MACRO-ECONOMIC FLESH FOR THE SKELETON OF THE INTERNAL MARKET

REDISCOVERING MACRO-ECONOMIC POLICIES FOR EUROPE

A macro-economic strategy from the ETUC to achieve high non-inflationary and investment-led growth

Micro needs macro and social

More competition through a better functioning internal market and drawing more people into the labour market are the backbone of the recent European Commission proposals to relaunch growth in the European economy. This is, however, only part of the story.

It is not enough, because it also depends on *how* people are drawn into the labour market. Should this be on the basis of €1 jobs? Or through social protection/labour market policies that provide social support and training investment for the unemployed so that skilled people can be matched by productive jobs?

It is also not enough because there must be enough 'capital' available. For skilled workers to be employed in productive jobs, there has to be sufficient machinery, offices, network infrastructure, etc

What is driving investment?

Investment (another word for building the capital stock) is thus the key to a high-growth scenario of more *and* better jobs.

What factors drive investment? Essentially a combination of three factors: sufficient profitability, sufficient financing available at low long-term interest rates, and *above all* sufficient demand prospects. Research from the ECB (*Monthly Bulletin*, February 2004) indeed confirms that investments are primarily driven by demand. If firms are confident that there will be sufficient demand for their products, they will release their 'animal spirits' and start investing.

Does this imply continuous aggregate demand injections?

Yes to the latter part of the question. Aggregate demand injections are enormously important to *trigger* a cycle of investments. When investors' and consumers' confidence is low and when the level of aggregate demand is insufficient compared to the already available capital stock, then active aggregate demand policies are indispensable. They restore investment incentives by eliminating existing slack. They provide a basic element of the investing climate by reassuring potential investors that, even if demand falls and capacities are under-utilised, fiscal and/or monetary policies will help.

No, to the former part of the question. Once investments take off, the growth cycle will reinforce itself. This is because investments do not only build additional capital and supply; they are also a component of aggregate demand itself.

This has enormous implications for fiscal policy. It means that a temporary increase in the budget deficit (from 2 to 3% or from 3 to 4% of GDP) can push the economy into an investment-led, self-sustaining, non-inflationary growth cycle. This, in turn, offers the possibility of gradually bringing down deficits and debts thereafter.

How important can such a macro/investment strategy be for growth?

Very important. When investments are growing at an annual rate of 7-8% a year, the expansion of the capital stock is such that the economy's potential growth rate increases 0.2-0.3% *per year*. In other words, Europe's potential growth rate could be raised from 2% now to 3% or even 3.5% by 2010.

Will triggering an investment-led cycle immediately bring back the inflation spectre?

Not if there is spare production capacity and high unemployment (and this is indeed the case now in the euro area). If so, the additional aggregate demand that macro-economic policy injects can be met by using these spare capacities. Moreover, and if necessary, imports from third countries constitute an additional buffer to address part of the additional demand temporarily, until new investments create additional production capacity. This also implies that actual growth can and should be higher than potential growth for a couple of years. With potential growth estimated at 2% and an amount of slack in the economy of around 1.5-2%, this means Europe's economy can grow in the coming three years at an average rate of 2.5-3%. And by then, growth potential will have increased because of the expansion of the capital stock.

How is it possible to avoid the investment/growth cycle being undermined in the medium run by accelerating inflation?

It is necessary to adapt the balance in macro-economic policy-making *once the investment-led cycle has convincingly taken off.* At that moment, economic common sense dictates gradually withdrawing the initial demand stimulus because the cycle has become self-sustaining through the dynamics of investment. Otherwise, the economy will indeed overheat and inflation could follow.

Here, we discover the real sense and meaning of the Stability and Growth Pact. Cutting deficits without paying attention to the economic context is ludicrous. But gradually cutting the deficit, and even turning it into a sizeable surplus, is entirely rational and indispensable when achieved in line with such an investment-led growth cycle.

