

## **Miguel Fernández Ordóñez: Labour market experiences – towards more efficient labour markets**

Opening speech by Mr Miguel Fernández Ordóñez, Governor of the Bank of Spain, at the high-level seminar on Labour market experiences: towards more efficient labour markets, International Monetary Fund (IMF)–Banco de España, Madrid, 11 May 2010.

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Let me first thank you all for accepting the invitation to participate in this high-level seminar on “labour market experiences: towards more efficient labour markets”. In particular I would like to thank Olivier Blanchard, chief economist at the International Monetary Fund, for participating in this event and accepting to share with me these introductory remarks.

In fact, the idea of organising this seminar was originally from the IMF, which last autumn suggested staging this event, mindful as it was of the potential role played by the Spanish labour market institutions in explaining some of the specific inefficiencies of our economy. The Fund viewed the conference as a way of promoting discussion about possible avenues of reform. The Research Department of the Banco de España then took up the IMF’s baton, drawing on its long tradition of sound economic research and deep analysis on this topic.

We are certainly proud to have been able to assemble such an eminent and diverse group of professionals on the occasion of this event in Madrid. The range of participants and audience at this conference is precisely something I would like to stress, the main goal of the seminar being to promote an exchange of views and flow of ideas and thinking among the various groups having a say on this topic, namely academia, international organisations, policymakers, social agents and the private sector. Only by covering all the different aspects and by sharing the different country experiences on this matter can we expect to make the right diagnosis of the problems and facilitate the acceptance and implementation of the reforms that might be needed.

As you may be aware, I myself have repeatedly been suggesting the need for a labour market reform in Spain. But it is not the goal of this conference to act as a platform for announcing or defending the views of the Banco de España. On the contrary, its spirit is to incorporate different views into the discussion and promote mutual learning. I should like particularly to stress the importance of grounding and testing our opinions and proposals in rigorous analytical and empirical economic research.

The main idea I would like to convey in these introductory remarks is that if during the crisis economic policies have concentrated – with some justification – on measures that are intended to have a short-term impact, the time has come to shift the focus onto reforms which are designed to have only medium and long-term effects but that, through a change in expectations can provide a shot of confidence, a key ingredient for resuming a sustainable growth path.

The global economy is certainly recovering from its deepest downturn since World War II. We have witnessed a period of crisis in which economic policies have reacted in an unprecedented manner, focusing on countering in the short run the highly adverse economic and financial situation. Major central banks reacted decisively by providing abundant liquidity to financial systems and substantially cutting their key interest rates. These standard monetary policy measures were later complemented by other, non-conventional measures, to avert the threat of a drastic loss of liquidity in the financial system as a whole and support the flow of credit to firms and households. Fiscal authorities, in turn, put in place a number of measures aimed, first, at supporting financial systems and, further, at stimulating demand. And there is broad consensus that this policy reaction was warranted and has played a crucial role in halting the risk of collapse and containing the crisis.

After the foundations for a potential turnaround became discernible, the policy debate turned to the appropriate exit strategies from these expansionary policies. In the case of monetary policy, the central banks of the main developed countries have already announced – and begun to implement in some cases – plans to withdraw their unconventional liquidity-support measures. In the case of fiscal policy the challenge is successfully to apply fiscal consolidation. That will require a significant effort if public finances are to be set on a sustainable path.

However, it is also time to shift our focus from the short to the medium and long run and start to address the structural problems of our economies. There are several arguments justifying this need for a shift in policy perspective.

First, the historical evidence suggests that output may remain well below pre-crisis trends in the medium run. The associated losses in capital, employment and total factor productivity during the crisis could be long-lasting, leaving an enduring imprint on productive capacity. And medium-term output dynamics may also be affected. In particular, investment has fallen dramatically in the crisis, resulting in a slowdown in the rate of accumulation of productive capital. This, when combined with higher rates of capital obsolescence, is lowering potential growth in the short to medium run. In addition, these adverse effects could persist in the long run if there is a permanent step-up in the cost of capital due to changes in attitudes towards risk among investors. These developments may also affect the rate of technological progress in the long run if, for example, they lessen the incentive to engage in innovative activities. And we cannot forget the risk of the observed increase in unemployment translating into a parallel increase in structural unemployment, an issue I will deal with later in my speech. Therefore, structural reforms appear to be the only available tool to avert the risk of the crisis exerting more permanent effects on both the level of output and the growth rate of the economy.

Second, structural reforms cannot be seen in isolation from the other measures that are needed, in particular those stemming from the exit strategies, but rather as a necessary complement to them. As an example, the dramatic increase in fiscal deficits and government debt levels during the crisis, exacerbating fiscal sustainability concerns for a number of economies, would worsen if output losses were permanent and constrained government revenues and expenditures in the future. By the same token, growth-enhancing structural reforms may smooth acceptance of the fiscal adjustment or even reduce its magnitude if they prove to be effective.

