

WHAT ARE THE EURO ZONE'S MAIN DIFFICULTIES?

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We look at the euro zone's major structural difficulties and the ways to correct them. They are: the growing heterogeneity of the member countries' economies, due in particular to diverging productive specialisations and the fact that this heterogeneity is not corrected by federalism; the end of capital mobility between OECD countries; the lack of coordination of the economic policies that generate externalities between the euro-zone countries; the asymmetrical nature of adjustment mechanisms (fiscal policies, cost competitiveness), which are only implemented by the troubled countries; and the difficulty in managing fiscal policy and public debt.

Keywords: Euro zone, Heterogeneity, Economic policy coordination, Externalities.

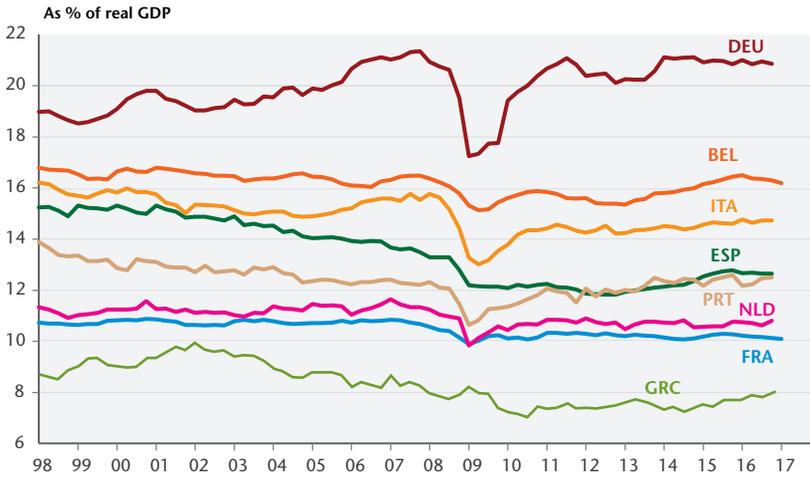
We believe the euro zone's difficulties can be divided into three categories: the lack of mechanism to combat heterogeneities; the lack of economic policy coordination and the divergence in the functioning of labour markets; the errors of economic policies in their design and their implementation.

1. Lack of Mechanism to Combat Heterogeneity

The euro-zone countries' heterogeneity is not due to cyclical asymmetry between these countries (the correlation of cycles is strong between the euro-zone countries, (De Grauwe and Ji, 2017; Belke, Domnick and Gros, 2016; De Haan, Inklaar and Jong-A-Pin, 2008). The heterogeneity is due to structural asymmetries between the countries.

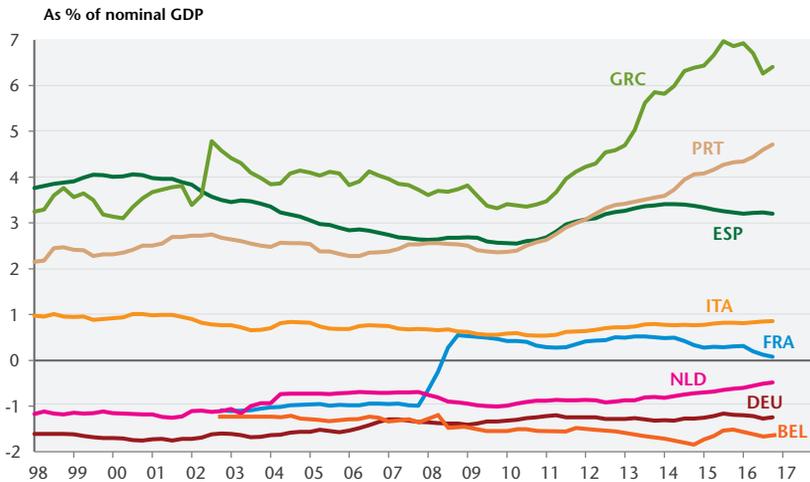
These structural asymmetries are explained by differences between productive specialisations. Chart 1 shows, for example, the weights of manufacturing industry in GDP, Chart 2 trade balances for tourism..

Chart 1. Value added in the manufacturing sector



DEU: Germany, BEL: Belgium, ESP: Spain, FRA: France, GRC: Greece, ITA: Italy, NDL: Netherlands, PRT: Portugal. Sources: Datastream, Eurostat, Natixis.

