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Assessing the link between labour markets and deflation: How southern European labour markets affect deflation and what can be done about it

An IoD Policy Report
by Michael Martins

Simon Walker
Director General of the IoD

“The UK’s economy is deeply intertwined with the other members of the European Union, so we cannot turn a blind eye to the situation in Southern Europe.

The blunt truth is that for far too many workers in these countries, the prospects are dire. Rigid and dualised labour markets, which protect permanent employees at the expense of everybody else, have led to shockingly high unemployment, especially among the young. In some countries, more than half of young people cannot get a job, and it is not far-fetched to suggest we risk seeing a ‘lost generation’.

“These countries are also suffering from deflation, which makes it harder for them to tackle their high debt burden and increases the risk of default. The UK is not insulated from these woes, and so we must work with our European partners to encourage the reforms needed to make labour markets more flexible and to strengthen the economic fundamentals of southern European states.

The alternative is continued stagnation, if not decline.”

The Institute of Directors (The IoD)

The IoD represents 34,500 directors, and their firms, from across the business spectrum. 80% of its membership is SMEs, which tend to employ native Britons more so than larger firms. The organisation is, therefore, numerically politically important at Westminster and difficult for policymakers to ignore.

The IoD has a royal charter mandating it to “represent the interests of members and of the business community to government and in the public arena, and to encourage and foster a climate favourable to entrepreneurial activity”, while also acting “for the public benefit.”

In the event of a referendum on the UK’s EU membership, which the majority (51%) of IoD members support, 51% say they would vote to remain in the EU only if the UK government could secure EU reform, with more than half of this group (28%) in favour of pan-European reform against the 23% who want to see powers returned via treaty change. 40% would stay in the EU in all circumstances and 7% would opt to leave the EU in all circumstances. Just 13% of IoD members think the EU’s socio-economic model is a viable one, underscoring the increasing need for changes to make the whole of the EU competitive, and 89% of members think that a renewed economic and/or currency crisis in the Eurozone would negatively affect their business in 2015.

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Executive Summary

Southern European countries, namely Spain, Italy, Portugal, and Greece, have entered deflation. Deflation is being driven by internal structural factors, particularly dualised and rigid labour markets, internal devaluation, and unrepresentative collective agreement bargaining and extension, and global factors, such as the shifting of mid-value added manufacturing to different areas in the world, notably China.

Deflation exacerbates two risks, debt default and deflation exportation, in both the individual countries and the EU. These countries' private and public sectors are highly indebted, so as deflation expectations become entrenched, debts become more expensive, increasing the likelihood of default. These countries are significant trading partners for each other and other countries in the EU, notably the UK and Germany, and can therefore both directly and indirectly export deflation to other EU countries and the world at large.

The EU as a result faces a collective action problem. Southern European deflation risks affect all of the EU, but the necessary labour market reforms must be undertaken by individual countries that have historically done so only during times of crisis and external pressure. The European Commission's "Europe 2020" growth strategy document acknowledges this: "reforms, or the lack of them, in one country affect the performance of all others.[1]

Concurrently, the main proxy for the UK's continued EU membership has been the issue of immigration of EU nationals to the UK. The UK has mostly focused effort on curtailing immigration by making it more difficult for EU migrants to arrive and claim benefits, although there is not a significant body of evidence to demonstrate how causal the link is between UK welfare benefits and EU migration to Britain.[2] Rather, it is more likely that they seek economic opportunities in the UK that are unavailable in their native country.[3] In parallel, many eastern and southern European countries worry about 'brain drain' and are actively trying to stem this trend in a manner similar to the UK's reactionary approach to benefit reduction. For example, Hungary has sought to force graduates to remain the country for 10 years after graduation to pay back the state for their education.

Therefore, both the UK and its southern and eastern European partners want the same thing, namely for peripheral Europeans to work and live in their native countries. What the UK should be doing, therefore, is looking at the causes of emigration in the source countries, and working with these countries and others to make it less desirable for emigrants to leave by making it preferable to stay. There is enough consensus within the European Commission, the European Council, and the European Parliament to affect change, and the UK can lead the way. The main beneficiary of the UK's inaction is France, whose policy goals are most aligned with Southern Europe, but whose economic and political clout is similar to the UK. The two countries effectively compete for influence as swing states in the EU.

At the same time, the argument for a reformed EU has become more important in the UK's debate about EU membership. If the UK led reforms that benefitted all of Europe and came from a pan-European consortium, it would be in a position to build the political capital necessary to create the requisite coalitions to build and implement reforms to increase the EU's internal and international competitiveness. Concomitantly, it signals willingness to work within the EU. To do so, however, it needs to win allies, not create enemies.

High structural unemployment, low productivity growth, and minimal employment growth derive from rigid and dualised labour markets.[4] Labour market reform to make permanent employment more flexible and temporary employment more secure would ameliorate these problems. There are several member states of the European Union that are natural allies for the UK in this regard, specifically those outside of the Eurozone in Central and Eastern Europe.[5] Many of these states and their politicians, however, view the UK as a liability and not worth the political capital expenditures cooperation would necessitate. Signals sent from cooperation could help to alleviate this situation.[6]

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[1] European Commission, "Europe 2020", March 2010

[2] For example, the Labour government under Tony Blair opened UK labour markets to new EU countries from Central and Eastern Europe in 2004, but limited access to the UK's welfare system. Citizens of new EU member states gained access to income-related benefits (income support, jobseeker's allowance, housing benefit and council tax benefit) only after 12 months of continuous employment in the UK.

[3] Immigrants to the UK from the EU tend to be young (the average age is 26), higher educated and less likely to claim benefits than UK natives. For an overview, see Dustmann and Frattini 2013,"The Fiscal Effects of Immigration to the UK".

[4] Labour market dualisation is defined as a process by which labour markets are divided into two main segments, 'insiders' and 'outsiders'. 'Insiders' enjoy permanent, open-ended employment and are protected from termination through employment protection legislation (EPL), usually in the form of long notification periods or high severance pay, that makes their termination very difficult. 'Outsiders' work on temporary, fixed-term employment contracts; their severance pay is much lower and notification periods much shorter. This incentivises short term, temporary employment over permanent employment during times of economic malaise and serves to dualise the labour market.

[5] Namely Bulgaria, Croatia, Czech Republic Hungary, Poland, and Romania

[6] The UK's debate around Eastern European immigration in particular has alienated these countries from adding another perspective on labour market issues.

As the EU becomes increasingly fractured between those in the Eurozone and those outside, and as the UK questions its membership, there is an increased incentive for non-Eurozone but EU member states to work with Eurozone members rather than cooperate with each other to achieve beneficial goals. These very same Eurozone members represent the countries where the difficult decisions and labour market reforms have not been made, and it is therefore unlikely that this will change. If anything, labour markets could be made more rigid and mass unemployment could continue to plague Southern Europe as a result. **Given this alternative, there is a unique opportunity for the UK to act as a swing state.** It can build coalitions and consensus within Brussels, Rome, Madrid, Lisbon, and other capitals, to achieve outcomes beneficial to itself as well as the EU. Doing so builds the political capital necessary to achieve meaningful future reforms in other sectors and areas where the EU is uncompetitive.

Contents

Introduction

Deflation has taken hold in several European Union countries, notably Greece, Italy, Portugal, and Spain, the so-called European periphery. The focus on deflation, however, has been at the international level, and on its rise in either the Eurozone or the European Union as a whole, rather than individual countries.[7] The inflationary context in Austria is very different than in Portugal, for instance, where, in February 2015, the former enjoyed 0.5% headline inflation and the latter suffered from -0.1%.[8] This report seeks to rectify that oversight, while also spurring debate around the issue, highlighting opportunities, risks, and solutions.

Various local, national, and global factors have caused deflation in the EU, and as a result, necessary reforms, and how they can be achieved, varies, given the current political economy of the EU, the UK, and the peripheral countries. What the latter countries do have in common, however, are rigid labour markets, similar demographics, and historic comparative advantages that are no longer globally competitive to the scale traditionally experienced, namely mid-level manufacturing. In order to act upon these facts, curtail deflation, increase economic growth, and pursue better outcomes for their people, however, reform must come from within. This has not traditionally been the case, however. External pressure, whether it comes from capital markets or the Troika, namely the European Central Bank (ECB), the European Commission (EC), and the International Monetary Fund (IMF), has usually served as the catalyst for reform. Although questions of sovereignty arise with the troika's role in driving structural reform, the consequences of inaction, specifically exported deflation and debt default, are shared regionally, in the European Union, and the world at large.

With these points in mind, this report will first discuss the UK's political context. It will then outline what deflation is and how it impacts an economy, followed by the effects that the European Central Bank's (ECB) decision to undertake quantitative easing (QE) will have on deflationary environments in the EU. It will then outline and highlight the four main factors, namely internal devaluation and prolonged economic uncertainty, globalisation, labour market rigidities, and demographic trends, that have contributed to deflation in peripheral Europe.[9] It will then discuss Spanish, Portuguese, and Italian political contexts, political economies of their respective labour markets, enacted reforms and recommendations for further reforms, as case studies. The next section will discuss the European Semester and Country Specific Recommendations as an avenue for reform. The next will outline the risks of deflation to the individual countries, to the EU and the UK, and to the world at large, namely debt default and exported deflation. The penultimate section will highlight opportunities for the UK, and the final section will conclude.

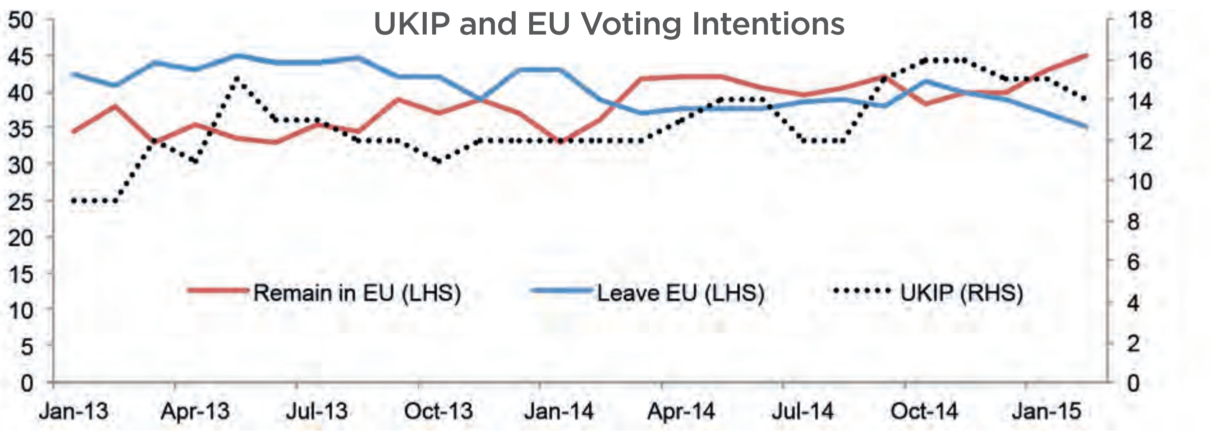
[7] Claire Jones and Tobias Buck, "Eurozone falls deeper into deflation," The Financial Times, 30 January 2015, accessed 30 March 2015.

[8] European Central Bank, "Euro Area Statistics"

[9] Peripheral Europe is defined, in this case, as Greece, Spain, Italy, and Portugal. These countries share similar histories in some cases, such as Spain, Portugal and Greece, which joined the EU upon emergence from dictatorship, but all were most heavily affected by the recent crisis and have experienced similar economic effects during and as a result. Eastern European countries such as Romania, Bulgaria, Slovakia, Slovenia, Hungary, and Poland are often referred to as peripheral Europe, but their economies have grown somewhat more robustly during the crisis, mainly from a lower starting point, and they have not had the same experience with deflation that is facing southern Europe. As well, their institutional past is different than southern Europe due, notably, to their Soviet past.

The UK's General Election and EU membership

The rise of the United Kingdom Independence Party (UKIP) has significantly shifted the political debate in the UK. In the build up to the general election, the debate became increasingly more focused on immigration, specifically how to curtail immigration from the EU, and EU membership. The main political parties, Labour and Conservative, shifted their message to reflect increased competition from UKIP. The Conservatives made 'capping welfare and reducing immigration' part of their Party platform,[10] while Labour has argued for 'earned entitlements', whereby immigrants won't be able to claim benefits for at least two years, while also arguing that 'to walk away from Europe...would be a disaster for Britain.'[11] At the same time, the smaller parties followed suit, for example the Liberal Democrats argued for 'exit checks' and the Scottish National Party argued for a 'controlled points-based system' of immigration.[12]



Source: YouGov

Out of this shifting political landscape, the debate surrounding EU membership has shifted to the presentation of three alternatives: membership without reform; membership with reform; and exit from the EU (Brexit). Reforms, however, are difficult to define, given they operate on multiple levels and with diffuse interests. This report will focus on reforms to how labour markets operate in peripheral Europe and the problems their current functioning creates.

For reforms that are ongoing in nature and do not require individual member state consensus, in this case labour market reforms, the UK can lead in Europe. It has allies with mutual interests, depending on the issue, and a history of successful labour market reforms. By OECD measures and as discussed by Nobel laureate Christopher Pissarides (2013), the British labour market in the 1970s bore many similarities to peripheral European labour markets: employment legislation made it difficult to fire employees, trade unions had much more power, notification periods were longer, and severance pay for permanent employment was high. This led to high levels of structural unemployment and inefficient delivery of many public services, for example, electricity and transport. However, the 1980s saw labour market liberalisation on a scale presently demanded of peripheral Europe: tougher unemployment and non-participation support incentivized employment, more flexible employment protection legislation was passed and large public sector monopolies were broken up.[13]

In order to get reform in EU labour markets, it is necessary to have a conversation about mutual self-interests. When it comes to immigration, for instance, Southern European countries are in the top 20 source countries for National Insurance Numbers (NiNo) registrations in 2013 and 2014.[14]

[10] The Conservative Party (UK), "The Conservatives' Long-Term Economic Plan", accessed 14 March 2015,

[11] The Labour Party (UK), "Labour Party – Immigration", accessed 14 March 2015; Ed Balls' speech at British Chamber of Commerce Annual Conference, 10 February 2015

[12] The Liberal Democrats (UK), "Liberal Democrats – Immigration" accessed 12 February 2015; The Scottish National Party, "What a Yes vote means for immigration", accessed 15 February 2015

[13] See Pissarides 2013, "Unemployment in the Great Recession," for an overview.

[14] National Insurance Numbers are mandatory for individuals formally employed in the UK labour market, and are used to collect taxes and receive benefits, among other purposes

Italy and Spain are 3rd and 4th, respectively, while Portugal ranks 7th and Greece 18th, and in aggregate, they total almost 150,000 immigrants, or roughly 24% of the UK's total during this period.[15] These source countries have seen emigration to the UK increase by double digits. Italy, for example, saw 60% growth between 2012 and 2013.[16] Emigrants tend to be the highest educated young people from these countries as well, bringing up issues of 'brain drain' in their home countries.[17]

The UK has mostly focused effort on curtailing immigration by making it more difficult for EU migrants to arrive and claim benefits, although there is not a significant body of evidence to demonstrate how causal the link is between UK welfare benefits and EU migration to Britain.[18] Rather, it is more likely that they seek economic opportunities in the UK that are unavailable in their native country.[19] What the UK should be doing, therefore, is looking at the causes of emigration in the source countries, and working with these countries and others to make it less desirable for emigrants to leave by making it preferable to stay. This will also be beneficial to the UK's future in the EU, as it would be seen as more of a partner rather than a recalcitrant, wavering member. Many southern European countries worry about 'brain drain', and are actively trying to stem this trend in a manner similar to the UK's reactionary approach to benefit reduction. Italy, for example, began in 2011 to offer tax breaks to highly educated academics to incentivise for their repatriation.[20] Therefore, both the UK and its southern European partners want the same thing, namely for peripheral Europeans to work and live in their native countries.

Although the debate in Whitehall is shifting, the debate as seen from Brussels, whereby the UK is seen as a reluctant member at best and downright hostile at worst, gives little reason for the EU to take the UK seriously.[21] The UK's build up to its EU membership referendum will do little to further the cause of the UK in the EU. From the perspective of an EU country, there is little reason to invest political capital in the UK if it might be leaving or when it is creating a lot of animosity in the EU, especially with the EU's larger countries like Germany and France, or emerging powers, notably Poland, which tend to have more influence.

It is in the interest of EU countries to remain in the EU and to work with whom they can to best deliver results in their national interest. As an example, EU member countries in Eastern Europe are more concerned about security issues due to their proximity to the Russia-Ukraine conflict and Soviet history. They see euro adoption as an additional deterrent to Russian influence as Russian President, Vladimir Putin, tests the resolve of NATO.[22] Lithuania's recent entry and Romania's intentions to join by 2019 highlight this point.[23]

The EU has also begun to bifurcate in two main ways. Firstly, Eurozone countries are continuing to pursue deeper and further integration, while those in the EU but not the Eurozone are left to compete with each other or band together and pursue influence with countries on the margin in the Eurozone. Second, countries that are economically growing and those that are not have each tended to band together. The UK is a growing, non-eurozone member that is numerically and politically important, and can effectively act as a swing state in the EU, building coalitions and pursuing policies that can make the EU more competitive internally and internationally. The greatest threat to the EU as a whole, however, is not Russian incursion, a two-speed Eurozone, or Brexit. It is deflation.

Deflation and its effects

Deflation happens when the aggregate price level decreases. This can have pernicious effects as an economy can quickly enter a deflationary spiral, whereby deflation expectations become entrenched, and it is always less expensive to spend money in the future, and therefore money is never spent. This causes a contraction in the money supply.[24] When the money supply contracts, the remaining supply of money becomes more valuable relative to previous levels because it is rarer. As a

[15] Department for Work and Pensions, "National Insurance Number Allocations to Adult Overseas Nationals Entering the UK – Registrations to December 2014,"

[16] Valentina Romei, "Renzi's hidden problem: the brain drain," The Financial Times, 27 February 2014, accessed 28 February, 2015,

[17] Helen Warrell, "Migration research challenges warning of record inflow to UK," The Financial Times, 29 March 2015.

[18] For example, the Labour government under Tony Blair opened UK labour markets to new EU countries from Central and Eastern Europe in 2004, but limited access to the UK's welfare system. Citizens of new EU member states gained access to income-related benefits (income support, jobseeker's allowance, housing benefit and council tax benefit) only after 12 months of continuous employment in the UK.

