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LABOUR MARKET ADJUSTMENTS AND EMU: THE CASE OF FRANCE

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Introduction

If nominal convergence is a prerequisite for a lasting monetary union, a similar convergence in wage policies could be at least as important for the cohesion of EMU. Without exchange rate flexibility, it is the labour market which has to bear the main part of the adjustment to asymmetric shocks, both through wage flexibility and through labour mobility. Even if the integration of the goods market is strong and that of capital market is nearly completed, the labour markets remain national and labour mobility is weak between European nations. In others words, Europe is far from satisfying the criteria of an optimal currency area in the traditional Mundell sense. And labour mobility is an important factor in re-equilibrating the labour market between US states, as have illustrated Blanchard and Katz (1992). Labour market adjusments would be all the more necessary as EMU will not benefit from the stabilizing effects of a federal budget which have been illustrated for the US and Canada by numerous studies since Barro and Sala-i-Martin (1990).

After the failure of the isolated expansion during 1981-82, France radically changed its economic policy. The hard franc approach follow since 1983 has meant that external competitiveness is no longer sought through devaluation. By making the franc-mark parity the major objective of its macroeconomic policy, France, like others countries in the hard-core EMS, has already borne the costs of Monetary Union (the loss of the exchange rate instrument). But the French experience of 'competitive disinflation', as this policy was called, illustrates the mechanisms by which the labor market flexibility will compensate for the lack of exchange rate flexibility in a monetary union.

This is why, after having describe the main features of wage bargainning and of macroeconomic and wage policies in France during the last two decades, we take a brief look at the impact of labour market flexibility on macroeconomic adjustement in a monetary union (or under fixed exchange rates). This analytical framework serves both to understand the macroeconomic adjustment mechanisms in a monetary union in the face of asymmetric supply or demand shocks, as well as to describe the process through which France has adapted to low inflation by tying its exchange rate to the mark.

1. Institutional Background and Wage Policy

The French system of wage bargaining is characterized by three features:
— the division of the trade-unions and the low percentage of unionized workers (it has fallen from 20 to 10% during the last thirty years);
— the predominance of industry collective bargaining;
— the role of the state in fixing wages through legislation relative to the minimum wage and, at certain times, by directly intervening in the evolution of wages.

Traditionally, sectoral bargaining concerns the raising of the wage grid and, more rarely, the structure of the job classification. But the existence of an interprofessional minimum wage (SMIC) generally greater than the minimum of the wage grids negociated at the industry level implies as a consequence, that the industry wage barganing has a small impact on the evolution of the effective wage. The grids negociated at the industry levels are indeed generally very different from the effective wage structure in firms. Moreover, as in others European countries, the superposition of industry bargaining and entreprise bargaining leads to more favourable conditions for employees (sectoral bargaining defines, in a way, the minimum conditions for the remunerations of employees in the sector).

An important development in collective bargainning was implemented in 1982 by the 'Auroux laws'. They introduce an obligation for the employers and unions to engage in regular negotiations both at industry and at firm levels. At industry level there were to be annual negociations over salaries, and negociations over job grading every five years. At firm level, they introduce for firms with fifty or more employees, the obligation to hold annual negotiations over real pay and over the lenght and organization of working time. A second objective of the reform was to increase the efficiency and coverage of existing representative institutions. The central traditional institution of collective worker representation in the firm was the Company Committee. This committee did not have negociating rights, but was to be informed about the economic state of the company. The law extended the rights of the Committee to information about the firm's economic situation, its use of manpower and its plans regarding the introduction of new technologies.

The government plays a major role in the evolution of renumerations by raising the minimum wage applicable to all professions (the SMIC). This minimum wage is indexed to consumer prices and it is raised at least on the 1st of July every year and each time the rise in prices reaches 2% since the last increase. The rise in July is accompagnied by a rise in the purchasing power of the minimum wage at least as great as half of the the rise in the purchasing power of the average wage observed during the past year.

The economic policy U-turn which made disinflation a priority after 1982-83, led the government to directly intervene in the wage negotiation process, first by a price and wage freeze during the six months after the devaluation in June 1982, and then by the disindexation policy in 1983-85.

