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HOW TO GET OUT OF THE CRISIS?

by

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The subject How to get out of the crisis? is of such overriding importance that an Institute like the ISS is in fact obliged to contribute towards its answer.

This paper is divided into five sections. The first reviews the changes that took place in the 1970s. The second is called From recession to depression. In the third I consider whether things might possibly have been different. The fourth section, the core of the paper, deals with policy answers to the present world economic situation. Lastly, I examine possible objections, at the same time making allowance for the discussion that followed the presentation at the ISS seminar.

I. Some major changes in the 1970s

In retrospect, it is interesting to note that the 'dull' 70s, following close on the heels of the 'roaring' 60s, were crucial from the economic and social angle, as the following points illustrate.

This paper is based on an article that I wrote for a Dutch economic weekly* and on a seminar given at the Institute of Social Studies. The subsequent changes and adaptations have been sufficiently numerous to make this an altogether different piece from the original Dutch text.

*'Hoe komen we uit de depressie? Een poging tot synthese' in: Economische Statistische Berichten (ESB) 12.1.1983.

o Even at the end of the 1960s, the manufacturing industries in industrialized countries had started to stagnate from an employment-creation point of view. From the 1970s onwards, production also started to slow down and in certain cases even declined.

o A second important phenomenon in the 1970s was the accelerating inflation; that occurred partly as a result of American policies, including the war in Vietnam.

o The third point is that the early 1970s witnessed the beginning of the end of the Bretton Woods system; the dollar left the gold standard, floating and flexible exchange rates were introduced, etc.

o Another striking feature which became apparent in the 1970s was the ruthless economic restructuring policy of Japan and its heavy investments in modern technology, particularly micro-electronics. This process actually started in the 1960s, but few then paid any attention to it.

o The OPEC price movements in 1973 and in 1979 have been the subject of so much discussion that they need only be recalled here for the record.

o The rapid economic and export growth of a few developing countries (later to be called Newly Industrializing Countries or NICs). This must be seen in relation to the first point mentioned above. Important changes in the international division of labour were a result of these movements.

o The seventh and final point concerns the discussion on the New International Economic Order (NIEO) which, at one point in the 1970s, seemed as though it would go somewhere. This was an important initiative taken by the developing countries in the wake of the OPEC oil price hike.

A survey of the world economic scene at the end of the 1970s showed that Japan and a number of newly industrialized countries were apparently on the offensive; the USA, although slowing down, was holding its own. The emerging crisis was felt principally in Europe, which was on the defensive, and in many middle- and low-income developing countries.

II. From Recession to Depression?

In the light of the changes that occurred during the 1970s, it seems probable that the traditional industrialized countries have pursued inappropriate economic policies.

In retrospect, for example, their economic subsidy policies vis-a-vis national enterprises in difficulties, which were aimed mainly at alleviating short-term employment problems, have been wrong. Most of the subsidies that were fed into these enterprises eventually disappeared because of the lack of competitiveness of the enterprises: employment opportunities were lost in addition to the money. To crown it all, the economic structure of the country became more rigid instead of evolving with the international division of labour. In many European countries, attempts to maintain relatively labour-intensive industries have been successful due to the joint pressure groups of trade unions and employers' associations; but as a result, our economic structures are more and more losing touch with the fast-changing world economic structure. This is the first reason why the situation went from bad to worse.

A second reason is that once the economic machine in an industrialized country starts to hesitate, a very perverse effect sets in due to the existence of the welfare state that was established during the 1950s and '60s. Once the economic machine slows down and unemployment moves into higher gear, the injurious effect is set in motion: state income starts to stagnate, while expenditures accelerate. At present, for example, unemployment in the Netherlands amounts to 17 percent and about the same percentage of people are 'unfit for work'. All these people have to be paid. In other words, state outlays in such a period increase disproportionately in relation to its income. The welfare state, however, assumes an ever increasing and expanding economy.

My third point is the vicious circle that sets in: obsession about the level of public expenditures, government obsession with bringing down financial deficits, obsession about the level of wages and salaries, all of which give rise to a downward spiral.

