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Euro Area Unemployment:
Prospects for Macroeconomic Policy Action

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Abstract

Recent political and institutional changes in the euro area have led to a polarised debate on the role of co-ordination of monetary and fiscal policies to improve the unemployment situation. This paper assesses of the scope for such co-ordination. The main finding is that monetary policy has a role to play in response to observed structural changes in labour markets. Nevertheless, the most important role is in supporting overall framework conditions for sustained growth, such as price stability.

Key words: unemployment, macroeconomics, policy co-ordination

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1 Conclusions

Unemployment in the euro area remains disturbingly high, and strategies for reducing unemployment could therefore be reviewed. Two points should be kept in mind during such an exercise.

- First, nothing is gained from oversimplifying the problem. The ultimate objective is not merely a reduction in headline unemployment, but rather a sustained and equitable increase in living standards arising from each individual having a real opportunity to contribute to overall economic growth and prosperity, and to benefit from the same.

The mix of required policies will depend on the mix of the unemployed: by age groups, gender, education, length of unemployment, and so on. Trying to solve the problem with short term growth-stimulating policies alone would be counterproductive for two reasons: it does not reach important groups of marginalised workers, and it jeopardises macroeconomic stability over the longer term. To be effective, policy must address the root causes of the problems in a sustained, co-ordinated and comprehensive manner.

- Second, there is considerable path dependency in designing labour market policy, and policymakers today are not starting from a clean slate. A variety of initiatives have been put into place in recent years, as a part of a longer term strategy that is already showing some results¹. To suddenly reverse course or to start fresh would be disruptive and result in a loss of policymaker credibility.

Therefore, any new proposals need to take due account of the strategies that have been followed to date, and the lessons that have been learned across the euro area. All of the euro area countries have actively participated in EU and OECD work in this area, notably the report prepared for the May 1999 Ministerial, “The OECD Jobs Strategy: Assessing Performance and Policies”. This builds on the 1994 two-volume OECD Jobs Study, the OECD Jobs Strategy agreed by Ministers in that same year, as well as the subsequent 1997 report requested by Ministers on “Implementing the Jobs Strategy: Lessons from Member Countries’ Experience”.

A key question that remains unanswered concerns the balance that should be struck between macroeconomic and structural policies. The answer to this depends largely on (i) how much of unemployment we believe to be structural, and estimates for this vary considerably; (ii) the role and current environment of macroeconomic policy; and (iii) the nature, structure and distribution of the labour force in the euro area. The sections that follow present an overview of each of these factors.

In summary, the problem has many dimensions, and a selective reading of the data can yield contradictory policy conclusions. For the Central Bank, adhering to the primary objective of price stability is consistent with a successful employment strategy. Nevertheless, long-term success also requires complementary measures to be taken by governments.

¹ The EU has adopted a set of Employment Guidelines at the end of 1997, and a set of Jobs Strategies have been developed under the OECD umbrella since the early 1990s. Progress so far is cited in follow-up work of the EU and the OECD, such as European Commission (1999a) and OECD (1999a).

2 How much of euro area unemployment is structural?

For analytical purposes, total unemployment is sometimes divided into two parts: cyclical and structural unemployment. Cyclical unemployment refers to such unemployment that appears during cyclical downturns and disappears during upturns. Structural unemployment refers to that part of unemployment which is not cyclical, i.e. by definition it cannot be reduced by macroeconomic policy measures to stimulate demand without causing wage growth and thus inflation to increase².

Structural unemployment is common to every economy, and generally results from mismatches in location and/or skill requirements between workers and jobs. Administrative unemployment statistics will also include some persons who register as unemployed without actually being interested in finding employment. Notably, structural unemployment is not stationary; it can vary considerably from year to year.

In the debate over macroeconomic measures to reduce unemployment, the question of just how much of euro area unemployment is structural is important because macroeconomic policy manipulates aggregate demand. Therefore, if all unemployment is structural, there is no point in trying to alleviate it with macroeconomic policy – the appropriate solution involves microeconomic measures that adjust the structure of taxes and benefits, the regulation of labour and product markets, and so on. This point has been made repeatedly by the ECB.

