

ECO FLASH

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About structural unemployment in France

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- The conceptual distinction between structural and cyclical unemployment is crucial to the conduct of economic policy.
- However, estimates of structural unemployment – which cannot be observed – pose major difficulties, which become even greater when an economy suffers a prolonged crisis.
- The idea that France's current unemployment rate (9.5%) is entirely structural merits discussion. In particular, how does this idea square with France's low level of inflation?

Structural and cyclical unemployment

It is common to break down the unemployment rate into structural and cyclical components. Cyclical unemployment is the portion that depends on an economy's position in the cycle, i.e. on its current level of demand. When growth is weak, i.e. lower than its potential rate, this will typically push up cyclical unemployment. Structural unemployment, on the other hand, does not respond to fluctuations in activity. It only depends on the structure of the economy (working age population, skills levels etc.), institutional factors (unemployment benefit, the level of the minimum wage, contribution rates etc.) and technologies. It is also known as the equilibrium unemployment rate, i.e. the rate that is seen when GDP equals its potential level, i.e. when output is at the maximum level achievable without generating excessive inflation (i.e. inflation above the central-bank target). Generally, it is thought that reducing structural unemployment requires the adoption of reforms to boost the supply side. Reforms to liberalise the labour market fall into this category.

Structural unemployment is not observable and so has to be estimated. That estimate is a crucial part of defining the right economic policy. If an economy's unemployment is mainly structural, only policies to support the supply side will give satisfactory results. Policies that boost demand – through monetary and/or fiscal loosening – will have a limited positive

effect, and at best will lead to a temporary and limited fall in unemployment. However, the negative effects may be large and sustained, including higher inflation, wider budget and/or current-account deficits and lower competitiveness, all of which weaken the supply side. In the end, such policies risk pushing structural unemployment higher.

However, if unemployment includes a cyclical component, eliminating it will require policies to support the demand side. This will allow the unemployment rate to fall back to its structural level. But policies to boost the supply side could aggravate the problem, in this case weak demand. Putting pressure on wages when the economy is suffering from insufficient demand may create more unemployment in the short term.

Estimation difficulties...

As a result, there are no policies that are effective in all situations. Everything depends on the accuracy with which the causes of unemployment are assessed, in this case the estimate of the level of structural unemployment. This is where the difficulties begin.

We have just defined structural unemployment as being insensitive to movements in demand, and determined solely by supply-side factors. In practice, however, estimating structural unemployment is hard. It often turns out to be procyclical, i.e. it tends to increase when the economy is weak and vice-versa, which goes against the definition of the concept.

The most common estimate of the structural unemployment rate is the NAIRU (Non-Accelerating Inflation Rate of Unemployment). This is the unemployment rate at which supply equals demand for labour without generating inflationary pressure. The European Commission uses a concept similar to NAIRU, i.e. NAWRU (Non-Accelerating Wage Rate of Unemployment).

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Generally, the equilibrium (or structural) unemployment rate is estimated using an equation such as the following:

$$\Delta \text{rulc}_t = -\beta (u_t - u^*)$$

Where: U_t represents the unemployment rate; U^* the structural unemployment rate, rulc_t real unit labour costs.

It assumes that changes in real wages relative to labour productivity give relevant information about the actual situation in the labour market. If real unit labour costs are stable – i.e. if real wages are moving as labour productivity – this means that unemployment is entirely structural: there is no cyclical unemployment. Cyclical unemployment only appears when real unit labour costs fall. Conversely, an increase in real unit labour costs points to an overheating economy: the unemployment rate is lower than its equilibrium level, which skews the distribution of value added in favour of wages, causing inflation to rise under an unchanged profit margins assumption.

Looking at productivity-adjusted real wage growth at a given point in time therefore allows us to determine the structural portion of unemployment, which seems to fit the theory: if productivity growth slows and real wages fail to respond, this points to a tight labour market (competition from unemployed people is ineffective), which is characteristic of an economy close to its potential.

