

Alan Greenspan and the ECB: Different Policies, Different Results

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The monetary policy charted by the Federal Reserve Board during Alan Greenspan's tenure provides a stark contrast with the policies pursued by the European Central Bank (ECB) and by its predecessor European national banks in the years after the Maastricht Accord. While the Greenspan Fed was willing to test the economy's limits, and allow the unemployment rate to fall below the level that had been thought to be consistent with stable inflation, the ECB and its predecessors have consistently pursued contractionary policies, even in the absence of substantial evidence of inflationary pressures. As a result, the United States saw its unemployment rate fall below 4.0 percent for the first time in 30 years. By contrast, the unemployment rate in the euro zone appears to have bottomed out slightly above 8.0 percent, and is now on the rise, as Europe is being dragged down by the recession in the United States.

The current (February, 2002) interest rate policies show the sharp differences in the approaches of the two central banks. The Federal Reserve Board has lowered its short-term interest rate from 6.5 percent in December of 2000, to 1.75 percent as of December of 2001. By contrast, the ECB has been far more cautious, lowering its short-term interest rate from 4.75 to 3.25 percent over the same time frame. This caution persists in spite of the fact that the euro zone has maintained a somewhat lower rate of core (excluding food and energy) inflation over this period than the United States. Core inflation in the euro zone has averaged close to 2.0 percent, while core inflation in the United States has been near 2.5 percent through most of the last year.

The consequences of a monetary policy that is too restrictive are enormous. Standard estimates put the amount of lost output associated with a percentage point of excess unemployment (the "Okun Gap") at 2 percent of GDP in the United States, and often higher in European nations. This implies that 1 percentage point reduction in the unemployment rate is associated with an increase in annual GDP of 2 percent, or more. There is no other economic policy that can produce near term gains of a comparable magnitude. If restrictive monetary policy is artificially raising the unemployment rate across Europe, then the euro zone nations are paying an enormous price for their central bank's policies.

¹ This paper comes out of a common research project with Andrew Glyn, David Howell, and John Schmitt. They are in no way implicated in the views expressed here.

This paper will briefly examine the argument that the ECB must maintain high unemployment rates due to structural features of the economies of the euro zone nations. The next section discusses this perspective in the context of the conventional views about unemployment and inflation in the United States, prior to the boom of the late nineties. The second section examines the evidence for structural obstacles to lower unemployment in Europe. This is followed by a short conclusion.

The Death of the NAIRU in the United States

Until the last few years, the vast majority of economists believed that the inflation rate would begin to rise if the unemployment rate fell below 6.0 percent, which was viewed as the non-accelerating inflation rate of unemployment (NAIRU). According to this view, if the unemployment rate fell below the NAIRU, then the inflation rate would increase. It would continue to increase as long as the unemployment rate remained below the NAIRU. This meant that eventually it would be necessary to live with an unemployment rate that was at or above the NAIRU, or endure hyperinflation.²

It would be difficult to exaggerate how widely this view was held among economists at the time. In fact, Paul Krugman, the distinguished Princeton University economist, wrote an article in late 1995 attacking the integrity of economists who questioned the NAIRU theory. In this article (which was titled "Voodoo Redux"), Krugman compared the economists who disputed the NAIRU theory to the scientists who disputed the evidence of damage to the earth's ozone layer -- most of whom appeared to be on the payroll of industries responsible for the damage. Krugman went on to explain that mainstream economists were right to be offended by the critics of the NAIRU theory for what he termed "the political reopening of a settled question."³ While Krugman may have been more blunt than most of his colleagues, there were few who would have differed with his assessment.

If it is possible for an economic theory to be disproved by events, then the NAIRU has been disproved. The unemployment rate in the United States first fell below 6.0 percent in September of 1994. In the seven and a half years that the unemployment rate has been below the NAIRU -- at times by as much as 2 full percentage points -- there has been no acceleration whatsoever in the inflation rate. The core inflation rate has remained in a 2 to 3 percent range throughout this period. The standard NAIRU models predict that the low unemployment of recent years should have increased the rate of inflation by approximately 4 percentage points.⁴

While some have tried to explain the discrepancy between theory and evidence by a set of fortuitous events in the late nineties, this requires a very large role for fortuitous events.⁵ Other economists have sought to explain the low inflation of the late nineties by a "time varying NAIRU,"

² Gordon (1994) and Weiner (1994) lay out the standard NAIRU review at the middle of the nineties.

