

## Chapter 7

# Wages and economic performance in Europe

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### 1. Introduction

‘Austerity is a form of voluntary deflation in which the economy adjusts through the reduction of wages, prices and public spending to restore competitiveness which is (supposedly) best achieved by cutting the state’s budget, debts and deficits.’ (Blyth 2013: 2)

Mark Blyth’s definition of austerity concisely describes the overarching idea that guided the crisis management pursued by policymakers at European and national level. In particular, it highlights the fact that a narrow conception of competitiveness as *cost* competitiveness has become the dominant frame of reference for current approaches to European economic policy based on austerity and internal devaluation.

The first approach follows the logic of ‘expansionary austerity’ (Giavazzi and Pagano 1990), which implies essentially that major reductions in government spending will help to expand private consumption and thereby lead to overall economic growth. The underlying rationale of this logic is what Paul Krugman (2013) calls ‘the belief in the confidence fairy’: in other words, the idea that credible attempts at fiscal consolidation by seriously cutting public spending will increase market actors’ ‘confidence’ and thus induce them to invest and consume more, thereby creating growth and employment. Since public sector wages on average account for more than 20 per cent of total public spending in the EU, cuts and freezes in public sector wages play an important role in this approach.

The key focus of this chapter is, however, on the second approach, namely ‘internal devaluation’, which is essentially based on the view that the current crisis of (cost) competitiveness is due mainly to divergent wage

developments within the euro zone. Since in the economic and monetary union (EMU) currency devaluations are ruled out in principle as a means of adjusting cross-country differences in competitiveness, reducing labour costs in deficit countries through wage cuts and freezes is seen as the only way to overcome the growing macroeconomic imbalances and to restore growth within the euro zone. Thus, following the ‘ideological mantra of competitiveness’ (Misik 2013), one key objective of EU reform policies is to achieve moderate wage developments across the euro zone by ensuring that nominal wages stay in line with productivity without any further compensation for price increases.

The measures taken in order to achieve this objective include, besides direct interventions in national wage policies via the new European system of economic governance (see the introduction of this volume), repeated political initiatives to put the internal devaluation approach on a stronger institutional footing. The latter involve repeated (unsuccessful) attempts by the German Chancellor Angela Merkel to initiate the conclusion of competitiveness pacts between the EU and member states and, more recently, in June 2015 the ‘five presidents’ initiative to set up so-called ‘competitiveness authorities’ at national level with the explicit objective of ‘assessing whether wages are evolving in line with productivity’ (Juncker *et al.* 2015: 8).

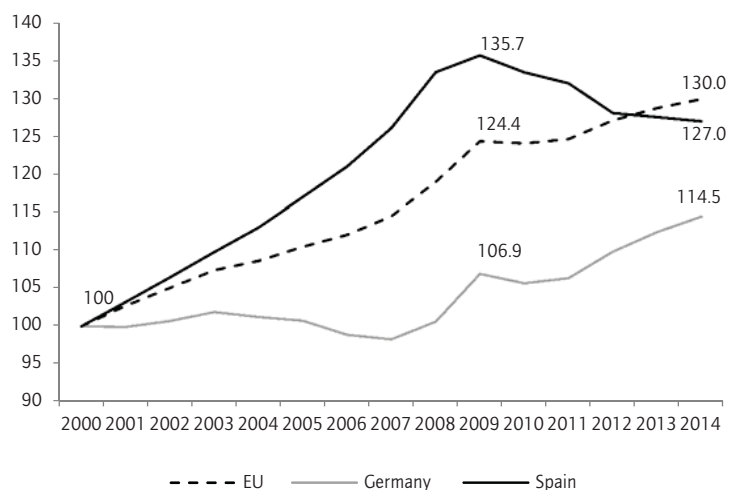
Because the powers-that-be claim that ‘there is no alternative’ (TINA) to an approach based on improving competitiveness through internal devaluation our objective in this chapter is to critically discuss the underlying assumptions and the argument of what we shall call the ‘standard view’ of the current crisis and appropriate crisis management. This will be done in three steps. In a first step, the standard view will be outlined in more detail, focusing in particular on the alleged causal link between divergent developments of wages and unit labour costs and macroeconomic imbalances. In a second step the standard argument will be taken apart into its main components in order to investigate whether the assumed causal links stand up. The key objective here is to illustrate how, at different junctures of the argument, the proponents of the standard view have neglected other important explanatory factors, which thus led them to the wrong policy conclusions. Against this background, the third step is to present an alternative and more sustainable growth model, which is based on a more expansive wage policy.

