The Principles of the European Social Model and the Practice of Economic Policy in the EU

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This paper summarizes the main points of a short presentation on a rather wide range of problems. Hence, the paper can only sketch the main observations and arguments and should not be considered a piece of scientific research but rather a short essay. The main theses are derived from a comparison between what I consider the basic principles of the European social model and a set of observations on the guidance of economic policy in the EU. Hence, this paper follows an inductive approach which contains also important subjective elements. This concerns in particular the selection of the observations since I focus deliberately on those aspects which are rather neglected by mainstream economists. E. g., unemployment is mostly analyzed only in the context of the labour market whereas I stress the fact that macroeconomic policy might play an important role insofar as it influences the growth of production and, hence, of employment not only over the short run but also over the medium and even long run.

The sketchy character of this paper implies also some very simplifying assumptions. E. g., Germany is taken as example of the "typical" European economy. Even though this "pars-pro-toto"-approach can to a certain extent be justified by the fact that Germany represents the largest European economy which has been significantly shaped by the principles of the European social model ("Soziale Marktwirtschaft"), it is certainly true that other

European countries have adopted different strategies of economic policy over the past 15 years (notably, the Scandinavian countries and in recent years also the United Kingdom). These and other shortcomings of this paper can only be justified by the fact that it represents just a sketchy essay (also in literal sense).

The paper is structured as follows. First, I describe the main principles of the European Social Model (ESM) in comparison to the US model of economy and society. Then I derive from these principles some general guidelines for an economic policy which accords to the ESM. In the third part I evaluate the practice of economic policy in the EU since the early 1990s against the backgrounds of the guidelines according the ESM. In addition, I elaborate the characteristics of economic policy in the EU by comparing it to the strategies adopted by the US.

Table 1: The European social model versus the US model

	Europe	USA
Long-term development path	Citizens embedded in social contexts (feudal system, communities, interest groups, welfare state)	Citizens as (former) immigrants: Mentality of adventurers, Competition as dominant form of social interaction
Pursuit of interests	Mainly through organisations (unions, etc.)	Predominantly as individuals in markets
Fundamental values	Individual freedom and social justice ("Liberte, egalite, fraternite")	Individual freedom ("pursuit of happiness")
Importance of trade unions and organisations of entrepreneurs	Great	Little
Labour relations	Corporatism	No institutionalized cooperation
Labour markets	Regulated	"Hire and fire"
Insurance against illness, old-age Poverty, unemployment	Provided by welfare state	Mainly private (or no) insurance, unemployment benefits modest
Education system	Primarily run by welfare state	Mainly private
Relationship market/state	Complementary	Antagonistic
Importance of the welfare state	Great	Little
Importance of the financial sector	(Traditionally) Little	Great
Role of (stock) exchanges	(Traditionally) Less important	Very important
Focus of making profits	(Traditionally) Real economy	Real and Financial Economy
"Economic culture"	"Real capitalism" combined with welfare state	"Real and financial capitalism" ("Silicon Valley culture" combined with "Wall Street culture")

Principles of the European social model

Table 1 summarizes the main aspects, hence, I discuss them only briefly.

The roots of the ESM lie in the traditionally great importance of citizens being embedded in social contexts. The respective social organizations range from the feudal system or the guilds of craftsmen in medieval times to interest groups like trade unions and up to the modern welfare state. In the US, by contrast, competition as individuals is the most important from of social interaction. This is related to the fact that the US has evolved from a society of immigrants in which the individual fight for survival and expansion is of central importance.

As a consequence, organisations like trade unions or political parties as a means of pursuit of interests play a comparatively greater role in Europe than in the US where people pursuit their interests rather as individuals in markets. Hence, Individual freedom and social justice can be considered the traditionally most

important values of European society ("Liberte, egalite, fraternite"). In the US, by contrast, (just) Individual freedom ranges by far highest ("pursuit of happiness").

