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Contents

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Together with other members of the European Union, France and Germany are about to embark on an unprecedented cooperative venture. To be successful, Economic and Monetary Union will require a very high degree of mutual understanding among the policymakers of the participating countries. It will also require upgrading the dialogue between those who contribute to shaping the policy debates on both sides of the Rhine.

France and Germany have a long tradition of high-level dialogue and cooperation in the framework of bilateral and European institutions. But the dialogue between their civil societies does not match this spirit of cooperation. Economists and those involved in practical economic policy makink from both countries in particular rarely talk to each other to find out why they may have differing visions of the functioning of Economic and Monetary Union and of the associated challenges, and even more rarely try to narrow the divergence of their views. This lack of dialogue contributes to keeping alive entrenched prejudices on the other country`s supposedly hidden policy agenda.

Yet, an Economic and Monetary Union in which policy debates with a bearing on European policy choices remain confined within national boundaries would be prone to instability, because disagreements about policies would tend to end up in disputes between countries. It is, therefore, of utmost importance to foster the emergence of a genuine *European* professional discussion on major economic policy issues.

The purpose of the *Deutsch-Französisches Wirtschaftspolitisches Forum/ Forum économique franco-allemand* is to contribute to this discussion through the organisation of a series of informal meetings between French and German economists.

The Forum assembles professional economists from academia, business and the public sector. As a non-partisan institution, the Forum brings together participants from all strands of thinking about economic policy with the aim of stimulating fruitful debate. Each meeting is devoted to one or two major policy issues: employment, exchange rate policies, the organisation of economic policy in Economic and Monetary Union, its relations with non-participating countries, and the immediate policy challenges on the eve of monetary union, to name just a few. The Forum commissions papers to provide an informed basis for the discussion, but the focus will be on debate and the exchange of views, starting with reactions from discussants whose role will be to present alternative views and to frame the key issues for the debate.

The proceedings of each meeting are published in working paper format. With the present brochure, we present the opening address delivered by Minister Strauss-Kahn together with papers and a summary of the discussion from the Forum's first meeting on 4-5 July 1997. We hope that this will be a useful input into an emerging public debate on Europe's economic policies in our two countries and beyond.

Jürgen von Hagen
Jean Pisani-Ferry

Opening Address

Dominique Strauss-Kahn
Minister of Finance, the Economy, and Industry

France and Germany have a long tradition of dialogue at the level of heads of state and government, ministers, as well as that of senior civil servants. This dialogue has been instrumental in the building of an increasingly integrated Europe, and I am keen on developing it further with my colleague Theo Waigel.

However, the dialogue at the level of civil societies does not take place with similar intensity. This is also true among professional economists. Opportunities for exchange are rare, and opinions on the other country's policy frequently fail to be based on a sufficiently deep understanding. The lack of dialogue contributes to keep alive misunderstandings and prejudices.

This has to change. The success of Economic and Monetary Union requires that professional discussions develop across borders, and that debates on European policy issues do not remain confined within boundaries. EMU will not eliminate discussions and disagreements. But it is vital that tomorrow's debates take place at a truly European level.

Economists have a particular responsibility in shaping public perceptions. Especially in Germany, but also increasingly in France, they frequently intervene in public debates on monetary union. As the general public does not have a clear vision of what EMU will imply, people tend to rely on the judgement of experts. The least experts should do is thus to listen to each-other.

In this situation, I especially welcome the initiative taken by German and French economists to create a French-German Policy Forum and to hold regular meetings on European policy issues. There are many topics on the agenda that deserve a thorough professional discussion. Some have to do with the operation of monetary union, other with different aspects of European integration, like the current debates on employment or the outlook for enlarging the EU. I look forward to learning much from the Forum's analyses and discussions.

Does European Monetary Union Need an Employment Pact?

Klaus-Werner Schatz

Institute for World Economics, Kiel

Calls for some type of an employment initiative are not new on the European economic policy agenda, and the reason seems to be straightforward. For more than two decades and with the exception of only a few countries, unemployment in Europe has been increasing. In each of the three recessions, beginning in the first half of the 1970's, millions of working places have been lost, and in none of the following upswings these losses have been met by gains of newly created jobs. Unemployment does not only mean a waste of resources which reduces rates of economic growth, but it also causes fiscal revenue losses and additional public expenditures, and, hence, it endangers fiscal sustainability. Above all, with the size unemployment has attained, it is becoming a threat to the stability of the economic and political system in Europe.

In its most recent report on the business outlook for the member states the European Commission has estimated that the average unemployment rates in the communities will be reduced despite the current upswing from the record level of 11.3 % in 1994 by only one percentage point till 1998[1]. Hence, again unemployment will remain on a higher level then it had attained before the recession in the first half of the 1990s. In its white book of December 1993, which had a particular focus on unemployment, its causes and strategies toward more employment, the Commission rightly pointed out that since the early 1980s the development of the European labour market contrasts sharply with that in the United States[2]. While in the European average unemployment rates have roughly risen by half compared to the level at the beginning of the last decade, they half been roughly reduced by half in the USA and are as low at present as they were 25 years ago.

In addition, unemployment rates tell not the full truth about the performance of labour markets, as the following comparison between the USA and Europe may underpin[3]:

- Between 1970 and 1994 the US labour force has increased by 43.3 Mill. persons. The

[1] Unemployed in p.c. of civilian labour force.- European Commission, Directorate-General for Economic and Financial Affairs, Economic Forecasts 1997. Summary. Brussels, April 18, 1997, table 30.

[2] European Commission, Growth, competitiveness, employment: The challenges and ways forward into the 21st century. White paper. Brussels, December 5, 1993, p. 2.

[3] Gern, Klaus-Jürgen et al., Industrieländer: Stabilitätsorientierte Geldpolitik - fortgesetzter Aufschwung. In: Thesen zum Kieler Konjunkturgespräch. 51. Kieler Konjunkturgespräch, Kiel, 20./21. März 1995, table 1. - Own calculations based on OECD, Labour Force Statistics.

number of working places has even risen by 44.4 Mill..

- In the same period in Western Europe the labour force has grown by 51 Mill. persons, but only 12 Mill. additional jobs have been created.

Hence, while in the USA each entrant to the labour force could be offered a job, in Europe additional jobs have been available for only 23 p.c. of the persons by which the labour force increased (West Germany: 31 p.c.; France: 18 p.c.; Italy: 12 p.c.; UK: 24 p.c.; in comparison Japan: 85 p.c.). Hence, for more than three quarters the fate was: unemployment, early retirement schemes, reception of social welfare payments, withdrawal from the labour market etc. Also, younger people stayed longer in schools or universities.

In view of rising unemployment a European employment initiative or a common employment policy was held the more urgent by many as it was felt that in the process of European integration much emphasis was put on the realisation of the common market and on the development of the respective common policies, but little attention paid to the possible repercussions of intensified competition in the common market or with third countries on labour. In response, the Treaty of Maastricht amended the former Art 2 establishing the European Economic Community by adding the achievement of a high level of employment as a new task for the community.

Yet, an employment pact has not been decided upon and the Commission has not been assigned a common employment policy. The calls for such a pact and a mandate for the Commission have become loud, however, as 1 January 1999, the date of entry into stage three of the European Monetary Union (EMU), is approaching, better: as April 1998 is approaching, when it will be decided, which countries meet the criteria of the Treaty of Maastricht and are qualified for membership in stage three[4]. There are two reasons for these calls. The first is, that some countries want to avoid negative side effects on employment possibly resulting from the reduction of the public sector deficit in relation to GDP to three per cent, which is the reference value of the Treaty of Maastricht to qualify for membership in the European Monetary Union. The second reason is, that countries wish to supplement the so-called Stability Pact by an employment pact to make it clear already in advance of EMU that equal weight is to be given to a high level of employment. Here it is important that, in EMU, governments of member states lose sovereignty over monetary policy and can conduct anticyclical fiscal policies within a range only which is determined by the Stability Pact.

Turning to the first reason and with a view on whether EMU will begin upon time, in Germany it has been stressed times and again that the union will start only if the criteria of the Treaty of

[4] For reasons of simplicity and convenience, in the following it will often be talked of the begin of EMU on January 1, 1999, while more precisely stage three of EMU begins.

Maastricht are met, and that only those member states of the European Union will be admitted to participate from the very beginning which precisely fulfill the reference value for the public sector deficit in 1997. Germany in particular pressed for the Stability Pact, which, after controversial discussions, has been agreed upon in principle in Dublin last year. This Pact is to ensure that the financial policies of the member states of EMU will be sustainable, and that countries will be fined, if they violate the reference value for the budget deficit after entry into the Union.

In the last three or four months matters have changed in France and in Germany in a non predicted manner. Meeting the reference values has forced all countries to undertake significant efforts. As the European Monetary Institute has pointed out in its convergence report of last autumn, deficit reductions have been mostly achieved by increases of taxes and other revenues, to a lesser degree by cuts on public expenditures[5]. In any case, the short term effect of fiscal policies on economic activity is certainly dampening.

