

Erkki Liikanen: The great recession and its long shadow – youth unemployment

Speech by Mr Erkki Liikanen, Governor of the Bank of Finland, at the University of Tartu, Tartu, 30 May 2012.

* * *

Unemployment to center of policy debate

The financial crisis has brought unemployment back to center of the policy debate in Europe and elsewhere. Almost 4 million jobs were lost in the euro area since the start of the crisis in 2008, and employment still remains about 3 million workers below the pre-crisis level.

Differences in unemployment experiences and youth unemployment reflect shocks and institutions

The impressive aggregate figures mask large differences across countries and across worker groups. While some euro area countries have experienced dramatic increases in unemployment, in others the labour market adjustment has been milder than expected. On the one hand these differences reflect the different nature of shocks affecting individual countries. On the other hand, they reflect labour market institutions and policies in place in these countries.

The shocks and institutions are also behind the perhaps most worrisome manifestation of the crisis on the labour market, the rise of youth unemployment to record levels. It has risen to a half of the youth labour force (aged 15–24) in Spain and Greece and a third of the youth labour force in Ireland. In Estonia the youth unemployment rate stands at the current 25% (although peaking at 40% in 2010). However, at the same time some countries have experienced only moderate increases in the youth unemployment rate, and in Germany it has actually fallen to the current 8%.

Earlier debate on shocks and institutions relevant again

Looking at these recent developments, the debate on the interaction of shocks and institutions behind the rise and persistence of European unemployment seems highly relevant again.

The chief economist of the IMF, then a professor at MIT, Olivier Blanchard claimed in 2000 in his Harry Johnson lecture and his article with Justin Wolfers (Blanchard & Wolfers 2000), that to explain both the rise and cross country heterogeneity in European unemployment since the 1960s, the interaction between shocks and institutions is crucial.

Lars Ljungqvist and Thomas Sargent (1998) blamed the high European unemployment since the 1980s to welfare states' diminished ability to cope with more turbulent economic times, such as the ongoing restructuring from manufacturing to the service industry, adoption of new information technologies, and a rapidly changing international economy.

Assar Lindbeck and Dennis Snower (2001), in their insider-outsider theory, examine why labor markets are segmented into “good jobs” (with relatively high wages and high job security) and “bad jobs”. They also examined how various types of labor turnover costs give insiders their market power, how they use this power to their own advantage (e.g., in pushing up their wages), how the insiders' activities affect the outsiders and vice versa. They also assess, what this insider-outsider interaction implies for employment, unemployment, and other macroeconomic activities.

Discuss shocks and institutions behind the European youth unemployment

High costs for both individuals and society

Relevant in European countries fighting with deteriorating public finances, competitiveness and aging populations

Today, I will discuss the shocks and institutions behind the European youth unemployment problem. The relocation of unemployed young workers to new jobs is a key policy issue facing European policy makers, as prolonged unemployment at the start of the working career has substantial short and long term costs for both individuals and society. In addition to the immediate lost output, these costs may include loss of skills, lower productivity and wages and a permanent decrease in potential output (or increase in the NAIRU) in the years to come. These costs are especially relevant in Europe, where countries are fighting with deteriorating public finances, competitiveness issues and aging.

A well-functioning labour market improves the efficiency of monetary policy transmission

The functioning of the labour market also affects the economic environment in which monetary policy is conducted. A flexible and well functioning labour market improves the efficiency of monetary policy transmission, and provides an economic environment which facilitates price-stability oriented monetary policy of the ECB.

Why is youth unemployment generally higher than that of other age groups?

Youth unemployment has more than doubled in some countries

The rise of youth unemployment since the start of the crisis is stupefying. The euro area aggregate youth unemployment rate (i.e. 16–24 years old) exceeded 20% by the end of 2011.

In some countries, however, youth unemployment has more than doubled during the crisis. In Spain it has risen from 19% to 51%, in Greece from 23% to 50% and in Ireland from 9% to 31% and in Estonia from 7% to the current 25% (although it peaked at 40% in 2010q1). Although less dramatic, the rise in youth unemployment in Italy and Portugal has been considerable.

