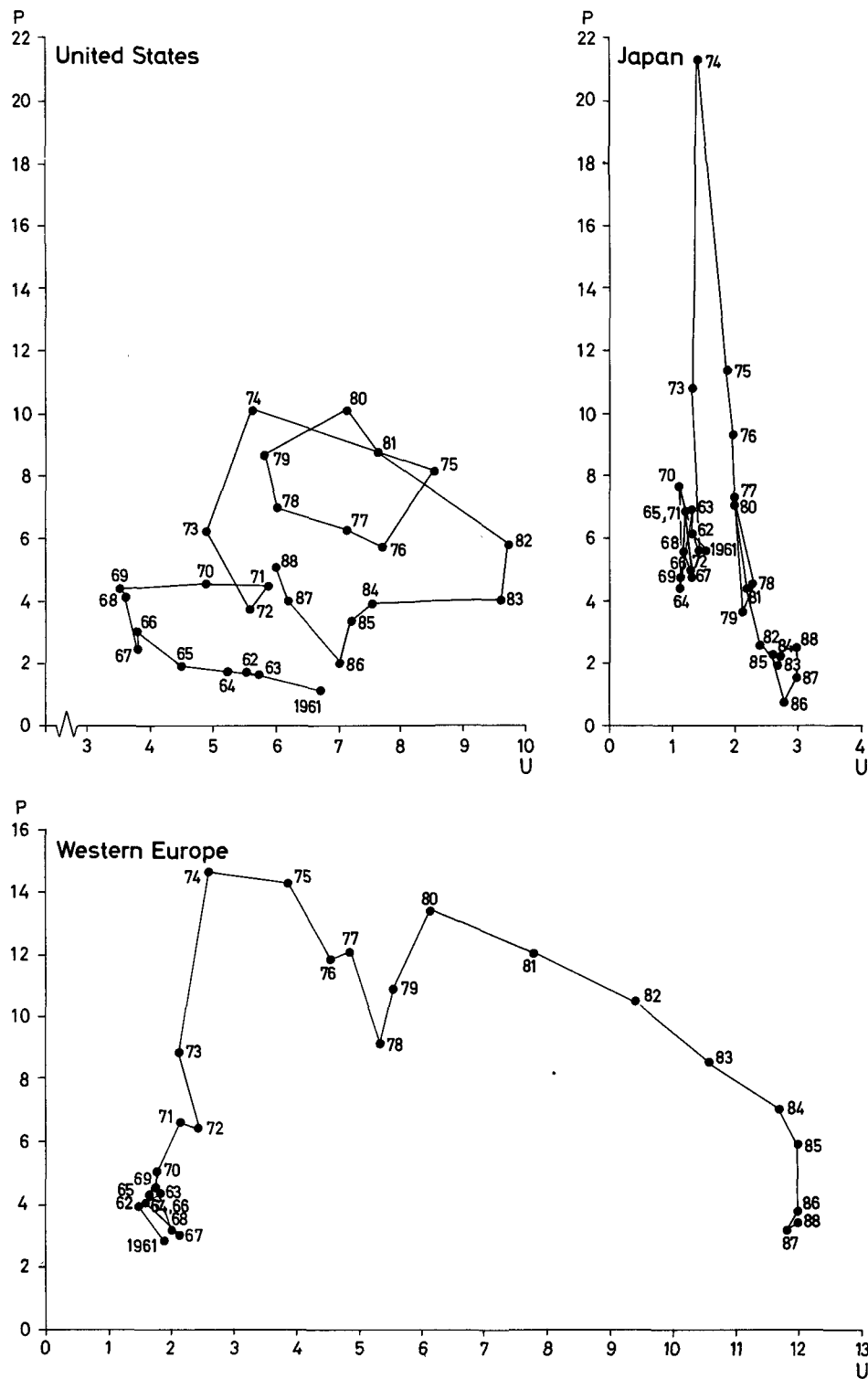
### III. No Hope for Lower Unemployment in Europe?

