

## Mario Draghi is right to doubt that austerity is working, but wrong to argue for wage reductions

**Martin Myant and Agnieszka Piasna, of the ETUI in Brussels, pick apart recent pronouncements from the ECB's Mario Draghi**

Mario Draghi's speech of 22 August 2014, *Unemployment in the euro area*,<sup>[1]</sup> represents a change in ECB thinking and a recognition that austerity is not bringing economic recovery in the Eurozone. His solution appears to include some degree of demand stimulus but he combines this with continued insistence on labour-market reforms to allow for greater downward wage flexibility. This sits oddly alongside talk of stimulating demand. It also, as argued in a recent ETUI Working Paper,<sup>[2]</sup> cannot be supported by a serious analysis of the links between wages and unemployment.

Three points are missing, or given only passing references, in his account;

- the first is the need to take account of past economic structures. Thus Germany is said to experience lower unemployment because of the effect of Hartz Reforms in making labour markets more flexible. Germany differs from other countries most strikingly in the absence of either a construction or a real-estate boom prior to the 2008 crisis. A very large share of unemployment in other countries came from collapse in construction sectors.
- second is the use of unemployment rates as a basis for comparison. A different story is told by using employment figures. The difference reflects discouraged workers, who no longer see the point in even looking for jobs that no longer exist, and, often very significantly, the effects of migration. This changes comparisons in some cases quite dramatically, for example making the performance of the 'flexible' US labour market worse rather than better than that of Europe.
- third is the reliance on aggregate figures across whole economies without looking at individual sectors. Wages have moved rather differently in different parts of economies and looking at individual sectors shows even more clearly the complexity and variety of relationships between wages and employment levels.
- fourth is the dependence on a few examples to illustrate points. A comparison between Spain and Ireland is picked on. It does not prove Mario Draghi's points, but other comparisons can be used to point even more clearly in different directions.

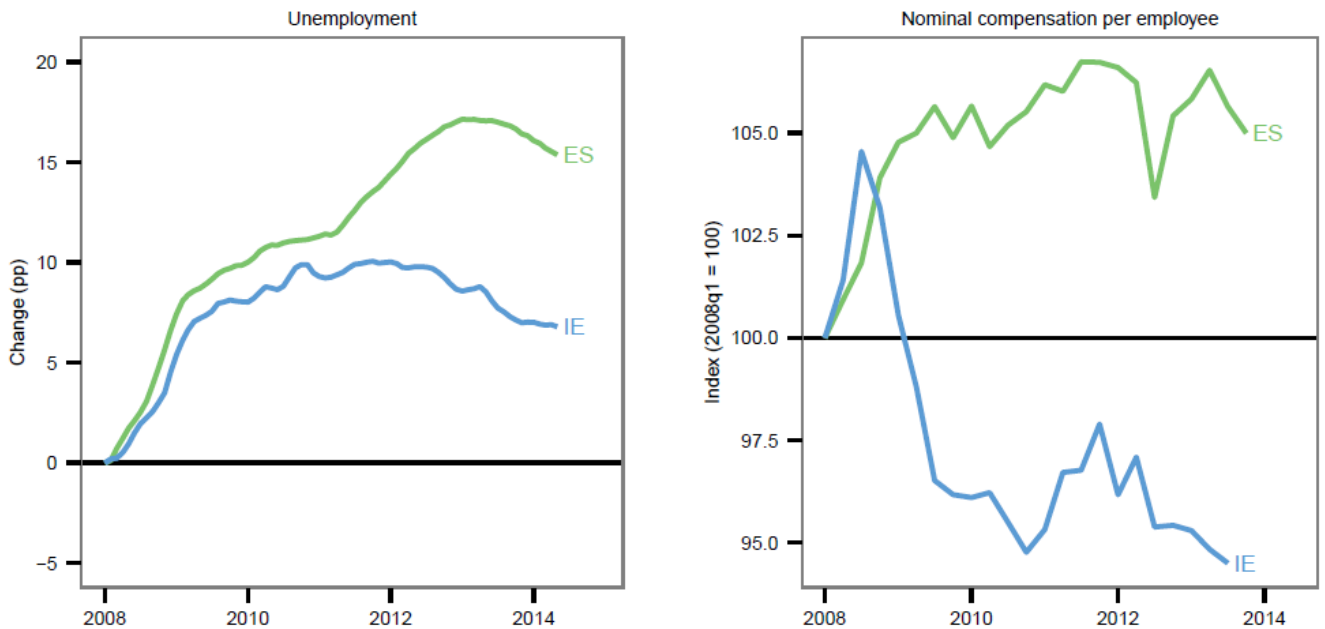
Nevertheless, we will start with Draghi's favoured example and his claim that *'whereas the Irish labour market facilitated some adjustment through prices, the Spanish labour market adjusted primarily through quantities: firms were forced to reduce labour costs by reducing employment'*. Therefore, the unemployment rate in Ireland stabilised and then started to decline in 2011, while in Spain it increased up to 2013. The figures below are used by Draghi to illustrate his argument.

