

MONETARY POLICY AND THE MACROECONOMICS OF 'SOFT' GROWTH

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Since the end of WW2, there existed between European construction and the fulfilment of national economic policy objectives of EEC countries a virtuous circle: the pursuit of policy objectives was facilitated by European construction and the latter was greatly helped by the achievement of both full-employment and rapid growth. The EEC was a means to achieve the ultimate ends of economic activity, i.e. a rising standard of living in a cohesive society apt to offer all its members a job and an opportunity for progress. The question *why Europe* had such an obvious answer that it was not even raised.

Since the beginning of the 90's the context has apparently dramatically changed. Full-employment and growth on one side and the European construction on the other seem to be independent if not conflicting objectives. Building Europe seems to require structurally restrictive policies in a context of high, even massive unemployment, low inflation and slow growth. Peoples' outlook is no longer a rising standard of living, but a decrease in social protection within the framework of a leaner welfare state. Europe is no longer seen as a road to prosperity, a mean to achieve higher growth, but an aim by itself whatever the sacrifices it requires from the peoples of European countries. It may well be that this radical change has some rationale in the wake of the globalisation of markets, and the subsequent increase in the intensity of competition to which it leads, but that is not really explained, and people are still waiting for an explanation of why policies should be so restrictive in a context where inflation is no more a credible threat. It may also be that the new steps in the building of Europe require a bigger investment and hence a sacrifice in terms of present consumption — the fruits of which will appear latter — but the sacrifices seem so unevenly distributed that the feeling that there will be permanent losers, a large group indeed, in the process is by now widespread.

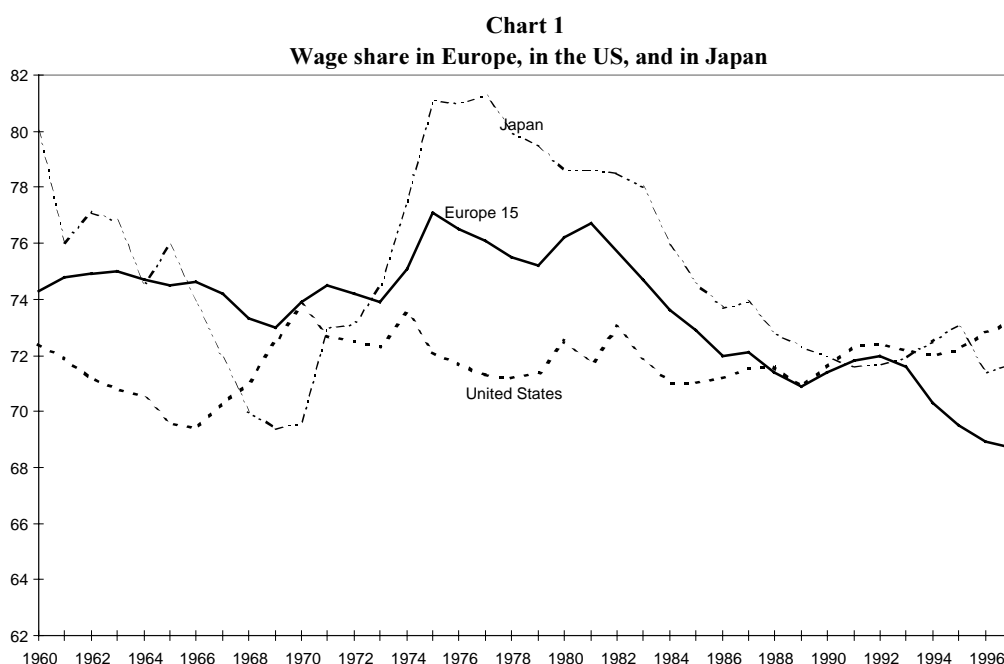
One could argue that the problem is a classical problem in economic policy: if European construction becomes by itself an independent economic objective, there is for any single European country one more objective than instruments to reach them. That will normally lead to policy dilemmas, which will be solved only when European construction, i.e. monetary union, will be achieved. In the interim another policy objective has to be given up, say growth, and if the remaining instruments are not adapted to the new, lower rate of growth consistent with European construction, this will lead to mounting disequilibria in the public finances.

Ex-post, it is now argued that the origin of the 1990's slump in Europe lies in past activism of the European states which is now crystallised in mounting public debts, huge budget deficits and high taxation. The eurosclerosis explanation—which was already invoked at the beginning of the eighties — is rejuvenated, public finance being this time the main suspect. Hence, the Maastricht criteria have had the merit of highlighting the impotence to which such an evolution has led, and by now each government is convinced that it has to cut public expenditures sufficiently to allow for both a reduction in budget deficit and a decrease in taxes. Even if the debate about the causes of high interest rates is far from being closed, everywhere in Europe governments take as absolutely true the contention that the main cause of the high level of interest rates is the increase in public debts.

It does not need more than a modicum of historical sensitivity though, to know that alternative explanations are available, especially in periods of disinflation. That both short and long term real rates of interest were at historic high levels in almost all countries in the first part of the thirties is also an inescapable fact. And by now, no one would argue that this was the reflection of an insufficiency of saving: it has always been hard to prove the existence of an excess demand in periods of declining inflation rates. If the supply-side recommendation of Robert Mundell — use restrictive monetary policy to fight inflation and expansionary budgetary policy to reduce unemployment — were implemented though, such an outcome could be possible. (But in Europe something is missing for one to argue that the same constellation is prevailing, namely a sufficient rate of growth in both output and employment).

Of course it is also possible to refer to structural factors to explain both slow growth and rising unemployment in a context of excess demand: wage inflexibility may lead in

the presence of adverse supply shocks to an increase in the «natural rate of unemployment», a decrease in profitability and thus through a permanent decrease in the investment ratio to a lower rate of potential growth. A process of this kind was surely at work in the second half of the 70's-beginning of the 80's when the oil shocks led to an increase in labour's share in national income throughout Europe. But since then the process has been more than reversed: the real price of oil has sharply declined — it is now at a level below its pre-first oil shock value — and, perhaps more importantly, the share of wages has everywhere declined to a level which is well below its value of the sixties.



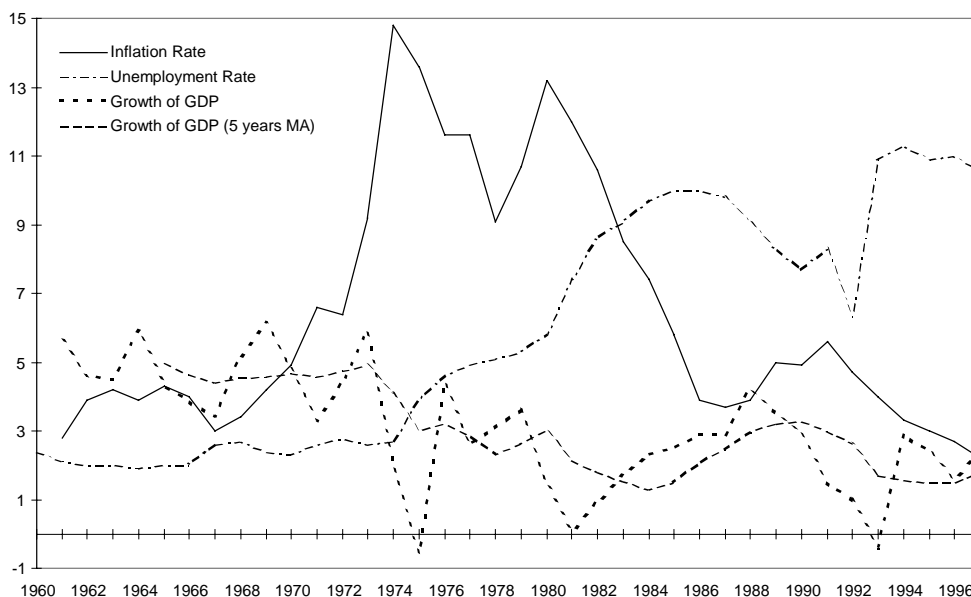
Source : EC

Thus the wage share is today 8 points less than its peak value of 1975, but strikingly, more than 5 points less than its average value of the sixties. It is particularly difficult to make sense of the assumption of real wage rigidity to explain unemployment in a context where the share of profit is increasing.

There is no question that monetary policy since the end of the eighties has been very restrictive, but the question of whether fiscal policy was too expansionary remains open. Of course, it is not easy to measure the degree of tightness of fiscal policies and hence to give a definitive evaluation of the course of fiscal policy. There is no agreement among economists on the best way to measure potential growth and hence structural deficits. But

whatever boost has occurred in structural deficits at the turn of the eighties and the nineties, it has not prevented growth to slow down and inflation to decelerate: 6 records have thus been achieved in the nineties: the highest level of unemployment in Europe since WW2; the lowest average rate of growth for a five year period also since WW2; the lowest inflation rate and wage share since 1961; the highest real short term interest rate in the post period.

Chart 2
Inflation, unemployment and growth in Europe



Source : EC

It is thus difficult to sustain the claim that fiscal policy was unduly expansionary as it appears obvious that the policy mix was globally restrictive: whatever the degree of laxity in fiscal policy it was not enough to compensate the restrictiveness of monetary policy. In a situation where the excess saving of the private sector more than compensates the dissaving of the public sector, it is hard to continue to assert that the cause of abnormally high interest rates lies only in the mounting debt of the public sector.

I. Macroeconomic policies in Europe since the second oil shock

I.1. 1979-1987: a restrictive, but time consistent policy-mix

The second oil shock happened at a time when, whatever the criteria chosen, inflation was a real evil. For the E15, the rate was 9.1% in 1978. Moreover, even if for some countries unemployment was already a threat — having risen steadily since 1973 — it was, by present standards, very low, 4.9% of the European work-force. It was clear that the European countries had not yet absorbed the first oil shock. Besides, the course of macroeconomic policies was very expansionary: the short term real rate of interest was, for many countries, negative and for the E15 averaged -1.2% . But fiscal policy was also lax, as the structural deficit (measured by the OECD) was high: -4.0% of G.D.P.

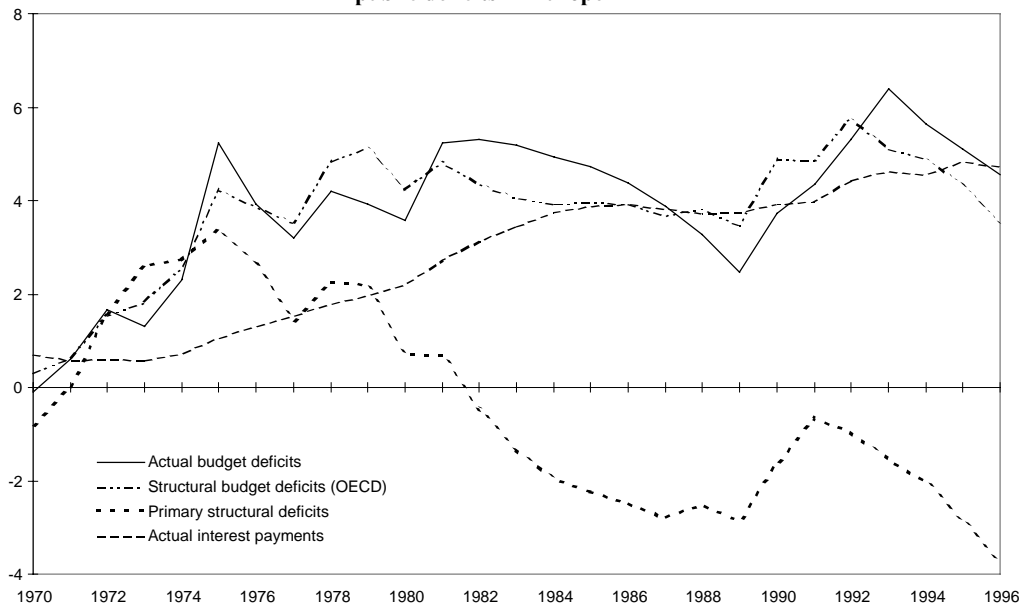
In such a context, it is easy to understand why the fight against inflation became a priority throughout Europe. All over the world monetary policy became very restrictive first under the leadership of the US — which may explain at least partially the appreciation of the dollar in the first half of the eighties —, and later from 1986 onwards, under European leadership, real short term interest rates have been consistently higher in the E15 than in the US.

