HELMUT WAGNER
Editor

Globalization and Unemployment

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With 32 Figures
and 24 Tables

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Introduction

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Globalization and unemployment are two phenomena which are among the most widely discussed subjects in the economic debate today. In Europe in particular the tendency of unemployment to rise since the 1970s has become a center of political conflict which has had a seriously negative effect on the political confidence of the public in the ability of politicians and their advisors to act as crisis managers.

However, a view of the causes was very quickly developed which diverted responsibility from politicians and attributed it to an apparently exogenous factor. For example, many observers attributed the increase in unemployment above all to the worldwide trend towards globalization, i.e. to the increase in the world economic interdependence of markets and corporate activities, and the rapid spread of technologies, which has happened above all in the last two decades. However, this is countered by the success in many countries in combating unemployment in this period, above all in the USA, but also in Great Britain, the Netherlands and other smaller countries.

In principle, the correlation between globalization and unemployment has still not yet been fully clarified. Clarification of this correlation is not only of academic interest, but is also decisive for the drafting and designing of the fight against unemployment in terms of economic policy.

In this book experts examine fundamental questions on this subject, in particular the following:

What are the challenges of globalization in the advanced economies and how can they be met?

How did previous processes of globalization turn out, what economic consequences did they have (in particular on unemployment), and how were they stopped?

How has unemployment developed internationally? What common features were there, and what were the differences?

How can unemployment be explained? What are the different approaches for explaining it, and what are their common features and differences?

What impact does technical progress have on the structure of (un)employment and wages?

What influence does globalization have on the development of unemployment? What certain knowledge is available, and which questions are still open?

Will the EMU, which can be regarded as a specific characteristic or consequence of globalization, intensify or tend to weaken unemployment in Europe?

What role can national labor market policies play in an era of globalization?

What are the measures that a national fiscal policy can take to counter possible negative consequences of globalization for employment?

What are the effects of globalization on inflation, and beyond this on national stabilization policies and unemployment?

The following provides a brief overview of the contents of each article which is based on abstracts which were mainly drawn up by the authors themselves.

Most of the articles, including the accompanying commentary papers, were presented and discussed at a conference in Hagen in March 1999, and then revised. The purpose of the conference, and of this volume, was/is (as with the previous project: Wagner, H., Current Issues in Monetary Economics, Physica-Verlag 1998) to have recognized experts deal from different sides with a current, strictly delineated subject in accordance with a defined structure, which was developed and stipulated by the editor.[1]

Following this introduction, the book starts with the first part which contains two papers on globalization. The first article by **Daniel Citrin and Stanley Fischer** (the First Deputy Managing Director of the International Monetary Fund) explores the extent to which globalization has increased policy interdependence and reduced governments' ability to control their own economies. They ask: does globalization make it more difficult to achieve the legitimate and desirable aims of economic policy? Their answer is that globalization makes it easier to attain the ultimate goal of economic policy, which is higher incomes; redistributive policies and social safety nets, however, should be used to ensure that these gains are shared fairly. Even in a business cycle context, they argue, globalization is on the whole a force for greater stability—even though at times large short–term capital flows can adversely affect macroeconomic stability, and asset prices, including exchange rates, can as a result become misaligned. Globalization can act as a force for stability by limiting the scope for countries to pursue policies that are

[1] As the editor of the book, I would like to thank all authors for their cooperation during the long process of organizing this project, of conducting the preparatory conference and for revising their papers under consideration of the strict layout requirements set by the editor and the publisher.

incompatible with medium–term financial stability. The disciplining effect of global financial markets applies not only to policymakers, via financial market pressures, but also to the private sector, by making it more difficult to sustain unwarranted price markups and non-productivity driven wage increases.

They stress, however, that at the same time, it has to be recognized that overexuberant international capital flows can at times permit disequilibria to develop, and can require excessively large output adjustments in emerging market countries when flows reverse. These real possibilities reinforce the case for strengthening macroeconomic policies and financial systems in emerging market countries—and they also emphasize the urgency of strengthening the international financial architecture.

In the following paper, **Kevin O'Rourke** examines the role of globalization in a historical perspective. He makes clear that globalization has been an ongoing process for centuries and that history shows that globalization can and has often been reversed. This reversal can be linked to the distributional consequences of globalization, at least in the cases of commodity trade and labor migration, as O'Rourke illustrates in his paper.

