

## UNEMPLOYMENT CRISIS

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# UNEMPLOYMENT CRISIS

## THE UNEMPLOYMENT CHALLENGE IN EUROPE

STEPHEN NICKELL\*

### Where are we now?

Europe, like much of the World economy, is in the middle of a serious recession with GDP in many countries having fallen significantly. Interestingly enough, looking across the OECD countries, there has not been a very strong correlation between the rise in unemployment and the fall in GDP. For example, in the last year (up to 2009 Q1), GDP in the United States has fallen by 2.5 percent and unemployment has risen by four percentage points. By contrast, German GDP has fallen by 6 percent but unemployment has risen by less than one percentage point. On the other hand, Spanish GDP has fallen by 3.1 percent whereas unemployment has risen by eight percentage points.

To some extent, these differences reflect the productivity levels in the hardest hit industries. For example, in Spain, there has been a huge contraction in the relatively low productivity construction sector generating large falls in employment relative to GDP. In Germany, on the other hand, the high productivity capital goods sector has been badly hit leading to much smaller falls in employment relative to GDP. The other major factors are labour market institutions and specific employee retention policies. For example, countries with a combination of very flexible short-term contracts and very inflexible permanent contracts will see large falls in employment. Indeed these falls may be exacerbated by the fact that those on permanent contracts will be less inclined to moderate their wage demands because their security of employment is much enhanced by the existence of a large cushion of short-term contract workers. Use of short-time working subsidies, by contrast, will tend to attenu-

ate employment losses. This has been a key factor in Germany.

Overall, however, prospects for unemployment look bad across the board. While GDP growth in Europe will probably be positive in 2010, it could well be below trend and this will not bring down unemployment. So what is to be done?

### How can we mitigate the rise in unemployment?

#### *Macroeconomic policy*

It goes without saying that we need, and by and large we have got, expansionary monetary and fiscal policy as befits a situation in which aggregate demand has fallen and there was little in the way of core inflationary pressure even before this fall. This was not a recession generated to squeeze inflation out of the system.

#### *Labour market policies*

The issue here is the extent to which the rise in unemployment can be attenuated relative to any given fall in GDP. Firms which are confident in their long-term prospects and employ a high proportion of workers with firm-specific skills may employ a variety of policies to retain employees at reduced costs such as hour reductions, compulsory vacations, pay cuts and so on. Subsidy policies can be used to encourage this, the justification being that this will sustain labour market attachment. Maintaining attachment to the labour market is one of the key ways of maintaining the health of the labour market in the long run and this is one method which has been employed effectively in some EU countries. The cost of this method is that it may impede the movement of workers towards more productive activities and prevent the contraction of less productive industries or industries where there is general overcapacity. For example, competitive protection of automobile manufacturing across the world may ensure that overcapacity is sustained even as the world emerges from the



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recession. Of course, there is a collective action problem here since no one country wishes to contract its domestic automobile industry to the long-run benefit of the rest of the world.

As we have already noted, the structure of employment protection rules will impact on the rate at which unemployment rises. Strict rules will, of course, slow the rate of job loss in a downturn at the expense of slowing the rate of job gain in the upturn. Making the rules stricter in response to a recession is probably not to be recommended at a time when firms are under severe financial pressure.

### **Bringing unemployment down in the recovery and preventing persistence**

*Can labour market policy make a difference in the short run?*

The speed of the recovery will, of course, depend crucially on how macroeconomic policy develops, how credit markets recover and how the manifest problems facing the world economy are resolved. Generally speaking, those economies which have seen faster falls in employment relative to GDP in the downturn will probably see faster rises in employment relative to GDP in the recovery. Indeed, the existence of flexible short-term contracts and, particularly, widespread temporary employment agencies may allow faster expansion of GDP without excessive inflationary pressure.

*What measures are to be avoided?*

In order to prevent unemployment persistence and, indeed, to sustain labour supply more generally, it is crucial to continue the labour market attachment of those who lose their jobs. Historically, we have not been good at this. Under the pressure of rising unemployment, the force of the 'something must be done' argument tended to grow and it was easy to succumb by removing people from the labour force via early retirement, disability and so on. While this reduced the number of the non-employed who were actually looking for work (the unemployed) in the short run, in the long run the inactive population became larger while the unemployment rate was unaffected. The growth potential of the economy was reduced and the fiscal position was worsened.

There is a long and unfortunate history of this policy response so, by the early 2000s, in the vast majority of OECD countries there were more inactive men aged 25–54 than unemployed men in the same age group, mostly long-term sick or disabled. Furthermore, in many countries, inactivity rates among men aged 55–64 had risen to very high levels in the three decades up to the mid-1990s, despite male life expectancy having risen steadily throughout. The consequences for pension systems were plainly adverse. So one thing to avoid above all others, is to be tempted into providing individuals with incentives to retire early or to enter long-term sickness or disability. Sustaining and enhancing long-run labour supply is the direction in which to move.

### **How do we maintain labour force attachment?**

As we have already noted, the key to maintaining the long-term growth potential of the economy is to prevent those who lose their jobs from getting into a situation where it is very hard to get back into work. So they must avoid going into long-term unemployment, early retirement or the disability benefit system. In normal times, it is sensible to devote significant resources to assisting those who are already in one or other of these states back into the labour market. In a recession, given limited resources, the main focus has to be on those entering unemployment. There will, of course, be much larger numbers of these than in normal times.

The standard policy shortly after entry into unemployment is mandatory participation in an activation programme, monitoring of job search, counselling and job search assistance in return for receipt of benefits. For those lacking skills, policies to enhance employability may be in order although such evidence as we have suggests that training for the unemployed is not a very successful policy. Targeted recruitment subsidies can be more effective. EU countries vary greatly in the rigour and effectiveness of their activation policies.

When unemployment duration reaches a given point, six months or twelve months say, then to sustain labour market attachment it is worth introducing a job/training guarantee in return for continuing receipt of benefits. The work would be temporary (6–12 months) and part-time with the individual continuing to search for a regular job at the same time. The work would be socially useful, requiring mini-

mal training, organised at public expense by local authorities or voluntary groups. Only a small minority of EU countries have mandatory schemes for all the unemployed who reach a certain duration although in most EU countries unemployed individuals can be referred to such schemes by the employment service.

There are two problems with all these kinds of policies. First, they are expensive. However, in a serious recession, fiscal policy is going to be expansive and some of the extra expenditure should be diverted in this direction. Second, a highly professional and well organised employment service is required. Furthermore, its capacity must be increased rapidly as the inflow into unemployment rises, otherwise activation and related policies may be overwhelmed.

### **Tackling vulnerable groups in the short and long run**

#### *The short run*

The vulnerable groups are the young, the unskilled and those potentially suffering from long-term sickness or disability. As we have already noted, for the first two groups, the focus has to be on assistance in obtaining work and enhancing employability which should start immediately upon entry into unemployment. For the third group, if individuals lose their jobs because of sickness or ill-health, it is vital to mobilise support before they enter long-term disability. This plainly involves medical support, a focus on the sort of work which the individual can manage and immediate access to effective psychological therapies for those affected by depression and anxiety disorders which may indeed be worsened by unemployment. The worst strategy is simply to allow general practitioners to sign people off work with no further intervention.

#### *The long run*

For the young, the evidence suggests that countries which have so-called dual systems have lower levels of relative youth unemployment and smoother and more rapid transitions from education into work. A dual system is simply one where a national apprenticeship is the way into skilled work for those outside university. The essence of these schemes is that they are national, there is a contractual relationship between employers and workers, the training is of

high quality and there are standards which are imposed at a national level, like a driving test. These schemes have been around for a very long time in Austria, Denmark, Germany and Switzerland, and are hard to start up from scratch. However, some countries feel that it is worthwhile trying to move in that direction, notably Norway, Australia and Britain, because the benefits for the young are so great.

For the unskilled and those without qualifications, it is plain that the quality of schooling at the lower end of the ability range is a key factor. Evidence from the International Adult Literacy Survey indicates that there are huge cross-country variations in the proportion of the population of working age who have minimal skills. It is clear that the labour market will work much better and poverty will tend to be much lower if there is only a small group of individuals with very low literacy and numeracy skills. Those at the bottom of the ability range require additional resources for them to receive effective education. If they can develop marketable skills when young, their entry into the labour market is much easier to organise effectively.

In many, if not most, countries of the developed world, there are more prime age men (aged 25–54) on disability benefit than there are on unemployment benefit. This was not the case in the 1970s. The key factors are the structure of the disability benefit system and the way in which individuals are moved into this system from employment or unemployment. In order to reduce the numbers on disability benefit, two things are required. The first is to control the inflow using policies described above. The second is to apply the standard activation mechanisms allied to medical support to individuals who are already on disability benefit. A good example is the Pathways to Work scheme introduced recently in Britain which has already had some success.

Overall, policies should be work friendly and always aim at enhancing labour supply over the longer term.

### **European Economic Recovery Plan**

It is worth briefly commenting on the European Economic Recovery Plan in this context. This Plan covers a number of the points considered here. In particular, it focuses on using flexible working time



to avoid ‘wasteful’ labour shedding due to temporary demand disturbances. The problem is, of course, knowing what demand disturbances are going to be temporary. We can be fairly certain that the demand for sophisticated capital goods will recover with the world economy and that the demand for new housing will not recover rapidly in countries which have seen huge house-building booms. But, in many industries, the longer term prospects are less certain.

The Plan rightly concentrates on activation measures for the unemployed and the necessity of avoiding long-term unemployment, recommending the use of temporary hiring subsidies. It also recommends reducing social charges on lower incomes to support the low skilled. As a temporary measure as part of a recovery plan this is, perhaps, not a well-targeted policy. It is expensive, it has little impact on poverty since most low paid individuals are not in poor households, and will probably have little impact on employment.

### Summary and conclusions

The key in a recession is to sustain the attachment of workers to the labour force and to protect those who lose their jobs. Therefore

- It is worth subsidising worker retention in those sectors where demand is likely to return to pre-recession levels. This can be a very effective policy for sustaining attachment to the labour force.
- At all costs countries should avoid providing individuals with incentives to retire early or to enter long-term sickness or disability.
- Those entering unemployment should participate in an activation programme including monitoring of job search, counselling, job search assistance and medical/psychological support for those suffering from ill-health. Policies to enhance employability and targeted recruitment subsidies may be worthwhile. It is important to expand the capacity of the system to cope with the increased inflow into unemployment.
- Beyond a certain level of unemployment duration, it is worth introducing a job/training guarantee in return for continuing receipt of benefits.
- National apprenticeship systems generate smoother and more rapid transitions from education to work and lower youth unemployment than average. Things are even better if those towards the

lower end of the ability range have achieved high levels of literacy and numeracy by the end of compulsory school.

- Strict controls over entry into long-term disability and activation mechanisms plus medical support for those already in long-term disability help to control the number of inactive individuals in the working age population.



## UNEMPLOYMENT CRISIS – CHALLENGE AND OPPORTUNITY

LARS LJUNGQVIST\*

The recent financial crisis has caused increased unemployment throughout the world. We focus on the implications for future labor market performance and on a reform proposal for Europe. The consequences of the present crisis for Europe depend on whether today's higher unemployment reflects a temporary elevation that will recede with the crisis, or if it will cause an increase in structural unemployment that will persist beyond the recovery of the world economy. To analyze this question one needs a theory that can also explain the evolution of European unemployment prior to the present crisis. In particular, the European employment experience during the last 60 years can be divided into a period with low unemployment in the 1950s until the mid-1970s and thereafter a large increase with persistently high unemployment since the 1980s.

We discuss two theories of the European employment experience, which have different predictions for what the unemployment consequences will be of the crisis and hence, imply different policy recommendations. One theory that has recently gained much attention is the analysis of Nobel Laureate Prescott (2004 and 2005) who attributes low European employment to higher labor taxes in Europe as compared to that of the United States. After explaining the mechanics of that macroeconomic analysis (which are not so well-known outside of the academic profession) and a microeconomic critique of it, we conclude that Prescott's theory has the sanguine implication of unemployment returning to its pre-crisis level as soon as the world economy

recovers. In contrast, the alternative theory by Ljungqvist and Sargent (1998 and 2008) identifies forces by which the elevated unemployment during the crisis might result in a persistent increase in structural unemployment.<sup>1</sup> This theory focuses on how microeconomic turbulence at the worker level can cause individuals with disadvantageous labor market outcomes to become discouraged and to withdraw into benefit dependency.

The risk of increased long-term unemployment constitutes a real threat to Europe with its generous welfare programs. Policy makers would now be wise to introduce reforms that provide proper incentives to work as the world economy recovers. Acknowledging the limits that a social consensus in Europe exerts on how much benefits can be cut, we advocate a complementary way of realigning incentives – the imposition of social work requirements on benefit recipients. There have been various attempts of imposing such requirements in the past, but we argue that those earlier programs have generally failed, and discuss conditions for succeeding. We conclude that the present unemployment crisis poses both a challenge for policy makers as well as an opportunity to reform social safety nets to permanently improve their effectiveness.

### Theory I: taxes and a high labor supply elasticity

In his theory of the European employment experience, Prescott (2004) focuses on measures of hours worked per person in working age rather than looking at classifications of inactive individuals as unemployed or as recipients of various welfare benefits. Table 1 contains three countries that illustrate Prescott's thesis where France and Germany represent and make up a large part of continental Europe. Employment is depressed in France and Germany



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<sup>1</sup> Total unemployment consists of frictional and structural unemployment. *Frictional* unemployment refers to the normal but time-consuming process of workers looking for jobs in an economy with search frictions. We let *structural* unemployment denote any additional unemployment that arises in a malfunctioning labor market. In the analysis of Ljungqvist and Sargent (1998 and 2008), frictional and structural unemployment become synonymous with short- and long-term unemployment, respectively.

**Table 1**  
**Labor supply, taxes, benefits and benefit dependency**  
**in working-age population**

	France	Germany	US
Hours worked per person relative to the US (US = 100) <sup>a)</sup>			
1970–74	105	105	100
1993–96	68	75	100
Labor tax rate (%) <sup>b)</sup>			
1970–74	49	52	40
1993–96	59	59	40
Net unemployment benefit replacement rates (%) <sup>c)</sup>			
First year of spell	79	66	34
Second and third year of spell	63	63	9
Fourth and fifth year of spell	61	63	9
Benefit dependency rates (%) <sup>d)</sup>			
1980	13.9	15.2	16.8
1999	24.2	22.4	13.7

<sup>a)</sup> Prescott (2004, Table 1), data refers to population aged 15–64; – <sup>b)</sup> Prescott (2004, Table 2); – <sup>c)</sup> Martin (1996, Table 2), data refers to single-earner households without dependent spouse in year 1994, including housing benefits; – <sup>d)</sup> OECD (2003, Table 4.1), data refers to population aged 15–64, measured on a full-time equivalent basis.

Sources: Martin (1996); OECD (2003); Prescott (2004).

by 32 percent and 25 percent respectively, relative to the United States in 1993–96. Prescott's (2004) model can account for these differences as well as the changes in employment from 1970–74 under the assumption that only taxes differ across countries and across time. The tax data in Table 1 shows that (i) the trans-Atlantic labor tax differential in 1993–96 is roughly 20 percentage points, and (ii) about half of that differential was already in place in 1970–74 when European employment was not depressed relative to the United States (but rather higher than that of the United States, as shown in Table 1). Evidently, the labor supply elasticity is very high in Prescott's model when tax increases in the order of 10 percentage points can generate such large reductions in employment.

To understand what gives rise to the high labor supply elasticity in Prescott's analysis, we need to review the aggregation theory of Rogerson (1988). Consider a large number of households who have to make labor supply decisions in a static model of a single period. Labor is indivisible in the sense that a household can only choose to work either full time or not at all.<sup>2</sup> A household left on its own in such a world, would choose to work if the wage is high enough and

<sup>2</sup> While the assumption of indivisible labor is a stark one, it does capture salient features in the real world where full-time jobs are dominant and even in the case of part-time jobs, there is considerable lumpiness in the observed number of hours worked. Reasons for labor being indivisible could be setup costs such as a worker's commuting time to work, and any startup time at work before an employee becomes fully productive. For these reasons, a firm that needs e.g. secretarial services is more likely to hire one secretary full time rather than eight secretaries, one for each working hour of the day.

otherwise choose to stay idle, i.e. a household's behavior could be described in terms of a reservation wage such that for wages above (below) the reservation wage, the household chooses to work (to stay idle). But Rogerson (1988) demonstrated that this outcome is not an optimal one. Instead, each household's expected utility is higher if it could participate in an 'employment lottery', and then use lottery-outcome-contingent claims to insure its consumption against the uncertainty of the employment lottery. For example, a household that chooses a fifty-fifty chance of working could hold claims that guarantee a consumption level equal to

that of an hypothetical person who chooses to supply labor to half of a job (even though that latter choice is infeasible since labor is indivisible). By so expanding the choice set of consumption levels (and the associated probabilities of working), the employment-lottery equilibrium does not only increase all households' expected utility, but it also gives rise to a high labor supply elasticity. As emphasized by Prescott (2005, 385), "the aggregate labor supply elasticity is much greater than the individual labor supply elasticity". Specifically, the equilibrium fraction of households working responds sensitively to small changes in the after-tax wage rate.<sup>3</sup>

Skeptics have expressed doubts about the microeconomic realism of employment lotteries and markets for insuring consumption against the lottery out-

<sup>3</sup> A critical assumption in Prescott's analysis is that tax revenues are handed back lump sum to the households. If instead tax revenues were used to finance benefits for the unemployed, equilibrium employment would plummet much further than what is predicted by Prescott, as we discuss next in the main text. In contrast, if instead the tax revenues were used for public goods or wasted, taxation would have hardly any effect on equilibrium employment. The reason for the latter outcome is that Prescott, like most macroeconomists, specifies a utility function that is consistent with balanced growth. Specifically, in spite of all economic growth in the last half century, households in the United States continue to work about the same number of hours per capita, see Prescott (2005). To be consistent with this fact, the utility function is such that the income and substitution effects cancel each other when the real wage increases over time – a higher wage means higher income so that a household would like to consume more of everything including leisure, but a higher wage also means that the relative price of leisure has gone up so that the household would like to substitute away from leisure toward consumption of goods. A corresponding argument (with the opposite signs) would apply to a tax increase that reduces the after-tax wage. But Prescott's assumption that tax revenues are handed back lump sum to households arrests the income effect and hence, the remaining substitution effect explains why higher taxes in Europe cause households to work less. For a further discussion, see Ljungqvist and Sargent (2006).

comes. In the Handbook of Macroeconomics, Browning, Hansen and Heckman (1999, 602) voice a common criticism of these models when arguing that “the employment allocation mechanism strains credibility and is at odds with the micro evidence on individual employment histories”. Ljungqvist and Sargent (2006) offer still another criticism by showing that the employment-lottery model is not compatible with the existence of generous welfare benefits such as those of Europe. For example, if the French unemployment insurance system replaces 60 percent of lost labor income as suggested by Table 1, Ljungqvist and Sargent (2006) show that Prescott’s model implies that French employment should be depressed by 66 percent relative to the United States, i.e. more than twice the actual outcome. The reason for this counterfactual outcome is that Prescott’s high labor supply elasticity does not only make employment respond sensitively to tax levels but also to benefit levels.

For our present purpose to predict the unemployment consequences of the current crisis, we conclude that Prescott’s theory implies that employment will return to its pre-crisis level as soon as the world economy recovers. According to Prescott’s analysis, employment outcomes in the future would only be different if tax policies were changed.

### Theory II: benefits and increased turbulence

The analysis of Ljungqvist and Sargent (1998 and 2008) differs from that of Prescott (2004) in two critical dimensions: First, the analysis now includes generous European unemployment benefits, at the level of the empirical estimates in Table 1. Second, the disutility of work is much lower than that of Prescott’s analysis. Because of the lower disutility of work, Ljungqvist and Sargent’s theory can explain why European labor market outcomes were not much different from those of the United States until the late 1970s despite much more generous benefits as well as higher taxes in Europe as compared to the United States.<sup>4</sup> According to that theory, European workers prefer to work and reap their full labor market earnings rather than collecting benefits of

around 60 percent of foregone wage earnings. At least, this was true until the late 1970s.

So what happened at the end of the 1970s and the beginning of the 1980s that can explain the outbreak of high and persistent European unemployment? Ljungqvist and Sargent (1998 and 2008) argue that the cause is an increase in microeconomic turbulence in Europe as well as in the United States and elsewhere. It is a widely held notion that the economic environment has become more turbulent in the last three decades and, for example, OECD (1994) suggests that liberalization and deregulation of markets, heightened technological change, especially in information technologies, and the trend towards globalization have contributed to this development. While not taking any stand on the precise sources of turbulence, Ljungqvist and Sargent base their analysis on the well documented findings of increased labor earnings instability (e.g. see the survey of Katz and Autor (1999)). As in the data, turbulence is assumed to impinge on labor market outcomes for individual workers. The predictions of the theory is that turbulence should have led to long-term unemployment in Europe, where the unemployed with spells longer than one year should make up approximately half of all the unemployed, but there should not have been much of an effect on US unemployment outcomes. This is indeed an accurate characterization of the trans-Atlantic employment experience since the 1980s until the present financial crisis.

According to the theory of Ljungqvist and Sargent (1998 and 2008), unemployment benefits with generous replacement rates are not much of a problem in tranquil times when laid off workers can find new jobs with pay comparable to previous earnings. But the adverse incentive effects of such generous benefits come unleashed in times of economic turbulence when unlucky workers experience shocks that diminish their earnings potential – old human capital becomes obsolete because of new technologies, firm-specific and industry-specific skills are lost during restructuring in response to increased international competition, union wage premia fall after deregulation, etc. Displaced workers in Europe who find themselves under these circumstances will have a hard time to find new jobs that are acceptable to them. Their earnings potential have fallen, yet they compare any job prospects with their lost earnings since benefits are based upon past earnings via replacement rates. Because of the difficulty in find-

<sup>4</sup> In fact, European unemployment rates were significantly lower than those of the United States before the late 1970s (which is consistent with Prescott’s employment data in Table 1 that shows France and Germany ahead of the United States by 5 percent in the early 1970s). The analysis of Ljungqvist and Sargent (2008) attributes this outcome to European employment protection that reduces labor mobility and therefore, suppresses frictional unemployment. For a summary of the analysis and the historical record, see Ljungqvist (2003).

ing acceptable jobs, many displaced workers become discouraged and they reduce their search intensities in the job market which further exacerbate the adverse effects of generous benefits in turbulent economic times. In contrast, in an economy with stingy rules for unemployment benefits, such as in the United States, the theory predicts that the unemployed workers 'bite the bullet' and search intensively for less well-paying jobs as compared to their lost earnings.<sup>5</sup>

From the perspective of the theory of Ljungqvist and Sargent (1998 and 2008), the unemployment consequences of the current crisis depend on who make up the presently swollen ranks of the unemployed. On the one hand, if the additional unemployed are temporarily laid off from firms that intend to rehire them after the crisis has receded, or more generally, if the market value of the unemployed's skills is unaffected by the crisis, the theory would predict that there is no force other than the sluggishness of the recovery itself that slows down the reversion of unemployment to its pre-crisis level. On the other hand, if the extra unemployed suffer the type of negative shocks to earnings potential as the theory uses to explain why Europe has experienced high long-term unemployment in the last three decades, then the future outlook for Europe looks yet bleaker. It becomes more important than ever to reform benefit systems in order to insure proper incentives to work. Before turning to a reform proposal for Europe, we first discuss recent research that holds out the promise of settling some of the dispute between advocates of theory I and II, respectively.

### **A life-cycle perspective imparted on theory I and II**

Sometimes research in economics leads to surprising results. At a first glance these results might seem perplexing but then they enhance our understanding and we gain new insights. One such example is Ljungqvist and Sargent's (2006) inquiry into the determinants of the high labor supply elasticity implied by Rogerson's (1988) aggregation theory that was used by Prescott (2004 and 2005). In a life-cycle model, Ljungqvist and Sargent (2006) close down the insurance markets and the employment lotteries, and assume that households must rely on

savings to smooth consumption between times of working and not working. Under the additional assumptions of no uncertainty and no accumulation of human capital, this alternative model (surprisingly enough) generates the very same aggregate labor market outcomes as the employment-lottery economy. But now the households choose fractions of their lifetimes spent working rather than probabilities to work in an employment lottery. The implied high labor supply elasticity is also shown to be numerically robust in more general settings with both uncertainty and positively-sloped experience-earnings profiles.

By abandoning the contentious notion of employment lotteries and replacing it with individuals choosing career lengths, a consensus should emerge about the proper objective of inquiry – individual workers' lifetime labor supply.<sup>6</sup> So what would such a consensus say about the implication of theory I that a 10 percentage point increase in German and French labor taxes can explain why the employment of these economies is 25 to 32 percent depressed relative to the United States? The first thought might be that it lends support to Prescott's analysis since a high labor supply elasticity does emerge in a life-cycle model as long as individual workers' choice of career lengths is at an interior solution. It is certainly true that people do not work their entire lives, so it might seem to follow that their choice of career lengths is at an interior solution and hence, the aggregate labor supply elasticity should be high. But the answer is more complicated than so.

If we were to ask individuals with a strong attachment to the labor force about their planned retirement age, the most common answer would probably be the official retirement age in the government-run retirement benefit program. If that is so, individual workers' choice of career lengths is not at an interior solution but rather at a corner solution. Many retirement systems are associated with implicit tax wedges so as to compel large numbers of workers to retire at the official retirement age. At such a corner solution for career length, small increases in labor taxes would not affect individuals' planned retirement age because the alternative of enjoying privately financed early retirement would not be attrac-

<sup>5</sup> For a further concise description of the facts and the theory of Ljungqvist and Sargent (1998 and 2008), see Ljungqvist (2003) from where this last paragraph is excerpted.

<sup>6</sup> Prescott (2006a) embraced the Ljungqvist and Sargent (2006) life-cycle framework with indivisible labor as "the initiation of an important research program ... to derive the implications of labor indivisibility for lifetime labor supply". While Prescott's (2005) original Nobel lecture was devoted to the employment-lottery aggregation theory, a subsequent version (Prescott 2006b) contains an added section on 'The Life Cycle and Labor Indivisibility'.



tive enough. Thus, the reasoning above that seemed to lend support to theory I fails.

In contrast, Kitao, Ljungqvist and Sargent (2008) enrich and strengthen theory II in an explicit life-cycle model. While workers originally plan to retire at the official retirement age in that model, individuals who suffer unforeseen negative labor market shocks will re-optimize their planned career lengths, especially in Europe where benefits are generous for the long-term unemployed and for those who claim disability. The risks for negative earnings shocks are assumed to be the same for all workers, but the theory predicts that older workers are more prone to withdraw from active labor market participation in response to such shocks. The reasons are that older workers are closer to the official retirement age which makes it less attractive for them to start investing in new careers after negative labor market shocks, and older workers are also at the peak of their lifetime earnings, so benefits based on past wage earnings are relatively generous. Hence, the outcomes of theory II are the same as those stressed by President Barroso of the European Commission when he deplores the fact that European workers “start exiting the labor market on a very large scale by the time they reach 55 years of age” (European Commission 2005, 26).

As described, theory II can explain why a more turbulent economic environment since the late 1970s has caused high long-term unemployment to erupt in Europe while leaving US labor market outcomes largely unaffected. The theory predicts correctly that older workers are the ones who are most likely to suffer from long-term unemployment.<sup>7</sup> Regarding the elevated unemployment in the present financial crisis, the same theory warns of dire future unemployment consequences for Europe if the additional unemployed in the crisis are affected by the kind of negative individual shocks that have driven the high European unemployment rate for the last three

decades. If so, the additional unemployed today are likely to add to the ranks of tomorrow’s long-term unemployed, and this risk is highest for older unemployed workers. Hence, it is more important than ever to reform social safety nets so that there are proper incentives to work as the financial crisis recedes and the world economy recovers.

### **Reform proposal: social work requirements**

There are two ways of strengthening incentives to work – the return to working can be increased and the return to being unemployed can be decreased. Examples of policy changes that operate on these two margins are reductions of labor taxes and cuts in benefits, respectively. There are constraints on how far any one of these measures can be taken. The fiscal needs to finance the extensive welfare states of Europe place restrictions on how much taxes can be reduced. Societal preferences or norms impose limits on how much benefits can be cut before benefit levels are deemed to be too stingy and to not provide enough of a social safety net for the unlucky ones. For example, it is probably safe to say that there is a strong European sentiment that the low benefit levels for the long-term unemployed in the United States would not be acceptable in Europe. The question becomes then how to reform the unemployment insurance system so that it provides proper incentives while preserving the social fabric of Europe. One answer is that proposals to decrease the return to being unemployed do not necessarily have to take the form of benefits cuts but could also be accomplished by reducing the amount of leisure available to the unemployed.

We propose a system that requires the long-term unemployed to perform ‘social work’. While different forms of work requirements have been tried in the past, e.g. the so-called one-euro jobs in Germany, we think that past measures have had limited success because of failing to address a number of issues that we lay out below. A common flaw of past measures has been the lack of an infrastructure that is both sustainable and commensurate to the size of the problem of benefit dependency in Europe. To envision a successful policy reform, we discuss general principles for program design, particular program features of concern to participants, and considerations during an implementation phase.<sup>8</sup>

<sup>7</sup> Kitao et al. (2008) analyze also youth unemployment. New labor market entrants are assumed to go through a phase of inexperience before they settle into careers. The phase of inexperience is associated with considerable job churning which explains why young workers typically experience higher unemployment than adult workers across countries and throughout time. But why have many European countries seen additional increases in youth unemployment rates in the last decades? In the model of Kitao et al. (2008), it is a challenge to generate such outcomes because young individuals are eager to begin their careers and to accumulate job experience that will lead to higher earnings. To frustrate those ambitions in the European economy of the model, it is assumed that there is a minimum wage that restricts the set of admissible job opportunities – a barrier that mainly affects inexperienced workers with their lower potential earnings. On the prevalence of much higher minimum wages in Europe as compared to the United States, see e.g. Dolado et al. (1996).

<sup>8</sup> For an earlier exposition of this line of argument, see Ljungqvist (1999).

*Program perspective*

(a) Comprehensive and sustainable system: the sheer size of benefit dependency in Europe calls for a large-scale reform. A social-work program should not only accommodate a large number of benefit recipients but must also be made viable in the long run.

(b) Delimitation of social work from employment: to avoid interference with the functioning of a market economy, clear boundaries must be established between social-work assignments and regular employment in the private as well as in the public sector. The delimitation should be further accentuated by the feature that social work entitles to the continued collection of benefits rather than any wages or salaries.

(c) Useful assignments with few prerequisites: besides that there is no reason for wasting the resource that social-work participants constitute, meaningful assignments help to build general support for the program. Because of the diverse backgrounds of benefit recipients and the expected high turnover in social work, there cannot be much of prerequisites for social-work assignments.

*Participant perspective*

(a) Gradual increase of social-work requirements: at the beginning of unemployment spells, benefit recipients should have most of the time free to look for jobs. The anticipation of a future imposition of social-work requirements, like the anticipation of any future reductions in benefits, strengthens the incentives to find regular employment.

(b) Self-selection of participants: if the states of long-term unemployment and regular employment are not that different in terms of hours devoted to either social or regular work, individuals with sufficient abilities can be expected to self-select out of benefit dependency. Though, social work would continue to provide a meaningful social context to individuals who cannot make that transition for various reasons.

(c) Fair and predictable rules: to make social work feasible for most individuals, the assignments should neither be too physically demanding nor

involve predominately outdoor tasks. Fairness and predictability are insured by offering all benefit recipients the same opportunities and obligations regarding social work.

*Implementation perspective*

(a) Gradual phase-in with anticipatory effects: a full implementation of a social-work program would take time, but a credible reform announcement followed by a gradual but deliberate implementation would have immediate incentive effects. In anticipation of the program's full implementation, benefit recipients with sufficient abilities would already start to search for regular employment.

(b) Promotion of rigorous analysis in mass media: a major policy reform is meant to have large effects, but in individual cases there might also be unintended, adverse consequences. To balance the media's rightful coverage of such individual cases, the government must promote an overall analysis of how the reform will reshape incentives and why that is necessary for the fiscal sustainability of the welfare state.

