

22 February 2012

Eurozone Must Rebalance More So than Retrench its Way to Stability

The core problem in Eurozone is that of internal rather than external imbalances. The overall single currency area is running a broadly neutral balance of payments position and the fiscal deficit is relatively modest by comparison with other leading developed economies. However the period of easy credit and misjudged country risk from the introduction of the Euro until about 2007 spawned a growing imbalance in competitive conditions between the core economies like Germany and the so called PIIGS economies. The cumulative divergence in CPI indices and in unit labour costs over this period bears testament to the scale of the imbalance in competitiveness that now exists (see chart). Severe fiscal deficits in the PIIGS economies are a notable symptom of the problem, but the overall imbalance is best described with reference to large balance of payments deficits in Portugal, Italy, Greece and Spain mirroring large surpluses in Germany, Netherlands etc.

The depression prone PIIGS economies cannot achieve the illusive growth factor until the imbalance in competitiveness is rectified. Ongoing deflationary fiscal retrenchment is necessary in these economies but austerity fatigue will become an increasing political and social risk in the more advanced stages of retrenchment unless a return to growth starts to bring unemployment down from worryingly high levels. Various initiatives by governments to create employment are doomed to failure unless the conditions for growth and employment are present in the form of more competitive labour markets in these economies.

The only way to restore competitiveness, growth and employment in the PIIGS economies is through a major reduction in unit labour costs relative to Germany. The traditional fast route to renewed competitiveness through currency devaluation is clearly not available in the context of continued Euro membership. Furthermore, it seems quite possible that any attempt to re-introduce former currencies would fail. Gresham's law observes that strong currencies drive out weak currencies and a likely severe lack of public confidence in a re-introduced currency would be a strong force for the relevant country to remain de facto "Euroised". So direct adjustment in relative labour costs is the only realistic solution.

The required rebalancing of competitiveness is as much about reflation in Germany etc as it is about ongoing deflation in the PIIGS economies. Ongoing fiscal and wage deflation is absolutely required in the PIIGS economies but so too is a period of rising wage inflation, driving a relative boom in domestic demand, in Germany and other core economies. This pincers movement would be a natural rather than artificial resolution to the problem. It is vital that policy makers recognise this because a solution based solely on retrenchment in the PIIGS economies is dangerously prone to eventual political and social breakdown.

