

## In search of symmetry in the eurozone

Paul De Grauwe\*

No. 268, May 2012

One of the major problems of the eurozone is the divergence of the competitive positions that have built up since the early 2000s. This divergence has led to major imbalances in the eurozone where the countries that have seen their competitive positions deteriorate (mainly the so-called 'PIIGS' – Portugal, Ireland, Italy, Greece and Spain) have accumulated large current account deficits and thus external indebtedness, matched by current account surpluses of the countries that have improved their competitive positions (mainly Germany).

There is now a large consensus that in order to correct these imbalances it will be necessary for the PIIGS to engineer an 'internal devaluation', i.e. to reduce prices and wages relative to Germany and the other core countries. There is no doubt that such an 'internal devaluation' is painful as it tends to reduce aggregate demand and domestic production. This in turn increases government budget deficits and deteriorates the fiscal position of the countries concerned. Countries forced to engineer an internal devaluation risk being pushed into a 'bad equilibrium'.

All this leads to a lot of pessimism about the capacity of the PIIGS countries to get out of these bad equilibria. Many commentators now take it for granted that the PIIGS countries will not easily improve their competitive positions and that they will be stuck in their bad equilibria for years to come. Is this pessimism warranted?

In Figure 1, I show the evolution of the competitive positions of the PIIGS countries (measured by their relative unit labour costs) since 1999. Two features stand out. First, from 1999 until 2008-09, one observes the strong deterioration of these countries' competitive positions. Second, since 2008-09 quite dramatic turnarounds of the competitive positions have occurred in Ireland, Spain and Greece, and to a lesser extent in Portugal and Italy.

We show the sizes of these internal devaluations that have occurred in the PIIGS countries since 2008-09 in Table 1. We compute the internal devaluations by the difference between the competitiveness index at its peak (which in some countries occurs in 2008, in others in 2009) and the index in 2012. This difference is expressed as a percentage, and can be interpreted as an internal devaluation, i.e. it measures the decline in the relative unit labour costs of these countries achieved between the peak year and the year 2012. From Table 1 we observe that the Irish internal devaluation of 23.5% is substantial. The internal devaluations of Greece and Spain (11.4% and 8.9%) are lower but significant. The internal devaluations of Portugal and Italy are much less impressive.

The last column of Table 1 shows how much of the deterioration of the competitive positions of the PIIGS countries accumulated during 1999-2008-09 has been eliminated by these internal devaluations. In the case of Ireland and Greece, the internal devaluation has eliminated about 75% of the losses of competitiveness accumulated

\* Professor at the London School of Economics and Senior Associate Fellow, CEPS. The author is grateful to Daniel Gros for useful comments.

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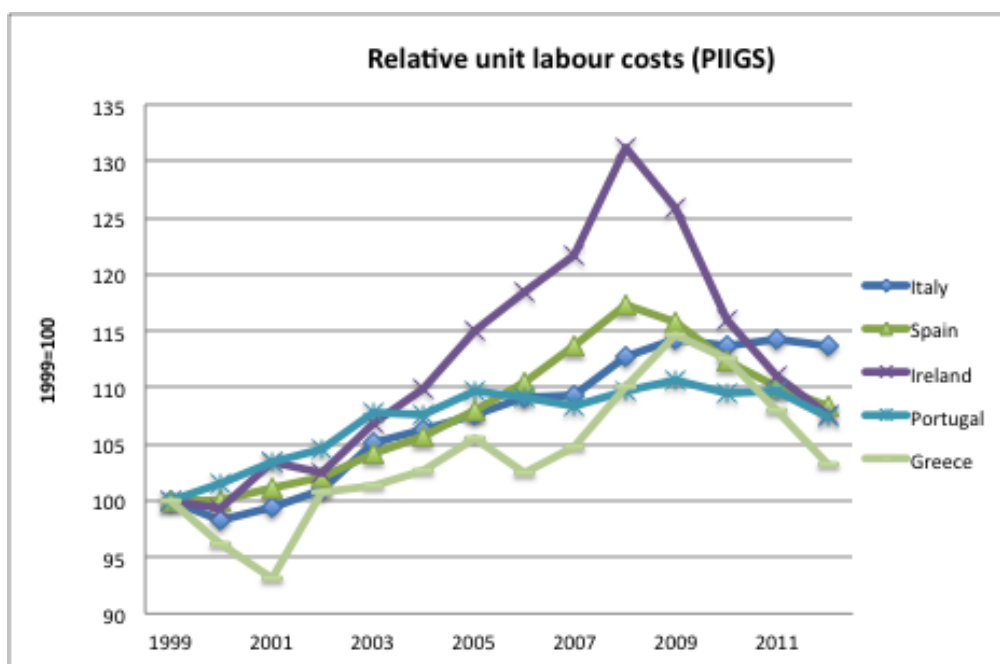
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during 1999-2008-09. In the case of Spain this percentage is 51% and in the case of Portugal 30%. The Italian internal devaluation stands out as being almost non-existent.

