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Social Pacts, Unemployment, and EMU Macroeconomic Policy

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1. Introduction[1]

The purpose of this chapter is to raise some broad issues concerning the role social pacts can play in solving the most serious problem in the European economy: the problem of unemployment. As many cases suggest, social pacts may be able to help cope with the problem in the individual countries in which they have occurred. But caution must be exercised in extrapolating from those cases to the European economy as a whole. The countries with social pacts which are members of the European Monetary Union (EMU) are regions within a single market, with a single macroeconomic policy, run by the European Central Bank (ECB), and all trade mostly with each other. Thus, the EMU has to be understood as a single economic entity and the member countries as units within it. The contribution that the pacts can make to solving the problem in that economic entity therefore cannot be assessed by considering each of them in isolation from each other, individually or comparatively. It can be done only by considering their joint effects. These are likely to vary depending on the macroeconomic policies determining demand in Euroland as whole, particularly the monetary policies implemented by the ECB.

The macroeconomic policy regime built into EMU, particularly as it seems to be interpreted by the ECB (uncertain as that still is) is a highly restrictive one that could keep the growth of demand in Euroland as a whole too low to allow a significant reduction of unemployment to occur. Under those circumstances, the contributions social pacts can make to reducing unemployment are limited. Depending on whether there are social pacts in all or just some of the member states, and which ones they are, the pacts could at best bring about a marginal reduction in unemployment. Alternatively, they might simply redistribute unemployment among states with varying success in reaching social pacts. In the worst case, they might enter into a deflationary vicious circle of beggar-thy-neighbor internal devaluations whose joint effects would be an increase in unemployment. Which effects social pacts will have along this wide range of possibilities will depend very heavily on the rate of growth of demand the ECB is willing to allow. So far, there is reason to doubt that the ECB will create a macroeconomic environment in which social pacts can contribute significantly to lowering unemployment in Euroland.

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[1] Prepared for a book on Social Pacts to be published by the *Observatoire Social Européen*, Brussels. A previous version was presented at a conference organized by the *Observatoire* on February 3, 2000. I am grateful to Anton Hemerijck and other participants in the conference and to Paul de Grauwe, Ton Notermans, David Soskice, and Wolfgang Streeck for comments and criticisms on that and earlier versions. If I had been able to more adequately address all the issues they raised this version would have been improved much more than it has been.

This view is elaborated in the following discussion, which is divided into two main parts.

In the first, I simply set forth the argument that the contributions which social pacts can make to reducing unemployment are limited by the highly restrictive macroeconomic policy regime built into EMU, and that unemployment is likely to fluctuate around high levels as long as that regime persists. In the second, I offer some support for the argument. In particular, I suggest that the allocation of responsibility for price stability and employment institutionalized in the EMU policy regime embodies a mistaken view of the relationship between macroeconomic policy and unemployment, and that this view rests heavily on an explanation of why unemployment has been lower in the U.S. than in Europe since the early 1980s which is seriously flawed because it fails to take into account the fact that macroeconomic policies have been more expansionary in the U.S. than in Europe over much of that whole period. I conclude that European unemployment cannot be brought down toward U.S. levels unless the current EMU macroeconomic policy regime is replaced by a similarly more expansionary one, in which Euroland macroeconomic policy, particularly the ECB's monetary policy, is made responsible for employment as well as price stability, and that only then can social pacts make a significant contribution to reducing unemployment and keeping it low on a sustainable basis.

2. The EMU Macroeconomic Policy Regime and Unemployment

The basic issue in the debates over European unemployment and policies for reducing it concerns the relative roles of demand and supply side policies, first, in causing the high unemployment and, second, curing it. On one side is the current orthodoxy which insists that the unemployment is almost entirely a result of structural flaws in markets, particularly labor markets, and that the cure lies almost entirely in supply side policies that remedy the flaws. On the other side is the dissenting position that the high unemployment is almost entirely due to deficient demand resulting from excessively restrictive macroeconomic policies, and that the cure lies almost entirely in expanding demand. This difference is reflected in the ECB's frequent declarations that expansionary macroeconomic policy should not be used to compensate for the lack of structural policies,[2] and in its critics' response that structural reforms, however

[2]. According to ECB President, Wim Duisenberg, "Monetary policy could not compensate for structural rigidities." Quoted in *International Herald Tribune* (1999). According to ECB Governing Board member Tomasso Padoa-Schioppa, the ECB should avoid the "error [of]

desirable, should not be used to compensate for excessively restrictive macroeconomic policy.[3]

Many protagonists in these debates actually concede that both demand and supply side factors are involved, even as they differ over their relative importance. Indeed, a growing literature argues that both demand and supply side measures are needed to reduce European unemployment - that a "two-handed" strategy is needed - and that one without the other can accomplish much less than the two together can.[4] Even the OECD and the European Commission now give some recognition to the validity of this position, though the ECB still does not seem to do so. In any case, the questions of what the relative importance of the two kinds of factors is and how they interact remain unsettled. It does seem clear that those questions have to be answered differently for the causes and cures of Europe's unemployment. There seems little room for doubt that European unemployment was driven up by several successive episodes of highly restrictive macroeconomic policy which sharply curtailed the growth of demand. On the other hand, a good case can be made that unemployment which is caused and prolonged by insufficient demand tends to be transformed into structural unemployment that is increasingly unresponsive to accelerated demand growth, so that it cannot be cured only by the expansion of demand but also requires supply side measures. At the same time, supply side measures alone cannot cure unemployment in the absence of a sufficient expansion of demand. In this view, then, a combination of demand expansion and structural reforms, reinforcing each other incrementally over an extended period, is needed to bring unemployment down.

In contrast, the rationale for the macroeconomic policy regime built into EMU by the Maastricht and Amsterdam treaties, at least as the ECB evidently interprets it, confines the management of demand to the maintenance of price stability. Essentially, it denies that macroeconomic policy has any direct responsibility for growth and employment, assigning virtually all responsibility for the latter to supply-side or structural policies.[5] The term "policy regime" refers to the pattern of policy which decision-makers pursue over the long run - the goals which they prioritize, their conception of how the economy works so as to affect those goals, and the measures they rely on to influence the economy

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compensating for the lack of structural policies by implementing unnecessary monetary stimulation." *Le Monde* (1999).

[3]. "Structural reforms [may be] badly needed [but] we have to make sure that they are not mainly needed to compensate for bad macroeconomic policies." Fitoussi (1997).

[4]. The term "two-handed" strategy was coined in Blanchard et al (1985).

[5]. The theoretical underpinning of this rationale is the old idea of the long-run neutrality of money. For a critique, see Notermans (2000), and Ostrup (2000).

so as to achieve those goals. Other economic actors make their decisions in the light of their expectations of what the decision-makers will do, based on the observed pattern of policy as much or more than the decisionmakers' declarations. Thus, as long as government commitments to a full employment policy regime were rendered credible by the measures they took, other actors based their decisions - about investment, wage demands, etc. - on the expectation that governments would continue to take such measures. To the extent that governments have instead credibly committed themselves to a price stability regime, particularly by giving central banks the independence to pursue that goal, other actors' expectations and hence their decisions have been reshaped accordingly.[6]

The shift European governments have made to a price stability regime is clearly reflected in the EMU's institutional structure. As is well known, the only macroeconomic policy instrument established for Euroland as a whole is the monetary policy instrument placed in the hands of the ECB. More independent than any other central bank in the world, it is required to dedicate monetary policy to maintaining price stability, as it chooses to define it.[7] There is no Euroland fiscal policy instrument; only a fiscal policy rule that severely limits the member states' discretion in using the only macroeconomic instrument still available to them. The only formal mechanism concerned with member states' fiscal policies is the surveillance procedure by which compliance with the fiscal policy rule is monitored by the Commission and the Council of Economic and Finance Ministers (ECOFIN). There is no mechanism for authoritatively coordinating the member states' fiscal policies so as to construct a fiscal policy for Euroland as a whole, much less for coordinating fiscal policy with the ECB's monetary policy so as to determine a Euroland macroeconomic policy mix. The ECB president may attend ECOFIN meetings (which include EU member states not belonging to EMU) and the ECOFIN president and a Commission member may attend ECB Board meetings, but none have voting rights in each other's decision bodies. There is also some potentially more important scope for informal coordination within the framework of the Euro-11 group - in which the EMU member state finance ministers meet together with the European Commissioner responsible for economic policy and the president

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[6]. This follows the conception of a policy regime in Temin (1989: 91). "The regime is an abstraction from any single policy decision: it represents the systematic and predictable part of all decisions. It is the thread that runs through the individual choices that governments and central banks . . . make. It is visible even though there inevitably will be some loose ends, that is, some decisions that do not fit the general pattern. These isolated actions have little impact because they represent exceptions to the policy rule, not new policy regimes." See also Notermans (2000).

