Recommendations for Europe

Chapter 2: EUROPEAN IMBALANCES

There is no quick-fix solution for countries that have lost their competitiveness. These countries need a realignment of prices. An internal devaluation through falling prices is usually accompanied by mass unemployment and deep recession, which can potentially stoke social unrest. An external devaluation, achieved via exiting the euro, is likely to create capital flight before the event, and uncertainty afterwards as a result of ensuing legal challenges, particularly from non-residents. An internal devaluation by inflating the core countries may generate political resistance and violate the ECB's mandate of maintaining price stability. However, countries struggling to restore competitiveness can:

- **Try a fiscal devaluation.** Increasing VAT while cutting direct taxes might be a way to slightly improve the competitiveness of uncompetitive euro countries.
- **Cut expenditure rather than raising taxes during fiscal consolidation.** The empirical evidence shows that tax-based fiscal adjustments tend to be less successful than expenditure-based ones. The periphery countries should therefore focus more on cutting expenditure, rather than raising taxes to reduce their deficits. Ireland and Spain, for instance, relied more on cutting expenditure and seem far more on track with their internal adjustment than Greece and Portugal, which raised taxes.
- **Reduce the Greek debt overhang.** Policy-makers should deal with Greece's debt overhang in a credible way that does not require hard-fought political renegotiation every few months. Writing-off a significant amount of Greek debt under strict conditionality and surveillance would be one way forward.

Chapter 3: LABOUR MARKET REFORMS AND YOUTH UNEMPLOYMENT

- **Two-tier labour markets** should be eliminated. They are characterised by a marked distinction between temporary and permanent jobs. The burden of adjusting to change falls heavily on those in temporary jobs, while those in permanent jobs are shielded from it. They tend to make the position of younger workers, among others, more precarious. Efforts to reduce these differences should be kept up.
- **Make dismissal costs for firms modest and predictable.** Long drawn-out legal proceedings with highly uncertain and costly outcomes must be avoided. Where they do not already exist, it may be worthwhile to establish employment tribunals or an arbitration service to resolve labour disputes quickly and cheaply. Severance payments should depend on the length of time a worker has been employed.

- **Reconsider the automatic, legally binding extension of wage bargains across sectors.** Wage bargains should not be imposed on firms where unions do not represent a large enough fraction of the labour force. There should be further moves towards firm-level bargaining. In cases where industry-wide agreements exist, firms and their workers should be able to deviate from them, as local conditions dictate.
- **Vocational education, training and apprenticeships** need to be improved in most European countries.

Chapter 4: US PRECEDENTS FOR EUROPE

- **Establish a common state before federalising debt.** In the United States, the federalisation or mutualisation of state debt depended on the creation of a fiscal mechanism that produced a stream of revenue to service the debt. Debt was only mutualised after the foundation of a common state.
- **Limit liabilities.** The 1790 US compromise might be seen as a precedent for limiting the liabilities of the northern European surplus countries in the case a common European bond, or Eurobond, is created.
- **Fiscal Equity.** The choice of the fiscal mechanism to service a federalised debt potentially raises deeply divisive issues about the distributive effects of the tax or tariff on the constituent states.
- **Ensure that Europe's central bank is flexible and strictly governed.** Designing a central bank for a very large area is complicated, and requires some measure of flexibility (such as differing collateral requirements) to respond to local or regional circumstances, as well as checks and balances in its governance structure.
- **Set up a US-style settlement mechanism in Europe.** Europe needs a US-style settlement mechanism that requires a securitisation of balances to keep outstanding debts small; and even creates incentives to take countervailing local policy measures to avoid the build-up of balances in the first place. A settlement system would protect the European creditor countries against losses arising from a break-up of the currency union, while making them more resistant to pressure to participate in bail-out activities.