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The high growth and innovation agenda of Lisbon: The role of aggregate demand policies

European Economic and Employment Policy Brief

No. 1 - 2005

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Introduction: Lisbon is also about macroeconomic policies

The Lisbon agenda is often interpreted as a programme for 'structural reform'. However, the Lisbon presidency conclusions are also very explicit in the need for 'sustaining the healthy economic outlook and favourable growth prospects by applying an appropriate macroeconomic policy mix'.

Thus in reviewing the progress made with the Lisbon agenda it is entirely correct to ask whether the macroeconomic policy mix has been appropriate. Such an approach has been taken recently by the report by the High-level group led by Wim Kok which mentioned the importance of macro policies in sustaining buoyant demand as a pre-condition for achieving the Lisbon targets.

The traditional view on aggregate demand policies

In the European policy debate, the relevance of aggregate demand policies is often being played down. Indeed, many European policy makers believe that a policy of managing aggregate demand, decried as 'Keynesian', will, at best, only deliver a short-lived bout of somewhat higher growth, and ultimately will only lead to higher inflation. Instead structural reform measures that raise the potential growth rate of the European economy are considered to be crucial.

Not only does this consensus view claim that active aggregate demand policies are irrelevant. It also claims that active demand policies are in fact dangerous for the objective of higher growth in the long run, for two main reasons. First it is argued that, by supporting growth and employment in the short run, the political momentum to actually implement painful reforms may be lost. Second, it is feared that active demand policies will threaten monetary stability, leading to higher long-term interest rates and thereby sacrificing longer term growth. Higher and more volatile inflation expectations and/or higher public deficits will push up capital market rates, which would in turn weigh negatively on investment and growth.

In other words, in this view of economic policy making, macro policy making should be limited to pursuing price and financial stability, while aggregate demand policies focused on sustaining economic growth are at best seen to be beside the point and more probably as counterproductive.

Objective of the discussion note

The purpose of this note is to present and discuss an alternative approach to the role of aggregate demand policies. In our view the distinction between demand policies that (only) raise growth in the short term and structural reform policies that are supposed to raise potential growth over the long term is artificial. Instead, demand policies that stimulate an economy in which economic activity and investor and consumer expectations are depressed have an important role to play in raising the longer-term growth potential of the European economy. This note highlights the different channels through which short-term stabilisation policies influence long-run growth potential. Ultimately, the key issue is that the potential growth rate of an economy is not known to policymakers, nor is it independent of the current growth rate.

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Importantly, this note does *not* argue that a structural reform agenda is not necessary or that a boost in aggregate demand is all the European economy needs. Instead, the European economy needs *both* an active aggregate demand policy that is continuously testing the supply-side limits to non-inflationary growth, *as well as* those structural policy measures that that are genuinely effective in removing those limits. However, at present, policy makers, for different reasons, seem focused virtually exclusively on structural reforms, and here on a rather narrow reform agenda (although the question of which structural reforms actually do raise potential output is not addressed in this paper).

Raising potential growth by building the capital stock

High growth rates can only be achieved on a sustainable basis if the economy's capital stock is also growing at a sufficient rate. Alongside labour utilisation, 'capital extension' (in other words additions to the economy's capital stock) is a major determinant of potential growth. This can also be seen from the angle of prices and inflation. If sufficient productive capacity is available, firms do not find themselves in a 'seller's market' in which they can raise prices and thus rekindle inflation. Thus a high rate of investment is likely to ease capacity constraints and, other things equal, enable the central bank to keep interest rates low. When a cycle of investment and growth can be triggered, then this cycle, by combining the supply and demand factors that are necessary to achieve sustainable growth, is to a considerable extent self sustaining.

This leads to the question: what determines investment? Economic theory points to factors such as high margins (price minus cost for each unit of output) and the cost of capital (low long term interest rates). Yet, theory also underlines the importance of expectations of demand. Even if profit margins are high, actual investment decisions will not follow unless potential investors are confident that they will not remain stuck with stocks of products for which there is insufficient demand. For those making physical investments in capital, the existence of at least stable, and if possible growing, demand is arguably the key consideration.

Policies that stabilise aggregate demand are therefore essential in any policy mix that aims to raise potential growth. In an economic downturn, stabilisation policies eliminate existing slack in the economy, thereby restoring the incentives to invest. More importantly, they give investors confidence that their investments will generate returns in the future by shielding the economy from negative shocks. And vice versa, in times when there's a threat of overheating, adequate stabilization of the economy can, by avoiding an early emergence of inflation, prolong the period of economic growth. An inflation-targeting central bank will do this, but only to the extent that negative demand expectations are reflected in inflation falling below its inflation target. There are a number of reasons why this will not always be the case, however (e.g. import prices, administered prices). A central bank using a Taylor rule is confronted, among other things, with the problem that potential output is not known and thus also the size of the output gap. We return to this issue below.