[7]. The British government sets the inflation goal which the newly independent Bank of England is mandated to pursue.

of the ECB prior to the formal meetings of ECOFIN - but it has no decision-making authority, and, from the ECB's standpoint, there can be no question of negotiations over macroeconomic policy. Thus, even if the member states overcome their conflicting interests enough to coordinate their fiscal policies, the ECB rejects any negotiation with the member states through which to agree on a Euroland fiscal-monetary policy mix. Thus, there is no institutional mechanism by which aggregate demand in Euroland as a whole can be managed so as to pursue the goal of employment as well as price stability.

A weak form of accountability is imposed on the ECB. It is required to report annually to the Council, the Commission, and the European Parliament. The ECB president has to present the report to the Parliament in person, and the president or other Board member now regularly engages in "monetary dialogue" with the Parliament's Committee on Economic and Monetary Affairs four times a year. However, the Parliament cannot instruct the ECB or even negotiate agreements with it any more than any of the other bodies can, and does not have the implicit leverage over the ECB that the U.S. Congress has over the Federal Reserve Bank (Fed) by virture of the fact that the Fed's very existence and duties rest on legislation enacted by Congress, which it can change, and has changed. In contrast, nothing short of a unanimous decision of the member states to revise the Treaty can change the ECB's legal status and mandate.[8]

This allocation of responsibility for the different elements of economic policy, and particularly the insulation of the only form of demand management there is for Euroland as a whole from political deliberation, is also reflected in the EU's so-called Employment Strategy. Launched at the special 1997 Luxembourg Summit after employment was declared an EU goal in the Amsterdam Treaty, the strategy is almost entirely about supply side changes while demand management, which is exclusively in the ECB's monetary policy domain, is kept off limits.

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[8]. The Treaty, in Article 105, says that "Without prejudice to the objective of price stability, the ESCB shall support the general economic policies in the Community with a view to contributing to the achievement of the objectives of the Community as laid down in Article 2." The objectives laid down in Article 2 include "a high level of employment and social protection." However, there is no institutional mechanism by which the member states, through Community institutions or otherwise, can determine how the goal of price stability is defined or require the ECB to pursue it in way that supports the general economic policies on which they may decide. The Community economic policies are defined by the Broad Economic Policy Guidelines adopted by ECOFIN but they are not binding on the ECB beyond the loose obligation imposed by Article 105. The ECB's reporting obligations are spelled out in Article 109b.

This policy regime and the political structure that perpetuates it consigns social pacts largely to the supply side and structural measures to which the employment strategy is effectively confined. This is so except insofar as the pacts include wage restraint, as many pacts do, given that the overall rate of growth of wages is an essential component of the macroeconomic policy mix. Aside from that, social pacts are inherently about the supply side because in EMU they have no leverage on the only macroeconomic policy there is for Euroland, i.e., the ECB's monetary policy. So far, the pacts are national deals, and national governments, whether they are parties to the deals as they typically are or base their positions on deals struck only between the social partners, are constitutionally denied any voice in the ECB's policy decisions. Even if there could be a Euro-zone social pact among governments, unions, and employers, it would still have no leverage over ECB decision-making, just as the member state governments acting in the Euro-11 council or more formally in the EU Councils, cannot compel the ECB to reconcile its monetary policy with their employment goals. The macroeconomic dialogue introduced by the 1999 Cologne summit does not change this in any fundamental way.[9]

It is precisely this relegation of social pacts to the supply side that severely limits what they can be expected to accomplish toward reducing unemployment. This is not to deny that social pacts can accomplish something toward that end. If one looks at individual countries, a good case can be made that social pacts have contributed to the reduction of unemployment, by restraining wage growth, flexibilizing employment regulations, etc. There are clear differences in levels of unemployment among European countries, whether within EMU or not, and it is plausible that social pacts help explain lower levels in some countries.[10] Social pacts have been reached in most of those countries and have contributed to structural reforms in labor and product

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[9]. Under the German Presidency, the June 1999 Cologne European Council adopted a resolution providing for a Macroeconomic Dialogue, consisting of two meetings a year at which representatives of the three European level peak organizations of unions and employers (ETUC, UNICE, CEEP), the ECOFIN and Labor and Social Affairs Councils (member state cabinet ministers), the Commission, and the ECB are to exchange views on economic policy in the EU. The meetings occur in association with ECOFIN meetings dealing with the Broad Economic Policy Guidelines prescribed by the Treaty, and each of these "political level" meetings is to be prepared by a "technical level" meeting of representatives of the participating bodies. The first meetings took place in October and November 1999.

[10]. At the low end of the range in 1997, unemployment was 4.4 percent in Austria, 5.2 percent in the Netherlands, and 5.5 percent in Denmark, while at the high end it was 12.4 percent in Italy, 12.1 percent in France and 10 percent in Germany. It was 13.3 percent in Finland but it represents a special case, in which unemployment has been rapidly declining. *OECD Economic Outlook*, 64 (December 1998), Annex Table 22. See also Blanchard and Wolfers (1999).

markets, which in turn probably contributed to the lower levels of unemployment.[11] This would be consistent with the general proposition that variations in the institutions that structure markets result in different levels of unemployment at a given level of demand.

Yet, if one shifts one's perspective from individual countries to Euroland as a whole, then it is not clear that social pacts have contributed much, if anything, to reducing the aggregate levels of unemployment in the Euroland economy. They may indeed have succeeded only in redistributing employment, enabling some countries to capture an increased share of the demand to which macroeconomic policy has limited the Euroland economy. This they can do by securing a real devaluation through pacts that lower unit labor costs relative to those in the other member countries in ways other than the reduction of nominal exchange rates that are rendered impossible within EMU, or by increasing productivity faster than in other member countries. This is what the Dutch are alleged to have done through wage restraint aimed at keeping Dutch wage growth at some 20 percent below German wage growth.[12] Of course, in EU countries outside EMU that retain the possibility of floating exchange rates, social pacts can also serve in similar ways to preserve any real exchange rate advantages that might be gained by nominal depreciation against the Euro or other currencies. In other words, social pacts can serve and evidently have served as instruments of national competition. Thus, social pacts have been quite aptly characterized as "competitive corporatism" (Rhodes, 1998, 2000).

But what is rational for each individual country that successfully engages in competitive corporatism is not necessarily collectively rational for the set of interacting countries as a whole. It is not possible for every EMU country to improve its competitive position by a real devaluation any more than it is for every country in the international economy to achieve an export surplus. In such a competitive game, there will necessarily be relative gainers and losers, with different net effects on employment in the multi-country economy as a whole, depending on the growth of demand in the economy as a whole. There is a wide range of possible net effects. If there is insufficient demand growth, the inter-country distribution of employment growth could be affected without any net reduction of unemployment - the gains in employment achieved by some countries could be at the expense of foregone employment growth in others. In the worst case scenario, there could be a net diminution of employment if each country seeks to retaliate against the internal devaluations by others with internal devaluations of their own - whether by social pacts or some less

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[11]. International Labour Organization (1999). Barrell and Genre (1999).

