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EMU Challenges Regional Labor Markets

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EMU CHALLENGES REGIONAL LABOR MARKETS

Abstract

The paper deals with the challenges that European monetary union (EMU) exerts on European labor markets, giving special emphasis to the regional dimension of the European unemployment problem. We argue that the inability of labor markets to adjust to shocks is to a large extent a regional problem within countries rather than a purely national matter. Thus, any attempt to successfully reform European labor markets and "make them fit for EMU" has to take the regional perspective – and in some instances even a more decentralized, firm perspective – into account.

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I. INTRODUCTION

The debate about European monetary union has so far been dominated by questions of fiscal convergence and the macroeconomic stability of the euro. Relatively little attention has been given to the labor market effects of EMU although labor market performance will be crucial for the long-term success or failure of EMU. In this paper we focus on the question how EMU might affect the future performance of European labor markets and discuss ways of coping with the adjustment requirements in the various regions of the euro area.

II. EMU AND NATIONAL LABOR MARKETS

It is an undisputed benefit of EMU to cut back the costs of conversion, currency exchange and hedging, to increase the heat of competition in goods and factor markets and, thus, to stimulate trade, investment, growth and employment. However, the members of a currency union lose two important policy instruments: an independent monetary policy and the option of changing nominal exchange rates. The loss of a macroeconomic response via devaluation or loosening monetary policy in case of asymmetric shocks entails an increased pressure on national labor markets and calls forth a risk of rising unemployment.

Exchange rates between EU member states have played an important role as shock absorbers in the past: Empirical evidence suggests that several EU member states have been hit by various asymmetric shocks and did adjust to them by a price response (particularly by a change of the nominal exchange rate) rather than by a quantity (output) response. The incidence of asymmetric shocks has been rather high for Portugal, Greece, Spain, Italy, the U.K., Ireland, Sweden, and Finland, whereas asymmetric shocks have been relatively rare in Germany, France, the Benelux countries, Austria, and Denmark.

To assess the *status quo ante* impact of EMU on labor market performance in the EU member states Table 1 combines this evidence with the results of an in-depth analysis of labor market flexibility in EU member states (see Dohse and Krieger-Boden 1998 for details). *Ceteris paribus*, countries on the northern and southern peripheries of the EU (Finland, Italy, and Spain) face a high risk of increasing unemployment. The probability for these countries to be hit by asymmetric shocks has been high in the past, whereas labor market flexibility has been low. The Netherlands and Austria appear—from a labor market point of view—to be the countries best prepared for EMU. Countries of Group 2 with their high exposure to asymmetric shocks would benefit from their high labor market flexibility, whereas shocks—even if rare—hitting countries of Group 3 would most probably translate into higher structural unemployment. This scenario might render EMU a ‘Mundellian nightmare’ (Burda 1999) for at least some EU member countries.

Table 1. Labor Market Risks for EU Countries at the Eve of EMU

Probability of asymmetric shocks 1/	Current labor market flexibility 1/	
	High	Low
Low	Group 1: Netherlands, Austria	Group 3: Germany, France, Belgium (Denmark) 2/
High	Group 2: Ireland, Portugal (United Kingdom)2/	Group 4: Finland, Italy, Spain (Sweden, Greece) 2/

Source: Dohse and Krieger-Boden (1998, p. 95).

1/ Compared to EU average.

2/ Not joining EMU from the start.

However, the historic patterns of susceptibility to shocks - as well as the low labor market flexibility at the eve of EMU - may not persist in the euro area. One reason is that major sources of asymmetric shocks, i.e., inconsistent national monetary policies or

speculative attacks on national exchange rates, have been eliminated by EMU; moreover, the scope for destabilizing national fiscal policy is constrained.

However, even a common monetary policy in the euro area may be a source of asymmetric shocks to its member countries (and their regions). In the case of the U.S., for example, the federal monetary policy has been found to create asymmetric shocks to U.S. regions because of structural differences of their economies. Hence, the future probability of asymmetric shocks will depend upon the economic structures of the countries participating in the currency union. The critical question is how EMU will affect this structure and what the impact will be on the synchronization of their respective cycles. Two opposing tendencies are discussed in the literature:

- One line of reasoning says that tighter forward and backward trade linkages between the participating countries tend to make the respective economic structures and business cycles more similar and shocks more symmetric. Such an outcome is considered to be most relevant if demand shocks (or other common shocks) predominate or if intra-industry trade accounts for most of trade (Frankel and Rose 1998).
- An opposite line of reasoning emphasizes that in a common currency area there are better opportunities for the exploitation of scale economies (e.g. via localized knowledge spillovers). These tend to foster the spatial concentration of industries and increase the likelihood that a given shock will have asymmetric effects on different regions because of differences in their production structure (Krugman 1993).

