SUMMARY

2012 was another tough year for the world economy, and especially for the euro area. The euro crisis, which developed into more than just a sovereign debt and a banking crisis, intensified during the first half of 2012. This triggered recessions in many member countries, although tensions and fears have abated somewhat in recent months. The underlying roots of the crisis are the balance-of-payments imbalances that accumulated in the years preceding it. This year's EEAG report addresses the resulting need for a major rebalancing within Europe.

Chapter 1 of the report discusses the immediate macroeconomic outlook for the global economy, with a particular focus on the European situation. Chapter 2 focuses on the major macroeconomic imbalances within the euro area and argues that a substantial devaluation in the crisis economies is needed to achieve a sustainable solution. Against a background of surging unemployment rates in many European countries in recent years, Chapter 3 analyses European labour markets, with a special focus on youth unemployment. Finally, Chapter 4 looks at the situation in Europe from across the pond to determine whether Europe can learn any lessons from the historical development of a fiscal union in the United States.

Chapter 1: Macroeconomic Outlook

A renewed escalation of the euro crisis pulled the world economy out of recovery mode in mid-2011. Global economic momentum has slackened since, primarily due to the huge adjustment processes that are currently taking place in the euro area. Especially the bursting of real-estate bubbles in a number of countries led to job-losses and declining income levels, resulting in very high levels of private debt that in many cases are no longer serviceable. This, in turn, created further distress in the banking sector, causing the macroeconomic conditions for finance to deteriorate significantly as the inflow of private capital from abroad dried up, or even reversed in the form of capital flight. The deleveraging of private debt and the reallocation of production factors required to improve the situation will probably take some time. Meanwhile, the problems outlined above are considerably heightened by the state of public finances in the crisis-afflicted countries (Greece, Ireland, Portugal, Spain, Cyprus and Italy).

In response to the sharp increase in perceived solvency risks, these countries have launched extensive austerity programmes and implemented a series of structural reforms in recent years. The resulting contraction in their economies not only carried over to the rest of the world via massively reduced demand for imports, but also through a heightened increase in uncertainty. This, in turn, led to a sharp decline in capital flows to the emerging economies of Asia, Latin America and Eastern Europe.

Some of the economic decisions taken in the summer and early autumn have had a somewhat calming effect on the financial markets. It was agreed in July 2012 that Spain should receive up to 100 billion euros from the ESM's permanent rescue fund to support its beleaguered banking sector. The early election in the Netherlands also handed anti-euro parties a bitter defeat and produced a relatively stable coalition, which has agreed to continue fiscal consolidation. In addition, the German Constitutional Court gave a green light to the permanent ESM bail-out mechanism. Finally, shortly thereafter the ECB announced a new programme of unlimited purchases of government bonds. This reduced the risk of disorderly exits from the monetary union by member states and has since been reflected in lower risk premiums in the European sovereign debt markets. Macroeconomic uncertainty nevertheless remains high and is placing a huge burden on economic development in the European Union, especially in the euro area.

Unlike developed countries, most emerging economies have significantly more fiscal room to manoeuvre and stimulate their economies thanks to their relatively low public debt levels. Many emerging economies are expected to ease their fiscal policies this year, albeit moderately. Monetary policy has already, or looks set to, become more accommodative in these countries too. Furthermore, increasing levels of disposable income should provide an additional stimulus to private consumption. Economic activity in emerging countries is therefore likely to pick up noticeably and should prevent the world economy from slipping into a recession this winter. Global economic expansion is expected to accelerate somewhat over the course of the year, but remain below its potential.

With the contractive fiscal impulse set to have a lesser impact on the euro area than in 2012, the advanced economies should also see slightly higher growth this year. The US economy is also expected to continue along a moderate growth path, i.e. after the negative fiscal shock at the beginning of the year, growth will gradually strengthen again. This will especially be driven by the improving real-estate market, as well as the slowly, but steadily improving asset positions of private households.

In the European economy, domestic demand looks set to shrink further in 2013. Tight fiscal policies, albeit less restrictive than in 2012, will dampen economic activity in almost all member states. The continued deterioration of the labour market and further efforts to reduce private debt will also put an additional strain on the willingness of private households to spend. On a brighter note, expansionary monetary policies and increased growth in exports will allow private investment to stabilise somewhat in the second half of 2013. With imports set to remain very weak, net foreign trade will provide a strong positive impulse and GDP growth in the euro area should pick up slightly over the year, albeit remaining at a low level.