A note of caution should be made here. The percentages in the last column of Table 1 assume

that in 1999 these countries had the right competitive position. To the extent that prior to 1999 the PIIGS countries had already lost competitiveness, the numbers in that column underestimate the effort that still lies ahead.

Figure 1



Source: European Commission, Ameco.

Table 1 Internal devaluation in PIIGS countries (since 2008-09)

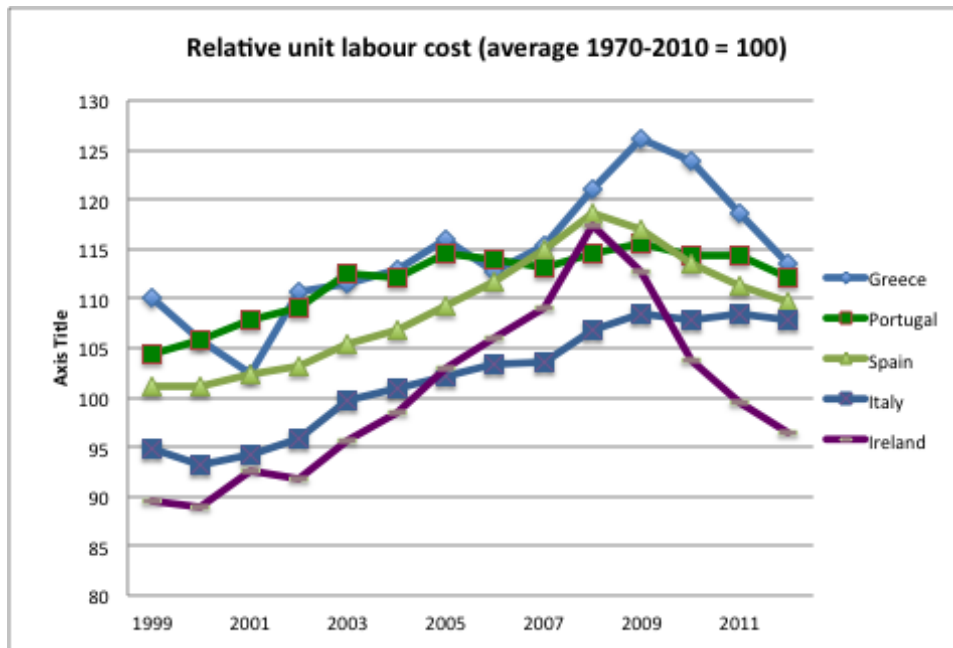
	Devaluation	% Achieved since peak
Ireland	23,5	75%
Greece	11,4	78%
Spain	8,9	51%
Portugal	3,2	30%
Italy	0,6	4%

Note: Calculations based on Figure 1.

