

The Portuguese Economic Crisis: Policies and Outcomes

Pedro Portugal



Policy Brief

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Executive summary

“Portugal is in serious trouble. Productivity growth is anemic. Growth is very low. The budget deficit is large. The current account deficit is very large ... In the absence of policy changes, the most likely scenario is one of competitive disinflation, a period of sustained high unemployment until competitiveness has been reestablished.”

*Olivier Blanchard, 2007
currently Chief Economist, International Monetary Fund,
Washington D.C*

The financial and economic crisis in the aftermath of 2008 is unique for several reasons: its depth, its speed and its global-entanglement. Simultaneous economic decline in many economies around the globe sent out political shockwaves. In Europe, the crisis served as a wake-up call. Policymakers responded to the social and political insecurity triggered by economically unsound practices with solidarity and with EU-scepticism. The recession confronted Euro zone countries with a number of similar problems, although each was embedded in its own set of country-specific challenges. The tools with which each began to counteract the financial and sovereign debt crisis differed. This policy brief examines the Portuguese path to recovery. It outlines some of the great recession’s main impacts on the country’s labour market, as well as analyses the path it has taken to restore sustainable jobs.

In sum, Portugal’s recovery offers four lessons for policy-makers in the EU: 1) to include labour market reforms in any adjustment programme, 2) to monitor closely wage-setting systems, 3) to cut the tax burden on labour input, and 4) to increase (European) support for low wage earners.

Note from the Bertelsmann Stiftung

The policy brief “The Portuguese Economic Crisis: Policies and Outcomes” is part of the Bertelsmann Stiftung’s ongoing work to contribute to an evidence-based debate on how to strengthen Europe’s economies and how to improve the economic governance of the European Union. Even before putting countries like Greece at the brink of default in 2012, the crisis had transformed into a political one too, and fuelled an unhealthy antagonism of Euro zone creditor and debtor countries.

In September 2014, the Bertelsmann Stiftung launched an EU-wide social justice index for EU member states. The Social Inclusion Monitor revealed a significant decline not only in absolute terms but also a widening gap between northern and southern EU countries.

In November 2014, the Bertelsmann Stiftung and the Jacques Delors Institute Berlin presented a joint study, “Repair and Prepare: Strengthening Europe’s Economies after the Crisis”. Its policy recommendations aim to allow Europe to repair the economic and political damage wrought by the ongoing euro crisis and to prepare for future shocks.

More information available at:
<https://www.bertelsmann-stiftung.de/en/our-projects/strengthening-and-connecting-europe/>
and <http://www.social-inclusion-monitor.eu>

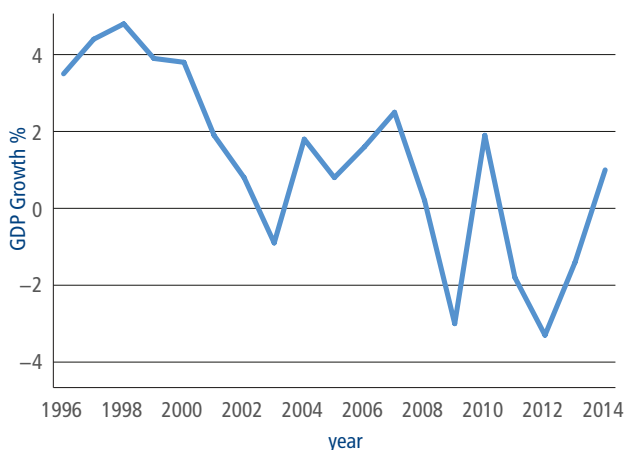
Gütersloh, February 2015

1. The Boom and the Bust

The Portuguese economy was in serious trouble well before being hit by the financial crisis. Severe macroeconomic imbalances were transparent both in terms of persistent large external deficits and budget deficits. Underlying these worrying outcomes, Portugal observed low rates of economic growth and of total factor productivity growth for a long period of time.

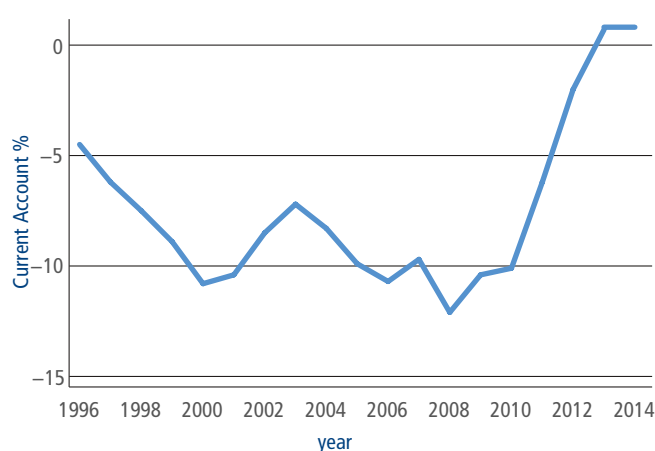
The bust followed a boom (fig. 1). Earlier, low interest rates, made possible by being part of the Euro zone, fueled an economic expansion that was supported by high expectations regarding future productivity growth and was financed by debt (fig. 2 and 3). The increase in demand pushed wages well above productivity levels, and engendered a severe loss of competitiveness (see fig. 4) (Franco, 2003).

