

Is There a Role for Demand Policy?

Rudiger Dornbusch*

Summary

■ There are two rival schools of thought regarding the appropriate adjustment response to high unemployment. One view emphasizes conservative financial management and the gradual building up of credibility. In this view tight money, fiscal consolidation and a move to markets and incentives must be at the center of any action. A very different view holds that demand policy can play a useful role – easier money, currency depreciation and even targeted fiscal expansion. The paper strikes a balance between these views. It strongly endorses the role of markets and incentives, but it dismisses the credibility theme while endorsing the arguments for a supportive demand policy.

Much of the problem in a country like Sweden has built up over decades of the welfare state. But a good portion is due to the mismanagement of currency by hanging on to overvalued exchange rates at any price in an elusive attempt to build credibility. Easy money, even today, is decried as the first step to disaster. The paper dismisses this view and tries to build a balanced case for demand and supply action in remedying the unemployment problem. ■

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European unemployment continues to rise. Solutions to the problem run along two lines. For some observers the cure must come from the supply side – freeing up the labor market and reducing the “incentives” for unemployment in the form of overly generous compensation. Others put most of the weight on the need for demand – unemployment will fall if demand grows enough and the easiest way to get there is expansionary financial policies. We argue here that demand policies should and can play a role. But it is essential to place the position in perspective. Demand policy must be *part* of a policy mix, not the only element.

The labor movement, not surprisingly, is on the defensive and is doing poorly on the retreat. It has been the architect of the formidable social structure that today stands in the way of an effective adjustment mechanism; it is the partner with large business in building a corporatist structure that defends its bureaucratic attitudes against shocks and against competition. The response of the labor movement to the need for adjustment is to try and strike a modern note – retraining and infrastructure as opposed to unemployment benefits and public works. But the difference from its traditional approach of the past decades runs very thin.

The European Socialist Parties’ “European Employment Initiative” (European Parliament, 1993) argues against radical reform and as such fails to be persuasive:

“We reject the efforts of the Right to scrap the European model of society, making Europe a marketplace, instead of a welfare society.

**I am indebted to Lars Jonung and Lars Svensson for their insightful comments and criticisms at the conference. Lars Calmfors generously provided me with incisive and ample suggestions for improvement of an earlier draft.*

All experience shows that their recipe leads to increased class differences, high unemployment and social exclusion.”

That position is difficult to share. The increasing role of the public sector, and of regulation, throughout Europe over the past two decades makes it difficult merely to plead for more of the same. Even arguing that now it should be done better, with more thought, more hard choices and the discipline of better targeting simply rings hollow.

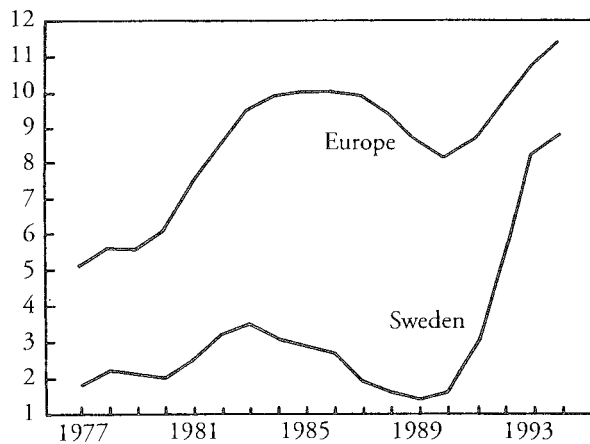
Protagonists of a radical market approach seem to be having the upper hand in the debate. For the moment they enjoy a measure of credibility – so far, at least, they have not failed. They also carry favor with all those who feel they have not gotten their money’s worth from the government. In fact, the only welcome expanded government gets on a wide political spectrum is for protection against the rest of the world; of course, that is the worst kind of direction to go.

This essay will strike a balance between the two camps. I will argue that there is an important role for demand-side policies in the present difficult macroeconomic situation. But in taking that line it should be made clear at the outset that in no way whatsoever can demand policies be a substitute for deep and thorough reform of the European labor markets and the economic role of government. Demand-side policies can be an effective complement of radical reform. But without reform, demand-side policies may risk being counterproductive just as reform by itself, without demand-side accommodation, may just mean distress rather than building prosperity.

It might be argued, all too easily, that demand-side policies have failed and therefore should no longer play a role and that the moment they appear, the need for a reform of the supply side recedes into the background. In that sense, demand-side policies are dangerous and nothing short of a supply-side revolution, single handed, must go forward. Of course, there is a kernel of truth here, but the case is overstated, more so if there is any hope that policymakers do learn from past mistakes. There is no reason for all-out pessimism. Hence we support here the two-handed approach: radical reform combined with accommodating demand-side expansion.

Faced with high and rising unemployment (see Figure 1), policymakers hear two sharply opposing views. One holds that this *is* the time for some good old-fashioned fiscal stimulus. There are also some more moderate statements of this position, focusing on this being a poor time to consolidate budgets. While there may be no room for expansion, at least there should be a transitory halt to efforts for further deficit cuts. The alternative view highlights the role of credibility and holds that, above all, this is the

Figure 1. Unemployment in Sweden and in Europe
Percent



Source: OECD

time to push budget consolidation and not relent. Failure to achieve this deficit containment or reduction would further undermine credibility, enhance financial fragility, and thus hold back the forces of recovery.

