



Perspectives by Ruth Lea

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The divergent eurozone: no easy solutions in sight

Introduction

The current debate on Greece's fiscal difficulties, possible bailout or default or, even, possible withdrawal from the eurozone is but one aspect of the seemingly intractable economic problems facing certain members of the eurozone. Back in the mid-1990s there was a hotly-contested debate about the potential eurozone as a possible optimal currency area in which all members could not just live with, but economically thrive, with the same currency and the same short-term interest rates as set by a European Central Bank. It clearly is not.

Joining the euro clearly puts major strictures on individual members' room for macroeconomic manoeuvre. Euro members:

- Cannot unilaterally change their short-term interest rates.
- Cannot unilaterally influence the value of their currency.
- Theoretically are restrained fiscally by the Stability and Growth Pact (SGP), which originally stated that the annual budget deficit should be no higher than 3% of GDP and the national debt should be no more than 60% or heading in the right direction. The criteria for the SGP were relaxed in 2005 in order to make it more "flexible". And, in the economic crisis of 2008-2009, the SGP was all but ignored.

In the run-up to the launch of the euro in 1999 there was also a hotly-contested debate about the preparedness of the potential member countries for their fitness for eurozone membership. Specifically the debate centred on the Maastricht economic convergence criteria, which purported to measure the degree of economic convergence deemed necessary for membership. These criteria related not just to Government deficits and debt, but also to inflation, long-term interest rates and Exchange Rate Mechanism (ERM) membership.¹ The Maastricht criteria were heavily criticised at the time as inadequate because of the strong probability that they could be met on a temporary basis – "ships passing in the night" - but not necessarily on a sustainable basis because of profound structural economic differences.

Specifically there were concerns that there was a potential fissure between what are loosely known as the "core" economies centring on Germany, France and the Benelux countries (along with Austria and Finland), on the one hand, and the peripheral "Club Med" centring on Italy, Spain, Portugal and Greece (along with Ireland) on the other.

The euro, the irrevocable locking together of eurozone currencies, was launched in January 1999, with notes and coins introduced 3 years later. There were originally 11 members: Germany, France, Netherlands, Belgium, Luxembourg, Italy, Austria, Finland, Spain, Portugal and Ireland. Greece joined in 2001 after “fiddling” the economic statistics in order to meet the Maastricht criteria.² Slovenia joined in 2007, Cyprus and Malta in 2008 and Slovakia in 2009, making 16 members of the eurozone in all.

In the late 1990s and early 2000s there was considerable pressure on the “outs” – then just the UK, Denmark and Sweden – to join the euro.³ But such pressure has, to date, failed. The British Government insisted in 1997 that its “Five Tests” had to be met before joining.^{4,5} Crucially these tests emphasised the need not just for “any old convergence” but convergence on a permanent basis. The need to meet this fundamental convergence test is as relevant today as it was over a decade ago.

The diverging eurozone

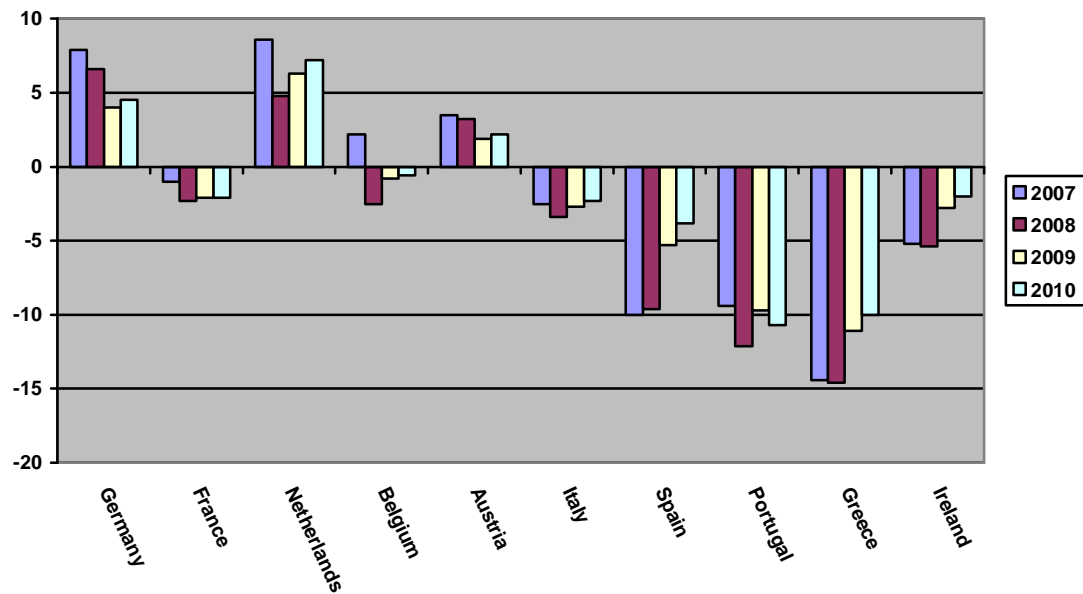
The recent economic crisis has highlighted the fundamental structural differences between the eurozone economies. In the analysis below we use the two very broad groupings already referred to:

- The “core” members: including Germany, Netherlands, Belgium and Austria. France is customarily added to this group though in many ways, in its attitude to fiscal rectitude where it is currently at odds with Germany for example, it displays aspects of the Club Med group.
- The peripheral “Club Med” members: Italy, Spain, Portugal, Greece and Ireland. There are, of course, differences within this group as well.

The first point to note is the disparities between the groups concerning the external balances (chart 1). These show that Germany and the Netherlands ran large current account surpluses in the run-up to the economic crisis in 2008. Significant proportions of these surpluses were with the Club Med countries. Much of the demand for German exports came from credit-fuelled demand in peripheral countries with booming property markets, for example. Spain, the largest and most important of these countries, ran huge external deficits.

This credit-fuelled demand in the peripheral economies has disappeared – maybe permanently. The hundred dollar question now is whether Germany will stoke up domestic demand that could help the beleaguered peripheral countries, reduce the trade imbalances within the eurozone and increase overall eurozone demand. It looks unlikely.

Chart 1: Eurozone, selected countries: balance on current account, as a % of GDP, 2007-10

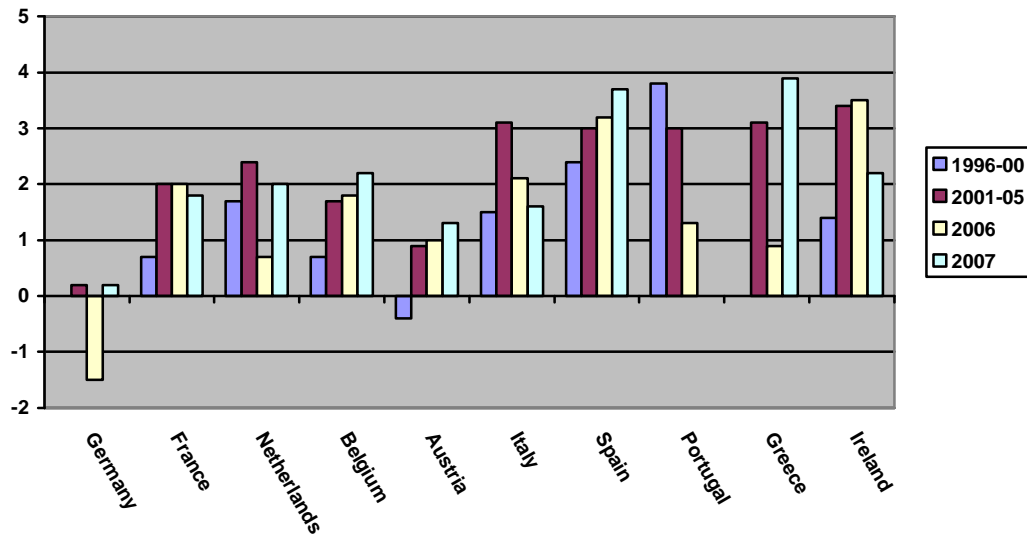


Source: OECD, *Economic Outlook number 86*, preliminary version, November 2009.

The second point to note is that in the early 2000s Germany's economy showed very weak growth. German GDP actually fell 0.2% in 2003.⁶ The ECB kept rates low during this period partly in response to Germany's difficulties. (The ECB's main refinancing rate was 2.00% to 2.50% for much of 2003 to 2006.) This was the appropriate interest rate policy for Germany. But these rates were significantly too low for Ireland, Greece, Spain and Portugal. They were a major contributory factor to their unsustainable credit-fuelled private spending and property booms (already mentioned) which undoubtedly exacerbated their subsequent recessions and have damaged their prospects of recovery. In currency unions members need similar interest rates for optimal performance. In the run up to the 2008 economic crisis this was demonstrably not the case.