Germany has to be singled out. It is a case apart. First, at the onset of the second oil shock, it had both a very low inflation rate (2.7% in 1978) and a very low unemployment rate (3.1% in the same year). By European standards, it was the only country to have achieved a decrease in its unemployment rate! It had of course suffered an increase in its budget deficit following the episode of the « locomotive » in 1978, but it was certainly in a better shape than any other European country. When the EMS was created, it was obvious that Germany would be the leader of European monetary policy as it had already achieved what was being targetted by the other countries. And it has to be emphasized that through the EMS, the fight against inflation has been less costly than it would otherwise have been, the other European countries benefiting from a « surcroît » of credibility, their currencies having the DM as an anchor. It was then the right strategy as until 1988 the German nominal and real short term interest rates remained below the US ones. In retrospect such a strategy could be considered as a cooperative one, where each country in Europe was buying at a cheaper rate something it needed. Most European countries were achieving disinflation, at a cost in terms of employment, but a lower one (at least politically) than would have been the case if they had to fight inflation alone. On the other hand, Germany was benefiting from a competitive advantage as it had a structurally lower inflation rate and the rules of functioning of the EMS did not allow for devaluation to

fully compensate for inflation differentials. In other words, Germany benefited in terms of employment and a current account surplus from an undervaluation of its currency. The other countries of the EMS accelerated their disinflation thanks to an overvaluation of their currencies. This cooperative game was all the more necessary as for all European countries, the inflationary consequences of the second oil shock have been magnified by the huge real appreciation of the dollar during the first half of the eighties.

This may explain why, in Europe, restrictive monetary policy has not been compensated at least partially by an expansionary fiscal policy, as it has been in the US. Feldstein (1986), when the fight against (« real ») inflation was raging, was even tracing the European unemployment problem to fiscal austerity: the shrinkage of public services and public sector capital expenditures, and the maintenance of tax rates at pre-slump highs. The European austerity was often contrasted with the activist budget deficits run elsewhere: the red ink in the United States and, earlier, Japan, particularly. With hindsight, we may now claim that fiscal policy in Europe was mildly restrictive until 1987. For the E15, the structural budget deficit as measured by the OECD declined between 1979 and 1987, from 5.1% of GDP to 3.7% of GDP. This evolution of structural deficits is all the more remarkable as it was paralleled by a steady increase in the servicing of the debt as during the same period actual interest payments by General government increased by more than two points of GDP for the E15. Hence for the whole of Europe, the primary structural deficit had been reduced by more than 5 points of GDP, which actually means that by 1987 and until the end of the eighties, the structural primary deficits was largely in surplus.

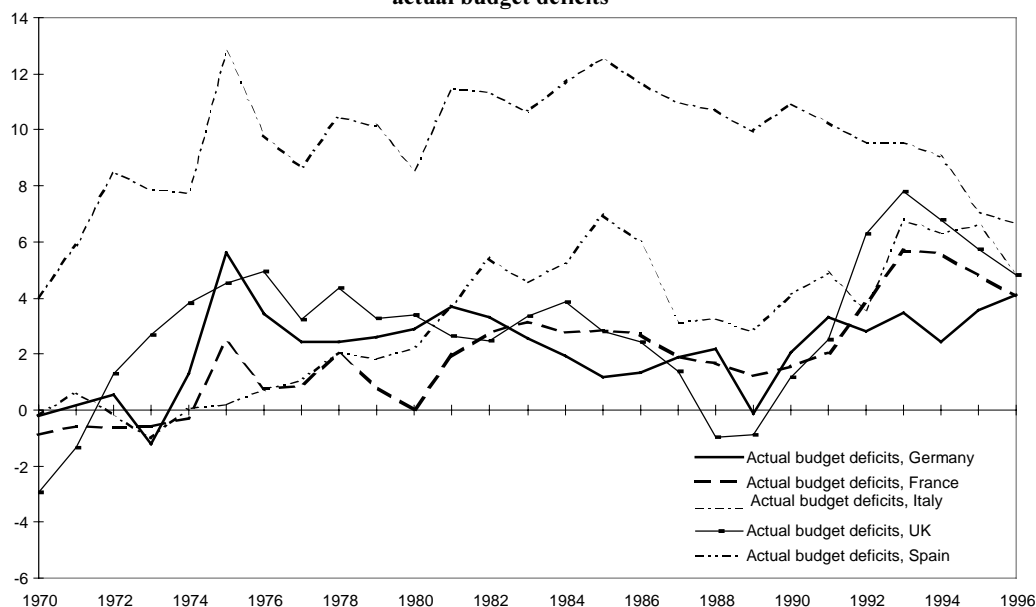
Chart 3
public deficits in Europe



Source : OECD

Of course, if we consider the same evolution, country by country, the picture is much more diverse, Germany being the country whose fiscal austerity was the most severe, Spain and Italy, the countries for which it would be difficult to even speak of austerity. But, on the whole, the proposition that fiscal policies in European countries were ranging from very restrictive to, at a maximum, neutral holds on average during the eighties.

Chart 4
actual budget deficits



Source : OECD

In a nutshell, the policy mix in Europe was during most of the eighties very restrictive — as it combined an increase in real interest rates of about 300 to 400 basic points and a reduction in structural deficits — but time consistent as monetary and fiscal policy were not in conflict with each other. Macroeconomic policy was, to say the least not directed against unemployment, as it was busy elsewhere, attempting (successfully) to reduce inflation. It should then not come as a surprise that until 1986-87 unemployment was rising, approaching 10% for the E15.

We may summarise this phase of European development by two propositions:

- Decentralized monetary union has a deflationary bias of which the unemployment rate may be a systemic measure (Fitoussi and Flandreau, 1994). The reason being that union members had to align their policies to be consistent with the preferences of the country which was most inflation-averse. This was the case of the functioning of the EMS.

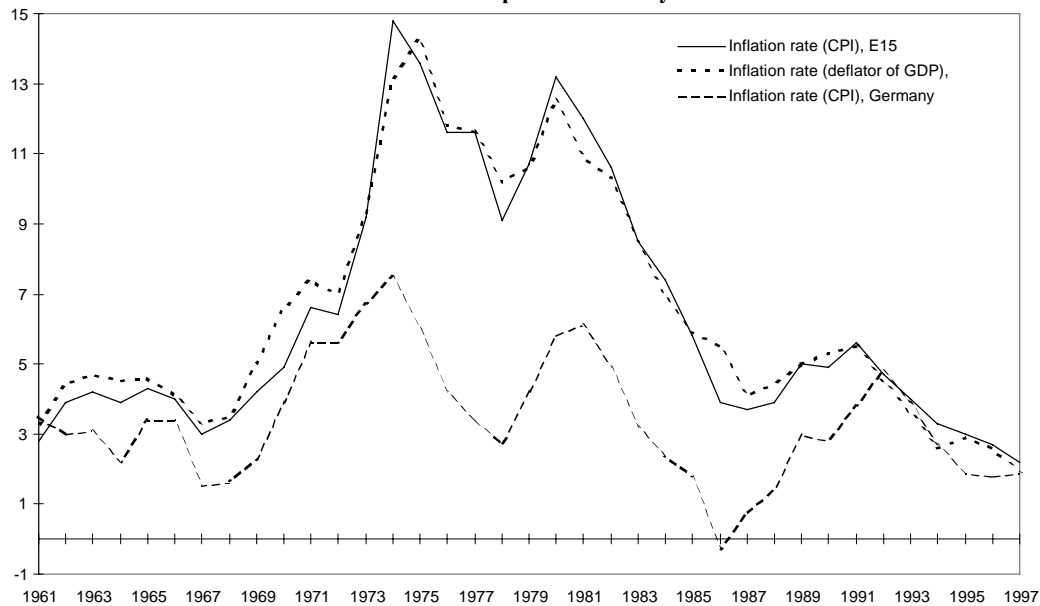
- But during this first period under review, one could argue that this deflationary bias was exactly what most European countries were aiming at. Indeed all the countries in the world were looking for means to achieve at the least cost a sizeable reduction in the inflation rate. For Europe, the EMS was thus a convenient device to achieve that aim.

1.2. 1987-1990: The years of recovery: was the inflation-threat an illusion?

Continuing to look at Europe as if it were a single country, it appears that the recovery of output begins in 1986, the date of the oil counter shock. Of course chronology is a matter of convention and it may be argued that Europe was already in 1986 in the upward phase of a cycle as the rate of growth was increasing since 1982-1983. But before 1986 unemployment was still rising and the process was rather a process of *soft growth*, i.e. under potential which did not show any acceleration before 1986. For the E15, growth reached its peak level in 1988 and then began to decelerate steadily, reaching a negative figure in 1993. By 1990 one could argue that the rate of growth for the E15 was still above potential. Indeed, according to OECD calculations, the output gap (the difference between actual GDP and potential GDP) was positive for Europe between 1988 and 1991, showing a surplus of 1.2% as late as 1991. (Even if it is hard to believe that a group of countries, the E15, growing at an average rate of 1.5%, were characterised by a positive output gap).

On the eve of the counter-oil shock, the battle against inflation was not, but almost, won. For the E15 the inflation rate was at its lowest level since 1971 (5.8%), in constant deceleration since 1980 when it was 13.2%. This pattern was common to most European countries, with, as always, Germany achieving the lowest rate of inflation (1.8%) in 1985. In this context, the sharp fall of the price of oil, magnified by the depreciation of the dollar, gave a strong supplementary disinflationary impulse: between 1985 and 1986, the E15 inflation rate decreased by about 200 basis points, the German inflation rate becoming negative. The core European inflation did not of course decrease that much: the implicit GDP deflator was, only in 1986 only half a point lower than its 1985 level.

Chart 5
Inflation in Europe and Germany



Source : OECD

But this sharp movement of the measured inflation rate will later lead to what may be called « the European inflation illusion »: it was obvious that the contribution of the oil counter shock to the disinflationary process would slowly decrease giving the impression of a return of inflation. And by 1988, indeed, the rate of inflation began to increase again for the E15 reaching, in 1991, a level of 5.6%.

This picture obviously looks very different if we measure the acceleration of inflation taking 1985 or 1986-87 as the starting year of the period.

Table 1 gives the measures of the increase of the rates of inflation for the E15 and each country in Europe.

