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Comment on Charles Wyplosz: Demand and Structural Views of Europe's High Unemployment Trap

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I find Charles Wyplosz' paper both illuminating and balanced. The analysis of equilibrium unemployment with a wage-setting schedule added to the traditional labor-supply and labor-demand framework is quite useful. It would have been nice, however, to have a closer integration of this approach with the subsequent labor-flow and search analysis in the paper. I do not regard these approaches as competing, but rather as complementary.

Wyplosz' reflection that Europe has run into persistence/hysteresis problems not only for unemployment, but also for investment is an interesting observation. A closer analytical connection between unemployment persistence and investment persistence is perhaps an interesting task for future research.

There are, of course, lots of gaps in a short paper like this on an issue as broad as the European unemployment problem. It would, for instance, have been useful to clarify further the channels by which product demand shocks are transmitted to the demand for labor and aggregate employment. There is a tendency in the political discussion to argue as if product demand shocks influence aggregate employment quite automatically. The issue is, of course, much more complex than that. It is well known that imperfect (such as monopolistic) competition in the product market, combined with nominal rigidities, generate such a transmission mechanism. But the outcome also depends on how the supply side of the economy functions, such as the ease of the entry of firms, the incentives to invest, the willingness of firms to hire workers, the incentives of em-

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ployees to accept job offers, including offers of jobs at lower wages than they received earlier, etc.

I salute Wyplosz' insistence that unemployment depends on many factors, each of which may not be very important when taken separately. I agree that it is, therefore, sensible to fight unemployment by a large number of simultaneous actions – a "package approach". The uncertainty of the effects of each measure strengthens the case for this strategy. It is, however, not obvious why such a package approach should be characterized as an "explicit social contract".

Wyplosz' recommendation of debt-financed fiscal expansion (to avoid a large increase in the quantity of money) makes sense in countries were budget deficits and public sector debts are modest initially. The recommendation is more problematic in countries with large and rapidly rising public sector debt. Indeed, recent experience suggests that policies that create very large budget deficits may be counterproductive from the point of view of employment. There are at least two reasons for this. One is that large deficits may create great uncertainty among households about the ability of the government to fullfil its social security obligations. This may induce households to increase their savings, which tends to accentuate the recession. Thus, while the permanent income and life-cycle theories of saving suggest that the saving rate falls in recessions, reflecting consumption-smoothing behavior, increased uncertainty in recessions would be expected to work in the opposite direction, generating a tendency for the saving rate to rise, which has procyclical consequences.

The other reason for doubts about the efficiency of fiscal expansion in countries with large public sector deficits is that large budget deficts seem to make the agents in today's highly internationalized financial markets nervous. It is generally believed that interest rates will rise as a result. If this is the case, large and increasing public sector debt may counteract, and possibly even overcompensate, for the traditional expansionary effects of fiscal policies that generate public sector budget deficits. It is, however, not clear exactly what the mechanisms for such effects would be, except that a rapidly rising public sector debt may create fears of more inflation and expectations about devaluations in fixed-exchange-rate regimes, which certainly result in higher domestic interest rates.

Wyplosz' argument that the best way to avoid unemployment persistence is to pursue an expansionary demand management policy early in recessions makes sense in principle. The problem, though, is that it is difficult to know in advance if a sudden drop in demand is temporary or if it is more permanent. In other words, we are confronted by the traditional objection to "fine-tuning" policy: it is difficult to make forecasts, and there is, therefore, a risk that the effects of policy actions come in the "wrong" cyclical situation.

I am, however, sceptical to Wyplosz' suggestion that "early fiscal expansion" in recessions explains the low unemployment in the Scandinavian countries during the 1970s and early 1980s. I would rather argue that these countries kept unemployment down during the 1970s and 1980s by methods that were not sustainable in the long run: (i) by way of recurring reduction in real wages via devaluations, and (ii) by way of gradually increased (permanent) public sector employment (see Lindbeck, 1993, 144–149). In Sweden, for instance, there were five devaluations in the period 1976–1982. They resulted in considerable reductions in real wage rates, which lasted for a number of years. Moreover, the number of public sector employees increased from 20 to 35 percent of the labor force between 1970 and 1985. It is a controversial issue just how long-lasting the effects on aggregate employment are of devaluations and increased public sector employment. In the long run, we would expect the effects of such policies on aggregate employment to die out. It is, however, interesting to observe that when the devaluation policy was discontinued around 1990, and the government did not compensate the fall in private employment with increased employment in the public sector, unemployment exploded.

Let me add one important point. Increased employment in Europe today requires that the market sector for household services expand. There are, however, strong obstacles to this in Europe. For instance, broad tax wedges hit the production of services much harder than the production of goods. Few people choose to build a Mercedes car in their own garage. But they may wash it. They may also paint their house, fix their garden or make their meals themselves, rather than buying these services in the market.

In other words, the elasticity of substitution between do-it-yourself work and purchases in the market is much higher for services than for goods. The service sector is also harmed by regulated wages that keep up wage rates for low-productivity workers in the service sector. There are also various types of restrictions on the entry and operations of firms in the service sector.

The possibilities of reducing unemployment substantially in Europe in the future, therefore, largely depend on the ability to "free" the service sector from its present chains. After all, it is the private service sector that has been the "job machine" in the United States during the last quarter of a century. The main defect, though, of the US labor market is the poor education and training of the lowest deciles of the labor force (in terms of human capital), with a large number of working poor as a result.

Reference

Lindbeck, A. (1993), Unemployment and Macroeconomics, MIT Press, Cambridge, MA.