Finally, let me say that the crisis in the developing countries has reflected itself almost exclusively at the level of the external accounts: balance of payments deficits and foreign debts; in the industrialized countries, on the other hand, the crisis is reflected in huge unemployment figures and stagnating industrial activity.

When Helmut Schmidt puts the question: "Is there a probability that we are entering the second big crisis of the century?", I would be tempted to answer in the affirmative. There is indeed a possibility that we shall enter a second depression, for reasons which I will outline later. Government obsession with financial deficits, which is only one dimension of the problem, makes it likely that this will take place.

III. Intermezzo: Could things have been different?

We are sometimes so blinded by our daily problems that it is often difficult to reflect on how we got into our present intricate economic and social situation.

We have illustrated above how incidents can accumulate to the level of a depression, but as they have occurred one after the other they have not been given sufficient attention, all the more so since they took place in the general euphoria of the 1960s and in a large part of the 1970s. Also, however, our way of looking at things has changed.

Firstly, industrial stagnation has triggered off a discussion on re-industrialization and economic restructuring, which in the Netherlands only started in 1980. During the 1960s and 1970s very few, if any, were preoccupied with the stagnation of industry; on the contrary! Were we not on our way to a <u>post</u>-industrial society and didn't we have, in this country for example, well-known economists such as Hans v.d.Doel, who believed that paradise was located in the quarternary (the non-commercial services) sector? Why did we believe that? And why do we now believe that our economic survival depends on re-industrialization? This is indeed a significant <u>volte-face</u>, a change of attitude with regard to economic policy. So far, no convincing answer has been given as to why this <u>volte-face</u> has come about.

The second example is that of the welfare state. Obviously we have always known that certain measures of the welfare state could have the opposite effect of the one intended and sometimes did so. In this country, we spend 32 billion guilders on medical care and technology. I now realise, as do Ivan Illich and others, that medical technology can make things worse rather than better, can make people more ill instead of curing them. There is also the old debate about differences in the levels of unemployment benefit and minimum income. We know that if that difference becomes very small, or even non-existent, it will have implications for the

duration of the unemployment period: the smaller the difference, the longer the period of unemployment tends to be! Other examples can be given of measures which have been perverted and have turned the safety net of the welfare state into a hammock ...
We showed little interest in such consequences because we did not read the economic signs on the wall.

The third example is that of the economic policies of the United States with their emphasis on monetary policies and the implicit high rates of interest. There is no doubt that U.S.policy has had tremendous implications world-wide, in particular on the foreign debts problem. But thousands of us, including the best in the profession, thought that inflation had to be fought and controlled before anything could be done about our economic and unemployment problems. I remember one of the first documents that came out of the OECD after van Lennep took over as Secretary-General at the end of 1969. This document was on the inflation/unemployment trade-off and came out squarely in favour of fighting inflation first.

Again, we let all these things pass until the crisis point arrived!

A fourth example: the attempts of the developing countries, within the framework of the NIEO, to do something about commodity prices and, in general, to attain a more equitable global income distribution. The North has systematically played the card of its own short-term interests instead of taking longer-term interests of a global nature into account. We made little effort to move in the direction of more equitable prices, except in the case of OPEC where we had no choice.

And that leads me to the fifth example, the OPEC price hike of 1973-1979. Again, it is part of the problem, but also part of our own long-term interest. Indeed, the price increase provided a major incentive for research into alternative energy sources. In this context, it is significant that a slight panic occurred in March 1983, when it was not clear whether OPEC would be able to control the downward spiral of oil prices....

IV. Current and desirable economic and social policies in OECD countries

Almost everyone now favours a return to economic growth. That is contrary to what many believed in 1972 when the Club of Rome published its first report. Many were then in favour of zero growth. Now that we have zero growth, we realise the problems that have to be faced when one gets into such a situation, unprepared. In particular, social tensions are created by unemployment and by the increasing discrepancy between government revenues and expenditure. There is now near-unanimity, even among those who favour a longer-term solution of a qualitative growth type, that what is required right now is a return to economic growth in order to ease such tensions.

