Despite signs of recovery, the Eurozone crisis is still far from over

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The Eurozone emerged from recession in the second quarter of 2013, with the single currency area's GDP increasing by 0.3 per cent. **Bob Hancké** *writes that although the situation in the Eurozone has improved, a closer look at the economic data would suggest reason for caution. He argues that the root cause of Europe's sovereign debt crisis may not have been excessive public spending, but rather a divergence between wages in sheltered sectors (largely in the public sector) and the manufacturing (export) sectors in European economies, which affected states' external competitiveness. Until this problem is solved any recovery is likely to be short lived.*

There's a lot of talk of the Eurozone crisis abating. In that story, austerity and structural reforms have done their job, current account deficits have been reduced or disappeared altogether, and countries such as Spain are now more competitive than France (as stated by former President of the European Central Bank, Jean-Claude Trichet, in an Official Monetary and Financial Institutions Forum Commentary), while Ireland is ready to go back to the markets and leave the umbrella that the European rescue package offered the country.

Some point out, bitterly, that the collapse of demand in the 'peripheral' economies of the Eurozone is the main reason why current accounts have become more balanced, killing off imports, but nonetheless accept that something positive has happened. Link that to the ECB's policy to do whatever it takes (if ever asked) and the permanent rise of the euro against the dollar and the pound – a sign of confidence by international financial markets – and the optimism seems to have firmer roots than the pessimists (including me) thought half a year ago.

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In Monday's Financial Times, Wolfgang Münchau laid out, in his usual acerbic style, the problems with this argument. His point is that if things have started to go better for the euro, it is because the euro area's external position has improved quite substantially: EMU now has a trade surplus of the order of 2.5 per cent of GDP against the rest of the world, and things have moved a bit within the Eurozone on the back of that. But fundamentally not much has changed: Münchau uses Spanish adjustment to make his case.

Competitiveness would improve if two conditions were met: one, if costs in the sheltered sector in Spain (adjusted for productivity) grew at a rate that was considerably slower than in the sector that is exposed to trade; two, if costs, including wages, in the Spanish export sector (shorthand for tradables, ie. exposed) grew, again adjusted for productivity, at a slower pace than those of their main trading partners in the same sectors. And that has not happened, he claims, or at least not enough.

I agree with this analysis. In a recent LEQS paper co-authored with Alison Johnston and Suman Pant from Oregon State University, we analyse, in all EMU member states and a few outside, the divergence in wages (expressed in

unit labour cost terms, ie. adjusted for labour productivity) between sheltered sectors (primarily the highly unionised public sector) and the manufacturing (export) sector in the run-up to the crisis of EMU.

Those countries that ended up in serious trouble around 2010 all had a massive divergence between these two wage developments, while the others did not. Where trouble emerged, public sector wage growth translated into a higher aggregate price level, which became a problem for external competitiveness. The export sector, then, was incapable of controlling wages in the public sector through laws or other forms of coercion, was unable to compensate for inflationary pressures by raising its own productivity while moderating wages, or failed because of institutional weakness, low productivity traps or simply its relatively small size. The result: a collapse in relative competitiveness and a massive current account gap.

Münchau is right, I think, in putting his finger on those still very weak spots in the euro system. And if we are right in our understanding of where the roots of the problem lie, then the crisis of the euro is far from over.

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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.

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