Oddělení strategií a trendů EU, Úřad vlády ČR

Evropské unie
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Oddělení strategií a trendů

The euro crisis, labour markets and the analytical future of the European integration

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Masaryk University

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Content

1. Euro a critical element of the crisis
2. The consensus narrative of the crisis
3. Consequences for the labour market
4. How to make the euro viable and robust?

The situation before 1999

- Everything was different
  - Different inflation expectations
  - Different perceived interest rates
  - Different wage setting mechanisms
  - Different nominal interest rates
  - Floating exchange rates

What happens when imbalance?

if money stock too high => inflation => real value of money lower

if money stock too high (due to external debt) => devaluation

if inflation too high => nominal interest rates high => real interest rates stable

if wages rise faster than productivity => higher inflation => lower exchange rate

The situation before 1999?

- Some nations got used to higher inflation
  – Their „inflation expectation“ rose
- Inflation expectations influences real perceived interest rates
  – But in borrowing there is nothing but perceived real interest rates
- Some nations had perceived the same nominal interest rates differently

With the euro, everything is different

With the euro, everything is different

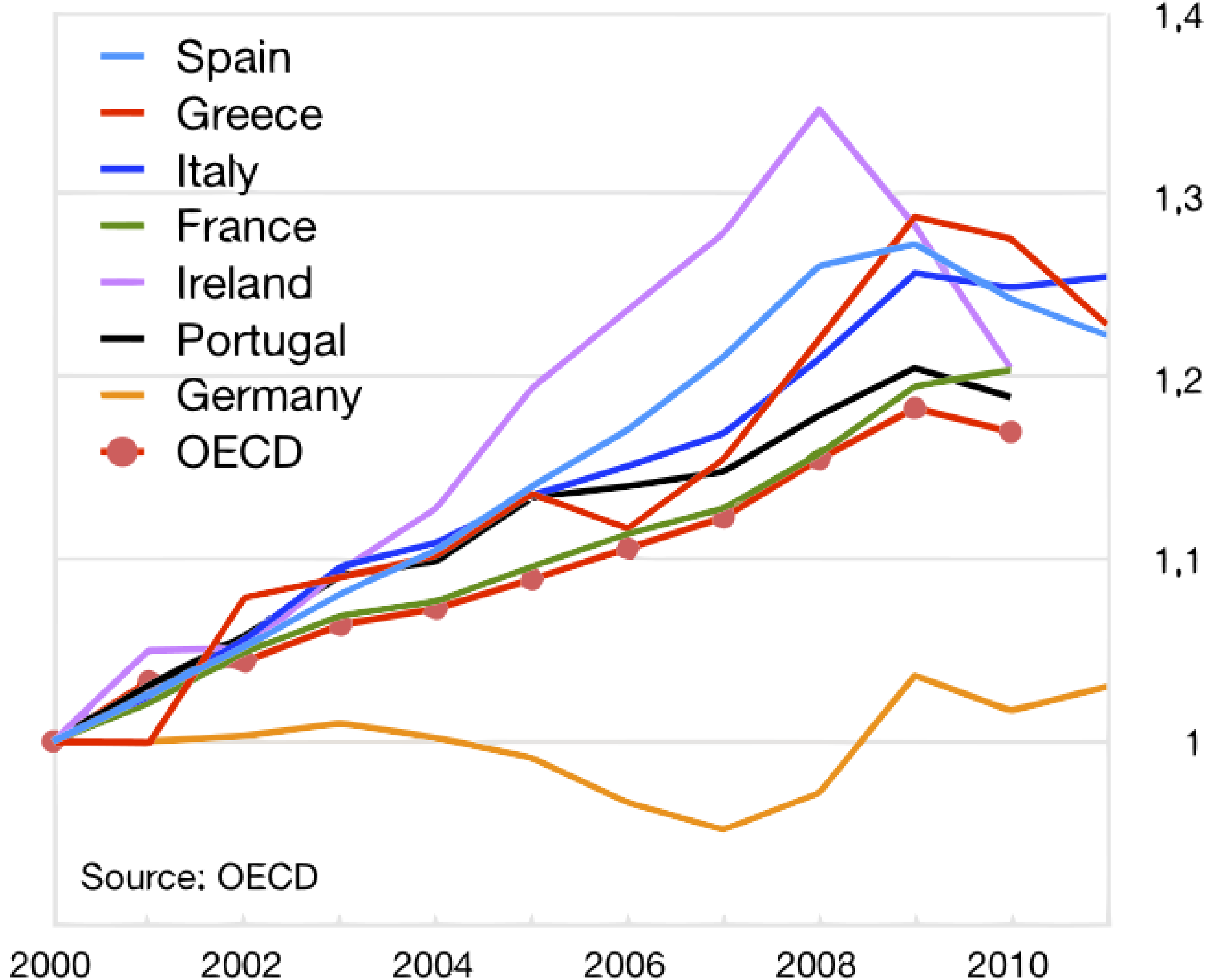
Because some things are the same...

The situation after 1999

- Everything was different, but...
  - Different inflation expectations
  - Different perceived interest rates
  - Different wage setting mechanisms
  - **Same nominal interest rates**
  - **No exchange rates**

Explanation 1: Wages

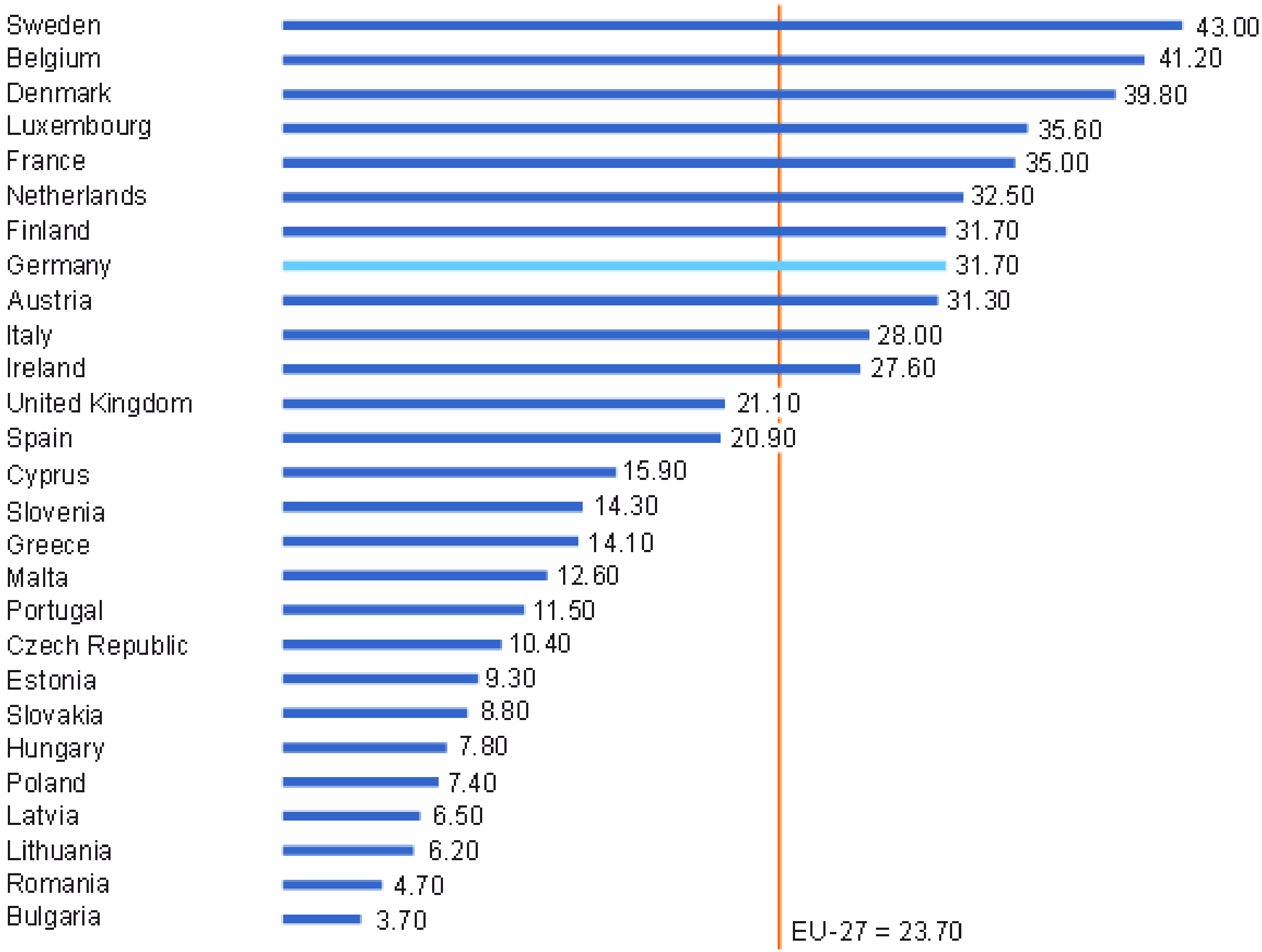
Change in unit labour costs since 2000



Wages and public debt as a motor of the crisis?

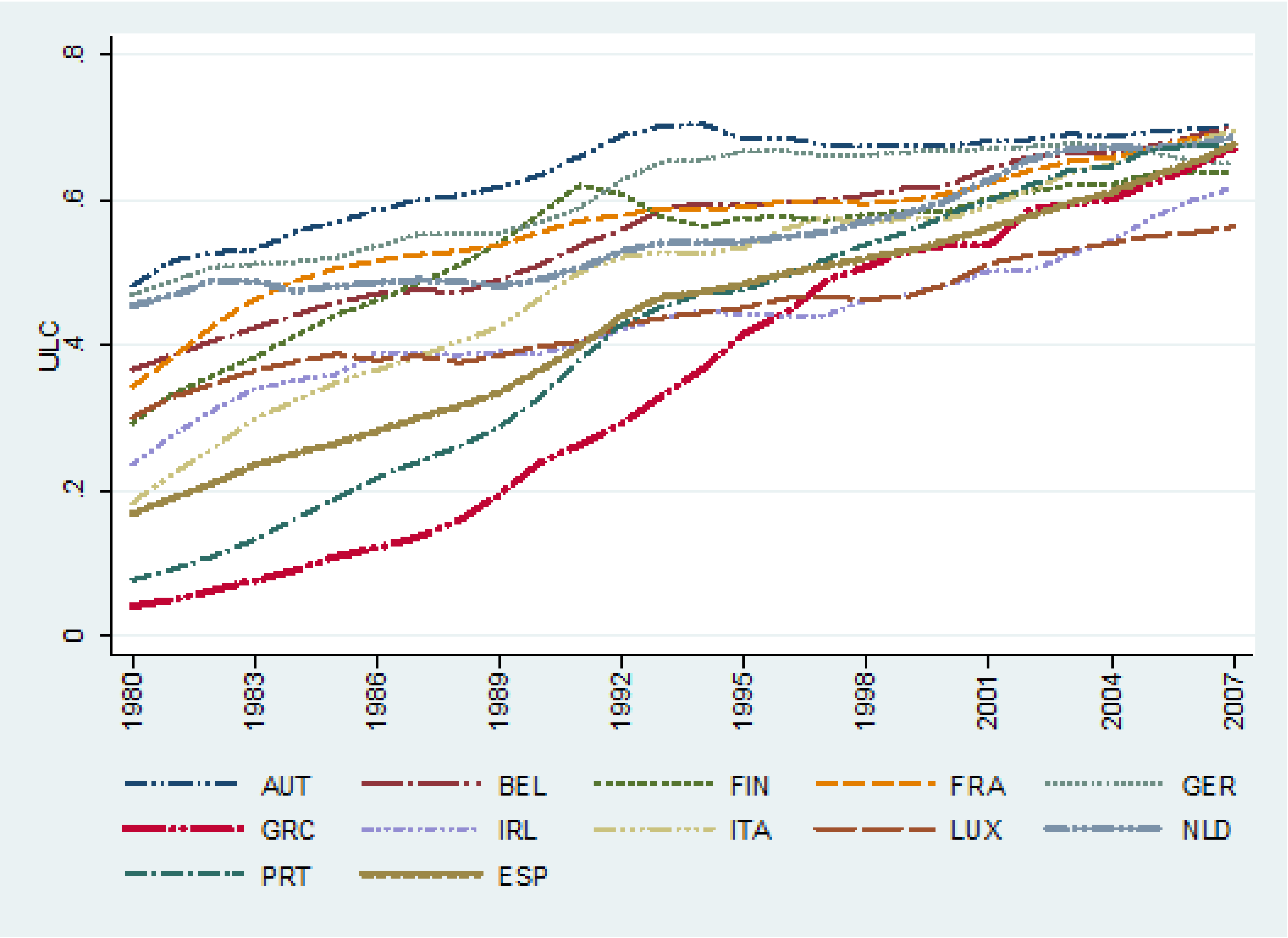
- South was used to higher inflation
- Therefore (or because?) wages rise more quickly
  - Faster than productivity
- The price competitiveness decreases
- Imports rise faster than exports
- Trade deficit is created
- People/companies/government borrow to finance this

But what about those nominal numbers?



Source: Own computations on the basis of Eurostat data.

