

No 3 | 2014

# Economic Briefing



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# Foreword

## Forecasts point to stagnation, not recovery - the need for a new approach

As global economic elites meet in Davos, opinions on the state of the global economy remain divided. On the one hand, latest projections from the World Bank suggest that global growth will pick up from 2.4% in 2013 to 3.2% in 2014. The Bank says that high-income countries “appear to be finally emerging from the global financial crisis”.<sup>1</sup> On the other hand, as this economic briefing (prepared by Carolin Vollmann, Economist at the ITUC) shows, forecasts by the International Financial Institutions have been revised downwards successively since 2010 when restrictive policies were introduced in many countries. The Managing Director of the IMF herself has recently said “... we see rising risks of deflation, which could prove disastrous for the recovery”.<sup>2</sup> It is becoming clear that the global economy cannot recover on export-led growth that so many countries are espousing. There must be an expansion of demand particularly from working households.

The World Economic Forum’s own Outlook on the Global Agenda 2014 and Global Risks Report<sup>3</sup> identify widening income disparities and structural unemployment as the most serious problems confronting the global economy this year. The current policy stance of most governments will do little to address either of these risks. On current policies, global unemployment and inequality will continue to rise in 2014. The call for a policy change has been supported by the WEF’s own Global Agenda Council on Employment stating that “What started as a deep but temporary jobs crisis is becoming a persistent challenge with serious effects on the social fabric. Little respite is on the horizon in 2014 without significant changes in policy.”<sup>4</sup>

The shift in policy that the global labour movement is calling for is to move from austerity to:

- Targeted investments in infrastructure to improve long-term productive potential and move to a low-carbon economy;
- Raising the purchasing power of low and middle-income households by reducing inequality and strengthening collective bargaining and minimum wages;
- Investing in active labour market policies to raise skill levels and reduce youth unemployment;
- Reducing informality and creating decent work in emerging and developing countries.

The global labour movement is mobilising around these objectives of investment and jobs, wages and social protection at Davos, the G20, the IMF, the World Bank and the OECD who have to provide stronger leadership in the interests of the world’s working people.

*John Evans*



*John Evans, ITUC  
Chief Economist.*

<sup>1</sup> World Bank Global Economic Prospects, January 2014

<sup>2</sup> IMF [www.imf.org/external/np/speeches/2014/011514.htm](http://www.imf.org/external/np/speeches/2014/011514.htm)

<sup>3</sup> [http://www3.weforum.org/docs/WEF\\_GAC\\_GlobalAgendaOutlook\\_2014.pdf](http://www3.weforum.org/docs/WEF_GAC_GlobalAgendaOutlook_2014.pdf)

<sup>4</sup> WEF Global Agenda Council on Employment “Jobs and Skills: Tackling the Global Unemployment Crisis – Preparing for Growth”, January 2014



# Economic Briefing

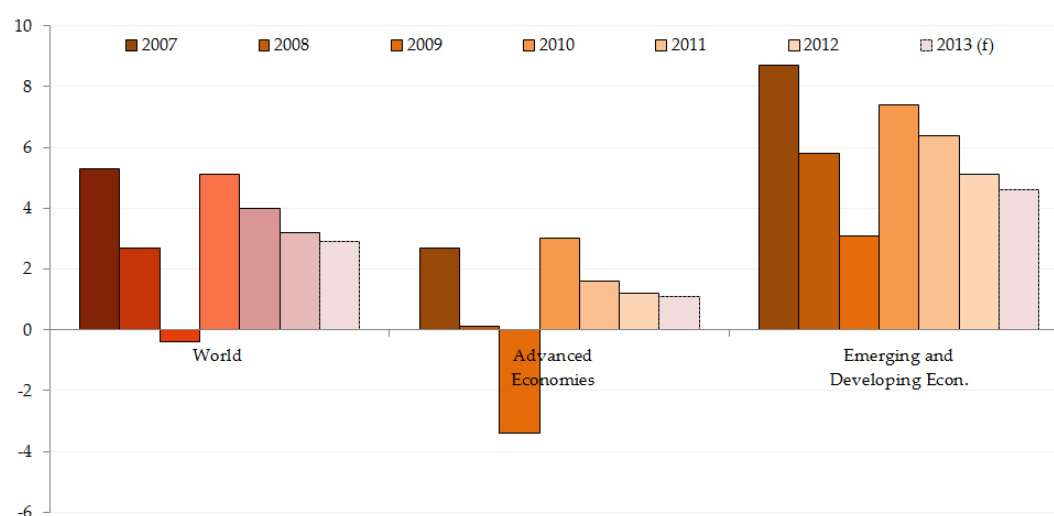
## The Future of Growth: Are we heading towards a lost decade?

Table 1: Forecasts for 2013 in percent of different organisations

Source	Month of publication	Global	Developing economies	Emerging markets	Developed markets
UN DESA	January	2.4	5.1	3.6	1.1
World Bank	June	2.2	5.1		1.2
UNCTAD	September	2.1	4.7		1.0
IMF	October	2.9	4.6		1.1
OECD	November	2.7	--		OECD total: 1.2

In the latest IMF World Economic Outlook of October 2013, global growth numbers were yet again corrected downwards. The IMF lowered its global growth forecast for the seventh consecutive time from 4.1 % in April 2012 to a mere 2.9 % in October 2013. The difference corresponds roughly to one trillion USD.<sup>1</sup> Forecasts for 2014 have also been revised from 4.1 % in January to 3.6 % in October 2013.<sup>2</sup> Earlier in 2012, the IMF predicted a three-tier recovery with the emerging economies as its main drivers as they were less severely hit by the crisis and bounced back more strongly in 2010 (see Figure 1). Given the fact that growth slows down in these countries, this scenario becomes increasingly unlikely. The main reasons for this slowdown were strong capital outflows following the announcement of the Fed to taper its quantitative easing program as well as the progressive fall in global demand, specifically in industrialised countries.

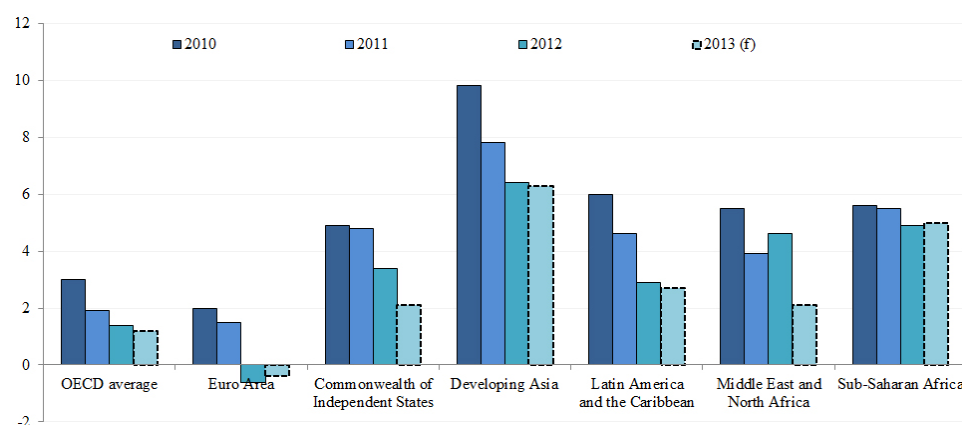
Figure 1: Real growth in emerging economies is slowing down again



Source: IMF (2013) World Economic Outlook, October, p. 153.

The IMF and the OECD project that the Euro Area has shrunk by a further -0.4 % in 2013.<sup>3</sup> It is, however, the only region of those depicted in Figure 2, which has been upward corrected from -0.6 % by the IMF since July. GDP growth in Sub-Saharan Africa remains the most stable at around 5 %. This is mainly due to the fact that investment flows (direct as well as portfolio investment) increased into this region. Forecasts for Latin America and the Caribbean were reduced slightly by 0.3 percentage points to 2.7 %. In other regions, growth projections were also corrected downwards: in the Middle East and North Africa by 0.9 percentage points, the Commonwealth of Independent States by 0.7 percentage points and by 0.6 percentage points in developing Asia.

**Figure 2: In the regional perspective growth in Sub-Saharan Africa is the most stable**



Source: IMF (2013) World Economic Outlook, April and October; OECD (2013), Economic Outlook, November.

As shown in Table 2, all of the BRICS countries are considerably below pre-crisis growth rates as well as those from 2010. Growth in China, South Africa and Russia is declining further compared with 2012, while Brazil appears to recover from its economic slowdown. However, volatility of capital flows remains high and resilience to external shocks weak. The recent capital outflows from emerging markets into “safe havens” were mainly short-term portfolio investments seeking higher returns as interest rates remain subdued in advanced economies. According to the IMF, net private portfolio investments are estimated to decrease in emerging and developing countries by roughly 33 % in 2013, while net private direct investments will shrink by 9 %.<sup>4</sup>

**Table 2: The growth engine “BRICS” is stuttering**

	1995-2004	2009	2010	2011	2012	2013 (f)
China	9.2	9.2	10.4	9.3	7.7	7.6
India	6.2	8.5	10.5	6.3	3.2	3.8
South Africa	3.1	-1.5	3.1	3.5	2.5	2.0
Russia	2.8	-7.8	4.5	4.3	3.4	1.5
Brazil	2.5	-0.3	7.5	2.7	0.9	2.5

Source: IMF (2013) WEO, October.

