Editors' introduction

Four of the papers in this issue were presented at the 34th *Economic Policy* Panel meeting held in Brussels on 19–20 October 2001, and two were presented at the previous Panel meeting in Stockholm on 6–7 April 2001.

After several years of favourable macroeconomic conditions, anxiety about the ability of industrialized economies to create and sustain employment has become much more widespread in recent months. We open this issue with two papers that provide striking evidence about the conditions and the policies that favour employment creation. What works and what doesn't? The answers are surprising and disturbing: some popular and long-established policies are ineffective, and may even prove counter-productive.

PUBLIC EMPLOYMENT: DOES IT INCREASE UNEMPLOYMENT?

The question may sound strange, because since at least the Great Depression public employment programmes have been advocated as remedies for poor labour market performance. However, studying aggregate labour market performance from an equilibrium perspective casts doubt on this conclusion. Yann Algan, Pierre Cahuc, and André Zylberberg show that public job creation can not only reduce private employment, through intuitive crowding-out effects, but can also further increase unemployment by drawing additional workers into the labour market. The overall impact on unemployment depends on circumstances that are illuminated by the paper's careful and original discussion of the various channels through which public employment works, and the importance of which is sensitive to features of product as well as labour markets. Theory also offers shrewd insights into how to disentangle empirically the complicated web of interactions between public employment and labour market performance. The paper brings those insights to bear on available data, and offers a striking empirical answer to the question of interest: regardless of

estimation techniques, public employment never appears to reduce unemployment or increase private employment (both theoretically possible outcomes) in OECD countries. Quite the contrary: private job creation is more than fully offset by private job destruction in the authors' estimates, and plays an important role (alongside more standard variables representing labour market institutions, and depending on other features in ways consistent with theory) in explaining labour market performance heterogeneity across industrialized countries. We think this paper's theoretical and empirical results will need to be taken into account in future studies of labour market performance, and we share the authors' puzzlement in finding that the relevant channels of interactions have so far been largely neglected in the literature. Like the discussants and the Panel, we are not yet fully convinced by the empirical results, and explanations of unemployment remain only marginally less elusive after reading this paper. However, it appears impossible to extract better information from existing data. And it is certainly very impressive to find those imperfect data in broad agreement with economically sensible, but complex and often elusive interaction mechanisms.

EMPLOYMENT GROWTH: ACCOUNTING FOR THE FACTS

So what are the other factors that influence aggregate employment creation? The paper by Pietro Garibaldi and Paolo Mauro offers a fascinating collection of facts and interpretations. It systematically analyses the wildly heterogeneous employment-creation performance of industrialized countries. In doing so, it finds clear negative evidence as to the relevance of some previously proposed explanations: the sectoral composition of employment is of minor importance, as is the incidence of part-time and temporary job creation, which is largely offset by reductions in regular full-time contracts. The paper is perhaps less convincing, but certainly more interesting, where it argues that labour market institutions play a crucial role in determining employment growth (which the authors choose, in light of recent EU policy objectives, as the performance indicator of interest). Evidence is provided not only that in the long run countries with low employment protection and otherwise 'flexible' labour markets are able to create more jobs, but also that the European countries whose employment growth has recently accelerated are the same that implemented labour market reforms in the mid-1990s. The paper's empirical exercises are admirably clear and exhaustively documented, and easily allow readers to compare the results with their own prior expectations. We, and the Panel, believe the paper's wide-ranging and well organized evidence will require a re-evaluation of some of the conventional wisdom on the causes of employment growth. Whether the resurgence of European employment growth in the 1990s was a (reform-based) structural or cyclical feature may not become clear for some time, but in the meantime the paper's state-of-the-art information will be highly valuable to researchers, and policy makers faced with urgent reform choices.

Much of the literature on employment and unemployment policy has looked at the influence of national institutional and other factors, but the next paper provides striking evidence that regional factors may have an important, and hitherto neglected role in the generation of unemployment.

REGIONAL UNEMPLOYMENT CLUSTERS

Unemployment and regional inequalities are two of the most persistent challenges facing European policymakers. Many studies have looked at these issues separately; but the paper by Henry Overman and Diego Puga takes a novel look at the connection between these two problems. They find that regional unemployment clusters do not respect national boundaries. More specifically, the authors show that unemployment rates in Europe's regions have become polarized since the mid 1980s. As a result, nearby regions have tended to share similar outcomes regardless of whether the regions were in the same nation. While not denying standard explanations of unemployment (which tend to emphasise national labour market features), the authors find that near-ness also matters.

