

**"MACROECONOMIC POLICIES FOR 1992:
THE TRANSITION AND AFTER"**

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ABSTRACT

The structural gains expected from 1992, if as significant as expected, will affect the European macroeconomy in more than one way. First, during a transition period, some adverse effects may be front loaded: this concerns unemployment, regional inequities, heightened overall uncertainty. Second, over the longer run, more intense interactions will appear in the operation of both monetary and fiscal policies. These effects are surveyed and a number of policy proposals are offered.

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* Final version of the 1988 CEPS Macroeconomic Policy Group report.

INTRODUCTION

The Single European Act envisages the ending of all remaining restrictions on the intra-Community flow of goods, labour and capital by 1992, thus creating a single market bigger even than the United States. By eliminating the costs of administration and delays at frontiers, by improving efficiency through greater rationalisation and exploitation of economies of scale, and by increasing competition, the measures raise the prospect of a significant improvement in the economic performance of Community. While quantifying the gains is not an easy matter, the comprehensive study into the likely benefits of the Single Market recently published by the Commission¹ produced estimates that seem broadly sensible. Employing a wide variety of methods to quantify the various effects, this study reached the conclusion that over the medium-term the completion of the Single Market could raise productive potential by as much as 5 per cent.

If this assessment of the gains from 1992 is correct, then it represents a significant macroeconomic boost to the economies of the European Community. While beneficial for the Community as a whole, there will nevertheless be individuals, regions or countries who may suffer, both during the transition phase and after the completion of the Market in 1992. In this report we examine the nexus between the essentially microeconomic measures envisaged in the Act and the macroeconomic performance of the Community, and consider how macroeconomic policies will need to be modified if the Community is to reap the full benefits of the Single Market.

The transition period up to 1992 may require a modification of the stance of macroeconomic policies as individuals and firms respond to the challenge posed by the Single Market by rationalising production, investing in additional capacity and so forth. In the short-run this supply-side

boost may well have a depressing effect on employment and aggravate regional imbalances. The first part of this report discusses the setting of macroeconomic policies during the transition phase in the light of this.

The completion of the Single Market will also permanently affect the way the European economies interact. The removal of restrictions on the flow of capital will inevitably limit the scope for independent national monetary policies and have implications for the durability of the current exchange rate regime. This loss of monetary independence carries with it significant fiscal implications for some countries. Furthermore the completion of the Single Market will itself affect both the feasibility and desirability of fiscal action as a macroeconomic policy weapon. The second part of this report therefore examines the question of the post-1992 policy regime.

I. MACROECONOMIC POLICIES IN THE TRANSITION PERIOD

We take it for granted that the application of the Single European Act will not be delayed, so that in the run-up to 1992 there will be an acceleration in the process of structural change as a result of the creation of the Single Market. The extent of this acceleration is difficult to gauge since there are a variety of adjustment costs which will counteract the effects of the new economic incentives facing firms and households. But there is no doubt that a significant acceleration will occur and that macroeconomic policy making should take it into account.

Clearly, however, macroeconomic trends in the Community and the rest of the world also need to be borne in mind. The problems presently facing the Community arise as much from recent economic developments in the European and world economies as from the need to promote a good start to the Single Market. Indeed an accurate assessment of these trends is of paramount importance for a correct diagnosis of the challenge to macroeconomic policymaking posed by an acceleration in the process of structural change for, as we argue below, the extent of the macroeconomic problems during the transition period will very much depend on the degree of dynamism exhibited by the European economy during the first part of the next decade. To set the stage for a discussion about the nature of the structural changes to be expected from the completion of the internal market and the appropriate policy stance during the coming years, we must therefore first assess both current macroeconomic trends in the world economy and within Europe.

1. Current Macroeconomic Trends

Given the medium-term perspective of this report, we must focus on two questions posed by recent economic developments. First, does the

surprisingly robust economic performance during 1988 of the world economy in general, and the Community in particular, signify a durable expansion is underway? Second, are there signs of a better comparative performance by the Community after the significant deterioration in European competitiveness in the late seventies and early eighties. These two questions are addressed in turn.

1.1 1988: A Surprising Year

At the beginning of 1988, in the immediate aftermath of the stock market crash, there was an air of pessimism surrounding forecasts of economic growth. In the event, growth in the world economy and within Europe has surpassed even the wildest expectations. Why was this and is the growth likely to be durable?

First the direct effects of the stock market crash seem to have been rather modest. Viewed with hindsight the behaviour of world stock markets during 1987 looks increasingly like an epiphenomenon largely unrelated to underlying movements in expected profitability and interest rates. The crash of October 19th, 1987 simply looks like a much needed correction to a bull market that had got out of hand². Consequently the implications for investment were likely to be much less catastrophic than if the crash had signalled a fundamental downward revision in expected profitability. Analysis in the autumn of 1987 concentrated on the direct effect on consumption of the fall in household's evaluation of their wealth, assuming that this fully reflected fluctuations in stock market prices. Most estimates then suggested that, even so, the effect on consumption could be expected to be rather small in most countries - less than $\frac{1}{2}$ per cent of GDP in the United States and less than $\frac{1}{4}$ per cent of GDP elsewhere. The partial recovery in world stock markets since then means that even these effects have been attenuated. There remained the possibility that the

crash and the uncertainty it engendered, could have severely dented consumer and industrial confidence and provoked a financial crisis as investors switched from risky to liquid assets. In fact confidence remained remarkably buoyant and a temporary global relaxation in monetary policy, coupled with some selective rescue operations, forestalled any collapse of the financial system.

Some commentators view the post-crash relaxation in monetary policy as excessive, but it is difficult to believe that the much faster-than-expected growth experienced in 1988 can be attributed to this, for by the middle of 1988 interest rates in many countries were back to pre-crash levels. It seems clear that other factors must have been driving economic growth. Exactly what were these factors?

Table 1 gives the estimated rate of growth of the main expenditure categories during 1988 for the major world economies, drawn from the latest Commission forecasts. The table also gives the contribution to GDP growth of each category (an expenditure category may, of course, grow very rapidly, but it will have little effect on total growth if the share of that category in total output is small). The striking feature is the relatively rapid growth in investment, exports and imports in most countries. Of course, a major component determining total output growth in all countries is consumption, but this is probably largely a reflection of the rapid growth in incomes associated with unusually rapid domestic output growth. Similarly the rapid growth in exports, everywhere except the UK, is a reflection of the unusually rapid growth in world output, while rapid import growth again is to be expected in the face of rapid domestic demand growth.

To identify the fundamental causes of the unexpectedly fast economic growth in 1988 it is not enough, therefore, to identify which categories of

expenditure grew rapidly, nor even which grew unexpectedly rapidly relative to forecasts made at the beginning of the year, because of the endogeneity of each component of expenditure. The only way to satisfactorily discuss the issue is with the aid of a fully specified and calibrated economic model which describes the interactions between each of the economic variables. One can then split movements in these variables into that part which is explicable, conditional on the evolution of the rest of the economy, and a residual reflecting the unexpected, or unpredictable part.

Such an exercise is well beyond the scope of this report. However, most empirical investment equations suggest that, because of time-to-build lags and the like, the response of investment to changes in demand, profitability, interest rates, and so on, is somewhat delayed. Consequently, most of the investment that took place in 1988 probably reflected decisions, and therefore also economic developments, in 1987, or before. So it seems clear that at least one major source of forecasting error lies in the underprediction of investment growth. Table 2 indicates the extent to which both the Commission and the OECD underestimated the buoyancy of investment in 1988.

So why has investment been so buoyant? The buoyancy of investment in U.S.A. and Japan may not be too surprising as both economies have displayed vigorous growth in recent years. By contrast growth in the Community, with certain exceptions, has been steady rather than spectacular. At the same time capital formation has been depressed throughout the late seventies and early eighties. Thus, over the first half of the seventies the share of investment in GDP in the Community averaged more than 23 per cent, but has averaged less than 20 per cent during the eighties. The result of this has been a shortfall in the capital stock by 1987 of around a quarter compared to an extrapolation of the 1960-74 trend. This capital shortfall and its

possible implications for output and employment has been the subject of a previous Macroeconomic Policy Group report³.

Figure 1 plots the private non-residential investment rate (Gross private non-residential fixed capital formation relative to the gross non-residential capital stock) and the profit rate (real operating surplus relative to the same capital stock measure) since 1955 for France, Germany and the United Kingdom. The picture is the same for other Community countries. The decline in investment that occurred from 1973 or thereabouts is clearly preceded by the decline in profitability, that occurred one or two years earlier. However, since around 1982 profitability has been recovering, as both the utilisation of existing capacity has increased and labour cost pressure has moderated. These are, of course, only the proximate determinants of profitability. Higher capacity utilisation is likely to itself reflect increased price competitiveness, so the role of a reduction in wage pressure at a given level of activity is greater than would be suggested by a straightforward examination of the actual path of labour costs. Of course, expected future profitability rather than past profitability is what really matters, and the opportunity cost of funds (i.e. real interest rates) and the certainty with which expectations of costs and demand are held must also be relevant. Nevertheless the picture certainly suggests that a primary driving force behind the resurgence in investment has been the improvement in profitability.

To put a little more flesh on this, Table 3 reports the results of some simple regressions of the investment rate on past values of profitability and real interest rates over the period 1960-87. Profitability indeed plays an important role, although the role of interest rates is less pronounced. We have then used the estimates to project forward the

investment rate, and by implication the growth in investment, for 1988. These appear in the last line of the table. For both Germany and the United Kingdom a significant spurt in investment is forecast, although the projected investment growth for France is much more modest.

One should not take these results too seriously but they do support the idea that the 1988 investment boom was at least in part a response to the recovery in profitability. Provided capacity utilisation remains high and the moderation in labour cost pressure is sustained, there is every possibility that this recovery in investment could continue. But it would be complacent to assume it will necessarily continue on its own accord. A major task of macroeconomic policy, therefore, is to try to ensure that this investment-friendly economic environment persists.

It is, of course, possible that some of the increase in investment reflects strategic behaviour by companies prior to 1992. An underprediction of investment by existing relationships would certainly be consistent with this. However, we are inclined to doubt such an explanation. The "news" about 1992 really occurred during 1988 itself. Prior to this, awareness by businessmen of the new opportunities provided by the completion of the internal market seemed relatively limited. By contrast, in response to widespread media coverage, almost no businessman can now fail to be aware of the changes taking place. But given the usual gestation lags between investment decisions and realisations we would not expect this to start affecting the recorded capital formation statistics until 1989 or 1990. If such strategic investment does turn out to be qualitatively important it would give a further beneficial upward thrust to productivity and output in the next few years.

This resurgence in investment in the Community is especially welcome on two grounds. First, survey evidence suggests that investment is

increasingly being undertaken with the objective of expanding capacity rather than substituting capital for labour. Consequently the employment potential of the Community is increasing which is good news in the continuing fight against unemployment. Second, the modernisation of capacity will enhance the competitiveness of European producers and may help to reverse their deteriorating position on world markets.

Nevertheless the major imbalances in the world economy remain. Although the outlook is brighter than anyone can have hoped a year ago, the possibility - if no longer the probability - of a slump in either World or European demand remains. But European growth may also turn out to be constrained by supply bottlenecks. In particular, shortages of skilled labour may become more serious if the recent relatively rapid growth in demand continues. Despite the good news of 1988 uncertainties about the path of the European economy in both a downside and an upside direction are still present.

1.2 Europe in the World Economy

We start by examining the deterioration in Europe's competitive position during the late seventies and early eighties. What is at issue is the demand for European output at given prices, rather than movements in price competitiveness. For succinctness we shall refer to this as "competitiveness" instead of the more usual, but also rather cumbersome, term of non-price competitiveness. The exact extent of this loss in competitiveness is difficult to gauge, partly because it was unevenly distributed among member countries. However, macroeconomic performance has been indicative of a fundamental underlying competitiveness problem.

In comparison with the rest of the industrialised world, the Community experienced a sharper reduction in output growth and a larger increase in unemployment during this period. This was symptomatic of an underlying

competitiveness problem. In several countries policymakers could not stimulate aggregate demand without causing an unacceptable deterioration in the current account. Attempts to circumvent this by engineering a depreciation were likely to lead to inflationary pressures in the labour market. In this way the deterioration in competitiveness acted as a constraint on medium-run output and income growth.

Lawrence⁴ has investigated this thesis by using empirical trade equations to calculate the foreign and domestic growth rates consistent with balanced trade, at unchanged terms of trade. Of the three largest European economies only West Germany could maintain balanced trade while matching a 3 per cent growth rate in the rest of the OECD. Without the windfall gain of North Sea oil, the United Kingdom would have been able to grow at no more than half that rate. Finally, France whose performance compared well with Germany in the seventies, performed very poorly after 1980.

