



THE EUROZONE: AN INCONVENIENT TRUTH¹

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Abstract

In this study, we show that the main problem facing the Eurozone economy is the relatively low competitiveness of the PIIGS economies compared with other economies in the region. Findings show that the defining trait of PIIGS countries is neither budget deficits, nor public debt, but rather the current account deficits (<http://ideas.repec.org/a/oen/econom/y2012i03id332.html>). The politicians' initial assumption that joining the Eurozone would lead to the convergence of productivity trends failed to materialize. We argue that, while tightening fiscal discipline within the Eurozone is a must, it does not solve the problem of lack of competitiveness. Adopting rules on capping structural deficits at around 0.5 percent of GDP might prove premature, given the private sector deleveraging process. We reveal the solutions that help exit the crisis without deepening the recession. Among them, a weaker euro would buy time for countries facing a competitiveness deficit to implement far-reaching structural reforms conducive to higher labor productivity. The European Central Bank's quantitative easing is compatible with this solution.

Keywords: competitiveness, productivity, current account deficit, crisis, recession, quantitative easing, Eurozone

JEL Classification: E58; E32; E44

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1. Foreword

The current plan to deal with the euro area crisis focuses on the adoption of a fiscal accord to limit the ratios of structural budget deficit and public debt to GDP by way of constitutional provisions or the like. Introducing such a rule (hereinafter referred to as the D/D rule) into the constitution is expected to contribute to restoring confidence in the short run, as well as to strengthening the economic and financial stability in the long run. This rule, albeit necessary, will prove ineffective in producing the desired

¹ The opinions expressed herein are those of the author and do not, in any way, reflect the official position or policies of the National Bank of Romania. This study was first published in Romanian in January 2012 (<http://www.bnro.ro/Puncte-de-vedere-4011.aspx>) and then included in the 2012 author's book "Monetary Policy: Unconventional Approaches".

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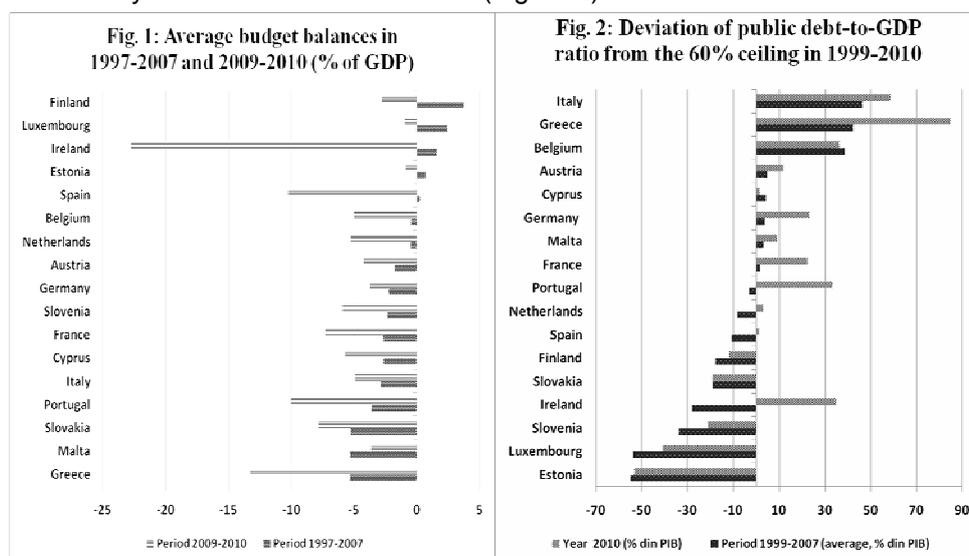
effects if implemented too early and in the absence of an additional rule to change the financial entities' expectations of the government conduct during times of crisis.

In the near future, the D/D rule is not an adequate response to the euro area crisis since it does not target the root cause of the crisis. In the long run, the rule does not hinder government bailouts of private entities, allowing the private sector to assume imbalances wider than those considered prudent in the absence of possible government bailouts. As a result, relatively small public deficits and debts may co-exist with huge private sector imbalances, which can be as harmful as the public sector ones. Large imbalances in the private sector may be at any time a trigger of a crisis.

2. Causes of the Eurozone crisis

While they may create problems in the future, neither budget imbalances nor public debt levels have been the causes of the crisis hitting the PIIGS³ economies. In the pre-crisis period (1999-2007), only Greece and Portugal out of the PIIGS group, along with Malta and Slovakia, posted average budget deficits larger than 3 percent of GDP (Figure 1).

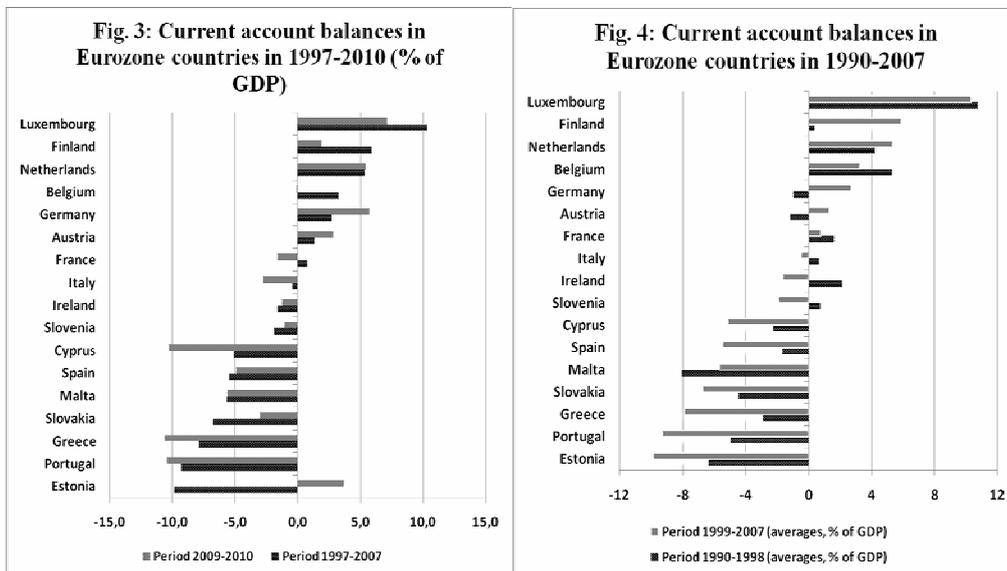
With regard to public debt, only Italy and Greece of the PIIGS group exceeded the 60 percent debt-to-GDP ratio, the same as Belgium, France, Cyprus, Malta, Austria and Germany in the Eurozone as a whole (Figure 2).



Source: Author's calculations based on AMECO data. Source: Author's calculations based on AMECO data.

