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Limits to Macroeconomic Intervention

Asbjørn Rødseth

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Around 1970 it was generally believed in the Nordic countries as elsewhere that clever demand management could keep average unemployment close to zero. Finland, Sweden and Norway had not had unemployment rates above four per cent for two decades. Denmark had not been quite so lucky, but in all four countries the unemployment problem seemed to be under control. This belief was shaken in the mid-seventies by the increase in unemployment in Denmark, and in other European countries, to around ten per cent. However, it lasted until the late 1980s (Norway) and early 1990s (Sweden and Finland), before high unemployment spread to the other Nordic countries. The present mood seems to be that demand management is not the clue to low unemployment, and that we have to live with high unemployment for a long time.

There seems to be fairly general agreement that some of the increased unemployment in the Nordic countries is due to higher equilibrium unemployment.[1] There are different ways of defining this concept. When we think of small open economies, one useful definition is this: Assume that the exchange rate is kept constant, and that inflationary expectations are correct. The equilibrium unemployment rate is the lowest unemployment rate which is then compatible with unchanged international competitiveness. If unemployment is below equilibrium, demand pressure in the labour market makes wage costs increase faster than in competing countries. In the long run this must harm domestic employment, and thus an unemployment rate below equilibrium is not sustainable if the exchange rate is fixed.

If the exchange rate is floating, an unemployment rate below equilibrium may result in depreciation of the currency instead of in loss of competitiveness. Then, however, inflation will tend to accelerate without limit unless action is taken to restrict aggregate demand. An unemployment rate below equilibrium is not sustainable in this case either.

In the 1980s it seemed impossible to keep wage inflation down and the economy

* University of Oslo, Department of Economics. Support from the Norwegian Research Council is gratefully acknowledged

competitive without unemployment rates that were higher than in the 1960s. We do not know exactly why. Perhaps the unemployment rates in the 1960s were below equilibrium. A tendency to increased inflation and weakened competitiveness in the 1960s may indicate this. However, if unemployment stayed below equilibrium for such a long period, the equilibrating forces in the economy must have worked at a slow pace. Perhaps changes in unemployment insurance and in collective bargaining have raised equilibrium unemployment? Maybe increasing specialization in the labour market is to blame? Did the rapid productivity growth in the first decades after the war contribute to an unusually low equilibrium unemployment rate? This is not the place to answer these questions, nor do I have a definite answer. I think it is still an open question what the equilibrium unemployment rate is, by how much it has increased, and how much can be done to bring it down.

The existence of an equilibrium rate of unemployment obviously puts a limit on what can be achieved by macroeconomic policy. In this comment I first discuss the nature of this limit. I then go on to discuss how the liberalization of the financial markets has affected our ability to conduct successful macro policies. It should not be forgotten, however, that the equilibrium unemployment itself may also be affected by "microeconomic" policy in various ways. This is not the subject here.

The role of demand management

The role of aggregate demand in determining employment differs substantially depending on whether there is or is not nominal rigidity in the economy. Even if there is no nominal rigidity, aggregate demand may have some effect on aggregate employment if labour markets are not perfectly competitive, but these effects are often ambiguous. Whether an increase in aggregate demand raises or lowers employment depends on the nature of the distortion and on the source of the demand shock. With nominal rigidities we can tell a simpler story of how aggregate demand can have large and consistent effects on employment.

Nominal rigidities could be either in expectations of future nominal variables or in price setting. A standard example of the first kind of rigidity is "adaptive expectations", a standard example of the second kind is contracts where the nominal price is fixed for a time interval. The discussion below assumes that some nominal rigidities exist, and that because of them aggregate demand has a strong influence on total output and employment in the short run. This approach is often criticized by economists who adhere to models with continuous market-clearing. Some of them claim that models with nominal rigidities are unscientific because we lack a good theoretical explanation for the nominal rigidities. The obvious question to counter with is: Do we have a good theoretical explanation of why markets always clear? As far as I can see, there is no sound methodological reason to prefer the one approach to the other. We always start from some premises, and we can always ask for deeper explanations.