The economic divide among individual member states in the euro area will continue to widen, while aggregate production in most of the crisis-afflicted countries looks set to shrink. Fiscal policy in these countries will be far more restrictive than in the rest of Europe. Although financing conditions in the crisis-afflicted countries have already started to improve, and despite a more expansionary monetary policy, they are likely to remain relatively unfavourable, at least compared to the European core countries. After a temporary period of weakness this winter, stable economies like those of Germany, Finland and Austria will benefit from relatively stronger demand from emerging markets and domestic forces during the rest of 2013.

Chapter 2: European Imbalances

Europe is in the grip of three interrelated crises: a balance-of-payments crisis, a sovereign debt crisis and a banking crisis. Although progress has been made to resolve the sovereign and banking crises in the past four years, policy-makers have paid little attention to the balance-of-payments problem. Yet a credible strategy for getting the euro back on track needs to address this key issue.

Large imbalances have emerged in the euro area since 2000 in the form of current account deficits and surpluses. The euro area periphery countries of Greece, Portugal, Spain and Ireland in particular experienced credit bubbles that led to current account deficits and corresponding capital imports. The Northern core of the euro area, on the other hand, ran persistent current account surpluses. This led to an accumulation of net foreign liabilities in the periphery and net foreign assets in the core. Prior to the crisis the current account imbalances were financed by private capital inflows. When the crisis struck, however, these private capital inflows were increasingly replaced by public flows, primarily by the ECB's Target balances, and to a lesser extent by the various aid packages of the European Union, the ECB and the IMF.

The periphery countries therefore now have to devalue to make their consumers and firms switch from imports to domestic goods, thereby reducing their imbalances. Ireland is the only country to have achieved this to date by cutting wages, contributing to a fall in its price level relative to the core of the euro area. The key policy question is whether the other periphery countries affected by the crisis will also pursue this course, i.e. the course of internal devaluation; or whether they will resort to an external devaluation by exiting the euro area. As yet, no clear answer to this question has emerged. Let us consider the basic mechanism of an external devaluation. As a country devalues, the prices of its exports and imports change, making the former more profitable and the latter more expensive. This boosts exports and reduces imports, thereby improving the current account. Under an internal devaluation, this process – due to price and wage stickiness – takes a long time to complete because it requires higher inflation in the core than in the periphery. Moreover, it is also associated with a prolonged recession and high unemployment because prices only adjust slowly. Under external devaluation this process is completed over a short period of time, since the exchange rate depreciates quickly. Moreover, there is theoretically no loss of output and employment.

Both external and internal devaluation inevitably raise the debt-to-income ratio, which may drive companies into bankruptcy. In addition, the prerequisite of external devaluation is an exit from the euro area, and anticipation of such an event could cause destabilising capital flight and contagion effects. Only an internal devaluation via price increases in the core would be able to improve the competitiveness of the periphery countries without increasing the relative burden of external or internal debt. However, this would violate the ECB's mandate to ensure price stability and would meet with considerable resistance in the core countries, since it would deprive savers in the core of some of their wealth. In other words, the euro area appears to be trapped in a situation with no easy escape route.

Since the beginning of the crisis, the periphery countries have all been undergoing adjustment. Ireland was hit first. It started its adjustment early, introduced decisive policy measures and underwent a significant internal devaluation. The other Southern countries were not hit by the crisis until almost two years later. Given that some of them were largely financed by the ECB, they delayed the reforms required and initially made little progress along the painful road towards internal realignment. Their current accounts improved largely because of a sharp decline in imports due to the recession. In addition to Ireland, Spain was also able to improve its exports, suggesting that it is making progress. Adjustments in Portugal, on the other hand, and particularly in Greece, seem to be slow. According to the data available at the time of writing, Greece has done very little to date to improve its competitiveness.

To help the crisis-afflicted countries get back on their feet, a significant amount of debt needs to be written off. The countries themselves should, in turn, reduce government deficits. Empirical evidence shows that tax-based fiscal adjustments tend to be less successful than their expenditure-based counterparts. The periphery countries should therefore focus more on cutting expenditure than on raising taxes to reduce their deficits.

Chapter 3: Labour Market Reform and Youth Unemployment

Youth unemployment rates in Greece and Spain recently reached alarming headline figures in excess of 50 percent. At the same time, long-term and overall unemployment have grown considerably in the wake of the 2007–8 global financial crisis and the subsequent euro area public debt crisis, with its attendant austerity policies. The unemployment data focus attention on youth unemployment and labour market performance. Why has youth unemployment risen so much? What can and should be done about it? Why has overall unemployment risen so much? What can and should be done? Are labour market institutions at fault in some way? Should they be reformed?