Attempts at providing a decomposition between cyclical and structural unemployment are always ambiguous, for three reasons. First, there are interactions between the two. Factors that increase structural unemployment will often exacerbate cyclical unemployment, while cyclical unemployment, if it persists, may lead to an increase in structural unemployment.

Second, since structural unemployment itself is a theoretical construct, it cannot be directly measured. Various proxies that have been used³ include the non-accelerating wage rate of unemployment (NAWRU), derived from plotting changes in wage inflation against unemployment⁴; the unemployment rate associated with a “normal” vacancy rate derived from the Beveridge curve which plots vacancies against unemployment; and the full capacity utilisation rate of unemployment, derived from the Okun curve which plots capacity utilisation rates against unemployment.

² See IMF (1999) Box 4.1.

³ See OECD Jobs Study Part 1, 1994, pp 66-68. The OECD finds that for the EU, the estimation procedures resemble a moving average of actual unemployment and differ from each other systematically by up to 2 percentage points.

⁴ A similar but cruder measure which is also popular is the NAIRU, the non-accelerating inflation rate of unemployment. Estimates for this are compiled by both the OECD and the IMF. 1997 figures are listed in IMF (1999). For the Euro area countries, OECD estimates of the NAIRU are virtually identical to NAWRU estimates, with the exception of Finland, for which the OECD and IMF NAIRU estimates were 11.3 and 10.2 per cent, respectively. Bank of Finland calculations put the figure at around 9.5 per cent (Rasi and Viikari 1998).

Third, as a practical matter, there are several co-existing definitions of structural unemployment that are more precise and more tailored to be useful for policymakers and analysts with particular questions or issues in mind. Confusion is avoided by taking care to define carefully what is meant by structural unemployment in a given context. For the purposes of this paper, I will stick with the definition given at the beginning of this section.

Commonly cited estimates for structural unemployment are those provided by the OECD, which are based on OECD Secretariat estimates of the non-accelerating wage rate of unemployment (NAWRU). Recent figures for the euro area are as follows⁵:

Table 1. **Structural unemployment in the euro area countries, 1990–1997¹**

As a per cent of total labour force in the nineties the structural unemployment rate has...			
		1990	1997
... increased:			
	Finland	7,0	12,8
	Germany	6,9	9,6
	Italy	9,7	10,6
	France	9,3	10,2
	Belgium	11,0	11,6
	Austria	4,9	5,4
... remained fairly stable:			
	Spain	19,8	19,9
	Portugal	5,9	5,8
... decreased:			
	Netherlands	7,0	5,5
	Ireland	14,6	11,0

¹ Based on commonly used definitions of unemployment. A change is considered significant (in absolute terms) if it exceeds one standard deviation.

Source: OECD Secretariat

Not only were there large changes in the rates of structural unemployment presented in Table 1, but these changes correlated very highly with changes in actual unemployment rates. For the figures above, the correlation coefficient is 0.9.

Robustness of these calculations has been tested by using competing methodologies for estimating structural unemployment. OECD 1999a (Annex 2, p.5) provides a comparison between estimates for the G7 countries that are generated by two alternative methodologies⁶. A cursory glance at these numbers suggests that the methodologies yield estimates that are within one percentage

⁵ Reproduced from OECD (1998), Table 1. As of April 1999, the OECD Secretariat was in the process of updating estimates of structural unemployment in Member countries.

⁶ Specifically, a Kalman filter applied to the price-inflation Phillips curve and the NAIRU, following the framework used by Gordon (1997), and an extended multivariate filter used by Laxton and Tetlow (1992).

point of each other⁷, and show similar trends over the 1990s. The conclusion to be drawn from this is that nearly all unemployment in the euro area is structural. Therefore, scope for activist cyclical policy in bringing down unemployment is quite low, and focus should be placed on structural measures.

