With no political union in Europe, the Euro crisis may be a ‘never ending game’ for deep-rooted economic reasons

Mar 15 2012

The long term causes of the Euro crisis were a Euro monetary policy that in combination with wage policies fuelled rapid growth and wage inflation in smaller economies like Greece, Portugal, Spain and Ireland, while simultaneously depressing growth in the stronger economies like Germany. Bob Hancké *argues that fiscal federalism, i.e transfer arrangements between the faster and slower growing regions, may have softened the crisis. But for now it seems, there may be few ways out.*

Now that the immediate Greek crisis appears behind us (with the second bailout formally approved this week), we can take a fresh look at how we got into this mess in Euroland in the first place and whether there is an end in sight. According to the Brussels-Frankfurt-Berlin consensus, the causes are clear for all to see: exactly the fiscal profligacy that Theo Waigel’s, Helmut Kohl’s fiscal lieutenant during the Maastricht years and architect of the now defunct Stability and Growth Pact (SGP), warned us about in the 1990s.

Yet, as Martin Wolf pointed out in the Financial Times (£) a few months ago, up until the onset of the crisis in 2007 all countries in the European Monetary Union (EMU) except Greece ran a deficit within the 3 per cent limits imposed by the SGP. Germany and France, the somewhat grumpy headmasters of the current cohort, in fact ran among the higher deficits in the group, and their public debt position was not brilliant either. The real problem, as Wolf points out, lay elsewhere: massive current account deficits in Greece, Portugal, and Spain (and in Ireland after 2007 but not before) against permanent surpluses in the north. (The EMU is an almost closed economy, so current account deficits have as their counterparts surpluses elsewhere within the currency area). Current account surpluses are balanced by capital account deficits: the surplus countries export their surplus to deficit countries via banks and sovereign debt, thus stoking an asset inflation boom – which ended up being unsustainable.

What’s missing in the analysis

So far there is not that much new under the sun. But this analysis leaves us with a feeling of incompleteness. How *exactly* we got there is considerably less well understood than what happened once we ended up there. In essence, two very counterintuitive mechanisms reinforced each other to produce these imbalances. One is monetary policy, which has effectively been pro-cyclical in its consequences since EMU’s inception. Imagine, for ease of exposition that EMU consists of two economies of equal size, called DE (i.e. Germany with its north-west European neighbours, including Austria) and RE (for Rest of Europe).

At the start of EMU, DE’s inflation rate is slightly below RE’s rate, because of DE’s more strongly coordinated wage-setting system; they average two per cent, which is the European Central Bank (ECB)’s inflation target. The ECB sets its interest rate for all members to reflect the difference between the target and the actual (i.e. the aggregate/average) inflation rate of DE and RE. Consequently the real interest rate (the nominal interest rate that the ECB sets for all countries, minus the country-specific inflation rate) is therefore lower in the country with high inflation (RE) and higher in the low-inflation country (DE). These differences between real interest rates and domestic institutions have several consequences that are poorly understood.

First of all, the country with a higher inflation rate in effect has a more accommodating monetary policy than it should, because the bank's target is lower than its actual inflation rate. The country with a lower inflation rate, on the other hand, will have an unnecessarily restrictive monetary policy, which will not have a significant effect on price dynamics (since inflation is low already), but only on growth. Note that the opposite would happen if monetary policy were decided for each country individually: if inflation in DE were to fall, DE's central bank would almost certainly lower the nominal,(and therefore effectively the real) interest rate. If inflation rises in RE, RE's monetary policy would tighten.

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None of that happens in EMU, where rising inflation is implicitly rewarded through a falling real interest rate. This pro-cyclical dynamic is partly compensated by a lower real exchange rate (or RER) in the low-inflation DE countries, which improves competitiveness and therefore exports. However, this compensatory effect is limited to the export sector, which makes up at most half of the GDP of small economies in EMU and not more than a quarter of output in large economies.

