

# Europe's Recurrent Employment Problems

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As the euro crisis continues and unemployment climbs to new heights, the clamour calling for Europe to 'do something' is getting louder. But the real question is: can Europe, or rather the EU, do 'something' that would actually have a real impact on unemployment? In other words, does a European plan or employment strategy make sense?

The honest answer is that the EU as such can do very little to affect employment in the short run. And over the long run, there is scant evidence that the EU's Lisbon strategy had a significant impact on employment.<sup>1</sup>

The present 'reorientation' of priorities constitutes a recurring pattern in European politics: at first austerity is proclaimed as the precondition for growth, but when recession bites, growth and employment become the precondition for continued austerity. Europe has already been through this cycle, about 15 years ago. In the early 1990s, when plans for EMU were drawn up, Germany pushed through the 'Stability Pact' as a price for giving up the Deutsche Mark. As Europe sank into deep recession after 1995, attention shifted to growth and the 'Stability Pact' became the 'Stability and Growth Pact' (SGP) when the European Council adopted a Resolution on Employment and Growth in 1997. However, this Resolution, which contained the already familiar list of ingredients

(labour market reforms, education, etc.) remained 'aspirational' - although the unemployment problem then was as acute as it is today.

If Europe is to avoid falling into the same trap again, a few hard facts need to be faced. Moreover, Europe's policy-makers need to realise that this recession is different so not all of the old recipes will work this time.

It is always best to start with the facts:

## 1) Southern Europe has a structural unemployment problem

First of all, it should be recognised that the unemployment problems of the euro area's South are endemic. Figure 1 shows the unemployment rates of the euro area 'North' (Germany, the Netherlands, Austria, Finland, Belgium and Luxembourg) and the euro area 'South' (Spain, Italy, Greece, Portugal, Malta and Cyprus). It is apparent that southern unemployment rates were almost always much higher than those of the north. This salient fact tends to be overlooked today, but in the 1990s it played a key role because it was taken as proof that price stability and fiscal rectitude also delivered higher employment.

However, this key insight was forgotten as the long credit boom allowed the South to reduce unemployment on the back of huge capital inflows. When these flows stopped (economists call this a 'sudden stop', which was only supposed to happen in emerging markets), unemployment shot up. Figure 1 also shows that

<sup>1</sup> Gros, D. (2006), "Employment and Competitiveness: The Key Role of Education", CEPS Policy Brief No. 93, February (<http://www.ceps.eu/book/employment-and-competitiveness-key-role-education>).

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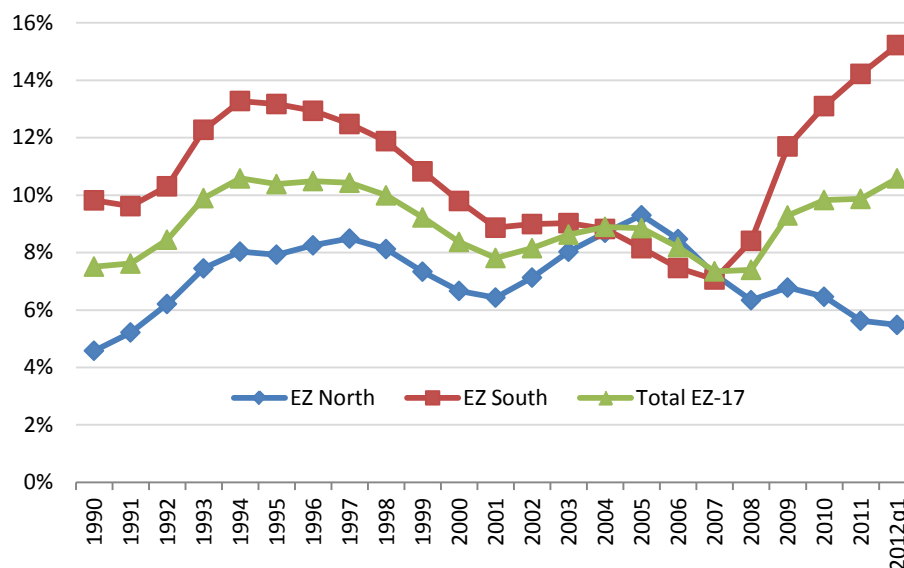
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15 years ago the unemployment problem was as urgent as it is today. In Spain the unemployment rate was above 21% in 1994 – almost as high as it is today, and in Italy it was higher in 1996 than it is today.

