The Irrelevance of Aggregative Policies against Inflation under Conditions of Resource Misallocation

By Paul Löwenthal

The paper deals with the inadequacy of disinflation policy by aggregate restraint and gives some guidelines for a better arbitrage between short- and long-term requirements.

1. The Issue

There has been increasing awareness of the allocative nature of the post-1974 economic crisis. Resource allocation was all but optimal in the early seventies, as was evidenced by growing worldwide inflation, profitability losses, overindebtedness of all sectors, the overflowing of the international monetary system, or by all kinds of social discontent towards the costs of economic growth. The blowing-up of the international price structure and of industrial cost structures, because of wide exchange rate adjustments and the oil-price increase, disrupted the world economy as a system.

The policy issue was however proposed in terms of symptoms rather than causes. It was unemployment on the one hand, and a set of monetary and financial disequilibria on the other hand: inflation, private, public and external deficits, and exchange rate instability. The political debate, which economists were not able to inform adequately at the time, focused on the dilemma between stimulation and stabilization. And it was discussed, then designed, along the usual aggregate and short-term lines.

In a short-term perspective, the two targets were conflictual indeed. Financial stabilization called for curbs in wages and in public expenditures. Stimulation would have implied sustaining wages and public expenditures. Only in a long-term, allocative perspective could the trade off be overwon. Such long-term concerns would have been the most relevant, indeed, but we were not intellectually prepared to design them, and short-term concerns looked urgent.

In the keynesian tradition, I shall consider as of long-term relevance, all that is related with the production or allocation of resources, and as

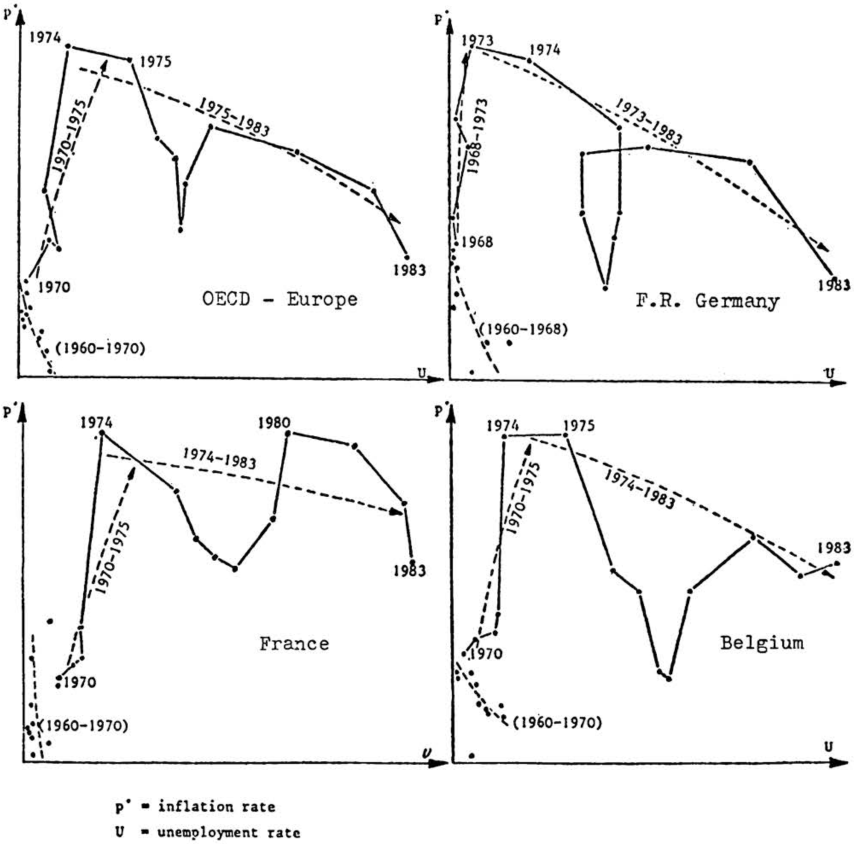

Figure 1

of short-term relevance all that is related with the rate of utilization of resources. A distinction which mixes the one between supply and demand which is presently in fashion, with that of micro- and macroeconomic (aggregative) approaches. Thus defined short and long do not refer to the time horizon for decisions or adjustments, although it will be obvious that s. c. long-term policies are mostly longer to enforce or to succeed.