[19] Immigrants to the UK from the EU tend to be young (the average age is 26), higher educated and less likely to claim benefits than UK natives. See Dustmann et al. (2013) "The Labour Market Impact of Immigration" for an overview

[20] The Economist, "Italy's brain drain", 6 January 2011.

[21] Prominent examples include Financial Times columnist, Janan Ganesh's speech, "From a Reluctant European: a memo to the Prime Minister" at Open Europe on 2 February 2015; and Professor Anand Menon of King's College London at the Social Market Foundation, "Britain's relationship with the EU", 30 January 2015.

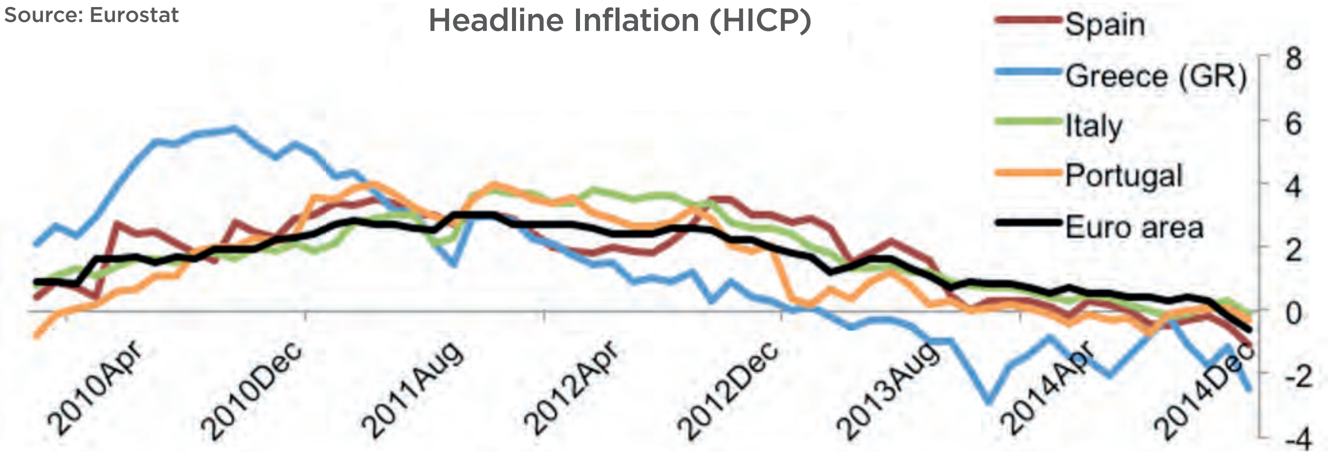
[22] Milda Seputyte, "Euro Seen as Shield by Lithuanian Banker Wary of Russia", Bloomberg Business, 23 December 2014.

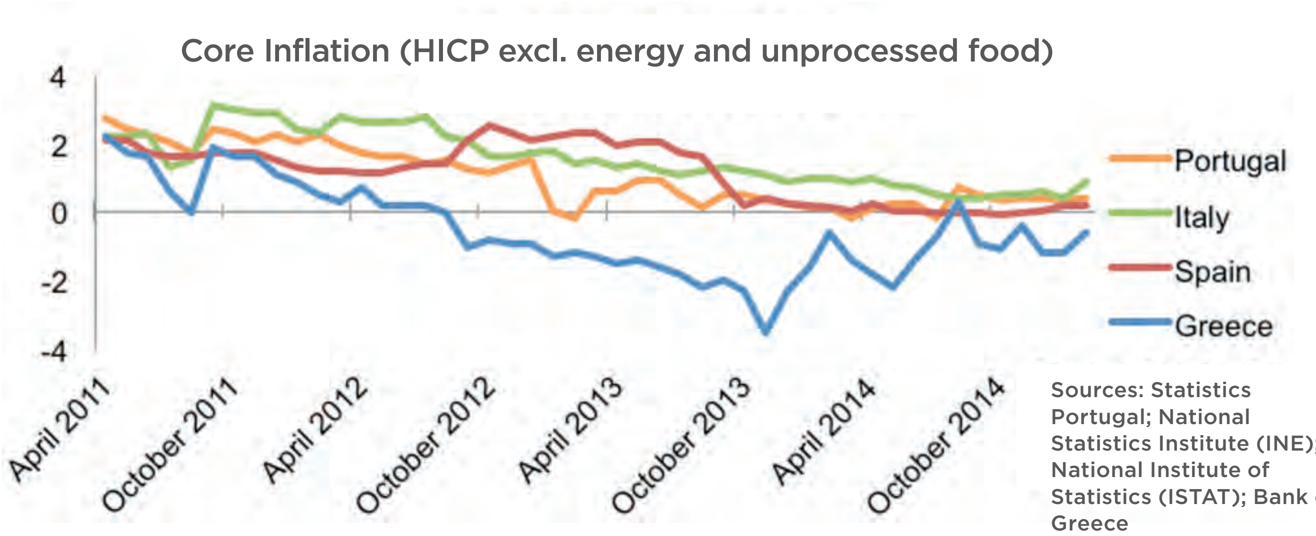
[23] The Economist, "Why Lithuania is about to adopt the euro", 15 December 2015.

[24] The money supply is increased via the 'money multiplier effect'. Banks take in money as deposits and then lend a certain percentage of it out as loans. This money is also spent and saved by individuals and firms, allowing banks to again lend out a certain percentage of new deposits. If there is little spending and a lot of saving, fewer loans are issued, leading to less money creation.

somewhat extreme example, if a television costs £100 on Week 2, but used to cost £125 on Week 1, consumers can reasonably assume that the price will be further lowered in Week 3. A relevant European example comes from Italy, where home fixtures maker Iaquone's owner, Benedetto Iaquone, says that "people are now only changing their windows when they fall apart," and has had to cut prices as a result, a sentiment substantiated by the fact that up to 40% of products in Italy are now being sold below recommended retail prices.[25] This phenomenon can be carried into the future indefinitely, so consumers will always prefer not to purchase a television because they will always get a better deal in the future.

Source: Eurostat





Sources: Statistics Portugal; National Statistics Institute (INE); National Institute of Statistics (ISTAT); Bank of Greece

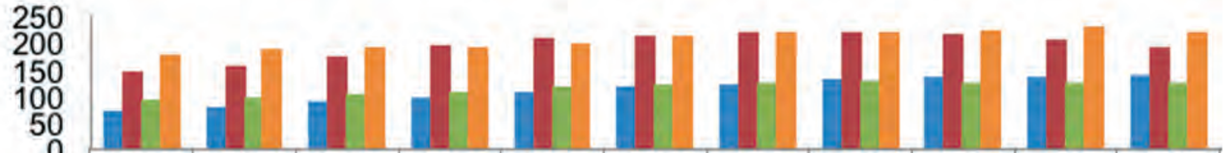
[25] Gavin Jones, "Special Report: Why Italy's stay-home shoppers terrify the Eurozone", Reuters, 28 November 2014.

The velocity of money (how often and how quickly money is spent), can also impact deflation. If consumers opt to not spend money, firms will decrease price levels in the hopes of incentivizing consumption. However, consumers are aware of this, and opt not to spend, knowing that their money will always be worth more in the future as price levels decline. This causes decreased profits, downward pressure on wages, and incentivizes firms to lay off workers, which further incentivizes decreased consumption, at which point economic uncertainty and decline set in. The cycle can be very difficult to break, as evidenced by the Japanese experience, which has only recently entered positive inflation after more than a decade of deflation (although this may be attributable to Japan's overreliance on energy imports after the Fukushima nuclear disaster, and the subsequent closure of the country's nuclear facilities, coupled with the decrease in energy prices).[26]

Problematically, deflation makes fixed debts, such as mortgages and bank loans, more expensive. If wages and prices continue to fall, many borrowers will have difficulty meeting their debt obligations.

Worryingly, Greece, Spain, Portugal, and Italy are home to high levels of private and public sector debt.[27]

Private Sector Debt as a Percentage of GDP



	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Greece	68.8	74.7	86.5	93.3	102.2	113.8	117.5	128.8	130.6	130.5	135.6
Spain	142.3	154.1	170.2	193	206.1	210.2	215.3	216.9	213	203.4	187.2
Italy	89	93	98.8	105.2	113	116.7	122.6	123.9	122.2	122.7	120.8
Portugal	172.8	184.2	186.9	187.6	196.7	208.2	217	215.9	220.7	226.7	218

Source: Eurostat

[26] Takatoshi Ito and Frederic S. Mishkin "Two Decades of Japanese Monetary Policy and the Deflation Problem", *National Bureau of Economic Research*, October 2004,

[27] According to the European Commission, 'private sector debt is the stock of liabilities held by the sectors Non-Financial corporations and Households and Non-Profit institutions serving households. The instruments that are taken into account to compile private sector debt are Debt securities and Loans. Data are presented in non-consolidated terms, i.e. taking into account transactions within the same sector and expressed in % of GDP and million units of national currency. Definitions regarding sectors and instruments are based on the ESA 2010.

The traditional view of deflation, however, is unrealistic for southern Europe. Consumers are less concerned with lower prices in the future, and are more affected by the microeconomic uncertainty under which they operate. Individuals are more worried about their future prospects rather than delaying purchases until prices decrease. Short-term, tenuous employment, for instance, and the uncertainty attendant to it, namely unsure future continuation of temporary or permanent employment, unlikely transition into permanent employment from temporary employment and/or decreased nominal and real wages (although permanent employment tends to have high levels of nominal wage rigidity, incentivising further reduction in temporary employment nominal wages), delays and hinders consumption and investment decisions.

With these factors in mind, businesses have been reluctant to expand and to make capital investments, consumers have been reluctant to spend, and banks have been reluctant to lend, although the latter tendency also has to do with increased capital requirements, increased underwriting standards, increased financial sector fragmentation as banks have retreated into their home markets, and the general economic malaise and uncertainty under which they lend and operate. More than one fifth of Portuguese SMEs, for example, note that their greatest concern is access to finance, and those that do obtain new credit may pay interest rates of around 5.5%, high when compared to the 2% average that German and other Eurozone core countries face.[28] Growth has stagnated as a result, further entrenching deflation expectations.

Although the Eurozone has technically entered deflation as one entity, this aggregation is unreflective of economic reality. There are variations between countries, for example in Q4 2014, Austria enjoyed quarterly headline inflation of 1.68% (or 6.72% annualised) inflation, whereas Greece experienced -1.83% (or -7.3% annualized) deflation. Although most countries experienced disinflation in December 2014, in the majority of EU countries this was an aberration caused mainly by the fall in energy prices.[29] Importantly, harmful deflation is not just a short-term fall in the price level, but also expectations of future price levels. In countries where deflation has taken hold, disinflation began prior to the fall in energy prices in September 2014, and has continued. Greece, for example, has had negative inflation rates for 22 of the past 24 months, whereas in Belgium this only occurred once, in December 2014, over the same period.

The common measure for inflation expectations in the Eurozone, the five year/five year forward inflation expectations (what the markets think inflation will be five years ahead for a five year period, so 2020-2025), operates at the euro-wide level, so is, as a result, somewhat inaccurate at the individual member-state level.

Several examples from Italy and Spain, the two countries of the four with comparatively higher levels of inflation, highlight how deflation expectations have become entrenched at the member-state level. The Bank of Italy, the Italian central bank, in their Survey of Inflation and Growth Expectations October 2014, published inflation expectations of firms. Two year CPI inflation expectations have decreased by almost 100% since December 2013, from roughly 1.3% to .7%. 90% of firms think that inflation will be in the area of .2% in the next 6 months, roughly 80% think it will be .3% in the next 12 months, and almost 70% think it will be in the area of .4% in the next 24 months.[30] PwC, the auditing firm, does a quarterly economic survey of Spain, where they poll firms as to what they think the rate of inflation will be a year forward. Inflation expectations for 2016-2017 are negative, in the range of 0 to -0.15.[31]

[28] International Labour Organization, “Portugal: Tackling the Jobs Crisis”, p. 2

[29] The latest available data from Eurostat at time of publication. Disinflation is when the inflation rate rises, but at a slower rate than in previous measurements

[30] The Bank of Italy, “Survey of Inflation and Growth Expectations October 2014”,

[31] PwC, “Consenso Económico: Primer trimester de 2015”.

Monetary policy options

There are two traditional paths to relieve deflation: monetary easing and currency devaluation. When central banks opt for monetary easing, there are two standard policy options: interest rates are lowered and, more recently, assets are purchased, a practise known as quantitative easing (QE). The ECB has already lowered interest rates into negative territory, with the deposit facility rate at -0.20%.[32] The remaining policy option, QE, will do little to curtail deflation in the Eurozone. Although QE has been successfully carried out in several economies, namely the US and the UK, it has also had mixed results, notably in Japan. The differences are mostly structural and reflect both the demands of the crisis and the political feasibility of actions. The US banking sector was insolvent and unemployment quickly rose, necessitating the US Federal Reserve (the Fed) to buy asset-backed securities (notably toxic mortgage-backed securities or MBSs) and T-bills in order to force investors into riskier equities and the government to undertake fiscal stimulus and increase the generosity of automatic stabilizers, for example, extending unemployment benefits to 99 weeks. The Bank of England (BoE) bought government bonds, which lowered their yield and decreased the amount of money that the government had to pay in debt interest, which allowed the government to undertake less onerous public sector restructuring. The Bank of Japan (BoJ) bought government bonds and the Japanese government undertook fiscal stimulus. However, Japan's real problem lay in its remarkably rigid labour market, which has contributed greatly to the country's stagnation and relative decline. This is the fear surrounding Europe, which shares Japan's history of rigid labour markets, but where QE's effects will be lopsided and marginal and where there is little chance of fiscal stimulus where it is most needed.

Although QE can increase inflationary tendencies through several channels, these mechanisms are unrealistic at present. European firms tend not to rely upon capital markets financing, where the ECB could buy debt, pushing down spreads, but rather rely on bank lending. Although QE will make bank lending easier because loan interest rates are linked to sovereign debt interest rates, increased capital requirements, continued restoration of southern European banks' balance sheets, and more rigorous underwriting standards, along with general economic uncertainty, make lending for investment unlikely to happen.

The ECB will be left to purchase government bonds, push down their spread, and increase the money supply. This acts as windfall revenue to governments, much like the UK's experience with QE. The interest payments on debt decrease because yields decrease and governments are able to shift these resources to other priorities, for example further debt reduction, financing of infrastructure projects or continued spending on healthcare or education. The latter two decisions are a form of fiscal stimulus, and would tend to give a short-term inflationary boost to the economy, whereas the first would tend to increase the long-term economic stability of the country, depending of course on the debt burden and the country's economic fundamentals. Fiscal stimulus is unlikely to occur in southern European countries, which are undergoing structural reforms that curtail government spending. Given already quite low spreads on government bonds for peripheral EU countries, with the notable exception of Greece, it is unlikely that the windfall in revenue will be large enough to allow for significant debt reduction, especially given that QE will be enacted based on the Capital Key, which reflects the respective country's share in the EU's total GDP and population. Those that would be most likely to benefit tend to be smaller, for example Portugal, which has a 1.7434% share of the Capital Key as of 1 January 2015. So what QE does come their way, will be too little to make a meaningful difference.[33]

COUNTRY	CAPITAL KEY %
Deutsche Bundesbank (Germany)	17.9973
Banque de France (France)	14.1792
Banca d'Italia (Italy)	12.3108
Banco de España (Spain)	8.8409
Banco de Portugal (Portugal)	1.7434
Bank of Greece (Greece)	2.0332

[32] This means that banks are charged to hold liquidity with the ECB.
[33] The chart below is current as of 1 January 2014

Currency depreciation

Eurozone QE will cause currency depreciation, however, which will make European exports cheaper abroad, and mainly help export-oriented economies, notably Germany, France, Belgium, Netherlands, and Italy, the five largest exporters in the EU, excepting the UK and as measured by exports internal and external to the EU. Currency depreciation will also be aided by the Swiss Central Bank's decision to effectively float the Swiss franc, which had previously been pegged to the euro. As a result, one of the largest buyers of euro has disappeared from the market, which will increase the effect of currency depreciation.

Currency depreciation will stoke inflation in some of these countries. German firms tend to have low levels of debt and therefore increased exports will likely lead to plant expansion, increased wages, job creation, or a combination of all three. Portuguese firms, on the other hand, have had their share of manufacturing exports significantly decline (albeit from a low level) and the firms that do survive tend to have high levels of debt and high levels of unionization, incentivizing debt reduction and temporary employment rather than plant expansion.[34] Italian exporters tend to be in the northern part of the country where economic conditions are more favourable to expansion and growth and where the labour force was less affected by the crisis (unemployment rates in the Southern part of Italy are roughly 2.5 times higher than in the Northern part, according to the International Labour Organization, for example), and it is therefore unlikely that currency depreciation-fuelled export growth will stoke growth in the comparatively worse-off southern part of the country.[35] Furthermore, 95.2% of Italian firms employ less ten people and 99.9% employ less than 250. Because export-orientation is positively correlated with firm size, it is unlikely that export-fuelled growth will benefit more than a small segment of the Italian economy.[36] Concurrently Italian firms have deep ties with German firms, who have curtailed imports due to the Russia-Ukraine conflict.[37]

Currency devaluation

The other alternative, currency devaluation, is unavailable to the Eurozone. Currency devaluation occurs when a central bank decides to lower the value of their, usually pegged, currency relative to another.

A prominent example is Iceland, whose currency, the krona, was devalued at the onset of the 2008 financial crisis.[38] Wages in Q1 2008 were roughly 5% higher (in euro) than Ireland, a fairly relevant comparative country that experienced a similar crisis. By Q4 2008 wages had fallen to 40% of the Irish level, lowering unit labour costs and allowing Iceland to return to growth relatively quickly. The euro, however, is not pegged to any other currency, and although it will depreciate as a result of QE, devaluation for the sake of international competitiveness will be internal and focused on peripheral countries which are uncompetitive relative to both the Eurozone core and the world at large. In pursuit of reduced unit labour costs in order to decrease prices and increase their competitiveness, peripheral countries have entered the beginnings of a potential deflationary cycle.

