



LEARNING TO LIVE IN EUROLAND

THE ROLE OF FRANCE AND GERMANY

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ABSTRACT

France and Germany have been the motor of European integration for half a century. During this process their economies have converged to a remarkable degree. Their present difficulties in terms of economic growth, unemployment and public debt are shown to depend largely on fallacies of macroeconomic management, rather than on the “European social model”, which they have adopted.

However, European monetary union has profoundly changed the conduct of macroeconomic management in Euroland. Structural reforms alone cannot improve the economic performance in large regions of a monetary union, unless they are supported by fiscal policies determined at the European level. This opens important questions for democracy and the governance of Europe.

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BY STEFAN COLLIGNON

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France and Germany have been the motor of European integration for half a century. Together, they represent roughly a third of the EU's population and half of Euroland's GDP. The construction of modern Europe would not have been possible without the reconciliation of these two nations after the war and their close political cooperation. Although their social models used to be classified as "state interventionist" and "social market economy" or "state capitalism" versus "managed capitalism" (Schmidt, 2002), political orientations and social institutions seem to have converged in the direction of some common "European social model" (Martin and Ross, 2004). On the one side, both countries have opened up to globalisation and Europeanisation, deregulating financial and product markets and giving individuals and companies greater choice. On the other side, labour markets and social regulation reflect the shared model of a "conservative" welfare regime clearly distinct from neo-liberal, Anglo-Saxon traditions or social democratic, Scandinavian countries (Esping-Anderson, 1990). While both countries were highly successful and inspirational until the 1990s, something seems to have changed in recent years. Germany is no longer Bonn's Federal Republic. Previously an economic giant, it has become the laggard amongst the countries that form the Monetary Union. France is paralysed by self doubt and growing political disenchantment and lack of economic dynamism has prevented the creation of jobs and caused a "social fracture."¹ Moreover, both countries together seem to have lost their capacity to act as political initiators. They are no longer the powerhouse for European integration in an enlarged Union of 25 countries .

Exploring the causes of this development would require a book in itself. It is today fashionable to blame France and Germany's underperformance, relative to the USA or the UK, on the inflexibilities of the economic structures underlying the "European social model" (Amable, 2004). But the story is more complex, as we will see. Not only France and Germany; but all of Europe is challenged by the economic transformation resulting from globalisation and changes in demography. They all share the challenge of reconstructing the social model on which Western Europe has been built. In addition, the German economy is still under shock from the consequences of its unification and this has also affected neighbouring European

¹ The expression was coined by J. Chirac during his presidential election campaign in 1995.

countries. Finally, the political dynamics of European integration, and particularly the creation of European monetary union, have transformed the established patterns of economic development and adjustment. I will argue that re-igniting economic growth in Germany and France, and Euroland as a whole, requires a solution of the inefficient governance of the Eurozone, with the formation of a political union with full democratic legitimacy (see also Collignon 2003, 2004). Unless France and Germany lead the way here again, there is a risk that half a century of European integration will be eroded by political gridlock. However, political cooperation needs economic foundations. If the two countries' economic performances converge, common policies are more likely to be sustainable than if developments point in different directions. While most of the "models of capitalism" literature analyses changes (or persistence) in institutions and behaviours, I will focus here on the economic infrastructure of the French and German models of society.

I will first compare their economic structures and performances, and then turn to the question how France and Germany are adopting to Euroland.

Features of French and German economic performance

Evaluating the structural features of France and Germany's economic performance requires a look at the long term. I will therefore focus on the persistence and changes in economic variables dating back several decades.² I will first analyse the growth performance, then the contribution of labour and capital and finally discuss the role of the public sector.

The problem with economic growth

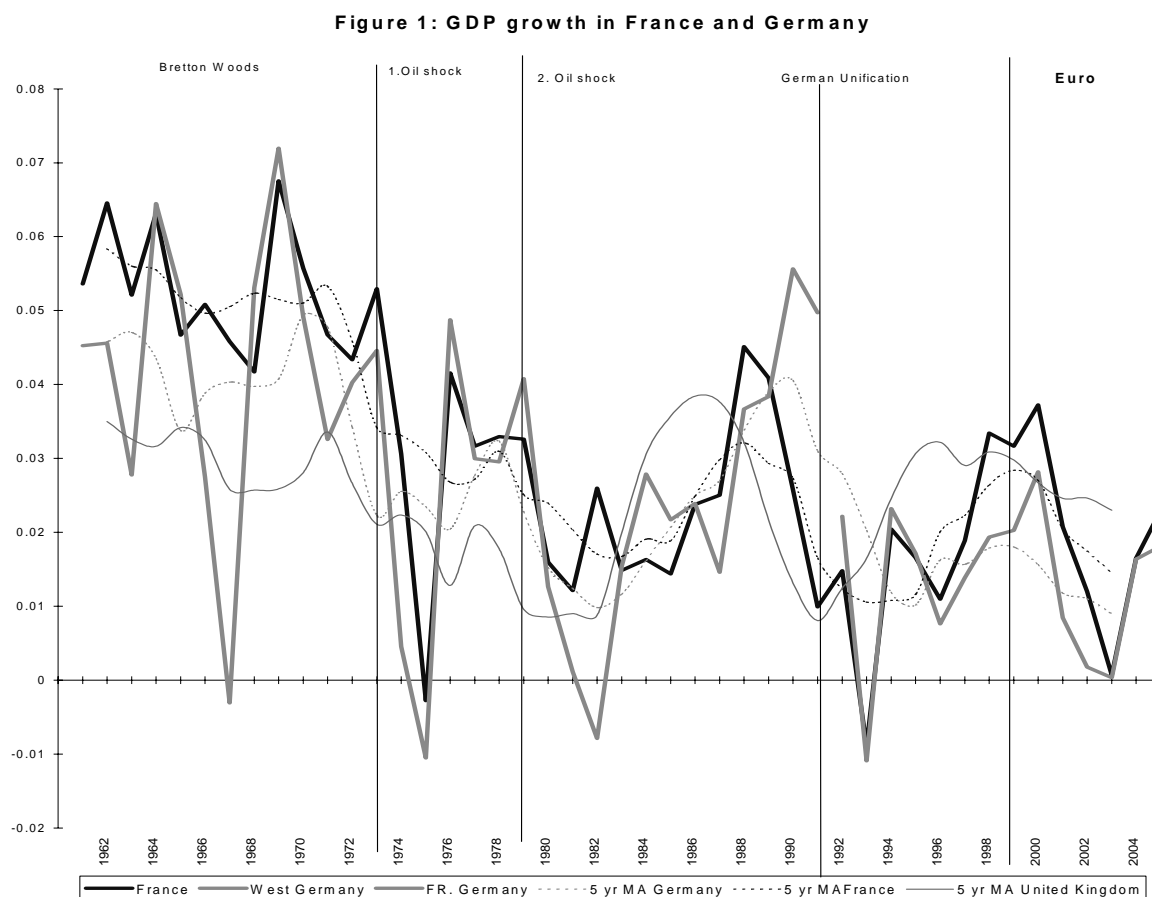
In the 1950s and 1960s, under the Bretton Woods System, economic growth was generally high, on average around 4 to 5 percent.³ During the Golden Age of Bretton

² In this paper, all data are taken from the European Commission's AMECO data bank, unless alternatively indicated.

³ In France, it has become fashionable to talk of the "*trentes glorieuses*" (1945-75), but overshadowed by serious economic difficulties, the late 1940s and 1970s were hardly glorious.

Woods, productivity grew rapidly, unemployment was practically non-existent and high rates of investment helped to modernise France and Germany. Germany thrived on its model of “social market economy” and in France, the new Fifth Republic finally provided the framework for political, fiscal and economic stability that became the backdrop for *expansion* and Keynesian macroeconomic policies.

The growth of GDP



Germany experienced its first post war recession in 1966, but this was quickly remedied when Social Democrats joined the government and introduced Keynesian macroeconomic policies into the ordo-liberal model of the social market economy. The Golden Age came to an end in 1971/73. Irresponsible US policies had caused rising world-wide inflation, leading to the breakdown of the Bretton Woods System. In the context of the subsequent flexible exchange rate regime, the severe oil shocks of the 1970s transformed the framework for economic policy and development. The Age of Great Inflation and major recessions followed the tripling of the oil price in

1973. Figures 2 show that France first accommodated inflation, but changed policy after 1983, when converging to the German model of price stability through competitive disinflation became the priority. After German unification in 1991, French inflation remained significantly below German inflation.

The second oil shock in 1979 was followed by harsh disinflation policies worldwide. Starting in the USA, interest rates rose worldwide to very high levels. As a consequence, economic growth fell in all industrialised countries, but in France and Germany it never came back to the previous levels. Resisting inflation more radically (accepting even a fall in the consumer price level in 1986) and embarking on drastic fiscal consolidation after Kohl took power in 1982, German economic growth suffered more than French. It is useful to compare this performance with the UK as an alternative to the French and German model. Britain's economic growth remained systematically behind France and Germany in those years, while inflation was higher. Growth only started to pick up after inflation was brought down in the mid-1980s but it fell behind when the Thatcher government first started to shadow the Deutschmark and later joined the European exchange rate mechanism to contain inflation.

Figure 2a. Inflation

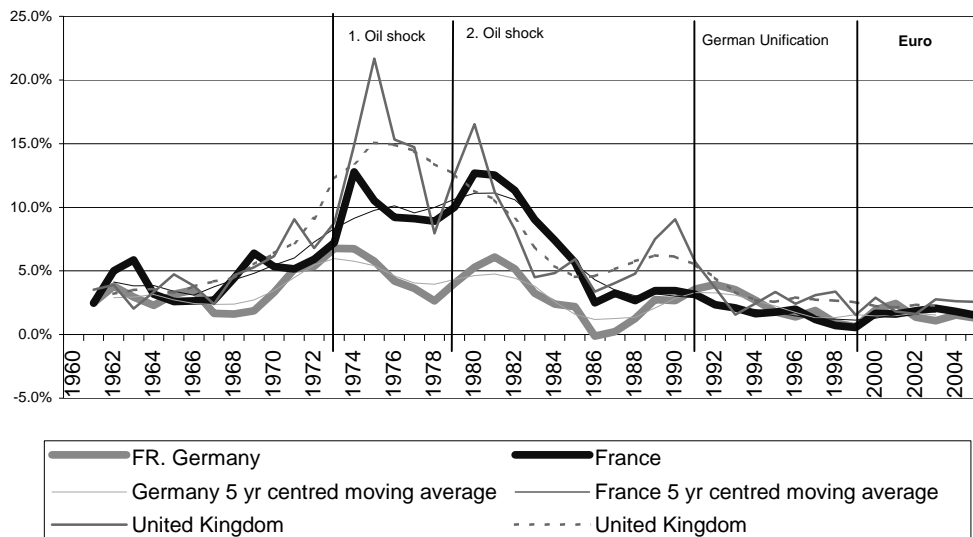
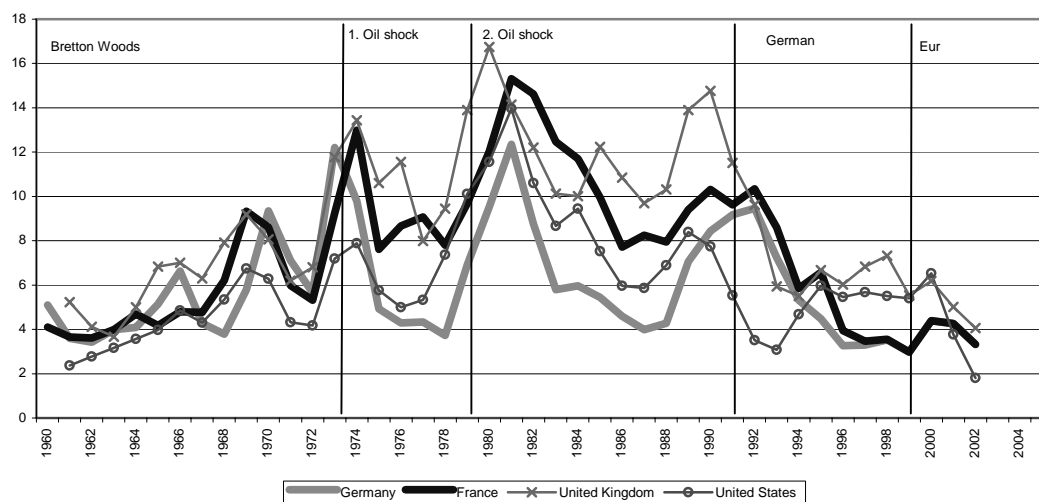


Figure 2b. Nominal short term interest rates



After the second oil shock and the subsequent long period of disinflation, economic crisis became an endemic phenomenon, at least within the European Monetary System. Unemployment and public debt shot up, largely driven by shocks, and the subsequent resumption of growth was never sufficient to reduce these variables to their previous levels (Figures 3 and 4). In the UK, however, results were different. Although unemployment increased more rapidly after shocks, it has continuously declined since 1993. The contrast is even more dramatic with respect to fiscal policy. After World War II, Britain was left with a huge public debt, which was gradually brought down by conservative budget policies and higher rates of inflation. The Thatcher government particularly focused on budget consolidation from 1984 to 1989. But during the subsequent ERM-period, deficits rose again, peaking at 8 percent of GDP in 1993. Only in 1998 did the budget move into surplus again, lowering the debt- GDP ratio.

Figure 3. Unemployment rates

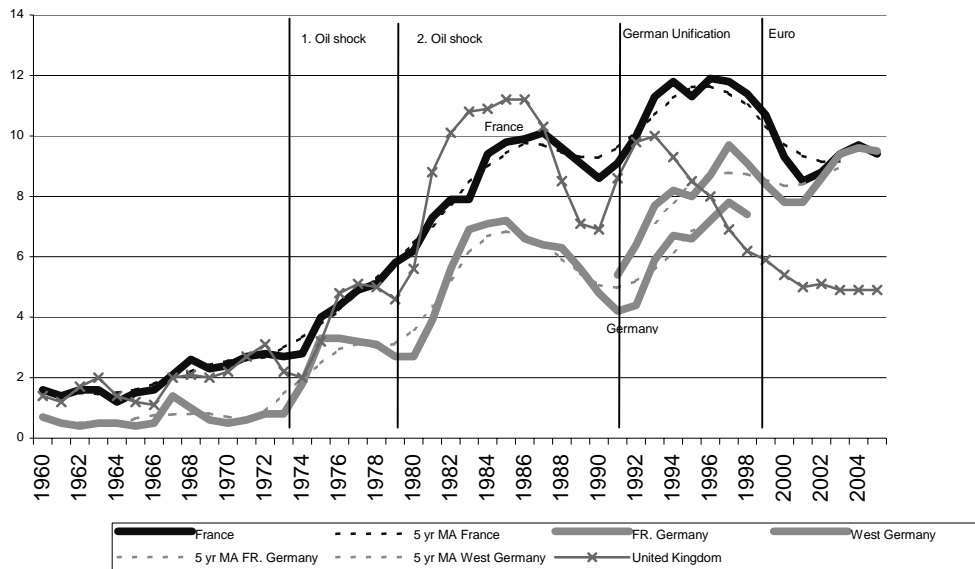
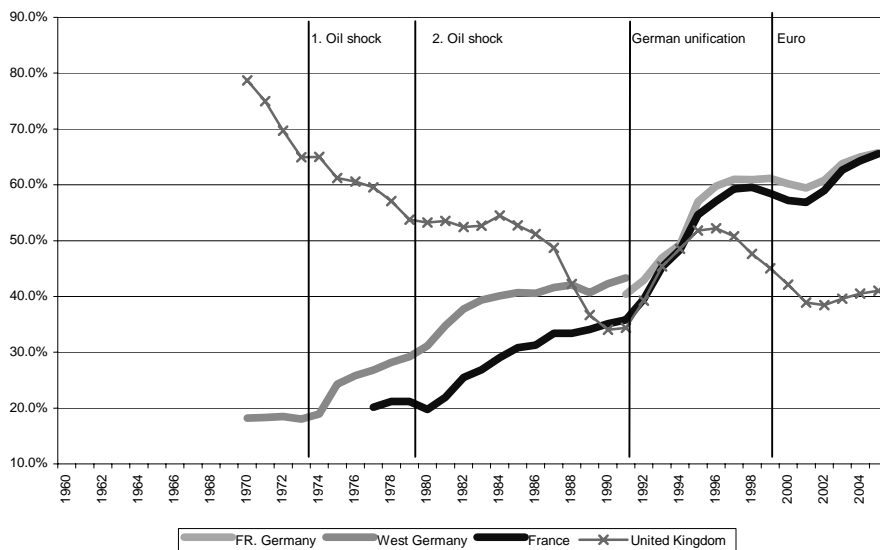


