AUSTERITY and its ALTERNATIVES

Internal Devaluation and its Outcomes in Southern Europe

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ABOUT US

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Introduction

During the early 2010s, the Southern member states of the Eurozone were strongly pressured by Eurogroup partners and creditor institutions to resolve their external debt imbalances through a strategy of internal devaluation. This strategy had two principal components. The first was fiscal austerity, applied at the height of a severe recession. Such pro-cyclical fiscal consolidation would dampen domestic demand and thereby contribute to external deleveraging and a fall in imports. The second component were labor market measures including cuts in employment protection and unemployment benefits and the decentralization of wage bargaining, all of which were designed to intensify downward wage pressure (for example see Asmussen 2012; Trichet 2011; Draghi 2012, 2014). To different degrees and with some different components, the governments of Greece, Italy, Spain and Portugal all responded to these demands, which aggravated recessions in all four countries.

It is now widely recognized that the combination of fiscal austerity and labor market deregulation during the financial crisis aggravated recessions in all four of the Southern European countries. However, from a political economy perspective, the strategy of internal devaluation through demand repression and labour market deregulation also entails serious questions about the type of recovery (or "growth model") that Southern Eurozone states will be able to pursue within the currency union. The strategy assumes that these types of measures would eventually allow the Southern states to achieve an export-led recovery. But the growth model literature tells us that growth based on domestic demand and wage-repression also has significant distributive consequences that, in turn, can also affect future growth (Baccaro and Pontusson 2016).

Because of their membership in the currency union and because of the way Southern Europe has been integrated into global production chains, the effort to rebalance external accounts through a strategy of export-led growth is also likely to present these countries with a particularly acute trade-off between moving up the value added chain –the "high road" of specialization in higher wage/higher productivity sectors –with poor overall employment growth or moving down the chain in order to attain higher employment growth. The focus on fiscal consolidation at a time when unemployment levels remained so high is also likely to be particularly punishing for public investment in these countries, another factor that the supply-side focused literature on growth models (Beramendi 2015) tells us is critical to the achievement of growth with more equitable outcomes.

In a set of papers (Perez and Matsaganis 2017; Matsaganis and Perez, under review) Manos Matsaganis and I have looked at the effects of fiscal consolidation at the height of the European sovereign debt crisis on distributional outcomes in Southern Europe and at the impact of labor market deregulation on exports and employment growth. In the second paper we ask, in particular, whether attempts to start recoveries through internal devaluation "within the Euro" likely to produce sufficient employment to reverse the demographic damage inflicted over recent years.

In what follows, I summaries the key finding of he two papers. On both counts – fiscal consolidation and labor market reforms – we observe a paradoxical finding. Italy, the country now often seen as the main case of failure for having imposed the smallest fiscal adjustment and the most delayed process of labor market deregulation, has in more than one way (not commonly recognized) paid the smallest overall price in terms of employment over the last decade. In addition we find that labor market deregulation, pursued much more aggressively in the other three cases (but in particular in Greece), has failed to reduce labor market dualism. And success in the area of exports has not translated into success in overall employment creation. Overall, the outcomes we observe suggest that internal devaluation in the absence of more aggressive macro-economic promotion of growth in the Eurozone cannot provide a viable growth strategy to the Eurozone's South.

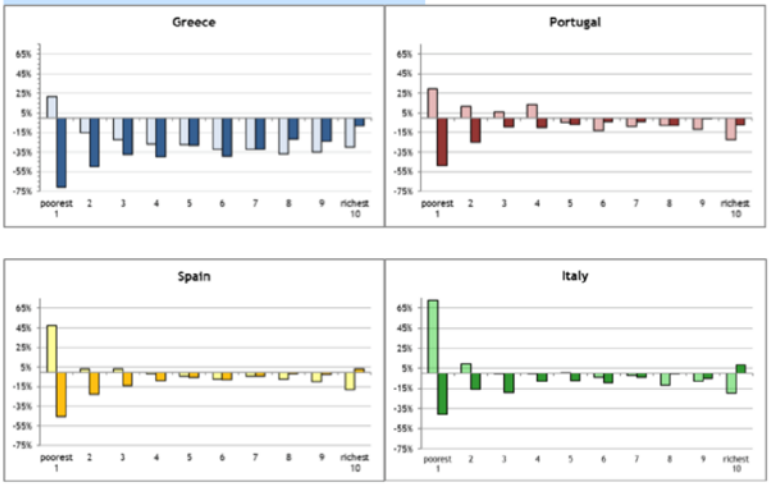
Fiscal Austerity & Distributive Outcomes