(c) Moral and fiscal 'high ground': while there is a wide consensus in Europe to preserve the welfare state, there are also growing concerns for fiscal sustainability and social cohesion in times of increasing benefit dependency rates. It is therefore likely that social work will be deemed as being fair, and be seen as an opportunity for benefit recipients to make contributions to society in exchange for the support received.

**Challenge and opportunity**

While the present unemployment crisis poses a major challenge for policy makers, it is also an opportunity to reform social safety nets to permanently improve their effectiveness. The crisis is an especially opportune time to introduce social work for benefit recipients. While social work might be welcomed as a way to create productive activities for the unemployed until the demand for labor picks up again, it should be made clear that social work is here to stay to tackle structural unemployment in Europe. It could become the reform of the century.

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## RECESSION AND UNEMPLOYMENT IN THE OECD

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### Introduction

The ILO estimated that world unemployment reached nearly 212 million in 2009, an increase of 34 million since 2007 (ILO 2010). The increase is a consequence of the worldwide recession that was triggered by failures in various interlinked credit markets, including the subprime mortgage bubble in the US housing market. The increase occurred even though many governments intervened to maintain demand, by loosening monetary policy, including quantitative easing, as well as through cutting taxes and/or increasing government spending. Consequent fiscal imbalances are resulting in funding difficulties for many of these governments. The cost of credit default swaps, which are used to insure against sovereign debt default, have risen very sharply for governments that have no credible plan for reducing their budget deficits. Thus there is a significant risk that recovery of world demand will be anaemic, with further increases in unemployment likely.

Nearly half of the increase in world unemployment has occurred in OECD countries. From March 2008 until the end of 2009, unemployment in the OECD increased by 16.5 million. The growth in OECD unemployment has been dominated by Europe and the United States, with increases of 7.5 and 7.0 million respectively. In 2009, the US unemployment rate reached 9.2 percent, exceeding that in the European Union for the first time since comparable figures were available.

This paper reviews the declines in employment and increases in unemployment across the OECD both

by country and by groups within countries. The latter highlights the extent to which the costs of unemployment are distributed unevenly across populations. We also reflect on the effects of unemployment on individual well-being.

### Employment

Labour is a derived demand and the present recession has been driven by a collapse in demand for goods and services. In consequence the demand for labour has fallen. But there has been no consistent relationship between falls in output and increases in unemployment across OECD countries. This is shown in Table 1, where we date the beginning of the recession from the first quarter of 2008. Not all countries experienced the first reduction in output during this quarter, but this is the modal measure of the start of the recession in the OECD.

What is evident is that there has been huge variability in the labour market responses to downturns in demand. Some countries (e.g. Germany, Italy, Japan) have experienced large falls in output, but relatively modest decreases in employment. Other countries (e.g. the United States, Ireland) have experienced more rapid declines in employment than in output. A simple regression of the changes in employment on the change in output from Table 1 yields an estimated slope of 0.43 with a p-value of 0.001 and an  $R^2$  of 0.32. Thus, for these OECD countries over approximately seven quarters of the current recession, the short-run elasticity of demand for labour has been relatively low. Clearly, changes in demand only explain a relatively small share of the inter-country differences in employment response.

One possible explanation is labour hoarding, reflecting the notion of labour as a quasi-fixed factor. Employers may seek to minimise short-run costs by reducing the demand for labour at the intensive margin. Thus, in Japan, though employment had only fallen by 2.7 percent from 2008 Q1

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Table 1

## Changes in output, employment and unemployment in OECD countries 2008 Q1 to 2009 Q3

	Percentage change		Number of change (in 1 000)	
	GDP	Employment	Employment	Unemployment
Australia	1.7	-0.7	-81	199
Austria	-3.9	-0.5	-21	55
Belgium	-3.1	-1.1	-50	59
Canada	-3.0	-2.0	-337	502
Czech Republic	-3.3	-2.2	-109	146
Denmark	-5.5	-2.9	-81	84
Finland	-7.8	-3.8	-98	64
France	-2.9	-0.9	-241	592
Germany	-5.6	-1.9	-726	36
Greece	-1.0	-1.1	-50	101
Hungary	-9.0	-4.8	-186	116
Iceland	-12.0	-7.8	-14	10
Ireland	-9.3	-11.9	-255	146
Italy	-5.9	-2.3	-535	305
Japan	-7.7	-2.7	-1 727	813
Korea	1.6	-1.0	-241	106
Mexico	-6.6	0.0	0	1 137
Netherlands	-4.7	-1.2	-89	82
New Zealand	-1.1	-2.4	-54	17
Norway	-1.2	-1.5	-37	65
Poland	2.5	-0.5	-77	106
Portugal	-2.9	-3.9	-201	131
Slovak Republic	-2.3	-4.3	-107	66
Spain	-4.5	-8.1	-1 363	2 206
Sweden	-5.9	-2.9	-136	147
Switzerland	-1.7	0.0	-2	52
Turkey	-10.2	-5.1	-1 131	1 247
UK	-5.9	-2.1	-609	842
USA	-1.6	-5.5	-8 115	7 787
OECD total	-4.9	-2.4	-12 983	16 614

Source: OECD database.

to 2009 Q3, aggregate hours of work fell by 6 percent, almost matching the decline in output. The German government introduced a policy to subsidise short-term working arrangements. It pays half of employers social security contributions for the loss of earnings associated with reduced working hours. In 2008 Q4, 1.6 percent (626,000) of employees were registered with this scheme. Further examples of hours adjustment are shown in Figures 1 and 2. Figure 1 shows the share of part-timers in total UK employment from 2007 to 2009. There is a relatively sharp increase in the share of part-timers in total employment from 2008 Q1, when the recession started in Britain. Figure 2 shows average hours worked by all private sector employees in the United States from 2006 to 2010. A relatively sharp decline in average hours worked is apparent from early 2008. Productivity per

worker may have declined as a result of labour hoarding, but productivity per hour may not have fallen as much, if at all. Nevertheless unit costs will tend to rise due to the fixed costs of labour.

Reductions in employment have not been uniformly distributed. In the United States, for example,

Figure 1

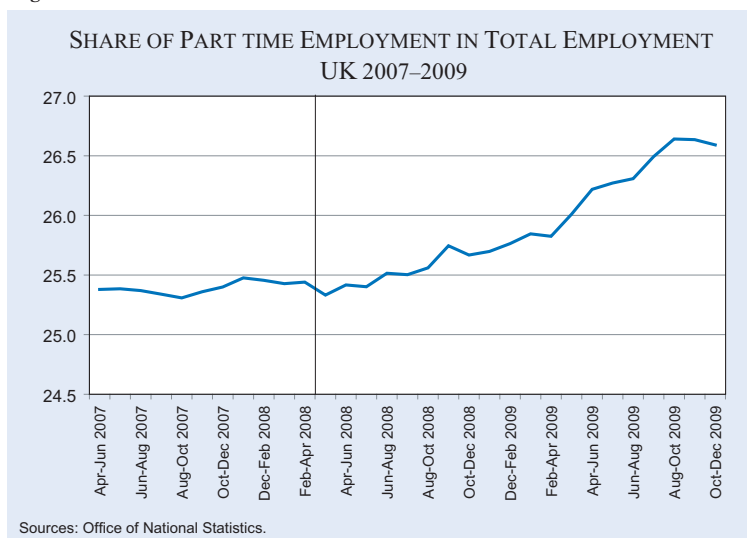
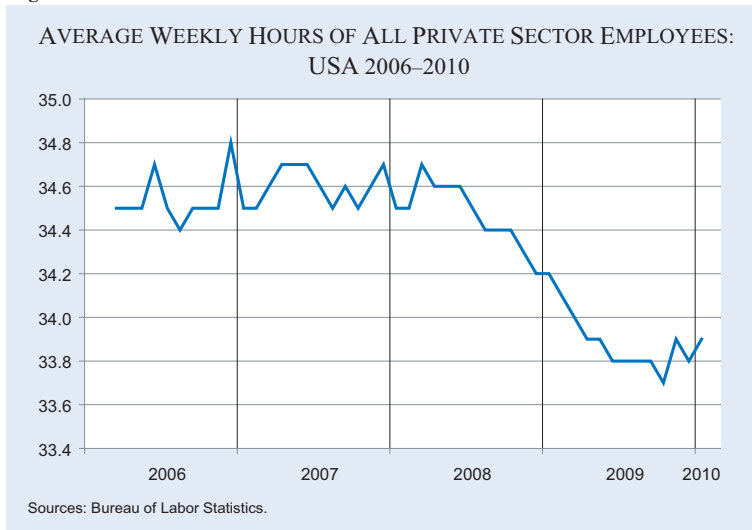
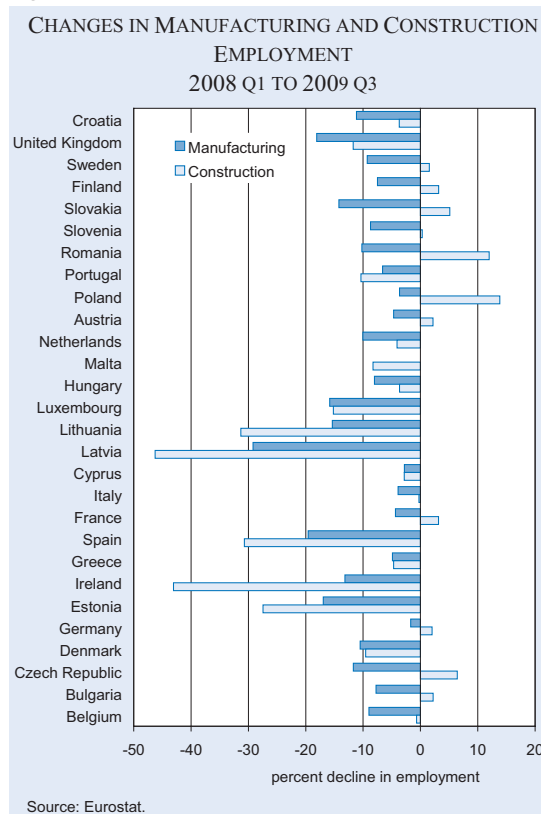


Figure 2



the construction and manufacturing sectors have experienced a very rapid declines in jobs. Between mid-2008 and January 2010, employment in construction in the United States fell by 21.5 percent, while employment in manufacturing fell by 13.9 percent. Similarly large declines in construction employment occurred in countries that had experienced asset bubbles in either domestic or commercial property, such as Estonia, Latvia, Spain and Ireland. Figure 3 shows the extent of the decline in manufacturing and construction employ-

Figure 3



ment across Europe from 2008 Q1 to 2009 Q3. It illustrates the great diversity of the demand shocks as well as differential labour market responses.

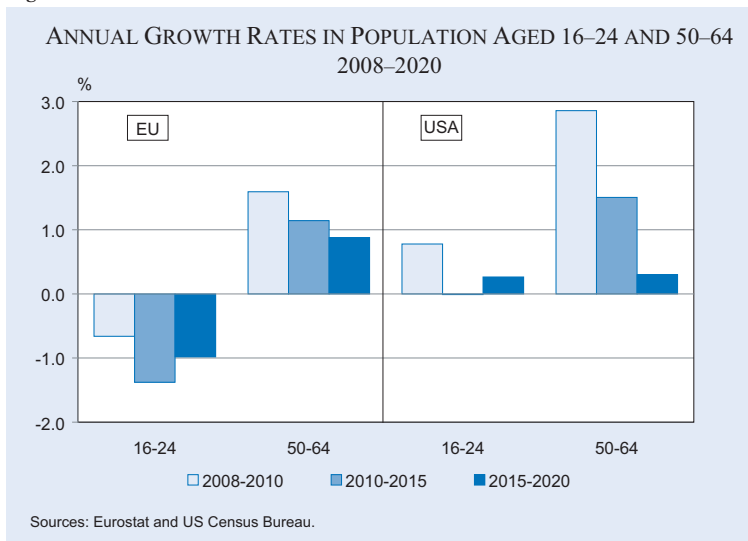
The specific nature of the shocks results in differential impacts on particular groups within the population. One of the most striking effects has been on the age structure of employment. In the EU employment fell by 5.1 percent for those aged 15-24 between 2008 Q1 and 2009 Q3. In the United States the equivalent decline was

15.4 percent. But for those aged 50+, EU employment increased by 4 percent, while in the United States there was a 2.5 percent increase in employment of those aged 55+ during the period when the US labour market lost over 7 million jobs.

There are a number of forces that likely underlie this development. First, older people may be staying in the labour market longer because falling asset values associated with the recession have reduced their expected retirement income. Second, because employment has increasingly concentrated away from manufacturing and construction towards the service sector, the costs of substituting older workers for the relatively young has likely decreased. Increased competition from older workers makes it more difficult for the young to find employment. Third, young people, anticipating that the labour market may be difficult, may be switching to attending college in the hope of improving their prospects. In Britain applications to attend university increased by 22 percent between 2009 and 2010, with increases for those aged 21 to 24 up by 44.8 percent and 63.4 percent for those aged over 25.

A further part of the explanation of differential growth rates by age group is demographic. Annual growth rates of those aged 16-24 and 50-64 in the EU and the United States over the period 2008-2020 are shown in Figure 4. The number aged 16-24 in the EU will decline slowly between 2008 and 2010 before declining much more rapidly thereafter. Nevertheless the decline in employment is much more rapid than the decline in population over the 2008-2010 period. In contrast, numbers aged 16-24 in the United States are broadly constant. And for those aged 50+ in the workforce, there will be a rapid

Figure 4



increase in both Europe and the United States. For this group, the growth in employment in Europe has been more rapid than the growth in population over the 2008–2010 period, though by a smaller margin than the disparity in the 16–24 age group. It appears that, for Europe, changes in demography explain a share of the change in employment.

There have also been marked changes in employment by educational status. These are shown in Table 2, which uses Eurostat data to track how changes in employment have been distributed across International Standard Classification of Education (ISCED) qualifications between 2008 Q1 and 2009 Q3. What is evident is that the recession has reduced employment among those with low qualifications than among those with intermediate or higher qualifications. In the EU as a whole, employment among those with qualifications up to ISCED Level 2 (lower secondary school) fell by 3.2 million (6.3 percent), while for those with tertiary education, employment levels actually increased by 4.7 percent. The recession appears to have moved Europe towards forms of production that are more human capital intensive. The most dramatic falls in low skilled employment have

Table 2

## Change in employment in Europe classified into educational status 2008 Q1 to 2009 Q3

	Primary, lower secondary (%)	Upper secondary and post-secondary (%)	Tertiary (%)
EU27	-6.30	-0.98	4.71
Belgium	-13.42	0.07	5.60
Bulgaria	7.78	-2.54	1.15
Czech Republic	-8.95	-2.63	11.17
Denmark	2.92	-3.33	-5.72
Germany	-8.13	-0.13	8.28
Estonia	-18.10	-14.43	3.62
Ireland	-24.17	-12.10	2.01
Greece	1.15	0.28	0.81
Spain	-14.00	-5.08	-0.86
France	-5.85	-0.01	6.46
Italy	-3.02	1.68	-1.03
Latvia	-20.63	-17.16	-5.83
Lithuania	-19.83	-5.52	-3.73
Hungary	-5.62	-3.14	4.60
Malta	3.76	0.86	0.00
Netherlands	-1.75	-0.19	4.23
Austria	-6.32	2.38	10.19
Poland	-1.55	0.06	14.59
Portugal	-7.90	10.93	1.65
Romania	15.48	0.31	7.16
Slovenia	-6.12	0.47	8.85
Slovakia	-4.76	-2.79	8.37
Finland	-1.64	1.62	-0.85
Sweden	-1.60	-1.68	2.91
UK	-8.27	-3.70	4.54
Croatia	-0.04	-1.00	6.80
Turkey	9.34	5.07	14.52
Iceland	-10.13	0.18	7.27
Norway	-6.06	-0.38	3.68

Source: Eurostat.

been experienced in countries that experienced house price bubbles, notably including Ireland, the Baltic States and Spain. Employment declined for all levels of education in countries where there were very large falls in output. Uniquely, Denmark has experienced employment falling among the better educated, but rising among those with the lowest level of qualifications. Thus, while there is a general trend to relative worsening of employment prospects for those with low levels of qualifications, there are wide variations between countries that reflect patterns of demand and the organisation of the labour market in these countries.

Temporary contracts have become an increasing feature of employment arrangements in recent years. In the EU15 the number of workers on temporary contracts increased from 18 million to 21 million between 2000 Q2 and 2008 Q1, a rise of 16.6 percent. But between 2008 Q1 and 2009 Q3, numbers employed on temporary contracts fell by 3.3 percent, while total employment fell by around 2 percent. Consistent with the insider-outsider version of labour market behaviour, being on a temporary contract increased the probability of job loss. But this is not a general finding across the EU: it is concentrated specifically in Spain, where more than a million workers on temporary contracts lost their jobs between 2008 Q1 and 2009 Q2, almost 2/3rds of the total job loss. This is generally ascribed to the rigidity of permanent employment contracts in Spain. In the rest of the EU15, temporary employment has actually risen since the onset of the recession. This may reflect employers changing the nature of employment contracts to limit their contingent liabilities. It is certainly not consistent with the insider-outsider version of labour market.

Downward wage flexibility may be another response to weakness in labour demand. Data on annualised changes in hourly earnings for some countries where data is available is shown in Table 3. Growth rates of earnings have slowed markedly in France, Japan and Britain, but have increased in Germany. Interestingly, although both are classed as having very flexible labour markets, wage growth slowed more in Britain than in the United States. One possible explanation of this is the British tax credit system, which means

Table 3

**Annualised rate of increase in hourly earnings  
in selected developed countries**

	2005 Q1 to 2008 Q1 (%)	2008 Q1 to 2009 Q3 (%)
France	3.7	1.2
Germany	1.6	3.5
Japan	0.6	-3.8
UK	4.4	1.4
USA	3.9	3.2

Source: OECD Main Economic Indicators database.

that relatively low paid workers willing to accept wage cuts face less than the equivalent reduction in net income. Thus, tax credits play a perhaps unexpected role as automatic stabilisers within the British economy.

### Unemployment

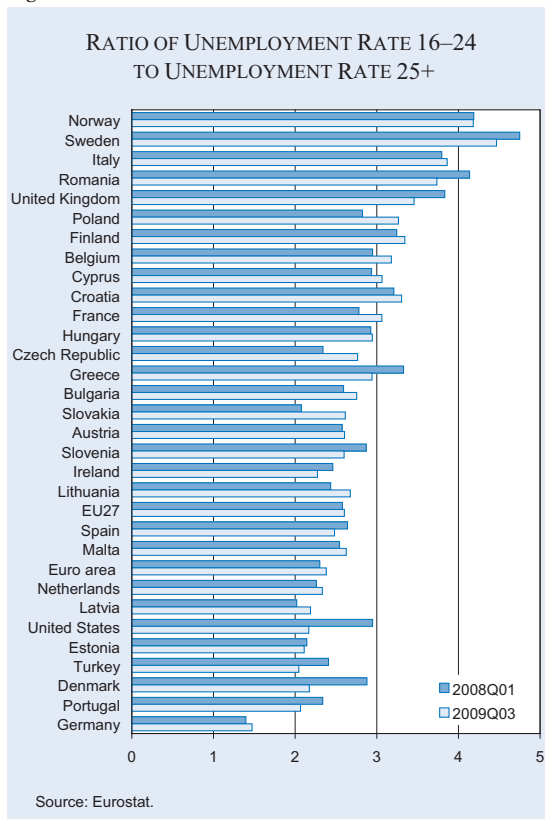
The change in unemployment by OECD countries is shown alongside the absolute change in employment in column 4 of Table 1. Since the beginning of the recession, the increase in unemployment in the OECD as a whole has exceeded the decline in employment by more than 3 million. But a simple regression of the change in unemployment on the change in employment for the 28 countries included in Table 1 gives a coefficient of -0.94, which has a p-value close to zero but is not significantly different from one. The discrepancy between the overall change and the regression result is likely due to differences in the implicit weights in the two calculations.

The rise in unemployment has been substantial, especially for the young. Youth unemployment rates for the under 25s averaged 20.9 percent in January 2010 in the EU as a whole compared with an EU overall average of 9.9 percent. Youth unemployment rates are 39.6 percent in Spain and 32.4 percent in Ireland, compared with 33.1 and 18.5 percent, respectively a year earlier. Figure 5 shows the ratio between under-25 and over-25 unemployment rates by country in 2008 and 2009 which average around 2.5:1. Male unemployment rates are higher than female rates in most countries but in several the reverse is the case (Austria, Czech Republic, Spain, France, Italy, Cyprus, Luxembourg, Malta, Poland and Slovakia).

The rise has also been unevenly distributed across countries. Active labour market policies (ALMPs)



Figure 5



have been unable to offset the negative labour market consequences of a massive drop in product demand. We discussed the evidence on ALMPs in a previous paper (Bell and Blanchflower 2000a), arguing that there is no clear evidence in their favour. However, in Germany, for example, direct intervention in the labour market through the use of subsidies for short-term working has contained the fall in employment and rise in unemployment to a greater extent than some countries with 'flexible' labour markets, such as the United States. Subsidies to short-time working have been introduced in France, Spain, the Netherlands and Italy. Clearly these raise competition issues as well as questions over whether their effects can be anything but temporary if national governments have to restore their fiscal balances.

Countries with a more rapid rise in unemployment than fall in employment are experiencing rises in labour supply. This may come from a number of sources. More young people may be joining the labour market. Fewer older people may be leaving the labour market. Fewer people of working age may be taking a break from the labour market. And finally economically active immigrants may exceed the number of economically active emigrants. And these

effects need not necessarily be working in the same direction, since they reflect the incentives that individuals are confronted with in different parts of the labour market.

There is evidence that young people in some countries are seeking to prolong their stay in education as a way of postponing labour market entry. In Britain there has been a 23-percent rise in college applications for 2010–2011. The increase has been particularly marked among those aged 25 and over. There has also been a slight decline in the number of adult overseas nationals seeking national insurance numbers in Britain since late 2007. The UK government claimed that there has been a 33-percent rise in the number of non-British citizens emigrating from this country in the year since March 2008, reducing net immigration to Britain to 147,000. As we have seen, there has also been an increase in the number of older workers continuing to seek employment.

So what are the factors that have influenced the probability of being unemployed, at a European level before and during the recession? We have already investigated this in the UK context in a previous paper (Bell and Blanchflower 2009a). Using Labour Force Survey data, we showed that the probability of unemployment increased with age, was typically higher for non-whites, and was particularly high for black youths. As implied by our earlier argument unemployment rates declined with higher levels of education, conditional on other characteristics. And finally, regional variations in unemployment within the country, which played a significant political role in past recessions, have become much less significant.

In this paper we extend the analysis to Europe. Columns 1 and 2 in Table 4 show the results of a dprobit model where the dummy dependent variable takes the value 1 if the person is unemployed and 0 if employed. Data are drawn from two Eurobarometer surveys for the years 2006 and 2009. The results are broadly consistent with those from Britain. Unemployment probability declines with age, is higher from males and for those who left school early. The change in country coefficients in the individual regression broadly corresponds with the aggregate unemployment data. Thus, Spain, Lithuania and Latvia have experienced the largest increase in their country coefficients between 2006 and 2009, while the country coefficients in Germany, Italy, the

Netherlands and Austria declined relative to Belgium. All of these countries have short-time working arrangements in place.

The individual regressions suggest what individual characteristics have made the greatest difference to the probability that individuals in Europe have

Table 4

## Life satisfaction and unemployment probability equations

	Unemployment probability		Life satisfaction (OLS)	
	2006	2009	2006	2009
15–24 years	.0925 (8.65)	.1150 (10.52)	.2434 (11.66)	.1961 (9.27)
25–34 years	.0120 (1.71)	.0188 (2.51)	.1472 (10.05)	.1080 (7.11)
45–54 years	-.0159 (2.39)	-.0150 (2.15)	.0465 (3.39)	.0499 (3.60)
55–64 years	.0026 (0.33)	-.0106 (1.27)	.0455 (3.06)	.0588 (3.97)
65+ years	-.0459 (2.76)	-.0821 (5.06)	.1311 (7.24)	.1531 (8.50)
Male	-.0320 (6.56)	-.0172 (3.39)	-.0375 (4.14)	-.0293 (3.39)
ALS < 16	.0371 (1.93)	.0772 (3.82)	.0303 (1.17)	.7545 (2.95)
ALS 16-19	-.0147 (0.87)	-.0111 (0.67)	.1265 (4.85)	.1839 (7.36)
ALS 20+	-.0681 (4.25)	-.0720 (4.54)	.2425 (9.07)	.3192 (12.47)
Austria	-.0712 (5.64)	-.0899 (6.87)	-.0838 (2.77)	-.1430 (4.63)
Bulgaria	.0515 (2.91)	.0023 (0.14)	-1.1688 (38.25)	-.9295 (29.43)
Croatia	.0482 (2.65)	.0432 (2.23)	-.3886 (12.78)	-.2040 (6.61)
Cyprus	-.0795 (4.83)	-.0869 (4.92)	-.0615 (1.65)	-.0236 (0.62)
Czech Republic	-.0542 (4.02)	-.0127 (0.73)	-.3040 (10.13)	-.2558 (8.36)
Denmark	-.0527 (3.52)	-.0337 (1.92)	.3573 (11.74)	.4705 (15.26)
Estonia	-.0738 (5.31)	-.0366 (2.21)	-.4608 (15.08)	-.3772 (12.19)
Finland	-.0364 (2.34)	-.0516 (3.07)	.0211 (0.70)	.1050 (3.42)
France	-.0326 (2.18)	-.0127 (0.73)	-.1678 (5.57)	-.2285 (7.49)
Germany	-.0113 (0.80)	-.0393 (2.69)	-.2698 (9.79)	-.1422 (5.09)
Greece	-.0557 (3.84)	-.0593 (3.87)	-.5149 (16.90)	-.6967 (22.49)
Hungary	.0023 (0.13)	.0203 (1.08)	-.6492 (21.40)	-.7343 (23.79)
Ireland	-.0784 (6.11)	-.0545 (3.61)	.0840 (2.74)	.1695 (5.45)
Italy	-.0712 (5.56)	-.0921 (6.98)	-.3027 (9.87)	-.5343 (17.36)
Latvia	-.0140 (0.93)	.0356 (1.96)	-.5997 (19.72)	-.6516 (21.01)
Lithuania	-.0315 (2.04)	.0297 (1.60)	-.5813 (19.05)	-.6891 (22.25)
Luxembourg	-.0796 (4.50)	-.0936 (5.09)	.1854 (4.99)	.2376 (6.32)
Malta	-.0624 (2.89)	-.0836 (3.95)	-.1458 (3.84)	-.0396 (1.03)
Netherlands	-.0477 (3.23)	-.0777 (5.02)	.1540 (5.10)	.3101 (10.20)
Poland	.0538 (2.88)	.0152 (0.82)	-.4006 (13.13)	-.3375 (10.84)
Portugal	-.0229 (1.45)	-.0486 (3.16)	-.6477 (21.04)	-.6984 (22.23)
Romania	-.0517 (3.54)	-.0379 (2.35)	-.8634 (27.85)	-.6631 (21.44)
Slovakia	-.0369 (2.63)	-.0642 (4.51)	-.5243 (17.57)	-.3740 (12.18)
Slovenia	-.0378 (2.50)	-.0143 (0.81)	-.0924 (3.06)	-.0707 (2.29)
Spain	-.0367 (2.41)	.0128 (0.70)	-.0527 (1.72)	-.1379 (4.44)
Sweden	-.0442 (3.05)	-.0685 (4.46)	.1698 (5.61)	.2926 (9.51)
Turkey	-.0292 (1.79)	-.0137 (0.77)	-.1843 (4.93)	-.5234 (16.52)
Turkish Cyprus	-.0719 (4.37)	-.0595 (3.19)	-.3000 (9.50)	-.4944 (13.02)
UK	-.0392 (2.80)	-.0330 (2.13)	.0540 (1.89)	.1583 (5.48)
Married			.1348 (8.72)	.0767 (4.95)
Remarried			.0774 (2.35)	.0587 (1.79)
Living together			.0594 (3.16)	.0126 (0.66)
Previous living			-.0736 (2.98)	-.1891 (7.73)
Divorced			-.1384 (6.37)	-.1639 (7.59)
Separated			-.1927 (5.21)	-.1879 (5.08)
Widowed			-.0484 (2.32)	-.0870 (4.13)
Home worker			-.0733 (4.68)	-.0492 (2.94)
Unemployed			-.3099 (17.89)	-.3417 (20.92)
Retired			-.0901 (6.10)	-.0939 (6.35)
Student			.2821 (8.72)	-.0939 (6.35)
Left (2–3)			.0441 (2.47)	-.0069 (0.41)
Centre (5–6)			.0809 (4.89)	.0402 (2.59)
Right (7–8)			.1304 (7.11)	.0597 (3.44)
Right wing			.1277 (5.88)	.1375 (7.00)
Constant			2.8804	2.8364
No. of observations	15,692	16,297	29,027	29,012
Pseudo R <sup>2</sup>	.0768	.0790	.2591	.2752

Notes: Excluded categories: employed, no full-time schooling, Belgium, single, left wing, 35–44 years. Samples in columns 1 and 2 are the workforce (= employed plus unemployed), while samples for columns 3 and 4 are the total population. ALS = age left school; left, centre and right stand for political affiliation. The *t*-statistics are in parentheses.

Source: Eurobarometer 65.2 (February–March 2006) and 71.1 (January–February 2009).



become unemployed since the recession began. While the country effects are consistent with our understanding of the differential national downturns in demand, the groups of coefficients that have changed most over the course of the last three years are those associated with age. Increase in the probability of unemployment for those aged 15 to 24 has been much greater than the impact on living in a particular country, having particular level of education, or being male or female.

### Well-being

Finally we examine the question of whether the recession has affected well-being. One obvious channel through which this might take place is unemployment, given that we know that the unemployed are generally less satisfied with their circumstances than are those in employment. Thus we ask whether the substantial deterioration in labour market conditions in different parts of Europe since the onset of recession affected individual well-being.

We know that unemployment, as well as having a range of social costs, also tends to reduce well-being. Social costs are discussed in Bell and Blanchflower (2009a). These include educational underachievement, inactivity, crime and health. We also discuss individual costs such as the scarring effect of unemployment on younger workers. Thus, using the National Child Development Study (NCDS), which follows a group of people born in Britain during a specific week in March 1958, we showed that if these individuals experienced unemployment at age 23, then conditional on their other characteristics, they were unlikely to experience lower life and job satisfaction, poorer health, earn lower wages and be more likely to be unemployed at age 46 than those who did not experience early unemployment.

We approached this question using recent data from Eurobarometer. We used these to estimate OLS regressions for well-being in European countries in 2006 and 2009 – ordered logits gave similar results. Columns 3 and 4 in Table 4 show our results. Consistent with almost all studies of individual well-being, we find that unemployment has a negative effect on happiness, and that this has increased somewhat since the beginning of the recession. Most other coefficients take their expected signs, such as gender, marital status etc. Also those of a right wing political

persuasion have higher well-being than those politically in the centre or left.

Another interesting feature of these results is the changes that have taken place in country coefficients between 2006 and 2009. Conditional on unemployment and other regressors, the largest declines in well-being are associated with countries that have experienced significant difficulties in their goods, and/or their labour markets as a result of the recession. Those experiencing the most dramatic decline in well-being were France, Greece, Hungary, Italy, Lithuania, Turkey and Spain. Many possible explanations could be consistent with these findings. Issues of fiscal stability at the national level may have reduced individual feelings of confidence and self-worth. In countries where there have been asset bubbles, individuals may have suffered drops in average wealth, a factor not captured by the regressions. One exception is Ireland, which interestingly is the European country that has taken the most decisive action in response to its fiscal crisis.

### Conclusions

This paper has examined recent changes in OECD labour markets. It has established that there have been a wide variety of responses of employment to changes in demand and also a wide variety of responses of unemployment to changes in employment. Thus some countries have experienced large falls in output without necessarily much change in the number of workers employed at the extensive margin of the labour market. Some countries have subsidised employment; others have sought to incentivise adjustment on the extensive margin, through measures such as subsidies to short-time work, while others have relied on automatic stabilisers, such as tax credits, to facilitate labour market adjustment. Complex adjustments on the supply side through changes in participation, and in levels of migration, may explain differences by country in the response of unemployment to changes in employment.

