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Responding to the crisis: Paths to stability

Policy makers seeking guidance in the current financial crisis may wish to consult the findings of the **PEGGED** research project. Analysis and advice on vital aspects of the crisis, such as sovereign debt and the banking system, has been produced by the team of researchers from seven European institutions, led by David Vines from The University of Oxford. (more...)

AUGUR: Routes to financial recovery in Europe

The major global financial crisis, into which Europe plummeted in 2008, showed the existing framework of banking regulation to be vulnerable. The **AUGUR** research project explored possible scenarios for Europe's economic, social, political and environmental position in 2030, and produced a set of recommendations to policy makers on how to tackle the deficiencies in the banking sector. The key is greater cooperation at the international level and 'macroprudential regulation'. (more...)

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FULL ARTICLES

Macroeconomic models: A comparative tool for policy making

Modelling techniques are crucial for economic forecasting and, by extension, for the planning of macroeconomic policy. Unfortunately, economists have not come up with any single model that works optimally in all situations. With numerous competing models to choose from, policy makers face a daunting task deciding which ones to utilise in addressing specific economic challenges. Their job could be made easier if they were given the ability to plug planning variables into lots of different models, providing a more complete picture of possible outcomes. Thanks to the **MONFISPOL** research project, macroeconomic policy makers now have this comparative option at their disposal.

Led by Professor Michel Juillard at CEPREMAP (Paris), the research consortium consisted of six partner institutions from five EU Member States (France, the UK, Spain, Germany and Italy). Among other key outputs, MONFISPOL spent three years developing and refining a database that includes around 50 empirically estimated macroeconomic models. Many of the models are commonly used by economic researchers, treasury officials and central bankers for quantitative analysis of monetary and fiscal stabilisation policies. These models, however, are generally used only in an 'insular' fashion and differ from one another significantly in terms of economic structure, estimation methodology and parameter estimates. Such heterogeneity makes comparison difficult.

The MONFISPOL project set out to remove the obstacles preventing easy comparison of macroeconomic models. Before the MONFISPOL project got underway, large-scale systematic comparisons of the empirical implications of multiple models (and comparisons of different policies across them) had been "infrequent and costly"[1], the consortium observes. These efforts typically involved different teams of researchers, each focusing on just one single model or a subset of a model. MONFISPOL succeeded in coming up with a new comparative approach that enables researchers to perform model comparisons "easily, frequently, at low cost and on a large scale".

For policy makers, a comparative approach to macroeconomic modelling broadens their perspective, helping them to see 'blind spots' they might otherwise have missed. That's because any given policy can be seen to have different effects depending on what model is used for its evaluation. From a due diligence perspective, it is therefore advisable to assure that policy measures perform reasonably well not just in one model but in several. At least in theory, the comparative approach should enable macroeconomic researchers to offer recommendations with a stronger empirical base; and that, in turn, should allow decision makers to come up with policy rules that will be regarded as more 'robust'.

As one might expect, the methodology employed by the MONFISPOL researchers to build their comparative database is rather technical. But basically it boils down to a process of model augmentation. MONFISPOL created a common set of comparable variables, parameters, equations and shocks that were retrofitted onto the various models. The researchers say the augmentation process was designed in such a way that new models can be added to the database easily.

Anyone wanting to access the database (which uses a software package known as DYNARE) can do so by simply visiting the website http://www.macromodelbase.com and registering. Upon registration an access code is sent via email. The code enables users to log on to the website and download the software needed to launch the tools and get started with systematic model comparison.

Acknowledging that macroeconomic modelling has been heavily criticised in the wake of the global financial crisis, the researchers point out that much of the blame has been attributed to over-reliance on "a particular class of macroeconomic models"[2] that did not perform sufficiently. The MONFISPOL team have taken a different approach to the challenge, one that is open to a wide variety of paradigms and reflects the need for a more 'pluralistic' kind of economics. The comparative database developed by MONFISPOL should go some way toward creating a more level playing field in the competition between rival macroeconomic models and help decision makers move beyond the 'insular' approach to macroeconomic policy making.

