



*What Happened to
European Mass Unemployment?*

Tito Boeri



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in the Humanities and Social Sciences

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Introductory remarks by Victor Halberstadt, President of the Willem F. Duisenberg Fellowship Foundation

Thirty-eight years ago, the University of Amsterdam appointed a new Professor. The man's name was hardly known to his colleagues in this town or the rest of the country. Wim Duisenberg had studied and worked in Groningen, where he also wrote his dissertation titled *The Economics of Disarmament*. Subsequently he spent a few years in Washington and at the Dutch Central Bank. And then one day – rather unexpected for many his name appeared as the new Professor of Macroeconomics. Due to the remarkable university democracy of those times I remember that day, in spring 1970, very well. Lest we forget: rather bizarre consultations were required before a nominations committee could complete its work. At the beginning of the new academic year, September 1970, Wim and I found ourselves housed together in a spectacular old building, soon afterwards – rightly – transformed into the University's theater. Soon he held his inaugural lecture, in this same hall. The subject was *Imported Inflation*, a major concern in those days. These were exciting times in the world economy, and in Dutch politics. As Duisenberg later recalled we felt - largely for the wrong reasons – that we were really in the centre of it all. But we were idealistic, ambitious and celebrated the times we lived in. Then, only two years later, it got serious. One day – mid 1972, I was asked to discreetly test Wim. Would he – if invited - join the so-called shadow-government of the three opposition parties? If the elections were won he would eventually be either Minister of Economic Affairs or of Finance. The young professor's reply to this challenge was not ambiguous: it was very enthusiastic. In fact, with hindsight, less cautious than one would expect. The rest is history, most of it already documented and published. Wim Duisenberg did, of course, become Minister of Finance, later President of the Dutch Central Bank and ten years ago President of the European Central Bank. It is now generally recognized that his optimistic and tenacious contributions to European integration are of true historic significance. At his farewell from the ECB in October 2003 he himself noted: "I had the privilege of being part of history. Being responsible for the introduction of a new currency is the dream of any central banker". Shockingly, in the summer of 2005 Wim died suddenly, far too young. The world lost an important architect of our political and economic environment. A few weeks later a memorial service was held. On that occasion Nout Wellink and Jean Claude

Trichet, among others, spoke. That same afternoon, on August 6 2005, it was agreed to establish a rotating professorial fellowship in Wim's name at the Netherlands Institute for Advanced Studies. In fact, this built on the earlier Fellowship for the late Jelle Zijlstra, Duisenberg's predecessor at the Central bank. We are here today because the University of Amsterdam is the obvious place for the inaugural lecture of the Duisenberg Fellow.

It goes without saying that we are proud that Tito Boeri accepted our invitation to be the first Willem F. Duisenberg Fellow. We will listen to him later this afternoon. Finally, I am particularly pleased that both Jean Claude Trichet and Nout Wellink have agreed to make introductory remarks this afternoon. Their reflections are, of course, always important. That comes with the job. But this afternoon more than usual because both are Wim Duisenberg's successor, both were his close colleague and both were his personal friends over many years. And, in fact, both of you – Jean Claude and Nout – are unique in terms of the personal characteristics you share with Wim Duisenberg: simplicity, imagination, humor, friendship and relentless commitment. I can testify to that. Our friend Wim thought highly and warmly of you both. He would surely smile if he could have heard you all this afternoon.

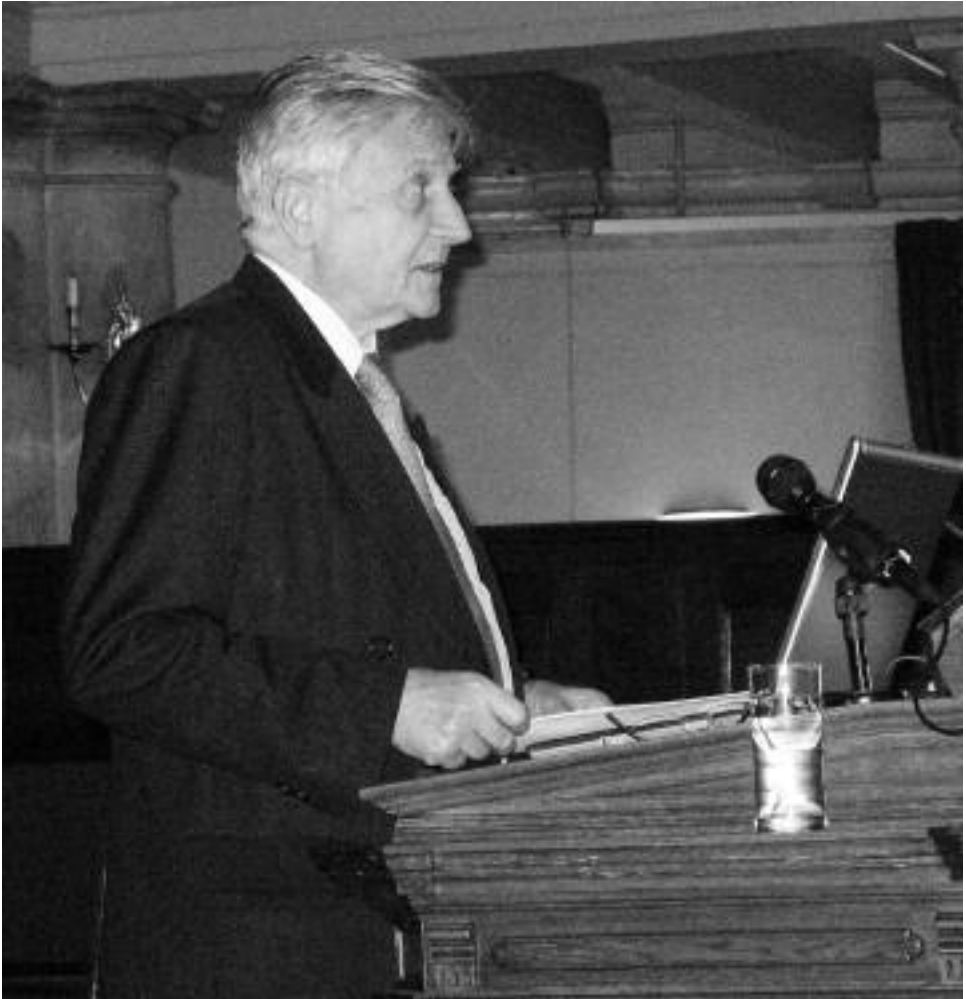


Photo: Dindy van Maanen / NIAS

Introductory remarks by Jean-Claude Trichet, President of the European Central Bank

It is a great pleasure for me to be here today in Amsterdam to inaugurate the Willem F. Duisenberg Fellowship of the Netherlands Institute for Advanced Study.

