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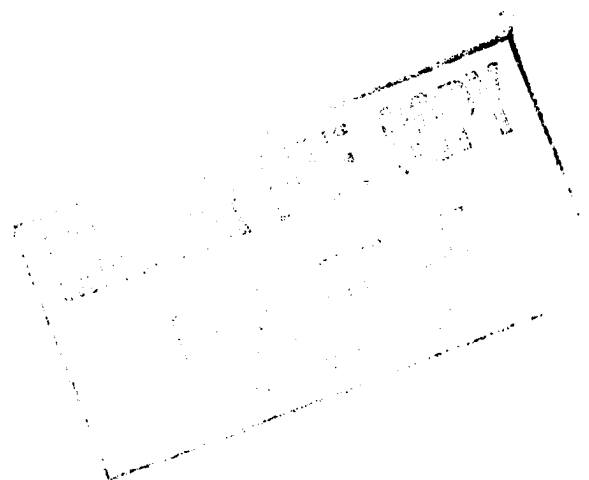
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# Western Europe: The Unemployment Crisis



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**An Intelligence Assessment**



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*EUR 83-10271  
December 1983*

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# **Western Europe: The Unemployment Crisis**

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**An Intelligence Assessment**

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**Western Europe:  
The Unemployment Crisis**

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**Key Judgments**

*Information available  
as of 14 November 1983  
was used in this report.*

We believe Western Europe faces a continued period of high unemployment, possibly averaging 12 percent through the end of the decade. Although the public has shown an unusual tolerance for unemployment, this persistent trend will increase pressure on political and social institutions and disrupt US–West European economic relations:

- By the second half of the 1980s, Western Europe may enter a period of frequent oscillation between governments of the left and right because incumbent leaders, unable to solve the unemployment problem, will become increasingly vulnerable to opposition attacks.
- Political extremism may become rampant among young people as much of an entire generation of youth faces years of joblessness or underemployment.
- Foreign workers increasingly will become targets of resentment by the unemployed, leading to social strains both within and among West European countries.
- Trade conflicts between Western Europe and the rest of the world will become more numerous and hotly contested as West European governments increasingly equate trade opportunities with job opportunities. Recent trade disagreements with the United States over steel and agricultural goods could become the rule, not the exception, and may spill over into other areas such as political and military cooperation. Moreover, the increasing importance of exports will put pressure on West European countries to relax—or less strictly enforce—trade restrictions on sales to the Soviet Bloc.
- As trade difficulties mount, protectionist pressures in Western Europe will grow. New barriers against US products likely will be limited, but restrictions against other countries, particularly Japan and the NICs, may increase, forcing those countries to offset lost sales in Western Europe by boosting sales efforts in the United States.

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- Dim unemployment prospects also will make it more difficult for West European countries to meet their defense commitments to NATO. Unemployment already has caused a severe fiscal drain on governments, and, with budgets likely to remain tight, pressure to curb defense spending will mount.

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Fundamental structural economic problems—rapid growth of the labor force, accelerating labor costs, and inability to restructure industry—are the main causes of Western Europe's unemployment problem; cyclical economic conditions are only a secondary factor. The unemployment rate in the region has been climbing almost continuously since 1970 and by mid-1983 reached over 10 percent. During the 1970s the total population increased very little, but the prime working-age population (ages 25 to 54) grew at twice the increase of the previous 10 years. Simultaneously, wages and nonwage labor costs skyrocketed, discouraging employers from expanding their work force and forcing them to reduce jobs through attrition. Western Europe's inability to move its employment base away from declining traditional industries into high-growth areas further depressed job creation in the 1970s.

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We do not expect Western Europe will be able to solve its structural unemployment problems quickly, and as a result the number of unemployed will continue climbing, albeit slowly, throughout the decade. Demographic trends will add even more prospective workers to the labor force than during the 1970s. Economic growth probably will be insufficient to offset the expansion of the labor force. Labor costs, on the other hand, should moderate in part because of high unemployment, but this marginal improvement alone will be insufficient to reverse the dismal unemployment trends. We see little chance for a significant pickup in the pace of industrial restructuring, thus employment growth will continue to be held back.

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Although the present course of macroeconomic policy should help to promote an economic climate more conducive to improved economic growth without rapid inflation, the underlying causes of Western Europe's unemployment problem are not, in our view, being adequately addressed. For the most part, governments are concentrating their efforts on employment programs—such as reducing working hours and government subsidies for hiring long-term unemployed—which do little more than redistribute the present unemployment. Few countries are implementing plans that

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encourage overall employment by holding down nonwage labor costs on employers; nor are governments actively trying to reduce public intervention in the economy—a major factor slowing the restructuring process. Moreover, governments are continuing to prop up outmoded, uncompetitive industries rather than promote investment in new, more dynamic industries.

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Most of the uncertainty in our assessment probably lies on the upside. Labor costs could moderate even more than we now expect, thus encouraging job creation. As workers continue to lose jobs and factories in traditional industries continue closing, unions may opt to preserve as many jobs as possible rather than press for higher wages. In addition, Western Europe may be able to restructure its industrial sector faster than we can foresee at present. Nascent efforts to move into high-technology areas may begin to pay off more quickly than we expect. Increased efforts to capitalize on existing technology through joint ventures with Japanese and US companies may help Western Europe become more competitive. Moreover, real economic growth may be more rapid than we now expect, particularly if the US recovery retains its momentum and the world trade picture improves. Nonetheless, even under the best conditions, we would expect these improvements to lower unemployment only marginally, leaving it still high by historical standards.

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**Western Europe:  
The Unemployment Crisis**

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**Severity of the Problem**

The struggle to overcome the highest levels of unemployment since postwar reconstruction is unquestionably the number-one economic problem facing West European leaders today. By mid-1983 unemployment in Western Europe had reached an estimated 18 million workers, 10.6 percent of the combined work force. Half of those unemployed are citizens of only four countries—France, West Germany, Italy, and the United Kingdom; but the problem is more broadly based because the unemployment rates are well into double digits in several other countries (see table 1).

The employment situation in Western Europe has been deteriorating almost continuously for nearly two decades. Prior to 1974, unemployment grew slowly, although the overall West European jobless rate remained below 4 percent of the work force. Although unemployment rates jumped precipitously during the recessionary periods of 1974-75 and 1980-83, joblessness continued to spread even in the intervening years of relative prosperity (see figure 1).

The composition of the unemployed population is nearly as disturbing as the overall levels. Unlike in previous recessions when laid-off workers could find alternative employment within a few months, a full 40 percent of those unemployed today have been out of work for more than a year. Moreover, prime working-age males (ages 25 to 54)—most of whom are the main family breadwinners—have been losing ground in the job market faster than women or youths. By mid-1983, about 9 million of these men were unemployed, accounting for one-half of total unemployment. In contrast, at the height of the 1974-75 recession, this age group only accounted for one-fourth of the unemployed.

Perhaps more socially troubling is the high rate of unemployment among young people. By mid-1983, over 9 million people between the ages of 15 and 24—one out of every four—were unable to find work

**Table 1  
Western Europe:  
Midyear 1983 Unemployment**

	Rate (percent)	Number Unemployed (thousands)
<b>Total</b>	<b>10.6</b>	<b>18,306</b>
Big Four countries	10.1	9,577
West Germany	8.9	2,320
France	8.5	2,029
Italy	9.7	2,258
United Kingdom	12.4	2,970
Smaller countries	11.8	8,729
Austria	3.2	145
Belgium	11.9	510
Denmark	10.6	285
Finland	6.8	150
Greece	10.0	370
Iceland	1.3	1
Ireland	14.2	146
Luxembourg	1.3	2
Netherlands	17.4	841
Norway	3.4	61
Portugal	9.0	390
Spain	17.5	2,141
Sweden	3.4	135
Switzerland	0.8	52
Turkey	20.0	3,500

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in Western Europe. In the largest four economies, youth unemployment rates range from a low of 13 percent in West Germany to over 30 percent in Italy. In some smaller countries the situation is even worse; in Spain, for example, over 40 percent of the young people are jobless.

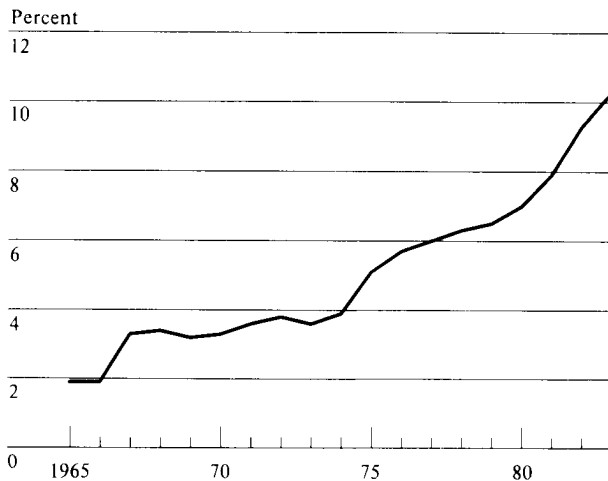
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**Figure 1**  
**Western Europe: Unemployment Rates**



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**The Causes of Unemployment**

We believe that frictional unemployment and cyclical factors account for close to 60 percent of the unemployment in Western Europe and attribute the remainder to deep-rooted structural problems.

**Frictional Unemployment**

The level of frictional unemployment—the “normal” unemployment associated with a full-employment economy—varies from country to country depending on social as well as economic structure. We assume that in Western Europe frictional unemployment is about 3 percent. This rate is low compared with

<sup>1</sup> Frictional unemployment—that resulting from normal labor turnover during periods of strong economic growth; *cyclical unemployment*—that caused by temporary economic fluctuations; *structural unemployment*—that caused by fundamental, longer term economic problems.

frictional unemployment in the United States.<sup>2</sup> West European unemployment prior to the 1970s, however, had consistently been less than that in the United States. Immediately prior to the economic disruptions of the 1970s when most West European economies were producing at high-capacity utilization rates, unemployment in the region averaged about 3 percent; we believe that is a fair guide to what the unemployment rate would be today if cyclical and structural trends were more favorable.

**Cyclical Unemployment**

The slowdown in economic growth that began in late 1980 has been an important, though only partial, cause of Western Europe’s unemployment problem. The region’s economic growth slowed from an annual rate of 3.3 percent in the 1970s to 1.4 percent in 1980, and remained essentially flat through 1982. The slowdown particularly affected industrial output, which dropped 3.5 percent between 1980 and 1982. Meanwhile, the unemployment rate grew from 6.5 percent in 1979 to 9.8 percent in 1982.

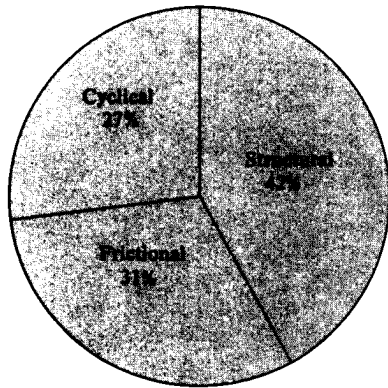
We estimate that the recent recession accounts for roughly one-fourth of Western Europe’s total unemployment (see figure 2). To determine how much unemployment is cyclically related, we used our econometric model, the Linked Policy Impact Model (LPIM),<sup>3</sup> to simulate the level of unemployment that would have existed had Western Europe not been in a recession. If the region had continued to grow at the

<sup>2</sup> Although no definitive estimate of US frictional unemployment exists, the consensus among observers of the US economy is that about 6 to 7 percentage points of the US unemployment rate is accounted for by frictional factors. Since the aggregate unemployment rate for the United States in 1982 was 9.6 percent, cyclical and structural factors would account for between 2.6 and 3.6 percentage points.