## 2 The components of growth

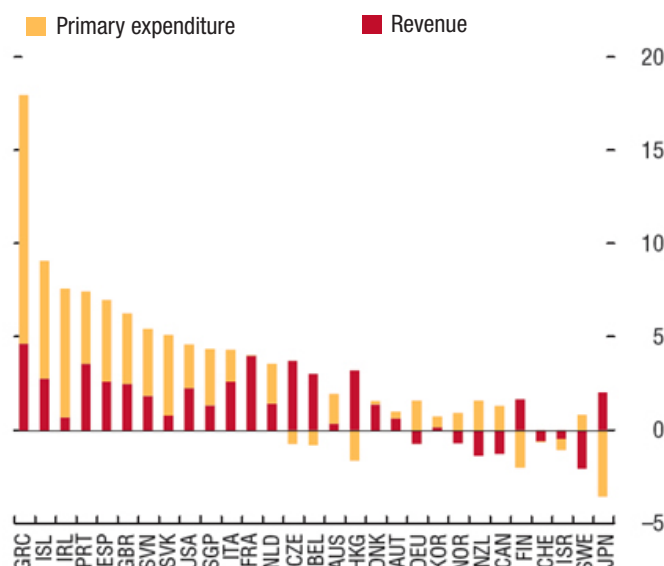
Policy actions since 2010 were working against increasing demand. High unemployment, wage cuts and high levels of household debt have kept demand in key economies in the doldrums. Growth strategies are still mostly focused on exports, specifically in Europe.

<sup>3</sup> IMF (2013) World Economic Outlook – update, July, p. 2 and IMF (2013) World Economic Outlook, October, p. 153.

<sup>4</sup> IMF (2013) World Economic Outlook, October, p. 174.

However, in a stagnant global economy, it is not investment and exports that kick-start demand but rather the other way around. Several countries recognized this by applying fiscal stimulus and internal growth strategies with greater success – among them, Japan, China, Brazil as well as Finland and Hong Kong.

**Figure 3: Composition of Adjustment, 2009-13**  
(Cyclically adjusted; percent of potential GDP)

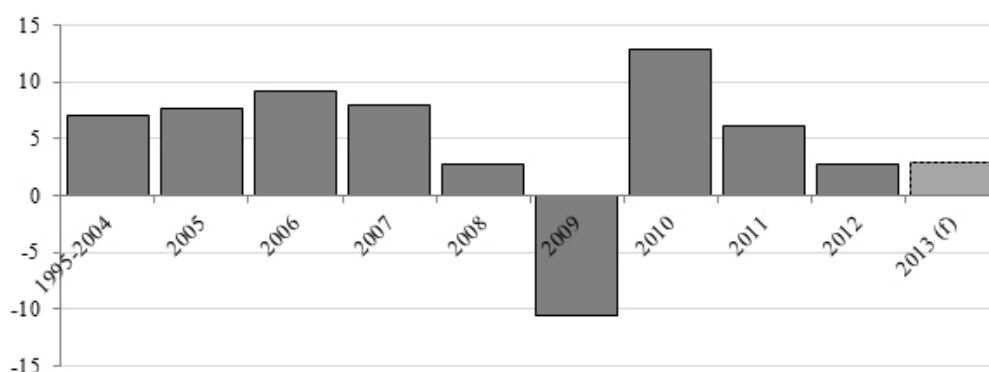


Source: IMF (2013) Fiscal Monitor, Taxing Times, October, p. 5.

## 2.1 Exports and imports

Policy approaches focusing primarily on export growth are not paying off. While real global trade will most likely increase by around 3 % in 2013, a return to pre-crisis growth rates of around 7 % is out of reach (see Figure 4). The bounce back of trade was strongest in 2010, the year following strong efforts of industrialised economies to stimulate growth through public spending.

**Figure 4: Global trade in goods and services is far below pre-crisis levels**



Source: IMF (2013) WEO, October, p. 166.

### The IMF: Self-assessment without consequences

Ireland exited its international financial rescue programme at the end of 2013 and is not applying for a back-up credit line, which again would come with harsh conditions. While its unemployment rate dropped below 13 %, there is little positive that came out of the imposed policies of front-loaded austerity in the three years of the program. Gross public debt stood at 117 % and private debt surpassed 300 % of GDP in 2012. Poverty has almost doubled since 2009 and migration flows are reversed.

Similarly, Spain will not apply for any further ESM financial assistance following its programme exit in January 2014. The far-reaching labour market reforms have just worsened the job situation in Spain, where almost 27 % are unemployed and 28 % were at risk of falling into poverty in 2012. In both, Spain and Portugal, collective bargaining has collapsed from 11.6 million workers covered by registered collective agreements in 2007 to 4.6 million in 2013 in Spain and from 1.9 million in 2008 to 328.000 in 2012 in Portugal.

Portugal and Greece are still under Troika programs and unlikely to exit them in the near future. In Portugal, the constitutional court has recently prevented the cut in public pensions as another loan condition. In Greece, the next loan agreement will focus on privatisation – the most unsustainable way of reducing the public deficit. The situation in Greece has been widely documented. The failed policy of the Troika is displayed by every social and economic indicator: Unemployment, GDP, export, investment, poverty, suicide and crime rates and even the core target of austerity policies, the reduction of public debt have only worsened.

Within the last five years of misguided policies, there have been voices of critical self-assessment inside the IMF. In January 2013, the IMF published the now “famous” working paper, in which it has been admitted that the effects of fiscal multipliers were underestimated. At the IFI Spring meeting in 2013, debt reduction as a precondition for growth has been questioned by Herndon, Ash and Pollin, when they challenged the findings of Reinhart and Rogoff’s publication “Growth in a Time of Debt”(2010) that attributed a causal link between high public debt and low growth.

Furthermore, the IMF announced that unemployment is caused by a lack of demand rather than by structural factors. In an IMF discussion note titled “Labor Market Policies and IMF Advice in Advanced Economies During the Great Recession” published in March 2013, the authors state: “The IMF has taken the view that high unemployment was and remains largely cyclical, that in most countries there is still a substantial unemployment gap, and that policies that sustain aggregate demand are still of the essence.” (p. 14)

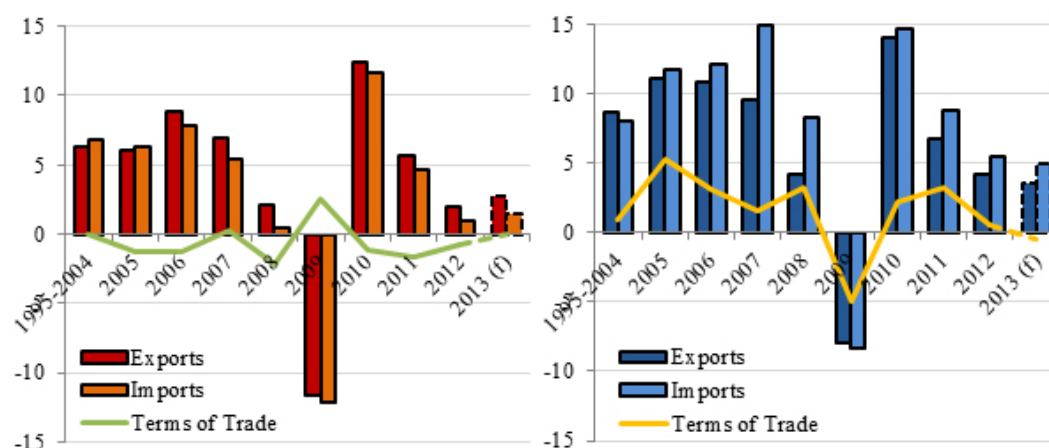
Nevertheless, the IMF continues to maintain its recommendations for harsh structural reforms in all of its country programs. This is in contrast to their position on the role of public spending in times of crisis, although the intensity of austerity measures seems to have shifted to a certain extent. In June 2013, the policy paper “Reassessing the role and Modalities of Fiscal Policy in advanced Economies”, which has been agreed on by the Executive Board, referred to fiscal policy as “an appropriate countercyclical policy tool when monetary policy is constrained by the zero lower bound, the financial sector is weak, or the output gap is particularly large.”(p. 2)

This statement was complemented by an IMF discussion note in September 2013 called “Dealing with High Debt in an Era of Low Growth”, in which the authors talk about frontloaded fiscal consolidation (defined by expenditure cuts rather than tax increases) as running the risk of being “self-defeating” (p. 25). However, as Figure 3 exhibits, a substantial share of austerity measures involved expenditure cuts, most severely in Greece and Ireland. This was not only the case in crisis countries but also in the UK, the US, Singapore and the Netherlands. Whether the IMF will stick to their change in policy advice on the country level remains yet to be seen. A first test could present itself with the pension reforms in Portugal.