How believable is this conclusion? One of the main arguments for more active macroeconomic policy in Europe to reduce unemployment is that the structural unemployment estimates above are all biased upwards. The reason for this bias is that a combination of technological change, institutional reforms and increasingly competitive conditions on world markets has changed these markets in ways that the estimation procedures are unable to take into account, because all estimation procedures are inherently backward looking.

Evidence for this view is the very low non-inflationary unemployment rate currently experienced in the United States – all estimates of structural unemployment cited above suggest that the United States should be experiencing accelerating inflation. The argument goes that if technology and globalisation are behind a decrease in structural unemployment in the United States, then why should the same factors not apply to Europe?

In the case of Finland, a relatively high level of education has resulted in the widespread and rapid absorption and adoption of productivity-boosting technological innovation. Taking this into account, the structural unemployment rate may be closer to 8 per cent, rather than the OECD-estimated 12.8 percent. This seems plausible, given the lack of any resurgence of inflation at the current unemployment rate of 10.8 per cent. This is also more consistent with internal Bank of Finland estimates (see Rasi and Viikari 1998).

Nonetheless, the limits of this argument are clear. The slow rate at which inflation has declined in Europe does not suggest a high rate of cyclical unemployment. In conclusion, while we must acknowledge the limitations of the estimates of structural unemployment in Europe, there is still credible evidence that structural unemployment is a major part of total unemployment in the euro area⁸.

⁷ There is always an exception. The case of Finland presents analytical difficulties, due to the extraordinary depth of the recession suffered in the early 1990s. For this reason, Rasi and Viikari (1998) found that NAIRU estimations were indeed sensitive to model specification.

⁸ This conclusion is explicitly stated in IMF (1999) and OECD (1999a).

3 Effectiveness of macroeconomic policy tools in reducing unemployment

There are two different circumstances under which European monetary policy may usefully support fiscal and structural initiatives in an overall unemployment-reduction plan. One is in providing favourable framework conditions, the other is in soaking up additional labour market slack which has been created by successful structural reforms. I will deal with each of these in turn.

Macroeconomic policy does not reduce unemployment directly. Rather, it serves to create an environment that is suitable for the creation of jobs and thereby an increase in employment⁹. Key aspects of this environment are, first, price stability, and second, availability of financing for productive activity. Both are necessary to secure and sustain adequate rates of saving and investment. Sustainable growth is generally expected to follow from the establishment of these conditions.

In the Euro area, price stability is now a reality, which by itself stands as a remarkable achievement. The long-term credibility of this accomplishment being sustained can readily and continuously be assessed by observing the level of long-term interest rates. Low rates reflect beliefs both that monetary policy will continue to restrain inflation, and that the trend path of fiscal balances will lead to observance of the Stability and Growth Pact for the foreseeable future. The decline in real interest rates from levels in the early 1990s has improved the scope for financing productive long-term investment for the future growth of the economy.

By virtue of sustaining a positive environment, macroeconomic policy complements structural policies to reduce unemployment in a process that can be characterised as a virtuous cycle. Structural reform which makes labour and product markets more flexible will also shorten economic downturns and speed adjustment to economic shocks.

The EU and the OECD have identified a series of practical considerations for policymakers who would like to actively use macroeconomic policy to close output gaps. Specifically¹⁰,

- The conduct of monetary policy should be governed by considerations of credibility, with concerns about inflation expectations and the likely movement of long-term interest rates. Benefits from monetary expansion are offset if activism leads to reduced confidence and increased long-term rates.
- Scope for fiscal activism is limited by high budget deficits or by high or rising public sector debt levels; in these circumstances fiscal policy is also offset by reduced confidence and increase long-term interest rates.
- The links between fiscal and monetary policies should also be borne in mind. Tighter fiscal policy allows lower interest rates to prevail. In turn, lower interest rates, once justified on monetary policy grounds, can directly and indirectly improve budgetary positions.

⁹ This is a view that has consistently been repeated by the EU, the OECD, the ECB and national central banks.

¹⁰ OECD Jobs Study Part I, 1994, pp. 70–74.

So long as inflation is not an immediate problem, and the constraints above are not relevant or binding, a convincing case could be made for some counter-cyclical policy. This case is stronger the greater the output gap and the more clearly the economy is off course.