Determinants of investments: research from the ECB

Analysis from the ECB's Monthly Bulletin (July 2003) concluded that investments were determined by profitability, capital costs and aggregate demand. However, the ECB also concluded that aggregate demand was the most important determinant, far outweighing the other factors.

An obvious conclusion from the ECB's own research would be that monetary policy, by steering short term interest rates, can increase investments through the channel of demand. This will raise not only short-run growth, but also the productive potential of the economy.

Short term interest rates impact on aggregate demand by changing:

- the cost of consumption credit
- the return on short term savings
- international capital flows, impacting on exchange rates, and
- consumer and producer confidence.

In other words, aggregate demand policies are not just about closing the (negative) output gap and reaping 1 or 2 extra percentages of growth over a two year's time span. By eliminating aggregate slack in the economy, a cycle of dynamic investments will be triggered and this will in turn boost the potential growth rate. Thus, positive effects of aggregate demand policies are not limited to short term effects; they also impact on the economy over the medium and even the long term. This also explains the observation that institutions such as the OECD or the IMF have been making recently. They observe that the longer the slump in European growth lasts, the more the estimates of Europe's growth potential are being revised downwards. Indeed the Commission's estimates of potential output have been revised downwards by almost one percentage point in recent years (European Commission, 2004 Economic Review). In the light of the previous arguments, this is hardly surprising. The failure of Europe to arrest the downturn and to stage a real recovery is indeed depressing investments and capital accumulation and this weighs negatively on potential growth. It also implies that a return to effective growth will lead to an increase in potential growth through the channel of capital accumulation.

In addition the importance of expectations and confidence should be underlined. The precise setting of interest rates by the central bank, while obviously important, is only part of the story: perhaps equally crucial is the message that the central bank sends out to investors and consumers. Just as it is important that the Bank convinces actors that it will take steps to halt any rise in inflation, so it is vital that they believe that the Bank will take vigorous action to sustain demand where necessary. While the ECB's inflation-fighting credentials are well-established – which is welcome – the ECB is not widely seen as being equally concerned with sustaining demand. Partly this is a question of presentation, partly a result of the fact that inadequate demand will not always show up in falling prices.

Increasing investments and building the capital stock: positive effects on the innovation record of an economy

Expanding the capital stock not only implies that a higher employment rate can be attained without triggering price pressures, capital accumulation also increases labour productivity, innovation and potential growth, through a number of channels.

- *Vintage effect:* With increased investment activity, latest innovations will be added to the existing capital stock. Hence, the quality and thus the productivity of the capital stock as a whole will improve.
- *'Learning by investing'*: Introducing new capital can also be expected to lead to more modern organisation and better management. By this means, too, not only will the capital-deepening aspect of productivity, but also the efficiency of the use of factor inputs (total factor productivity) will be increased.

If capital accumulation interacts in a positive way with productivity and innovation, then one implication is that creating employment by slowing down the substitution of labour by capital is perhaps not the most sensible policy approach. In other words, if wage moderation is pushed through too much and if the capita-labour substitution effect is slowed down too much, then this will have a negative impact on the overall productivity and innovation record of an economy. This raises questions as to the longer term desirability of such a strategy. Conversely, faster economic growth will lead

to faster wage growth which – provided, of course, that it remains within limits – can act as a ‘productivity whip’ on firms to raise their productivity. In many analyses of the successful period of economic performance during the so-called Fordist era (or the ‘trentes glorieuses’) this mechanism is accorded great importance.

Aggregate demand and innovation: other channels

- *‘Increasing returns to scale’*: In an expanding economy the size of the market is also growing. As we have known since Adam Smith, this opens up more possibilities for specialisation and the resulting scale effects. This can lead to a virtuous circle whereby these additional productivity effects allow prices to decline and the market to expand further
- In a gloomy economy, with household’s psychology fixed on precautionary savings instead of trying out and buying new products or services, firms may be less likely to invest in product innovation and may cut back research and development budgets.
- Some research indicates that an unequal income distribution does not provide a widespread demand for new innovative products. Here, by limiting economic downturns (which tend to hit lower wage workers the hardest) aggregate demand management can underpin product innovation activities.