³ Krugman's article appeared in the November-December issue of *The International Economist*.

⁴ A standard rule of thumb is that the inflation rate increases by 0.5 percentage points for each year that unemployment rate is a full percentage point below the NAIRU (Congressional Budget Office 1994, p 14).

⁵ Blinder and Yellen (2001) is the most prominent example of an account that attributes the low inflation of recent years to fortuitous events, rather than any flaw in the NAIRU theory.

which fluctuates in a largely random manner through time.⁶ Whether true or not, because of their ad hoc nature, neither of these explanations can provide much guidance for policy. The factors that, in retrospect, are now viewed as being responsible for holding down inflation, were not regarded as relevant to the inflation rate three or four years ago. Nor was the movement in the time varying NAIRU evident at the time when it shifted.⁷ If the random factors play a large role in determining the levels of unemployment that the economy can maintain, or if the NAIRU fluctuates in unpredictable ways that cannot be recognized until years later, then the estimates of the NAIRU cannot provide much basis for the conduct of monetary policy.

The Federal Reserve Board did not deliberately set out to test the NAIRU.⁸ In early 1994, as the unemployment rate was falling to generally accepted estimates of the NAIRU, the Federal Reserve Board began to raise interest rates. From February of 1994 to February of 1995, it raised the short-term interest rate by 3 full percentage points, from 3.0 percent to 6.0 percent. While these rate hikes did slow the economy, they did not prevent the unemployment rate from falling below 6.0 percent. However, at this point the Federal Reserve Board departed from its prior practices. When it became clear that there was no evidence of inflationary pressures in the economy, the Federal Reserve Board lowered the interest rate in the second half of 1995, in spite of the fact that the unemployment rate was below accepted levels of the NAIRU.

The Federal Reserve Board allowed the unemployment rate to continue to edge down to almost 5.0 percent by the end of 1996, because inflation remained under control. A tightening that began in early 1997 was halted by the East Asian financial crisis. To help maintain stability in international financial markets, the Fed cut interest rates even though the unemployment rate was below 5.0 percent at the time. This allowed the unemployment rate to fall further, with the level eventually hitting 4.0 percent at the beginning of 2000. The Fed did begin another round of tightening in the fall of 1999, but the source of the current recession lies much more in the collapse of the stock market bubble (an area where the Fed deserves considerable blame), than in the rate hikes from late 1999 through 2000.

The simple lesson from the experience of the late nineties is that economy benefited enormously as a result of the Federal Reserve Board's willingness to test its limits. Had the Fed adhered strictly to the NAIRU view, it would have raised rates as long the unemployment rate was below the accepted estimates of the NAIRU. The fact that Alan Greenspan was willing to wait until there was actual evidence of inflationary pressures allowed millions of people to get jobs who would not have otherwise.

Since the burden of unemployment is not evenly shared, the gains from lower unemployment went disproportionately to the most disadvantaged segments of society. The unemployment rate for African-Americans fell from 11.5 percent in 1994 to 7.6 percent in 2000. The unemployment rate for African-American teens fell from over 35 percent in 1994 to under 25 percent in 2000. It also appears that the decline in unemployment disproportionately boosted wage growth for low wage workers. Workers in the bottom three deciles of the wage distribution appear

⁶ The best examples of this approach are Staiger, Stock, and Watson 2001, and Gordon 1997 and 1998

⁷ Staiger, Stock, and Watson 1997 produced a wide range of estimates of the NAIRU by varying the data and structure of their regressions. But their results centered on the 6.0 percent level generally accepted at the time. Their newer work shows that the time-varying NAIRU had fallen to 4.6 percent in 1992.

⁸ A fuller account of this history can be found in Baker (2000).

to get the largest gains from a decline in the unemployment rate.⁹ As a result, the low unemployment at the end of the last cycle was an important factor counteracting longer term trends of increasing wage inequality in the U.S. economy.