The limitations to export-led growth apply to both advanced as well as emerging markets, even though it is more severely constrained in the former (see Figure 5). In 2012, exports in advanced economies grew as poorly as in the crisis year of 2008, in emerging markets export growth was slightly higher but with declining tendencies. What is also remarkable is the development of the terms of trade (ToT) depicted in Figure 5. The ToT are the ratio between export and import prices. A negative value means that either the price of one's export goods has fallen or those of import goods has increased. Such deterioration entails that more exports have to be sold in order to be able to acquire the same amount of imports. In advanced countries, this relates to the ratio between manufacturing goods and primary goods. With the exception of 2009, when prices of primary goods such as minerals and oil plummeted, the ToT of advanced economies have been deteriorating over the last decade in favour of emerging economies, which enjoyed greater export numbers.

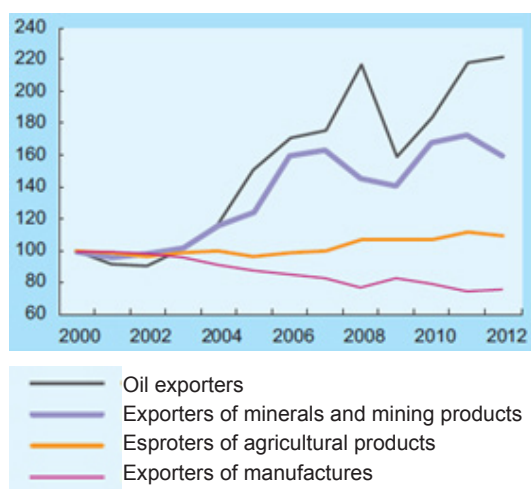
Figure 5: Trade components in advanced economies (left graph) and emerging and developing economies (right graph)



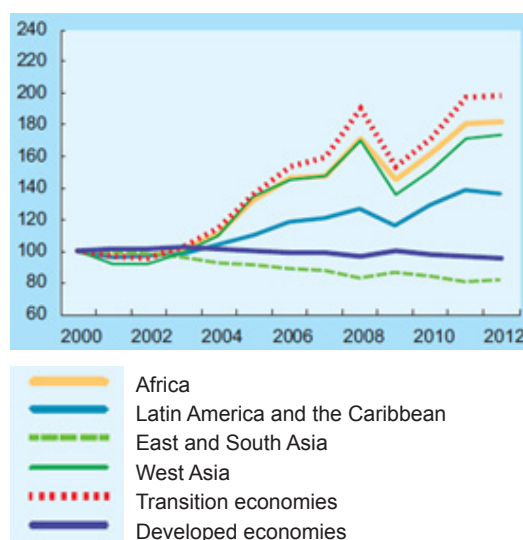
Source: IMF (2013) World Economic Outlook, October, p. 166.

Figure 6: Development of Terms of Trade

by export structure



by region and economic group



Source: UNCTAD (2013) Trade and Development Report, 2013, p. 52

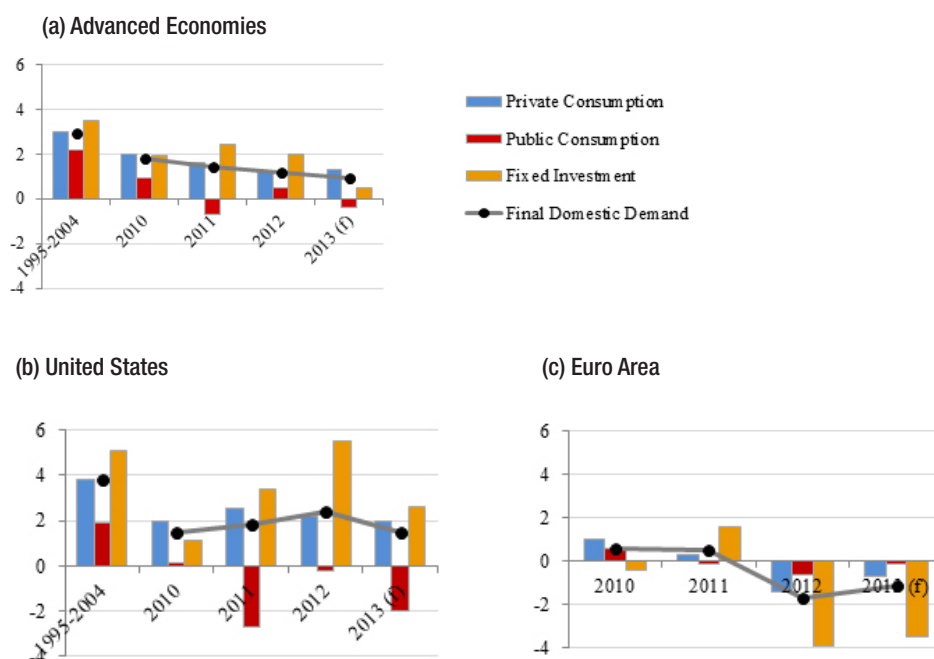
Countries specialised in oil and minerals and mining products could benefit most from their exporting activities (see Figure 6). The strong price increase for these commodities was mainly driven by two factors: strong investment speculation and strong demand in emerging markets, mainly in India and China.<sup>6</sup> However, countries such as Spain, Italy and Ireland as well as those from the East and South Asia region, which are still focused on the production of low- and medium-technological manufacturing, have experienced an export price reduction resulting in the need to export higher volumes for the same amount of imported goods.

The competition over wage/price reduction rather than quality and know-how has been driven predominantly by countries like Japan and Germany, which continue their export-led growth strategy on higher than ever current account surpluses,<sup>7</sup> while the discomfort of political and economic partners is mounting. The frustration of the US with the German export obsession was clearly stated in the latest Treasury report issued in October:

*“Within the euro area, countries with large and persistent surpluses need to take action to boost domestic demand growth and shrink their surpluses. Germany has maintained a large current account surplus throughout the euro area financial crisis, and in 2012, Germany’s nominal current account surplus was larger than that of China. Germany’s anaemic pace of domestic demand growth and dependence on exports have hampered rebalancing at a time when many other euro-area countries have been under severe pressure to curb demand and compress imports in order to promote adjustment. The net result has been a deflationary bias for the euro area, as well as for the world economy.”<sup>8</sup>*

In fact, their urge for more balanced growth strategies and international trade is what the IMF’s role initially was meant to be according to Article 1 of its founding Agreement: *“The purposes of the International Monetary Fund are ... [t]o facilitate the expansion and balanced growth of inter-national trade”<sup>9</sup>*

## 2.2 Consumption and investment



Source: Author's own depiction, based on IMF (2013) World Economic Outlook, October, pp. 154-156.

6 UNCTAD (2013) Trade and Development Report, 2013, p. 52f.

7 Andy Sharp and Toru Fujioka (2013), "Japan Current-Account Surplus Exceeds Economists' Estimates", Bloomberg, Nov 11, available at: <http://www.bloomberg.com/news/2013-11-11/japan-s-current-account-surplus-unexpectedly-expands-on-income.html>; Chris Bryant (2013) "Germany's export surplus hits record high", Financial Times, November 8, available at: <http://www.ft.com/intl/cms/s/0/bf49b530-4852-11e3-8237-00144feabdc0.html#axzz2nuNINMGb>; Martin Wolf (2013) "Germany is a weight on the world", Financial Times, November 5, available at: <http://www.ft.com/intl/cms/s/0/291a5ca6-42ec-11e3-8350-00144feabdc0.html#axzz2ohjDKqcl>.

8 U.S. Department of the Treasury Office of International Affairs (2013) Report to Congress on International Economic and Exchange Rate Policies, October 30, available at [http://www.treasury.gov/resource-center/international/exchange-rate-policies/Documents/2013-10-30\\_FULL%20FX%20REPORT\\_FINAL.pdf](http://www.treasury.gov/resource-center/international/exchange-rate-policies/Documents/2013-10-30_FULL%20FX%20REPORT_FINAL.pdf).

9 IMF (1944) Articles of Agreement of the International Monetary Fund, p. 2, available at: <http://www.imf.org/external/pubs/ft/aa/pdf/aa.pdf>.

In advanced economies, domestic demand remains depressed (see Figure 7(a)). It is projected to grow by a mere 0.8 % in 2013, considerably lower in comparison to pre-crisis levels of growth of around 3 %. The main albeit weak element of its growth private consumption, including the consumption of domestic and imported goods is growing by 1.3 %. However, this is only half of its average growth rate of 3 % between 1995 and 2004. Meanwhile, the figures on public consumption reflect the effects of austerity policies. In 2013, projections assume a contraction of 0.4 %, which will be followed by a further contraction in 2014 (for 1995-2004 average annual growth was 2.2 %). The forecasts of fixed investments are equally bleak for advanced economies. In 2013, the IMF expects growth of 0.5 % compared with average pre-crisis growth rates of 3.5 %.