In my view there is no evidence that demand policies simply do not work. The theoretical conjecture and the political rhetoric do exist, of course, but not the well-established body of evidence. On the contrary. There is a question though as to whether expansionary demand policies involve tradeoffs and whether they are affordable. The only way to formulate a policy recommendation is an evaluation of the likely success and costs of alternative strategies. If the European scene of persistently high unemployment suggests anything at all, it surely is that doing nothing is not really a good idea: moreover, restrictive policies that seek to “build credibility” are even worse. Old-fashioned demand policies, particularly monetary ease, have been shunned all too long.

The U.S. recoveries of the 1960s, the 1980s, and the present boom attest to the power of demand stimulus. Of course, it will immediately be argued that the United States is just an entirely different economy. That is true, but one must not allow the discussion to reject *any* evidence that rejects the credibility story, then to be left with no evidence at all and the sheer faith that sitting tight is the only option. In fact, the protagonists of the sit tight/build credibility school had argued that in Finland, Sweden, Britain, Italy and elsewhere, letting currencies go and accepting depreciation would do irreparable damage to credibility – and they are still arguing it. The immediate disaster they predicted never came off. On the

contrary, export growth is the only growth in some of these economies. But that has not dissuaded the hard money people. Now their argument has shifted to become "just wait, you'll see". I am unconvinced by their case. In my view, where currency depreciation has been allowed, real interest rates have fallen and trade has started creating growth. The same is true for financial workouts of overburdened financial systems.

Of course, every one of the European economies faces different initial conditions in their fiscal situation, their unemployment levels and their degree of consensus on the need and scope for reform. Even so, there is enough common ground to discuss the scope for demand policy in the European context. Sweden will serve as a special case because the consciousness of a need for radical supply-side reform runs especially deep, the budget is disastrous and the notion that nothing can be done abounds.

To build up a case for activism, we start with a key distinction between classical and Keynesian unemployment. From there we proceed to the empirical relation between demand growth and unemployment, a review of depression mechanisms, and a discussion of possible policy remedies. To obviate the need for reiterating the point at every stage, we state here once more the basic position: demand policy can help, more so, the more it is part of a combined reform and stimulus program. Reform by all means; but that does not mean reform only or reform first and demand later.

I. Classical and Keynesian unemployment

Unemployment arises from four sources: excessive support for the unemployed, information and friction problems that impede easy matching in the labor market between jobs and unemployment, excessive real labor costs, and lack of demand for the goods labor produces.¹ The traditional discussion of European unemployment has emphasized classical unemployment as the principal source with firing costs and large overhead expenses as important considerations.² Keynesian unemployment, while not ruled out as a matter of principle, was never singled out as the central reason for unemployment. The reason, in part, is the implication: with Keynesian unemployment, lack of demand is the explanation, making demand is the remedy. Making demand had fallen out of favor in the 1980s.

¹ See, for example, Dornbusch and Fischer (1992) or any of the other balanced treatments of modern macroeconomics.

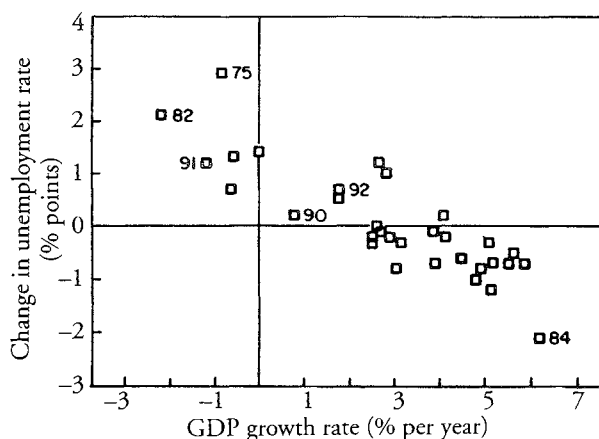
² See, for example, Lawrence and Schultze (1987), Lindbeck (1993) and Lindbeck *et al.* (1994) for an extensive discussion and references on eurosclerosis.

The disdain for demand policies is, of course, understandable. As Figure 1 shows, every unemployment plateau in Europe is higher than the preceding one. This suggests that whatever inroads demand can make are only temporary. Policies toward unemployment should address the rising plateaus. Suspicion of demand policy is also appropriate in hindsight. In response to supply shocks of the 1970s, demand expansion was the wrong answer. It meant more inflation and it did not necessarily speed up the real adjustments required by the increased real cost of oil.

The distinction between classical and Keynesian unemployment is possibly overdone. Suppose new technologies emerge that make it profitable to produce with lower labor requirement per unit of output. Or suppose that foreign competitors innovate and invest with the result that they enter the market and gain a larger market share. In each case a higher level of demand would solve the problem, unlike in the classical case. At the same time, as in the classical case, a lower level of wages would also do the job, assuming that such an adjustment mechanism in the aggregate is stable.

The point here is that with imperfect competition, unlike in the case of perfect competition, demand does matter. Under perfect condition, unlike in the real world, firms are price takers and thus do not think about demand. They simply ask how much it is profitable to produce and sell at the going price. With imperfect competition, by contrast, firms set both prices and output; where their demand curve sits is of prime concern for the price and production decision. A higher level of demand means that more can be sold at given costs and prices. Thus higher demand also means more jobs. One can get there by lower wages and/or overhead costs and thus reduced prices or by any method that will shift out the demand curve for a country's products. The overly rigid separation between Keynesian and classical unemployment artificially narrows the scope of demand policies.

