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ECONOMIC GROWTH AND THE LABOR MARKETS: EUROPE'S CHALLENGE

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Editorial

On May 11-12, 2000 the National Bank of Belgium hosted a Conference on *"How to promote economic growth in the euro area?"*. A number of papers presented at the conference is made available to a broader audience in the Working Papers series of the Bank. This volume contains the fourth of these papers. The other five papers were issued as Working Papers 5-7 and 9-10.

Abstract

This paper reviews the accumulated theory and evidence on the sources of European underperformance in terms of economic growth and unemployment. It takes the view that the main problem lies with labor market institutions, ranging from negotiation structures to hiring and firing costs, unemployment benefits, minimum wages and taxation. It adopts the view that undesirable labor market structures have interacted with adverse shocks. An important question concerns the reasons behind reluctance in some countries to undertake reforms. The paper's thesis is that such reforms are not Pareto improving: a majority of the population stands to lose while a minority would benefit. The largest countries, where co-operation does not come naturally, are particularly vulnerable to a no-reform outcome. This observation is next used to outline possible scenarios. The paper concludes with a discussion of what could be the ECB contributions to either make reforms more acceptable or to cope with a separation of Europe in two groups of countries, those which have managed to implement reforms and those that will continue to operate with a high rate of equilibrium unemployment.

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1. INTRODUCTION

Something bad happened to Europe in the early 1970s when its remarkable postwar growth performance deteriorated and its unemployment rate, virtually nil since 1950, started to move upward and has kept creeping up. It has taken 25 years for unemployment to start seriously declining and for growth to return. For a while, it seemed that all OECD countries shared this misfortune, and much effort was being spent on understanding the puzzling fact that a temporary shock --the oil shock-- could have permanent effects, see Bruno and Sachs (1985). It soon transpired, though, that only in Europe was the effect permanent. The puzzle remains, but it is distinctively European which has prompted research into the question of what makes Europe different from the US.

It could be bad macroeconomic policies, or inefficient markets, or adverse political situations. It would be strange that policies would have been inept in all the European countries that suffered from the bad turn of events, and there is plainly no evidence that politics have gone particularly wrong either. This is why, from the beginning, the main suspect has been the existence in Europe of inefficient markets, in particular, the labor market. Section 2 makes the case that this diagnosis is unassailable.

The next question, the, is precisely what happened with the labor markets? A first possibility is simply that demand has been too weak for far too long. There have been indeed period of slow demand and slow growth, but can they account for what looks like a permanent increase in unemployment. Section 3 presents two supporting views. Another possibility, is that it is the market structure which has been inefficient all along. This view is appealing as it clearly separates out the European and US experiences. It is developed in Section 4. But do we need to choose between these two views? Recent research, summarized in Section 5, has started to build bridges and to improve the precision of the diagnosis that lies behind the unemployment debacle.

Understanding unemployment is not enough to get rid of it, though. Most of the recent results are second-order refinements of analyses developed long ago, for example by Layard et al. (1991). The most vexing puzzle is that some countries have been able to implement fairly early on reforms of their labor markets, and have achieving impressive results, while others --importantly, the largest ones-- still seem to be debating and stalling. It is being increasingly recognized that the biggest stumbling block is political. Labor market reforms can reduce unemployment and promote growth, but they hurt powerful entrenched interests. The political economy aspects are reviewed in Section 6.

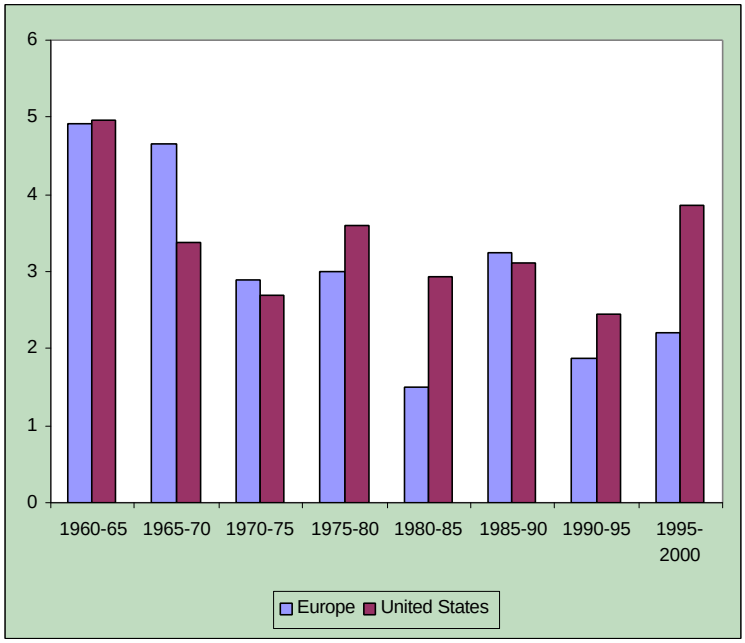
The paper concludes with a discussion of what can be the role of monetary policy in the recently formed European monetary union. It dismisses the view that unemployment and labor

market reforms is not something that the ECB should concern itself with and looks at the issues that need to be faced. Clearly, the fight against unemployment, and the return to a steady and robust growth performance will require efforts by all parties concerned, including the ECB.

2. EUROPE'S GROWTH PERFORMANCE: A QUICK DIAGNOSIS

Growth has slowed down after the 1960s in both Europe and the US[1] But Europe's decline has been more severe than in the US, and has continued from decade to decade as Figure 1 shows. While individual countries have experienced various declines, the pattern is fairly general throughout Europe, enough to warrant a search for common causes.

Figure 1. GDP growth.
(average annual increase in GDP per capita)

