The Phillips curve and pensions

How looming fiscal and social crisis could weaken the Euro in the future

by Jean-Jacques Rosa

Who remembers the Phillips curve - that inverse relationship between unemployment and inflation which guided macroeconomic policy-making during the sixties? It offered governments a choice between the two evils of price rises and unemployment. Came the seventies and the oil crises, which, as it happens, turned out to be a convenient cover up for other more general factors like over-lax monetary policies, resulting from the breakdown of the system of fixed exchange rates and the financing by the U.S. of the war in Vietnam. The sudden speed-up in inflation was followed by a rise in unemployment rather than the fall usually expected in an expansion phase.

Without further ado, economists drew the conclusion that the Phillips relationship was lost and gone forever. That being the case, the only thing for monetary policy to do was ensure price stability, without any impact on employment levels. Just in time to justify the restrictive policy of the eighties designed to eradicate two-digit inflation.

A few economists persisted in the belief that the Phillips curve remained a useful description of cyclical reality but that it could have shifted: in certain periods, the exchange rates corresponding to each level of inflation could rise, or fall, for other – structural – reasons. But the basic connection between increased unemployment and a slowdown in inflation remained.

The experience of the nineties confirmed this judgement. Periods of disinflation were again reflected by a rising trend in cyclical unemployment, while upturns in activity led to a fall in unemployment. This fits with what we see today: the exceptional expansion in the U.S. over the last few years has run into some late, but not unexpected, inflationary tensions. In Europe, where the depreciation of the euro has spurred growth to a more modest degree, the countries with the highest expansion rates like Ireland, Portugal and Spain have recorded a return of inflation such that, for the eurozone as a whole, the officially tolerated threshold of 2% of aggregate price levels has been crossed. At the same time, unemployment is falling rapidly and has passed the 10% level on the way down.

It thus turns out to be possible to bring down European unemployment substantially and rapidly by monetary policy alone without any noticeable reduction of structural unemployment, which goes to show what the lengthy run-up to the euro with a deliberately strong franc policy has cost the French economy in terms of lost jobs and lost production.

This does not mean that the reforms of the labor market, the regulatory ones and especially those affecting the pension and health systems, all the non-wage costs that are responsible for pushing up the taxes on labor, are not necessary. But their main effect will be to cut down the structural unemployment that the current expansion will encounter sooner or later, when cyclical unemployment is eliminated.

Going round preaching the virtues of structural over macroeconomic policy, as advocates of the euro have spent their time doing, was indeed a pointless exercise. Both have their part to play and together, contribute to the performance of the economy. Now that monetary and exchange rate policy has returned to reason, with expansion back in an acceptable zone, it becomes both easier and more necessary to embark upon structural reform policies, all the more since budgetary and fiscal difficulties flowing from these obsolete structures could well lead monetary policy into perilous waters.

The fact that, since its creation, the euro has fallen 20% or more against the dollar, the yen and the pound is essentially a return to the equilibrium determined by the old purchasing-power parity theory after long years of over-valuation of the currencies that make up the single currency.

But a currency is a claim on the party issuing it, which is generally a state. If its financial situation suggests it might in the future print paper instead of turning to taxation to finance expenditure, or reduce its expenditure to current tax revenues, the value of the currency plummets. Now, as Kotlikoff and Ferguson point out in the latest issue of *Foreign Affairs (1),* all European states which jointly guarantee the value of euro will be facing a serious financial crisis in the next decade on account of claims from a growing number of pensioners. They will all be hard put to it to increase the already high level of contributions or cut back pensions being paid. The temptation to print money may, at some stage, prove irresistible.

This might put the euro on the skids once again and an under-valued currency would mean a big hike in inflation in Europe. The solution is in the hands of the managers of each state's public finances and out of the Europe Central Bank's control and competence. It all depends on the fiscal and social policies that each of the eleven countries individually goes for.

Prospects look bleak with pressures on the Euro and collisions between member countries, as well as between them and the bank in Frankfurt.

1. Niall Ferguson & Laurence Kotlikoff, "Can the Euro survive?", *Foreign Affairs*, March-April 2000.

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