### Figure 1: Unemployment and nominal compensation developments in Ireland and Spain.

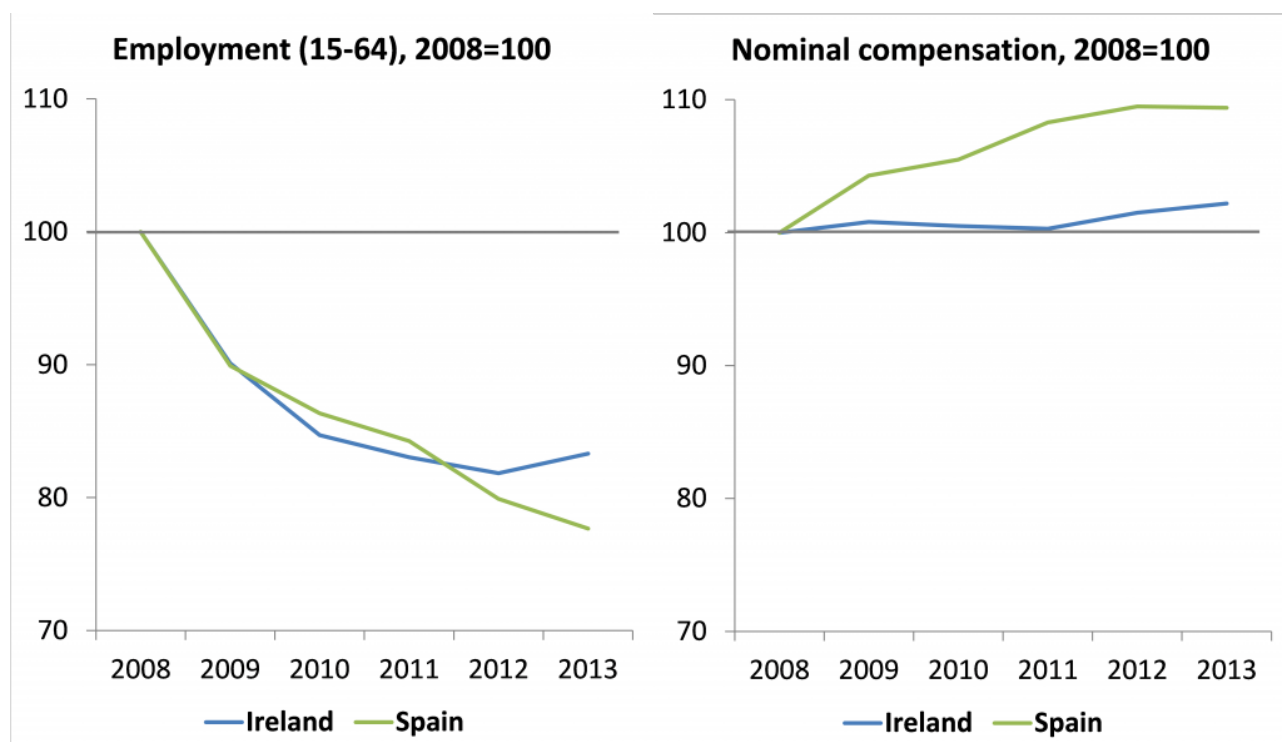
Source: Mario Draghi's speech, Jackson Hole Symposium. Based on Eurostat and ECB calculations.