At the moment there is a most remarkable debate about the miracle remedy which ought to do the trick. The mutually exclusive debates between competing economic approaches that struggle for attention are incomprehensible: Keynesianism, post-Keynesianism, monetarism, supply-side economics, the rational expectations school, and others. This illustrates the fact that there is not even consensus on the diagnosis of our economic ills, let alone on the remedies that should be applied.

In most OECD countries present policies show that the focus is still primarily on fighting inflation, or on preventing a return to inflation. One of the main culprits of the present state of affairs is supposed to be over-consumption, particularly in the public sector.

Many would agree that the 1970s has been a decade of over-consumption and under-investment in the industrialized countries, especially in the public sector. Policymakers are rightly preoccupied with widening the scope for investments. Hence, the concentration on reducing government deficits by introducing cuts in government expenditure and social services in order to provide more room for private sector investments.

Policymakers are only secondarily concerned with economic restructuring and with attempts to ensure that no further slips can occur with respect to the fast changing international division of labour. In the industrialized countries, little more than lip-service is paid to the mounting unemployment problem. The policy-priority ranking in the majority of OECD countries would seem to be: primary concern with inflation and government deficits; secondary concern with the unemployment problem.

Almost tautologically, the result of such a policy package is downward adjustment to zero or negative economic growth. It is a quasi-passive policy by which the economic scene is adjusted downwards by cutting wages and salaries and reducing public expenditures. Both domestic production and exports suffer as a result because all countries are pursuing the same policy. Indeed, the generalised downward pressure on the purchasing power of the public causes internal markets to stagnate or even diminish, and also, for that matter, external markets.

Take a country such as the Netherlands. The sight of all Government Departments desperately cutting their expenditures irresistibly evokes the image of the primitive Gosplan in the Soviet Union, where all enterprises did their utmost to fulfill the quantitative targets, whatever the price for the others. Take the Institute of Social Studies as an example. If the Government were to cut the ISS budget, the Ministries of Education and of Foreign Affairs would save money, but we should have to sack some individuals and they would have to be paid out of the budget of another department. In other words, someone has to pay and it is not at all clear whether present policies are indeed reducing government deficits because, in fact, they create additional outlays in other places.

Advocates of current economic and social policies must be asked: "How long will the transition period last?", "How low should inflation sink?", "How small has the Government deficit to become?", before it is decided to start-up a reflationary and expansionary policy. I have put these questions to a top civil servant in the Ministry of Finance, and his answer to the first was "10 years!" I then asked: "If we already have 15 percent unemployment without the cutting measures having had their full effect, how much more unemployment do you think we can afford before we emerge from the 10 year-tunnel?" He looked at me in desperation and said in almost these words: "Well, what do you expect with 75,000 more people coming onto the labour market every year? There simply are too many people around!"

An alternative policy approach

There is no doubt in my mind that a much more comprehensive policy package is required in industrialized countries. A policy package that, to some extent, would be a synthesis of many of the measures which have been proposed as 'miracle' measures on their own merits. The package should combine short-term and long-term, supply- and demand-oriented, structural and cyclical elements, and have at least six components.

1. A careful streamlining of the welfare state

Two purposes: tighter control of public expenditure; and setting the incentives structure straight.

It has already been mentioned that certain excesses may have developed in the welfare universe, that disincentives may have resulted as a consequence, and that, therefore, less rather than more may have positive results. An absolute condition is that streamlining of the welfare state is guided by vision. If building up something needs vision, then restructuring surely needs it even more. What is happening in actual fact is that cuts are being made haphazardly and totally *ad hoc*. It is not at all certain that the longer-term consequences of some proposals (e.g. cutting down orchestras and theatre groups, as well as educational facilities) have been properly thought through.*

At the risk of repeating myself, let me say that a more systematic policy would have to start by critically examining those welfare state measures that have had opposite effects to what was intended. Some examples have been presented above. Intervention in such measures would result both in a decrease of public expenditures and a re-equilibriation of the incentive structure.

