Internal Devaluation as a Commitment Device in the Euro Area Crisis

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Abstract

To overcome the Euro Area crisis, periphery countries were pushed to cut labour costs. However, internal devaluation (ID) is known to improve exports only partially. This opens the question as to why ID was so central in managing the crisis. We argue that ID, beyond its purely economic impact, functioned also as a commitment device to overcome two other intertwined crises. First, as stabilization did not suffice, it was necessary to enlarge the initial minimalist architecture of the EMU, overcoming the resistance from the core. Second, to aggravate matters, periphery governments emerged from the crisis in the eyes of the core even less credible than before. ID acted as a commitment device because (i) it was accepted in the core, particularly in Germany, as the best recipe to recover competitiveness; (ii) it implied political costs for incumbent periphery governments and thus revealed a genuine will to reform.

Keywords: Internal devaluation; commitment; competitiveness; Euro Area crisis

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Contents

1. Introduction ................................................................. 3
2. The Competitiveness Debate in the Euro Area Before the Crisis .................. 4
3. The Competitiveness Debate After the Crisis: Two Intertwined Issues .......... 5
   Loss of Credibility of the Periphery .......................................... 6
   From Stabilization to Institutional Reform: The Role of Competitiveness ....... 7
4. The Effects of Internal Devaluation on Exports in the Euro Area ................. 8
5. Internal Devaluation as a Commitment Device ................................ 9
6. Conclusion ........................................................................ 11
References ........................................................................... 12
1. Introduction

The Euro Area (EA) crisis has been complex and its management, controversial. Policymakers have been dealing with events by order of urgency, focusing primarily on the fiscal and financial manifestations of the crisis. The third fundamental vector that explains the irruption of the crisis is competitiveness – or lack thereof. This paper studies how the dominant narrative about competitiveness in the EU has shaped the policy responses to the crisis.

Competitiveness has always been on the agenda. However, beyond its policy prominence, it is an academically controversial issue even within mainstream economic analysis (Krugman 1996, Sala-i-Martin 2010). In essence, there is no univocal way of understanding the competitiveness of an economy, but rather through two basic concepts: internal and external competitiveness. The former is expected to capture the efficiency of the domestic conditions of production (i.e. productivity) and the latter, the ability of domestic firms to sell products and services abroad better than their competitors.

The distinction is heaped with policy relevance. The textbook approach to economic policy suggests that improvements in internal competitiveness translate into gains in external competitiveness. By reducing wages, firms are able to sell cheaper products better in international markets and countries’ net exports grow. This rationale, referred to as internal devaluation (ID), has comprised most of the policy recommendations to boost economic growth and recover competitiveness in the EA in the aftermath of the crisis (Decressin et al. 2015).

To motivate our subsequent analysis, this article first holds up this notion to closer scrutiny for the five largest EA economies between 2000 and 2015. We review the available empirical evidence and we conclude that internal competitiveness explains only weakly the export performance in the post-crisis period as well.

This finding leads to the main question of the paper: if ID has not been determinant in improving competitiveness, why has it been so central to the management of the crisis? We will argue that ID served the rational purpose of a commitment and signalling device that contributed to overcome a credibility crisis between the periphery (Greece, Ireland, Italy, Spain and Portugal) and the core (Germany, Netherlands, Austria, Belgium) of the EA. For the EA economic administrations (the European Commission and the European Central Bank), it was necessary to overcome the credibility crisis as a pre-condition to protect the stability of the Economic and Monetary Union (EMU) and to enable the periphery to honour its debts with the core’s financial institutions.

This work is directly related with the recent literature that has studied the political-economical tension between the core and periphery (Armingeon 2012, Bonatti and Fracasso 2013, Bailey et al. 2014, Hall 2014a, Steinberg and Vermeiren 2016, Howarth and Rommerskirchen 2017, Burns et al. 2018, Clifton et al. 2018). Some have analysed the various constraints the German government was facing in its management of the crisis, the consequences for EA citizens of the reforms engineered adopted in the periphery or the extent to which there has been “policy transfer” within the EU. With respect to this literature, this paper focuses on just one of the elements of the crisis management package, ID, and aims at rationalizing it relying on the key notion of credibility. In this respect it is closely related to the recent work by Perez and Matsaganis, (2019).

