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Unemployment in the United States and in Europe
A Contrast and the Reasons

I hope it will be understood from the beginning that I am not one of those Americans who think that the Celestial Economist smiles with special favor on the U.S.A., or that American businessmen are more entrepreneurial, American workers more ingenious, and American policies more appropriate than their European counterparts. Not at all: I spend most of my time finding fault with American businessmen, workers and economic policies, and with American ideas about those things. Nevertheless, what I plan to say today is implicitly critical of European and German thinking about macroeconomics, and also about the policies that follow from that thinking. I ask you please to keep it in mind that I am really trying to make a few general remarks about macroeconomic principles and macroeconomic policies. I could just as well be talking about two places called Ruritanien and Schlaraffenland, not Germany and the U.S., and maybe I am.

The basic facts we have to understand are easy to describe and well known to most of us. In 1970 the unemployment rate in the U.S. was five percent, that in (West) Germany was one percent, and in the rest of the European Union the unemployment rate stood at three percent. In those days, myself included, used to wonder that the U.S. would have to do in order to reproduce the European experience. In 1997 the unemployment rate was still five percent in the U.S. (4.9 percent to be exact) and in 1998 it was a full half-point lower. Meanwhile the (Unified) German unemployment rate was at ten percent and the rest of the European Union was between eleven and twelve percent.

The contrast is certainly striking. Europe used to have consistently lower unemployment than the U.S.; now it has higher. Since 1970, there has been no trend in U.S. unemployment; it is actually a bit lower than it was then. But there have been marked business-cycle fluctuations, with the unemployment rate peaking in 1975, 1982 and 1992, and reaching low points before and after the peaks. Today we have the lowest unemployment rate in 30 years. When you look at the European experience, the clear impression is that there has been a strong upward trend that dominates the business cycle. Unemployment fell cyclically in the late 1980s, but not sharply; it has fallen a bit recently, but even less sharply. There seems to be no

tendency for the European unemployment rate to go back to the levels that were commonplace thirty years ago.

It is very important to realize that this striking contrast can not be explained by a corresponding difference in the size of the working population. It is not the case that unemployment is now low in the U.S. and high in Europe because Americans choose not to join the labor force while Europeans do. It is, in fact, the other way round. In 1997, 73.5 percent of Americans between 15 and 64 years of age were employed, as against 60.4 percent for the European Union and 63.5 percent for Germany. the figures for participation in the labor force are, of course, similar: 77.4 percent of Americans in that age group are counted in the labor force, as against 67.7 percent in the EU and 70.4 percent in Germany. Those observations apply to men and women together, but the figures would be pretty much the same if we considered men and women separately. In fact the contrast is sharpest for women: 67.1 percent of the age group is employed in the U.S., 50.5 percent in the EU, and 54.6 percent in Germany. We shall have to explain the contrast in unemployment by explaining the parallel contrast in employment.

I want to make another observation that may be useful later on. It is that unemployment has fallen much further in the U.S. in the past six years than most economists thought it could do without setting off a burst of inflation. I can easily remember when most of my colleagues believed that whenever the unemployment rate fell below six percent - some said 6.5 percent - inflation would get worse. We crossed that line more than four years ago and are now at 4.3 percent unemployment. During those years of considerable prosperity and job creation, there has been no tendency for the price level to rise dangerously. Very recently there has been a slow acceleration of wages, not yet translated into prices, though of course there is every reason to watch carefully.

Those are the basic facts. I have ignored a few minor details, some of which would sharpen the contrast and some of which would weaken it. Conscience requires me to say that a part of the ability of the recent American economy ot have very low unemployment and very low inflation at the same time is just good luck. This good luck takes several forms, including (a) the spectacular drop in the price of computers, combined with large and growing purchases of computer equipment, (b) a period of slow growth of the health-care costs that are otherwise such a problem

for the U.S., and (c) continued improvements in the measurement of the Consumer Price Index itself, most of which eliminate earlier overstatement of inflation. These sources of price stability can not continue forever, so a time may come when the performance of the U.S. economy will no longer seem so wonderful. But I want to emphasize that the minor amendments I mentioned will not change the basic contrast you have seen. There might be a gentle rise in the U.S. unemployment rate after 1970, instead of fluctuations around a horizontal trend. But the rise would still be small compared with what has happened in France and Germany, and elsewhere in the European Union.