He first provides a brief survey of broad trends in the integration and disintegration of the international economy. He then focuses more specifically on the impact of globalization on labor, concentrating on the last great wave of globalization which occurred a hundred years ago. Finally, he explores the political issues associated with international trade and factor flows, again mainly in the context of the late 19th century.

It is argued in the paper that the late 19th century resembled our own period in many respects, with rapid changes in the international division of labor due to declining costs of doing business across frontiers. The key differences between the two periods appear to have been (1) that many more international transactions take place within the firm today than was true a hundred years ago; and (2) that international flows of labor and capital were proportionately much larger then than now.

The distributional consequences of these shocks were much more clear cut for land than for labor, at least insofar as commodity trade was concerned. In labor-abundant Europe, left wing parties favored free trade more because they thought it would bring cheap food, than because they believed it would expand labor-intensive activities and promote employment. In the rich, labor-scarce New World, where globalization might have been expected to lower real wages rather than raise them, there were far more echoes of today's concerns about trade, inequality and unemployment in OECD economies.

O'Rourke illustrates that it was migration that had the greatest impact on workers' living standards, and when immigration led to unskilled wages lagging excessively behind average incomes, governments intervened to stem the migration flows. There are obvious parallels here with today's concerns that rising inequality will undermine the political support for globalization. However, as O'Rourke argues, there are important differences between the two epochs. The mass intercontinental migration which lowered New World living standards is absent today; while international institutions such as the WTO would make it much more difficult for politicians to dismantle today's international economy, should their constituents demand that they do so. Nonetheless, he emphasizes that the late 19th century experience does serve as a useful reminder that the political support for globalization cannot be taken for granted, and that the distributional consequences of a more tightly integrated international economy matter not just in their own right, but because of the policy responses which they can provoke.

The **second part** of the book contains three articles on empirical and theoretical aspects of unemployment. It starts with a paper by **Ronald Schettkat** who focuses on the definition and measurement of unemployment and establishes some facts about unemployment in an international comparative perspective. Schettkat emphasizes the difficulty of measuring unemployment because of the theoretical and empirical problem of distinguishing between unemployment, employment and leisure. He stresses that unemployment (i.e. involuntary unemployment) can only exist in models of imperfect labor markets, but that there is no clear dividing line between 'unemployment and employment' in a theoretical sense. Apart from theoretical problems there are more pragmatic problems about the way in which unemployment and employment are classified. Schettkat discusses these pragmatic problems and deals with questions such as the following: are workers in public work programs employed, or is this kind of work so artificial as to equal unemployment? He then proceeds to a comparison of different data series measuring employment and unemployment. He uses national definitions and compares them with internationally comparative data provided by the US Bureau of Labor Statistics (BLS). This analysis provides a basis on which to evaluate the sensitivity of labor market figures to national definitions.

Another issue is the choice of indicators used to represent employment and unemployment. Different indicators (unemployment rates, employment-population ratios, and working volume per head of population) are used and the relationships between them are investigated. Finally, Schettkat briefly investigates simple relationships between labor market indicators and other key economic variables, such as growth, wages, technological progress and inflation.

The main empirical findings of the paper are as follows. All G7 countries experienced a rise in the unemployment rate in the 1970s and 1980s, although the trend was less pronounced in Japan and the USA. These unemployment trends were accompanied by very different trends in the employment-population ratios. Countries with declining employment-population ratios also experienced a decline in average working hours. A comparison of unemployment rates and employment-population ratios as measured by national concepts and the approximated US concept shows that the difference is important for unemployment figures. Only the USA displays a strong positive trend in working hours per head of adult population, which is mainly caused by increasing participation. Employment growth and population growth are closely correlated. Differences in GDP growth rates cannot explain divergent employment trends, although economic growth, of course, affects employment positively. Countries with strong employment growth also show a high employment elasticity of GDP growth.

In the 1990s, inflation has been lower than in the 1960s, in all G7-countries, but at the same time, unemployment is higher everywhere, with the exception of the USA. This pattern is broadly consistent with the unemployment-inflation trade-off, but unemployment is much higher in the 1990s compared to the 1960s suggesting a rise in the NAIRU, which –except for the US- can be found in the data everywhere. The problem with NAIRU explanations is, however, that they do not fit institutional changes well.

