

Devaluation through wages in the euro zone: a lose-lose adjustment

by Sabine Le Bayon, [Mathieu Plane](#), Christine Rifflart and Raul Sampognaro

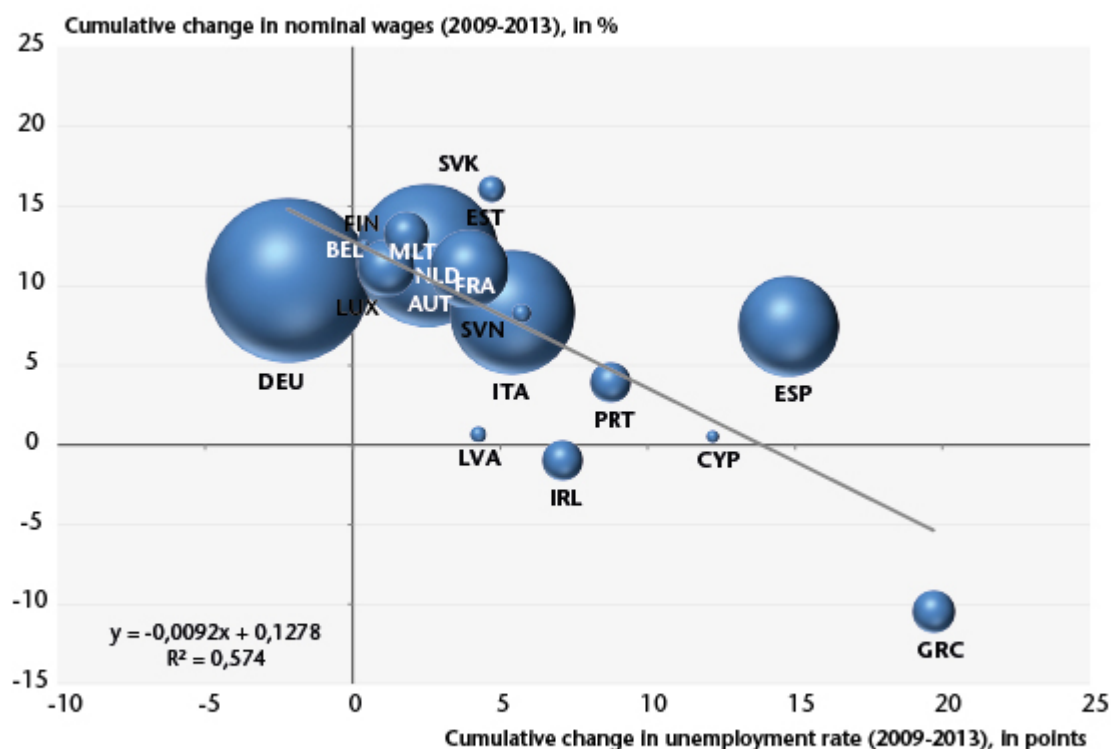
Since the outbreak of the financial crisis in 2008 and the sovereign debt crisis in 2010-2011, the euro zone countries have developed adjustment strategies aimed at restoring market confidence and putting their economies back on the path to growth. The countries hit hardest by the crisis are those that depended heavily on the financial markets and had very high current account deficits (Spain, Italy, but also Ireland, Portugal and Greece). Although the deficits have now been largely resolved, the euro zone is still wallowing in sluggish growth, with deflationary tendencies that could intensify if no changes are made. Without an adjustment in exchange rates, the adjustment is taking place through jobs and wages. The consequences of this devaluation through wages, which we summarize here, are described in greater depth in [the special study published in the dossier on the OFCE's forecasts \(Revue de l'OFCE, no. 136, November 2014\)](#).

An adjustment driven by moderation in wage increases ...

Faced with falling demand, companies have adapted by making heavy cutbacks in employment in order to cut costs, which has led to a steep rise in unemployment. The number of jobless in the euro zone was 7 million higher in September 2014 than in March 2008. The situation is especially glum in countries like Greece, where the unemployment rate is 26.9%, Spain (24.2%), Portugal (13.8%) and Italy (12.5%). Only Germany has experienced a reduction in unemployment, with a rate of 5.0% of the active population.