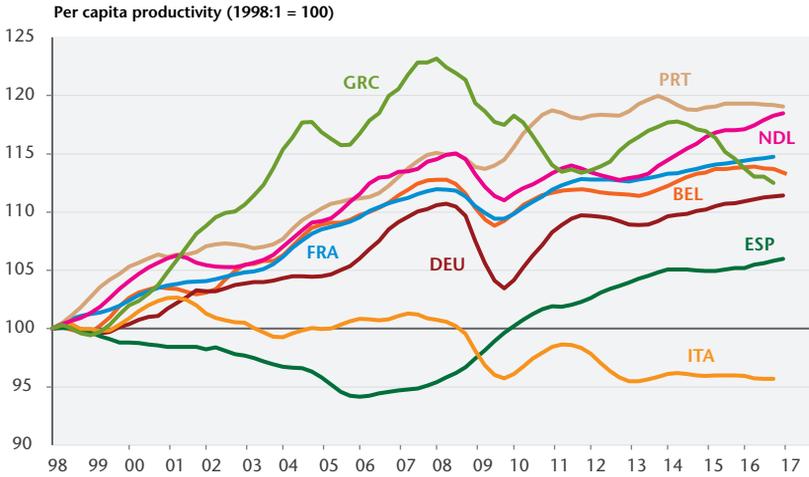
Chart 2. Trade balance in tourism



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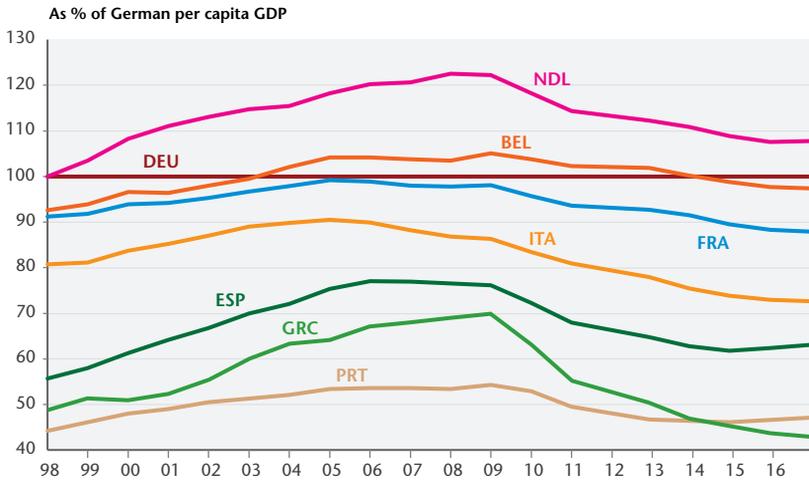
As productive specialisations are different, the result is diverging labour productivity (Chart 3) and therefore diverging per capita income (Chart 4).

Chart 3. Per capita productivity



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Sources: Datastream, Eurostat, Natixis.

Chart 4. Per capita GDP in euros

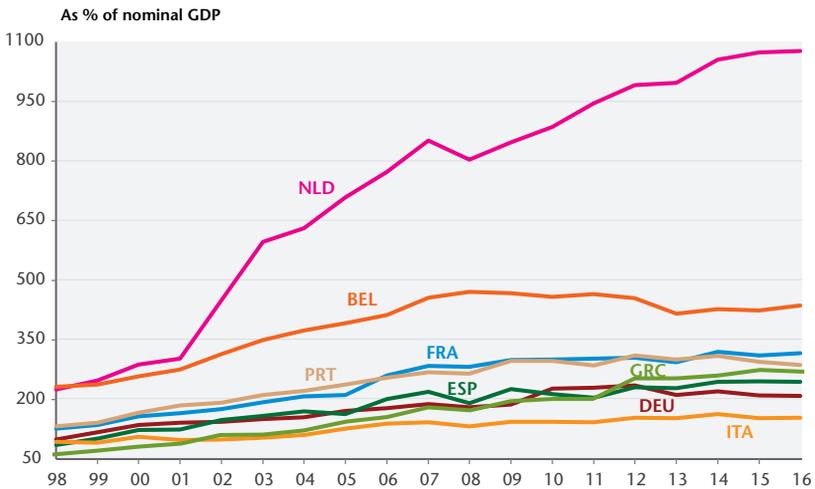


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In a federal state, heterogeneous income levels are corrected by income transfers from the richest to the poorest regions thanks to federalism. This is not the case in the euro zone, where nothing offsets the diverging income levels, which obviously creates a political and social risk in the longer term.

Since the monetary integration in the euro zone has gone very far (with massive external debts and assets in euros, Chart 5), the cost of leaving the euro would probably be huge (Guiso, Sapienza and Zingales, 2016).

Chart 5. Gross external debt



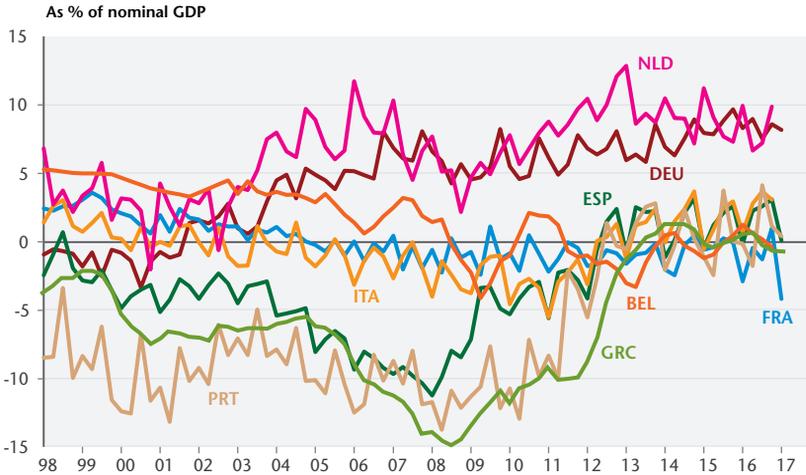
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Sources: Datastream, Eurostat, Natixis.

