Comment on Jørgen Elmeskov: Nordic Unemployment in a European Perspective

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The rapid increase in unemployment in the Nordic countries in the early 1990s, towards the levels of other European countries, has brutally brought the unemployment problem into the minds of many economists not previously interested in labor market economics (and of non-economists as well, of course). To such non-specialists (at least among the economists), Elmeskov's review provides a useful summary of the current state of knowledge. The review can also serve as stimulation for further research, not least because of the author's open and eclectic attitude.

While I have personally benefited from considering Elmeskov's knowledge in the field, I question some of the grounds for his conclusions about why unemployment in the Nordic countries was previously so low, why it suddenly increased, and whether the future development will be more "European".

Elmeskov seems to draw the conclusion that the persistence in European unemployment reflects slow adjustment to the equilibrium rate, after various disturbances, rather than permanent changes in the equilibrium rate. He recognizes that it is practically impossible to discriminate between the different hypotheses on empirical grounds (technically, to distinguish a stochastic trend or unit root in the unemployment series from a near-unit root). The problem is aggravated, however, by a lack of theoretical precision in the hypothesis formulation. It is unclear, for example, how the NAWRU estimates in Section 1.2 are related to the theoretical model in Section 1.1.

If the long-run wage-setting relation between the real wage and unemployment is vertical, as suggested by Elmeskov, then only changes in this

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relationship will matter for the long-run (equilibrium) rate of unemployment. Changes in labor supply and labor demand can only explain short-run fluctuations in the unemployment rate. If the aim is to understand and compare the long-run trends in European and Nordic unemployment, it may therefore seem surprising that Elmeskov devotes so much space to changes in labor supply and labor demand. My interpretation is that Elmeskov views the changes in the wage-setting relation, i.e., the equilibrium rate of unemployment, as less important. This is consistent with the view of European and Nordic unemployment as resulting from slow adjustment to various shocks, e.g. to labor supply and labor demand.

Elmeskov suggests that pro-cyclical labor supply and slowly adjusting labor demand may explain why unemployment fluctuations in the Nordic countries have been relatively dampened. This does not, however, have any implication as to what the sources of the shocks might be. Elmeskov explicitly discusses shocks to technology and public employment. It is conceivable that the slowdown in the rate of technical progress during the 1970s and 1980s bears part of the responsibility for the (transitory?) rise in unemployment, since the problem of misaligned real wages is less severe (less persistent) when labor productivity increases rapidly. It is also plausible that the public employment expansion has in some cases kept unemployment down, although I hesitate to attribute much of the increases in public employment to "shocks".

Since Elmeskov reports some estimates of the slopes of wage-setting curves, it may be worth pointing out that such studies often suffer from a lack of identification (cf. Manning, 1992, 1993). It is not clear that the real wage-unemployment elasticities convey information about a structural parameter behind the wage-setting curve, rather than about the average relation between these two variables in the whole system (as depicted e.g. in Elmeskov's Figure 2). The connection between the wage-setting curve in the theoretical model in Section 1.1 and the discussion about relative wages and curve shifts in Section 2.3 is also unclear.

Elmeskov points out that Denmark has experienced unemployment rates similar to those of other EC countries, despite the fact that labor market institutions resemble those of the other Nordic countries. This suggests, in my interpretation, that Denmark's (and Europe's) unemployment record can largely be explained by macroeconomic policies, in particular monetary and exchange rate policies. The fact that the other Nordic countries had roughly the same experiences, after (fruitlessly?) having tried to follow the "hard-currency" policy, supports that interpretation.

Elmeskov draws two conclusions. The first is that unemployment has been lower in the Nordic countries because shocks to these economies have been less severe. However, the examples he gives do not support this conclusion, since they seem to regard propagation mechanisms rather than shocks. The second conclusion, that the unemployment problem can be mainly explained by structural problems in the labor markets, seems to be at odds with the evidence presented in his own review.

The *existence* of unemployment must, almost by definition, be attributed to structural problems; market imperfections imply that demand and supply is not equalized. Given these imperfections, there is room for other factors to explain sudden *changes* and subsequent *adjustments* in unemployment. After reading Elmeskov's review, I gather that there is little evidence of a permanent rise in the equilibrium rate of unemployment (in the Nordic countries or elsewhere); that Denmark's, and more recently the other Nordic countries' experiences suggest that the commitment to German monetary policy explains part of the rise in unemployment; and that public employment policy is another crucial factor. Although the role of the slowdown in the rate of technological progress and the nature of the wage-setting relation warrant further research, the current state of knowledge, judging from Elmeskov's review, seems to point to monetary and fiscal policies as the main factors behind the troublesome unemployment development in Europe, including now also the Nordic countries. This, rather "Keynesian", conclusion is not in line with the current consensus of many European economists, but it seems unavoidable. It also suggests that there are reasons for optimism, given that we are willing to learn from past mistakes.

References

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