Growing Eurozone Inequality And What To Do About It

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Growing inequality between eurozone members is one of the least welcome legacies of the euro- and sovereign debt crisis. The idea that the less well-off member states would catch up with the better-off in terms of GDP per capita was one of the great promises of the Maastricht Treaty, although very little emphasis is given to it whenever eurozone reforms are discussed. The truth is that convergence never really got off the ground after the treaty was signed.

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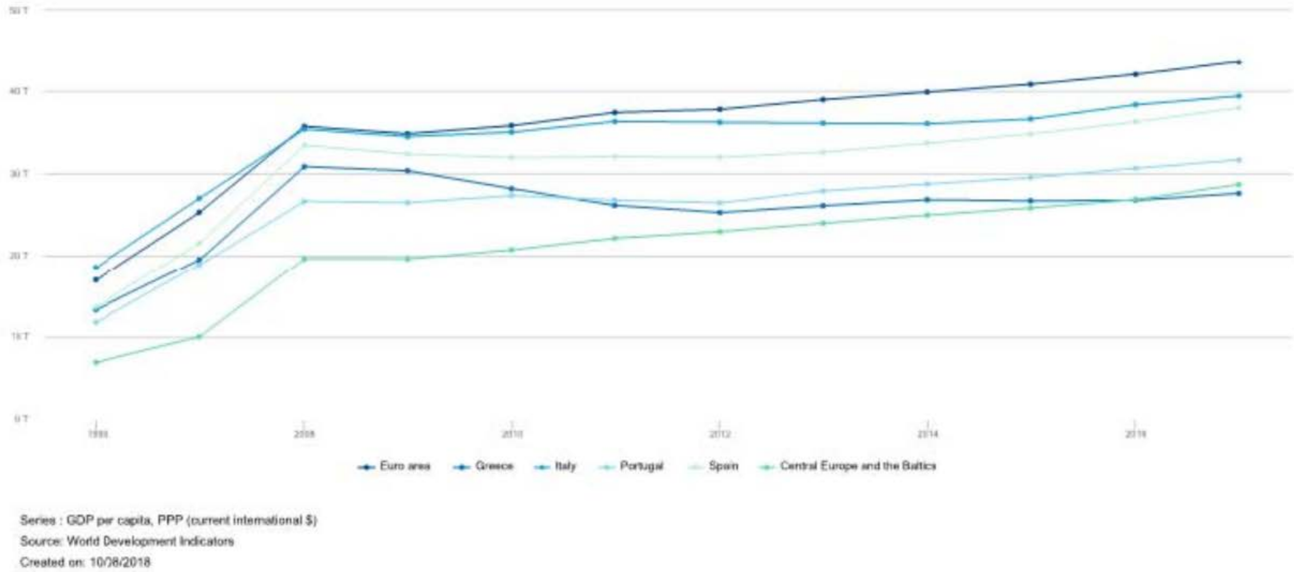


Income convergence is not only a legitimate expectation of the less well-off. It is also a condition that has to be fulfilled for the euro to be socially and politically sustainable in the long run. Increased market integration only translates into a durable higher growth potential if members also become more resilient to shocks and downturns. Instead, economic recovery has been slow and unequal during the decade and regional differences have become more pronounced (OECD). This undermines – with reason – public support for the common currency.

Several factors account for this alarming trend. While some are peculiar to the member states individually, some others must be addressed at eurozone level.

