Macroeconomic management and structural unemployment

*The **Governor** explains[1] the limited contribution that macroeconomic policy can make to resolving the problem of unemployment. He describes the experience of unemployment in OECD countries in the post-war period and the differences between the experiences in the United States, Japan, the United Kingdom and the rest of Europe. He examines the development of theories of unemployment and points out that, by almost any reckoning, a large element of unemployment at present is* structural*, and so beyond the immediate reach of macroeconomic policy.*

He examines the causes of structural unemployment, exploring in particular two commonly emphasised influences—technology and international trade. Both exert powerful commercial pressures on countries to adapt their types and processes of production; in so doing, they affect the pattern of the demand for labour. The level of structural unemployment, he suggests, depends on the interaction of these pressures and an economy's flexibility to respond, which is constrained in a number of ways.

Although there may be little direct contribution that monetary policy can make to alleviating structural unemployment, central banks do have a small but direct role, through helping to improve the supply-side functioning of the economy—and particularly by trying to ensure that the financial sector gives effective support to the wider economy.

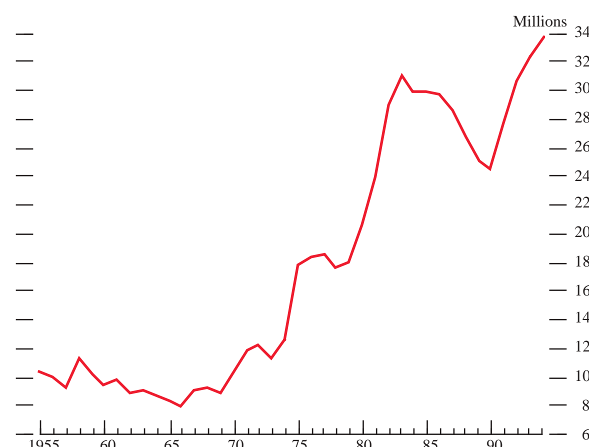
I am delighted to be here to give the 1994 Ashridge/City University lecture, and I have chosen to speak on the subject of unemployment. Those of you who read a series of newspaper headlines through the summer, suggesting that 'Unemployment is not our problem, say central bankers', may find this choice of subject somewhat quixotic. It is a fact—a regrettable fact—that central bankers do, through their emphasis on the importance of price stability, give the impression that they are indifferent to the problem of unemployment. That is not true in my experience, and I should like to try to dispel that false impression this evening.

I don't know any central banker who does not see price stability as a *means* to the end of sustainable economic growth and employment. But we are all very conscious of the limits to which monetary policy—and macroeconomic policy more generally, including overall fiscal policy—can contribute directly to 'full employment' in some absolute sense. I should like, therefore, to try to explain the important, but limited, contribution that macroeconomic (or conjunctural) policy can make to resolving the problem of unemployment; and then to explore some of the more deep-seated *structural* causes of unemployment.

Some facts

Let me begin by setting out some of the sad facts about unemployment—which is, of course, a problem in nearly all industrial countries, not just a problem for this country.

Chart 1
Unemployment in the OECD area



Note: 1994 observation point based on data available to Q3.

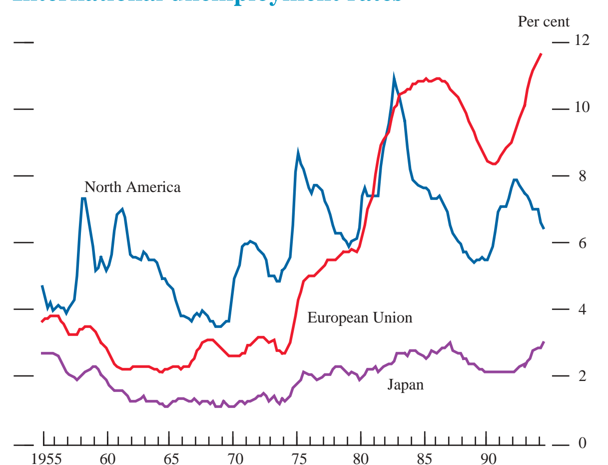
Unemployment in the OECD countries currently totals some 34 million people (see Chart 1)—and I emphasise that we are talking about people and not just numbers. That represents some 8% of the labour force across the whole area. The problem is less acute in Japan than elsewhere, with 2 million people unemployed, or only some 3% of the labour force—although there is a widespread perception of underemployment in Japan, with much recent talk particularly of 'window-side workers'. It is worse in the United States, some 6%. And it is most severe in Europe where, on OECD data, there are 17 million people unemployed in the European Union (excluding eastern

(1) In the 1994 Ashridge/City University lecture at Merchant Taylors' Hall on 2 November.

