

## **Lessons to be Learned from the European Unemployment of the 80s**

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Economics as a science is aimed at dealing with specific phenomena. Its progress indeed comes from reflections and research works motivated by real problems. European unemployment of the 80s is a major fact today. Studying it and reflecting on it ought to be more generally rewarding for a scientific understanding of the economic phenomena. This is thus a topic that should interest economists around the world. Although it is well recognized, its significance may be underrated, in particular in North American universities, which play such a dominant role in what the profession talks about.<sup>1</sup>

In order to induce a wider discussion of what ought to be learned from this recent historical experience, I shall first summarize the description of the phenomenon and the main explanation that has to be given of it. I shall then be in a position to consider the implications for building the macroeconomic theory. In the last section of this talk, and speaking more tentatively, I shall venture some conclusions for development economics.

### **I. THE PHENOMENON**

For present purposes a general overview may describe not only the main trends in the labour market but also their impact on European society. While dealing with explanations, it must also discuss what is meant by an explanation and which approach is appropriate for deriving it.

#### **1. A Sustained Unemployment with Disparities**

According to standard statistical definitions and methods of observation, the unemployment rate for the nine countries of the former European Economic Com-

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<sup>1</sup>Some good research work, however, is done in the US on European unemployment. A particularly notable example is provided by a recent book by R. Lawrence and C. Schultze (1987). A careful reader will note significant differences between some of the explanations put forward in that book and the ones stressed here.

munity<sup>2</sup> fluctuated around 2 percent in the 60s. It had slightly increased by 1973 (2.4 percent). The crisis at the time of the first oil shock brought it up to 5 percent in 1977. With the depression of the early 80s it jumped to 11 percent in 1984, remained roughly constant for three years, and is now only slightly decreasing. For 1989, it should still be about 10 percent and present forecasts anticipate only a slow recess.

The present high unemployment is very unevenly distributed, according to age and sex, but still more according to the level of qualification and according to region. For individual characteristics I may give the 1987 reliable French figures, which are roughly typical for Europe, in spite of some national specificities. For adult men (25 to 49 years old) the unemployment rate was equal to 6.7 percent, and for adult women to 8.0 percent. But the levels and the sex disparities were definitely higher for older workers (8.4 and 13.3 percent) and for younger ones (20.7 and 28.5 percent). For workers of all ages and sex, the unemployment rate was lower than 5 percent in the various categories of professionals and the self-employed; but it exceeded 15 percent for unqualified manual workers and white-collar employees.

Within the European Economic Community, national differences are important, ranging in 1989 from 5.6 percent in Germany and 5.2 percent in Portugal (not to speak of Luxemburg at 1.8 percent), to 17.6 percent in Spain. Moreover, within large countries, there are often very important regional disparities: in Italy, for instance, more than 15 percent in some of the southern regions and less than 5 percent in Valle d'Aosta.

## 2. An Endured Unemployment

The conventional wisdom in postwar Europe upto the early 70s was that our society would never accept again the mass unemployment that had prevailed in the 30s. Social objectives were said to be highly valued on our side of the Atlantic, where the welfare state had indeed been much developed. Any major increase in unemployment would cause a socio-political disruption. Such a belief explains the first reactions to stagflation in most countries in the mid-70s.

Since then it has been a surprise to realize that unemployment was endured and occurred generally with less public unrest than had been experienced during the last decade of fast growth. The acceptability of unemployment, of course, has to do with the income compensation granted to the unemployed: it is now fairly substantial and extends in Europe for much longer spells of unemployment than in the

<sup>2</sup> I.e., excluding Greece, Portugal and Spain, for which comparable data are not available before the 70s (but including them would not change the picture and only slightly increase the level of the aggregate unemployment rate).

U.S. Although poverty did develop in Western Europe during the past fifteen years, it does not hit the majority of unemployed workers. It was, for instance, estimated in France in 1979 that on average unemployment of the husband or wife in a manual worker's households meant a decrease of consumption of some 15 percent only [Fournier, Glaude et and Reynaud (1984)].

The slowdown of the growth of real product, of course, directly reacted to the improvement in standards of living. But most of the previous social transformations went on pretty much along the same trends as before. One can witness the significant impact of unemployment only on the labour market behaviour: the trend towards earlier retirement accelerated, while the trend towards a larger participation of women in the labour force somewhat slowed down.

By far the most important change was an increased duality in the European society with respect to working status: while a large majority of the working age population holds permanent jobs, young people, particularly those unqualified, often experience years during which they can find only occasional work between periods of unemployment; some adults remain unemployed for a very long time, and a few others work in the black economy with little social protection. For people living in hard conditions within the Third World, this duality would appear fairly innocuous; but its progress in Europe is undoubtedly resented.

### **3. Explaining it: The Approach**

The lessons to be learned from this unexpected and unwanted phenomenon, of course, depend on the explanation that is given of it. But the explanation must receive a sufficiently large support in the profession, so as to provide an objective reference. This requirement unfortunately forces us to remain at the level of a fairly immediate, hence not a very deep, explanation.

