The euro complements Northern European economies more effectively than those in Southern Europe

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Why has the Eurozone crisis affected Southern European countries more severely than Northern European countries? **Benedicta Marzinotto** *writes that it is necessary for monetary and fiscal policies to complement structural factors within an economy, such as labour market institutions. She argues that the transition to the euro created problems for Southern European countries as the single currency's macroeconomic regime was at odds with some of the structural features of these economies. In contrast, countries like Germany were shielded from these problems because the new system was similar to the previous German model.*

There is a tendency in the economics profession of treating macroeconomics and structural issues as two separate compartments, each governed by a different logic. So, whilst monetary and fiscal policy tend to be depicted as universal sets of instruments that could be employed anytime anywhere with the same impact on the economic cycle, structural issues such as labour markets and welfare states are rightly regarded as socially embedded, inertial and "reformable" only with the support of the very same forces that have until then determined their inertia.

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This vision is conveniently endorsed by policy-makers including those that participated in the construction of the euro, which was at least in the early days about rendering sovereignty over "universal" tools, whilst retaining control over sensitive areas (e.g., labour markets, education systems and welfare states). Yet, macroeconomic policies are embedded in national institutional settings too and interact with other institutions of each national political economy, especially labour markets, in more or less efficient ways.

Much of the crisis dynamics can be explained by the fact that the institutional complementarity between macroeconomic and structural policies could be preserved in some cases, whilst it was not redefined or improved in others. Before the euro, Germany was the clearest example of a virtuous institutional complementarity between macroeconomic policies and labour markets. Wages were set at the sectoral level meaning that there were relatively few wage setters, say, one per sector. The risk was that each medium-sized wage setter could ask for strong wage increases, thereby almost certainly creating inflation.

But two factors prevented this from happening. First, the German macroeconomic regime was non-accommodating. The Bundesbank would have reacted to excessive inflation reducing money supply, with dismal consequences for employment. Second, of all sectors, the export-oriented one was the lion's share. Labour unions in the manufacturing sector were deeply committed to wage moderation, as a restrictive response by the national central bank would have led to currency appreciation besides everything else, magnifying output costs.

Fiscal policy was equally rigid, as it could not override the objective of monetary policy. Rigid fiscal rules were also necessary to ring-fence the system from the possibility of free riding by public sector unions, who had little reason for self-discipline, as their jobs were not a function of interest and exchange rates.

Scandinavian countries worked equally well. Up to the 1980s, wages were set at the national level, which guaranteed both wage moderation and wage compression. With virtually one wage setter, there was no advantage from having a rigid macroeconomic regime, as there was no risk of free-riding. The single wage setter was selfdisciplined because excessive wage growth would have immediately translated into inflation, thereby also leaving workers' purchasing power unchanged. The macroeconomic regime in these countries was thus essentially accommodating and supportive of employment creation.

When wage bargaining became more decentralised in the late 1980s and more similar to the German system, macroeconomic policy rules were introduced including in countries that were not participating in the European monetary union (e.g. Sweden). So, here, the regime change was largely endogenous, with countries moving from one institutional equilibrium to another, which was equally efficient.

The South of Europe deserves special attention. Prior to joining the euro, national systems were not necessarily as efficient and equitable as they were in Germany or Scandinavia, but they had their own internal consistency. So, for example, public debts were generally high, but few wage setters and powerful labour unions contributed to strong inflationary pressures. This ended up creating substantial problems over time, but also helped reduce the real obligations of future generations in countries where, for most of the post-war period, the stock of public debt was domestically owned.

That macroeconomic regimes must have some complementarity with labour market institutions was also well understood in these countries. For example, in Italy, once the policy of monetising the public debt was ended in the early 1980s, serious budget reforms were put on the table and wage indexation was first softened and then fully scrapped in the early 1990s.

The European monetary union was a shock for two reasons. First, all public debt suddenly became foreign debt. Now there are only two possible strategies to support debt sustainability: fiscal adjustment to eliminate the problem at its source, or enhanced competitiveness to create the conditions for repaying debt through exports. The latter requires supportive labour market institutions, but it also comes with short-term costs because the immediate effect of lower relative prices is to increase the value of the debt and hence the share of exports necessary to repay it.

Second, countries such as Ireland, Spain, Greece and Portugal and, to a much lesser extent, Italy, moved from macroeconomic regimes characterised by high interest rates but the option of devaluation, to the euro regime, where devaluation is not possible, but interest rates up to the crisis were extremely low, reflecting abundant money supply. This de facto accommodating monetary regime went hand in hand with wage setting institutions that were neither fully decentralised nor fully centralised, but somewhere in between, and thus inconsistent with prevailing real monetary conditions. They also lacked an export-oriented sector that was strong enough politically and institutionally to impose discipline on other sectors, and which was ultimately capable of repaying the huge stock of debt that had become "foreign" all of a sudden.

By contrast, the euro's macroeconomic regime was no shock to a country like Germany because it turned out to be akin to the previous one, with the result that the complementarity with the existing labour market institutions could be fundamentally preserved.

Macroeconomics does not operate in a vacuum and varieties of capitalism offer a valuable analytical tool to understand the build-up of macroeconomic imbalances in the euro area. To be efficient, coordination of economic policies in Europe requires understanding all of these complex institutional knots in each country.

Research behind this piece was conducted before the author joined the European Commission. The views expressed in this piece do not represent the view of the EU.

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