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ETUC AND THE LISBON MID-TERM REVIEW:
A DISCUSSION AND BACKGROUND DOCUMENT

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Introduction

The political commitment behind the Lisbon agenda is one of following a 'high road' strategy. Instead of cutting wages and competing on deteriorating working conditions, the Lisbon agenda has opted for a strategy of innovation and high productivity/good quality jobs in order to make Europe the most competitive region on the world.

Obviously, the ETUC has welcomed such a Lisbon strategy and has urged recent European councils to reinforce the Lisbon agenda by:

- Pursuing policies to give the European recovery a chance (see resolution of the Executive Committee of 4-5 December 2003).

- Rebalancing the strategy by strengthening the social pillar (see resolution of Executive Committee of 17-18 March 2004).

The upcoming mid-term review of the Lisbon strategy is vital to keep and implement the original Lisbon approach of pursuing high growth <u>and</u> social cohesion <u>and</u> sustainability <u>at the same time</u>.

In practice, this mid-term review is being launched by a high level group (HLG) under the presidency of Wim Kok. This HLG will present its report to the new Commission President at the end of October, with a first discussion already planned at the European Council on 5th November. On the basis of this HLG report, the Commission will produce its own communication, with a final discussion planned for the 2005 Spring Council meeting.

In order to weigh on the Spring Council conclusions, the ETUC has to get its messages into this process of mid-term review. This note provides a first draft on what could be the ETUC's input in this process. This background document has been discussed at the Economic and Employment Committee in September. Together with the discussion at the ETUC's Executive Committee in October, along with the final HLG report, this will allow us to draft a Resolution for the December Executive Committee meeting.

This background document first presents what could be the 'key' ETUC messages and policy requests into the Lisbon mid-term review. A second chapter elaborates further on the need to improve the policy focus in the Lisbon agenda and, on the basis of country comparisons, argues that we need to focus on a set of policies that are beneficial to both economic growth as well as social cohesion. A third chapter zooms in on the need to reform the macro–economic policy regime in order to make Europe its own engine of economic growth.

Chapter I: Key ETUC messages and key ETUC proposals

A. Key messages

Yes to Lisbon. No to ‘trickle down’ strategies

The basic philosophy of ‘Lisbon’ is to reach ambitious objectives in the economic, the social and the sustainability dimension through a strategy of innovation and by investing in a knowledge society.

The mid-term review of the Lisbon process should continue to respect this approach and should certainly not be abused in order to narrow the Lisbon agenda down to the sole pillar of competitiveness. ‘Trickle down’ strategies which only have eyes for competitiveness and forget about the social and environmental dimension will not work:

- Economic success does not automatically equal high social cohesion. At present, there are several member states that are achieving high employment rates while at the same time also suffering from very high poverty rates. In these member states, one third of children live in families in poverty, which does not bode well for the future human capital stock of these countries (see Chapter I for further information).

- Competing the emerging economies on the basis of low wages, long working hours and bad working conditions is a dead–end street. There will always be countries with even lower wages and worse working conditions. In a globalising economy, Europe should instead harness competitiveness by investing in innovation, productivity and in the skills of workers.

- If Lisbon becomes equated with the dismantlement of social Europe, the ‘ownership’ of the Lisbon strategy as such will be refused. Workers and the European public will not accept such policies, with a worsening ‘delivery gap’ as a consequence.

In short, the Lisbon strategy must not be transformed into a pure ‘business’ or ‘market strategy’.

Focus on the policy agenda. Put Social Europe at the heart of the Lisbon strategy.

In past years, Lisbon has been 'about everything, hence about nothing'. In order for the Lisbon process to work, it needs to focus on a set of policies which are essential for growth, social cohesion and sustainable development.

Here, the Lisbon policy makers need to learn from those member states that have succeeded in combining high employment rates with high social cohesion. All of these high employment/high social cohesion countries have, with no single exception, invested massively in active labour market policies (including high unemployment benefits), in education and lifelong learning, in policies to reconcile work and family life, in workers' participation and in research and development. These countries have not taken the 'low road' of reducing wages to the lower productivity levels of some workers. Instead, they have chosen for the 'high road'. Instead of adapting wages to productivity, they have sought to increase the productivity of all workers in order to ensure high(er) wages. <u>In other words, these particular member states have used the productive force of social policies.</u>

By focusing on this set of social policies, the Lisbon process can be much improved. In the present policy process, this focus has been missing. For example, whereas the number of active people involved in lifelong learning activities modestly increased from 8 to 8.5% from 2000 to 2004, substantial amounts of the public budget have gone to reducing wage costs for lower skilled workers in some countries, leading to a (downward) break in the trend of labour productivity. Also, the different Lisbon council reports lack transparency, in particular they fail to provide statistics that compare between the different years. It should therefore not come as a surprise that there is not much peer pressure on these issues.

Yes to a European internal market with social minimum standards. No to unfettered competition

The ETUC's philosophy has always been to support the idea of the European internal market. Whereas the single market has indeed sometimes led to painful adjustment processes for workers, it has also provided for higher productivity through economies of scale and re-specialisation of productive activity. However, this support for the European single market does not come without additional and strict conditions.

- One condition is that workers need well developed social policies in order to be in a better position for coping with shocks and change (‘security in change’). This is the agenda of active labour markets policies, well developed unemployment benefits systems, education, training and lifelong learning (see previous point).

- The other condition is that there needs to be a ‘social level playing field’. On a single market, the forces of competition need to be guided in order to eliminate ‘perverse’ competition on the basis of poverty wages, bad jobs that are excessively flexible, exaggerated long working hours and dangerous working conditions need to be avoided. Such practices may improve competitiveness, but only in the very short run. In the somewhat longer run they will lead to an unhealthy, demotivated, burned–out and insufficiently skilled work force, hence in an uncompetitive work force. Here, social minimum standards have a key role to play. Social minimum standards ensure that corporations and workers do not get trapped into a competition that is detrimental to economic development in a longer time frame. Moreover, in doing so, these social minimum standards also force corporations to make another policy choice and to address the fierce competitive forces of a single market on the basis of productivity and innovation. In short, if the single market wants to focus on high productivity, then it urgently needs social minimum standards that close down the ‘low’ road of going for short run competitiveness on the basis of poverty wages and bad working conditions.

In the current Lisbon review, a particular important aspect of this is the services directive proposal which is seeking to boost an internal market for services while at the same time making it impossible in practice to implement and respect minimum labour standards.

Another issue to focus on are the new member states, where the implementation of the ‘European social acquis’ still needs much improvement. For example, inquiries by the Dublin Foundation reveal that 40% of workers in the new member states complain of work related diseases (as opposed to 25% in the EU-15). In order to maintain a competitive work force in the future, this situation needs to be addressed.

Deliver the Lisbon results by reforming Europe's macro-economic policy regime

If there is now a sense of failure surrounding Lisbon, it is because of the poor growth and job outcomes of the last four years. And these poor outcomes have nothing to do with structural weaknesses and so–called rigidities of the European economy. The type of labour and product market regulations that exist now in Europe also existed when growth was good and was reaching 2.5 to 3% in the second half of the nineties. Instead, the 2001-2004 slump in European growth has everything to do with the existing European macro-economic policy regime. This regime is exclusively focusing on the goal of macro–economic stability, and is leaving the job of stabilizing the business cycle to policy makers in the rest of the world (who then are supposed to engage in those policies which Europe deems 'irresponsible' and is failing to do, i.e. slashing interest rates and providing fiscal policy relief for the economy). This policy of over reliance on external demand growth weakens consumer's and investor's confidence and makes the European economy vulnerable and non–resilient when hit by shocks.

