Labour market reform in Italy: Matteo Renzi up against the wall

By Céline Antonin

While Matteo Renzi had enjoyed a relative “state of grace” since his election in February 2014, the Senate vote in early December on the hotly disputed reform of the labour market (the Jobs Act) has led to a general strike, a first since he took office. Is this the end of Matteo Renzi’s honeymoon with the Italian people? Although his ascension to power had sparked a wave of hope, the initial results have been disappointing. The reforms are going down poorly as Italy experiences its third consecutive year of recession (-0.2% growth forecast in 2014), and the country is facing criticism from the European Commission for its inability to reduce its structural deficit. This reform is inspired by a free market approach and aims to introduce a flexi-security system. The measure that is the particular focus of passion would remove Article 18 of the Labour Code, which allows reinstatement in the case of unfair dismissal.

In the latest *Note de l’OFCE* (no. 48, 16 December 2014), we study the reform of the labour market being undertaken in Italy, which is a major challenge due to the segmentation of the labour market, high youth unemployment and inappropriate costs relative to labour productivity. However legitimate the Jobs Act may be, it seems too partial to have any real impact. In the short term, Italy’s priority should be on investment. The only way the country can re-establish normal access to bank financing and return to growth is through the combination of an expansionary monetary policy, the continued pursuit of a banking union, and an ambitious public investment policy. Once these conditions have been met, then the question of a structural reform of the labour market will arise; this reform must be coupled with reform of the goods market in order to allow Italy to restore productivity and achieve a sustainable improvement in its growth potential.

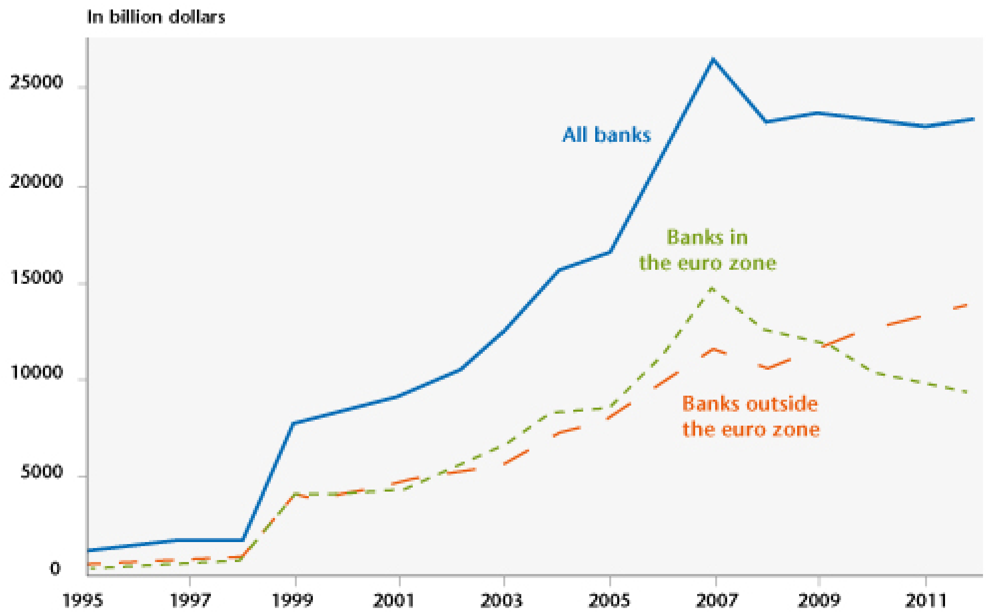
An unprecedented retreat by the euro zone's banks

By Anne-Laure Delatte, CNRS, OFCE, CEPR, Visiting Lecturer at Princeton University

Another small step was taken last month towards a euro zone banking union when the European Commission presented its proposal for the union's Single Resolution Fund [1]. While observers generally agree that the 55 billion euros in the Fund are just a drop in the ocean, we show in a recent study that the euro zone's banks are increasingly isolated from the rest of the world (Bouvatier, Delatte, 2014 [2]). In reality, the fragmentation of the euro zone's banks that the banking union is supposed to resolve is merely one aspect of the international disintegration of Europe's banks.

In 2013, cross-border capital flows came to only 40% of their 2007 levels, and the largest decrease in activity was in international bank lending. Figure 1 shows changes in foreign claims by the banks of 14 countries vis-à-vis their partners and breaks the data down by whether the banks are in the euro zone or not.[3]

Figure 1. Consolidated claims with foreign partners, 1995-2012



Source: Authors' calculations (Bouvatier, Delatte, 2014), using IRB data.

