Institutional requirements for full employment in advanced economies

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Institutional Requirements for Full Employment in Advanced Economies [1]

> The problem of maintaining equilibrium in the balance of payments between countries has never been solved . . . the failure to solve this problem has been a major cause of impoverishment and social discontent and even of wars and revolutions . . . to suppose that there exists some smoothly functioning automatic mechanism of adjustment which preserves equilibrium if only we trust to matters of laissez faire is a doctrinaire delusion which disregards the lessons of historical experience without having behind it the support of sound theory. (J.M.Keynes)[2]

I. Introduction: The Analytical and the Policy Context

In the 1980s, fifty years after the Great Depression industrial countries came again to be haunted with the spectre of mass unemployment. The unemployment situation, into the 1990s, continues to be dire in several European Union countries. Double digit unemployment rates are currently being recorded by Belgium, Denmark,

[1] I am extremely grateful to Brian Reddaway for his detailed comments on the first draft of this paper. I have also benefitted from discussions with John Eatwell and Bob Rowthorn. The usual caveat applies.

[2] Moggridge (1980), pp. 21-22.

France, Italy, with near double-digit rates in several others including Britain, Germany and Sweden. On the most recent available official data, nearly a quarter of the labour force in Spain and Finland are unemployed.[3] As the recent OECD jobs study[OECD 1994] noted, the 35 million people presently unemployed in the member countries "represent an enormous waste of human resources, reflects an important amount of inefficiency in economic systems, and causes a disturbing degree of social distress".

The OECD study estimates that unemployment in the form of involuntary part-time work, short-time working and the discouragement of job seekers from looking for new employment could add 40 to 50% to the unemployment figures outlined above. Apart from economic inefficiency, the study rightly notes that mass unemployment does enormous damage in other ways. "It brings with it unravelling of the social fabric, including a loss of authority of the democratic system and it risks resulting in the disintegration of the international trading system." It is important to stress this social dimension of unemployment since professional economists in their dispassionate and objective studies are prone to overlook it. Whether or not there is a link between joblessness and crime, there is evidence that unemployment leads to social degradation, is associated with health problems, lower self-esteem, is de-motivating and creates

[3] The source of these data which for most countries pertains to September or October 1994 is The Economist, 5 November, 1994.

insecurity and resistance to organisational and technical change.[4]

The current mass unemployment stands in striking contrast to the situation which prevailed in the industrial countries in the not too distant past. During the 1950s and the 1960s, leading industrial countries not only enjoyed full employment but had over-full employment. In addition to being able to employ all their own people, these countries also provided jobs for additional labour from abroad. In countries like France and West Germany nearly 10 per cent of the labour force came from other nations.

The period 1950-1973 has been aptly described as the Golden Age of the world economy. In the advanced economies during this period, there was a historically unprecedented expansion of production and consumption at a rate of nearly 5 per cent a year. This was accompanied by a huge increase in world trade, particularly in the export of manufactured products, The latter grew in volume terms at a very fast rate of nearly 10 per cent a year. Most developing countries also participated in and benefitted from this world wide prosperity. Many Asian and Latin American countries embarked on a veritable industrial revolution in these post-war decades.

The Golden Age of simultaneous prosperity for the North and the South

[4] For evidence see OECD (1994) and Clark and Oswald(1994).

evidently came to an end with the first oil shock in 1973. Since then, the rate of growth of the OECD and the world GDP has nearly halved. Significantly, the recorded rate during the last twenty years is much more in line with the long term trend rate of growth of industrial countries in the hundred years before the Golden Age. (Reynolds, 1983; World Bank, 1987). It is therefore not surprising to find the high rates of unemployment recently experienced by the OECD -- rates which were unthinkable in the preceding period. It is for the same reason, that for a large number of countries in the South, in contrast to the industrial revolution, greater employment opportunities and significant rises in the average standard of living of the Golden Age, the last fifteen years have been marked by de-industrialisation, considerable falls in per capita incomes and much increased under and open unemployment[5]. The end of the Golden Age has also coincided with a significant deceleration in the expansion of world trade in manufactures.

In view of its magnitude, durability, and intractability so far, the unemployment problem today is at the top of the political agenda.

[5] There have been important intercontinental differences in the economic experience of developing countries in the 1980s and into the 1990s. During the last decade, whilst Asian countries continued with their previous momentum of rapid industrialisation and development, economic growth collapsed in Latin America and Sub-Saharan Africa. Between 1980 and 1990 per capita income fell on average by 10% in Latin America and by as much as 25% on average in the Sub-Saharan African countries. In contrast, the Asian countries recorded on average a more than 50% increase in their per capita incomes. See further Fishlow(1992), Singh (1993,1994).

During the last two years it has drawn serious attention at G7 summits and at meetings of the European Council. There have been important official documents, for example the European Commissions White Paper of December 1993 and the OECD study of joblessness, referred to above. The subject has also led to a staggering amount of academic economic literature in the recent period. [For recent reviews, see Bean, 1994; Elmeskov, 1993]. However, this literature is very far from having produced either an analytical or a policy consensus. Nevertheless it will be fair to say that to the extent that there is any agreement among economists, it is on a negative point, with most of them believing that the restoration of sustained full employment in industrial countries in the foreseeable future is utopian and impractical. The weight of opinion seems to be that, unless entirely new instruments and policies are introduced, unemployment can, at best, only be significantly reduced from its present high levels, but it cannot be eliminated in the way it essentially was during the Golden Age.

This paper outlines what shape such new instruments and policies would need to take in order not just to reduce unemployment but to restore full employment. [6] It also departs from much of the

[6] The concept of what constitutes full employment is of course highly controversial, both analytically and empirically. Many economists would define full employment in terms of the "non-accelerating inflation rate of unemployment" (NAIRU) or the "natural rate of unemployment". (See section VI for an analysis of these concepts). The present paper does not share these conceptions and regards full employment and price stability as two related but

literature by adopting an explicitly historical and institutional approach to the analysis of mass unemployment. It focuses on the Golden Age of full employment in the North and the harmonious development of the North and the South, to ask the questions: Why did the Golden Age of plentiful jobs and fast growth arise? Why did it come to an end? What lessons can we learn from it for the present? The basic theses of the paper may be summarised as follows:

*It is not possible to explain the Golden Age economic boom simply as a product of a chance combination of favourable circumstances.