In order to check how robust the results are to the choice of base year, I took as an alternative the average relative unit labour cost over a long period, i.e. 1970-2010. It is more likely that this average is closer to the equilibrium than the 1999 number. I use that average as the base to compute

the evolution of the relative unit labour costs since 1999. The result is presented in Figure 2. We find that the broad movements are very similar as in Figure 1 (which is not surprising as we divide by just another constant). As a result we find that the internal devaluations that have occurred since 2008-09 are broadly similar to the ones obtained from Figure 1. This can be seen by comparing Tables 2 and 1. What is different though is that the additional internal devaluation necessary to reach the equilibrium now looks somewhat different. Comparing the last columns of these two tables we find that Ireland has over-adjusted in 2012, while Greece has only done half of the necessary internal devaluation to reach equilibrium. Portugal and Italy here also appear to be in need of substantial further internal devaluations.

Figure 2



Source: European Commission, Ameco.

Table 2. Internal devaluation in PIIGS countries (since 2008-09)

	Devaluation	% Achieved since peak
Ireland	21,1	121%
Greece	12,6	48%
Spain	9,0	48%
Portugal	3,4	22%
Italy	0,6	7%

Note: Calculations based on Figure 2.

Whichever base year one chooses, it remains true that the size of the internal devaluations achieved by a number of PIIGS countries (Ireland, Greece, and Spain) is remarkable. It certainly goes counter to the widespread view that these countries are incapable of producing internal devaluations.

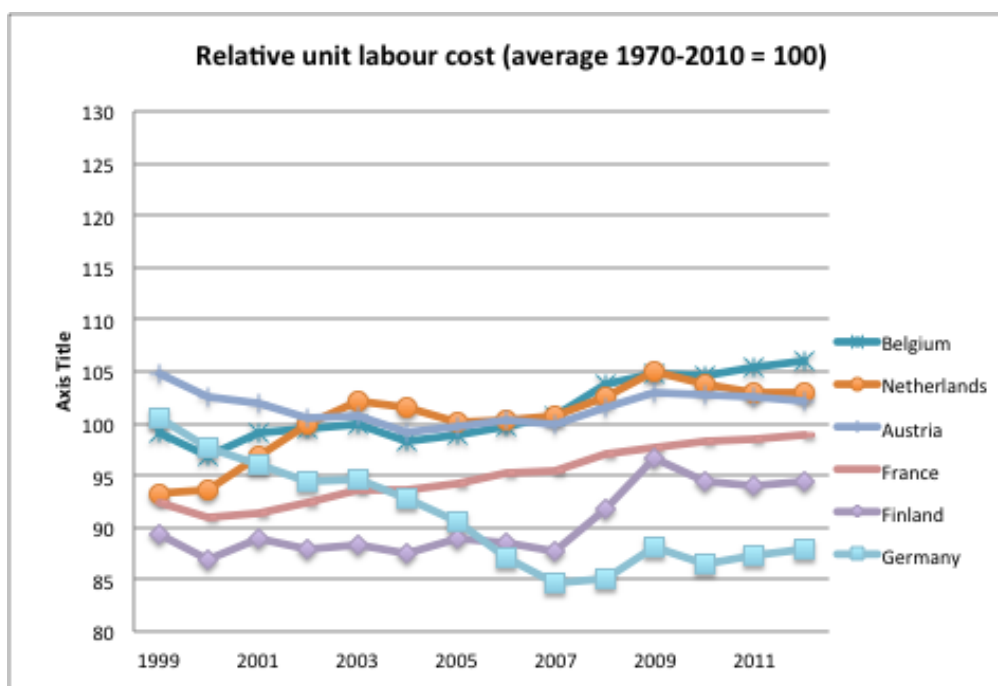
It should be stressed, however, that these internal devaluations have come at a great cost in terms of lost output and employment in the PIIGS countries. As these internal devaluations are not yet completed (except possibly in Ireland), more

losses in output and employment are to be expected.

It is now becoming increasingly accepted, at least outside Germany, that internal devaluations in the GIIPs countries are less costly when the surplus countries are willing to allow for internal revaluations. Is there evidence that such a process of internal revaluations is going on in the surplus countries? The answer is given in Figure 3 that presents the evolution of the relative unit labour costs in the core countries. We observe that since 2008-09 there is very little movement in these relative unit labour costs in these countries.

