Financialisation and financial crisis: vulnerability and traumatic shock

By Jérôme Creel, Paul Hubert, Fabien Labondance

Since the mini-crash that took place in the Shanghai stock market in August, financial instability has resurfaced in the markets and the media and, once again, the link with financialisation has been evoked. The Chinese crisis resulted from a combination of real estate and stock market bubbles that were fed by the abundant savings of a middle class in search of high-yield investments. It feels like we've gone back almost ten years when what is considered the excessive financialisation of the US economy – with abundant savings from the emerging countries enabling the build-up of widespread US consumer debt – is treated as the cause of the financial instability and crisis that was triggered in the summer of 2007.

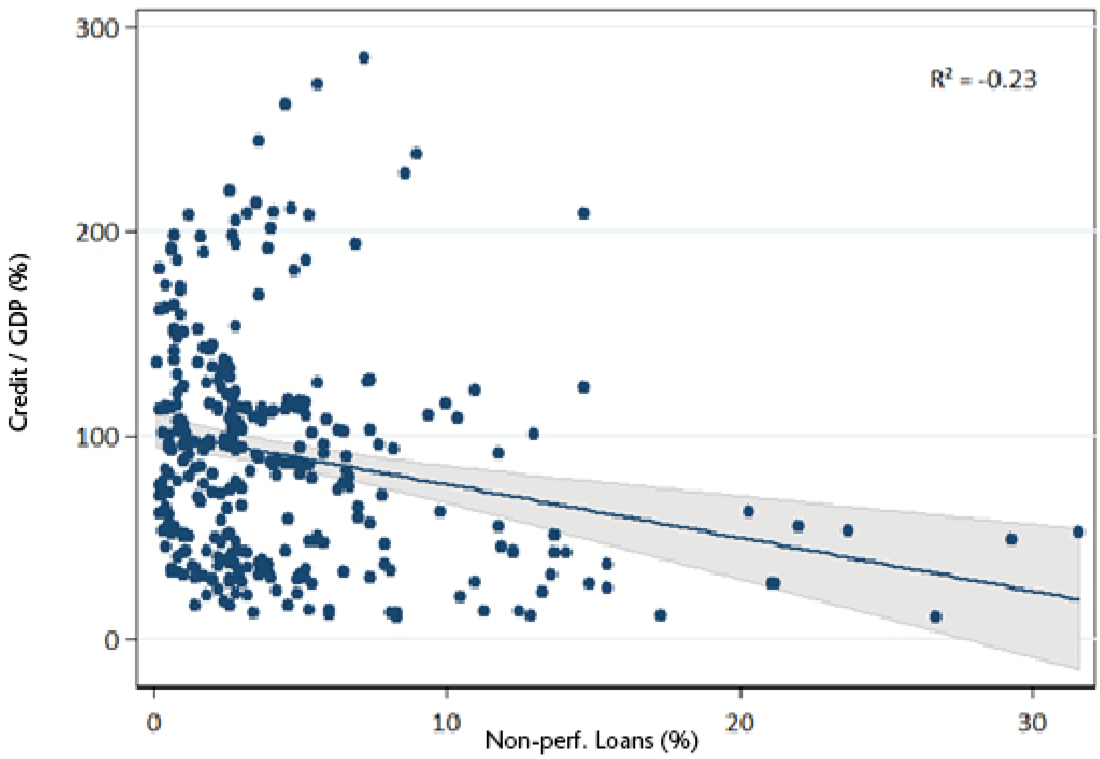
Is there really a link between, on the one side, increasing indebtedness and the great variety of financial investments, and on the other, volatile stock prices and a deterioration in the quality of bank loans? And if there is, what is the direction of the dynamics: from financialisation to financial instability, from financial instability to financialisation, or both at once? A rise in indebtedness could well lead to increasingly risky lending to agents who wind not being able to repay them, which would then lead to a financial crisis: this is one possible case. The occurrence of a crisis would change the behaviour of households and firms, causing them to reduce debt: this is the second case, in which financial instability reduces the financialisation of the economy.

