

## Growth and Unemployment in the Eurozone: What's really happening?

By **Bob Hancké, LSE**

To the surprise of many, the EMU crisis has actually forced reform (as measured by the OECD's Reform index) in countries where that had seemed very difficult or impossible before: Greece and Spain being the key examples here. By contrast, in countries outside the EMU crisis there has been little or no reform, with this being particularly marked in North-West Europe, where the crisis was least destructive.

In sum, whatever you may think about the effects of labour market reform, all the culprit countries that got in trouble since 2009 have done their homework, often at great social and political cost. Note, however, that I am actually quite sceptical about their positive effects – there is not a single study that shows a secular positive effect. They are essentially beggar-thy-neighbour policies since they target real wages which, in a low-growth (no growth) world, would mean redistribution of output, not increased growth.

Yet despite all that effort, they have very little to show for that: unemployment rates remain stubbornly high in Spain and Greece. In Ireland, it has only come down a bit by creating a new underclass of the working poor (and considering that the Irish LM already was very liberal compared to the Southern European economies, there was not really that much to reform). All in all, it remains hard to tell the difference in terms of economic performance between unreformed France or Italy and the reformed labour markets elsewhere.

What seems to have improved is the competitiveness position of the so-called periphery: current account deficits have been reduced significantly. As a result, the immediate crisis of EMU is abating alongside interest rate risk premiums: falling current account deficits imply that governments/countries will be able to finance themselves in the future. Importantly, and sadly, this has happened not through moderate unit labour cost growth based on higher productivity, but because of strangled domestic demand (falling real wages), which significantly reduced imports.

One thing is important to keep in mind here: the public deficit and debt position is only one part of the story. At least as important – and, as Spain and Ireland suggest, perhaps even more important because less manageable – is private debt. That too has to be financed, and that too passes through the current account but, crucially, through the private banking system. For example, Deutsche Bank lent money saved by German households to Spanish families to buy a house in the run-up to the crisis, and now countries with an acceptable fiscal position, such as the Netherlands and Denmark, are running large private sector deficits.

The stylised picture of the labour markets of EMU member states is therefore relatively clear. The countries that were not massively in trouble before the crisis are doing quite well on the whole, while the others have more or less done their homework without a significant improvement in their employment situations. The reason is, to a large extent, that (a) supply-side reforms on their own never have the beneficial effects that textbook economics ascribes to them, and (b) that the main driver of employment remains aggregate demand, as Keynes pointed out a while ago.

**Bob Hancké is Associate Professor in political economy at the London School of Economics.**