But the inability to correct income inequalities between the member countries definitely creates a risk of break-up. Some authors also mention that the centrifugal forces are not only of an economic nature, but are also due to asymmetries and cultural differences: role of the State, religion, role of women, solidarity (Guiso, Morelli and Herrera, 2016; Alesina, Tabellini and Trebbi, 2017). The diversity of productive specialisations also led to diverging current-account balances until the euro crisis (Chart 6).

The countries that had structural external deficits (Spain, Italy, Portugal, Greece) were then (from 2010) faced with a balance of payments crisis, a “sudden stop”, as they were unable to finance their external deficits. This crisis forced these countries to reduce their

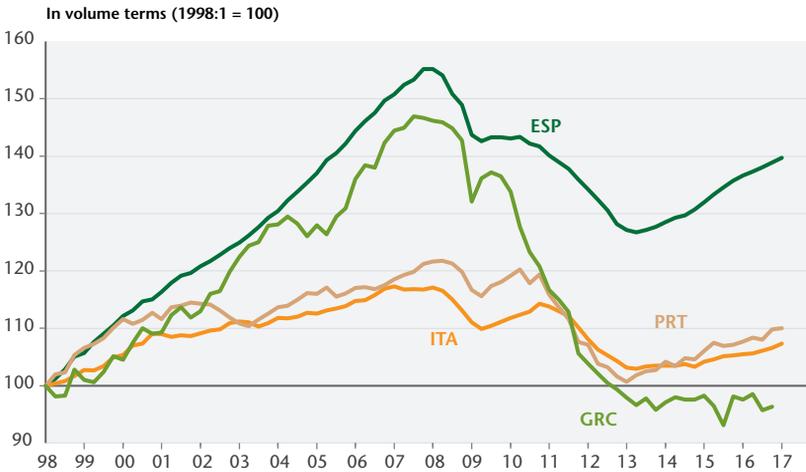
domestic demand (Chart 7), enabling them to eliminate their external deficits.

Chart 6. Current-account balance



DEU: Germany, BEL: Belgium, ESP: Spain, FRA: France, GRC: Greece, ITA: Italy, NDL: Netherlands, PRT: Portugal.
Sources: Datastream, Eurostat, Natixis.

Chart 7. Domestic demand



ESP: Spain, GRC: Greece, ITA: Italy, PRT: Portugal.
Sources: Datastream, Eurostat, Natixis.

The divergence of current-account balances until the euro crisis in 2010 was initially due to the divergence of productive specialisations. But it was worsened by the excessive growth in real estate investment (Lane and Pels, 2012), the lack of monitoring of external deficits at the time (Giavazzi and Spaventa, 2010), Blanchard and Giavazzi, 2002), the lack of market discipline (financial markets did not correctly value the risks related to indebted countries, Wickens (2016), Dellas and Tavlas (2012), Shin (2012), and the correlations between sovereign crises and banking crises, (Mody and Sandri, 2011, Reinhart and Rogoff, 2011).

We do not claim in this paper that the entire divergence between current-account balances is explained by a divergence of productive specialisations. There are obviously also the causes mentioned above, especially a poorly managed financial integration until 2009 (Delatte-Ragot, 2016): the countries that had surplus savings lent to the countries with a shortfall in savings, and these loans were partly used for speculative or unproductive purposes: financing of the real estate bubble and excessive household borrowing in particular.

But we believe it is clear that the divergence of productive structures played and will continue to play a major role, and we can now see that it cannot be corrected by “six-pack” rules: what is the point in imposing a maximum external surplus on Germany if this country concentrates industrial production in the euro zone?

It therefore seems that federalism is necessary for two reasons. First, to correct increasing standard of living disparities between the countries through income transfers; second, to correct the impacts of productive specialisation disparities on current-account balances: income transfers between the member countries would balance the current accounts, even with trade imbalances.

This finding seems obvious: so why is federalism not implemented in the euro zone? The current economic policy debate on the issue of institutional reforms in the euro zone clarifies this point. The “French” view is that the bases of federalism must be created (euro-zone budget, financed by common taxes or by issuing eurobonds).

The “German” view is that the countries' heterogeneity is primarily due to poor economic policies. It is therefore the responsibility of each euro-zone country to avoid excessive fiscal deficits and to implement the structural reforms that can restore potential growth and lower structural unemployment.

Our point here is that the countries' heterogeneity – beyond possible economic policy errors – is mainly explained by the inevitable, normal and even desirable divergence of productive specialisations.

