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OCCASIONAL PAPERS

Economic and Social Policy Series

EPS 68

EMU, Macroeconomics and Children

A. B. Atkinson

unicef

United Nations Children's Fund

International Child Development Centre

Florence - Italy

1998

Innocenti Occasional Papers
ECONOMIC AND SOCIAL POLICY SERIES no. 68

EMU, Macroeconomics and Children

A. B. ATKINSON*

December 1998

*Nuffield College, Oxford, UK

Acknowledgements
Paper prepared for the UNICEF Project on "EMU and Children". I am very grateful to Essie Linton for research assistance which has provided the basis for Section 2, and to John Micklewright and Kitty Stewart for their very helpful comments on the first draft, which led to significant improvements.

Cover design: Bernard Chazine

Printed by: Arti Grafiche Ticci - Sovicille (Siena), Italy

ISSN 1014-7837

Readers wishing to cite this document are asked to use the following form of words:

Atkinson, A. B. (1998), "EMU, Macroeconomics and Children". Innocenti Occasional Papers, Economic and Social Policy Series, No. 68. Florence: UNICEF International Child Development Centre.

Executive Summary

The aim of this paper is to provide a framework for answering the question: How can EMU be expected to affect the children of Europe? Macroeconomics in OECD countries has tended to become a remote and abstract subject, discussed in aggregate terms which seem far removed from the everyday experience of families. Much of this paper is concerned with making the link between macroeconomic analysis and family welfare, a link which is important for all age groups, but is particularly so for children. Childhood is a vulnerable stage of the life-cycle, and children may be especially sensitive to macroeconomic shocks.

The public debate about EMU has been largely divorced from the concerns of families and children. Anxiety about employment is one connecting link, but, this apart, there has been little consideration of what EMU means for family welfare. Discussion in the UK has been dominated by business and monetary issues, as is shown in the paper by a review of official publications and the press. The impact of EMU on consumers has been more to the fore in the publications of the European Union than in those of the British government, but there appears to be little feedback to the macroeconomic analysis.

Turning to the macroeconomics of EMU, we find that the policy choices of the European Central Bank are often modelled in terms of the variability of output and inflation, but, like the British government's "five tests", these are better seen as "intermediate" goals. Minimizing the variance of inflation or output contributes to the welfare of citizens, but is not a direct measure of that welfare. The paper goes on to examine the relation with employment, with wage levels, with take-home pay, with interest rates at the household level, with consumer prices, and with public services.

Several proposals emerge from the analysis for improvements in our monitoring of economic performance to make them more family orientated. The first is for a child-focused unemployment rate. The individual unemployment rate is not the indicator most relevant to children; what affects them is whether they are living in a household without an income from work. Governments should publish a statistic which shows the number of children adversely affected by unemployment. The paper compares for the UK the proportion of children living in households where there is no one in paid full-time employment, with the conventional unemployment rate. The two series moved upward together in the early 1980s, but did not return to the same level. Recorded unemployment in 1990 in the UK was down to its 1979 level, but the proportion of children living in households without paid work was much higher.

The second proposal is for the construction of a European price index for families. This could take the form of an index for households with children or of an index which reflects the pattern of expenditure on goods and services for children. This could be combined with a “cost of participation index”.

A third proposal is for the calculation of measures of the cost of borrowing for families. Much of public attention has been focused on interest rates, but what does this mean at the level of the family? Countries differ in their credit markets, and these need to be taken into account.

Such developments are necessary to allow proper analysis of the potential impact of EMU on families and to put children centre stage in the policy debate.

Abstract

This paper provides a framework for answering the question: How can EMU be expected to affect the children of Europe? It makes the link between macroeconomic analysis and family welfare, a link important for all age groups, but particularly so for children. The policy choices of the ECB are often modelled in terms of the variability of output and inflation, but these are intermediate rather than final goals. The paper examines the relation with employment, wage levels, take-home pay, interest rates, consumer prices, and public services. The paper proposes new indicators of economic performance which are sensitive to the needs of families and children: a child-focused unemployment rate, a European price index for families with children, and measures of the cost of borrowing for families.

Keywords: Macroeconomics, Children, Unemployment, Europe, Monetary Union
JEL classifications: E6, I3

1. Introduction

Europe is embarked on yet another major step towards integration, with the introduction of the euro on 1 January 1999. The people of Europe are ambivalent about this development. Some are enthusiastic about European Monetary Union (EMU); others are vehemently opposed. Many people feel sometimes positive, sometimes negative.

