NATIXIS

FLASH ECONOMICS
ECONOMIC RESEARCH

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Moral of the euro-zone crisis: No currency area without federalism between countries whose productive structures are too heterogeneous, especially as a currency area increases this heterogeneity

The euro-zone crisis sends a strong message: a currency area without federalism between countries whose productive structures are very heterogeneous cannot succeed. The reason is that it then becomes normal that some countries have external surpluses, other countries external deficits, and these imbalances are not offset by the income flows that federalism would provide for. Since the accumulation of external debts must then be stopped, countries with deficits must wipe out these deficits; if they are very deindustrialised, this cannot be achieved by improving competitiveness or even by leaving the currency area and devaluing or through a depreciation of the common currency, but only through a decline in purchasing power and, accordingly, a decline in demand and imports.

This prospect is obviously unacceptable for deindustrialised countries, and a key point is that the deindustrialisation is accelerated by membership in the currency area: the deindustrialised euro-zone countries would have benefited from a weak currency 15 years ago, but no longer now.

ECONOMIC RESEARCH
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Heterogeneous productive structures in euro-zone countries

The euro-zone countries have extremely different productive structures, in particular as regards **the weight of industry** (or exporting sectors more generally, **Charts 1A** and **B**).

Chart 1A
Manufacturing employment (as % of total)

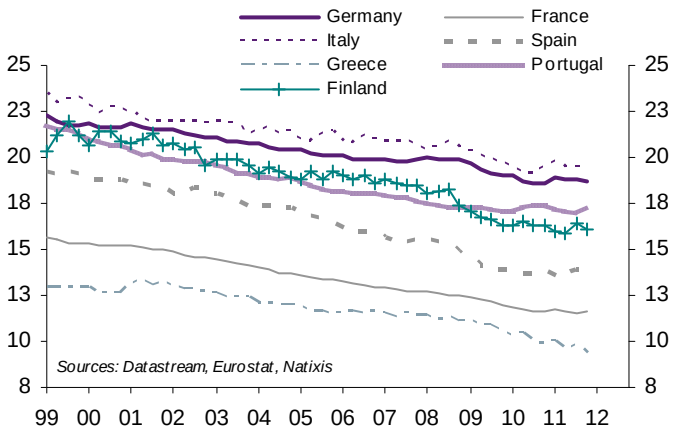
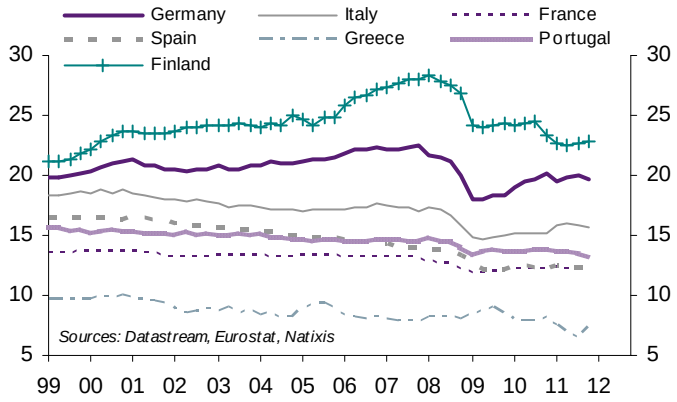


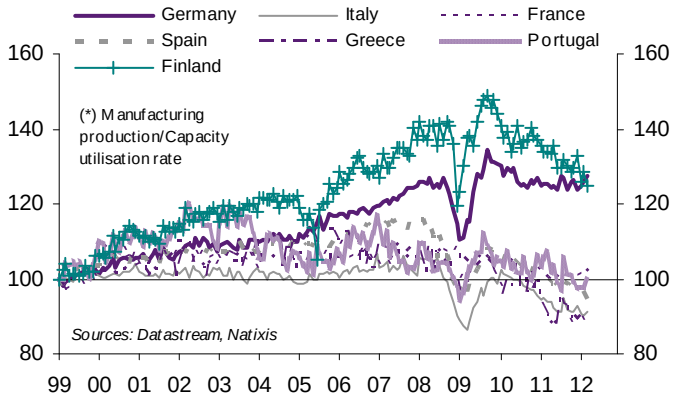
Chart 1B
Value added in the manufacturing sector (in volume terms, as % of GDP)



At the time of the creation of the euro, these countries were already heterogeneous, but the monetary unification amplified the heterogeneity due to the disappearance of exchange-rate risk and the resulting productive specialisation.