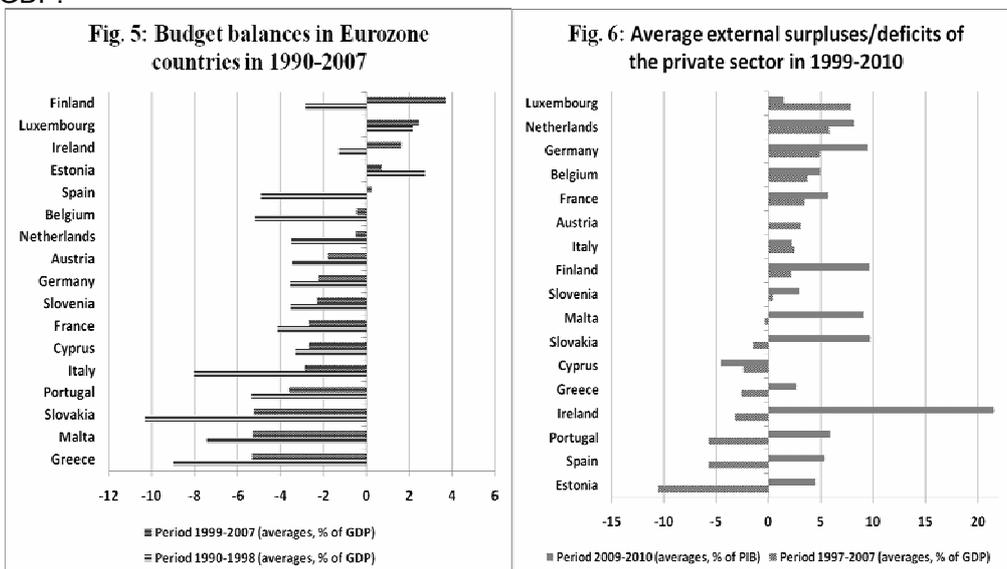
In fact, external imbalances are the problem of the euro area. The relatively high current account deficits are a common feature of the PIIGS countries, except Italy (Figure 3). The current account deficits of the PIIGS economies widened in 1999-2007 as compared with 1990-1998 (Figure 4).

³ Portugal, Italy, Ireland, Greece, Spain.



Source: Author's calculations based on AMECO data.

By contrast, in the same period, their fiscal deficits narrowed or even turned into a surplus in the case of Ireland and Spain (Figure 5). This is clear evidence that, in the PIIGS countries, except Italy, current account imbalances of the private sector (Figure 6) have been the real problem lying at the root of the crisis that broke out in 2007. Greece was an outlier, with its average budget deficit exceeding 5.5 percent of GDP.

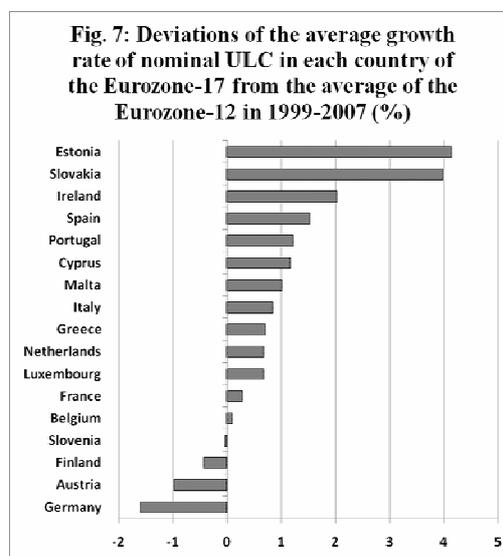


Source: Author's calculations based on AMECO data. Source: Author's calculations based on AMECO data.

The euro adoption caused the external imbalances of the private sector in these countries to widen, thus increasing their dependence on unit labour costs, namely the ratio of nominal wage to labour productivity. The assumption on the convergence of productivity trends in euro area countries failed to materialise, so that the divergent growth rates of nominal wages (in Annex 2 we present indexes of nominal compensations per employee) led to larger trade imbalances.

In 1999-2007, the nominal unit labour costs grew at a faster pace in Ireland, Spain, Portugal, Italy and Greece (in this order) than in the other Eurozone-12 countries⁴ (Figure 7). The PIIGS countries recorded the highest and the lowest growth rates of labour productivity, as well as the fastest rates of increase in compensation per employee in the Eurozone-12 countries.

Out of the Eurozone-12 countries, Greece and Ireland posted the highest labour productivity increases, which were, nonetheless, eroded by the swiftest rises in compensation per employee. In Portugal, labour productivity also rose at a faster pace than in Germany and France, yet the growth of compensation per employee was much higher than in any Northern European country of the Eurozone-12 group. In contrast, Spain and Italy reported the lowest labour productivity increases in the Eurozone-12 countries (Annex 1 and Figure 14 in Annex 3), but not the smallest rises in compensation per employee, which grew more rapidly than in Germany, Austria, France and Belgium.



Source: Author's calculations based on AMECO data Source: Author's calculations based on AMECO data

⁴ Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain.

Should the national currencies of the countries where unit labour costs rose relatively fast still have been used, they would have depreciated in order to counterbalance the overly rapid increase in wages and the rather slow growth of labour productivity. Currency depreciation would have fostered exports and slowed imports, and thus would have narrowed the private sector external deficits in Portugal, Spain, Ireland and Greece, while also reducing the trade surpluses of Germany, the Netherlands, etc. However, given the single currency, deficits were further dependent solely on the growth rates of wages and productivity.

The appreciation of the single European currency amplified the competitiveness losses arising from the rather rapid increase in nominal unit labour costs in Italy, Greece, Portugal, Spain, and Ireland. In the Eurozone as a whole, the stronger euro eroded average competitiveness and put upward pressure on the current account deficit vis-à-vis the non-euro area markets. Moreover, in the Southern euro area countries, the euro appreciation overlapped the lack of real convergence, causing the worsening of competitiveness to lie at the root of the Eurozone crisis.

In the case of a single currency, price competitiveness differentials basically depend on the inflation differential. This can be analysed by writing unit labour costs as a product between GDP deflator (GDP DEF), the employment-to-employees ratio (EMPT/EMPS) and the share of nominal compensation of employees in GDP (NC/GDP). Annex 4 shows the developments in these indicators by country. The evolution of GDP deflator obviously explains the unit labour costs dynamics, while neither the share of compensation of employees in GDP, nor the ratio of employment and employees underwent significant changes. Data validate the assumption that, in a single currency area, countries with relatively high inflation rates incur competitiveness losses.

The developments in the competitiveness of the PIIGS countries after their joining the euro area show an inconvenient truth, namely the countries that entered the monetary union while having low competitiveness could not sustainably converge – for reasons that need to be thoroughly assessed – to the productivity levels of Northern euro area countries. The crisis revealed that the adoption of the single currency alone is not sufficient for productivity trends to converge. Due to their massive indebtedness in euro, these countries cannot leave the Eurozone in order to become competitive enough without incurring huge costs. This implies rising costs for all euro area countries.

