

A VIEW ON EUROPEAN UNEMPLOYMENT

Prakash Loungani

Advisor, Research Department, IMF

Co-Chair, IMF “Jobs and Growth” Working Group

May 3, 2013

VIEWS EXPRESSED SHOULD NOT BE ATTRIBUTED TO THE IMF OR TO MY CO-AUTHORS.

I thank Celine Allard and Petya Koeva Brooks for very useful comments and inputs and Ezgi Ozturk for excellent research assistance. An earlier version of this presentation was made at the EUI-nomics conference in Florence, April 26, 2013. I thank conference participants for comments.

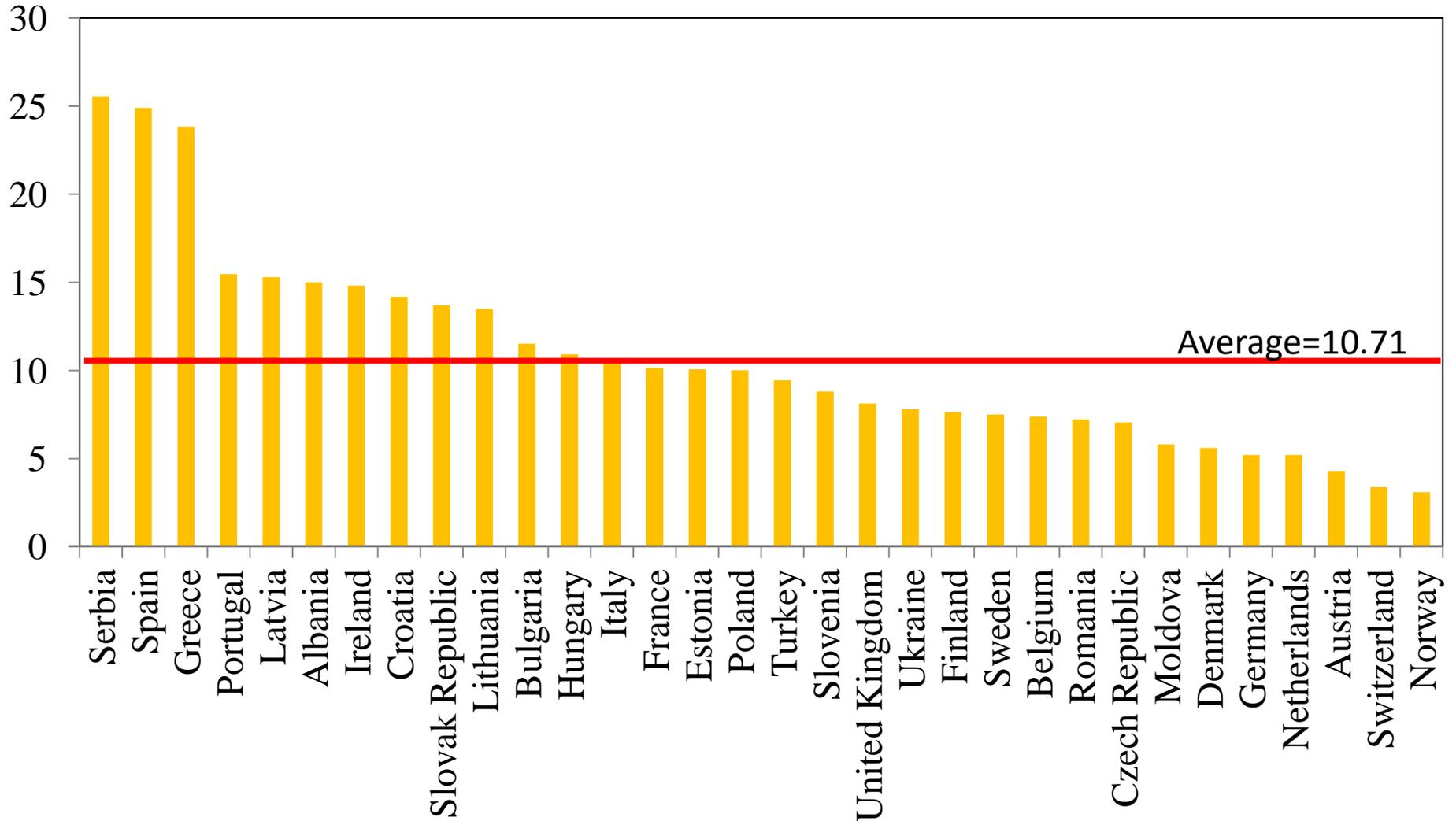
Outline & Summary

1. Unemployment and output are linked, even during the Great Recession & Not-So-Great Recovery
 - [Ball, Leigh and Loungani \(NBER WP, 2013\)](#)
 - » [VoxEU](#) and [Econbrowser](#) *summary*

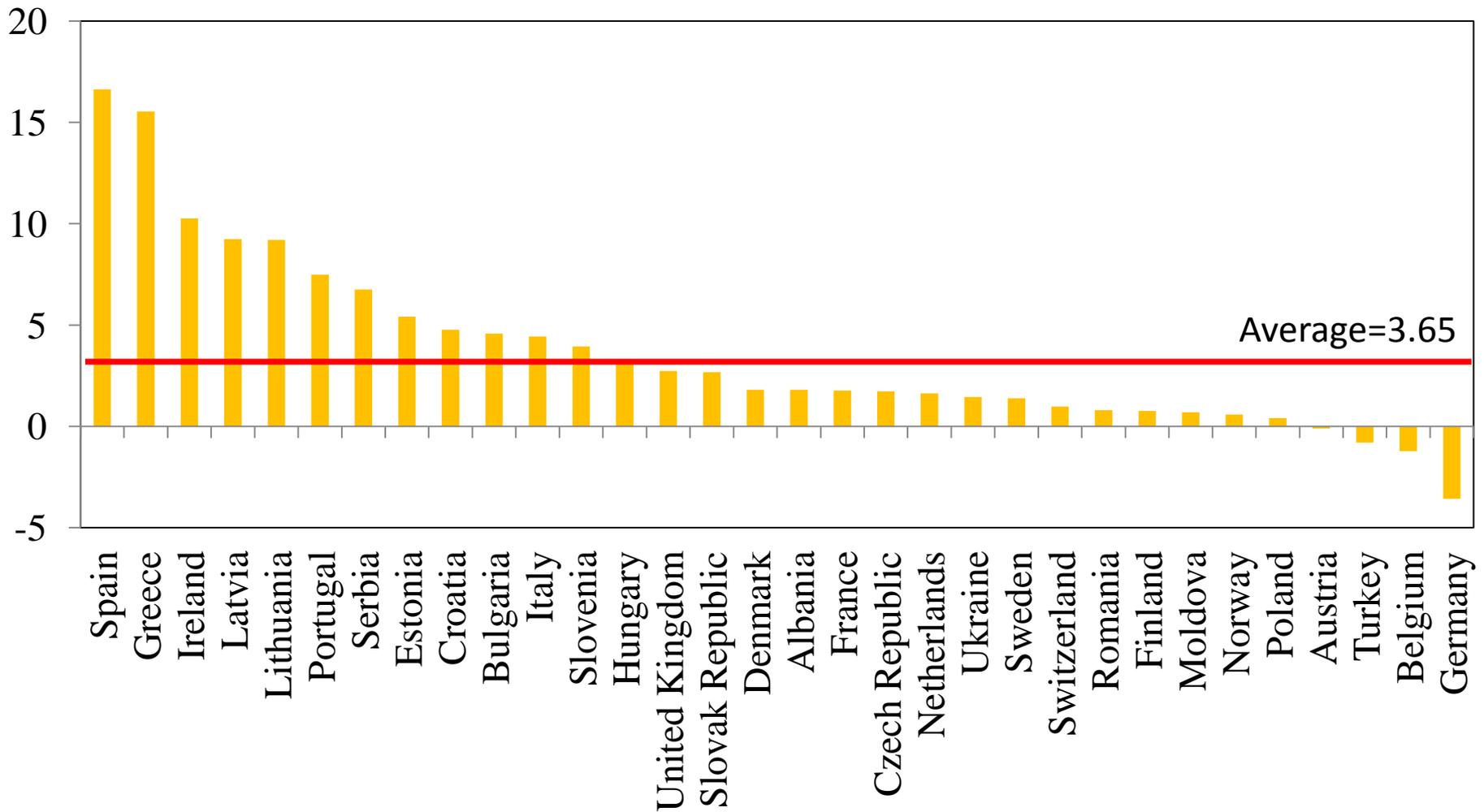
2. Many reasons for slow recovery in output
 - One possibility: Fiscal policy has not been able to provide the support it did in previous recoveries
 - [Kose, Loungani and Terrones, WEO 2013, Box 1.1](#)
 - » [VoxEU](#) *summary*

