European Labour Markets and the Economic Crisis

Christopher A Pissarides

London School of Economics and University of Cyprus

A Bundesbank Conference
Eltville 12/13 June 2014

European labour markets

- The European Union is clearly not delivering what it promised with the single currency
- High and persistent unemployment supported only with expensive programmes is not what made countries rally to it
- Does the fault lie with the structure of labour markets?

The European crisis

- The post-Great Recession European crisis started as a debt crisis
- Policies to reduce public debts have exposed weaknesses in European labour markets
- For this reason, the crisis is often presented as a crisis of competitiveness and flexibility
- But it is not: it is a crisis of managing a common currency area when the criteria for optimality fail

Labour markets in crisis?

- European labour markets have become inflexible
- Many reformed: UK in the 1980s, Netherlands in early 1990s, Germany in 2002-2005
- Reforms are essential in Europe for reasons other than debt management (e.g., for competitiveness and adaptability)
- Debt management and inflexible labour markets got confused with bad outcomes for each

Optimal Currency Area?

- Once the monetary policy tool is removed economic policy becomes more constrained
- OCA requires similar economic structures and business cycles to reduce the risk of different policy requirements
- OCA requires labour and capital mobility to correct imbalances that may require different policies
- Fiscal transfers can also offset imbalances, often recommended in addition to factor mobility

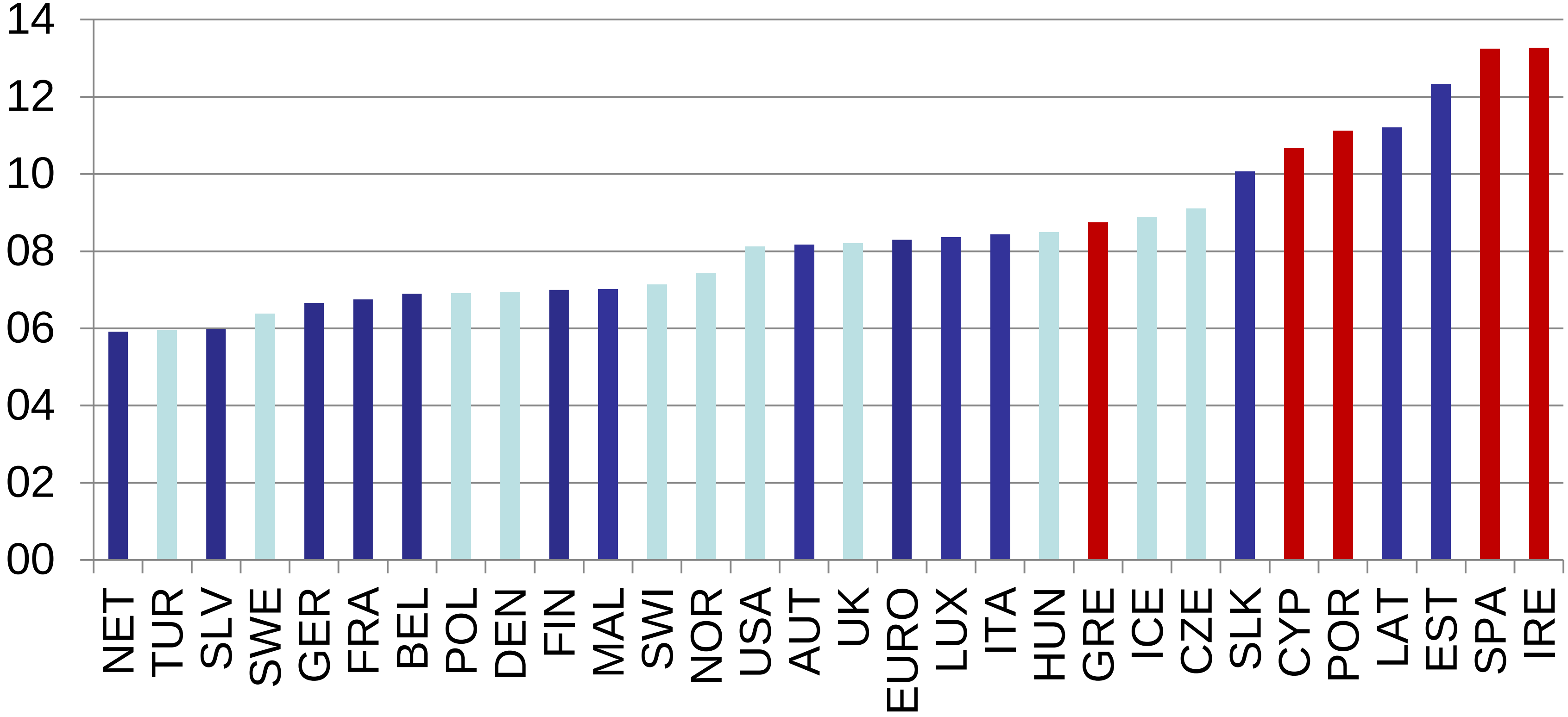
Is the Eurozone one?

