The Problem is Inflation-control, not Spending-control

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The 1980s and 1990s have been marked by major annual deficits in the national government's accounts in most countries, and by mounting concern because the consequent rapid growth of their debts appears to be out of control in most cases.

The ratio of government debt to gross domestic product (GDP) is commonly used as an indicator of the seriousness of the burden on the economy, and the relative growth rates of debt and GDP as an indicator of the sustainability of current trends. If the debt is growing less rapidly than GDP, the trend is presumably sustainable, though not necessarily healthy.

Montgomery (1994) presents a chart showing the debt-GDP ratio for the G-7 countries from 1980 to 1992. The ratio for Japan levelled off about 1987 and has declined moderately since; for Britain it declined from about 1984 to about 1990, but began to rise again thereafter; for the other five countries it has followed a rising trend throughout. The current level of the ratio is about 24% for France and Germany, about 40% for Britain, about 50% for Canada, Japan, and the USA, and slightly over 100% for Italy.

The conventional wisdom declares: (i) that these deficits and debts are the result of extravagant government overspending; (ii) that the debt problem is rapidly getting worse, and in some countries will soon become so serious that financial markets will refuse to accept further government issues and will begin to dump those they now hold, thus precipitating a major financial disaster, unless corrective measures are taken promptly; (iii) that the only viable remedy is ever more drastic cuts in government spending.

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BNL Quarterly Review, no. 193, June 1995.

The conventional wisdom is quite right in identifying rapidly mounting government debt as a problem that threatens to bring on a financial meltdown. These are *unproductive* debts – they are not being used to finance new productive facilities that will pay for themselves in useful goods and services; instead, they will be a deadweight drain on future government income. Indeed, to the extent they are owed to foreign residents or to foreign organizations, they will be a deadweight drain on the real income of the entire economy.

However, the conventional wisdom is quite wrong in its diagnosis of the cause of the trouble, and in its prescription of a remedy.

These deficits and debts are *not* due to overspending by extravagant governments. On the contrary, they have been incurred by governments that have used monetary and fiscal retrenchment to control inflation, and *because* they have done so.

The fact is that most national governments for over 20 years have been fighting a 20th-century problem with 19th-century weapons. The proper solution to their debt problems, and to most of their associated economic and social problems as well, is to get their economies growing again and creating jobs. That requires finding a way of controlling inflation that does not make unemployment worse.

The real danger is that repeated predictions of doom by business and government leaders may eventually precipitate matters in one or more countries, and become a self-fulfilling prophecy. Indeed, in view of the tendency for a financial crisis in one country to spread to others, it would probably become an international financial crisis very quickly. The recent troubles of the Mexican peso, and the spinoff effects on the US and Canadian dollars and other currencies, are ample evidence of the seriousness of that threat.

We do have some time yet to set matters right, but not unlimited time.

The start of the debt problem: the factual record

Widespread major government deficits first appeared in the mid-1970s. For six of the seven members of what is now the G-7 Group, 1975 marked an abrupt and adverse change in the budgetary accounts of their national governments; for the seventh (Italy), a

similar abrupt change occurred three years later (see Table 1).[1] Most other countries had basically similar experiences.

In Britain, Canada, Germany, and Japan the change was from years of substantial annual surpluses to substantial annual deficits, or to materially smaller surpluses and occasional deficits. In France it was from substantial surpluses to substantial deficits and occasional surpluses. In the USA it was an approximate doubling of the annual deficits, followed by a further sharp escalation in the 1980s. In Italy there was a sharp break between relatively moderate deficits and materially greater deficits in 1978, and a further escalation in the 1980s.

Except for Germany and (after 1986) Japan, deficits predominated in the 1980s. At the start of the 1990s, with the exception of Japan and the partial exception of Britain, all were experiencing major deficits.

The roots of these deficits and the consequent debt problems go back to the late 1960s. Since World War II, demand management had maintained high levels of output and employment in most countries. World trade and world real income expanded greatly. It was a time of world-wide prosperity and hope, the like of which has never been seen before or since, though most people nowadays seem to have forgotten all about it. Most government budgets were predominantly in surplus.