That contrast poses an inevitable question: what explains the difference between the current levels of unemployment in Europe and the U.S.? There is a tendency in matters like this to assume that there must be one single answer to this question, one secret ingredient that explains why the U.S. has kept its unemployment rate moderately low while Europe has seen its rate rise to high levels and get stuck there. That would make for drama; but economic life is not necessarily like a detective story, what Americans call a "whodunit". It is more likely that the difference between American and European unemployment arises from the cumulation of several differences in institutions and policies.

Furthermore, the talk of "Europe" is not always appropriate. There are big differences within Europe; for instance Austria, Norway and, more recently, the Netherlands and Denmark have avoided the high unemployment that has continued to characterize France and Germany. In particular, as you know better than I, Germany has special problems of its own, associated with reunification and with the international role of the Bundesbank. The most I can hope to do is to pick out a few useful lessons that bear on the main issue.

The conventional understanding of this contrast, especially among Europeans, seems to rest entirely on *labor-market rigidities*. As evidence I can cite the title of a recent and exhaustive article (in English) by my old friend Professor Horst Siebert, President of the Kieler Institut für Weltwirtschaft, member of the Sachverständigenrat, and certainly one of Europe´s leading economists. The article was called "Labor Market Rigidities: At the Root of Unemployment in Europe".

Beyond doubt there are plenty of labor-market rigidities to rest an argument on. The main ones to attract attention seem to have been: (a) the relatively low replacement rate embodied in the U.S. unemployment insurance system compared with most European countries, as well as the relatively short duration of benefits allowed in the U.S., the natural consequence being more active search by unemployed workers and more willing acceptance of inferior job offers; (b) the broad scope of legal restrictions on discharging workers in Europe which, though perhaps working against unemployment in the short run, has the long-run effect of discouraging job creation and strengthening the power of incumbent workers to protect wages at the expense of outsiders seeking employment: (c) the relatively low minimum wage in the U.S., which allows higher employment of low-productivity workers at the expense of greater wage inequality; (d) Siebert points out that the U.S. labor market generally allows greater wage differentiation between classes of workers than in Europe, but I think this may be a more complicated matter than just a difference in labor-market institutions; (e) the greater density and power of trade unions in Europe; (f) the wider wedge of payroll taxes and social charges in Europe that surely pushes some low-wage workers below the margin of employability; even if the long-run incidence of such charges is generally on workers´ wages, this tax-shifting may not be possible at or near the minimum wage.

That is an impressive array of labor-market rigidities. So perhaps it is understandable that this is the *only* explanation of high unemployment that is ever discussed seriously by civil servants and central bankers in much of Europe, especially Germany. Consequently the only potential cure for high and persistent unemployment that is ever seriously discussed is labor-market reform and wage moderation, though that process is inevitably slow and sure to be socially divisive.

One important respect in which labor-market rigidity clearly plays a major role is in the employment of low-wage workers in an important industry like retailing in the U.S. The relatively low minimum wage has allowed the retail-trade sector to absorb a large number of low-productivity, low-wage workers. And retail formats have evolved correspondingly. In France, for instance, the high minimum wage simply cuts off many workers from the job market. Germany does not have a legal minimum wage, but custom and the large tax wedge must have a similar effect. This part of the population is larger in the U.S. than in Europe, probably because of badly-run, ineffective school systems, especially in poor neighborhoods. Of course

I would not recommend that the E.U. imitate the U.S. in this respect; but it could learn from American experience and find its own mode of adaptation.

