Possibilities and Constraints for National Economic Policies in Small Countries: The Case of Austria[1]

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Small Countries in the Shadow of Worldwide Changes: Some Theoretical Aspects

Like Switzerland, Norway, and Sweden, Austria, as a small economy—with a 40 percent openness measured in imports as a percentage of GDP—with a high degree of openness, is particularly vulnerable to international changes. Unlike the United States, whose degree of openness is about 10 percent, and where the development of the domestic market is the main source of economic activity, Austria depends for its economic performance ultimately on the international economic environment. In contrast to Germany, whose economy is open but large enough to influence the world economy, Austria and other small countries have to accept external variables such as world prices and interest rates as given. It will be argued here that worldwide changes, in general, do not make national policies obsolete. I further submit that even small countries do not have to give in to international constraints, but have the possibility of taking free rider positions and, therefore, of pursuing national economic policy strategies. Finally, it will be shown that Austria's economic policy, though suffering from increased international constraints, can still be interpreted as a successful free rider story.

In this theoretical part I focus on the limits and constraints of national policies, in the shadow of one particular world-wide change, namely, increasing nationalization, as expressed in the increase of financial capital, real capital, and labor mobility. There has been a dramatic change in the economic paradigm in the eighties, the proclamation of the end of Keynesianism, the change to supply-side oriented theory and politics. To analyze the limits of all these different policy measures would surpass the limits of this paper. But since the "failure" and "impotence" of traditional Keynesian politics has been declared so decisively by supply siders, I will concentrate on this topic and only analyze two issues:

the limits of a Keynesian employment-oriented monetary and fiscal policy and the limits of distributionary policy.[2]

According to the "policy-impotence" argument, the constraints on national economic policies under increasing internationalization are the following:

1. Interest rates are determined abroad (in the case of perfect capital mobility not even the slightest interest difference would be possible due to arbitrage except for differences in exchange rate expectations and perceptions of whether countries are credit worthy).

2. If international competitiveness on goods markets is to be maintained, the terms of trade have to stay (at least) constant. This means that (given fixed exchange rates) a small country's price levels (especially the prices for tradable goods) or rate of inflation are largely determined from abroad. (In the case of perfect real capital and labor mobility, prices would have to be exactly the same between countries.)

3. The overall balance of payments has to be in equilibrium in order to avoid foreign exchange reserve losses and exchange rate deteriorations, which would in turn affect the domestic price level and the terms of trade.

These three constraints affect small and large countries differently. Large countries can influence interest rates and price levels, while small countries are price takers and have to adjust their economy accordingly (see, for example, Memorandum 1990, showing the possibilities for autonomous German policy even in the very sensitive field of interest rate determination; for a more skeptical view, see Scharpf 1987). Given these three heavy constraints there would not be much room left for small countries' national economic policies:

1. If interest rates are determined abroad, a traditional Keynesian monetary policy cannot be practiced any longer. Any increase in the money supply which the central bank used to lower interest rates in order to induce additional investment would result in an immediate outflow of capital until the money supply and the interest rates were the same as before.

2. If domestic interest rates are fixed by international conditions, traditional Keynesian deficit spending becomes ineffective in the medium run. The reason for this can be found in the increased balance of payment problems which now cannot be financed through higher interest rates. This would mean that differences in budget deficits between countries should diminish. Small countries, especially, would have difficulty in maintaining high deficits if big countries decided on austerity policy.

3. If the domestic interest rate is exogenously determined, functional distributive policy also becomes ineffective. This is because the interest rate on financial capital is linked to the rate of profit on real capital. According to Keynesian theory, for example, the marginal investor will expand investment until the marginal efficiency of capital (that is, the rate of profit) equals the interest rate. For a rational economic agent, the returns on both financial and real capital as well—given equal perceived risk—have to be equal at the margin. But if the profit rate is determined, then (for a given relation between the profit rate and the wage rate) the distribution of income between capital and labor is also determined. The primary distribution of factor income is then a datum. (Scharpf 1987 stresses this point when he describes the impotence of European national monetary politics to lower the real interest rates below the American level in the early 1980s.)

4. If the domestic price level is largely determined abroad, national economic policies that have inflationary impact have to cease. If budget deficits increase inflation, they cannot be sustained without being a danger for international competitiveness. In the economic debate the inflationary argument of budget deficits is introduced in two different ways. On the one hand, it is argued in the "old-fashioned neoclassical crowding out" debate (Buiter 1985) that the increase of (public) demand would induce a demand-pull inflation. On the other hand, according to the short-term Phillips Curve argument, deficits improve employment and the situation in the labor market, thereby increasing workers' wage claims and therefore inducing a cost-push inflation.