Depending on which is the case, the public policies needed differ. In the first, we need to monitor the degree of the economy's financialisation and target, for example, a maximum ratio of bank credit to GDP in order to prevent the rise and bursting of speculative bubbles. In the second case, there are two possibilities: to treat the causes, and thus to monitor the quality of loans to households and business so as to ensure the proper allocation of capital in the economy; or to treat the consequences by supporting productive investment to annihilate any rationing of credit.

In the course of the debate on the links between financialisation and financial instability, and on the consequences to be drawn in terms of public policy, the European situation is interesting for two reasons: the European Union has set up a system for monitoring external imbalances, including financial ones, from 2011, and a banking union since 2014. In a recent working paper, we look at this debate for several groups of countries in the European Union over the period 1998-2012.

At first glance, the relationship between these two concepts is not easy to demonstrate, as can be seen in the graph below. It shows a scatter plot that for each year and for each European country gives the levels of financialisation (approximated here by the share of credits / GDP) and of financial instability (approximated here by non-performing loans). The correlation between these variables is -0.23.

Figure. Financialisation and financial instability



Note: Non-performing loans, or bad debt, expressed as a percentage of total loans granted by banks.
Credit/GDP: total amount of bank credit expressed as a percentage of GDP.

Source : Creel et al. (2015) based on GFDD databases.

We test the two typical cases discussed above. We call the first case the vulnerability effect. As financialisation develops, it engenders a sort of euphoria that leads to granting loans that are increasingly risky, which fosters financial instability. This hypothesis derives from the work of Minsky (1995) [1]. We simultaneously test the potentially negative relationship between financial instability and financialisation, which we call the trauma effect. The very occurrence of financial instability as well as its impact encourages economic agents to take less risk and to shed debt. Our estimates show that the link between financial instability and financialisation is not uni-directional. Contrary to what is suggested by the simple correlation coefficient, the sign of the relationship is not the same when looking at the effect of one variable on the other, and vice versa. Both the vulnerability and the trauma effect have been at work in the European countries. A macro-prudential policy intended to monitor the policy on granting bank loans, in terms of their volume and quality, therefore does indeed seem necessary in Europe.

We also tested the possibility that these effects are non-linear, that is to say, that they depend on reference values. The vulnerability hypothesis depends both on the level of financialisation (the higher it is, the stronger the relationship) and on time. This last point shows us that the positive relationship between financialisation and financial instability shows up at the moment of crisis for countries that are already heavily financialised. Finally, in the countries on the EU periphery [2], long-term interest rates and inflation rates greatly influence the financial instability variable. Consequently, it seems that for these countries there is a need for strong coordination between banking supervision and macroeconomic surveillance.

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[1] Minsky H. P. (1995), “Sources of Financial Fragility: Financial Factors in the Economics of Capitalism”, paper prepared for the conference, *Coping with Financial Fragility: A Global Perspective*, 7-9 September 1994, Maastricht, available at Hyman P. Minsky Archive. Paper 69.

[2] This group consists of Spain, Ireland, Italy, Greece, Portugal and the countries from the Eastern enlargements in 2004 and 2007. The establishment of this group is explained in the working paper.

The upward drift in senior unemployment continued in August

Analysis and Forecasting Department (France team)

The figures for the month of August 2015 published by France's Pôle Emploi job centre show a significant increase in the number of people registered as Category A (+20,000), i.e. an additional 156,000 job seekers over one year, following two months of relative stability. While this figure is undoubtedly disappointing, the uncertainty surrounding monthly fluctuations in enrolment at the job centre should not be forgotten. Despite the downturn in the numbers registered in categories B and C in the last month (-11,600), the number of job seekers who have carried out an active job search has risen by nearly 332,000 since August 2014.