However, at the same time some countries have experienced only moderate increases in the youth unemployment rate, and in Germany it has actually fallen from 11% to 8%.

Youth unemployment is high over the cycle also a structural issue

Youth unemployment is higher than unemployment for other age groups also over the business cycle. On average, it is more than double the overall unemployment rate for euro area countries. In Italy and Sweden it is more than three times higher than the overall unemployment rate. We have seen a strong rise in youth unemployment during the crisis, but it is also a structural issue. Policy measures must be designed accordingly.

Young workers as labour buffers

Young people are more vulnerable on the labour market than other age groups and they are also easily used as labour buffers when employers adjust their work force. Reasons for high youth unemployment lie in the properties of young workers relative to older workers, in habits and common practices in the labour market as well as in labour market institutions.

As to getting hired and being laid off, young workers have a disadvantage relative to their older colleagues. They have limited or no work experience and in particular they have little firm-specific skills. The unemployment rate of labour market entrants tends to be high due to frictions in the transition from education to work (e.g. inexperienced in job search). Often

young workers have temporary contracts, and they are subject to last-in-first-out rules when personnel reductions take place.

Labour market institutions that differentiate across worker groups often penalize youth. In particular, dual employment protection legislation (firing costs) that depends on employment duration (e.g. Italy, Spain) is commonly seen as an important factor behind the spectacular rise in youth unemployment during the crisis in e.g. Spain. The ease of ending temporary contracts relative to permanent ones has led to a situation where young workers on temporary contracts can be laid off without costs, while older workers on permanent contracts have largely kept their jobs.

The youth are also typically overrepresented in cyclically sensitive sectors such as construction, which also reflects dual labour market institutions in European countries.

Sectoral shocks from the crisis have hit hard on the young

Collapse of construction sector in Spain, Ireland and Estonia massive job destruction

The rise in unemployment and youth unemployment has been strongest in the countries where imbalances, a booming construction sector or accumulated loss in competitiveness, have been prominent before the crisis.

In the run-up to the crisis, the construction sector absorbed a large share of the workforce, and young people were overrepresented in this growing sector. For instance in Spain, dropping out from studies to work on the construction sites was a large scale phenomenon. The subsequent collapse of the overheated construction sector in Spain, Ireland and Estonia, lead to a massive loss of jobs. In Ireland and Spain, the construction sector accounts for around 50%, of the overall employment contraction. Relative to the peak of the cycle, the Spanish construction sector has lost 1.1 million jobs, and the Irish equivalent 160,000 jobs. These jobs focused particularly on the young because in these countries the construction sector employed an especially large number of young people.

Industry accounted for the bulk of the employment decline in Slovakia, Slovenia and Italy although the number of jobs in this sector also decreased markedly in Estonia and Spain.

Temporary export shock in Germany and Finland labour hoarding by adjusting working time

In contrast, in Germany and Finland the crisis was felt mainly through the export sector while domestic demand remained relatively robust. The downturn in international trade was rather short, which made it possible for firms to focus also in the availability of labour in the future. Labour hoarding, by adjusting hours of work rather than the number of workers, moderated the rise in unemployment. Unlike in the construction sector, the loss of jobs in the export sector was not particularly focused on the young, as the proportion of young people in the manufacturing is approximately the same as their share in the work force as a whole.

Property bubble and a credit crunch lead to more domestic disturbances, more permanent restructuring than temporary export shock

The source of the shock has been an important factor for the labour market consequences. The export shock during the initial quarters of the crisis was temporary and hence firms could retain workers in anticipation of the trade recovery. The bursting property bubble and a credit crunch lead to more domestic disturbances, more permanent restructuring and uncertainty so that firms are more reluctant and less able to retain staff.