Germany), an unemployment rate of 11½%. Other measures put the number of people unemployed in Europe even higher.

For the area as a whole—and for Europe especially—these levels are without precedent in the post-war period (see Chart 2). In fact throughout the 1950s and 1960s, the number of people unemployed in the OECD area was around 10 million. It trebled between 1969 and 1983, declined only modestly—by some 6 million—in the later 1980s, before rising again, by some 8 million to the current level, so far in the 1990s. Most of these changes reflect what has happened in Europe, and the European Union in particular, where the rate of unemployment is roughly four times what it was 20 years ago, having risen from 2¾% to some 11½%.

Chart 2
International unemployment rates



To put it in context, although unemployment is now falling in the United Kingdom, we still have some 2½ million people unemployed—about 9% of the workforce—which is less than in most of the rest of Europe (see Chart 3). As in Europe, the UK labour force has increased very rapidly—by 1½ million in the past decade (see Chart 4).

Now there was a time when many people took the view that unemployment was essentially a result of inadequate demand, and that it could be reduced quite simply by pursuing expansionary fiscal and monetary policies. And so, of course, it could—up to a point and for a time. But what we saw in practice—rather clearly in this country, but not only in this country—was that there were limits to this approach, limits that were repeatedly exceeded.

Chart 3
UK unemployment rate

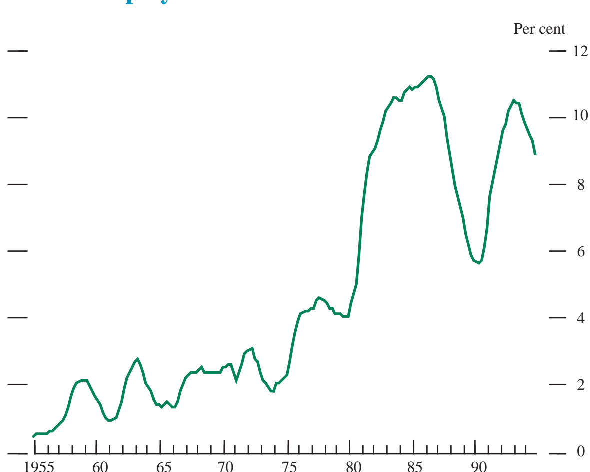
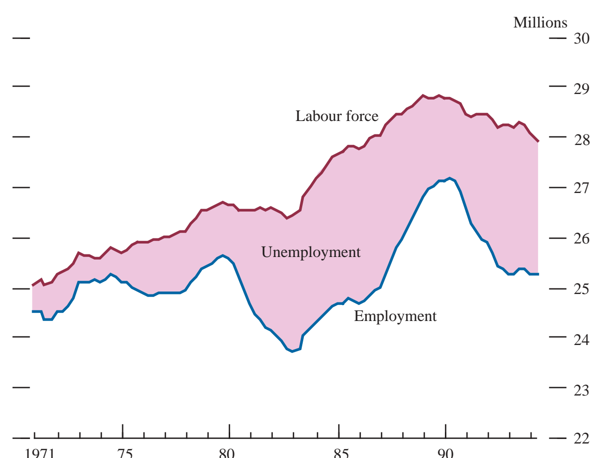


Chart 4
UK employment and labour force



Carried too far—or persisted in for too long—expansionary macroeconomic policies with the aim of boosting economic growth came up against capacity constraints and then spilled over into higher and accelerating inflation, and a worsening external trade balance. Policy then had to be tightened to bring the situation under control, which inevitably caused a short-term rise in unemployment.