The third point is that the boom years for the peripheral economies did not just mean higher private spending and booming property markets. They also experienced some wage inflation, driven by powerful trade unions. The result was that their unit labour costs rose faster than in the "core" countries (chart 2) which reduced their relative competitiveness within the eurozone. Moreover these cost increases occurred in countries already noted for long-term economic weaknesses - Greece, Italy, Spain and Portugal. Arguably these economies are over-dependent on low-tech industries where they are in competition with Asia, but increasingly cannot compete.

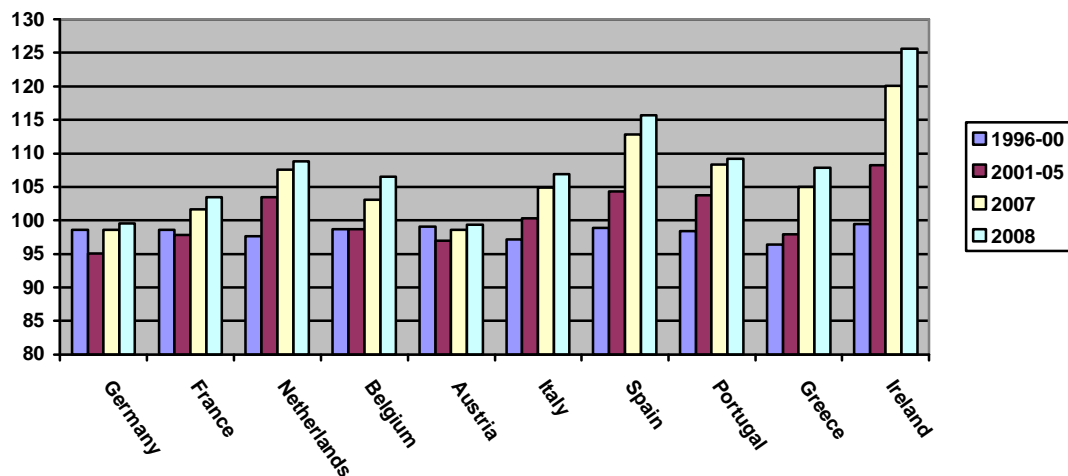
Chart 2: Eurozone, selected countries: unit labour costs, annual % changes, 1996-2007



Source: European Central Bank, *Statistics Pocket Book*, December 2009, data not provided for Portugal for 2007. Unit labour costs are for whole economy, annual % changes.

Another factor determining eurozone competitiveness has been the strengthening euro, reflecting the fact that Germany is highly competitive and running surpluses. Chart 3 shows the changes in eurozone competitiveness, allowing for exchange rate movements. Falls indicate improved competitiveness, rises indicate worsening competitiveness. The falls in Irish and Spanish competitiveness are especially notable.

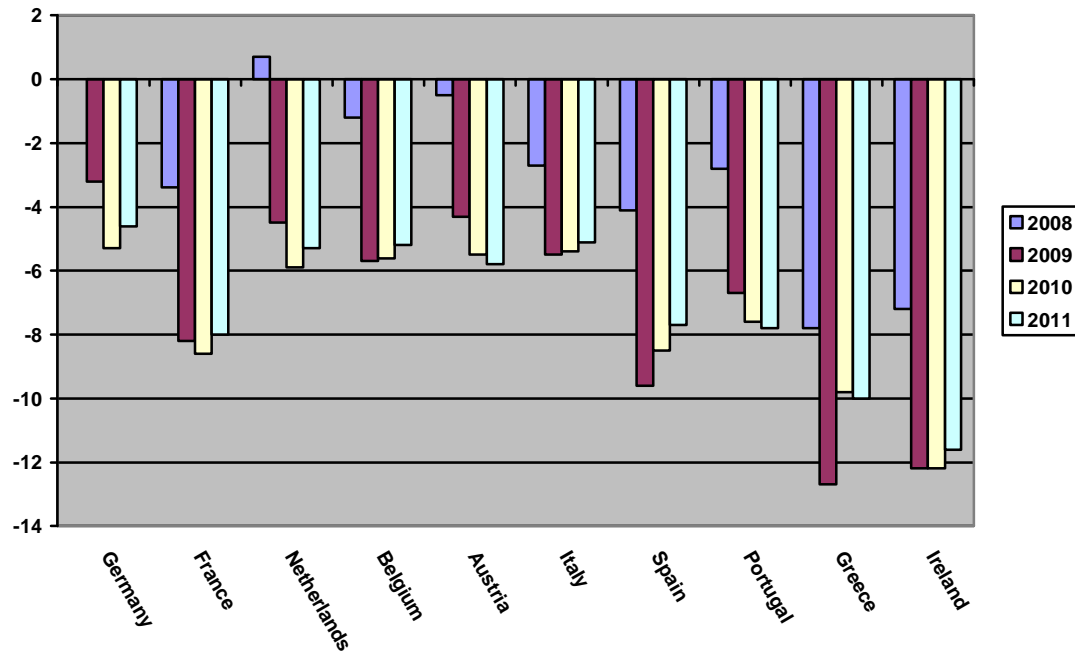
Chart 3: Harmonised competitiveness indicators, 1999Q1=100, 1996-2008