After the switch to austerity following the devaluation of March 1983, the government invited both sides of industry to agree on the future pattern of wages increases by signing contracts on a different basis than before. First, the average wage increase for the coming year, would be detemined in advance in accordance with national inflation objectives. The target were 8 % in 1983, 5 % in 1984, 4.5 % in 1985 (observed inflation rates were respectively 9.3 , 6.7 and 4.7 %). This would replace the system of quarterly backdated increases based on past inflation. Second, there should be an adjustment at the end of the year but this should not be automatic and should take account of the national situation or of circumstances peculiar to the firm. Third, wage bargainning had to be conducted on the total payroll rather than on changes in the reference wage. The purpose here was to focus the bargainning on the conditions required form firm's financial equilibrium.

The wage and price freeze, combined with disindexation policy (indexation of wage on expected inflation rather on past inflation) have contributed strongly to the French disinflation during the period 1982-1984: between one third to half of the observed disinflation (see Muet, Fonteneau [1990, chap 5])

The change in the wage-bargaining process, combined with the development of the practice of collective bargaining in firms, introduced by the Auroux law, led to the development of systems of individualized wages in order to limit the progression of the wage bill, while still renumerating the most productive employees. It is large firms which ususally practice this kind of individualization, which principally concerns technicians and executives. This wage flexibility is beyond the realms of industry bargaining and creates an even greater gap between the industry-level bargaining and the evolution of effective wages in firms.

2. The major change in France's macroeconomic strategy in the eighties: from competitive devaluations to the strong-franc

In the years preceding the first oil shock, the French economy grew more rapidly than its partners without, however, being able to contain the rise in unemployment since the rise in the labour force which started at the beginning of the 1960's. The recurrent external deficits which resulted from this growth differential, but also from an inflation rate above that of its partners, were almost always absorbed by competitive devaluations which the fixed exchange rate regime made possible and relatively efficient, when accompanied by price and wage controls. For example, the wage explosion in May 1968 was erased by the 10% franc devaluation in 1969, which allowed France to regain its competitiveness and to experience higher growth at the beginning of the 1970's, while even its trading partners entered, in 1970-71, a downturn.

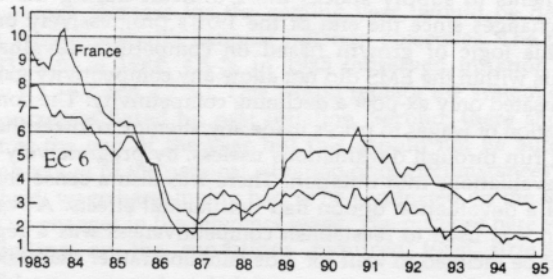
The consequence of this strategy was, however, a progressive acceleration of inflation which led to a complete indexation of wages to prices which made the adjustments to supply shocks more difficult during the 1970's. The structural changes since the end of the 1970's progressively brought into question this logic of growth based on competitve devaluations. The realignments within the EMS did not allow any competitivity gains ex-ante, but compensated only ex-post a declining competitivity. The complete long term indexation of wages to prices made any attempt to lower the wage costs in the long run through devaluations useless, by progressively translating nominal devaluations into inflation. There was also a sense that the very presence of a devaluation option had detrimental effects. A regime where devaluation was used to reestablish competitiveness was a regime where firms might be inclined to wait for a devaluation rather than take the more difficult and conflictual measures needed to improve productivity and competitiveness that way. Firms might also be too soft in labour negociations, assuming that wage settlements, if they where to prove too high later, would be offset by devaluation.

These considerations led to a radical change in French economic policy after the third devaluation of the Franc in EMS in March 1983. For the next few years, macroeconomic policy was aimed at fighting inflation. The Franc was pegged to the DM and fiscal consolidation made a priority. By 1985, French inflation was down to the level of its EC trading partners and the costs in terms of unemployment of the disinflation process was reduced by the disindexation policy established by Jacques Delors in 1983-1985. From 1986 to 1988, under 'cohabitation', theses gains were consolidated. Two corrective devaluations were used to partly undo the effects of past inflation differentials. But fiscal austerity and a committment to low inflation remained the rule and macro-policy was accompanied by structural policies aimed at improving market mechanisms, from the liberalization of prices to the lifting of restrictions on foreign exchange transactions.

