Internal devaluation policies and their impacts during the great recession

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Research for new economic policies

Crisis build-up (2000-2007)

Euro area imbalances, % GDP

Ireland, Spain: Credit boom and private debt build-up (mainly house building)

Greece, Portugal: Fiscal deficits and fast growth in personal consumption

	Fiscal Balance 8-year Average		Current Account Balance 8-year Average
Greece	**-6.4%**	**Portugal**	**-9.4%**
Portugal	**-4.4%**	**Greece**	**-8.4%**
Italy	-3.0%	**Spain**	**-6.0%**
France	-2.7%	**Ireland**	**-1.8%**
Germany	-2.4%	Italy	-1.3%
Austria	-2.1%	France	0.4%
Netherlands	-0.6%	Austria	1.6%
Belgium	-0.5%	Belgium	3.0%
Spain	**0.4%**	Germany	3.2%
Ireland	**1.5%**	Netherlands	5.4%
Luxembourg	2.4%	Finland	5.6%
Finland	4.1%	Luxembourg	10.1%

Internal Devaluation (ID)

- An economy's competitiveness and balance of payments can deteriorate
  - in the wake of a domestic asset price or consumption boom
  - if domestic inflation persistently runs ahead of productivity gains, or
  - If the exchange rate appreciates against competitors/trading partners.
- Loss of competitiveness negatively affects net exports as well as employment in the traded sectors. If large enough will induce a balance of payments crisis.
- Countries within a fixed exchange-rate regime such as the euro area are unable to directly reverse a loss of competitiveness and balance of payments imbalance through a nominal devaluation of the currency.
- Loss of competitiveness can only be reversed internally through relative gains in the efficiency of production - often only achievable gradually and over the medium-term - or through direct action to reduce individual domestic prices, for example the cost of capital or the cost of labour.
  - In practice direct action on domestic prices to induce so called 'internal devaluation' usually refers to policies aimed at reducing wages and other labour costs.

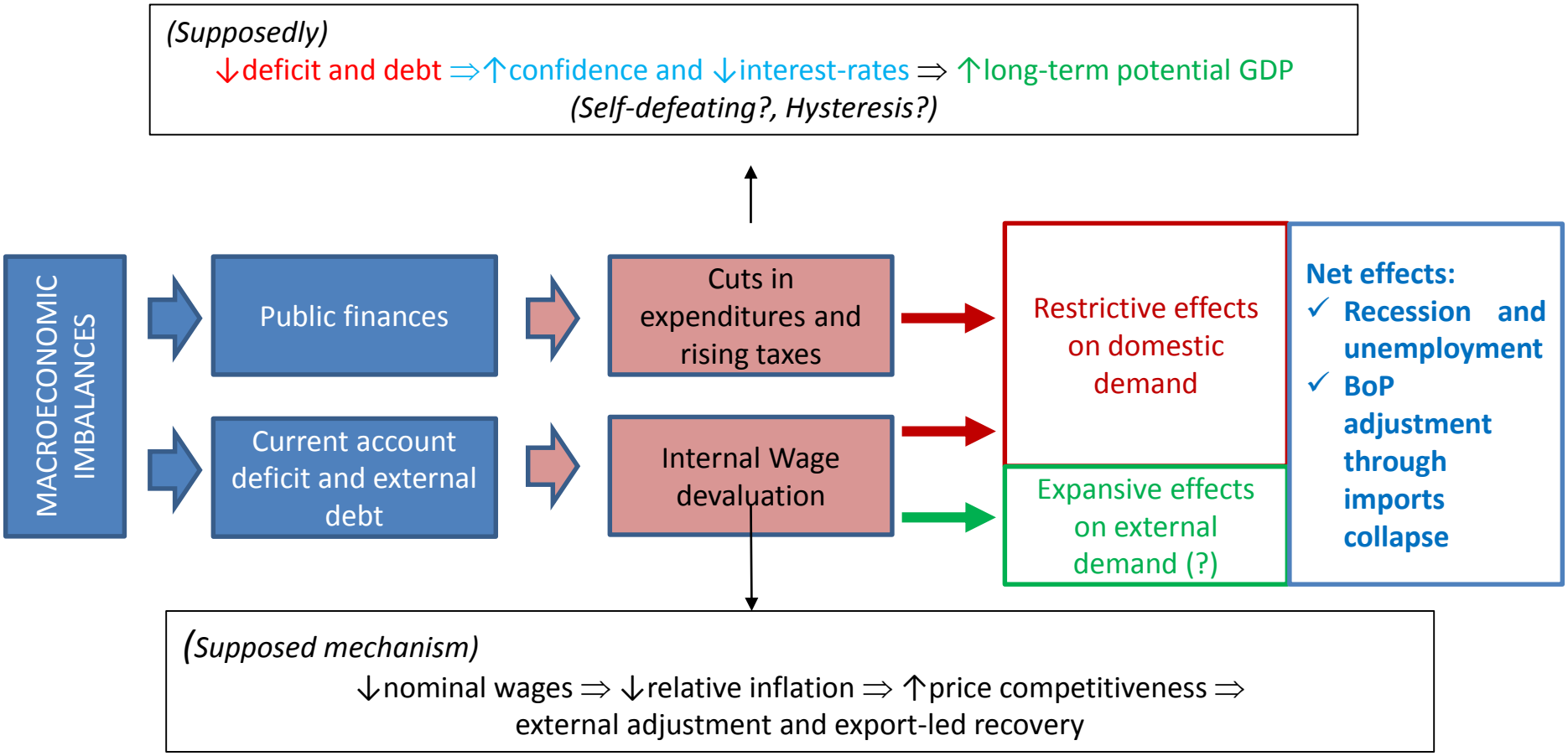
Internal Devaluation Policies

ID policies are those aimed at reducing unit production costs

- Not just policies to cut wages and other labour costs, but also policies to increase productivity, reduce social benefits and public spending, as well as structural 'reforms' to increase flexibility and reduce job security
  - But the emphasis tends to be on lowering wage rates
- The idea is falling labour costs will reduce export prices at constant exchange rates while falling wages will reduce domestic demand for imports so the overall effect will be to boost net exports.
- Much more difficult to achieve than nominal devaluation because it involves changing thousands of prices and wages across the economy. The process is likely to be expensive, slow, uncertain and politically damaging.
- Governments operating within a monetary union have very limited direct influence on unit labour costs in the traded export sectors.
- Even so, governments can indirectly influence private sector labour costs in a variety of different ways:
  - (A) through the tax system; (B) through changes to sectoral wage floors; (C) through coordinating centralised bargaining
- As such governments can indirectly pursue ID.

Fiscal Austerity and Internal Devaluation

(Source: Uxó, Febrero, Bernejo, 2016)



Internal Devaluation

IRELAND – CASE STUDY

T. MCDONNELL

Internal Devaluation in Ireland

Selected Policy Decisions

- Policy contributed to declining unit labour costs in various ways
  1. Measures to reduce public sector pay rates.
     - Direct impact on competitiveness is likely to be marginal as there is no direct transmission from public sector pay to private sector pay in the traded sectors.
  2. Changes to wage setting mechanisms to create a regime that was conducive to ID through lower wage rates and more flexible conditions (23% of private workers)
     - **A)** clauses to allow enterprises to derogate downwards from the terms (to the level of the minimum wage) - where employer can show a sustainability risk, **B)** regular JLC reviews, **C)** requiring wage setting to take account of wages in other Member States, **D)** severe restrictions on the content and scope of the EROs
  3. Cut to the minimum wage (reversed - but no change in nominal terms between 2008-2016)
  4. Cuts to various welfare rates (indirect effects)
     - E.g. unemployment benefits for under-25s
  5. Activation measures (cheap labour – sub minimum wage)
     - E.g. Jobs bridge
  6. Fiscal Policy (employers costs)
     - E.g. Reduced rate for employer PRSI

Crisis Build-up

General Government Balance, (% of GDP)

Source: IMF Fiscal Monitor

Government explicitly adopted policies of pro-cyclical fiscal austerity from late 2008 onwards – citing need to bring public finances and the cost of borrowing under control

- –Given negative consequences for domestic demand, the Government, at least in rhetorical terms, embraced an export led growth strategy which, they argued, would have to be driven by economy wide competitiveness improvements
- –As Ireland does not control its own monetary policy it was argued that such competitiveness improvements would have to be driven by internal devaluation

	2006	2007	2008	2009	2010	2011	2012	2013
Overall Balance								
Ireland	2.9	0.1	-7.3	-13.8	-30.5	-13.1	-8.2	-7.4
Euro area	-1.3	-0.7	-2.1	-6.4	-6.2	-4.2	-3.7	-3.0
Overall Balance (exc. financial sector supports)								
Ireland				-11.3	-10.5	-8.9	-8.2	-7.4

IMF estimates for the overall balance are for general government and include financial sector supports.