I do not think one can deny the significance of labor-market rigidities in Europe, and the likelihood that greater flexibility in the U.S. contributes to its much more favorable performance in terms of employment. But I believe that the almost exclusive focus on this aspect of the problem is a major mistake. It hides other, very important, lines of causality, and steers Europe away from possible policy strategies that could have substantial results in much less time, and with a fairer distribution of the burden.

I think this is in part an intellectual failure. Sometimes it is hard to escape the thought that the single-minded focus on the labor market stems from the naive belief that unemployment *must* be a defect in the labor market, as if the hole in a flat tire must always be on the bottom, because that is where the tire is flat. Alternatively, or in addition, one detects an equally naive belief that a complicated market economy achieves some sort of favorable, unimprovable, equilibrium very quickly, smoothly and inevitably.

There are good empirical reasons for rejecting this convenient belief that the labor market *by itself* provides an adequate account of the sad story of European unemployment. At the crudest level, the timing is wrong. One of the two big increases in unemployment took place in the early 1980s, although there was no change in labor-market regulation to account for it.

The argument was sometimes made that European wage determination (unlike the U.S.) exhibited "real-wage resistance" or effective indexing of the nominal wage. This stickiness of the real wage could certainly be a source of unemployment in principle and in fact. But real-wage resistance must eventually have worn off. The profit share has risen to very high levels in Europe, meaning that real wages have not kept pace with productivity. But unemployment did not wither away, so this story is inadequate. And the further rise in unemployment after 1990 came during a period when labor markets were being deregulated in the major nations of Europe. (The most recent increase in Germany, in 1996-97, actually happened at a time of wage moderation.) Some other forces must have been at work.

The second empirical reason for rejecting an exclusive focus on the labor market is less obvious and more indirect. A useful summary indicator of many kinds of labor-market rigidity is the position of the so-called *Beveridge curve*, named after Sir William Beveridge´s famous wartime report *Full employment in a Free Society*. Beveridge chose to define "full employment" as a situation in which there are as many unfilled jobs as there are unemployed workers. The definition was not generally acceptable, but it suggested studying the relation between the number of unemployed workers and the number of unfilled jobs, both expressed as a fraction of the labor force.

In any country at any moment, the Beveridge curve is a downward-sloping relation between the vacancy rate and the unemployment rate. One can usually find such a curve in national time series, if the relevant data exist. It has a negative slope for the common-sense reason that jobs are easier to fill, and the vacancy rate therefore is lower, the more unemployed workers there are for employers to choose among. A perfectly flexible or efficient labor market would interpose no obstacle to the frictionless matching of an unfilled job and an unemployed worker with the appropriate skills. Flexible wages would adjust so that every part of the labor market had, within reason, adequate employment opportunities. In that case, vacant jobs and unemployed workers could not coexist. The Beveridge curve would coincide with the axes of the diagram: there could be vacancies with no unemployment or there could be unemployment with no vacancies. One would expect pressure on wages in either case.

Of course no real-world labor market could be perfectly flexible in that sense. Labor-market rigidities (including skill mismatches as a special form of rigidity) are precisely what allow vacancies and unemployment to coexist, and the more rigidities there are, the more the Beveridge curve diverges from the hypothetical limiting case, the further from the zero-zero point it is located.
It is easy to check that each of the specific symptoms of labor-market rigidity that I enumerated earlier has the likely effect of shifting the Beveridge curve outward. Looking at the history of a nation´s vacancy and unemployment rates will tell us something about the extent to which its labor market has become more or less flexible. In the U.S., for instance, there appears to be a well-defined Beveridge

curve for 1958-71 that shifted adversely in the early 1970s and then returned to its initial position in 1987-88, and has stayed there since.