On theoretical grounds, both hypotheses seem equally plausible, and the empirical evidence is inconclusive as yet. Our estimates suggest that in most EU countries regional specialization increased in the early 1980s, whereas it decreased in the early 1990s (table 2). Hence, policy should take a cautious stance and prepare for potential shocks.

Table 2. Coefficients of Specialization in Manufacture, EU-Countries 1980–93 1/

Country	Coefficient		Change of coefficient	
	1993	1980–85	1985–91	1990–93
Sweden	34.9	0.6	1.5	–0.4
Finland	46.6	–9.7	3.0	6.8
Denmark	41.2	0.4	2.7	–1.8
Germany 2/	18.5	3.5	–2.3	0.5
Austria	32.1	1.0	–1.9	2.7
Netherlands	30.5	4.1	0.8	–6.8
United Kingdom	12.1 3/	0.0	3.4	–2.3 3/
France	11.2	1.3	1.4	–0.4
Italy	27.0	2.0	1.0	–0.3
Spain	29.2 3/	1.8	0.9	–0.4 3/
Portugal	55.2	9.9	2.3	–7.0
Greece	60.4 3/	6.0	–0.2	–1.2 3/

Source: OECD (1996b); own calculations.

1/ A coefficient of specialization (CS) compares the sectoral structure of a given economy with that of a reference economy, here: with the EU average. Definition: $CS = \sum |s_g - s_r|$

where s_g and s_r are industrial shares in total value added of manufacture of the given and the reference economy, respectively. A coefficient of 0 indicates completely identical structures, whereas the structures are the more divergent the higher the coefficient is.

Belgium, Luxembourg and Ireland, are not included due to data limitations. The coefficients have been calculated on the basis of the 3-digit ISIC-classification, i.e. on the basis of 20 industrial branches.

2/ Western Germany.

3/ Data for 1992 and 1990–92, respectively.

III. The Regional Perspective

Some stylized facts of European regional unemployment

Europe's unemployment problem is to a large extent a regional problem within countries. Regional disparities vary significantly among EU member states: France, the Netherlands, the U.K., Sweden, and Austria show a relatively high degree of homogeneity in their regional unemployment rates, whereas especially Italy, Germany, and Finland are characterized by large regional disparities (table 3).

Table 3. Unemployment Disparities by Region 1985, 1990, 1995–97

	Standard Deviation					Coefficient of Variation				
	1985	1990	1995	1996	1997	1985	1990	1995	1996	1997
Belgium	2.25	2.69	3.22	3.26	3.27	0.19	0.36	0.34	0.32	0.35
Greece	2.16	2.22	2.45	3.03	2.59	0.37	0.37	0.33	0.38	0.33
France	1.79	1.72	2.03	2.37	2.55	0.17	0.19	0.18	0.20	0.21
West Germany	2.26	1.92	1.76	1.84	1.98	0.30	0.36	0.26	0.26	0.25
Whole Germany			3.50	3.63	4.69			0.42	0.43	0.47
Italy	3.51	6.50	6.82	7.28	7.31	0.38	0.64	0.55	0.58	0.59
United Kingdom	2.89	3.48	1.63	1.47	1.41	0.23	0.43	0.18	0.19	0.19
Spain	4.78	6.11	5.70	5.40	5.54	0.23	0.38	0.26	0.25	0.28
Netherlands	1.65	1.76	0.98	1.28	1.05	0.16	0.23	0.13	0.20	0.20
Europe 1/	5.03	5.13	5.94	6.01	5.68	0.47	0.59	0.55	0.55	0.54
United States 2/	1.92	1.10	1.26	1.23	1.21	0.27	0.21	0.24	0.24	0.25

Source: Eurostat (1998b); United States, Bureau of the Census (1997).

1/ European Countries: regions according to the Eurostat regional classification NUTS level 2.

2/ U.S.: State level.

Unemployment rates in some problem regions of the community are more than ten times higher than unemployment rates in the best performing regions (table 4). The problem regions are concentrated at the periphery of the Union: Southern Italy, Spain, Ireland, Finland, and east Germany. Regional disparities are especially large with respect to youth unemployment, which is a very severe problem in southern Europe (Italy and Spain), but less so in northern and central Europe.

The European regional problem—measured in terms of unemployment disparities — has become more acute over time. The dispersion of regional unemployment rates across the EU in 1995 was three times higher than in the late 1970s (Martin 1998, p. 20).

Table 4. The EU Regions with the Highest/Lowest Unemployment Rate (April 1997)

Region	Unemployment rate (percent)
Luxembourg	2.5
Oberösterreich	3.0
Berkshire. Buckinghamshire. Oxfordshire	3.2
Niederösterreich	3.4
Centro (P)	3.4
Trentino—Alto Adige	3.8
Burgenland	3.8
Salzburg	3.9
Sicilia	24.0
Calabria	24.9
Campania	26.1
Ceuta y Melilla	26.4
Extremadura	29.5
Andalucia	32.0

Source: Eurostat (1998b).