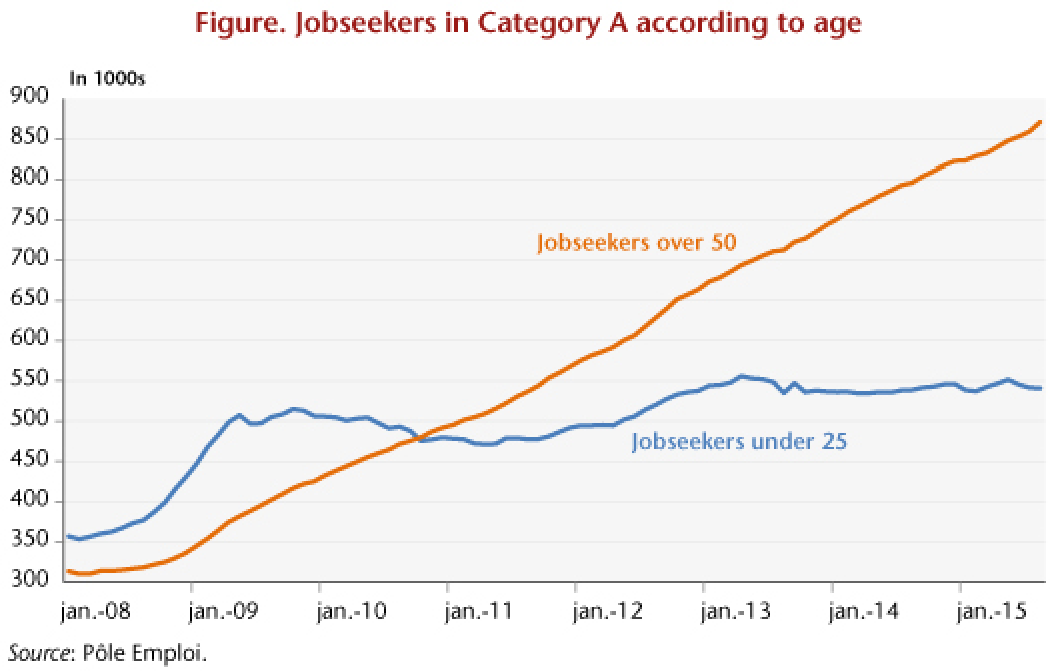
This figure nuances the publication of the unemployment rate as defined by the International Labour Office (ILO), which gives a less negative image of the French labour market. This statistic points to a slight fall in the unemployment rate in the first six months (-0.1 point), largely due to shrinkage of the labor force (-0.2 point).

Beyond the total figure, the data published for August confirms the divergences observed between different age groups. While up to September 2010 the number of people aged 50 or over registered in Category A at the job centre was lower than for the under 25 age group, there are now 330,000 more unemployed seniors than unemployed youth (graph). The increase in this gap since 2010 is due to several factors. The implementation of a series of pension reforms (2003, 2010), coupled with the elimination of exemptions for seniors on job-seeking, has led to a longer duration of employment and a later statutory retirement age. In a context of weak growth, the rise in the rate of senior employment has been insufficient to absorb the growth in the workforce for that age group, resulting in a higher unemployment rate for the over 50s.

The weaker increase in the number of unemployed youth is the result of two main factors. First, the employment policies implemented since 2013 have targeted youth in particular, including the *emplois d'avenir* programme. Second, the weak job creation in the market sector has mainly taken the form of temporary jobs (CDD fixed-term and temporary contracts), an area in which young people are heavily represented (34.2% of young people in employment are on CDD contracts or temping, versus 8.4% for other age groups).

Finally, while seniors are unemployed less often than young people (4.6% of those aged 50-64 against 8.6% for 15-24-year-olds), they are more exposed to long-term unemployment. 62% of the seniors registered at Pole Emploi have been jobless for more than a year, against 21% of young people.

All this indicates that only a macroeconomic policy aimed at increasing the overall level of employment is capable of simultaneously dealing with unemployment among both young people and seniors. Otherwise, in a situation where employment is lacking overall, policies that are aimed at certain categories, even if effective for that specific target, may lead to adverse effects on other categories.