The main difference between the 1990s' cycle and that of today is that during those years the South and the North experienced broadly the same cycle, albeit with differing amplitudes. Today the divergence is much more extreme: unemployment rates in the North and South are actually moving in opposite directions. This has

concrete implications: for Germany and its neighbours, there is simply no 'employment emergency' and hence zero political appetite for special efforts to stimulate the economy or undertake labour market reforms. On the contrary, in Germany minimum wages are now being extended to more and more sectors. This is of course the opposite of what Germany is preaching to other countries. But in reality it should be regarded as a small but useful contribution to the much-needed rebalancing exercise within the euro area.

Figure 1. Unemployment rates



Note: EZ North includes Germany, the Netherlands, Austria, Finland, Belgium and Luxembourg; EZ South includes Spain, Italy, Greece, Portugal, Malta and Cyprus.

Source: Eurostat.

## 2) Youth unemployment is ingrained

The second hard fact: youth unemployment has now reached 50% in Spain and is soon likely to reach a similar level in Greece. This is always described as 'unacceptable'. However, the sorry reality is that it was already that 'unacceptably' high in Spain in the mid-1990s. Moreover, the relationship between youth unemployment and general unemployment has generally not differed in this recession from previous ones. Figure 2 shows the ratio of youth unemployment (population aged 15-24) relative to that of total unemployment (ages 15-64yrs). It is apparent that in most countries this ratio has been constant,

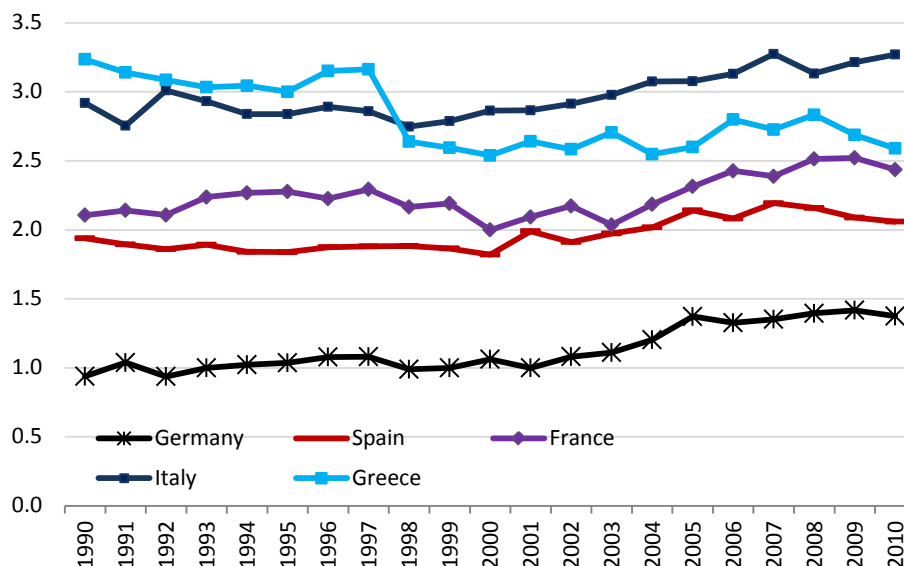
indicating that the current extreme levels of youth unemployment in southern Europe are neither unprecedented, nor should they be considered surprising given the deep recession. In southern Europe the youth unemployment rate has always been between two and three times as high as the overall unemployment rate.