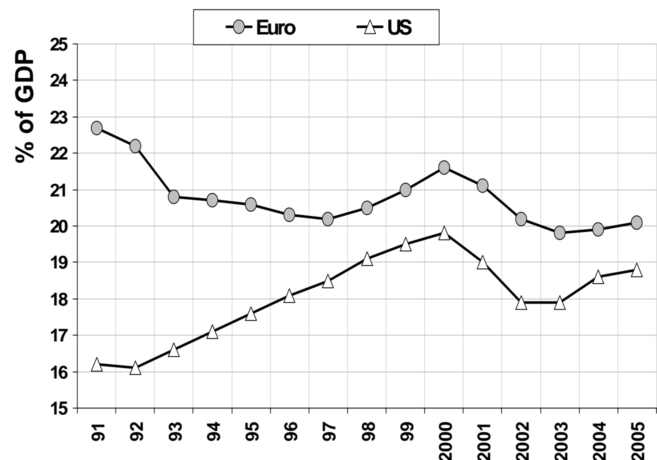
Aggregate demand and the labour market: the hysterisis effect

Demand-side policies that actively shield the economy from downturns and continually seek to test the supply-side limits to economic growth are also important in order to improve the functioning of the labour market and thus to raising potential output. On the one hand, avoiding a deep and prolonged economic slump minimises the risk that unemployed workers lose their skills as well as the motivation to stay engaged in the labour market. There is a danger of them becoming permanently excluded from the labour market, as ‘discouraged workers’ who no longer have an impact on wage negotiations, or of being only qualified for lower productivity jobs. All these effects are likely to increase the rate of unemployment below which inflation begins to rise (NAIRU). This effect, by which cyclical unemployment is converted into structural unemployment, is known as ‘hysterisis’. The prime task of macro policy must be to ensure that the extent and duration of downturns and thus unemployment spells is minimised, otherwise the damage will be not just to current, but also to potential economic growth.

The question is also how such ‘hysterisis’ effects can be reversed. Some economists think that, even if the unemployment was originally caused by macro or cyclical factors, once it has become ‘structural’, then labour market policy measures are required. There is considerable strength in this argument (which re-emphasises how important it is to prevent mass unemployment occurring in the first instance).

However, there are a number of channels by which an aggregate demand policy that tests the limits of so called structural unemployment by reducing unemployment – gradually – through demand led growth, will set in motion labour market mechanisms that will improve the functioning of the labour market, and also lead to declines in structural unemployment (some empirical evidence for this is given below). For instance, firms experiencing difficulties in finding skilled labour will see the need to provide and finance more training for (unemployed/young) workers. In turn, unemployed workers and those ‘discouraged’ from entering the labour market at all due to the lack of jobs, realising that there are indeed increased job openings and opportunities will again ‘tune in’ on the labour market. Also, ‘ladder effects’ (firms engaging higher skilled workers for lower skilled jobs) will be put in reverse, thereby alleviating low skilled unemployment In this sense, aggregate demand policies can be seen as ‘grease’ for a better performing labour market.

Again, there is no question of the need also for 'structural policies' to promote skills, mobility, improve matching on the labour market, facilitate female employment etc. Yet aggregate demand policies can have a major positive impact on the functioning of the labour market, hence on potential growth. Importantly, labour market reforms are not simply implemented from the economist's blackboard into reality, but by means of a complex political process. It is highly likely that it is politically easier to implement reforms in the context of expanding demand. Conversely, 'negative structural reforms' such as some types of early retirement policy were the political response to high levels of unemployment (and not their cause).

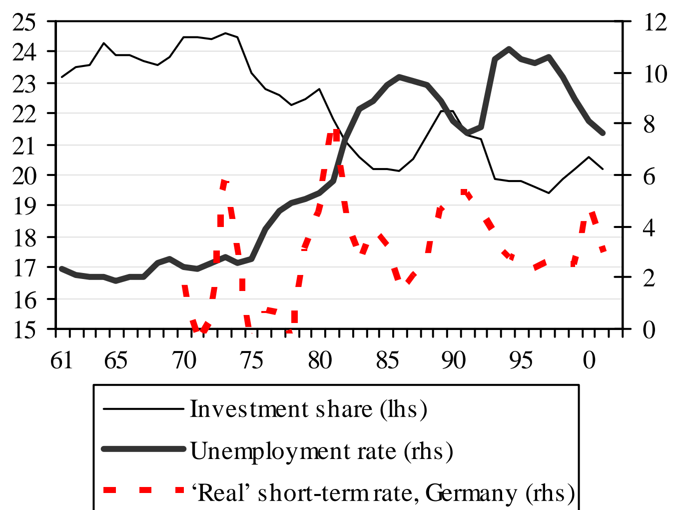


Empirical indications

First and foremost, many of the effects of demand policies on potential growth that have been described here can be recognised in the practical experience of the US in the nineties. Against the background of a spectacular increase in the investment share (see graph), the US economy was able to combine high employment growth with accelerating and high productivity growth. High (investment) growth also went hand in hand with high innovation activity. And finally, unemployment fell substantially below the consensus estimate of structural unemployment; it had been 6%, but unemployment fell as low as 4%. All that time, monetary policy was accommodating high growth, thereby making this innovation and productivity scenario possible.

