

Europe's Economic Problems in an International Perspective*

1. Introduction

What is Europe's problem? This question is not a trivial one, nor should it be dismissed too lightly. Many are prepared to argue that some key European countries — and especially Germany — are now about to reap the fruits of policies aimed at “consolidation” of the budget and strict monetary control: spontaneous market-generated recovery of investment and consumption will fuel a durable expansion of output in a situation of price stability. It is, therefore, only a question of maintaining the present policy stance and waiting for the recovery which, thanks in part to the positive terms-of-trade developments, will certainly be buoyant especially with respect to consumer demand.

In order to comment on this scenario it is necessary to set the question in a broader framework of both time and space horizons.

2. Growth and Employment Trends

To start with, there can be little doubt that since the first oil shock Europe's main problem has been that growth was insufficient and labour markets were too rigid to generate employment (Table 1). In 1973 total employment in Europe was 159.7 million, as against 87.3 million in the United States and 52.6 million in Japan. In 1986 the

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corresponding figures are estimated (Wharton, 1985, 1986) to be: 153.4 million (-3.9%); 111.6 million (+27.8%) and 58.5 million (+11.1%). The unemployment rate in Europe thus climbed from 3.9 to 12.0 per cent of the total labour force.

TABLE 1

TOTAL EMPLOYMENT AND RATES OF UNEMPLOYMENT
IN THE 7 MAJOR INDUSTRIAL COUNTRIES: 1973 AND 1986

Countries	Total employment		Unemployment rate	
	millions		Per cent of total labour force	
	1973	1986	1973	1986
United States	87.3	111.6	4.8	7.0
Canada	8.8	11.6	5.5	9.6
Japan	52.6	58.5	1.3	2.8
Europe	159.7	153.4	3.9	12.0
Germany	27.0	25.2	0.8	8.3
France	21.4	21.3	2.6	10.3
United Kingdom	24.8	23.9	3.2	13.3
Italy	19.6	21.1	6.2	10.4

Source: WHARTON, *World Economic Outlook*.

Recent empirical work on these developments sheds light on the employment problem.¹ Reference will be made in particular to statistical evidence collected by the OECD covering the period 1973-83 (Tables 2, 3). Four major points can be made.

First, there is a demographic problem: the labour force is growing at a slower pace in Europe than in the United States and in Japan. In the decade under consideration the labour force increased in the four major European countries by 5.9% as against 24.1% in the United States and 10.5% in Japan. Europe is, of course, a group of very different countries, a difference which extends to growth of the labour force: Germany stands out with a very small increase of 264,000, which is slightly less than in Denmark and approximately one-tenth the increase recorded in Italy.

¹ See, in particular, LINDBECK and SNOWER (1984), SOLOW (1985), McDONALD and SOLOW (1985), SACHS (1986), BLANCHARD and SUMMERS (1986), GORDON (1986), PHELPS and FITOSSI (1986).

TABLE 2
CHANGES IN LABOUR FORCE, SECTORAL EMPLOYMENT AND UNEMPLOYMENT
IN THE 7 MAJOR INDUSTRIAL COUNTRIES: 1973-1983¹

Countries	Labour force	Employment in:					Unem- ployed	Memorandum items:			
		Industry	Agricuit.	Private services	Public services	Total		Unemployment rates		Total labour force	
								per cent of total labour force		millions	
								1973	1983	1973	1983
United States	22.1	- 0.9	- 0.3	13.8	1.8	14.4	4.8	9.5	91.7	113.8	
Canada	2.9	+ 0.1	-	1.4	0.4	1.9	5.5	11.8	9.3	12.2	
North America	25.0	- 0.8	- 0.3	15.2	2.2	16.3	4.9	9.8	101.0	126.0	
Japan	5.6	+ 0.4	- 1.8	5.7	0.6	4.9	1.3	2.6	53.1	58.7	
Germany	0.3	- 2.2	- 0.6	+ 0.3	+ 0.6	- 1.9	0.8	2.6	27.2	27.5	
France	1.7	- 1.1	- 0.6	+ 1.5	+ 0.5	+ 0.3	2.6	8.3	22.0	23.7	
United Kingdom ²	1.3	- 2.0	- 0.1	+ 0.9	+ 0.4	- 0.8	3.2	12.6	25.6	26.9	
Italy	2.3	- 0.2	- 0.7	+ 1.5	+ 0.6	+ 1.2	6.2	9.8	20.9	23.2	
Four major European countries	5.6	- 5.5	- 2.0	+ 4.0	+ 2.1	- 1.2	3.0	9.5	95.7	101.3	

Source: OECD, *Economic Outlook*, May, 1986. ¹ Totals may not add due to rounding. ² Data partly estimated.

