

**After 25 years of high unemployment.
What have we learned?**

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How to reduce unemployment?

Many strong opinions:

- eliminate “labor market rigidities” (list follows...)
- use macroeconomic policy more aggressively (list follows...)

After nearly 25 years of research, I am much more agnostic. Goal of the lecture: Summarize what we know, what we do not know, and implications for policy.

Do it in six steps:

1. A quick look at facts, over time and across countries
2. A central distinction: Actual versus natural unemployment rate
3. Determinants of the natural rate: Shocks and institutions
4. The panel data evidence
5. Unemployment “miracles”: Ireland, the Netherlands, Sweden
6. Policy lessons.

1. Basic unemployment facts

Two essential facts:

- The steady increase in the EU unemployment rate since the early 1970s.

Earlier on, the “European miracle” ...

Increase in the 1970s, the 1980s, the 1990s. Turnaround since the mid 1990s?

Figure 1. EU-wide unemployment rate.

- The very diverse country evolutions.

Figure 2. EU unemployment rates. (For each country: Mean, centered over 5 years).

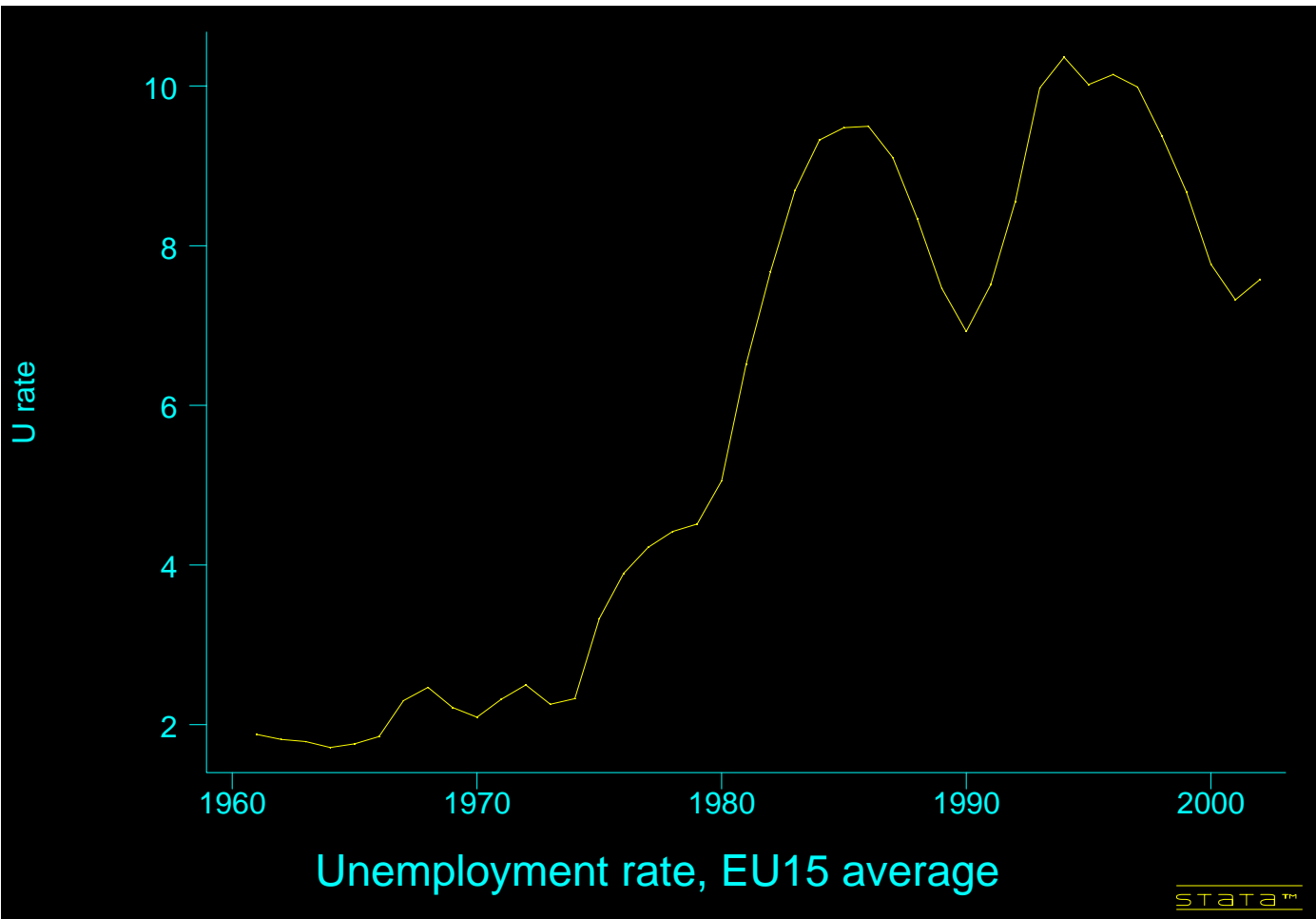
At the top: Spain At the bottom, typically, Luxembourg, Austria, Sweden.