In the US, public investment has dropped to 3.6 % of GDP, which is the lowest level since 1947 and considerably below the post-war average of 5 %.<sup>10</sup> The recently agreed two-year public budget plan will make any increase in investments unlikely in the medium term. Contrary to the picture transmitted through media coverage, over the last three years, government has been downsized in both, employment and spending falling almost by 3 % in this period. Public spending cuts have been made in crucial areas such as education, infrastructure, research and conservation.

In the Euro area, the pace of austerity has slowed but government consumption remains stagnant and fixed, while total investment contracted heavily in 2013, proving the confidence trail wrong once again (see Figure 7(c)). Eurostat data project an annual change in total investment (or gross capital formation) of 3.1 % for the EU 27 area and -3.6 % for the Euro Area (see Table 3). This contraction is less strong than in 2012 (-5.6 % and -6.5 % respectively) but the actual level remains roughly 7 percentage points below 2005 levels. Specifically in crisis countries, where large scale labour market reforms were applied in the belief that they would also trigger an investment boost, investment contraction has continued to be high. In Spain and Greece, investment levels are projected to shrink in 2013 to 56 % and 69.6 % respectively from their value in 2005. The only two European countries that show rather positive investment trends in 2013 are Denmark and Norway.

**Table 3: Annual percentage change of total investment (Gross capital formation)**

	2006	2007	2008	2009	2010	2011	2012	2013 (f)
EU 27	7.1	7.6	-2.3	-18.1	4.1	3.2	-5.6	-3.1
Euro area	6.7	6.2	-1.9	-16.6	2.7	2.9	-6.5	-3.6
Denmark	11.9	1.9	-5.1	-25.2	4.5	5.7	-1.1	1.7
Norway	12.5	9.3	-0.3	-17.0	4.1	5.8	6.3	3.0
France	4.4	7.1	-0.8	-15.6	2.1	8.4	-5.3	-2.1
Germany	8.8	9.1	0.6	-14.6	8.5	6.4	-4.9	0.3
UK	5.2	9.4	-7.5	-22.7	9.6	0.9	-1.0	-0.3
Netherlands	8.6	6.1	2.7	-14.2	-2.0	6.5	-2.7	-12.8
Spain	8.0	4.2	-4.2	-18.3	-4.2	-5.6	-6.9	-6.3
Romania	26.1	29.2	3.7	-24.1	-0.3	7.3	2.1	-5.5
Portugal	-0.6	2.1	-0.1	-13.3	1.4	-11.1	-13.1	-8.1
Greece	21.1	12.9	-10.4	-25.0	-8.3	-16.4	-17.5	-3.7
Cyprus	7.9	10.9	10.4	-16.2	4.2	-12.0	-11.9	-25.8

Source: European Commission (2013) Eurostat Database.

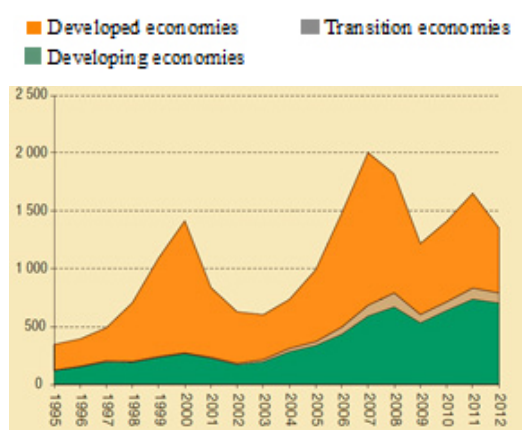
<sup>10</sup> Robin Harding, Richard McGregor and Gabriel Muller (2013) "US public investment falls to lowest level since war", Financial Times, November 3, available at: <http://www.ft.com/intl/cms/s/0/10e71a16-4487-11e3-a751-00144feabdc0.html#slide0>.

UNCTAD reports that Foreign Direct Investment (FDI) - defined as cross-border investment - shrunk globally by 18 % to 1.35 trillion USD in 2012. This is well below the pre-crisis level of over 2 trillion USD in FDI in 2007. In 2013, FDI is projected to increase only slightly by 3.6 %. <sup>11</sup>

The decline of FDI in- and outflows was much stronger in developed economies reaching up to losses of 31.6 % (inflows) and -23 % (outflows) in 2012. Inflows into the European Union declined sharply by 41 %, into the US by 26 %, into Australia by 13 % and into New Zealand by 33 %. Meanwhile, they increased in Japan and the UK. Outflows from the EU and the US declined by 40 % and 17 % respectively, while those from Japan grew by 14 %.

Developing economies proved to be more resilient. FDI inflows shrunk by only -4.3 % between 2011 and 2012 (see Figure 8) and for the first time ever developing countries received the bigger share of total inflows with 52 %. Moreover, FDI outflows from developing countries increased reaching a record high of 426 billion USD, accounting for 31 % of global outflows in 2012. <sup>12</sup>

**Figure 8: FDI inflows, global and by sub-groups of economies, 1995-2012 (Billions of USD)**



Source: UNCTAD (2013) World Investment Report 2013, p. 3.

Africa has been the only region, which has experienced an increase in inflows in 2012, mainly coming from emerging markets with the highest shares belonging to Malaysia, South Africa, China and India. Investments in the extractive sector still form the most significant share, specifically in countries such as the Congo, Mauritania, Mozambique and Uganda. However, between 2008 and 2012, the share of Greenfield FDI<sup>13</sup> going to consumer-oriented manufacturing and services increased from 7 % to 23 %. Outflow from African countries nearly tripled in 2012, though from a very low level of 5.4 billion USD.

In Asia, inflows declined by 7 % in 2012, with South-Asia as the most severely hit region. Total outflows remained stable in 2012, accounting for 22 % of global outflows, with China reaching a record high of 6 % of total global FDI outflow.

The overall FDI inflows to Latin America and the Caribbean were relatively stable but increased in South America at the expense of Central America. FDI in manufacturing particularly increased in Brazil and Mexico.

In South-Eastern Europe, inflows almost halved. In the CSI region, they declined considerably mainly due to struggling European markets. Outflows also declined sharply. Russia dominates the outflows of this region with a share of 92 %.

Finally, investments to Least Developed Countries grew by 20 % hitting a record high of 26 billion USD. Among the beneficiaries were the Congo, Liberia, Mauritania, Mozambique and Uganda. <sup>14</sup>

### 3 Wage development and the labour market situation

The downside of export-led growth strategies is the rise in inequality as they prompt a race to the bottom of wages and a constantly growing imbalance between the share of income

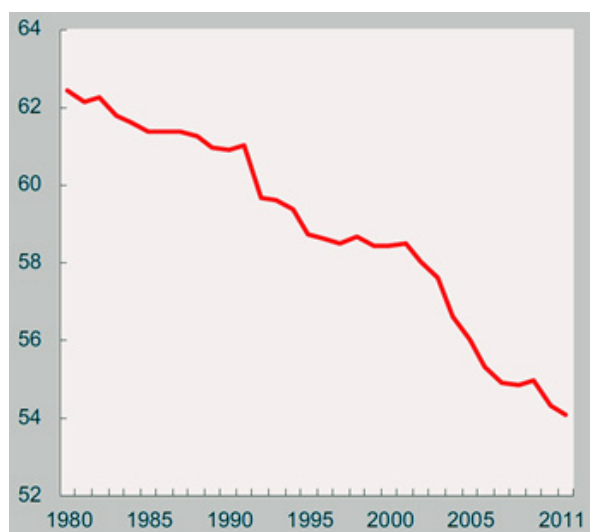
<sup>11</sup> UNCTAD (2013) World Investment Report 2013, p. 2, available at: [http://unctad.org/en/PublicationsLibrary/wir2013\\_en.pdf](http://unctad.org/en/PublicationsLibrary/wir2013_en.pdf)

<sup>12</sup> UNCTAD (2013) World investment report, pp. 2 and 213.

<sup>13</sup> Greenfield Investments are investments that establish new companies as opposite to mergers and acquisitions which involve the purchase of existing entities.

<sup>14</sup> UNCTAD (2013) World Investment Report 2013, pp. xii-xiii.