<sup>3</sup> The Linked Policy Impact Model is an econometric model of the world. It economically integrates individual 200-equation models of the seven major industrialized economies—West Germany, France, Italy, the United Kingdom, Canada, Japan, and the United States—and smaller models of regional economic groups—the smaller developed countries, OPEC, and non-OPEC LDCs; the centrally planned economies are represented only by trade-flow equations.

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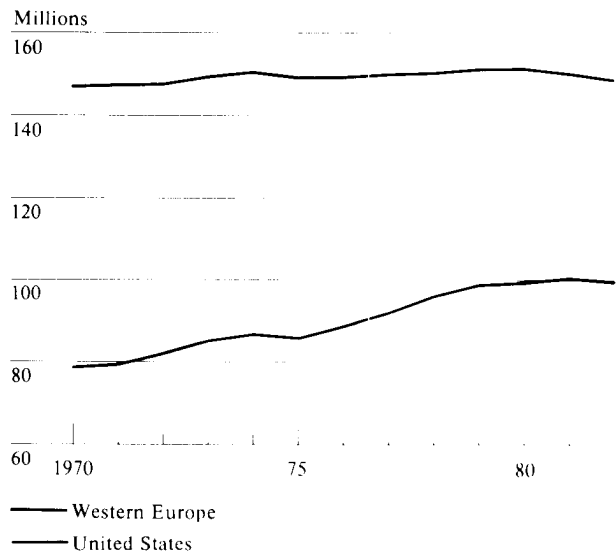
**Figure 2**  
**Western Europe: Causes of Unemployment<sup>a</sup>**



<sup>a</sup>The percentage distribution applies to 1982 when the total unemployment rate reached 9.8 percent.

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**Figure 3**  
**Western Europe and the United States: Employment**



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average annual rate of the 1970s, the LPIM simulations indicate that unemployment would have reached only 7.1 percent in 1982. In other words, about 2.7 percentage points of Western Europe's unemployment rate in 1982 was caused by the recession, while the remaining 7.1 percentage points resulted from other factors.

**Structural Unemployment**

We calculate structural unemployment as that amount remaining after accounting for frictional and cyclical factors. By our estimate, the structural unemployment rate in Western Europe could amount to 4.1 percentage points in 1982—42 percent of the region's unemployment rate.

There are several structural factors that aggravate the unemployment levels. Demographic trends—the baby boom of the early 1960s and increasing female participation rates—have rapidly boosted the supply of labor. Escalating labor costs—both wage and nonwage—over the past decade have depressed the demand for labor by making it increasingly expensive to hire workers compared with automating factories.

Rising labor costs also have reduced the international competitiveness of a number of traditional high-employment West European industries, such as steel, textiles, and autos, leading to company closures and worker layoffs. At the same time, the West European economies have been unable to reorient their economic base toward new industries in the high-technology and services sectors.

The severity of Western Europe's structural economic problems are even more apparent when comparing US and West European job creation during the 1970s. During that period, when economic growth was about comparable for the two areas, the West Europeans added only 5.3 million new jobs despite an 11.6-million increase in the labor force; the United States meanwhile added 20.6 million jobs with a jump of 24.2 million in the labor force (see figure 3). If job creation in the United States had been as poor as it was in Western Europe, by 1980 the unemployment rate here would have topped 16 percent.

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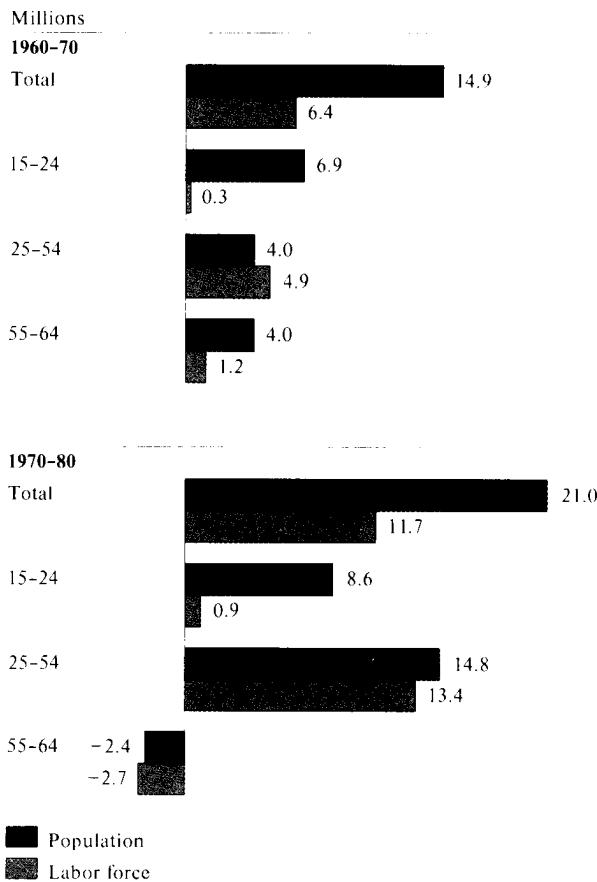
**Table 2** *Millions*  
**Western Europe: Working-Age**  
**Population and Labor Force,**  
**by Age for Selected Years**

	1960	1970	1975	1980
Working-age population	215.3	230.2	240.5	251.2
15-24	49.5	56.4	59.6	65.0
25-54	131.2	135.2	146.0	150.0
55-64	34.6	38.6	34.9	36.2
Labor force	145.9	152.2	157.6	163.9
15-24	35.3	35.6	34.5	36.5
25-54	90.8	95.7	105.1	109.1
55-64	19.8	21.0	18.0	18.3

**Demographics Intensify the Problem.** Western Europe's labor supply grew unusually fast in the 1970s compared with the previous decade, thereby exacerbating the region's unemployment problem. From 1970 to 1980 the labor force expanded 7.7 percent—adding almost 12 million more prospective workers—compared with a growth of only 4.4 percent, or 6.4 million people in the 1960s. The total working-age population grew only slightly faster than in the previous decade. Much of the more rapid growth in the labor force was caused by the changing age distribution of the population. The number of people in the prime working-age category—25 to 54—jumped dramatically and was coupled with increasing female participation rates. Moreover, in the 1975 to 1980 period, the number of youths 15 to 24 looking for work jumped sharply for the first time in two decades (see table 2).

The rapid expansion of the prime working-age population was caused by a combination of more people coming into the lower end of this age group—a result of increasing birth rates in the 1950s and 1960s—and a smaller number of people leaving the group at the upper age bracket—a result of heavy World War II casualty rates. Between 1970 and 1980 the prime-working-age population increased by 14.8 million people, leading to a 13.4-million-person, or a 14-percent increase in the labor force of this age group. During the 1960s this group expanded by only 4.9 million people—a 5.4-percent rise (see figure 4).

**Figure 4**  
**Western Europe: Population and Labor Force**  
**Changes, by Age Group**



The growing proportion of the female population seeking work also contributed to the expansion of the labor force in the 1970s. Between 1970 and 1980 female participation rates for the prime working-age group increased from 43 percent to 48 percent. The change alone would have led to a 2.6-million increase in the female labor force over the decade, even if the total number of working-age women was constant; the number of working-age women actually grew by 6.2

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million, however. Major factors undoubtedly responsible for larger female participation were: increased educational levels; a tendency toward smaller families; increased availability of household appliances; higher unemployment among married men; increased opportunities for women in service sectors, which tend to be relatively attractive for women; and changing social attitudes that encouraged more married women to work.

The number of young people 15 to 24 years old looking for work became another burden on the West European labor market in the latter half of the 1970s. The baby boomlet of the early 1960s boosted the population of the 15- to 24-year-old age group by 5.4 million people in 1975-80, compared with only a 10-million increase in the previous 15-year period. The labor force of this age group actually declined by 1.1 million between 1970 and 1975, thus helping to offset increases in other groups; during the following five-year period, however, 2 million additional youths began job hunting.

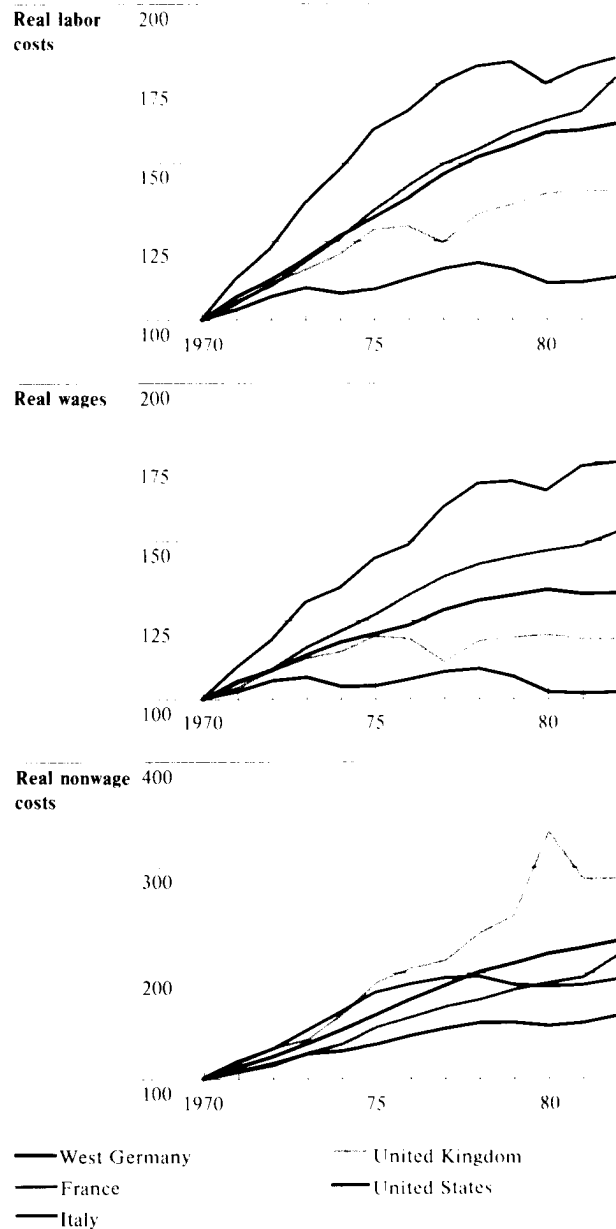
The changes in the youth labor force resulted primarily from a leveling off of participation rates following a 15-year fall as enrollment in full-time education by youth leveled off. During the 1960 to 1975 period, youth labor force participation rates dropped from an average 69.5 percent to 56.4 percent as more and more young people chose to continue their education rather than immediately enter the labor force. The youth participation rate dipped only 0.8 percentage point from 1975 to 1980.

**Labor Costs Rise.** Surging labor costs—both wage and nonwage—in Western Europe over the 1970s contributed to the unemployment problem by depressing the demand for labor. In the Big Four countries, total labor costs in the manufacturing sector rose an average of 60 percent in real terms between 1970 and 1980; Italian labor costs rose the most at 75 percent and British costs the least at 40 percent (see figure 5). In contrast, labor costs rose only about 12 percent in the United States during the same period. With this rapid escalation in the price of labor, companies increasingly found ways to get more output out of

**Figure 5**  
**Big Four and the United States:**  
**Index of Total Labor Costs, Wages,**  
**and Nonwage Costs**

Index: 1970=100

*Labor costs, both wage and nonwage, rose faster in the Big Four than in the United States . . .*



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**Table 3** Percent  
**Western Europe: Nonwage Costs as a Share of Direct Wages, 1970-82<sup>a</sup>**

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981 <sup>b</sup>	1982 <sup>b</sup>
West Germany	42.1	44.3	46.9	49.8	52.3	56.1	59.8	61.8	64.5	66.3	68.3	70.6	72.6
France	59.0	59.6	60.8	63.0	64.6	69.1	70.1	71.4	72.3	75.0	76.6	77.8	83.8
Italy	77.7	81.1	83.7	86.4	93.6	97.5	98.7	94.2	90.7	91.4	87.6	84.4	86.1
United Kingdom	14.6	15.7	17.2	20.2	20.5	23.4	25.2	28.1	29.7	31.4	33.9	35.8	35.8
United States	24.7	25.9	26.6	28.6	30.0	31.4	32.8	33.7	34.6	35.4	36.3	37.4	38.7

<sup>a</sup> "Nonwage costs" are defined here as pay for time not worked (vacations, holidays, and other leave), all bonuses and other special payments, the cost of payments in kind—before payroll deductions of any kind and employer contributions to legally required insurance programs and contractual and private benefit plans.

