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EMU Calls for Comprehensive Labour Market Reform

The debate about European monetary union has so far been dominated by questions of fiscal convergence, the adequate conversion exchange rate and the stability of the Euro. Relatively little attention has been given to the labour market effects although labour market performance will be crucial for the long-term success or failure of EMU. The following article deals with the interrelationship between EMU and labour market flexibility in Euroland.

We have passed 'E-day', January 1st, 1999: European monetary union (EMU) is reality. Euroland comprises all EU memberstates except for Greece, which did not meet the Maastricht criteria, and Sweden, Denmark and the UK, which voluntarily abstained.

So far, questions of fiscal convergence, the adequate conversion exchange rate and the stability of the Euro have been predominant in the currency union debate. By contrast, relatively little attention has been given to the labour market effects of EMU. This is all the more striking since the labour market performance in the future common currency area is crucial for the long-run success or failure of EMU: with the introduction of the Euro, the exchange rate will no longer be available as a tool for macroeconomic adjustment. The effects of external shocks and of internal policy failure (e.g., wages rising faster than productivity) will hit labour markets harder than before. Hence, politicians, trade unions and employers in Europe are at a cross-roads:

☐ Either they understand that the introduction of the Euro is sharply intensifying competition in Europe and that they have to get their hands on a comprehensive labour market reform, bringing about more flexibility via a more suitable institutional framework. In that case, EMU, as a major institutional innovation, has a good chance of leading European labour markets into a virtuous circle.

☐ Or they will try to escape the increasing competitive pressure by taking recourse to protectionist measures and increasing transfer payments between EU member states. If this happens, EMU might entail an interventionist spiral, a vicious circle for European labour markets.

Chances and Risks for Employment

We can be brief on the often described upside of the employment prospects: a single currency reduces the transaction costs among the EMU countries, and hence raises the static and dynamic efficiency of the economy. It eliminates the exchange rate risk between EMU countries as well as the costs of conversion, currency exchange and hedging, which is just another way of saying that the real resources employed in foreign-exchange trading can be shifted to other productive uses.[1] Furthermore, transparency will increase and this fosters the intensity of competition in goods and factor markets. This in turn stimulates innovation, investment, trade and growth, thereby improving employment prospects.

On the downside, EMU heightens labour market risks. Within the analytical framework of the theory of optimal currency areas it is maintained that exchange rates are useful tools for macroeconomic adjustment in the case of asymmetric shocks. The argument goes like this: the appropriate reaction to asymmetric shocks is a change in real exchange rates. If nominal wages are sticky, at least in the short run, an external shock can be buffered by a movement in the nominal exchange rate. If, for example, a country experiences a decline in the demand for its exports, the external value of its currency will decline. The currency depreciation will, after a while, entice an increase in exports and a reduction of imports thus dampening

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[1] P. B. Kenen: Preferences, Domains, and Sustainability, in: American Economic Review, Papers and Proceedings, Vol. 87 (2), 1997, pp. 211-213, here p. 212.

the rise in unemployment caused by the initial loss of exports. Exchange rates can therefore be seen as 'a device whereby depreciation can take the place of unemployment when the external balance is in deficit, and appreciation can replace inflation when it is in surplus.'[2] A member of a currency union loses this device for a spontaneous macroeconomic response to shocks. Hence, asymmetric shocks in a currency union exert an increased pressure on national labour markets and entail a substantial risk of rising unemployment. A rise in unemployment due to the loss of exchange rate flexibility can only be excluded if (at least) one of the following three conditions holds:

□ the exchange rate mechanism between EMU countries did not work in the shock absorbing way predicted by theory, hence nothing would be lost by giving up this device, or

□ there is little probability that members of EMU will be hit by asymmetric shocks anyway, or

□ national labour markets are flexible enough to adapt to external pressure without a rise in unemployment.

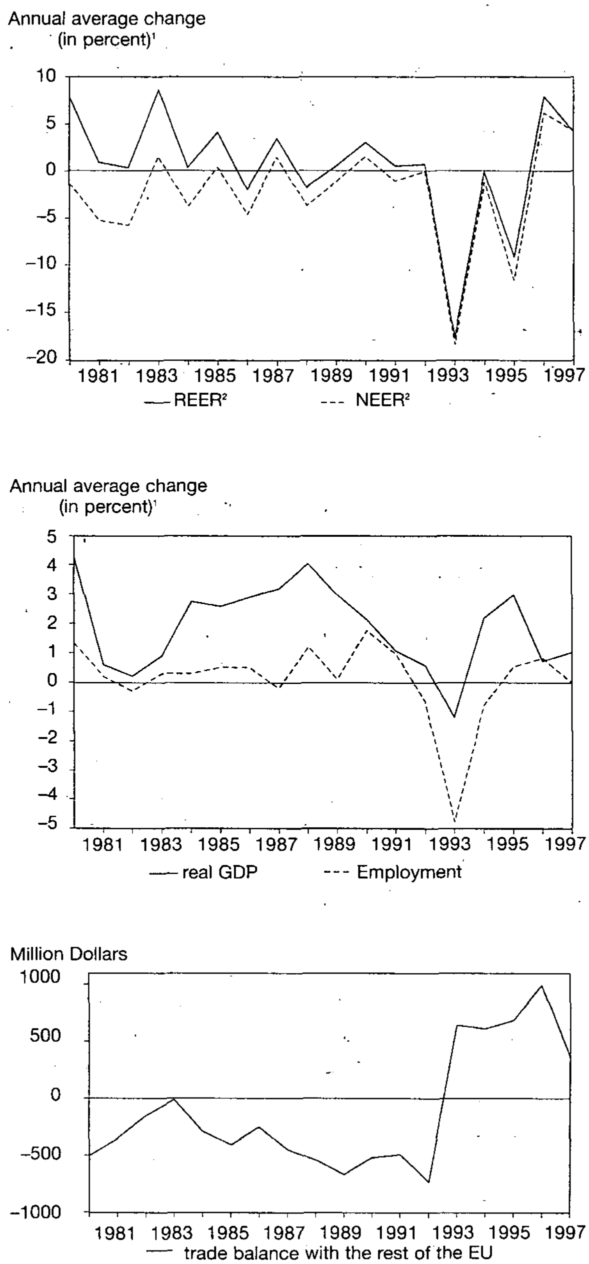
Let us now have a closer look at the empirical evidence on these crucial criteria.