*Rather the Golden Age was the outcome of a unique economic regime - a new development model - which was very different from that prevailing in the inter-war period, and also from the one which has been instituted in the last decade and a half.

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independent objectives (Meade 1993). Therefore, for the purposes of this exercise, full employment is taken to be synonomous with low or negligible levels of "involuntary" unemployment. In more practical terms, Beveridge's (1944) definition of full employment still has considerable merit. Beveridge defined full employment as a state of affairs where there are slightly more unfilled vacancies than the number unemployed, and "that the jobs are at fair wages, of such a kind, and so located that the unemployed men can be expected to take them". This definition implies that "unemployment at any time is due to the normal lag between a person losing a job and finding another". Eatwell (1994) proposes a useful amendment to the definition: he suggests that the "discouraged" workers should added to the number unemployed. On that basis, Eatwell estimates that in 1993 in UK there were over four millions inactive workers (2.8 million officially unemployed and the rest discouraged workers) as against the total number of vacancies of little over 100,000. See further Worswick (1987), Blinder (1988), Meade (1993), Eatwell (1993), Britton (1994), Singh and Zammit (1995).

*The Golden Age economic regime was not a spontaneous development, but reflected in part a carefully designed stragegy. It involved gigantic institutional innovations by leading industrial countries at both the national and at the international levels.

*The demise of the Golden Age was due to events overtaking the existing institutional framework. For the Golden Age to have continued, the system required some of the extant institutions to adapt to the new situation. But it also needed the building of fresh institutions.

*An analytical and historical examination of the Golden Age has important policy lessons for the task of restoring full employment in industrial countries today. The implied policy proposals are, however, rather different from those which follow from the conventional analyses of unemployment.

II. Current Unemployment in Historical Perspective: Empirical Phenomena to be Explained

Tables 1 and 2 bring out some of the main features of unemployment, employment, output and productivity growth in industrial countries during the last three decades. The main points which emerge from these tables may be summarised as follows:

1. Unemployment There has been a huge trend increase in unemployment in the post-Golden Age period in all leading industrial countries, including the United States. (Table 1). However, the rise has been much greater in Europe than in the US. The West German case is particularly striking, as average unemployment there during the last decade of the Golden Age was only 0.79% of the labour force; it rose eight-fold in the decade 83-92. These empirical phenomena raise for analysis the following questions.

-Why has there been such a large trend increase in industrial country unemployment during the last 15 years, compared with the Golden Age?

-Why unemployment has risen more in European Community countries than in the US?

-Why has unemployment risen much less in non-EEC European countries than in EEC Europe?

The last point is not evident from table 1, but emerges from the more detailed data provided by Bean(1994). These data show that not only US but also a number of Nordic countries did relatively well with respect to unemployment in the 1980s and early 1990s.

2. Employment The data in Table 2, and other available information not presented in the table, reveals the following additional aspects of industrial country unemployment since 1973.

a. The rise in unemployment in industrial countries in the post-Golden Age period has, in large part, been associated with an increase in the supply of labour.

b. The increased supply of labour is almost entirely due to a rise in the participation rates of women, rather than due to a faster population growth or immigration.

Thus it would seem that after 1973, women have been gaining jobs while men have been losing them. However, as Howes and Singh(1994) have argued, that given a persistent gender division of labour, mass unemployment in industrial countries should be attributed partly to separate forces operating on men and women: on the one hand, the rate of growth of men's jobs have fallen, while men have not withdrawn from the labour force at a comparable rate; women, on the other hand, have been entering the labour force at very high rates, but demand for female labour, though rising, has failed to keep up. Thus in the Howes and Singh analysis, high aggregate rates of unemployment arise both from high rates of labour force participation by women, and, importantly, also from 'deindustrialisation'. The two authors suggest that the differences in unemployment rates between countries and between men and women are largely due to differences in the rates of these two processes.

3. Output and Productivity The aggregate data in Table 2 show that although GDP growth in Japan, US and OECD Europe fell after 1973, the rate of growth of productivity fell even further. Consequently, the net rate of aggregate employment creation in these countries(see column 3 of table 2) is little different in the post-1973 period, from that during the Golden Age.

However, this aggregate result hides the important fact that in most industrial countries, the rate of job creation in both manufacturing and services has decreased after 1973, compared with the Golden Age.[7]

The above data on productivity growth also bears on the extremely important question of how far the high unemployment in the post-Golden Age period can be attributed to an acceleration in the rate of technical progress. Freeman(1989) has argued that the current revolution in information and communications technology is similar in its pervasive all around effects on the economy to the previous three major technological revolutions of the last two centuries. However so far this technical change is not reflected in the increase

[7] Howes and Singh note that during the Golden Age, the faster growth of manufacturing and service jobs was able to absorb the large reductions in agricultural employment which occurred. There is a reduced decline in agricultural employment in the post-1973 period, which may, in itself be in part due to the slower growth of available manufacturing and service jobs.

in productivity growth as one would expect. Disaggregated data for individual countries and regions also indicates an almost universal trend fall in productivity growth in the period 1973-87 compared with 1960-73(Singh, forthcoming; see also below). All this suggests that either the pace of technical progress is no faster than before, or that the full benefits of these technological achievements have not been realised. In either case, acceleration of technogical progress cannot be blamed for the increase in unemployment.

4. Inflation The data on inflation presented in Table 3 shows that the rate of inflation greatly increased in all leading industrial countries in the decade following the Golden Age. However, since then inflation has come down and during the last ten years the average rate of price increases has been much the same as during the Golden Age.

