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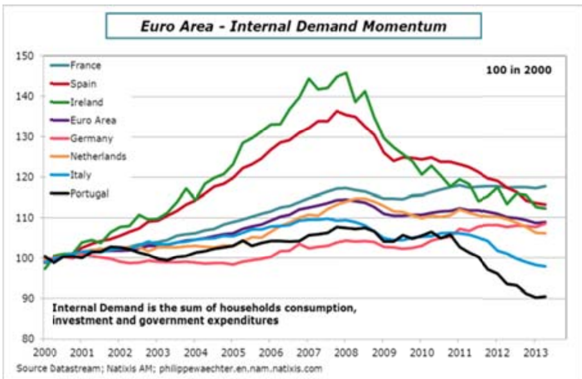
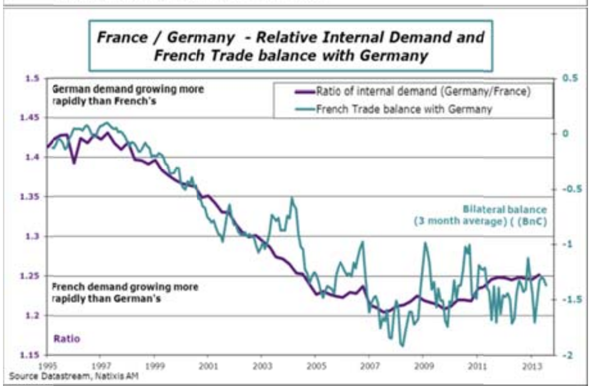
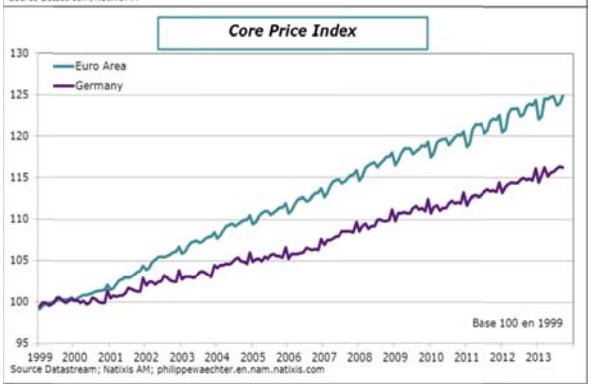
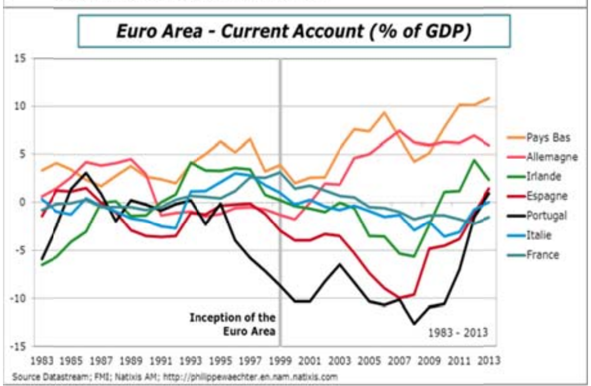
Euro Area – Towards a New Equilibrium

The perceived risk of deflation and the ongoing adjustments in the Euro Area are forcing the establishment of a new status quo. The mechanisms in place prior to the crisis, which had afforded Germany a strong position, are coming under scrutiny. With the emergence of new constraints and new opportunities, not to mention changing power balances, the Euro Area has to find a new model for working together. It is this "new geography" that has to be redefined within the Euro Area. Convergence towards this new status quo is a necessary precondition for a future era of prosperity.









Building up imbalances

The chart opposite, which shows the domestic demand profile of a number of countries, illustrates the situation in the Euro Area pre-crisis. Up to 2011, Germany had the weakest domestic demand. Between 2000 and 2011 it only grew by a little over 5%. Spain and Ireland, on the other hand, led the way. In France, domestic demand outpaced that of the Euro Area as a whole.

The slower growth in domestic demand meant that German imports grew only moderately while its exports benefited from the strong internal demand of other Euro Area countries.

This is illustrated in the case of France by the second chart. It shows both the relative change in German domestic demand versus that in France as well as the bilateral trade balance between France and Germany. Since French domestic demand was stronger than that in Germany, the French bilateral balance deteriorated. This scenario is commonplace in many counties that experienced rapid growth in their domestic demand.

