

# The economic crisis is a crisis of economic policy

By [Jean-Luc Gaffard](#)

The simultaneous increase of inflation and unemployment in the 1970s indicated that Keynesian theory and policy had run into a wall. No longer was it simply possible to arbitrate between the two evils and fine-tune economic activity by acting solely on aggregate demand through the budget channel. This failure together with the persistence of high inflation eventually convinced policymakers of the need and urgency of prioritising the fight against inflation.

The economic theory devised by the new classical school came in support of this policy decision with the claim that inflation and unemployment were distinct phenomena that should be handled with distinct methods. If inflation takes off, it is because of a lack of monetary discipline. If unemployment rises, it is due to increased rigidities in the functioning of the markets. The famous Phillips curve, the basis for arbitrating between the two, theoretically becomes vertical, at least in the long run. Macroeconomic policies thus become dissociated from structural policies: the first are intended to stem inflation, the second to curb unemployment. The only relationship that they have with each other is that cyclical policy does not allow the economy to escape for long from the position determined by structural policy, a position that reflects the so-called natural unemployment rate. One attraction of this theory is the simplicity of its recommendations to government. Policymakers can (and should) meet a single target, inflation, by using a single instrument wielded by a central bank that is now independent, especially as hitting this target also ensures that the natural employment level will be achieved at the lowest cost in terms of inflation. If by chance the unemployment rate is considered

too high, policymakers should take the view that this reflects dysfunctions in the markets for goods and labour, and they can then decide to introduce a well-organised set of structural reforms designed for market liberalisation. In this wonderful world, reducing the budget deficit is always profitable. The basic model teaches that, after such a reduction, income and employment decrease initially, but then, thanks to a reduction in interest rates, private investment quickly increases and with it income and employment. The new medium-term equilibrium may even correspond to a higher level of income and employment, as private investment expenditure is considered to be more efficient than government expenditure. An independent central bank and financial markets that are deemed efficient play the role of disciplining the government by punishing any inappropriate budget deficits.

Europe has been a prime testing ground for this theory. Monetary policy is in the hands of a central bank, and its governing treaties ensure that it is independent and that its sole objective is price stability. Structural policies and reforms are a matter for the states, which are responsible for choosing the natural unemployment rate that they consider acceptable or, if they consider unemployment to be too high, they can impose reforms. If unemployment is higher in one country than in another, in the medium term, this can only be due to structural differences, in other words, to the existence of greater rigidities in the way the markets in this country operate. Once the recommended reforms are implemented, things will get back to normal. The theory thus formulated is expected to survive the crisis: for Europe to regain its lost coherence is a simple matter of policy choices. Excessively indebted countries need to reduce their budget deficits and make the structural reforms that they have put off for too long in order to restore growth, full employment and price stability. At most, some are proposing that debts be pooled in return for a commitment to implement structural reform. Germany, which has preceded the others down this particular

path to virtue, has nothing to fear from this scenario, since the renewed growth of its partners will ensure the long-term viability of its commercial outlets. Furthermore, the European Central Bank does not need to concern itself with financial stability, as markets punish impecunious States and force them into fiscal austerity by driving up the interest rates paid on their borrowings.

This entire beautiful structure rests on assumptions that are not very robust, in particular that any increase in market rigidities, particularly on the labour market, *e.g.* due to an increase in unemployment benefits, redundancy costs or employee bargaining power, shifts the long-term equilibrium position of the economy and inevitably produces an increase in the “natural” unemployment rate. It is, of course, always possible to compare long-run equilibria that are distinguished only by the value of certain structural data. It is riskier to deduce the path that leads from one to another. We should have learned from the experience of the 1930s that rigidities in prices and wages are a way to stem rising unemployment in a depressed economy, that is to say, when it becomes important to block reductions in prices and wages that are increasing the burden of private debt and putting downward pressure on aggregate demand. It should also be clear that structural reforms intended to reduce the natural rate of unemployment often lead immediately to a redistribution and reduction in income, which leads in turn to higher unemployment. But nothing says that this increase will only be temporary and will not trigger a chain reaction through the channel of aggregate demand. Rigidities remain a factor in reducing the risk of instability inherent in any structural change, whether this involves reforms in market organisation, the emergence of new competitors on the market or technological breakthroughs. A better allocation of resources may justify calling these rigidities into question, but care must be taken to avoid the inherent risk of instability. Certainly, when structural reforms aimed at introducing more flexibility undermine

domestic demand, the latter can then be boosted by stimulating external demand with lower prices. The unemployment rate may then fall. But it is actually exported to countries that might well not yet have undertaken such reforms, where unemployment thus inevitably exceeds the level deemed natural. "Every man for himself" begins to prevail over solidarity.

Europe is currently going through this scenario. Germany, in particular, carried out the structural reforms required by the prevailing theory, but at the cost of the segmentation of its labour market and the growth of low-paid insecure jobs, which resulted in turn in a slowdown in domestic demand. The improvement in Germany's export performance, based on the quality of its goods as well as on the international fragmentation of the production process, has been offsetting the slowdown and helping to contain or even reduce the budget deficit. The unemployment rate has been rising in many other European countries in parallel to their budget deficits. The correction required by the experts (and in fact imposed by the financial markets), which involves simultaneously reducing public spending, raising taxes and making structural reforms, will very likely further reduce domestic demand in these countries, increase their budget deficits and ultimately hit German exports. [Recession, if not a general depression, lies at the end of this path.](#) The cause is a series of internal and external imbalances. And things could get even more complicated if performance gaps in the countries concerned widen even further and lead to divergences in their goals and interests.

Economic policy is unfortunately more complex than modern macroeconomics would have it. The long term is not independent of the short term; and the goals pursued are not independent of each other, and not always inter-compatible. Policies that are categorised as cyclical and structural are not really independent of each other, nor can they be targeted exclusively at a single goal. If there must be structural

reforms, they need to be accompanied by expansionary cyclical policies to counteract the immediate recessionary effects that they may amplify. Even so, cyclical policies are not sufficient in themselves to ensure strong, steady growth.

It is unrealistic and dangerous to expect to break free of the current impasse through generalised fiscal austerity in Europe. Compromises are needed that involve the acceptance of some disequilibria in order to alleviate others. The only way out is to accept budget deficits for a while longer. Without a recovery in the balance sheets of both firms and households, there will be no positive outcome from the rebalancing of public accounts, if indeed that even occurs.

There is of course no doubt that we must achieve greater harmony in the fiscal positions of countries belonging to the same monetary zone. Fiscal federalism is necessary to deal with monetary federalism. But federalism does not stop with the actions of a central bank that has been stripped of its basic functions and is unable to carry out common national fiscal contractions. It demands genuine budget solidarity, including to intervene to prevent the insolvency of States that are facing exorbitant interest rates. It also involves structural policies that not only refrain from reforms that could exacerbate fiscal and social competition, but also promote industrial and technological projects funded by a common European budget that has been strengthened through the establishment of a federal tax. State budget deficits will not be contained and the objectives and interests of states will not converge without the implementation of the cyclical and structural policies needed for a general recovery of growth.