Financial emergencies were considered more binding than social ones, and the stabilization camp won the contest. Under the sponsorship of international organisations and with big countries leading the way, disinflation was set as the first priority in OECD-countries, generally so as from 1979 and with the only temporary exception of France. It was admitted to be restrictive in the short run, but said to be the necessary, even sufficient condition for an economic recovery to occur, indeed spontaneously, after a few years' time. But the depressed transition period is now felt to be exceedingly long, tough and exerting worrysome fallout effects upon the rest of the world. As far as industrialized countries themselves are concerned, the inflation-unemployment diagram illustrates the case in point (fig. 1).

The apparently changing relationship between inflation and unemployment in the long run can only mean two things. Either, one at least of the relationships is spurious. The apparent one(s) would only evidence the working of some third factor on (one of) the variables: on increasing unemployment, or on fluctuating inflation. Or both relationships hold, which implies that one, at least, of the two variables must be further analyzed: unemployment in its keynesian and classical components, or (dis)inflation according to its determinants. Let us first look at the recent disinflation period, where the old negative relationship à-la-Phillips seems to hold.

2. Disinflation or Deflation?

That macroeconomic policies were predominantly restrictive after the first oil shock, and massively so for the ultimate years, is hopefully well ascertained by such indicators as: monetary aggregates related to real growth capacity or to inflation; real interest rates; fiscal impulses after allowance is given for built-in stabilizers and the excess-interest burden on public debt; the purchasing power of households. More "structural" action was eventually exerted, e.g. on energy consumption, to develop new technologies or against social rigidities: OECD's.c. "positive adjustments". But this occured at a reduced scale under strictly binding financial contraints. The latter evidently dominated, in a short run that lengthens by hint of repeating itself.

As a result, we have experienced a further phasing out of economic trends as from 1980 (fig. 2). Some developments are now negative, not only cyclically but even trendwise: industrial production, at least in Europe; private consumption; world trade.

The odds of the post-1979 period suggest the working of some new behaviour or mechanism, rather than just the joint consequence of the second oil shock and of restrictive, short-term policies. Unemployment shows this best: apart from cyclical fluctuations, some countries, notably USA and F.R. Germany, managed to stabilize their unemployment at its (relatively high) 1975 level up to 1979. It blew up afterwards, not only during the 1980 - 81 recession period but at least till the 1983 cyclical recovery (fig. 3).

