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Upswing in Europe gains momentum, but unemployment remains high

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Upswing in Europe Gains Momentum, but Unemployment Remains High

by Klaus-Jürgen Gern, Joachim Scheide, and Markus Schlie

CONTENTS

- The expansion of Western European production accelerated in the first half of 1997. Exports were the main engine, driven by a devaluation of European currencies and strong growth abroad. Domestic demand also picked up somewhat led by investment in machinery and equipment. Inflation remained at low levels. However, in most countries the bottom seems to have been reached. One major concern is the rise in import prices. The upswing will further gain momentum in the coming months and in 1998 as conditions shaping the cycle remain favorable. Real GDP in Western Europe will increase by 3 percent in 1998.
- Under the assumption that the decision concerning EMU due in spring 1998 is made in favor of a large monetary union, those countries with relatively high short-term interest rates will lower them quite substantially in next year. Against the background of high unemployment, countries with low interest rates will not raise key interest rates significantly. As a consequence, monetary policy in Western Europe on average will be further loosened. This will additionally stimulate economic activity but also raise risks of inflation.
- The major problem in Western Europe is unemployment, which remains stubbornly high or is even rising. As a contrast, unemployment in the United States has come down to the lowest level since decades. It is often stated that high unemployment in Europe is due to a restrictive monetary policy, led by a—supposedly—deflationary policy pursued by the Deutsche Bundesbank. This view, however, does not find any support when indicators of monetary policy are taken into account. Rather, they suggest that monetary policy has been expansionary in Europe for some time. In addition, the reduction of inflation since 1990 has been equally pronounced in Europe and the United States, which indicates that the monetary stance has not been significantly different. Furthermore, a striking fact in this regard is that the relatively steep fall of inflation in the United Kingdom was associated with a significant decline in unemployment.
- While total unemployment in Europe has followed an upward trend resulting in an approximate doubling of the rate, there have been notable exceptions within Europe. Among those economies that have experienced a decline in recent years are the United Kingdom, the Netherlands and Ireland; other countries seem to have joined the club. Overall, a variety of measures has contributed to the improvement of labor market performance in these countries. They include deregulations of product and labor markets that have led to wage moderation and more wage differentiation, and reforms of the tax and transfer systems that have resulted in improved incentives for both labor demand and labor supply. A central feature of individual countries' experience is that reforms tend to be more effective when they are comprehensive since there are important synergies between structural reforms in different fields.

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Contents

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I. Recovery in Western Europe Gains Momentum

The countries in Western Europe are in the fifth year of the economic upturn. The strength of the increase in production so far is similar to the previous recovery in the early 1980s. While the expansion accelerated during the first half of 1997, unemployment remained stubbornly high. However, there have been remarkable differences in the performance of national labor markets.

The European economies have received strong impulses from abroad. The upswing in the United States has even gained some strength. Exports to Asian and Latin American countries have remained high, and those to Central and Eastern Europe have increased rapidly. Domestic demand has been stimulated by monetary policy: Short-term interest rates have remained low, and the expansion of monetary aggregates has accelerated. Furthermore, long-term interest rates have continued to be low.

During the first half of 1997, exports were the driving force of the upturn (Figure 1). One reason was the devaluation of most European currencies against the dollar. Furthermore, the competitive position of firms has improved because of their efforts to increase productivity by rationalization. But also domestic demand has accelerated slightly, in particular investment in machinery and equipment. Private consumption has stayed on a moderate path since real disposable income has risen only slightly and fiscal policy generally has remained restrictive. Only in a few countries — for example, the United Kingdom, the Netherlands and the Scandinavian economies —, consumption of households has expanded rapidly due to the improved employment situation.

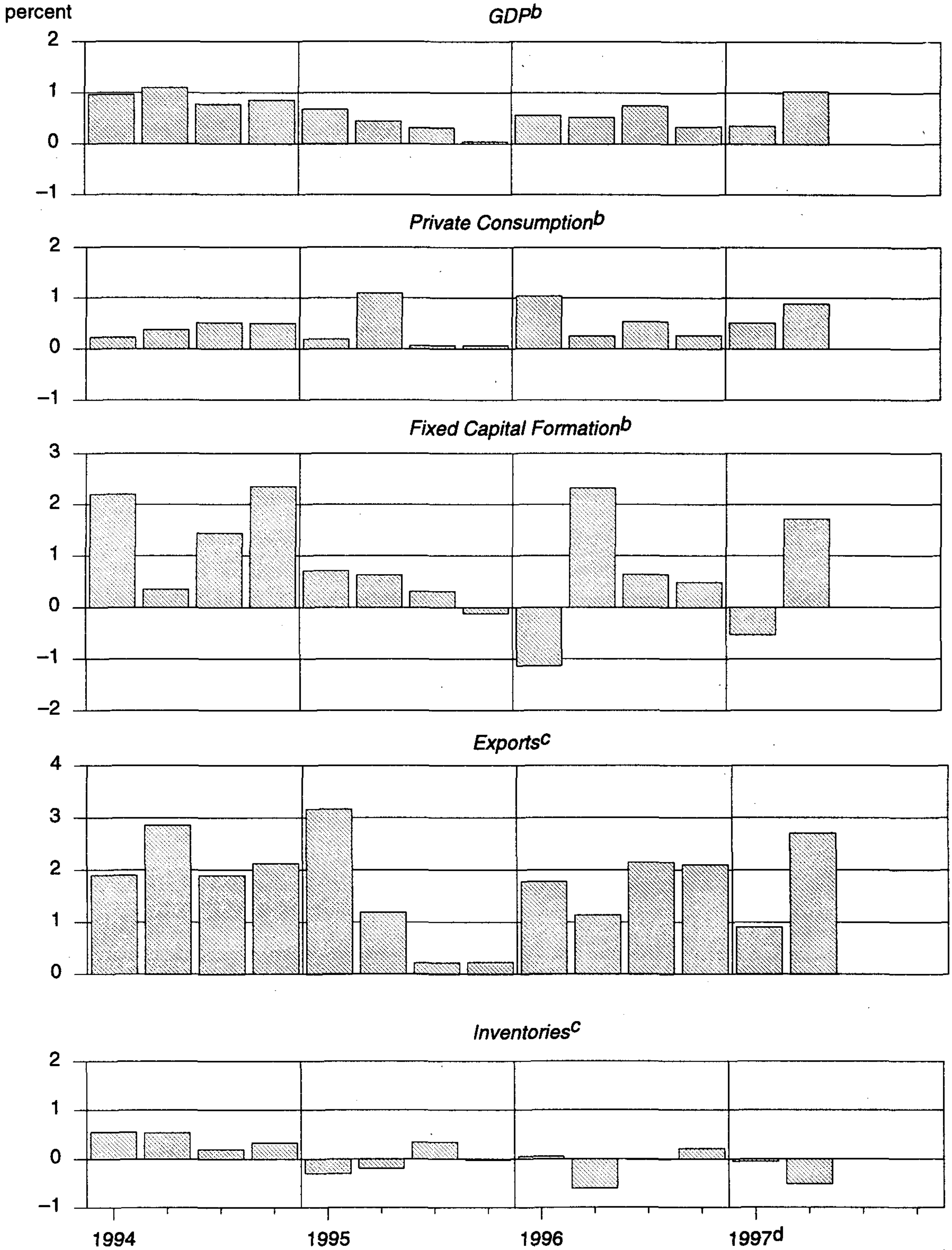
Inflation in Europe has remained moderate. However, in most countries the lowest level seems to have been reached; in a few countries, the rates already began to creep up again. While wage costs have been a dampening factor, import prices have risen markedly.