Table 1
Increase in the rate of inflation during the recovery period

	1985-1991	1986-1991	1987-1991
E15	- 1	+ 2.4	+ 2.8
B	- 1.7	+ 1.9	+ 1.7
DK- 2.3		- 1,3- 1.6	
D	+ 1.4	+ 3.7	+ 3.4
GR	+ 0.2	- 3.5	+ 3.1
E	- 1.9	- 2.9	+ 0.6
F	- 2.7	+ 0.5	+ 0.1
IRL	- 2.3	- 0.7	0
I	- 2.9	+ 0.5	+ 1.5
L	- 1	+ 2.8	+ 3.1
NL	+ 1.6	+ 3.7	+ 4.3
P	- 8.4	- 0.8	+ 1.5
UK- 0.2		+ 2.5+ 1.8	
A	+ 0.1	+ 1.6	+ 1.9
S	+ 1.9	+ 5.1	+ 5.1
SF	- 1.5	+ 0.7	+ 0.9
US	+ 0.6	+ 2.3	+ 0.5
J	+ 1.2	+ 2.6	+ 3.2

Source : EC

Three conclusions emerge from this comparison:

- The 1991 rate of inflation is below its 1985 level for Europe as a whole and for the great majority of the countries.
- Taking 87 as the starting year of the period the increase of the inflation rate appears very modest for the vast majority of the countries and also very modest for the E15.
- The only noticeable exception to this general picture is Germany (and Netherlands) where the 1991 rate of inflation is not only well above its 1987 level (by 3.4) but also sizeably above its 1985 level (by 1.4 points).

We had tried to simulate with Mimosa (the multinational model of OFCE), the disinflationary impact of the oil counter shock for Europe as a whole. It is then easy to calculate what would have been the E15 rate of inflation without this shock. The result is shown in table 2.

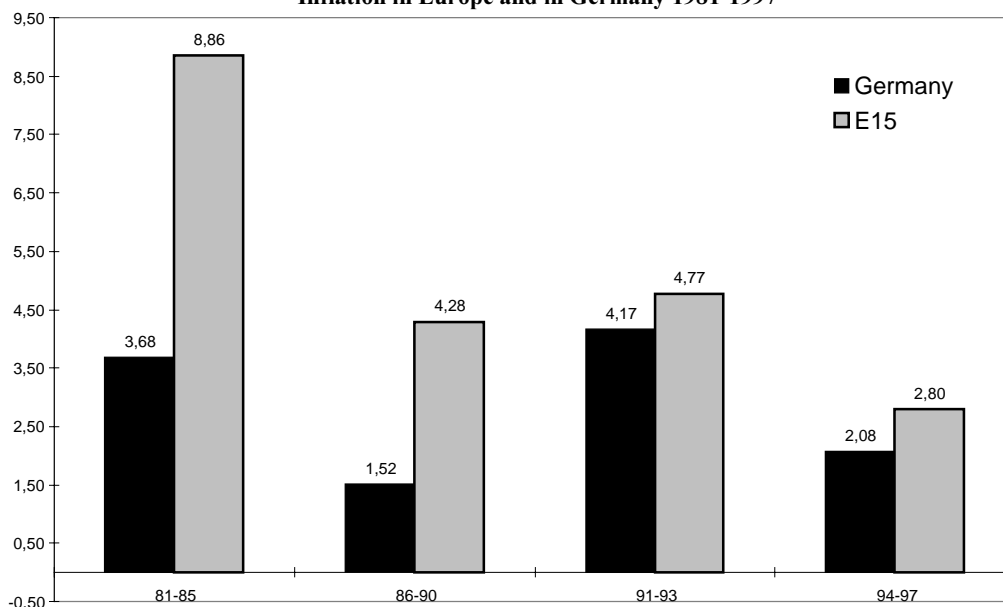
Table 2
Impact of the counter oil shock

	1985	1986	1987	1988	1989	1990	1991
• Impact on the average inflation rate in Europe	—	- 1.2	- 1.2	- 0.8	- 0.6	- 0.5	- 0.5
• E15 inflation rate corrected from the effect of the counter oil shock	6.1	4.9	4.5	4.5	5.8	6.3	5.6
• German inflation rate corrected	2.2	1.1	1.4	2.1	3.4	3.2	4.1

Sources : MIMOSA OFCE and EC.

This table shows that the disinflation process continued at least until 1988 for Europe as a whole and apparently stopped in 1989-90. But taking into account the weight of Germany, and having in mind table 1, it may be safe to argue that the « return » of inflation was a German phenomenon, not an European one. One should add that it was actually not a return but the reflection of a new, historical shock Europe-specific this time, German unification. The following chart comparing the average rate of inflation in different sub-periods from 1981 to 1997 for the E15 and for Germany, makes this point abundantly clear.

Chart 6
Inflation in Europe and in Germany 1981-1997



Source : OECD

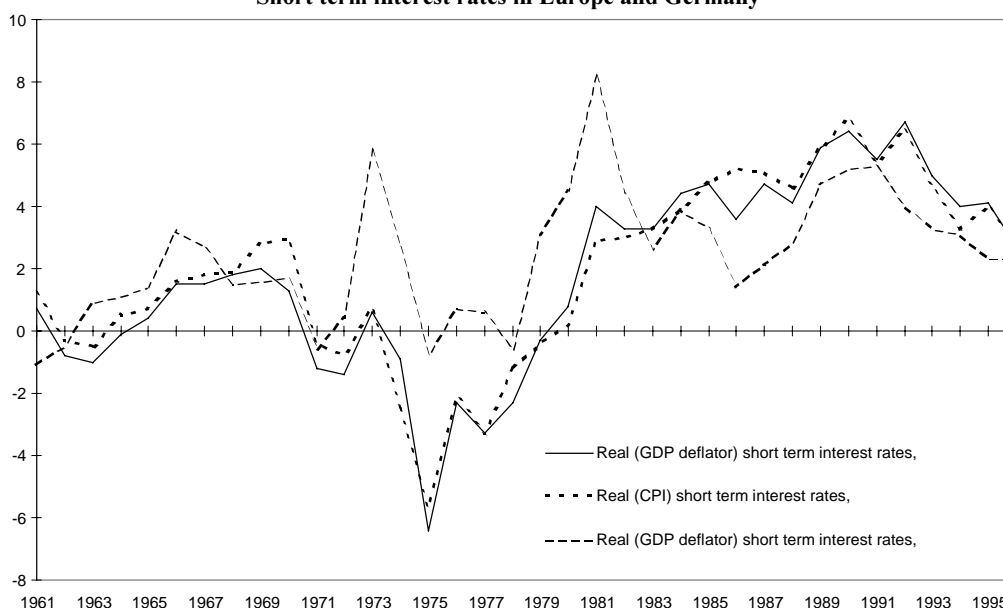
Hence one could barely speak of a threat of inflation for Europe as a whole. Indeed, in 1992-93, while the German inflation rate continued to increase reaching levels unusual for Germany — in 1992, the German inflation rate was just 1.3 point lower than what it was in 1981, i.e. its highest level immediately following the second oil shock — the E15 inflation rate continued to decrease.

At most, one could characterise this period as one of normal very modest fluctuations in the inflation rate brought about by a large fluctuation in the rate of growth, as this latter had almost doubled for many countries. The apparent puzzle is rather how such a large movement in output has been consistent with such a small variation in the inflation rate. At the end of the sixties, for example, a (proportionately similar) fluctuation in the rate of growth had been accompanied by a much larger variation in the rate of inflation. The answer probably lies in the unemployment problem which characterised Europe since the mid-eighties, that is the importance of the degree of slack in the labour market.

A question, then, naturally arises: did such a small increase in the rate of inflation justify such a severe move in monetary policy? Between 1986 and 1990, the real short term interest rate had increased by 280 basis points for the E15, when using the GDP deflator to calculate the real rate. Using the same indices and for the same period, it

increased by 380 basis points in Germany. If we choose the CPI index the acceleration appears to be less dramatic, but still important. And besides, the average level of the real short term interest rates appear much higher in the period 1986-1990, than it was in the period 1981-1985. Actually the acceleration in interest rates, begun in 1988-89 and would persist until and including 1992.

Chart 7
Short term interest rates in Europe and Germany

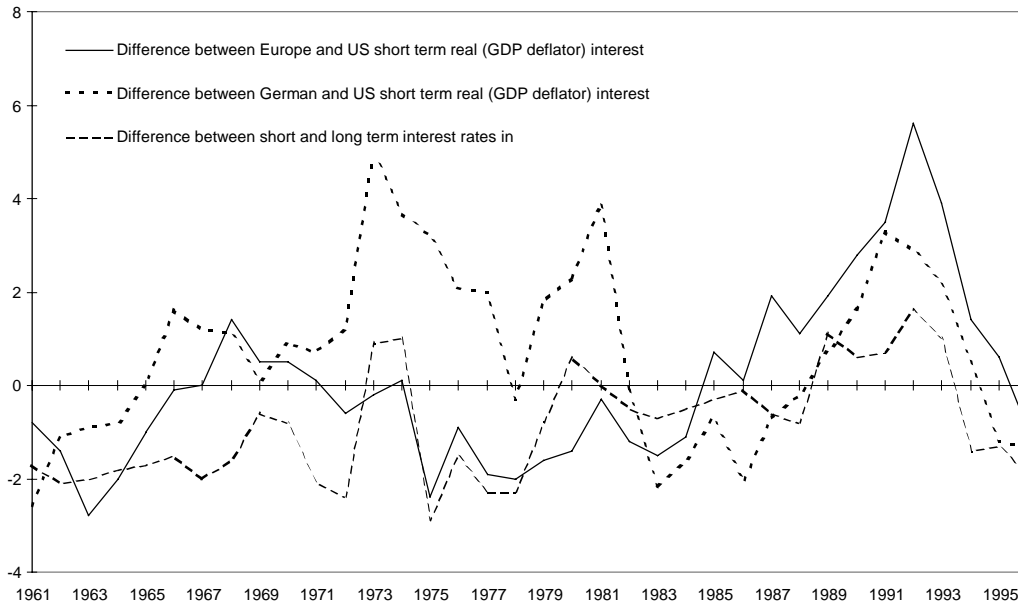


Source : OECD

But it is worth emphasising two others facts about monetary policy before studying its consequences. From 1985 until 1995, the real short term interest rate was consistently higher in Europe than in the US. The same statement holds for the period 1989-1994 for the German interest rate as compared to the US one.

