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HOW A FLAWED STRUCTURE IS HURTING THE EUROZONE - ECONOMICALLY AND POLITICALLY

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Economically, the Eurozone is finally recovering. “The wind appears to be back in the sails of the Eurozone economy,” says EC President Mr. Juncker, brimming with optimism.

Politically, the far-right, anti-€ populist ferment in Europe is far from dead; e.g. Wilders in NL; Le Pen in France; AfD in Germany; FPO in Austria; M5S in Italy.

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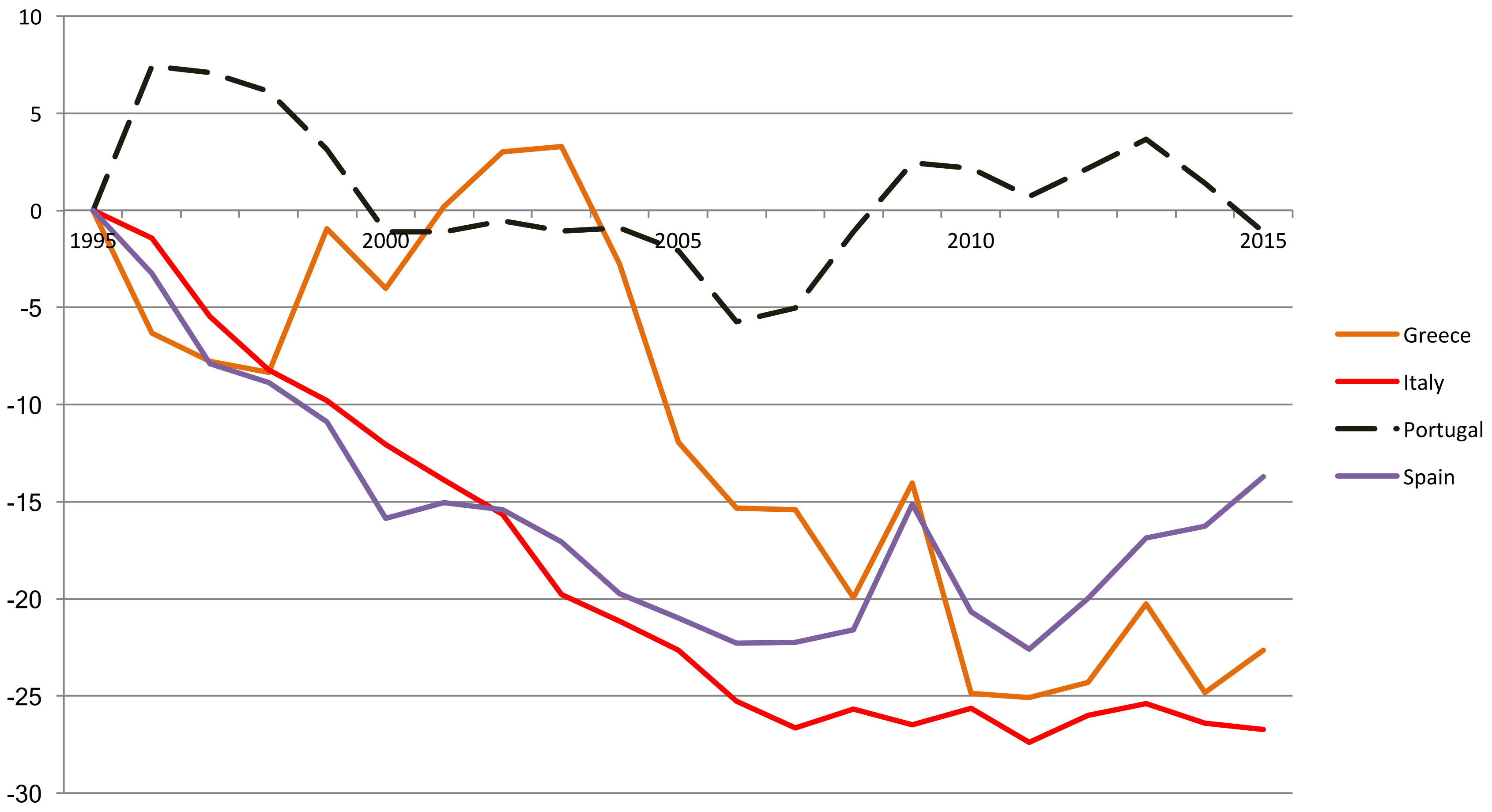
Reasons to be less optimistic than Mr. Juncker:

- can the recovery be sustained without unconventional monetary policy of ECB?
- Eurozone banks are still structurally weak, not just in Italy; (household) debt levels remain high; asset-price inflation in Germany.
- downside risks are large, but policy buffers are thin.
- Achilles' heel is productivity (growth) divergence in the Eurozone (IMF 2017; EC 2017). See next graph.

Manufacturing Productivity Divergence (1995-2015): Southern Europe relative to the Eurozone “core” (Aus/Bel/Fr/Ger/NL)



What is the benefit (or cost) in terms of real GDP per capita of EMU membership?

	before the crisis 1997-2007	during the crisis 2008-2014
Austria	+6.3%	+2.3%
Belgium	+5.3%	+1.6%
France	+2.7%	+0.9%
Germany	–0.8%	+4.7%
The Netherlands	+7.3%	–1.0%
Greece	+9.8%	–16.0%
Italy	+0.3%	–7.6%
Portugal	+7.8%	–4.1%
Spain	+10.4%	–7.6%

Source: Verstegen, van Groezen and Meijdam 2017.

