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Eurozone at a Crossroad: Politics Confronts Economics

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ABSTRACT

Eurozone (and implicitly the whole EU) finds itself at the crossroad. Economic "dynamism" of the last few years resulted in the growing differences between the Northern European "core" centered on Germany and the Mediterranean countries plus Portugal and Ireland. The key for the explanation of the rising differences in the economic dynamism between the European "North" and "South" is the understanding of the existence of two economic and social models within the original eurozone countries. Under the given circumstances, it would make sense to restructure the Monetary Union so that the each (currently) member country has a monetary policy suitable to its economic reality. However, the economic logic notwithstanding, the Eurozone member states remain firmly committed to its current form, albeit with minor adjustments in operational procedures The answer to this "mystery" lies in the fact that the Euro was, first and foremost, the political creation and basically remains so. It follows that the key to the Eurozone's survival is the political commitment. The political interests of member countries dominate the economic logic.

Keywords: Europe, Economic Dynamics, Economic Logic, Eurozone, Politics

INTRODUCTION

Eurozone (and implicitly the whole EU) finds itself at the crossroad. Economic "dynamism" of the last few years resulted in the growing differences between the Northern European "core" centered on Germany and the Mediterranean countries plus Portugal and Ireland. France stands economically in the middle. However, the growing number of observers and economic commentators stress that France is sliding from the "dual leadership" (together with Germany) to a biggest – and certainly the most important – member of the "Mediterranean" group.

The key for the explanation of the rising differences in the economic dynamism between the European "North" and "South" is the understanding of the existence of two economic and social models within the original eurozone countries. The extensive social welfare state is characteristic for both groups of countries. However, the "northern" model is more supply side, productivity oriented, whereas the "southern" model relies more on the demand side management. Those differences reflect both the different production mixes and the different structures of labor markets.

Different socio-economic models make for different preferences as far as economic policies are concerned. "Northern" countries prefer the concentration on the price stability and the related nominal wages moderation. In such an environment the productivity gains transform themselves into an increased competitiveness and a moderate, but steady rise in the real consumption. "Southern" countries model then enhances the rise of wages resulting in a competitiveness deterioration, which was historically countered by gradual depreciations.

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Under the given circumstances, it would make sense to restructure the Monetary Union so that the each (currently) member country has a monetary policy suitable to its economic reality. (Whether such restructuring implies the leaving the common currency or the introduction of the parallel currency is, indeed, a matter of a detail analysis of individual country circumstances.) However, the economic logic notwithstanding, the Eurozone member states remain firmly committed to its current form, albeit with minor adjustments in operational procedures.

The answer to this "mystery" lies in the fact that the Euro was, first and foremost, the political creation and basically remains so (DG ECOFIN, 2008). It follows that the key to the Eurozone's survival is the political commitment. The political interests of member countries dominate the economic logic.

Currently (and in the foreseeable future) the key political interests of the Eurozone member countries are the preservation of Europe as a community of the free, democratic societies and the one of the key world players politically, economically and culturally. European Union – and its extension, the Eurozone – are seen as the umbrella guaranteeing peace, individual freedom and liberty. (That may seem as a grandstanding, but given the not so distant European history, it still resonates with the population.)

Moreover, the existence of the common economic space and the common currency increases the influence of the large European countries on the world scene and, perhaps more importantly, provides the poorer "southern" countries with a protection from sinking into the abyss of the insignificance in the globalized world economy.

Finally, the existence of a common organization – like the Eurozone – provides the smaller countries with the voice in the determination of their fate – the voice they may not have if standing alone.

Below, part II provides the more detailed discussion of the Eurozone's social and economic models and their interplay with the economic policies. Part III argues that the survival of the Eurozone is, first and foremost, a political phenomenon, in the face of the economic reality. Part IV concludes.

Economic and Social Models in the Eurozone

The discussion of the existence of the different economic and social models within both the EU at large and the Eurozone specifically is not new. However, in the most discussions of the protracted Eurozone crisis the explicit recognition and analysis of the existence of the different socio-economic models within the Eurozone is omitted, even if the relevant differences are assumed implicitly.