This favourable experience was brought to an end by the alarming acceleration in most countries, beginning in the late 1960s, of what had long been merely creeping and relatively stable domestic inflations, for reasons that are beyond the scope of this article. In response, the authorities generally allowed interest rates to rise and unemployment to increase appreciably – some sooner, some later.

The rates of inflation in the major industrialized countries had diverged significantly throughout the postwar period, but by the late

[1] Note that the figures in the Table are for calendar years, and are statistical summaries of official government financial statements on the so-called "National Accounts basis". They are designed to be comparable to private-sector financial statements, and therefore more meaningful for the general public.

In most countries the official financial reports are designed primarily to show that revenues have been collected and appropriations have been spent as the legislature intended; the concept of "profit" or "loss" does not apply. For this and other reasons they may contain important peculiarities that have no parallel in private-sector accounting, and that therefore may cause confusion when direct comparisons are attempted.

TABLE 1

ANNUAL CENTRAL-GOVERNMENT DEFICITS IN THE G-7 COUNTRIES, 1946-1994

	Britain	Canada	France	Germany	Italy	Japan	USA
Unit *	MM	MM	MM	MM	MMM	MMM	MMM
1946	−856	−385	n.a.	n.a.	n.a.	n.a.	3.3
7	−92	608	n.a.	n.a.	n.a.	n.a.	13.4
8	433	762	n.a.	n.a.	n.a.	n.a.	9.2
9	505	568	n.a.	n.a.	n.a.	n.a.	−2.5
1950	591	671	n.a.	630	n.a.	n.a.	8.2
1	538	995	n.a.	1,820	n.a.	n.a.	6.0
2	258	317	n.a.	3,010	n.a.	n.a.	−3.4
3	85	202	n.a.	4,560	n.a.	n.a.	−5.9
4	112	30	n.a.	5,500	n.a.	n.a.	−6.1
1955	370	282	n.a.	6,980	n.a.	n.a.	4.2
6	279	695	2,361	7,660	n.a.	n.a.	6.3
7	379	374	2,860	6,300	n.a.	n.a.	2.2
8	465	−548	7,120	5,450	n.a.	n.a.	−8.5
9	335	−80	8,380	5,320	n.a.	n.a.	−2.6
1960	40	112	8,520	8,510	n.a.	n.a.	3.5
1	278	−236	8,470	10,030	n.a.	n.a.	−2.6
2	600	−387	7,700	8,290	n.a.	n.a.	−3.4
3	168	−204	9,940	7,920	n.a.	n.a.	1.1
4	422	396	17,008	10,430	n.a.	n.a.	−2.6
1965	800	713	18,961	7,360	n.a.	n.a	1.3
6	1,104	459	20,985	8,730	n.a.	n.a.	−1.4
7	1,178	169	13,940	6,290	n.a.	n.a.	−12.7
8	1,749	267	13,597	8,170	n.a.	n.a.	−4.7
9	2,939	1,267	22,292	16,720	n.a.	n.a.	8.5
1970	3,532	481	22,875	19,390	255	1,686	−13.3
1	2,842	107	21,152	21,280	−869	1,380	−21.7
2	1,163	−197	24,934	11,490	−1,470	1,843	−17.3
3	894	815	27,712	20,320	−2,934	3,357	−6.6
4	609	1,826	29,116	17,070	−1,852	1,786	−11.6
1975	−997	−3,200	−3,167	−6,040	−3,192	−1,754	−69.4
6	−2,648	−2,729	25,413	2,890	−1,990	−2,513	−52.9
7	−1,340	−6,774	6,312	9,570	−2,220	−3,621	−42.4
8	−3,491	−10,308	−7,196	7,360	−15,550	−2,774	−28.1
9	−2,430	−9,221	−3,832	9,140	−16,502	−4,730	−15.7
1980	−2,988	−10,481	21,248	6,610	−19,139	−4,680	−60.1
1	−4,671	−7,305	−7,307	−4,600	−30,419	−5,241	−58.8
2	−5,025	−20,004	−35,404	−4,620	−41,558	−5,971	−135.5
3	−5,346	−24,536	−89,292	3,170	−56,829	−6,228	−180.1
4	−6,619	−28,667	−93,523	7,070	−60,815	−5,079	−166.9
1985	−4,644	−30,463	−98,592	12,010	−66,189	−4,615	−181.4
6	−5,559	−22,955	−71,100	7,920	−70,800	−3,214	−201.0
7	−2,532	−20,209	−61,096	590	−73,377	488	−151.8
8	7,267	−18,451	−49,789	−6,970	−75,764	2,462	−141.7
9	10,500	−20,342	−37,347	19,200	−80,576	1,670	−134.3
1990	5,601	−25,245	−23,449	−20,640	−89,833	6,800	−166.2
1	−2,681	−30,296	−80,447	−25,300	−106,490	6,129	−203.4
2	−23,979	−28,012	−178,855	4,050	−135,134	736	−276.3
3	−31,668	–	–	–	–	–	–
4	–	–	–	–	–	–	–