The second ill-understood effect is that the lower real interest rate that RE has faced during the first ten years of EMU feeds into a path of higher growth in RE, fuelling higher (wage) inflation. At the same time, the tighter than necessary monetary policy imposes further disinflation through wage moderation on DE. The very small differences in inflation that existed at the start of EMU thus have become more pronounced in the second round – causing rising asset-price-fuelled inflation in RE countries, and externally imposed disinflation further reduced prices in DE countries. And the perverse pro-cyclical effects gain in strength, pushing the inflation rates and the competitiveness of DE and RE on sharply diverging paths.

Finally, the differences in wage setting between DE and RE countries play a crucial role in this process. Not only did different wage-setting systems put DE and RE on different tracks from the start; in addition the ability of DE to counter inflationary pressures through wage coordination around more slowly growing unit labour costs is almost perfectly mirrored by the inability of RE to do so. Because inflation is more of a problem in RE (although hidden under the beneficial effects of very low real interest rates), the lack of capacity to disinflate implies that RE slowly but steadily loses competitiveness relative to DE.

In itself this change does not have to be deeply problematic: if RE can grow through trade outside the European Monetary Union, it can compensate its falling competitiveness within EMU through rising competitiveness outside it. But EMU is essentially a closed trade area, with only about ten per cent of GDP leaving the single currency zone, most of which goes to other EU member states. In addition, this closed trade bloc has faced a relatively low growth regime since its inception. Within the bloc DE's rising competitiveness *must imply* RE's falling competitiveness. Trade in EMU has, in effect, become a zero-sum game in which one's gains are another one's losses, and DE's improving competitiveness and current account surplus are mirrored in current account deficits in RE.

Why fiscal transfers (or their absence) are key

From a longer-term perspective, the crisis of EMU is the result of this combination of a pro-cyclical monetary policy and divergences in domestic wage-setting institutions pushing inflation differential out in every bargaining cycle. The effect is a dramatic drop in competitiveness in the higher-inflation countries and a dramatic increase in competitiveness in the other countries, reflected in the current account imbalances within the EMU that we see today.

Such current account surpluses and deficits exist in every monetary union, of course. Take the USA and Germany before EMU: both these large countries contain sub-regions that are either more or less competitive. And the policies of the central bank were probably also more or less always wrong for any individual sub-region. But both these countries – and Italy, and Spain, and Belgium, and Japan, and so on – were also political unions, with a constitution that produced and imposed a common destiny, plus a fiscal regime that compensated for these divergences within countries. As wealthier regions grew faster, they contributed more taxes to the central pool, and poorer, slow-growing regions drew on that pool to raise their fortunes. Inflationary pressures in the first wealthier group thus were eased while deflationary pressures in the second poorer group were compensated by cheaper money from the wealthier regions.

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Perhaps such a transfer arrangement would have helped EMU in the past – and thereby made the current problems more digestible. If the fast-growing Spanish and Greeks had been forced to fund the slow-growing Germans in the first ten years of EMU, it would probably have been easier to ask the faster-growing Germans today to help the stagnating Greek and Spanish economies. A political union, especially if it involves fiscal transfers, creates solidarity and trust. (Without fiscal transfers it would be an incomplete union). Initial trust likely would have engendered more trust, up to the point where Greece might have taken German pleas for a more effective taxation system more to heart than they do today, with a proverbial knife against their throat.

But history does not really appreciate words like 'perhaps'. Turning back the clock and redoing EMU, this time with a political union (and slightly less paranoid central institutions, perhaps) is impossible. And instituting it now does leave a bitter aftertaste, and with good reason. Last time I looked neither the German nor the Greek voters were asked about their forced marriage – even if it looked like the right thing to do for EMU. That means we are saddled, it seems, with what David Marsh (of the Official Monetary and Financial Institutions Forum) has recently called the 'never-ending game' of the EMU crisis.

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Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics.

This blog post is loosely based on Bob Hancké, 'Worlds Apart: Labour unions, wages and monetary integration in continental Europe'*, Working paper no 128 of the Institute for Advanced Studies, Vienna.*

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