Counter-cyclical macroeconomic policy has a poor track record, however. A major reason for past failure has been loss of credibility of the strategy when it has been implemented asymmetrically. In other words, the political pressure for expansion in recession is not matched by pressure for contraction in a boom, resulting in a bias towards deficits and inflation. Other reasons for failure have been unexpected external shocks to the economies¹¹.

On balance, the EU and the OECD seem sceptical of the degree to which unemployment can be brought down to acceptable levels in the Europe via the use of countercyclical macroeconomic policy. A preferred prescription is the one that has been followed¹², i.e. country-specific structural reforms supported by stability-promoting macroeconomic policy. Likewise, IMF (1999, ch. 4) states that "...structural reforms are required to restore reasonable labour market performance in Europe. Attempts to reduce unemployment by more than its cyclical component through demand management policies would risk the resurgence of macroeconomic imbalances (inflation and fiscal deficits) that plagued many advanced economies during the 1970s and 1980s".

These statements have to be qualified by the policy sequencing issue alluded to above. Once structural reforms begin to take root, a much stronger argument can be made for easing monetary policy. It is recognised that well-designed structural reform eventually increases potential output, but the automatic adjustment mechanisms that are supposed to absorb cyclical unemployment do not do so quickly, even in flexible market economies. Benefits of reforms can take considerable time to become fully apparent, which loses political momentum and support. The IMF (1999) believes that there is room for carefully timed accommodative macroeconomic policies that follow major structural reforms with a lag.

In particular, the IMF (1999) calls for ECB alertness to structural developments in the labour market: "...in the present circumstances, if governments succeed in implementing the comprehensive and deep labour market reforms required, failure to accommodate the resulting positive supply shock would risk entailing deflationary pressure. ... This need for an easy monetary policy to accommodate the absorption of labour market slack is consistent with the need to stimulate complementary business investment".

The key question in this regard is one of separating permanent structural changes in the economy from temporary favourable shocks. Policy prescriptions would differ across the two; while monetary policy should accommodate the

¹¹ While there surely some truth to this, the argument is inherently suspect because it is easy to abuse. After the fact, shocks can always be found to explain an increase in unemployment.

¹² OECD (1997) states that "Experience shows that the Jobs Strategy can work if the recommendations are implemented in a coherent and consistent way, coupled with the political will to do so. However, many countries have not yet done so. There are many reasons for this hesitation, but a major one is concern that implementation of ... recommendations ... calling for greater labour and product market flexibility will threaten social cohesion by leading to growing earnings inequality and poverty".

former, an overreaction to the latter would lead to a resurgence of inflationary pressures¹³.

4 Matching structural policy to the structure of the euro area labour force

There is scarcely a country in the world that is completely satisfied with its labour market and social policies. While the time horizon for many policies has to be long, shifts in the structures of both the labour force and the job market can arrive with surprising speed. Policymakers are thus faced with a moving target, long lags between policy implementation and measurable results, and a complicated web of interlocking policies and institutions that reflect history as much as expected future developments. Nonetheless, the issues are such that responsible governments cannot leave them unaddressed.

In redesigning policies to combat unemployment in the euro area, it should be noted that in their details, labour markets are very difficult to compare across countries. Statistics that are administratively gathered by e.g. labour offices will reflect country-specific bureaucratic realities such as labour legislation, definitions of employment/unemployment, etc¹⁴. Likewise, institutional constraints to policy implementation will also differ across countries. Nonetheless, several observations apply to the euro area in general¹⁵.

- First, over the past three decades, average European unemployment has shown an upward trend, ratcheting up with the passing of each economic downturn. It appears that jobs are more readily destroyed during economic downturns than they are created during economic upswings. This problem is explained by asymmetric *hysteresis*, which is a widely accepted theoretical concept that explains why the structural unemployment rate follows the actual unemployment rate. Put simply, shock-induced changes in actual unemployment gradually become permanent. Main mechanisms for asymmetric hysteresis include gradual erosion of skills of the long-term unemployed, as well as the insider-outsider problem whereby collective bargaining by a subset of the employed (=insiders) leads to wages generally

¹³ This observation was made by US Federal Reserve Governor Lawrence B. Meyer, on 14 April 1999.