In parallel, German wage costs and the core price index rose at a slower pace than those of other countries within the zone. This gives it a competitive advantage. The chart shows the change in core price indices in Germany and the Euro Area since 1999. In other words, the euphoria had led to significant wage increases in many countries within the zone, ultimately triggering higher inflation.

The primary effect of these changes has been the appearance of major imbalances within the Euro Area. In short, the current accounts seen in the chart opposite show a very rapid deterioration, consistent with the domestic demand profile.

This situation wasn't tenable because financial systems and policies are still very local. This lack of integration means that external accounts continue to play their traditional role. Where major imbalances arise there are no endogenous adjustments to allow for spontaneous rebalancing.

Crisis dynamics

The crisis period within the Euro Area is one of a change in reference framework.

Behavior must change to bring countries onto more compatible paths.

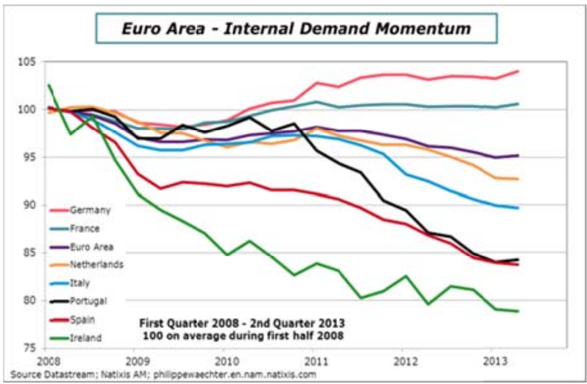
The first option is to endeavor to correct the nominal imbalances. The idea is to take steps to replicate a devaluation, thereby spurring that economy's competitiveness. This requires spending cuts that in some instances are severe.

The only thing is that the mechanism takes longer than a devaluation, which can be done over a weekend. With spending adjustments, and in particular wages, it takes much longer because employees have to be won over and welfare systems weakened.

To speed up a return to a more balanced situation the authorities wanted to forcefully reduce the deficit current accounts. The best way of doing this was to increase savings by encouraging the budgetary authorities to introduce highly restrictive policies. This is what was done from 2011 on. For the countries affected, the austerity strategy caused the domestic demand profile to be turned on its head, resulting in a return to balanced current accounts. These goals were achieved even if the cost was a long recession.

Towards a new equilibrium

If you look at the domestic demand indicators from 2008, the year the crisis began, a completely different picture emerges. Germany is the country with the strongest domestic demand. Ireland, Spain, Portugal and Italy suffered the consequences of austerity policies, resulting in very weak domestic demand. It is hardly surprising that inflation rates reversed and that a risk of deflation arose.



The challenge in making the Euro Area work is how to bring such divergent paths together.

The adjustments were brutal in the peripheral countries but the crisis doesn't seem to have troubled Germany's management of its domestic demand. This can be seen in chart 4, as it was in chart 1. This requires complex economic policy management because it is necessary to both satisfy German demands that its remarkable economy not be disturbed while also underpinning activity in countries where demand has collapsed.

From this perspective, the reaction following the ECB's refinancing rate cut on April 7 is significant. Dissatisfied Germans added to calls for a more orthodox policy to dampen any inflationary pressures that may arise over time.

Moreover, these changes in the pace of domestic demand resulted in a rebalancing of current accounts and a marked slowdown in German exports to Euro Area countries. This meant that Germany had to channel its exports to other regions, Asia in particular, to take advantage of the strong growth and need for investment there.

However, the current situation is not tenable because each country is overly focused on its own fortunes. What is required is a collective effort to drive growth within the Euro Area and avoid the risk of a deflationary period. Germany has a critical role to play by doing more to spur its domestic demand so as to encourage exports from other countries within the zone and achieve a permanent rebalancing of current accounts. This can be achieved by budgetary measures or by population movements as seen at present.

In other words, the new status quo must be more collaborative and coordinated. Germany must retain its ability to tap into global economic growth but must also facilitate the spreading of these outside opportunities throughout the Euro Area. It is up to each country to have the necessary flexibility to tap into these opportunities and amplify them in their domestic markets.

This more cooperative framework requires different structural reforms in each country within the zone. Spain has started to implement such a strategy. It wants to be able to amplify the impact of its higher exports.

It is this profound change that must be undertaken in order to spur renewed growth and employment.

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