To sum up, the post-Golden Age economy in industrial countries has fared much worse than the Golden Age in terms of output expansion, productivity growth and employment. However, if we take a longer historical perspective (over a century or more), the economic record of the last two decades appears in a very favourable light.(Matthews and Bowen, 1988). In such a long term quantitative perspective, it is the Golden Age which stands out as a historical aberration.

III. **What Made Full Employment Possible? the Institutional**

Framework of the Golden Age

Kaldor(1976) observed: "The first twenty-five years after the end of the Second World War were an exceptional period of economic growth and prosperity in the leading industrial countries . . . I think I can safely say that almost no-one expected this to happen, since it was in such marked contrast to the course of events after World War one. This time there was no post-war slump." (emphasis in original, page 516).

However, although there are many studies of why the Golden Age came to an end, economists have paid much less attention as to why the Golden Age happened in the first place. Yet, as Matthews and Bowen point out in their study of post-war macroeconomic trends, this phenomenon "needs explanation at least as much as the far more studied deterioration after 1973. Like most recent authors, we shall have little to say about it, beyond pointing out its importance". In quantitative terms the significance of the Golden Age cannot be exaggerated. Measured with respect to the rates of growth of output, productivity, capital stock, the period 1950-73 in advanced economies as a whole unquestionably represents a highly distinct deviation from the long-term trend values of these variables over the last two centuries. (Maddison, 1982).

We present here in a summary form the comprehensive analysis of the

Golden Age by Glyn,Hughes, Lipietz and Singh(1990). For reasons of space, what follows is necessarily a highly schematic and condensed account of the investigation of a rather large question: why did the Golden Age arise and why did it come to an end? First, Glyn et al show on the basis of a detailed examination of the data that the length, steadiness, speed and spread of the Golden Age economic boom was such that the these could not be accounted for by an accidental combination of favourable economic circumstances. Secondly, they contend that the extraordinary economic performance of industrial countries was brought about and sustained by a specific economic regime. This regime, which differed in very important respects from the inter-war pattern of development, made full employment of labour force and full utilisation of resources, a primary objective inter alia for the governments to pursue.

How this regime came to be instituted out of the ruins of the Great Depression and the Second World War is a complex question. At the international level, however, the answer is fairly straight forward. Careful plans were made by the United Kingdom and the United States governments during the course of the war. Specifically, Article 7 of the Mutual Aid Agreement, signed in February 1942, committed the governments of the US and the UK to international co-operation after the war, and to embody in that co-operation two obligations, (i) the freedom of trade and (ii) the pursuit of full employment. Scammel(1983).

This planned, new, post-war international economic order accorded with the national security conceptions of the US State department and particularly of Secretary Cordell Hull. A pre-war State department memorandum outlines these concepts as follows: "A great expansion in the volume of international trade after the war will be essential to the attainment of full and effective employment in the United States and elsewhere, to the preservation of private enterprise, and the success of an international security system to prevent future wars". Gardener(1969). Secretary Hull and his colleagues felt that the protectionism of the inter-war period was responsible both for mass unemployment and the deterioration in the international security situation, ie. that protectionism led both to unemployment and to war, and that the best guarantee against either was the institution of a liberal international capitalist regime.

It is highly significant that full employment is a recurring theme in most official documents of the new post-war international economic order. Thus, for example, the contracting parties to GATT in the very first clause of the Preamble declared themselves as:
"Recognising that their relations in the field of trade and economic endeavour should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, developing the full uses of the resources of the world . . ." (emphasis added). Thus, under

GATT, free trade was not regarded as an end in itself. The paramount importance of other objectives such as full employment and steady growth of real incomes and effective demand were explictly recognized.

Turning to the national rules of co-ordination, the establishment of the Golden Age economic regime had a great deal to do with the post-war historical conjucture which was characterised by contention between the liberal, free market world economic order led by the United States and the alternative, represented by the then triumphant Soviet Union. It will be recalled that at the end of the second world war, the Soviet model had important attractions for people in Western Europe. The country had just played a critical role in defeating fascism; the crimes of the Stalin era had not yet been revealed. Equally importantly, compared with the mass unemployment in the inter-war period in the industrial countries, Soviet planning was regarded as having achieved full employment of resources. (see further Glyn et al, 1990). Although the West European trade union movement was weakened by its split into communist and christian blocks, nevertheless, in the context of this contention between the two systems, it was able to achieve far reaching institutional changes which, as will be explained below, were critical to the success of the Golden Age regime.

At a purely descriptive macro-economic level, Glyn et al show that the Golden Age was characterised by two extremely important relations: (a) rapid and parallel growth of productivity and capital stock per worker; and (b) parallel growth of real wages and productivity. The significance of these two relations is that they guarantee both a roughly constant profit rate and roughly equal growth of consumption and production, thus ratifying and maintaining the initial rate of accumulation.

However, such a macro-economic growth path could only be perpetuated if it were compatible with the behaviour of individual economic agents - firms, workers, consumers. This compatibility in the Golden Age was insured by a social consensus around institutional arrangements in respect of setting of wages and prices, the distribution between wages and profits, and the state fiscal, credit and welfare policies which guaranteed minimum living standards and maintained aggregate demand. In the sphere of wage setting, for example, productivity wage bargaining which flourished during this period played a key role both in keeping a rough constancy of the share of wages and profits in the national product and also in helping to provide an adequate rate of growth in consumer demand. Similarly, at the international level, under the leadership of a singe hegemonic power for much of this period, the US, the global economic system functioned under stable monetary and trading arrangements.