¹⁴ ECB Board Member Domingo Solans complained on 25 March 1999 that difficulties in comparing national statistics was making it hard to achieve the correct balance of fiscal and monetary policy. Mr. Solans specifically said that some indicators such as labour market statistics needed to be enhanced. "Better labour market statistics are important, not only for the ECB's assessment of possible inflationary pressure, but also to improve understanding of the structure of labour markets in our countries, and the rigidities which impede the achievement of fuller employment." (Reuters, 25 March 1999).

¹⁵ Eurostat has developed a benchmark employment series which merges 6 quarterly labour force surveys, three annual labour force surveys, three national accounts series, one registration data series and one microcensus. Eventually, it is hoped that this monster can be replaced by a well-designed quarterly labour force survey that is run in all Member states.

being set high enough to stabilise employment at downturn levels¹⁶. The rate at which hysteresis occurs has been the subject of much research and debate.

- Second, and related, long-term unemployment is a much more serious issue in Europe than in e.g. the United States, with about half of the unemployed having been without work for over one year and 30 per cent for two or more years. In the United States, fewer than 10 per cent of the unemployed have been out of work for over one year.
- Third, over the past 15 years, employment in the euro area has generally grown more slowly than increases in the size of the labour force. Moreover, a large proportion of the jobs that have been created have been part-time or temporary jobs¹⁷. This is partly reflected in the particularly weak real earnings growth for low-paid workers. The division between public and private sector jobs is also eye-catching; between 1970 and 1998, non-government employment in the euro area grew by less than 5 per cent (as compared to 70 per cent in the United States)(IMF 1999).
- Fourth, education has become an increasingly important factor in explaining European unemployment, and the trend is continuing. According to EU statistics, between 1992 and 1997, the number of high-skilled jobs grew by more than 2 per cent per year in the EU, whereas the number of manual jobs declined significantly. In terms of the educational background of the EU unemployed, around 47 per cent of both unemployed men and women over 25 had no educational qualifications beyond basic schooling¹⁸.
- Fifth, the growth in working-age population has been slowing for several years, and is expected to continue slowing in the years to come. At the same time, both labour force participation rates and employment of youth have dropped in almost all of the euro area countries, with the exception of the Netherlands¹⁹. As is usually the case with labour market developments, however, this trend is not easy to interpret. Declining youth participation rates may well reflect a growing proportion of young people to pursue more education, and the particular characteristics of that group of young people which does enter the labour force may be weaker than in the past. Alternatively, more unproductive options may have emerged for young persons to avoid entering the labour market, as a result of well-intentioned but unsuccessful labour market policies.

¹⁶ IMF (1999, ch. 4) states: "In euro area countries there is often a large difference between the number of workers represented by the unions carrying out the wage negotiations and the number of workers to which the negotiated results apply. The obvious danger of such a framework is that the interests of both employers and employees who are not involved in the bargaining process are not taken sufficiently into account. ...This seems indeed to entail high rates of unemployment in countries like France and Spain...".

¹⁷ European Commission (1999a) claims that in 1997, for the fifth time in six years, there was a decline in the number of full-time jobs, and part-time jobs accounted for all the net jobs created. 62 per cent of the net new jobs created were held by women, a slight decline from previous years.

¹⁸ See European Union 1999a, p. 2.

¹⁹ See OECD Employment Outlook 1996, p. 111.

- Sixth, concerns about growing job insecurity have increased sharply and become widespread²⁰. This is in spite of the fact that jobs overall seem as stable in the 1990s as they were in the 1980s, with the exception of blue-collar and less educated workers. The paradox is explained by pointing out that the consequences of separation have grown more severe, including the ease of finding a new job, the characteristics of the new job and the experience of being jobless. Insecurity is “lower in countries where the unemployment benefit replacement rate is higher, there is a high level of collective bargaining coverage and collective bargaining is more centralised” (p. 150).

