Lost In Contradiction

The IMF And Competitive Wage Dumping In The Euro Area

Ronald Janssen, *Social Europe Journal*, 27 November 2015

A staff discussion note published recently by the IMF addresses the argument that squeezing wages across a large part of the euro area is dangerous and deflationary as it will not improve anyone's relative competitive position while undercutting domestic demand everywhere. Since the IMF has always been a staunch advocate of the ongoing euro area experiment of substituting currency devaluation with wages devaluation, it is worth taking a closer look at its work.

"Beggar-thy-neighbour' wages policy is indeed deflationary….

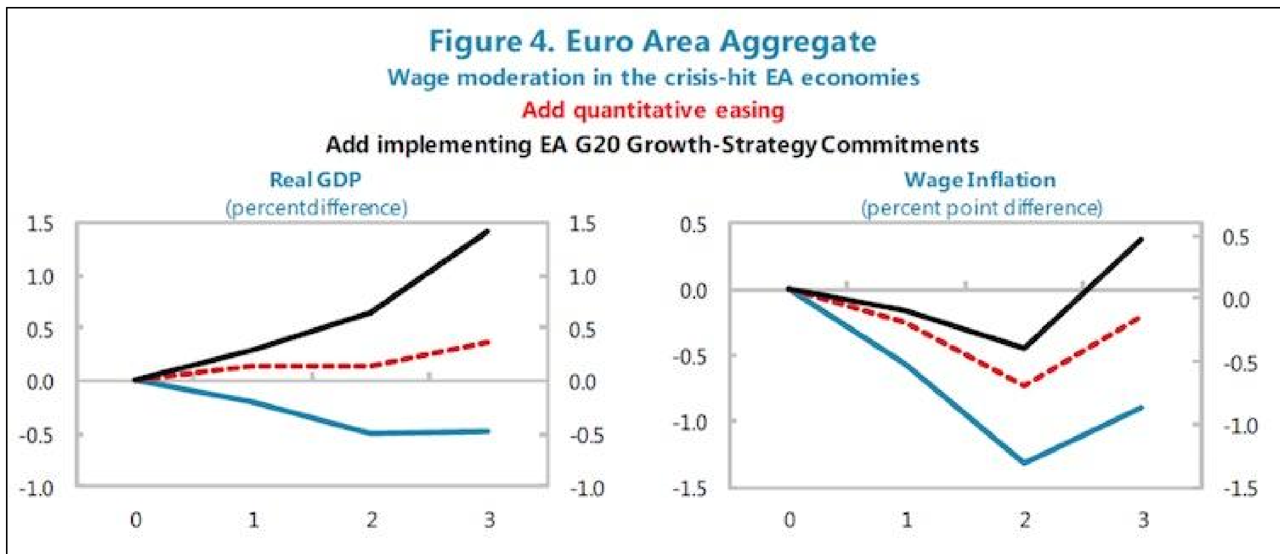
The IMF bases its findings on a simulation whereby nominal wage growth in a set of five countries representing an economic weight of 30% of the euro area (Greece, Italy, Spain, Portugal, Ireland) is reduced by 2 percentage points over the course of two years. Importantly, this simulation is carried out under the assumption that the ECB's hands as regards cutting its interest rates are tied because these rates are already hitting the zero mark. It is also assumed that lower wages growth is fully passed on into domestic prices, implying that there are no cuts in real wages.

To a certain degree, the IMF does underline the negative effects and dangers of a wages devaluation policy that is operated on a common basis. The impact of a wage moderation of 2% carried out in all of the five crisis-hit economies listed above on the overall level of Eurozone economic activity is negative. Euro area GDP tumbles 0.5% below the level that would otherwise have been the case. Meanwhile, inflation is pushed down an additional percentage point. The latter number indeed represents the difference between low inflation and outright deflation.

…. but quantitative easing can fix things.

