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Eurozone faultlines have reached the core

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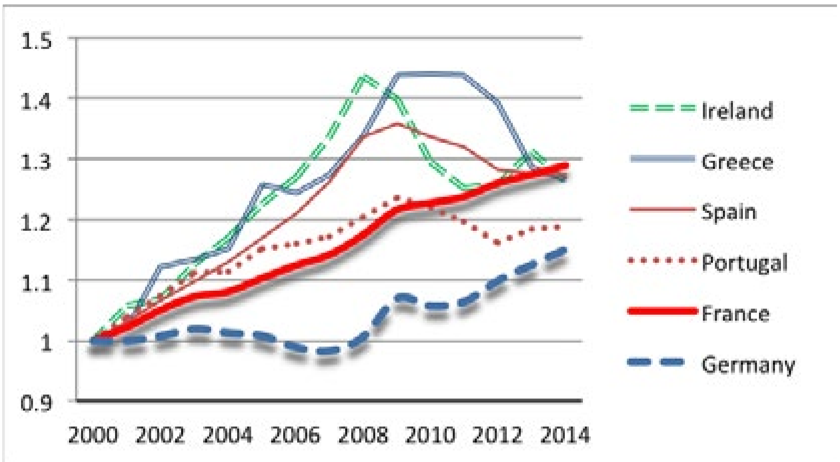

FIGURE 1: UNIT LABOUR COSTS, INDEXED TO 1 IN YEAR 2000. SOURCE: AMECO

The eurozone crisis is back. In reality, it never went away—tranquillity in the bond markets allowed complacency to set in and attention was claimed by other issues. But the prospect of outright price deflation across the zone has again focused attention on matters closer to home. As depression and deflation stalk core countries, bond markets have taken a second look at the periphery: with the Greek government due to return to the open market at the end of the year, investors appear to have had a change of heart. Bond yields climbed gradually higher through the autumn before spiking above 9 per cent on 10-years in October.

While the snap presidential elections called by the Greek government provide the most likely trigger for a new phase of market turmoil, deeper faultlines in the eurozone are emerging. France's worsening competitive disadvantage to Germany reproduces the pre-2008 trajectory of peripheral nations which resulted in current account imbalances, rising leverage and the initial outbreak of the crisis. This Policy Viewpoint briefly revisits the underlying cause of divergence between the core and periphery before showing that France is following a similar path to that of the periphery before 2008.

The current fragile conjuncture is the entirely predictable result of the on-going lack of decisive anti-deflationary action. It is the result, above all, of the impasse between chronic lack of demand across the currency bloc and obduracy regarding stimulus—both fiscal and monetary—and wage policy. Despite overwhelming evidence to the contrary, a steadfast belief remains that 'internal devaluation' in the periphery can bring about a situation in which the private and public sectors simultaneously deleverage even as German current account surpluses continue to rise. As Martin Wolf memorably put it, 'the eurozone is at war with double-entry bookkeeping.'

It is worth recalling how this situation came about: by joining a currency union at over-valued exchange rates, peripheral countries found themselves at a significant competitive disadvantage to Germany. This position was reinforced in subsequent years by continued repression of German wages—given higher levels of inflation in peripheral countries, the yawning gap in competitiveness between the periphery and the core could only widen further.

In the absence of an exchange rate mechanism through which peripheral countries could adjust, the inevitable result was current account imbalances mirroring the divergence in competitiveness—deficits in the periphery and surpluses in the core. The profits of artificially-gained competitive advantage were recycled by lending them back to both private and public sectors of peripheral countries. Financial integration and deregulation allowed cheap credit to plaster over the cracks for a time.

This was the state of play when the eurozone was hit by a massive aggregate demand shock as the US housing bubble collapsed. Simultaneously, large swathes of European bank balance sheets—which had been accumulating securitised sub-prime debt—were wiped out. The result was private sector retrenchment and

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deleveraging alongside ballooning government deficits. Deficits, it must

be repeated, that were the result of the crisis and not its cause.

Rather than allowing deficits to take the slack while bank balance sheets were rebuilt and the private sector deleveraged, the eurozone launched its war on double-entry bookkeeping, imposing brutal austerity on peripheral countries and causing unprecedented suffering for millions who played no role in generating the imbalances that led to the rupture.