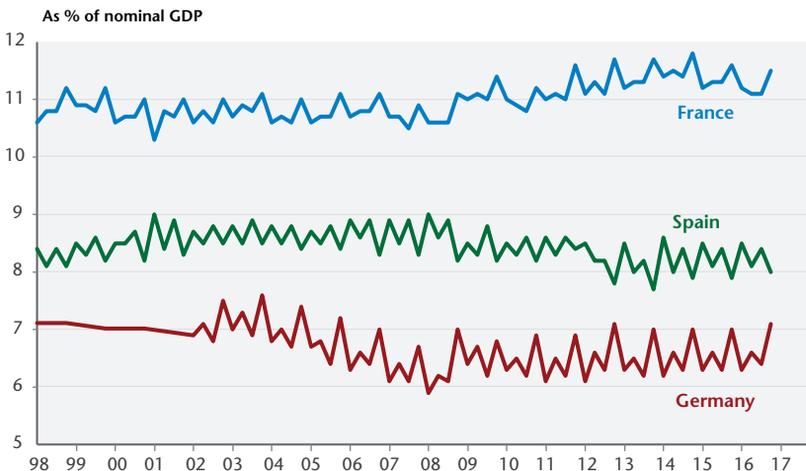
This heterogeneity between countries cannot be corrected if it is due to a legitimate divergence of productive specialisations caused by the divergence of the countries' comparative advantages. Accordingly, it is permanent transfers from rich to poor countries that must be considered.

2. Lack of Economic Policy Coordination and Functioning of Labour Markets

In a currency area, differences between economic policies or gaps between production cost levels obviously cannot be corrected by exchange-rate fluctuations. This requires coordination of economic policies and wage policies when they generate externalities between the other countries.

Coordination of economic policies is nonexistent. We see, for example, that Germany lowered social contributions for companies in the first half of the 2000s, Spain has done so since 2009, and France is about to do so (Chart 8), with the clear objective of gaining market shares against other countries.

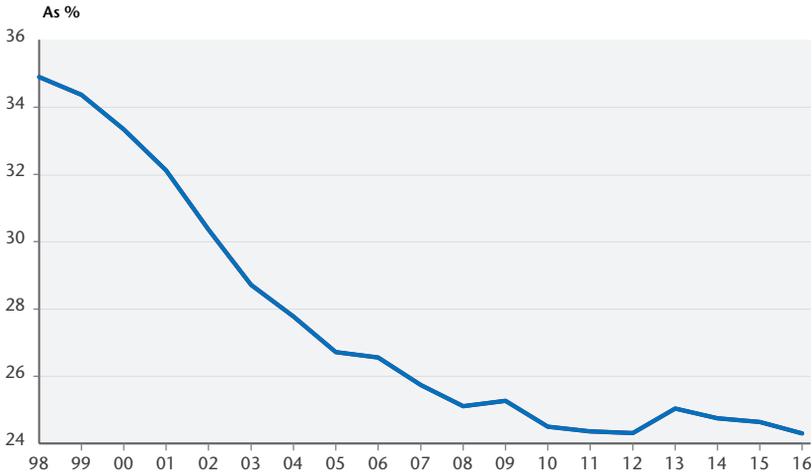
Chart 8. Companies' social contributions



Sources: Datastream, Eurostat, Natixis.

We see that tax competition also works through a lowering of corporate taxes, and that this has led to a continuous fall in average tax rates on earnings in the euro zone (Chart 9).

Chart 9. Zone euro*: Average tax rate on corporate profits



* Eu-10 average.

Sources: DG Taxation and Customs Union, OECD, Natixis.

The lack of tax policy coordination in the euro-zone countries leads to a risk of a “race to the bottom” (Mendoza, Tesar and Zhang, 2014): a convergence towards a very low tax rate in all countries with mobile production factors, requiring a sharp reduction in public spending and in the generosity of social welfare.

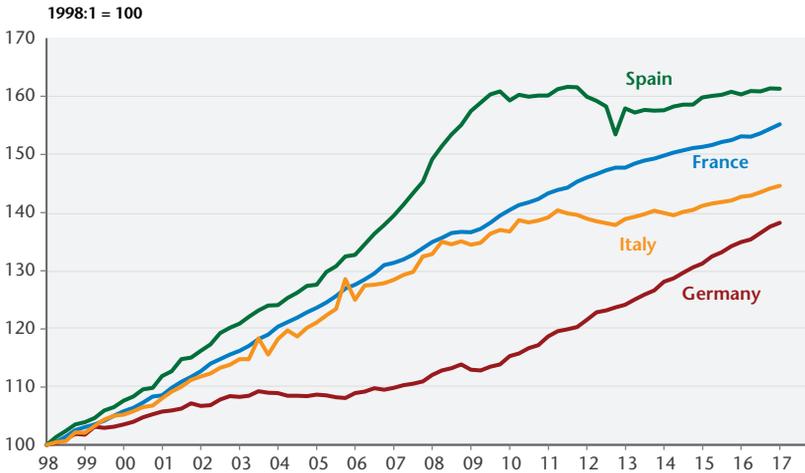
The same holds for wage formation. Labour markets function differently in the different euro-zone countries, and the wage formation models are not coordinated. This has led to diverging wages and labour costs since the creation of the euro (Charts 10 and 11).

Some countries may therefore accumulate a significant cost competitiveness shortfall against the other countries (Spain until 2008, France and Italy currently), forcing them to implement an internal devaluation (a contraction in wages in a currency area), like Spain from 2009, with the associated costs: declining domestic demand, rising unemployment (Chart 12).