We have also investigated the effect of the recession on individual well-being. Our results confirm the usual finding that the unemployed feel less satisfied with their lives than the employed. Thus the overall increase in unemployment is likely to have resulted in a reduction in aggregate well-being across OECD countries. But, conditional on unemployment, we

also find that countries which have experienced large increases in unemployment, or have suffered fiscal crises, show additional negative impacts on well-being. Unemployment hurts.

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## UNEMPLOYMENT PERSISTENCE

TORBEN M. ANDERSEN\*

Higher unemployment is an inevitable consequence of the financial crisis. According to OECD projections, unemployment for the OECD countries will on average rise from less than 6 percent in 2007 to 9 percent in 2010. Higher unemployment is a direct cost of the financial crisis, and there is a widespread fear that the increase in unemployment may become persistent. The experience from the 1970s and 1980s with high and persistent unemployment stands out as a worst case scenario with large social costs and severe consequences for the already much strained public finances. Accordingly, how to minimize the risk of persistent high unemployment is an important policy question.

Many countries have resorted to an active demand management policy as a response to the crisis, and this has undoubtedly helped mitigate the consequences of the crisis. It has also been argued that an aggressive demand management policy may even pay off in the medium to long run by reducing persistence in unemployment. The argument being that by reducing the impact effect of the crisis on unemployment, fewer will risk becoming long-term unemployed. While this argument has some weight, one must be realistic about the potential of fiscal policy in this respect. This is so due to labour market dynamics and heterogeneity, where two dimensions are particularly important. First, the sectors adversely affected by the crisis (building sector, financial sector, export

sector) are not necessarily those which would benefit from a more expansionary policy increasing public and/or private demand. Hence, the perceived effect of fiscal stimulus on aggregate demand may underestimate the implied need for labour restructuring and adjustments. In short, the areas experiencing job creation are not necessarily the same as those suffering from crisis induced job destruction. The second reason is that labour dynamics imply that increasing unemployment is an unbalanced event tending in particular to affect the young, the old, the less skilled, immigrants and other marginal groups in the labour market.

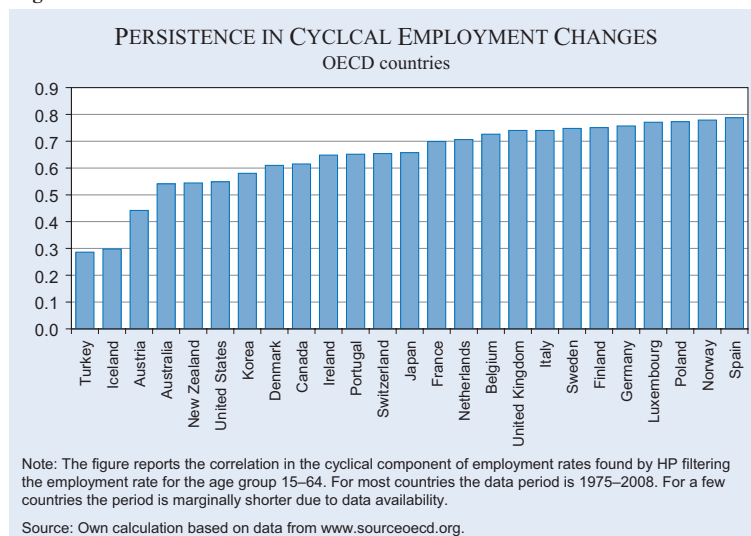
In sum, aggregate demand management policies are effective in mitigating some of the consequences of the financial crisis, but it is neither a guarantee against persistence in unemployment, nor necessarily well-targeted in counteracting persistence.

### Persistence in the labour market

It is well-established empirically that labour markets display substantial inertia in the sense that (un)employment is highly persistent. Figure 1 illustrates this by reporting a metric for the persistence in the employment rate for OECD countries. The employment rate is used rather than the unem-



Figure 1



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ployment rate, because the measured unemployment rate is affected not only by changes in employment but also by changes in labour supply tending to move pro-cyclically. Hence, a more reliable measure of the state of the labour market is the employment rate. This variable also better summarizes the implication of the labour market stance for public finances. Although there is some variation across countries, the figure shows that the persistence in the employment rate is high in most OECD countries.

Such simple historic measures should be interpreted with some care. They do not clearly separate the role of shocks and their persistence from the persistence generating mechanisms arising from sluggish adjustment of various forms. Moreover, the adjustment path and thus persistence depend on institutional settings and policy reactions which may shorten or prolong the adjustment.

While unemployment persistence may arise for various reasons, it becomes particularly important when it reflects that unemployment is concentrated on a specific group, the long-term unemployed. In itself this has social costs, and it also implies that the effective labour supply is reduced in a medium-term perspective due to human capital depreciation. The latter, in turn, makes it difficult to bring employment back to its initial level and thus reinforces persistence. Prolonged unemployment may imply a depreciation of human capital along various dimensions including work experience, self-esteem, social capital, networks etc.

### **Losing the young or dropping the old?**

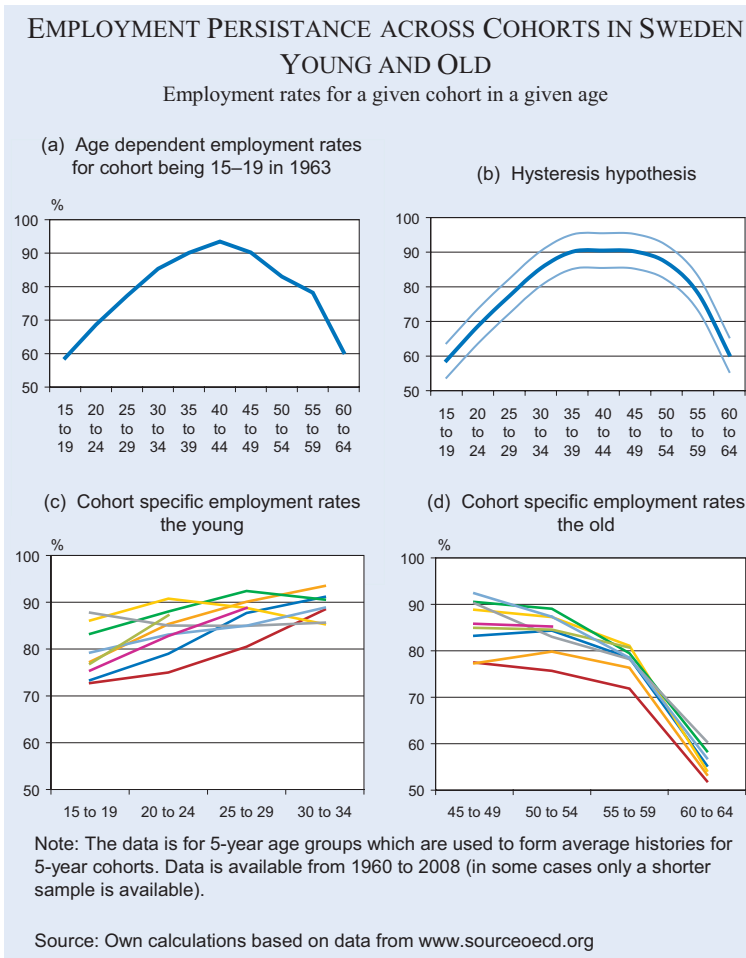
These concerns are supported by the fact that a number of countries have experienced a steep increase in youth unemployment and there is fear that generations will be lost. At the same time, increasing unemployment among older workers is in itself a problem, which moreover may challenge the agenda in most countries to increase retirement ages as a remedy to counteract the effects of ageing. The fact that youth unemployment is particularly sensitive to the business cycle is often taken as an indication that persistent youth unemployment is the major risk. However, it is not clear that one can infer from cyclical variability to the risk of persistence, as is seen by considering the labour market performance of young and old.

The typical labour market history has the employment rate at first increasing and then decreasing with age, i.e., an inverted U-curve – see Figure 2a. The persistence hypothesis can be summarized as follows: if a cohort for some reason is exposed to a negative or positive shock, then this will tend to affect the labour market history of this cohort for several years, and possibly its remaining labour market horizon. This is illustrated in Figure 2b by the dotted lines indicating two such profiles: a young generation happening to enter the labour market in a very favourable period which permanently results in a higher employment rate at all ages, or – in contrast – another generation entering in a period with low employment and later suffering from lower employment rates. Clearly, such shocks may arise at different ages for different cohorts. Figures 2c and 2d look at this issue separately for the young (age 15 to 34) and the old (age 40 to 64): the separation is made as the data availability provides few complete labour market histories. Figure 2c thus addresses whether the young become a ‘losing’ or ‘winning’ generation depending on whether they enter the labour market during a boom or recession. Similarly, Figure 2d considers how the old fare in the labour market.

Figures 2c and 2d provide the data for Sweden, but the pattern is similar for most countries for which data is available. For the young there is an unclear pattern; some generations start out with a low employment rate relative to other cohorts, but end up with a relatively high employment rate. Obversely, some cohorts starting out with a relatively high employment rate end up with a relatively low employment rate. In short, there is no clear pattern suggesting strong persistence in employment across cohorts in the younger ages. For elderly individuals there is a clearer picture in accordance with the persistence hypothesis. Cohorts having a relatively low (high) employment rate in the midst of their labour market career also tend to have a low (high) employment rate for their remaining labour market history. Persistence in employment for elderly workers is resolved when they retire. Hence, shocks affecting the middle-aged will typically produce persistent effects on the overall employment rate for a period of 15 to 20 years.

Figure 3 illustrates the correlation in cohort specific employment rates at various ages. The correlation indicates how employment of the age group 30–34 depends on employment of the age group (20–24) and how the employment of the old (60–64) depends

Figure 2



on employment as middle aged (45–49). In the case of the young there is no clear evidence of persistence, and in many cases the effect is wrongly signed.<sup>1</sup> The employment rate for the young seems to depend more on the current business cycle situation than their earlier employment rate. For the old, in most cases, there is a much clearer indication of persistence implying that a low employment rate as middle aged tends to lead to a low employment rate for the remaining labour market history.

Thus, there seems to be a particular risk that a deep recession may permanently reduce employment rates for older workers, whereas it is less clear whether youth unemployment will produce ‘losing’ generations. Either persistence is more important for the old or policies have been more active or successful towards the young. There are various possible explanations for these facts. The implications of human capital depreciation may be more important

for elderly workers since knowledge and experience accumulated through a long work career may become suddenly obsolete. Moreover, a shorter remaining labour market horizon may have adverse effects on both the demand and the supply side of the market in relation to employment. The employment path for elderly individuals is also affected by various pathways out of the labour market such as early retirement and disability pensions. In contrast, there has been more political willingness to pursue more active policies towards the younger age groups.

### The role of labour market policy

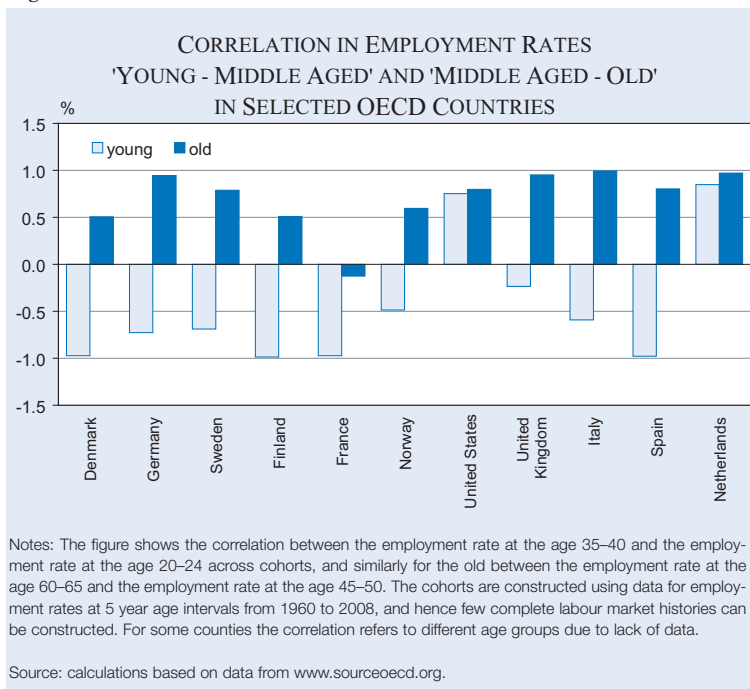
It is a primary purpose of labour market policies to address the problem of persistence and long-term unemployment. As a consequence of the crisis, the policy orientation therefore has to change from focussing on reducing the stock of long-term unemployed and marginalized to minimizing the inflow into long-term unemployment. The evidence above shows that it is particularly important to avoid that middle-aged workers become marginalized.

The clearest policy lesson from the 1970s and 1980s is that reductions of labour supply (e.g. early retirement schemes) were not successful in solving the underlying problems, but had large long-term costs since the schemes have been politically difficult to reverse. This lesson seems to have been learned, since few new passive measures allowing easier exit from the labour market have been introduced in response to the financial crisis. However, some of the existing pathways out of the labour force via early retirement, disability pensions and the like may be further used as a response to the increasing unemployment problem.

As a first response to the increase in unemployment, some countries – beyond aggregate demand measures – have made changes to unemployment insur-

<sup>1</sup> Note that this focuses entirely on employment rates, but there can be other scarring effects of youth unemployment, see Bell and Blanchflower (2010).

Figure 3



ance schemes and the social safety net to ensure income protection for those adversely affected by the crisis. There is not necessarily a problem in offering better insurance in a difficult situation with a high unemployment rate. This has direct welfare effects, and the implied distortions are likely to be smaller in a situation with high unemployment. The critical aspect is to ensure that such changes are temporary. This can be achieved by linking the properties of the unemployment insurance benefit (UIB) scheme more explicitly to the state of the labour market. This is known from the United States where the benefit duration depends on the unemployment rate. An even more sophisticated scheme is applied in Canada where benefit eligibility, benefit levels and duration depend on the labour market situation. Theoretically, it may be argued that such a scheme may strike a better balance between insurance and incentives by providing more insurance when the need is largest (high unemployment periods) and strengthening incentives when the distortions are potentially largest (low unemployment periods) – see Andersen and Svarer (2009).

It is sometimes argued that schemes offering better insur-

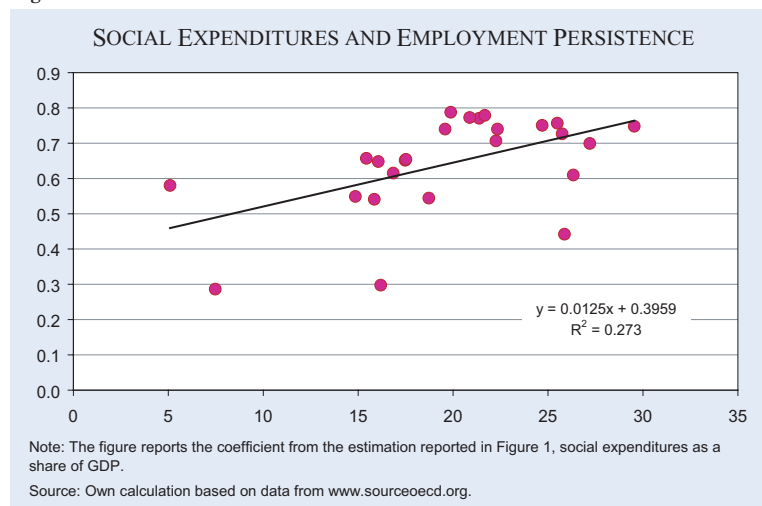
ance are bound to cause more persistence due to a weakening of incentives. The latter arises from the fact that needed adjustments or changes in reservation demands are delayed. Hence, there is allegedly a trade-off between cushioning the effects of the shocks and their persistence. Whether this is the case obviously depends on various dimensions of the safety net (e.g. duration of unemployment benefits) and policies aiming at strengthening job search and employment including active labour market policies. It is an open question whether there is empirical support for the view that a generous social safety net strengthens persistence. Based on summary statistics as given in

Figure 1, there is no evidence of such a relation. Obversely, it is clear that persistent unemployment has significant effects on public finances in a system with a generous tax-financed social safety net.

#### Active labour market policies

The main reason for the changed labour market situation is a fall in aggregate demand and thus labour demand. Therefore an obvious short-term remedy is measures aiming at increasing labour demand. However, as argued above, the risk of long-term unemployment is not necessarily well-targeted by

Figure 4





aggregate demand measures, and more specific measures may be more appropriate. One such instrument is a wage subsidy targeting particular groups like long-term unemployed, immigrants etc. Work sharing arrangements are also a useful instrument for sharing jobs over a short period of time, since it permits a larger pool of workers to remain in job. This will keep a larger group in contact with regular jobs for which it is hard to think of equally efficient active labour market policies. A more unequal sharing increases the risk of long-term unemployment for the affected. Clearly, it is important for such schemes to be temporary so as not to impede structural changes.

To reconcile insurance with incentives, and hence to counteract persistence, active labour market policies play a crucial role. An increase in unemployment raises a number of issues for active labour market policies. The direct effect is that an increase in unemployment causes a volume increase for given rules with respect to the timing and type of activation programmes. This means a larger inflow into programmes. Moreover, the composition of the pool of unemployed people changes. In recent years with falling unemployment, the focus shifted towards integrating more marginalized groups in the labour market, but the increase in unemployment will bring more core workers into active labour market programmes.

Active labour market programmes serve various purposes including incentives, matching and qualifications. In the current situation when unemployment increases due to falling demand, the main problem is not to maintain incentives for job search. For many groups affected by unemployment there is a strong economic incentive to search for jobs. Moreover, matching problems cannot be argued to be the main problem. Hence, both of these factors imply that there can be a huge deadweight cost of early intervention applied to the increasing number of unemployed. Politically, there may be strong pressure to focus on such schemes to signal that problems in the labour market are taken seriously, but it is questionable whether this is a sensible strategy. Although unemployment increases and affects many, it does not imply that all of them are on the verge of becoming marginalized. Despite increasing unemployment, there are still substantial dynamics in the labour market, and many are affected only by a short spell of unemployment. For example, in Denmark 40 per cent of those who became unemployed in early 2009

have found a job within 13 weeks, which underlines the risk that early intervention may cause huge deadweight costs.

The key task of active labour market programmes is to ensure that an unemployment spell does not turn into long-term unemployment. The crucial difficulty is to identify those in the risk group. In some cases this may depend on individual characteristics, e.g. lack of qualifications, but in other cases it is more difficult to predict who will be affected. The crisis is associated with large structural shifts, and this implies that labour has to be reallocated and thus possibly re-trained, and although such macro changes can be identified, it is not necessarily clear which individuals will be adversely affected. An increase in unemployment thus raises a sorting problem of how to target groups with a high risk of long-term unemployment. Some useful criteria can be found by combining education, previous experience, and age. Profiling may be one way to address this problem.

Retraining of various forms may be required for many unemployed. For the young the focus should be on entry into the ordinary educational system. For older workers there may be a need for retraining to overcome structural changes and facilitate job finding. Standard arguments against such programmes are that they imply lock-in and have moderate effects on later labour market performance. While there are good reasons to be sceptical about very general across-the-board training programmes for all unemployed, there is also a good case to be made that re-training is required in many cases. Moreover, the cost of lock-in is clearly smaller in a high unemployment period. Recent Swedish experience indicates more positive effects which may be attributed to the fact that the programmes have been well targeted to job relevant education (see De Luna et. al. 2008).

One way to balance these considerations may be to design active labour market policies so that intensive intervention starts when unemployment duration passes some time threshold and to focus on maintaining contact with the labour market. Since private job training has been found to be the most effective in bringing the unemployed into regular work, there is a case for focussing more on this, but also for making workers more willing to accept short-term jobs. The latter can be implemented by changing the



employment criteria for remaining eligible for unemployment insurance benefits.

A recession raises a number of risks for active labour market policies. This includes increasing cost and overload, but also questioning the efficiency of such programmes. The latter may raise a political risk that it becomes difficult to maintain support for such policies when unemployment is increasing. However, in this debate is it important to take into account that the likely alternative to active labour market policies is an exit from the labour market, and this is an irreversible decision with large costs. A first priority of labour market policy is to ensure that the current crisis does not translate into a shrinking labour force.

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## DO WE NEED CRISIS-SPECIFIC LABOR MARKET POLICIES? LESSONS FROM THE DUTCH MIRACLE – PART II

JAN C. VAN OURS\*

### Introduction

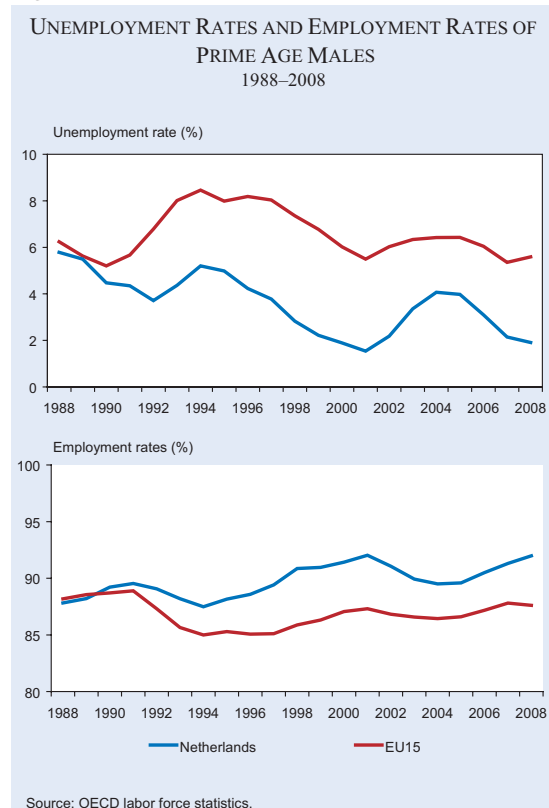
A ghost wanders about Europe, a ghost of rising unemployment. In some countries, such as Ireland and Spain, the rise in unemployment has been spectacular. In other countries the rise in unemployment has been milder and its rate is still low. A striking example of this is the Netherlands, where the unemployment rate amounted only to 4 percent in 2009. Figure 1 gives an overview of unemployment and employment developments in the past two decades, comparing the Netherlands to the EU15. The upper diagram shows the evolution of unemployment rates of prime age men (age 25–54) over the period 1988–2008, 2008 being the year before the crisis started. Clearly, whereas the unemployment rate of the EU15 at the end of the investigated period was roughly as high as in its beginning, reaching around 6 percent, the Dutch unemployment rate declined to about 2 percent in 2008, from 6 percent in 1988. Furthermore, it is also clear that the cyclical fluctuations in the unemployment rate in this country have been very much the same as in the EU15. Unemployment rates declined until the early 1990s, then increased in 1994/95, fell thereafter until the early 2000s, rose in 2004/05 and then fell again until 2008, shortly before the crisis started to affect the unemployment rate. The lower diagram in Figure 1 suggests that in terms of employment rates of prime-age men, developments in the Netherlands were also different from those in the EU15. Whereas the employment rate in the EU15 remained at about 88 percent, its rate increased in the Netherlands from 88 percent in 1988 to 92 percent in 2008.

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The drop in unemployment and the increase in employment during past decades fall under the heading of ‘Dutch miracle – part I’. The long-lasting good performance of the Dutch labor market is attributed to three policy shifts (Visser and Hemerijck 1997). First, there was wage moderation, which started in the early 1980s and ended in the negotiations between trade unions and employers in 1982. Because of this the competitiveness of Dutch industry increased significantly. Second, there was the reform of the social security system, starting with a freezing of benefits in 1983 and an overhaul of unemployment insurance in 1987, followed by further reforms in social security in the early 1990s and the early 2000s. The third policy shift concerns the innovative labor market policies and the emphasis on activating measures of various kinds. Nickell and Van Ours (2000) conclude that the unemployment rate in the Netherlands decreased because of a significant reduction of the equilibrium unemployment rate since the early 1980s. An important



Figure 1



characteristic distinguishing the Dutch labor market from other European countries is the emphasis on financial incentives to get the unemployed back to work or prevent them from entering the pool of workers collecting disability benefits (see, for example, Van Ours 2006a and 2006b).

The question addressed in this article is whether there are lessons to be learned from the current low level of unemployment in the Netherlands, which might go under the heading of ‘Dutch miracle – part II’. A review of recent developments in the Dutch labor market is provided with a focus on financial incentives and the use of labor market related benefits, i.e. unemployment benefits (UB), welfare benefits (WB) and disability benefits (DB). This will be followed by a comparison of recent developments in the Netherlands to those in other European countries and the United States. After comparing recent policy measures aimed at tackling the ‘jobs crisis’, some conclusions will finally be drawn.

### Recent events in the Netherlands

#### *Pre-crisis characteristics*

Table 1 provides an overview of Dutch labor market characteristics shortly before the effects of the crisis started kicking in. The table distinguishes unemployment rates, employment rates and the use of benefits by gender and age.<sup>1</sup> Unemployment rates of prime age individuals were rather low in 2008. Even youth unemployment rates, at 5.7 percent for men and 5.5 percent for women, were not very high. In comparison, unemployment rates among elderly workers were rather high but still lower than youth unemployment rates. In 2008 employment rates were low at the extremes of the age distribution. Yet, for prime age men (consisting of the age groups between 24 and 54) employment

**Table 1**  
**Characteristics of the Dutch labor market, 2008**

Age group	U (%)	E (%)	The use of			Pop (million)
			UB (%)	WB (%)	DB (%)	
<i>Men</i>						
15–24	5.7	69.6	0.3	0.5	2.9	1.0
24–34	2.0	92.9	1.1	1.7	3.3	1.0
35–44	1.6	93.6	1.5	2.2	4.6	1.3
45–54	2.2	89.5	1.9	2.5	9.3	1.2
55–64	4.0	60.2	3.5	2.4	20.8	1.0
Total	2.8	81.9	1.7	1.9	8.2	5.5
<i>Woman</i>						
15–24	5.5	68.7	0.3	0.9	2.3	1.0
24–34	2.5	83.2	1.1	2.6	3.7	1.0
35–44	2.8	80.5	1.6	3.1	5.6	1.3
45–54	2.6	75.2	1.9	3.4	8.9	1.2
55–64	3.4	41.1	2.2	3.4	14.4	1.0
Total	3.2	70.2	1.5	2.7	7.1	5.5

Notes: U = unemployment rate; unemployment as a percentage of the labor force, E = employment rate; employment as a percentage of the population (Pop); UB, WB, DB = unemployment benefits, welfare benefits and disability benefits as a percentage of the population, respectively.

Sources: Statistics Netherlands (CBS), Netherlands Institute for Social Insurance (UWV), OECD labor force statistics.

rates were close to or above 90 percent, compared to 75 to 85 percent in 2008.

In Table 1 the use of benefits is given as a percentage share of the population in a particular age group. The use of unemployment benefits (UB) generally amounted to below 2 percent in 2008, except for elderly men (3.5 percent) and elderly women (2.2 percent). The use of welfare benefits (WB) increased with age, from less than 1 percent for young individuals to about 2 to 3 percent for elderly individuals. The main distinctions between the age groups are shown in the use of disability benefits (DB). Whereas 0.5 percent of young men and 2.3 percent of young women collected disability benefits in 2008, the comparable share amounted to 20.8 percent and 14.4 percent for older men and for older women, respectively.

#### *Unemployment benefits*

The law on unemployment insurance benefits was introduced in 1949 to insure workers against the financial consequences of unemployment.<sup>2</sup> In the aftermath of the large-scale unemployment growth in the early 1980s, the UB system was greatly restructured in 1987. One of the main elements of this restructuring was to make entitlement to UB dependent on previous work experience. Entitled to unemployment insurance (UI) benefits are all employees

<sup>1</sup> Note that the use of particular benefits is not exclusive of other benefits. Individuals may, for example, receive part-time disability benefits in combination with part-time unemployment benefits.

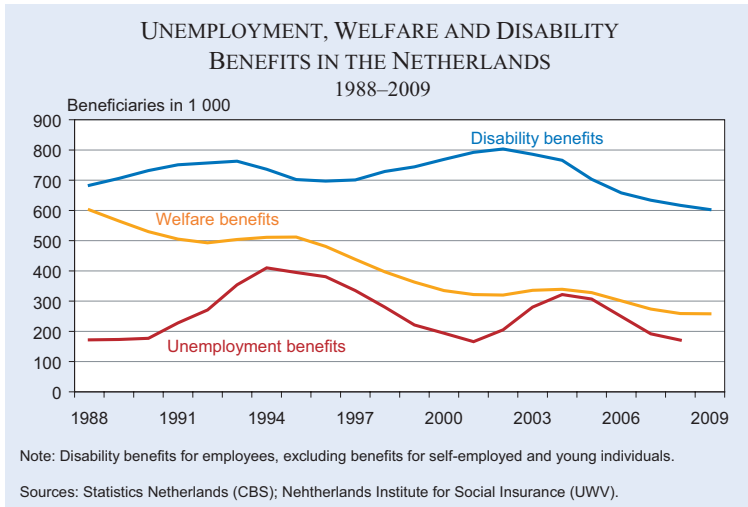
<sup>2</sup> Excluded from UB are individuals who receive full-time disability benefits or have reached the age of 65.

who become unemployed involuntarily and lose their earnings for at least 5 hours or half of their working hours. They must have been employed for a particular part of the period before becoming unemployed. The benefits end when individuals are no longer unemployed or reach the maximum benefit duration. The potential benefit duration (PBD) and the benefit level depend on the type of UI-benefits that may be collected. After the 1987 reform, individuals were eligible for short-term benefits, wage-dependent benefits or extended benefits. Eligibility for these three benefit types depended on labor experience and the age at which the individual became unemployed. The wage-dependent benefits are granted for at least 6 months and are extended at 3 months intervals to 4.5 years, depending on labor experience. Initially, labor experience was calculated as the number of years in the 5 calendar years prior to being unemployed, in which the individual has received wages for at least 52 days, plus the number of calendar years between the year in which the individual turned 18 and the 5 years prior to unemployment. In 2005, a larger part of actual labor market experience was used to determine potential benefit durations. All individuals who received wage-related UI-benefits were also entitled to extended benefits. However, extended benefits were abolished on 11 August 2003.

In the course of 2006, the new Unemployment Insurance Act was introduced (see De Mooij 2006). First, the maximum duration of unemployment benefits was reduced from 60 to 38 months; the maximum benefit duration in months equals the employment record in years prior to the application. So, the maximum period applies to people with an employment record of 38 years. Second, the benefit level was raised from 70 to 75 percent of the last wage for the first two months of unemployment. After this initial period, benefits were reduced to 70 percent. Third, the new act had more stringent entitlement conditions.

Figure 2 illustrates the annual number of unemployment benefits over the period 1988–2009. There are clear and sizeable fluctuations. Whereas in 1988 less than 200,000 workers collected unem-

Figure 2



ployment benefits, in 1994/95 this number was more than 400,000. This was followed by a decline to a low of 200,000 in 2001, and then an increase to a little over 300,000 in 2004 and another decline to 200,000 in 2008. So, whereas there are sizeable fluctuations, there is no clear trend in the use of unemployment benefits. The upper diagram in Figure 3 shows the inflow and outflow of unemployment benefits. Clearly, the cyclical fluctuations in benefits flows mimic the fluctuations in the number of benefits provided with the fluctua-

Figure 3

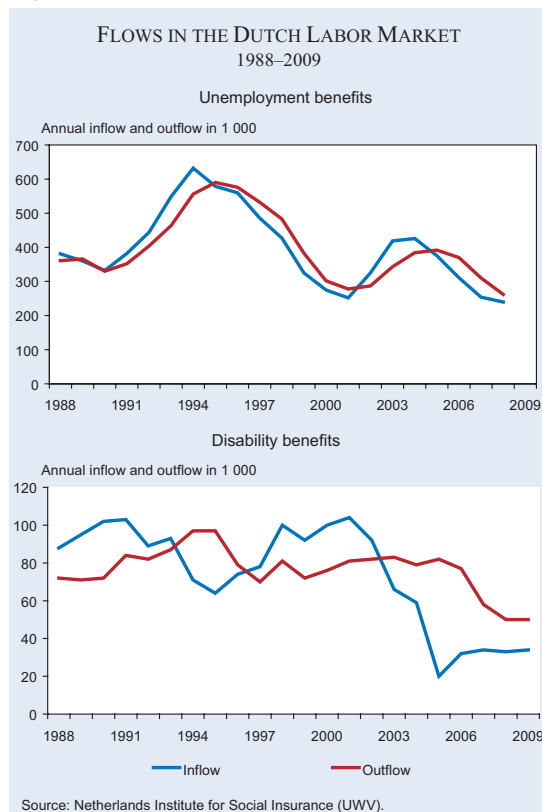
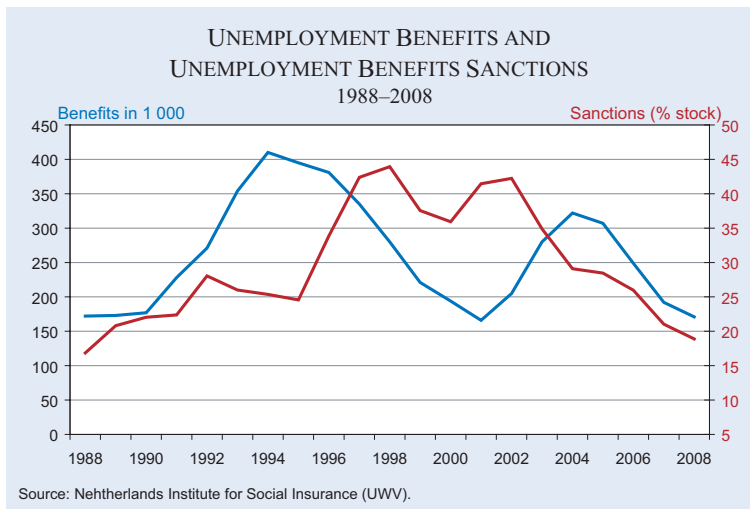


Figure 4



tions in inflow preceding those in the outflow by about a year.