## 2. Wages and economic imbalances: the standard view

As Höpner and Lutter (2014: 3) succinctly illustrate, the standard interpretation of the current crisis is based on the following causal link: divergent developments in unit labour costs lead to different price developments, which in turn lead to divergent trends in competitiveness, which then cause divergences in current account balances between surplus and deficit countries. Considering, for example, nominal unit labour cost developments in Spain and Germany during the 2000s, the former was very much above the EU average, while the latter was very much below (Figure 1). Thus, the standard view sees the Spanish unit labour cost developments as the major cause of increasing account deficits, while the large account surplus in Germany is seen as a result of its high degree of competitiveness rooted in very moderate unit labour cost developments.

As divergences in nominal wage developments are claimed to be at the root of the current macroeconomic imbalances, the key problem, supposedly, is that, in contrast to the so-called ‘surplus countries’, nominal

Figure 1 Nominal unit labour costs in Germany, Spain and the European Union



Source: AMECO Database, authors' calculations.

wages in the so-called ‘deficit countries’ have outpaced productivity developments. Since nominal unit labour costs are defined as nominal wages divided by productivity (usually measured in GDP) the different developments of nominal wages led to divergences in the development of unit labour costs, which have increased continuously since the establishment of EMU. Due to the close link between unit labour costs and inflation, divergences in the former lead to an ever increasing gap in prices for goods and services produced. The divergent developments of inflation meant that the real exchange rates of surplus countries depreciated so that comparable goods and services could be offered abroad more cheaply. The result was an ever widening (cost/price) competitiveness gap between the two groups of countries, which in turn had far-reaching implications for international trade flows. Due to the competitive cost and price advantage, exports in surplus countries far exceeded imports, while in deficit countries the dynamic was the other way around, leading to the observed macroeconomic imbalances.

This, in a nutshell, is the logic on which the standard view of the current crisis as a cost competitiveness crisis is based. However, with regard to the measures needed to address this crisis two different strands can be distinguished. For the first strand of the standard view the key problem is the ‘excessive’ development of wages and unit labour costs in the deficit countries alone. The proponents of this view therefore suggest that the deficit countries should follow the example of the surplus countries – and in particular Germany – in ensuring moderate nominal wage developments in line with productivity. The policy measures proposed by the proponents of this perspective to solve the deficit countries’ competitiveness problem have two basic elements: first, to pursue a strategy of ‘internal devaluation’, which is a euphemism for wage cuts and freezes; and second, to implement ‘structural reforms’ aimed at increasing the downward flexibility of wages.

This is the dominant perspective among European policymakers, in particular the European Commission’s DG ECFIN, the European Central Bank (ECB) and the European Council. They have used the new system of European economic governance, which was set up in order to cope with the current crisis, for unprecedented political intervention in national wage setting and collective bargaining in order to ensure implementation of the strategy of internal devaluation and neoliberal structural reforms (Schulten and Müller 2015). This finds its clearest expression in the Memorandums of Understanding (MoU) signed by the

so-called 'Troika' and the countries in need of financial assistance, and the country-specific recommendations (CSR) proposed by the European Commission and adopted by the European Council in the context of the European Semester (the EU's annual cycle of economic policy guidance and surveillance). Both, the MoUs and the CSRs repeatedly call for moderate wage developments (involving cuts and freezes of public-sector and minimum wages) and for measures leading to the decentralisation of collective bargaining, in particular the introduction of more restrictive criteria for extending collective agreements (Schulten and Müller 2015: 338).

The second strand of the standard view of wages and economic imbalances shares with the first strand the notion that divergent wage and unit labour cost developments are a central factor causing the macroeconomic imbalances. However, while the first strand puts the whole burden of rebalancing on the deficit countries, for the proponents of the second strand surplus countries could play an equally important role in dealing with macroeconomic imbalances by promoting stronger domestic wage growth (for example, Grauwe 2012; Malliaropoulos and Zarkos 2013; Flassbeck and Lapavistas 2013). From this perspective, the fact that German nominal unit labour costs persistently undershot the commonly agreed inflation target of 2 per cent in the run up to the crisis contributed as much to that crisis as the overshooting of nominal unit labour costs in many southern European countries. Thus, what is needed to deal with the macroeconomic imbalances is a process of asymmetric adjustment in which wage moderation in the deficit countries is complemented by substantial wage increases in the surplus countries.