Figure 4. Debt to GDP Ratio



Many economists have explained the persistence of the dissatisfying experience in France and Germany during the 1980s and 1990s by the role of institutions. Labour market institutions are most prominent. It is argued that social protection was high, making labour markets inflexible and pushing the public sector beyond sustainable levels. By contrast in Britain, the Thatcher reforms created flexibility and dismantled the state. A recent study by Bertelsmann Foundation (2004) reiterates the argument: France and Germany are classified as “red lanterns” with rank 20 and 21 respectively on an index of 21 industrialised countries that measures economic activity and labour

market performance. The authors see the inflexibilities of German wage bargaining systems, employment protection and the crowding out of private investment by excessive public expenditure as the main culprits for this negative development. Sinn (2003) has made similar charges, claiming Germany needed a “radical cultural revolution” like Britain, before Thatcher. It is, however, remarkable that in the Bertelsmann Study, Germany’s performance index improved from 80 to 110 between 1987 and 1991 and then, after unification, it fell continuously to below 70. This puts some question marks behind the proposed explanations. As Blanchard (2004) has pointed out, labour market institutions had already come into being before 1970s and were not incompatible with low unemployment and high growth in those years. Since the mid-1980s, reforms actually *improved* labour and product market flexibility, but unemployment has not fallen significantly. Labour market institutions are therefore a doubtful variable for the explanation of low economic growth in France and Germany.⁴

If there is a set of institutions that clearly has changed in a profound way since the early 1970s, it is monetary institutions - the change in international and national monetary systems has transformed the nature of economic policy making. Under the fixed exchange rate system, monetary policy was endogenous and internationalist, while fiscal policy was exogenous and could be used for macroeconomic demand management. With flexible exchange rates, monetary policy became exogenous, focusing on national objectives, like price stability, and fiscal policy became endogenous.⁵ With the growing dominance of private capital flows, monetary policy became subject to the “quality control” of private investors. The international monetary system changed from a government-led to a market-led system as the large volumes of petro-dollars needed to be recycled and financial controls were abolished (Padoa-Schioppa and Saccomanni, 1994). Private financial markets have also become more dominant in both countries. Equity financing has increased and firms’ market capitalisation has been rising rapidly. Large companies increasingly make use of securitization and less of their “*Hausbank*.” This transformation has gone further in France than in Germany, partly because French industry is more strongly dominated

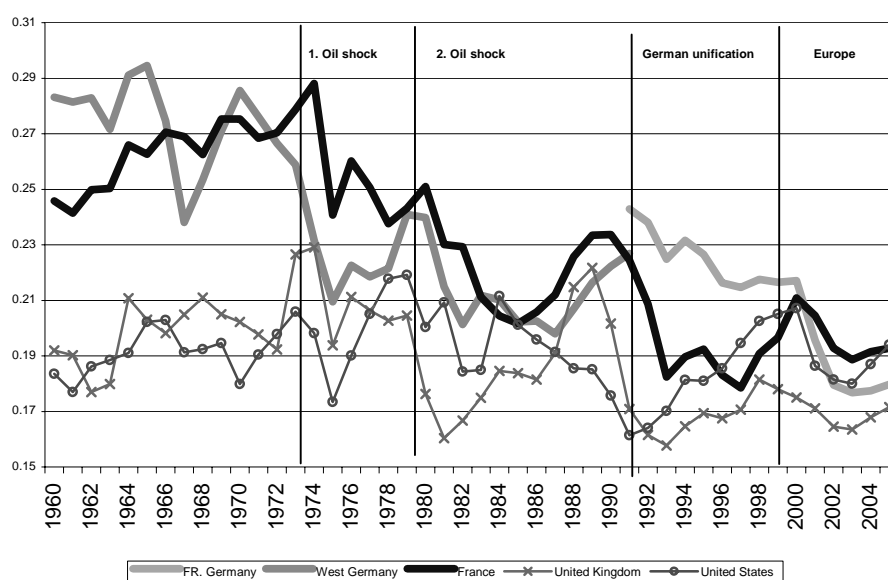
⁴ This does not exclude that labour market reforms may have merit in themselves, especially in order to ensure the sustainability of the welfare state, as Scandinavian countries have demonstrated.

⁵ By endogenous fiscal policies, I mean that the debt dynamics depend more on interest rates and growth than on the discretionary variations of public spending. (See Collignon and Mundschenk, (1999))

by large companies and Germany by smaller *Mittelstand*. In the context of general financial market liberalisation, maintaining price stability was a necessary condition for financial assets to be an attractive store of wealth. Combating inflation required high interest rates, and as a consequence, economic growth faltered and public debt exploded. As a consequence, fiscal policy could no longer be used for discretionary action and the focus moved to debt consolidation. The high levels of interest rates reduced the scope for profitable investment opportunities, while the volatility of exchange rates and other financial variables created uncertainty for long term investors and the investment ratio fell (Figure 5). This reinforced economic stagnation and a general sense of “crisis”: labour productivity and technological progress slowed down as the capital stock became older and real wage increases reflected this development. Interestingly, in the UK, the investment ratio has remained well below France and Germany, despite the supposedly business-friendly reforms of the Thatcher government.

The creation of the European Monetary System (EMS) by Helmut Schmidt and Valery Giscard D’Estaing was the first institutional response to these shocks, aiming to create “a zone of monetary stability” (Collignon and Schwarzer, 2003).

Figure 5. Investment ratio



The German Deutschmark soon became the anchor for countries who sought to stabilize their economic environment. But at the same time, this peg made them vulnerable to the spill-over effects from domestic policies in Germany. France probably suffered more than any other country from the Bundesbank policies, because

of the unintended deflationary consequences of bloc floating. In fact, it can be shown that in a world, where many countries peg to a few anchor currencies and where these key currencies float freely against each other, the peripheral countries suffer deflationary pressures and these pressures are the larger, the larger a pegged country's size is relative to the anchor (Collignon, 2002). This was clearly the case for France in the late 1980s and early 1990s, but also for Italy or the UK, until it left in ERM.

The second institutional response, which aimed at overcoming these deficiencies, was the creation of a unified monetary policy that began in the mid-1980s after the Single European Act had opened the way for a truly integrated European market. The path to completion of the project was arduous. In the early 1990s, after the Berlin Wall had come down, Germany experienced a temporary boost in demand. But when the Bundesbank reacted by tight monetary policies, the boom was quickly followed by a recession, which hit Germany's neighbours first, because the interest shock was amplified by the exchange rate mechanism. However, when growth resumed in the mid 1990s, the German economy suffered from the indigestion of the East. GDP-growth has remained persistently low. By contrast, France benefited from the advent of European Monetary Union, which dissolved the deflationary bias of block floating. Its growth performance was again significantly higher than Germany's (Figure 1).

Thus, for over half a century, France has grown on average faster than Germany with the exception of the late 1970s and the "hard EMS-years" in the early 1990s. However, the range of growth differentials between the two countries is only plus/minus 1 percent, indicating significant convergence and similarities between the two economies. Furthermore, the movement of GDP growth rates is usually well correlated between France and Germany. Since the 1970s the coefficient of correlation over a 5-year period has always been above 60 percent; in the 1990s it was even above 90 percent. The only significant exceptions were caused by major "national shocks": first, in 1982, the left-Keynesian experiment after Mitterrand came to power, then in the early 1990s when German unification also created a major asymmetric demand shock in the European Union. Thus, France's and Germany's economies seem to be well tuned to each other and respond in similar, symmetric fashion to exogenous shocks; only politics seems to be able to divide the two economies.

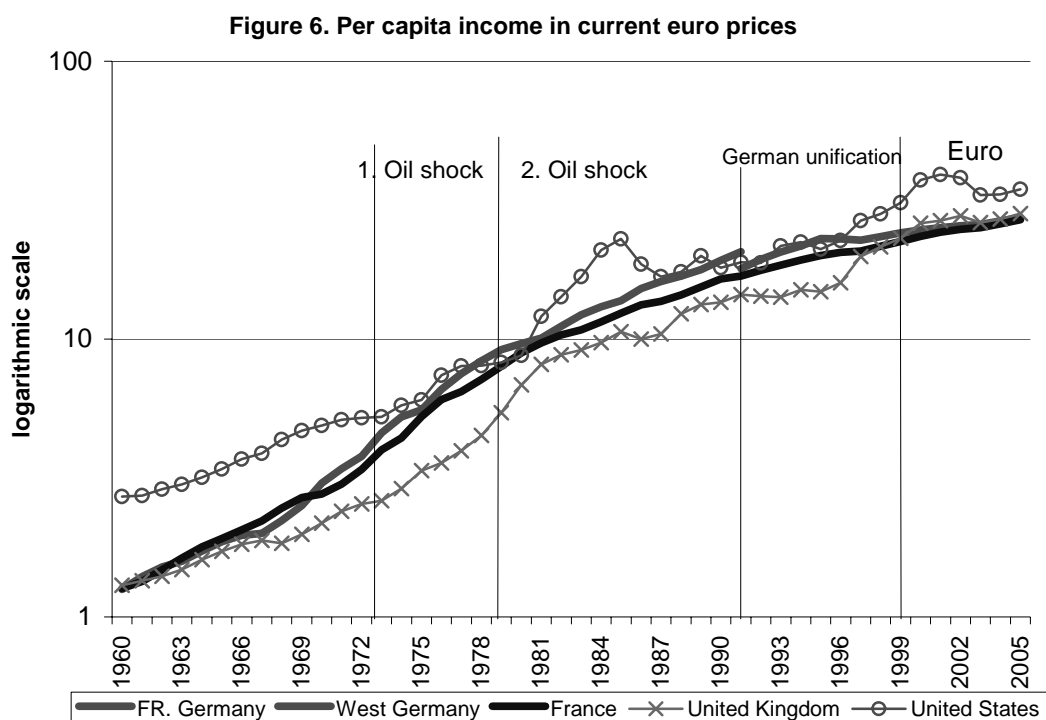
For both countries, the turning points in their development have been the two oil shocks, German unification and more recently, the regime change of EMU. But one has to keep in mind that one shock rarely comes alone: the first oil shock came soon after the demise of Bretton Woods, the second oil shock was followed by the so-called Volker-shock, a highly restrictive monetarist anti-inflation policy worldwide. German unification also caused tight money and high interest rates. European Monetary Union may have been accelerated after the German unification shock⁶, but it reflected institutional regime change. At first, it gave rise to the “magic of all beginnings” (Herman Hesse), with a boom in 2000. But American economic policies, coupled with 9/11, caused a recession that spelt over into Europe. France and Germany seem to have been slow to move out from it. We will need to clarify why. Can the social model be blamed?

Per capita income

For an evaluation of the relative performance of the social-economic model of society, it is more appropriate to concentrate on the average income per person i.e GDP per capita. Figure 6 shows per capita income in current euro prices for France and Germany as well as for the UK and the USA. The growth of capita income has slowed down in the 1980s and 1990s compared to the previous decades, partly reflecting disinflation.⁷

⁶ The myth that EMU was “the price” Germany had to pay for its unification is false. The EMU-project had a long history and was prepared by Helmut Schmidt and Valery Giscard d’Estaing long before Kohl and Mitterrand took it on as their own. It was a systemic necessity after the creation of the single market. See Collignon and Schwarzer, 2002.

⁷ The growth rate is reflected in the slope of the logarithmic chart in Figure 6. I have used nominal per capita income in euro, as it seems the more reliable indicator for relative income levels between countries.



Germany's image as a rich and powerful country dates back to the 1970s and 1980s when per capita income grew faster than in France. In 1960, the two countries were at similar levels around 1,260 euros per head. Eight years later, German nominal per capita income had fallen 10 percent below French levels. However, comparing these nominal data with real per capital income reveals that this improvement in French relative wealth was largely due to higher inflation under the fixed exchange rate regime. Several subsequent revaluations of the Deutschmark contributed to the rebalancing of German relative income. In 1987, with nominal per capita income of 16,128 euros, the average German citizen was about 18 percent more prosperous than his French counterpart. These trends may explain why it took so long to appreciate the value of price stability in France: with fixed exchange rates, inflation seems to increase relative income, even if competitiveness suffers. In Germany, a strong Deutschmark and nominal revaluations were tools that apparently made the country more prosperous, while low inflation relative to other European partners in the EMS ensured high competitiveness. This logic came to an end in the early 1990s, when France and most other EU-members states converged to price stability, but the myth of the beneficial strength of the DM continued to haunt the German public debate until 1997. Germans also took time to realize that unification had caused a fundamental regime change. The country's long-term trend had been broken and the pattern of economic development transformed. By merging with the unproductive

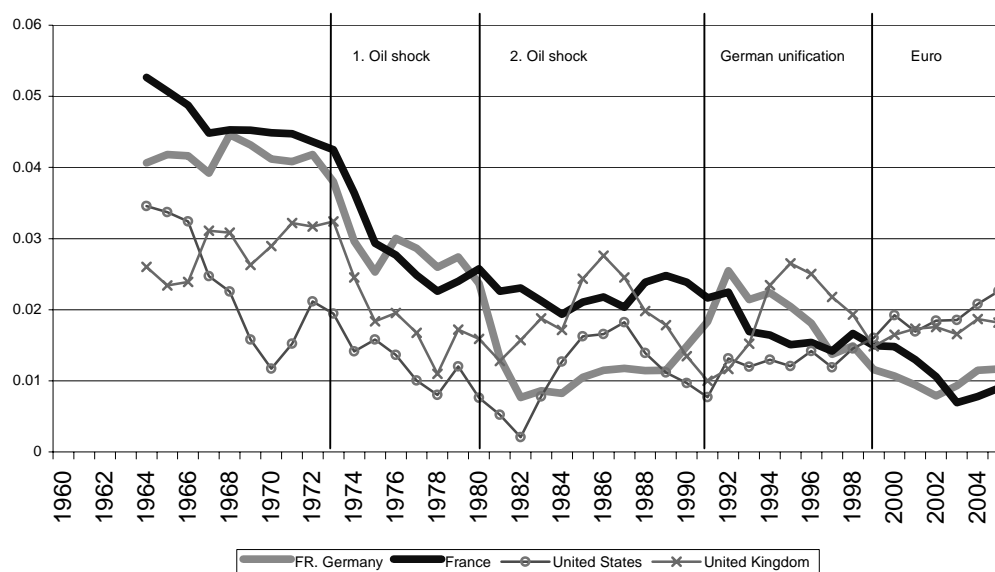
assets of the former German Democratic Republic, per capita income of the united Germany fell from 20,646 euros in the former West Germany to 17,912 euros of the united Germany in 1991, a reduction of 13 percent. Since then the prosperity of Germans relative to French citizens has been falling continuously and has achieved equality by now.

The performances of the US and the UK, relative to France and Germany, are also interesting. Converting their per capita income into euros is obviously affected by fluctuations in the exchange rate. This is most evident for the US in the mid 1980s and in the early 21st century when the dollar was overvalued. However, the apparently spectacular performance of the UK is largely due to the strengthening of pound sterling relative to the euro in the late 1990s until 2002, while the Thatcher years do not stick out as a remarkable performance. In purchasing power terms, the three major European countries (or four if Italy is added), have essentially the same real per capita income, while the average US income is approximately one third higher.

Labour productivity

Which factors determine per capita income? In line with orthodox economic thinking, we will first look at the supply side of the economy. We can approach this question from two angles by focusing solely on the role of labour and its apparent productivity or considering the shared contribution of labour and capital to output. Let us start with the role of labour alone. Per capita income then depends on the rate of labour productivity and the rate of employment in the total population. Figure 7 shows the medium term evolution of labour productivity. In order to catch the structural features, I took the moving average over a five-year period, thereby smoothing out some of the short-term business cycle distortions. The most striking features are the high growth rates in the Golden Age of the 1960s, their dramatic collapse in the 1970s, a short-lived pick-up in the late 1980s and further slowdown since the 1990s. Despite smoothing out business cycle effects, labour productivity seems strongly affected by oil shocks and economic recessions.