Unemployed workers are entitled to UB as long as they fulfill certain requirements with respect to search intensity and administrative obligations. In August 1996 a new law on benefit sanctions was introduced in the Netherlands. Figure 4 presents information about the use of UI benefit sanctions over the past 20 years. As a percentage of the stock of UI benefits, the sanction rate increased substantially from 1988 onwards, from about 17 to 45 percent in 1998. From 2002 onwards there is a strong decline in the sanction rate, which is due to the number of sanctions falling more than the number of UI benefits.<sup>3</sup>

#### *Welfare benefits*

Welfare benefits (WB) support those people without income who are not entitled to any other benefits scheme. In addition, the individual must be legally allowed to stay in the Netherlands, and be over 18 years of age. Unemployment assistance (UA) benefits are means-tested. If the unemployed worker has a partner with a sufficiently high labor income, or if the worker has a sufficiently high amount of assets, he generally does not qualify for welfare payments. Young individuals aged 18 to 21 are supposed to be financially supported by their parents. Welfare recipients have the obligation to search for a job in order to remain entitled to the

<sup>3</sup> The use of benefit sanctions is effective in inducing unemployed workers to find a job more quickly. Abbring et al. (2005) analyze how benefit sanctions affect the transition out of unemployment, using data from the early 1990s. They find that individual re-employment rates of males increase by about 60 percent and of females by about 100 percent.

benefits. Municipalities have the power to provide bonuses on top of the basic benefits level. For example, some municipalities pay bonuses for the use of sports facilities and public transport, or for health-related expenses. The types of bonuses, the rules on entitlement to a bonus and the levels of the bonuses vary considerably across municipalities.

Figure 2 shows the development of the number of WB over the past decades. There appears to be a secular decline apart from

some ‘wrinkles’ that are highly correlated with the evolution of the unemployment rate. The decline is from about 600,000 in 1988 to less than 300,000 in 2009.

For a long time, the municipalities could reclaim a large part of their expenditures on welfare benefits from the central government. The new Welfare Act introduced in 2004 changed this. It made local authorities financially responsible for the welfare benefits they provide. In particular, local governments receive a fixed budget for welfare benefits and activation. If they are successful in getting UA recipients back to work, saved funds can be used for other local spending. This encourages local governments to invest in efficient administration, tight monitoring and tough activation programs.<sup>4</sup>

#### *Disability benefits*

Disability insurance for employees was introduced in 1967. Under the terms of this law, workers were insured against wage losses caused by long-term disability. From then on, if a worker became ill, he was allowed to claim a benefit under the illness scheme for a maximum period of one year. After that he could claim a disability benefit. Workers were entitled to disability benefits (DB) after a so-called disability examination that consisted not only of a medical examination but also of an investigation of the labor market position of the worker. A worker was considered ‘disabled’, if there was no suitable job for him at his own educational level in his previous

<sup>4</sup> Monitoring and benefit sanctions are also very effective in bringing welfare recipients back to work more quickly – see, for example, Van der Klaauw et al. (2004).

occupation. Furthermore, unemployment was ‘internalized’, which means that those workers who were considered to be partially (more than 15 percent) disabled, could collect full disability benefits because it was assumed that the partially disabled were doomed to remain unemployed. The benefit amounted to a maximum of 80 percent of the wage in the last job. The DB could be collected until age 65.

Since its introduction, the number of workers collecting disability insurance (DI) benefits has increased massively. This huge increase in DB numbers induced the government to adjust the system several times. In 1985, the maximum replacement rate was reduced from 80 to 70 percent. In 1987 there was a major restructuring of the DI benefit system, whose the main objective was to reduce the inflow into disability. The most important change was the abolition of the ‘internalization of unemployment rules’. Partially disabled workers were considered as such and were expected to find a job or claim unemployment benefits for their remaining work capacity.<sup>5</sup> In the early 1990s, there were some further changes. The DI premium was experience-rated, the disability examination no longer considered the availability of suitable jobs with respect to education and previous employment, the duration of benefits was limited to five years, after which a re-examination had to take place, and all disabled workers below 50 years of age had to be re-examined. In 2002, the so-called ‘gatekeeper’ model was extended. In this model employers and workers carry more responsibility concerning the inflow of workers into disability.

In 2006, the government replaced the disability scheme by the Law on Work and Income According to Labor Capacity – WIA (see De Mooij 2006). As before, WIA offers insurance for occupational diseases and employment injuries (*risque professionnel*) and for other risks (*risque social*). People can apply for WIA after a period of two years of sick leave that are covered by employers. WIA consists of two schemes: one for the fully and long-term disabled (IVA), and the other for the partially disabled (WGA). The term ‘fully and long-term disabled’ means that someone will never be able to

earn more than 20 percent of his previous salary. The IVA equals 75 percent of the final wage until retirement.

Figure 2 also presents the development of the DB number in the past two decades. It increased until 1990. Then after a decline in the number of benefits, the use of DB increased again and reached a maximum in the early 2000s, followed by a reduction thereafter. The lower diagram of Figure 3 depicts the inflow and outflow of DB. Until the early 1990s, the entry into DB was substantially larger than the exit. In the 1990s there were a number of reforms which are discussed in more detail below and over a couple of years in the mid-1990s the outflow was larger than the inflow, causing a decline of the DB stock. The reform of the DI system in the early 2000s also contributed to the outflow being larger than the inflow for a couple of years. After the most recent reform, the outflow has again remained larger than the inflow.

## International comparison

### Developments

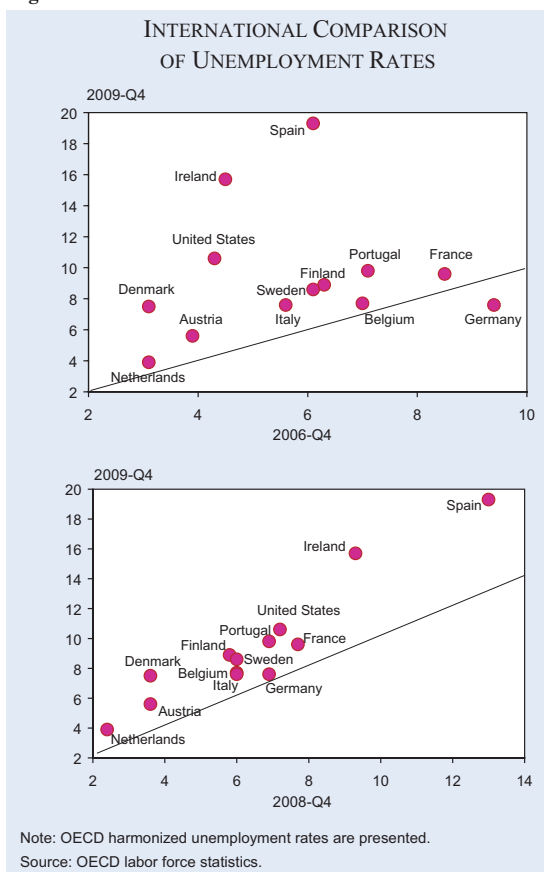
Figure 5 shows recent changes in unemployment rates across a number of European countries and the United States. The upper diagram plots the unemployment rates in the fourth quarters of 2006 and 2009. Clearly, except for Germany, these rates increased over this three year period. Unemployment growth was particularly significant in Spain, Ireland and the United States. The lower diagram of Figure 5 gives the most recent growth, from the fourth quarter of 2008 to that of 2009. In this later period, unemployment rates went up in all countries by the same figure. Surprisingly, with the exception of Ireland and Spain, it is a shift that occurred almost parallel to the straight line shown in the diagram, which indicates a non-changing unemployment rate. Apparently the crisis has affected countries in a similar way.

The upper diagram of Figure 6 shows the relationship of GDP growth in 2008 to the change of the unemployment rate in 2009. Although there is variation across countries (and Spain is an exception), there is a clear negative relationship between GDP growth and change in the unemployment rate. To the extent that there is variation in unemployment growth, this can be at least to

<sup>5</sup> Empirical studies find that before the DB system reform in 1987 up to 50 percent of the disability enrollment was related to the redundancy of workers. Hassink et al. (1997), for example, show that at the end of the 1980s employers used disability enrollment as an alternative to dismissals. They find that about 10 percent of the transitions into disability were due to the redundancy of the worker.



Figure 5



some extent explained by differences in GDP growth.

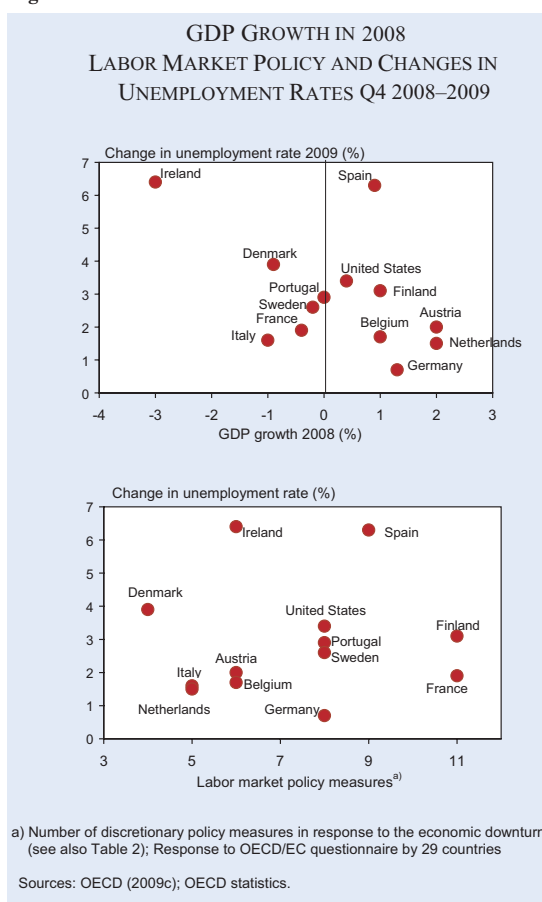
#### *Tackling the jobs crisis*

Many countries have used extensive fiscal packages to support their economy and thus aggregate demand. So, at least in the short run, job losses were limited. In addition, many countries have taken additional measures to cushion the effects of the crisis on their labor market.

Table 2 provides an overview of these additional measures.<sup>6</sup> The measures are categorized under four headings. First, there are measures to support labor demand, including reductions in non-wage labor costs and new or expanded job subsidies as well as public sector job-creation schemes. New subsidies to encourage short-time working schemes, which avoid layoffs, have been introduced in some countries while existing schemes have been reinforced in other countries. Eligibility for short-time subsidies has

<sup>6</sup> The information in this table comes from an OECD/EC questionnaire sent to all member countries in January 2009 with an update of responses in May 2009. The information refers to discretionary measures at a national level.

Figure 6



been extended to new groups of workers and participation has been made more attractive by increasing the maximum duration of the subsidies. The introduction of subsidized training for workers on short-time work is a notable new tendency.<sup>7</sup> Second, there are measures aimed at helping the unemployed find work. Some countries relaxed activation requirements, while others have tightened activation requirements for the unemployed by intensifying contacts with the case-workers. Most countries strengthened job search assistance available to the unemployed, sometimes targeted at particular groups or regions facing high numbers of mass redundancies. A number of countries expanded the capacity of their public employment service. Some countries introduced expanded work experience programs; other countries expanded training programs with often the extra training slots being reserved for vulnerable groups. A third category comprises income support measures for job losers and low paid workers. Some countries reinforced

<sup>7</sup> The short-time work scheme in the Netherlands has a novel feature which requires employers to reimburse one-half of the benefit paid to participating employees if they are dismissed during the three months following short-time work.

Table 2

## Discretionary changes in labor market policy in response to the economic downturn

	AUT	BEL	DNK	FIN	FRA	DEU	IRL	ITA	NLD	PRT	ESP	SWE	USA
<i>Labor demand</i>													
Job subsidies, etc.						x				x	x	x	x
Non-wage labor costs reductions		x		x	x	x				x	x	x	
Short-time work schemes	x	x	x	x	x	x	x	x	x				
<i>Help unemployed find work</i>													
Relaxation of activation requirements			x	x			x	x		x			
Job search assistance	x	x		x	x	x	x	x	x		x	x	x
Job-finding incentives				x						x	x		
Work experience programs					x		x			x		x	x
Training programs	x		x	x	x	x	x	x	x	x	x	x	x
<i>Income support measures for job losers</i>													
Changes of generosity or coverage of unemployment benefits		x		x	x			x		x	x	x	x
Social assistance		x			x								
Other payments				x	x	x				x	x		x
Fiscal measures for low earners	x	x		x	x	x					x	x	x
<i>Other training measures</i>													
Training for existing measures	x			x	x	x			x		x	x	x
Apprenticeship schemes	x		x	x	x		x		x				

Notes: This table refers only to federal government initiatives; in Denmark active labor market expenditure increases automatically when the unemployment rate increases; neither these automatic increases, nor increases in expenditure on unemployment benefits as a result of growing numbers of unemployed, are shown in the table.

Source: OECD (2009c).

income support for job losers through changes of unemployment benefits, social assistance or in-kind support systems. Other countries increased benefit generosity, extended maximum benefit durations or combined the two. The fourth heading relates to other training measures. Most of the measures are of a temporary nature, and additional funds for labor market programs are rather limited. Indeed, the lower diagram of Figure 6 shows that there is no obvious relationship of the number of crisis policy measures to the change in unemployment rates in 2009.

## Conclusion

The Netherlands has been successful in bringing unemployment rates down to a level far below the European average. This improvement of the labor market falls under the heading of ‘Dutch miracle – part I’. There was no blueprint for the reform of the labor market. Not everything was carefully planned, and the effects of the reforms did not occur immedi-

ately. The Netherlands started the reform of the social security system in the mid-1980s and continued it until the second half of the 1990s before the Dutch employment miracle occurred.

Although the economic crisis kicked in, the unemployment rate in the Netherlands has remained low and it looks like the Dutch miracle is continuing. The ‘Dutch miracle – part II’ is not due to recent crisis policy measures, but to a structural improvement of the Dutch labor market. The latter does not mean, however, that the labor market is robust to cyclical fluctuations in the economy. Indeed, as Figure 2 shows, the cyclical fluctuations in the Netherlands and across Europe are very much the same. This graph provides the best representation of the idea that bringing unemployment down requires restructuring of the labor market and a lot of time. It does not seem to be possible to deviate from these long-term developments over a short-time period. Country-specific labor market policies to tackle the crisis are bound to have limited short-run effects.

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## CREDIT AND UNEMPLOYMENT: DO INSTITUTIONS MATTER?

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### Introduction

Among various consequences of the subprime mortgage crisis, which broke out during the summer of 2007, the burst of unemployment is undoubtedly the most concerning. The rise in unemployment has been particularly pronounced in the United States. While the OECD harmonised unemployment rate (HUR) had decreased from 6 percent in 2003 to 4.6 percent in 2007, it suddenly climbed to 5.8 percent in 2008 and reached 8.1 percent during the first quarter of 2009. The evolution is less clear-cut in the EU, in which the average HUR has changed from 9 percent in 2003 to 8.2 percent in the first quarter of 2009. But this average hides significant differences among European countries. Some of them exhibit a particularly alarming employment situation, as exemplified by Ireland (with a HUR of 4.8 percent in 2003 against 11.8 percent in 2009) and Spain (11.1 percent in 2003 compared to 18.1 percent in 2009).

The most direct manifestation of the subprime crisis for the 'real' economy has been the dramatic reduction in access to credit faced by households and, above all, by firms. The credit crunch mainly results from both liquidity shrinkage and failures in the banking system. On the one hand, distressed banks tend to squeeze credit in order to restore their liquidity. On the other hand, banks' failures destroy the long-term relationships that lenders and borrowers have been building for many years (Bernanke 1983). As bank information about borrowers is inherently private, firms face difficulties in getting credit from other lenders. This leads to a reduction of credit

availability, which can be amplified by a decline of share prices in financial markets. For example, firms with credit lines from the Continental Illinois incurred a significant fall in their share's value just after the bank's collapse in 1984 (Slovin et al. 1993). When the crisis is systemic, the whole stock market is affected, as testified by the decline in all major stock indexes since 2008.

The credit squeeze induced by the subprime crisis raises the more general point of the link between credit and labour market performance. The aim of this paper is to examine this issue and its normative implications. Following this introduction, we analyse the relationship between firms' access to credit and unemployment in the second section. The third section is dedicated to the literature on institutional and legal determinants of the access to credit. In the fourth section, we both complete and moderate the view developed in the second section, stressing the complex interactions that exist between financial arrangements and labour market institutions. The final section concludes.

### Access to finance and unemployment: theoretical and empirical arguments

The links between access to credit and unemployment have been widely studied in the theoretical and empirical literature. To start with, there exists an indirect transmission channel that relates to the financial determinants of capital demand and the sensitivity of investment to cash-flow. In the new-Keynesian view, information asymmetries between lender and borrowers are analysed as market imperfections that result in credit rationing and investment contraction (Stiglitz and Weiss 1981). Using American firm-level data, Fazzari et al. (1988) estimate empirical investment models. They examine whether investment decisions depend on the availability of internal funds and whether this sensitivity is higher for high information-asymmetry firms. They confirm the existence of financial constraints, especially for low-dividend firms. A large empirical literature has then developed in



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line with this approach.<sup>1</sup> Unfortunately, none of these studies examines the effect of investment fluctuations on labour demand and employment performance.

A second strand of literature deals more explicitly with the issue of employment. To start with, finance directly affects employment through its impact on the new establishment of firms. According to Acemoglu (2001), job creation mainly occurs in innovating firms. Reducing the access to credit for entrepreneurs prevents the emergence of new firms and penalises employment. Belke and Fehn (2002), Fehn and Fuchs (2003) and Belke et al. (2004) focus on venture capital as a particularly appropriate source of finance for innovating firms. Their theoretical and empirical studies reveal that an insufficient development of venture capital hinders the establishment of new firms, thus harming employment.

Greenwald and Stiglitz (1993) as well as Arnold (2002) use an alternative approach, relating the new-Keynesian literature on capital demand to the issue of labour demand. They show that firms' labour demand depends on their financial constraint and fluctuates according to their balance-sheet position. Hence, employment declines when firms face a credit squeeze. This theoretical result has been corroborated by empirical studies. For example, Sharpe (1994) finds that the sensitivity of American firms' labour demand to sales increases with their leverage ratio. Using a set of British firms, Nickell and Wadhvani (1991) show that employment decreases with firms' leverage ratio and increases with their market capitalization. Moreover Nickell and Nicolitsas (1999) conclude that employment falls with the ratio of interest payments to cash-flow. Benito and Hernando (2008) obtain the same outcome for Spanish firms. Using Italian data, Caggese and Cunat (2008) establish that firms facing stronger financial constraints resort more intensively to fixed-term rather than to permanent workers.

Finally, the recent paper by Campello et al. (2010) proposes an encompassing analysis of how financial constraints affect both investment and employment. Their contribution is all the more interesting as they concentrate on the subprime crisis period. The authors survey 1,050 chief financial officers in the United States, Europe and Asia in order to distin-

guish financially-constrained and non financially-constrained firms. Their study provides evidence that during the crisis (i.e. during the last quarter of 2008), American financially-constrained firms were planning to cut their fixed capital expenses and reduce employment more intensively than non financially-constrained firms. Moreover, the difference between financially and non financially-constrained firms' reactions is significantly larger during the crisis than before (i.e. from the third quarter of 2007 to the last quarter of 2008).

### **Institutional and legal determinants of the access to credit**

In most countries prudential and credit-boosting policies have been undertaken in order to bail out the banking system and to tackle the credit crisis. But access to credit also has structural determinants such as the legal and institutional framework. This idea is at the heart of the so-called 'law and finance' view, developed in the wake of the seminal paper by La Porta et al. (1997). The main argument propounded in this literature is that the availability of external finance strongly depends on the degree of investor protection as well as on the efficiency of law enforcement. Special attention is devoted to countries' legal systems. They distinguish four legal systems: the English, the French, the German and the Scandinavian system. The literature mainly contrasts the English and the French system. While the former, which prevails in Anglo-Saxon countries, is based on Common Law, the latter, in force in France as well as in many southern European countries, is based on the French Code Civil. According to this literature, the English system is more favourable to financial development and growth than the French one (La Porta et al. 1997; La Porta et al. 1998a; Levine 1998; Levine 1999; Beck et al. 2000).

In the same line as this literature, Djankov et al. (2003) and Djankov, Hart et al. (2008) focus on the access to credit.<sup>2</sup> They use several indicators that depend on the legal system and determine credit availability. Djankov et al. (2007) concentrate on the creditor rights index, built by La Porta et al. (1997) and La Porta et al. (1998a). This indicator encompasses several criteria: (a) whether there exist res-

<sup>1</sup> See notably Hoshi et al. (1988) who use Japanese data, and Bond and Meghir (1994) who test UK data.

<sup>2</sup> In the same line, some other works concentrate on securities laws (La Porta et al. 2006) and self-dealing (Djankov, La Porta et al. 2008) as well as on the quality of government (La Porta et al. 1998b) and the legal framework of new firms' entry (Djankov et al. 2002).

trictions (such as creditor consent or minimum dividends) when a debtor files for reorganization, (b) whether secured creditors can seize their collateral after the approval of a reorganization, (c) whether secured creditors are paid first out of the liquidating firm (before workers and the government), and finally (d) whether an administrator (instead of the manager) runs the business during the reorganization. Adding a value of 1 each time one of these four conditions is fulfilled, one obtains a creditor rights index that varies between 0 (poor creditor rights) and 4 (strong creditor rights). Following La Porta et al. (1997) and La Porta et al. (1998a), Djankov et al. (2007) find that the Common Law system is associated with a higher creditor index compared to the French legal system (2.278 in 2003 for the former against 1.313 for the latter), suggesting that Anglo-Saxon countries offer better legal protection to creditors. Using a set of 133 countries in the period from 1978 and 2003, the authors also regress the ratio of private credit from deposit financial institutions to the private sector to GDP on several control variables (such as GDP, GDP per capital growth, inflation, etc.). Their OLS estimates confirm the results obtained by La Porta et al. (1997) on a shorter data set (49 countries for the year 1994). The degree of creditor protection is shown to favour access to credit: when the creditor rights index (measured in 1999) rises by 1 percent, the ratio of private credit to GDP increases by 6 percent.

The authors also discuss the role of credit information sharing among creditors. Their idea is that information sharing alleviates insolvency risk, thus making banks less reluctant to grant credit. To measure the extent of information sharing in each country of their data set, they use two indicators. The first one relates to public registries that collect data about borrowers' indebtedness and make them available to lenders. It equals one if there exists a public registry in the country, zero otherwise. The second indicator refers to private credit bureaus, which allow banks to share their information about borrowers. It is equal to one if there exists a credit bureau in the country, zero otherwise. Public registries are more widely established in French-system countries than in Common Law countries while the reverse holds for credit bureaus. Using the same econometric method as for their study of credit rights, Djankov et al. (2007) find that the presence of private bureaus has a positive impact on the ratio of private credit while public registries favour access to credit only in low-income countries.

Djankov, Hart et al. (2008) examine the efficiency of debt enforcement as a determinant of access to credit. Their study is based on a survey of attorneys and judges in 88 countries, completed in 2005. Three variables are used to measure debt enforcement: the time to resolve the insolvency process (taken from Djankov et al. 2003), the cost to complete the insolvency process, and the likely disposition of assets (whether assets are preserved as a going concern or sold piecemeal). An encompassing measure of efficiency of debt enforcement is then computed. The higher it is, the more efficient is law enforcement. Here again, the English legal system is shown to offer a higher debt enforcement efficiency than the French system. The average index amounts to 72.1 for Common Law countries while it is only 40.4 for French legal system countries. The econometric approach of the authors is the same as in Djankov et al. (2007). They establish that the efficiency of debt enforcement positively affects the ratio of private credit to GDP. When debt enforcement efficiency increases by 10 percent, the ratio rises by 5 or 6 percent, depending on the econometric specification.

These elements support the view that the institutional environment crucially accounts for access to credit. They also suggest that the Anglo-Saxon legal system is the most appropriate from this point of view. Hence, reforming legal systems in the direction of a higher creditor protection, a reduction of the time and the cost of the insolvency process as well as a preservation of corporate assets should foster credit availability. This is precisely the kind of policy advocated by the World Bank. In its annual report 'Doing Business', explicitly inspired by the 'law and finance' literature, the World Bank proposes a ranking of countries based on various institutional indicators of doing business easiness, some of which especially affecting access to credit. Table 1 reports the value of these indicators for selected countries.

The World Bank also lists the countries engaged in significant reforms of their credit access regulation. For example, the Doing Business report indicates that, over the last five years, the main area of reform from this point of view has been the strengthening of creditor rights, especially in high-income countries (among which are Denmark, United States, Finland, France, etc.). According to the report, these reforms improved the credit recovery rate. Hence, they should also increase credit availability. The other



**Table 1**  
**Institutional determinants of access to credit**

Countries	Legal rights index <sup>a)</sup> (0–10)	Information index <sup>b)</sup> (0–6)	Public registry coverage <sup>c)</sup> (as % of adults)	Private registry coverage <sup>d)</sup> (as % of adults)
USA	8	6	0	100
UK	9	6	0	100
Canada	6	6	0	100
Germany	7	6	0.8	98.3
France	7	4	32.5	0
Italy	3	5	12.2	77.5
Spain	6	5	45.3	7.6
Sweden	5	4	0	100
Japan	7	6	0	76.2
Singapore	10	4	0	40.3
Taiwan	4	5	0	63.2
China	6	4	62.1	0
Argentina	4	6	34.3	100
Chile	4	5	32.9	33.9

<sup>a)</sup> Measure of the legal rights of borrowers and lenders through collateral and bankruptcy laws (the higher the index, the stronger the protection). –  
<sup>b)</sup> Measure of the scope, access, and quality of credit information (the higher the index, the better information). –  
<sup>c)</sup> Number of individuals and firms listed in a public credit-registry as a percentage of adult population. –  
<sup>d)</sup> Number of individuals and firms listed in a private credit-registry as a percentage of adult population

Source: World Bank (2009).

important area of reform pointed out by the World Bank has consisted in increasing the efficiency of the liquidation process, notably through a reduction of its duration. This trend has been particularly pronounced in eastern European countries.

It is noteworthy that these policy recommendations are generally deregulation-oriented. For example, reducing the liquidation duration and softening the procedure contribute to make firms' closure easier. Similarly, promoting the development of credit bureaus implies a reduction of banks' information monopoly and an increase in banking competition (Brown et al. 2007). The deregulation dimension of reforms advocated by the World Bank is particularly confirmed by the comments of Djankov et al. (2007) on the positive impact of public credit registries in low-income countries: "these results [...] point to a beneficial role of public credit registries in poor French legal origin countries – a rare example of an apparently successful state intervention" (Djankov et al. 2007, 301).

Combined with evidence given in the second section, these arguments suggest that reforming the institutional determinants of credit granting in the way defined by the 'law and finance' literature could significantly improve employment performance.

### Interactions between credit availability and labour market institutions

The aim of this section is to take a critical look at the view developed in the previous section. Our main criticism concerns the existence of complementarities or substitutability among various institutional arrangements. Two policies or institutions are said to be complementary (resp. substitutable) when the efficiency of the one increases (resp. decreases) with the presence or the implementation of the other. Recent empirical and theoretical contributions<sup>3</sup> provide rich analyses of institutional interactions among labour market institutions (labour legislation, unemployment protection, union density, wage taxation, etc.) and

product markets institutions (barriers to entry, price control, etc.).

But there also exist interactions between credit market regulation and labour market institutions. The literature on this issue is particularly interesting because it shows that the links between credit policies and unemployment are more complex than exposed in the third section. However, it is limited to a few theoretical papers. A first category of studies considers financial deregulation and labour market flexibilization as substitutes. In Rendon (2001), reducing firing and hiring costs boosts employment. Access to external finance curbs unemployment since it allows firms to finance labour adjustment costs. Therefore, if credit is easily available, removal of labour market adjustment costs becomes less effective since these costs can easily be financed by external finance. Symmetrically, if the labour market is made perfectly flexible, access to external finance has a weak impact on employment. In Belke and Fehn (2002), strong labour protection allows workers to partly capture the rent resulting from the entrepreneur's project. This decreases the project's rate of return below the minimum threshold required by fund providers. Hence, the firm cannot

<sup>3</sup> See Blanchard and Giavazzi (2003); Griffith et al. (2006); Berger and Danninger (2007); Fiori et al. (2007); Kugler and Pica (2008); Amable and Gatti (2006) as well as Amable et al. (2010).

be established and no jobs are created. However, the rise in unemployment yields a decline in labour protection and a subsequent rise in the project's return above the fund providers' threshold. Nevertheless, financial constraints slow down this adjustment process so that the return to higher employment is delayed. Symmetrically, when the labour market is flexible, there is no unemployment, and financial deregulation becomes ineffective. When the financial system is frictionless, the return to employment is immediate and a deregulation of the labour market becomes less interesting. According to these approaches, improving firms' access to external finance may not be always effective. If the labour market is highly deregulated, boosting credit turns out to be ineffective. However, it can be effective in countries where labour markets are highly regulated.

Another series of papers regard financial deregulation and labour market flexibilization as being complementary. Koskela and Stenbacka (2002) model the effects of a reduction of bank competition in an economy where workers are remunerated by a bargained base wage and a share of the firms' profit. Because the firms' hiring policy is financed by borrowing, an increase in the interest rate implied by a reduction of banking competition hinders employment. But workers internalize the rise in hiring costs and bargain less harshly about their base wage. The moderating effect dominates when unions are powerful. Otherwise, the former effect prevails. Hence, promoting access to credit through higher banking competition may be particularly effective if there is no moderating effect, i.e. if union density is weak. More generally, this suggests that financial liberalisation boosts employment only in countries with weakly deregulated labour markets. It becomes less interesting if the labour market is highly regulated. This contradicts the conclusion drawn from Rendon (2001), and Belke and Fehn (2002).

The outcome of Acemoglu and Pischke (1999) provides an even greater contrast. In their model, regulation of labour markets and financial systems (rather than *deregulation*) are seen as complementary. The authors argue that credit rationing favours employment since it entices firms to invest in human capital rather than in physical capital. The effect of a credit squeeze is particularly positive when labour market regulation hinders employment.

In summary, according to the nature of institutional interactions between labour market and financial arrangements, promoting firms' access to credit may have no effect on employment. This theoretical conclusion has important implications for empirical research. It notably suggests that it is urgently necessary to determine which one out the three configurations prevails in each country: substitutability between financial deregulation and labour market flexibilization, complementarity between financial deregulation and labour market flexibilization or complementarity between labour market and financial system regulation.