Economic Trends

Cumulative Fiscal Adjustments 2008-2014, (€ billions)

Sources: DOF, Budget Documentation

Reasonable to anticipate gains from ID in the form of higher net exports, but also reasonable to anticipate deflating labour costs will reduce aggregate demand through lower household consumption and investment

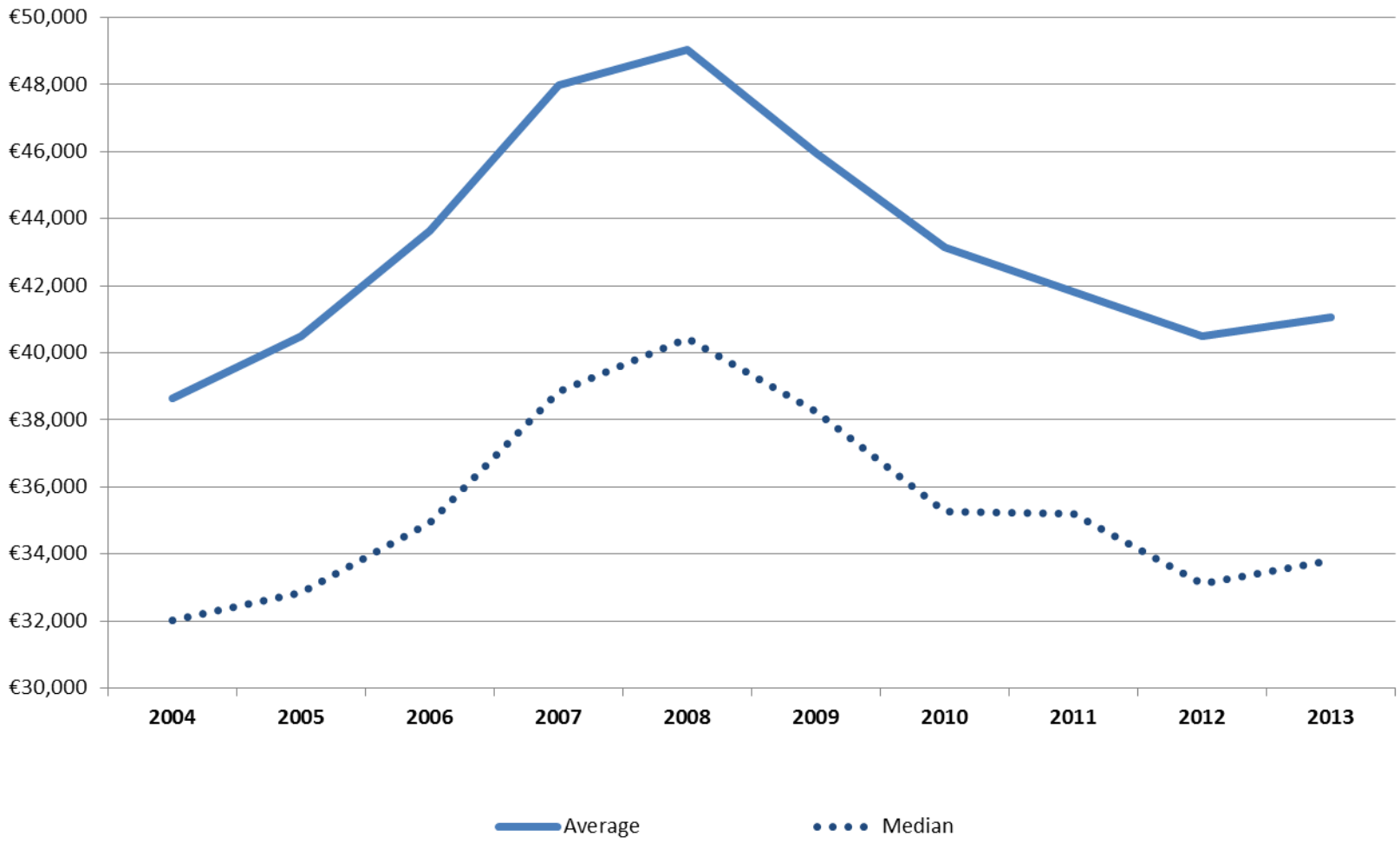
An empirical question, when anticipating short-to-medium-term outcomes for output and employment, as to whether, in terms of size, the positive *net export effect* from ID outweighs the negative *domestic demand effect* from internal devaluation

	Total	2008-2010	2011-2013	2014
Revenue	**10.8**	5.6	4.3	0.9
Expenditure	**19.2**	9.2	8.4	1.6
of which				
Capital Expenditure	*5.0*	*1.6*	*3.3*	*0.1*
Current Expenditure	*14.2*	*7.6*	*5.1*	*1.5*
Total fiscal contraction	**30.0**	14.7	12.6	2.5

Economic Trends

Household Disposable Income in Ireland (2004-2013)

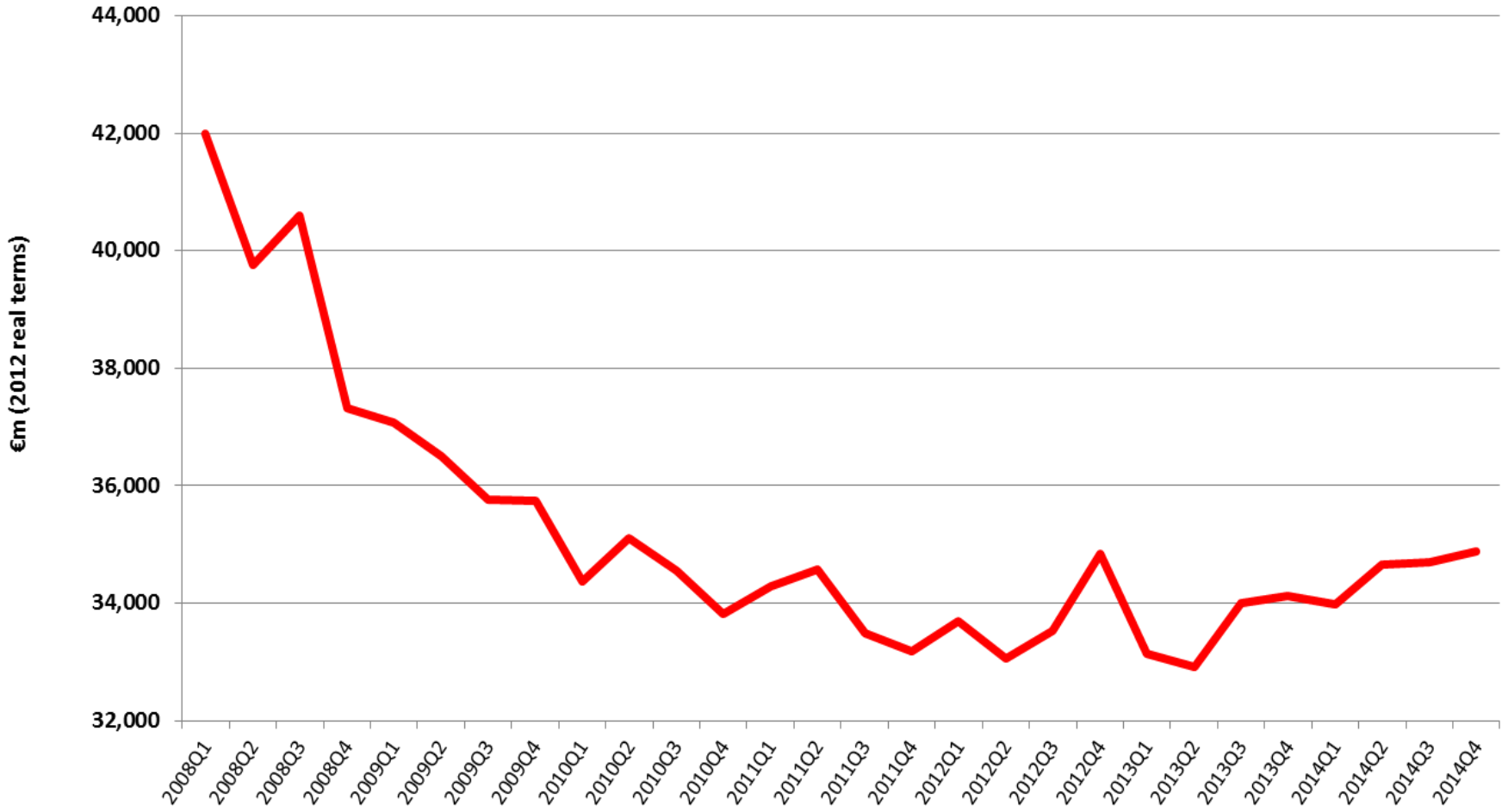
Sources: CSO, SILC and NERI, QEF



Economic Trends

Final Domestic Demand in Constant 2012 prices, (€ millions), Quarterly Data (2008 - 2014)