The first need is to take account not just of unemployment, but also of employment. The latter did fall more sharply in Spain but, thanks largely to high levels of emigration from Ireland, the difference between the two is roughly half that indicated by using unemployment figures. Then we need to break the economies down into sectors and even the most basic division, into public and private sectors, proves revealing. In both private sectors employment fell sharply and in both nominal wages increased (Figure 2).





**Figure 2: Private sector: developments in unemployment and nominal compensation in Ireland and Spain.**



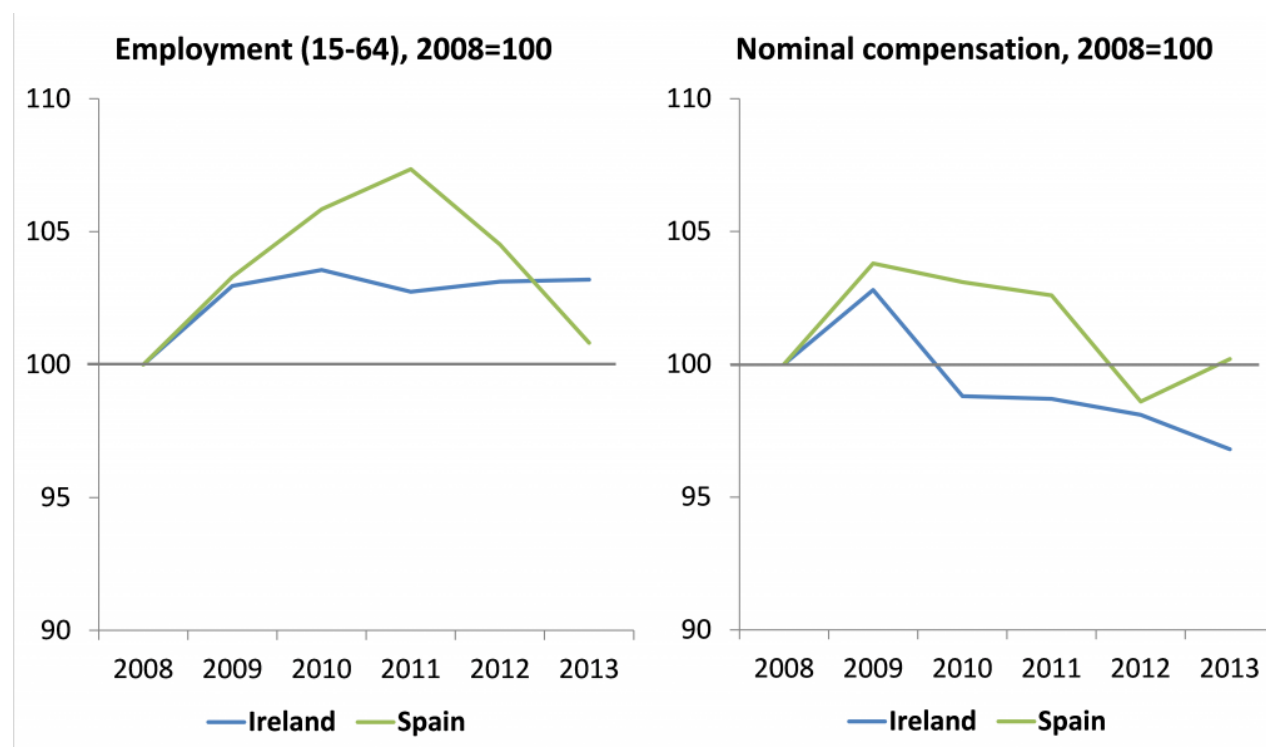
*Note:* Employment for the age group 15-64. *Source:* Eurostat and ETUI calculations.

