

Eur-Only as Sovereign as Your Money

California's Lessons for the European Union*

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When the issue is what policies might be taken to lower unemployment - a high priority in many European Union (EU) countries - or accomplish some other macroeconomic goal, the standard answer of economists is "monetary and fiscal." Of course, there are other policies that might also be cited. But without monetary and fiscal policy, countries are lacking very important macroeconomic instruments.

The planned move to a single currency issued by a single central bank in Europe will remove monetary policy from the control of any one participating country. It might appear that such countries will at least have fiscal policy remaining at their disposal. But what remains of fiscal policy under such conditions will be very limited. Why do I make such an assertion? I make it from California's direct experience.

The California Example

As it happens, I come from an economy containing 33 million people with a per capita income slightly above the U.S. national average. That economy

belongs to the State of California. And as its boosters like to point out, if California were a country, it would rank about 8th among other nations of the world in terms of its gross product.¹ But, of course, California is not a country. It has no currency of its own. Monetary policy is made for California by a central bank whose authorities meet in Washington, D.C., three time zones to the east. California has no special influence over those authorities, despite the critical nature of their decisions for its economy.

Chart 1 plots the annual change in nonfarm employment in California against nonfarm employment in the rest of the U.S. If the two lines appear correlated, it is because they are tightly locked together by internal trade and investment. The U.S. business cycle essentially dictates the California business cycle. Deviations can occur in California. But since 1940, those deviations have largely been functions of military spending. Wars, including the Cold War, have stimulated the California economy because of the state's concentration of aerospace production, especially in the Los Angeles area. Cuts in military spending, on the other hand, have histori-

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¹ This ranking is based on 1995 gross products in U.S. dollar terms at prevailing exchange rates.

Eur-Only as Sovereign as Your Money

cally had a disproportionately negative effect on California's economy.

The California state government, of course, takes in tax revenue and spends its funds. In that sense, the state has a fiscal policy. Indeed, the state's annual consolidated budget runs about \$70 billion at present. But how independent is California in conducting its fiscal affairs? More particularly, what can state government do to stimulate the California economy during periods of macroeconomic difficulties such as high unemployment? The answer is, "not very much".

Colorful History

Indeed, there is a history of tacit recognition of the state's fiscal impotence. In the 1930s during the Great Depression, various colorful populist social and political movements arose in California. They went under such names as EPIC (for "End Poverty in California"), the Utopian Society, and "Ham and Eggs for Californians" and they roiled state politics for several years. A common theme among these interconnected movements was that California should create some kind of state currency to finance additional stimulatory expenditures. Odd as these movements were, their founders had grasped a fundamental truth. Absent its own monetary policy, there was little California could do to get itself out of the Great Depression.²

Lessons from the 1990s

However, it is not necessary to reach so far back into history to see what it means for a large economy such as California's to have no monetary policy. Nor is it necessary to focus on so dramatic an episode as the Great Depression. In 1990-1991, the U.S. economy suffered a brief and mild recession.

Not surprisingly, the California economy turned down at the same time. But the California economy also was hit by the end of the Cold War. Chart 2 shows the marked decline in real U.S. defense spending after 1987. Chart 3 shows the fall in aerospace employment in California that resulted. The compounding of the U.S. recession and the aerospace shock set in motion a major recession in California, far deeper and more prolonged than that of the rest of the country.

Home prices tumbled in the state, an asset deflation for California residents that reduced personal consumption and compounded the recession. And, of course, California unemployment rose well above the U.S. average. One does not have to be an economic determinist to see a connection between these developments and the 1992 Los Angeles riots.

While the U.S. level of nonfarm payroll employment regained its previous peak in 1993, California did not get back to its prior employment peak until late 1995. And, of course, the labor force had continued to grow during 1990-1995 so that unemployment remained high even then. As Chart 4 shows, the California slump left a permanent mark on the state. Compared to the previous growth path, 2.5 million nonfarm jobs were permanently "lost" to the state. So the question naturally arises, what did the state government do about the California recession, given the fiscal resources it had? The answer is that the state government followed anti-Keynesian policies, raising taxes and cutting expenditures. In short, state fiscal policy aggravated the recession; it did not resist it.