**Figure 7. Average labour productivity growth
(5 year moving average)**



Since the early 1990s, labour productivity growth has fallen again in both France and Germany, but for different reasons. The reduction in France by more than 50 percent is partly due to the productivity measure of output per employee, which was negatively affected by the reduction of working hours, especially the *loi Robien* (June 1996) and the *lois Aubry I* (June 1998) and *II* (January 2000). As a consequence, measured labour productivity, i.e. the ratio of output per person employed has slowed down, although labour productivity per hour worked does not seem to have suffered (INSEE, 2003) or even increased (Fiolle et Roger, 2002). The deceleration of German labour productivity since unification, has been more rapid than in France, with the exception of the last few years. Germany improved productivity growth immediately after the Berlin Wall came down, partly because of the resulting demand boom, partly because of the liquidation of unproductive assets in the East after unification. But Germany now seems to have returned to its steady state of productivity growth that has prevailed since the 1980s, although it is possible that the Schröder reforms are changing the trend. This negative performance contrasts with the steady increases of labour productivity in the US economy since the early 1990s. In the UK, labour productivity has been more volatile – although, it has taken a more stable path in recent years. The lesson from figure 7 is that labour productivity developments cannot be attributed simply to specific forms of social models. At certain times, Germany and France have been leaders, while the Anglo-Saxon model was clearly

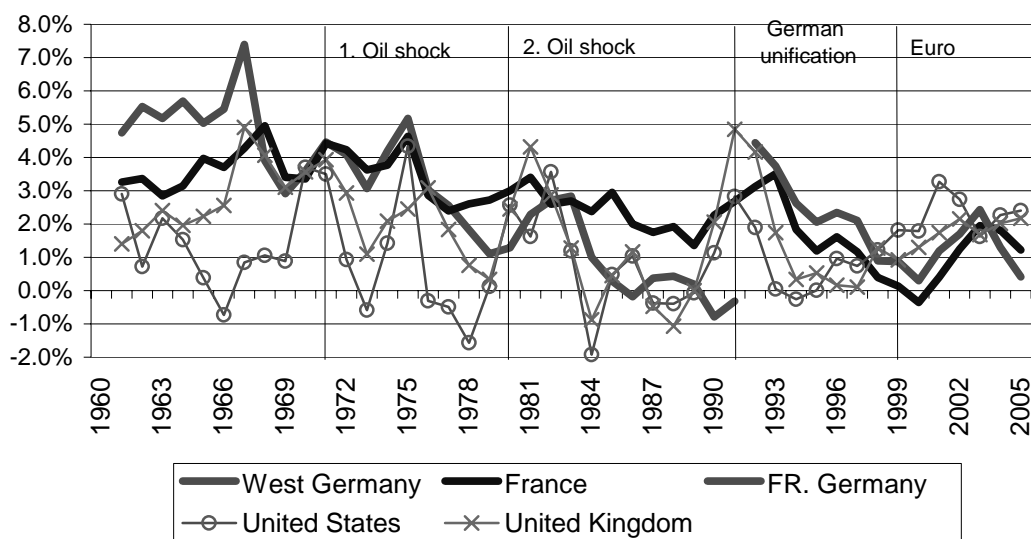
inferior. In recent years, this seems to have changed but one has to be careful in explaining the underlying causes.

Capital Intensity

Why did labour productivity increase? Most growth theories model labour productivity as a function of capital intensity, i.e. the capital-labour ratio. By using more capital, workers are becoming more productive, *ceteris paribus*. A look at this ratio shows that during the 1960s, German capital intensity grew faster than in France, advanced at the same speed in the 1970s, but stagnated in the 1980s. In fact, a first break comes in 1983 with the change to the Kohl government, which pursued aggressive budget consolidation and a limited roll-back of the welfare state (Seeleib-Kaiser, 2004). Unification has caused a second major shock in the data for Germany. The under-capitalisation of East Germany necessitated a rapid capacity building, but capital accumulation per worker has now returned to previous levels. The amount of capital per worker used in 1991 in the old West German Federal Republic was 162.6 thousand euros; in the new unified Germany, this value was reduced to 144.7 thousand euros. Significant private and public investment efforts followed to build up the East and in 1996, the united Germany reached the same capital stock per worker that West Germany had attained in 1990. At this point, labour productivity has also returned to the level, which had prevailed in the West in 1990. However, capital accumulation per worker has continued to decelerate until 2002 and so did labour productivity. By contrast in France, the accumulation of capital per worker follows a smoother path, decelerating at a slow rate from mid-1970 until the beginning of EMU.⁸ In the two Anglo-Saxon countries, the growth of capital intensity is more volatile, but it is clear that their improvements in labour productivity since the mid-1990s are correlated with increases in the capital intensity. In the late 1990s, several reforms reduced average working time per worker and, as a consequence, the slow down in capital intensity growth accelerated (INSEE, 2003). It only returned to previous levels after these effects were incorporated in economic behaviour.

⁸ Augmented Dickey-Fuller tests reject the null-hypothesis of a unit root at the 1% confidence interval, so that we can assume that the growth of capital intensity decelerates at the rate of -0.07 percent. Partly, this deceleration trend may reflect the technological catch up of the French economy to US-levels.

Figure 8. Growth of capital intensity

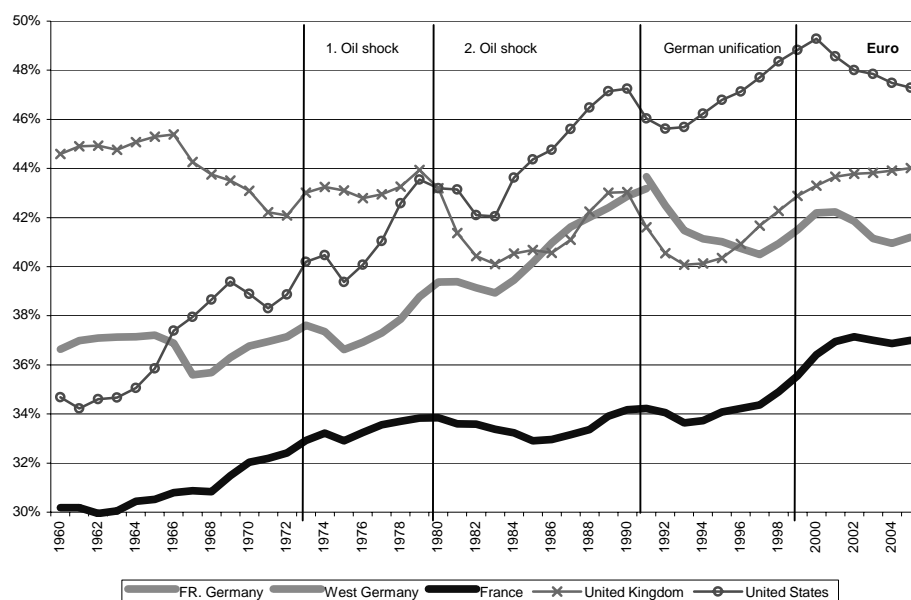


Employment rates

If labour productivity has grown less rapidly than previously, per capita income may still have improved by bringing more people into work. Figure 9 shows that a good part of the improved prosperity in France can be related to the increasing rates of employment in the 1960s and 1970s and again in the run up to, and early years of, the euro. The oil shocks caused temporary stagnation in the employment rates, both in France and Germany. The main improvement in average German income during the 1980s was therefore due to the higher rate of employment, just as the reduction in wealth after German unification is due to the loss of employment in the eastern part of Germany. In France, the number of people in employment used to be stagnant, but increased after the labour market reforms aiming to reduce working time in the late 1990s. But, because apparent productivity growth per employee decreased, the rise in the employment rate in France has not significantly contributed to higher income for the average French person in this decade. On the other side, the British improvement in per capita income is mainly due to higher employment rates since New Labour came into power. Only in recent years has it been complemented by higher productivity. In America, per capita income improved due to high employment during the Clinton years, but deteriorated after George W Bush came into power.

The aggregate employment figures hide some important transformation of the economic structures in France and Germany. In both countries, the share of employment in manufacturing has fallen, and the share in services has increased. While Germany has always had a larger manufacturing industry than France (42 percent against 31 percent in the early 1960s, 22 percent versus 15 percent today), the relative weight has continuously declined. Clearly, Germany's larger industrial sector is a sign of its comparative advantage, which also shows up in export figures. But the reduction of the manufacturing sector in both countries to nearly half its previous importance reflects the profound change in the world economy, where an increasing

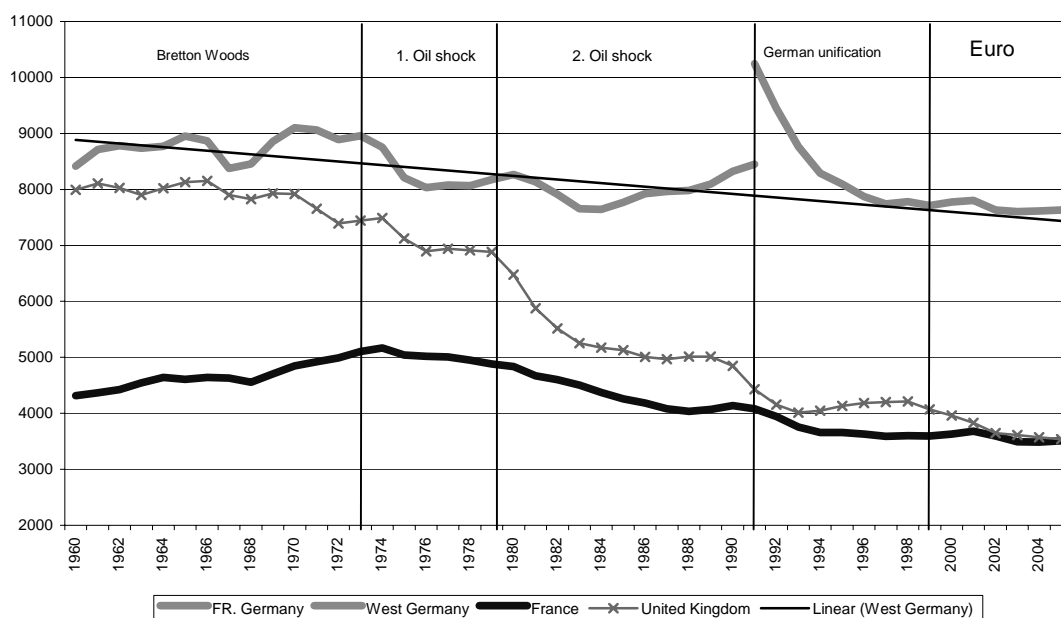
Figure 9a. Employees as percent of population



amount of manufacturing is produced in formerly less developed countries. For example, the share of world exports in textiles from developing countries has increased between 1980 and 1995 from 34 to 54 percent, in chemicals from 7.8 to 16.4 percent in machinery from 5.8 to 22 percent. (Baker, Epstein and Pollin, 1998: 16). These are the consequences of globalisation. In France, they have contributed to job losses in manufacturing of roughly one million, between 1973 and 1991 and a further 570 thousand between 1992 and 2005. In West Germany, the loss was 510 thousand between 1973 and 1991, but 2.6 million since unification. As Figure 9b shows, this dramatic change has largely been to the detriment of East Germany today: Unified Germany employs the same amount of workers in manufacturing that West Germany would have employed without the East. However, this dramatic social

transformation is not the fault of Germany's social model. Despite all liberal market flexibility, the UK lost 3 million jobs in manufacturing between 1973 and 1991 and 855 thousand between 1992 and 2004.

Figure 9b. Employment in manufacturing



Job losses in manufacturing have been more than compensated by job gains in services. France created 4.2 million between 1973 and 1991 and 2.7 million between 1992 and 2001. The equivalent amounts in Germany were 5.5 and 3.4 millions. In the UK they amount to 3.7 and 2.9 millions. Thus, contrary to a wide-spread perception, France and Germany are not lagging behind the UK in creating jobs in services.

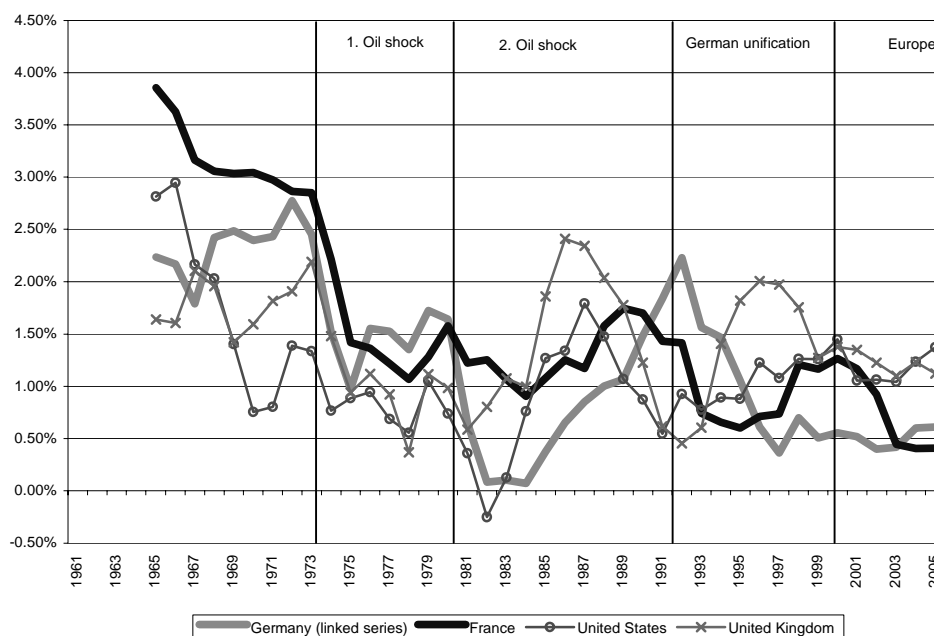
Total factor productivity

The second approach to explaining per capita income looks at the improvement of the economy with respect to the contribution that the two factors of production, labour and capital, make jointly to the creation of aggregate output. Figure 9a indicated the additional input of labour into the production process. We will now focus on the role of capital. Figure 5 showed the evolution of the investment ratio, i.e. the increase of the capital stock over GDP. In this section, I will refer to the rate of capital accumulation, i.e. the growth rate of the capital stock, but to keep the paper short, I

will not show the chart separately. Its general pattern is similar to Figure 5, also the variations are more volatile.

First, we notice that during the years of high economic growth in France and Germany, capital accumulation was high – but low in the Anglo-Saxon economies. The growth rate of the capital stock fell after the first oil shock continuously until the mid 1980s from over 5 percent to below 2 percent. In the second half of the 1980s, when economic growth resumed, capital accumulation also accelerated, although in the 1990s, after the German unification shock and the high interest rate policy in the European Monetary system, growth of the capital stock fell back in both France and Germany – attaining its lowest historical level in France. In the run up to European monetary union, when interest rates started to come down in the late 1990s, French capital accumulation resumed, although it collad again during the world slump following 9/11: the capital stock grew only at a historically low level of 1.7 percent. In Germany capital accumulation is today also at its lowest historical point since

Figure 10. Total factor productivity growth moving average over 5 years



World War II - at less than 1 percent growth of the capital stock and an investment share of 18 percent. This slowdown in capital accumulation contrasts significantly with the performance of the US and the UK since the early 1990s where the capital stock has grown at rates in excess of 2.5 or even 3 percent. The different

performances between continental Europe and the Atlantic countries may explain the attractiveness of the Anglo-Saxon model over the last decade.

The efficiency of the combined use of labour and capital is measured by total factor productivity (TFP). A huge literature has tried to explain, which factors affect this efficiency residual. The accumulation of human capital, education, training, research and development are the most prominent research variables, while newer theories also look at the role of institutions. Policy makers have drawn their conclusions, too. The Lisbon Strategy, decided by the European Council meeting in 2000, focuses on improving total factor productivity by emphasising education, the knowledge economy, research and development and education. So far the success has remained questionable to say the least (Kok, 2004). Neo-liberal economists claim that greater flexibility in markets and social arrangements would improve TFP. But this is not obvious from the facts. While it is true that in recent years the Anglo-Saxon model seems to have fared better, it is also interesting that TFP is correlated with oil shocks and macro economic performance. In particular in the UK, total factor productivity has improved during the Thatcher reform years in the mid-1980s, but collapsed during the DM-pegging period. After the exit from the ERM, TFP caught up with previous growth rates. But only under New Labour has TFP finally settled at, what appears for the moment, a steady state above 1 percent growth per annum. This is more than twice the German rate, but France seems to oscillate between the two. It therefore does not seem justified to blame the difference in economic performance on social models alone.

