The Economist

Search Economist.com

Welcome
My account
Log out
Manage my newsletters

Tuesday December 29th 2009

Site feedback

Home
This week's print edition
Daily news analysis
Opinion
All opinion
Leaders
Letters to the Editor
Blogs
Columns
KAL's cartoons
Correspondent's diary
Economist debates
World politics
All world politics
Politics this week
United States
The Americas
Asia
Middle East and Africa
Europe
Britain
Special reports
Business and finance
All business and finance
Business this week
Economics focus
Management
Economics A-Z
Business education
All business education
Which MBA?
Markets and data
All markets and data
Daily chart
Weekly indicators
World markets
Currencies
Rankings
Big Mac index
Science and technology
All science and technology
Technology Quarterly
Technology Monitor
Books and arts
All books and arts
Style guide
People
People
Obituaries
Diversions
Audio and video
Audio and video library
Audio edition
The World In
The World in 2010
The World in 2009
The World in 2008
The World in 2007
The World in 2006
The World in 2005
The World in 2004
Research tools
All research tools
Articles by subject

Special report

A special report on the euro area

Warmer inside

Jun 11th 2009
From *The Economist* print edition

The gains outweigh the losses

THIS crisis has tested many schemes and wheezes (some to destruction), from securitised mortgages to collateralised-debt obligations, from light-touch regulation to inflation targeting. How does the euro fare in this reckoning? According to one school of thought it is a fair-weather set-up, seemingly effective when economies are expanding but poorly equipped to deal with crises and manage the pressures and conflicts of a sinking economy. Conversely, many in Brussels and Frankfurt argue that being in the euro zone helped member countries emerge relatively unscathed from the worst financial crisis since the 1930s. Which view is right?

The extreme lurches in markets during the worst of the crunch last autumn made the certainties of fixed exchange rates look enticing. One lesson from the crisis is that asset prices can be unduly volatile and often veer wildly from their true values, in ways that undermine economic stability. That goes especially for housing but is also true of other asset prices, such as exchange rates. Another message is that interest-rate policy is not as powerful a stabilising force as had been thought. Other means of shaping demand are needed to complement it. Swapping an independent monetary policy for the stability of a fixed exchange rate now seems less of a sacrifice. That also closes off the escape route of letting the currency slip if wages move out of line with productivity. Yet deflation seems such a threat precisely because prices and wages are proving less "sticky" on the way down than macroeconomic textbooks had reckoned with.

On standard gauges of competitiveness, such as real effective exchange rates, a number of euro-zone countries appear to have big problems. Yet things may look worse than they are. Measures based on relative unit wage costs across the whole economy are crude. In booming Spain and Greece, much of the heat in wages was in parts of the economy, such as construction, that serve domestic spending and are sheltered from foreign competition. Export industries may have a better chance of benefiting from a global recovery than the figures suggest at first glance.

Spain, in particular, may not be quite as uncompetitive as it seems. José Luis Escrivá, an economist at BBVA, a Madrid-based bank, reckons that Spanish exporters have performed fairly well in retaining export market share against other countries, bar super-competitive Germany. "What Spain had mostly was an

Recommend (47)
E-mail
Share
Print
Buy PDF
Reprints & permissions

Related Items

In this special report
Holding the euro area together
The euro's tortured history
The euro and its troubles
No euro exit
Euro reform
The euro and the crisis
The euro and the state
Euro positives
Sources and acknowledgments
Offer to readers

Audio
An interview with John O'Sullivan, author of this special report.

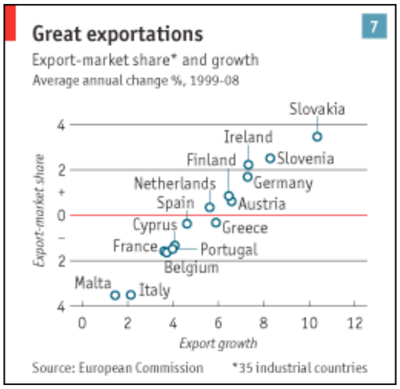
Video
Reports on Italy and the euro and Spain and the euro.

Country briefing
Italy, Spain

More articles about...
The European Union
The euro

Websites
The EU has economic statistics for its member states. The ECB and the European Commission both give historical information on monetary union and the euro.

import boom," he says. Now imports are declining at a much faster rate than GDP, which will trim Spain's current-account deficit to a more manageable size.