The Bond Market Rules

Why was such a perverse fiscal policy followed? The answer to that question is simple. The

² Canada's Social Credit movement had similar elements. This movement took political control of Alberta province but was thwarted in its monetary objectives by the central government.

state had no choice. Since there is no California currency and no California central bank, the state government is limited in the budget deficit it can run. Technically, there are legal requirements that the state balance its projected budget. But it is not the legalities that drive state fiscal policy; it is the bond market. Since California can't create its own currency, it cannot run large deficits without making its securities risky. Lenders demand higher and higher interest rates as state deficits rise to compensate for the risk of default. Eventually, they would refuse to lend at all if the state acted "irresponsibly."

During the California recession of the 1990s, tax revenue to the state naturally declined. Reduced personal incomes cut income tax collections. Reduced profits cut receipts from corporation taxes. Reduced consumption cut sales tax and excise tax revenues. So - in response - California's tax rates were raised and its government expenditures were cut. And much of the expenditure cut fell on social programs.

Political Response

Realizing that no fiscal or monetary solutions were available, state politicians were nonetheless anxious to do "something" to appease their angry constituents. However, all they could do was to try and improve the state's "business climate" and to try and make the state more "competitive" relative to other states. It was hoped that such actions would encourage investment from the rest of the U.S. and deter California businesses from leaving the state.

In the end, there was much symbolic political action. The state legislature became focused on reducing the cost to employers of the workers' compensation program, a mandatory program of insurance which compensates workers who experi-

ence job-related injuries or illness. While the program certainly needed reforms, there was minimal relation between these reforms and state economic performance. For most employers, the change in premiums paid to support the workers' compensation program was too small to affect job creation or retention.

Wages Don't Adjust Easily

In principle, the state might have made itself more competitive by cutting its wages relative to those of other states. Had California been a separate country with its own currency, it might have devalued to achieve that effect. But the only way such labor cost cutting could have been achieved (absent a monetary system) would have been through reductions in nominal wages in California relative to other states.

Did market forces produce such a relative wage decrease? At the start of the recession in 1990, California's annual and weekly wages were 10% above the national average. By 1996, the state's wage premium did drop, but only to 9%.³ That is, there was virtually no relative wage adjustment despite the severity of the California recession. This result is not surprising; empirically-oriented economists have long known that wages are not very responsive to economic slack.

Adjustment Through Migration

So how did California adjust to its unavoidable job losses? The drop in employment was particularly severe in the manufacturing sector, especially for occupations involving just a high school education or perhaps some college or post-high school training. In simple terms, job losers in those categories eventually left the state to look for jobs elsewhere. California, which had historically experienced net in-migration

³ These figures are based on private employment covered by unemployment insurance.

Eur-Only as Sovereign as Your Money

from domestic and foreign sources shifted to net out-migration, as shown on Chart 5. Foreign immigration slowed and domestic migration became negative, although the state's population continued to grow through natural increase (excess of births over deaths).

Now that the California economy has resumed its upward movement (although on a lower track than before), the migration pattern has reversed. California is again experiencing net in-migration. In short, the adjustment mechanism for California is migration, not wages. During booms, people come to California for jobs. During slumps, they leave.

A Europe of Californias?

European states who join the European Monetary System are turning themselves into economic Californias. They are surrendering their economic sovereignty. Of course, they will still be countries with flags, postage stamps, and ambassadors. (California, in contrast, has a flag but no postage stamps or ambassadors.) Whether there are more pluses than minuses in that decision is far beyond the scope of this report. Obviously, the states of the U.S. - including California - obtain many benefits from being within a monetary union. So I am not arguing that the EU shouldn't form a monetary union. However, I am arguing that there are implications for labor policy of the EU's move to monetary unity.