As is suggested by the Phillips curve, runaway unemployment has eventually affected the conditions governing wage increases, especially in the most crisis-ridden countries (Figure 1). While between 2000 and 2009 wage growth was more dynamic in the peripheral countries (3.8% annually) than in the countries in the euro zone core (+2.3%) [1], the situation reversed after 2010. Nominal wage growth slowed in the peripheral countries (0.8%), but stayed close to the pre-crisis rate (+2.6%) in the core countries. This heterogeneity is due to differences in how much unemployment has worsened in the different countries. According to Buti and Turrini (2012) [2] from the European Commission, reversing the trend in wage dynamics will be a major factor driving the rebalancing of current account positions in the euro zone.

Figure 1. Changes in unemployment rates and nominal compensation per employee



Note: The size of the bubble is proportional to the GDP of each country in the euro zone.
Sources : Eurostat, OFCE calculations.

Furthermore, an analysis at the macroeconomic data level masks the extent of the ongoing wage moderation, as the effects of the crisis are concentrated on the most vulnerable populations

(young, non-graduate employees) earning the lowest wages. The deformation of the structure of employment in favour of more skilled and more experienced workers ([see the OFCE post: On the difficulty of carrying out structural reforms in a context of high unemployment](#)) is also pushing up mid-level wages. As can be seen in a number of studies based on an analysis of the macroeconomic data [3], wage growth after correcting for these composition effects is below the increase in the average salary.

... that compresses domestic demand and is not very effective in terms of competitiveness

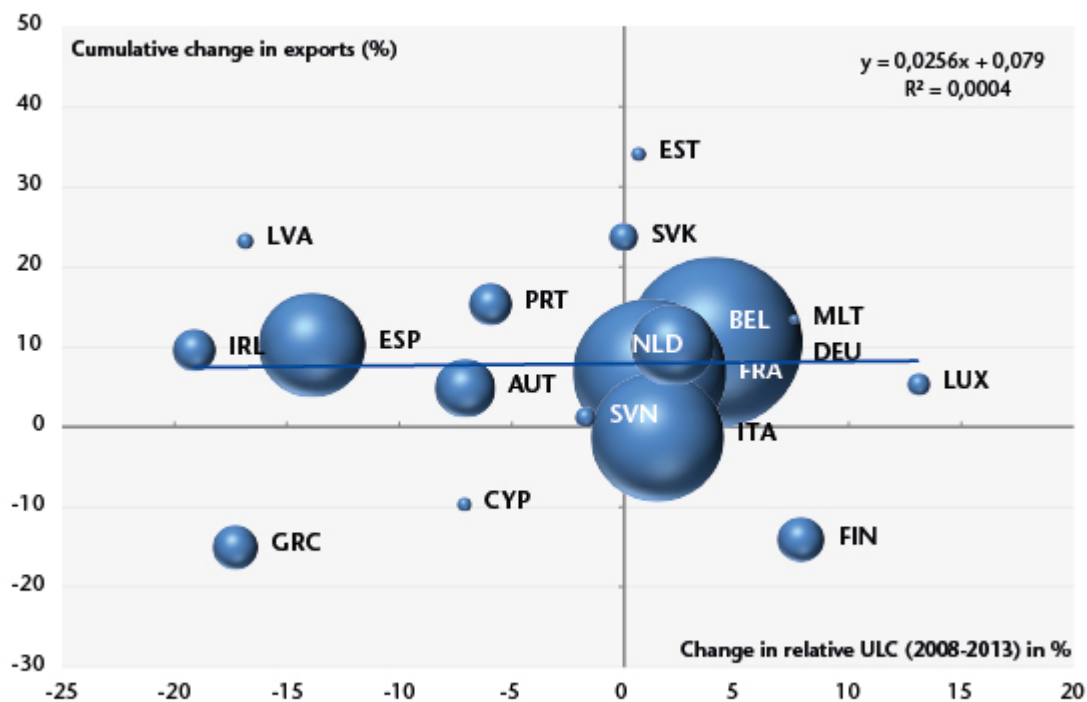
Underlying this policy of deflationary adjustment through wages, what is important for companies is to improve competitiveness and regain market share. Thus, compared with the beginning of 2008, unit labour costs (ULC) [4] fell in the countries deepest in crisis (Spain, Portugal and Ireland), slowed in Italy and continued their upward progression in the countries in the euro zone core, *i.e.* those facing the least financial pressure (Germany, France, Belgium and the Netherlands).