TABLE 3
LABOUR COSTS IN SERVICES RELATIVE TO MANUFACTURING
IN THE THREE MAJOR INDUSTRIAL COUNTRIES: 1973-1983¹

Countries	Years	Wholesale ²	Transport ³	Finance ⁴	Community ⁵	Private services	Government ⁶ services
United States	1973	0.66	1.17	0.86	0.56	0.72	0.85
	1983	0.56	1.14	0.84	0.57	0.67	0.79
Japan	1973	0.95	1.25	1.23	0.73	0.97	1.58
	1983	0.83	1.21	1.34	0.79	0.93	1.60
Germany	1973	0.83	1.16	1.26	-	0.92	1.25
	1982	0.78	1.02	1.22	-	0.85	1.05

Source: OECD, *National Accounts*. ¹ Compensation per employee relative to manufacturing. ² Including restaurants and hotels and retail trade. ³ Including storage and communication. ⁴ Including insurance, real estate and business services. ⁵ Including social and personal services. ⁶ Producers of government services.

Limited growth in the labour force is of course a double-edged sword: on the one hand, it should make it comparatively easy to absorb new additions into employment; on the other hand, it lessens the incentives, especially for governments and trade unions, to pursue active employment policies and to increase labour market flexibility.

We come therefore to the second point: the decline in total employment in Europe. Over the decade employment fell by 0.2 million in Europe, while it increased by 14.4 million in the United States and by 4.9 million in Japan. In the four major European countries the absolute decline amounted to 1.2 million. Here again significant differences are present: employment rose in Italy and France, but declined by 1.9 million in Germany and 0.8 million in the United Kingdom.

Third is the point of origin of the decline in employment. As Table 2 indicates, it is industry which has registered the most severe shake-out. In the four major European countries 5.5 million jobs were lost in this sector. In absolute terms the largest decline is recorded in Germany: 2.2 million. In the United States and in Japan too the industrial sector underwent a significant restructuring, but with limited net labour shedding.

Manufacturing has been the industrial sector most affected by adjustment forces, and this is clearly related to the character of technological innovation in production techniques, mainly as a result of the introduction of computer-controlled machine tools.² In all major countries employment in the manufacturing sector declined. It is clear, however, that Europe suffered the worst crisis. The four major European countries showed a 4.4 million decline in actual employment over the period under consideration, as against 1.5 million in North America and 0.3 million in Japan.

The fourth point is that services — private and public — are *the* source of new employment. In particular, employment in private services went up by 13.8 million in the United States, 5.7 million in Japan and 4.0 million in the four major European countries (0.3 million in Germany). Here also there are significant differences between the various countries: the two extremes are the United States and Germany; total employment in the services sector has increased by no less than 15.6 million in the former compared to just 0.9 million in the latter.

² For a description of these changes, see STECKE *et al.* (1983).

A key to the explanation of the diverging overall employment trends is to be found in these differential movements in the services sector. The German case is of particular interest for the European observer: it can indeed be argued that one of the roots of the weak European performance is the inability of the German economy to generate sufficient jobs in this sector!

Improper functioning of the labour market in Europe is a key element in this picture. The OECD study provides clear evidence of the importance of segmentation in the labour market in explaining employment trends. In particular, with low and declining relative pay in services, the unemployed from the industrial sector demand such a high reservation wage that they are unable to find a job in services. Countries like Germany, with (i) large losses in industrial jobs, (ii) slow growth of the labour force and (iii) large wage differentials between manufacturing and services (Table 3), can be expected to show a low expansion of overall employment. And all the more so if public spending (and therefore public employment growth) is kept under strict control.

While the downward rigidity of real wages after the first oil shock, in the face of the sharp terms-of-trade deterioration and productivity breaks, goes a long way towards explaining the rise of unemployment in the 70's,³ in the present decade aggregate real wage gaps have declined substantially in all major European countries.⁴ Traditional *aggregate* analysis of the relationship between nominal wage income, prices and adjusted productivity does not therefore appear adequate to explain the recent rise in the unemployment rate. The hysteresis approach to equilibrium unemployment and the specific insider-outsider models represent a useful line of analysis,⁵ but should be developed to account for sectoral employment structure and shifts.