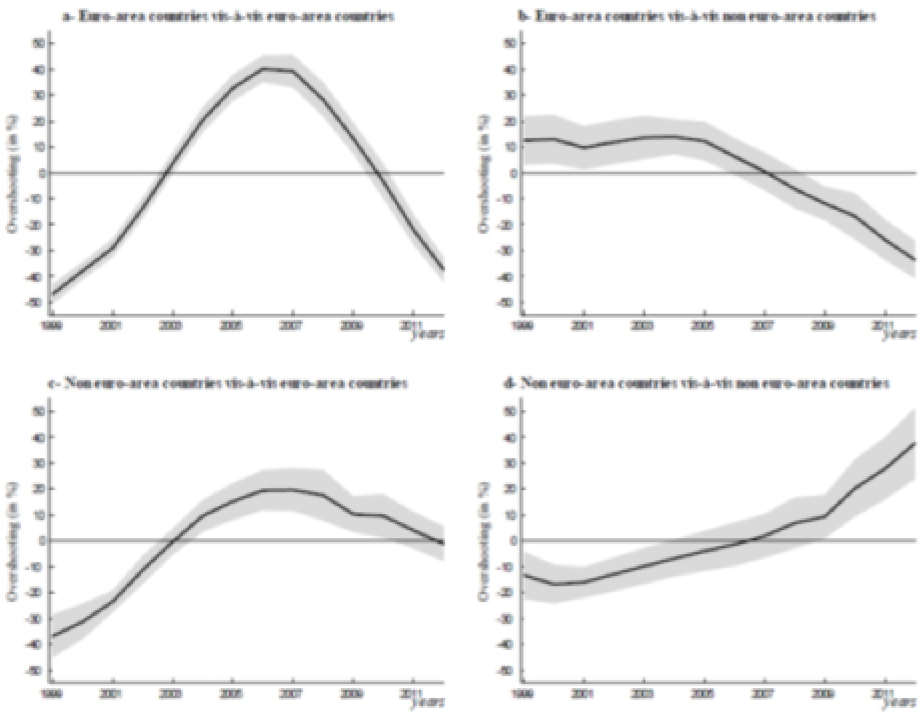
The global financial crisis undoubtedly dealt a serious setback to banking activities: in 2008, foreign claims declined significantly, and then remained at this lower level. However, the aggregated situation conceals two conflicting trends. While the international activities of banks outside the euro zone were undoubtedly hit hard in 2007, they quickly began to pick up again thereafter. In contrast, the activity outside the euro zone of the euro zone's banks has continued to fall. In 2012, the euro zone's banks accounted for 40% of international banking activity, compared with 56% in 2007. In short, the raw data suggest:

(1) A massive downturn for banks located in the euro zone, and

(2) An interruption that was only temporary for banks located outside the euro zone.

To what extent can these different trends be explained by differences in economic conditions between the euro zone and the rest of the world? The countries of Europe have in fact faced a series of crises since 2008 (the financial crisis, then the sovereign debt crisis), and today the euro zone is one of the few regions where growth has not resumed. At the same time, the past decade has resulted in a sharp increase in banking integration in the euro zone. So is this just a correction? Also, what differences are there in the way banking integration has taken place in the euro zone and in the rest of the world? To answer these questions, we have developed a unique way to measure international banking integration. Our measure is based on a statistical model of banking that can isolate frictions and variable factors over time [4]. We have extracted temporal trends by geographic region, which enables us to measure at each date where banking activity is at in comparison with the model's predictions. The four charts in Figure 2 show our measurements.

Figure 2. Banking integration. Deviation relative to the predictions of the model (in %)



Source: Bouvatier, Delatte, 2014.

First, it is striking to note that, following the financial crisis of 2008, all the trends in the euro zone were down (Figures 2-a, 2-b and 2-c), in contrast to the situation in the rest of the world (Figure 2-d). Then we see that only banks in the euro zone are going through a process of disintegration (the curve is below the x-axis in Figures 2-a and 2-b). In contrast, the exposure to euro zone debt of banks located outside the euro zone is at precisely the level predicted by the model (Figure 2-c). In other words, non-European banks are less involved in the euro zone, but this is a correction of the 20% excess existing prior to the crisis, and not a downturn. In contrast, the euro zone's banks have massively reduced their international exposure to inside and outside the euro zone, with a level that is over 30% below the model's predictions. Thus, the banks' massive pull-back is not due solely to the economic slowdown in the euro zone since 2008 (as our estimates take the slowdown into account). More importantly, this decline goes well beyond a correction and indeed constitutes a significant level of disintegration. In other words, the bank fragmentation taking place in the euro zone is merely one part of a larger process of the disintegration of the euro zone's banks.