We can also look at the change in the **production capacity of manufacturing industry (Chart 1C):** since the creation of the euro, it ranges from -12% to +28%.

Chart 1C
Manufacturing production capacity*
(1999:1 = 100)



The heterogeneity of the productive structures has led to heterogeneous foreign trade situations: the highly deindustrialised countries (Greece, Spain, France, Portugal) have had structural current-account deficits (Chart 2A), and have therefore accumulated growing external debts (Chart 2B), while France has been one of the countries posting an external deficit only for a few years.

Chart 2A
Current-account balance (as % of GDP)

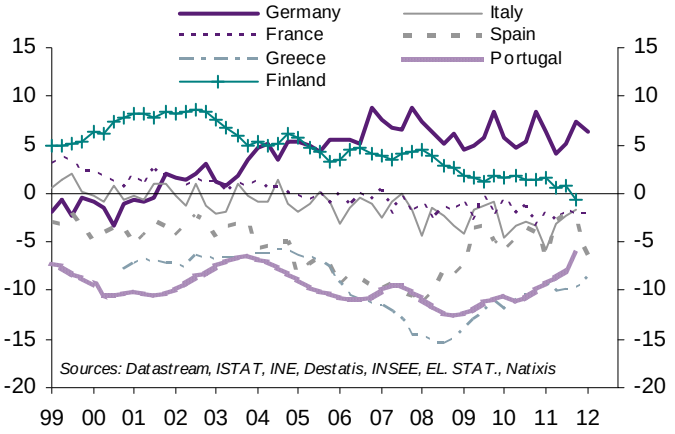
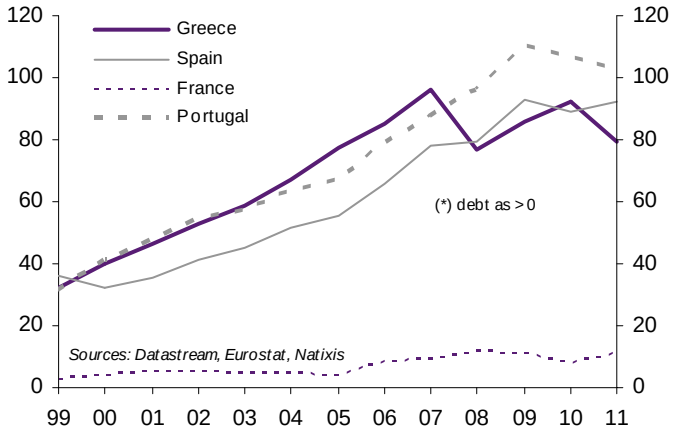


Chart 2B
Net external debts* (as % of GDP)



The need to eliminate external deficits in a currency area without federalism

In a currency area without federalism, i.e. without government transfer payments between countries, **the member countries cannot have a chronic external deficit:** these countries' external deficit is not offset by income flows linked to federalism, which means they have to accumulate external debt **to the point where they lose their external solvency.**

When we look at the level of external indebtedness (**Chart 2B**), the current-account deficit (**Chart 2A**) and trade deficit **(Chart 3A)**, we can see that in the euro zone today, **Spain, Greece and Portugal have lost their external solvency.**

Italy has accumulated external debt, but remains a highly industrial country (**Charts 1A** and **B** above) with a large trade surplus for industrial products **(Chart 3B)**, and a current-account deficit that has become small (**Chart 2A** above).