5. If prices are determined from abroad, unit labor costs cannot differ largely between countries. This means that the autonomy of income policies is threatened not only from the interest-profit rate

side, but also from the goods market and international competition side.

The "impotence" argument of Keynesian policy, therefore, seems to be based on solid ground. An expansionary Keynesian policy without expansive monetary policy and without increasing budget deficits seems to be a contradiction in itself. Nevertheless, three points should be envisaged:

1. Factors are not perfectly mobile. Economic reality always means friction, imperfections, uncertainty, lack of information, and lags in reaction. In this imperfect world traditional instruments can still perform, though their meaning and potency obviously decline with increasing mobility. Even in the very sensitive field of finance, it can be shown that arbitrage does not perfectly adjust interest rates. The suggestion of Tobin to tax foreign exchange transactions, the so-called Tobin tax, in order to reduce speculation and to allow for national economic policies is, therefore, a feasible strategy (see Steindl 1989 for a critical evaluation of this proposition, as well as further expansions of it by Dornbusch 1986 and Badhuri/Matzner 1990).

2. Small countries can take free rider positions as long as the "big" countries do not react drastically. In open macroeconomics the example most often cited for this is the "beggar my neighbor" policy. If a small country devalues only once it can improve its international competitiveness. Under "normal" conditions (more precisely, those postulated by Marshall Lerner), this country's exports will increase, since they are cheaper now for foreigners and its imports will decline (since they are more expensive for domestic individuals). The result is therefore an improvement in the balance of payments and increased employment to the disadvantage of other countries. The country herewith not only exports goods but also unemployment to other countries, since the latter will suffer a reduction in their exports. This free rider policy works so long as other countries do not devalue their own currencies. (A further condition is that the devaluation be large enough so that it not give rise to further devaluation expectations because then importers would quickly increase their import orders and exporters would have to wait until their products get cheaper still.) A less quoted example of small countries' free rider possibilities is especially relevant for the planned EC monetary union. If countries build a

block of common restrictive monetary policy and have the same currency they have to pursue also a restrictive fiscal policy in order to maintain low inflation rates. A small country can now simply pursue expansionary policies, leading to higher output, imports, and balance of payment deficits, which are now "unpunished" (at least in the short and medium run), since there cannot be any exchange rate effects. This country would have lower unemployment than the big countries while profiting from their low rate of inflation (as will be shown in the next section, a similar argument can be developed for Austria's low inflation/low unemployment situation in the 1970s).

3. Keynesian politics have to be reformulated in order to meet new demands. The structure of taxes and expenditure becomes more important when their level cannot be expanded much further. Given increased uncertainty not only about the future economic situation but also about the effectiveness of various policy instruments, a bundle of policy measures becomes more promising than single instruments (Rothschild 1990, Marschoun/Marterbauer/Unger 1990 demonstrate this point in an international comparison of employment policy strategies). Given increased internationalization, some policy fields have to be transferred to an international level, while others have to be reinforced nationally.

Policies that should be reinforced at the international level are—due to high capital mobility—especially monetary policy and exchange rate policy. Trade unions should view wage policies and working time policies at a more international level. Domestic policies should stress structural and distributionary policies more. Differences in tax and social security systems will still stay significant since historically developed, country-specific differences will prevail. (The high "property taxes" in Anglophone countries, for example, would appear revolutionary in, for instance, Germany and Austria, while the high income taxes of the latter countries would shock Americans. Also, differences in the pension systems cannot be changed in a few years.)

Possibilities and Constraints for Austria in the 1970s and Early 1980s—The Breakdown of "Austrokeynesianism"

Not only is Austria a small country; it has also experienced quite an economic success story since World War II. Furthermore, it is still number one in the ranking of corporatism (see Calmfors/ Driffill 1988, for an overview of rankings). Compared to other corporatist countries, the social partners are much more integrated into macroeconomic decision making. Worker and business associations have an extremely high degree of influence not only with respect to wage determination, but with regard to all economic decisions. Economic policy is decided between the government and the "big four" (that is, two associations of businesses and two of workers).