Figure 1: Economic Growth



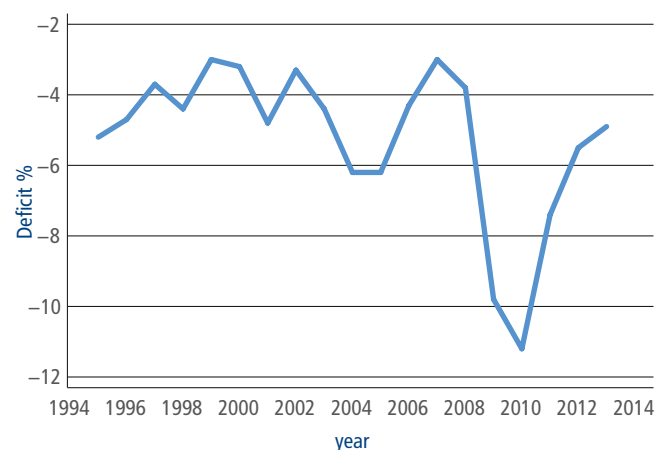
Source: INE (Instituto Nacional de Estatística). | BertelsmannStiftung

Figure 2: External Deficit (in percentage of GDP)



Source: INE. | BertelsmannStiftung

Figure 3: Budget Deficit (in percentage of GDP)



Source: INE. | BertelsmannStiftung

Figure 4: Unit Labor Costs



Source: INE.

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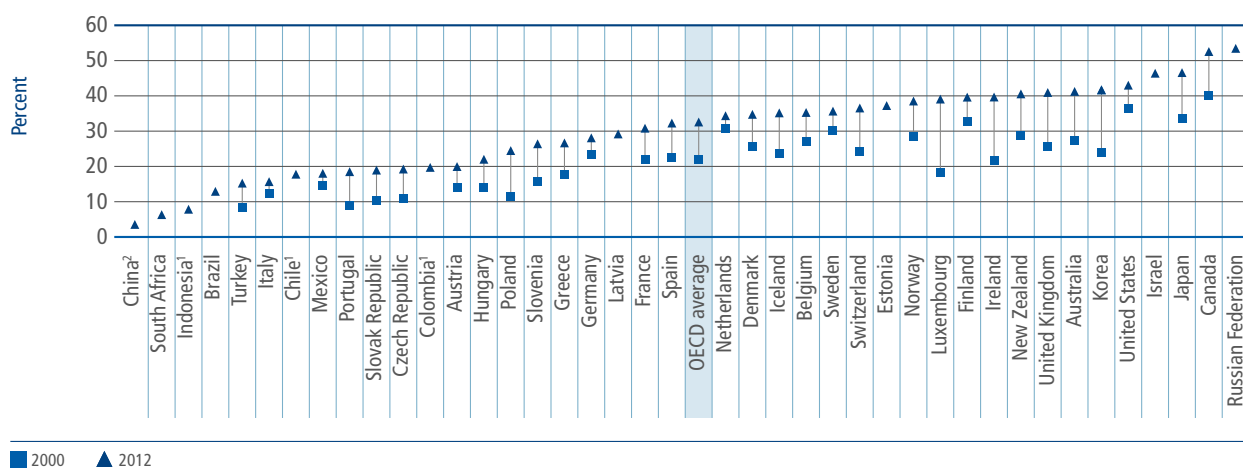
The Portuguese economy was set to enter a painful process of competitive disinflation. But, in 2015, the macroeconomic prospects are much less clouded. External imbalances are considerably reduced, public finances are viably improved, and the financial conditions are stabilized. Portugal is following a path comparable to the one successfully pursued by Spain and Ireland and is regaining gradually its economic competitiveness.

But economic trouble was not confined to macroeconomic misalignments. Two other chronic problems hampered, the Portuguese economy in prior decades.

First, the human capital investments and thus skills available to the Portuguese labour market were low. This was due to an under-investment in education. At the turn of the century, Portugal had one of the lowest rates of education achievement among the OECD countries (fig. 5). Low education translates into low productivity growth. Second, the economy was served by ill-conceived labour market institutions, in particular those related to job protection and wage setting, which over the years played a significant role in destabilizing the Portuguese economy. One indication that the economy was faltering was when Portugal's sovereign bond rating was cut in summer 2010.