The IMF, however, does not give up so easily and attempts to save its traditional policy message that wage dumping, even if it is undertaken by many member states at the same time, is still a good thing. To do so, the IMF invokes the alternative policy of quantitative easing (QE). If it is not possible for monetary policy to cut short-term interest rates, then the ECB should refocus its money-printing machine on buying longer term bonds or other financial assets so that long-term market interest rates can be brought down further. The IMF paper then proceeds to do an additional simulation whereby the ECB's QE policy brings down long-term interest rates by 50 basis points.

The graphs below, which are taken from the IMF paper, show how the results change. The red line represents the scenario that combines 2% wages moderation in the five crisis-hit economies with QE by the ECB. It shows that overall euro area output would slightly increase (by around 0.5% of GDP) whereas inflation over the medium-term would barely go down.



In terms of regional composition (not shown here), the rest of the euro area (outside the five countries) would still be losing economic activity (minus 0.4% of GDP). The set of five crisis-hit economies, however, would now gain substantially by increasing GDP by 2%. The latter allows the IMF to stick to the view that, provided the ECB undertakes quantitative easing, squeezing wages is still the right way out of crisis for the debt-ridden economies of the euro area. If this then causes output to drop slightly in the other euro area economies (who are relatively doing better anyway!), so be it.

Quantitative easing: Not the magic bullet the IMF pretends it to be

Quantitative easing is basically a policy whereby the central bank pumps money it is printing into the economy by massively buying financial assets such as sovereign bonds and private bonds as well as, in some cases, even business equity. The key hope is that this extra (and often enormous!) volume of money will, somehow or other, be used by households and companies to consume or invest more.

However, whether printing money succeeds in rekindling aggregate demand depends on what those who own the financial assets actually do with the new money they receive in exchange. Banks, for example, may find it rather difficult to lend out this extra money if households and companies are already highly indebted and thus reluctant to take out new loans. And, while wealthy households (who own the bulk of financial assets) will gain significantly more value by selling their portfolio of bonds and assets at a higher price than they originally paid for them, chances are slim that this liquidity will actually be spent on goods and services as the relative propensity of the 1% or 10% wealthiest households to consume is much lower than average.

The IMF is certainly not unaware of the difficulties involved in transmitting the additional money that is injected into new demand by using asset markets. However, it hides this knowledge in a footnote (number 28):

It is also worth acknowledging that the evidence regarding the effect of unconventional monetary policies on output is not clear cut. Chung and others (2012) conclude that the Federal Reserve's asset purchases (…) did not prevent the zero lower bound constraint from having first order adverse effects on real activity and inflation.

There is however one way to ensure the money that is printed by the central bank effectively ends up in more aggregate demand. If the new money the ECB prints is used to directly fund an increase

in public deficits and additional government spending, preferably public investment, then the impact on aggregate demand is fully ensured.

