Is Europe Working?

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Is Europe Working?

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Regius Chair in Economics Inaugural lecture
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LABOUR ISN’T WORKING.

UNEMPLOYMENT OFFICE

BRITAIN'S BETTER OFF WITH THE CONSERVATIVES.
Did Europe ever work?

• YES: it brought lasting peace to Europe!

• The single market in Europe has been good for jobs and growth

• Trade expanded, the poorer countries caught up and internal migration removed bottlenecks

• It is essential to complete the single market in services because this is where Europe’s future job growth lies
Is Europe still working?

- The single currency seemed to be a great idea as the next step in European integration
- But it back-fired. It is holding back growth and job creation
- Present situation very unsatisfactory: the Eurozone should either be dismantled or the leading countries should do the necessary as fast as possible to make it growth- and employment-friendly
- For the sake of further European integration and peaceful coexistence
Eurozone countries are the laggards of the OECD
Cumulative change in GDP 2007-13 (Eurozone in red)
Cumulative change in GDP 2007-13 (below average EZ)

MoU country average -10.2%
Unemployment rates 2013
(Eurozone MOU countries in red)
Youth unemployment, 2013
age group 15-24
Leading country policies:
Good for Europe?
The political issues
National and European interests

• Despite claims to the contrary, the interests of European countries have never been as diverse as they are today

• National leaders are following policies that are dictated by national interests; not pan-European interests
Why is that?

- The power base of European politicians is their national vote
- They care about their votes in national elections, not in European ones
- Campaigning in Germany for what’s good in Greece will not win you votes!
Why have European voters turned against Europe?

- A necessary condition for integration in the eurozone is transfer of money from the rich to the poor
- Fast integration needs investment in new technology, infrastructure and education
- If countries borrow to fund them, they run into debt problems; if they tax their citizens they hit disincentives
- Convergence needs concerted European action with fiscal transfers
Other countries

- In America, the West was developed with East Coast money providing the infrastructure, delivered via Washington.
- The defence budget and federal taxation are still transferring vast amounts to poorer states.
- West Germany transferred vast amounts of resources to East Germany after the fall of the Berlin Wall.
- China funds infrastructure development inland with East Coast money.
Why not in Europe?

- The Americans, Germans and Chinese pay because they care about the whole of their country

- Europeans don’t feel that way: rich nations regard money given to the poorer ones as wasted
Current policies in Europe
Current transfers

- Some money is transferred in Europe through the structural budget and some through the rescue packages
- But the structural budget is not enough
- And rescue packages come with many conditions attached
Conditions for rescue

- The conditions “agreed” are mainly dictated by Germany with support from some others (e.g., Netherlands, Finland)
- Austerity is the most infamous (more of this later)
- They are very unpopular in the countries seeking loans from their partners
The emperor’s new clothes

• The German/Brussels response is to pretend the problem is not there. Wolfgang Schäuble, German finance minister, in the FT, September 16, 2013, writes:

The world should rejoice at the positive economic signals the eurozone is sending almost continuously these days ... This has taken critical observers aback ... Despite what the critics of the European crisis management would have us believe, we live in the real world, not in a parallel universe where well-established economic principles no longer apply.
• Hernan Van Rompuy, President of European Council, at the *Friends of Europe* conference 2 October 2013

National and European interests coincide more and more ... we need an “ever closer” eurozone... The integration via the euro is so profound that Europe has become part of daily life.... Indeed, to some extent solidarity is a new idea in the Union.
Some views from the parallel universe

- Martin Wolf, FT

If depressions and mass unemployment are a success, then adjustment in the eurozone is indeed a triumph. Mr Schäuble accuses his critics of living in a “parallel universe”. I am happy to do so rather than live in his

- Joseph Stiglitz in Project Syndicate

The euro was supposed to bring growth, prosperity, and a sense of unity to Europe. Instead, it has brought stagnation, instability, and divisiveness
North-South divergence

- Progress since the introduction of the euro: difficult to see the “profound integration”

<table>
<thead>
<tr>
<th>Per capita GDP, constant prices and PPP, relative to EU average</th>
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<tbody>
<tr>
<td>Germany</td>
</tr>
<tr>
<td>---------</td>
</tr>
<tr>
<td>1999</td>
</tr>
<tr>
<td>2012</td>
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</tbody>
</table>
What went wrong?
New lessons

• Both economists and politicians got it wrong with the euro

• The founding fathers assumed each country’s politicians would behave in the interests of the Union: “Solidarity” was the key word

• In fact they more likely tried to exploit the new freedom given them by the monetary union for their own good
Debt crisis

• Large budget deficits and borrowing, debt build-up, over-extended banks

• Confidence now has gone to the other extreme: no trust in political Europe

• Lesson: if the euro is to have a future it needs stricter central control to restore confidence
Economists got it wrong too

- Modern economics is still struggling to find a reason for price stickiness that hurts the real economy.

