The Unemployment Crisis in Europe

The relentless rise in unemployment, particularly youth unemployment in the majority of the eurozone member countries over the last three years is one of the most dramatic consequences of the protracted crisis in the euro area. At this stage, a quarter of young Europeans have no job and face daunting prospects, to say the least, with reference to the possibility of finding employment. Finding measures to mitigate this problem and prevent the deepening of the unemployment crisis has become a major undertaking in Europe.

An effective and wide plan of action with concrete answers to this challenge is needed. The real contribution that Europe can make to the fight against unemployment, including youth unemployment, today is actually linked to the revival of the growth process. In the context of a prolonged overall stagnation in the euro, no incentive to the labor market will be sufficient in the absence of a sustained economic recovery. This applies today, as we argue below, to the profound changes in the austerity policies adopted so far. These policies are at the root of the ongoing crisis and will penalize the European economies for an extended period of time. The recent recognition in Brussels that a further softening of budget-cutting targets is required given the economic reality of record unemployment and a second year of recession in the euro area is not enough. Rather than being abandoned, austerity has simply been prolonged.

Another reason why Europe should act is that Fed Chairman Bernanke recently announced that the several rounds of QE, the greatest experiment in the history of central banking, might be nearing its end. Since 2009, the Fed has been buying financial assets—U.S. Treasury bonds and some types of corporate debt—paid for by an expansion of the monetary base. This kept interest rates low and helped indebted businesses and households. It has also been the major support for booming financial markets.

After the announcement by Chairman Bernanke, there has been a big sell-off of risky assets in emerging markets and, to a lesser extent, in developed markets. It is too early to say whether this is a temporary development or just a moderate de-risking. There are substantial risks with the Fed's exit plan. Stimulatory effects could be reversed before private demand is strong enough and the U.S. recovery might slowdown, taking the entire global economy down with it. Bond yields could rise too rapidly or too unevenly, and become a danger to the financial system. Both effects could have negative repercussions for the euro area and in particular for the peripheral high debt countries. This is yet another reason not to further delay policy reform to boost growth and reduce unemployment in the euro area.

The Recessionary Phase of the Euro Area

The euro area registered its second recessionary phase in the last four years and a very modest recovery of 0.7 percent is expected for 2014 although the unemployment trend will continue. The other very disappointing outcome shown by the data is that the gap between the reasonably prospering North and the struggling South is persistent but has slightly consolidated. Unemployment rates are around 5 percent in Austria, Germany and the Netherlands in 2014, but above 25 percent in Greece and Spain and in the 11 to 16 percent range in Ireland, Portugal, Italy and France.
Despite these alarming trends, the dominant and rather optimistic European view is that the current combination of fiscal austerity and national structural reforms are working well. According to this view, these policies need more time and a more flexible application at the country level to produce the expected results. France and Spain were among those provided with this flexibility to meet their fiscal deficit-reduction programs.

My fear, however, is that this apparent shift in policy amounts to little more than a tactical retreat to respond to the backlash against austerity. Austerity is prolonged through these means, and this strategy will not be sufficient to modify the present negative trends in Europe.

The optimistic reading suggests that the economic performance of high debt countries has in fact started to improve, and an effective adjustment process is underway. It is true that some recent improvements and real adjustments are taking place. A more careful look at the ongoing rebalancing in the euro area and European Union (EU) indicates that, in quantitative terms, the external adjustment of current account deficits is not sustainable and fiscal problems remain devastating. Additionally, rebalancing to-date is predominantly the result of the adjustment in the deficit. The main issue is that the improvement of the deficits and economies of these member countries largely reflects internal devaluations and collapsing domestic demand, which have plummeted in all highly-indebted countries (more so in Greece and Ireland, less in Italy, Spain and Portugal). It is not at all clear that these countries could maintain their external balance if growth and imports start to recover.