II. Monetary Policy Will Stimulate Economic Activity in 1998

Monetary policy in Western European countries has been expansionary for more than two years now. The future course depends crucially on the decisions concerning the European Monetary Union (EMU). Our assumption is that the convergence criteria will be interpreted generously so that EMU will start on January 1, 1999 with a large number of countries. Only four countries will probably not participate in the early stage: Due to the substantial deviation from all reference values, Greece will almost certainly stay out; furthermore, the United Kingdom, Denmark and possibly also Sweden do not want to join the monetary union from the start. It was announced in last September that at the same time the member countries will be nominated, the bilateral conversion exchange rates will also be fixed.

These decisions will have important consequences for monetary policy in the near future. In particular, the monetary union will de facto start already in May 1998. This means that short-term interest rates can be equalized immediately after the decision without any risk of major exchange rate movements (Scheide and Solveen 1997a). Countries that currently have relatively high interest rates can lower them substantially to the level prevailing at that time in low-interest rates countries such as Germany. The scope for reduction is substantial

Figure 1 — Components of Western European Real GDP, 1994–1997[a]



[a]European Union. — [b]Change over previous quarter. — [c]Contribution to GDP growth. — [d]Partly estimated.

Table 1 — Three-Month Money Market Rates in the EU Countries, mid-September 1997

	Interest Rate (%)
Germany	3.2
France	3.3
Italy	6.7
United Kingdom	7.2
Spain	5.2
The Netherlands	3.4
Belgium	3.4
Sweden	4.5
Austria	3.4
Denmark	3.5
Finland	3.0
Portugal	5.5
Greece	10.4
Ireland	6.2
Luxembourg	3.4

as rates in EU countries currently differ markedly (Table 1). Italy, Spain and Portugal, but also Ireland, will have ample room for reductions. These expansionary measures will most likely not be compensated by interest rate hikes in the other countries. A substantial increase of key interest rates in Germany, France and other countries is not likely because of strong resistance in the light of high unemployment. On the whole, therefore, monetary policy will become more stimulative in 1998. As this will be the fourth year of an expansionary course, the inflationary risk in Europe will increase. It should become visible soon because capacity utilization goes up to its normal level or even beyond that in most countries; furthermore, import prices will increase substantially as European currencies will continue to be weak, and finally, raw material prices will advance considerably because of the strong growth of world output.

This outlook will leave a tough decision for the European Central Bank (ECB) in 1999: Key interest rates will have to be raised markedly if the ECB wants to establish a reputation of setting a priority for price level stability. As a consequence, economic activity in Western Europe would be dampened considerably.

III. Fiscal Policy Will Cease to Be Restrictive

Fiscal policy in most countries is intended to achieve the reference value of 3 percent for the deficit-to-GDP ratio in 1997; therefore, revenues were raised and expenditures were cut, often considerably. Thus, the overall stance of fiscal policy is restrictive in the current year, which is decisive for the evaluation of fiscal policies and the decision on EMU membership. The thrust can best be measured by a reduction of the structural deficit, which is expected to amount to a little more than 1 percent of GDP for the EU countries as a whole. While this is somewhat higher than in previous years, it has to be kept in mind that part of this decline is due to one-off or bookkeeping measures that do not have the full negative impact on economic activity.

In 1998, fiscal policy will leave its restrictive course although there will probably not be a turnaround because the budget deficits will not be allowed to rise substantially. Nevertheless, the efforts of consolidation will weaken because the budget deficits will tend to decline for cyclical reasons as, for example, tax revenues will increase faster. While most countries will try to keep the deficit ratio below the 3 percent level in order to consolidate budgets further, it is not likely that new measures will be taken if it becomes likely in the later course of 1998 that the 3 percent target cannot be achieved. The reason is that after the decision on the member states of the European Monetary Union is made, an important element of fiscal discipline will be missing: The possible threat that has so far been the exclusion from EMU will not exist anymore. The sanction mechanism of the stability pact is much weaker and therefore hardly an incentive for fiscal discipline (Scheide and Solveen 1997b). In addition, the political will to fully apply the mechanism of the stability pact could be undermined if a significant number of countries has problems in keeping the deficit ratio below 3 percent.

IV. Strong Upswing in 1998

The upswing in Western Europe will strengthen further. The impulses from abroad will continue to stimulate export activity. While the expansion in North America will slow down slightly, growth in most other regions of the world economy remains high. We expect world GDP to increase by 4.25 percent in 1998, after 4 percent this year. Consequently, the volume of world trade will expand rapidly (8 percent in 1997 and 1998). The conditions for a strengthening of domestic demand are also favorable. Monetary policy will become even more expansionary as short-term interest rates will converge at a low level. Finally, fiscal policy will leave its restrictive course in 1998, so there will hardly be a dampening effect on economic activity from this side.

On the whole, real GDP in Western Europe will increase by about 3 percent in 1998 (Table 2). There will be no major differences in the growth rates as those countries that were still lagging — Italy is an example — will also recover. Inflation rates are likely to move up slightly; the average increase in the consumer price index (CPI) will be about half a percentage point higher in 1998 than in 1997. This is due to the continued expansionary course of monetary policy, which leads to higher capacity utilization; its normal level will, in general, be reached in the course of 1998, and in several countries it will even increase beyond that. The behavior of unemployment has been strikingly different so far; while this will continue, we nevertheless expect a decline also for Western Europe as a whole. The improved outlook for employment will also stimulate private consumption, which will expand much faster in 1998 than in previous years (Table 3). Investment will also rise faster than in 1996 and in 1997. This is particularly true for investment in machinery and equipment. However, construction expenditures will go up only moderately also because of the cuts in government spending on infrastructure.

Table 2 — Real Gross Domestic Product and Consumer Prices, 1995–1998 (percentage change over previous year)

	Weights (1996 GDP)	Real GDP				Consumer Prices			
		1995	1996[a]	1997[b]	1998[b]	1995	1996	1997[b]	1998[b]
Germany	26.1	1.9	1.4	2.5	3.0	1.9	1.5	1.8	2.1
France	17.1	2.1	1.5	2.2	3.1	1.8	2.0	1.3	2.0
Italy	13.3	3.0	0.7	1.3	2.8	5.4	3.9	1.9	2.5
United Kingdom	12.6	2.5	2.1	3.3	2.5	3.4	2.4	3.0	3.5
Spain	6.4	2.8	2.2	3.5	3.5	4.7	3.6	2.0	2.5
The Netherlands	4.3	2.1	2.8	3.0	3.0	1.9	2.1	2.5	2.5
Belgium	2.9	2.1	1.5	2.5	3.0	1.5	2.1	2.0	2.5
Sweden	2.9	3.6	1.1	3.0	3.0	2.5	0.5	1.0	2.5
Austria	2.6	1.8	1.1	1.5	2.5	2.2	1.8	1.5	2.5
Denmark	1.9	2.6	2.7	3.0	3.0	2.1	2.1	2.0	3.0
Finland	1.4	4.5	3.3	3.5	3.5	1.0	0.6	1.5	2.0
Greece	1.4	2.0	2.6	3.0	3.0	9.3	8.5	5.0	4.0
Portugal	1.2	1.8	3.0	3.5	3.5	4.1	3.2	2.5	3.0
Ireland	0.7	10.8	7.3	5.0	5.0	2.6	1.7	2.0	3.0
Luxembourg	0.2	3.8	3.9	3.0	3.0	1.9	1.4	1.0	2.0
EU countries	95.0	2.4	1.6	2.5	3.0	2.9	2.3	2.0	2.5
Switzerland	3.3	0.8	–0.2	1.0	2.5	1.8	0.8	1.0	1.5
Norway	1.7	4.1	5.3	3.5	3.0	2.5	1.3	3.0	3.5
Western Europe	100.0	2.4	1.6	2.5	3.0	2.9	2.3	1.9	2.4

[a]Partly estimated. — [b]Forecast.