The paper by **Thomas Beißinger and Joachim Möller** deals with the theoretical explanations of unemployment. In the 1970s and 1980s, various competing theories put forward by the classical and Keynesian camps tried to find a convincing explanation for the unemployment problem. The structuralist model emerged from these research efforts as the dominant approach of the nineties, combining both classical and Keynesian features. By generating a relationship between changes in inflation and deviations of unemployment from the long-run equilibrium, this approach carries on where the old Phillips curve debate left off.

In their contribution, Beißinger/Möller do not confine themselves to a review of the research from the last decade, but rather stress the implications of several extensions of the macroeconomic model as well. Whereas in the standard structuralist model the demand side has a negligible influence on unemployment in the medium term, they show that stabilization policies are of greater importance once unemployment persistence and/or the openness of economies are taken into account.

Furthermore, Beißinger/Möller build on the structuralist framework to address not only the macroeconomic aspects of the unemployment problem, but also the debate between trade theorists and labor economists about the impact of globalization and biased technical change on the employment performance of different skill groups. In the literature, contra-factual implications of the standard Heckscher-Ohlin model are often used as an argument against trade-based explanations of the unemployment problem. By relaxing the assumption of perfect competition, they show that major aspects of this critique can be overcome. On the other hand, conventional wisdom which favors the biased technical change hypothesis, can be questioned. Things are less obvious if the general equilibrium effects of biased technical change are taken into account. In contrast to results following from a simple partial framework, it has been shown that the unskilled could profit via indirect effects from biased technical change. To obtain the stylized fact that the unskilled lose employment shares, Beißinger/Möller stress that not only is a high elasticity of substitution needed, but also certain additional assumptions about the impact of biased productivity growth on the skill-specific wage formation process.

The following paper by **Winfried Vogt** analyzes the interaction between the changing structure of employment and wages and a biased technical progress. The analysis is based on a two-sector model. The two sectors can be interpreted in two different ways. In the first interpretation, there is an industrial and a service sector (or a country which mainly supplies industrial products, compared with a country in which the service sector dominates). In the second interpretation, there is a sector (or a country) with skilled labor and a sector (or a country) with unskilled labor. If there is a trade-off between sector-specific rates of technical progress, a mutual dependence exists between the structure of wages and employment on the one side, and a biased technical progress on the other side. This interdependence causes endogenous changes in the structure of employment and wages. The main conclusions are: firstly, as the elasticity of substitution between the industrial and the service sector is likely to be low, an industry-biased technical progress will eventually disappear. In the long run, the industrial and the service sector will grow at the same rate, and the structure of employment will remain constant. Secondly, as the elasticity of substitution between skilled and unskilled labor is likely to be high, skill-biased technical progress will gradually increase. This will lead to a rising inequality of earnings. If there is an appropriate wage floor (fixed by the state or the unions), which prevents inequality from growing, the increase in inequality will be replaced by a continuous increase in unemployment for unskilled workers. If unskilled workers have the option to become skilled, they may still be worse off, if they have to bear the training costs. Nevertheless, the rising relative supply of skilled workers could prevent the decline of the relative position.

The **third part** of the book is concerned with the effects on unemployment resulting on the one hand from globalization in general, and on the other hand from the introduction of the European Monetary Union which can itself be regarded as a consequence of the globalization process. The paper by **Oliver Landmann** examines the effects of globalization on unemployment. The recent debate about the labor market effects of globalization has been shaped by the coincidence of several major trends:

- The emerging economies' share in world exports of manufactured goods has sharply increased since 1970 and is due to increase further in the future.

- In most advanced countries, since 1980 at least changes in the structure of labor demand have clearly favored skilled labor at the expense of unskilled labor.

– Wage differentials have markedly widened in the United States (and to some extent in the United Kingdom), but have remained largely constant or have even narrowed in most continental European economies.

– At the same time, the growth rates of real wages and labor productivity have been substantially higher in Europe than in the USA.

– Europe has experienced stagnant employment and rising unemployment, in particular among the unskilled, whereas the United States has enjoyed brisk employment growth and thereby kept unemployment low.