There is another reason for believing that the distinction is overdone. There are mechanisms at work both on the side of employers and on the side of workers which translate spells of high unemployment into a persistent rise in unemployment. Whether to call this classical or Keynesian is open to discussion, but the implication is not. Experiences of high unemployment make it harder to bring unemployment down. Following on a spell of high unemployment, firms would want to see lower wages or stronger demand prospects to be persuaded to engage additions to the workforce who they believe are on average tainted by a long-term unemployment experience. On the side of workers it may take higher wages or easier ways of finding jobs for them to search and locate jobs. One way or the other, hysteresis is an issue and demand can be part of the answer.

Figure 2. Okun's Law in the United States: 1960-93

Source: Data Resources, Inc.

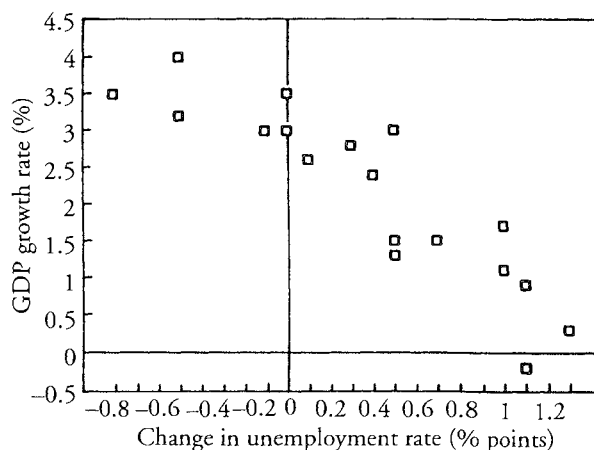
2. Okun's Law

As a first approximation, unemployment grows whenever the growth rate of demand and output is low. Employment is determined by two factors, the level of output to be produced and the productivity of labor. Employment growth is equal to the rate of output growth less the rate of increase in productivity. The second relationship is that between unemployment over time and employment growth. The unemployment rate will be rising unless employment growth exceeds the growth rate of the labor force.

The link between changes in unemployment and the growth rate of GDP is commonly known as Okun's Law. Growth of output has to reach a certain level just to assure constancy of the unemployment rate. Higher growth rates reduce unemployment, lower rates imply rising unemployment. For the United States where the "law" has been part of the tool kit for macroeconomic forecasting since its invention in the 1960s, the benchmark growth rate to assume a constant unemployment rate is approximately percent 2.25-2.5; see Figure 2. Okun's Law is implicit in the recognition that on the current 3.5 percent growth path, the U.S. economy will be at full employment by the end of 1994.

Figure 3 shows the data underlying the relationship for Europe.³ The diagram shows the correlation between changes in the unemployment rate

³ The data are from *OECD Economic Outlook* and the definition of Europe is that of the OECD.

Figure 3. Okun's Law in Europe: 1977-94

Source: IMF

and the growth rate of output for the period 1977-94. A similar empirical Okun relation seems to hold, although it is less stable and harder to pin down than in the United States. In Europe, because of higher trend productivity growth, the growth rate necessary for stable unemployment appears close to 2.75 per cent. For every extra percentage point of growth sustained for a year, the unemployment rate seems to decline by about 0.5 percentage points. The EU Commission believes that a growth rate of 3.5 percent leads to a fall of the unemployment rate of three quarters to one percentage point.⁴ This implies a far more powerful growth impact on unemployment than is documented for the United States. Without a good reason for this stronger effect we might as well treat it skeptically. But the point remains: if unemployment is to go down, output growth over and above productivity increases is the only way.

The immediate implication of this relationship is that on current forecasts of European growth, unemployment rates are bound to rise significantly in 1994 and beyond (see Table 1). Output is not growing fast enough and the reason advanced here is a lack of demand, domestic and foreign. We focus on demand rather than supply because the evidence of the late 1980s demonstrates so clearly how, in the face of an increase in demand, supply and employment expand vigorously. It is doubtful, judging from the performance of export firms or of output in the period 1987-89, that firms are just refusing to produce at current costs. De-

⁴ See Commission of the European Communities (1993).

Table 1. Europe: Unemployment and growth
Forecast

	1994	1995
Growth	1.5	2.6
Unemployment rate	11.4	11.5

Source: OECD

mand does have to be brought into the discussion as the leading short-run determinant of employment and unemployment.

It might be argued that wages or non-wage labor costs are not falling fast enough and that is why supply is not rising. But once again, the chief channel is still demand. Higher cost competitiveness (via a devaluation, for example) would raise demand and thus make firms willing to hire.

Setting aside the case where people leave the labor market, Okun's Law cannot be circumvented. Unemployment falls only to the extent that demand for labor expands and that will occur only if the goods can be sold. Changing the terms of unemployment compensation will make it far less attractive to be unemployed and helps improve the budget. But it does not reduce unemployment unless the measures translate into an increase in product demand and employment. Measured unemployment may decline, but joblessness will not unless product demand increases.

The link from unemployment compensation to product demand is twofold. On one side, reduced unemployment compensation means reduced real incomes for those who do not have jobs and as a result less spending. The other mechanism is more aggressive competition in the labor market with the effect of softening wages, reducing costs and increasing competitiveness and the profitability of investment. The experience of the Great Depression in the United States and Canada does not, however, suggest that wage competition of people without unemployment coverage is an effective way to full employment.