Source: OECD (1997a), own calculations and forecasts.

Table 3 — Economic Indicators in Western Europe, 1995–1998 (percentage change over previous year)

	1995	1996[a]	1997[b]	1998[b]
Real GDP	2.4	1.6	2.5	3.0
Private consumption	1.8	1.9	2.3	2.9
Public consumption	0.8	1.4	1.1	0.5
Fixed capital formation	3.9	1.3	2.7	4.3
Machinery and equipment	6.4	1.6	4.1	6.9
Construction	0.0	–1.2	0.3	2.4
Inventories[c]	0.2	–0.2	–0.2	0.2
Net exports[c]	0.3	0.3	0.7	–0.1
Domestic demand	2.2	1.4	1.9	2.9
Consumer prices	2.9	2.3	1.9	2.4
Unemployment rate[d]	10.5	10.7	10.5	10.2

[a]Estimated. — [b]Forecast. — [c]Contribution to GDP growth. — [d]Number of unemployed as a percentage of the civilian labor force.

Source: OECD (1997a), own calculations and forecasts.

V. Germany: Export Boom Fosters Growth

The cyclical upswing in Germany gained momentum in the course of the first half of 1997.[1] In the second quarter, real GDP increased at an annual rate of 4 percent, after 1 percent in the first quarter. However, despite the strong recovery the labor market has not yet improved. The number of employees continued to decline — albeit at a slower rate — and unemployment rose. Inflation went up in the middle of the year, consumer prices were about 2 percent higher than a year ago. The recovery is still export-led, domestic demand hardly contributed to growth. The export boom is mainly due to the strengthening of economic activity in Germany's main trading partner countries. Moreover, the significant devaluation of the D-Mark has markedly improved the competitiveness of German firms.

Due to increasing demand from abroad, capacity utilization in the manufacturing sector has risen noticeably. The recent order inflow suggests that this is likely to continue; recently, orders from abroad have continued to expand rapidly, but also domestic orders have picked up somewhat. With a broadening of the recovery, capacity utilization in manufacturing will further increase in the course of next year and reach a level as high as the one recorded in 1989, i.e., the year before the unification boom.

In the past, high capacity utilization in the manufacturing sector often coincided with a marked increase in inflation. As a consequence, the Bundesbank usually raised its interest rates significantly which was followed by a slowdown of economic expansion. However, as the recent development in the United States shows, high capacity utilization need not necessarily lead to an acceleration of inflation.

In order to keep inflation low, the Bundesbank will have to shift monetary policy from its current expansionary course towards a more neutral stance. In early October, the Bundesbank raised the repo rate by 30 basis points to 3.3 %. It is likely that a further increase in interest rates in the course of 1998 is necessary to limit the inflationary risks. However, any ambitions of the Bundesbank for substantial hikes are likely to be resisted by the other member countries of the future EMU. After the decision in May 1998, the Bundesbank will be no longer able to pursue an independent monetary policy.

Fiscal policy is strongly aiming to meet the reference value of the Maastricht Treaty in 1997. For that purpose, taxes and other duties were raised and expenditures were cut. Recent data suggest that the fiscal deficit in relation to GDP will be close to the 3 percent target. Next

Table 4 — Indicators of the Catching-Up Process in Eastern Germany, 1991–1998[a]

	1991	1992	1993	1994	1995	1996	1997[b]	1998[b]
GDP[c]	31	40	48	52	55	57	57	57
Investment in machinery and equipment[c]	64	77	100	112	.	.	.	.
Residential construction[c]	44	63	82	112	133	144	143	135
Nonresidential construction[c]	89	145	193	230	237	226	213	198
Labor productivity	29	42	51	54	56	58	59	59
Unit labor costs	160	147	132	129	125	124	122	123

[a]Index for Western Germany = 100. — [b]Forecast. — [c]Per capita values in current prices.

Source: Statistisches Bundesamt (1997), own forecasts.

year, the solidarity surcharge will be cut by 2 percentage points. This will lead to an income tax relief of about DM 7 billion. All in all, fiscal policy will be neutral with respect to economic activity next year.

The conditions are favorable that the recovery will continue. Throughout 1998, output growth is likely to remain somewhat higher than the growth of the production potential (2.2 percent). While the recovery has so far been mainly export-driven, domestic demand will gain momentum and significantly contribute to growth next year. Tax cuts and an improvement in the labor market will stimulate private consumption. In line with strongly rising profits, corporate investment will continue to expand rapidly. Real GDP will increase by about 3 percent in 1998, after a rate of 2.5 percent in 1997. In both years, output growth in East Germany will be somewhat lower than in West Germany as the drag from construction is more pronounced there (Table 4). Obviously, the catching-up process of the new Länder has come to halt. This is mainly due to the lack of competitiveness of firms in Eastern Germany as indicated by, for example, the fact that unit labor costs are about 25 percent higher than in Western Germany.

Inflation in Germany is likely to accelerate slightly from 1.8 percent in 1997 to 2.1 percent next year. The improvement in the labor market will be moderate; the number of unemployed is likely to decline by about 250, 000 persons until the end of next year.

VI. Recovery in France Continues

The economic expansion in France continued in the first half of 1997 at a moderate pace. Exports are still the strongest force of the recovery. Due to the devaluation of the French franc — especially against the US dollar and the pound Sterling — the competitiveness of exporters improved; furthermore, the upturn in main trading partner countries stimulated export growth. Investment activity picked up only slowly despite low interest rates and improved sales and profit expectations, the main reason probably being the low rate of capacity utilization in important sectors. Construction was weak mainly due to the restrictive policy of the French government; in particular, public infrastructure investment was cut. Private consumption practically stagnated reflecting the slow expansion of real disposable income; the number of employees was almost unchanged and wages rose only moderately.

Inflation remained at a moderate level. In August 1997, the year-over-year increase in consumer prices amounted to 1.5 percent; producer prices even fell. The labor market situation remained gloomy; despite the recovery, the rate of unemployment fell only slightly to 12.5 percent in recent months.

The Banque de France has continued to pursue an expansionary course. This is indicated by the low short-term real interest rates and the unusually large difference between the long-term and short-term interest rates. In early October, key interest rates were raised following the move of the German central bank. For the beginning of next year, we expect the Banque de France to again increase short-term interest rates moderately, in line with the Deutsche Bundesbank. This does not, however, imply a change in the policy stance.

In general, the new French government pursues the consolidation course of the previous government and tries to bring the budget deficit down to meet the reference value of the Maastricht Treaty. For this reason, it decided upon a new package of deficit reduction measures, which are equivalent to 0.4 percent of GDP consisting mainly of an increase of corporate taxes and some unspecified expenditure cuts. Despite the generally unchanged course, the government will focus more on an active labor market policy: The government plans to create several hundred thousand jobs in the public and private sector by means of subsidies. These measures are to be financed by a reshuffling of funds within the budget, not by increasing the deficit. In 1998, pressure for consolidation will continue because one-off measures — such as the payment of France Télécom — contributed to the reduction of the deficit in the current year. Overall the impact of fiscal policy will be moderately restrictive in 1998.

