

## **Comment on Rudiger Dornbusch: Is There a Role for Demand Policy?**

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Rudiger Dornbusch's paper provides a very interesting, thoughtful, and somewhat provoking discussion of the role of demand policy, both fiscal and monetary, in remedying European unemployment. I will make one comment with regard to his discussion of fiscal policy; the rest of my comments will refer to the discussion of monetary policy.

### **1. Ricardian Equivalence**

Dornbusch firmly rejects Ricardian Equivalence in his discussion of fiscal policy. He argues that an increased budget deficit would not lead to a compensating fall in private aggregate demand. Hence an increased budget deficit would increase aggregate demand.

Most of us would probably agree that in practice, under normal circumstances, the offsetting due to Ricardian Equivalence is much less than 100 percent, due to some households being liquidity constrained, imperfect inheritance adjustment, high discounting of uncertain future effects of fiscal consolidation, etc. However, the current situation with the huge deficit in Sweden is clearly far from normal. In such an extreme situation, when the deficit is conspicuously unsustainable, a fiscal consolidation may be generally expected to occur very shortly. A consolidation may bring reduced public expenditures, reductions in public employment, reduced benefits, and increased taxes. This will affect broad segments of households and firms. I believe that households and firms in such a situation are likely to internalize the public budget constraint to a much larger extent than under normal

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circumstances. Then the expansionary effect of an increased budget deficit may be much less, perhaps even negative and contractionary.

The great uncertainty about how the fiscal consolidation will be achieved, and the uncertainty for each household and firm as to how it will be affected, should have an independent effect. New theories and empirical studies have shown how uncertainty that will be resolved later induces postponed investment in production or consumption of durables because it increases the option value of waiting (Dixit and Pindyck, 1993; Pindyck and Solimano, 1993; Hassler, 1994).

Increasing the budget deficit further in such a situation may increase both the expected magnitude of future fiscal consolidation and the uncertainty about how it will be achieved, which will both have offsetting, perhaps even dominating negative effects on aggregate demand. Increasing the budget deficit may therefore be a very dangerous policy. My interpretation is that there are instead strong arguments for fiscal consolidation soon, or at least for a credible plan for fiscal consolidation with sufficient political support.

## **2. Monetary policy**

With regard to monetary policy, Dornbusch suggests a considerable monetary expansion in Europe, with "competitive depreciation accompanied by radically low interest rates." In support of this view, first the experience of the monetary expansion in the United States during 1992–93 is mentioned. Second, data are quoted for several countries showing that considerable depreciation during 1992–93 was not accompanied by rising inflation during those years (including a forecast of inflation for 1994). The implication would be that the European countries can safely pursue more expansionary monetary policy without any risk of increased inflation.

### **2.1. The United States experience**

Let me start with the recent experience of the United States. During 1992–93 the Federal Reserve set very low nominal and real Federal funds rates, and in that sense pursued a very expansionary policy. For this period there was no sign of increasing inflation, and long bond rates (and corresponding implied forward rates) fell, indicating either falling long real interest rates, falling inflation expectations, or falling risk premia.

One interpretation is that the Fed had developed a fair amount of long-term low-inflation credibility during the 1980s, which allowed it to pursue such an expansionary policy without causing either inflation or expectations of inflation. It does not follow that all European countries can do the same; it may be that some long-term credibility is necessary for an expansionary monetary policy not to result in increased inflation expectations and a period of persistent higher inflation (Bernanke and Mishkin, 1992; Hörngren and Lindberg, 1993; Svensson, 1994). If an expansionary monetary policy is instead interpreted as the beginning of a new era of high inflation, price and wage adjustment will be much faster, which will reduce the real effect of a given monetary expansion.