This study was carried out at an aggregate level⁵ and did not distinguish between intra- and extra-Community trade. Supplementary evidence at a more detailed level has been provided by work undertaken at the Commission by Catinat. This shows that, over the period 1975-86, the European countries roughly maintained their shares in OECD manufactured exports towards extra-Community markets (with the notable exception of the United Kingdom), but that this was achieved through slow domestic growth which forced producers to look elsewhere for markets. It also implied a decrease in the share in total world exports where the Newly Industrialised Countries played an increasingly significant role. Moreover, during the same period, only Germany and Italy were able to increase their shares in intra-community markets, while the shares of France and the smaller countries declined.

In order to reach a fuller understanding of the changing role played by Europe in the international division of labour it is also necessary to look at the product composition of exports and imports. Table 4 gives a breakdown of the European trade balance by industry over the last twenty years. It shows that the European position remains relatively strong for mechanical and chemical products, and that it has actually improved for food and agricultural products. The resistance during the last ten years in textiles and clothing is also noteworthy. But the losses, mainly to Japanese competition, have been very pronounced in vehicles, electric and electronic products. These *ex post* figures would, of course, have been still more unfavourable during the last fifteen years if, given the state of European competitiveness, activity in Europe had been less depressed.

Buigues and Goybet⁶ have analysed the decline of European competitiveness distinguishing three broad sectors within manufacturing. They aggregate 14 industries on the basis of the growth of demand for their output during the period 1972-85. The sector characterized by strong demand (comprising Office and data processing equipment, Electrical and electronic equipment, and Chemicals and pharmaceuticals) is particularly troublesome. Demand in the Community grew at an annual rate of 5.0 per cent; but the penetration rate (the proportion of domestic demand accounted for by imports) jumped from less than 10 per cent in 1972 to 20 per cent in 1985. Simultaneously the European export market share for these products in the OECD area declined from 28 to 25 per cent. An increasing proportion of output was exported (16 to 24 per cent), but the production of this sector grew at a much slower pace than in the rest of the world; this illustrates nicely the macroeconomic argument spelt out above. The picture in the two other sectors, in which demand growth was less rapid is by contrast much less unfavourable.

These results indicate that the loss of competitiveness is intimately related to Europe's inability to shift human and capital resources to the growing industries quickly enough. Yet these are industries in which the Community should not have had any natural comparative disadvantage. It thus appears that Europe may have lagged behind in adapting to changes in the structure of demand and in the international division of labour. Trade and macroeconomic policies could not fully make up for this; slow aggregate growth and high unemployment followed. The challenge now is to undertake the necessary reorientation of the Community's industrial structure. Meeting this challenge will, however, be made more difficult by the current imbalances and instability prevailing in the world economy.

Except for the two sharp increases of the oil price in 1973 and 1980, the imbalances in the world economy during the last fifteen years have tended to be rather beneficial to Europe. The heavy borrowing by developing countries in the seventies helped to sustain the demand for the output of European firms, and overvaluation of the dollar from 1983 to 1985 and the American boom gave them a competitive advantage that helped the slow upturn in activity that began in 1984. But the situation has now been almost fully reversed. While the relative price of oil will probably remain low for some time to come, high interest rates and heavy indebtedness has forced many debtor countries to follow import-reducing policies. Similarly the US current account deficit, although falling, still has long way to go⁷. These two factors mean that European firms will face serious competition on foreign markets, many of which will probably no longer be growing rapidly.

At present this background is made less severe by the stronger than expected growth in the OECD area that has been recorded in 1988. But it would be foolish to place confidence in the permanence of this growth. On

the contrary, the major imbalances in the world economy remain. If real interest rates remain high, then international indebtedness will not decline unless a significant portion of the debt is waived. While a major financial crisis has so far been avoided - and indeed the risk of such a crisis is probably less now than it was - the risk will remain for the foreseeable future. Similarly, despite the Louvre Accord and Plaza Agreement, it would be premature to assume that the severe misalignments in real exchange rates that occurred in the past will not do so again.

To summarize, the Community needs to make up for its relatively poor competitive performance during the past fifteen years and must recognise that this will probably have to take place under relatively unfavourable external conditions. Are there any signs indicating that Europe is beginning to meet this challenge?

Since competitiveness is the main issue, unambiguous evidence about a reversal would come from the evolution of market shares outside and within Europe. Aggregate industrial data (in value terms) do seem to show that, since 1984, export market shares have increased and penetration rates stabilized slightly, so that the previous unfavourable trend may at least have been brought to an end. But the recent evolution owes much to the improvement in the European terms of trade. Volume figures give a rather different picture, with in all probability a continuous decrease in the shares held by the Community countries in World markets, once the increase in the share of the NICs is taken in account.

This combination of outcomes is not surprising, considering the evolution of the industrial terms of trade. Cost and price competitiveness were favourable to European industrial firms in the first part of the decade, but by 1987 had roughly returned to their 1979 level. During these eight years, losses of market share were significant despite the fact that

exchange rate movements should have tended to boost European competitiveness. The question now is whether, given a more sustainable pattern of exchange rates, Europe will regain part of this lost ground and succeed in reversing the trend of its non-price competitiveness. For the time being data on trade flows cannot tell us much of significance on this crucial issue.

More instructive is a direct examination of the factors that may lead to growth in the supply of output by European firms. In this respect the recent sharp upturn in (capacity-expanding) productive investment is most encouraging. Moreover figures seem to show that this revival is particularly marked in those branches of industry producing goods for which world demand is strong. If European producers believe they are in a better position to meet foreign competition the prospect of a durable expansion in European supply is that much brighter. Whether this expansion in capacity will be associated with an improvement in European trade performance remains to be seen however.

In any case, one particular feature of the present situation must be faced, concerning not only European competitiveness but also other aspects relevant for the design of macroeconomic policies. This is the disparate performance of different countries in domestic and foreign markets. A rather crude indicator of this is provided by the ratio of the current balance to Gross Domestic Product in different countries (see Table 5). In 1988 this ranged from -3.1 per cent in the United Kingdom to +4.0 per cent in Germany and this divergence between countries tends to be greater now than in the past. Moreover some of the deficit countries do not view their situation as either satisfactory or sustainable over the medium term. A tightening of the stance of macroeconomic policies in these countries may

then be necessary to counter these deficits, possibly accompanied by a moderate exchange rate realignment to correct for past disequilibrium.

Finally in considering present supply trends one should not forget the labour market. It is clear that in many firms and sectors labour hoarding is no longer as prevalent as it used to be. The demand for labour has been steadily increasing during the last four years and in some cases firms are now experiencing shortages of skilled labour. While some labour hoarding no doubt remains, it is no longer of the same importance. Rather manpower shortages may well begin to constrain production.

2. The Effects of Completing the Internal Market

As we noted in the Introduction, the completion of the internal market represents a significant supply-side boost which will lead to an acceleration in the process of structural change. The nature of the potential gains has been fully studied by the Commission and are of two kinds. The first results from increased efficiency in firms and within the economic system as a whole, bringing with it lower costs and higher welfare. These can be adequately analyzed by standard comparative static methods, although most of the effects are not actually instantaneous and result from the working out of the competitive process. Others, however, are fundamentally dynamic, and concern the pace and strength of innovative activity. These two types of effect raise distinct macroeconomic problems and will be considered in turn. In dealing with the first, however, it is convenient to distinguish a timing question from that of the geographical distribution of the gains.

2.1 The Employment J-Curve

The timing issue was well exhibited in the Commissions's study. The macroeconomic assessment concluded that the completion of the internal

market was likely to have both favourable and unfavourable effects on employment. In the long run the former would dominate, but the latter could be important in the short run. This was supported by an illustrative (rather than predictive) simulation. Under the extreme assumption that the completion of the internal market occurred instantaneously (rather than being drawn out as it is likely to be in practice) and also assuming other policies remained unchanged, this simulation showed a significant depressing effect on employment during the first two years, with the impact becoming positive only later - a sort of J-curve in employment. The study went on to argue that the completion of the Single Market would create new room for expansionary policies. Under unchanged policies it would act to reduce inflation, lower budget deficits and improve the balance of payments. Exploiting this new margin of freedom open to policy makers would lead to higher employment than would otherwise be the case, although it could not fully eliminate the initial negative impact of measures that will ultimately boost European productivity and competitiveness.

While accepting the analysis without reservation, we should like to add that the time profile itself will depend on several factors and will depend not only on the economic environment, but also on the way economic policy is patterned.

This "employment J-curve" results from the lags involved in the realization of the benefits present in the comparative statics analysis: essentially the cost reductions, and the accompanying fall in required labour input, arrive before the increase in output stimulated by higher purchasing power and enhanced competitiveness. But this timing is not mechanical; it depends crucially on the expectations held by economic agents and on the nature of the market disequilibrium prevailing when the institutional change occurs.

The lags in standard econometric equations measuring the main macroeconomic effects are based on past history. They reflect the average conditions prevailing over the sample period, including both anticipated and unanticipated changes. But the objective of completing the Single Market by the end of 1992 has now gained considerable credibility with economic agents; consequently the changes resulting from it will be, to a large extent, anticipated. Lags in the response to these changes will then be shorter than observed in the past for other, largely unanticipated, shocks.

One can even push the argument a bit further. Since the completion of the internal market will ultimately not only raise output because of increased efficiency but also stimulate greater competition, firms may act strategically in order to enhance their competitive position ahead of the completion of the Single Market. This could take the form of the launching of new research and development projects increased investment in equipment, the building of suitable commercial and distribution networks, and the recruitment and training of manpower.

On the other hand, one must also remember that the impact of a shock depends on the nature of the constraints or disequilibria affecting the economy. A shock to demand will have a different effect on output if firms find themselves constrained by capacity or manpower, than if they have an abundance of capital and labour. Now the completion of the Single Market is very similar to a productivity shock, increasing the supply of goods while simultaneously reducing the demand for labour. Conventional macroeconomic models usually assume the economy is characterised by spare capacity and an abundance of labour. In that case the completion of the Single Market will aggravate matters, at least to begin with. This is precisely what the descending part of the "employment J-curve" shows. But

depending on business conditions at the beginning of the next decade, this hypothesis may be more or less appropriate.

Previous reports of the CEPS Macroeconomic Policy Group have argued that the recent poor European economic performance is partly due to weakness on the supply side. Indeed, poor European competitiveness in world markets is precisely a reflection of that weakness. The gains to be expected from a productivity improvement in Europe are recorded by econometric models, but in a fashion that usually ignores possible variations in the structure of market constraints and disequilibria.

In our view the Community will continue to be characterised by significant unemployment in the run-up to 1992. But we cannot rule out the possibility that excess supply in the labour market will be less acute. Besides the main scenario that was explored in the Commission's study, one might consider another in which shortages of labour, especially skilled manpower, have reappeared, not perhaps everywhere, but at least more widespread than has been observed since the beginning of the current decade. To the extent that improved productivity economizes on the use of the kinds of labour that are in short supply, it will lead to higher output (rather than lower employment) and thus a more favourable economic picture than might otherwise be the case.

2.2 Regional Implications

The acceleration of industrial restructuring cannot be expected to be geographically neutral. Some regions and some countries will, for a while at least, benefit more than others. Even after the transition period, some areas may find they are worse off and have lower employment than if the completion of the internal market had not occurred. This problem is all the more serious, because even after the removal of remaining barriers to the free movement of labour, mobility within the Community will remain

imperfect because of the natural frictions induced by cultural heterogeneity. It therefore deserves some attention.

The pattern and conditions of regional developments will be determined primarily by changes in the industrial composition of Community output. The acceleration in restructuring following from the completion of the internal market is likely to mainly benefit high technology industries, for this is where the potential for the exploitation of economies of scale and scope and technical progress are greatest. These are also the industries where Europe has tended to lag behind. In these industries European firms, benefiting from a large internal market and enhanced profitability, will be able to develop and expand their product range, at the same time filling niches in markets outside the Community. By contrast the declining traditional industries have less to gain from the completion of the internal market and their demise may be hastened.

A mechanical projection based on the present pattern of regional specialisation would suggest an accentuation of the problems of the peripheral regions and thus an increase in the imbalances in economic development. Of course, such a mechanical projection exaggerates the problem because it neglects the comparative advantage that peripheral regions have within the declining industries and the stimulation that their exports to the rest of the Community may experience as the European market becomes more integrated. The current expansion in Spain and Portugal illustrates this process at work. However, its impact should not be overestimated.

The occurrence or even just expectation of worsening regional imbalances may act to impede the successful completion of the Single Market to a significant effect. Countries that find they are (or fear they might be) losers rather than gainers will be tempted to try to introduce measures to

protect threatened firms and regions. A commitment to the letter of the Single European Act falls far short of a commitment to the spirit of the Act, and there are countless ways that governments could discriminate in favour of indigenous producers without obviously violating the Act.