A characteristic feature distinguishing Europe from the U.S. is the high degree of persistence in the regional unemployment discrepancies over time (table 5).

Table 5. Persistence of Regional Unemployment Differentials: Rank-Order Correlations, 1985–97

	1985–90	1985–95	1985–96	1985–97
France	0.79	0.79	0.84	0.84
West Germany	0.96	0.79	0.84	0.85
Italy	0.87	0.89	0.89	0.85
United Kingdom	0.96	0.90	0.87	0.90

EU as a whole 1/	0.96	0.91	0.83	0.78
United States 2/	0.58	0.41	0.49	0.50

Source: Eurostat (1998b); United States, Bureau of the Census (1997).

1/ Europe's big four: NUTS2-level regions.

2/ U.S.: State unemployment rates.

Within the four largest EU member states the ranking of regions by unemployment rates in any given year is highly correlated with the ranking in previous years.¹ In this respect, regional unemployment in most EU countries behaves quite differently from that in the U.S., where one period's high unemployment region can become the next year's low unemployment region (Bertola and Ichino, 1996). The rank-order correlation coefficient of Europe as a whole reflects the decline of unemployment rates in the Netherlands, Denmark and the United Kingdom: the coefficient did decline from 0.96 for 1985–90 to 0.78 for 1985–97, which nevertheless remains markedly above the U.S. coefficients of about 0.50.

A recipe for failure: region-specific shocks and regional non-adjustment

The labor market risks of EMU result—to a large extent—from the high probability of region-specific (asymmetric) shocks in combination with the lack of functioning adjustment mechanisms at the regional level:

- Because many countries participating in EMU comprise very heterogeneous regions, EMU may have very different effects on the regions of a country: For example, the west German 'Rhineland' region with its spatial proximity to the Netherlands, Belgium, and France will arguably benefit more from the currency union than the east German 'Oberlausitz' region, which is adjacent to Poland. Furthermore, the sectoral structure of the west German economy is closer to the EU

¹Martin (1998) finds similar results for NUTS1-level-regions (NUTS is the nomenclature of territorial units for statistics compiled by EUROSTAT. Level 1 (NUTS1) is the largest, NUTS2 the medium and NUTS3 the smallest level of regional disaggregation).

average than the structure of the east German economy which implies a higher susceptibility of east Germany to asymmetric shocks. The same type of argument holds for the Mezzogiorno in comparison to the north and central regions of Italy.

- EMU seems to discriminate particularly against problem regions, as they are typically peripheral regions (i.e., they do relatively little trade with the other EMU countries, profit less from the elimination of the national currency and are more prone to asymmetric shocks), and labor market stickiness is very pronounced in these regions.
- Asymmetric shocks are much more pronounced on a regional than on a national level in the EU. Growth rates of output usually vary almost twice as much in the case of regions within a country as among EU countries. Similar results are obtained by looking at employment changes. Moreover, several studies that analyze the components of regional output or employment changes reveal a considerable relevance of the region-specific component.

Well-functioning regional labor markets are crucial to weather out adverse region-specific shocks. Whereas labor migration plays a substantial role as an adjustment mechanism to shocks in the U.S., interregional labor mobility is rather limited in the EU. This leaves regional wage flexibility as the main adjustment mechanism within EU member states. Empirical studies show, however, that wage policy in Europe is not region-specific: wage setting in prosperous regions spills over to problem regions where productivity growth is slower than in the rest of the economy. Furthermore, labor market institutions such as unemployment benefits, minimum wages, dismissal protection laws, working hours regulations, are mostly shaped at the national level and offer few possibilities for region-specific adjustment to shocks.

If there is neither labor mobility nor wage flexibility, there will be either increased interregional transfers or an increase in unemployment (open or disguised) in regions hit by adverse shocks. However, long-run transfers are in fact not an adjustment mechanism but a

practice that prevents adjustment and structural change. Hence, the major threat of EMU for the labor market is the combination of regional susceptibility to asymmetric shocks and the lack of regional adjustment instruments. In addition—and not to be underestimated—there are substantial moral hazard effects implied in massive regional transfers.

IV. THE POLICY CHALLENGE: ENLARGING INSTITUTIONAL AND REGIONAL DIVERSITY

Will EMU give momentum to labor market reform?

In preparing for the monetary union and in response to increasing adjustment pressures EU member states have taken steps in opposite directions: On the one hand, we observe efforts to stifle competition that might easily lead to a *'vicious circle'*. On the other hand, there are indications of a potential *'virtuous circle'*, as several EU member states have, different in speed and scope, implemented measures to decentralize and deregulate their economies and to increase the flexibility of their labor markets (the UK and the Netherlands have gone farthest down that road).

