Is Austerity Being Reconsidered in Europe?

Angel Ubide says the tough austerity programs adopted by Spain and Italy are being revised, but only on the margins.

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Steve Weisman: The headlines out of Europe this spring suggest that European leadership is rethinking the regime of austerity imposed especially on the countries of the southern periphery. There may be a growing realization that austerity imposed by the IMF [International Monetary Fund] and the ECB [European Central Bank] is causing unemployment and economic contraction, and some kind of correction is necessary. Angel Ubide, senior fellow at the Peterson Institute for International Economics, is here with me, Steve Weisman. Is a rethinking under way in Europe?

Angel Ubide: There is a bit, if you want, on a fundamental level that too much austerity could backfire. Now we need to put this in context. There is a multiyear program of reduction of deficits in Europe. This program is really driven by legislation at the European level. We forget that the fiscal compact is in place, the six-pack, the two-pack [regulations governing Stability and Growth Pact] that imposed some rules into the system.

Now what we have forgotten is that these rules are defined in terms of the structural deficits, not nominal targets. The nominal targets were imposed at the beginning of the crisis as an idea of where we wanted to go.

Steve Weisman: Explain the difference between structural deficits and nominal targets.

Angel Ubide: Nominal target is when we simply talk about deficit. The deficit is 3 percent of the GDP. That deficit can be caused by two things: one is the changes in policies, and the other one is the changes in the business cycle.

Steve Weisman: Right.

Angel Ubide: What is called the automatic stabilizers.

Steve Weisman: Right.

Angel Ubide: So the idea in Europe over the last couple of years has been, we will let the automatic stabilizers work to a very large extent, and we will continue with a steady reduction in the underlying deficit; and I think that policy still remains.

Steve Weisman: But there is some easing in some countries in the periphery, particularly Italy and Spain.

Angel Ubide: There is. And this is coming because the new concept, if you want, is that there has been too much emphasis on austerity and not enough emphasis on reforms; and there is a little bit of a quid quo pro that is being offered—if you give me more reforms, we’ll give you a little bit more of time to reduce that structural deficit. And that is part of what I think is being discussed and what has been the genuine change over the last couple of months.
Steve Weisman: Let’s talk about Italy, which has a brand-new government. What direction do you see that going in along the lines you’ve just mentioned?

Angel Ubide: The new government, we need to see how it operates. One of the initial statements coming from the government is the elimination of the transformation of some of the tax increases that have been put in place by the [former Prime Minister Mario] Monti government. At the same time, in the same sentence, they say, “We will have to find some money to pay for this.” So we will have to see what the new discussions with the European commissions are in terms of the deficit path and what the new budget shows. I would expect that most of this cancellation of tax increases will be paid for. Perhaps they will get a little bit more of time to reduce the structural deficit and the emphasis should be put on the structural reforms. Italy has two issues, which are political reform and true structural reform.

There is a commitment to change the electoral law, which as you know, has been their key reason why it has taken so far at the end to form a government, and some other constitutional issues in terms of reducing the cost of government, which will be very important in terms of thinking about the long-term future of Italy. So there is going to be work on reforms, definitely.

Steve Weisman: But I’ve heard you and others say that reforms, however beneficial they are, will take a long time to show up in terms of improving the economy, and therefore producing the revenues that would reduce the structural deficit. How could it really be a quid pro quo if the quo is so long in coming?

Angel Ubide: I completely agree, and that is the problem. At the political and at the economic level, a lot of these reforms will only play up in the next cycle, in the next upswing. The austerity is needed because some of these deficits need to be reduced no matter what. So where is growth going to come? Well, we are forgetting another leg of the policy mix, right, that should be the monetary policy. I think that is an unspoken element in all of this debate; that is, you can put emphasis on reforms to increase potential growth, you can put emphasis on deficit reduction because that’s what you need to do in terms of reducing the balances, but you need an offsetting component to boost the amount, and that should really come from monetary policy in my view.

Steve Weisman: What about Spain? Where are they in this process?

Angel Ubide: Spain is in the following situation: They just renegotiated their deficit targets for the next two or three years. They have been given a little bit more time to achieve their nominal targets because growth is weak and therefore they are letting the automatic stabilizers operate, and Spain has also presented a package of reforms. Now, a lot of these reforms are unfortunately the same reforms presented last year that were not put in place on time, and now they are essentially being repeated again with a newer schedule. There isn’t anything really new. At the same time there has been a fair amount of traction in several areas in Spain, in pensions and in the labor market, so things are moving as well.

Steve Weisman: Give me an example or two of what you think is a reform that Spain or Italy should undertake.

Angel Ubide: To take both cases, what they call the cost of politics and the cost of the public administration is very high, and that in some sense is a deadweight loss. If you could operate a country with a smaller cost, then you will be a more profitable country. So in
Italy, there are many jurisdictions that are essentially redundant. They are talking, for example, of eliminating the provinces.

In Spain, with the process of regional devolution, there have been several layers of government that have been created that are also introducing a lot of deadweight cost. There has been a bit of a breakdown of the internal marketing in Spain. There are 17 regions, the regions have their own competencies over a lot of it. You would call it here in the U.S. interstate commerce, that make it complicated and expensive to have an operation that covers the whole country.

Steve Weisman: So you lose efficiency and growth. What finally is the best way of tackling the frightening cost of the high unemployment rate among youth? I don't hear anything in these reforms that are going to lead to jobs for these youth.

Angel Ubide: I agree. I mean, there are two answers that come to my mind. One is to really do a total reform of the labor market to make these young elements of the labor force employable. You need to make them more skilled, you need to facilitate their arrival into the labor force with contracts that are flexible, but at the same time allow them to acquire skills on the job.

For example, in Spain there has been a lot of emphasis on temporary jobs versus permanent jobs. Temporary jobs are really bad, because people are hired for three months or six months and then they are fired. So there is no incentive on the part of the employer or the part of the employee to learn something on the job, because you know you are not going to stay. It would be much better to be hired part time, but on a longer more permanent contract, because then it's the same amount of hours but there is a commitment on both sides to learn something and that increases productivity growth.

Steve Weisman: And there are regulations that prevent that?

Angel Ubide: It's not that there are regulations that prevent it; it's just there are no regulations that make it easier, if you want, comparatively speaking to some of the other options.

So some of the labor market reforms are going in that direction—try to introduce flexibility. For example, in the case of Spain as well, there has been an increased use of what they call EREs in Spanish, which essentially means rather than firing you, you are going to work 80 percent of the time. That was something that didn't really happen before that much. It was much more complicated to put in place and it's responsible for the increase in unemployment. Now if you operate on the hour's margin rather than on the employer's margin, it is better for everybody. I remain employed, it is good for my mental health, it's good for my skills, and you'll have the same reduction in labor costs that you were seeking and that is important. So that is one step forward. The other step forward is to create demand.

Steve Weisman: Right.

Angel Ubide: And demand is not going to come unless, as I said, we have a policy mix that is better suited for the European situation. Fiscal policy is tight, monetary policy should be looser.

Steve Weisman: Thank you, Angel.

Angel Ubide: Thank you, Steve.