BOOSTING EU COMPETITIVENESS: THE ROLE OF THE CESEE COUNTRIES

NATIONAL BANKS OF AUSTRIA AND POLAND CONFERENCE AT WARSAW, OCTOBER 2015

SUMMARY OF SPEECH BY PETER SINCLAIR ON LABOUR MARKET ASPECTS

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1: The recent record is a Curate's Egg: there are good and less good parts. Good: evidence of continuing convergence in wages and living standards between the previous EU core and 2004's new members- on a PPP basis, OECD data tell us that, for example, Poland's average wage rose from under half in 2000 to 54% of Germany's in 2014; growth convergence; downward unemployment trend in the new members. Less good: EZ-19 lost 4,997,000 jobs, 2008-14; but NEZ-9 gain 108,000 (Eurostat data); despite strong gains by Germany, EZ aggregate real GDP growth and unemployment since 2008 discouraging - outperformed by Canada, Japan, US and non-EZ EU; post-2007 intra-EZ12 unweighted unemployment variance jumps tenfold against 2000-7.

2: Gali's (nber wp 21430, 2015) EZ-US aggregate comparisons on Phillips curves: unlike US, EZ exhibits hysteresis, a near-unit root, and recently, super-flat Phillips curves. But to me, unscrambling the aggregates post-2007 nuances this: the big-economy French, Italian and German money wage increase / detrended gdp PCs are indeed roughly horizontal, and Germany's may slope up, but Irish, Greek, Portuguese and Spanish PCs are varied, all downward sloping - and all convex.

3: the unhealthy Mediterranean economies show growing real estate booms, external uncompetitiveness and large private/public borrowing pre-2008; since then, monetary policy was limited by ZLB and destabilized by Walters mechanism (union-wide nominal rates imply lower real rates and extra spending where labour is tighter, and the opposite elsewhere); fiscal reflation has been blocked by Maastricht breaches and tough bail-out conditions.

4: some non-EZ countries also suffered grievously from the GFC: e.g. Hungary. Currency mismatch underlay this: Euro-denominated debts jumped in local currency after devaluation, for example. But there, and in Latvia (see Blanchard-Griffiths-Gruss Brookings PEA 2013), GDP bounced back very much faster than in the Mediterranean EZ. In future, macropru in non-EZ countries should presumably limit net borrowing in euro or, like Serbia, initiate full-scale de-euroization.

5: Several arguments commend keeping the EZ intact: (a), depreciation-triggered inflation in a departing country borrows jobs at a huge interest rate; (b), surprise inflation can't bring a "gentleman's default" since debts are fx-denominated; (c) an independent floating currency can dampen foreign shocks but amplify home ones; (d) market wolves ask "Who's next?" (e. g. ERM 1992-3, Gold bloc 1936); (e) value of waiting - dissolution easier to postpone than reverse; (f) sunk costs are bygone; (g) euro is ironically often most popular in the most troubled EZ countries.

6: real exchange rates can in practice be quite flexible for a troubled currency union member. IMF data suggest relative real unit labour cost depreciation, 2010 to April 2015, was: 21.1% in Greece; 5.1% in Italy; 10.5% in Portugal; and 27.3% in Spain. Unless delayed or neutered by factor market irreversibilities, an adverse labour demand shock should cut the real wage or employment dimensions of the wage bill – or both. EU economies differ here: in Greece, nominal wage and GDP deflator fell

almost in parallel 2008-13, so employment tumbled 20%; Spain's changes were smaller but similar; but Italy's average product real wage fell little more than jobs (4.3% against 3.8%). In the UK, this period saw jobs grow by 1.6% while product real wages fell 5.1%. In the UK, as elsewhere, concern has centred on labour and total productivity. Here hourly labour productivity (HLP) seemed to collapse, due in part to factor substitution – for all but the largest firms, a much higher cost of capital and much cheaper labour; but data are iffy: post-2008 official estimates of whole economy HLP changes have been repeatedly later revised up, more than down, by what on the latest figures adds up to a cumulative 12%.

7: Alesina et al (Austerity 2009-2013, nber wp 20827, 2015) find that tax increases have been more contractionary than spending cuts. Nonetheless, euro-retention is insisted on by or for troubled EZ countries, tax increases are presumably unavoidable. Farhi-Gopinath-Itskhoki (FGI, nber dp, 2011) give a model of "fiscal devaluation" – a country in "fundamental disequilibrium" with a binding nominal exchange rate commitment can replicate the effects of the banned devaluation it needs, by raising VAT (added on imports, rebated on exports) and using proceeds to subsidize employment. (Marginal employment subsidies, especially for youths, have many attractions). Imbalances between the markets for labour, and for traded and non-traded goods, should go.

8: Brussels-Frankfurt-London consensus says to work, a monetary union must also be a fiscal union. FGI provides one of several powerful counterarguments to this view. Another turns on the severe disincentive effects and revenue losses when a poorer country, with modest non-work benefits and a stepped marginal income tax structure, has to adopt a richer neighbour's system with bigger transfers and income tax exemption limits. And a related problem is regional destabilization: under current arrangements, emigration from a heavily indebted country just raises the debt charges falling on those who stay behind. (Detroit). A solution to that: income tax is collected by the host country but paid to the source country's authorities, and based on the source country's tax scales.

9: If EZ fragmentation is unthinkable, the *Impossible Trinity* implies that restrictions on international capital movements might sometimes have to be imposed. Their recent emergency use in Greece and Cyprus was accompanied by the "corralito" limit on cash withdrawals from local banks. But the two types of intervention are quite different. They do not have to be combined. Memories are fading, but post-WW2 west European experience of multiple exchange rates and external capital controls (ECC) is substantial: France, Italy to 1990, the UK up to 1979, and BLEU 1959-74. Transitional ECC, possibly quite long-lasting, and realistic government debt write-downs, might be perfectly natural bedfellows in very serious cases.

10: Dams to stop cross-border capital movements can leak. They are never first best. Yet they need not restrict workers' freedom of movement. Aoki-Benigno-Kiyotaki (CEP dp 921, 2009) show that their removal brings a temporary downturn, but longer term gains later on, in financially mature economies – and the exact opposite where borrower quality is poorly perceived by lenders. Where insurance and lending are conducted largely within extended families, loan-making banks face a big lemons challenge, especially if they are foreign, and the quick boom - long bust pattern may well ensue. ECC seem most natural in any part of the world where families still form the bedrock institutions, and governments are not greatly respected, weak, and chronically cash-strapped.