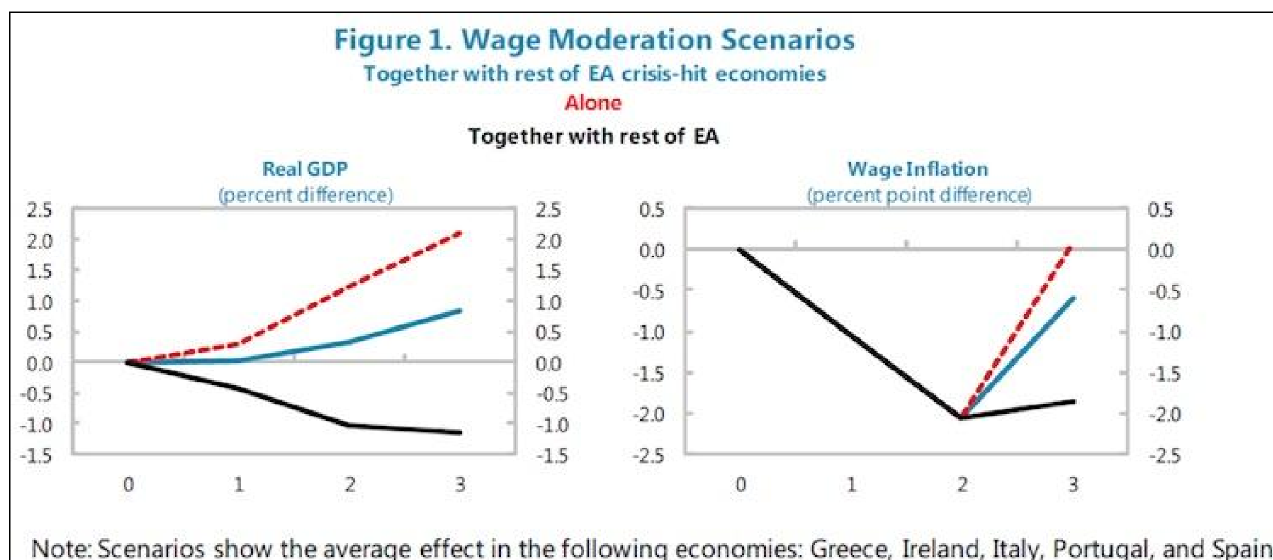
Unfortunately, this road is firmly closed down in the euro area. The first problem is that the ECB is explicitly prohibited by the European Treaty from directly financing public deficits. This legal obligation could perhaps be circumvented by the ECB immediately buying newly issued sovereign bonds on the secondary market from a financial 'go-between'. In that case, however, all of the fiscal rules that Europe has installed, from the Stability Pact to the Fiscal Compact, will kick in and make this a non-starter. The European fiscal framework is indeed always about cutting deficits and never about member states engaging in increased deficit spending to inject additional aggregate demand.

The simulation the IMF keeps silent about: A joint relaunch of wages would boost growth and restore price stability

In the end, the IMF paper continues to promote deflationary wages policy across a large part of the euro area. Given the fact that the EZ economy is already very close to the brink of deflation and given the problems with implementing unconventional QE there, the IMF is prescribing a policy which it knows has no chance of success.

What is the alternative? Here, the IMF itself (most probably unconsciously) indirectly offers evidence that contradicts its own policy advice on deflationary wage moderation.

Indeed, another scenario explored in the IMF paper is what happens in the five crisis-hit countries when the 2% wages moderation is not limited to them but is applied in the entire euro area and this, again, against the background of policy interest rates already hitting the zero mark. It turns out (see the full black line in the graphs below) that the outcome is devastating. The five crisis-hit countries would see a drop in GDP of 1% and, with inflation falling by 2%, get firmly trapped into deflation. The reason is again the zero lower bound. If the pace of inflation goes down while nominal interest rates stay at the same level, then real interest rates increase and (durable) consumption demand and investment go down.



Note: Scenarios show the average effect in the following economies: Greece, Ireland, Italy, Portugal, and Spain.

This scenario gives a clear hint as to what would happen if, as the ETUC is demanding, wages were to be increased in a concerted way across all member states of the euro area. In that case, no member state would lose competitiveness relative to another as all would move wages upwards.

Moreover, with inflation far below the ECB's price stability target, the ECB has no reason whatsoever to pull the trigger on interest rates in order to get inflation back down again by stifling growth and disciplining wages. However, if inflation goes up and the ECB does not increase nominal interest rates, then real interest rates go down and aggregate demand goes up.

In other words, the forces at work are exactly the inverse of the IMF scenario above in which all euro area members moderating their wages. The results can therefore be expected to be the inverse of the outcomes depicted by the black line in the previous graphs. Output in the crisis-hit economies will not fall but increase by 1%. And inflation would be lifted from (below) zero to a rate that is closer to the ECB's price stability target.

The question is therefore why the IMF, instead of inventing all possible and impossible arguments in order to continue with the dangerous experiment of wage devaluation, does not further explore the positive case for rebuilding wages institutions and dynamics across the euro area. Could it be a matter of ideological blinders?