It is sometimes contended that because the US economy itself did not perform as well as other industrial countries in the Golden Age, this suggests that all that happened during this period was a process of 'catch-up'. It is indeed true, that unlike the European countries and Japan, the rate of growth of GDP for the US during the Golden Age, was not higher that in any previous period. However, the US rate of growth of productivity (measured by GDP per man-hour) was faster than ever recorded before, although again for this variable, the European and the Japanese performance during the Golden Age was far superior. These facts are compatible with the 'catch-up' theory, but what is not compatible is the fact that almost as big a gap (and hence the scope for 'catch-up'), between US and European levels of productivity existed at the start of the First World War in 1913, as it did in 1939 (Matthews and Bowen, 1988; Cairncross and Cairncross, 1992). In other words, there was no 'catch-up' at all in the inter-war period. What made it possible in the post-World War II period was not merely the existence of a technological gap, but more crucially, the institutional system at the national and the international levels which allowed this technological potential to be harnessed.

IV. The Erosion of the Golden Age and the New Post-1980 Development Model

Glyn et al suggest that the process of the erosion of the Golden Age began well before the oil price shock of 1973. Serious difficulties arose at the levels of both the national and the international regulatory regimes; these began to interact with each other in a cumulatively adverse way to the detriment of the system as a whole. The Bretton Woods monetary system broke down in the late 1960s, partly as a consequence of the success of the Golden Age itself - the rise of the Japanese, the West German and other European countries in the international market place led to serious balance of payments problems for the US, hitherto the lynch pin of the international system. There is also evidence of a slow-down in the growth of productivity by the late 1960s in several leading industrial countries, which was not matched by a deceleration in the rate of growth of real wages, thus leading to a profit squeeze.

By the early 1970s, the Golden Age system was so fragile, that it disintegrated under the impact of the two oil shocks, thus pushing the world economy into a period of prolonged slow growth which began in 1973. The social consensus of the Golden years which was crucial to the functioning of the economic system as a whole broke down. For a while, after the first oil shock, the governments of some OECD countries tried to restore the Golden Age institutional consensus, by following expansionary economic policies. But, since inflation could not be controlled, this attempt was finally abandoned in 1979.

V.2 The Post-1980 Development Strategy

This abandonment was symbolized by the so-called 'Volcker shock' (named after the then Chairman of the U.S. Ferderal Reserve, Paul Volcker). This involved the implementation of deeply contractionary monetary policies in the United States, which were subsequently widely followed in other industrial countries, largely by a process of 'competitive deflation'. Singh (1986). These policies led to a more than ten-fold jump in real interest rates compared with the preceding period and gave rise to a prolonged recession in industrial countries.

The effects on the Third World countries of these measures was devastating. They were disadvantaged through the following main channels: a) a reduced rate of growth of demand for the South's products in the North; b) as a consequence, a big fall in commodity prices and adverse terms of trade; c) a large rise in debt service payments; d) a sudden and a huge fall in normal capital flows to the South, particularly to the African and Latin American economies. [Dornbusch, 1985; Fishlow, 1992; Singh, 1992.] The net result has been a long economic crisis and the 'lost decade' of the 1980s for large parts of the South.

In the 1980s and into the 1990s, the leading OECD governments have been attempting to create a new economic system based much more on free market principles. In pursuit of this objective, there has been a widespread movement towards "privatisation", "de-regulation" and the erosion of Golden Age arrangements with respect for example to wage bargaining and to the provisions of the welfare state (with the professed aim of increasing labour market flexibility). Moreover, in the adoption of rules about monetary growth and public sector deficits in most countries, there has been an implicit abandonment of the full employment policies of the Golden Age. The countries of the South have also had to implement similar arrangements in order to meet the conditionalities of the Bretton Woods institutions.

The retreat from the Golden Age institutions and customs with respect to employment protection, labour standards, welfare state privileges, trade union activity, has inevitably occurred at different speeds in various European countries. However the UK seems to have gone further than most in the direction of adopting this new post-Golden Age development model of market supremacy and labour market flexibility. UN (1994). At the international level the new economic regime is characterised by ever greater integration of the world economy through trade, portfolio and foreign direct investment. Close international financial integration has been a particularly significant feature of the post-1980 world economy. Such integration has been brought about by the more or less complete abolition of exchange controls in leading industrial economies and the globalisation of the stock markets. (Cosh, Hughes and Singh, 1992).

The post-1980 development model has been successful in some ways - the most conspicuous being the sharp decline in the OECD rate of inflation. Instead of 'stagflation' of the 1970s - ie. low growth and high inflation - the 1980s and the 1990s so far, have been characterised by low growth and low inflation. However, this 'victory' over inflation has come at an exceptionally high cost in terms of social justice and economic efficiency. The extension of the role of free markets in the name of efficiency has, paradoxically, generated massive inefficiency characterized by a huge underutilization of resources worldwide, not least human resources. It is therefore not surprising that the new free-market model does not yet command a broad social consensus in industrial countries.

V. The Analytics of the Fall of the Golden Age

In their conceptualisation of the demise of the Golden Age, Glyn et al emphasise the role of the following factors.

1. The perpetuation of the Golden Age of full employment and low growth required the smooth and consistent operation of both the internal and external rules of coordination of the economic system . As long as the system was working, it had strong positive feedback mechanisms. However, it was an unstable equilibrium - relatively small exogenous shocks or changes in endogenous variables outside

their normal range could push the industrial country economies off the high employment growth path.

2. One factor which plays a key role in Glyn et al's analysis is that of productivity slow-down towards the end of the 1960s in industrial countries.[8] There was no institutional mechanism for there to be a concomitant reduction in the rate of growth of real wages. The result was a profit squeeze which was further exacerbated by international factors such as the rise in raw material prices in the early 1970s.