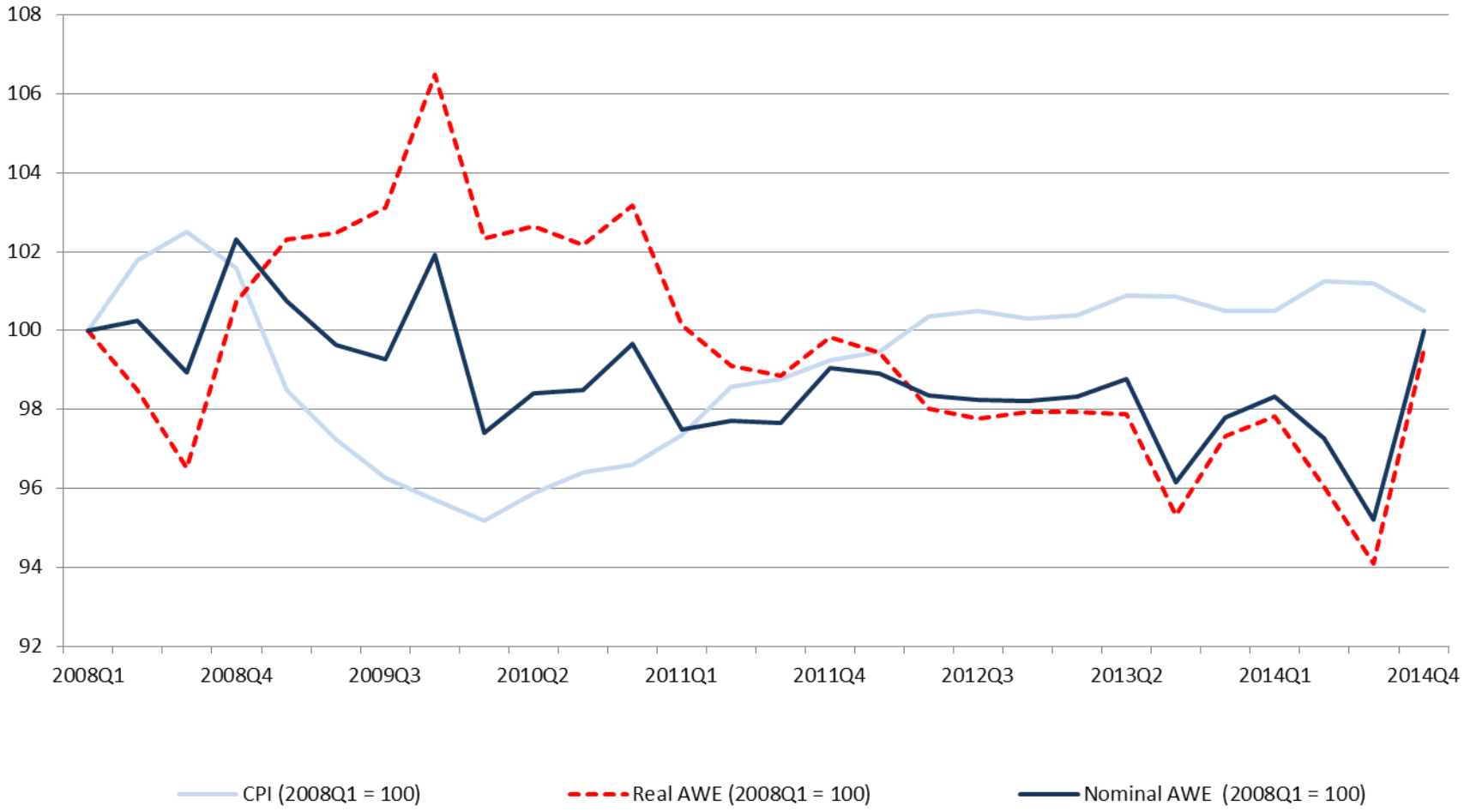
Source: CSO, QNA



Trends in Wages

Average Weekly Earnings (AWE) and Prices (CPI), 2008 to 2014

Sources: CSO, CPI and CSO, EHECS

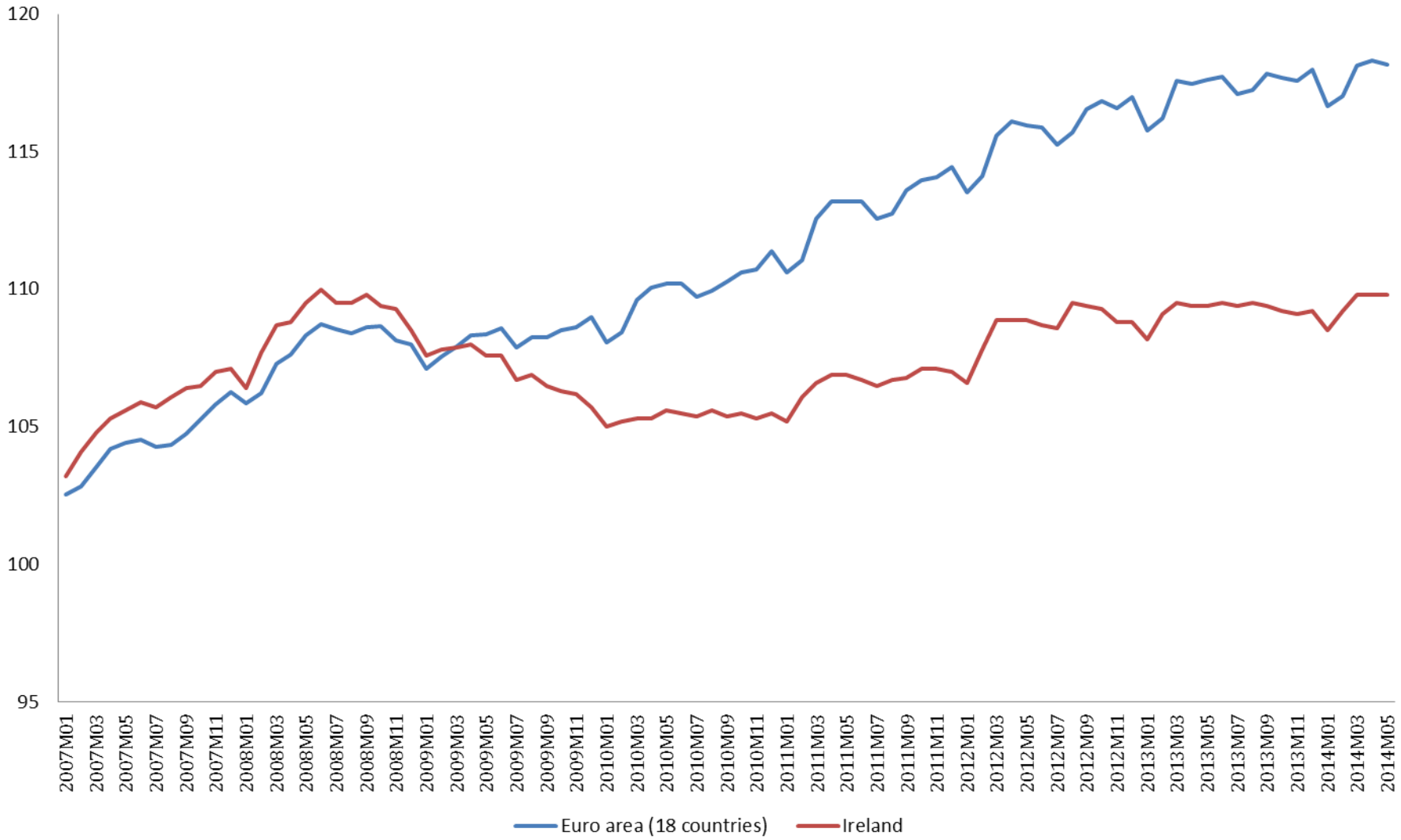


Trends in Prices

HICP in Ireland and the Euro Area, 2007- 2014

Base year 2005=100

Source: Eurostat HICP



Trends in Trade

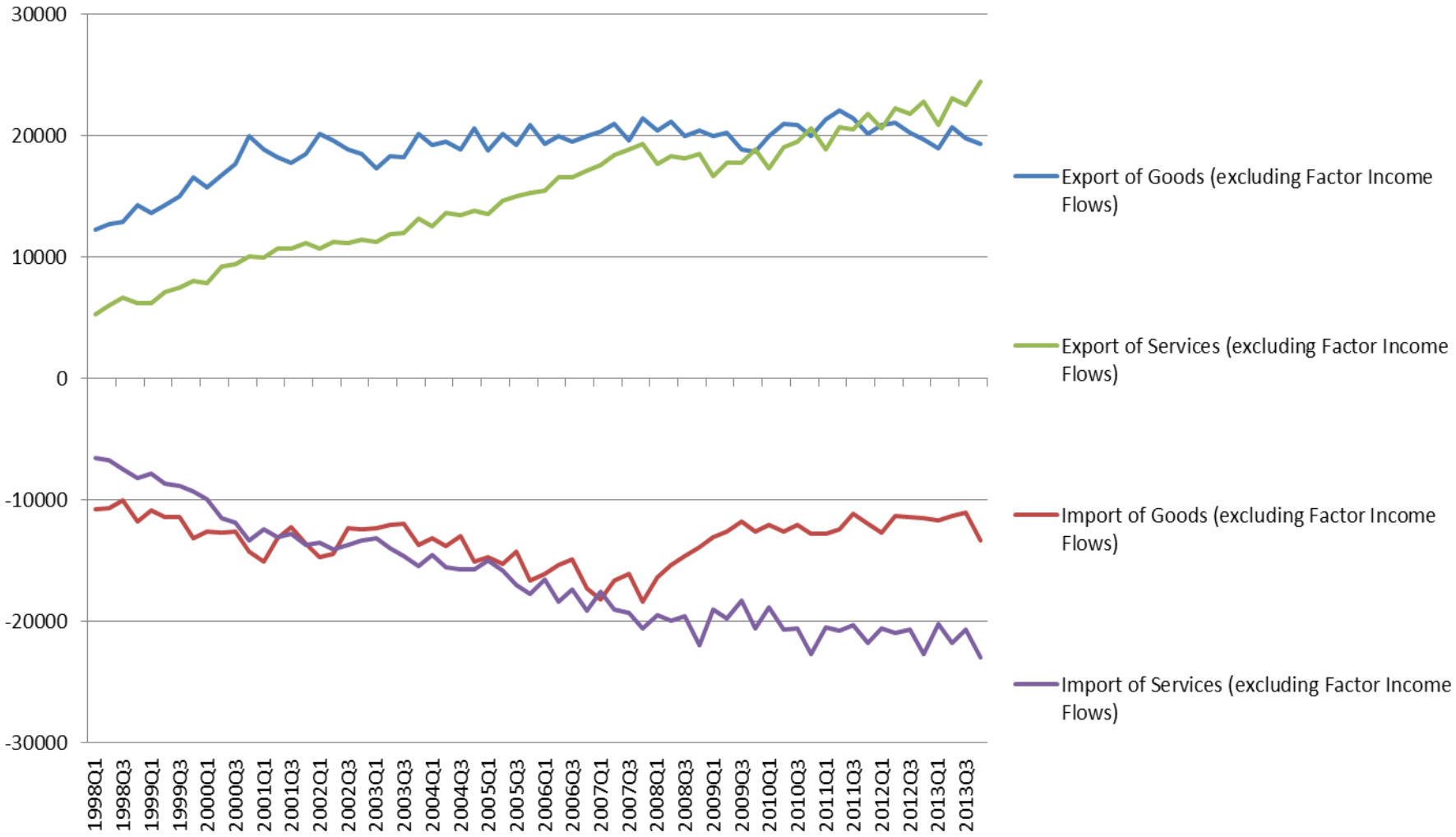
Current Account and Trade: 2008 to 2013

- Since 2008, the current account (CA) has moved from deficit to surplus, reflecting improved cost competitiveness, allied to reduced consumer demand for imported goods.
  - CA moved from a deficit of €10 billion in 2007 and 2008 to a small surplus in 2010 and a surplus in excess of €10 billion by 2013.
- The only substantial change in trends since the onset of the recession was the fall in goods imports.
  - Fall in goods imports is very much in line with expectations given the general fall in household disposable income, investment levels and aggregate demand.
  - Service imports and exports have continued to grow along pre crisis trends.
- Share of world trade fell continuously year-on-year between 2002 and 2006 and again between 2009 and 2012.
  - Share of world trade, which peaked at 1.4 per cent in 2002, fell to 1.0 per cent by 2012. Share of merchandise trade fell even further from 1.4 per cent in 2002 to 0.6 per cent in 2012. Suggests a loss of competitiveness in merchandise production.
  - Share of the global services market increased from 1.0 per cent in 2000 to 2.7 per cent in 2012. Ireland's share is broadly unchanged since 2007 which suggests no fundamental improvement or decline in competitiveness in services provision since 2007.

Trends in Trade

Quarterly Imports and Exports, Real Terms, (€ million), 2008-13

Source: CSO, QNA



A Sectoral Perspective

Employment Shifts by Economic Sector

Source: CSO, QNHS