The fundamental question is why economic growth in France and Germany has been so low and unemployment levels and public debt so high over the last few decades. The explanation of the inflexible social model remains inconsistent with a number of facts. First of all, if there was underperformance, it only occurred in the recent decade, while the institutions of the social system are much older (Blanchard, 2004). In fact, they seemed to have contributed to better performances in earlier years. Second, rigidity and flexibility in social structures are related to institutional complementarities and types of strategic coordination. They fulfil functions with respect to the externalities of micro-economic behaviour that cannot be changed easily and without unintended consequences (Hall and Soskice, 2001). On the other hand, a

number of exogenous shocks and changes have already led to major adjustments in the economic system – from market deregulation to employment rules (Schmidt, 2002; Martin and Ross, 2004: 14). Many of these changes are – rightly – articulated in the context of European policy making. The most profound regime change has been the creation of European monetary union but, as I will show below, the necessary consequences for Euroland’s economic governance have not been drawn. Hence, neither France nor Germany are reaping the full benefits from the creation of the euro, and these deficiencies cannot be remedied by “economic supply-side reforms” alone. Rather than imposing a neo-liberal system of “flexible markets” on all countries, it is necessary to deal with structural reforms, such as adapting health insurance and pension systems to demographic change or improving the quality of the labour force, in their systemic context. Micro-reforms need to be complemented by a supportive, macroeconomic environment where resistance to change is minimised (Arthus and Cette, 2004). We therefore now need to look at the demand side.

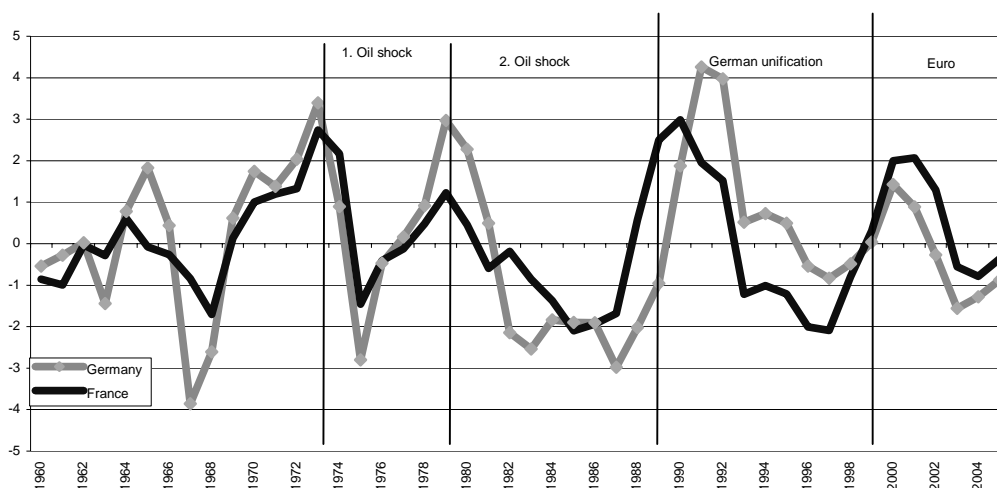
Growth and effective demand

An alternative explanation for lacklustre growth in Europe is insufficient effective demand. This can be measured by the output gap, i.e. by the difference between actual and trend GDP. Figure 11 shows the evolution of output gaps since the 1960s. The exactness of their measurement is, of course, subject to endless debate⁹. Nevertheless, the gaps indicate roughly whether, in the short term, demand was higher than the potential supply of output, or if it was lagging behind. Yet, the two variables are not independent. If demand remains behind supply for a considerable period of time, prices are depressed and investment into new productive capacities is likely to be reduced; inversely, if demand frequently exceeds supply, investment would be stimulated by profitable market opportunities. Hence, it is difficult to disentangle demand and supply effects from estimated output gaps. Rather than using the disputed values for output gaps, it may be more instructive to look simply at the distribution of number of years with positive and negative gaps. In a world of rational expectations, this should give an idea of the probability that firms will encounter favourable or unfavourable conditions in their markets. Over the long run, we should

⁹ For a discussion of German output gaps and different methods of calculation, see Sachverständigenrat, 2003, para..734 ff. For a French discussion: *Economie interationale*. La Revue du CEPII, No 60, 1997.

expect that good and bad years are equally distributed – an idea already mentioned in the Bible’s seven fat and meagre cows.

Figure 11. Output gaps: France and Germany



In reality, however, output gaps are not always equally distributed. This was still the case in France during the 1960s and 70s, when growth was high. But in those years, Germany benefited of 13 years of demand stimulus against 7 years with negative gaps, a ratio of nearly 2:1. After 1980, the situation deteriorated in both countries. Germany now had only 11 out of 26 years with positive output gaps and France only 10:26. The likelihood of a bad year was therefore sixty percent. Thus, for a quarter of a century France and Germany have suffered from insufficient demand. Since the beginning of European monetary union, the situation has improved for France and for Euroland as a whole, but not for Germany. The probability of better demand prospects has increased in France (and Euroland) to 57 percent, but in Germany it is still only 43 percent.

In figures 12a and b, I have constructed a very simple index of demand, assuming that expectations are formed with respect to whether output gaps were positive in the previous, in this, and in the next period. The index is the weighted moving average over these three years.¹⁰ We find a positive correlation between high/low demand periods and high/low investment ratios in France and Germany.¹¹ We may therefore

¹⁰ A value of 0 implies three consecutive years of negative output gaps, a value of 0.33 or 0.66 reflects two negative and one positive year or respectively one negative and two positive years. The value 1 indicates 3 consecutive years of demand exceeding supply.

¹¹ The coefficient of correlation is 0.526 for Germany and 0.303 for France.

conclude that there is at least some evidence, whereby investment in these economies does in fact respond to the prospects of economic demand, as one would expect from economic theory. If France and Germany are not doing well in terms of economic growth and job creation, then this cannot be blamed on their rigid social model and supply side effects alone. Macroeconomic policy must play an important part in it.

Figure 12a. Demand and investment: Germany

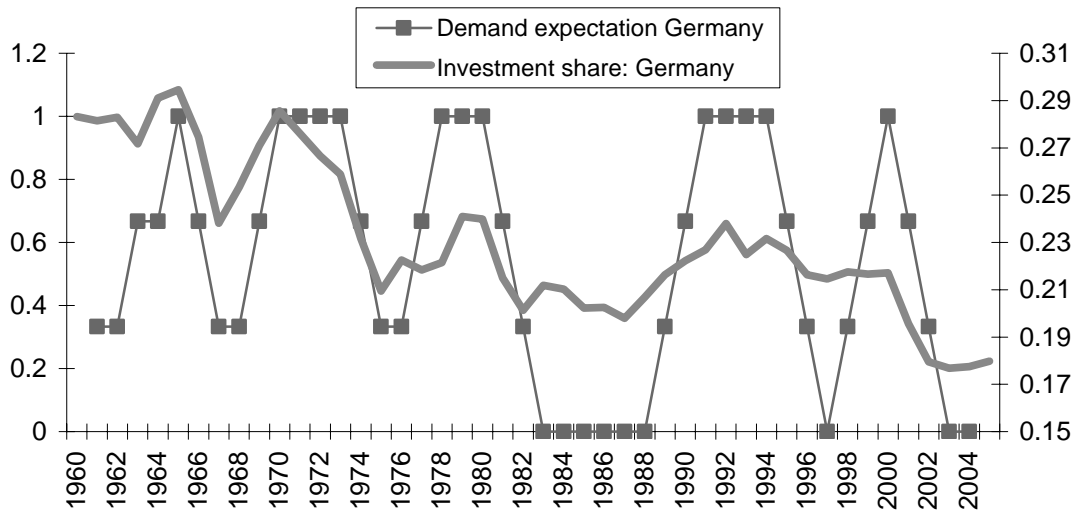
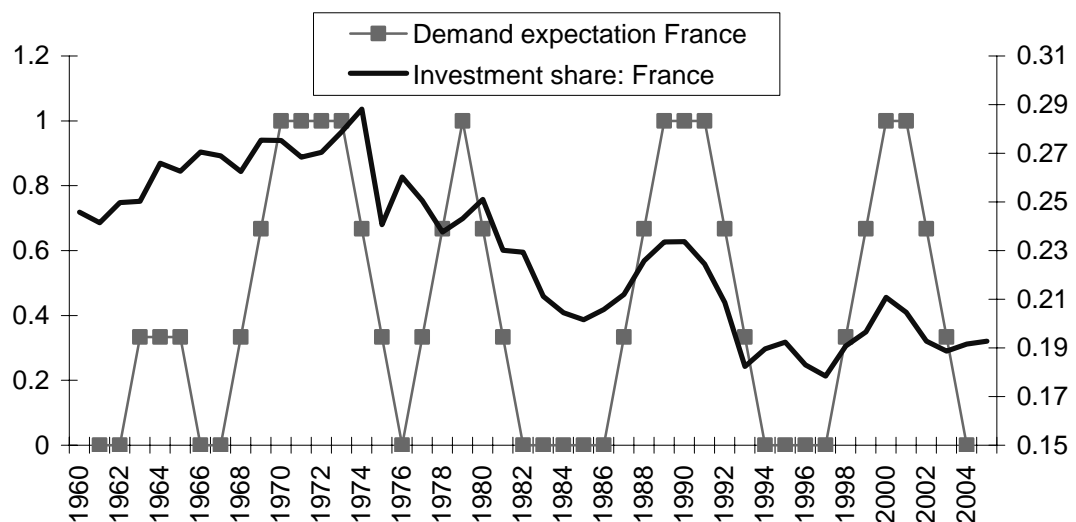


Figure 12b. Demand and investment: France



Wages, profits, investments and jobs

It should not be surprising that private investment and therefore economic growth respond to expectations about demand in the market. When demand prospects are weak, prices are depressed and firms will seek to reduce costs by improving productivity and increasing capital intensity, but they will not expand capacity. Hence, the investment ratio will fall, while the capital-labour ratio and unemployment will increase. Insufficient demand can therefore cause capital-labour substitution and high capital intensity, even if wage moderation prevails. In this case, it is not the rigidity in the labour market, but rather suboptimal macroeconomic policies, which would be the cause of persistent unemployment.

This is what we observe in the years of lagging economic performance in France and Germany. During the slump of the early 1990s, the capital-labour ratio has risen, while real wages (i.e. the ratio of nominal wages to the price level) also rose. One may think that the capital-labour ratio has increased, because real wages have been pushed up by powerful trade unions and this is the cause for high unemployment. But wage bargaining is about nominal wages, while real wages depend also on prices and inflation. If restrictive monetary policies depress prices, real wages will also rise. In reality we observe (see below, Figure 14b) that nominal wages have increased at the end of the 1980s, pushing real wages up, but as soon as the Bundesbank reacted by raising interest rates, a policy that spilled over into France, nominal wages have remained stable. Now, it was the falling price level that pushed real wages up and this has maintained the pressure for higher productivity and capital-labour substitution. As this development, exacerbated unemployment, labour market reforms in France, starting in the mid-1990s, aimed to reduce working time through promoting part-time and less working hours per week. In Germany, similar reforms were only becoming prominent under the Schröder government (see below).

The dependence of job creation on aggregate demand can also be approached from a different angle. It is well known that the United States and in recent years also the UK have had higher rates of job creation than France and Germany. The creation of new jobs necessarily implies that GDP grows at a faster rate than labour productivity,

for otherwise all additional output would simply be produced by the same labour force. Comparing France, Germany and the United States, a striking feature emerges: the consistently high rate of GDP-growth relative to labour productivity in the US, and the failing demand in Europe. In France, jobs were destroyed in the two major recessions in the early 1980s and 1990s. In Germany the same happened after unification with the East, and again in recent years. By contrast in the USA, GDP-growth has always been higher than productivity growth and job creation is generally high. In order to bring unemployment down and the employment rate up, as agreed between governments at the European Council in Lisbon in 2000, the rate of GDP growth must be in excess of productivity growth for a significant period of years. Lowering unemployment to 4 percent from the 9 percent where it is today, and with the labour force growing at a rate of 1 percent, an average job creation rate of 1.5 percent is needed over one decade. Given recent increases in labour productivity, this implies GDP in Germany and France should grow between 3-3.5 percent. This is comparable to the growth of the US economy during the Clinton years. But how can this be achieved in “old Europe”?

Figure 13a. Job creating growth in Germany
(5-year moving average)

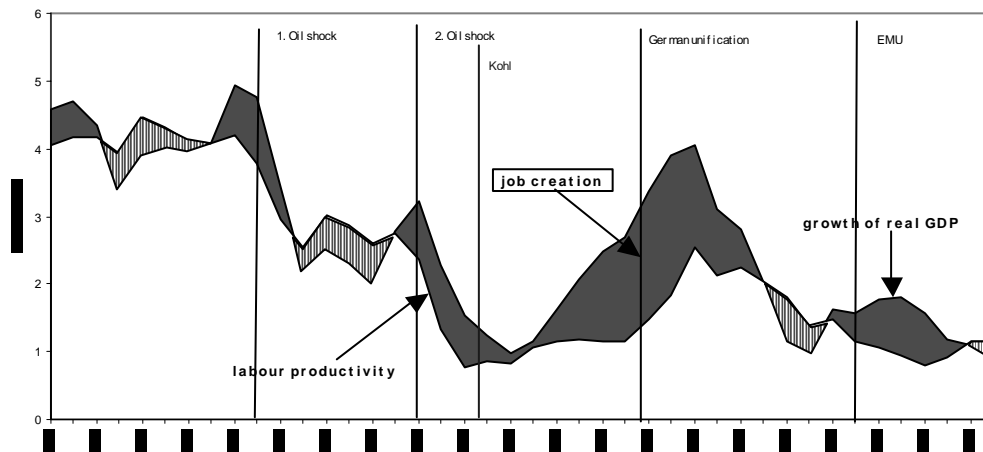


Figure 13b. Job creating growth in France
(5-year moving average)

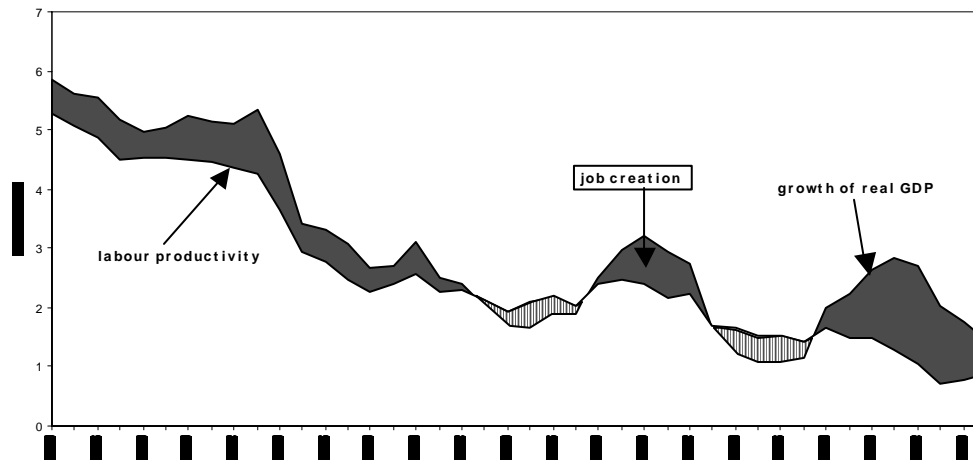
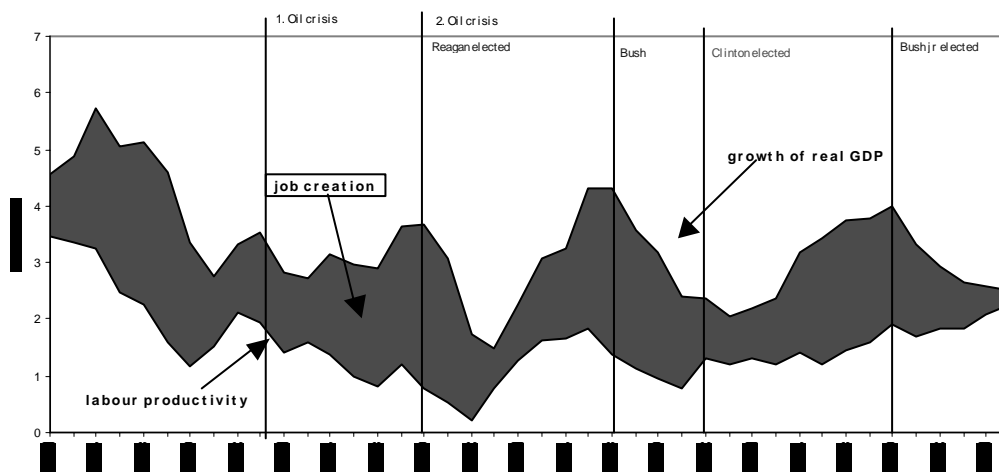