This method makes the idea of structural unemployment similar to that of nominal rigidities, which may arise from certain labour market failures. An example would be a high level of duality, where insiders (permanent staff) can increase or maintain their real wages at the expense of outsiders (unemployed people or those on temporary contracts), because they know that replacing them with new people will be expensive. This situation may be magnified by factors such as a high level of labour protection, centralised collective bargaining, and the cost of recruiting and training outsiders.

However, the method does not take into account the nominal rigidities that form part of the normal running of an economy, such as the fact that wages are subject to contracts that fix their value for a certain period. That rigidity is not a problem when inflation is close to 2%: a freeze on nominal wages reduces real wages. In a recession, however, when inflation falls close to 0%, the nominal rigidity of wages becomes a real rigidity. Since apparent labour productivity declines (output falls faster than employment¹), higher unemployment is interpreted as an increase in structural unemployment, which is not necessarily the case.

In addition, as well as nominal rigidities, real rigidities can also exist without necessarily reflecting structural market failures. The theory of the efficiency wage (Yellen, 1984) shows that it is not in the interest of companies, which cannot directly observe labour productivity, to reduce wages, since to do so could discourage employees. Real rigidities can also result from implied contracts (Azariadis, 1975) between employers wanting to limit transaction costs and risk-averse employees, who collude to smooth the path of real wages over the cycle.

¹The phenomenon can be amplified by government action encouraging companies to maintain employment through specific measures such as reducing employer social-security contributions.

During a recession, companies see labour productivity falling but do not adjust wages because the fall is attributed to the economic situation.

... and supply endogeneity

As we have just seen, the way in which structural unemployment is estimated cannot totally strip out the cyclical element. This is particularly problematic during major recessions: a prolonged period of weak demand will give rise to a sustained increase in unemployment, which will be interpreted as permanent.

Nevertheless, this assimilation has theoretical support in the idea of hysteresis. According to this theory, popularised by Blanchard and Summers, prolonged cyclical unemployment tends to become structural as the long-term unemployed lose skills and become unemployable. More generally, the hysteresis phenomenon explains how sustained weakness in demand ends up affecting supply, with falling actual GDP dragging down potential GDP. Although demand and supply were conceived separately, they are actually interdependent, and this results in a pro-cyclical effect.

However, several problems remain. On the one hand, although hysteresis may occur, there is nothing to say that it explains all of the *measured* increase in structural unemployment. In other words, the estimation method based on real labour costs may still overestimate the real extent of structural unemployment, even taking into account a hysteresis effect. On the one hand, if we accept that prolonged weakness in demand can affect supply, and a sustained increase in unemployment can turn into a permanent increase in unemployment, we must also consider the opposite situation, where prolonged stimulus to demand can raise potential supply and push down structural unemployment. In an economy receiving long-term stimulus, companies will have greater incentive to recruit the long-term unemployed and give them new skills, making people who were unemployable in bad economic times employable again. As a result, it seems difficult to regard hysteresis as a factor that can increase structural unemployment *a priori*. The argument is merely that a temporary shock can become permanent if nothing is done to address it. The hysteresis effect would show up through inflationary pressure arising at a higher level of unemployment than in the past, since the long-term unemployed no longer influence wage formation. This is not what we are currently seeing in the Eurozone and in France.

French unemployment: solely structural?

In its last set of forecasts (autumn 2017), the European Commission (EC) estimated France's structural unemployment rate or NAWRU at 9.2% in 2017, very close to the actual unemployment rate of 9.5%². In other words,

² In its spring forecasts, the EC estimated the NAWRU at 9.4% in 2017. In general, the EC's forecasts are very volatile, although retropolations give them an appearance of stability. Putting together a series NAWRU estimates for a given year made in the same year (i.e. estimates for 2009 made in 2009 etc.), we see a gradual increase in the equilibrium unemployment rate that follows the increase in the actual unemployment rate. In the future, we can expect that NAWRU estimates will fall as actual unemployment also falls.

according to the EC, weak demand is only having a marginal effect on France's high unemployment, since cyclical unemployment is almost non-existent.

