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Fiscal policy in the macroeconomic policy mix: A Critique of the New Consensus Model and a comparison of macroeconomic policies in France, Germany, the UK and Sweden from a Post-Keynesian perspective

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Eckhard Hein and Achim Truger

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## **A critique of the New Consensus Model and a comparison of macroeconomic policies in France, Germany, the UK and Sweden from a Post-Keynesian perspective\***

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### **Abstract**

The New Consensus approach in macroeconomics is criticised for its exclusive but unwarranted reliance on stabilising monetary policies, for its ill-designed approach to the role of wages and wage policies, and for its complete neglect of fiscal policies. From a Post-Keynesian perspective, it is argued that fiscal policies play an important role for macroeconomic development, albeit the whole macroeconomic policy-mix of monetary, fiscal and wage policies as well as open economy conditions should be considered. Based on this view macroeconomic performance and macroeconomic policies in France, Germany, Sweden and the UK between 1996 and 2005 are analysed, with a special focus on the role of fiscal policies. It is shown that the fiscal policy stance is important for the explanation of different developments in these economies. However, fiscal policies are not the whole story, monetary policies, wage policies and open economy conditions matter as well.

**JEL code: E61, E62, E63, E64, E65**

**Key words:** Fiscal policy, macroeconomic policies, New Consensus, Post-Keynesian macroeconomics, France, Germany, UK, Sweden

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## 1. Introduction

Mainstream macroeconomics today is dominated by New Consensus Models (NCMs). In these models, monetary policy applying the interest rate tool is able to stabilise output and employment in the short run, but in the long run it is neutral and only affects inflation. Fiscal policy is downgraded and is to support monetary policy in achieving price stability. Post-Keynesians have criticised these NCMs for a variety of reasons. Broadly summarized, the critique is related to the assumption of a stable long-run equilibrium ‘Non Accelerating Inflation Rate of Unemployment’ (NAIRU) in the NCMs, determined exclusively by supply-side factors to which actual unemployment can be adjusted by means of monetary policy interventions, on the one hand, and to the assumption of the independence of this NAIRU from the development of actual unemployment determined by aggregate demand, and hence from monetary policies, on the other hand. Related to this critique of the basic NCM is a critique of the macroeconomic policy implications derived from this model. Besides questioning the ability of monetary policy to adjust actual unemployment to the NAIRU, the complete neglect of fiscal policies in the NCM has been criticised. And the NCM view on the role of wage formation and wage bargaining, demanding nominal and real wage flexibility by means of structural reforms in the labour market and decentralisation of wage bargaining in the case of persistent unemployment, has been under fire.

The focus of the present paper is on the role of fiscal policy in the macroeconomic policy mix. Against a Post-Keynesian theoretical background we deal with the NCM proposition that real stabilisation can and should effectively be brought about by means of monetary policy and that fiscal policy is inessential for this purpose. In comparative case studies for Germany, France, Sweden and the UK for the period 1996 to 2005 we show that in effect fiscal policies were essential for the degree of recovery – or non-recovery – from the 2000/2001 recession/growth slowdown in these countries. However, in order to obtain a full picture of the respective macroeconomic regimes, the other macroeconomic policies have to be taken into account as well in each case. Therefore, we do not mean our arguments to imply that monetary and wage policies, as well as open economy issues, were unimportant. Our analysis rather shows that fiscal policies should not be neglected and that the NCM assignment of macroeconomic policies and their instruments to their respective goals or targets may be misleading.<sup>1</sup>

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<sup>1</sup> Our analysis therefore complements the theoretical work by Setterfield (2007) who has shown the potentially stabilising role of fiscal policies in the NCM.

The paper is organised as follows. In the second section we elaborate on the Post-Keynesian critique of the NCM and contrast the NCM assignment with a more appropriate Post-Keynesian assignment of the macroeconomic policies and their instruments to their respective targets. In the third section we give an overview of macroeconomic performance in the four countries under investigation, France, Germany, the UK and Sweden, from 1996 until 2005. In the fourth section we present a qualitative as well as a raw quantitative assessment of the fiscal policy stance and see how much of the different macroeconomic performance in the four countries can be explained by differences in fiscal policies. Since we believe that the chosen macroeconomic policy mix as a whole is important for the explanation of comparative macroeconomic performance, we complement the analysis of fiscal policy with an analysis of an appropriate set of indicators for the macroeconomic policy mix in the fifth section. Based on the results obtained we identify different macroeconomic policy regimes followed by the four countries under investigation in the sixth section. In the seventh and final section we briefly summarise and conclude.

## **2. Fiscal policy in the macroeconomic policy mix – a critique of the New Consensus model and an alternative Post-Keynesian assignment**

In mainstream New Consensus models dominating present macroeconomic policy analysis, the short-run impact of aggregate demand on output and employment reappears, which has been absent from New Classical economics and Real Business Cycle models.<sup>2</sup> Due to nominal and real rigidities, for which microfoundation based on imperfectly competitive markets is delivered, the short-run Phillips curve is downward sloping again. In the long run, however, there is no real effect of aggregate demand, and the equilibrium unemployment rate, the NAIRU, is exclusively determined by structural characteristics of the labour market, the wage bargaining institutions and the social benefit system. Therefore, the long-run Phillips curve remains vertical. Monetary policy applying the interest rate tool is able to stabilise output and employment in the short run, but in the long run it is neutral and only affects inflation (Fontana/Palacio-Vera 2007). Fiscal policy in these models is downgraded and is to support

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<sup>2</sup> See Clarida/Gali/Gertler (1999), McCallum (2001), Meyer (2001), Walsh (2002), Snowdon/Vane (2005: 419-427) and Carlin/Soskice (2006: 27-172) for New Consensus models. These models are basically characterised by three equations: 1. an aggregate demand function derived from households' and firms' optimisation behaviour which relates the output gap inversely to the real interest rate, 2. an expectations-augmented Phillips-curve which makes the rate of inflation positively dependent on the output gap in the short run, and 3. a central bank reaction function in which the nominal interest rate set by the central bank is determined by the inflation rate, by the equilibrium real interest rate, by the output gap and by the deviation of actual inflation from the inflation target (Taylor-rule).

monetary policies in achieving price stability (Arestis/Sawyer 2003). Therefore, the economic policy implications of NCMs are quite straightforward: Prevent unemployment in the short run by means of applying appropriate monetary policies, and reduce the existing NAIRU by means of ‘structural reforms’ in the labour market and the social benefit system, which reduce labourers’ nominal wage demands and hence inflation pressure and therefore allow for more expansive monetary policies.

Post-Keynesians have criticized these NCMs for many reasons.<sup>3</sup> Broadly summarized, the critique is related, on the one hand, to the assumption of a stable long-run equilibrium NAIRU determined exclusively by supply-side factors to which actual unemployment can be adjusted – almost without restrictions – by means of monetary policy interventions. In particular, the effectiveness of monetary policies is questioned in this context. And on the other hand, the critique has targeted the NCMs’ assumption of the independence of the NAIRU from the development of actual unemployment determined by aggregate demand, and hence from monetary and macroeconomic policies. Long-run endogeneity of the NAIRU with respect to actual unemployment, and therefore to macroeconomic and monetary policies, has been related to different channels: labour market hysteresis (Blanchard/Summers 1987, 1988, Ball 1999), capital stock and productivity growth effects of investment (Rowthorn 1995, 1999, Sawyer 2001, 2002, Arestis/Sawyer 2004a: 73-99, 2005), adaptive wage aspirations (Setterfield/Lovejoy 2006, Stockhammer 2008), and distribution effects of interest rate variations as the monetary policy instrument (Hein 2006, 2008: 133-152). Therefore, what has been questioned by Post-Keynesians is the short-run stability and the long-run exogeneity of the NAIRU with respect to effective demand, and hence the assumed long-run neutrality of money in the NCMs. If there is anything like a ‘NAIRU’, it is only a short-run ‘inflation barrier’ enforceable by monetary policies in an asymmetric way, which is endogenous to effective demand and hence path-dependent in the long run.