Finally, Figure 2-d, which traces the situation in the rest of the world, highlights a surprising difference: not only has banking integration not weakened, but, on the contrary, the trend grew stronger after the crisis. In other words, the downturn in banking activity observed in 2008 in the raw data was due entirely to temporary frictions.

Based on these observations, we can draw the following conclusions. First, our estimates suggest that the euro zone's banks have permanently lost market share at the global level. Second, it is striking to note that the banking integration achieved through the monetary union has been totally erased in recent years. In other words, the benefits conferred by the single currency have fallen in number, while the costs are continuing to rise. Finally, our results concerning the mass pull-back of the euro zone's banks vis-à-vis the rest of the world suggest that the banking union, though crucial to supplement the single currency, will not be enough to meet the banking challenges facing the euro zone.

[1] "Europe bancaire: l'Union fait-elle la force?", Céline Antonin and Vincent Touze, *Note de l'OFCE*, no. 46, 18 November 2014.

[2] Vincent Bouvatier and Anne-Laure Delatte (2014), "International Banking: the Isolation of the Euro Area", *Document de travail OFCE*, forthcoming.

[3] Among the 14 countries reporting, seven belong to the euro zone: Austria, Belgium, Germany, Spain, France, Italy and the Netherlands. The seven other countries are Canada, Switzerland, Denmark, the United Kingdom, Japan, Sweden and the United States.

[4] More specifically, we have used the approach of Portes and Rey (2005), who were the first to estimate gravity equations to study the determinants of financial activity. See Portes, R. and H. Rey (2005), "The determinants of cross-border equity flows", *Journal of International Economics* 65(2), 269-296.

Banking Europe: Strength in the Union?

By Céline Antonin and Vincent Touzé

On 4 November 2014, the European Central Bank became the single supervisor of banks in the euro zone. This was the first step in the banking union.

The economic and financial crisis that started in 2007 has exposed several European weaknesses:

1. The national bank markets, though seemingly compartmentalized, proved to be highly interdependent, as was seen in the high level of propagation-contamination;
2. There was often a lack of coordination in the national support provided;
3. Given the context of high public indebtedness, State support for the bank system led to a strong correlation between bank risk and sovereign risk;
4. The absence of fiscal transfer mechanisms strongly limited European solidarity.

In 2012, the idea of a banking union arose out of a triple necessity: to break the link between the banking crisis and the sovereign debt crisis by enabling the direct recapitalization of troubled banks through the European Stability Mechanism; to prevent bank runs; and to prevent the euro zone banking markets from fragmenting.

The banking union is being built on three pillars: a single supervision mechanism (SSM); a single resolution mechanism (SRM), with a resolution fund and a bail-in process; and a single deposit guarantee system with a guarantee fund.

The banking union sets out new solutions. Nevertheless, grey areas remain, and the European solidarity provided by the banking union could prove insufficient to deal with major shocks.

The latest *Note de l'OFCE* (no. 46 of 18 November 2014) reviews the context surrounding the establishment of the banking union and takes stock of the advantages and limitations of the progress made in constructing the union. This Note was produced as a special study entitled "Comment lutter contre la fragmentation du système bancaire de la zone euro?", [How can the fragmentation of the euro zone banking system be fought?] *Revue de l'OFCE*, no. 136 (2014).