[12]. Soskice (2000: 63). This view is contested, however. See Hemerijck et al. (2000) in this volume.

attractive methods - possibly setting in train a deflationary vicious circle that could diminish demand in the multi-country economy unless there is an offsetting expansion of demand by some institutions with the capacity for it, such as Euroland's ECB.[13] Employment will grow in all only if there is sufficient demand growth to support it, even if it grows faster in some than in others as a result of differential success in reducing unit labor costs. In Euroland as a whole, in other words, the net employment effects of social pacts in some or all of the member states depends on the rate at which the ECB decides that demand should be allowed to grow.

Summing up, social pacts fit well into Europe's Employment Strategy with its focus on the supply side and exclusion of the demand side. But that is precisely why the pacts cannot contribute much to reducing unemployment in Europe, insofar as that strategy relies on supply side measures alone to do the trick. It thus leaves unchallenged the ECB's apparent position on the matter. If there is a change in that position and the ECB acknowledges that it has some responsibility for employment as well as price stability, and that monetary policy has to sustain expectations of continued growth in demand if unemployment is to be brought down, social pacts could play a more positive role. They could significantly contribute to a "two-handed" strategy for doing so by helping to keep wage growth from accelerating and to make social policy and labor market institutions more "employment friendly." If there is no such change in the ECB's position, however, Europe will be condemned to struggling against unemployment with one hand tied behind its back, unless there is the political will to challenge the fundamental rationale and change the institutional structure of the current EMU macroeconomic policy regime.

So far I have simply asserted the argument that the potential contribution of social pacts to solving Europe's problem of unemployment is severely limited as long as there is no shift from the current restrictive macroceonomic policy regime to a more expansionary one. But is it valid? Some support for the argument, however partial and tentative, is presented in the remainder of this chapter.

[13]. The possibility that social pacts could degenerate into a vicious circle of beggar-thy-neighbor competitive wage cuts is stressed by Bispinck and Schulten (1999).

3. Unemployment in Europe and America: Divergent Trends and Conflicting Explanations

The rationale for the EMU policy regime, which assigns price stability to demand management, principally by monetary policy, while assigning employment to supply-side policies, principally those which increase the flexibility of labor markets, rests heavily on an explanation of why unemployment rates have been higher in Europe than in the U.S. since the early 1980s, with the gap in favor of the U.S. increasing further in the 1990s (Figure 1). According to that explanation, the difference in employment performance is almost entirely accounted for by differences in the structures of labor and product markets. The greater emphasis seems to be placed on the differences in the interacting sets of social policy and industrial relations institutions that structure and condition the operation of labor markets, or what we can call the labor regimes, in Europe and the U.S. The differences are familiar. Briefly summarized, collective bargaining, labor law, and taxes and transfers play a much larger role in determining the terms of employment, disposable income, and alternatives to employment incomes in Europe than in the U.S., with its weak unions, limited labor market regulation, and residual welfare state.[14] The European labor regime thus provides people with more protection against the risks inherent in labor market participation while contributing to relatively lower inequality than the U.S. labor regime does. But for this very reason , according to the EMU orthodoxy, it also results in higher unemployment in Europe because it makes the European labor market more rigid than the American, thereby retarding the adjustment of labor to changes in the level and composition of demand for labor. It is thus the purportedly greater flexibility of the American labor market that is credited with the much greater success of the American "jobs machine" in providing employment since the early 1980s. Most of Europe's high unemployment can accordingly be remedied by "structural reforms" that make European labor regimes more like the American one.[15]

When the trends since the early 1980s and also over a longer span are examined more closely, however, this explanation is called into question.[16] In

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[14]. The contrast is between the U.S. and continental Europe insofar as the British labor regime has become increasingly like the American.

[15]. According to a member of the ECB governing board who required anonymity, Europe could solve its unemployment problem by importing the American labor market. The attribution of unemployment to "rigidities" in the European labor market is certainly not new. An earlier statement of it is Giersch's essay on "Eurosclerosis" (1985). The OECD Jobs Study (1994), along with its successor documents, is the canonical elaboration of this view. A recent brief summary is Siebert (1997).

[16]. For an earlier comprehensive analysis which concludes that "comme l'inflation, le chomage reste du domaine des politiques macroéconomiques," see Muet (1994: 38)

the discussion that follows, I consider the consistency of these trends first with the labor regime explanation, then with an alternative in which they are explained by differences in macroeconomic policy, and finally with an explanation based on the interaction of labor regimes and macroceonomic policy.

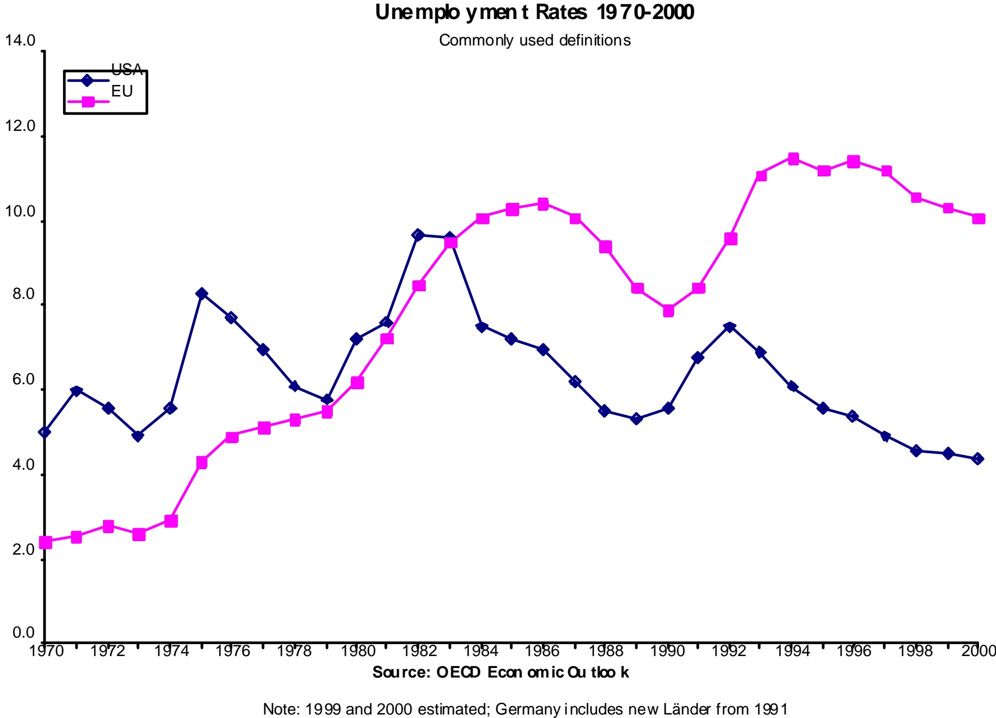
3.1. Unemployment Fluctuations and the Labor Regime Explanation

What is most striking over the longer period is that the relationship between unemployment trends in Europe and the U.S. since 1983 is a reversal of the relationship that prevailed throughout most of the preceding decades following postwar recovery. Moreover, during the four years preceding 1983 in which the largest part of the rise in European unemployment occurred, from around an average of about 5 to nearly 10 percent, U.S. unemployment was not only slightly higher but also rose in parallel with European unemployment, except in the last year of this subperiod when the gap in favor of Europe was closed by a slight decline in the U.S. Then the gap switches dramatically in favor of the U.S. when unemployment drops sharply in 1984 while continuing to rise in Europe, widening further in the following two years, though at a slower pace. But then the gap narrows slightly as unemployment declines in Europe a little faster than its continued decline in the U.S. and slight rise in 1990, and it narrows slightly more as unemployment rises more steeply in both economies during the next two years. It is after 1992 that the gap in favor of the U.S. reopens and grows more sharply than ever as unemployment there abruptly begins its long sustained decline while unemployment in Europe continues its steep rise to a plateau of nearly 12 percent where it stays for the next few years until it beginsa gradual fall in the two most recent years.

