

The Economics of Unemployment. Shocks, Institutions, and Interactions.

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The object of these lectures is shown in Figure 1, which plots average unemployment rates over 5-year intervals, starting in 1960 and ending in 1999, both for the OECD–Europe as a whole (the line) and for 15 individual European countries.¹ The figure shows the increase in the overall unemployment rate, from 1.7% in the early 1960s to 11.0% in the mid 1990s, together with the large dispersion in unemployment rates across countries, from 4.0% in Switzerland to more than 20% in Spain in the mid 1990s.

[Figure 1. The evolution of unemployment, from 1960 to 1999, for 15 European countries]

Explaining this evolution, both over time and across countries, has proven to be a serious challenge. When unemployment started increasing in the mid–1970s, the focus was on the role of shocks, from the increase in oil prices to the slowdown in productivity growth. Later on, as unemployment remained high, the focus shifted to institutions, to the adverse effects of the “welfare state.” In the recent past, a broad consensus appears to have emerged, based on both shocks and institutions. It goes roughly like this:

Some time in the 1970s, the period of fast technological progress which had characterized the post-war period (what became known in France as “les 30 glorieuses”—the 30 glorious years), came to an end. It took a while for the economic actors to understand what had happened, all the more so because the slowdown was partly hidden by two sharp increases in oil prices, and two sharp recessions. Aspirations and wage demands continued at the old pace for some time, leading to a decrease in employment, profitability, and capital accumulation. Low, even negative, real interest rates initially softened the impact in the 1970s, only to increase and make things worse in

¹The 8 time periods are 1960–1964 to 1995–1999. The 15 countries included in OECD–Europe are Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom.

+ Average unemployment rate, E15 Unemployment rate by country

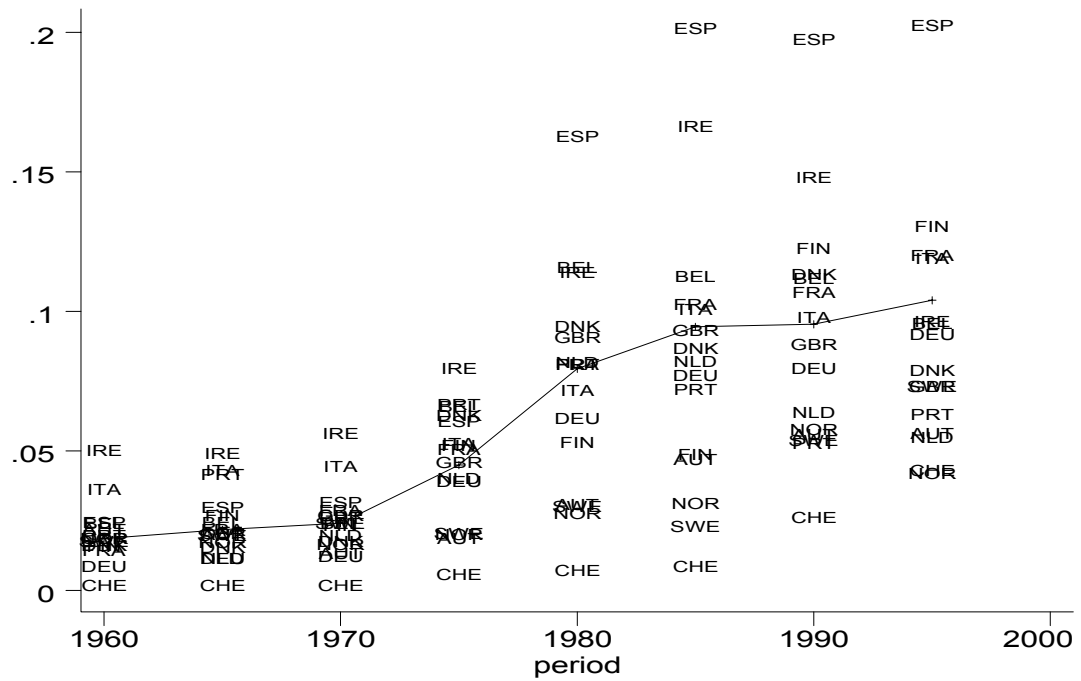


Figure 1. Unemployment Rate, E15

the 1980s. Since the mid 1980s, success stories, among them the Netherlands and Ireland, have typically been associated with the reverse process, with wage moderation leading to an increase in employment, profitability, and capital accumulation. Most other European countries now appear to be following suit.