Figure 1 plots French against and its main EC trading partners' inflation since 1983 and shows the rapid reduction in inflation from 1983 to 1986, a reduction helped in France and elsewhere by the fall in oil prices. Since 1986 inflation has remained roughly constant in France, in contrast to other industralized countries which experienced accelerated inflation at the end of the 1980's.

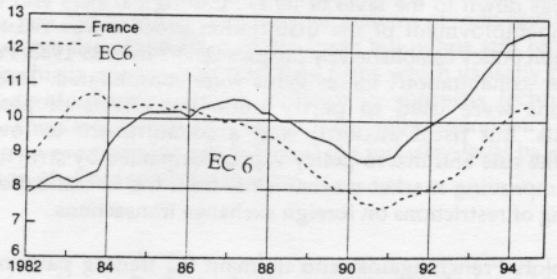
Figure 2 shows the evolution of unemployment for France and others EC countries: the inversion of the inflation differential has an almost perfect mirror image in the inversion of the unemployment differential. We will see later that this inversion of the inflation differential is mainly due to unemployment remaining above its equilibrium rate, even during the economic upturn in the second half of the 80's when France's main trading partners experienced accelerated inflation.

Figure 1 Inflation rate (France and 6 main partners)



Source : OFCE. *Note :* EC6 : Belgium, Germany, Italy, Netherlands, Spain and UK

Figure 2 : Unenployment rate (France and 6 main partners)



Source : OFCE. *Note :* EC6 : Belgium, Germany, Italy, Netherlands, Spain and UK

4. Wage, profitability and competitiveness

a) Real wages grow less rapidly than productivity

Empirical studies on wage formation in France show that wage equations are very stable, whatever the specification. With the exception of the brief period of wage freeze in 1982 and of disindexation in 1983-84, the slowdown of real wage growth resulted mainly from the level of unemployment. Such stability may seem surprising given such an important change in regime. The indexation of wages to prices is complete within one year. By contrast, the productivity gains are only partially taken into account in the growth of

real wages. Therefore, the slowdown in productivity gains contributed, with the worsening of the terms of trade, to the rise in equilibrium unemployment after the oil shocks. The following table shows that unemployment exceeded its equilibrium rate until the beginning of the 80's, but that the situation completely reversed itself after 1983, which explains why inflation became and remained lower in France than for its main trading partners from the middle of the 80's.

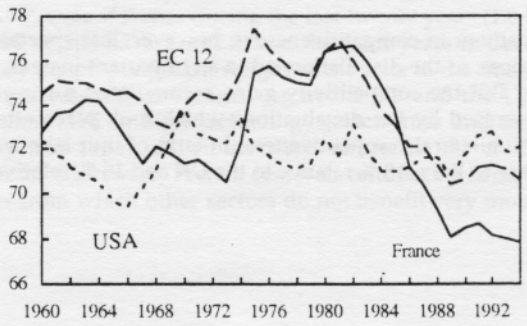
Table 1: Unemployment and equilibrium unemployment in France

	1960-1972	1973-1983	1984-1994
Unemployment rate	2	5.5	10.3
Equilibrium unemployment	2	8	6/7
Inflation	4.8	10.7	3.4
Wage share (% GDP)	72.5	75	70

Source: Confais and Muet [1994].

By lowering real wages, unemployment not only contributed to low inflation, but led to an important increase in the profits of firms since the middle of the 1980's. Graph 3 shows that the share of profits in the value-added, which had greatly decreased at the beginning of the 80's, considerably increased thereafter. The reduction of the wage share that we also observe in other countries, was more pronounced in France. In particular, the rate of investment self-financing ratio which fell to 50 % at the beginning of the 1980's, exceeded 100 % in the last three years, without, however, leading to the favourable effects on investment that many hoped for. Indeed, empirical simulations from models under different regimes suggested that in such a situation, the evolution of demand would become the main determinant of investment. The decrease in the share of wages would dampen consumption without a corresponding benefit to investment. The restrictive wage policy, justified at the beginning of the 1980's, is today counter-productive, but it seems difficult to reverse it in a time of massive unemployment.