Alternatively governments and producers may be tempted to press for a raising of external barriers to compensate for the removal of internal barriers where such an action would be permissible under the GATT. In this respect the field of financial services is especially open. Increasing protectionist pressures in the United States make retaliation all the more likely, to the general detriment of consumers within Europe and outside. Arguments for "reciprocity" may be valid in some cases, but all too often are likely to simply camouflage protectionist measures.

These problems are less likely to arise if countries and regions know they will not suffer noticeably from the increased competition resulting from the completion of the Market. Rapid growth will help, because even declining firms and industries will benefit from increasing demand for their products. But it is a pious hope to assume that everybody will benefit without some conscious effort to redistribute resources across regions, or to limit the growth in regional imbalances through appropriately targeted economic policies.

In recognition of precisely this problem, the Community have decided to roughly double the size of the structural funds (in real terms) by 1993. Furthermore these funds are to be concentrated increasingly on the poorer regions of the Community, especially Portugal, Greece, Ireland (including Northern Ireland) and substantial parts of Italy and Spain. Including loans from the European Investment Bank the anticipated resource flows to these regions are considerable - in the range 3-6 per cent of GNP for the first three countries. This is of the same order, relative to the

recipients GNP, as the Marshall Plan for the post-war reconstruction of Europe (although the size of the transfers relative to the *donor's* GNP is considerably smaller at less than $\frac{1}{2}$ per cent). The funds are intended primarily to facilitate investment in infrastructure and manpower training i.e., to increase the stock of physical and human capital in the beneficiaries, and thus put them in a better position to exploit the completion of the internal market.

As such the funds will play a role in redistributing income within the Community and contribute to long term development objectives. However, it is not necessarily the poorer regions that may suffer from the completion of the internal market. The operation of the law of comparative advantage means that some individuals and enterprises in the better-off parts of the Community could also suffer. The regulations for the administration of the expanded structural funds also permit assistance to declining industrial regions with above average unemployment.

Where the adverse impact of the completion of the internal market is quite widespread, this may serve to compensate losers adequately. However, some adversely affected individuals and enterprises will not benefit from this redistribution, and accordingly will be more likely to press for special treatment. It is important that such special pleading does not jeopardise achieving the full potential gains from the Single Market.

2.3 The Impact on Innovation

The loss of European competitiveness is to a large extent due to a lower rate of innovation in comparison to both Japan and the US. At least part of the explanation lies in the low level of profitability that prevailed during the seventies which discouraged firms from investing in research and development and undertaking risky new ventures.

This situation has now changed. Profit rates look satisfactory on average and in some industries and firms are historically high. The question remains, however, as to whether the high real interest rates have not led too many firms to concentrate on reducing their indebtedness, or even entering into financial operations, rather than investing in physical capital in order to exploit new market opportunities. The current boom in industrial investment suggests this may not be a problem but the stakes are too high to discard the hypothesis completely.

Since the completion of the internal market will improve efficiency and increase competition it will probably act to encourage increased innovation also. (Strictly speaking the reduction in monopoly profits might discourage innovation, but overall we believe the effect coming from increased competitive pressure on firms will dominate.) But it should have an even more direct impact on those activities that are subject to economies of scale. By stimulating competition in those activities where only a few European firms can efficiently operate and by *de facto* removing some duplication of effort, it should lead to an increase in the resources devoted to research and risk taking, while at the same time making the use of existing resources more efficient. As a consequence total factor productivity should rise.

How large this effect is however, will depend not only on the impact of the present Community effort in research and development, but also on how various Community policies operating after 1992 are patterned (and whether they are announced in advance): in particular policy with respect to competition within the completed internal market, with respect to public procurement; and with respect to the promotion of research. These policies will be particularly significant for the success of high technology industries. However meeting the challenge posed by this required increase

in innovation, as well as by the acceleration in industrial restructuring with both its timing and regional implications, requires that all policies are set up so as to facilitate the smooth introduction of the post-1992 regime. That is why we must now be more specific on the appropriate macroeconomic strategy for the transition period.

3. Macroeconomic Policies in the Transition Period

Previous reports of the CEPS Macroeconomic Policy Group argued for a two-handed growth strategy, acting simultaneously through both the supply and the demand sides of the economy. Successive reports studied different aspects of this strategy and also attempted to explain why it was not more wholeheartedly embraced by member governments. Looking ahead to 1993, if anything, reinforces the arguments in its favour, even if recent developments somewhat change the desirable policy mix. On the supply side promoting efficiency and flexibility would improve European competitiveness and lead to more effective employment of the available labour force. A sustained growth of demand on the other hand would minimise the adverse effects of the phenomenon illustrated by the employment J-curve and contribute greatly to generating the forward looking spirit that is necessary for a durable European recovery. But the challenge of 1992 also increases the need to avoid divergences in national performance, which could otherwise disrupt the process of market integration. The need to consider these medium-term objectives coupled with the recent favourable trend in business activity, thus somewhat shifts the main focus of our attention away from immediate policy concerns towards the framework for guiding economic policy during the transition phase.

This slight reorientation should not, however, hide the extent of the difficulties that need to be overcome. The present level of unemployment

is still quite unsatisfactory. In section 1.2 we saw, moreover, that halting the decline in European competitiveness may not be easy because of both the strength of the past trend and the adverse developments (from a European perspective) that may occur in the world economy.

Against this background we will first briefly review how the two hands of the growth strategy - supply and demand - need to be modified, before considering how best to pursue medium term objectives, including guidelines for behaviour in the face of unexpected developments.

3.1 The Supply Side

The agenda proposed in the 1987 Report of the group⁸ stressed five groups of measures intended to promote competitive European supply. How does this agenda need to be modified in the light of 1992?

a) One group of measures should consist in "public infrastructure investments likely to raise productive efficiency". The completion of the internal market will significantly raise the volume of trade between different regions of the community. As a result the social return to investment in road and rail networks and associated projects is likely to increase. Yet spending in this area has frequently suffered during the process of fiscal consolidation of the eighties. Now is a good time to re-examine priorities in this area.

A high priority should also be given to public research. As we saw in Section 2.3, the reorientation of European productive capacity toward advanced technology industries requires an exceptional research and development effort. Private firms will be able to assume part of this effort, but only public laboratories and research institutes will be in a position to carry out the more fundamental investigations. Because the results are widely diffused and the main economic benefit in general do not accrue to the successful research teams such research has the character of

a public good. Furthermore the public sector may also need to give some support to projects whose size or riskiness is too great for a single private enterprise. In close contact with this research activity public education must improve the training and retraining of engineers, technicians and other skilled workers. Again the fact that private firms usually cannot be sure they will harvest the returns from such investment in human capital means that the social return exceeds the private return.

b) The 1987 report also recommended continued "medium-run labour cost reductions" (meaning real unit labour costs). In most European countries real unit labour costs have continued to decline, although often at a slower rate and primarily as a consequence of the productivity gains induced by faster growth. A fresh assessment may thus be called for. On the one hand the restoration of profitability may not yet have gone far enough to ensure a return to full employment in due course. On the other hand, a further significant decline in real unit labour costs might be difficult to achieve given the existing structure of labour markets. If further cuts in real unit labour costs do turn out to be necessary, governments must be aware that special effort will be needed because productivity growth is not likely to accelerate further and indeed will probably decline if the pace of expansion slows.

As we saw in section 1.1. industrial rates of return now seem to have recovered. Conceptual and statistical difficulties abound, but work at the Commission and OECD leads to qualitatively similar results. Depending on definitions and statistical sources the present level compares more or less favourably to the one achieved in the early seventies. But the figures given in the Commissions 1988-9 *Annual Economic Report* may be taken as representative and they show that profitability has not quite recovered to its 1970 level. It can, moreover, be argued that profit rates need to be

higher now than in the past. First, responding to the challenge of restoring European competitiveness requires active promotion of entrepreneurship. In this respect one should not forget that the rate of productive investment is still low by comparison with the level attained in the sixties. Second, increased uncertainty has probably led investors to seek higher risk premia on new projects. Third, high real interest rates have raised the opportunity cost of capital.

On the other hand, a healthy European social and economic development requires that profit rates not become too high. It would be better to try to attack the three problems just mentioned above directly. If completion of the internal market proceeds without hesitation and on schedule, this will do a lot to change the expectations of businessmen, making them more confident in economic prospects and less sensitive to uncertainty.

From this we draw the conclusion that many policy instruments have a role to play. However, abandoning the objective of maintaining continued downward pressure on real unit labour costs at the present juncture would require that the competitive position of European firms has improved and will remain strong in the years ahead. As we noted in Section 1.2 caution is called for in this respect.

c) The last group of measures advocated in the 1987 report concerned flexibility. We can here only repeat the plea for "a more pronounced reduction in overall wage costs for unskilled workers and for workers in depressed areas" as this will smooth the transition phase. A significant reduction in labour taxes or social security contributions on the wages of these workers might be the best way of achieving a further moderation of labour costs.

However in the context of 1992, there are two other aspects of flexibility that are worthy of further brief consideration. First, in some

countries the structure of the housing market discourages labour mobility. Reducing transactions costs and encouraging a revival of rented accommodation benefit worker mobility. In particular eliminating tax incentives discriminating in favour of owner occupation is desirable. Second, at the level of the Community, the international migration of labour, which has slowed since 1973, will resume, perhaps on as large a scale as twenty years ago. A study of the particular problems posed by this phenomenon might help to ensure that this occurs as smoothly as possible.

3.2 The Demand Side

Previous reports of the group also advocated an active fiscal stimulus to the demand for goods in the Community in order to achieve a higher growth of output and employment. Fortunately, the present favourable trends in business conditions suggest that no further action to stimulate demand is required at the moment. So far supply has increased fast enough to match this surge of demand, although at the cost of increased trade imbalances within the Community. However, the rate of capacity utilisation has reached historically high levels and further increases in demand run the risk of initiating a burst of product price inflation.

It would, however, be complacent to assume that conditions will continue to be as favourable in the future. External conditions are likely to become less favourable to Europe as we saw above. But a continuation of the resurgence in investment, and with it an expansion in capacity and employment, requires not only that labour costs are contained, but also that existing capacity is fully utilised. Furthermore sustained growth will help to alleviate the adverse effects exhibited by the employment J-curve and facilitate the process of industrial restructuring. So it is important that fiscal policy, supported by an accomodating monetary policy,

stands ready to ensure that the growth in demand for goods produced within the Community matches the growth in supply. Yet it should be recognised that this will occur in an environment in which the process of fiscal consolidation still needs to continue in many countries and in which the external positions of all countries will probably be deteriorating. So despite the recent encouraging trend in business activity, the outlook for macroeconomic policy makers may be less rosy than it seems at present. The rest of this section goes on to examine aspects of the management of demand in more detail.

3.3 Fostering Convergence

One should first note with satisfaction that disinflation has also meant a steady convergence of inflation rates: most of those countries in which the rate of inflation was high five years ago have seen a very marked reduction in inflation. This will facilitate the introduction of free capital movements in 1990 (see below). However, even this is subject to reservations. On the one hand, the general pattern does not apply to Greece, where prices are still increasing at 15 per cent per year, nor to Portugal, where the annual rate still is about 9 per cent (although down from 25 per cent in 1983). On the other hand, among other countries, the spread is still around 4 per cent, which is more than can be sustained without either frequent changes of parity, or a chronic loss in the competitiveness of the countries with higher inflation.

Other economic indicators paint a less rosy picture. During the past five years unemployment has shown little sign of falling markedly especially in high unemployment regions. This difficulty of high unemployment countries in generating a sufficient growth in employment is symptomatic in part of their lack of international competitiveness.

In the same vein, the dispersion in current account performance has also increased. Among the larger countries, the spread between the German surplus and the British deficit could be as much as 7 per cent of GDP in 1988. And of the high unemployment countries, Spain, Italy and France all record a small but significant deficit.

Finally, public debt kept increasing fast in countries in which the debt-income ratio was already high (Ireland, Belgium, Italy, the Netherlands) while the debt-income ratio has fallen in the United Kingdom and Denmark where it was low to begin with.

As we noted above, the continuation and aggravation of these imbalances is likely to hamper the smooth completion of the Single Market. How can policy help? The expansion of the structural funds will certainly do something to attenuate the impact of geographical imbalances. However, conventional macroeconomic policy also has a role to play. The 1987 report paid particular attention to the co-ordination of fiscal policies and to the role that the three large countries, with a relatively light public debt and a surplus or a balance on their foreign transactions (Germany, U.K. and France), could play. We shall not repeat the arguments in favour of this strategy. Here we just note that the very rapid expansion of demand in the United Kingdom during the last year and the resulting deterioration in its foreign position suggests an increase of the role that Germany ought to take if and when intensification of this co-ordinated action is required.

