Editorial

Prof Dr Lutz Hoffmann,
President of the German Institute for Economic Research, asks:

'Can fiscal expansion avoid danger of deflation?'

On 1 January 1999 the euro became legal tender in 11 European countries. Without doubt this marks a key step on the way to full economic integration in Europe. In order to achieve this goal, opponents of the euro, mistrustful of economic policy laxity, had to be mollified by introducing restrictive institutional regulations. This was a high price to pay. The scope for monetary and fiscal policy action has been restricted to such an extent that policy makers' hands are tied to a far greater extent than in Europe's leading competitor, the USA.

The European Central Bank (ECB) is independent and its monetary policy is committed primarily to the goal of price stability. Already all the signs are that it will interpret this goal strictly. The ECB Council has not set a concrete inflation target, but merely a maximum of the Harmonised Consumer Price Index of 2%. The impression gained from statements issued by representatives of the ECB is that the further the actual inflation rate is below this ceiling, the better. This is hardly surprising given that the institution was created with virtually only the price stability goal in mind, and was then allowed to define the target itself.

In Germany the Bundesbank, Employers' Federations and the Council of Economic Experts are lobbying for a policy of wage restraint that would perpetuate the trend of declining unit labour costs that has been maintained for the past three years. Given that competition on goods markets will become more intense within the euro zone, and global economic activity is tending to weakness, firms will be forced to pass on these cost reductions in the form of lower prices. Inflation, currently at the very low level of between 1% and 1½%, will thus continue to fall. The risk of deflation can then no longer be precluded. Once a deflationary process has set in, central banks can do little about it. As the example of Japan currently illustrates, economic policy makers then have great difficulty in preventing the economy drifting into a deep recession.

The Keynesian answer in such a situation would be an expansionary fiscal policy. Yet Paul Krugman has recently pointed out that traditional pump timing, that is a short, sharp fiscal impulse, cannot function, and even in the 1930s, contrary to the conventional view, was not responsible for the economic recovery. Consequently, fiscal expansion would have to be maintained at a significant level over an extended period. Yet it is precisely this that is not possible under the Stability Pact. Moreover, in the longer run it would have highly damaging implications for government debt and the fiscal policy room for manoeuvre in the future. This implies that things must not be allowed to get so bad in the first place. For the policy of the ECB this means that it should interpret the target rate of inflation in such away that a significant undershooting of the target induces an equally vigorous reaction by monetary policy as its overshooting.