- Eurozone excludes fiscal transfers. Maastricht criteria are supposed to make sure they are no needed
- There has been some relaxation recently, with ESM
- Mobility of labour and capital are free
- Economic structures are broadly similar but recent crisis exposed the dissimilarities with bad consequences

The origins of the debt crisis

- Things seemed to have worked well up to the crisis
- But Ireland, Spain, Portugal and Cyprus grew very large construction sectors
- Banks over-extended loans in this sector
- Once the housing crisis hit and governments guaranteed the banks, these countries effectively received a differential shock from the rest of the Eurozone

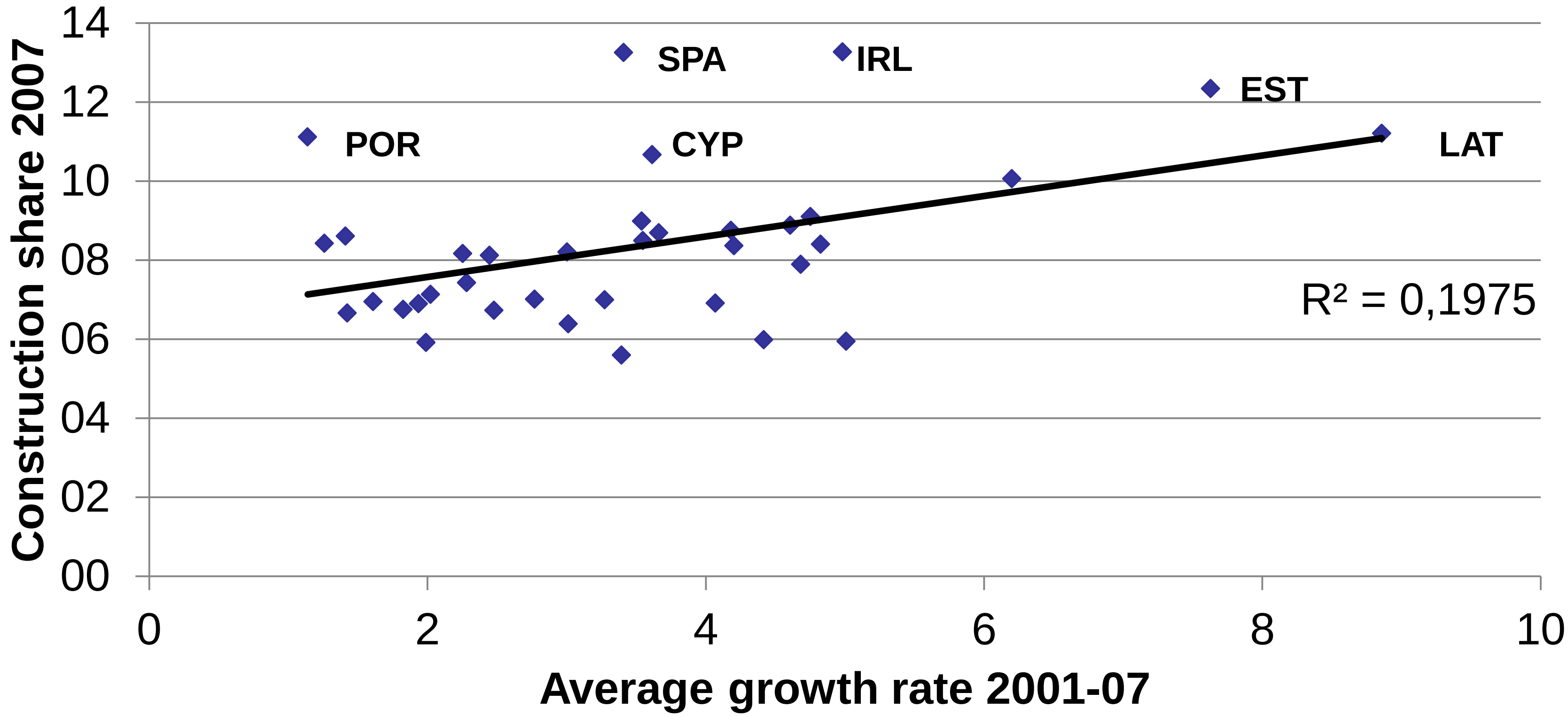
Construction employment shares, 2007 (in red: MoU countries)