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* It takes a few generations to build up a stock of human capital. A country that attacks its stock of human capital as some of our countries are now doing, no longer believes in the future. Where is the vision?

2. Economic restructuring

Not only re-industrialization, but agriculture and commercial services need to be restructured. As I have mentioned earlier, Europe is economically on the defensive, and in many instances economic and technological structures have not kept pace with the rapidly evolving world economic structure. There is an obvious tension between short-term employment objectives and what might be called the economic robustness of a country, including its longer-term employment objectives. Much of our subsidy policies are myopic. Nothing can be gained by keeping outdated economic entities artificially alive.

3. Incomes and labour market policy

Labour costs should be contained, for reasons I shall come to in a moment. However, I agree with those who would do so by concentrating on the social security component of labour costs rather than on the wage component. In other words, and consistent with what has been said earlier, everything possible should be done to maintain the purchasing power of the people, which is now being put into jeopardy by current policies.

Why the emphasis in many quarters on labour cost reduction? Above all, in order to reduce public expenditure, because a significant proportion of the labour bill originates in the government sector. Secondly, in order to increase the degree of competitiveness of the economy. This is somewhat of an illusion however, if all countries follow the same policy, which they do.

Since it is important to maintain the purchasing power of the population as much as possible, it stands to reason to look at the social expenditures component of the labour cost rather than at the wage component.

4. Taxes and fiscal policy

I would agree with those who argue in favour of abolishing the capital gains tax for a number of years in order to provide investment incentives to enterprises or production units. While the first and third measures would save money, this measure would cost the state money. Care should therefore be taken that these measures are mutually consistent.

The policy package so far attempts to combine savings on public expenditure with maintenance of purchasing power and the stimulation of investments within the framework of economic and technological restructuring.

5. Stimulation of demand

The four preceding elements would probably be considered by most government economists as an acceptable basis for discussion. The fifth element, however, brings us into an area of controversy and debate. Demand can be stimulated in at least three ways:

(i) a generalised expansionary policy in the entire OECD area (few people would argue in favour of this);

(ii) a selective expansionary policy in certain countries of the OECD area. More and more people have argued in favour of this since the end of 1982, including for instance Dr. Witteveen (the previous Managing Director of the IMF), Helmut Schmidt, even Henry Kissinger (both of whom happen to be out of power), and also 27 leading economists and bankers in a booklet published in December 1982 under Fred Bergsten (the present head of the International Institute of Economics in Washington).

(iii) the stimulation of international demand in middle-income third world countries.

Few people would argue in favour of the latter, but I would reason strongly in its favour. Many proposals have been made during the second half of the 1970s for a kind of global Marshall Plan in this area. One of the latest was the so-called Brandt Report of 1980 (not to be confused with the recent Brandt Memorandum of 1983).

I wish to say a few words about how to finance such an expansionary policy, with special reference to the stimulation of international demand variety. The immediate reaction usually tends to be: "But how can you possibly recommend an expansionary policy, a policy of stimulating international demand, in a period when all attention focuses on reducing the financial deficits of governments?".

There are at least three ways of financing such a policy. The first would be monetary financing, nationally as well as internationally, through the creation of additional SDRs. The second would be by restructuring the budget: perhaps a little less on defence and a little more on a global Marshall Plan. Third, I would personally be prepared to earmark additional public outlays for such a programme in order to stimulate international demand. Indeed, a careful distinction must be made between government outlays on which a positive rate of return for the economy can be expected on the one hand, and government outlays that result in a zero, or even negative, rate of return. In the present debate this distinction is not made with sufficient care: as a result the discussion is muddled.

As an example, and to make this more concrete, there is a distinction between spending billions of monetary units on trying to keep people out of the labour market, to make then unhappy, or on trying to save enterprises that cannot really be saved - all massive expenditures on which there is no economic rate of return whatsoever - and expenditures that do have a positive rate of return like the stimulation of international demand which will result in export orders for our economies.

