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# The Economics of the Eurozone

## *The Chronic 'Flu'?*

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For the last decade the media and economics community have become familiarly accustomed to narrating a poor performing Eurozone. Debt crises, growth crises, disintegration talk and a rise in right wing politics have left permanent scars on the credibility of the Euro currency. This is not surprising. Whilst periods of subtle respite, falls in monthly indicators is hardly headline news. As of recent years, industrial production has fallen, as has business confidence, along with retail-sales growth. Leading indicators for GDP begin to decline in growth, suggesting that the trajectory of economic progress is on the further decent. And this is 10 years after the 'European Debt Crisis' began. After such a large period of what economists would now call 'hysteresis' (some may call this a very shallow cycle), why does the Eurozone continuously falter? Why is progress anaemic? It may not be hard to guess, but one issue is demanded sided; there is a lack of activity. However more worryingly, the biggest issue is one of the 'supply side'. The context within which demand and growth is created is highly faulty. In other words, the architecture of the Eurozone is dysfunctional and unsustainable 'for' growth. This area of contest has been heavily studied, particularly from the economist's lens. Economics often cites the 'Optimum Currency Area' theory of Robert Mundell to argue how the Eurozone is 'not' optimal. But this is misleading and not empirically complete. This diagnostic synopsis will consider the issues with the Eurozone, extending from the present dominance of critiques you will read from mainstream academia.

## *The Eurozone Architecture - Chronic Flu*

A set of 'guiding' principles outlined under the 1992 Maastricht Treaty and implemented in 1999, the problems of the Eurozone can be traced back to these very rules. Politicians at the time were more focussed on the progression of the political ideology under the 'European Project' via monetary integration without considerations of how it could be economically stable and equitable. This is where the debates over the endemic Eurozone crisis revolve. The main question that arises is whether 'Europe is an optimum currency area'? Robert Mundell applied the common definition of a currency area as a "domain within which exchange rates are fixed". For him an optimum currency area is a region and not the nation, where he strikes vital importance to the mobility of capital and labour. Europe needs high internal factor mobility and high external factor immobility if it 'is' to be successful. A (brief) synopsis of the theory would suggest that external shocks (for example, global recessions) cannot be absorbed where European factors such as labour cannot adjust or change. Due to limited labour mobility in Europe, it is suggested that there is a higher risk of unemployment in the case that both employees and employers cannot balance against economic shocks, such as through firing workers. Labour is largely immobile for linguistic, economic and cultural reasons. This is the common perspective, albeit stylised in subtly different ways.

But this perspective is contradictory. The highly 'immobile' countries are those that are more 'successful'. The likes of Germany, Finland, Netherlands and Austria fall into this category. These countries operate an export-led growth model built on wage coordination, complementary use of vocational training and generous welfare systems to protect against the investments in skills. Yet the relatively more 'mobile' countries of 'southern' Europe are the poor performing states. So why is this?

Firstly, from a regional perspective, the Eurozone is marred by poor performance simply because they have combined too many countries that are too economically dissimilar. Whilst this perspective is an encompassing feature of the optimum currency areas, my reasoning is slightly different. The way in which different nations accumulate growth is too varied, in the sense that creates regional divisions, or in other words, a ‘two-speed’ Eurozone. You have Northern Europe who can sustainably create a ‘high value-added’ industrial base, whereas Southern Europe is stylised by a ‘low value-added’ industrial base built on low cost labour. The reason this is can be studied from the field of ‘political economy’, the combination of politics and economics. The political economy of Northern Europe is designed as such that industrial competitiveness can be maintained via a stabilisation of wages and high export activity. Generally these exports are sold to the Southern European states, whose economies are based on consumption and as such private debt. These countries cannot maintain competitiveness given they have little means to adapt. Nonetheless, a slowing Germany generally means a slowing Eurozone as competitiveness is the key differential through a capital transfer cycle.

Secondly, from a national perspective, macroeconomic theory suggests that countries can only adjust and maintain competitiveness through the following mechanisms. Countries can change their exchange rates (external devaluation), monetary policy stance, fiscal policy stance and/or through wage moderation (internal devaluation). National Governments/authorities of the Eurozone, since they are part of a single currency, give up some of these mechanisms to adjust. They cannot devalue their currency, nor do they have power to change monetary policy, this is decided by the independent European Central Bank. They have less power to change their fiscal policies, this is a politically sensitive area (nationally and at the European level) and one that is bound by the Stability and Growth Pact (SGP - although very few countries adhere to these 'rules'). This leaves adjustments through wage moderation as the only tool to maintain some competitiveness. In a short sense this is where the problem lies. Germany and neighbours, with trade unions work for the benefit of industries by stabilising wages at a level commensurate such that the unit labour cost (ULC) is reduced or maintained. Southern European states have more decentralised wage systems meaning a lack of moderation. Relative unit labour cost adjusts upwards, with a returning increasing real exchange rate, relative competitiveness declines. The capital transfer cycle accelerates.

## *Structural Adjustments and Political Desire*

This orientates the view that the Eurozone is merely fiscal towards a view that labour market institutions matter through the ability of some countries to shift their real exchange rate downwards (increasing relative competitiveness) via wage moderation. The issue is supply-sided. As such, the Eurozone needs significant structural adjustment (an economist's version of 'gutting') and political will to do so. This does not seem an imminent agenda.