Figure 3: The share of wages in value added



b) Competitiveness and trade balance

The change from a regime of adjusting to competitiveness by devaluation to one in which adjustment takes place by competitive disinflation has led, as shown in graphs 4 and 5, to an initial worsening in competitiveness and to a strong decrease in manufacturing trade balance.

Figure 4: French trade balance manufacturing and Energy

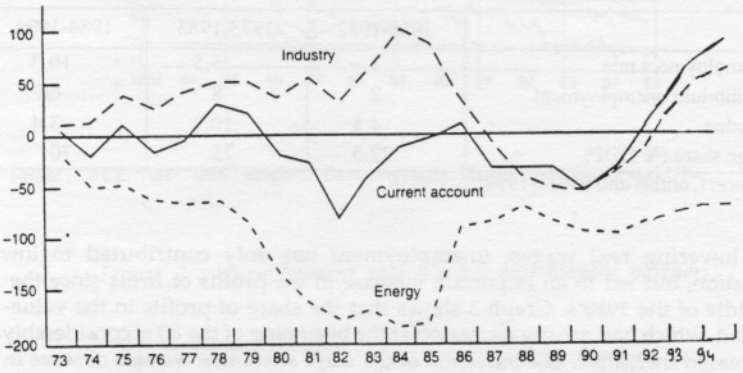
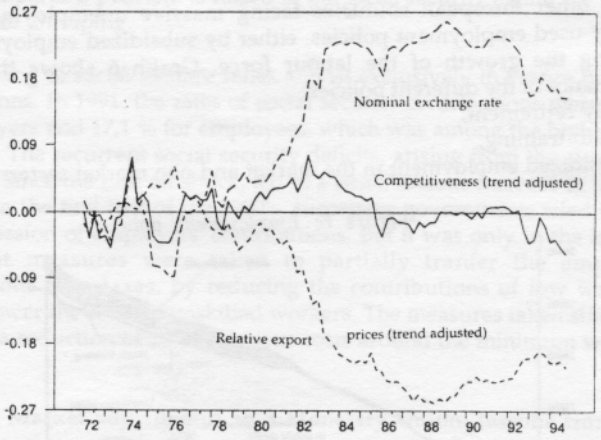


Figure 5 shows the evolution of French competitiveness within the EC. The evolution is further decomposed between two components: the evolution of relative export prices, and the evolution of the relevant nominal exchange rate. Until 1987, decreasing but still higher inflation in France led to a steady loss in competitiveness, which was far from offset by the last two devaluations in April 1986 and January 1987. But since 1987, export price inflation has been lower than that of France partners. Combined with a stable exchange rate until the 1992 devaluations, this has led to a steady improvement in competitiveness. In terms of unit labour costs expressed in francs, competitiveness gains seems impressive during that period. From 1987 to 1991, relative unit costs have improved by 15 % compare to Italy and 28 % relative to the UK and Spain.

The improvement in competitiveness is, however, less spectacular in terms of export prices, as the disinflation led to an important increase in the mark-up of firms. But the competitivity gains accumulated during 1987-91 were completely erased by the devaluations which took place after 1992. From 1991 to 1995, bilateral competitiveness (in term of unit labour costs) fall by 30 % compare to Italy, 18 % relative to the UK and 19 % relative to Spain.