Before I am more explicit in the next section about this explanation, I must avoid misunderstandings and make a methodological point. A good deal of the literature that pretends to explain European unemployment is really addressing a different question; not why unemployment is so high but why it is that the excess supply of labour did not spontaneously disappear. This is, then, a question about the working of the economic system. The question has a clear theoretical interest, but answering it is neither necessary nor sufficient for our purpose, which is more practical or empirical.<sup>3</sup>

It is also worth making another methodological point. The requirement to base our reflections on a solid explanation of the phenomenon rules out acceptance

<sup>3</sup>The distinction between the empirical question and the theoretical question was made by A. Blinder (1988) in his Ely Lecture, but was not much stressed by him. Indeed, he spent almost all his time on the theoretical question.

of synthetic hypotheses that are supposed to provide a single broad explanation for a wide range of phenomena, but have not yet been submitted to really persuasive tests. Typical, in this respect, is the thesis proposed by M. Olson (1982) giving the main role to the rigidities and inefficiencies generated by the development of pressure groups in non-perturbed societies. Such broad theses do suggest useful conjectures at the exploratory stages of research, but they assume too many untested cause-effect relations to provide the required reference for purposes such as those of this lecture.

In other words, I believe that we must accept in our search the step-by-step strategy that is common in mature sciences and implies that one identifies first the most proximate causes, then looks for an objective assessment of the causes of these causes, going progressively upstream the causation chains, making each step secure before going to the next one. We have to make a reference to what has been so proved up to now.

#### **4. Explaining it: Present Conclusions<sup>4</sup>**

Almost everybody agrees that the present high unemployment in Europe means an excess supply of labour, and is mainly due to a deficiency of the demand for labour. This starting point is hardly disputed in practice, except by very few economists with a strong attachment to equilibrium analysis with market clearing.

Similarly, almost everybody agrees on the proximate causes explaining why the demand for labour was deficient; these causes are the disorder of the world economy since 1971 (wide fluctuations of exchange rates, abrupt changes in the price of oil, depressing effects of excessive indebtedness as well as of oil shocks, and so on), the increasing competition from Japan and the Newly Industrialized Countries, and finally a particularly poor European adaptation to the new situation so created. But in what and for what reason was European adaptation poor?

The dominant thesis explains the poor adaptation by three features: (i) political division and the low degree of coordination between national economic policies, and this feature inducing a deflationary bias; (ii) institutional rigidities, which prevented the free working of competition and therefore the necessary adaptations; and (iii) an inappropriate response of the system of prices and remuneration rates, resulting notably in too high real wages during a decade or so. But within this main thesis, opinions vary as to the respective importance of these three features and their interplay. For some people (i) is the main problem; for others it is (ii); for

<sup>4</sup>The following presentation has to be brief, hence it must accept the risk of appearing disputable. A much longer text would be required if justifications had to be spelled out. The precise meaning of some statements would require a good deal of explanation for a reader not acquainted with the macroeconomic literature.

others still it is (iii), which some, however, may explain in part by (ii).

Without denying the roles of the two other significant features of European stagnation, I concentrated my reflections during the past decade on trying to evaluate the responsibility to be given to the macroeconomic disequilibrium of remuneration rates. Briefly stated, my conclusion is that we should focus our attention on the profitability of production; we then see that it was strongly depressed both by high real wages and high real interest rates. There exist good reasons to believe that, when profitability is low, a further deterioration following, for instance, a wage push has a negative impact on the evolution of productive capacities and of competitiveness; hence also a negative impact on the medium-term evolution of employment [Malinvaud (1989)]. This factor was certainly significant in Europe in the 80s, up to quite recently.

## II. LESSONS FOR MACROECONOMIC THEORY BUILDING

What are the conclusions to be drawn from this historical case for our more general understanding of economic phenomena? The question deserves a wide discussion among economists. As for me, I believe I see fairly well its implications for macroeconomic theory; they are the importance of the medium run, the significance of disequilibria, the nature of supply analysis, and the role of competitiveness.

### 1. The Medium Run

Macroeconomics was promoted in the 40s as a theory of the short run, with direct applicability to business fluctuations. Later, the emergence of growth theory, with the work of Solow in particular, resulted in a macroeconomic theory of the long run. The vision most commonly entertained in the 60s about the macroeconomic evolution assumed the existence of short-term fluctuations super imposed on long-term trends. An analysis of each one of these two aspects could proceed independently of an analysis of the other.

This natural division of the discipline is now challenged in various ways. In particular, one can no longer be satisfied with the idea that business fluctuations ought to be studied as being only the rather short-lived impacts of a sequence of random perturbations. Some argue that the main change in our vision ought to be to recognize that the effects of many perturbations persist in the long run, as in a random walk. I do not want to dismiss here this new conception, although it may be a little overstressed at present. In any case, I believe it is hardly better suited than the previous one for dealing with the phenomena that have the dimension of a decade or so — as the European mass unemployment has.

We cannot expect to find a reliable framework in a purely mechanical model, whose justification would only come from the observed macroeconomic regularities. A long experience with the empirical search for such regularities has shown that it

almost always was disappointing. One should have realized by now that, in order to take full advantage of macroeconomic observation for the scientific determination of economic laws, one has to confront this observation with theoretical models, whose assumptions embody our direct knowledge of economic institutions and of the constraints and motivations of economic behaviour. In this respect, some of the recent literature promoting the random walk vision appears as retrograde.