This is a lesson that euro area candidate countries need to learn: once the assumption of productivity convergence within the euro area was not confirmed, the entry into the monetary union should be postponed until labour productivity levels near those in Northern euro area countries, no matter how long it would take. Nevertheless, keeping in place a relatively close date for joining the Eurozone is beneficial, as it can lead to the step-up in the reforms necessary for narrowing productivity gaps.

In addition, the Eurozone entry needs to be prepared by creating the mechanisms (sources) to ensure the sustainable increase in labour productivity after adopting the euro as well, for the purpose of avoiding the emergence of disparities between labour productivity trends in new euro area member states and in highly productive countries.

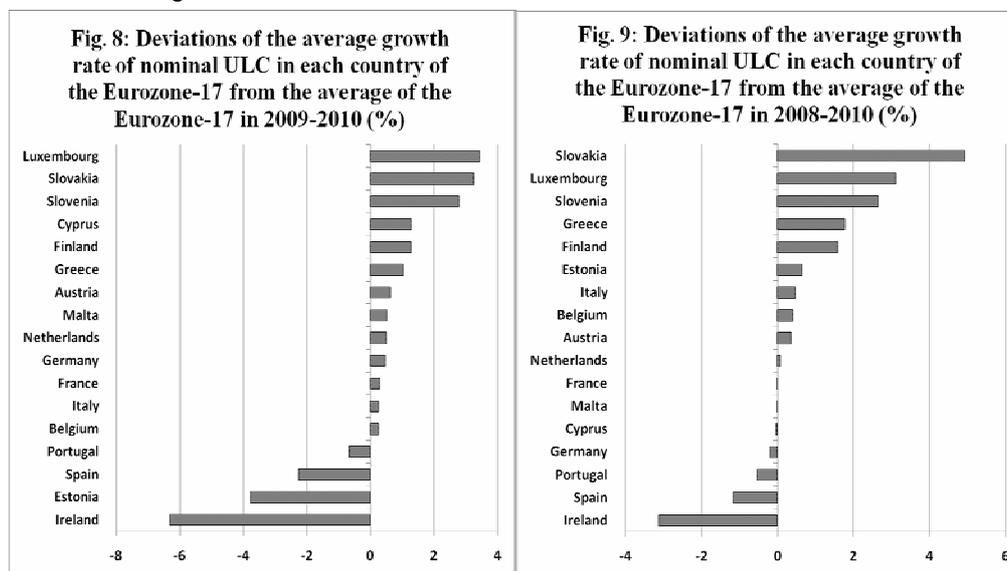
Insufficient preparations would translate into a crisis, as it was the case of the PIIGS countries.

3. Changes the Crisis Have Brought About

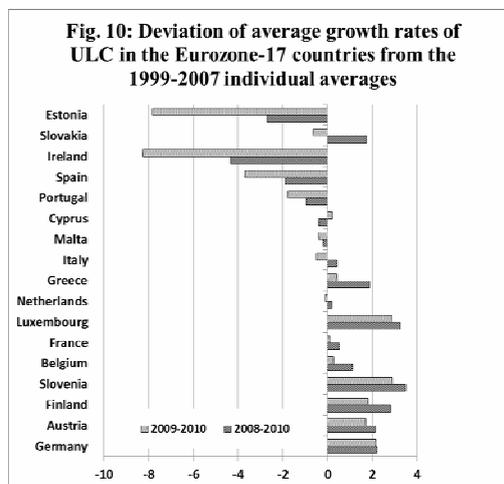
The economic crisis stemmed from the external imbalances between the more competitive countries in Northern Europe and the less competitive ones in Southern Europe. Prior to the crisis, private fund surpluses in some of the Northern countries were used to finance private deficits in other euro area countries. Once the crisis set in, these foreign private funds were slashed and private deficits collapsed.

The crisis brought about two major changes that, however, neither led to the elimination of the current account deficits, nor significantly altered the deficit distribution by country. The first change resides in the emergence of current account surpluses in the private sectors and, as a result, all the countries, except Cyprus, posted, on average, private sector external surpluses in 2009-2010 (Figure 6).

The emergence of private sector external surpluses in the PIIGS countries reflects (apart from Greece and Italy) substantial decelerations of the average ULC growth rates to levels below the Eurozone average (Figure 8 and Figure 9), including through domestic devaluations, namely through cuts in relative wages. Compared to the individual average growth rates reported during 1999-2007, the average ULC growth rates during 2009-2010 slowed down in the PIIGS countries, except Greece, and rose in Germany, Slovenia, Finland, Luxembourg, Austria, France, Belgium and Cyprus (Figure 10). The build-up of surpluses generates recession, but what stands behind this is a very strong reason, i.e. the private entities' need to cut back on their external debts following the decline in asset value.



Source: Author's calculations based on AMECO data. Source: Author's calculations based on AMECO data.



Source: Author's calculations based on AMECO data.

The second major change was attributed to economic policies. The private funds in the Northern countries were replaced by public funds. Therefore, during 2008-2010, budget deficits in all euro area countries exceeded by far the average levels recorded in 1999-2007, nearing those seen in 1990-1998. Thus, current account deficits as a share of GDP remained relatively unchanged at pre-crisis levels. The Northern countries further recorded current account surpluses, while the Southern countries displayed current account deficits.

4. Possible Short-Term Solutions

As long as imbalances remain large, the risk of new crises is high. There are several ways to reduce imbalances. Some are recessionary, while others are not. Capping structural general government deficits at 0.5 percent of GDP is one of the solutions that do not support short-term growth. Since the distribution of external imbalances by country remained relatively similar to that recorded prior to the crisis, it appeared logical that public sectors should continue to make efforts to reduce current account deficits via cutting budget deficits and creating rules against their subsequent build-up. But the D/D solution does not necessarily solve the issue of competitiveness and generates recession as well.

Other solutions to reduce imbalances among those that do not stimulate short-term economic growth can also be explored. The first solution consists in continuing domestic devaluations (relative wage reduction), which will cause even higher external surpluses of the private sectors in the PIIGS countries. However, competitiveness gains would be outweighed by severe recessionary consequences.

The second solution resides in the fast reduction of the budget deficits in the countries posting current account deficits. This solution, just like the first one, would push the PIIGS countries deeper into recession, which, in turn, would make them even more vulnerable. The reduction of current account deficits by this approach would not necessarily entail the narrowing of competitiveness gaps.

The reduction of current account surpluses in Germany and other Northern countries ranks among the solutions aimed at adjusting external imbalances that would also boost economic growth. In practice, for these countries, this would translate into more credit, larger wages and higher inflation. The benefit for the Southern area would be the rise in exports. It is obvious however that Germany would have difficulties in accepting the inflationary increase of domestic demand as this might lead to competitiveness losses and less bright long-term growth prospects.

Finally, the fourth solution may be to further increase competitiveness via euro depreciation (Feldstein, 2011), which would reverse, at least partly, the appreciation trend initiated many years earlier. Along with the competitiveness gains already recorded following the crisis by the Southern euro area countries, this depreciation might help the EU in its entirety to reduce the existing imbalances by boosting exports and depressing imports. The effect will be more manifest in the countries where the shares of exports to and imports from the countries outside the Eurozone are larger.