Related to this critique of the basic NCM is a critique of the macroeconomic policy assignment drawn from this model, and in particular criticism of the exclusive focus on monetary policies as a short-run stabiliser of output and employment and a long-run stabiliser of inflation. We briefly review the Post-Keynesian critique of NCMs’ assignment for monetary, fiscal and wage policies and the implications for an alternative Post-Keynesian assignment in turn.<sup>4</sup>

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<sup>3</sup> For Post-Keynesian critique of the New Consensus models and its core, the NAIRU, see the brief literature review in Hein/Stockhammer (2007).

<sup>4</sup> For an attempt of a formal Post-Keynesian model as an alternative to the NCM see Hein/Stockhammer (2007).

### *Monetary policy*

As already mentioned above, the ability of monetary policy to adjust actual unemployment, determined by effective demand, to the NAIRU, determined at whatever level by ‘structural characteristics’, is questioned.<sup>5</sup> NCM theorists have to suppose that central banks are free to apply the interest rate tool according to domestic conditions and to adjust the policy rate to the equilibrium or ‘natural’ rate in the long run. However, there may be restrictions given by the effects of monetary policies on the exchange rate, which may inhibit the required variation in the domestic interest rate, even if there is no explicit exchange rate target for monetary policies. Further on, there are asymmetries in the monetary policies’ ability to manipulate the relevant interest rate for private actors and asymmetries in the effects of changes in the relevant market rate of interest on effective demand.

Let us first discuss the case when unemployment exceeds the NAIRU and falling inflation rates and finally deflation emerge. Here, central banks’ nominal base rate cuts may not affect long-term market rates fast enough, due to rising liquidity preference and rising risk assessments in the commercial banking sector. Even if nominal market rates fall, the reduction in real rates might be insufficient, or will not take place at all in the case of deflation due to the zero lower bound for the nominal rate. And even if real interest rate cuts take place, these may be insufficient to stimulate demand because of interest rate inelasticities in investment caused by depressed profit expectation, debt-deflation, and so on. Therefore, there are serious doubts in the central banks’ ability to adjust unemployment to the NAIRU in this case.

In the opposite case, when unemployment falls below the NAIRU and inflation accelerates, central banks are always in the position to raise the real market rate of interest by means of increasing the base rate, for which there is no upper bound, thus choking effective demand and adjusting unemployment to the NAIRU. However, a persistent increase in real interest rates increases firms’ costs and will hence increase their target mark-ups and prices in incompletely competitive goods markets in the long run. Therefore, distribution conflict will be intensified, the NAIRU will increase, and inflationary pressure will finally rise again, undermining monetary policies short-run effectiveness with respect to containing inflation (Hein 2006, 2008: 133-152, Hein/Stockhammer 2007).

From this critique, different implications for more adequate monetary policies have been drawn. Applying the distinction made by Rochon/Setterfield (2007), either an ‘activist’ position or a ‘parking-it’ approach is proposed. The proponents of the ‘activist’ position

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<sup>5</sup> See, in particular, the discussion in Arestis/Sawyer (2004a, 2004b, 2005, 2006), Fontana/Palacio-Vera (2007), Hein (2004, 2006), and Palacio-Vera (2005).

demand more careful counter-cyclical stabilisation from monetary policies applying the interest rate tool and taking into account its real and potentially asymmetric effects (Fontana/Palacio-Vera 2007, Palley 2006). The ‘parking it’ position focuses on the long-run distribution effects of monetary policy, which we have highlighted in our own work, too (Hein 2004, 2006, 2008: 133-152, Hein/Stockhammer 2007), and recommends to stabilise the long-term rate of interest at a certain level. Different targets for the long-term rate of interest have been proposed. Smithin (2004), for example, suggests that the real interest rate should be set to zero, or as close to zero as possible, allowing rentiers to maintain their stock of real wealth but not to participate in real growth. Lavoie (1996) and Seccareccia (1998) are in favour of setting the real rate of interest equal to productivity growth which allows rentiers to participate in real growth and keeps distribution between rentiers, on the one hand, and firms and labourers, on the other hand, constant (Pasinetti’s ‘fair rate of interest’). Downgrading the importance of monetary policy in regulating real economic activity (cycles) in the short run and inflation in the long run, means allocating these functions to the other economic actors, to fiscal policies and to wage policies.

### *Fiscal policies*

Because of the ineffectiveness of monetary policies as a real stabiliser in the short run and the problems associated with attempts of long-run nominal stabilisation by means of monetary policies mentioned above, the complete neglect of discretionary fiscal policies in the NCM turns out to be a major problem (see in particular Arestis/Sawyer 2003, 2004a, 2004c).<sup>6</sup> Therefore, Post-Keynesians have argued in favour of real stabilisation by means of fiscal policies. This has again two dimensions: Since an adjustment of actual unemployment to a NAIRU can be expected neither from market forces nor from monetary policies, in particular in a deep recession, fiscal policies are required for short-run real stabilisation. And since the NAIRU is endogenous to actual unemployment and hence to effective demand in the long run, fiscal policies do not only have short-run real effects but also affect the economy’s long-run development through the endogeneity channels mentioned above.

Arestis/Sawyer (2003) demonstrate that the major arguments put forward against the use of discretionary fiscal policies, ‘crowding out’ (through higher inflation and associated real balance effects or higher real interest rates) and the ‘Ricardian equivalence theorem’,<sup>7</sup> are

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<sup>6</sup> What is allowed for in NCMs, is to let automatic stabilisers work under the conditions of balanced budgets over the business cycle.

<sup>7</sup> For a discussion of further institutional aspects of fiscal policies that are said to produce ineffectiveness of fiscal policy, as model uncertainty, decision and implementation lags, deficit bias for political economy reasons, etc. see also Arestis/Sawyer (2003).



therefore unconvincing, on theoretical and empirical grounds. Both arguments have to assume that the economy operates at full employment equilibrium level.<sup>8</sup> But if there is already full employment, there is no need to implement expansive fiscal policies in order to achieve full employment and hence there is no need to think about ‘crowding out’ or ‘Ricardian equivalence’!

What might occur, in an economy governed by effective demand – with investment (and government deficit spending) causing saving (mainly through income effects) also in the long run – and characterised by endogenous money, is ‘crowding out’, but only if central banks deliberately raise interest rates in the face of expansive fiscal policies. And even in this case, crowding out might not materialize because the negative effects of rising interest rates on investment may be too small to overcompensate the positive effects of higher demand on investment decisions. However, we should add that rising interest rates will have distribution effects which negatively feed back on economic development in the long run, as argued above. Making use of government deficit spending for stabilising effective demand in the short and in the long run, in the sense of ‘functional finance’, that is compensating private sector full employment saving by government deficit spending,<sup>9</sup> therefore requires that central banks do not interfere with expansive fiscal policies and stick to a policy of low interest rates, as recommended above.