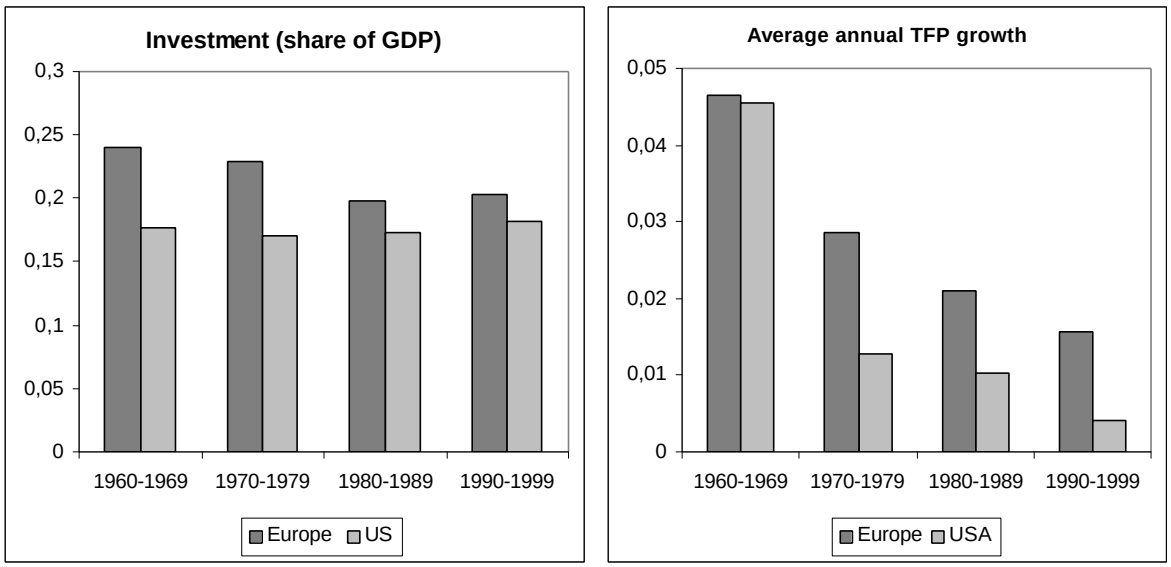


Source: OECD.

When growth declines, it is natural to start with the Solow decomposition and investigate the evolution of factor inputs and total factor productivity (TFP) growth. Figure 2 presents the share of GDP devoted to private and public investment and TFP growth. Europe's investment ratio has declined since the 1960s, but the decline is both limited and much smaller than the one observed in the US. Clearly, Europe's growth slowdown is related to these factors, but not its poor performance relatively to the US. This suggests that Europe's predicament is unambiguously related to the remaining input, labor.

[1] Unless otherwise specified, Europe includes the European countries belonging to OECD.

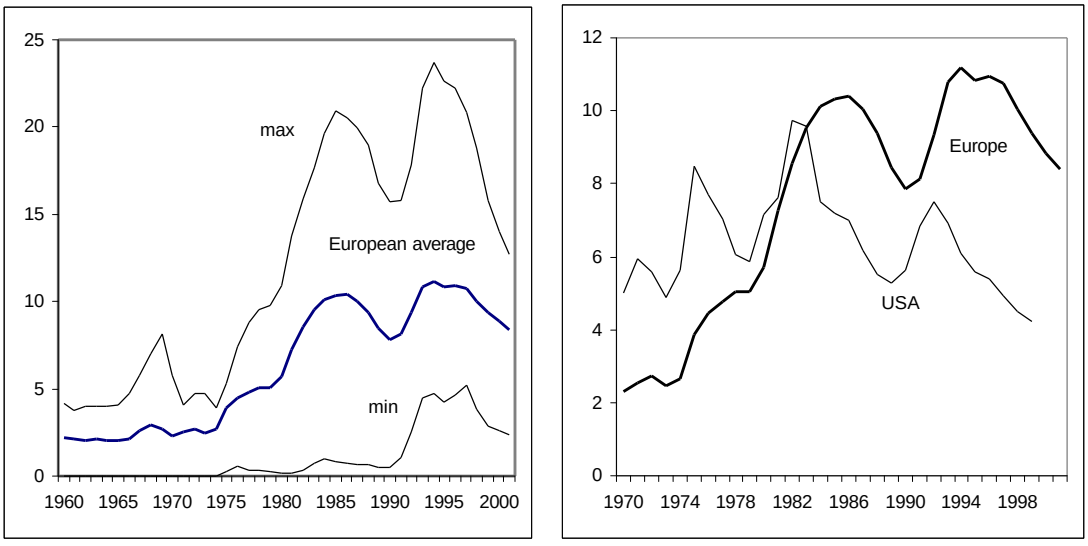
Figure 2. Investment and TFP growth.



Sources: Investment: OECD, Banchard and Wolfers (1999).

Indeed, the camel hump-like shape of the rise in European unemployment, shown in Figure 3 is well known. Also well known is that this evolution has been quite diverse within Europe, as is visible from the curves depicting the highest and lowest unemployment rates in Europe. The poor European performance is made worse in comparison with the US, where unemployment has only been fluctuating --widely-- around a seemingly stable equilibrium level[2].

Figure 3. European rate of unemployment.

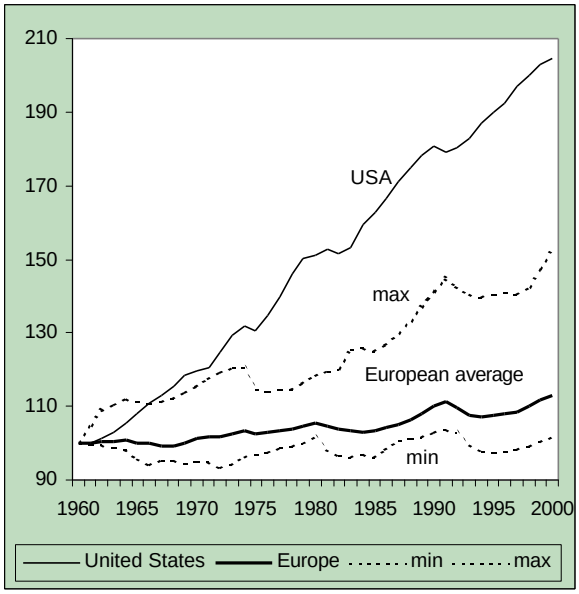


Source: OECD.

[2] There is much debate on whether the US equilibrium unemployment rate has recently declines. It will be some time until enough information accumulates enough to allow for firm conclusions.

More impressive even is the comparison of employment between Europe and the US. Since 1960 the number of jobs has more than doubled in the US while virtually no net increase has been recorded in Europe. Figure 4 displays this evolution, normalizing the number of jobs to 100 at the start of the sample period. It also the displays the minimum and maximum among European countries. Even the best European performer --Switzerland until Ireland takes over in the late 1990s-- remains far below the US.

Figure 4. Employment.
(Index 1960 = 100)



Source: OECD.

While one may quibble with the details, this quick overview does not leave much to be debated about. Europe's growth slowdown and rise in unemployment are two facets of the same phenomenon. To a first order of approximation, these two aspects are not related to a capital shortage (as argued by e.g. Bean and Dreze, 1990) nor to the productivity slowdown, as is often believed. In explaining Europe's growth underperformance and shift to mass unemployment, not much is lost by focusing on the labor market, this is what the rest of the paper does.

3. DEMAND-SIDE EXPLANATIONS OF MASS UNEMPLOYMENT IN EUROPE

Traditionally, two main explanations are considered when looking at a long-lasting increase in unemployment: the demand and the supply side. The demand-side explanation argues either that restrictive policies have hampered growth and therefore employment, or that higher real interest rates have led firms to take measures that raise the rate of return on capital. Supply-side explanations focus on labor demand and inefficiencies in the labor market.