Economic Sector	Q3 2007	Q3 2012	Q3 2014	Change 2007 to 2014	Employment Q3/14 relative to Q3/07
Declining Sectors					
Construction	270,800	100,000	112,400	-158,400	41.5%
Industry	307,400	230,800	238,800	-68,600	77.7%
Admin. and support service	83,600	64,700	65,200	-18,400	78.0%
Wholesale and retail trade	310,900	270,900	275,200	-35,700	88.5%
Public admin. and defence	107,900	99,300	98,100	-9,800	90.9%
Transportation and storage	92,800	90,000	87,500	-5,300	94.3%
Financial, insurance, real estate	106,600	100,900	103,100	-3,500	95.2%
Agriculture, forestry and fishing	112,200	84,800	109,700	-2,500	97.8%
Expanding Sectors					
Accommodation and food	139,000	119,300	139,800	+800	100.6%
Professional, scientific and tech.	115,400	101,700	116,900	+1,500	101.3%
Other NACE activities	97,700	100,800	101,600	+3,900	104.0%
Education	133,700	145,900	144,100	+10,400	107.8%
Human health and social work	218,900	243,700	249,500	+30,600	111.3%
Information/communication	67,400	78,300	79,300	+11,900	117.7%
Total in employment	**2,169,600**	**1,832,700**	**1,926,900**	**-242,700**	**88.8%**

A Sectoral Perspective

Decomposition of Nominal Unit Labour Costs,
(Difference Relative to Peak of 2008)

Source: O'Farrell, 2013

The economy-wide fall in Nominal Unit Labour Costs was driven mainly by compositional effects

- i.e. movements away from labour intensive activities (low productivity sectors like construction and retail trade)

NULC was generally stagnant within the economic sectors

- Though a relative competitiveness improvement vis-a-vis the euro area

	2000	2004	2008	2012
Change in Nominal Unit Labour Costs (NULC) holding sectoral composition of employment constant	-32.5%	-19.4%	0.0%	-0.7%
Changing composition, fixed Nominal Unit Labour Costs	-4.3%	0.9%	0.0%	-9.7%

The total change in unit labour costs is based on factor cost. The fixed composition uses 2008 sectoral weights.