However, it is also natural to ask whether the present pattern of exchange rates is conducive to achieving convergence. The question has particular importance during the transition period since a fair degree of stability of exchange rates within the completed market will, in any case, be necessary for its successful working. Hence, sustainable parities need

to be established in the mean time. The main operational issue at present concerns parities within the EMS and is discussed in an appendix to this report. We conclude that while exchange rate realignment alone cannot be expected to correct current account imbalances resulting from differences in real factors, it may be useful when confronted with purely nominal shocks or an initial disequilibrium. In the two years since the last realignment differential core inflation rates have led to a modest drift in real effective exchange rates, and a moderate realignment of around 5 per cent between the Belgium, Dutch and German currencies on the one hand and the Danish, French and Italian currencies on the other, would compensate for this cumulated difference in past inflation rates. If this could be made without the pressure of a speculative crisis, it would demonstrate progress in the development of the EMS. Alternatively inflation rates in the second group of countries will have to fall below those in the first group for a while in order to eliminate the current disequilibrium.

3.4 Medium-Term Objectives

Let us now take a longer-term view of the whole transition period. It is of course full of uncertainties that cannot be ignored. Both good and bad surprises are possible and policy must be contingent on these. In this regard it is still unclear whether the good news of 1988 is indicative of further good news to come, or whether it was simply a flash in the pan. For the present, one must focus attention on a set of objectives that one can reasonably consider as attainable and with respect to which economic performance can be judged.

If the present trend rate of increase of employment in the Community of roughly 1 per cent per annum continues, the aggregate unemployment rate will decrease only very slowly at about 0.3 per cent per annum. The present resurgence in investment, the trend in unit labour costs relative

to the cost of capital and the few steps taken to improve flexibility, all suggest that capacity employment, i.e. the maximum employment consistent with the available capital at the prevailing factor proportions, will increase at a faster rate than during the recent past. Given the present small surplus on the balance of payments of the Community, there is some margin of action for increasing demand if necessary with the aim of maintaining the present rate of capacity utilization (and sustaining the increase in investment). It seems to be a reasonable objective to aim at a decrease of half a point per year in the unemployment rate, which would correspond to an annual growth in employment of between 1.3 and 1.5 per cent.

In order to sustain such an increase in the demand for labour during the next four years, output will need to grow at an annual rate of 3 to 3.4 per cent, since one may expect the present trend of labour productivity (roughly 1.8 per cent per year) to be maintained. (More intensive and flexible use of labour should mean less pronounced productivity gains, but the acceleration of industrial restructuring should have the opposite effect.) In other words, the objective should be to maintain output growth in the Community at about its present rate, and slightly above that of the past three years. After more than a decade of slow growth such an objective may appear unrealistic. However, it is rather more modest than the one proposed by the Commission in its 1986 economic report in its co-operative scenario⁹. It is also more modest than the growth achieved by the U.S. economy between 1983 and 1987.

Now it is possible that the good news of relatively rapid growth during 1988 is indicative of a relatively permanent upward shift in the sustainable non-inflationary growth rate of the Community. If this is indeed the case then Europe may be embarked on a virtuous circle in which

faster total factor productivity growth is associated with high profitability, high investment, and high output and real wage growth. The exploitation of the gains associated with the completion of the Single Market can be expected to raise the growth potential to a certain degree. However, it is possible that we are witnessing the first stages of a return to the relatively rapid growth of the golden age of the fifties and sixties.

We believe this is unlikely however. That period was characterised by a considerable productivity gap between Europe and the United States, resulting from the wholesale destruction of the European capital stock during the Second World War. As a result the marginal product of capital was especially high during this period (see the high profit rates in Figure 1). The relatively rapid productivity growth over this period was due in large part to high rates of capital formation as this initial disequilibrium was eliminated. However, the initial productivity gap has now all but disappeared for the major European economies (except for the UK). Figure 2 illustrates this by plotting comparative labour productivity levels evaluated at OECD purchasing power parities. An upward shift in the present trend of European productivity growth alone would lead to it overtaking the United States (which has always exhibited relatively slow productivity growth) before long. Now technological possibilities in Europe and the United States are probably not too dissimilar and the high degree of international capital mobility should ensure that, in the long run at least, the marginal product of capital does not differ too greatly between Europe and the United States. Thus labour productivity should not differ too much either. Consequently, on theoretical grounds we are sceptical of any scenario which involves a much better comparative productivity performance by Europe for a sustained period. Of course, the

high levels of investment during 1988 may be indicative of a global increase in the rate of total factor productivity growth, presaging a worldwide acceleration in labour productivity growth as well. This is by no means impossible, but we would be wary of reading too much of a good thing into one year's data.

We shall not venture to give figures for the objective of achieving better convergence within the Community. However, on the inflation front there is still probably too large a dispersion in inflation rates for the trouble-free introduction of full capital mobility. We return to this issue in the second part of this report. With respect to external objectives, the aim should not be to achieve exact equilibrium in each country's balance of payments, but rather a pattern of surpluses and deficits and hence an associated flow of savings that would be consistent with differences in real rates of return and hence with the long-term development of the Community. In particular a deficit in the periphery countries should be welcomed if it is associated with a spurt in productive investment.

3.5 Responding to Shocks: A Two-Stage Approach

Having dealt with the policy guidelines to be applied in the proximate future, we must now discuss how the Community ought to react to changes in business conditions during the transition period or to a drift with respect to its objectives. Our intention is not to provide rules to be applied mechanically, but rather to set up a general framework within which the policies to meet any unexpected development can be framed.

Ideally the formulation of macroeconomic policies within the Community should proceed in two stages. At the first stage the common objectives must be agreed at a Community level. At the second stage the role of individual countries must be defined. Without full unification such a two

stage procedure is unavoidable. No country should resent the fact that, when the second stage comes, its policies are discussed collectively and may be found wanting. The efficient response to shocks also requires that such a collective examination be frequently repeated.

The distribution of roles was examined rather fully in the 1987 report of the group, at least for the case in which a stimulation of aggregate demand is called for. Such a stimulation of demand is difficult for countries experiencing a substantial current account deficit (more specifically with high levels of external indebtedness). Similarly fiscal expansion is out of the question where public indebtedness is very high. Countries facing neither of these difficulties must then assume the main role, and perhaps a larger one than they would have chosen in isolation. Similarly when a moderation of aggregate demand is required, countries with high levels of internal and external indebtedness should do most of the work.

Since the removal of the remaining barriers to capital mobility within the Community will eliminate most of the remaining autonomy of national monetary policies, it is essentially only through budgetary policies that the volume of aggregate demand can be changed. The same instrument can be used to counter inflationary pressure where wages and prices are affected by the pressure of demand.

How should the two-handed strategy be implemented at the global level? Supply-side measures were considered above. However, before considering the demand side, some attention should be paid to the impact of interest rates.

By historical standards long term real interest rates in most countries have been high for an exceptional period of time. The reasons for this are still imperfectly understood. High public indebtedness (especially in the

United States), high private investment, and low saving rates provide the most commonly given explanations. They almost certainly have some role to play although it should be noted that in Western Europe, at least, reduced indebtedness of enterprises and a lower corporate borrowing requirement has offset high public borrowing.

However, another possibility is pure hysteresis in the market evaluation of long-dated debt after a period when high short-term interest rates had been deployed to stop inflation. A spontaneous drop in long-term interest rates is therefore a possibility, especially if there is an attenuation in growth. Were this to happen it would help stimulate and sustain investment, research and innovative activity, which as we have seen are particularly desirable at the present juncture. It would also reduce the cost of public borrowing and thus give more leeway for the active use of budgetary policy should it become necessary.

Now the link between monetary policy and the behaviour of long-term interest rates is a complex one which depends to a large degree on the effect any change in monetary policy has on expectations of future inflation and short-term interest rates. Under the right circumstances a careful monetary relaxation might help to lower long rates, but at the present juncture priority should be given to consolidating the successful disinflation of the last few years, which may come under increasing threat if demand continues to grow strongly; and to helping limit volatility in the rates of exchange between the main currency blocks. Reduced exchange rate volatility should be conducive to better world economic performance after a rather difficult fifteen years. However, policy should also seek to further any changes in real exchange rates that may be necessary to reduce world payments imbalances. This requires steering a middle course between avoiding a real appreciation against the dollar¹⁰ but facilitating

a depreciation of the ECU against the Far Eastern currencies. Consequently we see little scope at the present for any easing of monetary policy.

What should be the global stance of budgetary policies in the Community? We record with satisfaction that no new fiscal stimulus to demand is required at present, since the rate of utilization of capacity is high. But, present conditions cannot be expected to last indefinitely. It is possible that the pressure of demand on capacity will further increase and a fiscal contraction will then become advisable. Or, and in our view this is more likely, capacity utilisation will fall (partly as a consequence of the recent spate of capital-widening investment). In that case renewed stimulation of demand will be appropriate, provided that inflationary pressures in the labour market can be contained.

II. MACROECONOMIC POLICIES AFTER 1992

4. Monetary Policy and the Exchange Rate Regime

We now turn to a consideration of the post-1992 policy regime. The smooth operation of macroeconomic policies after 1992 requires that members of the Community agree on the institutional arrangements governing monetary policies and exchange rates. Such an agreement cannot be reached and maintained without a common understanding of the problems. This requires a careful consideration of the respective costs and benefits of the available alternatives. However, before going into details, let us sketch out the nature of the problems.

Notwithstanding the present existence of non-tariff barriers, discrimination in public procurement and so forth, there is no doubt that goods markets within the Community are already fairly integrated. Financial markets by contrast are still segmented; for example by capital controls in countries such as France, Italy and Spain and bank reserve ratios ranging from roughly zero in the United Kingdom to 25 per cent in Italy. This segmentation is precisely what the internal market is supposed to eliminate. The effects of 1992 may thus be more pervasive in financial than other markets.

The clearest implications of financial integration are for the exchange rate system that currently governs eight out of the twelve Community currencies. The EMS works as a system of fixed but adjustable parities: such a system is likely to come under pressure with full financial integration because central banks will find it increasingly difficult to fend off speculative attacks sparked off by the prospect of a realignment.

For reasons spelt out in Section 4.1, we believe the Community is right to persist with attempts to stabilise intra-European exchange rates. There

are then two acceptable directions in which the Community could move. The first is to abandon realignments altogether, that is to say form a monetary union. This itself has two implications. First it imposes common trend inflation rates across countries which has further implications for the financing of public sector deficits; this is discussed in Section 4.2. Second it rules out exchange rate realignments as a tool for easing adjustment in the face of idiosyncratic shocks (or the differential effect of shocks emanating from outside the Community); this is discussed in Section 4.3.

We argue in Section 4.4 that full monetary unification by 1992 is unlikely, which suggests that the EMS will need to evolve in a different direction, one which will permit occasional realignments without being subject to speculative attacks. This is likely to be along the lines of the Nyborg agreement of September 1987. Extending the role of the European Monetary Cooperation Fund would strengthen the position of "soft currency" central banks and somewhat wider fluctuation bands, at least for some currencies, would permit smooth but no more frequent realignments; Section 4.5 expands on this. This, of course, may be but a staging post on the road to eventual monetary unification.

4.1 Capital Mobility, Monetary Independence and Fixed Exchange Rates

An important plank of the move towards the Single Market is the removal of remaining restrictions on capital flows between countries. This has profound implications for European monetary policies, for there is an essential tension between the three objectives of free capital movements, national monetary autonomy and fixed but adjustable exchange rates¹¹. Capital controls limit the scope for speculation against countries that are expected to devalue. Their use has made possible periodic realignments, thus allowing some countries to maintain substantially different rates of

inflation over the medium term, but without experiencing a chronic loss in competitiveness.

The elimination of credit controls jeopardizes the possibility of any realignments of exchange rates which involve discrete changes in the rate. The reason is that at the moment of a realignment the rate of capital loss on assets denominated in the devaluing currency will be infinite. Consequently rational behaviour by participants in the foreign exchange market requires switching out of these assets completely in the face of an anticipated change in parities. Similarly producers and purchasers of traded goods will speed up or delay transactions in order to take advantage of the expected realignment.

If there is a widespread belief that a realignment is imminent such capital flows will themselves precipitate an exchange rate crisis, which the authorities will be powerless to forestall if they have access to only a limited stock of foreign exchange reserves. Furthermore the possibility of a future realignment can produce an exchange rate crisis today as speculators anticipate the fall in domestic asset values that would accompany any future speculative attack. And what matters is not whether the authorities do or do not intend to make such a realignment. Even the mere possibility of one in the eyes of participants in the foreign exchange markets, say because of a perceived inconsistency between monetary policies in different countries, may be enough to provoke a speculative attack. Because such speculation will itself precipitate an exchange rate crisis and a realignment, even if the authorities had no prior intention of realigning, it has the nature of a self-fulfilling prophecy.