Exchange Rates as 'Shock Absorbers'?

There is evidence that exchange rates between EU member states in the past have in various instances played an important role as shock absorbers. Let us take the experiences of Italy (Figure 1) and Finland (Figure 2) in the early 1990s as conspicuous cases in point.

Italy was hit hard by the 'shock' of German unification and the ensuing boom in economic activity in Germany. To keep inflation at bay, the Bundesbank pursued a tight monetary policy. The resulting strength of the D-mark forced Italy — as well as several other EMS countries — to follow suit in pursuing a tight monetary policy to defend the lira's external value vis-à-vis the D-mark. However, at the same time, Italy went into a recession, the lira was overvalued and the country's export performance was quite poor. The EMS crisis in September 1992 caused a sharp nominal depreciation of the lira and Italy (as well as the UK) left the exchange rate mechanism. In contrast to earlier nominal deprecations of the lira, this time the nominal depreciation led to a similarly strong real depreciation. This real depreciation was harnessed by fundamental reforms such as the abandonment of the 'scala mobile' in 1992, a wage indexation mechanism that had speeded up the inflationary effects of Italian monetary policy. The

Figure 1
Economic Development in Italy 1980-1997



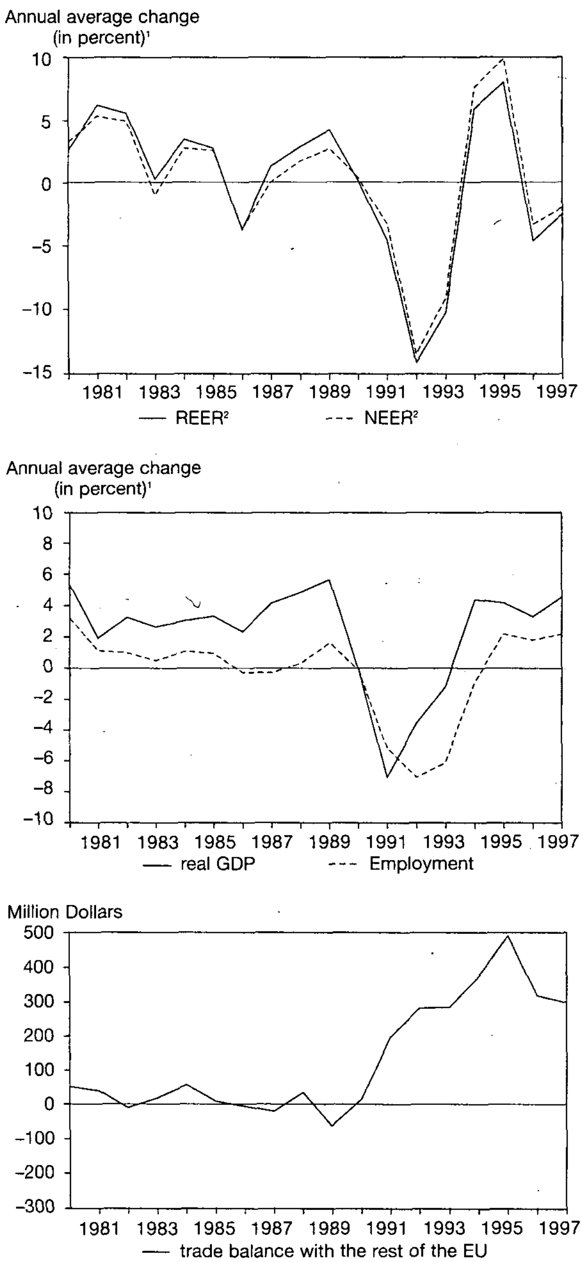
[1] Values greater than 0 mark an increase, values below 0 a decrease.
[2] (Real and nominal) effective exchange rate of the lira vis-à-vis the currencies of the other EU member states.