The paper is organized as follows. Section 2 analyses the competitiveness debate in the EA before the crisis and shows how central credibility and trust were in the adoption of the EMU. Section 3 extends the theoretical analysis to the crisis and post crisis period and argues that the crisis forced
the EA economic administration to deal simultaneously with two connected challenges: loss of credibility in the periphery and the need to overcome the core’s resistance to closer economic integration. It is in this setup that internal devaluation stands out as a major lever, part of a larger set of measures, to stabilize the EA crisis. Section 4 provides the factual check of the presumed virtues of the internal devaluation and it reviews some of the recent economic literature on its impact on export performance. Section 5 argues how internal devaluation, by acting as a commitment device, contributed to alleviate this problem and section 6 concludes.

2. The Competitiveness Debate in the Euro Area Before the Crisis

In this section, we will argue that the Economic and Monetary Union (EMU) project, an unprecedented effort to set up a monetary union with an otherwise minimalistic economic and political architecture, was based on the core’s twofold belief that the periphery would converge in competitiveness and that the ECB would guard the process. In essence, the EMU was a matter of inter-state trust and credibility.

The EMU was a central provision in the Maastricht Treaty signed in 1992. The prevailing view at the time in the European economic policy circles outside Germany – a special case to be discussed below – was that the EMU could facilitate the convergence of member countries (Sapir 2016). In the best-case scenario, the EMU was deemed capable of both harmonizing countries’ policies and making exogenous, asymmetric shocks less likely (Buti et al. 1998). The EMU was expected to push national governments to reform as they had been deprived of autonomy in monetary and (to a degree) fiscal policy (Bean 1998). This confidence in the potential of the project led the majority of the European economic policy establishment at the time to dismiss criticisms against the EMU and push to adopt it promptly (Camdessus 1997).

In contrast to this, prominent views from the U.S. – notably, with diverse ideological accents and from both the New-Keynesian and anti-Keynesian camps – advanced the idea that the EMU was deeply problematic. The intellectual basis for this opposition was a particular form of the Optimal Currency Area (OCA) theory (Mundell 1961). At the centre of their worries was precisely the doubt as to whether this monetary experiment could harmonize the opposing competitiveness trends in the EA countries. Some considered the main obstacles were the variability of real exchange rates, a low degree of labour mobility and low correlation of shocks among countries (Eichengreen 1992). Some others argued that the EMU could only be expected to increase unemployment in the continent, as the member states would be “trapped” in fixed exchange rates and unable to devalue in order to regain competitiveness (Dornbusch 1996; Feldstein 1992; Friedman 1997) and some warned about the pernicious effects of lacking a fiscal authority to support the EMU (Tobin 2001).

This latter concern was also put forward by C. Goodhart who in 1998, arguing from beyond the OCA paradigm, noted that historically when states or territories joined together in a monetary union, the main political and fiscal competencies also “migrated” to the federal level. He warned that there would be “an unprecedented divorce between the main monetary and fiscal authorities” (Goodhart 1998).

Germany looked at the EMU ambivalently and negotiated the Maastricht Treaty with different motivations, reflecting the two fundamental principles of the modern German state: ordoliberalism and European pro-integrationism (Dyson and Featherstone 1999, Bulmer 2014).

On the one hand, Germany had been the most European pro-integrationist member state since the early 1960s. Some circles considered the adoption of the EMU a key milestone in the foreign
policy agenda with plenty of political meaning as well as a leap to further ease the way for German exports to neighbouring EU markets. This principle had been supported both by the Foreign Office and, to varying degrees, by the chancellors (Bulmer 2014). The argument goes even further and it can be rightly argued that some clusters of societal interest in Germany were expecting material benefits from the EMU because the euro would eliminate nominal devaluation in periphery countries “allowing German export-oriented firms to turn an overvalued real exchange rate into a substantially undervalued one” (Steinberg and Vermeiren 2016, p. 390). This would enhance the role of the country as the “main continental factory” of the EA (Bonatti and Fracasso 2013).