It is more interesting and relevant to look at France and Germany, where the story is quite different. I will show you the pictures: it is hard to decide if there was a small adverse shift in the French and German Beveridge curves around 1975 or if there was none at all. We do not need to know: even if there was an adverse shift, a worsening of overall labor-market rigidity, it was very small compared with the U.S. The main message transmitted by the Beveridge curves for France and Germany transcends this minor possibility of alternative interpretations. The message goes squarely against the cliché that high and persistent unemployment is entirely or mainly a matter of worsening function of the labor market. It is precisely in France and Germany that there is no sign of a major unfavorable shift of the Beveridge curve during the period of rising unemployment.

To the extent that the location of the Beveridge curve is a reasonable summary of the degree of labor-market rigidity, the large continental economies do not seem to have suffered from noticeable more rigid labor markets during the high-unemployment 1980s than they did in the low-unemployment 1970s. In fact, what stands out from the data for France and Germany is precisely the depressed level of the vacancy variable, i.e., the weakness of the demand for labor. Unfortunately the data sources do not allow the analysis to be extended to the 1990s (especially for Germany after unification), but there is no reason to suppose that the situation has changed. A pure supply-side explanation of the difference between the U.S. and Europe seems to be quite inadequate in view of the facts.

I think I detect also in Germany a tendency to identify "supply-side policies" with labor-market deregulation. That does not have to be the case; and I think it very likely that part of the European problem stems from differences centering around product markets. These take the form of excessive product-market regulation, accompanied by practices that limit the exposure of European firms to competition from best-practice firms, especially from transplants. A closely related deficiency is that European capital markets fail to force corporate governance structures to achieve better performance. I can not take time to provide the evidence for these suspicions now; it is contained in some studies of French and German economic

performance made by the McKinsey Global Institute, in which I have participated along with some other economists.

What has this sort of thing got to do with unemployment? Careful studies in the U.S. have demonstrated the importance of analyzing net changes in employment and unemployment as the resultant of *gross flows* of job creation and job destruction. One notices that, even when total employment and unemployment are hardly changing at all, large numbers of jobs are being created while others are being destroyed. There is always movement in and out of the three basic states: employed, unemployed, inactive.

As I hinted earlier, much of the European failure to reduce unemployment arises from low exit rates from unemployment during limited business-cycle upswings. This in turn suggests that an important part of the problem is an inadequate rate of job creation. Here may be the source of the shocking difference between Europe and the U.S. in the incidence of long-term unemployment. In the U.S. in 1997, 8.7 percent of all the unemployed had been out of work for more than 12 months. The corresponding figure for Germany (1996) was 47.8 percent, for France 41.2 percent, for the U.K. 38.6 percent, and for the E.U. as a whole 50.2 percent. Even in recession years the incidence of long-term unemployment is much lower in the U.S. If more jobs were being created in Europe, in a variety of industries in a variety of places, the exit rate from unemployment would be higher. It is even possible that the tolerant character of the European unemployment insurance system is as much a response to as it is a cause of the low exit probability from unemployment.

A weakness in job creation could have several sources; one of them might be those legal restrictions on firing workers. But I suggest that product-market deregulation (of opening hours, land use, banking practices) and increased competition might help to reduce unemployment by improving employment prospects. This would look fairer and be fairer than a narrow focus on labor-market measures that would just increase working class insecurity. If it should be confirmed that European firms are backward about creating jobs, then one can easily think of other ways to improve the situation, like easing the supply of venture capital and finance for small and start-up firms. Exclusive focus on the labor market tends to crowd such possibilities completely off the radar screen.

Now I want to speak about the unspeakable: I am almost tempted to suggest that women and young people leave the room. The subject is one that, if it is mentioned at all in polite company, is grouped with witchcraft, drunkenness, and the abuse of children, things that we know are there but that are best denied. It is possible that one source of continued high unemployment in Europe is that the domestic demand for goods and services, and therefore for labor, has been forced to unnecessarily and unhealthily low levels?