In practice the timing and size of realignments is uncertain and this does serve to mitigate the problem somewhat, provided the authorities are prepared to offer a short-term rate of return sufficiently above that on

competing foreign assets to compensate for the currency risk¹². For instance suppose a realignment of 5 percent is known to be necessary, but there is only a 10 percent chance of it occurring this week (or in any week thereafter); interest rates would need to be 26 percentage points higher than would otherwise be the case to compensate for the possibility of a capital loss. However, governments are unlikely to be happy to accept frequent gyrations in short interest rates in order to maintain the exchange rate in the face of changing market sentiment.

Thus the removal of capital controls will automatically produce a conflict between the twin objectives of fixed exchange rates with periodic realignments and permitting substantially different trend inflation rates. This overstates the problems that would be faced by an unreformed EMS after 1990 because there is a band within which currencies can fluctuate, but so long as there is the possibility of discrete changes in market rates problems may arise. There are two directions in which the Community could head. One (which we do not advocate) is to move away from stabilising nominal exchange rates altogether and return to free (or managed) floating. The other is to abandon, either partially or totally, the goal of monetary independence. However before considering the implications of the latter it is worth recording what the costs of moving towards greater rather than less flexibility of exchange rates would be.

The first achievement of the present regime of fixed, or quasi-fixed, exchange rates between EMS currencies has been to avoid gross misalignments of real exchange rates of the sort that afflicted Sterling in 1980-81 and the Dollar between 1982 and 1986. Although day-to-day volatility has been reduced, it is not this that is particularly costly since firms at least can insure against short-term fluctuations by operating in the forward

exchange markets at relatively little cost. However, this is not possible in the face of large sustained swings in (real) exchange rates.

If these movements are misperceived as permanent when they are in fact transitory, they may result in major resource misallocation. A large real depreciation that is viewed as permanent will encourage firms to incur the fixed set-up costs necessary to enter foreign markets that were hitherto unprofitable. Similarly a large real appreciation may lead to firms re-locating their production activities overseas to take advantage of lower production costs. If the swings in the exchange rate are subsequently reversed these may turn out to be *ex post* rather unwise decisions. Even if firms do not misread the nature of the swings in real exchange rates, the increased uncertainty is likely to lead them to adopt a more cautious "wait-and-see" attitude, which again imposes a deadweight welfare loss on the economy by impairing resource allocation¹³.

A second possible¹⁴ achievement of the present exchange rate system has been to serve as a credible nominal anchor for those countries with high initial inflation, such as France and Italy, during the disinflation process of the eighties. Inflation rates differ for a variety of economic and political reasons. However, in high inflation countries the mere announcement by the authorities of a program of counter-inflationary policies might have rather little effect on the expectations of wage bargainers and investors, because the authorities do not have a good record of sticking to non-inflationary macroeconomic policies. By linking themselves to the Mark, countries like France and Italy were able to "borrow" the anti-inflationary credibility of the Bundesbank to help reduce the output costs of disinflation. Of course, if realignments were costless this would be ineffective, because the French and Italian authorities could have accepted any rate knowing that any adverse effects on competitiveness

could be offset by an appropriate realignment of exchange rates. A crucial ingredient is thus that realignments are costly. One argument might be that while changes in the rate under floating can be blamed on market sentiment, devaluations in a fixed rate system are politically costly. Another view¹⁵ is that *de facto* realignments have often not completely offset inflation differentials so that a faster than average inflation rate has entailed a steady loss in competitiveness, thus raising the cost of high inflation macroeconomic policies.

Now the removal of credit controls and other barriers to international capital movements is a desirable objective in so far as it is one condition for achieving the full efficiency of the capital market in matching the supply of funds to borrowers. However, if this objective cannot be achieved without the loss of the two beneficial effects of exchange rate stability described above then all things considered, the price of capital mobility is too high. A return to freely floating exchange rates necessarily involves the loss of the beneficial credibility effect more inflation-prone countries derive by being linked to the Mark. In principle it need not involve an increase in the variability of real exchange rates provided there is little uncertainty about future policy action and reactions. In practice there is an unavoidable uncertainty about policies associated with uncertainties in the economic environment and the day-to-day vicissitudes of the political process. This is likely to invite speculative behaviour in the exchange markets and brings with it the possibility of sustained swings in real exchange rates that are not always justified by movements in the underlying fundamentals. We see no reason to believe that future experience under a regime of free floating would be any different from what it was in the past.

There is, however, the possibility of a regime of managed floating, perhaps in the guise of a rather softer version of the EMS without discrete realignments, thus reducing the incentive to speculate against a currency and eliminating the scope for a self-justifying speculative attack. This could be achieved either by having smaller and more frequent realignments or by having wider bands (or a combination of the two). Some restrictions on the frequency or reason for realignments would be necessary if the system were to be different from one of pure floating, and the nature of these rules would determine how open the system was to sustained exchange rate misalignment. One obvious set of rules would be built round the objective of maintaining purchasing power parity, possibly with some adjustment factor to cater for differing rates of growth, etc. This would be very similar to the "target zone" system of Williamson¹⁶. The problem is that the very "softness" of the regime engenders uncertainty about policy reactions and invites speculative behaviour. How well such a system would function in a European context is thus something of an unknown quantity.

A return to either free or managed floating throughout Europe would in our view thus be a retrograde step. Fortunately this is a view which also seems to be widely held by the present members of the EMS. However, it is possible that the EMS will not develop in the fashion necessary to accommodate the increased capital mobility that will occur after 1990. In that case there is a danger that a return to floating, or the reimposition of capital controls, may happen through default, simply because governments are unable to agree on the nature of the best-of-all-possible worlds.

4.2 The Costs of Inflation Convergence: Fiscal Implications

In practice the Community is moving towards a system embodying less rather than more nominal exchange rate flexibility, and consequently a loss

of national monetary independence. In the limiting case of a full monetary union exchange rates would be irrevocably fixed. The benefits of exchange rate stability have already been outlined, but what costs does it impose?

An argument sometimes voiced against a monetary union is that some countries - especially Greece, Italy, Portugal and Spain - simply cannot afford to relinquish monetary sovereignty because of the fiscal implications of a loss of seigniorage revenue. In these countries tax revenues are below the European average and seigniorage is a relatively more important source of government financing. These low tax revenues often reflect the combination of a narrow tax base and relatively high tax rates: it is thus not clear that substituting seigniorage for regular taxation is possible without increasing other distortions in the economy.

The basic facts are summarised in Table 6 which shows that in those countries where tax revenues are relatively low, the Treasury finances a larger share of the budget through loans from the central bank. Money financing amounts to 2.5 per cent in Greece; 1 per cent in Italy and in Spain. In Portugal there has been a sharp turn-around in the most recent years: money financing has fallen from 5-7 per cent of GDP to zero. In northern Europe on the other hand money financing accounts for a negligible share of GDP - less than $\frac{1}{2}$ per cent.

The fiscal asymmetry documented in Table 6 raises two questions. One is a matter of principle: are there any arguments which justify differences in the degree of money financing? The second is an empirical question: do the differences that are observed in the degree of money financing really correspond to differences in seigniorage revenue, or do central banks sterilise the effects on the monetary base of their loans to the government?

As far as the first of these question goes, one line of argument is that all taxes (other than lump-sum ones) involve distorting the choice between different commodities and consequently produce welfare losses. Keeping these losses to a minimum requires the broadest possible tax base and this dictates that money balances (which provide liquidity services to the holder) should be taxed like any other commodity, at a rate that depends on the scope for alternative taxes and the responsiveness of the demand for money to its price (i.e. the interest elasticity of money demand). Since the tax base, and perhaps also the interest elasticity of the demand for money, vary across countries, the optimal - from a public finance perspective - inflation tax will consequently also vary across countries. Those countries with a small tax base and high marginal tax rates on other commodities (including income taxes) should thus tend to have higher inflation rates¹⁷.

The counter argument to this is that money is not really a commodity like sausages or wine which directly produce welfare for consumers. Rather it is more in the nature of an input into the production process which by facilitating exchange makes the consumption of different commodities possible. And the same economic logic which suggests that, in a world where all taxes have some distortionary effects, all commodities should be taxed also dictates that intermediate inputs which yield no direct welfare should not be taxed¹⁸. The moral seems to be that economic theory gives rather little guidance as to the optimal inflation rate from a public finance perspective.

A second argument for a positive inflation rate is that it is a way of broadening the tax base by taxing activities in the underground or black economy which would otherwise remain untaxed. Many of these activities are financed by cash in order to avoid detection. If policing the underground

economy is costly then there is a "second-best" argument for resorting to the inflation tax as a means of tapping this source of revenues and lowering the tax burden on the legitimate economy. In countries such as Italy where the underground economy is especially large this is not an irrelevant consideration. (It could be argued, on the other hand, that the removal of the inflation tax option might encourage governments to create a more rational tax structure and be tougher in their enforcement of the existing tax laws.)

Despite this, we believe on balance that designing an intra-European monetary system which permits substantially different inflation rates over the long-term should not be an overriding concern. This is especially so since the cost is likely to be a greater vulnerability of exchange rates to speculative attacks and as a result more frequent misalignment.

Now let us consider the second question posed above: does a fall in inflation and in the growth rate of money necessarily have to be associated with a fall in seigniorage revenue? Some European countries have accompanied the disinflation with an increase in reserve requirements: in Italy, for instance, marginal reserve requirements were raised in a few years from 15.75 to 25 per cent; in Spain average reserve requirements were below 10 per cent up to 1982, and jumped to 25 per cent in 1983; in Greece average reserve requirements were also raised from 12 to almost 30 per cent in the early 1980s. In each case the timing of the increase in reserve requirements corresponds to a policy shift in the direction of reducing inflation.

The view that central banks in southern Europe used an increase in reserve requirements to widen the inflation tax base in the presence of falling inflation is attractive. Table 7 shows that the increase in reserve requirements that occurred in each of the four countries (Italy,

Greece, Spain and Portugal) in the early 1980s was not fully offset by a fall in bank deposits, and thus produced an increase in the ratio of base money to GDP. However things are not quite this simple because bank reserves in these countries pay interest; 5.5 per cent for example in Italy. The implicit tax rate thus falls along with the fall in inflation and in nominal interest rates. In Italy, in the late seventies and early eighties when the difference between the lending rate and the rate paid on bank reserves was about 14 per cent, the yearly tax revenue was more than 1 per cent of GDP; by 1986-87, when the interest rate wedge has fallen to 9 per cent, revenue had declined to less than $\frac{1}{2}$ per cent of GDP.

Thus while an increase in reserve requirements allows the authorities to pursue a tighter monetary policy, without requiring an immediate increase in either taxes or the public debt, this is at best a temporary expedient for the increase in the required reserve ratio will have to come to a halt sometime, and, moreover, as inflation falls so will the seigniorage attached to bank reserves which pay a fixed rate of interest. In those countries where money financing is a relatively important source of revenue, a shift to a less expansionary monetary regime implies a choice between higher taxes (or lower government spending) now and higher taxes (or lower spending) in the future. If the tax base is small, and revenues can only be increased by raising marginal tax rates, it may be sensible not to shift the entire burden of the fiscal correction onto explicit taxes immediately. An increase in reserve requirements can avoid building more public debt in the meantime.

This analysis of the role of required bank reserves has important implications for the creation of a unified market for financial services in Europe. Since reserve requirements work like a tax on the interest paid on bank deposits, banks subject to relatively higher reserve requirements

would tend to go out of business. It would thus be difficult to keep different reserve requirements in an integrated financial market. In countries such as Italy, where the shift to a less inflationary monetary regime has already occurred, the setting of reserve requirements to the European average would have only a minor effect on the public finances amounting to less than $\frac{1}{2}$ per cent of GDP. By contrast, in countries such as Greece and Portugal, where inflation is still relatively high, it may be unwise to remove reserve requirements as a policy instrument and, at the same time, mandate a shift to a less inflationary monetary regime. Some transitional arrangements for these countries may therefore be called for.

4.3 The Costs of Inflation Convergence: Implications for Macroeconomic Stabilisation

Accepting the convergence of inflation rates is tantamount to surrendering national monetary independence. Beyond the loss of the inflation tax as a fiscal instrument, there is a second group of costs resulting from the loss of monetary policy/the exchange rate as a tool for macroeconomic stabilisation in the face of shocks. Indeed the traditional arguments for or against fixed exchange rates hinge less on the scope for long-run differences in inflation rates, but on the ability of countries to insulate themselves from shocks originating abroad by adjustments in the rate of exchange. In the long-run, of course, flexible exchange rates can do little to insulate an economy from the effects of real, as opposed to nominal, shocks such as, say, a decline in the demand for that country's exports. However, flexible exchange rates may ease the transition process because wages and prices take time to adjust. A nominal depreciation can bring about the required change in relative prices instantaneously, without disrupting activity unduly. By contrast, with fixed exchange rates a

temporary increase in unemployment may be required to bring about the necessary deterioration in the terms of trade.