While improved labour market functioning is central to achieving stronger employment performance in Europe, this does not imply that fiscal and monetary policies cannot play a role in sustaining more vigorous growth in a non-inflationary framework.

Here again, however, the entire question should be addressed by setting the European and especially the German case in a world context. Let us recall, to start with, that at current exchange rates Europe's nominal GDP is approximately nine-tenths of American output and

³ See for instance BRUNO and SACHS (1985).

⁴ See OECD, *Economic Outlook*, May, 1986.

⁵ For a review of these points see MORRIS and SINCLAIR (1985) and MODIGLIANI *et al.* (1986).

twice that of Japan. The output of the four major European countries taken together is nearly two-thirds and one and a half that of the U.S. and Japan respectively. This is simply to underline Europe's continuing crucial economic role. More specifically, European countries can hardly deny that world economic developments are affected by their joint action.

On the other hand, it must be acknowledged that in practice the lack of economic integration and the fragmentation of economic policy make Europe highly dependent on economic policies pursued by the United States. Perhaps only Germany enjoys a significant degree of freedom in framing domestic economic policy.

3. Fiscal and Monetary Policies in a World Perspective

The second important element necessary to explain the weakness of the European economy does indeed lie in the interaction between the fiscal-monetary policy mixes pursued in Europe, in the United States and in Japan: let us refer to some stylised facts which center on the interrelationships between saving and investment in the three major economies, and their interplay with sustainable balances of payments on current account (Tables 4 and 5).

Between 1981 and 1986, according to OECD estimates, the general government budget deficit increased in the United States by 2.4 percentage points with respect to GDP; it declined by 3.1 and 2.9 points in Japan and Germany respectively. If changes are computed on an inflation-adjusted, structural budget basis, the results are similar.

Comparable changes, in the opposite direction, were recorded by the *current accounts* of the balance of payments of the three countries.

Many factors no doubt combined to generate these shifts, which were accompanied by sizeable movements in exchange rates. I am convinced, however, that changes in budget policies in the three countries, together with the relatively stable financial balances desired by the respective private sectors, played a significant role. Clearly, this is so when account is taken of the fact that fiscal expansion in the U.S. was accompanied by restrictive monetary policies, which assured confidence in control of inflation and high real yields on financial assets.

TABLE 4

GENERAL GOVERNMENT BUDGET DEFICITS¹

United States						
	1981	1982	1983	1984	1985	1986*
General government deficit ²	-1.0	-3.5	-3.8	-2.9	-3.5	-3.4
Mem. item: Federal government	-2.1	-4.8	-5.4	-4.7	-5.1	-4.6
Change in actual balance ³	+0.3	-2.5	-0.3	+0.9	-0.6	+0.1
Change in structural budget balance ³	+0.9	-1.3	-0.7	-0.3	-0.4	-0.1
Change in inflation-adjusted structural budget balance ³	+0.3	-1.5	-0.8	-0.2	-0.5	-0.1
Japan						
	1981	1982	1983	1984	1985	1986*
General government deficit ²	-3.9	-3.6	-3.7	-2.2	-1.3	-0.8
Change in actual balance ³	+0.5	+0.3	-0.1	+1.5	+0.9	+0.5
Change in structural budget balance ³	+0.6	+0.5	+0.5	+1.3	+0.7	+0.8
Change in inflation-adjusted structural budget balance ³	+0.2	+0.1	+0.4	+1.4	+0.7	+0.3
Germany						
	1981	1982	1983	1984	1985	1986*
General government deficit ²	-3.7	-3.3	-2.5	-1.9	-1.1	-0.8
Change in actual balance ³	-0.8	+0.4	+0.8	+0.6	+0.8	+0.3
Change in structural budget balance ³	+0.1	+1.4	+1.1	0.0	+0.6	-0.2
Change in inflation-adjusted structural budget balance ³	+0.2	+1.4	+0.9	-0.1	+0.5	-0.5

Source: OECD, *Economic Outlook*. * OECD forecasts. ¹ Percentage of nominal GNP. ² Surplus (+), deficit (-).
³ A (+) indicates a move towards restrictions; a (-) indicates expansion.

