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# One size fits none

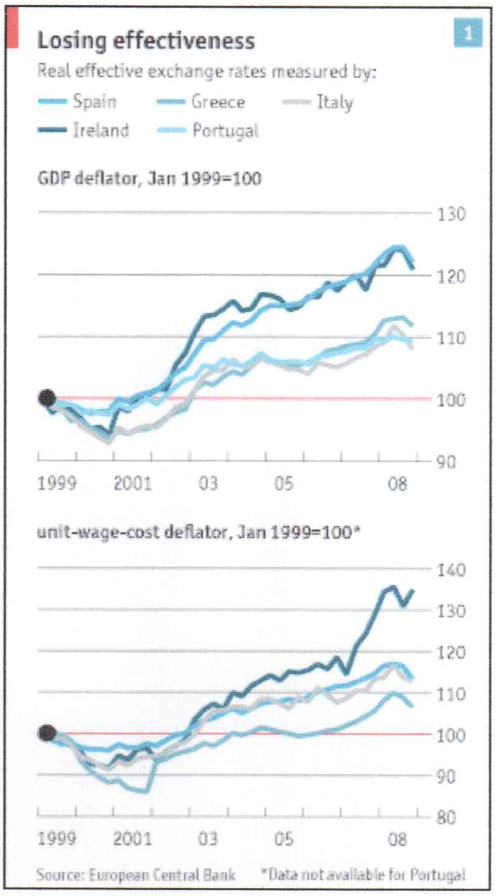
Jun 11th 2009
From The Economist print edition

**The euro did not cause all the euro area's troubles, but it will make them harder to put right**

TALK of economic hardship seems out of place on a sunny April day in Barcelona, one of Spain's most prosperous cities. Yet for all the bustle along the Rambla de Catalunya, the city's main drag, the restaurants and cafés are not as full as you might expect at the start of the Easter break. Jordi Galí, an economist at the nearby Universitat Pompeu Fabra (UPF), gives a decidedly unsunny assessment of the task facing Spain.

The country is enduring a painful housing bust that has led to a collapse in the construction industry, doubling the unemployment rate to 18.1% in little more than a year. Recovery seems a distant prospect, not least because during Spain's long boom production costs rose far faster than they did across the euro area as a whole. If left unchecked, higher costs will make it hard for exporters to compete with firms from other euro-zone countries, which account for most of Spain's foreign trade.

Locked into the single currency, Spain can no longer regain its lost competitiveness by cutting its exchange rate. Mr Galí frets that this may condemn the country to a protracted slump. "The discipline of living without devaluation is tough," he says. "It's like enrolling your child in a demanding school. Results may improve, but there's also a risk the child will rebel and fail if you push too hard."

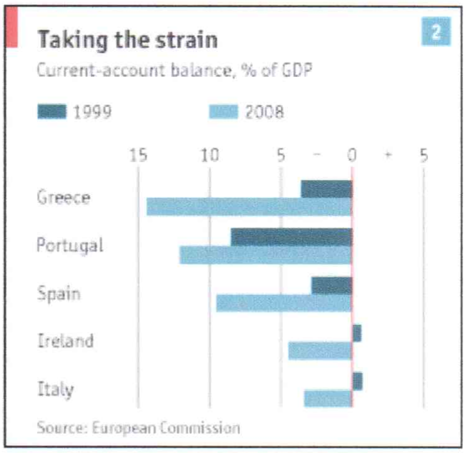



Defiance will be all the greater after a long period of relative ease. For most of the euro's first decade Spain was a star pupil. Its economy grew at an average annual rate of 3.9% between 1999 and 2007, almost twice the euro-zone average and much faster than in any of the currency area's other big countries, France, Germany and Italy. Unemployment fell from close to 20% in the mid-1990s to just 7.9% in 2007. Even that startling drop does not do justice to the pace of job creation. Employment rose at an average annual rate of 2.8% between 1997 and 2007. The boom in housebuilding lured in migrant workers, many from Africa. The proportion of women at work increased from 38.5% in 1999 to 54.7% in 2007.

Now the legacy of that long boom threatens to deliver a long slump. Of the 11 countries that adopted the euro in 1999, Spain has seen the fastest rise in output prices. Its real effective exchange rate, which measures the rise in domestic prices compared with those in 36 countries weighted by their trade with Spain, rose by around a fifth in the decade after the euro's launch (see chart 1, top). Competitiveness gauges such as these are notoriously sensitive to the price measure used, but on another indicator, based on relative unit wage costs, the erosion of Spain's cost edge is almost as marked (see chart 1, bottom).

Both gauges point up problems in the same handful of countries: Portugal, Ireland, Italy, Greece and Spain—a group given the ugly acronym PIIGS. All five have seen a sharp deterioration in their current-account balances since the start of EMU (see chart 2). Those shifts testify to unsustainable booms in domestic demand, but also signal that local firms have found it hard to compete with imports at home and to sell their wares abroad. Pay rises ran well ahead of efficiency gains in all these countries. In Ireland and Greece gains in output per worker were healthy but wage inflation was high. In Portugal and Spain inflation was a little lower but still well above the euro-area norm. The bigger issue was dismal productivity growth, which was Italy's main problem too.