One cannot however tell the full story without taking into account the role of institutions. Institutions have played two distinct roles:

Changes in the institutions have also shaped the evolution of unemployment. It is not true, as some claim, that current European labor market institutions emerged in the 1970s: Stories which blame the increase in unemployment on the rise of the welfare state simply rewrite history. But some programs indeed became more generous in the 1960s, when times were still good and countries thought they could afford a more generous social insurance system. Others were extended in the 1970s and the 1980s when times turned bad, and governments tried to temper the effects of adverse shocks on unemployment. In the last 15 years, as it has become clear that some of these earlier changes had been counterproductive, changes have gone mostly the other way. These evolutions also play a role in explaining both the rise, and the more recent fall in European unemployment.

And institutions have shaped the effects of the shocks on unemployment. True, the slowdown in productivity was smaller in the United States than in Europe, and this may explain in part why the increase in unemployment was more limited in the United States. But, leaving this aside, the United States appears to have institutions which lead to a much more stable natural rate than Europe. And, within Europe, largely similar shocks have had widely different effects on unemployment. Looking across countries, some labor market institutions, from high employment protection to long-lasting unemployment benefits, appear to affect both the strength and the persistence of the effects of shocks on unemployment.

The story is very plausible. A number of recent econometric studies suggest that it provides a good statistical description of the evolution of unemployment rates both across time and across countries. In a series of contributions, Steve Nickell (Nickell [1997], Nickell and Layard [1998]) showed that one could relate the increase in unemployment across countries to differences in labor market institutions. Following his lead, Justin Wolfers and I (Blanchard and Wolfers [2000]) looked at the panel data evidence; we constructed measures of shocks and institutions, and concluded that a specification based on observable shocks, and interactions of these shocks with measures of labor market institutions, gave a good statistical account of unemployment across time and countries over the last 30 years. We found in particular that differences in the response of unemployment to shocks across countries could be statistically related to differences in institutions. Some countries, such as the United States, indeed appear to have a set of institutions which dampens the effects of shocks on unemployment and thus leads to a stable natural rate. Some countries, such as Spain, have a set of institutions which seems instead to amplify the effects of shocks on unemployment.

Despite these successes, there are good reasons to remain skeptical however. After the long wars between proponents of alternative theories, the ecumenism of the consensus has the feeling of a compromise (To use another French expression, it feels like the “paix des braves”, a peace treaty accepted out of sheer exhaustion). It remains fuzzy. The exact nature of the shocks, the relative importance of shocks and changes in institutions, the exact mechanisms through which institutions and shocks interact, remain largely to be established. While I believe the general story, I feel I master few of the details. My goal in these lectures is to explore three aspects of the general story, trying in each case to assess what we (I) know and do not know.

Let me draw a rough map of where I intend to go.

- Lecture 1 focuses on the role of shocks. To do so, I construct what may be one of the simplest models to think about unemployment, a model in which profit maximizing firms use labor and capital, where the interest rate is given, and the wage required by workers is decreasing in the unemployment rate. I use the model to explain the evolution of European unemployment, from the effects of the productivity slowdown on the 1970s, to the gyrations of real interest rates in the 1970s and 1980s, to the role of wage moderation in the sharp declines in unemployment in the Netherlands and Ireland since the mid 1980s—the so-called Dutch and Irish miracles.
- Lecture 2 focuses on the role of changes in institutions, and in particular the effects of product and labor market regulation and deregulation. To do so, I introduce two elements missing from the model of the first lecture, monopolistic competition in the goods market, and bargaining between firms and workers in the labor market. I then use the model to provide an explanation to may be one of the most puzzling aspects of European unemployment, the persistence of unemployment for most of the 1990s, despite a very large increase in the profit share in most continental European countries from the mid-1980s on.
- Lecture 3 focuses on interactions between institutions and shocks. I construct a model of the labor market which takes into account the importance of flows and bargaining, and allows for a discussion of the effects of labor market institutions. Having done so, I focus on the effects of employment protection. I show that employment protection makes the labor market more sclerotic—characterized by lower flows of workers through the market, but also to higher unemployment duration. Sclerotic markets exhibit much higher long-term unemployment, and this leads me to explore an old theme in the literature, namely that long-term unemployment does not exert much effect on wages,

leading to larger and longer lasting effects of shocks on unemployment. I focus on the interaction between shocks, long-term unemployment, and duration dependence. I conclude that, while the argument makes sense, its quantitative relevance appears more limited than casual arguments have often suggested.

References

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