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12. The role of wage-setting in a growth strategy for Europe[1]

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INTRODUCTION

Economic performance in Europe has been disappointing since 2000, when EU heads of state and government agreed, at the Lisbon European Council, to make the European Union 'the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion'. In the Euro Area, economic growth averaged just 1.4% from 2001 to 2004, compared with 2.7% from 1996 to 2000. Employment growth in the same periods also halved and the rate of unemployment rose by a full percentage point from an already unacceptably high level.

The explanation of this dismal performance offered by mainstream economists, and accepted by parties across much of the political spectrum, is simple: labour market and other institutional imperfections – and thus a 'lack of structural reform' – are making it impossible for Europe to compete against more flexible advanced capitalist countries (like the US) and the rising low-wage economies of Asia, while such institutional rigidities raise unemployment by maintaining wages above 'equilibrium' levels.

Ultimately it matters little that the facts (not least Europe's rather good economic performance in the late 1990s and the growth and employment patterns *within* Europe) do not support this simplistic view. European governments, spurred on by the Lisbon Strategy, have embarked on a series of liberalising reforms, particularly in the area of labour market and welfare state institutions. To date these reforms appear, if anything, to have worsened an already difficult situation. At the time of writing, Germany, which accounts for one third of EMU output, appears set to embark on a further round of cutbacks and tax increases; meanwhile the European Central Bank (ECB) has begun to raise interest rates. It is hard to see how, under such conditions, the fragile upturn that had just begun

to manifest itself after five years of virtual economic stagnation can be sustained.

From both the academic and political margins, there has been a sustained critique of this mainstream view: Europe's economic woes are due not to its labour market institutions or other 'market rigidities', but, largely, to inappropriate macroeconomic policy. Both the monetary policy of the ECB and national fiscal policy, as constrained by the Stability and Growth Pact, have come in for criticism, and a range of reform proposals made.

This contribution is located broadly within that second, Keynesian-inspired tradition. However, it deals less with macroeconomic – monetary and fiscal – policy itself, focusing rather on the contribution that wage-setting can play, *in conjunction with* a more expansionary macroeconomic policy stance, in addressing Europe's economic and employment growth problems. The aim is to set out the role that wage-setters along with the monetary and fiscal authorities would need to play to achieve higher economic growth over an extended period, bringing Europe close to what might be considered 'full employment'. Attention will be paid to the coordination requirements of such a strategy.

The proposals made here need to be seen in the light of 'political economy' constraints. As I have argued in previous work, the Maastricht architecture is effectively 'set in stone' (Watt, 2005). Fundamental changes to that 'regime' are unlikely, except, possibly, by way of a major economic crisis, whose political outcomes might well prove less rather than more favourable. Consequently, an attempt is made here to build on existing institutions and to argue, where possible, in ways that can be related to elements of mainstream thinking and policymaking.

The paper is structured as follows. Section 1 briefly reviews the treatment of wage-setting and wages (or incomes) 'policies' in post-Keynesian thought, showing how the focus has moved away from incomes policies since the end of 'full employment capitalism' in the 1980s. It also discusses the role of the non-accelerating inflation rate of unemployment (NAIRU) in mainstream thinking, and how it might be conceived in a Keynesian-inspired policy perspective. Section 2 presents a simple model of the interaction between 'wage policy' and 'macroeconomic demand policy' in the context of a monetary union. An optimal trajectory for nominal wage growth and nominal demand is set out. Section 3 considers the extent to which such an optimal constellation can be realised in a real-world situation such as EMU and what reforms this would require. The paper concludes with some brief reflections on policy and theorising in the Keynesian tradition.

1. WAGE-SETTING IN POST-KEYNESIAN THOUGHT AND THE ROLE OF THE NAIRU

In 1979, just before the shift in economic policy paradigm that followed the elections of Thatcher and Reagan, Alfred Eichner edited *A Guide to Post-Keynesian Economics*, one of the first overviews of post-Keynesian thinking. In his Introduction Eichner describes as 'one point on which economists with a post-Keynesian perspective are likely to agree':

> The conventional policy instruments . . . do not moderate, except most imperfectly, the income claims against available output so that the growth of nominal income over time will be equal to the growth of real income, without the need for rising prices to bring the two into balance. It is for this reason that post-Keynesian economists, instead of asking whether an incomes policy is necessary, have generally moved on to the question of how an incomes policy can be made to work effectively and equitably (Eichner, 1979: 17)

Most of the other contributors, whether discussing income distribution, pricing, or the labour market, also refer to the need for (and in some cases the problems of) incomes policies. While expressing some scepticism about controlling wages, Basil Moore closes with three basic policy alternatives:

> Continuing and possibly increasing wage inflation . . . . A slump and a massive rise in unemployment to keep money wage increases low. Or some sort of incomes policy. These three alternatives exhaust the set. There are no other games in town. (Eichner, 1979: 138)

Moreover, closing the book with 'A look ahead', Eichner states:

> The preceding essays have been like a chorus in arguing that inflation cannot be brought under control – except at too great a cost in terms of reduced output and higher unemployment – unless the conventional policy instruments for regulating the economy are supplemented by an incomes policy (Eichner, 1979: 174).