### *Wage policies*

The NCM view on the role of wage formation and wage bargaining, demanding nominal and real wage flexibility by means of structural reforms in the labour market and decentralisation of wage bargaining in order to accelerate the adjustment towards the NAIRU and in order to reduce the NAIRU, has also been criticised (Hein 2004, 2006, 2008: 133-152). Nominal wage flexibility tends to destabilise the economy rather than stabilise it, because – with productivity given or following a secular trend – nominal wages determine nominal unit labour costs which are a major determinant of prices and inflation in incompletely competitive goods markets. In a credit economy with forward contracts denominated in nominal money terms, falling nominal unit labour cost growth and hence falling inflation rates in the face of

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<sup>8</sup> For a survey of empirical studies on the effects of fiscal policies confirming the real effectiveness of this policy instrument, also in very restrictive empirical model settings, see Hemming/Kell/Mahfouz (2002).

<sup>9</sup> The ‘functional finance’ view, pioneered by Lerner (1943), recommends government deficits, the difference between government spending (G) and taxes (T), to mop up the excess of private sector planned saving (S) over planned investment (I), plus the difference between imports (M) and exports (X), at a desired (full employment) level of economic activity:  $G-T = S-I+M-X$  (Arestis/Sawyer 2004c). Applying government deficit spending in the ‘functional finance’ way assures that there is always enough saving to fund government deficits by means of issuing bonds and/or increasing the central bank’s money supply, buying government bonds through open market operations. Crowding out will not occur, provided that the central bank does not raise the interest rate.

unemployment exceeding the NAIRU, and finally deflation, will therefore further depress effective demand and increase unemployment because of real debt deflation and expectation effects on investment and consumption decisions. Since nominal wage moderation in more or less open economies is usually also associated with real wage moderation and a falling wage share, because changes in domestic unit costs are not fully passed to prices due to international competition and/or prices of imported materials not changing in step with domestic unit labour costs, effective demand, output and employment are further weakened, provided effective demand and growth are wage-led.<sup>10</sup> Finally, wage moderation and redistribution at the expense of labour will not only negatively affect effective demand and employment in the short run, as well as the inflation barrier in the long run through the channels mentioned above, it will also be associated with weak real wage induced productivity growth which will further add to the weakening of long-run growth.<sup>11</sup>

In order to avoid the destabilising effects of nominal wage flexibility, Post-Keynesians advocate rigid nominal wages and allocate the role of nominal stabilisation to wage/incomes policies. Nominal unit labour costs should grow at a rate similar to the country's inflation target, which means that nominal wage growth should equal the sum of long-run growth of labour productivity and the target inflation rate. Under the conditions that the mark-up in firms' pricing remains constant and that imported material costs grow in step with domestic unit labour costs, following this wage formula will also keep income shares constant, and the destabilising effects of real wage flexibility in wage-led economies will be avoided, too. Implementing this wage formula is tantamount to making the short- and the long-run Phillips curve horizontal. Variations in unemployment will hence have no effect on the inflation rate, and fiscal policies are therefore free to improve effective demand and employment without the risk of accelerating inflation rates. Post-Keynesians hold that in particular a high degree of wage bargaining coordination at the national or even supranational level, strong labour unions and employer organisations and hence organised labour markets should be particularly suitable for pursuing this nominal stabilisation role of wage bargaining (Hein 2002, 2004, 2006, Hein/Stockhammer 2007, Kriesler/Lavoie 2005).

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<sup>10</sup> See Stockhammer (2004) for theoretical analysis of the effects of redistribution on the stability of the NAIRU in wage- and profit-led economies.

<sup>11</sup> See Bhaduri (2006a, 2006b) on the theoretical arguments and Naastepad (2006) for an empirical analysis for the Netherlands.

### *A Post-Keynesian assignment*

From this critique of the role and the assignment of monetary, fiscal and wage policies and its instruments to their respective goals in NCMs, an alternative Post-Keynesian assignment follows. This should be more conducive to reasonable growth, high employment, stable inflation and balanced development between different economies or currency areas - or within these currency areas, if they consist of different national economies. In this assignment or policy-mix, wage policies, and hence wage bargaining parties, are responsible for stable inflation rates, and hence for nominal stabilisation. This should also be conducive to balanced developments between countries within a currency union, as the Euro area, and also to stable exchange rates and hence balanced developments between different currency unions, provided that the implementation of such a policy starts from some kind of external equilibrium situation.<sup>12</sup> Government fiscal policies are responsible for maintaining effective demand at high employment levels and hence for real stabilisation in the short and in the long run. Monetary policies by the central bank should neither aim at fine tuning the economy in real nor in nominal terms, and should thus not interfere with the tasks of wage and fiscal policies, but should rather focus on stable distribution between rentiers, on the one hand, and firms and labourers, on the other hand, in order to avoid destabilising distribution effects of changes in the interest rate.

In the following section we shall assess the macroeconomic development in France, Germany, Sweden and the UK against the background of this Post-Keynesian understanding of the roles and tasks of wage, fiscal and monetary policies taking into account different open economy and currency conditions in these countries. We will focus, in particular, on the real stabilisation role of fiscal policies, in order to explain different developments between countries.<sup>13</sup>

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<sup>12</sup> If major external imbalances, as presently in Euro area, have to be corrected, deviations from the wage formula are, of course, necessary.

<sup>13</sup> For more detailed country studies of the macroeconomic policy regimes in the economies under investigation see Arestis/Sawyer (2007), Hein/Truger (2007a), Heine/Herr/Kaiser (2006), and Trautwein (2000).

### **3. Macroeconomic performance in France, Germany, the UK and Sweden from 1996 – 2005**

For our case studies of the effects of the macroeconomic policy mix, in particular the effects of fiscal policies, we have chosen four countries. With France and Germany we have the two economically most important countries of the Euro area, the development of which dominates the Euro area as a whole. Although economic policies in these two countries since the mid 1990s has been dominated, first by the preparation for the currency union and hence by the attempts to fulfil the nominal convergence criteria of the Maastricht Treaty, and then since 1999 by the ‘Maastricht regime’, that is the Stability and Growth Pact (SGP) and the monetary policy of the European Central Bank (ECB), economic performance since the 2000/01 recession/growth slowdown has been different. We will attempt to show that this is due to the chosen policy-mix within the overall ‘Maastricht Regime’.

With the UK and Sweden we analyse the development of two countries which are members of the European Union but not of the Euro area, and which have performed fairly well after the 2000/01 recession/growth slowdown. Since both economies represent completely different models of capitalism, the Anglo-Saxon liberal capitalism, on the one hand, and the Northern welfare state model, on the other hand, we suspect that the similar performance is not caused by structural characteristics of the labour markets and the social benefit systems but by the chosen macroeconomic policy mix. Both countries had suffered from currency turbulences in the early 1990s. The UK left the European Monetary System after a short period of membership in 1992, sterling depreciated considerably and the British government refrained from participating in the Euro area (Heine/Herr/Kaiser 2006: 159-179). Because of speculative attacks, Sweden gave up the one-sided alignment of the Swedish crone with the European Currency Unit (ECU) in 1992, the Swedish crone also devaluated considerably, and Sweden refrained from participating in the Euro area, too (Trautwein 2000).

