The wrong solution for the wrong problem: Why Europe needs to shift away from fiscal policy and focus on labor markets

By Alison Johnston, Oregon State University

As the European debt crisis enters its sixth year, European elites continue to propose new policy "solutions" that previously were deemed by integration scholars as a bridge too far. From the creation of Europe's first banking union to the establishment of common EMU fiscal resources that faltering member-states could draw upon, to even Angela Merkel's vocal support of a disciplinary fiscal union, giving the EU unprecedented veto powers over national budgets[1], Europe's Economic and Monetary Union (EMU) has an abundance of action plans.

Thus far, these suggestions have been ineffective at restoring confidence in the common currency. Though one could argue that it is too soon to assess new banking reform, the European Financial Stability Facility and the European Financial Stabilization Mechanism, launched in May, 2010, have proven woefully inadequate at calming market fears of instability in EMU's peripheral economies (Greece, Ireland, Italy, Portugal, Spain and now Cyprus).

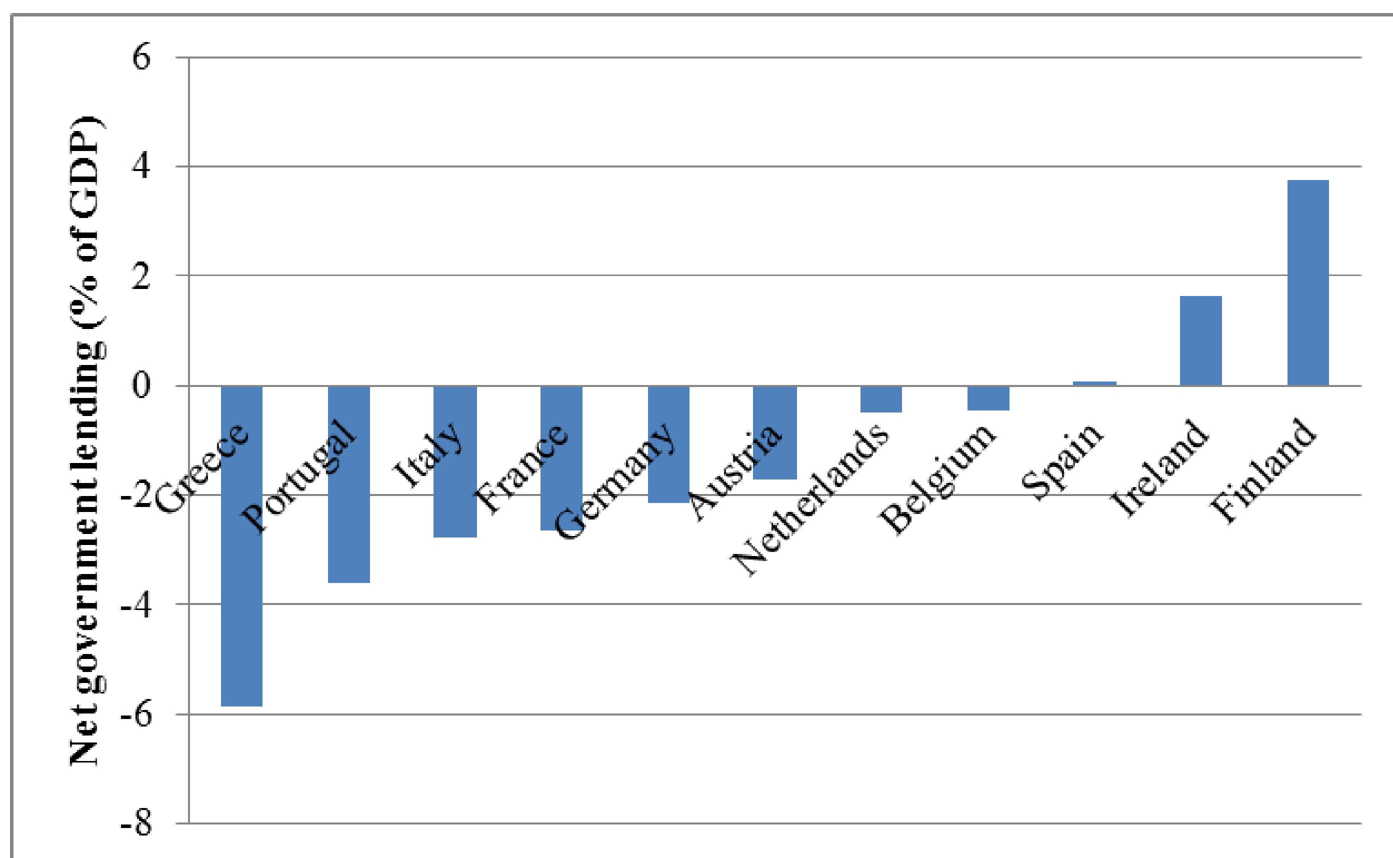
Why has Europe been unable to get out of this mess? A convincing case can be made that it simply lacks the resources at the EU level. Complete optimal currency areas, national currency zones, are not immune from asymmetric economic shocks between regions that cannot rely upon tailored monetary policies for adjustment. Yet unlike EMU, national currency unions can rely upon significant fiscal redistribution from booming to stagnant regions through a centralized fiscal budget.

Lacking this important re-distributionary crisis management tool, the EU has turned towards its familiar regulatory role of increasing the monitoring of member-states' fiscal balances, attempting to introduce more stringent measures to penalize "excessive" deficits. While one can question the credibility of this new wave of fiscal monitoring (if the EU was ineffective at monitoring fiscal deficits before 2008, what will make it effective now), this regulatory approach suffers from an additional caveat: EMU's current crisis is not the result of widespread fiscal mismanagement.