Figure 5: Percentage of tertiary-educated adults in 2000 and 2012

25–64 year-olds



■ 2000 ▲ 2012

1. Year of reference 2011. 2. Year of reference 2010.

Countries are ranked in ascending order of the percentage of 25–64 year-olds who have attained tertiary education in 2012 (or latest available year).

Source: OECD, Table A1.4a. See Annex 3 for notes (www.oecd.org/edu/eag.htm). <http://dx.doi.org/10.1787/888933114951>

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2. The Adjustment Programme

The government had two objectives in responding to the financial and sovereign debt crisis: to maintain the stability of the Portuguese financial sector and to buffer the domestic impact of the crisis. Yet increased public spending and reduced public revenue made access to international financial markets increasingly difficult, and (May 2011) led to an economic rescue plan agreed upon the Portuguese government, the European Union, the European Central Bank, and the International Monetary Fund.¹ Structural reforms are one essential ingredient of this plan; institutional reforms, namely labour market institutions, are also part of it.

The plan's Memorandum of Understanding (MOU) imposed ambitious budgetary targets (very likely due to the limitations of the financial package that was made available), forced a demanding deleverage of the banking system, and specified a long and detailed list of reforms across all areas of government. But a critical evaluation of the MOU should not overlook the fact that a (planned and agreed) key policy – a significant fiscal devaluation – failed to materialize. Indeed, the plan to reduce social security taxes and compensate the loss in fiscal revenues through an increase in consumption taxes (VAT taxes), – which was classified by the IMF as a “game changer” – unfortunately failed, to gain political support. Although it is debatable, if indeed a fiscal devaluation can mimic the changes in relative prices similar to an exchange rate devaluation, there is general agreement that it can contain job destruction, and sustain job creation.

Over the course of the crisis, the Portuguese economy faced severe headwinds. First, the macroeconomic adjustment took place at a time when the EU was facing a recession. Second, inflation rates were very low making wage adjustments much harder due to downward nominal wage rigidity. And third, the regulatory requirements of the international assistance programme necessary to reestablish financial stability generated severe credit restrictions to (much indebted) Portuguese non-financial firms.

In this unfavorable environment, perhaps attainable fiscal targets, that facilitated success at each evaluation of the adjustment programme would have better fostered recovery, and attenuated “adjustment fatigue”.² The relaxation of fiscal targets in exchange for significant structural reforms, not only would have made those reforms more likely to be executed, but also would have boosted their political support. A remarkable example is, precisely, the implementation of the fiscal devaluation.

¹ In EU jargon “Economic Adjustment Programme”. Irrespective of the exit from this financial assistance programme in May 2014, Portugal's budget is still being monitored through the excessive deficit procedure, the so-called corrective arm of the stability and growth pact (Art. 126, Treaty on the Functioning of the European Union – TFEU).

² It can be safely argued that, at the early stage of the programme, the failure to attain the announced fiscal targets seriously depreciated the, initially high, social and political support for the adjustment.

3. The Memorandum of Understanding and Labour Market Reforms

The MOU measures dedicated to the labour market reflected the understanding that Portuguese labour market institutions were poorly designed, contributing to the dysfunctionality of the labour market (Blanchard and Portugal, 2001). In effect, international comparisons highlight the fact that job protection in Portugal used to stand out as an extreme case, as did unemployment protection, and nominal wage rigidity (Dickens, et al., 2007). The rigidity of labour legislation has had its consequences: Portugal is the OECD country where the average unemployment period is the longest, where the arrival rate of job offers is the lowest, and where the share of temporary work is the second highest. The MOU aimed to gradually move Portuguese legislation closer to the mainstream European practice.

The evolution of wages over the previous decade was misaligned with that of the feasible wages – that is, those wage levels that could be supported by a balanced economy – generating a serious external competitiveness problem. For this reason, the MOU includes a general concern about containing or reducing labour costs: reducing social security contributions, reducing overtime payments, freezing the minimum wages and public sector wages, reducing severance payments, and reducing the amount and duration of unemployment benefits.

The most significant change, however, was related to the mechanisms of wage setting, through the controls imposed on collective agreements extensions with the whole industry; on the obligation of negotiators to reveal their true constituency; and on the possibility for companies to negotiate wage agreements at the firm level. Highlighting the need to move away from the labour market division of “insiders” (workers with open-ended contracts) and “outsiders” (workers with temporary

contracts and the unemployed) a number of proposals were agreed to reduce firing costs. In practice, the changes in the unemployment insurance rules and in severance payments did not apply to rights already accrued by the workers, meaning that it will take a long time to observe its full impact.

One policy that was openly discussed and partially supported in the MOU, one that would target labour market fragmentation more efficiently, was the introduction of a single contract for new-hires (of the type recently approved in Italy), offering less protection than open-ended contracts but significantly more than fixed-term contracts. Understandably, this proposal was objected to by the social partners and failed to gain the necessary political support in order to be legislated.