Sources: IMF: International Financial Statistics (var. issues); OECD: Monthly Statistics of Foreign Trade (var. issues); Deutsche Bundesbank: Devisenkursstatistik (var. issues); own calculations.

[2] R. A. Mundell: A Theory of Optimum Currency Areas, in: American Economic Review, Vol. 51, 1961, pp. 657–665, here p. 657.

depreciation of the lira proved beneficial for Italy: it improved the country's price competitiveness and led to fast growth of the export sector, high surpluses in trade with the rest of the EU and stabilisation of GDP and employment (Figure 1).

Figure 2
Economic Development in Finland 1980-1997



[1] Values greater than 0 mark an increase, values below 0 a decrease.
[2] (Real and nominal) effective exchange rate of the finmark vis-à-vis the currencies of the other EU member states.

Sources: IMF: International Financial Statistics (var. issues); OECD: Monthly Statistics of Foreign Trade (var. issues); Deutsche Bundesbank: Devisenkursstatistik (var. issues); own calculations.

Finland went into a deep crisis in the early 1990s: COMECON vanished as a major trading partner, world recession hit exports and pulp and paper prices fell sharply. A skyrocketing increase in unemployment from moderate 3.5 per cent in 1990 to more than 18 per cent in 1994 was accompanied by a massive rise in the budget deficit. After trying to defend the exchange rate vis-à-vis the D-mark, the central bank finally gave up this strategy and allowed a drastic depreciation of the Finmark. This nominal depreciation translated into a long lasting real depreciation. Although a drastic fall in output and employment could not be averted, the depreciation helped the Finnish economy to become competitive again relatively soon. Thus, the foreign sector mitigated the extent of the decline.[3]

These two examples[4] are in line with mainstream economic reasoning which holds that exchange rates are a useful tool for macroeconomic adjustment if:

- ☐ the change in the nominal exchange rate leads to a change in the real (effective) exchange rate in the same direction,
- ☐ such adjustments do not happen too often (since they require a certain degree of exchange rate illusion),
- ☐ the exchange rate adjustment is accompanied by a credible policy change addressing the root causes of the unemployment problem.

We conclude that the exchange rate mechanism did work as an effective 'absorber' for asymmetric shocks on several occasions in the past.

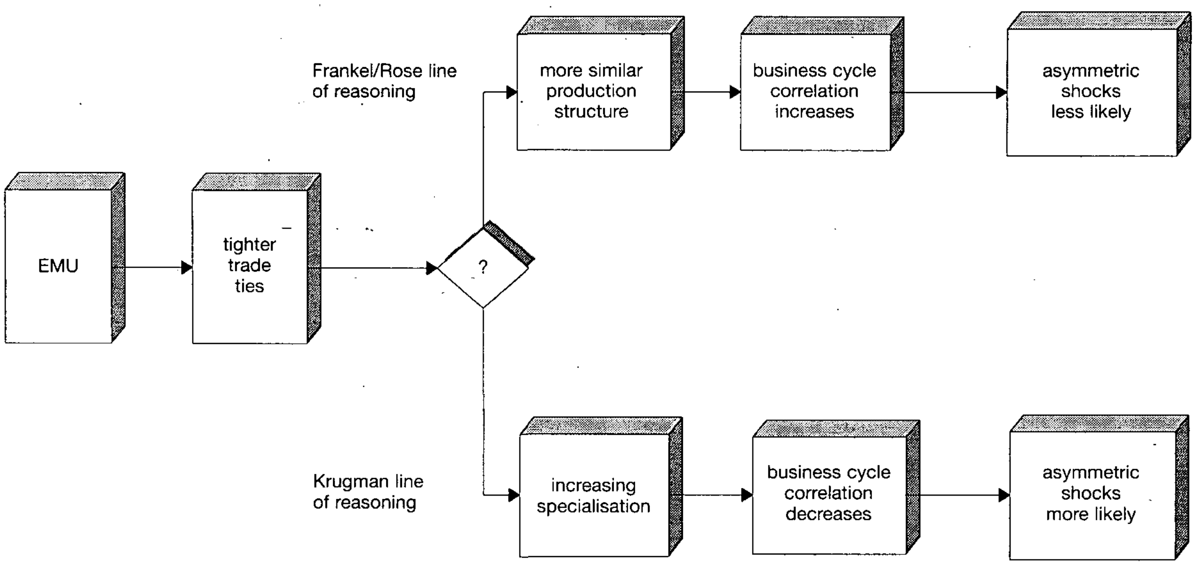
Will There be Asymmetric Shocks in Euroland?

Will EMU countries be hit by asymmetric shocks? In recent years, numerous empirical studies have dealt with this question analysing the variability of output fluctuations as well as real exchange rate variability in the past. In these studies, the experiences of EU member states have been compared to those of existing currency areas such as the USA and Canada or, taking each EU country as a currency union, to those of European regions.[5] In a nutshell, the result of these studies is:

[3] R. Dornbusch: The Effectiveness of Exchange-rate Changes, in: A. Botho (ed.): International Competitiveness, Oxford Review of Economic Policy, Vol. 12, No. 3, 1996, pp. 26–38, here p. 31.