3. Complementary role of labor market policies, particularly where competitiveness is an issue
 - [Blanchard, Jaumotte, Loungani \(IMF Staff Discussion Note, 2013\)](#)
 - » [IMF Survey](#) *summary*

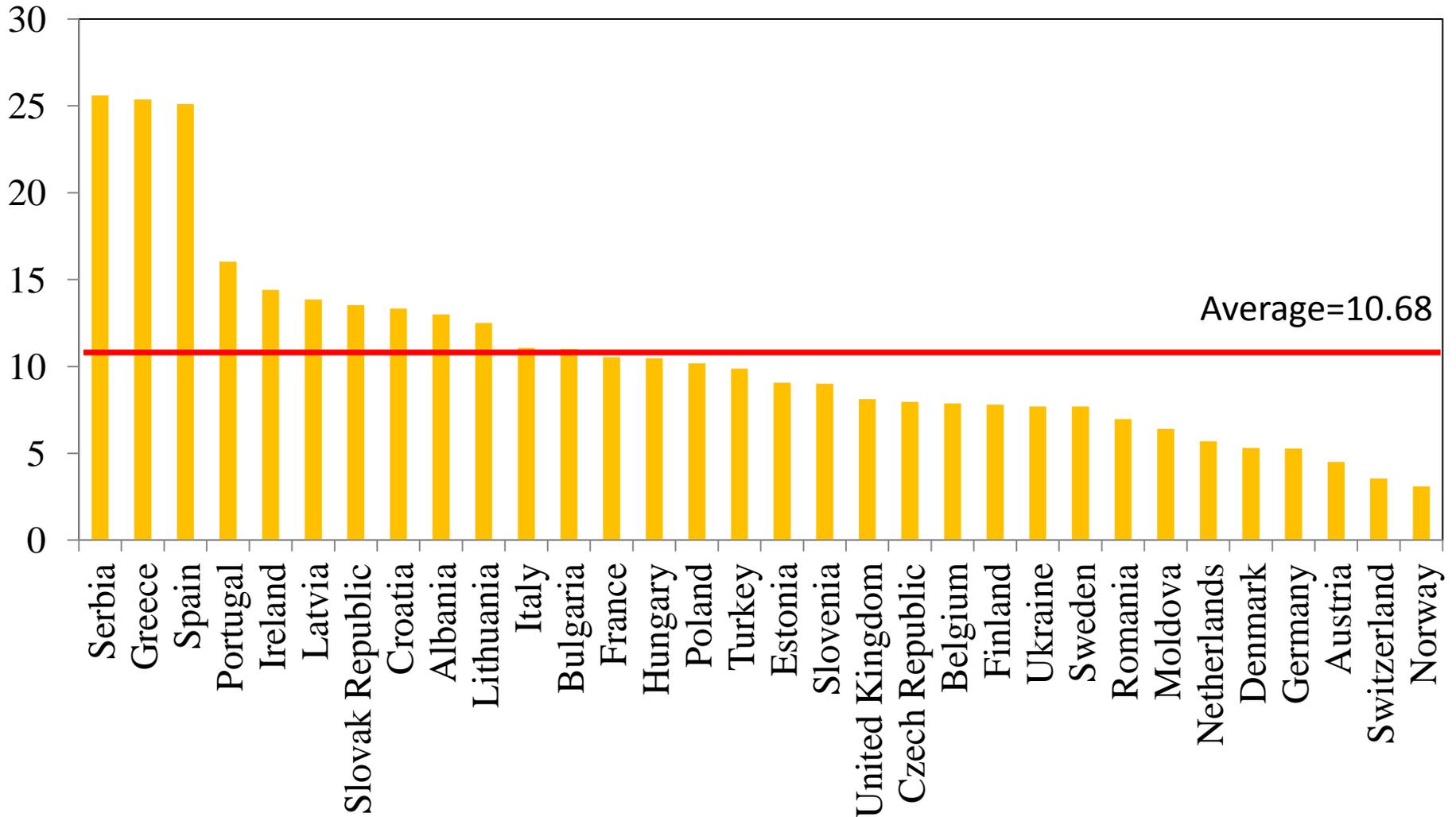
Unemployment Rate: 2012



Change in Unemployment Rate: Between 2007 and 2012



Unemployment Rate: 2013 WEO Forecast

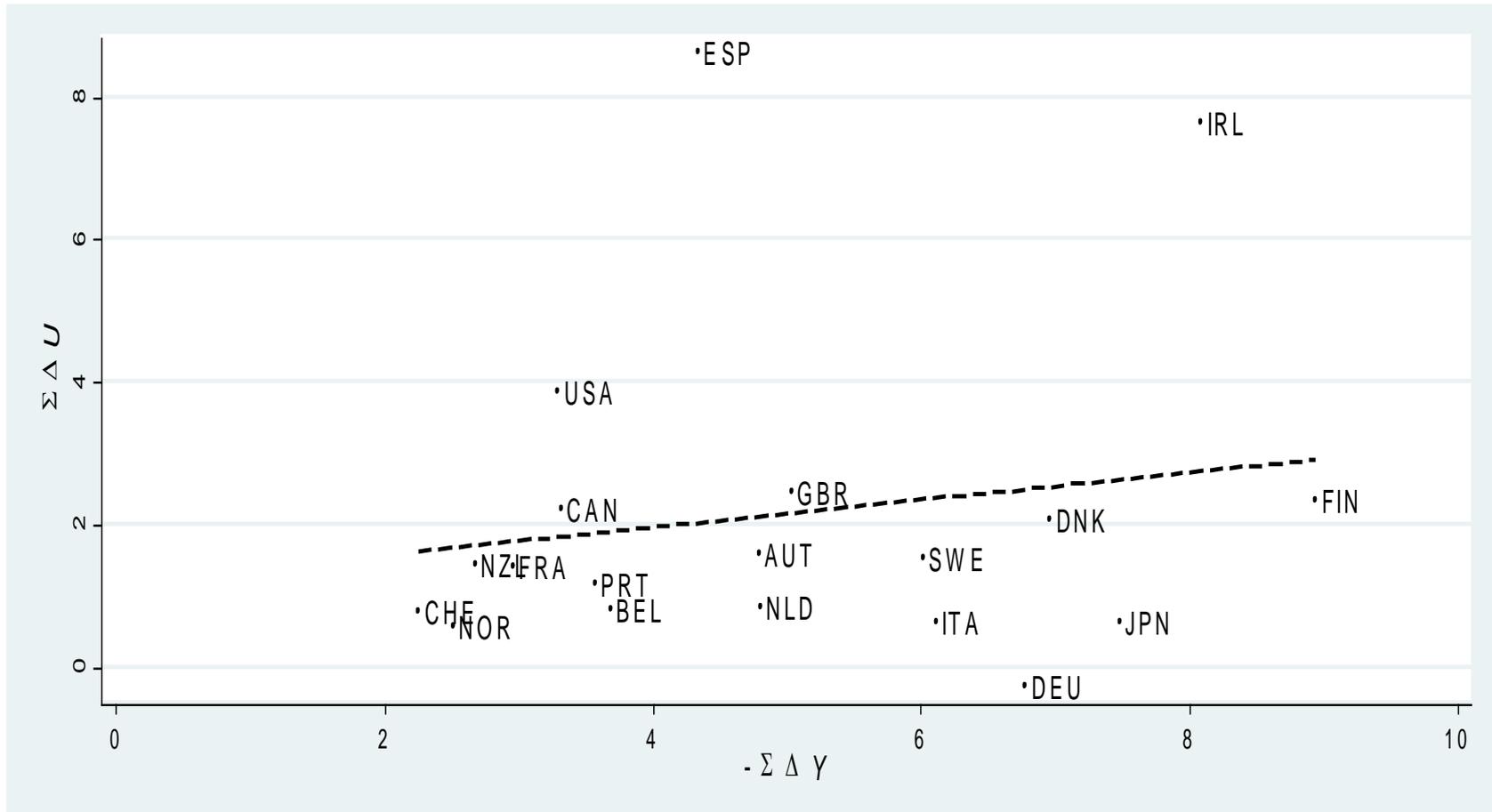


1. Unemployment and output are linked, even during the Great Recession & Not-So-Great Recovery

Ball, Leigh and Loungani (NBER WP, 2013)