**Figure 9: Labour income as share of total global output**

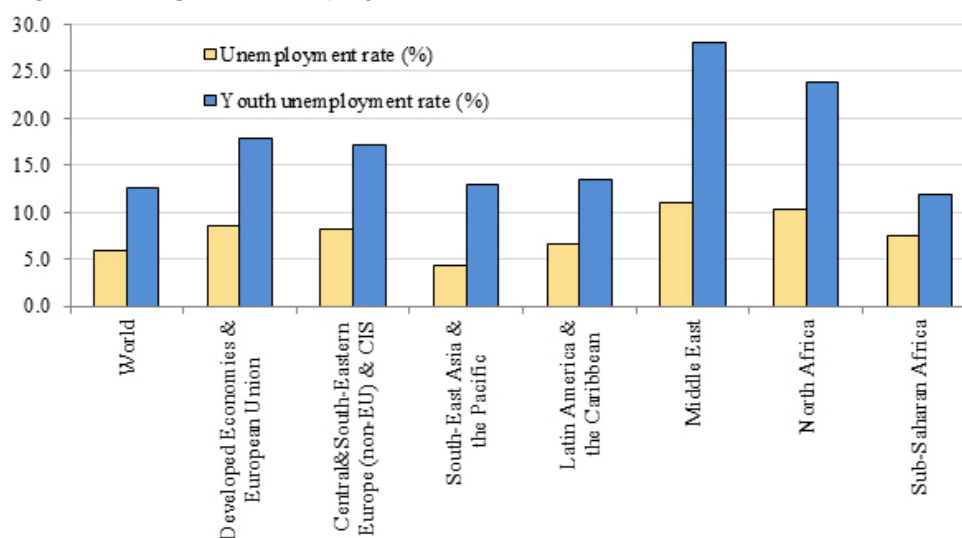


between labour and capital. Figure 9 shows the development of labour income as a share of total global output. It has fallen by over 8 percentage points in the last thirty years, corresponding to roughly 6.7 trillion USD.<sup>15</sup> The steepest reduction happened in the period leading up to the crisis. Between 2001 and 2007, the labour share had decreased by over 3 percentage point of real global GDP. After a short interruption in 2007/2008, this trend continued at an even higher pace. In the UK, real wages have fallen by more than 9 % since early 2008, the steepest and longest decline since records began in mid-19th century.<sup>16</sup> In Germany, roughly 18 % of all

workers earn less than 8 Euros gross income per hour, in the Eastern part of the country, this affects up to almost 30 % of employees.<sup>17</sup> Between 2007 and 2011, wages have fallen for those up to the eighth decile and most severely for those in the lowest decile.<sup>18</sup>

Global unemployment has increased in the second quarter of 2013 by 0.2 % on a year-to-year comparison comprising 75 countries according to the ILO. In developed countries, it fell to 5.6 %, while it increased in developing countries by 1.3 %. The increase in employment in developed economies was much more moderate, amounting to only 1.2 % between the

**Figure 10: Regional Unemployment in 2012**



Source: UNCTAD (2013) Trade and Development Report, 2013, p. 52

second quarter of 2012 and 2013. This leads to the assumption that most of the reduction in unemployment numbers is due to discouraged workers dropping out of the labour market

<sup>15</sup> Measured in USD purchase power parities and prices of 2012 based on IMF World Economic Outlook data.

<sup>16</sup> Elizabeth Rigby (2013) "Ed Miliband offers 'living wage' help for business", Financial Times, November 3, available at: <http://www.ft.com/intl/cms/s/0/ed2e67f6-4493-11e3-a751-00144feabdc0.html#axzz20hjDKqcJ>.

<sup>17</sup> Thorsten Kalina und Claudia Weinkopf (2013) Niedriglohnbeschäftigung 2011: Weiterhin arbeitet fast ein Viertel der Beschäftigten in Deutschland für einen Niedriglohn, Inst. Arbeit und Qualifikation, Duisburg, IAQ-Report, 2013-01, p. 10.

<sup>18</sup> Bundesministerium für Arbeit und Soziales (2013) Lebenslagen in Deutschland – Armuts und Reichtumsberichterstattung der Bundesregierung, March, pp. XXIV.



rather than by real employment growth. In developing economies, unemployment increased by 0.7 % during the same period. Employment in manufacturing continued to shrink by 0.6 % in developed countries.<sup>19</sup>

**Figure 11: Construction sector in Ireland**

(Purchasing Managers Index; levels above 50 denote expansion)



Even based on “optimistic” forecasts of recovery, the OECD projected that labour market conditions will only improve gradually (Table 4). The employment rate in the OECD area would increase at a slow pace, with the US mainly driving it, while unemployment will remain high in the Euro area especially up until 2015.

Source: Jamie Smyth (2013) “Ireland lays foundations for revitalising construction industry”, Financial Times, November 24.

**Table 4: OECD labour market conditions are likely to improve only slowly**

	2010	2011	2012	2013	2014	2015
Percentage change from previous period						
<b>Employment</b>						
United States	-0.6	0.6	1.8	1.1	1.4	1.6
Euro area	-0.3	0.3	-0.7	-0.9	0.0	0.5
Japan	-0.3	-0.1	-0.3	0.5	0.0	0.0
OECD	0.3	1.0	1.0	0.6	0.9	1.1
<b>Labour force</b>						
United States	-0.2	-0.2	0.9	0.4	0.8	1.0
Euro area	0.3	0.4	0.6	0.0	0.1	0.2
Japan	-0.3	-0.6	-0.6	0.2	-0.1	-0.1
OECD	0.5	0.6	1.0	0.7	0.8	0.8
<b>Unemployment rate</b>						
	Per cent of labour force					
United States	9.6	8.9	8.1	7.5	6.9	6.3
Euro area	10.0	10.1	11.3	12.0	12.1	11.8
Japan	5.0	4.6	4.3	4.0	3.9	3.8
OECD	8.3	8.0	8.0	8.0	7.8	7.5

On a regional level, Middle East and North Africa have the highest unemployment rate, which is especially high for young workers and is hence of deep concern (Figure 10).

<sup>19</sup> ILO (2013) Global Trends: Unemployment rate, ILO Department of Statistics, November 2013, available at: [http://laborsta.ilo.org/sti/QUERIES/GLOBAL\\_EN.pdf](http://laborsta.ilo.org/sti/QUERIES/GLOBAL_EN.pdf).

Table 5: Unemployment and employment rates across the developed world

	Harmonised unemployment rate							Employment-to-population-rate (15-64)			
	Q1-2013	Q2-2013	Jul-2013	Aug-2013	Sep-2013	Oct-2013	change (Q4 2012 - Q3 2013)	Q1-2013	Q2-2013	Q3-2013	change (Q4-2012 - Q3-2013)
Norway	3.6	3.4	3.6	3.5	3.4	..	-0.07	75.5	75.4	75.4	-0.06
Japan	4.2	4.0	3.8	4.1	4.0	4.0	-0.23	71.2	71.5	71.8	0.96
Australia	5.5	5.6	5.7	5.8	5.7	5.7	0.32	72.3	72.2	72.0	-0.32
Germany	5.4	5.3	5.3	5.3	5.2	5.2	-0.20	73.1	73.3	73.4	0.29
Netherlands	6.2	6.6	7.0	7.0	7.0	7.0	1.37	74.7	74.4	..	..
New Zealand	6.2	6.4	..	..	..	..	..	72.6	72.7	73.2	1.93
Canada	7.1	7.1	7.2	7.1	6.9	6.9	-0.33	72.5	72.6	72.4	-0.07
UK	7.7	7.7	7.6	7.5	..	..	..	70.4	70.6	70.8	0.21
US	7.7	7.6	7.4	7.3	7.2	7.3	-0.63	67.3	67.3	67.4	0.05
Sweden	8.2	8.0	7.8	8.0	8.0	7.9	-0.13	74.2	74.3	74.5	0.68
France	10.8	10.8	11.0	11.0	11.1	10.9	0.50	64.0	64.0	..	..
EU 28	11.0	11.0	10.9	10.9	10.9	10.9	0.13	64.0	63.9	..	..
Italy	11.8	12.1	12.1	12.4	12.5	12.5	1.17	56.0	55.6	55.4	-1.05
Euro Area (17)	12.0	12.1	12.1	12.1	12.2	12.1	0.40	63.5	63.4	..	..
Ireland	13.7	13.7	13.2	12.8	12.7	12.6	-1.57	59.7	60.1	60.7	1.44
Portugal	17.5	16.9	16.2	16.0	15.8	15.7	-1.27	60.2	60.6	61.3	0.80
Spain	26.4	26.5	26.6	26.6	26.6	26.7	0.47	54.5	54.3	54.1	-0.55
Greece	26.6	27.4	27.3	27.3	..	..	..	49.7	49.3	49.1	-1.32

Source: OECD Database

The most recent figures on unemployment and employment show some improvements in crisis-hit countries (Table 5). Specifically, employment growth of 2.5 % in Ireland has exceeded expectations.<sup>20</sup> Ireland, which exited its IMF lending program at the end of 2013, is currently reviving its construction sector by implementing tax breaks for home renovations. At the peak of the building boom, the construction sector accounted for 25 % of GDP and for 13 % of employment. With the new support for the sector, there are now some signs of recovery (see Figure 11).<sup>21</sup>

However, in all Eurozone crisis countries unemployment rates remain high and in most, the upwards trend of unemployment continues – the situation hence remains very alarming. Those countries include Greece, Spain and Italy (see Table 4).

The recent US jobs data has shown conflicting trends. It remains unclear how much of the short-term increase in employment is just a result of the termination of the government shutdown in October.<sup>22</sup> According to official data, depicted in Figure 12, a surge in real employment has yet to come. Meanwhile, declining unemployment numbers can mainly be attributed to a shrinking participation rate, while the employment-to-population rate remains flat since the beginning of the crisis.

20 Jamie Smyth (2013) Irish unemployment falls to lowest level since 2009, Financial Times, November 26, available at: <http://www.ft.com/intl/cms/s/0/46f30f24-56a2-11e3-ab12-00144feabdc0.html#axzz2och3qF05>.