The most significant adjustment took place in Spain. Deflated by inflation, its ULC has fallen by 14% since 2008, 13 points of which are explained by the recovery in productivity, which was achieved at the expense of massive cuts in employment. Real wages increased only 1% over the period. Conversely, in Italy, the adjustment has focused on wages, whose purchasing power has fallen by 5%. However, this decline was not sufficient to offset the fall in productivity, and thus to prevent an increase in the real ULC. In Germany, after the real ULC rose in 2008, real wages continued to rise, but less than gains in productivity. In France, real wages and productivity have risen in tandem at a moderate pace. The ULC, deflated by inflation, has thus been stable since 2009 but has still worsened compared to 2008.

Even though this deflationary strategy is intended to restore business competitiveness, it is a double loser. First, as the strategy is being implemented jointly in all the countries in the euro zone, these efforts wind up neutralizing each other. Ultimately, it is the countries that carry the strategy furthest that win the “bonus”. Thus, among the euro zone’s larger economies, only Spain can really benefit due to the sharp reduction in its ULC, which reflects not only its own efforts but also some continued wage growth among its key partners. France and Italy are not experiencing any gain, and Germany has seen a deterioration in its ULC of about 3% between 2008 and 2013. Moreover, while the wage devaluation might have helped to boost activity, this will have been accomplished through a rebound in exports. But it is difficult to find any correlation between exports and wage adjustments during the crisis (Figure 2). These results have already been pointed out by [Gaulier and Vicard \(2012\)](#). Even if the countries facing the deepest crisis (Spain, Greece, Portugal) might gain market share, the volumes exported by each of them are in the short/medium term not very sensitive to changes in labour costs. This might be explained by companies’ preference to rebuild their margins rather than to lower export prices. Even in countries where the relative ULC fell sharply, the prices of exports rose significantly (6.2% in Greece, 3.2% in Ireland since 2008, etc.).

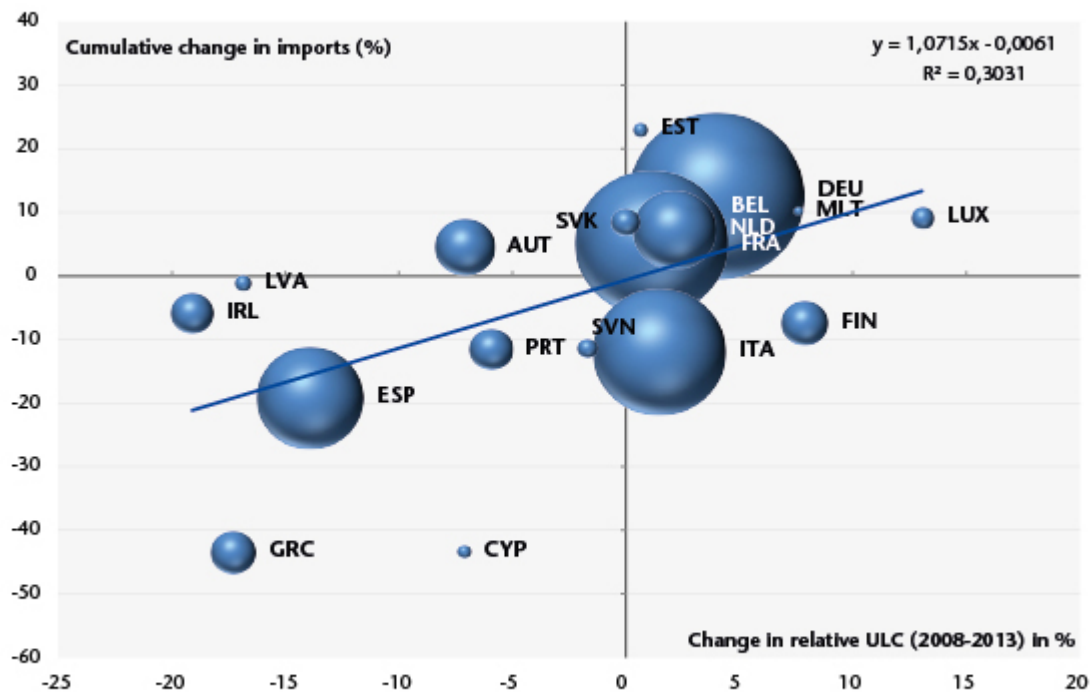
Finally, in an effort to improve their cost competitiveness, companies reduced their payroll by cutting employment and / or wages. This strategy of competitive disinflation results in pressure on household incomes and thus on their demand for goods, which slows the growth of imports. Indeed, in contrast to what is observed for exports, there is a close and positive relationship between changes in the relative ULC and in import volumes over the period 2008-2009 (Figure 3). In other words, the greater the adjustment effort in the ULC with respect to competitor countries, the slower the growth in import volumes.