The paper by Gatti et al. (2009) is precisely aimed at filling this gap. Using annual data for 18 OECD countries for the period of 1980 to 2004, they investigate how labour and financial factors interact to determine unemployment. They estimate a dynamic panel model using the system generalized method of moments (GMM). Enlarging the analysis of access to credit to the more global issue of external finance, they consider three types of financial variables: stock market capitalization, intermediated credit (claims to the private sector by deposit money banks, insurance companies, private pensions, pooled investment schemes and development banks) and banking concentration. The main conclusion of the paper is that the impact of financial variables strongly depends on the labour market context. On the one hand, increased market capitalization and decreased banking concentration reduce unemployment only if the level of labour market regulation, union density and coordination in wage bargaining is low. On the other hand, increasing intermediated credit and banking concentration promote employment when the degree of labour market regulation, union density and coordination in wage bargaining is high. These results have important policy implications: in countries with high levels of labour market regulation, union density and wage bargaining coordination, boosting intermediated finance (through higher intermediated credit and banking concentration) appears much more appropriate than promoting market-based finance (through increased capitalization and lower banking concentration).

### Conclusion

The aim of this paper was to stress the importance of institutions as critical determinants of the relationships between credit and employment. Its main conclusion is that this relationship does not only depend

on the legal determinants of credit but also on their interactions with other institutional arrangements such as labour market institutions.

We have already emphasised the need for empirical evaluations of institutional interaction effects. But there is also much theoretical work to be done. A particularly important inquiry avenue concerns accounting for product market institutions. In so far as they are closely linked to labour market institutions, how do they interact with financial factors? This calls for an encompassing theoretical model including not only labour market and financial arrangements but also product market institutions. This very hard task undoubtedly constitutes a motivating research agenda.

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## ITALY: INCHING OUT OF THE GLOBAL CRISIS

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Despite being one of the large members of the EU, when it comes to the world scenario Italy remains just one in a group of several small advanced, open, slow-growing economies, with little room to maneuver by themselves, and no clear idea in which direction to play their limited options. This is even truer now, in the grand scenario of 2010, as the world's worst economic crisis of the last seventy years has been halted, and economies are slowly recovering, but with no clear sign of direction and many unresolved issues that only temporarily have been brushed aside.

The world economy has indeed been rescued. Generally speaking, the measures adopted were prompt, several had not been previously tested, and many went against conventional (academic) wisdom. But they seem to have worked, which is even more a tribute to those who decided to adopt them. But rescue is not recovery. That will take more time and will be more difficult to achieve, also because recovery might take pressure away from painful reforms.

In this paper I would like to highlight two aspects. First, in order to get out of the recession, there was little that Italy could do by itself, especially in terms of short-run policies. Its monetary and exchange rate policy is set by the European Central Bank (ECB). Its fiscal policy is effectively blocked by its enormous debt. Its ability to reform is hindered by the lack of social and policy consensus, and by the deterioration of the climate for public and policy debates. In this respect, the policy choice has been not to fight the recession head on, but to minimize some of its social costs. Within these limits, results have been positive.

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Second, the measures that have been adopted are going to have at best a modest influence on the causes of Italy's persistent slow growth. They are qualitatively insufficient to promote a more sustained recovery and to reactivate a growth process, the engines of which have been stalled for quite some time. One possible outcome is that Italy is likely to remain a country in relative decline. But as Italians were relatively well off before the crisis and their plight is not uncommon in Europe, they will find this situation not too alarming, at least for a while. But as limited signs of a more positive determination to resume growth are also apparent (as I will argue in the end) the final outcome might still be different.

To develop my arguments, I will briefly relate to the current state of the crisis in the first section; then discuss in the next section why the financial crisis affected only marginally the Italian financial system. In the third section I will briefly characterize the transmission of the crisis to the economies of the euro area, followed by the examination of government response to the crisis in Italy. The final section concludes.

### Legacies of the crisis

The US house price bubble began to burst in September 2007, and the US stock markets began to slide after 8 October 2007, followed by the rest of the world. The slide became a crash after March 2008. On the real side, the US economy had reached a peak in December 2007, while the euro area did not peak until the first quarter of 2008. The first signs of recovery came about a year later. Stock markets seem to have bottomed out in March 2009 and also the real economy slowly began to grow in the second half of 2009, both in Europe and in the United States.

World output declined by 0.8 percent in 2009, and is now expected to rise by 3.9 percent in 2010. In this scenario growth will be 2.7 percent in the United States, and only 1 percent in the Euro area (see



**Table 1**  
**World economic outlook projections (%)**

	2008	2009	2010	2011
<b>World output</b>	3.0	-0.8	3.9	4.3
Advanced economies	0.5	-3.2	2.1	2.4
Euro area	0.6	-3.9	1.0	1.6
Germany	1.2	-4.8	1.5	1.9
Spain	0.9	-3.6	-0.6	0.9
France	0.3	-2.3	1.4	1.7
Italy	-1.0	-4.8	1.0	1.3
UK	0.5	-4.8	1.3	2.7
USA	0.4	-2.5	2.7	2.4
Japan	-1.2	-5.3	1.7	2.2
Emerging & developing countries	6.1	2.1	6.0	6.3
<b>World trade volume (goods &amp; services)</b>	2.8	-12.3	5.8	6.3
Imports				
Advanced economies	0.5	-12.2	5.5	5.5
Emerging & developing countries	8.9	-13.5	6.5	7.7
Exports				
Advanced economies	1.8	-12.1	5.9	5.6
Emerging & developing countries	4.4	-11.7	5.4	7.8

Source: IMF (2010).

Table 1). The main emerging markets are leading the recovery, even more firmly than they were leading growth before the crisis. Not only (with the exceptions of Russia and Mexico) they have decoupled from the worst of the crisis, but they have re-asserted a yearly growth differential of about 4 percent against the advanced economies. This new balancing of the world economy does not show only in the GDP data: China, now the world's largest exporter, increased its share of exports to developing countries from 50 to 56 percent during 2009.<sup>1</sup>

Recovery in the advanced economies will probably continue to be slowed down both by the unresolved issues from before the crisis and the added difficulties of unwinding the expansionary fiscal and monetary policies that have been adopted during the crisis. And no matter how necessary such policies have been, the exit strategies they now require are not going to be a stimulus for further growth.

To discuss the situation of Italy, first in the crisis and now in the recovery, I begin in the next section with a short discussion of the impact of the crisis on the financial system.

### The financial crisis: why not in Italy?

Although the crisis originated in US financial markets, and owed a large part of its global dimension to the global connectedness between financial

institutions within and across countries, the financial aspects of the crisis came to Italy mostly as a side-show. This sets Italy apart from other European countries, where finance played a much more important role in both the local origin and the spreading of the crisis.<sup>2</sup> This is particularly true for banks, an issue which is worth examining in more detail.

#### *Banks' losses ...*

In the United States, according to a report by Credit Suisse in January 2010, banks are facing about USD 1.4 trillion of commercial real estate (CRE) loans maturing in the next four years. Almost 55 percent of the commercial mortgages that will mature until the end of 2013 are currently 'underwater', meaning the borrowers owe more than the value of the property, according to the research company Foresight Analytics.

For the euro area, the ECB had observed in its mid-year review of 2009 that euro area banks could face a total loss estimated at USD 649 billion over the period 2007–10. At the end of May 2009, "the write-downs on securities by euro area banks had amounted to USD 215 billion. At the same time, in 2007 and 2008, euro area banks provisioned and wrote-off USD 150 billion of their loan exposures. Looking ahead, therefore, there is potential for euro area banks to suffer a further USD 283 billion in losses, mainly originating from loan exposures" (ECB 2009a, 103). More recent loss estimates, published in December 2009, are bigger: "the total (i.e. already reported and yet to come) write-downs for the euro area banking system are likely to amount to around € 553 billion for the period 2007–10. Of this total, cumulative total write-downs on exposures to securities are likely to amount to around € 198 billion, while the predicted figure for total loan-losses is around € 355 billion. [...] Splitting the total loss figures into what has already been reported and what is

<sup>1</sup> See Financial Times, 10 February 2010.

<sup>2</sup> Financial aspects of the crisis were of paramount importance in Britain, Spain, Ireland and Iceland, and to a lesser extent also in Germany, Austria, Sweden and the Netherlands, as well as in many countries in the CEE.



yet to come by the end of 2010, there is a potential for euro area banks to suffer an additional € 187 billion in losses, mainly as a result of their loan exposures” (ECB 2009b, 89).

In the crisis, banks have come under increased scrutiny and pressures by shareholders, market participants and regulators over their capital adequacy and excessive leveraging. These pressures could be accommodated in three directions: (i) re-capitalization and increase in capital ratios; (ii) issuance of safer or guaranteed liabilities; (iii) reduced lending, especially to those debtors perceived to be more at risk. In general, all “EU governments implemented support measures to alleviate strains on their banking systems. These measures complement the extensive liquidity support that has been provided by the ECB” (ECB 2009a, 87).

*... and de-leveraging*

In particular, in reference to (i) above, capital ratios of banks held up well, thanks partly to government recapitalizations and especially to the quality and composition of capital. This is also true of Italian banks. The first five banking groups in Italy increased their total capital ratio by 0.6 percent to 11 percent in June 2009, while their tier 1 ratio has increased by 0.7 to 7.4 percent, compared to the increase in the core tier 1 ratio by 0.8 percent to 6.6 percent.<sup>3</sup> These ratios are still slightly below those of comparable EU banks (ECB 2009a). On the other hand, overall leverage for large Italian banks is down to 24 (from 26 at the end of 2008); this may be compared to the European average for large banking groups, which amounts to 34. Reduced leverage is probably one reason why the Italian banking system has been less and more marginally affected by the crisis, relatively to other European banking systems.

A second reason is the reliance of Italian banks on a stable deposit and funding base, with a much more limited recourse to money market liabilities: in a comparison of 27 banking groups in six European countries (Britain, Italy, France, Germany, the Netherlands and Spain) in June 2009, the average ratio of (non-interbank) deposits and own bond lia-

<sup>3</sup> See Banca d'Italia (2009). Total capital ratio is equal to the ratio between a comprehensive measure of bank capital (total regulatory capital, which includes tier 1, tier 2 and tier 3 plus supplementary capital) and risk-weighted assets. Tier 1 capital includes core tier 1 (shareholders' equity and retained reserves) plus hybrid capital instruments. Leverage is the ratio between un-weighted assets and total regulatory capital.

ilities to total liabilities was 42.6 percent for the other five countries, and 62 percent for Italy (data courtesy of the European Banking Report Observatory of ABI<sup>4</sup>).

In Europe, many governments have been supporting banks through the issuance of guaranteed bank bonds. These measures have been attractive to banks especially in Britain, Spain, Ireland, Germany and Austria, and to a lesser extent in Sweden, the Netherlands and France. In Italy, a similar initiative (called ‘*Tremonti* bonds’<sup>5</sup>) has been largely ignored, as banks have preferred to issue non-guaranteed bonds (about 50 billion euros). This has been a clear sign of the strength of the banking sector in Italy, as Italian banks could raise credit at a lower cost (or with less conditionality) than if they had accepted the support of the government.

*Credit crunch? not here, thanks*

Worldwide, several factors helped induce a contraction in the supply of bank loans: the scarcity of bank capital; the mounting of on and off-balance sheet losses; the deteriorating quality of creditors; and pressures from regulators, politicians and market participants alike, all asking banks to de-leverage. It would have been overly optimistic not to expect a worldwide credit crunch. And thus it came, despite the extreme laxity of monetary conditions almost everywhere. The IMF estimated a financing gap of about 460 billion euros for 2009 in the euro area, and one of 150 billion euros for Britain (IMF 2009a).

In Italy, the credit contraction has been less pronounced than elsewhere: outstanding loans reached a maximum around the summer of 2008, and have decreased by only 0.2 percent in the 12 months to November 2009 (Banca d'Italia 2010), although their overall quality has also deteriorated. Several specific measures have been adopted in Italy (in addition to the bank bond guarantees discussed above) to stimulate lending to private borrowers:

- State-guarantees and refinancing of the guarantee funds to insure bank loans to small and medium enterprises, and a revamped role for the “*Confidi*” (consortia promoted by local entrepre-

<sup>4</sup> ABI is the Italian Banking Association.

<sup>5</sup> See Ministero dell'Economia e delle Finanze-Dipartimento del Tesoro (2009) and Panetta et al. (2009) for a documentation and analysis of measures of bank support adopted worldwide.

neurial associations to co-insure access of firms to bank loans),

- Monitoring activity of credit conditions to be enacted by the provincial government offices (*prefettura*),
- The proposal of a new “*Banca del Mezzogiorno*”.

Of these, probably only state guarantees and the role of the *Confidi* have been of great importance in ensuring continued access to credit for small and medium enterprises. This has helped to avoid an overall contraction of credit flows in Italy. On the other hand, the monitoring measures are likely to have been irrelevant at best, while the proposal for a new bank ‘for the South’ has not become operative yet and it is probably wise to be sceptical about its design.<sup>6</sup>

### The crisis and how it came to Italy

Thus, the way the crisis came to Italy (and to a large part of Europe as well) was essentially through the ‘real’ dimension. How did that happen? Why didn’t Europe decouple from the United States? Let us focus on the euro area which had already been a slow growth region at least since 1999.<sup>7</sup> In 2009, exports and imports of the euro area declined by 18 and 22 percent, respectively, relative to those of 2008 – almost five and six times more than the contemporaneous decline in GDP. This was also a much larger fall relative to the other advanced economies and to the emerging and developing countries. And Italy’s exports and imports (including those with the rest of the EU) declined even more, by 22 and 23 percent, respectively (see Table 2). This was presumably to be expected, given the weak positioning of Italy’s trade and its high sensitivity to the depreciation of the dollar. Hence, while still waiting for a more precise quantitative assessment, it appears that the euro area’s recession was due in large part to the fall in world – especially US – demand for euro area exports, which quickly fed into the demand for capital goods (the decline in gross fixed capital formation in the euro area was probably more than 11 percent in 2009).

<sup>6</sup> There is actually little or no evidence that banks with headquarters in the North have penalized borrowers in the South. In the twelve months to November 2009 loans to the South have actually been increasing by 2.5 percent (implying that the crunch, to the extent that there was one, was only felt in the Centre-North).

<sup>7</sup> Average real GDP growth in the euro area was 2.2 percent from 1999 and 2007, compared with 2.9 percent in the United States.

**Table 2**

**External trade growth (change 2009 over 2008 in %)**

	Exports	Imports
EU27	-16	-23
Euro area	-18	-22
Germany*	-20	-18
Spain*	-20	-29
France*	-18	-19
Italy*	-22	-23
UK*	-21	-22

\* Only January to November.

Source: Eurostat.

And although Europe’s economy held up a little longer than in the United States, when the crash did come the damage was even larger: in the euro area, industrial production fell by 21 percent between April 2008 (the peak of the previous expansion) and April 2009 (the worst month of the crisis); in the United States the fall was only 14 percent in the same period. Italy took an even greater blow, minus 25 percent. Recovery has since been very slow and even slower in the euro area than in the United States (Table 3). Everywhere, the fall of production is greater for capital goods industries.

How did the labor markets keep up as these unfavorable events were unfolding? In the industrialized world unemployment rates had been declining almost everywhere since 2006, reaching a low of 4.3 percent in the United States in December 2006, and of 7.2 percent in the euro area in May 2008. In the second half of 2008 the trend turned upwards almost everywhere, and by the end of 2009 unemployment had reached 10 percent in the euro area, 8.8 in Italy, and 9.7 percent in the United States, and the IMF is forecasting further deterioration in the course of 2010 (see Table 4).

On both sides of the Atlantic, this crisis has been the deepest one since the 1930s and bears little resemblance to other recessions experienced since the

**Table 3**

**Industrial production growth  
(change in %, m/m-12, NSA)**

	April 2009	December 2009
EU27	-19.4	-4.7
Euro area	-21.4	-4.8
Germany	-24.1	-7.4
Spain	-19.4	-1.4
France	-19.9	-2.9
Italy	-24.6	-5.6
UK	-11.9	-5.7
USA	-13.7	-4.9*
Japan	-29.9	-3.8*

\* Data for November 2009.

Source: Eurostat.

Table 4

## Unemployment rate (harmonized monthly rate in %, NSA)

	Dec. 2006	Jun. 2007	Dec. 2007	Jun. 2008	Dec. 2008	Jun. 2009	Dec. 2009
EU27	7.7	6.9	6.9	6.8	7.6	8.7	9.5
Euro area	7.9	7.1	7.4	7.3	8.2	9.1	10.0
Germany		8.1	8.1	7.6	7.3	7.5	7.2
Spain	8.3	7.9	8.8	10.7	14.9	17.6	19.6
France	8.9	7.8	7.9	7.2	8.5	8.9	10.0
Italy	6.2	5.4	6.7	6.6	6.8	7.3	8.8
UK	5.3	5.3	4.9	5.5	6.2	7.9	
USA	4.3	4.7	4.8	5.7	7.1	9.7	9.7
Japan	3.7	3.6	3.5	4.0	4.1	5.2	4.8

Source: Eurostat.

Second World War. On the whole, the crisis in the real economy came to the EU and the euro area just a few months later than in the United States, but the final impact is of a similar magnitude, although the fall in aggregate demand and supply has been deeper on the European side, while the consequences on the labor markets have been less harsh in the larger European countries (with the exception of Spain) than in the United States.

### Fiscal stimulus

The reaction to the crisis has been quite fast everywhere. Generally speaking, it involved fiscal stimulus, specific measures to sustain employment and specific measures to deal with financial markets and intermediaries. Here I look at the fiscal stimulus from an aggregate viewpoint. In this perspective, several facts ought to be noted from Table 5, based on IMF estimates of October 2009. With the exception of Germany, which delayed its response until 2009, all countries in the table immediately and indeed 'automatically' reacted to the real contraction with a fiscal expansion that amounted to 1.2 percent of GDP for the euro area. This expansion further strengthened to more than 5.6 and 6.0 percent in 2009 and 2010. For Italy, it amounted to 3.9 percent

in 2009 and 4.4 percent in 2010. It must be noted that expansionary policies were also adopted, and with a similar intensity, by all the major emerging economies. In a related paper, the IMF also suggest that in the advanced G20 economies discretionary measures contributed less than one third to the stimulus of 2009, and in particular that Italy basically abstained from any discretionary stimulus, whereas in Germany discretionary measures amounted to more than 40 percent of the stimulus.<sup>8</sup>

Hence, the aggregate dimension of Italy' stimulus was essentially obtained by letting the automatic sta-

<sup>8</sup> See IMF (2009b). It is also useful to recall that, as soon as the crisis developed, the European Commission drafted a plan for European economic recovery (see <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:52008DC0800:EN:NOT,26 November 2008>). The main purpose of the plan was to recommend to Member States an immediate budgetary expansion of 170 billion euros, adding into an overall stimulus of about 200 billion euros, or 1.5 percent of the EU's GDP. Although no formal process of coordination took place, most countries – Italy included – presented their own, independently adopted fiscal maneuvers as consistent with the European Commission's (see Stability and Convergence Programmes Submitted by Member States, [http://ec.europa.eu/economy\\_finance/thematic\\_articles/article10982\\_en.htm](http://ec.europa.eu/economy_finance/thematic_articles/article10982_en.htm)). Overall progress is documented in [http://ec.europa.eu/economy\\_finance/publications/publication15048\\_en.pdf](http://ec.europa.eu/economy_finance/publications/publication15048_en.pdf). In all of these cases, these measures imply a breach of the 3 percent threshold of budget balances, to be maintained for a few years. Hence, the European Commission was forced in the following months to begin for each country an 'excessive deficit procedure', finding that in most cases – Italy included – both the deficit and the debt criteria were 'not to be fulfilled'. The procedures initiated by the European Commission are listed at [http://ec.europa.eu/economy\\_finance/sg\\_pact\\_fiscal\\_policy/excessive\\_deficit9109\\_en.htm](http://ec.europa.eu/economy_finance/sg_pact_fiscal_policy/excessive_deficit9109_en.htm).

Table 5

## General government fiscal balances and debt (in % of GDP)

	2007	2008	2009	2010	2008	2009	2010	2007	2010	2014
	Actual balance				Balance change from 2007			Gross debt		
Euro area	-0.6	-1.8	-6.2	-6.6	-1.2	-5.6	-6.0	65.7	86.3	95.6
Germany	-0.5	-0.1	-4.2	-4.6	0.4	-3.7	-4.1	63.4	84.5	89.3
Spain	2.2	-3.8	-12.3	-12.5	-6.0	-14.5	-14.7	36.1	69.6	
France	-2.7	-3.4	-7.1	-7.1	-0.7	-4.3	-4.4	63.8	82.6	92.6
Italy	-1.5	-2.7	-5.6	-5.6	-1.2	-4.1	-4.1	103.5	120.1	128.5
UK	-2.6	-5.1	-11.6	-13.2	-2.5	-9.0	-10.6	44.1	81.7	98.3
USA	-2.8	-5.9	-12.5	-10.0	-3.1	-9.7	-7.2	61.9	93.6	108.2
Japan	-2.5	-5.8	-10.5	-10.2	-3.3	-8.0	-7.7	187.7	227.0	245.6

Source: IMF (2009c).

bilizers operate. This has been a sound choice and the reason is apparent from the last two columns of Table 5: simply by letting the stabilizers work, Italy's debt-to-GDP ratio, the highest in the EU, will increase by 17 percentage points by the current year, and by 25 percentage points by 2014, reaching almost 130 percent (by then, debt in the euro area will have increased by 30 percentage points, in Britain and the United States by approximately 45 percentage points, but still, the US debt-to-GDP ratio of the United States will be about 20 percentage points lower than that of Italy). Note that in this perspective the debt positions of the main emerging countries are going to be even more conservative. Hence, my point is quite simply that, if Italy had chosen to conduct a more aggressive fiscal expansion, it would now be hitting the headlines at a faster pace than the news from Greece or Spain, and only thanks to the conservativeness of the government in this respect it is not.<sup>9</sup>

Of course, a standard response to these objections is that debt will be paid back through faster growth or, as Germany's chancellor Angela Merkel put it recently: "we must pursue a growth path, otherwise we cannot generate the needed savings [to pay for the debt]".<sup>10</sup> Nevertheless, Italy has a proven record of no-correlation between fiscal profligacy and faster growth.

### Did Italy do it right?

Italy's room for (fiscal) maneuver was thus quite limited. But was this small space put to a good use? Let us take a few steps back and look at two aspects that characterize fiscal policy and the budget procedure in Italy.

#### *Rising pressure*

Fiscal pressure in Italy has constantly been high (in relative EU terms), and has actually been increasing in the last three years (to reach 42.8 percent of GDP in 2008). The huge bill for servicing the debt (which had decreased from 11.5 percent in 1996 to 6.4 percent in 2000, and then more slowly to 5.1 percent in 2008), is one cause, but clearly not the only one. A rather schizophrenic set of decision making procedures (which provides for a considerable regionalization of decisions, but only on the expenditure

side) and the coalitional nature of all Italian governments since at least the X legislature (July 1987)<sup>11</sup> should perhaps also be kept in mind as causes of this outcome.

#### *Lengthening the horizon*

Since the Berlusconi government took power (on 8 May 2008), and thus well before the crisis had become apparent, the government has begun to adopt a series of innovative measures in the field of public finance. First, the new government confirmed the commitment of the previous one (Prime Minister Prodi, 2006–2008) to reach a balanced budget by 2011 (the so-called '*stabilizzazione triennale del debito pubblico*'). And even at that time, it was clear that the main route to achieve a stabilization had to be the containment of the 'spontaneous' growth of public expenditures ('*Una politica di serio contenimento delle dinamiche incrementalì della spesa pubblica*'), as it was defined by the Economics Minister Giulio Tremonti in a parliamentary speech on 25 June 2008).

Thus, the government confirmed the decision not to adopt an expansionary stance even once the crisis became apparent, although it did leave the automatic stabilizers free to operate. This limited the aggregate dimension of the fiscal stimulus, and created some tensions both within the governing coalition and between government and opposition.

#### *A summary ...*

Since the inception of the crisis the Italian government has adopted numerous policy measures. A list of the more important ones is contained in the appendix. Here I assess them synthetically, comparing their intended and likely achievements. First, the overall impact on the public sector's aggregate receipts or outlays is likely to be small. In fact, fiscal pressure is expected to rise from 42.8 percent of GDP in 2008 to 43.0 percent in 2009 and then to decrease only to 42.5 percent in 2010, while expenditures (net of interest costs) are expected to rise from 40.4 percent in 2008 to 43.1 percent in 2009 and 42.7 percent in 2010. As we saw earlier on, this increase is mostly due to automatic stabilizers.<sup>12</sup>

<sup>11</sup> On the relevance of coalitions in this context – see Hallerberg (2004) and also Hallerberg et al. (2007).

<sup>12</sup> It must be noted, however, that tax revenue on a cash basis decreased by 2.6 percent or 10.6 billion euros, against increases of 9.6, 4.8 and 0.7 percent in the three previous years. Revenue in 2009 was boosted by the extraordinary receipts from the one-off withholding taxes introduced by the first anti-crisis decree (Decree Law 185/2008) and the foreign assets disclosure scheme (Banca d'Italia 2010).

<sup>9</sup> Also note that the cost of servicing Italy's debt is already enormous, above 5 percent of GDP (See Banca d'Italia 2010).

<sup>10</sup> Quoted in the Financial Times, 26 October 2009.

A question arises, however, on their aggregate impact over the longer run. In this respect, a sharp criticism has been voiced by Mario Draghi, the Governor of the *Banca d'Italia*, in his remarks before the parliament in July 2009. He observed that 2009 is the first after 18 years in which Italian public finances would register a primary deficit (that is, an excess of government expenditures over revenues, even before accounting for interest expenses). While he accepted the need for fiscal policy to accompany the exit from the crisis, he also noted that the “*Documento di Programmazione Economica e Finanziaria*” (DPEF: Document for Economic and Financial Planning) for 2010–2013 “does not include information on the levels and composition of revenues and expenditures”, which in turn “makes it difficult to evaluate some crucial aspects of the proposed budgetary policy”.

The absence of this information is critical, since in order to achieve the desired targets for deficits and debts in 2013 it would have been necessary to cut current expenditures in real terms during each year until then, and any such cuts would go against the recent experience (current primary expenditures have been increasing by more than 2 percent per year in real terms between 1999 and 2008). In this context two challenges stand out in particular: one coming from the ageing population (and the corresponding increase in pension expenditures); the other from the need to adopt a series of reforms to strengthen the enterprise sector and restore conditions for growth.

Second, the policy measures may be distinguished into those (which could be termed ‘demand-side’) meant to address the gravest aspects of the economic uncertainty caused by the crisis, and those (‘supply-side’) meant to address the long run, long overdue problems of low productivity growth.

On the demand side, the relevant provisions are the introduction of a ‘social card’ and a bonus for low-income households. Also, the refinancing and extension of income subsidies for redundant workers (*‘Cassa Integrazione Guadagni’*) goes in this direction. However, it must be noted that some of these measures essentially re-invent previous commitments: for instance, the re-financing and extension of the *Cassa Integrazione* has taken the place of expenditures for active labor market policies.

As regards the supply side or pro-growth measures, the negative trend of labor productivity growth in

Italy, compared to the euro area, explains the need for urgent action. Such action includes policies to encourage labor productivity and to retrain temporarily unemployed workers; to stimulate new investments and to incentivize new entrepreneurs; to raise the retirement age and to re-model the tax pressure; to boost productivity in the public sector and to provide a substantial improvement in public (infrastructure) capital. However, with the possible exception of measures to enhance productivity in the public sector and infrastructures, it is doubtful whether the scale of the policies adopted is proportionate to the effort which is required to restore productivity growth.

... and some critiques

The measures adopted by the government have been subject to several criticisms, both within the government coalition (where some ministers have explicitly criticized the strict budget limits enforced by the Economics Minister Giulio Tremonti), and by the opposition (which, however, seemed keener on asking for more ‘debates’ in the parliament than on proposing well structured alternatives).

Among the criticisms, those that advocate more deficit spending, or a drastic reduction of the overall tax levels, appear quite unreasonable, for the reasons outlined above. Let us examine instead in more detail some individual measures:

- **Fiscal shield.** The main purpose of this measure was to induce tax evaders, who had illegally exported funds, to repatriate them. This aroused three main criticisms: (1) the tax rate (a flat 5 percent) is too compliant towards tax evaders; (2) there will be no request to recapture foregone tax revenue; and (3) there will be no controls on how the capital to be ‘shielded’ had been obtained in the first instance, so that in fact the shield may encourage money laundering (see Giannini and Guerra 2009). To some extent, these criticisms appear justified. In particular, in a country where social capital and civic duty have been downgraded, it is fair to question whether it is appropriate to indulge in efforts to re-legitimize illegally-earned capital. On the other hand, as the recent arguments with neighboring states (Switzerland and San Marino) show, the adoption of the fiscal shield is part of a wider strategy to get tough on tax evaders (or at least against illegal



capital exports): this effort is to be appreciated and supported.

- **Retirement age.** Under pressure from the European Court of Justice, the government adopted measures that require public sector workers of both genders to have the same retirement age by 2018. This actually introduces a disparity between women in the public vs. private sector, and does not address the main issue with respect to the retirement age, which is to render the whole question more flexible, with appropriate incentives for those who want to retire at a later date. While it is clear that the government did not want to confront the opposition of left-wing unions and (within its own coalition) also of the *Lega Nord* party, this has been in fact a missed opportunity. This is particularly true given that a more radical (and immediate) reform of the retirement age would generally improve the long-run outlook of public finances.
- **Regional taxes.** Although the government introduced a new law on fiscal federalism (rather vague, in fact, on empowering regions with fiscal powers), it did not take the opportunity of the crisis to redefine or rationalize the existing “regional” taxes, and especially IRAP.<sup>13</sup> In fact, the crisis could have been the appropriate time to rationalize this tax, but (despite some debates, even within the government majority) the opportunity has been missed.
- **Shock absorbers.** The government has essentially refinanced shock absorbers, without introducing radically new measures or reforms, and possibly at the expense of funding alternative labor market policies. This position has encountered two main criticisms: (i) this was a lost opportunity to reform the whole system, in order to adopt a more modern system of shock absorbers, which should be focused on stimulating re-employment opportunities; and (ii) many unemployed persons do not receive any compensation for lost jobs.

On the first point, the position expressed by a government minister, that Italy has ‘a good system of social shock absorbers’<sup>14</sup> is surprising. While the rate of unemployment has increased from a low of 5.7 percent (August 2008) to

8.8 percent in December 2009, the number of workers covered by the three forms of ‘*Cassa Integrazione*’ (*ordinaria, straordinaria, in deroga*), and as such not included in the unemployed, has reached a record level in the first nine months of 2009, probably above 600.000. Still, many temporary workers receive no benefits upon losing their jobs (especially the so-called ‘*Lavoratori coordinati e continuativi a progetto*’).

Some of the reform proposals in the spirit of introducing a system of homogenous universal benefits, should undoubtedly be explored with more determination (Boeri and Garibaldi 2009). On the other hand, it is also fair to say that a more comprehensive system of unemployment benefits, with an emphasis on re-employment, is a fairly complex mechanism of incentives, and if improperly designed, it could easily yield perverse results. Hence, it would be wiser to introduce such a new system after adequate experimentation, and not in the rush of a crisis.

On the second but related point, the question arises why this crisis has not been used as an opportunity to modify the law on labor contracts, aiming at reducing the existing segmentation between fully protected insiders and unprotected outsiders. While the recent remarks of Economics Minister Giulio Tremonti on the desirability of ‘permanent’ job positions could perhaps be interpreted as an *ouverture* to this option, it is unfortunate that no serious debate on these issues is apparently taking place, either within the government or with the parliamentary opposition. Silvio Berlusconi and other ministers have instead re-emphasized the socially stabilizing role of the traditional Italian family; hardly a promising starting point for a debate on how to restore dynamism into the Italian productive sectors.

- **Focus on growth and productivity.** A criticism related to the previous one is that the set of measures adopted, up to the Financial Law passed in December 2009, lacks an overall focus on growth. In the medium and long run, Italy’s problem is not only to fight recession but to resume growth. As Table 6 shows, Italy’s sluggishness in the last decade (which has brought its GDP per capita from 117.5 percent of the EU27 average in 1999 to 102 in 2008, and well below the euro area average) can be summarized by the abysmal performance of labor productivity (on a hourly basis the comparison would be even less flattering). In this respect, while some of the adopted measures do focus on infrastructure improvements and on tax

<sup>13</sup> IRAP is a peculiar version of a corporate tax, as it includes also the labor and interest costs in the tax base, and in many cases it must be paid even after reporting a loss in the statement of profits. On the other hand, this tax generates a large part of the resources that fund the regional health services, thus it is rather difficult to dispense with it.