3. The breakdown of the Bretton Woods system and the international rules of coordination meant that the balance of payments disequilibria between nations, arising from the first oil shock, could not be resolved at a rate of growth of world demand in real terms which was compatible with full employment and low inflation. Most economists at the time believed that introduction of floating exchange rates will make the system more flexible and remove an important restraint on economic growth. In practice this turned out to be an illusion and the asymmetrical adjustment processes of

[8] Matthews and Bowen(1988) agree that the 'watershed' - the trend change in long-term economic growth - came before 1973. The two authors, as well as Solow(1992), also underline the significance of the productivity slow-down in the late 1960s. Section V of Glyn et al's essay provides a systematic comparison of their analysis of the various aspects of the Golden Age with that of Maddison(1982), Lindbeck(1983), Bruno and Sachs(1985) and others.

the international economic system soon reasserted themselves. Countries which followed Keynsian expansionary policies in the wake of the oil price increase became balance of payment constrained and were faced with the prospect of currency depreciations in inflationary conditions. The simultaneous breakdown of the internal rules of coordination with respect to wages and prices made it more difficult to use exchange rate movements as an equilibriating device in the international sphere.

4. In the analysis presented by Glyn et al, the Golden Age would have come to an end through its own internal logic even if there had been no exogenous shocks, such as the oil price increases. The efficiency of the central institutions of the Golden Age economic regime became progressively eroded the longer the system was in operation. Internally, the prolonged full employment increased the power of the workers and through their successful wage demands undermined the social compromise with the employers. Similarly, the international coordination became much more difficult with the relative economic decline over time of the United States, the hedgemon in the system. The continuation of the Golden Age would have required institutional renewal to address these difficulties of the economic regime.

VI. Conventional Economic Analysis and Mass Unemployment

In order to put into perspective the institutional analysis of the economic record of the Golden Age and its aftermath, it may be useful to see how successful are the conventional economic models in accounting for the long-run variations in employment, unemployment, inflation and productivity in industrial countries. The following points are relevant in this context.

1. Jacob Frankel and Harry Johnson in their then highly influential book, <u>The Monetary Approach to the Balance of Payments,</u> published in 1976, observed:

> "That the monetary approach (to the balance of payments) largely assumes a fully employed economy is partly the result of the fact that in the context of a growing world economy in the long run, the assumption of wage rigidity and variable employment becomes uninteresting; either employment expands into the full employment range and quantity adjustments yield to money price and wage adjustments, or it contracts and people starve to death and go back to full employment numbers, or there is a revolution on Marxist lines, or more likely the public simply votes for the other political party than the one in power, since all of them maintain full employment and the public expects them to do it ...... More fundamentally, the assumption of normally full employment reflects the passage of time and the accumulation of experience of reasonably full employment as the historical norm rather than the historical rarity that Keynes's theory and the left-wing Keynesian methodology made it out to be."

In other words, these distinguished economists of the Chicago school were taking the Golden Age of full employment as the norm for a capitalist economy, and were asserting that there is sufficient wage-price flexibility for the labour markets to yield full employment. Later these types of analysis were formalised in the 'new classical' models which postulate full employment in the way attributed to the proverbial caricature of economic modelling: "let us assume that there is a can opener". Despite the obvious lack of perfect competition in the labor market, the simple formal argument is of course that the labor market is fully competitive, and behaves like any other such market. The market clearing process leads to full employment, and any unemployment must therefore be voluntary. The main conclusion of the more complete analysis from this paradigm is that unemployment is always at its natural rate bar any unanticipated shocks to the economy - i.e. there is no trade-off at all between unemployment and inflation either in the short or the long runs.

2. The left Keynsian-Marxist position on the subject was put forward fifty years ago in a brilliant essay by the Polish economist, Michael Kalecki. Kalecki (1943) wrote: "'Full employment capitalism' will have, of course to develop new social and political institutions which will reflect the increased power of the working class. If capitalism can adjust itself to full employment a fundamental reform will have been incorporated in it. If not, it will show itself an outmoded system which must be scrapped. .....But perhaps the fight

for full employment may lead to fascism? Perhaps capitalism will adjust itself to full employment in this way? This seems extremely unlikely. Fascism sprang up in Germany against a background of tremendous unemployment and maintained itself in power through securing full employment while capitalist democracy failed to do so. The fight of the progressive forces for full employment is at the same time a way of preventing the recurrence of fascism."

Kalecki was sceptical about the possibilities of permanent full employment in capitalist economies with their extant institutions. The main reason for his scepticism was his view that unemployment, or the reserve army of labour, had an essential disciplinary role under capitalism. Unless different institutional mechanisms were available
to perform this task, capitalists will oppose the achievement of prolonged full employment by Keynsian means.

3. It is necessary to emphasise that none of the leading economic models - the traditional Keynsian, new classical, neo-Keynsian (NAIRU) - can on their own satisfactorily explain the stylised facts about inter-temporal and inter-country variations of unemployment during this century. With respect to the former, recall from section II, that the main empirical phenomena that require explanation are the following combinations of unemployment and inflation: (a) Mass unemployment with low inflation during the inter-war period; (b)

full employment and moderate inflation during the Golden Age; (c) stagflation of the 1970s and (d) mass unemployment and moderate inflation during the last decade. In relation to inter-country variations, the chief contemporary issue is why unemployment is so much higher in EEC countries than either in the US or the non EEC nations.

4. This subject cannot be discussed in any detail here but it may be observed that the models which look for explanation of these phenomena in the labour market are unable to account for much of the inter-temporal variation. For example Matthews and Bowen (1988) point out that real product wages rose more and there was less labour market flexibility in the Golden Age than in the inter-war period. Yet the earlier period experienced the Great Depression and the later had full employment. Similarly, the traditional Keynsian-Phillips curve models broke down in the stagflation of the 1970s.

5. Some argue [see for example Krugman, 1994] that the leading mainstream models today are all based on the concept of NAIRU.[9] However, such models have great difficulty in accounting for the facts of the Golden Age. For twenty long years, in the 1950s and 60s there was full employment, or even overfull employment in

[9] See Layard et al (1991), for an authoritative exposition of the NAIRU analyses.

countries like the UK and West Germany, and the inflation remained moderate - it did not accelerate into hyper-inflation. [See contributions on this point by Vines, Solow and Worswick in Cairncross and Cairncross (1992).] Moreover, Solow (1994) notes that the NAIRU model cannot satisfactorily explain the step increase in European unemployment in the 1980s (the European economies, as noted above, were moving towards labour market flexibility and market supremacy during this period, which under the NAIRU paradigm should have lowered rather than increased unemployment). At best, NAIRU models assume given positions on key (unspecified) variables in the short run, but do not explain why the positions may change drastically between periods and so drastically alter the relationship between unemployment and inflation.