These observations raise a number of questions about the labor regime explanation. To begin with, have there been changes in European and American labor regimes that are fairly consistently correlated, perhaps with some lags, with the changing relationships between unemployment trends in the two regions? If there have been, that would strongly suggest a causal link between the labor regimes and unemployment trends, even if it would remain to be demonstrated. Thus, if there were changes in one or the other or both labor regimes prior to or around the main reversal in the relationship in 1983 that would have made the European regime relatively more unfavorable to employment - presumably more "rigid" - than it had been in the earlier postwar period, that might well be why the reversal occurred. But if there were labor regime changes with such direct causal effects, the later 1980s present a puzzle. That is when the trend in European employment performance was as good or better than in America - though the gap that had opened up was only slightly

narrowed. Were the effects of the labor regime changes suspended during those years? If so, why were they suspended? Were they then resumed in the 1990s? If so, why? And was their resumption enough to account for the renewed and even greater deterioration in Europe's relative employment performance? If not, what further changes in the European and American labor regimes occurred to account for it? As implied by these questions, for any labor regime changes themselves to have had such on and off effects seems implausible, so if there were changes that made those in Europe relatively more unfavorable to employment than the American one, they could account for the variations in the employment performance gap between the two regions only insofar as they interacted with other factors, including macroeconomic policy, making them have different effects under different conditions.

Figure 1.



However, a preliminary search finds little evidence of labor regime changes consistent with those variations, even if the late 1980s are set aside. [17] Most of the build-up welfare states and strengthening of unions in Europe occurs in the

[17]. The preliminary character of the search must be stressed. I make no claim to an exhaustive search of the relevant literature bearing on the issues involved here; only that there is enough evidence to be at least skeptical of the labor regime argument. Note that the issue here is whether labor regime factors provide all or most of the explanation, not whether they provide part of the explanation. That they do so by the way they interact with macroeconomic policy is argued section 3.3.

earlier postwar decades when unemployment was lower there than in the U.S. There are some further increases in the generosity of the welfare state and rigor of labor standards in some European countries over the last couple of decades, but the general trend seems to be in the other direction (OECD, 1998, Nickell, 1997, Clayton and Pontusson , 1998, Pierson 2000). Although there is no major retrenchment in social policy or attack on labor rights in any European countries except Britain under Thatcher, there are various changes such as reductions in replacement ratios, tightened eligibility rules, some weakening of unions and decentralization of collective bargaining. These are unevenly scattered around continental Europe but their overall effect should have been to make labor markets less rather than more rigid over the period as a whole, though perhaps not much less so and certainly not as much as the OECD and others have been urging (Blanchard, 1999, Gregg and Manning 1997). And insofar as there have been changes in either direction, there does not seem to be any systematic relationship between their timing and the fluctuations in the employment performance gap in the sub-periods since the early 1980s.

There is more evidence of changes in the American labor regime that increase the difference between it and the continental European regimes in ways consistent with the labor regime explanation. Thatcher's policies in Britain were in some respects paralleled by the Reagan Administration's attack on unions (encouraging intensified attacks by management) and erosion of various social benefits, while the elimination of "welfare as we knew it" during the Clinton Administration took the U.S. another step away from a welfare state toward a "workfare state." These changes could have contributed to a lower equilibrium unemployment rate in the U.S., permitting unemployment to reach the lowest levels in decades before any signs of renewed inflation appeared. Some argue that this is particularly due to the prolonged decline of American unions, which has left the Federal Reserve Bank (Fed) free to relax monetary policy more quickly than European central banks faced with strong unions, though others cite evidence to the contrary. But if Fed policy has been more expansionary as a result of this particular, ostensibly growing, divergence between American and European labor regimes, it is not that divergence alone but its interaction with differences in monetary policy that offers an explanation of the variations in the employment performance gap.

However, even in the absence of changes in the labor regimes preceding or coinciding with these variations, the labor regime explanation could nevertheless be right. Various mechanisms have been suggested by which constant differences in labor regimes could produce the successively wider gaps between unemployment in Europe and the U.S. One is that greater "rigidities" in European labor markets, even if unchanged, make any increases in

unemployment from whatever cause more durable than in the U.S. Thus, an increase in unemployment resulting from a shock, such as a demand deficiency induced by domestic policy or by external developments (e.g., oil price increases, recessions abroad), will tend to persist longer in Europe and be less responsive to a reversal of the conditions that produced it to begin with. To the extent that the unemployment produced by one shock is not eliminated by the time the next shock occurs, unemployment from the new shock starts from a higher level than at the time of the preceding shock, adding to the unemployment remaining from the previous one. Unemployment is thus ratcheted up by successive shocks, resulting in an upward secular trend.

Various features of European labor markets are said to give them the rigidities that make unemployment last longer. The list includes high minimum wages, unemployment benefits, and taxes on labor. They are described as having the net effect of making it "difficult (and/or unattractive)" for workers to find jobs at wages corresponding to the decline in productivity that increases with the duration of their unemployment (De Grauwe, 1998: 5). These and other features of European labor markets are discussed more fully below. Here it suffices to note that this mechanism depends on how much of a given volume of unemployment is responsive to a reversal of the conditions that caused it and, if so, at what rate. Insofar as unemployment is responsive to increases in demand for labor, and if the demand for labor is at all affected by domestic policy, then the extent to which the labor market institutions produce an upward secular trend may depend on whether policy increases the demand for labor quickly enough to limit the unemployment resulting from a given shock and keeps it rising long enough to eliminate all the unemployment resulting from that shock, whether policy-induced or not. Thus, if macroeconomic policy stays restrictive too long, or becomes restrictive again too quickly, relative to the (institutionally determined) reaction time of unemployment to demand for labor, any upward secular trend would be accounted for at least partly by macroeconomic policy. If European macroeconomic policy displays these characteristics more than American policy in the periods when European unemployment is increasingly higher than in the U.S., that policy difference would have to be part of the explanation for the growing employment performance gap.

Other mechanisms by which differences in labor market institutions could account for the variaitions in the employment performance gap have been suggested even if there were no changes in the institutions, including those that structure wage determination as well those like the ones cited earlier which affect incentives to offer or accept jobs. But again, as I suggest in more detailed discussion below, it is not the labor regime differences alone but their interaction with other factors that provide the explanation. Before proceeding

with that discusson, however, it is necessary to consider the differences in macroeconomic policy.

3.2 . The Macroeconomic Policy Explanation

The evidence for the argument that differences in macroeconomic policy largely account for the differences between European and American employment performance seems clearer, with respect to timing as well as the policy-mix, than the evidence for the labor regime explanation. Over a period of nearly two decades following the breakdown of the Bretton Woods system, virtually all OECD countries eventually reacted to the difficulty of maintaining full employment without inflation by shifting toward more restrictive macroeconomic policy regimes, giving top priority to price stability and relying on monetary policy to achieve it (Notermans, 2000).

Germany's Bundesbank was a leader in this regime shift, announcing it in 1974 and acting as a driving force since then. In the U.S., the Carter Administration gave up on its efforts to curb inflation in the face of OPEC II and turned the task over to the Fed, whose drastic tightening of monetary policy necessarily had the greatest international contractionary repercussions. In France, the Mitterand government's attempt at domestic expansion in the face of that "monetarist shock" - while France was particulary ill-equipped with the institutions with which to avert the expansion's inflationary effects - ended with the 1982-83 U-turn that marked its shift to the price stability regime. Even Sweden, ostensibly among the best equipped with the requisite institutions, made the shift in 1990 after an initially successful but ultimately failed attempt to find a "Third Road" between Thatcherite contraction and Mitterand's unsustainable domestic expansion.[18] Finally, this shift was incorporated into the construction of EMU, supported by the conviction that price stability must be the main aim that now prevails among economic policy-decision makers in most OECD governments - the finance ministers and central bankers who, along with many economists, form a kind of epistemic community that enforces this "pensée unique" intellectually as well as politically (McNamara, 1998).