The special features of the medium run, by comparison with the short and the long run, have two origins. On the one hand, some exogenous perturbations to the growth process are sustained for a number of years without being permanent. Moreover the most significant ones are identifiable, hence they should not be treated as random shocks. Nevertheless their role may very well be negligible in the short-term analysis. On the other hand, experiencing a lasting disequilibrium the economic system and the socio-political system react. These reactions are of a different nature from the one that patterns short business fluctuations. They may contribute to the long-run stability of the system.

Different kinds of exogenous perturbations, different kinds of endogenous reactions: two reasons for a relative autonomy of the study of the medium run with respect to that of the short run. Similarly, perturbations and reactions may not be a matter for major concern when a long-term horizon is considered; this explains the relative autonomy of the growth theory with its study of equilibrium paths. Of course, the phenomena involved in the three time dimensions are not really independent of one another. But since the representations provided by our theories necessarily simplify, it seems to be legitimate at this stage in the development of economics to spend efforts for the building of theories intended to be efficient for dealing particularly with the medium-term phenomena.

Focusing on this objective may lead not only to concentrate attention on substantial questions that were not studied enough. Some of these I am going to discuss, and also reconsider some methodological practices concerning econometric inference as well as model building.

## **2. Disequilibria**

It would be out of place here to discuss at length what should be understood in economics by the words "equilibrium" and "disequilibrium". This has been done many times, at least since the essay written on this subject by F. Machlup (1958). As I have had occasion to stress earlier E. Malinvaud (1977), the present usage entails a serious risk of confusion: equilibrium is most often meant as a hypothetical situation meeting a number of consistency requirements specified in the theory under discussion; disequilibrium is most often meant as a discrepancy between the demand for some goods or services and the corresponding supply. This last usage also prevails when the discourse implicitly or explicitly refers to a theory that does

not require market-clearing; hence a theory in which an "equilibrium" admits "disequilibrium" on some market. A single man cannot change the accepted language; hence I have to conform to it. But I thought at least a warning was necessary.

European unemployment shows that a situation of excess supply can last for a fairly long period in the labour market, even in developed market economies. Hence, the macroeconomic theory of the medium-term phenomena must recognize the possibility of this type of disequilibrium. More delicate is the question to know whether it must also recognize the possibility of a lasting disequilibrium on the markets for goods. In this respect, the choice of the proper specification seems to be somewhat uncertain at present. Reflecting on the European experience may help in identifying the issues.

Neglecting short-term fluctuations, one may say that the margin of unused industrial capacity did not change much in Europe during the last two decades. There was a moderate upward trend in the 70s and a downward trend in the 80s. As a first approximation, one may speak of a match between the medium-term evolutions of productive capacity and of output. There was no massive excess supply of goods: at almost any time output would have positively reacted to an increase in demand, although much less than the traditional multiplier theory would have implied.

Neither can one speak of a visible excess demand for goods. Buyers were not rationed. Since all European economies are largely open to foreign trade, this is not surprising. To a large extent, increases in the demand for goods tended to be met by imports. The resulting deficits in current balances of payments induced two reactions: on the international financial markets an interest rate differential occurred against the currencies involved; alternatively, or often simultaneously, governments of the countries concerned adopted deflationary policies in order to curb the increase in demand and to restore external balance.

From this account one may draw a first conclusion, namely, that an analysis of the changes in the supply of goods has to play an important role in the macroeconomic theory of the medium run. This was perhaps obvious, considering in particular the role of supply analysis in the theory of growth. But I think it is often not fully recognized.

Beyond this conclusion, whose consequences will be discussed in the next section, the question that remains to be answered is how one should best specify the model for the whole economy. I consider the question to be still largely open today. As on other occasions, several types of models, dealing with different aspects of the phenomena and thus complementing each other, may provide the best answer. In particular, static and dynamic models may both be useful for a complete grasp of what is a complex reality. My comments, however, will be limited here to the specifications suited for static analysis.

Clearly, one simple specification within the framework of the Barro-Grossman model or equivalently the model used in E. Malinvaud (1977) would not be suited, namely, the one in which the market for goods is assumed to be cleared by an adjustment of the price of goods, whereas an exogenously given nominal wage rate prevails on the market for labour. Such a specification, which was sometimes said to be implicit in Keynes' General Theory, would be unrealistic since econometric studies show everywhere a high degree of actual indexation of wages on prices. Moreover, it does not take into account the fact that many market for goods are open to foreign trade.

One may find interesting specifications in the literature dealing with the short-term equilibrium with rigid prices and wages in open economies [see for instance Cuddington, Johansson and Lofgren (1984)]. Some of these specifications may be appropriate with little change for medium-run analysis. For instance, for some applications one may assume exogeneity of both the real wage rate and the prices of traded goods, whereas the prices of non-traded goods clear their market. The foreign trade balance may then induce policy reactions intended to control the evolution of domestic demand.

It seems to me that many questions concerning medium-run disequilibria are properly discussed in a model that assumes exogeneity of the real wage rate and does not distinguish between traded and non-traded goods, but introduces a feedback from the foreign trade balance to the real interest rate [E. Malinvaud (1989a)].