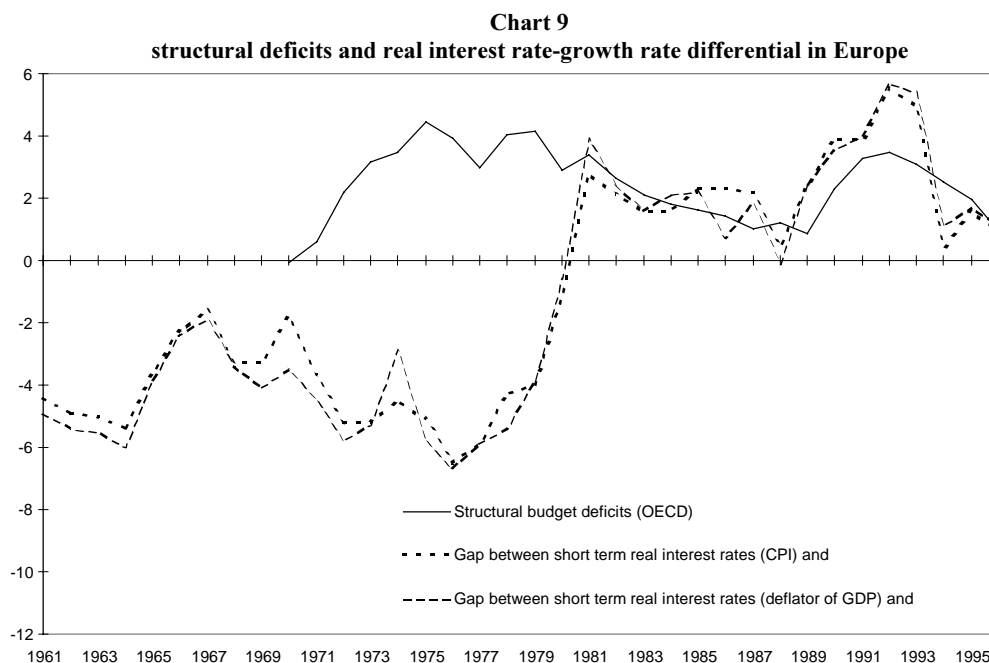
Second (and more importantly?) between 1989 and 1993, real short term interest rates have been consistently higher than long term ones for the E15. This was clearly not the case for the US.

Chart 8
interest rates differentials



Source : OECD

All these facts seem to indicate that monetary policy was the prime mover in the process which had led Europe into a situation of slow growth. This interpretation seems all the more plausible as the structural deficits of European countries did decrease until 1989, that is one year after monetary policy had become very restrictive. Indeed in 1989, the structural budget deficit as measured by the OECD reached, for Europe as a whole, its lowest level since the second oil shock despite the huge increase in real short term interest rates (the average real short term interest rates — taking the CPI to calculate the rates — between 1986 and 1989 has been 5.2%; the figure was about two points lower in the first half of the eighties).

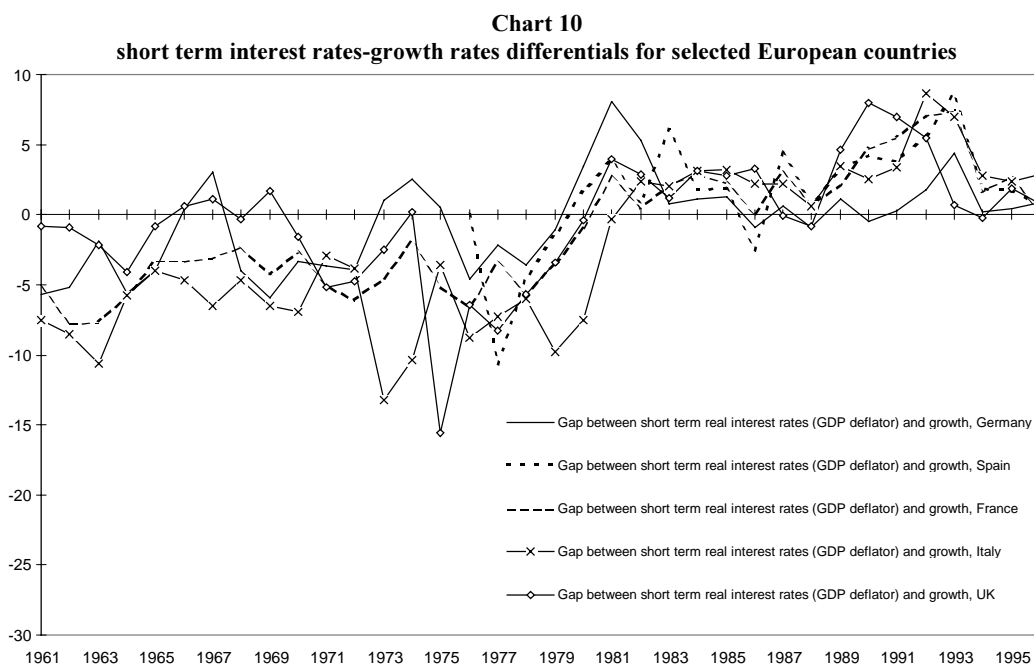


Sources: EC, OECD.

1.3. The recession of the 90's and after

We may interpret the preceding episode in two ways. The first one will emphasise the weight of the fear of inflation in the conduct of monetary policy: in many ways the belief in the return of inflation at the end of the eighties was an illusion, but the European countries having paid such a high price to defeat inflation did not want to take any risk. The second will emphasise the mismanagement of the EMS at the turn of the eighties and the nineties. What is clear by now is that inflation was not at all an illusion for Germany. The German economy was clearly overheated, but this was not in general the case for the other European economies. But through the EMS, there was no escape but to adopt German monetary policy. The rest follows: from 1990, the European GDP began to decelerate — the movement being universal for almost all European countries — but this deceleration did not bring any relief on the real interest rates front. The reasons are easy to understand: both the inflation rate and the growth rate continued to increase in Germany, contrary to what happened in the other countries. The German rate of growth was as high as 5.7% in 1990, 5% in 1991. At the same time inflation went from 2.8% in 1990 to 3.8% in 1991 reaching its climax in 1992 (4.8%) and staying as high as 4% in 1993. 1992 and 1993 were the only years since 1961 when German inflation was higher than or as high as

the European average. The result is striking: the critical gap between the real short term interest rate and the growth rate was negative in 1990 and about nil in 1991 in Germany whereas it was for the same years 3.9% for the E15. The situation was even worse for some of the big European countries .



Source: EC.

In 1990, this critical gap was respectively of 5.0; 3.9; 8.9; for France, Italy and the UK. All this reminds one of a trivial fact: you should not give the same monetary medicine to a country which is suffering from fever and a country which is suffering from anemia.

It is not clear whether it is the threat of inflation which has led to the mismanagement of the EMS, or whether the latter has been ex-post justified by the former. But what on sheer facts appears clear is that there was a mismanagement. It would otherwise be hard to explain why in a period of falling inflation and growth, real interest rates increase.

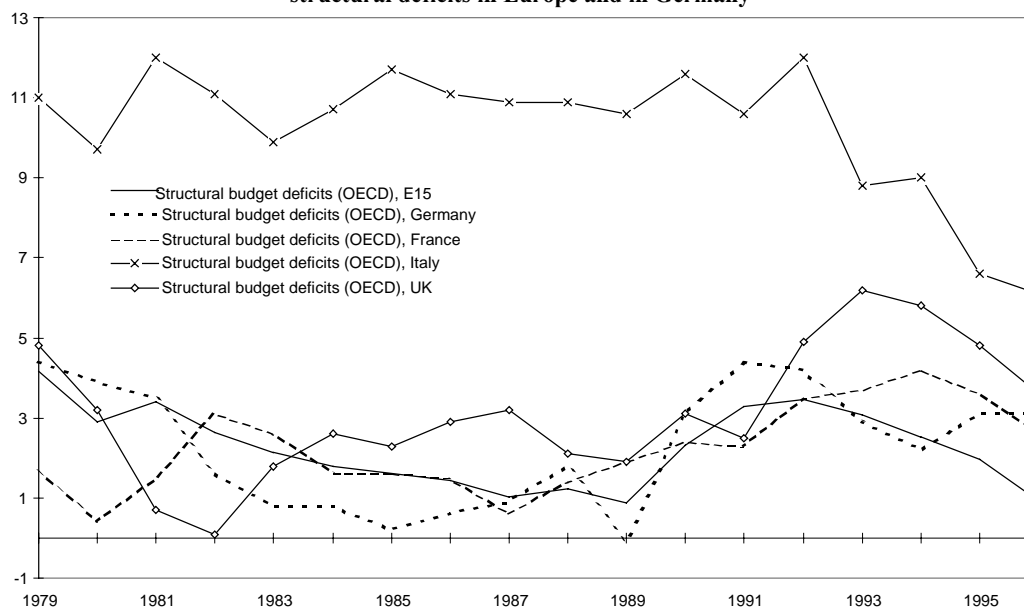
But more importantly, having a very restrictive fiscal policy as well would be hard to justify. Public deficits, and unemployment were increasing because a misadapted monetary policy has, if not caused, at least accelerated the slowdown of growth. It was clear that the extent of the slowdown was unexpected as was the increase in real interest rates necessary to keep the existing parities within the EMS. Which government would be

strong enough to add to the pains of the population by announcing huge cuts in public expenditures and/or important increases in taxes? On the contrary, governments would try to alleviate even mildly the pain. Confronted with the biggest decrease in employment that Europe has known since WW2, they will not only let automatic stabilizers work, but where possible they will increase social expenditures.

It is exactly what happened during this period. The European budget deficits deepened because there was no escape: fiscal policy had to bear the burden of adjustment in countries where it was possible. In other countries such an option was simply not available, because the critical gap had reached values unseen since the thirties: 7.8% for Italy, for example, where the deficit was already about 10%. These countries had no other choice than to change their monetary policy and indeed « the foreign exchange market » constrained them to do so.

There is some truth in the contention that European governments should have taken advantage of the resumption of growth at the end of the eighties to reduce their structural deficits more willingly. The problem would now have been less acute. But this contention misses an important point. There was no way of preventing the increase in the structural deficit in Germany as this increase was the consequence of a country-specific shock — truly autonomous; an historical shock indeed, a magnificent one, the unification of a country. Hence there is something wrong in dealing with the increase in net public borrowing in Germany as if it were a structural problem: the country was investing into a very rewarding project — German unification — whose long-term rate of return would certainly prove to be fairly high. It was hence quite rational to borrow to implement such an investment. In some sense, it is inappropriate to deal with what is a profitable investment — which had to be public in view of its collective impact and of its externalities — as if it were an increase in the structural deficit of the country. That there is a discontinuity in the time series of « structural deficits » at the very moment when this investment begins should then not come as a surprise. The macroeconomic nature of the calculation misses an important point: something completely new had happened — a kind of regime shift — whose qualitative nature can't be crystallised in a quantitative measurement.

Chart 11
structural deficits in Europe and in Germany



Source: OECD.

Just looking at the figures, it appears that the increase in structural deficits in Europe beginning in 1990 is mainly the consequence of what happened in Germany: between 1989 and 1991; the German structural deficit increased by 4.5 points of GDP while for Europe as a whole it increased by 2.4 points. To belabor the evidence, one may add that between the same years gross fixed capital formation increased by 3 points of GDP in Germany and slightly decreased in Europe. In 1995, Germany was the only large country in Europe (and in the world) whose rate of investment was higher (by more than 2 points of GDP) than its 1987 level. For Europe as a whole it was lower by a bit less than a point; for France by 1.7 point; for Italy and UK by 2.8 points!

But whatever confidence we have in the measurement of structural deficits when something essentially new happens — and what has been said before means that our degree of confidence is very low — the evolution of the net borrowing position of European governments during this period means that the mismanagement of the EMS lead to a completely wrong, and unsustainable policy mix in Europe. The policy mix was time inconsistent, in such a way that it could have led to the strange monetary arithmetics described by Sargent and Wallace: a too restrictive monetary policy may lead to

inflationary expectations as it implies, through the slowing down of growth, a huge increase in public deficit.