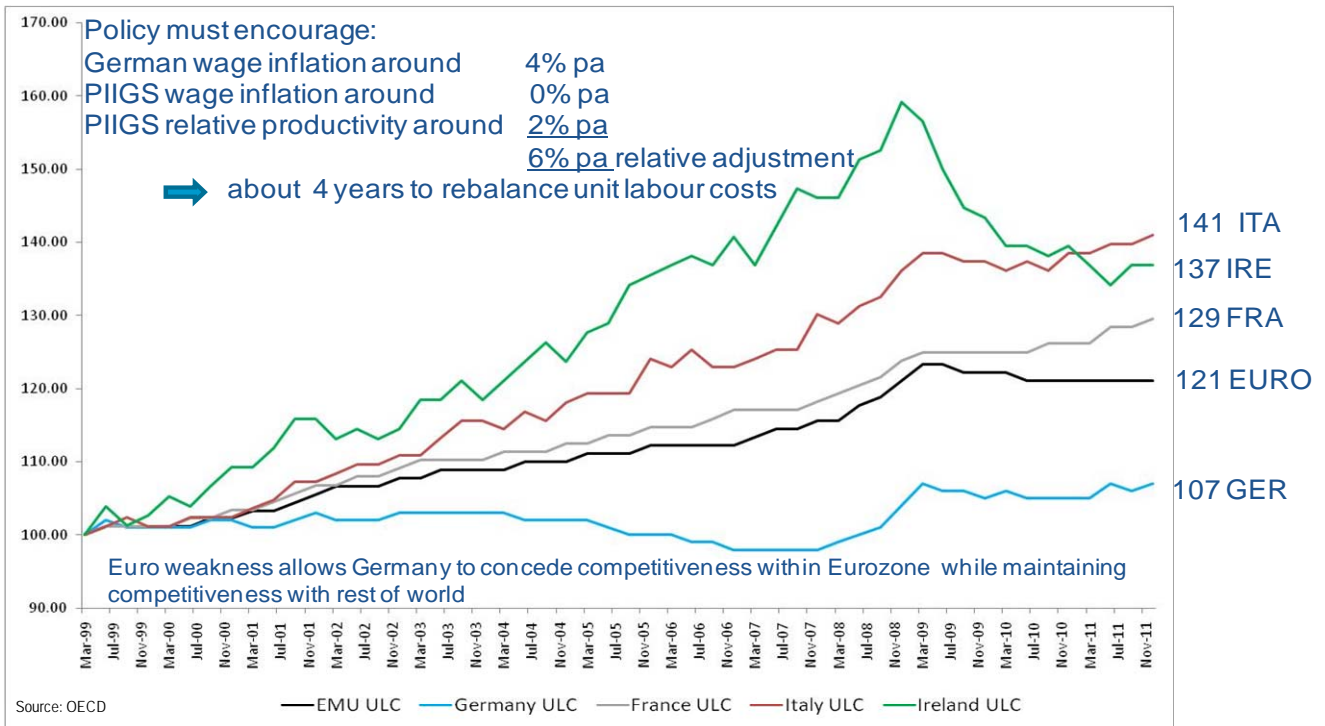
The natural tendency of labour markets is already facilitating this pincers movement. With unemployment at a 20-year low in Germany, labour unions are demanding wage increases of 4% and more. Meanwhile, with unemployment at worrying record highs in the PIIGS economies, the trend is towards a sustained freeze in wages at best. There must certainly be "low lying fruit" in terms of potential productivity improvements in the PIIGS economies and the German template for bringing down unit labour costs is there to be copied. Provided that the required labour market reforms are implemented, it is reasonable to expect that these economies can now achieve productivity improvement of say 2% per annum relative to Germany over the next few years. A 4% per annum relative adjustment in wages together with a 2% per annum relative adjustment in productivity amounts to a 6% per annum rate of rebalancing and about four years of this would unwind the overall imbalance in competitiveness between PIIGS and Germany. Growth would start creeping back into the PIIGS economies as they regain competitiveness and as their exports benefit from rising German domestic demand on the back of generous pay settlements.

A weaker Euro also plays a very important role. Euro weakness allows German companies to concede competitiveness within Eurozone while maintaining competitiveness with the rest of the world. Many of the PIIGS economies are not significant direct beneficiaries of Euro weakness because their exports are mostly within Eurozone. However, they do benefit indirectly when Euro weakness spurs strength in German exports to the rest of the world that in turn feeds through to stronger German domestic demand.

Policy makers must let nature take its course. A pick up in wage inflation in Germany, Finland, Netherlands etc should be seen as good news rather than bad news. The ECB should be planning for higher than target inflation in Germany as an offset to lower than target inflation in PIIGS as it adjusts its policy settings with reference to overall Eurozone inflation.