Factors contributing to European deflation

European deflation has begun to take hold as individuals become progressively more pessimistic about their future economic circumstances. This is the product of four interrelated external and structural factors. First, reduced aggregate demand and prolonged internal devaluation, and the attendant microeconomic uncertainty, continue to stifle growth. Second, the crisis exacerbated the delayed effects of globalization on the manufacturing and construction sectors. Third, peripheral European labour markets are quite rigid, incentivizing short-term employment and fostering labour market dualism. Fourth, demographic factors have increased labour market dualism and polarization and further entrenched labour market mismatches. These factors have forced households to delay consumption and firms to delay expansion. Marginal employment creation after massive employment destruction has increased risk aversion and reduced the velocity of money, which has reduced the effectiveness of the money multiplier and induced deflation. This behaviour is effectively the same action as in the traditional deflationary model discussed above. Rather than individuals opting to delay purchases because prices in the future will always be less expensive, they are doing so because their economic future is very uncertain. As these trends continue, deflation expectations will become more entrenched and pernicious.

[34] Manuela Gorreti and Marcos Souto, 'Macro-Financial Implications of Corporate (De)Leveraging in the Euro Area Periphery" IMF working paper 13/154

[35] Peter Garibaldi and Filippo Taddei "Italy: A dual labour market in transition" International Labour Organization, 2013, p. 14

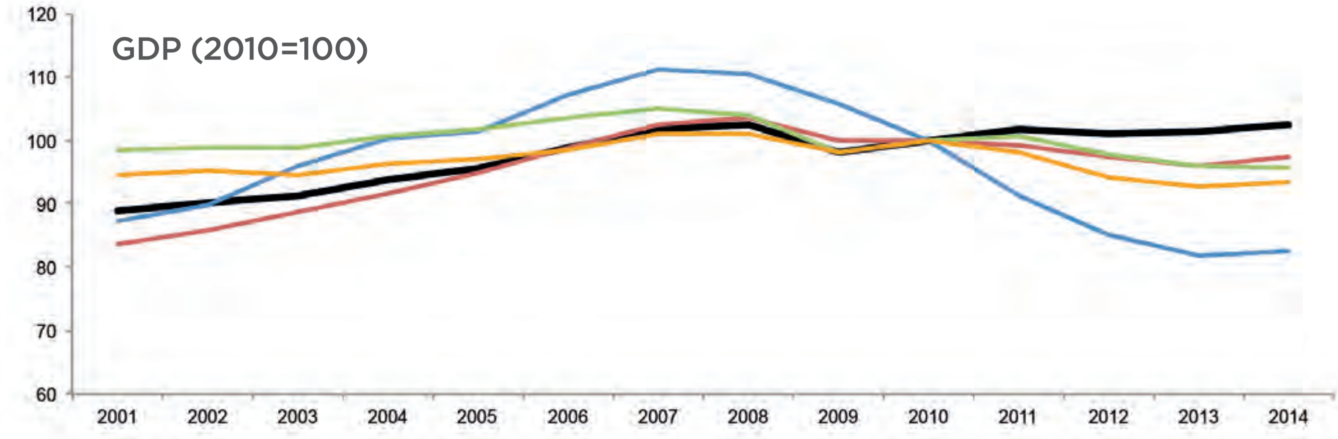
[36] European Commission, "Country Report Italy 2015", p. 24

[37] Economist Intelligence Unit, "Italy: March 2015 Country Report"

[38] Paul Krugman, "Exchange Rates and Wages", The New York Times, 24 December 2011, accessed 1 February 2015.

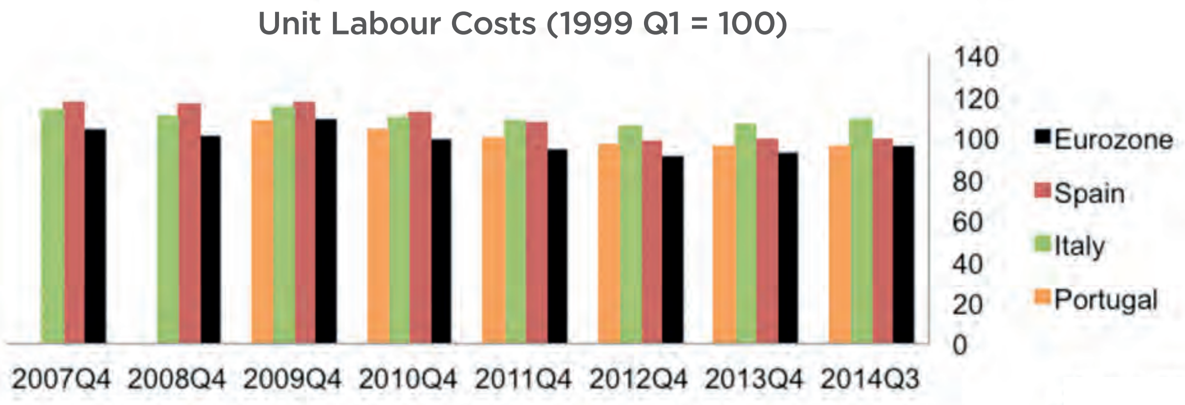
Reduced aggregate demand, fixed exchange rate, and internal devaluation

Post-crisis fiscal austerity and significant internal devaluation led to a collapse in aggregate demand and high levels of unemployment, factors which in turn have been exacerbated by rigid labour markets. According to Eurostat, between 2009 and 2014, GDP shrunk by 6.5%, 4.3%, 2.6%, 17.5% in Portugal, Spain, Italy, and Greece, respectively, compared to the EU average of growth of 4.2%. The traditional route for countries that experience recessions due to aggregate demand reduction has been to devalue or depreciate their currency in order to increase exports and stimulate aggregate demand. However, members of the Eurozone are locked into a fixed exchange rate. The exchange rate cannot be used by individual member-states as a policy tool to devalue in order to make exports more competitive and rebalance their domestic economy. A country can only achieve competitiveness in the short run by deflating wages and prices and reducing labour costs.[39] At the same time, wages need to rise in other areas to offset the anticipated fall in peripheral European wages. This has not occurred in any meaningful sense. In Germany, for instance, low-waged workers, direct competition to low-waged workers in peripheral Europe, have seen their wages fall in real terms due to wage restriction policies.[40]



Source: ECB

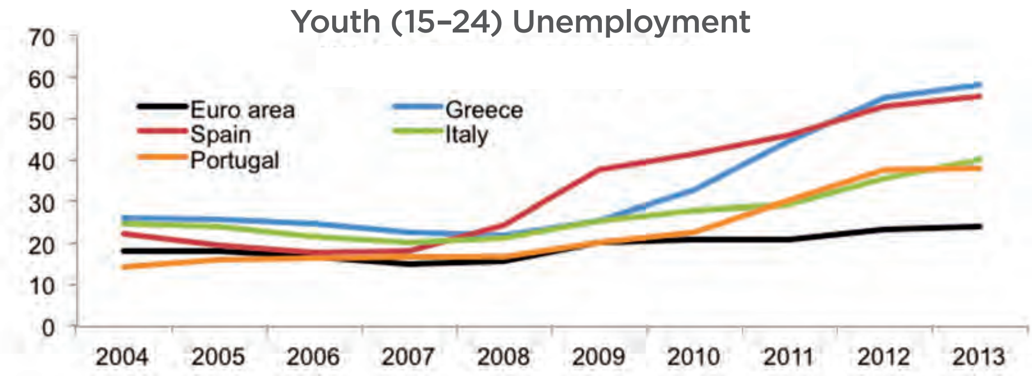
As a result, internal disequilibrium remains and the European periphery continues to experience prolonged economic stagnation, and, depending on the country, outright decline. According to Eurostat data, youth unemployment (15 – 24 year olds) sits at 55.5% in Spain, 58.3% in Greece, 38.1% in Portugal, and 40% in Italy, compared to their 2007 numbers of 18.1%, 22.7%, 16.7%, and 20.3%, respectively. On the other hand, the aggregate Eurozone youth unemployment average was 24% in 2013 and 16.6% in 2007. Total unemployment (15 – 74 year olds) is at 27.5% in Greece, 26.1% in Spain, and 16.4% in Portugal, whereas the Eurozone sits at 11.9%.



Source: ECB

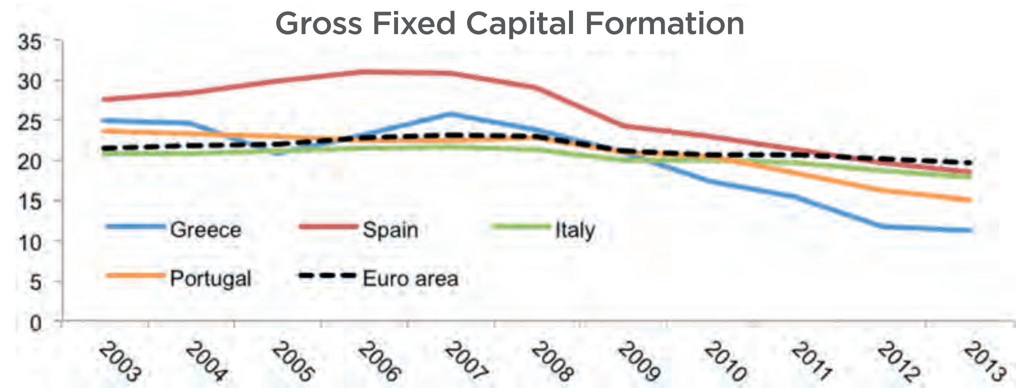
[39] Paola Subacchi, "The Euro Was a Bad Idea From the Start", Foreign Policy, 25 February 2015, accessed 1 March 2015.

[40] European Central Bank, "Competitiveness Indicators"; Richard Wood, "Europe: The Failure of Internal Devaluation", EconoMonitor, 13 November 2013, accessed 28 January 2015.



Source: Eurostat

This has predictably created considerable microeconomic uncertainty. Firms have held off on investment. Gross fixed capital formation, a proxy for firm-level investment, in Spain, Italy, Portugal, and Greece are at levels below the EU15 and non-peripheral EU15 average. Spain and Portugal's gross investment rate of non-financial corporations was 27% lower in 2013 compared to 2007, for example.



Source: Eurostat

Globalisation

Globalisation served to hollow out low- and mid-value added manufacturing and exacerbate the decline of construction, both labour-intensive sectors which benefitted greatly from EU integration. Pre-crisis construction was fuelled by increased access to inexpensive credit, induced by the fall in interest rates that attended peripheral Europe's ascension to the European Monetary Union (EMU), and unsustainable trade- and increased-income induced demand for infrastructure and housing.[41] Manufacturing firms were able to export and import throughout the EU due to reduced transaction costs and frictions.

However, these sectors are countercyclical and were the first to shrink during the crisis. Between 2008 and 2010 over 10% of pre-crisis employment was destroyed in each sector.[42] Portugal, for example, saw half of its total employment losses in 2012 in the construction sector.[43] As well, these sectors, and construction specifically, tend to have both high levels of fixed-term temporary work and high levels of informal economic activity, so access to social security after a downturn was more limited compared to other sectors.[44] Those that were employed on fixed-term contracts were often not employed long enough to benefit from the social safety net.[45] At the same time, because construction expanded so rapidly and wages were relatively high, many of the young opted not to pursue further education, and because they were often on fixed-term contracts, firms opted not to invest in skills training and upgrades. In Spain, the high availability of jobs through flexible, short-term contracts led to a high dropout rate of youth from compulsory education (31%) during the 1990s and early to mid-2000s, for example, and this situation is typical for peripheral Europe, although to a lesser extent.[46]

Although mid-level manufacturing fell to roughly 16% of EU GDP in 2013 from a high of 21% in 1995, the crisis served more to speed up the effects of globalisation and the bifurcation of the international manufacturing sector.[47] High-value added, high skill-based manufacturing has become dominant in developed countries with

[41] Bentolila et al, "Reforming an Insider-Outsider Labor Market: The Spanish Experience", IZA, December 2011, p. 3
[42] Eurofound "Employment Polarisation and Job Quality in the Crisis: European Jobs Monitor 2013", p. 13
[43] Roughly 100,000 of 200,000 net employment losses, as discussed in Maria Prandeka "Portugal: Labor Market Reforms – A Summary of Main Problems and Actions Taken", 13 June 2013, *Eurobank*, p. 3
[44] The data on this point is, by definition, sparse.
[45] Eurofound, "Employment Polarisation and Job Quality in the Crisis: European Jobs Monitor 2013", p.5
[46] Samuel Bentolila et al. "Two-Tier Labor Markets in the Great Recession: France vs Spain", November 2010, IZA, p.12
[47] Eurofound, "Employment Polarisation and Job Quality in the Crisis: European Jobs Monitor 2013", p. 12

comparative advantages in human, physical and financial capital, for example aerospace in Germany and automobile manufacturing in the UK. Medium and lower quality, but also less expensive, manufacturing has become dominant in China, which has seen wages and skill levels rise in recent years. This, in addition to its joining the WTO, has led China to begin to export to other developing countries more concerned with price point and less with long-term quality. According to Chinese customs bureau data, since 2000, the total value of exports to ASEAN has increased 25.3%, in contrast to a 10.2% and a 9.7% increase for the European Union and North America, respectively. In contrast, according the MIT Atlas of Economic Complexity, eight of the top ten trading partners of the US are developed nations, while all of Germany's top ten trading partners are developed nations.[48]

Peripheral European medium level manufacturing also faced and continues to face the dilemma of technological progress and high unit-labour costs, both of which incentivize automation of medium and low-skilled repetitive manufacturing. Given the high upfront cost of automation and the relatively low access to finance (32% of SMEs in Greece, and 17% in Spain and Portugal named access to finance as their most pressing problem), and the high long-run cost of high waged labour, it is no surprise that firms have opted to shut down, rather than compete with China, where labour standards are lax, finance is relatively cheap (there is significant overlap between the private sector and government) and multinationals are willing to accept the possibility of intellectual property right infringement in order to access the Chinese domestic market.[49] These trends have served to hollow out the mid-level manufacturing sector where peripheral Europe used to excel; between 1998 and 2010, over 500,000 net jobs were destroyed.[50]

Rigid labour markets

Labour markets in peripheral Europe are quite rigid and are divided between 'insiders' and 'outsiders', where the former work on permanent, open-ended contracts that are heavily protected and the latter work on temporary, fixed short-term contracts that usually do not lead to permanent employment. The inability of firms to make firm-specific employment responses to business conditions incentivises insecure, temporary employment rather than secure, permanent employment, the former of which is where the majority of both pre- and post-crisis employment growth has come from.

Collective bargaining agreements are not universally brokered nor applied in the EU. Agreements vary between member-states and between industries and sectors within individual countries and across the EU as a whole. There are generally two factors that affect how collective bargaining impacts a labour market. The first, union membership density, measures how large a percentage of the workforce is unionized and proxies for representativeness. The second, collective agreement coverage, measures how large a percentage of the workforce, industry or sector is covered by a collective bargaining agreement. Certain member-states tend to have high levels of both metrics. According to the European Trade Union Institute, 71% of the Swedish workforce has some type of union membership and 88% of its workforce is covered by a collective agreement extension. As a result, collective agreement negotiations and outcomes tend to be highly representative and can substitute for firm-level negotiations typical of the other extreme of the spectrum, where union membership and collective agreement extension are both low, in a country like the UK, for instance.

The UK has a union membership rate of 26% and a coverage rate of 29%, so the segment of the workforce that tends to be covered by collective bargaining agreements also tends to be represented during the process. At the same time, however, the public sector is represented to a much greater extent than the private sector, at roughly 56% compared to 14%. As a result, the majority of the workforce and the private sector tends to engage in firm-level bargaining, making the labour market both more flexible and more reflective of local conditions.

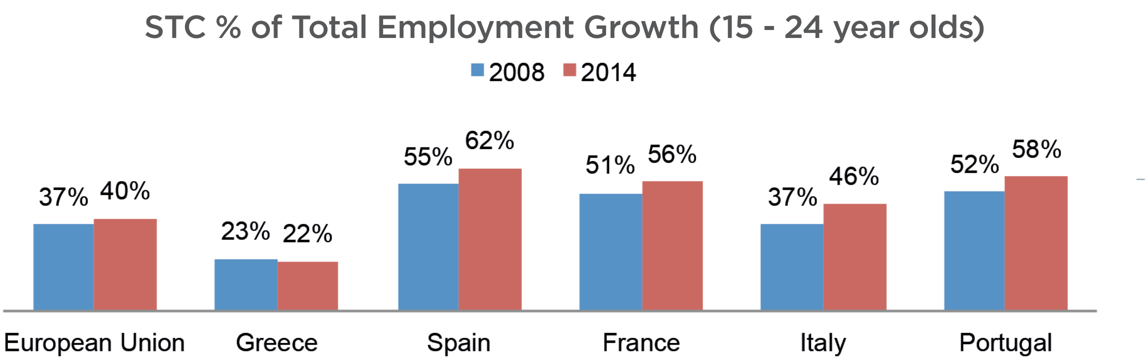
Italy, Spain, Portugal, and Greece have a mixture of these two extremes. Collective agreement bargaining tends to cover large segments of the labour market, in the area of 75% to 90%, but unions and employer federations that broker those negotiations represent a relatively small segment of the labour force, in the area of 10% to 35%, making unions unrepresentative.

Wages and benefits are determined at the sectoral or industry level and applied nationally.This tends to privilege and give political and economic leverage to a few, usually larger, older, and more influential unions, while the majority of the non-unionized workforce must uphold the outcomes of the unrepresentative collective agreements. Labour markets are dualised as a result, with the 'insiders' protected from employment termination and guaranteed unemployment and pension benefits, and less generous wages and unemployment benefits for 'outsiders', who tend to be young and non-unionised.

[48] Massachusetts Institute of Technology, *"The Observatory of Economic Complexity"*,
[49] European Central Bank, 'Survey on the access to finance of enterprises in the Euro Area,' p. 5
[50] Eurofound, "Employment Polarisation and Job Quality in the Crisis: European Jobs Monitor 2013", p. 32

There has been some progress on increasing flexibility since the onset of the crisis. Much of the progress, however, has come at times of increased stress and external pressure, notably from either the Troika (the ECB, the EC and the IMF), in the case of Greece and Portugal, or capital markets, in the case of Spain and Italy, or both.[52] The labour market reforms undertaken have focused on liberalization of short-term employment contracts (STCs) with less focus on permanent employment, the latter of which can compose up to 80% of the labour force, mainly because temporary employment reforms have faced less political resistance and its vested interests are less economically and politically entrenched and influential. Spain and Greece, for example, have made no impactful reforms on severance pay for the long-term employed, while at the same time reducing severance for those on STCs.[53] Notification periods and procedures have not decreased in Italy, although they have decreased in Portugal, Greece, and Spain, albeit from a very high average.[54] Reforms were meant to make it easier for firms to take on or terminate employment on the margin, for example if there is less of a need for an additional employee due to a short run slowdown, but have actually made it difficult to create new permanent employment because firms find it in their interest to hire a temporary employee that is relatively easier to let go if economic circumstances dictate.