Chart 3A
Trade balance in goods
(in EUR bn, annualised)

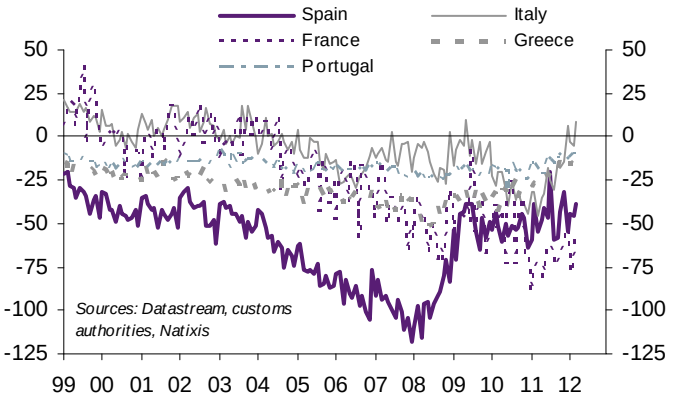
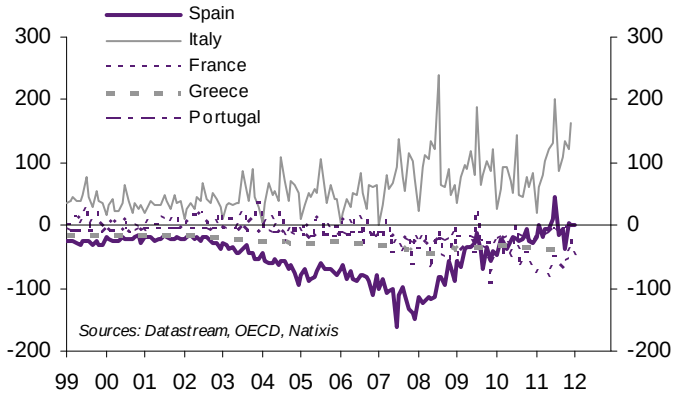
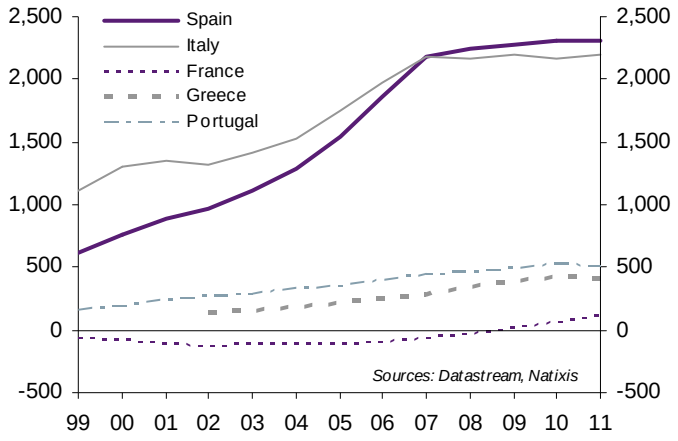


Chart 3B
Trade balance in manufactured goods
(in EUR bn, annualised)



France has a substantial and growing external deficit (**Charts 3A** and **B** and **2A**), but low external debt (**Chart 2B**). Besides, we should **rather look at the gross external debt (Chart 4) than the net external debt** (**Chart 2B** above), as the external assets tend to be corporate assets that cannot offset the external debts (of governments and banks).

Chart 4
Gross external debt (in EUR bn)



How can the external deficit of the deindustrialised countries be wiped out?

So in a currency area without federalism, like the euro zone, the external deficits must be wiped out to stop the accumulation of external debt.

How can the external deficit of deindustrialised countries be wiped out?