In France, as in Germany, in the past the focus of fiscal policies has been on complying with the reference values. The newly elected French government seems to have changed the stance of policies quite a bit. It has been argued that domestic policies should be more balanced, that the reduction of unemployment should be paid more attention and the government has announced a comprehensive effort to do so. The French government urged for a European employment pact to supplement the Treaty of Maastricht and seemed to make its acceptance of the Stability Pact dependent on the agreement on the employment pact. The German government disliked the idea of an employment pact, arguing that the a common initiative would cost money. For a while, it seemed as if the timely begin of stage three of EMU was put into question because of disputes in these matters between France and Germany. Meanwhile, with the compromise of Amsterdam on June 16 and 17, 1997, the dispute seems to have been settled. It is my interpretation of this compromise that an employment pact has not been decided upon which would deserve this name; but the compromise leaves the issue on the European agenda and a door has been opened widely through which such a pact could eventually pass.

Turning to the second reason, on the one hand the introduction of the Euro improves the employment opportunities. EMU allows to make better use of the advantages of the common internal market of the European Union, though the effects should be rather limited. It reduces transaction costs which are due to different national currencies such as those stemming from exchanging currencies, from exchange rate changes or from costs of insuring against such changes. Smaller and medium sized companies in particular will presumably draw advantages from this. On the other hand, the more the opportunities will be seized from the replacement of national currencies by the Euro, the more will competition be intensified within EMU at the same time. This requires flexibility in the

[5] European Monetary Institute, Progress towards convergence 1996. Frankfurt a. M., November 1996, pp. 19 - 30.

markets to adjust to competitive pressures, which may be concentrated on certain industries and regions, and to specialise on new productions and to adopt new technologies. In particular, to avoid employment losses flexibility in the labour market and of wage structures and wage levels is necessary. Countries and regions which will exhibit much flexibility will benefit from EMU, while others will suffer. The loss of an own exchange rate may of course also mean adverse effects on the labour market from competition outside the community and events like the oil price shocks in the 1970's, depending on whether community regions adjust flexible to them or not.

Europe needs more employment, but this has been true already for long. For the reasons mentioned above, the need for jobs may increase with EMU. But does EMU mean that we are also in need of an European employment pact? I suspect that claims for a pact at least to a substantial part mirror the unwillingness or the inability to increase flexibility or the expectations, that, as in the past, improvements will be too poor to cope with unemployment. It must be clarified what policies could be carried out within the framework of an employment pact and whether they would comply with other policies, aims and determinations of the Treaty of Maastricht or of the Stability Pact. Further, whether at all an European employment pact would help to increase employment depends on the nature and on the causes of unemployment. And finally, it must be discussed whether common policies are better to fight unemployment than national or regional efforts.

One argument for a European employment pact could simply be that by the introduction of a common currency the scope is reduced for national macro-economic policies which are carried out to prevent employment losses and to diminish unemployment. In this view the European employment pact could then be a substitute for national policies which cannot be applied anymore or to a limited extent only. Among the reasons to be taken into consideration are the following:

Within EMU countries will be deprived of the possibility to conduct independent exchange rate policies. Could a currency depreciation contribute to the solution of the European unemployment problem? Would a strategy of a weak Euro be advisable as a policy within a European employment pact? Many countries in Europe have depreciated their currencies in the course of the 1980's and 1990's; the experience is, to put it positively, at least mixed, but there are apparently voices within the Community calling for a weak rather than a strong Euro. It has to be asked, however, under what circumstances a depreciation really helps to reduce unemployment. In this respect, it is decisive, whether unemployment is due to some unexpected, one-time external or internal event, or whether employment losses are a permanent feature and have nothing to do with singular events. If deprecating the Euro were the chosen economic policy strategy, it would require more expansionary monetary policies than in the relevant competitor countries, above all in the USA. This strategy can be a remedy against unemployment in some cases, e.g., where real wages for what ever reason were increased across the members of EMU to a level exceeding the level of labour productivity. If nominal wages are sticky, a transitory higher rate of inflation could be used to reduce real wages to a lower level, and the Euro would depreciate. Hence, the real costs for labour in Euro and its nominal costs in international currency would be diminished and the demand for labour be increased. Whether such an effort will be successful depends on the acceptance of the reduction of real wages by workers and trade unions. However, above all it has to put into question that the case of a uniform wage shock (or other shock) as discussed here has anything to do with past or future European realities and is the main cause for European unemployment.

Instead, there is much evidence that because of continued trade union pressures real wage increases have been too fast in most European countries to allow for a high degree of employment[6]. In these circumstances and if trade unions insist to defend real wage levels, depreciating the Euro will not contribute to a solution of the European unemployment problem. With faster inflation, nominal wages will rise faster, too: Nominal short and long term interest rates would be higher, and real rates, too, as the Euro would promise less stability than other currencies. The depreciation of the Euro would only make up for more inflation in EMU than in other regions of the world, and to the extent that real interest rates would be higher, the depreciation would be detrimental. It goes without saying that a depreciation strategy would conflict both with the spirit and the wording of the Treaty of Maastricht, as economic growth in the Union must be non-inflationary according to Art. 2 of the Treaty.

Therefore, depreciating the Euro is no meaningful proposition for a European employment pact. European and other countries have, however, in the past conducted monetary policies without the aim of an outspoken depreciation strategy, but just to stimulate economic growth and employment by expanding the volume of money more rapidly and lowering central bank rates. In the future, countries will not enjoy anymore this opportunity; but it has to be asked if a basis can be found here for a European employment pact. It could be argued that the European economies suffer from a lack of demand, but enjoy production capacities which are basically competitive, and that unemployment results from the lack of demand. Monetary stimulation could then bring about increasing demand and capacity utilisation declining unemployment. As competition would be fierce at least initially because of low degrees of capacity utilisation, inflation must not accelerate.

This argument is rather dubious. If unemployment is high and even increasing over a longer time period, including several economic upswings, this provides always reason to assume that production capacities and working places are not available to employ significant part of the unemployed. As a matter of fact, already for 1994 the Directorate-General for Economic and Financial Affairs of the European Commission estimated that cyclical unemployment made up for only 2.1 percentage points

[6] Empirical evidence for instance reveals that since the early 1980's wage increases in Europe have been significantly faster than in the USA, and the performance on the labour market severely poorer, suggesting that wage increases have been a major cause for rise of unemployment in Europe. It is no contradiction, that unit labour cost increases were very similar in both regions. For, unit labour costs are an ex post major measure including labour productivity increases which result from the shading of labour which is uncompetitive at the increased wages.

of the unemployment rate of then 10.9 percent[7]. Hence, it would have been to a rather limited extent only that unemployment could have been reduced in the European economies by returning to a full use of their production capacities. For 1997, the production gap has been estimated to account for only 0.5 percent of potential output in the European average[8], and at present, capacities in a number of European countries are used even above their long term average levels. The same token, the OECD forecasts cyclical unemployment to make up for only 0.8 percentage points of an unemployment rate of 10 percent in the European Union in 1998[9]. Hence, lower interest rates could hardly contribute to more employment, but they would with a certain time lag even lead to overheating of the European economies, to rising rates of inflation and to higher capital market rates. This would then jeopardise the efforts to induce more investment and the creation of jobs.

However, it has been argued that, even if degrees of capacity utilisation are high, monetary expansion might be a success if it comes as a surprise. The ample supply of money and low central bank interest rates may yield an increase of both demand and supply of new capacities at the same time, and as they would be going hand in hand, supply bottlenecks could be avoided and prices be kept from rising. The argument rests on the assumption, that market participants cultivate illusions: faster expansion of the money supply is not taken as a signal of possible inflationary dangers. A look at the financial markets and the attention, which market participants pay to interest rates and all news on central bank policies can easily proof that such an illusion does not prevail in practice. Hence, I see no place at all for monetary policies in an European employment pact.

In EMU, countries can continue to conduct their own fiscal policies and other economic policies. They could aim at stimulating the economy and at reducing unemployment by faster growth of public expenditures, and even with the provisions of the Stability Pact certain possibilities for deficit spending are given.[10] However, similar to a monetary expansion, it would only be in the case of a cyclical underutilisation of production capacities and of cyclical unemployment only that expansionary fiscal policies could be applied successfully. It is true that such a policy would not lead to higher inflation, as long as the European Central Bank conducts price stability oriented monetary policies; but taxes and other duties to the employed and to companies would be higher and, hence, unemployment would be aggravated, as incentives to invest and to create jobs would be reduced. The policy would be the less

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[7] Study No 2 - Competitiveness, productivity and employment. In: European Commission, Directorate-General for Economic and Financial Affairs, Annual Economic Economic Report for 1995. European Economy No 59. Brussels, Luxembourg, 1995, table 2.

[8] European Commission, Directorate-General for Economic and Financial Affairs, Annual Economic Economic Report for 1996. European Economy No 61. Brussels, Luxembourg, 1996, table 2.

[9] OECD, Economic Outlook 61. Paris, June 1997, table 9.

[10] The Stability Pact provides that deficits are close to zero or the budget even balanced normally. Deficits may be raised to three p.c. in relation to GDP e.g. in case of a recession.

sustainable, as the countries' relative position with regard to taxes and to fiscal stability would worsen within EMU and currency depreciation is not available so to make up for (part of) this worsening.

Therefore, a European employment pact could also mean an agreement on the co-ordination of national fiscal policies to be more expansionary simultaneously. While I do not deal with co-ordination (as it is not the topic of my paper), I want to say only that the damage from wrong policy is of course not diminished, if the policy is pursued commonly; the damage will be the more significant as counteracting policies are ruled out.

