



International Review of Applied Economics >

Volume 29, 2015 - [Issue 6: Changes in income distribution, their causes and consequence](#)

1,125 23

Views | CrossRef citations to date | Altmetric

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NAIRU economics and the Eurozone crisis

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Pages 843-877 | Received 22 May 2014, Accepted 09 Apr 2015, Published online: 24 Jun 2015

Cite this article <https://doi.org/10.1080/02692171.2015.1054367>



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Abstract

Intra-Eurozone current-account imbalances (and divergent external debt positions) cannot be attributed to the deterioration of cost (or price) competitiveness in Europe's periphery vis-à-vis its core. Imbalances were driven by high domestic demand growth in the periphery, which was financed by capital flows from the core. The external finance – following capitalist logic – ended up in non-traded medium-low-tech activities (e.g. construction). This points to a structural problem in pan-European financial integration – which we locate in the economic ideology guiding the EMU: NAIRU economics. We zoom in on the reasons why NAIRU-based monetary policy deepened the already existing structural heterogeneity in the Eurozone, locking the Southern-European economies up in low- and medium-technology activities often in direct competition with China. The only way out is a rethink of Eurozone macroeconomic and industrial policies which – going beyond often-made calls for broad-based fiscal stimulus or a clearing arrangement – fundamentally reconsiders the role of the ECB in light of what needs to be done to create Europe's non-price comparative advantage of tomorrow.

Keywords:

economic and monetary union (EMU)

employment

equilibrium unemployment

NAIRU

unemployment

macroeconomics

international growth competitiveness

income distribution

JEL Classifications:

E00

E02

E12

F02

F15

Acknowledgment

This paper as presented at the International Workshop Full Employment in Europe: With or Without the Euro? organized by Centre de Recherche en Economie de Grenoble (CREG) – Université de Grenoble – and the Institute for New Economic Thinking, 15–16 May 2014. We are grateful for the comments given by Andrea Fumagalli and Ariel Luis Wirkierman. We thank the Institute for New Economic Thinking for financial support.

Disclosure statement

No potential conflict of interest was reported by the authors.

Notes

1. The Marxist labels ‘core’ and ‘periphery’ are now widely used, ironically also by neoclassical economists, to classify Eurozone member countries into ‘stronger’ and ‘weaker’ economies. The labelling is intrinsically problematic, of course, but following Diaz Sanchez and Varoudakis ([2013](#)), Gaulier and Vicard ([2012](#)), Simonazzi, Ginzburg, and Nocella ([2013](#)), Darvas and Merler ([2013](#)) and many others, we define the ‘Eurozone periphery’ to include the countries of the monetary union most affected by the sovereign debt crisis: Greece, Ireland, Italy, Portugal, and Spain. These are the largest net debtor countries in the Eurozone, although in some countries (particularly in Italy) the current-account deficits have not been excessive. The ‘Eurozone core’

countries are defined to include: Austria, Belgium, Denmark, Finland, France, Germany, the Netherlands, and Slovenia.

2. The magnitudes of the shifts in RULC and/or real exchange rates are actually so small that they cannot explain the growing imbalances even when we assume the trade elasticities to be much larger (in absolute terms).

3. We use Nechio's ([2011](#)) stylized version of the Taylor-rule, because it has been widely debated (see Darvas and Merler [2013](#); Krugman [2011](#)) and because it uses the unemployment gap as the indicator of the level of economic activity, as we do in this article. We agree with one of the referees that Nechio's Taylor's rule is problematic in its choice of weights, inflation index, and definition of expectations. But we use it here in a descriptive ex-post manner, not as an ex-ante (optimal) prescription. In doing so, we are following a large literature which shows that this simple Taylor rule approximates ECB monetary policy decisions fairly well (Blattner and Margaritov [2010](#); Van Poeck [2010](#)).

4. Of course, we do not subscribe to Taylor's rule and the claim that ECB monetary policy should have been more restrictive. If it had been more restrictive, the Eurozone would have entered a phase of secular stagnation already in the early 2000s – rather than in 2009–2010. But perhaps its foreign imbalances would have been smaller.

5. Absent a central fiscal authority to police the no-bailout rule, this clause lacked credibility.

6. This is an example of Keynesian animal spirits governing financial markets.

7. Atoyan, Jaeger, and Smith ([2012](#)) conclude that push factors (low returns in the core), rather than pull factors (high returns in the destination countries) drove most of the capital flows coming from the Eurozone core.

8. This shows that the crisis was not at all a fiscal crisis, but a private sector (households) debt crisis. As Table 5 shows, governments of Greece, Italy and Spain actually reduced their indebtedness during 2001–2008. The Eurozone crisis is the by-product of the 2008 Financial Crash, which forced governments to bail out their insolvent banking systems. In the periphery, this led to the situation that the health of their financial system became prey to the health of their public finances, and vice versa.

9. This finding is consistent with findings that there is more product differentiation in high-tech than in low-tech industries. For similar evidence for the Eurozone and the UK, see Buisán, Learmonth, and Sebastiá-Barriel ([2006](#)).
 10. Bloom, Draca, and Van Reenen ([2011](#)), analysing a panel of up to half a million firms over 1996–2007 in 12 European countries, find that jobs and firm survival rates declined for firms in low-tech sectors, but are relatively protected for firms in high-tech sectors. Technological upgrading in response to increased import competition from China holds the key.
 11. A Eurozone break-up is generally expected to lead to an appreciation of the (new) German currency and a drastic depreciation of the currencies of the peripheral economies.
 12. The kind of convergence we mean here is exemplified best by the experiences of Belgium and the Netherlands in the 1980s and 1990s. Both countries reformed their wage- and price-setting systems in a painful process, reducing their real wages (relative to Germany) by 20–25%, while avoiding a large devaluation of their currencies and maintaining the hard peg (i.e. monetary union) with the Deutschmark. See Temin and Vines ([2013](#)) for a discussion.
 13. The ECB has no accountability on the inflation target, but the consensus is that the ECB is following the Taylor principle (Blattner and Margaritov [2010](#); Fendel and Frenkel [2006](#); van Poeck [2010](#)), adjusting the interest rate in response to real economic activity.
 14. We note that the ECB was not designed to act as a Eurozone lender of last resort for banks or as a government-bank for Eurozone sovereigns in distress. This proved a near-fatal design flaw that did unnecessarily escalate the Eurozone crisis (Arestis and Sawyer [2011](#)).
 15. We acknowledge that the target is to keep inflation below but close to 2%, which is not exactly the same as to keep it at 2%.
 16. See Galí ([2011](#)) for empirical evidence of the interest rate rule for the ECB.
 17. Source: <http://www.imf.org/external/pubs/ft/survey/so/2010/new050910a.htm>.
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