How useful the option of realigning exchange rates is obviously depends on how rapidly wages and prices adjust to excess demand or supply and how easily unused factors of production can be reallocated. If unused factors relocate rapidly across not only sectors, but also across national boundaries, then the cost of fixed exchange rates will be small. This idea lies behind Mundell's original characterisation of an optimal currency area as one in which capital and labour are completely mobile¹⁹. The completion of the internal market will ensure that capital can flow freely across national boundaries and in principle the removal of remaining restrictions on the flow of workers between countries should do the same for labour. In practice, however, the most important barriers to labour mobility across frontiers are not national regulations, but the natural barriers created by cultural and language differences. These can not be removed by fiat - and indeed it is not desirable that they should be since cultural diversity within Europe is something to be cherished. The parallel that is often drawn between the U.S. economy and the European Community after 1992 breaks down at this point. Whereas cultural homogeneity and a common language ensure that unemployed workers in New Jersey can easily migrate to California in order to find work, it is much harder to envisage a similar movement of the European unemployed to countries or regions enjoying prosperity.

There is no reason to believe that the completion of the internal market will eliminate idiosyncratic shocks. Consequently there is a respectable argument for retaining the option of exchange rate realignment in the face of such shocks. Consider, for instance, the effect of a permanent fall in the oil price. For a country which is an oil exporter,

like the United Kingdom, the result is a decline in the value of those exports. To ensure long-run external balance a reduction in the relative price of (net) non-oil exports and an increase in their volume will be required i.e. a deterioration in the non-oil terms of trade. This can be brought about swiftly through an exchange rate realignment rather than more painfully by a recession.

It is natural to ask whether there are fiscal actions which would have precisely the same effect as an exchange rate realignment. The answer is that any fiscal action would need to be discriminatory. For instance in the example just cited, a temporary subsidy to the exporting sector would be called for, possibly coupled with the simultaneous introduction of a tax on non-tradable services. Such discriminatory tax/subsidy schemes are rightly permitted under Community regulations only under very special circumstances. The frequent resort to such schemes would be open to abuse and is not something we would recommend. A realignment in such circumstances would be a cleaner and more effective way of achieving the desired objective.

However, it must be emphasised again that exchange rate realignment can never insulate an economy completely from the effect of real shocks, only ease adjustment. A more cohesive Community raises the prospect of using redistributive fiscal policy as a way of insulating member countries from the effects of idiosyncratic shocks. This is a theme which we take up in Section 5 of this report. However, here we note that if an adequate fiscal mechanism exists for insuring countries against idiosyncratic shocks, the need for nominal exchange rate realignment as a tool for easing adjustment is likely to be diminished somewhat. Consequently monetary union looks more attractive if accompanied by fiscal reform.

4.4 Can Full Monetary Union be Achieved by 1992?

Any change from the *status quo* will bring costs as well as benefits. Moving to full monetary union with a common currency (or irrevocably fixed exchange rates) necessarily implies greater convergence of inflation rates and more loss of monetary independence than a suitably modified version of the EMS which permitted occasional realignments. Are the somewhat greater costs of full monetary union outweighed by the greater benefits? The advantages of a common currency should not be underestimated. It completely eliminates the problems posed by speculative behaviour in exchange markets by eliminating the markets themselves, and lowers transaction costs for transactions between nationals of different countries. By replacing several national monetary authorities by a single European Central Bank it also removes the inefficiencies that result from unco-ordinated decision-making by national monetary authorities. Finally, it is an important symbol of political unity. Whether these benefits outweigh the costs imposed by a loss of national monetary independence is open to debate. However, we believe that full monetary union by 1992 is rather unlikely, and indeed forcing less willing governments in this direction by offering them a suitable *quid pro quo* may jeopardise other benefits from the Single Market.

The reason is that full monetary union necessarily raises the issue of who decides monetary policy and to what ends? This requires a considerable degree of consensus on both the objectives and the *modus operandi* of monetary policy if countries are to be willing to participate in a monetary union. During the process of disinflation there has been relatively little conflict because the non-German members of the EMS have been happy to ride along on the Bundesbank's reputation for a tough counterinflationary stance. However as inflation has subsided and unemployment and growth have

once again become the major economic problems, so the tension between conflicting national objectives has become more open. This tension, of course, will be present under almost any fixed exchange rate system. History suggests that one country always becomes the leader of such a system, leaving open the possibility of conflict with other members. However, in the final reckoning a dissenting country always has the option of quitting a fixed, or quasi-fixed, exchange rate regime and floating if it feels that the constraints imposed by the need to maintain a parity are too great. There may, of course, be a major political cost to this, but it remains a fallback option. Full monetary union, with a single European central Bank would remove this option.

At present, however, there does not seem to be sufficient consensus between member governments on the way European monetary policy should be organised and conducted to make full monetary union feasible in the immediate future. Consequently it seems likely that the post-1992 exchange rate system will retain national currencies with the possibility of occasional realignment.

This does not imply that full monetary union will never occur. But it will probably only occur when the level of political co-operation has been substantially increased. (As a historical precedent note that the Reichsbank only came into being after the political unification of Germany. The same is true of Italy.) One way to prepare the way at this juncture would be to promote the ECU as a unit of account. Thus encouraging governments to issue debt denominated in ECU, as the United Kingdom government has recently done, would be useful. A more radical step would be the introduction of a European currency based on the ECU as a parallel medium of exchange to national currencies. However, we are sceptical that consumers would be willing to conduct exchange in two currencies

simultaneously. Furthermore, such a currency would be attractive because it would carry very little exchange risk and would thus be subject to Gresham's law - bad money drives out good - with consumers and firms tending to hoard the currency that is likely to appreciate in value. Consequently the final step in monetary unification will probably require a centralised political decision first. We believe this is still some way off.

4.5 The EMS with Closer Inflation Rates

If not full monetary unification then what else? The problem with the present EMS is that the mere possibility of a realignment may threaten the stability of the system by provoking a speculative attack. This means avoiding discrete realignments by ensuring that pre- and post-realignment bands overlap and, above all, ensuring that "soft currency" central banks have unlimited access to credit from "hard currency" central banks so that they can successfully beat off a speculative attack. (Present arrangements do in fact give central banks such unlimited credit lines for up to seventy-five days.) Notice that for the system to be durable it is not enough for governments to announce that particular parities will be maintained. Not only must the supporting fiscal policies be consistent with them so that the announcement is credible, but also that in the event of a speculative attack, even if it is unwarranted, the parities can be maintained. That is why unlimited access to foreign reserves is so necessary.

What sort of convergence of inflation rates does this imply? A fluctuation band of plus or minus $1\frac{1}{4}$ per cent would imply a maximum realignment of the band of $2\frac{1}{2}$ per cent at any moment. If realignments occurred more often than yearly the system would start looking like one of managed floating with rather little external discipline on a country's

monetary policies, so that a maximum inflation differential of 5 percent across the Community might look about right. But one cannot ignore the possibility of unforeseen events and speculative movements which might increase tension within the EMS. So the maximum inflation differential would probably be closer to about 3 per cent per annum. Most EMS countries, with the exception of Denmark and Italy, are within this sort of band, so it does not require any major effort to harmonise inflation rates further. By contrast, the spread of inflation rates across all Community countries is rather greater and increased inflation convergence is necessary if the post-1992 exchange rate mechanism is to embrace all Community countries.²⁰

Even with the limited flexibility offered by occasional realignments, there will be times when a country faces a conflict between abiding by the rules of the exchange rate mechanism and pursuing domestic policy objectives. In these circumstances, despite heavy political costs, the country might choose to leave the exchange rate mechanism and float its exchange rate. Further the mere possibility that this could happen may trigger destabilising capital flows. Obviously the durability of the exchange rate regime rests on making this an unlikely event. Increasing the political commitment to remaining in the exchange rate mechanism is one way to do it. But it will also be much less likely if fiscal action, either at a national or a Community level, provides a viable alternative. There is thus a connection between the durability of the exchange rate regime and the post-1992 fiscal regime. It is to the question of fiscal policy that we therefore turn next.

5. Fiscal Policy

5.1 The Effectiveness of Fiscal Policy

An important consequence of the completion of the Single Market should be an increase in the flow of goods and services between countries. As well as reducing transport costs by eliminating customs formalities, etc. at borders, the removal of remaining barriers between countries will permit greater specialisation and greater exploitation of comparative advantage. This will inevitably mean that a greater proportion of any fiscal (or monetary) stimulus to demand will leak abroad.

Our previous report discussed the inefficiencies that can arise from unco-ordinated policymaking when governments ignore the externalities (beneficial or adverse) that their actions impose on their trading partners. The report argued that while the need for co-ordination between the United States and Europe was not that important, because the marginal propensities to import between the two blocks were relatively small, the need for co-ordination within Europe was much more pressing because of the greater openness of the European economies vis-a-vis each other. The greater economic integration that follows from the completion of the Single Market can thus only increase the need for consultation and co-ordination between national fiscal authorities within Europe.

Should there be any formal set of rules to enforce co-ordination of fiscal policies? The Padoa-Schioppa report²¹ recommended that national governments should pursue targets for the rate of growth of nominal income. This is a moderately sensible operating rule for certain environments: nominal shocks to demand are offset, while excessive wage pressure is not accommodated. For certain sorts of real supply shocks it even produces the right response²². However, in the context of an exchange rate regime like the EMS which imposes constraints on monetary policy, especially after

1992, it represents a rule for the conduct of fiscal policy. It is unlikely that governments would be willing to accept constraints on their room for manoeuvre on the fiscal front in addition to the constraints imposed on their monetary policies by a regime of quasi-fixed exchange rates. Without greater political integration and co-operation it is not obvious what institutional changes could be carried through to improve policy co-ordination. But a strengthening of the channels for communication and the exchange of economic information at least seems desirable.

At the same time as the impact of fiscal policy on domestic demand is attenuated the scope for variations in tax rates across national boundaries will also be somewhat reduced. Variations in income tax rates will lead some workers and firms in high tax areas to migrate to countries with lower taxes. However, for the reasons set out in Section 4.3 such migration by workers might be quite limited. Similarly variations in expenditure tax rates will lead consumers to indulge in cross-border shopping where profitable. But it is easy to overdo this. What variations in tax rates are feasible will depend on the "natural" barriers - in the form of language differences, transportation costs, etc. - between countries that will remain after 1992. It may be difficult for Luxembourg to have higher tax rates than its neighbours, but easier for, say, the United Kingdom.

The reduced scope for variations in tax rates will inevitably place a greater burden on variations in public expenditure for the purposes of macroeconomic management. However, there are other considerations which are also relevant in determining the level of public expenditure which will prevent its untrammelled use in this role. First, and most obviously, public expenditure is usually directed to meet specific social objectives. Consequently frequent variations in the level of spending involves

variations in the level of services provided by that expenditure and may lead to severe hardship for some sectors of the population. Variations in this component of public spending for macroeconomic objectives is thus undesirable. It is only public sector investment projects which offer much scope for short-term variation as these can usually be postponed or brought forward without incurring the same hardships. Second, debt management objectives may constrain public expenditure options (and also of course the revenue side of the public sector accounts). However, the completion of the Single Market does not, *per se*, limit the use of public expenditure as a tool of macroeconomic management, unlike the structure of taxes which is intimately related to the whole organisation of the internal market. For this reason we do not consider it further in this report.

5.2 The Need for Redistributive Fiscal Policy

The completion of the Single Market will thus reduce the efficacy of both monetary and fiscal policies at a national level as a means of easing the adjustment to a variety of shocks. However, such policies can do little more than facilitate the adjustment to real supply-side shocks for in the long-run real shocks must have real effects and will raise or lower the real standard of living of the population of the country concerned. This is especially important since, as made clear in the first part of this report, the run-up to 1992 will involve a quickening of the pace of structural change in Europe, and this itself represents a major supply shock that is beneficial to many but adverse to some. There is a case for retaining policy options which help ease the adjustment process.

But even if there were no adjustment problems there would still be a strong case for policies which redistribute the burden of idiosyncratic adverse shocks (and the gain from beneficial ones) across the whole Community as a mechanism for providing a risk-averse private sector with

insurance. For the holders of entitlements to physical capital this is not too important. They can hold shares in many different companies, across different countries and so spread risk. However, holders of human capital - the workers - can as a rule not diversify their portfolio in the same way. Their skills are often industry - and even firm - specific and consequently they tend to suffer most in the face of adverse shocks.