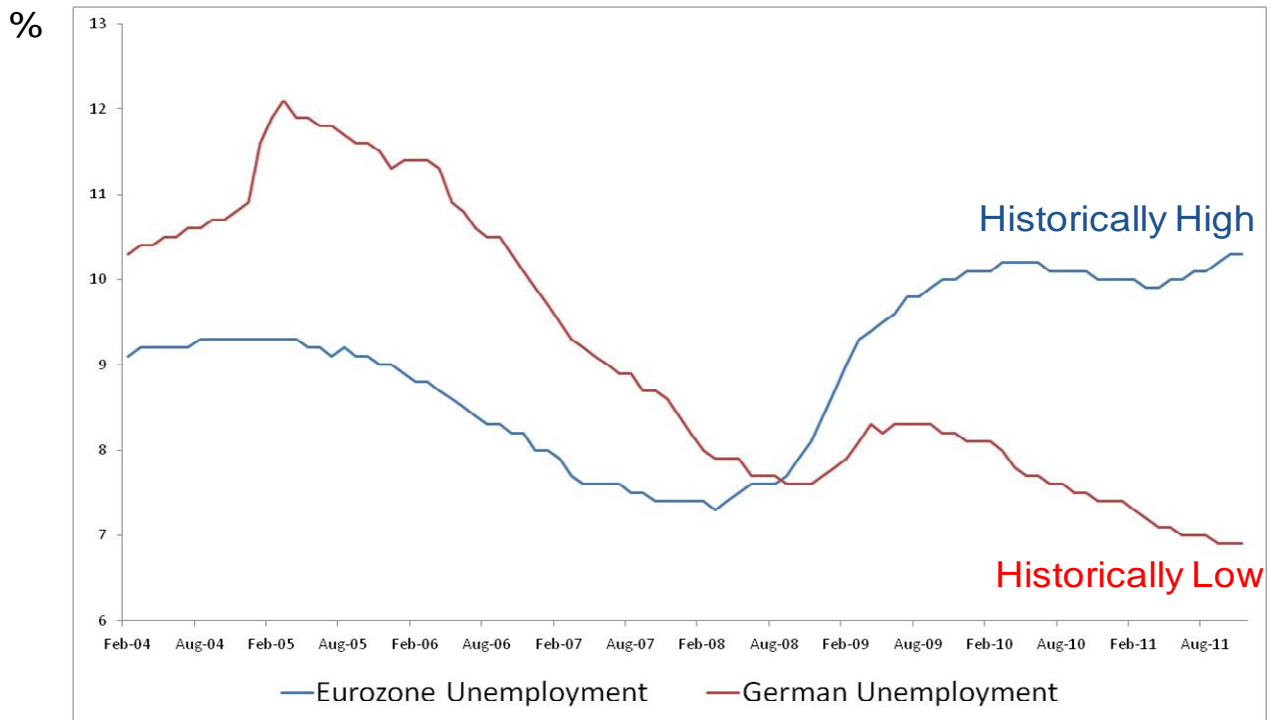
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Eurozone Must Rebalance Rather than Retrench its Way to Stability