## Swines with flu




All these countries suffer not only from a lack of competitiveness but from other, perhaps more damaging, disorders too. Heavy public-debt burdens and chronic deficits were a feature in Greece and Italy long before the current crisis. Ireland and Spain enjoyed house-price and construction booms that have now turned to busts. In Ireland propping up ailing banks that had lent too freely to property developers and homebuyers, at home and abroad, has bumped up the fiscal cost of recession. (Luckily for Spain, its regulators forced commercial banks to behave more prudently in the boom.) A steady accumulation of current-account deficits has left Greece, Portugal and Spain with net foreign debts of 80-100% of their GDP. These frailties are a threat to the stability of the euro area as a whole.

How much of these imbalances are due to the euro itself? The ECB, a fledgling institution, has managed to keep a lid on inflation: in the euro's first decade consumer prices across the currency zone rose at an average of only 2.1% a year. But in such a large and diverse economy price pressures naturally vary. Capping inflation in fast-growing hotspots, such as Greece and Spain, would have needed a far tighter monetary policy than in the cooler northern climes. Interest rates that seemed right for the whole euro area were too high for sluggish Germany and too low for friskier Greece, Ireland and Spain.

The ECB's one-size-fits-all monetary policy can never be perfectly tailored for any individual member country. In principle, higher inflation should act as a coolant to overheating economies by reducing real household incomes and by making firms less competitive, reducing the incentive to invest. In practice, strong real growth and high inflation are a draw to foreign capital, adding more fuel to the fire. For the same exchange-rate risk, a euro put to work in Spain might earn a better return than in slower-growing parts of the euro zone.

The main hazard for investors in high-inflation countries—that a steady loss of domestic purchasing power will drag the currency down—is eliminated in a fixed-exchange-rate zone. The removal of currency risk from within the euro area helps explain why some countries were able to run eye-watering current-account deficits. In 2007 both Spain and Portugal had deficits close to 10% of GDP. Greece's was 13%. In its absolute size, Spain's deficit was second only to America's.

Foreign capital kept booms going for longer, but that was true in many rich countries outside the euro zone as well. There were other factors at play. The euro was created at a point when the Great Moderation, a long period of stable growth and low inflation in rich countries, was in full train. Investors had come to believe that wild swings in the business cycle were a thing of the past, making them all too willing to take on risk, including loans to countries that already had large foreign debts. Exchange rates often provide useful warnings about emerging imbalances, but overconfidence and herd behaviour weakened the signal.

Even if the first wave of currency union had excluded Spain and Greece, as some German policymakers had wanted, their economies might still have sucked in foreign capital. The eight eastern European countries that joined the EU from 2004 attracted huge sums of foreign capital even though for many of them euro membership was a distant prospect. This suggests that, even outside the euro, Spain and Greece would have had access to plenty of foreign credit with which to feed a domestic spending boom.

Ireland and Spain were ripe for housing booms too. Both countries have a high rate of owner-occupancy and space for fresh construction. The obsession with housing spilled over from Britain, a serial miscreant when it comes to house-price booms. When Spain and Ireland adopted the euro, they imported low interest rates from Germany: the ECB was the Bundesbank writ large. By then Britain had already adopted the German model of a central bank free from political influence and determined to fight inflation. The results, inside and outside the euro zone, were much the same: lower interest rates that sent house prices mad. Britain, at least, was able to tailor its interest rates to local conditions, but not by enough to prevent a housing bubble.

If euro membership is only partly responsible for the overheating in Ireland, Greece, Portugal and Spain (sluggish Italy can only dream of such excesses), it will make it harder for these countries to deal with the resulting loss of competitiveness. Spain's unemployment rate is already the highest in the euro area and likely to rise further. If Spain's jobless rate sticks at 20%, will voters blame the euro?

## A handy scapegoat

"No one sold the euro as a solution to high unemployment," says Mr Galí. But, he adds, the economy used to benefit when market pressures forced down the local currency: "In 1992 and 1993 a series of devaluations got us out of trouble." Now Spain needs other adjustment mechanisms: lower wages to restore cost competitiveness to its firms and a flexible job market to speed the flow of workers from industries such as construction, which catered to a boom fired by domestic demand, to export firms that can generate the revenues to service Spain's debts.

That transition would be hard enough in the best of circumstances. Spain has one of the most rigid job markets in the developed world. Many jobs are heavily protected and wages are set centrally. That will make adjustment all the more difficult. The fear is that Spain will stagnate even as other economies start to revive. "My nightmare is that the world economy, including Europe, recovers and Spain does not manage to hook up to that," says Andreu Mas-Colell, another economist at UPF. "That would be a disaster. It would strain the link between Spain and the rest of the EU. We will also have to deal with tighter monetary policy if the rest of the euro area picks up, creating more pressure."

That fear of being left behind is widely shared in other countries too. Some economists believe that countries now stuck in a slump and unable to adjust their production costs may well start questioning the benefits of euro membership. But where is the exit sign?