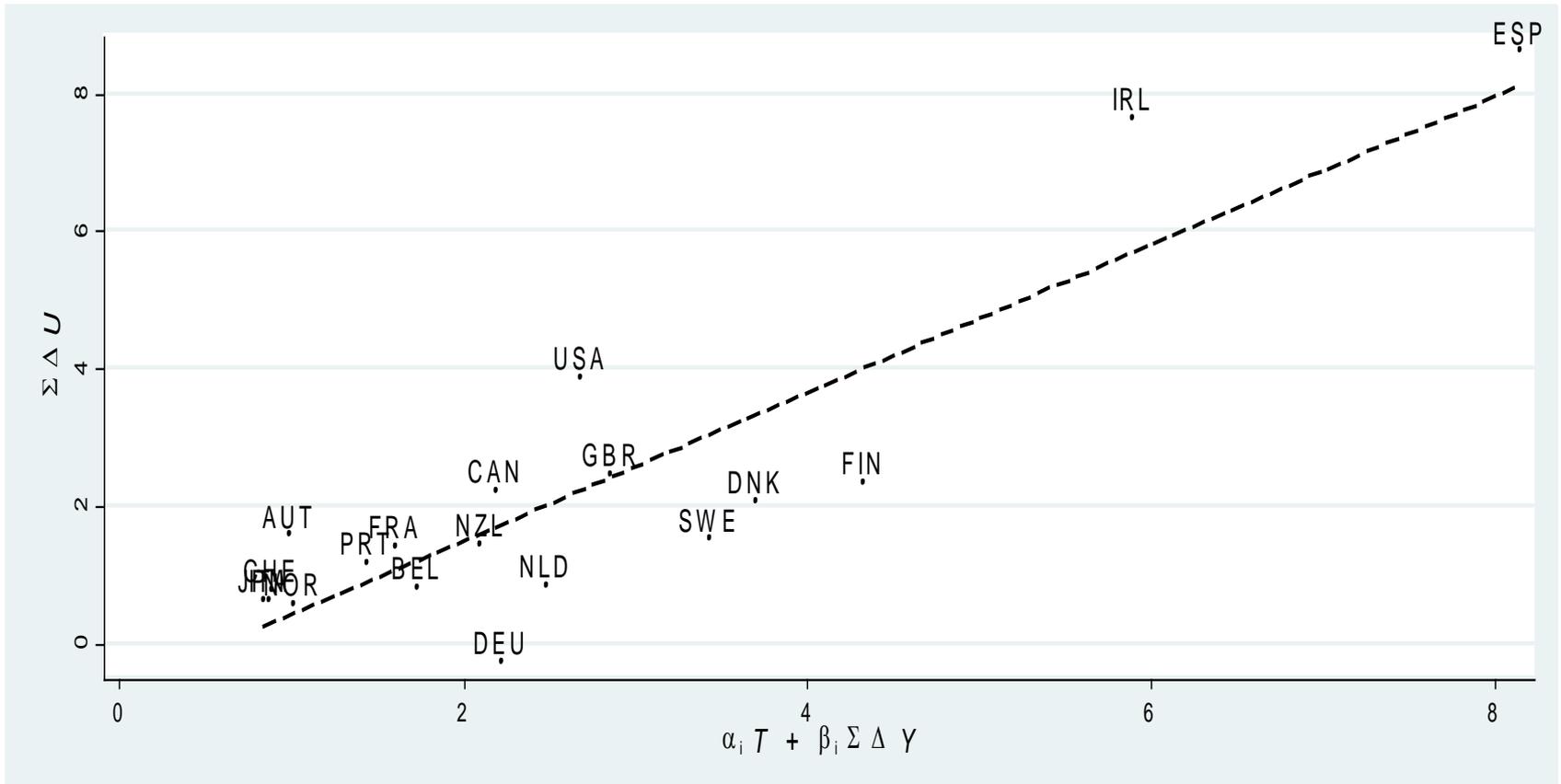
VoxEU *and* *Econbrowser* *summary*

The Relationship between Unemployment & Output: Okun *looks* Broken ...



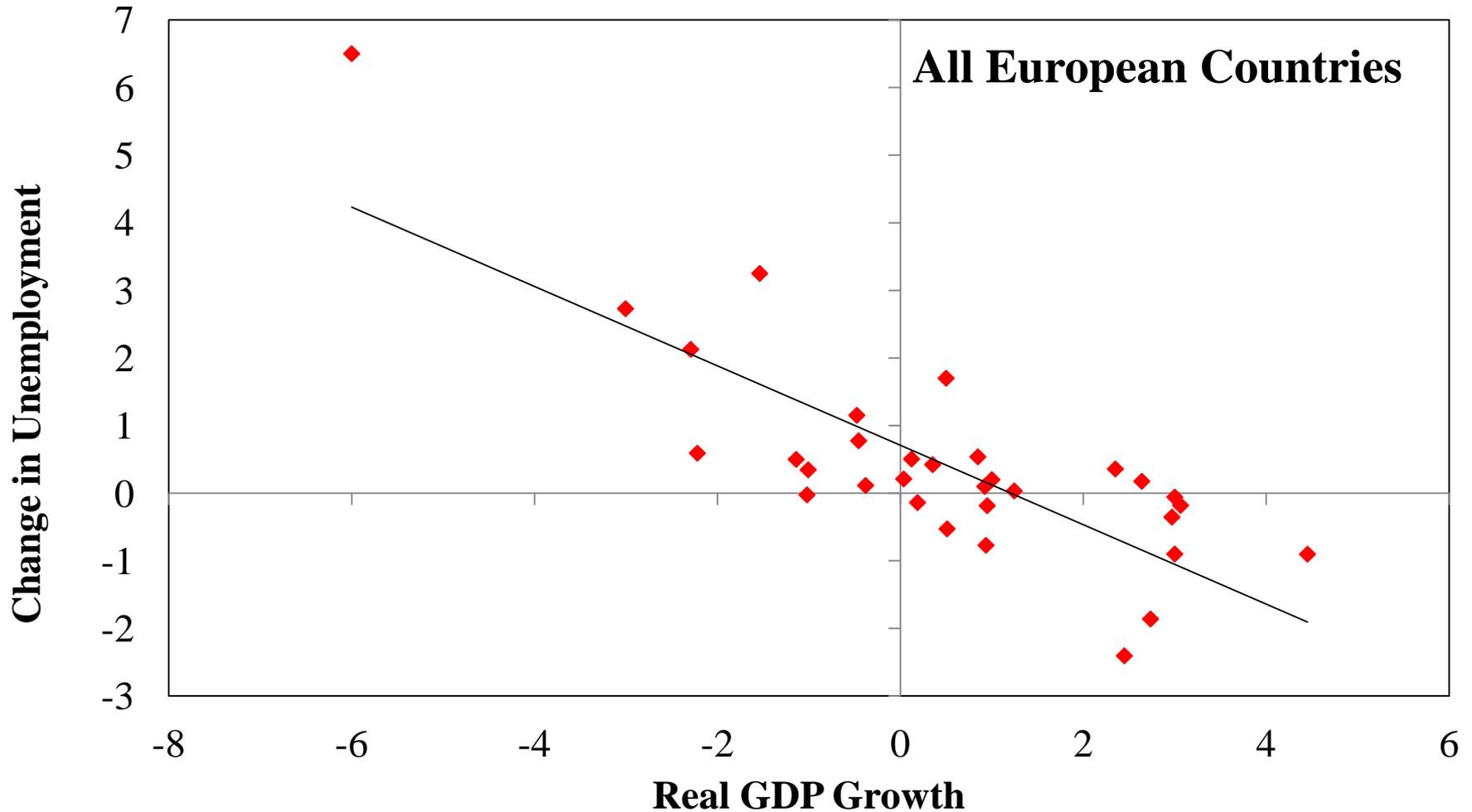
Peak-to-Trough Output and Unemployment Changes
in Advanced Countries During the Great Recession

... but isn't



The Great Recession: Peak-to-Trough Output and Unemployment Changes, with adjustments for duration of recessions and country-specific Okun coefficients

Unemployment and Output have remained linked during the Not-So-Great Recovery *(2012, in percent)*



A Debate since the 1970s ...