Wage rise


ULC
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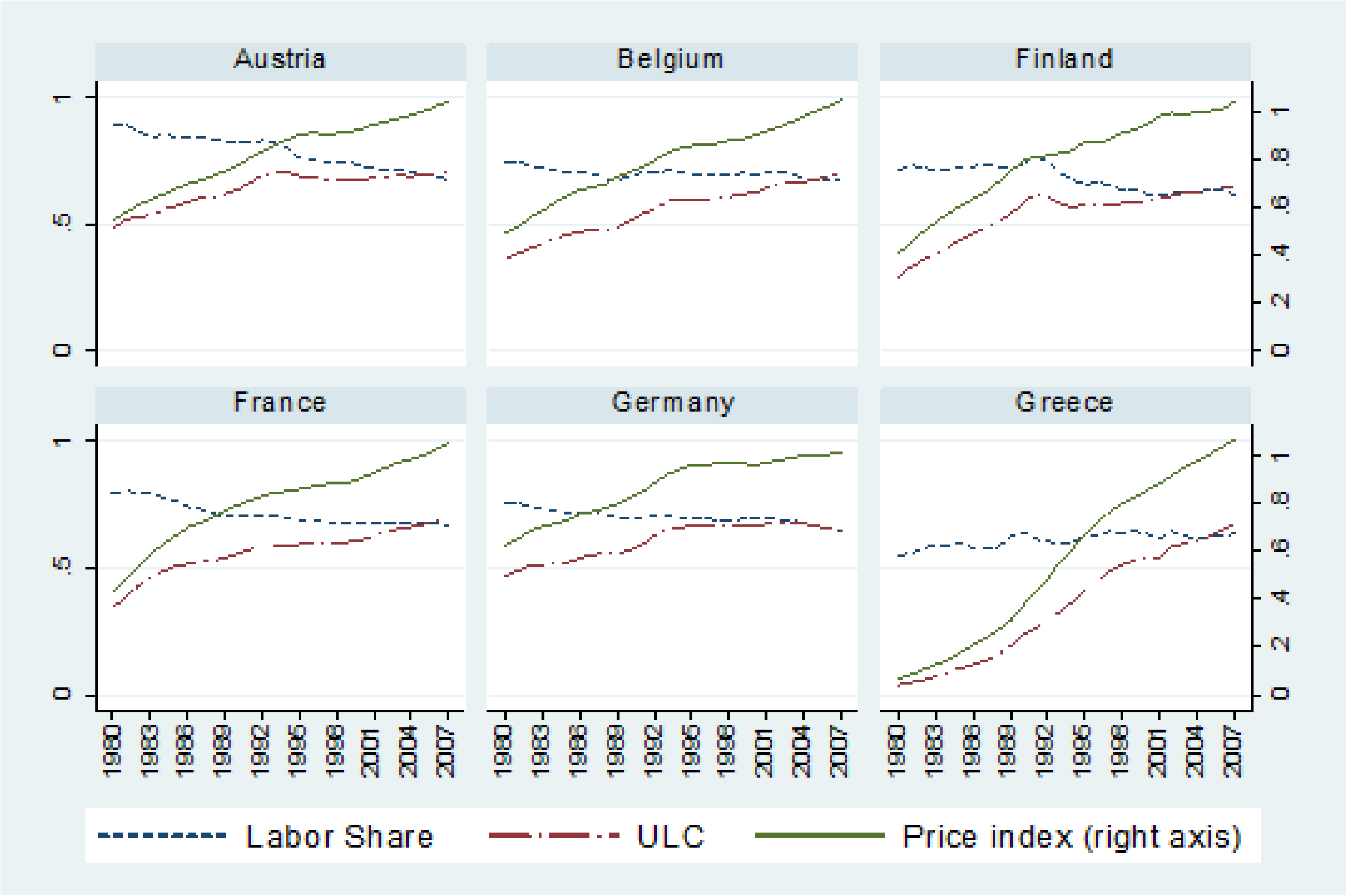
Wage rise



Austria
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Greece
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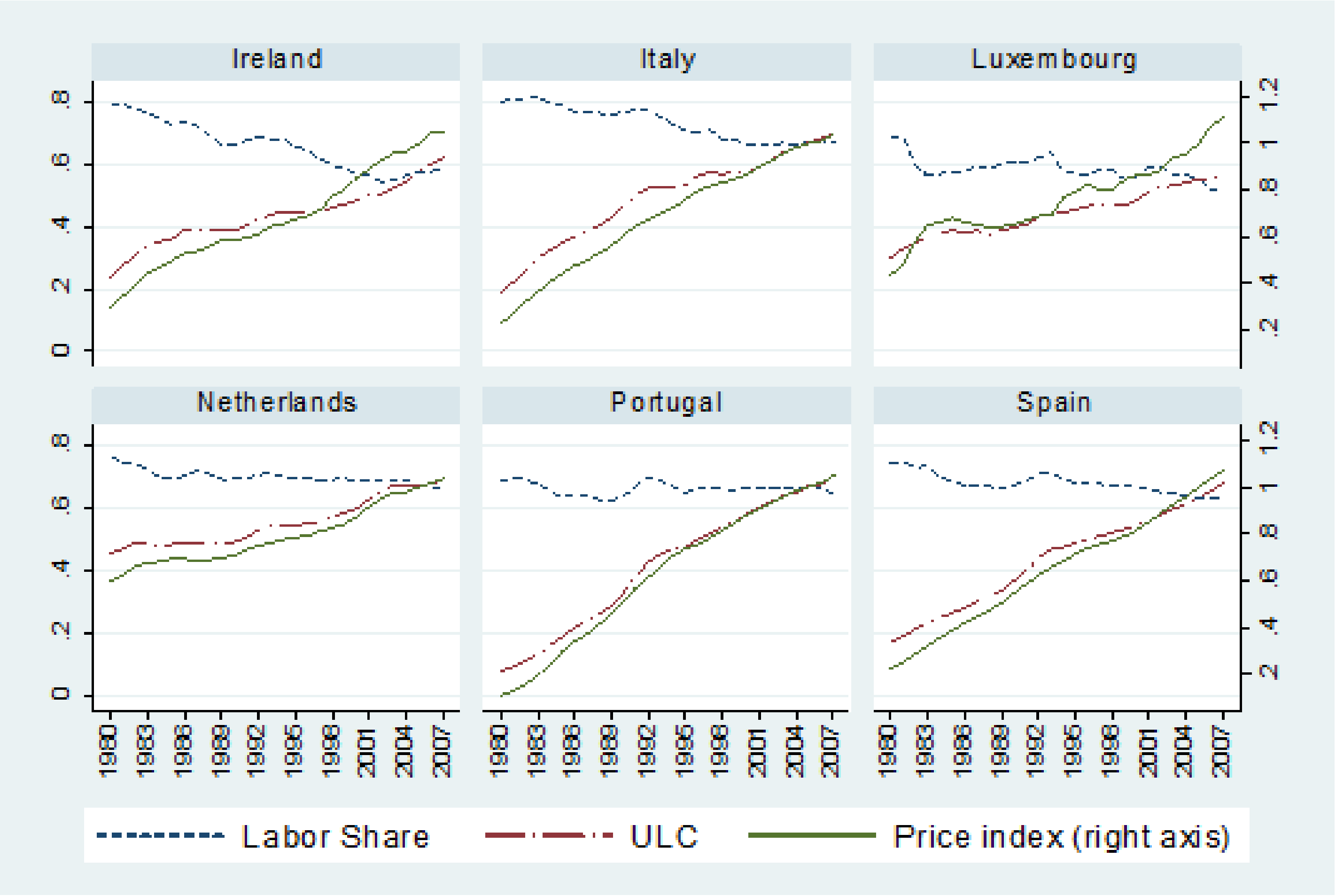
Labor Share
ULC
Price index (right axis)

Wage rise



Ireland
Italy
Luxembourg
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Spain
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1980
1983
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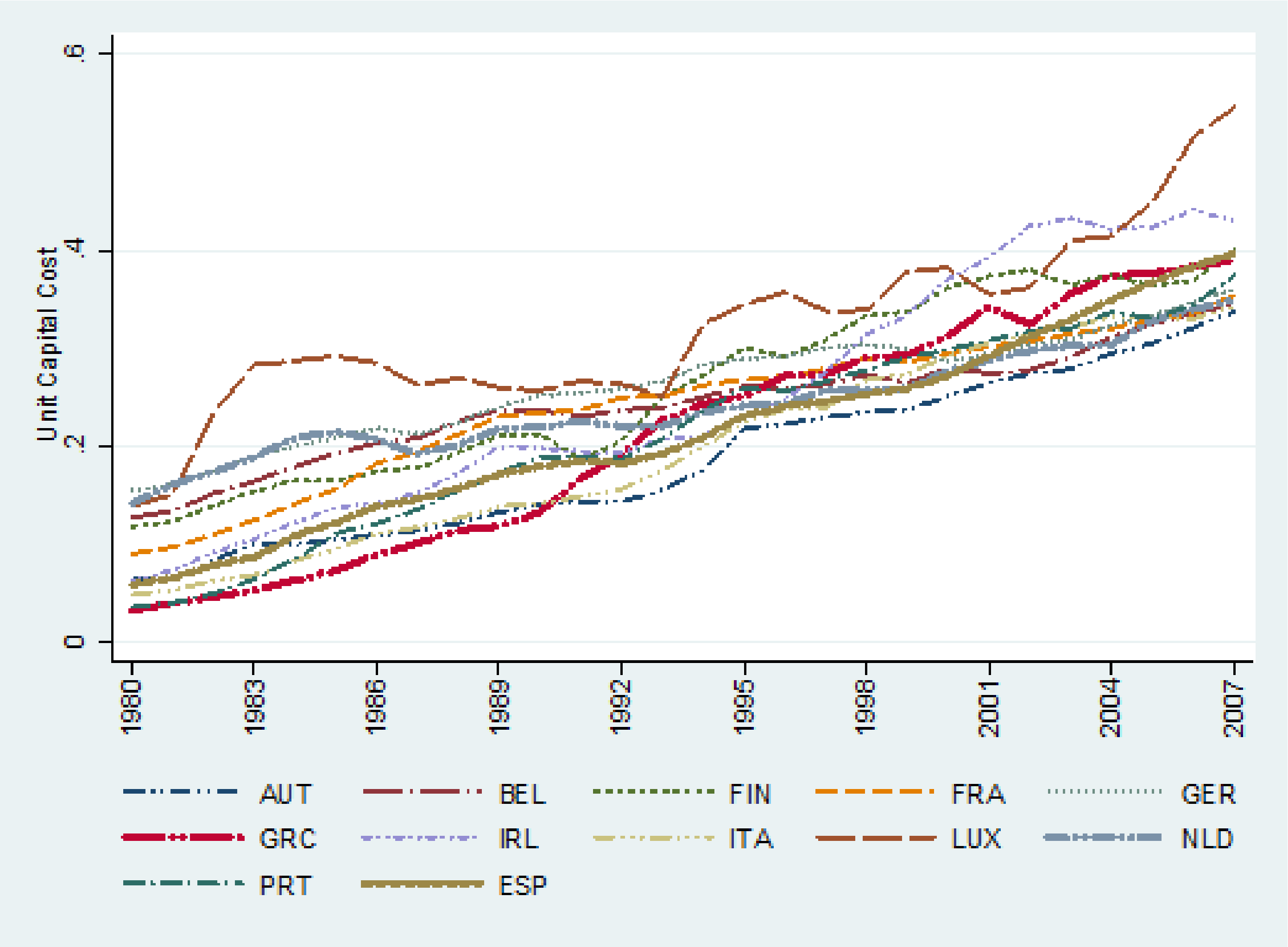
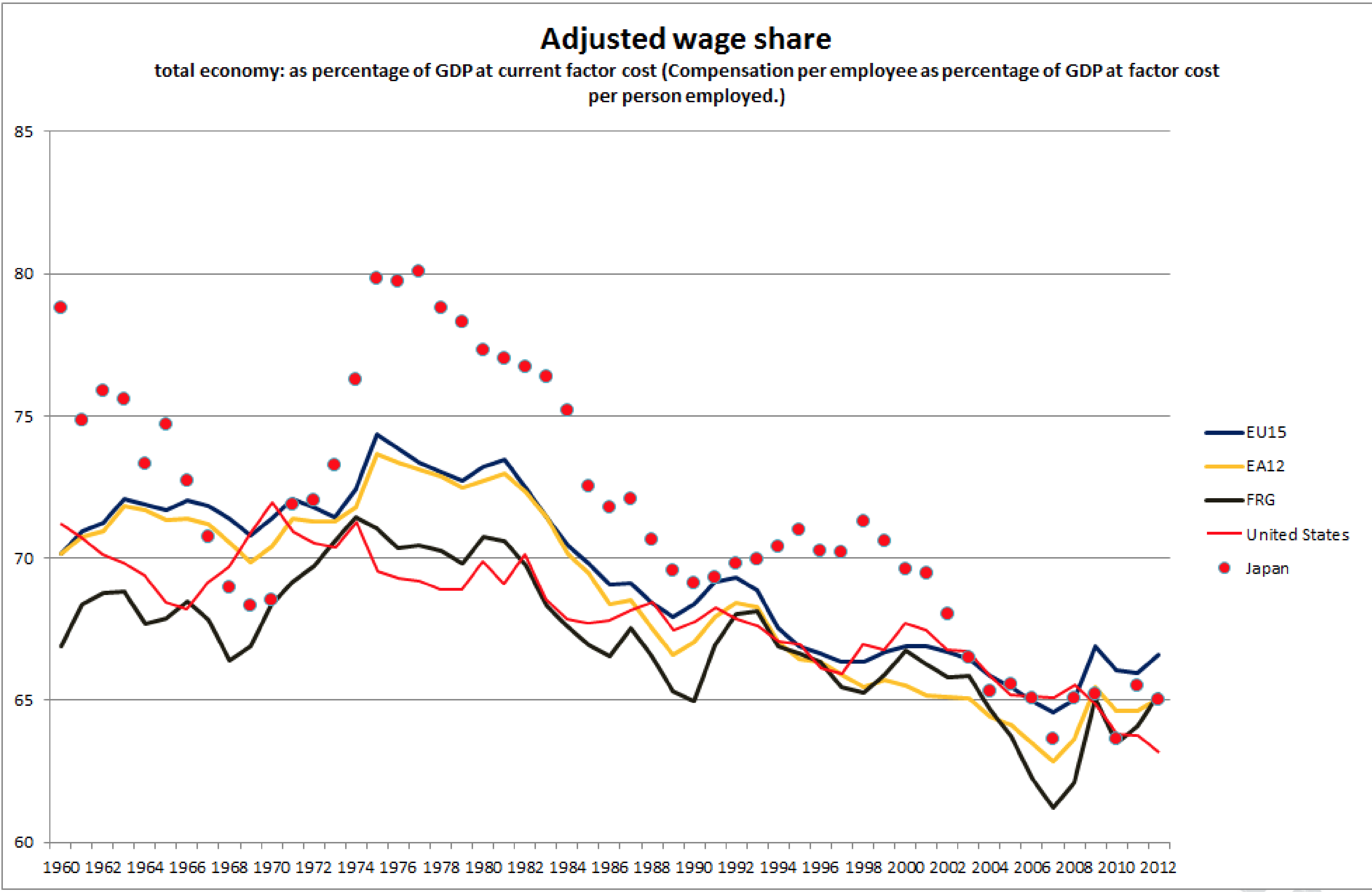
2004
2007
Labor Share
ULC
Price index (right axis)