Sectoral shocks and reallocation

After the crisis, the need for alternative sources of employment has grown. In particular this is the case in countries such as Spain and Ireland, where the sectoral growth outlook for the hardest hit sector (construction) remains poor.

Relocation is a slow process

The relocation of surplus labour from permanently downsized sectors to more resilient ones with a better growth potential can be a slow process even in a growing economy. In the absence of robust growth this is an even more daunting endeavor. In Spain, it is made more difficult by the low educational level of a part of the young people, as during the upswing many abandoned their education to work on the building sites.

In manufacturing, too, there is pressure for reallocation. Already before the crisis, the employment trend in Europe has been downwards for an extended period. The EU27 area has lost 5.8 million manufacturing jobs since the year 2000. This persistent weakness on the labour market and the slow relocation of labour into potential growth sectors is harmful to both labour productivity and labour supply. The loss of young people's labour input, in particular, will have long-lasting consequences.

Restructuring is a factor behind the perhaps strikingly large and persistent employment consequences of deep recessions

Implies mismatches evidenced by outward shifts of Beveridge curves

As Reinhart and Rogoff (2009) point out, restructuring during deep recessions is a factor behind the large and persistent employment consequences of deep recessions. The need for relocating unemployed workers to different sectors of the economy implies mismatches on the labour market that will make unemployment more persistent in the years to come. These mismatches are already manifested by an outward shift of the euro area Beveridge curve and by outward shifts of the Beveridge curve in countries most severely hit by sectoral shocks.^{1,2}

Failure to reallocate young workers would lead to a lost generation

Given the magnitude of the youth unemployment problem, European economies cannot afford to fail in relocating the unemployed young workers to new jobs. Failure in this task would imply a lost generation and all the individual and macroeconomic costs that follow with it.

Dual labour markets place young people in the frontline in a recession

In many countries specific worker groups are affected by labour market institutions in different ways. This certainly applies to employment protection legislation. Since the implementation of labour market reforms in the 1980's, efforts have been made to increase

¹ Bonthuis, Jarvis & Vanhala (2012) find a significant shift in the euro area Beveridge Curve since the onset of the crisis, but considerable heterogeneity at the country level. At the extremes, country level differences include a significant outward shift in the Beveridge Curve for Spain, an inward shift for Germany.

² The Beveridge curve is widely used to describe the cyclical state of the labour market and the efficiency of the labour market in terms of matching unemployed workers to job vacancies. It traces a negative relationship between unemployment and vacancy rates over the course of a business cycle, tracing the evolution of the economy from expansionary phases (leading to lower unemployment and higher vacancies) to contractions in activity (with higher unemployment and lower vacancies). Shifts in the Beveridge curve are of particular interest in times of crisis, since they are suggestive of structural changes in the unemployment-vacancy relationship.

labour market flexibility in European economies. The reforms were targeted at reducing the high and persistent structural unemployment rates in European countries, and to ease the relocation of labour from stagnant sectors of the economy to sectors with growth potential.

Partial reforms focused on more flexible use of temporary employment contracts

These partial reforms, however, focused primarily on more flexible use of fixed-term employment contracts. Carrying through these reforms was easier politically than changing the conditions applied to permanent employment contracts (eg diluting employment protection). This created a dual labour market in many European countries, not only in Spain, but also in France, Italy, Portugal (and Sweden).

Relative position of fixed-term (typically young) employees has weakened

As the labour market has split in two, the position of fixed-term, often young employees has weakened relative to permanent (typically older) workers. The reforms have liberalised regulations concerning the use of temporary contracts, while the conditions for permanent contracts have been left literally unchanged. The use of temporary contracts had earlier been restricted to e.g. seasonal work in agriculture, tourism, and construction, but after the reforms they could be used more easily for regular activities.

Differences in severance payments between fixed-term and permanent employment contracts have grown, and in some cases there are no severance payments related to the termination of temporary contracts. Temporary contracts can typically not be contested in labour courts.