Devaluation through wages in the euro zone: a lose-lose adjustment

by Sabine Le Bayon, Mathieu Plane, Christine Rifflart and Raul Sampognaro

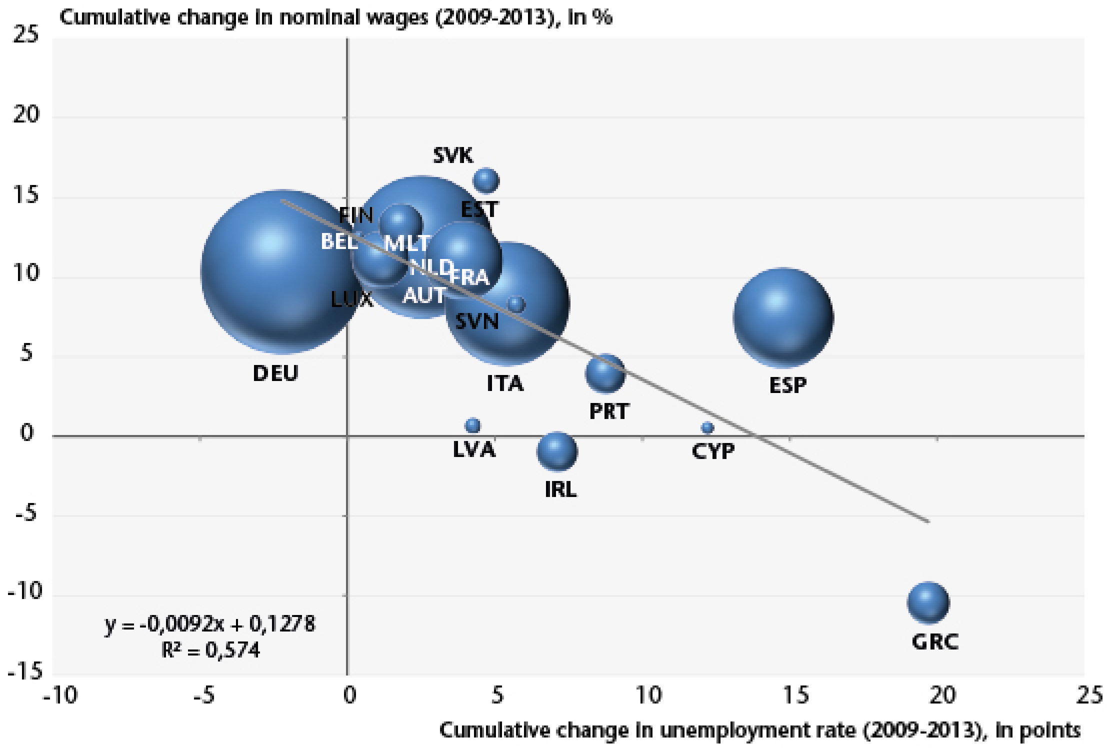
Since the outbreak of the financial crisis in 2008 and the sovereign debt crisis in 2010-2011, the euro zone countries have developed adjustment strategies aimed at restoring market confidence and putting their economies back on the path to growth. The countries hit hardest by the crisis are those that depended heavily on the financial markets and had very high current account deficits (Spain, Italy, but also Ireland, Portugal and Greece). Although the deficits have now been largely resolved, the euro zone is still wallowing in sluggish growth, with deflationary tendencies that could intensify if no changes are made. Without an adjustment in exchange rates, the adjustment is taking place through jobs and wages. The consequences of this devaluation through wages, which we summarize here, are described in greater depth in the special study published in the dossier on the OFCE's forecasts (*Revue de l'OFCE*, no. 136, November 2014).

An adjustment driven by moderation in wage increases …

Faced with falling demand, companies have adapted by making heavy cutbacks in employment in order to cut costs, which has led to a steep rise in unemployment. The number of jobless in the euro zone was 7 million higher in September 2014 than in March 2008. The situation is especially glum in countries like Greece, where the unemployment rate is 26.9%, Spain (24.2%), Portugal (13.8%) and Italy (12.5%). Only Germany has experienced a reduction in unemployment, with a rate of 5.0% of the active population.

As is suggested by the Phillips curve, runaway unemployment has eventually affected the conditions governing wage increases, especially in the most crisis-ridden countries (Figure 1). While between 2000 and 2009 wage growth was more dynamic in the peripheral countries (3.8% annually) than in the countries in the euro zone core (+2.3%) [1], the situation reversed after 2010. Nominal wage growth slowed in the peripheral countries (0.8%), but stayed close to the pre-crisis rate (+2.6%) in the core countries. This heterogeneity is due to differences in how much unemployment has worsened in the different countries. According to Buti and Turrini (2012) [2] from the European Commission, reversing the trend in wage dynamics will be a major factor driving the rebalancing of current account positions in the euro zone.

Figure 1. Changes in unemployment rates and nominal compensation per employee



Note: The size of the bubble is proportional to the GDP of each country in the euro zone.
Sources : Eurostat, OFCE calculations.

Furthermore, an analysis at the macroeconomic data level masks the extent of the ongoing wage moderation, as the effects of the crisis are concentrated on the most vulnerable populations (young, non-graduate employees) earning the lowest wages. The deformation of the structure of employment in favour of more skilled and more experienced workers (see the OFCE post: On the difficulty of carrying out structural reforms in a context of high unemployment) is also pushing up mid-level wages. As can be seen in a number of studies based on an analysis of the macroeconomic data [3], wage growth after correcting for these composition effects is below the increase in the average salary.