Our investigation covers the period from 1996 to 2005, hence a full trade cycle which is divided by the 2000/01 slowdown into two five-year periods. We have chosen to start in the mid 1990s, because we wanted to exclude the recession and the currency turbulences of the early 1990s in order to have a clearer picture of the effects of the macroeconomic policy regimes in our countries: France and Germany dominated by the ‘Maastricht Regime’, on the one hand, and the UK and Sweden as EU countries outside the ‘Maastricht Regime’ on the other hand.



average values for 1996 – 2000 and 2001 – 2005

Source: European Commission (2007), authors' calculations

The key indicators of macroeconomic performance for the four countries under investigation show some striking features (Figure 1 and Table 1): First, France, the UK and Sweden consistently outperformed Germany over the whole period with respect to both GDP growth and the development of employment/unemployment. Second, whereas France and particularly Germany had major difficulties to recover from the global economic slowdown 2000/01, both the UK and Sweden managed to avoid a deep slump and recovered quickly. During the second sub-period from 2001 to 2005, they both clearly outperformed Germany and France. Inflation was very modest in all of the countries considered. Third, the structure of growth was far from uniform in the four economies, especially in the second subperiod from 2001 to 2005: Growth in the UK and to a lesser extent in France was exclusively driven by domestic demand, with considerable negative contributions by external demand. In Sweden growth was driven both by domestic and external demand, with the positive contribution from foreign demand remarkably increasing. The German economy, in contrast, relied entirely on foreign demand with a negative contribution of domestic demand.

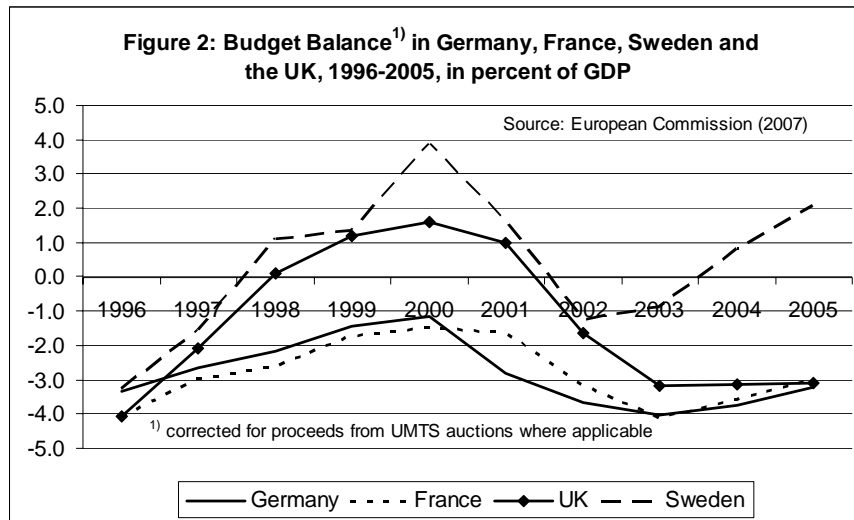
## **4. Assessing the impact of fiscal policies**

### **4.1 A note on methods**

As a first step to take account of the macroeconomic impact of fiscal policy one may look at the development of actual budget deficits. Figure 2 shows a similar pattern for all the countries with decreasing deficits/increasing surpluses over the first sub-period and increasing deficits/decreasing surpluses in the second, one important difference being the much more pronounced movements in the UK and Sweden. It is, however, not at all clear, how to interpret these facts. Actual deficits may simply reflect the underlying economic situation and not the impact of active fiscal policy. A widespread alternative and possibly better indicator to determine the extent to which fiscal policy exerts a stabilising or destabilising influence on the business cycle would be the development of cyclically adjusted deficits in relation to variations in the output gap. Data for both the output gap and the cyclically adjusted deficits are readily available from the OECD or the European Commission.<sup>14</sup>

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<sup>14</sup> For a detailed exposition of the methods used by the OECD see Giorno et al. (1995). For those of the European Commission see Denis et al. (2006) and European Commission (2005).



Such cyclically adjusted measures, however, can be criticised for a number of theoretical and empirical reasons and must therefore be interpreted with great care. Theoretically, they are very close to the idea embedded in the standard NAIRU models: There is a long-run equilibrium, determined by structural characteristics of the labour market, which is independent of the short-run fluctuations generated by demand shocks or macroeconomic policies. We do not share this view (Hein 2004, 2006). Empirically, these measures are very sensitive to the exact method used and to the choice of observation period: The separation of a cyclical from a potential or trend component will be biased because the potential component is endogenous. After some years of high (low) growth caused by ‘short-term’ demand side measures or shocks, the potential or trend growth will go up (down) thereby underestimating the cyclical component compared to a situation without such demand side measures or shocks (Horn/Logeay/Tober 2007). Therefore, the cyclically adjusted budget deficits (surpluses) for low (high) growth countries may be considerably overestimated. Because of these serious problems we refrain from using such cyclically adjusted measures here.<sup>15</sup> Instead, in what follows we use a qualitative method of identifying the fiscal stance developed in the analysis of expenditure paths as a consolidation and coordination instrument (Hein/Truger 2007b). We then refine the method and try to obtain some raw quantitative estimates for the fiscal policy stance in the four countries.

<sup>15</sup> In our earlier work (Hein/Truger 2007b) we nevertheless used the methods, but not in an uncritical manner. We applied them in order to show that the relevant Post-Keynesian results could easily be derived, even if standard mainstream procedures were used.

## 4.2 A qualitative assessment

Our method of assessing the qualitative stance of fiscal policy tries to stick as close as possible to the ‘raw’ nominal government account data without the use of possibly misleading deflators or cyclical adjustments. However, if one wants to stick to the idea of a reference level for neutral fiscal policy, one still has to assume some trend for nominal GDP growth. The idea of neutral fiscal policy then is, to let the part of government expenditure that is conceptually independent of the business cycle and that can therefore exogenously be set by the government (as a first technical approximation: government consumption, investment and subsidies) grow in line with the nominal GDP trend. We here identify the nominal GDP trend as the real GDP trend (moving average of the preceding six years) plus an inflation target of 2 percent. By using the inflation target and not the actual inflation rate we avoid that purely changes in the inflation rate lead to changes in the expenditure path. With neutral fiscal policies, government revenues and cyclical expenditures (as a first technical approximation: social benefits in cash) during the business cycle should float freely around the trend which means that automatic stabilisers can perfectly do their job. On average over the business cycle, cyclical expenditure should therefore follow the nominal GDP trend.<sup>16</sup> Government revenues are assumed to be neutral if they follow actual GDP growth.<sup>17</sup>

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<sup>16</sup> There are, of course, some implicit and problematic assumptions in this definition of neutrality. For example we have to assume that unemployment related benefits grow in line with trend GDP, which implies that, *ceteris paribus*, there is no change in the unemployment rate at trend GDP growth. This, however, is only true if trend GDP growth equals productivity growth plus growth of labour supply (i.e. the natural rate). In addition there is a conceptual bias in taking all of the social benefits in cash as cyclical expenditure, because some of them (for example public pensions, payments in the health system) are not necessarily related to the business cycle and the unemployment rate. Unfortunately there were no internationally comparable detailed government accounts available.

