

Philippe d'Arvisenet
Global Chief Economist
ECONOMIC RESEARCH DEPARTMENT

***GROWTH IN THE EURO ZONE :
TO WHAT EXTENT THE LABOUR
MARKET SHOULD BE REFORMED ?***

December 2004

CONTENTS

I - POTENTIAL GROWTH, PRODUCTIVITY AND
LABOR MOBILIZATION

II - THE LABOR MARKET DOESN 'T WORK ADEQUATELY

III - LABOR DEMAND

IV - LABOR COSTS SETTING

V - LABOR SUPPLY

- | -

POTENTIAL GROWTH, PRODUCTIVITY AND LABOR MOBILIZATION

- **Potential growth is low**

- **It will be adversely impacted by:**

- **Demographics: decline in the working age population**

- **Hourly productivity gains**

- lower proportion of IT producing sectors which generate high productivity gains
- lower investment in IT in the other sectors
- rigidities which are an impediment to the optimal use of IT

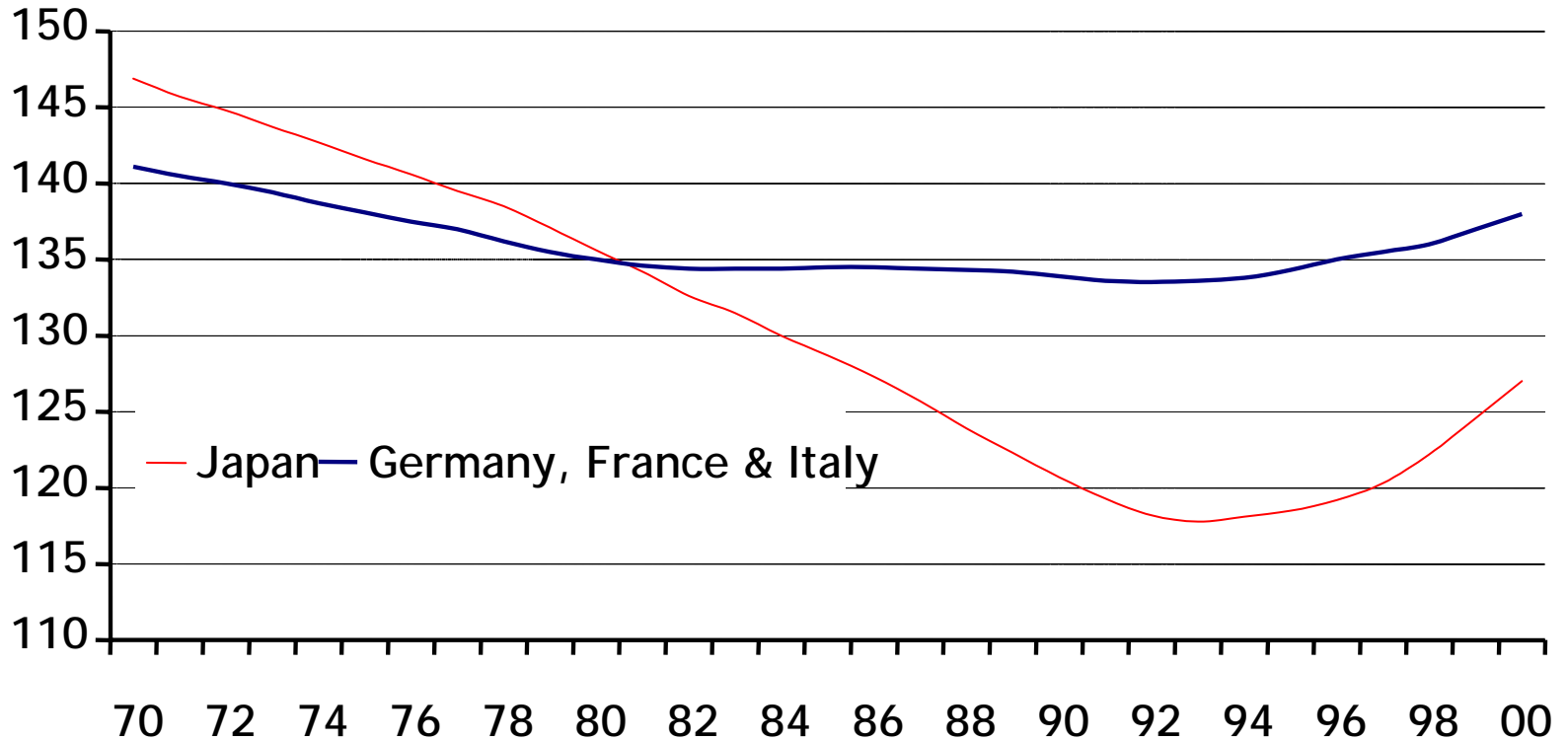
- **Productivity gains per capita have been impacted by a reduction in working hours**

- In order to mitigate or reverse the trend towards a impoverishment relative to the US, apart from higher productivity gains, a better mobilisation of labor is necessary
- To achieve that would be good news for the financing of pensions, health care...
- A higher rate of potential growth would invite to a more accommodative monetary policy

Real GDP*/capita in the US compared to other main countries

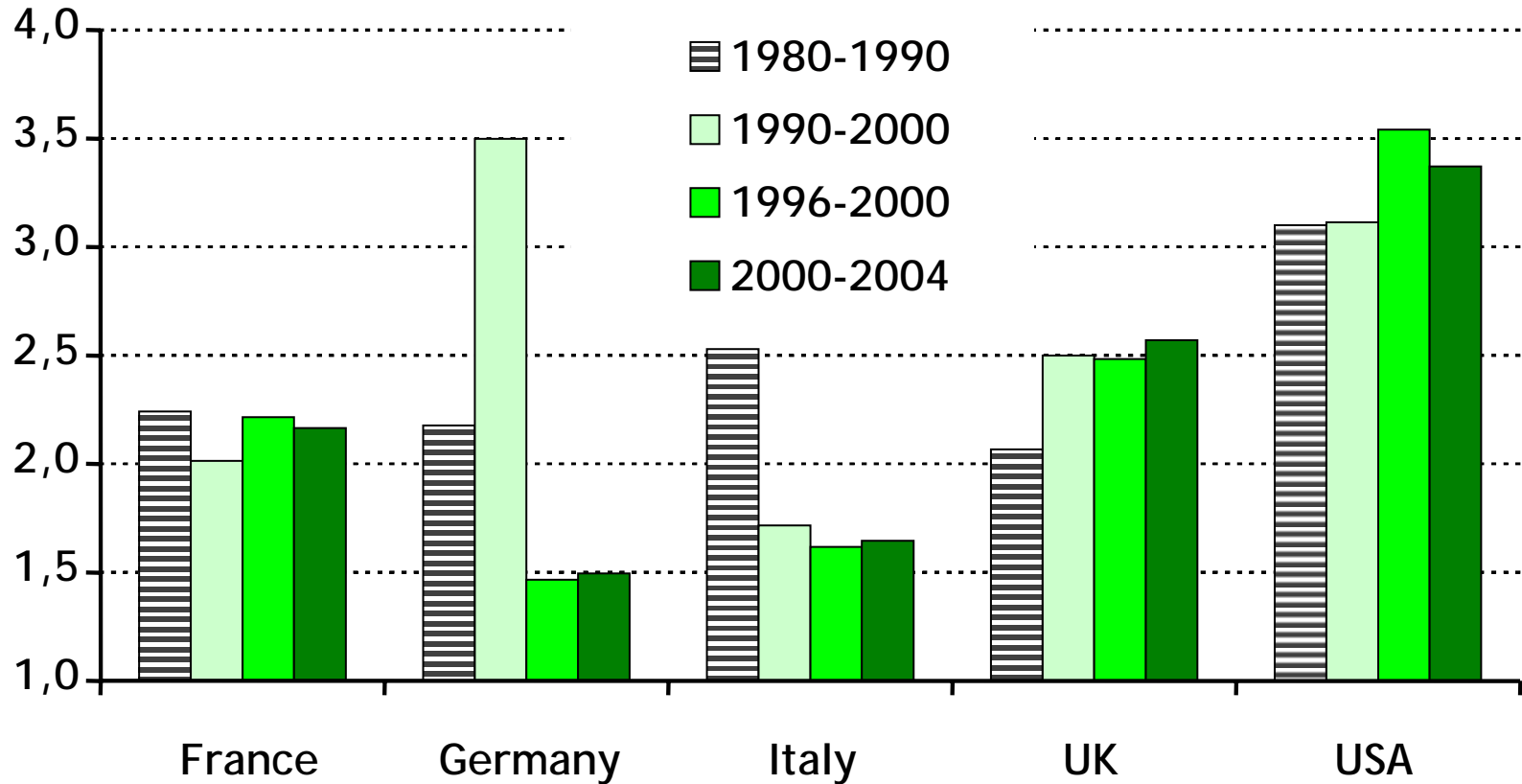
(* PPP's and 1995's price, in tendency)

out of USA = 100



source: OECD

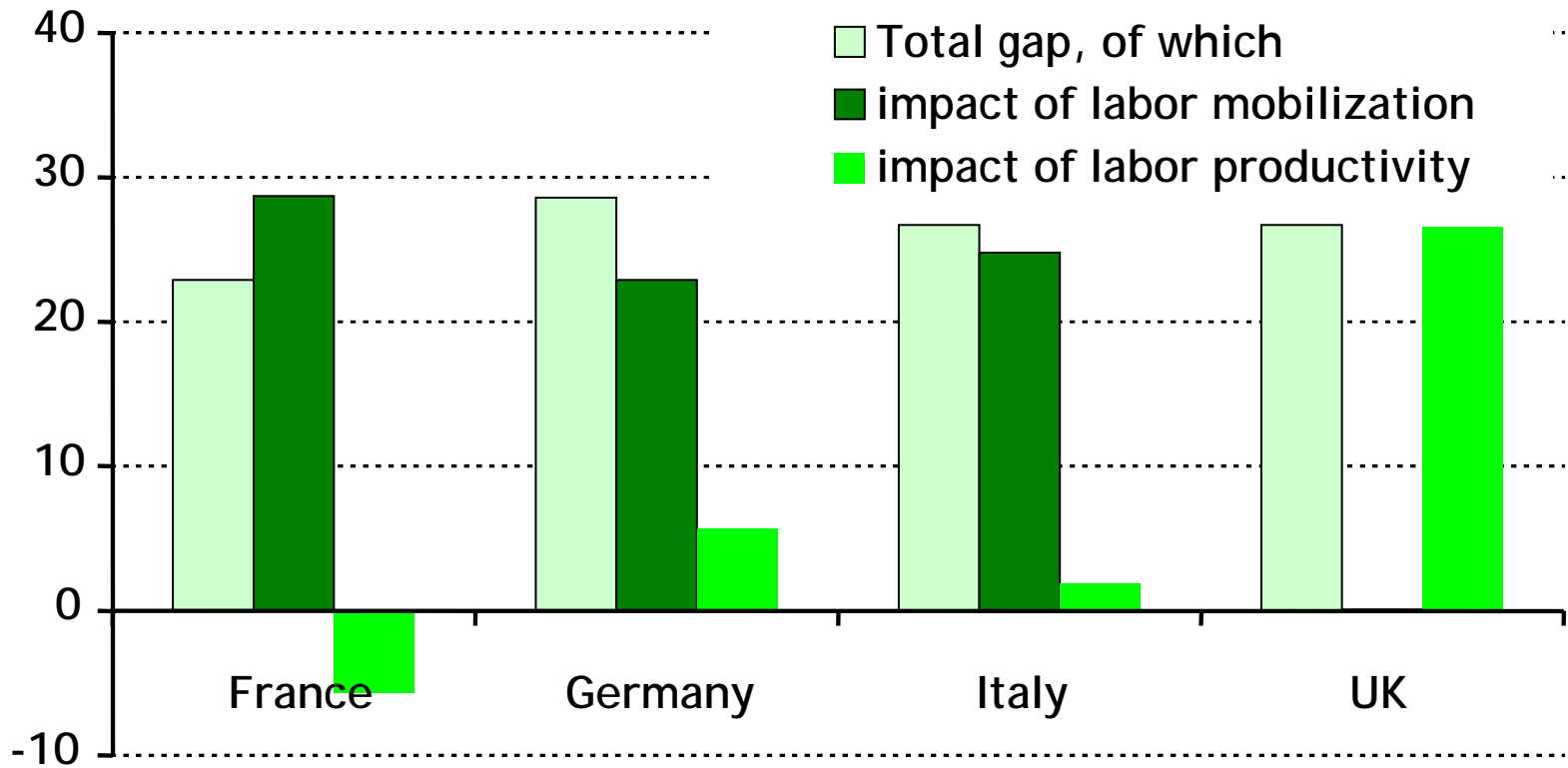
Potential rate of growth (average growth per annum)



source : OECD BNP Paribas's calculation

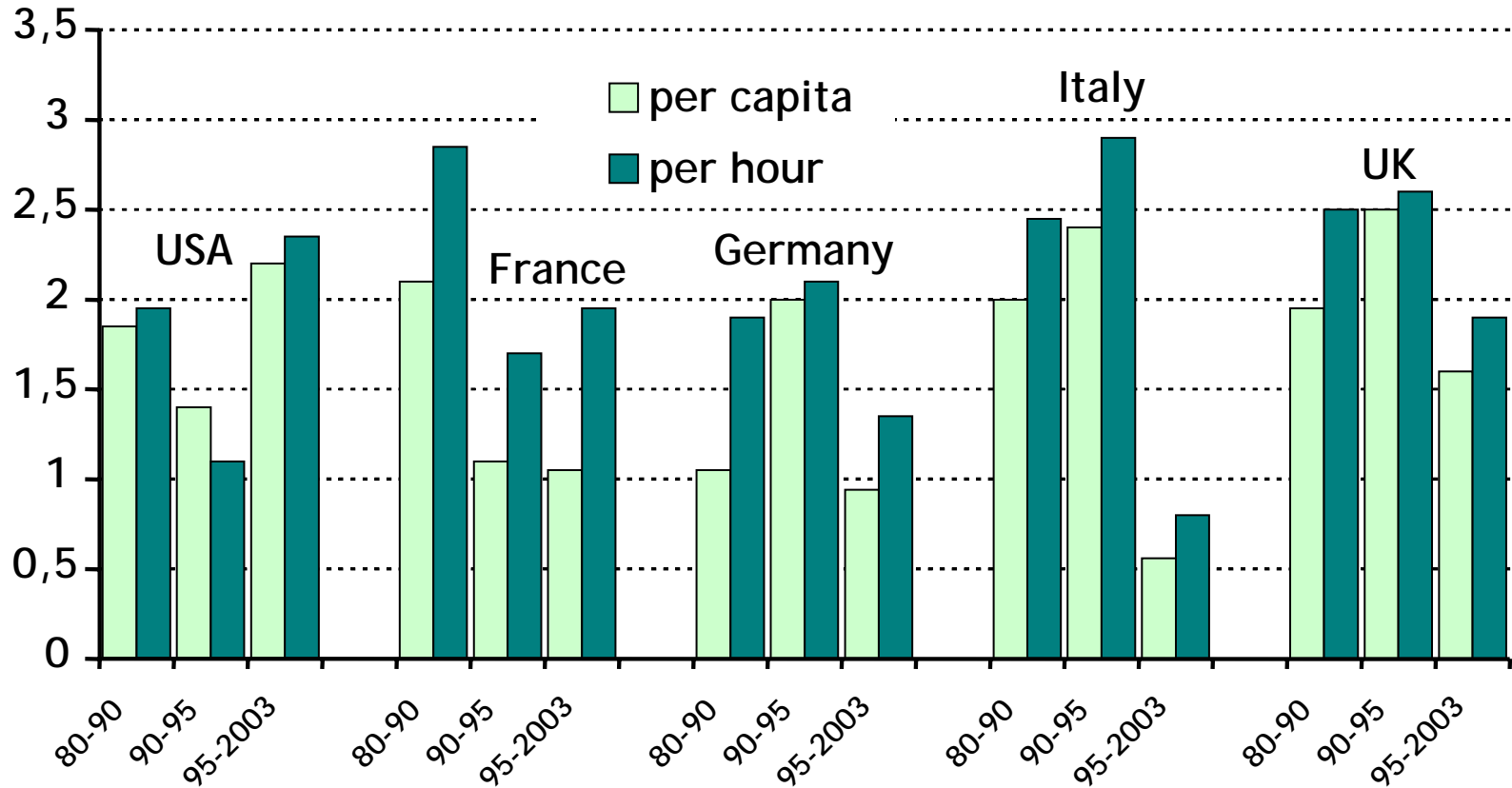
Sources of GDP/capita differences against the US in 2002

(PPP, 2000)



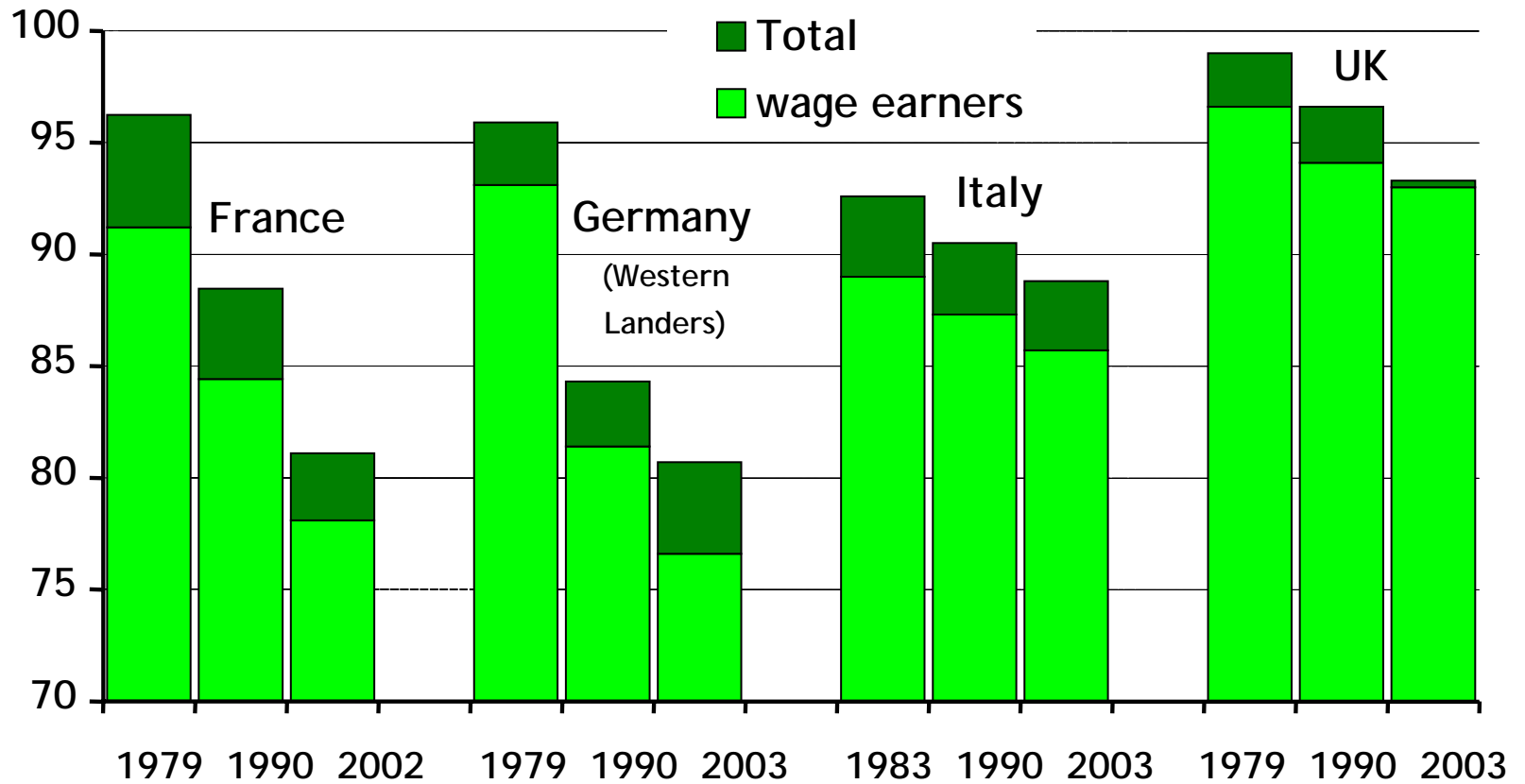
source: OECD

Labour productivity: average annual growth %



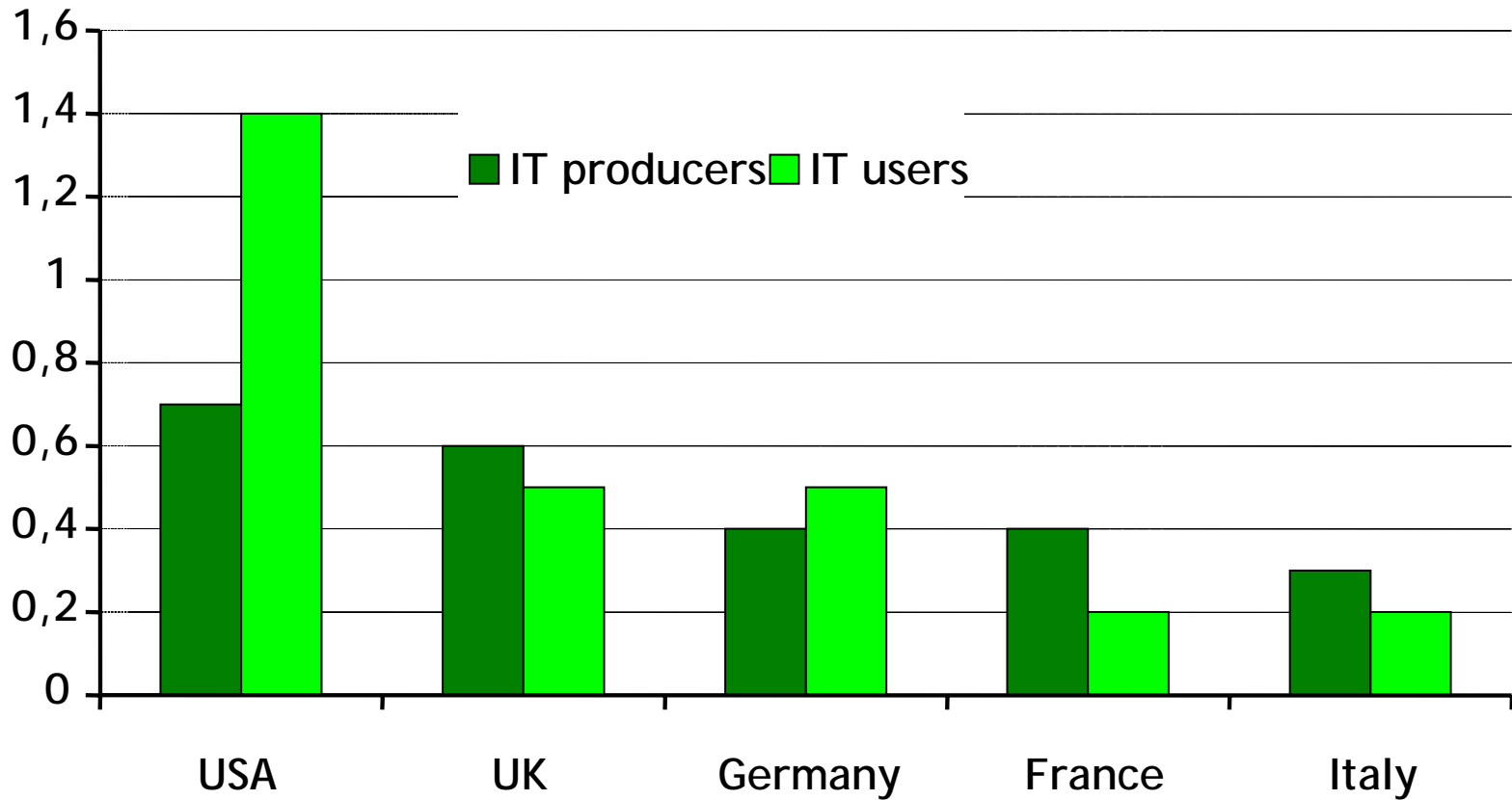
source: OECD BNP Paribas's calculation

Hours worked (USA = 100)