At this point, I wish to draw the attention to one aspect which is trivial, but central to the discussion of whether EMU needs an employment pact, and, yet, is neglected often. The news of the monetary union is that member countries will lose their exchange rates. In this respect monetary union goes beyond the establishment of the common market. If EMU poses a particular problem, disregarding such issues like possibly higher rates of inflation than some countries are willing to accept, it is that not all members and not all regions of the member states can cope to the same extent with the challenges of a common exchange rate. As mentioned, some may benefit, others lose. Such differences in performance cannot be taken into account by any macro-economic policy to be conducted in the framework of a European employment pact, how dubious it may ever be for other reasons. For example, lower interest rates would apply to all regions and not only to those who suffer from unemployment. Therefore, any employment pact and policy which would have to be justified by the establishment of EMU would have to be selective in nature. What could it be?

The real issue is not fighting that part of unemployment which may additionally stem from the realisation of EMU, but to find a solution for the European employment problem in general. For one, it will be hardly possible to identify that fraction of unemployment which goes back to the introduction of a common currency. For another, as earlier mentioned unemployment in Europe is above all non-cyclical, and unemployment which may result from EMU will be non-cyclical, too. The policies required to achieve higher degrees of employment are pretty much the same irrespective of the causes for such non-cyclical unemployment.

In order to explore what type of employment pact would be needed, if at all, we have to become clear about the world economic environment. What used to be discussed as "Eurosclerosis"in the 1980's has returned to the economic policy agenda under the heading international locational competition in the 1990's. The world economy is undergoing fundamental changes. In the first decades after World War II, liberalisation efforts concerned above all international trade in goods. In an open, multilateral world trade order all countries should enjoy the opportunity to exploit their competitive advantages as given by their endowments with capital, labour or know how and other factors of production. Differences in the internal political or economic system should not matter for international trade.

In the meantime, barriers to international trade in services have been removed to a large extent, too, and the liberalisation of international capital movements has gone so far that today we can talk by and large of a single world capital market. To provide two examples: Cross-border transactions in bonds and equities have increased rapidly. In case of both the USA and Germany, they made up for roughly one third of GDP in 1985; they accounted for 152 percent of GDP for the USA and for 197 percent of GDP for Germany in 1996. In the same period, the figures for France were 21 and 229 percent respectively, for Italy 4 and 435 percent, and for Canada 27 and 235 percent[11] respectively. Furthermore, in 1970 the number of countries providing convertibility of currencies for current account transactions was 35 (30 percent of IMF membership); it has risen sharply to 137 in early 1997 (76 percent of membership)[12]. Consequently, the per capita income level of a country and its ability to mobilise internal savings must not limit investment activities; for capital may be borrowed from the world capital market and supplied by external investors.

In addition, an increasing number of countries has given up step by step previously interventionist economic systems or central planning - not only in Central and Eastern Europe, which may come into mind immediately, but all over the world: I just mention China, Vietnam, and India, or Argentina, and Mexico. Foreign investors receive equal treatment with domestic ones or even a preferential treatment, the risk of expropriation has been reduced largely and the transfer of profits is being granted. In a similar way in which the supply of capital can be increased by relying on external sources, the supply of human capital and of know how to the domestic economy can be enlarged by foreign investors. Moreover, technological innovation in telecommunications and in information has reduced the economic costs of geographical distance dramatically. Again one example: If the cost for one unit of computer services are set to equal one US-$ in 1997, the cost would have been 36 000 US-$ in 1980[13] and 195 000 US-$ in 1970. Today, huge amounts of information can be processed or exchanged world wide in a very short time and at a low price, and transparency in the world economy has increased.

Under these circumstances, old industrial locations lose inherited competitive advantages, which they enjoyed in a world where goods trade was liberalised, but capital or know how bound within national borders, and where foreign investors were discriminated against and the economic costs of distance were so high that they meant effective protection against competition from many parts of the world. Financial and human capital have become mobile, and today the immobile factors of production at a location compete for them. In the choice of investors, cost differences between locations matter, hence wages and other labour costs to the employer, the costs of land, taxes, and other duties, and the costs which emerge from public regulation and other institutional provisions including the

[11] IMF, World Economic Outlook May 1997. Washington D.C., 1997, p. 60.

[12] Ibid, p. 46.

[13] Own estimate for 1997 based on the U.S. Departement of Commerce computer price deflator for 1970 and 1990. - Ibid, p. 46.

behaviour of public administrations. In this context is not important whether the locational conditions in Europe have worsened over time in an absolute sense, but whether they have worsened relative to other locations in the world economy. To put it the other way round: there has certainly been some progress in Europe and in a number of cases it has been even significant, but the speed of globalisation has been so fast that it outperformed European achievements.

What could be done in Europe, how could an employment pact be helpful? In the global economy national borders are becoming less and less important for the movement of capital and of know how, and the same is true with regard to borders of the European Union vis à vis third countries. The means are not available which could prevent capital and knowledge from flowing outside. In Germany and in other European countries it is popular at present to claim a world wide arrangement to impose globalisation rules: certain minimum wages or social welfare payments, minimum insurance provisions for sickness, unemployment and retirement and minimum standards for the protection of the environment should apply world wide so as to reduce incentives for capital to move. Also, taxes and tax systems are to be harmonised to a certain extent to avoid tax competition. Those claims have no chance for realisation. They wish to defend locations in the highly developed countries. But there are too many have-nots in the world economy which will not agree to protect the have-alls.

Hence, if a world wide arrangement or a cartel is no solution, the competitiveness of locations must be improved to reduce unemployment. The nature of unemployment in Europe and in the European regions is far from being uniform. As locational competition matters, in the end regions must discover the answer to the challenges which are posed, meet the requirements of structural change and find ways to achieve more employment. They must offer advantages to investors, e.g. advantages resulting from the supply of public goods or from the quality of labour, which can make up for regional costs; if such advantages cannot be achieved costs must be reduced.

If an employment pact would mean that the European Commission gets a mandate to conduct employment policies, the open question is what the Commission would have to offer except possibly money. The Commission ought to have supreme wisdom on how the regions can better cope with the challenges of the global economy in - which should be emphasized - practical matters, in contrast to wisdom in an abstract and academic sense. It must be definitely doubted that the Commission can have better knowledge about regional requirements than is available in the regions themselves. If funds were taken away from the member states and regions to be distributed by the Commission, this would be a loss and counter-productive with regard to the reduction of unemployment.

This is not to say that the Commission has no role to play at all in reducing unemployment in Europe. The breakthrough toward the common internal market of the European Union was achieved by more or less replacing the host-country principle of regulation by the home-country principle; it meant that competition could take place in the community without previously harmonising national determinations or replacing them by common policies. The home-country principle also affects competition among national legislation, as locations with more business-friendly regulations will attract economic activity and foreign investors. Complementary to the home-country principle, the subsidiarity principle was agreed upon at the begin of the 1990's; accordingly central decision making and policies are required only where they clearly promise advantages compared to decentralized action. Both principles are adequate responses to the challenges of the global economy, too.

These challenges can be met only if the manifold national impediments to structural change and to the emergence of new activities and additional employment are reduced, which have been erected in the past for a plethora of reasons. Very often they prevent European economies from diminishing unemployment and achieving higher rates of growth. Based on the home-country principle and on the provisions of the Treaty underlying the establishment of the common internal market the European Commission has become a deregulation machinery. National regulations have been revoked and competition has been achieved in transport, telecommunications and many other fields, though much remains to be done.

The Commission has drawn much criticism by the interest groups which have been affected; national governments often would not have dared to undertake deregulation, which they did referring to European requirements. The Commission has important additional tasks. It could play a most beneficial role in perpetually making clear the assignment problem: the Commission can act in a subsidiary manner and it should and could contribute more to clarify the economic issues which are at hand, as the national governments have to resume their responsibility to achieve more employment. At the core of the European unemployment problem are wrong economic policy assignments, distorted incentives and unnecessarily costly welfare systems; they all result in excessive burdens from taxes and other duties both to investors and to the labour force and reduce efforts to offer working places and to accept them. They are to be found more or less in all member countries of the European Union (although some have achieved significant improvements); in my reading the most important message of the White Book of the Commission of 1993 was exactly on these issues.

Whether and to what extent unemployment can be reduced, crucially depends on the trade unions and on the employers associations. In the past, wages have been increased neglecting the differences between regions, the abilities of companies to pay higher wages, and the quality of labour. Trade unions perceived their task in increasing wages while the government and labour market policies were held responsible for the level of employment and the care of those eventually becoming unemployed. This is a wrong assignment. Any government would be overcharged with supplying jobs for an ever increasing number of those who do not find them in private industry or with coping with rising mass unemployment. The unions must accept their responsibility for the employment level. Decentralisation of bargaining, more differentiation of wages, more wage determination at the company level are required as well as lower wages for the unemployed in order to give them a chance to become re-employed.

More employment in Europe is an aim that deserves priority on the European and the national economic policy agendas, but a European employment pact has no place on the European agenda. Practically everything that promises more employment can only be realised by local agents, and the best which can be done to reduce unemployment is to give more freedom for decentralized action.

IS THE STABILITY PACT AN EFFICIENT AGREEMENT?