Much of the fluctuation in output and employment in Finland, Norway, and Sweden since the early 1980s can be explained plausibly as driven by aggregate demand. It is easy to tell a story where the boom in consumption and investment demand in the mid and late 1980s is the

main driving force. The boom was set in motion by different combinations of international impulses, credit market liberalization, and lax fiscal policy. It is much harder to find a driving force on the supply side which could explain e.g. that real GDP in Finland dropped by 7.1 per cent in 1991. However, supply-side developments may still have been important for the long-run trend in unemployment.

Even if aggregate demand has a substantial effect on total employment in the short run, it need not have much effect on average unemployment over longer periods. This is most easily seen if we think of an economy with a fixed exchange rate. If the unemployment rate is below equilibrium, wage costs increase more than abroad, and the country's cost competitiveness is eroded gradually. If the unemployment rate is below equilibrium, the rest of the world loses competitiveness. Countries cannot continue to lose cost competitiveness forever. As mentioned, this means that in the long run it is impossible to sustain unemployment rates different from the equilibrium rate, at least if expectations are correct on average.

However, the conclusion that the unemployment rate in the long run tends towards the equilibrium rate, does not imply that unemployment is independent of demand management if we average over a long period of time. Fiscal and monetary policy can have an effect on the long-run average for at least three reasons:

i) Path dependence in the equilibrium unemployment rate (hysteresis). The equilibrium unemployment rate may depend positively on past actual unemployment rates. The reason usually given is the loss of skills and motivation when people are unemployed. Another reason may be the declining quality of the pool of unemployed as the best candidates for jobs are picked out through the hiring which takes place even at high unemployment rates.

ii) Convex short-run Phillips curve. Econometric estimates of the relation between wage inflation and unemployment often end up with a convex relation between the two. This means that nominal wages go up more quickly than down. The short-run "Phillips-curve" is steep at low unemployment rates, nearly flat at high rates. If the exchange rate is fixed, one consequence of a convex Phillips-curve is that every period of unemployment below equilibrium has to be paid for with higher average unemployment. In order to regain the competitiveness lost in the period when the unemployment rate is say 1 per cent below equilibrium, it is necessary to have a longer period when the unemployment rate is 1 per cent above equilibrium (unless one is saved by unexpectedly rapid wage increases in other countries).

iii) The equilibrium unemployment rate may depend on the rate of inflation. It is generally agreed that at high inflation there is no connection between the inflation rate and the equilibrium unemployment rate (i.e. the "long run" Phillips curve is vertical). However, there is still some debate about whether there is a negative relation between the rate of inflation and the equilibrium unemployment rate when the inflation rate is close to zero. There are legal and institutional obstacles to wage cuts (see Holden (1994)). The labour market may function more smoothly when relative wage changes do not require wage cuts.

If we accept these three points (there is still a

need for more empirical evidence), we get the following directions for monetary and fiscal policy:

1)Aim for an inflation rate which is low, but not too low. Choose your exchange rate policy with this in mind.

2)Restrain demand in booms in order to minimize the loss of competitiveness. Otherwise the price in terms of high unemployment later can be high.

3)Stimulate demand when unemployment is far above the equilibrium rate, since there is then little to lose in terms of increased cost inflation, and much to gain in terms of reductions in future equilibrium unemployment rates.

In particular I would like to stress the importance of restraining booms, since it is often overlooked that this keeps down average unemployment. A budget cut in a boom year may contribute more to low average unemployment than a similar expansion in a moderate recession.

These conclusions need to be supplemented with a remark about exchange rate policy. When a domestic boom has eroded international cost competitiveness, devaluations provide a short-cut to regained competitiveness without a prolonged period of unemployment first. There is some evidence that this method has worked for the Nordic countries in the past[2].

However, there are inherent dangers in a policy which uses frequent devaluations, since it may raise inflation expectations. This expectation effect means that repeated devaluations cannot keep the unemployment rate below the equilibrium level. However, they do not preclude a devaluation from easing the adjustment to a past shock which eroded competitiveness. If the event which leads to the devaluation is unique, and if the devaluation is combined with sufficiently restrictive demand policies, it may be rational to expect that it will not be followed by a surge in the domestic component of inflation. The devaluation may then be a success. In other cases it may only postpone unemployment for a while.