[4] More evidence on successful – as well as on less successful – currency devaluations is given in D. Dohse, C. Krieger-Boden: Währungsunion und Arbeitsmarkt. Auftakt zu unabdingbaren Reformen, Kieler Studie, No. 290, Tübingen 1998, p. 30 ff.

Figure 3
Integration, Specification and Asymmetric Shocks



☐ variations of output are more symmetric between EU member states than within existing currency areas, whereas

☐ variations of real exchange rates are less symmetric between EU member states than within existing currency areas.

This evidence suggests that several EU member states have been hit by various asymmetric shocks in the past and did adjust to them by a price response (particularly by a change of the nominal exchange rate) rather than by a quantity (output) response. In a core group of countries – Germany, France, the Benelux countries, Austria and Denmark – asymmetric shocks have been relatively rare as variations of output and of real exchange rates were quite symmetric; by contrast, the probability of being hit by asymmetric shocks has been rather high for Portugal, Greece, Spain, Italy, the UK, Ireland, Sweden and Finland.

More interesting than looking back is looking ahead. Asymmetric shocks that are triggered by monetary policy are unlikely in a currency union. Hence, the similarity of the underlying economic structures of the countries participating in the currency union comes to the fore to account for asymmetric shocks. Therefore, the critical question is how EMU will affect the structure of the participating economies and what it does to the synchronisation of their respective cycles. There are two opposing hypotheses in the literature (Figure 3).

One line of reasoning is that EMU leads to tighter international trade linkages between the participating countries, makes their economic structure and their business cycles more similar and asymmetric shocks less likely.[6] Such an outcome is considered to be most relevant if demand shocks (or other common shocks) predominate or if intra-industry trade accounts for most of trade.

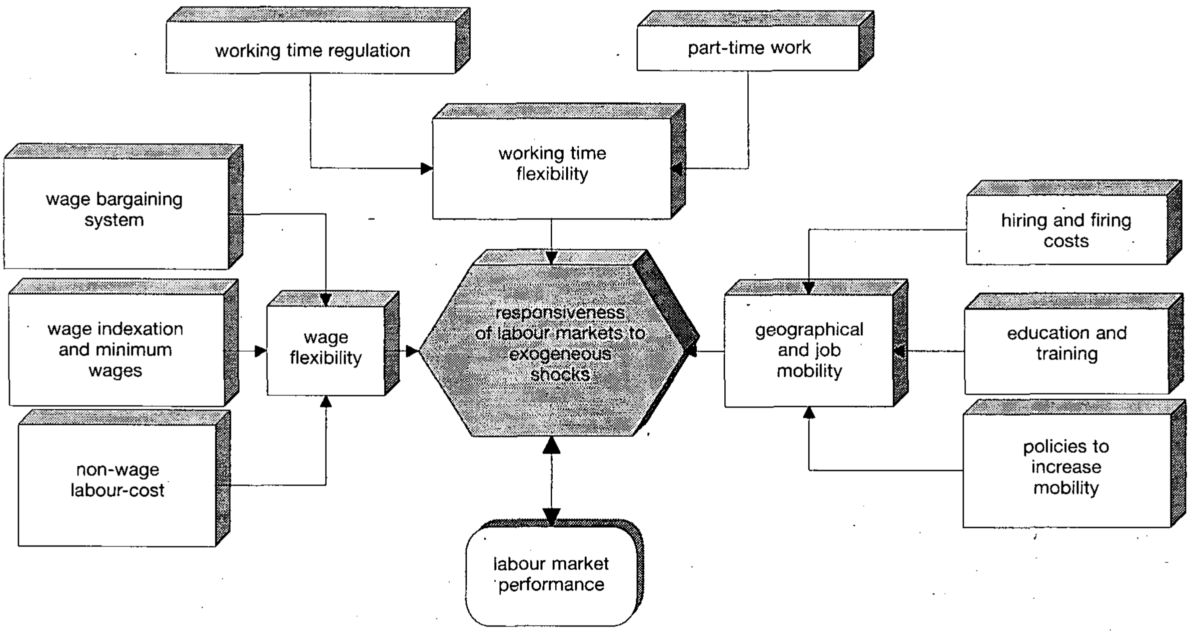
The opposite line[7] says that closer trade ties may not necessarily lead to more similar economic structures. The Krugman argument focuses on new opportunities for the exploitation of scale economies, knowledge spillovers etc., all of which will foster the spatial concentration of industries. In that case, EMU will give sectoral and regional specialisation in Europe a push, such that the probability of asymmetric

[5] See for instance P. De Grauwe, W. Vanhaverbeke: Is Europe an Optimum Currency Area? Evidence from Regional Data, CEPR Discussion Paper, No. 555, 1991; T. Bayoumi, B. Eichengreen: Shocking Aspects of European Monetary Integration, in: F. Torres, F. Giavazzi (eds.): Adjustment and Growth in the European Monetary Union, Cambridge, Mass. 1993; J. Decressin, A. Fatás: Regional Labor Market Dynamics in Europe, in: European Economic Review, Vol. 39, No. 9, 1995, pp. 1627-1655; for an overview see D. Dohse, C. Krieger-Boden, op. cit., p. 19 ff.