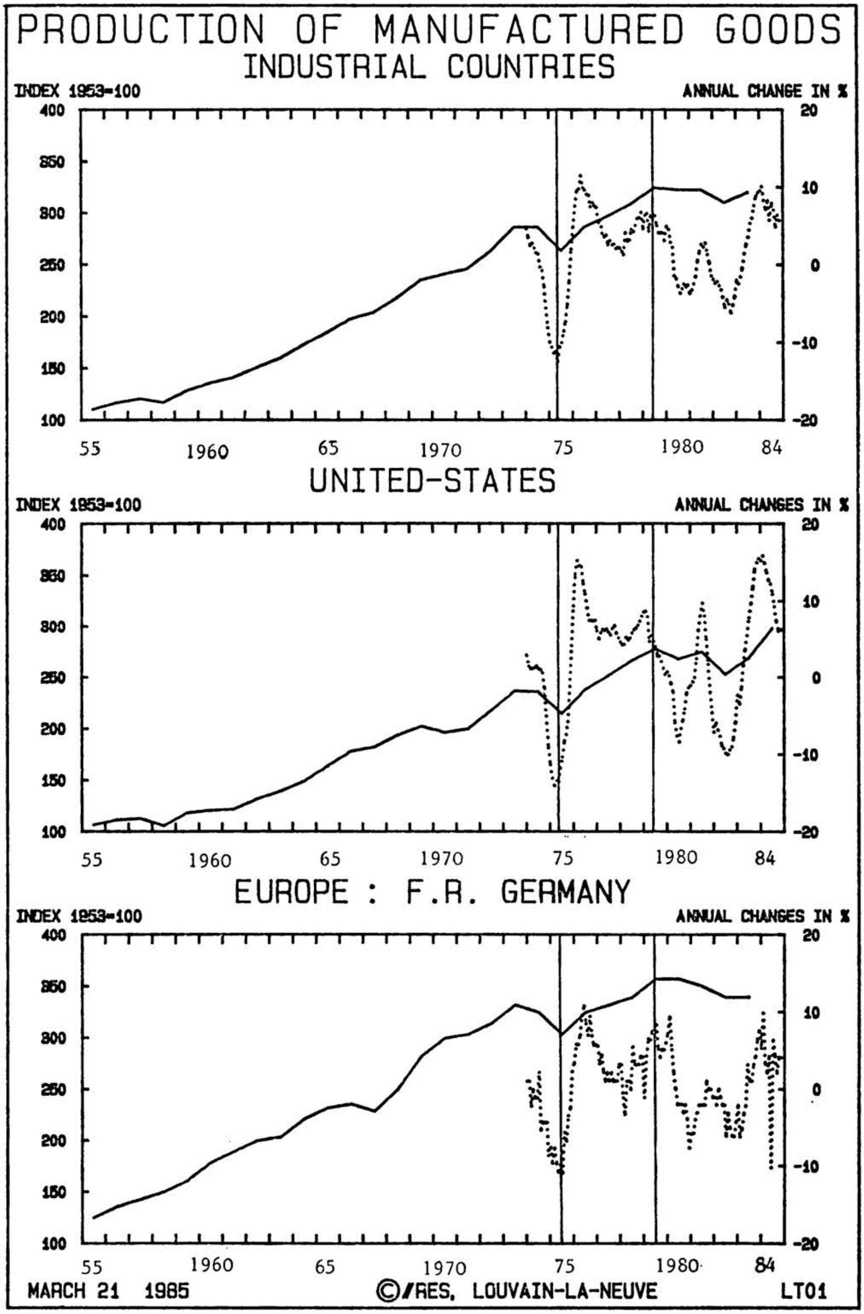
PRODUCTION OF MANUFACTURED GOODS
INDUSTRIAL COUNTRIES
INDEX 1953=100
ANNUAL CHANGE IN %
400
350
300
250
200
150
100
20
10
0
-10
-20
55
1960
65
1970
75
1980
84
UNITED-STATES
INDEX 1953=100
ANNUAL CHANGES IN %
EUROPE : F.R. GERMANY
INDEX 1953=100
ANNUAL CHANGES IN %
MARCH 21 1985
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Figure 2

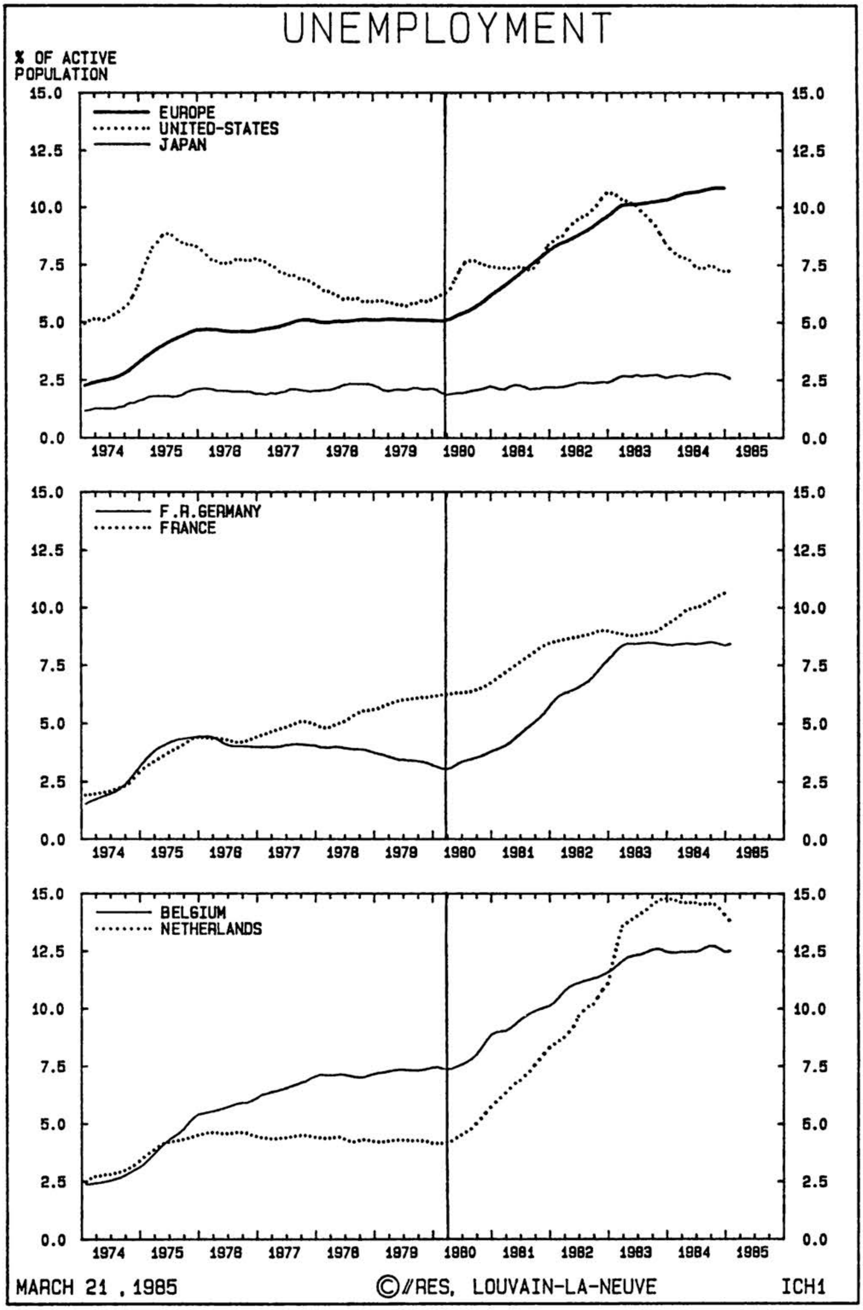
UNEMPLOYMENT
% OF ACTIVE POPULATION
15.0
12.5
10.0
7.5
5.0
2.5
0.0
EUROPE
UNITED-STATES
JAPAN
1974 1975 1976 1977 1978 1979 1980 1981 1982 1983 1984 1985
F.R.GERMANY
FRANCE
BELGIUM
NETHERLANDS
MARCH 21 , 1985
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Figure 3