6. However, NAIRU models claim to be able to account for the present differences in the US and EU unemployment rates. It is suggested that the superior employment performance of the US economy relative to the Europeans is due to its greater labour market flexibility and lower growth of real wages. Europeans, on the other hand, have a more extensive welfare state, less flexible labour markets and therefore higher NAIRU. The result is higher European unemployment, but also higher growth rates for real wages compared with the United States.

It is interesting in this context to recall the late Lord Kaldor's

Cambridge Keynesian explanation for the same phenomena. In the spirit of the Keynesian causal mechanism, in which employment is determined not in the labour market but by aggregate demand and output, Kaldor argued that the lower US unemployment was due to the greater growth of demand and output in the US economy, arising from the more expansive stance of fiscal policy in the US. Similarly in keeping with the Keynsian theory that only wages (and not employment) are determined in the labour market, Kaldor ascribed the US-Europe differences in growth of real wages to the differences in productivity growth on the two sides of the Atlantic.

7. Not only are the conventional models not very satisfactory in accounting for the patterns of unemployment and inflation in industrial countries, they are also not very helpful with respect to the important question of explaining changes in productivity growth. Consider for example the trend fall in productivity growth in the world economy in the post Golden Age period compared with the Golden Age. Table 4 provides figures for the growth of GDP, capital and labour inputs and total factor productivity (TFP), separately for each of the sub-periods, 1960-73 and 1973-87, for the four leading industrial economies, for each of the five developing regions as well as for a group of 68 developing economies. These data show that in every region, and for each country or group of countries shown in the table except South Asia (ie. in nine out of ten observations), the rate of growth of TFP fell substantially during 1973-87, compared

with 1960-73.

None of the conventional models referred to above make any attempt to explain these variations in productivity growth, despite the critical role this variable plays in these models. As Matthews and Bowen observe, the silence on this subject of the new classical models which stress the supply side is particularly striking. Let us consider, nevertheless, how such models will explain a decline in productivity growth. In terms of the new classical paradigm, a fall in productivity growth can arise from a variety of supply side factors: supply side shocks, price distortions, or in dynamic form, a lower rate of technical progress due to increased market imperfections and distortions in the incentive system, lack of integration with the world economy etc. The evidence, however, is not compatible with such an analysis, since as noted earlier, under the new post-Golden Age development strategy, there has actually been more competition, greater integration of the world economy, less distortions in the labour and other markets in the latter period (particularly in the 1980s) than in the former. Moreover the supply side shocks which occurred in the 1970s (rise in oil and commodity prices) had more than reversed themselves in the 1980s.

These facts are much more in accord with the Kaldorian perspective (Verdoorn's Law) which would suggest that the fall in the world and the national economic growth rates in the post-1973 period was responsible for the decline in the rate of growth of productivity in most regions. Verdoorn's Law[10] predicts that the faster (slower) the growth of production, the faster (slower) the growth of productivity. Simple regression analysis confirms the positive relationship between the two variables in Table 4.[11] The decline in world economic growth after 1973, in terms of this analysis, is attributed to a lower rate of growth of world and national demand caused by the whole range of factors connected with the fall of the Golden Age of development of the OECD economies.

VII. Policy Implications

This section comments on the policy implications of the institutional and historical analysis of the rise and fall of the Golden Age for the 1990s and the new millennium. However, before doing this it will be useful to examine some aspects of the post-1980 development strategy which is currently being implemented in industrial countries (as well as in many developing countries).

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[10] The classic references here are Verdoorn (1949) and Kaldor (1966). For a review, see McCombie (1987).

[11] The analysis produced the following fitted regression equation.

$$p = -.17 + .59q$$
$$(-.54) \quad (3.8)$$
$$R2 = .60$$

Where p is the change in the growth rate of productivity and q is the change in the growth rate of output between the two periods. Parentheses give t values of the coefficients.

As seen earlier, although under the new regime, inflation has become moderate, unemployment remains extremely high. It could however be argued that this regime is still in its transitional stage and not yet fully established. That raises the question, will the free market regime be more successful once it is completely operational?

The problem here is, how is the "success" to be measured? It may be suggested that, from the point of view of the conservative ruling circles in industrial countries, the strategy is already highly successful. It has changed the balance of power both internally within these countries as well as with respect to developing countries. It will be recalled that not too long ago, developing countries were vociferously demanding a new international economic order. Today, not many people are. In the 1980s, as a consequence of the changes in economic policy in industrial countries under the new strategy (the Volcker shock) and the resultant debt crisis, many Latin American and African nations were reduced to being supplicants before the international financial institutions. Similarly, in industrial countries themselves, the balance of power has shifted decisively in favour of capital. Union power has greatly diminished and profit rates, which had plummeted in the 1970s, are now back to their highest levels in the post-war period. In these circumstances, unless mass unemployment becomes electorally expensive, these is no reason for these governments to change their economic policies.

It is important to appreciate that just as it has not done so in the last decade, the pursuit of labour market flexibility on its own is unlikely to lead to an appreciable rise in employment in the current circumstances of the European economies. In principle, the governments could abolish all trade union rights as well as the entire social security system. If that were done,the social and employment situation in industrial economies would become similar to that found in developing countries. The recorded rates of unemployment in the latter group tend to be relatively low. This is because in the virtual absence of a publicly provided social security system, people are obliged to engage in any economic activity, howsoever non-remunerative and non-productive that may be. The problem of 'unemployment' in poor countries, therefore, manifests itself generally in the form of what Joan Robinson called 'disguised unemployment', or as 'underemployment'.