- In 1990s they were too optimistic about an economy’s ability to adjust to a common currency: although exchange rates are fixed, other nominal adjustments can take their place.

- So they didn’t think freezing exchange rates between North and South would hurt.
Wage reductions

• But this proved wrong: The nominal adjustment that everyone was looking for was wage reductions

• Only Greece has done it to the full: wages came down by 25%. And Italy to some extent

• Even if you turn a blind eye to the riots, the breakdown of social order, the rise of the extreme right and left and the daily anti-German rhetoric…

• … the wage reductions have hurt for pure economic reasons
Why don’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 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
Is there an alternative?

• America is lucky to have a Fed Chairman who studied and understood the Great Depression

• The vicious circle can break only if you **inflate**, not deflate

• The ECB needs to create more inflation that will depreciate the euro and reduce the real burden of the debt; or issue euro bonds that spread the debt burden

• Debt/GDP in the eurozone is less than in the US
What is the ECB doing?

- Economists evaluate monetary policies with the Taylor rule
- If we apply the Taylor rule to Europe we find that ECB’s policy is 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!
The Taylor drivers

<table>
<thead>
<tr>
<th></th>
<th>inflation</th>
<th>unemployment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Germany</td>
<td>1.34</td>
<td>5.0</td>
</tr>
<tr>
<td>Club Med average</td>
<td>-0.36</td>
<td>20.5</td>
</tr>
</tbody>
</table>
Lessons from the monetary union
Exchange rates

• Tying in the smaller unproductive and low-productivity growth economies of the European south with a large high-productivity and high-growth economy like Germany doesn’t work

• Real exchange rates need to adjust and *in theory* adjustment with fixed nominal exchange rate requires either
  – Inflation of prices and wages in the high-growth countries, or
  – Deflation in the low-growth countries

• Germany doesn’t allow the former, Keynesian depression in demand follows the latter
Labour markets

- Monetary union also 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 took place in favourable conditions and still had their impact 4 years later
Austerity and reform

• Austerity has an immediate impact on the economy

• Its large negative effects undermine the reform programme and make it more difficult to reach the longer-term objectives

• Timing of austerity and reform is not conducive to quick recovery and growth

• In the eurozone more attention is paid to austerity and debt levels than to structural reform
Keynesianism once again

• Once again, just as in Thatcher’s Britain, a Keynesian response of the economy to the austerity is what we see; How we respond is political rather than economic

• Gerhard Schroeder in the WSJ recently said German experience with reforms shows that EU should go easy on austerity (e.g., by financing large investment projects) to give the reform programme time

• Schäuble in the FT made the Thatcherite “no alternative” statement: it’s working out nicely…
Banking and fiscal reforms to save the euro
Fiscal and monetary policies

• The lesson of recent events in Europe is that the split between fiscal and monetary policy is untenable.

• National governments need to recapitalise their banks and insure their deposits. This involves fiscal spending and build-up of debt.

• Poor bank supervision can lead to a deteriorating fiscal balance.
Banking union

• A banking union is needed urgently that goes beyond the current proposals

• The current proposals are better than nothing – but too much procrastination is holding them back – instead of 2013, we now expect something by 2015

• We need more powers for the ECB (or independent regulatory authority)
Banking union

• The ECB’s proposals of strong central regulator who would supervise and have powers to order bank closures or recapitalisation is necessary

• All banks should be included, not only “systemic”, to avoid political manoeuvring and tricks played by banks, like splitting up subsidiaries

• Retaining national authorities and working for more cooperation, as Germany requested, won’t work. we need a large central fund for insurance
On the ground

- European banks have never been so home-biased as now
- They are concentrating on their sovereign’s debt and lend domestically
- Not surprising – but sharing risk across the Eurozone necessary if the group is ever going to work as a single monetary unit
Restoring trust

• There is no trust now in each other’s banks

• Of course, with trust a decentralised supervisory authority can work

• But it has failed badly: we need the central control to bring back trust
Fiscal policy

- We also need at least some central control of individual countries’ fiscal finances.
- But large fiscal transfers are not palatable to European voters.
- With some control over national budgets, large transfers will not be necessary and the present system might be sufficient.
Fiscal supervision

- Fiscal supervision is necessary. The European Commission does some but it will be more credible if it is done by an independent body – a Brussels-based ‘fiscal policy council’ (FPC).

- Some fiscal transfers will always be necessary but they will be minimised if there are early warning signals from an independent FPC that worked closely with national FPCs.
Conclusions

• Current Eurozone policies are not conducive to growth – or to a healthy future for the single currency

• Keynesianism is back with a vengeance

• We need coordinated investment policies to enrich infrastructure and create jobs

• Austerity and structural reform need to be better coordinated
Final remark

• The single currency is holding job creation and growth back: Europe is the sick man of the global economy

• Urgent coordinated action is needed either to dismantle it or rescue it, for the sake of European integration

• And for the sake of the lost generations of youths without prospects of a job
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