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MASS UNEMPLOYMENT: INTERNATIONAL EXPERIENCE AND LESSONS FOR POLICY

RICHARD JACKMAN

Centre for Economic Performance
London School of Economics
Houghton Street, London WC2A 2AE, UK

While variations across countries in the experience of mass unemployment have been extensively analysed, the even more striking variation over time is much less well understood. This paper argues that the capacity of a nation to maintain full employment by means of 'Keynesian' fiscal and monetary policies is constrained no longer so much by the need to contain inflationary pressures (where the wage setting arrangements of corporatist countries are an advantage) as by the growth of international trade and capital mobility. It is argued that traditional corporatist institutions are not well-suited to these developments. (JEL E24, E60)

1. Introduction

During the 1980s, many of the industrialised nations suffered higher and more sustained levels of unemployment than had been experienced at any time since the great slump of the 1930s. Table 1 sets out the experience of persistent mass unemployment, defined as an unemployment rate in excess of 10 per cent on the OECD definition sustained for at least four years, in OECD countries since 1945. The table lists seven cases of persistent mass unemployment, all but one (Canada) being European countries and, perhaps more remarkedly, all the episodes being during the 1980s. In this paper we will attempt to explain these patterns and examine their implications for policy to avoid mass unemployment.

To guard against the risk that the striking patterns noted in Table 1 are the product of the particular definition of mass unemployment adopted, Table 2 documents the experience of more persistent spells of high unemployment, that is of unemployment rates of over 7 per cent persisting for 6 years or more. There have been eleven such cases since 1945, all but three in Europe and none starting before mid-1970s. As a broad generalisation, it appears that the incidence of mass unemployment in recent years has been much more severe in Europe than in North America or in Japan, and within Europe has been more severe in the EC countries than in the Nordic countries, Austria or Switzerland.

Table 1. Persistent Mass Unemployment. OECD countries since 1945. Unemployment rates of 10 % or more for at least 4 years.

Country	Dates	Maximum %
Belgium	1981–87	12.6
Canada	1982–85	11.8
France	1985—88	10.5
Ireland	1982–	17.5
Netherlands	1982–85	12.0
Spain	1980–	21.4
UK	1982–87	12.5

Source: Layard *et al.* (1991, Annex 1.6)

Table 2. Persistent Unemployment. OECD countries since 1945. Unemployment rates of over 7 % for at least 6 years.

Country	Dates	Maximum %
Australia	1982–88	9.9
Belgium	1977–	12.6
Canada	1976–	11.8
Denmark	1980–	10.4
France	1981–	10.5
Ireland	1975–	17.5
Italy	1983–	7.9
Netherlands	1981–	12.0
Spain	1979–	21.4
UK	1981–88	12.5
USA	1980–85	9.5

Source: Layard *et al.* (1991, Annex 1.6)

Table 3. Unemployment in the Corporatist Countries. Worst experience.

Country	Dates	Minimum %	Maximum %
Austria	1982–	3.1	3.8
Denmark	1980–	7.0	10.4
Finland (1)	1977–79	5.8	7.2
(2)	1982–87	5.0	5.4
Norway	1988–	3.2	5.3
Sweden	1981–86	2.1	2.9
also			
Japan	1976–	2.0	2.8

Source: Layard *et al* (1991, Annex 1.6)

Table 4. International Cross-Section Equation for Unemployment. 20 OECD countries.

$$U = \underset{(0.1)}{0.24} + \underset{(2.9)}{0.92}\,BD + \underset{(7.1)}{0.17}\,RR$$

$$-\underset{(2.3)}{0.13}\,LMP + \underset{(2.4)}{2.45}\,UN$$

$$-\underset{(2.0)}{1.42}\,UCD - \underset{(2.9)}{4.28}\,ECD - \underset{(2.8)}{0.35}\,\Delta^2 P$$

$(N = 20 \;\; \bar{R}^2 = 0.91 \;\; s.e. = 1.41$

Source: Layard (1991, Table 10.3a).

