THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
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Washington, D.C. 20002
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A "J-Curve" *for the* Eurozone Periphery

The prospects for labor market reform.

BY KLAUS F. ZIMMERMANN

Remember the international trade debate of the 1980s and 1990s? Much of the international discussion about the global economy back then was shaped by references to a rather obscure term, the "J-curve." The term sought to capture the fact that, as nations sought to improve their economic fortunes by devaluing or depreciating their currencies, there was a time lag before any improvement would show up in that nation's trade balance.

Now, amidst the debate about economic reforms in Europe, another kind of J-curve effect is upon us. Crisis-ridden countries such as Italy, Spain, and Portugal have embarked on a healthy diet of labor market reforms, but even under the best of circumstances it will take some time before this tough medicine yields improvements in these nations' employment and growth statistics.

The current effort seeks to pass laws to bring these nations' labor market policies into line with those of other, more successful economies. As important as these steps are, they are but a first step in the reform process. They increase employers' readiness to hire more people only very gradually.

If those measures had been taken earlier, well before the onset of the global financial crisis, they could have yielded positive effects by now. The German case, where unemployment is at lows not seen in thirty years, shows the benefits of deploying such strategies early. The fact that Italy and Spain waited so long does have significant consequences. Employers' hiring calculations are currently not just handicapped by excessive job protection policies, but by a prolonged recessionary environment. The longer confidence in the smooth workings of market mechanisms has been lost, the harder it is to regain.

But that makes these measures all the more crucial. They include the reduction of often excessive, multi-year payouts which employers in those countries have to pay

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Mario Monti

in case they need to lay off people. And they include curtailing a routine use of the courts to contest individual layoffs in trials regularly stretching over several years.

These societies need to sort out some very basic questions. None is more important than this: Having high levels of job protection always sounds desirable, until one realizes that it means that an entire generation of young people is basically denied access to full-time jobs, as we currently witness in Spain.

Weighing down companies with overly generous severance pay obligations for employees (witness Italy) or a shortened work week at full pay (as is the case in France) neglects economic realities in the global age. The times when national governments could turn companies into convenient scapegoats or automatic milk cows are long gone.

All across Europe, we need to develop a new appreciation of the fact that companies are the job creators. Interestingly, precisely that kind of rethinking has firmly taken hold in the countries that, a couple of decades ago, would have been thought the least likely to adjust to that reality: Northern Europe's social democracies, from Scandinavia to Germany.

In contrast, Italy and Spain have insisted on keeping far too much of the burden of adjustment to changing economic circumstances on employers. These countries sought to "lock in" employees into their present jobs and firms in order to reduce their national budgets' potential exposure to paying unemployment benefits.

The credit boom after the introduction of the euro masked this fundamental imbalance. It injected firms and the economy as a whole with ample credit (read: debt). For a while, that gave the impression that the basic imbalance of rights and obligations in the labor market could be rectified magically. It was not to be.

The only rational answer is to allow firms more flexibility in the job market. Otherwise, the skills of the young generation, and their orderly entry into the job market, will be stifled for good. The talk of a "lost generation" is for real. So are the data: The longer young people stay in temporary jobs, the more their long-term earnings potential will be diminished, not to mention their overall outlook on life. Italy's prime minister, Mario Monti, used a more dramatic term for this state of affairs. He called it a form of "apartheid."

Some critics argue that undertaking these labor market reforms now is an insufficient response to the current crisis and advocate strongly for reflationary measures to stimulate these economies.

I disagree, at least for now. The key is to use the current crisis to make those long-overdue labor market reforms. Once they are firmly in place, we will see the economy rebalance itself. The key danger now, as was the case so often before, is to look for an easy way out.

Even assuming one of the most often-cited quick fixes—a currency depreciation—was available to eurozone countries, it rarely yields the hoped-for results. The UK economy is the prime evidence for that. Despite relying on a flexible exchange rate, the country is not only de-industrializing, but economic growth is sluggish at best. It also has severe problems in combating youth unemployment.

As it turns out, ultimately there is no substitute for the hard slog of solid structural reforms. These reforms include steps such as a well-resourced and nationwide apprenticeship system in order to ensure that young people are offered training and career opportunities in non-academic pursuits. Without a doubt, setting up such a system is a painstaking and complex undertaking. But it remains one of the best strategies for aligning market needs, labor supply, and a nation's economic future.

It is good news that Spain and Italy at long last have embarked on a course correction. As with any J-curve, it will take some time for these efforts to bear fruit. But bear fruit they will. What we need to remember is that, despite all the understandable yearning for shortcuts and easy ways out, ultimately there are none to be had. Any postponement only maintains that vicious cycle of creating false hopes and giving the workforce a misleading sense of security. ◆

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