IS UNEMPLOYMENT INEVITABLE?

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VIEWS EXPRESSED ARE THOSE OF THE PRESENTER AND SHOULD NOT BE ASCRIBED TO THE IMF.

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IS UNEMPLOYMENT INEVITABLE?

No.

• In 1970’s inflation was regarded as an intractable problem but it was cured.
• With sufficient policy attention, we can have low average rates of unemployment.
1) Could we have done better?
(Could we have gone through Global Financial Crisis with lower unemployment)?

– Crisis not inevitable, but once crisis—and the resulting collapse in growth—occurred, some unemployment was unavoidable.

– Increases in unemployment largely be explained by the fall in output

– Initial policy response to dampen the fall in output was good
  • cut in policy interest rates by central banks; coordinated global fiscal stimulus.

– Work sharing shielded German unemployment.
  • Could it have been used elsewhere?

– Around 2011, concerns of fiscal sustainability got prominence.
  • Countries/institutions were aware that this would moderate the forces of recovery but felt it was needed.
2) What to do now?
 ‘A two-handed approach’

On demand side:
• Continued ease in monetary policy
• Calibration of fiscal policy
• Countering drag from deleveraging
• Public investment: boosts demand, also medium-run effects

On supply side:
• Labor markets reforms: micro & macro flexibility
• Migration: can be useful adjustment mechanism
• Reforms of the financial sector
• Product market reforms
1) Could we have done better?
Unemployment and Output
Output and Employment Since the Great Recession

Employment growth since the Great Recession can be explained well by changes in output.

\[ y = 1.03 \times x + 1.03 \quad (\text{Adj. } R^2 = 0.8) \]
Spain’s unemployment & employment growth can be explained by fall in output.
Much of increased youth unemployment can also be explained by fall in output.
Unemployment: Cyclical vs. Structural

• Initial increase cyclical rather than structural

• Greater uncertainty about relative proportions now, but cyclical component remains important in most countries
  • Beveridge curve stable relative to past shifts; moreover shifts may not be sign of increase in natural rate (Diamond 2013)
  • Other measures of mismatch back to normal
  • Lack of deflation not a sign of small unemployment gap

• Stability of Okun’s Law suggests jobs will return if the growth returns.
2) WHAT TO DO NOW?
AN ENCORE FOR THE TWO-HANDED APPROACH

ON WEDNESDAY, LASZLO ANDOR TALKED ABOUT ‘DÉJÀ VU’
THIS WILL BE ‘DÉJÀ VU ALL OVER AGAIN’
ECONOMIC PAPERS

COMMISSION OF THE EUROPEAN COMMUNITIES • DIRECTORATE-GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

No. 36 June 1985

Report of the CEPS Macroeconomic Policy Group
Employment and Growth in Europe:
A Two-Handed Approach

O. Blanchard, R. Dornbusch, J. Drèze,
H. Giersch, R. Layard and M. Monti

Internal Paper
Facts and Diagnosis, 1985

• “[In Europe] **11.2% of the labor force is unemployed today** compared to only 2% in 1970. Long-term unemployment is a large and increasing portion ... [There has been] an increase in both the level of youth unemployment and its share of total unemployment since 1979”

• “These are very gloomy statistics. Do they reflect an **inevitable new economic reality, or can employment growth be restored?”**

• “... **a sharp decrease in aggregate demand is indeed the proximate cause of the rise in unemployment in the EC since 1980**. The use of monetary policy to fight inflation and the major shift in fiscal policy towards "budgetary consolidation", however justified, seem to explain much of the poor growth performance of the 1980s “
Recommendations, 1985

- “Neither supply nor demand measures will by themselves create and sustain employment growth. This simple point forms the basis of our approach ...”

- “Supply measures, without accommodating demand policies, will have little impact on employment and output, at least in the short run ... if firms do not see improved sales prospects, they will not increase capacity in response only to an improvement in factor prices ... it is essential to make sure that demand is there to sustain supply ... [But without supply measures] gains will be temporary at best and may in fact worsen structural problems. Thus, our call for a two-handed approach.”

- “We believe that structural changes on the supply side are more important than wage cuts at this stage, that they require a social compact which may not be feasible if workers are asked to take substantial wage cuts”

- “In summary ... What is now needed is a social pact in which supply-friendly measures go hand in hand with a vigorous recovery”
An old view: getting macro policies right will help labor markets

• “There is sometimes the naïve belief that unemployment must be due to a defect in the labor market, as if the hole in a flat tire must always be at the bottom, because that is where the tire is flat” (Solow, 2000).

• "It takes a heap of Harberger triangles to fill an Okun's gap.” (Tobin, 1977)
Reasons for Slow Recovery in Output
Why is the recovery slow?

Many theories

• Deleveraging
  • Sovereign spreads have come down, but financial fragmentation still exists, especially when it comes to smaller and medium-sized firms. This keeps the cost of capital high and investment low compared to previous ‘twin’ crises

• Policy constraints
  – Limited exchange rate adjustment
  – Fiscal consolidation
The Divergence in Recovery between Advanced Countries and Emerging Markets

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

Notes: Dashed lines denote WEO forecasts. Indexed to 100 in the year before global recession. Zero is the time of the global recession year. Each line show the PPP-weighted average of the countries in the respective group.
Divergence in Government Spending between this Global Recovery and Past Global Recoveries: US and Euro Area
Aggregate and Distributional Impacts of Fiscal Consolidation

Episodes of fiscal consolidation (on average a 1% of GDP reduction in government budget deficits):

- lower GDP by 0.6 percent over the following two years;
- lower share of wages in income by about 0.5 percentage point of GDP over the medium-run;
- raise the long-term unemployment rate by about ½ a percentage point over the medium-run.
Fiscal consolidation lowers wages more than profits & rents, thus lowering wage share of income.