3.1. Demand Side I: Restrictive Policies

There is little doubt that, following the surge of inflation associated with the oil shocks of the 1970s and 1980s, Europe has devoted much effort at bringing its inflation rates down to more comfortable levels. There is also little doubt that the convergence program agreed upon as part of the Maastricht Treaty has led to monetary policies designed to achieve a low inflation culture as well as fiscal policies which managed to first stop and then reverse the public debt buildup.

Yet, conventional theory does not support the view that macroeconomic policies can have long-lasting effects on unemployment. Restrictive policies are presumed to initially raise unemployment but it is expected that higher unemployment, in turns, reduces wage aspirations, which ultimately brings about wage moderation and a restoration of labor costs compatible with a return of the unemployment rate to its equilibrium level. Thus, demand-side interpretations must be completed by either of two additional explanations: a very slow reaction of wages to unemployment and of unemployment to wages, or hysteresis. Both explanations involve supply side considerations.

Rising unemployment is expected to lead to wage moderation as employees and their trade unions either recognize the need to rekindle demand for labor, or see their bargaining power decline and settle for less. Several factors can stand in the way of this mechanism.

- First, for wages to decline in the face of rising unemployment the alternative to wage moderation has to be clearly unappealing. In the presence of unemployment benefits which are both generous and long-lasting, trade unions may consider that fighting unemployment through a reduction in real wages is not desirable.

- Second, trade unions may feel that wage moderation will not work. This will be the case is wages are set at the industry level for, in that case, reductions do not affect individual firm's competitiveness, at least at the national level. As far as international competitiveness is concerned, relative wage reductions are more easily achieved through exchange rate adjustments which, unions correctly conclude, is beyond their responsibility.

- Third, there might be little room open to real wage reductions in the presence of binding minimum wages. Given the social role of minimum wages, trade unions are unlikely to argue for their reduction. Indeed, unions are more likely to call for a defense of minimum wages along with increases in unemployment benefits if they perceive an adverse effect on unemployment,.

These factors are all in the nature of partial equilibrium so one would expect that, eventually, market forces will prevail. This explains a very slow process, one that could easily takes years if not decades to work itself out, a possibility defended inter alia by Karanassou and Snower (1998). In that case, Europe is simply in the middle of a very long transition period that started in the early 1970s.

Another possible interpretation is hysteresis. Layard, Nickell and Jackman (1991) argue that long-unemployed workers become unemployable, largely because of the stigma that potential employers attach to prolonged spells of joblessness. As a result, they are not effectively competing for jobs with others and therefore do not exert the wage moderation effect expected from observed increases in unemployment rates. Hysteresis is important because it explains how temporary shocks can have permanent effects. In practice, it has proven impossible to distinguish between pure hysteresis and very slow returns to equilibrium exchange rates.

In any case, both interpretations must explain why the labor markets in Europe are so much slower to exert wage moderation than in the US. The answer must come from the supply side, the features of labor market institutions that suppress or moderate adjustment to demand shocks. More generally, demand-side interpretations fail to come to grip with an essential message from Figure 4, that Europe's inability to create jobs goes as far back as 1960.

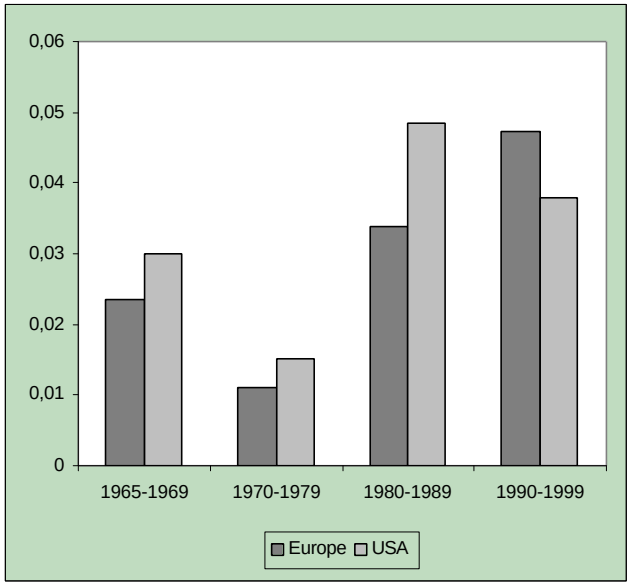
3.2. Demand Side II: the Real Interest Rate

Phelps (1994) has developed an alternative demand-side view that associates decade-long periods of slow growth and high unemployment with (exogenous) long-lasting increases in the real interest rate. This view does not attempt to disentangle slow adjustment from hysteresis as it argues that real interest rates go through long cycles. High required return leads firms to either slow down capital accumulation or to reduce the real wage that they are willing to offer. The resulting equilibrium is therefore one where real wages increase as employment declines during periods of high real interest rates.

Phelps reports supporting econometric evidence, and Figure 5 informally confirms that the pattern of unemployment rate --low in the 1960s, raising in the 1970s and 1980s, declining over the 1990s in the US but still rising in Europe-- bears some resemblance with the real interest rate.

Yet, Figure 5 fails to explain the difference between Europe and the US. It also leaves the evolution of the real interest rate unexplained.

Figure 5. Real Interest Rates.



Source: Banchard and Wolfers (1999).

4. THE SUPPLY-SIDE EXPLANATIONS OF MASS UNEMPLOYMENT IN EUROPE

In the end, while demand side stories may have some explanatory power, they fail to account for the bigger part of the picture. This is why, as observed by Phelps, today "we are all structuralists", i.e. structural features of the labor markets have to play the central role. Over the years, much evidence has been produced to back up this general view and to pinpoint the particular features which are most clearly linked to the rise in unemployment.

The supply-side view is a priori plausible. It clearly distinguishes Europe from the other OECD countries, and the US in particular. It also sheds light on the different evolution of unemployment in Europe, exploiting the vast contrast within European countries. And it also accounts for the progress achieved in some countries which have embarked on labor market reforms, for example the Netherlands and the UK (Nickell and van Ours (2000)) or Chili (Edwards and Edwards (2000)).

The literature is vast and under continuing development. Recent surveys are Nickell (1997), Nickell and Layard (1998), Blanchard and Wolfers (1999) and Phelps and Zoega (1999). These studies carry out or report detailed econometric tests which go beyond binomial analysis. What follows is a summary of the main conclusions which have been found to be robust in formal tests.