#### 1. *Phillips Curves in Industrial Countries: Where Do We Stand?*

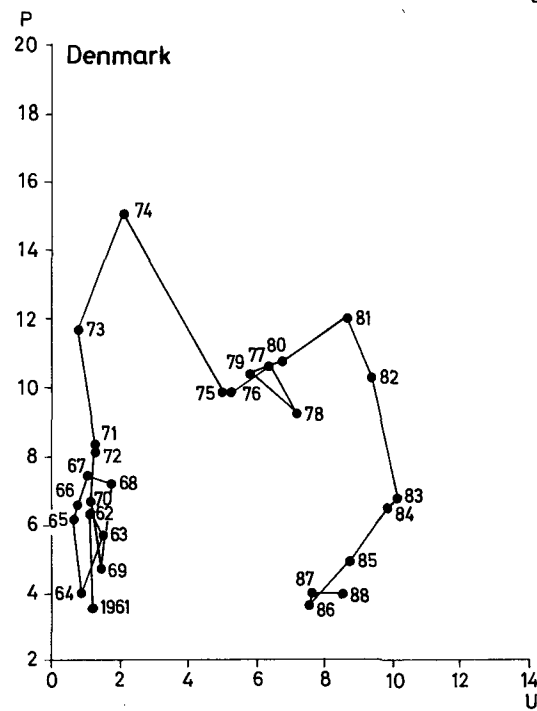
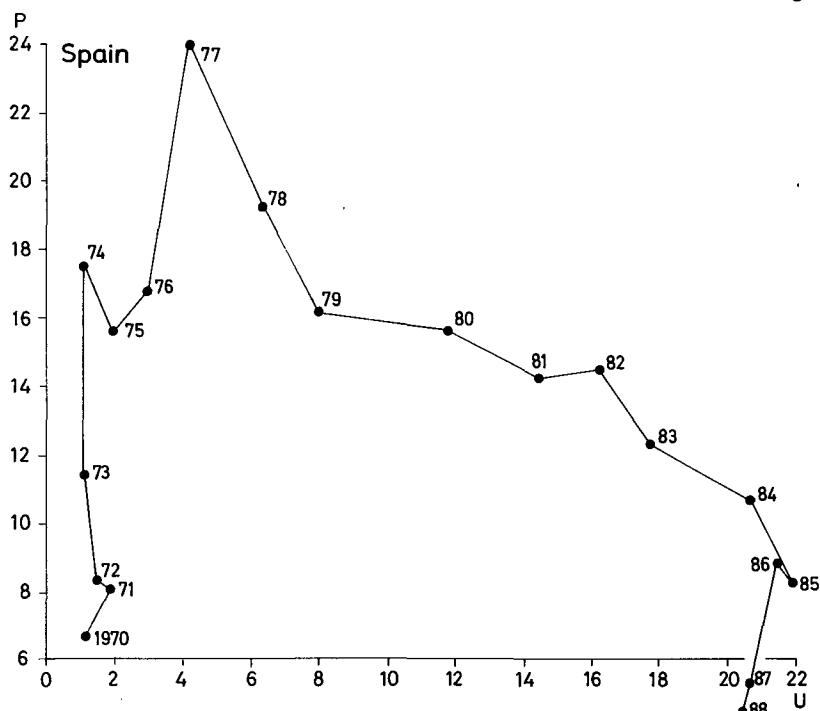
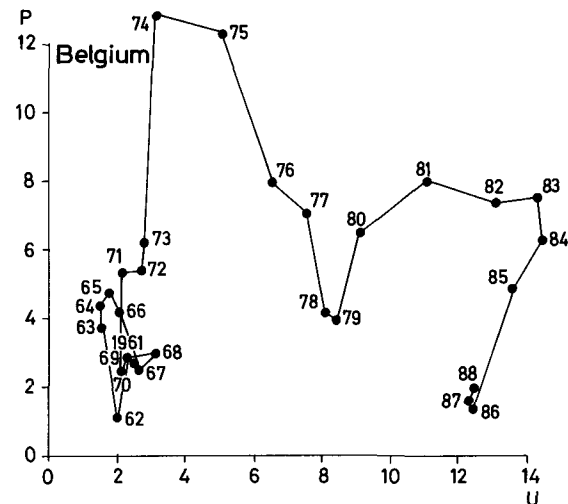
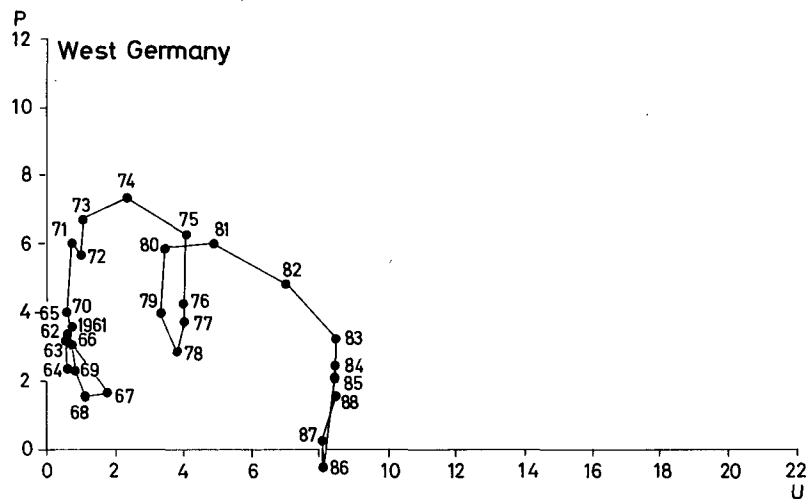
Some fundamental issues in the controversy about the appropriate monetary and fiscal policy can be illustrated in terms of the Phillips curve; in fact, this is another way of looking at the long-term problems mentioned in the previous chapter. Since we cannot observe the Phillips curve directly, we may use the actual combinations of unemployment and inflation as proxies for one curve or several curves valid for a (possibly limited) period of time. In none of the countries do we find the postulated negative relationship, at least not for the entire observation period (Graph 7). Instead, the long-run curve seems to be even positively sloped if we concentrate on the 1960s and 1970s alone, but there is no clear-cut movement along one curve. In some cases (the United States, West Germany, the United Kingdom) we can observe Phillips loops, i.e., there is no unidirectional relationship. The 1980s again seem to tell a different story: inflation has been cut drastically, unemployment has increased, and, at least in Western Europe, has remained high. This seems to validate the hypothesis of a negative slope of the Phillips curve for practically all European countries. The tradeoff is more favorable for low-inflation countries (West Germany, the Netherlands) than for - formerly - high inflation countries. But it can also be put the other way around: the costs of a one-percent reduction of inflation in terms of more unemployment were relatively high in West Germany and the Netherlands. The curve looks a lot different for the United States and Japan, where unemployment today is only slightly or not at all higher than it was ten years ago. In the United States, the recovery after 1982 has led to a substantial reduction of unemployment. In Western Europe, average unemployment increased from one cycle to the next.