Moreover, one should keep in mind that the 50% youth unemployment rate refers to the percentage of young people looking for work, but unable to find it. In southern Europe there are actually relatively few (even before the crisis) young people looking for work, given that youth labour force participation rates are low. The 50%

unemployment rate in Italy refers only to the less than 30% of all youth (aged 15-24) who are actually looking for a job. This explains why there are more unemployed young people in the UK (1 million) than in Spain (900,000) or Italy (600,000),

even though the youth unemployment rate in these two latter countries is so high. The reason is that despite these extreme youth unemployment rates, still 'only' 20% of all unemployed people are young (compared to 40% in the UK).

Figure 2. Youth unemployment relative to total unemployment, selected countries



Source: European Commission Services.

### 3) What can be done?

The official mantra is of course more labour market reforms. No self-respecting economist would ever object to them. But can they have a significant impact in this crisis?

The 'GIPS' (Greece, Ireland, Portugal and Spain) face a fundamental problem of re-allocating labour from construction (Spain and Ireland) or domestic consumption (Greece and Portugal) to tradable goods (manufacturing and tourism). In Spain, for example, there are over one million unemployed construction workers alone. No amount of labour market flexibility will transform them into skilled manufacturing workers who can compete, even on very low wages, with their German or Chinese competitors. A substantial increase in long-term unemployment is thus unavoidable. This is not to say that none of the unemployed today can be used in other sectors of the economy, especially those producing goods and services for export. But the required massive re-allocation of labour will take time and will

require lower wages to price the new workers into the market.

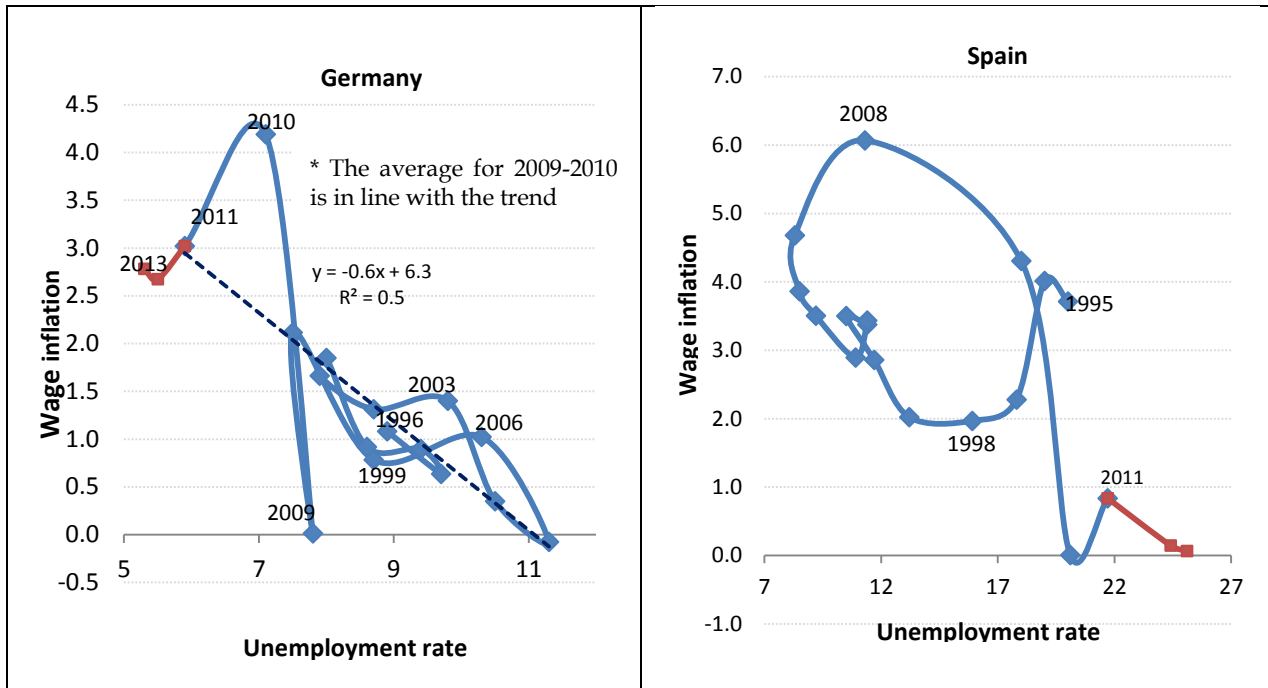
How much time? The problem for the GIPS is the scale of the shift in labour that is required. Given the size of their current account deficits at the peak of the boom, in both cases it should be much more than 10% of the workforce. Realistically, even with a very flexible labour market, it will take the better part of a decade for this to happen. In Germany it took almost ten years (from 1995 to 2005) to digest the aftermath of the re-unification boom. Politicians should acknowledge this timeframe instead of always promising a recovery just a few quarters away. Lower wages are part of the process. But with a normally functioning labour market some reduction in wages should not require any special government action when unemployment is in double digits.<sup>2</sup>