Figure 13c. Job creating growth in USA
(5-year moving average)



The labour market

One may argue that this job creation objective is more easily achieved if labour productivity is growing less strongly, a strategy sometimes called “lowering the employment threshold” of economic growth.¹² It is obvious that this threshold is determined by the growth of labour productivity and nothing else. However, productivity can be measured in different ways, such as output per worker, output per hour worked, output per hour paid and this yields different thresholds. Logeay (2001) has calculated a range between 1.1 and 2 percent for Germany in 1994-2001. Policies to lower the threshold have aimed at shifting output growth towards sectors with low

¹² In french: *enrichissement de la croissance en emploi.*

productivity, frequently by developing the service sector. They have also focused on the incentive structures for firms to employ low skilled labour. In France, this was achieved by changes in social security laws favouring part-time employment introduced in 1992, the reduction of social security charges on non-skilled labour in 1995, and the reduction of working time by the *lois* Robien (1996), Aubry I (1998) and Aubry II (2000). Reforms introduced by the Schröder government have also focused on facilitating part-time employment with reforms in 1999 and 2003 (BMGS, 2003) and the reduction of the relative cost of unskilled labour. For example, the eco-tax introduced in 1999 with estimated revenues of 57 billion euro was used to reduce employers' social contribution. In addition, measures to subsidise self-employment (*Ich-AG*) have reduced the employment threshold, too: in the first 12 months after its creation, 90,000 persons applied for *Ich-AG* status. Although many of these measures are a success in themselves, the general deterioration in the economic climate has reduced their effectiveness.

Today, the debate among economists goes even further, seeking to reduce not only unskilled wage costs, but even average wages. For example, Hans-Werner Sinn, president of the Ifo-Institute claims (2003:95): "Whoever is looking for work will find work, provided one allows the wage to fall far enough - for the more it falls, the more it will be attractive for employers to create jobs in order to exploit profitable opportunities." But this statement is misleading. First of all, whether there are profitable opportunities or not does not depend on nominal wage *levels*, but on the *relation* between nominal wages, productivity and prices. This relation is described by the simple identity :

$$(1) \Delta \text{ wage share} = \Delta \text{ nominal wages} - \Delta \text{ prices} - \Delta \text{ productivity.}$$

The inverse of the wage share is the share of capital income and presumably this is what investors seek to maximise¹³. But clearly, only if productivity and prices are assumed constant, will lower nominal wages translate into profitable opportunities. In this case, profit margins will increase and this may attract investment, thereby raising productivity, output and creating jobs. However, assuming prices stay constant (for which there is no guarantee), lowering nominal wages may lead to lower productivity,

¹³ I will question this below.

as is well known from the theory of adverse selection. This has been confirmed with respect to East German wages (Görzig et al, 2004). An INSEE study (2003) estimates that the slowdown in the growth of French labour productivity over the last decade can be attributed by a quarter to the reduction of working time, a quarter to lower social charges on low skilled labour and the rest is mainly due to structural changes in the production function. Under these circumstances unit labour costs do not necessarily fall with lower nominal wages. Therefore cutting wages by an average 10-15 percent, as Sinn (2003:95) proposes,¹⁴ could decrease the employment threshold by lowering productivity, but it does not assure higher employment, if there is no additional demand. Furthermore, lowering productivity implies lowering standards of living. This is hardly a strategy to improve the competitiveness of any country. A persistent slowdown in productivity would lead to a downgrade in the position of wealth, influence and the power of individuals and nations. It would make the consolidation of public deficits more difficult and prevent the financing of new collective goods and social challenges resulting from changing demography.

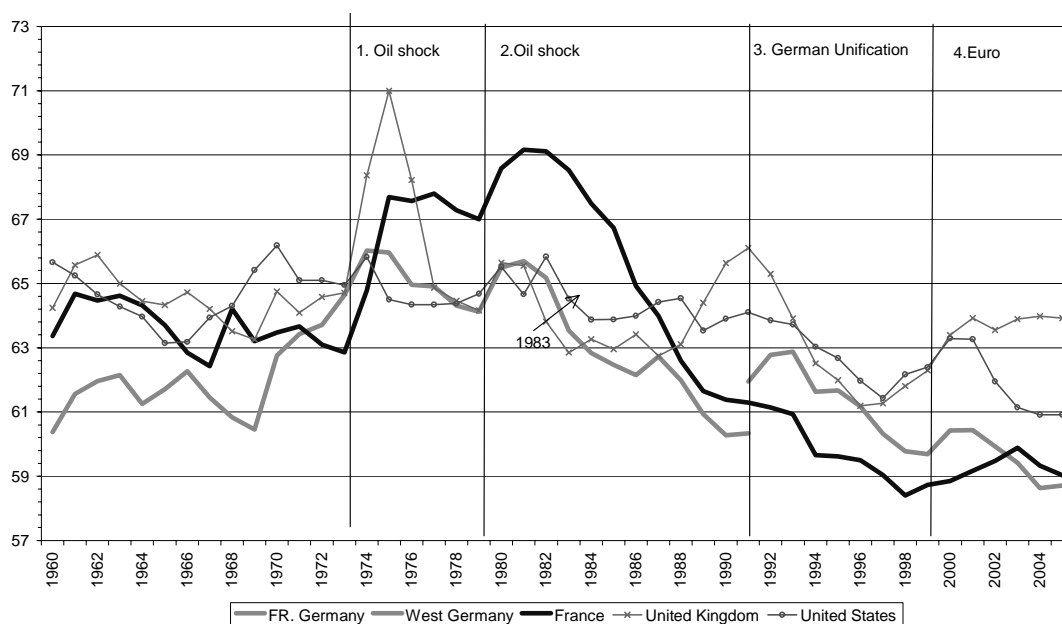
Sinn (2003:98) argues that Germany's problems are due to firms rationalizing production to compensate for excessive wage increases caused by Trade Union pressure. The validity of this argument hinges on the idea that nominal wage increases reduce profit margins and therefore push marginal firms into liquidation. "Insiders" benefit from higher wages, while "outsiders" remain unemployed. Here, the hidden assumption is that prices and aggregate demand is constant. Less workers produce the same output, but there is no additional demand to bring the unemployed back into employment. This assumption is also used by the political left, with trade unions seeking to re-distribute the fruits of technological progress by reduced working time.

However, these measures do not really bring down unemployment, although they may help to make it more acceptable. The only strategy to reduce unemployment is the creation of new jobs and this requires higher profits as an incentive for firms to invest. What matters for profit margins is the relation between prices (average income per unit of output) and costs per unit of output. If unit labour costs increase less than prices, the share of capital income will increase. A common approach, which I will

¹⁴ For unskilled labour, he even recommends a reduction by 30 percent.

question below, is to interpret the aggregate profit margin as the inverse of the wage share. Thus, by demanding that wage increases should remain 1 percentage point behind productivity, Sinn (2003:118) recommends de facto a deflation of unit labour costs by 1 percent. When at the same time inflation increases by 2 percent, profit margin would grow and the wage share would fall by 3 percent. Whether this happens or not is, however, a question of monetary policy and not of excessive trade union power. For it is generally accepted amongst economists, that it is the central bank's task to look after inflation and maintain price stability. In fact, we observe that despite the alleged Trade Union stranglehold, the wage share in Germany and France has fallen for nearly two decades (Figure 14a). In France, it fell consistently from the Mitterrand policy turnaround in 1983 until the advent of the EMU. Germany's development was less uniform, the most dramatic change being caused by the shock of unification, when acquiring non-performing assets in East Germany pushed labour productivity down and unit labour cost up. One may argue that this was due to rigid Trade Union power, but the same phenomenon would have occurred with a perfectly flexible labour market where labour mobility ensures a uniform market wage in nominal terms, while productivity levels vary between East and West. To be fair, we do observe a small increase in the wage share after unification and in the boom of 2000. But if Sinn were right, we would expect a lasting increase in the wage share due to nominal wage increases in excess of productivity plus inflation. But this is not what happened. Sinn's policy recommendation neglects price and productivity developments.

Figure 14a. Wage shares



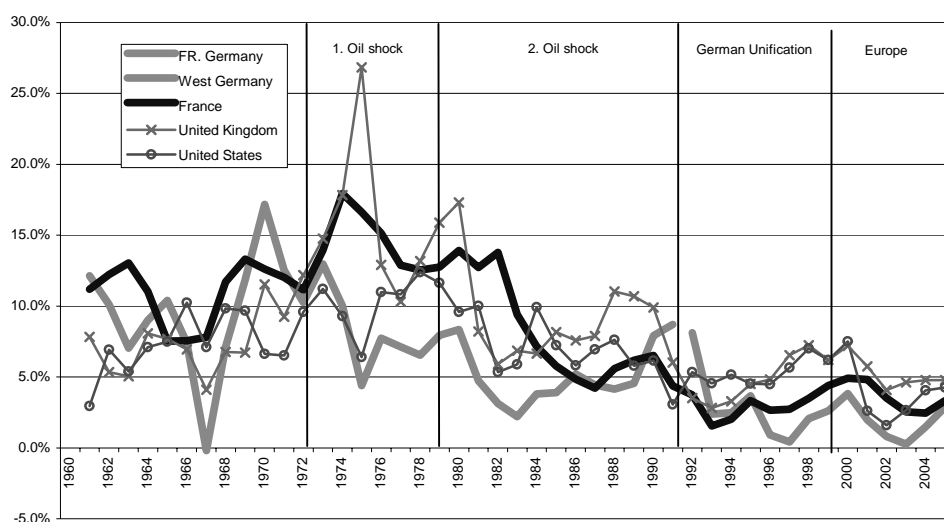
In fact wage moderation has been an essential factor in first bringing down inflation in France and Germany and in keeping price stability now in Euroland. Figure 14a reveals, that nominal wages responded in all major economies to monetarist anti-inflation policies and record high interest rates in the early 1980s. Only in France was this development delayed by Mitterrand's initial left wing Keynesianism. But after the 1983 decision to stay in the European Monetary System, and the new income policies put together by finance minister Jaques Delors, wage moderation has become an enduring feature in France; for nearly two decades, nominal wage increases have now remained behind Germany. Interestingly, the Anglo-Saxon model, characterised by greater flexibility in the labour market, has consistently produced higher wage increases. Thus the charge, so forcefully raised by Sinn, that Germany's economy is "in the stranglehold of monopolistic Trade Unions" seems somewhat excessive.

More important might be the development of real wages. Here we find indeed a more volatile performance in the Anglo-Saxon economy and more stability in France and Germany. While real wages increased faster in France than in Germany during the 1970s and 80s, when labour productivity also grew at a faster rate, the two countries have converged in the 1990s. Since the start of EMU German real wages have stagnated or fallen, with the exception of the boom in 2000, while they slowed down markedly in France. The main reason for this significant wage moderation is

mounting unemployment, particularly in France (Desplatz et al., 2003). But wage-disindexation and active labour market policies like the reduction of working time have also played an important role.

Neoliberal economists, like Sinn, claim that unemployment is high because wage rigidity, caused by excessive social protection, prevents the labour market to adjust to equilibrium and they propagate economic reforms that put into question the historically grown institutions of the welfare state and social market economy. There are many ways to measure labour market rigidity. As a simple indicator, Table 1 gives the standard deviation of nominal and real wage growth. The difference between the Rhenish and the Anglo-Saxon model is less the rigidity in nominal wages, which are

Figure 14b. Nominal wage increases



subject to wage bargaining and related institutions, but the real wage. Here, flexibility is generally higher in the US and the UK, although this was not the case in the 1960s. Thus, the flexibility in real wages must be explained by the higher volatility of inflation in the UK and the USA. Over a 45 years period, the standard deviation of inflation has been twice as high in the UK as in Germany and France and even three times higher in the US. In particular since the European Central Bank has become responsible for price stability, inflation has been low and steady. We must conclude that the real wage flexibility is to a large degree determined by monetary policy and less by labour market institutions.

Table 1. Labour market flexibility**Nominal wage flexibility**

	Germany	France	UK	USA
1961-2005	0.037	0.047	0.046	0.027
1960s	0.045	0.023	0.021	0.022
1970s	0.027	0.021	0.050	0.020
1980s	0.015	0.033	0.017	0.017
1990s	0.022	0.011	0.016	0.013
EMU	0.012	0.010	0.011	0.021

Real wage flexibility

	Germany	France	UK	USA
1961-2005	0.038	0.036	0.060	0.092
1960s	0.027	0.033	0.034	0.018
1970s	0.031	0.036	0.074	0.073
1980s	0.036	0.029	0.072	0.159
1990s	0.029	0.023	0.057	0.071
EMU	0.017	0.012	0.044	0.087

Price volatility

	Germany	France	UK	USA
1961-2005	0.037	0.036	0.069	0.095
1960s	0.037	0.025	0.037	0.024
1970s	0.035	0.041	0.082	0.066
1980s	0.028	0.021	0.075	0.166
1990s	0.033	0.017	0.068	0.074
EMU	0.006	0.003	0.050	0.101

The capital market

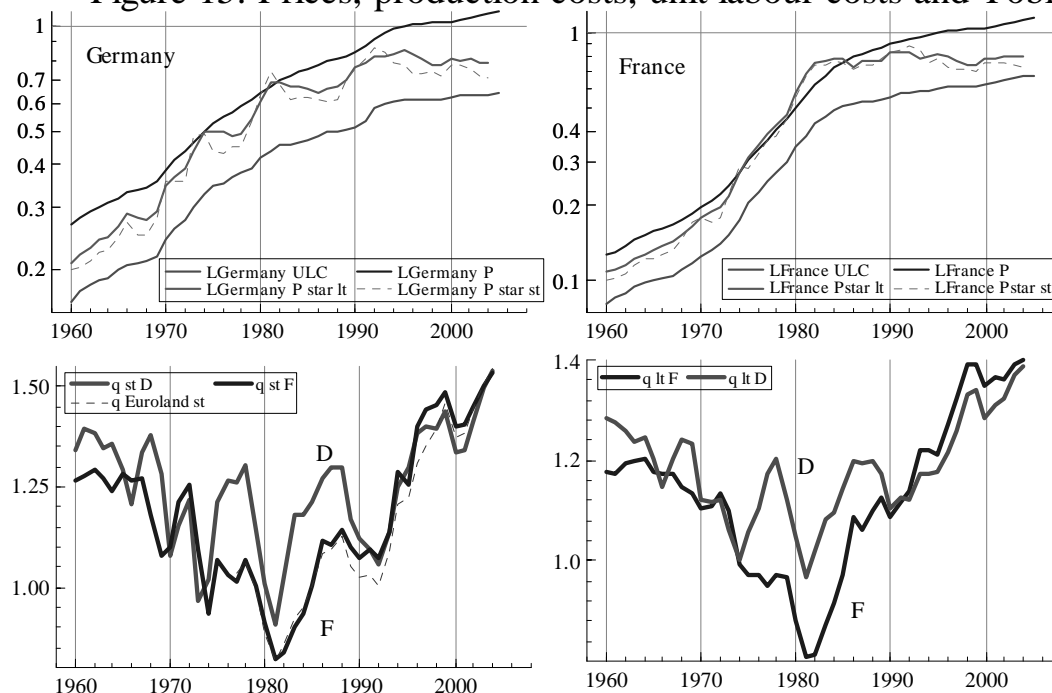
A rising capital share may be a necessary, but it is not a sufficient condition for economic growth and higher employment (See also Blanchard, 2000). What matters from a firm's point of view is not only the cash flow, but ultimately profits to shareholders who invest in risky ventures. From a macroeconomic perspective this is reflected in what Keynes called *entrepreneurial profits*, that is the excess of income over the cost of labour plus capital. This concept can be translated into Tobin's investment function, which made the rate of investment dependant on the ratio of a firm's market value to it's cost of reproduction. There are several forms of calculating and expressing this ratio of "Tobin's q", but a simple way is comparing the aggregate price level to the cost price, which covers unit labour costs and capital costs per unit of output (Collignon, 1997).