Figure 2 : Change in relative ULC and exports, in volume



Note: The size of the bubble is proportional to the GDP of each country in the euro zone.
Sources : Eurostat, OFCE calculations.

Figure 3. Change in relative ULC and imports, in volume



Note: The size of the bubble is proportional to the GDP of each country in the euro zone.
Sources : Eurostat, OFCE calculations.

This non-cooperative strategy to rebalance the current account can permanently affect an economic recovery in a context where reducing the debt of both private and public agents will become even more difficult if deflationary pressures are felt in an ongoing way (due to increases in real terms in debt and interest rates). The imbalances in the current accounts of the various euro zone countries will thus be dealt with *mainly* by a contraction of imports. The correction of such imbalances by means of a wage devaluation, as was the case in 2010-2011, is therefore doubly expensive: a low impact on competitiveness, relative to competitors, due to the simultaneous implementation of the strategy in the various euro zone countries, and an increased risk of deflation, making it more difficult to shed debt, thereby fuelling the possibility of a scenario of prolonged stagnation in the euro zone.

[1] Germany, France, Belgium and the Netherlands. The peripheral countries include Spain, Italy, Portugal and Greece.

[2] Buti and Turrini (2012), "[Slow but steady? Achievements and shortcomings of competitive disinflation within the Euro Area](#)".

[3] For a comparison of a number of euro zone countries at the start of the crisis, see ECB (2012), "[Euro Area Labor Markets and the Crisis](#)". For the case of Spain, see Puente and Galan (2014), "[Un analisis de los efectos composición sobre la evolución de los salarios](#)". Finally, for the French case, see Verdugo (2013) "[Les salaires réels ont-ils été affectés par les évolutions du chômage en France avant et pendant la crise?](#)" and Audenaert, Bardaji, Lardeux, Orand and Sicsic (2014), "[Wage resilience in France since the Great Recession](#)".

[4] The unit labour cost is defined as the cost of labour per

unit produced. This is calculated as the ratio between compensation per capita and average labour productivity.

The French fiscal devaluation, or the French Achilles strives to catch the German tortoise

By [Sarah Guillou](#)

In the 1980s, under the European Monetary System (EMS), France repeatedly carried out currency realignments – in 1981, 1982, 1983 and 1986 – that were tantamount to devaluations. For its part, Germany had – already! – adopted a rigorous strategy of competitive disinflation, which, it was said at the time, led to disciplining its companies, which could not rely on the temporary advantages gained by currency devaluations rendering its exports more competitive. They were compelled instead to make investments so as to build up their future non-price competitiveness. Which they did...

During this same period France's devaluations left it with imported inflation and companies that had less incentive to invest in non-price competitiveness. The peg to the deutsche mark and then the Monetary Union were presented as ways to break out of this endless strategy of inflationary devaluations. France belatedly wound up adopting Germany's strategy of competitive disinflation and renouncing currency devaluations, with a strong franc strategy characterizing the

1990s.

Today, the terms of the debate seem reversed, even though France is still in the position of Achilles chasing the German tortoise. A new form of competitive devaluation is in favour: not based on the exchange rate, since the euro is part of a market mechanism that determines its value, but one that involves a reduction of the labour costs borne by business, funded in part by an increase in Value Added Tax (VAT). This is called a fiscal devaluation. In an article entitled "Changer de Modèle", P. Aghion, G. Clette and E. Cohen defend this on the grounds that it is necessary to "think differently"[\[1\]](#). The government is also implementing this through the Competitiveness and employment tax credit (CICE) and its plans in the 2015-2017 Stability Pact to cut social security charges.