Considerable work has recently gone into analysing which policies have worked well, with particular emphasis on the success stories of Ireland and the Netherlands (European Commission 1999a, OECD 1999a, IMF 1999). This work is valuable in establishing a consensus on best practices. Nevertheless, labour market measures that have been effective in some countries may be quite dependent on complementary policies in other areas, as well as cultural factors and expectations of the population generated by policies in past years. Institutional differences across countries also matter. Experience has shown that regardless of their importance, any changes in institutions is a very long and drawn-out process.

Moreover, there is an issue of robustness of institutions to handle unemployment levels that suddenly rise sharply, as was the case in Finland in the 1990s. It is now clear that the institutional difficulties in administering key elements of labour market policy, such as the requirement that those registering for unemployment benefits are in fact actively looking for work, increase exponentially as unemployment rises above the 5-7 per cent range. Thus, a generous policy that may have been very effective in the past can suddenly develop into a serious liability once unemployment exceeds a critical threshold.

²⁰ This issue was surveyed and analysed in OECD Employment Outlook 1997, Chapter 5.

5 Organising a strategy to reduce unemployment

From the above, it is clear that labour force issues have a great many dimensions. There is a consensus among labour economists and major policymaking bodies that in order to be effective, a strategy must involve a multitude of co-ordinated measures that are implemented for a sustained period of time²¹. There is no shortage of recommendations for components of this strategy. Moreover, there is basic agreement on the broad measures to be taken, which are succinctly expressed in the OECD Jobs Strategy (1994):

- Set macroeconomic policy such that it will both encourage growth and, in conjunction with good structural policies, make it sustainable, i.e. non-inflationary.
- Enhance the creation and diffusion of technological know-how by improving frameworks for its development.
- Increase flexibility of working-time (both short-term and lifetime) voluntarily sought by workers and employers.
- Nurture an entrepreneurial climate by eliminating impediments to, and restrictions on, the creation and expansion of enterprises.
- Make wage and labour costs more flexible by removing restrictions that prevent wages from reflecting local conditions and individual skill levels, in particular of younger workers.
- Reform employment security provisions that inhibit the expansion of employment in the private sector.
- Strengthen the emphasis on active labour market policies and reinforce their effectiveness.
- Improve labour force skills and competences through wide-ranging changes in education and training systems.
- Reform unemployment and related benefit systems -- and their interactions with the tax system -- such that societies' fundamental equity goals are achieved in ways that impinge far less on the efficient functioning of the labour markets.
- Enhance product market competition so as to reduce monopolistic tendencies and weaken insider-outsider mechanisms while also contributing to a more innovative and dynamic economy.

Another objective is the promotion of equal opportunities for women and men, as expressed in the EU Employment Guidelines (EU 1999a) as one of four pillars (along with improving employability, encouraging entrepreneurship and increasing adaptability). Under these four pillars are listed 22 measures.

Effective labour market policy must take into account the country-specific institutional framework, which both administrates policy and provides a variety of incentives and disincentives both with regard to job-seeking behaviour of the unemployed and job creation. Given national differences in tax and public transfer policies, education systems, institutions to support small and medium sized enterprise development, etc., it is important that flexibility is retained within the

²¹ See e.g. Coe and Snower 1997, OECD 1994 and 1999a and b, European Commission 1999a and b.

euro area co-ordination framework for countries to meaningfully pursue policies that are tailor-made for domestic and regional circumstances.

At the same time, effective labour market adjustment in the euro area, in response to various shocks, will require intergovernmental co-ordination on promotion of labour mobility. Such issues range from housing markets to recognition of educational qualifications to unemployment insurance coverage to pension entitlements to public sector employment access.

In retrospect, the difficulties with showing progress are even greater than many had expected, and there is some disappointment in progress made so far at national levels (see OECD 1999a and b). The 1997 Amsterdam Treaty, declaring that EU Member States shall treat employment as a matter of common concern, and shall co-ordinate their actions, also remains unratified.

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