The relative importance of trade unions and organisations of entrepreneurs in Europe as compared to the US as well as the different role of corporatism and labour market regulations correspond to the different social values (table 1). This is also true for the way how insurance against basic risks of life is provided and how the education system is organised. In both respects the welfare state plays a much more important role in Europe as compared to the US. As a consequence, the relationship between market and state is considered complementary in Europa but rather antagonistic in the US.

Significant differences have also been prevailing as regards the relationship between the real and the financial sphere of the economy and the related "economic culture". European economies have been traditionally focused on the real economy, most typically reflected by the specialisation of Germany on high quality manufactures ("real capitalism"). In the US, by contrast, the "Wall Street culture" has traditionally been an important segment of the US economy system (in some socialpsychological sense corresponding to the tradition of individual adventurers and heros). Hence, the US economic system should be considered as a combination of "Real and financial capitalism".

Guidelines for Economic Policy according to the ESM

Table 2 sketches those guidelines for economic policy which can be derived from the principles of the European social model.

In order to achieve the goals of the ESM economic policy has to focus simultaneously on different targets, in particular on full employment since it represents the financial base of the welfare

state. Full employment can best be achieved and maintained through a sufficiently high and stable economic growth.

The main instruments for smoothing business cycles are an active monetary and fiscal policy. By preventing or mitigating recessions such a policy contributes also to higher growth over the medium and long run. This demand-oriented policy has to be completed by continuous improvements of supply conditions, in particular through public investments in education and infrastructure.

Table 2: Guidelines for economic policy according to the ESM

Main targets of economic policy	Full employment, high economic growth, social security, "fair" income distribution, social coherence
Main instruments for Full employment and high economic growth	Countercyclical monetary and fiscal policy, public investment in education and infrastructure Focusing profit seeking on the real sphere of the economy
Improving social security	Consolidation of public health and pension systems, unemployment insurance, active labour market policy
Fair" income distribution and social coherence	Incomes policy, public education system, tax policy
Price stability	Incomes policy

In addition to that economic policy should provide incentives for the business sector to focus its profit seeking on the real sphere of the economy (instead of speculation and investments in financial markets). Such a policy is necessary to keep private investment and, hence, economic growth, on a sufficiently expansionary path over the long run.

In order to strengthen the citizens' confidence in their social security (which in turn fosters their consumption demand) public health and pension systems have to be adjusted to changing

framework conditions (e. g., changes in the demographic structure) without significantly reducing the benefits traditionally provided by these systems. The same holds true for unemployment insurance which has to be completed by an active labour market policy.

A coordinated incomes policy is not only necessary to make income distribution more "fair" as compared to the market outcome (thereby strengthening social cohesion) but serves also as an efficient means to achieve and maintain price stability.

It is interesting to note that the above sketched guidelines shaped economic and social policy in Western Europe over the 1950s, 1960s and (to a lesser extent) over the 1970s.

Practice of Economic Policy in EU since the early 1990s

The practice of economic policy in the EU has been in marked contrast to the principles of the European social model. This policy was shaped by the following general guidelines:

- Restrictive regulation of fiscal and monetary policy
- Deregulation of financial, goods and labour markets

These guidelines can be considered the political essence of the neoliberal/monetarist view of the (economic) world which has increasingly shaped the thinking of professional economists, journalists and politicians in Europe since the late 1980s (in the US, by contrast, this "Weltanschauung" has started to progressively loose its influence on the practice of economic policy as shall later be shown).

The most important regulation of fiscal policy was settled in 1992 as the famous "Maastricht criteria". These rules were initially set only as conditions for entering the European Monetary

Union. However, in 1997, the validity of these restrictions on an active fiscal policy was prolonged to an infinite future in the Treaty of Amsterdam.

Over the past 10 years the Maastricht criteria forced most European governments to adopt a savings policy. This policy affected the economic performance in three different ways (all of them contradict the guidelines for economic policy according to the ESM):

- In periods of a weakening private demand fiscal policy was not used to stimulate the economy (as 1993 and in particular 2001 and the subsequent years).
- The savings policy weakened specifically the systems of social security and public education.
- Public investment in the infrastructure declined in most countries. Hence, the improvement of the conditions for economic growth also on the supply side was neglected.