Conclusion

- Difficult to identify a clear causal link between ID and the substantial movements in employment post 2008
- Wages are now relatively lower than in other EU countries (compared to 2008)
  - This is not due to a coordinated policy, but to a weak Irish economy and a collapsed construction sector - and in large part to the policies of austerity which served to increase unemployment (see e.g. Rannenberg et al for a meta-study)
- Experiences with ID in the euro area have not been happy ones. Countries deemed to have undergone 'successful' IDs have also generally undergone damaging recessions (hysteresis effects).
  - Regional internal revaluation represents a better alternative within a currency union to a strategy focused purely on ID in debtor countries (country specific recommendations).
  - The official preference for ID over internal revaluation has created a deflationary bias for the euro area and for the world economy.
- Finally, what explains the recent recovery in the Irish economy?
  - Oil prices; exchange rates (Ireland asymmetrically benefits); monetary policy; mild fiscal stimulus; pent-up demand; up-swing multipliers; trading partner performance (US/UK)

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Internal Devaluation

GREECE – CASE STUDY

S. THEODOROPOULOU (2016)

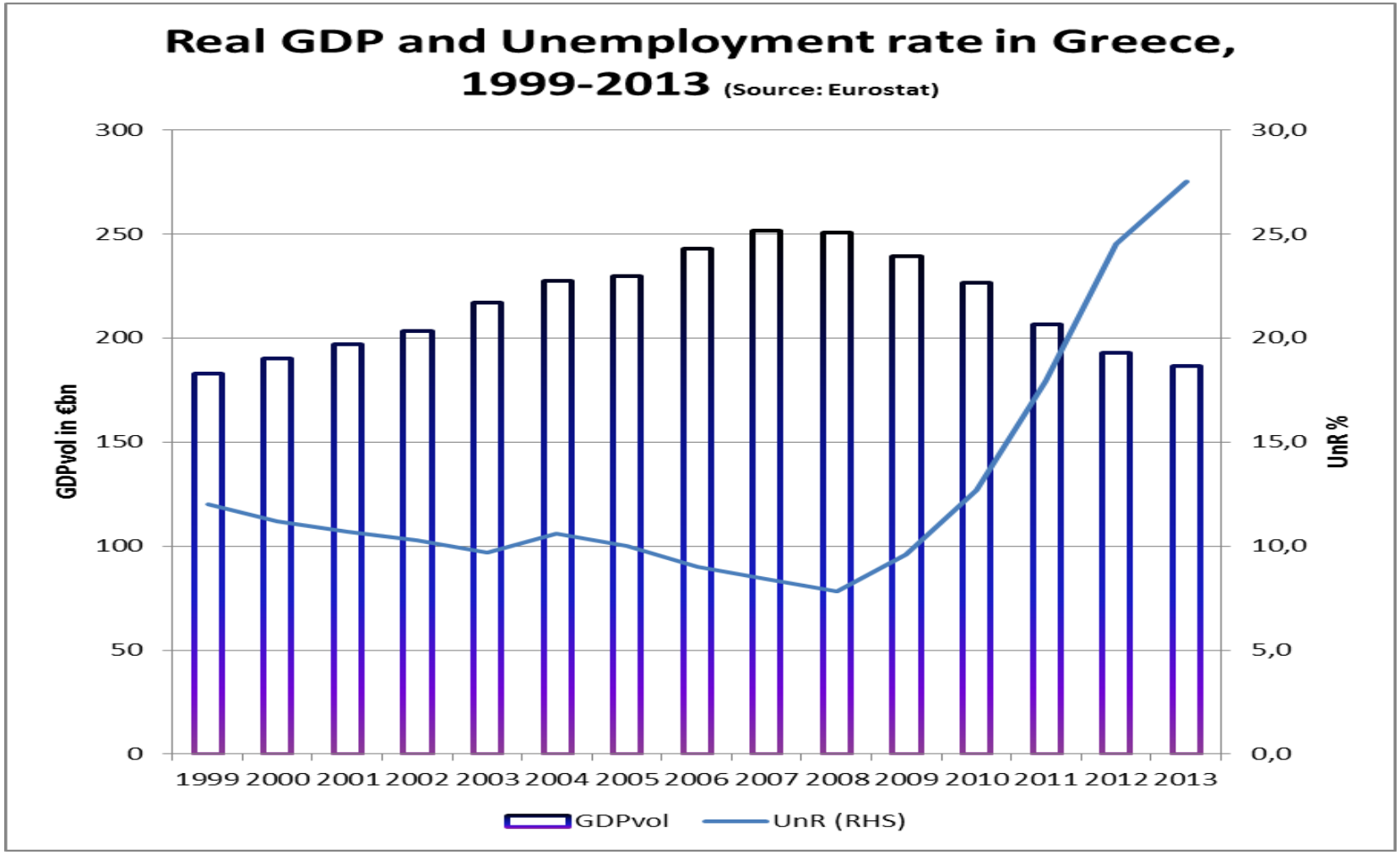
ID in Greece

(Theodorpoulou, 2016)

- In 1st MoU (2010), internal devaluation to be promoted through structural reforms that would strengthen external competitiveness and facilitate reallocation of resources from NT to T sectors (European Commission 2010)
- Fiscal austerity with public sector wage cuts also to contribute by reducing relative wage costs of 'non-tradable' public sector
- Conditionality on private sector wages left out
- Change of approach in 2nd MoU (2012): deeper recession due to fiscal austerity--> explicit targets on private sector wage adjustment in attempt to 'stimulate external demand'
- Risky approach: labour costs=only 17% of output value in mnf sector; Greece very closed economy; asymmetric adjustment

By 2013 output is lower that at the start of the century…….

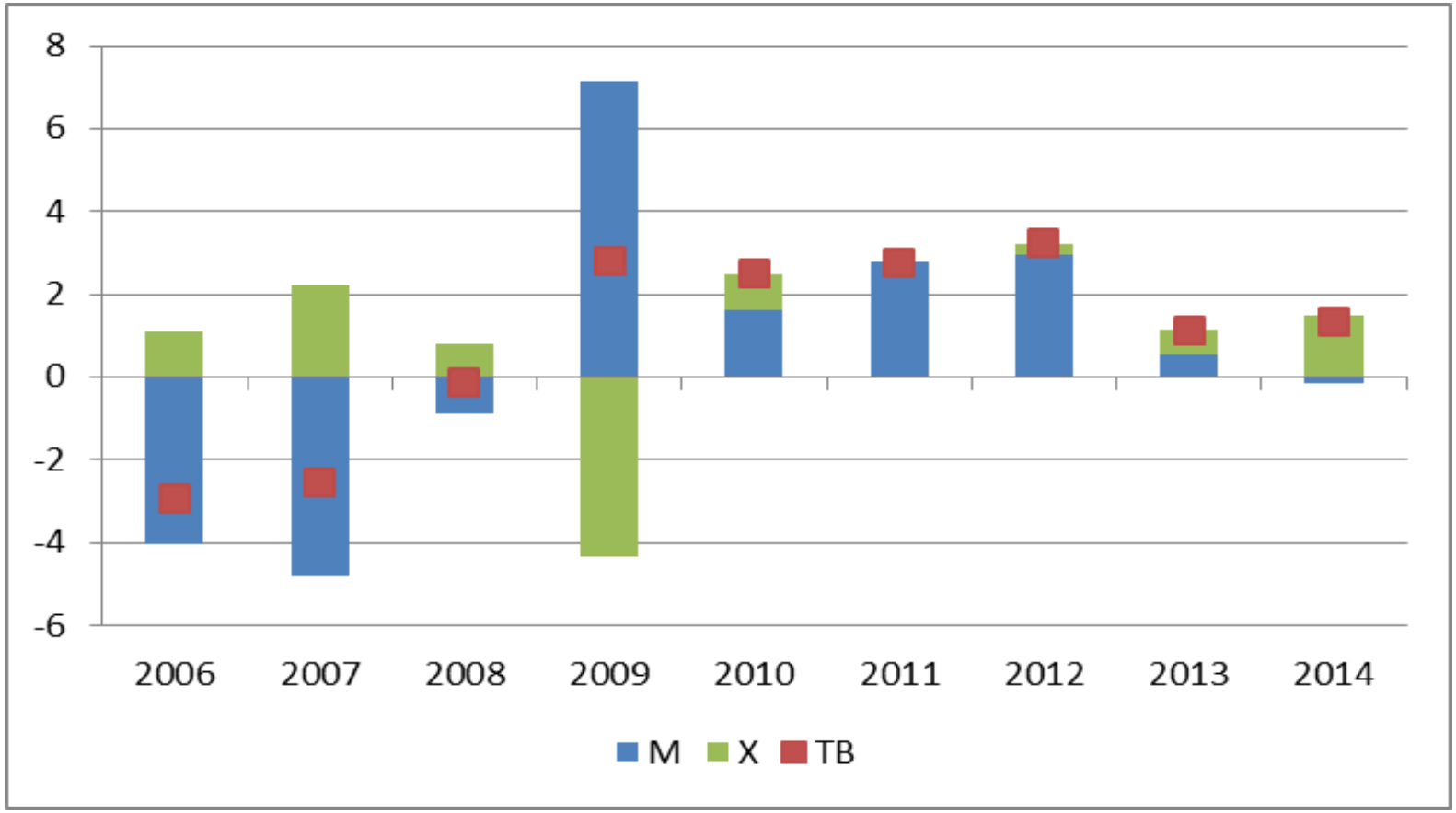
(Theodorpoulou, 2016)