Use of temporary contracts has become more widespread has particularly affected the position of young people, as fixed-term employment contracts are common among the young

Consequently the use of temporary contracts has become more general with these labour market reforms, but there are large cross-country differences. In Spain the proportion of temporary workers of all workers was about 30% before the crisis (in 2007), in Portugal it was 22% and in France 15%. These differences are in part explained by differences in severance payments. For example, severance payments for permanent workers in Spain are much higher, and the regulations concerning the use of temporary contracts much laxer than in France.

The trend towards dual labour markets has particularly affected the position of young people, as fixed term employment contracts are common among the young. In France, Sweden and Spain over 50% of employment contracts for young people are fixed-term.

Dualism has directed the employment shocks especially to fixed-term workers and, by extension, young people

During the crisis the rise in unemployment has been strong particularly in southern European countries. The dualism in labour markets has directed the employment shocks especially to fixed-term workers and, by extension, young people. In Spain, 88% of layoffs has been focused on temporary contracts, and thus strongly on young workers.

The key problems of duality

A key problem in dual labour markets is that temporary contracts do not work as a “springboard” to more stable employment relationships. The transition from temporary contracts to permanent ones is low, and workers find themselves in a vicious circle of temporary jobs, including recurring spells of unemployment.

The problem lies in the large gap in firing costs between permanent and temporary jobs, and in the discrete jump in the cost

The problem lies in the large gap in firing costs between permanent and temporary jobs, and in the jump in the firing cost when a temporary contract is converted to permanent one. In addition, lax regulations concerning the use of temporary contracts worsen the situation.

Threshold to regularize a worker is high

For the employer there is a large step in the potential firing cost when converting a temporary contract to a permanent one, and therefore the threshold to regularize a worker is high. In particular, this is the case when regulations concerning the use of temporary contracts are lax. Temporary contracts will be renewed or the workers will be changed to avoid paying the firing cost. This has often been the case in recent years in e.g. Spain.

The consequences of high and persistent youth unemployment

The relocation of the unemployed youth to new jobs is a pressing issue, as prolonged unemployment at the start of the working career has substantial short and long term costs both for individuals and for the society.

Unemployment at the start of the working life can cast a long in terms of wages, productivity and employment

At the individual level, unemployment at the start of the working life can cast a long shadow over the working career. Wages and productivity are deteriorated by the reduced early career work experience that is caused by unemployment. In addition, a vicious circle of fixed-term contracts influences productivity due to weaker incentives for both employers and employees themselves to invest in the training. Weak labour force attachment also raises the risk of exclusion and poverty.

At the macro level, the costs include foregone output, higher social security outlays and lower level of potential output and overall welfare

At the macro level, the immediate cost of youth unemployment is lost output and social costs. Still more important are the macro level long term costs. Weak labour productivity evolution at the individual level accumulates to a lower level of potential output (or increase in the NAIRU) and overall welfare in an economy.

The costs of prolonged unemployment, weak labour market attachment, exclusion, including costs related to higher criminality and worse health outcomes, build a heavy long term burden on public finances.

Highly relevant in the current European context, where countries are fighting with deteriorating public finances, competitiveness issues and aging populations

These costs are especially relevant in the current European context, where countries are fighting with deteriorating public finances, competitiveness issues and aging populations.

The functioning of the labour market also affects the economic environment in which monetary policy is conducted

The functioning of the labour market also affects the economic environment in which monetary policy is conducted. A flexible and well functioning labour market improves the efficiency of monetary policy transmission, and provides an economic environment which facilitates price-stability oriented monetary policy of the ECB.

What can be done about youth unemployment?

The structurally high youth unemployment and its spectacular rise during the crisis can be explained by the properties of young workers relative to older workers, the institutions that govern the educational system and the labor markets, as well as the nature of the shocks during the crisis.

May not always be meaningful to focus policy measures on the youth in particular

If the consequences of youth unemployment are considered more serious than those of other age groups, it may be justified to focus measures particularly on the youth. At the same time many measures aimed at lowering unemployment in general, affect the young unemployed more than other age groups. This is why often general measures to lower unemployment are most important for the young unemployed. They can be complemented but not replaced by specific measures which focus only on the young.