It might be claimed that the European experience of the late 1980s shows that because of the unfavorable structure of the labor market, demand expansion just does not translate into employment gains and lower interest rates – higher demand means inflation, not employment. It is true that demand expansion was highly inflationary in Germany, for example. But the expansion in demand did produce a dramatic reduction in unemployment at the same time. At best there is a discussion about the Phillips curve tradeoff between inflation and unemployment being very unfavorable. That demand growth did reduce German unemploy-

Table 2. German growth and unemployment

	1987	1988	1989	1990	1991
GDP	1.5	3.7	3.6	5.7	4.5
Employment	0.7	0.8	1.5	3.0	2.6
Unemployment ^a	7.6	7.6	6.9	6.0	6.7

^a Percent of the labor force

Source: OECD

ment in 1987–90, despite the migration wave, is just not in question. There simply was no supply-side revolution that could be invoked in support of the growth spell (see Table 2). One should also note that the discussion about the unfavorable labor market and regulatory environment continued unabated throughout that experience.

3. Depression mechanisms

In classical economics there are no coordination problems. Self-interest and flexibility of prices, without guidance or assistance, assure that the economy follows the full employment path. Deviations, of course, are incipiently possible. But where they do occur, the adjustment mechanisms are stable in a fashion that assures an automatic and rapid return to full use of resources.

Keynesian economics has questioned the automaticity, stability and/or promptness of that mechanism and insisted that demand policies could and should be enlisted to help. One strand of the argument holds that real wages influence not only employment via the supply side, but that they also may influence the level of demand. Once that connection is made, real-wage cutting need no longer be a mechanism for creating jobs. Structuralists in particular would emphasize that the income effect on aggregate demand works much faster and pervasively than the substitution effect on the side of labor demand.

James Tobin (1975), for example, highlights that price flexibility *per se* need not be dynamically stable. In the same fashion it has been questioned whether wage cutting will stabilize output and whether easy money, in a deep recession setting, will be an effective stabilizing mechanism. In light of persistently high and possibly rising levels of unemployment, these questions come up once again.

Tobin emphasized the role of expectations and their inelasticity to an

upturn in the context of a depression state of mind. If the public places a high expectations weight on a persistence of bad states, an upturn is unlikely to be seen as persistent and hence induces very little of an increase in permanent income and spending.

Summers and De Long (1986), similarly, have asked the question whether price flexibility is necessarily stabilizing. For example, falling prices raise real interest rates and thereby reduce final demand as well as the demand for inventories. By implication, if price flexibility is found to be destabilizing, reliance on price flexibility as the adjustment mechanism would be precarious. Summers and De Long conclude that, indeed, price flexibility is a problematic adjustment mechanism.

Following up on Irving Fisher's theory of credit in the business cycle, research by Bernanke (1983, 1993) has emphasized the role of credit in macroeconomics. He notes that in depression situations especially, credit mechanisms work in a strongly destabilizing fashion. In a deep recession environment, durable purchases in particular will be held back. Financial markets react with persistent, severe credit rationing on the supply side and with an unwillingness to incur debts relative to stagnant income prospects or, worse, a precarious outlook.

Consumer and business confidence is shaken not only by lack of profitability, credit, demand and jobs but by much broader questions about the operation of the economy and society. If it appears that the existing social safety nets are suddenly becoming unaffordable and debts become unpayable, surely it is a poor time to invest and spend.

These various depression mechanisms are, of course, only marginally significant in ordinary recession. They do, however, come into their own when output growth plunges and unemployment and deficits skyrocket as has been the case in Sweden and Finland, for example. These extreme experiences, especially, raise the question as to what policy responses, if any, are available and what might be the best package of measures so as to assure a return to high levels of employment in the near term and sustained, noninflationary growth beyond.

4. Policy responses

There are four main policies to influence the demand side:

- (i) Fiscal expansion
- (ii) Easy money
- (iii) Increased competitiveness via currency depreciation

- (iv) Improved operation of credit markets via restructuring of the financial system.

They are listed here separately and apparently independently. Of course, that is not the case and the discussion will bring out the linkages. We discuss each in turn.

4.1. Fiscal expansion

Tax cuts or increased public spending are the old-fashioned policy responses to slump or recession. They have never been uncontroversial. Keynes (1929) lamented the lack of vigorous fiscal expansion in England:

"... one-tenth or more of the working population of this country have been unemployed for eight years – a fact unprecedented in our history...

It is not an accident that Conservative Government have landed us in the mess where we find ourselves. It is the natural outcome of their philosophy. You must not do anything because this will mean only that you can't do something else. Safety First! The policy of maintaining a million unemployed has now been pursued for eight years without disaster. Why risk a change?"

In the United States, president Hoover ran on a balanced budget and Roosevelt's deficit policies were viewed with deep suspicion. Kennedy's deficit spending in the 1960s needed all the dressing up and rationalization of the New Keynesian Economics. Reagan's deficit strategy had the intellectual cover of Supply-Side Economics. Deficit policies never look good in and of themselves, but they can be made to look good. Above all, one fact stands out: they do work.⁵

The objection to fiscal policy comes in one of three ways: that it is outright *counterproductive*, that it is by and large *ineffective*, or that it is for better or worse simply *unaffordable*.

⁵ Was it, in fact, fiscal expansion that did the work? It had never occurred to me to doubt the proposition, but to respond to the editor's prodding here is an answer. There was no supply-side revolution at the time, but demand was driven up by a strong expansion of the full employment deficit with accommodating monetary policy. Output growth did pick up strongly for eight years. No competing explanation is on record. Specifically, the new classical economics has not claimed this period as a key example of unidentified productivity shocks (UPS).