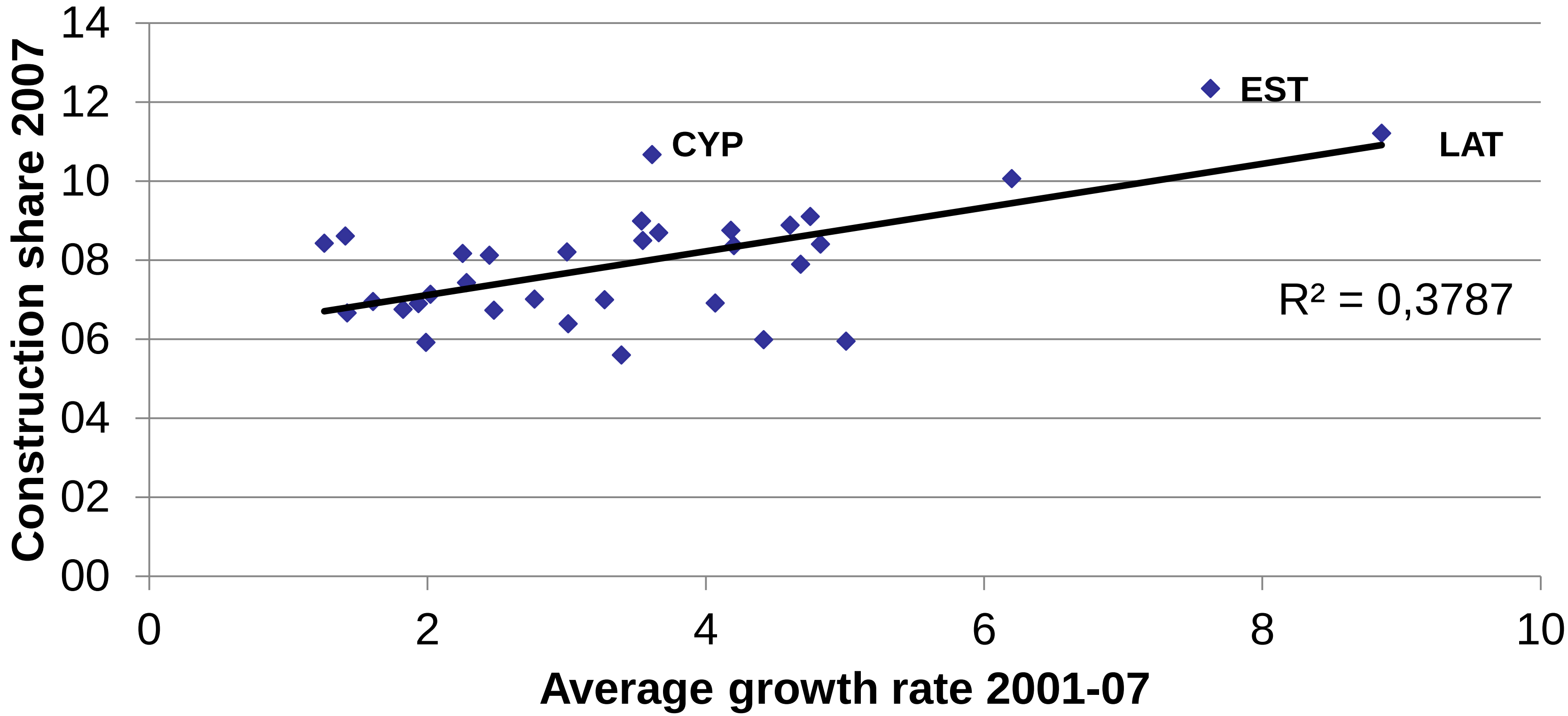
Why not the Baltics and why Greece?

- In the case of the two Baltic states their large construction sectors seemed to be justified by their large growth rates following transition
- In the case of Greece the problem was not so much the bursting of a construction bubble but a large public debt accumulation prior to crisis
- In the case of Cyprus problems from a moderately large construction sector were reinforced by excesses in banking sector and economic mismanagement