<sup>2</sup> For an in-depth discussion of the link between wages and competitiveness, see Daniel Gros (2012), "Macroeconomic Imbalances in the Euro Area: Symptom or cause of the crisis?", CEPS Policy Brief No. 266, April.

Lower wages will evidently have a pro-cyclical effect in the short run as they reduce demand. This is unfortunate, but unavoidable. The argument that lower wages would reduce demand, and might thus be counterproductive to employment, was also very popular in Germany during the early part of the last decade. The government mostly ignored it; but more

importantly wages were set according to labour market forces, as demonstrated by a stable relationship between unemployment and wages (also called the 'Phillips curve' by economists), as shown in Figure 3. Today, all agree that ultimately the payoff from 'wage moderation' (market-led, not politically enforced) was very high.

Figure 3. Phillips curves: Germany vs. Spain



Source: Own elaboration based on Commission Services data (Ameco).

The key issue now for the GIPS is how well their labour markets will work. Unfortunately, the record on this account is rather discouraging for the country with the biggest problem (Spain), if one considers the relationship between unemployment and wage growth (the Phillips curve) for Spain, shown in Figure 3. It is apparent that the curve has deteriorated since 2007, when the rate of wage inflation was much higher in 2008 for the same level of unemployment as in the early 2000s. This is probably due to the backwards wage indexation that transmits the terms of trade shocks from higher oil prices to the labour market. Consequently an unemployment rate of at least 20% is needed to keep wage inflation close to zero.

The key reason why unemployment has such a low influence on wages in Spain must be the extreme 'insider-outsider' structure of this market. The brunt of the reduction in

employment that has occurred since the start of the crisis is accounted for by job losses in temporary or other 'atypical' employment. Further research will be conducted to test the insider-outsider model.

The good news, however, is that the German Phillips curve seems to be working: wages are increasing as unemployment falls. What is still untested is the flexibility of labour markets in the south of Europe. Very recent data from some countries is encouraging, with unit labour costs falling rapidly (relative to Germany) in some countries (Greece and Spain, for example).

For almost a decade in Germany the overvaluation with which it entered the euro was offset by a differential of about 2-3% per annum in wage costs as German costs were flat, but were increasing by about 3% in southern Europe. On current trends it would take less than a decade for

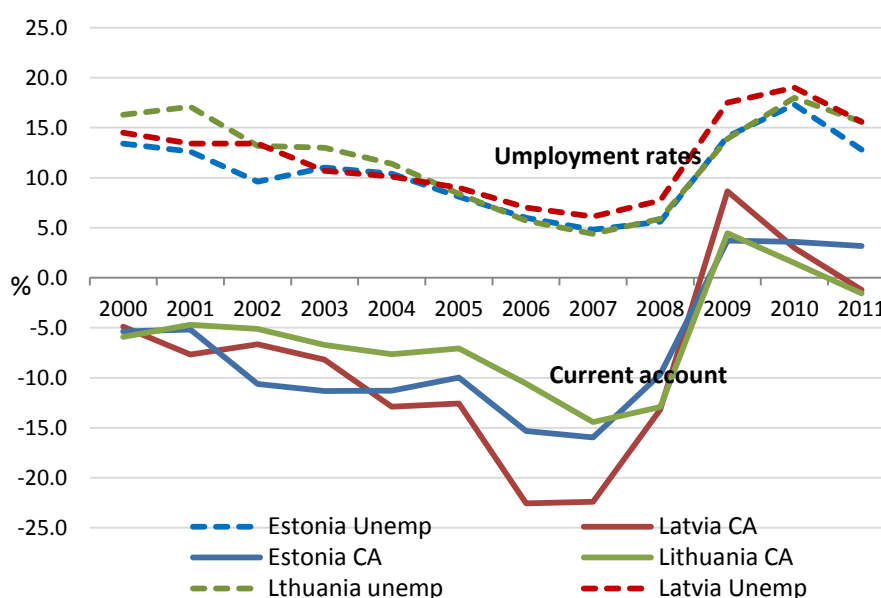
the GIPS to close the gap with Germany. The adjustment has thus clearly started. The real difficulty is, in contrast to Germany in the late 1990s, that the GIPS are starting with a debt overhang, and so financial markets are unlikely to provide financing for the lengthy adjustment period that is still ahead.