Landmann's paper reviews some widely held views ('conventional wisdoms') concerning the causes of and the interrelation between these developments. One such view states that every economy faces a trade-off between real wage growth and unemployment. The United States, it appears, has opted for high employment growth and low real wage growth whereas most European countries, through the design of their labor market institutions and policies, have made the opposite choice. Landmann maintains that this view rests on weak foundations: there is no relationship between the extent of wage pressure and the productivity of jobs in the long run, once the induced adjustment of investment spending is taken into account. However, a high-wage policy can influence the composition of the jobs that are viable and thereby affect the aggregate wage and productivity statistics. A negative relation between employment and the average wage level thus reappears as a composite effect.

Another conventional wisdom investigated in the paper claims that the shift of labor demand towards high skills has created a trade-off between wage inequality and unemployment. If labor markets are flexible, and if the demand shift dominates any shifts in relative supplies (that may occur at the same time), the wage differential between skilled and unskilled labor widens, which is what happened on the US labor market. In contrast, if relative wages are rigid, which is largely the case in most continental European economies, the demand shift leads to an increase in unskilled unemployment. This proposition is built on theoretically more robust ground than the first. But this does not mean that relative demand shifts are necessarily the dominant force behind the rise in European unemployment, nor is the empirical picture quite as sharp as one might expect. The correlation between measures of relative wage rigidity and the unemployment rates of unskilled labor is somewhat fuzzy, as Landmann stresses. This is not entirely surprising once it is recognized that skilled labor can be adversely affected even if labor demand shocks are biased against unskilled labor, and that unskilled labor is disproportionately affected even by aggregate labor demand shocks.

A third proposition, examined in the paper, concerns the role of globalization. According to widely held views, which are often reinforced by the popular press and the infotainment industry, globalization is a major cause of labor market problems in general and of the deteriorating situation of the less-skilled in particular. Landmann maintains that mainstream academic research does not support this view so far. The volume of North-South trade is simply too small for competitive pressures from low-wage imports to become a major cause of labor market disruptions in the North. Instead, non-neutral technological change is seen by Landmann as the main driving force behind the structural changes on the demand side of the labor market. But, as he emphasizes, it would certainly be premature to regard the issue as resolved. Once channels of causation are considered that lie outside the focus of traditional HOS models of trade, the case for a major impact of globalization appears to grow stronger. On a more fundamental level, recent work questions the separability of technological change and globalization.

The following paper by **Ansgar Belke and Daniel Gros** deals with a special regional aspect of globalization, namely the European Monetary Union, and its consequences for unemployment. It finds that intra-European exchange rate variability had significant economic costs. Simple VAR causality tests show that higher short run variability of exchange rates was associated with higher unemployment, less employment and lower investment for most EU member countries (including France and Germany). The evidence is somewhat less consistent for dollar variability. Robustness tests show that this result holds up in the presence of a variety of policy instruments (e.g., interest rates) and cyclical variables (e.g., GDP growth) that might have also had an impact on exchange rate variability. The point estimates suggest that EMU could lower the German unemployment rate by about 0.5 to 0.75 percentage points. These statistical findings can be interpreted in the context of a simple model that incorporates the 'option value of waiting' and which suggests that even short-term spikes in volatility can have a strong impact on investment, one of the main determinants of the labor market stance. Moreover, given the high cost of firing workers in Europe, the same reasoning should apply to employment. The implications for the cost-benefits analysis of EMU are clear. Should these results also be confirmed for other countries there would also be implications for the desirability of floating exchange rates in general and the role of the Fund in the global monetary system.

Eliminating intra-European exchange rate variability is often portrayed as one major advantage of EMU (reducing it was already a goal of the creation of the EMS in 1979). But Belke/Gros ask: why should politicians and economists care about exchange rate variability? Up to now the answer has usually been that exchange rate variability discourages trade. Unfortunately, a large volume of empirical literature on this issue has not been able to document a strong link between exchange rate variability and the volume of trade. However, Belke/Gros argue that the absence of a strong impact of exchange rate variability on the volume of trade does not imply that there should be no link between exchange rate variability and (un-) employment and investment. They ask: why would an increase in exchange rate volatility lead quickly to a lower volume (flow) of trade? The theoretical models that are used in this context start typically from the idea that in order to export a sunk cost must be maintained. This sunk cost is meant to represent the need to build up a distribution system in foreign markets and that this is really a sunk cost like in the bare bones model used here. But in Europe most firms already have a very elaborate distribution network in all member countries. A German automobile manufacturer will typically not have to build up a new distribution system in order to increase sales in other European countries. Hence Belke/Gros argue that certainly for intra-European trade (the focus of their empirical work) market access costs cannot be the main reason why exchange rate volatility should affect trade.