Patrick Artus

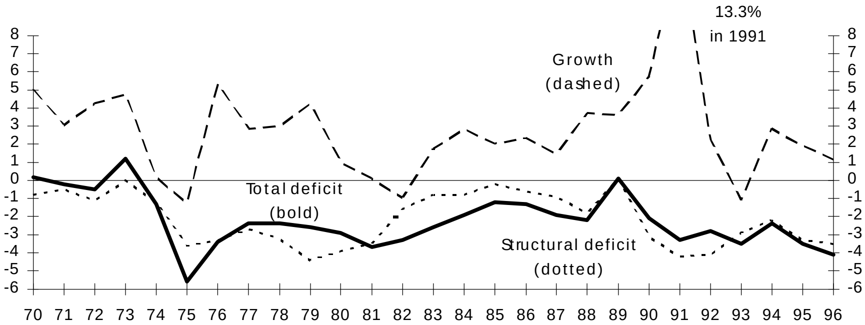
Caisse des Dépôts et des Consignations, Paris

1 – Will the capacity to stabilize cycles be reduced?

The Stability Pact, barring exceptional circumstances (negative growth of less than -¾%) curbs a country's public-sector deficit at 3% of GDP. A first fear concerns the losing of the possibility of smoothing economic cycles with fiscal policy. Such a development would be particularly serious since monetary policy will be defined for the entire area and will not be able to react if a regional recession occurs (i.e. is limited to a small number of countries).

Let us examine the situation in the past in a few countries (chart 1: Germany; chart 2: France; chart 3: Italy; chart 4: Spain; chart 5: Belgium; chart 6: Finland; chart 7: Netherlands; chart 8: Ireland).

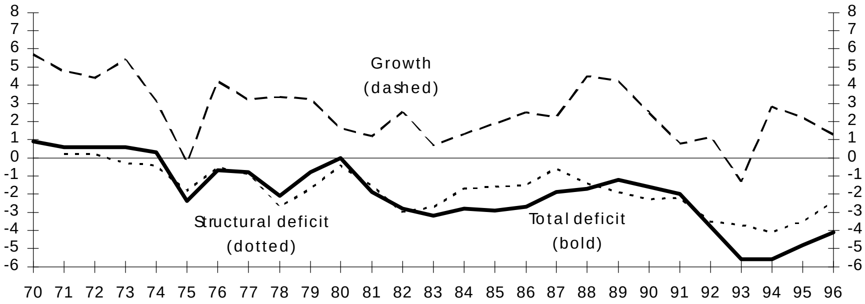
Chart 1
Deficit of public authorities and growth in Germany (as %)



Source: OECD

Chart 2

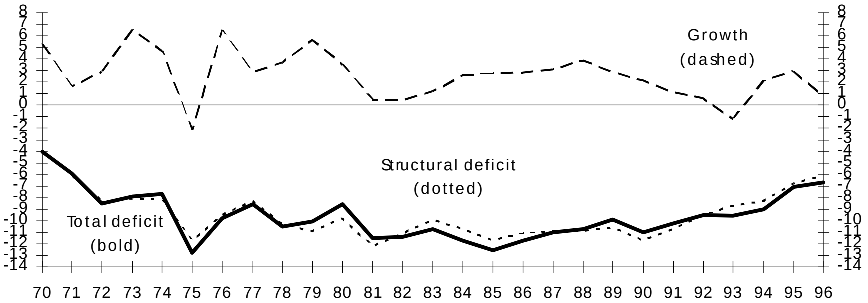
Deficit of public authorities and growth in France (as %)



Source: OECD

Chart 3

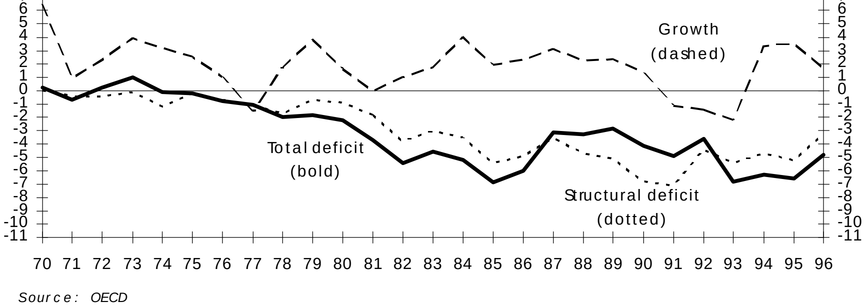
Deficit of public authorities and growth in Italy (as %)



Source: OECD

Chart 4

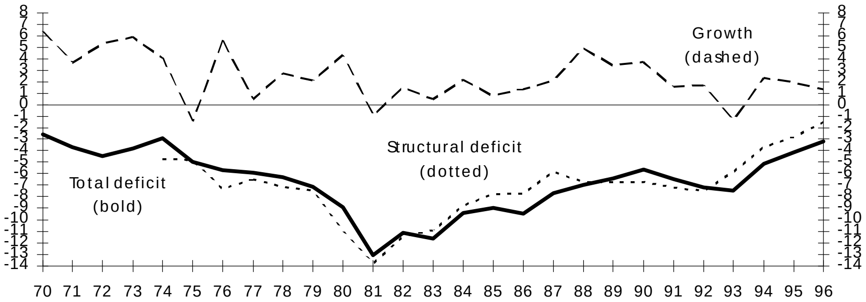
Deficit of public authorities and growth in Spain (as %)



Source: OECD

Chart 5

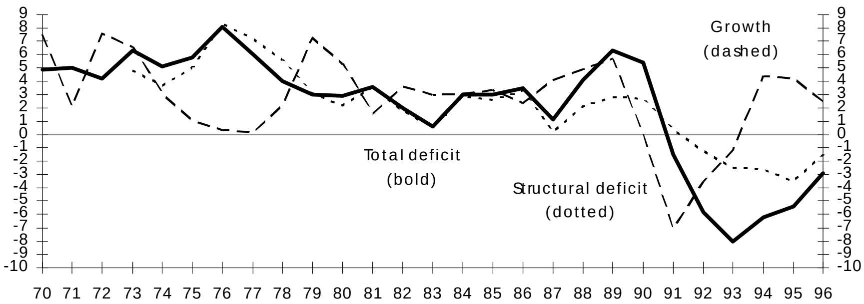
Deficit of public authorities and growth in Belgium (as %)



Source: OECD

Chart 6

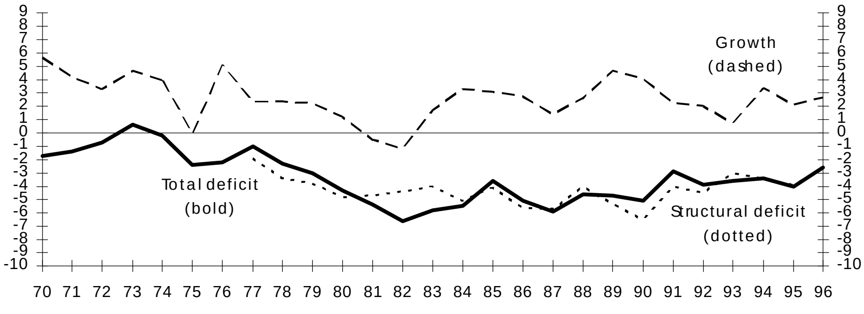
Deficit of public authorities and growth in Finland (as %)



Source: OECD

Chart 7

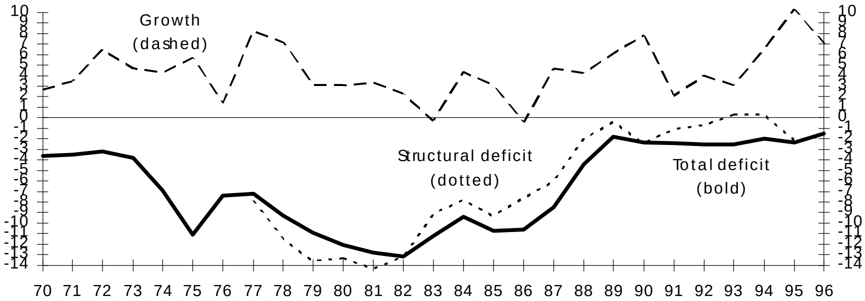
Deficit of public authorities and growth in the Netherlands (as %)



Source: OECD

Chart 8

Deficit of public authorities and growth in Ireland (as %)



Source: OECD

A few countries have recorded unique situations in their public finances: a surplus until 1990 in Finland followed by an enormous deficit; a steady fall in the deficit since 1981 in Belgium and since 1985 in Italy; and a slashing of the deficit from 1987 to 1989 in Ireland. Let us now concentrate on countries having experienced a steadier trend and look at the cost of drops in growth in terms of the deficit, by looking at the gap between the structural deficit and total deficit in these periods (the gap represents the effect of the economic cycle on the deficit). In Germany, it exceeded 2% in 1975 and 1.75% in 1983; in the Netherlands, 2% in 1982; 2.5% in Spain in 1990; slightly above 2% in France in 1993; nearly 6% of GDP in 1993 in Finland!

Overall, it would seem that a margin of 2-2.5% of GDP is required for the budget to be as countercyclical as in the past without running into the 3% constraint. In other words, in periods of normal economic activity, the deficit should lie between 0% and 1% of GDP, i.e. well below the level that ensures stabilization of the rate of public-sector indebtedness in Europe. This level stands at about 3 percent of GDP if European public-sector debt steadies at about 80% of GDP, with the real interest rate close to 4½%, inflation at around 1.5% and growth around 2.5%, and corresponds to a primary surplus of 1.6%. The Stability Pact indeed projects balanced public finances in growth periods, i.e. a decrease in the debt ratio. A noteworthy point is that, de facto, if the unprovisioned actuarial debt of pension systems (at least a year and a half of GDP) is included in the public-sector debt, markedly more drastic fiscal austerity is required to cut the total debt ratio (public authorities and discounted debt of the pension system). Clearly, such a tightening becomes excessive in this case.