European labour markets feature, to varying degrees, high levels of employment protection, high minimum wages, high taxes, generous unemployment benefits, generous publicly provided pay-as-you-go pensions schemes, pensions available from an early age, and strong trade unions. All of these features lead to a high structural unemployment rate. Public sector employment accounts for a large fraction of the total. The short-term need to cut deficits has led to cuts in the numbers of public employees and in public sector pay, increased retirement ages, and less generous benefits. There have also been moves to cut minimum wages in some countries.

The experiences of Germany, where the Hartz reforms of 2002–2004 lent new dynamics to a sclerotic labour market, and cooperative industrial relations delivered wage restraint from 2001 to 2008, contributing to falling unemployment since 2005, are widely seen as a model. The successes of the Danish (and to some degree Dutch) system of "flexicurity" have been trumpeted repeatedly. However, the large rise in unemployment in Denmark since 2007 casts doubt on its superiority. When demand contracted sharply in 2008, flexicurity naturally enabled Danish firms to reduce their staff numbers rapidly. The labour market policies of the British government lean towards the free-market end of the spectrum. They have delivered a low rise in unemployment, despite the UK's prolonged fall in output. There is a contrast between those countries in which policies that encourage short-time working have spread the cost of the recession and created small increases in unemployment, and others such as Denmark, where employment cuts took the form of a rise in unemployment, rather than widespread reductions in working hours.

Pressure to reform labour market policies and institutions has been fuelled by the need to cut public borrowing. Policy changes in Spain and Italy, for example, have reduced the differences between temporary and permanent jobs, advanced progress towards a single form of labour contract, and reduced employment protection for established workers. However, they have hardly touched upon the problems of youth unemployment and vocational training. There are good reasons why youth unemployment rates are almost always higher than those of older workers, but the current figures nevertheless give cause for concern. The scarring effects of unemployment at the start of, or early in, a working life tend to be lasting. They suggest that resources are being largely wasted, and that many young workers will suffer. The youth unemployment problem is the result of a combination of: (i) two-tier labour markets, in which well-established workers enjoy heavily protected jobs while others, including many new entrants, work in unprotected temporary jobs, and can be dismissed at low cost to the employer; (ii) unsatisfactory arrangements for apprenticeships and vocational education in many European countries; and (iii) the collapse of the house-building boom in Spain and Ireland. These problems tend to go hand-in-hand and have thrown the burden of adjusting to the recession onto young and unskilled workers.

While Germany, Austria, and Switzerland have highly successful apprenticeship and vocational education systems that have been much studied by their neighbours, few countries have been able to emulate them. The German system succeeds in Germany with the support of local firms, chambers of commerce, trade unions, colleges and public authorities: a post-apprenticeship qualification is a legal requirement for those seeking to work in many skilled trades. While the success of the system is envied, its rigidity is an obstacle to its adoption elsewhere, as it channels young workers into a particular occupation at an early stage. In the United Kingdom, by contrast, young workers typically hold a succession of jobs for short periods, interspersed with periods of unemployment, while they look for a suitable career. College training aims to impart general skills, while short apprenticeships are intended to provide on-the-job training and firm-specific skills. Many observers, however, merely regard the latter as subsidised labour for firms. Spain, Italy, and other European countries face similar problems.

While it is tempting to advocate the universal adoption of successful labour market institutions, caution is advisable. Institutions do not transplant easily and what works in one socio-economic environment may not work in another. The social pacts possible in a small, cohesive Nordic country may not be realistically applicable to a large, more diverse society like that of Spain. Besides, beyond the policy changes and reforms imposed by the need to stabilise national debt levels, longer-term changes, aimed at improving the labour market's functioning when growth returns, may increase public spending and unemployment in the short term.

Some aspects of current labour market institutions nevertheless demand attention. Two-tier labour markets – created by introducing temporary contracts, but leaving regular employees well-protected against losing their jobs – have thrown the burden of adjustment onto a small fraction of the labour force. The distinction between regular and temporary employment needs to be narrowed. There is a case for devising procedures for resolving labour disputes, like employment tribunals, that would be able to resolve disputes arising from severance decisions without recourse to very long and costly court procedures. Moreover, the legally enforced extension of pay bargains to all firms in an industry has allowed a few workers in highly unionised firms to impose unsuitable wage settlements on a wider industry, with adverse consequences. Greater flexibility in wage bargaining is needed. Finally, massive improvements are required in the provision of education and training for young people in most European countries, both to improve their level of skills and to reduce unemployment.