This should also be reflected in the crisis management pursued by European policymakers. One major criticism levelled by the proponents of the second strand against the current crisis management concerns its one-sided focus on deficit countries. The institutional bias towards the deficit countries is reflected in the fact that the macroeconomic 'scoreboard' used to monitor current account imbalances foresees different thresholds for deficit and surplus countries. While current account imbalances for deficit countries are considered problematic in excess of -4 per cent, for surplus countries the corresponding threshold is 6 per cent measured in terms of three-year averages (Leschke *et al.* 2015: 311).

However, regardless of the concrete policy conclusions drawn by the proponents of the two perspectives they both share the key focus on

wages as the main adjustment variable for the macroeconomic imbalances within EMU. In Section 3 we subject this close link between wages, competitiveness and economic performance, which is inherent in both variants of the standard view, to a critical review.

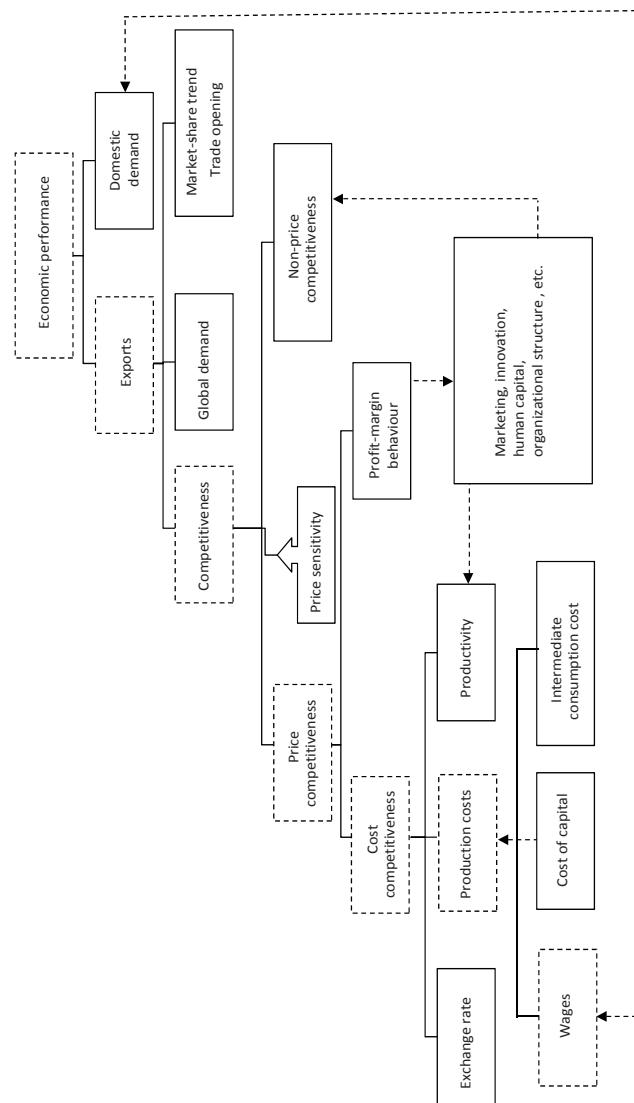
### 3. Critique of the standard view

The objective of the following critique is to debunk the standard argument by breaking up the causal chain leading from divergent wage and unit labour cost developments to differences in economic performance into its three main components and basic assumptions. These are: (i) there is a direct causal link between unit labour cost developments and a country's price competitiveness; (ii) there is a direct causal link between the development of price competitiveness and export performance; and (iii) growth and economic performance are driven mainly by a country's export performance.

Figure 2, which provides a stylised overview of the determinants of economic performance, illustrates that each of these assumptions is characterised by an overly narrow focus on certain explanatory factors (see dashed boxes) at the expense of others that have not been taken into consideration sufficiently. In the following each of these assumptions will be reviewed critically in light of recent studies that demonstrate that there are alternatives to the interpretation put forward by proponents of the standard view.

The three key assumptions of the standard view are derived essentially from the belief that there is an analogy between corporations and countries. According to this view, countries – just like corporations – are in direct competition with each other and can outperform each other in an attempt to gain international market shares (Krugman 1994: 30). This analogising is problematic in a number of respects. Leaving aside the fact that it is not countries as such but companies and their products that compete, another problem is that it considers international trade to be a zero sum game in which the gain of one country comes at the expense of another. However, in an internationally integrated economy, countries are not only home to companies that compete in the domestic market, but are also one another's export markets and suppliers of useful imports (Krugman 1994: 34). Thus, better economic performance in one country can often benefit other countries as well.