1 "A New Comparative Approach to Model Building and Policy Analysis: An update", Presentation, Volker Wieland, MONFISPOL Conference. London, 5 November 2010

2 "A New Comparative Approach to Macroeconomic Modelling and Policy Analysis", Working Paper, Volker Wieland, Tobias Cwik, Gernot J. Müller, Sebastian Schmidt and Maik Wolters. 21 August 2009

__MONFISPOL – Modelling and implementation of optimal fiscal and monetary policy algorithms in multi-country econometric models__ (duration: 1/10/2008 – 30/9/2011). FP7 Socio-economic Sciences and Humanities, Activity 1 "Growth, employment and competitiveness in a knowledge society", Research area 1.3 "Strengthening policy coherence and coordination in Europe". Collaborative project (small and medium scale focused research project).

See: *http://www.monfispol.eu/*

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Social investment policies needed to integrate work and welfare

Although there was an increase in the employment rate in Europe during the 2000s, the quality of jobs created has not kept pace. According to the **RecWoWe** network of excellence (FP6), quality and equality were forgotten in the rush to increase employment. The RecWoWe co-ordinators call for policy changes to reconcile and find a balance between the worlds of work and welfare.

Work and welfare are the most important domains that provide for individuals and influence their life chances. However, developments in the welfare states, which were set up in an industrial era, and changes to the labour market in Europe, have not been sufficiently integrated.

The labour market has been seen as inflexible in the face of increasing globalisation, technological change, the decline of industries, the growth of knowledge-based jobs, an increase in the service sector and a more dynamic demand for labour. At the same time, traditional programmes of welfare, modelled on male-dominated, full-time and continuous work patterns have become increasingly inadequate for a large section of employees engaged in non-standard types of work.

Reforms in recent years to Member States' employment and welfare policies have been primarily aimed at increasing employment levels – so-called 'activation policies'. These include placing conditions on the unemployed in return for benefits, such as signing contracts to agree to look for work, following a training course, or being obliged to accept offers of work.

In preference to activation polices are 'social investment policies'[1] aimed at giving individuals the necessary support to succeed in life, and in reconciling work and welfare, by investing in childcare and education, further education and training for those of working age, and introducing measures to enable older workers to continue to work.

RecWoWe, managed by MSH Ange Guepin, Nantes France, created a durable interdisciplinary network of over 200 researchers and 30 universities from 17 European countries, to overcome the fragmentation of existing research on employment and welfare, and study it from a comparative perspective. It has engaged with young researchers, as well as policy makers and stakeholders, and built up a valuable resource of people, data and knowledge, related to relevant policy issues, such as the Lisbon and Europe 2020 strategies, and to the economic crisis.

It was innovative in only funding research projects that focused on the interplay between work and welfare. It took a 'bottom-up' approach, accepting projects proposed by any member of the network rather than imposed from above, and combined simple rules with a consistent management approach.

RecWoWe's main goal was to integrate research on the labour market and on the welfare state, which would have been impossible to achieve from a national point of departure. RecWoWe has contributed to the evolution of a truly European research community, potentially the largest in the world in the field of social policy, welfare state and labour market studies, enabling researchers to work in a consistent manner and allowing for a better understanding of current developments in Europe.

The RecWoWe network identified and based its work around four main tensions between work and welfare:

- **Flexicurity** - Tension between a call for more flexibility in the labour market and a need for security for citizens.

- **Work-life balance** - Tension between work and family life, increased fluidity in family patterns, and enhanced flexibility in employment patterns and relationships.

- **Quality and quantity of jobs** - Tension between the number of jobs created and their quality.

- Tension induced by the development of 'employment-friendly' **welfare reforms**, i.e. political tensions created by the difficulties in matching welfare systems set up in the industrial era to the requirements of creating post-industrial jobs.

RecWoWe has achieved a large number of outputs, including the European Data Center for Work and Welfare[2], a meta-data shell which forms a harmonised portal linking most existing research in the area (at European and national levels). Other outputs include a substantial number of publications, including a Working Papers series, a newly created book series on 'Work and Welfare' (with Palgrave Macmillan) and journal publications (an impressive total of 25 collective volumes).

Among the network's key findings are:

- **In-work poverty** - Levels of poverty, inequality and social exclusion in EU Member States have remained stubbornly high over the last decade. Even during periods of employment growth, there was little sign of a reduction in in-work poverty, with migrants and women most at risk.