Even admitting that several routes may be worthy of a theoretical exploration, I must, however, stress two methodological points. On the one hand, the distinction between demands and supplies, together with the recognition of the mutual autonomy of several of their respective main determinants, must remain a basic principle of macroeconomic analysis. The importance given to this distinction is now questioned by some economists who argue for an approach in which its role would appear as secondary [see for instance C. Plosser (1989), p. 57]. This is tantamount to suggesting that no disequilibrium has to be identified in economic phenomena, no matter what the facts are.

On the other hand, looking at the anomalies in the structure of prices and remuneration rates is as important as looking at excess demands and supplies, because these anomalies play an important role in market disequilibria. They have often been called "distortions"; but using this word may convey the idea of a deliberate action at imposing wrong prices. In actual fact, the spontaneous evolution of the economic system may very well be responsible for what occurs. Even the word "anomaly", making a reference to the normal course of events, may not be good. I prefer to speak of disequilibria in the structure of prices and remuneration rates. In any case, the important point is to recognize that price disequilibria may be sustained for such a long time as to have significant impacts on medium-run



evolution: an example is provided by the too low business profitability that lasted for more than a decade in Europe.

### **3. Supply Analysis**

Shortly after World War II, the macroeconomic theory was built for a proper study of the aggregate demand formation. One later realized that such a unilateral focus could not suffice. Unfortunately, the expression "supply analysis" was often used to mean any kind of addition to demand analysis. For instance, the Phillips curve was said to represent the supply side of the economy, whereas it only concerns the determination of the nominal wage rate.

By supply analysis we must mean the study of the determination of potential output, i.e., of the productive capacity that will indeed be used if the demand permits. It may be an admissible extension to still speak of supply analysis when we consider the determination of the input mix, i.e., in particular the determination of the relationship that will give the demand for labour as a function of output. The reason simply is that the same operation commonly decides about both productive capacity and the input mix. Similarly, we are still doing supply analysis when studying the short-term decisions concerning the degree of utilization of labour and equipment. But extending the concept beyond those uses would unduly dilute its meaning.

European experience of the past twenty years is much richer in information for supply analysis than I can report here, or been able to identify. It will be an important source for future econometric research. I shall limit my comments here to a few, hopefully significant, points.

We witnessed in our countries a sharp reversal of the trend of the relative cost of labour with respect to capital, with a very fast increase up to the middle 70s and a sharp decrease in the early 80s when the real interest rates jumped and the real wages stagnated. For a time, this change seemed to have no impact on the trend of the input mix, a trend that was characterized since the early 60s by a fast substitution of capital for labour. Only recently did it appear that this substitution was slowing down. This fact gives support to the view according to which the putty-clay hypothesis on the technology is much better suited for medium-run analysis than the hypothesis of a traditional production function.

In Western Europe, as well as elsewhere, many firms found themselves overly indebted in the early 80s and quite a few had to close down. One might have thought that indebtedness was then an independent cause of the sluggishness of supply, over and above what was already implied by poor demand prospects and low profitability. But so far as I know, this effect does not appear to have been significant at the aggregate level. Indeed, the ratio of business debt to the value of productive capital does not even seem to be higher now than twenty years ago, the inflation

in the meantime having reduced the burden of the old debts. Some argue in Europe that, while the actual debt ratio has not increased, the desired debt ratio has sharply decreased as a result of the rise in real interest rates and that, therefore, indebtedness remains a deflationary factor [see for instance V. Lévy-Garboua et al. and G. Maarek (1985)]. One may also wonder whether the burden of debts was not less evenly distributed among firms, as it was in earlier times. On these debated questions the final word has probably not yet been said.

My own reflection during these past years concentrated on analyzing the respective roles of demand prospects and profitability as determinants of productive capacities, because I considered that clarifying these roles was the most crucial task for a good understanding of the medium-run evolution of unemployment. The first task was to make precise what was exactly meant by profitability, a concept intended to capture a possible disequilibrium in the structure of remuneration rates. For this purpose, a significant indicator may be defined that tracks the impact that the changes in remuneration rates have on a kind of Tobin's  $q$  ratio.

The outcome of the substantial analysis was that, for a given level of profitability, productive capacity tends to expand approximately in proportion to the expected demand for the output, but that the elasticity of capacity with respect to profitability varies a great deal, depending on the reference situation: this elasticity, which of course also has to do with the uncertainty of demand prospects, is high at a very low level of profitability, but it quickly decreases if this level improves in the reference situation. It is then only in exceptional cases, such as the one recently experienced in Europe, that the independent role of profitability becomes important [Malinvaud (1989)].

#### 4. The Elusive Concept of Competitiveness

The loss of European market shares explains to a large extent why unemployment was particularly high in our region. This loss cannot be explained by the evolution of the common indicators of price competitiveness. Except for important fluctuations, these indicators lead to the conclusion that European price competitiveness is about as good now as it was in the early 70s. For this reason in particular, the European case provides an interesting subject to anyone who wants to reflect on the nature and determinants of competitiveness.

Changes in the ability of an agent to compete on the markets are probably best viewed as changes in the respective supplies of this agent and of its competitors, or rather in their respective supply curves. The immediate impacts are changes in the share of demand addressed to this agent, changes that combine their effect with that of the movements of overall demand.