n.a.: Not available.

* MM = millions of national currency units, MMM = milliards.

Sources: Data for Britain, Canada, and the USA are from the National Accounts as published by their respective statistical services; data for France, Germany, Italy, and Japan are from Volume II of the OECD's *National Accounts*.

1960s they began to diverge even more (see Table 2). These divergences had already caused the many currency crises that dotted the postwar years; in the end they brought about the collapse of the Bretton Woods system of normally fixed exchange rates in 1973, and the shift to a regime of flexible rates.

Inflation soared anew everywhere thereafter – to 31.6% per annum in Japan (1974), 24.3% in Britain (1975), even 7% in prudent Germany (1973 and 1974). Demand management as then understood proved incapable of controlling this new threat to economic progress. To this day the fear of encouraging a renewal of inflation is the main economic obstacle to the implementation of measures designed to support output and employment.

At the first "summit" conference in France in 1975 the six participants (Britain, France, Germany, Italy, Japan, and the USA) agreed that their economies needed stimulation to reduce unemployment, but the emphasis changed rapidly thereafter. By the second summit in Puerto Rico a mere seven months later (thereafter known as the G-7 Group, including Canada) there was a consensus that inflation had to be combatted vigourously. Failing the proposal of any better solution, and enlivened only by predictably unsuccesful attempts at price controls, by then most major industrialized countries had adopted or were adopting the centuries-old remedy: a strategy of combined monetary and fiscal retrenchment.

To put it bluntly, this meant deliberately and substantially depressing the national economy – temporarily, it was doubtless hoped, but that is not how it worked out.

Personally, I admit to being as guilty as anyone else at that time in not foreseeing all that was implied in the new direction economic policy was taking, and not being able to offer any better advice until too late.

Actually, retrenchment had begun even before the 1976 G-7 agreement. Monetary policy, traditionally the first line of defence against inflation, was tightened promptly in most of these seven countries by 1973, and progressively tightened further in succeeding years. Before the war that had always brought a fairly prompt end to inflation, but this time inflation *increased*.

As already noted, some fiscal restraints had already been imposed in the late 1960s, as government after government compromised its support for output and employment in the face of rising inflation. As time passed, these restraints were brought increasingly

TABLE 2

ANNUAL INFLATIONS IN THE G-7 COUNTRIES, 1946-1994
(% per annum)