Moreover, lower public deficits will feed into the capital market, balancing higher capital demand coming from the investments with lower capital demand from the government side. This helps to keep long-term interest rates low so as not to discourage investors.

What role for wages in this?

Collective bargaining partners, both trade unions and employer organisations, have an important role to play here. There needs to be sufficient profitability (compared to the return on alternative capital investments, for example the long-term interest rate) for Europe to enjoy an intensive investment-led growth cycle. Profitability is not a problem at the moment. Profitability is now roughly comparable with the 'golden sixties', when Europe indeed enjoyed dynamic investment.

If and when a new growth cycle, accompanied by falling unemployment, takes off, then it is important to avoid real wage evolution outstripping productivity, thereby pushing profitability and investments down and inflation up.

That is why systems of *coordinated* collective bargaining are so important. Through coordination of collective bargaining, attention can be paid to macro-economic needs (such as the need to maintain price stability) and the competitive bidding-up of wages from enterprise to enterprise can be avoided.

At present, however, with workers' insecurity at a maximum level, the challenge is just the opposite. It is to avoid competitive wage dumping where workers are under pressure from employers to 'export' unemployment by cutting wages. This strategy, however, weighs on aggregate demand and partly explains why the European economy is not staging a convincing recovery.

Is the present European macro-economic framework promoting such a high growth/high investment strategy?

No, not at all. At present, both fiscal and monetary policy-making is dominated by the drive for 'stability'. Proactive aggregate demand policies are simply rejected and policy-makers adopt a 'wait and see' attitude:

- Finance ministers have stood by and watched the slump push deficits higher. The automatic stabilisers may have prevented the slump from turning into a fully-fledged recession, but this has not been enough to turn the slump around towards strong recovery. No fiscal policy initiative has been taken to get the economy back on its feet.
- Monetary policy has acted, but too little and too late. Interest rates were reduced long after the slump had already unfolded.
- This 'wait and see' attitude has failed to prevent investors' and consumers' confidence from falling. The end result is high deficits and low interest rates without much growth. If policy had been implemented in time to support economic confidence, then high deficits and low interest rates would have delivered higher growth (see also the note 'Europe has itself to blame').

Instead of defending Europe's economy against downturns and setbacks in confidence themselves, policy-makers place their hope in the rest of the world, and recovery of demand coming from exports to third countries. For an economic entity such as the euro area (a large, closed economy) this does not make sense. Instead of taking its economic destiny in its own hands, Europe's recovery becomes dependent on the whims and moods of American consumers. The experience of the past years shows that such a strategy does not work.

Reforming Europe's macro-economic framework. How to focus on stability *and* high growth?

What should be done?

- Ensure that the Ecfin ministers' reform proposals for the Stability and Growth Pact are not limited to avoiding a fiscal contraction in a downturn. Also make sure that they offer countries a sufficient dose of macro-economic reactivity. Do so by 'Lisbonising' the pact and considering Europe's innovation gap as an 'exceptional circumstance' warranting a temporary deviation from the Stability Pact and its 3% barrier, for those Member States investing in the Lisbon priorities of research, training and active labour market policies. Coordinate and monitor such countries' action plans at the European level, so as to give the European public a signal of confidence.

- Strengthen economic governance in the euro area. Improve fiscal policy by focusing on the euro area's average deficit and drawing up a European budget.

- Reinforce the existing macro dialogue (Cologne Process). Increase awareness of this institution by making the key positions of the different parties known to the public. Link up the macro-economic dialogue with the Tripartite Summit of social partners. Organise joint Ecfin/ Employment Councils with a hearing of the social partners and central banks to connect the dialogue up with actual policy-making.

- Open an in-depth discussion and dialogue with an *independent* ECB on its mandate (price stability *and* growth as described in the Treaty), its inflation target and its monetary policy strategy. In particular, convince the ECB that monetary policy-making must be forward-looking and that it should be as active in cutting rates when inflation threatens to dive under its price stability target as it is tough when inflation goes above the target ('symmetrical' monetary policies).