Special report

A special report on the euro area

The non-nuclear options

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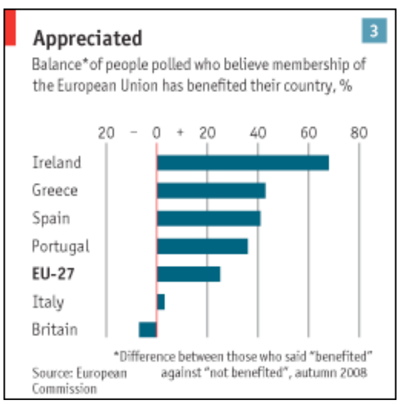
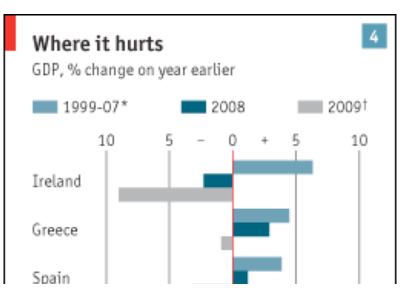
In place of devaluation, troubled members could try reform

SPAIN may soon be faced with two options, says UPF's Mr Mas-Colell: a permanent slump or economic reform. "A third option, exit from the euro, is not a possibility. Spain won't leave because it is very pro-Europe. To leave would be seen as a national failure rather than a liberation." Euro membership is a symbol of Spain's progress as a democracy as well as its economic development. For some, it is an insurance against a return to dictatorship and autarky. "Our experience is that when we went for being more European, the results were positive," says Elena Pisonero, a former vice-minister for commerce, now at the Madrid office of KPMG, a consultancy. "In the past [during the dictatorship of Francisco Franco, which ended in 1975] we were closed off. Opening up our borders brought huge benefits."



Ireland, like Spain, has been helped by EU funds for roads, farming and universities. According to the most recent Eurobarometer, a twice-yearly opinion poll, 79% of respondents in Ireland believe that overall their country has benefited from EU membership, and only 11% think it has not. The positive response in Greece, Spain and Portugal was above the average for all EU countries (see chart 3).

Most Greeks are in favour of the euro, and only 12% think EU membership is bad for their country. That is poor ground on which to build a case for quitting the euro. Greece's finance minister, Yannis Papathanassiou, thinks that the recent spike in Greece's borrowing costs was driven by the mistaken belief that last December's violent street protests were due to a faltering economy. In fact the demonstrations were sparked by the killing of a 15-year-old boy in Athens by a policeman. Some people had taken rising bond spreads as an omen of default and euro break-up. That prospect, always distant, has now receded further. "Despite the high spreads, we have shown that we can refinance our debt," says Mr Papathanassiou.



Italy's economic travails have attracted less attention recently. Unlike Greece, Ireland and Spain, whose economies grew rapidly before crisis struck, Italy has seen its GDP growth drift consistently below the euro-zone average (see chart 4). Its cost-competitiveness has declined and its public debt was already 106% of GDP last year and will now rise still further. Yet in March, when the strains in the euro area's public-debt markets were at their greatest, Italy's

ten-year bond yields were around 1.5 percentage points above Germany's, compared with a gap of 2.8 percentage points for Greece.

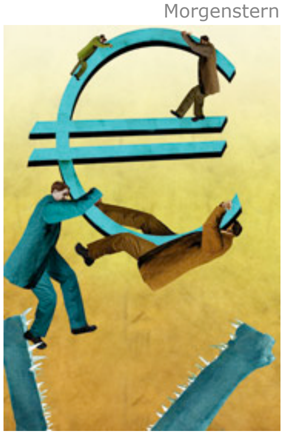
Nor was Italy's public debt downgraded. "Perhaps the credit-rating agencies are being responsible," an Italian economist suggests by way of explanation. If Italy did get into funding trouble, that would have repercussions for the rest of the euro zone. Its public debt dwarfs that of countries the size of Ireland or Greece.

If the rating agencies have been careful not to sound the alarm, the same is true of Italy's politicians. In the past Silvio Berlusconi, the prime minister, and Giulio Tremonti, the finance minister, have been quick to blame the euro and the ECB for Italy's economic problems. Bashing the euro was a useful way of attacking Romano Prodi, a centre-left opponent, who in his first stint as prime minister, in the late 1990s, took Italy into the euro before becoming president of the European Commission. The rhetoric has noticeably softened. Earlier this year Mr Tremonti described the euro zone as "totally sustainable". The currency crises in Hungary and Iceland were salutary, says Roberto Perotti of Milan's Bocconi University. "No serious politician now says 'let's leave'."

Devaluation by proxy

Is there a way of achieving the effects of a fall in the real exchange rate without going to the extremes of ditching the euro? As long as it does not trigger a burst of wage inflation, a devaluation lowers wage costs relative to those of workers abroad, improving the competitiveness of firms producing things that can be traded across borders. A weaker currency also shifts the balance of demand by making imported consumer goods dearer and exports cheaper. That cools spending at home and tilts the scales towards firms that sell abroad, nudging workers and capital in their direction.

Illustration by M. Morgenstern



In a currency union, pay needs to adjust that much more quickly to changing market conditions to shift workers out of high-cost industries. But until quite recently pay has tended to be "sticky" on the way down: workers have generally been reluctant to take wage cuts, at least in nominal terms, which has made real-wage adjustment slow. On many reckonings, the rate at which Germany went into the euro in 1999 was too high. The traded value of the Deutschmark had not fallen to reflect the higher unit wage costs that were a legacy of the unification boom. It took many years of very low wage growth and rising productivity before Germany regained its edge on costs.

That route to redemption has become even harder for today's high-cost countries because there is little consumer-price inflation around to erode real wages and rebuild profit margins. Unemployment seems likely to rise steeply before wages start to adjust.