As mentioned above, the key element of the programme was the fiscal devaluation. In particular, it was expected to have a positive effect on employment, containing job destruction and favoring job creation. Since the planned reduction in social security taxes was rather substantial (representing 2 percent of GDP, according to the IMF) significant positive employment effects were expected. High estimates of labour demand elasticities for the Portuguese economy were an additional reason to be hopeful. However, political resistance by Portuguese decision makers (and lack of common will among the Troika) during the early phase of the programme, largely based on the uncertainty that consumption taxes could indeed compensate the loss in social security taxes, and a politically unfeasible design of the measure at a later stage, led decision makers to abandon this policy.

4. Labour Market Outcomes

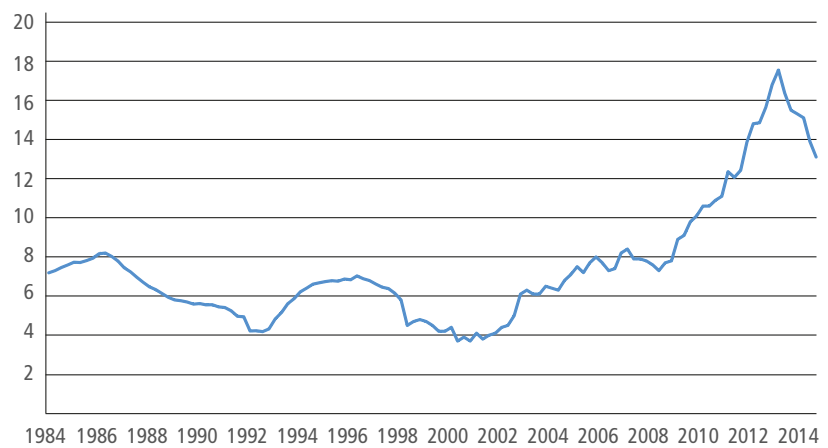
At the end of the adjustment programme in May 2014, Portugal faces the serious economic challenge of reducing unemployment rates, in particular, youth unemployment and long-term unemployment rates. The sharp decline in hiring rates, which is a stylized fact of the great recession in many economies, also impacted in the Portuguese labour market, affecting severely the transition from unemployment of young job seekers. Currently, youth unemployment rates in Portugal (around 33 percent) are comparable to the ones observed in Italy but not as dramatic as those of Spain or Greece.

Portugal is recovering from a severe recession that generated historically high unemployment rates – in 2012 the unemployment rate reached 17.7 percent. Unemployment rates increased very rapidly, but are also decreasing at a fast rate (fig. 6).³ This evolution reflects not only the depth of the recession, but also the underlying macroeconomic dynamics. As compared to past recessions (fig. 7), it is clear that during the current recession the unemployment rate increased more, and faster. It remains to be seen whether this means that recovery will follow the same pattern or not: comparing

³ There is a possibility that, due to methodological reasons, the Employment Survey may have overestimated the incidence of unemployment during the early phase of the Portuguese crisis (Economic Bulletin, Bank of Portugal, 2014).

Figure 6: Unemployment rate

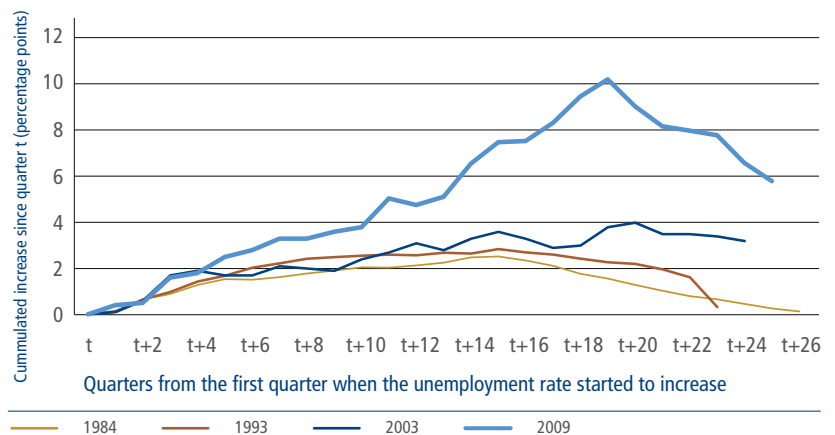
(quarterly data; percentage of civilian labour force)



Source: INE.

