European Labor Markets and Structural Reform: Does the Euro Have a Future?

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The brief history of Economic and Monetary Union (EMU) in Europe, and the concomitant birth of the euro as the new single currency, has provided Europeans with some moments of cheer in recent months. The euro has climbed to new heights against the dollar and several other major currencies. But the apparent Asuccess@ of the euro has exposed some other major concerns for the future of EMU, and indeed for the future of the European Union. High on the list of these concerns is the glaring lack of flexibility in European labor markets and the exceptionally high natural rate of unemployment in most Continental labor markets. Embedded in this set of issues are concerns about Ainstitutions, culture, and ethics in a market economy,@ the theme of the 2004 program of the Association of Private Enterprise Education.

The state of European labor markets

There can be little doubt that Europe suffers from persistently high unemployment. Since the mid-1980s, Europe=s natural rate of unemployment has diverged from that of the United States to the point where it approximately doubles the U.S. rate on average. What are the available explanations for this divergence?

Perhaps the most straightforward explanation of Europe=s high natural rate of unemployment is the existence of a set of restrictive legal and institutional constraints that drive up the real wage. Examples of such constraints abound in Europe: high minimum-wage laws, centralized wage-setting, requirements for extended notification prior to worker dismissal or plant closure (more than 11 months in Italy), generous family leave policies, and extension of union wages to large numbers of non-union employees (up to 90% in France). The result of these and other restrictions on labor-market flexibility is prevailing wages well above the marketclearing equilibrium real wage (Quintin 2001). This implies a persistently high natural rate of unemployment. European governments often respond to the abnormally high unemployment by instituting active labor market policies (ALMP), which attempt to force down the unemployment rate using the weight of the public sector (Bierhanzl 1999). Often, these ALMP worsen the situation by adding layers of bureaucratic red tape to labor market processes, making it less likely that European employers will hire additional workers. In addition, firms in Western Europe are given more grounds for seeking more fertile territory to deploy their capital outside of Western Europe. In the 1990s, BMW and Daimler-Benz Adiscovered@ South Carolina and Alabama. Now, West European firms such as Volkswagen, Peugeot Citroen, and GM=s Adam Opel unit are moving eastward to Poland, the Czech Republic, Hungary, and Slovakia, forcing western trade unions to respond by reluctantly agreeing to relax restrictive work rules in order to retain jobs in the west (Boudette 2004).

An added complication for the adjustment of European labor markets is the problem of labor immobility across national borders. Although EU policy attempts to facilitate international migration within the Union, linguistic, cultural, and even religious differences often impede cross-border labor mobility within the EU. For all of these reasons, there is far less labor mobility among the countries in Europe than among the states in America. This, along with the fact that economic activity historically has been better synchronized among the states in the U.S. than among the countries of Europe, makes America (at least the lower 48) more of an optimal currency area than Europe.

Structural reform has often been urged as the solution for Europe=s high natural rate of unemployment, but it seems very difficult to implement such reforms, given the role of trade unions in the European political process (Benoit 2004; De Lange 2004). Although a number of European politicians speak about the need for Astructural reform,@ these commentators often add that no workers should be displaced from their jobs, as a result (see Mira & Ringholm 2004).

Successful experiments in small countries

It is clear that not all EU member states are the same regarding the state of their labor markets. For instance, Ireland and the Netherlands, starting in the mid-1980s, had implemented significant labor market reforms that resulted in dramatic reductions in their unemployment rates. Unemployment compensation in the Netherlands fell from about 80% of market wages to nearly 60%, thus raising the opportunity cost of labor market searching by unemployed workers. In addition, the Dutch reduced minimum wage rates by more than 25% in real terms. Moreover, the Atax wedge@ that Dutch employers must pay for workers they hire has been cut from 30% to 14%. The payoff on all this is that the unemployment rate in the Netherlands had fallen to about a third of the all-EU average (Tille & Yi 2001). Although there may have been some backsliding on these flexibility gains in the Netherlands, Dutch unemployment is still about one-third lower than euro area=s unemployment rate.