Ireland will make the adjustment more quickly than the others. Already there are signs that private-sector wages are falling in response to rapidly rising unemployment. The 7.5% cut in public-sector pay that came into force in May was mostly a response to the fiscal crisis, but was also sold as a remedy for lost competitiveness. Ireland is set to endure a deeper recession than other rich countries because of its "globalised" economic model. But because of that sensitivity to the world business cycle and its reliance on big multinational firms for investment, wages are unlikely to stay out of whack for too long.

In the Mediterranean economies the pressure on wages is mostly in the wrong direction. In Spain most private-sector pay deals contain clauses that compensate employees if inflation is stronger than expected. The country also has a managed system of wage-setting that fails to make enough allowance for different productivity levels across the economy.

Wages in Italy are set centrally too (as they are in Greece), although compensation for inflation is no longer automatic. The infamous *scala mobile*, which maintained a rigid link between Italian wages and prices, was scrapped in 1992 after a long struggle.

Here today, gone tomorrow

The spread of fixed-term employment contracts in Spain (from the mid-1980s) and Italy (in the mid-1990s) helped make hiring and firing more responsive to the business cycle. The innovation had an immediate pay-off: it created jobs. Firms were content to take on temporary workers, often immigrants, because they knew they could easily lay them off again. Before the crisis hit, temporary jobs accounted for more than a third of Spain's total, the largest share in the EU. Tito Boeri of Bocconi University reckons that a fifth of Italy's workforce are on (short) fixed-term contracts. The rest enjoy a high level of job protection which politicians dare not dismantle. Both countries saw temporary contracts as the only way to free the jobs market.

Jobs that were created in good times are now being shed quickly. The downturn has highlighted the gross unfairness of the dual labour market. It puts the burden of adjustment on groups with no tenure (women, immigrants and the young). Protected workers, the bulk of the workforce, cling to their jobs. That tends to fossilise the structure of the economy. Old industries, where productivity is waning, are slow to die and new firms slow to start up.

The growth of temporary contracts hurts productivity in another way. Firms are obliged to lay off (typically young) contract workers at the end of a fixed period, so they have little incentive to train tomorrow's workforce. Instead they are stuck with older, tenured workers heading for retirement. The result in Italy, says Mr Boeri, is a "lost generation" of workers with limited skills. Admittedly the growth in temporary contracts has helped many people back into work and has lowered long-term unemployment. But the evidence from Spain suggests that such contracts are rarely a bridge to better things: less than 5% are converted into permanent jobs.

A group of economists led by Samuel Bentolila of CEMFI, a graduate school in Madrid, have set out a reform manifesto for Spain's jobs market. They suggest that wage-setting could be made more flexible if deals struck at the level of individual firms were allowed to prevail over regional or industry agreements. They also propose replacing fixed-term contracts for new hires with a permanent contract in which firing costs rise with seniority but not as high as at present.

Mr Boeri and his colleagues have called for a similar scheme in Italy, where workers build up employment rights over time. Abolishing job protection makes most workers worse off, so it tends to run into political obstacles. The next best thing is gradually to reduce average firing costs and giving firms better incentives to train their workers. If Italy wants to encourage workers to risk moving jobs, it also needs to beef up its skimpy unemployment benefits. "Italy should say to its partners: 'our fiscal stimulus is to introduce a welfare safety net to speed up the reallocation of jobs'," says Mr Boeri.

Never a good time for reforms

Such reforms would be desirable even if nobody had signed up to the euro. When the currency was created, the hope was that the loss of the safety valve of devaluation would help to boost productivity and make markets more flexible. For most of its first decade timid politicians were able to shelter behind the economic stability that the euro helped provide. Without a crisis it is hard to persuade voters of the need for radical change. Yet recession is the worst time to make changes that leave some groups poorer.

Italy's previous big recession, in 1992-93, prompted a wave of reforms: privatisations, changes to pension entitlements, the creation of a competition authority and the demise of the *scala mobile*. Greece is now inching ahead with some reforms along similar lines. The government has sold Olympic Airways, a subsidy-thirsty airline, and a competition law is going through parliament that will give antitrust authorities more power to challenge—and break up—big companies that can set prices. In Spain one relatively painless reform would be to change the rules for renting out property, which currently overprotect tenants. If owners felt more relaxed about letting out second homes, workers might find it easier to move in search of jobs. It might even lift house prices.

For now, policymakers are too worried about fragile demand to risk tackling the supply side of the economy. Today's economic crisis has little to do with differential wage costs within the euro. In terms of relative unit wage costs, Germany's competitiveness has improved by around 13% since the euro started. Yet this year the German economy is set to shrink by more than any other in the euro area bar Ireland because of its heavy reliance on exports. Greece is expected to hold up better because it is less exposed to the global economy ("a good thing for a bad reason," notes one policymaker). Its GDP is likely to fall by around 1%, making it one of the most resilient economies of the OECD's 30 members. Italy's economy will do far worse, but there is less of a sense of crisis because it has long been struggling anyway.

Root-and-branch structural reform will have to wait a while longer. Germany's travails are not a good advertisement for maximising competitiveness. Only in Ireland, where the economic model is based on openness to trade and foreign investment, is competitiveness a big part of the policy debate. Elsewhere politicians seem somewhat stuck. "At some point we'll have to accept that it's better to have people in work than to have high wages," says Mr Mas-Colell. "In Spain we are not ready for that. There is an illusion, a hope, that we will wake up tomorrow and things will be better."

Yet all the current troubles of the hardest-hit euro-zone countries do not seem to have put off a raft of applicants, mostly in eastern Europe, from trying to join the club. Indeed, if anything, the financial crisis has made many countries even keener to join. Do they know what they are doing?

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