<sup>17</sup> For this definition to be plausible we have to assume a revenue elasticity of 1, which may seem restrictive. However, the European Commission’s (2005) estimates of the revenue elasticity for the four countries under investigation are in the interval between 0.94 and 1.1, so that the value of 1 seems to be a good approximation.



**Table 2:**

**Reference value for fiscal policy neutrality, nominal GDP, government expenditure and revenue in Germany, France, the UK and Sweden, average growth rates in percent**

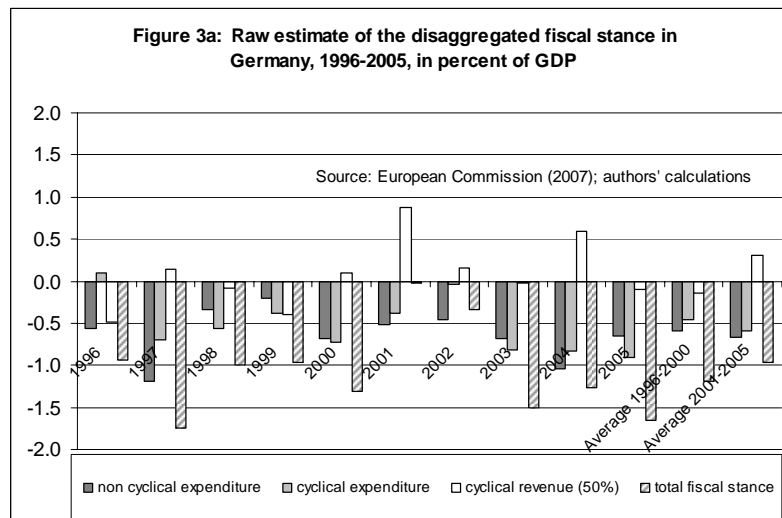
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With the help of the definition of neutrality just given one can easily identify the qualitative stance of fiscal policy for a given time period by simply comparing the average growth rates of the respective fiscal aggregates with the reference value for neutrality (Table 2). In the first sub-period from 1996 to 2000 obviously all countries used restrictive fiscal policies to consolidate their budgets: For all the countries the growth rates of non-cyclical expenditure was below the reference value for neutrality, with Sweden and Germany outstanding as especially restrictive. In addition, total revenue grew faster than nominal GDP which is a hint to discretionary tax increases with the aim of consolidating the budget. With the exception of Germany, social benefits grew less than nominal trend GDP which signals prospering development in the three economies concerned during the first sub-period, an interpretation which is confirmed by the fact that GDP grew stronger than trend GDP in those countries. Germany on average over the first period, in contrast, still showed a weak performance because it managed as late as 1999 to overcome the economic slowdown following German unification. Therefore, the conclusion seems justified that fiscal restriction in Germany came at the wrong time and was procyclically restrictive, whereas for the other economies the restriction can be regarded as counter-cyclical.

After the 2000/01 worldwide economic slowdown, fiscal policy in the four countries reacted in a very diverse manner. The UK switched in a very aggressive counter-cyclical way from fiscal restriction in the first sub-period to expansion in the second one. Non-cyclical expenditure growth rose way above the neutrality path, cyclical expenditure increased in a less aggressive way and revenues grew about neutrally on average over the period from 2001 to 2005. France and Sweden on average did not see a switch to fiscal expansion on the expenditure side because cyclical and non-cyclical expenditures still grew weaker than the neutrality path. However, the growth rates were raised substantially from their low values in the first sub-period. Further on, in Sweden weak revenue growth hints to discretionary tax cuts in order to stimulate the economy. Again in contrast, German fiscal policy did not alter its strongly pro-cyclical course of fiscal restriction on the expenditure side after the 2000/01 economic slowdown – nominal non-cyclical expenditure almost stagnated over the five year period. As can be seen in the spectacularly low revenue growth of only 0.4 percent as compared to an average nominal GDP growth of 1.7 percent, the German government tried to boost the economy via tax cuts, however (Truger 2004, Truger/Jacoby 2004).

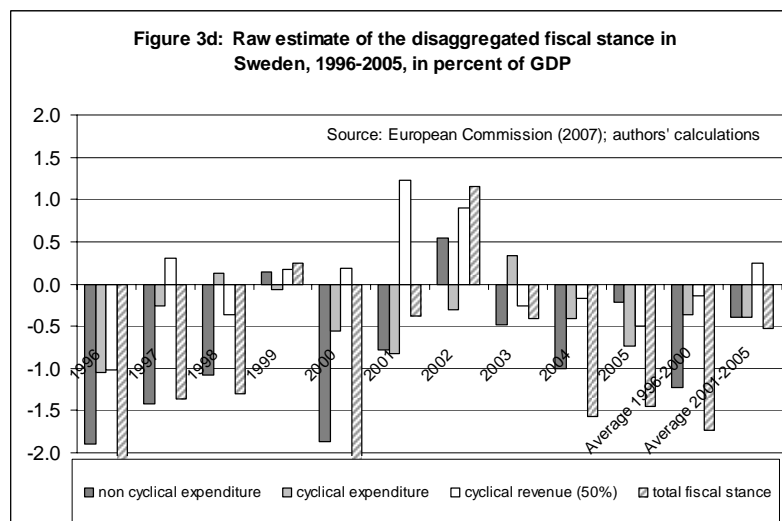
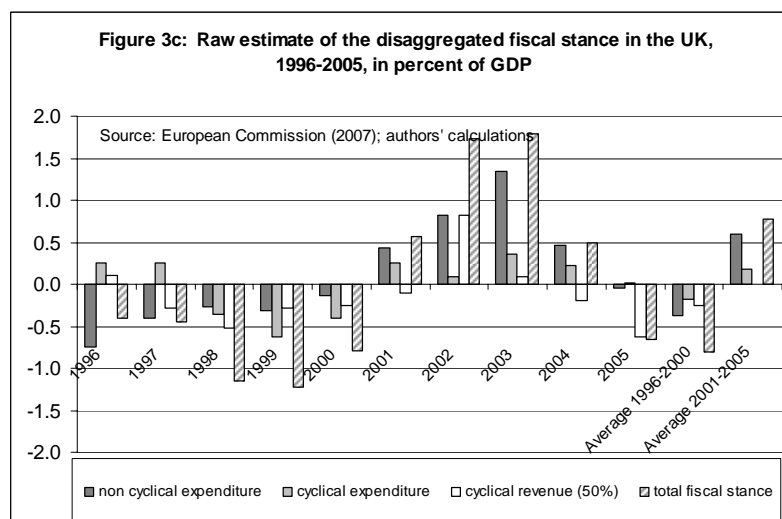
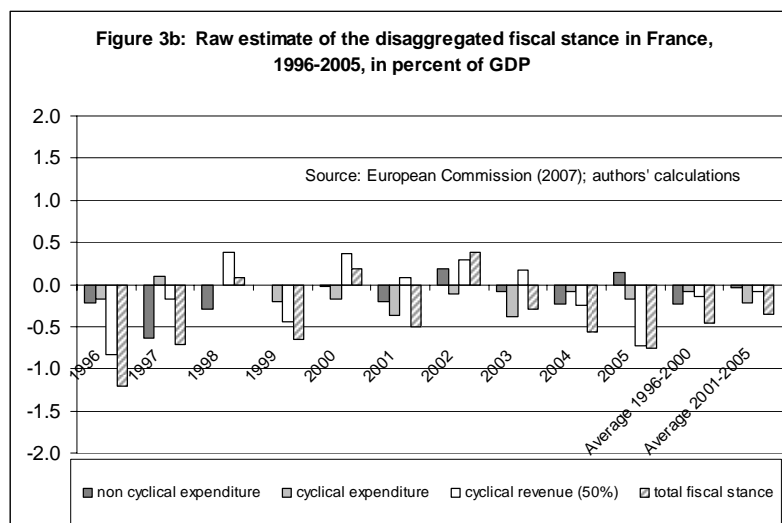
### 4.3 A (raw) quantitative assessment