In explaining this fact, the authors assert that European economic integration can produce changes in the economic fortunes of clusters of regions where the clusters do not necessarily respect national boundaries. This spatial reallocation of economic activity, combined with low labour mobility and wage rigidity can account for the near-ness effect. Of course, a very natural counter argument is that the unemployment clustering reflects straightforward clustering of regions that tend to specialise in hard-hit sectors, like agriculture, coal and steel. Yet in their empirical work, the authors show a significant neighbour effect remains even after controlling for the fact that the regions that suffered the most also tended to start out with a low-skilled labour force and a concentration of badly performing industries.

Why should one care about regional unemployment clusters? First, the findings reinforce the impression that tackling Europe's unemployment problem requires more than a focus on *national* labour market problems. Cross-regional policies to fight unemployment clusters should encourage regional wage setting and short-distance mobility within and between regions. And the findings suggest that trans-national considerations might usefully be included in EU regional policy. The argument for EU-wide coordination rests on the standard policy spill over argument; neighbour effects imply that anti-unemployment policies paid for by one region will benefit neighbouring regions. Because local politicians gain no votes or tax revenues from these 'spillovers', they are likely to underestimate the true benefit of the policy and thus tend to undertake too little of it. EU coordination, perhaps via Structural Fund spending, could help alleviate this. Indeed, we have commissioned a future paper on the effects of Structural Fund expenditure that will help such conjectures to be given a more informed basis.

The next two papers address highly topical issues surrounding the introduction of the euro.

EURO'S FOREX ROLE

While euro cash came into circulation only this year, the euro as a financial currency has been in existence since 1 January 1999. What impact has the euro had on the world's foreign exchange market? Harald Hau, William Killeen and Michael Moore take a first look at the role of the euro in the foreign exchange (forex) market, comparing this to the role of the German mark prior to 1999. Their data indicate that the euro lost ground against the US dollar in forex spot trading and in some dimensions does not even match the international transaction role of the German mark. They also find that the standard measure of the transaction costs in the forex market, the bid-ask spread, was higher for the euro than for the German mark in their two data sets, and that the corresponding spreads for dollar trades actually decreased or did not increase as much. These empirical findings are somewhat puzzling. It was widely expected that transaction costs for euro trading would fall due to the scale economies stemming from the combined trading volumes of the legacy currencies. The authors consider and reject a number of possible explanations such as the impact of consolidation in the banking sector and electronic trading (these affected both euro and non-euro transaction costs, so they don't help account for differences in euro and dollar spreads). What they propose instead is the 'market transparency hypothesis'. Trading in the forex market is huge, over a trillion dollars a day, and much of this is professional traders selling to each other. All this 'hot potato' trading allows traders to pool the risk from sudden exchange rate changes. Because bid-ask spreads are the reward to traders, the usual risk-versus-reward logic implies that lower risk means narrower spreads. The authors argue that by eliminating various trading possibilities (e.g., German mark to the dollar, French franc to the dollar and all the cross trades among the euro's legacy currencies), the euro reduced opportunities for risk pooling since it made the overall exposure of individual traders in particular currencies harder to hide from the market. The resulting increase in the risk faced by individual traders (which is distinct from overall fluctuations in the value of the currency as a whole) forced traders to widen spreads.

The paper was subject to a vigorous debate at the Panel. The comments by Patrick Honohan and Julian Franks question the reliability of the paper's evidence and explanations, and the comment of Richard Portes asserts that the paper is 'just wrong'. In our view, the authors' evidence and explanation are intriguing, if not yet fully convincing. The authors' data go only up to the end of 1999, and concern a rather rarefied dimension of reality, namely the size of spreads in the wholesale currency market. Nevertheless, whatever the definition of such spreads (another matter on which authors and discussants had a vigorous interchange at the panel), they do change just at the right time to support a euro-based interpretation, and the real-life

relevance of those apparently small changes is consistent with the huge volume of inter-dealer transactions, for hedging as well as trade purposes. As usual in equilibrium models, especially those where information plays a crucial role, trade does not need to be large to have important implications on prices. Disappearance of the mere possibility of 'hiding' in cross-trades could indeed rationalize synchronized patterns of change such as those documented by the paper. The hypothesis is scientifically intriguing, if hard to falsify, and some readers may find it (like the facts it aims to explain) a little too far removed from day-to-day experience to catch lasting attention. Nevertheless, it is topical, interesting and may turn out to be correct. We hope future work on this subject will clarify the developments with which it deals. Indeed, we have commissioned further such work for *Economic Policy*, and hope our readers will enjoy in the next issue a session featuring additional facts and further theoretical probes by leading researchers in the field.