To be more blunt, I mean to suggest that American fiscal and monetary policy has been more successful than Europe has been in supporting aggregate demand, and above all more aggressive in taking advantage of opportunities to expand whenever inflationary pressure has been weak, whatever the cause of that weakness. This could be important for two reasons. The first reason is quite direct: the direct effect of excessively tight fiscal and monetary policy on an economy with limited wage and price flexibility, that is, on any economy we know. It is not a new thought that the imposition of the Maastricht criteria and the rush to satisfy them have forced European economies into fiscal consolidation and high real interest rates. The only dream-like aspect of this is the belief sometimes expressed and tacitly accepted that this can have nothing to do with high unemployment.

The second reason why demand-side policy could be very important has to do with its interaction with the supply side. Any gain in labor-market flexibility or in product-market deregulation will be both more effective and more easily accepted if it occurs at a time when aggregate demand is strong and market prospects are favorable. There is likely to be considerable payoff to coordination of supply-side and demand-side policies within the large European countries and among members of the European Union.

In even more unfashionable words, I think that some part of European and German unemployment is "Keynesian" in character and would respond to expansionary demand-side policy at a time when there is little inflationary pressure. I do not want to guess how much unemployment, in Germany for instance, is accounted for in this way. I have seen one estimate that it could be between 1.5 and 2.5 percentage points. Other nations of the European Union could of course differ, in either direction. This is just the sort of question that economic research could illuminate; the puzzle is that more is not being done.

Bad policy sometimes comes from bad ideas (although it may occasionally happen that bad ideas are fabricated to justify bad policies). I have just suggested that a key question for Germany (and France and much of Europe) today is this: how much scope is there for deliberate expansion of demand? To put it more explicitly: by how much could the level of production and income rise without pressing on productive capacity and stimulating inflation? For economists this very same question appears in a slightly different form: what is the gap between the current level of aggregate output and *potential* output, the level of GDP that would employ capital and labor fully, without stretching or overheating?

It seems to me that, in Germany, both the Bundesbank and the Sachverständigenrat answer that question in a doctrinaire way. They simply *assume* that the gap is almost never more than trivial. In other words, they take it for granted that, in the absence of inflation, the economy is always producing just about the right amount, employing just about the right number of people, utilizing its capital at just about the right intensity, given the rules governing the labor market. In that view it is essentially never correct to use fiscal and monetary policy to create additional demand for goods and services in order to induce higher production. At least it is never correct *now*, whenever now is.

There is a very strange asymmetry at work here, however. I suspect we could all easily imagine circumstances in which the Bundesbank would think it appropriate, even necessary, to use monetary policy to eliminate excess demand, i.e., to cause the economy to contract. It is therefore possible for demand to exceed supply in the aggregate. But somehow it never happens that demand falls short of supply persistently enough to call for offsetting policy. I think there is no good theoretical argument to support this view. It is at best an article of faith. Where I come from, many economists think that the gap between actual and potential output is a quantity that may be positive or negative, depending on circumstances. In any case it is a quantity to be imperfectly estimated, not something known by divine intuition.

Some European central banks, including the Bundesbank, go through the motions of estimating the gap by a more or less elaborate statistical procedure. I can not go into the technical details here, but these procedures are essentially a dogmatic exercise. They are guaranteed either to smooth away any persistent difference

between actual and potential output, or else to tell you that if output is below potential this year it *must* have been above potential last year or the year before. I can be more explicit: if I understand the Bundesbank´s method adequately, it is *required* always to make the average level of potential output during each four or five year period equal the average level of output actually observed during that same period. This means that the calculation can never conclude that there has been a persistent gap in either direction. This method is not confirming the dogma; it is part of the dogma.

If this method had been applied in the 1930s, it would have reported a much smaller Depression than we believed then and believe now to have occurred; it would have claimed that the Depression was only about half as bad as it appeared to be. In addition, it would have come to the truly remarkable conclusion that some of those long depression years - which certainly contributed to the rise of Hitler - were actually years of excess demand and overemployment. The Bundesbank, if it had existed then, would have felt impelled to contract the already desperate economy; and the Sachverständigenrat would have agreed.