I am particularly delighted to be here for two reasons. First, this new Fellowship was set up in honour of Wim Duisenberg, the first President of the European Central Bank (ECB), who successfully led us through the uncharted territory of introducing the euro as the new currency for the, by now, around 320 million fellow European citizens. Second, the Willem F. Duisenberg Fellowship establishes another European programme that will foster top-quality research in the field of applied monetary and macroeconomics. It will thereby contribute to the continuous upgrading of our knowledge in these areas of research, which is fundamental for the sound conduct of monetary policy and of economic policies in the euro area.

Let me also say now that we are in the *purdah* period as far as the Governing Council of the ECB is concerned. Nothing in what I will say is intended to and should be interpreted in any respect in terms of future monetary policy.

The ECB has, from the very beginning of its existence, attached great importance to establishing close ties with academic research, in order to ensure the constant exposure of our analyses and views to external ideas and expertise. We foster these close ties in various ways. We frequently co-organise conferences, workshops and seminars on topics relevant for policy-making in the euro area. To give you an idea, last year alone, we were involved in the organisation of 17 such events. Furthermore, we also frequently invite academics to come to the ECB to present their work, for example, in the context of a weekly, invited speaker seminar, called the Joint Lunchtime seminar, which we organise together with the Center for Financial Studies and the Deutsche Bundesbank. In addition, we make sure that the analytical output of our staff members is regularly presented and discussed at international research seminars and conferences. Finally, our close links with academia are also promoted through external consultancies and visiting research fellowships.

In order to ensure that there is fruitful interaction with academic researchers, we need to maintain strong in-house analytical capabilities at the ECB. This allows us to continuously follow the latest developments in academic research and to assess their relevance for monetary policy. It also enables us to better connect the worlds of academia and policy-making, as well as to identify and to contribute to closing gaps in research areas where we feel more in-depth knowledge is required to support policy-making. This has been successfully carried out, for example, in the context of a number of Eurosystem research networks that have been led and coordinated by the ECB, the past Monetary Transmission and Inflation Persistence Networks and the currently ongoing Wage Dynamics Network.

While keeping up with academic research, which is very important for central banks, we must at the same time refrain from jumping immediately on the bandwagon of every new paradigm that is proposed by some academic researchers. Prematurely accepting new, untested theories entails the risk of serious policy errors if such work turns out to be flawed. This is what the experiences of the past have taught us.

In the 1960s and 1970s, many economists subscribed to the view, which was also supported by a number of leading academic researchers at the time, that a permanent trade-off between inflation and unemployment existed, and that inflation was, to a large extent, driven by non-monetary factors outside the realm of monetary policy. This view also influenced a significant number of central banks' policy conduct at that time, leading to an overly-expansionary monetary policy stance, eventually resulting in what is today known as the Great Inflation. These developments brought academic researchers and monetary policy-makers to recall in particular one long-standing macroeconomic principle that had fallen into oblivion: that inflation is ultimately a monetary phenomenon, meaning that inflation is, in the long run, solely determined by monetary policy.

Today, there is far-reaching consensus between academics and policy-makers, distilled through decades of academic reflection and policy experience, that price stability is a necessary condition for sustained economic growth and sustained job creation, and that the responsibility for price stability is best placed in the hands of an independent central bank. This consensus is enshrined in the ECB's and many other central banks' institutional architecture, which is characterised by two constituent features: a clear mandate to safeguard price stability, and institutional independence in order to ensure that this mandate is effectively pursued.

While monetary policy can make an important contribution to economic welfare by maintaining price stability, and thereby eliminating distortions arising from high and volatile inflation, the development of growth and employment are ultimately determined by the structural features of an economy. Well-designed structural policies promoting flexibility in product and labour markets, enhancing education and training and fostering research and development are, therefore, crucial for the long-run performance and smooth functioning of an economy. This holds particularly true in a monetary union like the euro area, where national monetary and exchange rate policies are no longer available as adjustment mechanisms.

Recognising the need for sound structural policies, the Member States have established a comprehensive reform agenda in the context of the Lisbon Strategy aiming at enhancing the growth and employment potential of the euro area countries. Yet, while there have been some remarkable improvements, reflected, in particular, in the creation of 15 million new jobs in the euro area since the start of Economic and Monetary Union (EMU) compared to only around three million new jobs in the nine preceding years, in many countries, structural reform efforts have not sufficiently enhanced the flexibility and efficiency of product and labour markets. This is evidenced by the still unacceptably high unemployment rate in some regions or segments of the labour market, and the very low level of labour productivity growth in the euro area.¹

Implementing and carrying out structural reforms is undoubtedly a challenging and arduous task. However, it is particularly important to resolutely pursue such reforms in the current environment, where the euro area economy is facing a number of important challenges, including rapid technological change, accelerating globalisation forces and ageing populations.

The experience of those European countries, which have undertaken courageous and successful reforms in the past, shows that they pay off.² The Netherlands is one such country, and is now characterised by a flexible labour market with the

¹ The annual growth rate of real GDP per hour worked in the euro area averaged only 1.3% over the period 1999-2006.

² A. Annett "Lessons from successful labour market reformers in Europe", *IMF euro area policies: selected issues*, 2006.

lowest unemployment rate in the euro area at 3.2% in 2007. In addition, with a total participation rate of 78.5% in 2007, the highest in the EU, and a female participation of 72.2%, two of the Lisbon objectives have already been met.

I would like to turn now to some of the reform policies pursued in the Netherlands that led to the remarkable performance of the Dutch labour market over the last quarter of a century. Speaking of structural reforms, and the successful reforms carried out by the Netherlands, it seems fitting that Professor Boeri, who is known as a forceful exponent of economic liberalisation and structural reform in Europe, and in particular in his own country, will be conducting his fellowship at the Netherlands Institute for Advanced Study located in Wassenaar, where, 25 years ago, the decisive Wassenaar Agreement was signed, steering the course towards change and initiating the remarkable and substantial recovery of the Dutch economy.

The main outcome of the Wassenaar Agreement was the establishment of wage moderation, which, in turn, helped firms to restore profitability and stimulate both investment and employment.³ Prior to this agreement, the Netherlands had been gripped in a wage-price spiral. However, through this agreement, which considerably diminished wage indexation, a platform for the remarkable turnaround of labour-market performance was created.

In addition, a continuum of supportive policy frameworks aimed at reforming labour market institutions was adopted, thereby ensuring the underpinning of wage moderation.⁴ The expansion of the part-time and temporary agency work sector in the Netherlands, combined with the implementation of effective policies, has resulted in both greater flexibility in the labour market, and job certainty for part-time and temporary agency workers. Moreover, it has assisted in alleviating the “insider-outsider” characterisation of the European labour market. Furthermore, the steady reduction in tax wedges and reforms of the benefit system, in particular, the shortening of the maximum duration of unemployment benefits and the reforms governing the disability scheme which were implemented over several years, have also helped increase the labour market’s performance.