Even with the somewhat limited reform progress in mind, which will be fully documented below, the dualised nature of peripheral European labour markets remains because of the incentives firms face that privilege temporary employment over permanent employment. Permanent employment tends to have notification periods that are greater the longer the duration of employment, severance pay for permanent employment is higher than temporary employment, and the duration and complexity of the termination process is greater relative to temporary, fixed-term contracts. If the potential future costs of permanent employment outweigh the potential current marginal gains of permanent employment, the alternative of temporary employment is the logical option taken where marginal gains, probably smaller than permanent employment, outweigh the potential future costs of termination.



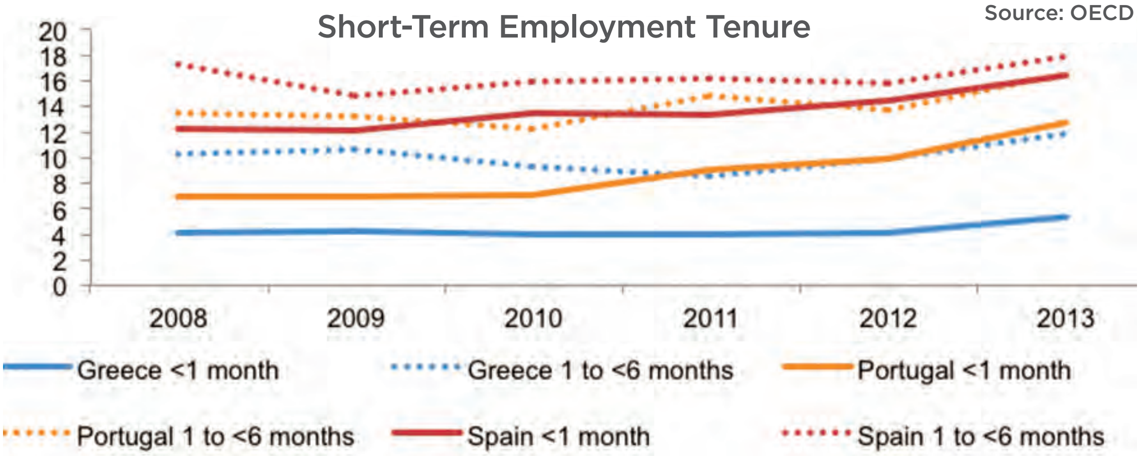
Source: Eurostat

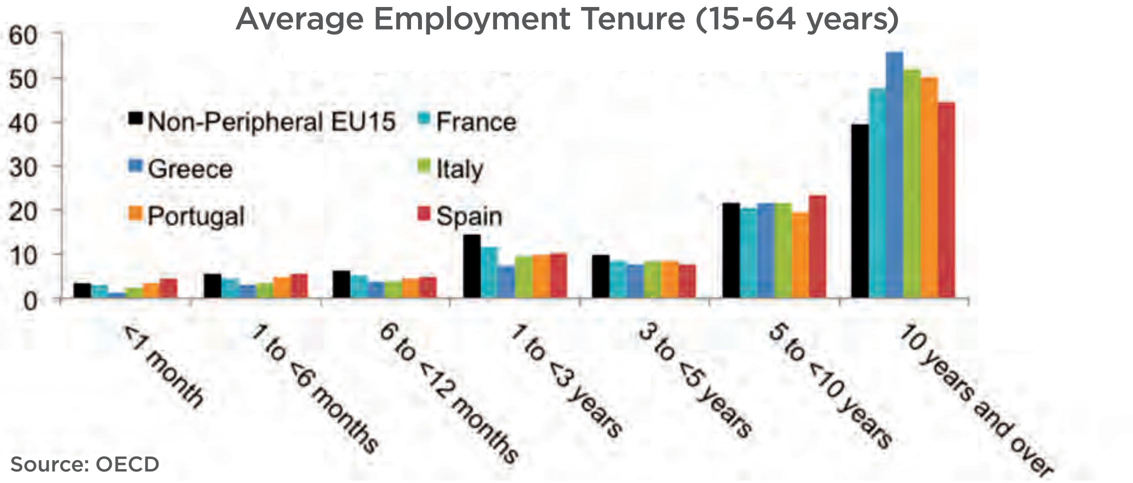
The evidence bears this idea out. Firms have responded by becoming markedly more risk averse and have hired temporary staff rather than permanent staff. The percentage of youth on temporary contracts between 2009 and 2013 has increased by 15.9% in Italy, 15.8% in Spain, and 11.3% in Portugal, for example.[55] Although hirings have recently increased, this reflects the rolling over of temporary employment contracts rather than the creation of new permanent employment opportunities, which directly impacts the country's economic competitiveness and productivity. Temporary work, coupled with a low rate of promotion into permanent employment, incentivizes high worker turnover, which makes it uneconomical for firms to invest in their employees. If uncertainty surrounds how long a short-term employee will remain with the firm, it makes little sense, from the firm's point of view, to invest in their human capital. Dolado (2011) estimates that this caused 20% of the stagnation in Spanish total factor productivity (TFP) during 1992 – 2005, and Bentolila *et al* note that roughly twice as many permanent employees received on the job training as temporary employees.[56]

It also incentivises permanent employees to remain at one firm for the duration of their career, limiting knowledge spillovers and disincentivising productivity. As a proxy to highlight this point, these countries have the lowest rates of permanent employment turnover and the highest average tenure in employment over 10 years, according to the OECD.[57]

[52] Italy and Spain, for instance, have pushed forward legislation that decentralized collective bargaining in the former and reduced the power of unions in collective bargaining rights in the latter
[53] OECD, "Indicators of Employment Protection", accessed 15 February 2015
[54] OECD, "Indicators of Employment Protection", accessed 15 February 2015
[55] Eurostat, "Temporary employees as a percentage of the total number of employees, by sex and age (%)" dataset: lfsq_etpga
[56] Bentolila *et al*, "Reforming an Insider-Outsider Labor Market: The Spanish Experience", IZA, December 2011, p. 8
[57] OECD Employment Database, "Employment by job tenure intervals"

When it is less expensive to fire a temporary worker than a permanent one, this incentivises employers to utilise temporary workers in sequence rather than converting them into long-term contracts.[58] As a proxy to highlight this point, the cap on the number of times short-term contracts that can be undertaken by one individual has increased from 2 to 4 in Portugal and to an unlimited number in Greece, and the cumulative amount of allowable time on short-term employment has





increased to three years in Greece, three years in Italy, and four years in Spain.[59] Accordingly, the majority of Portuguese, Spanish, and Italian youth, aged 15 – 24, work on temporary employment contracts, and the former two also have higher rates of short term employment tenure, ranging from less than 1 month to 6 months, for 20 – 24 year olds than the EU average.[60] As well, all peripheral European countries have a greater share of involuntary part-time workers than the EU average.[61] The Greek average, for instance, is three times the EU average. And finally, to offset the potential biases associated with the volatile youth segment of the labour force, which has a higher tendency to drop out of work to pursue education, all peripheral countries have a higher percentage of youth not employed or involved in further education or training (NEET) than the EU average (12.8% in 2013): Italy 22.2%, Greece 20.4%, Spain 18.6%, and Portugal at 14.1%.[62]

[58] Samuel Bentolila et al. "Two-Tier Labor Markets in the Great Recession: France vs Spain", November 2010, IZA, p. 2
[59] OECD, "Going for Growth", February 2015
[60] Eurostat, "Temporary employees by sex, age and duration of the work contract", dataset: lfsq_etgadc
[61] Eurostat, "Involuntary part-time employment as percentage of the total part-time employment" dataset: lfsq_etgadc
[62] Eurostat, "Young people neither in employment nor in education and training" dataset: edat_lfse_20

Demographic trends

Demographic factors have exacerbated the trends toward permanent employment entrenchment and increased short-term employment, leading to a polarized labour force and labour market mismatches. Educational attainment has bifurcated the workforce, and employment growth has taken place predominantly at the high and low end of the skills and education attainment spectrum, while unemployment has grown exponentially among the low-skilled segment of the population.

High skilled, knowledge-based sectors have been resilient throughout the EU during the crisis. Employment in the highest wage quintile, which tends to proxy for high-educated, service based segments of the economy, grew by over 1% per annum from 2008 Q2 to 2012 Q2. Over the same period, employment in the second and third income quintile, which proxies for mid-level manufacturing and construction, decreased by over 5 million jobs. In contrast, between 2011 and 2012 knowledge-intensive service employment in the top quintile grew by 400,000 new jobs.[63] This trend is especially stark in peripheral Europe. High-skilled employment's share of aggregate employment has remained relatively stable or grown by up to 10%, depending on the sector, compared to medium-skilled employment throughout the crisis.[64] Low-skilled service employment, where skills cannot be automated or exported, for example barbers and waiters, has also grown although to a lesser extent.[65]

Due to the labour-intensive, low-skill nature of the peripheral countries' mid-level manufacturing and construction sector, there was exponential growth in youth unemployment.[66] These people tended to have the lowest levels of education, relatively non-transferable skills, and were the least likely to speak a second or third language. They now form a relatively large pool of the structurally unemployed. Competition for medium and low-skilled employment increased, and the highly-skilled and highly educated are now competing with the low-skilled and low-educated for medium and low skilled jobs, and they have invariably won. The high-skilled and highly-educated tend to have more stable employment histories, and firms generally prefer them when making recruitment decisions. These factors make the low-skilled and low-educated more likely to become the long-term unemployed. A recent Eurofound report notes, for example, that in peripheral Europe nearly all net employment gains in mid and high-paid jobs were accounted for by highly educated employees.[67]

The large, low-skilled labour pool serves mainly to provide downward pressure on wages and entrenches the trend of short-term employment. Employment protection legislation provides a floor for permanent employment wages, meaning that any wage adjustments must come from those on temporary employment contracts, where legislation that does exist is less rigidly enforced. Portugal, for example, has seen its proportion of employees earning the minimum wage increase from 5.5% in April 2007 to 12.7% in April 2012, a proxy for short-term employment contracts.[68]

Labour market churn is unsurprisingly low. Those employed understand the uncertainty under which they work and are unwilling to take risks and seek alternative employment. Although short term employment has been liberalized, it is effectively insecure temporary employment, and from the worker with the permanent employment contract's point of view, there is little rationale to switch jobs, given how intense the competition is for short-term employment and how little job creation occurs in permanent employment. Unemployed youth aged 15 – 25 in Portugal, for instance, face roughly 9 other applicants per vacancy.

Emigration has traditionally served as a valve for excess labour. However, there are many frictions that limit labour mobility in the EU. Different languages and a dearth of economic linkages between source and destination countries are prominent examples. All peripheral Eurozone countries have foreign language abilities that are below average relative to the rest of the EU. Portugal, Greece, and Spain are in the bottom six, and Italy is below the EU average.[69] This group of peripheral Europeans tends not to be fluent in either German or English, the languages that proxy for where the majority of employment opportunities have grown.

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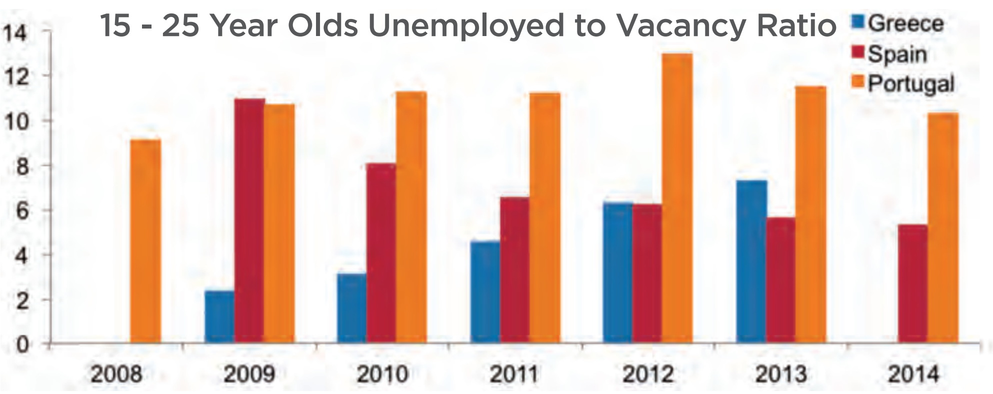
[63] Eurofound, "Employment Polarisation and Job Quality in the Crisis: European Jobs Monitor 2013", p.11
[64] Eurofound, "Employment Polarisation and Job Quality in the Crisis: European Jobs Monitor 2013", p. 60
[65] Eurofound, "Employment Polarisation and Job Quality in the Crisis: European Jobs Monitor 2013", p.28
[66] Spencer Thompson, "States of Uncertainty: Youth Unemployment in Europe", *IPPR*, November 2013
[67] Eurofound (2013) actually argues that *all* employment gains accrued to third-level graduates.
[68] International Labour Organization, "Portugal: Tackling the Jobs Crisis", p.40
[69] European Commission, "Europeans and their languages", *Special Eurobarometer 386*, June 2012, p. 14.



Source: Eurostat

This competitive disadvantage is exacerbated by their lack of information linkages in destination countries that are generally fostered through education, travel or family ties. Historically, peripheral Europeans have opted to go on vacation within their own country, and those that have emigrated have done so to areas outside the EU, notably North and South America, rather than intra-EU.[70] Information that impacts migration decisions is lacking as a result. In low-skilled sectors, where employment opportunities are often advertised through word of mouth and interpersonal linkages, even potential emigrants that are fluent in the right languages are unable to make an informed migration decision. Given the economic stagnation in these countries, it is likely that high cost decisions with high levels of uncertainty surrounding outcomes, like migration decisions, will not be undertaken due to the high explicit risks and the uncertain benefits. The long-term unemployed therefore tend not to emigrate.

There is little interregional migration, as well, due to the prevalence of short-term contracts. A temporary job in a different region does not provide much job security, whereas migrating means giving up, to a large extent, the support of family networks, which serve as an insurance mechanism in peripheral Europe.[71] Italy, for instance, has no solid system of unemployment benefits, amplifying the lack of regional migration.

The labour force has become progressively more generationally polarised as well. The long-term unemployed are often being supported by their parents who are competing with younger individuals for the same jobs. Less than 1% of the top 40% of high waged employment, which makes up the majority of employment creation, went to individuals under 30 years old in these countries.[72] Effectively, parents are competing against children, and have overwhelmingly won and entered employment, but find that they have to support both themselves and their offspring. The percentage of youth living with their parents highlights this trend.[73]

These trends highlight how likely it is for deflation to both remain and intensify. There is a high level of structural youth unemployment. These individuals tend to be low-educated, low-skilled, and monolingual, likely fluent in a language where economic opportunities are limited. They are unable to emigrate nor compete with higher skilled, higher educated or older individuals in their native countries. This large body of the structurally unemployed is putting downward pressure on wages, especially those on fixed-term contracts, where the employment protection legislation is, compared to permanent employment, less rigid.

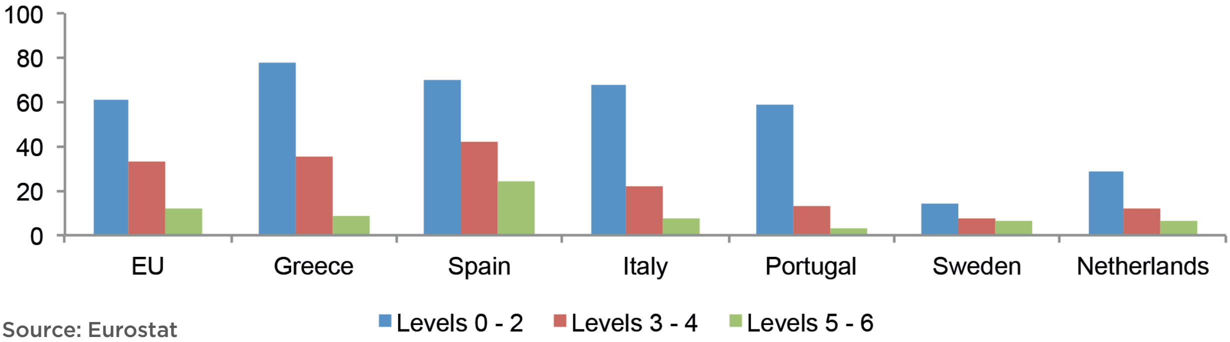
[70] McKinsey & Company, "Greece: 10 Years Ahead", March 2012, p.13

[71] Antolin and Bover (1997), "Regional Migration in Spain: The Effect of Personal Characteristics and of Unemployment, Wage and house Price Differentials using Pooled Cross-Sections"; Bentolila and Ichino (2008), "Unemployment and Consumption Near and Far Away from the Mediterranean"; Becker et al (2010) "Youth Emancipation and Perceived Job Insecurity of parents and Children".