In our paper on the effects of fiscal austerity measures on disposable incomes and income inequality, we argue that such affects can be divided into three categories: A set of first (a) and second (b) order short term effects, which include a) the direct and immediate effects of consolidation measures such as higher taxes, lower benefits and public sector job losses and wage cuts, as well as b) fiscal multiplier effects that come from lower consumption and investment, depressed profits wages and higher unemployment. When it comes to growth, the austerity measures carried out principally in the period 2009-2013), also are likely to have separate long term effects on future productivity that come from cuts in public investment, including infrastructure, education and health.

Measures of income inequality suggest that inequality went up during the period of the most severe austerity measures in all but Portugal (in terms of its Gini coefficient), and that this happened in all countries because of the disproportionate impact on the lowest end of the income distribution (including in Portugal).

Figure 1

Income growth by decile (2009-12)



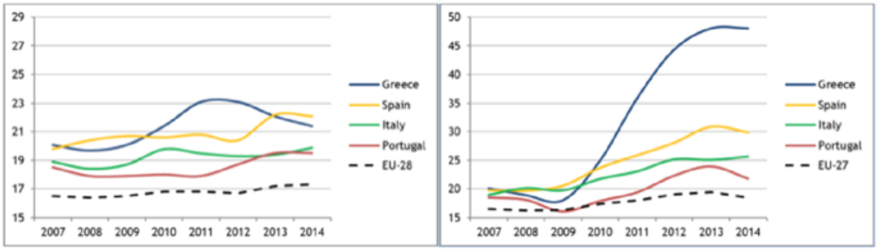
Note: Change in equivalised net disposable household income, in 2012 relative to 2009, in constant prices, by decile. Households ranked as in 2009 (light bars) and as in 2012 (right bars) respectively. Income reference years. Negative incomes set to zero.

Source: Own elaboration of EU-SILC longitudinal panel.

The most perturbing outcome, however, was a sharp rise in poverty levels, in particular if we anchor the poverty threshold in the year the recession started (anchored poverty). We believe that the fall in median incomes was large enough that the latter measure offers a better picture of the social impact of the crisis in the austerity period. The median income sets the basis for the poverty threshold.

Figure 2

Poverty (2007-2014)



Note: At risk of poverty rate (cut-off point: 60% of median equivalised income after social transfers). Left-hand panel: moving poverty threshold [ilc_li02]. Right-hand panel: poverty threshold anchored in 2007, adjusted for inflation [ilc_li22b]. EU-SILC survey data. Income reference years.

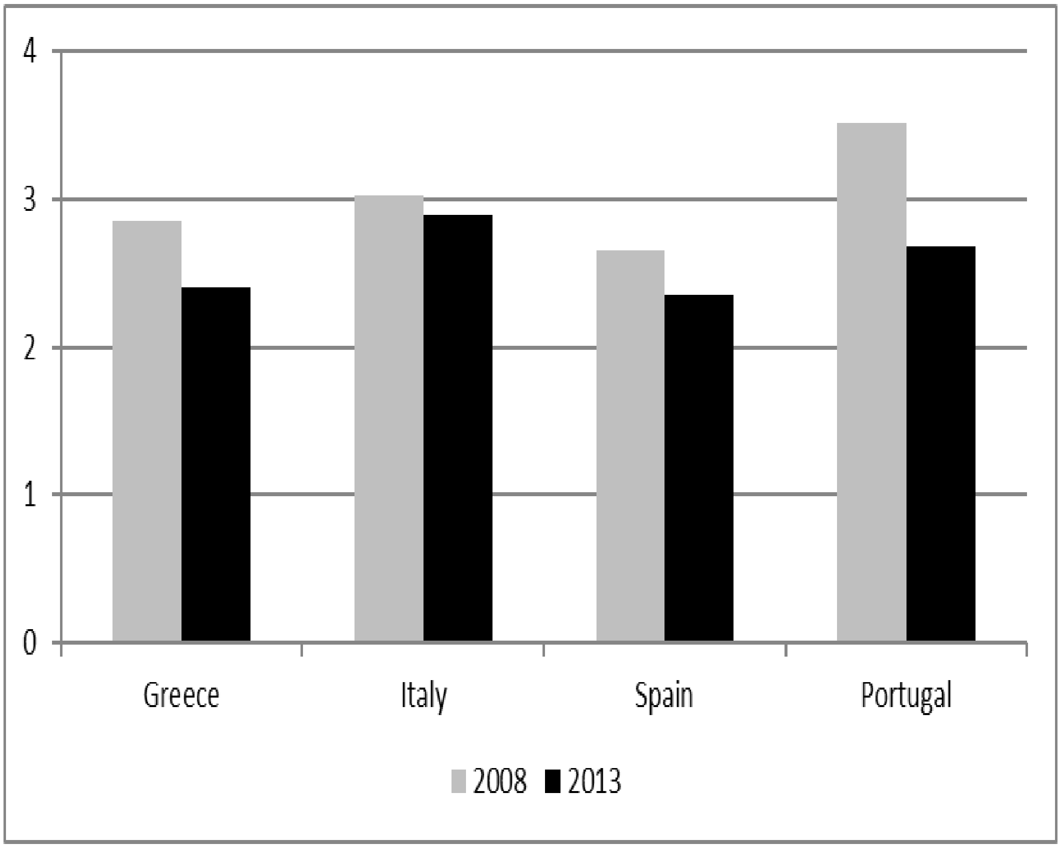
Source: Eurostat (extracted on 11 April 2017).