The euro is different from most economic policy initiatives. Typically the pain of economic reform is all too obvious, and the public has to be persuaded that there is some indefinite, possibly long-term, advantage. In the case of the euro, what is evident in the short-term is largely advantage. Every European citizen who crosses a national frontier will reap the benefit of not having to change currencies. There will be price transparency. Shopping opportunities will be everywhere. Residents of Italy will not have to worry about the exchange risk on their Deutschmark mortgages. This time, it is the costs that are long-term and indefinite. There is a fear that European monetary integration is laying up future economic problems, and that there will be insufficient flexibility to cope with economic shocks. (There are also, of course, advantages to the euro that are long-term and uncertain.)

This paper is concerned with the future in that it aims to provide a framework for answering the question: How can EMU be expected to affect the children of Europe? In part this is an attempt to humanize the debate about

EMU. Macroeconomics in OECD countries has tended to become a remote and abstract subject, discussed in aggregate terms which seem far removed from the everyday experience of families. Much of this paper is concerned with making this link, a link which is important for all age groups. It is however children who are my particular concern, for several reasons. Asking the question in terms of the specific impact on children means that it is sharply focused. Children are a constituency who are pan-European, but who are largely invisible in the public debate about Europe. Childhood is a vulnerable stage of the life-cycle, and children may be especially sensitive to macroeconomic swings. A period of austerity in public spending, which leaves schools underfunded, for instance, may leave a lasting scar.

What then is the possible impact on Europe's children of the new departures in European macroeconomic policy? How are they likely to be affected by the policy stance adopted by the European Central Bank (ECB)? Despite the fears for the future costs of EMU, this specific question is not one that has received a great deal of attention. The public debate about EMU has been largely about interest rates, fiscal stability, inflation and employment. It is about central bank independence, credibility and stability pacts. The nature of this discourse is the subject of Section 2 of the paper, which documents the absence from this important area of policy debate of concerns about the everyday lives of families and children.

Before we can assess the likely impact of EMU on Europe's children, we need a framework of analysis, and this is the subject of Section 3 of the paper. I set out a simple version of the model used to examine the determination of macroeconomic policy. This kind of model has been applied at a national level, but is relevant now at a European level, where the ECB determines monetary policy to influence aggregate inflation and employment.

What however do these macroeconomic objectives imply for Europe's families? In Section 4, I examine how we can build links between aggregate measures of output and the position of individual citizens, and develop indicators which reflect the concerns of families and children. Section 5 deals with the relation with inflation, and Section 6 with the direct impact of changes in policy instruments: the rate of interest and fiscal policy.

The paper seeks to provide a framework of analysis. It does not provide a final balance sheet. In the current state of knowledge, there are limits to what can be said about the repercussions of the convergence policy followed since Maastricht, of the likely policy of the ECB, and of the Stability and Growth Pact. The main conclusions, summarized in Section 7, are about the tools of analysis which need to be developed in order to provide a substantive answer to the question as to how EMU will affect Europe's children.

2. EMU in Public Debate

My personal impression of the public debate about EMU, before writing the present paper, was that it is largely divorced from the concerns of families and children. Anxiety about employment is one connecting link, but, this apart, there has been little consideration of what EMU means for the Schmidts or the Duponts. In order to explore whether this is more than an impression, I have studied a selection of recent writing on EMU. The study makes no pretence of being exhaustive, and is carried out from a British perspective, but it provides one slice through the recent material. Among the sources on which I have drawn are the publications of the British government, of the European institutions, the financial press, and academic texts.

A natural starting point in Britain[1] is the Treasury document (1997) *UK Membership of the Single Currency: An Assessment of the Five Economic Tests*. This document does not directly address the impact of EMU on the welfare of families and children (children as such are not mentioned anywhere in the 27 pages). The five tests are concerned with "intermediate" goals, that is, goals which may be seen as contributing to the welfare of UK citizens but which are not the welfare of citizens as such. The attraction of foreign investment (Test 3), for instance, is not an end in itself but a means to the end of increasing national prosperity. The latter appears in Test 5 as "higher growth, stability and a lasting increase in jobs", although again employment is presumably not an ultimate objective. The United States has a higher output per capita in part because more people over 60 are in paid work (like the pre-reform USSR, they develop the extensive margin). From the standpoint of their grandchildren, higher labour force participation may not be an unambiguous gain. The children might prefer spending time with their grandparents to receiving extra presents from grandparents they never see.

Much of what has been produced by the UK government on EMU has dealt with technicalities, and it would be unreasonable to expect children to figure much in these documents (except perhaps as users of slot machines, the conversion of which is one of the technicalities). It is to broader documents, such as David Currie's (1997) *The Pros and Cons of EMU*, published by the Treasury, that we should turn. Here the balance is interesting. The three main sections deal with "monetary union and national sovereignty", "macroeconomic consequences", and "EMU and business". Households make occasional appearances but mainly as liabilities (for example, in a box on the risk of unfunded state pensions). There is no section on "EMU and consumers".

[1] I cover only the period since 1 May 1997, on the grounds that I wanted to avoid the within-party debates under the previous Conservative government.