The sluggishness of demand perceived by European producers was partly due to the fact that their supply curve was overtaken by the supply curve of others.

The development of new capacities abroad imposed lower prices that were no longer rewarding for our producers, who then had to scrap some of their capacities. On the other hand, innovations slowed down in Europe and what could have been a balanced shift in the division of labour throughout the world turned out to be biased against our region.

The responsibility in such a case could be assigned on both sides. But as long as international trade operates according to unchanged rules, it is natural to admit that anyone has to take care of his own competitiveness and that the overall result will then be globally more satisfactory than it would otherwise be. (This statement is purposely less precise than some of the propositions made within the theory of international trade).

Competitiveness must then be viewed mainly as resulting from supply decisions, even though a significant role is also played in general by the evolution of real exchange rates, which are outside the control of producers. The same reasons that explain a slower growth of supply at home than within the competing foreign countries are likely also to explain a loss of competitiveness. In particular a lower profitability at home will induce less research and development, less innovation, a slower investment in new capacities and commercial networks, a relatively more important scrapping of existing capacities, and so on. The impact on competitiveness will be spread over a number of years, as domestic producers progressively withdraw from their older markets and fail to enter enough new markets. To reverse the trend will be all the more difficult.

Economists are certainly well aware of this chain of effects. But most often theoretical and applied macroeconomics do not seem to take it into account. Studying more explicitly its role and the way in which it ought to enter into our models appears to me as one of the main research priorities following from the lessons given by European unemployment.

### III. LESSONS FOR DEVELOPMENT ECONOMICS

Turning my attention now to what development economists ought to remember from the recent European experience, I am going to speak with much less confidence. The sense of my lack of competence suffices to explain it. Concerned as a human being about the huge problems faced by countries less developed than my own, I am nevertheless conscious of the limitations of my knowledge about them. Working on mathematical economic theory, on econometric methods, and on the macroeconomic analysis of industrial countries placed my reflections in a particular environment and did not provide me a familiarity with the conditions prevailing in LDCs, a familiarity that is required for a proper application of whatever scientific knowledge has been obtained in our young discipline.

To make matters still worse for me, I realize that development economics no

longer appears today as a well defined branch of economics that I could have learned like a student, acquiring its methodology, remembering its propositions, knowing what its pending questions were. Moreover, economic development problems can hardly be isolated from the broader socio-political context in which they take place, a context that much differs from the Western European one and about which an economist devoted to the objectivization of its discipline can only feel uncomfortable and clumsy.

I am, therefore, aware that my contribution here can only be marginal. It will be one of a witness coming from a different part of the world, reporting those events which he thinks will appear of interest to his audience, and occasionally adding a little moral of his own. A good report has to be short; I shall try to apply the rule.

I shall first describe a modestly historical perspective and comment on what happened to European development. I shall then consider the resurgence of forms of duality in the European society. Finally, I shall give an account of the debate on protectionism that at times arose in our countries.

### **1. Western European Development**

The economic history of Europe is well-known. It often was quite irregular, particularly during the first half of this century when wars and depressions alternated with periods of fast growth. After the last war we lived twenty-five exceptional years of an expansion that was hardly disturbed by occasional pauses here or there, and that more and more analysts confidently extrapolated into the future. Then came the period of industrial stagnation that I have been discussing.

This unfortunate turn of events shows that even a prosperous economy ought not to be considered as immune against the risk of being soon exposed to a depression. If this risk occurs, the process of adjustment may be much more painful than the people concerned were expecting.

Any reflection on recent European development should pay as much attention to the first phase of postwar evolution as to the second one. Indeed, the nature of the shift from the one to the other plus the poor adaptability that it revealed certainly find a good part of their explanation in some features of the preceding expansion. Without attempting to deal fully with this question, I should like to point here to one of its relevant aspects.

I tried to suggest earlier that the evolution of real wage rates had a responsibility in the disequilibrium of the system of remuneration rates; hence in the importance of unemployment. An explanation of the course of real wage rates can be found in the following account.

A long period of expansion had raised expectations about what was feasible. Progressively most people came to expect that each year a significant new increase

in their purchasing power would occur. These expectations raised aspirations. European workers and businessmen then did not realize that several reasons made it unlikely that the rate of growth of real incomes of the 60s could long be maintained: it was partly due to a catch-up with respect to the fundamental European potential after the slowdown of the 30s and 40s but this catch-up was coming to an end; stability in the world economy could not be taken for granted and instability would imply slower growth; neither could the then favourable evolution of European terms of trade be taken for granted. Whereas Japan and the Newly Industrialized Countries had been buyers of European industrial equipment goods, they were progressively becoming important competitors and the new international division of labour that was going to emerge would require important restructuring of our industries and less favourable export prices. All these risks, which could have been anticipated but were not, materialized in the 70s and early 80s. But expectations and aspirations were very slow in adapting to the new situation. Notice that they did, however, adapt when most people progressively accepted the notion that employment prospects would depend on business profitability, which required a strong wage restraint. After more than a decade of decline in this profitability, the last five years were marked by a recovery.