The Irish experience with labor market reform has been similarly beneficial, and Ireland now enjoys the fastest rate of economic growth in Europe and a substantially reduced rate of unemployment (Sigrid 2004). But these examples of successful labor market reform do not weigh heavily in the overall EU picture. Both Ireland and the Netherlands are relatively small countries, especially relative to Germany, France, and Italy, countries that continue to suffer the effects of labor market rigidity. Culture continues to play a significant role in this story and it is no doubt desirable that these cultural differences remain (Kay 2004). But persistent high unemployment and low rates of growth will no doubt continue to plague the EU economy so long as the issue of labor market rigidity goes unaddressed (Pfanner 2004). Political band-aides such as the mandating of a 35-hour work week will not fix the problem (Goldsmith 2003).

Effect on the euro

The residual question is how the problem of labor market rigidity might affect the new single currency of Europe, the euro. How might this seemingly unrelated problem affect the long-term viability of the euro?

Many observers, including Nobel laureate Robert Mundell, have projected a bright future for the euro (Mundell 1999; 2000). They are forecasting the ascendancy of the euro to at least co-equal status with the dollar in international financial markets. This belief is anchored in the presumed spread of the euro from its original base of eleven European countries to 25 or more nations in the near future. The expansion of Economic and Monetary Union (EMU) is presumed to follow the expansion of the European Union (EU) itself.

What is the future of Euroland?

The shape of EMU will change in the near future. This is based on the fact that ten new nations joined the EU in May 2004.[1] Although these new EU members will not immediately adopt the euro, it is a condition of joining the EU that these countries will eventually join EMU and adopt the euro in place of their legacy currencies at some Aappropriate time@ in the future. Three other candidate countries (Bulgaria, Romania, and Turkey) are deemed to be not yet ready for accession to the EU,[2] but again, when they are ready for EU membership, they must also begin preparations to join EMU and the euro.

[1]The first 10 accession countries are the Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia.

[2]Bulgaria and Romania have been deferred for accession because they do not meet the economic criteria for accession set by the Maestricht treaty. Turkey is in a different position in that it has not yet opened negotiations to join the EU. There is also the age-old AGreece-Turkey problem.@

In addition, there remain three EU hold-out nations (Denmark, Sweden, and the United Kingdom) that are still outside EMU. Although the present governments of these three countries all strongly favor joining the euro, the electorate in each nation must be convinced to vote in favor of joining. When and if these three EU members will join the euro zone is uncertain at this time. But the ringing defeat of a Ajoin the euro@ referendum in Sweden in the fall of 2003 and Gordon Brown=s recent negative assessment of the United Kingdom=s readiness to join the euro do not suggest that it will be anytime soon.

If all of the countries discussed above decide to join the euro, it would bring the total to 28 nations within Euroland. The combined GDP of these countries would more than match that of the United States, and the combined population of the new Euroland would substantially exceed that of the U.S.

One major qualification to the above rosy scenario is the likelihood of Britain joining the euro. Of all the potential accession countries discussed above, Britain is clearly the most important. London commands the central position in European (and world) financial markets, even without the euro. Britain has the largest, deepest, and most developed set of financial markets in Europe and therefore has the unique status of being needed by the euro far more than Britain needs the euro. It is also far from certain that the Labour government will be able to "sell" the euro to a skeptical British electorate, if and when that government decides to call a referendum on the issue.

Notwithstanding British reluctance to embrace the euro, the single currency=s influence is likely to spread beyond the boundaries of Europe to include African countries in the CFA franc zone and perhaps a number of Caribbean nations with close ties to their former "Mother countries." Some have suggested that even the Norwegians might reconsider their two-time defeat of EU entry and become another euro zone country.