³ J. Eriksson and E. Udden-Jondal “Lessons of the Dutch model”, *Riksbank, Quarterly Review* 3/4, 1997.

⁴ A. Annett (2006) “Lessons from successful labour market reformers in Europe”.

What the Netherlands and all successful reformers have in common is that they have, in parallel, successfully reduced product market regulation. This has led to more effective employment growth following an increase in labour supply, as wage moderation has fed through to jobs as opposed to rents.⁵ On this score, the proposed policies to further enhance the innovative environment of the Netherlands should be commended. In summary, a successful reform programme is more than just the sum of the individual reform policies due to the synergies that are created. Additionally, and as Professor Boeri has recently pointed out,⁶ there can be no steps backward in undertaking and implementing reforms, particularly with the need for greater flexibility in this era of rapidly changing economic environments.

Being here in Amsterdam today, on this given occasion, I should also like to take the opportunity to recall the successful transition to Economic and Monetary Union (EMU). It was here in the Netherlands where the milestones, on the way to this truly historical achievement, were set. The Maastricht Treaty, signed in February 1992, and the Stability and Growth Pact, sealed here in Amsterdam in June 1997, laid down the institutional framework for EMU, which provided the basis for the successful transition to the euro and the ECB's price stability-oriented monetary policy. And it was the Dutchman Wim Duisenberg, first President of the European Central Bank, who we are honouring here today with the inauguration of this new Fellowship, who led us into the most decisive phase of the monetary union. Indeed, for most of the 1990s, global investors and market participants had been lukewarm and sceptical vis-à-vis the prospects for EMU. But, in 1998, the markets radically changed the way they viewed EMU, recognising that the new currency would display the best – not the average – characteristics of the currencies that it was designed to replace. All along the yield curve, the future euro-area market interest rates became progressively aligned with the lowest market rates denominated in the most credible currencies, reflecting the stabilisation of inflation expectations in the euro area at the levels prevailing in those countries with the best monetary tradition available in Europe. All of us at the ECB, and at the national central banks of the Eurosystem – in the Netherlands the Dutch Central Bank with Nout Wellink at its helm – we will continue to preserve

⁵ A. Annett (2006) "Lessons from successful labour market reformers in Europe".

⁶ T. Boeri, "Europe is caught mid-river in labour reforms", *Financial Times*, 16 January 2008.

this legacy and to do our best so that, as Wim said, 'in the end history judges our new, shared currency to be a success'.⁷

⁷ W. Duisenberg, Address delivered on the occasion of a special ECOFIN dinner to pay tribute to his leadership of the European Central Bank, Venice, 29 October 2003.

Wim Duisenberg's Legacy as President of De Nederlandsche Bank

By Nout Wellink, President of De Nederlandsche Bank

I am honoured to be here today, at the inauguration of the Willem F. Duisenberg fellowship, and to have the opportunity to introduce to you Professor Tito Boeri, who will give the first Duisenberg lecture. De Nederlandsche Bank (DNB) encourages the initiative to continue this successful fellowship, and we are privileged that it has been given the name of DNB's former president Wim Duisenberg. I have many lively memories of Wim Duisenberg, some dating back more than 30 years.

Today I would like to take a closer look at the period when Duisenberg was president of the Nederlandsche Bank, the years between 1982 and 1997. Viewing back, from the current period of financial turmoil, those years may seem remote and relatively quiet. However, there was some turmoil at that time as well, and I think that our experiences of that time remain relevant today.

When Duisenberg became president of DNB in the early 1980s, the world economy was in a bad shape. The Bretton Woods system of fixed exchange rates had collapsed and the world had been shocked by two oil crises. The advanced economies were entering a deep recession. In the Netherlands, the economy suffered from what became known as the 'Dutch disease'. Essentially, it meant that we were living beyond our means, financed by the income from natural gas. As a consequence, the public sector expanded rapidly, including the social security system. Moreover, the wage share of national income exploded, and competitiveness of the Dutch business sector deteriorated. To top off all this, in 1982, inflation was very high, around 6%, the budget deficit was 9% of national income, and unemployment rate was almost 8%, more than doubled from two years earlier. Altogether, the economic situation was rather depressing, at the start of Duisenberg's presidency.

After the collapse of the Bretton Woods system in 1971, Dutch monetary policy remained directed at the exchange rate of the guilder. A strong currency was regarded as the best guarantee against imported inflation. Since Germany had a strong anti-inflation record, Dutch exchange rate policy amounted to keeping a stable exchange rate against the Deutsche Mark (DM). The Netherlands was the

first country to adopt this policy, and Duisenberg had already defended it strongly when he was Minister of Finance (1973-1977).

During Duisenberg's entire presidency, the Netherlands was a participant in the ERM, the Exchange Rate Mechanism of the European Union, which started in 1979. Throughout the first turbulent phase of the ERM, until 1983, the guilder remained the strongest currency in the ERM. In 1983, the guilder was devalued for the second time, and last time ever. The devaluation in 1983 was against the advice of Duisenberg, and for years the loss of confidence by the financial markets was felt through higher interest rates. In the end, this episode strengthened Duisenberg in his resolve to defend the exchange rate, even if significant interest hikes were required. In acting this way, Duisenberg quickly restored credibility in the markets, and in the course of that proved that credibility is achieved by action, not words.

Still, politicians were not always convinced that the exchange rate had priority over the interest rate. In 1992, for example, another Minister of finance (Wim Kok, in 1992) indicated that an interest rate increase was undesirable. Duisenberg took the unusual step not to follow Germany in raising the headline rate, but instead raised a less important rate (*beleningsrente*). It was accompanied by a press communiqué, indicating the Bank's dedication to fight inflation through a strong guilder. This illustrated Duisenberg's ability to avoid a public conflict about interest rates, a conflict that certainly had negatively affected the exchange rate.

A major test of the ERM and the Dutch exchange-rate policy came in 1992 and 1993, when speculative attacks caused several crises. In this phase the guilder-DM rate was the only exchange rate that was not under attack. The guilder-DM peg appeared to be the most credible and tightest bilateral exchange rate within the ERM. Looking back, this can only be explained by the credibility of Dutch exchange rate policy in the previous years.

The process towards Economic and Monetary Union, which started in the 1970s, was in full progress during Duisenberg's presidency. In the 1980s, capital markets gradually became less restricted, culminating in 1990, with the start of stage I of the EMU. On many occasions, Duisenberg explained that free capital flows were in the interest of The Netherlands. As a small, open economy, the Netherlands could only benefit from international cooperation, free trade and free capital markets. Duisenberg advocated the opinion that integration of monetary policy was the inevitable reply to this liberalization of European money and capital markets.