<sup>14</sup> See an interview with Renato Brunetta by Aldo Cazzullo, *Corriere della Sera*, 7 March 2009, [http://www.corriere.it/politica/09\\_marzo\\_07/intervista\\_brunetta\\_ammortizzatori\\_sociali\\_aldo\\_cazzullo\\_382e8f6a-0ae2-11de-a3df-00144f02aabc.shtml](http://www.corriere.it/politica/09_marzo_07/intervista_brunetta_ammortizzatori_sociali_aldo_cazzullo_382e8f6a-0ae2-11de-a3df-00144f02aabc.shtml).



Table 6

**Labor productivity per person employed**  
(GDP in PPS per person employed relative to EU27, EU27 = 100)

	2000	2005	2006	2007	2008	2009	2010
EU27	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Euro area	112.8	109.8	109.6	109.6	109.3		
Germany	108.0	109.4	109.2	108.3	107.0	101.3	102.8
Spain	103.7	101.3	102.7	103.3	103.6	106.4	106.4
France	125.1	122.2	121.2	121.6	121.6	120.6	121.3
Italy	126.0	111.0	110.1	110.2	109.7	105.3	105.3
UK	110.8	112.5	112.0	110.0	110.0	106.6	106.9
USA	141.8	144.1	143.8	143.2	144.9	146.0	147.8
Japan	98.8	99.5	100.0		99.7	95.5	96.3

Source: Eurostat.

exemptions for new capital investments (the so-called ‘*Tremonti-ter*’ law), as well as on boosting labor productivity within the public sector, the amount and type of the measures adopted to stimulate productivity and competitiveness are quite limited. And the way the shock absorbers operate, by essentially ‘freezing’ employees in their pre-existing jobs, might even reduce the ability of firms to adapt to the opportunities and challenges posed by the scenario post-crisis.<sup>15</sup>

On this point, however, the government has stated its intention to propose new, specific laws in the beginning of 2010 – although these are still in the waiting room. Perhaps more important, however, is that some crucial debates on growth-related issues are now hitting the headlines. One is the question of criminality and corruption, and of their negative impact not only on the ‘quality’ of life but also on economic performance: on these issues, a new determination and political consensus might be slowly emerging. The second is related to the refusal of car-maker Fiat to accept an ‘exchange’ of government subsidies for a commitment to keep an obsolete plant going that is located in Sicily. Both sets of issues might be conducive to more productive ‘soul-searching’ exercises about the causes of slow growth in Italy.

#### Dangers ahead and glimmers of local hope

Several international indicators are suggesting that the crisis is coming to an end: the US economy returned to positive growth in the third quarter of 2009, and in November the European Commission

announced that the “recession is over but major challenges persist”.<sup>16</sup>

A first challenge comes again from finances. The financial crisis has not ended yet. According to the IMF, write-downs on British bank assets are going to be USD 604 billion, USD 814 billion for the euro area and USD 1,025 billion for the United States. These are enormous sums. They are especially enormous for Britain, given its small size, but we have learned by now that it would be hard to contain any new financial crisis on a local dimension. In this respect, it is worrisome that the engine of structural and regulatory reforms seems to have run out of steam.

The other main challenge stems from the fall of the US dollar. A lower dollar is desirable, as it is the only way to rebalance the United States current account deficit *vis-à-vis* the rest of the world. Hence we should and probably will live with a weaker dollar relative to the euro. This is bad news for Italy, however. Given its weak export base, a lot of industrial restructuring will be needed before Italy can adjust to a stronger euro. This adjustment will cause pain but it could be helped by proper measures to help firms restructure and consolidate. And this will require more labor mobility and more organizational flexibility – which in turn will call for new social shock absorbers and new labor contracts, as well as a reform of the retirement age and an improvement of educational standards, as well as an enforcement of the ‘rule of law’ adequate to that of an advanced economy.

In the end it all fits together: global challenges require (also) local reforms, and we should realize

<sup>15</sup> An interesting (albeit negative) observation is that, based on data from the Innobarometer, Italy is one of the EU countries where firms have been induced to cut more from their innovation investments after the current recession (see Archibugi and Filippetti 2010).

<sup>16</sup> See [http://ec.europa.eu/news/economy/091103\\_en.htm](http://ec.europa.eu/news/economy/091103_en.htm).

this sooner rather than later. At least a reasonable division of labor is emerging. On the financial challenge, which is inherently global, Italy has some voice, but no real options. On the real economy challenge, Italy has a voice but could also exercise some options. The internal political economy for these options is not great, but affordable. And although a few opportunities have been missed, some appropriate measures have been taken. But many and more resolute ones should still be taken, and serious discussions are hopefully about to begin.

### Appendix: main policy measures adopted by the Italian government during the crisis 2008–2009

#### *Economic measures adopted during 2008*

- Decree No. 93, 27 May 2008; turned into Law No. 126, 24 July 2008:
  - Abolition of ICI (local property tax) for owner-occupied houses, and
  - Partial tax exemption of overtime work.
- Decree No. 112, 25 June 2008; turned into Law No. 133, 6 August 2008:
  - Adoption of a 3-year growth plan, aiming at concentrating the resources for underdeveloped areas ('FAS') on selected projects,<sup>17</sup>
  - Adoption of a program for 'strategic' infrastructures,<sup>18</sup>
  - Re-modulation of the tax base for banks, insurances, and energy companies (so-called 'Robin Hood tax'),<sup>19</sup>
  - Introduction of a 'social card' to subsidize basic consumption of the low income earners, and
  - Introduction of an 'industrial plan' to increase labor productivity within the public sector.
- Decree No. 185, 29 November 2008; turned into Law No. 2, 28 January 2009:
  - Bonus for low-income households,
  - 3 percentage points reduction of the corporate and regional (IRAP) tax,
  - Confirmation and strengthening of tax exemptions in favor of 'productivity wages', a refinancing of social shock absorbers, and
  - Financing and 'speeding up' of procedures for several large-scale or strategic infrastructures.

<sup>17</sup> [http://www.governo.it/GovernoInforma/Dossier/piano\\_trienale\\_sviluppo/](http://www.governo.it/GovernoInforma/Dossier/piano_trienale_sviluppo/).

<sup>18</sup> [http://www.governo.it/GovernoInforma/Dossier/manovra2009/allegato\\_infrastrutture.pdf](http://www.governo.it/GovernoInforma/Dossier/manovra2009/allegato_infrastrutture.pdf).

<sup>19</sup> [http://www.governo.it/GovernoAzione/politiche\\_economiche/manovra\\_2009/dpefopen.pdf](http://www.governo.it/GovernoAzione/politiche_economiche/manovra_2009/dpefopen.pdf).

#### *The first months of 2009*

Under the heavy pressure of the crisis, some new measures were adopted, which substantially confirmed and reinforced those previously adopted:<sup>20</sup>

- Law No. 15, 4 March 2009:
  - Incentives to improve labor productivity in the public sector.<sup>21</sup>
- Law No. 42, 5 May 2009:
  - Fiscal federalism.<sup>22</sup>

Regarding fiscal federalism it must be remarked that, although it will possibly become – in the long run – the most pervasive reform of all those adopted in the year, its effects on the current situation are in fact nil.

Another relevant act at the beginning of 2009 was the signing of an agreement (sponsored by the government) between the *Confindustria* (Employers Association) and the Trade Unions (with the exclusion of the more left-oriented CGIL) to reform wage bargaining in the private sector. The agreement introduces a two-level bargaining (national and 'second level') system, adopts a new reference European price index, sets a three-year length for all contracts, and confirms the tax exemptions on overtime.

#### *Measures adopted during the summer of 2009*

The government Decrees No. 78 of 1 July 2009 and No. 103 of 3 August 2009, which were respectively turned, with several changes and additions, into the Law No. 102 of 3 August 2009 and the Law No. 141 of 3 October 2009, contain several new measures:<sup>23</sup>

- Tax exemptions for new capital investments (the *Tremonti-ter*),
- An 'Employment Prize' for workers receiving income subsidies (such as the *Cassa Integrazione*) that will be employed in training projects with the same employer who put them under benefits,
- Re-funding of the system of 'social shock absorbers',
- Incentives for new self-entrepreneurs,
- A limited increase of retirement age,

<sup>20</sup> A detailed list of the most relevant laws and decisions adopted in the context of the 'Manovra per il 2009' – see [http://www.governo.it/GovernoAzione/politiche\\_economiche/manovra\\_2009/index.html](http://www.governo.it/GovernoAzione/politiche_economiche/manovra_2009/index.html).

<sup>21</sup> [http://www.governo.it/GovernoInforma/Dossier/lavoro\\_pubblico\\_riforma/legge\\_4marzo2009.pdf](http://www.governo.it/GovernoInforma/Dossier/lavoro_pubblico_riforma/legge_4marzo2009.pdf).

<sup>22</sup> [http://www.governo.it/GovernoInforma/Dossier/federalismo\\_fiscale/legge42\\_2009.pdf](http://www.governo.it/GovernoInforma/Dossier/federalismo_fiscale/legge42_2009.pdf).

<sup>23</sup> [http://www.governo.it/GovernoInforma/Dossier/decreto\\_antiscrisi260609/index.html](http://www.governo.it/GovernoInforma/Dossier/decreto_antiscrisi260609/index.html).

- Regularization of certain types of illegal immigrants (if employed in home services),
- A ‘moratorium’ on mortgage payments due by firms to banks, and
- Introduction of a new ‘fiscal shield’ (immunity from prosecution, in return for the payment of a flat 5-percent tax) for foreign investments previously undeclared to the fiscal authorities.

### *The Financial Law of 2010*

A somewhat confused debate has taken place since the presentation of the government proposal of the Financial Law, which took place in September 2009.<sup>24</sup> The discussion between the two parliamentary chambers ended on 22 December 2009, after a ‘confidence vote’ required by the government to cut short the debate. In the end, the government proposed, and the parliament approved, to use the revenue from the fiscal shield – probably in the order of 5 billion euros, and only for 2010 – to finance a number of measures (in areas like large infrastructure investments, tax credit for R&D expenditures, refinancing of shock absorbers, compensating local authorities for the loss of revenue from property taxes, and the institution of a new *Banca del Mezzogiorno* aimed at providing financial means for the development of the Southern Regions). These measures do not alter the macroeconomic picture, with a net indebtedness of the public sector of 5.3 percent of GDP in 2009, and 5.0 percent in 2010 (while the change in GDP is finally estimated at – 4.8 percent in 2009, and + 0.7 in 2010).

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## THE GLOBAL ECONOMY: RECOVERING FROM THE EDGE OF A FINANCIAL AND ECONOMIC ABYSS

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### Onset of the global financial crisis and recession

The global financial crisis of 2007–09 will go down in history indubitably as the foremost economic and financial cataclysm of the twenty-first century, a seismic economic and financial event. It also acquired the dubious distinction of being the gravest crisis since the Great Depression, adversely affecting both the financial and real sectors of the global economy. Banking and financial system in the advanced industrial economies was the epicenter of this crisis, which was driven close to a collapse. Soon it had dismal consequences for the global economy. Crises of this dimension transpire once or twice in a century. The contemporary phase of financial globalization was progressing at a commendable pace until the crisis interrupted. According to the McKinsey Global Institute (MGI 2009), financial assets in the international markets, which included equities, private and public debt and bank deposits, had increased almost four-fold during the 1980 and 2007 period. The crisis brusquely stopped three decades of expansion in the international financial markets.

Although multiple short- and long-term factors were responsible for the financial crisis, it was sparked by the bursting of the housing bubble in Britain and the United States in the autumn of 2007. The US housing bubble burst in August 2007 and in Britain the Northern Rock failed in September 2007. That said, the seeds of subprime mortgage crisis in the United States were sown much earlier, in the late 1990s. Large inflows of foreign capital and low interest rates had created easy credit conditions

for several years before the financial crisis essentially materialized. This financial environment not only promoted a housing market boom but also encouraged debt financed over-consumption. Such excesses are never sustainable. History testifies that such excesses, without fail, culminate in financial crises. Subprime loans were the riskiest category of loans. Consequently, in 2007 a dramatic increase took place in mortgage delinquencies and foreclosures in the United States, which had a severe adverse effect on banks and financial markets around the globe. The largest banks in the world like HSBC and Citigroup had begun writing down their holdings of subprime related mortgage-backed securities (MBS) since early 2007.

### *Financial crisis spills out globally*

The financial crisis spilled over globally when Lehman Brothers declared bankruptcy on 15 September 2008. This event traumatized financial markets, causing panic in the global financial system (Reinhart and Rogoff 2009). The failure of a reputed investment bank of long standing shocked the financial world. It took a heavy toll on market confidence. Other similar catastrophic events included near-failure of AIG, which occurred because it sold large amounts of credit default swaps (CDS) without properly offsetting or covering their positions. As market confidence plunged, many financial giants struggled to remain on their feet. After the failure of Lehman Brothers, Merrill Lynch came under pressure and agreed to be acquired by Bank of America. Other high-profile debacles included Washington Mutual, a prominent thrift institution, which was resolved by the Federal Deposit Insurance Corporation (FDIC). Wachovia, a large commercial bank, suffered large liquidity outflows and agreed to be sold. This list of demise of elite financial institutions is far from exhaustive. It manifestly caused unimaginable loss of wealth.

At this point many of the world's largest banks were undercapitalized. Day by day, the global financial system was inching close to sheer disarray and disintegration. These catastrophic events proved to be a



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catalyst for a massive sell-off in the credit and stock markets. They set off a general flight from risk to safety in the capital markets of the advanced industrial economies first and the emerging market economies (EMEs) followed suit. The financial crisis went into an intensified phase and mutated into a global recession. According to NBER (2008), the US recession had begun in December 2007. In its composition and character, this recession was a balance-sheet drive recession. It originated in the financial sector and spread into the real economy. Its tentacles spread into household budgets and balance-sheets of business firms, banks and non-bank financial institutions.

Given the economic, financial and trade inter-linkages of the global economy, the US financial crisis briskly spilled over into the other economies. The impact on and reaction from advanced industrial economies, EMEs and developing economies varied. They essentially depended on their degree of economic and financial integration with the global economy and the macroeconomic policy responses devised individually by them. Some large and venerable European banks were driven into enormous financial distress by their exposure to the so-called toxic assets. The Union Bank of Switzerland (UBS), the largest and most resourceful Swiss bank, which was reputed to be the world's largest wealth manager, was among the hardest hit banks by the sub-prime crisis. After suffering disastrous losses in the US housing mortgage market, USB was forced to write down the value of billions of franc worth of assets and retreat from its previously profitable investment banking operations.<sup>1</sup> Citigroup enjoyed the reputation of being world's most sophisticated financial institution with operations around the globe; this reputation was gravely tarnished by its *de facto* nationalization. Numerous hedge funds folded. There is no gainsaying that global financial system was driven to the brink of a collapse. So was the global economy. The worst point of the global financial crisis was the last quarter of 2008 and the first of 2009.

Stark forewarnings of dire consequences were given by Nouriel Roubini of Stern School of Business<sup>2</sup> and the Bank for International Settlements (BIS),<sup>3</sup> but they were ignored because relevant macroeconomic variables reflected sound economic health. Economic fundamentals justified rapid rise in asset

prices. Alan Greenspan (2005), erstwhile Federal Reserve Board (Fed) Chairman, supported the view that this was a new era of prosperity and its *causae causante* has improved productivity due to endemic use of computers, IT and other high-technology equipment. He found the pre-crisis years comparable to the periods of the advent of electricity and automobile. Large global capital flows into the US economy and worsening current account deficit was explained away by Greenspan by decline in home bias. To him global savers were reaching across national borders to invest in foreign assets. His logic was that the risk-adjusted expected returns in the US economy were higher, therefore, as the home bias declined, the demand for US financial assets increased globally.

#### *Failure of the economics profession*

No one foresaw the timing, extent, scale, intensity and severity of this crisis that convulsed the very foundation of the global financial system and economy. The economics profession was squarely excoriated from inside and externally for its failure to see the origins of the crisis and appreciate its worst symptoms. Trenchant criticism by Nobel Laureate Robert Lucas and Robert Barro was widely cited in the financial press. Paul Krugman (2009a) wrote about 'the dark age of macroeconomics' in his *The New York Times* column. A global recession of this dimension is undeniably an unmitigated economic adversity. One of this severity had occurred for the first time during the last eight decades. It is reasonable to ask to what extent it could have been foreseen. The answer is that its causes were a highly complicated and interconnected set of issues, errors and policy flaws. As seen below, no one institution or group thereof could be blamed for it.

However, on a fundamental level, failure of the economics profession to see the possibility of a catastrophic malfunction of market economy was unquestionably much worse than its predictive failure. During the halcyon period of global growth and

<sup>1</sup> In August 2009, it declared a loss of SFr 1.9 billion, the seventh quarterly loss in two years.

<sup>2</sup> On 7 September 2006, Nouriel Roubini told an IMF audience that a crisis was brewing. He admonished that the United States was likely to face once-in-a-lifetime housing bust, an oil shock, dramatic decline in consumer confidence followed by a severe recession. The sequence of events according to Roubini was going to be as follows: first the homeowners would default on their mortgage loans, trillions of dollars worth of MBS would be unraveled worldwide, which would lead to a financial disarray, if not a debacle, in the global financial markets. These developments in turn would cripple hedge funds, investment banks and other major financial institutions, like Fannie Mae and Freddie Mac. The moderator of the event reacted by asking for stiff drink in jest, while his audience was dismissive (Mihn 2008).

<sup>3</sup> See BIS (2004).



expansion, economists had come to the belief that markets were stable, even self-correcting. The economics profession went up the garden path because it “mistook beauty, clad in impressive-looking mathematics, for truth” (Krugman 2009b). For several decades they had regarded capitalism as a perfect and flawless system. They were in love with idealized vision of an economy in which rational individuals interact in perfect markets. During the contemporary period this idealized vision was fortified with fancy mathematical equations. This romanticized vision of the economy made economists disregard all that could possibly go wrong. They remained oblivious to “the limitations of human rationality that often led to bubbles and bursts; to the problems of institutions that run amok; to the imperfections of markets – especially financial markets – that can cause the economy’s operating system to undergo sudden, unpredictable crashes; and to the dangers created when regulators don’t believe in regulation” (Krugman 2009b).

The reputation of market forces and the institution of free markets took a knock during 2007–09. Particularly the financial meltdown of 2008 did considerable discredit to the mystique of free markets. Anglo-Saxon model of liberalism and deregulation was upbraided by many, ranging from Kevin Rudd to Yukio Hatoyama. Some of the ideas of Keynes, which held sway early during the post-World War II period, became relevant again in 2008. Keynes regarded market economies fundamentally uncertain and markets far from self-correcting. Large shocks like the current financial crisis were not anomalies but normal market behavior. Governments therefore need to intervene in crises, providing a judicious and firm hand on the tiller (Keynes 1936). Since the adoption of the free-market ethos of Reagan and Thatcher, Keynesian ideas were spurned.

### Sparks of an inchoate recovery from the crisis

In late 2008 and early 2009 the big question was whether recession would become depression. Global economy contracted by 6.4 percent in the first quarter of 2009 (IMF 2009b). European EMEs and members of the Commonwealth of Independent States (CIS) were the worst affected economies. However, the developing and emerging-market economies (other than European EMEs) relatively suffered less damage. Cline (2009) observed that these two groups

of economies were damaged less than they were during the debt crisis of 1982, for Latin America, and the financial crisis of 1997–98, for Asia. In general the EMEs (other than those of Europe) weathered the storm better than the rest of the global economy, which includes the advanced industrial economies. Conversely, several fiscal challenges will confront the advanced industrial economies in the near future. They will essentially stem from the high costs of the bailouts and recessionary fiscal losses.

Some indications of a nascent recovery in Asian EMEs became evident in the second quarter of 2009. This subgroup of EMEs performed far better than the rest of the global economy in the second quarter of 2009 and was in the forefront of a subdued global economic recovery. At the end of the third quarter of 2009 and the beginning of the fourth, the global economy began exhibiting signs of a slow recovery and bottoming out of the recession. The EMEs of Asia were projected to return to 6 percent GDP growth in 2010, the best recovery performance by any subgroups of the global economy. The role of Asian EMEs in underpinning the global recovery was widely acclaimed. The IMF opined that the global economy was being “pulled up by the strong performance of the Asian economies” (IMF 2009a, 1).

The signs of recovery included improved conditions in the global financial markets, which demonstrated decisive improvement. Dow Jones index topped 10,000 on 14 October 2009, which was indicative of a fairly rapid recovery in the US financial market. Also, most regional stock markets rose by approximately 50 percent from their lows around March 2009. Credit markets had improved markedly since the last quarter of 2008 and the first quarter of 2009, when the global financial system virtually froze. In addition, interest rate spreads were declining, business and consumer confidence in some advanced industrial economies was improving and inventory levels were declining. By mid-2009, anxieties of a systemic financial collapse had receded and the pall of gloom and insecurity began to lift.

That being said, even in the last quarter of 2009, high rates of unemployment in the advanced industrial economies not only persisted, but were also not showing any signs of amelioration. In addition, housing prices were still on the decline. Bank lending necessary for growth continued to remain anemic. Demand for credit was also weak as businesses and consumers had to be cautious. Capacity utilization



rates were low globally. Most forecasters expected the pace of recovery to be sluggish. This observation applied particularly to the advanced industrial economies, where unemployment rates were being projected to remain high.

The subdued recovery was developing at a characteristically uneven pace. The EMEs and large developing economies were ahead on the recovery path. The EMEs (other than those in Europe) managed financial turmoil well. These economies were damaged relatively less than the rest of the global economies by the current financial crisis. One of the reasons was that in response to the previous crises of the 1990s and early 2000s, their policy framework had significantly improved, which rendered economic resilience to this group of economies. It proved beneficial to the EMEs during this financially stressful period. Asian EMEs were leading the recovery. They in turn were led by China.

Unevenness of recovery extended to the two principal sectors of the global economy. That is, the financial sector moved up to the recovery path earlier than the real sector. This applied *a fortiori* to the advanced industrial economies, where the real sector remained sluggish and was expected to remain so in 2010. The high unemployment scenario was the result of sluggish real sector recovery in the high-income industrial economies, giving rise to anxiety about the threat of a jobless recovery. In contrast, with gradual recovery, commodity prices began to recover slowly. In particular, oil price reached 77 US dollars per barrel on 16 October 2008, the highest level in a year. It continued the rise thereafter and hovered around 80 US dollars per barrel. In February 2009 it had fallen to 34 US dollars per barrel.

The forces driving this recovery were somewhat temporary in nature. For one, central banks and governments were not expected to play the roles in 2010 that they did in 2009. Although considerably improved, the financial sector in most advanced industrial economies was still far from healthy. Credit conditions were still tight and de-leveraging by banks was still a possibility. If de-leveraging does take place in the future, credit flows may be reined in again in the advanced industrial economies, which in turn would stall the real economy. Thus, complaisance would be premature and unwarranted. The financial sector recovery that was underway in the third and the fourth quarters of 2009 could not be regarded as

one on the firm and steady footing. At this point, supportive macroeconomic policies were needed to be followed for the medium term. Global economy could then recover and be on an even keel. The next important policy measure will be to begin unwinding the exceptionally high level of public intervention that occurred during 2009.

#### *Tenuous recovery in the advanced industrial economies*

In the advanced industrial economies there were some feeble signs of recovery in the second quarter of 2009. For instance, France, Germany and Sweden, all three recorded minuscule positive second quarter GDP growth and were tentatively edging out of recession. Japan also began to show signs of a fledgling recovery, growing non-annualized 0.9 percent in the second quarter. In contrast, the third quarter growth performance in this group of economies was a trifle superior. The United States posted 0.9 percent growth. This was the first quarterly growth after four quarters of contraction. Although the largest economy in the world emerging out of recession was indeed a healthy development for the global economy, countering this was the consumer spending in the United States. It not only failed to pick up even in the third quarter but declined. The US recovery was *inter alia* driven by government programs like popular discounts on new motor vehicles which stimulated auto sales and production as well as an USD 8,000 tax credit for the first-time home buyers. The Japanese economy grew by 1.2 percent during the third quarter of 2009. Japanese exports contributed to it by jumping 6.4 percent. Also, capital spending jumped by 1.6 percent.

After a contraction of five consecutive quarters, the 16-country Eurozone recovered insipidly in the third quarter of 2009, with GDP expansion of non-annualized 0.4 percent. This weak rebound was supported by a strong revival in industrial production. It was also driven by the stimulus packages and less aggressive de-stocking. The Eurozone rebound was powered by 0.7 percent GDP growth in Germany, the largest economy in the Eurozone. Exports and investment had supported German growth, making up for a decline in consumer demand. Italy was another large European economy that performed well by growing at 0.6 percent and ending its recession. However, the French economy posted a surprisingly feeble 0.3 percent growth again. Strong industrial production had led to higher growth

expectations for France (Atkins 2009). Consumption did not grow in France at all. Austria, Belgium, the Netherlands and Portugal also emerged from recession in the third quarter. Conversely, GDP contracted in both Greece and Spain. Technically the Eurozone escaped recession in the third quarter. In contrast, GDP growth in Britain, the second largest economy in Europe, was – 0.4 percent even in the third quarter of 2009 and it continued to be in a recession. The fact that the advanced industrial economies began on their path of tenuous recovery was confirmed by the fact that the 30 members of the OECD grew by 0.8 percent during the third quarter.<sup>4</sup>

In 2010 and 2011, recovery in the advanced industrial economies of Eurozone and the United States will be supported by the rebound in world trade underpinned by increasing demand from the EMEs, particularly the large ones. Stockpiling by businesses and stabilization of housing market will have the same favorable impact on these economies. Recovery in Japan will be supported by strong growth in Asia, albeit weak domestic demand will continue to constrain growth. Consumer prices have been falling in Japan. It was partly because the economy was loaded with excess capacity after a sharp decline in exports during the crisis. Deflation may continue to plague the economy (OECD 2009).

#### *Early and strong rebound of China*

China rebounded faster from global downturn than any other large economy. It was able to lead Asia, particularly the EMEs, to a recovery. It also led the global recovery (OECD 2009). Estimated annualized quarter-on-quarter GDP growth plummeted to a low of 4 percent in the fourth quarter of 2008, but picked up to 8 percent in the first quarter of 2009 (Mussa 2009). China was helped by its limited direct exposure to the global financial crisis. Additionally, it had relatively sounder fundamentals and prepared a powerful policy response to the great recession. It also made a meaningful contribution in preventing the global financial crisis from getting worse. China had launched one of the largest fiscal stimulus packages, when measured as a proportion of GDP (see below). Its GDP growth rate picked up from 7.9 percent in the second quarter of 2009 to 8.9 percent in the third. It was well on track to hit its growth target

of 8 percent for 2009. However, according to the September 2009 Consensus forecasts, economy was projected to expand 8.3 percent in 2009 and 9.4 percent in 2010, when it is projected to become the second largest global economy, not in PPP terms but at market prices (Wolf 2009). This would be another notable milestone for China.

Earlier pick up of the Chinese economy was supported by a massive 4 trillion *yuan* (= 585 billion US dollars) stimulus package. It was one of the largest stimulus packages and was 4.8 percent of Chinese GDP (= 3.9 trillion US dollars). A major part of China's fiscal stimulus spending was committed to infrastructure projects. In addition, a huge surge in government-mandated bank lending followed, which amounted to 7 trillion *yuan* between January and June 2009. This monetary expansion resulted in new credit expansion of a huge proportion, almost 20 percent of the GDP. It made the economy vulnerable to overinvestment in several sectors; overcapacity had reached troubling proportions in steel, cement, glass, chemicals, coal, poly-silicon and wind-power equipment sectors (Roberts 2009).

China's GDP growth during 2009 stemmed largely from the investment. In addition, there was a revival in private real estate expenditure and resilience in consumer sector. Retail sales grew by 15.1 percent in first three quarters of 2009. Thus viewed, domestic demand supported and reinforced China's recovery. During the first half of 2009, real net exports made a significant negative contribution to the rise in GDP. China made a net positive contribution to demand of goods and services produced in other countries (Mussa 2009).

The recovery continued to broaden in the Chinese economy and with that it favorably influenced the neighboring Japan and Asia, in that order. As noted above, together the EMEs of Asia proved to be a locomotive force in slowly tugging the global economy out of recession. In the fourth quarter of 2009 China began implementing its exit strategy, which entailed gradual reduction in the level of stimulus, credit expansion and infrastructure spending. Rising private investment and consumption could pick the slack.

#### **The G20 and its role in stabilizing the global economy**

It was continually debated in the academic literature that the G7 or G8 had ceased to be a representative

<sup>4</sup>The quarterly growth statistics here come from media sources and various publications in which the announcements of the respective governments are reported.

group of economies in the present-day globalized economy. In addition, given the geography of large payments imbalances, the role, value, helpfulness and effectiveness of G7 or G8 had steadily diminished. Except Japan and Russian Federation, all the countries that succeeded in accumulating large forex surpluses are the non-G8.

In the backdrop of the global financial crisis, three successive summits of the G20 took place, in Washington DC (November 2008), London (April 2009) and Pittsburg (September 2009). The G20 economies were cognizant of the need of a harmonized global policy response to the crisis. The first G20 summit in Washington DC essentially focused on the fiscal stimuli, which played a crucial role in stabilizing the global economy. The G20 policy makers agreed to launch concerted and coordinated fiscal stimuli. China and the United States responded in the most forceful manner.

As the present crisis was essentially that of the banking and financial systems of the advanced industrial economies, the G20 members assigned a great deal of importance to strengthening financial regulation and supervision network in the first two meetings. The objective of the G20 summit of London was to stabilize the battered financial and banking systems in the EU and the United States. At this juncture, the G20 had achieved an unprecedented fiscal expansion as well as adoption of appropriately relaxed monetary measures, which became the turning point in addressing the worsening global recession. The G20 countries also agreed on and initiated national and international reforms in the oversight, supervision, and regulation of financial systems. They helped initiate a process of reform of the international financial institutions (IFI), which went a long way in restoring the IMF to its pivotal position in the global financial system along with the resources it needed to carry out this role (Bradford and Linn 2009). The G20 leaders also committed 1 trillion US dollars to assist the developing economies through the IMF. Many of these countries did not have adequate resources to assemble fiscal stimulus packages and rescue their respective financial sectors.

A timely decision with far-reaching consequences taken during the Pittsburg G20 summit was regarding supplanting of the old G8 by G20. The latter was designated the premier forum for glob-

al economic and financial cooperation; this represented a defining change in world economic order. It was an acknowledgement of the fact that global economic and financial coordination needs to be handled more broadly by a larger group of countries than the G7 or G8. This decision was of historic significance and denoted passing of the baton. In the Pittsburg summit members went further to 'commit to sustained recovery' until a durable recovery is secured. The communiqué was substantive and emphasized the need for a regulatory system for banks and other financial institutions that could "rein in the excesses that led to the crisis" (G20 Communiqué, 1). The Pittsburg communiqué also promised to peer-review members' economic policy, which was a first in global economic cooperation. The themes deliberated on were appropriate and courageous. Some of the notable concerns were regarding harmonization of macroeconomic policies to correct global payments imbalances with the IMF playing a central role, a meaningful shift of voting power towards the EMEs, reform of global reserve system and capital increases for the multilateral development bank (Dervis 2009).

There is little disagreement regarding utter lack of market discipline in the large financial markets being one of the causes behind the global financial crisis. Also, national financial regulators did not have a tradition of cooperating with one another. These limitations encouraged the G20 members to develop recommendations for strengthening national regulatory frameworks and cooperation among them. They also took initiative in strengthening the Financial Stability Board (FSB) and its mandate. Membership of the FSB was expanded to include all the G20 members, which drew in the large EMEs and some Gulf Cooperation Council (GCC) members (Lombardi 2009).

The G20 is gradually establishing itself as a forum responsible for global macroeconomic as well as monetary and financial policies. China and other EMEs had an input in the Pittsburg summit and they benefited from a greater voice in the IMF. The non-G7 members of G20 will be a part of the new steering committee for the global economic and financial decision making process. In the past, creditor countries tended to set the rules of global monetary system. It is logical then to assume that the influence of creditor Asian economies, particularly that of China, will soon rise.