[6] J. A. Frankel, A. K. Rose: The Endogeneity of the Optimum Currency Area Criteria, in: The Economic Journal, Vol. 108, 1998, pp. 1009-1025, here p. 1010.

[7] P. Krugman: Lessons of Massachusetts for EMU, in: F. Torres, F. Giavazzi (eds.), op. cit.

Figure 4
Components of Labour Market Flexibility



Source: D. Dohse, C. Krieger-Boden: Währungsunion und Arbeitsmarkt. Auftakt zu unabdingbaren Reformen, Kieler Studie, No. 290, Tübingen 1998, p. 49.

shocks will not necessarily decrease, but may even increase as a result of EMU.

On theoretical grounds both hypotheses seem equally plausible. Hence, we have to call upon empirical evidence. Here, Frankel and Rose[8] took the lead by presenting econometric evidence for their line of argumentation, using data for twenty industrialized countries covering a thirty year period. However, criticism emerges that such investigations encompassing a number of non-European countries may not be representative for the European integration process since the Single Market Programme seems to have increased rather than decreased specialization in the EU. Furthermore, the example of the other large currency union (the USA) suggests that integration may entail more interregional and intersectoral divergence rather than more homogeneity.

There is another aspect, hardly mentioned in the literature, which we would like to give more prominence. The Frankel/Rose as well as the Krugman hypothesis assume a monotonic relationship between integration and specialisation, which may be misleading, as one cannot be certain that any correlation between integration and specialization observed in the past will hold to continue in EMU. It is also possible that the relationship prevailing in the past may turn into the opposite after some critical degree of specialization is reached, i.e. there may be structural breaks in the course of the integration process.

Against this background, in a currency area as large and heterogeneous as Euroland, asymmetric shocks can never be excluded.

Labour Market Flexibility in the EU

Without the nominal exchange rate as a shock absorber, the effects of external shocks and of internal policy failure (e.g., wages rising faster than productivity) will hit the labour markets more heavily than before; hence, labour market flexibility is crucial. In labour markets there is a broad array of different flexibility instruments: (aggregate and relative) wage flexibility, working time flexibility, and spatial and job mobility (see Figure 4).

Although there is empirical evidence that real wages do react to changes in unemployment[9] there is

[8] J. A. Frankel, A. K. Rose, op. cit.

[9] R. Layard, S. Nickell, R. Jackman: Unemployment: Macroeconomic Performance and the Labour Market, Oxford 1991; T. Tyrväinen: Wage determination in the long run, real wage resistance and unemployment: multivariate analysis of cointegration relations in 10 OECD economies, Discussion Papers, No. 95, 12, Bank of Finland, Helsinki 1995.

hardly any scholarly disagreement that aggregate wage flexibility in most EU member countries is far too low. Furthermore, the experiences of various European countries (e.g. Sweden and Italy) suggest that even relatively high aggregate wage flexibility is not sufficient to restore labour market equilibrium in the era of increasing globalisation and intensified worldwide competition. Aggregate wage flexibility must be accompanied by a high degree of relative wage flexibility, regionally, sectorally and according to worker qualifications. However, in Europe relative wage flexibility is too low to help bring unemployment down to acceptable levels. High levels of unemployment compensation tend to act as a disincentive to work; minimum wages and high marginal taxes on labour reduce the demand for labour, specifically for low income workers. Also, existing wage formation systems in Europe are not structured to cope with the increasing heterogeneity of firms.[10] The well-known hypothesis of Calmfors and Drifill[11] according to which labour markets work best in those countries with either very decentralized or very centralized wage formation systems does not grasp recent experiences: countries with decentralized wage negotiations prove more successful than others with respect to labour market performance.[12]

Working time flexibility may – within a certain range – substitute for insufficient wage flexibility. Increased working time flexibility can help raise productivity and, thus, improve competitiveness. Working time flexibility is relatively high in the UK, Ireland, Portugal, the Netherlands and France, and relatively low in Germany, Greece and Belgium.[13]

Geographical and job mobility (i.e. the willingness of workers to change employer, occupation and/or place of residence, if necessary) may ease the strain on wages after a shock and may help maintain a high level of employment.[14] By contrast, institutional constraints on mobility, like high costs of hiring and firing, may strengthen insider positions in the wage bargaining process and thus contribute to reducing not only job mobility but also wage flexibility. In Europe, such constraints are widespread and as a result the mobility of workers is extremely limited not just between European countries, but even within them.

Although some institutional changes have been made in several EU member states (e.g., by a stepwise reduction in the stringency of collective wage agreements and by increasing working time flexibility), attempts at thoroughly reforming labour market institutions have been half-hearted. Only the UK and the Netherlands have implemented a broad and relatively consistent mix of flexibility instruments. In all other member states of the EU, current labour market flexibility is still far too low. Indeed, several countries are moving in the wrong direction; e.g. France and Italy by seeking to introduce a 35-hour working week or Germany with the intended lowering of the retirement age from 65 to 60 years.