The concept of Tobin's q reformulated in this way is interesting because it correctly assigns responsibilities to economic agents: workers earn wages to live, capitalists earn interest to cover risk, and entrepreneurs earn (pure) profits for innovation. Thus, the rate of interest allocates the operating income (the capital share) to entrepreneurs and capitalists. Investment, economic growth and employment are dependent on entrepreneurial profits not just the capital share. It is not the labour market that determines employment, but the capital market.¹⁵ Figure 15 gives a picture of the evolution¹⁶. Unit labour costs and the aggregate price level increased rapidly after the first oil shock and flattened in the disinflating 1980s. Fighting inflation was primarily achieved by high interest rates and this meant high cost of capital. It is possible that the exact level of the cost price relative to the price level has some data imprecision in the early years, but the main feature is clear: in Germany and France q -profits were low and falling in most of the 1970s. During this period both Germany and France's investment shares in GDP fell from just under 30 percent to 20 percent. Profits and investment recuperated subsequently, but the high interest period after German unification eroded profitable investment opportunities again. It is only since the beginning of EMU that Tobin's q has reached levels comparable or slightly higher than in the Golden Age of the 1960s and France and Germany have today nearly identical values. If, however, investment has not yet reached the levels of the 1960s, it is partly, as we will see, because profitability of investment is often higher in other parts of Europe and the world. We must therefore conclude that the slow economic growth and the low investment ratios observed in France and Germany are to a large degree dependent by macroeconomic policies. These are crucially determined by monetary policy, which I will discuss in the second part of this paper, but first we need to look at the role of the public sector, as it is often blamed for burdening the private sector and irresponsible fiscal policies.

¹⁵ After all, we live in capitalism, not in labourism. The allocation function of the labour market consists simply in finding relative prices for different kinds of labour.

¹⁶ ULC stands for unit labour costs, P for the price level, measured by GDP-deflator, P^* It is the sum of ULC and unit capital costs calculated with long term interest rates, and P^*_{st} is the equivalent measured with short term interest rate. q_{st} is Tobin's q for calculated with short term interest rates, q It with long term government bond rates.

Figure 15. Prices, production costs, unit labour costs and Tobin's



The democratic state and the public sector

A common caricature paints France as the country where the Colbertiste dirigiste state reigns as a Leviathan, while the German social market economy combines market efficiency with a strong regulatory state. This picture has been somewhat challenged by the recent fad for Anglo-Saxon neoliberalism, but it is important to understand how different societies articulate collective interests. In the French republican tradition, *la volonté générale* is the expression of free and equal citizens, understood as individuals engaged in the democratic management of public affairs. Their political equality, reflected in universal suffrage, legitimises therefore state intervention into the economy and the overriding of economic freedom. Liberalism as an economic ideology has therefore always remained subordinate to the political "*liberté républicaine*". An important side-effect of this concept was the elimination of intermediate institutions in the state and society (Rosanvallon, 2004) and therefore the strong dominance of a unitary state.

In Germany, the emergence of a modern, democratic state is more recent (Kvistad, 1999). The German concept of the state is both holistic in the sense of Popper

(1995)¹⁷ and communitarian in the sense that belonging to a cultural/regional or group identity dominates individualism. This political ideology is therefore better articulated through intermediate institutions, such as the federalist structure of the state or corporatist interest organisations in the economy. The democratisation of these institutions only took root in German society after the war, when Erhard's social market economy promoted consumerism ("*Wohlstand für Alle*") as a form of economic individualism and political and cultural individualism only emerged in German society during the late 1950s and the 1960s (Poiger, 1996; Kvistad, 1999).

These ideological orientations in France are distinguished from the new market ideologies, which took hold in the UK and the US in the 1980s. Neoliberalism was the attempt to roll back the state and re-dynamise the economy by liberating market forces. However, reducing the public sector also required invalidating the legitimacy of its activity. As a consequence, neoliberalism undermines the democratic dimension of the modern state. Yet at the same time, privatising the public creates externalities, which need to be internalised by collective rules and institutions. But as the state was discredited, the fall back position was the community: collective interests are now legitimately articulated by local private associations, NGO's, or cultural and religious groups and communities and less by the democratic choice of free and equal citizens. This development is particularly apparent in the USA. In Europe it manifests itself in the resurgence of nationalism, for which British Europhobia is the most flagrant sign. Hence, the unintended consequence of neoliberalism as a dominant political ideology is the sharpening of communitarian and nationalist conflict and the hollowing out of democracy. Both are a threat to European integration (Collignon, 2004a).

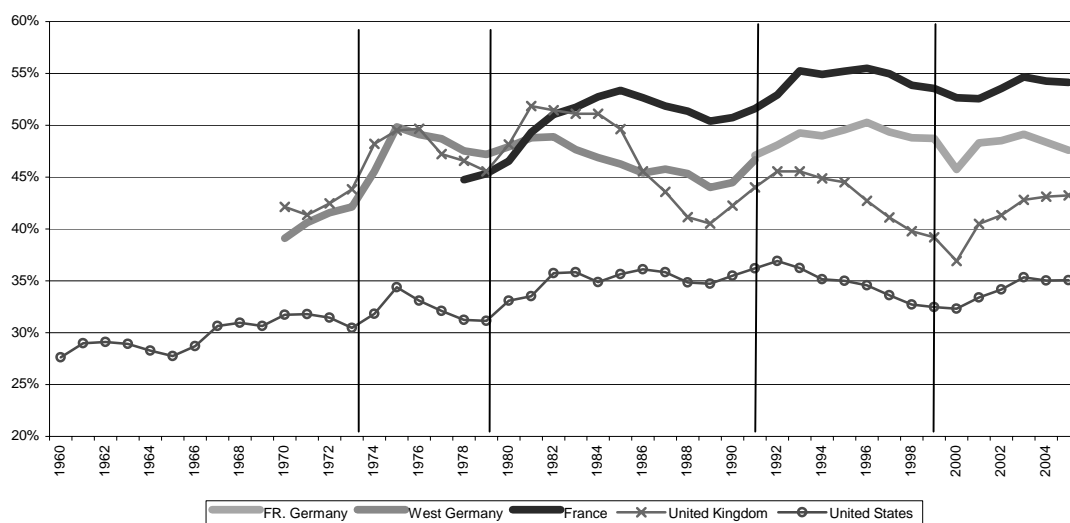
The public sector

French and German societies have resisted the dominance of neoliberalism, although this resistance is weakening given the persistent sense of economic stagnation and the ideological dominance of neoliberal media. But is the public sector really the obstacle for renewed investment and economic growth? Figure 16 shows the evolution of the share of total government expenditure in GDP. The low share in the US economy is

¹⁷ Popper (1995:100) defines holism as the norm "that the individual should subserve the interests of the whole, whether this be the universe, the city, the tribe, the race or any other collective body" he quotes Plato: "The part exists for the sake of the whole, but the whole does not exist for the sake of the part... You are created for the sake of the whole and not the whole for the sake of you."

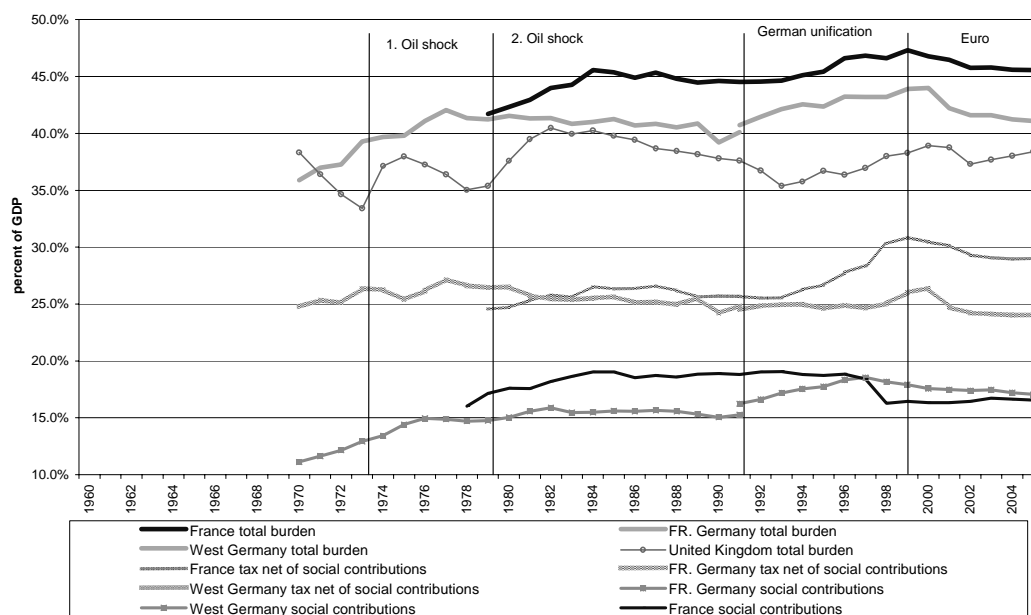
coherent with the neoliberal model, although the government ratio increased in the Republican years of Reagan and Bush Sr. and Jr from 31 up to 37 percent, while it shrank under the Clinton presidency. The “Thatcher revolution” is more of a role model. After the initial recession in the early 1980s had been overcome, Thatcher’s reforms reduced the government share from 52 to 40 percent. The increase in the early 1990s reflects partly the recession during years of ERM-membership. Only under the second term of New Labour does government expenditure grow again.

Figure 16. Public sector expenditure



In Germany we notice the strong expansion during the early years of the social democratic Brandt/Schmidt governments, but after the two oil shocks, and a widening budget deficit, the growth of the public sector is kept in line with economic growth. During the first two Kohl governments’ the focus is on deficit consolidation and a modest roll-back of the state took place. But with German unification, government expenditure reached it’s highest level ever. Not surprisingly, the consolidation of public finances became a priority after 1996, when the debt/GDP ratio approached the 60 per cent Maastricht limit (see Figure 4) and government expenditure was now kept constant, so that its relative share fell with GDP-growth. Schröder’s was the first and only government that ever cut expenditure in absolute terms in 2000. In France, public sector expansion coincided with the development of a modern welfare state in the early Mitterrand years, but expenditure progressed in line with GDP growth in the late 1980s. Its real growth increased from 2½ to 5 percent during the Jospin government and slowed down thereafter. Its relative share in GDP increased with the strong recession of the mid-1990s and this increase was largely financed by the deficit.

Figure 17. Tax burden
including imputed social security contributions



While expenditure is subject to some discretion by governments, and the variation of the public sector share is affected by economic growth, the tax burden (including social charges) is a better indicator for collective preferences for public goods. Figure 17 shows that these preferences have been relatively stable in Germany from the late 1970s to unification. But subsequently, the cost of redeveloping the East has pushed the German tax burden to historic heights and they are only brought under control by the reforms of the Schröder government. In France, the tax burden has been higher than in Germany for a quarter of a century and changing political majorities do not seem to affect this preference for public services significantly. In fact, as in Germany, it is the pressure of conforming to the standards of European fiscal policy that seems to have become more binding with the advent of the EMU: the tax burden increased when the debt ratio approached 60 percent.

In the UK, on the other side, two important breaking points stick out: Thatcher's tax reform in the early 1980s (higher VAT, lower income tax) has pushed tax revenue up, and the subsequent reduction in the share of public expenditure allowed the gradual lowering of the tax burden mainly by cutting income tax. In that respect, the Thatcher reforms are fundamentally different from Schröder's government, which has lowered taxes in the hope that this would stimulate output and future tax income, while France has done neither. Furthermore, despite the fact that British fiscal policy has remained

unconstrained during the severe recession in the early 1990s, a record deficit of 8 percent of GDP in 1993 necessitated tax increases to support fiscal consolidation. When economic growth returned, this produced a record budget surplus of 4 percent, allowing another tax cut in 2000.

The general picture that emerges from these data is indeed the relative stability of the public sector in France and Germany and the shrinking of government in the UK, although not in the US. Nevertheless, in the late 1990s, the role of government was reduced in all four countries in absolute and relative terms, even if only to a small degree. The question is: has the development of the public sector in France and Germany inhibited private capital accumulation, as neoliberals claim?

The evidence is mixed. The public sector does not appear to have crowded out private income, investment and dampened growth in France, where both the tax burden and the investment ratio rose together in the late 1990s and also fell together after 2001. But in Germany the argument is stronger. While the tax burden has risen by 4-5 points since unification, the investment share has fallen by a similar amount. Gross transfers from West to East have amounted to approximately 5 percent of GDP, amounting to 1250 billion euros for the 1991-2003 period.¹⁸ Thus, part of the slowdown of the German economy must be explained by a rising tax burden that is a result of unification.

Figure 17 also reveals that an important part of the tax burden is due to social contributions. It is apparent from Table 2 that France and Germany are both conservative welfare states, which finance social protection not by universal taxes but by status related contributions. Germany and France have the highest share in social contributions, although the total tax burden is much higher in Scandinavia.

¹⁸ Source: Der Spiegel, 15/2004

Table 2. Tax burden in percent of GDP: 2004

Country	Social contributions	rank	Taxes	rank	Total tax burden	rank
FR. Germany	17.2%	1	24.0%	16	41.2%	10
France	16.6%	2	29.0%	9	45.6%	5
Euro area	14.9%	3	26.9%	11	41.8%	7
Netherlands	14.7%	4	25.9%	12	40.6%	12
Sweden	14.7%	5	37.9%	2	52.5%	1
Austria	14.6%	6	31.4%	5	46.0%	4
Belgium	14.4%	7	33.4%	3	47.8%	3
EU-15	13.4%	8	28.3%	10	41.6%	9
Spain	12.9%	9	23.8%	17	36.7%	15
Italy	12.4%	10	29.3%	7	41.8%	8
Finland	12.3%	11	32.2%	4	44.5%	6
Portugal	11.8%	12	24.5%	15	36.3%	16
Luxembourg	11.6%	13	29.1%	8	40.7%	11
Greece	11.5%	14	25.4%	14	37.0%	14
United Kingdom	7.6%	15	30.4%	6	38.0%	13
Ireland	4.6%	16	25.8%	13	30.4%	17
Denmark	1.7%	17	47.6%	1	49.3%	2

In Germany, social contributions have risen rapidly after 1991. They were the “petit cash” (*Portokasse*) from which Helmut Kohl had promised to finance unification. It is commonly understood that this method of financing has distortionary effects by creating a wedge between labour costs and income and thereby contribute to unemployment. This issue was tackled more aggressively in France when the Juppé government imposed highly controversial reforms in 1995/6 that translated into a significant drop of social contributions but were refinanced by taxes. The irony is that it was a conservative government that moved France closer to the Scandinavian social democratic model.

Public investment

Another dimension is public investment. While gross fixed capital formation in percent of GDP has fallen in the private and public sectors, the relative importance of the public sector in the total capital stock has continuously fallen in Germany since the first oil shock from 4.4 to 2.5 percent in 1991, and German unification has even accelerated this trend. Today public investment is only 1.4 percent of GDP in Germany, against a stable share of 3 percent in France, 2.8 in the US. In the UK the share is up at 2.8 after its all time low at 1.1 percent in 1999. Thus, it is not true that the pressure from fiscal policy rules under the Stability and Growth Pact have imposed a “neoliberal” policy regime on France and Germany. In fact the distribution

of investment between the private and the public sector seems to follow an alternative logic to ideology: the share of public investment in the build up of the nation's capital stock is similar to France's in the USA and close to Germany in the UK.

In sum, it would appear that the claim of an excessive public sector, which is slowing down investment and growth, is overrated. Public investment can contribute to higher productivity and increased welfare and this is lacking, particularly in Germany. But public expenditure needs to be financed in a broad and egalitarian manner, which avoids distortions and gives the wrong incentives. This is clearly where the conservative social model in Germany and France is failing. France seems to have made slightly more progress than Germany, but as the economic results show, a lot more needs to be done.