The redistributive effects of the ECB's QE programme

By Christophe Blot, Jérôme Creel, Paul Hubert, Fabien Labondance and Xavier Ragot

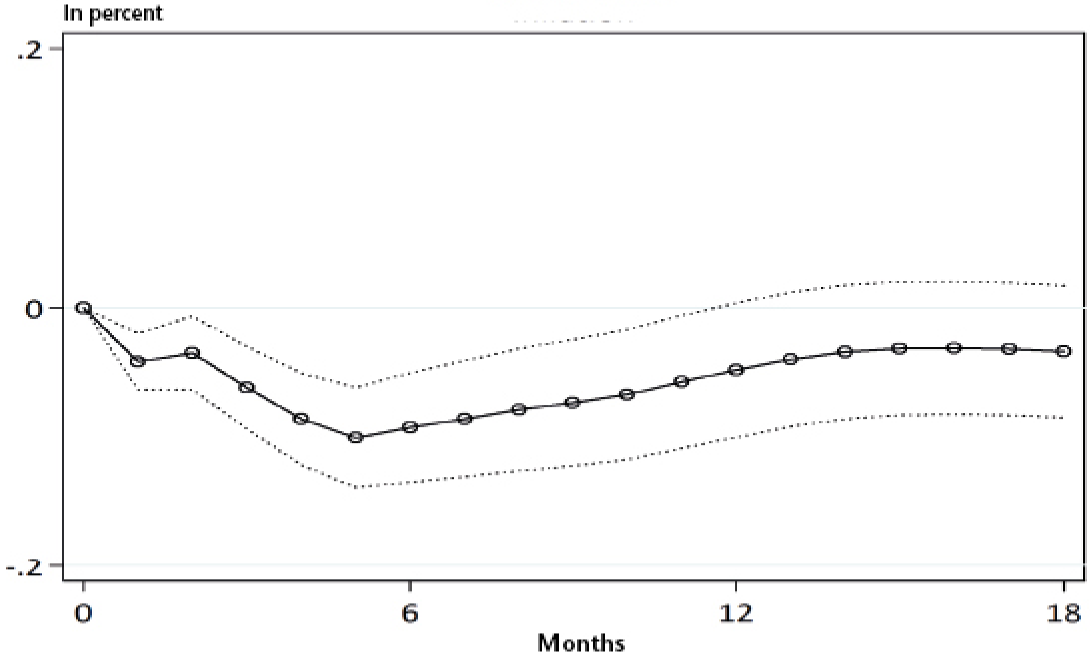
Rising inequality in income and wealth has become a key issue in discussions of economic policy, and the topic has inserted itself into evaluations of the impact of monetary policy in the US and Japan, the precursors of today's massive quantitative easing programmes (QE). The question is thus posed as to whether the ECB's QE policy has had or will have redistributive effects.

In a paper prepared for the European Parliament, [Blot et al. (2015)](#) point out that the empirical literature gives rise to two contradictory conclusions. In the US, the Fed's base rate cuts tend to reduce inequality. Conversely, in Japan an expansionary QE type policy tends to increase inequality. So what’s the situation in Europe?