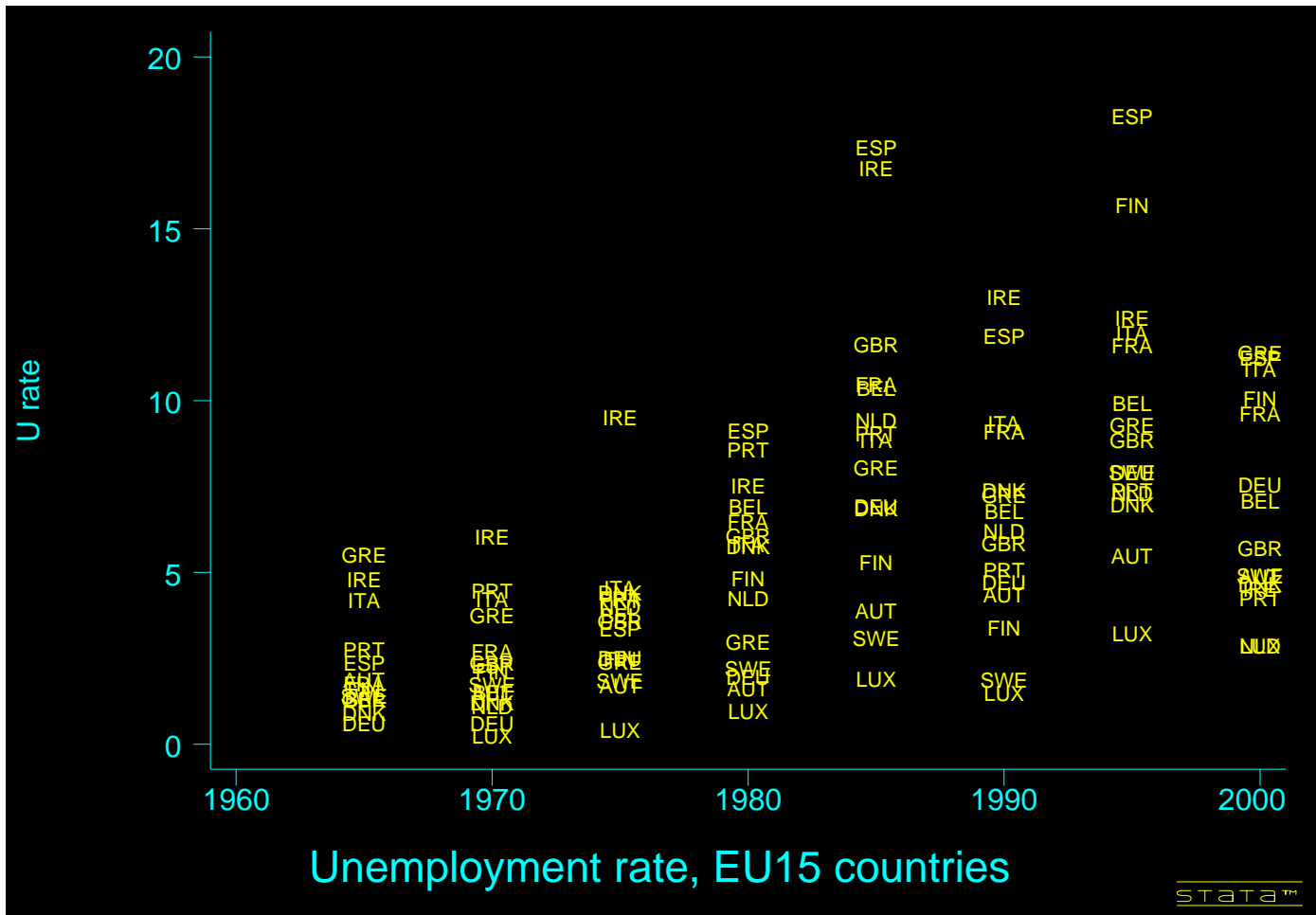
Four more revealing close ups: (Figure 3)

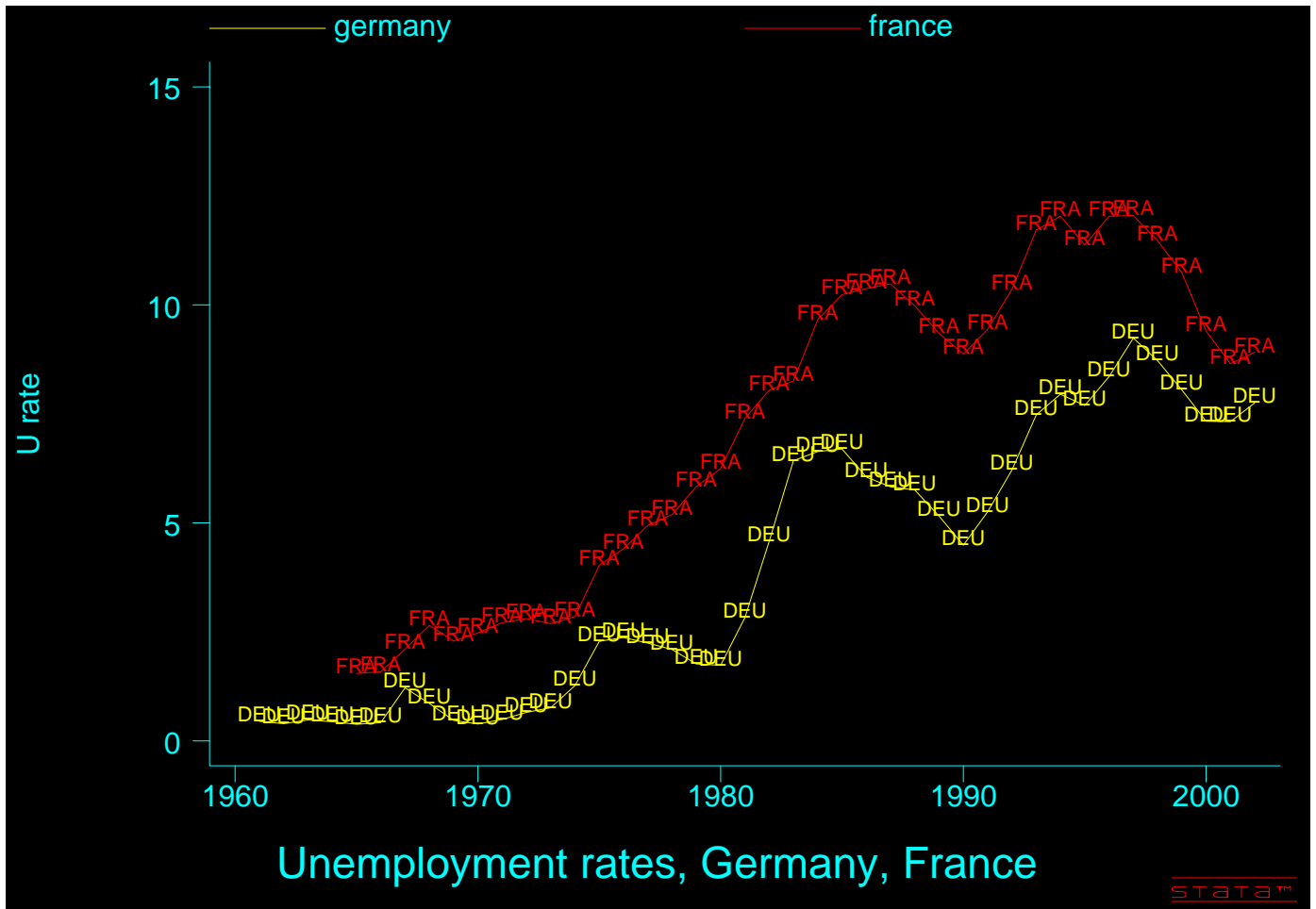
- Germany, France. The steady increase.
- Spain, Portugal. Surprising different evolutions.
- Scandinavian countries. A fever attack in the early 1990s.
- The turnarounds. Ireland, the Netherlands