Source: European Central Bank, *Statistics Pocket Book*, December 2009. Harmonised competitiveness indicators (real effective exchange rates) are based on consumer price indices, index 1999Q1=100.

The fourth point to note is that government borrowing has exploded in the most vulnerable countries - not least of all in Greece and Ireland (chart 4).⁷ France's deficit has also increased dramatically and, as already indicated, the French Government seems at odds with Germany over the need for fiscal rectitude.⁸

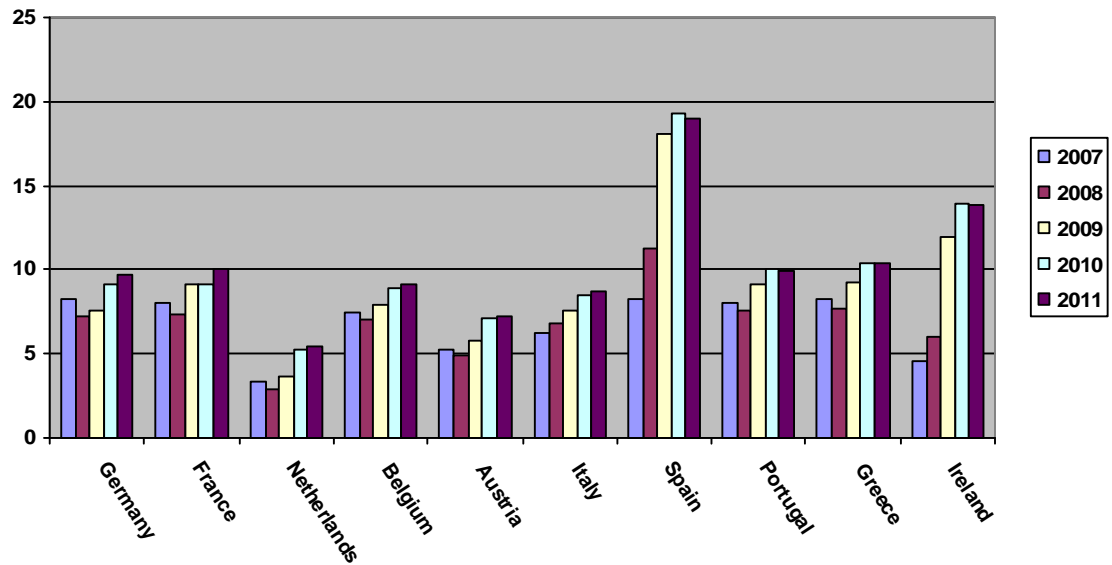
Chart 4: General Government financial balance, as a % of GDP, 2008-11



Source: OECD, *Economic Outlook number 86*, preliminary version, November 2009. Note these projections were, for example, prior to Ireland's tough December budget.

Finally, growth prospects look poor in the eurozone's peripheral economies⁹ and already unemployment rates have risen very rapidly (chart 5). Nearly 20% of the Spanish workforce is now registered unemployed.¹⁰

Chart 5: Unemployment rates (%), 2007-11



Source: OECD, *Economic Outlook number 86*, preliminary version, November 2009.

The peripheral countries: policy responses

Given the poor economic outlook, soaring unemployment rates and unsustainable public finances in most of the peripheral "Club Med" countries (Italy is arguably the exception), coupled with the restrictions on their policy choices because of euro membership, the policy options facing these countries are limited and without exception painful.

