SWEDISH ECONOMIC POLICY REVIEW 5 (1998) 383-388

Comment on Charles Bean: The interaction of aggregate-demand policies and labour market reform

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Unemployment in Europe is not only high, but it has persisted over a couple of decades. So a discussion of what can be done to overcome this problem is very relevant. This discussion is also important from a central bank perspective. It is important to clarify what central banks can and cannot do to contribute to increased employment and reduced unemployment.

Charles Bean provides an interesting and thought-provoking essay. The starting point of his paper is the need for structural reforms to combat unemployment. In other words, he views unemployment in Europe as primarily structural and not cyclical.

Bean discusses in detail what should be done if such reforms are to quickly lead to the desired result. He also takes up how the establishment of the EMU may affect prospects for success.

In my comments, I take up three aspects of the problem area that Bean identified. First I underline Bean's starting point, namely the need for structural reforms to be able to overcome the high level of unemployment. Then I comment on the role of monetary policy in connection with the implementation of structural reforms. Finally, I take up the EMU perspective and the possibility of implementing successful, structural reforms.

1. How can reduced unemployment be achieved?

If we assume a simple model where goods and services are produced with the input of the factors of production, labour, and capital, then in principle, the employment level can be affected in two ways:

- Growth where capital and labour increase at the same rate
- Changed capital intensity with a given total production

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If we examine the actual development since the first oil crisis in 1973-74, Table 1 shows that the differences in the development of employment between the EU and the US can be explained by the different development of the capital intensity in the production process rather than by large differences in growth. Capital intensity in the EU has increased. The increase in production has entailed, in relative terms, a reduction in the use of labour relative to the use of capital.[1]

Table 1. Growth in the EU, the US, and Sweden in 1974-95 (annual average growth rates)

	Growth	Employment	Labour productivity	Total factor productivity	Capital intensity
EU	2.1	0.2	2.0	1.1	0.9
US	2.4	1.8	0.6	0.6	0.1
Sweden	1.6	0.1	1.5	0.7	0.8

Note: The estimates for Sweden are approximate because they are based on measurements of the capital stock that only cover the business sector. Rounding-off errors may occur.

Source: European Economy, Annual Economic Report for 1997, No. 63, 1997; Statistics Sweden; Calculations at the *Riksbank*.

As shown in Table 1, labour productivity has increased considerably more in Europe than in the US in 1974-95. The productivity of labour measured *ex post* reflects not only the changes in an exogenously determined growth in labour productivity, but also is to a great extent the result of high wage costs that favour capital-intensive technology and force less efficient operations to stop production or shrink.

In the US, inputs of capital and labour increased to about the same extent. So employment also increased more rapidly without growth overall having been markedly higher than in the EU. It is close at hand to explain the increased capital intensity in the EU with a rise in the total price of labour in relation to the price of capital. Real labour costs (including wage-related taxes) increased more quickly in the EU than in the US. A further indication of this devel-

[1] An increasing capital intensity is not negative *per se.* On the contrary, it raises labour productivity, thus providing scope for high growth and a rising standard of living. But in a situation with high unemployment and a weak growth of employment, it can be a source of problems in the labour market.

opment is that the return on capital in the US has been higher than in the EU. On the whole, it seems that the relative price of labour has been higher in Europe than in the US, and that this can be an important explanation for the weaker growth of employment.

In Sweden, this trend seems to have been stronger than in the rest of the EU. This can have contributed to Sweden's weak economic growth during recent decades. A more stable macro-economic regime (of the type established in Sweden during the 1990s) is, in itself, a structural reform that can lead to higher growth than in the 1970s and 1980s.

2. Structural reforms—a path to increased employment

There are many indicators that the possibilities for overcoming employment problems in Europe are connected with the possibilities of achieving *both* an increased production potential and more balanced use in the future of the production resources, labour, and capital.

Structural measures are of strategic importance for the labour market (including wage formation) to be able to function better and to increase employment. This is also Bean's starting point in his paper. He points out that the flexibility of real wages must increase and that mobility on the labour market must be stimulated.

It is not clear to me that Bean's analysis considers the effects on the employment level of a more balanced use of labour and capital. The focus of the analysis seems rather to be how an increase can be achieved in overall growth, and in this way also in employment. But labour market reforms should also affect the capital intensity of production. Even if this mechanism is not explicitly contained in Bean's paper, it may very well follow from the structural reforms he advocates. It is in this case something that can soften the apparent conflict between the short-term and long-term effects that Bean analyses. If growth has a somewhat different content, with a greater input of labour for each unit produced, the time perspective for the increase in employment can be affected in a favourable direction.

3. The role of monetary policy in implementing structural reforms

Basically, Bean's view of the macroeconomic dynamics after the implementation of structural reforms seems to be reasonable. Due to individuals' uncertainty about the effects of reform, and the fact that prices and wages adapt slowly, it may initially lead to a short period of increasing unemployment. But subsequently, demand in the economy increases due to the capital stock being built up, so production and income will, after a time, be higher than before the structural reform was implemented. Employment increases and unemployment falls.