Note: dotted lines equal one standard error bands.

Slow Recovery in Output: Fiscal Constraints
Fiscal consolidation raises long-term unemployment more than short-term unemployment

Note: dotted lines equal one standard error bands.
Implications for Fiscal Policy:
Case-by-Case Assessment of Pace

• Since many governments entered the crisis with high debt-to-GDP ratios, attention turned to consolidation once financial conditions started to stabilize.

• Cognizant of the adverse impact of fiscal consolidation on growth, the IMF’s policy stance has been to support “a case-by-case assessment of what is an appropriate pace of consolidation” and to emphasize the need “to make fiscal policy more growth-friendly” (Lipton 2013).
Implications for Fiscal Policy: Helping the Unemployed

• Steps to address long-term unemployment are important in their own right and also to mitigate the distributional effects of fiscal consolidation (Bastagli, Coady and Gupta, 2012)

  • “protecting the most redistributive social benefits (including unemployment benefits) until the economy recovers and unemployment starts to decline can help to cushion aggregate demand and mitigate adverse impacts on income inequality.”

  • “In addition, expanding active labor market programs (such as job-search support, targeted wage subsidies, and training programs) can help to accelerate the decrease in unemployment as economic growth resumes and can help avoid persistently high unemployment levels.”
Implications for Fiscal Policy: Better Targeting of Spending and Revenue Measures

Evidence of the impact of consolidation on equity “strengthens the case for better targeting of both spending and revenue measures.” (Reassessing the Role and Modalities of Fiscal Policies in Advanced Economies, IMF Policy Paper, July 21, 2013.)

- “Revenue increases can be an important component of consolidation packages, even in countries where the adjustment should focus on the expenditure side, as in a number of European countries.”

- “Better targeted spending can also help achieve equity objectives, though there may be a trade-off between growth and equity concerns when choosing consolidation measures.”
Monetary and fiscal policies

• The IMF has welcomed recent measures by the ECB and the willingness to use further unconventional measures if inflation deviates further from its price stability goal.

• Fiscal policy at the aggregate level broadly balances growth and debt sustainability concerns. In case of a large negative growth surprise, additional consolidation should be avoided and automatic stabilizers allowed to work, using the full flexibility of the fiscal framework.
Labor Market Polices
“Labor Market Flexibility”: Moving Beyond Mantras

Diagram:
- Unemployment & Productivity Growth
  - Micro Flexibility
    - Unemployment Insurance
    - Employment Protection
  - Macro Flexibility
    - Minimum Wage & Tax Wedge
    - Collective Bargaining
- Protection of workers
Micro Flexibility: Two Key Institutions

Unemployment insurance (UI)
- welfare improving but possible efficiency cost
- what matters: design of the system
  quality of active labor market policies

Employment protection (EP)
- some of it is desirable but too much can be harmful
  (lower reallocation, longer unemployment duration)
- dual protection systems have ambiguous effects on efficiency and welfare
- reduce judicial uncertainty
Micro Flexibility
Some countries don’t do it well:
low flows, long U duration
Unemployment Duration and Employment Protection (months; 1995 – 2007 average)

Source: Organisation for Economic Co-operation and Development (OECD) and International Labor Organization (ILO).
See the work by Sandrine Cazes and the panel discussion on this issue on Thursday at this conference.
Macro Flexibility

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

Key institutions
- Minimum wage
- Tax wedge
- Collective bargaining structure
Level of Unemployment

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

Tax wedge
  – Tends to increase labor cost and U (especially in combination with high min wage or UI and if no deferred benefits)
Can Flexicurity Be Exported?
The Importance of Trust

Unemployment Rate versus Trust
(percent; 1995-2007 average)

1/Trust between firms and workers is measured by the extent to which industrial relations are perceived to be conducive to labor peace.
Increased Response of Migration?

This was discussed in Panel 4 at this conference: “Intra-EU labor mobility under attack. Why?” Corrado Giulietti said “we are not (yet) European enough”
Two-Handed Approach

- **Unemployment should be the focus**: European unemployment is high and expected to remain so; this has grave human costs.

- **Jobs and growth are linked**: Contrary to some assertions, jobs and growth remain linked. This raises the hope that the jobs will return when growth does.

- **Unemployment still has a large cyclical component**: Beveridge curve movements not extreme relative to past swings; mismatch indices back to normal.

- **Two-handed approach**: Boosting growth requires acting on both demand and supply fronts.
Getting Macro Policies Right

• *Slow Recovery in Output*: Many reasons for it, but inability of fiscal policy to provide support in this global recovery, unlike in past global recoveries, should be kept in mind.

• *Implications for macro policies*:
  – Careful calibration of fiscal policy
    • Case-by-case assessment of pace of adjustment
    • Measures to support the unemployed
    • Better targeting of revenue and spending measures to redress distributional effects
  – Continued support from monetary policy.
Strengthening Supply

- **Labor market policies**: Well-functioning labor markets require micro and macro flexibility while protecting welfare of workers.
  
  - To ensure micro flexibility while protecting workers, IMF advice during the crisis has generally been to support unemployment insurance benefits and to advocate a move away from duality and excessive protection.
  
  - Macro flexibility has proved more difficult. In countries where there is a need to boost competitiveness, the inability to reach national tripartite agreements has left no easy choices.

- **Migration response**: an important adjustment mechanism

- **Other structural reforms**
  
  - Product market reforms
THANKS!

And sorry for going over my allotted time