The crucial issue is whether European Union countries will tend spontaneously towards balanced public finances, or will be satisfied with a lower deficit (about 2 percent of GDP). In the latter case, clearly the possibility of ensuring cyclical adjustments will be markedly reduced.

If the past is examined again, it can be seen that in periods of steady growth the deficit fell back to around 2 percent of GDP in Germany and in France and 3 percent in Spain and in the Netherlands. One is therefore entitled to question whether the budget can be balanced on average.

We must now ask what gave rise to the idea of a Stability Pact.

2 - Externality linked to public-sector deficits in EMU and the Stability Pact: the fundamental justification

The basic idea is as follows: with **flexible exchange rates**, if a country follows an expansionary fiscal policy, its interest rate rises, but this does not penalize in any way the neighbouring country which is protected by the system of flexible rates. If international capital mobility is developed, the exchange rate of the country in which public spending is increasing will rise.

The causes of fiscal expansion can be varied. At the best, it is a response to a negative shock (specific to the country) in demand; in the worst-case scenario, it is a groundless budget deficit, resulting from the laxity of the country. **Insert 1** provides a simple model for such a situation limited to two countries. The first country has no aversion to a public-sector deficit, and is hit by an unfavourable shock (we therefore cumulate the issues of stabilization and laxity); the second country has an aversion to a public-sector deficit (and is not hit by a shock). In a system of flexible exchange rates (equation (4)), the former country achieves perfect stabilization, the latter is absolutely not affected.

In **EMU**, two situations may be discerned: either the financial markets discriminate between issuers, or they do not.

In the former case, if a country has a higher (or excessive) deficit, only its interest rate rises, even if it issues in the same currency as the other country. This is because spreads between issuers reflect their relative quality, not the general level of interest rates.

In the latter case, the financial markets penalize equally all issuers, seen as bound by solidarity, if one among them has an excessive government deficit (or debt) (this is represented by equation (3') of **Insert 1**). This may be reasonable if solidarity does exist: in the event of trouble besetting one of the sovereign issuers, the others must come to its help. The Maastricht treaty, however, explicitly includes a “no bail-out” clause, which bans assisting a defaulting issuer: the Treaty implies therefore that discrimination prevails, and each country is alone responsible for its situation.

Insert 1

Externality via the interest rate

In each country, production decreases with the interest rate, increases with the public-sector deficit and is affected by a random event:

(1) $$\begin{cases} y = -ar + g + e \\ y* = -ar * + g * + e * \end{cases}$$

where y is production, r the interest rate, g public-sector expenditure, e a random event; the variables of the second country are noted with an *.

The authorities minimize a loss function stemming from the output gap in relation to full employment output.

(2) $$\begin{cases} L = (y)^2 + Ag^2 \\ L^* = (y^*)^2 + Bg^{*2} \end{cases}$$

L is the loss, A and B the additional shortfalls recorded by the public-sector deficit $(g \; ou \; g^* > 0)$ in both countries, full employment output is assumed to be nil, by normalization.

We suppose that **the interest rate rises in line with the public-sector deficit** in each country, i.e.:

(3) $$\begin{cases} r = qg \\ r^* = qg^* \end{cases}$$

1 -In a system of flexible exchange rates, each government minimizes its loss (2) by taking the interest rates as given, hence:

(4) $g\left(A+1-qa\right)=-e$

We suppose, to assign an image, and in the remainder of this text, that **the first country has no aversion for a public-sector deficit** $(A=0)$, and **that it is hit by an unfavourable shock** $(e<0)$.

One then has:

(4') $$\begin{cases} g=\dfrac{-e}{1-qa}>0 \quad ; \quad y=0 \\ g^{*}=0 \quad ; \quad y^{*}=0 \end{cases}$$

The second country is absolutely not affected by the shock affecting the first country.

2 - In EMU, if the interest rates are common, (3) becomes:

(3') $$r=q\,\frac{g+g^{*}}{2}$$

hence (the first country minimizes L, the second L^{*}, and r comes from (3')):

(5) $$\begin{cases} \Delta y^{*}=Bqae<0 \\ \Delta y=0 \\ \Delta g=-e\left(2\left(B+1\right)-qa\right)>0\,;\,\Delta g^{*}=-qae>0 \\ \Delta r=-q\left(B+1\right)e>0 \end{cases}$$

with $\Delta=2\left(B+1\right)-qa\left(B+2\right)$

3 - In EMU, if fiscal policies are coordinated

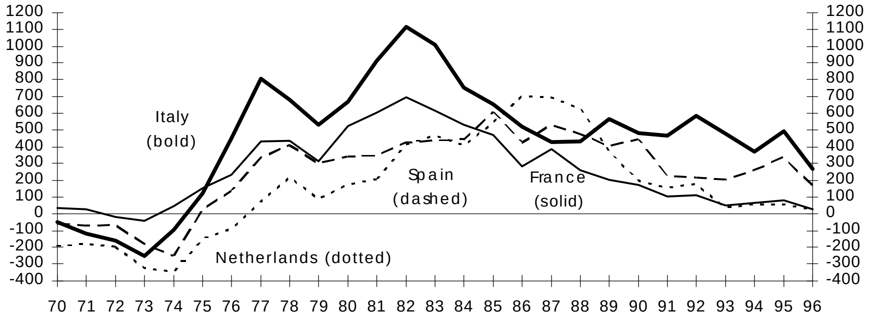
The authorities minimize $L + L^*$ by the shared choice of g, g^* given (3'). We then have:

$$(6)\begin{cases} \Delta' g = -e\left(1-\dfrac{aq}{2}\right)(1-aq+B) > 0 \,.\, \Delta' y = eB\left(\dfrac{aq}{2}\right)^2 < 0 \\ \Delta' g^* = -e\dfrac{aq}{2}(1-aq) > 0 \\ r = q\dfrac{g+g^*}{2}, \textit{hence } \Delta' r = -\dfrac{e}{2}q\left[(1-aq)+B\left(1-\dfrac{aq}{2}\right)\right] > 0 \\ \textit{with } \Delta' = (1-aq)^2 + B\left[\left(\dfrac{aq}{2}\right)^2 + \left(1-\dfrac{aq}{2}\right)^2\right] \\ \textit{and } \dfrac{1-aq}{2}\dfrac{(1-aq+B)}{\Delta'} < \dfrac{2(B+1)-aq}{\Delta}\,;\, \dfrac{aq}{2}\dfrac{(1-aq)}{\Delta'} < \dfrac{aq}{\Delta} \end{cases} \quad (6)$$

However, this clause is not very credible: could the other EMU countries leave a member facing difficulties to its fate? The global repercussions on the euro market might be far too serious. On the other hand, if a bailout occurs, one is indeed faced with externality operating via the rate.

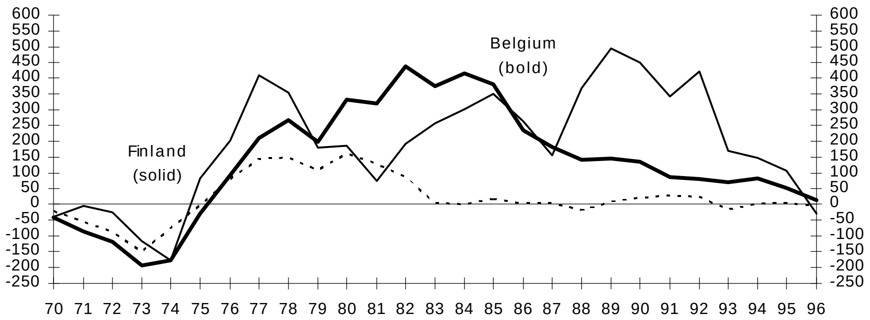
What can be inferred from the current situation? Yield spreads over Germany **(charts 9 and 10)** are not linked to levels of public-sector debt **(charts 11 and 12**) as shown very clearly by the examples of Belgium and Ireland (high debt and low rate) and Spain (low debt, high rate). It can be shown that they now depend exclusively on expectations of currency fluctuations: once hedged against currency risk, all the interest rates, in domestic currency, of countries of the euro area are similar. This observation argues against accepting the approach according to which one has discrimination among borrowers. However, the focusing on currency risk may have led to the disappearance of the other causes of yield spreads, and this situation could change after unification. Let us examine the worst case in which there is no discrimination. In EMU, if there is no coordination, the country affected by an unfavourable shock sharply increases its public-sector deficit and, if this does not hurt activity, stabilizes completely its economy and neutralises the impact of the shock on production.