But before going on to these options, it is worth emphasising what these countries cannot do:

- They cannot unilaterally devalue even though they have deteriorating competitiveness and structural external deficits. On the contrary, they have a strong currency driven by Germany's export competitiveness. In the absence of devaluation, their real economies are absorbing the necessary adjustment in terms of lower demand, lower growth, higher unemployment and worse public finances.
- They cannot use inflation to reduce the real value of their heavy debt – whether public or private sector – and their debt will act as a major drag on their economies. For heavily indebted economies rampant inflation is a superficially attractive way out. The ECB's remit is price stability, defined as CPI inflation of below, but close to, 2%. The notion that Germany would ever agree to raise the "target" to, say, 4% is fanciful.
- These countries have no obvious means of persuading Germany to switch its economy from an export-based one to one driven by expanding domestic demand. Such a move could help their economies directly by increasing demand for their exports and indirectly by lowering the euro. The eurozone needs Germany to be the "spender of last resort", driving growth and rebalancing the eurozone. It is unlikely to happen

Instead these economies are faced with the following options:

- They need to restrain labour costs and prices to restore competitiveness within the currency bloc in order to keep up with the leader, Germany. Ireland seems to have accepted that a lengthy recession is needed to reduce nominal prices and wages, but so far not Greece and Spain.
- They need to cut back their public sector deficits, especially Greece and Ireland. Again Ireland seems prepared to don the hair shirt, December's budget was tough. But the situation is currently less clear for Greece. Hard pruning of the deficits will however worsen their recessions, be politically unpopular and possibly spark social instability.
- There is also a need for greater flexibility, not least of all in labour markets, to improve competitiveness. But this is a longer-term consideration. Ireland is better placed than the other peripheral economies.

All in all, the peripheral economies are in a trap. They are arguably in a structural recession with no exit door. Whatever they do to improve their competitiveness or cut their public borrowing in the near-term will result in yet more economic pain. We referred to the current debate on Greece's fiscal difficulties and possible bailout in the opening paragraph of this Perspective and will come back to these issues in a future Perspective. But by way of a conclusion to this Perspective, it is clear that the current economic crisis is proving to be a hugely challenging test for the eurozone.

Even if Greece is bailed out with loans from other member states, this may only turn out to be a short-term "sticking plaster" measure. At some point the eurozone members will surely have to grasp the nettle of a central fiscal authority which redistributes cash assistance from the strong countries to the weak. This would be yet another step towards full political union of the eurozone countries. It should be remembered that few monetary unions have survived without political union.

References

1. The Maastricht criteria were: (1) inflation (measured by CPI) must be within 1.5% of the EC's 3 best performers over the period of a year; (2) long-term interest rates must be within 2% of the EC's 3 best performers over the period of a year; (3) Government excessive debt must be avoided - the Government sector debt/GDP ratio must be no more than 60% or heading in the right direction; (4) Government excessive deficits must be avoided - the Government deficit/GDP ratio must be no more than 3%; (5) currencies must have been kept within the narrow ERM bands, for at least 2 years – the criterion of exchange rate stability.
2. Charles Grant, "Ten years on, the eurozone must beware of Greeks bearing debts", *The Times*, 26 March 2009.
3. Of the accession countries since 2004 the following are not (yet) members of the eurozone: Poland, Hungary, the Czech Republic, Estonia, Latvia, Lithuania, Romania and Bulgaria.
4. Treasury: "UK membership of the single currency: an assessment of the five economic tests" (HMT, October 1997).
5. The "Five Tests" were: (1) Cyclical and structural convergence: are business cycles and economic structures compatible so that we and others could live comfortably with euro interest rates on a permanent basis? (2) Flexibility: if problems emerge is there sufficient flexibility (labour and product markets) to deal with them? (3) Investment: would joining EMU create better conditions for firms making long-term decisions about the UK? (4) The City: what impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets? (5) Employment and growth: in summary, will joining EMU promote higher growth, stability and a lasting increase in jobs?
6. OECD, *Economic Outlook number 85*, June 2009.
7. See also Ruth Lea, "The public finances are shocking – but an ageing population means there is worse to come", Arbuthnot Banking Group, 19 October 2009.
8. Wolfgang Münchau, "Diverging deficits could fracture the eurozone", *FT*, 5 October 2009.
9. OECD, *Economic Outlook number 86*, preliminary version, November 2009.
10. Victor Mallet, "Spanish unemployment nears 4m", *FT*, 6 January 2010.