The recovery will gain momentum in the coming year. Exports will be stimulated by the rapid expansion of economic activity in main trading partner countries. Investment will be pushed by the low interest rates and increasing capacity utilization. Private consumption will also rise — albeit moderately — mainly due to the improvement of the employment situation. Real GDP will increase by a little more than 2 percent in 1997 and by about 3 percent in 1998.

Inflation will remain moderate in 1997 with a year-over-year increase of consumer prices of about 1.5 percent. In 1998, it will accelerate due to the strong expansion of economic activity and to higher import prices following the devaluation of the French franc. On average, the increase in CPI will be around 2 percent next year.

VII. Expansion of Economic Activity in Italy Will Strengthen

The Italian economy has lagged behind other Western European economies since 1995 due to restrictive monetary and fiscal policies. The strong expansion in the second quarter of 1997 did probably not mark the start of a strong recovery since industrial production was mainly stimulated by public subsidies of new car purchases; also, the expansion was overstated due to a working day effect. However, in the first half of 1997, private consumption expanded at a healthy pace. In spite of the new temporary Euro-tax and a slightly falling number of employees real disposable incomes grew markedly because wages advanced considerably. Investment declined against the background of low capacity utilization and unfavorable profit expectations. Furthermore, real interest rates were still high. In spite of the strong expansion of economic activity abroad, exports remained weak reflecting the deteriorated competitiveness of firms; in part, this was due to a marked increase of wages.

The labor market situation has deteriorated since the beginning of the year. By the summer, the unemployment rate rose to around 12.5 percent, from 12 percent in the year before. Inflation slowed down to only 1.5 percent. This reduction is largely the result of the restrictive monetary policy. Last year, however, the central bank started to loosen its course somewhat. Key interest rates were successively reduced, and money market rates fell substantially. Consequently, monetary aggregates have increased markedly. Further small cuts in interest rates are likely in the coming months because inflation has come down considerably and the lira has been stable against other European currencies. After a positive decision on Italy's participation in EMU next spring, the Banca d'Italia will be able to cut short-term rates drastically to the level prevailing then in Germany. This will have a strong impact on economic activity already in 1998 but mainly in the following year.

The Italian government makes big efforts this year to limit the total budget deficit to 3 percent of GDP in 1997. The measures include expenditure cuts, tax increases, accounting measures and postponing of payments. It remains questionable, however, whether the measures planned will be sufficient to achieve the target of 3 percent. Next year, it will be all the more difficult to achieve the target because one-off measures like the postponement of payments cannot easily be repeated. Furthermore, the Euro-tax is only temporary. But there will also be some relief for the deficit because the marked fall in interest rates implies a substantial reduction of interest payments. However, in order to achieve a sustainable fiscal consolidation as required by the Maastricht Treaty, cuts in pension benefits seem to be invevitable. Altogether, fiscal policy will be neutral in 1998.

In the coming months, the recovery will gain some momentum. Exports will be stimulated by the rapid expansion of economic activity in main trading partner countries. Investment in machinery and equipment will pick up because of improved profit expectations and a better capacity utilization next year. Private consumption will rise due to the slightly higher numbers of employees. There will be no drop in the demand for cars because the government has prolonged the subsidization scheme for the purchase of new cars.

Real GDP will rise by a little less than 1.5 percent in 1997; thus, Italy will trail behind Europe's recovery. Next year, however, GDP growth will strengthen to the average European level of 3 percent. Inflation will accelerate moderately in the near future. The increase of the CPI will be about 2 percent this year, and some 2.5 percent in 1998.

VIII. Strong Upswing in the United Kingdom

The United Kingdom is in the sixth year of the recovery. In the first half of 1997, GDP growth remained strong. Private consumption grew rapidly against the background of increasing employment: The unemployment rate declined to around 5.5 percent, which is about 2 percentage points lower than a year ago. Investment in machinery and equipment accelerated during recent months reflecting favorable profit expectations. In the manufacturing sector, however, the appreciation of the pound Sterling has dampened sales expectations of firms.

Inflation has accelerated in recent months. The year-over-year increase in the retail prices (excluding mortgage interest payments) amounted to almost 3 percent in September, thus exceeding the rate of 2.5 percent targeted by the central bank slightly. Since it was granted independence in May, the Bank of England raised key interest rates in several steps from 6.25 % to 7 %. According to statements by the Bank of England, the actual level of interest rates should be consistent with the inflation target in the immediate future (Bank of England 1997). Further tentative interest hikes, however, will probably be necessary to get the retail price index down to the target value in view of the strong external demand and the fading effect of the appreciation of the pound Sterling. Thus, impulses from monetary policy will decrease in the coming months; in 1998, the policy stance will be roughly neutral.

The new government did not change the general course of fiscal consolidation after the election in May. However, there has been some change in detail. For example, the government launched a program aimed at reducing long-term unemployment and joblessness among young people. Also, the corporate tax rate was lowered to stimulate investment. Next year, fiscal policy will be slightly expansionary.

Over the forecast period, the upswing will lose some momentum. Despite the rapid expansion of economic activity abroad, exports will slow down due to the negative effects of the appreciation of the pound Sterling. Domestic demand will also decelerate somewhat because of the decreasing impulses of monetary policy. A strong increase in real disposable income reflecting healthy employment gains will more than compensate the dampening impact stemming from the rise in mortgage rates on the expenditures of households. As a result, private consumption will increase substantially. Furthermore, investment in machinery and equipment will expand rapidly as the rate of capacity utilization is high and the profit and sales expectations remain favorable. All in all, real GDP will increase by almost 3.5 percent in 1997; the growth rate will slow down to around 2.5 percent in 1998.

Inflation will accelerate slightly as the expansionary monetary policy pursued over an extended period will show effects. Retail prices will increase by 3 percent this year and 3.5 percent in 1998.