How is a reduction in the cost of labour comparable to a "fiscal" devaluation? A devaluation, it should be recalled, leads to lowering domestic prices relative to foreign prices as the value of the domestic currency is decreased relative to a unit of foreign currency. A devaluation of the euro, if it were possible, would mean a higher amount of euros to buy a dollar; consequently, a European car at 10,000 euros would go for fewer dollars and thus become more attractive to an American buyer who would still be holding the same amount in dollars in his wallet. More generally, a devaluation ensures that the production cost of domestic firms becomes cheaper relative to their foreign competitors, so that the former have a cost advantage and become more competitive. Hence the term "competitive devaluation".

By lowering companies' labour costs, it is assumed that the prices of exported products (and the goods and services included) will be lowered – despite the fact that labour costs do not cover the full cost of production. By increasing VAT on all products, the price of imported products increases as well. The devaluation effect – that is to say, the reduction

in domestic prices relative to foreign prices – will take place only if the competitors' prices remain constant – in other words, only so long as the competitor does not implement the same policy at the same time! Furthermore, this will really have an impact on competitiveness if the price differential existing prior to the fiscal devaluation is more than offset by the reduction in labour costs.

Two further questions arise. First, we do not know the price elasticity of the labour costs. In other words, we do not know the extent to which firms pass lower employer costs onto prices. Second, labour market studies show that wages have a positive elasticity to labour costs. In other words, in the medium term and especially for higher wages, cutting payroll taxes on wages will result in increases in pay.

The medium-term effects are then drawn on to defend the fiscal devaluation policy. The reduction in employer contributions initially gives some manoeuvring room, or rather a cash flow, that then leads companies to invest, precisely because of the recovery in their margins. Incidentally, this excludes the previous effect, *i.e.* a reduction in prices, or in any case will have a maximum impact if the price drop does not occur. It is possible however that higher margins are a side effect of a reduction in prices, which pushes up sales, while increasing the profit per unit in a cost structure with increasing returns to scale, even if this affects only a few companies. Now suppose that the margins generated translate into investments. This could improve the companies' non-price competitiveness (the intrinsic product quality) in the future. This second aspect of fiscal devaluation is often put forward in parallel with the observation that French companies, in particular manufacturers, suffer both from crippling tax and regulatory conditions that handicap their international competitiveness and from a lack of product quality. But here macroeconomic analysis can no longer be invoked, and with respect to non-price competitiveness we know much less about

the microeconomic dynamics due to the reduction of charges.

Let's conclude by considering the effects expected over the longer term. As pointed out by Aghion *et al.* in a footnote on page 58, the effects of a fiscal devaluation are temporary. Indeed, as with a currency devaluation, a fiscal devaluation will lead to an increase in wages due to the dynamics described above. Moreover, if the financing of the reduction in charges results in reducing households' purchasing power due to the VAT hike, then the latter could also demand an increase in their nominal wages. The initial reduction in relative prices will be wiped out over the longer-term by the rise in wages. The authors could draw on the quasi-deflation in Europe to deal with this side effect of a devaluation. They argue instead that the interval will give a new impetus to business. In fact, what the authors defend is not the direct effect of the devaluation but its indirect effect on the level of investment due to the increase in margins.

However, this is also undoubtedly the aim of the CICE tax credit, as it targets taxes and not employer charges directly, unlike the Responsibility Pact which is aimed primarily at employment. By granting a tax credit, the CICE seeks to generate margins for investment in order to develop non-price competitiveness. The problem is that an improvement in competitiveness is far from guaranteed (see Guillou and Treibich, [Note de l'OFCE, no. 41 of 19 June 2014](#) [in French] on the CICE and competitiveness), while the dual objective of this tax credit (employment and competitiveness) will complicate companies' decision-making.

To pick up on the suggestion by Aghion *et al.*, the memory of the French competitive devaluations of the 1980s could lead us to "really think differently", that is to say, to stop applying policies that others have already applied. To think otherwise would mean to anticipate future competition rather than to replicate a policy that other countries have already implemented, which is obviously not so simple. And the

interest of the work of Aghion *et al.* is in embracing a set of reforms that, taken **simultaneously**, could put France on a **different** trajectory.

But to undertake a fiscal devaluation while all the countries of Europe potentially will do or actually have done the same would generally be insufficient and even dangerous if it leads to a race to social dumping. It would be justified only because European integration requires a certain alignment of companies' cost conditions, and thus due to fiscal competition. Repeatedly lagging behind fiscally in an integrated European market is very costly, it is true, but the French Achilles will not catch the German tortoise that has set off early in the field of competitiveness by using the weapon of a fiscal devaluation.