On the other hand, however, the country had also a long tradition of ordo-liberalism and a “culture of stability” which, in general, were more reluctant about the EMU and agnostic (at best) about the periphery behaving properly in economic policy terms (Siems and Schnyder 2014, Ryner 2015, Matthijs 2016, Howarth and Rommerskirchen 2017). The ordo-liberal tradition was committed to monetary stability and fiscal discipline, sceptical about the value of activist, demand-led economic management, supportive of “sound money” and decided to preserve above all the international competitiveness of German companies and its export potential. Indeed, competitiveness was perceived in these traditions not as a mere economic goal but as a fundamental element to underpin Germany’s specific social and welfare model (Bonatti and Fracasso 2013). In the words of Norbert Walter, chief economist at the Deutsche Bank from 1990 to 2009 and representative of this view: “We don’t need to accept the shortsighted remedies proffered by Harvard economists and the advocates of the purchasing parity of wages” (Walter, 2009 as reported by Bonatti and Fracasso, 2013).

In the end, Germany’s willingness to accept the EMU required the reassurance that the European Central Bank (ECB) would pursue the stability goals and adopt the mandate and policy models of the Bundesbank, as it finally did (Bulmer 2014) as well as building a “minimalist” architecture for the monetary union, without fiscal policy or crisis management mechanisms at European level. This reflected a “practical convergence of traditional central European ordo-liberalism with the anti-Keynesian views of new-classical economics” (Constâncio 2018).

All in all, although monetary theory was sufficiently open in the 1990s so as to justify both scepticism or hope in the EMU, the prevailing sentiment in the EA was the trust in the project: “the dominant economic thinking at the time of its inception [of the EMU] favoured an optimistic view of how smooth and successful it could function” (Constâncio 2018). By the mid-2000s, the EMU looked like, that by integrating the EA financial system, it could succeed in levelling countries’ competitiveness as long as there was enough political capital to back this effort (De Graauwe 2006), the promises of structural reforms in the periphery remained credible, and the ECB kept aligned with the Bundesbank’s line of action: “Although Germany and several other countries in the union enjoyed low inflation before the adoption of the common currency (...), the ECB has been able to “export” that benefit to other members of the monetary union” (Bernanke 2005).

3. The Competitiveness Debate After the Crisis: Two Intertwined Issues

The filing for bankruptcy of the Lehman Brothers in 2008 acted as a ‘sudden stop’ that exposed the vulnerabilities of the whole system and took discussions back to the fundamentals mentioned above. In this section, we will argue that the crisis generated two entwined challenges for the EA and EU economic administrations. First, as the crisis unfolded, it became clear that conventional stabilization initiatives did not suffice and that it was necessary to
enlarge the initial ‘minimalist’ architecture of the EMU by creating new institutions – a path the core, particularly Germany, had resisted to take at the adoption of the euro. Second, to aggravate matters, periphery governments emerged from the crisis, in the eyes of the core, with more important moral hazard problems and less credible than before. The economic crisis reignited a core-periphery credibility crisis which was latent from the beginning of the EMU.

**Loss of Credibility of the Periphery**

The key economic benefits of the euro have come from expanding trade, lowering transaction costs and facilitating cross-border flows of people and capital (Bernanke 2005, Pisani-Ferry and Posen 2009). This generate a process of “nominal convergence”, perhaps best seen in the convergence of interest rates on government debt across the EA up to 2008 to unseen low levels. However, this very same process of convergence is now widely seen as a key element in the narrative of the crisis and the prevailing view is that “the crisis was not, at its roots, a government debt crisis. The key imbalance was the large intra-EA capital flows that emerged before the crisis” (Baldwin et al. 2015) confirming the findings by Jordà et al., (2016) that private credit booms, not public borrowing, tend to ignite financial crises in advanced economies.

As risk premia evaporated from all around the zone, periphery countries were increasingly relying on foreign capital mostly from core countries. The inflows contributed to generate large current account imbalances within the EA by debasing the competitiveness of the periphery. Fresh capital flows and increased liquidity led to a general increase in wages, and to the prices of assets and imports in the periphery. Although, in theory, some of these investments could have improved productivity (for instance, by investing in education and knowledge or building or repairing productive infrastructure), in practice, the lion’s share went to non-tradable sectors and to booming financial and real estate sectors. As, in parallel, some core countries, particularly Germany, undertook structural reforms to increase productivity (Bonatti and Fracasso 2013), the competitiveness gap widened.