However, there emerged a significant difference in the priority given to price stability over growth and employment and the way in which price stability was pursued in Europe, principally by the Bundesbank - which effectively set monetary policy for the rest of Europe - and in the U.S., by the Fed. This difference in macroeconomic policies, according to the alternative explanation, is the main factor underlying the reversal of the relationship between

[18]. The Swedish Social Democrats' "Third Road" is not to be confused with Tony Blair's "Third Way." For an analysis of the Swedish attempt and its failure, see Martin (2000).

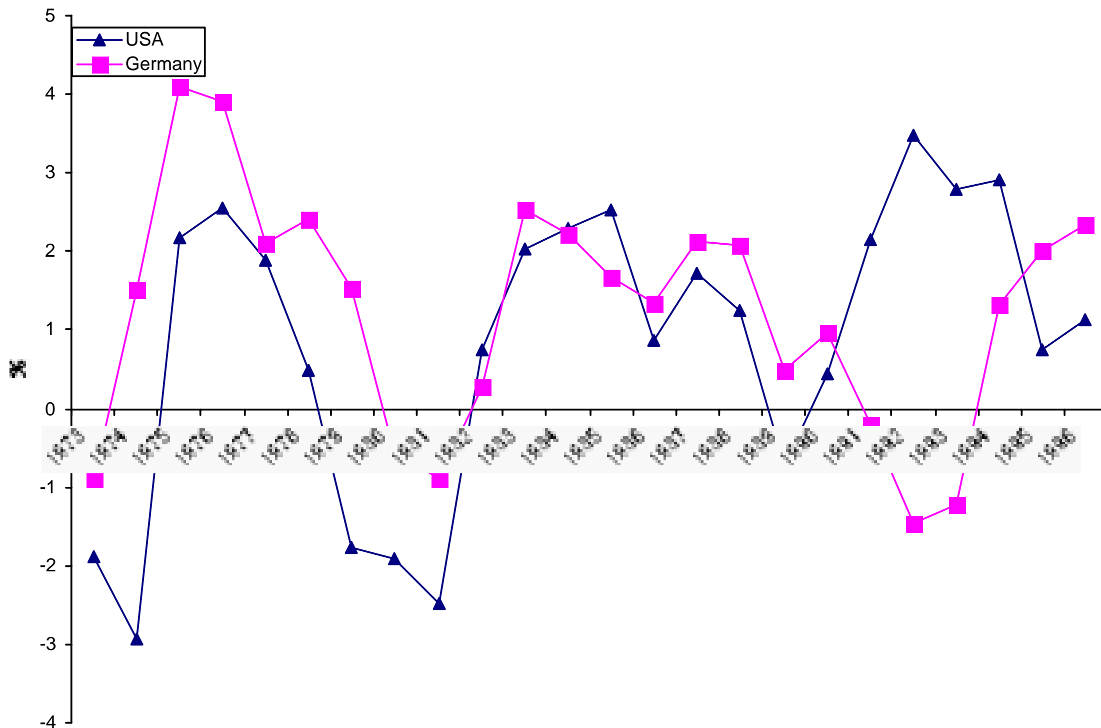
unemployment trends in Europe and the U.S. since 1983. The contrasting policies and their relationship to the employment performance variations are described in the following discussion but only one indicator of the differences between Fed and Bundesbank monetary policies is provided in the form of a comparison of yield spreads in Figure 2. The yield spread – the difference between real short term interest rates, set by central banks, and real long-term interest rates, set by bond markets – serves as a measure of the restrictiveness of monetary policy. Monetary policy can be said to be more expansionary the larger the positive spread – i.e. the lower that short-term rates set by central banks are relative to the long-term rates set by bond markets on the basis of inflationary expectations. As the spread declines to zero and turns negative – i.e., short-term rates become higher than long-term rates – monetary policy becomes increasingly restrictive.[19]

In the years after OPEC II when unemployment was rising steeply in both America and Europe, the extreme tightening of monetary policy by the Fed seemed to signal a shift to a price stability regime every bit as restrictive as that toward which European policy-makers were moving; indeed, the Fed took over the lead, closely followed by the British government, and adopted an even more restrictive stance than the Bundesbank did. But by 1983 the Fed had reversed itself and moved as strongly in an expansionary direction as it had in a restrictive direction. The Bundesbank reversed course as well but already began tightening monetary policy again while the Fed continued on an expansionary course for another two years. By the time Fed policy also turned restrictive again, highly expansionary fiscal policy had the U.S. economy booming. The Reagan Administration's huge tax cuts and increases in military spending combined with Congressional Democrats' resistance to large cuts in civilian spending to produce the largest peacetime fiscal stimulus in the country's history until then, implying at least a partial reversal of the earlier shift to a price stability regime. This marked divergence in macroeconomic policy stances in Europe and the U.S. coincided very closely with the first sharp deterioration in Europe's relative employment performance from 1983 to 1986.

Figure 2.

[19]. It would obviously be better to relate a measure of differences in monetary policy directly to the differences in unemployment in a single chart. This will be done future work but it would be better still to provide a formal analysis of the relationship, preferably within a macroeconomic model. If there is such an analysis in the literature, it has not been found yet.

Interest Rate Spread: Germany- USA



Source: IMF, Own computations.

The ensuing exchange rate gyrations and policy conflicts between American and European governments, which triggered the relaunch of monetary integration, complicates the comparison of policies and performance in the later 1980s (Henning, 1998). Except for 1987, when the Bundesbank's sharp tightening was blamed for the stock market crash, its policy in those years was less restrictive than the Fed's, and fiscal policies were more expansionary in Europe than America, notwithstanding the large Federal budget deficit that remained. The European economy received a powerful additional fiscal boost from the large budget deficits by which the German government financed unification. This offset the recessionary tendencies that had set in, as did a substantial easing of monetary policy by the Fed. This policy scenario is consistent with the slight narrowing of the unemployment gap between Europe and America, as unemployment fell until 1990 and then rose again in the next two years in both economies. Indeed, this is the period in which employment growth in Europe matched that in the American "jobs machine," despite the absence of any significant convergence of the respective labor regimes.

The end of that period was the point at which both policies and peformance again diverged sharply, producing by far the largest gap yet between European and American unemployment. While the Fed continued reducing interest rates, kept them low between 1991 and 1993, and varied them

slightly around a slightly higher level since then, the Bundesbank increased interest rates continuously beginning in 1988 until monetary policy became extremely tight in 1992, and then only slowly relaxed it in the following years. This combined with the tightening of fiscal policy due to the unyielding implementation of the EMU transition rules to make macroeconomic policy so contractionary as to plunge Germany and with it the rest of Europe into the deepest recession of the whole postwar period. The unfortunate responses of many actors to the issues posed by unification and the distribution of its economic burdens - which vastly exceeded optimistic expectations - all contributed to this disaster in a sequence of events too complex to describe here. What seems clear enough, however, is that the resulting macroeconomic policy mix drove unemployment in Europe up to record levels, while in the U.S. growth sustained by the relaxation of monetary policy made it possible to gradually reduce the Federal deficit without offsetting the expansionary effect of lower interest rates, bringing unemployment down to the lowest levels in decades.[20]

The apparently strong consistencies between contrasting macroeconomic policies and unemployment trends and weak or absent consistencies between labor regime variations and those same trends, preliminary and elementary as their analysis has been, suggests pretty strongly that the differences in macroeconomic policy are at least a large part of the explanation for the difference in unemployment trends in Europe and America. How large a part? And could they be the whole of the explanation? This is quite doubtful in view of the initial discussion of the labor regime explanation. While that discussion also made it quite doubtful that labor regime differences could be the whole explanation, it suggested that they may nevertheless be part of the explanation.