Figure 5: France competitiveness within the EC



c) Structural aspects

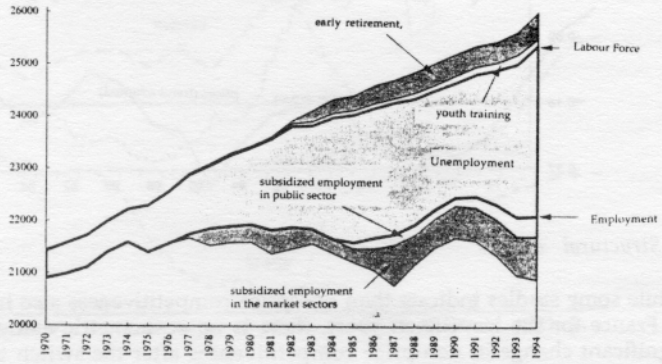
While some studies indicate than non-price competitiveness also improved in France for the last fifteen years, there is no econometric evidence of a significant change in non-price competitiveness after the switch to strong Franc policy. The impression which emerges is that the evolution of external trade during the period mainly reflects that of price competitiveness. France was ill-prepared for the real appreciation of its currency in the middle of the 80's. A detailed examination of trade in industrial goods highlights certain structural weaknesses in the pattern of France's foreign trade. Using a breakdown into 600 products, Delattre (1983) shows that whereas the specialization of France main competitors is often highly concentrated, French ones are spread widely: there are 'strong' and 'weak points' in each of the twenty industrial sectors. France also pulled out of declining sectors more slowly, while for example Japan undertook a profound restructuring of its comparative advantages.

France is also characterised by the small share it allocates to R&D as a percentage of GDP, even if it rose during the last twenty years (1.8 % in 1975 and 2.4 % in 1990 versus 2.2 % and 2.8 % in the same years in Germany and in the US) and by the preponderant weight of the state in the financing and implementation of research programs. As in the US and the UK, French research is concentrated in high technology (electronics and aero-space), While Germany and Japan dsitribute their efforts in the mid to high technology sectors. Moreover, French research conduct by firms is carried out in industries from which other sectors do not benefit very much.

5. Employment policies

As in other European countries facing massive unemployment, France greatly used employment policies, either by subsidized employment or by slowing the growth of the labour force. Graph 6 shows the growing importance of the different policies:
— early retirement,
— youth training,
— subsidized employment in the market and non market sectors.

Figure 6: Employment policies



The relative failure of the working time reduction policy at the beginning of the 1980's blocked the development of a policy aimed at reducing the working week to raise employment. The move from the legal length of the working week from 40 to 39 hours in 1982 only had a limited effect on employment, the 2/3 of the this reduction being accompanied by productivity gains. Although the effectiveness of this type of policy was often debated, notably during the last presidential elections, the reduction of working time has been realized these last few years by the development of part-time work. Part-time work was not very developed in France, compared to other European countries. It is its development from the beginning of the 1990's, combined with other forms of labour market flexibility (notably the development of labour contracts for a limited period), which explains why employment reacts more quickly today to economic activity. This type of flexibility is not, however, the most satisfying form of labour market flexibility as it tends to accentuate the economic cycle.

In order to avoid capital flows towards tax havens, most European countries — and especially France — have greatly reduced taxes on capital revenues over the last 15 years. This evolution is all the less desirable as the most heavily taxed factor, labour, is precisely the factor which is in excess supply in Europe. Transfering the taxation on capital to the European Union level would avoid — or at least limit — this problem. This transfer would have, among other things, an interregional stabilization effect because of the high

business-cycle sensitivity of the tax in question (notably corporate income tax). A comparable problem is raised in the social security area if we wish to avoid social dumping.

The financing of social welfare relies almost exclusively in France on wage contributions. In 1991, the rates of social security contributions were 43.8 % for employers and 17,1 % for employees, which was among the highest rates in the EC. The recurrent social security deficits, arising from the slowdown in growth since the first oil shock, led to a simultaneous increase in the two rates. From the first half of the 1980's, successive governments tried to limit the progression of employers' contributions. But it was only in the last few years that measures were taken to partially tranfer the employers' contributions onto taxes, by reducing the contributions of low wages in order to lower the costs of unskilled workers. The measures taken since 1993 represent a reduction of 10 % of labour costs around the minimum wage.