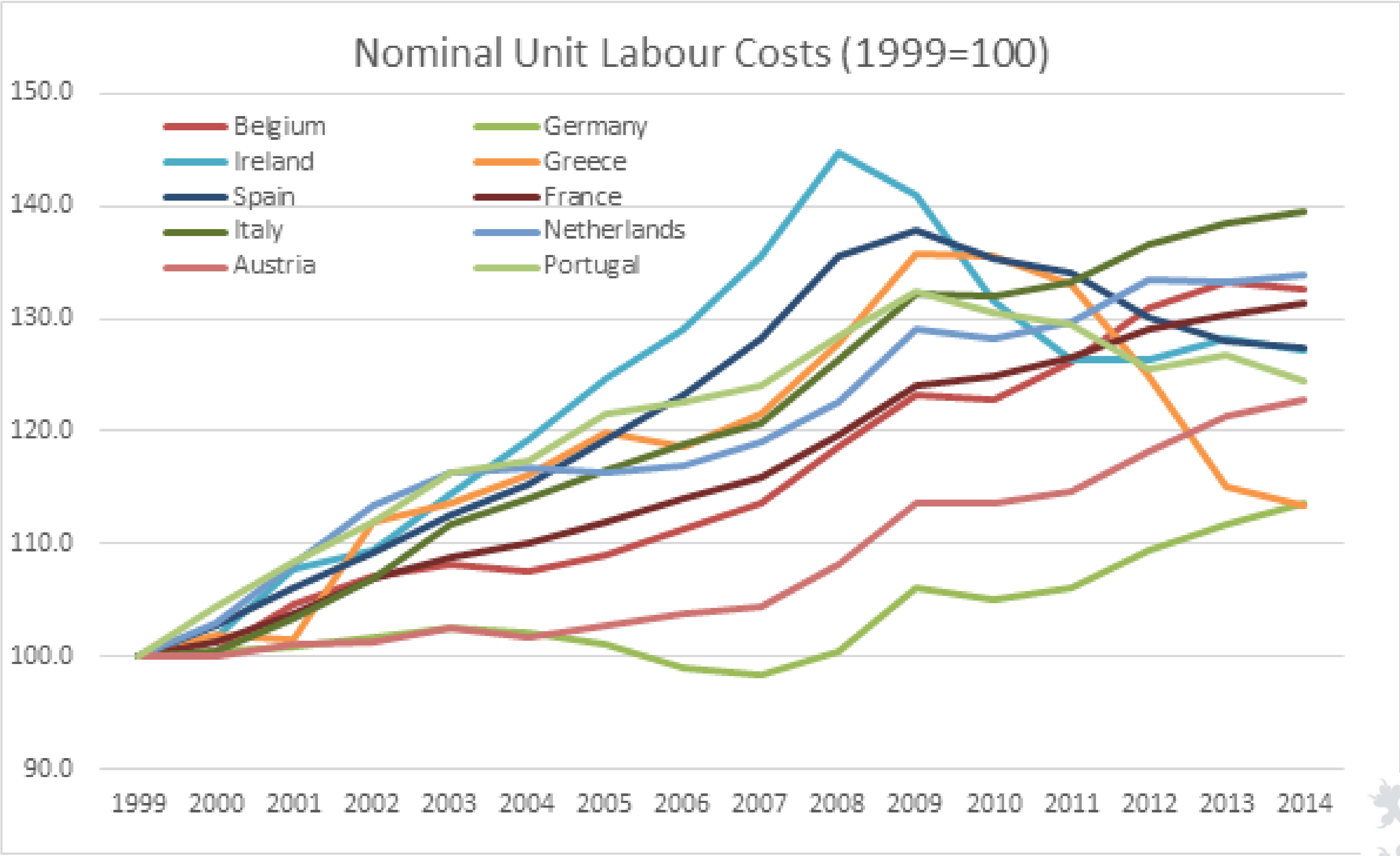
And the cost of capital rise!



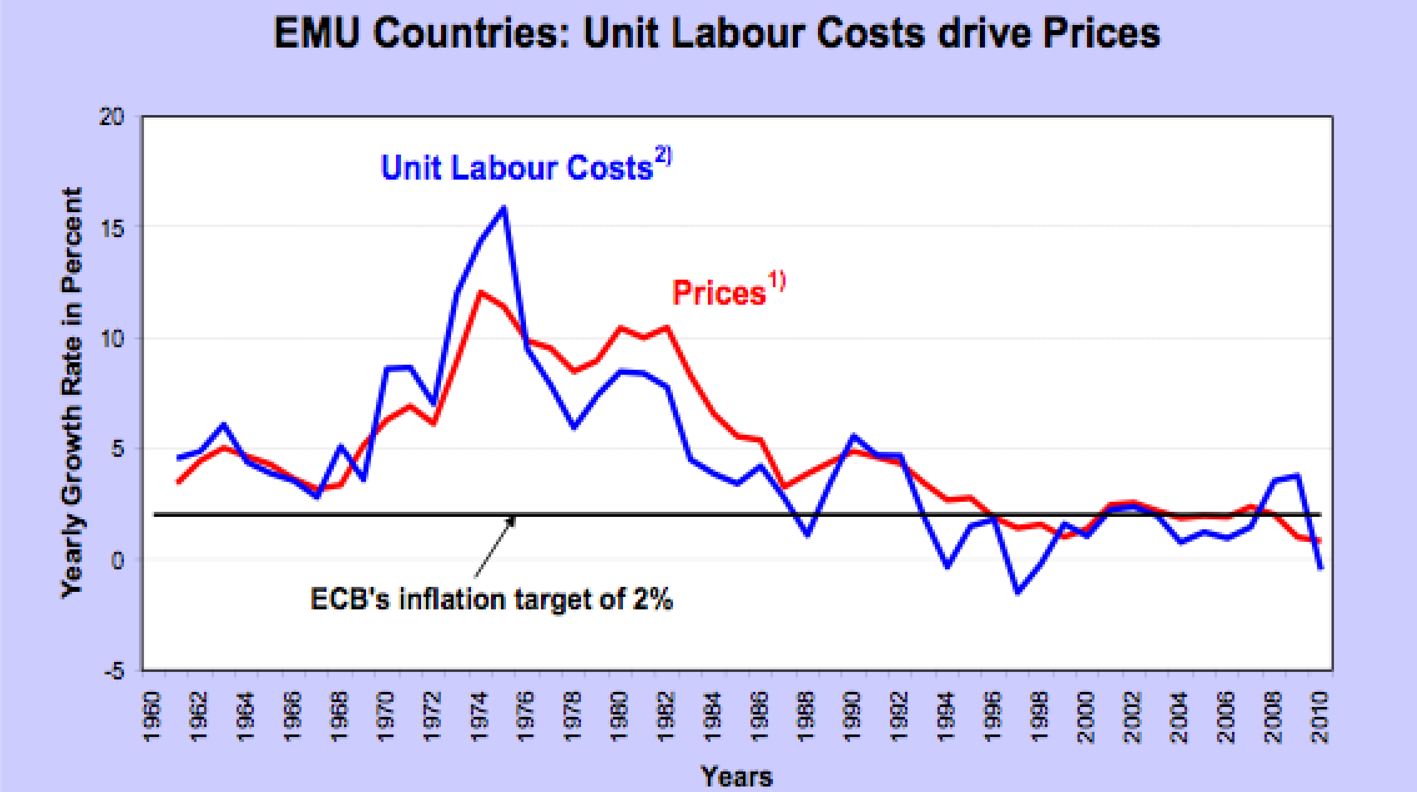


Adjusted wage share
total economy: as percentage of GDP at current factor cost (Compensation per employee as percentage of GDP at factor cost per person employed.)
85
80
75
70
65
60
1960 1962 1964 1966 1968 1970 1972 1974 1976 1978 1980 1982 1984 1986 1988 1990 1992 1994 1996 1998 2000 2002 2004 2006 2008 2010 2012
EU15
EA12
FRG
United States
Japan

Those damn wages



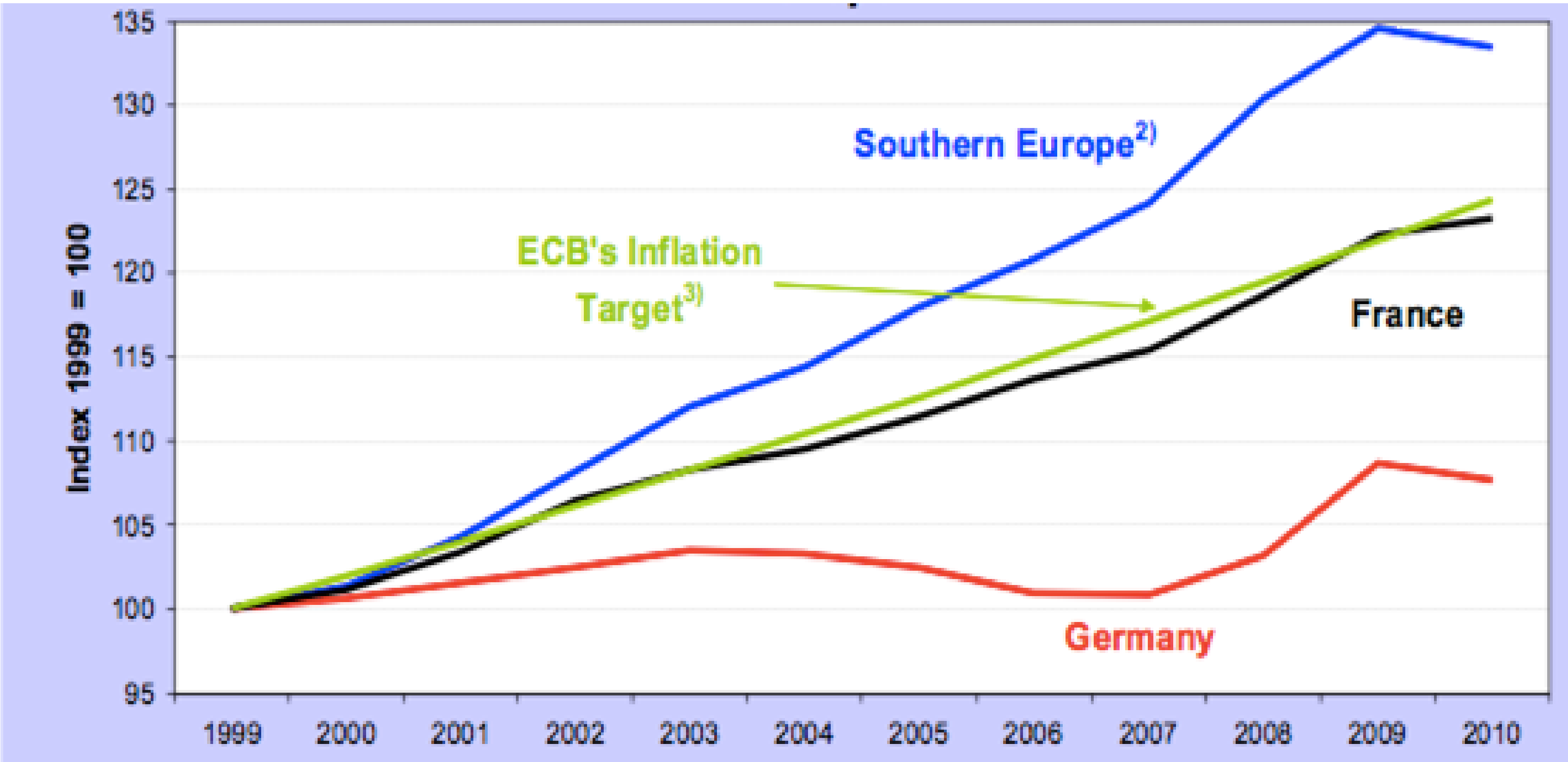
ULC drive prices



[1)] GDP deflator. [2)] Compensation of employees (total economy) in ECU or Euro per employee divided by real GDP per employed person; concept of fulltime equivalents where available.

Source: AMECO database (updated May 2011); own calculations.

One-size-fits-all monetary policy
One size fits France



You need more than wages

- But how can you rise wages if you don‘t get pay for it?
  - By borrowing to sustain them?
- There is a need for deliberate debt accumulation (public debt)
- Or an investment bubble...
- In reality the real exchange rates can‘t do the trick if interest rate and investment overhang doesn‘t follow

The consensus narrative

- Sudden stop of cross-border lending when the crisis came
  - Due to rising risk premiums
  - Banks and governements were cut off the capital flows they got used to
- Weak growth produced higher budget deficits
- Monetary union enabled the build-up of the imbalances unnoticed
- Incomplete architecture enabled a sudden loss of trust in deficit countries

The consensus narrative

- Too much public and private debt
- Big capital flows from the core (DE, FR, NL) to EA periphery (IE, PT, ES, EL)
- Not a problem solely of public debt
  - Just EL had one of the highest public debt in EA
  - IT and BE had over 100% debt yet did not need bailout, IE and ES with under 40% needed one
- Current account deficits of crisis countries
  - No country with surpluses was hit

The consensus narrative

- EA govs did not have a lender of last resort (LoLR)
  - Without a LoLR: the deficits and higher risk premiums lead to insolvency
- Devaluation impossible

=> a sudden stop crisis (developing countries)

- Close link between banks and govs
  - Vicious cycle – doom loop
- Slowing economy
  - i.a. due to lower bank funding in bank-oriented economies (basically all EU)
  - also lower gov spending, lower overall investment

The consensus narrative

- Rigidity of product and service markets makes restoring competitiveness slow and painful
  - High loss of output
- Mistakes were made in crisis management ("Greece is solvent!")
- But mainly: no institutional infrastructure to deal with the crisis on this scale
- You cannot deal with a financial/economic crisis together with a constitutional crisis

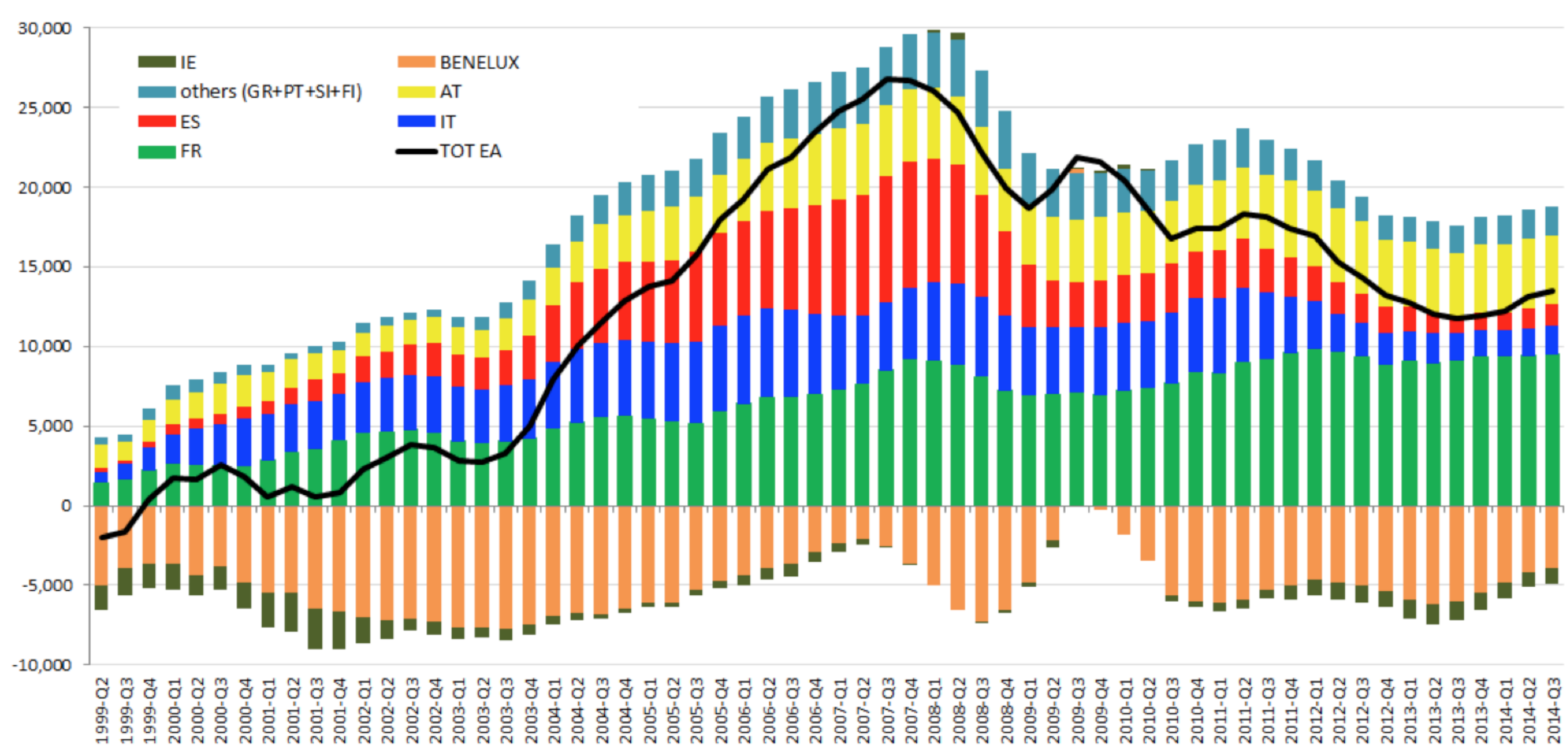
The consensus narrative

- Crisis management made mistakes (but mostly for objective reasons)
  - Because we were simultaneously fire-fighting + institution building
  - Interests of debtors and creditors hugely divergent
  - Economic crisis craved stimulus, while fiscal crisis craved consolidation
  - European citizens closely watching
- Extreme dead-weight losses both due to the crisis and to its management

