

Yes, it's the economy, stupid, but is it demand or supply?

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The recent conversion of François Hollande to supply-side economics is surprising. It makes the victory of the northern European policy-makers who believe that insufficient aggregate demand should be fought exclusively by supply-side measures complete. As I will argue, it is not the first time in post-war history that economists and policy-makers fight a problem by applying the wrong medicine; or to put it differently, it's akin to some generals who fight a new war by applying the strategies developed for the previous war.

When demand management prevailed...

Before the 1970s, economists had developed macroeconomic models of that focused on the question of how demand should be controlled. Two central ideas underpinned these models. First, supply was seen as flexible enough to always adjust to the level of demand. Thus, during the boom, supply would follow and during a recession, supply would decline. Supply was not a problem.

Second, demand had to be stabilised so as to prevent countries from being pulled into deflationary spirals when after a boom negative forces were bringing down aggregate demand. In these Keynesian models, countries could be pushed into bad equilibria, characterised by low output and high unemployment for a long period of time. This provided reason enough for the authorities, both monetary and fiscal, to follow countercyclical policies. Demand management was what macroeconomics was about. Few economists expected that the source of macroeconomic disturbances could come from the supply side. Economists were fully prepared to face the next demand shock.

... a supply shock occurred

Then came the 1970s. A large supply shock occurred. Economists were not prepared to deal with a supply shock. Not surprisingly, therefore, policy-makers who had been educated in this Keynesian framework reacted wrongly. When they saw output decline (prices did not increase immediately; prices usually adjust slower than output), they identified this as a negative demand shock that had to be fought by expansionary monetary and fiscal policies.¹

¹ Orphanides(2001) analysed how the US Federal Reserve misinterpreted the decline in output in the 1970s.

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This policy reaction created a double problem. First as the source of the shock was on the supply side and involved a decline in productive capacity, a demand stimulus could not really correct for this decline. This then led to the second and most spectacular problem. In the face of rigidity in supply, the demand stimulus led to a price-wage spiral and high inflation. Nothing discredited the Keynesian-inspired aggregate demand models more than the explosion of inflation that followed the ill-advised policy reaction of demand expansion.

As a reaction, economists develop supply-side models...

Having learned that the supply side matters, economists started to develop models that focused on the supply side. The 'real business cycle' models were created (see Kydland & Prescott, 1982 and Long & Plosser, 1983).² In the process, Jean-Baptiste Say, the 19th century French economist, was resuscitated. Supply creates its own demand. This was exactly the reverse of the Keynesian view. Now it was supply that should be managed carefully; demand would always adjust automatically.

A whole new generation of economists was educated in the view that supply is key and that demand should not be fine-tuned, for as the experience of the 1970s had shown, demand manipulation in a world where supply shocks occur, not only does not work but is harmful, as it will lead to systematic inflation.

This academic model became very influential also among 'practical men' in the policy-making world. This was especially the case in Europe. The only macroeconomic concern became the need to deal with structural rigidities (supply side) that abounded in Europe. These had to be corrected by structural reforms, i.e. making the supply side of the economy more flexible. By that it was usually meant making the labour market more flexible, i.e. making sure that it would work like other markets.

Underlying supply-side economics, which displaced Keynesian economics, there was also an important ideological shift. While Keynesian economics was generally sceptical about the ability of free markets to regulate the economy and to ensure that full employment would prevail, supply-side economics was confident that if markets were left free they would automatically lead to self-regulation, including a mechanism that would prevent unemployment from remaining high. All that was needed when unemployment increased was flexibility, i.e. a decline in real wages and policies that would not impede the free flow of demand and supply of labour. If labour markets were allowed to function freely, protracted unemployment would be cured automatically.

... and policy-makers embrace these models

This became the official view in Europe and led major institutions like the European Commission and the European Central Bank (ECB) to preach the virtues of flexibility as the key to macroeconomic stability. Surprisingly, these wonderful ideas were not applied to the market for central bankers. With the start of the eurozone and the consolidation of decision-making into the hands of one institution, the ECB, a massive oversupply of central bankers was

² These models are general equilibrium models. As a result, they also model the demand side. However, it is fair to state that these models focus on the supply side by stressing the importance of technological shocks in triggering business-cycle fluctuations. In addition, these models use the representative agent assumption. Thus the demand side is modelled as a problem of a single representative consumer maximising his inter-temporal utility. Since this representative consumer cannot make systematic errors, there is no reason why an outsider like the government should try to correct for the decision of the optimising consumer.

created in the eurozone. None of these central bankers thought of applying flexibility to their own market and to cutting their own wages.

Now, a demand shock occurs...