Our estimates of the contribution of fiscal austerity measures to these outcomes (which, following Matsaganis and Leventi (2014) are based on the EU tax-benefit microsimulation model (EUROMOD)), distinguishes between the direct impact of various types of fiscal consolidation measures from that their indirect second order effect.7 And they suggest that first-order effect of many austerity measures was to reduce inequality by compressing incomes downward while simultaneously causing low incomes to fall, thereby raising poverty. These direct effects of austerity policies were responsible for the bulk of the estimated rise in poverty (except for Greece) even as they reduced the Gini coefficient. But any reduction in inequality due to the first-order effects of austerity was wiped out by the second-order effects in all but Portugal (Table 2). In other words, even though austerity measures were often designed to limit a rise in inequality (in particular, but not only, in Portugal), their negative macroeconomic impact in turn raised inequality and pushed more people into poverty due to unemployment. With higher unemployment syphoning off even more government resources (despite quite draconian cuts to unemployment benefits in all but Italy) these measures created a vicious circle, which played its own role in raising government debt levels across the four cases.

Labour Market Deregulation, Internal Devaluation, and Employment Growth in the Euro South

By intensifying the fall in domestic demand and economic activity, pro-cyclical fiscal consolidation not only increased income inequality. It also contributed to the internal devaluation in labor costs that all the countries except Italy experienced. To reinforce this effect, the Southern states of the Eurozone were asked to implement labor market deregulation measures that were considerably more drastic than reforms carried out in prior decades. This short paper is not the place for a comprehensive description of these measures (for good summaries see Moreira et al. 2015; Afonso and Bulfone forthcoming; Cardoso and Branco 2015). But they resulted in significant reductions in employment protection levels, significant reductions in collective bargaining coverage, and significant reductions in unemployment benefits. Prior to the 2015 Jobs Act, Italy was the exception. But that country also did not have a fully universal unemployment protection scheme at the start of the period. And largely for political reasons, it took longest to implement the most radical labor market liberalization measures. Although we agree with Myant (2016) and others that it is often a misleading indicator, the relative importance in employment protection (at least through 2013) is reflected in the OECD's measure of the strictness of employment protection for individual dismissals.

Figure 3: Change in OECD Index of Employment Protection Regulation (2008-2013)



Notes: The indicator (EPR_V3) measures the strictness of regulation of individual dismissal of employees on regular/indefinite contracts. It incorporates 9 data items.
Source: OECD indicators of labour market regulation. Extracted on: 02/11/2018.

There can be no doubt that the labor market reforms coupled with the fiscal austerity measures worked as advertised to reduce wages. Real compensation of employees per hour worked in 2010-2013 fell cumulatively by 16.2% in Greece, by 7.3% in Portugal, by 5.7% in Spain, and by 3.7% in Italy. In contrast, in the Euro Area as a whole, the indicator went up, albeit very slightly (by 0.4%). Wage moderation also continued after 2013, with real hourly compensation of employees in 2013-2016 virtually zero in Greece, Portugal and Italy, and rising only slightly in Spain (by a cumulative 1.7% over the period, compared to 3.6% in the Euro Area of 19 countries).