- U – average unemployment rate (OECD definition) 1983–88
- BD – duration of unemployment benefit entitlement (years) (where benefits last indefinitely BD is set equal to 4)
- RR – replacement ratio (per cent)
- LMP – expenditure on active labour market policies (source: OECD, *Employment Outlook*, 1988, table 3.1)
- UN – union coverage (proportion of workers whose wages are determined by collective bargaining index 1 (low) – 3 (high)
- UCD – union coordination (index 1 (low) – 3 (high))
- ECD – employer coordination (index 1 (low) – 3 (high))
- $\Delta^2 P$ – change in inflation rate 1982–88 (percentage points)

These observations seem to fit the »revisionist» Calmfors-Driffill (1988) reinterpretation of Bruno and Sachs (1985 esp. ch. 11). It will be recalled that, in their analysis of the »worldwide stagflation» of the late 1970s, Bruno and Sachs had in particular noted the success of the »corporatist» economies in avoiding high unemployment. That success they attributed largely to the institution of centralised wage bargaining which allowed a co-ordinated and synchronised adjustment of money wage levels in response to macroeconomic shocks. In a decentralised system, uncoordinated and unsynchronised wage setting would lead to a situation where no one group or trade union would reduce its wage claim for fear that others would not follow. In the outcome, the group of workers would then suffer a cut in its real wage with no lessening of inflationary pressures in the economy as a whole. The economies to which the corporatist model most closely applies are the Nordic countries (Denmark, Finland, Norway and Sweden) and Austria. However, with respect to wage bargaining Japan also has some of the features of a centralised wage setting system by virtue of the synchronisation of wage claims and employer response in the »Shunto», or »Spring offensive». While there is no centralised bargain it is clear that there is considerable informal co-ordination on the side both of the unions and of the employers (see e.g. Gordon 1982).

The worst unemployment experiences of the corporatist countries, and of Japan, are recorded in Table 3. With the exception of Denmark there is no doubt that these worst experiences fall far short, in terms both of severity and persistence, of the experiences of other countries documented in Tables 1 and 2. To make matters more systematic, Table 4 records the results of a cross-section regression of the determinants of the average unemployment rate over the period 1983–88 (Layard, 1991). The union and employer co-ordination variables (UCD and ECD) are both negative and significant and between them make a substantial contribution to accounting for differences

in unemployment rates across OECD countries.

While by and large highly centralised countries have had good records in avoiding mass unemployment, the converse plainly does not follow: the most decentralised economies, in particular the United States clearly do not have the worst records. Calmfors and Driffill suggest that the relationship between the degree of centralisation of wage bargaining and unemployment may be hump-shaped, and suggest a model in which the equilibrium unemployment rate in both highly centralised and highly decentralised economies is low while in economies with an intermediate degree of centralisation the unemployment rate is higher. In fact, as an explanation of the relative flexibility of the American labour market the Calmfors-Driffill model is perhaps over-elaborate. Only about 10 per cent of private sector workers in the United States belong to unions, and, with a high degree of decentralisation on the employer side the American system comes closer to the textbook idea of a competitive market with wages set by supply and demand than to the European notion of wages determined by bargains between firms and workers.

Perhaps a simpler analytical framework is to think that, in wage bargaining, each union seeks to raise its relative wage. In a fully unionised economy, the outcome, of the attempt to raise relative wages is to raise unemployment, with of course no change in the relative wage of the representative group of works. The more powerful are the unions the higher will be the rate of unemployment. The rent-seeking activity of the unions which appears individually rational but ends up making everybody worse off can be seen as a form of »decentralisation externality» which can be internalised by the institution of centralised bargaining. The conclusion is that, in a decentralised system, union power raises unemployment, but where unions are powerful they may act together in a centralised way and where they do so unemployment rates will again be low (Layard *et al*, 1991 esp. ch. 2 part 6).