The main focus of British government attention has indeed been on business. The document *EMU Steps for 1999*, from the Euro Preparations Unit, in response to the question “What does EMU mean for the UK?” says that

> “The single currency will mark a fundamental change in the business landscape of Europe. . . . It is vital that British firms and public sector organizations are alert to the strategic and practical implications.” (HM Treasury, 1998a, page 2)

The government has set up a Business Advisory Group, whose January 1998 Report naturally focused on business matters. A number of the issues are relevant to households, such as exchange risk, lower transaction costs, dual pricing (after we join the euro zone), and price transparency, although the interests of business and households may not be identical. One key, and little discussed, question is how the costs of conversion will be shared between producers and consumers. There is no Consumers Advisory Group to discuss this, and other issues, from a household standpoint.

Within the euro zone, the European Monetary Institute (EMI) has concentrated on the technical aspects of the introduction of the euro and of a single monetary policy. The EMI reported in March 1998 on the progress made towards meeting convergence criteria, and the Commission made its report recommending adoption of the euro. At the same time as following the Treaty procedures, however, the Commission has been aware of the need to prepare the public. There has been extensive publicity material, such as *Inf-euro*, a regular Newsletter distributed free and downloadable from the website, *europa.eu.int/euro*. In the May 1998 issue, for example, there are articles about the implications for bank customers, about the double circulation of coins and banknotes, about dual prices in shops, and about the needs of people who may have particular difficulties with the new currency, such as the blind.

Part of the Maastricht Treaty was concerned with consumer protection, while emphasizing that it is first a national responsibility, with EU action being complementary. To this end, it has set up a Consumer Committee with membership drawn from national consumer organizations and European-wide organizations. The European Parliament has sought to highlight the benefits from having prices in one currency, and the fact that they chose pizzas for the example could be taken as a sign that they are concerned with the impact on families. Certainly children have been targeted in the education campaign:

> “a special effort will have to be made to educate schoolchildren under a unified, 7-year European programme. . . . children have a natural ability to learn, and they will be the best ‘ambassadors’ for the Single Currency” (*europa.eu.int/euro*, dossier 52, page 29).

Overall, the impact of EMU on consumers has been more to the fore in the publications of the European Union than in those of the British government, but this does not appear to have extended to systematic analysis of the likely impact on families and children.

In the media, one would expect the financial press to concentrate on the business dimension, and this has been the case, although they have not ignored the consumer side. The *Financial Times* survey of 30 April 1998 for example on “The Birth of the euro” includes an article entitled “Promise of a paradise for shoppers”. They are sceptical, suggesting that price changes will be limited and not all downwards. On 10 October 1997, they had an article on European differences in CD prices, and on 22 November 1997 on UK housing costs for mortgage holders.

Press coverage of the social implications of EMU in all 15 EU counties has been surveyed in a study by Pakaslahti (1997). This study brings out national differences, in such subtitles as “the weary German-French locomotive”, “Spain todo por Maastricht”, and “Nordic paradoxes”. There are however common themes, including reactions to public spending cuts which particularly affected social programmes, although it is recognized that the Maastricht fiscal criteria were only one of the reasons for such policies being adopted:

> “the need to consolidate public finances . . . would also have existed without . . . EMU and its convergence criteria. EMU as such should not be seen as a mere threat to social security nor as a scapegoat for the present difficulties of the welfare state.” (Pakaslahti, 1997, page 53)

Reaching such a fiscal balance is, moreover, seen in a number of countries, including the Netherlands and the Nordic countries, as consistent with maintaining a high level of social protection.

Finally, I have taken one of the leading economics texts in the UK: *The Economics of the European Union*, edited by Artis and Lee (1997). This volume certainly contains material on the household dimension, including a chapter on “Social Policy” by David Purdy. He classifies policies under the headings of “labour market” and “welfare state”, with macroeconomic management, active labour market policy and industrial relations appearing under the former, but immediately goes on to stress that “labour market and welfare state are inseparably intertwined” (1997, page 269). The problem is to carry this through into the analysis. The chapter on “European Monetary Union” by Michael Artis contains a concise cost-benefit analysis of a single currency, but the reader could be forgiven for asking “costs and benefits for whom?”. In some cases the answer is clear. The saving on foreign exchange transaction costs is evident as far as tourists are concerned. On the other hand, reduced transaction costs and exchange risk also work through intermediate purchases. The (much longer) discussion of asymmetric shocks in a monetary union is couched in terms of macroeconomic variables whose significance to individual households is less transparent.

From this partial survey, it appears that the impact of EMU on consumers is not being totally neglected, nor is that on social protection, and that children have been seen as at least having an educational role to play. However, this has little feedback to the macroeconomic analysis. As I said at the beginning of the paper, macroeconomics appears as a field apart.