Of course, we cannot know which Phillips curve is valid for the late 1980s. It seems that the curves have shifted over time, and they may move again. Those who propose more expansionary monetary and fiscal policies must identify substantial slack in the economies of Western Europe. For the sake of the discussion, let us take the example of West Germany, because this is usually *the* country singled out on an international level to stimulate demand. What could we expect if West Germany were to follow the proposals?

Graph 7 - Phillips Curve for Industrial Countries, 1961-1988



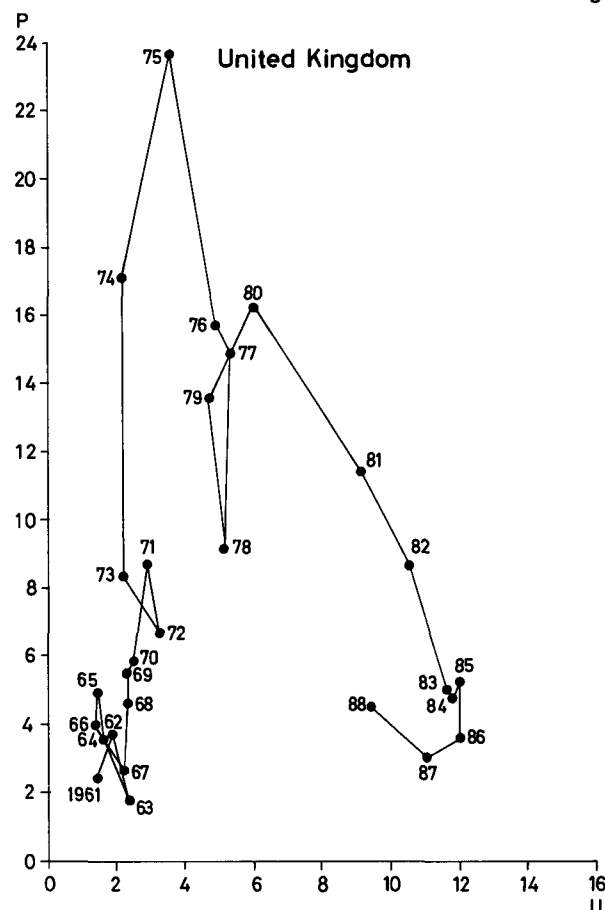
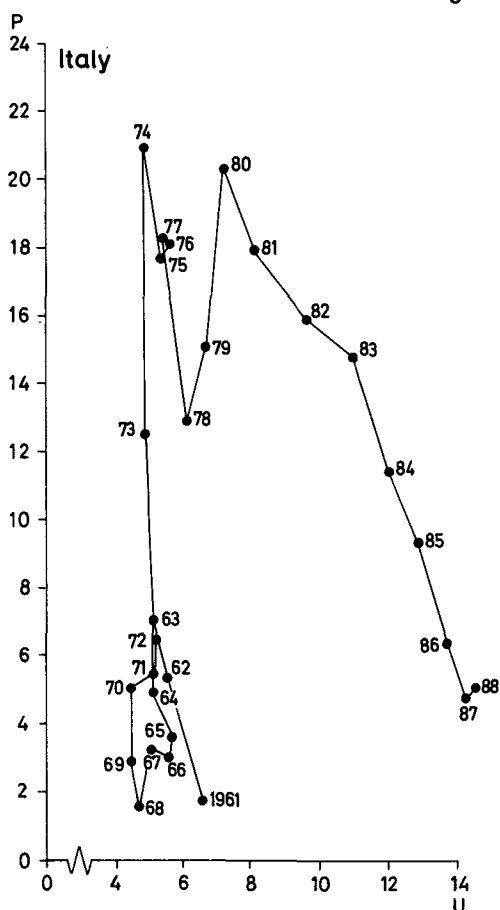
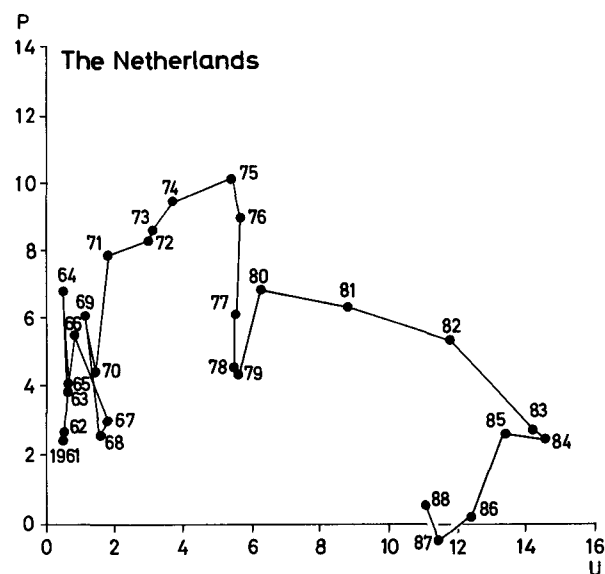
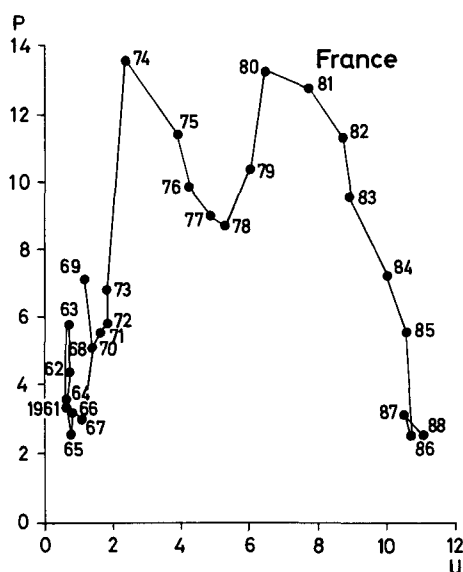
Note: P = inflation rate (deflator of private consumption); U = unemployment rate; 1988 estimated.