Unit labour costs also fell, though not in line with wages, as labour productivity growth also varied. Comparing peak to trough, nominal unit labour cost declined by 11.0% in Greece (in 2010-2016), by 6.5% in Portugal (in 2009-2014), and by 5.7% in Spain (in 2009-2016), while it kept rising in Italy (by 8.3% in 2008-2017, relative to 9.7% in the Euro Area as a whole). On the whole, with the exception of Italy, labour cost competitiveness in the South improved considerably vis-à-vis the rest of the Euro Area, at least when measured at the level of economies as a whole.

By contrast, when it comes to the success of internal devaluation in facilitating a shift to export-led growth, the evidence is less compelling. In Greece, where internal devaluation was massive, export performance was poor by contrast, with the volume of goods and services exported between 2010 and 2013 rising by a mere 2.7%. In Italy, where labour costs fell less than in the other three countries, exports increased more significantly, though still not as much as in the Eurozone as a whole (by 8.4% vs. 10.6% over the same period). Exports grew fastest in Spain (by 13.2%) and Portugal (by 18.4% in 2010-2013) in the immediate aftermath of the major reforms. And this pattern also persisted in the subsequent three-year period (2013-2016), with exports growing by 17.3% in Portugal, followed by Spain (14.6%), then Italy (10.2%), and Greece (9.3%) relative to a Eurozone average of 14.4% for the period.

If internal devaluation failed to produce export-growth consistently in Southern Europe, its success in kick-starting growth was even more equivocal. Once again, Portugal and Spain did better than Italy and Greece. However, in Portugal, where the fall in wages had been second only to that in Greece, and the shift to exports was greatest, cumulative GDP growth was only 4.3% in 2013-2016. By contrast, in Spain, where internal devaluation had been less dramatic than in Portugal and export performance less spectacular, the economy grew twice as fast (8.3% over the same period). The recovery was sluggish in Italy (+1.9% over the three-year period), and virtually non-existent (+0.2%) in Greece.

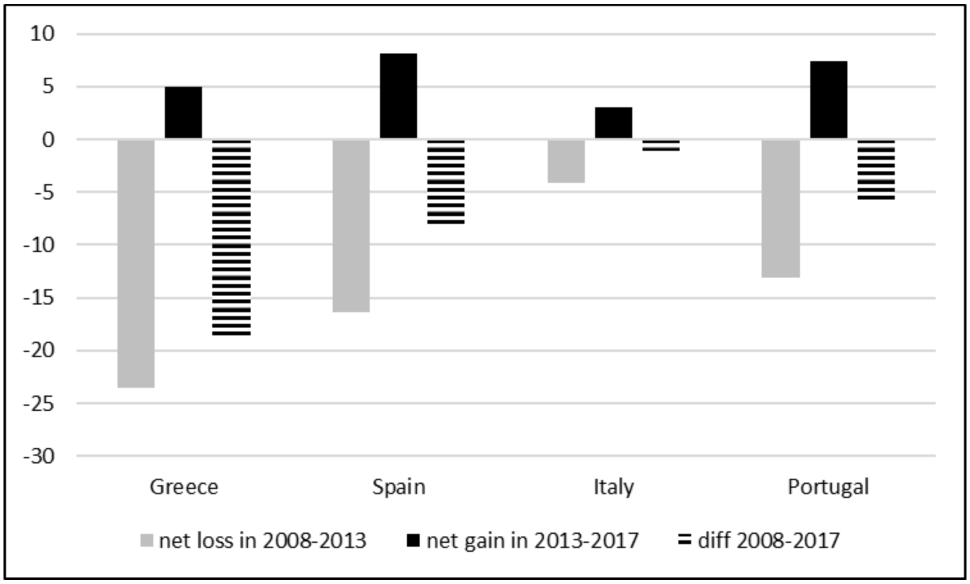
Internal Devaluation and Employment

However, where the internal devaluation experiment really appears to be failing is in the area of employment creation. In Greece, net job creation[1] since 2017 had made up for only 21% of the net job destruction during the Great Recession and the Eurozone crisis (2008-2013). In Spain and Portugal, the equivalent ratio was 50% and 57% respectively. In Italy, where fiscal adjustment had been considerably milder and wages had fallen less, by contrast, the ratio was 73%. In the Euro Area of 19 member states, more jobs were added in 2013-2017 than were lost in 2008-2013 (a ratio of 106%). Thus, while Spain and Portugal have received a great deal of favorable attention for being on the path of recovery (OECD 2018, pp. 221-226),