It is my contention that *the further weakening of trends after 1979 shows the perverse composition effects of aggregative restrictive policies in industrialized countries.* A vicious circle, the scope of which goes well beyond that of short run demand restrictions, since it embodies expectations and investment, hence the long run production of resources. Figure 4 outlines the point at stake. The purpose of s.c. stabilization policies, sketched by wage curbs, is to walk around the left-hand part of the diagram. The circuit is drown open, since more employment would lead to higher wages, hence this offsets part of the initial process rather than fostering it.

Critics to this policy stance insist that wages are not only a cost, but the main component of households purchasing power, hence of final demand. As shown symmetrically at the right hand of fig. 4, this leads to a depressing process, which this time makes out a closed loop, i.e. a self-sustaining, cumulative process.

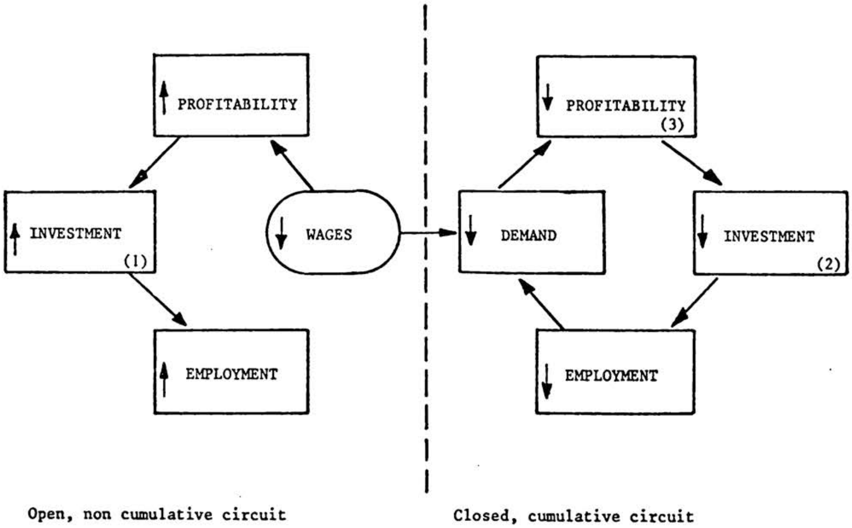
For the favourable, left-hand side to win over the perverse right-hand one, the link between wagecurbs (or any other restrictive measure) and global demand must be small. Such may be the case if the policy is enforced by one firm or industry in a country, or by one country in the world. Our present problem is that this policy has been followed for years by industrialized countries jointly.