Past experience shows that structural reforms are often adopted in times of economic crisis or prolonged episodes of slow or negative growth. This contrasts with the generalised view that it is easier to cope with these reforms, since their costs are generally less painful, and distributional effects less visible, when the economy is strong and income is growing rapidly. And the reasons for this cyclical pattern of structural reforms seem to be related to the fact that crises unmask weaknesses that were hidden by cyclical buoyancy, and these increase, at least partly, the social support for change.

The labour market is clearly first among the structural reforms that are needed. For one thing, labour markets play a key role in the functioning of the economy, in particular as a mechanism for adjustment in the face of adverse shocks. And their functioning has implications for competitiveness and productivity, two variables crucial for the long-term growth of any economy and, in particular, for those countries participating in a monetary union, as is our case. Likewise, there is sufficient evidence that labour market institutions play a key role as determinants of their sound functioning. In particular, we have evidence that labour markets have been pivotal in the response of the different economies to the current crisis. And they can play a central role in the persistence of the negative effects of the financial crisis in the medium and long run.

During the current recession output and unemployment responses differed markedly across the advanced economies. For instance, the peak-to-trough increase in unemployment during

the crisis was around 7.5 percentage points in Ireland and Spain, while output dropped by more than 8% in Ireland and only half as much in Spain. In the same vein, the UK unemployment rate increased by only 2.5% although output fell close to 6% and Germany underwent a decline in output of about 7%, but its unemployment rate actually decreased. This suggests that labour market mechanisms for adjustment in the face of adverse shocks are not working correctly in Spain, as employment is bearing the brunt of the adjustment and this entails a high cost, in terms of long-term economic growth and social well-being. These differences are not only seen in periods of recession, but also in economic upturns, in the form of diverse levels of unemployment, and of productivity and real wage developments.

And we know that there are major differences among countries as regards labour market institutions, thus suggesting that such different unemployment or productivity outcomes may, at least partly, be driven by regulatory differences. This is why it is important to look at the experiences of other countries in order to share experiences and to try to draw some conclusions on the pros and cons of the different institutional settings.

The medium-term effects of the crisis I mentioned before are also particularly dependent on the functioning of the labour market. First, the crisis may imply the need for a substantial reallocation of labour across sectors, something that may take time and increase medium-term frictional unemployment. Labour market institutions may, of course, play a key role in galvanising or impeding this process. Think, for example, of a wage-setting mechanism allowing for sectoral differences versus one that imposes uniform wages across sectors. Second, long unemployment spells may cause permanent destruction in human capital, giving rise to the process of “hysteresis” and leading to an increase in the structural unemployment rate. The concept of “hysteresis” being identified, among the first authors, precisely by Olivier Blanchard in 1986 in a joint paper with Larry Summers. Of course, this effect may be larger if rigid labour market institutions complicate the task of finding a new job, while the literature also finds that the level of the tax wedge or the inadequate design of unemployment benefits are important drivers of structural unemployment. In addition, a protracted recession may also reduce the potential labour force by discouraging vulnerable workers from seeking a job. This effect is again not independent of policies, since there might be social and financial incentives to stay away from the labour force, and the development in the past of early retirement schemes for older workers subsidised by governments in some countries is a good example.

Overall, looking at the research published, three elements of the labour market institutional setting seem particularly worth looking at as possible determinants of the different outcomes across countries: first, the legislation on types of employment contracts and unemployment protection schemes; further, the institutional design of collective bargaining; and finally, active labour market policies and labour market intermediation mechanisms. These three elements broadly correspond to the current structure of this seminar, and will therefore be treated in one way or another.

Let me conclude with two final points on the link between labour market reform and other policy measures. First, labour market reform is also the best case where the complementarities with the exit strategies needed are most obvious. If we take the Spanish case as an example, we can see that unemployment benefits amounted to around 3% of GDP in 2009. And the employment losses associated with this increase in unemployment have also had a significant negative impact on public revenues. Thus, a non-negligible part of the huge increase in the deficit in the past two years is directly or indirectly related to labour market trends. Preventing this increase in unemployment from becoming structural would greatly smooth the fiscal consolidation process.

That leads to me to emphasize a second point: it is important that different reforms should be pursued in unison, and in particular that labour market reforms be accompanied by product and services market reforms. In this regard, it is vital to push through structural reforms

providing for the elimination of obstacles to effective competition and of those that may hamper the reallocation of productive resources. Indeed, only with competitive and flexible product and services markets, would labour market reforms translate into higher activity and employment rather than higher rents. Also this broad comprehensive reform approach can help create the consensus that is needed for reform, as different actors perceive more clearly the benefits of a comprehensive reform package, and not only the costs to them of specific reforms. Some good examples of the benefits of this comprehensive approach are Denmark or the Netherlands, countries that adopted a mix of labour market, public finance and product market reforms that complemented and reinforced one another.

I do not want to take up any more of your time with these opening remarks. Let me simply thank you once again for sharing your thoughts with us. Here's wishing every success for the conference. Now Professor Blanchard will complete these introductory remarks. Olivier, the floor is yours.