But the problem with this approach went deeper than the mere ups and downs of each cycle. Over time, those ups and downs did cumulative damage. Though it's difficult to prove, instability almost certainly resulted in lower average growth and employment, and a lower rate of investment—and to that extent a lower potential rate of growth—than might have been achieved through the steadier and more stable expansion of demand and output.

The 'natural' rate of unemployment

The idea that there is a 'natural' rate of unemployment at which inflation is stable—a concept developed in the late 1960s—is now embedded in the economic literature. It emphasises that the results of trying to reduce unemployment below this 'natural' rate are unstable and potentially explosive for inflation. Conceptually, the 'natural' rate is determined by the structural characteristics of the economy, including importantly of the markets for labour and goods. Notionally, the question for macroeconomic policy is how to identify the 'natural' rate of unemployment at any particular time—in other words, to identify how far macroeconomic policy can be pushed before it begins to generate inflation. But beyond that are the much more fundamental questions about the structural characteristics that determine the 'natural' rate, and how it can be reduced in the future.

Again, conceptually, identifying the 'natural' rate of unemployment is largely a matter of separating out the cyclical component of unemployment from its trend. As a matter of observation, total unemployment in the United States has been characterised by a large cyclical variation around a fairly stable trend, while in the European Union the cycle—at least until the late 1980s—has been less pronounced but it has been superimposed on a strongly rising trend. And the United Kingdom has experienced large cycles in unemployment, around a less strongly rising trend; and it is encouraging to note that in the current cycle unemployment peaked at a lower rate than in the previous cycle and started falling much sooner—within a year of growth resuming.

From these observations it is possible to derive theoretical estimates of the 'natural' rate of unemployment in different countries or regions. By comparing these estimates with the actual levels of unemployment, you can then derive estimates of the cyclical component of unemployment which, again in theory, is that part of unemployment that one could legitimately hope to eliminate through an expansion of demand.

For what they are worth, the OECD's calculations along these lines suggest that the 'natural' rate of unemployment in the United States is some 6%–6½%, whereas it is 8½%–10% in the European Union. Their estimate for the United Kingdom—some 8%–8½%—is at or below the bottom end of the range for the rest of the European Union, and somewhere between it and the United States. Today, that leaves the United States pretty well at 'full employment' defined in terms of the 'natural' rate. Europe as a whole still has some limited scope—perhaps 1½%–3%—for a cyclical fall in unemployment which, on this particular arithmetic, is all that one could safely aim to achieve through macroeconomic management.

But these estimates are just that—estimates. Other estimates for the United Kingdom, for example, put the 'natural' rate much lower—down to perhaps half the OECD estimate. So they are not to be taken as a reliable guide for macroeconomic policy. The trend in unemployment itself may well be affected by the cycle or otherwise masked by it. As a practical matter, macroeconomic policy has to adopt a cautious approach, watching closely for early warning signs of renewed incipient inflationary pressure which, in terms of the theory, would signal that we were approaching the 'natural' rate of unemployment—or approaching it too rapidly—and, as they begin to appear, to slow the expansion to its sustainable rate.

Structural unemployment

But the more important point for my present purpose is that by almost any reckoning a large part of the present level of total OECD unemployment is *structural*. That means it is beyond the immediate reach of macroeconomic policy, and is unlikely to disappear as a result of the present cyclical expansion.

Confronted with this unpalatable prospect, Mr Chairman, it would not be surprising if the recent macroeconomic policy consensus within the OECD were beginning to fray. In fact I detect no signs of this.

Where the temptation in the past might have been for governments to seek to spend their way out of even structural unemployment, the shared understanding now is that unsound public finances, by pre-empting national savings and deterring private investment, would be likely only to make things worse in anything but the short term. Fiscal policy therefore is being directed to reducing government deficits, not just as a result of the cyclical upswing but also through discretionary tightening to reduce structural deficits. This certainly was the intention—and the effect—of the two budgets in this country last year.

Similarly, monetary policy everywhere remains firmly directed to achieving and maintaining price stability. In several countries recently, this has been seen in a greater readiness than in the past to tighten policy pre-emptively before pressures appear in the retail price statistics. The shared understanding here is that inflation is more likely to discourage investment, by damaging industrial confidence in the sustainable growth of demand, than timely—and in the end smaller—increases in interest rates.

