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How a Flawed Structure is Hurting the Eurozone —Economically and Politically

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The wind appears to be back in the sails of the Eurozone economy

Not so long ago, the Euro-project did inspire serious doubt, not hope, as a big part of the Eurozone economy was stuck in deep recession, a far-right populist wave was sweeping over its polity, and Eurozone policymakers appeared paralyzed, unable to cope with the unforeseen. But economically speaking, those days are over—or so it seems. The Eurozone economy now is in recovery mode, recording the highest and most broad-based economic growth since 2011 (at 2% in 2016/17) and growing faster than both Britain and the U.S. Eurozone unemployment, which is still high, is finally coming down. Short-run economic prospects look favourable. Little wonder that European Commission President Jean-Claude Juncker was upbeat during his annual state-of-the-union address in September, proclaiming that “the wind is back in Europe’s sails.”

Politically, there was a burst of optimism after the Dutch and French elections. But hopes that the election of President Macron and the re-election of Chancellor Merkel marked the end of what was believed to be an irrepressible populist wave, are clearly an oversimplification, and the optimism is ebbing again, because the political drift to the right has remained, witness the election result of the German AfD. The recent rightward lurch in Austria, with the People’s Party (ÖVP) and the Freedom Party (FP) emerging as the big winners, with 32% and 26% of the vote respectively, is the latest reminder that the populist ferment in Europe is far from dead. Mrs. Merkel will be only too conscious of this; her party lost an important regional election in its one-time stronghold in Lower Saxony in early October.

This Note cautions against the renewed confidence and Mr. Juncker’s optimism about the economic recovery of the Eurozone. The Eurozone has suffered and continues to suffer from a faulty construction and flawed policies—leading to internal contradictions which, when left unaddressed, show up in a deepening dualization of the Eurozone economy, both between member states and within the economy of each member state. The EMU reinforces structural inequalities between member states as well as dualism (or polarization) between social groups within countries. This ‘dualization’ is sure to fire up the considerable popular discontent on the continent. History shows that it does not take a lot to bring down societal order and for the economy to collapse.

... but the currents may still not be good

Juncker’s optimism about the Eurozone economy looks premature—as there are at least four fairly obvious causes for concern:

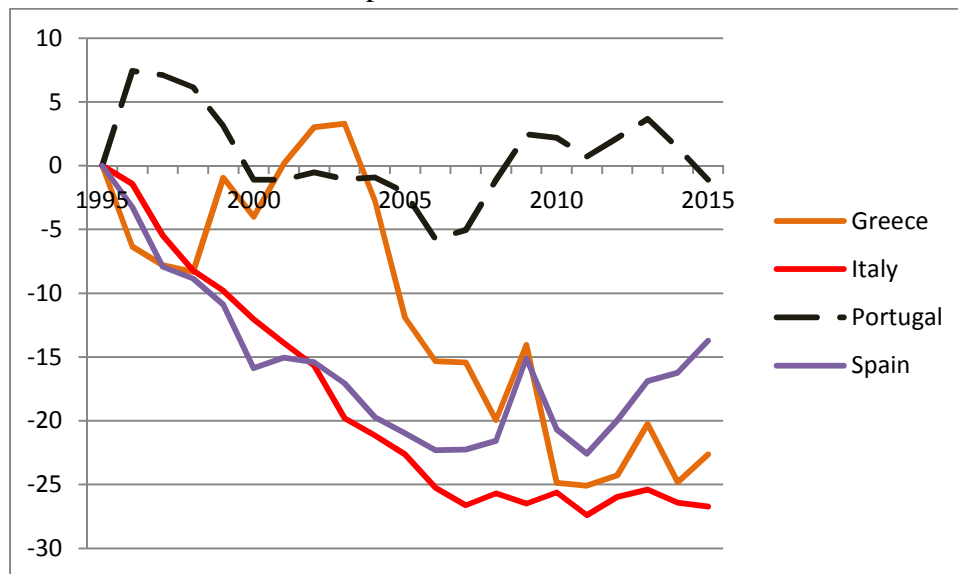
1. The recovery of Eurozone growth may be feeble as it is founded on the extraordinary monetary stimulus provided by the ECB, after Mr. Draghi made clear that the ECB would do whatever it takes to preserve the euro and introduced the Outright Monetary Transactions (OMT) programme. Eurozone banks received more than € 1trillion of liquidity via Long Term Refinancing Operations (LTRO) and the ECB has purchased over €2 trillion of government and corporate bonds in a programme, which

accumulates another €60 billion every month. Monetary accommodation calmed down financial markets, brought down bond interest rate spreads for Italy, Spain and Portugal—and broke the doom loop, or the potential for a vicious feedback cycle between banks and their government (this negative feedback arises when and if fear about the solvency of a nation’s government fans fears about the solvency the nation’s banks, and this in turn weakens the economy; what follows is a deadly spiral of rising risk premiums and deteriorating budget deficits.) But the Eurozone recovery remains on the cusp, and the recovery process could be slowed or halted once the ECB starts to return to convention.