TABLE 5

SECTORAL FINANCIAL BALANCES¹

United States					
	1981	1982	1983	1984	1985
Household	4.7	5.2	3.5	3.7	2.5
Corporate ²	-2.1	-0.3	0.7	-1.6	-0.3
Financial institutions	0.3	0.2	0.5	0.3	0.4
Government ²	-2.2	-4.7	-5.1	-4.2	-5.0
Foreign	-0.3	0.0	1.0	2.4	2.9
Japan					
	1981	1982	1983	1984	1985
Household	11.0	10.8	10.4	9.3	9.4
Corporate	-3.0	-3.8	-3.7	-2.1	-2.4
Financial institutions	-0.2	0.6	1.8	1.3	0.8
Government ³	-7.3	-6.9	-6.8	-5.8	-4.1
Foreign	-0.4	-0.7	-1.8	-2.8	-3.6
Germany					
	1981	1982	1983	1984	1985
Household	7.9	7.2	6.2	6.3	6.3
Corporate	-6.5	-4.6	-4.3	-4.6	-4.1
Financial institutions	1.3	1.0	1.1	1.1	0.9
Government	-3.7	-3.3	-2.5	-1.9	-1.1
Foreign	1.0	-0.4	-0.5	-0.9	-2.0

Source: BIS data-bank. ¹ Percentage of nominal GNP. ² Based on BIS calculation. ³ Including public enterprises.

The balance between *total* domestic saving and investment equals the current account position of a country: in turn total saving and investment are generated by aggregating the private and the public sectors. Solving in terms of the former we get:

$$(1) \quad S - I = G - T + X - M$$

If private saving (S) and investment (I) are stable functions of a selected number of variables, which do not simultaneously "explain" variables on the right-hand side, equation (1) links the current balance (X - M) to a fiscal policy tool (G - T).

Note that when the exchange rate floats freely the current balance is equal to net capital outflows (ΔNFA); from the balance-of-payments identity we have:

$$(2) \quad X - M = \Delta NFA$$

The total supply of funds available to finance (i) net domestic investment and (ii) the balance between current receipts and disbursements of the government sector thus consists of domestic private saving and foreign saving — as measured by recourse to international financial markets. Domestic private saving does not necessarily increase with rising interest rates, because of the interaction between wealth and substitution effects. Foreign saving is responsive to rising yields, thus making total savings a positive function of real returns.

Discarding "crowding in" and wealth effects, the inference from equation (1) is that an upward shift in the fiscal deficit will be matched by a combination of: (i) a rise in domestic real rates, which tends to increase the financial balance of the private sector and (ii) a real appreciation of domestic currency, which tends to reduce the current account balance.

However, these adjustments in goods markets require time: in particular, as we know, the immediate impact of an exchange rate change has a *perverse* effect on the current account. The burden of adjustment in the short run therefore falls on asset markets, and notably on the exchange rate which will have to move sufficiently to restore equilibrium in the foreign asset market. In other words, it is the right-hand term in equation (2) that must adjust. This explains why the exchange is dominated in the short run by financial forces and can far overshoot the "fundamentals", especially if exchange rate expectations are temporarily affected by extrapolative forces.

Once we note that the financial balance of the private sector (S - I) is equal to the difference between the changes in its financial assets (ΔFA) and its financial liabilities (ΔFL), we can rewrite equation (1) as follows:

$$(1') \quad \Delta FA = \Delta FL + \Delta D + \Delta NFA$$

where ΔD is the change in the public debt.

In financial terms, if a stable relationship exists between the stock of financial assets, income and other selected variables, net foreign savings will be tapped ($\Delta NFA < 0$) whenever the change in total domestic credit ($\Delta FL + \Delta D$) exceeds the desired change in total financial assets.

The general point is that current account balances — and the corresponding capital flows — are strongly affected by fiscal policies:⁶ the significant imbalances in current accounts among the three largest countries are to be explained largely by the working of opposite budgetary shifts. These altered the aggregate balance between saving and investment and helped determine sizeable movements in exchange and interest rates.

The contention here is that the underlying pattern of total domestic saving and investment in the three countries generated exchange rate, interest rate and trade repercussions that threatened the world payments system and jeopardized the possibility of achieving lasting internal and external stability.