[72] Eurofound, "Employment Polarisation and Job Quality in the Crisis: European Jobs Monitor 2013", p. 20

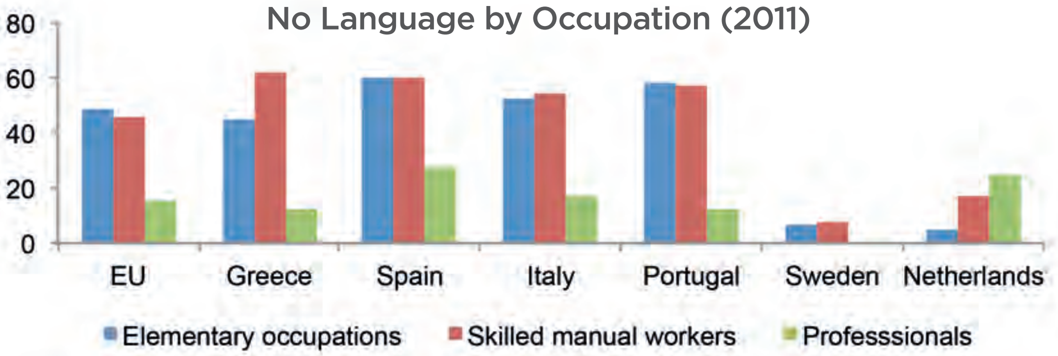
[73] Eurofound (2014), "Social situation of young people in Europe" p.8

No Foreign Languages by Education (2011)



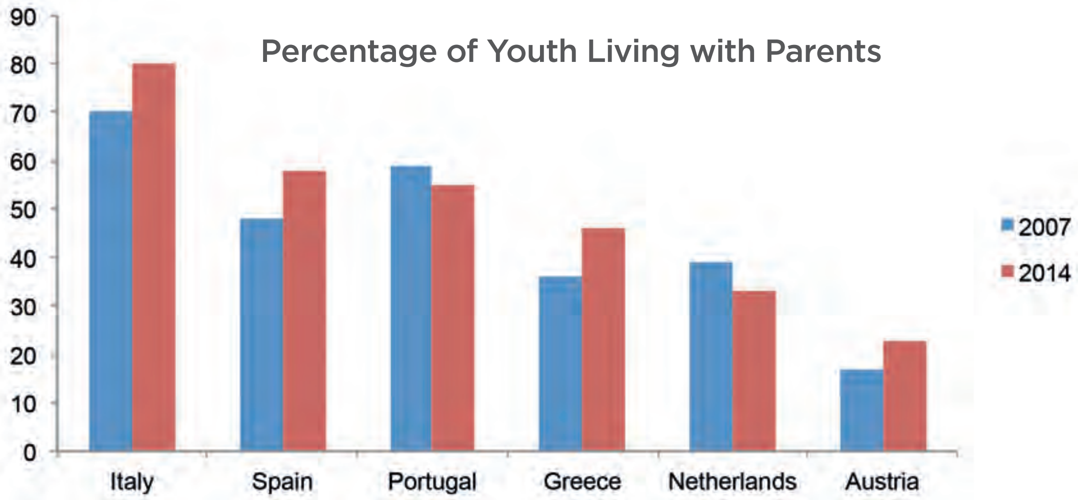
Source: Eurostat

No Language by Occupation (2011)



Source: Eurostat

Percentage of Youth Living with Parents



Source: Eurofound (2014)

The Spanish, Italian, Portuguese and Greek labour markets are markedly rigid. Employment protection legislation is much stronger for permanent versus temporary employment, privileging the former to the detriment of the latter. This has led to the growth of fixed-term employment and the absence of permanent employment creation. This creates an environment of microeconomic uncertainty, whereby those in employment opt not to spend for fear of not being able to spend in the future, while the unemployed have little money to spend or invest in human capital upgrades. This in turn makes it increasingly unlikely that firms will invest in either physical or human capital or expand and take on more permanent employees, given the drop in consumption and the resultant credit tightening. As a result, in these countries, a large percentage of the population have a strong incentive to save and to not spend, which has created the beginnings of a deflationary environment. If future expectations begin to change, if people begin to expect prices to continuously decline, the risks are manifold, but prominent ones are debt default and exported deflation, as will be discussed below. In order to guard against these risks, it is necessary that these countries' national governments implement reforms to their labour markets. They have a duty to their citizens, the EU, and the world at large to do so.

Reform recommendations

Reforms, when they have been implemented in peripheral Europe, have come from a source of external pressure. The troika, made up of the ECB, the European Commission, and the IMF, was instrumental in pushing through Greek and Portuguese reforms as a condition of financial assistance throughout the crisis, while both capital markets and the troika, the latter to a lesser extent, pressured Spain and Italy into implementing reforms as contagion spread.

With the implementation of QE, the euro will depreciate, making exports more competitive abroad. This will most likely prove a positive boon to Italy and Spain, given that they export more to countries outside the EU than Greece or Portugal, although the latter two will indirectly benefit due to their close trade ties with the former.[74] At the same time, interest payments on debt may decrease as spreads narrow, acting like windfall tax revenue. The environment would thus prove ideal to push through reforms. The potential short-run negative consequences, mainly potential employment termination, would be offset by these positive trends, and domestic governments will not have to spend political capital fending off attacks from their opponents.

The political situations in each country differ, however, making the likelihood of reform implementation variable. Each country has already faced or will face elections in 2015, so the opportunity for implementation is narrow, as electioneering will begin to overtake legislating. Spain and Greece, and to a lesser extent, Italy, have seen the rise of populist parties whose platforms are often in opposition to necessary labour market reforms, while Portugal has not. This has changed the political dialogue in each country, as well as impacting others. The rise of Syriza in Greece, for instance, has had an effect on *Podemos* in Spain and therefore the other Spanish political parties. The political context of each country will be discussed to highlight opportunities and risks for reform implementation.

Labour market institutions in these countries differ, as well.[75] Elementally, however, there are broad similarities. Power sharing agreements generally exist between unions, employer agencies and/or government. These agreements are usually automatically extended upon expiry. Union coverage tends to be high, but union density tends to be low, and wages are usually determined at the sectoral or industry level but applied nationally.[76] This tends to place a few, usually larger, older, and more influential unions at the heart of collective bargaining arrangements with government and employer federations, while the majority of the non-unionized workforce must uphold the outcomes of unrepresentative arrangements. Labour markets are dualised as a result, with the 'insiders' protected from employment termination and guaranteed unemployment and pension benefits, and 'outsiders' who tend to be non-unionized and young, and receive less employment security and less generous unemployment benefits.

Due to the nature of recent reforms, these fundamentals remain similar, but there have emerged changes. These changes can serve as opportunities to implement further successful reforms and build on positive outcomes. This section will highlight the political economy of each country (except Greece, whose structural problems are more multifarious and beyond the scope of this report), document recent reforms, and suggest areas where further reforms would be beneficial, given political and economic constraints.[77]

[74] Italy may not necessarily benefit as much as Spain, however, because it has deeper trade links with Germany, which is seeing decreased external trade due to the Russia-Ukraine conflict

[75] Institutions are defined in the Northian sense of 'the rules of the game'. See North 1990 ch. 1 for an overview

[76] The coverage rate is measured as the percentage of workers who are covered by collective bargaining agreements, regardless of whether or not they belong to a trade union. The union density rate is the percentage of workers belonging to a trade union, according to the OECD's *Going for Growth* 2015 report.

[77] For an overview of Greece's obstacles and strategies, see European Commission 2014, "Greece Country Specific Review", and the OECD "Economic Survey: Greece 2013".

[78] The parliamentary election must be held before 20 December 2015

Spain

Political Context

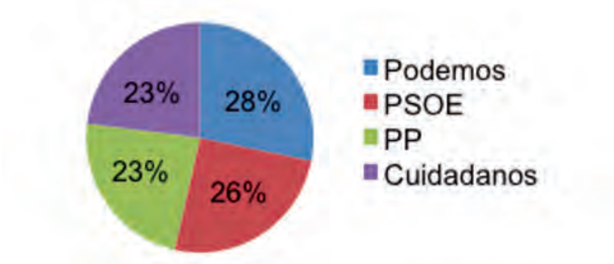
Spain faces three political challenges in the coming year that will impact its ability to implement reforms. First, parliamentary elections are set for the end of 2015 amid a highly volatile political landscape.[78] Second, the Catalan regional elections in September 2015 will serve as a proxy for the region's ambitions for autonomy, and depending on the outcome of the Catalonian election, there will likely be calls for constitutional change, which will cause a shift in political priorities to the detriment of reform implementation. Third, contagion from Eurozone weakness, notably the possibility of Grexit, will impact Spanish sovereign debt yield and interest payments, and therefore the feasibility of further labour market reforms.

First, voter discontent will be the key factor in the formation of the next government. Coalition government is fairly certain, although its composition is not. Currently, the centre-right *Partido Popular* (PP) governs with an absolute majority, and will serve a full term to the end of 2015.[79] Its popularity has waned, however, because it has been at the head of externally imposed austerity and reforms. Its traditional dominance and that of its main rival, the centre-left *Partido Socialista Obrero Espanol* (PSOE), has been undercut by the rise of several formerly marginal or non-existent parties, namely the left wing *Podemos* (We Can) in 2014 and the centrist *Ciudadanos* (Citizens) in early 2015. The 9 March Metroscopia poll of voting intentions puts *Podemos* first at 22.5%, the PSOE second at 20.2%, the PP at 18.6% and *Cuidadanos* at 18.4%.[80]

The Economist Intelligence Unit expects the next government to be a coalition formed by the PP, the PSOE, and *Cuidadanos*, although the Spanish political context is rapidly shifting, and it is therefore difficult to make accurate predictions.[81] The rise of *Podemos* has, however, shifted the political discussion in the run-up to elections to one of retrogressive steps rather than further reform implementation, so it remains to be seen who will come to power and what they intend to do.

Second, the Catalan region has made increasingly assertive moves towards secession. On November 9th 2014 a non-binding vote on independence was held in the region; roughly 80% voted in favour of independence.[82] The results make it likely that there will be a change in the region's constitutional status, which would require constitutional change, something the PP and the PSOE are unenthusiastic about. Both of their popularities are at historic lows, but it is unlikely that the call for autonomy will dissipate. The next regional elections in Catalonia, in September 2015, will serve as another proxy vote on independence. If Catalonia offers no alternative, the central authorities will most likely offer some reform of Spain's constitutional framework to quell growing support for more radical change before September 2015.

Spain 2015 Election Voting Intentions



Source: Metroscopia

Third, structural weaknesses in the euro zone remain a risk, with political events in Greece the most likely channel for contagion. The PP government has taken a particularly strong line against concessions to the new Syriza-led government in Greece at negotiations in Brussels, for fear of encouraging Podemos. This trend is likely to continue as the election approaches. Podemos and PSOE compete for left-of-centre voters, so the more vociferously Podemos electioneers, the more likely it is that PSOE will have to react. PP, on the other hand, does not compete with a similar problem on the centre-right, so its stance will not change too drastically.

[79]The date of the election is uncertain at present, but it will fall on or before 20 December 2015.
[80]Anabel Diez, "Podemos, PSOE, PP y Cuidadanos cerca del empate, lejos de la mayoria", *El Pais*, 9 March 2015, accessed 31 March 2015.
[81]The Economist Intelligence Unit, "Country Report: Spain March 2015", March 2015.
[82]"Catalonia vote: 80% back independence – officials" *BBC*, 10 November 2014, accessed 31 March 2015,. The regional government circumvented both the central government and the Spanish constitutional court to hold the vote, however, so its results are deemed illegitimate.

Labour Market

The Spanish labour market exhibits four main factors that influence its political economy.[83] First, roughly 70% of private sector workers are covered by collective bargaining regulations that are negotiated predominantly between two unions, *Comisiones Obreras* (CCOO) and *Unión General de Trabajadores* (UGT), and employers' organisations.[84] Second, collective bargaining agreements are signed and applied predominantly at the industry and national level, although there has also been recent decentralisation to the provinces. This means that when unions and employer organisations representing the shoemaking industry, for instance, come to an agreement, all Spanish shoemakers must abide by it. Third, collective bargaining agreements automatically extend to all those covered. Finally, union affiliation is quite low in Spain, at roughly 19% (in 2010), although this number hides disparities. Youth membership is roughly 2.5%, whereas 25-44 year olds display a 51.8% membership rate, for instance.[85] Unions are thus unrepresentative generally, and its membership is distorted to the older and permanently employed labour force.

Low union affiliation is a product of the incentives that workers face. Because industry-wide agreements are extended to all workers independently of their union membership status and firms that employ fewer than five people are barred from representation, and because unions tend to lobby for higher wages, increased benefits, or both, workers find it in their interest to free ride.

Only two labour unions have representative status at the national level, CCOO and UGT.[86] They are the only labour unions which surpass 10% of the total number of worker representatives in a given industry (or 15% in a given region), which allows them to participate in all bargains in the domain of collective agreement. Restrictions on who may participate in firm-level elections make labour unions unrepresentative. Elections in establishments with up to 5 employees are forbidden (over 90% of firms employ 9 people or less, and make up roughly 40% of the workforce).[87] These smaller firms might be priced out of the market due to increased wages or benefit costs, which larger firms can afford to pay, but are unable to influence policy developments. They also have to abide by these policies that they have no say over, incentivizing growth in the shadow economy, which, according to the World Bank, makes up 18.8% of the labour force.[88] As well, those employed with a firm for less than one month and those on lease from temporary work agencies cannot vote, nor can the unemployed. According to Dolado *et al.* (2010) in 2007 these criteria excluded around 30% of all employees and, in particular, 41% of workers aged 16 to 24, although this number is probably much higher at present due to the influx of youth into both unemployment and their reliance on temporary work agencies, as evidenced above.[89]

On the firms' side, employer representatives use collective bargaining agreements as an instrument to regulate competition by imposing wage and employment conditions on all firms, regardless of size or firm-specific needs and abilities. Unsurprisingly, bargained wages do not react much to changes in firm-specific productivity, while, due to wage indexation laws, they quickly adjust to increases in inflation. As a result, real wages and relative wages across industries display a high degree of downward rigidity, and firms find it difficult to adjust during slowdowns. During 2009 - 2011, for instance, when growth was poor, but inflation positive, firms were forced to increase wages and further decrease their competitiveness.

Reforms enacted

There have been three labour market reforms since the onset of the crisis. Although they are all different in their effect or aim, their genesis is quite similar. They have been the product of external pressure resulting from a renewed crisis and government, often to the protest of unions, has implemented them unilaterally.

The first reform, the *Real Decreto Ley* 10/2010, was passed in June 2010, and modified EPL to encourage open-ended contracts over temporary ones. In permanent employment, the economic-motivated dismissal definition was broadened to allow for easier dismissal, advanced notices were shortened and compensation was lowered in the case of unfair dismissals. EPL for temporary contracts was marginally strengthened through increased severance pay in the case of non-renewal from 8 to 12 days' worth of wages per year in order to make their use marginally more expensive relative to permanent employment, which was 45 days' worth of wages per year. SMEs, however, still prefer temporary contracts given the severance price disparity. Additionally, the legal process to terminate permanent employment is relatively more complex and thus uncertain for permanent employee dismissal compared to temporary employee dismissal. As well, a maximum of three years of temporary employment was legislated.

The second reform, *Real Decreto Ley* 7/2011, passed in July

[83] The following data is from Bentolila *et al.*, "Reforming an Insider-Outsider Labor Market: The Spanish Experience" and the Worker Participation Database, unless otherwise noted.

[84] Georg Picot and Ariana Tassinari, "Liberalization, dualization, or recalibration? Labor market reforms under austerity: Italy and Spain, 2010 – 2012" p. 10

[85] Institutional Characteristics of Trade Unions, Wage Setting, State Intervention and Social Pacts (ICTWSS) database. The ICTWSS database covers four key elements of modern labour market political economies: trade unionism, wage setting, state intervention, and social pacts. The database contains annual data for all OECD and EU member states, and runs from 1960 to present.

[86] There are other smaller unions which also attain that status in a given industry or region, although their influence is not national.

[87] European Commission, "Country Report: Spain", February 2015, p.18

[88] Mihails Hazans, "Informal Workers Across Europe', World Bank Research Paper 5912, December 2011,

[89] Dolado, J., F. Felgueroso, and M. Jansen (2010), "El conflicto entre la demanda de flexibilidad laboral y la resistencia a la reforma del mercado de trabajo en España," *Papeles de Economía Española* 124, 84-97.

2011. The reform established the precedence of firm-level collective agreements over industry-wide agreements, unless explicitly overruled by the latter, a practise that obviously happened quite frequently given that it would undermine the power of the negotiating parties.

The third reform, *Real Decreto Ley* 3/2012, was passed in February 2012. The reform made it easier and less expensive to fire workers, and encouraged companies to depart from collective wage deals and arrive at agreements at the firm level instead in order to limit job destruction. To do so, the law reduced severance pay in the case of unfair dismissal for all workers on permanent contracts from 45 to 33 days per each year of service, with a limit of 24 months' pay. It reduced the level of EPL for employees on permanent contracts and decreased considerably the firing cost gap between permanent and temporary employees, often identified as one of the main sources of dualism in the Spanish labour market. Additionally, the extension of collective bargaining agreements after their expiration was made limited to one year. Before the reform, previous collective agreements were applied until a new agreement was reached. Unions therefore had no incentive to bargain for or accept less favourable terms.

Reform recommendations

Given the political uncertainty due to the upcoming elections discussed above, reforms must be undertaken as soon as possible. It is likely that a coalition government will emerge after the election, and it will likely be made up of at least one centre-left party. These parties, namely the PSOE and *Podemos*, tend to support policies that reinforce labour market rigidity and dualism because their constituents do. Both parties are against further labour market reforms. As such, it is likely that the reform implementation process will face significant obstacles after the election in December 2015, and it is therefore imperative that pressure be externally exerted to push through as many necessary and beneficial reforms as possible.

There are three elemental reforms necessary for Spanish labour markets. First, representation requirements for both unions and firms for new sectoral collective agreements should be increased in order for new collective agreements to be more inclusive and flexible. The majority of SMEs, which in turn represent the majority of businesses in Spain, are excluded from the bargaining process, but must implement their decisions, often against their own interests. This stifles growth and incentivizes the underground economy, which makes up roughly a fifth of Spanish GDP.[90] Second, firms should be allowed to opt-out from new sectoral agreements. Rather than forcing all firms to abide by collective bargaining agreements, firms should be allowed to decide whether or not they would like to be. Collective agreement outcomes would become much more representative if only those who wanted to be involved were, and it would lower barriers to entry for new firms, incentivizing entrepreneurialism and stimulating growth. Third, equalise the employers' cost of termination for permanent and temporary contracts. This will already be the case by 2015 for firms with less than 25 employees due to a severance-pay subsidy in place for these firms and the schedule of increases in severance pay for fixed-term contracts approved in 2010. However, the majority of growth in the near term will be at large firms because they tend to export more than smaller ones.[91] Given the benefits that QE will bring to export-oriented firms, it makes sense to make it easier for expanding firms to hire permanent as opposed to temporary employment. Larger firms' employees also make up large percentages of membership in the two dominant labour unions. If the firms' membership is made more representative, it could make future beneficial changes easier to push through.