- *“There is sometimes the naïve belief that unemployment must be due to a defect in the labor market, as if the hole in a flat tire must always be at the bottom, because that is where the tire is flat” (Solow, 2000).*
- *“It takes a heap of Harberger triangles to fill an Okun's gap.” (Tobin, 1977)*

“We impute the higher [European] unemployment to welfare states' diminished ability to cope with more turbulent economic times, such as the ongoing restructuring from manufacturing to the service industry, adoption of new information technologies, and a rapidly changing international economy. “ (Ljungqvist and Sargent, 1998)

2. Many reasons for slow recovery in output

One possibility: Fiscal policy has not been able to provide the support it did in previous recoveries

Kose, Loungani and Terrones, WEO 2013, Box 1.1

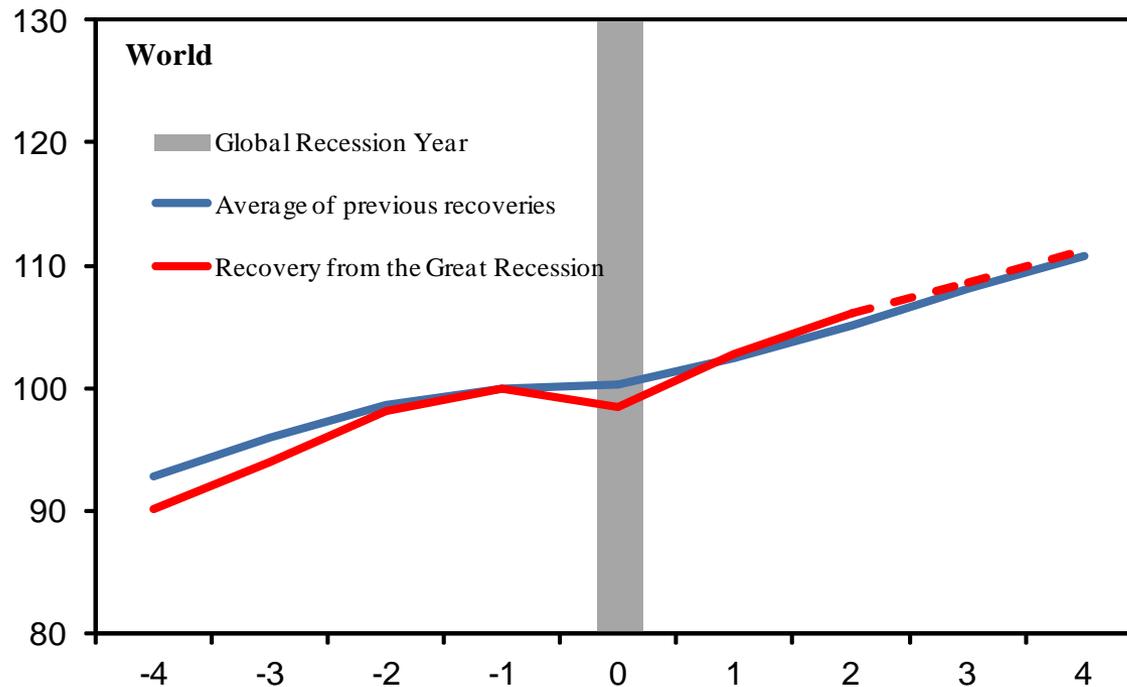
VoxEU *summary*

Why is the recovery slow?

- Many theories
 - recovery from financial crises are typically slower
 - deleveraging provides headwinds to the recovery
 - policy uncertainty
- Stance of policies

A Recovery on Track? World Real GDP per capita

Figure 1. Real GDP Per Capita
(index, PPP weighted)

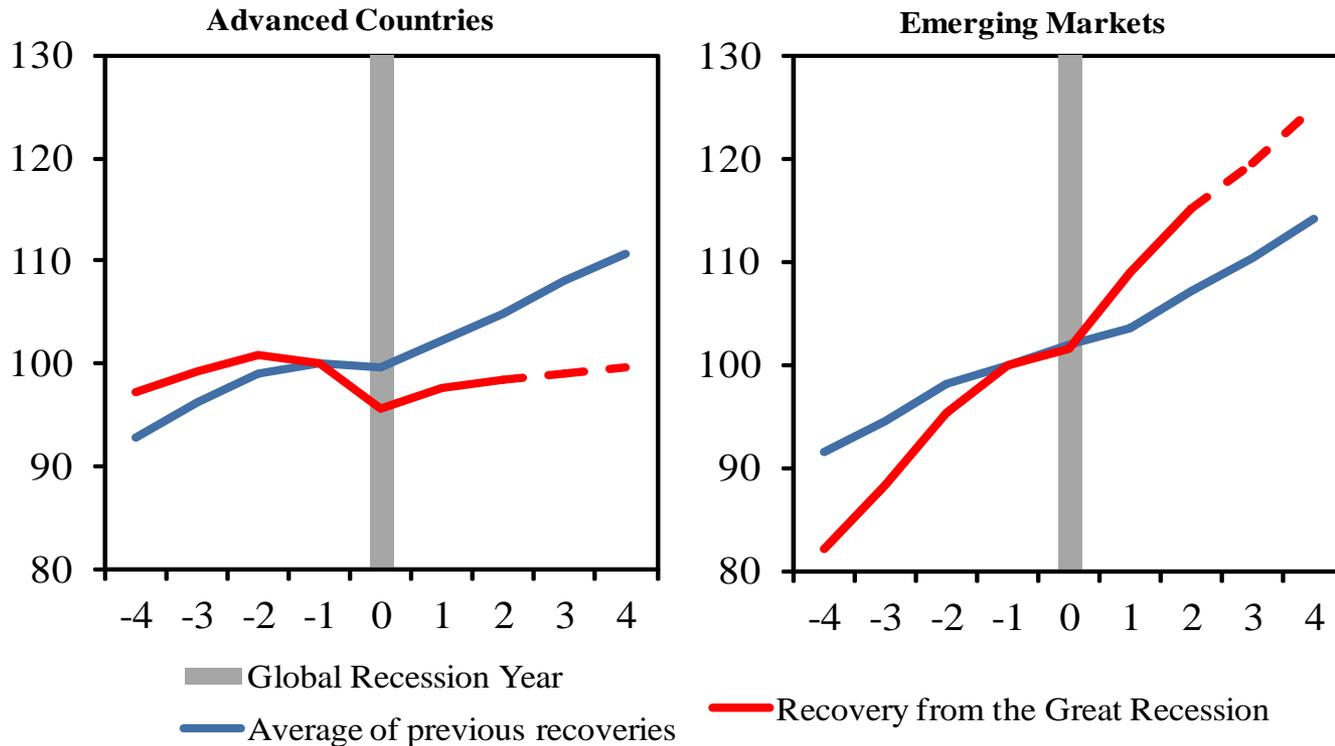


Notes: Dashed lines denote WEO forecasts. Indexed to 100 in the year before global recession. Zero is the time of the global recession year. Each line show the PPP-weighted average of the countries in the sample.