3.3 . The Interaction Explanation

If labor regime differences are part of the explanation, then the causes of unemployment and also the cures for it must lie in the ways in which macroeconomic policies and labor regimes interact. The view that the explanation lies in both and how they interact receives strong though partial and tentative support from a recent econometric analysis designed to explain both the levels of European unemployment and its variation among European countries. It may be the most ambitious attempt yet made to overcome the limitations of explanations based solely on either shocks or institutions. In the

[20]. The principal sources of the preceding account are the OECD country surveys and semi-annual *Economic Outlook*. For other comparisons of the policy-mix in the U.S. and Europe, particularly the sequencing of monetary stimulus and fiscal consolidation, see Baker and Schmitt (1999), De Grauwe (1998), Horn and Scheremet (1999), and Muet (1998)..

work done so far, "specifications that allow for shocks, institutions, and interactions can account both for much of the rise and much of the heterogeneity in the evolution of unemployment in Europe" (Blanchard and Wolfers, 1999). If that analysis were extended to include the U.S., it could be expected to support the view that the interaction of macroeconomic policy (whatever other sources of shocks there have been) and labor regimes largely explains the U.S.-Europe difference in unemployment trends. Other comparisons among the European economies as well as between them and the U.S. point strongly in this direction. There is great variation among them in labor market outcomes, as noted earlier, with unemployment higher than in the U.S. in some but lower in others over recent years. There is much work, including that on social pacts, suggesting that differences in the institutions that structure those labor markets at least partly explain the variation.

At the same time, careful analysis of the institutions calls attention to the need to differentiate among specific labor regime institutions rather than lumping them together in terms of generalized rigidity or flexibility, since different institutions have quite diverse effects on employment (Nickell, 1997, Nickell and Layard, 1999, OECD, 1999). Thus, some which make labor markets more "rigid" - e.g., protections against arbitrary dismissal - do not necessarily affect employment adversely, or affect employment differently depending on whether unemployment is increasing or decreasing. Moreover, the effects of some seem to depend on the presence or absence of other aspects of labor regimes - e.g., relatively high unemployment benefits are thought to contribute less to unemployment when they are coupled with strong requirements and support for re-employment than when they are not (Nickell, 1997). While the short-run unemployment effects of a given macroeconomic policy shift (or other shock) may vary as a result of such institutional differences, the latter may also have longer-run effects. For example, differences in institutions that result in variations in the distribution of unemployment of varying duration may affect the responsiveness of total unemployment to increases in demand, whether or not the latter are policy induced. More generally, institutions that make for greater persistence of unemployment than others may have cumulative effects, resulting in an upward secular trend in unemployment as successive cyclical downturns start at higher unemployment levels. As indicated earlier, it is argued that such path dependence or "hysteresis" at least partly accounts for the divergence between U.S. and European unemployment trends. Differences in institutions that structure wage determination may also have consequences for unemployment through long-run effects on investment behavior. To illustrate these possibilities, some of the main mechanisms can be sketched more fully.

Discussions of the relationship between labor market institutions and unemployment typically focus on the institutions' effects on wage determination, through their impact on workers' bargaining power and the incentive structure influencing how bargaining power is used. The basic idea is that through either channel, the institutions affect the equilibrium level of unemployment or steady state unemployment. This is commonly conceived as the non-accelerating inflation rate of unemployment (NAIRU) or non-accelerating wage rate of unemployment (NAWRU), and used as the basis for estimating the portion of actual unemployment that is "structural" - due to the structure of markets - as opposed to "cyclical" - due to the level of aggregate demand. The concept and the efforts to estimate its actual level are problematical, particularly because the estimated levels seem to be so variable, rising and falling with levels of actual unemployment.[21] Hence, the estimates and the validity of the concept itself are central issues in controversy over the causes and cures of unemployment. For present purposes, however, the concept can be assumed valid at least in the minimal sense that variations in unemployment have effects on the intensity of pressures for wage increases, depending on how institutions affect wage bargaining. The effects of the resulting wage growth on unemployment in turn depends on the reactions of other actors - employers on the one hand, and macroeconomic policy decision-makers on the other.

If worker bargaining power depends generally on the tightness of labor markets, the way that bargaining power is used may depend most on variations in the labor regime institutions that structure wage bargaining, principally trade unions and employer organizations. The familiar argument is that there is a hump-shaped relationship between variations in wage bargaining structure and the tendency for wage growth (and hence inflation) to accelerate as unemployment declines. Thus, the tendency is lowest toward either end of the range of variation where unions are weak and wage bargaining highly decentralized, as in the U.S., or unions are strong and bargaining is highly coordinated, as in Germany or Austria, while it is at its highest in the middle of the range where unions are strong but bargaining is not coordinated, as perhaps in Sweden since centralized bargaining was replaced by sectoral bargaining. As initially formulated, the argument focused on variations in union scope and structure and their consequences for union power and incentives to externalize or internalize the inflation or employment costs of wage increases. In this view,

[21]. Much policy discussion concerning the share of unemployment attributable to "rigidities" in labor market structures relies on estimates of the NAWRU by the OECD. But the methodology of those estimates has been criticized as seriously flawed. See Holden and Nymoen (1998), Staiger et al (1997), and McAdam (199?). The problems with the concept as applied in practice are not described here but skepticism is clearly warranted.

what makes the intermediate case the most costly is that the unions there have both the incentive - because their membership is a small enough portion of the labor force - and sufficient market power to externalize the price or employment effects of their wage increases (Calmfors and Drifill, 1988, Calmfors, 1993, OECD, 1997).

More recent versions have modified the argument in two respects. First, it is pointed out that coordination can be achieved by employer organization as well as or instead of by unions, and second, that wage bargaining structures do not determine actual unemployment levels alone but in combination with macroeconomic policy, particularly monetary policy. Central banks are thus said to tighten monetary policy less and ease it more readily where they face wage bargaining structures that contribute to lower equilibrium rates, achieving a given price stability target at a lower cost in unemployment, than where they face structures that raise the equilibrium rate. The conclusion drawn is that neither central bank independence nor either of the less inflationary bargaining structures by itself but rather their interaction when both are present achieves price stability at least cost in unemployment (Soskice,1990, Hall and Franzese, 1998, Iversen, 1998).

If this argument is valid, it lends some support to the view, mentioned above, that Fed monetary policy has been more expansionary over the cycle than the Bundesbank's because it does not interact with strong unions as the Bundesbank did. In this way it offers support for the view that differences between the American and European labor regimes at least partly explain why unemployment has been lower in the U.S. than Europe, but only in conjunction with macroeconomic policy. On the other hand, the wage bargaining structure that faced the Bundesbank was one characterized not only by strong unions but also a high degree of coordination, which should supposedly have led as effectively to a low equilibrium rate as the decentralized bargaining structure in the U.S. Accordingly, the difference between American and German wage bargaining structures does not seem to adequately explain why the Fed has had a more symmetrical reaction function than the Bundesbank.

Variations in wage bargaining structures may have much longer-term effects on unemployment. Thus, the reversal in the relationship between unemployment trends in Europe and the U.S. since 1983 may have had its source in wage developments prior to the reversal which had long-run effects on investment. It seems generally agreed that total productivity growth declined throughout the OECD area in the early 1970s (Blanchard 1999: 2, Armstrong et al., 1991: 241). This, along with the first oil shock, meant that profits could not

be maintained unless wage growth slowed down.[22] It evidently did not slow down as rapidly in Europe as in the U.S., as indicated by the fact that the labor share of value-added rose in Europe to a peak in the mid-1970s after which it fell fairly continuously, while in the U.S. the labor share varied cyclically without displaying any long-term trend.[23]

An explanation for this difference in the behavior of relative shares given in a recent study is that it reflected an "institutional environment" which gave greater bargaining power to workers in Europe than in the U.S. (presumably amplified by the lower unemployment in Europe than in the U.S. at the time), while higher unemployment subsequently reduced European workers' bargaining power, offsetting the "institutional bias" in their favor. The question then posed is why unemployment did not eventually fall after the capital share was restored to its earlier level, which should have revived investment, growth and employment. The answer offered is that European firms responded to the initial decline in the capital share by choosing technology that increased the capital intensity of production, in contrast with American firms which, not faced by the same decline in capital share, did not increase the capital intensity of production. The relative increase in European capital intensity necessarily took time since it could occur only gradually as successive vintages of capital were replaced, but the cumulative effect has been to raise the long-run elasticity of substitution between labor and capital, while it remained roughly constant in the U.S. Investment did revive in Europe but each increment resulted in a smaller increase in employment than the same increment of investment in the U.S., so that, as often heard in European discussion, the employment content of growth is too low to bring about as much of a reduction in unemployment as similar growth rates would have in the past. The argument is that this rather than demand deficiency attributable to restrictive macroeconomic policy explains the growing difference between European and American unemployment trends.

