FEDERAL RESERVE BANK OF DALLAS

Issue 4 July/August 2005

Southwest Economy

Globalization and Monetary Policy

Globalization is one of the most debated and analyzed phenomena of our time. Declining trade barriers and advances in technology have made it possible for consumers in the United States and around the world to purchase a variety of goods and services that would have been impossible a generation ago.

Cheaper imports have contributed to higher standards of living, but the growth of trade has also been associated with job losses as production shifts toward lowest cost producers. Freer flows of capital have made it easier for investors to seek out high returns and diversify their portfolios. International capital flows have also made it easier for businesses to raise funds for investment projects by making them less dependent on domestic institutions. Inflows of foreign capital have helped raise living standards in emerging market economies and have also increased the pressure on these countries' governments to pursue sound fiscal and monetary policies.

(Continued on page 2)

INSIDE:
Natural Gas Pricing: Do Oil Prices Still Matter?
•
Foreign Exchange Policy and Banking Reform in China

European Economic Integration: A Conflict of Visions

Economic integration is a key theme of the global era in which we live today. Perhaps the single most important example of such integration in recent decades is the European Union.

From the ashes of the wartime years, six core European nations forged a confederation that gradually grew to encompass 15 members and then 25. As the EU evolved into an economically freer and more integrated group of nations, the overall European economy has grown to the point where it rivals that of the United States (*Chart 1*).

(Continued on page 12)

European Economic Integration

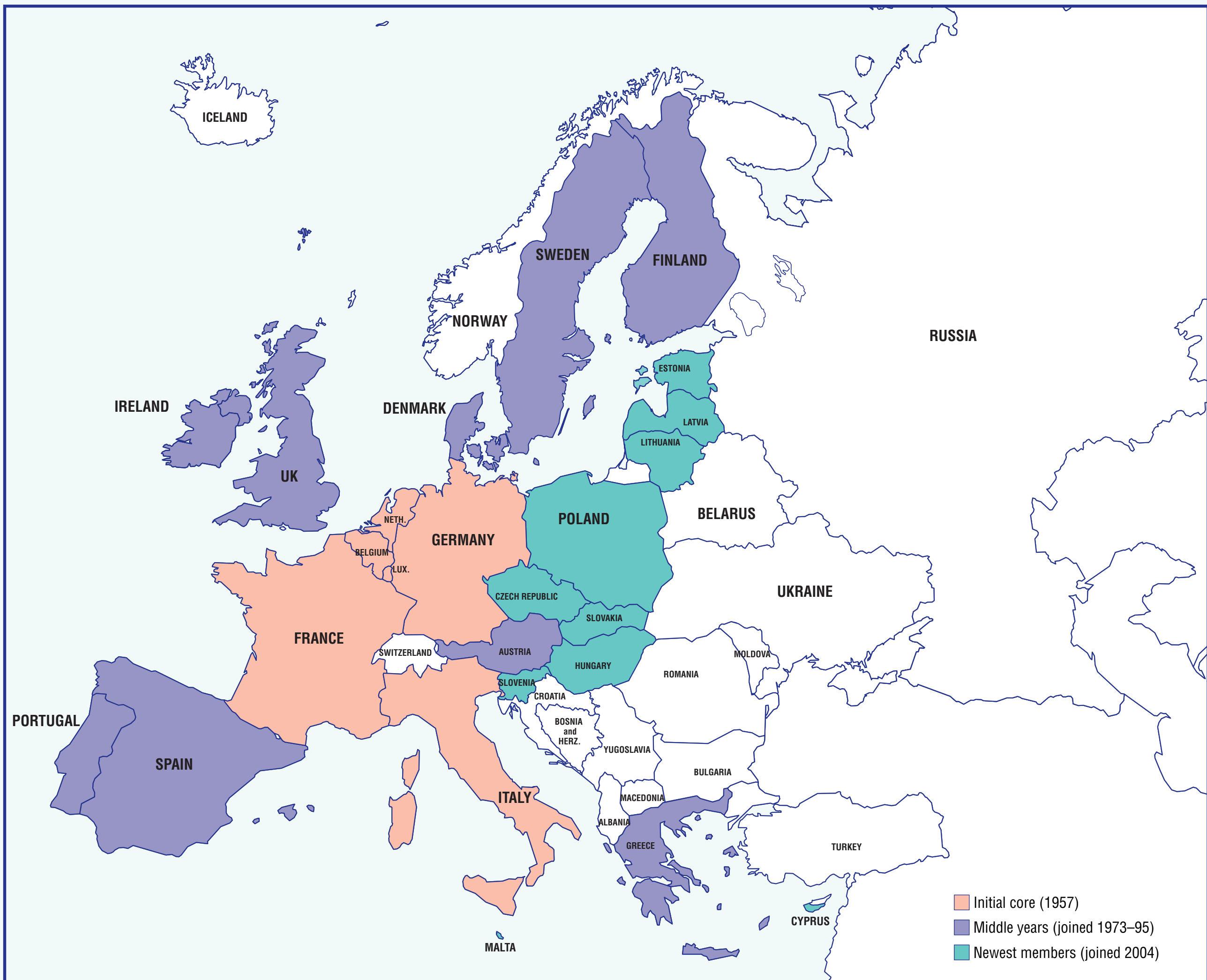
(Continued from front page)