That budget policy can influence the exchange rate is well-known; we have the classic result of Mundell-Fleming, according to which with floating rates and perfect capital mobility a fiscal expansion determines a real exchange-rate appreciation. But we also know that this is a short-run result. Once account is taken of the stock effects of cumulated current account imbalances, the initial impact can easily be reversed. After the initial appreciation, the exchange rate may have to fall, possibly below the original level, to generate a trade surplus sufficient to cover the interest rate burden on foreign debt:

$$(3) \quad \dot{d} = (r^* - g)d - b$$

where \dot{d} is the change in the ratio of foreign debt to domestic income, r^* is the rate of interest (foreign rate for all countries except the U.S.), g is the domestic rate of growth, and b is the trade balance as a proportion of domestic income.⁷

At the end of this year the net international debtor position of the United States will be well in excess of \$200 billion, and available forecasts agree that with present exchange rates the debt is likely to

⁶ On these points see FELDMAN (1986), BRANSON (1986) and DORNBUSCH (1986).

⁷ For simplicity's sake invisible items other than interest flows are neglected.

rise to over \$500 billion by the end of the decade. If the real rate of interest in the United States continues to exceed the rate of growth, the increasing burden of the debt will make it necessary eventually to record sizeable trade surpluses, in order to achieve a sustainable, consistent set of balance-of-payments positions.

According to most available econometric models this will require corresponding policies of fiscal consolidation in the United States and possibly some further decline in the external value of the dollar.⁸ The extent of the domestic fiscal consolidation and even more so that of the exchange rate adjustment will of course depend on concomitant developments in the rest of the world, especially in Japan, Germany and other European countries.

As Tables 4 and 5 show, when account is taken of the respective weights of the three major economies, the cumulative fiscal stimulus in the United States in the six-year period 1981-86 was matched by a similar contraction in Japan and Germany taken together.

Assuming a continuation of present and prospective trends in the developing countries,⁹ a reversal of budget policy in the United States and a shift towards desired positions of current account balance and trade surplus would have to be countered by significant offsetting changes in the domestic saving-investment balances in Japan and Germany. Otherwise, there is the risk that globally the sum of desired saving will exceed investments, with adverse consequences for growth.

The question is whether these changes can take place without some relaxation in the stance of fiscal policy in Japan and in Germany; given the strength and stability of households' propensity to save in the two countries, and the likely impact of exchange rate shifts on investment, this is unlikely, especially if the risk of creating excessive pressure to ease monetary policy in the future is to be avoided.

It is appropriate here to recall briefly some features of past fiscal developments that have a bearing on these issues. Traditional textbook analysis shows that the shift towards a mix of easy fiscal and tight monetary policy — such as that pursued by the United States — leads in principle to a low-saving and low-investment (high consumption)

⁸ Note in this respect that tax reform in the United States reduces both tax-shelter and real estate credit demand. *Ceteris paribus*, this will have a negative impact on the dollar.

⁹ This is clearly a second-best approach, which is predicated on the difficulty of resuming substantial net credit flows to LDCs. Ideally, the move towards equilibrium in the current account position of the United States should be accompanied by an increase in net lending and direct investment flows from other industrial countries to LDCs.

equilibrium. The reverse mix would, on the contrary, imply an equilibrium position characterized by a rapid rate of capital growth.

In reality, the U.S. experienced strong capital accumulation in the past recovery, but the paradox vanishes when allowance is made for the peculiar features of the fiscal stimulus. The Economic Recovery Tax Act implied significant reductions in companies' tax rate on new investment. It has been estimated that the cost of new productive capital was lowered by 4 per cent, and that of new infrastructure by as much as 17 per cent. These measures interacted with the existing facilities for interest deductibility and provided a strong incentive to capital accumulation.¹⁰

The American policy mix, by raising world interest rates and absorbing saving, had a negative impact on investment in the rest of the world, notably in Europe. However, this was partly tempered by the exchange-rate impact: real exchange-rate depreciation most certainly exerted a positive influence on investment spending in economies which were centered on export-led growth, such as Japan and Germany. The danger of the present situation is that unless real interest rates fall, the appreciation of their currencies will exert a strong negative pull on capital accumulation in these economies.

In Japan, in spite of the oil-price benefits, the expansionary phase of the economic cycle was not sustained in 1986, with investment, particularly in manufacturing, levelling off and exports declining.