In practice, it is very unlikely that any government in an industrial country will be able to flout the minimum norms of modern democratic societies with respect to trade union rights or social security entitlements. This therefore means that to achieve a sizeable reduction in the current mass unemployment, and certainly to attain full employment, it is essential to institute a substantial trend increase in the rates of growth of aggregate demand (in real terms) and output in industrial countries[12]. However, the demand constraint on OECD production is not technical: the constraint is deeply institutional. It cannot be removed simply by the leading industrial country governments changing their fiscal and monetary policies. If they did so, without an appropriate restraining institutional framework at the national and international levels, the result,on past evidence, would in large measure be a rise in commodity prices, an increase in trade union militancy and higher inflation, which in turn would thwart the expansionary process.

What policy lessons do we learn from the Golden Age episode with respect to these institutional requirements in order to obtain sustainable full employment with low inflation? These may be summarised as follows:

1. An extremely important lesson from the Golden Age is that, in the present interdependent global economy, it is necessary to have efficient and consistent rules of coordinating mechanisms in <u>both</u> the internal and the external spheres. As we saw in the

[12] Economists disagree as to whether the current high rates of unemployment are due to deficiency of demand in the Keynesian sense, i.e., that there is adequate capital stock but that the degree of capacity utilisation is low. The other view is that because of prolonged under utilisation, much of the capital stock has become obsolete and therefore must be replaced. As far as the argument in the text is concerned, whichever policy measures are taken (whether to increase the stock of capital, or to raise capacity utilisation), it would inter alia, lead to a rise in the overall demand pressure in the economy.

analysis of the demise of the Golden Age, by the late 1960s, both these mechanisms had eroded and were interacting with each other to generate evermore severe adverse consequences for the economy. Indeed, James Meade (1993), in his Nobel lecture, regarded internal balance, in the current circumstances of industrial countries, as a necessary condition for achieving an external balance.

2. As far as the internal balance is concerned, there are two points at issue here. Firstly, what is required is institutionalisation of an incomes policy to restrict money wage demands in line with the country's changing macroeconomic potential, so as to avoid leap-frogging inflation. It is also clear that, in order for such a policy to work, it must be seen to be fair, involve over time progressive redistributions of income, and not simply be a device for reducing workers' living standards or freezing the distribution of income.

It will be argued that incomes policies have not worked in the past. Why should they therefore be expected to work today? One important reason is that we now have experience of the alternative economic regime as well, with its unpleasant results. Instead of the continued waste involved in keeping an ever larger reserve army of the unemployed (with increasing NAIRU as unemployment grows), surely it is sensible to seek cooperative arrangements between employees and employers, which can at least reduce this waste.

3.Secondly, a central question in this context is whether the best way to institute such arrangements is through corporatist, normally centralised wage bargaining, with the government playing a key enabling role, or through decentralised systems, Until recently, it was accepted that the corporatist systems had performed better in terms of <u>both</u> employment and wage equality than decentralised systems. [Pekkarinen et al, 1992]. However, this conclusion has been put into doubt by the apparent recent failure of the Swedish model. But it is far from clear that the large rise in Swedish unemployment in the last two years is due to the weaknesses of corporatism, rather than to other causes. Rowthorn (1994) suggests that, although the system suffered from many faults, the huge increase in unemployment is due far more to the previous Swedish government's macroeconomic policy mistakes.

4.Nevertheless, the Swedish case does raise the important question of creating an institutional framework which keeps labour discipline and does not blunt incentives, even when the economy has sustained full employment. This of course was an issue which faced the central planners in the former socialist countries in an acute form. The problem, in principle, and in practice, is not insoluble, as the experience of large Japanese firms with lifetime employment of their workers and a remuneration package based in large measure on seniority, suggests. This permanent full employment of Japanese workers, as well as the existence of relatively narrow pay differentials within a typical large Japanese corporation, clearly has not reduced its efficiency, as is evidenced by the excellent competitive performance of the Japanese firms in the international economy. Indeed, many scholars of the Japanese economy would suggest that these rigidities of that country's labour market are positively functional. It leads workers to be willing to invest in firm-specific human capital, to welcome rather than resist technical change, and to identify their own interests with those of the corporations they work for.[13] It is also worth observing that lifetime employment was not a peculiar cultural trait of the inscrutable Japanese, but very much an institutional innovation of the postwar Japanese economy.

5. Turning to the international sphere, there are some important lessons which emerge from the analysis of the rise and fall of the Golden Age with respect to international economic coordination:

[13]For an excellent discussion of these issues, see Dore (1986). See also Chang (1993) and Singh (1993).

(a) A critical lesson of the Golden Age is that the US, as the hegemonic power, played the key role in the international coordination process during this period. It often supplanted the international financial institutions altogether. For example, the postwar rehabilitation of Europe and Japan was done by the US on its own (the Marshall Plan in Europe and the Dod Plan in Japan) rather than being entrusted to the IMF or the World Bank. During the Golden Age period, whether through altruism or through national security interest, the US acted on a farsighted design, based on non-reciprocity.[14]

With the relative decline of US economic power over time, and more recently by the ending of the cold war, the situation has radically changed. What is required now is for the international coordinating mechanism and the Bretton Wood Institutions to become genuinely multilateral. The IMF and the World Bank have evolved over time into simply being agents of the G3 or G7 to discipline the third world. However, in

[14] As Spiro (1977) notes: "In the short term it (the US) dealt with its own huge balance-of-trade-surplus and the European and Japanese deficits by foreign aid and military expenditures. In addition the United States abandoned the Bretton-Woods goal of convertibility and encouraged European and Japanese trade protectionism and discrimination against the dollar. For example, the United States absorbed large volumes of Japanese exports while accepting Japanese restrictions against American exports... To encourage long term adjustment, the United States promoted European and Japanese trade competitiveness." (emphasis added). [14]

the new world circumstances, multilateral institutions are needed to discipline the great powers as well when they follow economic policies harmful to the rest of the world (e.g the Volcker shock which precipitated the debt crisis and hence the "lost decade" in Latin America and Sub-Saharan Africa).

b) There is a need for symmetric adjustment in circumstances where it is required to raise the rate of growth of the world economy. Under the present system, if an important county such as Germany, chooses to put fighting inflation as a more important objective than reducing unemployment, other countries are obliged to follow suit in order to avoid balance of payments problems or runs on their currency. Not only the objectives of leading countries differ, equally importantly, they may have varying analyses of how the economic system functions. For full employment to be achieved in these circumstances would require adjustments by both deficit and surplus countries.