2. There remain serious concerns about the health of the Eurozone banking system which is suffering from structurally weak profitability (IMF 2017). Stocks of Non-Performing Loans (NPLs) remain high at about € 1 trillion. Italian banks hold more than € 300 billion NPLs, or nearly a fifth of all their loans. Most NPLs are made up of household debt. Problems are not restricted to Italy, however; the Eurozone’s largest and strongest economy Germany is wrestling with a potential banking crisis all of its own. The country’s largest bank Deutsche Bank AG was identified last year by the IMF as the world’s most dangerous bank, being the most important net contributor to systemic risk to the global financial system. Not only does it have a balance sheet that is worth 50% of the value of Germany’s GDP, but it is estimated to own trillions of U.S. dollars in high-risk derivatives (notional value).
3. The risks are large but the Eurozone ‘policy buffers’ are thin (EC 2017). Fiscal policy is constrained by high public debt-to-GDP ratio in the high debt countries (Greece, Italy) and the monetary policy arsenal of the ECB is all but exhausted. The financial system is not strong. The fiscal and monetary policy space, in other words, is limited (IMF 2017). In addition, income inequality has increased and socio-economic mobility has decreased in several Euro Area countries (including Germany; Odendahl 2017)—which is often held to be a contributor to rising populism, anti-E.U. sentiments, anti-immigration attitudes and growing (trade) protectionism (IMF 2017).
4. The Achilles’ heel of the Eurozone recovery is the divergence of labour productivity growth (IMF 2017), especially between the Northern Eurozone ‘core’ (consisting of Germany, France, Austria, Belgium and the Netherlands) and the Southern European ‘periphery’ (Greece, Italy, Portugal and Spain). The divergence in hourly labour productivity growth in manufacturing within the Eurozone during the twenty-year period 1995-2015 is illustrated in Figure 1. It can be seen that the divergence started already well before the crisis of 2008, particularly in Spain and Italy. Only Portugal did not experience a decline in relative labour productivity in manufacturing, although the country also did not manage to narrow the productivity gap with the core economies. During 1995-2015, Spain’s manufacturing labour productivity declined by 14% (in cumulative terms) relative to the average labour productivity in the Northern Eurozone, in Greece by 23% and in Italy by an astounding 27%. The weighted average decline in relative labour productivity in Southern European manufacturing is 21% in

twenty odd years. Of particular importance here is the big (and growing) gap in (manufacturing) productivity between Germany, the Eurozone’s largest economy, and Italy, the Eurozone’s third-largest and deindustrializing economy which also has a vulnerable financial sector. The divergence in labour productivity growth inevitably leads to income divergence between EMU member states—and this will put pressure on the economic and monetary union.

Figure 1
Manufacturing Productivity Divergence (1995-2015):
Southern Europe relative to the Eurozone “core”



Source: author’s estimation based data from the OECD STAN database.

Not all Eurozone economies benefit from their EMU membership

While recent indicators do suggest that the Eurozone economy is starting to recover, and while Mr. Juncker has reasons to be cheerful, it is fair to ask the question to what extent the EMU has been a factor conducive to economic recovery—or, alternatively, to what extent the recovery process has been hindered or hurt by a flawed structure. This is a difficult question to address, because to answer it the actual recovery (or lack thereof) of EMU member states has to be compared to a hypothetical counterfactual scenario of what would have happened if a particular European country had not joined the Euro project almost two decades ago. A recent attempt at such a counterfactual analysis comes from three Dutch economists from the University of Tilburg (Verstegen, van Groezen and Meijdam 2017) and their main results have been summarized in Table 2:

- During the pre-crisis years 1997-2007, membership of EMU was beneficial for all countries listed in Table 2, except Germany and Italy. EMU-membership is estimated to have increased per capita real incomes in Greece, Portugal and Spain by 8-10%, and most core economies, all German neighbouring states, Austria, Belgium and the Netherlands, also gained (in real per capita income).
- Things change considerably after 2008, however. Being part of the Eurozone has depressed the real incomes in Greece by 16%, in Italy by 8%, in Portugal by 4% and in Spain by 8% compared to the counterfactual. In contrast, most Northern ‘core’ economies (except the Netherlands) benefited from their EMU membership, as their actual per capita income levels are estimated to be higher than in the counterfactual scenario ‘without Eurozone membership’. Germany stands out in this post-crisis period 2008-2014, with the average German having an actual income which is about 5% higher than the estimated (non-EMU) counterfactual.
- What is noteworthy is that the gains (in terms of higher per capita incomes) which Greece and Italy derived from their EMU membership during 1997-2007, were more than offset by the losses they experienced during the crisis period. The income gains which Portugal and Spain experienced in the first decade (1997-2007) due to their EMU membership were almost fully wiped out by the negative consequences of being part of the Eurozone during 2008-2014 (Verstegen, van Groezen and Meijdam 2017).

Table 2
Estimated impact of joining EMU on real GDP per capita

	before the crisis during 1997-2007	during the Eurozone crisis period 2008-2014
<i>North</i>		
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%
<i>South</i>		
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).