The depreciation cannot be seen as a permanent solution since the real problem is the lack of non-price competitiveness of the PIIGS countries relative to Germany and other Northern countries. The depreciation of the euro versus not only the US dollar, but also the Asian currencies, would however allow the Southern countries to record higher productivity gains before the relatively sound fundamentals lead to euro appreciation once again. The solution is compatible with the resumption of economic growth and it would entail higher external competitiveness in the entire euro area compared with other countries.

For lack of sufficiently large funds in the Financial Stability Mechanism to restore confidence, an actually expansionary policy of the ECB cannot be averted in the future. This could lead to euro depreciation. Obviously, a significant depreciation will translate into higher inflation in the Eurozone. Considering the containment of the structural budget deficit to 0.5 percent of GDP and the depreciation, the problem sticks to choosing between short-term deflation and long-term inflation.

The containment of structural general government deficits to 0.5 percent of GDP in all the Eurozone countries is equivalent to increased austerity and implicitly to the option for short-term deflation. This option is a constraint for an expansionary policy in the Northern countries, which might prove useful, including for absorbing the possibly higher exports of the PIIGS countries. The containment of deficits by way of constitutional provisions should become effective only after the danger of recession is removed.

5. Conclusions

The problems associated with the competitiveness shortfall-induced imbalances would be dampened if the monetary union were reinforced by a fiscal union. The latter, in order to be democratic, should derive from the political union of the Member States. The issue of external financing that the less competitive countries of the monetary union are facing, as is currently the case, no longer emerges, by definition, in a fiscal union.

But the fiscal union does not guarantee sustainable economic growth and financial stability. It can only reduce the magnitude of the business cycle stages if it relies on

rules that ensure sound fiscal behaviour. Such a construction is necessary for the EU and all the more so for the Eurozone.

The D/D rule is a necessary, though not sufficient, step in this direction. It is necessary to prevent pro-cyclical fiscal behaviour that can overheat the economies or, on the contrary, can push them deeper into recession. The rule is insufficient from two perspectives. First, without a fiscal union, the issue of external funding for the countries recording competitiveness losses stays open even if general government deficits narrow. The second perspective reaches even further: the D/D rule cannot guarantee sound fiscal behaviour as its scope is limited. It does not limit state intervention only to entities rightfully considered 'too big to fail'.

For this reason, governments will be stuck in the expectations trap (see the article titled *Statul, criza și capcana anticipațiilor* – “The government, the crisis and the expectations trap”, Croitoru, 2012), where they have stayed for more than seven decades. The expectations trap is a frail balance under which, due to the prevalence of statist conceptions, governments tend to: (i) maximise bailouts (instead of confining these bailouts to the entities considered 'too big to fail') during episodes of crisis/recession and (ii) pay insufficient attention to regulation in times of economic boom.

Because of the expectation trap and the moral hazard induced by statist interventions, the general public came to regard government interventions in the economy as an option: governments must have a say in episodes of crisis, but refrain from doing so during booms (Croitoru, 2012). This imbalance in government interventions, combined with the regulators' trailing behind innovative markets, makes financial regulations unable to prevent sober expectations from turning euphoric or to mitigate the ensuing microeconomic behaviours.

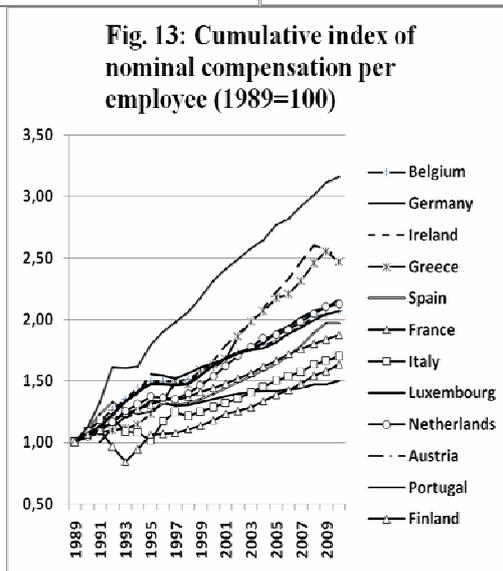
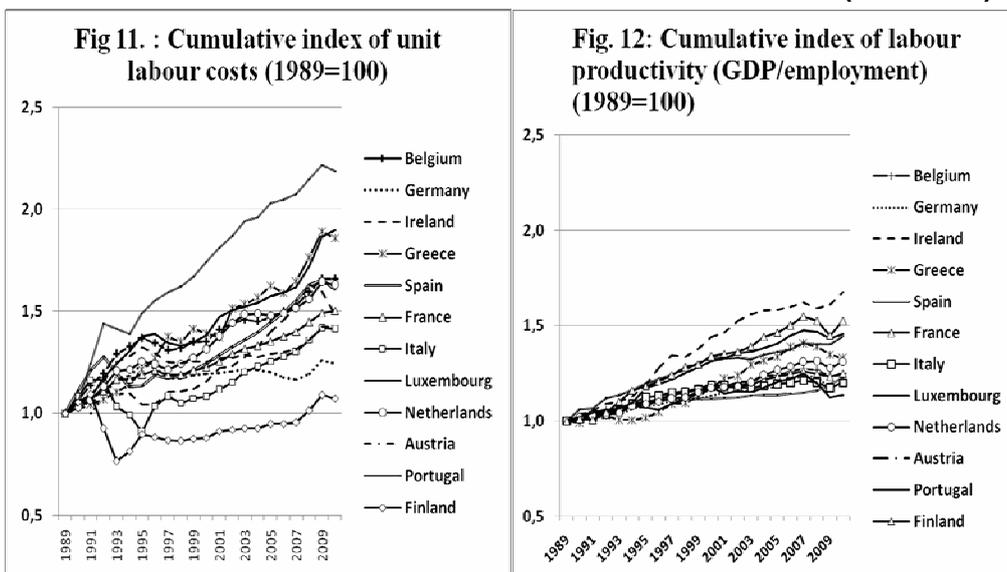
The poor fiscal behaviour induced by the expectations trap not only contributed to the over-indebtedness of the governments, but also had an adverse impact on the behaviour of the financial sector. During economic booms, financial entities maintained the capital stock at relatively low levels compared with those they would have built if they had known there was no possibility for governments to bail them out.

For this reason, even during the periods when governments capped their deficit and indebtedness levels, private sector imbalances increased noticeably. In my opinion, this is why, in recent history, countries that managed to implement prudent fiscal policies (the UK in the late 1980s, Asia in the mid-1990s) ended up in financial crises.

In the absence of rules meant to limit the bailouts by the governments of the 'too big to fail' entities, the expectations trap will continue to exist and the behaviour of the financial sector will not change. At best, the D/D rules could confine the maximisation of bailouts, but will not eliminate this process.