By depressing activity and inflation (since labour costs fall), internal devaluations also give rise to public debt crises by worsening countries'

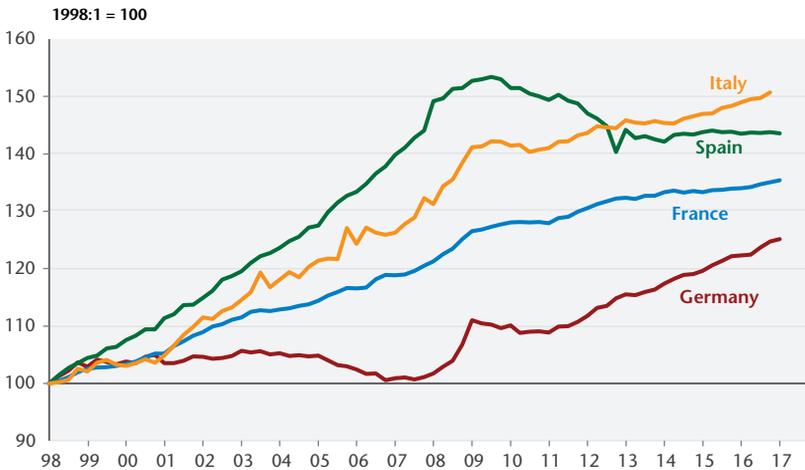
fiscal solvency. To make progress, the euro zone should therefore coordinate the tax policies that generate externalities; it ought to introduce a form of “labour market union”, to make wage formation between countries more similar and prevent cost competitiveness divergences.

Chart 10. Nominal per capita wage



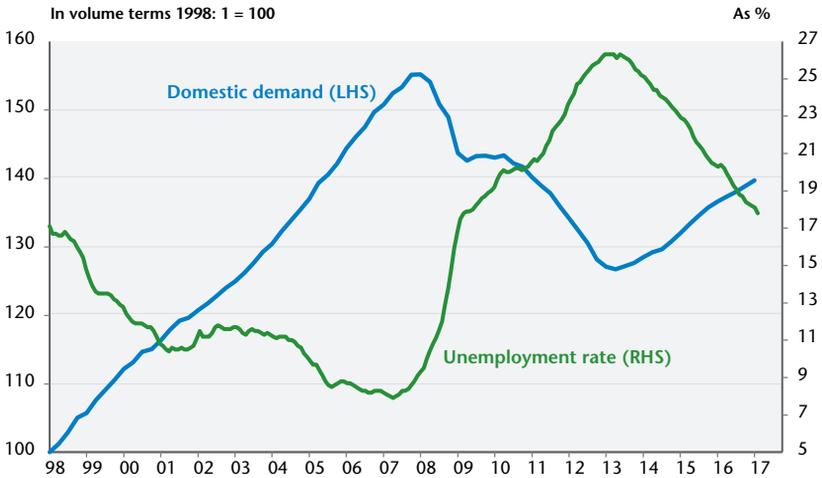
Sources: Datastream, Eurostat, Natixis.

Chart 11. Unit labour costs



Sources: Datastream, Eurostat, Natixis.

Chart 12. Spain: Domestic demand and unemployment rate



Sources: Datastream, Eurostat, Natixis.

This would require drawing up a list of all externalities that a euro-zone country's economic policies have on the other countries, and reactivating the concept of subsidiarity: as soon as there are significant externalities, economic policies should be coordinated; otherwise the principle of subsidiarity should apply: policies are better defined at the level of each country.

Admittedly, it may be difficult to identify externalities; if for example a country reduces social contributions paid by employers, it is logical to think that this will destroy jobs in the other euro-zone countries, but the magnitude of this negative externality would have to be quantitatively estimated. The problem here is obviously also political: in reality, no country will accept the abandonment of sovereignty that a coordination of the economic policies that generate externalities would require.

3. Economic Policy Errors in Terms of Design and Implementation

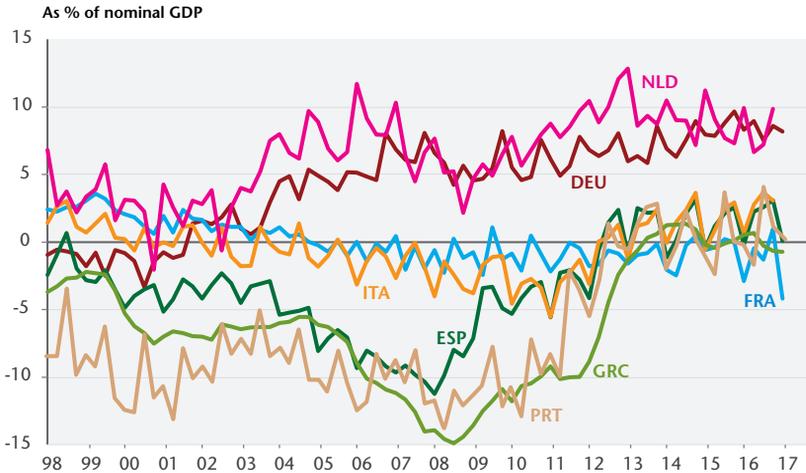
3.1. Design

We first believe there are two serious problems in the way euro-zone economic policies are designed.