Policy opportunities after deregulation

Managing aggregate demand is a difficult task. We have information lags, decision lags, imperfect knowledge of the structure of the economy and imperfections in the political system. As we all know, there is a risk that the policy will destabilize instead of stabilize. However, we cannot stop trying. The levels of fiscal and monetary instruments have to be set in any case, and in an environment which is continuously changing. It is like shooting at a far-off moving target. It is extremely difficult to hit the bull's eye, but when you have to shoot, it is fatally dangerous not to aim the gun. Anybody giving that advice would be regarded as out of his mind. In the same way we should disregard those who say that demand management is too difficult. The many difficulties with demand management means that we should proceed with caution and reason, but not that we should stop trying.

The preoccupation with supply-side policies in the 1980s may have led to some neglect of proper demand management among those responsible for policy. One example may be that while policy-makers were occupied with deregulating the credit market, too little attention was paid to restraining demand financed by borrowing.

A common view is that the consumption and investment boom and the

subsequent slump in Finland, Norway and Sweden was a one-time effect of the deregulation of the financial markets. However, we should not exclude the possibility that more volatility is inherent in an economy with fewer regulations. The quantitative regulations may have acted as a hindrance to change. The combination of a fixed exchange rate and high capital mobility in the 1980s meant that changes in the demand for goods could often not be met by offsetting movements in interest rates. Because of the high capital mobility foreign exchange interventions (purchases or sales of foreign currency by the central banks) lost much of their effectiveness. Instead, a country which wanted to keep its exchange rate fixed had to use its interest rate as the main instrument for achieving the exchange rate target. The interest rate was then not able to respond to variations in domestic demand in the desired way. The lack of an independent monetary policy was particularly problematic for Norway, where the business cycle was out of step with the rest of Europe.

More volatility in business investment should always be expected when capital movements and domestic credit markets are freed, see Razin and Rose (1994). On the other hand, liberal access to credit makes consumption-smoothing easier. It should reduce the marginal propensity to consume out of current income, and thus reduce the multiplier. However, consumption becomes more sensitive to expectations about the future. This means that a perceived change in permanent income may lead to a more than proportional change in consumption demand now, as people immediately increase their stocks of durable goods. With the old regulations people had to save first. Even if the marginal propensity to consume out of temporary income is reduced, the overall volatility of consumption may increase after deregulation.

It remains to be seen how volatile consumption and investment will be in the future. Denmark deregulated its financial markets earlier than the other Nordic countries, but still had large swings in consumption and investment in the late 1980s. On the other hand there are small countries with free capital movements and fixed exchange rates, notably the Netherlands and Austria, which have shown greater stability.

When monetary policy is tied to the exchange rate target, fiscal policy is the main instrument left for managing demand. It is sometimes claimed that high capital mobility makes fiscal policy more effective, since the effect of a fiscal expansion is not dampened by an increase in the interest rate. This is misleading. If there is a real demand shock, say a fall in investment demand, the fiscal intervention which is needed to stabilize demand at its old level is independent of the degree of capital mobility. It takes one billion kroner of government investment to compensate for a shortfall of one billion kroner of private investment whether capital mobility is high or low. When private sector demand becomes more volatile, the demands on fiscal policy increases.

However, there are clear limits to the use of fiscal policy for stabilization purposes. The labour force in our economies is highly specialized. It is not enough to stabilize aggregate demand if there are violent swings in its composition. If construction workers lose their jobs, they are not helped much by an expansion of government demand for nurses or economics professors.

The immediate fiscal answer to a

shift in private investment demand is a change in government investment demand in the opposite direction. However, in our economies the investment demand of the central government is often less than ten per cent of total fixed investment. Even if central government investment is halted completely during a boom, this may not be enough to prevent overheating of the economy. When there is a slump in private investment, it may be infeasible to raise central government investment enough to compensate. Monetary policy affects investment primarily through the cost of capital. In principle we may get the same effect on the cost of capital by varying tax rules. It remains to be seen how this can be done in practice without too harmful side effects.

The immediate answer to a shift in private consumption demand is a change in the tax level. With less credit rationing we should expect temporary changes in taxes to have less effect on consumer demand.