The *'vicious circle'* hypothesis relates to the effort of politicians, unions and interest groups to fend off adjustment pressures due to the completion of the Single Market, the globalization of markets and the introduction of EMU: A *'social dimension'* should protect European workers against *'unfair'* competition and *'wage dumping'* by way of European minimum standards for working conditions on the basis of the Social Charter and its accompanying Action Program. Since differences in productivity will not whither away quickly, however, more uniform minimum standards may entail rising unemployment in low-productivity countries and regions and raise demands for more EU development assistance. Financing these subsidies, though, is likely to restrain the economic dynamics of the prosperous areas.

The ‘virtuous circle’ hypothesis builds on the fact that by joining EMU the member countries did submit themselves to an external pressure shaping adjustment needs that one country cannot undo on its own. Member governments might use the implementation of EMU to cut back on the exuberant welfare state and to bring the incentive structures more into line with economic sustainability in order to foster market dynamics. Burda (1999) even argues that EMU is a ‘Trojan horse for decentralization’. However, there is no room for complacency that the circle will automatically be virtuous. Policy has to harness and foster the process of structural reform.

As a matter of fact, all EU member countries did commit themselves to the comprehensive and consistent labor market reform program of the OECD Jobs Strategy, albeit without really taking swift action (see IMF, 1999, p. 75). Since the various elements of labor market flexibility, such as wage flexibility, working-time flexibility and geographical mobility, are (up to a point) substitutes, there is no need for all countries to follow the same reform model to attain higher overall labor market flexibility. Country-specific preferences may lead to different mixes of flexibility characteristics with broadly similar efficiency properties. What is crucial, though, is to take the inherent complementarities among broad policy areas affecting the labor market into account.

The need for more regional and institutional diversity

Against the background of widely divergent economic (and social) conditions between countries as well as within countries it seems appropriate not only that reform packages be country-specific but that a country-specific package pays tribute to the importance of the regional dimension. There is a pervasive lack of institutional variety within national employment systems that does not allow for the appropriate dynamic reaction to idiosyncratic shocks. Institutions such as welfare and unemployment benefit systems, minimum wages, dismissal protection laws, even working-hours regulations, are mostly shaped at the national level and are very often homogeneous within a given country. Furthermore, housing market regulations and the taxation of housing transactions are important obstacles to interregional mobility.

The high degree of institutional homogeneity, prevailing in most EMU countries, may entail a mismatch between institutions and the economic conditions that prevail in the problem regions. The greater differentiation that exists across regions Europe-wide than within any individual country strengthens our concern that pressures toward greater uniformity of labor market institutions or wage equalization following monetary union would raise the risk of increasing institutional mismatch and hence jeopardize the efficiency gains expected from the implementation of the monetary union (see also Buti et al., 1998; Mauro, et al., 1999, p. 43). To achieve a broader regional diversity opt-out clauses from nationwide regulations may help fostering regional adjustment capabilities in the case of asymmetric shocks. A core element of successful labor market reform in Europe is, thus, more decentralization of fiscal competencies in order to harness institutional competition among the various sub-national layers of government.

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Appendix

Table A1. The EU Regions with the Highest/Lowest Youth Unemployment Rate in April 1997

Region	Youth unemployment rate (percent)
Niederösterreich	5.0
Oberösterreich	5.0
Oberbayern	5.7
Burgenland	5.7
Berkshire. Buckinghamshire. Oxfordshire	5.7
Drenthe	5.9
Ceuta y Melilla	58.4
Sicilia	60.4
Calabria	62.6
Campania	64.9

Source: Eurostat (1998b).

Table A2. The Mezzogiorno and East Germany compared, 1995

	Mezzogiorno	East Germany 1/
Percentage of national population	0.34	0.17
Percentage of total unemployment	0.52	0.33
Percentage of national GDP	0.22	0.10
Regional GDP per capita/national GDP per capita	0.67	0.57

Source: Eurostat (1998a and 1998b); own calculations.

1/ (East-) Berlin not included.

Table A3. Labor Costs and Labor Productivity Relative to the Rest of the Country

	Mezzogiorno				East Germany			
	in percent of Centro-Nord				in percent of west Germany			
	All sectors		Manufacturing		All sectors		Manufacturing	
	1997	(1993)	1997	(1993)	1997	(1993)	1996	(1993)
Labor productivity	81	(81)	77	(80)	59	(51)	64	(55)
Labor costs	77	(76)	80	(79)	75	(68)	67	(62)
Unit labor costs	96	(94)	105	(99)	127	(133)	105	(114)

Sources: SVIMEZ (1998); Boss and others (1998).