Assuming they are a permanent feature of the post-1992 environment the expanded structural funds will continue to reallocate resources across regions. However, despite the precise rules for their allocation, the centralised nature of their administration necessarily implies that the process will take time to operate. Furthermore the funds will only indirectly compensate those individuals adversely affected by any idiosyncratic shocks. The increase in the structural funds could therefore be usefully supplemented by introducing a Community element into unemployment insurance.²³ This constitutes a semi-automatic system of redistributing funds across regions which is also targetted at those who suffer, namely the owners of human capital. There would be a certain minimum level of unemployment benefit, financed from Community funds (although administered locally, of course), which countries would then be free to top up as they see fit. Because it is only a minimal scheme it should not be difficult to agree on eligibility conditions. This minimum benefit level could be fixed with reference to average earnings in the Community as a whole, but it is much more sensible to set it with reference to earnings in the poorest member states to avoid producing excessively high replacement ratios that discourage taking a job. It is also important that the benefits are only payable for a fixed duration of, say, six months so as not to discourage job search.²⁴

How would such a scheme be financed? We envisage the scheme as at least a partial replacement for existing unemployment compensation, so the presence of the Community scheme would simultaneously allow governments to reduce the funds collected domestically for national unemployment insurance. Consequently there is no need for the tax burden to rise significantly. Indeed because of the redistribution inherent in the scheme it would allow lower tax rates (for given levels of expenditure and public deficits) in high unemployment countries than would otherwise be the case. Lowering the tax wedge by reducing labour taxes is, of course, precisely one of the policy measures that we have advocated to encourage supply. The counterpart to this is higher than otherwise tax rates in booming countries. However, to the extent that, with unchanged public spending and deficits, tax rates could be lowered as higher activity increases the tax base, it does not necessitate higher absolute tax rates in booming countries. The scheme would thus ensure not only some assistance during the adjustment to idiosyncratic shocks, but also a real transfer from thriving industries/regions/countries to those either cyclically depressed or in long-term decline.

The introduction of a European unemployment insurance scheme, is not only desirable in itself on both equity and efficiency grounds, but will itself enhance the durability of the post-1992 monetary regime. We have seen that the removal of capital controls and the imposition of a common, low rate of inflation through a more rigid exchange rate mechanism has adverse fiscal implications for those countries that presently rely heavily on seigniorage as a source of revenue. Greater fixity of exchange rates implies less scope for the use of monetary policy in offsetting the effects of shocks and, ergo, a greater reliance on fiscal policy which will itself become less effective. Countries will be more willing to accept these

constraints on macroeconomic policy-making if they know that there are adequate arrangements to compensate them in the face of adverse shocks, to which they might otherwise respond by seeking an exchange rate alignment or, worse, by introducing measures which try to protect the affected domestic industries or regions. There is thus an important systemic link between the post-1992 monetary and fiscal regimes and even the free trade policies which underly the very creation of the Single Market.

6. Conclusions: The Macro-Micro Link

There is an important link between the completion of the Single Market in 1992 and the macroeconomy. This link runs in both directions. On the one hand the acceleration in the process of structural change that will accompany the creation of the Single Market will not only raise productive potential, but may also aggravate regional imbalances and, in the short-run possibly worsen rather than help Europe's unemployment problem. Faced with this, governments may be tempted to try to circumvent the spirit of the Act by selectively protecting the affected industries and regions. As a result many of the potential gains may be lost.

On the other hand more rapid economic growth will make such action less likely, as will the use of macroeconomic policies to reduce these geographical imbalances. The recent revival in investment is especially welcome since it has not only produced rapid demand growth, but also raised the prospect of better supply performance in the future. But maintaining this environment during the transition phase, when external factors are likely to move against Europe, may once again call for some fiscal stimulus to demand, and the need for fiscal and other action to improve supply performance is as strong as ever. So macroeconomic policies have an

important role to play in creating an environment which maximises the gains from 1992.

The link between the completion of the Single Market and the macroeconomy carries over into the period beyond 1992 as well. The Single Act does not imply the full convergence of inflation rates but increased capital mobility will increase the vulnerability of the EMS to speculative attacks and make realignments more difficult. Whether the system is suitably modified, or full monetary union is adopted, the scope for independent monetary policy will become more constrained and interdependence will be heightened. The same is true of fiscal policy as the remaining barriers on trade between countries are removed. This puts a premium on coordination and cooperation in macroeconomic policymaking. It also implies a reduced ability for individual countries to cope with idiosyncratic shocks, and introducing a Community-wide element into unemployment insurance would provide an automatic way of compensating individuals subject to adverse shocks. This would help to provide the right environment in which to secure the maximum gains from the beneficial supply effects of the completion of the single market.

TABLE 1

Sources of Economic Growth in 1988 (% Volume Change)

	Private Consumption	Public Consumption	Fixed Investment	Exports	Imports	Total Growth
France	2.1 (1.3)	2.0 (0.3)	6.9 (1.3)	7.2 (1.6)	6.5 (-1.4)	3.1
Germany	3.0 (1.9)	1.7 (0.2)	6.2 (1.2)	5.5 (1.5)	6.7 (-1.6)	3.2
Italy	3.8 (2.3)	3.3 (0.5)	4.9 (1.0)	6.7 (1.3)	8.5 (-1.5)	3.9
U.K.	5.4 (3.4)	0.8 (0.2)	9.6 (1.7)	1.9 (0.5)	11.2 (-3.1)	3.8
E.C.	3.5 (2.2)	1.9 (0.3)	7.1 (1.4)	5.3 (0.5)	8.0 (-0.8)	3.5
U.S.A.	2.4 (1.6)	0.8 (0.1)	6.3 (1.2)	17.6 (1.3)	7.1 (-0.8)	3.9
Japan	5.3 (3.1)	2.3 (0.2)	12.1 (3.4)	5.9 (0.6)	17.6 (-1.2)	5.6

Source: Commission Forecasts (October 1988).

Figures in parentheses give the contribution to GDP growth.

TABLE 2

Errors in Forecasting Investment in 1988

(Forecast Growth in GDFC at Successive Forecasts)

Forecasting Body: Forecast Date:	European Commission		OECD	
	Jan. 1988	Oct. 1988	Dec. 1987	June 1988
France	3.0	6.9	2½	4½
Germany	1.2	6.2	1½	2½
Italy	2.8	4.9	2½	3½
United Kingdom	4.2	9.6	5½	6½
E.C.	3.2	7.1	-	-
U.S.A.	2.6	6.3	2½	6½
Japan	5.6	12.1	4½	8½

Source: European Commission and OECD, Economic Outlook.

TABLE 3

Investment Functions

(Dependent Variable: Investment Rate)

Independent Variable	France	Germany	United Kingdom
Lagged Profitability	.0086 (3.19)	.0205 (2.95)	.0088 (3.06)
Change in Lagged Profitability	.012 (1.26)	.0023 (0.13)	.0026 (0.45)
Lagged Real Interest Rates	.0025 (0.08)	-.084 (1.32)	.0092 (0.63)
Change in Lagged Real Interest Rates	-.045 (1.49)	-.019 (0.34)	-.0033 (0.21)
Lagged Investment Rate	.726 (8.75)	.533 (3.17)	.68 (5.48)
Change in Lagged Investment Rate	-.037 (0.19)	.35 (1.93)	-.281 (1.30)
Standard Error (% points)	.26	.36	.23
Forecast Investment Growth for 1988 (%)	3.2	7.7	5.1

Notes: Sample 1960-1987
T-statistics in parentheses.

TABLE 4

European Trade Balance by Major Industrial Categories
(trade balance as per cent of world trade)

	<u>1967</u>	<u>1972</u>	<u>1979</u>	<u>1986</u>
<u>European strong positions</u>				
Chemicals	+10	+11	+11	+12
Mechanical engineering	+13	+12	+15	+14
<u>Improved position</u>				
Agriculture and food	-22	-17	-11	-6
<u>Losses to competition</u>				
Vehicles	+19	+18	+12	+7
Electrical equipment	+17	+14	+16	+10
Electronics	+6	+2	-2	-5
Textiles and Clothing	+8	+5	+2	-1

Source: Calculations by G. Lafay, using data from the CHELEM data bank.

Notes: Europe is the whole of Western Europe.

TABLE 5

Current Account (as % of GDP)

	<u>1961-73</u>	<u>1974-84</u>	<u>1988</u>
Belgium	1.1	-1.6	1.8
Denmark	-2.0	-3.4	-2.5
France	0.2	-0.5	-0.1
Germany	0.7	0.6	4.0
Greece	-2.9	-2.5	-2.8
Ireland	-2.5	-8.4	2.6
Italy	1.5	-0.7	-0.4
Netherlands	0.5	1.7	1.6
Portugal	0.4	-7.2	-0.1
Spain	-0.2	-1.7	-0.8
United Kingdom	-0.1	-0.2	-3.1

Source: European Commission

TABLE 6

Seigniorage and the Public Finances

	Monetary Financing of the Budget (per cent of GDP)			Tax Revenue (per cent of GDP)		
	1978	1981	1987	1978	1981	1986
Portugal	4.4	6.9	0.0	26.4	30.4	32.4
Greece	3.6	3.0	2.5	27.9	29.1	36.7
Italy (a)	2.2	2.9	1.2	27.1	31.1	36.2
Spain	1.0	-3.5	1.0	22.9	25.5	30.4
Ireland	0.0	0.0	0.0	31.5	35.2	40.2
France	0.0	0.5	0.0	38.6	41.9	44.2
Belgium	0.0	0.0	0.1	44.0	44	45.4
Germany	0.0	0.2	0.0	37.9	37.6	37.5
Netherlands	0.0	0.0	0.0	44.6	45.2	45.5
Denmark	0.0	-2.0	0.0	43.4	45.3	50.6
United Kingdom	-2.7	0.0	-1.5	33.1	36.7	39.0

Notes: (a) Old national accounts basis.

Source: F. Giavazzi "The Exchange Rate Question in Europe",
European Commission, Economic Papers, 1989.

TABLE 7

Base Money, Currency and Bank Reserves
(per cent of GDP)

	Monetary Base		Currency		Bank Reserves		Reserve Ratio
	1981	1987	1981	1987	1981	1987	1988
Portugal	25.0	27.8	12.5	9.2	12.5	18.6	15.0
Greece	22.6	25.5	12.9	10.1	9.7	15.4	7.5
Italy	15.1	15.2	6.3	5.5	8.8	9.7	25.0
Spain	13.6	22.6	7.8	7.7	5.8	14.9	18.0
Ireland	9.9	8.7	6.5	5.6	3.4	3.1	1.0
France	6.0	5.6	5.1	4.3	0.9	1.3	5.0
Belgium	10.6	8.1	10.1	7.7	0.5	0.4	0.0
Germany	9.8	10.4	5.5	6.2	4.3	4.2	6.6-12.1
Netherlands	6.6	8.1	6.3	7.6	0.3	0.5	0.0
Denmark	3.7	3.5	3.5	3.0	0.3	0.5	0.0
United Kingdom	5.1	4.2	4.2	3.4	0.9	0.8	0.5

Source: IMF, IFS, and J.P. Morgan World Financial Markets, 1988, No.5.

FOOTNOTES

- 1 "The Economics of 1992", European Economy, March 1988.
- 2 For an elaboration of the view that the stock market crash was the ending of a speculative bubble see C. Bean, Europe After the Crash: Economic Policy in an Era of Adjustment, Centre for European Policy Studies, Paper 37, October 1988.
- 3 See F. Modigliani, M. Monti, J. Dreze, H. Giersch and P.R.G. Layard, Reducing Unemployment in Europe: The Role of Capital Formation, Centre for European Policy Studies, Paper 28, 1986.
- 4 See R. Lawrence, "Trade Performance as a Constraint on European Growth", in R. Lawrence and C. Schultze (ed.) Barriers to European Growth: A Transatlantic View, Brookings Institution, Washington 1987.
- 5 Taking product and area specialisation into account shows that French export performance had already deteriorated prior to 1980.
- 6 P. Buigues and P. Goybet, "The Community Industrial Competitiveness and International Trade in Manufactured Products", mimeo, July 1988.
- 7 For an analysis of the implications for Europe of the U.S. budget and trade deficits, see C. Bean, *op. cit.*
- 8 J. Dreze, C. Wyplosz, C. Bean, F. Giavazzi, and H. Giersch, The Two-Handed Growth Strategy for Europe: Autonomy through Flexible Co-operation, Centre for European Policy Studies, Paper 34, 1987.
- 9 See p. 44, European Economy, No. 38, 1986.
- 10 See C. Bean, *op. cit.*, for an elaboration of the reasons why the dollar may need to fall further.
- 11 This inconsistency has, of course, already been noted by the Commission. See Creation of a European Financial Area, European

Commission, May 1988.