There is another way in which deregulation has made it more difficult to use fiscal policy to stimulate demand in deep recessions. If a recession struck, one old keynesian piece of advice was to lower interest rates first, and then use fiscal stimuli only if low interest rates were not enough. High international capital mobility may force a country which keeps its exchange rate fixed to keep interest rates high through the recession. A fiscal deficit then leads to a rapid increase in the interest burden of the public debt. If the recession lasts, this may cause concern about the sustainability of the country's economic policy. Investors may start to fear that the government will solve its debt problem by devaluing (or even defaulting). The result will be even higher interest rates. This vicious circle may undermine the expansionary effect of the fiscal policy. This has clearly been a concern for the governments of the Nordic countries.

On the other hand, one advantage of greater capital mobility is that the government has less need to be concerned with the current account. High capital mobility means that it is possible to finance large current account deficits. The individual borrowers (including the government) must of course convince the lenders that they are obeying their individual long-term budget constraints. If the government keeps its own finances in order, it has no need to worry about current account deficits. One error made in the early phase of the Norwegian recession was probably that the government was too concerned with the current account.

Financial deregulation may have given many advantages. However, it should be realized that it may have made aggregate demand more volatile, and has made it more difficult for governments to stabilize aggregate demand. If this is true, then we must be prepared to live with higher average unemployment rates.

Exchange rate policy

There may be one escape, however. So far our reasoning has been based on fixed exchange rates. From 1973 and far into the 1980s devaluations played an important role in the stabilisation policies of the Nordic countries, and, as already mentioned, there are indications that they contributed to the high levels of employment. The use of periodic devaluations came to be regarded as a failed policy in the late 1980s. One reason was increased problems with speculative capital movements after deregulation. It seemed better to keep the exchange rate fixed and build as much credibility as possible. That would make domestic interest rates equal to foreign interest rates, which would

be better than to have interest rates completely out of control, as they seemed to be when a currency was repeatedly exposed to speculative attacks.

However, the negative judgement on exchange rate policy may have been made too soon. If a boom which goes too far is normally followed by a devaluation, currency speculation raises interest rates during booms. That could be a good thing. The Norwegian devaluation in 1986 has often been cited as a reason for the high interest rates which hit the economy during the initial phase of the Norwegian recession from 1987. It may be queried whether the problem was in fact the reverse: that the high interest rates came because we devalued too little. Sweden got away with comparatively low interest rates after its 1982 devaluation[3], and even then there were fairly few restrictions on capital movements. The experiences after Finland and Sweden floated their exchange rates in 1992 may also be of relevance.

On balance one must probably conclude that the use of occasional devaluations has become more difficult. The government is not able to choose the timing of devaluations in the way it did before. The market may force a devaluation on the government before it has had time to make the necessary adjustment of fiscal policy, and before it has had time to secure consensus from the trade unions that competitiveness is a problem. A foreign exchange market that is always nervous about devaluations or revaluations may become a source of too many disturbances to the economy. Over time the economy may also acquire an inflationary bias.

Another alternative is a floating exchange rate combined with an inflation target. Monetary policy will then be directed at the inflation target instead of the exchange rate target. As long as the business cycle is driven by demand shocks, there is no conflict between stabilizing domestic inflation and stabilizing employment. However, when there are supply shocks, or shocks in the financial markets, there may be a conflict. Anyway floating exchange rates will require a fundamental change in the way of thinking in central wage bargaining. The Scandinavian model of wage setting is at risk when the exchange rate can no longer be thought of as exogenous.

Conclusion

Must the commitment to full employment yield? In my opinion deregulation of the financial markets means we should be prepared for somewhat higher average unemployment than before. With fewer instruments there is less we can achieve with policy, and with liberal access to credit there may be fewer automatic stabilizers, especially if the exchange rate is rigidly fixed. Perhaps this view is too pessimistic. It remains to be seen how deregulation affects the volatility of consumption in the longer run. It also remains to be seen whether a more flexible exchange rate policy can produce lower unemployment, or whether it leads to more problems of supply-side disturbances, and disturbances from the financial markets. Still I think we should not close our eyes to the possibility that deregulation of the financial markets may have a price in the form of somewhat higher average unemployment.

On the more constructive side; even if fiscal policy has limited power, it is still a useful tool for stabilizing aggregate demand and keeping down unemployment. In particular, much can be achieved by a sufficiently restrictive fiscal policy during booms.

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Notes

1. Edin and Holmlund (1994) disagree for Sweden.
2. See Gylfason (1990).
3. See Holden and Vikøren (1994).