Of course, an increase in volatility will lead firms to discount future profits from exports more heavily (as often assumed in the literature and also in the model they used, see below). But, as Belke/Gros stress, this implies only that firms will invest less in export (or in general in trade-) oriented activities. This might depress future export (trade) volumes but firms will not necessarily export less in the short run just because exchange rate variability has increased. The long-run response will be much more difficult to isolate in empirical work because there are other long-run trends (e.g. reductions in transport costs, shifts in tastes, etc.) and because variability changes so much over time. Trade volumes today might be a function of some average of the variability experienced over a number of years but this would be difficult to measure even with the annual data on volatility that is often used. Experience with large exchange rate swings in Europe during the 1990s has once again shown that there is a lot of 'pricing to market', i.e. firms keep local prices fixed even in the face of large exchange rate changes. This implies, as they point out, that quantities react little to exchange rates, but profits by much more. Firms simply keep producing and export more or less the same amount, but their domestic currency earnings become variable whereas their domestic cost remain stable. Exchange rate variability can thus certainly influence the variability of profits.

If firms react to an increase in exchange rate (and hence profit) variability in the first instance by reducing investment in trade related activities one would expect little impact on trade flows in the short run, but, potentially at least, a significant short-run impact on investment (as Belke/Gros find in their empirical investigations) and on (un-)employment because investment is an important component of demand. Moreover, they stress that in most continental European countries (and even in the UK until the 1980s) hiring workers represents also an investment in the sense that there are high costs involved in reversing this decision. This is an additional reason (independent of the demand effect) why exchange rate variability should affect (un-)employment. Moreover, if labor is de facto a semi-fixed factor of production, the short-run marginal costs of changing the volume of production should be very high. This fits well with the observed sluggish reaction of trade volumes to the exchange rate changes mentioned above. Belke/Gros therefore argue that exchange rate variability should have little impact on production and export sales in the short run. Firms will typically be reluctant to engage new labor (which involves a heavy sunk cost in most European countries) if the variability of the exchange rate is high so that the probability that this labor will not be used after all is also high.

The **fourth part** of the book deals with the economic policy consequences of globalization. It starts with a debate on the role of labor market policy in a globalized economy. First, the paper by **Norbert Berthold and Rainer Fehn** deals with the much discussed question of how to design labor market policy in a global economy. The starting point of the paper is the fact that national unemployment rates differ greatly, which implies that country-specific institutional factors are the most plausible culprits for increasing and lasting unemployment. Hence, identifying institutional setups which promote employment growth is seen as a prerequisite for successfully fighting unemployment. To this end the paper is divided into three main sections. The first section provides a non-technical synopsis of the main causes of persistently high unemployment which can be observed in particular in continental Europe. Special emphasis is put on the question of how the ongoing process of globalization of goods and factor markets relates to the rise in unemployment.

Berthold/Fehn argue that there can be little question that globalization opens greater exit possibilities for capital that has not yet been invested which, once invested, is threatened with appropriation by powerful insiders in certain countries. They maintain further that globalization increases the potential for specialization in production and the pressure to switch from a Taylorite to a holistic organization of production structures thus exacerbating appropriability problems; that it broadens the technological menu by facilitating international technology transfers, thus allowing a greater degree of substitution of labor by capital; and, finally, that it exposes firms and workers to greater volatilities, i.e. to a less stable macroeconomic environment. They show how these factors interact and how they conflict with important characteristics of the German economy in particular, which, however, is not too dissimilar to a number of other continental European countries. These characteristics are mainly generous and long-term transfer payments to the unemployed, high firing costs and centralized wage-setting.

The second section of Berthold/Fehn's paper discusses how labor market institutions should be reformed, and how labor market policy should be redesigned, in order to achieve better employment results. Under the premise that the above-mentioned factors are indeed important for explaining the severe unemployment problem, they argue that the thrust of such reforms must be in the direction of reducing aggregate wage pressure, of achieving greater flexibility in wage-setting and in employment contracts, of correcting the currently distorted incentive structures for the unemployed towards their acceptance of a greater variety of jobs, and of helping the unemployed to build the kind of human capital that is actually demanded by firms.