This bleak assessment of labour market flexibility in (most of) Euroland suggests that structural reform of European labour markets is definitely warranted, not only to alleviate the severe unemployment problems, but also to cope with the challenges that EMU will bring about. However, since wage flexibility, working time flexibility and geographical mobility are – to a certain degree – substitutes there is no need for all countries to follow the same reform model in order to attain higher overall labour market flexibility. Country-specific preferences may thus lead to different mixes of flexibility instruments which have roughly the same efficiency properties. Nevertheless, we have to take into careful consideration the 'all or nothing' warning issued by Coe and Snower:[15] they argue that piecemeal labour market reforms may have had so little success in reducing unemployment in the past because they disregarded the complementarities between a broad range of policies and institutions. Hence, what is needed is a fundamental labour market reform which is both broad and deep.

Which Countries Are Fit for EMU?

Let us assume for the moment that the probability of asymmetric shocks and the status quo in European labour markets will not change fundamentally with the

[10] F. Bickenbach, R. Soltwedel: Produktionssystem, Arbeitsorganisation und Anreizstrukturen: Der Paradigmenwechsel in der Unternehmensorganisation und seine Konsequenzen für die Arbeitsmarktverfassung, in: D. Cassel (ed.): 50 Jahre Soziale Marktwirtschaft. Ordnungstheoretische Grundlagen, Realisierungsprobleme und Zukunftsperspektiven einer wirtschaftspolitischen Konzeption, Schriften zu Ordnungsfragen der Wirtschaft 57, Stuttgart 1998, pp. 491-534.

[11] L. Calmfors, J. Drifill: Bargaining structure, corporatism and macroeconomic performance, Economic Policy 6, 1988.

[12] N. Berthold, R. Fehn: Evolution von Lohnverhandlungssystemen – Macht oder ökonomisches Gesetz?, in: W. Zohlnhöfer (ed.): Die Tarifautonomie auf dem Prüfstand, Schriften des Vereins für Socialpolitik, Vol. 244, 1996; D. Dohse: Charakteristika von Lohnverhandlungssystemen und makroökonomische Performance, Institut für Weltwirtschaft, Kiel 1999 (mimeo).

[13] D. Dohse, C. Krieger-Boden, op. cit., pp. 58 ff.

[14] OECD: The OECD Jobs Study. Evidence and Explanations, Paris 1994, p. 64.

[15] D. T. Coe, D. J. Snower: Policy Complementarities: The Case for Fundamental Labor Market Reform, IMF Staff Papers, Vol. 44 (1), 1997, pp. 1-35.

introduction of the Euro. Then, the countries at the northern and southern peripheries of the EU (Finland, Italy and Spain) will be subject to a substantial risk of increasing unemployment: the probability that these countries will be hit by asymmetric shocks is high, whereas labour market flexibility is low (Table 1). Germany, France and Belgium face a lower probability that they will be hit by asymmetric shocks. However, if such shocks do occur there is a high risk of a permanent increase in unemployment due to the low degree of labour market flexibility in these countries.

Ireland and Portugal are not subject to a very high risk of increasing unemployment due to EMU: although the probability that these countries will be hit by asymmetric shocks is high, the relatively high degree of labour market flexibility is an effective insurance against higher unemployment.

The countries that are, from a labour market point of view, best prepared for EMU are the Netherlands and Austria, since there is only a low probability that they will be hit by asymmetric shocks, and labour market flexibility is high compared with the EU average.

Vicious or Virtuous Circle?

It seems very likely, however, that European labour markets will change as EMU proceeds. As yet, in preparation for EMU, and in response to increasing adjustment pressure, steps in opposite directions have been taken by member states.

On the one hand, efforts, particularly at the European level, tend to stifle competition and might easily lead to a 'vicious circle': the completion of the Single Market, the globalisation of markets and the introduction of EMU, it is often argued by politicians, unions and interest groups, require a 'social dimension' for the EU to protect European workers against 'unfair' competition and 'wage dumping'.[16] In this vein the European administration opted for introducing European minimum standards for working conditions, e.g., the initiatives based on the Social Charter and its accompanying Action Programme.[17] Our assessment is that these standards reduce the flexibility of labour markets. Moreover, they are costly, particularly for those member countries in which minimum standards are relatively low. As differences in productivity are likely to linger on, more uniform minimum standards may lead to increased unemployment in low-productivity countries.[18] High and increasing regional unemployment levels might give rise to demands for more EU development assistance and financing these subsidies is likely to restrain the economic dynamics of the remaining areas.[19]

On the other hand, there are indications of a possible 'virtuous circle', as several EU member states have, though at rather different speeds and scope, fostered measures to decentralise and to deregulate their economies and to increase the flexibility of their labour markets. Other countries may imitate the examples of the United Kingdom and the Netherlands who have gone farthest down that road and, subsequently, experienced a marked decrease of unemployment. Moreover, in most member states (with the exception of Ireland) there is a tendency towards decentralising the process of collective bargaining. Thus, the scope for more flexible working conditions on the enterprise level has been widened and the flexibility of labour markets at large has increased somewhat in almost all member states.