The importance of reforming Europe's macro-economic policy regime can not be underestimated. While <u>positive </u>structural reform policies (as described above) are also necessary, they only result in more jobs and more growth when improvements on the supply side of the economy are being matched with similar developments on the side of aggregate demand. To put it bluntly, we can train as many workers as we wish, but this is to no avail if there are no job available. Moreover, business cycle stabilisation not only has static, one–off production and employment effects (closing the negative output gap) but also dynamic effects (increasing the potential rate of growth, triggering innovation processes). <u>In a nutshell, a growth–friendly macro-economic policy regime is the missing link in the Lisbon strategy!</u>

The mid-term review should pronounce itself clearly on the need to put adequate aggregate demand policies back in the focus of European policy making so that Europe can become its own engine of growth. The review should also spell out pathways for reform (see chapter III for further proposals).

A pro-active approach to sustainability

Like Social Europe, the area of sustainable development yields important benefits for Europe's competitiveness and its growth potential. Investing in sustainable development will:

- reduce Europe’s dependency on energy sources we need to import (petrol and gas). In fact, Europe’s dependency on these energy sources is projected to increase substantially, from 50% at present to 70% in 2030 for the EU–25. Together with the liberalisation of the energy market, this increases the risk of high volatility in oil prices, which in turn puts pressure on wage bargainers to moderate wages in order to avoid inflationary wage and price spirals.

- Improve European competitiveness by economising on expensive energy and raw material inputs.

- Provide extra jobs in sectors such as the sustainable energy sectors and clean technology development.

- Create a ‘first mover’ effect. Sustainable development solutions will, in the near future, be the sector for which demand in the world economy will grow the most. Europe’s industry must make sure it can provide the technological solutions to the pollution and waste problems caused by the intense industrial development in emerging market economies. Here however, it is necessary to correct for actual developments. At present, Europe is most competitive in ‘end of pipe technologies’, in providing solutions after the environmental damage has been done. More should be done to invest in preventive technologies which prevent waste and pollution.

But sustainable development is more than just good for growth and employment. Sustainable development policies are also good for social cohesion:

- Providing sustainable alternatives for imported petrol and gas will also reduce the phenomenon of ‘fuel poverty’. The number of households having to spend more than 10% of its income for heating purposes is increasing also in Europe.

- Environmental risks tend to be linked to risks for workers’ health. And so are ecological inequality and social inequality. Those workers in precarious employment and flexible jobs are also exposed to pollution in their living conditions and to poor housing conditions. Legislation to protect and improve the environment, investments in social housing will reduce social and ecological inequalities.

Simplify Lisbon. Involve the social partners

With 12 different OMC-processes and some 100 benchmarks, the Lisbon process is ‘heavy’ and prone to ‘policy picking’. At the European level, policy makers can use (abuse) Lisbon as a handy vehicle to spread any policy message that happens to be in fashion at the time, thereby delivering strange shifts in policy priorities from one year to another. And at the national level, national governments can pretty much choose which set of Lisbon policy priorities they want to pursue. Hence, a stringent follow–up, which is necessary for implementing ‘peer pressure’, is not very likely.

Simplification of the Lisbon process and national implementation of the Lisbon agenda can be encouraged by:

- Having the 2005 European Council decide on a ‘medium term Lisbon policy plan’ which identifies the set of policy priorities which are crucial for the Lisbon agenda and its three pillars. In our opinion, this would imply focusing on Social Europe and on a growth friendly macro-economic policy regime.

- In response, national governments are to produce one single national action plan, describing how governments will take up the general Council’s orientation (what will be the national targets, which measures should be taken?). **In drawing up this plan, social partners and national parliaments should be closely involved**. The national action plans also need to respect the balance between the three Lisbon pillars.

- As a follow-up, the Commission should produce an evaluation, to be discussed with national governments, social partners and national parliaments.

<u>Such a proposal would increase transparency and national ownership of the Lisbon policy agenda and would therefore be conducive for effective implementation of Lisbon. In addition, involving European social dialogue in this process (by having European social dialogue consultations before the Commission report on the Lisbon priorities for the Spring European Council) would also enhance ownership and involvement of the different policy actors.</u>

B. Key proposals for action: A first summing up

- A European investment plan in social infrastructure (lifelong learning, well–functioning employment services that provide guidance, counseling and training to the unemployed, childcare and care for the elderly, a special action plan on gender). A special action plan and particular attention also needs to be devoted to the urgent needs of the new member states.

- An action plan for social minimum standards and increased social cohesion in the European single market (adoption of an adequate minimum income guarantee and/or a relative minimum wage implemented either through legislation or collective agreements; strengthening instead of weakening the working time directive/a clear ending to the opt–out).

- Reforming the macro policy framework in Europe by making it friendlier to economic growth.

- An action plan for increasing workers' participation in order to support innovation and high performance work places

- Refocus tax policies by shifting the burden from labour to capital and environmental taxes. Addressing harmful tax competition between the member states, for example by installing a minimum tax on profits, is crucial for this.

Chapter II:
Putting Social Europe at the heart of the Lisbon process:
Focusing on social policies that are a productive force

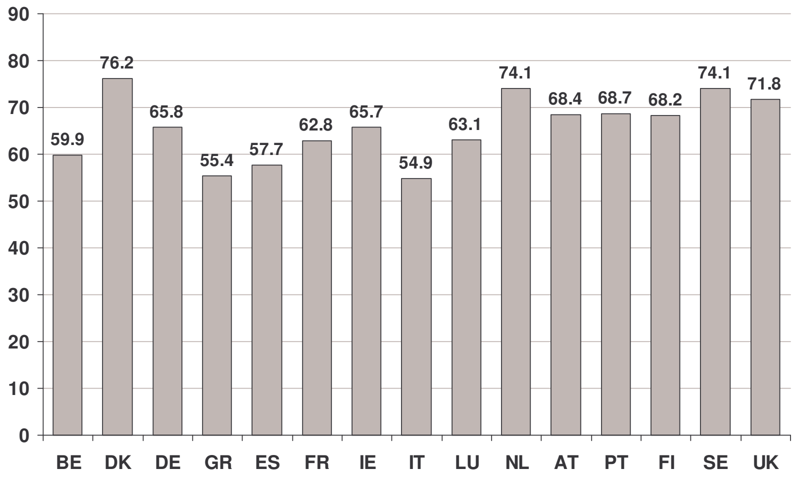
'Growth and competitiveness first, and social cohesion/sustainability policies only afterwards' seems to become a popular theme in certain policy cycles in Europe. In resorting to such 'trickle down' strategies, the original idea of Lisbon (which is that economic, social and environmental policies can and should be mutually reinforcing) tend to be neglected. However, experience to date in several Member States of the European Union clearly points to the fact that economic success and social cohesion can go hand in hand, and that social policies can contribute to growth and competitiveness in a decisive way. In other words, the links between competitiveness and social cohesion are not 'one-way traffic'.