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Figure 7: Unemployment rate behaviour in Portugal over the last recessions



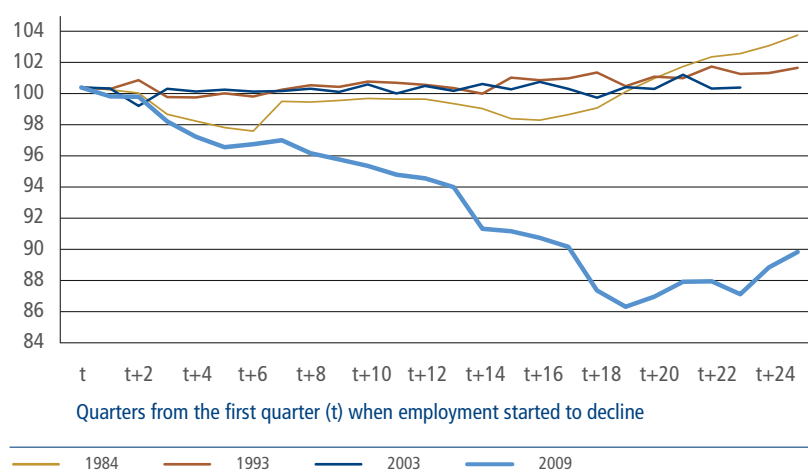
Source: INE and Banco de Portugal estimates.

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the magnitude and speed of downwards employment adjustment during the current and past recessions is not straightforward as the size of the underlying shocks are not similar. Likewise, the speed of the recovery cannot be simply extrapolated from past recovery patterns due to the fact the labour market institutions were reformed in the meantime and the results of such reforms are not yet known. An identically worrying pattern is found for the evolution of employment rate (fig. 8).

Notwithstanding, it is still worth noticing that adjustment to the previous recession (2003) followed a very different path than before: 24 months after the beginning of the 2003 recession, the unemployment rate was still three percentage points above its initial level, whereas in the past the corresponding figure was around one percentage point. This means that, even before the current recession, the Portuguese economy was not able to restore the pre-recession level of unemployment. Predicting whether the exit path from the current recession will be similar to what was observed in the past is akin to predict whether the reform of the institutions will work as expected or not.

Figure 8: Employment behaviour in Portugal over the last recessions



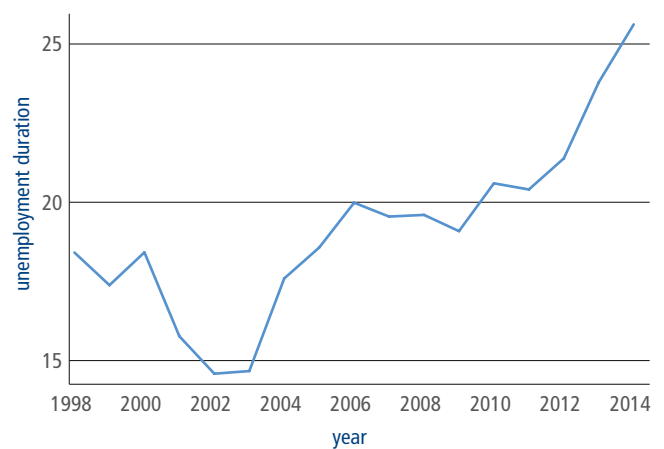
Source: INE and Banco de Portugal estimates.

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During the nineties, the Portuguese labour market was already conspicuous for exhibiting high mean unemployment duration. In comparison with the US, Portugal presented three times longer unemployment durations (Blanchard and Portugal, 2001). During the second half of the 2000s, mean unemployment duration increased significantly and reached historically high values in 2014 (fig. 9). This indication suggests that long-term unemployment, and thus, structural unemployment, is playing now a larger role than before. Indeed, the incidence of unemployment appears to be the main factor responsible for the increase in the risk of poverty in recent years (Schraad-Tischler and Kroll, 2014).⁴

In Carneiro, Portugal and Varejão (2014), the authors explored three different channels that may have amplified the response of employment to the great recession: the credit channel, the wage rigidity channel, and the labour market segmentation channel. They uncovered convincing evidence that the severity of credit constraints played a significant role in the current job destruction process. Wage rigidity was seen to be associated with lower net job creation and higher failure rates of firms. Finally, labour market segmentation seemed to have favored a stronger job destruction that was facilitated by an increasing number of temporary workers. I will explore the two crucial channels in more detail.

Figure 9: Average Unemployment Duration



Source: INE.

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⁴ The social justice index for Portugal's Labour market dropped from 6.14 in 2008 to 4.86 in 2014 on a ten point scale. According to Statistics Portugal, the risk of poverty increased from 18.0 percent in 2010 to 19.5 in 2013. In terms of income distribution, the Gini coefficient increased modestly from 34.2 to 34.5 during the same period.