6. Labour Market adjustments in a Monetary Union: lessons from French experience

The French experience of 'competitive disinflation' illustrates the mechanisms by which the labor market flexibility will compensate for the lack of exchange rate flexibility in a monetary union. With low labour mobility between European states, the mechanisms which work to re-equilibrate the labour markets in a monetary union are precisely those of « competitive disinflation ». To analyze the adjustment of national labour markets in the face of asymmetric supply or demand shocks, we make use of the model developed by Blanchard and Muet (1993). To simplify the presentation and as it doesn't change the nature of the analysis which follows, we retain a traditionnal Phillips curve to determine wages, rather than an more complicated model. With this hypothesis, traditionnal price and wage equations lead to an equilibrium unemployment which is independant of competiviveness[1] (the vertical SS curve in figure 7.a). When unemployment exceeds equilibrium, the real wage falls, competitiveness improves and the process continues so long as unemployment differs from its equilibrium. Absent nominal rigidities, the dynamics of competitiveness only depends on real rigidities (mainly the impact of unemployment on real wage growth) and on the relative distance to equilibrium unemployment (vertical arrows in figure 7.a).

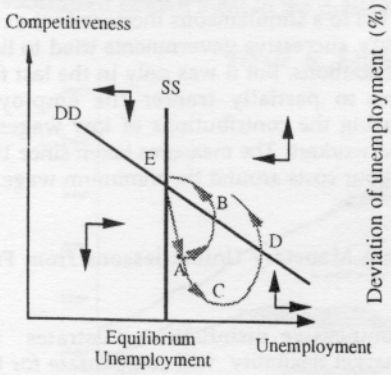
We can summarize the demand side by a negative relationship between competitiveness and unemployment (the DD curve in figure 7.a). An increase in competitiveness raises external demand for domestic goods and therefore lowers unemployment. In reality, demand adjusts slowly to competitiveness, production adjusts slowly to demand and there still exists an additional lag between the rise in production and the fall in

[1]When the long term elasticity of wages with respect to unemployment isn't infinite as in the Phillips curve, the equilibrium unemployment is an increasing fonction of competitiveness (the SS curve has a positive slope in figure 7.a), but the analysis remains unchanged.

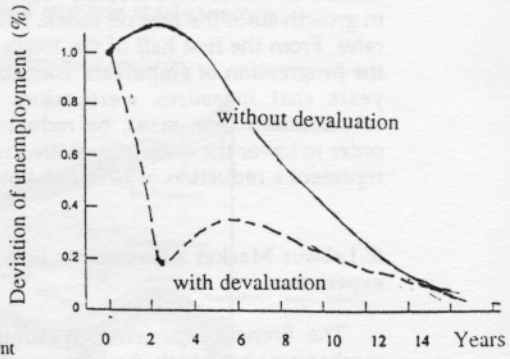
unemployment. All of these lags represent real rigidities that are summarized by a slow adjustment of unemployment to competitiveness around the DD line (horizontal arrows in figure 7.a).

Figure 7 : Labour market adjustment to asymmetric shocks

a) Unemployment and competitveness dynamics



b) Adjustment to equilibrium unemployment



A negative supply shock, for example an exogenous rise in nominal wages leads to a decrease in competitiveness and to a rise in unemployment (from E to A). Unemployment reduces real wage and raises competitiveness; at length, the rise in demand resulting from competitiveness gains leads progressively to the initial equilibrium unemployment (ABE). Similarly, a negative demand shock shifts the DD curve to the right and increases unemployment. From the initial position, A, the path is identical to the previous case: competitiveness improves and, after a certain time, unemployment returns to equilibrium value (ABE). We note that in an open economy, even in the absence of nominal rigidities, the adjustment to equilibrium unemployment is not instantaneous.

Without nominal rigidities, competitiveness is independent of the nominal exchange rate and its trajectory only depends upon the relative position to equilibrium unemployment. As the adjustment to equilibrium unemployment can't be accelerated by a parity change, there is no cost in proceeding to Monetary Union. We note, furthermore, that the nominal convergence problem preceding Monetary Union is — under this hypothesis — equally meaningless, as foreign inflation is immediately and completely passed onto national prices and that only the relative position to equilibrium unemployment explains the inflation differential.

The nominal rigidities — that is, the lagged adjustment of wages to prices and of prices to wages — have three consequences.

(i) The adjustment process is even slower than before and all the slower as the nominal rigidities are high.