IX. High Unemployment in Europe — Is Monetary Policy too Tight?

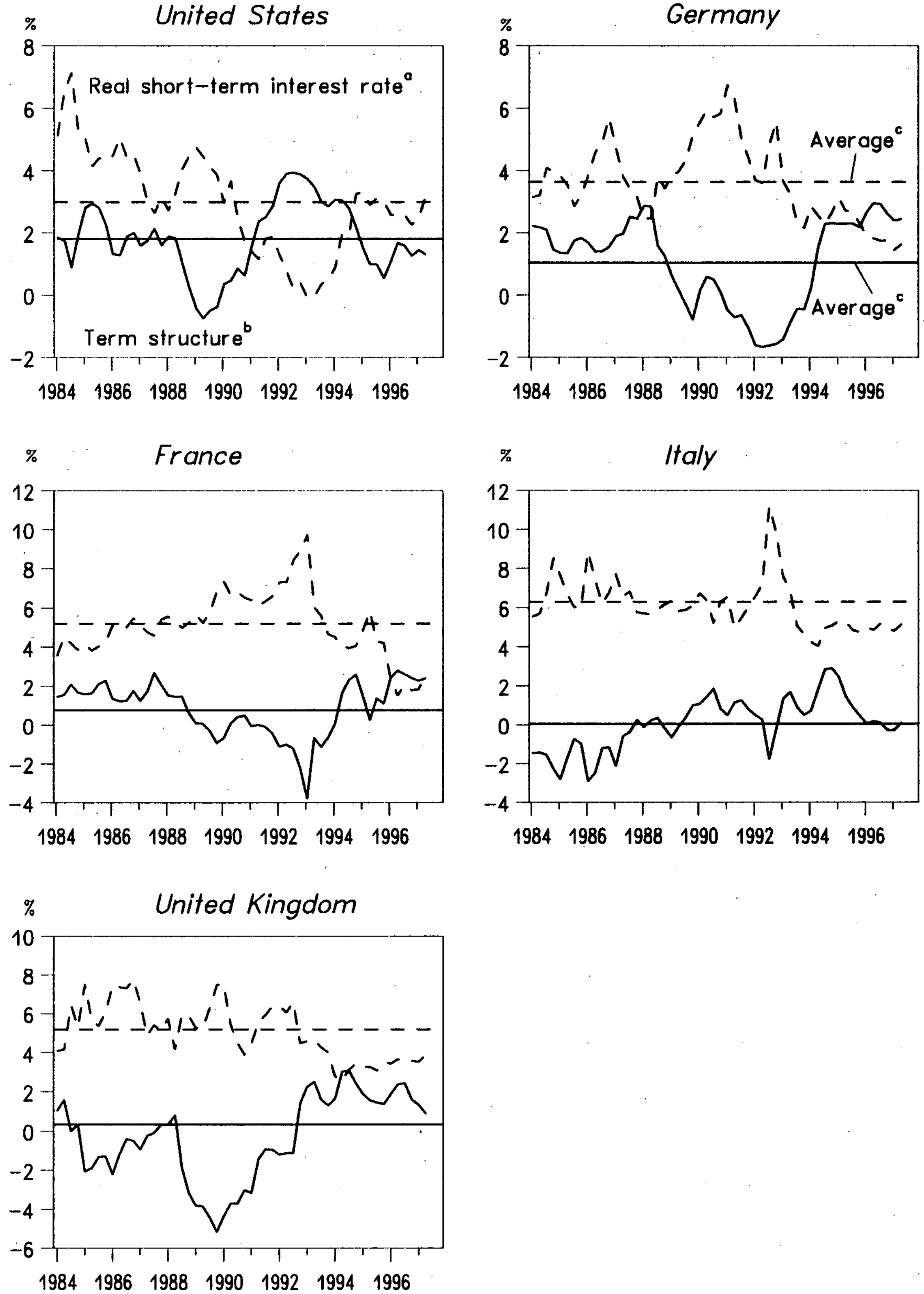
Unemployment in EU-countries remains at a stubbornly high level, in a number of economies it even reached new record highs. In contrast, unemployment in the United States has declined considerably and in 1997 reached its lowest level in the past three decades. Also, the recovery in the United States was stronger than that in Europe. It is often argued that the policy of European central banks — led by the Deutsche Bundesbank — has been unduly restrictive thus contributing to the sluggish recovery and to the persistently high unemployment. In order to examine this argument, we take a closer look at various indicators of monetary policy.

Interest Rates in Europe Suggest Expansionary Course

The behavior of short-term interest rates[2] gives some information on the stance of monetary policy. The reference here is the real rate, i.e., the nominal money market rate minus the current inflation rate. The average real interest level varies across the five countries under consideration (Figure 2). In the period 1984–1996, i.e., over more than just one business cycle, it amounted to some 3 % in the United States and in Germany. In the UK and in France, the short-term real interest rate averaged somewhat more than 5 % while it was a little above 6 % in Italy. The fact that the average is substantially higher in these three countries than in the United States and in Germany mainly reflects the exchange rate orientation of the respective central banks.[3] In order to judge the present stance of monetary policy, we look at the current level of real interest rates relative to the respective average. Evidently, real rates in Europe are at the present considerably below average. In Germany, the difference is about two, in France even three percentage points. This indicates an expansionary course of monetary policy. While the situation in the United Kingdom is similar, the stance in Italy is probably only slightly stimulative. As far as the United States are concerned, the Fed shifted to a more or less neutral course already in 1994. Since then, the real rate has been close to the average.

A similar picture arises if the term spread is used as an indicator. Over a longer time span, bond yields are usually higher than short-term interest rates because investors demand a higher risk premium for periods further into the future. In judging the current stance of policy, the relevant indicator is the deviation of the interest differential from its average, which corresponds to a neutral monetary policy.[4] In the period 1984–1996, the difference between long-term and short-term interest rates was

Figure 2 — Real Interest Rate and Term Structure of Interest Rates in Major Industrial Countries, 1974–1997



[a]3-month money market rate minus rate of consumer price inflation. — [b]Long-term minus short-term interest rate. — [c]Average in period 1984–1996.

quite different in the five countries. While it averaged almost 2 percentage points in the United States, it was — often considerably — lower in the European economies (Figure 2). Such differences may be due to the different maturities of the bonds included in the average yields. It is, however, also important that a few central banks often raised key rates substantially to defend their exchange rates; consequently, short-term rates were — as described above — relatively high, and thus the difference between long-term and short-term rates was relatively small. In the middle of 1997, the term spread in France and Germany was considerably above the long-run average, namely by more than one percentage point, indicating an expansionary policy. However, the value for the United States was somewhat lower than the average suggesting a neutral or even slightly restrictive course. To summarize: Neither the real short-term interest rates nor the interest differentials indicate that monetary policy in Western Europe has been restrictive in the recent past.

The Policy Stance According to the Taylor Rule

Central banks obviously look at several macroeconomic indicators when setting the short-term interest rate. This can be shown, for example, in estimates of reaction functions (Solveen 1997). The Taylor rule[5] can be used to analyze whether European central banks have been focusing more than usual on fighting inflation and thus have depressed economic activity. This equation describes the interest rate behavior of a central bank that tries to stabilize output and, at the same time, to achieve a target for the inflation rate. According to this rule, the market rate is relatively low if actual output is below potential output or if the inflation rate is low compared to the central bank's inflation target[6] (see Box).

Figure 3 shows the rate calculated on the basis of the rule and the actual money market rate. In the United States, the central bank stimulated economic activity in the early 1990s, i.e., the rate fell well below the rate according to the Taylor rule. However, already in 1994 the course was "corrected", and since then there has hardly been a discrepancy; this indicates a neutral course of the Fed. In Germany, the actual rate has been lower than the rate derived from the rule already since 1993. Recently, the difference has even become bigger indicating that monetary policy has become more expansionary.

According to the *Taylor Rule*, the nominal money market rate i is as follows:

$$i = i_r^* + \pi^e - 0.5(GDP^{POT} - GDP) + 0.5(\pi - \pi^{TAR})$$

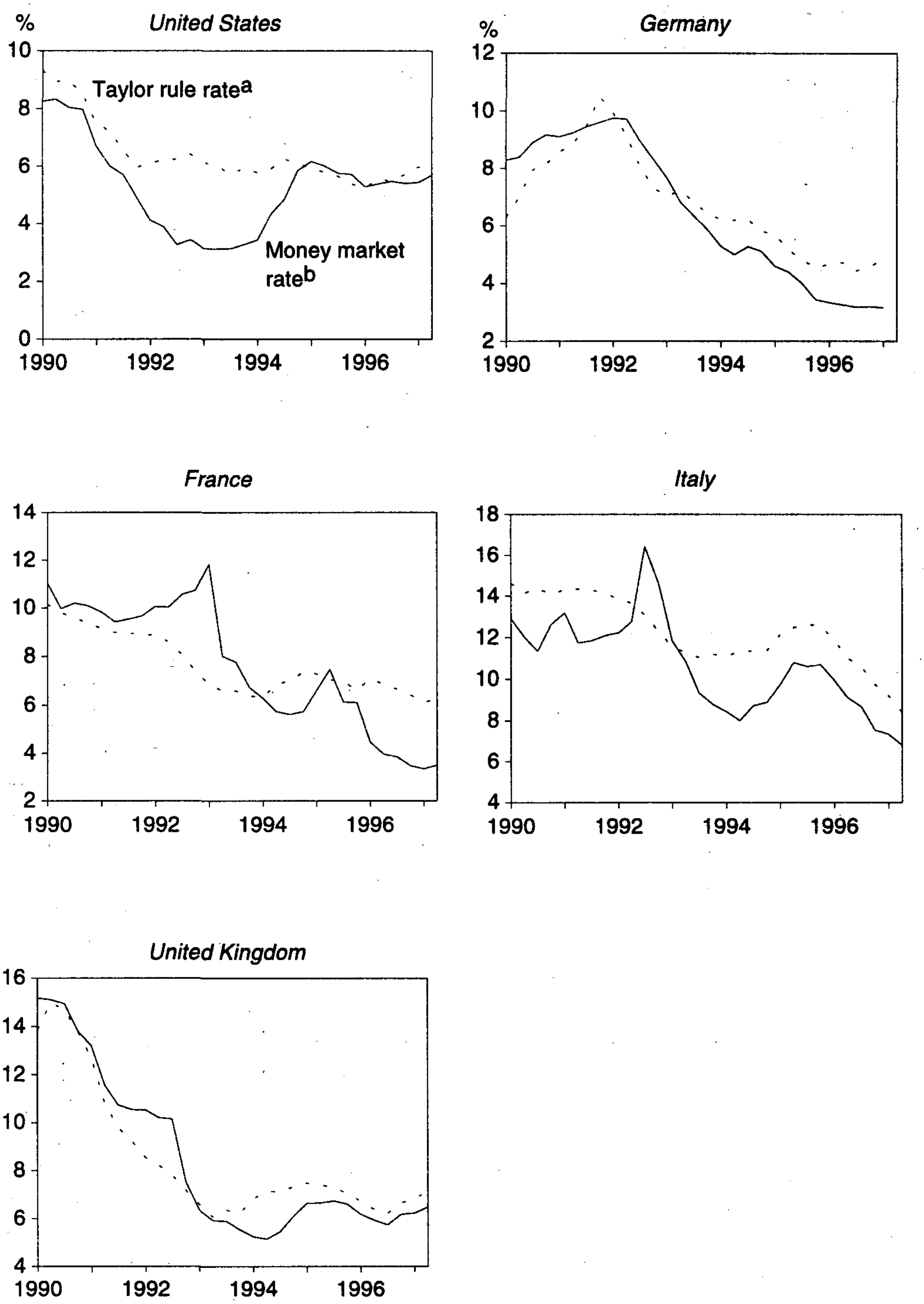
The variables are:

i_r^*	=	equilibrium real interest rate
π^e	=	expected inflation rate
GDP^{POT}	=	real GDP at normal capacity utilization
GDP	=	actual GDP
π	=	actual inflation rate
π^{TAR}	=	target inflation rate

In calculating the rate i, the average real interest rate for the period 1984–1996 is set equal to the equilibrium real interest rate. The expected inflation rate is approximated with the trend component of the Hodrick–Prescott filter (Krämer 1996). Normal capacity utilization is also calculated with the Hodrick–Prescott filter. The value for the inflation target is 3 percent for the United States and for Italy, 2 percent for Germany and for France, and 2.5 percent for the United Kingdom.

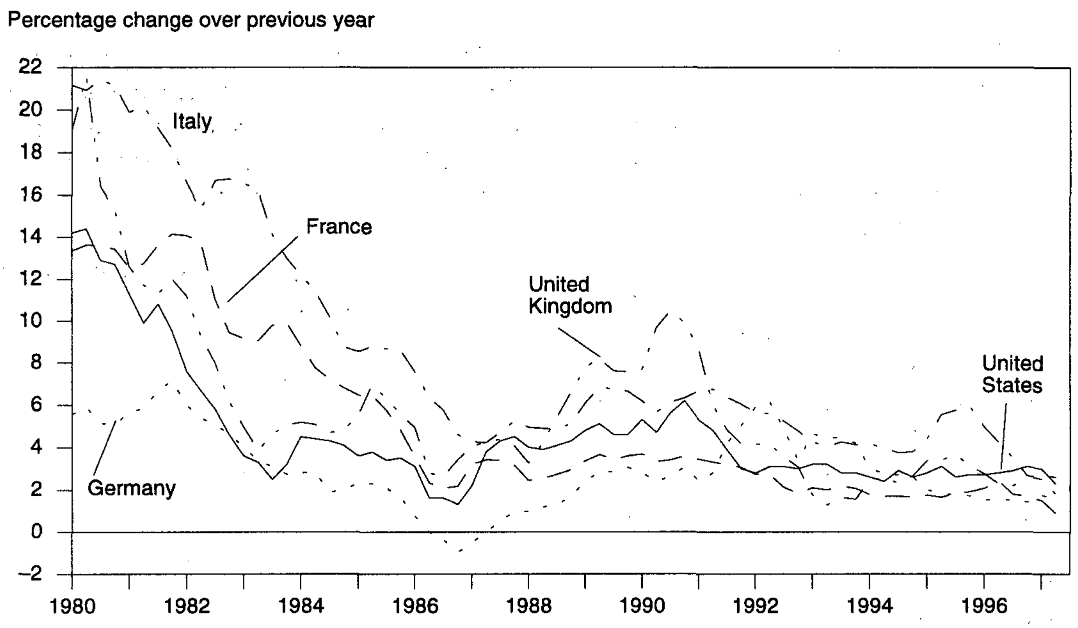
The situation is somewhat different in Italy and in France. The central banks in both countries obviously had to "accept" a higher interest rate in order to stabilize their currencies against the D-Mark.[7] Therefore, the money market rate was, on average, quite high. The difference between the rate according to the Taylor rule and the actual rate may therefore be misleading, the policy appears to be very expansionary. However, in 1994/95, the policy in France was probably not giving any stimulus to economic activity. But beginning in 1996, the French central bank successively reduced the money market rate to the level prevailing in Germany. Currently, the rate is much lower than the interest rate calculated on the basis of the rule.[8]

Figure 3 — Actual Money Market Rate and the Money Market Rate According to the Taylor Rule in Major Industrial Countries, 1990–1997



[a]Money market rate that would prevail in the case of central banks acting according to the Taylor rule. — [b]3-month money market rate.

Figure 4 — Consumer Price Inflation in Major Industrial Countries, 1980–1997



To summarize: According to the Taylor rule, which explicitly includes a "corrective reaction" to business cycle conditions, the policy in Europe cannot be judged as restrictive. Were the rule to be followed in the future, interest rates would have to be raised considerably because of the expected rise in capacity utilization and the slight increase of inflation. In the absence of such moves, the course of monetary policy would become even more expansionary.

Comparable Disinflation in the United States and in Western Europe

It is often stated that there exists a negative relationship between inflation and unemployment. The "Phillips curve" implies that a reduction of inflation leads to higher unemployment. If there was such a policy conflict and if the increase in unemployment could be explained with this hypothesis, one should observe that the reduction of inflation in Europe was relatively strong. However, the decline of inflation in the United States was as large as that in Western European countries in the 1990s; the same applies to the upswing period in the early 1980s (Figure 4). Particularly striking in this regard is the fact that in the United Kingdom the disinflation was more pronounced than in most other European countries; nevertheless, British unemployment declined whereas it increased, for example, in Germany, France and Italy. This observation does not support the notion that the disinflationary course of European central banks — led supposedly by the strict policy of the Deutsche Bundesbank — was more pronounced than that of the United States Fed.