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Graph 7 continued

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Note: P = inflation rate (deflator of private consumption); U = unemployment rate; 1988 estimated.

Source: Commission of the European Communities [1987]; own calculations and estimates.



- Would we get a substantial reduction of unemployment?
- If so, would this reduction be accompanied by constant or rising inflation?
- Hence, could we expect a possible movement toward lower unemployment to be permanent?

These are hard questions, but they need answering because depending on the answer policy conclusions may be quite different. For example, if unemployment can be reduced without accelerating inflation (a flat Phillips curve with present unemployment rate well above the NAIRU), expansionary policies promise a free lunch. Nobody would deny that such a development would be in the self-interest of West Germany. If costs are involved in terms of higher inflation (negatively-sloped Phillips curve), one would have to discuss whether it would be worth it; to be sure, the case for expansion could still be made, but risks are involved. Above all, will unions and workers accept a permanent fall in real wages through inflation on which they do not agree when they negotiate about wage contracts? And will savers supply capital at lower real interest rates? It can, of course, be argued that, while we do not know how inflation will behave, the risk is well worth taking (1) because the alternative of "doing nothing" does not promise any improvement. But then, the third question becomes relevant: can we be sure that we really gain something in the long run, or will we just get a short-lived boost and end up with higher unemployment again and possibly higher inflation rates (positively-sloped Phillips curve)? We certainly do not know all the answers, but we can utilize the experience and use it to make our judgement. Four observations are important:

- (i) If we connect the observations of the early 1970s with those of the present, we seem to get a negatively-sloped curve. But this is misleading because we have moved only in *one* direction, namely toward higher unemployment. Thus, we do not have one episode in which unemployment actually declined markedly, or in which we moved along that (imaginary) curve in the other direction. It is by no means clear that the process can be reversed.
- (ii) It seems implausible that an economy can experience seven years of substantial slack, i.e., a permanent excess supply. Prices are certainly not that rigid in an open economy, and the Keynesian hypothesis of downward

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(1) Those holding the hypothesis of hysteresis or efficiency wages would argue that a strong demand stimulus is indeed a highly effective way because they assume that a substantial slack exists.

rigidity of wages cannot explain these observations, either, because we have had substantial - and even rising - *increases* of wages in recent years. Finally, the economies were not subject to successive negative demand shocks.

- (iii) Demand stimulation was tried in West Germany before. Starting in 1977, monetary and later also fiscal policy became extremely expansionary. What was achieved? The unemployment rate declined only slightly (by about half a percentage point), and the price which had to be paid in terms of higher inflation was substantial by historical standards. In fact, this experiment was the main cause for the recession in the early 1980s following the experiment of the locomotive strategy. This does not support the case for more expansion through demand policies.
- (iv) The observations rather reveal that the unemployment rate hovered around a certain level for many years. Up to the early 1970s, the average unemployment rate was around one percent. It increased to some four percent in the second half of the 1970s. Now, it has been around eight percent for six years, and all forecasts say that it will stay there in 1988 and even 1989. Similar movements can be observed in other European countries. From this we must conclude that something has happened to the natural rate of unemployment. Just as it was too optimistic in the late 1970s to expect that the unemployment rate could be reduced to one percent (1), it may be as unrealistic to conclude today that it just needs a demand stimulus to reduce unemployment to more acceptable levels.