To the extent that a significant responsibility must be given to the factors I just outlined, as I think it must, a conclusion can be drawn. Misperception by economic agents ought not to be ruled out of our thinking. Moreover, this misperception might make matters worse than they would otherwise have been. The adaptation period, through which Europe had in any case to live, would have been less painful if it had been better understood and therefore better managed.

World economic history gives us, I believe, other examples of a similar nature. Often countries have experienced phases of buoyant growth during which their long-term prospects were grossly overestimated. This was true of Mexico and Brazil before the debt crisis. This was true also of cases in which initial government decisions after a major political change first appeared successful, and they were then thought to have engaged a process of sustained growth that later collapsed.

The possibility of such misperceptions is an important feature when we have to think about the role of the experts, whether or not they are called planners. On the one hand, one has to remember that experts too can make mistakes, the unfavourable consequences of which will be all the more important as their advices will be more carefully followed. On the other hand, one may expect the experts to make fewer or smaller mistakes than those made by the general public. Speaking now only for my own country, I can assert with confidence that economic performance would today be somewhat better and unemployment somewhat lower if the diagnosis given by the experts had been better listened to between 1974 and 1982.

## 2. Duality

Throughout this century upto recent times, European economic development was geared not only to an overall improvement of living conditions but also to making society more homogeneous. Diffusion of education, modernization of agriculture, reduction of disparities in wage rates, introduction of work laws and of progressive income taxes, elaboration of extensive social security systems, all pointed in the same direction. One must recognize that this trend is now reversed, not in all respects but in several of them. Forms of duality in European society are now identified.

This reversal is worthy of our reflections because it means a partial forsaking of the development objectives that were chosen in Europe in the late nineteenth century and reassessed after the last war. What are its causes? Is it only a transitory deviation from the previous pattern or a permanent one?

Speaking of such duality in Europe when one is addressing an audience in the Third World may be a shocking abuse of the word. What we so designate in our countries has much less of a structural character than the duality prevailing in the LDCs. It does not reflect the existence in the economy of two large sectors of production with widely different levels of productivity. It is really concentrated on the labour market or directly related to it.

The origin of the phenomenon was analyzed for instance by Berger and Piore (1980). The protection granted to a majority of the employed population by implicit or explicit long-term work contracts would give too much rigidity to productive activities if it did not coexist with the practice of temporary contracts used to match work needs that are expected to be temporary. But, since most workers prefer long-term contracts, obtaining one such contract is more difficult than finding a temporary one. The workers that appear the least attractive to employers cannot then reach long-term employment; in between periods of temporary work they remain unemployed for more or less long spells, which is detrimental both for their living conditions and for their chances of long-term recruitment.

Such a duality of the labour market, which is much more acute in developing countries than in Europe, has recently been stressed in the theoretical analysis of the operation of the law of supply and demand on this market. An insider-outsider theory was proposed by Lindbeck and Snower (1988), which intended to explain the interplay between wage rates, on the one hand, and supply of labour and demand for it, on the other hand. One concern is to better understand why spontaneous forces do not efficiently act in case of excess supply of labour. I may guess that, whereas the efficiency wage theory was first built for LDCs and later applied to industrial countries, the flow of ideas may very well go in the reverse direction with the insider-outsider theory, which could extend the range of analyses initiated by the Harris-Todaro model.

The logic explaining the duality of the labour market should not lead one to

accept a caricatural image of European labour markets. A large proportion of the workers holding temporary contracts are young people who do subsequently find long-term jobs. But there remains a small minority of workers who seem to be trapped in a permanently precarious situation and are exposed to poverty. Moreover, the size of this minority increased in parallel with the rise of unemployment and a certain development of the black economy.<sup>5</sup>

There is no doubt that part of this trend and the simultaneous increase in the heterogeneity of European society is a transitory phenomenon. A higher degree of business uncertainty in the late 70s and early 80s has led firms not only to moderate their demand for labour but also to give a higher premium to flexibility, while more gloomy employment prospects led workers holding long-term jobs to reduce their quit rate. One may then say that the European duality is to a large extent induced by unemployment, and will recede at the pace of the decrease in unemployment.

Similarly, the recent broadening of income inequality has much to do with the increase in real interest rates. The period of postwar growth was characterized by close to zero real interest rates in most European countries, the acceleration of inflation being partly responsible for that; such low real rates then contributed to the trend toward less income inequality. Since present rates are exceptionally high by historical standard, one may expect that they will decline sooner or later and that capital incomes, which are very unevenly distributed, will then become relatively less important.

However, it seems fair to say also that part of the reversal in the former general trend will remain. This may be explained by a change in the assessment of the exact trade-off between the drive toward equality and the promotion of economic growth. Most often the institutional changes and the measures that were introduced in view of reducing inequalities had not paid attention to possible negative effects on growth. Recent concern at the supply side of the economy has, on the contrary, emphasized the existence of these effects. Simultaneously, it was realized that the institutions of the welfare state had been much less effective for the reduction of inequalities than it had been expected. The reduction in the level and progressivity of income taxation is a clear sign of this change in the assessment of the trade-off. But there are others, for instance the revision of unemployment compensation rules, which have been made less generous, or the easiness with which people accept a lowering or even a removal of capital income taxes when they are told this is necessary for European economic integration.