<sup>b</sup> Preliminary estimates.

Source: US Department of Labor, Bureau of Labor Statistics, Office of Productivity and Technology, April 1983.

[Redacted]

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each worker—either by buying more productive equipment or by eliminating featherbedding. For the most part, this type of productivity increase did not result in direct layoffs, but, rather, firms simply failed to replace retiring workers. [Redacted]

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Labor costs in Western Europe rose rapidly because both wage and nonwage costs accelerated. The increase in direct wages accounted for more than one-half of the advance in total labor costs. Unions in Western Europe were particularly powerful in the early 1970s as economic growth was especially buoyant and through strike action or threatened strike action were able to extract sizable direct wage gains from employers.<sup>5</sup> Between 1970 and 1980 real wages in Western Europe grew about 40 percent. Of the Big Four, Italy had the most rapid increase in real wages, while the United Kingdom had the smallest increase, about 20 percent. In the United States, on the other hand, real wages grew only 2 percent during the past decade. [Redacted]

Nonwage costs grew at a more rapid rate than wages during the 1970s, not only because of union pressures, but also because of public sentiment for greater benefits to accrue to workers. For the Big Four countries, these employer expenses more than doubled in real terms over the last decade and in several West European countries began to rival the cost of direct wages (see table 3). In Britain, nonwage costs jumped a mammoth 230 percent. As a share of direct wages, however, British nonwage costs are still lower than in other major West European countries, in part because medical and dental benefits in Britain are paid under a social-medical system funded by general revenues, rather than by employment taxes. Nonwage costs also more than doubled in West Germany between 1970 and 1980, making their share of direct wages roughly comparable with those in France and Italy. The Social Democrats came to power in 1969 after 20 years of more conservative Christian Democratic rule and subsequently built an extensive social welfare system paid for in part by employer and employee contributions. [Redacted]

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Of the Big Four, French and Italian nonwage costs remained the highest as a share of direct wages throughout the 1970s and early 1980s. French costs rose steadily, continuing a trend begun in the 1960s. In Italy, however, nonwage costs as a share of direct wages peaked in 1976. Since then, successive Italian governments, with moderate success, have intentionally limited employer-paid taxes on employees in hope of stimulating employment. [redacted]

During the 1970s, the price of machinery and equipment in Western Europe grew less rapidly than labor costs, and, as a result, industries began to shift the relative mix of labor and capital used in the production process. Between 1970 and 1980 the price of labor relative to capital<sup>6</sup> advanced 45 percent in Western Europe; in the United States labor costs increased relative to capital by only 25 percent. Because of these relative price trends, West European businessmen sought to increase labor productivity. They invested in new capital equipment instead of enlarging their labor force as demand expanded; capital over labor was further encouraged by low real interest rates in Western Europe during the 1970s. Moreover, in those industries where demand was stagnant, business began using existing capital more effectively by eliminating unnecessary workers through attrition. As a result, industrial productivity grew more than 50 percent in Western Europe during the 1970s, while unemployment continued to mount. [redacted]

Our analysis shows that the countries with the greatest increase in the price of labor relative to the price of capital also had the biggest decline in the ratio of the mix of labor and capital used in the production process (see figure 6). The United States, with a relatively small increase in its labor cost/capital cost ratio had the least decline in the labor stock/capital stock ratio and managed to increase industrial employment by 12 percent during the period. [redacted]

<sup>6</sup> In this paper the price of capital—or capital cost—is represented by a price index for new plant and equipment. We have not attempted to estimate the total cost of capital, which would include the cost of raising funds for investment purposes. The source of our plant and equipment cost data is the *OECD National Income Accounts*, various years, Paris [redacted]

Although rising labor costs are not the only cause of high unemployment, for comparison purposes we used our LPIM to measure what would have happened to West European unemployment had the region held increases in relative labor costs to the same level as did the United States. Our model simulation shows that by 1982 about 5 million more workers in Western Europe would have been employed, giving the region an unemployment rate of only 6.7 percent, rather than the actual 9.8-percent rate of that year. [redacted]

**Restructuring Proceeds Too Slowly.** Western Europe's inability to adjust its economic base in the face of stagnant or declining output in high-employment, traditional industries, such as steel and textiles, has further depressed the demand for labor. Rapidly increasing labor costs and the advancing industrial sophistication of many LDCs have resulted in a number of old-line West European industries losing domestic markets to import competition. At the same time, Western Europe's agricultural employment has dropped dramatically as technological progress has increased agricultural productivity and reduced the demand for labor. The region has not moved rapidly enough, however, into new employment areas such as high-technology-related industries and the service sector—two areas of exceptional growth in the United States—to offset employment losses elsewhere. West European technology lags that of the United States, and, consequently, high-technology-related service jobs lag as well. In addition, rapidly escalating labor costs also have held back the growth of service employment. [redacted]

Despite rising agricultural output, farm employment in Western Europe dropped by about 5 million workers—17.8 percent—from 1970 to 1980 (see table 4 and figure 7). In the European Community, the elimination of agricultural jobs was even more dramatic, down almost 30 percent. Ironically, the benefits from the rise in production due to the increased use of machinery, fertilizer, and pesticides were largely offset by the higher costs of these inputs. Consequently, farm incomes in the European Community have stagnated in real terms since 1973, and farm employment has been further discouraged. [redacted]

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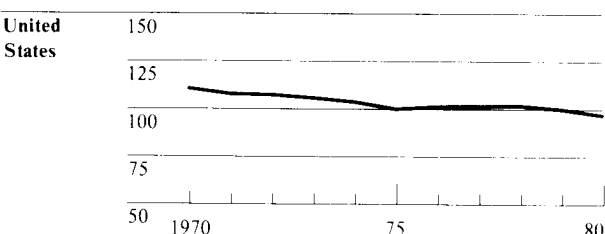
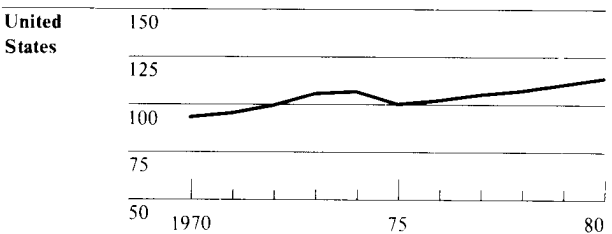
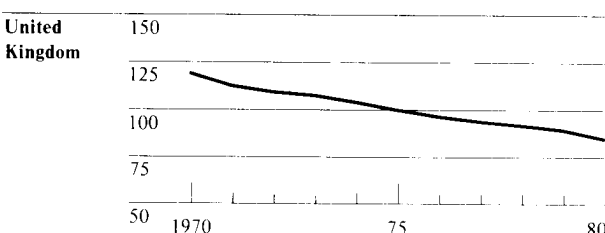
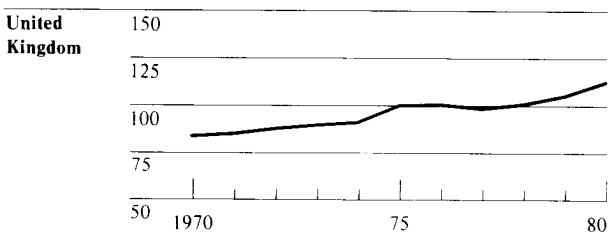
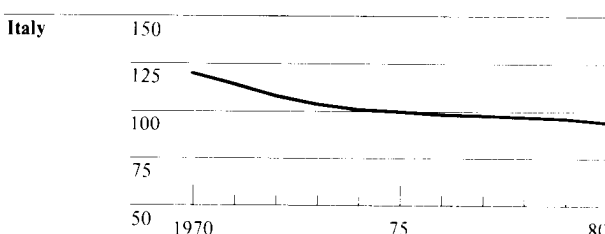
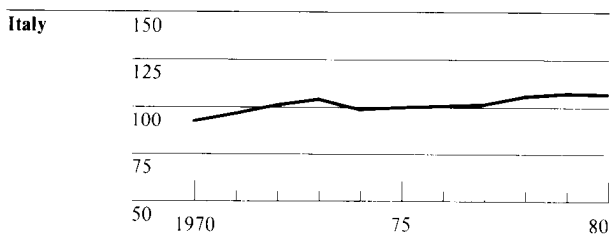
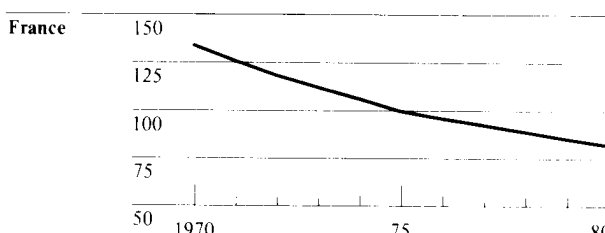
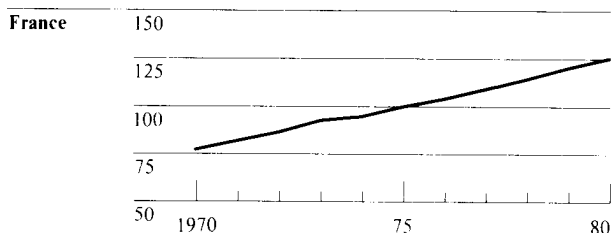
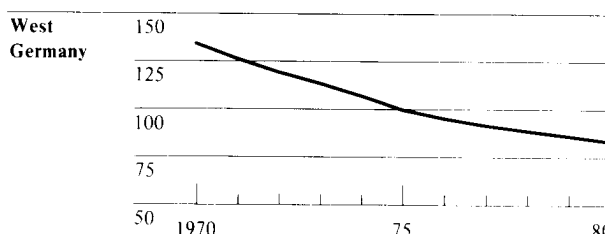
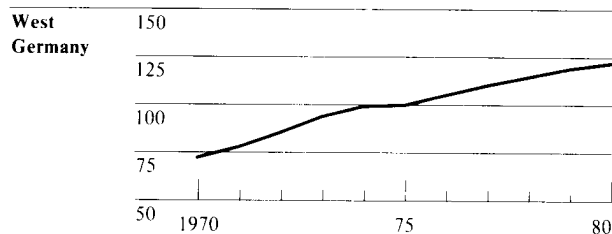
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**Figure 6**  
**Big Four and the United States:**  
**Ratios of Labor Costs to Capital Costs**  
**and Labor to Capital Stock**

Index: 1975=100

*As Big Four labor costs relative to capital costs rose . . .*

*employment relative to capital declined . . .*



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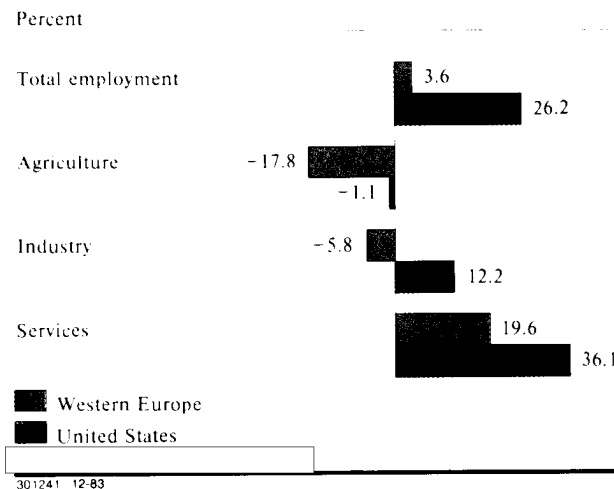
**Table 4**  
**Western Europe and United States:**  
**Labor Force and Civilian Employment,**  
**by Sector and Selected Years**