Net Exports – positive growth effect (mainly via falling imports)

(Theodorpoulou, 2016)

Contribution to GDP growth of Imports (M), Exports (X) and Trade Balance (TB), Greece 2006-14 (AMECO)



Conclusion (Greece)

(Theodorpoulou, 2016)

- Internal devaluation in a relatively closed economy with low % of labour costs in output value did not help exports but depressed domestic demand and created uncertainty that further hampered investment into tradable sectors
- In the s-r, when productivity growth not likely, policies promoting balanced adjustment of prices and nominal wages should be pursued

Internal Devaluation

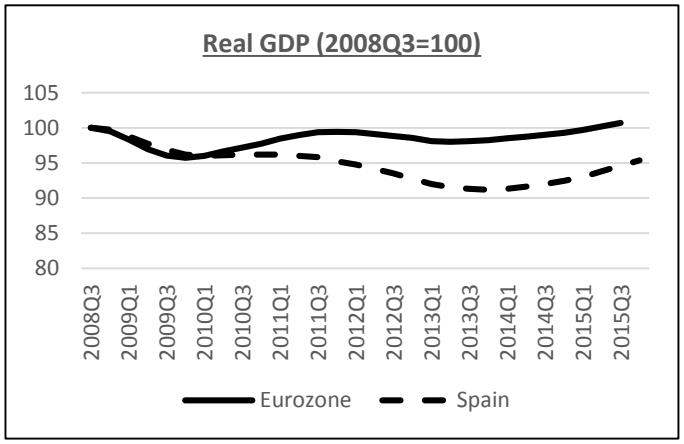
SPAIN – CASE STUDY

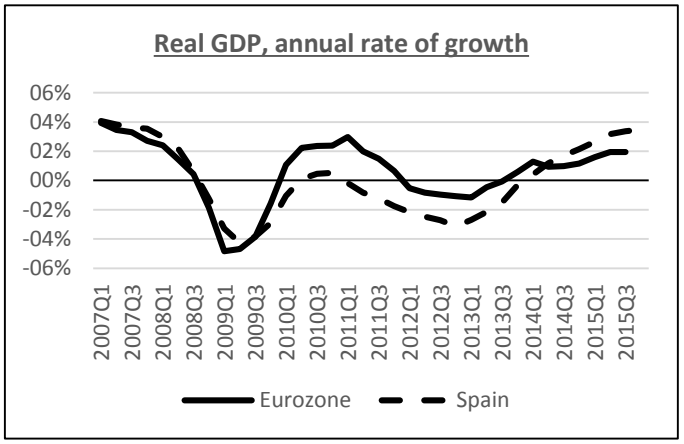
J. UXÓ, E. FEBRERO, F. BERMEJO (2016)

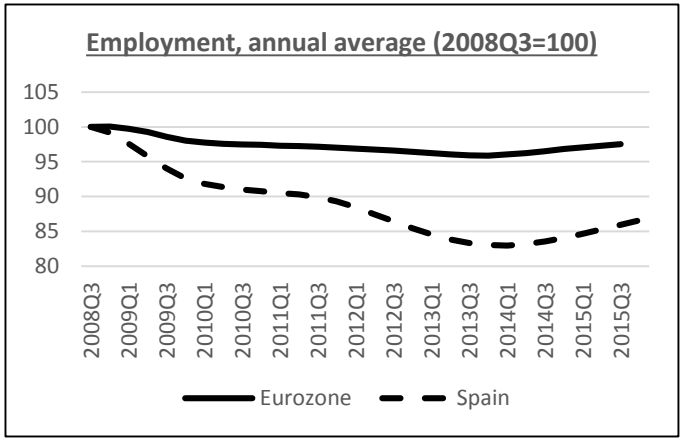
Employment and GDP in Spain (2008-2015)

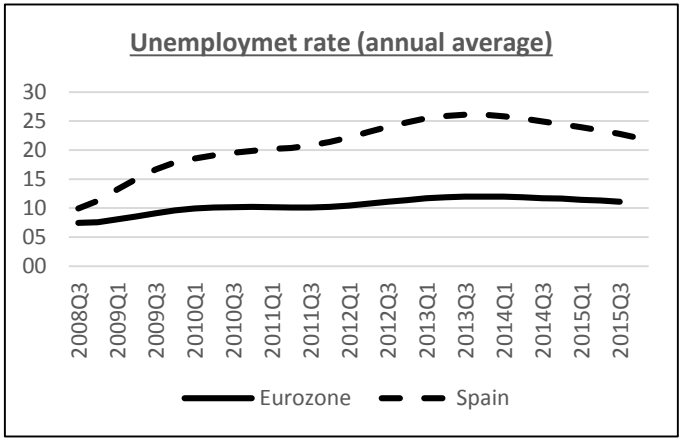
(Uxó et al. 2016)

1. Double-dip recession (2008-2009 and 2011-2013).
2. Intense job destruction and increase in unemployment.
3. Growth recovery (2014-2015) but levels of GDP and employment below 2008. All social indicators have worsened.