The financial sector will anticipate however that the D/D rules will most likely be bent, should a new crisis erupt. That is the reason why fiscal discipline defined as maintaining public deficits and debt at relatively low levels does not guarantee economic and financial stability. The already known business cycle model, with overheating episodes followed by relatively deep recessions, will continue to exist. In order to contain the magnitude of the business cycle phases it is necessary that, along with D/D rules, other rules should be put in place regarding the limitation of government bailouts of private entities only to those rightfully labelled as 'too big to fail'.

Unit Labour Costs in Eurozone-12 Countries in 1989-2010 (1989=100)



Note: In Figure 13, the base year of the fixed-base index is 1989 for all countries except Germany, in which case it is 1991.

Source: Author's calculations based on AMECO data.

Unit Labour Costs and the Influence Factors in Eurozone-12 Countries in 1998-2010 (2000=100)

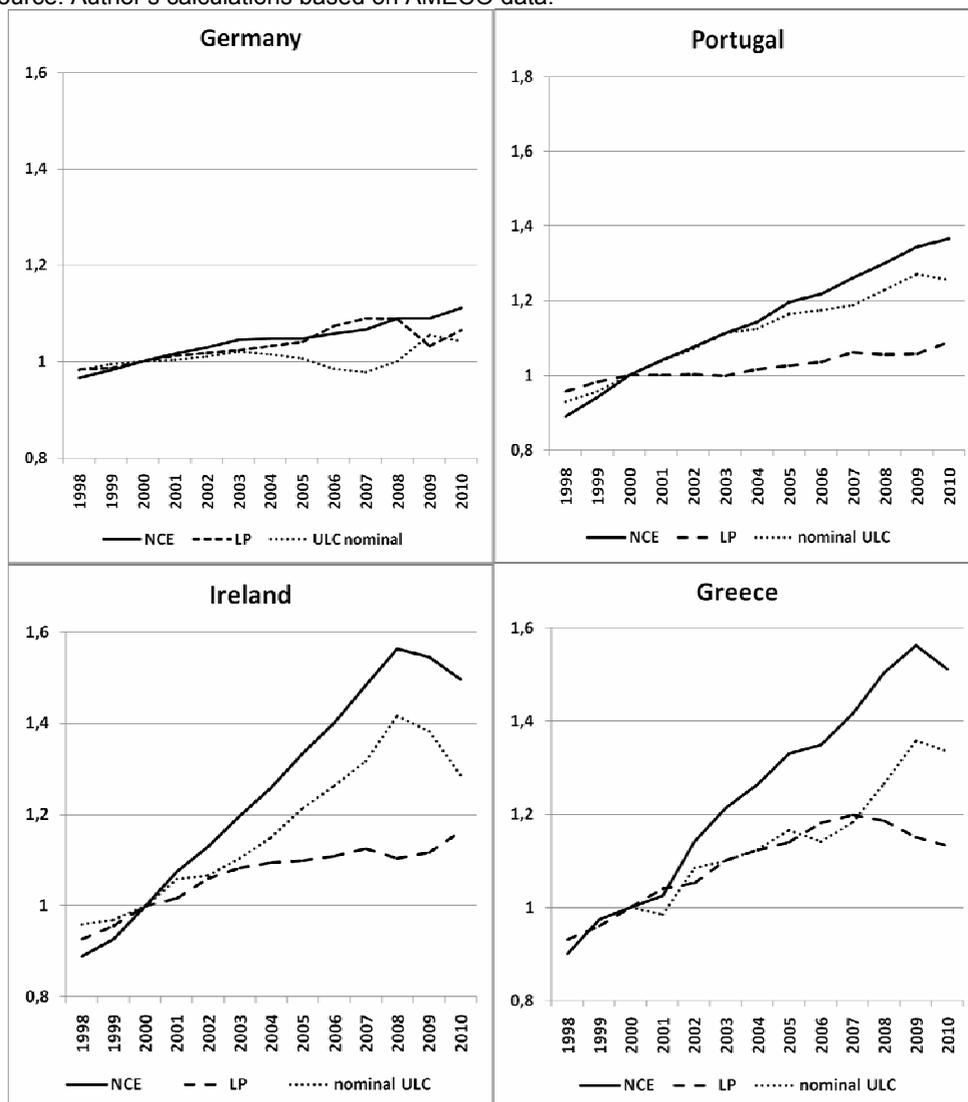
Legend: NCE = cumulative index of nominal compensation per employee

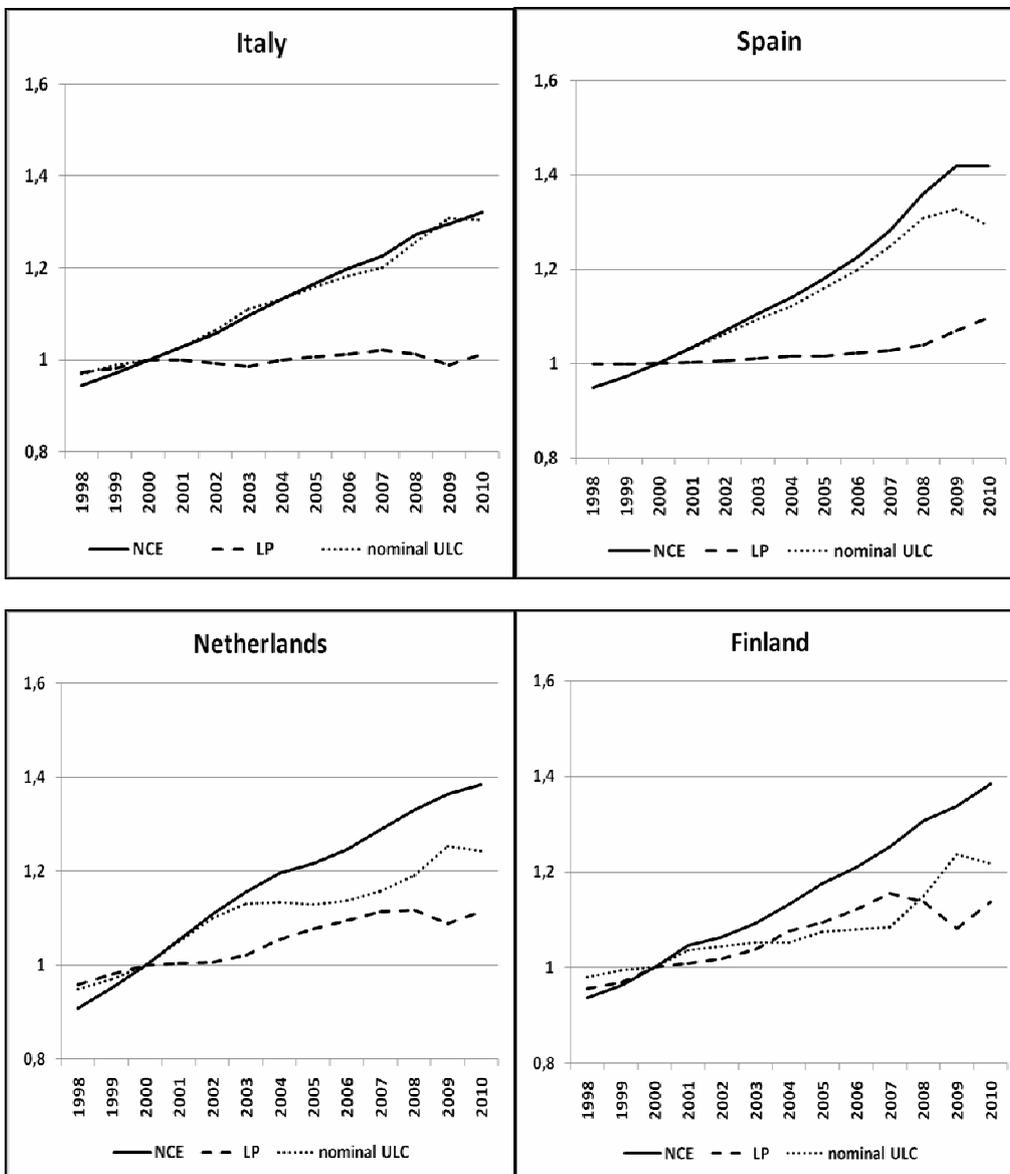
LP = cumulative index of labour productivity