Thousands

	1970		1979		1980		1981	
	Western Europe	United States	Western Europe	United States	Western Europe	United States	Western Europe	United States
Total labor force	152,179	82,771	162,368	104,962	163,924	106,940	165,434	108,670
Total employment	147,259	78,678	152,116	98,824	152,562	99,303	151,210	100,399
Agriculture	26,596	3,567	22,296	3,509	21,857	3,529	21,435	3,518
Industry	57,548	27,029	54,612	30,918	54,235	30,315	52,545	30,194
Services	63,115	48,082	75,208	64,397	75,470	65,459	77,230	66,687

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**Figure 7**  
**Western Europe and the United States:**  
**Employment Changes, by Sector, 1970-80**



- Steel output has dropped because other domestic industries, such as autos, have increasingly substituted less expensive and lighter weight materials and because of increased competition from low-cost producers in newly industrializing countries (NICs).
- The shipbuilding sector is depressed because of the present world ship glut—partially a result of lower oil trade volumes—and an increase in the shipbuilding capacity of some low-cost LDCs, such as South Korea.
- Although the drop in auto output primarily reflects the 1981 recession, the plunge in British production is mostly due to increased competition from imports (figures 8 and 9).

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In the face of declining output in basic industries, Western Europe has not been able to sufficiently increase job opportunities in other sectors, particularly in high-technology industry and services.

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The manufacturing sector was unable to make up for the jobs lost in agriculture because output in some industries was depressed in part by Western Europe's growing inability to compete successfully against imports:

- The textile industry has been particularly hard hit by import competition. While textile output in the major West European countries has been dropping almost continuously since the early 1970s, textile imports have been rising rapidly; in dollar terms, West European textile imports from outside the region grew sixfold between 1970 and 1980.

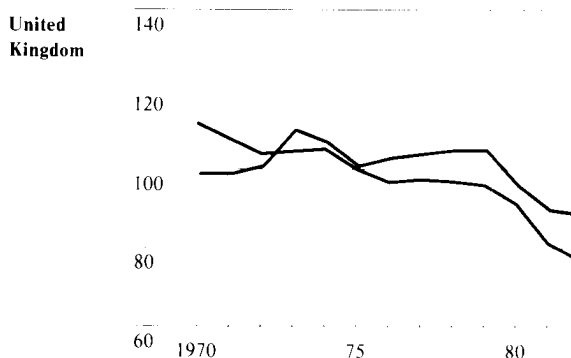
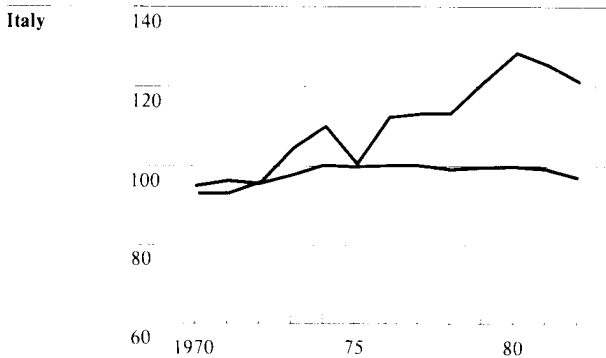
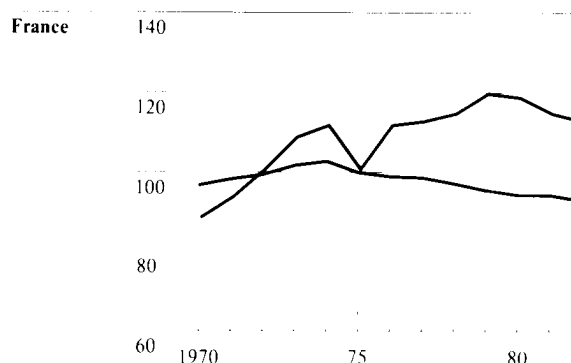
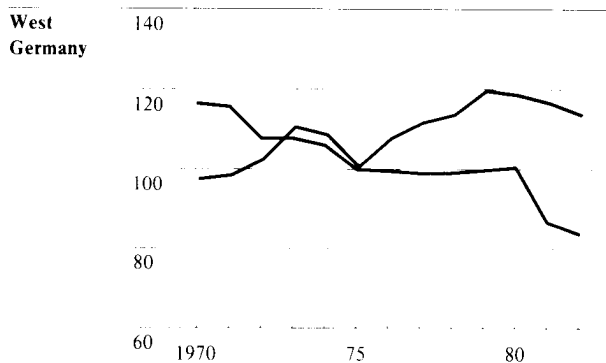


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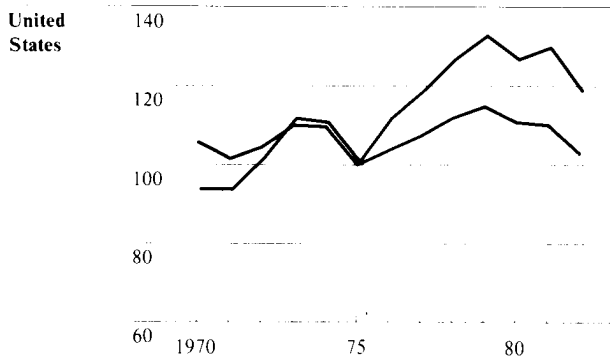
**Figure 8**  
**Big Four and the United States:**  
**Manufacturing Output and Employment**

Index: 1975=100

*When production rose, employment declined . . .*



*Until 1980, United States employment continued to climb . . .*



— Employment  
 — Production

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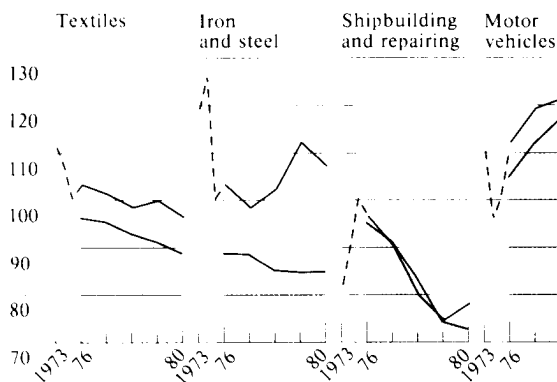
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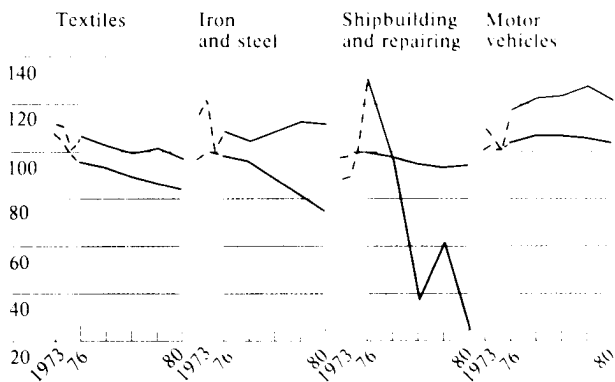
**Figure 9**  
**Production and Employment in Four Major Industrial Sectors**

Index: 1975 = 100

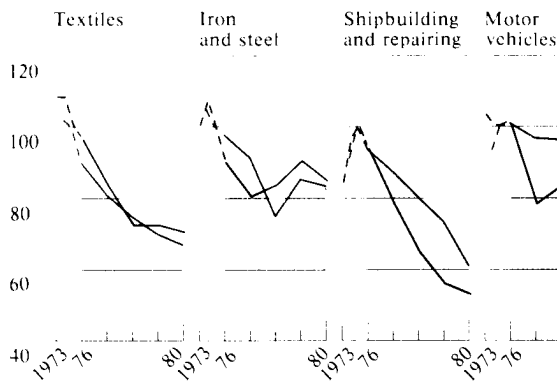
**West Germany**



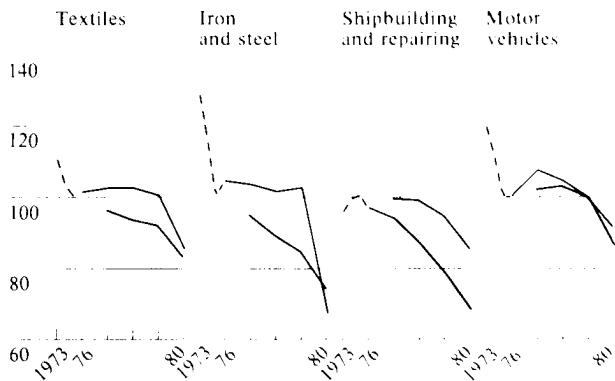
**France**



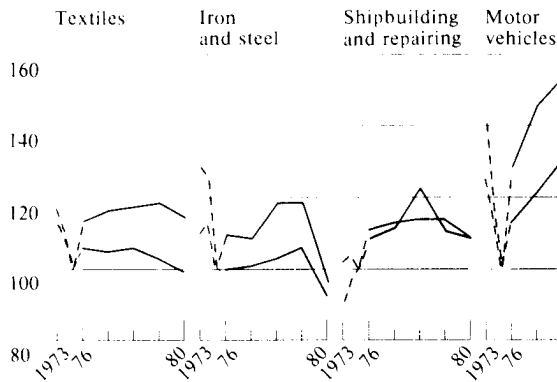
**Sweden**



**United Kingdom**



**United States**



— Employment  
- - - Production

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**Table 5**  
**International Trade in High-Technology Products <sup>a</sup>**  
**for Selected Countries, 1970 and 1980**

Million US \$  
(except where noted)

	France	West Germany	Italy	United Kingdom	EC Nine	Japan	United States
<b>1970</b>							
Exports	3,732.5	9,656.8	2,887.1	5,233.4	26,713.5	5,650.0	15,973.1
Imports	3,797.0	4,830.1	2,569.0	3,275.2	20,717.1	2,228.8	6,705.9
Trade balance	-64.5	4,826.7	318.1	1,958.2	5,996.4	3,421.2	9,267.2
Exports (percent greater than imports)	-1.7	100	12.4	59.8	28.9	153.5	38.2
<b>1980</b>							
Exports	25,841.5	52,558.2	18,033.1	31,768.9	157,808.6	42,068.7	65,614.0
Imports	25,125.2	33,687.0	16,371.6	20,335.8	126,502.7	11,187.0	34,966.4
Trade balance	716.3	18,871.2	1,661.5	11,433.1	31,305.9	30,881.7	30,647.6
Exports (percent greater than imports)	2.9	56.0	10.1	56.2	24.7	276.0	87.6

<sup>a</sup> "High-technology products"—as defined by Lester A. Davis in *Technology Intensity of United States Output and Trade*, Office of Trade and Investment Analysis, United States Department of Commerce, July 1982—are those 10 products that in the United States incorporate the greatest amount of research and development both in their final production process and in their components. To compare high-technology trade across countries, this definition was applied to other countries as well. The top 10 products consist of selected items within these SITC categories:

1. Guided missiles and spacecraft.
2. Communications equipment and electronic components.
3. Aircraft and parts.
4. Office, computing, and accounting machinery.
5. Ordnance and accessories.
6. Drugs and medicines.
7. Industrial inorganic chemicals.
8. Professional and scientific instruments.
9. Engines, turbines, and parts.
10. Plastic materials and synthetic resins, rubber, and fibers.