The imposition of austerity across the periphery reversed divergent trends in competitiveness. Mass unemployment and the removal of social safety nets had the desired effect of forcing those still in work to accept sharp wage cuts. Falling real wages (and, in some cases, prices) brought significant reductions in labour costs.

Austerity has not, however, been applied evenly: even as peripheral countries in the throes of bail-out programmes capitulated to demands for ever-greater pain, France successfully resisted the more extreme excesses of austerity imposed on the periphery. As a result, the reversal seen in the periphery has not taken place in France. Instead, French macroeconomic trends increasingly resemble those taken by the peripheral states in the pre-crisis period.

Figure 1 shows the history of unit labour costs for Germany, France and four peripheral nations—Greece, Ireland, Spain and Portugal. Between 2000, when the euro was first introduced as unit of account, and 2008, when the crisis hit, wage repression kept German labour costs flat. Over the same period, higher inflation in peripheral nations led to a steadily worsening divergence in competitiveness.

A marked reversal took place from 2009 onwards: recession and austerity reduced costs in the periphery, while German wages finally rose, albeit modestly. The competitiveness gap

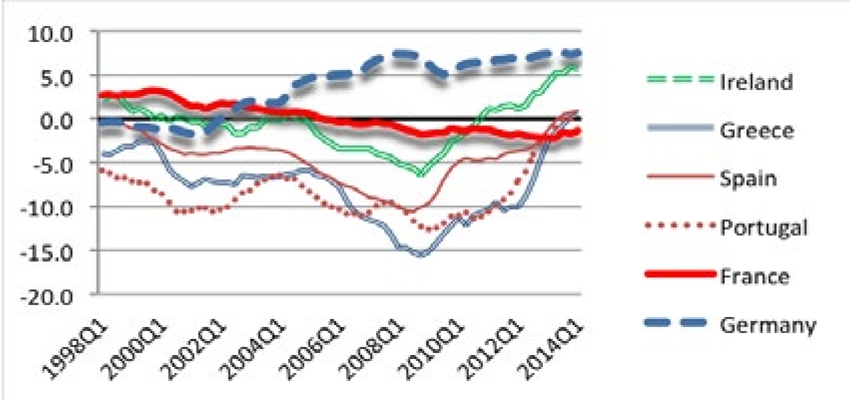

FIGURE 2: CURRENT ACCOUNT BALANCES. ANNUALISED PER CENT OF GDP. SOURCE: EUROSTAT

between Germany and the periphery has therefore closed substantially since 2009 although, it must be emphasised, through the most pointlessly destructive mechanism possible.

The story for France is different. From 2000 onwards, costs in France rose alongside those in peripheral states, leading to worsening differentials with Germany. Unlike the periphery, however, real wages in France have not fallen since the crisis—even as the unemployment rate reached 10.5% by September 2014.

This difference between France and the periphery is also apparent in current account balances, as shown in Figure 2. The balances of peripheral states have followed a path that mirrors labour costs: large deficits until the crisis, followed by a reversal leaving all countries in balance this year except Ireland which now runs a significant surplus.

The French current account position, in comparison, has steadily deteriorated from a surplus of three per cent in the late 1990s to a deficit of just below two per cent as of the third quarter of 2014 and is forecast to continue widening. Meanwhile, the German surplus of nearly eight per cent of GDP now makes it the largest net creditor in the world.

With the private sector still deleveraging, the implication of a current account deficit in excess of two per cent is that there is no chance of a government deficit within the EU limit of three per cent. Given the immutable macroeconomic accounting identity that the current account deficit equals the sum of the government deficit and the private sector surplus, this would require the private sector to reduce its saving to under one per cent of GDP.

The French government has given up any pretence of aiming for this impossible target and is openly planning to run a deficit in excess of four per cent for the foreseeable future. The recently presented French budget plan explained that 'No further effort will be demanded of the French, because the government—while taking the fiscal responsibility needed to put the country on the right track—rejects austerity.'

France, along with Italy, is right to refuse demands for further austerity and so-called structural reforms. The correct medicine for the eurozone—as it has always been—is wage rises in the core and fiscal stimulus across the currency union, backed by accommodating monetary policy and a system of fiscal transfers from surplus to deficit nations. Unfortunately this is unthinkable given the current legal and political obstacles.

Something has to give—the same faultlines that split the core from the periphery in 2009 have now unmistakeably appeared between the two largest nations in the currency union. Policy-makers ignore them at their peril.