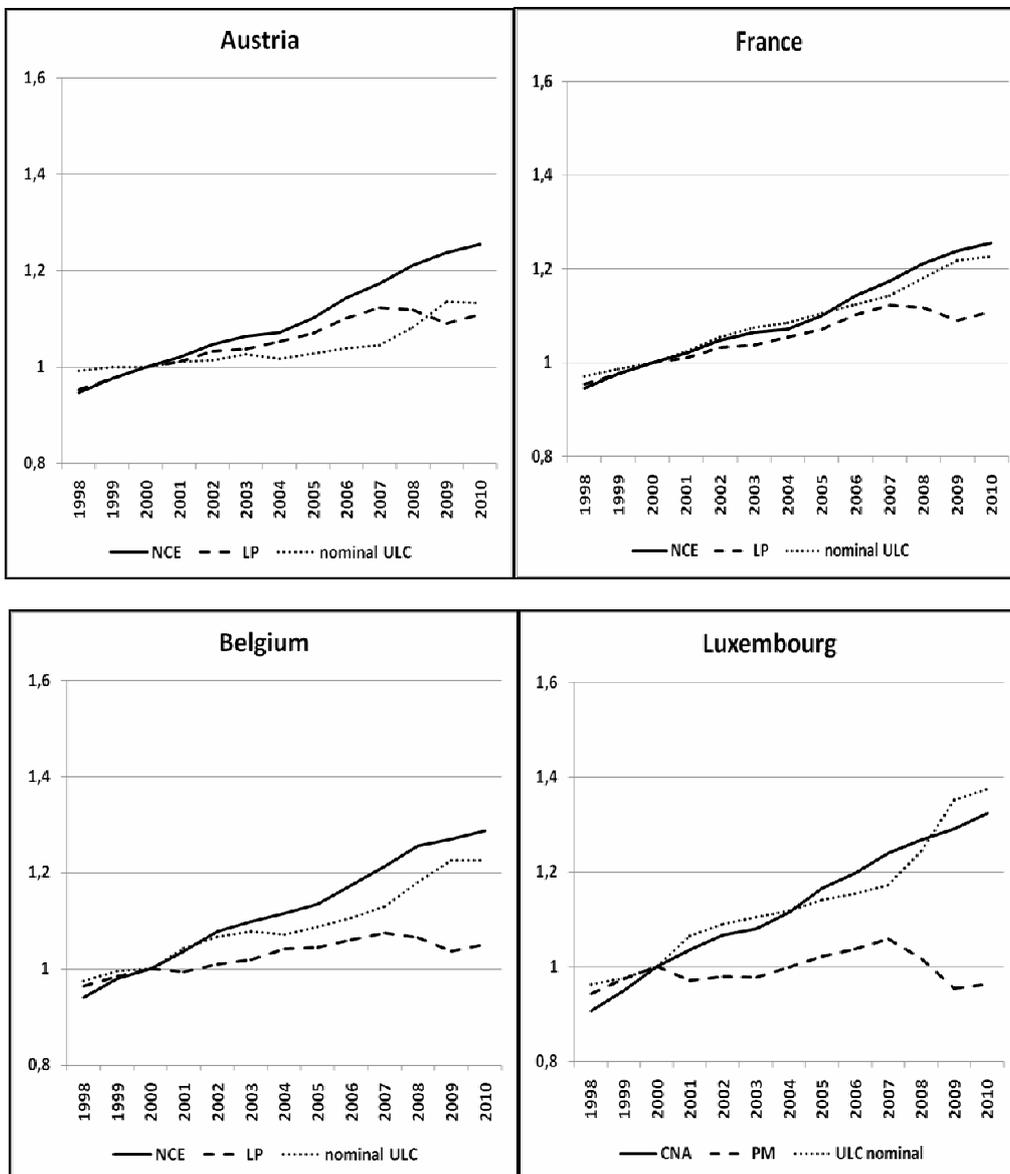
nominal ULC = cumulative index of nominal unit labour costs

nominal ULC = NCE/LP

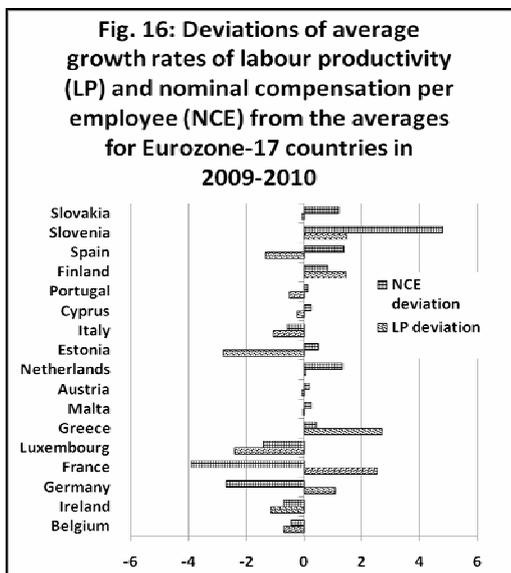
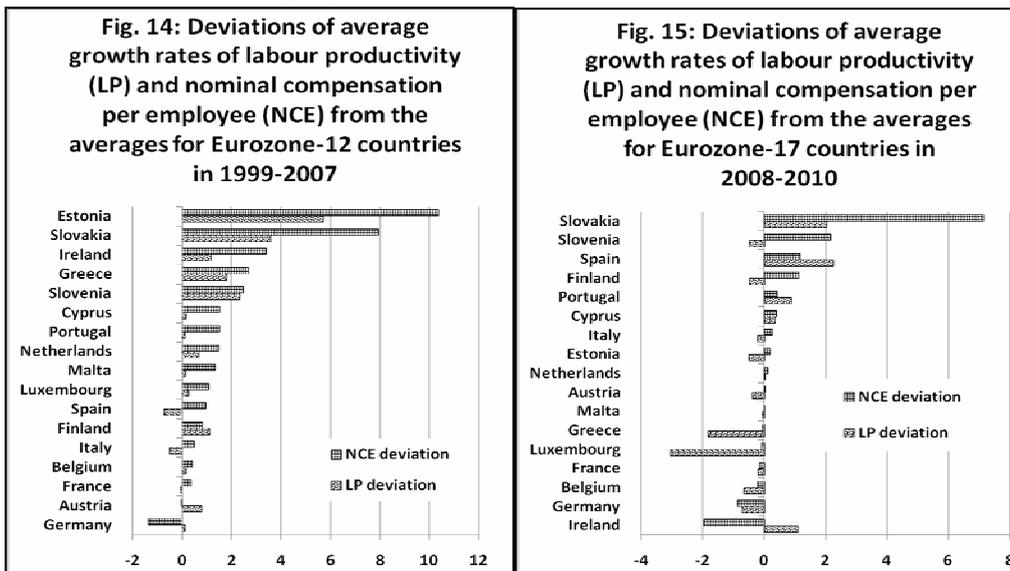
Source: Author's calculations based on AMECO data.