… that compresses domestic demand and is not very effective in terms of competitiveness

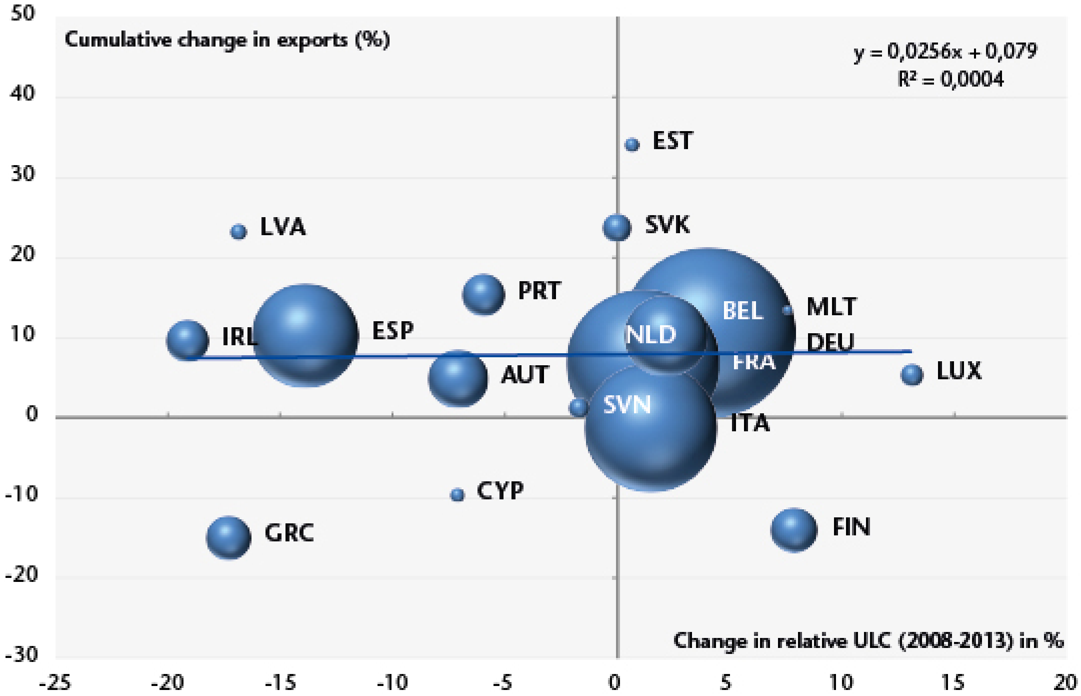
Underlying this policy of deflationary adjustment through wages, what is important for companies is to improve competitiveness and regain market share. Thus, compared with the beginning of 2008, unit labour costs (ULC) [4] fell in the countries deepest in crisis (Spain, Portugal and Ireland), slowed in Italy and continued their upward progression in the countries in the euro zone core, *i.e.* those facing the least financial pressure (Germany, France, Belgium and the Netherlands).

The most significant adjustment took place in Spain. Deflated by inflation, its ULC has fallen by 14% since 2008, 13 points of which are explained by the recovery in productivity, which was achieved at the expense of massive cuts in employment. Real wages increased only 1% over the period. Conversely, in Italy, the adjustment has focused on wages, whose purchasing power has fallen by 5%. However, this decline was not sufficient to offset the fall in productivity, and thus to prevent an increase in the real ULC. In Germany, after the real ULC rose in 2008, real wages continued to rise, but less than gains in productivity. In France, real wages and productivity have risen in tandem at a moderate pace. The ULC, deflated by inflation, has thus been stable since 2009 but has still worsened compared to 2008.

Even though this deflationary strategy is intended to restore business competitiveness, it is a double loser. First, as the strategy is being implemented jointly in all the countries in the euro zone, these efforts wind up neutralizing each other. Ultimately, it is the countries that carry the strategy furthest that win the “bonus”. Thus, among the euro zone’s larger economies, only Spain can really benefit due to the sharp reduction in its ULC, which reflects not only its own efforts but also some continued wage growth among its key partners. France and Italy are not experiencing any gain, and Germany has seen a deterioration in its ULC of about 3% between 2008 and 2013. Moreover, while the wage devaluation might have helped to boost activity, this will have been accomplished through a rebound in exports. But it is difficult to find any correlation between exports and wage adjustments during the crisis (Figure 2). These results have already been pointed out by Gaulier and Vicard (2012). Even if the countries facing the deepest crisis (Spain, Greece, Portugal) might gain market share, the volumes exported by each of them are in the short/medium term not very sensitive to changes in labour costs. This might be explained by companies' preference to rebuild their margins rather than to lower export prices. Even in countries where the relative ULC fell sharply, the prices of exports rose significantly (6.2% in Greece, 3.2% in Ireland since 2008, etc.).