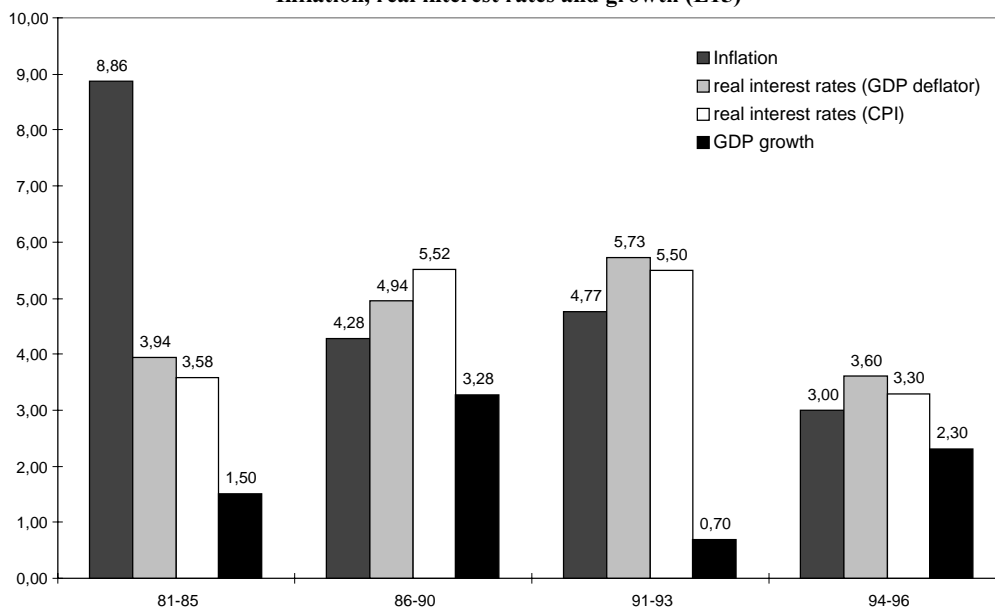
The story begins with a sizeable increase in real short term interest rates in Europe at a time when there was no clear sign of acceleration of inflation, if we take full account of the effect of the oil counter shock. (In 1989 the share of wages was lower than what it was in 1985 by 2 points of GDP for the E15). The slowdown in the rate of growth to which it led did have an impact on the cyclical deficits at a time when it was difficult for governments to deliberately reduce the structural deficits in view of the increase in unemployment. This situation should have put in motion some corrective mechanisms: a decrease in the real rate of interest due to the deceleration of the demand for money implied by the slowdown in activity and thus a real depreciation of most European currencies. The first corrective mechanism would have rejuvenated internal demand. The second would have boosted exports. But none of these effects was allowed to play any role. Instead, real interest rates continued to increase precisely to prevent the depreciation of the European currencies.

There was only one country for which this policy mix was right, namely Germany: the boom in investment, private and public, and the « real » inflationary pressure brought about by German unification should have led the mark to appreciate *vis à vis* all other currencies. The German policy mix was similar to the US one at the beginning of the eighties, save two points: restrictive monetary policy and expansionary budgetary policy were truly simultaneous — while in the US they had been consequential; and second, this policy mix was not a deliberate choice as there were no other ways to deal with the needs of German unification and the rebuilding of the eastern part of the country. Hence the appreciation of the mark should have been strong *vis à vis* the other European countries.

Instead the non-German members of the EMS were caught in a trap: private demand could not but fall in view of the increased restrictiveness of monetary policy, and there were no hopes of a boost in foreign demand because of the real appreciation of their currencies. The only means to soften the hardship of the recession was fiscal policy. Hence there is no mystery in the simultaneous increase in deficits and unemployment throughout Europe.

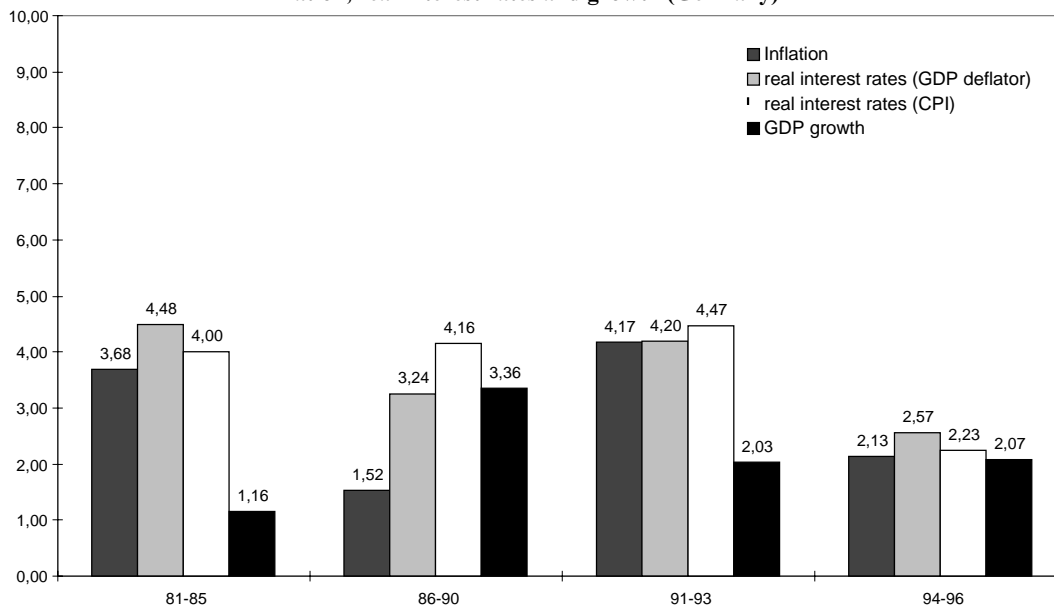
But once again this policy mix was unsustainable: it led some countries to leave the EMS in 1992, to a change in the rules of functioning of the EMS in 1993, and to the worst recession Europe has known since WW2. That in a year of negative rate of growth, 1993, the real short term interest rate was as high as 4.6% for the E15 will certainly remain a curiosum in economic history. The following two charts summarizing the evolution of inflation, real interest rates and growth from 1981 to 1996, give an idea of the violence of the recessive shock on all European countries but Germany.

Chart 12
Inflation, real interest rates and growth (E15)



Source: EC.

Chart 13
Inflation, real interest rates and growth (Germany)



Source: EC.

By 1994, it was obvious that what was needed was a complete and strong inversion of the policy mix for the whole of Europe. Obvious, but difficult to get through the paraphernalia of the discourses on economic policy. Another inversion was in effect taking place in the mind of governments and technocrats: the interest rate is so high because of the importance of public deficits. Cut first public-deficits by increasing taxes and/or decreasing expenditures, you will then get as a reward the decrease in short term interest rate you are aiming at. This attitude has, if anything delayed the much needed change in economic policy: it is difficult to get fiscal deficits down in a period where interest rates are still at a level considered too high.

In fact, it took almost two years to get interest rates down to earth, two years and (hopefully) a transitory interruption of what was expected to be a period of recovery. The story of this inversion and of its likely short and medium run effects will be told in section three.

II. The European unemployment problem in the 1990's : anatomy of soft growth

The preceding section has emphasized the role of monetary policy in Europe in building the « stock problem » — mass unemployment and mounting public debts — in which Europe is today trapped. That does not mean that the rise of unemployment in Europe in the past two decades has to be traced only to demand factors or that it has no structural roots. First demand-management policies may have structural consequences and second one can hardly refute the argument according to which the equilibrium rate of unemployment — call it the « natural » rate or the Nairu — has increased during this period. Hence some theoretical notes are in order.

II.1. The unemployment problem: theoretical notes

The various theories that seek to explain the unemployment problem may be interpreted as different diagnoses of a single illness. Each provides its own analysis of the rise of unemployment, and offers remedies that are related to the assumed nature of the disease.

II.1.1. General equilibrium analysis

In the framework of a general equilibrium model which describes a set of interdependent markets, nothing legitimates that one looks for the origin of the disequilibrium in the market in which this disequilibrium appears. The price vector may differ from its equilibrium level for a number of reasons of which only a few may have to do with the malfunctioning of the labour market. It remains true that the sheer existence of (involuntary) unemployment implies that some prices are « false » in the Hicksian sense, but this does not imply that the price of labour has to adjust or that it is the only one which should adjust.

More often, the search for efficiency will lead to reallocation on *several* markets (Malinvaud, 1977). Consider for instance inefficiencies arising from asymmetric information or market incompleteness. In this case, equilibrium prices will generally not be efficient. For instance, this may lead to a situation where real wages are high and some agents are unemployed. This does not mean, however, that real wages «cause»

unemployment, because both variables are endogeneous (Solow, 1986). If, for instance prices and wages both exhibit downward rigidities, unemployment and high real wages can result from restrictions upon money supply. Indeed, one may argue that such a situation was probably responsible for the recent deterioration of employment prospects in Europe (GIPE, 1994).

More generally, the very nature of problems associated with information asymmetries suggests that it is precisely in those markets which are in charge of coordinating intertemporal decisions that rigidities and inefficiencies are most common. Equilibrium interest rates might not coincide with full employment: since investment decisions (which in turn determine labor demand by firms) are made on the basis of signals sent by these typically inefficient markets, it is only too natural to expect that they lead to distortions. As a result, the burden of adjustment will fall upon other markets. For instance, a high rate of interest, by generating a reduction in profitability, will in turn produce a contraction of real wages if full employment is required.

The basic insight was spelled-out in Fitoussi-Phelps (1988). The Fitoussi-Phelps monograph traced the origin of the 1980's slump in Europe in the elevation of long term rates of interest which have been at historic highs from 1982 onwards. This increase was itself assumed to be the consequence of the change in the policy regime in the USA — a change in both its monetary and fiscal policies.

The theoretical models developed to study the effects of this change have the implication that an increase in the real rate of interest causes firms to increase the supply-price of output at a given level of the wage rate; similar to an adverse supply shock. Each of these models focuses on a different effect of the real rate of interest, but all go in the same direction. Hence the supply-shock mechanism operating through different kinds of investments can be considered emblematic of a polymorphous collection of real interest rate effects on unemployment.

In effect the demand for labour is a function of real wages (as in traditional approaches) *and* of the rate of interest which determines the price of the asset that firms seek to accumulate. Intuitively, this corresponds to the «customer» asset. If a firm expects an increase in the value of its customers, it will seek to expand its customer basis (or

« stock ») by lowering its product selling price with respect to that of its competitors. This will produce an increase in its production and in its demand for labor.

The capital market is the essential transmission mechanism, since asset prices are an inverse function of interest rates. A high level of interest rates lowers the price of assets and thus reduces the demand for labor. This produces an increase in the equilibrium rate of involuntary unemployment.

The reasoning may be put in terms of straightforward profit maximisation in an imperfectly competitive environment. In such a setting there is a trade-off between present profits and market shares, or equivalently between present profits and future profits, which is controlled by the real rate of interest. Hence desired mark-ups of individual firms are positively related to real interest rates. For an increase in the real interest rates to lead to increased unemployment, some degree of wage rigidity or stickiness is required, otherwise the increased markup of the firms would be accommodated by the decrease of the real wage at the existing level of employment.

If we believe in such a theory the policy conclusion is straightforward: in the presence of unemployment, the policy mix should never imply a too expansionary fiscal policy, nor a too restrictive monetary policy. This finding is quite important, especially in view of the policies adopted in Europe during the 1980s where typically neutral fiscal policies and very restrictive monetary policies dominated. The situation has further deteriorated since German unification. From that date on the policy mix in Europe was exactly contrary to what was required: short term real interest rates have been historically high, as well as budget deficits. As a result, the prospects for potential growth have deteriorated, and income inequalities have increased.