A recent study by the European Commission lends some support to that view. The export-market shares of Spain and Greece fell only slightly between 1999 and 2008 (see chart 7). Export growth was stronger than in Belgium, France and Portugal, if not as vibrant as in Austria, Finland, Germany and the Netherlands. Ireland's export-market share increased over the period, even if the greatest strides were made in the euro's early years. Perhaps its exporters, many of them big American-owned firms, were wise enough to hold back on big wage and price increases in a country that could not devalue.

Italian exports, however, were dismal. Firms in Italy lost market share faster than in any other big euro-zone country. Italy's undoing is to specialise in industries such as textiles and furniture where competition from China and other emerging markets is particularly keen.

A devaluation might offer temporary respite for Italian exporters, but it would not be a lasting solution to being in the wrong businesses. Neither could it disguise the economy's real problems: legal protection for jobs that stops workers moving from dying industries to growing ones; a wage-bargaining system that has made for poor matches between pay and productivity; and an unimpressive record on innovation that has inhibited the emergence of new firms in high-value-added industries. This familiar Italian litany is the "never-ending story of things that need reform", sighs one economist.

However, there are signs of progress. Confindustria, Italy's biggest employers' body, recently signed an accord with two of the three largest trade-union confederations to overhaul the national wage system. CGIL, the largest union group, did not sign up to the deal, but the Italian government said it would go ahead anyway.

Deconstructed

Spain and Ireland have more to worry about than wage costs in export industries. Big construction busts are, as a rule, hard to recover from. At the peak of their housing booms, up to a fifth of their workers had jobs related to construction or property sales. Many of those jobs will not come back, and finding other things to do for such an army of redundant workers will take time. Ireland has a more flexible jobs market, so its recovery is likely to be swifter, if still far from painless. Its GDP is set to shrink by as much as 9% this year. Spain's economy is more hidebound, so it will take longer to revive.

Illustration by M. Morgenstern

It is hard to see how a devaluation would help much even if that option were available. "If Spain's main problem were competitiveness, I wouldn't worry," says Mr Gros of the CEPS: "The Phillips curve [which suggests an inverse relationship between wage inflation and unemployment] would take care of it."

The lack of a "fiscal euro zone", a central spending body financed by a shared pool of tax revenues, has hampered an effective response to the economic downturn. Yet without the euro things might have been a lot worse. Co-ordinating a European response amid a series of currency crises or exchange-rate rows would have been far trickier. Bond investors have become choosier about sovereign credit risk, so some euro-area borrowers have had to stump up higher coupons for their recent bond issues. But no one was frozen out of markets. Even when spreads were at their widest, Greece and Ireland, the euro-zone's high-yielders, were able to finance their borrowing needs at a reasonable cost. The security of access to financing has made the euro area even more attractive to the EU's eastern states, some of which have had to fall back on rescue loans or precautionary credit lines from the IMF.

The prospect that a euro-zone country might default on its loans, never mind leave the euro, is fairly remote. But the taboo around the subject leaves bond investors uncertain about how such a problem might be resolved if it did occur. That uncertainty should be dealt with. Policymakers have dropped hints that should one country's financing troubles spread to another, a bail-out plan is in place. Yet the risk of contagion is overblown. An orderly debt restructuring for a country within the euro zone would not be the end of the world, or indeed of the single currency. A bail-out by fellow members might do greater harm by damaging popular support for the single currency.

There is a central irony about the euro. Many of its architects saw it as a means of advancing political union in Europe and were barely interested in a monetary union as an economic venture. Their hopes have been dashed, but as a technical exercise the euro has been a huge success. The currency is accepted in vast swathes of the rich world and quite a bit of the poor world too. The value of euro banknotes in circulation and the market for euro-denominated securities already rival the dollar, a long-established currency backed by a single nation-state.

For economists such as Robert Mundell and others, who saw huge benefits in shared currencies but had despaired of politicians giving up monetary control, the euro is an exciting experiment. By contrast, the politicians that made the leap have been disappointed by the euro's failure, so far, to spur deeper political integration.

For all its shortcomings, the euro zone is far more likely to expand than shrink over the next decade. Most EU countries that remain outside, bar Britain and Sweden, are eager to join. The harm done by housing and construction booms in Ireland and Spain should be a caution to would-be members who, once inside, may get carried away by low borrowing costs. Against that, a big lesson from the crisis is not to rely too much on short-term interest rates to rein in credit and home-loan booms. The rush to join the euro zone is surely a vote of confidence. It must be doing something right.

Next article »