21 Jamie Smyth (2013) "Ireland lays foundations for revitalising construction industry", Financial Times, November 24, available at: <http://www.ft.com/intl/cms/s/0/b6a94974-54e9-11e3-86bc-00144feabdc0.html?siteedition=intl#axzz2och3qF05>.

22 Robin Harding (2013) "Strong US jobs data raise expectations of Fed taper", Financial Times, December 15, available at: <http://www.ft.com/intl/cms/s/0/f4936f78-641e-11e3-b70d-00144feabdc0.html#slide0>.

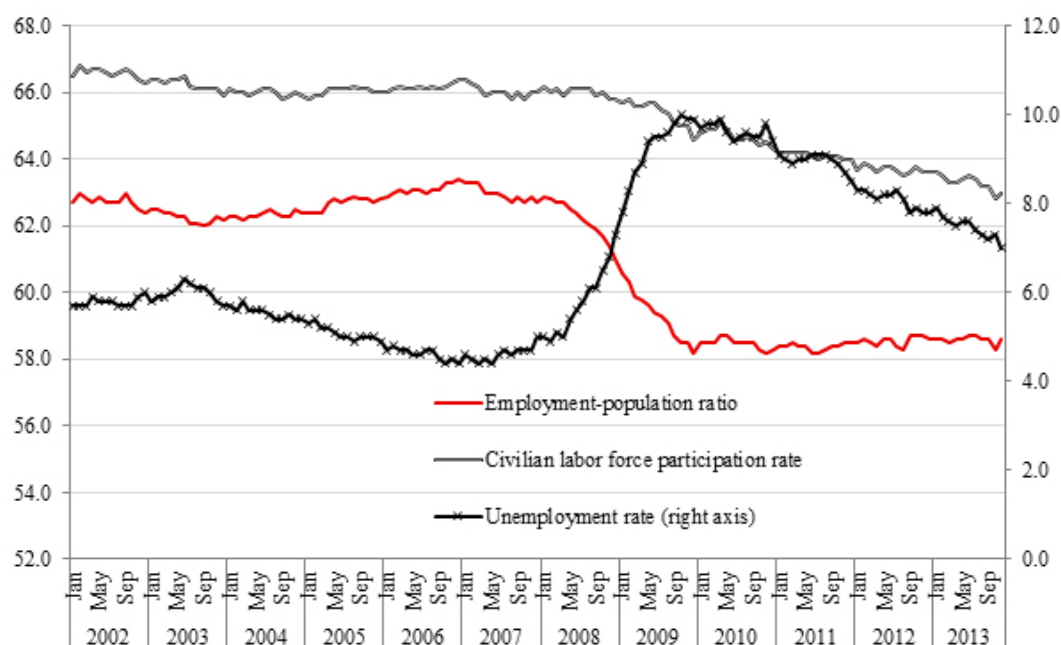
### Is the UK really on the recovery track?

Back in April, the IMF criticised the UK government harshly for its recovery strategy. In October 2013, it had to revise its projections by increasing their forecast by 0.5 percentage points to 1.4 % GDP growth. According to national statistical data, there is an upward trend for GDP growth, which is estimated to increase by 0.8 % in the third quarter of 2013 compared to the second. This growth is driven by the service sector with over 70 % as it is back to its pre-crisis levels of output.

The UK has been hit hard by the crisis with its GDP plummeting by 7.2 %. The downturn was much more extreme than in any of the previous crises in the 1980s and 1990s and more severely than in most other Central European economies. Up until today, GDP has not recovered this loss, remaining 2.5 % below its level in the beginning of 2008. While the trend of deindustrialisation and the reliance concentration on services has accelerated further, production levels, already stagnating prior to the crisis, shrunk by more than 10 percentage points when the crisis hit. In the third quarter of 2013, production industry remains still below the levels recorded in 2009.

Another threat to UK recovery is coming from households overburdened by debt. The Resolution Foundation warns that a potential interest rate increase to 3 % would mean that more than 1.2 million people would need to spend more than half of their net income on debt repayments. At the same time, productivity has slowed down again in the third quarter of 2013.

Figure 12: The US labour market



Source: US Bureau of Labor Statistics.



## 4 Financial markets

In early November, the European Central Bank lowered interest rates on the main refinancing operations to an all-time low of 0.25 %.<sup>23</sup> This decision was made in the light of an alarmingly low annual inflation rate of 0.9 % in the Euro Area and 1.0 % in the European Union as a whole in order to pump money into the monetary system. Prices are falling most dramatically in Greece by 2.9 % and are stagnant in other European crisis countries. It is alarming that in core countries such as France and Germany inflation is also considerably below the Maastricht target of 2.0 % (France: 0.8 % and Germany: 1.6 %) with the only Eurozone country in line with target inflation being Estonia with 2.1 %.

In fact, deflation in crisis countries following wage cuts was part of the overall rebalancing plan. A closer look at price levels reveals that specifically food prices are rising disproportionately with an annual inflation rate of 1.6 % until November 2013, while prices for industrial goods increased by 0.2 %. Such increases leave consumers in crisis countries with an even lower real income considering the substantial wage and income cuts that they are experiencing.<sup>24</sup>

The lowering of interest rates by the ECB and talks about implementing a Fed-style quantitative easing program divide central bankers, economists and politicians across Europe.<sup>25</sup> Under current circumstances, quantitative easing is a second best alternative to a mere balancing between fiscal and monetary policy.

The US Federal Reserve has been applying this policy of quantitative easing early on. In December 2008, they already reached the interest level of 0.25 %, the ECB is at now. In order to not get caught in the liquidity trap of low interest rates and low borrowing from banks, the Fed decided to directly purchase mortgage-backed securities of government-sponsored enterprises like Fannie Mae and Freddie Mac and ease the credit crunch by directly injecting money into the economy.<sup>26</sup>

### The effects of deflation....

High inflation can be dangerous as it erodes the real value of money. However, deflation, meaning that prices fall and the purchasing value of money increases over time, also has a severe impact on the real economy.

Firstly, it holds back consumption as the pure hoarding of money has a premium. It adds so to say to interest rates. In a situation, where consumption and demand are already low, it accelerates the downward spiral of low consumption, low demand, low investment and shrinking growth.

Secondly, it increases the real value of debt, making it even harder for governments and private actors to reduce their debt called deleveraging.

The consequence is wealth redistribution from those indebted to those holding large amounts of capital.

As a consequence, the Fed's balance sheet ballooned until July 2013 to over 3.5 trillion USD, with more than 1.2 trillion held in mortgage-backed securities.<sup>27</sup> In September, there were some signs that the Fed would end its quantitative easing program, causing capital flights from and a cascading currency devaluation in emerging economies.<sup>28</sup>

<sup>24</sup> European Commission (2013) eurostat newsrelease euroindicators, 196/2013, 17 December, available at: [http://epp.eurostat.ec.europa.eu/cache/ITY\\_PUBLIC/2-17122013-AP/EN/2-17122013-AP-EN.PDF](http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-17122013-AP/EN/2-17122013-AP-EN.PDF)

<sup>25</sup> See for example Martin Wolf (2013) "Why Draghi was right to cut rates", Financial Times, November 12; Angela Monaghan (2013) "ECB cuts interest rates: what the experts say", The guardian, November 7; Reuters (2013) "Printing money not the way out of crisis, ECB's Weidmann says", November 20.

<sup>26</sup> Federal Reserve Bank of St. Louis (2012) "Quantitative Easing: Lessons We've Learned", July, available at: <http://www.stlouisfed.org/publications/re/articles/?id=2258>.

<sup>27</sup> Board of Governors of the Federal Reserve System (2013) Quarterly Report on Federal Reserve Balance Sheet Developments, August, available at: [http://www.federalreserve.gov/monetarypolicy/files/quarterly\\_balance\\_sheet\\_developments\\_report\\_201308.pdf](http://www.federalreserve.gov/monetarypolicy/files/quarterly_balance_sheet_developments_report_201308.pdf).

<sup>28</sup> The Economist (2013) "The end of the affair", June 15, available at: <http://www.economist.com/news/finance-and-economics/21579461-prospect-less-quantitative-easing-america-has-rocked-currency-and-bond>.

At the end of September, the annual inflation in the US stood at 1.2 %, <sup>29</sup> considerably below the Fed's target of 2 %. <sup>30</sup> In response, a first downsizing of the program by 10 billion USD was finally agreed in December. <sup>31</sup> The Bank of Japan is taking a similar path of high money supply, <sup>32</sup> however, with the difference that it is combined with public spending.

The dilemma Central Banks face is that if they begin "tapering", stop artificial monetary expansion and increase interest rates, the real economy will be hit hard as growth is too unstable and real recovery has yet to materialise. However, holding credit cost low for too long without investment opportunities arising in the real economy increases speculation and the volatility of financial flows, which can then favour speculative bubbles. A monetary policy that is not linked to public spending has failed to bring recovery so far. Thus, a more coherent approach of monetary and fiscal policy is urgently needed.

