*Reforms are still needed, but the system works a lot better than the conventional wisdom maintains.*

# The Eurozone Is Underrated

**By Jørgen Ørstrøm Møller**

Since the outbreak in 2008 of the global financial crisis, a number of economists have written the euro's obituary. Eurozone members, however, adjust to economic shocks as do the U.S. and British economic and monetary unions, but differently.

In the United States, adjustment takes place through exchange rate flexibility, reduction of wages, worker layoffs, and federal transfers. For members of the eurozone, however, currency rate changes are ruled out by definition. There is less focus on regaining competitiveness through cuts in wage levels, and fiscal transfers are smaller; the emphasis is thus on domestic restructuring of the economy. Each model is anchored in societal structure, political conditions, and history. Probably both models are viable, and both monetary unions may be wise not to have opted for the alternative version of how to adjust.

Over the ten-year period from 2005 to 2015, Eurostat figures reveal per capita income (purchasing power parity) in the United States fell from 160 to 145 (EU 2005=100). The eurozone (nineteen member states) fell from 110 to 106, doing marginally better percentage-wise than the United States. Looking at the eurozone members hit by the crisis, the following picture emerges: Greece has unsurprisingly experienced a steep drop in per capita income compared to eurozone average (93 to 68). The other weak countries have done better than conveyed by mass media. Spain fell from 100 to 90, Italy from 109 to 96, and Portugal from 82 to 77, while Ireland after a dip in 2009–2013 saw an increase from 147 to 177. The United Kingdom registered a fall from 117 to 108—percentage wise marginally better than Italy, but worse than Spain and Portugal not to mention Ireland; substantially only beating Greece.

*Jørgen Ørstrøm Møller is a Visiting Senior Fellow at the ISEAS Yusof Ishak Institute, Singapore, and Adjunct Professor at the Singapore Management University and the Copenhagen Business School.*

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

The eurozone presents a much more balanced economy than does the United States, United Kingdom, and Japan. For 2017, the International Monetary Fund forecasts EU GDP growth at 1.9 percent, which is slightly below the U.S. forecast (2.1 percent) but higher than the forecasts for the United Kingdom (1.7 percent) and Japan (1.3 percent). Statistics in the weekly edition of *The Economist* report that the eurozone runs a surplus on the balance of payments of 3.1 percent compared to a deficit for the United States of 2.6 percent and the United Kingdom of 3.1 percent. Public debt has risen almost along parallel lines from 2008 to 2015. A combination of lower deficits and growth in the eurozone promises a substantial reduction in the debt-to-GDP ratio through 2016 and 2017. According to *The Economist,* the 2016 deficit in public finance was 1.9 percent of GDP for the eurozone, 3.2 percent for the United States, and 3.7 percent for the United Kingdom. For 2017, the eurozone deficit looks to be 1.4 percent, compared to 3.5 percent for the United States and 3.6 percent for the United Kingdom.

*The eurozone presents a much more balanced economy than does the United States, United Kingdom, and Japan.*

The higher unemployment in the eurozone compared to the United States is due to a higher share of the population available to the labor market. The World Bank points to, broadly speaking, a fall in the U.S. "participation rate" between 2000 and 2014 of about 3.9 percentage points (from 66.3 percent to 62.4 percent), while the eurozone participation rate has gone up 1.7 percentage points (55.08 percent to 56.85 percent), and the United Kingdom remained almost unchanged (61.9 percent to 62.1 percent). A calculation of the unemployment rate freezing the participation rate in the United States and the eurozone at year 2000 figures produces a reversal of roles with considerably lower unemployment in the eurozone than in the United States. Unemployment in the United States has declined because a growing share of people have given up finding a job, while those searching for a job in Europe continue to be measured.

The omission of the effect of currency rate changes is often highlighted when discussing the eurozone, seen as a *deus ex machina,* but this point overlooks that other policy instruments such as fiscal policy, monetary policy, and measures to reduce labor costs can deliver the same result.

Exchange rate adjustment basically means two things: enhancing competitiveness by depressing real wages while keeping nominal wages unchanged (counting on wage earners having a blind spot regarding the purchasing power of their take home pay); and increasing the share of profits at the expense of wage share. Consider the United Kingdom's experience. OECD Employment Outlook statistics show that real wages plummeted, putting the United Kingdom on par with Greece and Portugal as the only OECD countries experiencing a drop between 2007 and 2015—for the United Kingdom a 10.4 percent decrease compared to an increase for the OECD as a whole of 6.7 percent (Germany at 14 percent, France at 11 percent, and the United States at 6.4 percent).

The competitive advantage is normally ephemeral, as wage earners demand and get nominal wage increases taking the country back to square one. Strict domestic economic policies to keep wage increases in check can prevent that, but if applied, these policies come close to what is labelled internal devaluation (depressing wage rates in domestic currencies), and if there is political will to do so, then devaluation is not needed. Some of the Baltic states were successful doing precisely that in the aftermath of the global financial crisis, opening the door for them to join the euro.

The eurozone experience over the preceding ten years has highlighted the way devaluation serves as an instrument to maintain a distorted and non-competitive economic model, eschewing restructuring and reforms meant to do away with what we might call a "privilege" economy (public contracts not transparent, jobs in the public sector given to supporters of the party in power, combined with a good deal of corruption). The jury will be out for some time, but it can be said with some justification that if Greece had remained outside the euro, a devaluation of the drachma would have served to preserve precisely such a model.

The eurozone societal model—a kind of social welfare—is often criticized as promoting low productivity. This is, however, not substantiated by facts. According to the OECD, setting GDP per hours in the United States at 100, a comparable figure for the eurozone is 82.5, for Germany 90.9, for France 92.8, for Spain 78, for Italy 72.8, and for the United Kingdom 75.7. Yes, the United States is ahead of the pack but not substantially so. And the United Kingdom is behind.

