Without a rise in German wages, 2012 may see the beginning of the breakup of the Eurozone

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At the close of 2011, British Politics and Policy at LSE asked our contributors for their thoughts and predictions for 2012. **Tim Leunig** *offers his predictions for growth in the Eurozone in 2012, arguing that without significant intervention by Germany, in the form of pay rises for all workers, the Eurozone may well start to collapse.*

The world economy will grow in 2012, but growth will be largely confined to developing nations. Their ability to grow even when developed economies are struggling has surprised economists. It means that we can be confident that fewer children will go to bed hungry next year than this year. That is something to be celebrated.

Closer to home the Eurozone will remain a mess. This is because policy makers continue to concentrate on financial issues, rather than on fundamental economic issues. The critical issue is unit labour costs – as shown in Roger Bootle's "graph of the year", the seventh in this excellent series. Since the creation of the Eurozone, German unit labour costs have stayed low, while others have risen. The result is that Germany is super-competitive, and everywhere else is uncompetitive. The ECB buying – or not buying – Italian bonds makes no difference to this, and is simply papering over the cracks.

There are two ways out. Either all the countries on the graph except Germany can cut wages by 25%. Or Germany (and Austria, and a few others) can raise wages by 25%. Both will achieve what the Eurozone needs: internal economic balance.

Cutting wages by 25% is simply not going to happen. People have all sorts of bills that are fixed in nominal terms – most obviously mortgages and other debts. Utility prices, petrol, and the like are also essentially fixed by international levels of supply and demand. A 25% pay cut is not a vote winner and – Ireland perhaps excepted – it will not happen.

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The only way to envisage a long term future for the Euro is for Germany to announce a 2% pay rise for all workers, every month, for a year. The only exemptions would be for companies that formally filed for bankrupcy. If Germany is willing to do this, then the Euro will survive, because it will be balanced internally. It will not survive otherwise.

It would not be painless for Germany. Prices would rise, and Germans don't like that. Some German firms would lose out – VWs would become less competitive, and Fiats more so. At a macro-economic level that is a good thing, but it won't feel good in Wolfsburg, when workers lose their jobs.

Still, the alternative is for Italy to leave the Euro, and that is even worse for Germany. If Italy leaves the Euro, the lire will fall, and Italian firms, from Fiat to Luxottica will become more competitive. Italy produces things people want to buy and a fall in price will lead them to flock to the Italians' doors. Wolfsburg will suffer from Fiat's improved competitive position, but Germany will also have to cope with writing down the Italian debt held by German banks. Italy will also become the cheapest place to holiday in the Med, hitting every other Mediterranean country. For the Mediterranean, one out, all out, surely?

It is too early to predict the end of the Euro. But sooner or later, Italians are going to say: "You shall not press down upon the brow of labour this crown of thorns; you shall not crucify humanity upon a cross of Euros". Unless Germany does what needs doing, the Euro will collapse sooner or later. And if that is going to happen, better – for Italians at least – that it happens sooner.

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