	Britain	Canada	France	Germany	Italy	Japan	USA
1946	1.2	3.9	n.a.	n.a.	18.4	n.a.	8.0
7	1.6	8.8	n.a.	n.a.	63.8	n.a.	14.8
8	8.7	14.9	n.a.	n.a.	5.3	n.a.	7.5
9	3.0	3.0	16.0	n.a.	1.0	n.a.	−1.0
1950	2.7	3.1	8.0	−6.3	−1.0	−7.6	−1.3
1	9.9	10.4	17.6	7.8	12.5	16.5	8.1
2	6.3	2.5	12.0	2.1	1.8	5.0	2.1
3	1.6	−1.0	−2.1	−1.9	3.4	6.6	−0.8
4	1.6	0.6	0.6	0.2	2.9	6.5	0.4
1955	3.5	0.2	0.9	1.7	2.3	−1.0	−0.2
6	4.1	1.3	3.9	2.6	2.4	0.0	1.5
7	3.4	3.4	−0.5	2.0	1.1	3.1	3.3
8	2.8	2.7	15.2	2.2	2.8	−0.4	2.9
9	0.5	0.9	5.8	0.9	1.3	0.9	0.7
1960	1.0	1.4	4.2	1.5	2.1	3.8	1.6
1	3.5	0.9	2.4	2.3	2.0	5.4	1.1
2	4.1	1.2	5.2	2.9	5.0	6.6	1.1
3	2.0	1.7	4.8	3.0	6.7	7.8	1.2
4	3.3	1.8	3.4	2.3	6.3	3.7	1.3
1965	4.8	2.4	2.7	3.2	4.2	6.7	1.6
6	3.9	3.7	2.6	3.6	2.4	5.0	3.1
7	2.4	3.6	2.8	1.6	1.3	9.2	2.8
8	4.7	4.0	4.6	1.6	1.2	5.4	4.2
9	5.5	4.6	6.1	1.9	3.8	5.3	5.4
1970	6.4	3.3	5.9	3.4	5.0	7.6	5.9
1	9.5	2.9	5.5	5.2	5.0	6.3	4.3
2	7.1	4.8	6.2	5.5	5.7	7.5	3.3
3	9.2	7.5	7.3	7.0	10.8	15.7	6.2
4	15.9	10.9	13.7	7.0	19.1	31.6	11.0
1975	24.3	10.8	11.8	5.9	17.0	8.1	9.1
6	16.6	7.5	9.6	4.3	16.7	5.0	5.8
7	15.8	8.0	9.4	8.2	18.5	1.9	6.5
8	4.7	8.9	9.1	2.7	12.1	−2.6	7.6
9	13.4	9.1	10.8	4.1	14.8	7.3	11.3
1980	18.0	10.2	13.3	5.4	21.3	17.8	13.5
1	11.9	12.4	13.4	6.3	19.5	5.0	10.4
2	8.6	10.8	11.8	5.3	16.5	2.7	6.2
3	4.6	5.8	9.6	3.3	14.6	1.9	3.2
4	5.0	4.3	7.4	2.4	10.8	2.3	4.3
1985	6.1	4.0	5.8	2.2	9.2	2.0	3.6
6	3.5	4.1	2.8	−0.3	5.9	0.6	1.9
7	4.2	4.4	3.3	0.3	4.8	0.1	3.6
8	4.3	3.9	3.0	1.3	4.0	0.6	3.8
9	7.8	5.0	3.9	2.8	6.3	2.3	4.8
1990	9.5	4.8	3.2	2.7	6.4	3.1	5.4
1	5.8	5.6	3.2	3.5	12.3	3.3	4.3
2	3.7	1.5	2.4	4.1	5.2	1.7	3.0
3	1.5	1.9	2.1	4.1	4.5	1.2	3.0
4 *	2.9	0.2	1.7	2.9	4.0	0.0	2.9

n.a.: Not available.
* Estimated from third-quarter data.
Source: Computed from the annual country consumer price indexes in the IMF's *International Financial Statistics*.

into play, in the form of some combination of spending cuts and tax increases. Most other countries accepted the new G-7 orthodoxy, willingly or unwillingly. Some tried to resist, but fell into balance-of-payments difficulties for their pains, and had to conform eventually in order to get help from the International Monetary Fund.