A better strategy would be to get ahead of the game. In the absence of being able to harmonize companies' fiscal conditions, it is necessary to anticipate. Germany anticipated competition from the emerging countries and implemented social VAT, or a fiscal devaluation. A policy that would change the "model" should anticipate future competition in Europe and around the world. However, this competition will not be over the cost of labour. Proof of this lies in the approach of countries with a low relative cost of labour that are more and more replacing labour with capital. China for instance has already become the world's largest purchaser of industrial robots (*Financial Times*, 1 June 2014). Future competition will be structured around the pursuit of two trends already taking place: the division of the production process as it is being accelerated by technological possibilities, and the replacement of labour by technology. Most value added will be focused upstream of production in design and / or downstream in related services. In other words, the government also needs to take an interest in the cost of capital, particularly in terms of the opportunity cost of investment.

The question of labour costs concerns the employment of less-

skilled workers (obviously of great importance *per se*), but it is not at the heart of the problem of competitiveness. In attempting to solve the problem of the day, the cost of labour, there is a risk of not making the investments that ensure the future. Could France stop being the Achilles that chases the German tortoise? One way to resolve Zeno's paradox would be to invent a government that maintains continuity. Otherwise, we need to do away with a strategy of catching-up and opt for a more winning "model".

[\[1\]](#) This is in fact the title of the first chapter of the book by P. Aghion, G. Clette and E. Cohen, *Changer de modèle*, Ed. Odile Jacob, 2014.

What is a weaker euro likely to mean for the French economy?

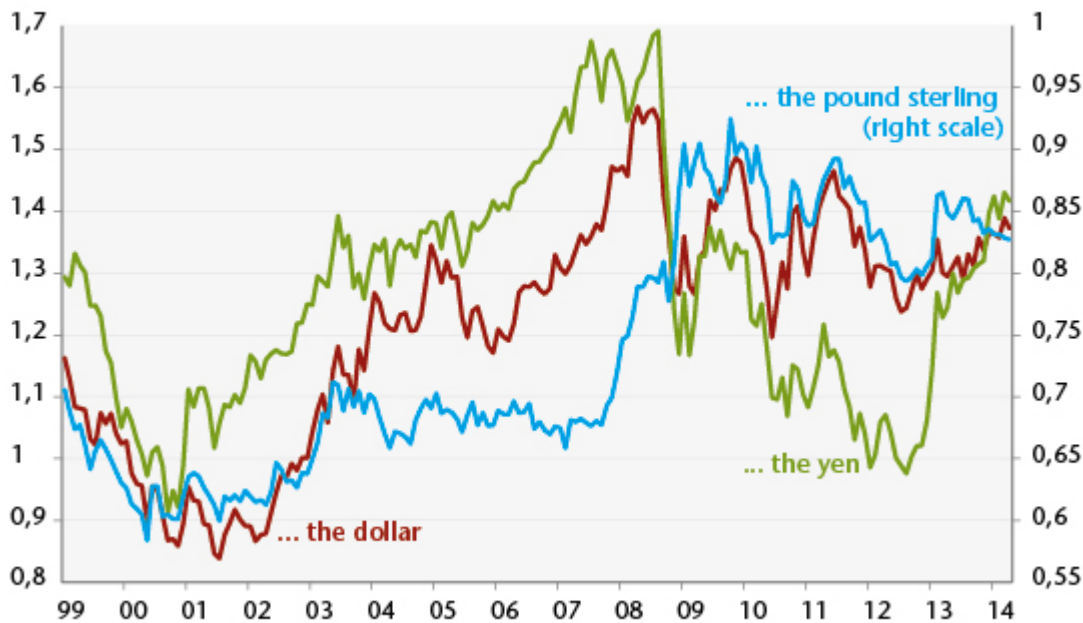
By [Bruno Ducoudré](#) and [Eric Heyer](#)

Faced with the rising risk of deflation in the euro zone, which has been reinforced since mid-2012 by the continued appreciation of the euro against other currencies, the heads of the European Central Bank have begun to change their tone in their communications with the financial markets: [they are now evoking the possibility of conducting a new round of quantitative easing](#). These measures are likely to lower the

exchange rate of the euro. This would provide valuable support for the euro zone economies by shoring up their price competitiveness vis-à-vis competitors outside the zone, in a context where fiscal consolidation policies will continue to dampen [the growth expected in the zone in 2014 and 2015](#). What are the likely consequences for the French economy from reducing the euro's value against other currencies? We briefly review past episodes of exchange rate changes, and then present the impact expected from a 10% depreciation of the euro against other currencies using the *emod.fr* model. These effects are more moderate than those projected by the government.