We can assess the youth unemployment also from the viewpoint of the supply and demand of the labour input of young workers, as well as mismatch problems and issues of specificity. We must also keep in mind structural as well as cyclical aspects of high youth unemployment.

(i) Labour supply

The value of alternative activity relative to job search and employment...

For the labour supply a key determinant, in addition to wages, is the value of alternative activity relative to job search and working. Labour market institutions and the educational system have a central role in determining the value of alternative activities and thus the supply of labour. In the long run labour supply determines the potential output of an economy. This is especially relevant with ageing populations.

Unemployment insurance reforms should activate workers and avoid income traps

Generous and long lasting unemployment insurance policies are criticized for their passivating effect on job search. For this reason many countries (e.g. Germany) have recently adopted policies aiming at activating workers. The measures include reducing overall the level and duration of unemployment benefits, tightening the rules of accepting job offers, at the risk of reduced or losing benefits, responsibility of job search, and means tested benefits.

Social security systems frequently have unintended effects, such as “income traps” where it is not worth accepting a job low wage or short term job for a worker. This is because the rise in earned income leads to a larger drop in social benefits. Effectively this implies a marginal tax rate of over 100%, which reduces labour supply. Measures that allow for some earnings before losing social benefits have been implemented for example in the German Hartz reforms.

Return to education in bad times may be rational

In recessions young workers exit the labour force more than other age groups. In many cases the young return to education, which may be a rational choice considering the lower opportunity cost of studying (expected value of job search is lower). Also a higher educational level improves labour market prospects for the worker. Promoting transitions to education by increasing temporarily the number students may be optimal from the society’s perspective as well, as the opportunity cost in terms of lost output is lower in a recession.³

³ This view has been advocated by the 2010 Nobel laureate Christopher Pissarides.

(ii) Labour demand

The demand for young workers may be associated with both cyclical and structural elements. When unemployment and youth unemployment is due to a cyclical weakness in aggregate demand, unemployment is involuntary (and supply policies may be relatively weak).

In recent years, efforts to sustain aggregate demand have been implemented through expansive fiscal policies. In the longer term this is not sustainable due to public finance constraints. Fiscal stimulus may also not address the underlying structural problems, such as the reduced competitiveness or the structural change needed in the economy.

A part of the job losses are permanent

During the crisis the level of output has dropped to a lower level in many countries, and part of the job losses are permanent. This means that a recovery will not necessarily bring back the lost jobs. It is possible that labour costs must fall, to bring employment back to its pre-crisis level.

The productivity of a worker and the cost of labour determine its demand

In the longer term the key factors for labour demand are the productivity of a worker and the price of labour, namely, the costs that accrue to the employer from a worker. The wage is, of course, an essential part of the costs, but the employer also bears other wage related costs, possible training, search and firing costs.

Wage formation that leads to a wage distribution that is more compressed than the productivity distribution, tends to weaken young workers employment.

The price of a labour is the wage. The productivity of young workers is often lower than that of older ones, but wages do not always fully reflect this productivity difference. If personnel reductions are focused on those for whom the productivity-wage difference (profitability) is the lowest, the reductions will primarily be on the young workers.

Overall, wage formation that leads to a wage distribution that is more compressed than the productivity distribution, tends to weaken young workers employment. A wage distribution that is narrower than the productivity distribution may be caused by a number of factors. These include aiming at wage inequality, wage bargaining institutions that represent the median worker or insider workers or minimum wages. A rapid rise in unit labour costs (wages that rise faster than productivity) may also endanger especially the jobs of the youth.

Many countries have reduced minimum wages for young workers

Minimum wages often concern the least educated and least productive workers, and often young people often fall into this category. Thus, the level of minimum wages is potentially important for the employment of young workers. In fact, many countries have reduced minimum wages for young workers, for example, 80% of the minimum wage. A reduced minimum wage is, however, meaningful only in countries where there is a significant share of workers working at the minimum wage (for example in France).