The first concerns the asymmetry of adjustment processes. If a euro-zone country has a cost competitiveness problem, it has to reduce its

production costs without the other member countries increasing their costs (we saw above the case of Spain from 2009); if a country has a problem with its external deficit, it has to eliminate it while the countries that have external surpluses keep them (Chart 13 shows the contrast between Spain, Italy, Greece and Portugal on the one hand, and Germany and the Netherlands on the other hand).

Chart 13. Currente-account balance

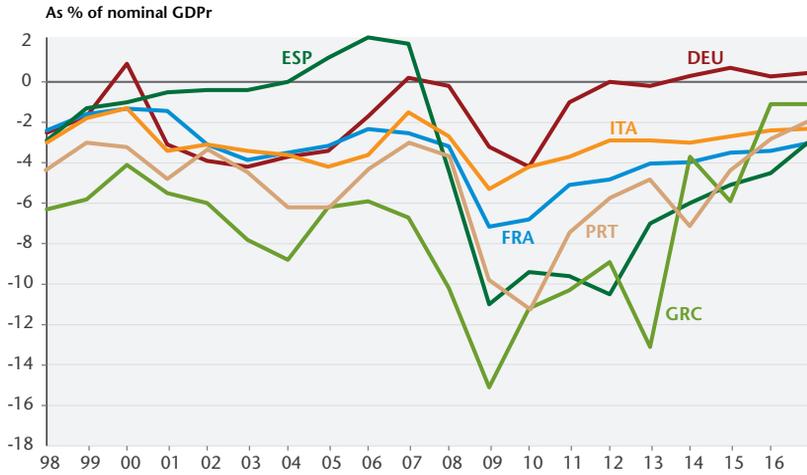


Sources: Datastream, IMF, Natixis.

If a country has a fiscal deficit, it has to eliminate it, while a country that has a fiscal surplus keeps it (Chart 14 shows the contrast between France, Spain, Italy, Greece and Portugal on the one hand, and Germany on the other hand).

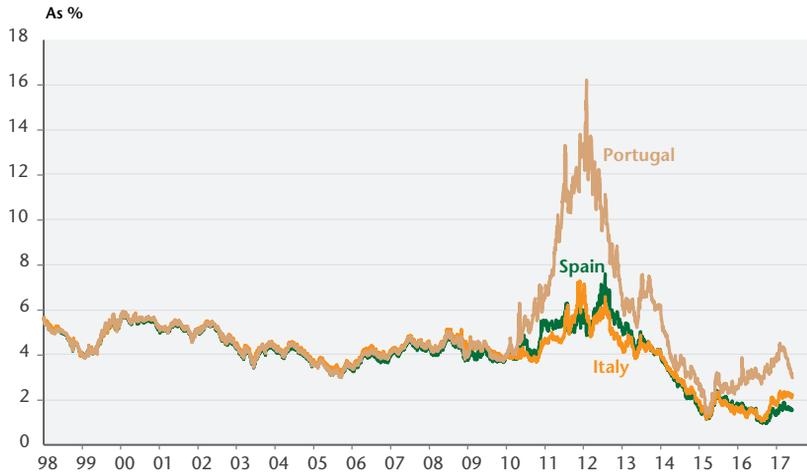
So we see that when economic policy is adjusted in the euro zone, there is always a restrictive policy in the troubled countries and no expansionary policy in the healthy countries, which creates a permanent recessionary bias (Orphanides, 2017). The other error in terms of economic policy design in the euro zone is the management of risk related to sovereign debt. The ECB let some euro-zone government bonds lose their risk-free asset status from 2009 to 2014 (Chart 15 shows the surge in the interest rates on these bonds; De Grauwe-Yi, 2012, 2013; Aizenman, Hutchinson and Jinsarak, 2011), whereas savers need a large quantity of risk-free assets (Caballero and Farhi, 2014; Van Riet, 2017).

Chart 14. Fiscal deficit



DEU: Germany, ESP: Spain, FRA: France, GRC: Greece, ITA: Italy, PRT: Portugal.
Sources: Datastream, prévisions Natixis.

Chart 15. Interest rate on 10-year government bonds



Sources: Datastream, Natixis.

Moreover, as soon as a country's public debt presents a default risk, a possibility of multiple equilibria for this debt appears, one of these equilibria being an increase in expectations of a possible default, leading to a rise in interest rates, and hence an actual increase in the default probability (Ayres *et al.*, 2015; Corsetti and Dedola, 2016; Jaro, cinski and Mackowiak, 2017).

There is no risk of a jump to an equilibrium with high default risk if there is a federal debt without default risk (eurobonds).

3.2. Implementation of economic policies

The key debate here concerns fiscal austerity. Many economists believe that euro-zone governments were wrong in reducing their fiscal deficits, especially the structural fiscal deficit, corrected for the effects of the economic cycle, in 2011 at a time when the unemployment rate and the output gap in the euro zone were still very high (Charts 16 and 17).

