Europe 1993: hope and disillusions

The Italian Chamber of Commerce organised a conference in September on 'Europe 1993: hope and disillusions'. In a speech to this conference, the ***Deputy Governor*** *argued that until supply-side reforms were in place, the outlook for European employment would remain depressed. A combination of effective macroeconomic management and essential microeconomic reforms would offer the best chance of reducing unemployment: any short-term macroeconomic stimulus not accompanied by supply-side measures would generate inflationary pressures and so set back the chances of a lasting improvement in European unemployment.*

We are here to discuss European hopes and disillusions, and in the short time available to me this morning I cannot do justice to such a big subject. However, two days ago the Governor of the Bank of England made a speech outlining a way forward for Europe's monetary arrangements, and I now want to complement his argument with some remarks about the performance of European economies. So this is, if you like, Part II.

To summarise the Governor's arguments in Part I, he discussed the case for supplementing the ERM's wider bands of 15%, so that each country would have an explicit commitment to price stability, plus the right arrangements to monitor these commitments. This would help to provide credibility for domestic policies. And once something close to price stability was achieved in EC countries, their exchange rates ought to become less volatile.

The watchword, in short, is stability. And that is the main contribution that Europe's central banks can make to improving another set of its statistics, those on unemployment. At the moment, European unemployment rates are painfully high, and in many countries they are still rising. In the European Community alone, the total number of people registered as unemployed has reached 17½ million. Five years ago, it was 16 million; ten years ago, in the same group of countries, it was 12 million.

The current figure is harmful in many ways. Most obviously, it represents a waste of human potential and, for the individual concerned, it often means a loss of self-respect. Beyond that, high unemployment frequently gives rise to social tensions, not least over immigration. It adds to fiscal burdens, because tax revenue is reduced and spending on jobless benefits is increased. No one, no European certainly, can take much comfort from economic conditions in Europe so long as 17½ million unemployed remains part of the tally. A fading of hope, a growth of disillusions: for many people, that is the reality that Europe presents in 1993, directly because of unemployment.

There are, of course, many dimensions to this unemployment, but I have time this morning to consider only some of them. It is hardly surprising that views differ on the economic causes of Europe's high jobless rates, and so differ, too, on the cures. If I can characterise one group of views (without, I hope, caricaturing them), there are those who say that high unemployment is the direct consequence of macroeconomic restraint. This line leads to the prescription that policy must be eased—budget deficits increased and interest rates reduced. Only then will the tide of unemployment be turned, bringing in jobs and growth to lift the lives and hopes of many.

This prescription sounds beguiling, not least because there is no doubt that it could be implemented. I have never yet met a politician who does not know how to increase public spending and cut taxes. And you may be reassured to know that, so far at least, every central banker I have met does know how to reduce interest rates.

So macroeconomic relaxation could certainly be done. The question is whether it would be right to do it. To that, I do not automatically answer 'no'. It is easy to imagine circumstances when policy would indeed be too tight, and policy-makers should take no comfort from running that type of policy, and get no credit for doing so. It is also possible to see, in the events of the recent past, how the policy need of Germany differed so much from those of other European countries that their macroeconomic conditions were becoming unnecessarily deflationary. The markets perceived that divergence, and the ERM suffered as a result. But I do take issue with the view that the fundamental cause of high unemployment across Europe as a whole is overly tight policy. Indeed, I think that the implications of that view—relax policy now—run directly counter to the long-term interests of the unemployed.

To explain my position, let me start with a few statistics. Twenty years ago, the EC's jobless rate was less than 3%, almost exactly half-way between the rate in the United States and the rate in Japan. Ten years later, the Community had moved to the top of this unenviable league, with its unemployment rate in double figures. In 1993, things are even worse: the EC's rate has continued to rise, whereas America's is substantially lower than it was ten years ago, and Japan's is still in the 2%–3% range. It is only in Western Europe that unemployment has got progressively worse, and this is not because macroeconomic policy here has got progressively tighter.

The macroeconomic task is clear, in Europe and everywhere else: to secure, as a matter of long-term routine, a non-inflationary and stable growth rate of spending in the economy. This will ensure that solid real growth in output and demand can be sustained. This much can be achieved by effective macroeconomic management, and it is hard to exaggerate the value of that achievement. But even excellent macroeconomic management would not be enough to ensure that unemployment was low and stable. For that, we have to look to complementary measures of a microeconomic kind: on taxation, on education and training, on regulation of all kinds. It is the combination of steady demand management and vigorous supply-side reform that offers the best chance of reducing unemployment.

