Foreword and overview

Andrew Watt and Ronald Janssen

This volume brings together papers presented at the conference 'Delivering the Lisbon goals: the role of macroeconomic policy', organised by the European Trade Union Confederation in collaboration with the European Trade Union Institute. The conference was held in Brussels on 1-2 March 2005 and attracted an audience of more than 100 policymakers, academics and trade unionists.

The aim of the conference, and of this book, is to analyse the role that macroeconomic policy should play in achieving the economic and employment goals the European Union set itself at the Lisbon Council in 2000. According to the conventional wisdom the answer is simple and a book or two-day conference would not be necessary to provide it: macroeconomic policy must be 'sound', generally taken to mean that it must – but can do no more than – ensure price stability. The contributions to this book are varied, but they are united in rejecting this mantra. Structural reforms of labour and product markets will, of course, be necessary if Europe is to raise its productivity and employment performance. But developments since (at least) 2000 have revealed the one-sided focus on the supply side for what it is: a misconceived failure. Europe's growth and employment performance was good in the late 1990s and some 13 million additional jobs were created. It was on this basis that the Lisbon employment targets were set. The inability to maintain the positive momentum after the year 2000 reflects primarily a failure to shield the European economy adequately from demand shocks and to provide a conducive environment within which the substantial economic reforms that have taken – and continue to take – place can be translated into lasting success on European labour markets.

The first section of the book **Performance of EMU** reviews the economic and employment performance of the European economy, with a focus on European Monetary Union or EMU. Jack Fayolle and Andrew Watt review the management of the European business cycle. Problems are identified in terms of both divergences within the euro area and the failure to insulate the currency area as a whole from external shocks, and particularly the downturn in the US. The former requires 'spatial' coordination between national-level fiscal policymakers and wage-setters, the latter 'inter-temporal' coordination between the main macro actors at European level.

Christopher Allsopp examines the claim that macroeconomic policy is partly to blame for poor performance from the starting point that inflation has *not* undershot its target. Despite this, central bank policy can be criticised for not ensuring that its monetary policy approach is perceived also as a strategy to maximise growth and employment, leading to a less favourable growth/inflation trade-off. Turning to the problems facing national fiscal policy the author argues that the interaction between a common monetary policy with a low overall inflation target, the necessity for some countries within EMU to adjust their competitive position by having below-average inflation, and national fiscal policy constrained one-sidedly by the Stability and Growth Pact can also worsen the overall growth inflation trade-off. This suggests a need for greater national fiscal autonomy. This must be managed carefully, however, as it raises questions about longer-term fiscal sustainability.

Rudolf Welzmüller examines the role wages play in the policy mix under the Maastricht policy assignment. Wage trends have been moderate since the start of EMU, but this has not been translated into expansionary macroeconomic policies to the extent required to generate faster employment growth. Europe's trade unions have an interest in coordinating their collective bargaining policies and have taken initiatives in this direction. Other actors, especially the monetary authority, must be convinced to build a more cooperative strategy around this.

Jörg Bibow argues that the key characteristic of the ECB is the pronounced asymmetry in its policy approach and mindset. Curiously, this asymmetry has not only given rise to an anti-growth bias, but to upward price pressures and distortions too. There is a link between stagnation and the persistence of inflation that is attributable to the ECB's failure to internalise the euro area's fiscal regime. Considerable reform of the monetary regime would be needed, but this would require Treaty changes. At least, the definition of the inflation target should be taken by democratically legitimated bodies, a reform that would not require changes to the Treaty.

The second section **Macroeconomic policy and potential growth** considers the rate at which the European economy can grow and can create jobs – its 'potential' growth rate – emphasising two channels by which aggregate demand policy can influence not only actual, but also potential growth: capital investment and the labour market. Ludwig Schubert identifies substantial growth potential in terms of both productivity growth and employment growth, permitting the European economy to expand for a considerable period faster than the usual estimates of around 2¼%. Given productivity growth of around 2%, employment growth of, say, 1% a year requires the maintenance of economic growth of at least 3% for a sustained period. The author charts out a scenario in which faster demand growth and support for additional investment steadily raises both actual and potential growth, permitting the European economy to bring large numbers of currently excluded workers into employment.

Reviewing the empirical evidence, John Morley shows how a failure, not least compared with the US, to manage economic shocks has steadily led to a worsening of the situation of European labour markets. He argues that the preoccupation with inflation, justified in the 1970s and 1980s has led policymakers in the recent low-inflation period to a mistaken belief that unemployment cannot be reduced below current high levels without igniting inflation. This is at odds with what we actually know about the features of Europe's labour markets, which are much more flexible than commonly supposed. Faster demand growth needs to be accompanied on the supply side by greater efforts (training, lifelong learning) to raise human capital.

