**EUROPEAN COMMISSION**

[CHECK AGAINST DELIVERY]

**László Andor**
European Commissioner for Employment, Social Affairs and Inclusion

# Towards a European Labour Model

Conference on "Labour Economics after the Crisis"
**Brussels, 18 September 2014**

Ladies and Gentlemen,

The topic of our session is "Strengthening employment policy in Europe". This endeavour was present already when the Europe 2020 Strategy was designed in 2010, including increasing the employment rate to a target of 75% .

In this period, the Strategy is under review, and I would like this event, and this speech, to contribute to strengthening the theoretical foundations of Europe 2020 and the European Employment Strategy in general.

***Europe's High Employment Ambition***

Our most important and comprehensive policy document since the launch of the Europe 2020 strategy is the European Commission's April 2012 Employment Package.

The need for a major employment policy initiative became obvious as the euro area sank back into recession at the end of 2011.

It was obvious that just sitting back and waiting for employment to pick up as a consequence of renewed growth would not be an option. We faced an urgent jobs crisis and the prospect of *hysteresis*: rising long-term unemployment, loss of skills and further erosion of Europe's growth potential.

That is why we came up with the April 2012 package under the ambitious title "Towards a job-rich recovery". The Employment Package emphasised that preservation and creation of jobs had to be pursued as a **direct and immediate objective**, and as part of the wider effort of combatting the economic crisis.

The Employment Package was innovative in many respects, mainly with its emphasis on stimulating demand for labour.

The OECD's influential *Jobs Study* in 1994 argued that job growth in an economic crisis would be kick-started by deregulating employment protection and reducing unemployment benefits – very much a supply-side approach.

The European Employment Strategy launched in 1997 also focused predominantly on supply-side issues, such as labour participation, adaptability and human capital investment.


However, the key problem we have been up against since the second eurozone recession has been **how to boost job creation and demand for labour in a low-growth environment**.

Make no mistake: we continue to face the same problem now, despite the mild and fragile recovery over the past 12 months. And unless we make major changes to our macroeconomic framework, the challenge of boosting employment in a time of low growth is likely to stay with us for quite some time.

So what have been the key points in the Employment Package agenda?

In order to strengthen demand for labour, we have emphasised the need for reducing the tax wedge on low-paid workers, deploying targeted hiring subsidies and boosting entrepreneurship, including social entrepreneurship. Equally important is to maintain existing employment through better adaptability and through internal flexibility based on social dialogue.

There is also an important sectoral dimension to boosting demand for labour. The Employment Package therefore outlined ways to tap the job potential of sectors set to grow in view of long-term structural trends, in particular the green economy, ICT and health and care services. Later we followed up on this sectoral dimension with innovative initiatives such as the Grand Coalition for Digital Jobs and the Green Employment Initiative.

The second main strand of the Employment Package consisted of structural measures to make Europe's labour market more *dynamic and inclusive*. The three main elements in this respect have been:

- balanced structural labour market reforms
- investment in skills and
- better conditions for labour mobility in a *genuine European labour market*.

Balanced structural labour market reforms include promotion of internal flexibility; reduction of labour market segmentation; investment in the capacity of public employment services; closer links between unemployment benefits and activation requirements. They also include introduction or maintenance of decent minimum wages across Europe.

One major structural labour market reform concept which we elaborated later on is the Youth Guarantee - a comprehensive scheme to improve school-to-work transitions and ensure meaningful labour market opportunities for all young people before they slip into prolonged unemployment or inactivity.

Thirdly, the Employment Package emphasised the importance of social dialogue in pursuing a job-rich recovery. We followed this up with an EU quality framework for the anticipation of change and restructuring. Moreover, we outlined ways how involvement of social partners in European economic governance could be improved.

The policy agenda articulated in the Employment Package has been largely reflected in recommendations issued in consecutive European Semesters. European labour markets were hit by the second recession, but we have been looking for new instruments in order to preserve our objective and potential for high employment in our Member States.

### ***Re-discovering the Phillips curve***

Ladies and Gentlemen,

I have briefly explained how the EU employment policy agenda has been strengthened during the crisis. Allow me now to zoom out and reflect again on the macroeconomic challenges affecting Europe's labour market. In particular, I would like to address the issue of *secular stagnation* – or, more simply, the threat of a prolonged period of low growth and low inflation.