One wage related measure is to reduce the employers' social contributions to targeted groups, such as low-productivity workers (often young), to promote employment of young persons. This is on the other hand has to take into account the losses to public finances caused by the reduction and substitute them from other sources.

Apprenticeship places that pay a sub-minimum wage, and where the contracts include a training commitment from the employer, have been successful (e.g. in France).

Dual employment protection legislation weaken the position of the youth

Firing cost should be gradually increasing with the duration of employment relationship

Employment protection legislation often treats different categories of workers in different ways. Differences in redundancy costs of fixed-term and permanent employees are large in a number of countries. Fixed-term contracts are common, particularly among young workers and ideally they can act as a “bridge” to a permanent position. But the temporary contracts are in a weaker position relative to ongoing contracts, and layoffs have been concentrated on fixed-term contracts. So young people are in general in a weaker position due to their over-representation in these contracts. For fixed-term contracts to be converted into permanent ones more frequently, the threshold for converting should become lower. A proposed solution has been that the firing cost would be gradually increasing with the duration of employment relationship (e.g. Bentolila et al. 2011). Then a large jump in the firing cost when continuing the employment relationship, would be avoided.

(iii) Mismatch and reallocation

The recovery in European economies and the success in reallocating the surplus labour from permanently downsized sectors to more resilient ones are intertwined and will determine the economic fortunes of European economies in the years to come.

If there is a problem of mismatch, a recovery or expansionary policies will not likely lower such structural unemployment

Indeed, understanding the nature of euro area unemployment has important policy implications. When unemployment is cyclical and due to a lack of job creation, a pick-up in economic growth or expansionary policies will tend to reduce unemployment. However, when there is a mismatch between job vacancies and available workers, a recovery in growth or expansionary policies will not affect such structural unemployment much.

Mismatch calls for measures that improve matching efficiency, along with adjustment in workers skills and adjustment in relative wages

This calls for measures that improve matching efficiency in European labour markets, along with adjustment in workers skills and adjustment in relative wages.

The transition from education to work is an important point of friction. According to the OECD job search programmes have proved to be successful and cost efficient in employing the youth who are employable.

Youth unemployment tends to be the highest for the least educated. Sufficient education, or lack of it, is crucial in determining labour market outcomes of young people. Completing basic education and obtaining a secondary degree are a minimum requirement for a young person to obtain and retain a job, as well as to being able to learn in a job. Especially for marginalized youth, education outside of the class room has been successful, so that the youth are continuously exposed to a work environment and accumulate experience. German style apprenticeship programs have been found to pave the way from education to working life.

Wages provide incentives

Wages provide incentives. The relative wages of different occupations should reflect demand and supply conditions and direct young workers to those sectors and occupations where work is available.

Is the “German labour market miracle” a textbook example of successful reforms?

In Germany both unemployment and youth unemployment have continued during the crisis, now the unemployment rate being at its lowest rate in two decades, at 6% and youth unemployment at 8.5%.

Although this impressive evolution of unemployment and youth unemployment is in part due to better economic development than in other euro area countries, the German labor market institutions play a role. The target of the German labor market institutions and reforms has not been the youth only, but because the youth are at “the margin”, meaning that changes in unemployment affect them more than proportionately, the general labour market reforms have successfully also reduced youth unemployment. The key institutions and reforms in Germany are the Hartz reforms (2003–2005), wage moderation, the “Kurzarbeit” short time working scheme, and the apprenticeship vocational training programme. All of these include elements that promote the fall in youth unemployment.

Hartz reforms aimed at both labour supply and demand

The Hartz reforms included a number of measures aiming at both labour supply and demand. By tightening the eligibility of and reducing the duration and level of unemployment benefits, as well as with different types of low-wage jobs and wage subsidies the German government aimed at activating unemployed workers. Labor market regulations were reduced, by altering employment protection and the rules for temporary contracts. Opening clauses to labour contracts were introduced, to bring flexibility in times of trouble. These concern flexibility of working time and wages.

