Eurozone: Trouble in the core?

by Simon Tilford

Many people lazily assume that the eurozone is now split into a strong, prosperous core and a weak, depressed periphery. Southern Europe and Ireland – the periphery – face exceptional economic weakness as they tighten fiscal policy and undergo a painful period of internal devaluation in a drive to reduce their costs relative to the core. By contrast, Germany, Austria, the Netherlands and Finland – the core – are assumed to be structurally robust economies, with sound public finances, competitive export industries, and good economic prospects. The reality is different and more worrying.

There is no doubting the existence of an arc of depression. Greece, Ireland and Portugal have already suffered huge collapses in economic activity. In the case of Greece and Portugal there is more to come, whereas Ireland faces stagnation. Italy is rapidly sliding into the depression camp: the Italian economy is now 7 per cent short of its pre-crisis peak and will contract sharply in 2013. The picture is similarly grim in Spain.

What about the eurozone's prosperous core? Germany's economy is growing, albeit slowly (it expanded by 0.9 per cent over the last year), and is around 2 per cent bigger than in the first quarter of 2008. This compares well with the periphery, and with the UK (whose economy is still 3 per cent short of its pre-crisis size). But it can hardly be described as dazzling; even the best performing economy in the eurozone is lagging the supposedly crisis-hit US.

Despite very low real interest rates, a relatively expansionary fiscal policy and low unemployment, domestic demand in Germany is barely growing. Investment has fallen for three straight quarters and is still down 8 per cent relative to its pre-crisis peak. The much prophesied surge in consumption has not materialised; private consumption has risen by just 0.6 per cent over the last year. Foreign demand is again the key source of stimulus – export growth easily outstripped that of imports during the 12 months to September 2012.

What about the rest of the core? Austria is performing pretty much in line with Germany. But Finland and the Netherlands are doing far worse. Finland's economy stagnated over the last year, whereas the Dutch one contracted by over 1.4 per cent. Strikingly, the Dutch economy is still 3 per cent short of its pre-crisis peak. The Finnish gap is

4.3 per cent, and hence not much narrower than Spain's at 5.6 per cent.

Germany and the Netherlands are running huge and growing trade surpluses – they are kept afloat by foreign demand (and the rise in indebtedness this implies in the countries running the offsetting trade deficits). Germany's surplus is now almost back to the level of early 2008 and the Dutch one is at an all-time high. Without the stimulus imparted by these trade surpluses they would be in economic crisis and no doubt running much bigger budget deficits. The two small core economies – Austria and Finland – have broadly balanced trade.

The problem for all the core countries is that their exports are now coming under strong pressure as the eurozone slides deeper into recession, and growth in the global economy falters. At the same time, fiscal policies – which had until recently been relatively expansionary, at least in Germany and Austria – are being tightened. The result will be a weakening of labour markets and further pressure on household spending.

What about France, a country that straddles the core and periphery? The French economy has barely grown over the last year, but it has almost recouped the activity lost in the downturn. France's superior performance to Finland or the Netherlands largely reflects stronger household consumption. The country is not considered part of the core because of concerns over its export competitiveness (it has a sizeable trade deficit). France has its weaknesses, but the country is hardly the 'sick man of Europe' (as *The Economist* recently implied).

Structural reforms will not lead to phoenix-like economic recoveries in the periphery. To suppose that they will is another example of the faith-based thinking that led many to argue that fiscal contraction in a recession would be expansionary. Reforms should boost productivity growth in the long-term, if combined with a recovery in business investment. But they are no panacea: after all, Finland, the Netherlands and Ireland are liberal and flexible economies, and are doing very poorly. Europe needs the eurozone core to generate strong domestic demand, and for inflation in the core to rise relative to the periphery. A stagnant core spells serious trouble for the eurozone; the periphery will remain stuck in a depression, with all the attendant political conflict.

In the face of stagnation at home, will core governments do more to boost demand? There is little sign of that in Finland or the Netherlands, both of which are tightening fiscal policy further and steadfastly opposing unorthodox steps to loosen monetary policy, such as quantitative easing. What about Germany? The German government will probably reverse the planned tightening of fiscal policy as Germany's economy weakens. But it is not about to undergo a damascene conversion to the cause of expansionary macroeconomic policies.

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CER in the press

The Economist
17th November 2012
Charles Grant of the CER believes that he [Mr Hollande] is trying to strengthen his position relative to Germany in three ways. One is to forge stronger links with Mediterranean countries, especially Italy and Spain, to form a block that could help to counter Mrs Merkel.

The Guardian
7th November 2012
The CER's John Springford has calculated the UK contribution would be £7.4bn a year if the EU budget were frozen, while the German or Commission plans would result in an additional £400m-550m a year "at most".

The New York Times
7th November 2012
"The reason why we've seen the economy implode much more rapidly than thought is that they grossly underestimated the impact that fiscal austerity of this magnitude would have on the Greek economy," said Simon Tilford of the CER.

The Wall Street Journal
2nd November 2012
Hugo Brady of the CER is worried the government's anti-EU stance may unleash a torrent in Brussels and in Westminster just as the bloc is reinventing itself. Mr Cameron's defeat in Wednesday's vote may be the first sign that euro-scepticism has slipped out of the government's control.

The Guardian
20th September 2012
Schäuble's mantra has consistently been that what's good for Europe is good for Germany... "He's an old-fashioned, very serious European federalist," said Katinka Barysch of the CER.

Channel 4 News
31st October 2012
Philip Whyte of the CER said that despite a complicated structure, reducing the UK's contribution would not result in a more efficient EU budget: "They are right that the structure is crazy. There is a huge appetite for reform, but cutting the budget will not help."

International Herald Tribune
30th October 2012
"The politics of the EU budget are always nasty, but they may be nastier this time partly because of Mr Cameron trying to be Mrs Thatcher," said Stephen Tindale of the CER.