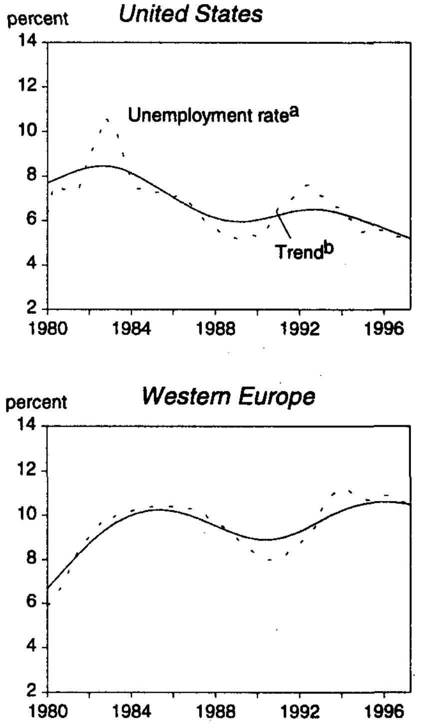
To summarize: The available indicators show that monetary policy cannot be made responsible for the different evolution of unemployment in various countries. There must be other factors that explain the trend behavior of employment in the 1990s and in other periods.

X. Comprehensive Reforms Necessary to Reduce Unemployment

For several decades, unemployment displayed strikingly different trends in industrial countries. As far as the period since 1980 is concerned, the United States stands out: The trend of unemployment, as measured by the OECD-standardized rate, declined throughout the period. In the summer of 1997, unemployment leveled off at 5 percent, which is approximately the same rate as in 1970 and well below its level in 1980 (Figure 5). The rises in unemployment that occurred during the recessions in the early 1980s and 1990s were corrected in the following upswings so that full employment was achieved. On the negative side, unemployment in Western Europe followed an upward trend resulting in an approximate doubling of the unemployment rate since 1980. While the increase owing to the recessions was in line with cyclical trends in the United States, employment gains in the successive upswings were much less pronounced resulting in an ever-increasing hard core of unemployment.

The different behavior in unemployment were associated with different trends in total employment. In the United States, 27.4 million jobs were created between 1980 and 1996; this is an average annual rate of increase of 1.5 percent (Table 5). At the same time, the working-age population grew by 22.6 million persons (0.9 percent per year). While the United States economy "delivered" 121 jobs for every 100 additional potential workers between 1980 und 1996, it was only 23 on average in Western Europe: The increase in employment by 3.6 million jobs (0.2 percent per year) was associated with an increase in the working-age population of nearly 16 million persons.

Figure 5 — Unemployment Rate in the United States and in Western Europe, 1980–1997



[a]Standardized. — [b]Calculated with the Hodrick–Prescott filter.

Table 5 — Employment Performance in Major Industrial Countries, 1980–1996

	Increase in Total Employment		Increase in Potential Labor Force[a]		Employment Performance[c]
	million	percent[b]	million	percent[b]	
United States	27.4	1.5	22.6	0.9	121
Western Europe[d]	3.6	0.2	15.7	0.5	23
Western Germany	1.2	0.3	4.4	0.6	27
France	0.4	0.1	3.8	0.7	11
Italy	–0.7	–0.2	2.4	0.4	–29
United Kingdom	0.5	0.1	1.9	0.3	26

[a]Working age population (15–64). — [b]Average annual percentage change. — [c]Absolute change in employment as a percentage of absolute change in potential labor force, 1980–1996. — [d]European Union, excluding Eastern Germany.

Source: OECD (1997b), own calculations.

While this is true for Western Europe as a whole, there are significant differences in labor market trends across countries. Unemployment is continuing an upward trend in Germany, France and Italy, for example, but the underlying trend in the United Kingdom and the Netherlands has clearly been moving downward since the mid-1980s (Figure 6). Recently, a strong reduction of unemployment could also be observed in Denmark and Spain. Because this evolution has started only recently, it is, however, not yet clear to which extent the reduction of unemployment exceeds the usual cyclical pattern and can be judged as structural.

The level and the trend of structural unemployment are determined by a number of factors that affect labor market outcomes and form a complex web of incentives and disincentives (Siebert 1997). Four important areas can be identified:[9]

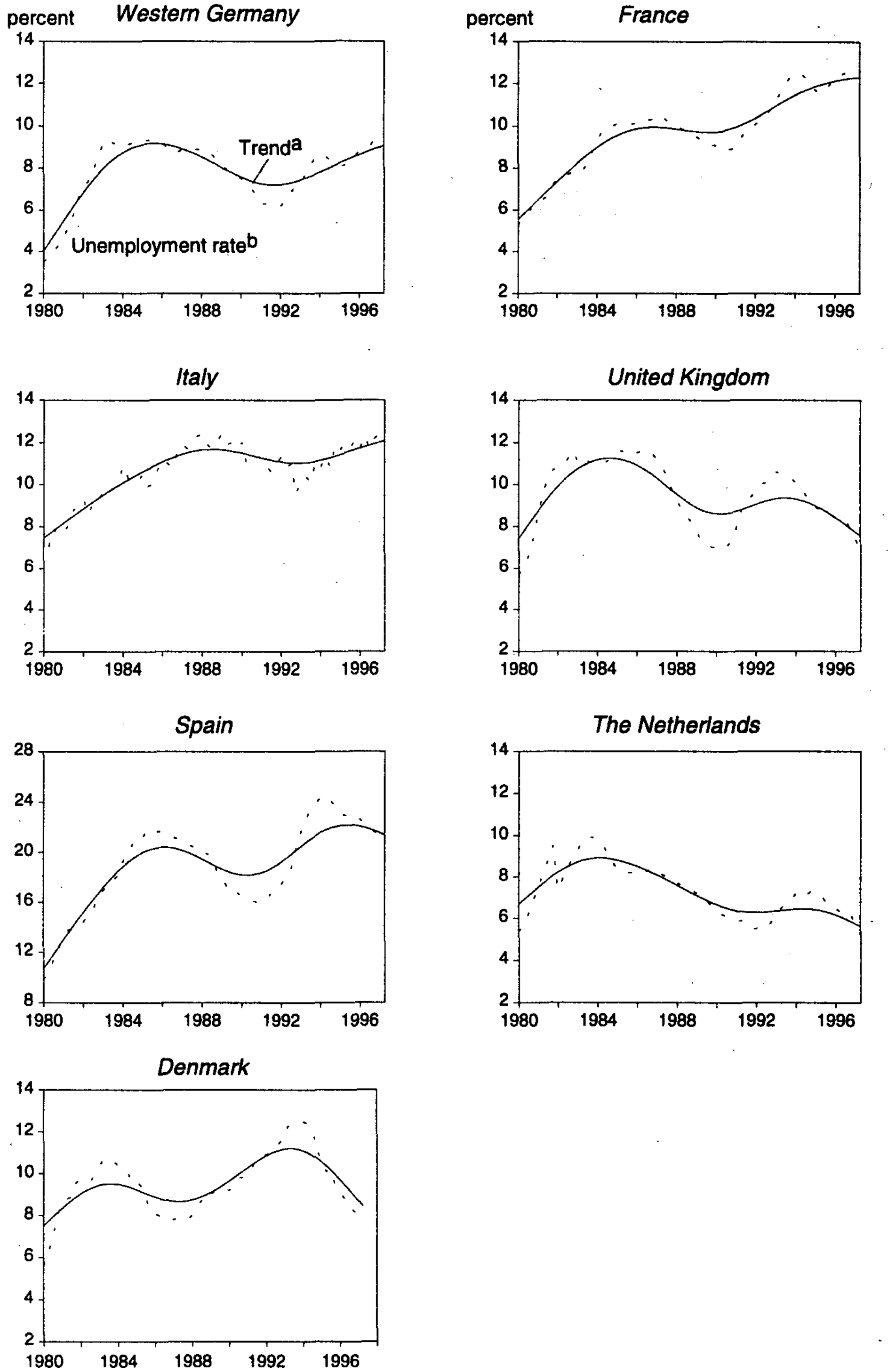
(1) The level of real wages (including nonwage labor costs) and (marginal) labor productivity determine the profitability of job creation. On the one hand, a way to improve employment perspectives is to increase productivity through qualification and training, or through improvements in the production process. On the other hand, real labor costs should increase at a slower pace than productivity in order to make the use of labor as a factor of production more profitable and thus increase labor demand. Moreover, it is important that wages to a greater extent reflect the relative scarcity of labor across regions and sectors as well as qualifications. Total labor costs should also include nonwage labor costs, such as employers' contributions to social security, costs related to sickness pay, severance pay, and the like. By introducing measures to lower these costs, e.g., appropriate social security reforms, economic policy can contribute to higher employment.