Implications

- Structural weaknesses of the EMU:
  - A tendency to develop imbalances as a feature of the systém, “not a bug“
  - Inherent deflationary bias
- The EMU architecture as an “assymetric shock“ by itself
- The signalling function of exchange rates lost
- Markets cannot correct imbalances
- Different business cycles and inflation expectations led to one-way capital flows
- Demand shock – different ULCs

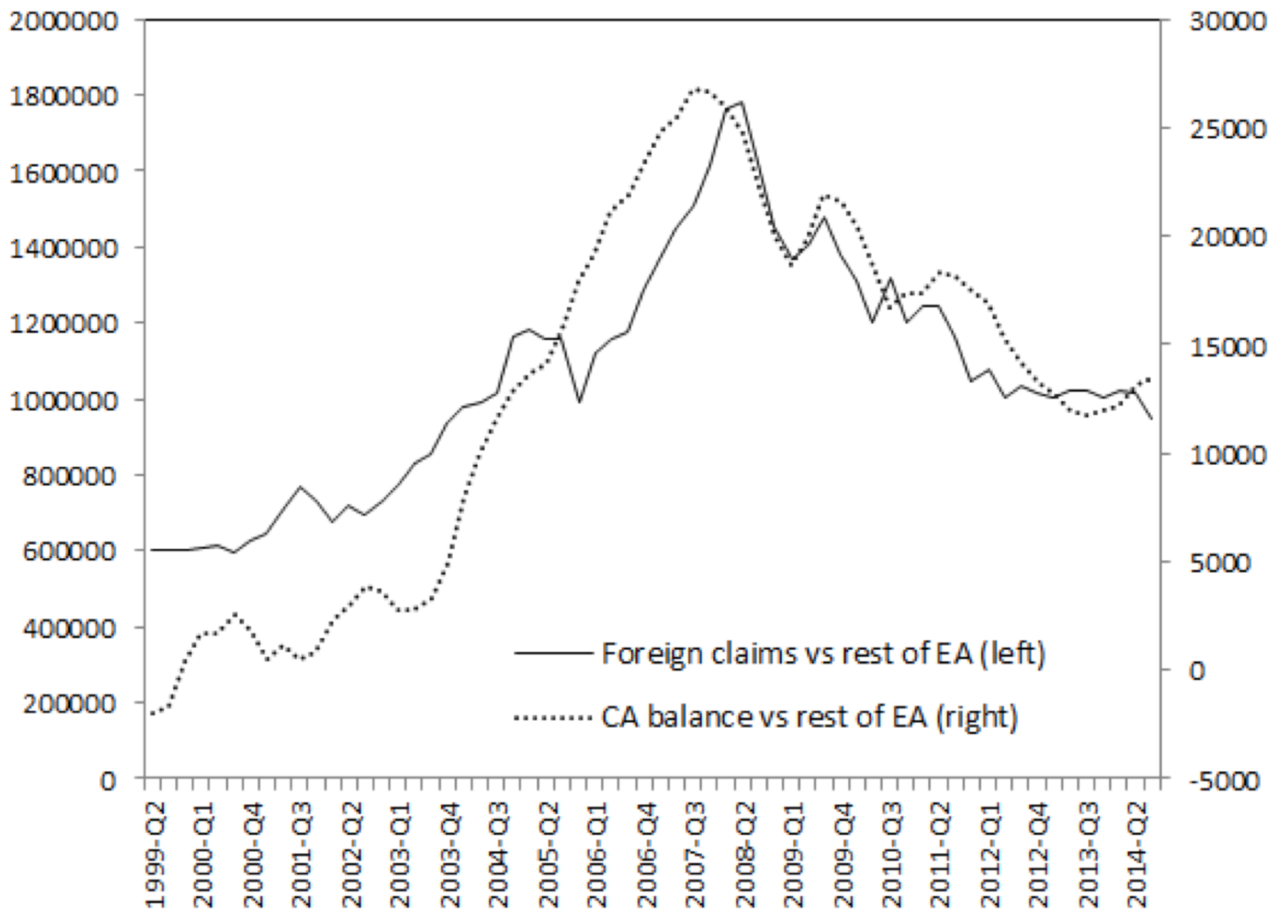
The story of the DE current account



Implications

- Positive and stat.significant correlation with DE bank exposure and current account (bilateral one)
- Relatively lower investment activity in DE
- The correlation continues
- The crisis caused by demand shocks and investment inflow
- Vendor-financing operation

The story of the DE current account



Implications

- Positive and stat.significant correlation with DE bank exposure and current account (bilateral one)
- Relatively lower investment activity in Germany
- The relationship continues
- The crisis caused by demand shocks and investment inflow
- Vendor-financing operation

Implications

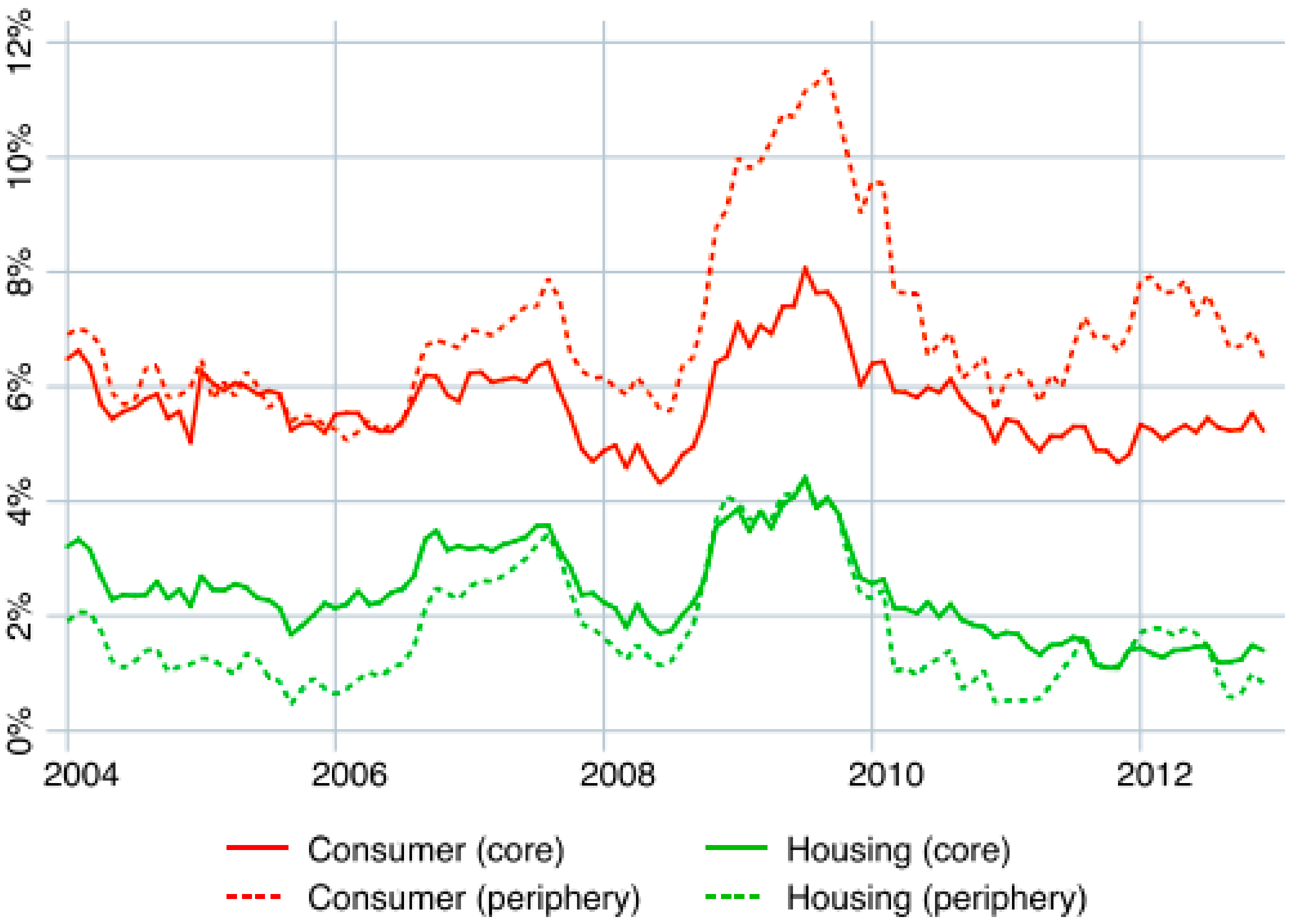
- Imbalances decreased by deacreasing demand of deficit-countries, but the causes remain
- Investment and demand not restored in surplus countries so to stimulate imports
- No common instruments for demand management
  - If only national level and if only adjustment through internal devaluation (= in most cases deflation)
- Deflationary bias
- Lower growth in good times, longer stagnations in bad times