Chart 9
Long-term spreads over Germany (in basis points)



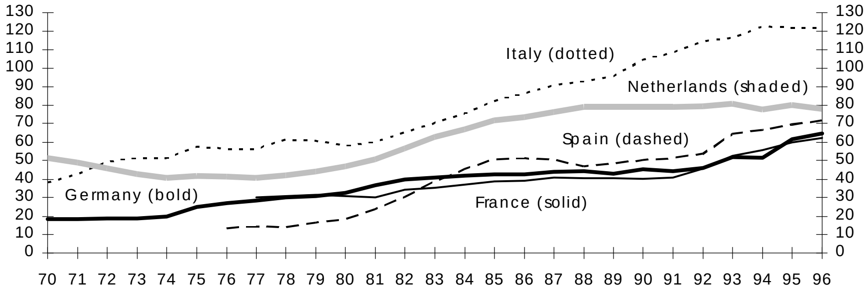
Source: OECD

Chart 10
Long-term spreads over Germany (in basis points)



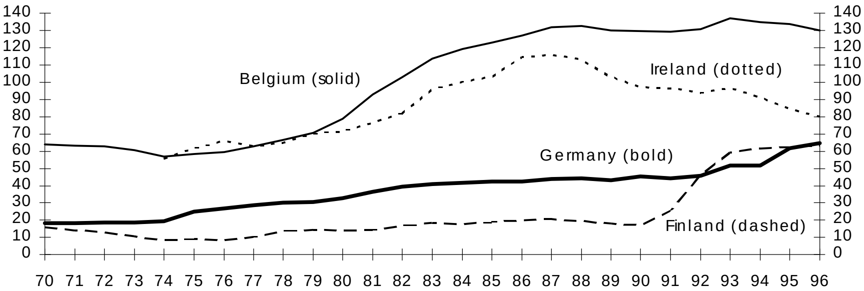
Source: OECD

Chart 11
Gross financial commitments of public authorities
as a % of GDP/GNP



Source: OECD

Chart 12
Gross financial commitments of public authorities
as a % of GDP/GNP



Source: OECD

The other countries are affected by the hike in the common interest rate, and have to increase their public spending. If they are characterized by aversion for a public-sector deficit, unlike the country in which the shock occurred, they record a loss in production (see (5) of Insert 1). The mechanism (externality of the deficit) can be sketched out as follows:

Pattern 1

Externality of public-sector deficits, absence of discrimination

Specific unfavourable shock →	Public-sector deficit in the country affected ↓	
	Increase in the common interest rate→	Fall in output in the other countries ↓
		Public-sector deficit in the other countries

If **fiscal policies were coordinated among countries** ((6) of Insert 1), public-sector deficits would be lower in all countries, in order to limit the interest-rate rise; the externality which moves on to other countries is reduced, but the correction entailed by the shock on the production of the country hit by the shock is limited.

Coordination therefore resembles the Stability Pact: the country affected by the shock does not see its deficit grow as much as it would in a situation in which budget policies are not coordinated.

This shows that an international accord such as the Stability Pact improves well-being in a very specific case: when public-sector deficits have a direct effect on the interest rate and when the financial markets do not discriminate between issuers.

We saw above that if discrimination does occur, the problem does not arise since the countries were not affected by the budget policies followed in other countries. We will now examine the relevance of the hypothesis that postulates a direct link between the interest rate and the deficit.

3 – Interest rate driven by monetary policy: the spontaneous and uncoordinated behaviour of governments is optimal if the central bank also takes into account the social objective

The previous hypothesis postulating a link between the interest rate and the public-sector deficit is highly debatable, for several reasons:

- EMU monetary policy reacts to shocks and fiscal policies; if a highly negative shock in demand affects a (significant) part of EMU, the key intervention rates will fall even if budget policies become more expansionary. It is only in the event of groundless public-sector deficits emerging that monetary policy can become more restrictive;

- if a country is in recession, even if its public-sector deficit increases and its private investment falls, it probably moves into a situation of excess savings, and its market interest rates decline.

In this part we shall drop the idea of an automatic link between public-sector deficits and interest rates, and suppose that the European Central Bank (ECB) chooses the common interest rate in accordance with activity and deficits. If activity drops sharply, the interest rate falls, in line with our approach regarding the link between interest rates and the real economy. We suppose therefore that the European Central Bank's objective is a truly social objective (combining full employment with the absence of a public-sector deficit) shared by all EMU countries. There is therefore independence with regard to the instrument (the central bank chooses independently the EMU interest rate) but not independence in terms of the objective set (the ECB sets the real objective of economic policy in Europe).

Insert 2

Spontaneous and optimal fiscal policy
when the central bank also seeks the optimum social outcome

We take the model of Insert 1 as a starting-point but we remove the automatic determination of the interest rate stemming from public-sector deficits. Instead, we suppose that the central bank sets the (single) interest rate in order to maximize well-being (i.e. minimizes $L + L^*$).

The central bank is independent and monetary policy is not coordinated (initially) with budget policies: this means that the central bank chooses r (the interest rate) by taking g and g^* (the public-sector deficits) as given; that the governments choose g and g^* by taking r as given. We remain within the case where $A = 0$ (the first country is not concerned by its deficit), $e < 0$ (it is hit by a negative shock in demand).

The first country minimizes L with its choice of g (by taking r as given); as $A = 0,$ it achieves $y = 0$ (0 is, like in Insert 1, full employment production) hence:

(7) $$g = ar - e$$

The second country minimizes L^* with $B > 0,$ hence:

(8) $$g^*(B + 1) = ar$$

The central bank minimizes:

$$L + L^* = (ar - g - 2)^2 + (ar - g^*)^2 + Bg^{*2},$$ hence:

(9) $$ar = \frac{g + g^*}{2} + \frac{e}{2}$$

and, lastly:

(10) $$\begin{cases} r = 0 \\ g = -e > 0 \\ g^* = 0 \\ y = y^* = 0 \end{cases}$$

Let us suppose now that there is cooperation between the central bank and governments. They jointly minimize $L + L^*$ with the simultaneous choice of r, g *and* g^*. Since there are three instruments for three objectives $(y, y^*, g^*),$ one necessarily obtains $y = y^* = g^* = 0,$ i.e. **the same solution as the solution obtained without cooperation (10).**

This results from:

– the fact that the central bank maximizes social well-being (in both cases we have

$$\frac{\partial\left(L+L^{*}\right)}{\partial r}=0)$$

– the fact that the public-sector deficit of one country does not intervene directly in the well-being of the other country, but only via its effect on the interest rate.

Against this backdrop, the need for the Stability Pact may come from **the lack of coordination of economic policies in Europe**. The various governments and the ECB choose independently, on the one hand, budget policies, monetary policy, on the other hand, without cooperation, with everybody pursuing their own objective.

It can be seen, however, that this situation is not detrimental. **When the ECB does have as its objective the real European social objective** (see a simple formal demonstration in **Insert 2**), **uncoordinated policy leads to the same economic equilibrium as coordinated policy** (among all governments and the ECB), **which by definition is not optimal**.

Why is this the case? For a need to regulate public-sector deficits to exist, one has to have a situation in which an excessive deficit in one country lowers the well-being of other countries. This was the case in the previous section when it was supposed that the common interest rate reacted automatically to public-sector deficits. Here, a rise in the public-sector deficit in one country impacts on the other countries only via its induced effect on the interest rate. However, the latter is set optimally by the central bank. Each country optimizes its well-being by the choice of its fiscal policy for a given monetary policy which happens to be the one that maximizes the joint well-being of the various countries. One therefore obtains the optimal combination of all economic policies, and there is no need for any additional regulation such as the Stability Pact.

Let us examine again the case in which a country is hit by an unfavourable shock in demand and, furthermore, does not penalize public-sector deficits. It will therefore implement an expansionary budget policy (see (10) of Insert 2) to stabilize its production. As the latter is lowered to the targeted level, the ECB — which is entrusted, according to the hypothesis made here, with the common well-being — does not have to intervene: the interest rate of EMU does not change, and the other countries are not affected by the shock. Consequently, they have no reason to implement an accord such as the Stability Pact.

4 - The case of a specific behaviour of the European Central Bank: price controls

In the above, we have supposed, and this was very important with regard to our results, that the ECB had as its objective the real common objective of European governments (the common social objective consisting in full employment, low deficits where they are penalized, etc.). This initial situation is perhaps not very realistic. For various reasons (simplicity, concept of task sharing between the central bank and the government, assessment of extent to which the objective is met, etc.), independent central banks set a specific objective. This is, usually, price stability or low price increases. Consequently, there is independence not only in terms of instrument but also of objective. Let us suppose that against this backdrop there is still no cooperation between the governments and the central bank, and also that the level of production ensuring price stability is lower than full employment production. The governments will implement useless fiscal expansion to seek to offset the fact that monetary policy is restrictive in order to stabilize prices (see (13) in Insert 3). If they take into account the central bank's policy, they realize this attempt is purposeless and do not seek to obtain a higher level of production than is compatible with the ECB's inflation target (see (14) of **Insert 3**). In this case, if **cooperation** (in which the central bank's objective is taken into account) is **impossible, the Stability Pact** (see (16) of Insert 3) is **effective, since it forbids governments to carry out sterile fiscal expansion drives.**

Insert 3

Spontaneous and optimal fiscal policies

when the central bank controls inflation

We complete as follows, the model of Insert 1: in each country, inflation p is given by:

(11) $$\begin{cases} \pi = y + q & \text{(first country)} \\ \pi^* = y^* + q & \text{(second country)} \end{cases}$$

with $q > 0$. This means that $y\left(y^*\right) < 0$ is required to avoid inflation, whereas $y = y^* = 0$ corresponds to full employment. The European Central Bank now has as its target the absence of inflation, at a European average, i.e. $p + p^* = 0$.

This implies for the choice of interest rate:

(12) $$ar = \frac{g+g^*}{2} + \frac{e}{2} + q$$

$q > 0$ represents the possibility of a conflict between government and central bank regarding the targeted level of production ; $e < 0$ an unfavourable shock in the first country.