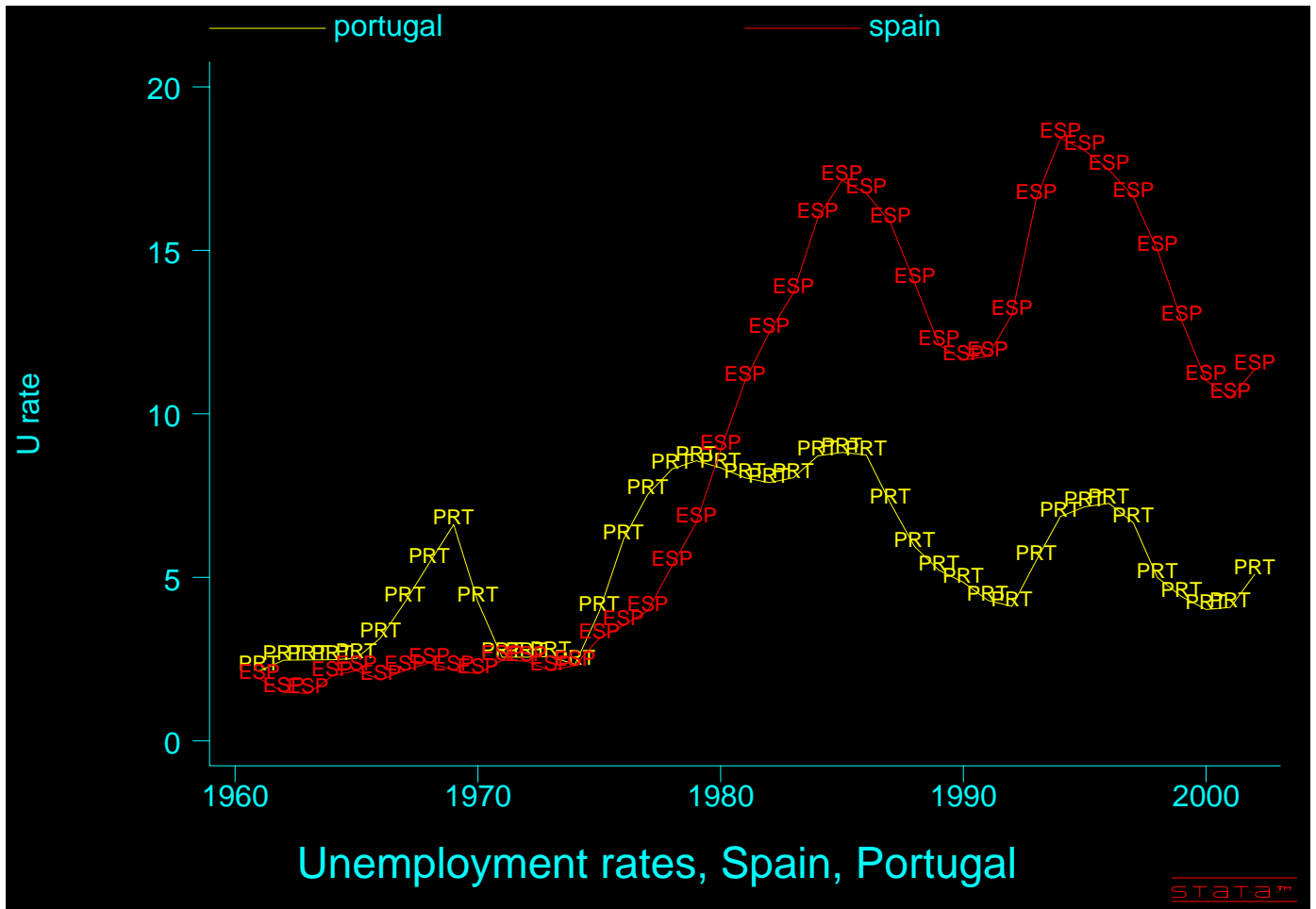
Good news: Hope for identification.