The economic concept of the 1970s is called "Austrokeynesianism" and consists of four pillars. The first two are traditional Keynesian policies, the other two are specifically "Austrian":

—an expansive monetary policy with low interest rates was intended to stimulate private investment and employment;

—traditional Keynesian deficit spending aimed at stimulating output and employment (a further Austrian variant is job promotion by nationalized industry);

—hard currency policy by pegging the Austrian Schilling to the Deutsche Mark should help to import low German inflation rates;

—modest income and price policy by the social partners should prevent domestically induced cost-push inflation. According to the predominant Austrian view the social partners can determine real, not only nominal, wages through their high influence on domestic prices. About 20 percent of the prices in the consumer price index basket and about 50 percent of industrial prices are regulated by them! (Nowotny 1989; a different view, which is underestimated in the Austrian debate, is Rosner 1987, who argues that this interpretation is a popular Austrian fairy tale and that mostly the social partners only react to foreign price changes in their price regulating behavior). Austria's income policy has in fact been very modest, since real wages were stagnant between 1975 and 1986.

Sometimes a fifth pillar is seen in the strategies of structural policy aimed at improving the balance of payments through import

substitution. This holds true in particular for the automobile industry and for the energy sector (Nowotny 1989). Nevertheless, there has also been serious neglect in some other fields and sectors.

The concept of Austrokeynesianism worked very well in the 1970s with regard to growth rates, low inflation rates, and full employment (see Table 1), but has been increasingly eroded in the 1980s partly for economic and partly for sociopolitical reasons (see, for example, Traxler 1988 for a detailed analysis).

TABLE 1: MACROECONOMIC PERFORMANCE

	1974-1779 Averages			1980-1988 Averages		
	Austria	Germany	OECD Total	Austria	Germany	OECD Total
Real GDP Growth	2.9%	2.3%	2.7%	1.9%	1.7%	2.7%
Rate of Inflation	6.3%	4.7%	10.1%	4.0%	2.9%	6.0%
Standardized Unemployment Rate	1.8%	3.5%	5.1%	3.3%	6.9%	7.5%

	1990 Forecast		
	Austria	Germany	OECD Total
Real GDP Growth	3.4%	3.9%	2.9%
Rate of Inflation	3.2%	2.6%	4.6%
Standardized Unemployment Rate	3.2%	6.1%	6.4%

Source: *Historical Statistics 1960-1988*. Paris: OECD, 1990; OECD Economic Outlook, June 1990

The first pillar to break down was the low interest monetary policy in 1980 (Winckler 1980). Austria had had constant, nominal interest rates during the 1970s. But due to increased capital mobility and high U.S. interest rates (up to 11 percent) there was a dramatic danger of capital outflow which forced the Central Bank to deviate from its traditional policy. This was a typical problem of a small country's economy. The Austrian Central Bank was not able to stand a high drain of foreign exchange reserves.

The second pillar which collapsed was expansive fiscal policy. Austerity and antiinflationary policy became worldwide slogans and Germany pursued these policies with increased vigor. Austria also declared "budget consolidation" (austerity) as a main economic aim. Adhering to hard currency policy meant that other economic instruments had to be adjusted to the German level. Germany had a high overall balance of payments surplus while Austria had a slight deficit. In the long run such a situation cannot prevail without resulting in exchange rate deterioration. But budget consolidation was also due to political reasons. New conservatism, electoral deficits of the Social Democrats, a political system confronted with increased demands from different groups used to pocketing money from government, high deficits and structural problems of nationalized industries, as well as political scandals, also played an important role.

The third pillar was a reduction in the influence of the social partners, once more only partly for economic reasons. The fact that interest rate incomes and good prices could no longer be controlled because of internationalization weakened their influence. In addition unemployment rates increased. Nevertheless, the impact of the social partners on the economy remained still the highest among all corporatist countries. Furthermore, they succeeded in maintaining lower unemployment rates than those of the OECD average (see Table 1).

The fourth pillar—the hard currency policy—still prevails. No longer a working element in the "Austrokeynesian" arrangement, however, it has become quite an isolated policy instrument.

In the terminology of Haberler, this instrument, combined with restrictive monetary policy, is, in times of balance of payment surpluses, "Austromonetarist" rather than Keynesian (Haberler 1982 and Nowotny 1985). Austria's economy clearly reveals the problems for a small open economy of increased internationalization. However, the country's economic performance continues to be better than the OECD average (see Table 1). There are still almost no strikes, and a high political and social consensus among all major players continues to prevail. The concept of "Austrokeynesianism" demonstrated that small countries can take free rider positions: Austria (combined with her domestic income policy) shared German price stability but applied its own employment policy. The evolving

trade balance problems were solved through higher interest rates in order to improve the capital balance so that the overall balance of payments did not deteriorate. The breakdown also demonstrated that, given increasing internationalization, this concept will not exist without modification in the late 1980s and 1990s. Nevertheless, Austrokeynesianism provided a sound economic basis which allowed politicians to get through the late 1980s with better preconditions (e.g., unemployment rates) than most other countries.