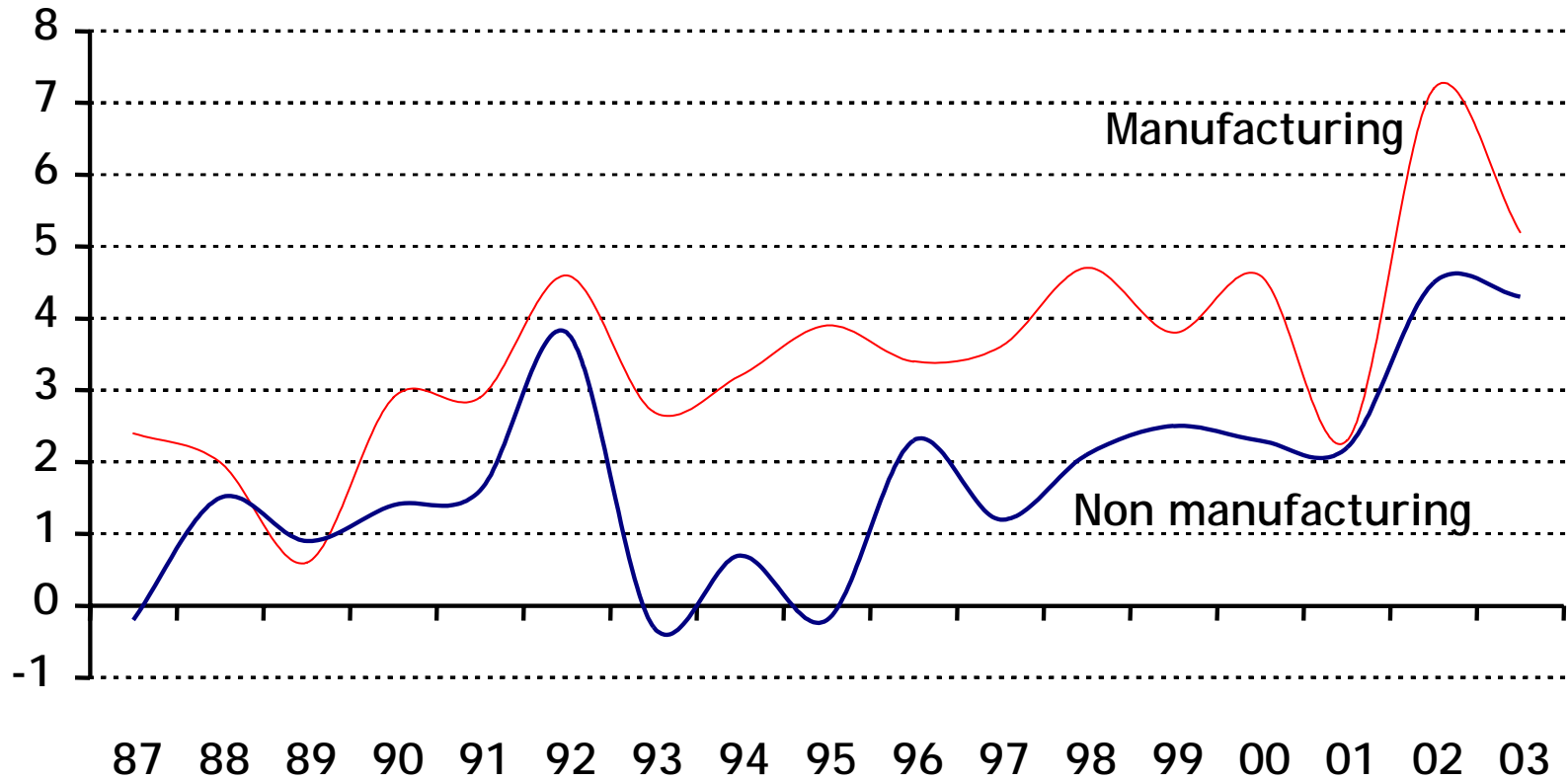
source: OECD

Contribution to productivity growth (1990's H2)



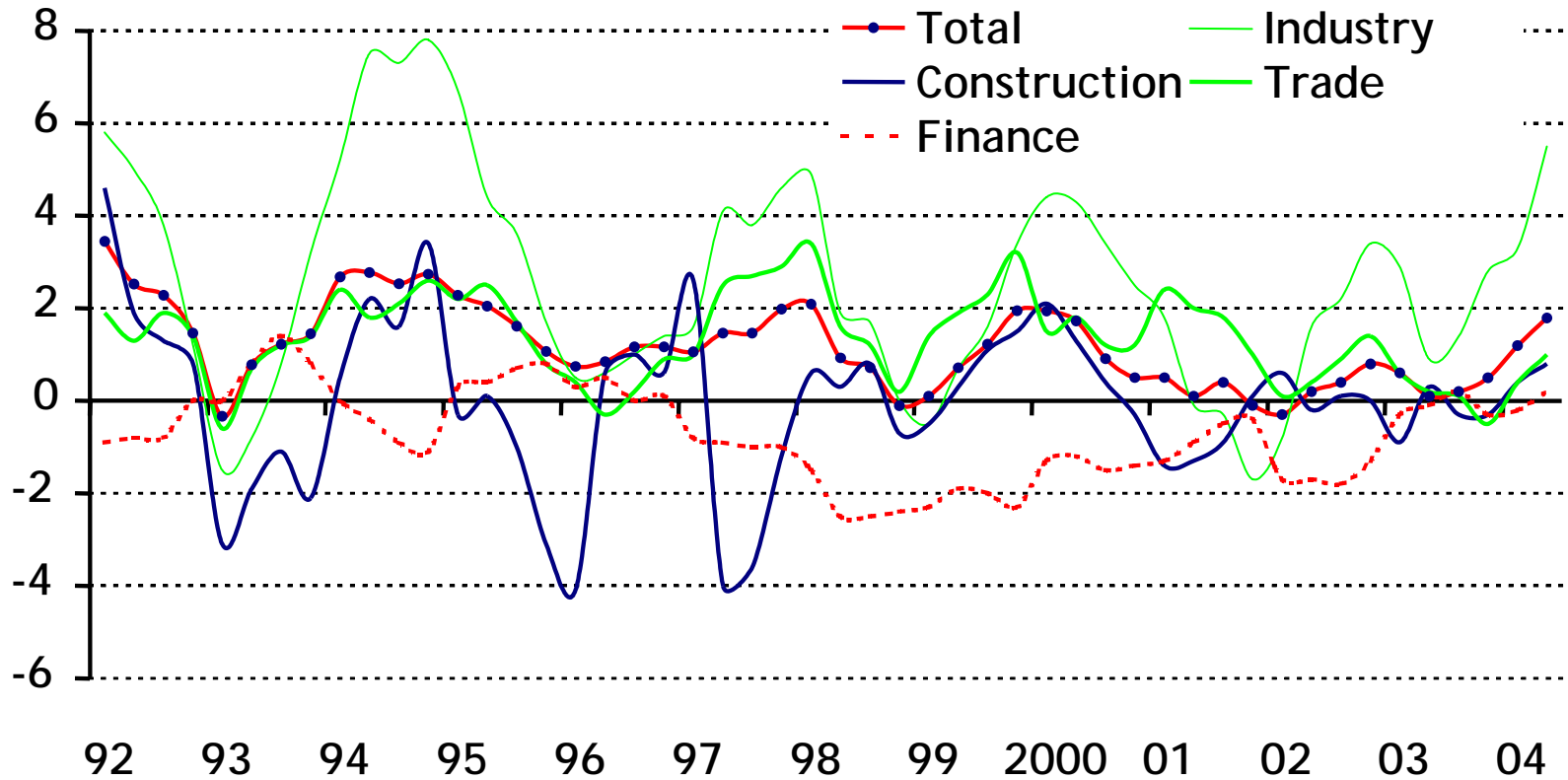
source: OECD

United-States: labor productivity, y/y %



sources: BLS, BNP Paribas

Euro zone: labor productivity, y/y %



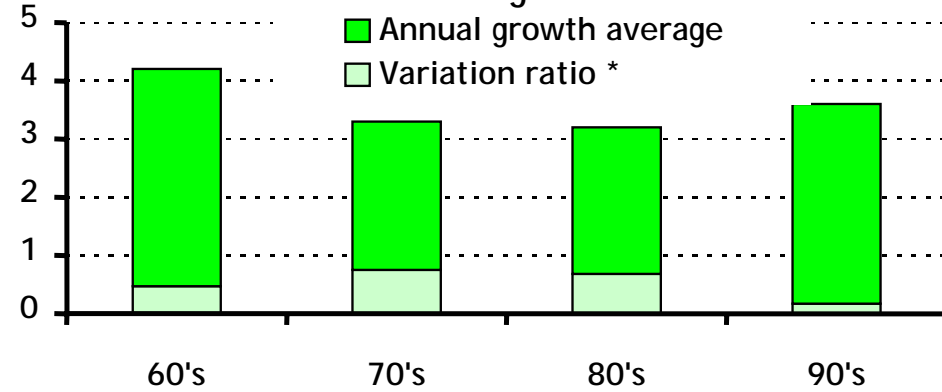
source: ECB

Macro economic stability

USA

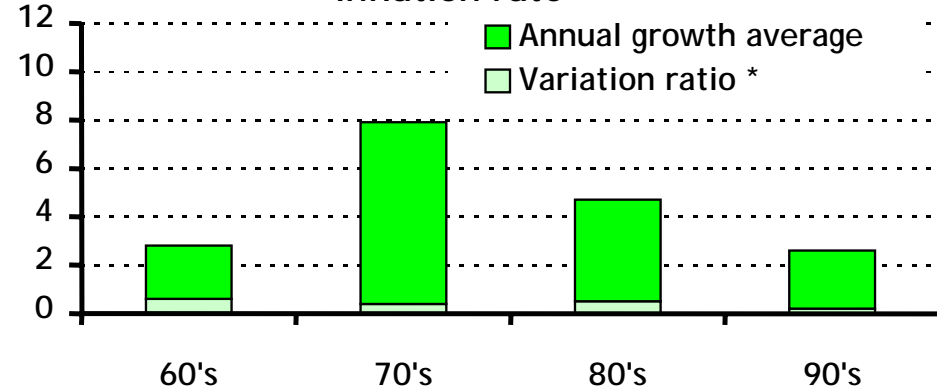
Real GDP growth

■ Annual growth average
 ■ Variation ratio *



Inflation rate

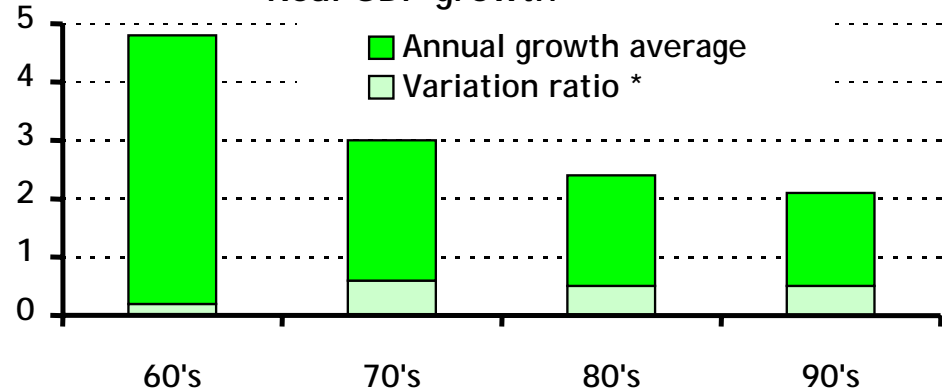
■ Annual growth average
 ■ Variation ratio *



Euro zone

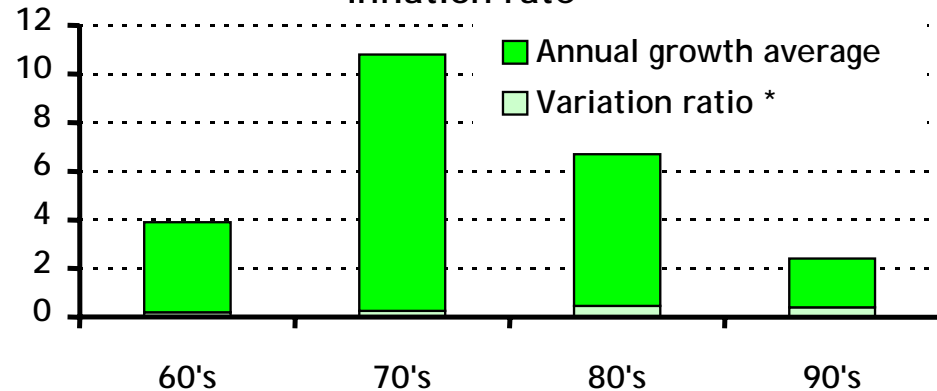
Real GDP growth

■ Annual growth average
 ■ Variation ratio *



Inflation rate

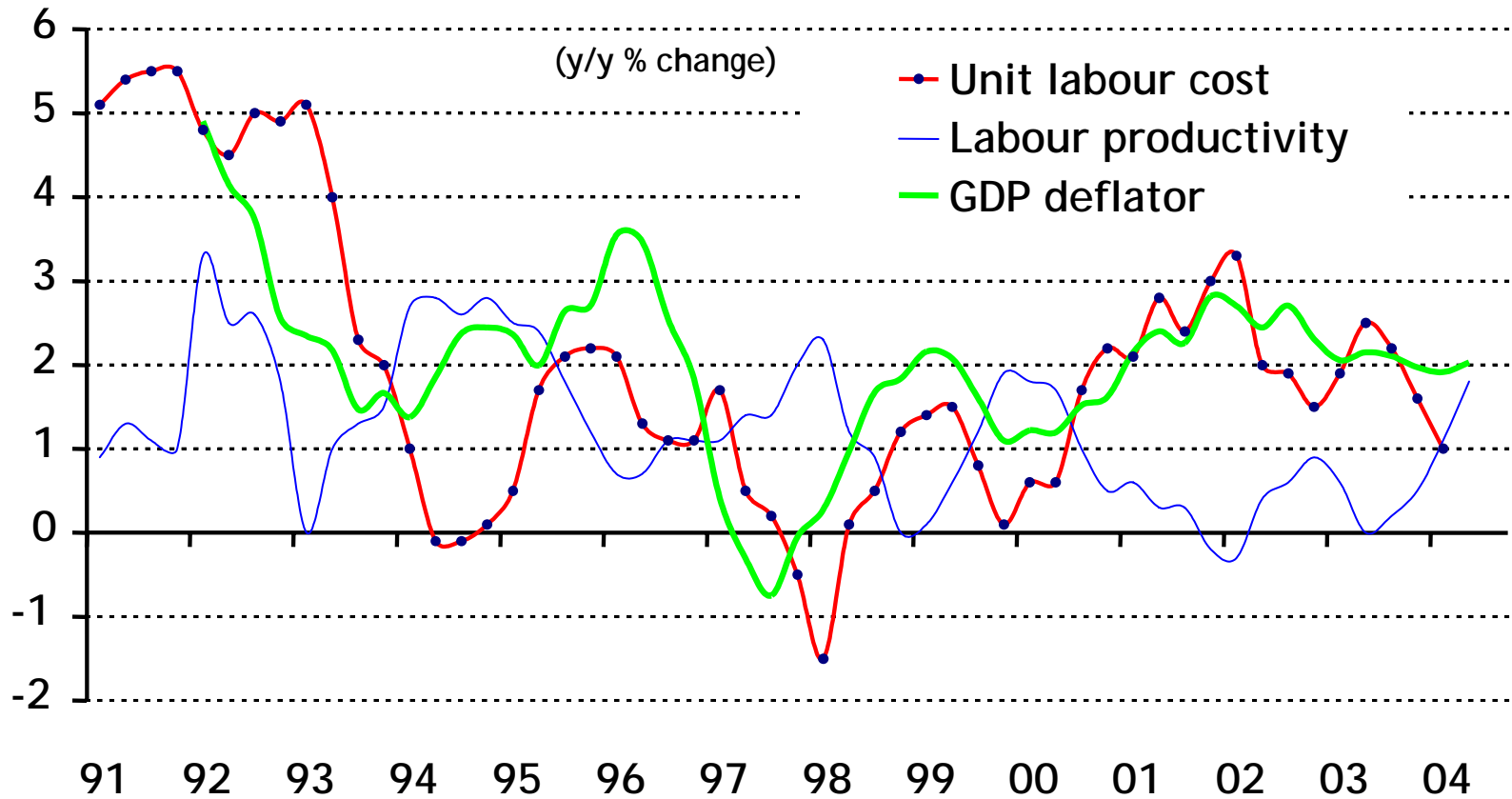
■ Annual growth average
 ■ Variation ratio *



* standard deviation/average

source: European Commission BNP Paribas's calculations

Euro zone: unit labour cost and GDP deflator



sources: ECB, Eurostat

- II -

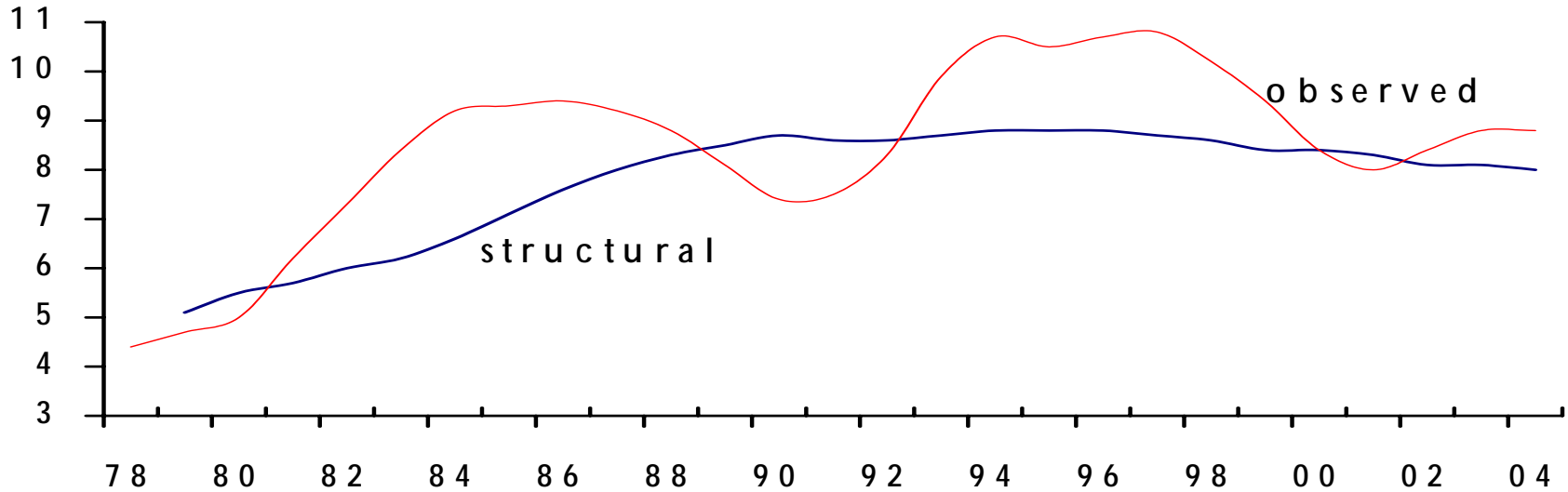
THE LABOR MARKET DOESN 'T WORK ADEQUATELY

- The structural rate of unemployment has dramatically increased in the 1980's, then exhibited resilience (with differences across countries)
- The participation rate can be very high together with low rates of unemployment
- A reduction in the labor force aimed at lowering the rate of unemployment has not proved very effective. Conversely, a low rate of unemployment drives the participation rate upwards.
- The government intervention on the labor market ("active measures" as opposed to "passive" (unemployment benefits) has not been effective despite its costs