In a nutshell, the preceding reasoning has belabored the point that in Europe, passive macroeconomic policies *vis à vis* unemployment (but very active macroeconomic policies *vis à vis* monetary stability) have shifted the burden in such a way that it falls disproportionnaly on the labour market, budget deficits and hence the social protection system. Or to put things differently the symptom of the European problem has changed, but not the illness which generated it: until the beginning of the eighties it was a two digit inflation rate; now it is a two digit unemployment rate, and an abnormally low growth rate. A rate of growth persistently lower than its potential leads as a result to the « good »

— increased competitiveness through disinflation, slowdown of imports through weak internal demand — but also to the bad — increased unemployment, fiscal and social deficits. If restrictive monetary policy is pursued despite these results — and despite the fact that the effective rate of inflation is below its target level — the only way out would be to cut public and social expenditures. This is the route now taken — if not in fact, at least in words — by most European governments. Apparently, the fact that when conducted simultaneously by all countries, this kind of policy is at least in part self-defeating, does not prevent most of the governments and international organisations to advocate it.

II.1.2. Partial equilibrium analysis

Hands-off policies are seen as the only way to enhance flexibility in the labour-market: too high a level of social protection has led to a weakening of incentives to work *and* at the same time to an increase in taxes and in the cost of labour. In terms of modern analysis of the labour market, both the demand for labour and the «surrogate supply» of labour have shifted adversely, that is to the left. Hence unemployment is structural, and the only way of dealing with it is deregulation through a decrease of social protection. The rise of unemployment and social deficits are a part and parcel of the same problem: but the causality is not, as emphasized before, from the former to the latter, but from the extent of social protection to the extent of unemployment. When it is pointed out to the advocates of a hands-off policy that a sizeable amount of deregulation has already taken place in most European labour markets, without leading to a boost in employment, they answer that what is important is not deregulation *per se*, but relative deregulation. According to them globalisation has changed the rules of the game and if flexibility is badly needed it is to enhance competitiveness in old industrialized countries to cope with increased competition from emerging countries.

To put things bluntly their answer amounts to saying that inequalities in industrialized countries, and especially in continental Europe, have not increased enough to cope with the globalisation phenomenon. There is though a puzzle in this answer because the data are not as consistent with it as it would seem at first sight. To clarify this point a comparison between Europe and the US is in order, as the latter is considered as the paradigmatic example of a free labour market. Two striking, very well known facts emerge from this comparison:

—There is an astonishing parallelism in the evolution of the rate of inflation in the two countries since the beginning of the sixties;

—There is a clear divergency in the evolution of the rate of unemployment as from, say 1975; much of the increase in European unemployment occurring between 1975 and 1985. Today the rate of unemployment is at its level of 1963 in the US, and five times higher in Europe.

La cause est entendue: much, if not all of the increase in European unemployment is due to an increase in the NAIRU, i.e. to a malfunctioning of the labour market. Otherwise if the actual unemployment rate in Europe was above its natural level, disinflation would have been much more severe in this latter region, and the European inflation rate would have diverged from the US one.

Usually, an increase in the natural rate of unemployment, when the economy is subject to an adverse supply shock, can always be traced to some kind of real wage rigidity. There then follows a profit squeeze, a fall in the rate of investment and thus an increase in the equilibrium rate of unemployment. A process of this kind seems to have characterised Europe between the first oil shock and the beginning of the eighties since during this period the share of wages in national income increased. But since 1982 the process has been more than reversed as we have already noticed that the share of wages has strongly decreased and continues to do so, and that as early as 1984-1985, its level was already below its pre-first oil shock value. Such has not been the case in the US where the wage share stayed roughly constant during that period. Clearly something else is needed to make this type of explanation convincing.

There is even a kind of recent laboratory experiment which contradicts the increase in natural rate of unemployment hypothesis, the case of the depreciating countries in Europe since 1992. If the natural rate story were true, these countries would have enjoyed, at best, a temporary increase in their competitiveness, because of the inflationary effect of depreciation through real wage rigidity. Gordon (1996) shows that the contrary was true. He compares the performances of the depreciating countries in Europe (Italy, Portugal, Spain, Sweden and the United Kingdom) to those of the appreciating countries, Germany excluded (Austria, Belgium, France, Netherlands and Switzerland). The strong surge of inflation in Germany until 1992 — see above — would have exaggerated the extent of disinflation in the period 1992-1995, which is precisely the period of the experiment.

Gordon's conclusions were then straightforward: « Both group of countries enjoyed an acceleration of nominal GDP growth, a deceleration of inflation, and thus an even greater acceleration of GDP growth. But there the similarities stops. The acceleration of nominal GDP growth in the depreciating countries exceeded that in the appreciating countries by 1.3 percentage points. *Yet none of this was absorbed by inflation; inflation actually decelerated more in the depreciating countries than the appreciating countries.* And as a result the acceleration of real GDP growth in the depreciating countries exceeded that in the appreciating countries by 1.7 percentage point. » (Gordon, p.34). These are clear evidences that the actual rate of unemployment is above its natural level, and that another explanation has to be devised.

The Fitoussi-Phelps hypothesis on the unemployment effect of the elevation of real interest rates has also been tested recently against more conventional explanations of which the preceding is a good example De La Croix and Lubrano (1996). The authors conclude that effectively for the European countries they have studied, real interest rates and unemployment are cointegrated, the former causing the latter, and that they have not found any trace of another variable which has such an impact on the unemployment rate, including the real wage.

II.2. Anatomy of soft growth

So what? Could be the answer to the preceding reasoning. There are good reasons why interest rates are so high, one of them being the increase in public debts since the beginning of the eighties. Everybody knows that high real rates of interest are a bad thing, but financial markets are sovereign and there is little a government can do to escape from the tutelage of these markets. Central Banks all over the world are just doing what is necessary to avoid the increase in long term interest rates which will follow a surge in inflationary expectations.

To understand what is true and what is dubious in the preceding argument, we have to attempt an analysis of *the dynamics of slow growth*.

II.2.1. The changing balance of powers

It could be misleading to speak of a market as if it were a person capable of decisions, and of imposing his tutelage on governments. The market is a method for allocating scarce resources, and when it is perfect the allocation is optimal. Financial markets, in particular, are seen as efficient, i.e. as leading to an optimal allocation of saving to investment opportunities. But we have already emphasized the fact that these kinds of markets have a quasi impossible task to perform: the coordination of intertemporal plans of economic agents. That means that they will, most of the time, be out of equilibrium. In such a situation the short side of the market will dominate, and the long side will be rationed. In present times, there is strong evidence that financial markets are dominated by "creditors" — a generic term to design those who possess the capital or those who act on their account. In effect, financial deregulation and globalisation have multiplied the opportunities of investment, without at the same time multiplying the amount of loanable funds available. So there is some truth in the contention that at the world level, there is a potential insufficiency of saving.

Besides, deregulation has increased the liquidity of the market and together with exchange rate flexibility, it allows the operators to play short term strategies with long term financial assets. What has increased is not only the degree of spatial mobility of capital, but also time mobility throughout the spectrum of maturities of financial assets. In a market in a permanent state of flux it is difficult to say what is causing what: is the long term interest rate causing the short term one or vice versa? As there is some evidence that money illusion determines at least partially the behaviour of real rates on higher maturities (see GIPE, 1993) and that short term interest rates strongly influence the determination of exchange rates, it seems that the potency of monetary policy has strongly increased since the beginning of the eighties, and that it bears some responsibility for the huge increase of real interest rates, and hence in the change of the balance of powers in capital markets.

But this change in the balance of powers in the financial markets will propagate to other markets. Mass unemployment, in particular, is the sign that labour markets are dominated by firms, i.e. that the demand for labour constitute the short side of the market. Hence the bargaining position of wage-earners is weak.

Domination of the « creditors » on financial markets and of firms on labour market are the main characteristic features of our time. They structure the future and lead to the mechanics of soft growth. By soft growth we designate a situation where the rate of actual growth is persistently lower than its potential, hence a situation where unemployment is above its natural rate and exhibits a tendency to increase.

II.2.2. The dynamic of soft growth

« Creditors » and firms do not in actuality share the same interest. Usually the business sector should be a net debtor of the other agents. They are thus rather in conflicting positions. But in this conflict the « creditors » are winners from the outset thanks to globalisation and the enormous investment needs throughout the world.

Hence firms will try as a normal strategy to gain autonomy *vis à vis* financial markets by increasing their profit margins so as to self finance their business. In a world where long term real interest rates are high and short term interest rates high and also volatile, it is better not to be indebted. Moreover high real rates of interest amount to a depreciation of the future. Hence profit margins have to increase not only to reestablish profitability, as in conventional equilibrium theory, but also to reflect the fact that the future is more heavily discounted. This may explain why, particularly since the beginning of the eighties, self-financing is very high in many countries of Europe, higher than 100%. In France, in particular since 1992 the business sector, for the first time since WW2, has a net creditor position! What could happen, when those in charge of building the future, i.e. of investing become net lenders?

The business sector can globally proceed to such an adaptation, and increase its profit margins (cash flow) only by economizing on its expenditures on investment and on labour. This process leads unavoidably to unemployment — wages can't have the flexibility which is assumed in a perfectly competitive market — and, with the help of the dynamics of unemployment, to wage moderation, i.e. a situation where wage increases are in general lower than the increases in labour productivity. In other words, downsizing is a constraint on the behaviour of firms. Hence the social game becomes deeply unbalanced, one of his actors — the workers — being in too weak a position. The constant threat of unemployment makes their situation too precarious.

This precariousness is contagious. It hurts first and most importantly unskilled labour but then propagates to the middle class and small firms. The problem of small firms is precisely that they are small and have limited possibilities of shedding labour. They thus cannot avoid calling on the « creditors ». But the banking system has faint confidence in their capability to reimburse. Those who have little collaterals will thus be credit-rationed. Moreover in the constellation of soft growth asset prices have to eventually fall, the rate of interest being too high. Hence the banking system will also eventually end in a bad shape. It is a kind of revenge, but of little help. The fact that the predator has lost weight is not a relief for a prey who is dying from hunger. But the difficulties of the banking system will increase the intensity of credit rationning in the economy.

As a consequence of mass unemployment, wage moderation and the increase in precariousness of a growing fraction of the society, there is a structural weakness in consumption. The household rate of saving will be higher than it would have been in a normal growth environment. But there is no growth without tensions and tensions are the things that « creditors » fear above all. Tensions may lead to inflation and inflation is the first evil for lenders. All in all, the present balance of powers is the most convenient for them. Too strong an increase in employment is good news for society as a whole, but an objectively bad news for those benefiting from the present balance of powers. It signifies indeed that this balance is changing; so there is nothing astonishing if such a news leads to a fall in financial markets.

The forces governing the mechanics of soft growth cannot but lead to a weaker, more impotent, state. In an economy, all agents cannot be creditors at the same time. Some debtors are badly needed. Of course one may theoretically imagine a situation where all agents are net lenders to foreign countries. But such a possibility implies that the competitiveness of the economy is so high that external demand is strong enough to more than compensate the structural weakness of internal demand. Except for very peculiar cases, such a configuration cannot be consistent with an overvalued currency. And if the process of soft growth is put in motion by a high rate of interest (in absolute terms and relative to other countries), it normally leads also to an overvaluation of the currency. (This is in stylised terms the case of Europe since at least the beginning of the nineties).