Broader interpretations of the EA crisis (Armingeon et al. 2016) suggest it can be seen at the outcome of a (failed) process to unite institutionally heterogeneous countries under a single currency (Hall 2012, Hancké 2013, Johnston et al. 2014, Nölke 2016). P. Hall (2012, p. 355) argues that “the roots of the crisis [lie] in an institutional asymmetry grounded in national varieties of capitalism, which saw political economies organized to operate export-led growth models joined to others accustomed to demand-led growth”. B. Hancké (2013) makes a connected point showing that countries where wage bargaining was more coordinated or centralized merged with others in which the process was less coordinated, with the result of inflation escalating in the latter ones (see also Baccaro and Tober 2017 on this issue). The first ten years of the euro did not make much to bridge this institutional gap.

Thus, the economic crisis reignited a credibility and trust crisis between the core and the periphery that was latent since the adoption of the euro. When the crisis burst, the EMU was widely believed to have failed in bringing about structural reforms in the periphery at the scale that was originally foreseen. Indeed, as budget constraints in the periphery were loosened rather than tightened, and consequences of bad decisions “are imperceptible when rising asset prices hide all mistakes” (Fernández-Villaverde et al. 2013), one could argue that the EMU had even jeopardized reformism in the periphery. In any case, periphery governments emerged out of the crisis in the eyes of the core, particularly in Germany, as having massively succumbed to moral hazard: “The German authorities, strongly supported by the majority of German citizens, refused the ‘deadly’ embrace of the periphery and claimed that their support would have (at
most) followed internal reforms in the countries in trouble and not vice versa”, (Bonatti and Fracasso 2013, pp. 1024–1025).

**From Stabilization to Institutional Reform: The Role of Competitiveness**

As the economic crisis was unfolding and the corresponding policy responses were being applied, it became increasingly clear that conventional stabilization policies would not suffice and that the adoption of institutional reforms in the direction of deeper economic integration was the only way forward (Ioannou et al. 2015).

Official policy responses to the EA crisis started in early 2009 when, amidst revelations of successive Greek governments having misreported public debt, the IMF and the EU lent funds to the Greek government. It developed gradually and reached a stable form by October 2012 when the European Stability Mechanism (ESM), also known as the “permanent bailout fund”, began its operations. The process alternated formal agreements, through Economic Adjustment Programmes and the memoranda of understanding (MoU), and more implicit arrangements. This was accompanied by the crucial change in the monetary policy of the ECB which in August 2012 announced (but not enacted) the Outright Monetary Transactions (OMT). A full recount of the policy reactions to the crisis is beyond the scope of this section. For a detailed analysis of the sequence, we refer to Steinberg and Vermeiren (2016) who identify two main stages: the escalation of sovereign bond yields (2011-12), and the mitigation of the deflationary pressures (2013-15). Building from their analysis, here we will show the role played by the competitiveness debate in the wider post-crisis management.

The debt of periphery countries with the core increased by a factor close to 4.5 between 1999 and 2009, from €463 to €2,033 billion (Baldwin et al. 2010). The core had thus strong incentives to adopt the various bail-out initiatives and financial support programmes. Indeed, as P. Hall has put it: via the ESM, the northern Europeans “were essentially bailing out their own banks” (Hall 2014b, p. 1231) and avoiding the break-up of the block which would have been disastrous for all and the “mother of all financial crises” (Eichengreen 2010).

However, the periphery countries could be ‘bailed-out’ only if they accepted certain economic conditions. This conditionality consisted of country-specific and time-varying mixes of three ingredients: fiscal consolidation; financial sector restructuring and recapitalization; and structural reforms. Within the menu of recommendations of structural reforms to overcome the crisis, ID has played a key role in the policy debate on how to restore competitiveness in the periphery after the crisis. In its most fundamental terms, this debate is a contest between two views that are connected with the conflicting perspectives about the EMU before the crisis reviewed in section 3.

The first one argues that the basic competitiveness problem in the EA arises from high labour costs and low productivity in the periphery (Thimann 2015). The source of this disadvantage are “structural barriers” to the private sector which make job creation costlier in the periphery. From this perspective, ID is unavoidable for periphery countries to recover their competitiveness, given that exchange rates are fixed. After twenty years, the early appraisals of the EMU resonate in these modern critiques (Feldstein 1992, 2012). In this view of the events, the liberalizing Hart labour market reforms adopted in Germany in the early 2000s, to be discussed in the next section, are frequently referred to as demonstrations of the virtues of ID (Carlin and Soskice 2009).