Several empirical studies (Rusek, 2012a, Aiginger, 2011, Chen et al, 2012) analyze the differences in the Eurozone performance between the "South" (often called the "periphery" – countries included are Greece, Italy, Spain, Portugal and Ireland) and the "North" (commonly called the "core" and including the remaining seven original Eurozone countries). These publications statistically analyze and confirm the growing dynamic differences between the just mentioned "North" and "South" of the Eurozone. However, they make no attempt to connect the observed divergent tendencies to perhaps the differing general history and the socioeconomic models.

There is, indeed, an area of research which stresses the existence of the different socioeconomic models within the Eurozone (or the whole EU). Aiginger (2009) defines the four different economic "systems" within the EU and conducts the comparative study of their economic performance. Hall (2013) distinguishes between the two economic models within the Eurozone and argues for the "systemic" causes of a different impact of the common monetary policy. In a somewhat different and broader approach, Spolaore and Wiarczarg (2013) argue that the different economic dynamics within the Eurozone is deeply rooted in the culture and history.

Broadly following the Hall, we distinguish between the two socio-economic systems (models) currently co-inhabiting the Eurozone. (It is possible to argue that there are actually three "models", with the so called "new EU members", i.e. the east European countries admitted after the 2004, constitute a separate category.) Mediterranean Countries (Greece, Italy, Spain, Greek Cyprus) plus Portugal constitute the "South", whereas Germany, Austria, Netherlands, Belgium, Luxemburg and Finland form the "North". Of the two countries in between, Ireland may be closer to the South and France to the North.

Differences in economic performance between the "North" and "South" are well documented in the publicly available data. Somewhat different strain of the analysis addresses the dynamics of the equilibrium values of the policy related variables (Rusek (2012b), Darvas and Merler, 2013). The conclusion here is not only that the equilibrium values for the variables like the real exchange rate and the nominal interest rate differ from country to country, but (perhaps more importantly) that the dynamic differences can be identified between the "North" and the "South".

The conclusion from the data are the persistent – and perhaps increasing – differences between the two parts of the Eurozone. In this context, the three interrelated questions arise:

1. What is behind the rising divergences in the performance of the different parts of the Eurozone?
2. Are these divergences the result of the common currency policies? (Or, in the alternative form: Do the policies necessary in the common currency area enhance the historically inherited differences?)
3. Are there policies which could overcome the divergent trends?

To answer the first question, let us compare the economies of the North and South (as defined above). We use three criteria. The first is the "response" to globalization and the emergence of the "Emerging Markets" (EM). The combination of the increased liberalization of the world trade (in the last about 15-20 years) and the rise of the Emerging Market (EM) economies (especially in Asia, but partially in Eastern Europe and Latin America as well) had two consequences. On the one side the growth of the "new economies" led to a rising demand for capital goods. This plays well into the hands of the North and its comparative advantage and tradition in heavy and precision engineering. On the other side, the rise of emerging markets was characterized by the rapid expansion in their exports, concentrated in the consumer goods and other "light" industries products – i.e. in the areas in which the Southern economic activity was and remains prevalent.

Given the different economic history and traditions, the advent of globalization created the opportunities for the North, but presented the South with rising challenges. One can interpret the impact of globalization on the Eurozone as the example of the Mundellian asymmetric shock par excellence. Given the generally expansionary impact of the globalization on the

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northern economies the policy of a monetary restraint was called for, with limiting the inflation providing the space for the increases in productivity to be reflected in the gradual decline in the unit labor costs, resulting in the gradual depreciation of the real exchange rate. Northern competitiveness improved on a global scale, to be reflected in a positive current account dynamics and a reduced unemployment (even if the impact of the demographic factors on the latter should not be ignored).

Where the South is concerned, the impact of globalization itself was in general contractionary. Increasing import competition was exacerbated by the trend of the exchange rate appreciation in both nominal and real terms.