This argument is not convincing. Even if there has been a relative increase in capital intensity in Europe, it is not clear why this should not be compatible with a narrowing of the difference in unemployment rates if there is sufficient growth in demand, providing that whatever other "structural" conditions might be necessary are met. Thus, the differences in macroeconomic policy that markedly affected demand growth could still have had a large part in

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[22]. "If workers and firms are slow to adapt to this new reality, wages increase too fast. Employment falls and so does the profit rate. Investment falls, leading to lower capital accumulation, and a further decrease in employment. The result is higher unemployment for some time. But for how long? Theory and empirical evidence strongly suggest that the answer is not forever" (Blanchard, 1999:2-3).

[23]. This observation and the discussion which follows is drawn from Berthold et al. (2000).

producing the divergence in unemployment. What the capital intensity argument seems to tell us is that there has been a secular shift in how investment decision-makers respond to what they expect the rate of growth of demand will be. They have to be concerned about expected demand growth to decide how much increase in production capacity is likely to be profitable, whatever the capital intensity of the production. Their expectations are bound to be significantly shaped by the rate of growth they believe macroeconomic policy authorities, particularly central banks, are likely to consistently permit over the time frame relevant to the profitablity of investments. The growth in capacity, and associated growth in employment at the given capital intensity, will presumably be adapted to the trend in demand growth that can be expected to result from the observable macroeconomic policy regime. Moreover, even if the average level of capital intensity has increased, employment growth in response to a given level of demand may be expected to vary with the differences in capital intensity across the economy. Through such shifts in the distribution of employment and other mechanisms, the economy as a whole should adapt to the change in technology over the long run, with the employment effects at any given stage contingent on the growth of demand as well as the effectiveness of the adaptation process. Such adaptation has historically confounded dire predictions that technological change will produce unemployment.[24]

In short, the postulated long-run effects of wage behavior on unemployment through the mechanism of increased capital intensity may help us understand how labor market institutions and macroeconomic policy interact, rather than providing us with reason to doubt that macroeconomic policy divergence has played a large part in the divergence between unemployment in Europe and the United States.

The effects of unemployment on wage pressures, and feedback onto actual unemployment are also related to differences in other labor regime institutions, such as employment protection and unemployment benefits. The effects of differences in such institutions on equilibrium unemployment are thought to operate by varying the proportion of actual unemployment that exerts downward pressure on wages (Blanchard, 1999: 14-18)·

For example, it is argued that such pressure on wages diminishes as the proportion of long-term unemployed (usually understood as more than 6 or 12 months) increases. This is because the longer workers are unemployed, the more difficult it is for them to get re-employed for a variety of reasons, including the

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24. "There is surely no long-run relation between the level of technology and the level of unemployment. And, if there is a long-run relation between the rate of technology progress and the unemployment rate, it appears to be a weak one at best" (Blanchard 1999: 3).

objective obsolescence and even deterioration of skills and the subjective tendency of prospective employers to believe that nobody else has hired workers unemployed over a long period because there is something that makes them undesirable employees. Insofar as employers accordingly regard the long-term unemployed as unemployable or risky to employ, and insofar as the long-term unemployed, partially as a consequence, are no longer actively searching, workers who do have jobs do not regard them as competitors for their jobs or for alternative jobs they could quickly get if, because their bargained wages exceed what employers can or want to pay, they lose their current jobs. In other words, it is primarily short-term unemployment rather than total unemployment that is thought to inhibit wage pressures. But the distribution between short- and long-term unemployment is itself related in part to the level and duration of unemployment benefits. Insofar as benefits set a "reservation wage" not far below wages when employed they reduce the disincentive for wage increases that risk costing jobs while increasing the incentive for unemployed workers to hold out for jobs that pay close to previous wages, at the same time as employers are reluctant to hire at those wages - effects which are prolonged to the extent that the duration of the benefits is prolonged. The net result would be to increase the duration of unemployment, and with it the proportion of long-term unemployed, thereby reducing the pressure of total unemployment on wages.

These arguments point to mechanisms by which some labor market institutions can turn some of the unemployment that is induced by reductions in demand growth into structural unemployment that will be less responsive to subsequent increases in demand growth, an effect which increases with the duration of unemployment (Layard et al., 1991, De Grauwe, 1998). If institutions that transform demand-induced unemployment into structural unemployment by such mechanisms characterize labor regimes in Europe more than in the U.S., that could certainly be part of the explanation for the successively greater divergence in unemployment trends between them. But this does not mean that differences in macroeconomic policy are not also part of the explanation. If macroeconomic policy not only induces an initial increase in unemployment through measures restricting demand growth but also keeps unemployment high through the continuation of its restrictive stance, it is likely to contribute to the growth of long-term unemployment. Thus, if measures that increase unemployment by reducing demand growth are not rapidly reversed, macroeconomic policy itself may contribute to an increase in structural unemployment. As our comparison of American and European policy indicated, restrictive measures, especially in monetary policy, were indeed more rapidly reversed in the U.S. than in Europe. Insofar as this difference in the central banks' reaction function made unemployment more persistent in Europe and

thereby increased the share of long-term unemployment, it may have had a lot to do with the successively higher levels of unemployment in Europe.

To the extent that the prolongation of restrictive policy increases long-term unemployment, it has potentially perverse feed-back effects that increase the unemployment costs of a price-stability regime. The longer a central bank depresses demand growth to keep unemployment from falling below what it regards as the level consistent with its price stability objective - i.e, its judgment as to the equilibrium rate of unemployment - the larger the proportion of unemployment likely to turn into structural unemployment. Accordingly, as noted earlier, there is a decline in the proportion of any given level of unemployment that functions to inhibit wage inflation (whether by workers successfully pressing wage demands or by employers successfully bidding scarce workers away from each other) - i.e., a decreasing proportion of unemployed workers consists of those credibly competing for jobs with employed workers or likely to be hired quickly when employers seek more labor. From the central bank's point of view the effective unemployment rate is thereby pushed toward or below the equilibrium rate. At best, this gives it reason not to increase demand growth to lower unemployment or, at worst, reason to decrease demand further in order to bring the effective unemployment rate back up to what it believes is the equilibrium rate! The ECB's contention that Europe's unemployment cannot be remedied by expansion of demand without risking increased inflation because most of the unemployment is structural could in this way be a self-fulfilling - or exceeding - prophecy.[25]

The more general proposition to which the preceding discussion points is that while labor regime differences, of some kinds more than others, may indeed help explain the difference in employment performance between continental Europe and the U.S., they cannot be the whole explanation, as postulated in the EMU policy regime's rationale, any more than differences in macroeconomic policy can be. Thus, even if there are still many unsettled issues and much additional evidence remains to be considered, the argument in support of the current EMU orthodoxy that ascribes the difference in European and American unemployment trends almost entirely to the difference in labor regimes breaks down once the difference in macroeconomic policy is taken into account.

[25] For a related argument, see Collignon (1998).