The second view opposes this narrative and indeed claims that the ID adopted so far has been detrimental for the competitiveness of the periphery (Storm and Naastepad 2015, Jones 2016).
From this perspective, what caused competitiveness imbalances were not higher wages in the periphery but the surge in imports, attributable to the growth of debt-financed domestic demand (Gabrisch and Staehr 2015). As a result, reducing wages via ID makes no sense if the other components of the total price of exports increase. From this perspective, competitiveness imbalances in the EA can only be resolved if labour productivity, technological potential and the institutional setup for economic activity in the periphery converge to the levels of the core.

4. The Effects of Internal Devaluation on Exports in the Euro Area

Has ID been preponderant in bringing about external competitiveness gains in the EA? The main message that emerges from the analysis of the empirical literature is that labour costs or export prices (the key price-cost competitiveness factors) can only modestly explain export performance in the EU countries and that other non-price/cost factors appear to prevail.

There are a number of studies that have looked at the recent evolution of the relationship between real effective exchange rate (REER) or other measures of price-cost competitiveness, and export performance in aggregate terms in EA countries. The REER is a generalization of the nominal exchange rate and it intends to capture the real price of a country’s currency, i.e. its relative price in terms of the currencies of its principal trading partners. The REER is thus an approximation to the relative price of the exports of one country in terms of the exports of its strongest international competitors. Constructed in this way, increases in a country’s REER (or, REER appreciations) imply a loss in competitiveness –its products or services become more expensive relative to its trading partners (Giordano and Zollino 2016).

There are several versions of the REER since there are several ways to compare currencies: based on inflation, prices of exports, GDP deflators, etc. One of the most widely used real effective exchange rates is based on unit labour costs (ULC). Unit Labour Costs (ULC) approximate the average cost of labour per unit of output and they are calculated as the ratio of labour costs to output. Therefore, the ULC-based REER rises when wage costs increase above productivity, in relative terms to trading partners.

In general, the ULC-based REER is found not to be strongly associated with the countries’ aggregate exports up to 2012 in the EA (Athanasoglou and Bardaka 2010, Bayoumi et al. 2011, Diaz Sanchez and Varoudakis 2013, Giordano and Zollino 2016) and export growth depends more on it having the ‘right’ structure (exporting high-demand products to high-growth destinations) than on REER depreciations (Cafiso 1996, ECB 2005, Storm and Naastepad 2015). As a result, both Giordano and Zollino (2016) and Storm and Naastepad (2014), emphasize the role of “non-price” elements in supporting export performance and competitiveness in the EA.

These non-price/cost competitiveness factors include, on the one hand, firm-level attributes and decisions - such as company size, investment in capital, skill-intensity in the labour force, R&D spending, product quality and diversification - and, on the other, demand-related scale effects in the destination markets and the right geographical structure of exports, i.e. exporting the right (high-margin) products to the right (high-growth) markets (Wyplosz 2013, Storm and Naastepad 2015, Giordano and Zollino 2016).

Relevant to, and consistent with, our paper is the recent work by Perez and Matsaganis (2019) who find that there is no linear relationship between ID and export growth in Southern Europe (Greece, Portugal, Spain and Italy). It has also been shown that the effect of wage moderation to boost competitiveness appears to be strong in Germany but not very relevant in other EMU countries, both with coordinated and uncoordinated labour markets (Baccaro and Tober 2017).
For a larger set of countries, Ahmed et al., (2015) also find that the elasticity of manufacturing export volumes to the REER has decreased over the period 1996 – 2012. The same qualitative result is obtained when comparing the relationship between changes in export prices and export market shares for a set of advanced economies between 1999 and 2011: the non-price determinants of competitiveness have been more important than export prices in explaining the variation of export shares (Cardoso et al. 2012).