Globalization's "Mundellian" shock to the Eurozone was amplified by the differing structures of labor markets and the associated welfare arrangements. "Northern" countries rely on what may be called a centralized coordination. Wages are set sectorally (by the agreement between the employers and unions representing the employees) and coordinated nationally. This facilitates the control of inflation and the unit labor costs, with the eye on the competitiveness. The improvements in the latter then facilitate the positive employment dynamics. This system is supported by the effective vocational training system and comprehensive and rather generous welfare arrangements, aimed not only at the income support but at the facilitating the return to a productive labor activity quickly as well.

In contrast, in "Southern" countries the labor market arrangements are more fragmented, characterized by several competing unions and employers federations. There is only a limited coordination of the labor contracting. The result is then the more effective pressure on the wages increases. In the absence of the corresponding productivity growth, the competitiveness tends to erode. The welfare structures are more limited as far as benefits are concerned. The major elements here appear to be strict regulations limiting the possible layoffs. The goal is to stabilize the labor incomes. However, the unwanted result is the gradual shift toward a part time employment and the time limited contracts. Finally, the productivity enhancing vocational education system is rather limited.

Finally, the "southern" countries economic structure is characterized by a "dual" character – a rather large number of small family type businesses on the one side and the large, often multiactivity corporate organizations on the other side. The presence of the most vital element of "northern" economies, generally known under their German term/description as "mittelstand" companies, is at best limited. That indeed affects the dynamics of productivity – and hence the unit labor costs and the real exchange rates. Moreover, over the long run it influences the behavior and the dynamic position of the banking system.

Historically, banks in the "southern" countries developed a close relationship with their respective countries' large companies and with the support of the state. Given the relatively low domestic savings rate, the state (i.e. the central bank) was often the major source of "loanable funds". The other potential bank customers – i.e. the small businesses and individuals – were basically neglected by major banks and their needs were serviced by local establishments – small banks and lending cooperatives, often established and operated by the local authorities (provinces and states).

Given the close and symbiotic relationship between the large companies, the large banks and the state, the interest rate often played a rather limited role in their operations and could be (and often was) manipulated in their mutual interests. As far as the "other" end of the financial

structure was concerned, the "small scale" of local operations, together with the lack of competition and a rather unclear risk implied rather high lending rates and a limited loan volume. The latter indeed tended to preserve the structure of economic activities and may be considered one of the factors weighting against the emergence of a significant "mittelstand" sector.

(It should be pointed out that the above described characteristics of the banking sector and its function were to a degree common to all original 15 EU countries. However, they were more entrenched in the "South", which played an important role in the processes of changes and transformations triggered by the establishment of the Euro. See the discussion below).

It should be obvious that the different economic systems in the European "North" and "South" – or the "core" and "periphery" , as those areas are sometimes referred to – are not the result of the adoption of the common currency Euro. They are the result of the extensive and long term historical dynamism, encompassing the differences coming from the religious, cultural and (to a degree) climatic differences. One may even discuss the impact of the "recent" history – WWII, Cold War and its aftermath. However, it should be equally obvious that the historically determined differences were moulded, modified and often "enhanced" by the processes of the adjustment to a new reality of the common currency.

It is generally recognized that the Eurozone at its inception was not an "optimum currency area" (OCA) in the standard Mundellian sense. (In fact the whole strand of the economic literature was developed by arguing the "concept" of the "endogenous" OCA – i.e. the establishment of the common currency will bring about the OCA properties subsequently for all participating countries). However, the differential impact of the common currency on the "Northern" and "Southern" economic models is seldom analyzed and the contributions of the differences between these models to a current crisis are seldom elucidated.

The introduction of the common currency required the complete liberalization of capital flows. That rather quickly resulted in a near equalization of the nominal interest rates. Inflation across the board remained close to the ECB target (below, but close to 2%) - even if this target was exceeded more often than not. However, within this broad average the inflation in the "south" generally exceeded the one in the "north" – which resulted in real interest rates in the "south" being consistently below the ones in the "north".