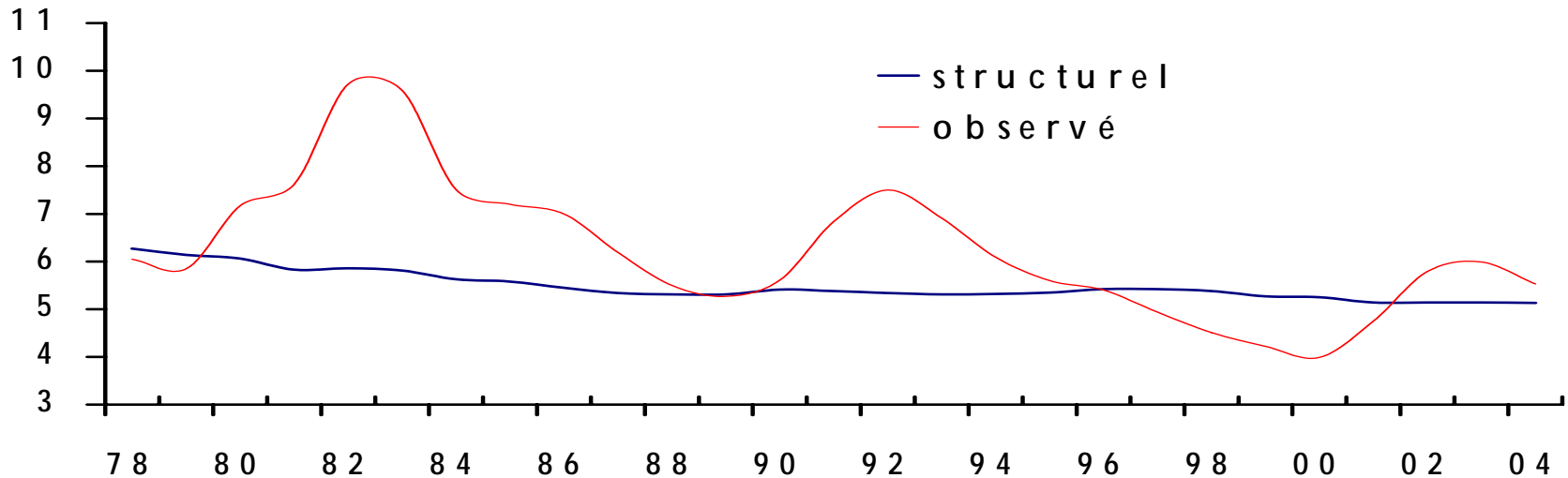
- The incidence of long duration unemployment is high. Labor mobility is slowed down by the burden of regulations
- The gaps between rates of unemployment across regions are resilient
- High structural unemployment goes together with matching problems, which have worsened in Euroland while they eased in the US
- The Phillips curve remained quite stable in Euroland over the last 25 years. It shifted inwards in the US, then flattened

- Weak productivity gains together with compensation inertia relative to labor market conditions resulted in an acceleration in unit labor costs (which decreased in the US): that put pressure on profit margins and put a drag on the aggressiveness of monetary policy
- As opposed to that, productivity gains recorded historically high performances in the US, non tradables sector included, which is not the case in Euroland

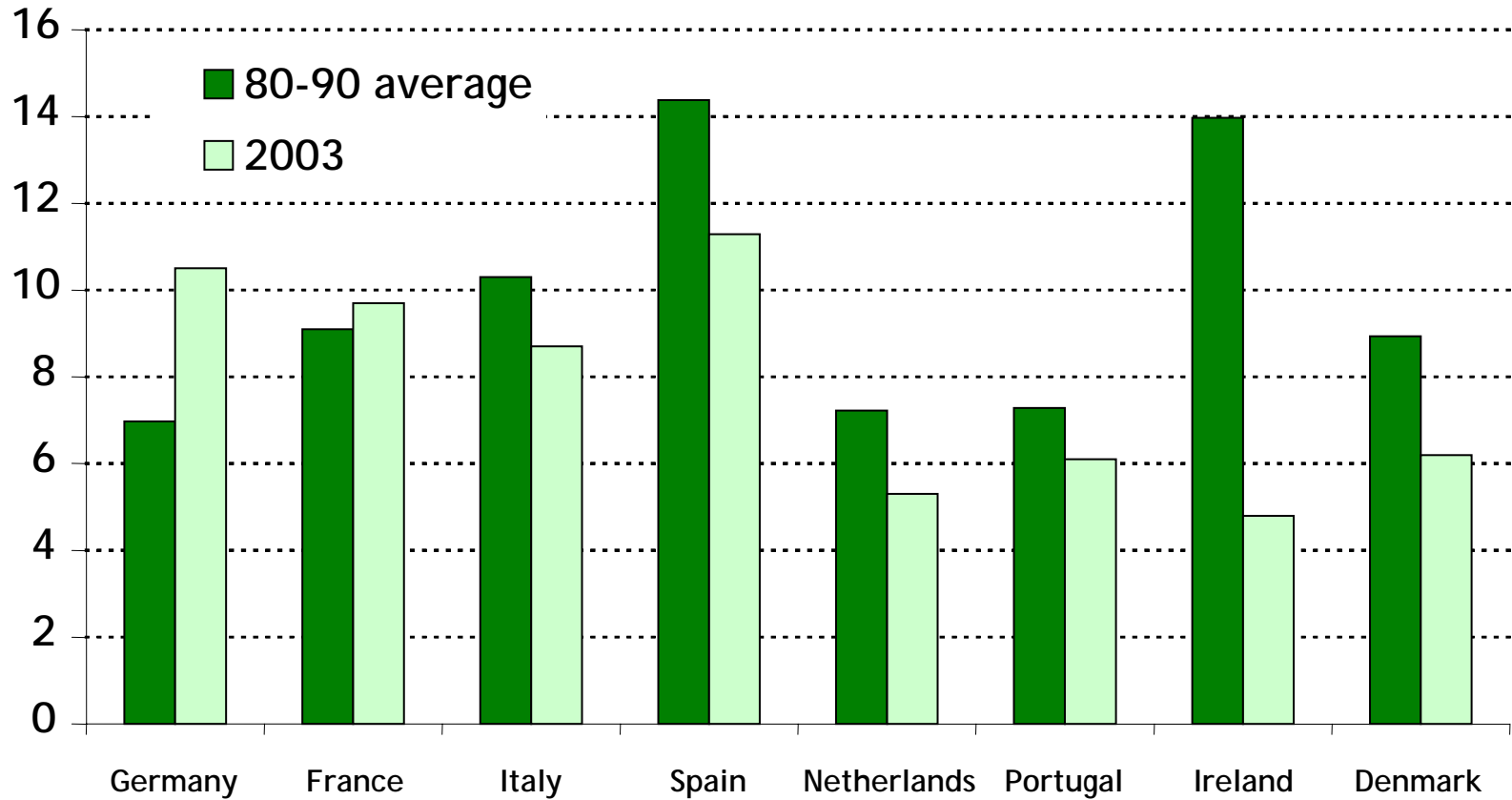
Euro zone: un employment rate,



Etats-Unis: taux de chômage

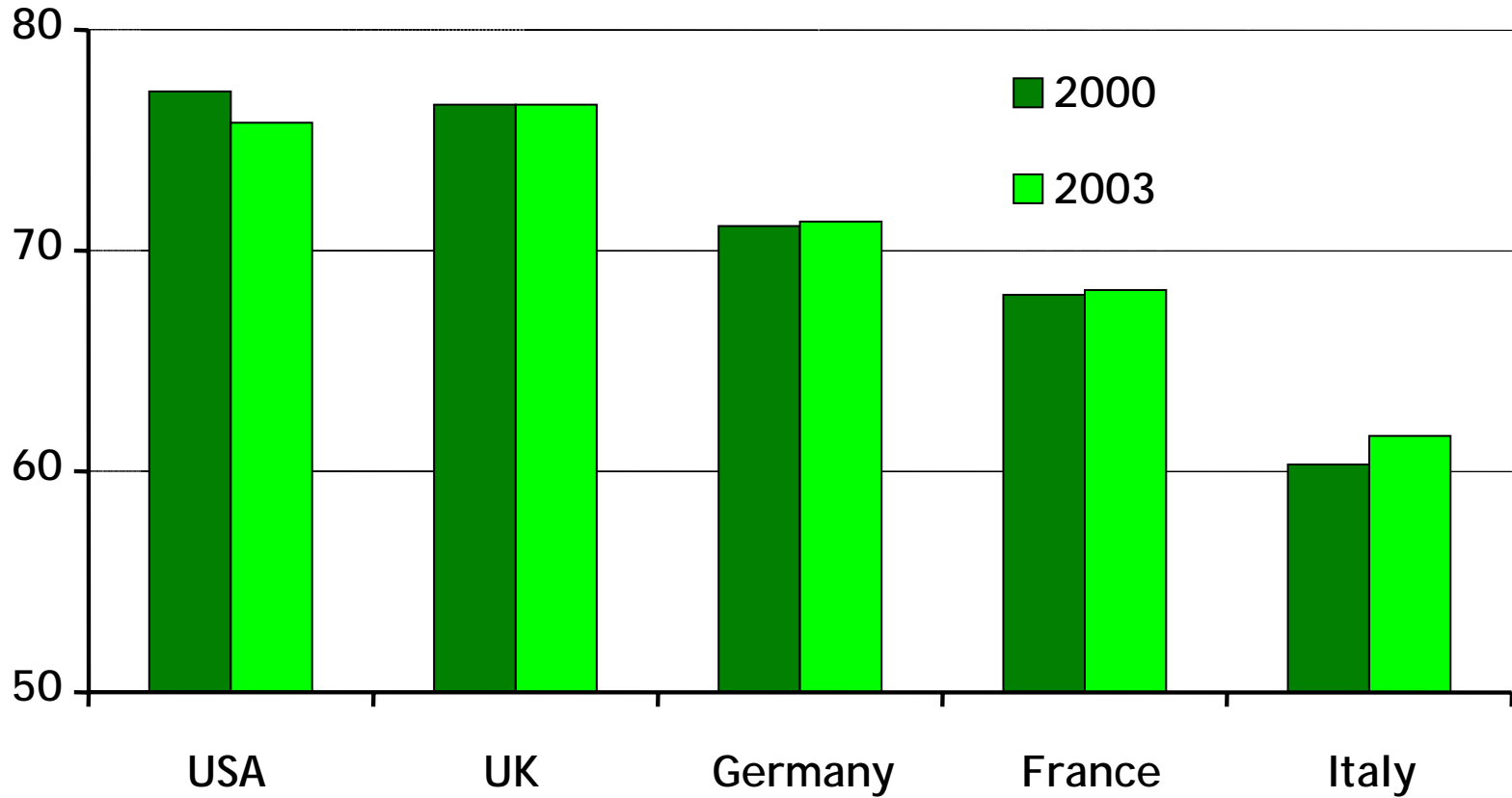


Unemployment rate, %



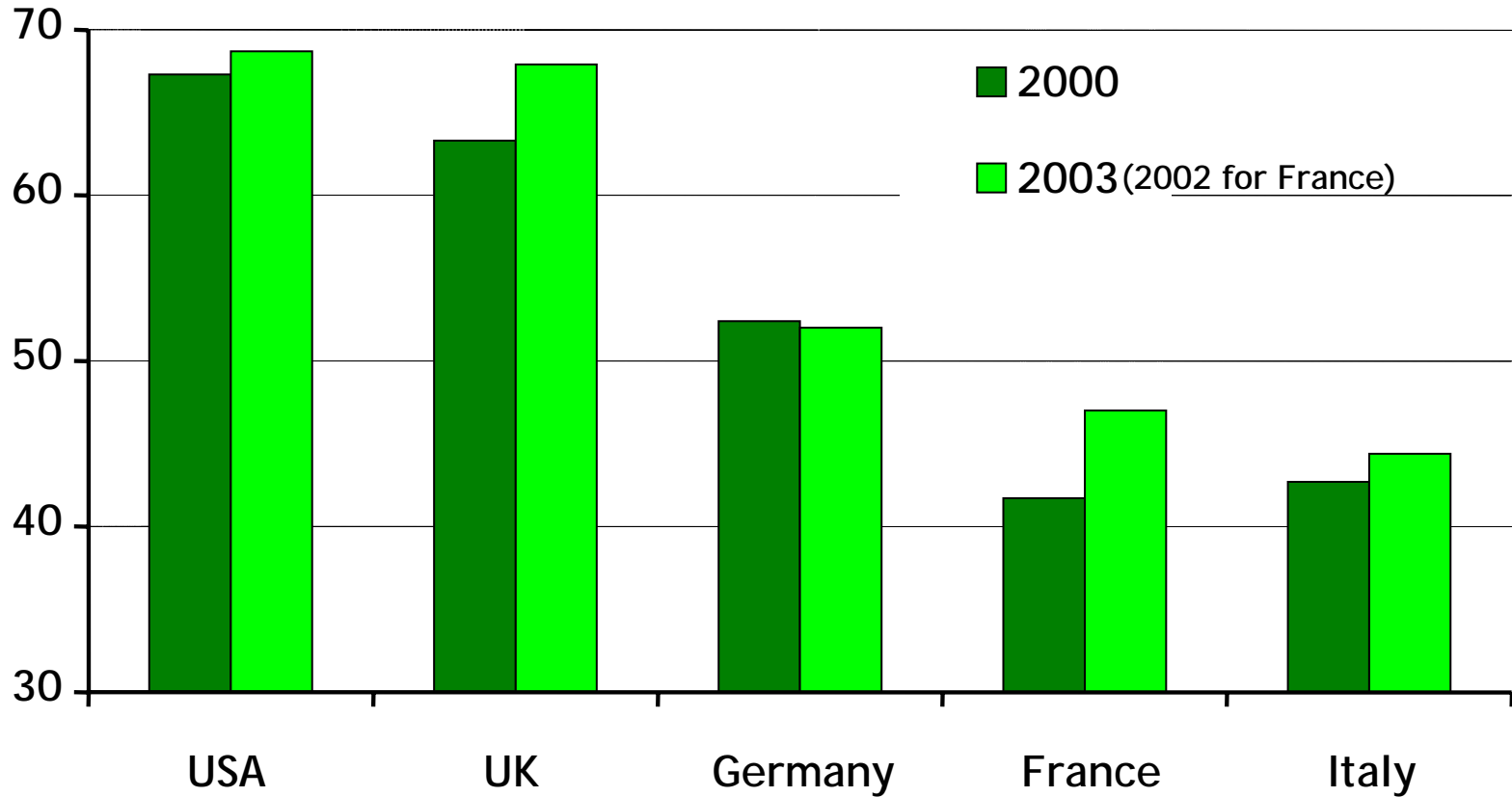
source: national

Participation rate (15-64 year)



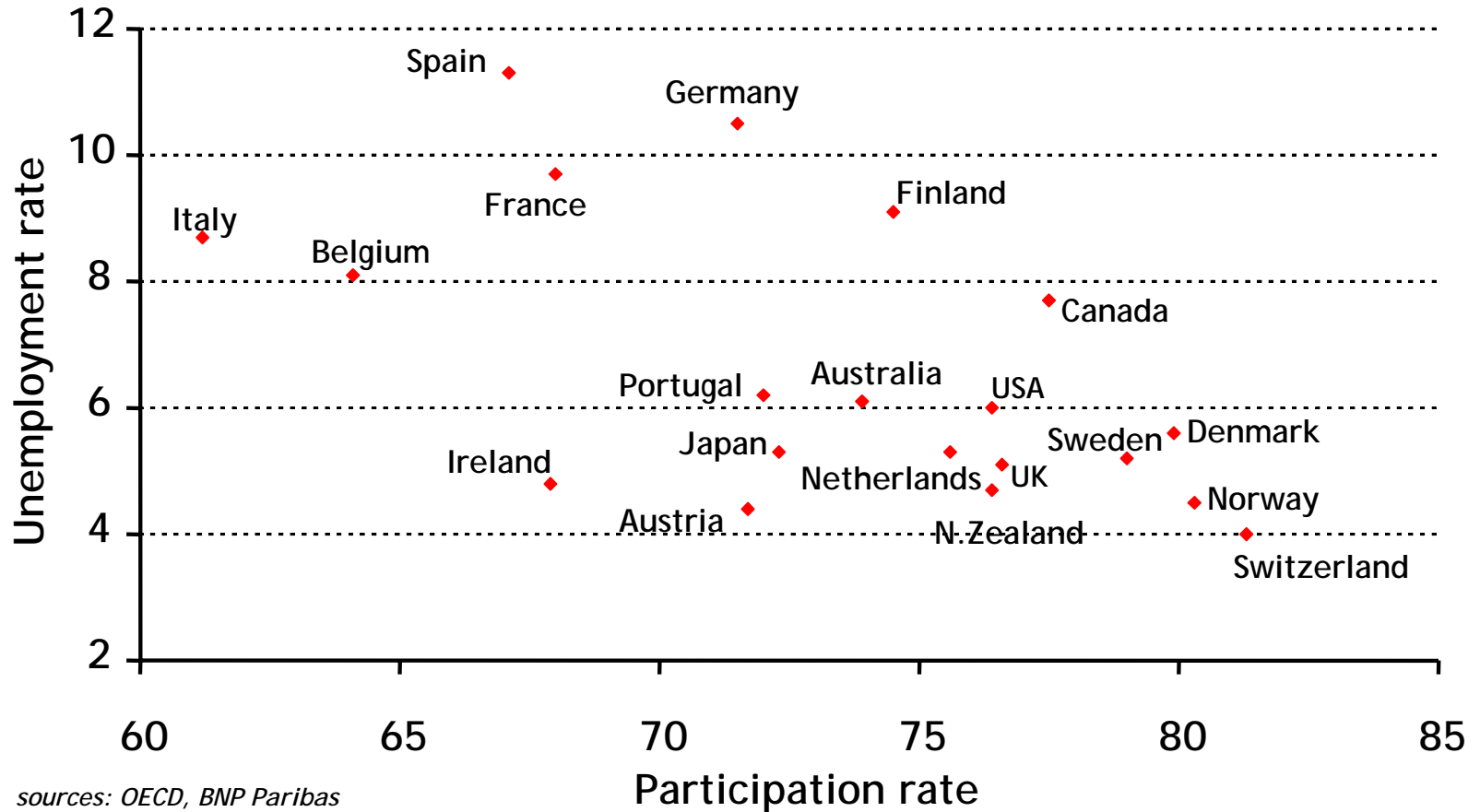
source: OECD

Men participation rate (55-64 year)

