Labour market institutions and macroeconomic adjustment during the Great Recession

Juan F. Jimeno*
Banco de España

Paris, December 3, 2015

*The views expressed in this presentation are solely mine, and, therefore, do not necessarily reflect those of the Banco de España or the Eurosystem.
Outline

• Facts
  – Unemployment: Unbearably high and unbearably divergent (across countries/population groups)
  – Income and earnings inequalities: Increasing

• Lessons on the importance of LMIs
  – Evidence on shocks vs. institutions during the Great Recession
  – LMIs and firms’ responses to shocks (WDN3 Dataset)

• Looking ahead:
  – Towards Persistent Stagnation?
  – Which reforms should be implemented
  – Political Economy: How to promote reforms (and how not)
Outline

• Facts
  – Unemployment: Unbearably high and unbearably divergent (also across population groups)
  – Income and earnings inequalities: Increasing

• Lessons on the importance of LMIs
• Looking ahead
Unemployment rates in the EU, EA, Japan and the US

Unbearably high
This time was different

Labor Force Participation rate (population 15-64 years old. %)

Recession United States European Union 21
Unbearably divergent
Chart 1. Unemployment rates (%) in EU countries
Chart 1. Unemployment rates (%) in EU countries
Chart 1. Unemployment rates (%) in EU countries
## Youth and Total unemployment rates (st. dev. across countries)

<table>
<thead>
<tr>
<th></th>
<th>Euro-zone</th>
<th></th>
<th></th>
<th>EU</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Youth (15-24)</td>
<td>Total (15-64)</td>
<td></td>
<td>Youth (15-24)</td>
<td>Total (15-64)</td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td>21.3</td>
<td>13.1</td>
<td>10.5</td>
<td>5.7</td>
<td>20.5</td>
<td>11.7</td>
</tr>
<tr>
<td>2000</td>
<td>14.7</td>
<td>10.0</td>
<td>7.2</td>
<td>3.9</td>
<td>17.9</td>
<td>10.1</td>
</tr>
<tr>
<td>2005</td>
<td>17.0</td>
<td>5.6</td>
<td>7.6</td>
<td>2.3</td>
<td>18.6</td>
<td>6.9</td>
</tr>
<tr>
<td>2010</td>
<td>20.4</td>
<td>9.4</td>
<td>9.0</td>
<td>4.2</td>
<td>23.2</td>
<td>8.8</td>
</tr>
<tr>
<td>2014</td>
<td>25.6</td>
<td>13.5</td>
<td>11.4</td>
<td>6.1</td>
<td>24.5</td>
<td>12.0</td>
</tr>
<tr>
<td>Regional dispersion of youth unemployment</td>
<td>2007</td>
<td>2013</td>
<td>Variation</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>-----------------------------------------</td>
<td>------</td>
<td>------</td>
<td>-----------</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EU regions (NUTS-2 level)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gini index</td>
<td>29%</td>
<td>37%</td>
<td>28%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Theil index (total)</td>
<td>13%</td>
<td>21%</td>
<td>58%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Theil within</td>
<td>7%</td>
<td>4%</td>
<td>-48%</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Theil between</td>
<td>8%</td>
<td>18%</td>
<td>135%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Standard deviation of ur across 5-year age groups X gender

Graphs by Country
ur_stdev: Standard deviation of ur across 5-year age groups X gender

ur_total: Aggregate ur

Graphs by Time
**Figure 5.3.** Labour income inequality is the main contributor to the dispersion in household market income

Contributions to the concentration coefficient of market income, working age population, in the late 2000s

Note: Contributions to overall household market income inequality are derived by multiplying the concentration coefficients of each income source by their weight in total market income. The data for Greece, Hungary, Mexico and Turkey are net of taxes. Data for France and Ireland refer to the mid-2000s.

Source: OECD Income Distribution and Poverty, OECD Social Expenditure Statistics (Database).

StatLink: http://dx.doi.org/10.1787/888932566516
Chart 27: Changes in market income and disposable income inequalities (2008–12), Gini index

Source: OECD, income sources database.