A. Economic success and social cohesion: the scoreboard inside Europe

Economic success measured as a high employment rate

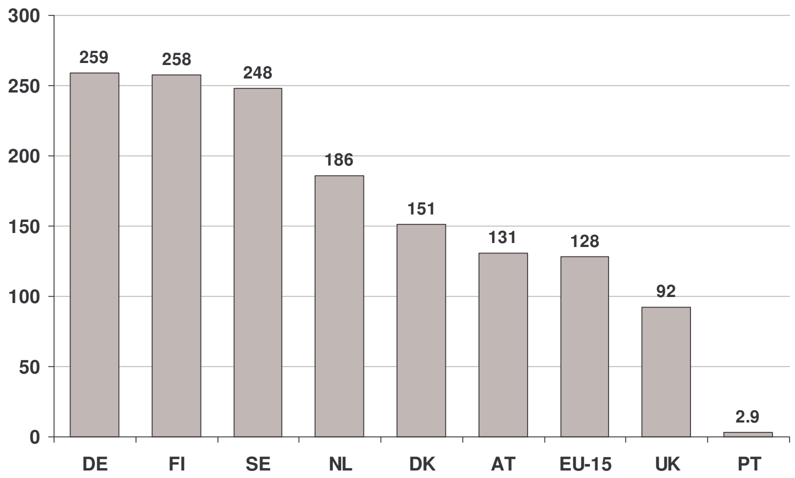
If economic success and competitiveness can be measured by a simple indicator such as employment rates, then Europe does have its national championships, setting records that are comparable or even better than the US. The UK, Denmark, Sweden and the Netherlands all have employment rates over 70%, whereas Austria, Portugal and Finland follow closely with an employment rate of around 68%.

Employment rates 2001



The major part (but not all) of these economies can also be described as being 'innovative'. The Scandinavian countries and the Netherlands in particular are leading the way towards the 'knowledge economy', when judged by the number of patents introduced at the European Patent Office, whereas the UK performance is below the EU-15average.

Patent Application at EPA, per million population, 2000

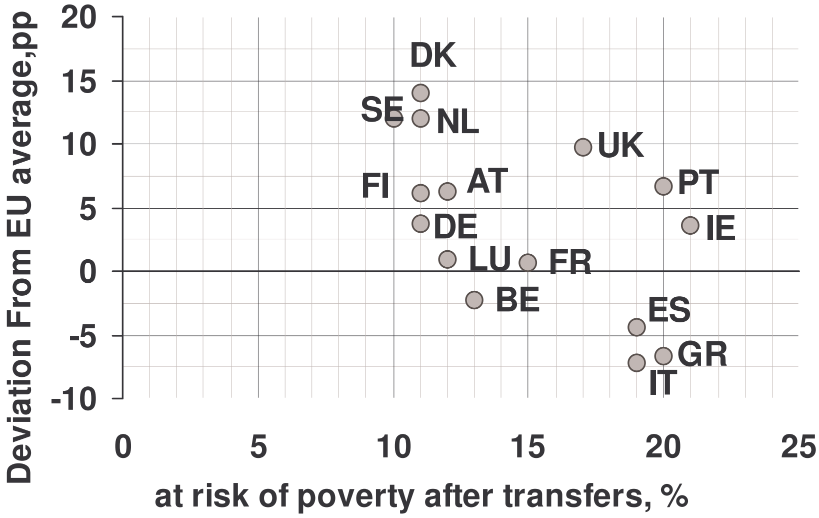


Economic performance and social cohesion

The following graph compares the deviation from the EU average employment rate (which was 62.1% in 2001) with national poverty rates. Several countries are able to combine above average and high employment rates with relatively low poverty rates

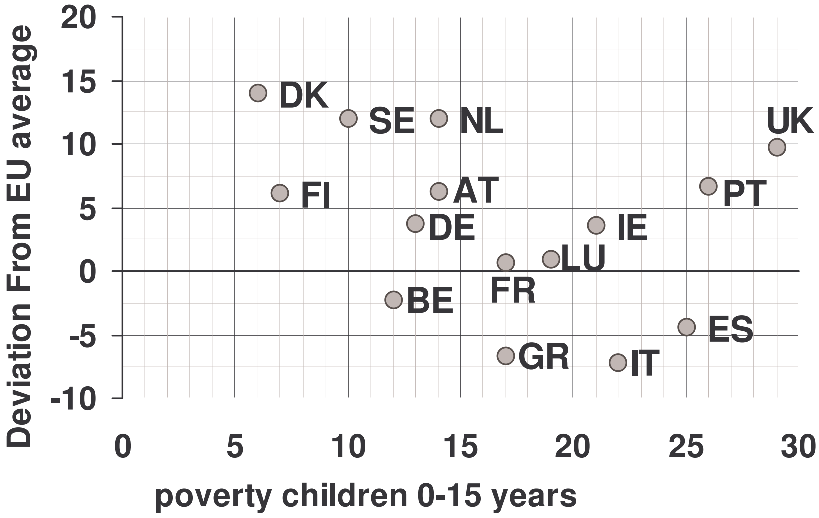
(Scandinavian countries but also Netherlands, Austria). On the other hand, economic success does not always guarantee high social cohesion: countries such as the UK and Ireland have a poor record on poverty rates.

Employment and poverty rates, 2001



A further comparison can be made by looking at the links between (high) employment performance and child poverty. Again, economic/employment success does not guarantee low poverty for children aged between 0 and 15 years. Moreover, high children's poverty rates in the Anglo–Saxon as well as Southern European economies raise questions to these economies' future potential for productivity growth.

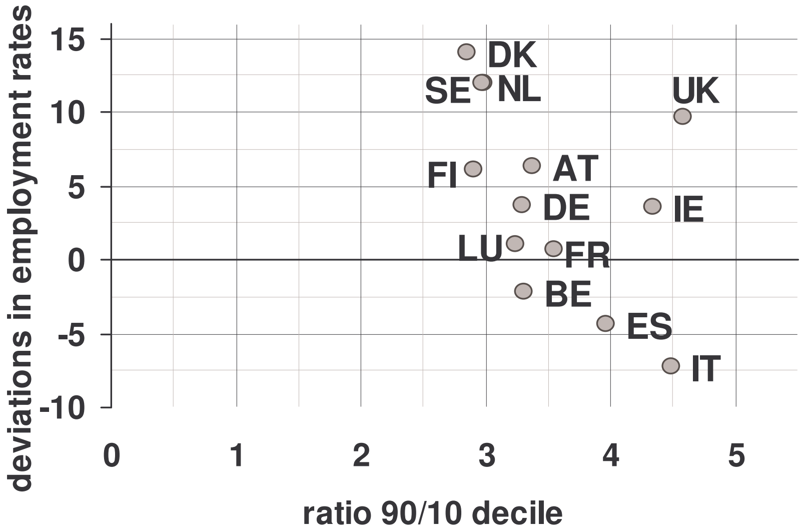
Employment and child poverty rates



A final look exercise can be made by looking at inequality rates. The next graph links the deviations in employment rates from the

EU average (in percentage points) with the ratio of the average income of the decile richest workers over the decile lowest paid workers. Again, the same cluster of countries that is extremely successful on the employment front (Nordic countries plus Netherlands and Austria) is at the same time being characterised by low income inequalities.