The argument that fiscal policy is counterproductive relies on some version of super crowding out – fiscal expansion brings about a fully offsetting (or even larger offsetting) reduction in private spending.⁶ The mechanisms for this crowding out are often obscure, but a generalized loss-of-credibility hypothesis is prominent. More spending would connote unsustainable deficits which backfire into higher interest rates, falling asset prices, distress and collapse. The entire notion should not be dismissed out of hand, but its plausibility of course will depend on the circumstances. Deliberate fiscal action in the face of vast unemployment, as part of a broader and responsible package of reforms, hardly seems an invitation for financial collapse.

The argument that fiscal expansion might be *ineffective* has far more solid foundations. It relies on the familiar Barro–Ricardo mechanism where households consider their intertemporal fiscal burdens and hence are not misled by the promise of short-term tax cuts or spending programs.⁷ Since they have to pay for them, sooner or later, fiscal largess is a mirage and hence cannot do much good. The evidence on this proposition continues to be debated. A preliminary judgment is that the argument, while plausible, overstates the case. Many frictions and imperfections, not in the least liquidity constraints, do give fiscal policy a positive effect. Macroeconometric models routinely assign multipliers of about 1.5 to 2 to fiscal policy as we will see below.

The effectiveness of fiscal measures depends, of course, on the extent to which they are targeted toward domestic demand and, on the side of tax cuts, toward those groups with the highest spending propensities and the most significant liquidity constraints.

A special complication with fiscal policy arises from the openness of the economy. Under fixed exchange rates, fiscal expansion creates a current account deficit which raises the issue of external financing. Under flexible rates there will tend to be a real appreciation along with the current account deficit and as a result a potential for crowding out.⁸

⁶ Giavazzi and Pagano (1990) have offered the surprising claim that in Denmark and Ireland fiscal consolidation worked as a stimulus to demand. Lachman (1994) strongly endorses the view that fiscal consolidation, via its impact on credibility, helps promote growth.

⁷ This point is familiar from the discussion around the Barro–Ricardo proposition. See any modern macro text for references.

⁸ We assume in the text that there is no loss in confidence. Loss of confidence was clearly an issue in the context of the French Socialist government of the early 1980s. A host of measures, including fiscal expansion but also plain socialism, led to a severe pressure on the franc. The experience has had a lasting and exaggerated impact on French policy-makers' assessment of the possibilities of fiscal expansion in an open economy.

Table 3. Sweden: Recent macro data and outlook

	1990	1991	1992	1993	1994 ^b
Unemployment	1.6	2.9	5.3	8.2	8.8
GDP	1.4	-1.7	-1.7	-2.7	1.5
Budget ^a	4.2	-1.2	-7.1	-14.7	-13.6
Primary	4.3	-1.1	-7.1	-12.9	-10.8
Structural	-0.3	-3.4	-7.0	-11.1	-10.1
Net public debt ^a	-5.6	-4.1	3.0	17.7	30.7

^a Percent of GDP. ^b Forecast

Source: OECD

The argument that fiscal policy is *unaffordable* is today the most important. Budget deficits are large and so are public debts. Prospective problems from public pensions and social security, interacting with an aging population, add to the difficulty in taking an easy view of increased deficits. Table 3 shows the case of Sweden: slow growth with high unemployment makes a case for policy intervention, but the budget deficit and the debt must raise eyebrows at that suggestion.

The perennial question of fiscal policy is whether tax cuts or spending increases can generate a sustained upswing in the economy such that, over time, the fiscal measures pay for themselves. We routinely teach that this is not the case, but the case is possibly overstated. When the lack of timely fiscal stimulus causes an economy to fall into a spiral of no growth and rising unemployment, the fiscal damage is presumably far greater than what a spell of well-timed stimulus would have cost. The case of Japan in 1992–94 comes to mind, where too little too late leads to a policy that keeps chasing after an ever-weaker economy but never quite manages to turn it around. More to the point, would a decisive fiscal action in the United States in, say, 1931–32 not have been far cheaper on the budget than the experience of the entire Great Depression?

In Europe, the fiscal question can be asked in two ways. One is to ask whether a very precarious recovery state is a good moment for fiscal consolidation. If this action engenders a boost in confidence, credibility, asset revaluation and declining asset yields, that case might be made. But if it cuts predominantly into barely rising confidence, then fiscal consolidation is counterproductive and stands in the way both of recovery and of sound public finance.

Structural fiscal measures in particular, such as limiting unemployment compensation duration, make a lot of sense if the jobs are there and

Table 4. Impact of a deficit increase
5 percent of GDP expansion in public spending, year 2

	Real GDP	Inflation	Unemployment
United States	0.6	2.9	-1.8
Germany	0.6	0.8	-0.8
Italy	1.6	1.3	-0.7
Canada	1.1	0.3	-1.2

Source: Bartolini and Symansky (1993)

waiting to be filled by recalcitrant unemployed workers. But if the jobs are not there, creating unsupported unemployment is bad economics and bad politics.

The more aggressive stance would be to call for further deficits by a deliberate program of spending and temporary tax cuts. Such a strategy would, of course, need support in a medium-term fiscal consolidation program, and it would need to be limited in time. It is not at all absurd, even in the face of large deficits. At least it is no more absurd than the defense of the exchange rate in 1992–93 with astronomical interest rates.