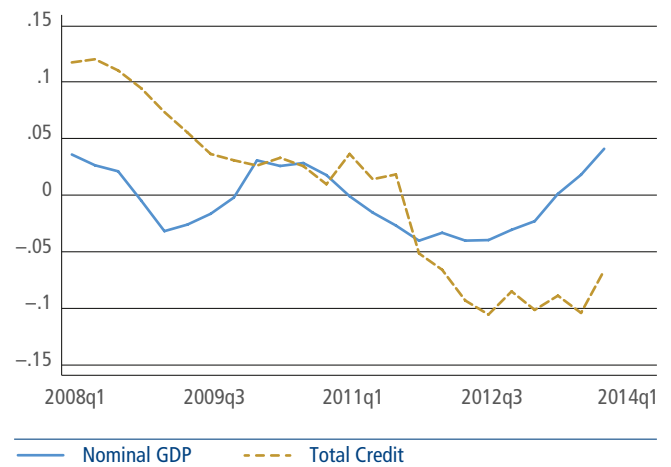
5. Credit Channel and Job Destruction

The unfortunate combination of the financial crisis, the sovereign debt crisis, and regulatory requirements of the international assistance programme necessary to reestablish financial stability generated severe credit restrictions to the Portuguese non-financial firms. Fig. 10 exhibits a sharp dive in the growth rate of credit granted to non-financial corporations (NFC). The decline was even much more pronounced for SMEs.

Equally worrying was the decoupling of Portuguese interest rates on new loans to firms from selected European economies illustrated in fig. 11. This means that Portuguese firms have been supporting financial costs well above those of their European competitors.

One can wonder whether this indication of severe credit constraints faced by Portuguese firms may be linked to the destruction of jobs. Carneiro, Varejão and Portugal (2014) shed some light on the nexus between the firms' financial conditions and employment. They argue, using micro data for the period of the crisis, that inward displacement of supply of credit was associated with higher firm failure rates and lower net job creation rates. These two pieces, taken together, can be interpreted as evidence that credit shortage confronted by Portuguese firms played a non-negligible role in the process that accentuated job destruction.

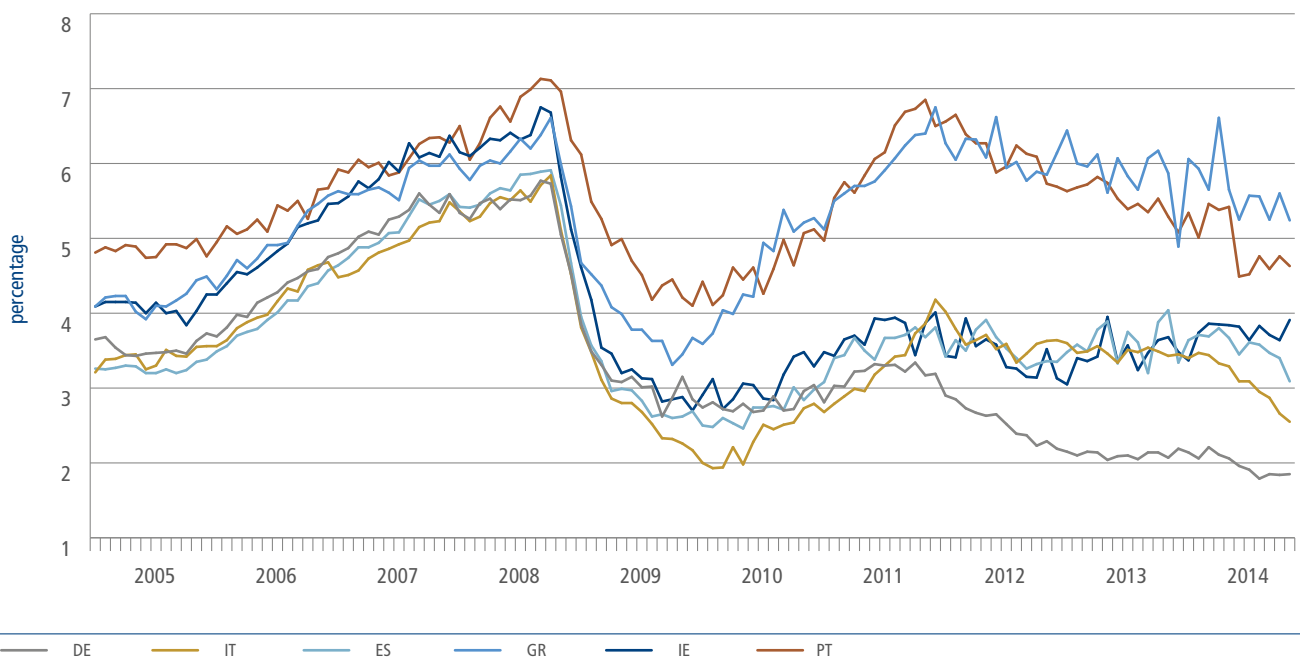
Figure 10: Credit flow growth: non-financial corporations



Source: INE (quarterly data).