4.1. Unemployment benefits

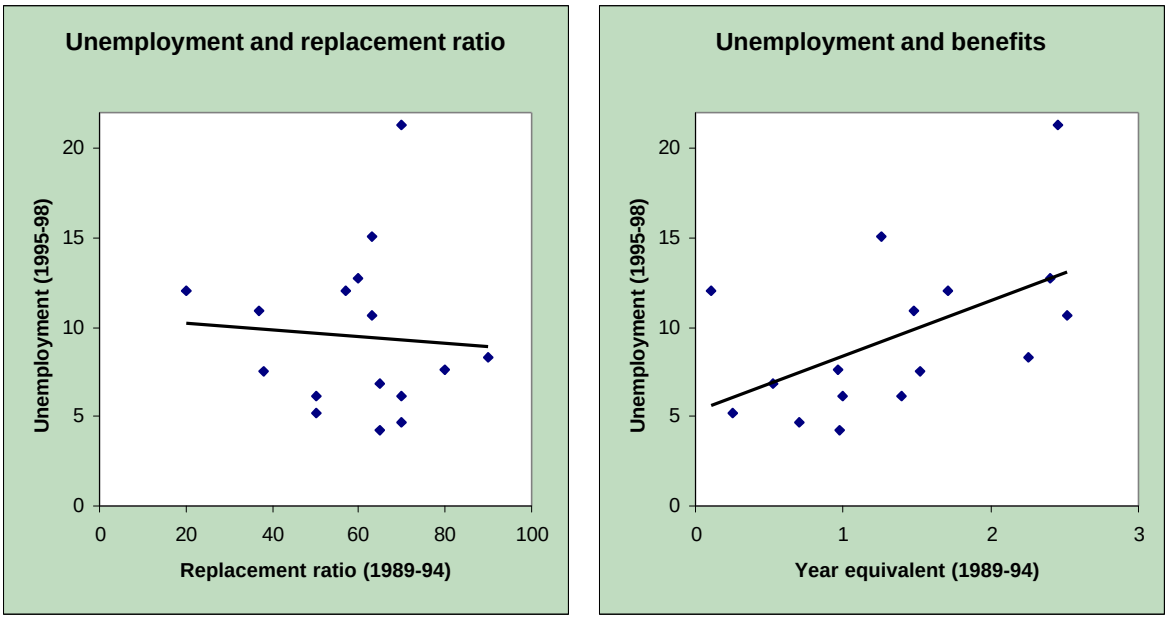
Unemployment benefits reduce unemployed workers' incentives to actively seek and accept new jobs, especially jobs that are either less qualified or less well paid than those previously held. This institution explains two important features of European labor markets: the lack of real wage flexibility and the presence of a large number of long-term unemployed. Surveys show that, over 1989-94, about 40% of European unemployed have not been working for over a year, in comparison with 10% in the US. Long term unemployment is important for three reasons. First, it means prolonged distress for the affected individuals. Second, it leads to disenfranchisement from the labor force, through a loss of human capital and contact with the market place, a possible channel for hysteresis. Third, the long term unemployed cease to exercise a competitive pressure on the market and to argue within trade unions for measures that could favor their re-employment, for example a reduction in remuneration, the potential adverse macroeconomic effect of hysteresis.

The role of unemployment benefits is highly controversial, both for its social implications and because of lingering doubts about the disincentive effects. The top panel of Figure

6 shows the relationship between the replacement ratio over 1989-94 (the average percentage of lost wages paid out as unemployment benefits) and the rate of unemployment over 1995-98. The difference in timing is meant to capture lagged effects given that disincentive effects will build up unemployment gradually over time. There is no clear pattern. The line shows a slight, but statistically not significant, tendency for unemployment to decline when the replacement ratio increases. This kind of evidence explains the source of controversies.

However, the benefit ratio is a poor indicator of the incentive to find a job quickly. What also matters is how long benefits are paid out after the loss of employment. Burda (1988) has shown that unemployed workers actually take into account the whole of the "package" available to them, i.e. how much for how long. The lower panel of Figure 6 measures the value of each country's "package": it is the product of the replacement ratio (shown in the upper panel) and the number of years during which this support is available in the event of job loss. The value of the unemployment benefit package is measured as the number of years of lost wage available through the welfare system to the average worker who becomes unemployed for indefinite duration.[3] The relationship comes up quite clearly, and is confirmed by the statistically significant regression line. The figure suggests that an increase by one year of benefit-equivalent raises the unemployment rate by a full three percentage points.

Figure 6. The role of unemployment benefits.



Source: OECD and Nickell (1997).

[3] For example, if the replacement ratio is 60% and unemployment benefits are served for two years at that level and then disappear, the "package" is worth 1.2 years. In practice, the replacement ratio gradually declines over time. The number shown is an approximation open to criticism as many countries provide a succession of welfare support arrangements which may not always be easily measured, in part because they depend upon varied individual circumstances.

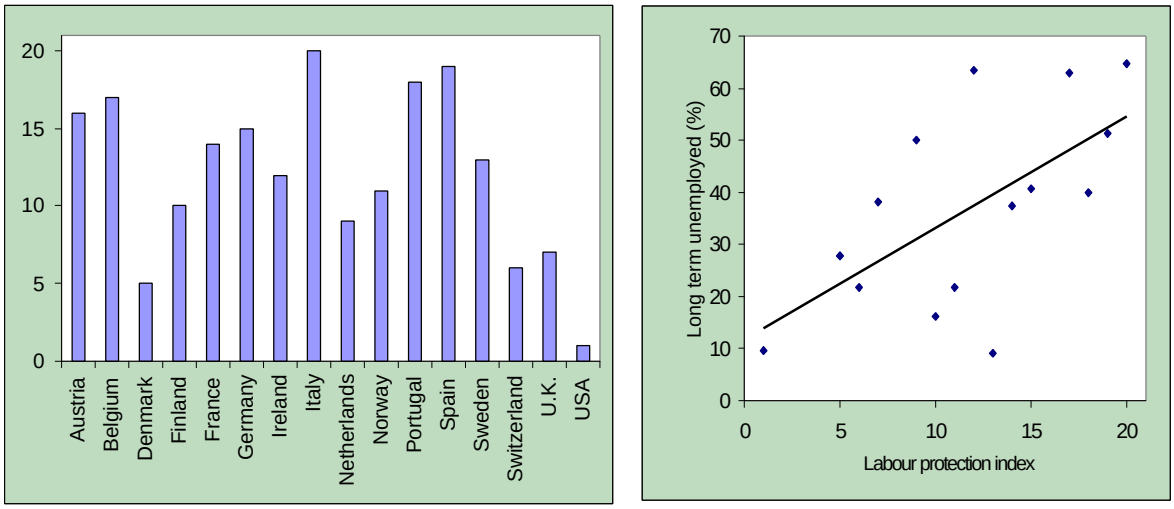
4.2. Hiring and firing restrictions

Another disincentive effect operates through the demand side of the labor market. When it is costly to hire and/or fire workers, it is expected that firms will display circumspection in choosing labor over mechanization wherever the margin exists. Quite obviously, equipment can often be quickly put in place in periods of high demand and easily turned off when a recession sets in. Hiring and firing costs put the labor at a clear disadvantage vis a vis mechanization. The top panel in Figure 7 presents a measure of the severity of legislation developed by the OECD. It is on a scale from 0 (no restriction) to 20 (heaviest regulation). There is no obviously visible link between this index and unemployment. Formal statistical tests confirms the absence of any such link.