The broad qualitative picture of the fiscal policy stance in the individual countries, interesting as it may be in itself, cannot answer the question how relevant fiscal policy was for the recovery or non-recovery in the respective countries. Therefore, in this section we try to complement the qualitative analysis with a rudimentary attempt to quantify the economic impact of fiscal policy. For this purpose we need some additional assumptions. In order to obtain a quantitative estimate of the stance of non-cyclical government expenditure we simply multiply the difference between the growth rate of non-cyclical expenditure and the neutrality path (trend GDP growth) by the share of non-cyclical spending in GDP. As for cyclical spending we do the same, but we correct for deviations of actual GDP growth from trend growth, assuming a GDP elasticity of social benefits of unity.<sup>18</sup> With respect to public revenue we calculate the corresponding fiscal stance as the difference between the revenue growth rate and actual nominal GDP multiplied by the revenues' share in GDP. The result obtained is multiplied by 0.5 in order to take into account that the standard estimate of the revenue multiplier is usually one half of the multiplier on the expenditure side which is often taken to be about unity.<sup>19</sup>



<sup>18</sup> The GDP elasticities for the four countries obtained by the European Commission (2005) with respect to unemployment related expenditures suggest that the elasticity for social benefits in cash as a whole which we assume is in the right order of magnitude for Germany and Sweden. For France and particularly for the UK the value of unity may well be too large. However, for simplicity's sake we still assume a uniform elasticity of unity for all the countries. Sensitivity analysis shows that the overall effect of different benefit elasticities on the fiscal stance is not large.

<sup>19</sup> See Hemming/Kell/Mahfouz (2002) for an overview of the literature on the effects of fiscal policy and multipliers.



Figures 3a to 3d show the results of our calculations for the individual countries from 1996 to 2005. In what follows, we concentrate on fiscal policies' reaction to the downswing after 2000/2001. In Germany fiscal policy proved to be a serious drag to the recovery. After an almost neutral fiscal policy in 2001, exclusively driven by huge discretionary tax decreases, German fiscal policy switched to pro-cyclical restriction in 2002 and increased the degree of restriction over the following three years. On average over the period from 2001 to 2005 the negative fiscal stance amounted to almost 1 percent of GDP. Given the assumptions of our analysis this amounts to saying that German GDP growth could on average have been higher by almost 1 percentage point if it had not been for the restrictive fiscal policy stance in that country.

For France the picture looks substantially brighter as it saw expansive fiscal policy in 2002. However, as in Germany, fiscal policy switched to restriction in later years, especially in 2005. The degree of restriction in France was much smaller than in Germany. On average over the period from 2001 to 2005 it amounted to about 0.3 percent of GDP, which was only mildly restrictive.

For the UK the qualitative picture of aggressive counter-cyclical fiscal policy is confirmed by our quantitative estimates. In that country fiscal policy in 2001 at once switched to perceptible expansion. The degree of expansion was increased over the following three years, before it switched to a slight restriction again in 2005. On average over the five years the positive fiscal stance amounted to about 0.8 percent of GDP. Obviously, fiscal policy provided the UK economy with a strong boost.

In Sweden fiscal policy in 2002 reacted in a strongly counter-cyclical way to the downturn. After that year, however, it switched back to a remarkably strong course of fiscal restriction. On average, fiscal policy proved to be a noticeable drag to the Swedish economy with a negative fiscal stance of about 0.5 percent of GDP.

From these results it can be seen that fiscal policy was indeed an important factor for macroeconomic development in the economies under examination. For Germany, France and the UK, the reaction of fiscal policy fits well to the development of overall macroeconomic performance sketched in Section 3. From the quantities involved, a fiscal drag of about 1 percent of GDP in Germany and a boost of 0.8 percent in the UK, fiscal policy was the dominating factor in explaining the two economies' differing performances. France with an almost neutral fiscal policy is somewhere in between Germany and the UK with respect to macroeconomic performance, which fits quite well into the picture, too. The fast, strong and lasting recovery of the Swedish economy, however, is difficult to explain by its negative

fiscal policy stance. We therefore have to turn to an analysis of the other macroeconomic policy areas to obtain a more complete and convincing picture.

## **5. The stance of monetary and wage policies as well as open economy issues**

### **5.1 Monetary policy**

Macroeconomic performance cannot be explained solely by fiscal policy but has also to take into account monetary and wage policies, as we have argued in Section 2. Monetary policy can be assessed by the development of the short-term real interest rate, because it is now widely accepted that modern central banks use the short-term nominal interest rate as an economic policy instrument (Table 3). If central banks target inflation they have to set nominal interest rates with an eye to the ensuing real rate, as, for example, proposed in the famous Taylor-rule (Taylor 1993). We expect a negative influence of nominal and real interest rates on economic growth, in the short and in the long run.<sup>20</sup> This influence, however, may be asymmetric for the reasons mentioned in Section 2.

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<sup>20</sup> For an overview of the transmission channels of monetary policies see Bernanke/Gertler (1995) and Cecchetti (1995), and for the short- and long-run real effects of monetary policies see the meta-analysis by De Grauwe/Costa Storti (2004).

**Table 3:****Monetary policies, wage policies, exchange rates, exports and imports**

average values for 1996 – 2000 and 2001 – 2005

	1996-2000				2001-2005			
	Germany	France	UK	Sweden	Germany	France	UK	Sweden
<b>Monetary policy</b>								
Short-term real interest rate, percent	2.4	2.4	4.8	3.3	1.2	0.8	3.0	1.4
Long-term real interest rate, percent	4.2	4.0	4.6	4.9	2.6	2.3	3.3	2.8
Short-term real interest rate minus real GDP growth, percentage points	0.4	-0.4	1.6	0.1	0.6	-0.7	0.5	-0.9
Long-term real interest rate minus real GDP growth, percentage points	2.2	1.2	1.4	1.6	2.0	0.8	0.9	0.5
<b>Wage policy</b>								
Nominal compensation per employee, annual growth, percent	2.4	2.2	4.7	4.7	1.8	2.8	4.4	3.5
Nominal unit labour costs, annual growth, percent	0.1	0.7	2.7	2.2	0.2	2.0	2.8	1.4
Labour income share, percent	65.6	66.6	72.1	67.1	64.9	66.2	73.7	70.0
Change in labour income share to previous year, percentage points	0.0	-0.2	0.2	1.1	-0.6	0.1	0.0	0.1
<b>Exchange rate, exports and imports</b>								
Change in nominal effective exchange rate, vis a vis 35 industrial countries, percent	-1.5	-1.1	5.5	1.2	2.0	1.9	-0.1	0.1
Change in real effective exchange rate, vis a vis 35 industrial countries, percent	-4.4	-2.8	6.0	0.9	0.1	1.8	0.9	-0.4
Real exports of goods and services, percent of GDP	29.1	25.7	26.7	41.4	38.6	28.7	28.3	47.7
Real imports of goods and services, percent of GDP	29.1	24.1	27.3	36.3	34.9	28.7	32.1	38.9
Source: European Commission (2007), authors' calculations								