If it is true that the natural rate of unemployment has increased, other measures than simple demand expansion are necessary - unemployment then is not a problem for fine-tuning. So the debate should focus on the question which measures are appropriate and necessary to achieve this objective. The following section deals with this discussion.

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(1) At that time, many observers were in fact talking about ample capacity to expand without any - or with only minor - danger for more inflation.

## *2. Regulations, Minimum Wages, and Unemployment Benefits: Causes for a Higher Natural Rate?*

Since 1970, conditions in labor markets have deteriorated markedly in most Western European countries. The first jump in unemployment rates took place after the oil-price hike of 1973/74 and in the subsequent recession in the world economy. Almost nowhere in Western Europe did unemployment return to pre-recession levels in the following recovery. Therefore, the level of unemployment was already high by any post-World War II standard, when the second oil-price hike occurred in 1979/80. As monetary policy aimed at bringing down inflation, joblessness rose once again to new heights. Thus, there was an upward-ratcheting of unemployment with the rate of unemployment rising from one cyclical recession to the next. The fact that unemployment remained high in upswing periods suggests that insufficient demand, while being the initial reason for the increase in unemployment, can hardly explain the persistence of high unemployment. When looking for the basic causes of the labor market problems, it is necessary to take into account wage policies as well as the development of nonwage employment costs. The latter include the costs created by the many labor market laws and regulations which have been tightened or newly implemented since the early 1970s. West Germany is a case in point (1).

- Since the early 1970s, the labor market situation in West Germany has deteriorated markedly. In 1986, total employment was about one million (4 p.c.) lower than in 1973. When the growth of the labor supply accelerated during the 1970s unemployment increased sharply. The unemployment rate rose from about 1 p.c. in the early 1970s to 9 p.c. in the mid-1980s.
- The West German labor market problems can be traced back to the change in the policy regime that took place in the late 1960s and was worked out during the 1970s. The political change in 1982 did not lead to a reversal of the legal and institutional setup that had been developed during the last two decades. After the late 1960s, the government moved toward more interventionist macroeconomic policies because there was widespread belief that a more active macroeconomic policy was necessary to maintain a high rate of growth and full employment; the

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(1) For an extensive discussion of this case see Soltwedel and Trapp [1987]; for an analysis for many industrialized countries see Emerson [1987].

market economy was considered to be inherently unstable. In addition, the federal government assumed responsibilities for industrial and regional developments. Furthermore, social reforms were implemented in order to achieve "social justice" and "social peace" which were regarded as a preconditions for political stability and for sustained economic growth. An outstanding element of the new policy regime was the unconditional "full employment guarantee" which the Federal Government declared at a time when the unemployment rate was below one percent.

- By taking over responsibility for full employment, the government increased collective moral hazard of both employers' associations and unions. These groups implicitly expected demand management as well as structural and social policies to take care of any labor market problem. The great number of programs to support growth and employment since the mid-1970s, the increase in subsidies, and the expansion of labor-market policies and of welfare benefits justified this assumption. Governmental interference enabled unions and employers to pursue collectivistic wage policies that ignored the need for lower real wage increases and for greater instead of smaller wage differentials in the economy.
- The readiness of the government to tackle or to relieve employment problems in combination with the monopolistic features of the wage bargaining system in West Germany led to a pronounced real wage rigidity. Thus, the adjustment to declining sales and prices is concentrated on employment, the creation of additional jobs through the establishment of new enterprises is hindered as these would have to pay the same (high) wages as the already existing companies, and the unemployed would not have the chance to find a job by accepting wages that are lower than the contract wages. Where outsiders are able to endanger the bilateral cartel on the labor market, the government steps in to provide protection against underbidding of insiders' wages by declaring the contracts also compulsory for nonpartisans. In those sectors of the economy where competition is particularly fierce, where employment decreases, where companies are small or are covered by collective agreements only to a relatively small degree - i.e., in sectors with a strong tendency to undercut the cartel's settlement - contractual wages and working conditions are extended to bind outsiders, too.
- Comprehensive social policy measures added substantially to the cost of labor. The share of fringe benefits in total labor costs increased from 43 p.c. in 1966 to more than 80 p.c. in 1984. In order to prevent companies from reducing employment "arbitrarily" and "unsocially", protection against dismissals was

intensified. In addition, labor law developed the idea of a "social property right" of employees in their current jobs. Any significant production change or reduction of employment would lead to costly social plans in order to reconcile technical progress with social targets. So it became increasingly expensive to change the firms workforce via dismissals or via restructuring production facilities.

