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Inflation and Unemployment In EMU and the United States

Robert M. Dunn, Jr

The original purpose of this paper was to see why the Phillips Curve numbers seem to be so much worse for the EMU countries than the United States since EMU was began operation in 1990. The problem is that there is no evidence of a Phillips curve relationship in EMU or in the United States during this seventeen year period. As can be seen in Figures 1 and 2, it just is not there. In about half the years unemployment and inflation moved in the opposite direction, as Phillips would predict, but in other half of the years they moved in the same direction. This may be a matter of time lags, with unemployment lagging inflation, but it seems clear that the Phillips curve is a poor tool for explaining these year to year outcomes in Europe or the United States.

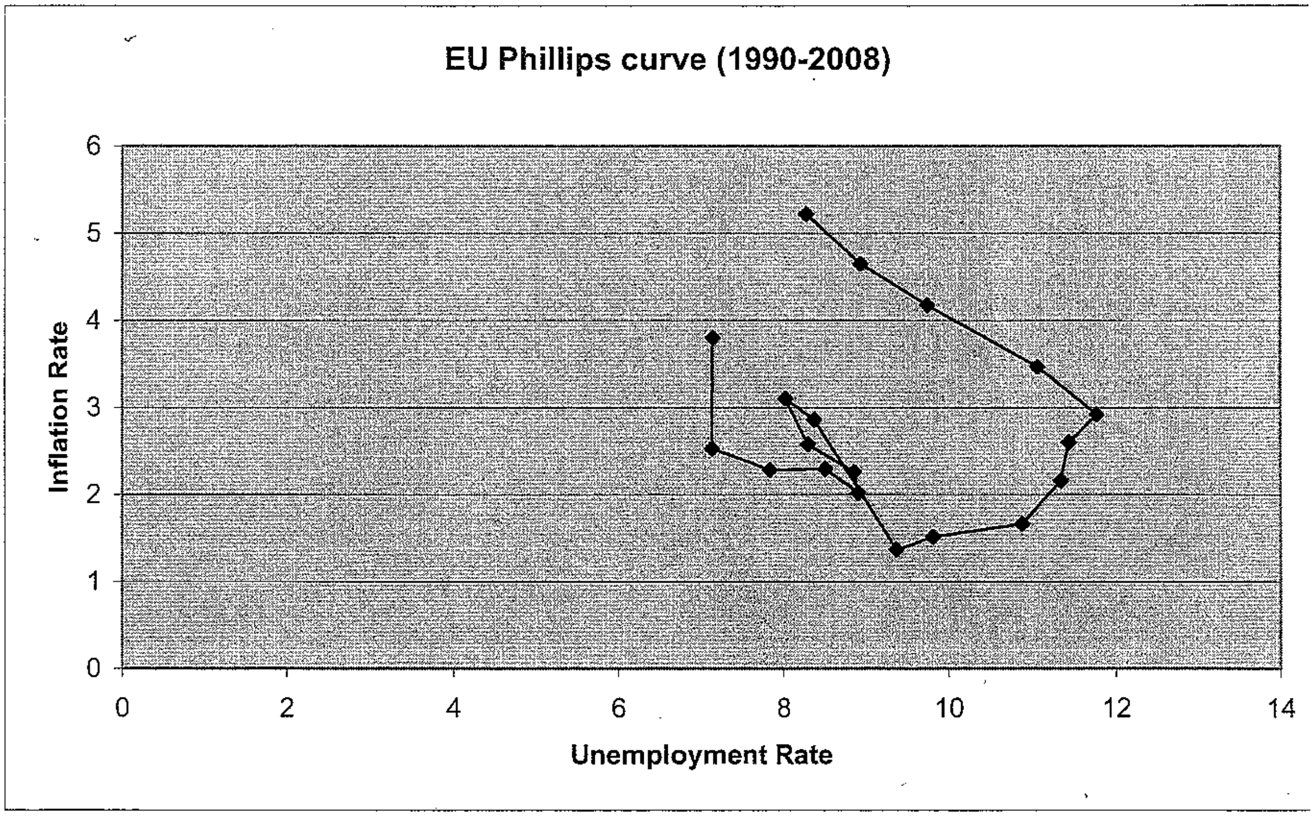
Insert Figures 1 and 2.

EMU displays a behavioral pattern that looks like a Phillips curve from 1990 to 1994, with inflation falling and unemployment rising, but then reverses course with a continuing decline in inflation while unemployment also falls in 1995 through the end of the decade. This pattern replicates what happened in the United States in the 1980s. Unemployment rose while inflation declined in 1979 through 1983 which matches the Phillips curve, but unemployment falls while inflation remains low for much of the rest of the decade. Neither the United States or EMU produce results which really support the Phillips curve. The numbers, however, are considerably worse for EMU than for this country, inflation being slightly worse but unemployment much worse in Europe.