There has been some sign of job growth in Ireland in 2013, noticeably coinciding with wage growth. Moreover, employment growth in Ireland after 2008 has been confined to high-wage and knowledge-intensive employment, while there is no evidence of job growth linked to low wages. Thus employment in information and communication services grew by nearly 14% between 2008 and 2013, while earnings rose by 6.8% in real terms. Evidently, relative success for this sector depended not on low pay but rather on high enough pay to attract qualified employees. In Spain there was no equivalent growth in high-wage sectors, requiring highly-qualified employees.

Public sector developments reflected government decisions and pay fell more rapidly in Ireland (Figure 3) as the effects of the financial crisis were felt in more severe form from early on. There was some increase in employment, notably in health care in Ireland and to a lesser extent in

Spain, but growth was low when set against that in Europe as a whole. Thus pay decline, or stagnation, did not lead to greater employment creation.

**Figure 3: Public sector: developments in unemployment and nominal compensation in Ireland and Spain.**



Note: Employment for the age group 15-64. Source: Eurostat and ETUI calculations.

Developments in construction (Figure 4) show remarkably similar employment changes in Spain and Ireland between 2008 and 2013 although very different wage developments. There was decline in Ireland and increase in Spain. In Mario Draghi’s account, an important feature leading to higher unemployment in Spain is an alleged dualism in the labour market such that some employees have more secure jobs than others.

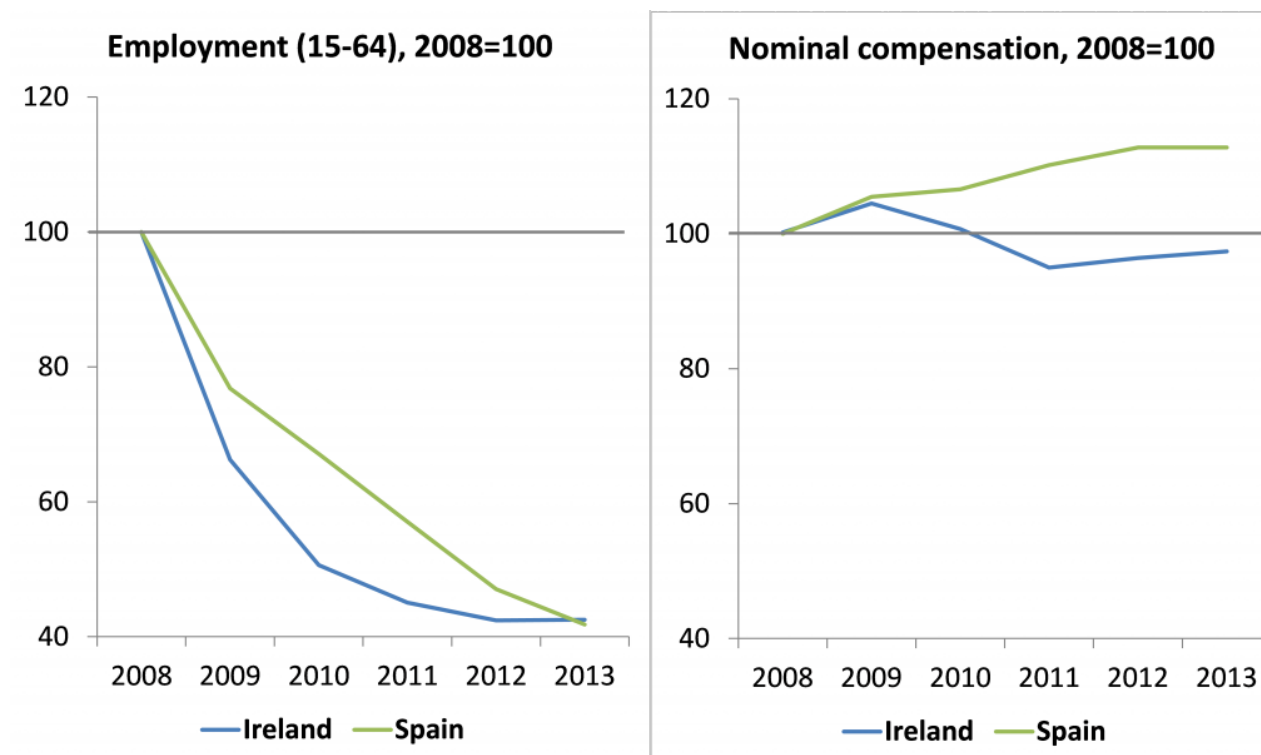
Apparently removing this will help the fight against unemployment. There is no logical reason why it should: it might change who is unemployed but need have no effect on the total number. The data here rather confirm that scepticism. Employment in the Spanish construction sector fell almost as rapidly as in Ireland, reaching the same point by 2013, and wage developments had no obvious impact on its final level. There is little reason why they should when the primary cause of job losses was the financial crisis cutting off credits.