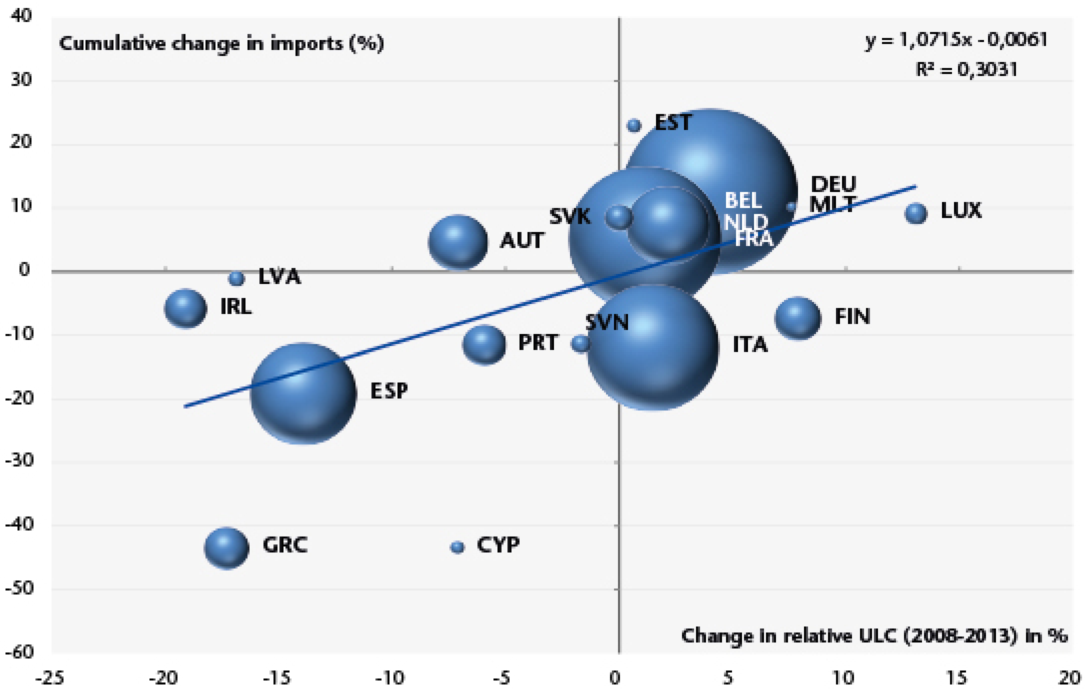
Finally, in an effort to improve their cost competitiveness, companies reduced their payroll by cutting employment and / or wages. This strategy of competitive disinflation results in pressure on household incomes and thus on their demand for goods, which slows the growth of imports. Indeed, in contrast to what is observed for exports, there is a close and positive relationship between changes in the relative ULC and in import volumes over the period 2008-2009 (Figure 3). In other words, the greater the adjustment effort in the ULC with respect to competitor countries, the slower the growth in import volumes.

Figure 2 : Change in relative ULC and exports, in volume



Note: The size of the bubble is proportional to the GDP of each country in the euro zone.
Sources : Eurostat, OFCE calculations.

Figure 3. Change in relative ULC and imports, in volume



Note: The size of the bubble is proportional to the GDP of each country in the euro zone.
Sources : Eurostat, OFCE calculations.

This non-cooperative strategy to rebalance the current account can permanently affect an economic recovery in a context where reducing the debt of both private and public agents will become even more difficult if deflationary pressures are felt in an ongoing way (due to increases in real terms in debt and interest rates). The imbalances in the current accounts of the various euro zone countries will thus be dealt with *mainly* by a contraction of imports. The correction of such imbalances by means of a wage devaluation, as was the case in 2010-2011, is therefore doubly expensive: a low impact on competitiveness, relative to competitors, due to the simultaneous implementation of the strategy in the various euro zone countries, and an increased risk of deflation, making it more difficult to shed debt, thereby fuelling the possibility of a scenario of prolonged stagnation in the euro zone.

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[1] Germany, France, Belgium and the Netherlands. The peripheral countries include Spain, Italy, Portugal and Greece.

[2] Buti and Turrini (2012), "Slow but steady? Achievements and shortcomings of competitive disinflation within the Euro Area".