However, returning again to the start of Duisenberg's presidency, the high inflation and interest rates in that period had a serious effect on the real estate market. In the early 1980s, several mortgage banks ran into trouble. In 1983 one of them, the Tilburgsche Hypotheekbank, became insolvent. This mortgage bank crisis was a serious test for the new prudential supervision regime of DNB, the Wtk of 1978. Duisenberg indicated firmly that supervision could only minimize the probability of failures, not exclude them. He showed that this tough policy line could be complemented by careful steering towards a private sector solution. Two of the mortgage banks could be rescued by other institutions, which benefited all stakeholders, including the creditors. Ultimately, 95% of the liabilities of the failed Tilburgsche Hypotheekbank could be paid off.

Duisenberg took a clear stand with respect to budgetary policy. Starting with his first annual report, Duisenberg has always maintained that DNB would not support an expansionary budgetary policy that would result in unsustainable deficits. This view was not at all evident in the 1970s and 80s. Between the Second World War and the 1970s, Dutch economic policy had been of a Keynesian nature, with scope for activist, counter-cyclical budgetary stimulus. In the early 1980s, the consensus view changed gradually towards a more restrictive budgetary policy. With patience and perseverance, Duisenberg continued to explain the adverse economic consequences of a high budget deficit. His main argument was the upward effect on interest rates, which reduced private investment and economic growth. Duisenberg also held the view that the Dutch welfare state could not be supported in the long run if budgetary policy did not change its course. Finally, Duisenberg argued, international coordination of economic policy required a budgetary situation that is under control and on a sustainable path. In a sense, he gave early arguments for the Stability and Growth Pact that was signed in 1997.

Duisenberg's view on economic policy was completed by respecting the crucial role of employers and employees in setting wages and labour costs. Next to stable exchange rates, low inflation and low capital market rates, wage moderation was central to improving the financial health of the private sector. This would lay the foundations for an improved investment climate, supporting labour demand. Here, the central bank had no other instruments than to use its influence and try to influence the private sector. The famous Wassenaar agreement of 1982 was supported by DNB, because it offered scope for restoring profitability of the business sector.

At the end of Duisenberg's presidency, some concluded, rather optimistically, that a Dutch miracle had replaced the Dutch disease. The Dutch economy had experienced a successful recovery that can be ascribed to many factors: monetary and budgetary stability, as well as wage moderation and structural changes in labour and product markets. It is safe to say that Duisenberg contributed to all of these factors. If one would try to summarize the legacy of Duisenberg's DNB presidency, I think the first central theme would be his aim for stability. He achieved that stability by a persistent policy and staying the course. Frequently, he had to defend this kind of policy line, for example regarding interest rate adjustments in view of the exchange rate. In Dutch, he described this kind of policy as '*stug*', translated as stiff or tough. '*Stug*' has the subtle connotation that, initially, he did not expect much support for his policy line towards stability.

Another central theme for Duisenberg was his relentless focus on the benefit of the Dutch society. This may sound self-evident for a policymaker, but Duisenberg interpreted this differently from a politician. He demonstrated that a central banker should look at the long-term costs and benefits. To give an example, at the time when politicians were celebrating the proceeds of natural gas production – 6% of GDP in 1981 – Duisenberg stressed that this was only temporary and warned that painful adjustments would be necessary in the long term.

The last central theme that characterizes Duisenberg's presidency is his European focus. With respect to economic policy, Duisenberg continuously stressed that an "Alleingang" would be catastrophic for the economic well-being of nations. An integrating world, with all its complexities and risks, required international cooperation and coordination. Duisenberg was aware as well, that a single monetary policy would not always match with local developments. His message is that the remaining channels to adapt to country-specific shocks should be safeguarded and strengthened. That is the main reason for his strong support for sustainable public finances and flexible labour markets. Duisenberg's strong support for international coordination combined with a global view earned him great support and these characteristics were highly valued while he was the first president of the European Central Bank.

Let me now conclude, by introducing the speaker of today's main lecture, Professor Tito Boeri. Professor Boeri was appointed three months ago as the first Willem F. Duisenberg Fellow. He is Professor at the Bocconi University in Milan, where he also acts as Director of the Fondazione Rodolfo De Benedetti. Professor

Boeri is a research fellow at two outstanding international institutes for applied economic research: the Centre for Economic Policy Research (CEPR) in London and the IZA (Institut zur Zukunft der Arbeit) in Bonn. His main research topic is the labour market, but he has also published on immigration, social security, pension systems and transition economics. Professor Boeri has published in highly-rated economic journals, and has also worked with organizations like the OECD, the European Commission, the International Monetary Fund, and the Italian Government. This indicates that Professor Boeri has the rare, but, in my opinion, invaluable mix of being both skilled in academic research and in applied, policy-oriented activities. Today, we will have the opportunity to benefit from this, as he will speak, in the first Duisenberg Lecture, about ‘the disappearance of mass unemployment in Europe’.





Tito Boeri, 28 February 2008

Photo: Herman Wouters / Hollandse Hoogte

What happened to European Mass Unemployment?

By Tito Boeri

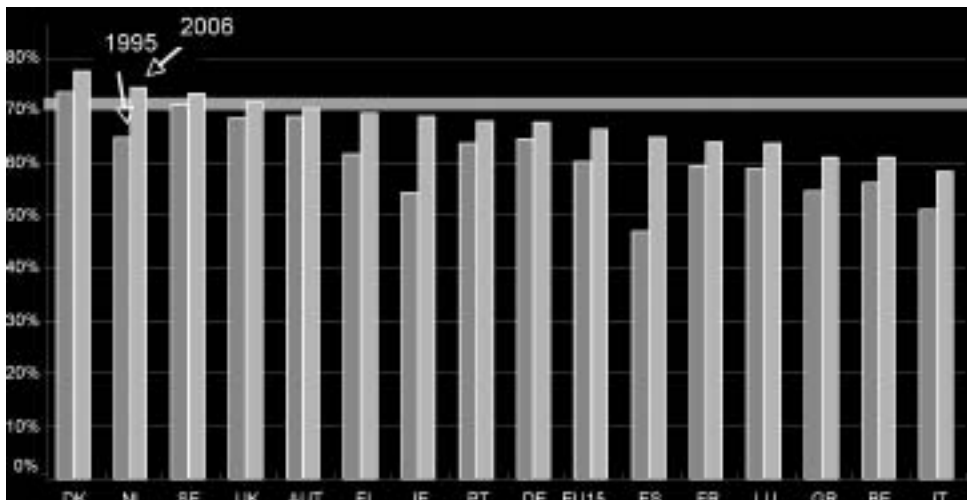
Europe is no longer a continent of mass unemployment. In spite of the numerous articles still being published on EU unemployment problems as well as persistent headlines about unemployment in the Continental newspapers, there has in fact been a sea change in the labour market conditions of Europe over the last 10-15 years. In my lecture today, I will try first to document this old European dream come true. Next, I will argue that this European dream is, paradoxically, turning into a European nightmare as citizens are becoming increasingly dissatisfied with labour market developments in the Union. Finally, I will try to explain this paradox and why it is happening. In order to understand these developments we need to look not only at stocks or at the number of unemployed, but also at labour market flows. These flows across labour market states, or transitions, are much more informative than aggregate employment-unemployment stock figures.