Of course that foolishness would never have occurred. Their own intelligence and common sense would have told the Bundesbank and Sachverständigenrat what was happening, and they would have reacted constructively. Yes, of course they would, but we are then entitled to ask the question: why should it take a catastrophe like the Great Depression to interpose a little common sense into macroeconomic thinking?

In the U.S., economists have developed simple methods to estimate the gap between potential and actual output that do not prejudge the answer. I do not think that we are foolishly optimistic about the accuracy of these estimates; we know that they rest on observed economic regularities that may change unpredictably; so the estimates are only rough approximations, and may be systematically wrong for a while before the errors are noticed and corrected. But at least they are a way to appeal to observation instead of doctrinaire belief. I am going to see what such methods might say about Germany today. Please do not take what I say literally. The exercise should be carried out by German research workers who are more familiar with the data than I am. I wonder why they are not already doing so.

The idea that I am trying out is based on what we call - maybe half-seriously - Okun´s Law: that the percentage gap between actual GDP and potential GDP is proportional to the difference between the current unemployment rate and some hypothetical "neutral" unemployment rate. Knowing *that* number is a question with no good answer. The practice in Germany that I just described and criticized amounts to *assuming* that the neutral rate is more or less identical to the average of current and recent unemployment rates, whatever they happen to have been. Since that simply wishes away the whole problem, there is need for a more open-minded, reality-oriented approach.

Indeed we can take a few useful steps without making any commitment to a particular value for the neutral unemployment rate. For instance, Okun´s Law allows one to estimate how fast potential output is growing. If I try that, using German data for the period 1981-1996 (omitting the transition year 1990-91, which is obviously distorted), the result is a growth rate of about 2.4 percent per year, with danger of a slight upward bias. This is fairly close to conventional estimates, and gives one some confidence in the procedure. (Using the whole period from 1970 to 1996 yields a higher figure for the potential growth rate, but I prefer to be conservative.)

Knowing the growth rate does not locate potential GDP. But suppose we knew in addition, or were prepared to assume, that some particular year was a year of very small difference between actual and potential GDP. Then the estimated growth rate would allow us to extrapolate the trend of potential GDP at least for a few years on either side of that year. My impression is that many German economists would accept that 1989-1990 was such a period; it will do no harm for me to proceed on that basis, because I am not looking for final results but merely for an illustration that will induce German macroeconomists to do the research properly.

If I use the estimated annual growth rate of 2.4 percent for potential output, and anchor the trend at 1990, I find that GDP in 1997 was as much as six percent less than potential. That is a large gap; it naturally leads me to worry that an overestimate of the potential growth rate might have led to an implausibly large gap in 1997. If the growth rate is scaled back to 2.2 percent a year, the estimated gap between actual and potential GDP in 1997 falls to 4.9 percent; if the rate of growth is as small as 2.0 percent a year, the gap is 3.7 percent.

Okun´s Law also provides an estimate of the excessive unemployment corresponding to any shortfall of GDP. In this case the suggestion is that something between two and a little over three percentage points of German unemployment is demand-related. That means: it arises not from a failure of the labor market but from unnecessary weakness of the aggregate demand for goods and services. It is clear from the data that, in manufacturing at least, the weakness is in domestic demand, and not in exports.

The exact size of the demand gap is not so important. The point of this exercise is *not* to propose simple Keynesian reflation of the German (or European) economy. I am *not* suggesting that supply-side policy be replaced by demand-side policy. The real point is more subtle. Yes, the German labor market is too rigid, and more flexibility would be a good thing. But merely creating a more flexible labor market by itself has two disadvantages. The first is that it will work to increase employment, production and income only very slowly, if at all. Business firms will not leap to create more jobs just because unemployment benefits are a bit less generous and wages can perhaps be driven a bit lower. The second disadvantage is that pure supply-side policy is redistributive. It will transfer income from workers to firms. It is bound to be socially divisive.