The third section examines the **Links between structural reforms and macro policy.** Gustav Horn presents simulations of what would happen to the German economy if a programme of 'structural' reforms were introduced with and without support from macroeconomic (in this case fiscal) policy. The simulations – which were conducted before the recent Hartz labour market reforms – show that without macro policy support the impact on growth and employment is negative, because of the damage reforms do to demand, especially consumer spending; employment is depressed for a considerable period and only recovers slowly. Exports are the only economic variable that unambiguously improves. This precisely fits the pattern of German stagnation accompanied by major export successes that we have seen in recent years. By contrast, accompanying such reforms with an expansionary fiscal policy leads to better growth and employment outcomes, and in the longer run also an improvement in the fiscal position.

David Coats gives a careful reading of the initial Lisbon strategy and a number of subsequent EU-level reports, in particular those produced by the working groups chaired by Wim Kok, and concludes that even in such 'official' thinking there is in fact recognition of the need to take account of the interaction between macroeconomic and structural policies. Unfortunately policymakers at European level have tended to neglect macro policy and focus on structural initiatives as the only way to energise the European economy. He also shows that the recent success of the UK economy is due not merely or even primarily to its liberalisation and that in fact the UK labour market has seen substantial re-regulation since 1997.

The contributions to the final section **The way forward: reforming Europe's macro policy regime** seek to draw out policy conclusions and to make appropriate recommendations. Franz Nauschnigg considers possible lessons to be learnt from 'Austro-Keynesianism'. He reviews the basic elements of that approach and shows how it came under pressure with Austria's accession to the EU, and the innovative solutions that Austrian governments up to 2000 found to enable them to continue with active demand management using fiscal policy. By contrast, policy since 2000, which has followed a neo-liberal paradigm, has seen relatively slower growth and higher unemployment in Austria compared with EU averages.

Ronald Janssen first debunks the myths that the poor growth record since 2000 has been caused by lack of structural reform, supply side rigidities or Europe being uncompetitive in the global market place. What is instead at the root of poor economic performance is lacklustre domestic demand.The lack of an expansionary macroeconomic policy response to the unfolding downturn has locked the European economy into a low confidence/low growth trap. So what is in need of urgent structural reform is the European macroeconomic policy regime. The ECB should make sure that monetary policy bites in downturns as well as in upturns, while fiscal policymakers should be investing in the Lisbon priorities. A coordinated initiative in which all member states draw up a Lisbon investment programme of 1% of GDP would make Europe its own engine of growth.

Paul De Grauwe argues that the design of the SGP is fundamentally flawed. Except for very highly indebted countries, for which there is logic in imposing external constraints on national freedom of manoeuvre in fiscal policy, the responsibility for budgetary discipline needs to be put back into the hands of the member states. Past SGP reforms have been generally in the right direction, but must be continued. In particular the 3% deficits as a share of GDP limit, a remnant of pre-scientific thinking, must go.

Andrew Watt shows that there is scope for a cooperative strategy, centred on wage-setters and the monetary authority, that could generate better economic and employment performance in EMU. While wage-setters anchor inflationary expectations by orienting nominal wages to the sum of productivity growth and the Central Bank's inflation target, the monetary authority seeks to maximise economic and employment growth. A change of behaviour by actors (rather than Treaty changes) is a sufficient condition for improved outcomes. Based on a simple formal model of policy cooperation between wage setters and monetary policy, the author examines the role that the Macroeconomic Dialogue could play in ensuring the required institutionalised cooperation between actors.

To round off the publication, we re-print two keynote speeches given to the conference. European Commission President Barroso sets out the Commission's view on how to move the Lisbon Strategy forward, while ETUC Deputy General-Secretary Reiner Hoffmann critically analyses the Commission's position and describes ETUC demands and perspectives for the Lisbon mid-term review.

It is to be hoped that the conference and this publication will raise awareness of the urgent need for a more pro-active, employment-oriented macroeconomic policy as a necessary condition, alongside structural reforms, for improved economic and employment outcomes in Europe. At the time of writing, with the economic recovery still fragile, the ECB has already started peremptorily to tighten monetary policy. It would be a tragic error if Europe were to repeat the mistakes of the past and kill the recovery before a lasting improvement in the labour market situation was achieved. In their different ways, all the contributions to this volume point out an alternative strategy based on a cooperative macroeconomic policy mix that would not lead Europe to repeat the mistakes of the past, but open up a pathway to higher employment, with all the economic and social advantages that would bring.

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