Developments in the eurozone member states with large current account surpluses have so far contributed only very marginally, if at all, to the rebalancing of the euro area. And this asymmetry has produced a deflationary bias in the eurozone as a whole. If most eurozone country governments cut spending at the same time, the deflationary effect on internal demand on GDP would be further magnified.

As a consequence, growth has suffered, recession and stagnation trends have hit all peripheral countries and the euro area at large.

The Deflation Will Not Work and Will Increase the Risk of Populist Revolts

The flexible approach to austerity adopted in Brussels, even assuming deflation is mitigated, will neither solve the difficulties of the eurozone nor offer a viable exit strategy from the prolonged debt crisis for two reasons. First, austerity has a self-defeating impact on growth when interest rates are close to zero. The IMF references this numerous times in its recent papers and analyses. Second, the unresolved banking crisis and associated credit crunch in the euro area will further depress nominal growth. As a consequence, this will increase the stock of debt in many highly-indebted countries. By deciding that the crisis was largely fiscal, policymakers ignored the underlying cause of the difficulties—irresponsible cross-border lending for which bank suppliers of credit are surely as responsible as citizens.

Given this perspective, it is very likely that the eurozone will face a prolonged slump of the kind that Japan has experienced over many years and will not return to significant economic growth for at least the next decade. In particular, the economic and social situation in Southern Europe is bound to remain grim for several years. As things stand, all Southern European countries are facing the prospect of a true lost decade. According to the IMF, their GDP per capita will be lower in 2017 than it was in 2007.

In this kind of scenario, one could see two main risks. The first risk is beyond this year and involves restructuring public and possibly private stocks of debts, which will likely become unavoidable in many eurozone countries. The second is that societies may lose patience as long as stagnation persists. As a result, the risk of populist revolts against EU-driven policies will increase and some countries may become difficult to govern.
Already, anti-European movements have gathered an increased following as voters associate structural reforms with rising unemployment and social stress. These forces have even had electoral success, as is the case with Beppe Grillo’s Five-Star Movement (M5S) in Italy. There is no doubt that European leaders need to address these dangers and try to avoid an extended period of populism-inspired movements.

An Effective Growth Strategy Requires Actions on Multiple Fronts

Is there any alternative to status quo policies in Europe? As we know the answer is yes—at least on paper. One should first acknowledge that the current strategy for combating the eurozone crisis is failing and needs deep reformulations and recalibrations. The issue is not whether fiscal consolidation and external rebalancing are necessary—they are. Instead, it is how to make them economically and socially sustainable. An alternative approach must combine more symmetrical macroeconomic fiscal adjustment and investments with microeconomic policy measures aimed at encouraging structural reforms and productivity increases (to narrow competitive gaps across member states). The categorical imperative for Europe is to return to growth. Only growth can allow peripheral countries in Europe to pursue a strategy of fiscal consolidation and gradual reduction in unemployment that is sustainable and effective at the same time.

An effective growth strategy requires actions on multiple fronts. First, policies that support demand are needed in the near-term. In this regard, the recent commitment by the ECB to keep the monetary policy stance accommodative for as long as necessary, is effective. Expansionary monetary policy can provide very useful space through additional conventional and unconventional measures. These measures include forms of credit easing, looser collateral requirements for securitized bundles of loans to small and medium-sized enterprises, a negative deposit rate, and credit easing for lending schemes.

Still, monetary action is not enough. To revive eurozone demand, Europe’s internal imbalances and Germany’s huge external surplus must be addressed. Large trade surpluses will remain a powerful drag on economic activity in the eurozone and put a big obstacle in the way of the needed adjustments between member states. European countries with current imbalances will have to demonstrate how they intend to close them; the onus lies equally with those running trade surpluses as those with deficits. In effect, the pace of fiscal adjustment and policy in the North has major implications for the Southern European countries. Collectively, the economies of the eurozone comprise the second largest economy in the world. The trouble is that the eurozone is managed as no more than the sum of its parts. The dramatic error of the austerity policy was, and is, to repeat this fallacy of composition.