Figure 2 Determinants of economic performance



Source: Adaptation of Sautard et al. 2014: 3.

Another problem with this thinking in analogies is that it implies a specific measure of competitiveness. It makes a country's trade balance – more specifically, its trade surplus – the main yardstick for assessing competitiveness. This chimes with a definition put forward by the European Commission according to which international competitiveness can be viewed as 'the ability to export goods and services in order to afford imports, and hence it will be summarised by world market shares' (European Commission 2010a: 23). However, as Krugman succinctly puts it, this means that competitiveness is commonly measured in terms of 'the ability of a country to sell more abroad than it buys' (Krugman 1994: 31), which in turn generates the erroneous view that exports are the key determinant of a country's economic performance. This aspect of the standard view's argument will be dealt with at a later stage. In Section 3.1 we discuss the relationship between unit labour costs and price competitiveness in more detail.

### 3.1 The relationship between unit labour costs and price competitiveness

One of the key assumptions on which the strategy of internal devaluation is based is that unit labour costs are the main factor that determine a country's price competitiveness. This one-sided focus on unit labour costs has been criticised from different angles. One of the first fundamental criticisms was developed by Cambridge economist, Hungarian-born Nicholas Kaldor. He found that between 1963 and 1975 countries with the highest increase in unit labour costs also had the best export performance measured in market share, which in the literature is referred to as 'Kaldor's paradox' (Kaldor 1978: 105). His analysis also yielded that for the majority of the 12 OECD countries he investigated the development of relative unit labour costs did not go hand in hand with the development of relative export prices. Against this background he concluded that 'the customary measures of "competitiveness", whether they be unit labour costs or export prices, are arbitrary and not an adequate indicator of a country's true competitive position' (Kaldor 1978: 106).

More recent criticism boils down to two main arguments: first, the one-sided focus on unit labour costs ignores the fact that not only wages and unit labour costs but also the cost of capital determine a company's production costs; and second, the one-sided focus on unit labour costs does not sufficiently take into account that price competitiveness is not only

determined by a company's cost competitiveness, but also by its profit margin behaviour; that is, it assumes a direct relationship between cost and price developments.

The first argument – that it is mainly unit labour costs that determine the cost of production and price competitiveness – has been challenged by Felipe and Kumar (2011a). By analogy with unit labour costs as an indicator of competitiveness from the workers' side they calculated the unit *capital* costs, defined as the ratio of nominal profit rate to capital productivity as a measure of competitiveness from the capital side (Felipe and Kumar 2011a: 14). Looking at developments in 12 different countries for the period 1995–2007, they found that, with the exception of Greece, unit capital costs grew faster than unit labour costs in all countries. This in turn illustrates that the 'loss of competitiveness' is a question not so much of nominal wages increasing faster than labour productivity as of containing the development of capital costs.

The relationship between the development of unit labour costs and price developments has been addressed by various studies from different angles. Feigl and Zuckerstätter (2012), for instance, looked at the extent to which unit labour costs and profit development contributed to inflation developments in different European countries. Their results show that for the euro zone as a whole between 2000 and 2007 income from profits contributed more to inflation than unit labour costs development. The most striking example is Spain. The contribution of nominal wages to inflation exceeded the margin that would have been compatible with the ECB inflation target by 7.3 per cent. However, the contribution of income from profits exceeded the margin defined by the ECB inflation target by almost 10 per cent, which in turn illustrates that the main problem for Spanish price competitiveness was not so much excessive wage developments but the profit margin behaviour of companies.

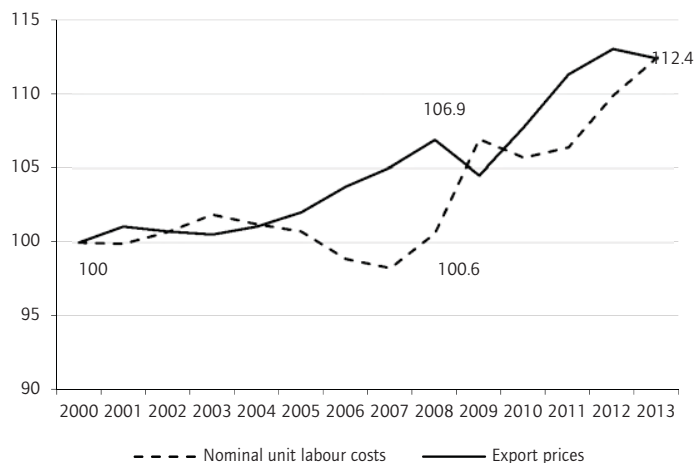
The limited impact of unit labour costs on international competitiveness is confirmed by Storm and Naastepad (2014b), who found that in the southern European countries Greece, Italy, Portugal and Spain unit labour costs make up only about 16 per cent of manufacturing gross output price, which in turn leads them to conclude that unit labour costs 'do not matter much for competition' (Storm and Naastepad 2014b: 9).