6. Complementary employment policies

Many people still believe that if, tomorrow morning, for example, through a set of policies as indicated above, we could return to a rate of economic growth of 3 to 5 percent, this would, by the same token, settle the employment problem and ensure a return to full employment. This is not true. The growth path of the future is anything but employment-intensive; although it would not represent 'jobless growth', it can be calculated on the back of an envelope that results in terms of employment creation cannot be sufficient to wipe out the present backlog of unemployment and to create enough employment opportunities to take care of the increases in the country's labour force.

Policies must therefore be designed to intervene on the supply side of the labour market in order to arrive at what could be called a 'full employment policy new style', through a better distribution of available work among those who are looking for paid employment.

There are about six ways in which the labour force may be constructively reduced, i.e. without sending people into involuntary unemployment: early retirement; postponing the entrance of young people onto the labour market by using the school as a parking lot; reducing the working week; longer holidays; reducing the working day (which is being discussed in this country, but not so much in other countries); and then there is my way, i.e. to reduce the period that a person spends on the labour market over the entire working-life by enabling him/her to take voluntarily and temporarily a period off, either to study or to do something else.

Since the objective of these measures is to realise 'full employment new style', workers and employees should withdraw from the labour force from time to time for a longer period, otherwise employers would not replace them with people at present unemployed. All other measures are ineffective from the employment point of view. For example, reduction of the working week does not change the levels of employment or unemployment in the middle and long term.

These levels are just as high or as low with a working week of 45 hours or 40 or even 35. Within a few years technology adjusts itself to such an extent that productivity increases and any employment gains will have been lost. More imaginative policies are therefore required.

These, then, are the six components of the proposed policy package for industrialised countries. Although I consider the Third World a crucial element in the international demand component and I would be willing to put up a strong fight to get the international stimulation of demand policy on its way, it is of course not true that as it stands now it has sufficient economic weight to get the world out of the crisis. That must come from the North, the South being in a very serious, because passive, situation. The economic and social situation in the South has deteriorated, but it is difficult to imagine how it could get back into shape without the North getting out of the crisis which it created in the first place.

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In summary, an economy not only needs 'air', i.e. more room for investments, it also needs 'food', i.e. markets in which its products can be sold. What is needed, therefore, is a combination of supply and demand measures. Everyone would agree that the old Keynesian measures are no longer sufficient. What is actually needed, is an eclectic cocktail of measures.

We must have measures that help control public expenditure - and I think that my first, and part of my third, measure would do just that. We also need measures to reduce the labour cost bill, and measures three and four would go some way in that direction. We need demand and investment impulses for which additional funds are required, see measures two and five. Whether or not the sixth measure would increase costs is a matter for debate. Many people, including the employers, claim that any specific employment policy measure would be cost-increasing. As far as I am concerned, this is not necessarily the case. Existing public expenditure must be used in a much more productive way: not for enterprises that are going down the drain anyway, but for enterprises with a future; not to keep people out of the labour market against their will, but to get them to step out of the labour market voluntarily for longer periods of time in order to restructure themselves in terms of human capital, as the economy is restructured in terms of physical capital.

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V. Objections

The oral presentation of the above paper was followed by a lively discussion. I shall attempt in this final section to present the gist of it and of the major critical comments that were made. I also take the liberty of summarising my answers.

In the presentation, little attention has been given to the Third World, although the developing countries were explicitly introduced in the policy component concerning the stimulation of international demand. Such a proposal goes much further than most people in the OECD countries would be prepared to accept. It is true that explicit attention has not been paid to the developing world, not because I underestimate their particular difficulties, on the contrary! It is clear, however, that the present world economic crisis has its origin in the industrialised countries and must therefore be solved in the first instance in the rich countries. The weight of the developing countries in the world economy does not yet have such impact that they would be able to get the world economic machine moving again by themselves. If this statement is acceptable, it follows that I was right to concentrate the major part of this presentation on policies and policy changes in the rich countries.