<sup>5</sup> For obvious reasons the black economy escapes precise statistical assessment. The fact that one speaks more of it now than one did before does not mean that it has increased. Actually, it is likely that the size of the French black economy is smaller today than it was thirty years ago. But an increase during the last decade is also likely.

It may be too early to say now what the new pattern of development objectives, that Europe is in the process of selecting, will be. The transition may very well be difficult and be a source of social instability, because old values have not been rejected and our people are much attached to many features of the welfare state built during the past decades.

### **3. The Debate on Protectionism**

I cannot claim to master the whole literature on trade and development. But so far as I know it, it deals with the long-term advantages or disadvantages of alternative trade policies and the implications of a priority given to favouring infant industries' growth. Mass unemployment in Europe led to stress another aspect of the problem, namely how, during a long depression, the degree of utilization of resources is likely to depend on trade policy.

The frequent popular requests for protection were directly motivated by the idea that unemployment was caused by foreign competition. Economists had to explain repeatedly that one must not isolate the difficulties of an industry from the prosperity of others, that protection would damage exports, and that the global effect on employment was far from being obvious whereas the effect on levels of living was very likely to be negative. But such arguments did not seem fully convincing to a minority group of economists who kept arguing for protectionism. Considering their position and wondering why it was not accepted by policy-makers may be instructive for development economists.

Some years ago, I presented Malinvaud (1984) the arguments put forward by the minority group, of which the best-known members were such Cambridge economists as N. Kaldor. I do not want to repeat that discussion here. I should just like to stress again that the correct theoretical framework for a preliminary study of the problem is provided by models of the general macroeconomic equilibrium under imperfectly flexible prices. Indeed, a discussion using this framework appears in [Cuddington, Johansson and Löfgren (1984), Chapter 7]. It concerns the impact of protection on a country that would use it with no retaliation from the rest of the world. It then shows under which conditions the effect on employment would be favourable.

From the policy viewpoint one must also study how a country or a group of countries can increase their protection without being exposed to retaliation. An explicit or implicit international agreement seems to be required, as was often recognized by the economists arguing for protectionism.

Why was the advocacy for this policy option not followed in Western Europe? Perhaps the argument was not made in such a way as to appear convincing. But I believe other reasons may have played a more important role, reasons that were not so often explicitly stated but to which our people attributed great importance in



their intuitive reactions.

There was first the memory of the past; how protectionism had been associated with catastrophic events in Europe during the 30s, and how the opening to foreign trade had been associated with fast growth during the 50s and 60s. No deep understanding of economics was involved then, but simply what seemed to have been learned from experience.

There was also the feeling that the proper geographical level for any conceivable protectionism would have to be the European Economic Community, if not the whole of Western Europe. This feeling was not always unanimously accepted. In its first few years of rule, the French socialist government was tempted by national isolation. Similarly, some nationalistic bias was perhaps present in the position of some members of the Cambridge group. But European unification was too widely accepted as a political priority for such attitudes to eventually prevail. This being given, people know that any major change in the European policy orientations is very difficult to decide. A serious temporary tightening of European protections was probably felt to require unanimous support, which was unlikely.

Finally, the existence of a trade-off between employment and the level of living was understood. Increasing European protections would have meant losing part of the satisfaction that people find in the availability of a rich, varied, and a progressive supply of goods; for instance, it might have meant giving up access to Japanese electronics. Confronted with this trade-off, people appeared to be reluctant to give priority to employment over the level of living. At the beginning of this lecture I stated that unemployment is now much more easily endured than it had been anticipated. The attitudes I am now reporting are part of the same phenomenon.

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## **Comments on "Lessons to be Learned from the European Unemployment of the 80s"**

It is a pleasure and honour for me to comment on the paper by Professor Malinvaud.

In the paper Professor Malinvaud considers the European unemployment of the 1980s. He notes that the industrial countries have lived the golden years starting from the end of World War II right until the beginning of 1970s. During these 25 years the industrial countries have experienced high rates of growth, low rates of unemployment and low rates of inflation. The unemployment rate during 1960s in EC has fluctuated around 2 percent. But by 1977 the unemployment rate had reached 5 percent, it had jumped to 11 percent by 1984, and it remained at this level for the last five years. Professor Malinvaud further observed that the large majority of the population of working age did hold permanent jobs, while young people often experienced year during which they could find occasional work between periods of unemployment.

Professor Malinvaud asks the question why the unemployment rate was so high during the 1980s, and why the European Society has experienced increased duality with respect to working status.

High rates of unemployment means excess supply of labour and thus deficiency of the demand for labour. Professor Malinvaud maintains that demand for labour was deficient mainly because the labour market could not adjust to the new circumstances. There was inappropriate response of the system of prices and remuneration rates.

According to Professor Malinvaud the main variable determining the unemployment rate is the profitability of production. By emphasizing on the profitability of production we require that in macroeconomic models dealing with unemployment we concentrate on the medium run, consider the significance of disequilibria, study explicitly the determination of potential output and analyze the role of competitiveness.