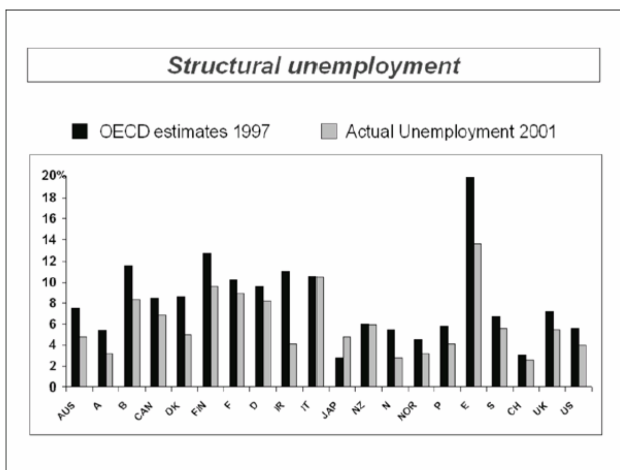
Secondly, there appears to be an extremely strong link between the investment rate and unemployment (see graph). It seems very clear from this graph that changes in the capital stock are absolutely key for determining the rate of unemployment (and not just of employment). The graph also shows the well-known sensitivity of investment to changes in real short-term interest rates which are, largely, set by the central bank.

Investment share and unemployment, EU-15, 1961-2001



Source: European Economy no. 4, 2002: Tables 3, 19, 24, 49: own calculations. Note: real interest rates time series not available for EU-15.

Thirdly, the impact of macro-economic expansion – whatever its source – on bringing down unemployment beyond what economists considered to be the point at which inflation would accelerate (the NAIRU) is clearly shown in the following graph. This is suggestive of the impact of the effects of capital stock expansion and the unwinding of hysterisis effects. To take an – extreme – example, note how the reduction in interest rates following the introduction of EMU led to a dramatic fall in unemployment in Spain, to a level that, although still high, was around 6 p.p. below what the OECD considered the NAIRU a few years earlier.



The indeterminacy of the NAIRU is one aspect of the wider problem that the rate of potential output is not known to policy makers a priori. All calculations of it, whether based on production functions or on filters of past actual growth rates are backward-looking indicators that are inherently unsuited to estimating the potential of an economy, which is a forward-looking concept.

Conclusions

The above analysis shows, in our view convincingly, that a more expansionary macro stance, defined as one that effectively shields the economy from negative shocks and continually tests the supply-side limits to economic growth is an important 'trigger' to, indeed we would argue a necessary condition for, higher effective *and* potential growth in a medium term scenario of 5-10 years. Ultimately the potential growth of the economy is unknown. In our view policymakers should focus on the 20-30 million additional jobs that the European economy could provide, if it raised its employment rates to feasible levels: *that* is the true measure of Europe's economic potential!

When combined with appropriate changes on the supply side – where we would emphasise the need for action to invest in positive labour market measures and social dialogue, not least within the Macroeconomic Dialogue, to coordinate wage formation with the objective of underpinning price stability – then the prospect of realising a growth figure consistent with the Lisbon targets (around 3% p.a.) is entirely feasible over an extended period.

In fact Europe has seen a huge amount of 'structural reform' in recent years: in labour and product markets, services, trade and other areas. Yet the expected (or promised) impact on productivity and employment has not been forthcoming. In our view this is due – alongside exaggerated expectations concerning the likely positive impact – largely to the failure to accompany structural reforms with a macro policy to push the European economy, via higher nominal demand, closer to its production possibility frontier. As a result, not only has growth been disappointing, policymakers are, as we have seen, now revising potential growth estimates downwards to match the poor actual performance. This has locked Europe into a low-growth equilibrium in which actors increasingly believe that Europe's relative economic decline is inevitable.

The upcoming mid-term review of the Lisbon process should be taken as an opportunity to underline the importance of positive aggregate demand policies for raising Europe's growth potential and achieving the Lisbon targets of higher growth and more and better jobs. The Macroeconomic Dialogue (in particular the

dialogue and interaction between the pillars of monetary and fiscal policy on the one hand and wage formation on the other hand) can play an important role in the mid term review of the Lisbon process. Suitably strengthened it can help to improve the consistency of the policy mix, underpinning expectations of continued wage and price stability as the European economy moves on to a higher growth trajectory.

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