Gradually as from 1980, our depression has spilled over to Eastern and Third World economies, whose import capacity is linked with their export income, or indebtedness capacity. The fact that OECD countries have managed to absorb their external deficit through less imports has thus led them to loose export opportunities (fig. 5). This vicious circle adds up to the first one.

3. Inflation and Aggregative Economics

If Governments have failed, after the mid-seventies, in their purpose to wander back towards both less inflation and unemployment, it must mean that they did not design their disinflation around the factors that caused inflation itself, or that disinflation was skewed by rigidities. In the latter case (downward price and wage rigidity, inertia in expectations), part of the effect is diverted towards real economic developments: such has obviously been the case, but too harshly and pervasively to be just attributable to adjustment sluggishness. Let us hence turn to the former argument.

I shall advocate that *disinflation through aggregate restriction, going along with more keynesian unemployment, did not cope adequately with the prevailing inflationary vicious circle sanctioned by monetary*



(1) increased, labour-using production capacities
(2) except rationalizations
(3) ↓ total profits + increased competition

Figure 4

accomodation but rooted in microeconomic disequilibria and that went along with classical unemployment.

Without entering fully into the inflation controversy, we can admit that many factors fostered price rises in OECD countries since the last 1960's: oil-price rises, obviously, which more or less boosted general price levels in the short run according to monetary policies, but affected relative prices and costs anyhow; financial deficits of firms, confronted with the disrupture in their terms of trade consecutive to the blowing up of international exchange rate and price structures; indebteness of private and public sectors alike in most countries, in an accomodating monetary framework and at a quicker pace than real economic developments; interindustry infection of wage rises, irrespective of productivity developments as of the distribution implications of an increasing share of incomes without market-productive counterpart (civil servants' wages, transfer income); a variety of market failures and productive inefficiencies, which prove growth inhibating in a monetary stable situation, but feed an inflationary vicious circle whenever the case.