Note: Year refers to SILC production year and not reference year. 2008 data not available for SE, DE, IT, FR, IT. 2012 data not available for BE. No data for Hungary.
Outline

• Facts

• Lessons on the importance of LMIs
  – Evidence on shocks vs. institutions during the Great Recession
  – LMIs and firms’ responses to shocks (WDN3 Dataset)

• Looking ahead
Facts pointing to institutions

• Participation is largely driven by institutions (retirement, part-time, family reconciliation)
• Institutions differ across rather than within countries and heterogeneity is driven by increased difference in national (as opposed to regional) unemployment rates
• Only about 50% of differences in unemployment variation during the crisis can be accounted for by size of the output fall
• Worker flows in the EU during the Great Recession (Casado, Fernández-Vidaurreta and Jimeno, 2015)
Worker flows during the Great Recession
(Casado, Fernandez, Jimeno 2015)

Changes in the probability of transiting between employment and unemployment between 2007 and 2012 for people of different ages, genders and education levels in various European countries

(annual flows in percentage points)
Worker flows during the Great Recession
(Casado, Fernandez, Jimeno 2015)

Changes in the probability of transiting between employment and unemployment between 2007 and 2012 for people of different ages, genders and education levels in various European countries

(annual flows in percentage points)
Worker flows during the Great Recession (Casado, Fernandez, Jimeno 2015)

Changes in the probability of transiting between employment and unemployment between 2007 and 2012 for people of different ages, genders and education levels in various European countries

(annual flows in percentage points)
Facts pointing to institutions (Casado, Fernandez, Jimeno (2015))

Figure 8: EFFECTS OF LABOUR MARKET INSTITUTIONS

Figure 8a: Employment Protection Legislation on HEU

Figure 8b: Employment Protection Legislation on HUE

Note: Each blue (red) dot represents the effect of the institution on the probability of leaving employment to unemployment (unemployment to employment). Employment protection legislation on temporary contracts is constructed as (S-strictness of EPL on temporary contracts) so it should be interpreted as the easiness to use them. Both indexes enter in the estimation in terms of deviations to the cross country means. Besides, in this case, both measures of EPL plus the interaction term enter in the estimation simultaneously.
Facts pointing to institutions: Learning from the Outliers

Figure 8 (cont): EFFECTS OF LABOUR MARKET INSTITUTIONS

Figure 8c: Replacement Ratio on HEU

Figure 8d: Replacement Ratio on HUE

Initial net replacement ratio

Note: Each blue (red) dot represents the effect of the institution on the probability of flowing from employment to unemployment (unemployment to employment).
Facts pointing to institutions: Learning from the Outliers

Figure 8 (cont): EFFECTS OF LABOUR MARKET INSTITUTIONS

Figure 8a: Expenditure per unemployed on HEU

Expenditure in ALMP per unemployed

Figure 8b: Expenditure per unemployed on HUE

Expenditure in ALMP per unemployed

Note: Each blue (red) dot represents the effect of the institution on the probability of flowing from employment to unemployment (unemployment to employment).
Okun’s law

\[ y = -36.524x + 4.2185 \]
\[ R^2 = 0.513 \]
WDN3 Dataset

\[ y = 0.1212x - 0.3219 \]

\[ R^2 = 0.579 \]
Deviations from Okun’s relationship, 2010-2013
(IV estimation, instruments: WDN3 shocks)
Facts pointing to institutions: Learning from the Outliers

**Germany**
- Adjustment along hours, wages and non-participation margins
- Short-time work. working accounts and mini(multiple)-jobs operating along intensive margin
- Collective. but decentralized bargaining allowing to trade wage reductions with less layoffs
- No increase in retirement age

**Spain**
- Adjustment only along one margin: temporary employment

Source: INE, Labor Force Survey.
Probability of reducing wages (base and flexible component) after being hit by a negative demand shock, 2010-2014
Probability of reducing employment (permanent, temporary) and working hours per employee after being hit by a negative demand shock, 2010-2014
Probability of reducing wages (base and flexible component) after being hit by a negative demand shock and suffering problems of access to finance, 2010-2014
Probability of reducing wages (base and flexible component) after being hit by a negative demand shock and suffering problems of access to finance, 2010-2014
Summary: Facts and lessons

• Different labour market institutions imply different labour response to output shocks. Look at interactions between shocks and institutions.

• Good to have institutions allowing for adjustment along several margins, not just (temporary) employment

• Need for micro rather than macro wage flexibility. Refinancing problems accommodated with wage reductions (borrowing from workers) but it is demand shock to be behind job destruction
Summary: Should LMIs be adjusted over the cycle?

• Case for rule-based countercyclical unemployment benefits

• Reforms of employment protection under recessions increase job losses with limited effects on job creation

• Increasing retirement age during downturns may increase youth unemployment
Outline

• Facts

• Lessons on the importance of LMIs

• Looking ahead
  – Towards Persistent Stagnation?
  – Which reforms should be implemented
  – Political Economy: How to promote reforms (and how not)
Towards Persistent Stagnation?