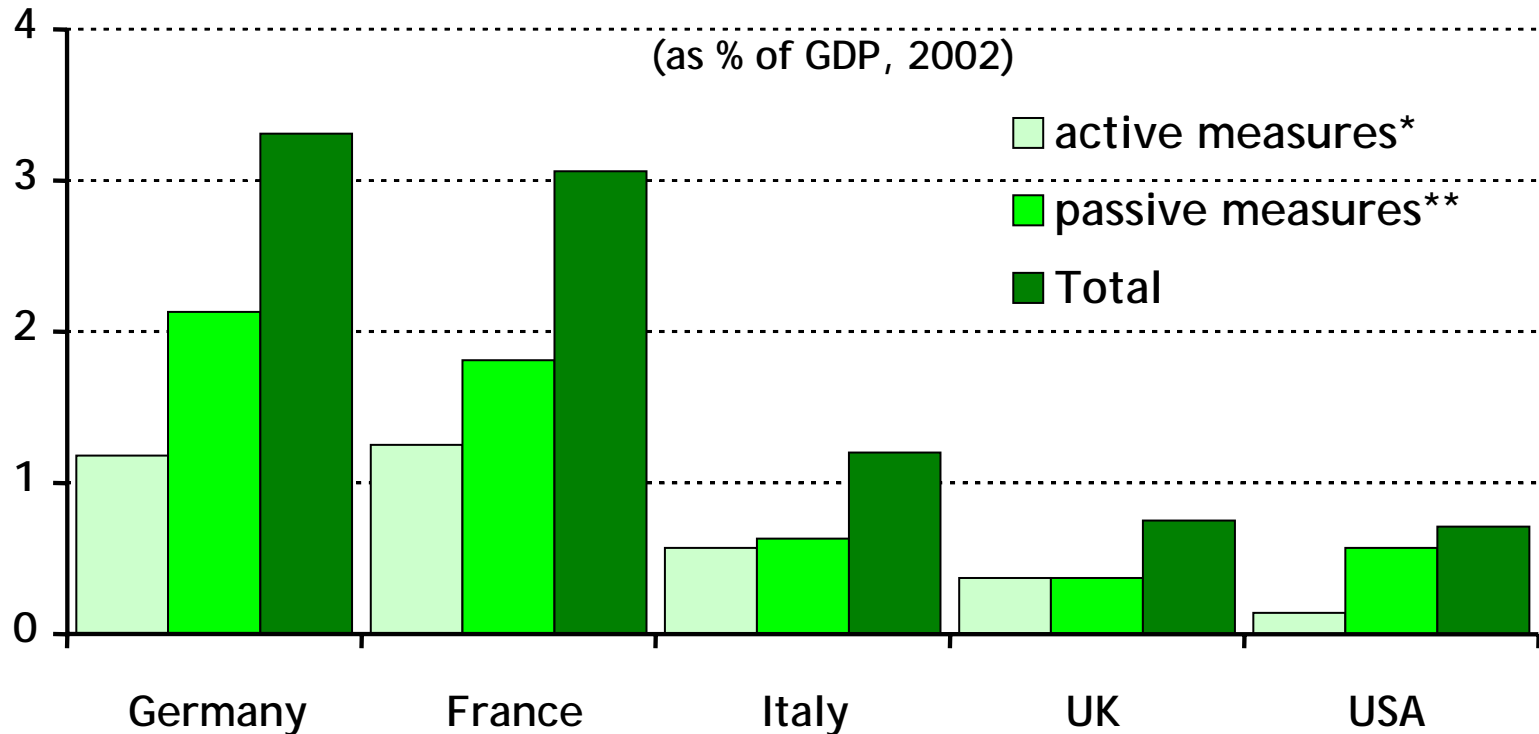


source: OECD

Euro zone: unemployment and participation rates



Government spending targeted at labor market and unemployment

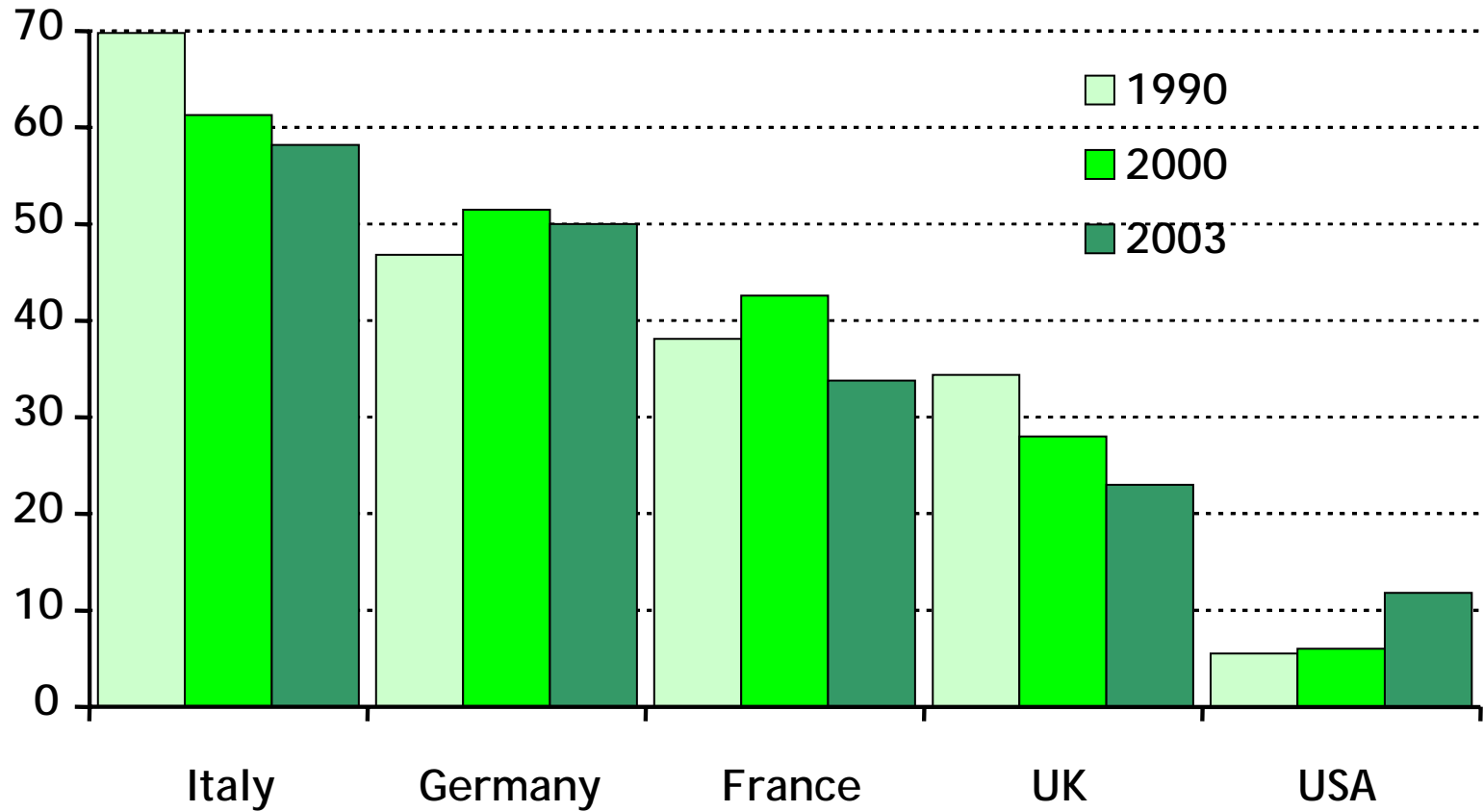


source: OECD

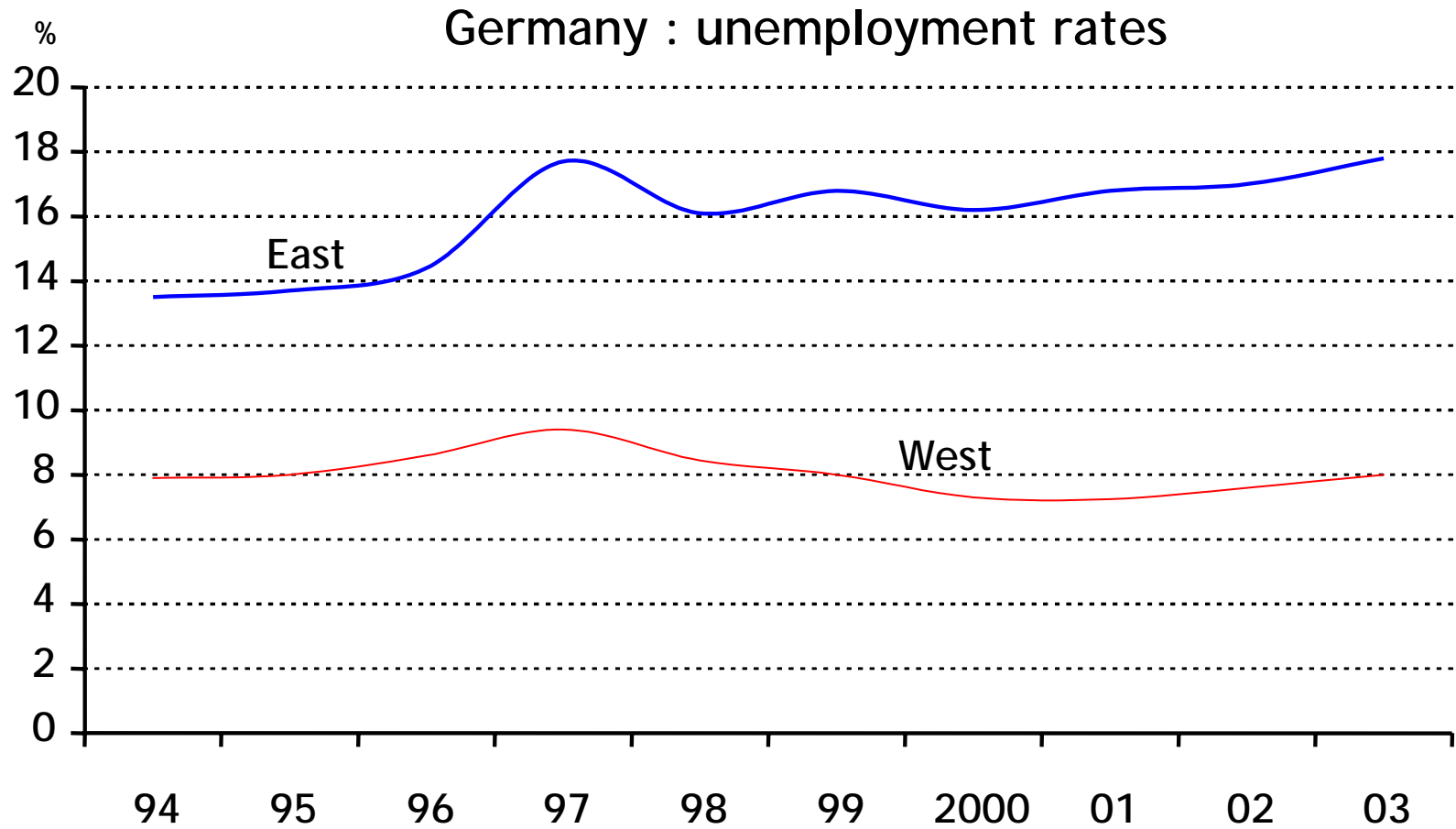
* training, incentives to hire, youth targeted programmes, job search support

** unemployment benefits and early retirement

Incidence of long duration unemployment (12 months and over)