Fiscal policy adopted by the US government has differed remarkably from the European approach over the past 15 years. Over the short run the US has been following a pronounced countercyclical course. E. g., in and after the recessions 1991 and 2001 the government increased the budget deficit deliberately and strongly. Afterwards it did not adopt a savings policy but let the automatic stabilizers care for a continuous improvement of the fiscal stance.

Monetary policy was regulated through the statute of ECB which gives price stability the highest priority: and leaves almost no room for other economic targets (by contrast, US central bank considers growth of production and employment as important as price stability). In addition to that, the ECB conducts monetary policy in a way more restrictive than called for by its statute. E. g., its statute does not oblige the ECB to define price

stability as an increase in consumer prices below 2% without accounting for the fluctuations of commodities prices and for the quality improvements of manufactures (both factors are taken into account by the Fed).

The concept of monetary policy as adopted by the ECB has two consequences. First, over the short run the ECB does not follow a countercyclical course as does the Fed. Second, over the medium and long run, the euro key interest rate lies in most countries significantly above the (nominal) rate of growth (the Fed keeps the interest rate close to the level of economic growth).

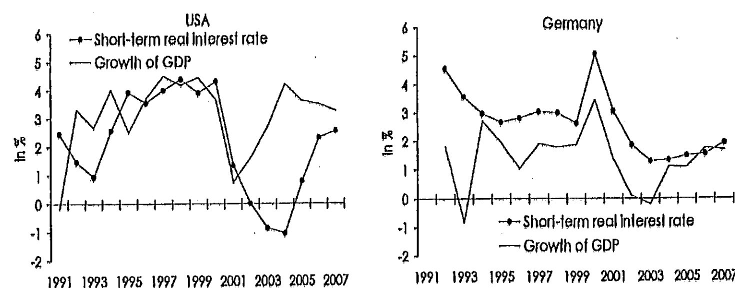
To summarize: A comparison of the fiscal and monetary policy adopted by the EU on the one hand and by the US on the other suggests that implicitly an exchange of concepts took place around 1990. The EU took over the monetarist approach of regulating fiscal and monetary policy in a restrictive manner whereas the US adopted de facto a Keynesian approach.

In the next section I will try to present some empirical evidence underpinning this statement.

Some observations on economic policy in the EU and in the US

First I present some observations on monetary policy. Figure 1 shows that the US central bank targets the nominal rate of interest in "normal" times approximately at the level of the nominal growth rate of the economy (as between 1994 and 2001). However, in and after recessions it lowers interest rates to a level far below the rate of growth (as between 1991 and 1993 and again – more pronounced – between 2001 and 2005). By following this strategy the Fed provides strong impulses for the economy when private demand is weak. It sticks to this type of low interest rate policy until the recovery of the demand of households and particularly of the business sector has become "self-sustained".

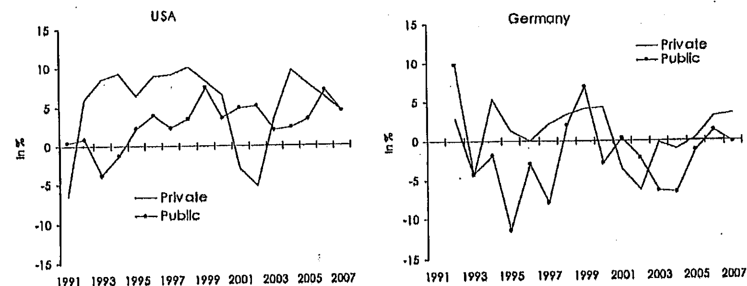
Figure 1: Rate of interest and rate of growth



Source: OECD

The ECB (and before 1999 the Bundesbank) follows a different course. It adjusts short-term interest rates to a much lesser extent to the business cycle as compared to the Fed. Over the medium run the ECB sets interest rates at a much higher level (in relation to GDP growth) than the Fed. For countries with low inflation and sluggish growth this policy implies that the interest rate exceeds permanently the growth rate. This has been the case in Germany. A positive interest-growth-differential dampens in turn the dynamics in the economy, in particular since it hampers investment financing (not at least due to the dynamic budget constraint).