The Elgar Companion to Post-Keynesian Economics, edited by J.E. King can be seen as a modern equivalent to Eichner's book, providing an overview of post-Keynesian thought at the start of the 21st century (and with contributions from a number of the authors in the earlier book). Of the more than seventy-five entries, there is no entry devoted to 'incomes policy' itself. There is a discussion of Weintraub's proposal for a 'tax-based incomes policy'. But even this is couched in terms of historical interest: Weintraub's work may prove useful 'should stagflation return' (Seidman in King, 2003: 336). Apart from that there are only fleeting references to wages policy, again often in an historical context. Discussing 'Economic policy',

in the same book, Malcolm Sawyer does mention incomes policy, as being supported by 'some' post-Keynesians, but the emphasis is placed clearly on policies to ensure sufficient investment to prevent inflationary bottlenecks.

Numerous other examples could be given of the preoccupation of earlier post-Keynesian economists.[2] The interesting question in the present context, though, is what explains the virtual abandonment or at least sidelining of this line of enquiry by most contemporary post-Keynesians, illustrated by the *Elgar Companion*.[3]

One obvious point is the decline in inflation. Incomes or wages policies were seen primarily as a means to reduce inflation, which in the 1970s was unacceptably high. Now that inflation has been conquered – albeit using hugely costly deflationary macroeconomic policies – Keynesian-oriented economists have lost interest in incomes policies as a means to reduce it.

Another possible reason lies in changes in collective bargaining systems. In many countries, and especially in the UK and the US, collective negotiation of wages, which is a prerequisite for getting a 'handle' on nominal wage developments, has been eroded in favour of more 'decentralised' forms of wage bargaining; see for example in Traxler *et al*. (2001) and Schulten (2004). This has been accompanied by declines in the union density and collective bargaining coverage indicators compiled by the OECD. Thus it can be argued that, even if a wages policy can in theory be a useful weapon in policymakers' armoury, it is not a practical alternative because the institutional basis is lacking.

A third reason is a concern that a wages policy is one-sidedly directed at labour, and will thus tend to promote a shift (or exacerbate an existing trend) in the functional distribution of income from labour to capital. To the extent that such a redistribution, via its effects on demand, is also held to be detrimental to growth and employment, such a policy is claimed to be both unjust and, ultimately, ineffective.

Yet arguments can be adduced against all three positions. To the first, I argue presently that a policy of ensuring appropriate net wage-setting is, at heart, a policy for growth and employment. I discuss the other two arguments more fully in Section 3. Suffice it to say at this stage that developments during the 1990s show that the trend to bargaining decentralisation is neither pervasive nor irreversible, and one of the main aims of focusing on a guideline for nominal wage growth is precisely to prevent a further deterioration in the functional distribution of income.

Unemployment and inflation can be seen as two sides of the same coin in a capitalist economy. This is evident from the post-Keynesian quotes above (and is, in principle, not a matter of dispute between different schools of economic thought). Thus in principle, an incomes policy approach that is suitable to reduce inflation without causing additional unemployment –

the issue in the 1980s – is also suitable to reduce unemployment without re-igniting inflation, the issue of today. Indeed, given the current institutional and political environment, *any* feasible proposal for faster growth and employment *must* address the issue of how inflation can be kept in check (see also Allsopp, 2006).

This puts centre stage the concept of the non-accelerating inflation rate of unemployment (NAIRU) to which many post-Keynesians are highly averse. Without entering into the extensive debate on this concept (amongst others, see Layard *et al.*, 1991; Galbraith, 1997; Sawyer, 2001; Hein, 2004; Stockhammer, 2004) a number of points are relevant to the analysis here. The NAIRU concept is used by mainstream economists to justify a focus on dismantling supposed labour market rigidities as the solution to unemployment. This requires (at least) that for any economy the NAIRU is: (a) a reflection of those rigidities, and (b) its position is known. Stockhammer (2004: 56 ff) terms this the 'NAIRU story'. All Keynesians reject this approach and the concomitant policy conclusions.

However, as Stockhammer and other post-Keynesians recognise, the NAIRU concept itself is very close to Keynesian ideas of inflation resulting from social conflict over incomes (rather than being caused by changes in the money supply). The point here is that, in conjunction with a central bank with a sole mandate to control inflation (and, in my view, the power to do so under most conditions), the conflict theory of inflation becomes a conflict theory of unemployment. The NAIRU does play a role in the 'story' told below, but a very different one from the mainstream narrative.