Here, too, the perception is that if monetary policy were to target unemployment directly, without regard to the supply capacity of the economy or to the inflationary consequence, that would only make the problem of unemployment worse in anything but the short term. That's what central bankers mean when they emphasise price stability. It's not that they don't care about unemployment; it is that price stability—a sound monetary framework within which businesses and their customers can plan their affairs for the longer term, without the fear that those plans will be upset by erratic and unpredictable fluctuations in the value of money—is the best contribution that we can make to getting unemployment down in the longer term.

Now this orthodoxy—and it is now the orthodoxy—is all very well, you may say. But if that's all you can do through macroeconomic policy—through monetary policy, in particular—what are we going to do about the appallingly wasteful and socially unacceptable levels of structural unemployment?

And that, of course, is the question which has increasingly, and quite rightly, pushed itself to the top of the political agenda. It is much the most urgent and important economic issue confronting the European Union; and in a different form, of low real wages—poverty in work—it is equally important in the United States. That is why we have seen this year the excellent OECD study on employment and unemployment published in May and on which I have drawn heavily in preparing this lecture. We have also had the Delors White Paper published towards the end of last year, together with the jobs summit in Detroit last March.

Composition of unemployment

You won't be surprised to learn that I don't pretend to know all the causes of structural unemployment, let alone the cures. But in thinking about them, it is probably helpful to start with some more facts—this time about the *composition* of unemployment within the OECD.

Obviously, some groups of people are affected more severely by unemployment than others. Unemployment among *young people* (under 25), for example, is much higher in the OECD than the overall average rate of unemployment—some 15% against 8%; and youth unemployment is much higher in the European Union generally (20%) than in the United States (13%). Within Europe, it ranges from 30% or more in Italy and Spain, and some 25% in France, to around 5% in Germany. In the United Kingdom, youth unemployment is closer to the rate in the United States.

Long-term (over one year) unemployment, which typically affects older people particularly severely, is also much higher within the European Union—nearly half of the total number of people unemployed—than it is in the United States, where the proportion is only around 10%. In the United Kingdom, long-term unemployment is about one third of the total, but again encouragingly peaked at a much lower figure than in the previous cycle and has started to fall more quickly.

These differences in the proportion of long-term unemployment reflect different rates of unemployment *turnover*, with the monthly inflow to unemployment in the United States more than six times higher than in the European Union, and more than three times higher than in the United Kingdom (see the table). And the United States

Unemployment flows and duration

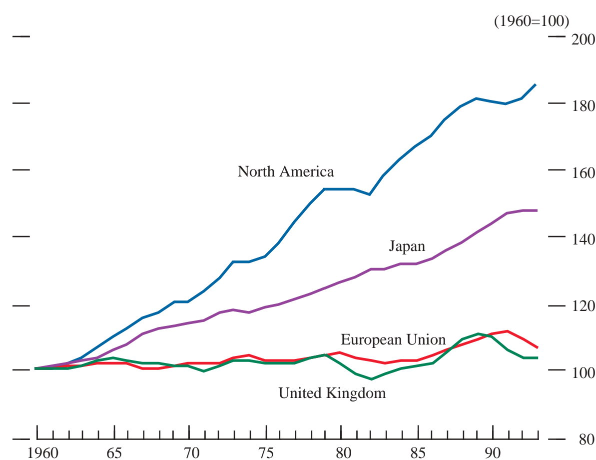
	Inflow rate (a) (1987–89)	Outflow rate (b) (1988)	Implicit average unemployment duration in months (1987–89)	Long-term unemployment (c) (1992)
United Kingdom	0.8	9.5	10.2	35.4
European Union (d)	0.4	4.7	30.9	42.2
United States	2.6	45.7	2.2	11.2

Note:
(a) Monthly inflow to unemployment as a percentage of labour force.
(b) Monthly outflow from unemployment as a percentage of total unemployment.
(c) Defined as duration > 12 months; expressed as a percentage of total unemployment.
(d) Because of lack of data, EU figures exclude Luxembourg and Portugal.