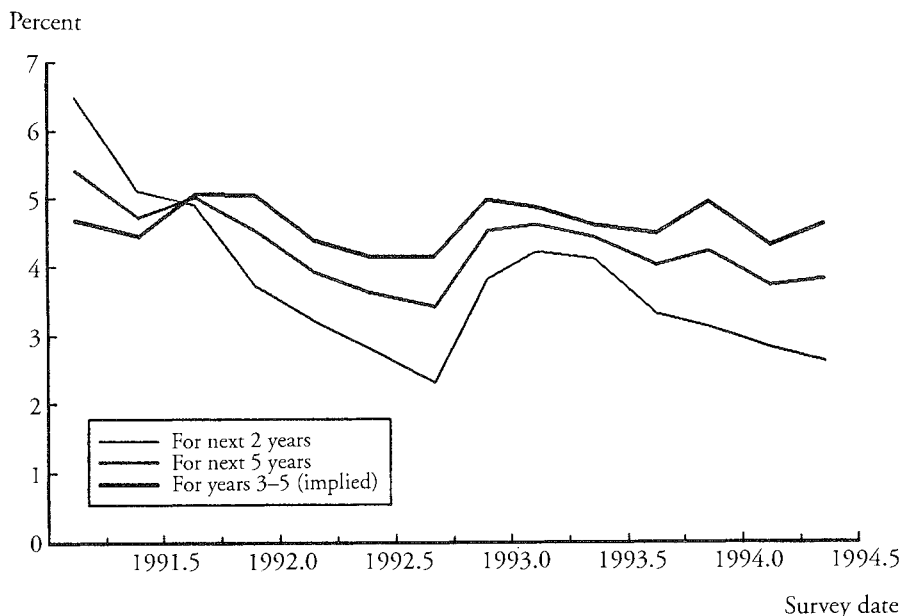
More recently, after the Fed's move in February 1994 to increase short rates, long bond rates and implied forward rates have increased substantially. Although part of this may be a correction of a previous, exaggerated bond price rally, and part may be an increase in real rates, it seems fairly obvious from many commentaries that inflation expectations have increased in the United States. One interpretation is that the credibility of United States monetary policy was more fragile than anticipated, and that perhaps previous credibility was overextended during the long period with very low Federal funds rate.

## 2.2. Inflation expectations for Europe

Dornbusch argues that competitive depreciation need not bring inflation. The evidence quoted on depreciation and inflation for European countries and Canada during 1992–94 is, however, clearly for too short a period and too recent for any conclusions to be drawn. Previous evidence of the inflationary consequences of competitive depreciations during the 1970s and the 1980s certainly speak against competitive devaluations.

Is there a risk for increased inflation today in Europe? Answering that question really means making a conditional forecast of European inflation for the next few years, something that is most warranted to guide monetary policy with floating exchange rates. Several central banks are working hard on learning how to make inflation forecasts, or improving previous forecast methods, in the new situation with more flexible exchange rates in Europe.

Even if it may be premature to make a precise conditional inflation forecast for Europe, one thing is clear. There are certainly *expectations* of future inflation for some of the European countries. This shows up both in surveys of inflation expectations and bond rates. For instance, Bank of

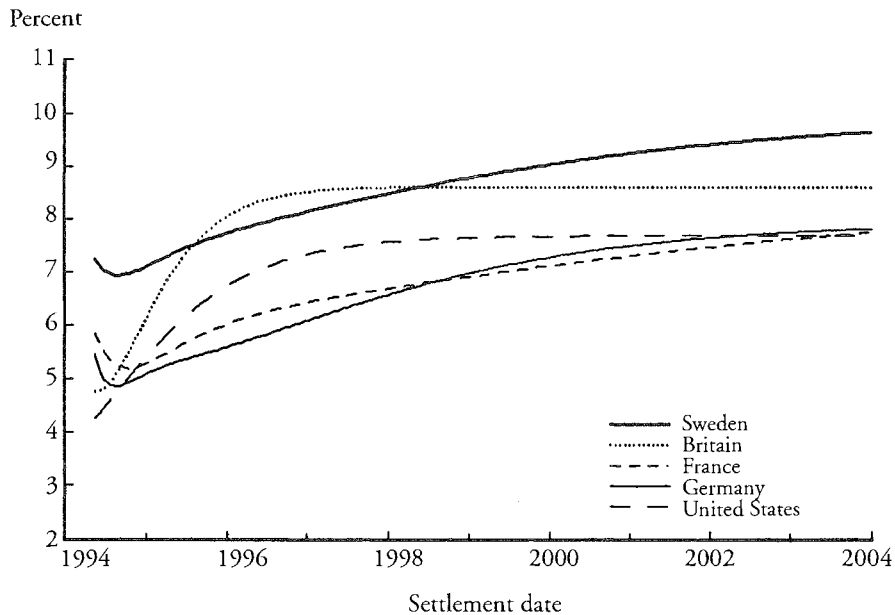
**Figure 1. Expected average future inflation rate, Sweden**