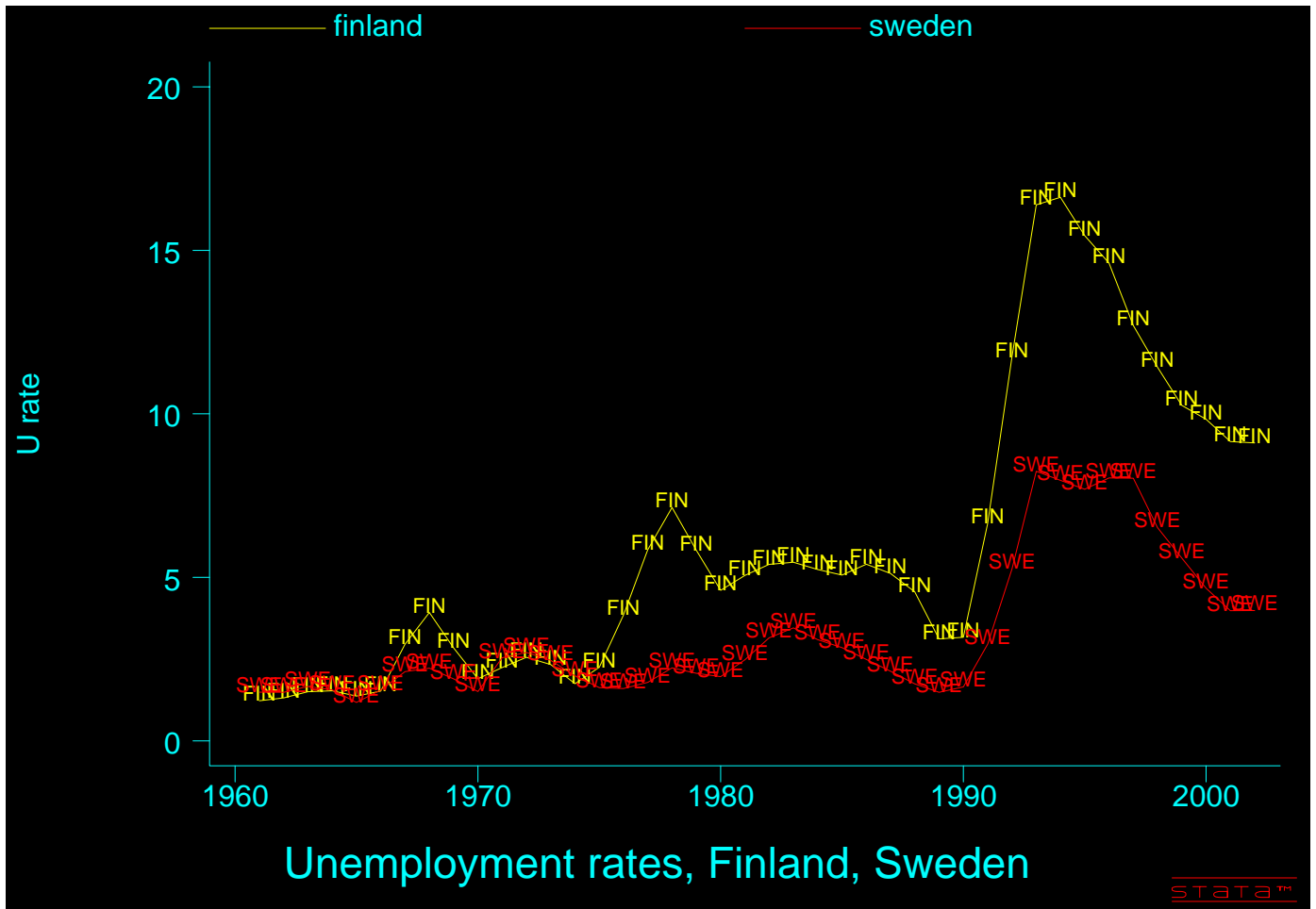
Bad news: One liners will not do.













2. Actual versus natural rate

A central distinction:

- From one quarter to the next, movements in unemployment determined by aggregate demand.
Correct policy measures: shift aggregate demand, through fiscal or monetary policy.
- Over longer periods (3,10 years?), unemployment rate returns to an equilibrium value, such that:
The wage demands of workers are consistent with the wages firms are willing to offer.

Called the “natural rate”. Worse choice of words ever: Depends on behavior of unions, monopoly power of firms, and so on.
Correct policy measures: Shift wage demands, or wages offered by firms.

Essential to know whether high u is high natural u^* , or large deviation from u^* .

Not easy:

- The natural rate is not constant
- It is not observable
- It may be affected by the actual rate itself (hysteresis)
- It depends on some of the same factors as the actual rate (interest rates for example)

Fortunately, a strong hint from theory: The behavior of inflation as a signal.

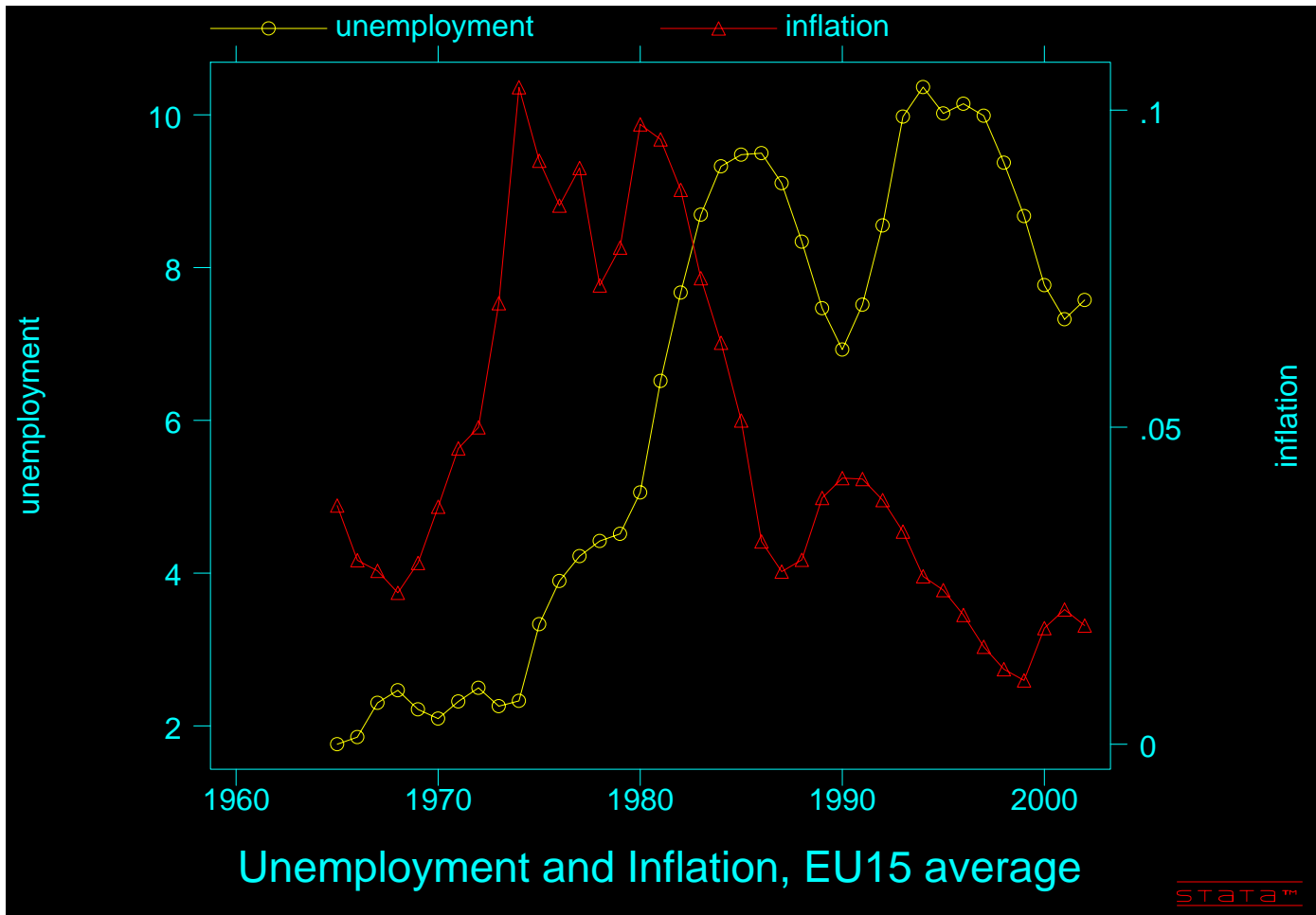
- If $u = u^*$, wage demands consistent with wage offers. Inflation stable.
- If $u < u^*$, inflation increases.
- If $u > u^*$, inflation decreases.