However, inflation proved very stubborn everywhere; in the G-7 Group it was not brought down to levels the national authorities were prepared to tolerate until the early 1990s, by which time their fiscal restraints had become very severe indeed in most cases. The tendency now is to favour spending cuts rather than tax increases.

Meanwhile, as described earlier, huge government deficits had suddenly appeared in or about 1975, and have persisted to this day.

The start of the debt problem: the causal sequence

The sudden appearance of huge government deficits, the start of unexpectedly persistent inflation, and the implementation of the retrenchment strategy at about the same time is *not* by any means a mere coincidence. The explanation lies in a certain aspect of demand management as it evolved after the war.

A major feature of those years was a great expansion of social-welfare systems, especially in those countries that had previously had limited provisions of this sort. These important institutional changes involved the establishment, partly by accident and partly by design, of what came to be known as "automatic stabilizers", which played an important role in demand management's successes. They operate through the spending stream – the circular flow of money payments that regulate consumption and production, and in the process generate the incomes out of which these payments are ultimately made.

These stabilizers proved ineffective against the strong inflationary pressures of the early 1970s, but they work very well against *de*flationary forces. If the spending stream weakens and threatens to throw the economy into a recession, social-security payments grow to support the newly unemployed and the newly impoverished, while government revenues decline. That automatically creates a government deficit, which re-expands the spending stream and significantly counteracts the recessionary forces.

The new stabilizers changed the response of the economy to official retrenchment in two important ways.

First, automatic government deficits substantially offset the effects of tight money and fiscal restraint in reducing the spending stream and fighting inflation. That is why it took the individual national authorities over 20 years to beat their domestic inflations back to levels they feel are tolerable.

Second, by 1975 the depressing effects of the progressively strengthening combination of fiscal and monetary restraints at last began to materially exceed the supporting effects of the stabilizers in most countries. That put their national government budgets into a series of monumental annual deficits.

High market interest rates meant that interest charges on these rapidly-mounting public debts further enlarged the annual deficits. In many countries tax concessions for the well-to-do, intended to stimulate new capital spending but ineffective in depressed economies, added to the problem.

Note that, although inflation has at last been brought under some semblance of control, it has not been entirely eliminated in any of the G-7 countries even now.[2] Indeed, it threatens to accelerate again if real national income begins to expand at more than a relatively moderate rate.

Monetary policy has now been materially eased in most countries, and fiscal restraint has become the main element in the retrenchment strategy. However, monetary policy stands ready to re-enter the fray if inflation threatens to get out of hand once more, and has recently done so in the USA.

This rather modest success has been obtained at tremendous cost in lost real income, unemployment, and other economic and social evils. The continuing conflict between repeated deflationary initiatives and the automatic stabilizers has thrown individual national economies and the world economy into a *depression* that has already lasted 20 years and shows no sign of ending. No other word does it justice. Recessions have been long and deep, recoveries slow and incomplete. Unemployment has been persistently high, and productive capacity has not been fully utilized even at the peak of each business cycle.

[2] The figure of 0.2% inflation for Canada in 1994 in Table 2 is a statistical anomaly. Federal and some provincial tobacco taxes were materially reduced early in the year to combat smuggling; prices excluding tobacco were up about 1.5%.

Deficit cutting and debt reduction can only be practiced without hurting the economy in good times, when the private sector is able and willing to borrow the money the government is repaying, and spend it on new productive facilities. In hard times the attempt is largely self-defeating, and only makes a bad situation worse.

We are faced with an entirely new problem that is peculiar to the last half of the 20th century: we now know how to use fiscal and monetary policies to support high levels of output and employment, and we have long known how to use them to combat inflation, but we have yet to find a way to achieve both objectives simultaneously.

A promising road out of the economic morass

Finding a remedy for inflation that does not make unemployment worse, yet is compatible with the free-enterprise money-and-market system, would solve the problem of government deficits by reviving government revenues and reducing social-support spending. Also, it would either solve most of each nation's other economic and social problems or make them manageable, and it would make a generous social-security net easily affordable.