• Structural trends: Decline in working-age population. increasing weight of retired population and low productivity growth...
• Legacy of the crisis: Overaccumulation of debt

• More likely to fall into deflation. liquidity/stagnation traps
• Little margin for stabilisation by macro policies (monetary and fiscal)
• Urgent need to increase productivity growth
Population 20-64 years of age (5-year growth rate)

- World
- Europe
- Eastern Europe
- Northern Europe
- Southern Europe
- Western Europe
Population over 65 years of age/Population 20-64 years of age
Five Presidents’ report:

“Sustainable convergence also requires a broader set of policies that come under the heading of structural reforms. i.e. reforms geared at modernising economies to achieve more growth and jobs. That means both more efficient labour and product markets and stronger public institutions”
Five Presidents’ report:

In Stage 1 (2015-2017): “Converge towards the best practices in Europe. building upon and further strengthening the current governance framework”

- A euro system of Competitiveness Authorities
- A stronger Macroeconomic Imbalance Procedure
- A stronger focus on employment and social performance
- A stronger coordination of economic policies

In Stage 2 (after June 2017): “Set of commonly agreed standards with a legal character”

A sense of déjà vu
What went wrong in Europe

- **Fiscal policy co-ordination** not allowing for gradual consolidation to countries undergoing a major recession. Automatic stabilizers could not operate.

- **EU Conditionality** imposing reforms that may backfire during recessions and missing other important reforms. Limited learning from the «European lab» (best practices).
Bad Conditionality

• When not bad advice. bad implementation
• Reductions in layoff costs rather than changing contract rules for new hires to address dualism
• Forced declines in the coverage of unemployment and health benefits. and collective bargaining
• Imposition of aggregate wage reductions (cuts to minimum wages) rather than changes in bargaining structures
• Imposed strong increase in retirement age
• Nothing on short-time work
Resistance to reforms

• Vested interests for the status quo
  – Mancur Olson (1965): Members of large groups do not act in accordance with a common interest unless motivated by personal gain (economic, social, etc.).
  – Long-run benefits versus short-run costs
  – Lack of recognition of structural problems: “someone else’s fault”
  – Lack of recognition of common interests (social cohesion, inequalities, country size)
  – Lack of trust (within and across countries)

• In the EMU:
  – Spillovers and Synergies (Blanchard, Erceg, and Lindé. 2014; Arce, Hurtado and Thomas, 2015)
  – EU institutions have limited mandate to enforce structural reforms. Complexity (of processes and implementation rules). Bad incentives for National Governments (Banerji et al., 2015)
  – Bad conditionality. Lack of ownership by National Governments of reforms imposed from abroad (Boeri and Jimeno, 2015)
  – Labour market heterogeneity and diversity of economic and social arrangements across member countries (Thimann, 2015)
  – Rising Politicisation and the “European blame game” (Thimann, 2015)
Towards positive conditionality

- Empowering citizens rather than Governments
- Introducing complementary institutions at the EU level rather than abolishing national ones
- Access conditioned to adopting “best practice” institutions
- Risk-sharing and solidarity principles
- Targeting individuals rather than Govts. EU contribution to individual accounts. such as:
  1. European Equal Opportunity Contract
  2. European Unemployment Insurance Scheme
  3. NDC Pensions as automatic stabilizers
Equal opportunity contract

- New open-ended contract with tenure-related “optimal severance” and individual accounts (Austrian Fund and Italian new open-ended contract)
- European contributions (Structural Fund. European Social Fund) to the individual accounts of workers hired under the new contract
- Employers benefit from change in EPL and lower labor costs
- Workers benefit from more stability
- Both gain from more human capital investment on-the-job
European Unemployment Benefit

• Implement the European unemployment insurance scheme through the individual accounts of the workers hired under the best practice institutions.

• Dolls, Fuest, Neumann and Peichl (2014): with proper contingent and claw-back mechanisms, it does not need to imply substantial permanent transfers across countries, while preserving some redistributive and stabilization properties.
Pensions as stabilizers

- Defined contribution systems allow for some sustainable flexibility in retirement age
- Actuarially neutral reductions for those retiring earlier
- This flexibility can be used during deep recessions to reduce impact on unemployment and allow "cleansing effects" of recessions to operate
Final Remarks

• LMIs of some European countries deserve another round of reforms
• Productivity-enhancing structural reforms in the product and labour markets
• There is a need for a different approach at supranational European institutions in promoting these structural reforms
• Put the money where the mouth is. Invest in the new institutions to promote structural reforms