#### 4) Learning the hard way?

The new member countries of the Baltic region (and Bulgaria) had even more extreme consumption and/or construction booms and should be facing the same problem as the GIPS. In fact, their problems should be even greater, since these countries had even larger external

imbalances and are in a 'quasi monetary union' with their currency boards (fixed exchange rate), but without access to cheap financing from the ECB for their banks. But, perhaps because of this lack of support from the ECB, the adjustment was swifter. As shown in Figure 4, their current accounts turned to surplus within two years. As a result of the rapid adjustment, their unemployment rates also rose, but peaked early (in 2010) to levels close to, but still below, those of Spain today. The recovery since then has been slow, but at least the worst is over as unemployment rates are now gradually coming down - in contrast to those of southern Europe, where they are still on the rise.

Figure 4. Current account and unemployment rates in the Baltic region



Note: Current account as % GDP.

Source: Eurostat.

#### 5) Let Europe spend more?<sup>3</sup>

The only policy instrument that promises a quick payoff in terms of higher employment is that of more spending. But, given that the EU budget amounts to less than 1% of GDP and is constrained by a multi-annual framework that ends in 2013, and which leaves very little room for amendment, it is clear that the EU as such could not create a significant number of jobs by

<sup>3</sup> This section is based on Daniel Gros (2012), "Europe's Misguided Search for Growth" (<http://www.ceps.eu/book/europe%E2%80%99s-misguided-search-growth>).

spending more. (Moreover, a majority of member states would rather cut the EU budget still further).<sup>4</sup>

However, as in previous recessions, two potential EU instruments are often mentioned: the European Investment Bank (EIB) and the EU's Structural Funds for infrastructure investment.

<sup>4</sup> On the myth of an ever-expanding EU budget, see Jorge Núñez Ferrer (2012), "Between a rock and the Multiannual Financial Framework", CEPS Commentary (<http://www.ceps.eu/book/between-rock-and-multiannual-financial-framework>).



The EIB: more funding for the EIB to lend to medium-sized enterprises (SMEs) is one standard element of EU employment plans, under the argument that SMEs create most employment. But the business model of the EIB would have to change radically to make it a useful instrument under current circumstances because the EIB always requires government guarantees. But the fiscally stressed sovereigns in southern Europe cannot afford further obligations. Moreover, contrary to popular misconception, the EIB cannot lend directly to SMEs. The EIB can only provide large banks with funding to lend to local SMEs. But this is essentially already being done by the ECB in its three-year loan operation (LTRO). Both the ECB and the EIB would be 'super-senior' and could thus be counter-productive by crowding out private lending.

At its meeting in June 2012, the European Council will examine the 'project bonds' proposed by the Commission. The idea is "provide EU support to project companies issuing bonds to finance large-scale infrastructure projects", where support means sharing, together with the EIB, part of the risk by improving the rating of the debt issued by the project entities.