If I may sum up my position with respect to the Third World, I would say the following. For the newly industrialising countries, international trade and access to markets are the crucial factors, and policy discussions should therefore concentrate on those dimensions. The low-income countries are in a very difficult situation and all development aid by donor countries should from now on be concentrated exclusively on these poorest countries. For the middle-income countries, whose difficulties are also enormous, I would reserve my proposal on the stimulation of international demand.

Next, there is the question of the absolute necessity <u>not to increase</u> government deficits and the alleged impossibility of starting an expansionary policy. There are two reactions to this kind of observation. The first relates to the fact that present policies do not reduce government deficits, because what is saved in one spot will have to be spent in another. I refer to my remarks about unemployment outlays in the main text. The second reaction concerns the fact that inflation and rates of interest are now on the decline, that in certain countries the balance of payments is in surplus, and that for those countries who combine these three favourable characteristics the time has now come to introduce expansionary policies.

A much more complicated question concerns the controversy about the kind of economic growth we would like to pursue, and the kind of economic and technological restructuring we would want to see introduced.

This brings us to the heart of the discussion between environmentalists (or more generally, people who believe that 'more of the same' in the field of economic growth would be bad) on the one hand, and those who argue in favour of relaunching the economic growth machine as soon as possible, on the other.

I think it can safely be said that most of us favour a selective growth path - selective in the sense of introducing environmental and other restraints. At heart, the discussion is between those who want economic growth <u>now</u> to ease the social and political tensions while at the same time ready to envisage a planned trajectory towards zero-growth, say 15 to 20 years from now, and those who want to introduce a highly decentralised, participatory, low-growth economy now. I would opt squarely for the first, because the second is impracticable and will not get us out of the serious problems into which we have manoeuvred ourselves.

The policy package outlined in the main body of this document has a moderately Keynesian dimension. A possible reaction to this could be: why have present policies found such fertile ground in practically all

OECD countries? As we have seen, these policies are very hesitant about any Keynesian impulse to stimulate demand and concentrate wholly on slimming-down and streamlining the economic structure, the labour market, the welfare state, etc., etc.

Either all the government economists behind such policies do not realise what they are doing, or it is a deliberate attempt, a conspiracy one would almost be tempted to say, to do away with what they consider the excesses of the welfare state accumulated over the years, so that when the long-term upswing of the world economy starts, our countries will be ready to take the lead again. Under such an assumption, unemployment is considered an unfortunate but unavoidable price to be paid.

The package I have proposed is distinct from such a single-minded pursuit, because it combines, pragmatically and eclectically, different approaches that will also meet the target of slimming and streamlining, but at much lower cost in terms of unemployment. It also supposes a much more active approach towards bringing the economic upswing nearer, rather than passively waiting for such a turn of events to happen of its own accord.

The example of the early economic policies pursued under the Mitterand Government in France has shown beyond the shadow of a doubt that when a country tries to introduce an expansionary policy by itself, the attempt is doomed to fail. Therefore, an expansionary policy within OECD countries, as well as a stimulation-of-demand programme addressed to developing countries, must be coordinated preferably OECD-wide, but minimally at the level of the EEC.

Another comment on my proposal was that I may have concentrated too much on the fact that cuts in public expenditure should be handled more rationally than is the case at present, and that therefore I did not adequately stress the necessity for fiscal policy. I find this criticism sufficiently interesting to reproduce it here in extenso.*

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* The following quoted comment was given by Prof. C.M. Cooper of the Institute of Social Studies, The Hague.

" Your ESB article and your seminar presentation are useful and gratifyingly positive contributions to the policy debate. At present, it is much easier for economists of your general persuasion and mine to keep their heads below trench level than to go on the offensive. That, indeed, is one reason why it seems that 'everyone' has moved into the contractionist, expenditure cutting, tight-money camp. I am accordingly, sensitive to the fact that the article puts you in an exposed position in a general political sense - and I would not like you to interpret my verbal comments and the following notes as indicating lack of awareness of that point.