Quantitative easing measures have been used extensively by the US Federal Reserve, the Bank of England and the Bank of Japan. Since mid-2012, the balance sheets of these three banks has continually increased, by respectively 6.5 percentage points of GDP, 1.3 GDP points and 15.3 GDP points. [During this same period, the ECB balance has on the contrary declined by 8.4 GDP points](#). This difference in strategy has led to a continued rise in the strength of the euro: now at 1.38 dollars, the euro has seen its value against the dollar increase by 12% since June 2012. During the same period, the single currency has appreciated 49% against the yen and about 3% against the pound sterling (Figure 1).

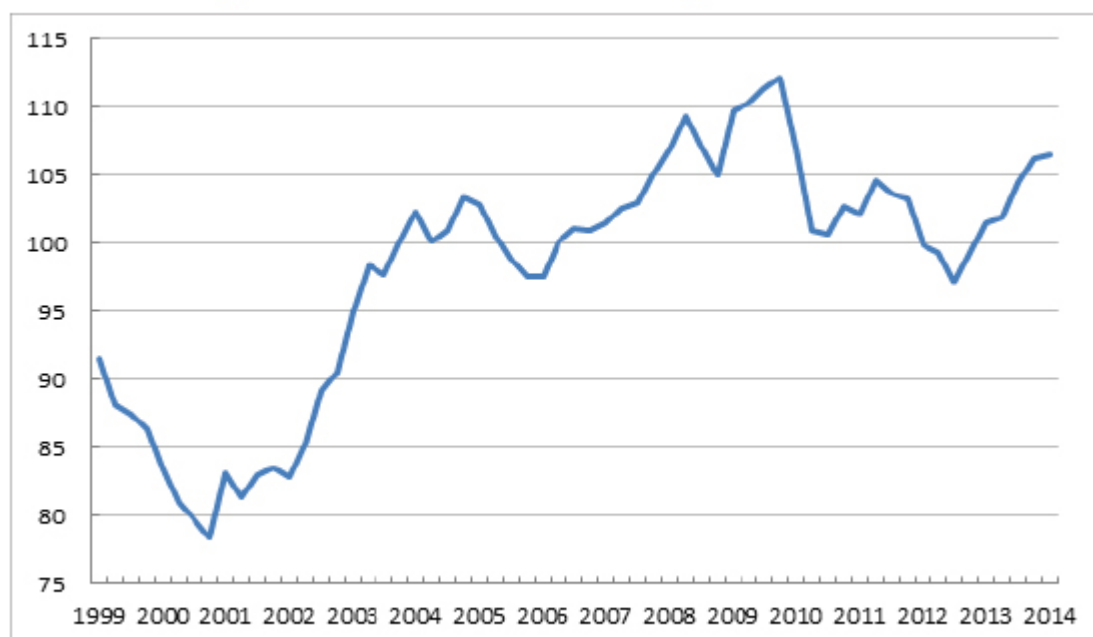
Figure 1. Exchange rate of the euro against...



Source : Datastream.

The nominal effective exchange rate of the euro, which weights the different exchange rates depending on the structure of trade in the euro zone, has thus appreciated by 9.5% since the third quarter of 2012 (Figure 2). This appreciation, combined with austerity policies and the competitive disinflation carried out within the euro zone, has held down GDP growth in the zone, which was negative in 2012 and 2013, as well as inflation. The absence of inflationary pressures and the past appreciation of the euro have now given the ECB leeway to try to influence the course of the euro against other currencies.

Figure 2. Nominal effective exchange rate of the euro



Source : OECD.

What would be the impact of a devaluation of the euro against all currencies?

The depreciation of the euro would have a dual effect:

- **An income effect:** a weak euro would increase the prices of imports. This would result in higher energy costs, a rise in companies' prices of production and a loss of household purchasing power;
- **A substitution effect:** a weak euro would decrease the prices of exports and increase their volume. Depreciation would also decrease the competitiveness of rival manufacturers, causing a decline in imports in favour of domestic production.