Useful tool, if complex to use (reliability at high, and at low inflation?)

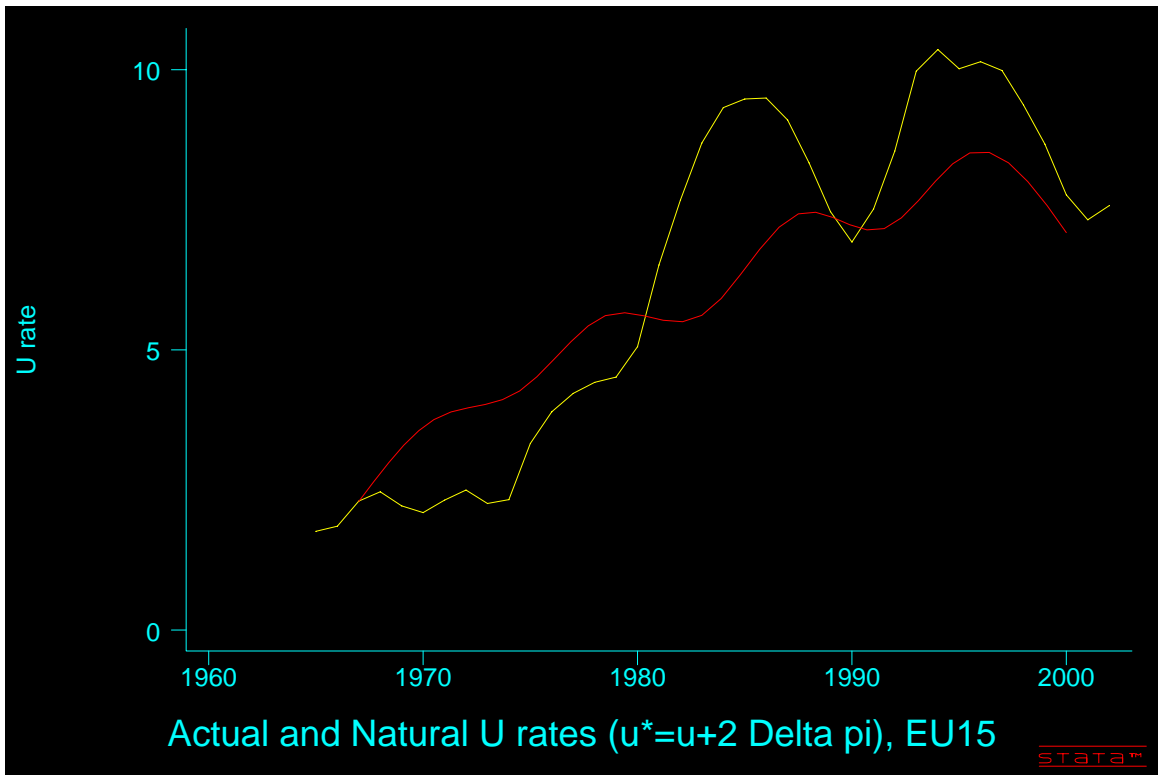
The evidence:

- EU inflation and unemployment. Figure 4.
- An estimated natural rate series. Figure 5.

Conclusions. For the most part, high u^* . Deviations in the 1980s, the 1990s, the early 2000s.



Unemployment and Inflation, EU15 average



3. Determinants of the natural rate: Shocks and Institutions

A very large amount of work over the last 25 years. Better models, integrating shocks and detailed institutions.

- An example of shocks: A decrease in the rate of technological progress.
Short and medium term effects. Wage demands may continue at the previous rate, until workers and firms understand.
Long term effects: Probably not much.
Unemployment will increase for some time, and eventually turnaround.
- An example of institutions. Unemployment benefits.
(At least some) insurance is desirable. But higher unemployment benefits increase unemployment:
They lead to higher wages, increase costs for firms, decrease job creation, and lead to higher unemployment duration.
They decrease search intensity, and so increase unemployment duration.
- An example of interactions.
Open-ended unemployment benefits in the face of an adverse technological shock can lead to long term unemployment, unemployability, and longer lasting effects of shocks.

The need to identify the respective role of shocks, institutions, and interactions.

4. Shocks and Institutions. The panel evidence

Explaining u over time and countries. A necessary intellectual discipline; otherwise too easy...

Shocks: A plausible list of adverse shocks.

- The slowdown in TFP growth from the 1970s on. More generally, the end of the “30 Glorious years”. Figure 6.
- The high cost of capital in the 1980s and early 1990s.
- An open question. The role of globalization/reallocation in the 1990s. Very much in the news. Harder to find in the data.

Measured shocks appear very similar across countries (some exceptions, Franco in Spain, Reunification in Germany...). So cannot explain cross country differences.