Sources:
(1) *High and persistent unemployment: assessment of the problem and its causes*, OECD Working Paper No 132.
(2) *OECD Employment Outlook*, page 12, July 1990.
(3) *OECD Jobs Study*, Table 1, 'The profile of OECD unemployment'.

has seen much faster *growth of employment* (see Chart 5), with a net 40 million jobs created in the United States since 1973—mostly in the private sector—compared with only around five million in the European Union, nearly all in the public sector. Indeed, within Europe, only the United Kingdom and Germany created net private sector employment during this period. In short, it is easier to lose your job in the United States, but easier to find another one; whereas in Europe, while there is less risk of becoming

Chart 5
Employment in OECD regions



unemployed, you are likely to remain unemployed for much longer.

Changes in the pattern of employment have been broadly similar throughout the OECD area, with a continuation of the long-term decline in employment in agriculture, and to a lesser extent in manufacturing, with most of the new jobs growth coming in service industries. Other characteristics include a reversal of the long-term decline in the proportion of self-employment in many OECD countries, including particularly the United Kingdom, as well as an increase in part-time working, again including in this country. And although I don't have internationally comparable data, I suspect that one would find a pattern of increasing employment in smaller-scale businesses if the UK experience is anything to go by.

Over the past 20 years as a whole, all OECD countries saw a shift of demand away from unskilled to more highly skilled jobs. But this shift did not persist in the 1980s in the United States, where wage differentials widened and real wages actually fell in absolute terms—in contrast to European experience.

Explanations of structural unemployment

Now, against that background, what are the *explanations* that are offered for the high level of structural unemployment? Recent discussion has tended to emphasise two main influences affecting both the overall demand for labour and the pattern of demand for labour in the industrial countries. They are technology and international trade, and I will discuss them in turn.

I suppose that throughout history established producers and their employees have felt threatened by new products and new techniques made possible by new inventions and new technologies. I dimly recall something about the Luddite riots from my history lessons at school. And of course innovation—driven by competition and itself driving competition—can threaten employees, businesses and countries whose established activity is challenged, making

particular materials or capital investments, or particular human skills, obsolete.

The experience of history, on the other hand, is that at the macroeconomic level technical progress is a very positive influence as an engine of economic progress, increasing *aggregate* economic activity and welfare, notwithstanding the often painful problems of transition as resources are transferred to meet other economic needs. History demonstrates too of course the ultimate futility of established interests seeking to hold back the tide of technical progress, which then simply washes all around the sand-castle until it is eventually overwhelmed.

Perhaps I am just getting old, but I am not alone in the impression that technical progress has been speeding up—and continues to accelerate—everywhere. The effect on the labour market, put very simply, is to increase the demand for new skills—typically 'higher' skills in the sense that they require more education and training or retraining to acquire—and to reduce, at least relatively, the demand for the less skilled or for skills that have become outdated. That certainly has been the pattern that we have seen throughout the industrial world. More rapid technological advance has also meant the more rapid rise and fall of particular companies or whole industries, with the result that fewer people can now expect to remain in the same job for life.

What it does for aggregate employment in the longer term is not clear, though, as I say, historical experience is generally encouraging, with technical progress tending to reduce the 'natural' rate of unemployment over time. At the level of the individual employee or the firm or the country or region, its effect depends on how adaptable they are. This is partly a matter of attitude, how far they embrace change rather than resist it; and partly a matter of the flexibility of the structural context—the flexibility of the labour market and of welfare arrangements, the regulatory regime, or the education and training system, for example, which help to determine how far at the microeconomic level people and businesses are capable of adapting.

Somewhat similar considerations apply in the case of international trade. There is no serious dispute that trade—within and between the industrial countries, but also globally—is a positive influence on world economic activity, encouraging global economic development and raising average living standards. But of course that does not mean that every employee or business or even nation necessarily benefits—certainly not in the shorter term.

The fashionable concern is over the 'threat' which the emerging countries, and some of the countries in transition to a market economy, pose to production and employment in the industrial world. It is, of course, a fact that productive capacity—capital, technology and management—can and does move very freely to almost anywhere in the world for many reasons, but one of them being to take advantage of low-cost labour (allowing for relative productivity).

