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Disinflation: West European Experiences

An Introduction

By Otmar Issing

1. The Colloquium at Frankfurt

The European Economic Associations want to foster closer cooperation between European economists and have for this reason decided to arrange colloquiums for which each country nominates two participants. The subject of the first meeting (1983) of this kind was "Macroeconomic Policies for the 80s" and took place in France. The second colloquium on "Disinflation: West European Experiences" was organized by the Gesellschaft für Wirtschafts- und Sozialwissenschaften, Verein für Socialpolitik, and was held from May 10 - 12 at Frankfurt. Revised versions of the papers given at the colloquium are published in this volume.

2. Inflation and Disinflation

The process of worldwide accelerating inflation started at the beginning of the seventies when international liquidity was tripled within a few years (1969 - 1972) and the system of fixed exchange rates spread price increases from "inflation leaders" to all other countries. After a short intermezzo (1976 - 1978) inflation rose again mainly as a consequence of the second oil price shock. But this time many industrial countries resisted the tendency of further acceleration in increases of the price level and tried — with more or less delay — to bring down inflation rates by monetary restraint.

In the following years inflation rates were significantly reduced — with great differences between the industrial countries, however. In this regard, the fight against inflation was quite successful. On the other hand, disinflation was accompanied by a severe recession. The growth rates of real GNP were drastically reduced and some countries suffered even absolute losses in output. The unemployment ratio (annual average) rose to 8.1 (1982) and 8.5 (1983) per cent within the group of ten (see table 2).

Table 1: Changes in consumer prices

Countries	Changes over twelve months ending									
	1972 Dec.	1974 Dec.	1976 Dec.	1978 Dec.	1979 Dec.	1980 Dec.	1981 Dec.	1982 Dec.	1983 Dec.	
	in percentages									
United States	3.4	12.2	4.8	9.0	13.3	12.4	8.9	3.9	3.8	
Japan	5.3	21.9	10.4	3.6	5.7	7.5	4.3	1.8	1.8	
Germany	6.4	5.8	3.7	2.4	5.4	5.5	6.3	4.6	2.6	
Netherlands	7.9	10.8	8.5	4.0	4.8	6.7	7.2	4.3	3.0	
Belgium	6.4	15.7	7.6	3.9	5.1	7.5	8.1	8.1	7.2	
Switzerland	6.9	7.6	1.3	0.7	5.2	4.4	6.6	5.5	2.1	
United Kingdom	7.6	19.2	15.1	8.4	17.2	15.1	12.0	5.4	5.3	
Italy	7.3	25.3	21.8	11.9	19.8	21.1	17.9	16.3	12.8	
Sweden	6.1	11.5	9.5	7.3	9.8	14.1	9.2	9.6	9.2	
France	6.9	15.2	9.9	9.7	11.8	13.6	14.0	9.7	9.3	
Canada	5.1	12.3	5.9	8.4	9.8	11.2	12.1	9.3	4.5	
Weighted average of Group of Ten countries ^{a)}	5.1	14.5	7.8	7.3	11.2	11.6	9.0	5.6	4.5b)	

a) With weights proportional to gross national products for the year 1981. — b) With weights proportional to gross national products for the year 1982.

Source: Bank for International Settlements, Fifty-Third Annual Report, p. 14, Fifty-Fourth Annual Report, p. 18.

Table 2
Unemployment

Countries	1974	1976	1979	1981	1982	1983
	annual average, as a percentage of the labour force					
United States	5.6	7.7	5.9	7.6	9.7	9.6
Canada	5.3	7.1	7.4	7.5	11.1	11.9
Japan	1.4	2.0	2.1	2.2	2.4	2.7
Germany	2.7	4.6	3.8	5.6	7.7	9.2
France	2.3	4.3	6.0	7.8	8.8	9.0
United Kingdom ^{a)}	2.4	4.9	5.4	10.0	11.7	12.4
Italy	5.4	6.7	7.7	8.5	9.1	9.9
Netherlands ^{b)}	3.3	5.5	5.1	9.0	12.6	17.1
Sweden	2.0	1.6	2.1	2.5	3.1	3.5
Belgium	2.6	5.7	7.1	9.4	10.9	12.2
Switzerland	0.0	0.7	0.3	0.2	0.4	0.9
Group of Ten countries	3.8	5.5	5.0	6.6	8.1	8.5

a) New series from October 1979.

b) New series from January 1983.

Source: Bank for International Settlements, Fifty-Fourth Annual Report, p. 17.

This is — very briefly — the empirical background against which the problems of disinflation have to be discussed.

3. The Costs and Benefits of Disinflation

The central question concerning disinflation is: what are the benefits and costs of anti-inflation policy and what factors determine these costs? (see the framework given by *Fischer*¹).