(2) Unemployment benefits and other transfers related to unemployment essentially determine the reservation wage, i.e., the wage rate necessary to make an unemployed person accept a job offer. As a consequence, transfers can effectively define the floor of the wage structure, particularly in a system where wage income is to a large extent implicitly taxed away through the reduction of benefits. In many cases, the system of income taxation and income-tested benefits leads to a situation where accepting a low-wage job only marginally increases household income.[10] A high reservation wage reduces the potential for wage differentiation, and low-skilled workers may be priced out of the market. The situation can be improved by reducing the implicit taxation of wage income, which, in effect, increases the net wage rate and improves the incentives to work. A different approach to raise the incentives for unemployed persons to accept job offers lies in tightening eligibility criteria of unemployment-related benefits, or in lowering the level of benefits in general.

(3) In many cases, potential job contracts do not materialize due to legal or other institutional restrictions. The freedom of contract is limited through a host of regulations, including official minimum wages and extension of labor contracts negotiated by labor unions and employers' associations to unorganized market participants. These regulations prevent that unemployed persons can price themselves into the market by accepting lower wages or by voluntarily foregoing nonwage benefits, and thus effectively protect job holders ("insiders") from unwelcome competition (through "outsiders"). They are a major factor behind the growing incidence of long-term unemployment. The labor market can be vitalized by market-oriented reforms of the labor market constitution (freedom of contract, competition) as opposed to the corporativistic structure of labor markets prevailing in Europe (Soltwedel 1997).

(4) The concert of various product market regulations hampers the rise of new enterprises and job creation. What is needed are supply side reforms that are capable of increasing the growth potential of the economy. Such measures should include a reduction of the government share in the economy and a reduction of distortions through reforms in the tax system.

Figure 6 — Unemployment Rates in Selected Western European Countries, 1980–1998



[a]Standardized. — [b]Calculated with the Hodrick–Prescott filter.

A detailed analysis of developments in the countries displaying a relatively favorable labor market performance reveals that significant progress has been made in the above-mentioned fields (see also OECD 1997c):

– In the *United Kingdom*, comprehensive economic reforms started already at the end of the 1970s. They included extensive privatization of nationalized companies and a massive transformation of labor market institutions including legal provisions concerning labor unions. Competition increased markedly on both product and labor markets, one result of these changes was an increase of wage differentiation.
– In the *Netherlands*, beginning in the early 1980s, the focus was on curtailing labor costs by wage moderation and by dampening the increase in social security contributions. An important aspect of the Dutch labor market is the rising share of part-time jobs. As a result, the number of employed outpaced the number of hours worked to a significant degree.[11]
– In *Denmark*, policies to promote employment included increasing competition on product markets (privatization, liberalization of shop-opening hours), reducing the level of benefits somewhat (although they remain on extremely high levels), and tightening eligibility criteria. Much of the reduction in unemployment has, however, been due to active labor market policies. In addition, several paid leave and early retirement schemes led to a significant reduction of the labor force. Such policies, however, do not increase employment, and in view of high budgetary costs it must be doubted that they are capable of reducing unemployment permanently.
– In *Spain*, the unemployment rate approached 25 percent in 1994 — the highest level in the OECD-area. Throughout the 1990s, the very restrictive employment protection rules that had been in place were successively loosened. This policy increased labor market flexibility and, in concert with pronounced wage moderation, should have contributed significantly to the fast employment growth that can be observed in the current upswing.

Summing up, the experiences of the countries show that there are several measures to improve the labor market performance. Most promising is a combination of policies reflecting the specific situation of the country. Moreover, reforms in different fields should be implemented simultaneously since there seem to be important synergies between structural reforms in different fields (Coe and Snower 1997).[12]

The example of countries with improved labor market outcomes — New Zealand and Ireland should be added to the countries discussed above — leads to the conclusion that policies are most likely to be effective when a large part of the population is exposed to structural reform. It is not sufficient to introduce specific provisions for small groups, e.g., the long-term unemployed. The rules of the game have to be altered for everyone, including the employed.

Endnotes

1 The section Germany is largely based on Boss et al. (1997).

2 A comparison of money growth is less instructive because of the apparent instability of money demand functions in a number of countries. Therefore, we look at short-term interest rates, which are largely controlled by the central banks.

3 In order to keep the exchange rate stable vis-à-vis the D-Mark, Italy and France had to accept higher real interest rates because the markets obviously put a risk premium on their currencies. From time to time, interest rates were raised substantially in these countries to counter speculative attacks, for example, in the fall of 1992 and in the spring of 1995, when there were crises in the EMS.

4 According to (almost) all business cycle theories, monetary policy does not have real effects in the long run. The average over a long period therefore reflects a neutral stance of monetary policy.

5 The rule is named after John B. Taylor, who advocated such a policy in a number of publications. This rule can be viewed as a compromise between targeting inflation on the one hand and stabilizing output on the other (Taylor 1993).

6 In some countries, there is an explicit inflation target. This may be constant over time, as in Germany or it may change like in the United Kingdom. The Banca d'Italia does not pursue a particular target. The "equilibrium" real interest rate is the rate that is neutral with respect to output; here, the average for the period 1984–1996 serves as a proxy.

7 In the countries that could keep the exchange rates stable in the EMS without major problems, the course of monetary policy is comparable to that in Germany; this applies, for example, to Belgium, Austria, and the Netherlands.

8 For the United Kingdom, there is a similar problem of the "correct" level because the real rate was, on average, quite high in the past. Accordingly, the policy of the Bank of England appears quite expansionary.

9 In a comprehensive study on industrialized countries' labor markets, the OECD (1994) published recommendations for policies that should be implemented to improve the labor market performance. The proposals for a "jobs strategy" are broadly in line with what is discussed here.

10 For an analysis of the German case see Deutsche Bundesbank (1996) and Gern (1996).

11 The share of part-time employed in total employment has increased rapidly since the early 1980s to 35 percent and is the highest among the industrial countries.

12 For example, the level of replacement rates affecting labor supply also influences the level of nonwage labor costs that have an effect on labor demand.

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