This estimate is similar to that of the OECD. The main difference lies in movements in the NAWRU: whereas the European Commission takes the view that equilibrium unemployment has been stable in the last 10 years (the NAWRU is retrospectively estimated at 9.2% in 2007), the OECD estimates that it has increased from 8.6% to 9.2%.

In both cases, estimates regarding France's high structural unemployment in 2017 pose a problem. We could take the view that it increased during the recession, as the OECD does, because of a hysteresis effect, in which case we run up against the objections set out above (does hysteresis account for all of the increase in the estimate? why inflation pressures do not materialise? is it really irreversible?). Or we could take the view, as the European Commission does, that structural unemployment has not changed, but that it is historically high (and was underestimated before the crisis). However, the latter option implies taking the view that the French economy was overheating (i.e. had a positive output gap) between 2000 and 2008, which is far from obvious: inflation remained close to 2%, real unit labour costs did not increase and although the current-account balance worsened, it remained very limited (a deficit equal to 1% of GDP in 2007).

So how can a structural unemployment rate of over 9% be explained? The question is especially important since the French economy is not currently showing any sign of upward pressure on prices. In theory, an economy close to potential should see inflation close to target. But this is not currently the case in France.

It could be argued that pressure on output factors is showing up through downward pressure on company profit margins. Indeed, they are relatively low, despite the support provided in the last presidential term through the CICE (competitiveness and jobs tax credit) and a reduction in employer social-security contributions. But then we have two contradictory propositions: on the one hand we are saying that there is no demand problem, but on the other we are saying that companies are struggling to pass on higher unit labour costs in the form of higher selling prices. Is this because of increased international competition, with French demand tending to be absorbed abroad? However, we can see that inflation in services (much of which is not tradable) is also historically low at around 1%. If this is down to higher internal competition and/or technological changes then there are no supply constraints problems. The French economy's recent good performance in terms of GDP growth proves that, so far, increasing demand has led to higher domestic output. The simultaneous deterioration in the current-account balance is merely the effect of an economic upturn (higher consumer spending, higher investment), since in the final analysis, the current-account balance measures the gap between national savings and investment.

We could show that high unemployment and weak company profit margins in France are caused by a shortage of demand.

Insufficient demand at a constant headcount implies a slowdown in the growth of labour productivity. Since nominal rigidities become real rigidities in periods of low inflation, real

■ Underlying inflation

— Services — Non-Energy Industrial goods

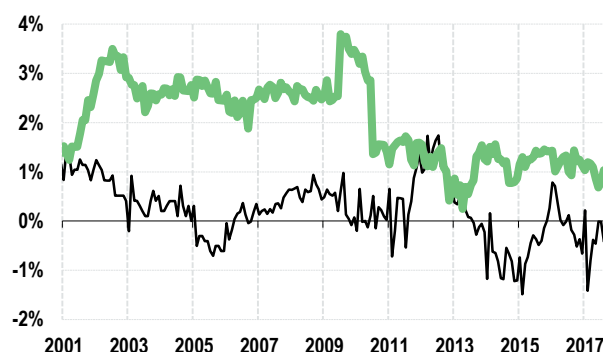


Chart 1

Source: Eurostat

unit labour costs tend to increase, and companies cannot offset that increase by raising prices. This puts downward pressure on profitability

Exogenous factors

If we want to explain that structural unemployment is high despite the absence of inflationary pressure, we must look at exogenous factors that explain each phenomenon.

Economists generally start by mentioning globalisation. International competition has pushed down inflation, partly through imports of goods produced in low-cost countries, and partly through the requirement for local companies to remain competitive (for example, wage arbitrage may take place between several production sites), keeping wages under pressure. International competition may also cause jobs to be lost permanently in "advanced" countries because of offshoring, a new international division of labour and the disappearance of some activities, which would make it a source of higher structural unemployment.