Now it is possible to exaggerate the present significance of this new 'threat'. Certainly developing-country exports to the developed world have been growing quite rapidly, and the four original newly-industrialising, or 'tiger', economies of Asia have been an important part of that, though they still account for only some 2% of world GDP and 7% of world trade. In the case of both the United States and the European Union as a whole, *total* imports amount to not much more than 10% of GDP and imports from the four Asian NIEs to less than 2%.

So competition is still being driven predominantly by trade within and between the industrial countries, and that in itself is enough to affect the pattern of demand for labour. Nevertheless it is clear that production will continue to expand very rapidly in many of the emerging economies, and that they will over time come to form a much larger part of the world economy. They will, therefore, increasingly challenge existing production in the industrial countries over a wider range of output.

Again at the macroeconomic level, the growth of the emerging economies is in the longer term an opportunity rather than a threat. Rising incomes there will spill over as increasing demand for those goods and services in which the industrial world has, and continues to have, a comparative advantage. There will be rich rewards for those—individuals, businesses and countries—that are able to adapt to the changing pattern, and to identify and satisfy those increasing demands. We are already seeing more and more specialisation, with even smaller businesses trading across a widening range of countries. Meanwhile, because much of the advantage of the emerging economies is based upon relatively low cost labour, their development is likely to accentuate the changing *pattern* of demand for labour already identified in the industrial countries as a whole.

Not surprisingly, on this front too some established interests are instinctively inclined to look for protection. This of course ignores the interests of consumers in the industrialised countries, who are less well organised and less able to make themselves heard. And it ignores the interests of those who can adapt and those who stand to benefit in future from growth in the emerging countries, who by definition are yet to be identified.

Taking technology and trade together, what we see then—up to this point—are powerful commercial pressures within and on the industrial countries to adapt both the pattern and the processes of production. These pressures are causing a major industrial restructuring, particularly by larger companies, which are typically reducing the size of—but improving the quality of—their workforce, changing the pattern of demand for labour in favour of the more highly skilled and those with transferable skills and against those with lower, more industry-specific, skills.

What that does to the overall demand for labour is unclear. Technical progress and international trade are continuous processes. It may be that the present restructuring is a

transitional period of particular turbulence, and that in the longer term the trend rate of growth in the industrial countries will be increased and the 'natural' rate of unemployment be reduced. In the meantime anyway, it depends—in the aggregate, but more particularly for each country individually—on how adaptable the industrial economies are and on how flexibly they respond to the pressure to change. In the remainder of my lecture, I will consider some of the factors that bear upon this capacity to adapt.

Flexibility in industrial economies

One factor which I have already touched upon is real wage flexibility. The changing pattern of demand for labour has produced a sharp widening of income differentials in the United States, with real wages for the unskilled falling in absolute terms, whereas they have risen elsewhere, including in the United Kingdom. Relative earnings of the top 10% compared with the bottom 10% of employees in the United States rose from under 5 to over 5½ times during the 1980s, whereas it fell marginally—to about 2¼ times—in Germany. In the United Kingdom, it rose from 2½ times to something over 3 times. This, almost certainly, is one reason for the impressive job creation in the United States and why unemployment there has not shown the same upward trend as in the European Union. It has, on the other hand, resulted in growing concern in the United States about 'poverty in work' of many of the unskilled employees.

But the degree of real wage flexibility is not the only difference between the US and the European labour markets. Broadly speaking, one might characterise the US labour market as largely unregulated, compared with the extensive regulation within continental Europe—with the United Kingdom somewhere in between.

There are many aspects to this and the position varies from one European country to another. But in general, labour market legislation imposes more restrictions, for example, on hours worked, more constraints on redundancy, and there is more provision for minimum wages. Labour taxes tend to be higher in Europe, while unemployment benefits are also typically higher in relation to average earnings and of longer duration. Typically too, labour market institutions are more structured in Europe than they are in the United States, with stronger trade union and employer representation—of 'insiders' at least—in industry-wide negotiations and so on.