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Figure 11: Interest rates on new business loans to NFC



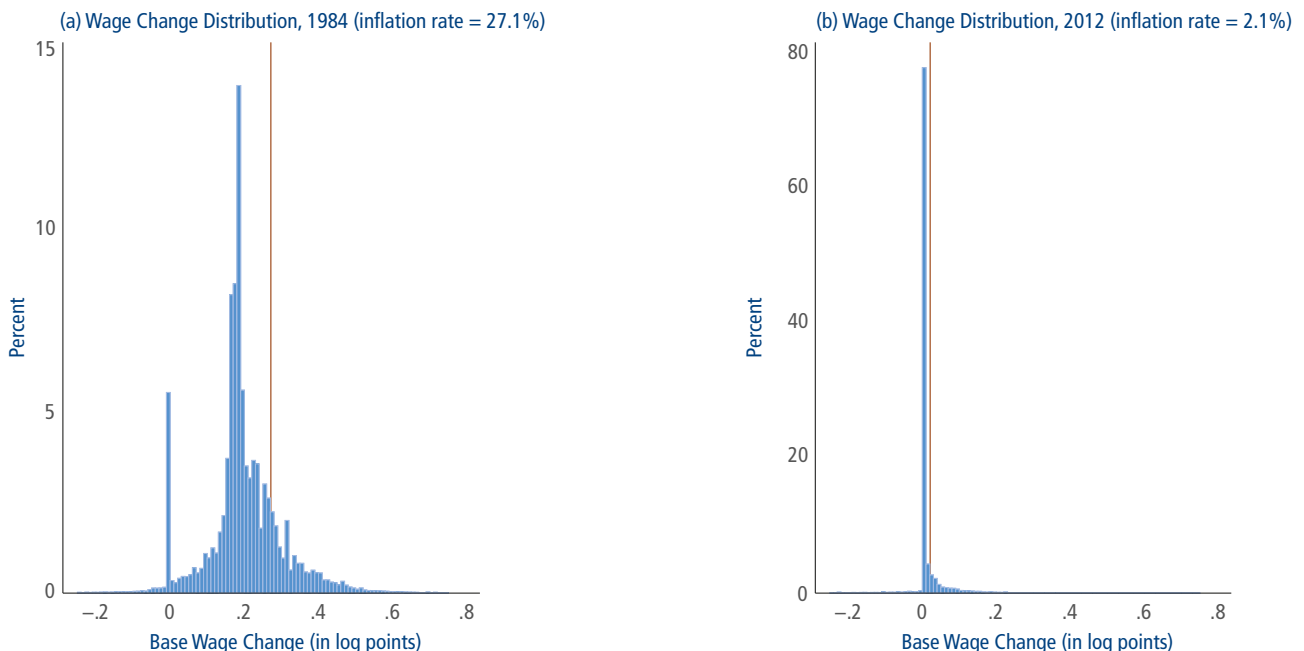
Source: Source: ECB.

6. Wage Channel and Job Destruction: The Role of Downward Nominal Wage Rigidity

On the wage-side, the recession was characterized by a huge increase in the share of jobs that are paid at the legal minimum wage and by an abnormal incidence of nominal wage freezes. Every year in Portugal collective agreements update the wage floors of around 30,000 job titles (Carneiro et al., 2014; Martins, 2014). Given the widespread use of extension mechanisms (“portarias de extensão”) the coverage of bargained wages is close to 90 percent of all dependent workers in the private sector. This occurs despite the fact that the union density rates are very low (around 10 percent according to Portugal and Vilarés, 2013).

The notable feature of the wage setting mechanism in recent years is the evidence of extreme nominal wage rigidity. This outcome is the result of a conflation of severe economic contraction and a low rate of inflation. A revealing exercise is to contrast the nominal wage change distribution in 2012 with that in 1984 when the economic recession was accompanied by high inflation. The respective wage change distributions (of job stayers) are provided in panels (a) and (b) of fig. 12. We focused on the base wage since this measure is more closely related to the theoretical notion of a negotiated wage rate.

Figure 12: Downward Nominal Wage Rigidity in High and Low Inflation Regimes



Source: Quadros de Pessoal 1984, Relatório Único 2012.

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Beginning with panel (a) of the figure, it can be seen that a tiny (2 percent) proportion of workers faced nominal cuts and a discernible share of worker (5 percent) experienced a wage freeze. However, the large majority of workers had nominal wage increases but real wage cuts. Only 18 percent of workers enjoyed real wage increases – those located in the wage change distribution to the right of the inflation rate, identified by the vertical red line. The share of workers located between the two vertical lines (74 percent) provides a rough indication of real wage contractual flexibility in the face of recession. On net, therefore one can speak of real wages having declined by 7.4 percent in 1984, much more than the decline in real GDP (-1 percent). Meantime, the unemployment rates increased very modestly from 8.2 to 8.5 percent.