- **Job quality and tensions between work and private life** - Policies designed to ease the work-family conflict are mainly aimed at families with children but tend to forget the need to care for other dependents. Opportunities to engage in part-time employment are highly influenced by the views and prejudices of organisations, the productive sectors and nations as a whole.

- **Gender equality** - There has been only a slow increase in the number of women in top management roles during the last decades, with faster progress in some countries (primarily in Scandinavia).

- **Life courses** - The financial basis for different life course activities, such as education, child-rearing and retirement, is confined to a 'shrinking middle' phase of employment.

- **Performance of social investment policies** – Analysis of social investment policies, such as those found in Nordic countries, suggests that they can successfully combine social and economic goals. These countries display higher education levels, which translate into higher levels of social capital and social cohesion; greater learning and innovation capacity at work; more flexibility in the labour market; and good economic growth, including the creation of more and better jobs.

Policy recommendations:

- Include as many people as possible in the labour market and introduce measures to ensure high quality education, social and health care.

- Implement structural policies and incentives for companies to increase the demand for labour.

- Encourage more comprehensive pension provision for workers with atypical careers, such as those taking career breaks.

- Incorporate working time standards and other rights formulated by the International Labour Office (ILO) into EU guidance in order to improve the quality of jobs.

- Introduce measures to address tensions in the work/family interface, such as flexible work schemes, and provide more support for high quality care of children and the elderly.

- Introduce gender quotas if self-regulation fails to close the gender gap in top management positions.

- Improve job quality to reduce in-work poverty.

- Embed social investment objectives, such as reducing school drop-out rates, increasing the number of graduates and reducing the number of people living in poverty, into budgetary and macroeconomic policy.

- Implement an EU 'Social Investment Pact' that could guide budgetary austerity policies towards long-term ends.

1 See: Morel, Palier and Palme, Towards a Social Investment Welfare State?, Policy Press, 2012.

2 See: http://www.EDACWoWe.eu

RecWoWe – Reconciling Work and Welfare in Europe *(duration: 1/10/2006 – 30/9/2011) was a Network of Excellence funded under the 6th Framework Programme for Research of the European Union, Thematic Priority 7 – Citizens and governance in a knowledge-based society.*

See: *http://www.recwowe.eu*

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Job quality can suffer even during employment growth in Europe

Employment in the EU increased by 7.9% from 2000 to 2008 (the period before the economic crisis). The **walqing** research project, however, has found that the quality of these new jobs was split almost 50:50 between those classified as lower quality and those classified as higher quality jobs. Therefore, employment growth does not automatically improve job quality. Active policy intervention is necessary to support better job quality through policy measures such as a minimum wage, standard setting, health and safety regulations, and regulating the informal part of a sector.

The Europe 2020 agenda sets the ambitious goal of an employment rate of 75% by the year 2020 for the population aged 20 – 64. According to the European Labour Force Survey (ELFS), the number of jobs in the EU rose from 209.874 million in 2000 to 226.552 million in 2008; an increase of 7.9%. During this time the proportion of service sector jobs increased from 65.9% to 70.45%, while jobs in agriculture declined from 7.3% to 5.6% and industrial sectors employment declined from 26.8% to 24%.

The walqing project has come up with new ways of understanding the consequences of the job creation process, enabling policy makers to find out which sectors are likely to grow, and where problematic working conditions are likely to develop. The researchers believe that although the economic crisis makes it harder to discern long-term job trends, the quality of employment growth is not purely market, and technology, driven but is amenable to policy initiatives.

walqing has now completed its first phases, which have created two new policy-relevant indexes:

- **The BART Index** (balanced absolute and relative trend index) on employment growth in various countries, which is innovative, since previous measures produced either a relative trend index (e.g. expressed in percentages) or an absolute trend index (expressed in numbers such as hours, workers or production output). Relying on either relative or absolute trends may lead observers to over-, or underestimate structural changes, and policy makers to misdirect interventions and investments in regional development or qualification. By balancing the trends, the BART index is able to avoid trends in large countries over-shadowing those in smaller countries.

- A **Job Quality Index** aggregating data on all aspects of job quality (work organisation, wages, security and flexibility, skills and development, engagement and representation), and weighting them according to their contribution to three aspects of employee well-being: physical well-being, psychological well-being and job satisfaction.