The Divergence in Recovery

between Advanced Countries and Emerging Markets

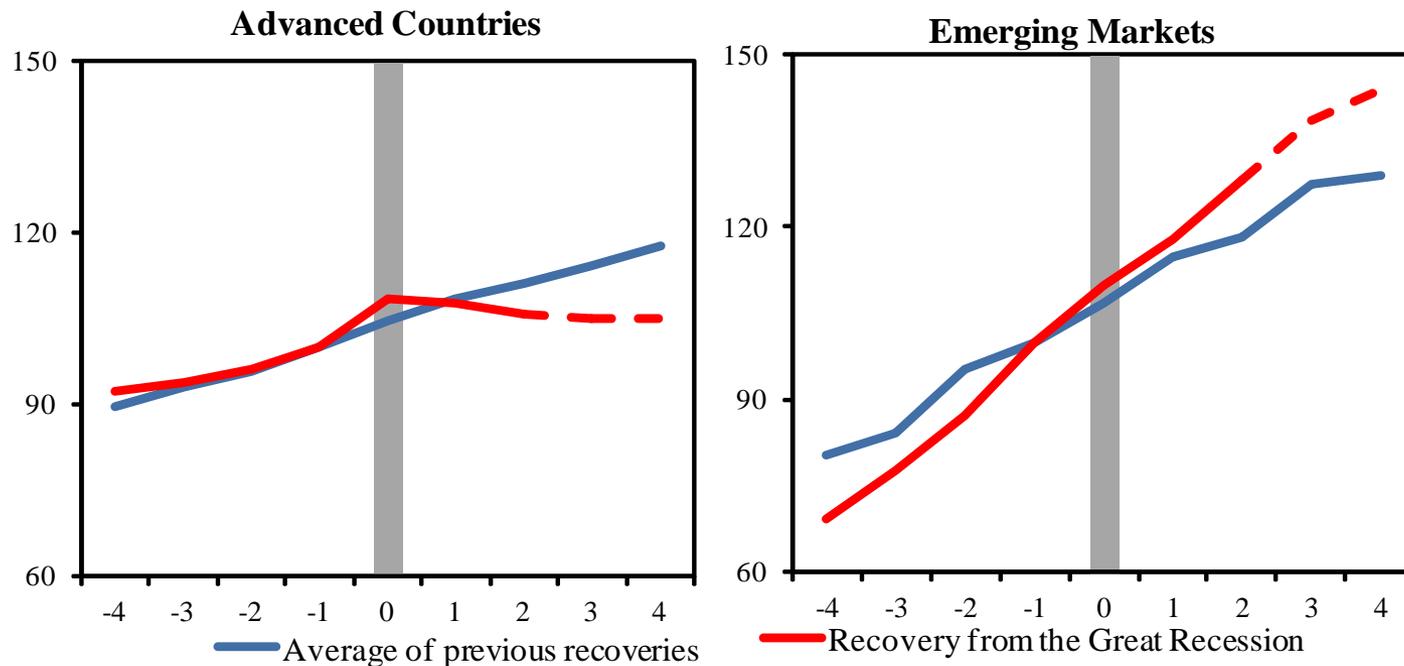
Figure 2. Real GDP per Capita: Advanced Countries and Emerging Markets
(index, PPP weighted)



Notes: Dashed lines denote WEO forecasts. Indexed to 100 in the year before global recession. Zero is the time of the global recession year. Each line show the PPP-weighted average of the countries in the respective group.

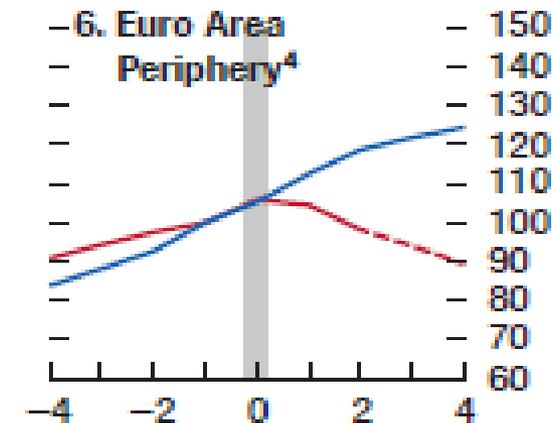
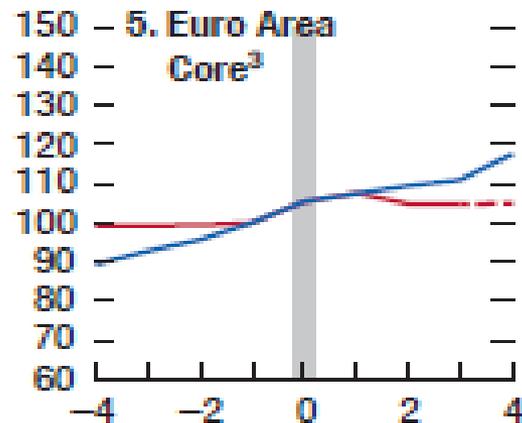
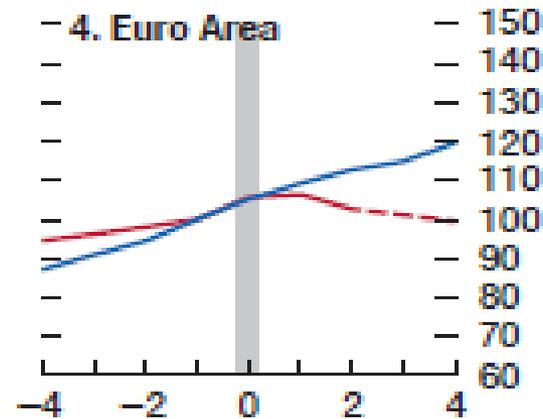
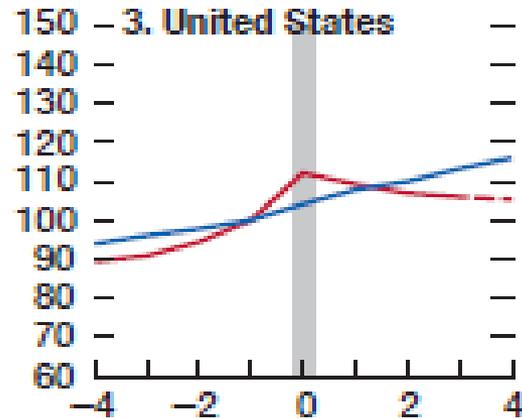
Divergence in Government Spending between this Global Recovery and Past Global Recoveries

Figure 3. Real Primary Expenditure
(index, PPP weighted)



Notes: Dashed lines denote WEO forecasts. Indexed to 100 in the year before global recession. Zero is the time of the global recession year. Each line show the PPP-weighted average of the countries in the respective group.

Divergence in Government Spending between this Global Recovery and Past Global Recoveries: US and Euro Area



Implications for Monetary & Fiscal Policy Advice

- Fiscal stimulus and monetary easing early in the crisis
- Now, fiscal consolidation
 - should be gradual, with credible medium-term plans
- Effects of fiscal consolidation on growth should be offset by other measures to the extent possible
 - Continued ease in monetary policies
 - Financial sector repair & reform

How IMF was viewed on fiscal issues during our Spring Meetings last week ...

How the IMF became the friend who wants us to work less and drink more

*-- Washington Post
April 16, 2013*

“It is to the credit of the economists at the Fund that their recommendations to policymakers have adapted to this strange world we’re living in rather than sticking with their more normal, doctrinaire advocacy of monetary and fiscal restraint.”

IMF Renews Push Against Austerity

*-- Wall Street Journal
April 17, 2013*

“ ... the International Monetary Fund called on countries that can afford it -- including the U.S. and Britain -- to slow the pace of their austerity measures.”