[90] Raphael Minder, "In Spain, Jobless Find Refuge Off the Books," *The New York Times*, 16 May 2012, accessed 14 February 2015,
[91] European Commission, "Country Report: Spain", February 2015, p. 15 – 16

Portugal

Political Context

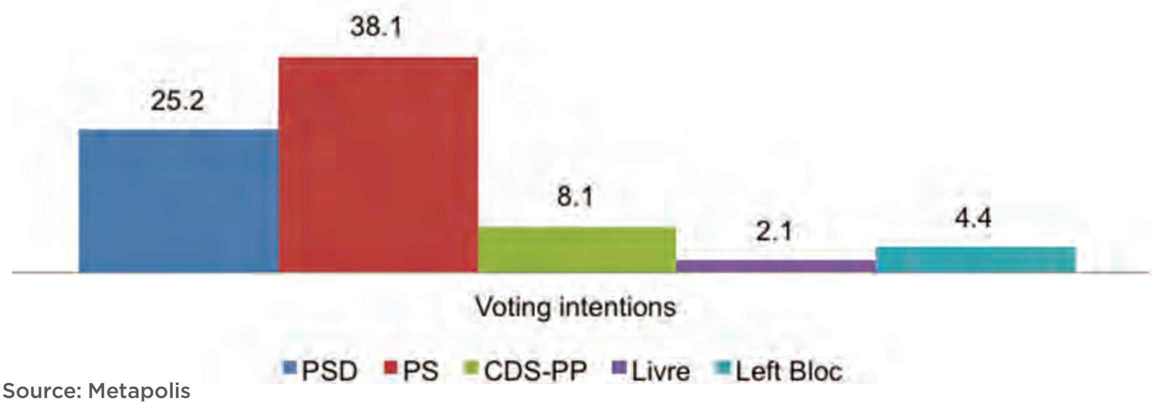
Portugal faces two main political challenges in the year ahead. First, the upcoming election in either September or October 2015 where the centre-right coalition of the *Partido Social Democrata* (PSD) and the *Centro Democratico e Social – Partido Popular* (CDS-PP) will most likely leave government and the current opposition, the centre-left *Partido Socialista* (PS) will likely come to power and govern in a coalition. This uncertainty impacts the second main challenge, namely the political and policy difficulties involved in returning the economy to steady growth, and public and judicial resistance to continued austerity after the end of the three-year bail-out programme.[92]

The currently governing coalition of the PSD and the CDS-PP have been in power since 2011, and are expected to remain in power until the general election, due in September or October 2015. However, the main opposition party, the PS, is expected to win the election, but without an absolute majority, and will govern either with a parliamentary minority or in coalition with the centre-right CDS-PP, although, according to Antonio Costa, the mayor of Lisbon and the PS candidate for Prime Minister, the Party will strive for a full majority.

The first option, that the PS governs with a minority government, is not ideal. The PS will have to rely on legislative compromise with either the PSD or a collection of votes from the smaller parties, and creates legislative uncertainty. As well, the previous minority PS government, led by José Sócrates, was forced to resign in 2011 when opposition parties rejected its austerity measures, highlighting how tenuous minority governments can be in Portugal.

The second option, that the PS secures a majority by forming a coalition with one or more of the smaller parties, is more realistic, although its options are somewhat limited. Options on the political left are restricted, as support for the radical and internally divided Left Bloc is in decline (at 4.4% in March 2015), while support for the newly founded Livre remains marginal (2.1% in March 2015).[93] The PS could work on the right with the CDS-PP, which has 8.1% share of support in March 2015, but this would be a less than ideal partnership for them as centrist compromises are more likely to be achieved, public debate more heated, and their accomplishments overshadowed.

Portuguese 2015 Election Voting Intentions



Source: Metapolis

[92] The Constitutional Court has rejected elements of the government's fiscal plans six times in the past two and a half years, for example

[93] Andrei Khalip, "Portugal PM upbeat on re-election chances, poll shows close race", Reuters, 28 February 2015.

Contrary to the political contexts in Spain, Italy, or Greece, where alternative political movements like Podemos or Syriza have risen, this has not been the case in Portugal. A number of factors contribute to this. The population and the government of all stripes broadly support the euro and the political system is highly centralised, for example. Portuguese left-wing parties also strongly defend the socialist-inspired constitution, in contrast to Podemos, the Spanish left-wing anti-establishment party, which opposes the current constitutional regime. The Portuguese Communist Party (PCP), relatively radical in its views for Portugal, has seen its share of support in opinion polls rise since the last general election in 2011. The party, however, opts to defend workers' rights, trade unions, the welfare state and the constitution from outside government.

The second main challenge comes from the Portuguese exit from the troika's bail-out programme. The current and future government of whatever stripes will have to attempt to sustain the pace of austerity in the absence of strict external conditionality, while balancing intensifying public opposition to austerity. If the government opts to slow down the pace of fiscal adjustment and structural reform, which is presumably what the centre-left PS will do, this would risk antagonising Portugal's EU partners and prompt increased concern among investors in the country's sovereign bonds, increasing spreads on sovereign debt and therefore interest payments, effectively enforcing future austerity. At the same time, resurgent fears of Greece's exit from the euro zone, associated with the attempt by Greece's new government to renegotiate the terms of its debt repayments, could exacerbate any deviation from reform by the Portuguese government.

Labour Market

Portugal's labour market bears many similarities to Spain's, although it has become somewhat more liberalized since 2011. Collective bargaining has traditionally been at the sector level between trade unions and employers' associations.[94] There are two main confederate unions, the *União Geral de Trabalhadores* (UGT) and *Confederação Geral dos Trabalhadores Portugueses* (CGTP), which hold disproportionate influence over bargaining agreements and represent the interests of hundreds of local and regional smaller unions. Union membership density as a percentage of the workforce is quite low at 11%, however, reflecting workers' incentives to free ride on unions, much like the situation in Spain, which, similarly, makes wage negotiations unrepresentative.[95] Workers find it in their interest to have unions argue for higher wages and increased benefits, along with other policies, while contributing neither time nor money. Employers' associations negotiate with unions, but they face the opposite incentives, whereby membership in an employer association increases the ability to influence the outcome of a collective agreement, and, like in Spain, raise barriers to entry and regulate competition. Employment associations are, as a result, more representative, at roughly 30%.

Sector agreements, used to determine wage floors, cover approximately 90% of the workforce, of which only 11% are unionized, and this percentage of the workforce tends to be employees of large firms, not the much more typical small or medium sized business, which make up 99.8% of firms and 58.1% of gross value added.[96] Government automatically extends the agreement at the request of either one of the two main unions or an employers' association, through administrative extension, although Government has recently taken steps to make this less automatic, as will be documented below. Agreement extension limits the scope for firms to adapt to their specific contexts and gives extra clout to those sitting at the negotiating table. By effectively stifling firm-level bargaining, this mechanism discourages the entry of new firms and competition. A traditional route of entry for new firms has been by paying lower wages than incumbents in order to charge lower prices, so their inability to do so stifles innovation and creative destruction, while protecting vested interests, in turn leading to higher prices and lower wages, both of which disproportionately affect the less wealthy. Martins (2014) found, for instance, that the total wage bill paid to all workers following an extension falls by 2.2% after four months, and is driven mainly by a reduction in hirings caused by legislation limiting employment reduction.[97] Firm exit also increases by roughly 4% over the same time, employment falls by 2%, and the latter effect is 25% larger across small firms, as they are less likely to be represented in collective agreement negotiations.[98]

[94] European Commission, "Country Report: Portugal", February 2015, p. 29

[95] Pedro Portugal and Hugo Vilares (2013), "Labor unions, union density, and the union wage premium," *Economic Bulletin and Financial Stability Report Articles, Banco de Portugal.*

[96] Pedro S. Martins, "30,000 Minimum Wages: The Economic Effects of Collective Bargaining Extensions", IZA, p. 3; Pedro Portugal and Hugo Vilares (2013), "Labor unions, union density, and the union wage premium," Economic Bulletin and Financial Stability Report Articles, Banco de Portugal; European Commission, "Country Report Portugal", February 2015, p. 20

[97] Pedro S. Martins, "30,000 Minimum Wages: The Economic Effects of Collective Bargaining Extensions", IZA, p. 14,

[98] Pedro S. Martins, "30,000 Minimum Wages: The Economic Effects of Collective Bargaining Extensions", IZA, p. 22.

Employment protection legislation (EPL) was, and generally remains, quite rigid. Until 2011, it was almost impossible to fire an employee, for instance, and Portugal, prior to its Financial Assistance Plan, consistently ranked the highest of OECD countries in terms of permanent employment protection. Larger firms, especially, face high barriers to reducing their workforce, as they face an expansive set of legislation and regulations that drive a wedge between the value of employees to the firm and the cost of employing workers, and this becomes more apparent as the firm grows larger. As well, legislation is more rigidly enforced at larger firms, and employees are more likely to be unionized.[99] These factors help to explain why 99.8% of Portuguese firms are SMEs.[100]

Enacted reforms

There have been several labour market reforms since the onset of the crisis, but the main foci have been reforming administrative extensions and employment protection legislation. Although each law is different in its effect or aim, their origins are quite similar. They have been the product of external pressure from the Troika, and Government has implemented them unilaterally.

In May 2011 the government temporarily suspended administrative extensions.[101] Because unions are protected by the Portuguese constitution (they are the only organisations allowed to represent workers), efforts to reform collective agreement extension have focused on employers' associations. In November 2012, the Portuguese government legislated that employer associations needed to represent at least 50% of the workers in a relevant sector when they negotiated with trade unions, which proved a significant obstacle to their re-emergence. The number of sectoral collective agreements declined as a result, falling from 172 in 2008 to 36 in 2012, while the number of extensions fell from 137 to 12 in the same period, according to the European Commission.[102] The government took a step backward, however, in June 2014, roughly a month after it exited its financial assistance program, when it passed legislation that reduced the representative requirements to 'if SMEs accounted for at least 30% of the employers' associations signing the agreement,' effectively allowing for sectoral agreements to be reintroduced.[103]

Employment protection legislation has been made less rigid, although it is still relatively inflexible compared to other OECD countries. Severance pay has been reduced from 30 to 12 days per year of tenure, with a 12-month ceiling instead of a 3-month floor, in an effort to achieve competitive parity between temporary and permanent employment while making employment reduction more financially predictable, and thus more likely to occur if necessary. Although existing contracts maintain entitlements accrued under the old rules, new ones do not, so the new less expensive and more predictable contracts will become the new norm. Individual dismissals for economic reasons no longer need to adhere to a pre-defined order of seniority. If an individual worker's capability or lack thereof proves the reason for dismissal, this has become possible in a wider range of circumstances. In both cases, the obligation to transfer the employee to another suitable position was replaced by a requirement on the employer to assess whether, in the case of redundancy or incapability, the employee can be transferred to a position compatible with their professional qualifications.

Recent legislation

The most recent law affecting labour markets, Law 55/2014, adopted on 25 August 2014, is promising, especially after the aforementioned retrogressive step taken by Government in June 2014. Law 55/2014 encompasses two measures. First, it reduces the survival of collective agreements that have expired and not been renewed, making them less automatic. Collective agreements that have not been renewed but nonetheless survive have seen their survival duration reduced from 18 months to one year. Additionally, a collective agreement's expiry, dependent on the existence of a new collective agreement, was reduced from five to three years. Collective agreements therefore last for less time, while new ones are harder to negotiate, making the labour market more flexible at the firm level. Second, the law introduces the possibility of temporarily suspending sectoral collective agreements at the firm level, which will make contractual adjustment more flexible. However, temporary suspension requires the intervention of the original signatories of the sectoral agreement, which is likely to limit its effective application.[104]
It is unlikely that unions will be willing to give up

[99] See Braguinsky et al. (July 2011), "The Incredible Shrinking Portuguese Firm", National Bureau of Economic Research, pp. 2- 8 for an overview. Employment legislation was, up until the financial assistance agreement negotiated with the Troika, the most restrictive in the OECD. Much of this is derived from modern Portuguese political and economic history. While under dictatorial rule from the 1930's to the 1970's, the only segment of the political spectrum that survived was the far Left, which acted to secure workers' rights in the constitution, and is reflected in current EPL.

[100] Braguinsky *et al.* (July 2011), "The Incredible Shrinking Portuguese Firm", National Bureau of Economic Research

[101] OECD (October 2014), "OECD Economic Surveys: Portugal", p. 26

[102] European Commission, "Country Report: Portugal", February 2015, p. 29

[103] European Commission, "Country Report: Portugal", February 2015, p. 29

[104] European Commission, "Country Report: Portugal", February 2015, p. 29

power so readily, so the benefits of this new law are likely to come in the medium term, when older agreements expire and new ones are easier to negotiate for smaller firms.

Reform recommendations

The two main areas where further reforms are possible are in the further curtailments of collective agreement extension and further reduction in the rigidity of employment legislation. The former would be more beneficial, but is more politically difficult, while the opposite is the case for the latter. Although politically difficult, the potential economic benefits are quite large. For example, the European Commission recently highlighted that in Portugal, a country where exports make up 40% of GDP, labour market reform to increase flexibility has improved its competitiveness in export markets by improving its production efficiency through reduced labour costs, which now sit at 80% of the EU average, and product quality, now above the EU average.[105]

Efforts to stem collective agreement extensions have proved politically difficult, but fracturing between the two dominant unions opens an opportunity for further reform. After Portugal entered the Financial Assistance Program with the troika, the two unions, which traditionally competed, were united in their interactions with government. As an example, they jointly held two strikes on 24 November 2010 and 24 November 2011.[106] However, this alliance did not last, as was readily apparent on 18 January 2012, where UGT signed a collective bargaining agreement with the government and the employers' federation, but CGTP walked out of negotiations.[107]

Because the two main unions are divided, favourable agreements can be reached with UGT to the detriment of CGTP, and incremental reforms can be pushed through. As Portugal exited its Financial Assistance Program, external pressure was relieved somewhat. As such, government can make less austere requirements and implement reasonable, incremental reforms to administrative extension. UGT represents certain sectors, notably finance and energy, and is supported by roughly 10% of citizens, compared to 21% for CGTP, which tends to represent manufacturing and the public sector.[108] Given this asymmetry, UGT seems the more reasonable partner to work with, given its relative unpopularity and therefore weakness, and given CGTP's manufacturing base, their opposition to new collective bargaining extensions is unsustainable. Collective agreements last shorter periods of time and must be renegotiated with more representative partners. UGT is more willing to negotiate and as such, reforms should be brokered with them, which achieves both the necessary reforms and undermines the power of CGTP.

If the PS enters government with the CDS-PP, as seems the most likely scenario, PS will have a scapegoat to blame for the necessary labour market reforms, which its constituents tend to oppose and which CDS-PP's constituents tend to support. Both political parties, would, therefore, accrue more political capital, while at the same time undertaking the necessary reforms.

Although the OECD calls for administrative extensions to be abolished altogether, this is politically infeasible at the moment.[109] That being said, however, further reducing the survival of collective agreements forces the social partners to update them more frequently, which would further divide the main unions and lessen CGTP's power and ability to disrupt implementation. The overarching goal should be to make it easier for firms to bargain with employees at the firm level so that local contexts can be factored into decisions, but the only way for this to be accomplished is to diminish the power of unions to influence national wage setting.

At the same time, because gradual reforms to administrative extensions have been difficult, by gaming the rules either to make it harder for unions to be involved or for employers' associations to be more representative, focus can also be shifted to making employment protection legislation gradually less onerous. Recent progress made in August 2014, notably reducing severance payments for permanent employment to bring them more into line with temporary employment legislation to incentivize permanent employment, outline that this is possible.[110] These trends should be strengthened by further reducing severance pay and the minimum payment that firms must provide employees after two months' tenure.

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[105] European Commission, "Country Report: Portugal", February 2015, p. 16

[106] The UGT is more centrist in their approach to labour markets, and have a socialist/social democratic political leaning and have traditionally be supportive of European integration, while the CGTP has Communist leanings, and has traditionally been opposed to further European integration, according to Hermes Costa, "From Europe as a model to Europe as austerity: the impact of the crisis on Portuguese trade unions", *Transfer: European Review of Labour and Research*, p. 401

[107] Hermes Costa, "From Europe as a model to Europe as austerity: the impact of the crisis on Portuguese trade unions", Transfer: *European Review of Labour and Research*, p. 406

[108] The Worker Participation Database

[109] OECD (October 2014), "OECD Economic Surveys: Portugal", p. 26

[110] OECD (October 2014), "OECD Economic Surveys: Portugal", p. 26

Italy

Political Context

The main risk to reform implementation is political uncertainty. The Italian government, led by Matteo Renzi of the centre-left *Partito Democratico* (PD), has to balance further austerity to reduce the public debt burden alongside further reform implementation to promote economic growth and reduce unemployment. Mr. Renzi and the PD-led coalition have achieved several necessary reforms, including the "Jobs Act" discussed below. Although Mr Renzi insists that his government will remain in office until the end of the parliamentary term in early 2018, it is likely, according to the Economist Intelligence Unit, that a general election will be called in 2015, due to the political obstacles he is facing and increased social unrest due to prolonged austerity.[111]

The PD, in conjunction with the main centre-right opposition party, *Forza Italia* (FI), led by former Prime Minister, Silvio Berlusconi, passed the 'Jobs Act' through both houses of the Italian Parliament.[112] This partnership no longer exists, however. The PD-led election of Italian President, Sergio Mattarella, a former centre-left politician and Sicilian constitutional court judge, and who was often critical of Mr. Berlusconi, proved the catalyst for the fracture between the coalition partners. Mr Renzi selected Mr Mattarella without consulting his junior coalition partners, including the centre-right *Nuovo Centro Destra* (NCD), and two small centrist parties, *Scelta Civica* and the *Unione di Centro* in order to appease dissident internal factions on the PD's far left, which had attempted to block the "Jobs Act" due to their trade union ties.

This strategy has, unsurprisingly, created tension between PD and its major coalition partners, the FI and the NCD. Several prominent members of the NCD have left or have threatened to leave the party after being called on to vote for Mr Mattarella. FI declared on 4 February that it considers the political reform pact with Matteo Renzi to be "no longer binding", and has begun to boycott parliament in order to block reforms that it has already approved in the Senate.[113] Since the election of Mr Mattarella, Mr Berlusconi has abandoned all form of dialogue with Mr Renzi in an effort to reunite his party and regain political influence. Mr. Renzi and the PD must now try to complete the process of introducing long-overdue political reforms without the support provided prior to the presidential election by FI and its far left factions.