Figure 2: Real gross investment



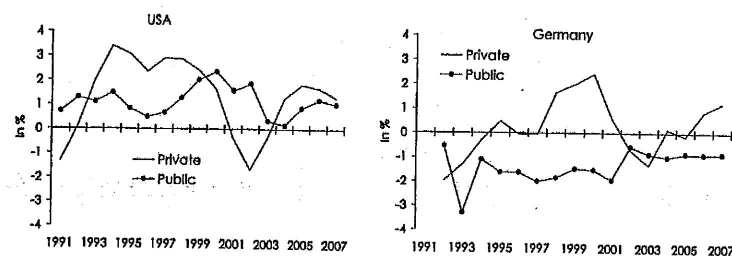
Source: OECD

Real public investment in the USA rose by roughly 5% in the recession year 2001 as well as in the subsequent year when private investment declined significantly (also public consumption was increased during these years of weak private demand). Over the past 10 years the state expanded its investments continuously thereby improving the infrastructure in the US economy over the medium run.

In Germany, by contrast, public investment was reduced in most years since 1992. This was in particular true for the period since 2001. This extremely restrictive policy has contributed not only to the stagnation of the German economy but also to the deterioration of its infrastructure.

A look at the development of private and public employment reveals a similar picture. Since the early 1990s public employment in the US has risen in every single year. Its expansion was particularly strong in those years when private employment declined as 1991/92 and 2001/2003 (figure 3). Almost exact the opposite is true for Germany: public employment was reduced in every single year since 1992, not even in years when private employment shrunk strongly did the state increase its labour demand.

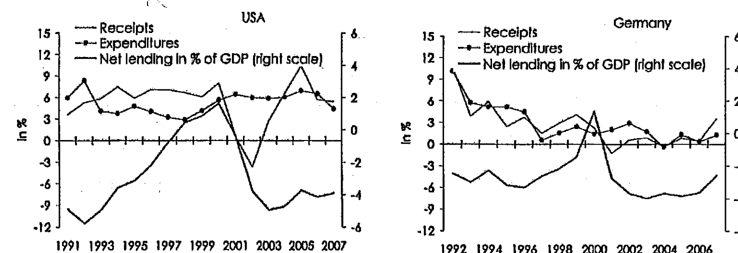
Figure 3: Employment



Source: OECD

The different strategies of fiscal policy are reflected by the development of public receipts and expenditures in the two reference countries (figure 4). During and after the last recession (2001) the US government let expenditures grow at a rate of more than 6% per year and accepted the decline in receipts. To be more precise, this decline was strongly and deliberately enlarged by the government due to two tax reforms. As a result the budget deficit soared between 2001 and 2003.

Figure 4: Public finances



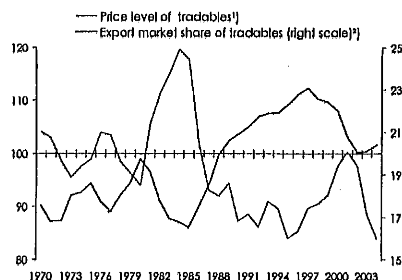
Source: OECD

The German government followed a very different course. It reacted to the decline in public receipts due to the recession by reducing the already very low growth in public expenditures (figure 4). This contributed to a prolongation of the stagnation which in turn led to a further deterioration of the fiscal stance. In effect the German government ended up with a budget deficit not significantly smaller than the US deficit. To put it differently: Whereas the US government had adopted a fiscal strategy of a deliberate deficit spending, the German government tried to stick to a "sound" policy in line with the Stability and Growth Pact. In part due to the lack of fiscal expansion the German economy turned from a recession into a persistent stagnation. Hence, also public receipts and expenditures stagnated causing the deficit to remain high year after year (figure 4).