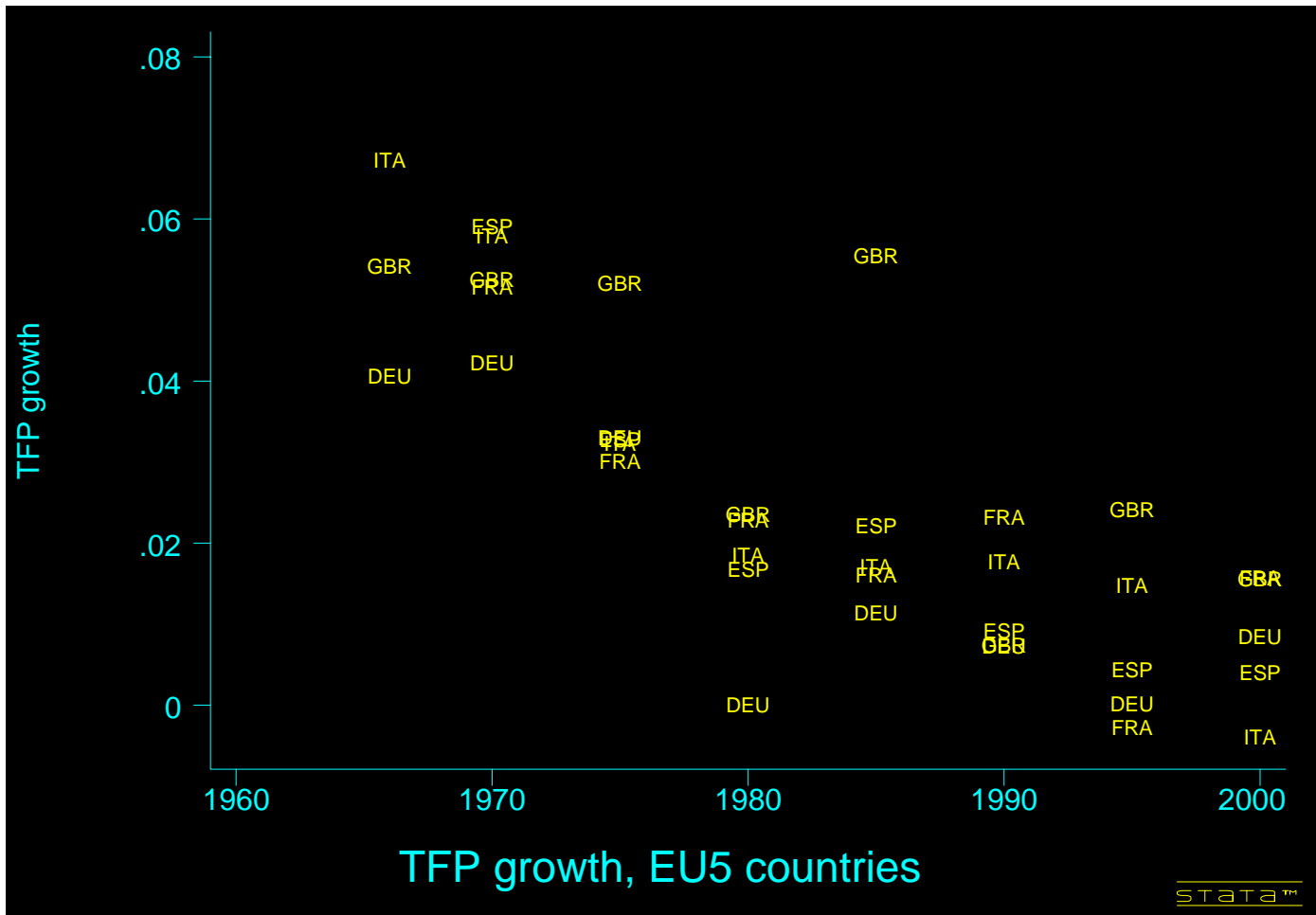
Labor market institutions

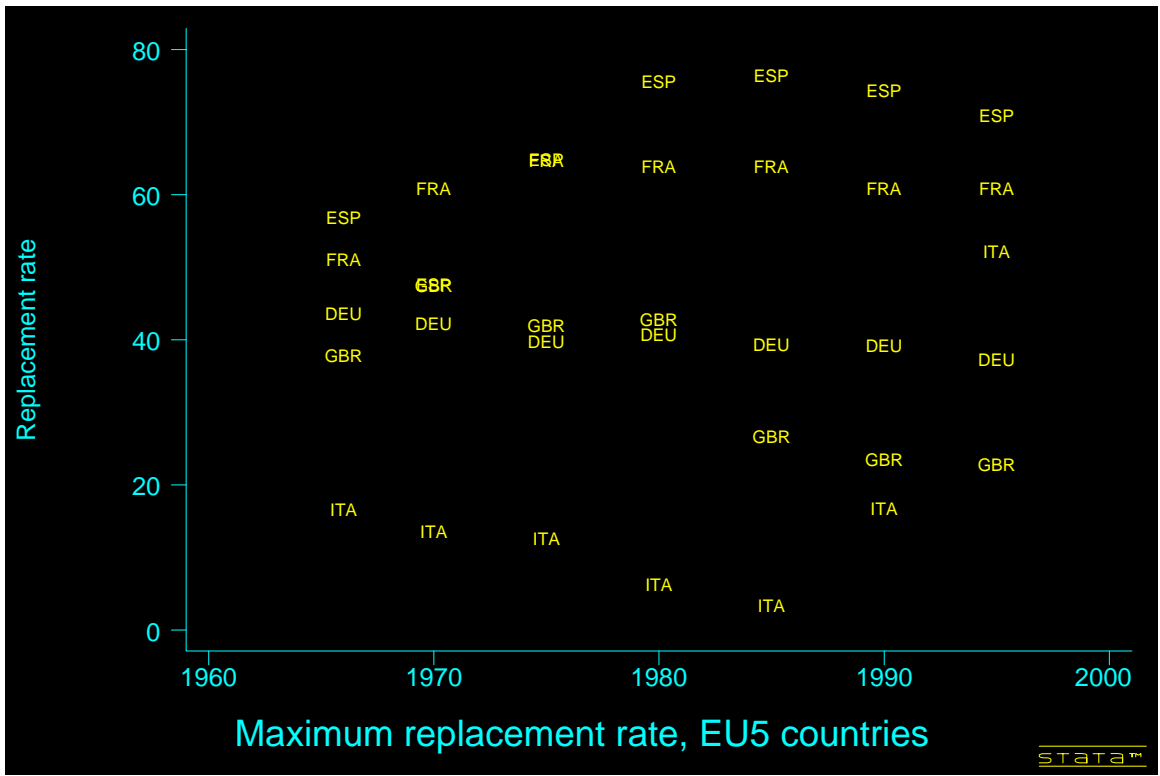
- Clear differences across countries. Form of wage bargaining, generosity of unemployment insurance...
- Relatively stable over time. A bit more protection in the 1960s and the 1970s. A bit less since.