At equilibrium without cooperation, each government minimizes its loss $\left(L \, or \, L^*\right)$ by taking r as given**,** hence the same reaction functions for g and g^* as in Insert 2.

$$\begin{cases} g = ar - e \\ g^*\left(B+1\right) = ar \end{cases} \qquad \left(e < 0\right)$$

and, lastly:

(13) $$\begin{cases} ar = 2q\dfrac{B+1}{B} \,;\, g = 2q\dfrac{B+1}{B} - e \,;\, y = 0 \\ g^* = \dfrac{2q}{B} \,;\, y^* = -2q \,; \end{cases}$$

The first country to have full employment as its sole objective achieves it by pursuing a highly expansionary fiscal policy. This drives up the interest rate sharply, and leads to a shortfall in production in the second country to prevent inflation $\left(y + y^* = -2q\right)$. **If there is cooperation,** it can only be between budget authorities since the central bank necessarily practises (12).

We therefore have: $Min \; y^2 + y^{*2} + Bg^{*2}$

with r taken as given, and this leads to the same solution as (13), since g does not influence directly the well-being of the second country, and g^* does not influence directly the well-being of the first country.

However, this is partial cooperation. Let us suppose now that (12) is taken into account. We then have:

$$Min\left(\frac{g-g^*}{2}+\frac{e}{2}-q\right)^2+\left(\frac{g^*-g}{2}-\frac{e}{2}-q\right)^2+Bg^{*2}$$

hence:

(14) $$\begin{cases} g=-e\,;\, y=-q \\ g^*=0\,;\, y^*=-q \\ ar=q \end{cases}$$

The shock is equitably shared $\left(y=y^*=-q\right)$; the deficit of both countries is far smaller than without cooperation but nevertheless $g>0$.

If there is a **Stability Pact**, let us suppose that constraints $g\leq 0, g^*\leq 0$ apply, and there is no cooperation.

We will have

$$(15)\quad \begin{cases} g=0\,;\, g^*\left(B+\frac{1}{2}\right)=\frac{e}{2}+q\left(or\ g^*=0\ if<0\right); \\ \qquad ar^{(1)}=\frac{B+1}{B+\frac{1}{2}}\left(\frac{e+q}{2}\right) \\ y^{(1)}=\frac{\frac{B}{2}e-(B+1)q}{B+\frac{1}{2}}\,;\, y^{*(1)}=\frac{-B\frac{e}{2}-Bq}{B+\frac{1}{2}}\,; \\ y+y^*=-2q \end{cases}$$

If $g^*=0\left(\frac{e}{2}+q>0\right)$:

$$(16)\quad \begin{cases} ar=\frac{e}{2}+q \\ y=\frac{e}{2}-q \\ y^*=-\frac{e}{2}-q \end{cases}$$

This situation appears if the shocks are small in relation to the scale of the conflict (measured by q) between the ECB and governments.

(1) in the case where $\frac{\varepsilon}{2}+q<0$, for example in the case where the unfavourable shock $\varepsilon<0$.

Let us suppose now that there is no long-term conflict between the central bank and the governments, thereby entailing that the production target of the latter is compatible with the central bank's inflation target), but return to the case of an asymmetric shock in demand in a country with no great aversion for public-sector deficits. The situation is then similar to that obtained when the ECB shared the social objective: if policies are not coordinated, this country hit by a drop in production, pursues an expansionary budget policy and, if it does not penalize the deficits, can return to full employment. As fiscal policy and the unfavourable shock offset one another, there is no reason why inflationary pressures should emerge. As a result, the ECB does not react, and this implies that the other countries are not affected by the shock, and the fiscal reaction of the country hit by the shock does not have to be limited. As in the case where the ECB shares the same objective as the governments, the fact that fiscal policy merely lowers production to its normal level implies that the ECB has no ground for changing interest rates.

The Stability Pact would therefore prevent a country hit by a recession from reacting (compare (14) and (15) in Insert 3). Consequently, its inflation would fall below the targeted level, the interest rate of EMU would be lowered and the other countries forced to implement an excessively restrictive fiscal policy since the common monetary policy would be too expansionary. Spontaneous equilibrium (without organized cooperation) is therefore preferable.

SUMMARY: in what cases is a Stability Pact required?

We have been able to ascertain three cases in which in a Monetary Union, an accord such as the Stability Pact draws near the optimal situation, improves well-being over the situation where fiscal policies are chosen independently by governments:

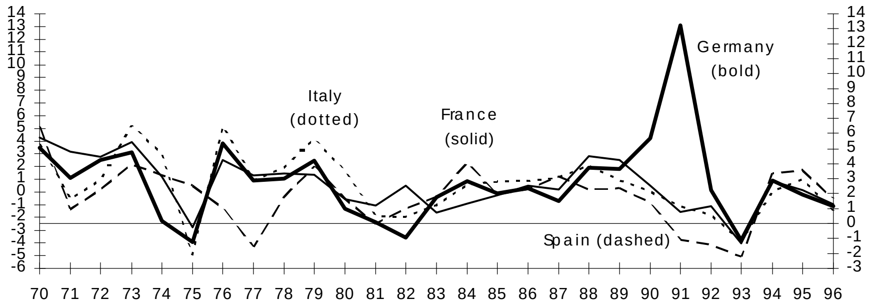
- the common equilibrium interest rate reacts directly to increases in public-sector deficits, regardless of the production level. Even if the country carrying out fiscal expansion simply seeks to stabilize its real activity, hit by an unfavourable shock, it consequently transmits an interest-rate hike to the other EMU countries. We have deemed this situation unlikely. On the other hand, the financial markets might discriminate between issuers, and only the interest rate specific to said country rises. This hinges mostly on the extent to which de facto solidarity among the issuers in euros exists. On the other hand, the formation mode thereby supposed with regard to interest rates is highly unlikely. If activity is depressed, a public-sector deficit should not drive up rates, certainly not the key intervention rates of the central bank, whether it has set an economic growth or an inflation target;

- certain countries run up continuous public-sector deficits without there being any weakness in their real activity. This raises the issue of discrimination between a cyclical correction and the ambition of stimulating durably growth. Fiscal policy must certainly not be used to achieve the latter objective, as the public-sector debt would grow steadily and it is natural that the systematic recourse to the public-sector deficit should be prohibited as opposed to a cyclical recourse. The problem obviously lies in that a threshold above the deficit (even with a degree of flexibility as in the Stability Pact) does not discriminate between the two possible sources of the deficit (one reasonable, the other reprehensible). Furthermore, the behaviour of European governments in recent years has shown that none intended resorting to a chronic deficit. The likelihood of a deviant EMU member country with a structural tendency to run up excessive deficits is low;

- the Stability Pact may be useful in the case of a conflict between the central bank and governments. We have envisioned the case whereby the lack of an inflation target at the ECB would entail a level of activity lower than what governments can accept. In this case, needlessly stimulatory policies, aimed at opposing the monetary policy, could be implemented and the Stability Pact would be effective in that it bans such policies. Currently, inflation is no longer feared in Europe, and probably with the high level of unemployment, ensuing productivity gains and low rises in unit costs, price rises will remain benign. Therefore this type of conflict between the ECB and governments will not occur. Nevertheless, the very possibility of such a conflict entails the potential danger to be found in granting to the central bank autonomy to set an objective which would be different from EMU's real social objective. We have seen that if there is independence with regard to the instruments but not to the objectives, the lack of coordination among fiscal policies has no unfavourable consequence.

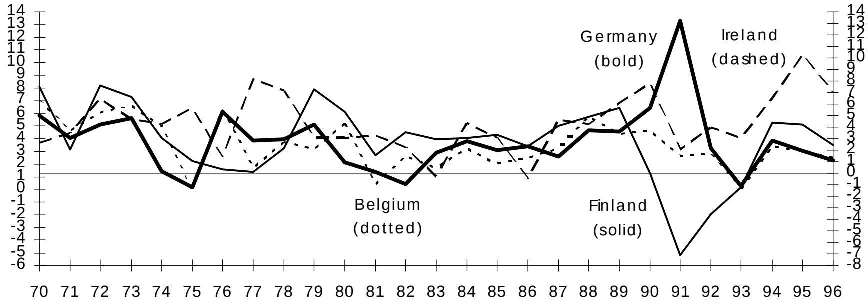
Lastly, the most likely situation is that in which the Stability Pact will play in the case of a one-off shock specific to certain EMU countries. **Charts 13 and 14** show the growth rate of a few European countries. They confirm that asymmetric (i.e. specific) shocks do occur: Germany's unification, Spain's recessions (1977 and subsequently 1991-1993), the crisis of Scandinavian countries (1990-1992); and Ireland's growth is continuously atypical. If an unfavourable shock occurs in a small country and if, as mentioned above, this country has not wisely cut its public-sector deficit beforehand to a level that leaves it with significant room for manoeuvre in relation to the 3% of GDP threshold, it will be in an inextricable plight. It will have no possible reaction in terms of monetary policy or exchange rate policy and hardly any fiscal measures to draw upon...