Note first that the level of mobility in Europe between countries is far less than between California and other states of the U.S. There are obvious language and cultural barriers in Europe that do not exist within the U.S. So the migration safety valve that California enjoys in recessions - if "enjoys" is the right word - does not exist in Europe to anywhere near the same degree.

Note second that in the U.S., the major labor and social insurance policies are made at the federal

level. Social Security is a federal program. Unemployment insurance is administered by the states but its broad outlines and funding mechanisms are largely federal. Occupational safety and health standards are federally set, as is the minimum wage. In some cases states can exceed the federal minimum standards if they wish, but they cannot go below them. Thus, although states may cut social programs and protections during recessions for reasons of "competitiveness" - as California did - there are federal limits to what can be cut.

Although the Europe is moving toward EU-wide social policies, the individual member nations are far more important in this sphere than are the states within the U.S. Social insurance, for example, is not provided at the EU level in Europe. That means that during future recessions, if European states compete to improve their business climates (as California did), the potential for social cuts and reduced job protections is much greater than in the U.S. One has to wonder, for example, about the fate of unfunded or underfunded national social insurance programs as the European baby boom ages. Will bond markets permit large government deficits to maintain such programs?

Even Non-Participants Can't Escape

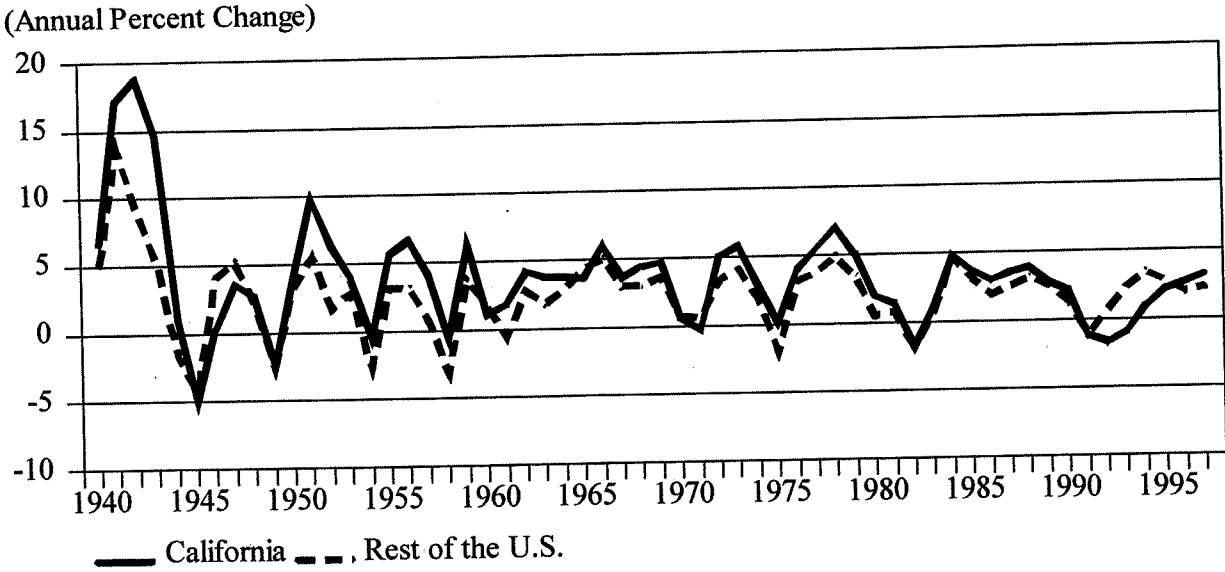
Finally, it should be noted that if the major EU countries become part of a unified monetary system, those countries which remain outside the system may not retain as much autonomy as they expect. Canada, for example, does have its own currency and monetary system. But it is locked into a tight trading relationship with the much larger and unified U.S. economy. Compared with the combined states of the United States, Canada's economy is small. Its gross product is less than two thirds the size of California's. The Canadian business cycle exhibits a somewhat greater degree of independence from the U.S. than does California's. However, it is still the case that Canada's business cycle heavily reflects U.S. economic conditions.