3. Macroeconomics and Families

How can one make the connection intellectually between macroeconomic analysis and the lives of families? How can one trace the implications of different policy choices by the new European Central Bank (ECB)? One of the key issues for EMU will be the way in which the ECB determines interest rate policy to balance inflation and output variability. To explore this, I take as an illustration the theoretical framework which has been adopted to examine the implications of central bank independence by Svensson (1996 and 1997), Bean (1998), and others. Of course, any actual policy simulations are based on more extensive, econometric macro-models, but the underlying thinking is typically based on a relatively stark theoretical model, and it is on the underlying thinking that I wish to focus.

At the core of this simple macroeconomic model are two relationships. The first is that aggregate demand, and hence output, is negatively influenced by interest rates, but with a lag. The negative effect operates in part via reducing consumption and investment demand, and in part through raising the level of the exchange rate and hence reducing net exports. As aggregate output goes up and down, so does total employment, according to Okun's Law (see for example Blanchard, 1997, page 363). In this aggregate (dynamic) IS relationship, we can also add a fiscal policy variable, where budgetary tightening can reduce aggregate output, again with a lag.

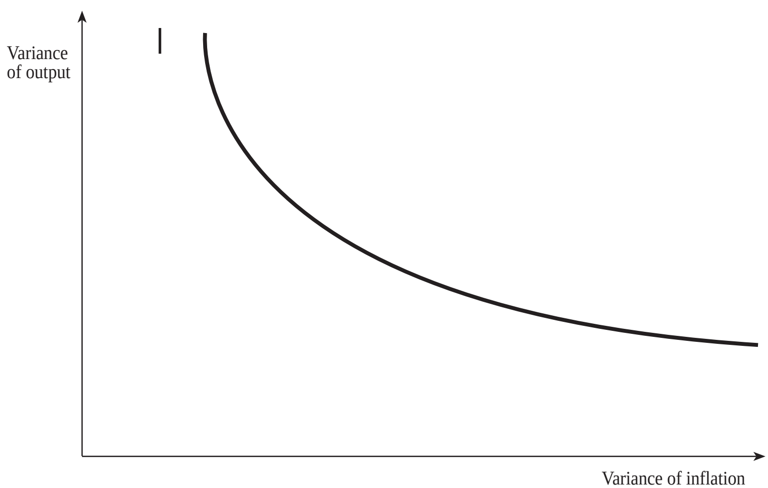
The second relationship concerns the rate of inflation, an "accelerationist Phillips curve", according to which inflation is assumed to stay the same apart from a random shock, unless output last year was above (below) normal, in which case inflation is higher (lower). So that if policy in year (t-2) is set to achieve in year (t-1) a level of output above normal, then higher inflation in year t is the result, and this persists (it being assumed that output returns to its normal level after year (t-1)).

If we suppose that monetary policy is set as a function of current inflation and output (and the overall fiscal stance is fixed), then these equations generate a tradeoff frontier between the variability of output, shown on the vertical axis in Figure 1, and the variability of inflation, shown on the horizontal axis. The lowest rate of inflation variability achievable is at I. The choice is described by Taylor:

"consider a situation where [real GDP equals potential GDP] and where inflation is equal to the central bank's target rate of inflation. Now suppose that there is an upward shock to the money supply due to an unavoidable error in measurement. The monetary shock will cause real GDP to rise above potential GDP, though with a lag of several quarters. This rise in GDP will cause the inflation rate to rise above its target. . . . If monetary policy is tightened sharply . . . the inflation rate will return to target quickly, but the economy will slow down and perhaps go into recession. Alternatively, if monetary policy does not tighten so much, the inflation rate will return to target more gradually, but there will be a smaller slowdown in real GDP. One policy reaction results in more inflation stability and less real GDP stability. The other policy reaction results in less inflation stability and more real GDP stability." (1996, pages 186-87)

In the formal analysis of the choice from this menu, it is typically assumed that the objective of the monetary authorities is the minimization of a weighted sum of the variances of inflation and output, with weights 1 and ß respectively. A value of ß equal to zero would mean that inflation is the only concern, so that the policy chosen is at I. Where some weight is attached to the variability of output, then a point is chosen to the right of I.

Figure 1: *Tradeoff between variability of output and variability of inflation*



The outcomes of macroeconomic policy are modelled in terms of the variability of output and inflation, but, as noted in the context of the British government's "five tests", these are better seen as "intermediate" goals. Minimizing the variance of inflation or output contributes to the welfare of citizens, but is not a direct measure of that welfare itself. We have to ask how the macroeconomic analysis relates to the everyday lives of European citizens? Do the macroeconomic variables have distributional overtones? On a first pass, we might identify single-minded pursuit of reducing inflation variability as a "conservative" position, and pursuit of the output objective as more "populist", concerned with jobs and families. It is however dangerous to make any simple identification. Those concerned with the welfare of children cannot assume that a higher value of ß is all that they need to see. In order to assess the contribution of macroeconomic outcomes, we need to consider the links between these variables and the welfare of families and children.