But, in general, cannot explain the time series pattern of unemployment.

Example: The maximum replacement rate over time. Figure 7.

This suggests the importance of interactions.





Interactions. The overall evidence is consistent with the following description:

- Largely common shocks.
- Countries with “worse institutions” have had higher, more persistent unemployment.
- Which institutions? Econometric answer:
 - Heavier employment protection
 - Open ended unemployment benefits
 - Low coordination of wage bargaining
 - Low “trust” between labor and capital

A large consensus, but still fuzzy:

- Exact channels?
- Spain versus Portugal?
- Difficulty of measuring institutions.

The usefulness of case studies. Looking at the “miracles”.

5.1. Ireland

Basic facts:

- From 5% in 1973, to 17% in 1986 to 4% in 2002.
- Mostly movements in u^* . Figure 8.
- For real? Yes. (Employment increase much larger)

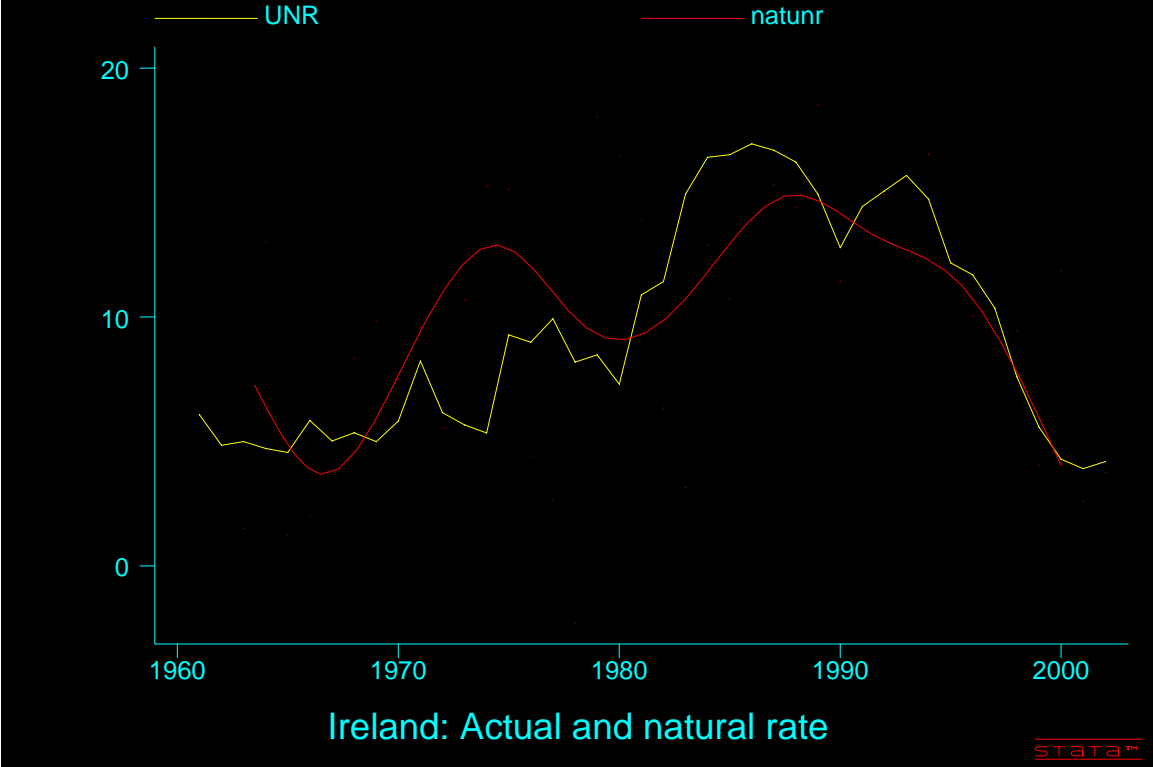
Proximate causes:

- Very high TFP growth
- Much lower real wage growth
- Lower cost of labor, and an increase in employment given capital
- High profit rates, capital accumulation and employment

Deeper causes:

- TFP growth. The trigger (and only the trigger) FDI, in part due to fiscal breaks.
- Wage moderation? A common labor market between the UK and Ireland. Or wage moderation and responsible unions, starting in 1987? Open question.

Lessons: Cannot export the experience. But an important lesson: Wage moderation can achieve miracles.



5.2. The Netherlands

Basic facts:

- From 1% in 1970, to 11% in 1983, to 2% in 2002. Figure 9.
- Mostly movements in u^*
- For real? (Part time employment, workers on disability?) Yes

Proximate causes: Same as Ireland, on a smaller scale

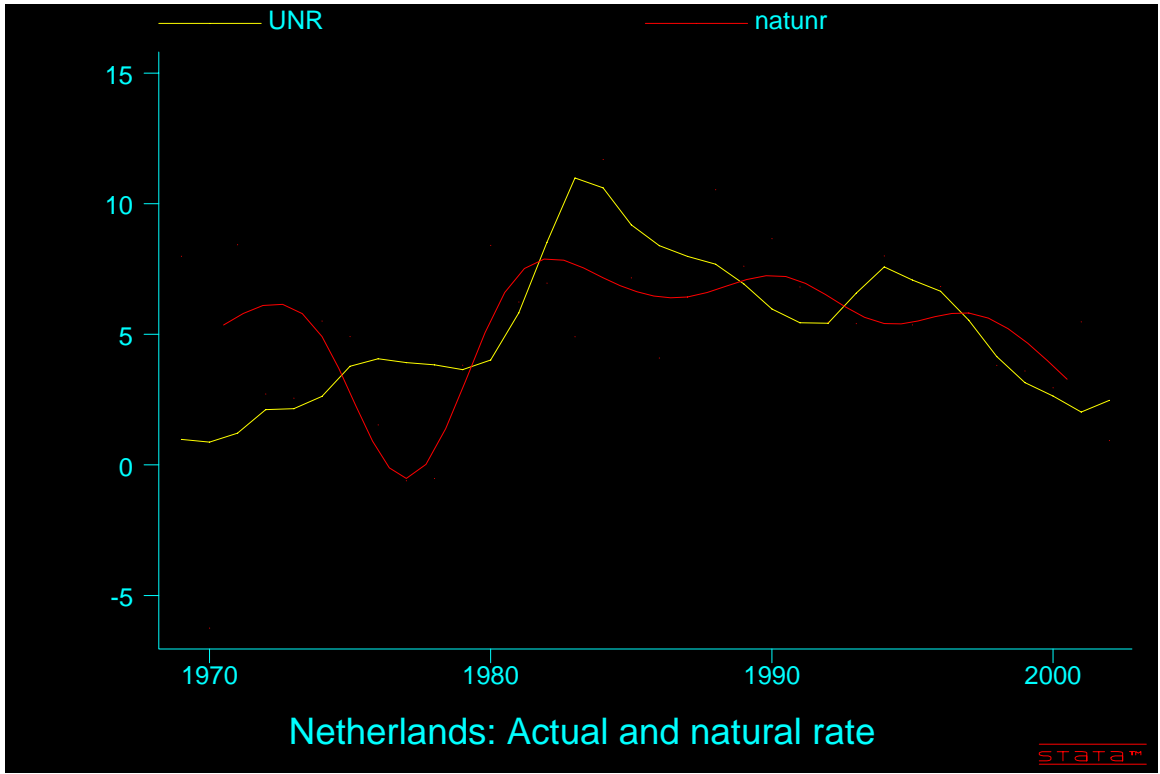
- Wage moderation. Wage growth below TFP growth, from early 1980s. Lower labor costs, higher profit rates
- More employment given capital. More capital