The regression equation quoted in Table 4 provides support for this interpretation, in that UN, the degree of unionisation measured by the proportion of the workforce whose wages are determined by collective bargaining, has a positive and significant impact on unemployment. The remaining variables in Table 4 refer to the benefit system (the length of time for which benefits are available and the replacement ratio) and expenditure on active labour market policies. For a fuller discussion see Layard *et al.* (1992 esp. pp. 48–56.)

While these institutional factors do appear to provide some insight into the differences between countries, in many respects the time series variation is more remarkable. Why is persistent mass unemployment an experience only of the 1980s? How did countries such as Britain, France or Belgium manage to maintain such low unemployment rates during the 1950s and 1960s? There were clearly major economic shocks during the 1950s, both external (e.g. the aftermath of the Korean War) and structural (the enormous decline in agricultural employment). Nor is there reason to believe that, on the supply side, markets were more flexible than they are today. I would instead argue that the main factors in this remarkable historical development were the widespread adoption but subsequent disintegration of Keynesian techniques of demand management. It is this, I will argue, which forms a backdrop both to the differential experiences of different economies during the late 1970s and 1980s and to the problems being experienced by the corporatist economies today.

2. *Demand Management and Full Employment*

Figure 1 shows the OECD unemployment rate over the period 1955–90. The period up to 1970 might be described as the heyday of Keynesianism, a time when governments throughout the Western world were committed to full employment as a policy objective and to the use of Keynesian instruments of demand management – fiscal and monetary policy – to achieve that objective. According to the Keynesian view of things unemployment was caused by a generalised deficiency of demand in the economy and the appropriate policy response was therefore to use instruments of government policy to make good any shortfalls in demand from the private sector.

For a long time, economists have been worried by the thought that, if governments were committed to full employment there would be nothing to constrain the general level of wage demands in the economy. But it was not until

the late 1960s that union militancy became a force to be reckoned with (Figure 2 shows the number of industrial conflicts per year since 1955). And the inflationary consequences of the Vietnam War, the breakdown of Bretton Woods and the first oil price shock of 1973 destroyed the »soothing agency» of money illusion to resolve conflict in society by enabling everyone to think they had improved their position.

Thus, by the 1970s, the key issue was not demand management but rather how to hold down inflationary wage pressure. If incomes policies, or other institutional measures, were unable to restrain wage demands then the only fallback would be to allow unemployment to rise to whatever level necessary to prevent inflation. It is in this context that the corporatist countries are seen to have been successful in that their institutions of centralised wage bargaining appear to have been better at delivering wage restraint than has decentralised bargaining. At the centralised level, the trade-off between wage increase and the maintenance of full employment is at the centre of attention in the wage bargain, rather than unemployment having to be raised to a level sufficient to counteract the rent-seeking behaviour of individual unions as in a decentralised system.

It may be argued, however, that this view of things is no longer appropriate. The enormous liberalisation of trade and of capital movements has meant first that the nature of the demand shocks hitting economies has changed, and that second the efficacy of traditional government policy measures has diminished. In a highly open economy, fiscal and monetary policy measures are both less appropriate and less effective in countering adverse demand shocks than in the traditional nation state.

The autonomous causes of fluctuations in aggregate demand in traditional Keynesian models have never been well defined. Keynes' own idea that the prime cause was fluctuations in business confidence caused by changes in the »animal spirits» motivating entrepreneurs is not much discussed now, because investment appears to follow rather than cause fluctuations in activity, and there appear to be few other genuinely exogenous domestic variables in the standard macro model.

In an open economy, a more important source of exogenous shock derives from the shifting patterns of international trade. Developments in technology and in relative factor prices mean that the comparative advantages of nations are continually changing, and demand shocks frequently take the form of the decline of a traditional export industry, or of a domestic industry being wiped out in the home market by foreign competition. But such shocks, unlike those of the standard Keynesian model, tend to be not only sector-specific but permanent. The adjustment of the economy to such shocks must therefore take the form of structural reallocation. It is not clear that traditional demand management policies have any useful role to play in this process. It seems more likely that such policies will impede the movement of factors and adjustment of factor prices necessary to re-establish trade competitiveness after an adverse shock.

