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LACK OF ECONOMIC GROWTH AND UNEMPLOYMENT:

THE COST OF NON-COOPERATION

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Executive summary

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Notre Europe

Notre Europe is an independent research and policy unit whose objective is the study of Europe – its history and civilisations, integration process and future prospects. The association was founded by Jacques Delors in the autumn of 1996. It has a small team of in-house researchers from various countries.

Notre Europe participates in public debate in two ways. First, publishing internal research papers and second, collaborating with outside researchers and academics to contribute to the debate on European issues. These documents are made available to a limited number of decision-makers, politicians, socio-economists, academics and diplomats in the various EU Member States, but are systematically put on our website.

The association also organises meetings, conferences and seminars in association with other institutions or partners. Proceedings are written in order to disseminate the main arguments raised during the event.

FOREWORD

In pursuit of our goal to take part in debates over the future of Europe, Notre Europe is publishing a series of collaborative studies that reflect our views under the title *Problématiques européennes (European Dilemmas).*

Our aim, however, is to work with academic and research communities within the framework of conférences (*) or by commissioning papers from experts reflecting their personal views.

The first such paper has been commissioned from Pierre-Alain Muet, Professor at the Ecole Polytechnique and Director of the Econometrics Department of the Observatoire Français des Conjonctures Economiques (OFCE). It concerns one of the fundamental questions facing us: how best to stimulate long lasting economic development and job creation in Europe?

In this respect, a look at the recent past is prerequisite for, as the author demonstrates, from 1992 onwards, higher economic growth and employment could have been possible, had there been any real coordination of national economic policies.

This paper represents one of the best introductions to the research activities and agenda that «Notre Europe» is developing to promote a balanced approach towards Economic and Monetary Union, an approach which corresponds to both the letter and spirit of the Maastricht Treaty.

Jacques Delors

(*) Two conferences will be organised this year:

- one in Brussels, May 29, 1997 in cooperation with the daily newspapers, «Libre Belgique» and «De Morgen» on economic convergence and employment under Economic and Monetary Union.
- another in Luxembourg, September 11, 1997 in cooperation with the Institute for International Studies of Luxembourg on the social model and industrial relations in Europe.

SUMMARY

Twenty years after the first oil crisis, the European Union (EU) has become a zone of mass unemployment compared to the United States and Japan which have not experienced prolonged periods of high unemployment. Why has this happened? Traditional economic theory treats labour market rigidities as the major cause of unemployment and regards as marginal, the Jack of economic growth that results from non-coordination of economic policies.

The aim of this paper is to show that lack of economic growth is, on the contrary, the major source of unemployment in Europe and that slow economic growth is caused by the widening gap between European economic integration and European political integration.

Labour market rigidities and structural factors?

European unemployment has all the characteristics of so-called structural unemployment: not only does it mainly affect young people, women and unskilled labour but more than half of the unemployed have been out of work for over a year. Nevertheless, these structural factors, so often mentioned to explain European unemployment, do not adequately account for the extent of the phenomenon.

Competition from countries with lower labour colts has played only a minor role in the rise of unemployment: it represents roughly O.5-1.0 percentage point of unemployment. Furthermore, whereas intra-European trade has expanded substantially in the post thirty years, Europe's trade with the rest of the world has hardly increased and so, today, Europe remains far less open than the United States. What characterises European countries is not the globalisation of their economies, but their «Europeanisation». That means that the causes of unemployment are to be found within the confines of Europe and not in its relations with the rest of the world.

7here is little evidence that the level or structure of fiscal and social security contributions has any influence on long term equilibrium unemployment. In Denmark for the part ten years, social security colts have been paid out of VAT taxes, yet unemployment there remains just as high as in France where the bulk of social charges are borne by employers. By

contrast, unemployment has been relatively low in Sweden (right up to the recession of the post three years) despite a record high level of mandatory social security contributions. Nor is there any obvious correlation between unemployment amongst unskilled workers and the existence of a minimum wage. For example, in the United Kingdom where there is no minimum wage fixed by law, it was just as hard for unskilled workers to find a job when unemployment was high as in France where the minimum wage is relatively high.

Structural unemployment: a case of prolonged cyclical unemployment?