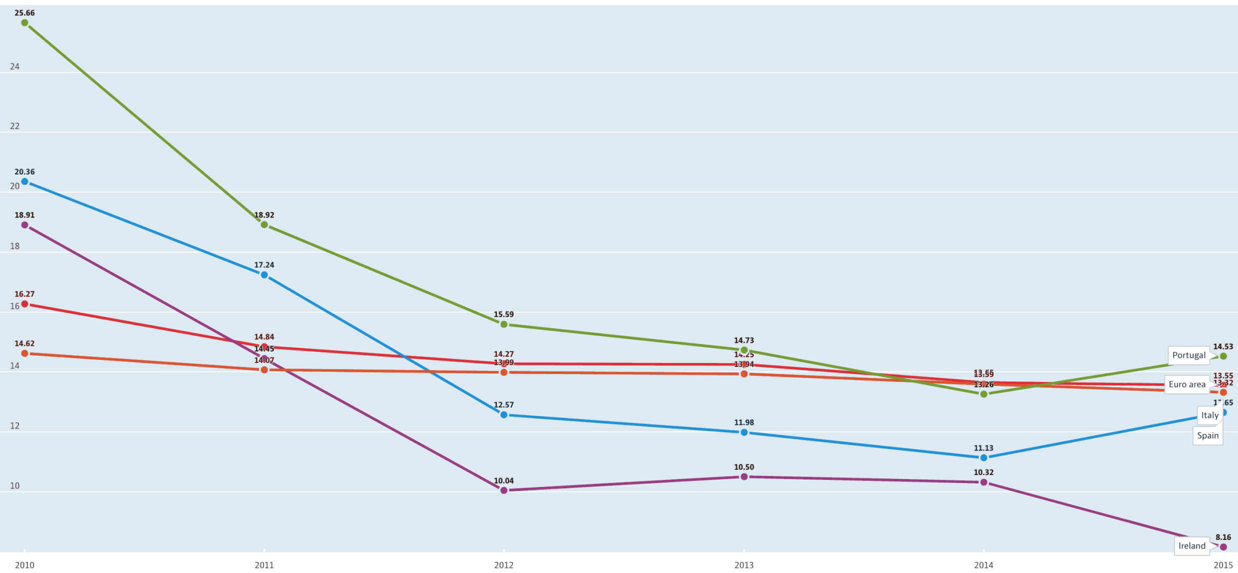
As to the former, the lack of convergence can largely be ascribed to persisting productivity gaps, which have even widened in the post-crisis years due to the debt overhang and firms' deleveraging.

As long as some of the causes of macroeconomic divergence lie in long-term endogenous trends, only the member states can do something about them, for instance by implementing the (in)famous structural reforms. Having been often construed as synonymous for "tightening one's belt", structural reforms prompt instinctive rejection amongst progressives. They can require the opposite, though, as the Italian case shows.

From the 1990s onwards, Italian firms and legislators attempted to counter Italy's decline on the world market by increasing wage competition and introducing ever new forms of temporary employment, instead of investing in higher skills, productivity-enhancing technologies, and active labor market policies. This kind of labor market "flexibility" did not halt the productivity decline of Italian producers.

The quality of public administration, of the legal system, and the level of workers' skills are all challenges that the less well-off member states will have to tackle on their own in the coming years. Debt overhang is, however, a high hurdle on this path. The countries more in need of reducing past debts are those that also find it more difficult to invest in productivity-enhancing reforms. Public investment is sluggish, while private investments also stagnate as a consequence of corporate sector deleveraging. This might deepen the productivity gap, notwithstanding some more recent positive signals in this regard.

Investment by sector: General government, % of GFCF, 2010 – 2015



Source: OECD

As a result, in the countries that the crisis hit hardest, growth is more at risk than elsewhere. Economic developments at eurozone level are therefore decisive for their recovery to be sustainable.

Two solutions commend themselves in this regard: a central fiscal capacity for investments and a tighter coordination of national economic and fiscal policies such as to fend off populism-fuelling deflationary tendencies.