Correlation between construction sector size and growth rates



Correlation between construction sector size and growth rates



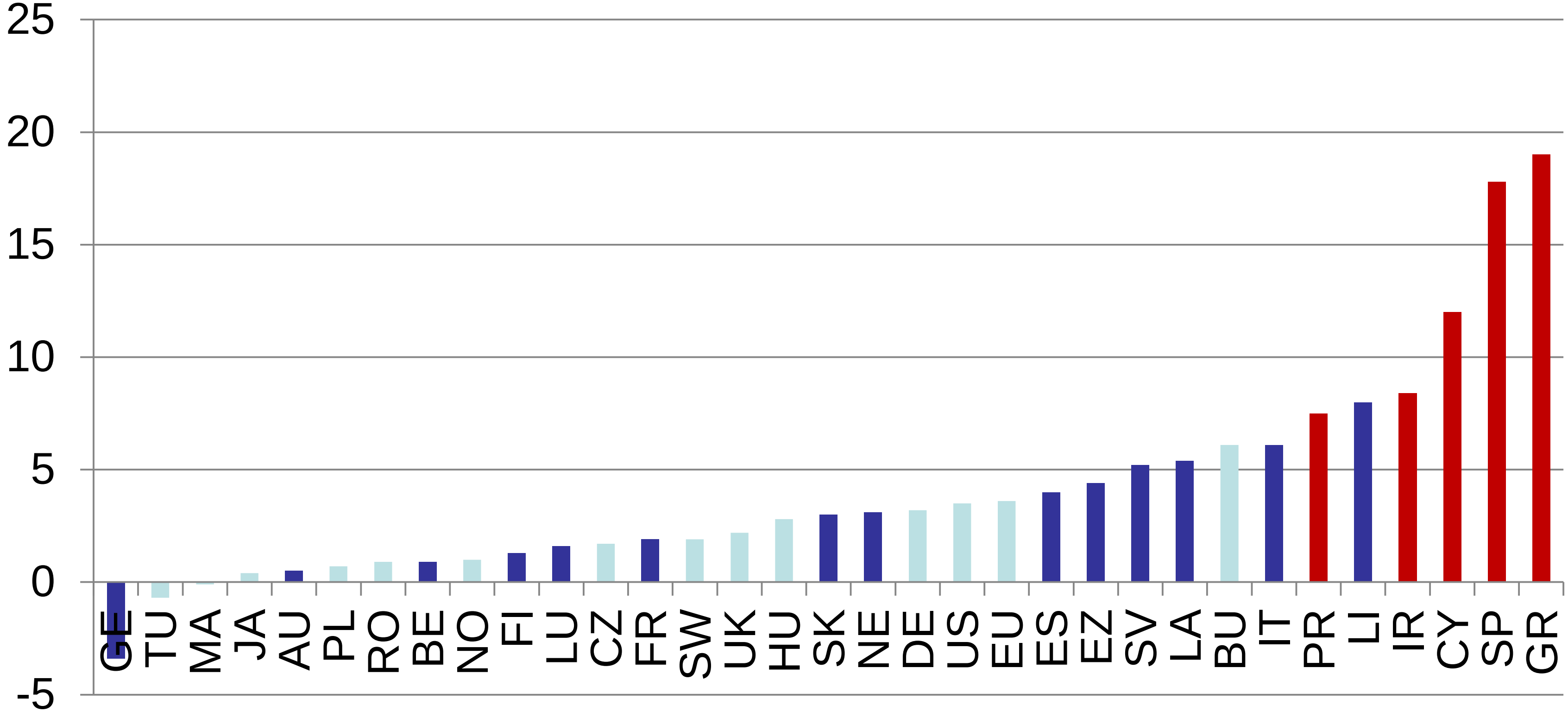
Labour market responses

- With flexible exchange rates, when big negative shock hits a non-tradable sector demand for tradable goods falls and exchange rate depreciates