Average Growth Rates of Labour Productivity and Compensation per Employee in Eurozone-17, in 1999-2010



Source: Author's calculations based on AMECO data.

Redistribution of Unit Labour Costs (2000=100)

Legend:

GDP DEF = cumulative deflator of gross domestic product;

EMPT/EMPS index = cumulative index of employment to the number of employees economy-wide;

NC/GDP = share of total nominal compensation and gross domestic product;

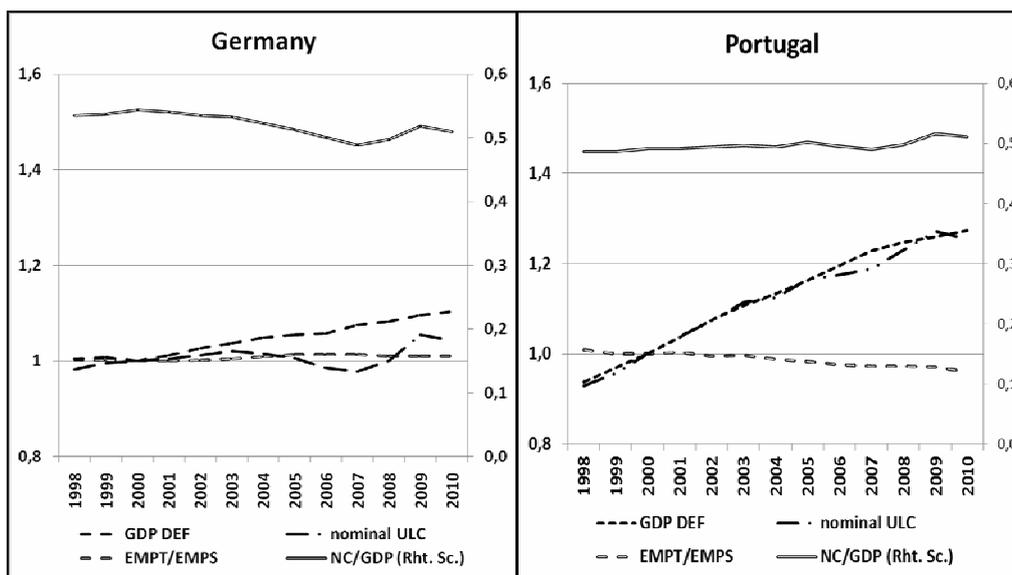
Nominal ULC = cumulative index of nominal unit labour costs.

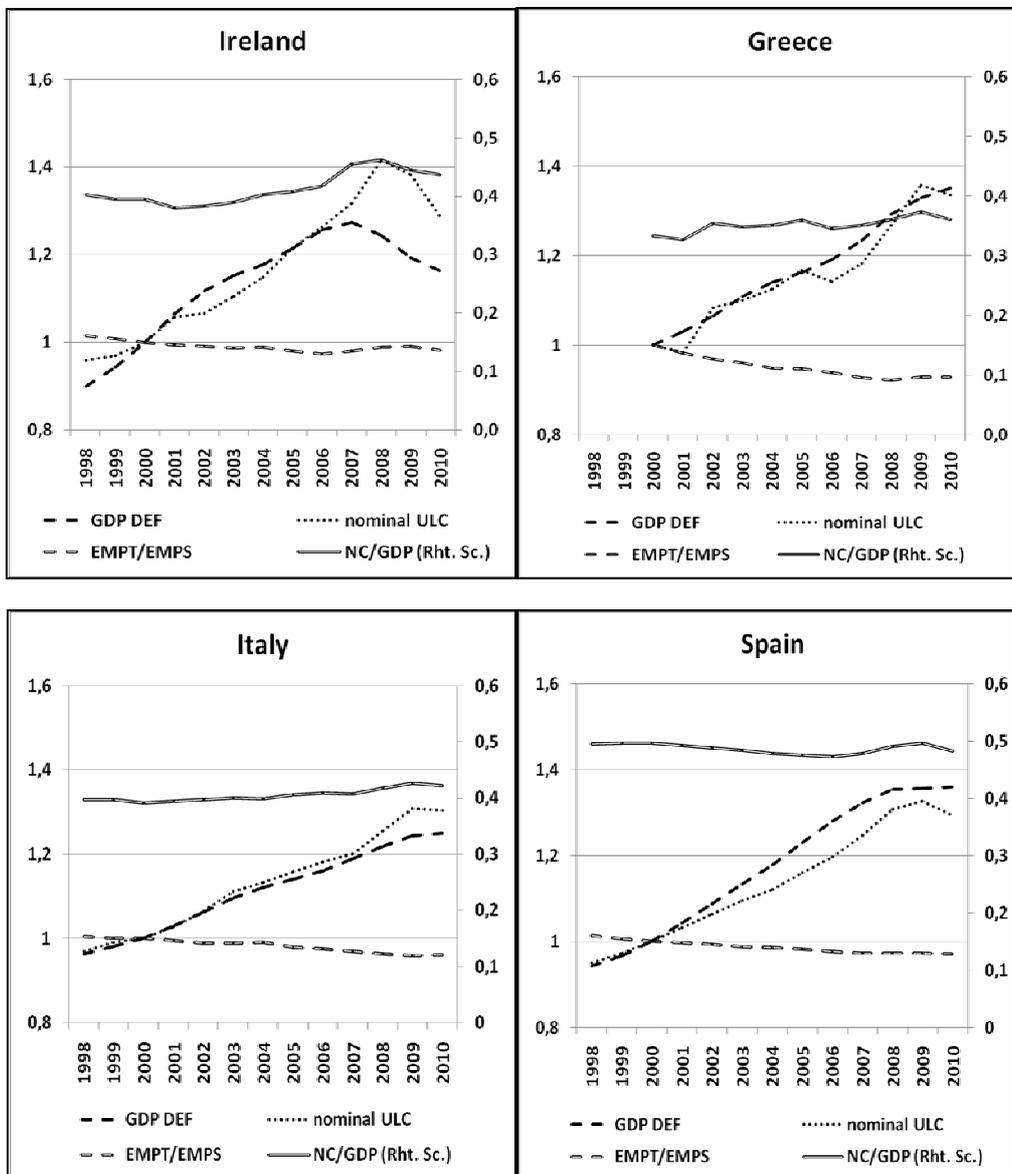
Nominal ULC = (EMPT/EMPS) x (NC/GDP) x (GDP DEF)