The countercyclical monetary and fiscal policy adopted by US authorities helped the economy to a considerable extent to over-

come recessions quickly and to expand over the medium run at a much higher speed than most other industrial countries. Thus, the most important costs of this strategy, namely, strongly rising budget deficits during and after recessions, turned out to be well "invested". This is so because the shorter recessions can be kept the less are the losses in human and material resources due to foregone employment and investments.

Figure 5: Price level and export performance of tradables: USA



Source: OECD, WIFO

[1] US dollar exchange rates relative to purchasing power parities of tradables vis-a-vis industrial countries (OECD24)

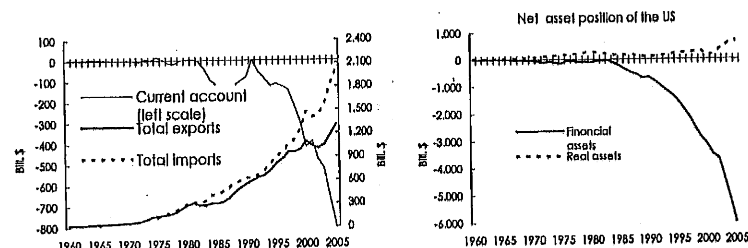
[2] In overall exports of industrial countries (OECD24)

US authorities try to support the own economy not only by means of an active fiscal and monetary policy but also by stimulating exports through an undervalued dollar exchange rate. E. g., during and after the recessions 1991 and 2001 the "talking the dollar down" on behalf of US politicians contributed to strong depreciations of the US currency. As a consequence, US exports performed better than those of the other industrial countries, i. e., the US gained export market shares (figure 5). This helped the economy to recover quickly from the recession.

The low real exchange rate of the dollar has been fostering the US economy also over the long run. Since the late 1980s the US dollar has been significantly undervalued relative to purchasing power parities of internationally traded goods and services. This undervaluation is the most important single reason for the strong gains of export market shares by the US economy (figure 5).

The attitude of the ECB vis-à-vis the external value of its (relatively new) currency stays in sharp contrast to the Fed's respective attitude. For the US central bank the level of the real dollar exchange rate does not represent a value in itself but rather an instrument to stimulate the domestic economy when necessary. The ECB, however, follows the tradition of the Bundesbank's "hard currency policy" and, hence, strives not only for a (restrictively defined) price stability in the euro area but also for a high external value of the "young" currency. As a consequence, real exports of the US have risen much stronger since 2001 than those of the euro area.

Figure 6: External imbalances of the US economy



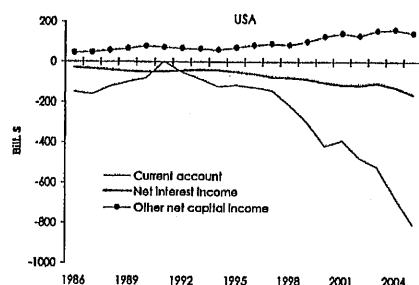
Source: OECD, Fed

The countercyclical and growth-oriented monetary and fiscal policy in the US and the comparatively "inactive" macroeconomic policy in the euro area are the most important reasons why domestic demand in the US has been growing much stronger over the past 15 years than in the euro area. At the same time also external demand for US products has been rising stronger than for products made in euro area due to the undervaluation of the dol-

lar and the corresponding overvaluation of the euro (or ECU, respectively). Hence, the significant growth differential between the US and the euro area since the early 1990s can to a large extent be explained by different macroeconomic policies and the (related) exchange rate misalignments.

This growth differential is in turn the most important reason for the US current account deficit which has widened dramatically over the past 15 years (figure 6). This becomes clear if one looks at the development of exports and imports separately. US exports have risen faster than those of its industrial competitor countries (figure 5), however, US imports have been expanding even faster, driven by the domestic demand of the US economy (figure 6). As a consequence, the US has become the by far biggest debtor country in the world economy, her net external (financial) debt reached roughly 6 trillion $ in 2005 (figure 6).