[Redacted]

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[Redacted]

Europe jumped almost 20 percent from 1970 to 1980, creating about 12.5 million additional jobs. In the United States, on the other hand, services employment bounded upward by over 35 percent, in part reflecting a higher percentage of females working and a related strong demand for restaurant and fast food establishments. If Western Europe had been able to increase jobs in this sector as rapidly as did the United States, another 10 million jobs would have been created. [Redacted]

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While the service industries in Western Europe grew moderately during the 1970s, employment expansion in this sector remained substantially slower than that in the United States. Services employment in Western

Traditionally, the West European service sector has employed a much smaller share of the work force than the United States. In 1970 the relative shares of Western Europe's and the United States' service

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sector employment to total employment were 43 percent and 61 percent, respectively; by 1980 the shares had increased to 49 percent and 66 percent, respectively. Western Europe's relatively smaller service sector is in part due to the emphasis on reindustrialization after the Second World War—Western Europe concentrated on rebuilding its industrial base while the United States, with its industries still intact, was able to support an expanding service sector. [redacted]

Western Europe's inability to move out of oldline industries into new, more advanced industries, including services, is a result of a number of complex and interrelated economic, political, and social factors.

*Insufficient Investment.* Venture capital is not readily available in Western Europe, thus investment funds are inhibited from flowing into innovative, newly emerging companies—the very companies needed to foster the restructuring process. Stock markets in most West European countries are not well developed, forcing entrepreneurs to raise capital by borrowing from banks—which by their conservative nature are predisposed not to finance small risky undertakings. In the United States, on the other hand, a well-developed stock market has made venture capital more available, thus helping to create the thousands of new, small firms that have been instrumental in producing new products and new jobs. In addition, tax laws in Western Europe have inhibited investment because interest payments on loans cannot be deducted as an operating expense—unlike the situation in the United States. Investment has been further held back by the declining profitability of many West European firms—profits have been squeezed by increasing production costs—particularly labor costs—and increased competition from foreign producers. [redacted]

*Unwillingness to Change.* Much of labor and management in Western Europe appear satisfied with the status quo, preferring not to adopt new technology. Labor unions point to automation as a major cause for job losses in the seventies, and the strong political position of unions has contributed to government efforts to maintain employment in traditional industries—the same industries in which union membership is concentrated. Much of management simply is unwilling to venture into untested areas. A statement by Eckert Van Hoover, a member of the board of

directors of Deutsche Bank, represents a pervasive West European business philosophy, "The banking profession clearly has the expertise to sail into the world of electronic banking, but not without paying a price. If the price means giving up the identity of the banking profession as we know it today, then to me the price is too high." [redacted]

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*Regulatory Rigidities.* A plethora of government regulations within West European countries has added innumerable delays and expense to doing business and has decreased the private sector's flexibility. In West Germany, for example, establishing a new business requires applications for up to 150 approvals; moving a plant to a new location entails obtaining several hundred permits. In France, it normally takes two years to incorporate a business. Regulations on services have impeded business expansion across West European countries. West Germany and France, for example, permit only locally established firms to write insurance policies. The company may be foreign owned, but must be registered in the country concerned. Professional qualifications—such as for doctors, lawyers, and accountants—are not universally recognized, thus professional services cannot move easily across borders. For example, the requirements for becoming a certified accountant vary from country to country, and only nationally certified accountants can do business in each country. [redacted]

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*Small Domestic Markets.* The small size of individual West European country markets forces many companies to seek out foreign markets in order to reach economies of scale in the production process, thereby adding additional uncertainty to corporate planning and increasing marketing and production costs—on top of already high labor costs. Although the EC countries have improved the economic integration of the region by eliminating tariff barriers among themselves, Western Europe remains a collection of highly individualistic countries, each with its own language, culture, and customs. Thus, penetrating even a neighboring market can be difficult and costly. In the United States and—to a lesser extent—Japan, the domestic market alone is sufficiently large to enable companies to benefit from economies of scale. [redacted]

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**Big Four: Fiscal and Monetary Policies**

West Germany's 1983 budget contained no major stimulative programs that would induce employment and pared social benefits by \$2.2 billion in an effort to hold down the deficit. The draft 1984 budget also carries an austerity label and calls for even more social spending cuts. Monetary policy has eased over the past year and a half, however, parallel to the declining rate of inflation. [redacted]

In the United Kingdom Prime Minister Thatcher has stuck firmly to conservative policies aimed at restructuring the British economy, despite an unemployment rate now approaching 13 percent—the highest rate among the seven major industrial countries. Thatcher's policies have been strikingly successful against inflation, which has been cut from a 22-percent rate when she took office in 1979 to 4 percent for the 12 months ending in April 1983. [redacted]

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In France the Mitterrand government is now trying to repair the damage done by the expansionary policies followed during its first year in office. From mid-1981 to mid-1982 Paris sharply boosted welfare benefits and other government spending and increased the money supply in an effort to stimulate the economy. Although France avoided the decline in GNP that afflicted most of its neighbors, economic growth was miniscule, and the country soon found itself saddled with rapidly worsening inflation and soaring budget and balance-of-payments deficits. Paris began to retrench in June 1982 and in March of this year imposed what is basically a classic austerity program: a package of spending cuts and tax increases designed to cut aggregate demand but which also will raise unemployment. [redacted]

Italy has been unwilling to give further stimulation to the economy because of the already huge budget deficit. The Bank of Italy, in particular, has resisted calls for lower interest rates. Unemployment appears to be even less of a political issue in Italy than elsewhere in Western Europe. In addition to generous social welfare programs, strong family ties, which provide a financial umbrella, have eased the burden of joblessness. Moreover, some of the officially unemployed probably have jobs in the extensive underground economy. [redacted]

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**The Policy Response**

Despite the gloomy unemployment picture, West European governments have made few efforts to put people back to work—a sharp change from their response to the 1974-75 recession. Although most governments have adopted a number of minor programs aimed at subsets of the unemployed, such as youth or older workers, none have implemented broad-based anticyclical economic policies intended to increase aggregate employment. We believe the West Europeans are not likely to initiate any major new employment-creation programs over the next few years or to adopt measures to correct the more fundamental factors depressing labor demand. [redacted]

The limited policy response in part reflects the realization by government leaders that the expansionary policies of the mid-1970s were not particularly successful, either in boosting economic growth or in creating jobs.<sup>7</sup> More importantly, however, governments are reluctant to increase expansionary efforts because most West European countries entered the current recession with inflation rates and budget

<sup>7</sup> In the appendix we analyze the impact of stimulative fiscal and monetary policies on the unemployment situation. In general, we conclude that the limited benefits from such policies would be more than offset by the negative impact of higher inflation and larger current account deficits. [redacted]

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### **Western Europe: Employment Programs**

**Reduced Working Hours.** Government initiatives and suggestions to private industry in this area are aimed at protecting existing jobs as well as creating new positions. In the Netherlands new civil servants are now being hired only for a 32-hour week with no change in hourly wages. In Belgium, the Martens government has proposed a 5-percent reduction in working hours accompanied by a 3-percent reduction in wages and a 3-percent increase in employment. Individual companies have made similar agreements in many industries, and it is estimated that 50,000 new jobs will have been created as a result of this program by the end of 1984. [redacted]

**Government Hiring Subsidies.** In an attempt to lower the high cost to the employer of hiring new employees, the British Manpower Services Commission has proposed outright subsidies to employers who hire the long-term unemployed. It proposes a subsidy of around \$75 per week to companies hiring workers who have been unemployed between six and 12 months and of \$100 a week for a person unemployed over a year. These subsidies would be paid at the full rate for nine months and at half the rate for a further nine months. [redacted]

**Early Retirement.** These plans are experiencing a new popularity with some government encouragement. The first round of early-retirement plans in the early seventies has already sharply cut the rates at which men over 60 are remaining in the labor force. Now plans call for further lowering retirement ages. Several major West German companies have introduced phased retirement from the age of 55. In Belgium a new subsidized early-pension system has been introduced allowing workers to retire at 60 without reduction of pension. One new employee must be hired for each early retiree. [redacted]

**Reducing Wages.** In the past year, most major governments have been active in promoting moderate wage gains or outright wage freezes. Wage moderation is viewed by some countries, especially Belgium, as a means of restoring international competitiveness and thus leading to a greater demand for labor. Last year the Belgian Government instituted a three-month wage freeze followed by partial indexation. Italy and France, however, still face high inflation in their economies. France's wage-price freeze in 1982

and 1983 and Italy's restructuring of the scala mobile were intended to lower double-digit inflation rates rather than directly create increased employment opportunities. [redacted]

**Direct Job Creation.** Make-work measures have been used modestly to create jobs usually for the long-term unemployed or those who suffer some other handicap. The Swedish Government has the largest relief work program with close to 1 percent of its work force in such projects; the British have about half that number in their projects. More innovative measures are being attempted by the British, French, and Belgians. They have all recently introduced modest plans to supply business startup funds rather than benefits to the unemployed as a way of putting the jobless back to work. [redacted]

**Apprenticeship Systems.** The purpose of these programs is to give on-the-job training in private firms to young people while paying them low wages at government expense. West Germany already has one of the most developed apprenticeship systems in Western Europe. In the past, the early development of marketable skills and workplace discipline resulted in an unemployment rate for West German teenagers slightly less than the rate for all workers. Recently, however, as unemployment has significantly worsened in West Germany, the unemployment rate for young people has climbed to over 15 percent. Apprenticeship positions are lagging the number of applicants for these positions. There are only 335,000 training places for 451,000 applicants. [redacted]

**Tighter Immigration Policies.** Switzerland began reducing the number of foreign workers in its work force before this recession. Now other countries are also considering tougher laws to make more jobs available for their own citizens. An estimated 11 million foreigners live in northern Europe of which 4.7 million are in West Germany. The West German federal Government has issued a bill encouraging foreign workers to leave the country by offering them cash payments. They can also claim all their previous contributions to the public pension funds, an option not open to West German citizens. Labor Minister Bleum expects 80,000 to 100,000 foreign workers to return to their own countries voluntarily because of these measures. [redacted]

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deficits that were already exceptionally high by past standards. In addition, high unemployment rates have generated surprisingly little social unrest. The extensive West European social welfare safety net has eliminated much of the suffering caused by joblessness. As a result, policymakers generally are sticking with relatively conservative anti-inflationary policies, despite mounting unemployment. [redacted]

Although the present course of macroeconomic policy should help to promote an economic climate more conducive to improved economic growth without rapid inflation, the underlying causes of Western Europe's unemployment problem are not, in our view, being adequately addressed. For the most part, governments are concentrating their efforts on employment programs—such as reducing working hours and government subsidies for hiring long-term unemployed—which do little more than redistribute the present unemployment. Few countries are implementing plans that encourage overall employment by holding down nonwage labor costs on employers. Moreover, governments are continuing to prop up outmoded, uncompetitive industries rather than promote investment in new, more dynamic industries; according to the EC Commission, subsidies by member governments to their faltering steel industries totaled an estimated \$20 billion between 1975 to 1981 and nearly that much again is planned up to 1985. Even if governments increase support for new industries, the more fundamental economic, political, and social factors that hindered industrial restructuring in the 1970s will continue to operate. [redacted]

A number of West European governments are implementing programs to promote new industries in the high-technology area. Most of the plans are small scale and by themselves are unlikely to significantly advance the region's high-technology competitiveness. The European Community recently started the \$1.3 billion Esprit Program that will fund over 10 years efforts to better coordinate research and development among the 10 EC members. Bonn already supports scientific foundations and provides the integrated-circuit industry with \$150 million annually in support for R&D funding. In a May 1983 speech, Chancellor Kohl promised additional measures would be taken to improve West Germany's international competitiveness in high-technology fields. Paris has planned to

spend \$7 billion over a five-year period (1982-86) to assist the electronics industry, although funds have already fallen well short of government goals. Nevertheless, in our opinion, funding for high-technology industries is likely to remain limited as long as budgets in Western Europe are tight and governments continue to prop up financially troubled traditional industries. [redacted]

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**Prospects**

Based on a simulation of our LPIM model, we believe that the unemployment rate in Western Europe will remain in double digits through the end of the decade. For the region as a whole, we expect the rate will edge up somewhat to perhaps 12 percent by 1990. These judgments are based on several key assumptions. On the negative side:

- Demographic trends will add even more prospective workers to the labor force than during the previous decade, thereby placing upward pressure on the unemployment rate.
- Overall economic growth prospects are dim.
- No fundamental change in the factors that have hindered Western Europe's restructuring thus far.