A Profound Social Experiment

Once much of the EU becomes a large, unified, single-currency economy, the economic autonomy of those nations that choose to remain outside will be limited, just as Canada's autonomy is limited. And those countries inside the monetary union - even those such as France which put great weight on cultural sovereignty and social policy - are surrendering their

economic sovereignty. In short, the EU - whose roots go back to a trade agreement of the 1950s - is now embarked on a profound social experiment. The experiment has important implications for employment practices and social policy. And it may be that other world trade blocs will eventually consider integration of their monetary systems along EU lines.

**Chart 1: Annual Percent Change in Nonfarm Payroll Employment:
California and the Rest of the U.S., 1940-1997**



Source: U.S. Bureau of Labor Statistics

Chart 2: Real U.S. Defense Spending

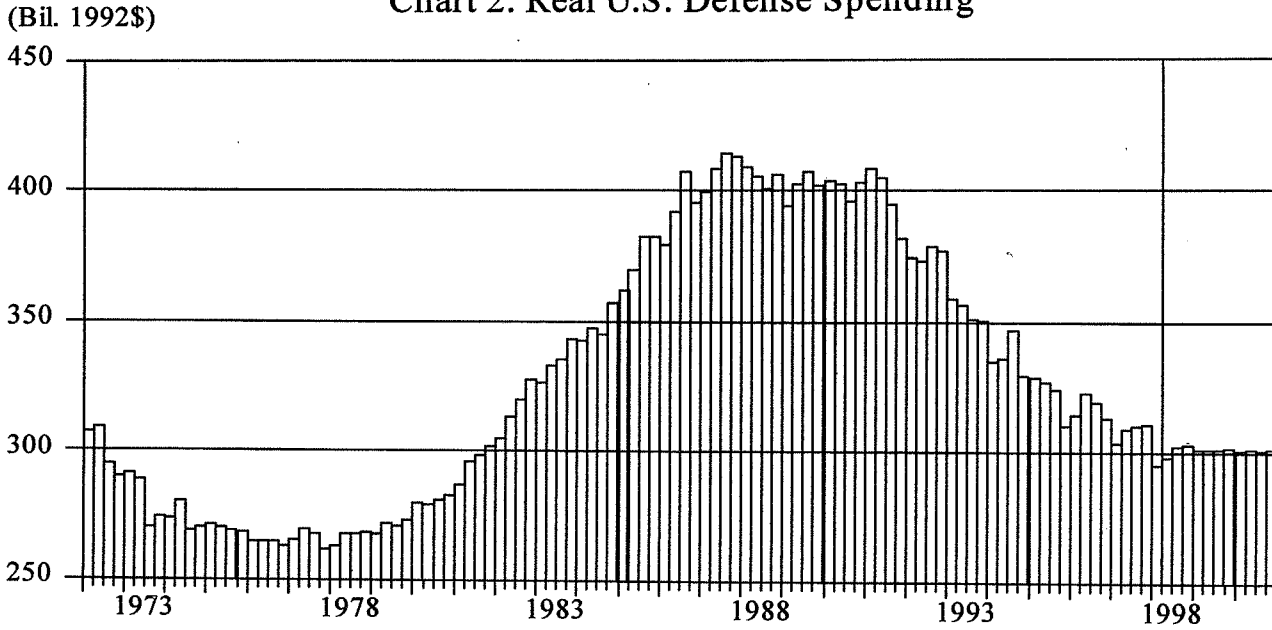
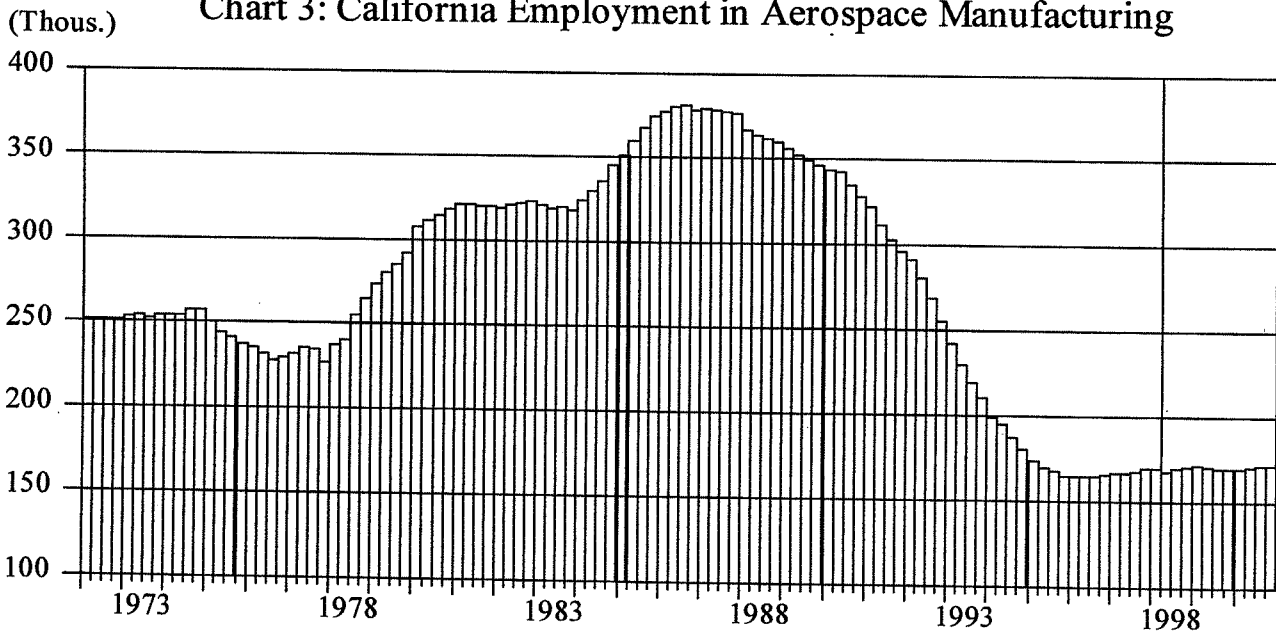