OECD figures reveal that in both the United States and the United Kingdom, working hours per year are considerably longer than for most of the eurozone members. Average annual hours actually worked per worker were 1,790 in the United States, 1,674 in the United Kingdom, 1,482 in France, 1,371 in Germany, 1,691 in Spain, and in

*Continued on page 47*

*Continued from page 39*

Italy—the only big eurozone country at the same level as the United States and the United Kingdom—average annual hours worked per worker were 1,725. The figures also spike the notion that the Greeks, the Irish, and the Portuguese work less, with working hours at respectively 2,042, 1,820, and 1,868. Since 2000, there has been little change as working hours have fallen 2 percent to 4 percent in all the countries mentioned above with the exception of Italy, Germany, and Ireland, with a somewhat but not substantially higher fall (about 6 percent).

One big difference between the two models is distribution of the burden of adjustment. In the United Kingdom, one out of eight workers (3.8 million) lives in poverty as reported by the Joseph Rowntree Foundation. A study published by NCBI disclosing 2010 figures tells that close to 18 percent of U.S. households (11 percentage points working, 7 percentage points nonworking) are in poverty, which is at the top of a list of twelve OECD countries. The eurozone countries opt for keeping nominal wages relatively unchanged, encouraging people to keep looking for jobs, while mobilizing social security systems to alleviate the burden. This is illustrated by inequality measurements lower than those of the United States and the United Kingdom, with Gini coefficients at 0.394 and 0.356 respectively, compared to France (0.297), Germany (0.289), Italy (0.326) and Spain (0.344). Greece, Ireland, and Portugal all have a Gini coefficient lower than that of the United Kingdom (OECD data).

*The eurozone societal model is often criticized as promoting low productivity. This is, however, not substantiated by facts.*

The eurozone adjustment policies work. Spain and Ireland are fully restored as competitive economies. Portugal still needs to do more work, but is out of the danger zone. Italy has shown lackluster growth for almost twenty years, but experience from before the single currency justifies the verdict that the situation has little if anything to do with the euro. Greece is slowly, slowly turning around to growth. Behind the curtain, a closer look discloses that, prior to joining the eurozone, overspending that inflated income per capita took place in Greece, partly facilitated by global banks to hide the truth from creditors, and Greece's economy is still in the grip of the privileged.

There has not been much convergence among U.S. states with regards to income per capita. According to an analysis published by *The Atlantic* in May 2012, five states—California, Connecticut, Illinois, New Jersey, and New York—annually pay Missouri, Tennessee, and Kansas between 15 and 30 percent of what these states tax people living there. The point is that this is done without much effort to restructure their economies, thus keeping them dependent on federal subsidies. It seems legitimate to ask why this is preferable to the European effort of restructuring and modernizing the economies of poorer member states primarily in the southern part of the European Union. Figures indicate that states tend to be locked permanently in their role as net contributor or net recipient.

The strains on the political system of permanent fiscal transfers among states are visible in the United States. The federal budget is kept at approximately 20 percent of GDP and every effort to increase taxes hits a wall. Voters react by limiting the size of the federal budget. The result is close to fifty million Americans below the poverty line and what may be termed a minimalist state with regard to public social services. Few Europeans would like to transform the European society model into a replica of what is seen in the United States and to a lesser degree in the United Kingdom.

The main problem for the eurozone is not the lack of a fiscal union limiting fiscal flows to smooth out the business cycle and in particular outside shocks, but the lack of a genuine European business space and capital market.

The large majority of European mergers and acquisitions take place among companies from the same nation-state or at most adjacent nation-states. Only the big ones cross borders. This has several implications. One of them is that in the long run, European small- and medium-sized enterprises may find it difficult to grow into bigger companies. Germany may be the only large eurozone country with a strong sector of small- and medium-sized companies, but one wonders how long this can go on. Anecdotal evidence is forthcoming that when current owners quit, the handover to the next generation is difficult.

There are no statistics to support such a view, but common sense and observing what is happening support the conclusion that these enterprises do not see possibilities for mergers and acquisitions involving similar enterprises in member stares beyond neighboring countries. It is rare to see a Swedish company merge with a Spanish company or an Italian company merge with an Irish or Finnish company. In that respect, the European Union and the eurozone have not developed into a single market. The same goes for a capital market. Beyond the larger cities, branches of major banks are not many and they do not see themselves as part of the banking system serving regions and local communities, nor do they see a role for making the money market function inside the eurozone, that is, smoothing out economic disruptions by transferring money among branches. Inside nation-states, banks "ferry around" money to help towns or regions, but they don't do this on the eurozone level. In reality, their role may often be pro-cyclical in the sense that branches in a region hit by an outside shock think first of avoiding losses, which will displease the headquarters, and only after that if at all whether they can do something for the town or region. The implication is that money is drawn out instead of flowing into areas needing stimulus.

*The higher unemployment in the eurozone compared to the United States is due to a higher share of the population available to the labor market.*

The fact is that the business sector and the banking system do not operate on a eurozone level as they do in the United States.

This is explained by a study by the International Monetary Fund. In case of "shocks" to a local community in the United States, about 80 percent is smoothed out by help from the rest of the country—the economic and monetary union. Only 15 percentage points comes from fiscal flows (lower taxes to the federal government and higher federal expenditure in the local community), while 65 percentage points can be ascribed to private sector flows.

In the eurozone, only 45 percent of a shock is smoothed out by help from the rest of the economic and monetary union, and fiscal transfers play a limited role.

This is where the main work of reforming the eurozone should be done. ◆