Developments in Spain and Germany are prominent examples that illustrate the criticism outlined above. Spain is particularly interesting

because the country is often portrayed as a model student in implementing the internal devaluation approach. In fact, by 2013 Spain – like two other southern European programme countries Portugal and Greece – managed to offset all the differences in unit labour costs growth compared with the rest of the euro zone which had been accumulated since 1999 (Uxó *et al.* 2014: 13; see also Figure 1). However, despite this substantial drop in unit labour costs the country still lags behind in terms of relative price developments. The key factor that explains this phenomenon is that the decrease in unit labour costs has only partially been passed on to prices and has instead been used to increase profit margins (Le Bayon *et al.* 2014). Because inflation is not only determined by wages/unit labour costs but also by profit margins and indirect taxes the substantial increase in profit margins more than offset the positive contribution of falling unit labour costs to inflation developments measured as the GDP deflator (Uxó *et al.* 2014: 9). The increasing profit margins also meant that unit *capital* costs in contrast to unit labour costs continued to grow during the crisis. Thus, whereas in the pre-crisis period the inflation differential between Spain and the euro-zone average was explained by higher growth in both unit labour costs and unit capital costs, the differences in price competitiveness since then have been due to the increase in profit margins and unit capital costs (Uxó *et al.* 2014: 10).

Germany is an interesting case because it is often presented as the role model of internal devaluation that deficit countries should follow. However, with regard to developments in Germany, even the European Commission's DG ECFIN acknowledges that the strong growth of German exports in the 2000s was not driven primarily by unit labour cost developments, but mainly the result of strong economic growth in Germany's main export markets (European Commission 2012a, 2014; Schulten 2015). As a matter of fact, Germany's dynamics were quite similar to those in Spain because falling unit labour costs did not translate directly into falling prices (and therefore export performance which was determined mainly by Germany's strong non-price competitiveness). Figure 3 illustrates that during the first half of the 2000s unit labour costs and export prices developed almost in parallel. In the second half of the 2000s, however, unit labour costs went down, while export prices showed a strong increase. Since the second half of the 2000s was also the period of Germany's fastest export growth, many German companies obviously saw no need to transfer the gains in price competitiveness from wage restraint into lower export prices (Herzog-Stein *et al.* 2013). On the contrary, the companies used wage moderation to realise extra profits.

Figure 3 Nominal unit labour costs and export prices, Germany, 2000–2013 (2000=100)



Source: Schulten (2015).

Developments in Spain and Germany highlight the deficiencies of the standard view's assumptions: first, wages and unit labour costs alone are not an appropriate measure of cost competitiveness because the cost of capital – that is, unit capital costs – also plays an important role. Second, there is no direct link between cost and price developments because price competitiveness is determined not only by cost competitiveness but also by profit margin behaviour.

### 3.2 The relationship between competitiveness and export performance

Figure 2 illustrates that export performance is determined mainly by foreign demand and competitiveness, which can be divided into price and non-price competitiveness. Of the three factors, price competitiveness plays by far the most important role in the narrative put forward by proponents of internal devaluation. Accordingly, the key factors often mentioned as contributing to the German success story are moderate wage developments and changes to the legal framework aimed at deregulating

labour markets and the social security system, promoted in particular by the notorious 'Hartz Laws' (Knuth 2014). To some observers following the standard neoclassical interpretation these policies are the main reason why Germany escaped the crisis largely unscathed and was able to transform itself from the 'sick man of Europe' at the beginning of the 2000s to an 'economic superstar' at the end of the decade (for example, Dustmann *et al.* 2014). The second strand of the standard view, on the other hand, heavily criticises these very same policies as 'wage dumping', according to which Germany has followed a beggar-thy-neighbour approach and has achieved its economic success mainly at the expense of other countries (for example, Flassbeck and Lapavistas 2013). As diverse as these interpretations are, they both share the same assumption of a direct link between the increase in price competitiveness and the success of Germany's export industries.