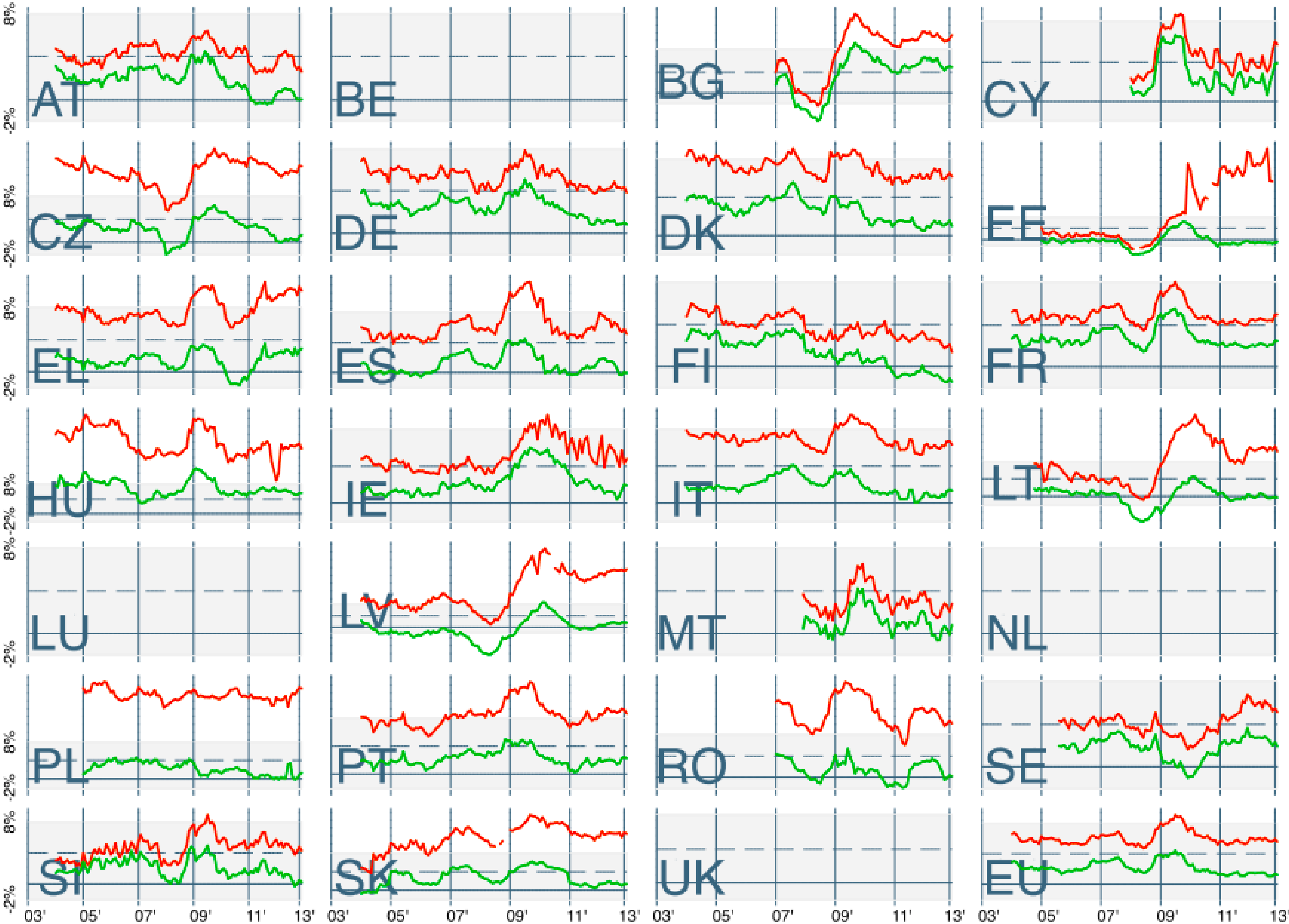
Two possibilities for the eurozone

1. Growth with imbalances
2. Stagnation without imbalances

Explanation 2:
Capital flows

Low, zero and negative interest rates





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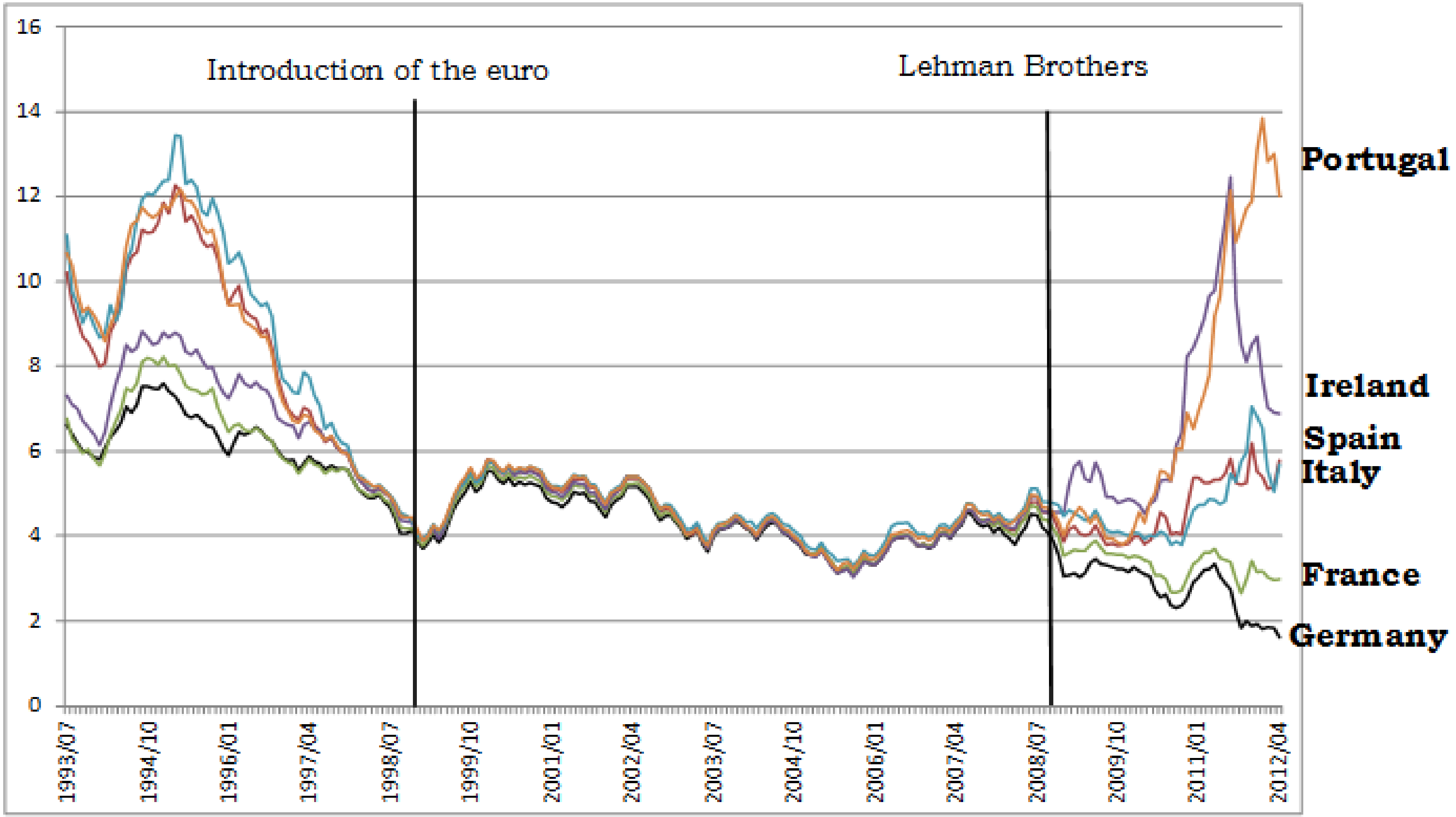
EL
ES
FI
FR
HU
IE
IT
LT
LU
LV
MT
NL
PL
PT
RO
SE
SI
SK
UK
EU
8%
-2%
03'
05'
07'
09'
11'
13'

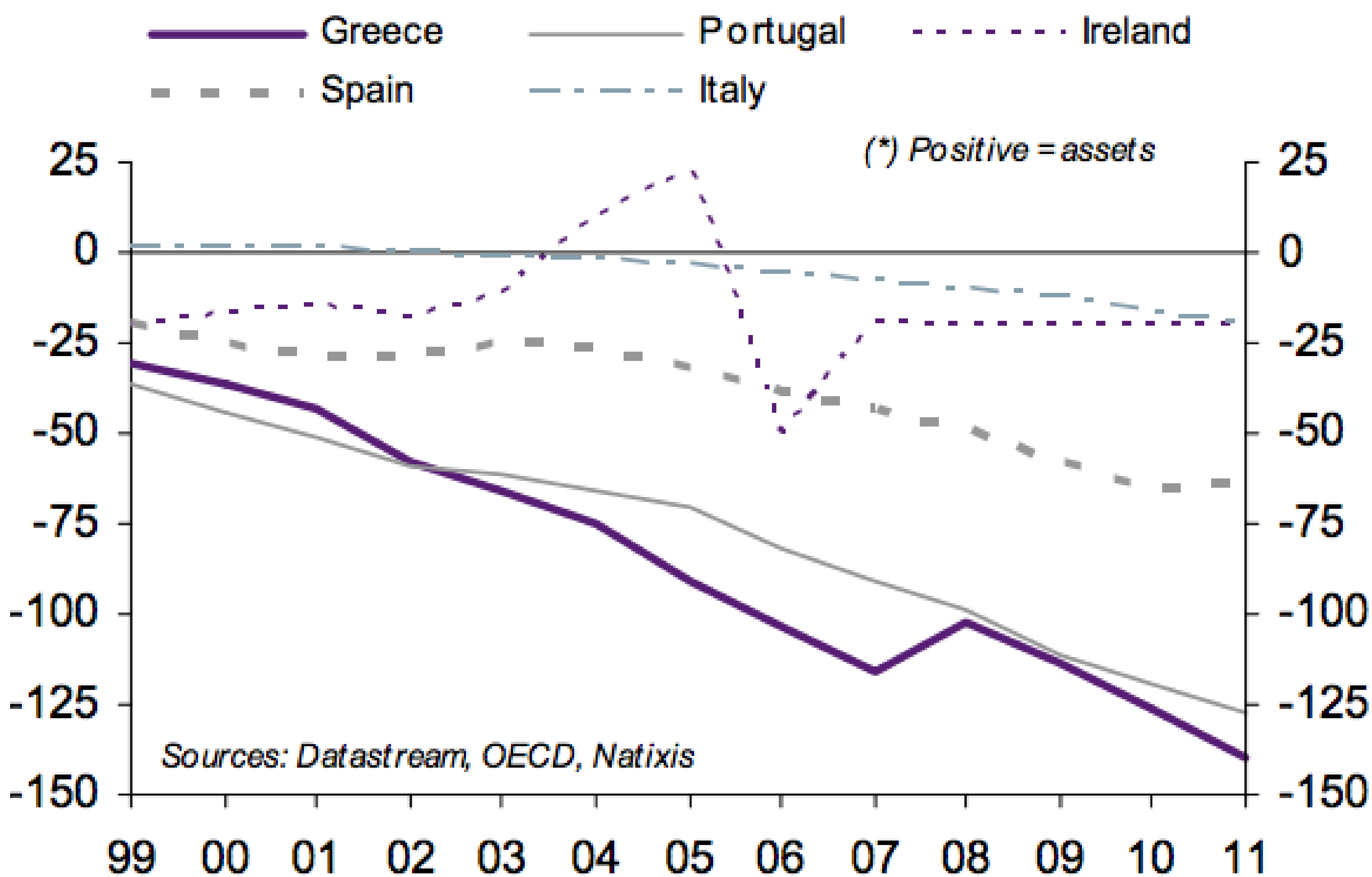
Interest rate and investment

- Nominal convergence of interest rates
- If you have high inflation expectations, the interest rates you „see“ are low
- Nominal interest rate reacts to the same monetary policy of the whole EA
  - And banks were not able to discriminate properly within the EA (one of the largest market failures in human history)
- Too cheap money + economy booming => unproductive investments