It is impossible to venture which of these two divergent tendencies will dominate in the long run. In favour of the virtuous circle hypothesis one may argue that by joining EMU the member countries did submit themselves to an external pressure shaping adjust-

Table 1
Countries

Probability of asymmetric shocks[1]	Current labour market flexibility[1] High	Low
Low	*Group 1* Netherlands, Austria	*Group 3* Germany, France, Belgium (Denmark)[2]
High	*Group 2* Ireland, Portugal (United Kingdom)[2]	*Group 4* Finland, Italy, Spain (Sweden, Greece)[2]

[1] Compared to EU average.
[2] Not joining EMU from the start.

Source: D. Dohse, C. Krieger-Boden: Währungsunion und Arbeitsmarkt. Auftakt zu unabdingbaren Reformen, Kieler Studie, No. 290, Tübingen 1998, p. 95.

[16] Although unions and employer's associations have been given 'voice' in the Maastricht treaty, in the foreseeable future, no European wage bargaining and no European collective wage agreements are to be expected.

[17] J. Addison, W. S. Siebert: The Course of European-level Labour Market Regulation, in: J. Addison, W. S. Siebert (eds.): Labour Markets in Europe: Issues of Harmonization and Regulation, Manchester 1997.

[18] K.-H. Paqué: Does Europe's Common Market Need a 'Social Dimension'? Some Academic Thoughts on a Popular Theme, in: J. T. Addison, W. S. Siebert (eds.), op. cit.; R. Soltwedel: Social Engineering in Europe: A German Perspective, in: J. T. Addison, W. S. Siebert (eds.), op. cit.

[19] Kronberger Kreis: Sozialunion für Europa?, Schriftenreihe des Frankfurter Instituts, Vol. 31, 1996.

ment needs which one single country cannot undo on its own. This may help advance solutions to get the roadblocks to political action for comprehensive labour market reform out of the way. That external pressure may be conducive to this end became apparent in the process of liberalization in the run up toward the completion of the Single Market: pointing at the commitment of the respective governments to the higher ranking objective 'European Integration' and the 'Single Market' offered an opportunity for politicians to escape the influence of well organized and powerful interest groups and to successfully make inroads into their privileges and exemptions from competition, i.e. in the area of transportation or telecommunications. Likewise, the convergence of inflation rates throughout the 1990s may be read as an outcome of the political commitment to EMU which allowed harnessing the zeal of national central banks to escape the influence of pressure groups urging a permissive monetary policy.[20] Thus member governments might use the implementation of EMU for an (implicit) agreement to really go for the badly needed cutback of the exuberant welfare state and to bring the incentive structures more in line with economic sustainability in order to foster market dynamics.[21] Thus, the introduction of EMU could call forth a reduction in the high costs of regulation and of social protection.

However, complacency is unwarranted that the circle will automatically be virtuous. National governments, the European administration, and, above all, employers and employees are under the gun and have to come up with a reliable commitment to institutional reform to achieve major progress in reducing unemployment.[22] Hence, there is an urgent need for an appropriate assignment of responsibilities.

Assignment of Responsibilities

The main responsibility for establishing the rules of the game is with national governments. Government has to provide an efficient institutional and legal framework within which the (national) agents on the labour market can act. This framework has to make it uncompromisingly clear to employers and employees that they must take market conditions into account when agreeing on working conditions. Furthermore, legal statutes that drive up the costs of employment have to be scrutinised, made more flexible or even eliminated. National governments have to be alert that the EU level is not seizing more competence than subsidiarity allows.

There is hardly a single member state, in which social policy is not characterised by poor transparency, financial illusion and disincentives, causing tremendous inefficiencies and impairing the awareness that social provisions have to be financed from distributable productivity growth.[23] In most of Euroland, the welfare system and the tax system add up to effective marginal tax rates close to 100 per cent for low-paid workers. Even if low-qualified workers were willing to enhance their work effort, they would run the risk of getting caught in this 'poverty trap'. Hence, staying unemployed and working in the shadow economy looks like the more promising alternative. Therefore, the attractiveness of (additional) work for low-qualified workers, for the unemployed, and for social security recipients has to be improved.

Also, the segmentation of labour markets has to be reduced in order to raise the employment opportunities of labour market outsiders. For instance, mandatory dismissal protection should be revised and limited to an economically reasonable extent. High legal and statutory protection against dismissals causes employers to calculate a risk surcharge based on the expected costs of the dismissal schemes. This risk surcharge discriminates particularly against the outsiders on the labour markets, who, lacking sufficient human capital, cannot rely on any 'economic' protection against dismissal.[24] The adverse effects of dismissal protection are all the more perceptible if other parameters of labour market flexibility are blocked. At the least, there should be legal 'exit options' out of mandatory dismissal protection.[25]

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[20] Sachverständigenrat zur Begutachtung der gesamtwirtschaftlichen Entwicklung: Reformen voranbringen, Jahresgutachten 1996/1997, Stuttgart 1996, par. 434; M. Mussa: Political and Institutional Commitment to a Common Currency, in: American Economic Review Papers and Proceedings, Vol. 87 (2), 1997, pp. 217–220.