This does not mean that government policy can have no function. Some policies, e.g. devaluation, may address the root of the problem di-

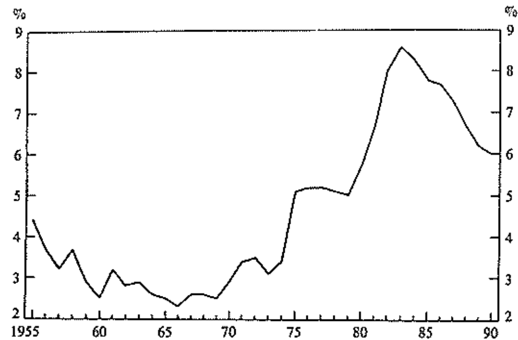

Figure 1. Post-War Unemployment in OECD Countries. OECD unemployment rate, 1955–1990.

The rate presented is the OECD labour-force-weighted average of the individual country rates.

Source: Layard *et al* (1991, p 389 and Annex 1.6).

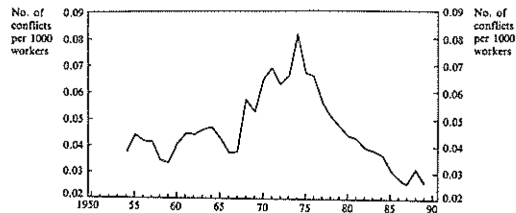

Figure 2. Industrial conflicts in the OECD, 1954–1989.

Sources: ILO, Yearbook of Labour Statistics, and OECD, Labour Force Statistics.

rectly. Other types of policy may facilitate factor mobility – e.g. support for training or assistance with relocation for workers, or investment grants. Some limited sector specific assistance may also be justified to mitigate the worst effects of sectoral decline during the inevitably lengthy time required for sectoral reallocation (e.g. public works in areas of high unemployment).

What it does mean, however, is that a traditional response of the form, for example, of a generalised increase in public expenditure makes no sense. A change in trading patterns may shift a county's comparative advantage from sector A to sector B. If the government provides public sector jobs for workers previously employed in sector A it can reduce unemployment in the short run, but only at the cost of either a permanent misallocation of resources or of a second restructuring involving cutting back the jobs created in the public sector to provide workers for sector B.

A case in point is Sweden in the late 1970s. With unemployment rates rising throughout the Western world, the Swedes maintained their commitment to full employment, but with adverse world trading conditions sought to achieve this objective by raising public expenditure and public employment. This increase was financed largely by borrowing which in turn was associated with an increased current account deficit. Sweden was essentially borrowing from abroad to pay for its high levels of public expenditure. By the 1980s it was clear that this policy could not continue permanently and the government then switched to »orthodox» policies of cutting back public expenditure and the budget deficit, in combination with devaluation of the krone, to reallocate resources to the traded goods sectors (Pekkarinen, 1990).

It is not my argument that this policy was necessarily wrong, but rather that the evidence of the two devaluations of 1981 and 1982 is to suggest that it permitted, or at least did not prevent, a significant overvaluation of the krone which itself would have inhibited the growth of the export sectors. It thus delayed the restructuring of the Swedish economy to the changed world trading conditions following the 1973 oil price shock. The rise in unemployment in Sweden in the early 1980s was of course quite modest, with a maximum rate of only 2.9 per cent reached in 1983, but it is not clear that had adjustment not been delayed the rise in unemployment would have been any greater.

Moving now from the appropriateness to the efficacy of traditional demand management policies there can be no doubt that the liberalisation of trade and capital flows puts great pressure on a government to become part of a fixed exchange rate zone. The greater the proportion of activity taking the form of international transactions the more disruptive are currency fluctuations. The exchange rate mechanism of the European Monetary System has become established throughout the European Community and most European countries which are not member states peg their currencies to the ecu. While monetary union may still be a distant prospect, we now have in Europe for the first time the combination of fixed exchange rates and perfect capital mobility familiar in textbooks as the Mundell/Flemming model. In these circumstances, as is well-known, nation states cannot pursue independent monetary policies: the commitment to the exchange rate determines domestic interest rates and thereby domestic monetary aggregates. In Europe, as it is frequently observed, monetary conditions are determined not by national governments but by the Bundesbank.