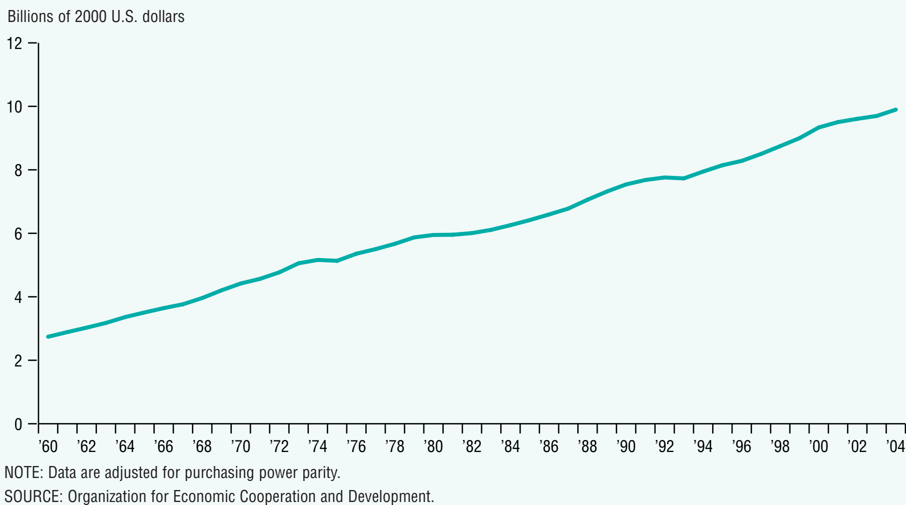
A further step toward economic integration was at stake on May 29, when French voters cast their ballots on a proposed European constitution. The debate had been framed in cataclysmic terms, with proponents arguing that a French rejection could be a "fatal blow" to further European integration. Proponents went on to say that there was no Plan B—implying the French either must approve the proposed constitution or bear responsibility for what former EU President Romano Prodi called "the end of Europe."

French voters rejected the constitution by a 10-point margin, and the Dutch followed suit three days later with an even more resounding rejection of the document. Yet the EU did not end. Indeed, it could not end because its existing treaties and regulations remain in place indefinitely unless superseded by a new governing structure. So in a very real sense, the EU to which French and Dutch voters awoke in June was the same Europe to which they had awoken the month before.