Two factors mitigate or even eliminate the problem that Bean highlights:

- The advantage of a monetary policy directed at explicit inflation targets, which partially takes care of the problem that Bean indicates
- The importance of considering the extent to which actors in the economy anticipate structural reforms and their effects

A labour market reform that leads to an increase in the supply of labour can, according to Bean, lead to reduced use of resources in the short-term and thus exert downward pressure on prices. This naturally affects monetary policy, which focuses on an explicit inflation target. An inflation rate that is lower than the target normally leads the central bank to cut the interest rate. Consequently, total demand and employment increase. So the negative effects that may arise are softened within the framework of the current monetary policy approach. If the instrumental horizon for monetary policy is one to two years, the central bank will accordingly be able to account for the effects of the structural reform in good time. This will be the case if the political situation is such that it is highly probable that the reform will really be implemented.

But I warn against implementing a monetary policy that entails risks in the area of inflation.[2] An expansive monetary policy approach can lead to inflationary expectations being adjusted upward. In turn, this would mean that the costs, in terms of reduced employment to get back to the inflation target, would exceed the short-term gains in the employment level from such a policy. The extent of the costs of an expansive policy would depend on how inflation expectations are formed. The risks of such a policy are probably very high for a country that, for a long time, has implemented a policy that led to high inflation and quite recently has come down to lower levels.

[2] Bean takes this up in Section 1.3 of his paper, where he writes: "With complete inertia in the money wage, this would require a temporary increase in domestic inflation, and *a fortiori* in consumer price inflation." In this context, Bean also refers to an earlier paper where a temporary increase of inflation is directly advocated.

Neither, in my view, is the type of package solution that Bean seems to recommend especially practicable. His idea is that a supply reform should be announced at the same time as the central bank provides assurances on increasing demand by reduced interest rates. The entire idea of separating monetary policy decisions from other political decisions by increasing the independence of the central banks is to counteract such confusion. Most countries (not least Sweden) have poor experiences of such arrangements. It can lead to periods of overheating, inflation, and unstable growth. If the effects of a package of this type with stimulating monetary policy are built into wage contracts, nothing will be achieved. It would rather lead to other types of costs.

4. The EMU perspective

A central mechanism behind the initial problems, which structural reforms are said to entail, follows from the implicit assumption that these reforms come as a surprise. This explains why a delay will arise between the effects on potential and actual production, respectively. This is exactly why, in Bean's opinion, the need for demand policy arises. From an EMU perspective, this will, in his view, be an even greater problem because monetary and foreign exchange policies are decided centrally. But the probability for co-ordinated reforms in all 11 EMU countries is low, and the Stability and Growth Pact restricts fiscal policy.

A basic issue is the probability that structural reforms will come unexpectedly. It does play a large role for the development of the economy if the reforms are instead foreseen.[3] So it is reasonable to assume that positive effects will appear more quickly. Labour market reforms are discussed and investigated for various purposes for a rather long time before being implemented. The entire process is probably long and drawn-out. Together, employers, workers, unions,

[3] In the simulations made at the *Riksbank* in the macro-model RIXMOD 2.0, it clearly emerges that the development of unemployment and the economy, as a whole, is different, depending on whether structural reform is totally unexpected or whether it is fully anticipated. In reality, it is difficult to see that a reform of this type could come as a total surprise. Neither does it seem probable that the reform would be fully expected. The probable effect is rather somewhere between these two extremes. My point is that the short-term negative effects will be smaller, the less unexpected the implementation of the reform is. This insight is something that could be used by the political system if it is thinking of carrying out a reform.

and other economic agents should at least be able to foresee, in part, the way things are moving. So it is not unreasonable to think that the positive effects of the reform will come earlier than if they came as a surprise. And there will be less need for demand stimulation than Bean anticipates.

Membership in the EMU should neither prevent nor make it more difficult to implement structural reforms, provided that the reforms are expected. An EMU country also has the option of using fiscal policy to support reform work, if necessary. Bean's starting point is that the Stability and Growth Pact strictly limits fiscal policy. It is worth emphasising that this is only the case if the countries permanently balance at the utmost limits of the Stability and Growth Pact. It is not a law of nature that this should be so. Swedish economic policy, for example, aims at building a surplus in public finances. If other countries adopt the same approach, there is a scope for action for fiscal policy as well.

5. Summary

It is important to discuss what can be done to reduce the high level of unemployment in Sweden and Europe. Many factors indicate that measures are needed, which affect wage formation and the working of the labour market, as a whole, in order for employment to significantly increase permanently. Bean advocates such reforms and discusses, in an interesting way, how they are to be implemented in the best possible way. I take up a few aspects that show that the implementation of such reforms need not be linked with the types of difficulty that Bean supposes. This is especially the case because they partially operate through mechanisms other than those that Bean explicitly discusses. Structural reforms of the labour market do not lead to increased employment only by increased economic growth: they can also change the way in which this growth is achieved. A more balanced mix of capital and labour is also a way to increase employment. And if structural reforms are expected, which is probably the case, the positive effects will probably be felt relatively soon. Otherwise, such a situation with initial negative effects, such as the one that Bean visualises, can be dealt with within the framework of a monetary policy focused on an explicit inflation target. EMU countries can use fiscal policy because countries need not necessarily stay at the limits of the Stability and Growth Pact. Sweden is an example of a country with a goal of achieving a surplus in public finances.