It is claimed that fiscal policy, which was restrictive too early, triggered the decline in activity in the euro zone from 2011 to 2014 (Chart 18) and the government bond crisis.

This takes us to the debate on the fiscal multiplier (impact of the fiscal deficit on GDP). Those who criticise the euro zone's fiscal austerity base their criticism on studies showing that the fiscal multiplier is high during recessions or when interest rates run into the zero lower bound (House *et al.*, 2017; Farhi and Werning, 2016).

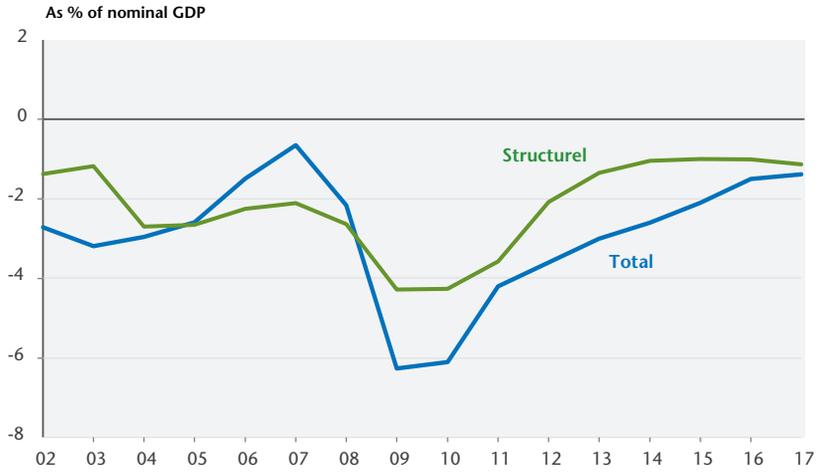
But other studies arrive at a very different conclusion, i.e. that the fiscal multiplier does not depend on the economy's cyclical position, but that it is high if public spending is reduced and low if government spending is cut (Alesina *et al.*, 2017; Alesina *et al.*, 2015).

If this second group of authors is right, the problem with the euro zone's fiscal policy was not the reduction in fiscal deficits from 2011, but some countries' use of an increase in the tax burden instead of government spending cuts to reduce the fiscal deficit (Charts 19 and 20).

It does not seem that the debate on fiscal multipliers is settled, given that the empirical studies have divergent results. A compromise is as follows: the euro zone's fiscal policy was procyclical from 2011 to 2014, and this is open to criticism, but the situation is different now; and the use of increases in the tax burden weakened corporate profitability and investment in many countries.

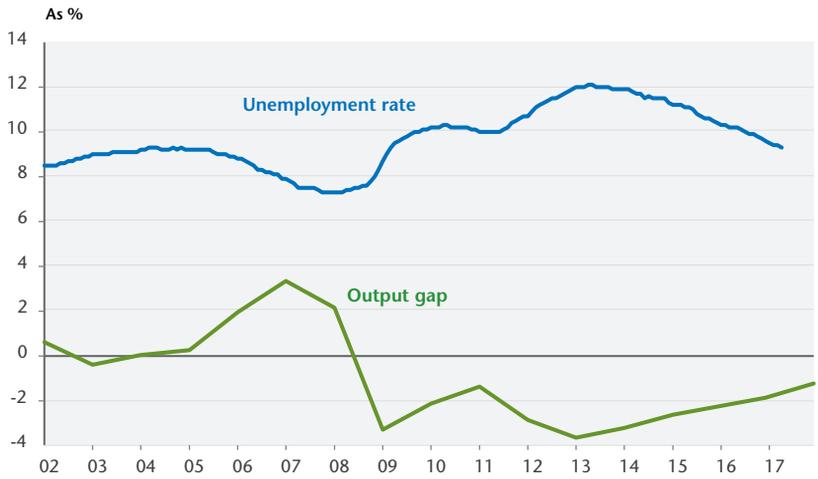
In our opinion, this is no longer one of the euro zone's key problems: the European Commission has enough flexibility to ensure that fiscal policy can be used in the event of difficulties; the euro zone's structural fiscal deficit has increased slightly since 2014, which shows that there is probably less budgetary dogmatism now.

Chart 16. Euro zone: Fiscal deficit



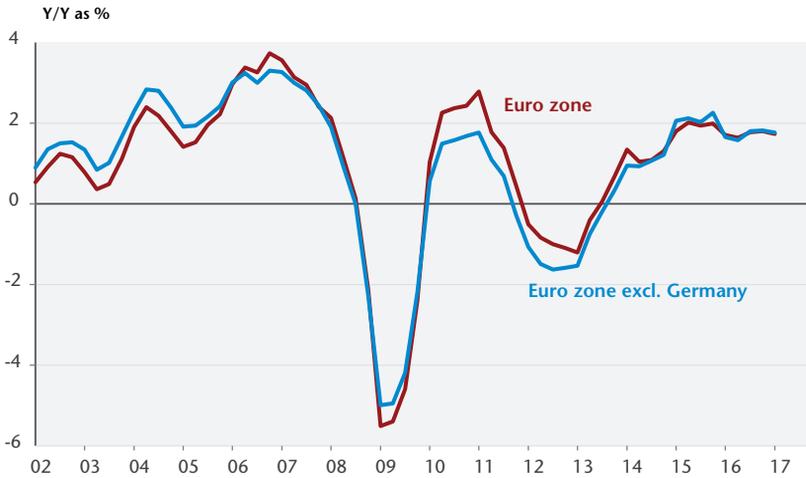
Sources: Datastream, EC, Natixis.

