

# Commentary: The Role of Demand Management Policies in Reducing Unemployment

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Charles Bean has written an interesting and thought-provoking paper on two topics: the first is whether demand management policies have a role in stabilizing unemployment; and the second is on the potential role of demand management policies in reducing European unemployment in the remainder of the 1990s.

## **Is there a role for stabilization policy?**

Bean is skeptical about the ability of policymakers to stabilize unemployment. He argues that while, in principle, policymakers could stabilize output and unemployment around their equilibrium values, in practice, all the familiar obstacles to perfect stabilization—especially lags and uncertainty about the structure of the economy and the way individuals form expectations—lead them to believe that "activist policies to eliminate such fluctuations [are] hazardous."

Of course, no one proposes policies that would attempt to eliminate rather than moderate business cycle fluctuations. We need also to recognize that policymakers **try** to keep both employment and inflation close to their target levels. If one then asks whether policymakers **can** and **should** attempt to stabilize the business cycle, the answer is yes.

That is what central banks try to do, often quite successfully. No central bank should be inactive in the face of a major disturbance;

indeed, it's even difficult to know how to define inactivity. Even if fine tuning is out, coarse tuning is not. In fact, Bean discusses such activist policies in the second half of his paper.

Bean's discussion of stabilization policy raises three issues that I would like to pursue. First, in several places he analyzes the implications of the nonlinearity of the Phillips curve. This is a worthwhile question, because the evidence suggests that the short-run Phillips curve is nonlinear: a one percentage point reduction in an already low unemployment rate will push up inflation more than a one percentage point increase in a higher unemployment rate will reduce inflation.

How should this affect policy? Bean shows in an interesting footnote that in the presence of a nonlinear tradeoff, the authorities should aim for a higher unemployment rate than the natural rate, because a positive shock that reduces unemployment will have a larger effect on inflation than a negative shock of the same size. Bean shows for a logarithmic example that the effect is quantitatively insignificant—but that, of course, depends on the extent of the nonlinearity.

Bean's discussion opens up a way for the quality of macroeconomic policy to affect the average rate of unemployment. Suppose that the Phillips curve is nonlinear, for example that the inflation rate is driven by the divergence between the logarithm of unemployment and the logarithm of the natural rate. Then, even if the log of unemployment is on average equal to the log of the natural rate, the average level of unemployment will be larger the greater the variance of unemployment. This result thus produces the intuitively appealing result that countries that conduct stabilization policy better will have a lower average unemployment rate.

Second, the paper raises but does not settle the important question of what the presence of persistence mechanisms implies for stabilization policy. Suppose that an adverse shock increases unemployment, and that any short-run increases in unemployment translate in part and gradually into an increase in the non-accelerating inflation rate of unemployment (NAIRU). Suppose that the monetary authority can reduce unemployment in the short run through expansionary monetary policy, at the expense of an increase in inflation. Then I conjecture

that optimal monetary policy will be more expansionary in response to a given unemployment increase when there is persistence than when there is not. The argument is that by moving more aggressively, the monetary authority can cut off the higher long-term unemployment that would otherwise result. But that is just a conjecture, and the answer must depend in part on nonlinearities in the Phillips curve and on the formation of expectations.

Third, Bean emphasizes that uncertainty about the natural rate or the NAIRU severely complicates policy. This argument is put into perspective if we focus on the NAIRU rather than the natural rate, and realize that the policymakers can judge where they are by watching for early signs of increasing inflation. It is thus not clear that the shifting NAIRU poses a special problem for macro policymakers.

### **The role of demand management in Europe in the 1990s**

The paper's main focus is on what should be done now to reduce European unemployment. Bean accepts with little discussion the argument put forward in the OECD report that policy should be vigorously expansionary until the economy comes within reach of the NAIRU.

The paper seems to give an indication of the excess of the actual over the natural rate of unemployment in Chart 1, which suggests about 1.5 percent. However, the no-demand shock locus in Chart 1 does not, in fact, correspond to the NAIRU. Other estimates suggest that European unemployment is currently about 2.5 to 3 percent above the NAIRU, which gives ample room for more expansion in Europe.

Bean's main interest is in aggregate demand policies as unemployment reaches the NAIRU. He accepts the diagnosis that the NAIRU can be brought down through supply-side policies; these are discussed briefly but the details are not important for purposes of this paper. The major recommendation of the paper is **that** monetary policy should accommodate the increased growth and declining unemployment that the supply-side measures should produce.

In discussing these issues, Bean very usefully takes us back to the

literature of the early 1980s on European stagflation. The diagnosis then was that Europe suffered from real-wage resistance, that European real wages were too high, and that there was a wage gap that had to be cut to restore full employment. We can interpret the modern discussion of supply-side reforms as explaining why there may be real-wage resistance and what policies can be adopted to reduce it.

Bean calculates that real wages would have to drop 5 percent to reduce the unemployment rate by five percentage points. If that is all it takes, then Europe will not have to go too far down the road of increasing inequality which several papers at this conference warn is the result of an American approach to the labor markets.

Bean's preferred strategy is to move as fast as possible on labor market reforms, while recognizing that they are politically difficult and will therefore take time to implement. At the same time, macroeconomic policy should be expansionary. Ideally, fiscal expansion should help power the recovery; it would then be throttled back as growth picked up and investment took over. Monetary policy would be sufficiently accommodating, not only to allow for the more rapid growth of real income, but also to produce a bit more inflation so that the real wage could decline.

But this strategy is ruled out, because there is no room for fiscal expansion. Full-employment deficits are too large in Europe, and most European governments are rightly planning to reduce them over the next few years. So expansionary fiscal policy is not available.

That leaves monetary policy as the only other aggregate demand policy. There would be no dispute that monetary policy should accommodate the increased growth that comes through the expansion of supply. Bean calculates that output would grow about 1 percent per year more rapidly, implying that money growth should be that much faster.

But should monetary policy also be used to try to reduce the real wage, by permitting more inflation? Before answering that question, let me diverge to discuss the two different approaches that the paper takes to the likely behavior of the real wage. The argument for inflation

assumes that the real wage should decline. But in another part of the paper, Bean argues that with the real interest rate unchanged, investment will grow massively; the same argument would imply that the real wage would not change at all. In that case, there would be no need for the inflation.

I believe that lower real wages—compared with what they would otherwise have been—will be needed in Europe. Nonetheless, I doubt that the slightly higher inflation policy makes sense. The same labor market reforms that are designed to reduce unemployment should also increase wage flexibility—they should reduce European real wage resistance, and presumably, also make nominal wages more flexible.

Since the adjustment that is being considered is not one that will cut real or nominal wages, but only require them to grow more slowly than they otherwise would have, it hardly seems necessary to ask for more inflation. Nor is Bean very firm in arguing for inflation, for he concedes that an extra 1 percent would probably not make much difference to employment.

In the end, Bean's discussion of macroeconomic policy in Europe for the remainder of the decade is an appeal to the central bankers to avoid cutting off the recovery prematurely. It is not a request for higher inflation, but rather an argument that the growth potential of a Europe enjoying a supply-side recovery may be as high as 4 percent a year.

If the supply-side measures are undertaken, central banks should not be alarmed by growth that looks high by the standards of the last decade. Rapid growth by itself would not be a good reason to reduce money growth or raise interest rates. Rather, central bankers should judge the supply potential of the economy by the behavior of the inflation rate—and they should be prepared to tighten policy when inflation threatens. They will surely be prepared to do that.