Wages have grown moderately

Wages have grown moderately in recent years in Germany, which has contributed to the fall in unemployment. The increase in low-wage jobs has in part supported the employment of low productivity workers, often the young.

“Kurzarbeit” has had a positive employment effect during the crisis beneficial especially for the employment of workers on permanent contracts, typically older workers

Whereas labour input adjustment has been made through the reduction of (temporary) workers in many countries, in Germany the adjustment has been made largely in hours per worker with the so called “Kurzarbeit” short time working scheme. In this programme, firms temporarily reduce the hours of their workers and the loss in wages is partly compensated by the public funds. This short time working scheme has had a positive employment effect during the crisis.

Short time working arrangements may amplify insider-outsider problems in the German labour market

The Kurzarbeit programme has, however, been beneficial especially for the employment of workers on permanent contracts, typically older workers. For temporary workers the effects have been smaller (Hijzen & Venn 2010). Thus the short time working arrangements may amplify insider-outsider problems in the German labour market. Until now the positive economic development of the German economy has kept this hidden.

A short-term vs. long term tradeoff: current employment vs. restructuring

The short time working schemes may also involve a short-term vs. long term tradeoff. Although these schemes have been successful in mitigating the rise in unemployment, they may also hinder the reallocation of labour across sectors of the economy. If this is the case, the short term benefits of higher employment may come at the cost a harder need for restructuring later.

Apprenticeships have served well to lead youth to jobs

In Germany vocational training is based on apprenticeships. About a quarter of employers offer apprenticeship training. Those in vocational training typically spend approximately 3 days a week in firms as part-time employees for 2–4 years. The costs of apprenticeship training are borne by the firms and the public sector. It is commonplace that apprenticeship places are converted into employment relationships at the end of the training period.

The export-driven German manufacturing economy may be especially well suited for a system of apprenticeships, for services it might be less suitable. The Netherlands and Austria have similar experiences from apprenticeships as Germany.

Monetary policy and the functioning of the labour market

The primary goal of the Eurosystem monetary policy is price stability. The monetary policy stance of the ECB is focused on the euro area and the primary objective of the ECB Governing Council remains to maintain price stability over the medium term. This is the best contribution of monetary policy to fostering growth and job creation in the euro area.

Having said this, it should be noted that the functioning of the labour market and monetary policy are tightly intertwined. To make this point, one can think of the following examples:

The functioning of the labour market affects the economic environment in which monetary policy is conducted

The functioning of the labour market affects the economic environment in which monetary policy is conducted. An inefficiently allocated labour force lowers the potential output of an economy and in the short run it limits the rate at which the economy can grow without generating inflationary pressures. Reforms that increase labour market flexibility in such a way that the job matching process becomes more efficient should temporarily increase the potential growth rate of the euro area economy until a higher employment rate is reached.

A greater matching efficiency of euro area labour markets and a higher wage flexibility should speed up the adjustment of wages and prices to monetary policy actions. This should reduce the short-run effects of monetary policy on the real economy. This improved short term inflation/growth trade-off would facilitate the conduct of the stability oriented monetary policy of the ECB.

Matching inefficiencies might lead to wage increases in excess of labour productivity growth, thus triggering inflationary pressures

Bottlenecks in the labour market resulting from matching inefficiencies might also lead to general wage increases in excess of labour productivity growth, thus triggering inflationary pressures.

Pressures on wages and wage dispersion, as well as inflation pressures may arise even in the presence of high aggregate unemployment

At first glimpse, this point may seem irrelevant in the current situation where there is an abundance of unemployed workers. However, the uneven sectoral developments and the composition of the unemployment pool (workers from downsizing sectors, long term unemployed) may lead to an environment where excess demand and supply of labour coincide. Sectors and occupations experiencing labour shortages will exert high wage demands even in the presence of high aggregate unemployment. Consequently, pressures on wages and wage dispersion, as well as inflation pressures may arise even in the presence of high aggregate unemployment.