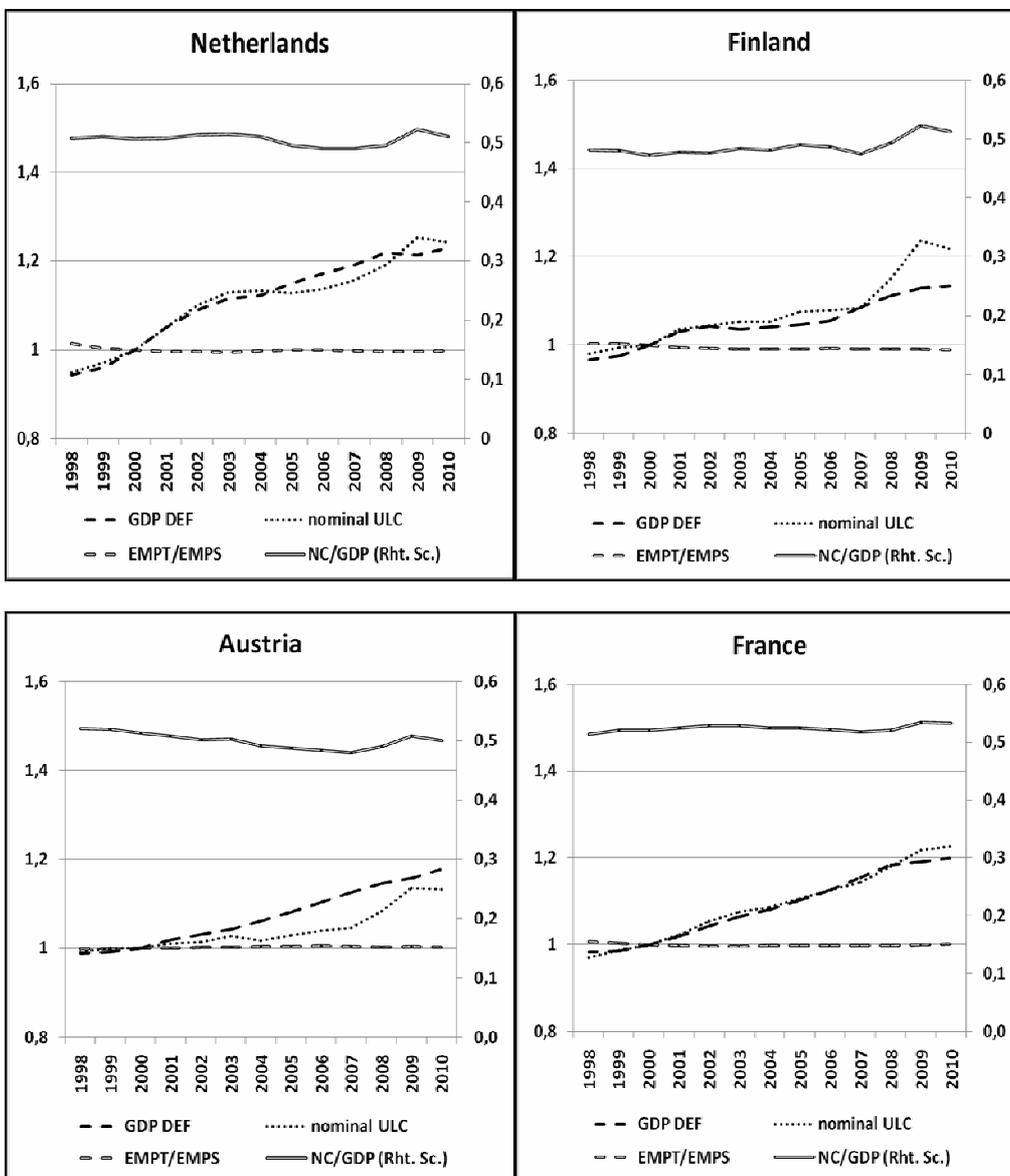
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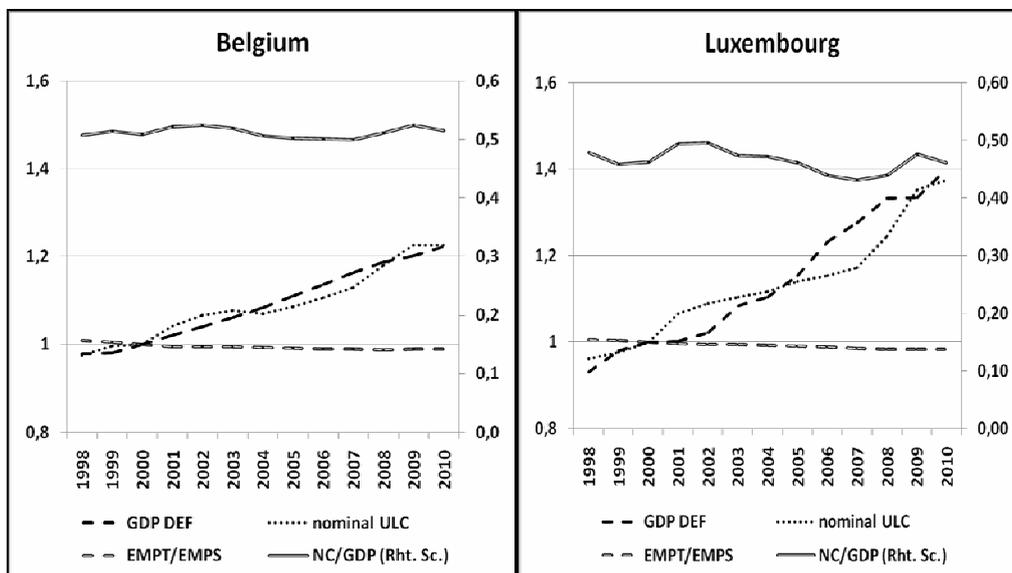
1. GDP DEF, EMPT/EMPS and nominal ULC are shown on the left-hand axis. NC/GDP is shown on the right-hand axis.
2. For Greece, 2000=100. Indicators GDP DEF, EMPT/EMPS and NC/GDP are calculated starting 2000, while for nominal ULC the base year is 2001.

Source: Author's calculations based on AMECO data.









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