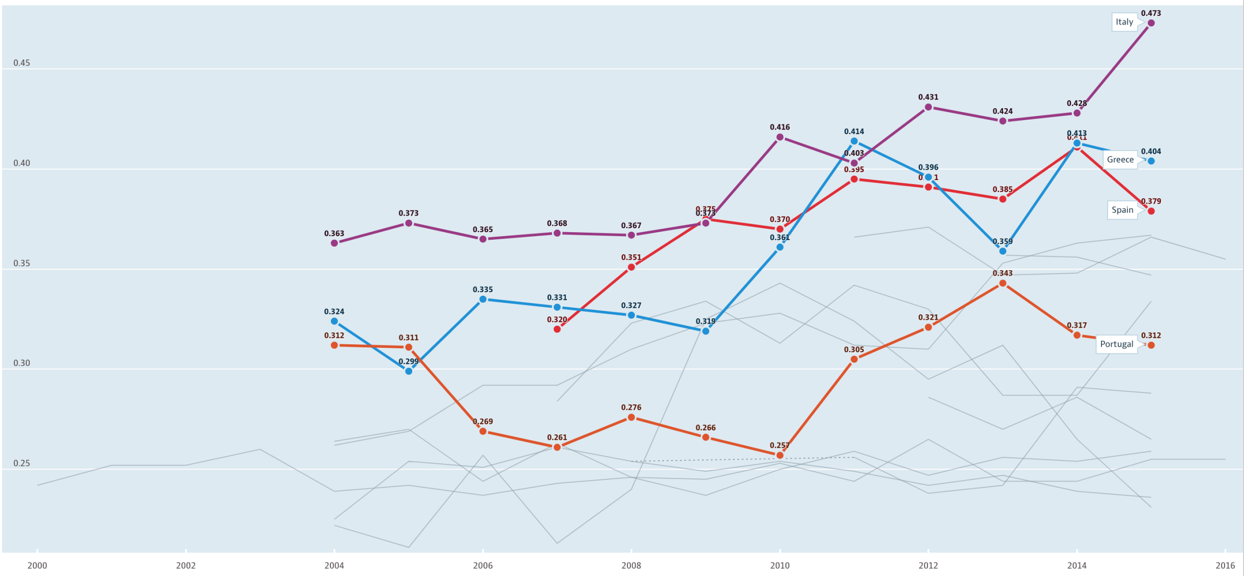
As to the latter, no news is reported. The Alert Mechanism Report 2018 highlights how a persisting lack of coordination represents one of the eurozone's key fragilities. Efforts towards rebalancing have rested entirely on the shoulders of deficit countries through internal devaluation and attempts to increase exports. The eurozone economy continues being an export-based system of competing national economies in which very little is being done for balanced and fair growth.

More is apparently being done for the institution of a central fiscal capacity to boost productivity-enhancing investments after the Franco-German Meseberg declaration of 19 June put a euro area budget on the table. This seems, however, only a small and very initial step in the right direction. In a letter sent to European leaders on 25 June, Eurogroup President Mário Centeno reports "differences of views on the need for and possible features of a eurozone budget for competitiveness, convergence and stabilization" and, indeed, the subsequent euro summit's final statement makes no mention of it. This comes as no surprise, as the Franco-German declaration has been an immediate cause of concern for a number of Eurozone partners. In addition, disagreement concerning the volume of the budget materialized in its immediate aftermath, with French President Macron speaking of an order of hundreds and German Chancellor Merkel of an order of tens of billions euros. Not a negligible difference.

Things are nevertheless on the move in the struggle for eurozone reforms, as the agreement of the two senior partners put a long-awaited issue on the leaders' agenda. This is normally the first step in European diplomacy for a new phase of negotiations to open in the first place, as Portuguese Prime Minister Costa underscored when stating that "no longer than two years ago the sole allusion at a eurozone budget caused a fit of apoplexy to half of the Council members".

The next struggle will be fought at the 2019 European elections, when the traditional parties will have to decide whether they want to take responsibility for the advancement of the Union's social cohesion rather than simply oblige parochial interests. A permanent, adequately funded, and centrally-financed investment facility for productivity-enhancing initiatives would help revitalize aggregate demand, smooth out internal adjustment processes and ease pressure on national budgets in times of deleveraging. This is especially important to the extent that inequalities are increasing not only between, but also within countries, and the more so the hardest they were hit by the crisis. The poverty gap has widened among the working-age population, as welfare provisions could not cushion ten years of sluggish labor markets, loss of production capacity, and skills mismatch.

Poverty gap: 18-65 year-olds, Ratio, 2000 – 2016



Source: OECD

Under the present conditions, social exclusion within countries and inequality between countries might become a permanent threat for the coming decades both in political and structural terms.