In order to take into account the underlying economic situation, we consider the differences between both the short- and the long-term real interest rate and real GDP-growth in order to evaluate the effects of monetary policies on economic performance. A positive value indicates

restrictive monetary policies; a negative value indicates expansive policies. Measured in this way, monetary policies affected the French, Swedish and UK economies after the 2000/2001 in a less restrictive/more expansive way than the German economy. Whereas in Germany the difference between the short-term real interest rate and real GDP growth on average in the period 2001 to 2005 even increased slightly in comparison to the period 1996 to 2000, it was noticeably reduced in the other three countries (Table 3). A similar picture emerges if we consider the difference between the long-term real interest rate and GDP growth. The swing in interest rate-growth-differences from the first to the second period was largest in Sweden, but it was also considerable in the UK, albeit with a much smaller spread between short- and long-term interest rates. And even in France with the most favourable relationship between real interest rates and GDP growth in the first period, this relationship improved in the second. In the UK immediate monetary policy reactions by the Bank of England in early 2001 contributed to the more favourable development compared to Germany. Detailed analysis reveals that the Swedish central bank took action only in 2003. This implies that immediate stabilisation in Sweden had a different source, namely net exports, as we will see below. The UK and the Swedish central banks have pursued an inflation targeting monetary policy strategy with a symmetric target of 2 percent for the HICP, with a band of  $\pm 1$  percent,<sup>21</sup> whereas the ECB (2003) has had a much more ambitious and asymmetric inflation target of 'below 2 percent' until 2003 and 'below, but close to 2 percent' since then for a much more heterogeneous currency area. Therefore, the more favourable real interest rate-real GDP-difference in France compared to Germany was only due to higher GDP growth and higher inflation. This made the French economy less vulnerable to the restrictive ECB monetary policy stance than the German, which - as a slowly growing low inflation economy - was hit most.<sup>22</sup>

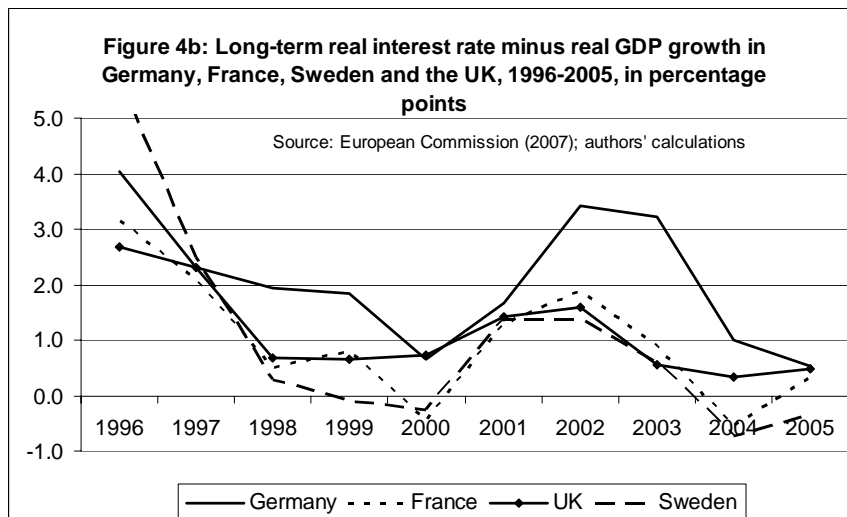
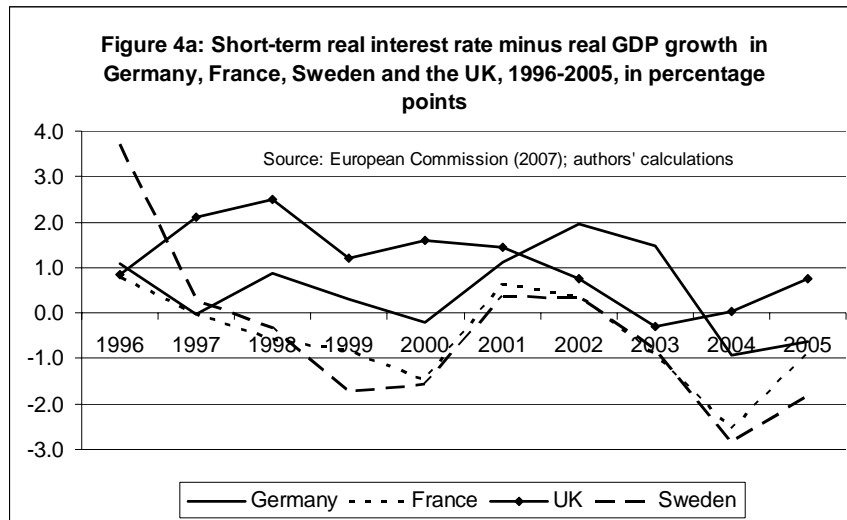
The general picture just described gets even more accentuated when looking at the annual development of the difference between short- and long-term real interest rates and real GDP growth rates, respectively (Figures 4a and 4b). The effects of the monetary policy reaction came faster and stronger in the other countries than in Germany, with the swing being most pronounced in France and Sweden.

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<sup>21</sup> Until 2003 the Bank of England had an inflation target of 2.5 percent ( $\pm 1$  percent) for the retail prices index.

<sup>22</sup> For a more detailed analysis of ECB policies and its effects in a heterogeneous Euro area see Hein/Truger (2007c).





## 5.2 Wage policy

Wage policies affect nominal wage growth (compensation per employee), unit labour cost growth and labour income shares (Table 3). As we have argued in Section 2, in order to avoid the destabilising effects of nominal wage flexibility, nominal unit labour costs should grow at a rate similar to the respective country's inflation target. With a constant mark-up in firms' pricing and costs for imported material growing in step with domestic unit labour costs, also the destabilising effects of real wage flexibility in wage-led economies would be avoided by the implementation of this wage formula. In profit-led economies, however, nominal and real wage moderation will be expansive, mainly through dominant effects of improved international competitiveness and net exports on aggregate demand. Empirical analysis has shown that aggregate demand and growth in medium and large not so open economies, as in

France, Germany, and the UK, tend to be wage-led, whereas small open economies tend to be profit-led (Hein/Vogel 2008, Stockhammer/Hein/Grafl 2007, Naastepad/Storm 2007).<sup>23</sup>

An inflation target of approximately 2 percent in all the economies under investigation gives us a benchmark for the ‘neutrality’ of wage policies via nominal unit labour costs growth. In Germany this benchmark was undercut most in both time periods. Disinflationary – and in 1997, 2004 and 2005 even deflationary – wage policies contributed to low inflation and increasing international competitiveness, but also to the highest real interest rates within the Euro area, given the nominal interest rates set by the ECB. In the second period from 2001 to 2005 nominal wage moderation was also associated with a considerable decline in the labour income share.<sup>24</sup> Disinflationary wage policies had a negative impact on aggregate demand and growth in the wage-led German economy, on the one hand, and increased deflationary pressure on the other member countries of the Euro area, on the other hand. In France wage policies were disinflationary in the first period, with unit labour cost growth far below the inflation target and with a declining labour income share in the wage-led French economy. In the second period, however, wage policies became ‘neutral’: nominal unit labour cost growth was exactly at target and the labour income share remained roughly constant. Wage policies in the UK were expansive in both periods: Nominal unit labour costs exceeded the inflation target and the labour income share increased. Since the demand and growth regime of the UK seems to be wage-led, too, expansive wage policies contributed to higher growth. However, unit labour cost growth above the inflation target may be a major reason for the high level of nominal and real interest rates in the UK compared to the other countries. In Sweden wage policies were expansive in the first time period with nominal unit labour cost growth exceeding the inflation target and rising labour income shares. In the second period wage policies became disinflationary with nominal unit labour costs growth below the inflation target and labour income shares roughly constant. Whereas in the first period wage policies stabilised domestic demand, in the second period disinflationary wage policies boosted net exports which became the main stabiliser of the Swedish economy (Table 1 and Table 3).