The European labour market is adversely affected by three key macroeconomic developments:

- First, there is a persistent gap between effective aggregate demand and potential output in most Member States, combined with high unemployment, large overhang of private debt, low inflation and nominal interest rates close to their lower limit. In fact, our economies may be facing a chronic shortage in demand for both consumption and investment. This is related to demographic trends, but also to rising inequalities and an increase in savings which are not being channelled to the real economy but parked in financial instruments, metropolitan real estate, etc.
- Second, there is an unprecedented polarisation in economic and employment outcomes across the euro zone, linked to the incomplete character of the Economic and Monetary Union, notably lack of aggregate demand management and of a shared fiscal capacity. The EMU's design has up till now forced macroeconomic adjustment to unfold predominantly through internal devaluation.
- Third, Europe struggles to reap the full job potential of structural changes under way, such as technological progress and further globalisation. The reason is that our labour market institutions, but also product markets, financial sector and public investment agencies are not capable of reallocating labour and capital in a flexible but secure way towards activities with a strong job-creation potential.

I consider these issues very important for policy-makers as well as academics. Secular stagnation, permanently depressed employment and rising inequalities may well become a reality if Europe's economy continues to be characterised by a large overhang of private debts from the past and at the same time low inflation.

Achieving higher employment in a low-growth environment would require higher inflation expectations and consequently very low or even negative real interest rates.

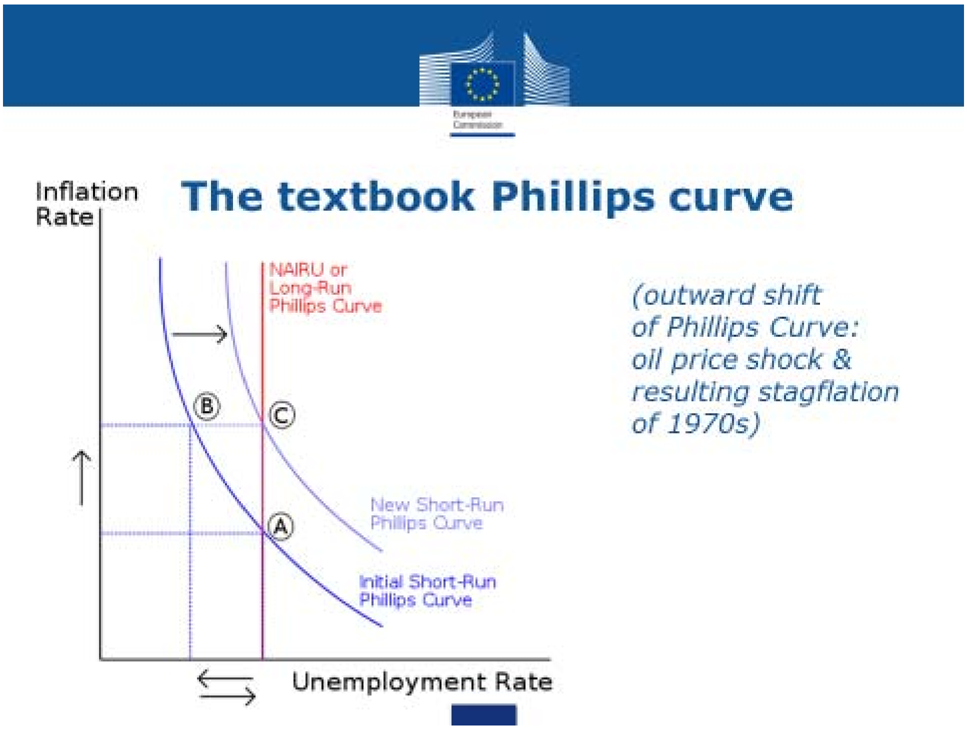
In practice, a negative real interest rate means some form of redistribution from savers to debtors. Such redistribution would in my view benefit the whole economy at the current juncture as it would strengthen aggregate demand, including demand for investment.

I would like to recall in this context a comment made by Nobel Prize Laureate Professor Pissarides at our conference on the Employment Package almost exactly two years ago. He argued that boosting employment would require that the ECB raise its inflation target to about 4%. Mind you, that was September 2012, when euro area inflation was over 2.5%, while today it is below 1%. We have gone in the opposite direction. Meanwhile, employment in Europe has continued to decline.

Since our conference is devoted to labour economics, I would like to inspire you with a concept which some of you may know and others may find it original.

It is the so-called Phillips Curve. Many years ago it used to encourage macroeconomic policy-makers to pursue full employment by using monetary and fiscal policies at their disposal.

In 1958, William Phillips highlighted the inverse relation between unemployment and nominal wage inflation in the UK in the previous century. A lot of similar empirical research followed and Samuelson and Solow soon re-stated the Phillips Curve as an inverse relationship between unemployment and inflation.