Employment performance and ratio 90/10 decile



Two conclusions

From these comparisons, two conclusions should be drawn:

- Economic success (high employment rates) does not automatically mean social success implying that 'trickle down' strategies do not work. It is not sufficient to get job creation going; specific social policies to improve social cohesion are needed. Economies such as the UK and Portugal have high employment but poor performance regarding poverty and inequality.

- Trade offs between competitiveness and social cohesion need not exist. Instead, social cohesion policies can act as a major force for productivity. The high employment/innovation performance of the Scandinavian countries and the Netherlands, together with the existence of a well developed welfare state with a low incidence of poverty and inequality point in that direction.

B. Making social Europe work as a productive force

What is the secret of these countries? How do they manage to combine high employment rates with high wages, adequate welfare provisions and high protection of labour?

Looking closer at the kind of structural policies that this cluster of countries have pursued, reveals that all of these countries, with no single exception, have invested massively in active labour market policies, education and lifelong learning policies, workers' participation, research and development and policies to reconcile working and family life..

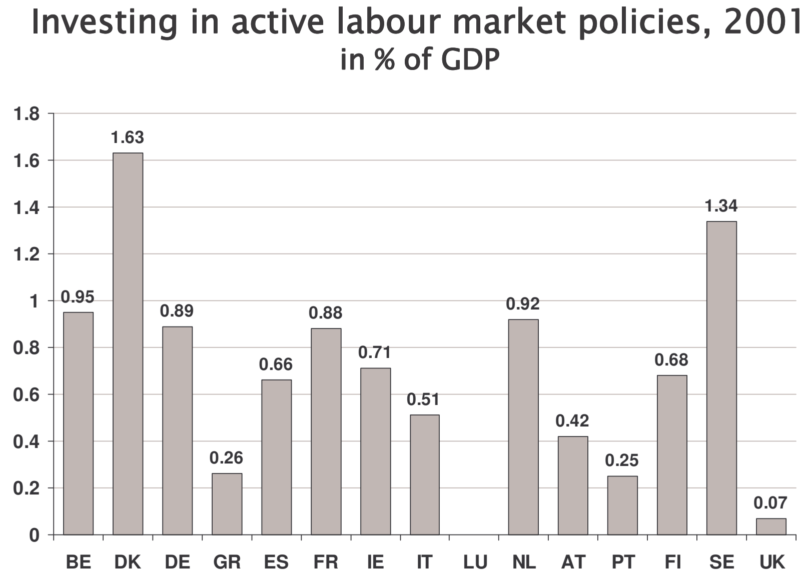
Active labour market policies

Scandinavian countries and the Netherlands combine high benefit replacement ratios and high benefit duration (labeled as 'passive' labour market policies) with active labour market policies providing training, job counseling and direct job creation for the unemployed.

In doing so, they pick out 'the best of both worlds'. On the one hand, generous benefit systems provide an important sense of security to workers, thereby making it possible for them to accept 'change' and the risks involved with it. It is not a coincidence that the Scandinavian countries are the most advanced in terms of product market flexibility, the existence of a well developed unemployment benefit system has allowed them to do so.

On the other hand, combining generous unemployment benefit systems with active labour market policies has proven to be an important countervailing power against possible disincentive effects that might arise from generous benefit systems, as well as an instrument to protect and upgrade the skills of the unemployed, which is in itself extremely important to control rising income inequality and to strengthen the innovative capacity of an economy (see further below).

The next graph illustrates that all of the identified 'success' countries invest heavily and substantially more than the EU average in these active labour market policies (sum of training, employment incentives, integration of disabled and direct job creation). The UK (despite the 'New Deal approach', activation of the UK unemployed does not seem to focus to take the same character as in the Nordic countries, cfr the low amounts spend on training and other active labour market measures) and Southern European countries do not seem to follow this road to the same extent as the Scandinavian countries.

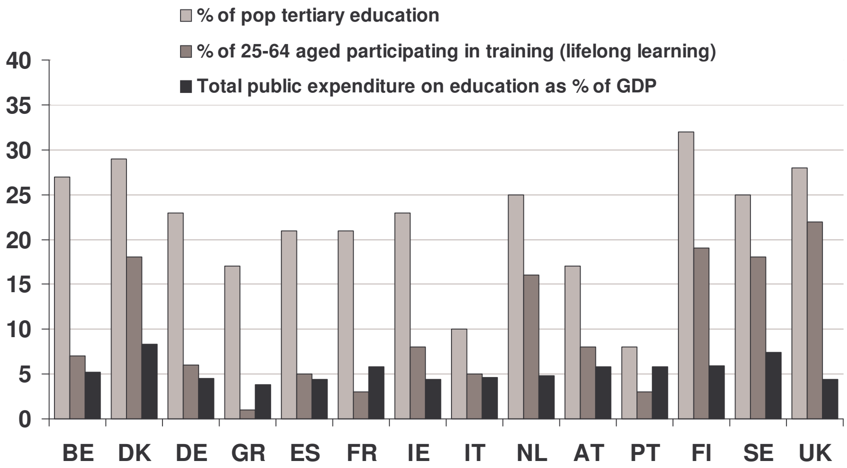


Investing in education and lifelong learning

The educational attainment of Scandinavian countries and the Netherlands populations is markedly higher than the EU–average. Moreover, a higher part of the population is involved in lifelong learning in these countries. With many workers having higher skills and having their skills upgraded, these countries are able to innovate their economy and to address the skill bias in technological progress while keeping wage inequalities low. In other words, they are winning the education race against globalisation and technological progress.

In this area, the UK is also performing well and this begs the question why an economy with a highly educated population (in terms of share of population having finished at least upper secondary education) is not able to record satisfying innovation and equality outcomes. The answer may lie in the fact that, in terms of share of GDP, the UK is investing much less in (public) expenditure on education.

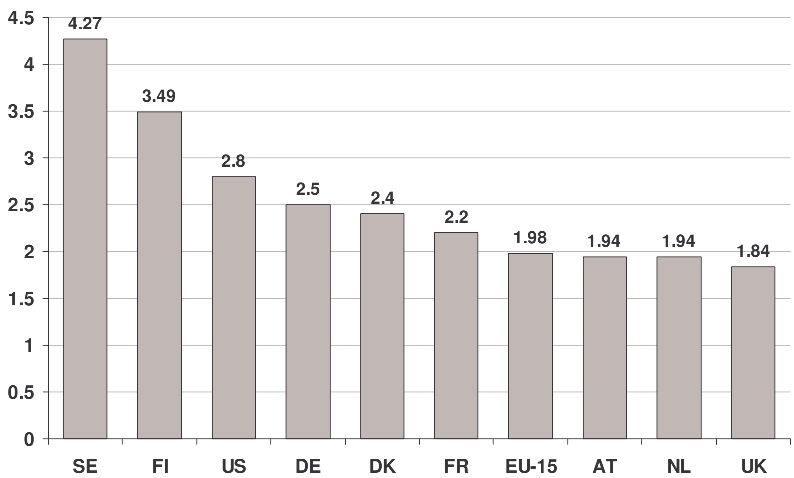
Investing in education



Research and Development

The Scandinavian performance is again outstanding (Sweden: 4.27% of GDP, Finland 3.5% of GDP), with Germany and France above EU-15 average performance. Neither the UK, nor the Netherlands is able to follow suit.