Note: The impact is estimated by comparing the actual income growth to a counterfactual, built using the synthetic control method in which an EMU country’s growth is matched as closely as is possible to the growth path of a control group of non-EMU member countries.

Clearly, these estimates must be taken with quite a few pinches of salt (after all, they are only as ‘good’ as the underlying counterfactual based on the performance of non-EMU control economies). Nevertheless they do suggest that the EMU framework has reinforced the *structural divergence* within the Eurozone (Storm and Naastepad 2015b; Stiglitz 2016). EMU membership is therefore ‘good’ for some member countries, but ‘bad’ or ‘not working’ for others. This Note highlights four major mechanisms by which the Eurozone structure reinforce this process of structural (core-periphery) divergence—and argues that this divergence will undermine the Euro project, if it is left unaddressed.

First mechanism: EMU’s ‘one-size-fits-all’ monetary policy does not work for all

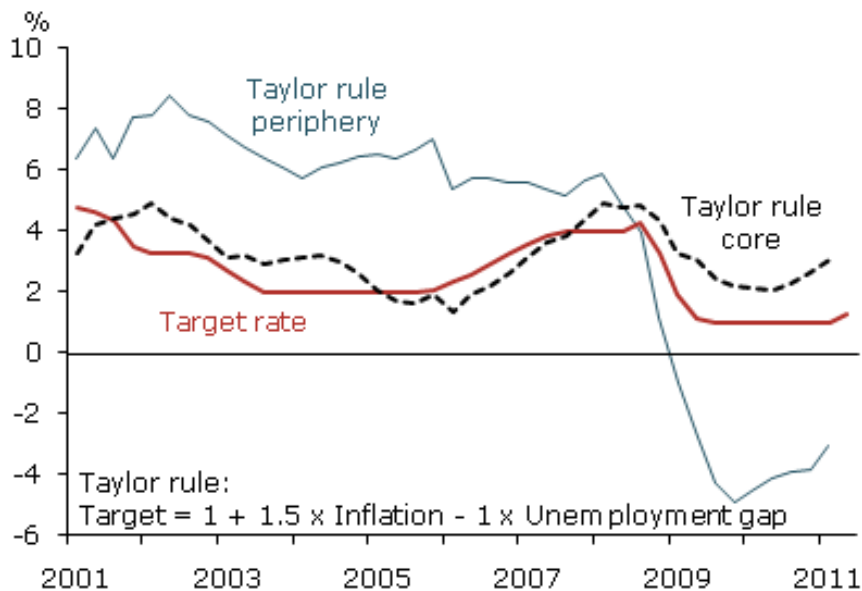
One structural problem of the Eurozone is that the ECB inflation targeting places a disproportionately high weight on economic circumstances in Germany and France (Storm and Naastepad 2015b; Seccareccia 2017). This means that interest rate policy has been out of sync with economic conditions in Southern Europe for most of the time. The actual ECB interest rate closely tracks the interest rate derived from the stylized Taylor-rule for the Eurozone core—which means macro conditions in the core carried the greatest weight in ECB policy decisions. This is graphically illustrated in Figure 2 (taken from Nechio 2011), which compares policy rates, which were mechanically derived from a stylized Taylor rule for the Eurozone core countries, on the one hand, and, for the periphery on the other hand, with the actual target interest rates set by the ECB (during 2001-2011).

- During the pre-crisis years 2001-08, the ECB “one-size-fits-all” target rate lay well *below* the level recommended by the Taylor rule for the Southern European (SE) countries. As inflation rates in SE economies were higher, real interest rates were even lower—and cheap credit thus fuelled SE economic growth which enabled these economies to ‘catch up’ (in terms of real per capita income) with the Eurozone North. This explains the estimates in Table 2: being a member of the EMU paid off for a short while for people in Greece, Portugal and Spain (Versteegen *et al.* 2017). Clearly, the historically very low real interest rates also led to asset price inflation (*e.g.*, during Spain’s real estate bubble) and unsustainable borrowing (in Greece and Portugal)—as well as large current account deficits (through higher imports). However, as insightfully observed by Arturo O’Connell (2015), while most (Northern) discussion of the Eurozone crisis has revolved around the alleged profligacy of the heavily indebted SE countries, one should acknowledge the reckless lending by banks located in the Eurozone North, mostly motivated by “push” factors coming from the economic and financial systems of those Northern countries themselves.
- However, during the crisis period (2008-now), the ECB interest rate remained too high for the SE economies—ceding control over interest rates and exchange rates turned out to be very costly for these countries as they did not have the macro-economic policy instruments to mitigate the fall-out of the Great Financial Crisis of 2008

(Stiglitz 2016). This explains why EMU-membership is associated with considerable costs in terms of per capita income foregone—as the estimates in Table 2 illustrate.

