Recovering from the crisis in the euro area: Exchange rates, inflation and real wages (by Fabrizio Coricelli)

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Professor Coricelli began his presentation with an important remark regarding the title of his presentation. As stated in the conference agenda, he was originally planning to talk about transition to the euro and the euro in transition. In order to focus on the current key issue of transition in the euro area, he has decided not to elaborate on transition countries attempting to introduce the euro and has presented only his opinion and results related to the transition of the euro itself.

There is a serious threat to the stability of the euro area and the survival of the euro as we know it. The public is increasingly sceptical about the euro. As Professor Coricelli states, economists can play a useful role in challenging the foundations of such scepticism. The solution to the crisis implies fiscal and banking union, which is ultimately a political decision. Unfortunately, politicians act within political incentives and constraints. Economists cannot do much about this. However, they can suggest solutions to specific problems behind the current euro crisis and increasing scepticism on the euro.

A frequently sugested solution for periphery countries is currency devalution. This myth assumes that if they were to be able to devalue, economic conditions would improve and the situation would be much better. The idea is that depreciation of national currencies would solve problems in the real economy, especially high unemployment in the hardest hit economies. Given the fact that the euro area countries no longer have their own currency, the argument entails exiting from the euro area. Professor Coricelli challenged the role of the exchange rate using findings from a recent study with Guillermo Calvo and Pablo Ottonello of Columbia University.[1]

In his fact-based presentation he tried to answer several important questions. He elaborated particularly on two of them: Is the Euro crisis a "competitiveness" crisis of the periphery? How can the periphery exit the Great Recession and especially how can it reduce unemployment? Using evidence from past financial crises in emerging economies he argued that the true issue was not one of competitiveness as measured by the real exchange rate. It is not the periphery countries' relative prices compared to Germany, but the real wages that matter. He stated that temporarily higher inflation rate in the euro area might help the periphery to reduce unemployment. At the end of his presentation he added that the optimal policy would be to directly address the credit constraints on firms.

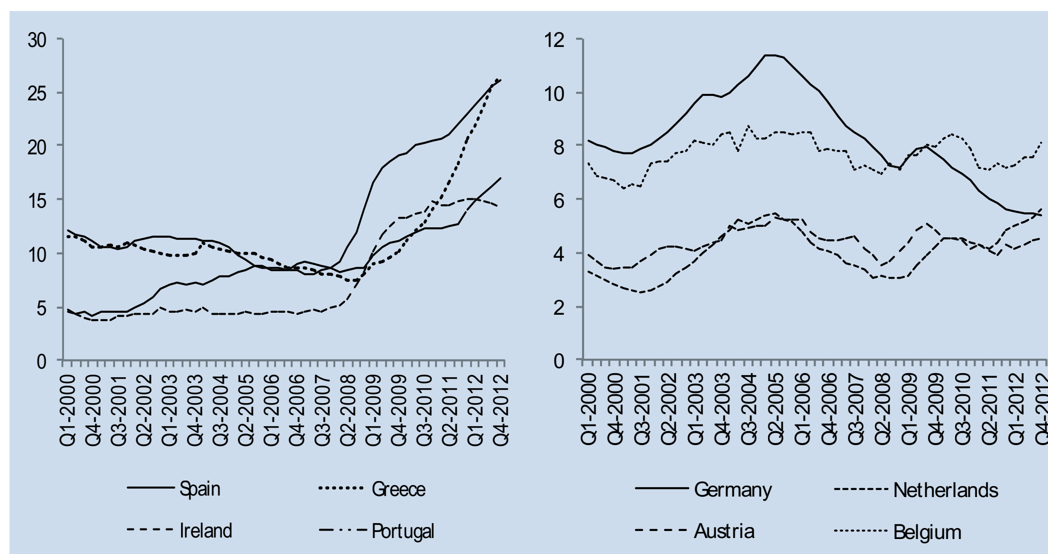
KEY CHALLENGE OF THE EURO AREA

According to Professor Coricelli, the key challenge in the current euro area is to improve conditions in labour markets in the hardest hit economies of the periphery. The Great Recession, as other financial crises, has had severe and persistent effects on labour markets. The unemployment rate in the PIGS has surged and remains stubbornly high. By contrast, Germany and a few other euro-area countries can claim a reduction or stagnation of unemployment. Even the current recovery success story in terms of internal devaluation – Ireland – records persistent unemployment. The problem is how to tackle the jobless recovery, i.e. the situation when an increase in output is not followed by an increase in employment, or decrease in unemployment.

Many commentators have emphasised the lack of exchange rate flexibility as the cause of persist-

1 *Calvo, G., F. Coricelli and P. Ottonello, "Jobless Recoveries during Financial Crises: Is Inflation the Way Out?", mimeo, 2013.*

Fig. 1 Unemployment rate in the euro area (PIGS vs. core; percentages)



Source: Eurostat.

ent economic stagnation and high unemployment. An ultimate belief is that exchange rate depreciation is the solution. The logic behind this is straightforward: nominal depreciation causes real depreciation, an increase in competitiveness and a recovery.

THE ROLE OF REAL WAGES

But what to do in a monetary union? In the absence of the exchange rate instrument "internal" devaluations (reduction of domestic prices) are the alternative. Professor Coricelli tackles this issue in one of his papers by looking at the entire sample of past financial crises in emerging markets. Together with Calvo and Ottonello[2] they find only little evidence on the key role of the real exchange rate. According to the authors, the key relative price seems to be the real wage.