Chapter 4: US Precedents for Europe

The discussion of European integration – both in the past and in the future – has largely been driven by analyses of how precedents on the other side of the Atlantic have worked. Two of the most widely debated aspects of US fiscal and financial integration are: (1) the federation's responsibility for state-level debts and the creditworthiness of states; and (2) the working of a federal central bank. Today's fiscal federalism in the United States is relatively robust, but the road from 1790 was rocky; and a closer analysis of the first two decades of the Federal Reserve System reveals that they were filled with monetary mistakes.

In 1790 Alexander Hamilton pushed through an assumption of state debt arising out of the War of Independence. The federalisation or mutualisation of state debt depended on the creation of a fiscal mechanism (a federally-administered customs tariff) producing a stream of revenue to service the debt. The

1790 compromise might be seen as a precedent for limiting the liabilities of the Northern European surplus countries should a common European bond or Eurobond be created. Important parts of Hamilton's financial architecture were not realised, or only realised imperfectly. He proposed a model of joint-stock banking on a national scale, which ran into immediate opposition, and which, curiously, was much more influential in Canada than in the United States. Secondly, his proposal for a national central bank, based on the model of the Bank of England, was eventually blocked by political opposition. Moreover, the choice of the fiscal mechanism to service a federalised debt potentially raises deeply divisive issues about the distributive effects of the tax or tariff on the constituent states, and the customs tariff was at first the major cause of the growing political strains between North and South. The fiscal union was also dangerous because it allowed states to recommence their borrowing. There are strong parallels between the development of American states in the 1830s and that of modern Europe. The American states that borrowed most heavily, and then ran into problems, were the less developed states that saw borrowing as a way of financing development infrastructure, especially in transport. The borrowing states were also keen to encourage the development of domestic financial institutions in order to stimulate growth and development. When problems emerged, discussions centred on whether they were due to external circumstances (a crisis in the world's financial centre, the United Kingdom then, the United States now), to a flawed development strategy, or to governance problems and corruption in both state governments and banks. These issues were extensively debated in the 1840s, and a contrast was made with the position of state finances in the aftermath of the War of Independence. In the case of the US state defaults of the early 1840s, as in that of contemporary Greece, the problems stemmed primarily from misguided policies, and cannot be blamed on external circumstances, war or a global crisis. The eventual solution lay in the adoption of debt restraints or balanced budget laws. A commitment not to renew the assumption of state debts was a condition for the stable financial and political development of the Union.

The question of the relationship of a central federal bank to local banking systems – and to the patronage systems built up by local elites – has always been a highly contentious issue in North American politics from the very outset. The Federal Reserve System relied on a complicated governance system that was designed to preserve checks and balances, and to ensure that the system could be neither dominated by the powerful East Coast financial community, nor by the federal government in Washington. The regional Federal Reserve Banks corresponded to what were felt to be logical economic areas, which did not necessarily overlap with state boundaries. Like national central banks in the international gold standard order, the various American Reserve Banks had their own discount policies and applied different rates – especially at moments of strain. By the late 1930s, the rate differences were disappearing, but they only vanished completely during World War II, for the simple reason that operating with federal bills (a single instrument) in open market operations, rather than with a multiplicity of differently valued private securities, became the primary tool of US monetary policy. When it came to monetary policy instruments, the ECB's founders adopted the practice of the post-war Federal Reserve, and assumed that the debt instruments of different member states could fill the monetary policy role of a single financial instrument (federal government securities) in the case of the Federal Reserve's open market policy. It was only in the 1930s, with the new Bank Law of 1933, that the Federal Reserve System really started to act as a modern central bank.

Interdistrict Settlement Account balances, like Target balances, expanded greatly in the aftermath of the 2008 financial crisis. These imbalances reflect the fundamentally changing market perceptions of US private financial institutions, and they do not display the permanence that has characterised their European equivalents, where banks in deficit countries are paralysed because of the ties between banks and sovereigns (with banks holding the paper of the sovereigns that bail them out). The pronounced differences between the United States and the European settlement processes stem fundamentally from the central fact that the Federal Reserve System as a whole has a sovereign as a counterpart, while the ECB does not. Moreover, only the United States has a settlement mechanism that requires a securitisation of balances. This system has kept the outstanding balances small, and has even created incentives to take countervailing local policy measures to avoid any balances in the first place. A settlement system would protect the European creditor countries against a break-up loss and make them more resistant to pressure to participate in bail-out activities.