As I prefer not to keep people in suspense about my conclusions, let me state them right at the outset. The explanation for the low-unemployment – widespread-dissatisfaction paradox in Europe lies in changes in risk-return within the labour market. The paradox can only be solved by ‘cheating’ the underlying employment-productivity trade-off. The fact of the matter is that Europe has not proved able to reconcile meeting the Lisbon employment targets with increasing labour-productivity. In the concluding part of my lecture, I discuss ways to reconcile these two objectives and argue that: yes, it is possible to have both higher employment and increased productivity.

A European dream came true...

The dream was written on the stone of the Treaty, signed in Rome on March 25, 1957: “The Community shall have as its task (...) to promote throughout the Community (...) a high degree of *convergence* of economic performance, a high level of *employment* and of social protection, the raising of the standard of living and quality of life, and economic and *social cohesion* and solidarity among Member States”. There are three key words here: employment, convergence and

Figure 1. Employment rates compared to working-age population rates in the EU15 and the distance from the Lisbon Employment Target (70%)

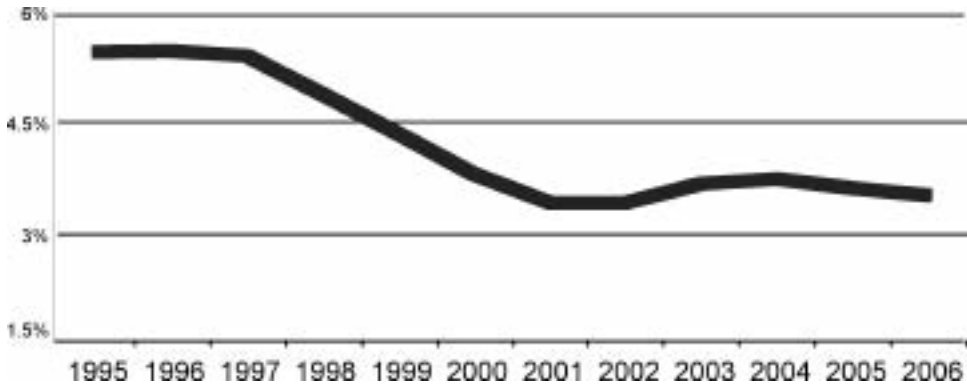


social cohesion. Has Europe made any progress related to these domains in the last decade?

Consider first employment and unemployment. Since 1995, 21 million new jobs were created in the EU. During this period, the European population has increased as a result of large migration inflows. However, employment has increased independently of population growth: there is not a single country in the EU that has not seen an increase in its employment rate (Figure 1), that is to say, the proportion of the working-age population that is in employment.

Over the last 10 years, European unemployment has fallen to a level not seen for over twenty-five years. If we look at the countries of the EU15, there are currently almost 4 million less people unemployed than in 1996. Long-term unemployment has almost halved (Figure 2): Europe is no longer a place where more than 50 per cent of jobseekers have been on the dole for more than twelve months, as was the case in the mid-1990s.

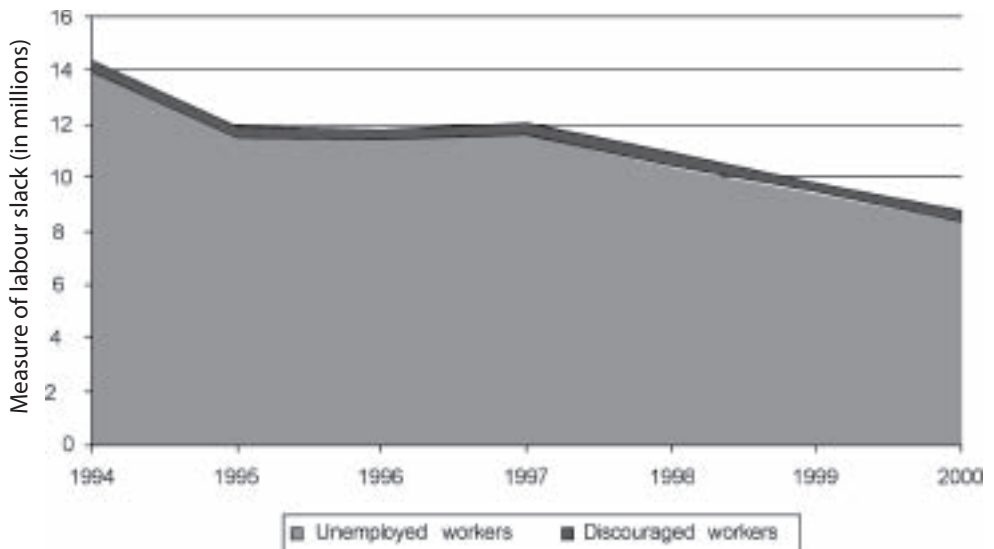
Figure 2. Decline in long-term unemployment rates in Europe (EU15) as a percentage of the labour force



The disappearance of mass unemployment in Europe cannot be explained as a side effect of falling participation in the labour market. As discussed earlier, the average employment rate in the EU15 has increased in real terms by more than six percent over the last ten years. This is the only area where Europe has been able to approach the Lisbon targets. It is not the case that there are many discouraged workers crossing the porous border between labour market participation and non-participation. There has not been an increase in the number of unemployed who stop looking for another job and then step out of the labour market because they believe that there are no vacancies for them (Figure 3). Whatever measure of labour slack we take, it is clearly declining - and not just by a small margin.

The countries that initially had the highest unemployment rates have been most successful in reducing unemployment. For example, Finland, Ireland, Italy and Spain, Italy, initially characterized by high unemployment rates, saw the greatest declines in unemployment. There was convergence in the dynamics of national unemployment rates, another relatively new phenomenon for Europe. In the previous decade, unemployment rose almost everywhere, including the high-unemployment countries. Thus, since at least the mid-1990s, we have made major progress in achieving *economic convergence* in terms of labour market conditions across the EU countries.