Chart 3: California Employment in Aerospace Manufacturing



Source: UCLA Anderson Forecast, June 1998

Chart 4: California Nonfarm Employment: Actual and Hypothetical 3% Trend from Third Quarter of 1990

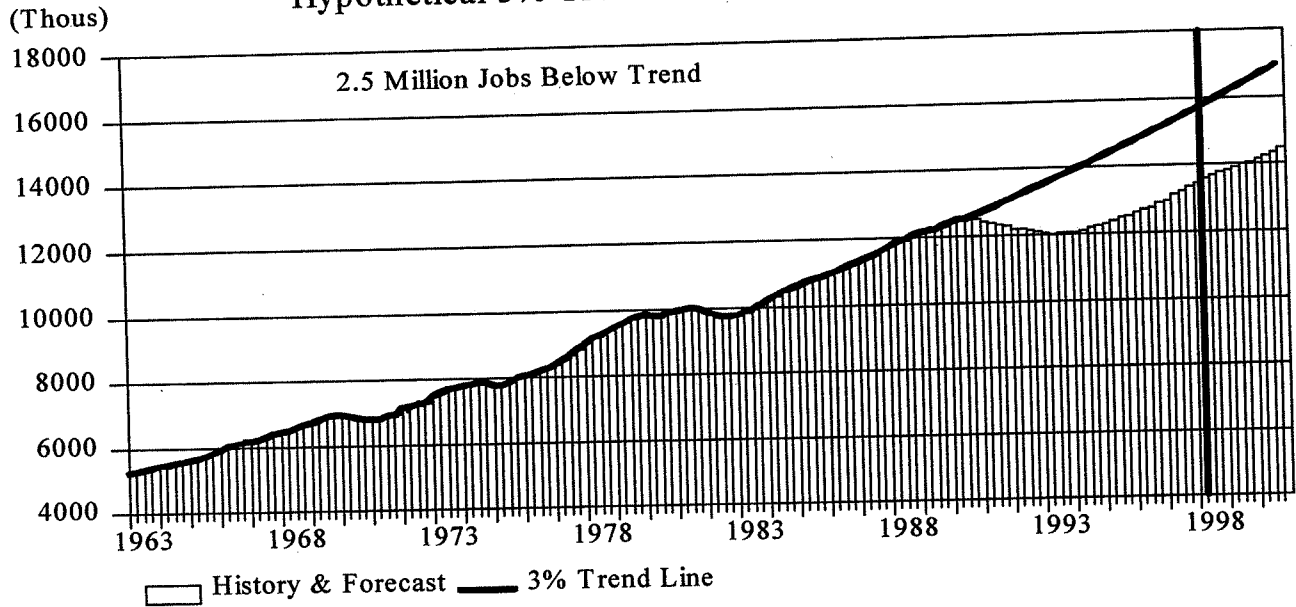
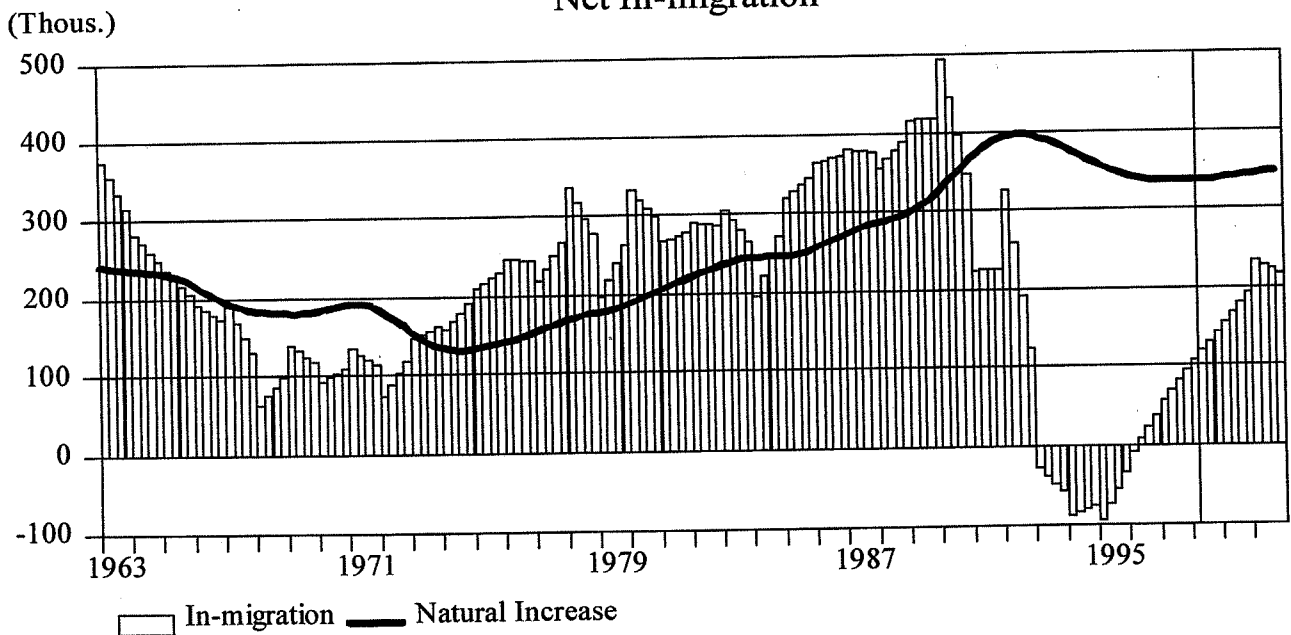


Chart 5: California Net Natural Increase and Net In-migration



Source: UCLA Anderson Forecast, June 1998

THE UCLA
ANDERSON
FORECAST



June 1998

THE UCLA ANDERSON FORECAST

FORECASTS:

FOR THE NATION AND CALIFORNIA

2nd Quarter 1998

4th Quarter 2000

47th Year