Simultaneous expansion of demand, by significant though not necessarily very large amounts, will make labor-market policy more effective and less divisive. Employment will rise more rapidly if firms see expanding markets. Some of the wage reduction that might come about in the pure supply-side scenario will be offset by demand-induced job creation. The extra employment will provide some tangible compensation to the workers´ side of the labor market, making the whole package more equitable and more acceptable.

The point of the casual calculation I reported a moment ago is to suggest that there may be room in the German economy for a non-trivial expansion of demand. The methods now used officially in Germany to make such judgments tend to prejudge the issue; they know that the answer is No before they look at the facts. Academic researchers in Germany should be making more knowledgeable and more extensive calculations of their own than an outsider can possibly do.

It will be said, and with some truth, that even modest demand expansion is now beyond Germany´s reach. Monetary policy is in the hands of the European Central Bank, and fiscal stimulus is ruled out by the Maastricht limits on budget deficits. I am willing to accept that judgment. It is not for an outsider to quibble.

But I have a different sort of suggestion to make, based on two hypotheses. The first is that most of Europe, like Germany, would be better off for some demand expansion, after a period of excessively contractionary policy in preparation for the European Monetary Union. The second hypothesis, which is not controversial, is that Europe, again like Germany, would be better off if demand expansion took the form of a sustained rise in investment spending. It is generally agreed that investment has stagnated, at some cost in productivity.

It would seem to follow from these presumptions that a reasonable macro-policy for Europe would start with a clear, steady determination by the European Central Bank to push nominal and real interest rates down. The recent action could be taken as a first step in that direction. The danger in such a policy is that the national economies of the Euro area are not all in the same position. Some may have larger demand gaps than Germany, and some smaller. They will individually need to make policy adjustments to balance their own economies, presumably through fiscal-policy changes. That is exactly the point of the proposal: a serious policy of monetary ease would need to be offset in most or all countries by a move toward *tighter* fiscal policy. And that is exactly the direction in which the Maastricht criteria leave everyone with freedom of action. Some coordination would be needed, but each nation could act in ist own interest.

This combination of low interest rates and tight budgets is exactly what is needed to revive investment demand and to help provide, through national budgets, the savings to finance the needed accumulation of capital. The coordinated use of two instruments, monetary and fiscal policy, allows in principle the achievement of two goals, expansion of aggregate demand and the favoring of investment.

I have one more brief general remark to make about the contrast between the U.S. and Europe. It has to d not with the details, but with the spirit of policy-making. I think it is fair to describe American monetary policy in recent years as above all opportunistic. When there has been a window for expansion - in particular a lull in

inflationary pressure - the Federal Reserve has generally allowed some expansion to happen, almost casually, all the while reminding us, quite honestly, of ist single-minded devotion to the constant struggle against inflation, and all the while prepared to reverse itself if things go wrong. The story of the past two years is a perfect illustration, and it has worked. Alan Greenspan and his colleagues deserve credit and admiration for pragmatism and flexibility. They are certainly not careless inflationists. And they have presided over a delicious fall in unemployment, to their own surprise, and mine.

In contrast, I think anyone would describe European monetary policy, which has meant in practice the policy of the Bundesbank, as rule-bound. I am sure that German and other European central bankers look at the figures, wet their fingers and hold them up to the wind. As Americans say, they talk the talk and walk the walk. But in the end, they do what preordained abstract "principle" tells them to do. If the Bundesbank were sitting in Washington, the American prosperity would have been cut off by higher interest rates at least two years ago, and more likely four years ago. The U.S. would have lost two years of upswing, maybe four. The unemployment rate would be at least one and a half points higher than it is now. As a reward, the Consumer Price Index which actually rose by 1.5 percent in the past year would have risen perhaps by only 1.2 percent. This does not seem like a bargain.

More flexibility in labor markets is a good idea, but it is not the only good idea.