Labour Market

The Italian labour market exhibits five main factors that influence its political economy.[114] First, roughly 80% of private sector workers are covered by collective bargaining regulations that are negotiated predominantly between three trade unions, the *Confederazione Generale Italiana del Lavoro* (CGIL), *Confederazione Italiana Sindacati Lavoratori* (CISL), *Unione Italiana del Lavoro* (UIL), and the employer federation, *Confederazione Generale dell'Industria Italiana* (Confindustria). Second, collective bargaining agreements (*contratti collettivi nazionali di lavoro*) last for three years, and are signed and applied predominantly at the national and sector level. Wages are, as a result, impacted mainly by economic conditions prevalent in the most dominant and prosperous sectors and regions, which tend to be in the north of the country and more heavily represented by unions and employer federations. Third, collective bargaining agreements automatically extend to all those covered, whether unionised or not, since a clause in the Italian Constitution guarantees the binding character of collective contracts. Collective bargaining agreements link contractual wages to CPI (excluding energy) forecasts, similar to the Spanish labour market, for the next three years. Once committed, adjustments can only be made at the next round of negotiations, three years later, according to the OECD's 2015 Economic Survey of Italy. This has resulted in increased real wages, increased unit labour costs and decreased productivity as firms become less competitive. As a result of these factors, firms cannot tailor their wages to local market conditions. In contrast to Spain, for example, where firms can now opt out of collective agreements, Italian firms need to negotiate with all trade unions in order to do so, a barrier that is too high for most firms to overcome.[115] Fourth, union affiliation is low, at roughly 36%, although this number hides disparities.[116] Representation skews towards the older segment of the population, as the young tend to be in temporary employment, which is unable to unionize.[117] Youth membership is roughly 4.2%, whereas 35-49 year olds display a 48.5% membership rate, for instance.[118] Fifth, the judicial system plays a key role in determining 'fair' employment dismissals, with expensive consequences if they are deemed unfair, creating a high level of uncertainty for employers, disincentivising new permanent employment and entrenching labour market dualism.[119]

[111] Economist Intelligence Unit, "Italy: March 2015 Country Report"

[112] The lower house, called the Chamber of Deputies, and the upper house, called the Senate, both have the same legislative powers, and therefore the same law in the same form must be passed through both houses, making it extremely difficult to pass wide-reaching legislation

[113] The Economist Intelligence Unit, "Forza Italia suspends Renzi-Berlusconi pact", 6 February 2015.

[114] The following data are from the Worker Participation database and Bentolila et al, "Reforming an Insider-Outsider Labor Market: The Spanish Experience", December 2011, unless otherwise stated.

[115] OECD (2015), "Economic Survey of Italy", p.22

[116] Georg Picot and Ariana Tassinari (2012), "Liberalization, dualization, or recalibration? Labor market reforms under austerity: Italy and Spain, 2010 – 2012" p. 10

[117] International Labour Office, "Italy: a dual labour market in transition", 2013.

[118] ITCWSS database - Membership rates for 50-64 year olds are lower, at 27.7%, but this is mainly due to an early retirement age of 60.

[119] Judgements of 'fair' termination focused on judges' interpretations of Article 18 of the 1970 Workers' Statute, which regulates individual unjustified dismissal for firms with more than 15 employees. Before reform in 2012 and 2014, if a judge ruled that a dismissal was unfair or unjustified, the worker chose between monetary compensation of 15 monthly salaries, or full reinstatement in their previous position, seniority retention and accrual of all monthly salaries and social security contributions for the period between dismissal and reinstatement. The law created uncertainties for employers, especially for smaller firms, regarding potential costs of dismissal.

Pre-crisis reforms

The Italian labour market and its reform history bear many similarities to Spain. To compete internationally prior to joining the EMU, Italian firms relied on price competitiveness through currency devaluation and low labour costs, namely temporary and lower paid employment, instead of through increased productivity via human capital accrual or meritocratic employment decisions (wages rise in line with age, not productivity, for example).[120] Prior to the crisis, the majority of labour market liberalisation focused on temporary employment, while permanent employment legislation remained unchanged.[121] Most of the employment gains between 1995 and 2007, for instance, were in temporary and part-time employment, where, according to the IMF, the share of the former increased from 7.2 percent to 12.4 percent, and the share of latter increased 10.5 percent to over 15 percent.[122]

Two reforms in particular served to further dualise the labour market, the Treu and the Biagi reforms.[123] The 1997 *Pacchetto Treu* (Treu Law) made the transformation of fixed term contracts into open-ended ones no longer automatic, while also legislating that dismissals required a court ruling.[124] The reform was passed under the centre-left Prodi government coalition, and was drawn up and passed in partnership with the trade unions.[125] In 2003, the Berlusconi government unilaterally passed the 'Biagi reform', which expanded the range of temporary and flexible contracts, increasing their prevalence at a time when Italy's economy was expanding. Unsurprisingly, employment growth came predominantly in temporary employment. Over this period, the share of workers employed under temporary contracts started increasing at a rate of 5.2 per cent each year, compared to 3 per cent on average in the EU-15.[126]

Post-crisis reforms

Post-crisis reforms have been implemented under external pressure from both capital markets and European institutions. In contrast to Spain and Portugal, post-crisis reforms were implemented both unilaterally by government and also through dialogue with employers' agencies and trade unions. Initial reforms, notably those passed under the Berlusconi government in 2011 and the Monti government in early 2012, were passed unilaterally due to external pressure from capital markets and European institutions. Later reforms under Monti, and more recently under Renzi, have been undertaken in cooperation with trade unions, specifically the CGIL, which has strong links with the centre-left Democratic Party (PD).[127]

The Berlusconi government, in 2011, passed Decree-Law 148/2011, which allowed company agreements to diverge from collective agreements and from legislation on dismissals and employment law, including the 1970 Workers' Statute. Collective bargaining became marginally more decentralized, but granted no power to employers to unilaterally change work conditions without the agreement of all local union representatives, effectively stifling true firm-level decision-making.[128]

In June 2012, the 'technical' coalition government led by Mario Monti, which included parties from both the centre-left and the centre-right, and in line with the recommendations of the European Council, passed the 'Fornero reform' (Law 92/2012). The government initially negotiated with the three unions and the employer federation, but eventually acted unilaterally. The reform notably amended Article 18 of the 1970's Workers' Statute by setting a maximum of 24 monthly retributions as monetary compensation for unfair dismissal cases and the payment of missed wages in case of reinstatement was capped at 12 months. Prior to the 'Fornero reform', a judge decided whether a dismissal was unfair or unjustified, regardless of whether the job was made redundant by technological progress or economic decline, for instance. If deemed to be either unfair or unjustified, a worker was entitled to either 15 monthly salaries or full reinstatement, seniority retention and reception of all monthly salaries and social security contributions for the period between dismissal and reinstatement. This obviously made employment termination a huge

[120] International Labour Organization, "Italy: a dual labour market in transition", 2013 p. 35, Wages rise in line with age, not skill, for instance; European Commission, "Country Report: Italy", February 2015, p. 31

[121] Called 'atypical employment' in Italy

[122] Martin Schindler (2009), "The Italian Labor Market: Recent Trends, Institutions and Reform Options", IMF Working Paper 09/47 p. 4. Increased use of temporary contracts has impacted productivity because their time-limited nature disincentivizes human capital investments and temporary employment creation tends to be in low-skill areas. Concomitantly, the high protection of permanent contracts made it difficult to lay off non-productive workers, biasing gains towards less productive employment.

[123] For an overview see William Tompson, "The Political Economy of Reform" *OECD*, 2009, pp. 247 - 269

[124] International Labour Organization, "Italy: a dual labour market in transition", 2013, p. 20

[125] Chiara Benassi and Niccolo Durazzi, "Matteo Renzi must work with Italian trade unions rather than against them if he is serious about reforming Italy's labour market", LSE EUROPP, 17 November 2014,

[126] Alessandro Giovannini and Ilaria Maselli, "The opposition of trade unions to Renzi's 'Jobs Act' shows they remain a conservative force in Italian politics", *LSE EUROPP*, 4 December 2014,

[127] Dell'Aringa, C., (2012), *"La riforma del lavoro: aspetti economici." In La nuova riforma del lavoro: Commentario alla legge,* edited by Magnani *et al.*

[128] Georg Picot and Ariana Tassinari (2012), "Liberalization, dualization, or recalibration? Labor market reforms under austerity: Italy and Spain, 2010 – 2012" p. 18

financial uncertainty for employers, disincentivising expansion, investment, and recruitment. At the same time, this lowered employees' productivity, who faced few incentives to increase output and were able to constantly threaten employers with legal action.

The most recent reform, the Jobs Act of 2014 passed by the Renzi government, lowered the effective costs of dismissals and reduced the uncertainty surrounding both hiring and firing, which will, in turn, serve to increase labour market flexibility.[129] This was achieved through several channels. First, it grandfathered in a standard contract that provides a basic level of employment protection for the first two years, after which the level of compensation for unfair dismissal increases.[130] Second, workers judged to be unfairly dismissed for objective reasons (i.e. where the firm gives economic or technological changes as reasons for the redundancy) are not eligible for reinstatement; firms provide severance pay instead.[131] Employers can pay the worker an indemnity equal to 1 monthly wage per year of service (a minimum amount equivalent to 2 monthly wages and a maximum amount equivalent to 18 monthly wages). If a worker accepts this transaction, they are prevented from launching any further dispute. Both parties have a strong incentive to settle the dispute through this procedure, since the sum paid is not subject to social contributions or taxation. This provides more financial certainty for the employer, who is able to budget for future outlays, thus allowing for an increased likelihood of an increase in new permanent employment. Third, it legislates that courts can judge only a few well-defined issues, with an emphasis on discriminatory dismissal, not whether a dismissal is fair. This curtails the legislative uncertainty that has prevailed in Italy to present. By increasing predictability, the Jobs Act reduces the effective present and future cost to firms of dismissal, which in turn should induce firms to create more jobs.

Reform recommendations

As noted recently by the OECD, Italy has made fairly good strides towards improving the flexibility of its labour market, and as noted by Bruegel, Italy is perhaps the best placed of the peripheral European countries to enact further reforms.[132] It stands to gain much from a depreciated euro, and the Jobs Act of 2014 will continue to incentivize permanent, less protected employment. However, the recent political events discussed above, especially the uncertainty surrounding whether or not Renzi and the PD will be able to enact further reforms, could undermine the steps recently taken. Mr. Renzi and the PD must now try to complete the process of introducing long-overdue political reforms without the support provided prior to the presidential election by FI and far Left PD factions. The FI in particular, is unlikely to change its course of action. It has been bleeding votes to both PD and the Eurosceptic, populist party, the *Lega Nord*, its centre-right competition. As such, Mr. Renzi is now actively seeking to attract several independent, moderate groups into the coalition to shore up his slim majority in the Senate to pass through further reforms. If Mr Renzi fails to put the reform process back on track, he will likely call an election by the end of 2015. If he were to remain in office until the end of the parliamentary term in early 2018 without making concrete progress on his reform agenda, he would risk losing the election and the leadership of his party. As such, he has a very strong incentive to enact further reforms so that he has something to show for the political capital he has spent thus far and to ensure that he remains both leader of his party and in government.

There are three main reforms that would make beneficial change. First, allow firms to opt out of collective agreements and their extensions without union consent, or with a majority of union consent. Union membership is concentrated in larger firms that tend to be in the north of the country. The wages that they bargain for cannot easily be paid in the south of the country, where, as a result, unemployment is higher and productivity is lower. A good first step and promising example for policymakers, came in January 2014 when the social partners signed an agreement for the manufacturing sector whereby firms could opt out based on union membership. These firms are the ones most likely to export, and given the depreciating euro, are most likely to grow, and would thus make a good poster child. Second, make earnings increase with skill and experience not age. This disincentivises productivity gains, as workers receive a pay rise every year, regardless of how productive they truly are. At the same time, it disincentivises human capital investments, given the marginal cost it places on firms, in addition to the fixed outlay on age-based pay rises, further reducing productivity. Third, make severance fees

[129] See OECD, "Economic Surveys: Italy 2015" pp. 19-20 for an overview
[130] OECD, "Economic Surveys: Italy 2015" p.19 - up to a maximum of 24 month's wages, against the OECD average of 14 months
[131] Compensation for unfair dismissal is much higher than for fair dismissals (effectively zero), which incentivizes going to court and increases the cost of litigation
[132] OECD, "Going for Growth 2015"; Alessio Terzi, "Are Italy's stars of reform aligning?" Bruegel, 18 February 2015

lower as court jurisdiction becomes more limited. As the opportunities for employees to argue that they were unfairly dismissed become more limited, it would make sense to bring severance pay down to reasonable standards. It is currently quite high, given that the OECD average for 20 years of tenure (which is not an unreasonable amount of time for an individual to remain at one firm in Italy, as discussed above, and given the incentives that the new standard contracts creates, whereby individuals on contracts agreed to prior to the Jobs Act face a disincentive to switch to the less lucrative new standard contract) is 14 months of wages, compared to between 18 and 24 months in Italy, depending on firm size and sector. There is thus scope for further reduction in severance pay. If potential future costs decrease in a predictable manner, this incentivizes employers to take on new permanent staff. Recent progress shows that this can be done, so this positive trend should be built on in order to create a more stable environment for employers to make hiring decisions.

European Semester and Country Specific Recommendations (CSRs) – An outlet for reform uptake?

The European Semester process of economic policy coordination across the EU could provide a beneficial starting point to take forward some of the above recommendations. This annual cycle is unique in that it includes macroeconomic and structural policies in addition to strictly budgetary matters. It was set up initially as an integral part of the new EU economic governance framework in 2010, under the auspices of the EU's 2020 growth strategy, in response to the Eurozone crisis, and in parallel with action to reform financial sector legislation and create permanent support measures to replace the temporary bail out mechanisms.[133] It effectively acts as a process of surveillance aimed at budgetary and economic policy reforms and convergence.

Beginning in November with the European Commission's Annual Growth Survey (AGS), the cycle continues with the Council agreeing in March on a set of economic policy priorities, using the AGS as its basis. National governments then submit their medium term (3 year) budgetary and economic strategies to the Commission in April, stating how they intend to implement reforms and meet the agreed policy priorities.[134] Euro area countries submit both budgetary fiscal plans called Stability and Convergence Programmes (and now actual draft budgets in October as part of the so-called "two pack" enhanced surveillance framework) which ostensibly help to ensure that they do not breach the Stability and Growth Pact, as well as National Reform Programmes dealing with wider macroeconomic and structural issues. Non-Eurozone members are only required to submit the latter of these. Finally, in June and July, the Commission produces country-specific recommendations (CSRs) to all Member States across a range of economic policy areas. The cycle begins again with the Commission's AGS which assesses the effectiveness of Member States' performance in responding to and implementing its policy guidance.

For budgetary and fiscal matters, the Commission is now equipped with wider powers to both incentivise and sanction Eurozone countries in order to ensure compliance with policy recommendations in the case of excessive macroeconomic and budgetary imbalances.[135] But the structural reform element of the CSRs remains relatively free of these enforcement mechanisms. This means there is an opportunity to use the European Semester to encourage and drive some of these labour market reform proposals without the duress and sense of force which has accompanied earlier action, particularly for those countries which have been in troika-administered adjustment programmes. The programmes have often led to labour market reforms being one of the most disliked and enduring symbols of the bailout agreements.

Additionally, the new President of the European Commission, Jean Claude Juncker, has explicitly tasked the Commissioner for Employment, Social Affairs, Skills and Labour Mobility, Marianne Thyssen, with "coordinating the employment policies of the Member States" and using the European Semester as "the vehicle for pursuing modernisation of labour markets."[136]

There has been pushback from the European Parliament, which has a very limited role and virtually no decision-making power in the European

[133] The European Commission, "Europe 2020: Economic Governance", accessed 14 April 2015.
[134] Nicolaus Heinen, "The European Semester: What does it mean?" 6 October 2010
[135] For more information see Hallerberg, Marzinotto and Wolff, "The legal and governance architecture". *An Assessment of the European Semester.* September 2012, pp.26-28
[136] Jean-Claude Juncker, "Mission Letter to Marianne Thyssen", 1 November 2014. p.4

Semester process, on labour market reforms to date. A recent resolution of a report of MEPs on the social and employment aspects of the European Semester posits that they "have not reduced job precariousness" and "regrets that the focus of the new Commission in structural reforms is geared excessively towards reducing employment protection for existing as well as new jobs."[137]

However, there is growing pressure on the European Commission and the European Council to allow the European Parliament to play a more active role in the European Semester, and it is likely that some limited concessions will inevitably be made. Therefore, it is even more important to incorporate into this process, particularly in the Country Specific Recommendations, these proposals which both tackle the deep systemic rigidity and dualism of southern European labour markets and seek to improve and strengthen both the quantity and quality of worker representation in collective bargaining. Additionally, there is scope to use the push from left-of-centre European parties for increased flexibility on fiscal and structural reforms to extend this to labour market flexibility that works for both employers and employees. This more balanced and inclusive approach would help change increasingly negative attitudes in Europe towards the EU's focus on structural reform.