Chart 17. Euro zone: Unemployment rate and output gap



Sources: Datastream, Eurostat, OECD, Natixis.

Chart 18. Real GDP growth



Sources: Datastream, Eurostat, Natixis.

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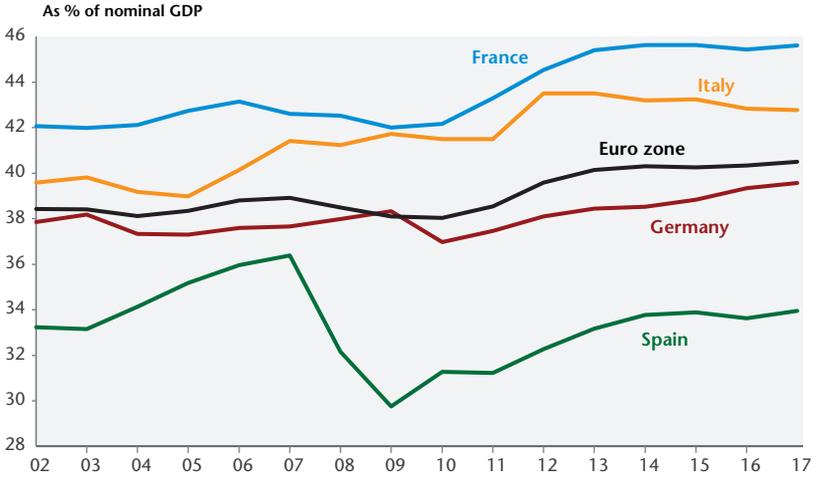
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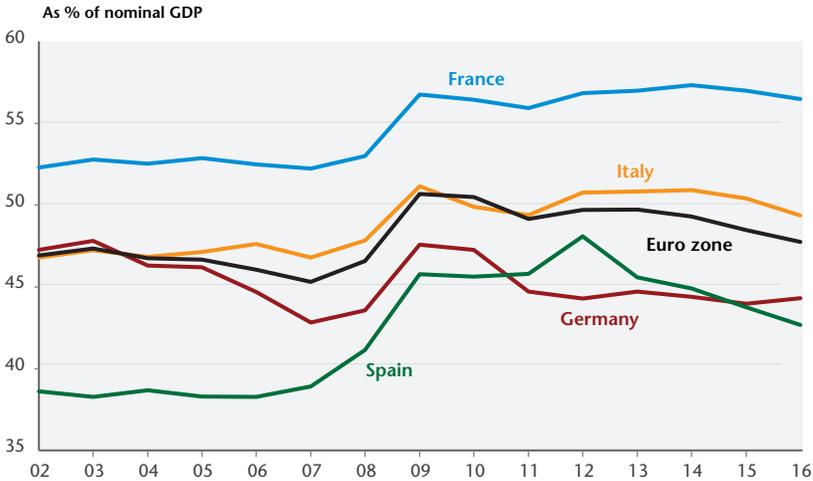
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Chart 19. Tax burden



Sources: Datastream, EC, Natixis.

Chart 20. Public spending



Sources: Datastream, EC, Natixis.

4. Conclusion: Which Macroeconomic and Economic Policy Debates Are Relevant for the Euro Zone?

The above shows that a number of macroeconomic and economic policy debates are crucial to analyse the euro zone's situation:

1. The effect of monetary unification on the member countries' productive specialisation and heterogeneity (which we have called the endogeneity of the criteria to create an optimum currency area);
2. The need for federalism (systematic income transfers, federal public debt) to ensure the medium-term stability of a currency area, and the means to ensure a transition to federalism that is acceptable to all;
3. The possibility that there may be balance of payment crises (sudden stops) affecting the members of a currency area without federalism; and likewise the possibility that these countries may be hit by self-fulfilling public debt crises;
4. The need to coordinate economic and tax policies that generate externalities between the countries in a currency area, and a reactivation of the concept of subsidiarity;
5. The danger posed by heterogeneous functioning of labour markets in the countries in a currency area;
6. The feasibility of internal devaluations in a currency area despite their high costs in terms of activity and jobs;
7. The need to have symmetrical adjustment mechanisms in a currency area; mechanisms that do not merely consist in implementing restrictive policies in troubled countries;
8. The risk that the government bonds of some countries in a currency area may lose the status of bonds with no default risk;
9. The need to continue to study the fiscal multiplier to determine whether it primarily depends on the economy's cyclical position or primarily on causes related to changes in the fiscal deficit (public spending or tax burden).

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