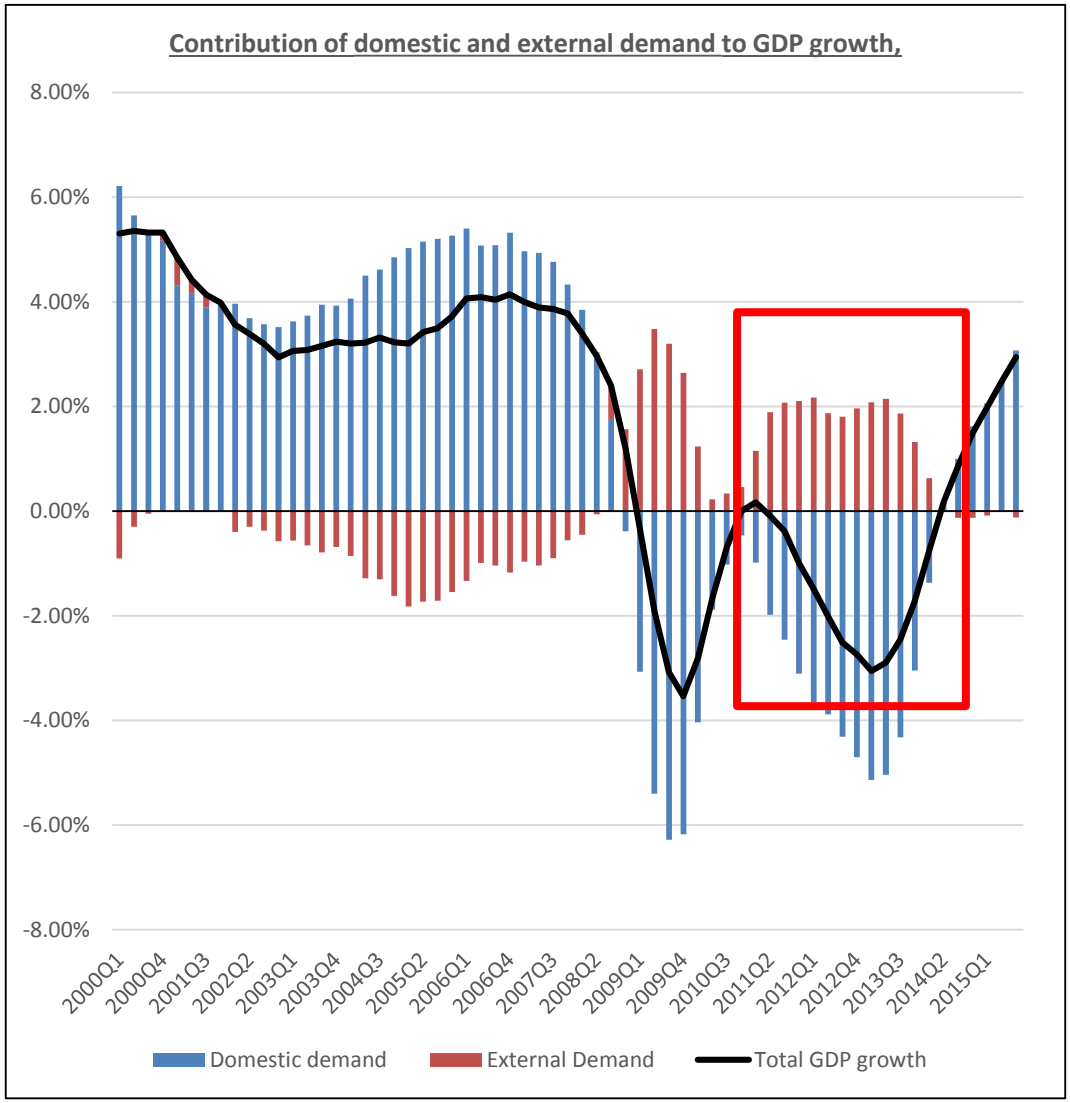


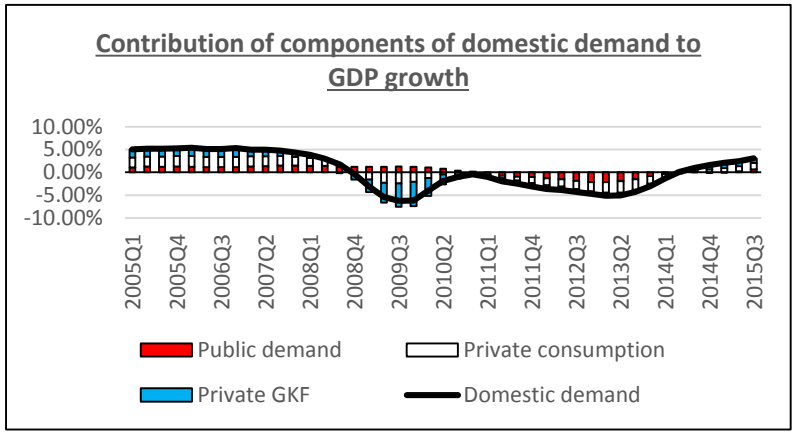


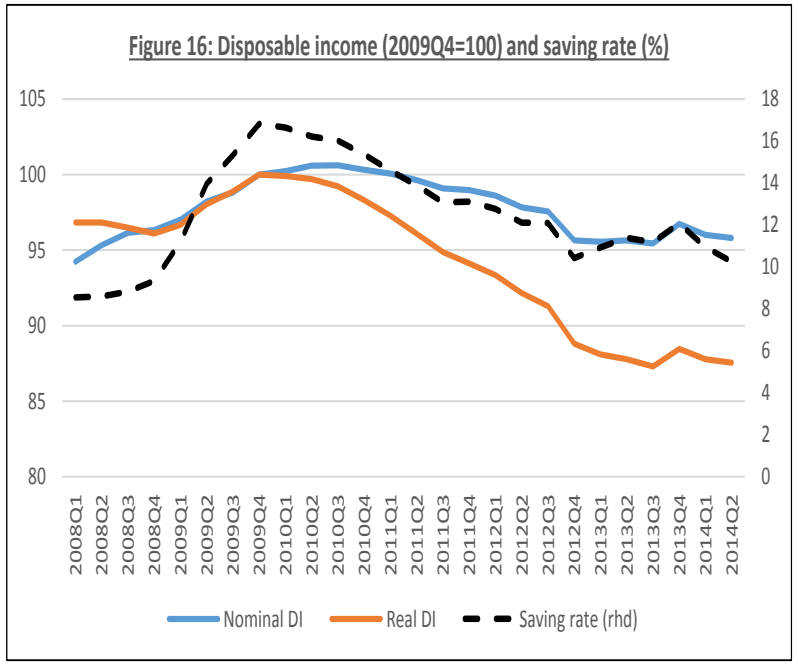


Downward trend in domestic demand

(Uxó et al. 2016)