This, indeed, increased the "Southern" demand for credit, accelerating the economic growth and hence increasing the tax receipts. Spain and Ireland run large budget surpluses, reducing significantly their debt to GDP ratios. Italy achieved a primary surplus. After violating SGP criteria at the beginning of the 2000's, Portugal achieved a budgetary stability. Only Greece remained a significant public finance problem, but it was not known at the time (even if suspicions existed).

The increase in credit was financed by the domestic banks which in turn obtained resources on the interbank markets – i.e. basically by tapping the "Northern" savings. Statistically, this phenomenon appeared as the capital inflow – i.e. the current account deficits.

However, this dynamics had important effects which remained unnoticed (or noticed but ignored) at the time. Most of the capital inflow financed the increase in consumption, especially in housing and related consumer durables. Given the generally lower consumption and the lower quality of the housing stock of the "Southern" countries, this kind of behavior may be

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sociologically and psychologically understandable, nevertheless…. Capital inflows maintained the domestic demand, a significant part of which fell on the non-tradeables sector. Combined with the labor markets rigidities, this tended to increase both employment and wages. However, the growth was mostly in the low productivity sectors (construction and services). Hence the unit labor costs (ULC) increased and the REERs based on ULC tended to appreciate. Simultaneously the Hartz IV reforms in Germany led to the (statistically observed) wage restraint and increases in productivity – i.e. the German ULC based REER tended to depreciate. These two phenomena led to the increase of the competitiveness gap between the "North" and "South". Moreover, the capital inflow induced demand (and wage and credit) expansion in the South tended to perpetuate the inflation and hence the real interest rate differentials. This prolonged the just described processes and led to increased "North-South" divergencies.

Additionally, this pattern of lending increased the risks for the banks' balance sheets – the phenomenon ignored by the national regulators. (One may surmise, however, that it would be ignored (or misunderstood?) by a hypothetical Eurozone-wide regulator as well. After all, the similar phenomenon was ignored by US regulators at the same period.) The problem here is that if a substantial part of bank assets (lending) is in the consumption – i.e. the individual income – related loans, then any shock to the individuals income generating power affects the loan servicing abilities, i.e. the riskiness of the lending institutions balance sheets. And indeed, if the lending bank resources depend on the interbank markets, the rising riskiness reverberates throughout the banking system.

The discussion up to this point leads to the two interrelated conclusions. The first is that the European North vs. South divide, characterized by the different, clearly distinguishable economic models, is not a consequence of the introduction of the common currency. These differences are the result of the hundreds of years of economic, political and cultural development and hence may be expected to remain for a foreseeable future.

It is, however, necessary to recognize that the North/South differences not only triggered, but dynamically exacerbated the current European crisis. Given the economic, political and social realities, the introduction of the common currency not only created the environment of the crisis, but is destined to lead, ceteris paribus, to a chronic crisis environment, punctuated, in the unpredictable intervals, by intensive outbreaks.

Given that conclusion, the last question above asked whether there are any answers cum solutions in the context of the preservation of the common currency.

Economic discussion in the last several years provides in general two kinds of answers. On the one side, the solution is seen in the federalization of European economies. The idea was best expressed by Nicholas Veron (2012) in the form of "four unions" – monetary, banking, fiscal and political. Appealing to committed supporters of the European integration, it implies a concentration of the important economic policy decisions (both macro and micro) on the European level, even if the implementation might (rather incongruously) be left to member states.

The problem with this concept is twofold. First is that it implies the reduction of the role of the national states far below the currently accepted compromises (aquis communitaire), which then raises the issues of the policy formulation and implementation in the situation where the common voluntarily accepted and popularly supported goals and operational procedures are difficult to discern. And second is that currently and in the foreseeable future any sustainable

European superstate (and that is what is implied by the "four unions") would imply the extended resource transfers from North to South. Indeed, this solution would require a significant revision of Treaties establishing the European Union – practically entirely new treaty. Chances of a success of such an endeavor today are practically nil.