(1) If a country has a small industrial sector (France, Spain, Greece, Portugal) a devaluation or an improvement in competitiveness does not work:

(a) If exports are small relative to imports (**Chart 5** shows the extreme case of Greece), a **devaluation increases the import price and this effect outweighs the improvement in exports, which are too small,** on the contrary leading to a deterioration in foreign trade. This holds for:
- **a withdrawal from the euro and a devaluation;**
- **a depreciation of the euro.**

The implications are important:

- **a withdrawal by Greece (Spain) from the euro would worsen the situation of Greece (Spain);**
- **the depreciation of the euro (Chart 6)** improves the situation of Germany and Italy, but worsens the situation of Greece, Spain, France and Portugal.

Chart 5
Greece: Exports and imports of goods (in value terms, in EUR bn, annualised)

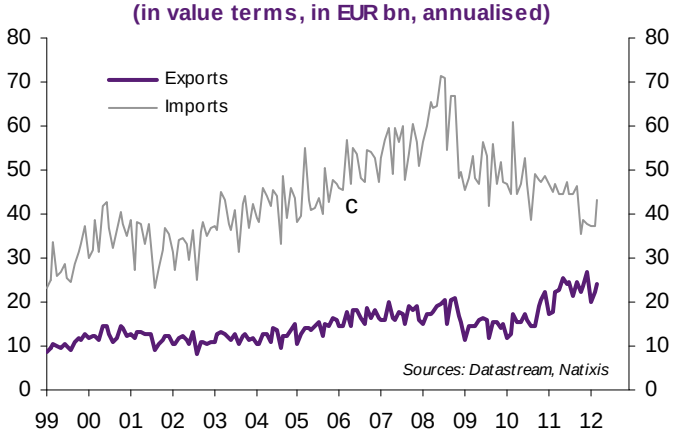
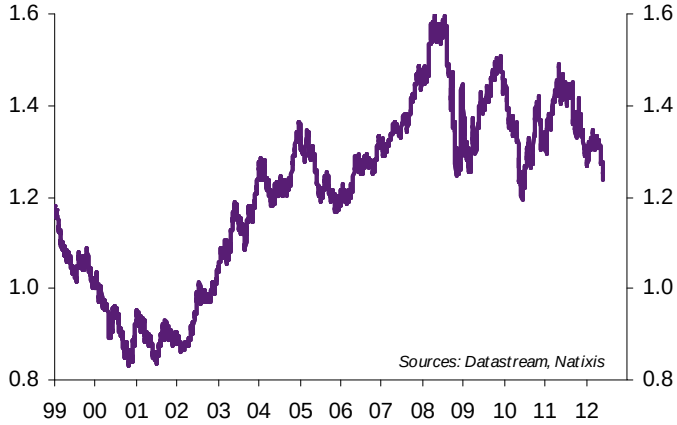
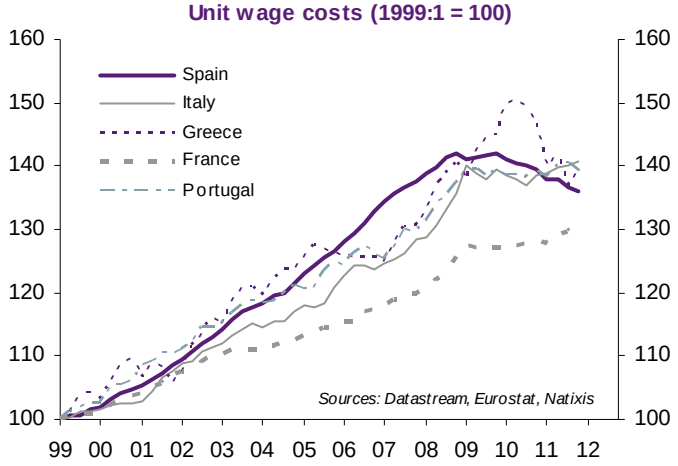


Chart 6
USD/EUR exchange rate



(b) The improvement in cost-competitiveness seen in Greece, Spain and Portugal (Chart 7) has a very limited effect on the foreign trade of a country whose industry is small.