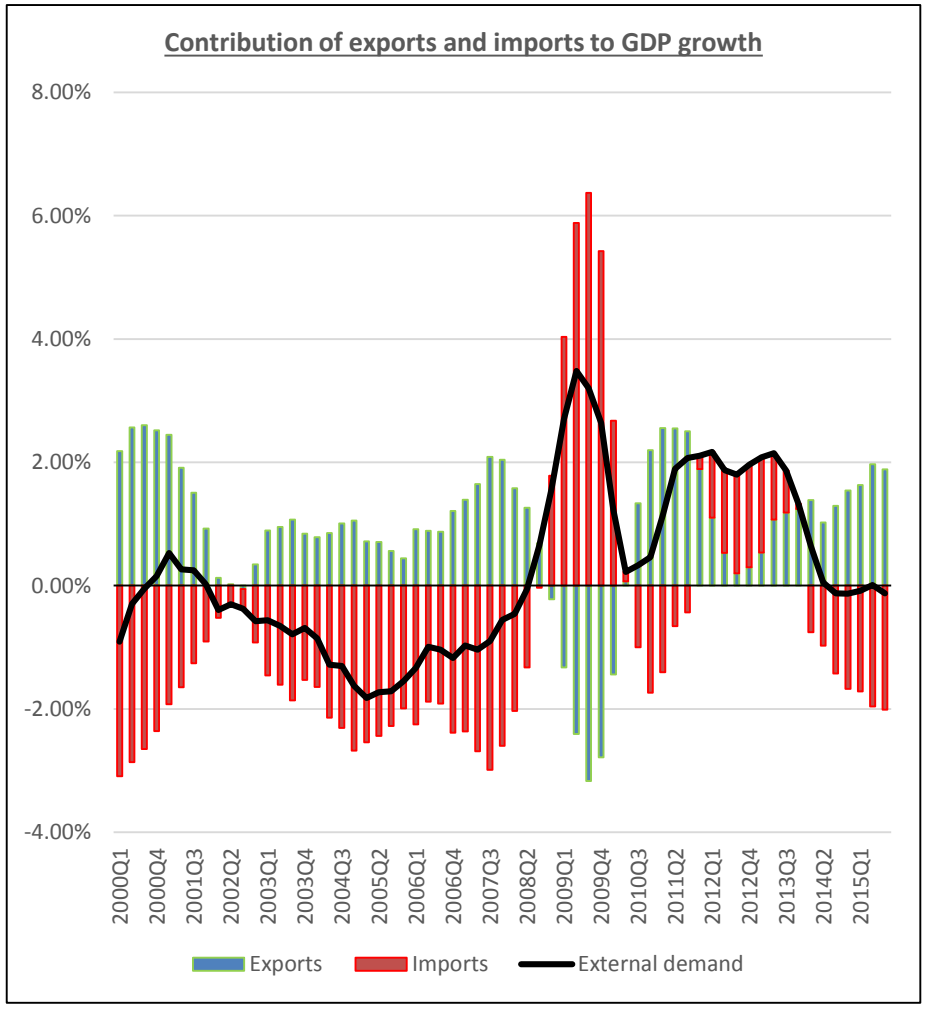


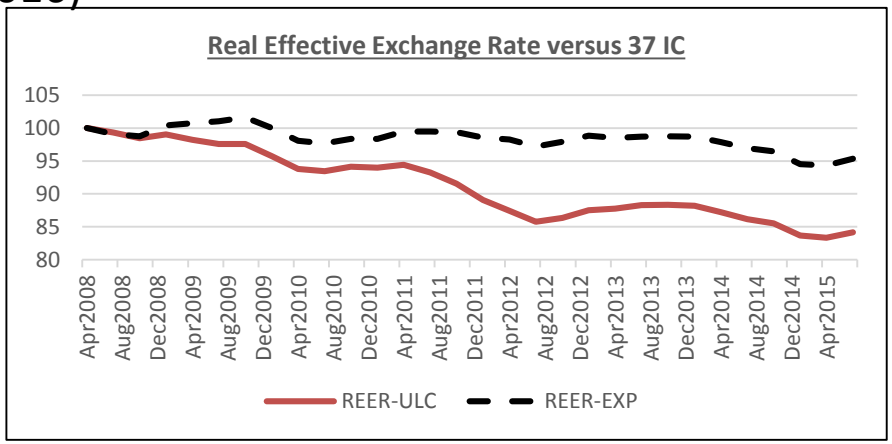


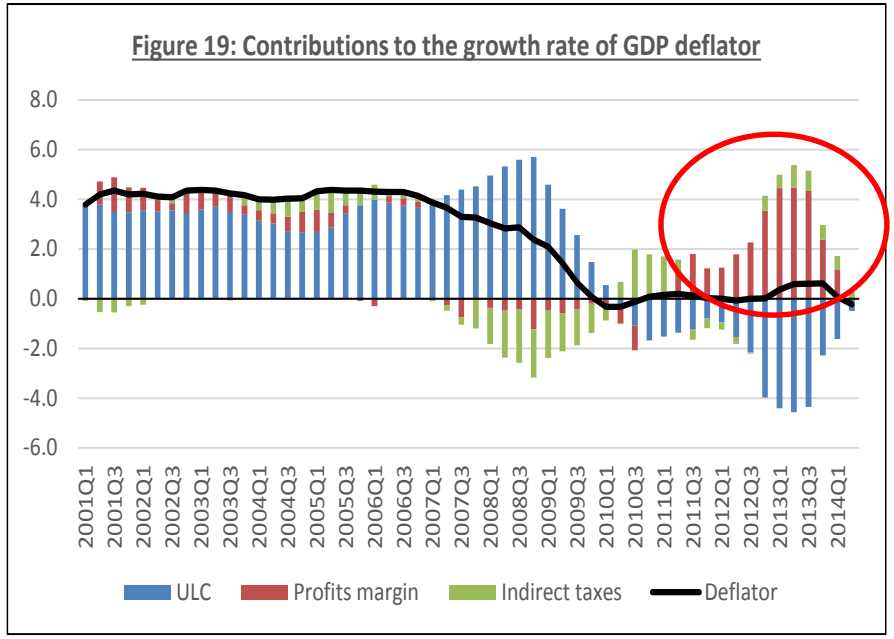


Internal devaluation did not trigger an export-led growth recovery

(Uxó et al. 2016)







Concluding remarks (Spain)
(Uxó et al. 2016)

- Fiscal austerity and internal devaluation have been **detrimental** to employment (**negative** correlation between decreasing labour costs and employment):
  - Direct impact on domestic demand derived from cutbacks in public expenditures.
  - Households' disposable income is lower and the burden of debt servicing is higher (debt deflation).
  - Social costs and inequality.
  - Falling wages and ULC have made no substantial contribution to rebalancing the external sector, and competitiveness gain has been much lower than the decrease in ULC (higher profit margins and indirect taxes).
  - Net exports contribution to growth is mainly explained by the collapse in imports, and it is not sufficient to offset domestic demand decrease.

- Labour market reforms have also **failed to reduce dualization and precarity**:
  - Nearly 50% of the unemployed in Spain have been either unemployed for 2 years or more, or have never worked.
  - Decreasing level of protection of unemployed.
  - There are very high percentages of employed people with involuntary part time or temporary labour contracts.

- Ongoing recovery is not the result of austerity + internal devaluation:
  - The need of an **alternative economic policy**.

Internal Devaluation

10 YEAR PERFORMANCE AND CONCLUDING THOUGHTS

NULC
(2010 = 100)

	2007	2014	2017
EU	95.9	105	107
Euro area	92.7	104.3	106.9
Greece	87.7	87.8	88.5
Ireland	107	99.3	84.7
Portugal	95.9	95.4	97.5
Spain	94.5	95.9	96.2
Latvia	103.7	114.2	130.0
UK	115	109.6	108.5
USA	95.6	106.7	142.4

Fiscal balance (% GDP)

	2007	2017	Change pp
EU	-0.9	-1.6	-0.7
Euro area	-0.6	-1.4	-0.8
Greece	-6.7	-1.2	+5.5
Ireland	+0.3	-0.5	-0.8
Portugal	-3.0	-1.8	+1.2
Spain	+1.9	-3.2	-5.1
Latvia	-0.6	-0.8	-0.2
UK	-2.7	-2.9	-0.2
USA	-3.5	-4.7	-1.2

Change in GDP at 2010 prices (2007 = 100)

	Ratio 2017/2007	Ratio 2014/2007
EU	107.3	101.1
Euro area	105.0	99.4
Greece	75.1	73.8
Ireland	139.4	101.0
Portugal	97.7	93.1
Spain	102.2	93.4
Latvia	99.6	92.0
UK	110.8	104.7
USA	114.5	107.5

Change in domestic demand (excl. Stocks) at 2010 prices (2007 = 100)

	Ratio 2017/2007	Ratio 2014/2007
EU	105.1	98.8
Euro area	103.8	97.2
Greece	69.2	67.7
Ireland	121.1	89.4
Portugal	92.8	87.3
Spain	91.9	84.6
Latvia	89.4	82.8
UK	107.7	101.7
USA	113.0	104.9

Change in imports at 2010 prices (2007 = 100)

	Ratio 2017/2007	Ratio 2014/2007
EU	125.7	109.2
Euro area	124.9	108.3
Greece	69.3	67.3
Ireland	169.7	121.4
Portugal	117.6	99.0
Spain	92.7	81.1
Latvia	102.8	88.9
UK	117.3	106.0
USA	119.5	107.8

Change in exports (g+s) at 2010 prices (2007 = 100)

	Ratio 2017/2007	Ratio 2014/2007
EU	131.5	115.3
Euro area	130.7	114.9
Greece	102.8	97.9
Ireland	189.2	132.4
Portugal	140.2	121.2
Spain	131.8	113.9
Latvia	143.2	130.5
UK	118.9	106.5
USA	133.1	128.6

Current account balances (% GDP)

	2007	2017
EU	-1.0	1.7 (2016)
Euro area	0.1	3.0 (2015)
Greece	-15.2	-0.5
Ireland	-6.5	4.8
Portugal	-9.7	0.4
Spain	-9.6	1.6
Latvia	-20.8	-0.7
UK	-2.4	-3.9
USA	-5.0	-2.8

Unemployment rates (%)

	2007	2017	Change pp
EU	7.2	8.0	+0.8
Euro area	7.5	9.4	+1.9
Greece	8.4	22.8	+14.4
Ireland	4.7	6.4	+1.7
Portugal	9.1	9.9	+0.8
Spain	8.2	17.6	+9.4
Latvia	6.1	9.2	+3.1
UK	5.3	5.0	-0.3
USA	4.6	4.5	-0.1

Employment ratios (2007 = 100)

	2017
EU	102.38
Euro area	101.38
Greece	86.11
Ireland	97.89
Portugal	92.78
Spain	89.78
Latvia	84.47
UK	108.65
USA	104.69

Alternative policies?

Nominal devaluation and internal revaluation

- External (nominal) devaluations are likely to be much more effective than IDs because they lower export costs without inducing a decline in domestic demand.
  - Not a policy choice available to governments in the euro area – but could have been imposed centrally
- The alternative way to restore lost competitiveness in the euro area periphery, while simultaneously supporting demand, would have been for the more competitive 'core' to engage in a process of internal revaluation
  - Provided inflation is higher in the more competitive economies the competitiveness gap will eventually close. Internal revaluation could be induced within the surplus countries through policies to increase wages, prices and domestic demand.
- Competitiveness is a relative concept
  - Economy-wide aggregates may be unhelpful
- Long-run growth depends on productivity and employment growth
  - Infrastructure; human capital; innovation (R&D); labour market barriers e.g. cost of childcare