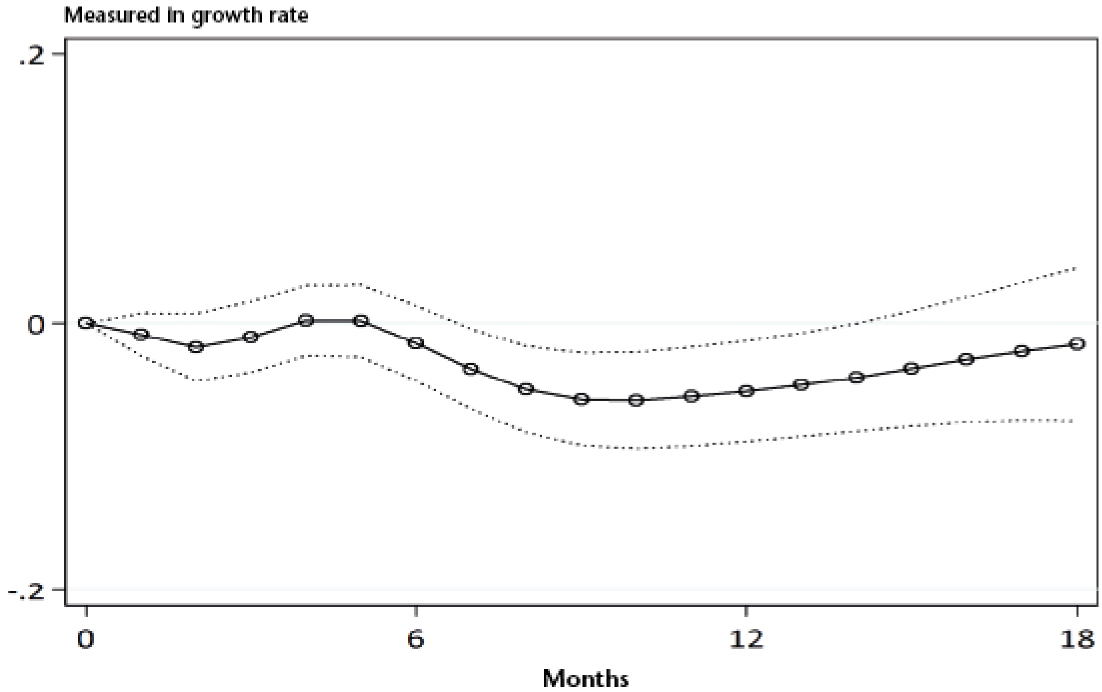
Based on macroeconomic data aggregated for the euro zone as a whole, Blot et al. (2015) show that while European monetary policy, conventional and unconventional, have indeed had an impact on the unemployment rate, the number of hours worked and the rate of inflation (see graphs), this was limited. This result suggests that the ECB’s expansionary monetary policy has tended to reduce inequality, but not by much. So when the ECB finally decides to wind up its expansionary policy, we can expect a slight increase in inequalities to follow. Because of this effect, though small, Blot et al. (2015) suggest that the ECB should be held accountable not just for price stability or economic growth, but also for the impact of its policies in terms of inequality and the mechanisms needed to take this into account.

Figures. The impact of a restrictive monetary policy shock (0.2 percentage point hike in the implicit interest rate) in the euro zone…