The second possible solution is seen in the enhanced process of structural changes within the framework of current treaties. Some ideas in this direction were expressed by Rusek (2013) and, indeed, there are others. It may be argued that this is the direction preferred by the European Commission and the member states governments currently.

However, as currently interpreted (and practiced) this policy is asymmetric – applied basically to the South only. And, indeed, in southern countries this policy is highly unpopular, bringing about the high unemployment and the political instability, with positive economic results difficult to see. One can imagine the prolonged "muddling through" policies. But again, the chances for a radical success – and hence a solution of the current crisis – are limited.

Indeed, the protracted economic crisis in the Eurozone's "South" raises many questions about the Eurozone's survival in its current scale. These questions are not new, but the recent book of the tested and committed Europeanist Francois Heisbourg (2013) should wake up even the most dedicated. When the man of his statue and political history calls the common currency Euro the cancer on the European body economic and the danger to the very existence of the EU, it should be clear to everybody that there is something rotten in current European arrangements.

Euro Survival: The Triumphs of Politics?

Previous analysis and all the available data would suggest that the common currency Euro in its present configuration should not survive. Its costs for the "South" are staggering, with no realistic hope of the way out. But Euro survives nevertheless. Why?

Prevailing opinions explain this "mystery" by a combination of several "realities". Germany in this picture benefits from the current situation. From its point of view the Euro is strongly undervalued (using the recently reported study of Deutsche Bank by about 25%) which only adds to German globalization advantages elucidated above. And as long as the ECB policy keeps inflation under control, German advantages will persist. Having a strong economic and budgetary position facilitates German support for the EU bailout policies (and bailout funds like ESM), designed to mitigate the worst impact of the crisis on the "South" (together with other policies described in Rusek, 2013). Together with ECB's OMT policy designed to counteract the market generated shocks to the sovereign fiscal positions as long as the affected countries exercise a fiscal restraint, this approach stabilizes the "South" economic position, albeit at a rather low level of the economic activity.

"Southern" countries accept this policy approach and support it (rather reluctantly) by limited structural reforms and a fiscal restraint under the EU (and indirectly the ECB's) supervision. Their rationale appears to be the fear (often fed by rather alarming speculation cum studies of financial companies and international institutions) of the "catastrophic" consequences of leaving the Eurozone and re-establishing the monetary autonomy.

But one may argue that there is more to the "southern" persistence to remain the part of the Eurozone than the limited "northern" help and the (rather irrational) fear of the "unknown".

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After all, no matter how self-centered the Eurozone is, it will remain the part of the world economy. And (as pointed out above) the globalization processes have a protracted negative impact on the "Southern" countries. Their need for structural reforms (basically across the board) is evident not only to elites, but to the majority of the population as well. The return to the own currency would certainly help to mitigate the current difficulties. But by removing (or rather by postponing) the pressure to adjust, those countries would face the danger of falling of the group of developed countries. Moreover, they would face the worsening situation basically alone.

The membership in the Eurozone (and the EU) provides the desired cover to elites to push for the unpopular structural reforms, in some sense a protection against some globalization pressures and, last but not least, the voice in policies shaping the outside environment. Moreover, assuming that the current difficulties may be overcome (or at least stabilized), the overall structural transformation of the EU economies is the only source of the funds (capital inflow) needed to finance successful structural reforms of "Southern" countries necessary to preserve their position in the world economy. And here the membership in the Eurozone is, indeed, of a paramount importance.

CONCLUSION

Eurozone is, first and foremost, the political creation. And as a such, its survival, with or without reform, is and always will be a political decision. Indeed, economic realities influence politics. But the policy – and hence the politics – is about more than the economy. Today both the "Northern' and the "Southern" European nations see their future in the European Union as the commonality of sovereign nations. EU institutions are the part of this shared attitude – which includes the current Eurozone. Economic reality is important, but it is only a part of the shared parcel. The realities, political views, and perceptions may change. But the Eurozone will survive as long as the interests underlying the political determination exist.

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