On the plus side, we believe that the rise in the relative cost of labor compared with capital will slow, thereby leading employers to hire more workers than would otherwise be the case if labor costs continued to rise at the pace of the 1970s (see table 6). [redacted]

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Most of the uncertainty in our assessment probably lies on the upside. Labor costs could moderate even more than we now expect, thus encouraging job creation. As workers continue to lose jobs and factories in traditional industries continue closing, unions may opt to preserve as many jobs as possible rather than press for higher wages. In addition, Western Europe may be able to restructure its industrial sector faster than we can foresee at present. Nascent efforts to move into high-technology areas may begin to pay off more quickly than we expect, particularly if increased efforts to capitalize on existing technology through joint ventures with Japanese and US companies help Western Europe become more competitive.

Table 6

Percent

**Western Europe: Baseline Projection for Economic Conditions and Unemployment Through 1990**

	1982	1983	1984	1985	1986	1987	1988	1989	1990
<b>Western Europe</b>									
Real GNP growth rate	0.5	0.8	2.2	2.4	2.4	2.4	2.4	2.4	2.4
Labor/capital cost ratio	2.2	2.0	2.1	2.2	2.2	2.2	2.2	2.2	2.2
Labor force growth	0.8	0.8	0.8	0.8	0.8	0.7	0.7	0.7	0.6
Employment growth	-0.5	-0.7	0.7	0.5	0.5	0.4	0.5	0.5	0.5
Unemployment rate	9.8	11.1	11.2	11.5	11.8	12.0	12.2	12.4	12.5
<b>Big Four</b>									
Real GNP growth rate	0.4	0.9	2.2	2.4	2.4	2.4	2.4	2.4	2.4
Labor/capital cost ratio	2.2	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8
Labor force growth	0.6	0.6	0.6	0.6	0.5	0.5	0.4	0.4	0.3
Employment growth	-1.1	-0.6	0.5	0.3	0.3	0.3	0.3	0.3	0.4
Unemployment rate	9.4	10.5	10.6	10.9	11.2	11.3	11.4	11.5	11.5
<b>West Germany</b>									
Real GNP growth rate	-1.1	1.0	2.9	2.5	2.5	2.5	2.5	2.5	2.5
Labor/capital cost ratio	1.9	4.0	4.0	4.0	4.0	4.0	4.0	4.0	4.0
Labor force growth	0.3	0.3	0.3	0.3	0.2	0.1	0.0	-0.1	-0.2
Employment growth	-2.3	-1.5	0.3	1.0	0.0	0.0	0.0	0.0	0.0
Unemployment rate	7.5	9.1	9.2	9.4	9.6	9.7	9.7	9.7	9.5
<b>France</b>									
Real GNP growth rate	1.9	-0.1	0.2	2.5	2.5	2.5	2.5	2.5	2.5
Labor/capital cost ratio	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0	3.0
Labor force growth	1.0	1.0	1.0	1.0	0.8	0.6	0.6	0.6	0.4
Employment growth	-0.3	-0.2	1.0	0.6	0.5	0.5	0.5	0.5	0.5
Unemployment rate	8.5	9.6	9.6	9.9	10.2	10.3	10.4	10.4	10.3
<b>Italy</b>									
Real GNP growth rate	-0.3	0.4	2.9	2.5	2.5	2.5	2.5	2.5	2.5
Labor/capital cost ratio	1.0	0.7	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Labor force growth	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Employment growth	-0.4	0.0	0.1	0.2	0.4	0.6	0.7	0.8	1.0
Unemployment rate	9.3	9.8	10.1	10.4	10.5	10.4	10.3	10.0	9.6
<b>United Kingdom</b>									
Real GNP growth rate	1.5	2.3	3.0	2.0	2.0	2.0	2.0	2.0	2.0
Labor/capital cost ratio	3.0	2.7	2.7	2.7	2.7	2.7	2.7	2.7	2.7
Labor force growth	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Employment growth	-1.0	-0.4	0.5	0.3	0.3	0.2	0.2	0.2	0.2
Unemployment rate	12.3	13.3	13.5	13.8	14.2	14.6	15.1	15.5	16.0

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**Table 7** *Millions*  
**Western Europe: Working-Age Population and Labor Force Trends 1980, 1985, and 1990**

	1980	1985	1990
Working-age population	251.2	259.0	264.6
Labor force	163.9	170.6	177.6

Source: OECD, *Demographic Trends 1950-1990*, Paris, 1979 and OECD, *The Challenge of Unemployment*, Paris 1982.

[Redacted]

Moreover, real economic growth may be more rapid than we now expect, particularly if the US recovery retains its momentum and the world trade picture improves. Even if all of these conditions improve, however, unemployment rates in Western Europe are likely to remain high by historic standards through the end of the decade. [Redacted]

**Demographics To Worsen**

Labor force trends will be even more of a problem during the 1980s than in the previous decade. Projections by the OECD show that the labor force will expand by about 13.7 million people during the present decade—an 8.4-percent increase compared with a 7.7-percent increase during the 1970s (see table 7). In other words, Western Europe will need to create 13.7 million new jobs just to keep unemployment from rising in the 1980s; during the past decade employment increased by only 5.3 million workers. [Redacted]

As in the previous decade, the expansion of the labor force during the 1980s results primarily from a change in the age distribution of the population and, to a lesser extent, changes in participation rates by sex. The OECD estimates that the working-age population in the 1980s will increase somewhat less than in the 1970s but will be more concentrated in the prime working-age group—the age group with the highest participation rates. Even in those countries such as West Germany where the working-age (15 to 64 years old) population is expected to decline in the second-half of the decade, the prime working-age group will still expand. In West Germany as well as most of

Western Europe, the number of young adults (15 to 24 years old) in the population will decline as will the labor force of that age group. Female participation rates are expected to continue rising, although some offset will come from projected lower participation rates for males. [Redacted]

**Slow Economic Growth**

Slow economic growth will be another factor keeping unemployment high during the rest of the 1980s. Although most economies in Western Europe began in mid-1983 to pull out of the recession, we do not expect economic growth to accelerate to the high levels following the 1974/75 recession. For the remainder of the decade, we estimate growth will average about 2.4 percent a year for the region as a whole, compared with an average of 3.3 percent annually during the 1970s. Already tight fiscal policies will probably be continued as governments further attempt to reduce large deficits that have developed over the past 10 years. In a number of countries, governments are cutting back spending plans, including politically sensitive social programs. Little help is likely to come from exports either, as the important LDC market will be plagued by the overhang of on-going financial difficulties. With oil prices likely to remain slack for some time, even the once lucrative OPEC market will probably show little growth. [Redacted]

Interestingly, our projection of high unemployment through 1990 is not significantly dependent on our estimate of economic growth because the most important problems in Western Europe are structural. Using our LPIM we simulated the employment impact of faster economic growth. More rapid than expected economic growth in Western Europe could occur for a variety of reasons. For example, the US economy may remain more buoyant than most private forecasters are predicting, or world trade may expand at a faster clip than present conditions lead us to believe. According to our econometric model, if economic growth averaged 3.4 percent a year for the remainder of the decade—reasonably high by 1970s standards—the unemployment rate in 1990 for Western Europe as a whole would be 3.2 percentage points

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**Table 8** *Percent*  
**Western Europe: Impact on Unemployment of  
 Faster Economic Growth**

	1982	1983	1984	1985	1986	1987	1988	1989	1990
<b>Western Europe</b>									
Real GNP growth rate	0.5	0.8	3.2	3.4	3.4	3.4	3.4	3.4	3.4
Employment growth	-0.5	-0.7	1.1	1.0	1.0	1.0	1.0	1.0	1.0
Unemployment rate	9.8	11.1	10.9	10.8	10.6	10.3	10.0	9.7	9.3
<b>Big Four</b>									
Real GNP growth rate	0.4	0.9	3.2	3.4	3.4	3.4	3.4	3.4	3.4
Employment growth	-1.1	-0.6	0.8	0.8	0.8	0.9	0.9	0.9	1.0
Unemployment rate	9.4	10.5	10.3	10.2	9.9	9.6	9.2	8.7	8.1
<b>West Germany</b>									
Real GNP growth rate	-1.1	1.0	3.9	3.5	3.5	3.5	3.5	3.5	3.5
Employment growth	-2.3	-1.5	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Unemployment rate	7.5	9.1	8.7	8.4	8.0	7.4	6.8	6.1	5.2
<b>France</b>									
Real GNP growth rate	1.9	-0.1	1.2	3.5	3.5	3.5	3.5	3.5	3.5
Employment growth	-0.3	-0.2	1.4	1.1	1.0	1.0	1.0	1.0	1.0
Unemployment rate	8.5	9.6	9.2	9.2	9.0	8.6	8.3	7.9	7.3
<b>Italy</b>									
Real GNP growth rate	-0.3	0.4	3.9	3.5	3.5	3.5	3.5	3.5	3.5
Employment growth	-0.4	0.0	0.5	0.5	0.9	1.0	1.2	1.3	1.6
Unemployment rate	9.3	9.8	9.8	9.7	9.4	8.9	8.3	7.6	6.6
<b>United Kingdom</b>									
Real GNP growth rate	1.5	2.3	4.0	3.0	3.0	3.0	3.0	3.0	3.0
Employment growth	-1.0	-0.4	0.7	0.7	0.8	0.8	0.8	0.8	0.8
Unemployment rate	12.3	13.3	13.3	13.2	13.2	13.1	13.0	13.0	12.9

[Redacted]

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below our baseline projection (see table 8). Of the Big Four, West Germany would benefit the most from more rapid economic growth—we calculate that the unemployment rate would drop 4 percentage points below the baseline projection by 1990. [Redacted]

**Slower Rise in Labor Costs**

Labor cost trends in the remainder of the 1980s should have a positive impact on employment. We believe that a number of factors affecting both wage and nonwage costs are working to hold back the rise in total labor costs, and as a result the labor-to-capital cost ratio should increase less rapidly than in the previous decade. In our baseline case, we project that for Western Europe as a whole, the relative cost of

labor should advance an average of only 2.2 percent a year during the rest of this decade, down from 3.8 percent a year in the 1970s.<sup>8</sup> With a smaller increase in labor costs relative to capital costs, business should hire more workers than if labor costs rose more rapidly. [Redacted]

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Increases in direct wage costs should moderate because excess labor will continue to flood labor markets, thus putting downward pressure on real wages.