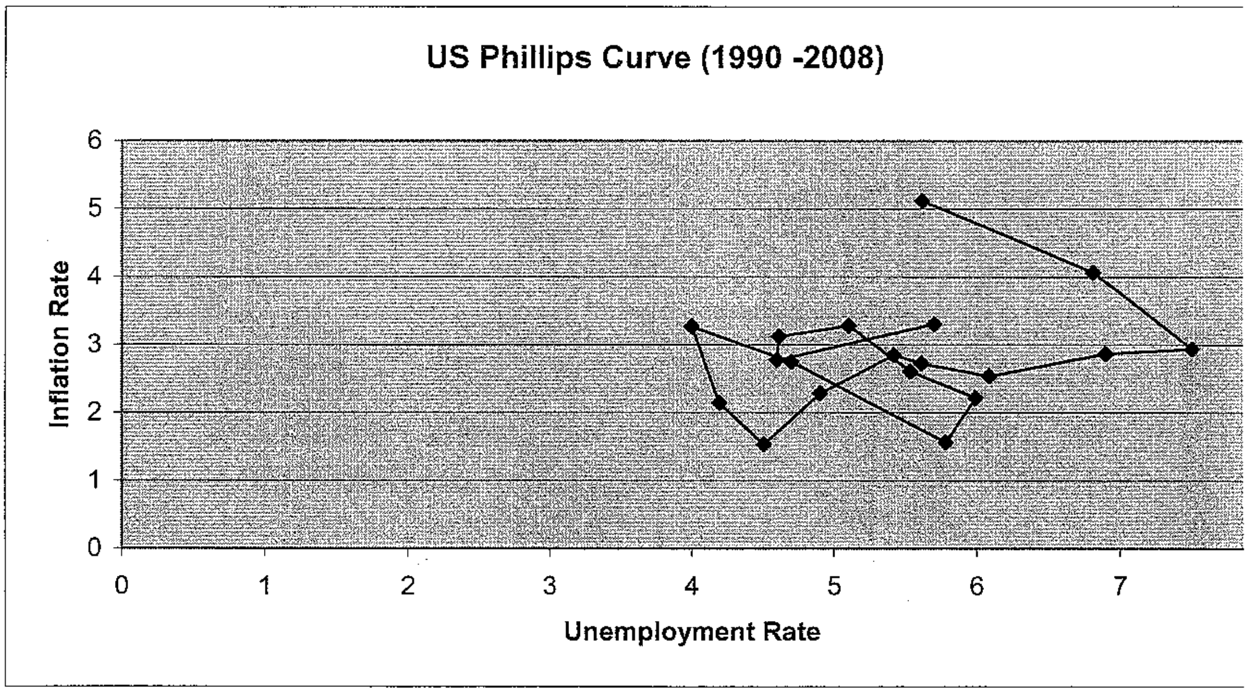
Inflation averaged 3.2 percent in EMU and 2.8 percent in the United States during the seventeen years, a difference of only 0.4 percent. Unemployment, however, averaged 8.6 percent in EMU compared to 5.5 percent in the United States over the same period, a difference of 3.1 percentage points, a much wider gap.

The European Central Bank appears to be much tougher on inflation and less intense on the subject of unemployment than is the Federal Reserve Open Market Committee. This may be because of the wording of the Maastrict Agreement, which is very firm and explicit on the subject of inflation, but which says little about unemployment. The relevant U.S. law, however puts equal stress on the two issues. The ECB operates under the presumption that its primary focus is controlling inflation, while the FOMC operates with more balanced views. The fact the nominees to the Board of Governors must be confirmed by the U.S. Senate, where unemployment is a very important topic, while there is no such confirmation procedure in EMU may also affect policies. Members of the Governing Council of the ECB are isolated from domestic politics and need pay no attention to the wishes of the voters. Members of the FOMC understand that the Congress created the Fed and could limit its powers by legislation. The public and the Congress were very unhappy with Paul Volker's tightening in the early 1980s which produced an unemployment rates that peaked at over 10 percent, and there was

	EU unemployment rate	EU inflation rate
1990	8.28	5.221682
1991	8.92	4.648529
1992	9.735	4.173326
1993	11.05909	3.468189
1994	11.76264	2.923644
1995	11.42636	2.600346
1996	11.33027	2.161524
1997	10.87836	1.668128
1998	9.807	1.516072
1999	9.358	1.36712
2000	8.367	2.861569
2001	8.017	3.104334
2002	8.292	2.578669
2003	8.842	2.259388
2004	8.892	2.024534
2005	8.5	2.295267
2006	7.825	2.284775
2007	7.117	2.528911
2008	7.125	3.8