R and D Investments as % of GDP

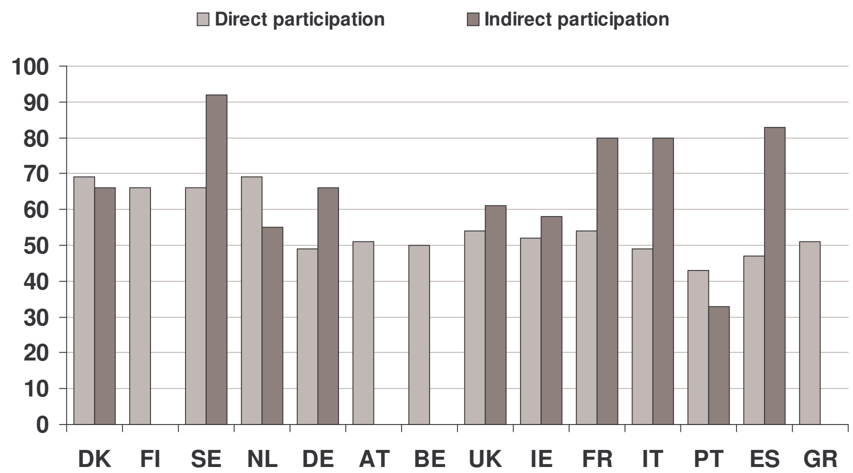


Workers' participation

Innovation is not only a question of inventing new products and processes, innovation also needs to be implemented. We have already argued that labour market policies (both active and passive) that provide security to workers reduce resistance to change. Another policy that reduces such resistance to implementing change is workers' participation. Both indirect (workers' councils for example) as direct participation (direct involvement of workers on the work floor) allow for an increased awareness of the necessity to change, reducing distrust between management and workers and making it possible to modulate the introduction of innovation so that workers' problems are addressed.

This is confirmed by the next graph, which confirms that the employment/innovation champions are again the ones that have the highest share of employees involved in direct (at the shop floor) and indirect participation (through workers' councils).

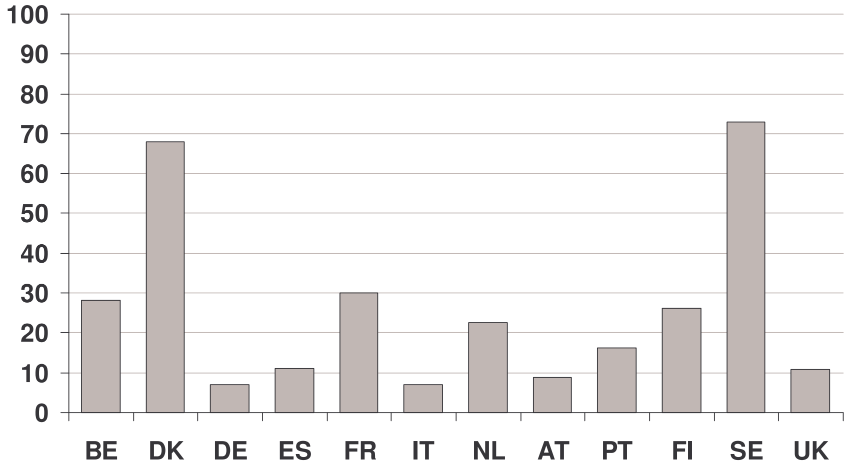
Worker's participation



Policies to reconcile working and family life

Finally, another area of social policy being crucial for high employment performance concerns measures to reconcile work and family life. Childcare policies for example (along with elderly care policies) allow female workers to combine a working career while raising children. Again, the statistics show Sweden and Denmark, and to a lesser extent Finland and the Netherlands, as having extremely high childcare coverage rates in the 0-3 age category.

Childcare coverage rates 0-3 years



C. Implications for the Lisbon mid-term review

Based on the experience of the Scandinavian and some other continental European countries, a particular set of social policies appears to be crucial for the Lisbon philosophy of synergy effects between economic and social policies and concerns. This policy set concerns active labour market policies, in combination with well developed systems of unemployment benefits, investing in research and development, supporting systems of lifelong learning, promoting workers' participation and developing childcare policies

However, experience with the actual Lisbon process does not testify to the fact that these policies have thus far received particular attention. Instead, they have been drowned in lots of other policies and benchmarking processes. In fact, data limitations (data on active labour market measures for example were only available for the year 2000 at the time of the 2004 Lisbon Spring Council) make it practically impossible to conduct a real peer review, let alone 'peer pressure'.

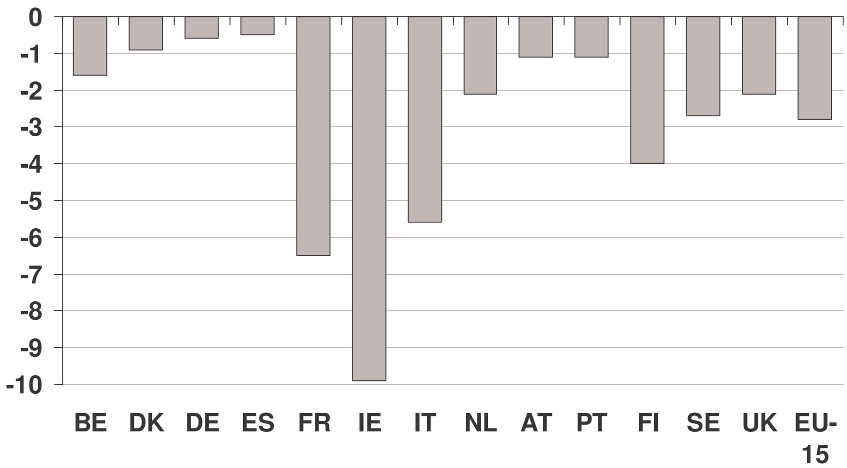
Even worse, from the scarce data that does seem available, it appears that active labour market expenditure and spending on training has not seen much of an effective increase in policy efforts. For example, the share of workers involved in lifelong learning has barely increased at the EU-15 level (from 8 to 8.5% of population aged between 25-64) and has stayed at extremely low levels in the three major economies of the euro area (see table). Indicators on activation of young, adult and long term unemployed now even appear to be missing from the latest 'joint employment reports' (with the exception of three or four countries).

Participation in education and training, in % of 25 -64 age population

	BE	DK	DE	GR	ES	FR	IT	NL	AT	PT	FI	SE	UK
2000	6.8	20.8	5	1.1	4.9	2.8	5.2	15.6		3.3	19.6	18.6	20.3
2002	6.5	18.4	5.8	1.2	5	2.7	4.6	16.4	7.5	2.9	18.9	18.4	22.3

In contrast to this, governments have devoted important resources and financial means on reducing the tax burdens and social security contributions for the low skilled workers. While this does preserve social cohesion (low paid workers do not suffer in terms of net wages), it does mean that in practice policy making in several European countries has tended to take the 'low' road. Instead of increasing skills and the productivity of lower skilled workers, the cost of low paid work has been reduced. The question is which consequences this might have in the longer run (such as acting as a disincentive for engaging in training and education).