IMF Statement on Spain

*“I strongly support the Spanish government's objectives of restoring a sound fiscal position while securing a recovery and creating jobs. **Today's announcement to pursue a more gradual consolidation path is a welcome step toward meeting these goals, building on major reforms and structural fiscal improvements last year.**”*

– Christine Lagarde, April 26, 2013

3. Complementary role of labor market policies, particularly where competitiveness is an issue

Blanchard, Jaumotte, Loungani (IMF Staff Discussion Note, 2013)

IMF Survey *summary*

Unemployment during the Great Recession

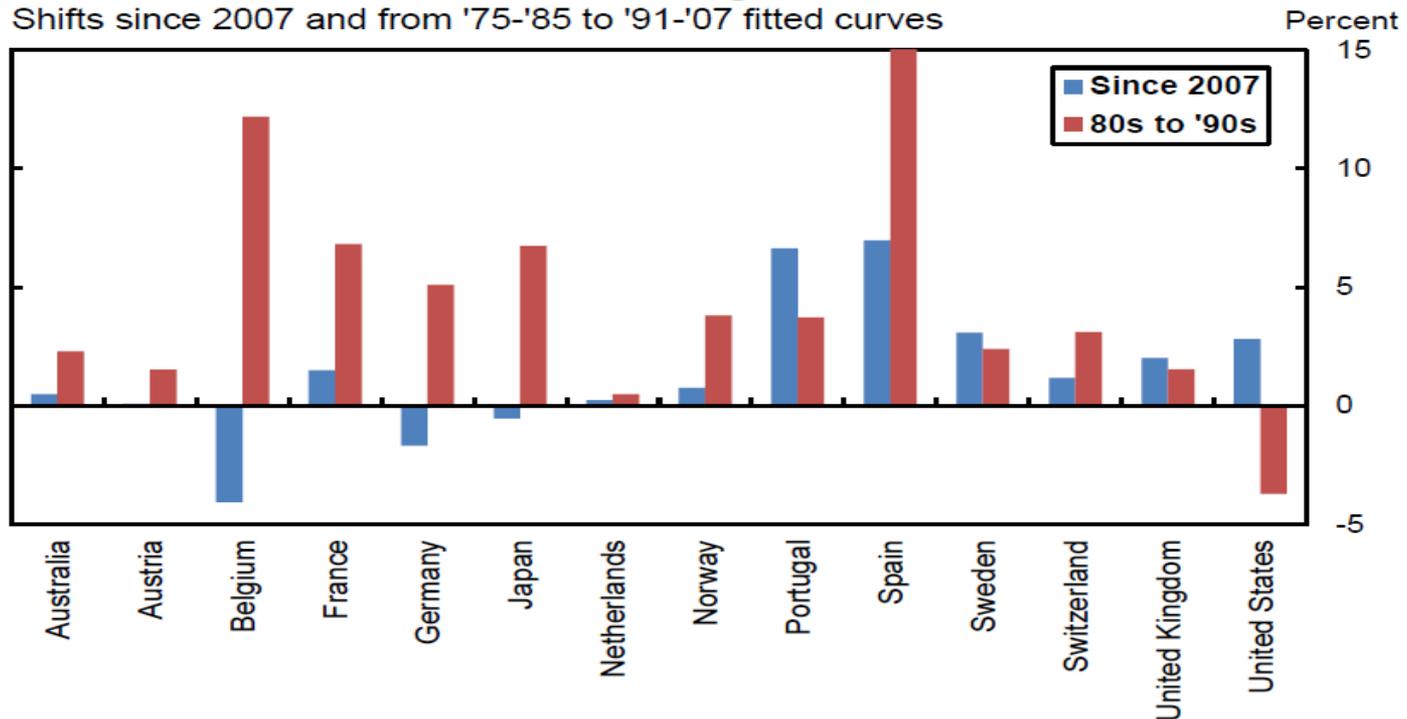
- Initial increase cyclical rather than structural
- Greater uncertainty about relative proportions now, but signs that cyclical component remains important in most countries
 - Beveridge curve quite stable; moreover shifts may not be sign of increase in natural rate (Diamond 2013)
 - Other measures of mismatch back to normal
 - Lack of deflation not a sign of small unemployment gap
- Stability of Okun's Law suggests jobs will return if the growth returns.

Stability in Beveridge Curve in Most Countries

(relative to past changes)

Current and historical Beveridge curve shifts

Shifts since 2007 and from '75-'85 to '91-'07 fitted curves



Graph shows average percent point deviation in the unemployment rate.

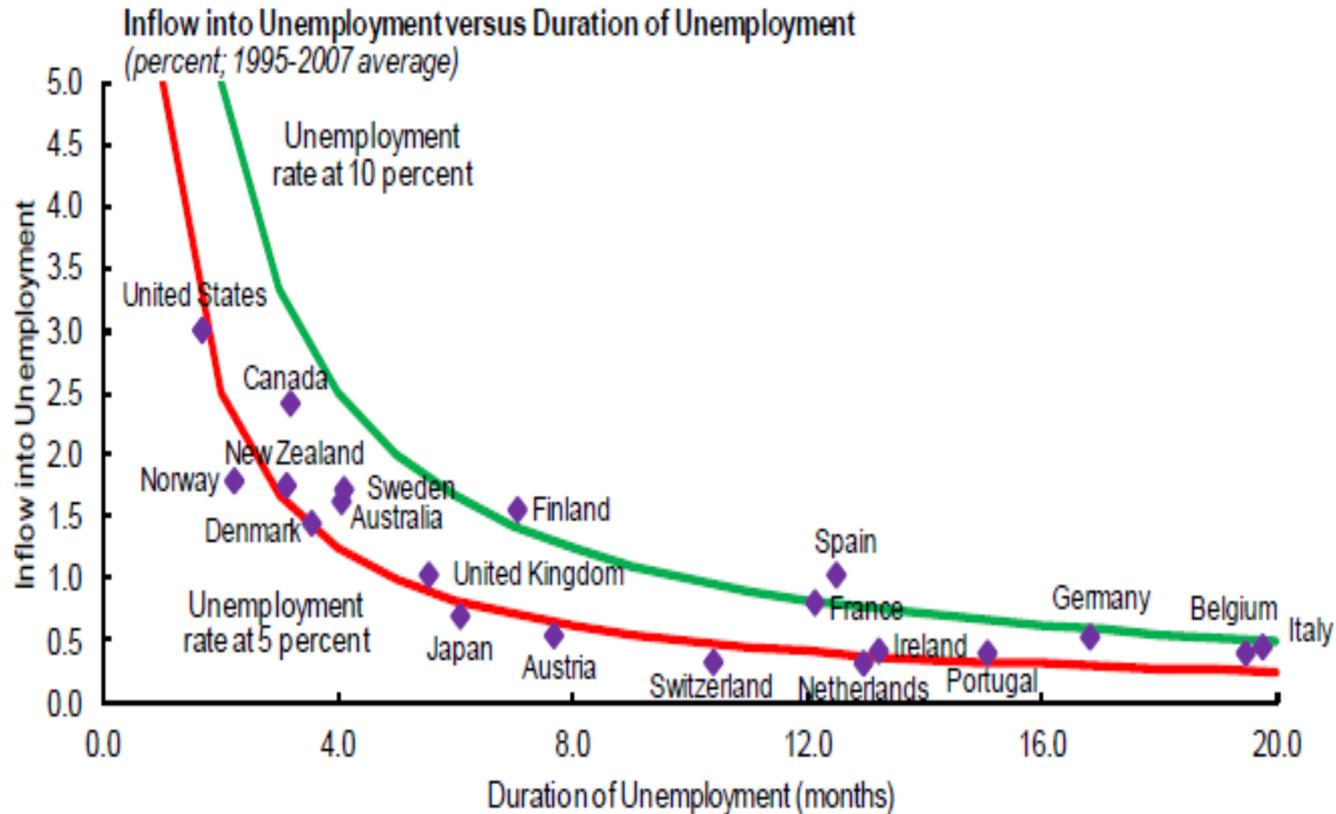
Source: Hobijn and Sahin (2012)

Key Concepts to Guide Design of Labor Market Policies

- *Micro flexibility*: reallocation of workers to sustain growth
- *Macro flexibility*: adjustment to macro-economic shocks
- But need to protect workers

Micro Flexibility

Some countries don't do it well: low flows, long U duration



Source: International Labor Organization (ILO). Based on Perez and Yao (2012).