A more detailed analysis carried out by Nickell (1997) confirms the initial results from Bentolila and Bertola (1990). Measures designed to make firing more difficult tend to reduce short term unemployment as they make it harder for firms to shed labor during cyclical downturns. Cyclical (short-term) unemployment declines. On the other side, firing restrictions make employers more prudent when comes the time of hiring at the next upswing. Long-term unemployment increases because finding jobs becomes harder in a market where firms are reluctant to add workers to their paylist. The adverse effect on long-term unemployment is statistically well-documented. It can be seen in the lower panel of Figure 7 which displays the index of labor market restriction along with the proportion of unemployed workers out of work for more than one year.

Regarding total unemployment, the two effects approximately cancel each other: the short-term gains are offset by the long-term loss. The good intention effect (discouraging firing during temporary economic slowdown) faces a perverse incentive effect (discouraging hiring in better times). In addition, there is mounting evidence that strong employment protection benefits the first family-earner while affecting adversely second earners who simply withdraw from the labor force, thus leaving no imprint on the unemployment rate while depressing overall employment and, quite possibly, growth.

Figure 7. Index of employment protection.



Source: OECD, Jobs Study.

4.3. Minimum wages

The standard presumption is that minimum wages protect workers from "exploitation" by unscrupulous employers, while pricing out of the labor market the least qualified segment of the population. The reasoning is quite simple: minimum wages raise labor costs at the bottom of the scale. Evidence supporting this presumption is surprisingly hard to establish. Some highly controversial work even claims that minimum wages increase employment.[4] There are a number of good reasons why the picture is muddled, and some useful lessons to learn from the confusion.

First, minimum wage regulations vary enormously from one country to another. In some countries (France, Spain, the Netherlands, Portugal) the minimum wage is set by the government while in other countries it the outcome of national (Belgium, Greece, Denmark) or sectoral (Austria, Germany, Italy) bargaining. Second, it can apply to all workers or only to particular industries (Ireland and, until this year, the U.K.). Third, there may be different minima depending on age, region, occupation, industry, firm size, tenure or family status.

Importantly, the level of the minimum wage also varies widely. Figure 8 shows how far is the (representative) minimum wage from the average wage. Very low minimum wages (e.g. in Spain, the U.K. and the US) have little impact, which is not the case when they amount to 70% of the average wage as in Italy. It also matters how many workers are actually paid the minimum wage, or just slightly more. For example, in Sweden, the minimum wage is relatively high (52% of

[4] Card and Krueger (1995) have reached this conclusion following a detailed study in New Jersey and Pennsylvania. This study has however been heavily criticized, see the *Industrial and Labor Relations Review*, July 1995.

the average wage) but the wage scale is extremely compressed as the result of a strongly equalitarian approach to remuneration. As a result, no Swedish worker is actually paid the minimum wage and the mechanism is not really binding. The proportion of workers at or near the minimum wage is displayed in Figure 8 for the countries where it is available. In France where more than 10% of the French labor force is remunerated at this level, the minimum wage is seriously binding and adversely affects unemployment.

Finally, there is a fine distinction between employment and unemployment. The claim that minimum wages may be a good thing in fact concerns employment: an increase in the minimum wage leads to an increase in the supply of labor, as low skill workers and second earners re-enter the work force because it now pays enough to work. If the minimum wage plus overheard costs are sufficiently low not to deter hiring, employment rises. Even in this (rare) favorable case, there is no evidence that unemployment declines.

Figure 8. Minimum wages.

Source: Dolado et al. (1996).

The most widely-held conclusion (Abowd et al. (1997), Dolado et al. (1996), Nickell (1997)) is that, in many countries, minimum wages are low enough not to raise unemployment among prime age males. In some countries where the minimum wage is both high and binding (France, Spain) it increases unemployment among the young and low skilled segments of the labor force.

4.4. Collective bargaining

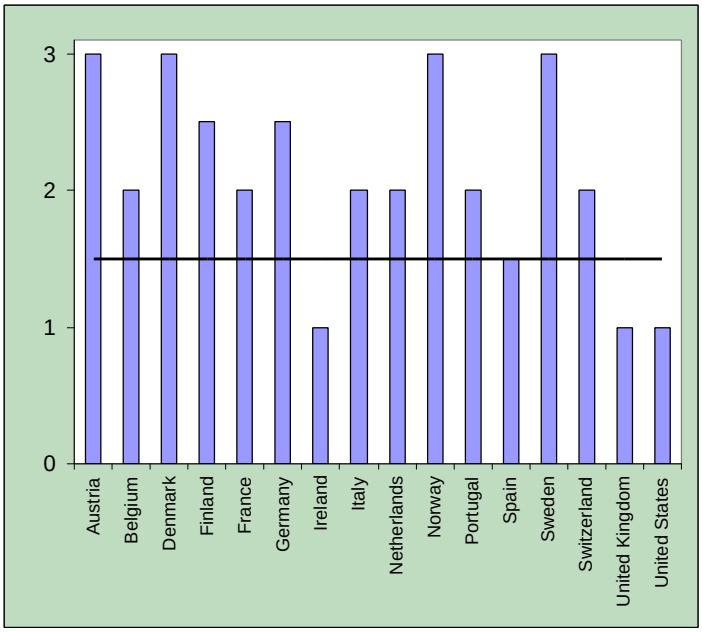
Wages are typically set through collective bargaining. The institutions of collective bargaining vary a great deal from one country to another. Usually trade unions play a key role, with

the exception of the U.K. and Switzerland. Negotiations can be nation-wide and their outcome made to apply to all workers, even to those which are not unionized (France). Alternatively they can be conducted at the firm or plant level. In some countries, unions and employers closely co-ordinate their negotiating positions (Austria, Denmark, Sweden) while elsewhere there is significant variability across industries or crafts.

Institutions have been found to matter significantly. At one end of the spectrum, negotiations are all-encompassing, being conducted at the national level, sometimes with explicit or implicit government participation. In that case, negotiators are keenly aware that high real wages will hurt the country's international competitiveness and backfire through unemployment; they tend to exercise restraint. At the other end of the spectrum, negotiations take place at the firm level. Negotiators plainly realize that the firm's ability to compete is at stake. In those cases, wage moderation and flexibility come naturally. On the contrary, where negotiations are conducted at the industry or craft level, the perception of competition is muted while the incentive to leap-frog over previous agreements is strongest. In those situations, wage moderation and flexibility are lowest.

Figure 9 reports estimates of the degree to which unions or employers co-ordinate wage negotiations. The index ranges from 1 (no co-ordination) to 3. It confirms the perception that Ireland, the U.K., and the US are countries where negotiations are most decentralized while Scandinavia and Austria display strong corporatist features. The econometric evidence tends to be supportive of the hypothesis that the extremes work better than the soft middle (Nickell (1997), Blanchard and Wolfers (1999)).