The key question with regard to the whole argument made by the proponents of the standard view is whether there really is a direct causal link between the development of price competitiveness and the development of exports. Empirical evidence suggests that the relationship is not as straightforward as the standard view would have us believe. A comparative study by the European Commission investigating the relationship between the development of real effective exchange rates (as an indicator of price competitiveness) and market shares (as an indicator of export performance) shows that price competitiveness in fact accounts for less than 40 per cent of the changes observed in the euro-area countries' export performance in the period 1998–2008 (European Commission 2010b: 24).

Particularly illustrative in this respect is a comparison between France and Germany. While both countries show an almost identical development of price competitiveness – both pre-crisis (2000–2008) and during the crisis (2008–2012) – the export performance of the two countries diverged substantially. While in the pre-crisis period price competitiveness in both countries deteriorated at roughly the same rate, Germany's exports grew, on average, by approximately 1 per cent a year, while in France the annual average change of exports was almost –3.5 per cent. By the same token, price competitiveness during the crisis period grew in both countries at roughly the same rate. However, the annual average change of export performance in France remained slightly negative, while in Germany the annual average change was almost 2 per cent (Sautard *et al.* 2014: 2).



According to Sautard *et al.*, these divergent developments in export performance despite almost identical developments in cost competitiveness can be explained by the fact that 'the contribution of non-price competitiveness exceeds the combined contribution of global demand and the real effective exchange rate' (2014: 4). This is confirmed by another study published by DG ECFIN (European Commission 2012b), which investigated the contribution of foreign demand, price and non-price competitiveness to export growth in manufactured goods. The DG ECFIN study yields three crucial results: first, foreign demand is one of the key drivers of export performance but to the same extent in France and Germany, which means that this cannot explain the difference in export performance; second, the role of price competitiveness in explaining the differences in export growth is marginal; and third, the factor that really makes the difference is the development of non-price competitiveness (measured as a residual, that is, that part of export performance not explained by prices and foreign demand) (European Commission 2012b: 23).

The importance of non-price competitiveness for export performance is confirmed by a number of other studies (for example, European Commission 2010b; Felipe and Kumar 2011a, 2011b; Storm and Naastepad 2014a, 2014b). Even though non-price competitiveness is very difficult to measure, the various studies show that the structure of the export basket in terms of its sectoral composition and in terms of the complexity and quality of the exported products is one of the key factors. Felipe and Kumar (2011a, b), for instance, show that between 2000 and 2007 the German share of total world exports of the top 100 most complex products was more than 18 per cent, compared with 3.6 per cent in the case of France or less than 1 per cent in the case of the southern European countries Greece, Portugal and Spain (Felipe and Kumar 2011a: 29). Thus, one important factor that explains Germany's better export performance compared with other European countries is sectoral specialisation, with a high concentration of its exports in the most complex product segments, such as automobiles, chemicals and machine-building. These are all knowledge- and technology-intensive industries with less price-sensitive products in which labour costs play only a minor role (Sautard *et al.* 2014: 6). Returning to the comparison between France and Germany, it is the more complex export basket and the lower price sensitivity of the exported products that mainly explain why the similar losses of price competitiveness in both countries had entirely different impacts on export performance.

Non-price competitiveness also is one of the key factors explaining what is sometimes referred to as the 'Spanish paradox' (Cardoso *et al.* 2012). The Spanish paradox refers to the comparatively good export performance of Spanish industry before the crisis despite above average unit labour cost developments and significant losses in price competitiveness (measured in terms of real exchange rate appreciation). Several explanations have been offered in the literature, but one crucial factor seems to have been that the positive effects of non-price determinants more than offset the negative effects of rising export prices (Correa-López and Doménech 2012: 25). This is not self-evident, however, given the overall low complexity of the Spanish export basket. Here it is important to look at disaggregated firm-level figures because Spanish exports are highly concentrated on large firms that have stronger non-price positioning in terms of market access, product complexity and R&D investment (Braunberger 2012). This does not show up in aggregated figures, however.

But non-price competitiveness comprises not only such factors as product differentiation, technological content or product quality and innovation. It also includes a broad range of features that are not directly measurable but which consumers use in making their choices, such as design, brand image, distribution networks and customer support services (Sautard *et al.* 2014: 3). From a broader perspective non-price competitiveness even includes basic societal framework conditions such as technological and logistical infrastructure, systems of skill formation and R&D or culture of labour relations.