The ECB and the Pursuit of Price Stability

While the Federal Reserve Board in the United States explicitly pursued a policy aimed at maintaining high levels of employment, as required by its legal mandate, the ECB and most of its predecessor national banks, have not viewed maintaining high levels of employment as part of their responsibility.¹⁰ By failing to take responsibility for maintaining high levels of employment, the ECB may be needlessly subjecting millions of European workers to unemployment, and costing the euro zone nations hundreds of billions of foregone output every year.

In addition, the restrictive monetary policy pursued by the ECB makes other public policy goals more difficult to attain. First in this category would be the deficit targets set in the Growth and Stability Pact. Due to the fact that the European economy is operating below its potential, budget deficits have expanded as a result of reduced tax collections and higher unemployment benefits. Also, efforts to sustain public sector pension systems will prove more difficult, if the Euro zone nations continue to experience high unemployment. High levels of unemployment are likely to force more workers to retire early and reduce contributions to the public systems. Continued high levels of unemployment will make the problems facing these systems much more severe.

Given the enormous economic, social, and political costs associated with high unemployment, there should be a high burden of evidence required to abandon efforts to lower the unemployment rate through stimulatory monetary policy. In fact, the evidence that European unemployment rates cannot be lowered through stimulatory policy is remarkably weak. The recent experience in the United States showed that well established estimates of the NAIRU were not accurate -- the unemployment rate has remained far below the accepted range of the NAIRU, without leading to any increase in the rate of inflation. However, in the United States, prior to mid nineties, there was at least a solid statistical basis for the NAIRU. Estimates of the NAIRU for European countries vary widely through time with no apparent justification. The table below shows the OECD estimates of the NAIRU for several European countries in 1990 and in 1997, and the actual unemployment rate the actual unemployment rates in these countries in early 2001.

⁹ Bernstein (2002) examines the relationship between wage growth and the unemployment rate at each decile cutoff of the wage distribution. This analysis finds that lower unemployment has the largest impact on the wage growth of lower wage workers.

¹⁰ The ECB's mandate explicitly states that it is obligated to promote price stability. Unlike the U.S. law governing the Fed's conduct, there is no mention of an obligation to maintain high levels of employment.

Unemployment Rates: NAIRU Estimates and Actual

	Estimated NAIRU 1990	Estimated NAIRU 1997	Actual 2001
Australia	8.3	7.5	4.8
Austria	4.9	5.4	3.2
Belgium	11.0	11.6	8.4
Canada	9.0	8.5	6.9
Denmark	9.2	8.6	5.0
Finland	7.0	12.8	9.6
France	9.3	10.2	8.9
Germany	6.9	9.6	8.2
Ireland	14.6	11.0	4.1
Italy	9.7	10.6	10.5
Japan	2.5	2.8	4.8
Netherlands	7.0	5.5	2.8
New Zealand	7.3	6.0	5.9
Norway	4.2	4.5	3.2
Portugal	5.9	5.8	4.1
Spain	19.8	19.9	13.6
Switzerland	1.3	3.0	
Sweden	3.2	6.7	5.6
United Kingdom	8.5	7.2	5.5
United States	5.8	5.6	4.0

Source: OECD 1998 and 2001.

The rise in the estimates of the NAIRU in many of these countries between 1990 and 1997 is substantial. For example, in France and Italy the estimated NAIRU rises by 0.9 percentage point over this seven year period, in Greece the increase is 1.6 percentage point, and in Sweden 3.5 percentage points. These increases are not easily explained by any changes to the economies of these nations over this period. (The large changes in the estimates of NAIRU for Finland and Germany can be explained by the collapse of the Soviet Union, Finland's major trading partner, and the inclusion of the population of East Germany in the 1997 estimate.)

Even more striking is that fact that by 2001, the unemployment rate in every European nation had fallen below its estimated NAIRU. With only one notable exception (Ireland), there has been very little acceleration in the core inflation rate. If these estimates of NAIRU had strictly guided monetary policy, they would have needlessly kept millions of people out of work, and cost European countries hundreds of billions of foregone output. Clearly the standard estimates of NAIRU cannot be viewed as credible. The estimates of NAIRUs generated through these regressions have no obvious use for economic policy -- they provide no basis for determining a floor for the unemployment rate.