In creating these indexes, walqing provides a new way of utilising existing European level data, such as the ELFS and the European Working Conditions Survey (EWCS). Using these indices means that trends in larger countries do not obscure interesting developments in smaller countries, and allow for ‘zooming in’ on national particularities in growing sectors.

Findings from the initial phase of research:

- Of the new jobs created during the period under review, 8.19 million were characterised as high quality jobs and 8.48 million were low quality.

- Jobs are categorised as belonging to one of six job quality types – ‘active’, ‘saturated’, ‘team-based’, ‘passive-independent’, ‘high-strain’ and ‘insecure’ jobs. Typical examples of these groups would be: research scientist, senior manager, software engineer, night security guard, manufacturing operator, and temporary office worker.

- The job type with highest job quality is the active job type, and the job with the least favourable outcomes is the high-strain job type.

- Women are at greater risk of working in low quality passive-independent and insecure jobs, working in low quality growing sectors, and having difficulties in progressing in, or re-entering, high quality growing sectors.

- The shift in employment to the service sector has only resulted in 895,900 extra high quality jobs during the period under review, a small proportion of the overall number of high quality jobs (100.428 million), which suggests that the shift to the service sector cannot be relied upon to increase the proportion of high quality jobs.

- Growing sectors of the EU economy with higher than average levels of job quality include real estate, education and health, public administration and financial intermediation.

- Lower than average job quality is found in construction, retail, and the hotel and restaurant sector. These sectors are strongly segmented by gender and have gender-specific profiles of problematic job quality.

- Growing sectors with poor working conditions have aspects in common – they are labour intensive jobs in sectors increasingly shaped by outsourcing and cost-based competition, attending to basic societal needs such as food, care, shelter, or cleanliness, often with physically hard working conditions and a requirement to work in a mobile setting, for example on the road or at a client's site.

- In some countries, social partners as well as NGOs have come up with good practices and solutions to address issues, such as precarious work, working hours and social inclusion of vulnerable groups, but these are not extended across comparable sectors or countries.

Interim policy recommendations:

- Policy makers should pay attention to growth sectors outside the knowledge-intensive cores of the economy, to limit tendencies to poor job quality and support innovation through regulation, social dialogue and mutual learning.

- Policies should be geared towards the promotion of high quality jobs, especially active and team-based jobs.

- Remedies for improving low quality jobs depend on the job type, for example high-strain jobs would need increased job resources and autonomy, while passive jobs would need increased resources and more demands.

- Low quality sectors have gender-specific profiles of problematic working conditions, and also frequently hire migrants, ethnic minorities or other vulnerable groups, such as young or older workers. Policies are needed to address both issues of inequality and social inclusion.

Evidence from the first phases of the project has been used to select subsectors, such as 'green' construction, consumer waste removal, office cleaning, catering and mobile elderly care, which are likely to expand further and present particular challenges for job quality. In these sectors, walqing has investigated social partnership structures and practices in a range of partner countries.

walqing is currently conducting detailed case study analyses of companies, taking note of best practices improving job quality and productivity. The project is also investigating individual employees' trajectories of work and concerns of work and life quality, issues of representation of vulnerable groups, and possibilities of action research interventions in selected workplaces.

Further results of the second phase of walqing will be disseminated online as they are produced during 2012, as well as at the project's final conference to be held in Vienna on 19-20 September 2012.

walqing - Work and life quality in new and growing jobs *(duration: 1/12/2009 - 30/11/2012). FP7 Socio-economic Sciences and Humanities, Activity 3 "Major trends in society and their implications", Research area 3.2 "Societal trends and lifestyles". Collaborative project (small and medium scale focused research project).*

See: http://www.walqing.eu/

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Responding to the crisis: Paths to stability

Policy makers seeking guidance in the current financial crisis may wish to consult the findings of the **PEGGED** research project. Analysis and advice on vital aspects of the crisis, such as sovereign debt and the banking system, has been produced by the team of researchers from seven European institutions, led by David Vines from The University of Oxford.

An interesting crisis-relevant example is the policy report titled 'The Future of Banking'[1]. Issued in the form of an eBook, this publication includes thirteen essays from leading European and American economists who discuss immediate solutions to the on-going financial crisis and propose bold regulatory reforms. The eBook was edited by project participant, Thorsten Beck, whose introductory chapter explores options for addressing the current banking crisis while anticipating long-term challenges.