### *Housing prices are skyrocketing...*

Since the real estate bubble collapsed in Spain and Ireland, housing prices have remained broadly stagnant (see Figure 13a). However, demand for real estate in some urban areas has been high caused by cheap credit and the lack of alternative investments. In Germany's biggest cities, house prices have seen increases of more than 25 % since 2010. In London, prices of high-end housing are now above their peak in 2008. Properties in New York, Washington and Los Angeles are considered safe haven investments, as well. <sup>33</sup>

Chinas' metropolitan regions Shanghai, Shenzhen and Beijing have seen price jumps of more than 20 % and of around 15% in smaller cities until September (on a year-to-year comparison). Equally dramatic is the situation in Hong Kong, where prices tripled in the last ten years, which is also the case in Singapore and South Africa (see Figure 13 (c)). What is a cause for concern in China is less the surge in prices in economically growing centres but the creation of ghost cities with extensive apartment complexes in areas that might not become affluent economic centres. The financing of these complexes is to a large extent built upon debt. With a declining population, it is doubtful that the expansion of living space will reflect real demand.

### **China's reforms**

China has announced its boldest social and economic reforms in decades. The plan is cross-cutting and includes a relaxation of the one-child-policy and foresees more independence of courts from the government. Pricing of fuels, electricity and other key resources will be exposed to market forces. Also, financial markets will be deregulated, risking to fuel the housing market further to unstable levels. (see Reuters (2013) "China unveils boldest reforms in decades, shows Xi in command", November 15)

29 Bureau of Labour Statistics (2013) CPI Detailed Report, Data for September 2013, available at: <http://www.bls.gov/cpi/cpid1309.pdf>.

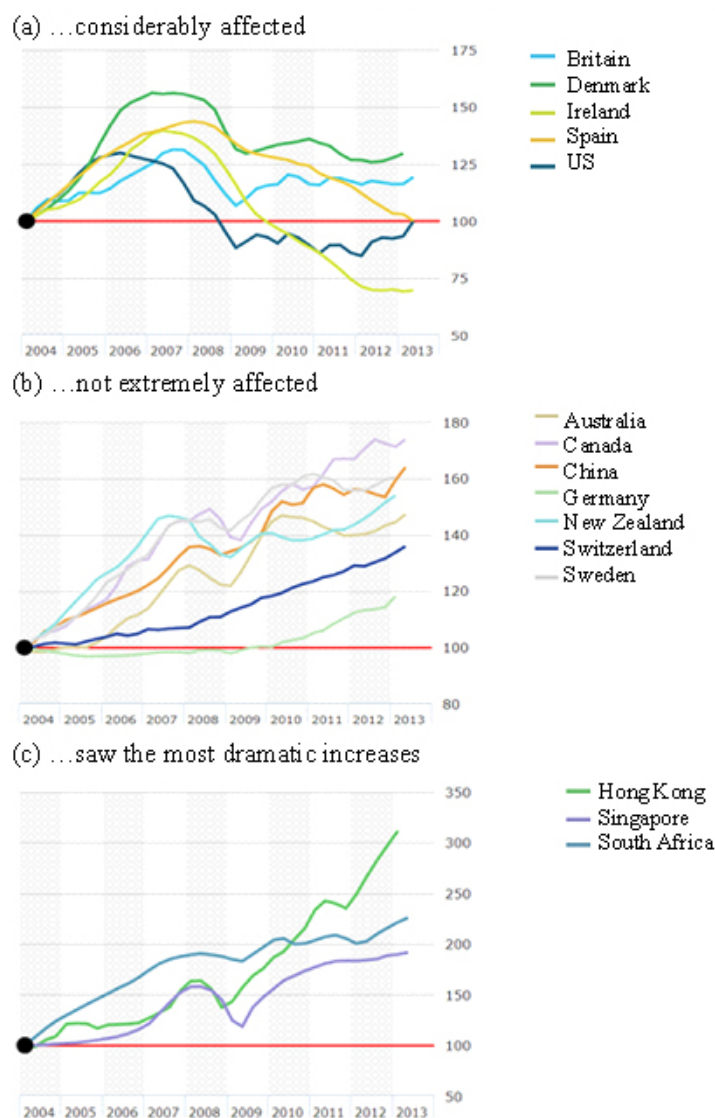
30 Board of Governors of the Federal Reserve System (2013) Statement on Longer-Run Goals and Monetary Policy Strategy as amended effective on January 29, available at: [http://www.federalreserve.gov/monetarypolicy/files/FOMC\\_LongerRunGoals.pdf](http://www.federalreserve.gov/monetarypolicy/files/FOMC_LongerRunGoals.pdf).

31 Joshua Zumbrun (2013) "Fed Trims QE Pace to \$75 Billion on Labor Market Outlook", Bloomberg, December 19, available at: <http://www.bloomberg.com/news/2013-12-18/fed-cuts-qe-pace-to-75-billion-on-improved-job-market-outlook.html>.

32 Ben McLannahan (2013) "Bank of Japan hints at extending ultra-loose monetary policy", Financial Times, November 21, available at: <http://www.ft.com/intl/cms/s/0/dc31b1d8-5262-11e3-8c42-00144feabdc0.html?siteedition=intl#axzz2I0USUHmC>.

33 Michael Steen and Lice Ross (2013) "German city apartments overvalued, warns Bundesbank", Financial Times, October 21, available at: <http://www.ft.com/intl/cms/s/0/e5cb6ab6->

Figure 13: Housing price indices of countries in which the real estate sector was...

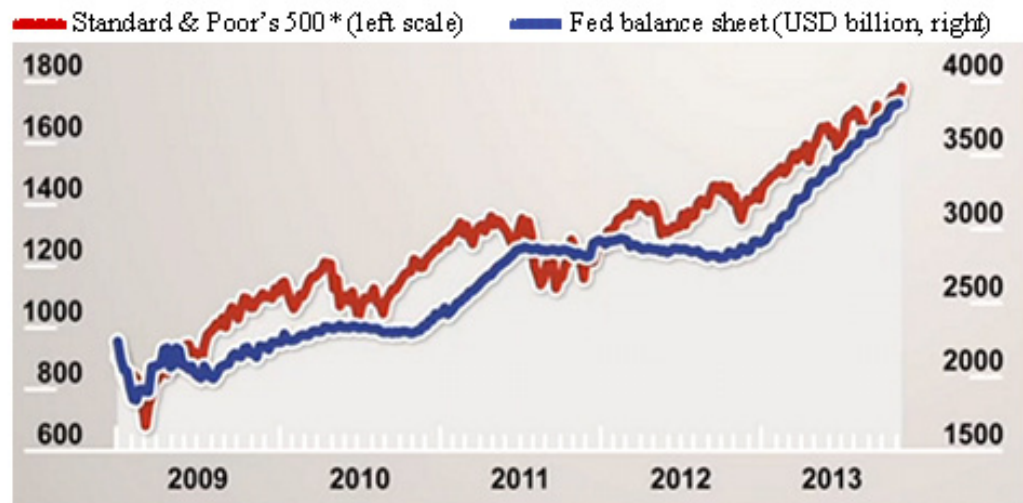


Sources: The Economist, Aug 29th 2013, <http://www.economist.com/blogs/dailychart/2011/11/global-house-prices>

### *...and stock markets are on the surge*

There is a link between low interest rates that make traditional savings less attractive and rising stock market exchanges as shares are a welcome investment alternative for loose money. High corporate profits and the reluctance of firms to invest into the real economy make stocks all the more attractive. Figure 14 depicts the close movement between the S&P 500 (reflecting the capital gathered in the stock market in terms of share value and their issued quantity) and the Fed's balance sheet, which increased by purchasing financial assets. While a causal relationship cannot be directly claimed, there is reason to believe that most of the Fed's money issued through quantitative easing is going into the stock market.

Figure 13: Housing price indices of countries in which the real estate sector was...



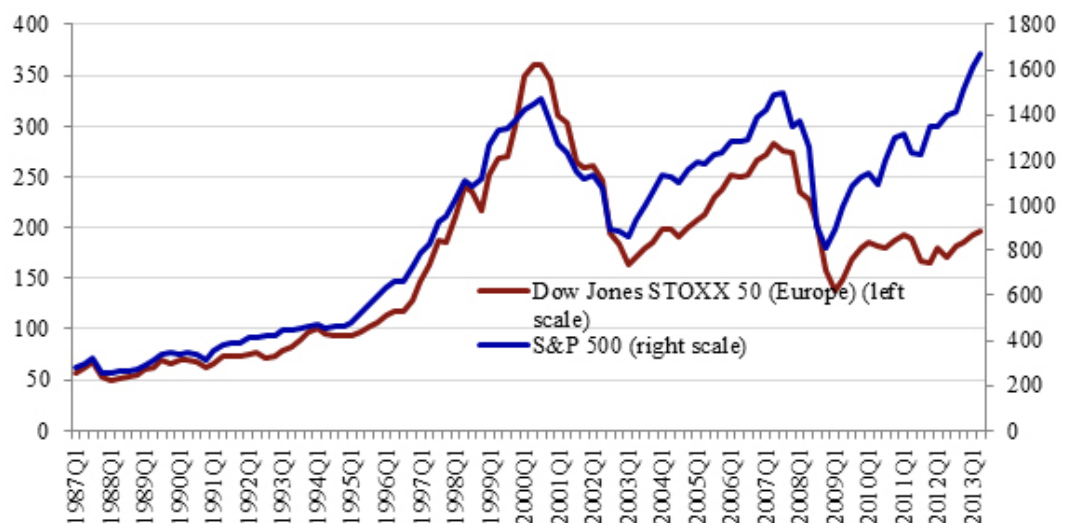
\* The Standard & Poor's 500 or short S&P 500 is a stock market index based on the share value and amount of the 500 largest companies in the US and is one of the most commonly used equity indices of the US stock market.