Though the US sub-prime mortgage crisis and the bankruptcy of Lehman Brothers have been widely acknowledged as critical catalysts of Europe's crisis, the fiscal hypothesis (that EMU's peripherial economies are heavily exposed to crisis and speculation because of their reckless fiscal records before 2008) has gained significant traction among Europe's policy elites. Given that the crisis originated in Greece, which emphatically was a fiscal basket case, this perception has spread to EMU's other "weakest links", as the trioka (the EU Commission, European Central Bank and the International Monetary Fund) perscribe the same policy solution – a large dose of austerity in return for bail-out assistance.

A look at EMU's pre-crisis fiscal balances suggests that there is a significant problem with this story. While Greece and Italy certainly conform well to this account (both countries had persistent deficits and high debts during EMU's pre-crisis years, see Figures 1 and 2 below), the rest of EMU does not. Spain and Ireland, which have encountered significant speculative pressure, consistently achieved fiscal surpluses between 1999 and 2007, and were among EMU's lowest debt performers. Belgium, which had a debt level exceeding 100% of GDP entering the crisis, and Germany and France, whose deficit records between 1999 and 2007 were largely similar to Italy's, have emerged unscathed.

Figure 1: Net government lending EMU11 (1999-2007 average)



Note: Positive/negative values indicate fiscal surpluses/deficits. Source: EU Commission's Directorate General for Economic and Financial Affairs Annual Macroeconomic Database (AMECO)

If fiscal records are not a consistent explanatory factor, then what separates those exposed to and spared from speculative crisis? One debate which is gaining significant ground is that divergence in speculation by financial markets was not tied to a country's fiscal, but total solvency, which was reflected in the size and persistence of a country's current account deficit, or *trade competitiveness*, during EMU's first decade (see Obstfeld and Rogoff, 2009, Wihlborg et al., 2010; Giavazzi and Spaventa 2011).

The "competitiveness" position provides a more encompassing explanation of diveregences in speculative crisis; the basic argument is that EMU's periphery ran persistent current account (trade) deficits with EMU's core (Austria, Belgium, Finland, France, Germany and the Netherlands), and had to rely upon external borrowing (predominantly from the same EMU countries it ran trade deficits with) in order to finance them, which ultimately exposed them to the current crisis. In considering both public and private elements of borrowing, the "competitiveness" argument highlights why the fiscal hypothesis offers neither a necessary nor a sufficient condition for speculative attacks; countries with public debt can avoid speculative attacks if they produce significant private savings (i.e. Germany) in the capital account, while countries with public savings can be subject to aggressive speculation if they produce significant (external) private dissavings (Ireland and Spain).

This argument is also more sound empirically. Unlike the fiscal hypothesis, which largely relies upon the experiences of Greece and Italy, the competitiveness hypothesis can explain the experiences of all EMU11 countries.

As the competitiveness hypothesis gains greater traction, many have attempted to dissect what features made EMU's core economies more competitive, and capable of running consistent trade surpluses, vis-à-vis their peripheral neighbors. A growing consensus has highlighted the importance of national unit labor costs, or more specifically differences in the core's and periphery's capacity to deliver wage moderation (keeping wage growth below productivity and inflation – Stockhammer, 2011; Holinski et al., 2012).

The EMU core ran persistent current account surpluses vis-à-vis the periphery because it persistently undercut wage growth developments in the periphery (see Figure 5), lowering their national inflation rate, and hence their real exchange rate, making their goods more competitive. Recent scholarship suggests that one factor which enabled the core to deliver significant wage moderation was corporatist institutions that granted exposed sector wage setters, the state, or both, pivotal agenda setting or veto powers in national wage setting (Johnston, Hancké, and Pant, 2015).

By using these institutions to successfully undercut wage-growth in the periphery, essentially a beggar-thy-neighbor policy, EMU's core economies' were shielded from the solvency crisis due their healthy current account surpluses that were in part delivered by their corporatist comparative advantages.

The crisis of EMU may primarily be a result of differences in wage-setting systems between north-western Europe and southern Europe, in which the former have been able to keep aggregate inflation under control through wage coordination, while the latter appear unable to do so. Understanding the EMU crisis in this manner alerts one to the fact that the crisis in the periphery was not caused by the periphery alone. By targeting unit labor cost growth below that of their trading partners, and using relatively tight systems of wage coordination to do it, EMU's creditor countries, one could argue, have imposed current account deficits on the others who lacked the institutional capacity to moderate wages.

What this suggests in terms of policy solutions, aside from the fact that national labor markets remain an important source of adjustment in monetary union, is that focusing on peripheral economies alone will not solve Europe's present crisis. Readjustment in the North, namely through wage inflation or demand stimulus, is required to correct the significant imbalances that have emerged between EMU's north and south. While employers and policy makers in EMU's northern economies remain largely opposed to such recommendations at present, Europe is likely to witness stagnant growth and high unemployment in the South for quite some time if the North continues on its present course. Alongside arguments for structural adjustment in the south, the European Commission should also consider using its influence to argue for significant wage increases or fiscal policies which increase disposable income, such as reductions in income and labor taxes, in the EMU core for several years to come in order to allow southern Europe the space to adjust.

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[1] http://www.bbc.co.uk/news/world-europe-15997784

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