Technical progress is another explanation. Technological innovation, when it generates productivity gains, partially absorbs wage growth and limits inflationary pressure. In addition, the development of the digital economy and e-commerce is making prices and competition between retailers more transparent, which is tending to reduce inflation by putting pressure on margins. Technical progress, like globalisation, may also lead to job losses as certain tasks are automated. More radically, some economists³ claim that new technologies are leading to a "third industrial revolution", which is mainly characterised by a disconnect between output and work. In other words, machines and technology will gradually replace humans in the production of common goods and services. In Rifkin's opinion, labour will not disappear completely but will be limited to certain sectors, those of the "manipulators of symbols" (experts, teachers, engineers, scientists etc.), while workers in the manufacturing and service sectors will lose their jobs as production is automated.

³ Rifkin, J., 1995. *The End of Work*. Putnam, USA

The third explanation is that structural changes in the labour market, partly linked to globalisation and technical progress, may be involved. The tertiarisation of “advanced” economies – i.e. the replacement of manufacturing jobs with service jobs – accompanied by a reduction in unions’ bargaining power and in the salaried workforce, may be loosening the connection between wage growth and the unemployment rate. As a result, we should no longer expect to see inflation rise as quickly as before when the unemployment rate bottoms out (i.e. hits its structural level).

Interpretation difficulties

However, these three explanations create a number of interpretation problems.

The globalisation explanation has obvious drawbacks when we consider that France’s low inflation is also the result of domestic factors, i.e. low inflation in non-tradable sectors. In addition, globalisation has not just happened in the last 10 years. How could we explain the fact that, before the 2008 crisis, France and the rest of the eurozone were seeing inflation close to 2% and an unemployment rate lower than today’s? Is globalisation really having a negative impact on total employment in advanced economies? It is possible to say that globalisation is adversely affecting unskilled jobs, while saying that it is positive for total employment. Viewing globalisation in terms of winners and losers is to ignore the fact that global growth benefits all its agents⁴, even if the effects vary between countries (with emerging-market countries typically growing more quickly in order to catch up) and within countries. In rich countries, the problem appears to be a widening of inequalities between skilled and unskilled jobs, not an increase in structural unemployment.

The problem is also temporary by its very nature. The catching up process should result in equalising prices and wages between countries, even though it may obviously take a very long time to get there.

As regards the technical progress argument, the most fundamental objection is that it simultaneously explains low inflation as resulting from a positive supply shock and higher structural unemployment as resulting from a negative supply shock. If technical progress increases the quality and/or quantity of output, with a moderating effect on prices, how can it be said to have a negative impact on employment at the same time? It is illusory to think that productivity gains destroy jobs at the aggregate level. In one way or another, productivity growth represents distributed income with benefits for both activity and employment (of course this fact does not prevent us from considering the optimal distribution of those benefits). In particular, productivity growth allows higher real incomes to be distributed without generating inflation. Higher productivity causes structural unemployment to fall. But in the same way that globalisation has varying effects, technical progress moves jobs between sectors of the economy. The industrial revolution in the 19th century did not destroy jobs, but rather jobs in craft industries were replaced by manufacturing jobs. At the macro level, this creative destruction generated both growth and jobs. Here again, the

main issue involves managing the distributive effects of technology rather than fighting what is wrongly regarded as its negative effect on employment. Rifkin’s vision of the end of work focuses on the destruction but ignores the creation. Rifkin’s reasoning is too much based on “all other things being equal”, disregarding the very essence of a “technological revolution”.

Finally, the argument based on tertiarisation and the reduced influence of unions in advanced economies may be useful in understanding the reduced explanatory power of the Phillips curve, but it does not help us understand why the structural unemployment rate would have increased. Stating that structural unemployment has risen but that it is not showing up in price formation because economies are shifting to the tertiary sector does not explain why the structural unemployment rate would have increased. On the contrary, it would appear that if each job has a reduced inflationary impact, then that would correspond to lower, not higher, structural unemployment. If each job produces less inflationary pressure than before, all that is required to hit 2% inflation is to generate more jobs. The real question concerns the best way of stimulating demand.