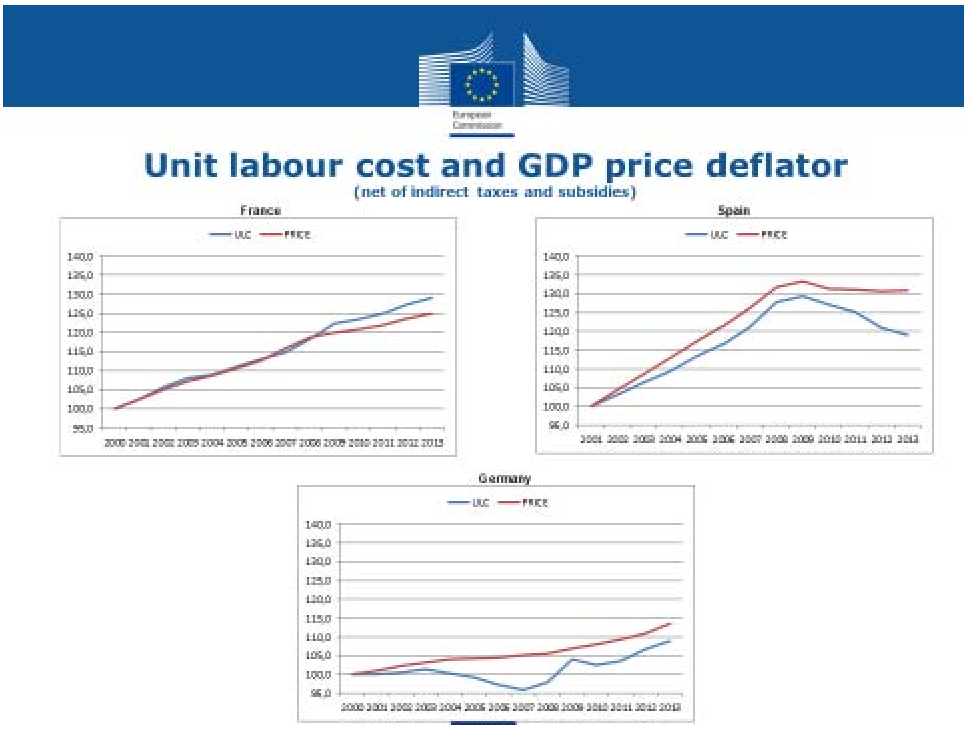
The policy implication of the "Phillips curve" is that increasing aggregate demand through monetary and/or fiscal policies is considered sufficient to increase labour demand and thereby bring unemployment down — provided we accept the higher inflation that goes with it.

Today, under the circumstances of the inherited, infantile and imperfect Economic and Monetary Union, adjustment to economic shocks tends to occur not through expansionary fiscal or monetary policies that would drive up inflation and reduce unemployment, but through internal devaluation which leads to low inflation or outright deflation, accompanied by high levels of unemployment.

Moreover, wage-inflationary pressures are much less likely nowadays than in the 1970s or 80s because trade union density has decreased considerably and collective bargaining has become more decentralised and easy to opt out from.

Empirical evidence from countries such as Germany, France and Spain confirms an inverse relationship between unemployment and wage growth over the last two decades, as the original Phillips curve suggested. The higher wage growth has been, the lower the unemployment rate.

The Phillips curve has certainly <u>not</u> become vertical as the monetarists had predicted. It is much closer to being **horizontal** in recent years. We nowadays observe relatively major differences in unemployment rates over time, while inflation has remained rather low and stable.




Furthermore, in many countries, such as Spain and Germany, the nominal unit labour cost has been rising less than overall prices, due to deliberate wage constraint or inefficient product markets. The result has been a further compression in aggregate demand and a more pronounced impact on unemployment.

What does all of this mean?

The Phillips Curve continues to be relevant, only it has been perhaps neglected in macroeconomic policy. We rightly pursue structural reforms aiming at reducing the long-term structural rate of unemployment, such as the Youth Guarantee or investments in education. But we may have forgotten that the way to the long term leads via several episodes of the short term.

Since 2010, we have allowed aggregate demand in Europe to drop and unemployment to shoot up, and today we see that this has negative impact on medium-term growth prospects. A protracted period of low or negative growth causes hysteresis (decline in human and fixed capital), in turn undermining the growth potential. Unemployment caused by a cyclical downturn becomes structural in its consequences if the downturn is not tackled.

I have already hinted what I consider to be the way forward, assuming that we take the objective of full employment seriously: inflation expectations need to rise. Economic agents (and especially the savers among us) need to accept the idea that very low or even negative real interest rates are needed for the sake of the whole economy's growth. Conditions for borrowing need to become more favourable, especially as regards young people and SMEs.

However, higher inflation and lower unemployment cannot be achieved on the basis of only fiscal or only monetary policies, nor only through structural changes like wage rises or greater redistribution. Concerted action on the fiscal, monetary as well structural dimensions is needed, much as in the concept of 'Abenomics', about which we heard earlier today from Professor Honda.

The recent speech of Mario Draghi in Jackson Hole goes in the same direction in the sense that it emphasises the need for more accommodating monetary policies and a more expansionary aggregate fiscal stance of the euro zone, so that Europe can implement structural reforms without risking further short-term contraction in GDP and further deflationary pressure.