[21] R. I. McKinnon: EMU as a Device for Collective Fiscal Retrenchment, in: American Economic Review, Papers and Proceedings, Vol. 87 (2), 1997, pp. 227–229, here p. 228; D. Salvatore: The Common Unresolved Problem with the EMS and EMU, in: American Economic Review, Papers and Proceedings, Vol. 87 (2), 1997, pp. 224–226, here p. 225.

[22] H. Siebert: The Euro: A Dozen Do's and Don't's, Kiel Discussion Paper, No. 312, Institut für Weltwirtschaft, Kiel 1998.

[23] The German reform of the sick pay scheme is a case in point. The legal obligation of the employer to pay a 100 per cent sick pay has been abolished, and although this regulation has returned as part of many collective agreements, the abolishment of the legal obligation has made employers and employees aware of the costs of such a regulation.

[24] Spain is a particularly conspicuous case in point for stringent dismissal protection resulting in skyrocketing youth unemployment. See OECD, op. cit.

[25] R. Soltwedel: Dynamik der Märkte — Solidität des Sozialen. Leitlinien für eine Reform der Institutionen, Kiel Discussion Paper, No. 297/298, Institut für Weltwirtschaft, Kiel 1997.

The European administration, being entitled to issue binding guidelines and directives, can and does play an important role in assisting member states in stimulating competition at the national level and thus in increasing the flexibility of their labour markets. The European Commission could spur institutional reform by setting incentives for decentralised experimentation in implementing its directives at the national level. This would give substance to the principle of subsidiarity. *Ex ante* harmonisation of national standards would not be necessary if the country-of-origin principle, i.e. the mutual acceptance of existing national standards, were applied. In this sense, the Council's posted workers directive of 1996 – to take just one of the EU's more recent regulative measures – provides the wrong signal. This directive hinders the cross-border movement of workers and thus impedes arbitrage on the labour markets by setting up new barriers between the national labour markets; this is in contrast to the spirit of the Cassis-de-Dijon type of decisions of the European Court of Justice.

It is certainly tempting for the EU Commission and national administrations to absorb increasing adjustment pressure literally at the European border, or to hand out bribes (i.e. subsidies) at the European level in order to make adjustment more 'socially acceptable'. Trade unions and employers' associations might very much appreciate such action: they might feel taken off the hook to meet the challenges of the increased competition that has been engendered by globalisation and monetary union. From this perspective, there is a risk that the enlarged competences for employment policies at the EU level (by the employment chapter of the Amsterdam treaty) could be used as a protective device. Such a shift of competences could further the zeal of the European commission to get additional own funds (in the form of taxing authority or own credit facilities on capital markets). The member states should keep a sharp eye at the endeavour for an active employment policy at the European level.[26]

To keep wages in line with productivity and to agree on labour market conditions that are conducive to an increase in employment is the main responsibility of employers' associations and trade unions in most EU member states. Coping with this responsibility will be even more difficult in a monetary union. German political and economic unification provides a good example of a 'wage and welfare benefit unification'. The implementation of the West German collective bargaining system with its tight and cozy corporatism aiming at swift wage equalisation turned out to be extremely harmful for East Germany; wage policy was completely decoupled from productivity and turned East Germany into a high cost location with unit labour costs exceeding the level of West Germany considerably throughout most of the 1990s. In recent years more and more East German firms have been trying – quite successfully – to get out of the cost-enhancing collective bargaining system, foreshadowing a fundamental shake-up of the whole system towards a more appropriate decentralised wage setting mechanism. Centralised collective bargaining, harnessed by politically induced objectives for wage policy, is apparently inappropriate in situations of widely differing conditions in labour markets as is the case for EMU member countries.

The need for decentralised wage policy is reinforced by the complex and comprehensive processes of reform in business organisation going on in many enterprises. The collective bargaining system must provide sufficient scope and opportunity to agree upon appropriate idiosyncratic solutions in wage contracting and regulation of working conditions given the increasing heterogeneity of enterprises.[27] Shaping pay systems in a more performance-oriented way, organising working hours more flexibly, forging agreements and contracts on guaranteeing employment and location security, and adopting measures for a long-term-oriented manpower policy – all of this can be done efficiently only at the enterprise level.

Conclusion

Given the stickiness of most European labour markets, the decision for EMU means that even more unemployment is looming around the corner after 'E-day'. Comprehensive reform of labour market institutions is a major precondition for EMU to trigger off a virtuous circle with improved growth and employment prospects. Vigilance is warranted, however, that the Employment Chapter of the Amsterdam treaty does not pave the way for a short-sighted and costly policy of transfers, inefficient employment programmmes, or *ex ante* harmonisation of working condition standards at the European level. Such a policy stance would inevitably end up in a vicious circle.

[26] Furthermore, the critical comments in the OECD Jobs Study on that type of policy should be kept in mind.

[27] See e.g. P. Milgrom, J. Roberts: Continuous Adjustment and Fundamental Change in Business Strategy and Organization, in: H. Siebert (ed.): Trends in Business Organization: Do Participation and Cooperation Increase Competitiveness?, Kiel 1995, pp. 231-258; as well as F. Bickenbach, R. Soltwedel, op. cit., and the references given there.