In and of itself, the proposed constitution would have little effect on the overall European economy. Indeed, primary author Valéry Giscard d'Estaing describes its economic provisions as a "tidying-up" of existing guidelines, rather than a renewed effort at economic reform. But the debate that has broken out in the wake of the French and Dutch referendums does have important implications for Europe's economic future and, by extension, the economic future of the United States. The question is simple: To what extent and in what manner should European integration continue?

The Evolving European Union





The Benefits of Economic Integration

Economists generally support economic integration because it eliminates certain inefficiencies. When states in a common market choose different tax and labor policies, for example, workers and businesses have an incentive to move from states where taxes are high to states where they are low. Similarly, those who receive government subsidies have an incentive to move from states where subsidies are low to states where they are high. This migration punishes socially progressive states by simultaneously raising the amount they must spend and reducing the tax revenue available to meet their obligations.

Some believe this competition goes too far. The Organization for Economic Cooperation and Development recently concluded that the developed world should eliminate "harmful tax competition" between states. German Chancellor Gerhard Schröder echoed these concerns in a European Union context, arguing that low tax rates in its newly admitted Eastern members constitute "unfair tax competition." French President Jacques Chirac even coined a new term—"social dumping"—to describe the process by which laissez-faire states import workers and businesses from more highly regulated EU members.

Economics textbooks reveal the solution to this apparent dilemma. If competition between states for individuals and businesses is undesirable, such competition can be reduced or even eliminated through common economic policies. Simply compel all members of a federation to offer the same business climate and social safety net, and neither individuals nor businesses will migrate in search of something that better suits their needs. This would relieve the fiscal pressure on high-benefit states and thereby strengthen what is often called "social Europe." Further economic integration, in other words, is the answer.

But there is more than one kind of economic integration. The North American Free Trade Agreement provides a useful example in this regard. When NAFTA was debated in the early 1990s, many unions felt the treaty should impose U.S. labor and environmental laws on Mexico. Business groups vigorously disagreed, arguing that such a requirement would weaken the competitive forces NAFTA was intended to unleash. The argument was not so much over whether to integrate the U.S. and Mexican economies but how to integrate them.

Much the same rhetoric has been heard in the debate over the European constitution. As Chirac said in mid-April, the EU faces a conflict of visions on how to further integrate members' economies. "The first," he said, is "to go with the Anglo-Saxon and Atlantic liberal current" of low tax rates and flexible labor mar-

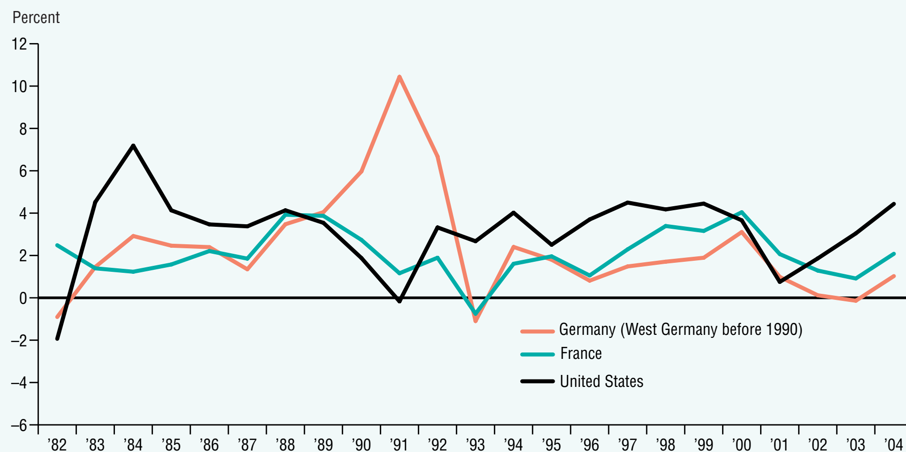
The debate that has broken out in the wake of the French and Dutch referendums on the proposed constitution has important implications for Europe's economic future and, by extension, the economic future of the United States.

kets. "That is not what we want. The second solution is that of a humanist and therefore organized Europe," he concluded, that can "stop the drift toward economic ultra-liberalism."