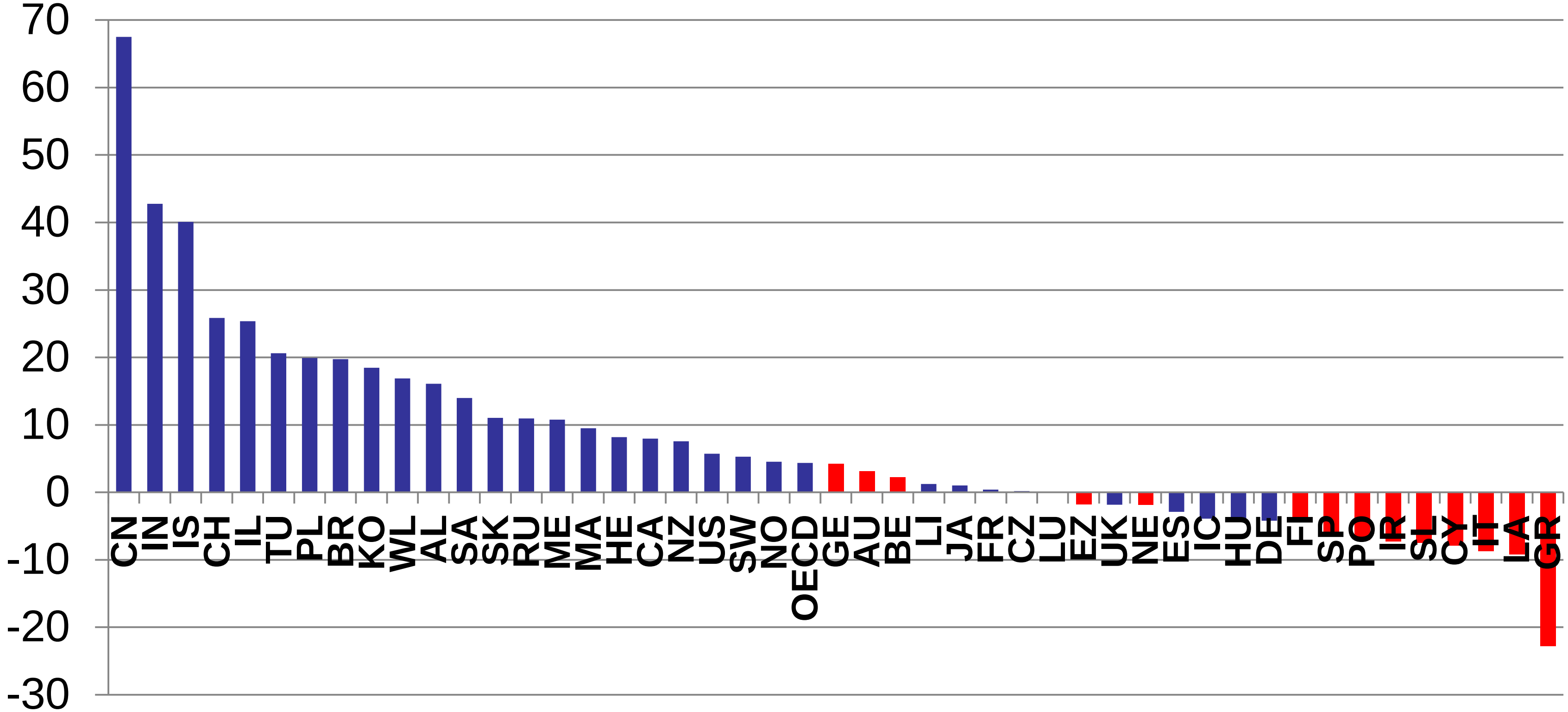
- With fixed exchange rates in a currency area out-migration and deflation of wages replaces this mechanism (or fiscal transfers)

- Unemployment needs to rise substantially to trigger this mechanism – and it did, causing also large recessions

Unemployment change 2007-2012



Cumulative change in GDP 2007-13 (Eurozone in red)