Economists traditionally draw a distinction between cyclical unemployment and structural unemployment or equilibrium unemployment. According to this approach, macroeconomic policies could have an influence on the cyclical component of unemployment but any reduction in structural unemployment would essentially be the result of an improvement in labour market flexibility. There could, however, be a radically different role for economic policy if the mechanisms for economic adjustment work so slowly that an economic downturn leaves long lasting effects. Then, the economy gradually adapts to a situation of high unemployment but market forces no longer act to restore the economy to the previous level of unemployment. In other words, structural unemployment is the result of prolonged cyclical unemployment (the hysteresis effect).

The estimate of equilibrium unemployment for the EU as a whole presented in this study shows that hysteresis has perpetuated unemployment over the part ten years even though the structural elements that cause equilibrium unemployment to rise have progressively been reversed. This leads to a twofold conclusion. The main reason why European countries have _failed to reduce unemployment is that they have abandoned expansionary policies. Second, any long-lasting expansionary policy aimed at gradually reducing the unemployment rate would wipe out both cyclical unemployment and an important part of structural unemployment. Such a policy would allow EU countries to bring the unemployment rate back down to 5-7 percent without adding to inflation.

Lack of growth and lack of ***political will***

Europe's weakness has less to do with the rigidity of labour markets or its capacity Io *face international competition than with its incapacity to stimulate growth within an economic* *space relatively free of national boundaries. Why was the United States able, by contrast to Europe, to return to* full *employment after the last two recessions? Because it kept the economy expanding at a rate far higher than its potential growth during recovery periods. However, this remarkable performance was the result of massive fiscal reflation during the 1980s and strong monetary expansion from 1992 to 1993. By contrast, European countries have virtually given up on expansionary policies since the beginning of the 1980s.*

Europe's inability to implement reflationary policies is characteristic of a group of politically independent nations that are nevertheless profoundly interdependent. The integration of commercial and capital markets has not made economic policies ineffective but it has highlighted the asymetry between different policies. Given the Jack of coordination, there has been too great an emphasis on supply-side policies aimed at improving flexibility and cost competitiveness, (which become all the more effective as they are implemented on a national scale). There is, however, far too little emphasis on policies designed to revive demand or on supply-side policies that encourage investment in new technologies. These would be to the benefit of all EU partners even though the colt has to be borne by the country Chat implements them.

This restrictive bias running through European policies is, in part, the cost of «non-Europe». European countries are nearly as interdependent as the fifty US states, but Europe does not yet have the federal and democratic institutions that would allow it to effectively manage its economic space.

At the start of the 1990s, Europe paid the price for not having monetary union. The countries of continental Europe wanted to maintain fixed parities but without the solidarity achieved by monetary union, they turned what might have been an opportunity for expansion (i.e. German reunification) into a recession. Furthermore, since its political institutions are not adapted to an Europeanised» economy, Europe was incapable of turning its economy around after the 1993 recession. Like the United States two Yeats before, all European countries were confronted by the need to reduce public deficits and unemployment. Europe should have adopted roughly the same policy that the United States had applied: first, implement monetary expansion while maintaining very low short term interest rates; second, implement fiscal restrictions once the recovery is under way. The only *problem is that in order for Europe to practice such a policy-mix, monetary union would already have to be in place along with close coordination of fiscal policies.*

What has been the colt to Europe of non-cooperative monetary policies over the past few years? An estimate of that cost can be reached by simulating the consequences of a coordinated 3 point drop in short-term interest rates sustained by the EU over three years from 1993 to 1995. Such a scenario suggests what might have happened, if Europe had already adopted monetary union and if a central European bank had pursued the same monetary policy as the US Federal Reserve. Under these circumstances, the level of real short-term interest rates in Europe from 1993 to 1995 would have been close to the rates attained in the United States from 1991 to 1993. The simulation, realised with the multinational MIMOSA model, shows that the 1993 recession could have been offset. Furthermore, at a practically negligible cost in terns of inflation, the recovery would have led to a substantial reduction in public deficits. In 1994, the average deficit in Europe would have been 3.4 percent of GDP instead of 5.2 percent. Fiscal policies which were largely restrictive in 1996 and 1997 could have been avoided. The recovery, barely begun in 1994-1995, would have carried on and European economic convergence would have developed more rapidly.

Whether it is a question of economic performance or of *unemployment or, indeed,* of *economic convergence, the same problem comes up - a political deficit in the construction* of *Europe. If we create an integrated market, larger than that of the US, but do not simultaneously make progress towards greater political integration, Europe will drift like a boat without a captain and without a destination.*