Learning to live in Euroland

Our analysis has shown that France and Germany have converged in their economic performance over the last decades and tended to adopt similar financial and with the euro even shared monetary institutions. On the supply side, these two economies resemble more to each other than, say, to the USA or UK. This may partly explain, why France and Germany were able to adopt the same currency, while this seems so difficult for the UK. However, economic policy operates under a radically changed framework in the EMU. By focusing on price stability, the European Central Bank sets the overall budget constraint for Euroland and individual firms and jurisdictions must compete for funds and revenue within the given parameters. I will now focus on the adjustment of the French and German economies to this new world, then on issues of macro-economic management and will conclude with some broader political considerations.

Adjusting to EMU

A monetary union is defined by equal and unrestricted access to liquidity, which is supplied by the central bank at an interest rate of its choosing. Thus, the cost of capital

is essentially the same across countries (abstracting from borrower risk). Monetary policy will affect q -profits for the whole of Euroland, but the distribution of entrepreneurial profits will depend on relative profit margins, i.e. relative prices and unit labour costs. It has often been asserted that forming a monetary union abolishes monetary policy as an adjustment tool and should only be acceptable when product and labour market flexibility is sufficient to allow the elimination of distortions and the adjustment after shocks. Even if it is doubtful that the exchange rate can serve as an adjustment tool other than in the very short term (Collignon, 2002), the capability to adjust is crucial in any economy. We will therefore now analyse this flexibility.

Relative price and cost adjustments

A unified interest rate implies equal cost of capital and therefore the disappearance of distortions, which previously prevailed in the European single market. In the old days, firms and borrowers outside the core countries with low interest rates, like Germany, the Netherlands and Austria, but also to some degree, France, had to put up with higher interest rates and therefore lower investment. This created a comparative advantage for firms in countries with high price stability and low interest rates. But once EMU was seen as a credible project, interest rates converged to German standards and their advantage disappeared. The previous high interest regions in Euroland became more attractive for investment and the location of production. Hence, in order to remain competitive, regions with a disappearing capital cost advantage had to compensate by creating a labour cost advantage. This required adjustment in the labour market. It has often been questioned whether Germany, and to a lesser degree, France were sufficiently flexible to adjust to the new environment, so let us look at the facts.

While in many other countries, entrepreneurial profits increased to the detriment of rentiers, this was less the case in those countries, which used to follow German monetary policies most closely in the past. Table 3 gives the increase in Tobin's q from 1996, when EMU became a realistic option, to 2001, a neutral year after the boom and before the crash. Tobin's q actually fell in the countries of the former hard Deutschmark bloc, stagnated in France, but increased by 7.2 percent in Euroland as a whole.

Table 3. Change in Tobin's q : 1996-2001

		rank
Netherlands	-6.4%	1
Belgium	-4.7%	2
Germany	-4.0%	3
Austria	-2.5%	4
France	0.2%	5
Finland	3.1%	6
Luxembourg	5.7%	7
Euro area	7.2%	8
Portugal	10.1%	9
Spain	17.7%	10
Ireland	21.7%	11
Italy	27.7%	12
Greece	49.7%	13

The striking feature is indeed the deterioration of Tobin's q in the countries closest to the old Deutschmark-bloc and the dramatic increase in the South-European countries with previously high interest rates.

A closer look at the change over time reveals that Germany had a significantly higher q before 1998 that fell below Euroland's aggregate q afterwards (see Figure 15). However, Germany has made efforts since 1999 to improve the situation and is now again catching up with the average Euro- q . On the other hand, France, which used to have a higher q than Euroland in the 1990s, has gradually lost this advantage and has now fallen slightly below the average. It is of interest too, that since 1999 there has been convergence of national profitability to the Euroland average among all countries of EMU. The standard deviation of Tobin's q in the Euro-area was close to 0.190 between 1996-1999, but after the ECB took over it fell to 0.104 in 2003. It can also be shown that economic growth was positively correlated with the relative improvement in profitability, even if there were some country specific differences (the correlation coefficient between the change in Tobin's q and GDP-growth is +0.48). Hence, overcoming stagnation in Germany and France requires a relative improvement in the profitability relative to other countries in Euroland. Obviously this adjustment is not related to the ECB's policy, because interest rates are identical for all operators in EMU. Increasing or cutting interest rates will stimulate or paralyse the Euro-zone as a whole. It is, of course, possible that some capital-intensive sectors, like manufacturing industry, may respond more strongly to interest variations. But in essence, monetary policy is a macro-instrument unsuitable for relative adjustment.

Competitiveness in Euroland

In the old days of the European monetary system and before unification, Germany's competitiveness was largely determined by lower inflation relative to other countries. With fixed exchange rates within the block, real exchange rates depreciated and Germany realised substantial trade surpluses in Europe. At the same time, the DM-dollar exchange rate appreciated and trade was more balanced. In 1989, Germany's trade surplus with EU-member states was over 5 per cent of GDP, but with the rest of the world only 0.8 percent. After unification, this imbalance was reduced. With the introduction of the Euro, the logic has changed. External price competitiveness depends now on the exchange rate of the euro, which is the same for all companies in Euroland. Within Euroland, it is a matter of relative prices. After introducing the euro, inflation has come under the control of the European Central Bank and is calculated for policy purposes for Euroland as a whole. Only small deviations of relative prices for product groups and regions (countries) are possible. These deviations reflect differences in taste and preferences, as well as differences in costs for non-tradable goods and inputs, of which labour is the most important on an aggregate level but they are not policy induced. While the cost of capital is essentially the same for every company operating in the same monetary area, an improvement in relative profitability can therefore only be achieved by two mechanisms: an adjustment in relative unit labour costs, or in prices.

Figure 19. Evolution of relative ULC levels in EMU

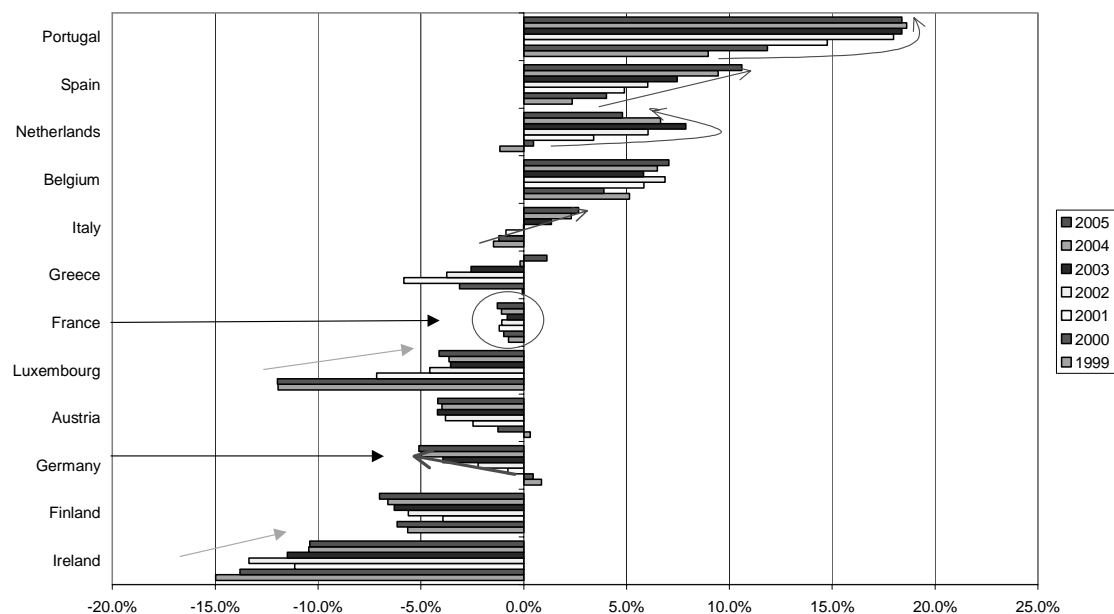


Figure 19 shows the evolution of relative unit labour cost *levels* in Euroland (as the deviation from average). We find significant country variations. While Portugal, Italy, Spain and Belgium have a clear competitive disadvantage, Ireland and Finland are attractive labour locations with low average labour costs. France and Germany are close to, but slightly below average. But while unit labour costs have kept a stable position in France, Germany has gained competitive advantage by keeping nominal wage increases behind productivity advances, as discussed above. Thus, the behaviour of wage moderation by German Trade Unions has supported the adjustment to the new environment of EMU, rather than “strangling the economy”.

But if Germany’s competitive cost position is improving, why is it not translating into higher growth and more jobs? The answer is that it actually does. Since 1999, Germany’s export share has increased from 25.7 percent of GDP to 32 percent in 2004 and its trade balance from 3.3 to 6.5 percent. However, the improvement is now more balanced between intra and extra European trade, which is what we would expect as a result of the weak euro and relative price adjustment within the Union. Yet, economic growth and employment are still disappointing. The reason must be that profits are too low, particularly in the domestic non-tradables sector. Without the improvements in the tradables sector, Germany’s situation would be even worse.

Given that the cost of capital are fixed by interest rates, entrepreneurial profits depend on operating profit, i.e. on the difference between prices and unit labour costs.

Table 4. Changes in Profitability: Euroland 1999-2004
(average changes per annum)

	Prices	<i>relative to €</i>	ULCs	<i>relative to €</i>	Margins relative to €	
EU-15	1.8%	0.0%	1.8%	0.2%	0.0%	-0.1%
Euro area	1.8%	0.0%	1.6%	0.0%	0.1%	0.0%
Greece	2.4%	0.7%	1.5%	0.0%	0.9%	0.7%
Ireland	3.2%	1.5%	2.4%	0.9%	0.8%	0.6%
Spain	3.3%	1.6%	2.7%	1.1%	0.6%	0.4%
Austria	1.2%	-0.5%	0.8%	-0.7%	0.4%	0.2%
Germany	0.9%	-0.8%	0.6%	-1.0%	0.3%	0.2%
Finland	1.5%	-0.2%	1.4%	-0.2%	0.1%	-0.1%
Portugal	3.1%	1.4%	3.0%	1.4%	0.0%	-0.1%
Italy	2.2%	0.5%	2.2%	0.6%	0.0%	-0.2%
Netherlands	2.8%	1.1%	2.9%	1.3%	0.0%	-0.2%
France	1.3%	-0.4%	1.5%	-0.1%	-0.2%	-0.3%
Belgium	1.2%	-0.5%	1.8%	0.2%	-0.6%	-0.7%
Luxembourg	1.9%	0.2%	3.1%	1.5%	-1.2%	-1.3%

Table 4 shows that average profit margins in Euroland have hardly changed in the first 6 years of the EMU. They have increased by one per mille per annum, because unit labour costs have grown slightly less than prices. But the relative position of individual countries has changed. Greece, Ireland and Spain, all fast growing countries in the Eurozone, have improved profitability relative to the average, mainly because they have been able to increase relative prices. By contrast, Austria and Germany moved marginally ahead by lowering unit labour costs more than prices relative to the average. By contrast, in France and Finland profit margins deteriorated because prices were more depressed than unit labour costs. In the Netherlands and Luxemburg profits fell because wages increased faster than prices, and in Belgium profit margins were diminished because prices fell and labour costs increased.

The return on capital

These changes in profitability show that the adjustment process in Euroland is working well, although in a more complex fashion than simple theories would expect. However, in order to understand the dynamics of investment and growth, profit margins and their distribution between rentiers and entrepreneurs are not enough. We need to compare the gross return on capital, which we may define as the share of

capital income (the inverse of the wage share) multiplied by average capital productivity (output per capital). For even if Tobin's q may be higher in France and Germany than in previous decades, the return on capital may still be higher elsewhere. With unrestricted capital markets investment may then still flow into countries where the return is highest, and domestic investment remains low.

Figure 20. Gross Return on Capital

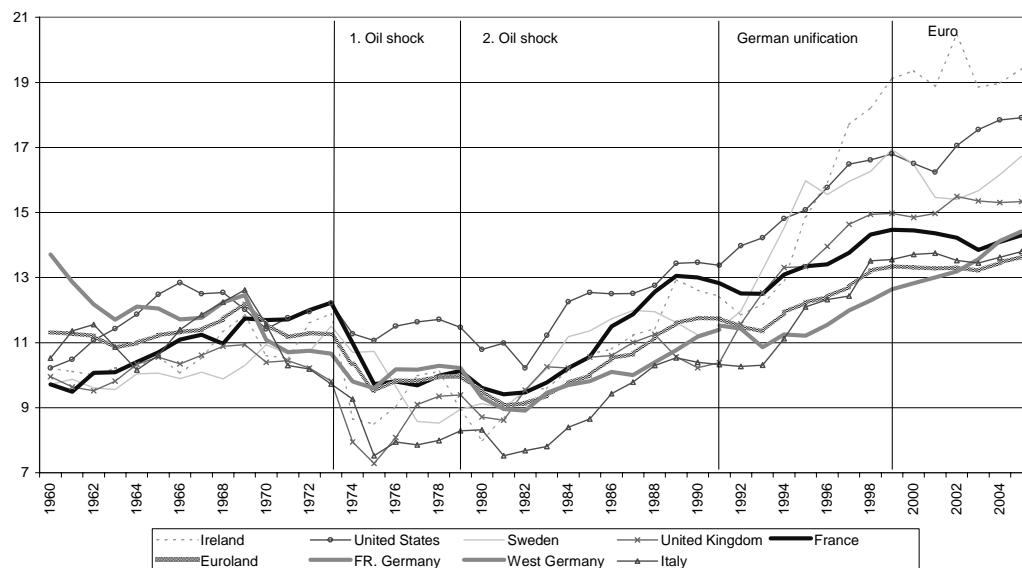


Figure 20 shows the evolution of the aggregate return on capital in some selected countries. The negative consequences of the two oil shocks are clear. By the mid-1980s, the gross return on capital improved across Europe, although the economic crisis caused by German unification and the subsequent monetary turbulences interrupted this trend. In Euroland the gross return on capital has been stagnating, although the Commission forecast for 2005 expects an improvement. Whether the stagnation of rates of return since the beginning 21st century reflects the slowdown after the 9/11 shock or a more fundamental structural change is uncertain.

Germany's main problem since the mid 1980s has been that the return on its capital stock has been below the returns achievable in other countries. Nevertheless, it is remarkable how returns on capital have continuously improved since 1995. This process continues unabatedly from the Kohl into the Schröder years. Given that it can only partially be explained by better profit margins (namely from 1993 to 1998 and not thereafter – see Figure 14), this must be due to improvements in the productivity

of the capital stock. Because new investment is weak, the adjustment takes the form of eliminating and liquidating less profitable productive capacity in a demand constrained economy. The picture that emerges here is that Germany is improving its competitiveness although with great pain and adjusting to the new economic environment in monetary union on the background of heavy burden acquired by unification, although with great pain.

This cannot be said of France. The profitability of the French capital stock has deteriorated as a consequence of the *35 heures*, the resulting lower productivity per employee and the rising wage share. Today both French and German capital stocks have the same return on average. Yet, both countries now achieve a higher return to capital than Euroland as a whole. But this profitability does not translate into productive investment and the expansion of capacity because both countries also share weak aggregate demand that depresses local prices. In both Germany and France, Tobin's q is slightly below Euroland as we saw before. The higher return on capital therefore benefits financial investment and not job creation. As Germany is now painfully discovering, reducing labour costs is not leading to higher investment because prices are falling even faster. Both countries together represent 50 percent of the Euro-economy. Therefore a beggar-your-neighbourhood strategy, which can be successful for small countries, does not work for *Franceallemagne*. The stimulus for economic growth has to come from a better policy mix for the Euro area as a whole.

The role of France and Germany for Europe's Policy mix

Given the weight of France and Germany in Euroland's GDP, the scope of relative adjustment with respect to the Euro average is necessarily limited for these two economies. While small countries must consider European competition as an exogenous constraint to which they can adapt, a reduction in the unit labour costs (ULC) of large countries implies a simultaneous lowering of the average unit labour cost for Euroland. Although this fact may push other countries above the average and therefore improve the relative competitiveness of the large country, the lower average unit labour costs have macroeconomic externalities: if the central bank kept interest rates unchanged, the aggregate price level (or inflation) would fall with average ULC as the cost of capital remain unchanged. But because wage bargainers take Euroland

inflation into account when setting nominal wages, the relative wage adjustment in large countries will lead to a general reduction in wage and price inflation. As a consequence, large countries will find it more difficult to improve profit margins by labour market adjustments than small countries.