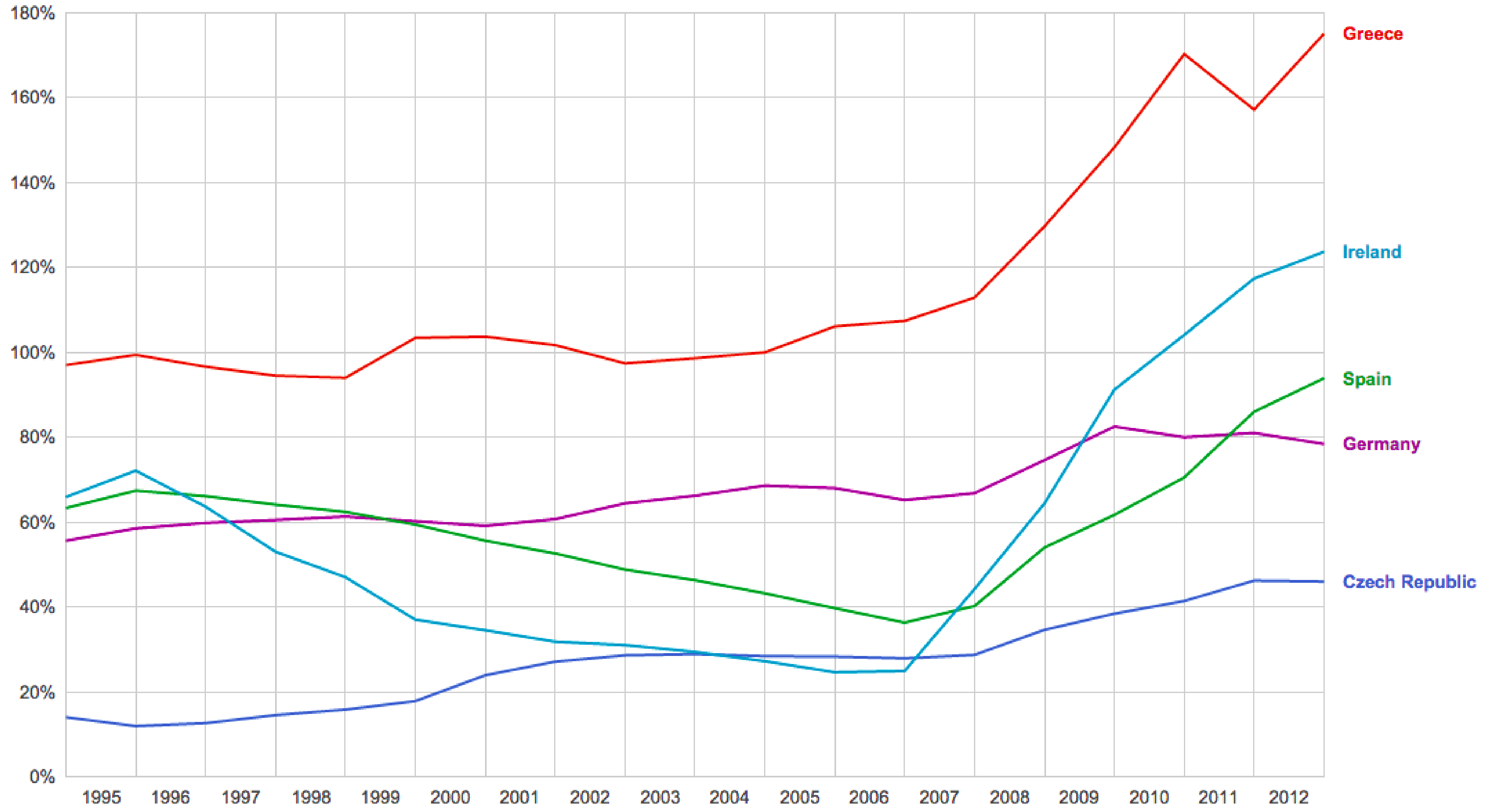
10yr bond yields



External debt

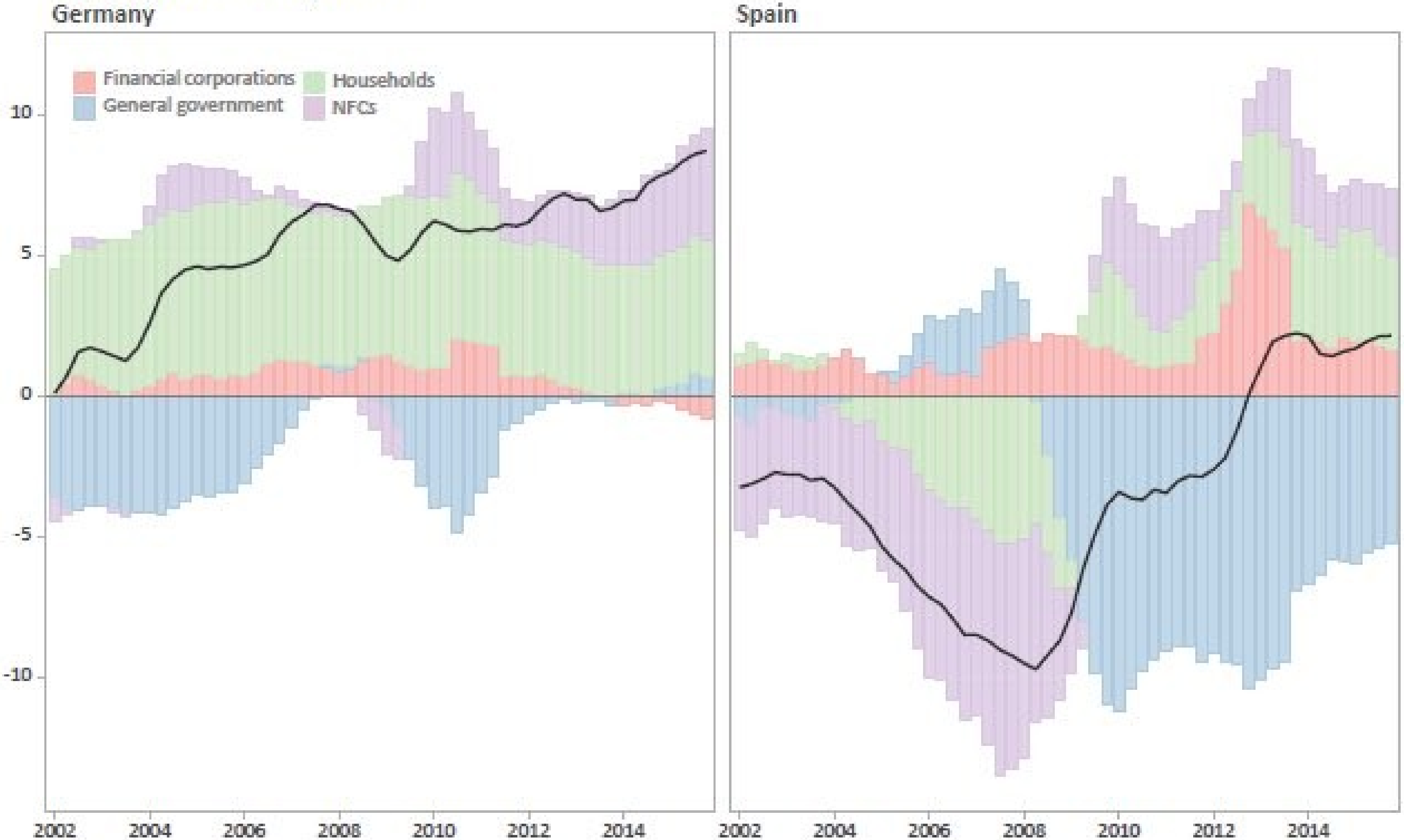


Not just public



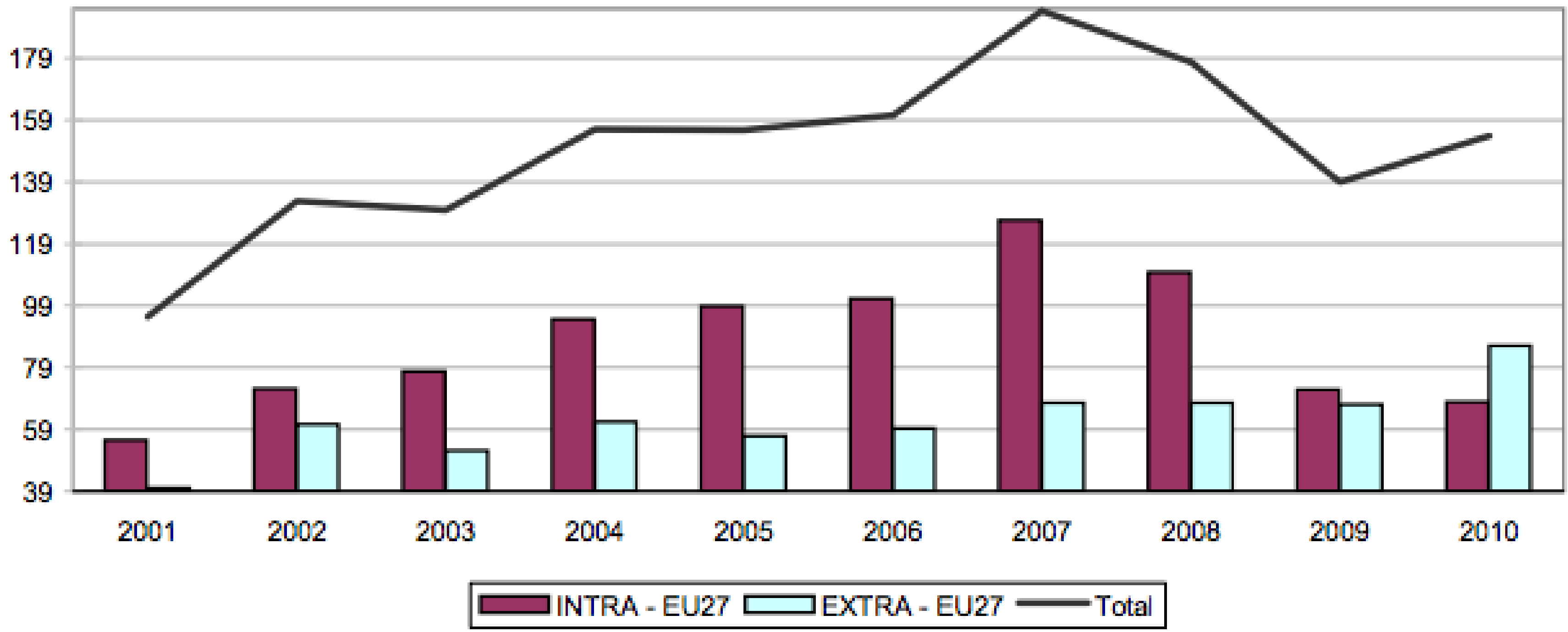
Net lending/borrowing

% of GDP over last four quarters

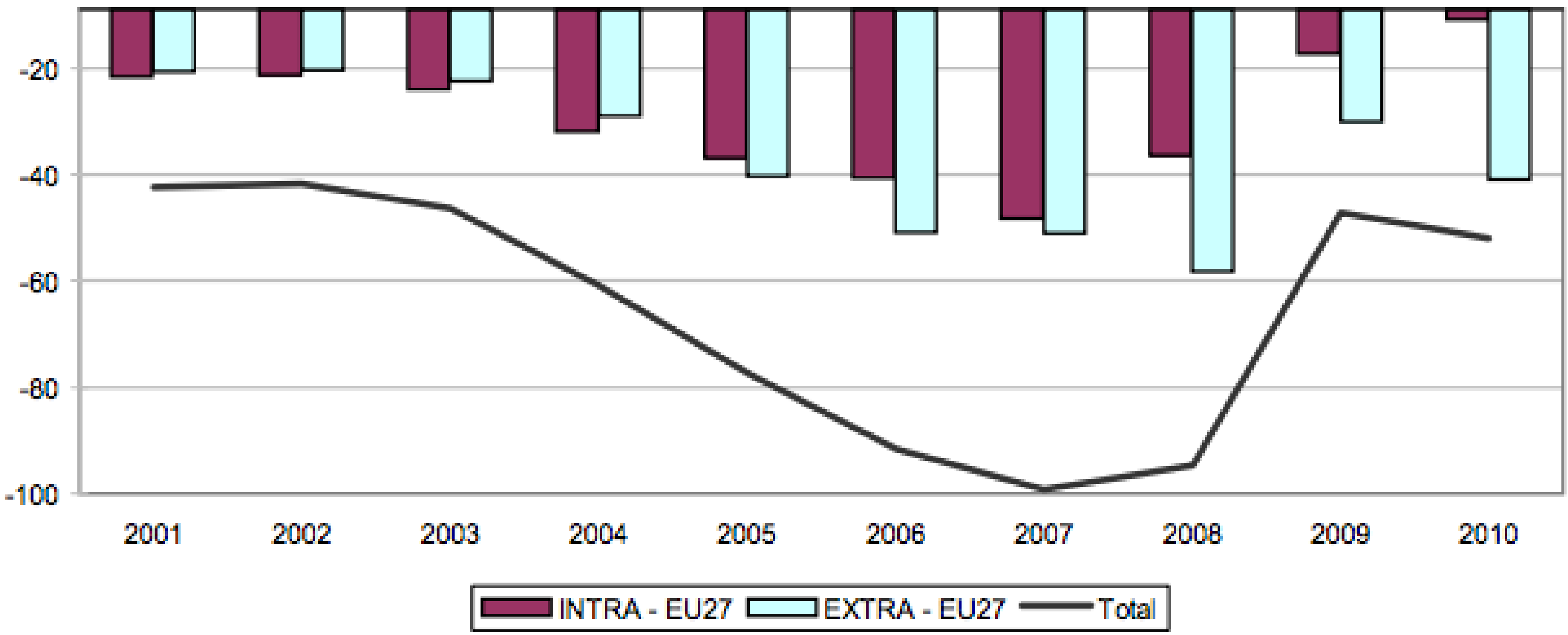


Source: EAA
Latest observation: 2015Q4
Note: Black line shows the balance of lending.

Trade balance of which country?



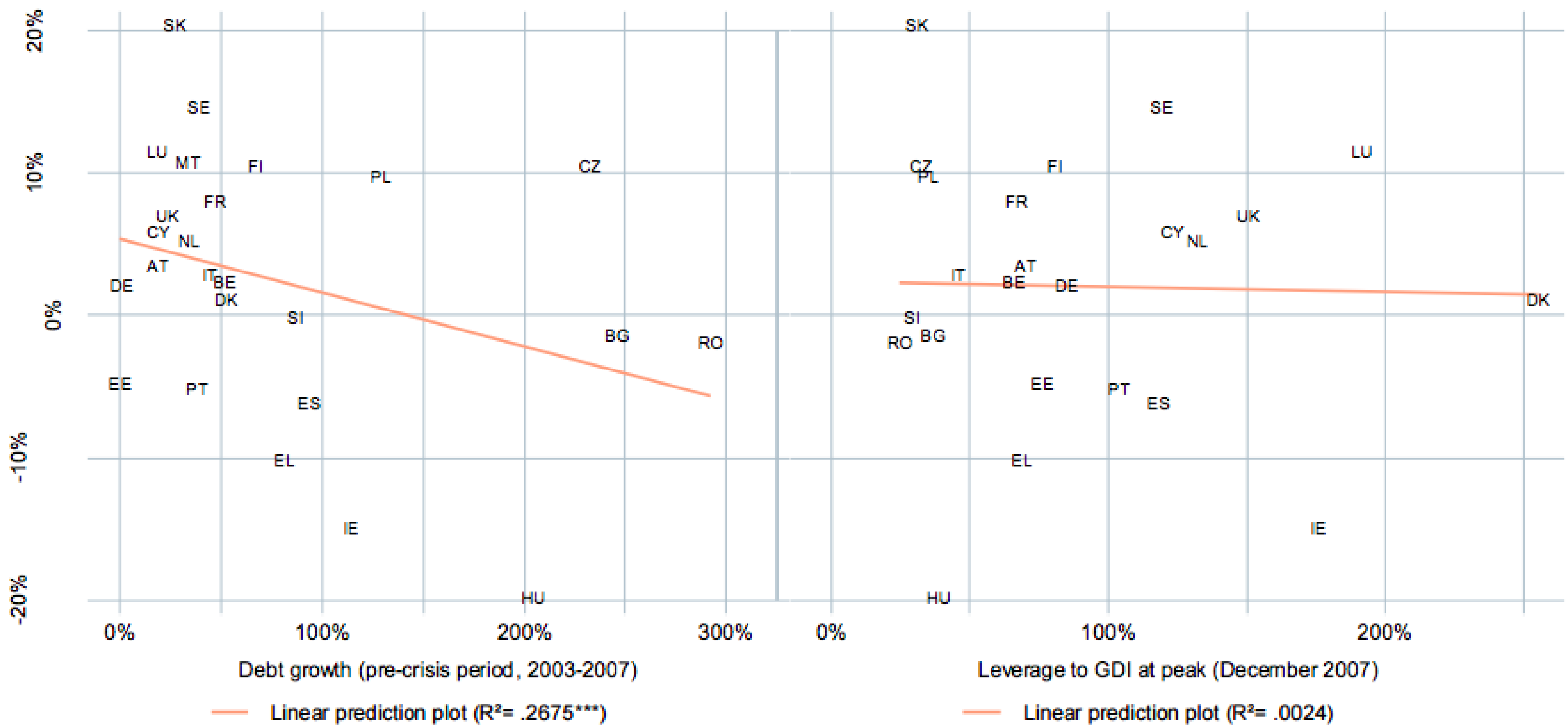
And this one is just the other way around



Share in exports by complexity

	Top 10	Top 100		1	2	3	4	5	6
Austria	1.73	1.62	1.58	1.49	1.10	1.23	0.85	0.23	
Belgium	3.76	2.26	3.21	2.89	2.01	2.05	2.60	1.85	
China	1.22	1.28	2.72	8.08	10.78	13.97	12.96	13.35	
Finland	0.50	1.09	1.05	1.38	0.59	0.72	0.29	0.22	
France	5.11	3.57	5.78	6.08	5.43	5.58	3.08	1.59	
Germany	12.24	17.99	17.73	13.50	8.01	7.64	4.65	1.89	
Greece	0.01	0.02	0.03	0.16	0.13	0.24	0.31	0.37	
Ireland	1.25	0.80	2.71	2.26	1.21	1.50	0.51	0.11	
Italy	1.40	3.07	4.04	4.30	3.15	3.87	4.69	2.56	
Luxembourg	0.81	0.15	0.14	0.30	0.15	0.20	0.11	0.03	
Netherlands	5.11	3.50	2.93	3.51	3.17	2.76	3.50	2.73	
Portugal	0.05	0.04	0.30	0.23	0.48	0.48	0.56	0.52	
Spain	0.23	0.88	2.23	2.36	1.70	1.85	2.46	1.28	

Deleveraging – the quick and the stable debt



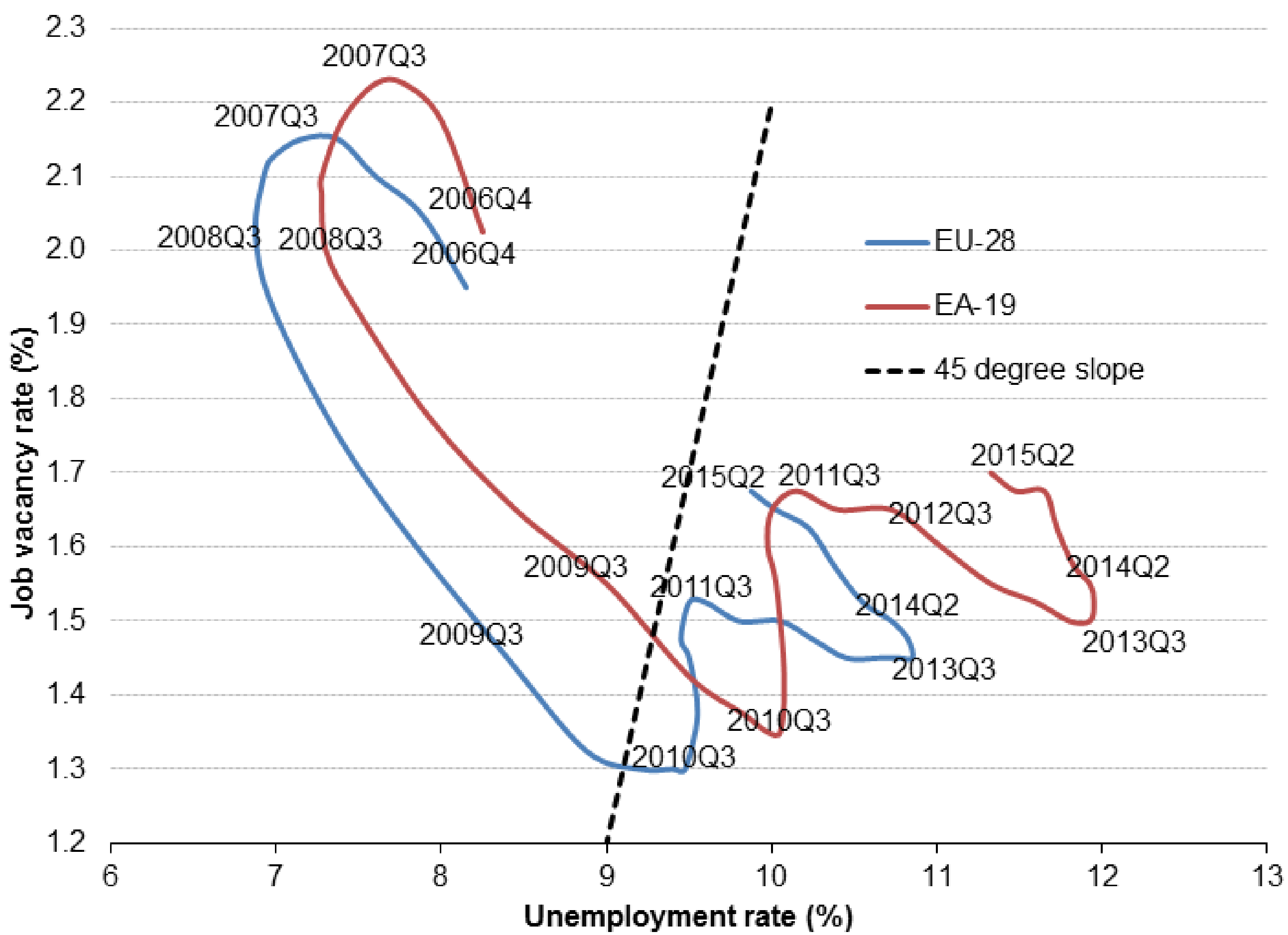
What happened during the crisis?