4. Outcomes of Macroeconomic Policy and the Impact of EMU on Children

The consequences of macroeconomic policy likely to concern the Schmidt family and their children, or the Duponts, or the Bianchi are:

(a) whether the parents are going to have jobs today, and they and their children have jobs in the future,
(b) what their jobs will pay,
(c) how take-home pay is affected by taxes and transfers, including child benefits and education grants,
(d) what interest rate the family has to pay on its borrowing, or gets on its savings,
(e) how much prices will rise and cause their housekeeping to become more expensive,
(f) what are the level and quality of provision of public education and health services, and the charges made for such services.

How do these relate to the aggregate indicators of "output" and "inflation"? This section focuses on (a), (b); the others are considered in later sections.

The discussion is framed in terms of families in a particular country, but it must be remembered that European policy may have differential effects in different countries. Pursuit of a specified macroeconomic policy by the ECB may lead to no change in total employment but to a rise in one Member State and a fall in another: the Dupont family may gain and the Bianchi family lose. The same macroeconomic shock may have different effects in different countries. One important example is given by Buti, Pench and Sestito (1998). Worker protection against employment shocks may be provided in some countries by unemployment benefits and in others by employment protection legislation. These may be equivalent in terms of their welfare consequences but have quite different implications for labour market adjustment.

■ 4.1 *Output and employment*

As an outsider, one cannot help being struck by the way in which macroeconomics involves equating a number of variables, treating them as synonyms, which complicates the process of interpreting the implications for family circumstances. Okun's Law, for example, is used as a basis for talking interchangeably about variations in *output* and variations in *employment*. However, a lot lies behind such a relationship.[2]

The first important consideration is the heterogeneity of the labour force. The aggregate labour market model takes no account of differences among the employed; the implications of a fall in the aggregate demand for labour may be quite different for workers with different skills. As Blanchard and Katz (1997) point out in their discussion of the natural rate of unemployment, one needs to integrate into macroeconomics the insights of labour economics, which has identified different ways in which labour markets may be organized. They identify three main approaches:

- matching of firms and workers where both have bargaining power at the individual level,
- efficiency wages, where firms pay workers above their reservation wages in order to motivate them not to shirk, or to secure greater cooperation, or to recruit and retain better workers,
- a "competitive" low-wage labour market, where workers have no bargaining power.

These apply differentially to workers with different skill levels. By the same token, an expansion of aggregate output may affect them differently. It may give rise to a different mix of increased employment and increased wages. Moreover, this may be influenced by policies designed to secure

[2] Nor can it be taken for granted at the aggregate level. One aspect not considered here is that there may be an asymmetry in the relationship, with negative values of y_t leading to falls in employment which are not reversed when y_t returns to zero, and positive values not leading to additional labour being taken on. Hence concerns about "jobless" growth.

greater labour market flexibility. Those at the bottom may find that unemployment has been replaced by working poverty.

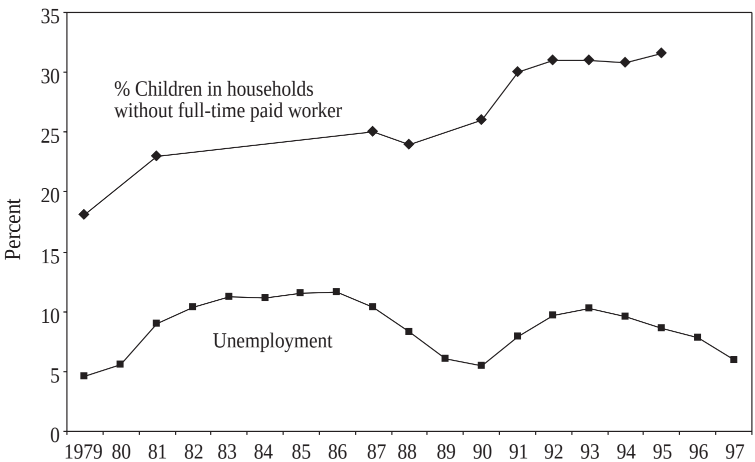
Related to, but different from, the different types of labour market are the differences in production sectors. A rise in interest rates does not have a uniform impact across sectors (nor does a tax rise). In the United States, construction and durable goods manufacturing are especially affected, with sectors such as nondurable goods, government, transportation, and mining barely affected (Thorbecke, 1997, page 14). In European economies (although not perhaps in the EMU), export industries may be particularly affected by exchange rate appreciation induced by higher interest rates.