CHALLENGES TO CURRENCY

Long lines at cashiers, mistaken calculations and shortages of coins and small denomination bills plagued the launch of euro cash along with more serious problems such as counterfeiting and armed robbery of cash shipments. No wonder that one retail store in Germany offered its customers a 20% discount if they paid with credit cards rather than cash. All this raises the question: 'Why do we still use cash in this age of plastic card payments?'

Mathias Drehmann, Charles Goodhart and Malte Krueger examine this topical issue in their paper on e-money. Their empirical work suggests that modern payment technologies – credit and debit cards, phone cards and more ambitious e-money schemes – have little impact on currency usage. Cash is still king for two main reasons. First, for small to medium size transactions the cost (to retailers and consumers) of paying with cash is still small compared to the cost of even the most advanced e-payment schemes. Second, a very large fraction of the total outstanding cash – about 50% in the US, Germany, and France – is in the form of high-denomination bills, which seem to be held for hoarding purposes and 'bad behaviour' motives (crime, and black and grey market activities). While it is conceivable that technological advances may eventually make retail e-money more attractive for retail payments, the authors argue that the sorts of e-money that governments allow will never be anonymous enough to attract the users of big notes.

The main policy implications are twofold. First, fears that central banks' influence will be undercut as e-money privatizes money creation are misplaced; physical banknotes will remain popular. Second, if cash is mainly subsidizing bad behaviour, governments might consider encouraging e-money as a means of controlling bad behaviour. Singapore, for instance, is planning to make electronic money legal tender by the year 2008, in part as a means of increasing government surveillance of commercial activities. After discussing the sorts of policies that would be necessary to do

this, the authors argue against such moves: 'We agree that governments should not wilfully encourage "bad behaviour", and hence . . . the issue of "large value" notes is undesirable. But any attempt to force a complete shift to electronic transfer, and to try to ban, or to prevent, the domestic use of cash would in our view be appallingly illiberal.'

EUROPEAN VENTURE CAPITAL

The US economy in the 1990s enjoyed astonishing output and employment growth. Observers across the world were struck by the fact that the US economy seemed to be especially good at creating new, fast-growing, high technology firms; and a key element in this success seemed to be financing by venture capitalists. Academic research has confirmed the importance of venture capital, but to date, most of the research has been done on the US venture capital industry and the firms they have backed. Laura Bottazzi and Marco Da Rin provide a first look at European venture capital that goes beyond simple aggregate statistics. They collected data directly from the listing prospectuses and annual reports of companies listed on Europe's new stock markets – the Neuer Markt, Nouveau Marché, etc. Only some of these companies were venture-backed, so the authors are able to compare the performance of venture-backed and non-venture-backed companies. What they find challenges the received wisdom – European venture capital does not seem to have the marvellous effects that its US counterpart does. Indeed they find that venture backing of the firms in their sample have only a limited effect on those firms' ability to raise funds, grow, and create jobs.

Being the first paper of its kind to offer results for Europe, the Bottazzi–Da Rin analysis is both highly stimulating and less than conclusive. Indeed, the surest policy conclusion from the paper is that Europe needs more research on the role of venture financing in the European economy. As the discussants and panellists pointed out, the authors were only looking at 'winners' since they only collected data on firms that were actually listed on one of the new stock markets. To measure the full effect of venture capitalists, one would have to examine the performance of all sort of firms – not just those that made it to stock market. For instance, it might be the European superstar start-ups have no need of venture backing and so refuse venture capitalists involvement, but many mediocre firms accept the backing knowing that it will make them good enough to get listed. In this hypothetical case, venture backing would not be systematically associated with high performance among firms listed on the new markets. However, among the crowd of mediocre want-to-be start-ups, venture backing might well be absolutely essential. Finding data on a wider range of firms is a daunting task, and the Bottazzi–Da Rin analysis has certainly raised the standard of research in this field, but until a more complete data are found, one cannot be sure exactly what effects European venture capital is having.