Source: Aragon Securities Fondkommission AB

England (1994) reports survey results indicating inflation expectations for Britain. The results of a survey of large bond investors' inflation expectations for Sweden is shown in Figure 1 (Aragon, 1994). The figure shows the result of quarterly surveys of inflation expectations for the next two and five years. From these it is easy to infer the implied inflation expectations for years 3–5, which are also shown in the diagram. Expectations of inflation for years 3–5 are in the 4–5 percent per year range, to be compared with the inflation target of the Swedish central bank of 2 percent per year from 1995 onwards, with a tolerance interval of  $\pm 1$  percentage point.

What about the evidence of inflation expectations in bond rates? In Britain inflation expectations can be inferred from bond rates with greater precision than for other countries, since Britain has both nominal and indexed bonds. Bank of England (1994), in its model quarterly inflation report, uses the term structure of both nominal and real interest rates to infer inflation expectations. By subtracting real implied forward interest rates from nominal implied forward rates, the term structure of inflation expectations is constructed.<sup>1</sup>

<sup>1</sup> See Svensson (1994) for details on the method.

**Figure 2. Implied forward rates 18 May 1994**

During the spring, both nominal and real implied forward rates have increased. The increase in real rates is about a third of the increase in nominal rates, so the gap between nominal and real implied forward rates has increased. This indicates an increase in inflation expectations, or an increase in the inflation risk premium (due to an increase in the perceived variance of future inflation), or increases in both. An increase in the perceived variance of inflation is, of course, a bad thing, just as an increase in the perceived mean. Any increase in the variance of inflation is unlikely to have been a mean-preserving one; more likely an increase in the variance goes together with an increase in the mean.

The other European countries do not have a market for indexed bonds, so any inference of inflation expectations from nominal bond rates must be conditional upon assumed real rates. Figure 2 shows nominal implied instantaneous forward rates of the trade date May 18, plotted against the settlement date, for Britain, France, Germany, Sweden and the United States. Suppose implied real forward rates for these countries were the same as in Britain at this time, that is, between 3.5 and 4 percent per year. Disregarding any risk premia, the difference between the nominal forward rates in Figure 2 and the assumed real rate can be used as indicating the expected future inflation rate. We see that inflation expectations for France and Germany are rather small (roughly 2–3 percent

per year for 1996–99), higher for the United States, and highest for Sweden and Britain (roughly 4–5 percent per year for 1996 onwards). Even allowing for various risk premia, it seems difficult to deny the existence of considerable inflation expectations for the last three countries.

My conclusion is that although inflation may or may not be dead in Europe, certainly the market thinks that it is very much alive in some of the European countries. This implies little low-inflation credibility for these countries, implying that any further monetary expansion is likely to either confirm existing inflation expectations or increase them further. This is likely to initiate price and wage increases and create actual and not only expected inflation, which in turn is likely to reduce the real effects of the monetary expansion. Far from being safe, a monetary expansion appears as a dangerous and possibly counterproductive policy. A temporary monetary expansion may be suitable for Germany, with its established low-inflation credibility, but hardly for the countries that lack that credibility.

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