All this has important policy implications in the context of crisis management. Even if one follows the assumption of the standard view that exports are the key factor determining growth, the focus should not be, in particular in the southern European countries, on cutting costs to improve cost competitiveness, even though in the short run this variable is the easiest to influence. The focus should rather be on boosting non-price competitiveness by investing in the (re)construction and upgrading of economic structures and the goods and services produced (Monokroussos 2015). If anything at all, this would be the real lesson to be learned from the German recovery (Storm and Naastepad 2014a: 21).

### 3.3 Significance of exports for overall growth

Because the standard view measures competitiveness primarily in terms of world market shares it systematically overestimates the significance of exports for a country's economic performance and growth. There are different ways to measure the significance of exports for economic growth in terms of domestic value added. One option, for instance, is to use the share of net exports in GDP, which is the procedure used by standard national accounting formulas. The implicit assumption here is that all imports are re-exported and that only the difference is used or produced domestically. This approach may be best suited to describe the situation of a pure trading port; however, even Hong Kong or Singapore would not fully fit into this model. This procedure is suited mainly to calculate domestic production in terms of the expenditure approach, but even then it would probably underestimate the importance of foreign trade in the national economy.

Another option is to compare total sales within a country to total exports. This calculation is based on the implicit assumption that exported goods and services have the same content of imported and other intermediate inputs as all other expenditure categories. This method could, however, run into trouble if, for example, export goods and services are produced in highly fragmented value-added chains, while goods for domestic use are provided by a single enterprise.

A more reliable measure based on readily available data seems to be the exports-to-final-use ratio. Final use comprises domestic demand and export and – by virtue of national accounting identities – has to equal GDP plus imports. Using this measure is equivalent to the assumption of uniform import contents across exports and domestic uses of goods. This assumption seems fairly sensible, at least for highly integrated industrial nations. As public services are usually not traded across borders, the share of exports in demand for national production might still be slightly overestimated. Calculations from IO data usually show a somewhat higher share of imported inputs in export goods than in domestic use.

Nevertheless, exports-to-final-use ratios are much closer to IO measures of actual value-added exports. Data on value-added exports to GDP, which is the correct measure to judge the importance of foreign demand for domestic production, are now available from the WIOD project

(OECD-WTO). Johnson (2014) gives an overview of their findings and consequences for trade analysis.

Calculating the significance of exports for overall demand on this basis reveals that, even in Germany, which takes a lot of pride in being 'export world champion', exports in fact account for only one-third of overall demand for goods and services (2012; see also table 1). For the euro zone as whole, exports accounted, roughly, for only one-fifth of overall demand in 2012 (for a more detailed account, see Feigl and Zuckerkstatter 2012). If one includes the rest of the EU and the European Economic Area the number is even smaller, so that aggregate demand and, with this, the economic performance of the EU depends on domestic demand to the extent of more than 85 per cent. This has important implications for economic policy because if the economies of Europe depend largely on domestic demand the contribution of exports to economic growth is too small to compensate for a decline in domestic demand as a consequence of a declining wage share.

Table 1 presents an overview of overall demand for the EU member states and confirms that the economic performance of EU countries depends overwhelmingly on domestic demand.

Against this background it should be clear that a Europe-wide export-led growth model based on a strategy of wage moderation across the EU is not sustainable in the long run. Advocates of such a model overlook the fact that, in a highly integrated economic area such as the euro zone, in accordance with the 'paradox of thrift', not all countries can cut their way out of the crisis at the same time. Within such an area, one country's domestic demand is another country's export potential (Janssen 2013). Thus, if all countries try to improve their competitive position by cutting wages at the same time in order to improve their export performance, overall domestic demand will collapse, as will, together with it, the flow of imports and exports between the euro-zone countries.



Table 1 Total demand: domestic, EMU, EU, rest of the world (2013 in %)

	Domestic demand	EMU	Non-EMU members of EU	Third countries	Exports, destination unknown
Germany	68	12	7	14	
France	78	10	3	9	
United Kingdom	76	9	1	13	
Italy	77	9	3	11	
Spain	75				25
Netherlands	55	24	7	14	
Sweden	84			16	
Poland	89			11	
Belgium	54				46
Austria	65	19	6	11	
Denmark	66	11	8	16	
Finland	71	8	8	13	
Greece	77	8	4	11	
Portugal	71	16	4	9	
Ireland*	53	17	10	19	
Czech Republic	87			13	
Romania	70	16	5	9	
Hungary	53	26	10	11	
Slovakia	51	21	18	8	2
Luxembourg	43				57
Croatia	70				30
Bulgaria	78			22	
Slovenia	58	23	6	13	
Lithuania	73			27	
Latvia	62	11	13	13	
Estonia	53	15	18	14	
Cyprus	67	8	6	15	3
Malta	38	12	8	14	27

Source: Eurostat.