So it is not economic integration per se that is being debated, because a uniformly low-tax Europe with flexible labor markets would be just as integrated as a Europe that embraces uniformly high tax rates and inflexible labor markets. Rather, the question is what sort of further economic integration Europe will pursue.

If the European economy would be equally productive under either approach, economics would have little to say about these two visions. But this is not the case. It may be true that individuals and businesses could not escape a uniformly high-tax, high-benefit Europe through migration. But individuals could reduce their workweek or leave the workforce entirely, and businesses that would barely survive under a low tax burden would fail if confronted by a higher one. Such individuals and businesses would simply cease to exist as far as production is concerned, becoming either welfare recipients or bankrupt enterprises.

Those are the unspoken economic stakes behind the conflict of visions. In essence, integration along British norms would propel EU members toward a future of high growth and low unemployment, while integration along German norms would drag EU members toward low growth and high unemployment.



Liberalization Versus Economic Integration

Does the evidence support the notion that high-tax, high-benefit economies fare worse than freer economies? A comparison of Europe and the United States sheds light on this question.

Over the past two decades, the U.S. economy has grown at an annual rate of 3.2 percent, while the French economy has grown by barely 2 percent per year (*Chart 2*). Except for a brief spike following reunification in the early 1990s, the German economy has fared even worse.

Unemployment is a good indicator of labor market flexibility, and here, too, the evidence is clear. U.S. unemployment has fallen from 8 percent to 5 percent over the past two decades, while the French and German rates have averaged about 10 percent (*Chart 3*). Although observers commonly point to the current economic performances of France and Germany as proof of the "Eurosclerosis" that besets Old Europe, it is this sustained difference that suggests something more fundamental is at work here. That fundamental "something" boils down to competitiveness.

The various organizations that evaluate the extent to which countries are economically free uniformly conclude that the United States is freer than all or most European nations. Perhaps the most well known of these evaluations is published jointly by the Fraser Institute and the National Center for Policy Analysis. It ranks the United States as the world's third freest economy, with Germany 22nd and France 44th. Rankings published by the Heritage Foundation and IMD International reach similar conclusions.

Why does the U.S. fare so well in these surveys? Simply put, America offers a lower tax burden and a more flexible labor market than France and Germany. The United States has fewer regulations governing the hiring and firing of workers and fewer governing the number of hours an employee can work. This increases the value of workers in the eyes of firms and thereby helps keep unemployment low—and production high. Low tax rates have a similarly laudable effect on the U.S. economy by facilitating business creation and fostering business growth.

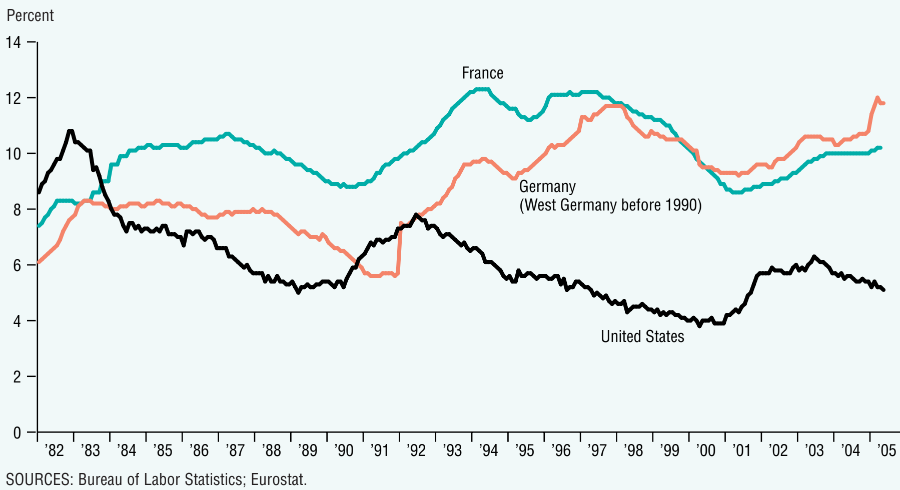
If it is well understood that inflexible labor markets and high taxes cost jobs and retard growth, why do some EU member states seek to impose them at the European level? The answer may lie in the distributional consequences of this choice. If it's assumed that France and Germany will not abandon the policies that encourage businesses and workers to flee those countries, the consequences of those policies can be mitigated by compelling nearby states that would otherwise attract those disgruntled workers and businesses to adopt the same policies. Businesses and workers for whom the economic climate is particularly oppressive might leave the EU entirely, but that is a much more costly decision than simply slipping from one European state to another. On net, the more highly regulated European economies may gain, even though the EU as a whole loses.