In disaggregate terms, the work by Benkovskis and Wörz (2014) decomposes export shares into different price- and non-price elements for the G7 and BRIC countries for the period 1996 to 2011. They attribute export share variations to a number of non-price, industry-specific factors, such as the ability to enter into new export markets, shifts in global demand, changes in the number of competitors, as well as to price factors. In line with the afore-mentioned research, these authors also find that non-price factors dominate over price-factors in explaining the variation of export shares over time.

In a different setup, H. Gabrisch and K. Staehr obtain very interesting results that point in the same direction to the simple analysis performed here. Using Granger causality tests, they show that changes in the current account balance precede variations of the ULC, with no significant effect in the opposite direction before the crisis, and this suggests that “the measures to restrain unit labour costs may have only limited effect on the current account balance in the short term” (Gabrisch and Staehr 2015, p. 558).

Finally, with a wider perspective, the debate about the overall economic impact of structural reforms, and ID in particular, is still quite open for several reasons. Firstly, it is increasingly recognized that if ID is implemented with the wrong timing (in recessions) or in the adverse context (with interest rates in the zero lower bound), it might have substantial contractionary and deflationary effects on the economy (Eggertsson et al. 2014, Ioannides and Pissarides 2015, Ostry et al. 2016). Secondly, it has been shown that those structural reforms that make product and labour markets more flexible are an optimal policy response only when shocks are permanent. When shocks are temporary, more flexibility is not the answer; what is needed, instead, are policies that help to absorb these shocks and stabilise the business cycles (Grauwe and Ji 2016). Thirdly, although the theory underpinning structural reforms looks simple (that is, opening up an economy to competition increases efficiency), it really usually requires targeting each economy’s specific ‘binding constraints’ rather than adopting incremental, one-size-fits-all reforms (Rodrik 2015).

5. Internal Devaluation as a Commitment Device

Given that ID has only a limited ability in improving competitiveness, why did the core push the periphery to adopt it? We have argued above that the economic crisis reignited a credibility-trust crisis between the core and the periphery. In this section, we will argue that ID, beyond its purely economic effect, functioned also as a commitment device to partially alleviate the credibility crisis and has thus underpinned the bailout and reform plans – a rational arrangement that was in the best interest of both sides.

We will embark on our discussion following two steps. First, we will consider why such a commitment and signalling was necessary and credible. Second, we will address the issue of why ID in particular was adopted.

The commitment was necessary mainly to overcome the resistance of the core to move towards closer economic integration. In what can be considered as fresh manifestations of the deeply-
rooted ordoliberal instinct (Howarth and Rommerskirchen 2017), some influential public opinion circles in the core, particularly in Germany, strongly opposed the various bail-out agreements and proposals for reforming the architecture of the EMU. The main concern was that these operations entailed the transfer of risks from the periphery without leaving the proper margin of autonomy and democratic control in the core over the issue.

As an illustration, a large and diverse group of German actors had brought lawsuits against the ESM on the grounds that the permanent bailout fund could undermine the German parliament’s autonomy. This conflict was resolved when the German Constitutional Court of Karlsruhe ruled, preliminarily in 2012 and firmly in 2014, that the ESM was compatible with Germany’s law under the proviso that changes in the volume of German national liabilities would require a parliamentary vote. In coherence with this decision, the Constitutional Court in June 2016 also ruled in favour of the ECB Outright Monetary Transactions (OMT) programme which had been also challenged.

It is well documented that this opposition was amplified by some mass media which intensively and systematically employed metaphorical structures that portrayed citizens of periphery countries as “lazy”, “needy”, “helpless” in contrast with their counterparts in the core, which were referred to as “heroic”, “generous” and the “true victims” of the crisis (Bickes et al. 2014).

In terms of what could make the commitment credible, promises are the most basic forms of commitment with third parties but it is well known they are surrounded by a plethora of credibility problems, particularly when agents fall into self-control problems (Brocas et al. 2003). The financial dependency of the periphery on the core, the inability to reform their own economies and the fact of having fallen systematically into the moral hazard trap (Obstfeld 2013) are typical manifestations of this type of problem. In this context, only costly actions, or costly “signals” in game theory terms, that reveal the will of keeping a promise become useful commitment devices, i.e. mechanisms that restore the credibility of a decision maker in the eyes of third parties. From a game-theoretic interpretation, these devices may allow the emergence of separating equilibria in which only true reformers (governments or political parties) will pay the cost associated to the commitment. Weakly-willed reformers will only play “cheap talk” strategies, which everyone discount in equilibrium (Cooley and Marimon 2011, Pollitt and Bouckaert 2017).