#### 4. Conclusion: wage-led growth as alternative to internal devaluation

The foregoing discussion of the three basic assumptions of the standard argument has shown that none of them are as straightforward as the proponents of the standard view claim. The discussion has illustrated that there is no direct causal link between the development of unit labour costs, price competitiveness and economic performance. The discussion has also shown that at each critical juncture the standard argument neglects alternative explanatory factors. However, this is not to say that wages and unit labour costs play no role at all in a country's economic performance and growth potential.

On the contrary, as the example of Germany again demonstrates. While restrictive wage developments were not the main drivers of Germany's flourishing export industries, they nevertheless have contributed strongly to the *downside* of the German export-led growth model, which is its largely underdeveloped domestic sector.

In the 2000s, German wage developments were – for various reasons, such as high unemployment, a partial erosion and fragmentation of collective bargaining and the deregulation of labour markets – characterised by two main trends (Schulten and Bispinck 2014). First, wage increases remained largely below productivity growth and were often even below inflation, which led to a further decline of the wage share and an ongoing redistribution from labour to capital income. Secondly, Germany saw a significant increase in income inequality boosted by growing wage dispersion and rapid expansion of the low wage sector.

Both wage development trends had a strong negative effect on the overall development of domestic demand as they significantly dampened private consumption (Sturm and van Treeck 2013). Between 2000 and 2008 average private final consumption expenditure in the EU grew by 16 per cent, which was four times that of Germany, where it was only 4 per cent (Figure 4). Only since the crisis in 2009 has somewhat higher wage growth in Germany contributed to higher growth of private consumption, while wage cuts and wage freezes in many other European countries have led to a stagnation of private demand (Schulten 2014).

Although Germany has obviously gained from its flourishing export industries, the weak development of domestic demand has strongly

Figure 4 Private final consumption expenditure in Germany and the EU, 2000–2013 (2000=100)



Source: Schulten (2015).

undermined the economy's ability to realise its growth potential (Herzog-Stein *et al.* 2013; European Commission 2014). Moreover, the underperformance of the domestic sector has also been – at least partially – responsible for the fact that import growth rates were no longer in balance with export growth (Detzer and Hein 2014). Thus, restrictive wage development in Germany has indeed contributed to the country's rising account surplus and increasing macroeconomic imbalances. However, this was due primarily to the dampening of domestic demand, not the strategy of 'wage moderation'.

In light of the importance of domestic demand for a country's economic performance, rather than focusing on exports a more promising approach would be to pursue a wage-led growth model based on reversing the current trends of falling wage shares and a redistribution from labour to capital income (Lavoie and Stockhammer 2013). Recent research by Onaran and Obst (2015) confirms that domestic demand in the majority of EU countries is wage-led and that therefore a fall in the wage share as a result of the policy of internal devaluation leads to lower growth. This means that the negative effect of a falling wage share on

domestic demand cannot be offset by potentially positive effects in terms of international (cost) competitiveness. This is, of course, completely at odds with the assumptions of the standard view. However, the study by Onaran and Obst (2015) furthermore illustrates that the positive effects for growth of an increasing wage share are even reinforced when introduced in a coordinated manner across Europe.

Implementation of a wage-led growth model would require various measures to strengthen domestic demand. With regard to wages and collective bargaining this would include the following measures in support of an expansive wage policy: the establishment of a decent minimum wage that is not below the low-wage threshold of two-thirds of the national median wage, improved legislative provisions to strengthen the bargaining power of trade unions and measures to increase collective bargaining coverage (Hein und Mundt 2013).

However, it is important not to repeat the mistake of the standard view by putting too much emphasis on wage policy as an adjustment variable. The pursuit of an expansive wage policy can be only one building block in the alternative growth model and needs to be complemented by a whole range of measures in other policy fields. They include increased public investment in social and physical infrastructure and targeted investments to improve non-price competitiveness by enabling countries to upgrade their export basket. In this way the pursuit of a wage-led growth model would acknowledge the multiple functions of wages, as a cost factor, on one hand, and as a driving force of domestic demand and social cohesion, on the other. In doing so, it would avoid the one-sided and narrow interpretations of the standard view.

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