### ***Investment and Adjustment***

Ladies and Gentlemen,

The main reason for Europe's continuing jobs crisis has been and continues to be weak macroeconomic performance, and in particular less effective fiscal and monetary responses to the financial and economic crisis than we could observe in the US and Japan.

The macroeconomic policy constraints faced by Europe are closely linked to the design of our Economic and Monetary Union and I have long argued that it is primarily through a reform of the EMU that we can make meaningful progress towards our 2020 target of 75% employment.

That said, I believe that the quality of employment and the quality of labour market policies continue to be the highest in Europe. I think we can confidently speak of **a European labour model**, namely a set of basic qualitative features which distinguish European labour markets from the rest of the world.

It is obvious that labour markets and employment policies in the Member States of the EU are far from being uniform, and indeed we have had a European Employment Strategy for nearly two decades which aims precisely at spreading good practices and fostering convergence with the best performers.

The crisis has made such convergence much more difficult, also because many Member States have been faced with a shortage of resources and declining institutional capacity to invest in modernising their employment policies.

But I think, nonetheless, that there are a number of features which Europe can very legitimately showcase to the rest of the world as a source of inspiration. In fact, this is what I was also busy doing last week at the meeting of G20 labour ministers in Australia.

So how is Europe different in terms of employment policies?

First, Europe stands out in terms of **investment in human capital**. We continue to have some of the best arrangements for social investment throughout the life-cycle, from childcare facilities to general education, dual-training arrangements and lifelong learning programmes. Rules on health and safety at work and arrangements for the reconciliation of work and family life also play an important role in supporting productivity and employment. The Youth Guarantee is a very important recent addition to this system of human capital investment, and there are good foundations on whose basis it can be put into practice.

Of course, rising income inequalities are having an impact, and many European countries are seeing growing inequalities in the performance of education and employment services, linked to budgetary constraints on public investment in human capital. However, this is something which we can fix. The foundations remain rather good.

Second, Europe does relatively well when it comes to managing **labour market adjustment to economic change**. Most Member States have functioning systems of social dialogue and labour market institutions that are able to support adjustment through investment in re-training and through unemployment benefits combined with job-search support.

We do less well when it comes to stimulating the development of new sustainable economic activities that would create jobs for the low-skilled and medium-skilled, but we do have an infrastructure of public investment agencies that could be mobilised to work with the private sector and the third sector to deliver new jobs.

There is in fact a *hierarchy of adjustment possibilities* in the labour market. If demand drops, the best way to adjust is through working time – and Europe indeed shows some great examples of negotiated short-time working schemes coupled with training, for instance in Germany. This internal flexibility provides a strong basis for an economic rebound once demand picks up.

The second best adjustment possibility is through moderation or reduction in real wage rates. This is more painful and takes more time to negotiate, but practically the whole euro zone 'periphery' has undertaken such real wage adjustment. This has helped somewhat to preserve employment, although the results would have been much better if the so-called 'rebalancing' had been symmetrical, namely if there had been an offsetting wage growth and/or fiscal expansion in the more competitive 'core' countries in order to uphold aggregate demand.

The third best option for adjusting to economic shocks is through external flexibility, namely layoffs. This has been unfortunately used more than anybody would like, and the more vulnerable groups such as young people have been particularly affected. Therefore one of the key questions for European labour markets – and for our conference – is how to integrate lower-productivity workforce back into employment. Clearly the answer will need to involve both supply-side and demand-side measures, and I am pleased that the Eurogroup meeting of last week has come out so strongly in favour of reducing the tax wedge on low-paid labour. They have called it a clear policy priority on the structural reform agenda, and I could not agree more.

The fourth and worst option for labour market adjustment is through early retirement. Luckily Europe has learned from the past, has understood the lump of labour fallacy and there is broad consensus that when the whole workforce is ageing and shrinking, it is not a good idea to just drop some of the older workers permanently. Instead, the right answer is to invest in re-skilling and to provide demand-side incentives for the re-employment of those who were laid off.

These European instruments for investment and adjustment work well if the social dialogue functions well at the same time.

Social dialogue has to be strengthened at all levels in the EU, or restored where it has been weakened or eliminated during the crisis years.

It is a basis for making European labour markets more resilient and job-rich.

### ***Conclusion***

Ladies and Gentlemen,

Beyond our crisis response so far, many things could be done to promote full employment in Europe. But we would first need to learn the lessons from our crisis experience.

I have summarised three key lessons in my speech.

1. The EU can and should maintain its commitment to high employment, including by having an ambitious target to raise the employment rate;

2. This commitment can be and should be integrated into macroeconomic policy, including fiscal and monetary policy; and

3. The EU can and should consolidate its specific instruments for investment and adjustment, and identify a European Labour Model.

Thank you very much for your attention.