These project bonds, to be issued in a very small amount, would not constitute 'eurobonds' as commonly understood (i.e. bonds with a joint and several guarantee of euro area member countries with which member states could finance their normal running expenditure). These project bonds should be understood as special 'covered bonds', to be used to finance cross-border infrastructure projects that yield their own cash flow to service these bonds. They would thus represent a useful, but rather minor, addition to the EU's arsenal of financial instruments (as opposed to aiming specifically at the financing difficulties of the peripheral euro area member states).

Structural Funds or jobs through infrastructure investment (a 'Marshall Plan' for Europe's South): this is another standard recipe that might not be appropriate this time. Fifteen years ago there was a clear need for better infrastructure in the South. But in the meantime, the region has seen a decade of rather high infrastructure investment with Spain, Greece and Portugal spending over 3% of their GDP on such development. Most countries in the South should have adequate infrastructure

stock by now<sup>5</sup>. By contrast, more infrastructure investment would actually make most sense in Germany, where spending on infrastructure has been anaemic (only 1.6% of GDP, half the rate of Spain) for almost a decade. This is why German autobahns are notoriously congested.

Table 1. Investment in infrastructure (% of GDP)

Country	Average 2000-2007	2010	2011
<b>European Union (15 countries)</b>	2.3	2.5	2.3
<b>Germany</b>	1.5	1.6	1.7
<b>Greece</b>	3.3	2.8	2.6
<b>Spain</b>	3.6	3.8	2.7

Source: European Commission, Statistical Annex to Spring 2012 Forecast.

But one does not need European funding to finance infrastructure in Germany when the government can raise funds at negative real cost. At the rates it is paying today, the German government should be able to find many investment projects that make a positive social rate of return. Given that Germany is close to full employment, more infrastructure-spending there would probably suck in imports (and attract unemployed construction workers from Spain). This would contribute to the much-needed rebalancing of the euro area.

But, unfortunately, this is unlikely to happen,<sup>6</sup> because this kind of spending runs up against popular opposition and in any event is not decided by the federal government but rather at local and regional level, where grassroots opposition against any large project is the strongest (it took over 20 years to push through the modernisation of the railway station in a mid-sized town like Stuttgart).

<sup>5</sup> In countries like Italy, for example, the amount of expenditure is not reflected in the quality of infrastructure. Considering that an important share of any eventual additional spending would be inefficient, a further increase in this budget is not recommended.

<sup>6</sup> This shows Germany's ability to follow its own priorities, which is of course another manifestation of the asymmetry in adjustment pressure pointed out by Paul de Grauwe (2012), "In Search of Symmetry in the Eurozone", CEPS Policy Brief No. 268 (<http://www.ceps.eu/book/search-symmetry-eurozone>).

## 6) What should be done?

The urge to be seen to be ‘doing something’ is leading Europe’s policy-makers to cast around for the few instruments with which the EU can claim to foster growth. However, a closer examination of the facts suggests that this time is indeed different. The North and the South of the euro area are diverging so much that they need very different policy prescriptions (the East is already recovering slowly after a very tough adjustment process).

Moreover, the two instruments the EU has to address structural problems in the South (the EIB and the Structural Funds) are unlikely to be effective this time.

Accepting the reality that very little can be done at EU level to create jobs does not mean that nothing can be done. Deep service-sector reforms in Germany would also be helpful to unlock the country’s productivity potential and open its market for the export of services from southern Europe. Table 2 shows that the regulation of the important sectors of professional services is even tighter in Germany than in France or Spain. Opening the German market yields a ‘double dividend’: not only does Germany benefit, but this way the South would have the chance to find jobs for its rather well-educated youth, which right now face only a choice between unemployment and emigration.

*Table 2. Index of intensity of regulation affecting professional services*

	Accounting	Architect	Engineer	Legal	Overall
<b>Germany</b>	2.43	3.05	2.31	3.62	<b>2.9</b>
<b>France</b>	2.85	2.76	na	2.82	<b>2.8*</b>
<b>Italy</b>	3.63	3.11	2.92	3.29	<b>3.2</b>
<b>Spain</b>	1.93	2.14	1.60	2.57	<b>2.1</b>

Source: OECD.



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