Reviving an idea which he admits "has not really been popular among policy makers these past years", Thorsten Beck says there are compelling reasons to force financial institutions to privatise their *losses* as well as their profits. This counterargument to those who advocate maintaining the status quo or nationalising bank profits is progressing. The current situation may be untenable because - as the crisis has shown - banks have come to expect public bailouts when things go wrong but keep the benefits when things go right. They are accustomed to externalising their losses, imposing enormous costs on the rest of the economy through their risk-taking and failure.

Not that banks alone are to blame for this situation. Policy makers failed to apply the lessons of the previous crisis of 2008. Noting that politicians "did not use the last crisis sufficiently for the necessary reforms", Beck suggests that forced privatisation of bank profits *and* losses may now be "an idea whose time has finally come".

Issuing a "Call for Action", the PEGGED policy report urges policy makers to undertake the following:

- Resolve the Eurozone crisis *forcefully* and *swiftly* using a two-pronged approach with separate policy tools to address the sovereign debt and banking crises.

- Create incentives that force financial institutions to internalise all repercussions of their risk, especially the external costs of their potential failure.

- Focus on the endgame - Create a credible resolution regime that forces risk decision takers to bear the losses of their decisions. (This is needed to correct the misguided practice of providing bailouts to banks upon failure, a policy that has encouraged excessive risk-taking.)

The eBook also offers carefully argued reflections on other key aspects of the Eurozone crisis including the much-debated financial transaction tax, Eurobonds and the policy of 'ring-fencing' (separating the commercial and trading activities of banks).

PEGGED has explored these and many other hotly discussed policy instruments in several conferences and papers over the past two-and-a-half years. As one might expect, some of the project's research-based output is rather technical in nature. (Readers with a strong interest in economics or finance may appreciate the PEGGED discussion paper 'Sovereign CDS and Bond Pricing Dynamics in the Euro Area'.[2]) However, many of the main policy-relevant publications produced by PEGGED have been written in a highly accessible way, providing valuable insights into key aspects of the crisis that are relevant to us all. One may not agree with all the policy positions taken by the researchers, but confronting their arguments and evidence is definitely a worthwhile exercise.

PEGGED was conceived with the express aim of helping Europe construct a "vision of how the global economic system should evolve". To achieve this goal, the project concentrated on four key policy areas:

- International macroeconomic governance.
- Globalisation and financial stability.
- Integration of markets for trade in goods and services.
- Migration and the mobility of labour.

1 See: http://pegged.cepr.org/files/policy_reports/The%20Future%20of%20Banking_Beck.pdf

2 See: http://pegged.cepr.org/files/working_papers/39th%20WP%20%28WP2%29%20Sovereign%20CDs.pdf

PEGGED - Politics, economics and global governance: the European dimensions *(duration: 1/7/2008 - 30/6/2012). FP7 Socio-economic Sciences and Humanities, Activity 4 "Europe and the world", Research area 4.1 "Interactions and interdependences between world regions and their implications". Collaborative project (large-scale integrating project).*

See: *http://pegged.cepr.org/*

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AUGUR: Routes to financial recovery in Europe

The major global financial crisis, into which Europe plummeted in 2008, showed the existing framework of banking regulation to be vulnerable. The **AUGUR** research project explored possible scenarios for Europe's economic, social, political and environmental position in 2030, and produced a set of recommendations to policy makers on how to tackle the deficiencies in the banking sector. The key is greater cooperation at the international level and 'macroprudential regulation'.

The banking crisis in 2008 is mainly attributed to the excessive build up of debt across the financial system, miscalculation of risk and overreliance on unstable, short-term funding (non-core liabilities) rather than actual cash flow (core funding). Since 2008, the danger posed by financial institutions previously deemed 'too big to fail' has been widely recognised.

It is now accepted that countries should avoid the situation where they are forced to bail-out such institutions. An overhaul of banking regulations is seen as essential to regain stability and to improve the way risk is managed in the long-term. But the important question is *what could these changes look like in Europe*?

As part of the AUGUR project, an international team of researchers explored a range of feasible scenarios on how regulation of the financial sector could take shape by 2030 and the role of international cooperation.

What is the best strategy for Europe?