- It can be argued that the ECB interest rate post-2008 has been too low for the Northern ‘core’ countries. This is certainly the view of important German politicians and policymakers who claim not just that the average German saver is suffering, punished by the low bank deposit rate—but also that the cheap credit will stoke up inflationary pressure. It is true that the low interest rates are fuelling asset price inflation in countries such as Germany and the Netherlands. For instance, between September 2010 and September 2017, the Frankfurt DAX-index has doubled—notwithstanding the Volkswagen diesel emission scandal and the fact that German real GDP increased by a mere 13% over the same period. And rising home prices in Germany and the Netherlands are reminiscent of earlier real estate bubbles. But as Thomas Fricke (2017) argues, in macroeconomic terms, Germany is gaining considerably from the low interest rates—as interest payments on its public debt are low and also because most households are de facto negative asset holders (or debtors). It also shows in Table 1: the real income gain to the average German associated with the (much maligned) Euro is estimated to equal about 5% during 2008-14. Germans turn out to be the main beneficiaries of the EMU, benefiting from it much more than the French and especially the Dutch, for whom EMU membership has been costly during the crisis years.

Figure 2
ECB Monetary Policy Rule: Periphery versus Core
(Quarterly data)



Source: Nechio (2011).

Note: Core countries include Austria, Belgium, France, Finland, Germany and the Netherlands. Peripheral countries include Greece, Ireland, Portugal and Spain.

Second mechanism: the common exchange rate leads to misalignments

The Euro was supposed to put an end to competitive currency devaluations, and with it ‘unfair competition’. But this has not happened. The Euro is undervalued for Germany, but it is also overvalued for the Southern European (SE) countries in the bloc. If the bloc were to break up, Germany’s restored currency would appreciate, but other restored currencies would depreciate. Because of the overvalued Euro, populations in the SE countries had the sense that they had more global purchasing power than their economic fundamentals could support and consumed accordingly. At the same time, and crucially, the Euro overvaluation put (exporting) producers in the SE countries at a competitive disadvantage. Germany, in contrast, enjoyed the ‘export pull’ from an undervalued Euro and thus became ‘Exportweltmeister’, even as its own consumers, feeling a little poorer than they otherwise might have, remained cautious. Germany refused to support the kind of monetary and fiscal stimulus that would have raised Germany’s imports and reduced its current account surplus, also by raising inflation. German firms in this situation made more productive investments, improving their economic fundamentals and labour productivity levels relative to the SE economies (Figure 1). These trends, in turn, helped to expand Germany’s current account surplus and reinforced the extent of Euro undervaluation for German exporters.

Table 3
Estimated Euro real exchange rate misalignment (2010-12)

	undervaluation	Overvaluation
<i>North</i>		
Austria	8.2%	
Belgium	—	
France		-12.8%
Germany	20.2%	
The Netherlands	7.4%	
<i>South</i>		
Greece		-24.5%
Italy		1.0%
Portugal		-15.4%
Spain		-14.1%

Source: Duwicquet, Mazier and Saadaoui (2016).

Recent estimations of the Euro exchange rate misalignment (2010-12) by Duwicquet, Mazier and Saadaoui (2016) appear in Table 3. Germany benefited from the undervalued Euro and a back-of-the-envelope calculation suggests that about one quarter to a third of the real per capita income gain (during 2008-14) to the average German due to EMU membership (estimated to equal 4.7% in Table 2), can be attributed to this exchange rate misalignment. Likewise, roughly a quarter to a third of the ‘damage’ due to the EMU in terms of per capita

incomes in Spain and Portugal (during 2008-14) can be ascribed to the overvaluation of the Euro, as seen from their perspective.

These misalignments constitute a strong force for divergence within the Eurozone. To make matters worse, export composition also conditions the effect of the real exchange rate on export growth: as Wiertz, Van Kerkhoff and De Haan (2013) conclude for the Eurozone countries, the effect of a real exchange rate overvaluation (or undervaluation) becomes bigger (in absolute terms), the lower is the share of high technology exports in total exports. This means that the SE periphery was hurt more by the (implicit) Euro overvaluation than that Germany benefited from the Euro undervaluation. It also means that Germany's recent export success is by no means of its own making, nor is the periphery alone to blame for its yawning trade deficit (Storm and Naastepad 2015a; 2015b). Greater intra-Eurozone divergence in economic structure and trade, in combination with the ECB's one-size-fits-all interest rate policy, unlimited capital mobility within the Euro Area, and the absence of a common (stabilizing) fiscal policy, has led to accumulated losses in non-price competitiveness and large external imbalances in the periphery—and these structural weaknesses, in turn, explain the periphery's inability to cope with and recover from the financial crisis.

Third mechanism: the fiscal austerity straightjacket hinders recovery and amplifies divergence

Although the Eurozone budgetary rules have moved from being too restrictive (following the toughening up of the fiscal rules of the Growth and Stability Pact in the midst of recession in 2012) to more 'neutral' ones (EC 2016), these fiscal rules constitute not just an obstacle to economic recovery, as is widely agreed (Stiglitz 2016), but they also reinforce the observed structural divergence of (labour productivity) growth within the Eurozone.