In order to trace the impact on household welfare, we need to link macro- and micro-models. Following the national accounting tradition, we could make use of a *social accounting matrix* (see Pyatt and Round, 1985 and Hughes, 1996). Such a matrix for the US is described by Roland-Holst and Sancho (1992) and was used by Thorbecke in seeking to answer the question "Who Pays for Disinflation?". Thorbecke's model has a ten industry breakdown, distinguishes five factors of production, and has four household types (classified white/non-white and rural/urban). This brief description serves to bring out the potential strengths of such an approach. Even if the matrix formulation imposes limits on the behavioural reactions which can be incorporated, it allows for a wide range of interactions.

From the standpoint of the impact on children, the household side would need to be elaborated, making use of household survey information. In particular, the analysis so far is potentially misleading in that it treats individuals on their own, rather than living in families or households. An important part of the story is the number of earners per household. If unemployment is concentrated, then its impact on the well-being of children may be much greater. Put another way, an expansion of total employment may make no contribution to helping children if it takes the form of providing additional jobs to people in households without children. As has been shown for the United Kingdom by Gregg and Wadsworth (1996), there may have been a simultaneous rise in both two-worker and workless households. If families with children are disproportionately represented among the latter, then their fortunes may not be adequately reflected by the movement in aggregate unemployment.

All of this means that the *individual* unemployment rate is not the indicator most relevant to children. What affects them is whether they are living in a household without an income from work. This points to the need to reconsider the macroeconomic indicators. We should publish a statistic which shows the number of children adversely affected by unemployment: a "child-focused unemployment rate". This does not happen at present in the UK, although, from the official publication *Households Below Average Income* (HBAI) (Department of Social Security, various), it is possible to construct the figures for the proportion of children living in households where there is no one in paid full-time employment (or self-employment). This is compared with the conventional unemployment rate (OECD version) in Figure 2. The two series move upward together in the early 1980s, but did not return to the same level. Recorded unemployment in 1990 in the UK was down to its 1979 level, but the proportion of children living in households without paid work was much higher. Whether the same happened with the decline in unemployment in the 1990s cannot be fully determined because the most recent HBAI estimates are for 1995/96, but there is no sign of a decline to date.

Figure 2: *Children in households without full-time paid workers in United Kingdom*



Sources: Unemployment from OECD (1997), data disk (Table 2.15); % children in workless households: Department of Social Security (1998), page 103 for 1979, 1994/95 and 1995/96; (1997), page 125 for 1993/94; (1996), page 123 for 1992/93; (1995), page 71 for 1991/92; (1994), page 69 for 1990/91; (1992), page 69 for 1979, 1981, 1987 and 1988/89.

This example for the UK illustrates the need not just for the statistics but for their timely publication. If the ECB is to take account of the impact on children, then it cannot be on the basis of evidence which is three years out of date.

5. Inflation, Real Wages and the Impact of EMU on Children

What is likely to be the impact of lower inflation, if that is the outcome of the ECB pursuing a rigorous monetary policy, on the welfare of Europe's children?

Again, we have to peel away layers of analysis. Macroeconomists tend to talk interchangeably about inflation of prices and of wages. The original Phillips curve was a relation between unemployment and the rate of increase of money wages. Today, according to the US textbook by Mankiw,

> "the modern Phillips curve substitutes price inflation for wage inflation. This difference is not crucial, because price inflation and wage inflation are closely related. In periods when wages are rising quickly, prices are rising quickly as well." (1994, page 304)

To the Smiths however one of the matters which worries them is the relation between wages and prices: will their pay keep up with rising prices? What will happen to real wages?

The aggregate picture is therefore one of unchanging real wages, whereas at the individual level this may not be the case. Apparent overall uniformity may not translate into neutrality for the individual. The same applies to the concept of increased labour market flexibility, which will differentially affect different groups in the labour force. To the extent that it reduces trade union power, it will affect those covered by collective bargaining, reducing their real remuneration, but will not directly affect those who bargain individually. Reducing unemployment benefit levels may increase the take-up of low paid jobs, but has no impact higher up the scale. For those "priced into jobs", real wages may indeed fall. In looking at real wages, it is therefore necessary to consider the micro- and not just the macro-picture.

There is moreover a distinction between real wage cost to the employer and the real wage in terms of worker consumption (the product wage versus the consumption wage). These can diverge. (One reason for a wedge is of course taxes, which are not considered here.) In the US the cost of living index has risen faster than the price deflator for GDP (Blanchard, 1997, page 524). There are several explanations, including a decline in the relative price of investment goods relative to consumption goods and a rise in the price of imports. Again, we need to follow through the matrix linking production industries to final demands.

Even if we look only at what the wage will buy in terms of consumption, this leaves the question: Whose cost of living? Not all prices rise at the same rate, and EMU will affect the prices of some consumption items more than others. The study of citizens along the French-German border by the Robert

Schuman Centre of the European University Institute (Gramberger, 1998) found that more than 20 per cent would increase their tourism expenditure, compared with an increase of only half that size in cross-border purchases of goods and a marginal or no increase in the use of services.