Underemployment and the unemployment halo

We can point to certain positive supply shocks – global to varying extents – that are pushing down prices. However, it is harder to see how these supply shocks are simultaneously having an adverse impact on total employment. On the contrary, a sustained improvement in growth goes hand-in-hand with lower structural unemployment. Instead, therefore, the current situation could involve an output gap that is larger than generally thought. As a result, the relevant question is whether that gap will close of its own accord or whether demand stimulus is necessary.

The ECB is leaning towards the second option, and that, in its opinion, justifies keeping its policy loose. It is focusing on the shortfall in demand remaining despite the cyclical upturn, which result in still subdued wages and prices growth. From this point of view, the flattening in the Phillips curve is a cyclical phenomenon: after a prolonged period of weak demand, as long as unemployment remains high (higher than its structural level) wages will be unresponsive (the curve is flat) but they will become more responsive (the curve will steepen) once unemployment has fallen to its structural level.

This position also invites us to consider the state of the labour market from a broader perspective, particularly through indicators such as those that take into account the quality of jobs (involuntary part-time work, fixed-term contracts etc.) and the unemployment halo (people available for work but not actively looking for work, or people actively looking for work but temporarily unavailable). Measures similar to U6 unemployment in the USA⁵ show a labour force underutilisation rate of 18.5% in France in early 2017 as opposed to 15.4% in 2008. Similarly, focusing on permanent or full-time jobs, the situation in the labour market appears less bright.

⁴Naturally, this does not mean that unfair competitive practices are not a problem. However, that problem concerns the “rules of the game”, not globalisation *per se*.

⁵These measures take into account the unemployment halo and involuntary part-time work. However, they do not take into account the proportion of fixed-term contracts nor the distinction by professional status (employees, self-employed etc.)

In conclusion, more comprehensive indicators – taking into account the quality of jobs created – would better explain the relative inertia of wages and the difficulty of reducing unemployment more quickly, since a cyclical upturn also involves a reduction in the “intensive margin”, i.e. the gap between unemployment and overall underemployment: increasing the number of hours worked, converting temporary contracts into permanent jobs, and integrating discouraged unemployed people back into the labour market.

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■ Employment rate (15-64 y)

Q1 2008 = 100

— All jobs — Full-time jobs

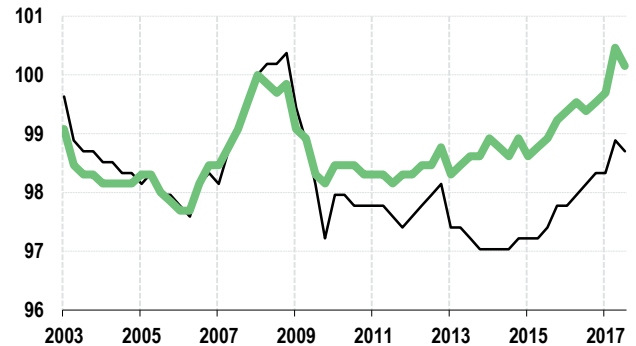


Chart 2

Source: INSEE

■ U6-type measure of underemployment

% of extended labour force

■ Unemployment ■ Involuntary part-time jobs

■ Available but not actively seeking ■ Actively seeking but temporarily unavailable

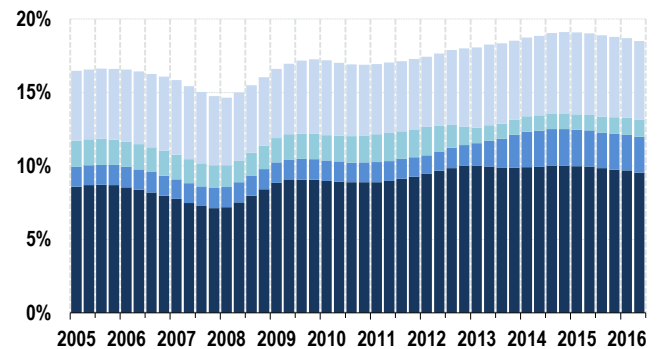


Chart 3

Source: Eurostat

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