

# “European Labour Markets in Open Economy: Between Proteus and Cyclops”

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In Greek mythology, Proteus is an early sea-god, embodying flexibility, adaptability and versatility. Yet, another Greek mythological figure, Cyclops, is a stubborn, abrupt of emotion creature, associated with massive masonry. Recently, Europe’s recipe to get through turbulent times has been to combine flexibility with security. I build a dynamic general equilibrium trade model with the frictions and duality of the labour market (the coexistence of “temporary” contracts with low or no firing costs and “permanent” contracts with high firing costs) to explore which Greek figure resembles the European reality better. The model permits the study of the formation, persistence and interdependence of “dual” labour market institutions as well as the interactions between the labour market and international trade. It demonstrates that countries with higher shares of temporary workers tend to be more cost-effective traders with less pronounced changes in labour costs. Moreover, for these countries, trade as a share of GDP is larger, whereas change in trade is smaller in reaction to negative trade shocks. The results also suggest that a more volatile labour market may lead to larger equilibrium income at a potential cost of higher unemployment. At the firm level, an increased labour market’s volatility positively affects total exporters’ value. At the aggregate (country) level, imports get cheaper for given exports (improvement in terms of trade). Most importantly, changes in wages seem to be dampened under dual markets thereby incentivising more firms to engage in trading. Hence, Europe seems to be stuck at a self-reinforcing dual track of labour markets largely propagated through trade linkages. Allowing for heterogeneous dynamics and crosssectional dependencies, empirical results from macro and regional level data tend to support the main findings of this paper.