Austria in the Late 1980s and Its Perspectives in the 1990s

Following six years of sluggish economic growth, the 1988-89 upturn was surprising (at least to OECD observers), in addition to being inflation moderate and balancing the current account. The rising trend of unemployment observed since 1981 was reversed and the budget deficit was brought down (OECD 1990). Is it another Austrian model or another Austrian miracle that stands behind this favorable economic development?

The unexpectedly vigorous economic growth was initially *export-led*. Exports in volume increased by 8.8 percent in 1988 and by 10.9 percent in 1989 (in 1987, only 2.4 percent). In particular, exports of raw material, mainly food, and of intermediate goods, especially metal products, rose. The major source of this positive development was the boom in Western Europe, where Austria could gain market shares. But trade with Eastern Europe also boomed. Gains in manufacturing exports were particularly impressive in Eastern Europe (real merchandise exports to all of Eastern Europe increased by some 17 percent, to Poland by 55 percent, to Hungary by 35 percent; see OECD 1990). A revival of tourism also contributed to growth and the improved balance of payments. The tax reform of 1989 was a fiscal stimulus, especially to domestic consumption. It therefore also contributed to increased growth rates. Though tax reform included reductions in income tax rates, tax revenue increased due to a higher national income. Together with an austerity program in public expenditures, the budget deficit declined. The fact that the increase in foreign and domestic demand did not lead to higher rates of inflation can be explained by foreign facts such as low oil prices and the weak dollar, but also partly by domestic facts. The unit labor costs declined by 5.4 percent in 1988 due to pressures on the labor market from an increased labor force. The influx of foreign workers, especially from Eastern Europe, meant higher competition

and downward pressure on wages. Even though employment rose by 1.3 percent in 1989 (OECD-standardized), unemployment still amounted to 3.15 percent, that is, only half a percent lower than a year earlier. The main labor market problems focus on actually increased long-term unemployment and illegal jobs.

The success of Austrian economic performance in the late 1980s is due to a combination of different—partly opposing—economic policy measures. National policy aimed at a continuation of supply-side policy (subsidies of investment and interest rates) as well as at new supply-side measures (reconstruction of nationalized industry partly through privatization, supply-side oriented reform in the tax and pension system). Traditional demand-side policy measures—like the budget deficit—were used in a restrictive way. An autonomous monetary policy was completely abandoned, since the policy-controlled interest rates in Austria and Germany have moved in tandem since. Hard currency policy was maintained. The domestic stimuli would have been much too weak for the Austrian economy. The rather restrictive domestic policy course turned out only to be adequate ex post facto, when unexpected increases in exports heated up the economy, so that no special domestic stimulus was needed. The current Austrian model can therefore be classified as a successful one of the "let's-hope-for-a-miracle-from-abroad" kind. This hope is not new and has—admittedly—sometimes also been nourished with a little help, such as structural policy that improved exports. It has, for example, always been the legitimation of hard currency policy, which is said to be the whip from abroad, forcing the export industry to restructure and lower prices in order to compete with the world market.

Austria clearly shows the problems of a short-term Keynesian policy management that lasts for many years. The emerging structural problems have to be met by different, more specific policy measures. The export-oriented structural policy measures were not sufficient. A highly corporatist regime which aims at minimizing conflicts reinforces these problems, since restructuring of the economy would also be to the disadvantage of special groups. The lopsided structure of Austrian industry towards basic goods was, for example, always recognized as a problem in Austria, but restructuring meant closing down large industry sectors. It therefore remained a very unpopular policy measure. For the political system

it is much easier to legitimate unpopular measures of restructuring or reducing the budget deficit with pressure from abroad.

The model of "let's-hope-for-a-miracle-from-abroad" seems also to be the predominant model of the 1990s. The "hope from the East" brought about by events in Eastern Europe and the "hope from the West" of membership in the EC seem to be the main pillars of this model.

