THE ECONOMICS OF EUROPEAN UNEMPLOYMENT; SHOCKS, INSTITUTIONS, AND INTERACTIONS.

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INTRODUCTION

Unemployment in OECD Europe since 1960. (5-year averages, 15 countries). Two characteristics:

- The general ebb and (recent) flow
- The heterogeneity. looks nearly multiplicative

Why?

- Initially, focus on shocks, oil, later on productivity slowdown.
  Problems with cross country dimension: Shocks not sufficiently different across countries.
- Later on, shift to focus on institutions: Blaming the “welfare state”.
  Problems with time series dimension: Institutions have not changed that much.

An emerging consensus:

- Shocks.

- Changes in institutions.

- Interactions between shocks and institutions.
Shocks

- Productivity slowdown (probably more important than oil shocks, which at the time were the central focus). (Figure). Stronger in Europe than in the US. But rather similar within Europe.

- Downs and ups of real interest rates (An issue. why did they move so much? Role of monetary policy). (Figure). Differences across countries. Germany versus Spain.

- Shifts in worker militancy (the late 1960s: May 1968 in France, the hot autumn of 1969 in Italy) or, more recently, wage moderation (the Wassenaar agreements in the Netherlands in 1982)? (Or different economic models held by unions?)

Actual versus equilibrium unemployment (the “natural rate”)? A hint of the relative evolution: The evolution of the change in the inflation rate. $u < u^*$ in the 1970s, $u > u^*$ in the 1980s and early 1990s.
Changes in institutions.

How much change? The notion that the creation of the welfare state led to high unemployment is simply wrong.

Institutions multidimensional and difficult to measure. But a number of measures for a number of countries. Some evidence:

- Unemployment benefits.

  Average replacement rates. (Figure). An increase, moderate for E5, larger for E15. Both in the 1960s and 1970-80s. But large differences across countries.

  Maximum replacement rates (Figure). Roughly similar, but flat or decreasing since early 80s. Large differences across countries.

- Employment protection. Overall index. (Figure). Increase until the early 80s. But again large differences across countries.

Questions:

- A positive theory of institutional change in this context? What was the role of good times of the 1960s, the role of bad times of the 1970s and later?
• If they indeed had an effect, why did the reforms of the 1960s take so long to show up in higher unemployment?

• What is the role of labor market reforms in the recent declines in unemployment?
Interactions

Different institutions have led to a different labor market in Europe. A labor market in which shocks have larger/longer lasting effects.

A number of stories/mechanisms


European labor market institutions were fine so long as there was no turbulence. In the presence of higher turbulence (more technological change, globalization), they have led to higher unemployment.

Two problems.


Theoretical: Why “rigidities” might hamper growth and adjustment is clear. Why they should lead to higher unemployment is less so.

- Another old theme. Sclerosis and hysteresis.

European labor market institutions have led to sclerotic labor markets: Low flows of workers through the market, long duration of unemployment, high proportion of long term unemployment.
Adverse shocks lead to an increase in duration, an increase in long term unemployment. The long term unemployed however exert little pressure on wages, leading to larger/longer lasting effects of shocks on unemployment.

A complex story, with many steps, and many questions, both theoretical and empirical.

- Other leads?
  An old one, from Bruno and Sachs. The nature of wage setting: nominal versus real, staggered versus synchronized. Can it really matter that long?

  A new one. The relative shift in skilled versus unskilled labor, together with wage compression or minimum wages. Works well for Europe versus the US, not so well within Europe. (Nickell). Agnostic; surely only a small part of the story.
Consensus plausible, and provides a good statistical description of the evolutions, both over time and across countries (Blanchard and Wolfers, building on Nickell).

Found a role for shocks (tfp growth, real interest rates), and for interactions with institutions (employment protection, length of unemployment benefits). No evidence in favor of a role for changes in institutions.

But still fuzzy: exact mechanisms, relative importance... Needs more work, micro and macro.
Conclusions and open issues

- Shocks. Open issues. The quantitative importance of the interest rate channel. Productivity growth and unemployment (Japan in the 1990s?). Relative shifts.


Normative: What is the right set of labor market institutions? How to provide unemployment insurance? If there is unemployment insurance, what else should be there?

Measuring them. After tax replacement rates? Fixed-duration contracts? (The example of France at this point).