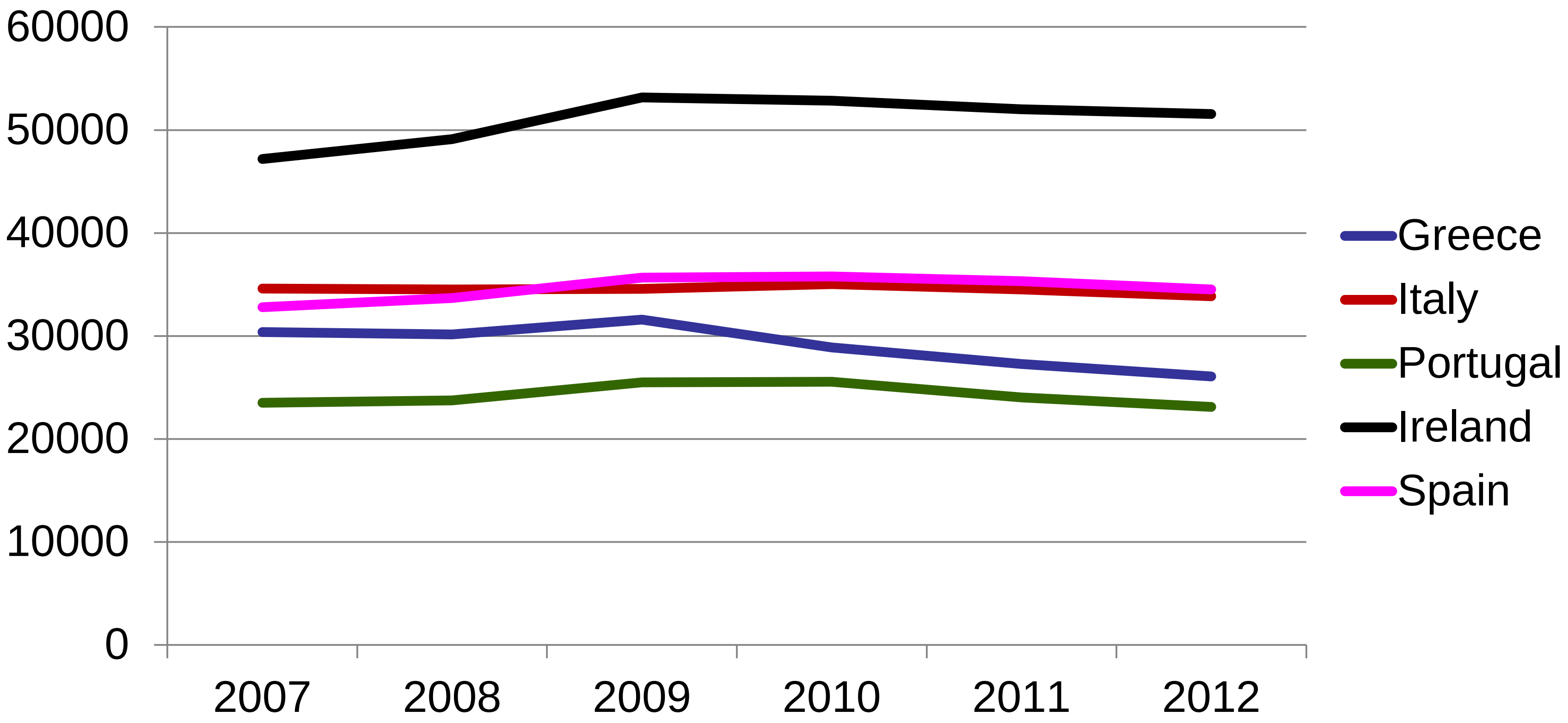
Did recession trigger the right labour market response?

- Migration is not popular amongst Europeans.
- Although some did migrate, it did not act as a corrective mechanism
- It would require massive flows to correct imbalances following the construction and debt shock. Migration not a credible correction mechanism for Europe