- Contractual wages are minimum wages and welfare benefits draw the bottom line for lower wage groups. By marked increases in welfare benefits relative to earned income, the government has supported unions' efforts to push for above-average wage increases for unskilled workers. The reduction of wage differentials in combination with the legal and institutional setup of the labor market has imposed severe barriers to entry for marginal groups of the labor force. This has caused serious problems because the labor force was increasing. While government interventions helped to enforce contractual wages as minimum wages, thus preventing efficient underbidding by outsiders, labor market policies and early retirement schemes deliberately aimed at buying out labor at existing wages in order to reduce the supply of labor. In addition, rather generous income maintenance schemes have implied considerable individual moral hazard.
- Due to the increase in government activities, the share of public expenditures has risen from one third to almost half of GNP over the past twenty years. Income tax deductions and social security contributions have risen correspondingly. High marginal tax rates have provided incentives for outsiders not to try too hard at underbidding in order to find employment in the official sector of the economy but to escape into the shadow economy.
- The increase in employment costs and the distorted incentives to work and to invest resulted in a severe economic loss that is mirrored in the depressed yield on fixed productive assets. Firms switched from investments in productive capacities to financial investments and to direct investment abroad. The consequence was a sustained slowdown in the growth rate of the productive potential of the economy.

#### IV. Policy Options

##### *1. International Coordination of Policies: In What Fields?*

There seems to be a consensus (of opinion) that international coordination of macroeconomic policies is necessary to achieve national targets. It has been argued that coordination is as self-evident as "motherhood"; it does not need discussing. Apart from platitudes like "we are all sitting in one boat" or "we have to work as a team", is the case for coordination really irrefutable (1)?

What remains undisputed is, of course, that coordination is appropriate in areas of international public goods. Examples are the international legal order and the reduction of trade barriers. In these fields, the advantages are obvious. One may wonder, then, why coordination does not take place, for example, in the field of trade liberalization. The reason may be that - apart from strong influence of lobbyists - governments do not agree on how to distribute the benefits among the countries. Otherwise, it is difficult to imagine that the summiteers cannot act on something they all agree upon.

What about supply-side policy? For example, should the United States or the United Kingdom have asked other countries whether they can reduce marginal tax rates? Obviously, they did not, and nobody is complaining - not even those countries which are experiencing a competitive disadvantage and which are losing investment funds.

The present discussion is directed toward the coordination of monetary and fiscal policy. Some critics argue that the case for coordination is not as obvious as it is usually stated:

- The game-theoretic approach rests on the ignorance on the part of policymakers: they do not know what foreign governments do and also do not consider the effects of their own measures on the actions abroad. This behavior leads to the (unsatisfactory) Nash equilibrium. It must be doubted, however, that politicians really behave that way: do international organizations, conferences, summit

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(1) For a discussion, see Scheide and Sinn [1987].

meetings, and so on not have the purpose of exchanging information?

- The game-theoretic approach leaves out one important player, namely the private sector. If private agents realize that a cartel is changing policy rules and is acting against their own interests, they will adjust their expectations. For example, if a cartel of central banks is established and this fact leads to expectations of higher inflation, coordination is counterproductive ("Rogoff paradox") [Rogoff, 1985].
- All empirical analyses rest on models that focus on the short run. However, the objective functions of the consumers probably do not have that time-horizon. In the longer run, the beneficial effects of coordinated measures - as calculated by econometric models - may be reversed, as even proponents of coordination concede. Therefore, the recommendations given on the basis of short-run models (e.g., in the case of overshooting exchange rates or with respect to the movement along a Phillips curve) are not persuasive anymore.
- Policymakers who often use different models do not know the true model. Thus, even if they have the best intentions, they agree on a coordination package that may not deliver the expected results. Therefore, coordination can be counterproductive on these grounds as well [Frankel, Rockett, 1986].
- The case for coordination is made because policy instruments are assumed to be scarce relative to the number of policy targets. The set of targets normally considered includes external targets such as the current account and the exchange rate. Although changes in both these variables always affect more than one country, coordination is not necessary in this area: exchange rates and current account balances are the result of market processes, they therefore should not be targets for government policies. After all, we cannot know whether deficits or surpluses are too high or too low; the same applies to exchange rates.

Apart from all this, what is the experience with respect to coordinated policies? The locomotive experiment of the late 1970s, usually cited by proponents as *the* example of good coordination, failed on grand scale. The failure of the Louvre accord (of February 1987) was due to the fact that policymakers cannot know the true value of exchange rates and do not know the true model - in this case, they could not predict what course of monetary policy would be necessary in the countries involved to keep the exchange rate on the level they had agreed on before.