These opposite effects would apply only to trade outside the euro zone. Trade with our European partners would not be directly impacted, as the prices of imports and exports to and from this area would remain unchanged. On the other hand, intra euro zone trade would be impacted by a weaker euro. But this involves the channel of addressed demand.

Table 1. Impact on the French economy of a 10% depreciation in the exchange rate of the euro against all currencies combined

(Difference with the reference scenario in %)	n	n+1	n+2	n+8
GDP	0,3	0,4	0,5	0,0
Total waged employment (1000s)	22	53	74	34
Household consumer prices	0,9	1,4	1,9	3,9
Public financing capacity (% of GDP)	0,0	0,2	0,3	0,2

Note: The euro's depreciation would be favourable to short-term activity due to an improvement in France's price competitiveness relative to countries outside the euro zone. The positive impact of the euro's depreciation on the activity of our euro zone partners and the negative impact on our partners outside the zone are taken into account.

Source : *emod.fr*

As is summarized in Table 1, a 10% depreciation of the euro against all currencies leads to a gain in price competitiveness for French exports vis-à-vis the rest of the world. Other countries in the euro zone would benefit from the same gain in competitiveness across all export markets. In this case, the impact on activity would amount to 0.3% in the first year, 0.5% after three years, and none after nine years. The increase in demand due to this improvement in the activity of our European partners would be broadly offset by a reduction in demand addressed to France from the rest of the world. As for the labour market, this depreciation would create 22,000 jobs in the first year and 74,000 jobs after 3 years. The public deficit would in turn improve by 0.3 GDP point within 3 years.

These results, while more moderate than those [published by the DG Treasury\[1\]](#), are nonetheless significant and are welcome in an economic situation like today's that is marked by sluggish growth and the risk of deflation. A depreciation of the single currency would also undercut the process of competitive deflation engaged in by countries in the euro zone.

[1] The publication of the DG Treasury argues that a 10% decrease in the effective exchange rate of the euro (against all currencies) would do the following: increase our GDP by

0.6 percentage point of GDP in the first year and 1.2 GDP points after three years; create 30,000 jobs in the first year and 150,000 jobs within three years; and reduce the government deficit by 0.2 GDP point in the first year and 0.6 GDP point after three years.

Is it possible to get over a banking crisis? Comparative analysis of Ireland and Iceland

By [Céline Antonin](#) and [Christophe Blot](#)

In economics, miracles sometimes prove to be mirages. Iceland and Ireland are witnesses. These two small open economies, paradises of liberalized deregulated finance, harboured growth in the early 2000s, but were hit hard by the financial crisis. The subsequent almost complete nationalization of their financial systems has had a negative impact on the public debt of the two countries. To stem the rising debt and the risk of unsustainability, since 2010 the two governments have implemented fiscal austerity plans, but with a difference: Ireland belongs to the euro zone, while Iceland doesn't. The latest [Note of the OFCE \(no. 25 dated 4 February 2013 \[in French\]\)](#) reviews the recent macroeconomic and financial situation of the two countries to show the extent to which different policy mixes may account for different trajectories for a recovery.

While in Iceland the banking crisis was amplified by a currency crisis, the depreciation of the crown was then a factor in the recovery, so that the country is now growing again. GDP was very volatile: between the third quarter of 2007 and the second quarter of 2011, GDP declined by more than 13%, but has rebounded by 5.7% since. There was less volatility and a shorter recessionary phase in Ireland than in Iceland (8 quarters), and the amplitude of the decline was smaller (-10.7%). However, the recovery is more timid, with GDP growth of only 3.4% since late 2009.

Our analysis leads us to two main conclusions: first, an internal devaluation is less effective than an external devaluation; and second, fiscal consolidation is less costly when it is accompanied by favourable monetary conditions and exchange policy. It is in light of these points that one can redefine the optimal policy mix in the euro zone, as we suggest in more detail in the [iAGS](#) report. An active monetary policy is essential to allow the refinancing of the public debt. The European Central Bank should therefore act as lender of last resort for the member countries. The countries running a surplus need a “reflationary” policy to help reduce their current account imbalances. Fiscal adjustments should be relaxed or even postponed to allow a more rapid return to growth.