- Some sectors went bust (e.g. construction)
- Unemployment in some sectors rises
- The output of the economy goes down
- Monetary policy cannot react if those shocks are localised unevenly and if you have just one
- Fiscal policy is national and it was ultimately prevented from borrowing

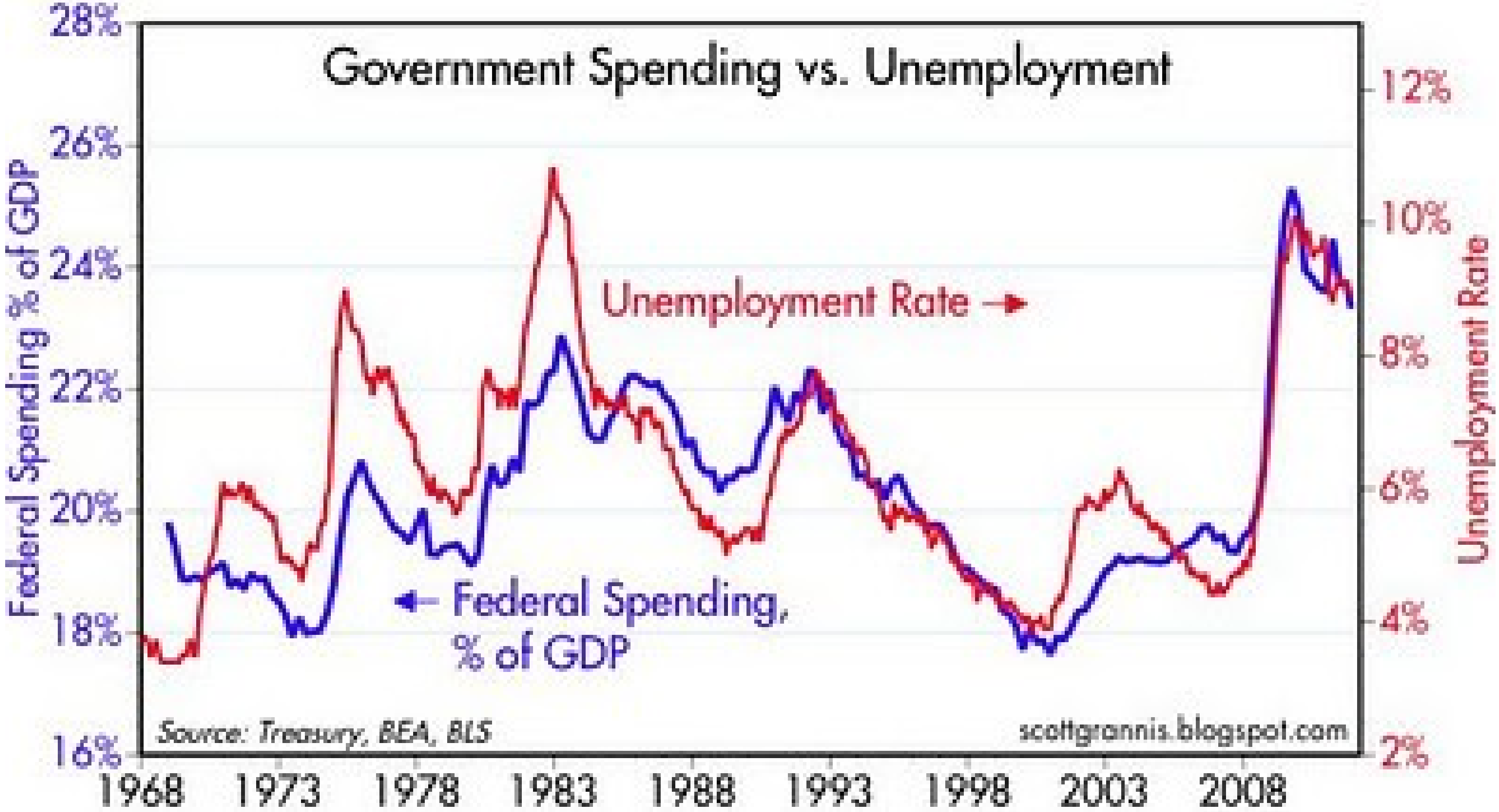
Asymmetric crisis

- Assymetric impacts of the crisis on different countries, especially on labour markets
  - Huge increase of unemployment (by 4 pp.)
  - Muted response of employment (large heterogeneity)
  - Young and low-skilled workers hit most heavily
- Explaining heterogeneity
  - Presence of imbalances before crisis (such as previous booms in the construction sector or accumulated competitiveness losses)
  - Export oriented countries hit less (related to the role of expectations if the shock is only temporary)

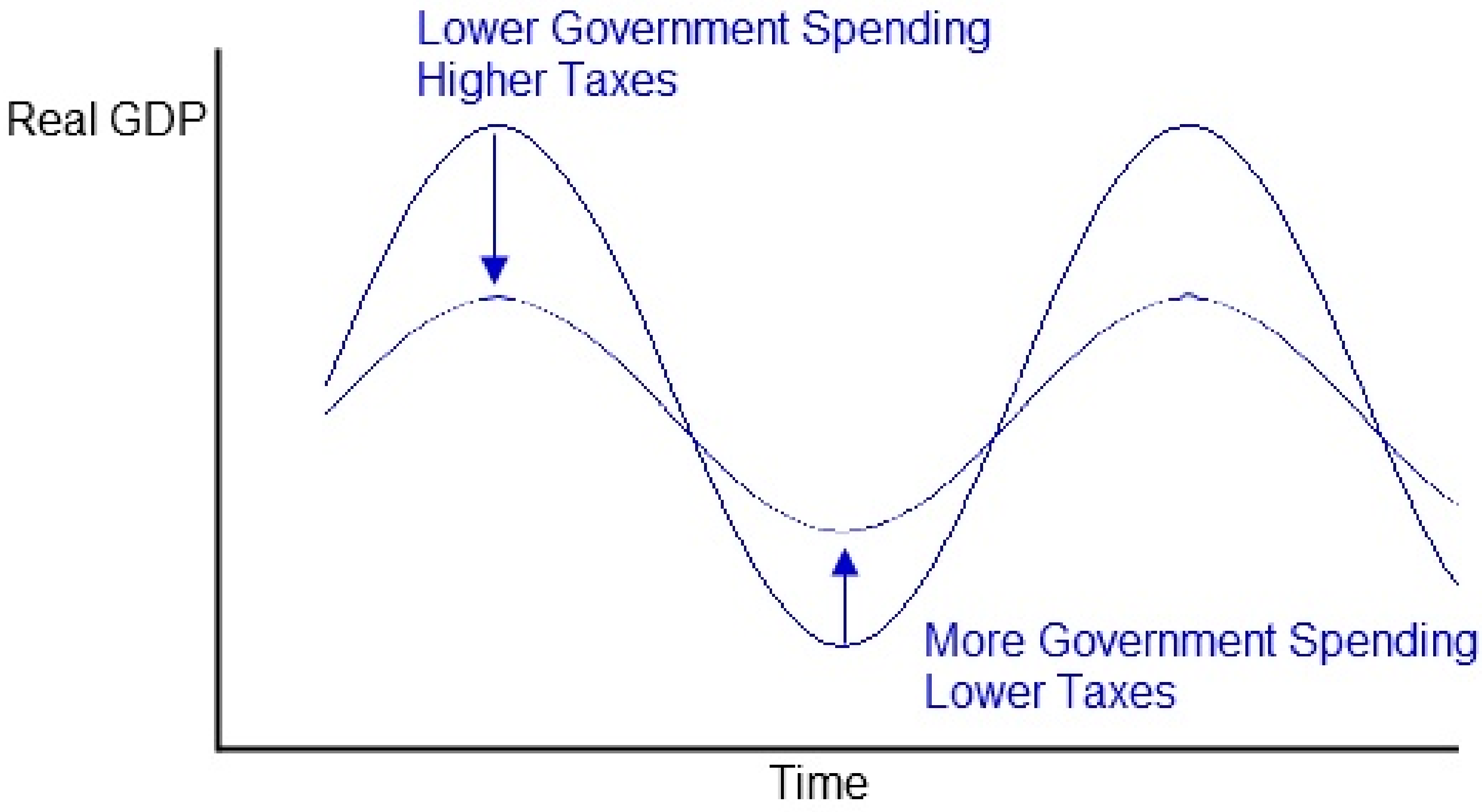
Dead-weight loss in the job market



The case of US



Automatic fiscal stabiliser



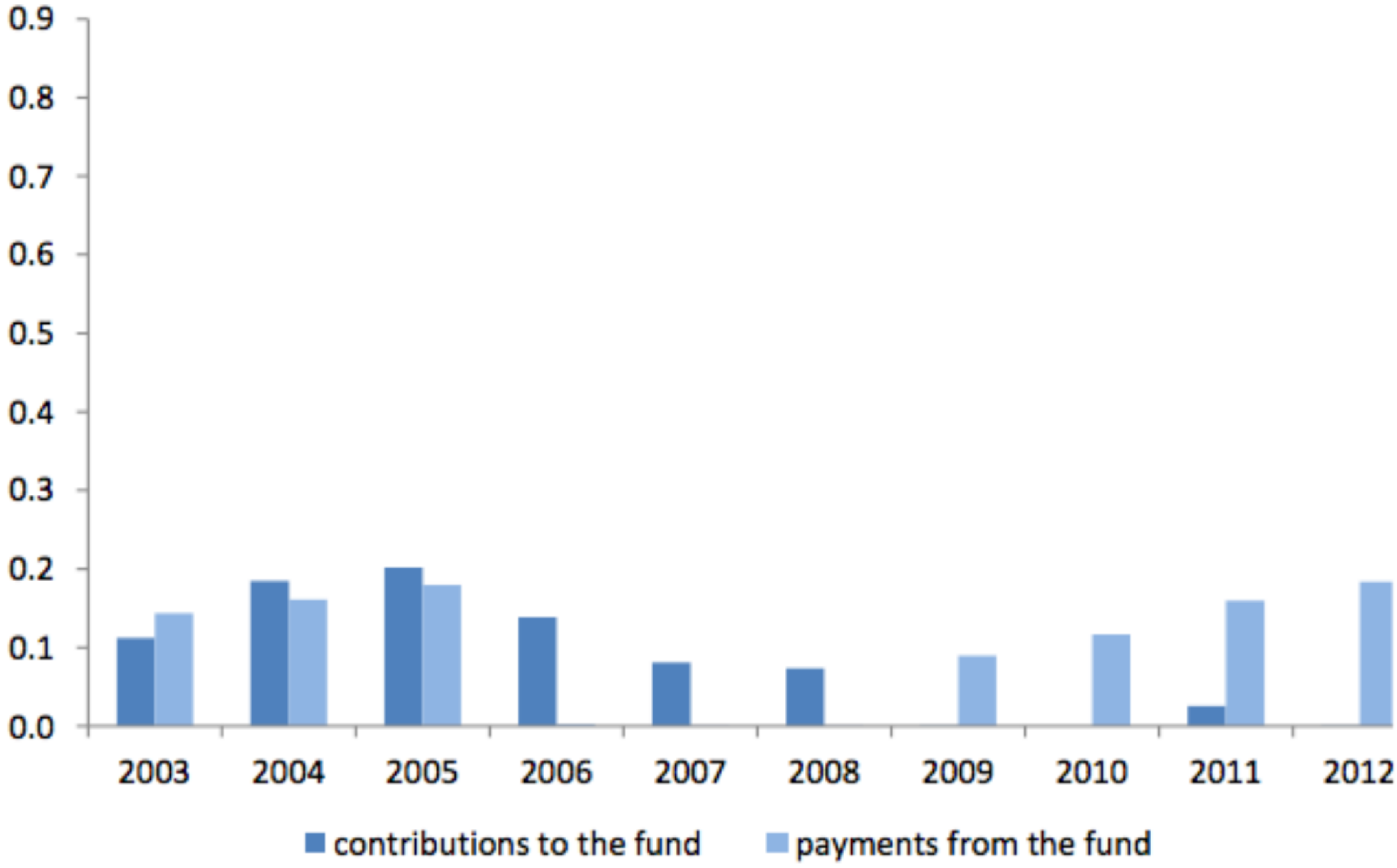
Automatic fiscal stabiliser
Shock absorber

- How should it help?
  - Transfers from less severely hit to those in the worst situation
  - Risk sharing
  - Avoidance of fiscal policy constraints
  - Gains for everybody – lower impacts of crisis, reduced public debt, confidence effects
- Drawbacks
  - Moral hazard problem
  - Need for consensus on a more harmonised social model
- Avenue for further harmonisation of labour markets?