What quantitative estimates help guide fiscal policy? The effectiveness of fiscal policy can be judged from a recent modelling effort by the IMF. Their econometric model of industrialized countries brings into play a labor market where extra demand for labor interacts with labor supply to generate both employment changes and changes in wages and prices. The national labor market characteristics as well as the exchange rate responses and monetary policies interact in shaping the macroeconomic response to disturbances. Table 4 shows the impact of a major fiscal expansion – a 5 percent of GDP increase in the budget deficit.

Three points emerge from Table 4: deficit expansion does raise growth of output, it reduces the unemployment rate and it increases inflation. Unambiguously, fiscal policy works and there are no surprises.

Table 4 reports only the impact in year 2. What can be said about the longer-run effects? Fiscal expansion by itself means crowding out of private investment and hence, over time, a reduction in the capital stock. This effect means that, at full employment, there will ultimately be lower real wages. These very long-run effects must be kept in mind, but they probably are irrelevant to the current issue in high-unemployment economies where there is no growth, no prosperity and no investment anyway.

In sum then, fiscal policy in principle works. In the European context it is not the first instrument to think of simply because of the poor fiscal

situation. Even so, consolidation runs counter to stabilization and, if it is chosen *now*, needs a strong offset in expansionary monetary and exchange rate policy.

4.2. Easy money

The United States in 1992–94 has been emerging from a recession, for the first time in the postwar period, without any assistance from fiscal policy (see Table 5). In fact, easy money has been the exclusive mechanism. A strategy of essentially zero real interest rates for 17 months worked to build up growth to the point where now a vibrant recovery is in place and the economy is heading for full employment within a few quarters. By early 1994 the strategy had succeeded to a point where full employment was coming in sight, as yet without inflation, and the need for a shift in policy became topical. In fact, in early 1994 the Federal Reserve started shifting to what it referred to as a “neutral” real interest rate posture. This presumably means moderately positive real interest rates.

Note that in the case of the United States the easy money policy made two contributions to the budget. First, by helping recovery and even a boom, low interest rates reduced the cyclical component of the deficit. Second, low interest rates directly reduce the cost of debt service. A sustained 1 percentage point reduction in interest rates reduces debt service by about \$30 billion or approximately one half percent of GDP. For countries with large debts and deficits, easy money is therefore especially helpful.

The mechanisms for easy money are manifold: cost of credit for firms and for consumers, increased asset prices, improved values of collateral,

Table 5. US recovery 1991–94

	1991	1992	1993	1994 ^d
Growth	-0.7	2.6	3.0	3.6
Unemployment	6.7	7.6	7.4	6.3
F.E. budget ^a	3.1	2.7	2.0	2.0
Actual budget ^b	4.8	4.9	4.0	3.4
Real interest rate ^c	1.5	0.5	0.0	1.1
Inflation	4.2	3.0	3.0	2.8

^a Full employment budget as a percent of GDP. ^b Percent of GDP. ^c Federal Funds rate less the rate of CPI inflation. ^d Forecast.

Source: Data Resources Inc. and Congressional Budget Office

Table 6. Impact of a monetary expansion
10 percent money increase, effect in year 2

	Real GDP	Prices ^a	Unemployment
United States	3.2	5.7	-2.7
Germany	2.5	6.0	-1.9
Italy	2.9	4.4	-0.9

^aCumulative increase in the price level relative to base line.

Source: Bartolini and Symansky (1993)

and reduced credit rationing. The process is strikingly slow, 2 or 3 quarters from the inception of easy money just to get started, but it does build up over time. Any thought that monetary policy does not work is squarely contradicted by the US experience. The experience of the United States also supports the view that long-term asset markets and the foreign exchange market do not react adversely to low short-term interest rates *per se*. In fact, in 1993 while the recovery was slow, the cut in the Federal Funds rate brought down long-term bond yields to less than 6 percent. Only in early 1994 when the prospect of a boom emerged and with it the possibility of reaching full employment rapidly and passing it, did a sharp increase in long-term rates come about.

It is often argued that monetary policy does not work – increases in the money stock quickly translate into currency depreciation, wage inflation and no real expansion. The estimates of the IMF model show otherwise in Table 6 and thus confirm our interpretation of the US experience. Monetary expansion unambiguously raises output, reduces unemployment and creates *some* inflation. But even after 2 years, a 10 percent increase in the money stock has only produced a 5 percentage point increase in the price level (relative to the baseline scenario) while having brought down unemployment quite a bit. Here the differences in national results are particularly interesting. In Italy, for example, monetary expansion is more inflationary than in Germany. But even here unemployment responds to monetary ease.

Europe has been indoctrinated with some very extreme ideas about monetary policy. That has especially been the case in Germany and France where the credibility issue has been exaggerated and where disinflation is being overdone. The basic point to be made is that a country can push interest rates to extremely low levels. In the presence of high unemployment, low interest rates will promote recovery rather than inflation. Of course, low interest rates are only possible in a setting where a

currency is undervalued. Specifically, cutting rates below those prevailing and likely to prevail in Germany requires an expectation of nominal appreciation. If that can be accomplished, the stage for growth and falling unemployment is set. Hence the critical role of the exchange rate in creating an environment for recovery.