Deeper causes:

- Explicit and sustained wage moderation. Wassenaar 1982 and follow up.
- Institutional reforms: Limited.
Employment protection: Decrease for full time, Increase for part time.

Unemployment insurance. Effective average replacement rate, from 71% in 1980 to 56% in 2000. (high relative to EU average)

Lessons: Wage moderation. Low unemployment consistent with high social protection.



5.3. Sweden

Basic facts:

- Below 3% until 1990. Then a sharp increase to 8% in 1993, then back down to 4% in 2002.
- The increase in the early 1990s is mostly due to deviation of u from u^* . Figure 10.
- For real? Yes but. Evolution of public employment.

Proximate causes for the 1990s fever: A standard boom-bust.

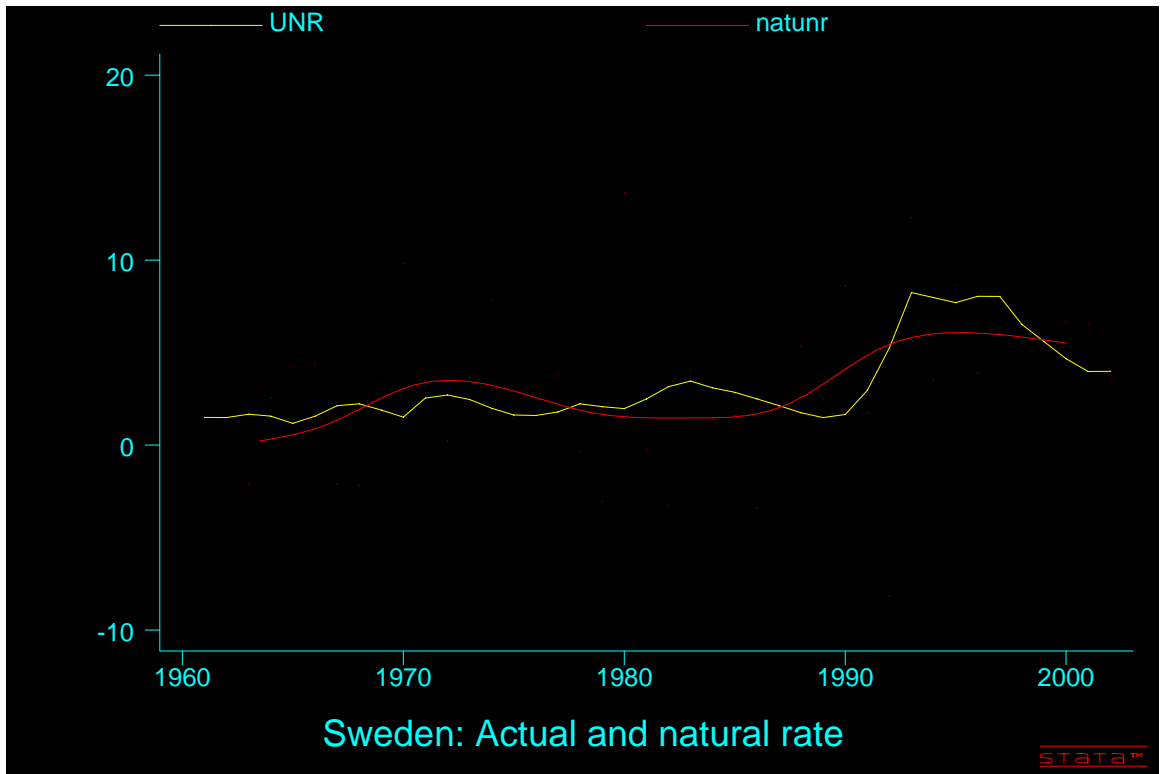
- Excessive demand in the late 1980s, due to liberalization of financial markets, sharp decrease in saving rate.
- Fixed exchange rate, inflation, appreciation. Then, from 1992 on, speculation, depreciation and return to normal.

Deeper causes for low u^* ?

- Wage moderation. In evidence in 1991-1993, after depreciation.
- Generous social protection. Not much change in level. Average effective replacement rate, from 90% in 1992 to 70% in 2000. But change in form: Linking unemployment benefits to search

Lessons. Low unemployment consistent with high social protection.

Can be exported?



6. Implications for policy

Stating them with more confidence than I do have:

- High social protection consistent with low unemployment. But has to be done right.

Employment protection. Layoff tax to finance unemployment benefits, but limited judicial intervention.

Unemployment insurance. Generous, but conditional on search and job taking.

Wage compression: A lower minimum wage, a larger role for the negative income tax

- Coordination, allowing for wage moderation when needed, and in response to shocks.

Necessary but not sufficient condition (Spain in the early 1980s). (Elusive “trust”)

- Make sure that if u^* goes down, u follows. In other words, more reactive demand policies. (probably more so than today).