On the first point: various studies, mostly based on research into the 'fiscal multiplier', conclude that the Eurozone's below-average post-crisis economic performance (compared to the rest of the world) was caused by the policies of fiscal consolidation (Storm and Naastepad 2015b; Stiglitz 2016). For instance, Gechert, Hughes Hallett and Rannenberg (2015) estimate that fiscal consolidation ('austerity') in the Eurozone during 2011-13 reduced GDP by 7.7 per cent. Another study reviewed by Fazi (2016) concluded that, had the SE economies of the Eurozone implemented fiscal austerity only half as severe over the 2010-13 period, Greek GDP would be nearly 14 per cent higher, Spain's GDP would be nearly 10 per cent higher, whilst Portugal's and Ireland's GDP would have declined by 5.5 per cent and 3.5 per cent less, respectively. Even Mr. Juncker's European Commission is now, belatedly, recognizing the crippling impacts of badly timed austerity (EC 2016).

On the second point: the Eurozone's fiscal rules have had structural impacts—locking economies into divergent productivity growth trajectories. Because fiscal multipliers are larger than unity, the (wrongly timed) fiscal consolidation, instead of being somehow magically 'expansionary', proved to be predictably contractionary—and in the process

increased the public debt-to-GDP ratios—which reduced the country’s solvency and credit rating. As Table 4 shows, the governments of the SE countries still pay a higher (average) interest rate on their outstanding public debts, and because their debts are higher (relative to GDP) than in the Eurozone North, these governments pay a higher fraction of their GDP as interest—the (unweighted) average public interest burden in the SE economies is 4% of GDP compared to 2.5% on average in the Eurozone core (we must note that the unconventional monetary policies of the ECB did bring down the interest rate spreads and thus reduced the interest burden to SE economies). This means that the economies in the Eurozone which need a bigger space for expansionary fiscal policy, in actual fact have a much smaller room for fiscal maneuver. This reinforces—through lower public spending on investment, education, R&D and infrastructure, which in a way gets ‘crowded out’ by the burden of public interest payments—productivity growth divergence within the zone (Storm and Naastepad 2016). Insolvent banks burdened by large stocks of NPLs become reluctant to lend, which in turn leads to a credit squeeze on what is already close to comatose investment and innovative activity—needed to upgrade technology and diversify the economy (Mazzucato *et al.* 2015).

Through these mechanisms the (long but ultimately temporary) recession was deepened in the SE economies, and this is leaving long-term ‘scars’—through hysteresis—in the form of permanently lower growth (Blanchard, Cerutti, and Summers 2015). The ‘scarring’ occurs because the ‘deepened’ recession reduced the country’s capital stock, damaged innovative capabilities (through declining public support and falling private spending), and led to the outward migration of highly educated workers. Social and scientific support structures underpinning R&D and the development of innovative capabilities have dilapidated. The SE economies become locked in into medium- and low-tech activities, in direct competition with producers in the emerging economies (where governments have been actively supporting industrialization through—often unprecedented—fiscal stimulus and monetary accommodation).

Table 4
Debt-to-GDP ratios and public interest payments (% of GDP): 2008-2016

	Average interest rate	Debt-to-GDP ratio	Interest payment
<i>North</i>	(0.030)		(2.5)
Austria	0.033	81.3	2.7
Belgium	0.034	102.5	3.5
France	0.028	86.9	2.4
Germany	0.029	74.4	2.2
The Netherlands	0.026	62.5	1.6
<i>South</i>	(0.035)		(4.0)
Greece	0.031	158.6	4.8
Italy	0.038	121.7	4.4
Portugal	0.037	112.0	4.1
Spain	0.034	78.1	2.6

Source: Author’s calculation based on Eurostat data.

Fourth mechanism: the ‘competitiveness myth’ or how the wrong lessons are learned from Germany’s relative economic success.

No other narrative has so profoundly shaped the *communis opinio* of the Eurozone policymaking community as the claim that the SE economies struggle so much (post 2008) because they have lost their ‘competitive edge’, while especially Germany has managed to navigate the crisis because of its superior ‘competitiveness’ (Storm and Naastepad 2015a; Storm 2016). The canonization of this consensus is the so-called ‘Competitiveness Pact’, a.k.a. the Euro Plus Pact, which puts competitiveness centre stage. German strength is—in this narrative—scribed almost completely to the so-called Hartz (labour market) reforms of 2003-5, which put an end to Germany’s social market economy and pushed millions of workers into insecure, low-waged jobs (see Odendahl 2017 for a useful description of these reforms and a ‘sober’ analysis of their impacts). The SE countries should therefore reform like Germany, *i.e.* deregulate their labour markets, in order to boost (export) competitiveness, growth and employment. French President Emmanuel Macron will test the soundness of this claim, as he is promising to impose ‘structural labour market reforms’ in France along German lines (Odendahl 2017). President Macro has the strong support of the IMF (2017, p. 15), which recommends in its Euro Area consultation report that the SE economies reduce the ‘Employment Protection’ to workers, as the ‘magic bullet’ to faster productivity growth:

“Faster progress on structural reforms would raise productivity growth, thereby helping to revive income convergence and narrow competitiveness gaps. Labor and product market reforms tend to boost productivity more in countries with low productivity levels and can therefore help reduce productivity gaps, contributing to income convergence.” (IMF 2017, p. 15)

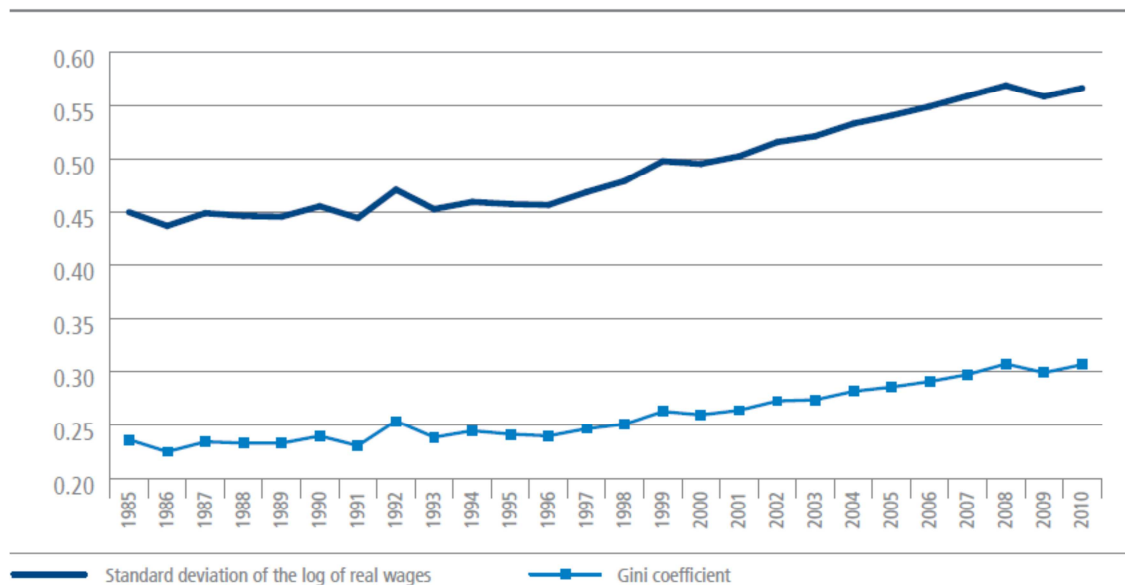
The importance of this narrative—centred on the productivity-growth enhancing and ‘competitiveness’ boosting impacts of labour market deregulation and real wage restraint—cannot be overstated: it is the official Eurozone view, informing and permeating all of the policy thinking and action by the European Commission (EC 2017), the Five Presidents (the Euro Plus Pact), and the ECB, with a status that is larger than life and certainly beyond empirical and/or historical falsification (Storm and Naastepad 2015a).

The problem is that it is wrong: Christian Odendahl (2017) rightly calls it ‘the Hartz myth’—I have called it “the labour cost competitiveness myth” (Storm and Naastepad 2015a, 2015b; Storm 2016). The myth is that nominal wage cuts will reduce (relative) unit labour costs of production, thereby improving the international costs competitiveness of firms, which will lead to higher exports, higher growth and lower unemployment. The IMF (2017) and the OECD (2017) are expanding on this mythology by claiming (in addition to the above) that lower wages (due to labour market deregulation) “tend to boost productivity” as well.

I do not want to repeat myself and hence summarize the main points why the dominant narrative is wrong:

- It is true that ‘competitiveness’ matters to (net) export growth, but it is overly reductionist to narrow the concept down to just (relative) unit labour costs. From innovation economics and analyses of foreign trade, it is clear that the impact on (net) export growth of relative prices and/or relative unit labour costs is overwhelmed by the impacts of ‘non-price’ or ‘technological’ competitiveness (Storm and Naastepad 2016). What matters is whether a country is specializing in low-tech/medium-tech goods (in direct competition with exporters from the emerging economies such as China), or specializing in medium/high-tech goods (often in niche markets).
- The elasticity of (net) exports with respect to relative unit labour costs is found to be small (Storm and Naastepad 2015a, 2015b). This is to be expected because labour costs make up only around 20-25% of total production costs. This implies that actual increases in relative unit labour costs of the SE economies explain only a small fraction the observed declines in their net exports (or current account imbalances). The current account deficits of SE economies (prior to the Eurozone crisis) are predominantly due to higher import growth (caused by higher domestic spending which was fueled by the asset price bubbles and/or higher indebtedness)—rather than caused by higher relative unit labour costs.
- Germany’s labour market deregulation (the Hartz reforms) did intensify the wage restraint which reduced consumption and imports. Odendahl (2017) further shows that outsourcing and offshoring were perhaps more important to cutting production costs than wage restraint in Germany itself. Both factors contributed to low inflation in Germany. Germany’s economic growth declined in response to the wage moderation and the creation of a two-tier ‘Hartz’ labour market, and German banks were ‘pushed’ to export finance—which help build up debt and property bubbles in SE (O’Connell 2015; Odendahl 2017; Seccareccia 2017), particularly because Germany’s slow growth and low inflation (before 2008) motivated the ECB to keep the target interest rate low for the Eurozone as a whole. “German wage restraint thus contributed to unsustainable growth, inflation and the build-up of debt elsewhere; those factors threatened the stability of the Eurozone a few years down the line,” writes Odendahl (2017, p. 10).
- The Hartz reforms did create more ‘dualism’ within the German economy, because it led to a two-tier labour market: core-sector workers (in manufacturing) working on permanent union contracts and peripheral, ‘flexible’ workers on temporary, non-standard, contracts, who mostly work in services, often in mini-jobs. Wage restraint was practiced mostly in (non-traded) services, not in the very competitive export manufacturing sector (Storm and Naastepad 2015a; Odendahl 2017). This dualism shows up in sharp increases in wage inequality (see Figure 3).