## *2. Fiscal Policy: Competition in Tax Policies*

Over the last twenty years, the - mostly unsuccessful - attempts to stabilize output and employment by means of fiscal policy went along with a strong increase in the public sector's share in total economic spending. On the one hand, the increase in public sector demand relative to private demand has strengthened the call for more government responsibility in managing overall demand and for more coordination of demand management policies. On the other hand, tax evasion and the growth of the underground economy have made it increasingly clear that the financing of a larger government share, namely higher marginal tax rates, has noticeably reduced the incentives to work and to invest. On a national basis, the dampening effects on production and investment have been reinforced by the increase in capital mobility since the late 1960s.

The recognition that taxation, among other factors, is a crucial variable determining a country's attractiveness as a location of production has revived competition in tax policies. In this respect, the United States took the lead in reducing income taxes and other countries followed suit. The measures ranged from a pure reduction of tax rates, a shift of the tax burden from direct to indirect taxes to the elimination of tax loopholes combined with a reduction of tax rates. Competition between national tax systems is the best way to search for the most effective tax system in terms of achieving a high rate of economic growth and full employment. Less successful countries can imitate the more successful ones and thus catch up. At the same time, national economies are free to determine the amount of public goods they want to produce and to fix the overall level of taxation accordingly. The more successful a policy is in reviving economic growth, the more scope there is for curtailing public expenditures and thus reducing the public sector's share in economic activity.

## *3. What Targets for Monetary Policy?*

Monetary targeting has gone out of fashion. In some countries, it has practically been officially dismissed (the United States); in other countries, monetary policy has successively failed to meet the pre-announced targets (West Germany). In



part, the monetary authorities claimed that certain relationships had broken down which before were reliable and could be used to gear monetary policy. This is particularly the case in the United States and also in the United Kingdom, where new definitions appeared and where the changes in the financial system have affected the reliability of some aggregates. However, from this it should not be concluded that monetary targeting is altogether useless. In most European countries, where these changes have not occurred, the relationships still hold. It has to be remembered that the correlation between money and various income variables have always been loose and not mechanistic. In Japan and West Germany, to name but two examples, monetary expansion has been higher than announced, not because of institutional or other aberrations but because of changes in the priorities of policy: exchange rate targeting has - at least for some time - replaced domestic orientation. In the United States, monetary policy seems to shift between sustaining the recovery on the one hand and reducing the external deficit on the other. To achieve this, the Fed sees its task in keeping interest rates low but not too low which would increase inflationary expectations. This is not a viable strategy.

All this reveals the uncertainty with respect to the problems of how monetary impulses should be measured and what monetary policy should be directed at. It also explains the search for new targets or indicators for monetary policy. Are the new indicators suggested really good alternatives?

- The stability of an index of *commodity prices* is not a sensible target for monetary policy, because it simply represents a subindex of more relevant price indices. Why should the stability of commodity prices mean higher welfare? What is important in a welfare sense is the stability of the purchasing power of money. Also, the relationship between monetary aggregates and commodity prices is certainly less precise than that between money and income. One of the reasons is that commodity prices seem to be more sensitive to supply conditions. To give an example: do the proponents of this strategy really want to tighten monetary policy when there is a harvest failure?
- *Interest rates* are very poor indicators for monetary policy because one cannot decide whether they are too high or too low by simply looking at them. The relationship between interest rates and income is loose in the short run; in the long run, they are positively correlated which means that a policy of lowering interest rates by liquidity measures cannot produce the desired results with respect to real income or similar target variables. Furthermore, real interest

rates can neither be observed nor be controlled by monetary policy. Approximations are, of course, possible, but the analysis of real rates must take into account real factors and not only money. For example, if interest rates are considered too high today, the conclusion does not have to be that monetary policy is too tight. Real rates of return on tangible assets may have risen elsewhere in the world and, due to the presence of capital mobility, there is no way of isolating the domestic capital market from this. Finally, interest rates themselves reflect expectations concerning future monetary policies: if interest rates rise because economic agents expect more expansionary monetary policies, actions to reduce interest rates will be counterproductive not only with respect to interest rates; they will also lead to more inflation.

- The same shortcomings apply to *exchange rates*. A judgement about the price for foreign exchange as being too high or too low requires knowledge about the underlying equilibrium rate. No model on exchange rates can deliver this. If market conditions are such that, for example, the D mark or yen appreciate vis-à-vis the US dollar, there is no indication for the West German or the Japanese authorities to loosen monetary policy. Such an orientation has prevented isolation from inflationary policies abroad in the early and the late 1970s. At that time, the US dollar depreciated because of inflationary policies in the United States, and interventions by other central banks helped to spread inflation internationally. Finally, if exchange rates are also determined by real factors, monetary policy cannot compensate for them.