If international monetary arrangements rule out the use of monetary policy for domestic economic objectives, the same cannot be said for fiscal policy. On the contrary, in the standard model, the effectiveness of fiscal policy is enhanced, because government borrowing can be financed from abroad and hence does not raise domestic interest rates. But here another argument comes into play. If one looks at a standard text on fiscal federalism (e.g. Oates, 1972) one learns that local governments should not attempt to manage the level of aggregate demand. There are two reasons for this. First, because local economies are highly open a large part of any demand stimulus flows out of the local economy. Second, debt issued to finance any deficit will be held largely by non-residents and hence its repayment will constitute a real burden on future local residents. They will be taking on debts in order to stimulate, in large part, their neighbour's economy.

But it is obvious that these considerations are as relevant to a small open economy in a world of fixed exchange rates as to a local government in a federal state. The ratio of exports and of imports to GDP is everywhere on

a rising trend and barriers to capital mobility are being swept away. National governments are becoming as impotent in the face of world economic conditions as, a few decades ago, local governments were seen as impotent in the face of national economic fluctuations. One can no longer have »Keynesianism in one country» if that country is a member state of a fixed exchange rate system.

The significance of this conclusion would be that a government in such a system can no longer commit itself to the objective of full employment even if wage bargaining institutions can prevent the emergence of inflationary pressures. The only way in which trade unions can preserve their members' jobs is by ensuring wages are maintained at a competitive level, and this of course they can do without the assistance of government. If corporatism is seen as a sort of grand bargain in which the government commits itself to maintain full employment while the unions deliver wage and price stability, these new developments mean that the government is no longer able to deliver its side of the bargain.

3. The Future of Corporatism

These developments call into question the rationale for corporatist institutions.

Although it is customary to describe corporatist countries as those in which, for reasons often unspecified, bargaining »happens» at the centralised level, the reality is of course much more complex. As papers in the recent volume on wage bargaining in the Nordic countries (Calmfors, ed, 1990) make clear, centralised wage bargaining is a unstable arrangement: groups of workers in different sectors are continually breaking away and resorting to individual bargaining to improve their own position. Indeed it is in some ways remarkable that the central bargain could hold together at all given that it is in the interests of individual groups to attempt to exploit their monopoly position by bargaining independently. The history of wage bargaining over the last 10 years in Sweden, for example, is that of a succession of times of fragmentation and breakdown, followed by attempts to reconstruct the centralised bargaining system (Calmfors and Forslund, 1990).

Even if centralised bargaining is generally perceived to be better than decentralised in terms of economic outcomes, there remains the »free rider» problem. It is in the individual interests of each union that others adhere to the central settlement while the union itself breaks away and negotiates a better deal for itself. To prevent such behaviour it is necessary that unions that deviate get punished, and the only effective punishment is that the whole system will break down. There must be an implicit coalition amongst the unions whereby each pledges to adhere to the centralised system so long as all the others do. Clearly for such a coalition to exist at all requires a relatively small and reasonably homogenous group of unions. This no doubt accounts for why corporatist arrangements have been more successful in the Nordic countries than in, say, Britain or France.

But nations with social structures conductive to corporatism now face a different problem, namely that the benefits that can be offered to unions in return for agreeing to bargain at the central level are no longer available. As noted above, full employment is no longer in the gift of governments, but rather depends on maintaining wages at internationally competitive levels. Not only that but the institutions of the welfare state, cherished in many of the corporatist countries, are themselves at risk by virtue of increased international factor mobility. It is again a standard proposition of fiscal federalism that, if factors are mobile between localities, local governments will be unable to pursue independent redistribution policies. A local government pursuing more redistributionary policies than its neighbours will find its richer citizens moving out and poor people moving in with the consequence that it will soon be unable to afford and have to abandon the policy. As factors become more mobile at the international level, the same problems will afflict the nation state wishing to pursue redistribution policies. In Sweden, for example, in the last few years, there has been much concern as to whether businesses would continue to locate in Sweden where the tax burden is so much higher than anywhere else, given the ending of barriers to trade and capital movements.