Figure 7: Mr Ponzi and the US current account



Source: OECD, Fed

This development was strongly facilitated by the fact that the US is the only country which can finance her external deficit through additional debt denominated in her own currency. This enabled the US to take new dollar credits from the rest of the world which by far exceed the net interest which the US should pay to its creditors for the already existing debt (figure 7). In other words: the US economy has been financing her external debt according to the famous Ponzi scheme (i. e., the creditors pay the interest for the outstanding credits to the US themselves by providing additional credits).

This unsustainable and somewhat grotesque development was strongly fostered by the fact that those countries which were particularly unable to stimulate their domestic demand (notably Germany and Japan) could prevent their economies from shrinking only though a continuous export expansion. Hence, even if they do not receive interest payments for their financial claims to the US (= accumulated net exports to the US) they are eager to further proceed on this neo-mercantilistic road (more sarcastically, one could say that countries like Germany or Japan act as Dagobert Ducks, which fits well to the US acting as Charles Ponzi). With respect to surplus countries of the Euro area, notably Germany, one could paraphrase this paradoxical situation also as follows: These countries are not able and/or willing to finance their own domestic demand but are eager to finance the domestic demand of the US economy without limits.

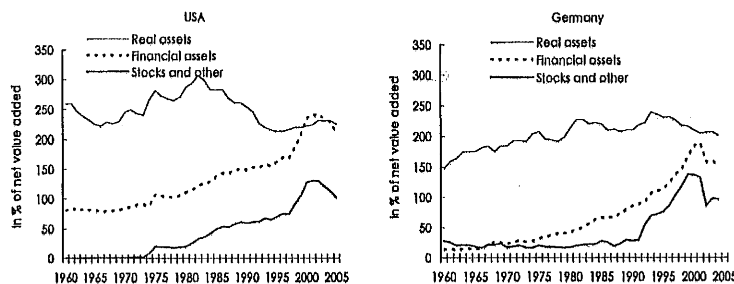
Finally I would like to shed some light on the long-term transformation of western market economies from "real capitalism" to "financial capitalism" and how this change in fundamental framework conditions affected the European social model. Real capitalism shaped the first half of the post-war period, namely (roughly) between 1950 and 1973 (international economy) and, respectively, 1980 (domestic economies).

The general characteristic of real capitalism consists of framework conditions which focus profit-seeking activities of non-financial business on the real sphere of the economy, i. e., on investment, production and trade. Financial markets were to a large extent regulated, exchange rates were stabilized and central banks kept interest rates at a level far below the rate of economic growth. The financial sector concentrated its activities on serving

the real sector through financing investment and facilitating transactions in domestic and international trade.

Under these conditions investment, production and trade provided the best opportunities to make profits, pure financial accumulation and speculation did not pay off. As a consequence, real capital accumulation and overall economic growth were strong and stable over the 1950s and 1960s, in many European countries full employment was already achieved by 1960. This historically unique economic performance enabled governments to continuously improve the systems of social security and education as well as the infrastructure. In turn, these improvements strengthened economic growth. Under the conditions of real capitalism, the stepwise realization and enlargement of the European social model on the one hand, and continuous improvements in economic efficiency on the other hand, completed one another.

Figure 8: Real and financial assets of non-financial business



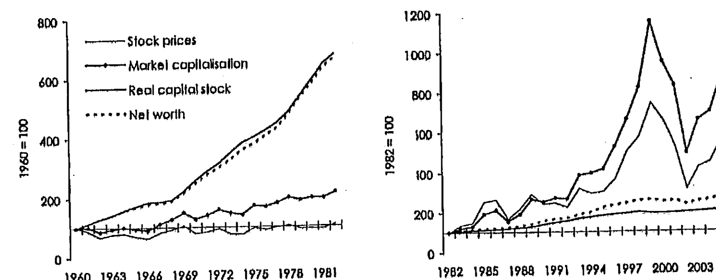
Source: Fed, Bundesbank

Figure 8 shows that non-financial business increased its real assets (real capital) over the 1960s and 1970s much stronger than production (net value added). This holds true for the US as well as for Germany. Over the same period financial accumulation of non-financial enterprises was negligible. At the same time stock prices stagnated and market capitalisation increased only slightly

between 1960 and 1982 (figure 9 demonstrates this for the case of Germany – the development in the US was similar).