A second related line of argument, put forward most notably by the OECD (1994(a) and (b)) is that it will be necessary to significantly weaken labor market protections in continental Europe, if

these nations are to enjoy the low unemployment rates experienced by the United States and England. The evidence that labor market regulations and/or unions are the major factors leading to high European unemployment is actually remarkably weak, given the prominence that this view holds in policy circles. Even leading proponents of this view acknowledge that the evidence for labor market rigidities causing high unemployment is not entirely compelling. For example, in a recent assessment of the evidence, Oxford University Professor Stephen Nickell (1997) began by commenting that the labor market rigidity view is "not *totally* wrong" (emphasis in original). In another recent study, M.I.T. Professor Olivier Blanchard noted that while one set of measurements of labor market rigidities produced results that supported this explanation of high unemployment, plausible alternative measures provided much less compelling evidence (Blanchard and Wolfers, 2000). This paper concluded that data mining (i.e. finding measurements that would support the labor market rigidity explanation) could not be ruled out.

While both Nickell and Blanchard have been among the most prominent economists to put forward the labor market rigidity view, their reservations are based on a realistic assessment of the data. In their own work, as well as that of others, many of the key sources of labor market rigidity -- such as union representation, union coverage, employment protection, and the duration of unemployment benefits are often found to have no significant relationship to the unemployment rate. In some cases, the link to the unemployment rate is rather dubious from the perspective of a labor market rigidity explanation of unemployment. For example, Nickell (1997) found that a higher replacement rate for unemployment benefits was associated with a statistically significant increase in the unemployment rate. However, it had no statistically significant relationship with the employment to population ratio. In other words, this finding can be taken to imply that higher replacement rates make work more attractive -- increasing the number of people who seek jobs, but also increasing the number of unsuccessful job seekers. The implication of this finding for policy, is that reducing unemployment benefits will have the effect of lowering the unemployment rate, by discouraging people from looking for jobs in the first place. It is not clear that lowering the unemployment rate by driving people out of the labor market is necessarily a step forward.

It is also worth noting that these regressions typically find strong positive effects for some labor market institutions, notably active labor market policies -- government programs to assist workers in training for and finding new jobs -- and coordinated bargaining among unions and employers. The regressions imply that the positive effects from these labor market institutions can largely or completely offset the negative effects associated with other various protections for workers.

But the main conclusion that comes from any serious examination of the evidence is the tentative nature of the finding that labor market rigidities are the main factor explaining high unemployment in many European countries. The results of the standard regressions used in this literature are very sensitive to specification, as is generally acknowledged. Regressions that use completely plausible measures of the key variables (including ones generated by the OECD), often show that there is no statistically significant relationship between various types of labor market rigidities and unemployment.¹¹

The fact that the empirical findings on the impact of labor market rigidities on unemployment are ambiguous should not be surprising, given that there are striking counter-

¹¹ For example, Blanchard and Wolfers (2000) found that in a model that interacted identifiable macroeconomic shocks with labor market rigidities, and used alternative measures for replacement rates or employment protection, most of the identified sources of labor market rigidities had no statistically significant relationship with the unemployment rate.

examples, where countries with "bad" institutions have relatively low rates of unemployment. For example, the unemployment benefits in Denmark, the Netherlands, Norway, and Sweden provide some of the highest replacement rates in the OECD, yet their unemployment rates are well below the OECD average. These four countries all have tax rates that are well above the OECD average. Sweden, Denmark, and Norway also rank number one, three, and four, respectively in union density in the OECD. In short, it is not easy to provide a simple link between labor market rigidities and high unemployment.

Conclusion

Given the weak empirical foundation for the link between labor market rigidities and unemployment, and the high cost borne by segments of society from weakening labor market protections, it is striking that weakening labor market protections would be so frequently advocated by economists as a remedy for high unemployment. Reducing labor market rigidities, for example by cutting unemployment benefits or weakening employment protections, have clear consequences for large segments of society. Workers will be far less secure in their employment and in their income as a result of such measures. In most policy debates a much higher standard of proof would ordinarily be demanded before implementing policies that have such large consequences.

By contrast, the restrictive monetary policy of the ECB would appear to provide a more obvious target for reform. At this point, there is very little evidence that a more expansionary policy would lead to higher inflation. Since the potential gains from lower unemployment induced purely by expansionary monetary policy are enormous, it seems reasonable to expect the ECB to be willing to test the economy's limits, in the same way that the Federal Reserve Board did under Alan Greenspan.

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