So who are the debtors? Governments, of course. The process which leads to their indebtedness is straightforward. The weakness of economic activity reduces fiscal receipts

at the very moment it increases social expenditures through mounting unemployment. Besides, the high level of interest rates and the low level of growth guarantee that the servicing of the debt will be high, adding to the increase in deficits. Public deficits have to be high because, in a way, governments substitute for firms as normal debtors. And to avoid a too fast increase in public deficits, governments will too, like the business sector, try to decrease public investment. To say the same thing in another way: the private sector is increasing its demand of safe financial assets and the public sector is constrained to supply them. Hence the process of soft growth leads almost unavoidably to an indebted state, and to the need to downsize the state itself. Whatever its causes, it comes at a time where, apparently, there is no other way than to pursue hands-off policies, that is to deregulate further the labour market and to downsize the welfare state. Structural reforms appear all the more necessary, that macroeconomic policies are ill-designed and through the supply side effects of the real rate of interest, have bad structural consequences.

The problem is the classical problem of the dynamic inefficiency of capitalism: a distorted income distribution may lead to over-accumulation or to under accumulation, i.e. to sub-optimal growth. A too high degree of income inequality, as summarised by a too significant positive gap between the real rate of interest and the growth rate leads to under-investment, through under-consumption. The phenomena is aggravated by credit rationing which is the normal consequence of an abnormally high level of interest rates, and by a too unbalanced power relationship on the labour market. If structural reforms add to income inequalities, it may perhaps lead to an increase in employment, but obviously it will strengthen the trend towards under-investment and increase the degree of inefficiency of the system.

What are the alternatives?

We can at least identify two others possibilities. In the first, Government tries to avoid the tutelage of the « creditors » by trying, like firms, to cut its expenditures and/or to increase taxes. The decrease in its deficit will entail a reduction in its net borrowing position. But first public and social expenditures do not have the flexibility of private ones. Their decrease has to be explained and accepted, at least if the country is a democracy. Second they are the reflection of a social contract which cannot be changed as frequently as a private one. And third, it needs a very strong belief in the Ricardian-equivalence theorem to take the risk of a radical reduction in public deficit at a time of

mass unemployment and slow growth. Of course one may believe in a more pedestrian effect: the decrease in interest rate allowed by the abrupt fall of deficits, will lead to an increase in both private investment and consumption. But for that to happen, one has to be sure that the high level of interest rate is not mainly due, from the outset, to a constraint on the exchange rate. Finally the program of restructuring the public finances has to be designed in such a way that at least it will have neutral consequences on the degree of inequalities.

In the second scenario, one gets, first, monetary policy right by durably reducing short-term interest rate. The hope is that the rate of self financing of the private sector will decrease allowing for a reduction in public deficits. But because some fraction of the deficit is structural, the government will also take advantage of the expansionary monetary policy to get further in the restructuring of the public finances (see for example the case of Italy).

On the face of it, both scenarios seem to amount to the same thing. In fact they are very different. In the situation where Europe finds itself today, the question of timing is essential. To begin with restrictive fiscal policy may lead to a lesser reduction in fiscal deficits as part of the ex-ante reduction in deficits will not show up ex-post because of a possible reduction in public receipts. And it will not be a relief if interest rates fall mainly as a consequence of a slowing down of growth — hence of the demand for money and credit. Thus is because such a slowing down could lead the government to reconsider its budgetary policy itself. It is, thus, all the more essential to get, first, the rate of interest down, because it takes time for monetary policy to affect activities.

The problem is to be clear about the threat of inflation that such a policy may lead to. We have already seen in the first part of this chapter that this threat was not truly justified for the bulk of the European countries at the end of the eighties. What is the situation 7 years later? There are a number of reasons why inflation will no more be a threat for many years to come.

The most important of them are structural. The factors which have led to inflation in the seventies and part of the eighties have completely disappeared: the Vietnam war, the end of the Bretton-Woods system, the oil shocks. The price of oil should not jump any more, as the entering of Russia and other oil-producing CIS members in the international

economic scene makes such an event very unlikely. A new structural factor is going to be increasingly important, namely globalisation of goods markets. The increasing degree of competition to which it leads has a deflationary impact on the price of goods — firms who believe that they may increase their prices in the future are becoming the exception; all over the world, the expectations and strategy of firms are on the contrary to cut prices — and perhaps more importantly on the price of labour. Unskilled labour has already been affected. But in the future medium-skilled labour and even high-skilled labour will be affected as well.

Two other factors we have already referred to, will play, in addition, an important role. Mass unemployment and the changing balance of powers to which it has led has structurally affected the bargaining power of labour. To get a feel for the importance of this factor we should just think of the answer we would give to the following question: what would be the course of the inflation rate if an oil shock of the same magnitude as the first one happened today? We have already noticed that the share of wage in national income is by now well below its level of the sixties in Europe and that it is likely to continue to decrease; these facts will help in answering the preceding question.

Finally, the structural deficits of European countries have been decreasing for a few years — a characteristic shared by all OECD countries.

For all these reasons, the fight against inflation has to be ended, because the phenomenon has disappeared, and there is not much to win in a fight against a ghost. The country will be exhausted and no energy will be left to confront real problems.

As Lester Thurow puts it: « It is well to remember that in 1931 and 1932 as the US was plunging into the Great Depression, economic advisers such as Andrew Mellon, Secretary of the Treasury, were arguing that nothing could be done without risking an out-break of inflation-despite the fact that prices had fallen 23 percent from 1929 to 1932 and would fall another 4 percent in 1933 ».

III. The current macroeconomic policy mix in Europe

The slowing down of growth in the early 90s in Europe — which is even more apparent excluding Germany — has reached its climax with the 1993 recession, the deepest, in most countries of continental Europe, since the aftermath of the first oil shock. This recession has been followed by a recovery that, by historical as well as international standards, may be deemed weak, the E15 annual growth rates for 1995 and 1996 being respectively 2.4 and 1.6%, so that the unemployment rate kept rising in 1996, to reach 11% of the European workforce, and fell only slightly in 1997 at 10.6%.

That the current situation in Europe is typically one of insufficient demand — or equivalently of excess savings — may be read from the various aggregate indicators. First, as already pointed out, inflation is extremely low and CPI growth rates probably overestimate underlying inflationary pressures, as high and rising unemployment generates wage moderation, while increased international competition on goods markets is pushing manufactured goods prices down. Second, despite better forecasts for 1998, in France for example, investment has been weak in the 1990s: in the E15, gross fixed capital formation has not yet fully recovered and was still below its 1991 peak in 1997. And while government sector net saving is still negative, the overall investment-saving balance in the E15 area — i.e. the external current account — displayed a surplus equivalent to 0.9 of European GDP in 1997.

In this context, the macroeconomic policy mix has shifted in a direction — tighter fiscal policy and less restrictive monetary policy — that would appear to be appropriate, but it has done so very slowly, and probably not in the right order of magnitude.

After four years (1989-1992) of extremely tight monetary conditions in Europe — with real short term interest rates reaching historical highs —, the easing of monetary policy has been prompted by the 1993 recession; but it has proceeded with the utmost caution, real short rates staying well above economic growth rates, as well as above US and Japanese ones until the end of 1995. Since the last quarter of 1995, monetary policy easing has proceeded at a somewhat faster pace, but seems to have come to a halt in the second quarter of 1996. Real short-term interest rates, as evaluated with ex-post variations in CPI, are currently in the vicinity of 1.5% in Germany, France and other « core-EMS » countries; but their E15 average is still around 3%. Long-term real interest rates have

abated as well, but they all linger around 3.5%. Thus, the critical gap between real interest rates and economic growth rates is still positive, whereas the slope of the yield curve, while at last positive, is moderate, compared to what it is in Japan, and even in the US, in spite of the very different current business conditions and short-term prospects.

As shown by the evolution of cyclically adjusted public sector net borrowing in the E15, fiscal consolidation has in effect started in 1993, albeit at a moderate pace in some of the larger EU large countries. The current orientation of national fiscal policies in almost all EU member states is, however, much more restrictive and plans have been announced everywhere to implement a severe fiscal contraction, mostly through reduced public spending, in 1997.

This generalised conversion to tight fiscal policy has been prompted by the determination of European governments to satisfy the public finance criteria of the Maastricht treaty by the agreed deadline, namely 1998, in a situation where only one country — Luxemburg — was meeting both the budget deficit and public debt requirements for monetary union. The economic rationale behind fiscal consolidation is two-fold: first it is stated that recent trends in national public finance are unsustainable; and second that fiscal consolidation will generate faster growth of economic activity, either through the neo-Ricardian mechanism of decreased private saving or through some form of supply-side « crowding-in » of productive investment and private spending, thanks to the beneficial effect of reduced public borrowing on real long-term interest rates.

There is little doubt that fiscal trends in some EU member states were unsustainable at the beginning of this decade. However, the sustainability of public debt critically depends on the gap between the real interest rate and the rate of growth of the economy in the medium and long run (Artus and Fitoussi, 1992; Creel and Sterdyniak, 1995; Aglietta and Uctum, 1996). So long as real interest rates remain high, the required primary surplus that would compensate interest payments is achievable only through a mix of expenditure cuts and tax increases that will adversely affect economic activity, making the move all the more painful, if not self-defeating.

Forecasts taking account of already implemented and announced fiscal austerity measures in the larger EU countries, using the mimosa model, concluded that, given the monetary policy stance of the 1996-97 years, the policy mix would have contractionary

effects in 1996 and 1997 (Le Bihan, Mathieu and Sterdyniak, 1996). According to more recent forecasts (Blanchard and Fitoussi, 1998), contractionary fiscal policies in the EU are responsible for an average annual reduction of 1.4% in GDP since 1991 and a 3.3 points increase in the rate of unemployment between 1991 and 1997. In addition, the burden of national policies of fiscal consolidation seems to fall disproportionately on fixed capital formation by the public sector, while there are good theoretical reasons to believe that these are precisely the categories of expenditures with the highest social return — and macroeconomic impact.

The argument that fiscal restraint may in fact boost economic activity, although theoretically valid under some assumptions, is often supported by empirical findings relating recent experiences in some European countries — Denmark and Ireland in the second half of the 80s, Italy in 1993-95. It should however be remembered that the former took place in small, open economies in a context of rapid growth in the rest of Europe and falling real interest rates, whereas the latter was accompanied by a sharp depreciation of the national currency that allowed for an almost full substitution of external demand for internal one: in all three cases, the success of the national policies pursued hinged on the condition that major trading partners would not do the same; they were thus to some extent non-cooperative moves, the outcome of which cannot be generalized to the whole E15 area.

The fact that eleven among the fifteen EU countries have succeeded in reaching the deficits targets by the end of 1997 may appear as beneficial to Europe if and only if these rooms to manoeuvre revive countercyclical fiscal policies (Blanchard and Fitoussi, 1998).

IV. Prospects and recommendations

Though appropriate for the current macroeconomic situation in the E15, the inversion in the policy mix that has been implemented over the past year or so is likely to work only slowly and may be insufficient in magnitude to lead to a solid economic recovery in Europe, which is a prerequisite for unemployment reduction.