[3] For a comparison of a number of euro zone countries at the start of the crisis, see ECB (2012), "Euro Area Labor Markets and the Crisis". For the case of Spain, see Puente and Galan (2014), "Un analisis de los efectos composición sobre la evolución de los salarios". Finally, for the French case, see Verdugo (2013) "Les salaires réels ont-ils été affectés par les évolutions du chômage en France avant et pendant la crise?" and Audenaert, Bardaji, Lardeux, Orand and Sicsic (2014), "Wage resilience in France since the Great Recession".

[4] The unit labour cost is defined as the cost of labour per

unit produced. This is calculated as the ratio between compensation per capita and average labour productivity.

On the difficulty of carrying out structural reforms in a period of high unemployment

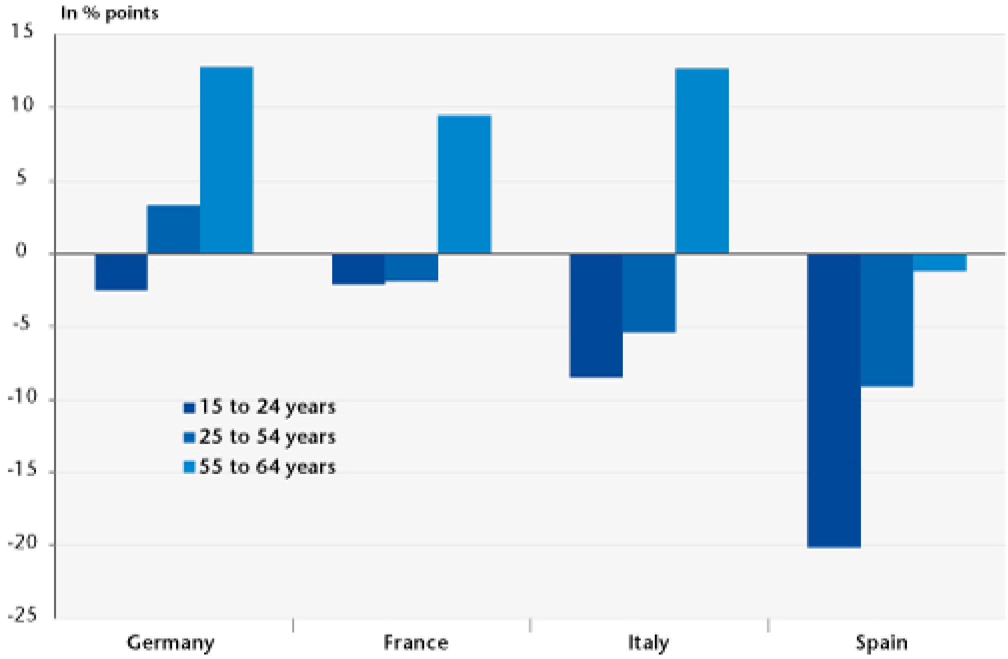
By Sabine Le Bayon, Mathieu Plane, Christine Rifflart and Raul Sampognaro

Structural reforms aimed at developing a more flexible labour market are often attributed all the virtues of fighting against mass unemployment and limiting the segmentation of the labour market between "insiders" on stable contracts and "outsiders" who are unemployed or on precarious contracts. When the economy is growing, these measures can facilitate job creation for the benefit of the outsiders, but the results are likely to be more uncertain in a context of mass unemployment and sluggish growth. Structural reforms can indeed reduce the labour market duality arising from regulatory measures but they cannot combat the duality of the labour market inherent in human capital, which is exacerbated during periods of mass unemployment: given the same qualifications it is experience that makes the difference, and given equal experience it is qualifications that make the difference. High unemployment therefore strengthens the phenomenon of "queuing" to access more stable jobs. Structural reforms aimed at streamlining the labour market will thus primarily affect employees who have less qualifications and experience without however enabling outsiders to gain access to more stable employment. This means that inequality between workers is likely to rise, with no positive impact on employment due to the sluggishness of the economy. Only macroeconomic management that takes on board the goal of returning to full employment could lead to successful structural reform.

As we show in a special study, "La dévaluation par les salaires dans la zone euro: un ajustement perdant-perdant" [Devaluation through wages in the euro zone: a lose-lose adjustment] (*Revue de l'OFCE*, no. 136, November 2014), labour market segmentation has increased during the crisis despite the implementation of structural reforms in the euro zone countries. Since 2008, the employment rate [1] of seniors and of the better qualified has fared better than for other population groups in the four largest countries in the euro zone (Figures 1 and 2).