In other words, convergence and adjustment will not happen automatically in the eurozone, but need to be policy-driven. New policy and governance priorities are thus required in the eurozone in order to put more emphasis on cooperative games in convergence and competitiveness. Three years ago, the European Commission argued that rebalancing within the eurozone needed to be symmetric if it was to be consistent with economic growth. It followed that economies with big trade surpluses are obligated to rebalance their trade as much as the deficit countries. In reality, very little emphasis has been placed on rebalancing the surplus economies so far.

A Banking Union is Essential for the Eurozone

Second, a banking union should be established and completed since it was always considered essential for the eurozone. The “vicious circle” between collapsing banks and national governments forced to bail them out lay at the heart of the eurozone crisis. Many countries are forced to seek EU rescue aid when they cannot afford on their own to bail out banks that misbehaved in the easy credit years before the crisis. In the present fragile situation of many banks and in a world that could soon be de-
prived of the Fed's QE support, a credible assessment of the quality of banks' assets is needed. Restoring the health of banks' balance sheets requires quantifying capital needs and creating a clear plan on how to meet these needs. Furthermore, a banking union process should be completed, with common deposit insurance and common resolution procedures. So far, only the single supervisory mechanism (SSM) pillar of the banking union has been realized and will enter into force next year. The European Commission has very recently published a proposal for a single resolution mechanism (SRM). In its proposal, the European Commission has a lot of power to make the final decision on which banks to resolve and how resolution funds are used. This is relatively reasonable, but Germany is unlikely to accept the commission's proposal. The risk is a delay in reaching a final agreement on the bank resolution and recovery directive. Still, the amount of hidden losses in bank balance sheets is ultimately quite large. In the meantime, the danger is that the bank-sovereign link will be reinforced causing an increase in systemic and contagion risks across the eurozone.

Third, there will also have to be some form of fiscal union and eurobonds, or an equivalent instrument. On the one hand, the eurozone periphery suffers from too little competitiveness to achieve external balance without significant domestic deflation and unemployment. On the other hand, the periphery has too large a stock of debt problem—both public and private. We know that the most direct way to address an excessive debt problem is to write down the debt, a very extreme solution indeed. As already mentioned, in the absence of a significant change in the obfuscate austerity policy, this extreme solution could become inevitable. Before that point, however, one should look to take alternative routes, and growth can also help address the problem. The “European Redemption Pact” in which EU countries without bailout programs would transfer the portion of their government debt that exceeds 60 percent of GDP into a common fund remains a valid proposal. Under the various versions of this proposed scheme, countries participating in the fund would have to make a binding pledge to redeem their debt over 20-25 years with convincing measures such as earmarked national tax revenues. Very recently the president of the European Commission formally launched the high-level expert group whose function is to recommend reforms of the banking sector. It is set to provide a feasibility analysis on a eurozone debt-mutualization scheme in the form of a redemption fund and eurobills.

The Fall of Popular Support for Europe

These proposals and necessary steps are obviously complex and difficult. But they are absolutely necessary to change the economic policy of the eurozone, moving in the direction of boosting growth and creating jobs, especially for the younger population. While some of these steps will be achievable within the current framework for European economic governance, other equally fundamental steps call for a significant deepening of the integration process together with a further centralization of policymaking at the European level.

This process will not be easy. The majority of European citizens are deeply disappointed and discouraged by the continuing crisis and the failed austerity policies intended to counter the effects. They now seem very unwilling, if not downright hostile, to the transfer of policy sovereignty to Brussels. Certainly there is still a strong consensus in all member countries—according to recent opinion polls—in favor of the euro choice. Yet popular support for the further strengthening of EU institutions is at very low level.

Ultimately this key issue should be addressed to ensure a smooth functioning of the monetary union and a revival of growth and employment in the eurozone. It is a narrow but mandatory path. The alternative is that Europe will keep muddling through; member states will continue with their current policies which will lead to depression and EU authorities will become increasingly unpopular. This scenario risks transforming the European dream into a nightmare for all euro member countries, Germany included.