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<sup>23</sup> Some studies even find that the Netherlands, as a small open economy, are wage-led (Ederer 2008, Naastepad 2006, Naastepad/Storm 2007). To our knowledge, for Sweden there are not yet any econometric results concerning the demand and growth regime available.

<sup>24</sup> See Hein/Schulten/Truger (2006) and Stockhammer/Hein/Grafl (2007) on this phenomenon in Germany.

### **5.3 Open economy, exchange rate and external demand**

In order to complete the macroeconomic analysis we take a look at the development of international competitiveness and the ensuing effects on the balance of goods and services. As key indicators we use the change in effective nominal and real exchange rates vis a vis 35 industrial countries (Table 3). A positive (negative) change indicates a nominal or real appreciation (depreciation).

From 1996 to 2000 German international competitiveness improved via a depreciation of the Deutsch Mark/the Euro. The change in the effective nominal exchange rate was strongly reinforced by the very low German inflation rate, mainly caused by wage moderation, so that the real effective exchange rate dropped quite dramatically. This, together with a strong growth in world trade improved Germany's balance of goods and services. From 2001 to 2005 Germany managed to keep its real effective exchange rate virtually unchanged despite a 2 percent appreciation of the euro, again via excessive wage moderation. This competitive advantage turned a balanced trade balance on average over the first period into a strongly positive balance of almost 4 percent of GDP in the second period.

France after a similar, but much weaker positive development in international competitiveness over the first period, could not compensate for the strong euro appreciation in the second period and had to face an equally strong appreciation in its real effective exchange rate undermining its international competitiveness and considerable worsening the balance of goods and services. The UK economy experienced a very strong nominal appreciation which was even slightly reinforced in real terms from 1996 to 2001. This already led to a negative balance of goods and services. From 2001 to 2005 despite an unchanged nominal exchange rate, the real rate appreciated due to expansive wage policies. This development led to a very substantial deficit in the balance of goods and services of about 4 percent of GDP.

After the depreciation shock in 1992 which had strongly stimulated demand for Swedish exports, the Swedish economy lost some of its international competitiveness over the period from 1996 to 2005. Nevertheless, it ran a large surplus in the trade of goods and services of almost 5 percent of GDP on average in that period. Due to wage moderation the Swedish real exchange rate depreciated from 2001 to 2005 with the result that the trade surplus on average increased to almost 9 percent of GDP, reaching double digits numbers in 2004 and 2005.

## 6. Identifying different macroeconomic policy regimes

In this section we put the pieces developed in Sections 4 and 5 together and characterise the macroeconomic policy regimes pursued in the four countries.

### *Germany: The dysfunctional mercantilist*

Germany has embarked on a very unfortunate mercantilist macroeconomic policy strategy. Extreme wage restraint due to corporatist agreements, high unemployment and strong downward pressure induced by radical labour market ‘reforms’ led to especially unfavourable effects of the ECB’s ill designed monetary policy in this country. Being a wage-led economy, wage restraint did not pay off, because the domestic economy suffered from comparatively high real interest rates and stagnating private consumption caused by redistribution at the expense of labour. This restrictive stance of monetary and wage policies on domestic demand was amplified by very restrictive fiscal policies. On the other hand, wage moderation and caused low inflation rates, dramatically increased international competitiveness and boosted net exports without, however, compensating for the loss in domestic demand. This ill designed strategy has not only harmed the German economy, it has also put severe pressure on the Euro area member countries and runs the serious risk of competitive wage deflation in the currency area as soon as the world economy will slow down.

### *France: The innocent victim*

France can be considered an innocent victim of the German mercantilist strategy. France combined a completely adequate wage policy, in total accordance with the ECB’s inflation target, with an only mildly restrictive fiscal policy. Together with the favourable interest rate-GDP growth-constellation associated with ECB policies, a favourable – or at least only mildly restrictive – macroeconomic policy mix emerged. However, this mix did not pay off because of serious and growing external account problems in the second period under consideration. But these problems were completely due to external circumstances, namely the appreciation of the euro and the mercantilism of the most important trading partner, Germany.

### *UK: The unbalanced growth machine*

There can be no doubt that in terms of its macroeconomic performance the UK economy was very successful over the decade under investigation. However, the underlying growth regime was not balanced. The UK economy saw expansive wage and fiscal policies combined with a

cautious but at least non-restrictive monetary policy. The ensuing very expansive domestic policy mix, and the overvalued currency due to comparatively high interest rates, however, caused competitiveness and external account problems. These will be difficult to solve in the future without changes in the current macroeconomic regime.

*Sweden: The functional mercantilist*

In particular after the 2000/01 growth slowdown, Sweden combined expansive monetary policies with restrictive fiscal and mildly restrictive wage policies. This resulted in a mildly restrictive domestic policy mix. Being a small open economy, and given the already existing competitive advantage, the mercantilist strategy of moderate wage growth paid off for Sweden, because net exports increased and boosted growth. Therefore, Sweden can be considered as an example of ‘functional mercantilism’, though one must concede that double digit export surpluses as a percentage of GDP make the Swedish economy quite vulnerable to external demand shocks.

## **7. Conclusions**

In this paper we have criticised the New Consensus approach in macroeconomics for its exclusive but unwarranted reliance on monetary policies when it comes to real and nominal stabilisation, for its ill-designed approach to the role of wages and wage policies, and for its complete neglect of fiscal policies. From a Post-Keynesian perspective, we have argued that fiscal policies play an important role for macroeconomic development, not only in the short but also in the long run. However, we are far from replacing the New Consensus ‘monetarism’ by a Post-Keynesian ‘fiscalism’. We rather hold that the whole macroeconomic policy-mix of monetary, fiscal and wage policies, together with open economy conditions (degree of openness of the economy, exchange rate and currency system), is important for the understanding of macroeconomic development. Based on this view we have analysed macroeconomic performance and macroeconomic policies in France, Germany, Sweden and the UK between 1996 and 2005, with a special focus on the role of fiscal policies. We have shown that the fiscal policy stance is important for the explanation of different developments in these economies. However, fiscal policies are not the whole story, monetary policies, wage policies and open economy conditions matter as well. Although we have attempted to calculate rough estimates for the fiscal stance in the respective countries, further research

should be devoted to quantify the effects of monetary, fiscal and wage policies on economic growth in a consistent way.

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