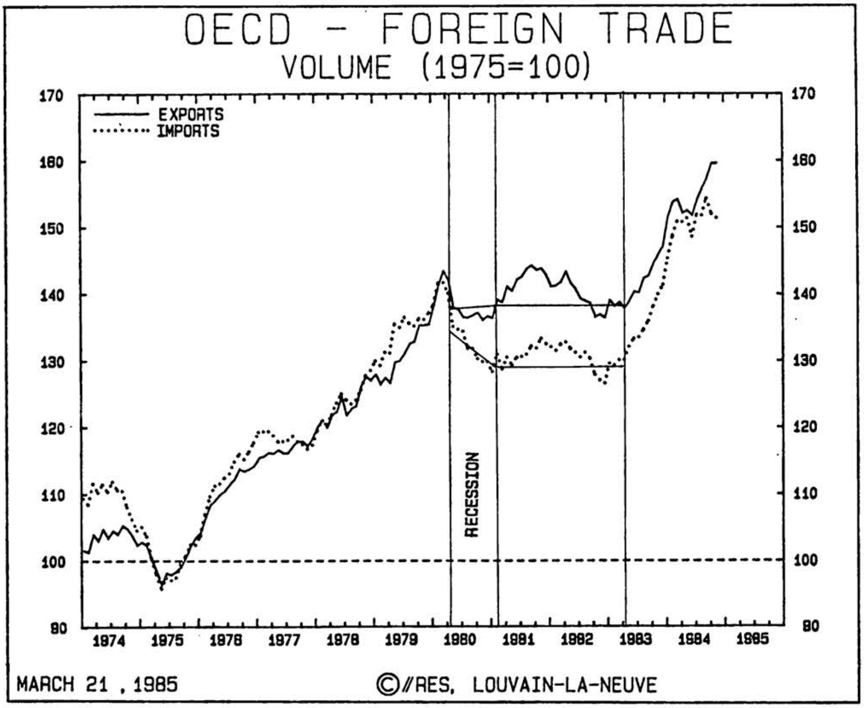
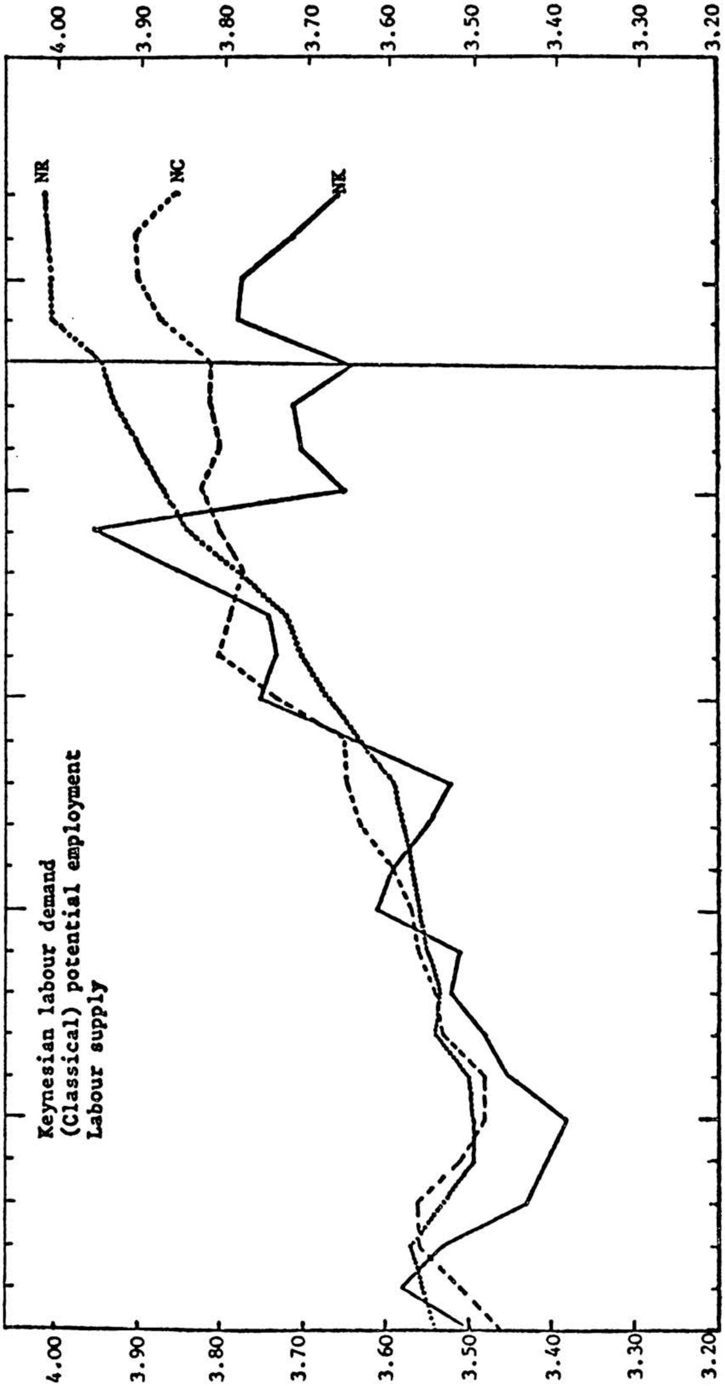


Figure 5

All these factors bear two consequences, or some combination of both: inflationary compensation of frustration or shortcomings on the one hand; rationalization or disinvestment on the other hand, along with classical unemployment.

The only purpose of this listing is to support the view that, although money is well present in the inflation process, it is in response to other factors. Money is the necessary and sufficient condition for both inflation and disinflation, but not necessarily their prime mover. As a consequence, if the movers or amplifiers of inflation are not removed, monetary disinflation will remain superficial: fragile to the very extent that it is constraining rather than achieving the "in-depth consolidation" which its promoters call for.

The lesson of getting "deflation" rather than disinflation in recent years, thus traces back to the non-monetary, or even non-financial factors behind the inflation of the previous decade. Disinflation would have meant a reduction in monetary developments *needed* by the economy, i.e. an improvement of economic efficiency, rather than just slope of the short-term Phillips curve, and the variances of different



Sources: Till 1978: *H. Sneessens* (1981). — After 1978: estimates by *C. Pauly* (unpublished).