Recent evidence points to the same conclusion. Last year the European Union considered a proposal to introduce free trade in services across its member states.[1] With free trade having been a core idea behind the EU's formation, and with the service sector having grown to the point where it now accounts for 70 percent of European output, free trade in services would seem like an almost automatic extension of the ever-closer union that EU policymakers say they seek. Yet the proposal was rejected.

In arguing against it, one European head of state decreed that the continent

Chart 3

French and German Unemployment Climb, While U.S. Rate Falls



SOURCES: Bureau of Labor Statistics; Eurostat.

"must not become a free trade zone," a statement consistent with the vision that Europe must achieve economic integration without further economic liberalization. But it is not consistent with the agenda to which a unanimous EU agreed in Lisbon, where Europe committed to having the world's most dynamic and fastest-growing economy by 2010.[2]

French Prime Minister Dominique de Villepin opined in late June that European leaders must either lead the charge to protect social Europe or else "we resign ourselves to making our continent a vast free-trade area governed by the rules of competition." Whether to accept or resist the "rules of competition," and the prosperity those rules bring, is indeed the choice Europe now confronts.

The Conflict of Visions

These facts by no means imply that European integration to date has been a mistake. As mentioned elsewhere in this article, European integration has facilitated a remarkable rise in Europe's standard of living. Nor do they shed light on whether Europe should or should not voluntarily sacrifice economic growth to achieve social goals it deems important. If Europeans wish to be less prosperous in the future so they can be more equal today, economics cannot call the wisdom of that decision into question. But economics can reveal its consequences.

Consider Singapore and the Soviet Union, and the conflict of visions becomes clear. Singapore is generally considered the freest economy on the planet (even more so than the United States), and its economic growth has been consistently strong. Yet the country has no formal structure anchoring it to the world economy beyond a strong business climate and membership in organizations like the World Trade Organization that promote business activity.

On the other hand, the Soviet Union is generally considered to have been one of the least free economies, and it exhibited weak economic growth for most of its history. Yet its member states were linked with a high degree of economic integration.

The point is that economic integration does not promote economic growth in and of itself. Only economic liberalization can do that. If the 25 members of the EU were to agree to integrate along French or German norms, the fact that the federation had achieved further economic integration would not save its economy from sliding into the night.

From an economic perspective, then, the ultimate fate of the European constitution is less important than the competing visions of the European future the ratification debate has exposed. On one side are countries, led by France and Germany, that believe the European economy should become more highly regulated. On the other are countries, led by Britain and the Netherlands, that believe the European economy should become less highly regulated. How can further economic integration simultaneously satisfy these two competing visions? The simple answer is that it can't.

As British Prime Minister Tony Blair put it, "Should Europe embrace globalization and try and make it work for us, or should we try and ward it off?" That is the question on which the economic future of the EU now rests.

—Jason L. Saving

Saving is a senior economist in the Research Department of the Federal Reserve Bank of Dallas.

Notes

1. Information about the proposal can be found at http://europa.eu.int/comm/internal_market/services/docs/services-dir/com-2000-888/com-2000-888_en.pdf.
2. For more information on the so-called Lisbon strategy, see http://europa.eu.int/growthandjobs/index_en.htm.