4.3. Competitiveness

Depreciation of the real exchange rate turns out to be the mechanisms that has most come back into its own in the past decade and the last few years. Starting with the unwinding of the US overvaluation, but more specifically in the context of the Italian, British, Spanish and Scandinavian devaluations of late 1992, the point has been made that nominal devaluation means real devaluation and hence an expansionary force for demand. The evidence is striking that real depreciation translates into a major adjustment of exports and imports. Thus, as a demand policy, real depreciation works. Of course, it has the added bonus of allowing a country to practice lower interest rates.

Two points are particularly controversial. First, there is the issue of whether a nominal exchange depreciation will in due course be eaten up by offsetting inflation. Second, the question is whether devaluation means loss of credibility and hence inflation. Both myths of the 1980s are now firmly rejected by the evidence.

The recent evidence from Europe and Canada squarely contradicts these assertions. Table 7 shows that very large real depreciations have occurred and are accompanied by declining inflation rates. That is an unexpected and important development which challenges the accepted views.

Table 7. Devaluation and inflation

	Depreciation 1992-93 ^a		Inflation			Unemployment ^c
	Nominal	Real	1992	1993	1994 ^b	
Italy	20.0	24.2	5.4	4.3	3.8	11.2
Sweden	23.0	25.3	2.3	4.8	2.0	7.8
Finland	16.0	15.9	2.6	2.5	2.5	17.8
UK	12.5	12.5	3.7	1.9	2.8	9.7
Spain	18.2	14.4	5.9	4.9	4.3	23.9
Canada	9.2	10.2	1.5	1.9	0.9	11.0

^a Depreciation of the IMF effective exchange rate, 1992:II-Sept. 1993. ^b Forecast. ^c Early 1994.

Source: *The Economist*, IMF, and Bank of Finland

The impact of depreciation on inflation assumedly comes via three channels.

(i) *Import prices*: Currency depreciation, given world prices, raises the prices charged in the devaluing currency by foreign suppliers. That is obviously true for commodities such as oil or copper traded at uniform dollar prices around the world. Here the pass through of devaluation is 100 percent, full and complete. For customer goods – automobiles, machinery, etc. – the pass through is likely to be somewhat less as foreign suppliers or importers must weigh giving up market shares against the losses they might suffer if they absorb the devaluation as a cut in their margins. But even here we would expect substantial pass through, more so the smaller the country and the less it justifies special pricing decisions.

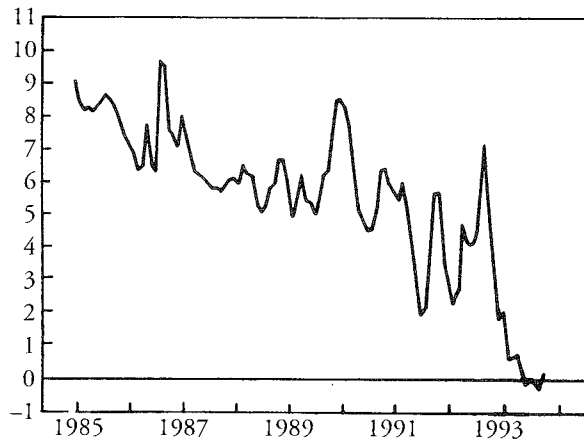
(ii) *Pass through to other prices*: If import prices rise, this raises directly the costs of imported inputs and in that fashion feeds into costs and prices. But it also creates the opportunity for domestic import competing firms to increase their margins. They might not fully match the increase in import prices, going for market share rather than margins, but some pass through is sure to happen.

(iii) *Real wage stickiness*: If devaluation causes *some* price rise, the next stop is wages. If *real* wages are sticky, then price increases will translate into extra wage increases. This is clearly the case if there is formal indexation, but even without, some extra wage pressure is to be expected.

(iv) *Vicious cycle*: If wages increase in response to devaluation, directly or because traded goods prices rise, the next round is a reaction in all other domestic prices. Thus the initial devaluation shock easily gives rise to a *vicious circle* of wage-price rises which may ultimately eliminate any gain in competitiveness but will speed up inflation.

But this has not happened in the cases shown in Table 7. There are two closely connected reasons. First, there is mass unemployment and deep slack in the devaluing countries. That means wages are far less responsive than they would be in a boom. Second, explicit incomes policy agreements, for example the earlier abolition of the *scala mobile* in Italy, have simply put a stop to any automaticity in the pass-through mechanism. In this climate depreciation works.

Figure 4. Finland – Germany interest differential
Percent



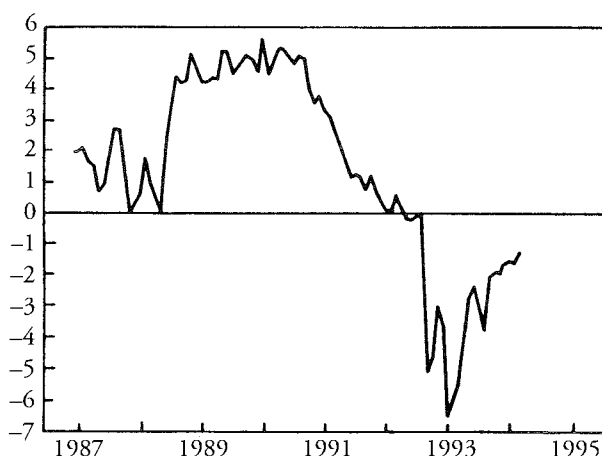
Source: IMF

Equally questionable is the proposition that depreciation leads to higher interest rates because of the loss of confidence. On the contrary, currencies that have come down a lot have *far* lower interest rates today than they had before. Of course, German interest rates have declined, too, but devaluing countries have collected a significant bonus which they would be unlikely to have, had they remained at their high and overvalued par values.