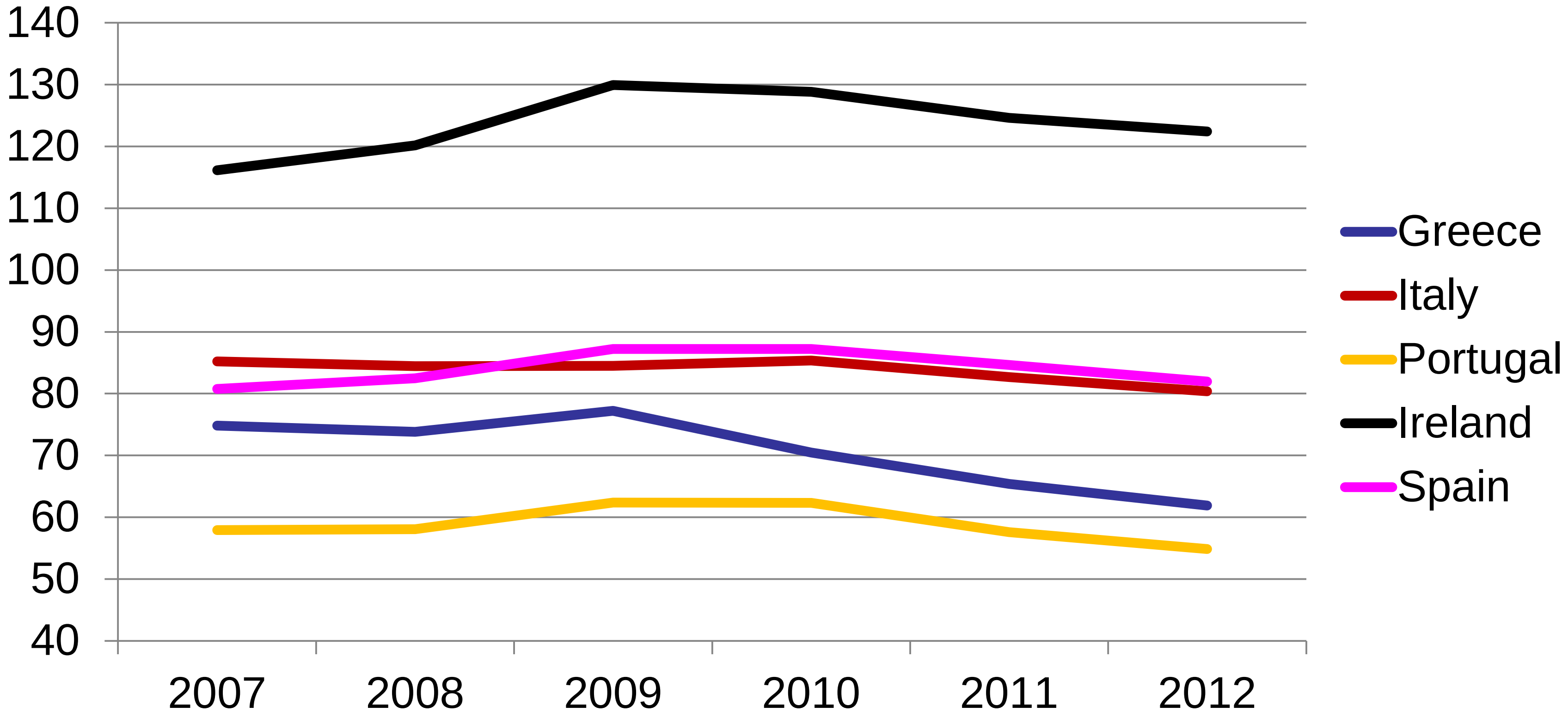
Internal adjustments

- Nominal and real wages fell everywhere in the periphery but only in Greece to a non-trivial degree: 14% fall in real average earnings

Real average earnings, USD PPP 2012 prices



Real average earnings, USD PPP 2012 prices, relative to Germany



Did wage adjustments bring the right results?

- Biggest failure of the combined programmes of debt reduction and economic restructuring
- Massive fiscal retrenchment was reinforced by real wage reductions that spilled out to the whole economy
- Classic Keynesian response of labour markets: negative fiscal multipliers reinforced instead of being offset by wage reductions

Why didn’t wage reductions work?

- For standard Keynesian reasons: deflation does not get a country out of a recession, especially one with large debts
- Wage and pension reductions accompanied by a fall in government spending, tax rises and dysfunctional (home-biased) banks reduce aggregate demand catastrophically
- The real value of debt rises; the troika forces further spending cuts to reduce the debt to GDP ratio; deflation gets worse
- A vicious circle that leads to more debt and unemployment

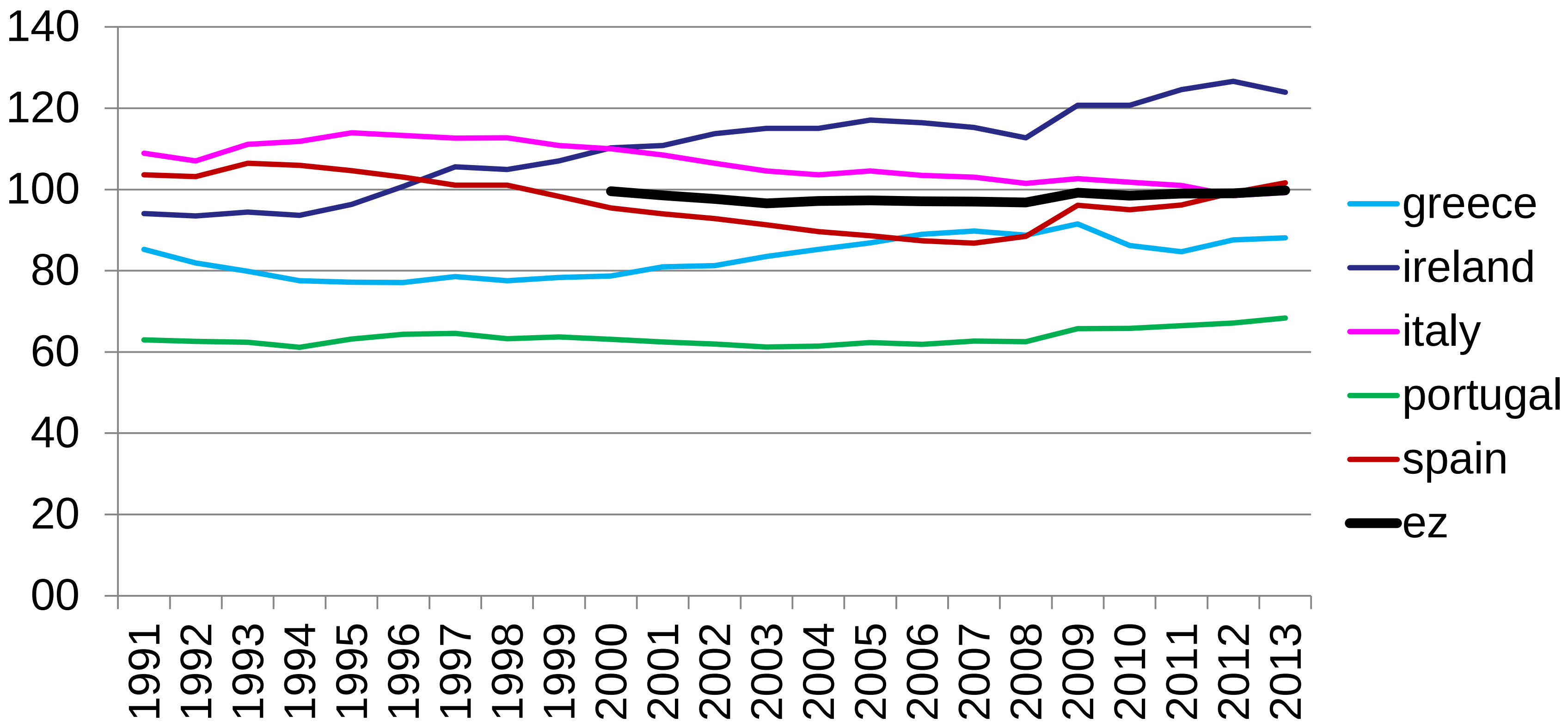
Labour markets at fault?