4. Curing Europe's Unemployment

If more restrictive macroeconomic policy than in the U.S. is the main or at least an important factor in causing Europe's higher unemployment, this does not mean that "structural reforms" in labor markets are not necessary in curing it, even if they alone cannot do so. Whatever the relative importance of macroeconomic policy and labor regimes in causing unemployment, accepting that both are involved, their relative importance in curing it may be different. In part, this is because of the tendency, cited earlier, of unemployment that is largely caused and prolonged by insufficient demand to turn into structural unemployment that is decreasingly responsive to a renewal of demand. This implies that to avert a tightening of labor markets and accelerating wages at earlier stages of recovery than would have been the case if demand had been expanded sooner, there is an increased need for measures such those that can facilitate re-employment. These include "active" labor market policies designed to bring the long-term unemployed back into the labor market and re-equip them for employment. Such measures for improving the "employability" of the long-term unemployed are of course a central feature of the EU's Employment Strategy. Their macroeconomic effect is presumably to increase the portion of unemployment that acts as a restraint on wage pressures, thereby lowering the equilibrium unemployment rate and encouraging the authorities to pursue more expansionary policies than they would in the absence of such supply-side measures.[26]

But this does not support the ECB position, and the Employment Strategy that acquiesces in it, that the reduction in unemployment has to come almost entirely from such supply-side measures, along with other structural reforms in the labor market. For one thing, employability itself seems to vary with levels of unemployment to some extent independently of its duration and the presence or absence of active labor market policies. For example, in the currently tight U.S. labor market, with virtually nothing in the way of labor market policies, employers are seeking out workers previously thought to be unemployable. Thus, employers are going into the black ghettoes of some central cities to find workers, providing the training needed for the jobs they seek to fill, thereby contributing to the recent diminution in the difference in unemployment rates of blacks and whites (Freeman and Rodgers, 1999). More generally, U.S. evidence shows that unemployment among those who are relatively disadvantaged in labor markets - less educated, nonwhites, and less-skilled women - fluctuates

[26]. The measures include not only such benign policies on employability as well as against discrimination but also retrenchment of benefits, job security, and collective bargaining so as to intensify the pressure of market forces on workers. For a brief wish list, see Calmfors (1998: 141-42).

more than that of the relatively advantaged - more educated white males (Hoynes, 1999)· In other words, workers are in effect lined up in queues in order of what employers regard as desirable characteristics (race and gender as well as skills). As unemployment goes up, employers go higher on the queues when they hire or lay off workers, and go lower on the queues as unemployment declines. At least some part of the concentration of unemployment on the less skilled is therefore simply a function of high unemployment rather than a function of the skill requirements of a given state of technology and work organization. Thus, if macroeconomic policy expands demand so that labor markets tighten, that by itself increases the job chances of those who had the hardest time finding jobs when unemployment was higher. Moreover, the supply of labor also tends to increase as labor markets tighten simply because discouraged workers who dropped out of the labor market are drawn back into it by the brighter prospects of finding jobs.

For another thing, even though active labor market and other policies can nevertheless facilitate re-employment in various ways, they can do so only to the extent that there is demand for the labor which the policies may make more qualified and readily available. For example, when unemployment is high, even the most ambitious re-training programs such as those in Sweden may simply cycle the unemployed through repeated spells of training, which may do little more than maintain their attachment to the labor market so that it is easier for them to be re-employed when demand for labor is renewed.

It is probably still true that unemployment caused by deficient demand is not entirely or quickly reversible without renewing inflationary pressures by a restoration of demand, but the extent to which this is so is unsettled. However, considerations such as those just cited suggest that an expansion of demand can reduce unemployment without increasing inflation to a greater extent than assumed in the EMU orthodoxy. There is the separate issue of how much of an increase in inflation should set the limit on demand growth.[27] The 2 percent upper limit which the ECB apparently places on inflation may well be too low, so that an expansion of demand that is aborted by tightening monetary policy as soon as that limit is approached means that there can never be sufficient sustained expansion to significantly reduce unemployment (De Grauwe, 1998). That this is probably so is a fundamental reason why the price stability macroeconomic policy regime built into EMU, as the ECB apparently interprets it, could doom Europe to continued high unemployment. Given the years it will take to reduce Europe's very high and long-lasting unemployment, the amount

[27] For arguments that some inflation facilitates resource allocation and that very low or zero inflation exacts permanent real costs that exceed its benefits, see Tobin (1972) and Akerlof et al. (1996).

of investment that would have to be sustained over those years in order to create the number of jobs needed may simply not be forthcoming without a modification in the EMU macroeconomic policy regime that assures investment decision makers that an expansion of demand will be sustained long enough to assure the profitability of the needed investment even if the inflation rate rises above the 2 percent which now appears to be the upper limit of the target range.

The point here is not that the stance of macroeconomic policy is too restrictive at the time of writing in early 2000, so that policies need to be changed to stimulate demand at this juncture. There are widespread indications of recovery and accelerating growth in Euroland, especially in the larger economies in which unemployment has been highest, so no further stimulus may be needed now. The question is how the ECB will conduct monetary policy in response to this expansion: will it do so in ways that lead investment decision-makers to believe that it will "give growth a chance," or that it will choke off the expansion before it induces a rise in investment sufficient to significantly reduce unemployment? In other words, the question is whether the ECB is committed to a price stability regime as restrictive as its declared interpretation of its mandate suggests that it is. It is still not clear that it is, even though the ECB has already responded by tightening monetary policy in several increments, albeit small ones, offsetting the slight loosening in response to the Asian financial crisis. On the other hand, those interest rate increases certainly offer little basis for confidence that the ECB is committed to a more expansionary policy regime.

5. Conclusion

It would not necessarily take a revision of the Treaty to bring about such a change in investor expectations. The Treaty requires the ECB to support the economic policies of the EU providing that it is done consistently with price stability but it leaves it up to the ECB to define price stability. The ECB could accordingly announce that it now interprets the price stability goal with which the pursuit of EU goals of growth and employment must be consistent as a steady underlying central inflation rate (i.e., excluding external price fluctuations such as those for oil) of around 2 percent or even somewhat more, averaged over some specified period. That would imply that the inflation rate would be allowed to exceed the central rate, under specified conditions, so that there need not be fear that the monetary brakes would be put on as soon as inflation moves up toward the 2 percent upper limit of the permissible range. It would of course then be necessary for the ECB to use its monetary policy instruments consistently with that new definition of price stability, and to reach agreement with member states on coordinated fiscal policies so as to secure a sustainable policy mix for Euroland as a whole.[28]

What it would take for the present governing board of the ECB to actually move toward a macroeconomic policy regime that assumes some responsibility for growth and employment as well as price stability, as does the U.S. Fed, is yet another question. It would probably take a great deal more political pressure than the governments of the EMU member states now seem prepared to exert, perhaps sufficient to induce some resignations in protest, and perhaps even a revision of the Treaty that explicitly makes the bank responsible for growth and employment as well as price stability.[29]

Whatever it would take, if such a long-term commitment of EMU macroeconomic policy to reducing unemployment could be established, it would open up the possibility of combining a gradual, carefully calibrated expansion of demand with a wide range of structural measures facilitating re-employment and inhibiting inflationary pressures, enabling the interaction of such a combination of macroeconomic and structural policies to be sustained for the long time needed for them to have its cumulative effect on unemployment.[30]

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[28]. This would include the tighter fiscal policies in member states with greater inflationary pressures than others. On the need for fiscal policy coordination, see Muet and Pisani-Ferry (1999) and Soskice (1999).

[29]. The Fed is obligated by law (the Humphrey-Hawkins Act) to direct monetary policies to the goals of growth and employment as well as price stability.

[30]. For a discussion of what such a strategy might look like, see Bean (1997) and the comment on it by Fischer. See also Blanchard and Fitoussi

In the context of such a "two-handed" strategy, social pacts could provide a valuable, even indispensable, method for bringing about and maintaining political support for the institutional changes needed and the attenuation of conflict over the distribution of the burdens and benefits of the long process of reducing unemployment. But if Europe is condemned to struggle against unemployment without the support of a more expansionary macroeconomic policy regime - with one hand tied behind its back - social pacts can do little to reduce unemployment in Euroland as a whole and could degenerate into a set of competing national beggar-thy-neighbor strategies which, in the worst case, would interact with restrictive ECB monetary and national fiscal policies to drive a deflationary vicious circle.

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