Differential price movements point to the need for separate price indices for different groups. Specifically, consideration should be given to the production of an index for families with children (just as the UK government for example publishes pensioner price indices). It may have been the case in the past that the presence of children made little difference to the rate of inflation: in the UK, Crawford (1996) found that over the period 1979-1992 the annual rise in the cost of living index for households with children was 0.07 percentage points below the population average. There is however no guarantee that this will continue to be the case.

Since March 1997 Eurostat has published a European Index of Consumer Prices, based on a weighted average of national Harmonized Indices of Consumer Prices. In order to monitor the impact of EMU on children, to this should be added a European price index for families. This could take the form of an index for households with children or of an index which reflects the pattern of expenditure on goods and services for children. There may be a strong case for removing "adult" goods from the basket and concentrating on the items specifically relevant for children.

The Boskin Report in the United States (Boskin et al, 1996) has caused statistical offices worldwide to re-examine the methods employed in constructing consumer price indices. The Report discusses separate price indices for different groups, such as the elderly, but makes no concrete proposals, for which it has been criticized (see Deaton, 1998, and Pollak, 1998). Much of its concern was with new products and with quality change, but for low income families as important may be the disappearance of commodities and services and the enforced move to higher quality as living standards rise in general (Atkinson, 1998). The decreasing availability of goods is an aspect of social exclusion (for example, football tending to disappear from free-to-air television and only being available on cable television), and this may particularly affect children's capacity to share in the lives of their peers. A "cost of participation index" may look different from a cost of living index, and these are matters which Eurostat should address.

6. Interest Rates, Fiscal Policy and the Impact of EMU on Children

One price to which families may be particularly sensitive is that of borrowing. It is expected that EMU will allow real interest rates (ie money rates of interest minus the rate of inflation) to be lower than they otherwise would have been. The beneficiaries will be net borrowers. Households buying their houses on mortgage will find that the real cost is lower, and this may – or may not – be reflected in the consumer price indices. House prices will go up less, but this will not offset fully the reduction in the money interest payments. The interest rate reduction also applies to borrowing to fund purchases of consumer durables and education, both of which are particularly likely to benefit families with children.

Again, links need to be built between the macro variable controlled by the central bank – the base rate, or repo rate, or minimum lending rate – and the financial impact on households. What is the chain of financial intermediation which determines how changes in this control rate affects the cost of consumer credit? Countries differ: for example in the relative importance of fixed rate and variable rate mortgages. Moreover, we need indicators that are sensitive to the needs of families. Just as measures are constructed of the cost of borrowing for firms (for example, King and Fullerton, 1984), so too we need indices of the cost of borrowing for families. Just as firms may have different sources of borrowing, so too families may face a range of options. Countries differ in the form of consumer credit, although this is one area which may change as a result of increased cross-border mail order purchasing, both as a result of the euro and of the internet. Countries differ in the availability of loan finance for higher education.

■ 6.1 *Fiscal Policy*

EMU means transferring to the ECB the control of interest rate policy. It also restricts the freedom of national governments to pursue fiscal policy. As it is put by Vanheukelen (1994), there is "pressure from above" and "pressure from below".

Pressure from below arises if EMU intensifies fiscal competition between Member States. This may take the form of direct migration of the tax base, as with cross-border shopping reducing indirect tax revenue, or the movement of workers or employers. It may take the form of pressures to reduce costs in order for products to remain competitive. Such pressures already exist on account of the Single Market, and there are reasons to believe that the quantitative significance of actual movement will remain limited. There remains however the possibility that, rather than real tax competition, there may be *virtual* tax competition based on potential or threatened movement of labour or capital. Hirschman (1970) distinguishes between 'exit' and 'voice' as reactions to economic change. Workers, or companies, who perceive that taxes are lower in other Member States may not migrate but may seek to exercise political power, or voice, to achieve lower taxes at home. Comparisons of tax rates with those in other member countries will play a role in national election campaigns. In a world where the presentation of policy and its reception by markets and the media are seen to be of paramount importance, it may well be that the perceived pressures of virtual tax competition become the most important restrictions on the freedom of national governments to carry out social protection. In such a case, the issue becomes largely political rather than economic.