Euro advocates argue that the future of the euro is indeed a bright one, and that it will rise to prominence in international financial markets so as to rival the dollar. Co-equal status with the dollar would include matching dollar holdings by central banks and major forex traders. In essence, the argument is that international reserve holdings of euros would equal or exceed those of dollar holdings. This would mean that America's "exorbitant privilege" (in the words of Charles De Gaulle) of being able to "pay its way" in international financial markets by simply issuing more dollars would be curbed. The political influence of Europe would likewise rise to at least match that of the U.S. in international affairs, according to euro advocates.

An alternate scenario

One potentially serious problem for the future of the euro is the structure of the ECB, especially after the accession of the ten new member states to EMU. This issue is potentially quite serious, but it is not the only source of concern for euro advocates. Other potential difficulties include the inherently fractious nature of European politics and the underlying slow rate of European economic growth.

Although the contentious nature of European politics is neither an economic problem nor a consequence of euro adoption, it is a fact of life that euro advocates must face and deal with. Some observers argue that the very existence of the euro is, at least in part, designed to deal with this problem. In other words, the birth of the euro is an attempt to bury the political past and bring significant political unity to Europe. Others (Schwartz 2001) have argued that this puts the cart before the horse, forcing the single currency to become the engine of political unification before a true federation is achieved. If Europe reverts to type in its political dealings, the euro may be subjected to forces that it cannot withstand.

Finally, Europe faces the long-term problem of slow growth, especially in comparison to the United States. Slow growth in Europe probably accounted for most of the 25% erosion in the value of the euro relative to the dollar in the first three years of the euro=s existence. Now, as the U.S. economy recovers strongly ahead of Euroland, the problem may resurface. Some New Keynesians (Blanchard & Summers 1986, 1987) have argued that Europe's problem is traceable to the phenomenon of hysteresis. This theory argues that long bouts of unemployment make it very unlikely that the unemployment rate will return to its Anormal@ level once the macroeconomy recovers from a recession. However, the root cause of this problem appears to circle back on insider-outsider models, which in turn point to the inordinate power of trade unions (the Ainsiders@) in setting European wages and the enforcement or imposition of other labor-market constraints that adversely affect non-union workers (the Aoutsiders@). In any event, the problem of slow European growth persists and may, in fact, be increasing, even as U.S. productivity growth shows no signs of slowing (Davis 2002). Some recent evidence from the Conference Board suggests that U.S. productivity growth is three times that of the EU.

The future of the ECB

Among a number of important questions about the ECB that require an answer is what the structure of the central bank will be in the near future. At the present, there appears to be a clear need for structural change as the monetary policy committee is soon to increase its size. At present, the committee consists of 18 members, but if ten or more new members are to be added sometime after 2004, the size of the group will grow to 28 or more members, too large to be manageable. The apparatus of monetary policy making, already somewhat confused and arcane, will become more so as new states accede to the EU and EMU. Few observers feel able to predict what, if any, changes in ECB structure are likely to be forthcoming.

As new countries join the euro, a significant question is what exchange rate is established to link the legacy currency of a newly joined nation to the euro? If the wrong exchange rate is selected, huge adjustment costs may be foisted onto the economy of the new member state. One only needs to recall the problems of the European Monetary System (EMS) back in 1992, when Britain, among other countries, was forced out of the new EMS by an overvalued pound sterling.

A potentially significant longer-term problem for the ECB is the unresolved issue of control over bank supervision in Europe and the provision of a lender of last resort facility. Some have argued that the ECB lacks these powers and therefore has less than optimal power to deal with future monetary crises in Europe. Others have argued that there is no reason to expand the ECB's power to include control over bank supervision and lender of last resort status. The fact that the Federal Reserve System possesses these powers adds little, if anything, to its ability to exercise control over monetary policy, some economists contend. In fact, one could make the argument that these added powers may distract the Fed from its real purpose (controlling the monetary base). Concerns over the extent of the central bank's powers may be simply chalked up to institutional power grabbing under the theory of bureaucratic behavior with no implications for the exercise of monetary policy making.