(ii) Nominal convergence isn't instantaneous any longer. Fixing the parity (or entering Monetary union) against a country with a lower inflation rate always has a temporary cost in terms of unemployment (indeed, there has to be an unemployment rate which exceeds the equilibrium rate in order to attain the partner's inflation rate). In particular, a supply shock which leads to a fall in competitiveness due to a temporary acceleration in national inflation, has a greater persistance in the presence of nominal rigidities, as the dynamics depend on the past inflation differential. In the figure 7a, the corresponding path isn't ABE, but ACDE. Because the inflation rate greater than the partner's, competitiveness continues to fall from point A to C, even though unemployment exceeds its equilibrium.

(iii) The most obvious consequence of nominal rigidities is that the adjustment process can be accelerated by a nominal devaluation. A devaluation allows the cost of unemployment to be reduced for a negative demand or supply shock, by reducing the circle ACBE.

Figure 7b represents the process of adjusting to equilibrium unemployment, when we simultaneoulsy take into account nominal and real rigidities (the simulations are from Blanchard and Muet [1993]). It takes between 6 and 8 years to reduce by half the distance from equilibrium unemployment. The nominal wage rigidity is relatively weak in France and Europe compared to the US, where the multi-annual feature of wage contracts leads to a slow indexation of wages to prices. In most estimations conducted, the mean lag is on average one semester in France while being more than one year in the US. But a weak nominal rigidity suffices for a devaluation to accelerate adjustments, as shown in figure 7b.

This way of characterizing macroeconomic adjustments is clearly very simplified. Other factors enter in re-equilibrating the labour markets, such as the effects of the labour cost on the demand for labour or on profitability, investment and growth, which are ignored in this model. But the quantitative analysis of the French experience during the 80's (Blanchard and Muet [1993]) clearly shows that this model captures the essential mechanisms which are at work in a system of fixed exchange rates and, subsequently, in a monetary union.

Beyond Monetary Union

For countries like France which have abandoned the use of the exchange rate instrument, monetary union won't imply additional costs. These costs were already borne by countries which tied their exchange rate to the mark in the mid 80's. It is clear that for France, adhering to a credible monetary union only has advantages. It has already borne the costs of nominal convergence and it has to bear the costs of reducing its deficit in any case. And, whatever the French politicians may say, this constraint is independent of the Maastricht criteria, since, in order to stabilize its debt to its current level (50 %), the deficit must be below 2.5 %. Under a fixed but

adjustable exchange rate system, with complete capital mobility, France bears the disadvantages of monetary union (the loss of monetary sovereignty) without benefiting from its advantages (the reduction in interest rates due to the absence of a risk premium vis-à-vis the mark).

The sluggishness with which the labour market re-equilibrates itself following supply or demand shocks is specific neither to France nor to other European countries. Even between the the US states, real wage flexibility plays a small role in the process of adjusting to asymmetric shocks, as shown by Blanchard et Katz [1992]. This mean that the European nations can hardly count on the flexibility of the labour market to adjust to the disequilibria resulting from asymmetric shocks. That is to say that the only instrument which is left for stabilization, fiscal policy, should be highly used. In principle, as fiscal policy is more efficient under fixed exchange rates, we can consider that it will suffice to let the automatic stabilizers play, or even to fully use discretionary fiscal policy in response to asymmetric shocks. But the most effective solution is clearly the regional stabilization achieved through a federal budget. By avoiding indebtedness and in automatically transfering revenue from regions experiencing growth to those in recession, the federal budget acts as an insurance system against asymmetric shocks.

The economic solidarity implied by monetary union doesn't make much sense unless it includes a greater degree of solidarity in the areas of politics and social welfare. The enlargment of the Union will accentuate the risks to the dillution of solidarity between States. Reality imposes the consolidation of that which exists: effective monetary union between hard core EMS, by reinforcing the simultaneous coordination of all policies (economic, social,...). By creating a consolidated centre, Monetary Union should have the task of polarizing all the States which wish to go further along the path of economic and political union, while opposing centrifugal forces arising from the enlargment of the European Union.

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