These international constraints then enormously limit the freedom of manoeuvre of government policy. Just as national governments recognise the limitations of their capacity for independent action by seeking to join bigger organisations of nations such as the Eu-

ropean Community so, within each country, individual groups become less concerned with national government policy as against international developments. The major benefit of corporatism as perceived by individual unions, that it was a means of influencing government policy towards full employment, the welfare state and so on is thus disappearing, and with it, presumably, the willingness of unions to adhere to the centralised system. Corporatism is an institution for a nation state, and like the nation state, its era is drawing to a close.

4. Implications for Policy

The problem with being part of a fixed exchange rate system is that it provides no mechanism for macroeconomic adjustment. Within such a system, interest rates are set by the dominant monetary authority, in Europe the Bundesbank, and if interest rates are too high to sustain an adequate level of demand there is not much the other countries can do about it. In principle the adjustment mechanism is that they should let their nominal wages and prices fall relative to those in Germany, but given Germany's record of price stability this will clearly be difficult if not impossible to achieve. It is one thing to bind one's currency to the Deutschemark as a discipline on domestic price and wage setters but quite another to force nominal wages and prices to be the sole mechanism of adjustment in the face of a German interest rate shock.

The costs of rebuilding Eastern Germany falling on the German government budget can, in conditions of capital mobility, be met either by German taxpayers or by borrowing from abroad. But the latter course requires a real appreciation of the Deutschemark. Most member states of the EMS are opposed to achieving this by means of a nominal appreciation of the Deutschemark because they fear that the apparent reciprocal devaluation of their national currency will cause a resurgence of inflationary expectations. The Deutschemark intended as the anchor of the system has, because of the East German problem, become a major cause of instability.

There seem to be two types of remedy to a deficiency of demand caused by monetary deflation at the international level. The first is a generalised currency realignment involving the depreciation of all the other European currencies against the Deutschemark. A coordinated devaluation would be intended to emphasise that the purpose of the exercise was to offset the German monetary shock rather than any change in domestic policies. The second policy would be a co-ordinated fiscal reflation where, for the same reason, the co-ordination of policy is taken to indicate that it is a response to an external shock. But in both cases the different interests and policies of the different states can be expected to rule out effective coordination.

In the circumstances, in the absence of policy coordination, devaluation is almost the only policy option left available to a national government. With the exchange rate as the key nominal anchor in the economy, any devaluation carries the risk of undermining the credibility of the policy commitment and thereby, following the standard results of Barro and Gordon (1983), leading to a permanent (or at least long term) increase in unemployment. But if, on the one hand, the authorities can plausibly point to external shocks as the cause of their policy action and thus maintain their anti-inflationary reputation, and on the other the domestic recession is sufficiently deep that the devaluation does not lead immediately to a resurgence of inflation, devaluation may assist an economy in mitigating the domestic consequences of international deflation. Even so it is a »beggar-my-neighbour» policy which creates inappropriate relative prices and trade patterns which will presumably need to be reversed once the recovery arrives.

There is, though, a much stronger case for devaluation to counter the effect of country-specific external shocks, such as the losses to Finnish exports resulting from the collapse of trade with the former Soviet Union. The equilibrating adjustment of this shock will presumably require a fall in real wages in Finland and this can be most conveniently achieved by devaluation. Again there is the risk that devaluation will destroy policy credibility, but as noted in the previous paragraph, there may be circumstances when this is a risk worth taking. While it is not for an outsider to judge, the situation in Finland in the autumn of 1991 would seem to satisfy all the preconditions for the successful operation of a policy of devaluation to achieve economic reallocation without creating inflation.

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