In Germany, growth was weak during the first half of 1986: it is expected that consumer demand will be buoyant in the second part of the year and in 1987, helped by the windfall terms-of-trade gains in real disposable income — and thereby pull up total GDP growth. As for investment, available forecasts are more mixed.

A relevant variable here is the level of interest rates and, more generally, the stance of monetary policy. There are great difficulties, especially under present circumstances, in measuring the level of real interest rates. "Forward-deflated" rates are likely to be more appropriate than "backward-deflated" rates. There is, however, the problem of having to estimate such figures through price projections.

Some traditional backward estimates (Tables 6 and 7) are presented here simply to make the point that interest rates are very high by historical standards, and particularly so if cyclical and inflation conditions are taken into account. The actual estimates would even point to rising rates, especially on bank lending.

¹⁰ For an assessment of the ERTA see JOHNSON and SCANLON (1985).

TABLE 6

NOMINAL AND REAL INTEREST RATES¹
(N: nominal rates; I: inflation rates; R: real rates)

		1982 Dec.	1983 Dec.	1984 Dec.	1985 Dec.	Jan.	Feb.	Mar.	1986			
									Apr.	May.	June	July
		<i>Money market rates²</i>										
United States	N	8.9	9.5	8.4	8.3	8.1	7.9	7.5	7.0	6.8	6.9	6.6
	I	3.9	3.8	3.9	3.8	3.9	3.2	2.2	1.6	1.5	1.8	1.6
	R	4.9	5.5	4.3	4.3	4.1	4.5	5.1	5.3	5.2	5.1	4.9
Japan	N	6.9	6.4	6.4	8.0	6.8	5.8	5.5	4.7	4.2	4.4	4.6
	I	1.8	1.8	2.6	1.8	1.4	1.8	1.1	0.9	1.1	0.6	0.1
	R	5.0	4.6	3.7	6.1	5.4	3.9	4.4	3.8	3.0	3.8	4.5
Germany	N	6.6	6.5	5.8	4.8	4.7	4.5	4.5	4.5	4.6	4.6	4.6
	I	4.6	2.6	2.0	1.8	1.3	0.7	0.1	-0.2	-0.2	-0.2	-0.5
	R	1.9	3.7	3.8	3.0	3.3	3.8	4.5	4.7	4.9	4.8	5.1
		<i>Long-term government bond rates</i>										
United States	N	10.6	12.0	11.6	9.7	9.6	9.1	8.1	7.5	7.8	7.7	7.3
	I	3.9	3.8	3.9	3.8	3.9	3.2	2.2	1.6	1.5	1.8	1.6
	R	6.5	7.9	7.4	5.7	5.5	5.7	5.7	5.8	6.2	5.8	5.6
Japan	N	7.5	6.9	6.3	5.8	5.8	5.2	4.7	4.7	5.1	5.0	5.1
	I	1.8	1.8	2.6	1.8	1.4	1.8	1.1	0.9	1.1	0.6	0.1
	R	5.6	5.1	3.6	4.0	4.3	3.3	3.6	3.7	4.0	4.4	5.0
Germany	N	7.9	8.2	7.0	6.5	6.3	6.2	5.9	5.5	5.8	6.0	5.8
	I	4.6	2.6	2.0	1.8	1.3	0.7	0.1	-0.2	-0.2	-0.2	-0.5
	R	3.2	5.4	4.9	4.7	4.9	5.5	5.8	5.7	6.1	6.2	6.3

Sources: IMF and national statistical bulletins; updations: *The Economist*. ¹ Inflation rates are defined as percentage changes of the consumer price index in the previous twelve months. ² USA: Federal funds rate; Japan: call-money rate; Germany: 3-month interbank rate.

The present inflation performance may of course be viewed as short-lived, and the anticipated underlying rate of inflation may therefore be considered to be higher than current rates. All the same, by the adjustment method used here, the *levels* of real rates are so high that one is left with the clear impression that some downward adjustment may be possible with no risk of rekindling inflation.

At any rate, the point that the perceived underlying rate of inflation is well above the current rate, and that this prevents long-term rates from falling further, can be used to refute views that oppose some

degree of monetary relaxation, especially in countries with large external surpluses.