For Austria, the lifting of the Iron Curtain means on the one hand, the loss of its traditional *Vermittlerrolle* between East and West, but on the other hand also the end of its status as a frontier at the edge of the Balkans. Economically, the events in Eastern Europe are definitely to Austria's benefit. It is not surprising that both Austrian forecasting institutes revised their forecasts regarding the future of the Austrian economy significantly upwards (Wörgötter 1990; WIFO 7/1990). The stock market shows high increases in Austrian construction shares. The opening of the Iron Curtain gives Austria a new economic role:

—the large new market of about 400 million potential consumers in a world of stagnant demand is a new chance for Austria as well as for the EC (and, by the way, a comparative disadvantage for the U.S. and Japan, being located so far away).

—the less developed region of northern Austria at the Czechoslovakian border will profit from the opening of the border.

—Austria has already accumulated in the past the necessary know-how for trading with Eastern country partners, since traditionally it entertains close trade relations with Eastern Europe.

—Austria could be the ideal location for multinational enterprises that want to trade with the East.

—And finally, the fact that the 1995 World Exposition will take place in Budapest and Vienna will be favorable for the eastern region of Austria.

When applying for EC membership, Austria signalled that it was ready to give up its autonomous macroeconomic policy, especially in the fields of high employment, distribution, and environmental policy. In addition to political reasons, there was the fear of being left out of the single market, since Austria has an extremely high

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[2]I will neglect supply-side policies aimed at directly influencing the production sphere, such as structural policy (research and development policies, subsidies, public investment policies, labor market policies, etc.) not because I consider them less important, but because the analytic framework for them is completely different (see, for instance, Helpman and Krugman 1989, IMF 1989), in focusing on microeconomics, while my arguments deal with macroeconomics.

trade involvement with the EC (about two-thirds of her exports and imports). But there was also the hope of adapting the structures of the Austrian economy to the European level with the "whip from abroad." The tenor of Austrian industry towards EC membership is positive, since it expects a gain of market shares in the EC, only small losses in Austria due to higher competition, and no change in the rest of the world (Pichl 1989). This is not surprising, since export-oriented industry will be a winner with admission of Austria into the EC. The losers will be agriculture and the craft sector in particular, which in Austria are much more highly regulated and sheltered than in the EC, and the banking and insurance industry, which had quasi monopoly profits because of the absence of foreign competitors. EC membership is therefore planned to play the role of the "whip" in the 1990s. I have always considered this "whip" too expensive, especially since there are other possibilities of participating in European trade. Instead of Austria waiting for EC acceptance or rejection, domestic problems should in any case be solved now, especially because membership in the EC does not mean cost-free problem solving through the EC. These problems include the restructuring of small industries whose size might prove a major liability by means of capital market and technological policy. (This cannot take place without foreign capital but it would mean less loss of autonomy than if there were an uncontrolled inflow of foreign capital as an EC member.) Deregulation of monopoly-protected sectors will produce the price reduction expected of EC membership autonomously, while there would still be a place for an autonomous employment policy. Also, noneconomic welfare effects of EC membership have to be taken into account. In this respect, environmental problems are of special importance to Austria. Austria would, for example, have to accept the EC principle of liberalization of traffic and would thus have far fewer possibilities of intervention aimed at reducing the (then even increased) north-south transit traffic by road transport which concentrates on its Alpine regions already now (Traxler 1990).

Being outside of the EC has its price, but membership also is costly. According to economic calculations, foregoing EC membership means lower growth rates. Moreover, the cost of membership will also be considerable since Austria would be a net payer to the EC at a cost of about one billion dollars, that is, 1 percent of the Austrian GDP (Breuss/Stankovsky 1988; Autorenkollektiv 1988).

What options does Austrian economic policy have, given the various possible outcomes of European trade constellations?

Whatever the outcome in Europe finally is—whether it is a reunified Europe, a European Economic Space, an EC versus EFTA bloc, etc.—Austria can and should pursue an autonomous national economic policy as much as a small, open economy can. Small countries can take free rider positions, as Switzerland and, even more impressively, Sweden have done for many, many years.

As Kurt Rothschild put it, economic policy is first and foremost politics (Rothschild 1990). There are no single solutions and *Sachzwänge* but there is always a political choice.

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[2]I will neglect supply-side policies aimed at directly influencing the production sphere, such as structural policy (research and development policies, subsidies, public investment policies, labor market policies, etc.) not because I consider them less important, but because the analytic framework for them is completely different (see, for instance, Helpman and Krugman 1989, IMF 1989), in focusing on microeconomics, while my arguments deal with macroeconomics.