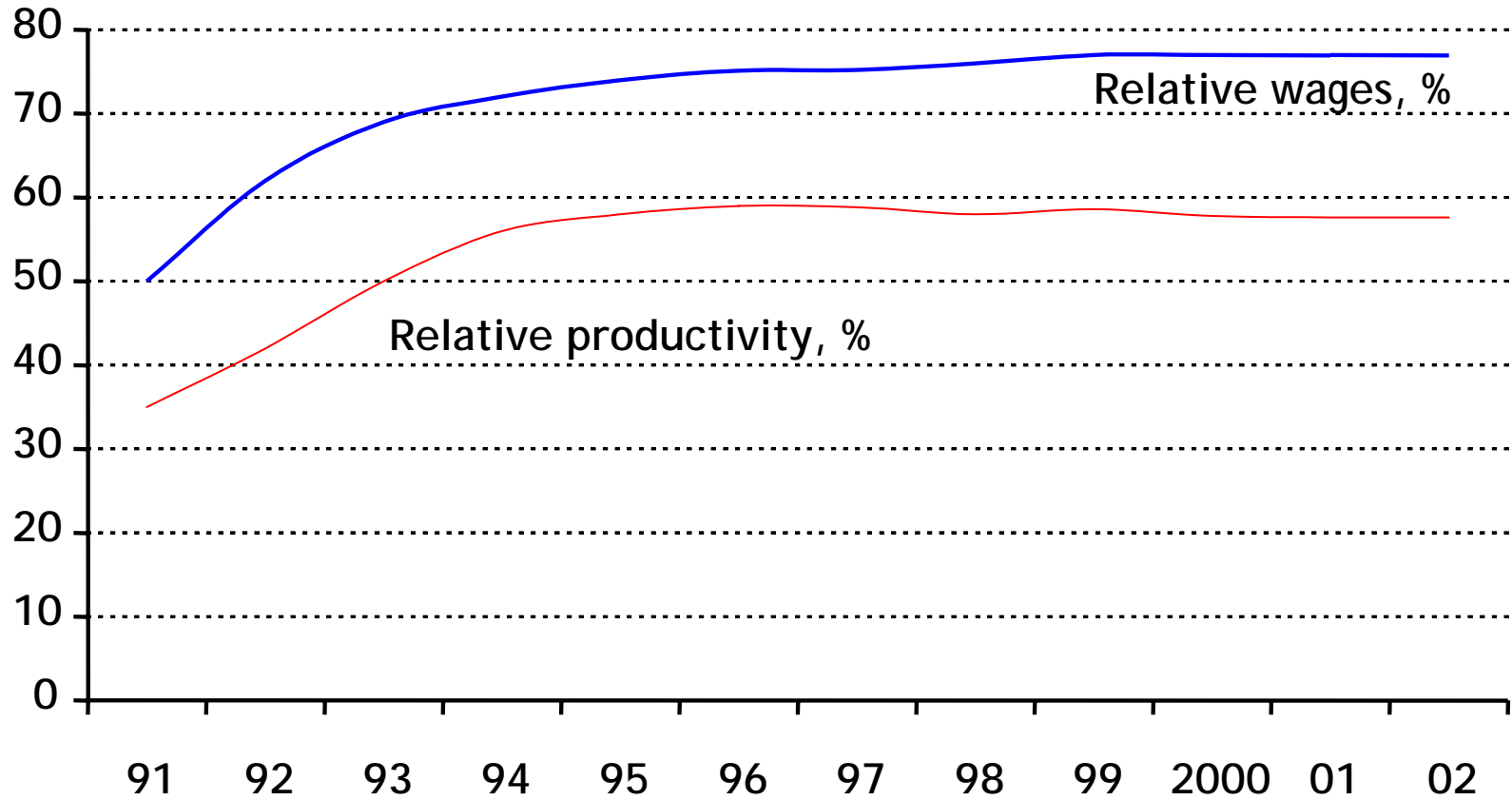


source: OECD



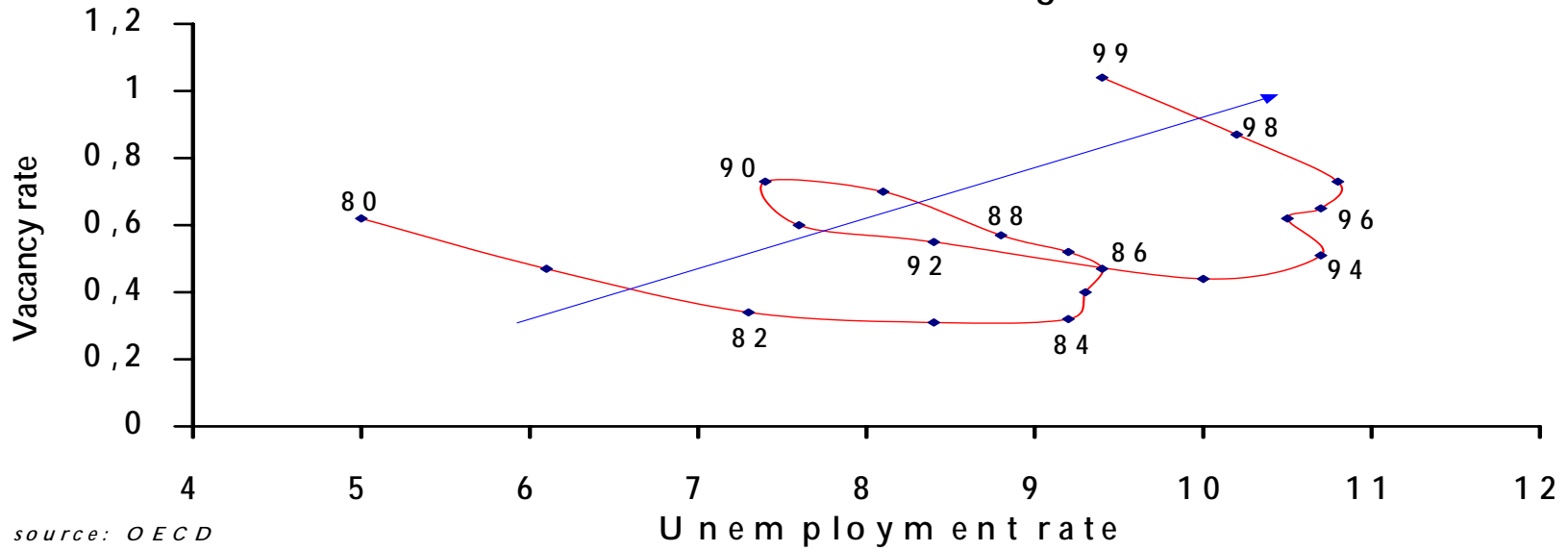
source: Federal Employment Services

Germany: East versus West

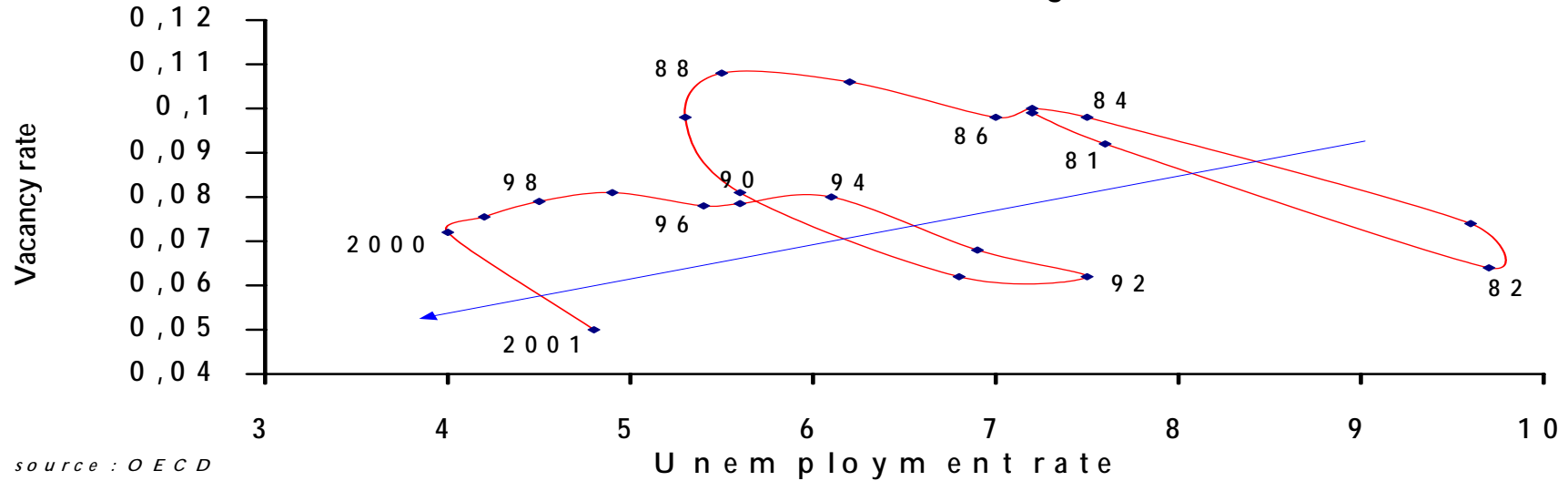


source: Federal Statistical Office

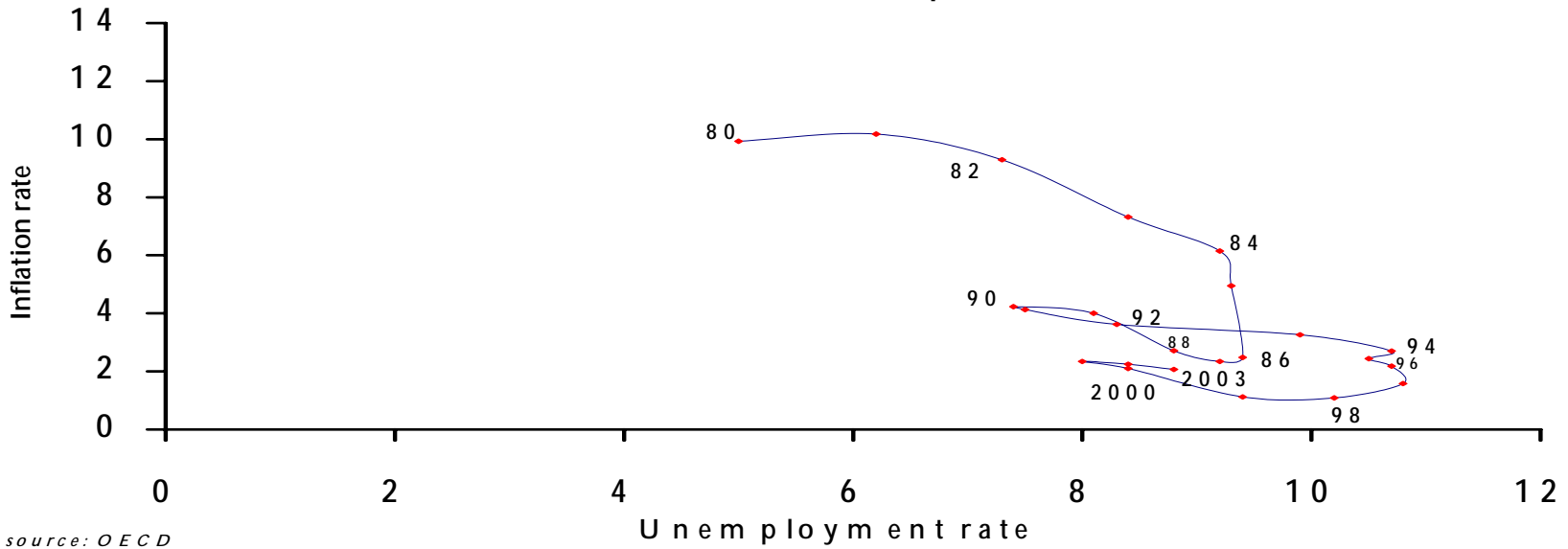
Euro zone: Beveridge curve



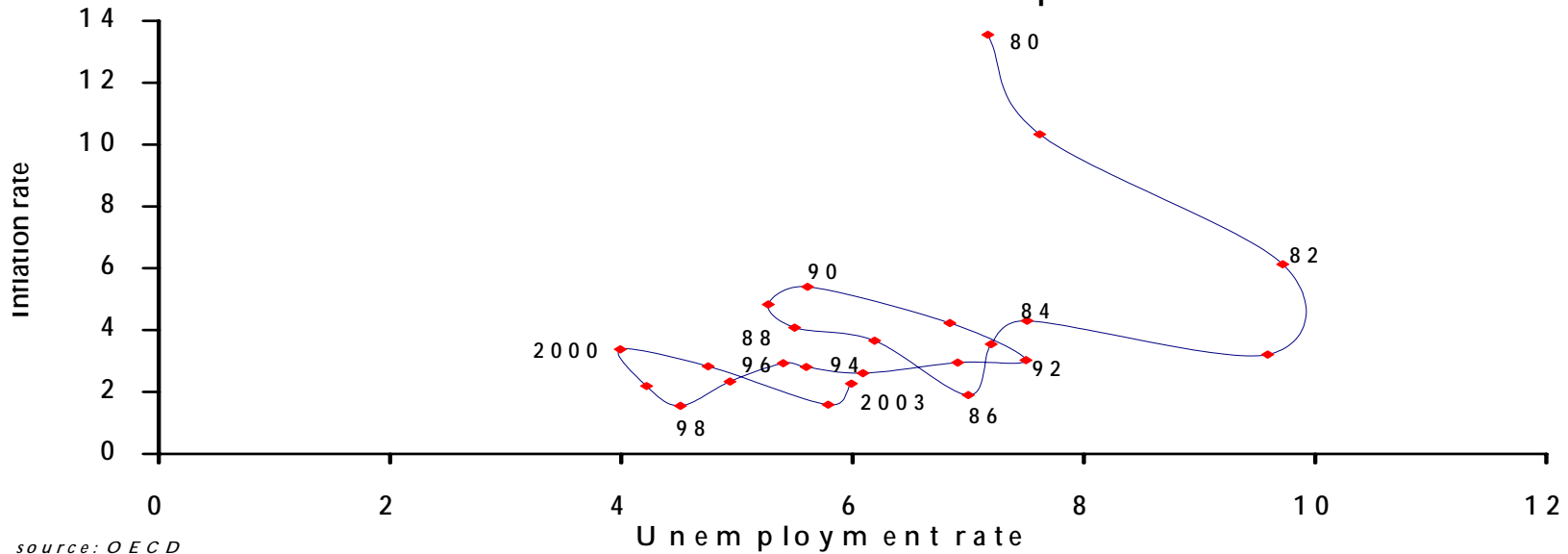
United States: Beveridge curve



Euro zone: Phillips curve



United States: Phillips curve



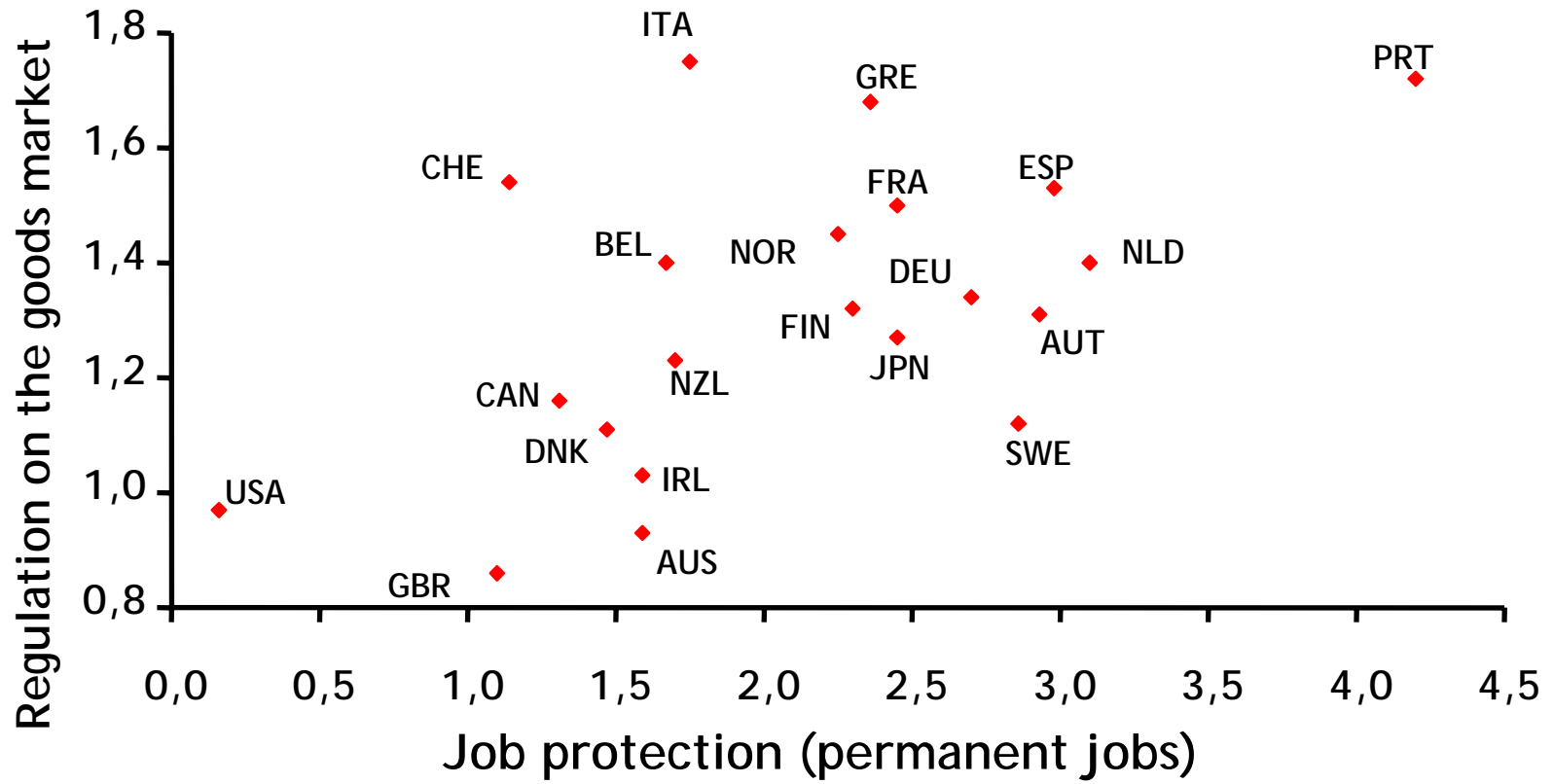
- III -

THE LABOR DEMAND

Labor demand

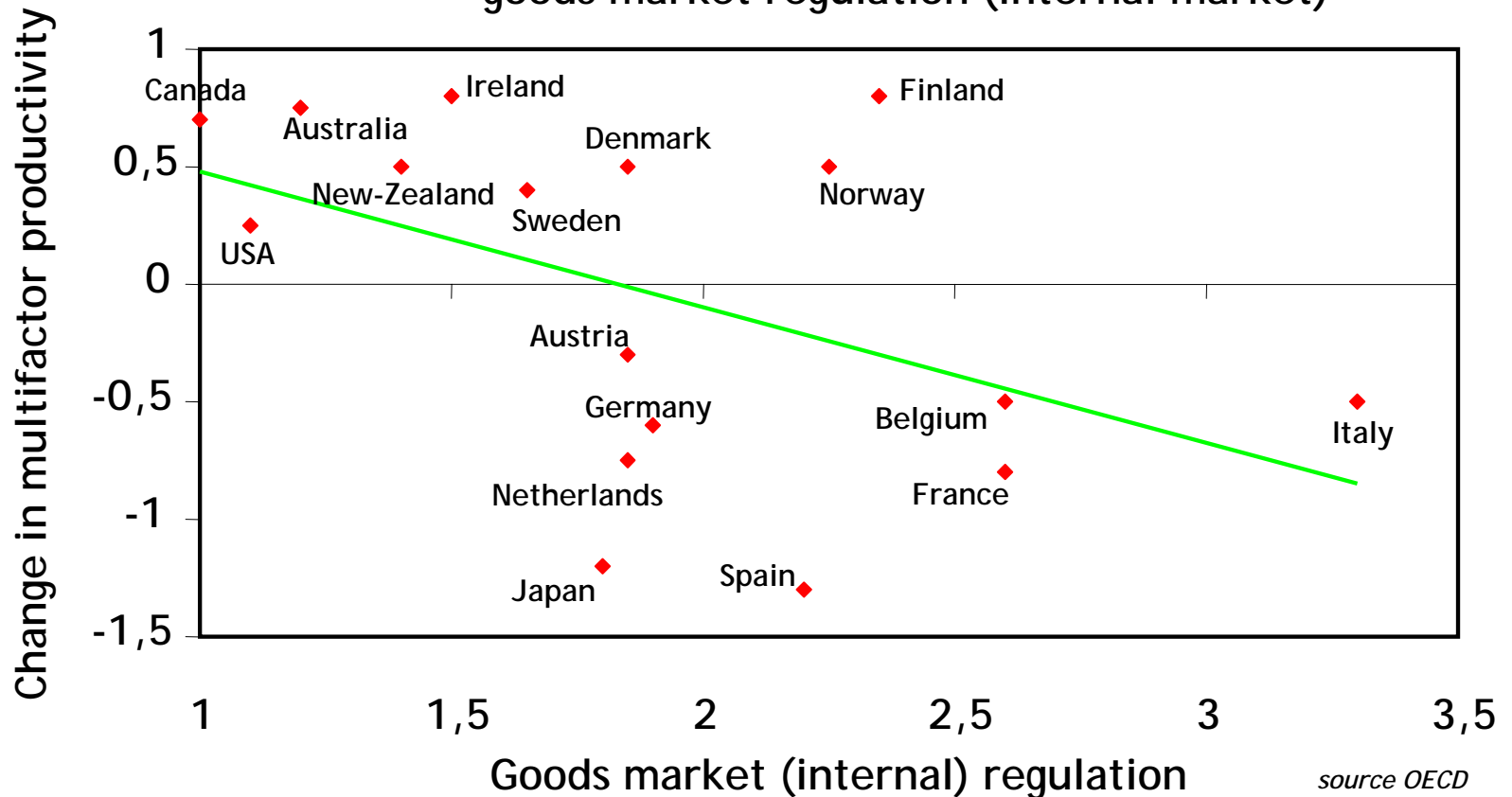
- The burden of regulations : an impediment to the adequate working of the labor market (goods market regulation and labor regulation go hand on hand)
- “Solutions” such as a higher reliance on temporary contracts have negative effects (dualism of the labor market “insiders” being even more protected, flexibility (adjustment), focused on a sub-population, disincentive to job training
 - The strictness in labor protections reduces the turnover
 - lengthens the duration of unemployment
 - together with goods market regulation it negatively impacts the participation rate

Regulation on the goods market and job protection



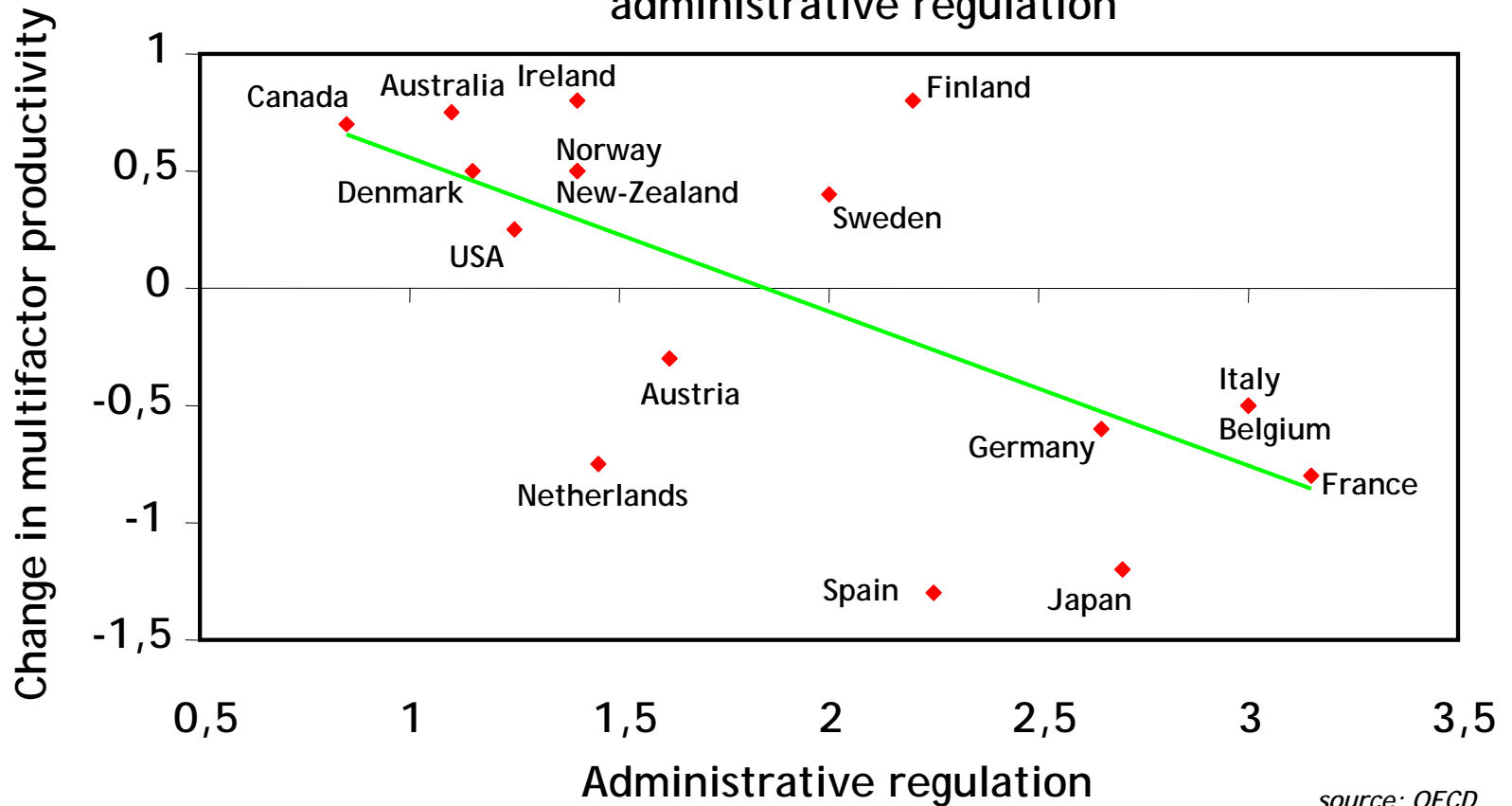
sources: OECD, BNP Paribas

Changes in multifactor productivity gains and goods market regulation (internal market)



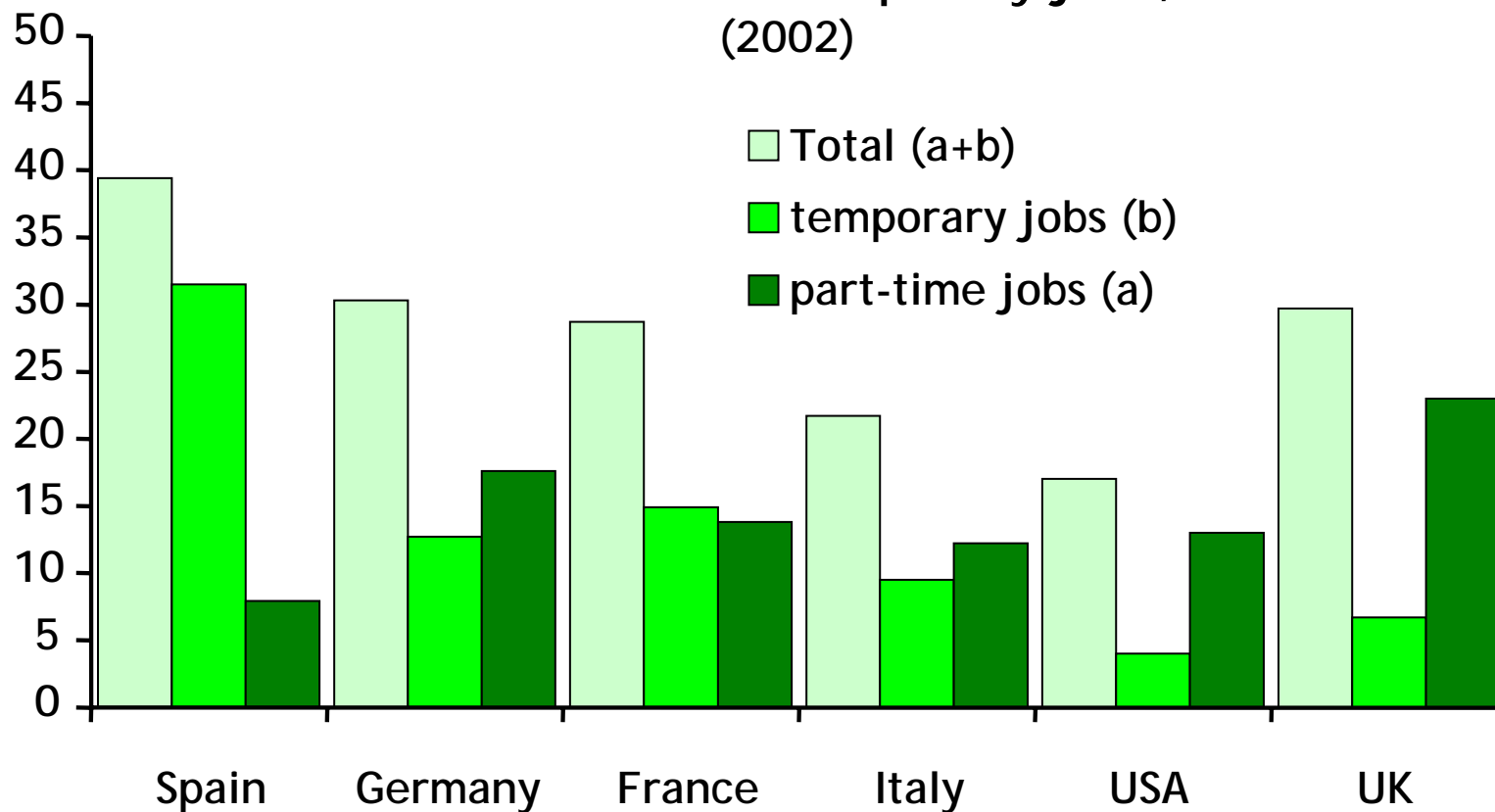
source OECD

Changes in multifactor productivity gains and administrative regulation

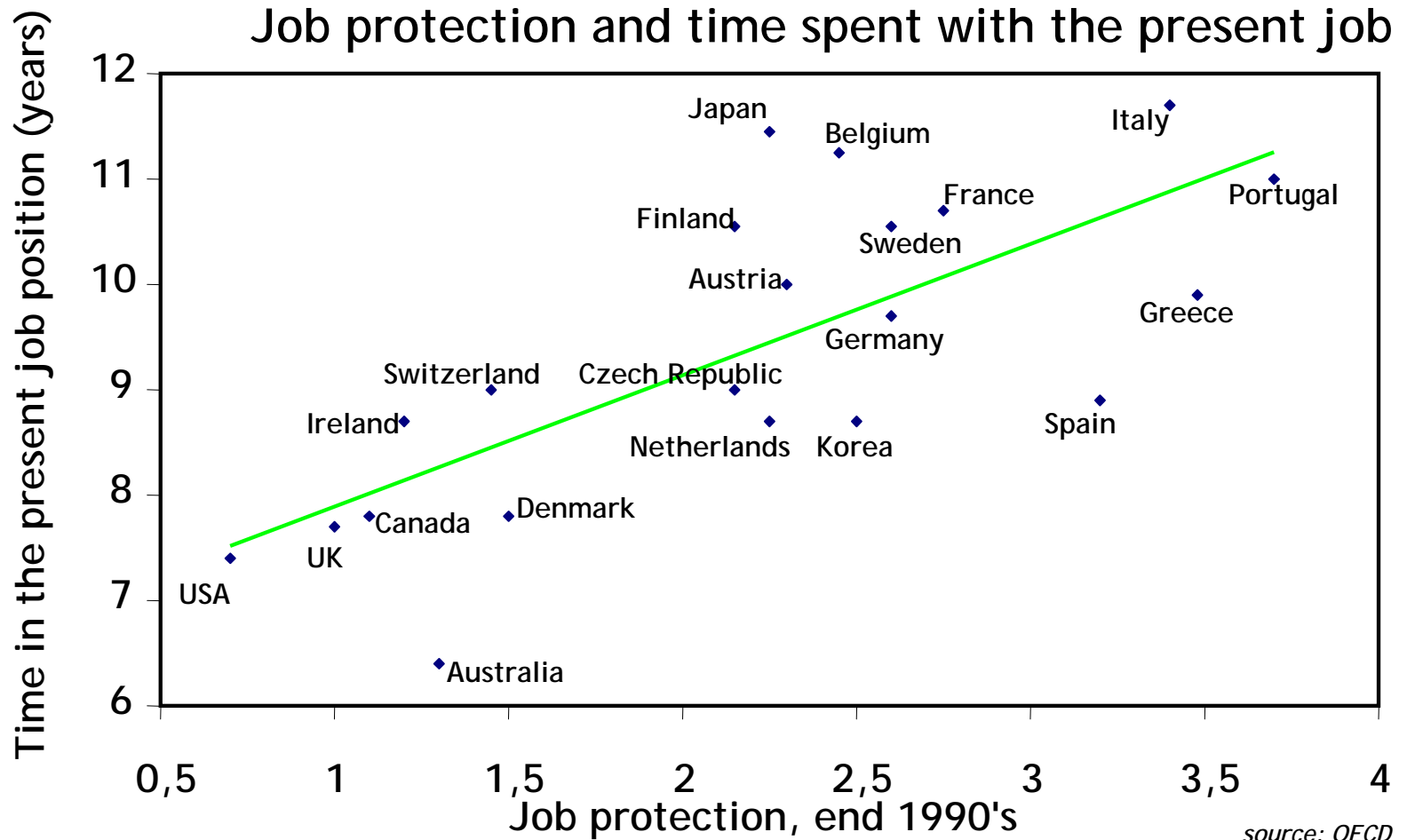


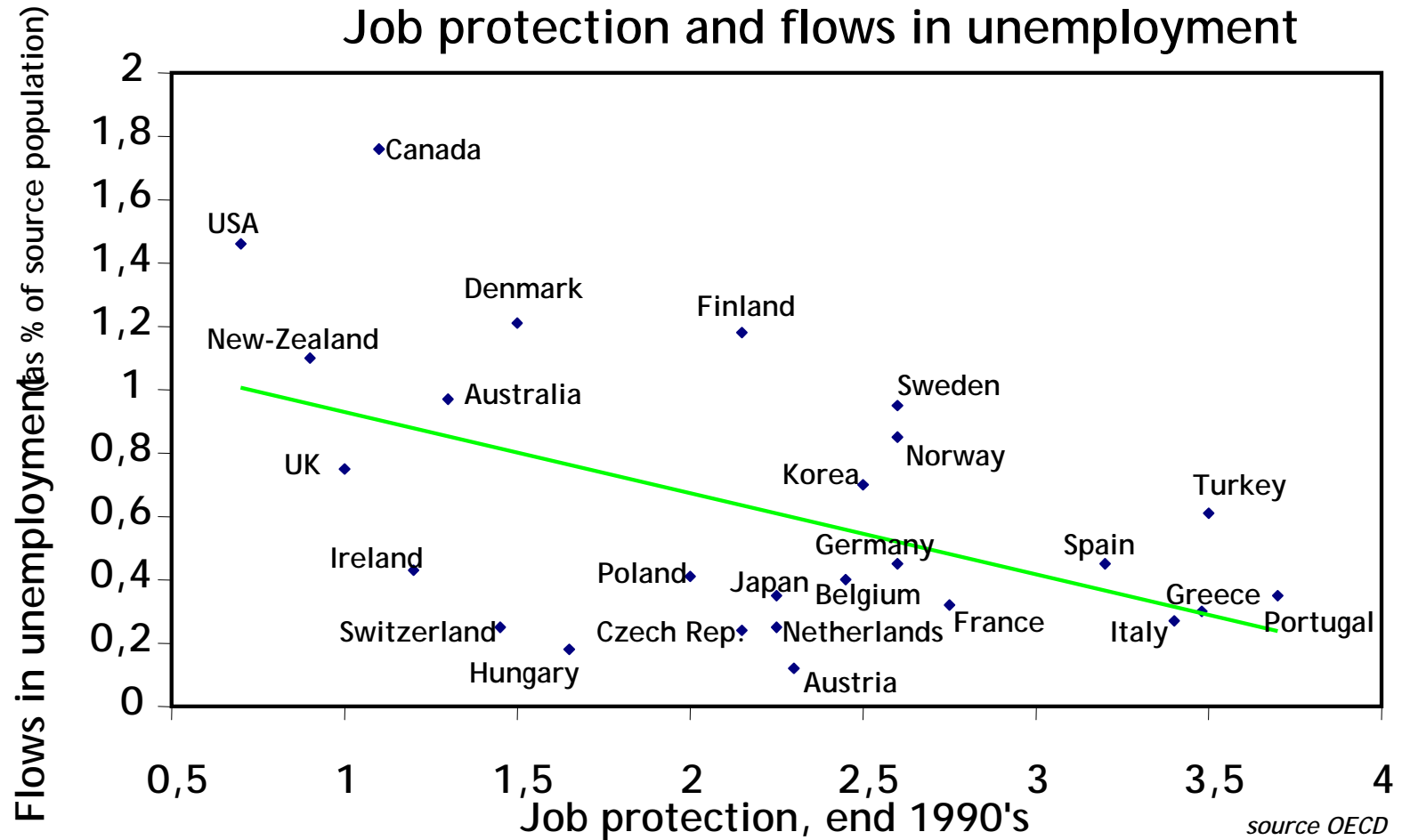
source: OECD

Part-time and temporary jobs, %
(2002)

