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## Article

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## EUROPE'S UNEMPLOYMENT: NO POLICY ISSUE, A POLICY ISSUE FOR EUROPE OR FOR MEMBER STATES OR FOR BOTH?

ALFRED STEINHERR\*

During the 1990s, unemployment in Europe has been high, increasing and very unequal across member states and their regions. In 1998, the average unemployment rate in the European Union was 10%, compared to around 8% in 1990. In 1998, six member states had an unemployment rate below 6% (UK, Denmark, Portugal, Austria, Netherlands and Luxembourg) and four member states had an unemployment rate at or above the EU average of 10% (Spain 18%, Italy 12%, France 12%, Finland 11.5%, Germany 10%). All the large EMU member countries are at the top of the unemployment league. Nevertheless, as demonstrated by the list of countries with low unemployment rates, EMU membership does not automatically entail high unemployment, nor does backwardness (Portugal), or the fact that a country is large (UK).

Neither the participation rate nor population growth can explain Europe's unemployment

### The structure of unemployment in the EU

In most countries of the EU youth unemployment is much higher than average unemployment. This has been a permanent feature for decades, but it has been increasing over time. In the EU, on average, some 17% of young people are unemployed. And in some countries like Spain, with Italy a close runner-up, the youth unemployment rate (defined by the age group between 15 and 24) is 40% and that is truly shocking. It is also troublesome because one can easily see the social and political

problems that can arise out of such a situation. But high youth unemployment is not a problem in all countries. In Germany, the age group most affected by unemployment is people over 50.

In terms of policy, it is quite obvious that major efforts are required at the national level with investments in education and training programs. The much better youth unemployment record in Germany is, to a large extent, due to youth training (apprenticeships) that also generates a lasting social benefit in terms of a highly skilled labour force.

Unemployment can increase for two totally different reasons. One is that there are fewer jobs available. Another is that more people are looking for a job, that is, the labour force is increasing. The labour force changes due to population growth (natural growth or through immigration), or for a constant population, due to an increase in the participation rate. Across Europe the average labour force has remained roughly constant during the last 20 years (a roughly constant population paired with a constant participation rate at 65% of the population between 15 and 64 years of age). In the United States, by contrast, the labour force increased dramatically: the participation rate increased from 67% in 1975 to 77% in 1995.

Thus, it is not the participation rate or population growth that can explain the increase in Europe's unemployment. Compared to Europe, the U.S. job creation record is all the more remarkable as the U.S. was able at the same time to accommodate an increasing population and a higher participation rate and nevertheless reduce unemployment. One extreme case is Sweden with a very high participation rate, and a policy response to unemployment consisting of measures to discourage participation. The other extreme case is Spain with a very low, but rising participation rate. Countries like Spain and Sweden have such differences in the structure of unemployment that they appear as countries from different planets, rather than

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from the European Union, an integrated economic space.

One way of responding to unemployment is to introduce more flexibility in work time and to make it easier to work part-time. The EU has over the years increasingly replaced full-time with part-time employment. In 1984 about 12% of the labour employed worked part-time compared to 14% in 1996. This is not a big change, but in some countries policy has induced big changes. The extreme example is the Netherlands. Whilst part-time jobs accounted for 16% in 1980, they represented 35% in 1997. That policy is a major reason for the low unemployment rate of the Netherlands. The country where part-time employment is least developed in Europe is Italy with only 6.5% of total employment, followed by Spain, and much higher overall unemployment. Whilst part-time work should not be imposed, it should not be discouraged by fiscal or contractual measures. In most EU countries much remains to be done.

I conclude this illustration of how different the structure and extent of unemployment across Europe are by noting the differences in labour costs in industry. Portugal has a total labour cost per hour, including social security charges, of about EUR 5.5 compared to Germany's EUR 27.5. Many people think that if productivity is high enough in Germany, it only stands to reason to pay corresponding high wages. That may be true when economies are at full employment, but not otherwise. Suppose there is a wage shock. Firms will try to substitute capital for labour to reduce costs, jobs will get lost and productivity (that is, output per worker) will go up. Because productivity has gone up, still higher wages appear now justified and the result is even fewer jobs. The problem is that productivity itself is an endogenous variable that responds to relative costs. In the high-wage countries of the EU it would be difficult to argue that high unemployment has nothing to do with wage costs. Germany's labour costs are extreme, followed by those of the other members of the EU core: a centre of gravity plagued by high unemployment.