<sup>8</sup> Ratios for individual countries vary considerably, but in general we assume that labor-to-capital cost ratios will advance one-third less rapidly than they did in the past decade. [Redacted]

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**Table 9**  
**Western Europe: Impact on Unemployment of Constant Labor/Capital Cost Ratio**

Percent

	1982	1983	1984	1985	1986	1987	1988	1989	1990
<b>Western Europe</b>									
Labor/capital cost	2.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Employment growth	-0.5	-0.3	1.3	1.1	1.1	1.2	1.2	1.2	1.2
Unemployment rate	9.8	10.8	10.4	10.0	9.7	9.3	8.9	8.7	8.4
<b>Big Four</b>									
Labor/capital cost	2.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Employment growth	-1.1	0.0	1.3	1.2	1.3	1.3	1.3	1.4	1.4
Unemployment rate	9.4	10.0	9.4	8.8	8.2	7.5	6.6	6.2	5.7
<b>West Germany</b>									
Labor/capital cost	1.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Employment growth	-2.3	-0.4	1.8	1.7	1.7	1.7	1.7	1.7	1.7
Unemployment rate	7.5	8.2	6.8	5.5	4.1	2.6	0.9	0.9	0.9
<b>France</b>									
Labor/capital cost	3.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Employment growth	-0.3	-0.4	1.8	1.7	1.7	1.7	1.7	1.7	1.7
Unemployment rate	8.5	8.2	6.8	5.5	4.1	2.6	0.9	0.9	0.9
<b>Italy</b>									
Labor/capital cost	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Employment growth	-0.4	0.2	0.5	0.6	0.9	1.0	1.2	1.3	1.5
Unemployment rate	9.3	9.5	9.6	9.5	9.1	8.6	8.0	7.3	6.4
<b>United Kingdom</b>									
Labor/capital cost	3.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Employment growth	-1.0	0.0	1.2	1.2	1.3	1.3	1.3	1.3	1.3
Unemployment rate	12.3	12.9	12.4	12.0	11.5	11.0	10.5	10.0	9.4

High unemployment already has decimated union membership, which has in turn reduced labor's ability to press for higher wages. In the past two years, real wages in Western Europe were essentially stagnant. Although some pickup in real wages is likely compared with the recent recessionary years, the advances in real wages during the remainder of the 1980s probably will not return to the pace of the 1970s.

Nonwage labor costs also should not rise as rapidly. Several West European governments already are cutting their generous social welfare programs, which in turn should reduce upward pressure on employer-paid payroll taxes. The West Germans have cut planned social programs in this year's budget, and the French

have recently cut first-year unemployment compensation by three-fourths for people who have worked less than six months.

A more dramatic—but unlikely—slowdown in the escalation of labor costs would improve the employment picture considerably over our baseline case. According to our LPIM, if labor costs relative to capital costs remain constant, unemployment in Western Europe would progressively decline during the rest of the decade and by 1990 would be below 8.5 percent (see table 9). Unemployment would drop the most—5.8 percentage points below the baseline projection—in the Big Four, with West Germany showing the biggest improvement.

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Table 10

Percent

**Western Europe: Impact on Unemployment of Rapid Rise in Labor/Capital Cost Ratio**

	1982	1983	1984	1985	1986	1987	1988	1989	1990
<b>Western Europe</b>									
Labor/capital cost	2.2	3.9	3.9	3.9	3.9	3.9	3.9	3.9	3.9
Employment growth	-0.5	-0.9	0.4	0.2	0.1	0.1	0.1	0.2	0.2
Unemployment rate	9.8	10.6	11.7	12.2	12.7	13.2	13.7	14.2	14.6
<b>Big Four</b>									
Labor/capital cost	2.2	4.4	4.4	4.4	4.4	4.4	4.4	4.4	4.4
Employment growth	-1.1	-0.9	0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Unemployment rate	9.4	10.8	11.3	12.0	12.6	13.1	13.7	14.2	14.7
<b>West Germany</b>									
Labor/capital cost	1.9	6.3	6.3	6.3	6.3	6.3	6.3	6.3	6.3
Employment growth	-2.3	-2.1	-0.5	-0.8	-0.9	-1.0	-1.0	-1.0	1.0
Unemployment rate	7.5	9.7	10.5	11.4	12.3	13.1	13.8	14.5	15.0
<b>France</b>									
Labor/capital cost	3.0	5.3	5.3	5.3	5.3	5.3	5.3	5.3	5.3
Employment growth	-0.3	-0.5	0.7	0.3	0.1	0.1	0.1	0.1	0.1
Unemployment rate	8.5	9.9	10.1	10.8	11.3	11.7	12.1	12.5	12.8
<b>Italy</b>									
Labor/capital cost	1.0	1.9	1.9	1.9	1.9	1.9	1.9	1.9	1.9
Employment growth	-0.4	0.0	0.1	0.2	0.4	0.6	0.7	0.8	1.0
Unemployment rate	9.3	9.9	10.4	11.0	11.3	11.6	12.0	12.4	12.9
<b>United Kingdom</b>									
Labor/capital cost	3.0	3.6	3.6	3.6	3.6	3.6	3.6	3.6	3.6
Employment growth	-1.0	-0.6	0.2	0.0	-0.1	-0.1	-0.2	-0.2	-0.2
Unemployment rate	12.3	13.4	13.8	14.4	15.0	15.7	16.4	17.0	17.7

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On the other hand, if relative labor costs rise more than we expect, unemployment would worsen. According to our LPIM, a resumption of the relative labor costs pattern of the 1970-80 period would lead to escalating unemployment throughout the decade. For the region as a whole, unemployment would rise to nearly 15 percent by 1990 (see table 10). Unemployment would be a staggering 5 percentage points higher in West Germany, rising to 15 percent. The rate would climb to nearly 18 percent in the United Kingdom.

**Limited Progress in Restructuring**

We believe the slow pace of industrial restructuring in Western Europe is likely to pick up somewhat during the next several years, but not enough to enhance appreciably the region's employment prospects. Venture capital will likely become more available, thus encouraging the creation of new, more innovative companies. Over-the-counter stock markets already are growing in the United Kingdom, France, and

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Sweden, albeit from a very small base. Investment by existing companies in new production methods also should increase as the economic recovery proceeds and profits show some improvement. Although unions continue to balk at automating production lines, some reduction in the level of resistance is appearing. In recent press conferences, leaders of West Germany's largest labor association—the West German Trade Union Federation (DGB)—have stated that they are willing to accept automation and modernization of factories if the union is consulted beforehand and displaced workers are provided retraining opportunities. Business as well is showing some signs of adapting to the new economic environment by increasingly pursuing joint ventures with US and Japanese companies in an attempt to acquire new technology. [redacted]

In addition, governments are gradually becoming aware of the economic rigidities created by excessive regulation and are starting to address these problems. The West German Government, for example, has established an interagency group to identify and eliminate regulations and requirements that inhibit market adjustment and increase costs for the private sector. [redacted]

Although these various factors seem to be moving in the right direction, we believe many more economic, political, and social adjustments are necessary if industrial restructuring is to proceed fast enough to correct the unemployment problem. Additional measures aimed at promoting the adjustment process will take time to implement, and more time will elapse before the economy will appropriately react. Western Europe's industrial problems took years to evolve; they will require years to solve. [redacted]

**Implications**

We believe that persistently high unemployment will increase pressure on political and social institutions in Western Europe and increase tensions between these countries and their trading partners. During most of the postwar period, economic growth has helped moderate conflicts over social inequality and trade policy. Sluggish growth combined with continuing record jobless rates, however, will reduce maneuverability and make these conflicts more contentious. [redacted]

High and rising unemployment already has made incumbent governments vulnerable to charges that they are unable to devise solutions to unemployment and could threaten their political survival. In polls throughout the region, overwhelming majorities of respondents say unemployment is their countries' leading economic problem and that government is responsible for solving it. To be sure, voters may become inured to high unemployment rates particularly if—as in the June 1983 UK elections—other economic indices are improving and noneconomic issues become more prominent. In addition, Western Europe's highly developed social welfare net has helped prevent mass demonstrations and civil disruptions. If, as we expect, the electorate sees no decline in unemployment over the next several years, campaign promises of opposition parties will become more appealing during the next round of national elections—scheduled for West Germany in 1987, and for France and the United Kingdom in 1988. As a result, many West European countries may be entering an era of frequent oscillation between governments of the left and right. In Turkey, where unusually high unemployment will be coupled with other economic problems and the lack of longstanding democratic traditions, joblessness could contribute to more serious political instability. [redacted]

Continuing high unemployment, combined with social welfare cutbacks and low real wage increases, may incite greater militancy on the part of West European labor for jobs and higher pay. High jobless rates have weakened organized labor's bargaining position and moderated its wage demands in recent years; but, once recovery takes hold and rank-and-file union members see no gains for themselves, they may renew demands for higher wages, as has been the recent experience in the US automobile industry. [redacted]

Youth unemployment poses particularly serious long-term problems for Western Europe and could lead to political extremism among this group. Much of an entire generation faces years of joblessness or underemployment. Resultant feelings of despair and discontent can easily engender disillusionment with

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democratic institutions. College-educated youth, who normally would become their countries' political and intellectual leaders, are especially susceptible either to political alienation or to extremism of the right or left.

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[Redacted]

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Persistent unemployment will also continue to exacerbate other social strains within and among West European countries, in our judgment. Foreign workers are likely to be a particular target of resentment. In a recent French opinion poll, for example, 51 percent of the respondents said the repatriation of foreign workers would be the best way to solve the unemployment problem. The foreign guest worker problem already troubles West Germany's relations with Turkey and—to a lesser extent—with Yugoslavia. The issue of labor mobility also is a stumblingblock in the European Community's accession negotiations with Spain and Portugal.

[Redacted]

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Continuing high levels of unemployment may cause West Europeans to more favorably view trade with the Soviet Union and Eastern Europe. Exports to the Bloc, as well as exports anywhere, have become increasingly important because foreign sales translate into jobs. The unemployment problem will put pressure on West European governments to relax—or less strictly enforce—trade restrictions on sales to the Bloc. In addition, Western Europe's disadvantage in high-technology areas may force the region to turn East to sell the less technologically advanced products it cannot sell elsewhere.

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The dim unemployment prospects also will make it more difficult for West European countries to meet their defense commitments to NATO. Unemployment already has caused a severe drain on government budgets. These expenses seem certain to continue and thus will keep the guns-versus-butter issue in the forefront of public debate. With West European budgets likely to remain tight for some time, pressure to curb defense spending will mount. Opinion polls in Western Europe indicate strong support for cutting defense spending and little support for curtailing social programs—particularly in a period of high unemployment.

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## Appendix

### Western Europe: The Cost of Stimulative Economic Policies

Our analysis indicates that stimulative fiscal and monetary policies are not the panacea for Western Europe's unemployment problem. The cost of bringing unemployment down through anticyclical policies would be accelerated inflation and deteriorating current accounts—the very maladies governments have been trying to cure for the past few years. These negative side effects result in part because expansionary policies have no impact on the more fundamental structural problems that are depressing employment growth. According to our Linked Policy Impact Model (LPIM), West European countries together would have to implement fiscal and monetary policies that would be large enough to boost real GNP growth 2 to 5 percentage points faster than we presently expect just to bring unemployment in 1984 back down to the 1982 rate. To lower unemployment further—back to acceptable levels—would require continued government stimulation for a number of years. The longer expansionary policies are applied, however, the more rapid prices rise, and the worse the current account position becomes.

#### The Policy Options

We explored three possible macroeconomic policy approaches to Western Europe's unemployment problem:

- An increase in nominal central government consumption spending.
- A reduction in personal taxes collected by the central government.
- An increase in the money supply.

