Structural reforms are back. Call the cops!

By Bob Hancké, LSE

Judging by the recent economic news, the real culprits in the crisis have finally been identified. In Italy, Matteo Renzi is putting a lot of his political capital in a labour market reform bill. In Frankfurt, Brussels and a few other important places in Europe, the ECB's Mario Draghi, 'senior' Commission officials and captains of industry and finance (yes, the bright lights who brought you the crisis in 2007-08), including a smattering of Goldman Sachs executives and ex-executives, have all discovered the persistent need for structural reforms. The ECB, thus the complaint, cannot do all the heavy lifting in the European economy. Governments and workers have to do their bit by accepting painful but necessary constraints. Banks are, supposedly, impossible to control in this sense, since they can relocate if regulated too tightly — which probably also explains why so few bankers (none, in fact) have ended up behind bars despite rather spectacularly bad behaviour: being too strict with them would undermine the competitiveness of the financial sector.

The miscreants, thus the standard refrain, are those who work for a living, have seen their job security fall, real wages collapse and life chances of their offspring diminish beyond all reasonable expectations. They are the conservatives in this narrative, who cling to their exuberant privileges, such as a decent job at a decent wage, and exclude others by pulling up the drawbridge once safely on the other side. They produce unemployment with their unreasonable demands for job security, and keep the economy at a low level of growth because of low productivity. And they make entire economies uncompetitive with their excessive wages. What is needed is a series of measures, thus the conclusion, that will shake up the supply side of the economy, make markets work their magic, and liberate the European economies from their shackles. Structural reforms are, again, on the agenda.

I am not often lost for words, but to consider this crisis a supply-side crisis, after over 5 years of credit rationing, sovereign debt, austerity and, hardly surprising, very, very low growth (with the exception of the US, where Obama opened the fiscal taps as much as his Republican opponents allowed him to do), requires some imagination. Once more, with feeling, therefore: I honestly don't think this is a supply-side crisis. Even Christine Lagarde of the IMF now seems to subscribe to this view. And in a recent *post-mortem mea culpa* (apologies for the mixed Latin metaphors) the OECD has accepted that it may have got some things wrong over the last few decades. However, according to Draghi during last Thursday's press conference and as reported in the FT, 'structural reforms come first, because many of the problems of the euro area are structural', without giving any examples. Why exactly the shining lights in the financial sector are now coming out with this particular piece of nonsense is a mystery to me.

Now, it is certainly very reasonable to say that the ECB cannot solve all the problems of the eurozone. In fact, the problem we seem to be heading into, deflation, is mainly of the ECB's making, but needs, indeed, solutions outside the Frankfurt-Brussels axis. Deflation is fought with money, lots of money: the orthodox Left-monetarist recipe is for governments to spend a lot, labour unions claiming more than their fair share of national income, and central banks underwriting that with loose monetary policy. That produces inflation, which greases the wheels, lowers the real value of government debt, and takes us back into terrain where we sort of understand how the economy works. But we have the latter, and the opposite of the former, in Europe: there is not a single government that is not told to tighten belts, and even the labour unions in Germany cannot lift inflation there above a meagre 1.5% — way too low to have a systemic inflationary effect across the eurozone. We are therefore saddled with very low inflation in EMU, falling prices in some of its member economies, and no way out.

And when it comes to unemployment: that is rarely the direct effect of labour market regulations and their consequences for wages. They may make some individual employers reluctant to hire an extra hand (i.e. in what economists call 'the margin'), and some individual workers may be able to exploit a cosy job situation as a result, sure; we all know of such instances. But regulations and wages do not have significant aggregate effects on the whole, because the aggregate (un)employment rate is ultimately determined not in labour markets, but in product markets. If demand for goods and services is high, output is high, and employment is, adjusting for productivity, high as well. Employers train and hire new employees, you see, when they anticipate full order books in the near future. Employment regulations and wages can influence that 'in the margin', but not by much.

Finally, it is a bit rich for a bunch of talking heads from the ECB and Goldman Sachs to start lecturing the world on what is actually wrong today. The ECB, recall, is the enlightened institution that saw the spectre of inflation everywhere in 2007 and raised interest rates in response, and which is today presiding majestically over the possibility of a lost decade for Europe. Goldman Sachs, ah! Goldman Sachs… How much time have you got?

The sudden revival of structural reforms is nothing but a smoke screen, hiding massive policy mistakes such as austerity, outright criminal behaviour by some financial institutions, and a monetary policy that increasingly resembles, in the words of Keynes, pushing on a string. Blaming the victim is easier than admitting that the policy paradigm underlying the responses to the crisis is completely and utterly wrong.

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