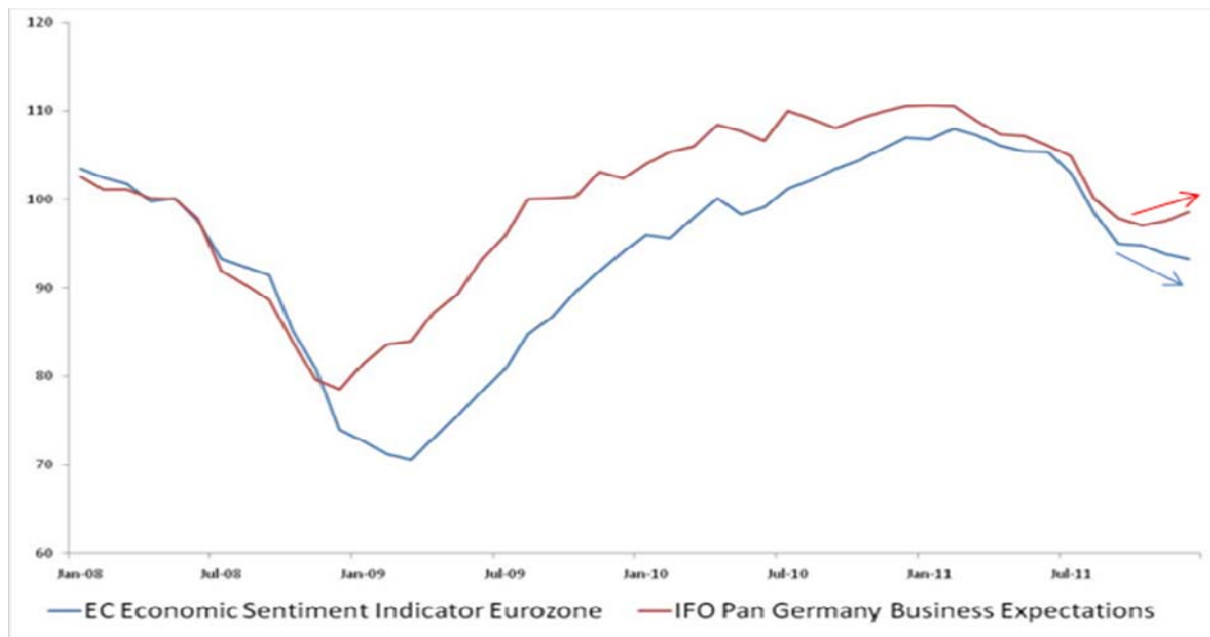


Rebased to 100 in January 1999

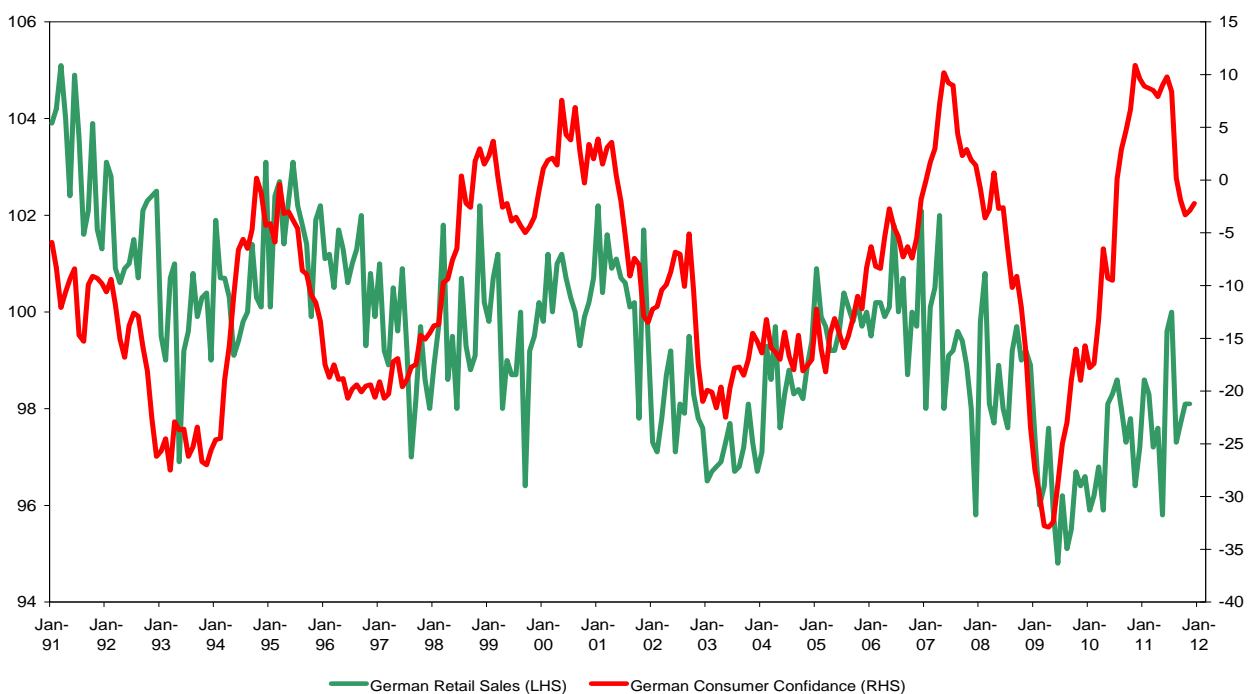
Labour market forces are a natural agent for rebalancing but policy must encourage rather than discourage this



Conditions are right for Germany, Finland etc to accelerate relative to PIIGS



Germany can be an engine for Eurozone rebalancing & reflation





Strategy Update

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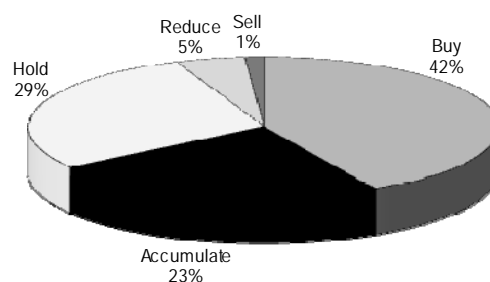
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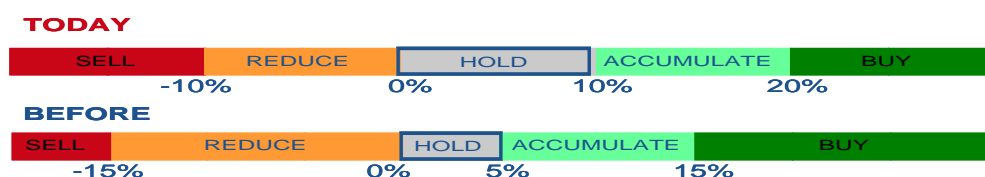


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