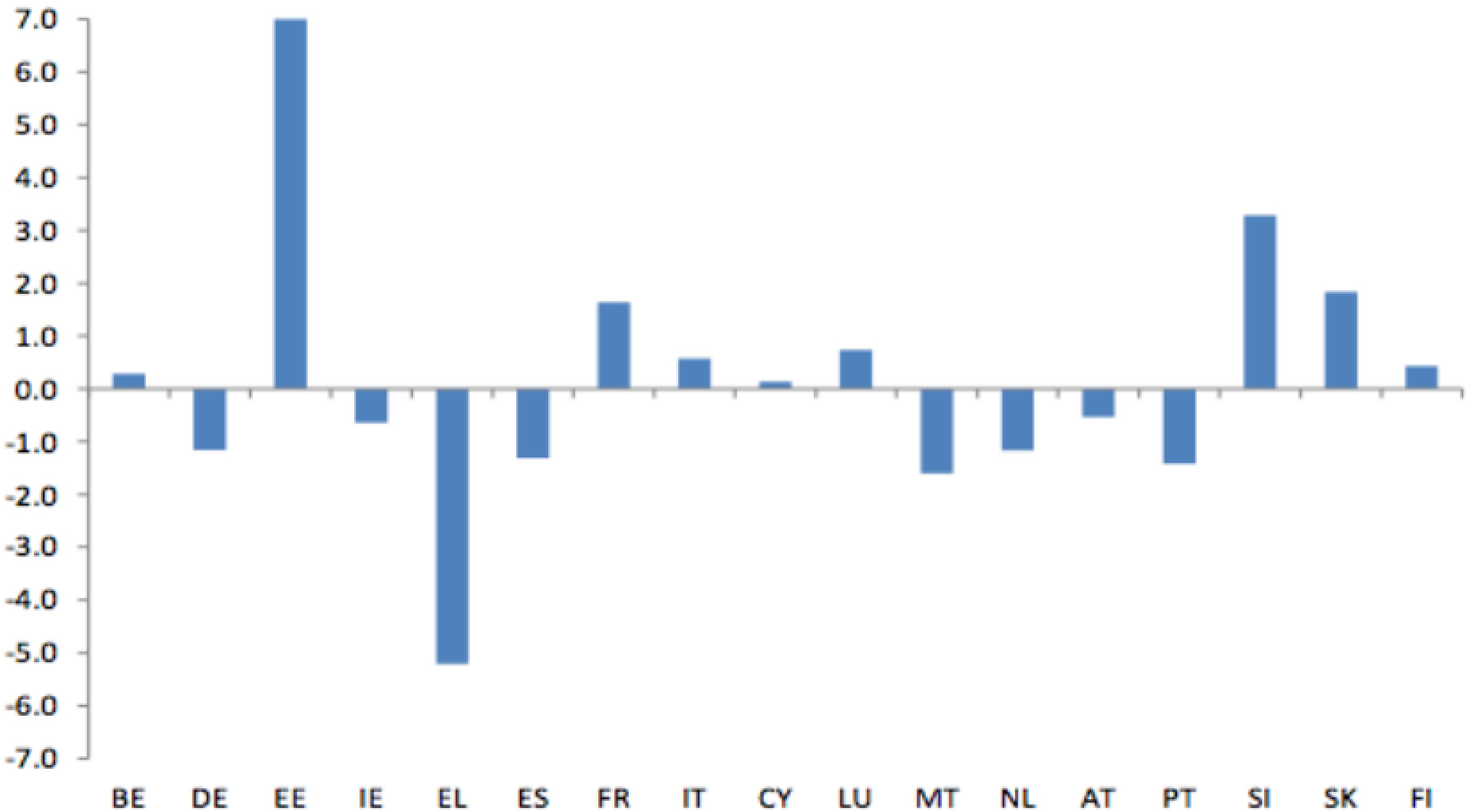
Social pillar

- Drawbacks of schock absorbers
  - Moral hazard problem
  - Need for consensus on one social model
- Reminiscent of something? Banking union
  - Harmonise, reduce risks
  - Then share risks (most difficult)
- **Social pillar is to the shock absorber what is stage 1 of the BU to SRF/EDIS**

Fiskální pojišťovací mechanismus



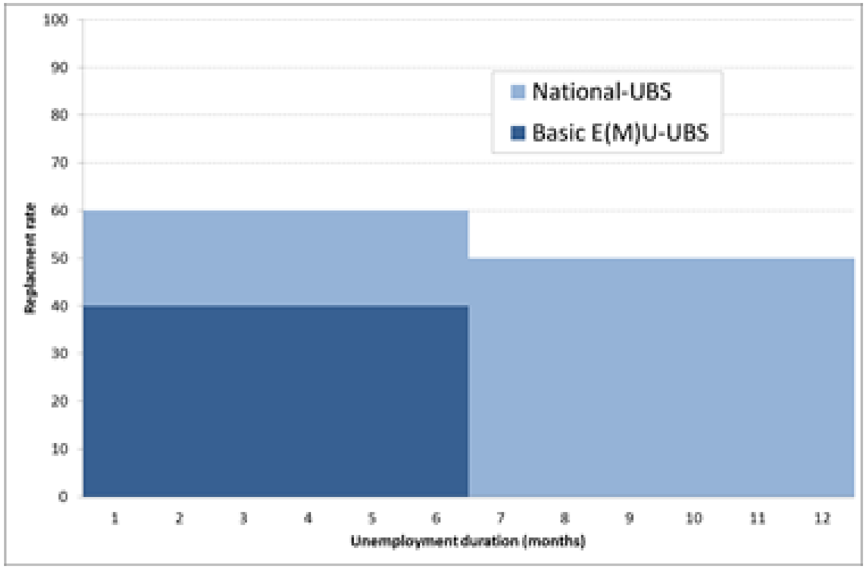
Fiskální pojišťovací mechanismus



European Unemployment Insurance Scheme

- Size of insurance
- Length and eligibility
- Permanent or crisis transfers
- Some countries with negative balance or negative system?
- Euro-area or EU?

Basic features of EUI



Zdroj: Andor (2014)

How to prepare for the next crisis?

Impacts on Czech Republic in billions of CZK

Varianta	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	Total
Basic	0,00	0,00	-3,51	-7,66	-8,03	0,00	0,00	-4,02	-8,10	-8,17	-44,86
Catastrophic, 60%	-1,53	-1,95	-2,81	-3,07	-3,21	20,79	14,63	10,86	-11,74	-13,89	7,52
One rate, 80%	0,00	0,00	-3,51	-7,66	-12,05	0,00	0,00	-4,02	-8,10	-12,26	-55,33
Differentiated, 60%	0,00	3,26	0,00	-3,83	-4,02	7,84	7,91	4,02	0,00	0,00	22,49
Differentiated, 80%	3,06	3,26	0,00	-3,83	-4,02	11,77	7,91	4,02	0,00	0,00	32,15

Zdroj: Modelace a Bruegel

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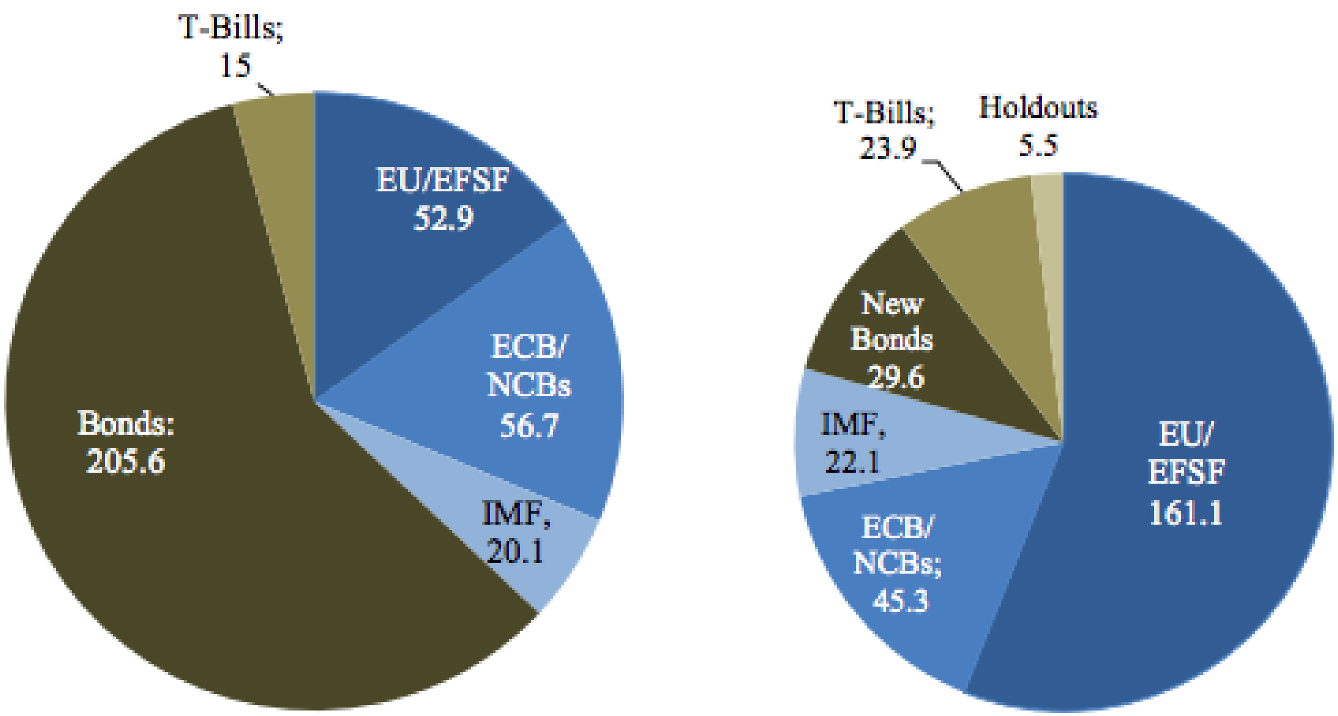
Change in Greek debt holders

Figure 7: Change in composition of Greek sovereign debt



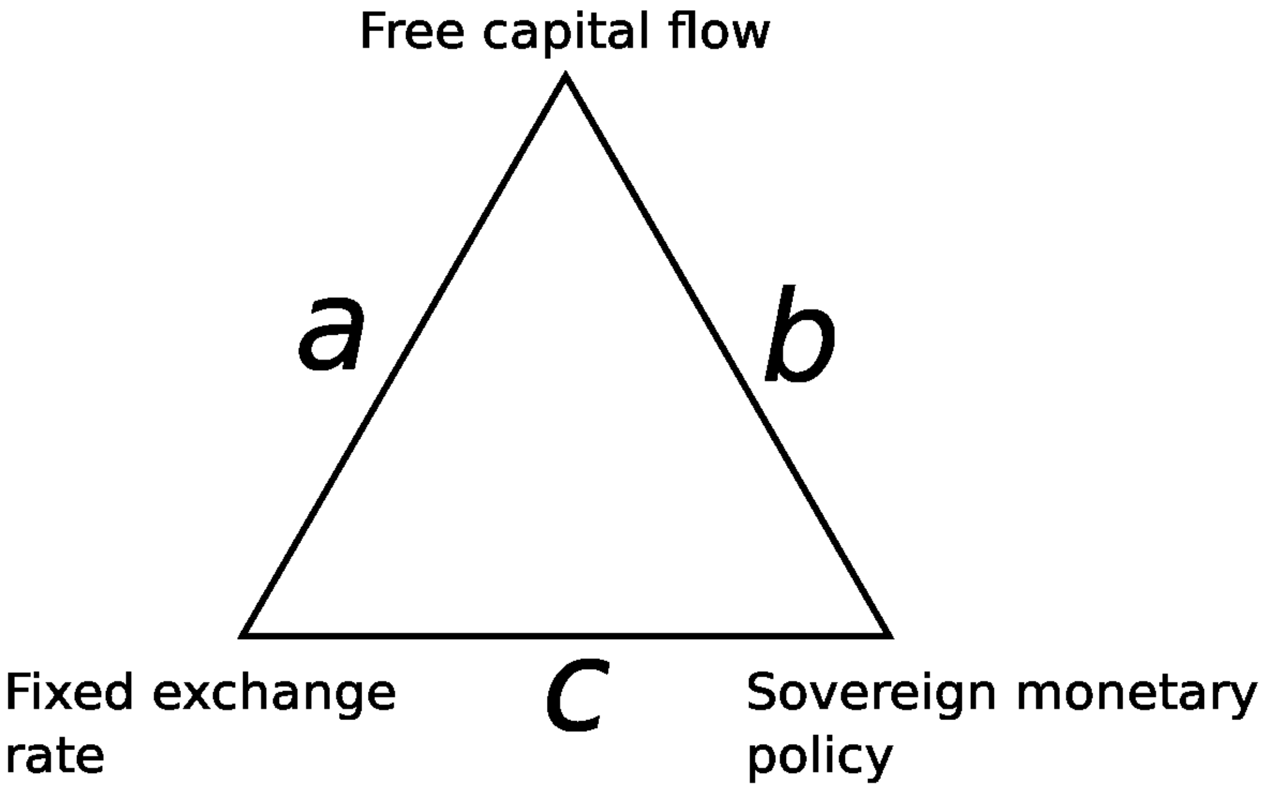
February 2012:
Before debt exchange

December 2012:
After debt exchange and buyback

Harmonization vs. Competing social models?

- What has happened in last few years?
  - Harmonization in market of services
  - Not a single social model and no convergence
  - Social dumping?
- Minimum wage and united rules for the whole EU?
- Social (tripartite) dialogue on EU level?
  - National Competitiveness Councils

Impossible trinity



Impossibility of creating a common currency

- Werner report
  - Brettonwood context
- Snake in a tunnel
- European monetary system
  - European currency unit
- It did not work (?)
  - Internal and external devaluation
  - Drop-offs from EMS

What enabled the euro?

- Monetarist revolution
  - Monetary policy can be technocratically created
  - How many states had an independent central bank?
- Reunification of Germany
- Mundell II

History of the EU – History of Rules

- ECSC and Euratom
- European Economic Communities
- Single market
- Euro
  - Maastricht criteria
  - Stability and Growth Pact
- Banking and fiscal crisis
  - Fiscal compact – Fiscal union
  - Aid programmes
  - Banking union

The Rules

- One set of rules that we can all agree on
- There is one best solution for everybody
- No discretion on the supranational level
- European commission is a rule processor
- Democratically elected EP merely controls

The rules

- **Perfect** – no discretion necessary
- **Amovible** – otherwise moral hazard
- **Consensual** – everybody agrees

The Rules of the Euro

- One perfect monetary (monetarist) policy

– Targeted inflation and nothing else

– No direct financing of government liabilities

– Rigid mandate

– No political meddling

- But what if the rules stop working?

$\Rightarrow$ Crisis management: Unconceavable

“Stability and Growth Pact didn’t work…

let’s make it more binding”

Economic vs. Political

- Mismatch of economic and political

$\Rightarrow$ Need for a (more) political union to balance

- Rules more binding? Or more political topics?
  - Already political functions
    - Security
    - Judicial cooperation
    - Common foreign policy
- What is political?
  - Democratic

Technocracy

- No margin for policy flexibility
  - Incapacity of crisis management
- Constitutional changes to cope with crises
- If discretion needed then illegitimacy
  - Troika, aid packages
- People’s despair
  - Elections don’t change policies
  - No hope for change

	Technocracy	Democracy
Legitimacy	Output	Input
Decision-making	Consensus (lowest common denominator)	Majority
Executive power	Pre-determined (bureaucracy)	Flexible
Democratic power	Controls the functioning	Determines the functioning

Democratic Union

- Political mandate for the supranational sovereign
- Flexibility
- Operational executive
  - the Commission, not the Council
- Ministers should not legislate

Towards a Democratic Union

1. The Commission accountable to the EP
   – More control, more responsibility, more power and legitimacy
2. Mandated officials to the Council
   – Transparent positions – publishing minutes
   – “Ministers should not legislate”

Can it happen?

- Maybe not
  - But then the EU will never go beyond the "bureaucratic, illegitimate, over-paid foreigners"
- Unfeasible! But what's the impediment?
  - People fearing loss of sovereignty?
  - Or the governments fearing loss of power?