Source: Thomson Reuters Datastream, drawn from Michael Mackenzie and John Author's "US Fed 'melt-up'?" Financial Times video, Nov 15, 2013, available at: <http://video.ft.com/2839223289001/US-Fed-melt-up-/editorschoice>.

Since the beginning of 2009, the S&P 500 has surged by more than 40 %, in Europe there is equally an upwards trend. The Dow Jones STOXX 50 for Europe surged in the same period by around 25 % (see Figure 15).

In order to examine whether stock markets are overvalued, analysts look at the price-to-earnings-ratio (PE-ratio), which puts share prices into perspective with the earnings those companies are actually generate. In the US as well as in Europe, the PE-ratio is on the rise indicating a stronger increase of share prices than corporate earnings would justify. However, in the US, this is still at moderate levels as corporate profits are extraordinary high.

Figure 15: Stock market development in Europe and the US

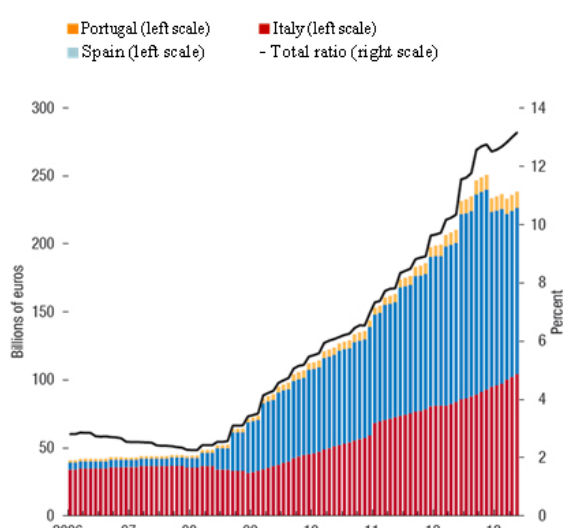


Source: Eurostat and Federal Reserve Bank of St. Louise, see <http://research.stlouisfed.org/fred2/categories/32255>.

The high levels of debt, US companies hold, are still a major concern.<sup>34</sup> Their after-tax-profit-share stands at a record high 10 % of GDP – its highest ratio since 1950 as it increased considerably after the financial crisis.<sup>35</sup> The generated high profits are not based on higher sales but on cost cutting. Companies are reducing expenditure through lower wages, outsourcing, the liquidation of stocks and the closing down of unprofitable entities. This becomes clear when the PE-ratio is compared to the price-to-sales-ratio as sales remain considerably below expectations.<sup>36</sup> Another option for companies to decrease costs is tax avoidance. The statutory corporate tax rate in the US is at 35 %. However, the effective corporate tax rate is around 13 % and out of all S&P 500 companies, 57 have paid an effective tax rate of zero in the last year.<sup>37</sup>

### *The long shadows of the financial sector remain*

**Figure 16: Non-performing corporate loans**



Source: IMF (2013) Global Financial Stability Report, October, p. 35.

news is that private creditors will have to shoulder parts of the losses. However, if further money is required – which is a more than realistic possibility given the small size of the fund – responsibility remains again with national governments. Given the still high vulnerability of the European banking sector, these steps therefore seem insufficient. The degree of non-performing loans has been considerably underestimated in 2008. Specifically in Spain and Italy their share is still on the rise (see Figure 16).

While the developments at the stock markets might become a new concern, old issues remain unsolved or have been addressed in an unsatisfying and unsustainable manner. Right before the end of the year and five years after Leman Brothers, the European Union laid the foundations for a Banking Union (or rather what has been left of the initial proposal). The contribution made by banks over a 10 year period will mount to a mere 55 billion euros, which is only a small fraction of the public aid approved by the Commission to the financial sector of 4.5 trillion (36.7 % of EU GDP) between October 2008 and October 2011.<sup>38</sup> The good

34 John Auther (2013) "Is US stocks' recovery sustainable?", Financial Times, Video, November 12, available at: <http://video.ft.com/2829280293001/Is-US-stocks-recovery-sustainable-/Markets>.

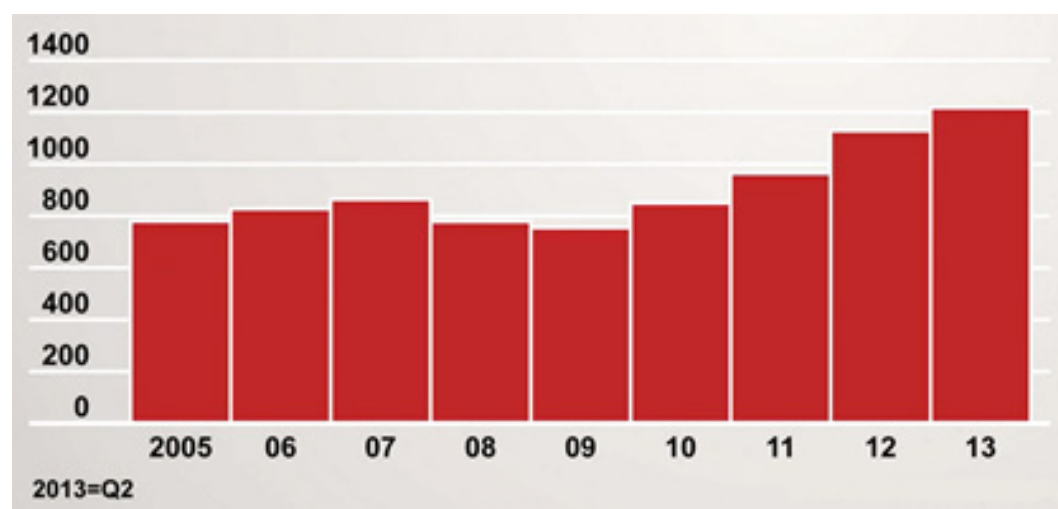
35 John Auther (2013) "Are record US corporate profits sustainable?", Financial Times, Video, November 13, available at: <http://video.ft.com/2832883657001/Are-record-US-corporate-profits-sustainable-/Markets>.

36 James Mackintosh (2013) "Shares riding high – can it last?", Financial Times, Video, November 14, available at: <http://video.ft.com/2838591702001/Shares-riding-high-can-it-last-/markets>.

37 United States Government Accountability Office (2013) Corporate Income Tax - Effective Tax Rates Can Differ Significantly from the Statutory Rate, May, available at: <http://www.gao.gov/assets/660/654958.pdf>; Matt Krantz (2013) "Large companies find ways to a zero tax rate", USA today, October 24, available at: <http://www.usatoday.com/story/money/business/2013/10/23/big-companies-pay-no-taxes/2480281/>.

38 European Commission (2012) "Tackling the financial crisis", April, available at: [http://ec.europa.eu/competition/recovery/financial\\_sector.html](http://ec.europa.eu/competition/recovery/financial_sector.html).

Figure 17: Assets of specialty lenders in the US in billion USD



Note: The categories included here are: specialty finance companies, business development companies and real estate investment trust.

Source: SNL Financial, drawn from <http://video.ft.com/2836492135001/The-shades-of-shadow-banking/editorschoice>

As regulations predominantly targeted banks, other financial intermediaries replaced them in the credit market and specifically in the mortgage market. In fact, assets in this high-risk-high-return segment are further on the rise as Figure 17 shows for the US. In the first half of 2013, the assets of specialty lenders exceeded 1.2 trillion USD, which only constitutes a fraction of the overall shadow banking business and the total amount might be much higher.

## 5 Concluding remarks

For the time being, GDP has stopped falling, but levels of growth that would restore the losses in output, demand and employment still remain absent. Urgently needed employment growth continues to be anaemic or dominated by low-wage/low-productive sectors, specifically the service sector.

Speculative risks remain in the financial sector with unsustainable levels of debt in some countries.

The pace of austerity is slowing. However, this is not enough to overcome the crisis and trigger investment. What is required is a coordinated public investment program to avoid an intensification of capital accumulation in non-productive, speculative sectors that could lead to over-pricing. As of today, a lack of leadership and political will has hampered commitment to such a program.

In addition, assuring a balanced wage growth is crucial for consumption and, in consequence for investment. A further depression is aggravating the situation in Europe as the imbalances in the Euro area remain.





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