The benefits result from the inflation costs which are avoided by disinflation. Because there exists a vast literature on the costs of inflation this topic is not further developed here.² The country studies reveal — as expected — great differences with high costs for Spain (*Paricio / Quesada*) and the United Kingdom (*Britton*) and surprisingly low costs for Switzerland (*Baltensperger*). The problem of relative

¹ All remarks of this kind refer to articles published in this volume.

² For a short survey see *Ackley* (1978).

price risk is controversially discussed in two papers (*Franz, Neumann / v. Hagen*).

Simply judged by their adaption of a disinflation policy, more and more countries have come to the conclusion that the costs of continuing or even accelerating inflation were intolerably high. From the beginning there was no doubt that it is not possible to disinflate without a more or less long period of reduced real growth and higher unemployment.

Generally speaking the costs of disinflation depend on the speed of the adaption of nominal variables to reduced inflation rates. Looking for the factors determining this process one comes to a fully anticipated disinflation as the pendant to the well known fully anticipated inflation. But, the verdict that there exists in reality no such phenomenon as a fully anticipated inflation applies even more to disinflation; consequently this statement leads to the existence of an asymmetry between the process of inflation and disinflation (*de Boissieu*).

One main factor determining the downward stickiness of nominal wages and interest rates is the length of contracts in which those nominal variables containing inflationary expectations are fixed; indexation could, therefore, be a decisive measure to hold the costs of disinflation low. Incomes policy as a possible alternative seems to have worked satisfactorily only in Austria (*Wörgötter*).

A factor which is important for the adaptation of expectations in the disinflation process is the “credibility” of anti-inflation policy. The credibility approach — according to *W. Fellner* — overlaps partially with that of rational expectations. One difference between the two concepts lies in the fact that the credibility approach limits the proper expectations of the public to a policy which is behaving consistently and in an understandable fashion. Another difference is that the credibility approach leaves room for real effects of policy. The credibility approach is thus the rational expectations hypothesis without its “unconvincing elements”³.

For policy-makers the central question is: How is credibility acquired? The monetarist answer is simple: set a clear, invariable target for the growth of money and announce it to the public. Stick to this target and never mind “actual” needs — credibility is gained in this case by itself.

Looking for credibility there is rarely room for the opposite position of a totally discretionary policy. Nevertheless, the question remains,

³ *Fellner* (1979), 168 - 172.

whether there are (avoidable) costs resulting from a strict monetary rule which might also endanger the credibility of disinflation policy. Should not monetary policy follow a somewhat more pragmatic path? If, for example, an autonomous shift in money demand occurs, should not monetary policy be accommodative? On the other hand the problem of the correct identification of the size and duration of those disturbances remains; this is especially true for changes in the real exchange rate (see the papers of *Ernst Baltensperger* and *Andrew Britton*).

Disinflation policy can follow a path of gradualism or try to bring down the inflation rate by shock therapy. There is no general answer to the question of whether gradualism or a cold turkey policy deserves more credibility. Shock therapy — implemented by currency reform — is probably the only promising way out of a hyperinflation, whereas a gradual approach is more apt to reduce moderate inflation over a period of a few years.

4. The Articles in this Volume

All articles are introduced by an abstract and end with an English and German summary. There is, therefore, no need to refer the content here again in detail.

Stanley Fischer gives a general survey on the problems connected with disinflation policy. The article by *Christian de Boissieu* is mainly concerned with the asymmetry (between inflation and disinflation) hypothesis. *Paul Löwenthal* describes the danger of a vicious circle in form of a cumulative process of disinflation and formulates some indications for a better policy. The problem of the influence of inflation on relative price risk is the topic of the article by *Manfred J. M. Neumann* and *Jürgen von Hagen* with empirical evidence for West Germany.

Two papers with a broad empirical background then follow. *Svend Hylleberg* and *Martin Paldam* study price-wage inflation in 17 countries for the period 1913 - 1980. *Alfred Steinherr* comes to the conclusion that an increase in the share of labour had a significant negative effect on employment in the EC-Countries, the USA and Japan.

The remaining articles are concerned with the process of disinflation in single countries. This is done in a broad context by *Ernst Baltensperger* for Switzerland, by *Andrew Britton* for the United Kingdom, and by *Joaquina Paricio* and *Javier Quesada* for Spain. Two papers (*Marcello de Cecco* and *Mario Arcelli*) examine the problems of monetary policy in Italy. *Reinhard Neck* compares the results of monetarist and keynesian econometric models explaining the Phillips phenomenon in

Austria, whereas incomes policy is the main topic of the article by *Andreas Wörgötter*. The German situation (1973 - 1983) is examined by *Wolfgang Franz*.

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