The drama of *contemporary* wage adjustment is illustrated in panel (b) of the figure. The wage change distribution nearly collapses at zero percent nominal wage change. Fully 86 percent of the workers experienced real wage decreases. Because the inflation rate was very low, the margin of downward real wage adjustment that would not imply nominal wage cuts was highly circumscribed. In these circumstances, a huge fraction of workers experienced nominal wage freezes (76 percent), an outcome without parallel in other developed economies. Overall, real wages fell by 1.3 percent in 2012 whereas GDP declined by 3 percent. Meantime, the unemployment rates increased substantially from 12.7 to 15.5 percent. It seems clear that, in the presence of downward nominal wage rigidity, a low inflation regime translated into protecting wages over job owners. Some other reasons why nominal wage were effectively frozen have to do with the notion that “upward nominal wage rigidity” was contained. They include the mechanisms that generate automatic

nominal wage increases, in the form of a sharp decline in new collective agreements, legal limits placed on the extension of such agreements, and a freeze on minimum wage hikes. In short, 2012 was a time in which incipient downward nominal wage rigidity became truly binding, the full consequences of which are to be felt in the future. These consequences include job destruction (Carneiro, Portugal and Varejão, 2014), pent-up wage deflation (Yellen, 2014), and only then, possibly, a crisis in industrial relations.

7. Lessons from the Portuguese Adjustment Programme: A Labour Economist Perspective

Severe macroeconomic imbalances and inappropriate labour market institutions impaired the Portuguese economy's ability to cope with the consequences of the 2008 global crisis. As the financial crisis turned into a sovereign debt crisis, the labour market response originated severe social costs associated with high job destruction rates, record high unemployment rates, and massive long-term unemployment. In other words, the depth of the recession exceeded the resilience of the labour market, i.e., its ability to weather economic downturns with limited social costs.

A recovery programme must include jobs

The adjustment programme, while successful in other dimensions, was rather disappointing in terms of employment outcomes. As argued above, the needed reduction in labour costs to restore competitiveness was limited by the failure to implement the planned fiscal devaluation. The labour market reforms approximated modestly the Portuguese legal framework closer to the EU mainstream practices. It is too soon to evaluate the full impact of those reforms. But, in our view, major changes are still needed, in particular with respect to the wage setting system.

Wage-setting systems still need to be reformed

Extensive empirical evidence call into question the functionality of the architecture of the Portuguese wage setting system. In particular, it raises very serious concerns with respect to the widespread use of extension mechanisms. Also, the limited role

played by the workers councils in the Portuguese legal framework seriously dampens any moves toward a decentralized (firm based) system of wage negotiations. In this framework, it seems justifiable to limit the extension of wage agreements to criteria based on the representativeness of the negotiation partners. The praised German experience (Dustmann et al., 2014) favoring opting out clauses and decentralized mechanisms where worker councils play an important role should also be given serious consideration, even though the governance structure of the Portuguese system of industrial relations is, unlike the German one, firmly rooted in legislation and overwhelmingly governed by the political process.

Tax cuts on labour inputs could benefit workers

It is not too late to reconsider the alleviation of the tax burden on labour. The debate on wage adjustments has not valued enough the possibility that labour cost savings can be achieved through means other than nominal wage cuts. In an environment of low inflation, in particular, it would be important to consider reductions in payroll taxes (or, more to the point, fiscal credits for earned income) benefiting mainly low wage (low skilled) workers. In other economies, in particular in the US, this kind of policy proved highly effective moving low qualified workers out of the inactivity trap. It is likely to be even more promising in Europe where the combination of wage rigidities and a low inflation regime tend to feed persistent structural unemployment.

More support for low wage earners

A European programme subsidizing low wage earners, which also has merits in terms of its desirable cyclical and redistribution properties, would make an effective complement of a basic European system of unemployment insurance. It is our contention that such programmes may well prove to offer better economic and social returns than the conventional European programmes.

Where are we now?

The economic recession is over, unemployment is declining at a healthy pace, and external competitiveness was restored at surprising speed. It is safe to say that the most painful part of the road to economic recovery was overcome.

Nevertheless, structural reforms in the product and labour markets still need to be more thoroughly addressed. In particular, as in other southern countries, the wage setting system is a (the) key factor responsible for high and persistent structural unemployment rates.

New improvements regarding the architecture of the EMU, enhancing the ability to anticipate and react in a flexible way to a future crisis, are certainly welcome. In this vein, a coherent framework of “reform, investment, and institutional improvements” of the type proposed by a recent study of the Bertelsmann Stiftung and Jacques Delors Institute (2014) merits consideration.

Finally, the recent decision of the European Central Bank starting a Quantitative Easing (QE) programme is likely to sustain a more favourable macroeconomic environment for the European economy. The QE in the US and the UK is commonly praised as instrumental in the economic recovery. But, in my view, it is not clear how to disentangle the role played by monetary policy from the flexibility of the labour markets. Or whether the transmission of monetary policy is favoured by wage flexibility. Nevertheless, as argued above, in countries where downward nominal wage rigidity is widespread, higher inflation certainly facilitates real wage adjustments.

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