Then came the shock of 2008-09. Economists and policy-makers were again unprepared. For this was not a supply shock like in the 1970s but a large negative demand shock. It was essentially the result of a consumption and real-estate boom fuelled by bank credit that had crashed, necessitating the deleveraging of the debt-laden private sector. Thus, the shock of 2008-09 was a demand shock *par excellence*, and a large one (see Eichengreen & O'Rourke, 2009, Eggertson & Krugman, 2010 and Koo, 2008). Initially, most economists and policy-makers recognised this to be a demand shock. Thus, during 2008-09, the policy response in important industrialised countries (e.g. the US, the UK and Germany) was to treat this as a demand shock and to allow the government budgets to turn into the red, thereby mitigating the severity of the shock. But then something remarkable happened in Europe. Once it became clear that the debt overhang would not easily disappear and in fact triggered a sovereign debt crisis in the eurozone, economists and policy-makers started looking at the world through the spectacles of their supply-side models. As a result, eurozone policy-makers shifted gears and started to interpret the shock as one arising from the supply side and applied the wrong medicine.

... and policy-makers repeat the same mistake

Policy-makers thus made the same errors as their predecessors in the 1970s who looked at the supply shocks of that time through the spectacles of a Keynesian demand model. Now European policy-makers were looking at a demand shock through the lenses of supply-side models. And as in the 1970s, the policy responses were the wrong ones and made things worse. Policy-makers in the European Union insisted that the cure to the shock was structural reforms, i.e. making labour markets more flexible. The latter was interpreted to mean several things. First, as unemployment was increasing, countries were told that the cure was to reduce wages. As a result, the drag on aggregate demand was exacerbated. Second, in the grip of demand deflation, countries were forced to impose legislation allowing firms to fire workers more easily. As a result, unemployment increased even more because firms were freed during the recession to fire employees and massively did so, thereby exacerbating the recession.

Third, the large budget deficits and debt levels that were the legacy of the 2008-09 recession were seen as the wrong policy response. One does not allow budget deficits to increase when a negative supply shock occurs. Thus, the automatic increase in the budget deficits had to be fought by austerity. The European Commission went on a crusade to impose austerity on all eurozone countries at the same time, thereby triggering a double-dip recession in 2012-13.

During the 1970s, economists found out that in the face of a negative supply shock a fiscal policy stimulus has little or no effect on output. The fiscal multiplier is close to zero. The new supply-side models that were subsequently developed had this feature of zero fiscal multiplier built in. When the demand shock of 2008-09 occurred, these models predicted that fiscal stimulus would have no effect on output (see Fama, 2009). Unfortunately, what is true when supply shocks occur ceases to be true when demand shocks occur that push the economy in a deep recession. It then turns out that fiscal multipliers are higher and can exceed 1. The IMF was forced to recognise this and admitted that its initial policy analysis of the 2008-09 shock had been based on models that predict low fiscal multipliers in the face of supply shocks (see Blanchard & Leigh, 2013). Other institutions, like the European Commission, have been unwilling to admit their error.

Five years after the negative demand shock of 2008-09, policy-makers continue to misdiagnose the nature of that shock. Now the French President François Hollande has joined the crowd of European policy-makers who strongly believe that supply-side measures are all that matters in Europe and that such measures will automatically lead to solving an insufficiency of demand. This is a surprising change of strategy especially now that, for at least one year, the rate of inflation in Europe, and especially in the eurozone, is declining continuously. In early 2014, it reached 0.8%. If the shock had come from the supply side, one would have observed an increase in inflation, very much like in the 1970s when the European and American economies were hit by a negative supply shock.

Hollande gives new boost to misdiagnosis

The change in policy strategy of François Hollande and his embrace of Say's law are surprising on another count. As mentioned earlier, supply-side economics together with a rejection of demand management is based on an ideological premise that markets have self-regulating characteristics, and that unemployment will therefore disappear automatically provided that the markets are left free. This conversion towards a belief in the power of free markets is not something one would have expected from a Socialist president. The European Commission, the German government and other European leaders are cheering. Together, they are more than ever determined to fight an insufficiency in aggregate demand with supply-side measures.

I certainly do not want to imply that there are no supply-side problems in the eurozone. The existence of dual labour markets, which makes it difficult for young people to enter the labour market, is a major source of concern. The low labour participation in many countries is another. There is a lack of competitiveness of firms in some eurozone countries due to institutional features that slow down the introduction of new technologies. All these features call for structural reforms. But these reforms were also called for during the boom period. Introducing these structural reforms will raise the long-run prospects of the eurozone. They will do little, however, to boost aggregate demand.

In fact, boosting aggregate demand is important to make some of these structural reforms effective. As I argued earlier, without such a boost, many of the structural reforms prolong the insufficiency in demand in the eurozone. Yet as the recent trip to Damascus of François Hollande indicates, European policy-makers are determined to cure a demand-side problem by focusing exclusively on supply-side medicine.

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