## Summary and conclusions

Three decades of commendable progress in financial globalization was brusquely stifled by the current financial crisis and recession. Its background was *inter alia* laid by the macroeconomic, financial and payments imbalances that steadily grew in the global economy over some ten years before the outbreak of the crisis.

Finance ministries and central banks in the systemically important economies of the world moved briskly, purposefully, resolutely and in a collaborative manner to avert a Great Depression like prolonged and severe crisis. Several of them designed and launched fiscal and monetary stimulus plans with alacrity. In this context, the G20 summit in London on 2 April 2009 and the successive G20 summits proved to be meaningful and fairly successful.

Financial crisis stalled financial globalization in its tracks; it proved to be an effective trend breaker. With the onset of recession, firms, investors and financial institutions in the advanced industrial economies began a large-scale repatriation of their capital. Deglobalization in the form of stalling or reversing of trans-border capital flows began and multilateral trade contracted at an alarming rate. Trans-border FDI flows also suffered seriously. After contraction in 2009, the OECD economies are projected to recover at a subdued pace in 2010. This, in turn, would affect the performance and recovery in the developing economies. The EMEs in general were showing symptoms of recovery earlier than other economies. In particular, Asian EMEs began to show inchoate signs of recovery in the second quarter of 2009. They were leading the recovery from the global financial crisis. Financial sector in the advanced industrial economies was recovering at a more rapid rate than the real sector, albeit unemployment continued to remain high and was persistently showing signs of worsening.

Global economy contracted in the first quarter of 2009. However, the EMEs weathered the storm better. Some indications of a nascent recovery in the EMEs of Asia became evident in the second quarter of 2009. This group of EMEs was the first to give an indication of coming out of the recovery and pulling the others out. At the end of the third quarter of 2009 and the beginning of the fourth, symptoms of a subdued global recovery in 2010 became more evi-

dent than in the past. The financial crisis, recession and the process of recovery from the crisis would change the post-crisis global economic and financial scenario to a considerable extent.

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## AFRICA'S ECONOMIC FUTURE: LEARNING FROM THE PAST

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### Introduction

African countries have been growing fast recently. In 2007, for example, GDP growth averaged 6.2 percent in Sub-Saharan Africa (SSA),<sup>1</sup> nearly double the rate in 2002 (World Bank 2009) and comparable to those in other regions of the world. Since 1995, some 26 African countries, representing 70 percent of the SSA population and 78 percent of the GDP, have grown their GDPs by an average of 6.9 percent annually, a rate that is comparable to the 6.7 percent rate over the same period for the emerging South Asian giant, India, for instance (Arbache et al. 2008).

Will the past serve as an appropriate guide for Africa's economic future? By the mid-1960s, most African countries had achieved political independence from colonial rule.<sup>2</sup> Although economic performance of the sub-continent has, in general, considerably lagged behind that of other regions of the world over the post-independence period, growth has been rather episodic. African countries grew fairly strongly until about the late 1970s; then the region's GDP growth began to decline substantially, falling short of population growth by the early 1980s and again in the early 1990s. Since the mid-1990s, however, Africa has once again grown strongly, with some signs of growth acceleration at the beginning of the 21st century.

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<sup>1</sup> 'Africa' and 'SSA' are used interchangeably in the paper.

<sup>2</sup> Although the majority of SSA countries had not yet achieved independence by 1960, it is the conventional starting date for the post-independence period. By 1965, however, most of the countries had. Those attaining independence after 1965 are: Botswana, Lesotho, Equatorial Guinea, Mauritius, Swaziland, Guinea Bissau, Angola, Cape Verde, Comoros, Mozambique, Sao Tome, Seychelles, Djibouti, Zimbabwe, Namibia and South Africa, in chronological order.

The weak overall growth since the late 1970s until recently is reflected in the dismal poverty picture in SSA over the last two and one-half decades. The proportion of the population earning less than 1 US dollar decreased only slightly from 42.3 in 1981 to 41.1 percent in 2004. Over the same period, this measure of poverty fell substantially for South Asia (SAS), as a reference region, from 49.6 in 1981 to 30.8 percent in 2004, so that the relative SSA/SAS poverty rate gap increased steadily by nearly 50 percentage points.<sup>3</sup> Recent growth resurgence has brightened Africa's poverty picture over the last decade, however. During 1993–2004, the poverty rates at the USD 1 and USD 2 standards fell by 4.4 and 4.1 percentage points for SSA, respectively, comparable to the 6.1 and 5.1 percentage points for SAS (see Fosu 2009a).<sup>4</sup>

The current paper, first, briefly discusses the African growth record. Second, it presents evidence on the historical sources of growth. Third, the paper employs the taxonomy of 'policy syndromes' to explain the observed growth patterns.<sup>5</sup> Fourth, it discusses how governance might help decrease the likelihood of these syndromes and hence increase growth.

### The African growth record

GDP of the SSA region grew at an average yearly rate of approximately 5.0 percent (per capita rate of about 2.0 percent) for about a decade and a half from 1960, with significant positive contributions from a substantial number of countries (Table 1).<sup>6</sup>

<sup>3</sup> However, the differences in performance between SSA and SAS at the USD 2 poverty standard since 1981 have been much less dramatic. The SSA rate decreased slightly from 74 in 1981 to 72 percent in 2004, while the SAS rate declined from 88 in 1981 to 77 percent in 2004, which remains greater than the SSA poverty rate. Hence, the SSA/SAS difference in the poverty rate increased by less than 10 percentage points, as compared with nearly 50 percentage points in the case of the USD 1 standard (Fosu 2009a).

<sup>4</sup> Indeed, the recently revised World Bank data show a slightly smaller percentage-point reduction in poverty in SAS than in SSA for the USD 1.25 standard: 7 versus 8 percentage points between 1996 and 2005, while both regions exhibit about the same 4 percentage-point decrease at the USD 2.50 standard. Unfortunately, the lack of poverty data prevents extending the analysis backward to the 1970s or 1960s.

<sup>5</sup> By the policy syndromes it is meant *ex-ante* anti-growth policies, classified as: 'state controls', 'adverse redistribution', 'suboptimal inter-temporal resource allocation,' and 'state breakdown'. The absence of any of these syndromes is referred to as a 'syndrome-free' regime. Details of this taxonomy are presented below.

<sup>6</sup> These numbers are the GDP-weighted growth rates which are consistent with the usual World Bank statistics.



Table 1

## Annual GDP per capita growth between 1960 and 2006, 5 year averages (%)

Country	61-65	66-70	71-5	76-80	81-85	86-90	91-95	96-00	01-05	2006	Average
Angola						0.69	-6.73	3.84	7.40	15.26	1.96
Benin	1.44	0.46	-1.13	1.13	1.17	-2.38	0.53	2.19	0.59	0.90	0.46
Botswana	3.64	7.75	14.33	8.12	6.45	8.51	1.27	6.23	4.17	0.93	6.59
Burkina Faso	1.40	0.89	0.80	1.28	1.68	0.16	0.96	3.71	2.89	3.24	1.57
Burundi	0.15	5.70	-0.29	1.87	1.88	0.60	-4.20	-2.63	-1.10	1.08	0.24
Cameroon	0.44	-0.86	3.86	3.73	6.23	-5.15	-4.54	2.25	1.30	1.59	0.82
Cape Verde					6.40	1.30	2.71	3.95	2.71	3.69	3.43
Central African Rep.	-1.21	1.08	0.02	-1.74	-0.53	-2.26	-1.64	0.09	-2.49	2.30	-0.89
Chad	-1.51	-0.71	-1.50	-6.52	6.47	-1.20	-0.72	-0.75	11.19	-2.62	0.46
Comoros					1.60	-1.00	-1.31	-0.65	0.64	-1.64	-0.20
Congo. Dem. Rep.	0.11	0.70	-0.58	-4.51	-1.04	-3.07	10.35	-6.01	1.02	1.79	-2.54
Congo. Rep.	0.74	1.99	4.76	1.95	7.28	-3.10	-2.33	-0.29	1.86	4.11	1.49
Cote d'Ivoire	4.06	5.15	1.94	-0.29	-4.20	-2.71	-1.67	0.58	-1.72	-0.91	0.10
Equatorial Guinea						-0.86	4.56	32.23	24.06	-7.76	13.91
Eritrea							12.19	-1.51	-0.51	-4.47	2.90
Ethiopia					-3.93	1.84	-0.50	1.81	2.98	6.19	0.66
Gabon	7.54	4.45	15.27	-2.23	-0.35	-1.34	0.28	-1.84	-0.03	-0.37	2.35
Gambia		1.55	2.04	1.06	-0.21	0.19	-1.62	0.87	0.74	1.61	0.60
Ghana	0.28	0.92	-2.57	-0.93	-3.56	1.82	1.44	1.87	2.71	4.01	0.30
Guinea				-0.19	-0.50	1.10	-0.05	1.91	1.18	0.82	0.58
Guinea-Bissau			0.96	-4.48	3.95	1.10	-0.04	-1.74	-3.13	1.12	-0.44
Kenya	0.22	2.37	6.11	2.45	-1.28	2.00	-1.49	-0.51	0.95	3.34	1.25
Lesotho	5.68	0.71	3.52	7.66	0.49	4.10	2.49	1.38	1.85	6.42	3.17
Liberia	0.47	3.65	-1.32	-0.88	-4.78	-16.32	-21.86	29.50	-5.60	3.67	-1.78
Madagascar	-1.14	2.02	-1.96	-1.27	-4.30	-0.13	-3.18	0.79	-0.26	2.06	-0.98
Malawi	2.18	2.34	4.32	1.51	-0.98	-2.90	2.14	1.03	-1.52	4.69	0.99
Mali		1.29	1.10	2.67	-4.43	1.38	0.34	2.38	3.27	2.16	1.03
Mauritania	8.85	2.76	-1.94	0.15	-1.71	-0.08	0.52	-0.27	1.09	8.74	1.21
Mauritius					3.29	6.55	3.87	4.21	3.18	2.70	4.16
Mozambique					-6.38	5.30	-0.62	4.71	6.01	5.71	1.95
Namibia					-2.75	-1.85	1.73	0.94	3.28	1.55	0.32
Niger	2.88	-3.62	-5.17	2.10	-5.18	-0.50	-2.59	-0.73	0.62	1.20	-1.30
Nigeria	2.12	3.05	3.10	0.98	-5.41	2.38	-0.40	0.33	3.10	2.75	1.07
Rwanda	-3.67	4.10	-2.24	6.73	-0.68	-1.96	0.75	2.00	2.85	2.74	0.92
Senegal	-0.87	-1.09	-0.56	-1.54	-0.04	-0.64	-0.67	1.40	1.99	-0.26	-0.23
Seychelles	1.04	1.33	4.88	6.88	0.01	4.77	1.41	4.71	-2.16	3.18	2.56
Sierra Leone	2.60	2.27	0.58	0.36	-1.16	-1.53	-5.30	-5.23	9.19	4.45	0.29
Somalia	-3.38	1.38	1.55	-5.17	2.57	0.49					-0.41
South Africa	4.05	2.91	1.35	0.89	-1.14	-0.68	-1.22	0.41	2.58	3.88	1.08
Sudan	-0.36	-1.02	1.96	-0.49	-2.36	2.12	2.46	3.88	4.35	9.41	1.35
Swaziland			6.54	-0.07	-0.50	6.88	-0.28	0.27	0.77	1.46	1.93
Tanzania						2.13	-1.39	1.53	3.84	3.31	1.61
Togo	8.16	2.10	1.00	2.38	-3.89	-0.84	-2.01	0.84	-0.72	1.31	0.79
Uganda					-2.48	1.24	3.38	3.39	2.33	2.08	1.59
Zambia	3.06	-1.55	-0.93	-2.79	-2.65	-1.39	-3.84	0.38	2.83	4.22	-0.66
Zimbabwe	0.22	5.86	1.40	-1.62	0.37	1.11	-0.95	-0.55	-6.00		-0.02
SSA simple average	1.64	1.87	1.80	0.55	-0.39	0.13	-0.86	2.29	2.10	2.54	1.05
World Bank SSA weighted average	2.63	2.02	1.52	0.07	-1.76	-0.34	-1.45	0.70	1.97	3.04	0.65

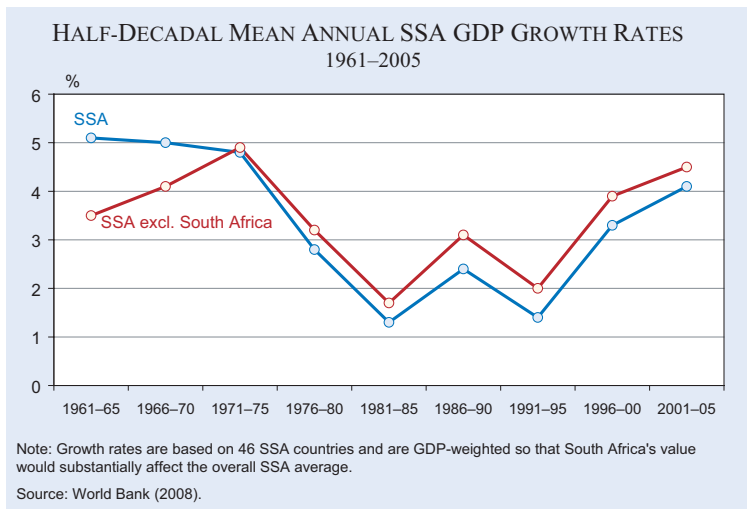
Source: World Bank (2008).

This rate could not be sustained in subsequent years, however, falling below population growth in the early 1980s and early 1990s. It was not until the latter 1990s that SSA began to grow sufficiently to overcome population increases. Thus, the issue of the overall African growth record is

not necessarily a case of consistently dismal performance, but rather one of episodic growth (Figure 1).

The aggregate evidence masks the considerable disparities in growth among SSA countries, howev-

Figure 1



er. During the period from 1981 to 1985, for example, when per capita growth was appreciably negative in SSA as a whole, many African countries actually registered growth rates of at least 1 percentage point above population growth.<sup>7</sup> Another salient observation is the heterogeneity in growth patterns across countries. Many economies that started as growth leaders in the 1960s had become growth laggards by 2000 (e.g. Cote d'Ivoire, Gabon, Kenya, South Africa, Togo, and Zambia – see also Table 1). Conversely, several laggards in the earlier period became growth leaders as of the 1990s (e.g. Benin, Burkina Faso, Ghana, Senegal and Sudan). In contrast, one African country that has exhibited consistently high economic growth is Botswana. Its GDP growth averaged about 10 percent annually over the entire period, and at least

nearly four times the world average, so that the region exhibited a lower mean growth with higher variance as compared to the rest of the world.

#### Sources of growth in Africa

Table 3 reports data on the sources of GDP growth for SSA over 1960–2000. These statistics show that, when SSA grew fairly strongly in the 1960s through the mid-1970s, growth was supported about equally by both investment and growth of total factor productivity (TFP). When economic growth fell substantially in the early 1980s and again in the early 1990s, however, it was mainly due to the deterioration in TFP. Moreover, the primary source of the growth recovery in the late 1990s was TFP improvement. The overall per-worker growth in SSA during the forty-year period was positive but modest. Furthermore, both physical capital and human capital (education) contributed favourably to this growth. In contrast, TFP's contribution was negative, though small. More importantly, there were considerable sub-period differences

Table 2

#### Annual growth of real GDP per worker – SSA versus other regions: mean and variability measures 1960–2000 (%)

	SSA	LAC	SAS	EAP	MENA	IC	Total
Mean (m)	0.51	0.76	2.18	3.89	2.37	2.23	1.63
Standard deviation (s)	3.24	2.79	1.47	2.46	3.13	1.77	2.87
Coefficient of variation (s/m)	635	367	67	63	132	79	176

Notes: SSA = Sub-Saharan Africa (19), LAC = Latin America and Caribbean (22), SAS = South Asia (4), EAP = East Asia and Pacific (8), MENA = Middle-East & North Africa (11), IC = Industrial Countries (20); figures in parentheses are the numbers of countries for the respective regions. Selected countries are those with consistent data over 1960–2000 and seem sufficiently representative of the respective regions. The 19 SSA countries are: Cameroon, Cote d'Ivoire, Ethiopia, Ghana, Kenya, Madagascar, Malawi, Mali, Mauritius, Mozambique, Nigeria, Rwanda, Senegal, Sierra Leone, South Africa, Tanzania, Uganda, Zambia, and Zimbabwe.

Source: Ndulu and O'Connell (2003).

5 percent every decadal period, though the record since the 1990s has been less than spectacular.

Furthermore, African countries have exhibited highly variable growth rates over the last four decades. The standard deviation of the per-worker GDP growth for a sample of nineteen SSA countries with consistent data averaged 3.2 percent over 1960–2000, which was the highest among all regions of the world (Table 2).<sup>8</sup> Indeed, SSA's coefficient of variation (CV) is

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<sup>7</sup> This point is further discussed below.

<sup>8</sup> See the notes of Table 2 for details. The 19 countries represent all sub-regions of SSA and constitute 72 percent of the SSA population, as well as the lion's share of the region's GDP. Nonetheless, they still represent less than one-half of the number of SSA countries, and this caveat should be noted in interpreting the present results.

**Table 3**  
**Growth decomposition for Sub-Saharan Africa 1960–2000 (%)**

Year	Growth of real GDP per worker	Contribution of growth in		Estimated residual*
		Physical capital per worker	Education per worker	
1960–1964	1.33	0.53	0.12	0.68
1965–1969	1.74	0.80	0.20	0.75
1970–1974	2.33	1.05	0.22	1.06
1975–1979	0.19	0.74	0.24	– 0.79
1980–1984	– 1.70	0.16	0.29	– 2.16
1985–1989	0.45	– 0.22	0.34	0.33
1990–1994	– 1.74	– 0.08	0.30	– 1.95
1995–2000	1.51	– 0.12	0.26	1.37
Total	0.51	0.36	0.25	– 0.99

\* A measure of growth of total factor productivity (TFP).  
 Notes: This is the Collins-Bosworth decomposition and is based on the production function:  $q=Ak^{0.35}h^{0.65}$ , where  $q$ ,  $k$  and  $h$  are GDP per worker, physical capital per worker and human capital (average years of schooling) per worker, respectively, with respective capital and labor shares of 0.35 and 0.65. The exercise is conducted on per-country basis for the 19 countries with consistent data for 1960–2000 (see also note for Table 2), and then aggregated.

Source: Ndulu and O'Connell (2003).

in the overall performance of African countries, in terms of growth as well as its sources, a subject to which I now turn.

#### 1960 to mid-1970s

This early period is characterised by relatively high growth, explained primarily by physical capital accumulation and TFP growth, at approximately 45 percent shares each (see Table 3). Growth performance was, however, uneven across countries (see Table 1). Although other country-specific factors explain the differences, it is observable that nearly all the high-growth countries during this sub-period had relatively liberal economic regimes nurtured by conservative political governments, while the reverse was the case for most of the low-performing countries. For example, Botswana, Cote d'Ivoire, Ethiopia, Kenya, Lesotho, and Malawi were countries with both high growth and market-oriented policies, supported by politically conservative governments during this period. In contrast, weak-growth performers such as Benin, Burkina Faso, Cameroon, Chad, Ghana, Guinea, Senegal, and Zambia had market-interventionist policies.<sup>9</sup> Beyond the control nature of the regime, the relatively weak growth in several countries, despite the overall good SSA record, could also be attributed to external factors, political instability, and weak institutions: e.g. Burundi, Mauritius, Rwanda, and Sudan.

#### Mid-1970s to early 1990s

The 1980s may be characterized as 'Africa's lost decade'; per-capita income of Africans at the end of the 1980s had fallen below the level prevailing at the beginning of the decade. The source of the contraction is primarily the deterioration in TFP (Table 3), likely attributable mainly to idle capacity, which became a major impediment to the industrialization process of African economies (Mytelka 1989). The supply shocks of the 1970s and early 1980s, both negative and positive, are observed to have engendered policy syndromes that resulted in weak growth performance (Fosu, 2008a).

Negative terms of trade provide only a partial explanation for the dismal performance. For example, among the countries registering negative growths in GDP, while Ghana, Mozambique, Niger, Namibia and Nigeria experienced substantial losses in terms of trade in the early 1980s, Togo, Mali and Madagascar did not. What appears to be a relatively common feature is that most of these poor-performing economies were saddled with control regimes inherent in the socialistic strategy of development: e.g. Ethiopia, Ghana, Madagascar, Mali, Mozambique, Niger, Nigeria and Togo.

Although SSA countries generally experienced poor economic growth during this sub-period, there were notable exceptions. For instance, many countries bucked the trend in the early 1980s (at least 1.0 percent per-capita growth): Benin, Botswana, Burkina Faso, Burundi, Cameroon, Cape Verde, Chad, Comoros, Congo Republic, Guinea Bissau,

<sup>9</sup> For regime classification, see Collier and O'Connell (2008). Politically conservative governments tended to have liberal market-oriented economic policies, while the socialist-leaning ones would generally resort to (soft or hard) controls on economic activities. As 'policy syndromes', control regimes are expected to inhibit growth. However, as the classifications were conducted independently of growth outcomes, as they should be, several cases do not conform to these expectations. For instance, Gabon and the Republic of Congo were classified as control regimes but exhibited relatively high growth during this period, while countries like Madagascar, Mauritania and Rwanda were viewed as syndrome-free regimes for most of the sub-period but experienced low growth. Similarly, Malawi was classified as syndrome-free throughout despite its growth record being checkered. Obviously, factors other than regime classification contributed to growth performance as well.

Mauritius, and Somalia (see also Table 1). Furthermore, in most of these countries, it was a continuation of the fairly strong growth in the 1970s. While the explanation of such relatively high growth is likely to differ across countries, one common feature was that nearly all these countries experienced considerable appreciations in their terms of trade during this period.

In spite of the slight growth recovery for SSA generally in the latter part of the 1980s, the early 1990s were simply calamitous, with similar abysmal growth as in the early 1980s. Much of this under-performance could be attributed to severe political instabilities, as in Angola, Burundi, Democratic Republic of Congo, Liberia, Rwanda and Sierra Leone, as well as to negative terms of trade shocks.<sup>10</sup> Despite the overall dismal growth performance of SSA in the early 1990s, however, there were a number of exceptions. The following countries registered decent growth (at least 1.0 percent per capita GDP growth): Botswana, Burkina Faso, Cape Verde, Equatorial Guinea, Eritrea, Ghana, Lesotho, Malawi, Mauritius, Namibia, Seychelles, Sudan, and Uganda (Table 1). What is interesting about this list of countries is that only a small number of them experienced appreciable terms-of-trade (TOT) improvements during the late 1980s or early 1990s. Instead, most these countries were 'syndrome-free' and many had adopted structural adjustment programs (SAPs), such as Burkina Faso, Ghana, Namibia and Uganda, suggesting that for such countries reforms may have aided growth.

#### *Since mid-1990s*

African economies have generally recovered since the mid-1990s (see also Table 1). Annual GDP growth has averaged approximately 4.0 percent (3.6 percent when South Africa is included and 4.1 percent when it is excluded: see Figure 1). Indeed, growth has accelerated to 4.5 percent for non-South-African SSA economies since the beginning of the millennium, while South Africa's GDP growth has averaged slightly less at 4.1 percent. This growth can be accounted for by TFP improvements (Table 3).<sup>11</sup> Bucking the trend during this period are mostly countries experiencing severe political instability, such as Burundi, Democratic Republic of

Congo, Cote d'Ivoire, Guinea Bissau, Seychelles, Togo and Zimbabwe.

One plausible explanation for the growth resurgence is the TOT improvements.<sup>12</sup> However, despite their general unpopularity,<sup>13</sup> the SAPs appear to have been beneficial to growth in several cases. Countries like Benin, Burkina Faso, Cameroon, Chad, Ethiopia, Ghana, Mali, Rwanda and Sudan undertook credible SAPs, leading to improvements of their respective macroeconomic environments for growth. Coupled with better macroeconomic environments, TOT improvements have apparently been translated to sustained economic growth. Actually, many countries have grown well since the mid-1990s despite weak TOT performance (negative or near-zero growth during 1996–2005): e.g. Benin, Botswana, Burkina Faso, Ethiopia, Mali, Mauritius, and Uganda. With the exception of Botswana, which apparently did not need SAP, all these countries had undertaken credible reforms, or were considered syndrome-free during the period.<sup>14</sup>

#### **Policy syndromes and the African economic growth record**

Numerous explanations have been offered for the African growth record. Receiving much attention have been initial conditions, including: colonial origins (Acemoglu et al. 2001), ethnicity (Easterly and Levine 1997), geography (Bloom and Sachs 1998), natural resources (Sachs and Warner 2001), and the slave trade (Nunn 2008). A recent comprehensive

<sup>12</sup> TOT grew strongly for SSA overall in 1994 and 1995 at rates of 2.9 percent and 6.9 percent, respectively, and averaged 0.6 percent and 1.5 percent annually in 1996–2000 and 2001–05, respectively, for a yearly mean of 1.0 percent since 1996 (computed by author using data from World Bank 2007).

<sup>13</sup> Many studies have, indeed, argued that SAPs have been detrimental to African development, including de-industrialization and diminution of the social sector (e.g. Cogan 2002; Lall 1995; Mkandawire and Soludo 1999; Mytelka 1989; Sender 1999). While such arguments have some merit, they tend to ignore the fact that the deindustrialization process had already begun in many African countries before SAPs, due primarily to industrial operation inefficiencies and adverse terms of trade shocks. Regarding the social sector, Fosu (2007 and 2008c) find that on average public spending on health and education in SSA actually trended upward in the latter 1980s and early 1990s, despite SAPs, an observation that corroborates an earlier finding by Sahn (1992).

<sup>14</sup> A considerable portion of the TFP improvements, leading to stronger growth performance, is likely attributable to reductions in idle capacity following the reforms. Gross domestic capital formation as share of GDP in SSA has also risen, from 16.8 percent in 2000 to 19.5 percent in 2006 (World Bank 2007). As early reformers among SSA economies, Ghana and Uganda stand out as possibly shining examples of how reforms may have worked. However, there were also countries, such as Malawi, which undertook credible SAPs but did not fare as well perhaps due to substantial TOT deterioration (– 2.3 percent annual average in 1996–2005 for Malawi). But, even Malawi's per capita GDP growth rebounded strongly to nearly 5.0 percent in 2006 following a mean annual decline of 1.5 percent during 1996–2005 (see Table 1).

<sup>10</sup> Indeed, for 1989–1993, SSA net barter terms of trade declined at an average of 2.5 percent per year.

<sup>11</sup> Note that Table 3 provides no evidence for the more recent post-2000 period.

Table 4

**Evolution of policy syndromes in Sub-Saharan Africa  
(half-decadal relative frequencies)**

Year	Syndrome-free	Controls	Redistribution	Inter-temporal	State breakdown	Soft control	Hard control
1960–1964	0.465	0.334	0.128	0.000	0.073	0.775	0.225
1965–1969	0.373	0.323	0.194	0.009	0.100	0.707	0.293
1970–1974	0.193	0.408	0.237	0.120	0.042	0.730	0.270
1975–1979	0.106	0.432	0.245	0.149	0.068	0.633	0.367
1980–1984	0.097	0.442	0.255	0.145	0.061	0.630	0.370
1985–1989	0.149	0.381	0.276	0.118	0.076	0.708	0.292
1990–1994	0.357	0.216	0.191	0.056	0.181	0.935	0.065
1995–2000	0.435	0.147	0.176	0.039	0.203	0.956	0.044
1960–2000	0.272	0.335	0.213	0.080	0.101	0.759	0.241

Notes: These figures are for 47 countries. All syndrome/syndrome-free classifications are defined in the text. The frequencies in the first five columns have been adjusted here to sum to 1.0 for each period, as multiple syndromes for a given country-year could occur. The frequencies of the last two columns have also been adjusted here to sum to 1.0.

Sources: Fosu and O'Connell (2006); Collier and O'Connell (2008) for raw data.

study, the 'Growth Project' of the African Economic Research Consortium (AERC), combines both cross-sectional analysis and at least 26 country cases to explain the African growth record since 1960.<sup>15</sup> The main thesis is that policies matter for growth in Africa, despite the initial conditions. The project characterizes the following policy syndromes as detrimental to growth: (a) state controls, (b) adverse redistribution, (c) suboptimal inter-temporal resource allocation and (d) state breakdown, while their absence is referred to as syndrome-free.<sup>16</sup> Discussed below briefly are these policy syndromes (see Collier and O'Connell 2008; Fosu 2008a; Fosu and O'Connell 2006), with their frequency data presented in Table 4.

#### *State controls*

A country was judged as having state controls, if the government "heavily distorted major economic markets (labor, finance, domestic and international trade, and production) in service of state-led and inward-looking development strategies" (Fosu and O'Connell 2006, 38). The relative frequency of state controls exceeded 30 percent in the early 1960s, reached a half-decadal peak in excess of 40 percent

during the early 1980s, but decreased thereafter, representing only about 15 percent by the late 1990s, perhaps in response to the SAPs.

#### *Adverse redistribution*

Adverse redistribution occurs when redistributive policies are determined as favouring the constituencies of respective government leaders, usually regional in nature and with ethnic undertones, likely resulting in polarization.<sup>17</sup> Also classified under this syndrome is the case of downright looting, such as the regimes of Mobutu in the Democratic Republic of the Congo (1973–97), Idi Amin in Uganda (1971–79) and Sani Abacha in Nigeria (1993–98) (Collier and O'Connell 2008). The relative frequency of this syndrome increased steadily right from the immediate post-independence period, until the early 1990s when it began to reverse course.

#### *Suboptimal inter-temporal resource allocation*

Suboptimal inter-temporal resource allocation represents revenue misallocation over time: overspending during commodity booms and expenditure under-spending during the subsequent busts. The incidence of this syndrome was relatively small, though, representing only about 10 percent of the country-years during 1960–2000. It was quite minimal in the immediate post-independence period, but then began increasing in the early 1970s, achieving a relatively high plateau beginning in the mid-1970s

<sup>15</sup> The project output appears in two volumes: Ndulu et al (2008a and 2008b). An epitomized version of the study is provided in Fosu and O'Connell (2006).

<sup>16</sup> Much of the present section derives from Fosu (2008a), which presents a number of case studies to illustrate each syndrome and syndrome-free. The definitions of the regimes, provided below, form the basis for the classification of each country-year into one or more of the categories by the editorial committee of the Growth Project. Note that "classification is based on policies, not growth outcomes" (Fosu and O'Connell 2006, 37). For example, though Sudan grew rather rapidly in the late 1990s it was not categorized during this period as syndrome-free but instead as state breakdown. Conversely, Malawi was designated syndrome-free throughout the post-independence period, yet it stagnated in the 1980s, and so did Cote d'Ivoire in the early 1980s despite its syndrome-free classification during that period.

<sup>17</sup> It is important to stress, though, that redistribution need not be adverse, that is, if it promotes harmony. As Azam (1995) for instance argues, governments could use redistribution to buy peace, especially between the north and south in many West African countries (e.g. Chad, Cote d'Ivoire, Ghana and Nigeria).



amidst commodity booms in many African countries, and then declined as of the latter-1980s.