Change 2002 -1995 in tax wedge as % of labour costs for low wage earners



There is one main conclusion from this for the Lisbon mid-term review. If Europe wants to be serious about the Lisbon goal of high employment/high productivity and social cohesion, then policy makers need to focus the Lisbon process on the 'synergy' policies described in this text.

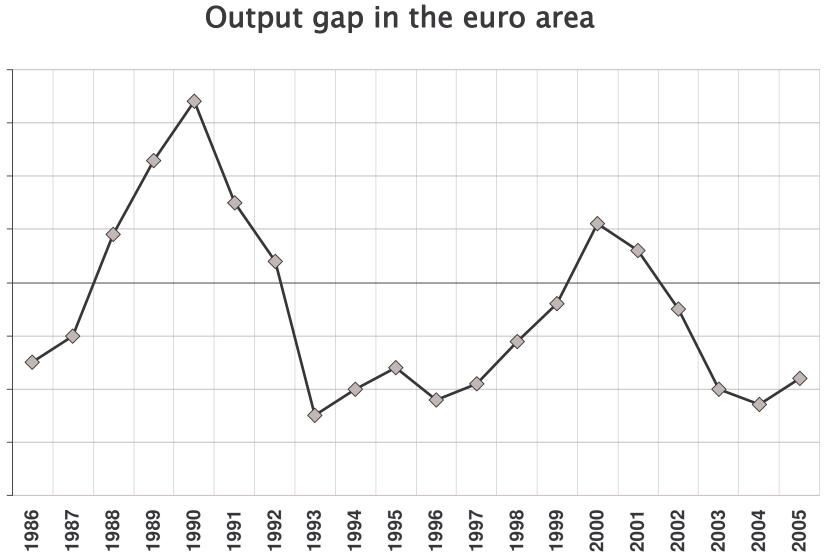
Chapter III:
Delivering the Lisbon results by reforming the European macro-economic policy regime

Using Social Europe as a force for productivity and innovation will enhance Europe's potential growth rate (see previous chapter). However, whether the improvement in the potential growth rate will also result in growth rates that are effectively higher, depends on the interplay between aggregate supply and aggregate demand. It is here that macro-economic stabilisation policies come into the picture. Macro stabilisation policies have the essential role of matching (enhanced) aggregate supply with higher aggregate demand, and thereby delivering effectively high(er) growth.

A. The failure of stabilisation policy in Europe

The 'track record' of stabilisation policies in Europe, particular the euro area, is disappointing. Graph I illustrates, on the basis of OECD's estimates of the output gap, the lackluster performance of the euro area in getting aggregate output back to its potential level after having been hit by a crisis. Starting from the beginning of the nineties, i.e. over a time span of more than ten years, the European economy has always operated below potential. Only in 2000 (and 2001) was effective production slightly above potential.

Graph I : Output gap in the euro area

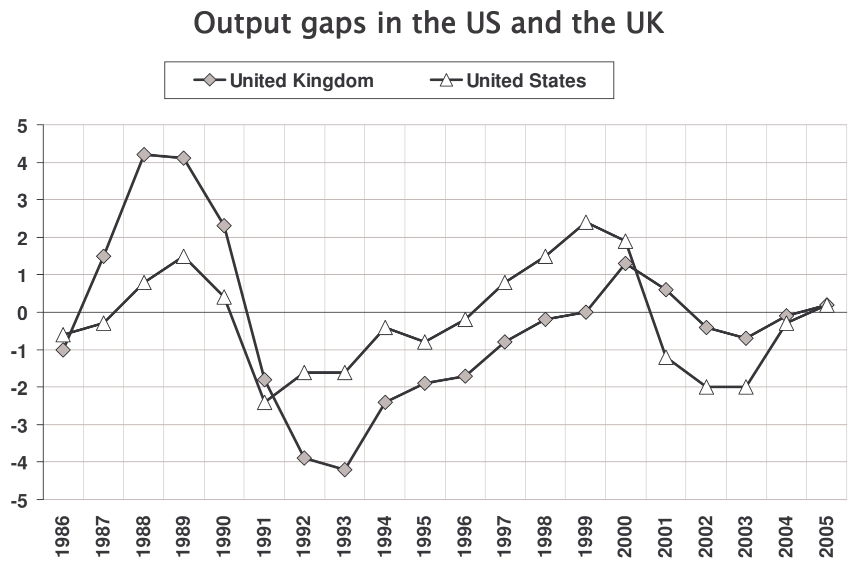


Source : OECD, June 2004 Economic Outlook

In other words, the European economy has problems in dealing with a downturn in the business cycle. Once hit by a shock it remains in a situation of major under–utilisation of productive resources for several years. In terms of the post-recession growth pattern, this translates into growth rates that are only at or even below potential for a number of years instead of a (temporarily) higher than potential growth rate in order to eliminate existing slack. For example, if the potential growth rate is 2% and the output gap is –3%, the economy would be able to grow at 3% for three consecutive years without triggering renewed inflationary pressures.

The European experience is in sharp contrast with other regions and countries which do succeed in reducing slack in the economy in a more rapid way. The US economy has always done a much better job in recovering from economic slack, whereas economies such as the UK as well as Scandinavian countries have recently succeeded in steering away from the slump altogether (see graph II).

Graph II : Output gaps in the US and the UK



Source : OECD, June 2004 Economic Outlook

Comparing the two previous graphs allows us to see the difference between the different regions. Whereas the US is able to eliminate the negative output gap of the beginning of the nineties in three years time, it takes the euro area five years to start reducing the amount of slack in the economy and another two years to bring output close to potential.

In the present cycle, an identical scenario is unfolding itself. Whereas the US economy is leaving the situation of general economic slack rapidly behind it, the recovery in the Euro area remains weak with growth below or at potential and hence not strong enough to get the output gap closing. Over the 2001- 2003 period, average annual growth in the euro area has been limited to a mere 1.1%, which is far below the estimated potential growth rate (around 2 to 2.5%). According to OECD estimates, production in the euro area is now 2.4% below potential. In the US on the other hand, average annual growth has been 2.5% and the negative output gap has now almost completely disappeared.

B. Why Europe's macro-economic framework is not delivering

Since the Maastricht Treaty on EMU, both principal macro policy actors (monetary and fiscal policy) are focused primarily on the objective of stability. The ECB has its price stability objective whereas fiscal policy is expected to eliminate public deficits over the medium run in the context of the Stability and Growth Pact. This raises the question which other policy actor in the euro area will/can take up responsibility for stabilizing aggregate demand in the economy.

Instead, the task of managing aggregate demand is in practice being delegated to macro policy actors outside the euro area. A recovery from an acute shortage of aggregate demand is always expected to come from a revival in world demand, in particular from the US economy. However, with the share of extra-European exports in GDP limited to 12–15%, this strategy of 'recovery by exports' is risky, especially when it is accompanied by a too extreme wage moderation strategy which in turn weighs negatively on domestic demand (which vice versa supports 80 to 90% of European GDP). In practice, the strategy works when the US economy is doing extremely well, but if the US is growing only moderately, then the European economy is only muddling through.

This overdependence on the rest of the world also raises an awkward paradox. While both monetary and (most) fiscal policy actors in Europe condemn or abstain from using active macro policies, they implicitly count on the Federal Reserve and the US budget to engage in exactly the same irresponsible kind of policy making in order to have world and US exports dragging the European economy out of the slump.