Another concern about the future of the ECB is summarized as the weak euro vs. strong euro conflict. Calomiris (1999) argues that the members of EMU will eventually fall into one of two camps, one favoring a weak euro (so as to underwrite significant national deficit spending) and the other favoring a strong euro (to guard against the emergence of inflationary pressures). Calomiris goes so far as to predict that EMU will fly apart over this issue, but Scott (1998) points out that there is no mechanism in the EU charter that allows for opting out. Now that 11 original legacy currencies have passed into history, the break up of Euroland seems to be less likely, but it is still conceivable.

The weak-strong euro debate probably centers on whether or not the ECB continues to stick to its mandate to control the inflation rate, although it appears to have weathered the storm of demands for a loosening of European monetary policy thus far. As a political institution with major structural changes ahead of it, there is no way to be certain that political forces will refrain from weakening the central bank's mandate in favor of other objectives. Moreover, one of the ironies of European politics is that the Germans, originally the most ardent supporters of a strong-euro policy, now find themselves on the "weak" side. Given the dominant position of Germany in the presently constituted EMU, the "German exception" looms as a large political problem for the future of both EMU and the EU itself.[3] In

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[3]The AGerman exception@ means one set of rules for everyone, except Germany. It now includes (1) the *Lex VW* exception to a proposed Europe-side takeover code; (2) sidestepping the European Commission=s desire to penalize France and Germany for allowing their budget deficits to exceed the limit of 3% of GDP imposed by the Stability and Growth Pact; (3) reform of new-car sales restrictions;

summary, many questions surrounding the ECB remain to be answered satisfactorily before one can claim that the euro's future viability is assured.

External shocks

Since the introduction of the euro on January 1, 1999, there has been no significant international currency crisis. In other words, no major asymmetric economic shock has yet tested the long-term stability and viability of the euro. Yet such external shocks are certain to materialize at some point in the future and it should not be assumed that the European Central Bank would be able to handle such a crisis when it does occur.

What is the potential role of asymmetric external shocks on the long-term health of the euro? What is the nature of the potential negative shocks that the euro will be likely to face? The trigger mechanism by which external shocks might be transmitted to EMU countries includes the outbreak of war and the possibility of a major oil shock. Other similar external shocks are conceivable and cannot be dismissed.

Damage control strategies

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and (4) the large government subsidy (34.8%) recently granted to BMW to build a new factory near Leipzig (Guerrera & Harnischfeger, 2002).

What if the euro *is* buffeted by a major external shock in the future? What strategies are available to limit the damage, to firms, to currencies, and to nations when they do occur? A major currency crisis is likely to require significant structural adjustment within Euroland. Such structural adjustment is likely to be necessary because individual nations within the euro zone have surrendered both their national monetary sovereignty and the ability to devalue the currency. Therefore individual euro zone nations must rely on fiscal policy alone. Moreover, even fiscal policy is constrained by the Maestricht Treaty rules limiting budget deficits to 3% of GDP and overall national debt to 60% of GDP (Sims 2004). If constrained fiscal policy alone is not adequate to the task, countries may be forced to adopt "other measures" to rescue their economies. These may include additional active labor market policies (ALMP), which have already slowed the European growth rate by limiting the flexibility and adaptability of Continental labor markets. A slower European growth rate is the exact opposite of what the euro zone needs to compete effectively against the dollar. This brings us full circle back to the problem of labor market rigidity and the persistent problem of AEurosclerosis.@

Conclusion

We conclude with the caution that the future of the euro is not as certain as most boosters of the single currency maintain. Although it appears likely that a number of additional countries will join the EU and EMU in the relatively near future, the accession of new countries does not assure the long-term viability of the euro. On the contrary, the addition of these new countries may destabilize the situation in the sense that simple enlargement of the membership of the monetary policy-making apparatus may make decisions more difficult and more political. It is also fair to say that the euro's future really depends on political choices that are yet to be made, especially choices about reform of European labor markets and the regulatory stance of the EU. External shocks, which will no doubt occur, cannot be predicted, nor can the euro's response to such future shocks be forecast with any certainty. *When* these external shocks eventuate, it will be interesting to observe how the euro zone deals with them.

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