European Labour Markets and the Euro: How Much Flexibility Do We Really Need?

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1 Introduction

In addition to evidence on the nature and source of regional fluctuations, European Monetary Union (EMU) will also provide economists with valuable new evidence on the monetary transmission mechanism. Given the scepticism with which macroeconomics currently regards monetary policy, current concern over real effects of EMU comes as a surprise; in a world of flexible prices, space-spanning contingent claims markets and complete information, it is difficult to see why monetary union matters at all for real integration processes already underway. For example, if the real business cycle paradigm (RBC) – which emphasises disturbances and propagation mechanisms in the non-monetary economy and ignores nominal rigidities – is approximately correct, the EMU exercise is nothing but a sophisticated veil. To the extent that EMU leaves fiscal policies and real behavioural incentives unchanged, the effects of a common currency are of second order at best. In short, this chapter has no real reason to be written.

Yet, the liveliness of the contemporary debate – among reasonable and cool-headed economists for the most part – is suggestive of an expectation that, for whatever reasons, real effects of EMU are in the cards. If this is indeed the case, the underlying presumption must be that nominal disturbances to aggregate demand and the money supply, in particular, can influence the short-run path of output and employment, and will continue to do so after EMU is up and running. Not wanting to make my life too easy, I have decided to write this chapter from the perspective of an eclectic who is willing to entertain new-Keynesian arguments. These arguments are important, as the survival of monetary union will rest on factors outlined long ago by Mundell (1961) and McKinnon (1963). In Europe, these are perceived to originate chiefly in labour markets. From a point of departure that money and monetary policy can influence real variables, I will discuss the macroeconomic impact of labour market rigidities on real and nominal adjustment to disturbances in ‘Euroland’. However, the most interesting aspects involve taking the
discussion one step further: for a number of reasons, the arrival of EMU will itself have significant effects on the functioning of labour and product markets and the relative importance of real and nominal rigidities. These feedbacks will ultimately affect the way Europe reacts as a macroeconomic entity to demand disturbances and how its central bank views the effectiveness of monetary policy.

This chapter surveys a number of issues too involved to be treated in model-theoretic detail here. I will furthermore abstain from econometric analyses for reasons which should be clear to all. There is a sense that the macroeconomic regime has changed in a way it has not in several hundred years in Europe: if the Lucas Critique has any relevance at all, it had better be here and now. I will adduce some empirical evidence however, which is suggestive of what one might expect in the future. The chapter is highly speculative, but meant to be so.

My discussion is organised as follows. In Section 2, I discuss the macroeconomic impact – at both regional and pan-European level – of the current structure of labour markets. Section 2 surveys the multifarious means by which a monetary union could affect the functioning of labour markets. This feedback takes some surprising turns, and may lead to a wholly different perception of the transmission channels of monetary policy in Europe. Section 3 adduces simple but striking evidence in support of my hypotheses and Section 4 concludes.

2 How will labour market inflexibility affect the macroeconomics of ‘Euroland’?

Real rigidities and regional fluctuations

Robert Mundell taught us long ago that the key to a monetary union’s success can be found in the synchronisation of underlying economic fortunes and, barring this, the mobility of factors of production, especially that of labour.\(^2\) Naturally, labour mobility is costly for both natural and man-made reasons, and immobility may be regarded differently across cultures and traditions. Abstracting from social valuations of immobility, losses of output and welfare are involved when labour does not move to job opportunities, in a geographic, industrial or occupational sense. To the extent that regional shocks – such as an oil discovery in the North Sea or German unification – continue to occur, they will wreak macroeconomic havoc on the real evolution of output, employment and other important variables in ways which are now well understood. The lack of a flexible nominal exchange rate in a world of nominal rigidities may imply protracted adjustment to regional shocks, unless labour and other resources move to follow better economic fortunes.

Indeed, the available evidence on labour mobility in the European context is remarkably discouraging and suggests that a major component of rigidity