Chart 7
Unit wage costs (1999:1 = 100)



(2) For a deindustrialised country, the only solution is then to reduce purchasing power, and hence domestic demand, and therefore imports, which we are seeing now **(Charts 8A, B** and **C)** in Spain, Greece and Portugal, and to a lesser degree in Italy.

Chart 8A
Real payroll received by households (deflated by consumer price deflator, 1999:1 = 100)

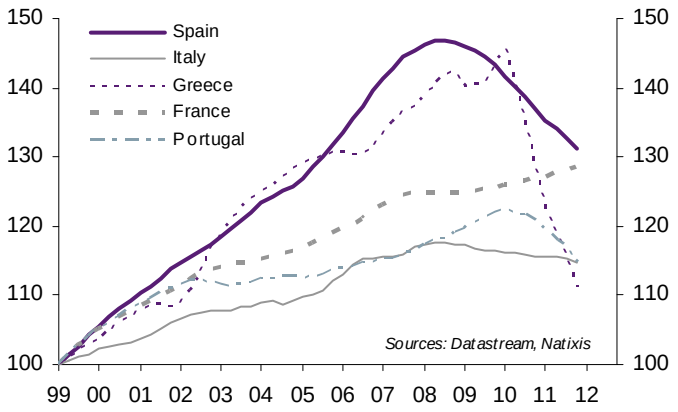


Chart 8B
Domestic demand (in volume terms, 1999:1 = 100)

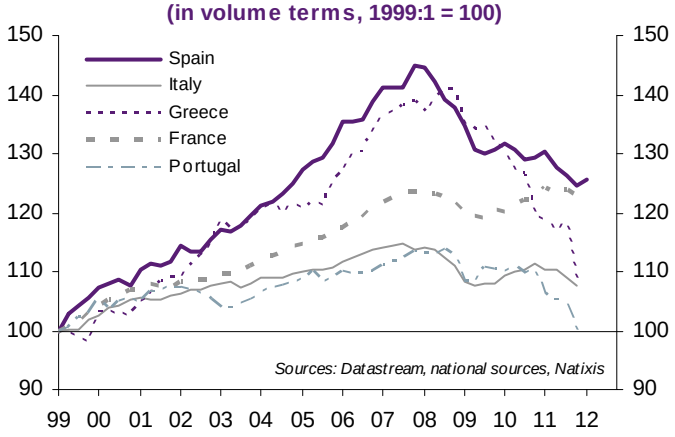
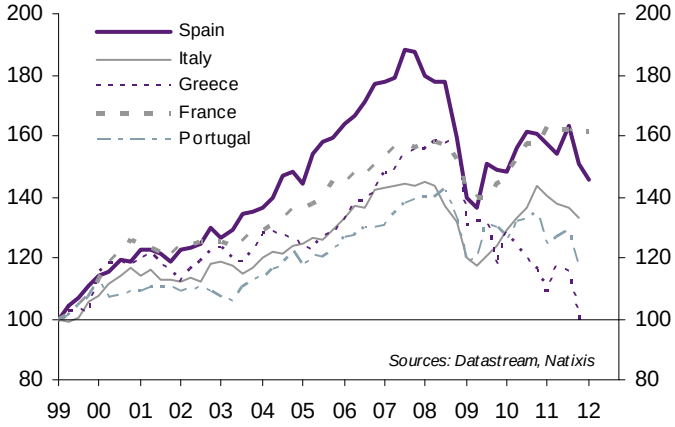


Chart 8C
Imports (in volume terms, 1999:1 = 100)



The impoverishment and rise in unemployment (Charts 9A and **B) resulting from such a policy of reducing the external deficit via a reduction in purchasing power** most often make this policy unacceptable politically and socially.