Figure 9. Degree of co-ordination over wage negotiations.



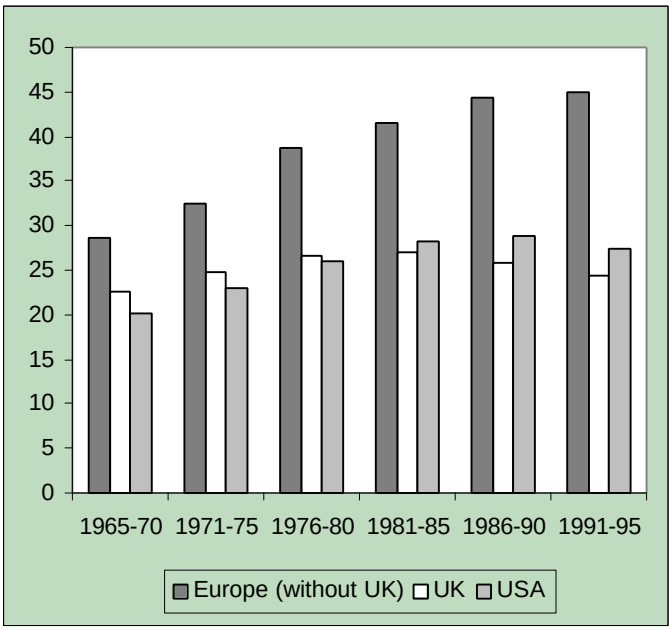
Source: Nickell (1997).

4.5. Taxes

Labor taxes are commonly believed to unambiguously increase unemployment. Yet, this view has been controversial in academic research. Both theoretical and empirical reasons lie behind the controversy. In principle, an increase in labor taxes initially reduce employment but this, in turns, should push net-of-tax wages down until gross wages are back to the pre-increase level with no permanent effect on labor costs and therefore employment. If, however, alternative income sources (unemployment benefits, employment in the underground economy) are less taxed than wages, or if minimum wages are binding, unions effectively resist wage tax reductions and higher taxes end up permanently raising unemployment.

Empirically, Figure 10 shows that labor taxes have been rising quite strongly in Europe since 1960. It also shows that Europe is characterized by much heavier tax rates than the US, and in this case the UK. Both observations are well in line with observed unemployment rates. However, for a long time, econometric estimates have only uncovered low or negligible tax effects (Layard et al. (1991), Nickell (1997)). More recent and careful work by Daveri and Tabellini (2000) reports convincing evidence of a strong effect on both unemployment and growth.

Figure 10. Effective labor taxes.



Source: Daveri and Tabellini (2000).

5. INTERACTIONS

The evidence so far is that structural features of labor markets exert a significant effect on equilibrium unemployment. When demand side effects are found long-lasting, the frontier between prolonged and permanent effects cannot be detected with currently available data and methodology. Facing the undisputed fact that unemployment is much higher and far more stubborn in Europe and the US, those who argue that the supply side is not important usually observe that most current labor market institutions were put in place in Europe before unemployment started to rise in the 1970s. This observation has so far been a powerful argument against the structural interpretation of European unemployment.

This observation has never been very powerful and is now being convincingly dismissed. To start with, the evidence presented in Figure 4, that employment has been flat in Europe since 1960, indicates that labor market inefficiencies predate the rise in unemployment. More to the point, over the recent few years, a number of researchers have started to investigate interactions between demand and supply-side effects.

In a nutshell, the idea is that the same shock --for instance the oil shock of the 1970s or the rise in worldwide interest rates-- can have a different impact depending on labor market institutions. As already noted, demand-side shocks are presumed to have temporary effects because it is expected that, eventually, high unemployment brings about wage moderation and a return to an unchanged equilibrium. If, however, labor market institutions prevent this market mechanism to operate fully, temporary demand shocks may affect the equilibrium rate of unemployment.

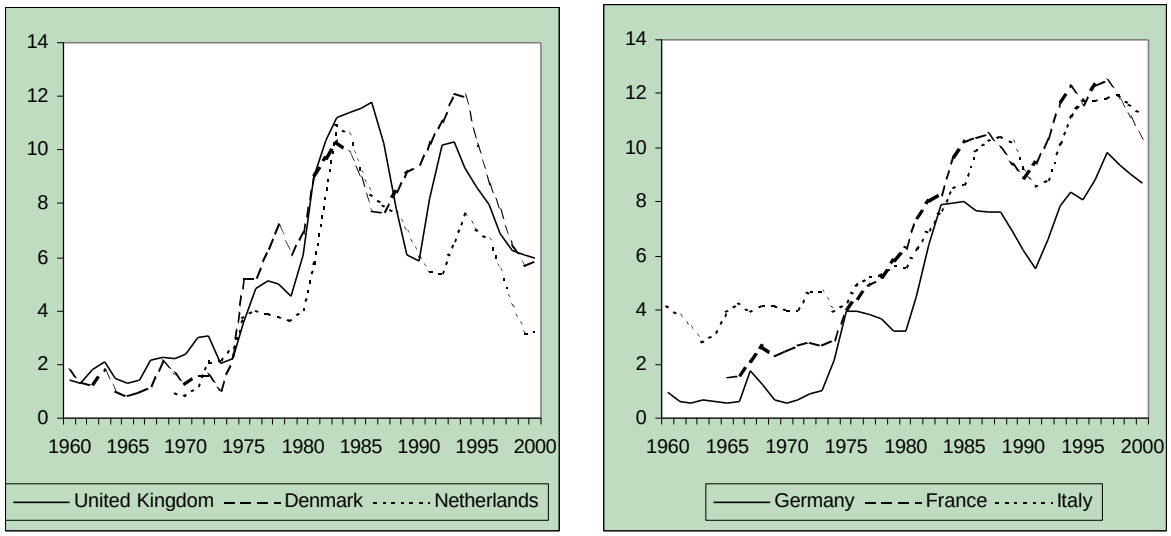
Evidence is now quickly accumulating that this is indeed the case. The empirical studies by Phelps (1994), Phelps and Zoega (2000), Nickell (1997) and Blanchard and Wolfers (1999) allow for the impact of a given shock to depend on labor market institutions. For instance, Daveri and Tabellini (2000) uncover strong labor tax effects only when they separate out countries according to their labor market structures.

These results tend to confirm the list of structural characteristics, presented in the previous section, which had been previously found as contributing to unemployment and slower growth. These results also go a long way towards solving the puzzling observation that Europe had low unemployment in the 1960s even though its labor markets were already more regulated than in the US: the severe shocks of the 1970s have exposed underlying labor market rigidities which were not readily apparent in an era of rapid catch-up growth.