The theory behind their contribution (based on a two-factor production function) starts with the fact that labour cannot serve as collateral in a credit contract. But capital can serve as so-called "intrinsic" collateral.[3] As Professor Coricelli explained, in the situation where the credit constraint is binding, tightening of the credit constraint induces a bias against labour.[4] Then, in the case of wage flexibility, we can expect real wages to adjust. However, in the case of wage rigidity, real wages remain constant and employment declines. In a more frequent environment of nominal wage rigidity, i.e. where nominal wages remain constant, but real wages can adjust, real wages fall with higher inflation. Therefore, high inflation may help reduce unemployment following a credit contraction by reducing real wages.

Professor Coricelli draws recommendations from a study of fourteen low- and nineteen high-inflation episodes in emerging markets. Together with his colleagues, they divide up the sample according to inflation. They compare peak-to-recovery cycles, i.e. real GDP returns to its pre-crisis level, in high (above median) and low (below median) inflation. They find that the key difference in the behaviour of unemployment is due to inflation. In a low-inflation environment the unemployment rate remains high beyond the output recovery point, i.e. a jobless recovery. In a high-inflation environment they do not see a jobless recovery; they find that unemployment decreases. The behaviour of real wages is inverse to that of unemployment: wages remain persistently low in high-inflation episodes, while they fully recover in low inflation. The authors also show that the real exchange rate behaves similarly; we observe significant real depreciation, in both high- and low-inflation environments. Exports increase, but there is little structural change or redistribution between tradable versus non-tradable output. During his presentation, Professor Coricelli also added that they did not find a long-run Phillips curve behaviour, i.e. spikes in inflation were only temporary. Even in episodes of very high inflation during crises the inflation rate rapidly declined towards pre-crisis levels. He concluded this part of his presentation by stating that it is the real wage that made the difference and not the exchange rate depreciation.

After his explanation of the adjustment mechanism observed in emerging countries, he continued with an example of its application in two European countries severely hit by the recent financial crisis – Iceland and Ireland. Giving the example, he challenged Krugman's arguments for the existence of national currencies in Europe and a possibility to use currency devaluation.[5] Professor Coricelli argued that we should not take the effects of devaluation as "miraculous". A simple look at the cross-country differences in unemployment and real wages confirms five percent lower real wages in Iceland compared to Ireland,

2 Calvo, G., Coricelli, F. and P. Ottonello, 2012, "The Labor Market Consequences of Financial Crises With or Without Inflation: Jobless and Wageless Recoveries", NBER Working Paper No. 18480.

3 By "extrinsic collateral" they mean liquid or other assets, that nomally allow firms to borrow.

4 If written in the form of an equation: $wL+K=C+(1-a)K$, a fall in C induces a decrease in wL. Where w stands for real wages, L for employment, C for collateral, and K for capital.

5 For illustration, he presented the following statement: Krugman (NYT, July 2012) "For the most part, Iceland's lesson is relevant to countries that experienced big capital inflows followed by a sudden stop — that is, the European periphery, not the US or the UK. What it demonstrated was the usefulness of devaluation (and therefore of having your own currency)…"

Fig. 2 Real GDP index (1 = pre-crisis peak)

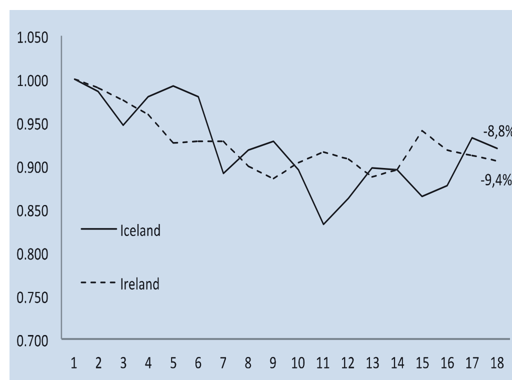


Fig. 4 Unemployment rate (Great recesion)

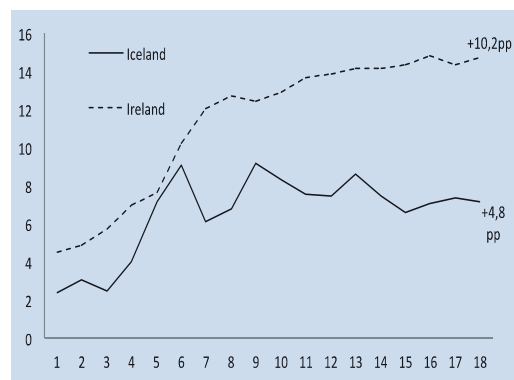


Fig. 3 Real wages (Great recesion)

Fig. 5 Customer price index

Source: Eurostat.

and a five percent higher unemployment rate in Ireland. Taking into account the fact that both countries witnessed an almost identical (9%) drop in gross domestic product within 18 months, and that nominal wages increased in Iceland, it was inflation that made the difference.

Implications for the euro area

The clear implication from Professor's findings is that a temporary spike in euro-area inflation would help to reduce unemployment rates in the periphery. However, lower unemployment has to be traded off with lower real wages. In addition, he suggested two policy implications for the European Central Bank:

1. to lift substantially (though temporarily) the euro-area inflation target
2. to focus on the indicators of the "troubled countries" (weak links in the chain) rather than average the euro area statistics.

At the same time, we should keep in mind that while temporary high inflation will help reduce unemployment, welfare will not necessarily rise, since real wages will be much lower.

Finally, Professor Coricelli mentioned that higher inflation is a sub-optimal solution to the current crisis. An optimal policy should target the financial origins of the crisis. The key is to address directly the credit constraints of firms in the periphery (including Italy). In his opinion, policies of lending to banks have not yet succeeded in channelling funds to firms. He concluded that we need to find more effective solutions, including funding for lending, and that the ECB should consider a direct lending facility for firms.

(Compiled by Tibor Lalinský)