Figure 3
Rising wage inequality in Germany: Dualization post 2003



Source: Felbermayr, Baumgarten and Lehwald (2015).

The key point is that the impact of ULC competitiveness on export (and import) growth is overwhelmed by the impact of technological competitiveness. Technological competitiveness depends on the technology-intensity of a country's production structure, or the nature of its specialization. Germany is strong in medium- and high-tech manufacturing, and this strength shows up in a strong export performance as well as a limited vulnerability to external shocks. This comparative advantage has been created by a deliberate nurturing of manufacturing strengths (often in global niche markets), close coordination of the interests of workers and firms, and stable strategic collaboration between banks (operating as Schumpeterian 'ephors') and *Mittelstand* firms. In contrast, the SE economies are stuck in low- and medium-low-tech industries (featuring lower labour productivity growth) where their firms are feeling the competitive headwinds of upcoming competitors from the emerging economies. The SE industries need to technologically upgrade, diversify and rebuild their comparative advantage in a changing global economy, not by cost competition and being cheaper than the Chinese (*i.e.* lowering their ULC vis-à-vis China) but building technological capabilities.

To illustrate the importance of (low) labour productivity (due to the 'wrong' kind of specialization in low/medium tech industries), let us decompose the increase in ULC in the manufacturing industries of the SE economies of the Eurozone's periphery (relative to ULC in manufacturing in the Northern core) in terms of relative nominal wage change (in the SE manufacturing relative to manufacturing in the Northern core) and the relative *decline* in

manufacturing labour productivity in SE compared to that in the Northern core. This is done in Table 5.

As Table 5 shows, during 1995-2015, unit labour costs (ULC) in manufacturing in Greece, Italy, Portugal and Spain increased relative to average unit labour costs in the manufacturing sectors of Austria, Belgium, France, Germany and the Netherlands. But except for Italy, the main source of rising ULC was the decline in manufacturing labour productivity in Greece, Portugal and Spain relative to the growing productivity levels in the Northern core economies. Consider the Portuguese case: nominal wage growth in Portuguese manufacturing during 1995-2015 was about equal to that in the Northern core countries, but average annual Portuguese labour productivity growth in manufacturing was about 0.74 percentage points lower than that in the Northern core. This productivity growth divergence completely explains the rise in Portugal's manufacturing ULC relative to the ULC in the Northern core economies.

After the crisis, during the period 2008-2015, Greece, Portugal and Spain slashed their nominal wages, which recorded average annual declines of 2.77%, 0.92% and 1.43%, respectively. But in Greece and Portugal slashing wages did not boost labour productivity (compared to the Northern core). Spain recorded a strong increase in labour productivity growth (relative to the Northern core economies), but at the cost of a sharp rise in unemployment and helped by an almost complete collapse of its construction sector (which features low productivity growth).

Table 5
Growth of Unit Labour Cost (ULC) in Southern European Manufacturing
relative to that of Manufacturing in the Eurozone 'core'

	1995-2015			2008-2015		
	relative ULC growth	faster nominal wage growth	slower labour productivity growth	relative ULC growth	faster nominal wage growth	slower labour productivity growth
<i>South</i>	1.59%	0.42%	1.15%	-0.70%	-0.42%	-0.29%
Greece	1.53%	0.24%	1.27%	-2.29%	-2.77%	0.48%
Italy	2.09%	0.52%	1.54%	0.55%	0.35%	0.20%
Portugal	0.71%	0.66%	0.06%	-0.92	-0.92%	0.00%
Spain	0.75%	0.01%	0.74%	-2.76%	-1.43%	-1.37%

Source: Author's calculation based on Eurostat data.

Note: The Northern 'core' includes Austria, Belgium, France, Germany and the Netherlands.

Table 5 indicates that cutting wages is not enough to bring down relative ULC. The SE economies also have to raise productivity levels and productivity growth. This brings me to my final point: the myth that structural reforms of labour markets in SE economies “tend to boost productivity.” I concur with Odendahl (2017) who writes, based on what happened in Germany in response to the Hartz reforms, that “giving companies more flexible access to workers and allowing more pressure on wages and working conditions can give firms an advantage over international rivals, but it does little if anything to boost productivity. In fact, it can even be harmful if such reforms lower the incentives for companies to invest in workers and equipment.” This is the exact conclusion of Storm and Naastepad (2015b; 2016).