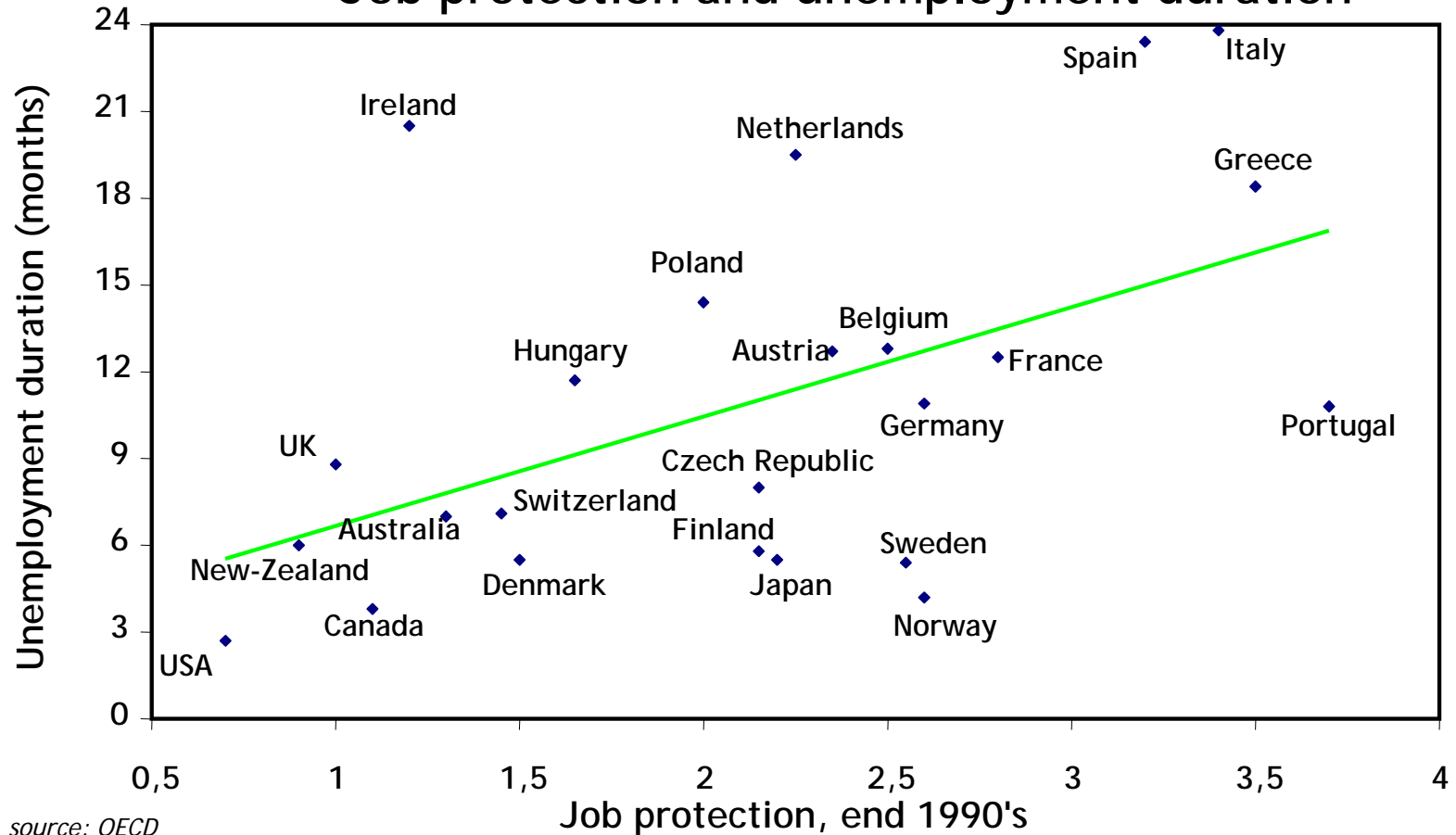


source: OECD



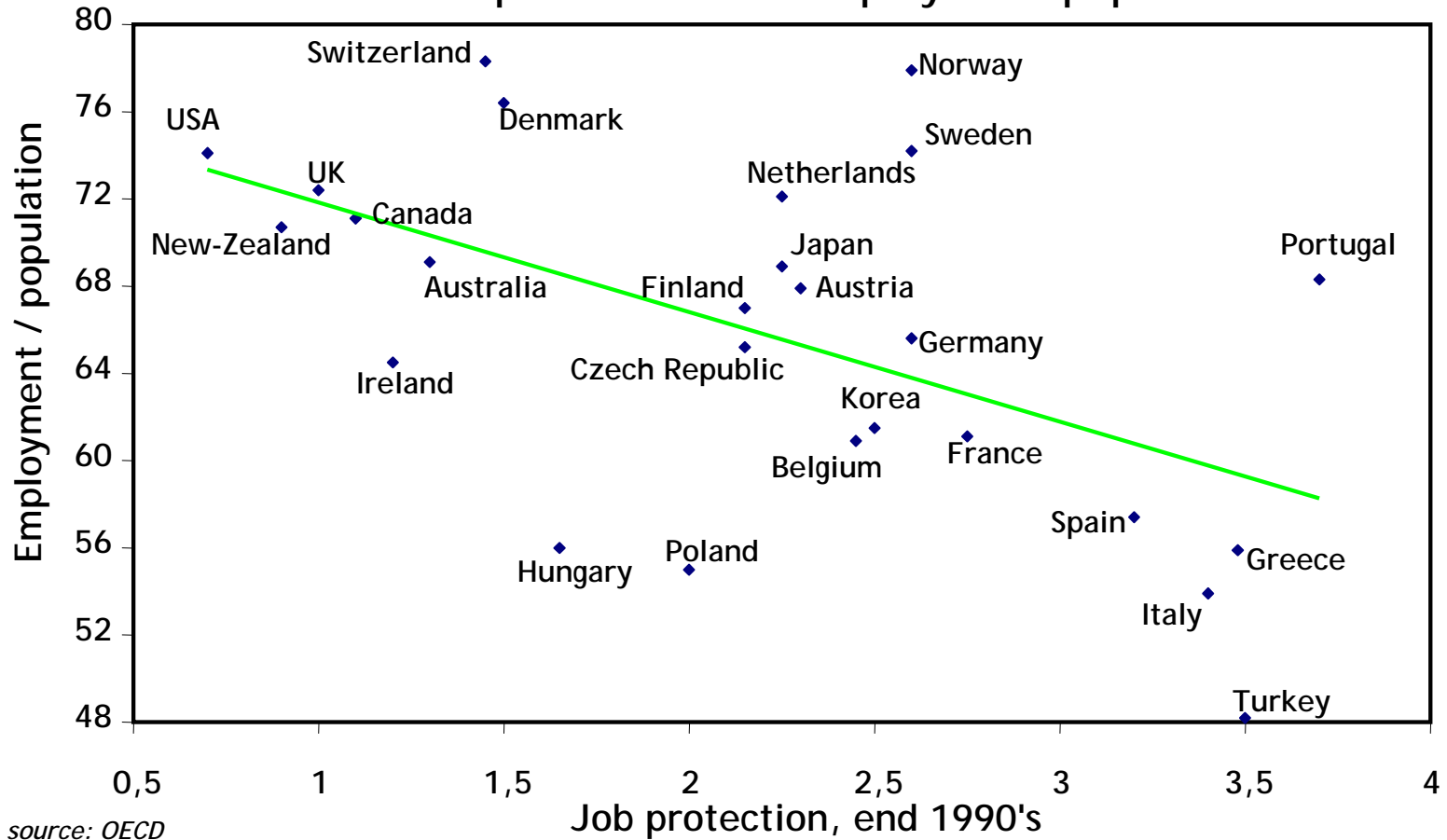


Job protection and unemployment duration



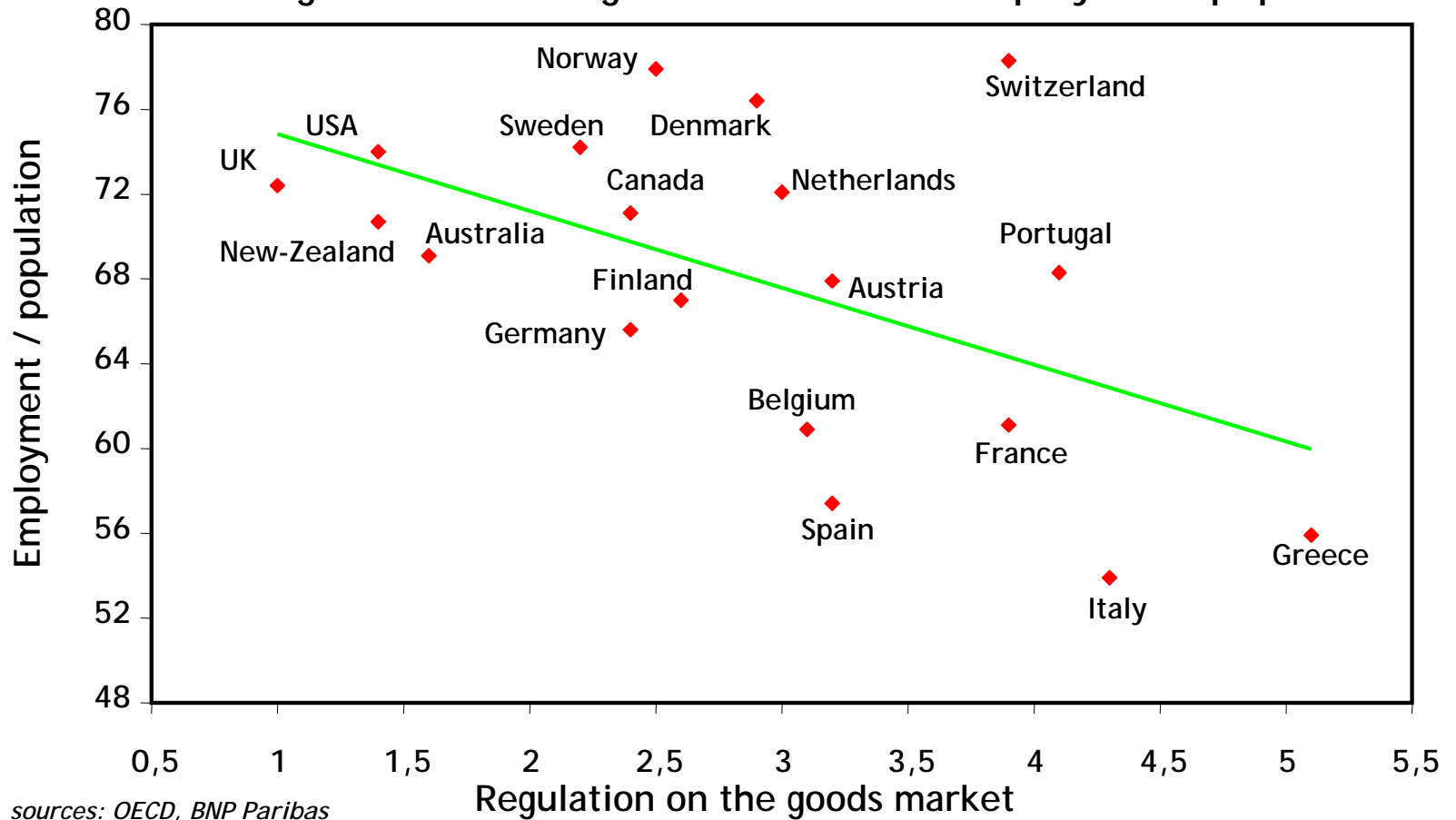
source: OECD

Job protection and employment/population



source: OECD

Regulation on the goods market and employment/population



sources: OECD, BNP Paribas

- IV -

LABOR COSTS SETTING

- The minimum wage

- A higher minimum wage doesn't automatically result in higher unemployment (US experience with marginal productivity remaining below hiring cost).
- When the minimum wage represents a significant proportion of the medium wage, it is an impediment to hiring low skilled workers (hence the positive impact from lowering social contributions) .
- Narrowing spreads between compensations is an impediment to mobility .

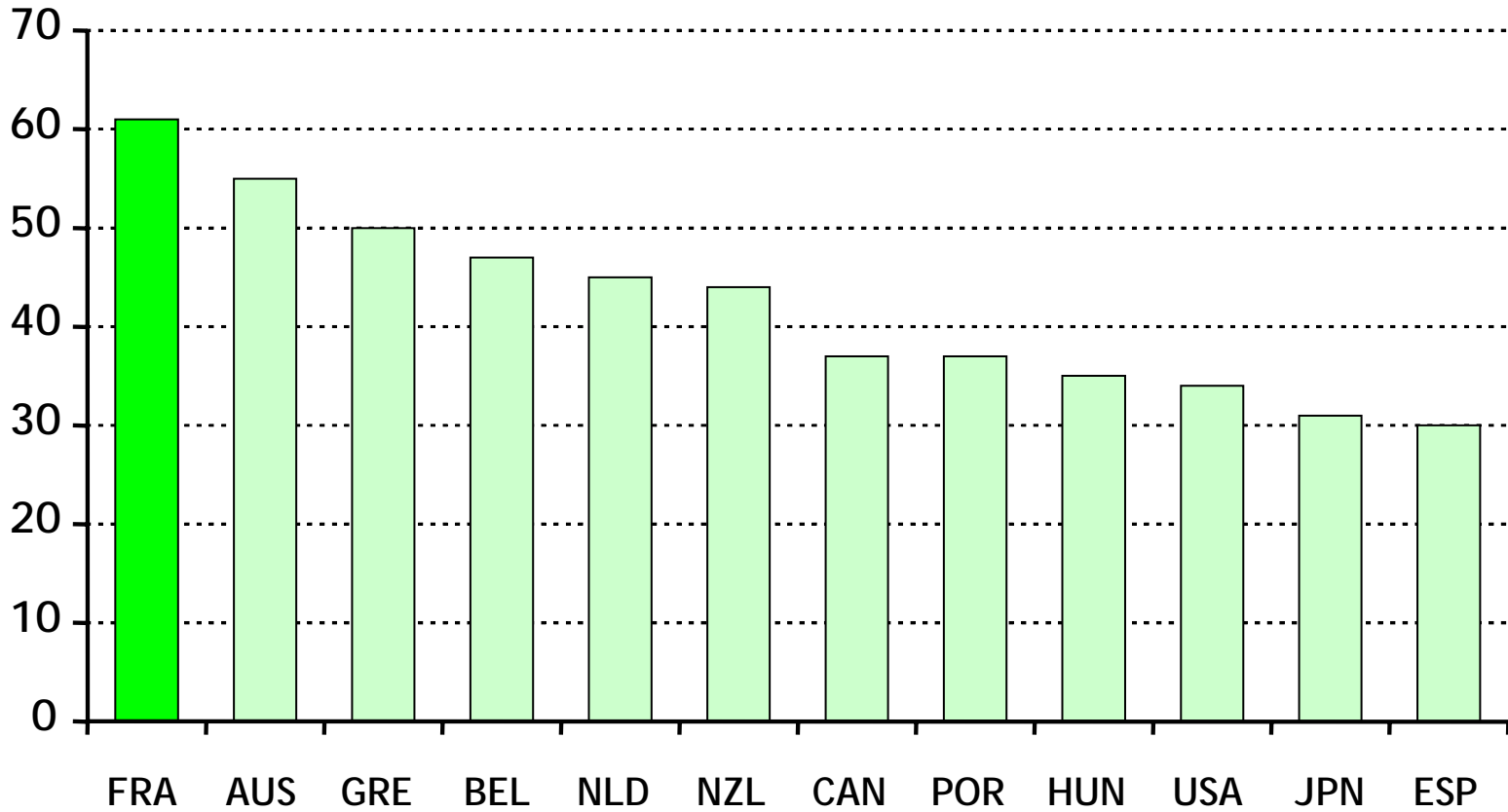
- Negotiations framework

- Negotiation levels

- centralized: externalities on jobs are taken into account
- decentralized: idiosyncratic situation of firms are taken into account
- negotiations taking place at an intermediate level are less effective regarding jobs

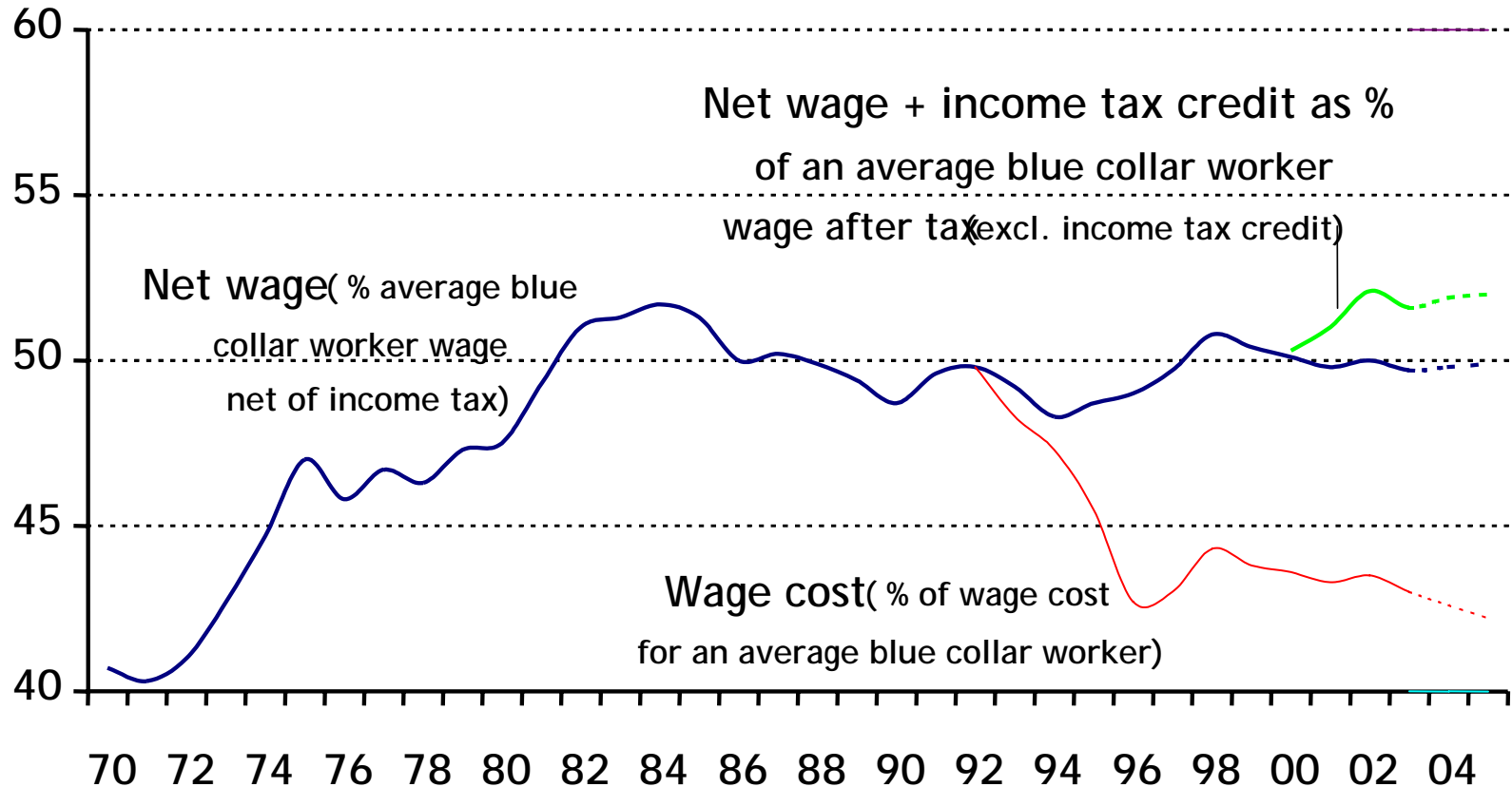
- A trend toward weaker unionization, but the coverage of collective agreements remains widely spread .