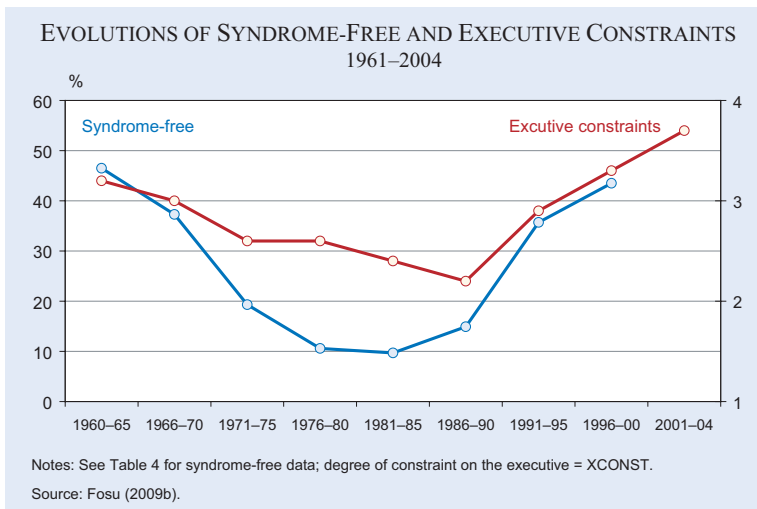
#### *State breakdown/failure*

State breakdown/failure refers mainly to open warfare, such as civil wars, but also to acute elite political instability involving *coups d'état* that result in a breakdown of law and order.<sup>18</sup> It constituted about 10 percent of the country-years during 1960–2000. Despite widespread belief, open warfare has historically been rather rare in Africa, that is, until more recently in the 1990s when its relative frequency doubled to 20 percent of the country-years, from about 5 percent in the 1970s. Despite this syndrome's historically low frequency, however, its impact can be quite large.<sup>19</sup>

#### *The syndrome-free regime*

Syndrome-free (SF) results if none of the above syndromes is present, that is, when there is political stability with reasonably market-friendly policies (Fosu and O'Connell 2006). Interestingly, at more than one-quarter of the country-years, the frequency of SF was rather large in 1960–2000, and higher than that of any syndrome except the regulatory. Indeed, in the immediate 1960–65 post-independence period, the relative frequency of SF was about 50 percent. Its prevalence, however, began to wane during the latter-1960s; the downward trend continued until roughly the mid-1980s when it reversed course. The upward trend actually accelerated in the 1990s, most likely as a result of the SAPs. Fosu and O'Connell (2006) find for 1960–2000 that SF was a necessary condition for sustaining growth and a near-sufficient condition for preventing a growth collapse. Attributable to SF is 2 or higher percentage-point increase in per capita annual growth (see also Collier

**Figure 2**



and O'Connell 2008; Fosu 2009b). Such an estimate represents about twice Africa's growth gap with the rest of the world during 1960–2000, a third of its gap with East Asia and Pacific, and more than the gap with South Asia (see Table 2).

#### **The role of governance**

Based on five-year panel country data over 1960–2000, Fosu (2009b) finds that governance, measured by the degree of constraint on the executive branch of government (XCONST) tends to increase growth in African economies; however, too much constraint could also hurt growth. More importantly, XCONST is positively correlated with SF. Indeed, it is better correlated with SF than with growth *per se*. As Figure 2 shows for the aggregate level, XCONST and SF track rather well inter-temporally.

In a follow-up study, Fosu (2009c) finds that the deleterious effect of ethnic fractionalization on growth could be attenuated by XCONST. Consistent with Collier (2000), then, 'good governance' may help reduce the incidence of policy syndromes. Furthermore, Alence (2004) observes that democratic institutions in Africa greatly improve 'developmental governance', which he defines as 'economic policy coherence (free-market policies), public-service effectiveness, and limited corruption'. He additionally finds that while 'restricted political contestation' (with limited executive constraints) has little direct impact on developmental governance, executive restraints improve developmental governance even if there is little political contestation. These results imply the critical role of XCONST.

<sup>18</sup> Most of the classifications into state breakdowns involved civil wars, which are growth-inhibiting (Collier 1999; Gyimah-Brempong and Corley 2005). However, many studies have also uncovered adverse effects of the incidence of *coups d'état* on growth – see Fosu (2002 and 1992); Gyimah-Brempong and Traynor (1999), which may not necessarily be classified under this syndrome.

<sup>19</sup> The impact of state breakdown on Africa's per capita annual GDP growth is estimated to be as much as 2.6 percentage points (Fosu and O'Connell 2006), the largest among all the syndromes, and slightly larger than the 2.2 percentage points obtained for civil wars by Collier (1999).

But how is the optimal XCONST level achieved for development governance purposes? One way is via a disciplined executive that constrains itself, as perhaps in the case of China; however, this strategy seems not to have worked well in Africa. Another is via a democratic process. Unfortunately, an entrenched executive may block attempts to restrict its power. One way to reduce this likelihood is to impose office-term limitations on the executive, as many African countries currently have. Furthermore, Fosu (2008b) finds that electoral competitiveness can enhance growth in African countries, but only in ‘advanced-level’ democracies. Apparently, certain countries are susceptible to political disorder that may occur at the early stages of democratization (negative ‘intermediate-level’ effects). An appropriate solution would entail identifying such countries *ex ante* and finding means of forestalling these potential adverse effects.

As indicated above, state breakdown has been the most potent detractor of growth among the various policy syndromes. Unfortunately, many African countries degenerated into political disorder and open conflicts in the 1990s, resulting in part from the political reforms that ensued in support of economic reforms. As previously authoritarian governments began to lose their grip on authority, a power vacuum was created, which tended to undermine the cohesion of the state. In other cases, distributive politics replaced authoritarian rule that had previously succeeded in preserving the nation-state, opening up wounds of divisionism and accentuating polarization with ethnic undertones. By the 1990s, countries like Burundi, Comoros, Democratic Republic of Congo, Djibouti, Liberia, Niger, Rwanda,

Sierra Leone, Sudan and Togo had all descended into severe political instability, most in the form of open conflicts.

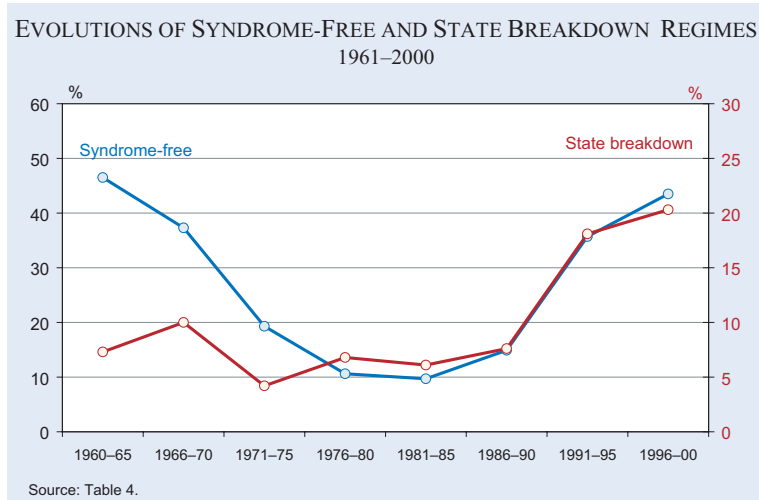
While political reforms may be blamed for many of these adverse political outcomes, it is also true that the new international political order that saw the diminution of the Cold War increased the tendency for insurrection, for the likelihood of their success increased. Thus, as SF has increased in the 1990s, so has the incidence of state breakdown (Figure 3), implying the need for increased attention toward post-conflict economies (Fosu and Collier 2005).

### Conclusions and policy implications

The present paper has argued that learning from the past will appropriately inform Africa’s economic future. First, presenting the growth record of African economies, the paper highlights that despite the usual observation that the overall post-independence growth has been paltry, the record has been less than uniform. From 1960 until the mid-1970s, African countries generally grew reasonably well, with GDP growth rates of nearly 2 percentage points annually above population growth, though this performance was still below that of other regions. Growth declined substantially in the 1980s and early 1990s, however, resulting in decreases in per capita income. Growth has resurged in many African economies since the mid-1990s, however, with per capita annual GDP increasing on average by about 2 percent once again. Indeed, there has been further acceleration in growth more recently

in the 21st century. The aggregate picture fails to properly reflect the heterogeneity in African country performance, though. For example, Botswana and Mauritius have performed spectacularly well during the overall period. Moreover, even when growth declined substantially in the early 1980s and early 1990s, many African countries bucked the trend. Country-level growth has also been episodic, with many of those starting out with relatively strong growth faltering subsequently, and conversely.

Figure 3



Second, the paper has presented evidence on the decomposition of economic growth. It finds that changes in total factor productivity (TFP) were strongly associated with economic growth performance in Africa generally. When growth was relatively strong in the 1960s and 1970s, TFP was a major contributing factor, which also explained the substantial deterioration in growth in the early 1980s and early 1990s. Similarly, the recent resurgence in growth has been associated with major TFP improvements.

Third, the 'policy syndrome' taxonomy explains the growth record reasonably well. The absence of syndromes, namely, a syndrome-free regime (SF), could raise annual per capita GDP growth by more than 2 percentage points, a rather large amount, given that SSA's growth has averaged less than 1.0 percent over the post-independence period. Much of this positive effect of SF is attributed to its favourable influence on TFP.

Fourth, 'good governance', represented by appropriate constraints on the government executive (XCONST), appears promising for augmenting SF and, hence, for increasing growth. Unfortunately, the recent rise in SF is also accompanied by an increase in the incidence of state breakdown. With the additional evidence suggesting that electoral competitiveness can enhance growth in relatively advanced-level democracies in Africa, it appears that the real challenge is to explore the path toward meaningful democratization that is capable of both augmenting SF and attenuating state breakdown. Meanwhile, as several African countries have already experienced conflicts, it is imperative that we accord special attention to post-conflict economies.

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## RENEWABLE ENERGY AND NET ELECTRICITY IMPORTS

MARC GRONWALD AND  
JANA LIPPELT\*

In the beginning of this year the so-called North Sea Countries Offshore Grid Initiative gained attention in the media. Nine European countries (Ireland, Belgium, Britain, the Netherlands, Luxembourg, Sweden, Denmark, France and Germany) plan to build an offshore wind energy grid in the North Sea. The aim is a better linkage of existing wind energy plants and, thus, an improved usage of wind energy. The unreliability of wind energy availability is often criticised – in many cases the wind does not blow when energy demand peaks. One particular aspect of this new grid is that it provides a link to the Norwegian hydroelectric plants, which would serve as a ‘natural battery’. As many renewable energy projects are planned to be located in the North Sea – not only offshore wind energy, but also tidal and wave plants – this initiative becomes very important. In consequence, the general tenor in the media was quite positive. It should be noted, however, that the investment volume of this project is about 30 billion euros – the complexity of such a giant project should not be underestimated.

Against the background of this project, this article presents data on global electricity net imports. The upper panel of Figure 1 displays 2008 import figures. It is evident that countries such as the United States, Italy and Brazil have the largest net electricity imports. Amongst the net exporters of electricity countries such as Canada and France stand out, but also Germany was a net exporter of electricity in 2008. Many African countries, in contrast, neither import nor export electricity. The same applies to developed countries such as Japan and Australia. For

these two countries this can certainly be attributed to their geographical location.

Figure 1’s lower panel presents the development of net electricity imports for a selection of European countries since the early 1990s. It is apparent that Italy’s net imports remain essentially unchanged. Norway, in contrast, exhibits a very irregular net import pattern. This feature can be attributed to the large portion of hydroelectric power in Norway – the amount of electricity generated from this source depends on random factors such as annual rainfall. France exports considerably large amounts of electricity; in the last few years, however, a declining trend is apparent. The development of net electricity imports for Germany and Spain is striking. While for both countries the pattern is irregular and the exported or imported amounts are negligible throughout the 1990s and the early 2000s, in 2008 both countries exhibit considerably large electricity exports. A possible explanation for this is the recent expansion of renewable energy in these two countries. As electricity exchanges trade excess electricity at very low, sometimes even negative prices, however, the export of electricity can not be considered a profitable business.

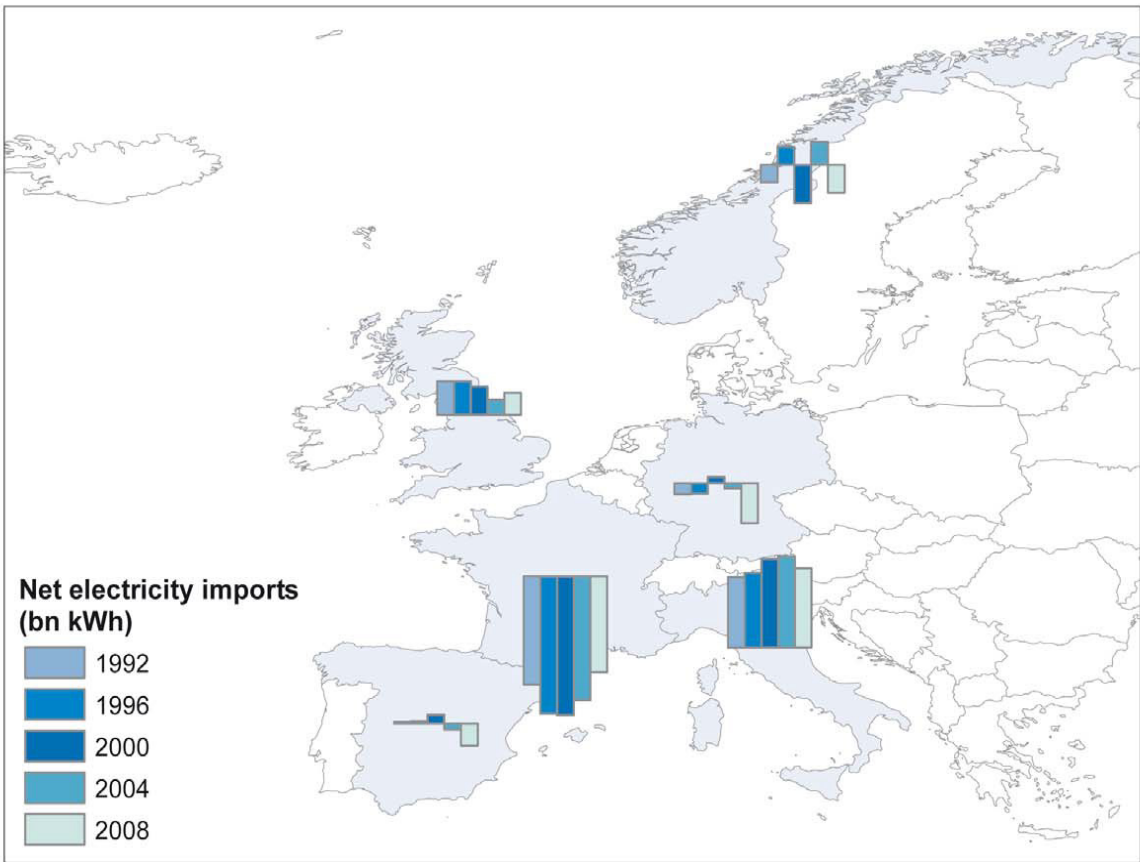
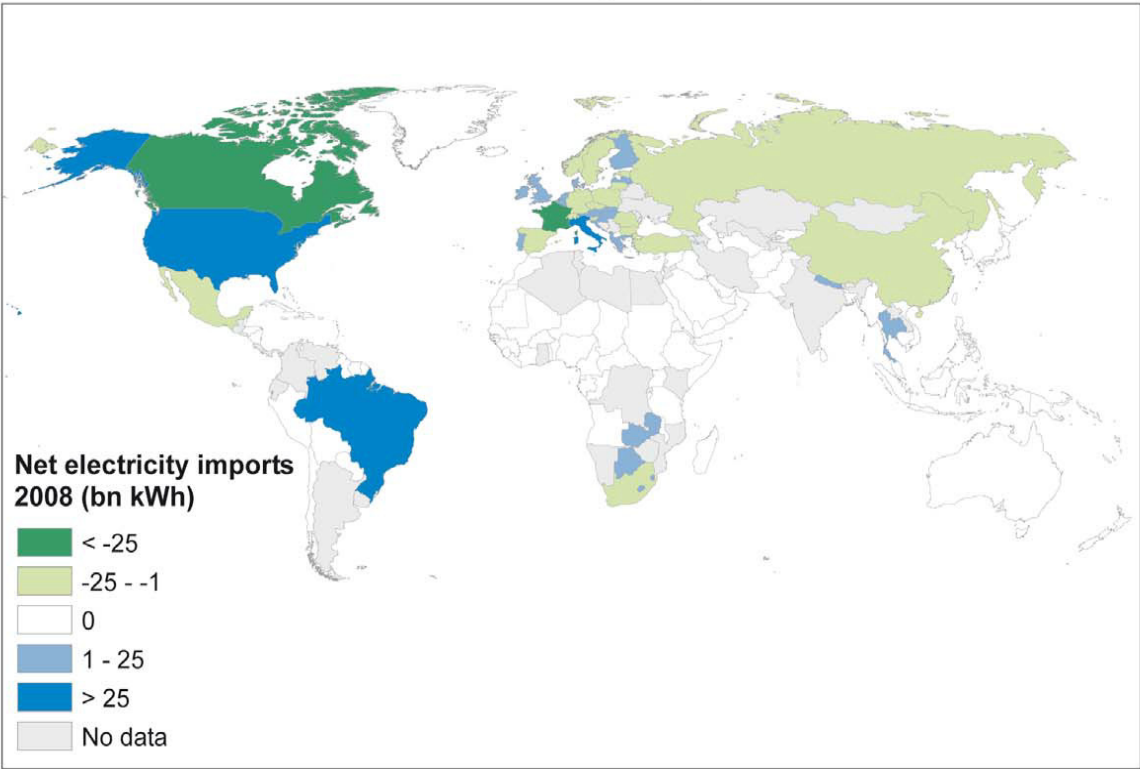
In a nutshell, a certain dynamic is present in the European electricity market. The patterns of electricity imports and exports are subject of a considerable change. This as well as the challenges associated with increasing shares of renewable energy discussed above indicate that adjusting and further developing the European electricity grid is an important part of establishing the security of the energy supply in Europe.

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\* Ifo Institute for Economic Research.

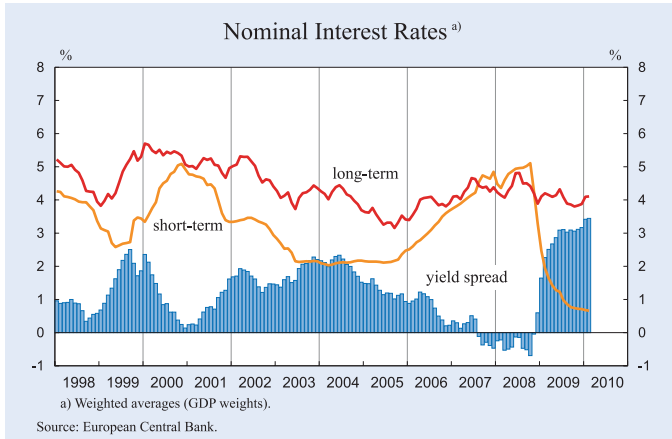


**Figure 1**  
**NET ELECTRICITY IMPORTS**

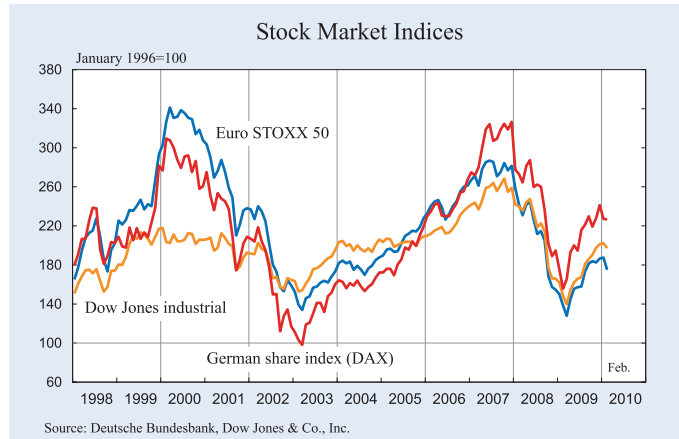


Notes: The lower panel displays net electricity imports for a choice of countries. Upward directed bars represent positive net imports, downward directed ones negative net imports and thus net exports. For all bars a standardized scale has been used.

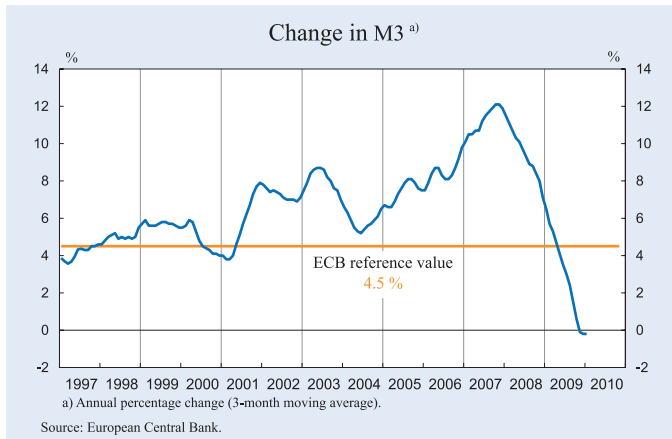
## FINANCIAL CONDITIONS IN THE EURO AREA



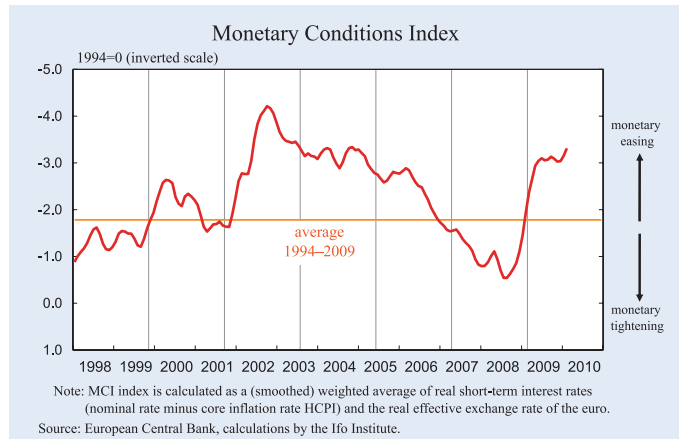
In the three-month period from December 2009 to February 2010 short-term interest rates declined. The three-month EURIBOR rate decreased from an average 0.71% in December 2009 to 0.66% in February 2010. Yet the ten-year bond yields grew from 3.88% in December 2009 to 4.11% in February 2010. In the same period of time the yield spread increased from 3.17% (December 2009) to 3.45% (February 2010).



The German stock index DAX declined in February 2010, averaging 5,598 points compared to 5,957 points in December 2009. The Euro STOXX also decreased from 2,908 in December 2009 to 2,727 in February 2010. The Dow Jones International declined as well, averaging 10,215 points in February 2010 compared to 10,433 points in December 2009.

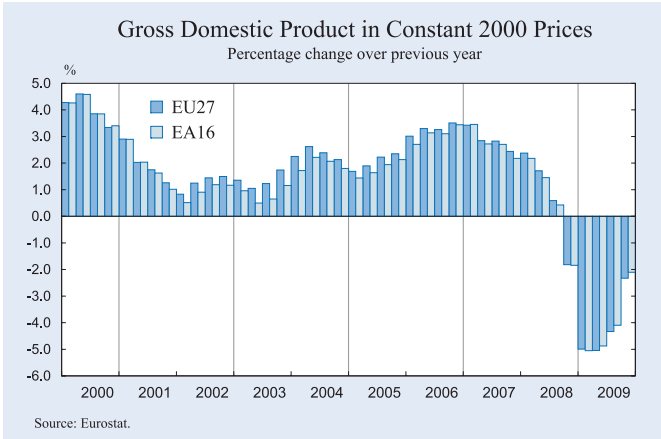


The annual growth rate of M3 decreased to -0.4% in February 2010, from 0.1% in January 2010. The three-month average of the annual growth rate of M3 over the period from December 2009 to February 2010 stood at -0.2%, unchanged from the previous period.

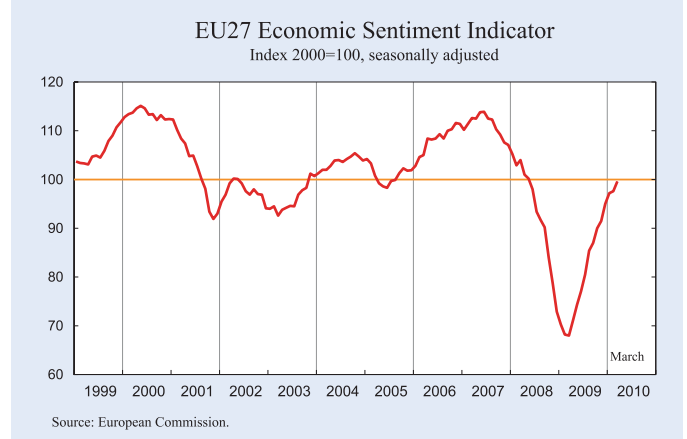


Between April and November 2009 the monetary conditions index remained rather stable after its rapid growth that had started in mid-2008. Yet the index started to grow again since December 2009, signalling greater monetary easing. In particular, this is the result of decreasing real short-term interest rates

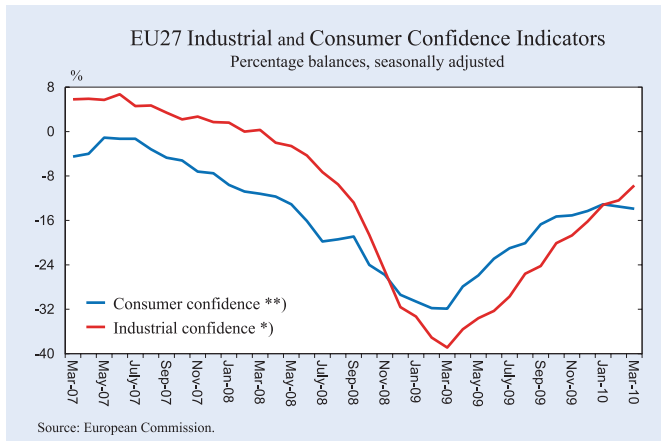
# EU SURVEY RESULTS



According to the first Eurostat estimates, GDP increased by 0.1% in both the euro area (EU16) and the EU27 during the fourth quarter of 2009, compared to the previous quarter. In the third quarter of 2009 the growth rate had amounted to 0.4% for the euro area and 0.3% for the EU27. Compared to the fourth quarter of 2008, i.e. year over year, seasonally adjusted GDP declined by 2.1% in the euro area and by 2.3% in the EU27

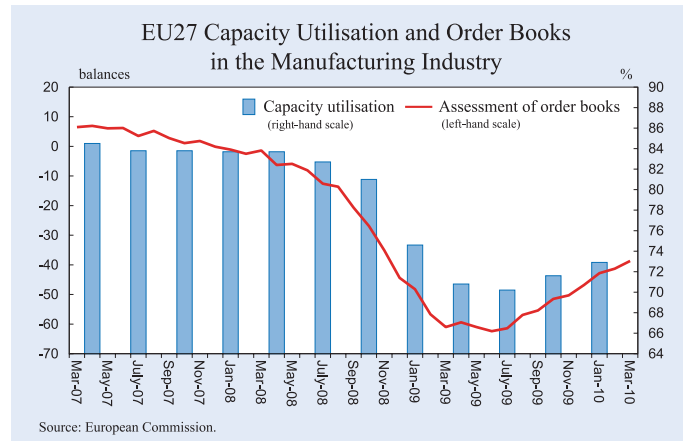


In March 2010, the Economic Sentiment Indicator (ESI) for the EU27 and the euro area (EU16) continued to improve. In this month the ESI increased by 2.0 points in the EU27 and by 1.8 points in the euro area, to 99.6 and 97.7 respectively. The ESI is now close to its long-term average, albeit it will still require further improvement for the economic activity to reach its pre-crisis level.



\* The industrial confidence indicator is an average of responses (balances) to the questions on production expectations, order-books and stocks (the latter with inverted sign).  
\*\* New consumer confidence indicators, calculated as an arithmetic average of the following questions: financial and general economic situation (over the next 12 months), unemployment expectations (over the next 12 months) and savings (over the next 12 months). Seasonally adjusted data.

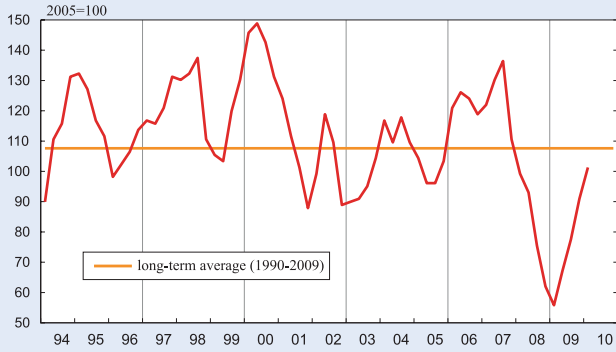
In March 2010, the industrial confidence indicator increased by 2 points in the EU27 and by 3 points the euro area (EU16), while the consumer confidence indicator decreased by 1 point in the EU27 but remained unchanged in the euro area. However, these indicators stood below the long-term average in both areas in March.



Managers' assessment of order books improved from - 42.8 in January to - 38.7 in March 2010. In December 2009 the indicator had reached - 46.8. Capacity utilisation increased to 72.9 in the first quarter of 2010 from 71.6 in the previous quarter.

# EURO AREA INDICATORS

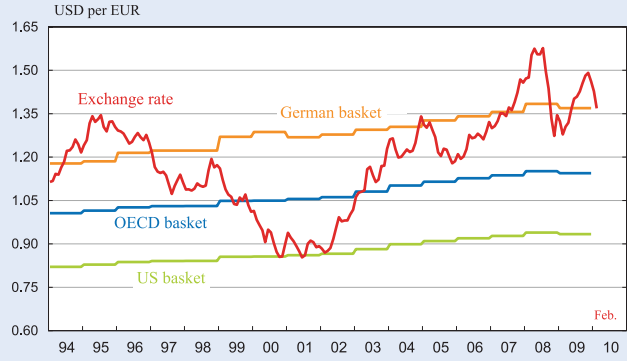
Ifo Economic Climate for the Euro Area



Source: Ifo World Economic Survey (WES) 1/2010.

The Ifo indicator of the economic climate in the euro area (EU16) improved in the first quarter of 2010 for the fourth time in succession. Both the assessments of the current economic situation as well as the expectations for the coming six months brightened noticeably. The latest results are an indication that the economic recovery that became evident already in mid-2009 will continue in the first half of 2010.

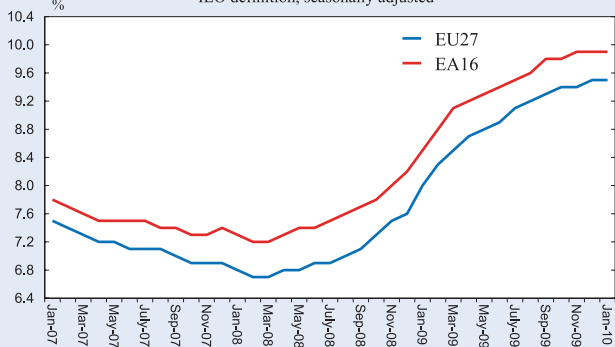
Exchange Rate of the Euro and PPPs



Source: European Central Bank, Federal Statistical Office, OECD and calculations by the Ifo Institute.

The exchange rate of the euro against the US dollar averaged 1.37 \$/€ in February 2010, a decrease from 1.43 \$/€ in January. (In December 2009 the rate had amounted to 1.46 \$/€.)

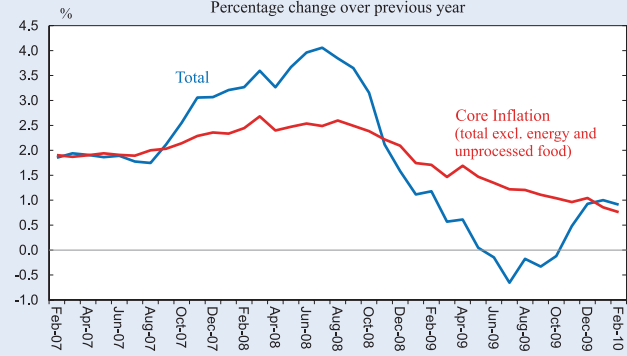
Unemployment Rate  
ILO definition, seasonally adjusted



Source: Eurostat.

Euro area (EU16) unemployment (seasonally adjusted) amounted to 9.9% in January 2010, the same as in December 2009. It was 8.5% in January 2009. EU27 unemployment stood at 9.5% in January 2010, unchanged compared to December 2009. The rate was 8.0% in January 2009. In January 2010 the lowest rate was registered in the Netherlands (4.2%) and Austria (5.3%). Unemployment rates were highest in Latvia (22.9%) and Spain (18.8%) in January 2010.

Inflation Rate (HICP)  
Percentage change over previous year



Source: Eurostat.

Euro area annual inflation (HICP) was 0.9% in February 2010, compared to 1.0% in January. A year earlier the rate had amounted to 1.2%. The EU27 annual inflation rate reached 1.4% in February 2010, down from 1.7% in January. A year earlier the rate had been 1.8%. An EU-wide HICP comparison shows that in February 2010 the lowest annual rates were observed in Latvia (-4.3%), Ireland (-2.4%) and Lithuania (-0.6%), and the highest rates in Hungary (5.6%), Romania (4.5%) and Poland (3.4%). Year-on-year EU16 core inflation (excluding energy and unprocessed foods) fell to 0.8% in February 2010 from 1.0% in December 2009.

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