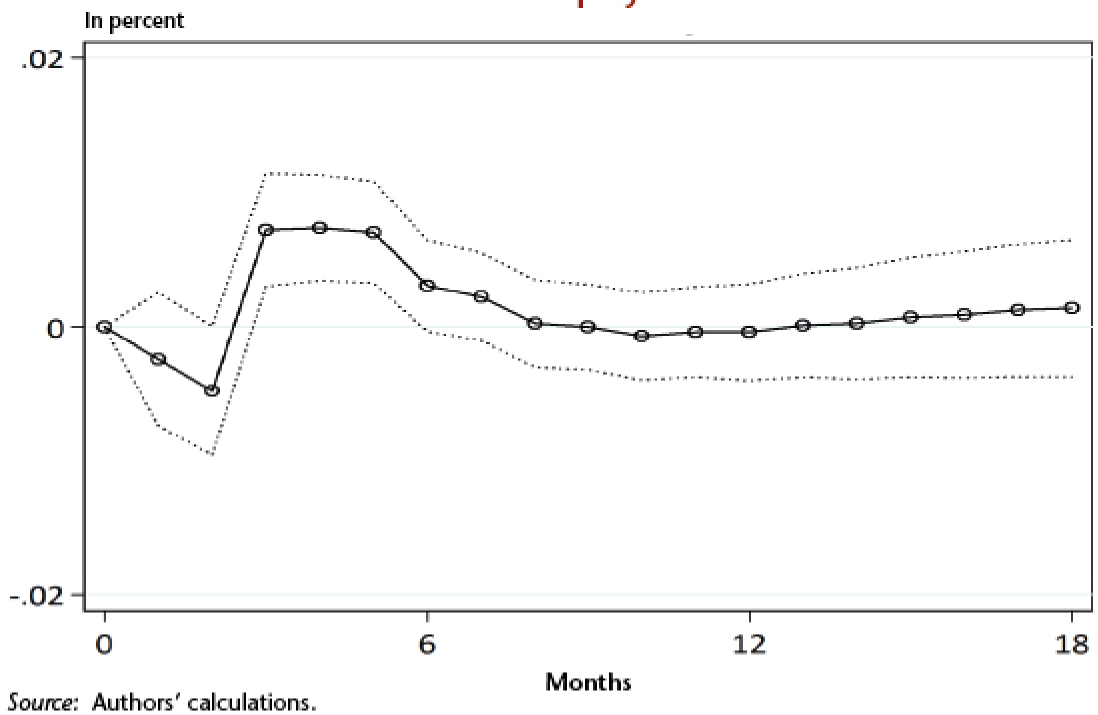
On inflation



On hours worked



On the unemployment rate



Source: Authors' calculations.

Wage moderation in Germany – at the origin of France's economic difficulties

By *Xavier Ragot, President of the OFCE, CNRS-PSE, together with Mathilde Le Moigne, ENS*

If the future of the euro zone does indeed depend on political cooperation between France and Germany, then economic divergences between the two countries should be a cause for concern. These divergences need to be analysed, with particular attention to three specific areas: the unemployment rate, the trade balance and the public debt. Germany's unemployment rate is falling steadily; in June it was under the 5% mark, which represents almost full employment, whereas the French rate is over 10%. Germany's low unemployment rate does not however reflect strong consumption by German households, but rather the country's export capacity. While France continues to run a negative trade balance (importing more than it exports), Germany is now the world's leading exporter, ahead of China, with a trade surplus that will run close to 8% in 2015. As for the public deficit, it will be around 3.8% in France in 2015, while Germany is now generating a surplus. This has impressive consequences for the way the public debt is changing in the two countries. In 2010 they were similar, at around 80% of GDP, but in 2014 Germany's public debt fell below 75%, and is continuing to decline, while France's debt has continued to grow, and has now hit 97%. This kind of gap is unprecedented in recent times, and is fraught with mounting tension over the conduct of monetary policy.

This triple divergence is inevitably leading to differences in the political response, with respect to the population's ability to take in migrants and to the understanding of countries facing economic difficulties, such as Greece, but also with respect to the ability to cope with future economic crises. Economic divergence will become political divergence. The point is not to idealize the German situation, which is characterized by a large number of workers who have failed to benefit from the fruits of growth, as is shown in a recent study by France Stratégie, as well as by a rapid decline in population. This should not stop us from taking a hard look at the economic gap arising between the two countries.

What are the reasons for Germany's commercial success?

Many factors have been advanced to explain the divergence between the two neighbours: for some, it's a matter of the German strategy – outsourcing value chains, aggressive wage moderation, fostering competition between companies – and for others, French weaknesses: poor geographical and / or sectoral specialization, insufficient public support for exporters, and a lack of competition in certain sectors. Our recent study emphasizes the delayed impact of German wage moderation and suggests that this could explain almost half of the Franco-German divergence. To understand the mechanisms involved, it is necessary to distinguish between the sectors exposed to international competition and the sectors that are sheltered. The exposed sectors include industry, but also agriculture, including animal husbandry, which is currently in the news, and some services that can be traded. The sheltered sector includes transportation, real estate, retailing and a large part of personal services.

While unit labour costs in France have risen regularly and at similar levels in the two above-mentioned sectors, they have remained extraordinarily stable in Germany for nearly ten years. This wage moderation is the result of both poor management of German reunification, which tipped the balance of power during wage negotiations in favour of employers, and, to a much less extent, the introduction of the Hartz reforms in 2003-2005, which aimed to create low-paid work in the less competitive sectors (particularly the sheltered sector). The cost of German reunification is estimated at 900 billion euros, in terms of transfers from former West Germany, or slightly less than three times the Greek debt. Faced with this kind of challenge, the wage moderation initiated in 1993 represented a strategy for re-convergence between the two parts of Germany. In 2012, German nominal wages were 20% lower than French wages in the exposed (tradable) sector and 30% lower in the sheltered sector, compared to the 1993 levels. A look at French and German margin levels shows that in the exposed sector, French exporters have made significant efforts by reducing their margins in order to maintain their price competitiveness. In the sheltered sector, French margins are on average 6% higher than German margins. The bulk of France's loss of price competitiveness is therefore a loss of cost competitiveness.