Europe still has not achieved steady demand management, though we are getting close to establishing the foundations for it. But the supply-side picture is depressing. Sometimes Europeans are bold and imaginative in reforming their economies; too often they are defensive or even complacent.

The best example of boldness is undoubtedly the 1992 programme to create a single market. It was launched in the mid-1980s, when governments and businesses realised the damage that was being done to European prosperity by the existence of barriers to commerce—barriers to the free movement of goods, services, capital and people. By inhibiting companies and their customers from meeting in the marketplace, governments were inhibiting economic growth.

The right response was long-term and structural, and Europeans chose it. The 1992 programme was difficult to implement, because it upset the established way of doing things, and upset many vested interests. In the end, however, these political difficulties were overcome. There is more 1992 liberalisation still to come, but the bulk of the necessary legislation is in place. It has not worked miracles, but there is plenty of anecdotal evidence to suggest that, thanks to 1992, Europe's companies are improving the way they do business. Over time, the benefits will become clearer, and we in Europe will shudder to reflect on what would have happened to our economic performance if we had chosen not to adopt the single-market programme.

The logic that drove 1992 is unfortunately being ignored in other areas of supply-side reform. I will mention only two: trade with the rest of the world, and the labour market. On trade, there are all too many Europeans who are inclined to regard imports as a threat to jobs and therefore something to be restricted and controlled. That calculation ignores the many other factors that are operating all the time to change the nature and number of jobs in any economy: technology, changes in consumer tastes, and so on. To single out trade as a destroyer of jobs is perverse. Worse, it neglects the competitive dynamism that trade injects into every trading economy, dynamism that is the surest source of new jobs and higher incomes.

It is a delusion to suppose that Europe can retreat into a fortress in order to boost its economy. We should remember this truism: you can't be competitive unless you compete. All sportsmen know that; chess players know that; so do the best executives. Most telling of all, in country after country across the third world, governments are now switching unilaterally to freer trade, because they have realised what damage their trade controls did to their own economies. For western Europe to go the other way, and increase its trade controls, would be a long-term tragedy. It would pose a serious threat to the Uruguay round of GATT talks, and that would be bad for every country. But the biggest losers from Fortress Europe would be Europeans themselves.

The other area where reform is badly needed is in the labour market. The same spirit and thinking that inspired the 1992 programme are now needed there, so that Europeans are not prevented by government regulations from meeting in the market place for jobs. It is encouraging that this issue is now being exhaustively studied by bodies like the OECD and the European Commission. There are many types of supply-side restraints—unsuitable education and training, restrictive working practices, the existence of minimum wage laws, the burden of taxes on employers and employees. Europeans will have to tackle these restraints if we are to be as successful in creating jobs as the United States has been in recent years.

Overall, the policy conclusion is unmistakable: western Europe must seek long-term microeconomic cures for its unemployment rather than rely on a quick dose of macroeconomic stimulus. Indeed, if any such stimulus came without supply-side reform, it would set back the chances of a lasting improvement in European unemployment. The more inflexible an economy's supply side, the more will any stimulus to demand feed through to higher prices rather than to extra real spending and more jobs. As any doctor will tell you, more food means you put on more weight, unless you do more exercise. In Europe's present condition, more demand would go straight onto the waist—and it is hard to lose it from there. In just the same way, an inflexible economy is also slow to bring inflation down again. Europe simply cannot afford another experiment with inflationary responses to what is fundamentally a structural problem.

Until the supply-side reforms are in place, however, the outlook for European employment will be depressing. When economic growth returns, several countries in Europe will find that the jobless rate stays up. That will be the point of greatest danger for macroeconomic policy, because 'jobless growth' is often seen as too-slow growth, and the remedy for too-slow growth is often seen as a fiscal or monetary stimulus. If that were to happen, the hard-won gains of the past few years could easily be thrown away.

That is not a prediction; merely a fear, but one based on ample precedent from the past 20 years. Although many policy-makers now understand that inflationary finance is the start of a road that leads eventually to higher unemployment, they are also reluctant to follow the signpost marked 'supply-side reforms'. That road is long and challenging, undoubtedly. But it is also a road of hope, not of disillusion, and we owe it to Europe's 17½ million unemployed to start down it without delay.