Chart 9A
Per capita GDP (in euros)

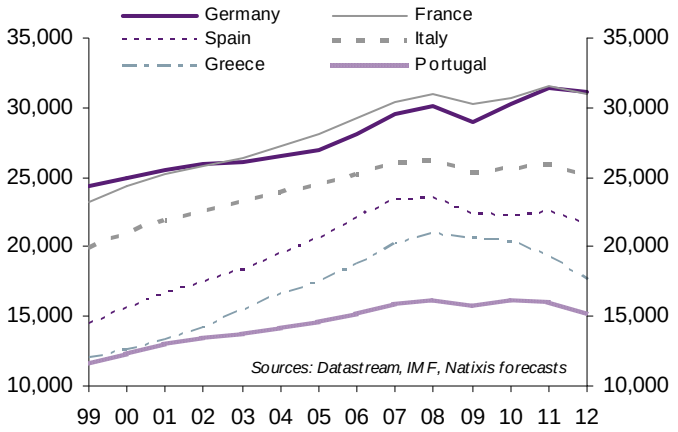
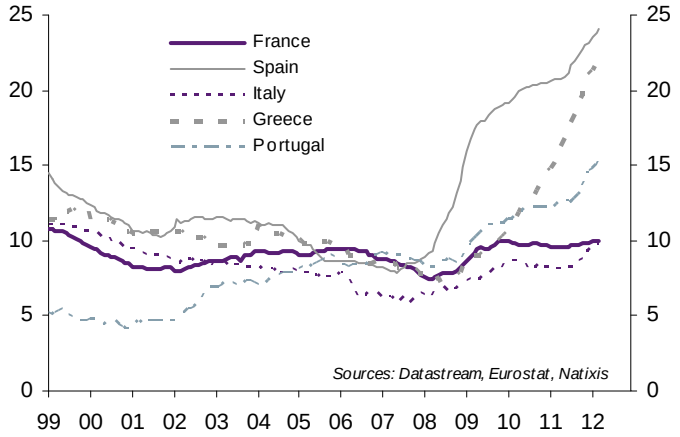


Chart 9B
Unemployment rate



But what is then the solution for the deindustrialised euro-zone countries?

- a contraction in purchasing power is rejected (Greece, Spain, etc.);
- a withdrawal from the euro, a devaluation, a depreciation of the euro, competitiveness gains, etc. are inefficient or even counterproductive.

If institutions are not changed (implementation of federalism in one form or another), these countries' situation is therefore serious.

Before the creation of the euro, their industrial sector was larger than today and their foreign trade (Charts 10A and **B) was balanced (Chart 10C).**

At that time, an exchange-rate depreciation improved foreign trade, as we saw in 1992-93 with the break-up of the European Monetary System **(Chart 10D)** in Spain, Italy and Portugal.

Chart 10A
Manufacturing employment
(as % of total employment)

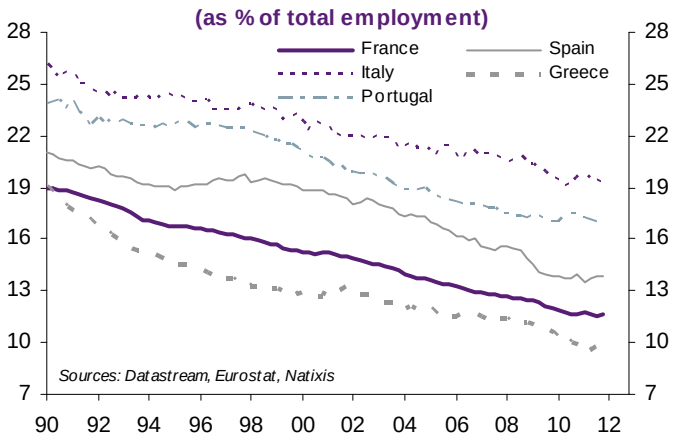


Chart 10B
Value added in the manufacturing sector
(in volume terms, as % of GDP)