Chart 13
GDP/GNP growth (as a %)



Source: OECD

Chart 14
GDP/GNP growth (as a %)



Source: OECD

We have seen that theoretically, and if interest rates are formed in a reasonable manner, limiting the deficit of the affected country is useless in the case of an asymmetric (transitory) shock. This is because the impact of the shock is not transmitted, under the guise of an interest-rate hike, to neighbouring countries. On the contrary, preventing a desirable fiscal expansion may lead to either a uselessly expansionary global monetary policy, if the country affected by the shock is big enough; or to an unsustainable situation, if it is a small country.

Summary of the Discussion

The first meeting took place in Paris and gathered about thirty economists from France and Germany. It was opened by an introduction of the organisers stating the aim of those meetings, which is to offset a lack of professional dialogue between the two countries. The wide diversity of opinions, as well as the origin of the participants should reflect the national debates and boost bilateral discussion. This will help reducing cross-border misunderstanding, a necessary condition for sound foundation of EMU.

Two topics were debated :

- does EMU need an Employment Pact? (see the paper by K.-W. Schatz)

S is the Stability Pact and efficient agreement? (see the paper by P. Artus)

Does EMU need an Employment Pact?

The discussion focused on three main points. First, the diagnosis of French and German unemployment in order to identify potential convergence between the two countries. The idea was to analyse the adequate policy responses, at the national and/or European level. A distinction was made between short-term policies (fiscal or monetary) designed to fight cyclical unemployment and longer-term policies targeting structural unemployment. The latter involve structural reforms of the labour market and/or the welfare system. The discussion then focused on the Employment Pact as an appropriate response with respect to this analysis.

1. Diagnosis

The common diagnosis was that unemployment rates have converged over recent years. However this convergence hides diverging situations among the unemployed:

- First, there is no specific youth-unemployment problem in Germany: the youth unemployment rate is equal to the national average. In France, the youth unemployment rate is twice the national average.

- Second, the distinction between structural and cyclical unemployment reveals two different situations. French economists generally agree that of the current unemployment rate, about 4% must be attributed to the business cycle, while the rest is related to a mix of factors linked to the welfare system and the organisation of the labour market. In contrast, the rise in the German unemployment rate is a more recent event (it mainly surged over the last 3 years). Hence, even though about the same proportion of the unemployment rate is cyclical, the structural unemployment rate ("Nairu") is much lower in Germany.

To synthesise, three main points can be highlighted. First, there is a specific youth problem in France. Secondly, in both countries, a relatively large proportion of unemployment is cyclical, but at the same time, there has been a rise in structural unemployment (though more so in France). The latter reflects characteristics of the labour market for most, but some also put forward the hypothesis of downward nominal rigidity.

2. Policy Management

Thais diagnosis emphasises that several types of policy interventions have to be considered, taking place at two different levels, namely short-term and long-term interventions.

Short term

There are clear differences between German and French policy management.

In Germany, policy action is, in principle, strongly decentralised, in the senses that one institution is responsible for one social objective. Thus, the Bundesbank is in charge of price stability; the Ministry of Finances is responsible for the budget; the Unions (employers and employees) deal with the level of unemployment. In reality, these distinctions are less clearcut, however.

French policy management, in contrast, traditionally combines a set of policies to fight a set of problems : the government tends to be present in several dimensions of policy management. However, this tradition is also evolving: the Banque de France is now independent and solely responsible for the price level. Still, the government, which is in charge of the budget, is also involved in employment and wage negotiations.

It emerged from this debate that French economists tend to favour a situation of policy-mix, such as in the United States, whereas German economists are more in favour of a clearly decentralised system.

Long term

Longer-run policies aim at targeting structural unemployment: the discussion distinguished between labour market regulations and the welfare system.

Structural policies appeared better candidates than short term policies for co-ordination at the European level, as long as they involve designing a set of rules, rather than raising special funds for reallocation. First of all, the introduction of more competition into the labour market ("introducing the market into the labour market") has already been discussed at the European level, in particular in the White Book of Delors, as well as in the development of the Single Market. The problem of labour mobility (between European countries as well as mobility within countries) could also be part of a European policy. The Commission could naturally be the institution in charge of designing such policies.

There was agreement that it is necessary to preserve "the European social model", although there was not a unanimously shared meaning of this term. Thais would make policy co-ordination at this level more difficult.

Finally, selective policy interventions at the European level were generally regarded as inefficient (their main effect being a switch in the queue to employment), and there was agreement that such interventions should remain State-specific.

3. Is the Employment Pact an Appropriate Response to the European Unemployment Problem?

First of all, there was a wide consensus that the conclusion of the Amsterdam summit was purely cosmetic. Its main aim was to send a message of concern regarding unemployment to the European population. Therefore, the discussion was set aside from the Amsterdam conclusion.

Second, a distinction between a "pact" and the co-ordination of macro-economic policy was regarded as necessary. A "pact" explicitly requires :

S the definition of a clear objective;

- the definition of the tools that may be used to reach this objective;

- the definition of sanctions should the objective not be reached.

From a practical point of view, a pact on unemployment seems difficult to implement. It would be hard for European countries to agree on a target rate for unemployment. Furthermore, there is no European institution that seems adequate to design and implement employment policies. Finally, the definitions (and the credibility) of possible sanctions would be rather difficult, as the experience of the Stability Pact shows.

Moreover, this reveals a problem common with any form of policy co-ordination regarding unemployment. The differences between French and German unemployment imply the use of different policies.

In Germany, monetary policy is believed to be exclusively designed for price stability. In France, it is a widely shared view that any room of manoeuvre should be fully utilised : hence it is believed that the central bank could have lowered interest rates a bit more to sustain a sufficient level of aggregate demand;

It was agreed that, judging from historical experience, the Stability Pact would not constrain fiscal policies severely. Furthermore, the responsibility to cope with asymmetric shocks should remain with each national government. Yet, some thought that the use of co-ordinated fiscal policies could help to cope with the common problem of weak demand, while remaining within the limits allowed by the Stability Pact.

To conclude, there was a consensus on the need for co-ordination of labour markets reforms. Regulation of the labour market may be done at the European level. But beyond the design and implementation of rules, it seems difficult to co-ordinate labour or welfare policies at the European level, even though a global debate seems necessary.

Is the Stability Pact an efficient agreement?

The discussion focused on three points. First, the justifications of the Stability Pact and its potential efficiency with respect to its objectives. Second, the case for co-ordination of the common monetary policy with national fiscal policies, and, third, the adequate weights of inflation and unemployment in a ?social objective? function.

<u>1. Justifications of the Stability Pact</u>

There was a widely shared consensus that the Stability Pact is primarily a political tool. It was designed to give the public assurances that monetary union would not endanger monetary stability.

Based on historical experience with the reaction of budget deficits to recessions, German and French economists tended to agree that the numerical targets for the deficit spelled out in the Stability Pact are not too restrictive, although the Stability Pact might require "fiscal adjustment" in times when these are least convenient. It was believed that the Pact would leave countries faced with asymmetric shocks enough room for manoeuvre.

Regarding the credibility of the Pact, there was a consensus that the constraints imposed by the Pact are not binding. The sanctions are difficult to enforce: public opinion, in all countries, would hardly accept to see a percentage of GDP going into common European funds, especially at the time of a recession.

The main advantage of the Pact is seen as implying more transparency in the conduct of national fiscal policies. This transparency should ease the conduct of monetary policy, in the sense that it will not have to counterbalance a lack of fiscal credibility.

2. Monetary and Fiscal Policy : A Case for Co-ordination?

For some, the Stability Pact was viewed as a second-best substitute to policy co-ordination. By ensuring a "reasonable" level of public sector deficits, a signal of sound public finances would be sent to the markets and the European Central Bank. This should help interest rates to remain low.

Several participants, mostly French, argued against this statement for two reasons :

S if markets are rational, given the no bail-out clause, the level of long term interest rates spreads will only reflect differences in sovereign risks;

- empirically, it is extremely difficult to provide evidence of a robust correlation between interest rates and public sector deficits.

The case for co-ordination of monetary and fiscal policy was therefore not regarded as clear-cut. French economists, on the one hand, tended to believe that there should be a strong economic authority not necessarily to counterbalance the European Central Bank, but one that would facilitate the implementation of a proper policy-mix as in the US. On the other hand, German economists tended to believe that monetary union will automatically lead to a stronger political union, but that this issue was unrelated to the co-ordination of fiscal and monetary policies.

3. The Appropriate Weights of Inflation and Unemployment in the Social Objective Function

Throughout the discussion, it appeared that, despite the very low inflation rates that have prevailed in Europe over the last ten years, inflation may not have altogether disappeared yet. Some still feared that a number of countries might use inflation to reduce the burden of public debt. Furthermore, the costs, in terms of unemployment, of low inflation policies appear so high that their sustainability may be put into question. Yet, as was underlined by some participants, the state of social security and pensions schemes, together with the demographic evolution, and the current level of saving rates should silence such fears.

Conclusion

Cultural differences in the conduct of macro-economic policies are quite strong. Germany has a federalist approach whereas France has a centralised one. A single policy formulated by a single European institution is, therefore, a big step forward.

There is agreement, in principle, that there is a need for co-ordination of labour market and fiscal policies. However, the form of coordination remains a subject of debate. With regard to the new institutions of the European Monetary Union, the Stability Pact was viewed is an inefficient agreement, as neither the no-bail-out clause, nor the sanctions were believed to be enforceable. Thus, it is at most a second-best solution to ensure collective discipline in the Union. The fight against unemployment needs to be tackled at both the national and the European level, but not with a Pact.

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