Several factors would seem to call for a further easing of monetary policy. First, as already emphasized, inflation rates are now at historical lows and prospects are favourable. Second, real short-term and, especially, long-term interest rates, although substantially lowered, are still high given the current cyclical position.

While favouring external depreciation, which would help boosting exports in a period of weak internal demand, a further decrease in short-term interest rates would also make it easier for tight fiscal policy to succeed in reducing budget deficits. By making the policy mix more consistent, it would also make it more credible and may thus yield an additional lowering of long-term interest rates.

But the favourable consequences of an easier-monetary/tighter-fiscal policy mix are likely to work their way through only slowly; hence this orientation should be pursued with resolve for a prolonged period. Indeed, one of the factors that have played a major role in the inception of the current slow growth episode has been the marked decline in asset prices — real estate, shares, as well as other intangibles — brought about by the rise in interest rates. The consequences of asset price deflation are manifold: they have a negative effect on spending propensities of both households and private businesses; and they also have very detrimental effects on financial institutions' balance sheets, through the fall in value of collaterals and the consequent rise in the proportion of bad debts. While preventing any further asset price deflation, a prolonged period of low short-term interest rates is also needed for banks and financial institutions to restore their profitability and start lending again.

Ideally, the policy mix should therefore move further in the easing of monetary policy, with the current rigor being maintained on the current public expenditures along with an increased efforts on public investment as advocated in the Commission Green paper on a European growth initiative or in the Drèze-Malinvand report. In order to explore the

macroeconomic consequences of these policy options, we may refer to the results of macroeconomic simulations realised with the OFCE-CEPII multinational model MIMOSA (Le Bihan and Lerais, 1998).

Table 3
Interest rate reduction in the EU

	1st year	2nd year	5th year
GDP			
United States	0.0	+ 0.1	+ 0.1
Japan	0.0	+ 0.1	+ 0.1
European Union	+ 0.4	+ 0.8	+ 0.3
Germany	+ 0.6	+ 1.1	+ 0.5
France	+ 0.4	+ 0.8	+ 0.3
Italy	+ 0.2	+ 0.4	0.1
United Kingdom	+ 0.3	+ 0.7	0.0
Northern EU	+ 0.4	+ 1.2	+ 0.4
Southern EU	+ 0.3	+ 0.6	+ 0.7
Unemployment (1)			
United States	0.0	0.0	0.1
Japan	0.0	0.0	0.1
European Union	0.1	0.3	0.2
Germany	0.2	0.6	0.6
France	0.1	0.3	0.3
Italy	0.0	0.1	+ 0.1
United Kingdom	0.0	0.1	+ 0.3
Northern EU	0.1	0.6	0.2
Southern EU	0.1	0.2	0.3
Consumption deflator			
United States	0.0	0.0	+ 0.1
Japan	0.0	0.0	+ 0.1
European Union	0.0	+ 0.1	+ 0.7
Germany	+ 0.1	+ 0.3	+ 1.3
France	0.1	0.1	+ 0.8
Italy	0.0	0.1	0.0
United Kingdom	+ 0.1	+ 0.2	+ 0.1
Northern EU	0.0	+ 0.2	+ 1.5
Southern EU	0.0	+ 0.1	+ 0.8
Public sector Balance (2)			
United States	0.0	0.0	0.0
Japan	0.0	0.0	0.0
European Union	+ 0.2	+ 0.4	+ 0.5
Germany	+ 0.2	+ 0.5	+ 0.6
France	+ 0.2	+ 0.4	+ 0.4
Italy	+ 0.1	+ 0.2	+ 0.3
United Kingdom	+ 0.2	+ 0.3	+ 0.2
Northern EU	+ 0.2	+ 0.5	+ 0.9
Southern EU	+ 0.2	+ 0.5	+ 0.7

Current account (2)			
United States	0.0	0.0	0.0
Japan	0.0	0.0	0.0
European Union	0.1	0.1	0.1
Germany	0.1	0.1	0.1
France	0.1	0.2	+ 0.2
Italy	+ 0.1	+ 0.2	+ 0.3
United Kingdom	0.1	0.2	0.2
Northern EU	0.0	0.5	0.6
Southern EU	0.0	0.1	0.5
Short term interest rates			
United States	0.0	0.0	0.0
Japan	0.0	0.0	0.0
European Union	1.0	1.0	1.0
Exchange rates (3)			
Japan	0.0	0.0	0.0
European Union	0.0	0.0	0.0

(1) % point difference from baseline, (2) % from baseline GDP, (3) an increase is a depreciation of the currency *vis-à-vis* the dollar.

Sources: MIMOSA CEPII-OFCE.

The first experiment consists in a drastic easing of monetary policy throughout the EU (see table 3). The assumption is that the Bundesbank — immediately followed by all other European central banks — permanently lowers its nominal short-term interest rate by 100 basis points, so as to bring the real short-term rate close to zero. Table 3 reports the major macroeconomic consequences of such a monetary policy experiment — differences from the reference scenario of no change in current macroeconomic policies: it generates a somewhat more favourable outlook in Europe — higher growth, lower unemployment, and lower budget deficits, but a slightly decreased current account surplus.

Table 4
An increase of public investment in Europe equivalent to 1% of GDP

	1st year	2nd year	5th year
GDP			
United States	0.2	0.3	0.1
Japan	0.2	0.4	0.1
European Union	2.7	3.7	1.0
Germany	3.4	4.5	0.9
France	2.7	3.7	0.3
Italy	3.3	4.6	2.9
United Kingdom	2.0	2.7	0.8
Northern EU	3.2	4.7	0.0
Southern EU	1.7	2.1	1.2

Unemployment (1)			
United States	- 0.1	- 0.1	- 0.1
Japan	- 0.1	- 0.1	- 0.1
European Union	- 0.9	- 1.7	- 0.9
Germany	- 1.4	- 2.8	- 1.4
France	- 0.8	- 1.5	- 0.5
Italy	- 0.8	- 1.5	- 1.8
United Kingdom	- 0.3	- 0.9	- 1.0
Northern EU	- 1.2	- 2.5	0.4
Southern EU	- 0.3	- 0.6	- 0.7
Consumption deflator			
United States	0.0	0.1	0.4
Japan	0.0	0.0	0.5
European Union	0.1	0.7	4.1
Germany	0.5	1.8	4.6
France	- 0.6	- 0.4	3.8
Italy	- 0.4	- 0.9	2.4
United Kingdom	0.4	1.5	6.6
Northern EU	0.3	1.5	4.6
Southern EU	0.1	0.6	2.8
Public sector Balance (2)			
United States	0.1	0.1	0.0
Japan	0.1	0.1	0.0
European Union	- 0.1	0.5	- 0.3
Germany	0.4	1.4	0.4
France	0.0	0.9	- 0.6
Italy	- 0.2	0.3	0.0
United Kingdom	- 0.5	- 0.1	- 0.6
Northern EU	- 0.2	0.1	- 1.3
Southern EU	- 0.2	- 0.1	- 1.1
Current account (2)			
United States	0.0	0.1	0.0
Japan	0.1	0.2	0.1
European Union	- 0.2	- 0.3	0.1
Germany	- 0.3	- 0.3	- 0.1
France	- 0.7	- 0.7	0.7
Italy	- 0.4	- 0.7	- 0.5
United Kingdom	- 0.3	- 0.5	- 0.3
Northern EU	0.1	- 0.1	0.0
Southern EU	0.3	0.5	0.4
Short term interest rates			
United States	0.0	0.1	0.1
Japan	0.0	0.0	0.2
European Union	0.0	0.6	0.9
Exchange rates (3)			
Japan	- 0.1	- 0.1	0.2
European Union	0.0	0.7	3.4

(1) % point difference from baseline, (2) % from baseline GDP, (3) an increase is a depreciation of the currency *vis-à-vis* the dollar.

Sources: MIMOSA CEPII-OFCE.

The second policy experiment consists in a boost of public sector investment in Europe equivalent to 1% of GDP, assuming unchanged nominal interest rates and nominal

exchange rates. Table 4 reports the simulated changes in major macroeconomic aggregates: given the high value of public investment multipliers and the low degree of trade openness of the EU, the consequences of this fairly large stimulus on output growth and unemployment are much more favourable than in the previous experiment; budget deficits are also reduced, while there is only a mild deterioration in the current account.

Although in the reported simulations, both policy experiments have some inflationary consequences, there are good reasons to believe that consumer prices over-react in the model, which has been estimated over a long time period and embodies a strong wage-price feedback whenever unemployment falls. Allowing for the various moderating influences that have been exposed in the previous section, it would seem safe to assume that inflationary consequences should, in both experiments, be less than reported in the tables.

However, the threat of inflation should not be over-estimated. First, if growth is boosted by an expansionary policy and if this growth is correctly expected, we see no reason why firms would not increase their production capacities in order to cope with higher demand. Second, the present rate of utilisation of production capacities is well below 85% in Europe ; hence, any threat about tensions on this indicator vanishes. Last, firms can promote some kind of reorganisation in capital and labour utilisation.

A third policy experiment consists in reducing social contributions for the less remunerated employees. It stands as a typical example of a demand policy with favourable impact on the supply side since it does not increase wage costs in the short run ; in the long run, it does create the conditions for a decrease in these costs, this type of policy being fundamentally a reduction in labour taxes.

The reduction in social contributions is equal to 3 points of GDP, and it is implemented in the whole EU. The simulations' results are reported in table 5 ; monetary authorities are supposed to keep nominal interest rates at their levels.

Table 5
Spontaneous increase of investment and consumption

	1998	1999	2000	2001	2002
GDP**	0.75	2.0	3.3	4.3	5.3
Unemployment rate***	- 0.35	- 0.9	- 1.45	- 2.05	- 2.65
Consumption deflator	- 0.1	- 0.05	0.45	1.1	2.8
Public sector balance*	0.4	1.05	1.75	2.4	2.8
Current account*	- 0.65	- 1.15	- 1.95	- 2.3	- 2.6

Ecarts cumulés par rapport au compte de référence sauf pour les soldes publics et extérieurs.

* en points de PIB, ** en % du niveau, *** en points de taux

Source : modèle Mimosa.

The decrease in unemployment is about 4 points after 5 years, while the annual inflation rate has increased by 0.5% on average. In a situation in which the annual inflation rate was initially less than 1.5% this « surcroît » of inflation and growth should not threaten the monetary authorities whose inflation target is 2%. The cost in terms of public deficits is almost nil after a year because receipts are increasing with growth. This result is due to the high multiplier associated with a co-operative European policy. Perhaps we should note here that the EU is as weakly open as Japan. As for the current account, it decreases by 0.8 points, not much as regards the French or German current surpluses.

Therefore, the EU having reached more favourable conditions (lower interest rates, lower public deficits), it seems quite possible to implement a *European-wide* expansionary policy in order to reduce unemployment sharply. This policy would not jeopardise public finances in the mid-run, and it would permit a return of the unemployment rate below 7.5%.

If the Maastricht fiscal criteria are to be respected in the short run, as the Stability Pact stringency seems to demonstrate, and in the absence of any co-operative European policy, reducing social contributions will not be possible without a rise in taxes or a further reduction in public expenditures ; but, this fiscal mix will not have any effect on aggregate demand. A long-lasting decrease in unemployment thus requires a period of huge and non-inflationary growth. To reach this growth, European countries need a demand impetus, as well as structural reforms.

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