My main concern about your paper and the seminar is about the 'modalities' (to use OECD 'Frenglish') for stimulating demand. In your discussion of the welfare-state, and of public finance in general, you leave a quite strong impression - without being fully explicit about the matter - that you lean towards a reduction or at very least a maintenance of the levels of public expenditure. Your main worry, indeed, is that cuts in public expenditure should be handled with greater rationality than at present.

This means, in effect, that you deny yourself any serious recourse to fiscal policy as a basis for demand stimulation. And this, in turn has the consequence that your demand expansion programme comes to depend on (a) expansion of international demand (international Keynesian policies implemented through aid and other transfer payments); and (b) expansion of private investment. I find this too limited. I believe you could argue, for a stronger response including a good dose of 'fiscality' - and even (dare one breathe the word) softer monetary policy.

The reasons why I think the approach too limited are:

(a) although it is, in my view, a thoroughly sensible idea - international Keynesian expansionism is hard to sell, so that political persons in particular will tend to be much more responsive to reliance on domestic private investment demand as the only 'real' basis for 'sound growth';

(b) if you centre - even implicitly - on private investment demand as a major demand stimulus, you place yourself far more in the monetarist camp than I believe you would wish. Indeed, as I have argued in my notes elsewhere, the kind of 'bastard monetarism' practiced in the EEC is ultimately almost entirely dependent on recovery of private investment to justify itself (i.e. 'tight money' to control inflation - via unemployment; public expenditure cuts to reduce borrowing by the state so that interest rates are kept down; low interest rates to stimulate private investment). I don't think this is a convincing formula. There is little empirical support for it and it is extremely risky.

Consequently, I think you should reconsider the issue of <u>expanding</u> public expenditures as part of the demand stimulation programme. I am not suggesting that public expenditure should be the <u>only</u> component in this programme, but I am pretty convinced that active fiscal policy has an important role to play. The following points are relevant.

(a) The fact that fiscal deficits are a large proportion of GNP in OECD countries, gives a misleading picture of the state of fiscal policy (at least in terms of 1960s and 1970s 'demand management' criteria). In fact, the so-called cyclically adjusted budget deficit (an up-to-date variant of the 'full employment budget deficit') for the largest 7 OECD economies put together has diminished steadily if somewhat slowly and is now very nearly zero. Fiscal policy is not expansionist at present. Indeed, as you observe, the mounting proportionate deficit is simply a reflection of recession (i.e. not just expanding unemployment benefits etc., but also reduced tax take). These are circumstances in which it is sensible to think of an expansion in public expenditure.

(b) Whatever form such an expansion of public expenditure might take, it might plausibly be expected to induce an <u>expansion</u> of private investment demand. If one takes the view (which I think is easily defensible) that the basic problem for private investment is not so much high interest rates per se, but that <u>expectations</u> are pessimistic, then a fiscally induced demand expansion could well have 'accelerator' effects. Since there is evidently a good margin of underutilised capacity, there is no reason in principle why expansion of public expenditure should not be <u>complementary</u> to an increase in private investment. It might of course be argued that an expansion in the fiscal deficit may force up interest rates. There are two answers to this: (i) it might, but would that matter? It could well be that positive expectation effects would outweigh negative effects of higher interest rates; (ii) if there is a real risk of rising interest rates holding back private investment, then accelerate the growth of 'real money' supply to keep rates down.

(c) One should note that the nature and pattern of public expenditure are important. An expansion in deficits is perfectly consistent with the rationalisation of purposes of public expenditure which you consider desirable. I suggest also that an expanded public expenditure programme could give priority to <u>public</u> creation of productive capacity, rather than just <u>public</u> consumption. "

I believe that the approach outlined above gives too much weight to traditional Keynesian policies. However, I fully agree that additional outlays are necessary which I personally would rather identify (i) in the monetary financing field; (ii) through the restructuring of budget expenditures, and - if absolutely necessary - (iii) in additional public expenditures.

THE HAGUE,
May 1983.