Also the labour market institutions in many European countries have produced an insider-outsider divide between workers (permanent contract older workers/temporary contract

young workers) where insiders may make high demands when outsiders are being laid off at the same time.

Conclusion

Shocks and institutions have piled employment adjustment pressures especially on the young

The interaction of shocks and institutions behind the rise and persistence of European unemployment received a lot of attention in economic research and policy debate at the turn of the millennium.⁴ Now the financial crisis has brought unemployment back to center of the European policy debate. Shocks and institutions have piled employment adjustment pressures especially on the young, and youth unemployment has risen to record levels.

If youth unemployment remains persistently high, the risk of structural unemployment (and exclusion) increases, because nothing converts cyclical unemployment to structural unemployment more efficiently than prolonged spells of unemployment.

The relocation of the unemployed youth to new jobs is a pressing issue

The relocation of the unemployed youth to new jobs is a pressing issue, as prolonged unemployment at the start of the working career has substantial long term costs for both individuals and society as a whole. Labour market institutions and policies should take this challenge seriously.

Labour market institutions in many European countries are slowing down the process of economic restructuring

In their present form, the labour market institutions in many European countries are slowing down the process of economic restructuring and hampering the pace of employee allocation between sectors. High and persistent unemployment makes fiscal consolidation more challenging, and hampers the monetary transmission mechanism.

Labour market institutions and reforms should avoid partiality

Labour market segmentation tends to amplify employment adjustment disproportionately for some groups, like young workers. Therefore labour market institutions and reforms should avoid partiality, ie. large differentiation across worker groups. The focus should be on comprehensive reforms that lower average labour adjustment costs across the whole economy instead.

Reforms that promote restructuring and reduce segmentation will pay off in the future in terms of competitiveness, potential output, welfare and public finances

The functioning of the labour market will be an important determinant for the speed or the recovery of European economies. Reforms that promote restructuring and reduce segmentation will pay off in the future in terms of competitiveness, potential output, welfare and public finances.

Thank you for your attention.

⁴ See e.g. Blanchard & Wolfers (2000) and Ljungqvist & Sargent (1998).

References

Bentolila, Samuel, Juan José Dolado and Juan F. Jimeno. 2011. "Reforming an Insider-Outsider Labor Market: The Spanish Experience", IZA Discussion Papers 6186.

Blanchard, Olivier and Justin Wolfers. 2000. "The Role of Shocks and Institutions in the Rise of European Unemployment: The Aggregate Evidence". *The Economic Journal*, Vol. 110, No. 462, C1–C33.

Bonthuis, Boele, Valerie Jarvis and Juuso Vanhala. 2012. "What's going on behind the euro area Beveridge Curve?" mimeo. Available at http://www.suomenpankki.fi/en/suomen_pankki/organisaatio/asiantuntijoita/Pages/vanhala_juuso.aspx

Hijzen, A ja D. Venn. 2010. "The role of short-time work schemes during the 2008–08 recession", OECD WP 115.

Karjanlahti, Kristiina and Juuso Vanhala. 2012. "Nuorisotyöttömyyden nousu duaalisilla työmarkkinoilla" BoF Online X/2012.

Lindbeck, Assar and Dennis J. Snower. 2001. "Insiders versus Outsiders", *The Journal of Economic Perspectives*, Vol. 15, No. 1, 165–188.

Ljungqvist, Lars and Thomas J. Sargent. 1998. "The European Unemployment Dilemma" *Journal of Political Economy*, Vol. 106, No. 3, 514–550

Pissarides, Christopher A. 2011. "Regular education as a tool of counter-cyclical employment policy". *Nordic Economic Policy Review*, 1/2011, 209–232.

Reinhart, C.M., and K.S. Rogoff. 2009. "The Aftermath of Financial Crises". *American Economic Review*, 99(2): 466–72.