- 12 See for instance F. Giavazzi and M. Pagano, 'The Advantage of Tying One's Hands: EMS Discipline and Central Bank Credibility', European Economic Review, 1989.
- 13 The role of fixed costs and uncertainty has been explored by R.E. Baldwin and P.R. Krugman, "Persistent Trade Effects of Large Exchange Rate Shocks", NBER Working Paper 2017, 1986; and A. Dixit "Hysteresis, Import Penetration and Exchange Rate Pass-Through", Princeton Working Paper, 1988.
- 14 Although for a dissenting view see C. Wyplosz, "Asymmetry in the EMS: Intentional or Systemic?" European Economic Review, 1989.
- 15 F. Giavazzi and M. Pagano, *op.cit.*
- 16 J. Williamson, The Exchange Rate System, Institute for International Economics, Washington, 1985.
- 17 See e.g. E. Phelps, "Inflation in the Theory of Public Finance", Swedish Journal of Economics, 1973; and R. Dornbusch, "The EMS, the Dollar and the Yen" in F. Giavazzi, S. Micossi and M. Miller (eds.) The European Monetary System, 1988.
- 18 See e.g. A. Drazen, "The Optimal Inflation Tax Revisited", Journal of Monetary Economics, 1979; and K. Kimbrough, "Inflation, Employment and Welfare in the Presence of Transaction Costs", Journal of Money Credit and Banking, 1986.
- 19 See R. Mundell, "A Theory of Optimum Currency Areas", American Economic Review, November 1961.
- 20 Full monetary union on the other hand, especially if it required convergence on the low German rate of inflation, would require a significant tightening of the macroeconomic policy stance even in EMS countries such as France, as well as Denmark and Italy, in order to

squeeze the remaining inflation out of the system. We do not judge this to be appropriate at a time when the macroeconomic policy stance needs to be set with at least one eye on the problems of the transition phase which were considered in the first part of this report.

- 21 T.Padoa-Schioppa and others, Efficiency, Stability and Equity, April 1987.
- 22 See C. Bean, "Targeting Nominal Income: An Appraisal", Economic Journal, December 1983.
- 23 A Community unemployment insurance scheme has been advocated at numerous times in the past, in particular by the Marjolin committee and in the McDougall report.
- 24 Note that there is no reason to believe that the market brings about the optimal amount of search. Increased duration of search by one unemployed worker has both a beneficial externality in improving the likelihood of a firm filling a job with a suitable worker and a negative externality in reducing the likelihood of other unemployed workers finding a job. See C. Pissarides "Unemployment and Vacancies in Britain", Economic Policy, October 1986.

APPENDIX

Realignment and the German Surplus

Table A1 provides some background statistics for the EMS countries on the current account, activity and the inflation rates since the last realignment. A traditional "elasticities approach" analysis would tend to suggest that a revaluation of the Belgian, Dutch, Irish and German currencies would be appropriate to obtain a more balanced set of current accounts. However, these surpluses and deficits could also reflect relative cyclical positions and on those grounds one would certainly want to exempt Ireland from this recommendation because of its high unemployment rate. In fact the pattern of realignments suggested by this rather mechanical exercise coincides the movements of the respective countries within their fluctuations bands since the last realignment.

However, an important question is whether such a realignment would have a material effect on this pattern of current accounts. The counterpart to the current account is obviously the capital account which serves to reconcile international differences in savings and investment. Surpluses and deficits are not necessarily the consequence of a misalignment of real exchange rates due to nominal price inertia. They may also reflect differences in growth paths resulting from differences in tastes and technologies. If such is the case then a devaluation (revaluation) by a deficit (surplus) country will simply lead to inflation (disinflation). Nominal realignments cannot hope to correct payments deficits due to real factors. If all of the differences in inflation rates since 1986 revealed in Table A1 reflected differences in "core" inflation rates (rather than a catch-up response to the previous realignment) one would be inclined to recommend roughly a 5 per cent revaluation of the Belgium, German and Dutch

currencies to correct for the cumulative disequilibrium due to differences in core inflation rates over 1986-88

An obvious question is what effect this could have, other things equal, on the pattern of surpluses and, in particular, on the very large German surplus. To get a handle on this we ran a regression over the period 1963-87 between the German current account, as a percentage of output (CA), and its proximate determinants: the levels of output in Germany (Y_G) in the rest of the community (Y_E), and the rest of the OECD (Y_W), relative export prices (P) and a time trend (t). We obtained the following result:

$$\begin{aligned} CA = & -161 + 19.7 \Delta (y_E - y_G) + 43.6 (y_E - y_G)_{-1} + 15.2 \Delta (y_W - y_G) \\ & (4.83) (1.48) \quad (4.09) \quad (1.81) \\ & + 39.6 (y_W - y_G)_{-1} - 3.11 \Delta y_G + 25.0 y_{G-1} + 11.0 \Delta p \\ & (4.60) \quad (0.29) \quad (4.19) \quad (2.37) \\ & + 9.1 \Delta^2 p - 10.2 p_{-1} - 1.14 t \\ & (1.92) \quad (1.94) \quad (5.37) \end{aligned}$$

Standard error = 0.65; $\bar{R}^2 = 0.76$; DW = 2.45.

where lower-case letters denote logarithms, Δ is the difference operator and the figures in parentheses are t-statistics.

Although the competitiveness terms are not precisely estimated, they suggest that in the long-run a 5 per cent revaluation of the mark, if it also resulted in a 5 per cent loss in export price competitiveness, would produce a fall in the German surplus of around $\frac{1}{2}$ percentage point of GDP.

Even allowing for the uncertainty associated with econometric estimates, it is clear that one could not expect a modest realignment to lead to the disappearance of the German surplus. That plainly must reflect underlying real factors. Faster growth in Germany relative to other countries would also help to reduce it, but here again the effect is

relatively modest ($\frac{1}{3}$ percentage point for each percentage point increase in the relative German growth rate).

The German surplus is thus likely to be rather durable. In this regard an important role in the equation is played by the term in the level of German output. This implies that the elasticity of net exports with respect to output in the rest of the world exceeds the (absolute value of) the elasticity with respect to German output, i.e. German net exports tend to do relatively better when World and German output both expand together. If this is indeed the case, then the explanation for the German surplus must be sought in its underlying industrial structure.

TABLE A1

Indicators for EMS Currencies

Country	Current Account, 1988 (% of GDP)	Unemployment rate (%)		Price ^(a) Increase since 1986	Unit Labour Cost Increase since 1986
		Level in 1988	Change from 1986		
Belgium	1.8	11.5	-1.1	3.2	2.3
Denmark	-2.5	8.5	1.1	9.3	14.5
France	0.1	10.7	0.1	5.2	2.4
Germany	4.0	8.1	0.0	3.8	2.0
Ireland	2.6	18.7	0.5	4.8	1.6
Italy	-0.4	15.0	1.3	10.0	8.8
Netherlands	1.6	11.3	-0.8	-0.7	1.7

Source: European Commission forecasts

Note: (a) GDP deflator.

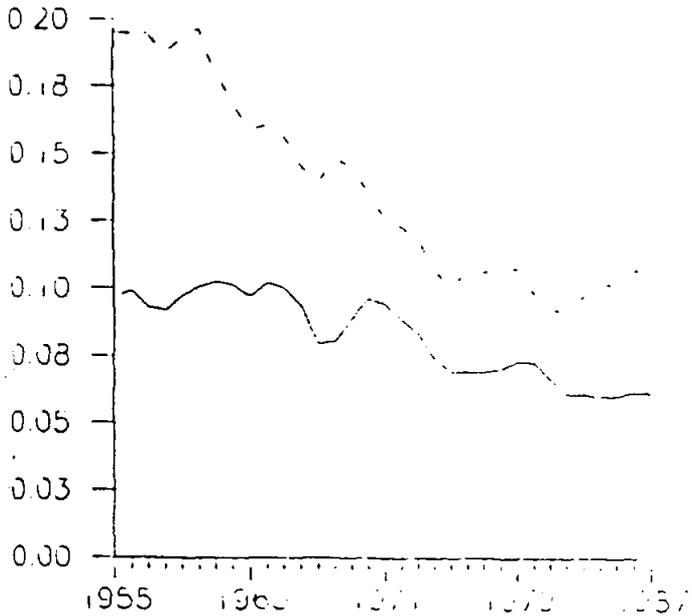
FIGURE 1

Investment and Profit Rates

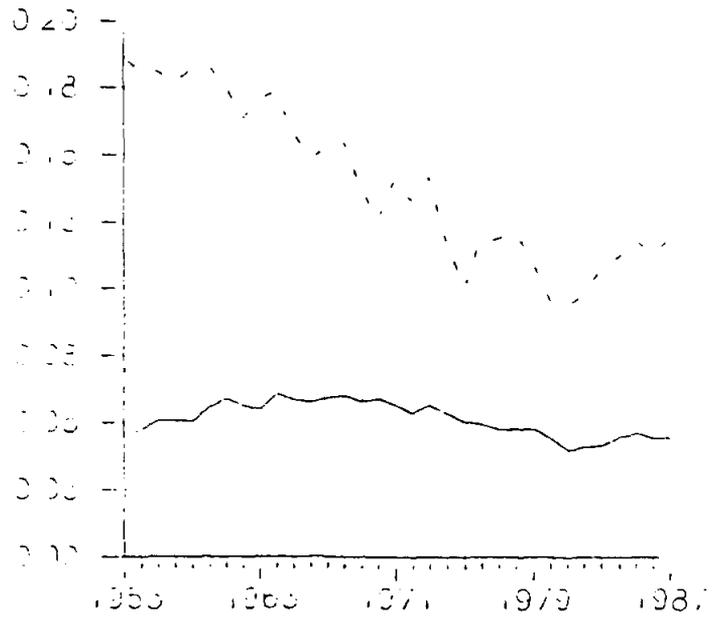
FRANCE



GERMANY



UNITED KINGDOM

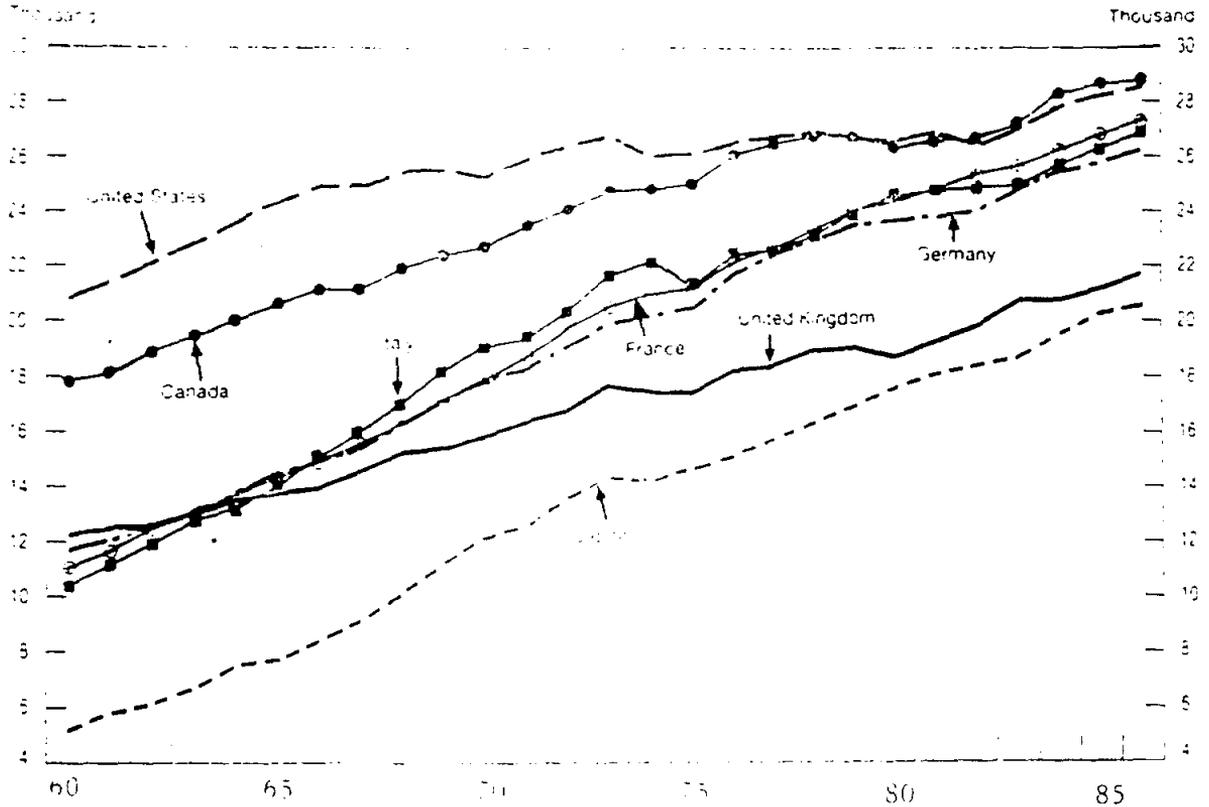


----- PROFIT RATE
————— INVESTMENT RATE

FIGURE 2

Labour Productivity

US Dollars (1980 prices and PPP exchange rates)



Source: OECD, 1988 p.52. Real output in 1980 is calculated using PPP exchange rates, and internal country growth rates are applied to calculate output in all other years.

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