How much have these differences contributed to unemployment and the trade balance in the two countries? Our quantitative analysis shows that if German wage restraint had not taken place between 1993 and 2012, today's 8% gap in the trade balances would instead be 4.7% (2.2% of this being due solely to German wage moderation in the sheltered sector). Thus, Germany's wage moderation policy explains almost 40% of the difference in trade performance between the two countries. We also found that this wage moderation accounts for more than 2 points of France's unemployment.

The non-price competitiveness gap

This leaves nearly 60% of the difference in the trade balances still needing to be explained. Our study suggests that this difference is due to the quality of the goods produced, so-called non-price competitiveness. Between 1993 and 2012, the German quality-price ratio increased by around 19% compared with that of France, which has therefore more than offset the rise in German export prices relative to French prices. There is clearly a "quality" effect in this non-price competitiveness: Germany produces “high end”, more innovative goods than France does in the same sectors. It is also possible to see an impact due to the outsourcing of some German production (nearly 52% of production volume in 2012) to countries where costs are lower: Germany today is a centre for design and assembly, which saves money on its intermediary costs, enabling it to invest more in brand strategies and efforts to move upscale.

This effect is nevertheless probably endogenous, that is to say, it flows in part from Germany’s advantage in cost competitiveness. Low labour costs have enabled German exporters to maintain their margins in the face of external competition. The funds generated have led to investments which French companies have probably had to forego in order to maintain their price-competitiveness, thus losing the opportunity to catch up with German products in terms of non-price competitiveness over the longer term.

A positive way out and up

The root cause of the gap in economic performance between Germany and France lies in the nominal divergence observed between the two countries since the early 1990s. One way to reduce these differences would be to promote convergence in wages in Europe and in its labour markets more generally. Germany would need to allow wage inflation that was higher than in the periphery countries, thereby dealing with the increase in social inequalities in Germany, while France must not fall into the trap of competitive deflation, which would destroy its domestic demand, while keeping wage movements under control. In this respect, the report of the five Presidents presented by the European Commission on 22 June 2015 proposes the establishment of national competitiveness authorities, which hopefully would allow greater cooperation on social welfare and employment.

The difference in wages between France and Germany has profound implications in terms of economic thought. The increased trade integration that followed the introduction of the euro led not to a convergence but to a divergence in labour markets. It is then up to each State to once again bring about convergence of the economies while supporting economic activity. This State intervention in the economy is more complex than the simple Keynesian framework for the management of aggregate demand, and now involves the convergence of labour markets. Heretofore, Europe’s response has been systematic cuts in labour costs, while what is really needed is to increase wages in surplus countries, such as Germany, for example by using the minimum wage as a tool. All this, it is true, is economics. The politics begins when we realize that only long-term cooperation can bring about a convergence in national interests.