The position of Germany stands out. During 1999-2007 Germany engineered a significant internal devaluation that contributed to its economic recovery and the build-up of external surpluses. This internal devaluation stopped in 2007-08. Since then, no significant internal revaluation has taken place in Germany. We also observe from Figure 3 that the other countries remain close to the long-run equilibrium (the average over 1970-2010) and that no significant changes have taken place since 2008-09.

Figure 3



Source: European Commission, Ameco.

From the preceding analysis, one can conclude that the burden of the adjustments to the imbalances in the eurozone between the surplus and the deficit countries is borne almost exclusively by the deficit countries in the periphery. Surely some symmetry in the adjustment mechanism would alleviate the pain in the deficit countries. The surplus countries, however, do not seem to be willing to make life easier for the deficit countries and to take their part of responsibilities in correcting external imbalances.

The asymmetry in the adjustment mechanism in the eurozone is reminiscent of similar asymmetries in the fixed exchange rate regimes of the Bretton Woods and the European Monetary System. In both these exchange rate regimes the burden of adjustment to external disequilibria was borne mostly by the deficit countries.

The asymmetry of the fixed exchange rate regimes arose because deficit countries at some point were hit by balance of payments crises that depleted their stock of international reserves. Empty handed they had to turn to creditor nations that imposed their conditions, including an adjustment process to eliminate the deficits. Creditor nations ruled supremely.

It was hoped that the European Monetary Union would change all that, but this appears to have been in vain. The adjustment process within the eurozone seems to be as asymmetric as the adjustment mechanisms of the fixed exchange rate regimes. Why is this? The answer is not because of balance of payments crises. There can be no balance of payments crises in the sense as those that occurred in fixed exchange rate systems because in a monetary union internal foreign exchange markets have disappeared. Another mechanism is at work in a monetary union.

This mechanism arises from the inherent fragility of a monetary union in which national governments issue debt in a currency over which they exert no control. When in such a system the fiscal position of a country deteriorates, e.g. due to the deflationary effects of an internal devaluation, investors may be gripped by fear leading to a collective movement of distrust. The ensuing bond sales lead to a liquidity squeeze in the country concerned. This 'sudden stop' in turn leads to a situation in which the government of the distressed country finds it impossible to fund its outstanding debt except at prohibitively high interest rates. It follows that in the absence of a lender of last resort, individual governments of a

monetary union can be driven into default by financial market panics.

In order to avoid default, the crisis-hit government has to turn hat in hand to the creditor countries that like their fixed exchange rate predecessors impose tough conditions. As the creditor countries profit from the liquidity inflow from the distressed country and are awash with liquidity, no pressure is exerted on these countries to do their part of the adjustment. The creditor countries reign supremely and impose their rule on the system.

The European Commission has now been invested with an important responsibility in monitoring and correcting macroeconomic imbalances in the framework of the Macroeconomic Imbalance Procedure (MIP). The key idea in the MIP is symmetry, i.e. imbalances between surplus and deficit countries should be treated and corrected symmetrically. As our analysis illustrates, up to now the European Commission does not seem to be willing (or able) to impose symmetry in the adjustment process.<sup>1</sup> It imposes a lot of pressure on the deficit countries but fails to impose a similar pressure on the surplus countries. The effect of this failure is that the eurozone is kept in a deflationary straitjacket.

All this does not bode well for the future enforcement of symmetry in the macroeconomic adjustments in the eurozone. The MIP is unlikely to work symmetrically for the same reason the EMS did not. In the absence of a lender of last resort in the eurozone, deficit countries will remain in a structurally weak position vis-à-vis surplus countries each time market sentiments turns against them. This will continue to make it easier for the European Commission to impose tougher adjustment conditions on the deficit than on the surplus countries, thereby becoming the agent representing the interests of the creditor countries. The tyranny of the creditor countries in the eurozone will not disappear quickly.

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<sup>1</sup> It is very revealing that the initial 'scoreboard' used by the European Commission had the same 4% trigger point for the current account imbalance, whether this was a surplus or a deficit. Mysteriously this was later changed into an asymmetric trigger: +6% for surplus countries and 4% for deficit countries.