6. THE POLITICAL ECONOMY OF LABOR MARKET REFORMS

While the list of reasons that lie behind Europe's high unemployment and low growth trap is still being refined, it is fair to assert that the first order of magnitude causes have been reasonably well established for several years now, as summarized for example in the influential OECD Jobs Study (1994). In fact a number of countries have dutifully embarked on extensive reforms of their labor markets, and the results have been remarkable. Nickell and van Ours (2000) describe the Dutch and British cases, and other successes can be observed in Denmark as Figure 11 illustrates. Ireland and Spain are other notable success stories. Other countries, notably the three largest ones France, Germany and Italy, have only taken timid steps in that direction, with even regressive measures as the 35 hours workweek in France. The recent improvement in the laggard countries, shown in Figure 11, is largely due to improved macroeconomic conditions, with limited gains in equilibrium unemployment.

Figure 11. Unemployment rates in selected countries.



Source: OECD.

6.1. Insiders versus Outsiders

Why then are some countries unable to pursue policies that should clearly be welfare-improving as they reduce unemployment and deliver a better growth performance? Truth is that reforms are politically unappealing. Labor market reforms are typically not Pareto-improving: there are winners but there also are losers. As long as the losers are cannot be credibly compensated, they naturally oppose reforms. As is shown below, the potential losers tend to be far more numerous than the potential winners. Reform therefore requires either an explicit transfer mechanism --always extremely difficult to set up-- or the willing cooperation of the potential losers. Labor markets rigidities may be economically inefficient but they protect some vested interests

pitting the insiders --those who have a job with long tenure-- against the outsiders --the unemployed, the employed without job guarantee, or the discouraged workers who dropped out the labor force (Lindbeck and Snower, Saint-Paul (1995)).

For example, firing costs and minimum wages act as an insurance protecting the employed insiders against a bad turn of events and whose costs are borne by the unemployed outsiders. In return the insiders finance the unemployment compensation system which makes unemployment less painful. Likewise, collective bargaining increase the ability of employed insiders to raise wages, or prevent wages from declining in the presence of an adverse shock. The cost falls upon the unemployed outsiders who cannot bid down wages in competing for jobs.

As long as the outsiders are less numerous than, and less well organized than the insiders, governments are unlikely to adopt policies protect the insiders from competition by the outsiders, even if they know that the result would be more jobs and faster economic growth.

6.2. The Politics of Successful Reforms: Three Examples

Labor market reforms are therefore unlikely as democracy fundamentally works to the benefit of the majority and, fortunately, an overwhelming majority of Europeans have jobs. Yet, some countries have successfully undertaken major reforms. This section briefly reviews three examples which illustrate three different political channels: in Spain the insiders have become the minority, in the UK the government took the major risk of confronting and then defeating the trade unions, while in the Netherlands the insiders have accepted to make concessions in the spirit of the old tradition of cooperation between unions, employers and government.

Spain

A legacy from the Franco era has been the prohibition of temporary jobs and discouragingly high firing costs. As a result, is was nearly impossible for firms to fire workers in bad times. Under such conditions, once the country opened up its borders and eventually joined the Common Market, Spanish firms could only compete by trimming their work force and substituting capital for labor. Unemployment quickly rose to above 20% of the registered labor force. At such a high level of unemployment, most families were affected through one or more members and willing to contemplate some change. The ability of trade unions to resist any reform became increasingly weaker. The government was able to move and chose first to allow the existence of temporary jobs, which had been so far illegal. Firms seized the opportunity and, gradually, through attrition of permanent jobs, the proportion of workers with temporary jobs rose and came close to 50%. The influence of the insiders, those who held older-type permanent jobs, declined. This made possible a major overhaul of firing restrictions in the Spring of 1997. Ever since the decline of unemployment

rate has been spectacular, from 22% to 14% in just five years, and the growth rate has reached nearly 4% per annum.

Great Britain

The key change was the Thatcher's government determined effort at breaking trade unions. This was achieved by completely overhauling labor negotiations, away from a system of centralized agreements by crafts towards full decentralization with firm level bargaining. New legislation was passed which reduced much of the statutory power of unions in the private sector. As a result trade union influence rapidly declined. The transformation of labor market institutions has continued, for example recently again when unemployment benefits have been severely curtailed and replaced with active labor market policies which provide strong incentives for workers who become unemployed to quickly find a new job. Unemployment has declined to one of the lowest levels in Europe, although part of it has been achieved through early retirements. Britain offers a striking example of outsiders losing at the expense of insiders; for instance, the rate of employment of women has considerably increased while unemployment among unskilled men has sharply risen.

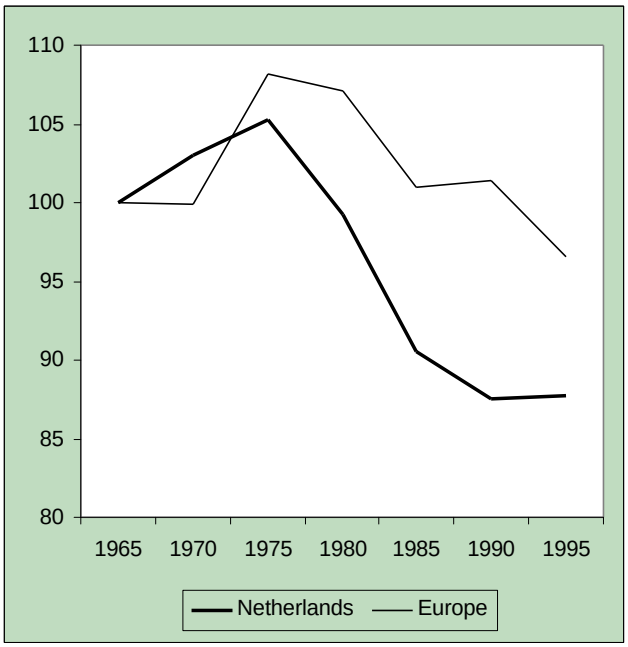
The Netherlands

The Dutch reforms resemble those in the UK with a crucial difference: while in the UK trade unions have been politically defeated, in the Netherlands by the insiders have agreed to give up many of the advantages previously obtained. Two main elements characterize the Dutch reform, the 'Wassenaar agreements' of November 1982. First, eligibility to unemployment has been seriously toughened, sharply increasing workers' incentives to seek new jobs when becoming unemployed. Second, part-time jobs long opposed by unions have become prevalent. By 1998, 18% of male workers and 68% of female workers were officially working part-time. Part of the spectacular decline in overall unemployment -- from 115 in 1983 to about 3% in 2000-- is a redistribution of jobs form males employed full-time to female employed part-time, but there is more than just that. The labor force has increased by almost 30% since 1983, largely as the result of the rise in women participation. As could be expected, such an increase in the supply of labor has led to wage moderation --Figure 12 illustrates the decline in real wages (the measure shown is corrected for TFP)-- and eventually more jobs.