A case in point is Finland. Figure 4 shows the Finland–Germany interest rate spread. Following an earlier devaluation in 1991, which, at least in hindsight, was far too small, the Finnish authorities vigorously defended the currency in a totally unrealistic setting through much of 1992. Mass unemployment was there for anyone to see, the government budget deficit increased and debt deflation and mass bankruptcy were underway on a major scale. The situation was indefensible. A major depreciation liberated interest rates.

The assertion that following a devaluation interest rates are lower than they were before needs some clarification. Of course, they are lower than at the time of a speculative attack. But that is not really interesting. What we would like to know is whether they would be lower today, had there not been a devaluation. (Of course, we would also want to know how long they would have stayed high and what unemployment would be as a result.) We do not have the means to conduct that counterfactual experiment. But we can look at a simple comparison of interest rates in France and the United Kingdom (see Figure 5). France held on to the DM while

Figure 5. Britain – France interest differential
Short and long-term rates



Source: IMF

the United Kingdom devalued. The evidence is ambiguous: France has higher short-term rates and lower long-term rates (not shown). Of course, France also has significantly less inflation. Clearly, the UK is not viewed as a hard currency country. On the other hand, the UK does have growth and less unemployment today than a year ago, while in France the opposite is the case. By early 1994, French unemployment was 12 percent and rising.

Going a step further, what would UK interest rates be if Britain had not devalued but rather remained in the exchange rate mechanism? Perhaps the rates might be as low as those of France. But that is far from assured.

More likely, Britain would have higher unemployment, higher interest rates and would be waiting every day for a currency crisis. The worst situation is to defend a credibility that nobody believes; when currencies are taken to realistic levels or undervalued *and* the inflationary response is absent, bond holders are willing lenders at very low yields.

4.4. Financial sector restructuring

When financial institutions are impaired, they restrict credit in an effort to rebuild their balance sheets. But credit is not fungible; the customers of impaired institutions find themselves cut off from credit with little chance of finding it elsewhere. As a result, problems of financial institutions spread to their customers and thus amplify macroeconomic instabil-

ity. Moreover, when financial institutions become insolvent, an easing of monetary policy may not be enough to stimulate growth. Financial restructuring may be a necessary complement to restore the operation of credit. The recent literature on credit suggests that in the ordinary transmission mechanism, credit is an important, independent channel. In a situation of financial distress, the malfunctioning of intermediaries becomes a critical obstacle to recovery.⁹

A financial system that is replete with bad loans, in conjunction with a high interest rate and low growth environment, cannot fail to grow into a major fiscal problem. On the way it is bound to impair recovery because it will primarily roll bad loans rather than create credit.

Restructuring the financial sector so that it becomes a source of credit is an important part of policies to support demand growth. Specifically, monetary and exchange rate policy can only be partially supportive if they do not have the support of credit expansion. This is all the more important since most enterprises will rely on bank credit to finance investment or supplement internal savings. Large firms may be able to borrow in the money market or across borders. But medium and small scale enterprises rely on their established credit relations and as a result are impaired or even brought down when their traditional credit sources are impaired.

Financial restructuring is, of course, costly. But the cost of an early, bold reform is well amortized in the limitation on losses that ultimately wind up in the public sector, in the reduced bankruptcies of companies that will not have to pay emergency premia, and in the support for recovery.

5. All things considered

How can recovery and sustained growth consistent with financial stability be brought about? In my view, controversial as it may sound, the best strategy is competitive depreciation accompanied by radically low interest rates. The evidence on the effectiveness of interest rates and exchange rates suggest that these policies work.

Moreover, they are even productive in an international context. The more the European periphery seeks devaluations on the hard currency block, the more the latter countries suffer trade deterioration and imported disinflation and thus come earlier to the point of joining in interest rate cutting. The more the periphery in Europe initiates the strategy and

⁹ See Gertler (1988) and Bernanke (1983, 1993) and the references given there.

pushes it ahead, the sooner the center – Germany – will follow. For years Germany has sought a real appreciation to obviate the inflationary consequences of unification. It is getting there piecemeal, but at a high cost to all of Europe. Less insistence on fixed rates and acceptance of depreciation by the periphery – Scandinavia, France, the UK, Italy and Spain – would have yielded a far better outcome than what we witness today. The fight to hold on to the DM was wasted; it has left a legacy of unemployment, budget deficits and bad debts and it has not enhanced credibility.

All of Europe, given the fiscal constraints – actual and imagined – needs to place much more reliance on easy money and real depreciation (relative to Japan and the US). The more the periphery initiates the strategy and pushes it ahead, the sooner the center will follow. Indeed, the more fiscal consolidation is imperative and inevitable, the larger the need for an accompanying policy of increased competitiveness and easy money.

Demand policies can be made to work: there is no grave risk, the pay-offs are obvious and the hard money doctrine of the 1980s is thoroughly discredited. By contrast, waiting for recovery will further weaken the economies, increase debts, break enterprises and confidence, and worsen the prospects for growth. But, connecting with our position at the outset, demand policy cannot work by itself. In the European context it needs as a partner a major dose of structural reform in the quest to reduce unemployment and restore growth in Europe. The two must go hand in hand, neither must take the back seat.

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