Using our LPIM, we determined how large the stimulation packages would have to be to reduce unemployment to a predetermined target. Our assumed policy target was to bring down the unemployment rate in each of the Big Four West European countries to the 1982 level in 1984 and to reduce it a further 1 percentage point each in 1985 and 1986. Hitting this target by 1986 would require a fall of about 3.8 percentage points for the group as a whole as our baseline unemployment projections show unemployment in the Big Four countries will reach 11.2

percent by 1986, compared with 9.4 percent in 1982 (see table 11). In each simulation, the policy variable was adjusted until the target was met. In effect, the policy variable was adjusted until real GNP growth was rapid enough to bring the unemployment rate down to the target range. The amount of improvement in economic growth—and hence the degree of economic stimulation—necessary to reach the target rate of unemployment varies by country in part because the gap between the 1982 unemployment rate and our 1984 projected baseline unemployment rate differs from country to country. After determining the necessary size of the stimulation package, we evaluated the impact of the policy on inflation and the current account.

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A fundamental assumption in our simulations was that the West Europeans acted together in implementing the policy in question. In view of France's bitter experience of the past two years, we believe it is extremely unlikely that any of the countries would attempt a go-it-alone approach to stimulating its economy.

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A second key assumption was that labor costs relative to capital costs would only rise about 2 percent annually compared with 3.3 percent annually in the 1970s—the same assumption used in our baseline projections. The relation between the price of labor and capital is crucial to our projections.

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Finally, under the increased government spending and reduced taxation options, we assumed that half of the resulting budget deficits would be financed through money creation. The other half of the deficit would be covered by direct borrowing from the public.

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#### The Simulations

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**Increasing Government Spending.** According to the LPIM, government spending in the Big Four West European countries would have to increase an average 3.2 percentage points in real terms in 1984 over the

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**Table 11**  
**Big Four: Baseline Projections**

	Unemployment Rate (percent)	Real GNP Growth (percent)	Inflation (percent)	Current Account Balance (billion US \$)
<b>Big Four</b>				
1984	10.6	2.2	6.9	-3.2
1985	10.9	2.4	6.9	-4.0
1986	11.2	2.4	7.0	-9.0
<b>West Germany</b>				
1984	9.2	2.9	2.8	12.5
1985	9.4	2.5	3.4	10.0
1986	9.6	2.5	3.1	10.0
<b>France</b>				
1984	9.6	0.2	9.1	-4.5
1985	9.9	2.5	9.1	-7.0
1986	10.2	2.5	8.9	-9.0
<b>Italy</b>				
1984	10.1	2.9	10.7	-3.8
1985	10.4	2.5	10.7	-5.0
1986	10.5	2.5	10.8	-7.0
<b>United Kingdom</b>				
1984	13.5	3.0	7.8	-1.0
1985	13.8	2.0	8.0	-2.0
1986	14.2	2.0	8.0	-3.0

baseline projection, 6.1 percentage points in 1985, and 6.8 percentage points in 1986 to pull down unemployment to the target rate in those years (see table 12). The necessary changes in government spending, however, vary considerably from country to country with Italian real government spending up only 0.5 percentage point in 1984 while British spending jumps 7 percentage points. The very small increase in Italian Government spending necessary in 1984 results in part because the unemployment rate that year needs to drop only 0.8 percentage point from our baseline projection to reach the target rate. In the United Kingdom, on the other hand, the 1984 unemployment rate must drop 1.2 percentage points from the baseline projection to reach the target rate. Moreover, increased government spending in Britain has a relatively less positive impact on real GNP—and hence

job creation—than in the other major West European countries because the British tend to direct a higher portion of their incremental income to imports.

For the most part, changes in government budget deficits reflect changes in government spending. The United Kingdom, for example, has the largest percentage-point increase in real government spending and the largest percentage-point jump in its nominal budget deficit. To some extent, however, the size of the percentage-point increase in the budget deficit is influenced by our baseline projection for the deficit.

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**Table 12**  
**Big Four: Impact of Increased Government Spending**

*Change from baseline projections*  
 (percentage points, except where noted)

	Target Unemployment Rate	Real Government Spending	Nominal Government Deficit	Real GNP Growth Rate	Inflation Rate	Current Account Balance (billion US \$)
<b>Big Four</b>						
1984	-1.2	3.2	20	3.5	1.5	-18.2
1985	-2.5	6.1	50	2.4	3.8	-46.1
1986	-3.8	6.8	68	2.2	6.6	-56.2
<b>West Germany</b>						
1984	-1.7	3.5	12	4.0	1.0	-3.4
1985	-2.9	5.0	31	1.5	2.2	-14.5
1986	-4.1	4.8	32	1.7	3.2	-15.5
<b>France</b>						
1984	-1.1	1.6	0.6	2.4	2.0	2.0
1985	-2.4	3.0	3.5	2.4	3.8	-2.2
1986	-3.7	4.3	6.0	2.2	6.4	-3.6
<b>Italy</b>						
1984	-0.8	0.5	-1.0	2.5	1.7	0.6
1985	-2.1	5.1	9.0	4.0	3.2	-7.3
1986	-3.2	6.7	8.0	2.7	2.9	-14.9
<b>United Kingdom</b>						
1984	-1.2	7.0	72	5.2	1.5	-17.4
1985	-2.5	12.4	175	2.8	6.6	-22.1
1986	-3.9	13.1	256	2.7	15.4	-22.2

In countries where the baseline deficit is small—such as the United Kingdom—a comparable change in the nominal deficit leads to a proportionally larger percentage-point increase in the budget deficit. [ ]

In each of the Big Four, inflation and the current account worsened as government spending was raised to bring down unemployment. The higher British propensity to import causes Britain's inflation and current account position to worsen the most. By 1986, inflation would be 15 percentage points higher and the current account deficit \$22 billion larger than in the baseline projection. Only in Italy is the inflationary impact so small as to not likely result in a political backlash. Moreover, the large current account deterioration that accompanies increased government spending in West Germany, Italy, and the United

Kingdom suggests that, even if these countries began to pursue stimulative fiscal policy, they soon would be forced to change course because of their worsening international payments position. France's current account, however, would improve somewhat in 1984 and deteriorate by only \$2.2 billion in 1985 and \$3.6 billion in 1986. The French current account performs relatively better because the French economy tends to increase imports more slowly in response to a rise in real GNP. Moreover, French exporters traditionally benefit more from increased real economic growth elsewhere in Western Europe than do exporters in the other Big Four countries. [ ]

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**Table 13**  
**Big Four: Impact of Reduced Taxes**

*Change from baseline projections*  
(percentage points, except where noted)

	Target Unemployment Rate	Real Taxes	Nominal Government Deficit	Real GNP Growth Rate	Inflation Rate	Current Account Balance (billion US \$)
<b>Big Four</b>						
1984	-1.2	-5.7	52	3.5	2.1	-19.3
1985	-2.5	-12.7	96	2.4	4.9	-47.9
1986	-3.8	-15.9	111	2.2	8.0	-57.8
<b>West Germany</b>						
1984	-1.7	-10.9	92	4.0	2.3	-3.3
1985	-2.9	-16.3	140	1.5	4.3	-15.3
1986	-4.1	-18.0	150	1.8	6.1	-17.0
<b>France</b>						
1984	-1.1	-1.7	5	2.4	2.2	2.0
1985	-2.4	-5.5	14	2.4	4.4	-2.1
1986	-3.7	-10.3	23	2.2	7.5	-3.4
<b>Italy</b>						
1984	-0.8	-0.7	0	2.4	1.8	0.5
1985	-2.1	-16.6	28	4.0	3.8	-7.0
1986	-3.2	-20.0	32	2.7	3.6	-14.7
<b>United Kingdom</b>						
1984	-1.2	-6.3	91	5.2	2.1	-18.5
1985	-2.5	-12.9	184	2.8	7.4	-23.5
1986	-3.9	-16.4	222	2.7	15.2	-22.7

**Reducing Taxes.** In general, our LPIM simulations show that tax reductions must exceed spending increases in order to bring about the same advance in real GNP—and hence a drop in unemployment—because not all of the tax windfall goes directly to consumption; some portion of it is saved. For the Big Four as a group, taxes in real terms must be reduced 5.7 percentage points below our baseline projections in order to reach the target unemployment rate in 1984, 12.7 percentage points in 1985, and 15.9 percentage points in 1986 (see table 13). The size of the tax reductions in West Germany needed to hit the target unemployment rate are the largest of any Big Six country primarily because the West German saving rate is the highest. France needs the smallest drop in taxes for the same reasons it had the smallest increase in government spending under the previous scenario.

The tax reduction in the United Kingdom is less than that in Italy in part because Britain's saving rate is the lowest among the Big Four.

Naturally, changes in government budget deficits reflect changes in taxes—the greater the reduction in taxes the larger the increase in the budget deficit. As in the government spending scenario, however, the percentage-point increase in the budget deficit is also influenced by our baseline projection for the deficit.

The economic impact of cutting taxes to reduce unemployment to the target rate is similar to that caused by increased government spending—inflation

**Table 14**  
**Big Four: Impact of Increased Monetary Base**

*Change from baseline projections*  
 (percentage points, except where noted)

	Target Unemployment Rate	Nominal Money Supply	Real Interest Rates	Real GNP Growth Rate	Inflation Rate	Current Account Balance (billion US \$)
<b>Big Four</b>						
1984	-1.2	19	-7.1	3.6	6.8	-23.9
1985	-2.5	14	-8.7	2.3	9.7	-64.6
1986	-3.8	17	-13.3	2.3	15.3	-72.6
<b>West Germany</b>						
1984	-1.7	24	-9.8	4.0	6.1	-1.5
1985	-2.9	2	-7.1	1.5	5.6	-16.9
1986	-4.1	-7	-2.1	1.7	2.1	-16.1
<b>France</b>						
1984	-1.1	15	-8.3	2.4	7.6	0.9
1985	-2.4	0	-2.4	2.4	2.4	-4.6
1986	-3.7	14	-10.6	2.2	8.2	-4.0
<b>Italy</b>						
1984	-0.8	2	-1.4	2.5	1.0	1.7
1985	-2.1	27	-6.6	4.0	5.2	-5.7
1986	-3.2	20	-7.4	2.7	5.8	-12.9
<b>United Kingdom</b>						
1984	-1.2	29	-5.4	5.2	11.2	-25.0
1985	-2.5	42	-20.9	2.8	29.0	-37.4
1986	-3.9	55	-39.3	2.7	53.0	-39.6

25X1

accelerates and the current account deteriorates. Inflation tends to be somewhat greater under the tax-cut option in part because the increase in the budget deficit is larger than under the government spending scenario. Although the degree of deterioration in each country's current account varies between the two policy options, the aggregate Big Four current account worsens by about the same amount under both scenarios. Just as in the government spending option, inflation and the current account worsen to the point that the tax-cut option would almost certainly have to be modified in order to maintain control over prices and international payments.

inflation and current account deficits generated by monetary stimulation almost certainly are not politically or economically acceptable.

25X1

According to the LPIM, the nominal money supply in the Big Four would have to increase 19 percentage points over our baseline in 1984, 14 percentage points in 1985, and 17 percentage points in 1986 to boost real GNP enough to hit the target unemployment rate (see table 14). In each of the countries the necessary money supply growth is enormous, but especially in the United Kingdom—by 1986 the money supply

25X1

**Boosting the Money Supply.** Sole reliance on monetary policy to reduce unemployment is the least realistic policy option of the three we tested. The

must expand 55 percentage points over our baseline, an unrealistic scenario. Britain requires such a tremendous hike in its money supply—and drop in real interest rates—to achieve the target unemployment rate because it must generate more real GNP growth and compensate for greater leakages to imports, as was the case in the previous two scenarios. [redacted]

25X1

Inflation and the current account worsen appreciably in all countries, but again the changes in the United Kingdom become unrealistically large. Rapid British money supply growth leads to rapid inflation, a massive increase in imports, and comparable deterioration in the current account. The monetary policy option is not likely to be pursued by West Germany, France, or Italy; it would be an absurd policy for the United Kingdom. [redacted]

25X1

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