Figure 3. Discouraged workers



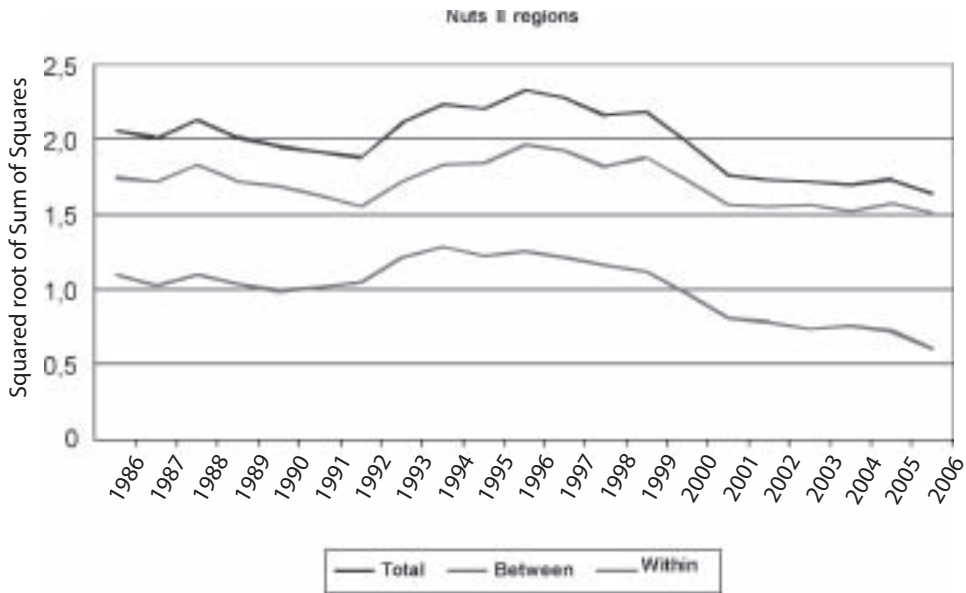
Note: Data refer to the following EU countries for which data about discouraged workers were available: Belgium, Denmark, France, Greece, Ireland, Italy, Spain and Portugal.

Social cohesion, the third goal stated in the (old) Rome Treaty was to achieve less asymmetry in labour market conditions, also within each EU country. The cross-sectional distribution of unemployment rates across the regions of the EU15 (Nuts II) declined considerably after 1995, as a result of less *cross-country* variations and less *within-country* variations in unemployment rates (Figure 4). This is another new development in Europe. Up to the mid-1990s, the *within-country* variation in unemployment rates was on the rise. Over the last 13 years, the EU-15 countries have become more homogenous societies, at least judging by regional labour market disparities.

... but it is turning into a nightmare

European Governments, however, are not capitalizing on these labour market success stories. The governments and coalitions who were in power when

Figure 4. Cross-Sectional variation in unemployment rates

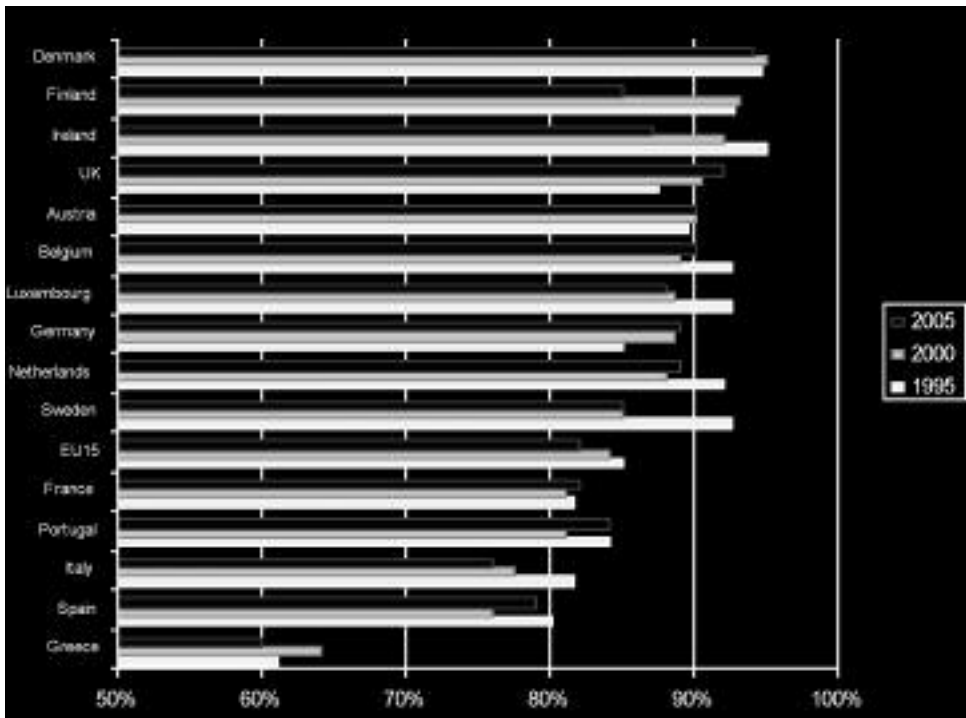


millions of jobs were created were not re-elected to office. In Italy, Berlusconi's 2001-2006 Government succeeded in creating 1.3 million jobs in five years, far more than the one million promised in the 2001 electoral campaign. This did not prevent the collapse of his popularity and his defeat at the next general election. Prodi's 2006-2008 Government had a very short life in spite of creating more than 400,000 jobs in less than 2 years. In Spain, Aznar lost the election in 2004 after halving Spanish unemployment. Apparently, his impressive record in creating jobs (almost 5 million jobs created during his mandate) was not appreciated by the Spanish electorate.

Public opinion polls point to increasing dissatisfaction with working conditions, notably in those countries that experienced the greatest decline in unemployment. Figure 5 displays the answers to the *European Working Conditions Surveys* carried out in 1995, 2000 and 2005 in different countries.¹

¹ Source: European Foundation for the Improvement of Living and Working Conditions.

Figure 5. Job satisfaction in EU Countries (% of employees expressing satisfaction with their working conditions)

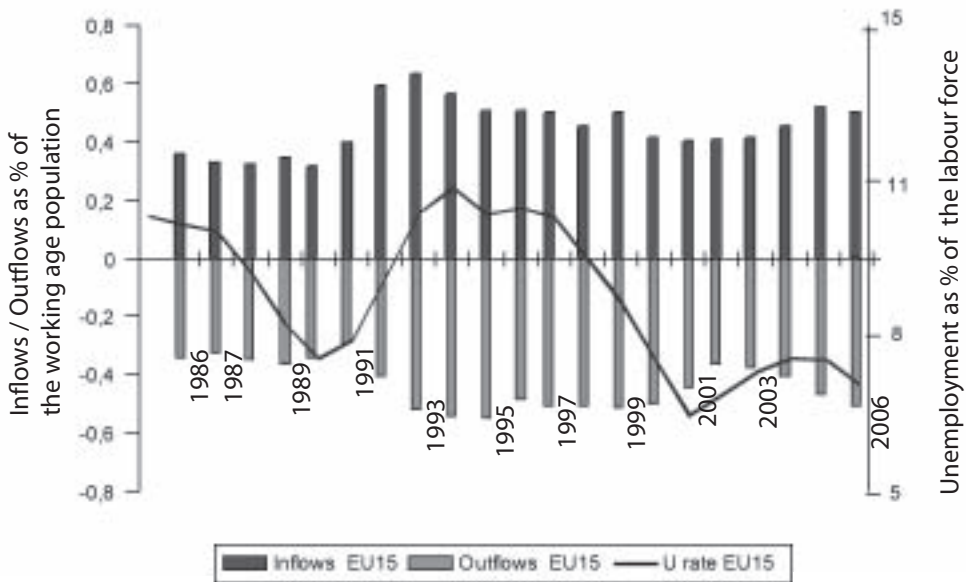


Similar results are obtained when we look at the *European Community Household Survey*, a longitudinal dataset (tracking the same individuals over time), which was unfortunately discontinued in 2001. The proportion of individuals “fully satisfied with labour market conditions” declined by one percentage point per year at exactly the same time that unemployment was improving.