In turn, this kind of 'begging to the US' poses dangers for the world economy as a whole. The system whereby the US is leading world demand and the euro area the laggard in demand results in disequilibria that are hardly sustainable. The combination of the high level of debt of US consumers with the twin deficits (high public and external US deficit) may burst sooner or later, throwing the world economy in the inverse spiral where the US will be leading the world downturn.

The price of a too low inflation target

No one can seriously argue that price stability is unnecessary and forget about the ravages that hyper–inflation produced in the previous decades. In fact this insistence on the need for controlling inflation is indeed one of the ECB's strengths. Anyone raising any alternative view is immediately rubber-stamped as being irresponsible and supposedly arguing for a return to the inflationary mistakes of the past. In this way, the debate on monetary policy making is transformed into 'un débat interdit' (Jean-Paul Fitoussi). It is therefore imperative to get the framework of this discussion right.

In fact, the ECB takes a giant step when it states that price stability is not only *necessary* but also *sufficient* in order to deliver high economic growth. In doing so, it tends to overlook the fact that price stability can be obtained in two different ways.

- One way to guarantee low inflation is to keep the economy operating at a level that is below its potential. This implies the use of so–called asymmetric (monetary) policy making. When there's an economic upturn, monetary policy making is very active and is effectively limiting and leveling out the upturn. In the other phase of the business cycle however, monetary policy making takes a passive and hesitating stance, thereby prolonging or even intensifying downturns. This kind of business cycle pattern, where the economy is almost continually characterised by slack and too high productive capacity is indeed observed for the euro area (see part A. of this chapter). This however comes at the expense of economic growth, not only effective but also potential growth. Potential output growth suffers because a systematic negative output gap sends the wrong signals to investors. Indeed, the investments of today are the productive capacity of tomorrow (see part B. of this chapter).

- However, it is also possible to follow the alternative scenario in which price stability and high growth go hand in hand. A central bank that is actively stabilising the business cycle in a symmetric way (so being as active in downturns as in upturns) will keep effective output as close as possible to potential output and, in doing so, will reassure investors by providing sufficient demand prospects. Again, with increasing investments, productive capacity is raised making it possible to enjoy higher economic growth without renewed inflationary pressures. Indeed, with demand (growth) <u>and</u> supply (investments, productive capacity) rising at the same time, firms do not find themselves in a market position to raise prices and profit margins.

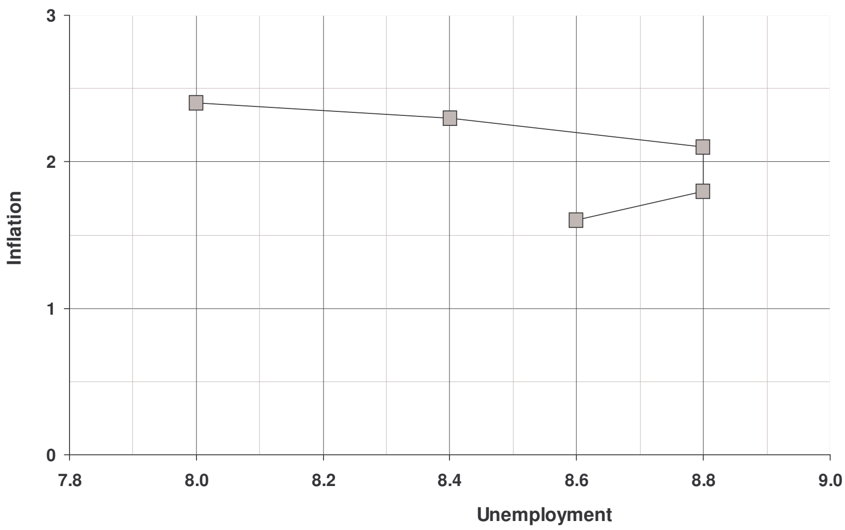
Implicitly, the European Treaty recognizes the difference between these two scenarios. Indeed, the Treaty does not give the ECB the mandate to defend price stability <u>and</u> <u>only</u> price stability. Instead, the ECB's mandate is to pursue price stability as a primary goal <u>and,</u> in the case when there is no danger to price stability, to support the other goals of the European Treaty (such as high growth, high employment and social cohesion). In doing so, the Treaty chooses for the latter scenario where high growth and price stability are being combined.

In practice, the choice of a price stability target is extremely important in directing monetary policy in the direction of this second scenario. The reason is that falling inflation will signal the ECB that there are unused capacities in the economy and that there exists a window of opportunity to stimulate the economy. In this way, giving the central bank a floor (and not only a ceiling) in the price stability target to target is providing the monetary policy making with a tool to engage in output stabilisation.

However, when the floor in the inflation target is set too low, this approach no longer holds. The lower the range of the zero inflation, the less likely it is that there will be an actual (big) fall in inflation. This will distort the signal that economic slack normally provides to the ECB. In this way, a policy trap is set by which a stable inflation rate goes hand in hand with an intensifying economic crisis. The ECB will observe rather stable inflation, while at the same time the economy is collapsing. In fact, the complaints the ECB is making about the 'stubbornness' of inflation in latest years can be understood in a radically different way. If the economy keeps on recording an inflation around 2% while at the same time other indicators (such as the percentage of firms reporting difficulties in recruiting staff) point to a serious crisis, then the conclusion should instead be that, although inflation is slightly higher than the 2% target the ECB has set for itself, there is room to reduce unemployment while at the same time keeping existing inflation stable.

Technically, all of this translates into a Philips curb that becomes horizontal at lower bounds of inflation. In fact, when looking at the combinations of inflation and unemployment in the last couple of years, one can observe that, although unemployment has increased steadily, inflation is remaining around the same level of 2 to 2,5%. Since the same low inflation rate delivers combinations with different unemployment rates, it is possible to reduce unemployment without transiting to a higher inflation level (see graph). There is also another important element and that is fiscal/tax policy that has been increasing indirect taxes and indirect wage costs in order to abide somehow to the SGP. In doing so, inflation is artificially being pushed up and kept above 2%. However, when correcting overhead inflation figures for this, it appears that corrected core inflation has gone down seriously to 1,4% in mid 2004. This fall in inflation indeed points to substantial slack but is apparently hardly noticed by the ECB which keeps on warning for high inflation, thereby basing itself on the overhead inflation figure of 2,5%.

Inflation and unemployment starting from 2001



Of course, if on the contrary the ECB does not exploit this policy margin and lets the economic crisis deepening, the specific structures and mechanisms that provide a floor in inflation (such as wage formation or unemployment benefits) will collapse and the real, ugly face of the crisis may then suddenly appear in the form of a rapid fall in inflation, possibly turning low inflation into deflation and thereby destroying the efficacy of monetary policy making.

The price of zero deficits

With a monetary policy framework in the euro area that is primarily focused on (a too low definition of) price stability, it would be up to the fiscal policies to provide a macro cushion when the economy turns down. But here, the Stability and Growth Pact, although not respected to the letter by all Member States, is acting as a barrier.

Again, the need to reduce public deficits cannot be denied. Arguments such as preparing the ageing society, and crowding in investment are valid. But wise economic policy making is not about applying rigid rules in any economic situation. In applying the Pact and in particular in setting the road and time framework to arrive at lower deficits, the economic situation of the euro area as a whole as well as the economic situation of individual member states should be taken into account.