Figure 12. Real wages in efficiency units.

(real wages/TFP)

Index: 100 = 1965



Source: Blanchard and Wolfers (1999).

6.3. Possible scenarios

Summarizing so far, the paper has made three main points:

- Europe's poor employment and growth performance is primarily related to its inefficiently rigid labor markets. These rigidities have resulted in a quasi stagnant pool of jobs since 1960, high unemployment, and a growth slowdown as the economy has been unable to deal with the various demand and supply shocks that have occurred over the years.

- The main sources of labor market inefficiency are reasonably well established. They include high hiring and firing costs, a system of unemployment benefits which undercuts incentives to search for new jobs when unemployed, wage bargaining structures which reduce trade unions' incentive to make room for more workers, and generally high labor taxes. In some countries minimum wages are binding and prevent wage flexibility, both over the cycles and in the long run.

- Labor market reforms are politically divisive, as they pit employed insiders against unemployed outsiders. A number of countries have managed to introduce labor market

reforms and have been richly rewarded. Others seem unable to raise to what is primarily a political challenge.

It is most disconcerting that little progress has been achieved in Europe's largest economies. This section attempts to map out three possible scenarios.

Erosion of TU power

Labor market reform must rest on a different relationship between trade unions and employers. Cooperation has been the leading factor in achieving reforms in Denmark and the Netherlands, while political confrontation has been the approach chosen by the Thatcher government in the UK. Both approaches are unlikely to come by naturally in the countries which have not made significant progress so far.

The Spanish experience represents a plausible scenario. High and lasting unemployment has weakened the unions, making it possible for the government to introduce partial reforms (part-time work) which have further eroded the unions ability to block further reforms. Indeed, throughout Europe, unions have become weaker, especially in the private sector.

Competition and the virtue of examples

By raising efficiency, labor market reforms increase the competitiveness of those countries which adopt them. With most of Europe now part of a monetary union, it has become impossible to raise competitiveness through exchange rate devaluations. Thus we now witness an indirect competition of labor market structures. The Luxembourg labor summit of 1997 has proposed regular reviews of labor market developments. If this process works, it can exert peer pressure among governments, reinforcing the influence of trade competition.

Two-Speed Europe

It remains possible that several governments will not master the political will or ability to undertake labor market reforms. This would lead to the gradual emergence of a two-speed Europe, with some countries growing faster and experiencing low unemployment rates. While of a different scale, we could observe the same kind of divergence as those observed between Northern and Southern Italy, or between the Flemish and Walloon region in Belgium.

7. CONCLUSIONS

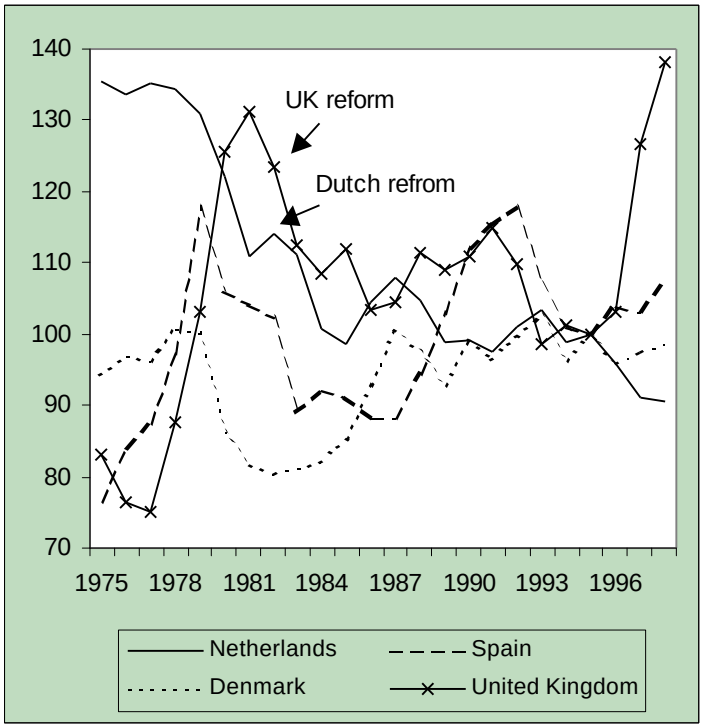
The ECB is now in charge of monetary policy over a huge zone, which is barely recovering from several decades of poor growth and high unemployment. As a conclusion, this last section takes up the crucial question of what can be the implications for monetary policy of the plausible scenarios presented in the last section. Officially at least, the ECB considers that unemployment and long-term growth are not a matter for monetary policy. This argument is far from convincing.

To start with, rigid labor markets mean that the economy is not well equipped to deal with demand shocks, and monetary policy can deal with demand shocks. At best, labor market rigidities imply very long and painful adjustment to demand shocks. At worst there is hysteresis and demand shocks affect the equilibrium rate of unemployment.

In addition, by closing down the devaluation option, the monetary union weakens the ability of national governments to deal with political pressure arising from high unemployment. By constraining fiscal policy, the Stability Pact further limits the scope for macroeconomic policies. Even though neither devaluations nor budget deficits are a cure for long-term unemployment, they provide temporary relief. Hard-pressed governments may soon run out of instruments at delicate times, and the ECB should not expect to always be able to stay above the political fray. Appealing to sound economic principles may just not be enough.

There are two ways in which the ECB can make useful contributions to the battle against unemployment. First, it can seek to encourage labor market reforms by recognizing its political difficulty. The equilibrium exchange rate has been found to respond to reform, but very slowly, a matter of several years. When they agree to reforms that curtail the welfare system, the insiders take a risk: they accept to give up now some components of an explicit or implicit insurance system in exchange for a promise of more growth and less probability unemployment to occur some time later. Acceptance of reforms is enhanced, and a backlash is made less likely, if the economy appears to respond. Figure 13 shows that previous reforms have typically been accompanied by a relaxation of monetary policy, as indicated by the real exchange rate. There is no reason to fear such a move: when supply-side measures increase competition in the labor market and work towards wage moderation, the risk of inflation is limited. Labor market reforms are in the nature of a social pact and the central bank can be a party. Monetary policy relaxation can be seen as anticipating on --and favoring-- future growth.

Figure 13. Real exchange rates and labor market reforms.



Source: IFS.

A different challenge awaits the ECB should several countries fail to undertake reforms and we move towards a two-speed Europe. In that case, normal cyclical fluctuations will tend to be accompanied by varied degrees of inflation responsiveness. For instance, in the upswing, countries with rigid labor markets will face rising labor costs earlier than those with flexible markets. The ECB will have to decide when to step in and adopt restrictive measures, which is bound to be either too late for the rigid labor market countries, or too early for the flexible labor market countries, or both. The "one size fits all" nature of monetary policy in the euro area is not well adapted to lasting structural differences among member countries.

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