[137] Motion for a European Parliament Resolution, "Report on European Semester for economic policy coordination: Employment and Social Aspects in the Annual Growth Survey 2015". 5 March 2015

The risks that deflation creates

As deflation takes hold in Spain, Italy, Portugal, and Greece, and the necessary reforms remain to be enacted, the risks both to individual countries and to the European Union become increasingly prominent. Risks surrounding financial flows, notably debt default, contagion and renewed sovereign debt spikes are notoriously volatile, and remain near-term explicit risks.[138] Trade flow risks, namely depressed trade and exported deflation are less fickle and will have an impact further into the future. Both risks, however, are weighted much more heavily among countries with close trade and financial linkages, as these countries do both with each other and the rest of the EU.[139]

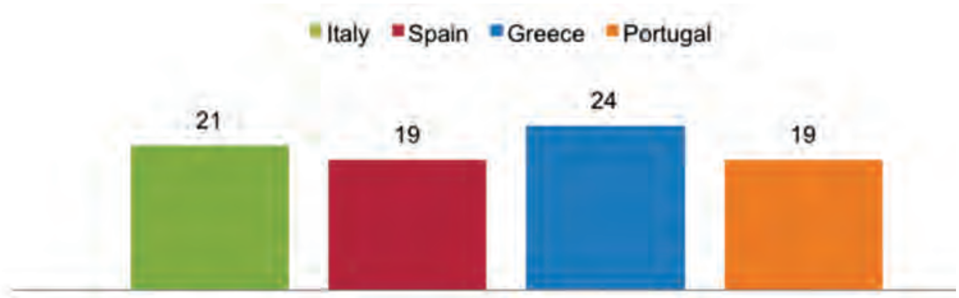
Debt default

The risks of default are especially dangerous. These countries have high levels of private and public sector debt. Italy and Spain, the fourth and fifth largest economies in the EU, respectively, are too big to save individually, as has been argued in the past.[140] If either comes close to default, contagion is likely to spread, increasing sovereign debt interest payments, making it more likely that that there will be multiple defaults in Southern Europe. Missio and Watzka (2011) highlight how, during 2009-2010, contagion spread between Portuguese, Spanish, and Italian yields, and Claeys and Vasicek note that spillover effects have increased substantially and permanently since the start of the financial crisis.[141] Although this argument has been made numerous times throughout the crisis, these countries were not deflating at the time, allowing them to inflate away some of their debt, while also still collecting tax revenues.[142]

Rank (global)	Country	Total Debt-to-GDP ratio (%)	Real economy debt change, 2007 – 2014 (percentage points)	Government debt to GDP ratio (percentage points)	Corporate debt to GDP ratio (percentage points)	Household debt to GDP ratio (percentage points)
4	Portugal	358	100	148	127	83
7	Greece	317	103	183	65	65
8	Spain	313	72	132	108	73
12	Italy	259	55	139	77	43

Once deflation expectations become entrenched, these two variables will change. Unemployment will continue to rise, tax receipts will therefore decrease and social security outlays will increase. Italy, for instance, in the Jobs Act 2014, made social security more inclusive, front-loaded, and generous. Deflation will begin to affect those in permanent, protected employment in a way that austerity has not. Unions will not be able to exert the political pressure necessary to shield themselves from this economic reality. More and more people will continue to be pushed into the informal sector, which grew partly in response to rigid labour markets, where wages are more reflective of market rates, but where neither social security contributions nor taxes are collected. According to the consultancy ATKearney, for example, upwards of 20% of GDP in potentially taxable economic activity is not reported to the authorities in these countries, and most have seen an upward spike since the onset of the crisis.[143] It will become increasingly apparent that these governments will be increasingly less able to fund themselves.

[138] For an overview of contagion in the EU, see Vitor Constancio (2012), "Contagion and the European debt crisis", European Central Bank.
[139] D'Auria et al. "Cross-border spillovers in the euro area", Quarterly Report on the Euro Area, Vol. 13 No. 4 2014, p. 11
[140] Nicholas Kulish and Raphael Minder "Spain Holds a Trump Card in Bank Bailout Negotiations", The New York Times, 6 June 2012.
[141] Missio and Watzka (2011), "Financial Contagion and the European Debt Crisis", CESifo Working Paper, No. 3554; Claeys and Vasicek "Measuring bilateral spillovers and testing contagion on sovereign bond markets in Europe," ECB Working Paper No, 1666
[142] The below chart comes from McKinsey & Company, "Debt and (not much) deleveraging", February 2015.
[143] Friedrich Schneider, "The Shadow Economy in Europe", *ATKearney*, July 2013,



Shadow Economy size (% of GDP)

Source: ATKearney (2013)

As the probability of default increases, so too will the spreads on bonds and therefore debt interest payments, if bond issuance can take place at all in these circumstances. It is likely that if these trends continue, investors will opt not to buy these countries' debt, given the increasingly high likelihood of default. Although bond spreads in the EU, excepting Greece, are quite low, this mainly reflects the 'whatever it takes' guarantee from the ECB. However, as noted above, if Italy or Spain's default risk increases, and contagion spreads in conjunction with deflation, debt becomes more expensive, and the ECB guarantee will be questioned by markets. Government will therefore be forced to make increasingly difficult decisions in the face of austerity, where their already limited resources will be further stretched to pay down their debt.

The private sector faces interest rates that have fallen less, relative to those on government debt, because banks have been forced to keep their margins high to cover past losses and guard against future ones. As prices decline, wages will continue to do so (Portugal and Spain have seen their average fall by 3% since Q1 2013, for instance), and individuals will have difficulty paying down debts such as mortgages and credit cards, increasing the likelihood that individuals default.[144] If they do so in large enough numbers, banks may face a credit crunch and further bank runs become a real possibility.

Household debt is the bigger risk in Portugal and Spain. Portuguese household indebtedness was over 80% of GDP in 2014 Q4, non-performing loans to households measured 5% in 2014 Q3, 12,979 individuals filed for bankruptcy in 2014, triple the amount that did so in 2010, and roughly 660,000 individuals, representing roughly 15% of all individual borrowers, have overdue loans.[145] Spanish household non-performing loans and mortgages make up roughly 6% of total issuance, and have been rising since 2011.[146] As household default becomes more likely, both nominal and real interest rates will rise (the latter because of deflation), credit will tighten and lending to both households and SMEs will decrease, prompting a negative spiral. This comes at a time when consumption and investment need to increase in order for each country to grow their way out of deflation.

Private sector debt is a substantial worry in each country. The Italian private sector has a high level of non-performing loans, at roughly 27.3% in the third quarter of 2014, or approximately 250 billion euro, and, according to the European Commission, this number is likely to rise significantly in the near term.[147] This makes it increasingly difficult for banks to lend to SMEs, which tend to be highly dependent on bank funding for investment. Since mid-2011, lending rates to SMEs, proxied by interest rates on loans of 250,000 euro or less, have risen by roughly .7%, from 3.5% to 4.2%, or 20%, while the spread between loan interest rates to large firms, proxied by loans of over 1 million euro, has increased by almost 100%.[148] Portuguese non-

[144] Eurofound, "Young People in Temporary Employment in Europe", 2014
[145] European Commission, "Country Report Portugal", February 2015, p. 18
[146] European Commission, "Country Report Spain", February 2015, p. 26
[147] European Commission, "Country Report Italy", February 2015, p. 37
[148] Banca d'Italia, "Indagine sulle imprese industriali e dei servizi – Anno di riferimento 2013", Banca d'Italia – Supplementi al Bollenttino Statistico, no. 40, July 2014.

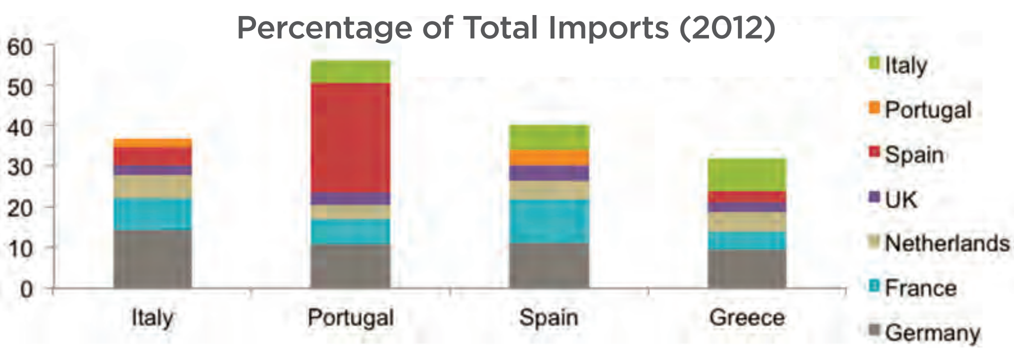
financial corporate non-performing loans have risen to 18.7%, as of Q3 2014, and by some estimates 90% of credit to the non-financial corporation sector is concentrated in roughly 10% of the firms with bank credit, increasing the risk of default.[149] Spanish corporate non-financial non-performing loans make up roughly 12.7% of banks' assets, as of November 2014. These statistics belie differences between countries in bank lending to SMEs. Portuguese and Italian credit has tightened significantly, whereas Spanish access to finance for SMEs has increased, although the latter trend mostly reflects the almost complete shutdown of bank lending to SMEs in Spain in the years after the crisis.

Imported deflation

The UK and the EU core are also at risk of importing deflation. If peripheral European firms opt not to import goods or services from the UK, it would be as if the two firms were on the same street in Athens, Madrid, or Lisbon, rather than in different countries. The majority of Spain's imports, for instance, are intermediary goods that UK firms tend to specialize in. UK firms will see their exports decrease and will have to make similar adjustments that European firms have made, albeit to a lesser extent. Peripheral Europe made up roughly 18% of the UK's total external exports and 39% of its total to the EU in 2013.[150] Exports tend to be high-value added goods, such as automobiles, and high valued added manufactures, such as aircraft parts.[151] These firms tend to employ high numbers of specially trained employees who may have difficulty shifting into other employment sectors, and are located in cities dispersed throughout the UK, which often serve as a municipal and regional locus for employment growth opportunities.

The UK could also indirectly import deflation from the Eurozone core countries that trade with peripheral Europe. Germany and the Netherlands, the UK's largest European export markets, export over 14% and 11%, respectively, of their total exports to Italy and France, for instance, the latter of which exports roughly 2% of its GDP to Italy and Spain.[152]

The chart below outlines the import origin countries of Italy, Portugal, Spain and Greece. The UK, the Netherlands, Germany and France make up between 21 and 30 percent of total imports for these countries. The proportion of total imports of these countries has also been steadily decreasing over time, as the chart below, outlining between 2009 and 2012 indicates:[153]



Source: MIT Trade Complexity Index

[149] Banco de Portugal, "Financial Stability Report", November 2015.
[150] Eurostat
[151] MIT Global Trade Complexity Index: Great Britain
[152] MIT Global Trade Complexity Index; European Commission, "Country Report France", February 2015, p. 35
[153] The data comes from the MIT Global Trade Complexity Index database

If Germany, France, and the Netherlands, too, import deflation, they could serve as the intermediary whereby deflation is exported to the UK.

	Germany	France	Netherlands	UK	Spain	Italy
Italy	-16%	-13%	-4%	-21%	3%	–
Spain	-23%	-12%	-1%	-18%	–	-17%
Portugal	-11%	-40%	-48%	-5%	-10%	-25%
Greece	-32%	-33%	-11%	-41%	-31%	-42%

Opportunities for the UK

The time is right for reform in these countries. With QE's introduction, the euro will depreciate, making exports more competitive abroad, and the yield on government bonds will go down, acting as windfall revenue for governments that face high debt interest payments.[154] These act as a subsidy for consumption or debt consolidation, and make it likely that there will be superficial, export-led growth, a welcome boon to countries that suffered greatly since the crisis. However, these numbers will reflect superficial growth in temporary employment, along the lines of Spain's 10% year-on-year average growth prior to the crisis, unless reforms are implemented. Given these trends, it is an enviable time to enact reforms. Rather than follow the pattern of crisis and minimal response, it would make sense to enact reforms while growing. History has taught us that this can only come externally to these countries, while at the same time, the risks are shared regionally and globally. As such, now is the time to build consensus in Europe around the issue of labour market reform. The problems are real, as are the consequences of inaction.

In the run up to the UK's general election, immigration rose to the debate's forefront, while also serving as a proxy for EU membership. Politicians have reacted by making welfare more difficult to access and the ruling Conservative Party has promised an EU referendum before 2017. Welfare reform will have a marginal impact on immigration at best. Recent ONS data confirms that in 2014 62% of EU15 citizens immigrated to the UK for work, while the number is higher for EU8 and EU2 citizens (67% and 71%, respectively).[155] Although the Conservative Party won a decisive Parliamentary majority, the debate about reforms and immigration remains relevant for several reasons.

First, the argument for a reformed EU has become more important in the UK's EU membership debate. If the UK led reforms that benefitted all of Europe and came from a pan-European consortium, it would be in a position to build the political capital necessary to create the requisite coalitions to build and implement reforms to increase the EU's internal and international competitiveness. To do so, however, it needs to win allies, not create enemies. The main beneficiary of the UK's inaction is France, whose policy goals are most aligned with peripheral Europe, but whose economic and political clout is similar to the UK. The two countries compete as swing states in the EU.

[154] Exports make up approximately 40% of GDP in Portugal for instance, European Commission, "Country Report Portugal", February 2015, p. 14
[155] UK Office for National Statistics, "Migration Statistics Quarterly Report", February 2015". The EU15 consists of Austria, Belgium, Denmark, Finland, France, Germany, Greece, Italy, Luxembourg, Netherlands, Portugal, Republic of Ireland, Spain, Sweden and the UK. The EU8 consists of Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, and Slovenia. The EU2 consists of Romania and Bulgaria.

Second, many eastern and southern European countries worry about 'brain drain' and some are actively trying to stem this trend in a manner similar to the UK's reactionary approach to benefit reduction. For example, Hungary has sought to force graduates to remain in the country for 10 years after graduation to pay back the state for their education.[156] Therefore, both the UK and its southern and eastern European partners want the same thing, namely that the structurally unemployed enter work in their native countries and spur local economic growth.

Third, deflation is a serious problem facing the EU. The Japanese experience highlights two key points. First, deflation, when it takes hold, is extremely difficult to overcome. Consumers lose confidence in their future, and opt not to spend due to heightened economic uncertainty, which leads to a further loss of confidence, and entrenches the deflationary cycle. Although deflation initially began in the 1990s, it has not been thoroughly vanquished since, even with large amounts of quantitative easing and fiscal stimulus. This failure highlights the second main lesson, namely that labour market flexibility is extremely important to a country's economic vitality. Without increased flexibility, it remains unlikely that the Japanese economy will expand or that inflation will take hold to any meaningful extent. Structural reforms are necessary to enact meaningful, positive change.

It makes sense to acknowledge and work on the other side of the coin by making peripheral source countries more attractive and competitive. Many of the problems discussed above can be ameliorated through labour market reform whereby permanent employment is made more flexible and temporary employment more meaningful. There are several member states of the European Parliament that are natural allies for the UK in this regard, specifically those outside of the Eurozone in Central and Eastern Europe.[157] At the moment, many of these states and their politicians view the UK as a liability and not worth the political capital expenditures cooperation would necessitate. As the EU becomes increasingly fractured between those in the Eurozone and those outside, and as the UK questions its membership, there is an increased incentive for non-Eurozone but EU member states to work with Eurozone members rather than cooperate with each other to achieve goals they deem in their national interest. These very same Eurozone members represent the countries where the difficult decisions and labour market reforms have not been made, and it is therefore unlikely that this will change. If anything, labour markets could be made more rigid. Given this alternative, there is a unique opportunity for the UK to act as a swing state. It can build coalitions and consensus within Brussels to achieve outcomes beneficial to itself as well as the EU. At the same time, it can build the political capital necessary to achieve meaningful future reforms in other sectors and areas where the EU is less competitive. It needs to recognize and act upon its exceptionalism.

[156] Lucy Ash, "Hungarian government 'traps' graduates to stop brain drain," BBC, 16 August 2016, accessed 14 January 2015.; "Matteo Renzi takes the stage in Italy", The Financial Times, 24 February 2014, accessed 1 March 2015

[157] Namely Bulgaria, Croatia, Czech Republic Hungary, Poland, and Romania

Conclusion

This report has highlighted how deflation has developed in the EU, the risks it entails, and what can be done about it. As a result of factors both within the purview of national governments, namely labour market rigidity and high debt levels, and beyond their control, particularly globalisation and demographic trends, Italy, Spain, Portugal, and Greece have entered deflation. The main problems that this poses are manifold.

First, these countries are heavily indebted, both publicly and privately, and have high levels of unemployment. These factors make it increasingly likely that individuals and firms will default, and make sovereign default more realistic. They are all linked through trade and finance with each other and other EU member states, allowing for contagion to spread. This has, of course, happened in the past, but not a time when the countries were deflating nor when governments had gone through prolonged periods of high levels of austerity. Italy and Spain are too big to save, for instance, so if both were to come under external pressure at once, perhaps if PD called a general election in the former or Podemos came into power in the latter, it would remain to be seen how they would adjust.

Second, these countries are not islands. They are relatively open to trade, and depressed consumption of imports is effectively exported deflation to the EU, the UK, and the world at large. Germany, in particular, may find itself particularly exposed given its deep trade linkages with Italy and Spain, for instance, while also experiencing negative trade growth due to the Russia-Ukraine conflict, the former of which has also been a historically large trading partner and energy supplier.

Third, reforms are self-determined at the national level and each country has had or will likely have an election in 2015. The national governments must push through necessary reforms that are often politically difficult at a time when they are trying to be re-elected and are shifting priorities from legislating to electioneering. If deflation becomes severe, it is likely that government will have an increasingly difficult time paying its bills, while its populace suffers concomitantly, making it less likely that meaningful reform will occur. If anything, these countries may take steps in the opposite direction, as Portugal did upon exiting its Financial Assistance Program in 2014.

It has also been argued that out of these risks come opportunities. This is a unique moment where Europe can come together to help their fellow Europeans solve a problem that privileges the few and affects all of Europe. There is an opportunity to use the European Semester and CSRs to encourage and drive some of these labour market reform proposals without the duress and sense of force which has accompanied earlier troika-administered adjustments. The European Parliament, which has a very limited role and virtually no decision-making power in the European Semester process, has pushed back on labour market reforms to date. However, there is growing pressure on the European Commission and European Council to allow the European Parliament to play a more active role in the European Semester, and it is likely that some limited concessions will be made. Therefore, it is even more important to incorporate into this process, particularly in the Country Specific Recommendations, these proposals which both tackle the deep systemic rigidity and dualism of southern European labour markets and seek to improve and strengthen both the quantity and quality of worker representation in collective bargaining. Additionally, there is scope to use the push from left-of-centre European parties for increased flexibility on fiscal and structural reforms to extend this to labour market flexibility that works for both employers and employees. This more balanced and inclusive approach would help change increasingly negative attitudes in Europe towards the EU's focus on structural reform.

The UK can exert its influence in Europe to achieve positive change, both tangibly, by arguing for implementation of labour market reform in peripheral Europe, and through the signals it can send, namely willingness to work within the EU. The goals that it wants to achieve are often aligned with other members, as the example of labour market reforms has shown. The UK should want just as much to increase employment opportunities in peripheral Europe as it does to reduce immigration to the UK. This typicality, as well as future similar scenarios, should be recognized and acted upon if the UK decides that it wants to be both an EU member and to shape it as it sees fit.

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