I argue that the imposition of ‘structural labour market reforms’ in SE economies will reinforce the divergence in labour productivity (growth) between the Northern ‘core’ and the Southern ‘periphery’ economies. The reason is that the labour market deregulation, leading to wage growth restraint, will be harmful to growth and competitiveness, in two ways:

1. The SE economies are ‘wage-led’ economies (Storm and Naastepad 2012), and hence a decline in real wage growth (or a fall in the wage share) will depress economic growth. The slowdown of growth, in turn, will depress (average) labour productivity growth, because—as Adam Smith observed, and Nicholas Kaldor formalized—the division of labour (or specialization) is limited by the extent of the market (or demand growth). That is, in a process of cumulative causation, slow growth of demand (due to wage restraint) weakens so-called ‘demand pull’ innovation (Pianta 2015) and slows down the speed of embodied (labour-saving) technical progress—quite like a lower price of coal would induce energy producers to prolong the economic lifetime of coal-powered electricity plants and stall innovative renewable energy projects.
2. Real wage restraint will slow down capital deepening—making production more labour-intensive (than would have been the case with higher wages). Employment will rise, but the jobs created will be low-wage, often precarious ones in low- or medium-tech industries. To produce the same income, the populations in SE economies will have to put in more hours—working more, rather than working ‘smart’. This is what happened in the Netherlands when unions, firms and government agreed of wage restraint in 1982—in a move later ‘copy-pasted’ by the German Schröder government in the form of the Hartz reforms (see Naastepad 2006).

The practical implication of all this is that labour market deregulation and wage restraint may well lead to lower productivity growth (Storm and Naastepad 2012). As I emphasized above, there was no wage restraint (worth the name) in Germany hyper-competitive manufacturing sector, but wage restraint was practiced in the (sheltered) non-tradable services (see Storm and Naastepad 2015a; Odendahl 2017).

Is there a future for the Eurozone?

There is agreement that the Achilles' heel of the Eurozone economy is the divergence of (labour) productivity between member states. As the European Commission (2017, p. 3) writes:

“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.”

It is therefore recognized that productivity, wage, income and wealth inequalities are rising both within and between member states, and that this could be a problem. It is probably also accepted that the common currency is benefiting some member states (through the undervaluation of the currency) and ‘punishing’ other members (which suffer an overvalued exchange rate). There is wide recognition that the Eurozone needs better mechanisms to share the risks and burden of adjustments of a global crisis or a premature tightening of ECB monetary policy, *e.g.* through the introduction of Eurobonds or a ‘Fiscal Pact’ (Simonazzi 2017); and it is agreed that some debt restructuring will be unavoidable and that the fiscal policy rules should not be overly restrictive. This is as far as we have come—after ten dire years of, mostly self-inflicted, recession and stagnation.

What will be needed (but there is no agreement on this) is a co-ordinated fiscal expansion. German growth alone will not be enough to help the SE economies on the recovery path, because the growth spillovers of a German fiscal stimulus turn out to be rather small (Picek and Schröder 2017). A co-ordinated fiscal expansion would work better and generate short-term stimulus. But by itself and without ‘directed’ structural change, this will not stop the process of productivity (growth) divergence within the Eurozone, and it may even reinforce it—especially if things are left to the over-reacting financial markets (Storm and Naastepad 2015b; 2016).

The ‘structural labour market reforms’ advocated by the European Commission, the ECB and the IMF will be a recipe for disaster, because these reforms can only intensify dualization between and within nations—thus reinforcing the productivity (growth) divergence, rather than ameliorating it. The technological leaders in the German-centred core are becoming stronger, while ‘weak’ countries, regions, industries and firms are becoming weaker (Pianta 2015). This is polarization or dualization, big time ! The political risks (in the form of a growing far-right populism) are non-trivial. Let Mr. Juncker be warned.

The only feasible strategy to stop and reverse the productivity (growth) divergence must include active industrial policy, aiming at diversifying, innovating and strengthening the economic structures of the peripheral SE countries (see Mazzucato *et al.* 2015; Simonazzi

2017). This is not what Mr. Juncker's 'Investment Plan for Europe' is capable of achieving—as it is based on limited public funding of € 21 billion which should be leveraged about 15 times by private financial investment. This is not happening (Pianta 2015). Building technological competitiveness is not for free.

The one lesson to learn from Germany's recovery from crisis and relative competitive strength is that both are based on strong 'technological' competitiveness, which is founded on relatively regulated and co-ordinated employee-employer relationships—rather than on deregulated labour markets and hyper-flexible employment relations. Imposing the wrong kind of structure on the SE economies will lock them into low- and medium-tech activities, often in direct competition with China, and with little to no space for upgrading, diversification, and advancement.

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