(c) Symmetrical adjustment is also required between strong and weak industrial countries. Strong industrial countries like Japan have developed a production structure which enables them to be perpetually in surplus at their desired levels of inflation and employment while competitively weak countries (e.g. like UK or US) are unable to achieve their economic objectives without running into a balance of payments constraint (or alternatively an ultimate debt constraint in a world of free capital movements).

(d) There are those who argue that all that is required at the international level is not close policy coordination, but rather a rule-based system with perhaps wider bands for permissible exchange rate movements. Williamson (1992) is an ardent exponent of this perspective. However, as a number of practitioners have pointed out, although such a system may have been workable during the golden age when there were capital controls, yet it would be overwhelmed in a world of free capital movements, where national economic objectives greatly differ. For the rule-based system to work in these conditions, it is essential to have the utmost commonality of objectives and close cooperation between central banks.

(e) Tobin (1992) has put forward a less ambitious proposal in this respect which may be more practical. He suggests that each country should frame its own targets for macro-economic policy. These will not then be imposed on it but what would be imposed would be policies consistent with their own targets. Tobin argues that this would lead logically to some determination of what movements and differences in interest rates should be permitted in different countries. However, whether such a scheme will yield an adequate rate of growth of world demand

and output to permit full employment for all those countries which wish to have it, is far from being clear.

It may well be the case that if the nation states, particularly the big economic powers, continue to differ in their objectives, it may be necessary to revert to the golden age system of capital controls[whether through a Tobin tax or more directly] to enable full employment to be possible in countries for whom this is a primary goal. Capital controls do impose a social cost in terms of reduced efficiency, but this has to be compared with the social and economic costs of unemployment.

(f)Nevertheless, it is worth noting that even in a world of conflicting national objectives and free capital movements, the task of international coordination will be much easier if the institutional mechanisms for securing <u>internal</u> <u>balance</u> were working adequately. This will enable countries to use the exchange rate much more freely to attain the external balance. As is evident, however, there is a close interaction between the internal and external instruments of coordination. The internal mechanisms (for example, an incomes policy) will work more effectively, the less the burden they have to carry of external coordination as well, i.e., the smaller for example the fluctuations in the world economy and therefore the smaller the required changes in the exchange rate.

(g) The concept of interaction between the internal and external instruments of coordination is all the more relevant with respect to the important question of fluctuations in international commodity prices. Kaldor argued that an important factor in sustaining the golden age economic boom was the general stability of commodity prices in the 1950s and 1960s (except for a very brief period during the Korean war). The mild fluctuations of commodity prices in real terms around a gently declining trend played a significant role in maintaining relative price stability in the golden age . Kaldor ascribed this time path of commodity prices to the following favourable circumstances: (i) a trend rise in commodity production as a consequence of technical progress and importantly the price support programmes in the US and other industrial countries; (ii) the US commodity stockpiles whose very existence damped speculative expectations of commodity price increases.

In the Kaldorian analysis, the commodity price boom of early 1970s (which raised commodity prices significantly in real terms) played an important role in triggering the stagflation observed during that decade. In an important contribution, Kaldor(1976) showed that commodity price stabilisation was not just in the interest of poor countries, but that it benefitted the rich countries even more. This is essentially because when commodity prices fall in real terms, it reduces the developing country demand for industrial country products and is therefore recessionary. However, when there is a real rise in commodity prices, the consequences are not symmetrical. The adverse terms of trade in industrial countries generate a wage-price spiral, which in turn obliges the governments to attempt to reduce monetary and real demand pressures in the economy to contain inflation.

In the light of this analysis, following Keynes, Kaldor together with Tinbergen and Hart proposed an international buffer stock scheme to contain commodity price fluctuations and at the same time to help maintain a high rate of growth of real world demand.[15] The scheme was not acted upon.

However such a scheme is all the more important today because of the greater fluctuations in commodity prices in the 1980s and 1990s. Despite the clear advantages of commodity price stabilisation for both the North and the South, stabilisation schemes have been resisted by the US and other industrial countries, often on ideological grounds.[16]

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[15]See further Kaldor, (1993).

[16] On these issues, see further Maizels,(1988); Singh and Tabatabai,(1993).

In the absence of this cooperation at the international level, as suggested above, even greater burden is put on the other institutional instruments for maintaining internal and external balance.

VIII. CONCLUSION

This essay has argued that the post-1980 economic regime of industrial countries based on labour market flexibility and market supremacy cannot by itself provide full employment. Restoration of full employment with moderate inflation requires the abandonment of this market confrontational model and its replacement by more cooperative institutional arrangements involving workers, employers and governments in industrial countries, as well as more cooperative relationships between nation states. At the international level, such a task is much more difficult today than it was during the Golden Age when a single hegemonic country, the US, was able to ensure global cooperation on what happened to be a generally benign design. In present circumstances, matters are greatly complicated by differences between countries, both in their economic objectives and their views about how the economic system works. The necessary work of institution building and institutional innovation and renewal, at both the national and international levels, for achieving permanent full employment in market economies is therefore certainly challenging, but not impossible. An essential first step in this endeavor is a fundamental change in intellectual direction and in the analytical approach to the problem. This paper will have served its purpose if it succeeds in making a small contribution towards that end.