The market mechanism, though not without serious flaws, is better than any other known system at so directing a given spending stream as to give each individual income-earner access to the most satisfactory mix practicable of the goods and services that his or her share of that spending stream can command. However, it is not very good at raising the economy's output to a reasonable approximation of its full potential, and keeping it there; that is exactly what led to the invention of demand management some fifty years ago.

The system of demand management that worked so well for 25 or 30 years after the war, and that I wish to reactivate in an improved and inflation-proof form, is perfectly compatible with the free-enterprise money-and-market system. It *supports* the market mechanism, it does not supplant it.

Demand management permits the market mechanism to do the things it does efficiently, while at the same time ensuring the achieve-

ment of high levels of output and employment. It cushions, but does not oppose, the structural adjustments that are more or less continuously necessary in a dynamic economy. It does not condone the protection or bailout of inefficient firms or industries, or other offences against economic common sense.[3] It yields a net economic benefit in the form of greater real income for the economy, and better overall welfare for its residents, than the unassisted market mechanism can deliver.

The search for remedies

The only actual attempt so far at a recession-free remedy for inflation has been price controls, but they have been thoroughly discredited in practice. Most past attempts have been ill conceived or ill administered or both. However, the most damning fault of even the best imaginable plan is that it is not compatible with the free-enterprise money-and-market system, which relies on prices and price movements to direct production and consumption efficiently.

There *are* other and more promising strategies available; several such proposals have already been made by a minority of economists over the years. Those by North American economists include:

(1) Incomes Policies – particularly Tax-Based Incomes Policies (TIPs), as proposed by Weintraub and Wallich (1971), Weintraub (1978), and others. The basic idea is to give a tax inducement to producers to keep costs and prices down, either by a tax penalty for exceeding certain guidelines or a tax reduction for keeping within them. An interesting procedural aspect is that it is commonly proposed to apply the plan to only the largest firms – in the USA, to only the 2000 firms that are said to account for 85% of total output. Also, it is argued that calculating the tax would require only about seven additional lines on the corporate tax return, so administrative costs would be small.

[3] If such actions are on occasion deemed justified, it must be because of special circumstances not related to the principles of demand management.

(2) Hellyer (1971, 1981 and 1984) has proposed what is essentially an incomes policy for Canada, aimed at getting the cooperation of labour.

(3) Most incomes policies, including the foregoing, apply only or primarily to wages, salaries, and other forms of personal remuneration, which unfairly leaves returns to the ownership of productive capital and resources free of restraint. Critics have argued that, for this and other reasons, they might only slow inflation down; they contain no mechanism for ensuring that "tomorrow's" enforceable money-income claims will be compatible with "tomorrow's" output valued at "today's" prices. However, the fact that they are directed at the firm's *labour costs* rather than its *income* suggests that a tax incentive should be addressed to *all* costs – including capital cost allowances as well as purchases of goods and services, which may be considered to be indirect factor costs incurred at earlier stages in the productive process (McLeod 1994, pp. 182 and 208-210).

(4) Lerner's market anti-inflation plan (1979). It proposes to give a strong market-determined incentive to all firms to limit their net sales per unit of input of productive resources, and to use the market mechanism to equate the increase in net sales for the nation with the increase in real output. It is designed to permit the money supply to be increased by just the amount necessary for economic health, and to stabilize average prices while leaving individual prices and wages free to adjust to changing circumstances. The central bank would open a MAP Credit Account for every firm, and credit it with 100% of the previous year's net sales plus an allowance for the estimated increase in productivity. Adding employees or capital would result in added credits, releasing employees or reducing capital would result in a reduction. Net sales in excess of the firm's credit balance would require it to buy credits from other firms, net sales of less than its credit balance would permit it to sell credits; the central bank would set up a market in these credits. The central bank would then announce an increase in permitted total sales for the new year, equal to the initial credits plus new credits equal to the expected increase in real income. As inflation ended, the price of MAP credits should fall to zero.