Figure 6: Estimated Values of the Determinants of Observed Employment (Belgium)

the reduction in monetary developments *supplied* to the economy, as it is. A microeconomic, long-term policy rather than just a macroeconomic (aggregative) short-term policy. Fighting both inflation and classical unemployment by resource reallocation and production, rather than fighting inflation alone by worsening unemployment, both keynesian (in the short run) and classical (in the longer run) (fig. 6).[1]

4. The Short-Term vs. Long-Term Arbitrage

The grass-roots objection to my arguments, is an alleged lack in alternatives in front of the emergencies. Whence the question as to whether, and inhowfar, long-term requirements can be met under the present short-term constraints. Or, to state it dually, whether short-term emergencies can be tackled in a way that respect, or possibly meet long-term requirements.

I am going to suggest a heuristic towards such a policy design, with as few materialization as possible in order to minimize the risk of raising a controversy about the content of the measures. Since I cannot totally avoid the risk, I shall insist that my purpose is only to show that there is a problem setting that can help us to find a way out. And I ask the reader, not to extend his disagreement on my suggestions, onto my analysis of present policies.

Figure 7 sketches the problem. Long-term targets can be made consistent, but short-term targets are globally conflicting, both mutually and with the long-term ones. There seems to be room for reconciliation only by selective action. Economically, by a selective investment promotion (in an industrial strategy) and an accordingly selective fiscal policy. Financially, through redistribution rather than global austerity, along with the acceptance of some moderate dose of financial (public and external) deficit. Socially, ethics and economic opportunity might converge in the protection of only small and/or labour earnings. In all instances, it would imply (re)allocation of resources.

Figure 8 brings this a step further, for the case of a country, or group of countries like Europe, with experiences a financial deficit in firms (lack of profitability) and in its public sector, with a financial surplus of households (thanks to transfer income, and low investment) and of the rest of the world. The upper part of the chart sketches the kind of correcting measures that have been taken so far under the austerity motto. The lower part suggests the complementary, allocative measures

[1] The graph illustrates the case of Belgium, as analysed by *Sneessens* (1981). For other European countries, estimations currently at hand suggest unemployment to be massively classicial, which seems unlikely but would, whenever the case, strenghten my interpretation.

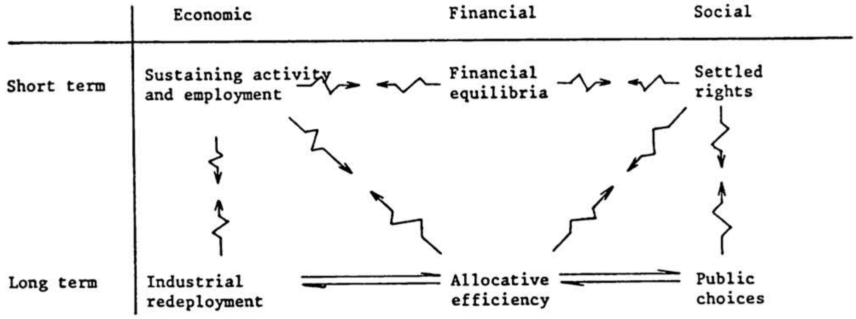
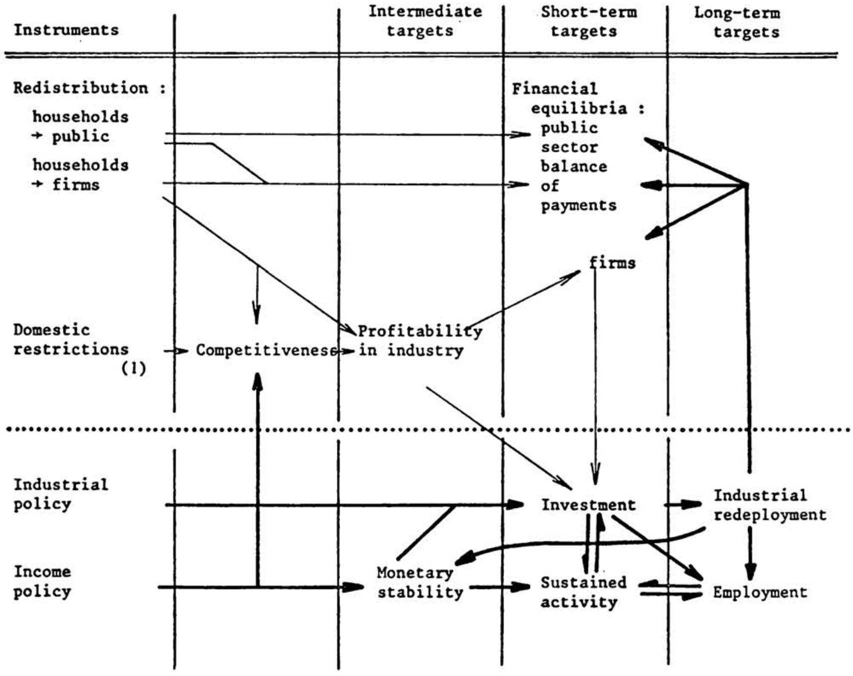


Figure 7



(1) In the case of some countries: currency depreciation.