Why?

Why is the European dream turning into a European nightmare? The simplest explanation one could offer is that the decline seen in unemployment is mainly due to a statistical, composition effect related to demographic developments that occur independently of changes in unemployment levels in specific socio-

Figure 6.



economic groups. If this were the case, then the improvement in labour market conditions would hardly be noticed by voters because the labour market risk does not decline. This could explain why improved unemployment figures can co-exist with such a low estimation of labour market conditions.

Europe's populations are ageing and it is known that young people are more likely to be unemployed than older workers. It follows, therefore, that an ageing Europe with a higher proportion of older people will display lower unemployment simply as a reflection of an older workforce. However, this simple explanation does not work. At the very most, this effect would explain only one-tenth of the reduction in unemployment. The remainder refers to a reduction in unemployment among all age groups. Nor can large-scale immigration, the second most important demographic phenomenon that has occurred in Europe over the last decade, explain the disappearance of European mass unemployment. If anything, more immigration should have increased unemployment, as the incidence of unemployment is typically higher among migrants than among natives in the EU15.

In order to understand what is going on in Europe and explain the paradoxical situation that its citizens are dissatisfied even though unemployment is disappearing, one has to go beyond labour market stocks and look at flows across labour market states.

Unemployment declines when either inflows into unemployment fall or outflows from unemployment increase. Figure 6 suggests that in the EU15, unemployment has been declining, notwithstanding a trend towards larger inflows into unemployment, as a proportion of the population at risk (i.e. the working age population minus the unemployed). In other words, it is mainly an increase in outflows from unemployment that has driven the fall in European unemployment. Other indications as to what could determine the evolution of unemployment can be obtained by analyzing transition matrices across labour market states (employment, unemployment and inactivity) and computing scalar measures of mobility. One such measure is the Shorrocks mobility index:

$$M=(S-\text{tr}(M))/(S-1)$$

Where S denotes the number of labour market states and $\text{tr}(M)$ traces the transition matrix that maps flows into and out of employment across the three main labour market states (employment, unemployment and inactivity). When the 'stayer' coefficients are larger than any individual 'mover' coefficient, the index is bound below from zero, where there is no mobility, and above from one when 'stayer' coefficients are not larger than $1/S$.

This analysis suggests that mobility across labour market states has increased quite dramatically in Europe. The mobility index was 28%, in the period 1985-1988, and increased to 32% in the period 2001-2004. Interestingly, increases in mobility were highest in countries that experienced the largest declines in unemployment.

It was reforms!

Thus, the European labour market landscape looks very different from the sclerotic situation of the early 1990s. Let us look back at what a very influential report commissioned by the G7, the 1994 OECD Jobs Study stated at the time: "In inflexible Europe ... the high incidence of long-term unemployment is associated with *low inflow rates into unemployment*". In the G7 study, the problem of unemployment in Europe was attributed to mounting long-term unemployment, in

comparison to the situation on the other side of the Atlantic Ocean. Not only is the EU 15 unemployment rate now a third lower than in 1994, at the time of the OECD Jobs Study, but long-term unemployment has almost been halved.

Why did this sea change from a sclerotic to a more mobile Europe occur? The driving factor behind the increase in labour market flows would seem to be the reforms of employment protection legislation. During the 1990s, there was a major increase in the number of reforms at reducing the costs of dismissal. There were four such reforms throughout the entire EU15 in the 1986-1990 period, while during the 1996-2000 period this increased to 16 reforms. Most of these reforms were marginal in that they were confined to reducing employment protection for New Hires, expanding the scope of fixed-term contracts and introducing more types of flexible contract (ranging from temporary agency work to job-on-call). This dramatically changed the conditions at entry into work. In the countries with the strictest provisions concerning the dismissals of permanent workers, the majority of New Hires are currently in these new and highly flexible contracts. To give an example, in Spain, nine out of ten transitions from unemployment to employment involve fixed-term contracts. The increase in unemployment outflows in Europe was largely associated with this new entry channel. More broadly, only the countries that reformed employment protection, in particular by expanding the scope of temporary work and fixed-term contracts and other type of typical context, experienced an increase in mobility. The same was also the case in the few countries that managed to reform regular contracts.

The trouble is that, rather than being just a port of entry, these flexible contracts are often a dead-end. The probability of moving from a fixed-term to a permanent contract within a year is indeed very low, of the order of one out of 20 or one out of 10. Table 1 below summarizes flows into and from temporary employment in Spain in the 2002-2003 period.

Almost 85% of workers still only have a fixed-term contract one year later. Only 5% succeed in securing a permanent contract. Roughly, 10% will become unemployed again: a probability of job loss that is almost 10 times higher than for those with permanent contracts.

In other words, these dual-track reforms have created long-lasting asymmetries in career paths. The risks have been concentrated on workers with flexible contracts. Based on transition matrices it is possible to predict (by estimating the ergodic

Table 1. Flows into and from temporary employment in Spain 2002-2003

2003 \ 2004	Permanent Contracts	Fixed Term Contracts	Unemployment	Inactivity
Permanent Contracts	97,2	1,1	1,0	0,7
Fixed Term Contracts	4,8	82,6	9,0	3,5
Unemployment	2,5	20,1	67,0	10,4
Inactivity	0,4	2,4	3,9	93,3

distribution) that, in the long run, up to one third of employment will be within such flexible contracts.

Can Europeans be happy about their new labour market?

The dissatisfaction of Europeans with the European labour market is ultimately related to this new and, apparently less favourable, risk-return combination. Labour markets are becoming more risky and this entails welfare loss for risk-averse workers unless this greater risk is compensated by a higher return. Pressure is mounting everywhere in Europe for more state involvement in wage setting. These pressures can also be interpreted as a need to compensate greater labour market risks. Nobody can be fully protected from it. Even insiders are exposed as they worry about job loss.

The pressure to return to the old situation is great. After having reduced state involvement in employment adjustment, it would now be a mistake to increase government involvement in wage setting. Setting statutory and industry-specific wage minima, as was recently done in Germany, exposes governments to even stronger pressures from national lobbies and encourages 'leapfrogging' games across industries. Moreover, there is no reason to reintroduce even the mild forms of income policy that were adopted in several EU countries in preparation for EMU membership. The problem is that centralised wage setting is not an appropriate instrument after EMU, as macroeconomic shocks are regional or industry-specific in nature. Thus, national-union-based systems of industrial relations are ill suited to address new demands for microeconomic adaptability.