Minimum wage as % of median wage



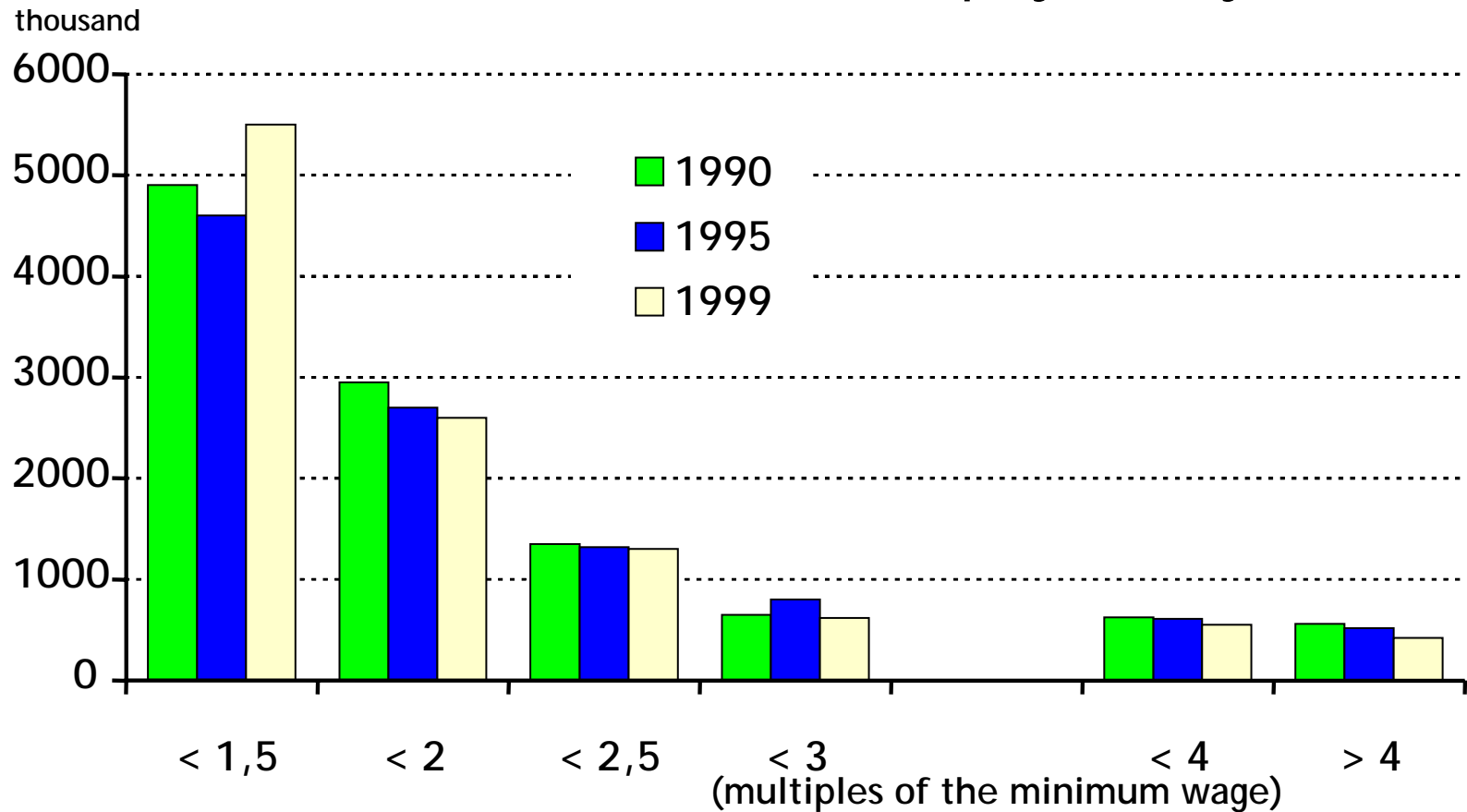
source : OECD

France: wage cost and net wage at minimum wage level



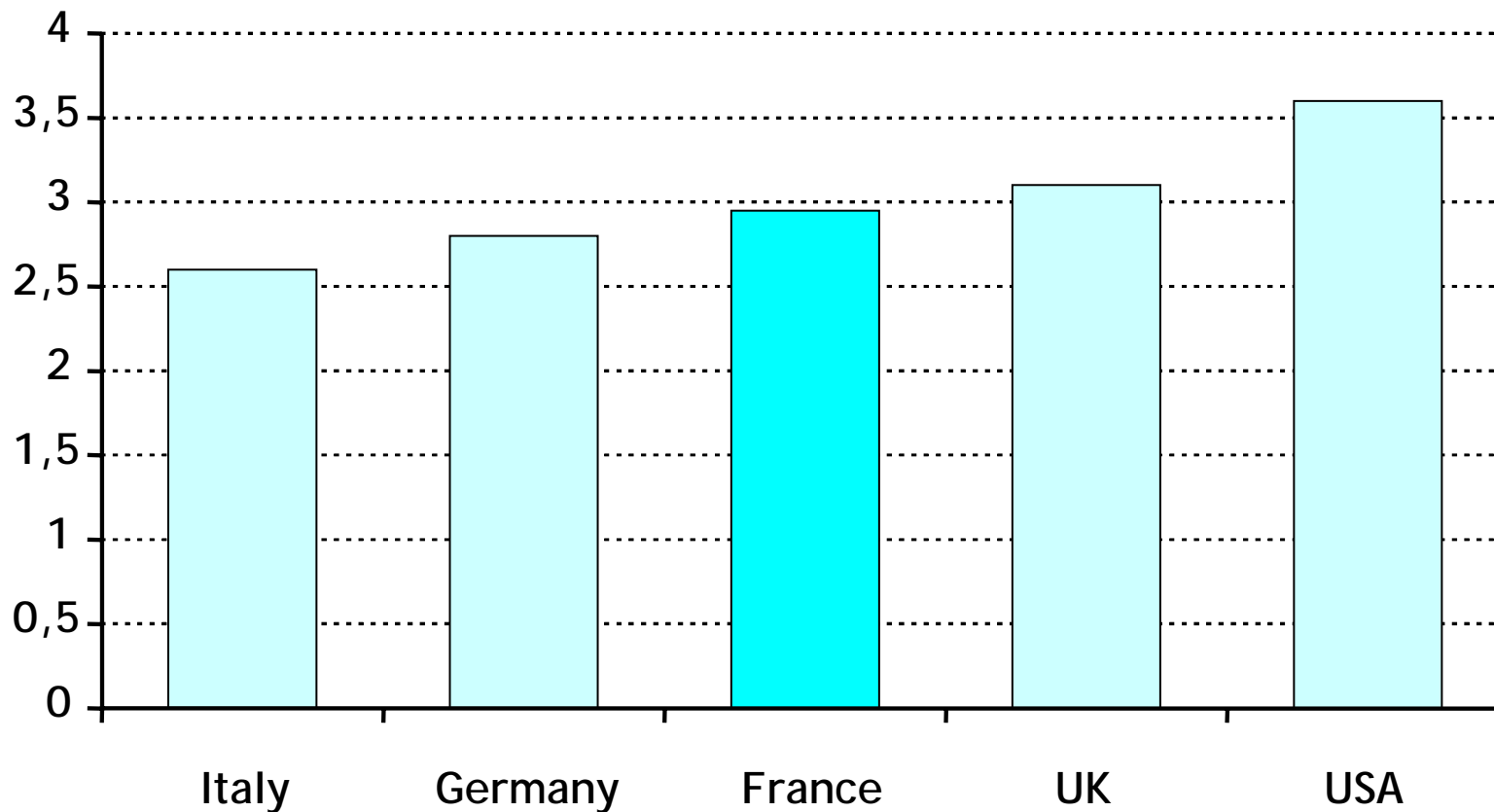
sources: OECD, INSEE

France: non subsidized full time employment by income level



sources: OECD, INSEE

Compensation distribution (D9/D1)



source: OECD

Negotiations conditions

	Unionization rate	Coverage by collective agreements
France	9	95
Germany	27	92
Italy	37	82
Spain	18	78
UK	34	40
USA	14	17

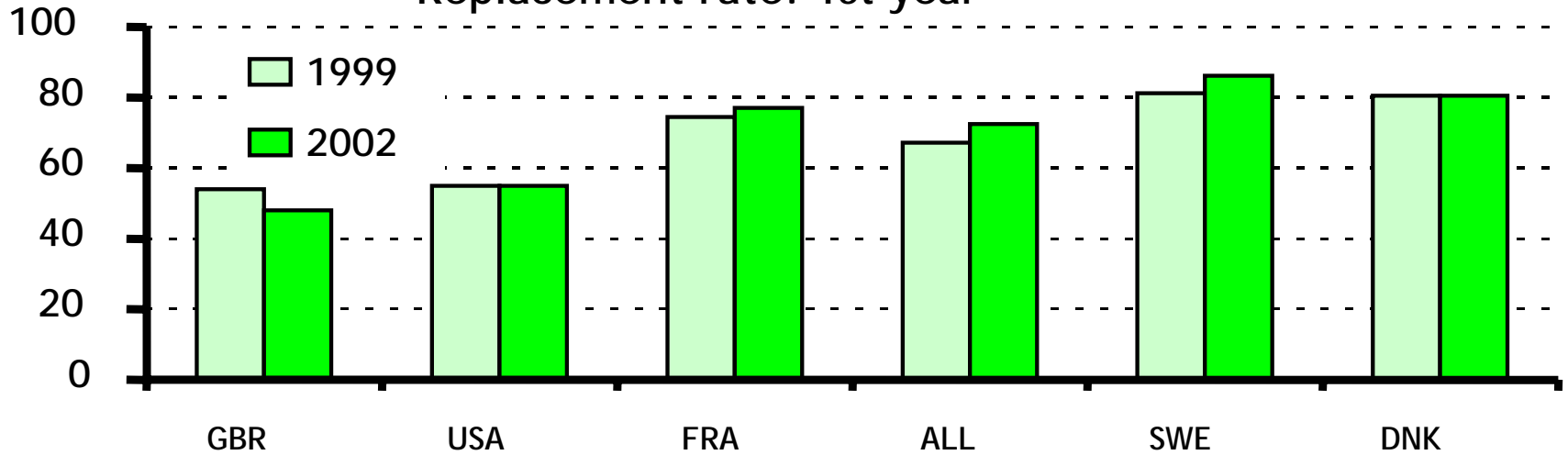
source: OECD

- V -

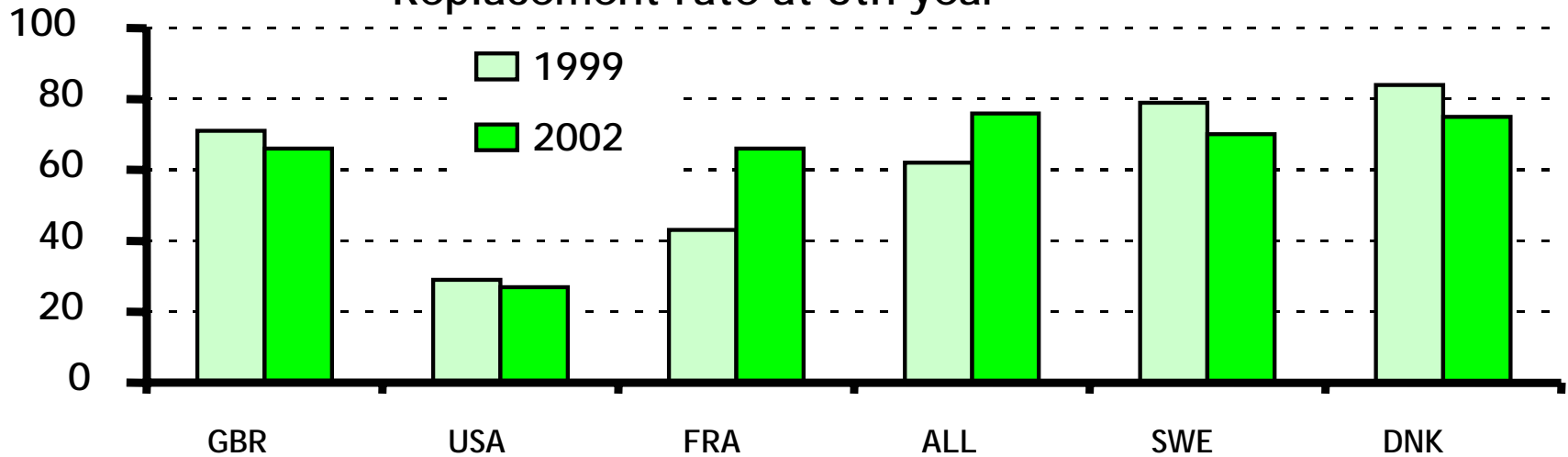
LABOR SUPPLY

- Taxes and contributions increase the hiring costs and reduces the willingness to work .
- Inactivity traps (minimum income + unemployment benefits together with income tax) .
- Tax wedges are very high in Europe .

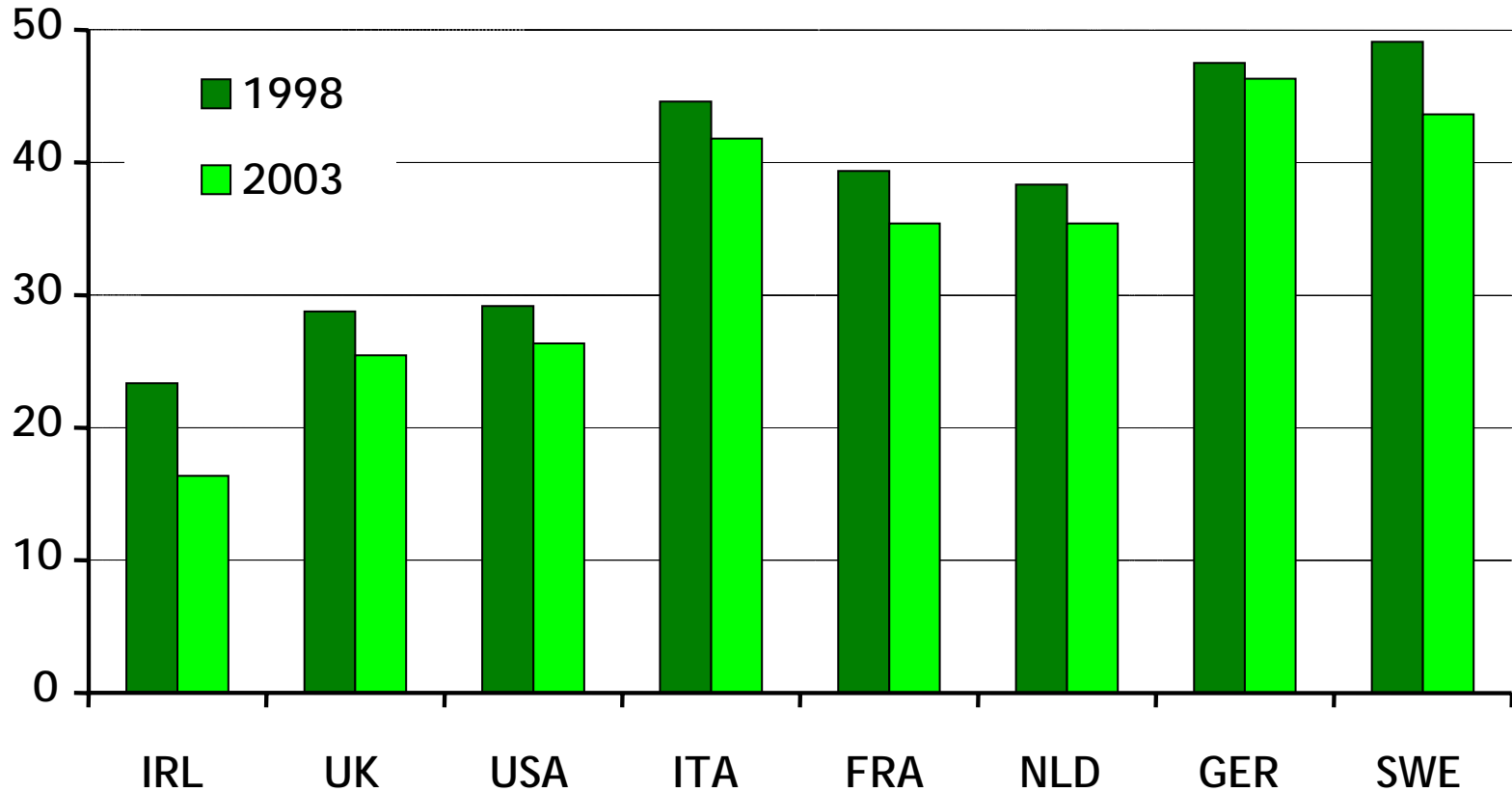
Replacement rate: 1st year



Replacement rate at 5th year

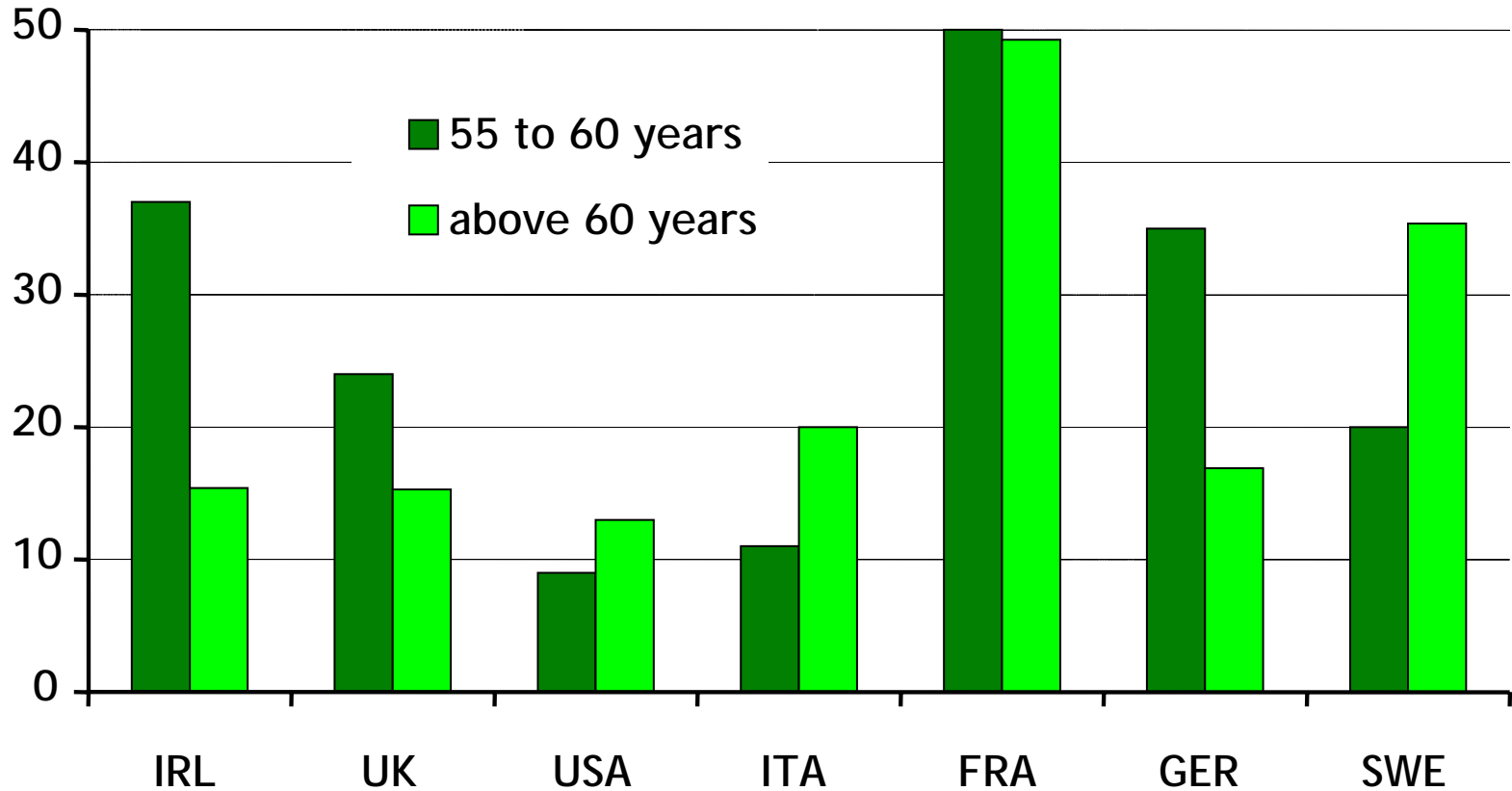


Tax wedge (at 70% of average wages)



source: OECD

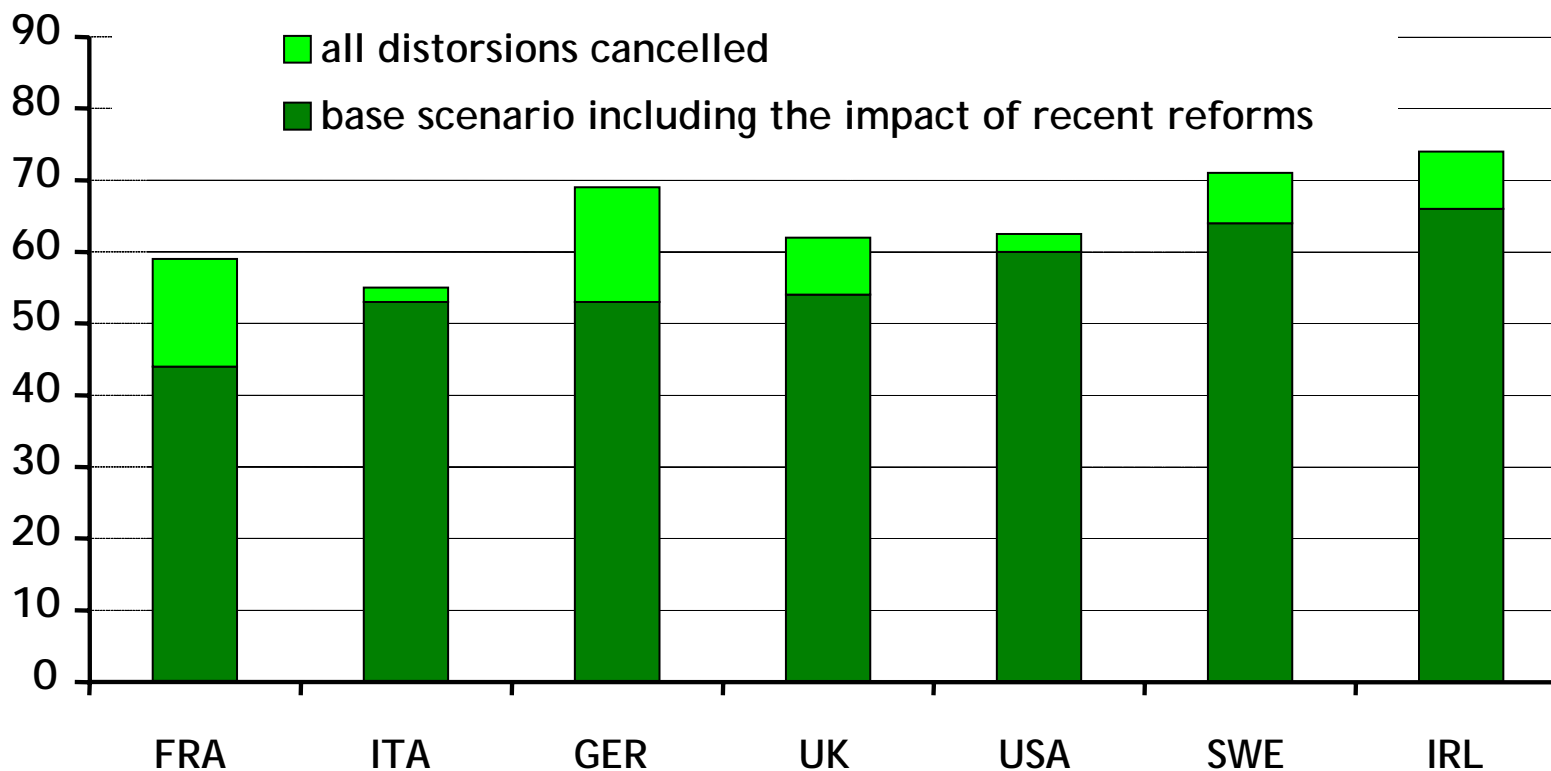
Implicite tax on labor



source: OECD

Potential impact of pension reforms on the activity ratio

(activity ratio for 55-64 years of age as projected for 2025 under different reform scenarios)