In short, more flexibility in applying the Pact needs to be inserted. The recent Commission proposals are one step in this direction, but need further improving, whereas the negative reaction by the ECB is problematic.

C. The costs of non–Keynesian policy: How short run stabilisation interacts with long rung growth potential

Driving down existing potential growth

Output gaps can be eliminated in two very different ways. The positive way is to increase effective growth and production through demand led action. The other option is to let the crisis situation drag on long enough so that eventually the level of potential output itself falls and adapts itself to the lower level of effective economic activity.

This latter effect operates through two different channels:

- Unused production facilities will eventually close down. In this way, capital and investments are being lost. The consequence is that available capital (machinery, production facilities) may well prove to be insufficient when a strong surge in demand eventually does appear. This shortage of capital places producers in a position to increase prices, resulting in accelerating inflation, even when unemployment is still high.

- Another channel is 'hysterisis' on the labour market. A prolonged slump will result in increasing long term unemployment, with people losing the skills, professional capabilities and motivation to continue to participate effectively in the labour market.

The fact that the tension between potential and effective production can be resolved in two, very different ways, has important implications for the design and making of monetary policies (see further below).

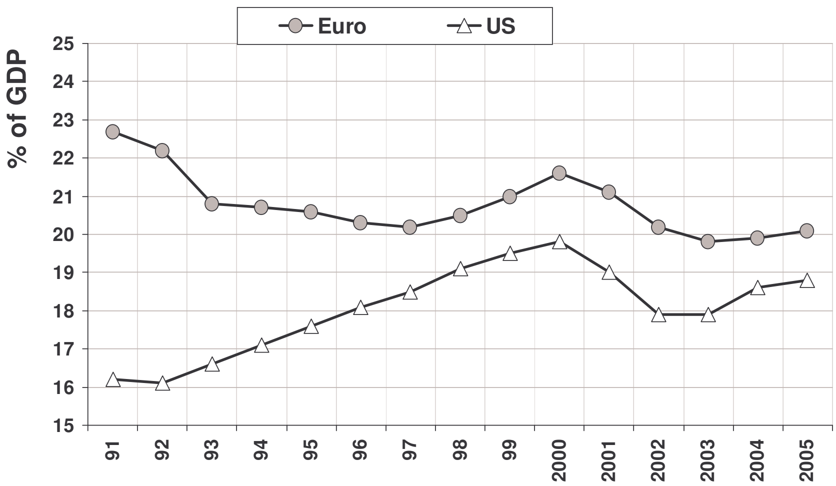
Pushing up the potential growth rate

Just as the lack of macro stabilisation policies can drive down growth potential in case prolonged slack is allowed to continue, active use of such policies can push up an economy's growth potential, especially when active stabilisation takes place in the context of a sound macro-economic policy mix.

Investments are the key in this scenario. If a big increase in investments can be triggered, this will add to productive capacity. And this increase in productive capacity makes it possible to keep the economy growing at a higher rate without rekindling inflationary pressures coming from firms that find themselves in a 'seller's' market characterized by insufficient production capacity. Stabilisation policies are important here to provide the right incentives to investments. In times of economic slack, investors need reassurance on sufficient demand prospects so that they will not remain stuck with overproduction nobody wants when they do decide to invest. Inversely, in times of a possible overheating of the economy, investors know they can count on stabilisation policies to prevent a boom that would entail high long term interest rates, making investment in fixed assets less profitable.

This reasoning was at the basis of the macro-economic strategy that was pursued in the nineties in the run up to EMU. It was argued (and effectively subscribed to in several joint opinions of European Social Partners) that the fiscal consolidation efforts implied by the Maastricht Treaty would push down long term interest rates, making access to capital cheaper for investors. Moreover, wage moderation would increase investor's profitability. If at the same time, monetary policy would score up demand (in order to provide potential investors with sufficient market prospects), all conditions for having higher growth without inflation would have been combined. However, in a monetary Europe torn apart under the old Exchange Rate Mechanism and dominated by the Bundesbank, this 'two handed' approach (lower public deficits and wage moderation on the one hand, active demand support from monetary policy on the other hand) did not work. Investments (as a % of GDP) only picked up in Europe at the end of the nineties, when there was indeed a boost in demand coming from low interest rates and a competitive exchange rate. In the US on the other hand, the experiment with the macro-economic policy mix did work out well. Fiscal policy remained somewhat restrictive, thereby driving down long term interest rates and providing a boom to the equity market (which was in turn important to keep health care premiums in wages down). On the other hand, the Federal Reserve supported this process actively by keeping interest rates low, even though unemployment fell substantially below the level that was considered as 'structural' unemployment (unemployment fell as low as 4%, while the 'structural' unemployment threshold was considered to be around 6%). The US finally saw a major increase in the share of investment in GDP, in other words a massive increase in the available capital stock which allowed having extremely high growth and high productivity increases without any sign of accelerating inflation.

Investment as a share of GDP



Disincentives for innovation

Inaction on the demand side resulting in protracted economic slack will also impact on the innovation performance of an economy:

- Weak investment performance implies that new investments, which incorporate the latest innovations, are not added in a substantial way to the existing capital stock. This tends to restrain the innovation quality of the average capital stock, thereby missing out on the possibility of accelerating productivity growth (which in itself supports higher non – inflationary growth).

- While product innovation tends to increase growth, it is also true that corporations will not invest in product innovation and related research when the economy is gloomy and when households' psychology is fixated on precautionary savings instead of spending money and buying new consumer products.

- Stabilisation policy can also be looked upon as insurance. In deciding on investment and innovation, companies ask themselves whether governmental policy will provide a cushion if and when a shock appears. If agents are confident that macro policy will take (positive) action in such a case, they will be more willing to take on extra risk and invest in innovative projects.

- Firms may also finds themselves constrained to introduce process innovation in an economic downturn, since this will imply retrenchment of a major part of their staff. In contrast, when the economy and demand is growing, innovation can result in higher production while retaining the existing amount of staff.

- Economic crisis goes hand in hand with wage moderation. If wage moderation hits the poorer paid workers foremost, then inequality rises. However, an unequal income (wage) distribution does not provide a sound basis for widespread demand for new innovative products.

D. Reforming Europe's macro-economic policy framework: Some proposals

Making Europe 'master of its own macro-economic destiny' involves the following:

- Reform of the SGP so that coordinated action to support the European economy in an economic downturn becomes possible by investing in public investment expenditure, with particular attention to innovation, research and development (and with special attention to the area of sustainable development).

- Focus the SGP on the overall euro area deficit.

- In evaluating national deficits, take indicators such as inflation and overall private savings surplus into account.

- Reform of the monetary policy regime in order to have the ECB take the situation of the real economy into account instead of practically only focusing on price stability. This implies a broader price stability target (2 to 3%), an explicit commitment by the ECB to have a symmetric approach and support growth as much as defending price stability, and a broad and regular consultation with the actors from the 'real' economy, social partners in particular (installing a 'conseil de régents' at the ECB).

- Strengthening the existing Macro-economic Dialogue (so called Cologne process) by increasing its visibility, intensify its working/meeting rhythm and by introducing national pillars to this process.

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