1 Note that job creation and job destruction take place simultaneously at all times. The difference between the two is 'net job creation' (or, when it is negative, 'net job destruction'). Note also that, strictly speaking, since it is possible for a worker to hold more than one job at the same time, changes in the number of workers in employment (as reported in the text) need not be identical to changes in the number of jobs.

unemployment levels remain very high in spite of internal devaluation. Indeed, the total number of workers in employment[2] (Figure 4) remained lower in 2017 than it had been in 2008 in all four countries. Ad Italy, where the internal devaluation strategy has been pursued most mildly and slowly, also turns out to have suffered the lowest net job losses.

Figure 4: Total Employment Change (2008-2017)



Notes: The grey bars show the difference in numbers of workers in employment in 2013 relative to 2008. The black bars show the difference in numbers of workers in employment in 2017 relative to 2013. The striped bars show the difference in numbers of workers in employment in 2017 relative to 2008. All three differences are normalised as a percentage of the number of workers in employment in 2008.

Source: Eurostat, Employment by sex, age and citizenship (1 000) [lfsq_egan], SEX: Total, AGE: From 15 to 64 years, CITIZEN: Total, UNIT: Thousand. Last update: 04/10/2018. Extracted on: 02/11/2018.

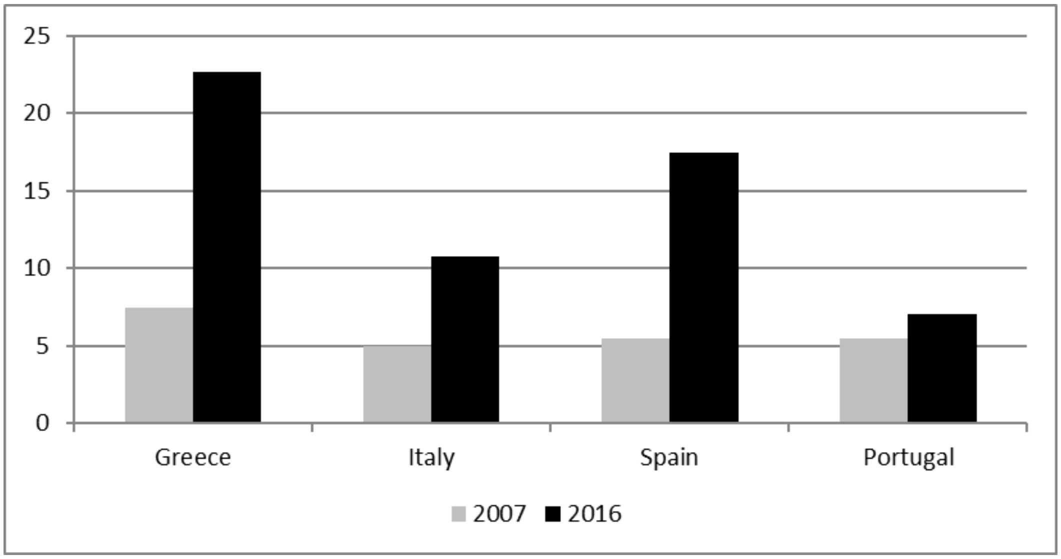
Employment growth in Southern Europe looks even more disappointing when we compare numbers of hours worked at different points in time rather than the number of workers employed. The share of full-time work has declined over the

2 Since the size of Southern European workforces has changed significantly (and differently) in recent years, the number of workers employed (or, arguably, of hours worked) is a better indicator of job growth than the employment (or unemployment) rate. The decline in fertility is one reason for that. The rise of migration out of Southern Europe is another. The combination of both, and with migration into Southern Europe, has resulted in shrinking populations in Greece and Portugal (by -3.3% and -2.5% respectively in 2010-2017), and stagnant population in Spain (+0.1% over the same period). In Italy, the effect of immigration more than offset that of emigration and low fertility (+2.4% in 2010-2017). In the EU as a whole, the population grew by 1.7% over the period.

period. While still less widespread than in the rest of Europe, part-time work has gained importance in all four countries, especially in 2008-2013. And most significantly, the percentage of part-time workers that are so involuntarily is considerably higher than in the rest of the Eurozone: 70% in Greece, 62% in Spain, 61% in Italy and 36% in Portugal, compared to 11% in Germany or 7% in the Netherlands. And compounding this trend towards involuntary part-time work, the relaxation of employment protection for indefinite workers has also failed to limit the tendency of business across Southern Europe to resort to fixed-term contracts. This is particularly striking, given that the objective of ending labour market dualism (between 'insiders' on permanent contracts and 'outsiders' on temporary ones) was offered as the principal justifications for labour market reform in Portugal, Spain and Italy.