In other words, small countries can improve profits and competition directly by wage adjustments while the profitability of investment in large countries is more dependent on macroeconomic policy. In fact, if average unit labour costs fall relative to the inflation target of the ECB, the central bank should lower interest rates in order to maintain price stability. This would increase Tobin's q for the whole Euro zone and push market prices above their now reduced cost-covering levels, leading to higher demand, investment and employment. In this case, the large country would benefit from the monetary policy stimulus as a result of relative price adjustments. But if the central bank fails to reduce interest rates, because for example lax fiscal policies require an increase in the equilibrium interest rate, then relative wage adjustments will not improve a large country's growth perspectives. Thus, wage adjustments in large countries require a supportive macroeconomic framework, while wage adjustments in small countries have little consequence for macroeconomic stability in Euroland. Re-igniting economic growth in France and Germany is therefore not only a question of labour market flexibility. It depends on designing a policy mix that stimulates investment and profitability generally without causing inflation.

Defining the policy mix

When discussing macroeconomic policy, we must distinguish between an efficient policy mix and an optimal policy mix. The *efficient* interaction between fiscal and monetary policy is defined by effective demand being equal to potential output, i.e. by the economy being in "full employment" without inflation. This macroeconomic equilibrium implies that many combinations of fiscal and monetary policy mixes are efficient. If budget deficits are high, equilibrium interest rates have to be high as well in order to restrain demand. And inversely, if the budget position is in balance or surplus, the equilibrium interest rate should be low (Collignon, 2003). Which particular combination between different efficient policy mixes is chosen is a matter of collective preferences, but if monetary and fiscal policy together are either too restrictive or too lax, the mix is *inefficient*, as it will cause unemployment or inflation.

An *optimal* policy mix maximises the collective utilities, given the constraint of the efficient combinations of monetary and fiscal policy. The collective preferences may change over time. For example, the then French finance minister Strauss-Kahn referred to the combination of high interest rates and high deficits in the US economy of the 1980s as the “Reagan-Volker policy mix”, while the combination of low interest rates and budget surpluses in the 1990s corresponded to the “Clinton-Greenspan policy mix”. In the United States these particular realisations were the result of collective choices made through the democratic process. Given that the federal deficit is the primary tool for fiscal stabilisation in the United States, electing a new President and Congress with different preferences automatically translated into a different policy mix.¹⁹ In Europe, however, finding an optimal policy mix is more complicated. While monetary policy is unified, fiscal policy remains splintered under the authority of national governments. As a consequence, the aggregate fiscal stance for the Eurozone is the more or less random result of uncoordinated fiscal policy decisions, which reflect the democratic choices made by different segregated national electorates. For example, after the Presidential elections in France in the year 2002, the structural deficit immediately deteriorated from 2 to more than 3 percent, reflecting Jacques Chirac’s electoral promise to lower taxes. Yet, although this choice had consequences for the policy mix in Euroland as a whole, citizens in no other member state could participate in the decision. A clear definition of what the *aggregate* European fiscal stance is supposed to be is therefore impossible within today’s institutional framework.

The role of fiscal policy

The existing institutional arrangement effectively deprives the European Union of fiscal policy as a stabilisation tool. In fact, fiscal *policy*, in the sense of choosing a sequence of measures aimed at optimising welfare, does not exist in Europe. The Stability and Growth Pact does of course provide a *rule* how the aggregate fiscal policy stance is to be defined, namely, each and every country should balance its structural deficits, so that the aggregate structural budget is also balanced. The efficient policy combination requires then that the European Central Bank sets interest rates so that the deviation from potential output are minimised. However, apart from

¹⁹ For a detailed description of the shift to the Clinton-Geenspan mix see Woodward, 2000.

the issue of whether the ECB does achieve this objective, there are two interconnected problems with this rule. First, member states are not complying; at least they have not been complying since the beginning of EMU. In 2003, seven out of 12 member states had structural deficits, according to the European Commission data. The aggregate structural deficit in Euroland was in excess of 2 percent and not zero as the Pact demands. The reason for this non-compliance is, of course, that national governments prioritise domestic choices over European commitments. Ultimately, the democratic process within countries will always take precedence over intergovernmental agreements made by ministers and their bureaucracies. In the long run, it is not realistic to expect that democratically elected governments would ignore voters who wish them to lower taxes and to increase deficits – just because some years or decades earlier an agreement was made to balance budgets.

This relates to the second difficulty of the Pact. Because the aggregate fiscal stance is uncertain, the central bank becomes obsessed with fiscal policy and underrates other factors like wage developments. In the existing set-up, stabilisation policy depends exclusively on monetary policy and the ECB tries to “signal” to governments what budget policy it expects so that its task of maintaining price stability is served. But as the Eurogroup of finance ministers cannot commit to a common stance for the above-mentioned reasons of democracy, monetary policy will over-react to fiscal laxity. Hence, demand management will focus primarily on budget policies and will not respond sufficiently to wage developments, which might allow more growth oriented monetary policies. This translates into a serious policy obstacle when average unit labour costs fall as a result of relative price adjustment in large member states.

Empirical observations

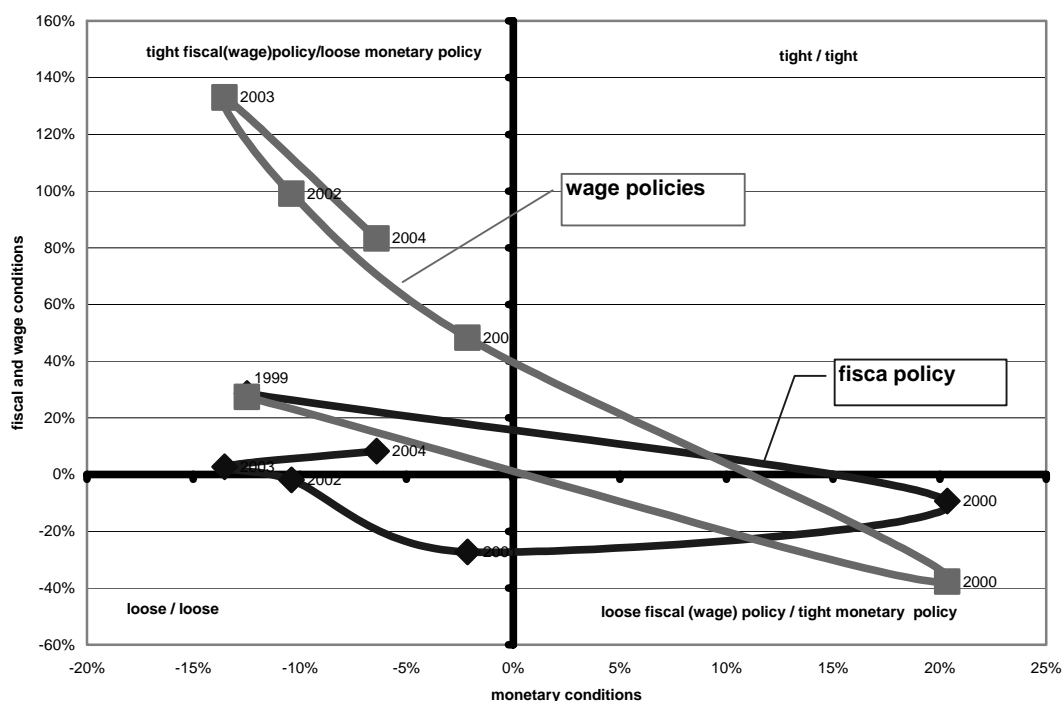
This dynamic has been clearly witnessed since the start of EMU. Figure 21 shows the combinations of monetary policy with fiscal and wage developments. Monetary policy is considered “loose” when the weighted index²⁰ of short term interest rates and the Euroland real effective exchange rate falls and “tight” otherwise. Fiscal policy is soft, when the structural budget position deteriorates and tight when it improves.²¹

²⁰ The formula is $(\Delta i + a \Delta \text{REER})/2$, where i is the short term interest rate, $a=0.26$ is the share of foreign trade (imports plus exports) to GDP and REER the Euroland real effective exchange rate.

²¹ The European Commission uses the structural primary budget position to define the fiscal policy stance. This is correct when looking at the discretionary fiscal choices of governments. However, I

Wage policy is tight, when nominal wages increase by less than 2 percent over productivity growth.²² In other words, wage restraint implies that wage inflation will remain below the ECB inflation target plus trend productivity. Wage policies are “loose” when unit labour costs increase faster than the ECB inflation targets.

Figure 21. The Policy Mix in Euroland



Two features are striking in Figure 21: During the first six years of EMU, the ECB has never tightened its stance when either fiscal or wage policies were conservative. Only in the boom year 2000, when both fiscal and wage policies were loose, was monetary policy restrictive. Second, monetary policy responds to fiscal and wage policies in a similar fashion, even if changes in the monetary condition are correlated with larger swings in wage dynamics than in fiscal policy. For example, a softening in monetary conditions by 10 percent in 2002 is correlated with a fiscal policy tightening of 27 percent, while wage restraint has undershot the inflation target by nearly 100 percent (which implies that unit labour cost remained constant). This is evidence that the ECB underrates wage developments relative to fiscal policy. Further and most importantly, the trend-lines of the two policy curves are both downward sloping.

focus here on the budget rule of the SGP and that requires using the structural deficit. Although the shape of the chart is affected by these measures, the fundamental message is not.

²² Productivity growth was averaged over 5 years in order to avoid distortions due to the business cycle.

Thus, both policies re-enforce each other.²³ As a consequence, fiscal laxity prevents interest rates from being reduced sufficiently when average unit labour costs in Euroland remain behind the inflation target. If the Euro zone wishes to return to more investment, growth and employment, wage restraint would have to overcompensate the fiscally induced rise in equilibrium interest rates. But this poses major problems for the adjustment of large countries in Euroland.

Since 1999, Germany, but not France, has consistently improved its competitive position, as we saw (Figure 19), by lowering unit labour costs relative to its neighbours. It has thereby also restrained the average growth of wage costs in Euroland. But wage moderation also implies less government revenue and larger public deficits. Furthermore, fiscal policy was loosened by the German tax reform in 2000, that intended to improve German competitiveness from the supply side. The result was an increase in Euroland's *aggregate* structural deficit (to which France also wholeheartedly contributed) and an increase in the equilibrium interest rate. Hence, monetary policy could not be loosened as much as was required by wage developments. The German adjustment strategy was counterproductive. This explains partly why Germany's profit margins are improving so little, despite rigorous efforts to reform labour markets and reduce unit labour costs.

The increase in equilibrium interest rates was not warranted by developments in the labour market but purely and simply a consequence of autonomous fiscal policy actions by member state governments. It has prevented a larger increase in Tobin's q , which is needed as an incentive for investment and to create jobs. Thus, it is the institutional arrangement of unified monetary policy and uncoordinated national responsibilities for fiscal policies that yields clearly sub-optimal policy results.²⁴ If fiscal policy is to be an instrument to stabilise the European economy, the aggregate fiscal policy stance has to be decided at the level of Euroland. However, such a European policy stance can only be legitimate if, and only if, it was endorsed by

²³ Regressing the monetary condition index on fiscal and wage policy variables is obviously not very significant with 6 observations and two parameters. But it gives a rough indication of the coefficients and their direction:

	Coefficient	Std.Error	t-value	t-prob	Part.R ²
change structural deficit	-0.279971	0.1854	-1.51	0.206	0.3631
ULC target deviation	-0.112608	0.03899	-2.89	0.045	0.6758

²⁴ The dominant neo-liberal discourse about the need for greater labour market flexibility obscures this institutional fact.

European citizens through a proper democratic process. Optimising the policy mix in Europe therefore poses the question of democracy.

Efficiency and legitimacy of economic policies in a democratic

European Union

The issues of efficiency and legitimacy of public policies are linked. Without legitimacy, efficient policies are not possible. However, the process of legitimate decision-making requires more than efficient policy output; it is dependent on constitutional rules and procedures, which allow individual citizens to participate in the process. This participation does not imply direct policy input by all citizens at all times, but the delegation of decision making to collective institutions where policy makers are accountable for their actions and revocable by citizens. Elections are the formal renewal of the contract, whereby the principal (citizens) charges an agent (the government) with the task of defending their collective interests and maximising welfare. No modern democracy is perceivable without this right. Furthermore, it is a central characteristic of democracies that, prior to the renewal of the agency-contract between citizens and governments, an electoral campaign takes place, in which citizen exchange views and opinions about collective preferences. During these campaigns citizens are not only informing themselves of the potential choices and options, but the process of deliberation during the campaign is a necessary condition for the emergence of public opinions that reflect at least the majority.

European democracy?

The European Union is not a democracy. It is true that member states are democratically elected and represent their citizens in the European Council. But with respect to *European* policies, the sovereign (i.e. European citizens who are affected by these decisions) have no institutional right to ask the European decision maker (the Council or the European Commission) to render accounts for their action and to dismiss them, if they do not reflect their preferences. The legitimacy of European policy-making is a derivative of national policy. No collective deliberation across countries takes place in the European Union, despite the fact the European Parliament

is elected by citizens. The reason is that the Parliament, despite an increasing role of co-decision in legislation, does not have the right to revoke decision-makers.²⁵ As a legislator, the (European) Council is more like “an eternal parliament” that gets repeatedly renewed by by-elections without ever having to undergo a general election. As a consequence, policy debates remain confined to national public spheres and debates and the emergence of proper collective European preferences takes extremely long, if it happens at all.²⁶ The fundamental social contract between European citizens and their European agent does not allow them to participate in the process of policy making. At best they learn from each other, as information “trickles down” from the interactions of policy elites. As a consequence, the lack of democracy in the European Union does not only contribute to a rift between citizens and European Policy makers but it also undermines the efficiency of outcomes from a welfare point of view.

The proper remedy for this dilemma is the creation of a European political union with full democratic legitimacy. Such a political union would then also be able to define and conduct more efficient macroeconomic policies. For example, it could set the aggregate fiscal policy stance, while leaving the implementation largely to national governments (Collignon, 2004). Here is not the place to discuss these ideas in detail. However, I would like to raise the question of whether France and Germany could become the motor for proposing such a new step of political deepening in the European union.

The Franco-German motor

The answer depends crucially on the understanding of the role of the State in society. In France, the idea of Republic has traditionally given a prominent role to individual citizens as actors in the political process, who express their *volonté générale* in the institution of the State. In Germany, the actor was usually conceived as the State-bureaucracy whose role was to protect the whole of a hierarchically structured community rather than individual citizens. However, in both countries political ideologies have evolved. Germany has become more democratic and citizen orientated, while France has recognised the need for decentralising the control of state

²⁵ The recent threat of rejection of the Baroso-Commission is both, a sign that things may change and a reminder of Parliament’s severe restrictions in appointing the Commission.

²⁶ In Collignon 2003, I have formulated this argument in a formal model.

organs and creating intermediated institutional layers. Both societies are therefore converging towards a model of society that is more individualistic and democratic. The holistic traditions, which were still so present in both countries' political ideologies during the 1960s and 70s, have lost some of their power. This offers an opportunity to go forward and confirm citizens in their status as European sovereigns.

This ideological convergence does not necessarily imply that both countries have become "neo-liberal". For neo-liberalism implies the fusion of liberal and nationalist or communitarian ideologies. In fact one of the consequences of the Mitterrand presidency and the Jospin premiership was the emergence of a more modern social-liberal society, based on monetary market economy. Simultaneously, the ordo-liberal legacy of the German model is melting, with Social Democrats promoting a more pragmatic form of managed capitalism (Dyson, 2003). This ideological conversion in France and Germany reflects, to a large degree, the economic convergence which has taken place in both countries over recent years and decades and was documented in this paper. As a consequence, it should be not only possible, but even natural, that together France and Germany could take the initiative of pushing European integration forward towards a political union that establishes proper democratic procedures. However, this process is unlikely to come from the bureaucratic elites and policy circles that dominate decision making in both countries. It will have to come from their civil societies. Ultimately, it is not up to France or Germany, but to European citizens whether they re-appropriate the power that is theirs as the European sovereign.

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