The Monetary Policy of the ECB and Automatic Stabilizers: Will they Work?

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Many commentators regard the Stability and Growth Pact (SGP) of the euro economies as unduly restrictive during economic recessions because of the maximum public sector deficit of 3 per cent of GDP. Instead, Euroland is to rely on automatic demand stabilizers (ADSs) while reverting to the path of its potential growth, as frequently announced by the representatives of the European Central Bank (ECB). The interest rate policy of the ECB indirectly supports such adjustment by reducing the allocative distortions of high and variable rates of inflation experienced in the past by most euro countries, enhancing the rate of their potential growth and speeding up the approach to it.

We argue that ADSs themselves will likely not do their intended job, nor would the opening up of the SGP help. The reason is in the simple notion of the ADSs. When production and income formation contract, automatic transfers such as unemployment benefits from the government to the private sector increase and, due to the progressive income tax schedule, the average income tax rate should automatically be lower. Therefore the fall of disposable income will be smaller than that of pre-tax income which is thought to cushion the initial fall in aggregate demand whatever its source. The decelerating economic activity brings forth looser monetary policy and lower interest rates as counter forces to stimulate aggregate demand again.

This kind of reasoning is blind sophomore macroeconomics of the 1960's. Income transfers are thought to be paid out lump-sum to unemployed workers so that their labour force participation choice would be minimally distorted to facilitate the working of the expansionary monetary policy. In most countries of Euroland in particular, they are conditioned on previous earnings. When part of the earnings related unemployment benefits is not financed from actuarially fair insurance premiums paid by the workers and their employers, but from general tax money, it creates an incentive for moral hazard in the wage setting, thereby increasing the probabilities of bad states-of-the-world occurring and consequently more frequent and longer unemployment periods. Job seekers are also protected from accepting just any offered job, but the one that matches their qualifications. The poverty trap, the effective marginal tax rate of 100 per cent, is the final killer of the incentive to accept a temporary employment: the loss of unemployment benefits and other possible income support schemes together with the income taxes from the temporary employment may mean that the job seeker's post-tax income does not increase after accepting such a job.

In the case of older workers the most important incentive derives from how their prospective old age pension will develop while unemployed and after accepting a new job after a period of unemployment. If pension rights accumulate during unemployment as if one were employed at the previous, good state-of-the-world earnings, the job seeker has no incentive to accept a job offer if his take-home pay over the post-tax unemployment benefit does not compensate a lower old-age pension. This is precisely the effect of various pre-retirement schemes in which politicians pen up the older unemployed. The role of many labour market programs is only to offer a bridge to the pre-retirement schemes.

These features change the optimum of the unemployed workers' remaining life-cycle leisure-work choices from what they were before the shock. Once unemployed they are less willing to accept and search for new job offers. This increases the cost of hiring, lowers investment and leads to new higher equilibrium rate of unemployment.

Therefore the ADSs destabilize production, the supply side of economies. Keynes's effective demand, the production that the entrepreneurs predict to materialise at the intersection of aggregate demand and supply, will therefore decrease due to the force of ADSs and shocks and does not increase as assumed by the simple ADS notion. The opening-up of the SGP would in part only make the destabilizing effect of the ADSs more severe.

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Europe's laws protecting employees against easy firing operate to the same direction. Not only do they cause once laid-off workers to have a more difficult time finding jobs, and therefore a regulated labour market to take much longer to get back to the equilibrium, but the equilibrium rate of unemployment will also be higher.

In fictive models of our science, stricter firing laws do not change the equilibrium rate of unemployment because shocks, negative or positive, are infinitesimal and independent of each others and laying-off is indistinguishable from firing, and businesses can rehire experienced skilled workers. In reality, shocks are sizeable and not symmetrically distributed. Firing is a highly costly activity due to the severance pay and other compensation to unemployed workers. Hiring of new workers is also costly due to training and loss of output while learning. The shocks cause additional one-off costs when some businesses die out, spreading the shock to their suppliers and customers, and totally new firms in totally new business areas get born.

When facing the likelihood of these kinds of shocks, every firm is willing to suffer losses both in a downturn and in a boom (overtime, lost output), in order to avoid reversing its decision and paying twice the fixed cost of the trip either through the unemployment pool or through the shop floor. The more expensive the worker protection laws, the longer are the time spans of losses both in downturns and in booms. Therefore, the relatively shorter are the time spans of positive cash flows from any project, the riskier they are. Thus, the lower is the net present value of any prospective project. The businesses are simply willing to sacrifice less sunk cost and invest less under stricter employee protection laws, raising the rate of equilibrium unemployment of euro economies.

In our analysis, it is the interest rate policy of the ECB which ameliorates these effects. The financing cost of losses during recessions and booms is lower with consistent, credible monetary policy aiming at price stability. Therefore the firms will tolerate losses to last longer and do not fire employees as early as with national monetary policies. This is the phase the euro economies are currently experiencing in their business cycle. Yet, the real test of the ECB will be whether it will deliver Euroland with lower long-term interest rates than the Fed is able to do in the USA, when they eventually shoot up.

The recent rise in the external value of the euro will lessen inflationary pressures in Euroland. But, the ECB will be cautious in cutting its steering rate to not repeat its spring 1999 error and cause unnecessarily variable interest rates. For, the real purpose of monetary policy is credible, low and as non-volatile nominal and real interest rates as possible over the long term, as taught by Keynes in his *General Theory.*