Micro Flexibility: Two Key Institutions

Unemployment insurance (UI)

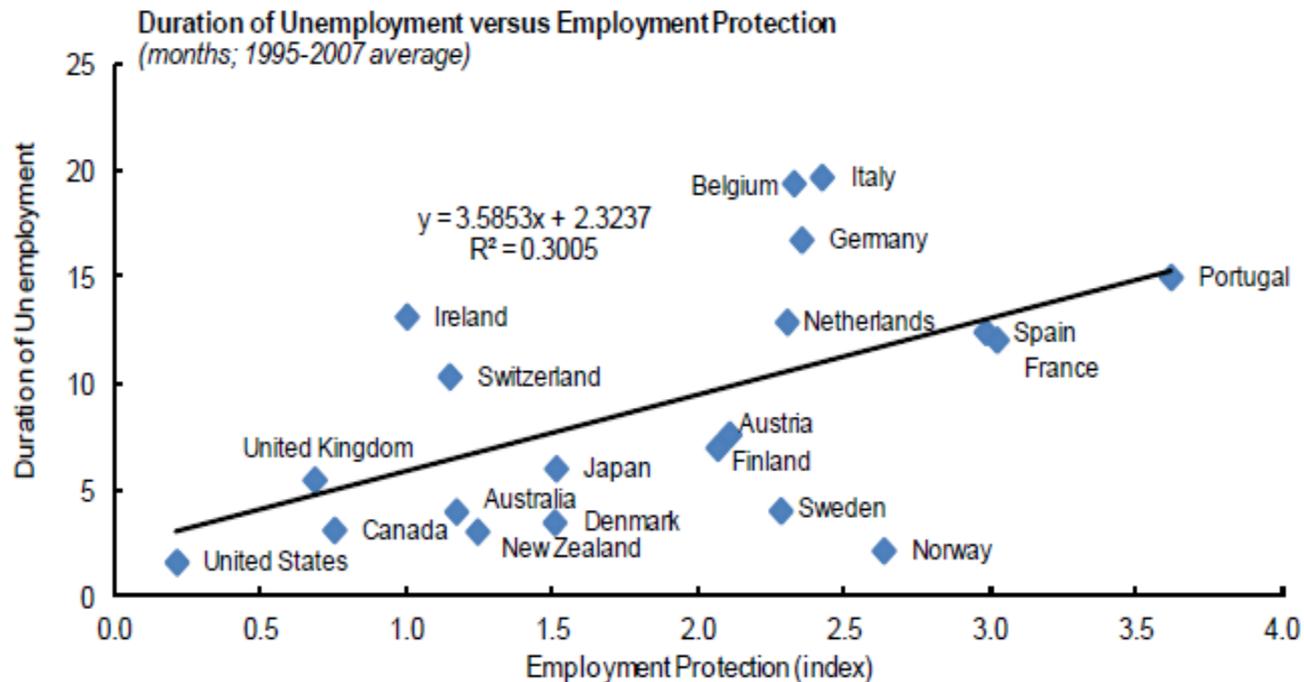
- welfare improving but possible efficiency cost
- what matters: design of the system
 - quality of active labor market policies

Employment protection (EP)

- some of it is desirable but too much can be harmful (lower reallocation, longer unemployment duration)
- dual protection systems have ambiguous effects on efficiency and welfare
- reduce judicial uncertainty

Unemployment Duration and Employment Protection

(months; 1995 – 2007 average)



Source: Organisation for Economic Co-operation and Development (OECD) and International Labor Organization (ILO).

Combinations of Institutions Matter in Ensuring Micro Flexibility

Two successful models (low U, reallocation)

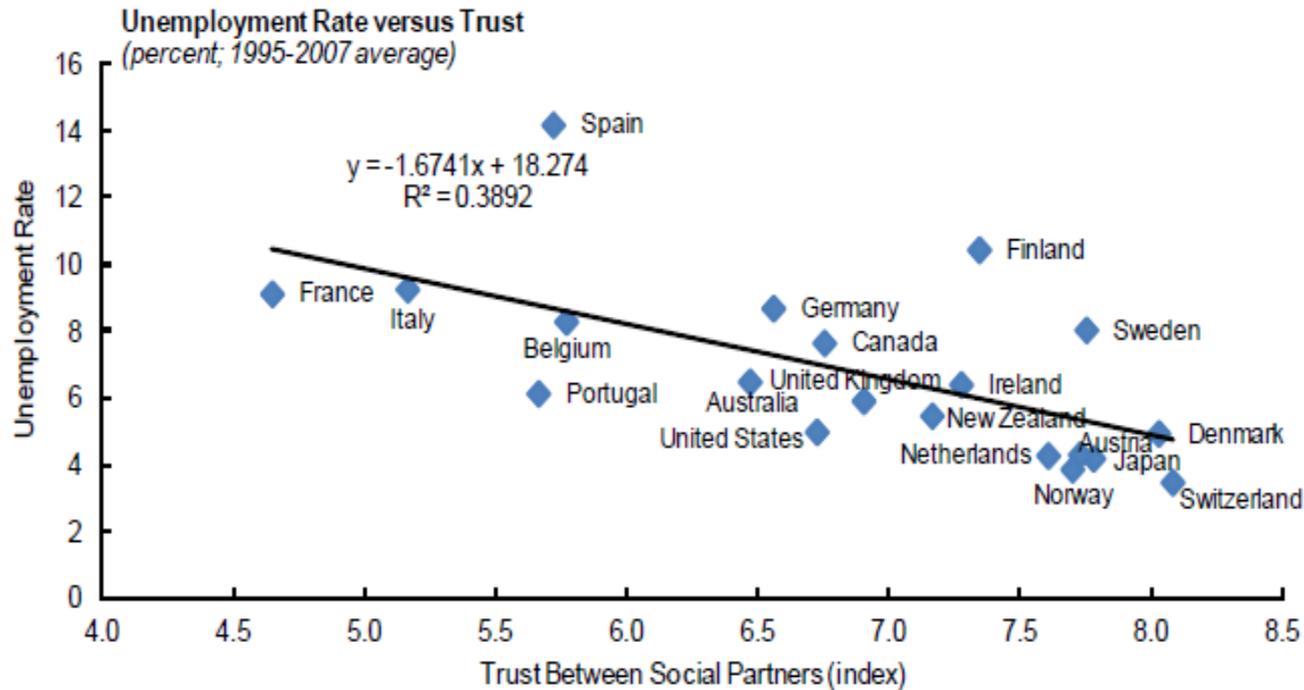
- Anglo saxon model: low EP, low UI
- Nordic model: some EP, generous but conditional UI, strong ALMP
 - **Flexicurity model: “protect workers, not jobs”**

One less successful

- Continental model: high EP, generous UI, limited ALMP

Can Flexicurity Be Exported?

The Importance of Trust



Source: Organisation for Economic Co-operation and Development and World Competitiveness Report.
1/ Trust between firms and workers is measured by the extent to which industrial relations are perceived to be conducive to labor peace.

Macro Flexibility

Two dimensions

- A low average U rate
- Limited fluctuations in U rate in response to shocks

Key institutions

- Minimum wage
- Tax wedge
- Collective bargaining structure

Level of Unemployment

Minimum wage

- Small effect on E or U within a range
- Limited redistributive role
- Redistribution through negative income tax (combined with low minimum wage)

Tax wedge

- Tends to increase labor cost and U (especially in combination with high min wage or UI and if no differed benefits)

Collective Bargaining Centralization

Ambiguous effects on **level** of U:

internalization of unemployed welfare vs. bargaining power of unions

Dominates for **responsiveness** of wages to U:

internalization of unemployed welfare *and* coordination argument

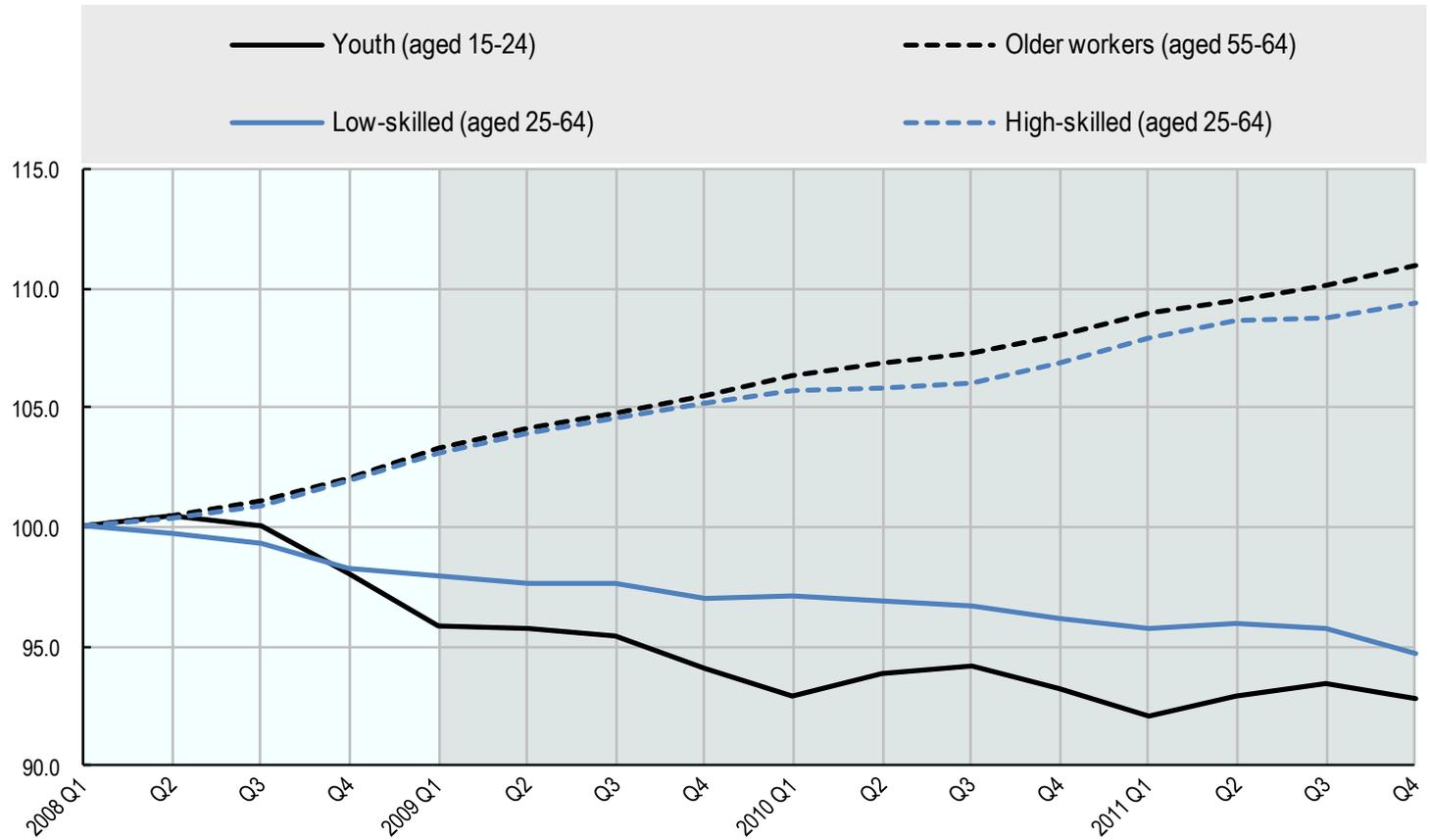
Combination of national and firm level bargaining seems preferable in principle; difficult to attain in practice?

Potential role of **trust**

Labor Market Policies and Micro Flexibility during the Crisis

- Extension of unemployment benefits
 - Iceland, Greece
 - But reduction in Portugal
- Targeted interventions to help some groups
 - Youth; Low-skilled; Long-term unemployed (see chart that follows)
- Move away from duality
 - Too late to stop layoff of temporary workers
 - But reduction in employment protection on permanent contracts could help hiring as recovery takes hold

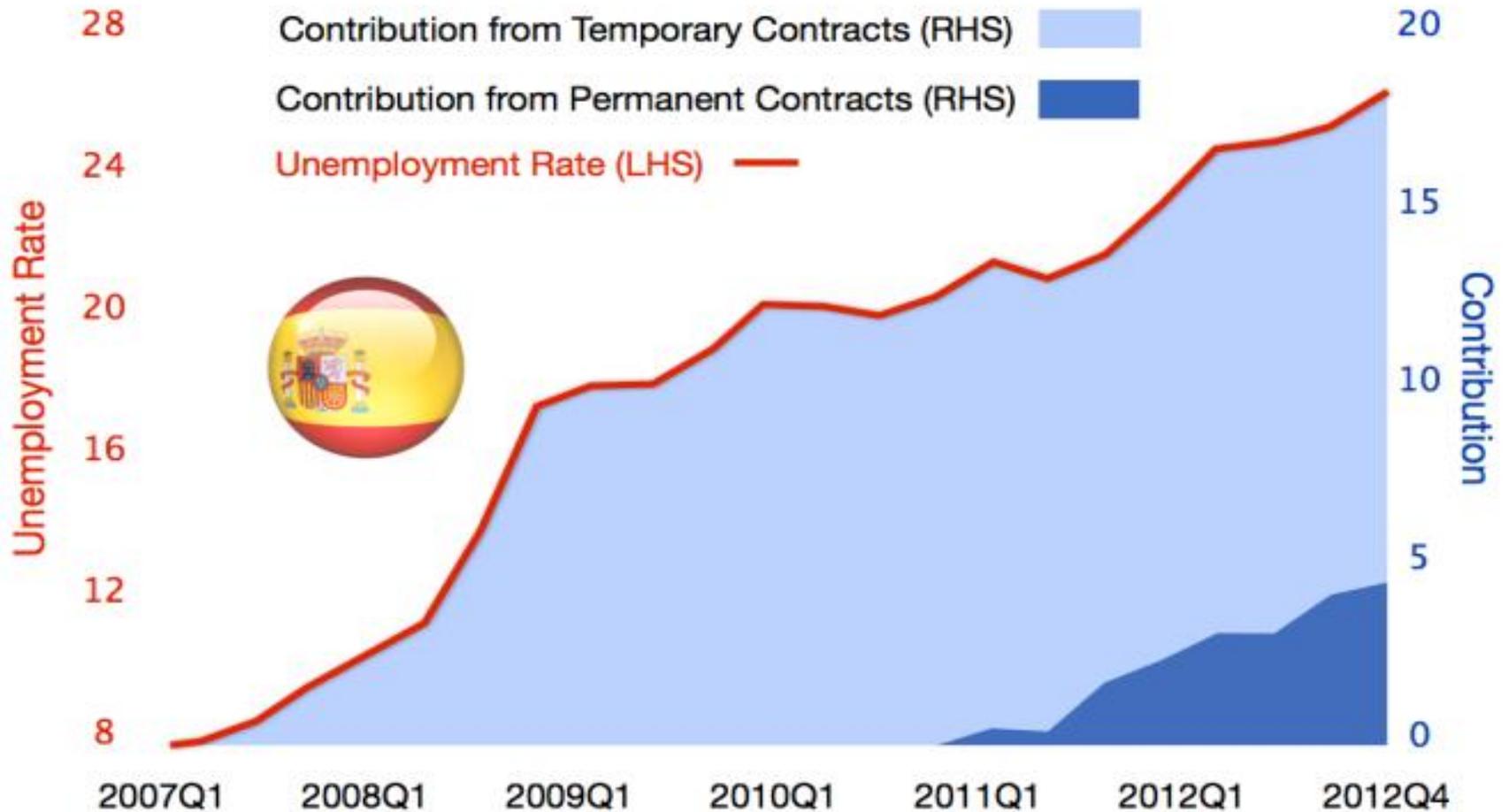
'Recovery' differs across groups



Ratio of each group's employment relative to overall employment, ^a OECD average, ^b 2008 Q1-2011 Q4, index = 100 at the start of the crisis

Structural reforms: The case of Spain

Unemployment and Duality



Competitiveness

- In some Euro area countries, need reduction in relative wages
- Best way to achieve would be through national tripartite agreement
 - Experience of Latvia, Ireland, Greece
- Without such an agreement
 - More flexibility in wage-setting
 - Reduction in public sector wages
 - Reduction in minimum wage
 - Fiscal devaluations
- Higher inflation in North relative to South

In conclusion ...

- European unemployment is high and expected to remain so; this has grave human costs
- Contrary to some assertions, jobs and growth remain linked. This raises the hope that the jobs will return when growth does.
- There are many reasons for the slow recovery in output and many policy actions are needed to boost output growth (e.g. banking union). But the inability of fiscal policy to provide support in this global recovery, unlike in past global recoveries, should be kept in mind. This requires careful calibration of fiscal policy to incoming data, as IMF has long advised.
- Labor market policies can play an important complementary role. Well-functioning labor markets require micro and macro flexibility, but also need to protect welfare of workers. IMF advise during the crisis has generally been to support unemployment insurance benefits and to advocate move away from duality.
- In countries where there is a need to boost competitiveness, the inability to reach national tripartite agreements has left no easy choices.