**Figure 4: Construction sector: developments in unemployment and nominal compensation in Ireland and Spain.**

Note: Employment for the age group 15-64. Source: Eurostat and ETUI calculations.

Thus there is little evidence of fundamental differences between Spanish and Irish experiences of a type that could justify placing downward wage flexibility at the centre of EU economic policy. They do differ in when the crisis had its biggest impact. They do differ in some aspects of wage developments. They differ in some elements of employment developments thanks not to those differences in wage developments but to Ireland having greater potential for some high-skill and high-wage activities.

A comparison between two countries can never be enough for a definitive conclusion. Extending the comparisons across more EU member states clearly indicates the absence of any relationship between employment changes and real earnings changes. This can be illustrated by numerous



comparisons between individual countries which would be just as valid as representative of any general trends as that between Ireland and Spain. Real earnings in manufacturing and in construction declined in the UK and increased in Italy, yet employment declines between 2008 and 2013 in both countries were almost exactly the same. Considerable cuts in real earnings in Greece, by around 20 per cent over 2008-2013, led to no significant improvement in comparison to Spain that saw a small increase in wages.

Similarly, a comparison across all EU member states together confirms the absence of a relationship between wages and employment changes. Thus for both manufacturing and construction, in no EU country was a reduction in real wages accompanied by job growth. On the contrary, rare examples of growth in employment in either of these sectors occurred only in parallel with wage growth (Austria for manufacturing and Germany, Sweden and Belgium for construction). This should not be any surprise. Employment growth in manufacturing depends to a great extent on international competitiveness which in turn depends on employment of highly-skilled and therefore well-paid personnel. Employment growth in construction came only in countries which had not experienced rapid credit-based expansion before the 2008 crisis.

Thus signs of a shift in ECB thinking towards recognising the limits of austerity are to be welcomed. However, claims that labour market changes to allow for pay reductions would contribute to solving the problem of unemployment are not supported by evidence. Employment growth, where it has occurred, has come from public sector spending and from modern and competitive economic activities that offer high, and not low, pay. An agenda focusing on reducing wages only makes such developments more difficult.

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[1] <http://www.ecb.europa.eu/press/key/date/2014/html/sp140822.en.html>

[2] M. Myant and A. Piasna, *Why have some countries become more unemployed than others? An investigation of changes in unemployment in EU member states since 2008*, ETUI Working Paper 2014.07. <http://www.etui.org/Publications2/Working-Papers/Why-have-some-countries-become-more-unemployed-than-others-An-investigation-of-changes-in-unemployment-in-EU-member-states-since-2008>



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