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Rebalancing the Euro Area: The Costs of Internal Devaluation

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Abstract

This paper investigates the economic costs of rebalancing current account positions in the Euro area by means of internal devaluation. Internal devaluation relies on wage suppression in the deficit countries. Based on an old Keynesian model we estimate a current account equation, a wage-Phillips curve and an Okun's Law equation. All estimations are carried out for a panel of twelve Euro area members. From the estimation results we calculate the output costs of reducing current account deficits. Greece, Ireland, Italy, Portugal and Spain (GIIPS) had, on average, current account deficits of 8.4% of GDP in 2007. To eliminate these current account deficits, a reduction of GPD by some 47% would be necessary. Trade imbalances can be resolved in two ways: deflationary adjustment in the deficit countries or inflationary adjustment in the surplus countries. The economic costs of deflationary adjustment to those countries are equivalent to the output loss of the Great Depression. An adjustment of the surplus

countries would increase growth and it would come with higher inflation, but it would allow rebalancing without a Great Depression in parts of Europe.

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Notes

[1]The Euro area overall has in the past decade had close to balanced current account, that is it rarely exceeded ±1% of GDP. However, individual Euro member states have had substantial deficits or surpluses. In this sense the Euro area has had on aggregate internal imbalances. Of course, member states have had substantial surpluses or deficits with the rest of the world.

[2]This section builds on Stockhammer (2011a, 2012a).

[3]The EU budget is restricted in size (to 2% of GDP) and too small (and too inflexible) to serve a macroeconomic function such as providing an expansionary stimulus in the face of (symmetric) adverse shocks.

[4]Buiter & Rahbari (2010) offer an interesting discussion on what the bail out clause precisely states.

[5]These references focus on recent contributions. There was also an earlier Keynesian criticism of the EMU project and the Maastricht Treaty, e.g. Godley (1992).

[6]This assumes a Phillips curve with a positive slope. The Phillips curve may, however, be relatively flat up to the point of full capacity utilization. In this case the adjustment in the surplus countries need not be inflationary, but could be inflation-neutral.

[7]A theoretical attempt to present in a Marxian fashion all these points as necessary moments within a specific organization of capitalist power can be found in Milios & Sotiropoulos (2010) and Sotiropoulos et al. (2013). They argue that the strategy of the euro corresponds to a mechanism for continuously exerting pressure for the reorganization of labour in the various member countries. In this sense, it is not just an income issue. Working people are being systematically attacked both at the 'centre' and at the 'periphery' of the Euro area in their conditions of production and reproduction. This strategy can be approached as an ideal design for the organization of capitalist power, the practical application of which has proved far from being perfect. The plan for the single currency very obviously generates strategic benefits for the collective capitalists of all the countries that participate in it.

[8]There is a certain economic logic to this. The real interest rates that businesses face are the nominal interest minus the inflation rate. But the inflation in producer prices (at which a firm can sell its output) depends on its sector. A Spanish automobile producer's prices are set by the world market (and not by Spanish inflation), whereas the real estate market has a regional dynamic (the real interest is negative if nominal interests are, say, 3% and house prices rise by 10%). The same nominal interest meant quite different real interest rates for different sectors; given a regime that encouraged capital flows, this meant that finance would be channelled to real estate (or, more broadly, non-tradable) sectors.

[9]The term 'recycled surpluses' is used to highlight the relationship between (German) export surplus and (Southern European) financial liabilities. However, the term is potentially misleading as the there is no one-to-one correspondence between export surpluses (of one country) and financial assets of that country. German banks could invest their surpluses in American government paper (or subprime derivatives) and loan it to a French bank. And French banks may borrow from German banks and lend to Spanish households. Borio & Disyatat (2011) warn against confusing current account imbalances (a flow concept) and financial liabilities (a stock concept).

[10]In equilibrium $\Delta ULC_t = \Delta ULC_{t-1}$.

[11]AMECO is the annual macroeconomic database of the European Commission's Directorate General for Economic and Financial Affairs (DG ECFIN).

[12]Cesaratto & Stirati (2011) cover a similar ground and suggest that labour market policies and German Neo-Mercantilism are more relevant.

[13]For useful brief presentations of the history of Phillips curve regression models see Galí et al. (2001), Montoya & Döhring (2011), Goodhart & Hofmann (2005).

[14]One could argue that the Phillips curve should be homogeneous of degree one with respect to import prices and past wages. If this condition is imposed the long-run effects are −1.42 and −2.19 for the 1999–2011 and the 1990–2011 samples respectively (available upon request).

[15]Okun (1962) presents several versions, all estimated with quarterly data. The first version estimates the difference in unemployment as a function of difference in (the logarithm of) GDP and is identical to our specification. The second version first calculates a potential GDP and an output gap. The unemployment rate is then related to the output gap.

[16]These inflationary policies will need a corresponding monetary policy and interventions in the workings of financial sector. The fact that we do not discuss them here does not reflect their importance but merely the scope of this paper.

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