Thus, these new suggestions do not promise to be good alternatives for monetary targeting. Monetary policy may have to be redefined in several countries. Firstly, monetary authorities should use an indicator which they can control; in many cases, this would be an aggregate which is equivalent to the monetary base. The broadly defined money stock (M3) the Deutsche Bundesbank has recently chosen as a target is not appropriate for various reasons (1). Secondly, monetary targeting does not mean that the target variable is fixed forever; in the case of deviation, however, a monetary rule should enforce that the central bank reacts to contingencies in a pre-announced fashion. Studies for the United States, the country with the supposedly greatest uncertainty as regards to monetary aggregates, have shown that a well-formulated rule would have substantially reduced cyclical fluctuations and also would have delivered price level stability in

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(1) For a discussion, see Institut für Weltwirtschaft [1988, pp. 39 ff.].

the medium run [McCallum, 1987]. This is more than an activist, discretionary policy could achieve. The important element is precommitment on the part of the central bank. Monetary policy should not shift priorities all the time or try to maximize welfare on a period-by-period basis; instead, only precommitment can guarantee policies with optimal outcomes in the medium run.

#### *4. Exchange Market Intervention: More or Less Stability?*

In the past three years, we have experienced strong interventions in exchange markets. In part, these interventions have taken the form of "talking the dollar down" and other elements of verbal attacks ("Baker-thy-neighbor policy"). But there was also a substantial amount of buying and selling foreign exchange, in particular after the Louvre accord of February 1987. Apart from these direct interventions, monetary policy was to a large extent outward-oriented: at first, the United States drove the dollar down by monetary overexpansion, and then tightened in order to prevent a further fall. In Japan and West Germany, but also in other countries, monetary expansion has been high because the authorities did not want the dollar to become too weak. International coordination took the form of more or less explicit target zones for exchange rates.

Even proponents of the target-zone concept argue today that it would not be good to try to fix exchange rates between major nations at present levels. According to their arguments, the rates do not come close to their equilibrium levels. In particular, current account balances or, for that matter, the balances of the capital accounts are not sustainable: they do not reflect the decisions of investors that are warranted by long-run considerations. Surplus countries in East Asia and also Japan and West Germany "save too much", the United States "borrow too much".

While the proponents' view is supported by recent developments, especially the massive central bank interventions of over US \$100 billion, target zones do not promise to be an improvement even "at normal times". Over the past fifteen years, we have been able to observe sizeable fluctuations of real exchange rates. These changes have amounted to fifty percent or more between major currencies over an extended period of time. Furthermore, current account balances have also reached large values. One could, of course, argue that these facts demonstrate that the

markets do not work properly, because exchange rates - for an extended period of time - move away from "fundamentals". However, if we take the view that agents who risk their own money do not behave permanently in an irrational manner, we have to conclude that we do not have a model that can fully - in a quantitative sense - account for the actual changes or even the fundamentals. What we do know is that market participants react to news or shocks, and the best way therefore to achieve more exchange rate stability is to avoid shocks, i.e., to ensure medium-term orientation of national policies. Exchange rate stability is not necessarily a desirable goal for its own sake, but it may well be a by-product of stable economic policies. Blaming exchange markets for producing irritations is misleading; instability is a symptom, not a cause of the problems.

There is also an inconsistency involved in the policies of intervention: on the one hand, many countries complain about the high external deficit of the United States or its slow reduction, on the other hand, they prevent one of the possible adjustment mechanisms by keeping the Dollar high through their policies.

##### *5. The EMS: Do All Countries Benefit?*

The EMS was established to enforce coordination among member countries. In particular, the target was to reduce inflation rates in all countries, and to achieve a convergence of inflation rates. Both targets have been achieved, although obviously not through the policy of coordination itself; OECD countries outside the EMS were as successful or even more so, even the uncoordinated countries in Western Europe. It is widely stated that the EMS was a means by which price level stabilization could be "forced" on countries with a relatively strong "inflation mentality"; the argument goes that those countries needed the imposition of discipline by the leader in that system in order to be able to sell the anti-inflationary policy at home.

Now that the EMS has fulfilled this task, criticism - within the system - of a new sort has emerged. Firstly, unemployment is now the most pressing problem. Therefore, West Germany should pursue a more expansionary policy. Other countries could not take the lead because they would have to fear devaluation. Secondly, the fall of the US dollar has led to a sharp revaluation of the European currencies.

While this may be warranted for the D mark because it is a relative close substitute with respect to the US currency, it is not the case for other currencies. Therefore, West Germany should - according to this view - reflate *and* revalue. Thirdly, West Germany has built up a substantial - and growing - surplus vis-à-vis most countries in the EC; in 1987, it amounted to some DM60 billion which is almost twice the surplus achieved in 1985. Often, German policymakers are openly reproached of pursuing a beggar-thy-neighbor policy.

What should be done? Nobody can know whether the EMS currencies are strongly over or undervalued. The only way to find out would be to let the exchange rates find their appropriate levels. If the member countries do not agree on such a solution, every country which feels that its currency has the wrong value is free to change it. It is remarkable how strongly countries have resisted realignments within the EMS that would just have equalled the inflation differentials, i.e., the necessary devaluations would not have had an inflationary impact. However, there obviously was competition in revaluing the currencies in real terms in order to import price level stability. The dissatisfaction of some members of the EMS reveals that cartels can obviously not deliver a combination of goods which is inconsistent in itself, i.e., a fair price *and* a fair share for each member.

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