During the 25 years after World War II expectations were raised in Europe about what was feasible. During the 1960s stability in the world economy was taken as granted. Everybody was expecting high rates of growth with low rates of unemployment and inflation. During the 1970s the world experienced the oil

shocks and saw the emergence of Newly Industrializing Countries as competitors. The profitability of production started to decrease. But expectations and aspirations changed only slowly to the circumstances. During the 1970s the wage-rentals ratio increased sharply leading to fast substitution of capital for labour. As a result unemployment rate increased in the industrial countries.

During 1980s real interest rates increased while real wages stagnated. The substitution of capital for labour was slowed down. After more than a decade of decline in profitability the profitability started to increase during the last few years.

The duality experienced in European countries with respect to working status is explained by the fact that the protection granted to a majority of the employed population by implicit or explicit long term contracts gives rigidity to productive activities. Workers prefer the long term contracts, and those who appear to be least attractive to employers cannot reach long term employment, and they remain unemployed for long periods.

In the last section of the paper Professor Malinvaud discusses the lessons to be derived for the developing countries from the recent European experiment. If I am not mistaken he maintains that similar considerations would apply in developing countries. Macroeconomic models to be built for developing countries should also concentrate on the medium run, consider the significance of disequilibria, study explicitly the determinants of potential output, and analyze the role of competitiveness. The emphasis should be placed on the profitability of production.

I fully agree with Professor Malinvaud in this respect. We, economists of the developing countries, would certainly benefit from the research work on European unemployment of the 1980s.

Thank you.

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**Subidey Togan**

## Comments on “Lessons to be Learned from the European Unemployment of the 80s”

Let me begin by expressing my great pleasure that the Quaid-i-Azam Lecture for 1989 was delivered by Professor Malinvaud. He is a role-model to all of us who think of *economics* as *economic science* and who try to follow his example of precise thinking and his quest for the “objectivization of knowledge”. We have now been exposed to this in a wide-ranging lecture which brings out, in addition, his concern for human betterment and welfare as well as his modesty and open-mindedness in expressing this concern.

In his lecture, Professor Malinvaud’s deals with European unemployment and this takes him from macroeconomics into development economics and also into questions of methodology.

For obvious reasons, I shall be brief as regards macroeconomics and simply draw your attention to Professor Malinvaud’s emphasis on supply decisions; on understanding factors primarily operating in the medium-run; and to his warning on an uncritical acceptance of rational expectations equilibria.

Misperception by economic agents ought not to be ruled out of our thinking. Moreover this misperception may make matters worse than they would have otherwise have been.

In the context of development economics, these ideas lead Professor Malinvaud to segmented labour markets and to the debate on protectionism. As regards the former, he mentions the Harris-Todaro model but gives an interesting twist to it in terms of long and short term labour contracts. It is clear that the ideas of Berger-Piore, and more recently, of Lindbeck-Snower have much to add to our understanding of these problems. A synthesis of these ideas with those of Harris-Todaro has unfortunately yet to be accomplished.

In his discussion on protection, Professor Malinvaud emphasizes the effects of foreign trade on unemployment and on the “trade-off between employment and the level of living”. It is interesting in this connection that preliminary studies reveal the importance of adjustment processes as well as the particular commodity, rural or

urban, that is being exported.<sup>1</sup> These factors do not arise in the more chartered and simplified world of the Heckscher-Ohlin-Samuelson or the Ricardo-Viner theory. Clearly, more remains to be done as readers of *The Pakistan Development Review* are well aware.<sup>2</sup>

It is questions of methodology that are tangentially raised in the lecture that I find particularly interesting. Professor Malinvaud begins his lecture with the statement that:

progress in [economic science] comes from reflection and research works motivated by real problems.

My question here is the obvious one of how one is to decide which problem is *real* and which is not and who is it that is to decide? One does not have to go quite as far as Feyerabend and take these decisions completely away from the expert,<sup>3</sup> but it is worth asking how much weight should be given to the profit maximizing commercial sector (i.e., the market), to the expert, to the bureaucrat, or to a committee of lay-men? This is of particular significance, it seems to me, in the context of the research strategy that Professor Malinvaud has in mind.

I believe that we must accept in our search the step-by-step strategy that is common in mature sciences and implies that one first well identifies the most proximate causes, then looks for an objective assessment of the causes of these causes, going progressively upstream the causation chains, making each step secure before going to the next one.

Another interesting set of ideas relate to the meaning of explanation.

Dealing with explanations [one] should also discuss what is meant by an explanation and which approach is appropriate for deriving it. But the explanation must receive a sufficiently large support in the profession, so as to provide an objective reference. This requirement unfortunately forces us to remain at the level of a fairly immediate, hence not very deep explanation.

My only comment here pertains to questions of timing; if one insists on acceptance in the very short-run, one is in the danger of stifling ideas that depart in a

<sup>1</sup>See Khan and Lin (1982).

<sup>2</sup>See, for example, Khan (1985).

<sup>3</sup>Professor Malinvaud himself alludes to the role of the expert in the last paragraph of his section titled Western European Development.

substantial way from the established canons currently prevailing in the profession.

I apologize for asking Professor Malinvaud to comment on aspects of his lecture which do not constitute his primary concern; my only excuse lies in the importance of clear understanding of his ideas by scholars here at the Institute (and elsewhere in the country) who have committed themselves to the study of economic science.

I thank Professor Malinvaud for an extremely stimulating lecture.

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