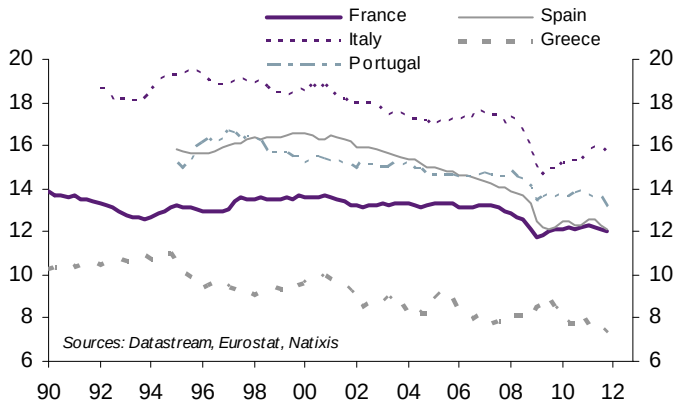


Chart 10C
Current-account balance (as % of GDP)

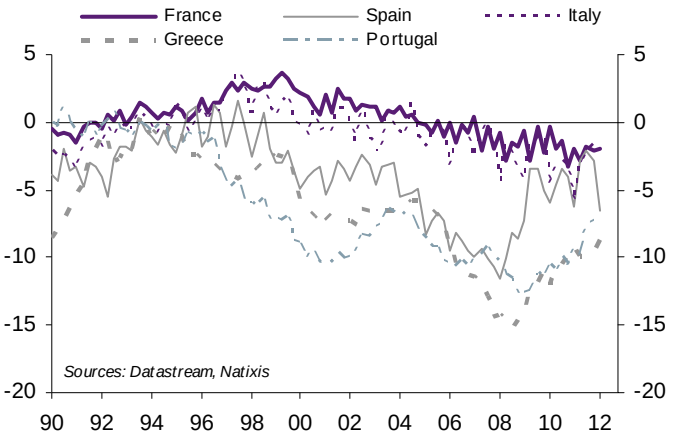
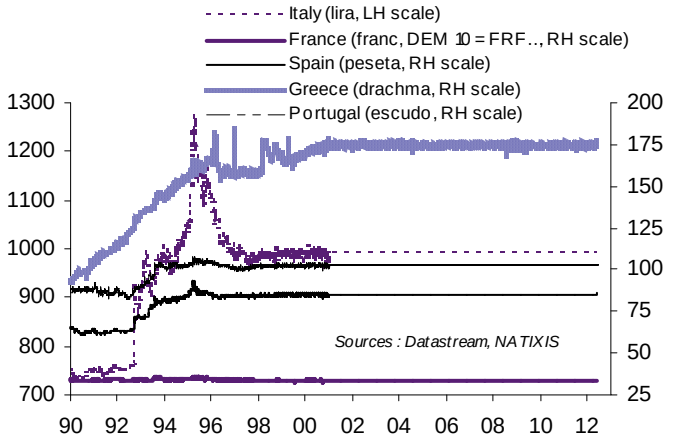


Chart 10D
Exchange rates against Deutschemark



But euro membership accelerated the deindustrialisation in France, Spain, Greece and Portugal, **leading to a situation today where an exchange-rate depreciation no longer improves these countries' foreign trade.**

Conclusion: The moral is clear

The moral is clear: **only countries that have similar productive structures - especially similar export capacity - should be members of a currency area without federalism.**

So the situation of the deindustrialised euro-zone countries is very serious: a devaluation or a depreciation of the euro would no longer improve their foreign trade, and the only remaining possibility to rebalance their external accounts is to reduce the standard of living significantly. **If the euro-zone countries definitely do not want federalism, the countries that were due to become very deindustrialised as a result of euro membership (Spain, France, Portugal) or which were already deindustrialised (Greece) should not have joined the euro zone.**

Currently:

- either the institutions will be rapidly changed towards federalism;
- or some countries will have to accept impoverishment;
- or some countries will leave the euro zone, but this will not solve their problems.

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