In essence, for the commitment to work, its signalling needs to be costly. Recent studies have indeed confirmed that the adoption of ID had significant costs for incumbent periphery governments. Countries pursuing fiscal austerity and related structural reforms during the crisis have systematically received lower levels of electoral support for the incumbent parties after controlling for the cyclical state of the economy (Talving 2017). Consonant with this, the electoral punishment has been even stronger in EU countries where these programmes were the result of the intervention of third, supranational organizations such as the ECB or the IMF (Hernández and Kriesi 2016).

We now turn to the issue of why ID in particular constituted the appropriate type of commitment. The prevailing narrative in the core understood the crisis fundamentally as a competitiveness and labour market phenomenon in which the periphery had failed to adopt the necessary “German-style culture of stability” (Howarth and Rommerskirchen 2017).

Several keynote German public figures insisted that the periphery should complete their “delayed homework” [sic] (Armingeon et al. 2016) much in the same way Germany had done its own reforms in the early 2000s by liberalizing its labour market and reforming the welfare state with the Hartz reforms. Although ID was not an explicit goal of the Hartz reforms, the combined effect of some of its elements led in the short run to the reduction of reservation wages (Bonatti and Fracasso 2013), and thus to general downward pressures on them.
The long term consequences of these reforms is still an open issue with some evaluation studies reporting inconsistent results (Jacobi and Kluve 2006). In purely economic terms, a recent comprehensive study has found that the reforms apparently did not play a decisive role in transforming the German economy. The main reason that could explain Germany’s economic success in the last fifteen years would be the specific governance structure of the labour market institutions that allowed for flexibility during the crisis (Dustmann et al. 2014). In political terms, the Hartz reforms had clear adverse electoral effects for the party that led their adoption, the German Social Democratic Party (SPD) (Schwander and Manow 2016).

However, in what is central for our discussion, in the early 2010s, when vital choices on the EA crisis management were due, the Hartz reforms were widely regarded in Germany and the competitiveness reform paradigm. They were considered responsible for having transformed the ‘sick man’ of Europe into an engine of growth and, therefore, as the role model for the reforms to be pushed abroad.

6. Conclusion

Recovering competitiveness and growth in the Euro Area is vital to sustain social progress and political stability in the region. The task, however, is complex and this paper aims at contributing to the debate of what should be done – and what is better to avoid.

The empirical consensus, which this present paper extends, does not hold that internal devaluation (ID) is useless towards this end. However, it suggests that periphery EA countries were put under pressure to adopt ID not on exclusively economic grounds and the central question of the paper is to contribute to better understand why.

We have argued that the EA economic crisis reignited a more profound, latent credibility-trust crisis between the core and the periphery as the expectations that EMU would mobilize reformism in the periphery proved unfounded. We have shown that ID meet the requirements for being considered necessary, feasible and the right type of commitment device to overcome this crisis. By performing this function, ID served the rational purpose of supporting the resolution of the crisis, which was in the interest of the economic establishments of both the core and the periphery.

Cutting costs and wages and liberalizing labour markets can be appropriate in particular times, industries or places. However, applying it as a general purpose, open-ended solution in the EA risks generating more pain than gain by fuelling expectations of deflation. ID may also jeopardize the ability of firms to compete internationally by affecting the very non-price/cost factors that play a major role in supporting competitiveness, such as the education and skills of the labour force or the innovation content of products and services. Finally, more generally, employing them systematically in the public discourse entails the risk of magnifying the rising Euroscepticism, both in the periphery and the core.

Our analysis warns against succumbing to the “competitiveness obsession” in the EA and putting ideology ahead of pragmatism. What looks like a better, more effective strategy is to aspire for a more comprehensive agenda that embraces the whole “triangle of growth” (Burroni et al. 2019), i.e. to create the conditions for the periphery countries to recapitalize their economies (particularly human capital and innovation capital) and strengthen their institutions. A corollary of our analysis, however, is that the core can only be expected to support this line of action if the periphery improves first its credibility by adopting genuine reforms of their economic institutions.
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