The emerging picture is that the labour market reforms carried out in the four countries have resulted in persisting, when not rising, labour market insecurity. This pattern is also confirmed by OECD estimates of the expected monetary loss associated with becoming and staying unemployed (Figure 5). Between 2007 and 2016, that loss rose threefold as a share of previous earnings in Greece and Spain, twofold in Italy, and less starkly in Portugal.

Figure 5: Expected Loss Due to Unemployment (2007-2016)



Notes: Expected monetary loss associated with becoming and staying unemployed as a share of previous earnings.

Source: OECD indicators of labour market insecurity. Extracted on: 12/11/2018.

In other words, efforts to pursue economic adjustment by way of labour market deregulation and internal devaluation have not produced either consistent export growth or success in job. At the end of the day, the outcomes across Southern Europe appear to range from the continued failure of the Greek economy to recover, to a situation in Spain and Portugal (the purported cases of success) where employment nonetheless remains lower than in the pre-crisis period, dualism has not been reduced, and job market insecurity has substantially increased.

Indeed, internal devaluation was unlikely to offer a viable strategy for economic recovery in Southern Europe for several reasons. One of these is that labour costs are only a small component of total costs in export sectors. Storm and Naastepad (2015, pp. 966-967), for instance, show that labour costs in 2005 made up only 16% of the manufacturing gross output price in Italy and Spain, 15% in Greece, and 17% in Portugal. And, in their study of the impact of export growth on employment in Spain, Dones Tacero et al. (2017) show that large Spanish manufacturing firms that are most successful in exporting are also those most engaged in labour substitution and least likely to have positive employment spill-over effects to the rest of the economy because of their heavy reliance on external providers. The only way to raise the contribution of exports to employment would be to promote internal hierarchical integration of production chains, or shift export specialization toward lower value added goods that are more labour intensive, which hardly seems desirable. Italian exporting firms, though more concentrated in capital goods than Spanish firms, have also increasingly relied on outsourcing lower skilled work, leading Iapadre (2011, p. 20) to express similar concerns about the possible trade-offs between export specialization in high value added production and overall employment growth.

Conclusion

The outcomes of internal devaluation suggests that there are numerous problems with this strategy for countries that are part of the Eurozone. The combination of labour market deregulation and continued fiscal constraint has meant that labour market dualism persists with larger numbers of people experiencing more precarious work conditions and a greater sense of job insecurity. Emigration has also been a significant result of the combination of austerity, precarious employment conditions, even during the recent recovery, and the stagnation in decent employment opportunities. The rise in in-work poverty has persisted even in Spain, which has seen the most substantial recovery in growth (although only after seeing a degree of job destruction that was second only to Greece), and the rise in poverty levels persist largely because the export-focused strategy has not spilled over into a better recovery in employment conditions in the rest of the economy. On the other and, Italy, where labour market reforms took longest to be implemented – and which has also seen a more limited pace of fiscal consolidation – looks better than is often assumed when we look more closely at how labour markets in the other three countries have evolved.

What is most worrisome, however, is that many of the consequences of internal devaluation – such as the depth and length of the recession in these countries – cannot yet be fully be appreciated. Without more substantial employment growth and the return of better pay and employment conditions, welfare states are likely to be over-burdened. Persisting unemployment, involuntary part-time and temporary work and emigration have put pension systems on an increasingly unsound footing in the South, a fact that is likely to be compounded down the line by a sharp fall in birth rates. How present levels of poverty, unemployment, and job precariousness will affect the future strategies of investment by individuals and firms in skill formation also remains unclear. The growth model literature tells us that high levels of public investment in education, health and infrastructure – one of the first casualties of fiscal austerity in Southern Europe – are required to attain some of the more egalitarian outcomes still appreciated in some (not all) of the Northern member states of the EU. Without other changes in the economic governance of the Eurozone, the strategy of internal devaluation through labour market liberalization does not in any case appear to offer a sustainable growth model for the Southern states. And the poor labour market recoveries we observe even in Portugal and Spain foretell intensified distributive battles in the future, whose political consequences remain yet to be seen.

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