(5) Fortin's arguments (1994) for deficit control in Canada through faster growth. His proposals are worked out in meticulous detail. He anticipates continuing inflation of the order of 1.5 per cent per annum, he explicitly accepts the conventional wisdom that a re-

pressive fiscal policy is necessary in order to prevent inflation accelerating, and therefore he relies primarily on providing stimulus through monetary policy alone. He does not attempt to raise the economy to the full-employment level, but he does plan to raise output as much as is possible without inducing an acceleration of inflation.

(6) A number of less sophisticated proposals that rely on an easy-money policy to effect a unilateral reduction of domestic interest rates to stimulate the economy, but with little concern for the revival of inflation. This is not a viable solution – not so much because of its disregard for inflation as because monetary policy is too weak a reed for the purpose in a depressed economy. Monetary policy has often been likened to a rope. Like pulling on a rope, tight money can rein in the spending steam when it is deemed to be excessive. Like pushing on a rope, easy money is virtually helpless to stimulate the economy when the spending stream is too weak.

(7) My own proposals have been presented in *The Fearsome Dilemma: Simultaneous Inflation and Unemployment* (1994), and in articles in various periodicals (1975, 1979, 1983, 1984, 1987, 1991 and 1993). The substance of my suggestion for immediate relief is to stabilize factor costs or factor returns – that is, the personal remuneration of "labour" of all kinds and the returns to the ownership of productive resources ("capital"), into which all business costs can be resolved. The prices of goods and services would *not* be controlled, and the profit motive would *not* be interfered with, but stable factor costs would be reflected in stable consumer prices. Longer-range remedies are also proposed for some of the inflationary biases now to be found in our economic system.

Five major concerns

Sobering economic and psychological problems will have to be overcome in successfully raising national economic outputs to or near their potential, no matter how well designed and how well administered the program is. However, these problems should not discourage us from making a valiant attempt, especially for such a worthwhile prize.

(1) The sheer magnitude of the problem is daunting. Recall that it took up to two years and milliards of francs or pounds or dollars or whatever in forced-draft wartime spending to get most national economies up to full employment in the war, and note that national productive capabilities are now much greater than they were in 1939. The gap between potential and actual output is large, for two reasons. First, many of the unemployed have been idle for a long time and lack the skills and the work experience they would need to become fully productive, even if all other obstacles to full employment were miraculously and instantly removed. Second, relatively low levels of output and capital formation this past 20 years have left productive facilities inadequate to employ all the would-be workers in most national economies, even if they could be miraculously and instantly retrained.

(2) There will be an immediate problem with the credibility of the new initiative, because the public has been persuaded that demand management will no longer work. It will be particularly important to win acceptance by the leaders of the business community, who must make the key decisions that keep the economy operating; many of them are now highly sceptical of income-supporting measures.

(3) The success of demand management in the early postwar years was materially assisted by the fact that a consensus developed in most countries, favouring income-supporting measures as a defence against falling back into depression. Furthermore, incomes were rapidly increasing, so the costs were easily met without reducing anyone's previous income materially. Thanks no doubt to 20 years of slow growth, that consensus has now evaporated.

(4) In its early days demand management was also aided immeasurably by the fact that the public had a huge backlog of demand for goods and services that had not been available for years, and accumulated footloose wartime savings with which to pay for them. This time there is again a huge backlog of unsatisfied demand, but not the same footloose savings; it is merely *wishful* demand, not *effective* demand (demand backed up by purchasing power).

(5) The postwar prosperity was further aided by the fact that most countries were following a similar strategy of income support; they reinforced each other's efforts by providing reliable export markets for one another, and thus offset the exchange drain that

would have depleted the reserves of any country that acted alone. Nowadays most countries are again following a similar strategy, but it is one of promoting depression, which means they are *discouraging* one another's exports. Now, if any country acts alone to expand its economy, it will face an exchange drain with no offset from the exchange drains of others. There *are* valid defences, but they may run afoul of today's international trade agreements.

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