Now there are no doubt pros and cons in relation to all of these arrangements. They—and their overall economic and social effect—are for others to debate. In all industrial countries, governments are re-examining labour market incentives and welfare provision, and the United Kingdom in particular has been active in these fields. My purpose this evening is simply to draw attention to the differences between the United States and continental Europe, which must go some way to explaining the greater labour market flexibility in the United States and its lower level of structural unemployment, albeit with lower relative real wages for the unskilled.

All of this, of course, is very sensitive ground for a central banker. But having got this far, let me venture a little further, because the potential for tension between the commercial pressures I have described on the one hand and social concerns, including unemployment, on the other does not stop at the influences on real wages and labour market arrangements. In principle, *any* form of social intervention—from state provision for education or health, for example, which has to be paid for through taxation, to regulation providing, say, for environmental or consumer or investor protection, which involves costs of compliance on industry—can, certainly for good as well as for ill, affect the ability of individuals, businesses and the economy at large to respond to the commercial pressures that confront all the industrial countries.

Now I don't pretend to any expertise in most of these areas. Nor do I presume to make social judgments. There clearly are areas in all this where the commercial pressures and the social concerns run—or can surely be made to run—in the same general direction. I would suppose that it is true of education and training, for example. But in principle it is true of anything that improves the productivity or potential productivity of the workforce. In other areas, it may be more difficult to strike the right balance between some particular forms of social protection, however desirable in themselves, and the flexibility and competitiveness of industry. All I would say, as a banker, is that there are always two sides to a ledger, and it is very important that both sides are carefully examined.

It is in this context that I welcome the fact that all new primary and relevant secondary legislation, including proposals for European legislation, is now subjected to a compliance cost assessment in this country; and the Deregulation Bill, which will help to identify unduly burdensome or unnecessary regulations, has a similar objective. I know that you, Mr Chairman, are forcefully representing the business case for deregulation in the expert group set up following the Corfu Summit earlier this year.

The limitations of monetary policy

My concern as a central banker, and my particular concern this evening, is not to try to provide the solutions. Rather it is to try to understand the questions—the reasons for structural unemployment in the industrial countries. If these are, as I suggest, to be found in the interaction between the commercial pressures of competition—stemming importantly from technology and trade—and constraints of various kinds on the flexibility with which the industrial economies can adapt to those pressures, then you will understand why central banks generally are so conscious of the limitations of monetary policy.

I don't believe that we would help to resolve these fundamentally difficult structural problems in an already

rapidly changing world by adding to them conjunctural uncertainty. That, in my view, would only make things worse, by obscuring the relative real values of different activities that has to guide the process of identifying our respective areas of comparative advantage.

Outside mainstream monetary policy there are, I think, things that central banks *can* do to improve the supply-side functioning of the economy, especially by trying to ensure that the financial system is effective in its support of the wider economy. This is why the Bank takes such a close interest in the financing of small businesses, for example; and it is why we are participating in the Chancellor's Private Finance Initiative, trying to find ways in which private-sector disciplines can be brought to bear on traditionally public-sector infrastructure projects. But the best help we can give through monetary policy is to provide a stable monetary framework within which government and everybody in the private sector can work together to solve the structural problems.

Now there will still be those who say, 'Well that's as maybe; but they really *could* do more through monetary policy, if they really understood the social and economic devastation that unemployment causes, if they really understood the effect on people's lives—if they really cared.' For them particularly, I should like to conclude with a quotation from a book published exactly 50 years ago this week. The book is *Full Employment in a Free Society* by William Beveridge—a man of immense compassion and passionate in his concern about unemployment. He wrote:

'The part of the State lies in the adoption of a definite policy of stable prices . . . it is unreasonable to expect from trade unions a reasonable wage policy, unless there is a reasonable price policy . . . One of the first and most obvious signs that total outlay was tending to be excessive in relation to the productive resources available would be a rapid rise in prices . . . Inflation is almost as much an evil as deflation. Price policy must be an integral part of the full employment policy. Nor is there room for practical doubt as to what that policy should be. It should be a policy of maintaining a stable value of money . . .'

You don't need to accept all of Beveridge—or his particular prescriptions for achieving this end—to realise that he had a crucial point. It is a point that we have not always taken in the intervening years—but one which is now more widely understood.