Pressure from above arises in the form of the Maastricht limits on government deficits and on overall government debt, and on the Stability and Growth Pact, agreed finally at Amsterdam in June 1997. The purpose of the Stability and Growth Pact is to provide incentives for national governments to avoid running "excessive" budget deficits, the Pact setting out the criteria by which "excessive" is to be assessed and the financial penalties to be applied. Views differ as to the extent to which this is likely to affect overall budgetary policy. Eichengreen and Wyplosz (1998) conclude, on the basis of a retrospective analysis of OECD budgets since 1955, and counterfactual simulations, that

> "Had the Stability Pact been in place over previous decades, it would not have had a devastating impact on the level and variability of output" (1998, page 95).

but their discussant (Bean) is less sanguine and suggests that the output losses could be larger than they estimate. Buti, Franco and Ongena (1997) and Buti and Sapir (1998), suggest, equally on the basis of a retrospective analysis, that there would have been no need for substantial changes in budgetary behaviour during recessions, but that there are risks where there is not an initially balanced budget or in the case of long recessions.

For families and children, the implications depend on how aggregate budgetary policy is translated into spending and tax changes. First, there is the balance between spending reduction and tax increases. In most countries spending reduction has predominated, but this has run into increasing resistance. The EU Committee of the Regions, in its Opinion of 18 September 1996, warned against further consolidation of public-sector budgets:

> "in some Member States government spending cuts have come dangerously close to exceeding the level judged acceptable by public opinion."

Secondly, where the policy is one of spending reductions, there is the question of what form these should take. It is true that social expenditures are a large part of the budget, but it does not follow that average shares should be a guide to the marginal reductions.

As in the case of monetary policy, we need to trace through the implications at the household level. In this case, a project is under way to construct at the European level a model which will allow analysis of the distributional impact of tax and transfer policies. EUROMOD (see Sutherland, 1997) will be an integrated benefit-tax model covering all 15 European countries. When operational (for a pilot version, see Bourguignon et al., 1997), the model will show the effect on the population of the EU, or of the monetary union, of changes in individual taxes and transfer programmes. It will be possible, say, to see how fiscal tightening in response to the Stability and Growth Pact affects families with children across countries.

■ 6.2 *Social Partners*

The role laid down for monetary and fiscal policy in the EMU world means that

> "the social partners will have more responsibility for determining wage levels, and will have to see to it that agreements reached meet the objectives of stability and growth" (*EMU-info*, April 1998, page 9).

In the UK, such an approach may be seen as harking back to incomes policies, now regarded as old-fashioned, but it will have to be taken seriously if the UK joins the euro zone. From the perspective adopted in this paper, one has to ask how the interests of those not in the labour market, such as children, are represented in the social dialogue. In Finland, for example, an agreement was reached in November 1997 between the main labour market organizations covering counter-cyclical measures, allowing the funding of unemployment benefit and pensions to respond in a stabilizing way, while maintaining benefits (*Inf-euro*, March 1998, page 8). A further reason why the Finnish experience is of particular interest is that the social partners have been examining the use of capital participation funds, which could be used to smooth fluctuations in employment. Symbolically, such funds would draw a parallel between investment in business assets and investment in bringing up children, with the important difference that the latter cannot be postponed.

Non-postponability brings me to the last point I wish to make. One of the major contributions of modern macroeconomics has been to highlight its intertemporal nature:

> "Interactions between the present and the future underlie many of the topics that make up macroeconomics and monetary theory." (Azariadis, 1993, page 174)

Important in this conception of the problem has been the assumed ability of individuals to smooth economic shocks. A consumer facing an intertemporal budget constraint can borrow or lend to so as to limit the influence on current consumption of macroeconomic volatility. But some effects are less easily smoothed. The child during whose early years hospitals have long waiting lists may have permanently reduced health status; children whose new school is postponed as a result of public expenditure cuts cannot relive their formative years; young people entering the labour market in a recession may suffer an enduring disadvantage relative to those cohorts who entered at a time of expansion. In the macroeconomic tradeoff between output and inflation variability, the temporal vulnerability of children should be a particular concern.

7. Conclusions

It is a brave person who would predict with confidence the outcome of monetary union, despite the volumes that have been written on the macroeconomics of EMU. As far as the impact of EMU on children is concerned, predictions are even harder since the subject has been largely ignored. The main point of contact is through the effect on employment, but I have argued that the link with family welfare is far from straightforward.

We need to humanize the debate, and in this paper I have tried to move towards this objective as far as children are concerned. Two main recommendations dominate the conclusions of the paper:

- we need to build links between macroeconomic analysis and the impact on families and children; such macro-micro links are essential to connect the two subjects of this paper: EMU and children;
- we need to develop indicators of economic performance which are sensitive to the needs of families and children; I have suggested (i) a child-focused unemployment rate, (ii) a European price index for families with children, and (iii) measures of the cost of borrowing for families.

Such developments are necessary to allow proper analysis and to put children centre stage in the policy debate.

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All correspondence should be addressed to:
UNICEF
International Child Development Centre
Economic and Social Policy Programme
Piazza SS. Annunziata 12
50122 - Florence / Italy
Tel. + 39 055.23.45.258
Fax + 39 055.24.48.17
E-mail: ciusco@unicef-icdc.it
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