In Germany this argument is particularly debated, and the conviction that high productivity justifies high wages is not easily assailed. But it is important to realise that the skill differences in Europe are small and that productivity is mostly driven by cap-

ital deepening. As German car producers have found out, productivity at their new plants in Spain or Portugal is just as high as in Germany – even though wages are much lower. As a result German industry is investing increasingly abroad. In 1998, net foreign direct investment reached nearly US\$ 67 billion or 3% of GDP.

The policy conclusions for the core countries of EMU are clear: real wage moderation, reduction of wage taxes, greater flexibility in employment contracts.

### The demand side

Countries participating in the EMS have faced the same demand curve: efforts to meet the Maastricht criteria resulted in stable exchange rates, converging inflation and interest rates and hence converging real interest rates. Here we have a common factor – aggregate demand – which affected all countries participating in the fixed exchange rate mechanism of the EMS, and then in EMU.

Since the early 1970s unemployment has been more or less on a continuous upward trend in the EU, except for the period 1986-1990. During that period EMS exchange rates were stable, despite strong fiscal and monetary expansions in some member countries leading to real overshooting and the explosion of the EMS in 1992. For the remainder of this period of 25 years and independently of whether times were good or bad, unemployment went up. It seems that there is a lot of hysteresis in the data. That is, with some unemployment already existing, even during an upswing of the economy there is no correction. For the U.S. the picture is drastically different. During good times unemployment went down, during bad times unemployment went up, with a modest downward trend.

Certainly, different supply features account for the greater cyclical behaviour of U.S. unemployment; but not for the difference in trend. In the United States, monetary policy was strongly counter-cyclical. When growth went down, monetary policy stimulated demand. In Europe, exactly the opposite happened. The growth decline after 1988 occurred on both continents, but interest rates in Europe were increased to reach their highest level for these 25 years in 1992. In that year, growth was already approaching zero, and became negative in

Greater working time flexibility and wage moderation to reduce unemployment in the EU core

1993. On that basis it is very hard not to argue that monetary policy had something to do with the increase in unemployment in Europe. Because of strong hysteresis, Euroland still suffered in the late 1990s from the restrictive monetary policy of 1989–93.

The fiscal story confirms the restrictiveness of EU demand policy. In 1992, the structural fiscal deficits were the same in the EU and the United States. Since then the unemployment rate has increased from 8% to 11% in Europe and the structural fiscal deficit has been lowered from about 4% to 1.5%. In the United States, the reduction in the structural fiscal deficit was even more pronounced but fully consistent with a decline in the unemployment rate from over 6% to 4%. The conclusion is clear: fiscal policy was overly restrictive in the EU and together with monetary policy squeezed aggregate demand during a period when relief measures would have been justified.

The monetary policy of the European Central Bank during most of 1999 was precisely what Europe needed: low interest rates and a weak euro. Unfortunately, low short-term rates did not translate into low long-term rates.

As for fiscal policy, the current desperate efforts to respect the Stability Pact are not in tune with employment needs. Here the problem is that the Stability Pact is framed in terms of actual budget deficits rather than structural deficits. This short-coming needs to be tackled to make the Stability Pact meet standard economic logic.

### **Demand meets supply**

That brings me to focus on a key component of overall demand, namely investment. Investment is, of course, not only a component of aggregate demand. Investment also improves the supply capacity and hence productivity. It is striking that since the early 1970s (the last time the EU had full employment) investment in the EU, as a share of overall GDP, has declined dramatically, from 25% to 18%. In a way, this comparison understates the problem, because the EU is no longer at full employment. In 1998, the share of actual investment in full employment GDP was only 15–16%. And this is, of course, the right reference because not only is GDP a function of the

level of investment, but the latter is also a function of current and expected future GDP.

Hence, actual investment is far too low for Europe's aspirations to a high and rising standard of living and full employment. Answering the question of why investment is so low is beyond the scope of this paper. But I have already implicitly touched upon one argument: during the 1990s public sector investment was halved throughout Europe from 4% to 2% of GDP as a result of EMU-driven fiscal consolidation. There is also a shortage of private investment, as European corporations invest increasing shares of their overall investment programmes outside the EU, and non-EU corporations have also shifted investment to other parts of the world.

The best way to make Europe invest more at home is to make Europe a more attractive investment location through a radical overhaul of the supply-side spectrum.

During the 1990s employment in Europe declined slightly. On average, investment has replaced old equipment and has failed to create additional employment. What this experience illustrates is that the employment creation problem should not be cast as a demand or supply side problem. Key is the interaction between the two. Improved supply may fail to create jobs if there is no increase in demand. Therefore, policies on both demand and supply sides are necessary to maximise job creation.

Tight monetary and fiscal policies in Europe and too little investment in the 1990s