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There are four mechanisms through which the Eurozone structure reinforces structural (core-periphery) divergence in (productivity) growth:

1. The ECB’s one-size-fits-all monetary policy
2. The common exchange rate is misaligned for ‘core’ and ‘periphery’ member states
3. The fiscal austerity straightjacket hinders recovery and amplifies divergence
4. The ‘competitiveness myth, aka the Hartz reforms myth

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The ECB's one-size-fits-all monetary policy

- During 2000-2008: interest rate set too low for SE →unsustainable debt-financed spending; real estate bubbles. "Bank credit glut".
- During 2008-now: interest rate set too high for SE → ZLB; high spreads in bond markets; doom loop.
- During 2008-now: interest rate too low for Northern 'core': Germany's DAX index doubled between Sept 2010-Sept 2017, German GDP rose by 13%. Rising home prices in Germany & NL.

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The common exchange rate is misaligned for ‘core’ and ‘periphery’ member states:

- € is undervalued for the trade surplus countries (Germany; NL); their net exports are ‘subsidised’ by the monetary union.
- € is overvalued for the trade deficit countries (SE); their net exports are ‘taxed’by EMU.

These misalignment reinforce divergence: core specialization in medium/high-tech exports; periphery specialization in non-dynamic low/medium-tech goods, in competition with China.

The fiscal austerity straightjacket hinders recovery and amplifies divergence

The Eurozone recession was largely self-inflicted, because fiscal austerity (consolidation) crippled the recovery. Fiscal multiplier > 1; austerity raised debt/GDP ratios.

The recession left permanent ‘scars’ (*hysteresis*), reducing potential growth through: lower capital stocks; halted embodied technical progress; declining infrastructure; weakened scientific structures; outward migration; collapsed systems of innovation; insolvent banks and more severe credit rationing (of SMEs).

The ‘competitiveness myth, aka the Hartz reforms myth

- Dominant narrative (e.g., *Euro Plus Pact*) is that the SE economies struggle because they are not ‘competitive’, while Germany is doing fine because of superior competitiveness.
- Competitive = lower relative unit labour costs (RULC) than competitors.
- Germany’s labour market deregulation (Hartz reforms) reduced RULC (through wage restraint) and supposedly turned Germany into “Exportweltmeister”.
- President Macron is copy-pasting the Hartz reforms (reducing Employment Protection etc.) – with blessing of the experts at the IMF, OECD, EC, ECB.

Why it is a myth

- **non-price (technological) competitiveness** matters more than RULC. German firms compete on quality, not on costs.
- ULC make up about 20% of production costs and price. Cutting ULC by 10% reduces price by just 2%. The elasticity of net exports to RULC is therefore small (in absolute terms).
- There was no wage restraint in Germany’s export manufacturing sector. The Hartz reforms affected non-traded services, creating low-wage flexible mini-jobs in services activities. The result: **dualisation**, a **two-tier labour market**.
- The Hartz reforms did **nothing** to boost German productivity (Storm and Naastepad 2015; Odendahl 2017).

A decomposition of the growth of ULC in SE manufacturing relative to ULC in Manufacturing in the Eurozone core (1995-2015)

(source: author's estimation based on Eurostat data)

	relative ULC growth	due to faster hourly nominal wage growth	due to slower hourly labour productivity growth
Southern Europe	1.59%	0.42%	1.15%
Greece	1.53%	0.24%	1.27%
Italy	2.09%	0.52%	1.54%
Portugal	0.71%	0.66%	0.06%
Spain	0.75%	0.01%	0.74%

European Commission (2017, May):

"Our Economic and Monetary Union stills falls short on three fronts.

First, it is not yet able to reverse sufficiently the social and **economic divergences** between and within euro area members that emerged from the crisis.

Second, **these centrifugal forces come with a heavy political price**. If they remain unaddressed, they are likely to weaken citizens' support for the euro and create different perceptions of the challenges, rather than a consensus on a vision for the future.

Finally, while the EMU is stronger, it is **not** yet fully **shock-proof**."

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‘structural labour market reforms’ will:

- create low-wage, flexible, insecure jobs
- raise in-work poverty
- raise wage and income inequality
- reinforce a DUAL two-tier labour market, made up of a high-wage/high-productivity ‘core’ of protected workers and a stagnant low wage periphery of flex-workers
- reduce aggregate (average) productivity growth because wage restraint lowers demand growth, which limits the ‘division of labour’ and slows down embodied labour-saving technical progress

Что делать? What is to be done?

- better mechanisms to share benefits, costs and risks of common currency. E.g. Eurobonds.
- coordinated fiscal stimulus ……. and restructuring of (bank) debts
- dual mandate for the ECB
- recognition that Hartz-like ‘structural reforms’ reinforce divergence between and within countries and have a heavy political price !
- active industrial policy to increase technological competitiveness of periphery