	US unemployment rate	US inflation rate
1990	5.617	5.121516
1991	6.817	4.062509
1992	7.508	2.940423
1993	6.9	2.866848
1994	6.083	2.540753
1995	5.61	2.729053
1996	5.42	2.84786
1997	4.9	2.283965
1998	4.51	1.528603
1999	4.2	2.140944
2000	4	3.266998
2001	4.7	2.748329
2002	5.78	1.561412
2003	5.99	2.219458
2004	5.533	2.607396
2005	5.1	3.281898
2006	4.617	3.124677
2007	4.6	2.773899
2008	5.7	3.304455



widespread discussion of 'doing something' about his policies. It may be that the timing of the easing of U.S. monetary policy in 1983 was affected by this political pressure. Volker certainly did not want to be remembered at the Chairman who lost the Fed's independence and probably acted to calm the atmosphere. As an economist at the Fed in the mid-1960s, I certainly remember the pressures from the chair of Banking and Currency Committee, a rather extreme populist named Wright Patmen, to ease money and the fear which he engendered at 21st Street and Constitution Ave.. The Fed lives in a political world, while the ECB is far more isolated from politics. The people nominated to the Board of Governors are likely to be far more politically astute than are people in leadership positions at the ECB. The Fed is not controversial at present, although that could change if a deep recession develops. The ECB has no such fears, and has frequently indicated a lack interest is softening policy in response to growing unemployment The French and Italian governments can complain loudly about the ECB's firm policies, but the leadership of that institution is under no requirement to pay the slightest attention to their wishes. And attention is not paid.

These arrangements are in part the result of German pressures at the time the Maastrict agreement was set. Germany, with its anti-inflationary attitudes was very fearful of Italian and/or French influence over the German money supply. 'Italian monetary' policy was seen as a horror. The Germans went along with EMU only with the understanding that they would be protected from their colleagues to the south. The fact that other countries to the south and east might be admitted and have votes on the Governing Council, stiffened their resolve.

The institutional arrangements for EMU create an anti-inflationary bias that is far firmer than in the Federal Reserve System. The inflationary experiences of the post-WWII era had quite a bit to do with this, European, inflation being worse than ours in that era. Europe has a long history of bad inflation after wars. which we happily lack, and memories are long on that side of the Atlantic.

Overall Economic Performance in EMU

It was noted earlier that both inflation and unemployment were worse in Europe than here during the 17 year period, with unemployment being particularly bad in Europe. Unemployment average 8.6 percent in Europe compared to only 5.5 percent here over the seventeen years. If the misery index is taken to be the total of the inflation rate an unemployment, that number averaged 11.8 percent in Europe and 8.3 percent in the United States, a difference of over 3 percentage points over the period favoring the United States. This striking difference raises the obvious question as to which outcomes should be so much worse over there than here. Our economic institutions and goals would appear to be quite similar, so why are such differences in outcomes?

There are many possible causes, more than one of which may operating. First, labor unions play very different roles in the two economies. A few decades ago, over 30 percent of the U. S. labor force was unionized, creating a strong bias toward higher wages and prices, and higher unemployment. Unions now represent only 11 percent of the labor force and they are down to about 9 percent in the private sector, government being the only segment of the economy (school teachers, and other local government employees) where they have had membership gains. The U.S. private economy now has a highly competitive labor market, which improves the unemployment/inflation situation. This has occurred in part because U.S many employers have moved to states with strong anti-union attitudes, particularly the south east. These states have right to work laws, which severely limit union activity. There are, of course, no right to work laws in Europe.

Whiles unions have also declined in Europe, the loss of membership is much smaller and they started from a stronger base. Unions remain very powerful in EMU countries, which considerably worsens the inflation/unemployment situation. It may be, however, that the slow decline in union membership in Europe will eventually make their labor markets more similar to ours. The continuing movement of European manufacturing to the east, where labor markets are more competitive, may accelerate this trend. For the time being, however, unions remain a considerable barrier to improved economic performance in EMU. In the United States, in contrast, unions are almost irrelevant in the private economy.

Europe's difficulties are increased by 'soft' unemployment insurance laws and by very generous transfer payment of all types. EMU citizens simply do not have the personal financial pressure to be employed that Americans face. The government provides so much, and taxes are so high (over 50 percent average in some countries) that the incentives for work are weak. This, however, however, may be changing. Stories about Dutch unemployment checks being sent to the Baleric Islands in the winter became a widespread source of humor, and the Hague has actually become somewhat tougher. There is now real pressure for the unemployed to get training and then to find jobs, and unemployment checks are no longer sent to sunny Spanish islands in the winter. These pressures have not extended to France, where their mere suggestion would probably cause riots, but there is increasing understanding in much of Europe that generosity to the non-employed had become excessive. Its costs were an excessive burden on taxpayers, and it discouraged work and entrepreneurship.

The arrival of eastern European countries, which are much tougher and more competitive, in the European Community has had effects to the west. If the French and the Germans do not care to work harder at lower cost, the Czechs and Poles will be happy to take their jobs. Germany which is next door to the Czech Republic, is a major source of shifting employment. A German businessman noted that he pays $35 per hour in Bavaria for workers when people who are just as skilled and productive are available a few miles away in western Bohemia for $10. The western part of the Czech Republic is now heavily populated by German and other western firms who have fled to the east. As the Czech Republic becomes more expensive, Slovakia, Poland, and their neighbors become more attractive. Eventually labor costs will converge, but that will take many years, and in the meantime many will have moved to the east.

It is a fascinating irony that the collapse of communism created a group of highly competitive industrial countries that are forcing western Europe to improve macroeconomic performance. The Czechs and their neighbor are convinced that they can out-compete Germany, France, et.al., and thus far their confidence seems well placed. The American left, which has viewed the western European social welfare model as an ideal, how looks rather silly. Marx and Stalin must be spinning in their graves.