The sharp decline in the youth employment rate since 2008 is general – including in Germany, where the labour market has remained dynamic – and contrasts with the increase in the employment rate of older workers (or the small decline in Spain). The difference between these two categories is between 12 percentage points in France and 21 points in Italy (15 points in Germany and 19 in Spain). The adjustment in the employment rate of the 25-54 age group lies in an intermediate position. The resistance of the employment rate of older workers to the crisis is probably due to a combination of two factors: the introduction of pension system reforms in recent years (lengthening contribution periods and / or raising the legal retirement age) and the relatively higher cost of dismissing senior citizens, who more often occupy higher positions in the job hierarchy. In a crisis, it is likely that this has led to a substitution effect with the employment of older workers coming at the expense of the young.

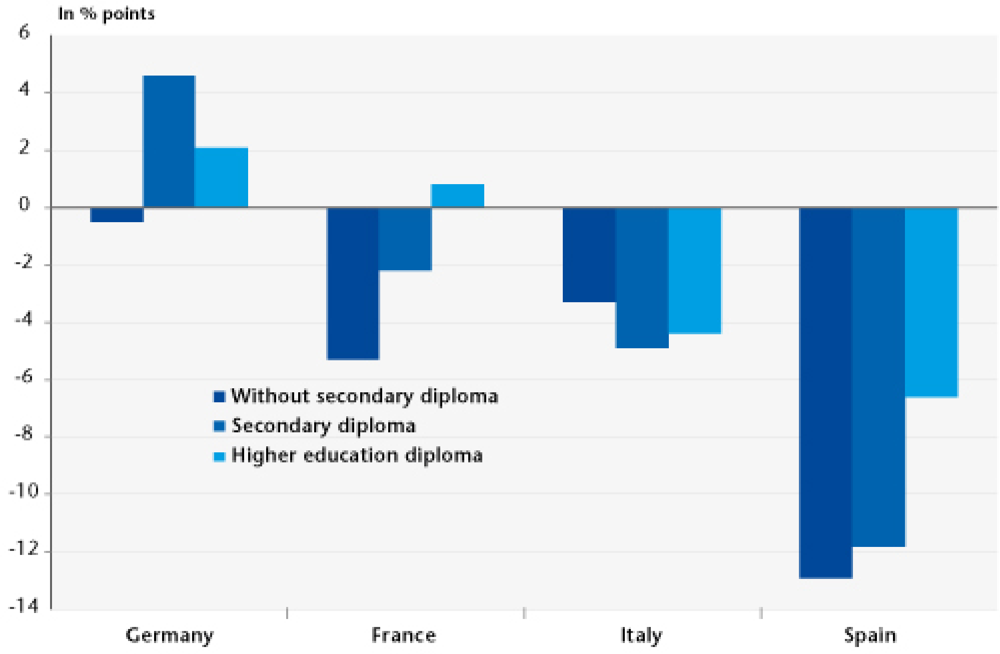
Figure 1 : Changes in employment rate by age group between 2008 (Q1) and 2014 (Q2)



Sources : Eurostat, OFCE calculations.

The adjustments in employment rates were also more striking for people without a high school diploma, with the exception of Italy, where the diploma does not seem to provide protection from unemployment or inactivity. In France, the adjustment in the employment rate clearly decreased with the type of degree. In Germany, the employment rate for those with less education has declined during the crisis while it has increased for the other categories. In Spain, the employment rate of university graduates has withstood the crisis better than the rate of other population groups. In addition to these developments in employment rates by educational category, wage income in Italy, Spain and France has fallen for the initial income deciles. This adjustment in the wage incomes of the lower deciles is probably due to a reduction in total working hours over the year (part-time work, shorter temporary contracts or longer periods of unemployment between contracts, reducing average compensation over the year). Thus, in the countries hit hardest by the crisis, the most vulnerable populations, with the least human capital, have found themselves more exposed to a deteriorating labour market, whether this has been felt through falling employment rates or a reduction in annual wage earnings.

Figure 2 : Changes in employment rate by level of diploma between 2008 (Q1) and 2014 (Q2)



Sources : Eurostat, OFCE calculations.

In the context of a deteriorating labour market, by accepting a slight downgrade the most qualified unemployed workers would be the first to find jobs, chasing out those who might otherwise have gotten it, who would themselves do the same thing at a lower level. This could explain why, at the end of the queue, it is the least skilled who are, regardless of labour legislation, the victims of unemployment and precarious employment.

The existence of a "spontaneous" segmentation in the labour market and the phenomenon of "queuing" may thus limit the success of a strategy of structural reforms and wage devaluation. In such a case, a more flexible labour market combined with a reduction in social welfare could increase inequalities between groups in the workforce without increasing the creation of full-time equivalent jobs.

[1] This is the ratio of the employed to the working-age population.