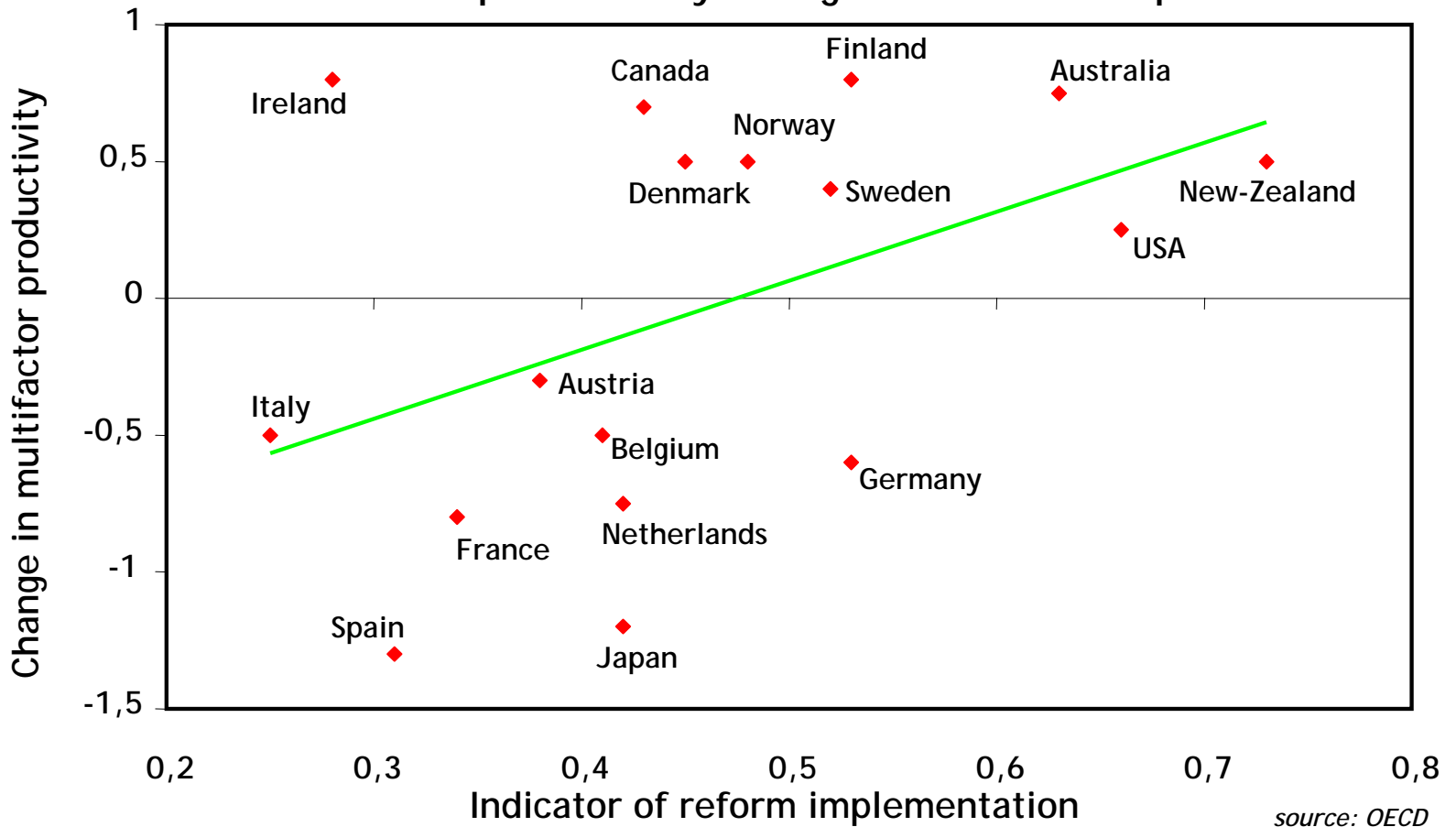
source: OECD

Conclusion

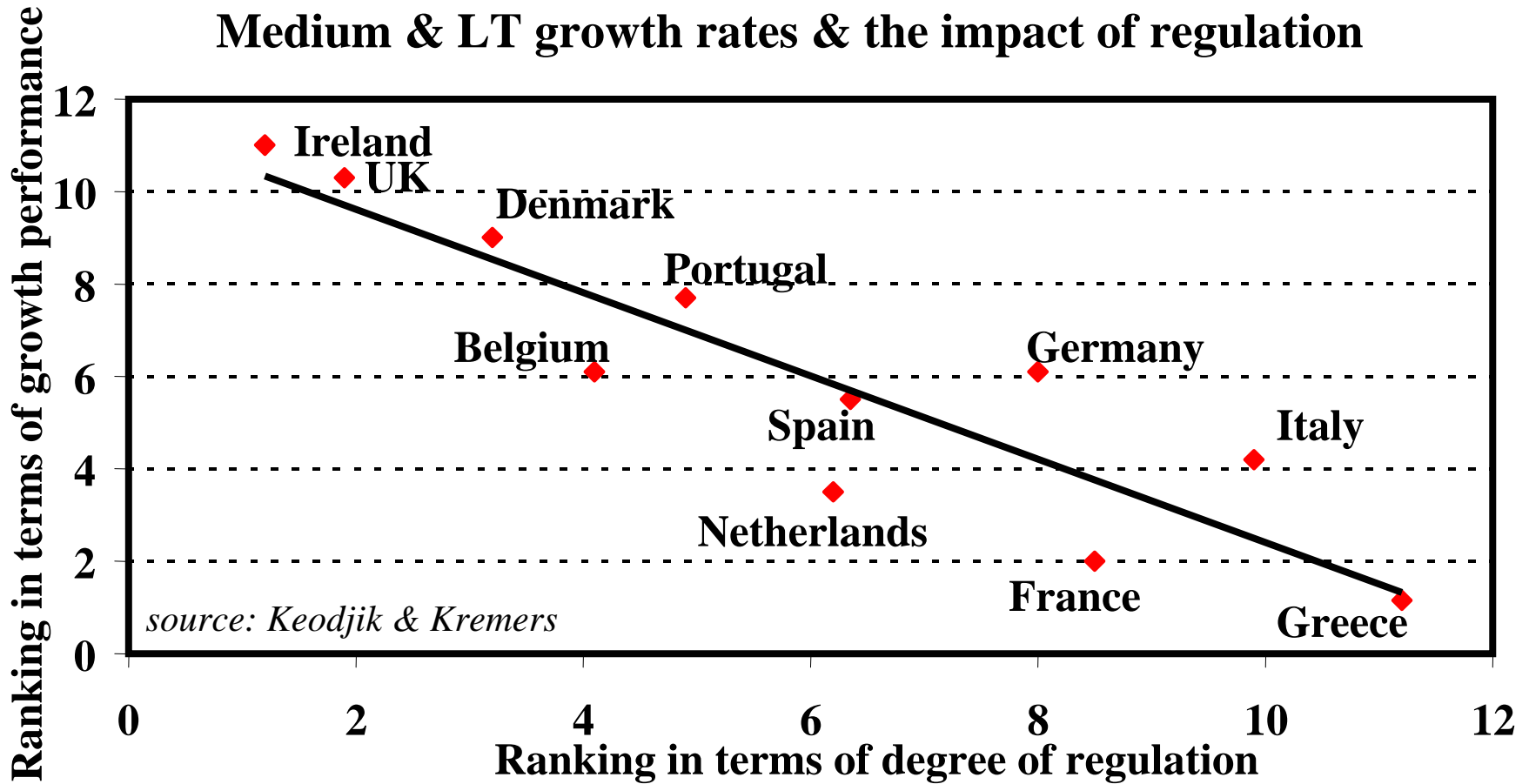
- The effectiveness of labor market reform supposes that the supply and the demand of labor as well as wage setting (why “making work pay” if there is no incentive to hire?) are simultaneously addressed.
- The implementation of reforms is difficult: these are mostly supply side reforms, their positive impact materialize in the medium/long term, their cost appear rapidly and fall on well identified groups
- Higher competition on the markets and between regulations should put pressure in favour of reform.

- A higher rate of potential growth give more flexibility to monetary policy
- Reforms are decided at country level, monetary policy is conducted at EMU level
- In order for a country to implement reform, it must be convinced that it will be “rewarded” by an easier monetary policy... but that can only take place if the “the others” also implement reforms, hence the incentive is weak.
- All governments share the same view and deliver the same messages... but the implementation of the Lisbon agenda... goes at a tortoise speed.

Multifactor productivity change and reform implementation



Medium & LT growth rates & the impact of regulation



List of charts and tables

- 1 : Real GDP/capita of the main countries
- 2 : Potential growth of the main countries
- 3 : Sources of GDP/capita differences against the USA
- 4 : Labor productivity per capita, per hour/country
- 5 : Hours worked/country
- 6 : IT contribution to productivity growth
- 7 : US labor productivity
- 8 : Euro zone's labor productivity
- 9 : Euro zone/USA, real GDP growth and inflation
- 10 : Euro zone, labor cost and productivity, GDP deflator
- 11 : Euro zone/USA, structural and observed unemployment
- 12 : Unemployment rate/country
- 13 : Participation rate/country
- 14 : Men participation rate/country
- 15 : Participation and unemployment rates of the Euro zone
- 16 : Government spending targeted at labor market and unemployment
- 17 : Incidence of long duration unemployment
- 18 : German unemployment rates
- 19 : Germany, East versus West
- 20 : Euro zone/USA, Beveridge curve

- 21 : Euro zone/USA, Phillips curve
- 22 : Regulation on the goods market and job protection
- 25 : Multifactor productivity and product market regulation
- 26 : Multifactor productivity and administrative regulation
- 27 : Part-time and temporary jobs
- 28 : Job protection and time spent with the present job
- 29 : Job protection and flows in unemployment
- 30 : Job protection and unemployment duration
- 31 : Job protection and employment rate
- 32 : Regulation on the goods market and employment rate
- 33 : Minimum wage as % of median wage
- 34 : France, wage cost and net wage at minimum wage level
- 35 : France, non subsidized full time employment by income
- 36 : Compensation distribution
- Table 1 : Negotiations conditions
- 37 : Replacement rate / country
- 38 : Tax wedge
- 39 : Implicite tax on labor
- 40 : Potential impact of pension reforms on the activity ratio
- 41 : Multifactor productivity and reform implementation
- 42 : Medium & LT growth rates and the impact of regulation

ECONOMIC RESEARCH DEPARTMENT

Philippe d'ARVISENET Chief Economist	33 1.43.16.95.58	philippe.darvisenet@bnpparibas.com
<u>OECD COUNTRIES</u>		
Philippe d'ARVISENET		
Eric VERGNAUD Structural issues, forecasts	33 1.42.98.49.80	eric.vergnaud@bnpparibas.com
Caroline NEWHOUSE-COHEN Country economics	33 1.43.16.95.50	caroline.newhouse-cohen@bnpparibas.com
UNITED STATES, CANADA Alexandra ESTIOT	33 1.43.16.95.52	alexandra.estiot@bnpparibas.com
JAPAN, AUSTRALIA, NEW ZEALAND Caroline NEWHOUSE-COHEN	33 1.43.16.95.50	caroline.newhouse-cohen@bnpparibas.com
EURO ZONE, PUBLIC FINANCES Florence BARJOU	33 1.42.98.27.62	florence.barjou@bnpparibas.com
FRANCE, EURO ZONE LABOUR MARKET Jean-Marc LUCAS	33 1.43.16.95.53	jean-marc.lucas@bnpparibas.com
GERMANY, AUSTRIA, SWITZERLAND, EU ENLARGEMENT Jean-Loïc GUIEZE	33 1.42.98.43.86	jeanloic.guieze@bnpparibas.com
SOUTHERN EUROPE, SINGLE EUROPEAN FINANCIAL MARKET Marie-Laure MICHAUD	33 1.42.98.44.24	marie-laure.michaud@bnpparibas.com
UNITED KINGDOM, NORDIC COUNTRIES, BENELUX, PENSIONS, LONG TERM FORECASTS Raymond VAN DER PUTTEN	33 1.42.98.53.99	raymond.vanderputten@bnpparibas.com

BANKING ECONOMICS
Van NGUYEN THE
Head

33 1.43.16.95.54

van.nguyenthe@bnpparibas.com

Laurent QUIGNON

33 1.42.98.56.54

laurent.quignon@bnpparibas.com
COUNTRY RISK
Guy LONGUEVILLE
Head

33 1.43.16.95.40

guy.longueville@bnpparibas.com
ASIA

Delphine CAVALIER

33 1.43.16.95.41

delphine.cavalier@bnpparibas.com

Nhu-Nguyen NGO

33 1.43.16.95.44

nhu-nguyen.ngo@bnpparibas.com
LATIN AMERICA

Bérénice PICCIOTTO

33 1.42.98.74.26

berenice.picciotto@bnpparibas.com

Christine PELTIER

33.1.42.98.26.77

christine.peltier@bnpparibas.com
AFRICA

Adama KONATE

33 1.42.98.02.04

adama.konate@bnpparibas.com

Emmanuelle VULLIEZ

33 1.42.98.56.27

emmanuelle.vulliez@bnpparibas.com
EASTERN EUROPE – CAPITAL FLOWS TO EMERGING MARKETS

François FAURE

33 1.42.98.79.82

francois.faure@bnpparibas.com
RUSSIA, FORMER SOVIET REPUBLICS

Tatiana ESANU

33 1.42.98.48.45

tatiana.esanu@bnpparibas.com
MIDDLE EAST – SCORING

Pascal DEVAUX

33 1.43.16.95.51

pascal.devaux@bnpparibas.com

Our internet site – economic-research.bnpparibas.com

Our publications

economic-research.bnpparibas.com

- **CONJUNCTURE** focuses each month both on the main economic issues and structural problems.
- **ECONOMIC MARKET MONITOR** provides a detailed follow-up of the economic situation whilst analysing interest and exchange rate developments in OECD countries (8 issues per year).
- **PUBLIC FINANCES IN THE EURO ZONE** is issued quarterly.
- **ECOFASH** comments and analyses the main economic events (data releases, economic policy decisions) in the hours following their release.
- **ECOWEEK** focuses on specific and current economic issues (every Monday).

To receive our publications, please contact :
Francine BATHREAU ☎ 33-1-43-16-95-48
francine.bathreau@bnpparibas.com

BNP Paribas is incorporated in France with Limited Liability. Registered Office 16 boulevard des Italiens, 75009 Paris.
BNP Paribas is regulated by the FSA for the conduct of its designated investment business in the UK and is a member of the London Stock Exchange.
BNP Paribas London Branch is registered in England and Wales under No. FC13447. Registered Office: 10 Harewood Avenue, London NW1 6AA
Tel: +44 (0)20 7595 2000 Fax: +44 (0)20 7595 2555 www.bnpparibas.com

The information and opinions contained in this report have been obtained from public sources believed to be reliable, but no representation or warranty, express or implied, is made that such information is accurate or complete and it should not be relied upon as such. This report does not constitute a prospectus or other offering document or an offer or solicitation to buy any securities or other investment. Information and opinions contained in the report are published for the assistance of recipients, but are not to be relied upon as authoritative or taken in substitution for the exercise of judgement by any recipient, they are subject to change without notice and not intended to provide the sole basis of any evaluation of the instruments discussed herein. Any reference to past performance should not be taken as an indication of future performance. No BNP Paribas Group Company accepts any liability whatsoever for any direct or consequential loss arising from any use of material contained in this report. All estimates and opinions included in this report constitute our judgements as of the date of this report. BNP Paribas and their affiliates ("collectively "BNP Paribas") may make a market in, or may, as principal or agent, buy or sell securities of the issuers mentioned in this report or derivatives thereon. BNP Paribas may have a financial interest in the issuers mentioned in this report, including a long or short position in their securities, and or options, futures or other derivative instruments based thereon. BNP Paribas, including its officers and employees may serve or have served as an officer, director or in an advisory capacity for any issuer mentioned in this report. BNP Paribas may, from time to time, solicit, perform or have performed investment banking, underwriting or other services (including acting as adviser, manager, underwriter or lender) within the last 12 months for any issuer referred to in this report. BNP Paribas, may to the extent permitted by law, have acted upon or used the information contained herein, or the research or analysis on which it was based, before its publication. BNP Paribas may receive or intend to seek compensation for investment banking services in the next three months from an issuer mentioned in this report. Any issuer mentioned in this report may have been provided with sections of this report prior to its publication in order to verify its factual accuracy.

This report was produced by a BNP Paribas Group Company. This report is for the use of intended recipients and may not be reproduced (in whole or in part) or delivered or transmitted to any other person without the prior written consent of BNP Paribas. By accepting this document you agree to be bound by the foregoing limitations.

Analyst Certification

Each analyst responsible for the preparation of this report certifies that (i) all views expressed in this report accurately reflect the analyst's personal views about any and all of the issuers and securities named in this report, and (ii) no part of the analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed herein.

United States: This report is being distributed to US persons by BNP Paribas Securities Corp., or by a subsidiary or affiliate of BNP Paribas that is not registered as a US broker-dealer, to US major institutional investors only. BNP Paribas Securities Corp., a subsidiary of BNP Paribas, is a broker-dealer registered with the Securities and Exchange Commission and is a member of the National Association of Securities Dealers, Inc. BNP Paribas Securities Corp. accepts responsibility for the content of a report prepared by another non-US affiliate only when distributed to US persons by BNP Paribas Securities Corp.

United Kingdom: This report has been approved for publication in the United Kingdom by BNP Paribas London Branch, a branch of BNP Paribas whose head office is in Paris, France. BNP Paribas London Branch is regulated by the Financial Services Authority ("FSA") for the conduct of its designated investment business in the United Kingdom and is a member of the London Stock Exchange. This report is prepared for professional investors and is not intended for Private Customers in the United Kingdom as defined in FSA rules and should not be passed on to any such persons.

Japan: This report is being distributed to Japanese based firms by BNP Paribas Securities (Japan) Limited, Tokyo Branch, or by a subsidiary or affiliate of BNP Paribas not registered as a securities firm in Japan, to certain financial institutions permitted by regulation. BNP Paribas Securities (Japan) Limited, Tokyo Branch, a subsidiary of BNP Paribas, is a securities firm registered according to the Securities & Exchange Law of Japan and a member of the Japan Securities Dealers Association. BNP Paribas Securities (Japan) Limited, Tokyo Branch accepts responsibility for the content of a report prepared by another non-Japan affiliate only when distributed to Japanese based firms by BNP Paribas Securities (Japan) Limited, Tokyo Branch.

Hong Kong: This report is being distributed in Hong Kong by BNP Paribas Hong Kong Branch, a branch of BNP Paribas whose head office is in Paris, France. BNP Paribas Hong Kong Branch is regulated as a Licensed Bank by the Hong Kong Monetary Authority and is deemed as a Registered Institution by the Securities and Futures Commission for the conduct of Advising on Securities [Regulated Activity Type 4] under the Securities and Futures Ordinance Transitional Arrangements.

Singapore: This report is being distributed in Singapore by BNP Paribas Singapore Branch, a branch of BNP Paribas whose head office is in Paris, France. BNP Paribas Singapore is a licensed bank regulated by the Monetary Authority of Singapore is exempted from holding the required licenses to conduct regulated activities and provide financial advisory services under the Securities and Futures Act and the Financial Advisors Act.

© BNP Paribas (2004). All rights reserved.