Europe's Troubled Economy and the Euro. Why the Euro Doesn't Work and Where it will Break.

The credit infused growth of the last twenty years has allowed many an inefficiency to persist undetected or un-addressed. The EUR is one such inefficiency. Unless national factor prices are flexible or factor productivities converge between countries in the Eurozone, a single currency must impede market clearing leading to inefficient allocation of resources leading to underemployment or unemployment. Only the acute dearth of credit has exposed this systemic weakness, at least to some. Many economists and central bankers continue to focus on the financial markets effects of the EUR without addressing its impact on the real economy. A point will be reached when the real economy issues will demand resolution.

The area most likely to demand attention is the labour market. As long as national level wages do not adjust to reflect differing levels of labour productivity, and without national currencies to effect that adjustment, unemployment must result in some markets, and shortages in others. Productive capacity may be shifted to reflect total factor productivity. This may hollow out manufacturing in some parts of the Eurozone to the advantage of others.

How does this micro structural inefficiency impact he UK and Switzerland? The answer is not simple. It is not clear if the EUR is over valued or under valued and thus if the Eurozone is beggaring its non EUR neighbours. Strictly, any distortion to relative prices is suboptimal for market clearing, so the region as a whole suffers. That said, there can be localized winners and losers. Many companies in Europe, both within the Eurozone and without, are global companies. Europe has a very open economy and so a weak currency helps Europe’s terms of trade and improves its balance of trade. Unfortunately, the weak currency strategy is not unique to Europe, Japan has recently begun to depreciate the JPY in an effort to get its exports going, and trade partners and competitors may not countenance more currency weakness as they too try to boost exports. Also, the common currency impedes price adjustments within the region creating intra European trade imbalances. Were intra European trade less significant the problem might be less troublesome but Europe does considerable trade with itself.

Even if The Eurozone does manage to boost exports, the distribution of profits will be unbalanced, precisely because of the internal misallocation of resources. Based on current observations, the owners and generators of intellectual property and brands will continue to thrive and the rest of the region will continue to struggle. For a more precise analysis of the fortunes of the Eurozone’s economies one would have to ask more specifically what each part of the world wants that The Eurozone can supply.

What must be apparent to observers who are not too close to sovereign bond and currency markets is that the cost of the EUR is not just financial sector stress and banking crises but more importantly a failure of the market in goods and services as well as factor markets. Yet it is the financial markets which have drawn the most attention and policy response. The recent actions of the ECB have removed much of the default risk from the banking system. Calls for closer banking union are misguided because they treat a tangential symptom. At he heart of Europe’s problems is that a common currency cannot serve a region with inflexible labour markets. The realization and the call to action will likely come from a chronic inability of the labour markets to clear.