The transition from real to financial capitalism took off in the early 1970s. After the break-down of the system of stable exchange rates (Bretton Woods) the dollar lost 25% of its value between 1971 and 1973. This development strongly contributed to the first oil price shock which took place in fall 1973 (since crude oil as well as almost all other commodities are priced in dollars any strong dollar depreciation puts commodities producers at an disadvantage). The oil price shock in turn triggered off the first global recession in 1974/75. The same sequence took place between 1977 and 1980. However, in this case the recession was additionally lengthened by a high interest rate policy on behalf of the most important central banks. Since then the rate of interest has permanently exceeded the rate of growth in most European countries (the US central bank dismissed the monetarist policy by the late 1980s).

Figure 9: Stock prices and real accumulation of non-financial business Germany



Source: Fed, Bundesbank

The enormous volatility of exchange rates and commodities prices as well the high level of interest rates had two effects on non-financial business. First, these conditions dampened its ac-

tivities in the real sphere of the economy since the outcome of these activities had become more uncertain and more expensive. Second, these conditions made financial speculation and accumulation more attractive. This attraction was further increased by the emergence of many financial innovations which facilitated speculative transactions (this concerns in particular all forms of financial derivatives). These innovations contributed to the dramatic expansion of financial markets over the 1980s and 1990s.

As a consequence of all these developments the dynamics of real capital accumulation slowed down over the 1980s. This was particularly pronounced in the US economy. At the same time financial accumulation became increasingly important for non-financial corporations in the US (figure 8). However, real accumulation picked up again in the US in the early 1990s, strongly fostered by the shift towards a growth-oriented and countercyclical monetary and fiscal policy. At the same time financial assets of non-financial business continued to rise faster than production, mainly due to the valuation effect of rising stock prices (however, also the acquisition of financial assets contributed to this development).

To put it differently: The "bastard-Keynesian" (Joan Robinson) policy in the US mitigated the negative effects of "finance-capitalistic" framework conditions on investment and production, in particular by keeping interest rates and exchange rates at low levels. Thereby profit-seeking activities through financial speculation and accumulation were focused on the stock market. These activities dampen activities of the business sector in the real sphere of the economy relatively little (at the same rising stock prices stimulate private consumption due to wealth effects).

In Germany economic development has been shaped by "finance-capitalistic" framework conditions only since the early 1990s (similar to the development in the US over the 1980s). Financial accumulation and speculation of (big) non-financial corporations began to boom, at the same time real accumulation declined relative to production (figure 8). Their real capital stock as well as their net value almost stagnated whereas their stock market value (market capitalisation) mushroomed due to booming stock prices. The sluggish business investment in turn contributed strongly to the weak overall performance of the German economy since the early 1990s (together with the restrictive monetary and fiscal policy already discussed).

Low economic growth over the 1990s and a persistent stagnation over the past 5 years caused unemployment to rise substantially. The public expenditures for the unemployed and dampened tax receipts became the most important reason for persistently high budget deficits. Mainstream thinking on behalf of economists and journalists considered the welfare state as such as the main cause of these developments (their diagnosis focused rather on the symptoms than on the systemic causes). Hence, the German government adopted a "reform policy" which weakened in particular the main components of the welfare state (unemployment insurance, social pensions, the health as well as the education system). This policy undermined the confidence of private households in their future social security. As a consequence, households increased savings and dampened their consumption. This development contributed significantly to a prolongation of the stagnation in Germany.

Traditionally I should now draw some final conclusions from the observations and interpretations presented in this essay. However, I prefer to leave this task to the reader.