Unemployment: a fall by temping

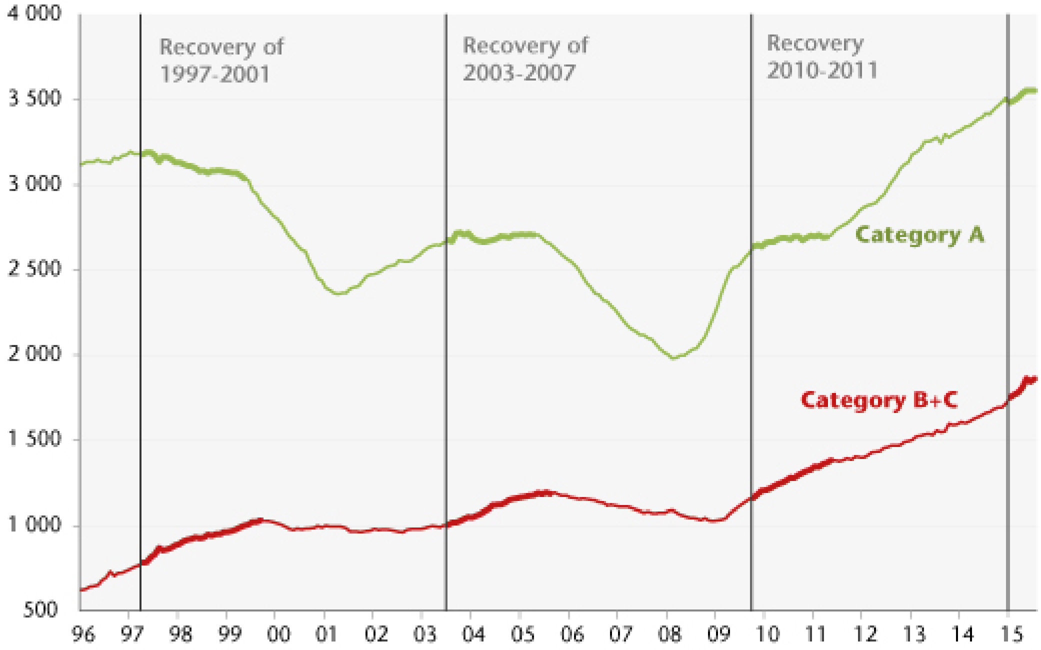
by Analysis and Forecasting Department (France team)

The unemployment figures for the month of July 2015 indicate a slight fall (-1900) in the number of people registering in category A. There is still too much uncertainty about monthly changes in enrolment at France’s Pôle Emploi job centre to conclude that there has been a lasting improvement in the state of the labour market. However, the increase observed since January 2015 (+50,900 registered in category A) is smaller in scale than the figures recorded for this same period during the past three years (+128,500 on average for the first seven months of the previous three years). It is comparable to the situation in 2010-2011 (+44,300 on average in the first seven months of both years), which were years of renewed growth.

Seen in the context of the first buds of recovery, this trend in unemployment is not surprising. First, the pick-up in GDP growth observed in the first six months (+0.7% according to preliminary accounts published by the INSEE) is expected to gain pace in the coming quarters. For now, this recovery has meant a rise in salaried employment of +26,600 in the competitive sector during the first six months of 2015. This has been sufficient to limit the increase in unemployment, without however reversing it, as labour force numbers have increased by about 75,000 during the half year.

Furthermore, the increase in registrations in categories B and C [1] has been more marked than for category A (+145,600 since the year's start). This is due partly to some switching by the jobless in category A into these other categories, which reflects an increase in precarious employment that is consistent with the increase in temporary jobs in the first half year (+11,600): historically, an improvement in the labour market starts with an increase in precarious jobs (fixed term, temporary). This is also coinciding with an increase in job offers collected by Pôle Emploi, as well as with exits from the job centre due to a return to work, a figure that reflects a return to levels comparable to those observed in 2010-2011.

Figure. Enrolment in the Pôle Emploi job centre by category



Source : Pôle Emploi.

Finally, the trends differ by age group: the number of people under age 25 registered in category A is 4,600 lower than its level at year-end 2014. In fact, the young, who are over-represented in so-called temporary jobs (34.2% of young people in work are on fixed-term CDD contracts or are temping, compared with 8.4% of those in other age groups), benefit from the creation of this type of job, and from the increase in subsidized jobs that are targeted specifically at their age group. Conversely, the enrolment in category A of people aged 50 and over is rising steadily (+36,100 since the year started). 62% of those aged 50 and older have been enrolled in the job centre for over a year, versus an average of 39% for other age groups.

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[1] These categories group people who have worked on reduced hours during the month, but are still registered at Pôle emploi.