TABLE 7

NOMINAL AND REAL COMMERCIAL BANK LENDING RATES
TO PRIME BORROWERS¹

(end-of-period data; N: nominal rates; I: inflation rates; R: real rates)

		1982 Dec.	1983 Dec.	1984 Dec.	1985 Dec.	Jan.	Feb.	Mar.	1986 Apr.	May.	June	July
United States	N	11.5	11.0	10.8	9.5	9.5	9.5	9.0	8.5	8.5	8.5	8.0
	I	1.6	1.0	1.5	0.6	0.3	-1.0	-2.6	-3.9	-4.1	-4.1	-4.9
	R	9.7	9.9	9.2	8.8	9.2	10.6	11.9	12.9	13.1	13.4	13.6
Japan	N	6.3	5.9	5.7	5.7	5.7	5.6	5.4	5.2	5.0	5.0	4.7
	I	0.1	-1.1	0.1	-2.1	-2.4	-3.0	-3.4	-4.2	-4.1	-4.2	-4.9
	R	6.2	7.1	5.6	8.0	8.3	8.9	9.1	9.8	9.5	9.6	10.0
Germany	N	8.8	7.8	7.8	7.3	7.3	7.3	6.8	6.8	6.8	6.8	6.8
	I	3.5	2.0	2.4	0.6	-0.3	-1.4	-2.0	-2.6	-3.2	-3.2	-3.8
	R	5.1	5.7	5.3	6.7	7.6	8.8	9.0	9.7	10.3	10.3	11.0

Sources: Morgan Guaranty, OECD. ¹ Inflation rates are defined as percentage changes of manufactures prices in the previous twelve months.

With (i) *negative* current inflation and positive prospective growth in prices, and (ii) financial innovation leading to competitive returns on monetary assets, it is reasonable to expect an upward shift in the demand-for-money function. The recorded increase in the money stock may therefore reflect a portfolio shift; attempts to resist it by slowing monetary base growth would imply monetary restriction. On the other hand, nobody would be prepared to argue that the situation in Germany and Japan in 1986 is already one of liquidity trap, with money demand infinitely elastic at current nominal rates and thus with no possibility of lowering them!

4. Summary and Conclusion

The problems of Europe cannot be seen and assessed in isolation from the world context. International consistency and compatibility of external payments in a sustainable medium-term framework requires reciprocal monitoring — and possibly adjustment — of the policy

mixes: the saving-investment and current-account approach is helpful in identifying economic interactions at the international level.

A reduction in the structural budget deficit in the United States is necessary: without this fiscal adjustment, devaluation alone will not produce the required changes in relative prices, nor induce a permanent shift between production and absorption. The problem is that the needed adjustment must not involve recessionary consequences and the appearance of abortive thrift at the global level. Thus, once underway, the adjustment is likely to require some offsetting relaxation of the fiscal stance in Japan and in those European countries where budget consolidation action has already brought very low actual deficits and structural balances in broad equilibrium, if not in surplus. These shifts need not imply a resumption of growth in the public sector. The desired change can be achieved without running this risk either through reduced taxation of incomes or temporary fiscal incentives to (labour-absorbing) capital investment.

On the monetary side, some reduction in nominal interest rates is possible and desirable in Europe on both domestic and external grounds. Measured against current inflation rates, real interest rates, in certain European countries in particular, are now at historic peaks. The fact that they are low in nominal terms, and that inflation in some countries is negative, can also help explain an upward shift in the demand-for-money function. Strict adherence to quantitative nominal targets may therefore imply a *restrictive* monetary stance in these countries.

As has been argued, the key domestic European problem is employment. Demographic factors will alleviate the difficulties in the medium term; but this is no excuse for accepting present levels of unemployment. Beyond the question of an appropriate macro-policy mix, employment growth in Europe requires significant improvements to labour market functioning. Prices in the labour market fail to reach market clearing levels; individuals are subject to rationing, being unable to work the desired number of hours at the current real wage rate; inter-sectoral shifts in employment, required by changes in demand and methods of productions, encounter serious obstacles. On the other hand, wage moderation in the past few years makes it hard to argue that Europe is witnessing merely "classical unemployment", with excess supply in the labour market and excess demand in the output market. "Keynesian" unemployment is also present.

All in all, therefore, a clear case can be made that those European countries which have already achieved structural budget equilibrium

and very low (or negative) inflation should discontinue the *restrictive* fiscal and monetary mixes which have been characteristic of the past few years. Microeconomic adjustment of the labour market to improve its functioning would be the appropriate complementary action in all European countries to move towards better internal and external balance.

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