Figure 8

that would contribute to short-term, financial targets, and help reaching the long-term ones.

The next obvious step would be to get rid of national external contraints and to exploit complementarities in their (structural or financial) situation in an international coordination.

5. Final Comments

Macroeconomic as all social phenomena are made up of composition, or aggregation effects. They can be favourable, as are multiplier effects, or harmful, either because of the influence of political or legal instability on expectations, or, conversely, because of the impact of lasting market disequilibria on supply. Attention has been recently focused on the former effect, whereas the latter has gathered momentum: it is namely an example of long-term perverse effects out of short-term policies, and of the short-sightedness of such policies.

National policies can prove harmful, because their efforts towards external equilibrium or competitiveness bear necessarily on other countries. Whenever all countries try together, they neutralize each other as to these targets, but cumulate the perverse, restrictive effect of the policies enforced. Industrial countries have experienced this as a whole after both oil shocks. It is only natural that individual agents, social groups, individual countries, and even groups of countries take their own decisions according to their own interests. It is thus natural that they disregard perverse effects from which they would suffer only through a feedback effect. It is still natural that they mistrust their partners' possible strategies. But it is all natural short-sightedness.

What we experienced, and go on experiencing, are all expressions of those two types of short-sightedness: either to stick to aggregative, short-term analysis and policies, or to focus on the financial symptoms of our disequilibria. Politically, it is probably another form of short-sightedness to have given and stubbornly maintained a total priority on financial disequilibria over unemployment. Not to speak of the protectionism of nations or of social groups. In a word, we are malthusianistic and do not seem to have learnt much from the thirties.

To end up, what can we expect under the present policy stance? In terms of the inflation-unemployment diagram (fig. 1), I explained why I would not hope for a leftward shift, with inflation stabilizing a some moderate pace. An upward shift is likely, but only in a short run, cyclical perspective. Beyond this respite, there seems to be room only for a further shift rightwards (more unemployment) and downwards, i.e. at the risk of reaching deflation in the strictest sense within a few years'time: with lowering prices, falling expectations, and the postponement of expenditures. Except for a longer-term, allocative approach, I am afraid the only other way out would then seem to be to let inflation, along with unemployment, be aigain the adjustment variable.

Summary

The policy issues of the post-1974 crisis, i. e. the stimulation-disinflation dilemma, are restated in view of resource allocation requirements (§ 1).

The high employment cost of attempts at disinflation and financial stabilization within OECD is traced back to the aggregate, short term approach of the prevailing restrictive stance and to the deflatory vicious circle it gives way to (§ 2).

It is advocated that such a global approach does not cope adequately with an inflation and with financial deficits that are rooted in microeconomic disequilibria (§ 3) and call for a better arbitrage between short- and long-term requirements (§ 4 - 5).

Zusammenfassung

Das Dilemmt zwischen Expansions- und Disinflationspolitik, das zentrale wirtschaftspolitische Problem der Jahre nach 1974, wird unter dem Gesichtspunkt der Ressourcenallokation neu formuliert (§ 1).

Die hohen Beschäftigungsverluste der Versuche zur Disinflation und Stabilisierung in den OECD-Ländern werden zum kurzfristigen, gesamtwirtschaftlichen Ansatz des vorherrschenden restriktiven Kurses zurückverfolgt sowie zum deflationären vicious circle, der dadurch ausgelöst wird (§ 2).

Es wird behauptet, daß dieser globale Ansatz keine angemessene Antwort auf eine Inflation und finanzielle Defizite ist, die aus mikroökonomischen Ungleichgewichten resultieren (§ 3). Statt dessen wird ein besserer Ausgleich zwischen kurz- und langfristigen Erfordernissen postuliert.

Reference

Sneessens H. R., (1981), Theory and Estimation of Macroeconomic Rationing Models. Berlin.