The key to overall financial stability, according to AUGUR, is effective 'macroprudential' regulation. It requires a level of international cooperation which is consistent with the level of financial integration. This means addressing the stability of the financial system as a whole as well as the stability of individual financial institutions (i.e. banks, building societies, mortgage loan companies and insurance firms).

Such an approach has been proposed before but is still not fully addressed under the Basel Committee Doctrine III[1], which is the international regulatory framework set up in 2009 in response to the financial crisis.

The implication of macroprudential regulation is increased supervision of the financial sector by Central Banks, taking into account the systemic risk induced by 'herding behaviour' of financial actors. This may imply increased coordination at the international level. Depending on the extent to which a macroprudential approach is taken, the AUGUR researchers envisage four possible scenarios for the future of finance in Europe in 2030:

- **Reduced government** – Multinational corporations take advantage of competition between national governments which seek to become more attractive by reducing their regulatory standards. The debt issue leaves most governments with very little room for manoeuvre.

- **China and US intervention** – The world of finance is dominated by two super powers which dictate key global finance regulations. This scenario would likely result in two different and competing models.

- **Regionalisation** – Economic spaces are created at the regional level and governed by common financial regulations. Regions include the EU and NAFTA (North-American Free Trade Agreement) but also new groupings, for example in Asia.

- **Multi-polar collaboration** – Major world economies reach an agreement to create a World Financial Authority to regulate financial markets worldwide.

The first scenario could lead to fragmentation by allowing sovereign states to regulate their own financial services. This 'reduced government' scenario would be a retrograde step in terms of financial stability.

The 'regionalisation' scenario represents a step-wise progression towards the best-case scenario, which is better allocation of capital and distribution of risk through a multi-polar (global) governance system. The level of coordination required, and the fact that the regions should be of sufficient size to adequately maintain and govern financial stability, means that the most realistic scenario by 2030 is regional regulation of financial institutions.

In order to make progress towards the regional or even multi-polar solution, the AUGUR researchers make the following policy recommendations:

- **Macroprudential policy tools** – Develop new instruments to act as early warning indicators of instability, e.g. monitoring the ratio of non-core liabilities to core funding could gauge potential vulnerability.

- **Levy on non-core liabilities** – Impose a levy or a tax on the non-core funding that makes banks vulnerable, to limit systemic risk. This would have the effect of an automatic stabiliser while leaving the essential functioning of the financial system unaffected.

- **Liquidity management** – Increase the amount of core funding (cash) banks are required to hold, to protect themselves against the risk of unexpected loss. This amount may vary with the level of economic activity in order to support reasonable growth rates.

- **International cooperation** – Establish a degree of coordination in line with the degree of financial integration necessary, to avoid international regulatory arbitrage.

What's next for the project?

In the closing months of the project, the AUGUR team will further explore the links between Europe's financial future and their projections for Europe in other sectors, including politics, society, trade, transport, the environment and technology. The development of these sectors and particularly of emergent markets, such as green technology and climate change adaptation, are likely to be underpinned by the financial situation in the coming decades, and the extent of regional or international cooperation.

However, the problem is that stability in the financial sector is difficult to predict since, experience tells us, the sector is vulnerable to a wide range of shocks. The question now is whether BASEL III, ratified at the G20 meeting in Seoul (November 2010), can meet the challenge of global stability by incorporating macroprudential innovation, which has previously fallen between the gaps in the regulatory system, and the extent to which this regulatory standard will be implemented by local regulators around the world.

Although the ideal outcome is a multi-polar macroprudential approach, we are also yet to see how far countries are willing to allow international governance of their finance sectors and, therefore, at which level (national, regional, European or international) a solution will emerge.

1 International regulatory framework for banks (BASEL III). See: http://www.bis.org/bcbs/basel3.htm and, for an abstract: http://www.bis.org/bcbs/basel3/b3summarytable.pdf

AUGUR – Challenges for Europe in the world of 2030 *(duration: 1/10/2009 – 30/9/2012). FP7 Socio-economic Sciences and Humanities, Activity 7 "Foresight activities", Research area 7.1 "Wide socio-economic foresight on key challenges". Collaborative project (small and medium scale focused research project).*

See: *http://www.augurproject.eu/*

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SEVENTH FRAMEWORK PROGRAMME

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