The best response that can be offered to deal with the paradoxical concerns of

Europeans with respect to lower unemployment is to decentralise wage setting even more and make it more responsive to productivity. Risk is magnified by the fact that any labour market transition involves a large wage loss. Centralized wage agreements tend to reward automatic adjustments of wages to tenure. Moving across jobs or experiencing even short spells of unemployment prevents workers from moving up the wage ladder. A better risk-return combination can be offered by linking wages more closely to idiosyncratic productivity. Insofar as changing jobs involves making a better match, wages would increase after changing jobs rather than the other way round.

At the same time, something must be done to tackle the increasing dualism between temporary and permanent jobs currently seen in most European labour markets. This dualism is costly for the society as it reduces incentives to human capital formation: workers with fixed-term contracts are less subject to on-the-job training than are other workers. A sensible policy would be to offer a clear 'tenure track' prospect to young workers by completing reforms of employment protection. Currently, there are no long-term prospects after the expiration of a temporary contract. Governments could promote entrance into the permanent labour market in stages, introducing graded employment protection and so avoiding the formation of a long-term dual market. Job security provisions, in the form of mandated severance payments, should increase steadily as workers acquire tenure without large discontinuities.

There is ultimately a trade-off between employment and productivity growth behind the dissatisfaction of Europeans with low unemployment. Employment growth is occurring at the cost of negative or low growth of labour productivity. This prevents workers being compensated for the higher risk they face. The fact of the matter is that Europe is still stuck half way across the river of labour market reforms. Pressures to go back to the old system are strong but governments should resist this pressure, as this would lead to a huge rise in employment costs. Increasing both employment and productivity in Europe requires doing just the opposite. Governments should take us to the other side of the river: a tenure track to more stable jobs should be introduced and wage setting should be decentralized to link it more closely to productivity gains. Some of these reforms are politically difficult. In the words of Wim Duisenberg, "carrying out structural reforms is politically difficult since they may be painful in the short term, and only bear fruit over a longer time". Wading through the turbulent river of labour market reforms may be a painful process but going back is simply not an option.

Closing words by Wim Blockmans, Rector of NIAS

You will agree with me that we are present at a most memorable event in honour of a remarkable person. We congratulate the initiators of the Willem F. Duisenberg Fellowship at NIAS and earlier, we heard from Professor Halberstadt how and when this decision was taken. It must give Willem Duisenberg's family great pleasure to know how highly his close friends think of him, and to see how much effort has been put into celebrating his memory. Many people have been involved in the preparations running up to this event but, in order not to burden you with too many names, I will name only one.

With no other motives than personal friendship and a strong commitment to the discipline of financial economics, Professor Halberstadt, as Chairman of the Willem F. Duisenberg Fellowship Foundation, has invested a huge amount of time in this initiative. I thank him most cordially for his tireless attention to major issues as well as details which matter.

Professor Tito Boeri is the first holder of the Willem F. Duisenberg Fellowship, and we have all just witnessed the depth of his analysis and insights. Over the past three months at NIAS, he has been hard at work exchanging ideas with colleagues from The Netherlands and abroad and sharing his wisdom with fellow economists at the Ministry of Finance, the Central Planning Bureau and various Dutch Universities. I believe that in the thirty-seven years of its existence, NIAS has never hosted an Italian scholar who showed so much enthusiasm for the institute and The Netherlands at large. He even sent his 14-year-old son to a Dutch Gymnasium and chose to spend the Christmas holiday with his whole family in these northern climes. Professor Boeri, we hope you are a trendsetter in this respect as well as being our first Willem F. Duisenberg Fellow.



Photo: Dindy van Maanen / NIAS

About the Author

Tito Boeri is Professor of Economics at Bocconi University in Milan, Director of DIEM (Degree of International Economics and Management) at Bocconi University. He is also Director of the Fondazione Rodolfo De Benedetti, a Milanese foundation to promote applied and policy oriented research on amongst others, the causes of European unemployment, its social costs and the political feasibility of strategies aimed at liberalising EU labour markets. His research interests are labour economics, redistributive policies and political economics.

Boeri obtained his Ph.D. in Economics from New York University in 1990 with his dissertation: *An Analysis of Firm Growth and Specialization*. He was Senior Economist at the Organisation for Economic Co-operation and Development (OECD) from 1987 to 1996. One of the tasks in this position was the coordination of all the work carried out by the OECD in the field of human resource policies in the central and eastern European economies in transition after 1990. Boeri was also consultant to the International Monetary Fund and the World Bank. He is also the founder of the economic policy watchdog website www.lavoce.info.

His papers have been published in the *American Economic Review*, the *Journal of Economic Perspectives*, *Economic Policy*, the *European Economic Review* and the *Journal of Labour Economics*. His recent publications include: "Two Tier Reforms of Employment Protection: a Honeymoon Effect?" *Economic Journal*, 2007 (with P. Garibaldi), *Structural Reforms without Prejudices*, Oxford University Press, 2006 (with M. Castanheira, R. Faini & V. Galasso, V. (Eds.)) and "Shadow Sorting", in: *NBER Macroeconomics Annual*, MIT Press, Cambridge, 2005 (with P. Garibaldi).

The Willem F. Duisenberg Fellowship Foundation aims to further the study of economics in the Netherlands. To this end a special fellowship building on NIAS's successful Jelle Zijlstra Fellowship programme was set up at the Netherlands Institute for Advanced Study in 2007 in honour of Willem F. Duisenberg. Willem Duisenberg (1935-2005) succeeded Jelle Zijlstra (1918 – 2001) as President of De Nederlandsche Bank in 1981. During his career Duisenberg also worked at the International Monetary Fund, as Professor of Macro-Economics at the University of Amsterdam, as Minister of Finance, and from 1998 to 2003 as first President of the European Central Bank. In this latter capacity he played a crucial role in the introduction of the European Monetary Union and the Euro. The Willem F. Duisenberg Fellowship is sponsored by the Dutch Ministry of Finance, De Nederlandsche Bank, AEGON, ABN AMRO, Fortis, ING and the Rabobank.

NIAS is an institute for advanced study in the humanities and social sciences. Each year, the Institute invites around 50 carefully selected scholars, both from within and outside the Netherlands, to its centre in Wassenaar, where they are given an opportunity to do research over a ten-month period. Fellows carry out their work either as individuals or as part of a research theme group, which NIAS initiates every year. In addition, through its conference facilities, the Institute also functions as a meeting place for scientific programmes of a shorter duration and more specific character, such as workshops, seminars, summer schools, and study centres.

NIAS is an institute of the Royal Netherlands Academy of Arts and Sciences (KNAW).