- One cannot argue that it is because of inflexible labour markets that the Keynesian response happened
- Ireland has flexible labour markets: its aggregates are similar to other countries hit by the construction shock
- In some notable cases (Spain!) labour market rigidities contributed to the rise in unemployment
- But the key reason for Europe's labour markets not working is the deflationary shock following the debt crisis

Are bad outcomes because labour markets failed to reform pre-2007?

- When they joined the euro countries had very different productivity levels
- Nothing wrong with that if exchange rates were right but opening of the gap could have caused problems
- But nothing much happening there

Labour productivity relative to Germany's



Keynesian lessons

- Debt explosion triggered deflationary fiscal policies
- But debt explosion took place because of recession, so deflationary fiscal policies reinforce economic shock
- Optimal policy response is to find expansionary policies elsewhere to offset the two deflationary shocks

Monetary policy

- The obvious alternative is expansionary monetary policy
- The ECB needs to create more inflation that will depreciate the euro and reduce the real burden of the debt; err on the upside on its inflation target
- Bank of England followed similar policy when Coalition government imposed debt-reduction fiscal policies in 2010

What is the ECB doing?

- If we apply the Taylor rule to Europe we find that ECB's policy is close to being good for Germany, badly off the mark for the European South

- With the latest data it's impossible to have a correct policy for all!

Can the ECB balance them out?

(Taylor rule driving variables)

Latest available figures (all per cent)		
	Inflation	unemployment
Germany	1.1	5.4
Southern periphery	-0.26	18.5
Eurozone	0.5	11.7

ECB policies

- ECB could err on the upside instead of the downside (compared to its 2% inflation target) – it tolerated 0.7% inflation with a target of just below 2%, it could have tolerated 3% for the benefit of the debt-laden periphery
- Even at the current average eurozone rates of 0.5 inflation and 11.7 unemployment the obvious policy response is to inflate
- Recent (5.6.14) measures welcome!

North-South divergence

- If convergence is the objective ECB should pay more attention to the south

Per capita GDP, constant prices and PPP, relative to EU average					
	Germany	**Italy**	**Spain**	**Portugal**	**Greece**
1999	122	111	100	85	81
2012	125	95	95	75	75

Lessons from the monetary union

- Fixing exchange rates with single currency and common monetary policy requires closer political cooperation, if not full union
- Market mechanisms in an open globalized world break down when exchange rates are fixed and countries are subject to different shocks
- Need political will to help each other: following independent fiscal policies does not work

Examples where monetary union worked

- United States when West opened up: infrastructure was provided with East Coast money
- German unification: East Germany was kick-started with West German money
- In both cases we had political union!

Conclusions on labour market reform

- Monetary union needs a flexible labour market: ostensibly, the reasons UK and Sweden did not join in 1999 are the inflexible labour markets of continental Europe (including Germany at that time)
- Many countries, especially in the south, still lack flexibility
- Recent structural reforms are in the right direction but they are taking time to have a positive impact and they need the cooperation of all social partners.
- The German reforms of 2002-05 tool place in favourable conditions and still had their impact 4 years later

Conclusions cont.

- But recent problems in European labour markets not due to inflexibility (which contributed substantially to the rise in unemployment only in the case of Spain)
- Eurozone under stress because of differential business cycle shock (associated with construction) for which it did not have a good policy response