2. A MODEL OF MONETARY-WAGE POLICY COORDINATION IN AN EMU-TYPE CONTEXT

This section[4] describes a simple model of how actors could behave to ensure a consistent policy mix that maximises growth and employment opportunities while ensuring price stability. It begins by abstracting from national differences, considering a single economy with a single monetary, fiscal and wage policy. In a second step we move closer towards the reality of EMU, with a single monetary policy, but national fiscal and wage policies.

a. A Single-Country Model

In this model it is assumed that, together, the public authorities can determine, in a medium-run perspective, the rate of growth of nominal demand in the economy. Simplifying further, the central bank is assumed to set short-run nominal interest rates in such a way that aggregate nominal

demand (M) expands at a given rate (m – throughout rates of change are indicated by lower case letters). This aggregate nominal demand has a quantity and a price component,[5] so that changes in nominal demand are the sum of changes in real output (y) and prices (p).

$$m = y + p \text{ or } y = m - p.$$

Output is also defined as labour input (employment, E) multiplied by the productivity of labour (Y/E),

$$Y = E * Y/E$$

Thus changes in output (economic growth) are also equal to the sum of the change in employment and in productivity (π), or

$$y = e + \pi$$

Combining the two equations for y and rearranging we obtain our basic equation:

$$e = m - p - \pi$$

that is, the rate of employment growth is equal to the growth of nominal demand less inflation, less the rate of productivity growth. We can now consider, in this simple model, 'optimal' behaviour by the different actors.

The task of an inflation-targeting central bank, as in the ECB mandate, is to ensure that inflation stays, in the medium term, close to a target (p^*).

The question is, what determines how nominal demand is transposed into increases in y and p. In standard models it is the level of domestic aggregate demand with respect to the existing productive potential that does this.[6] Assume that, at the outset, the rate of inflation is constant at the central bank's target. At this point the stock of existing capital is at its 'normal' capacity utilisation and the level of unemployment is such that trade unions are sufficiently weakened to prevent them pushing through inflationary wage increases, firms cannot raise prices, and the economy is considered to be in equilibrium: inflation will be constant at the target rate (p^*), output will be equal to productive potential (Y^*) and unemployment will be at the NAIRU. In the standard model, this is nirvana: macroeconomic policymakers can do no better than this. If the authorities expand nominal demand beyond this point inflation will result (m will no longer raise y but merely p). It is the lack of pricing power of workers and firms

(wage- and price-setters) resulting from 'sufficiently high' unemployment that ensures price stability.

Clearly this standard model assumes – among other things – that wages are determined in a simple way such that, when unemployment is above the estimated NAIRU, the growth of nominal wages is higher than the sum of productivity and the current rate of inflation, and below that sum when unemployment is below it. In a market-driven wage-setting environment (provided the NAIRU estimate is 'right' and everyone, the 'representative' wage-setter and the central bank believes in it) this may be true.

However, in reality nominal wages are set in complex institutional structures. Particularly in highly organised, centralised bargaining environments, which remain typical in much of Europe (Schulten, 2004) the 'social partners' reach agreement on rates of nominal wage growth for thousands or even millions of workers at a time. Suppose that they can set this rate at will. Specifically, assume that wage-setters agree on (and are able to enforce) a formula whereby, whatever the current rate of inflation and level of demand, nominal wages increase at a rate equal to the rate of medium-run labour productivity growth plus the target inflation rate of the central bank. Subject to the further condition that the scope for price-setters to raise prices is tied to the rate of wage increases – in other words that in the medium term the capital and wage shares of national income and thus the mark-up of prices over costs are constant – in such an environment, when M increases Y will increase by the rate of change of M, *whatever that rate is*, minus the target inflation rate of the central bank. Thus we can write:

$$y = m - p^*$$

Under these conditions, the labour costs of producing a unit of output are the decisive variable in determining inflation and thus the extent to which rising nominal aggregate demand is 'lost' to price increases rather than raising output and employment.

The two variables determining nominal unit labour costs (ULCs) are the growth of overall labour costs and of productivity. In the short to medium run, the growth of productivity is relatively insensitive to policy influence.[7] Thus nominal wage growth becomes the decisive variable determining the distribution of M between Y and P. Formally we arrive at the simple equation that, given the above assumptions,

$$e = m - w$$

In other words, employment growth is equal to the rate of nominal demand growth minus the rate of wage growth (see Koll, 2005: 189). Mathematically

this result is obtained by inserting the assumed $w = \pi + p^*$ into our basic equation $e = m - p - \pi$.

This, in turn, puts the institutional mechanisms of (nominal) wage determination and nominal demand creation centre stage. Provided wage-setters (can) set nominal wage growth at the rate of productivity growth plus the target inflation rate of the central bank, the central bank is able to set interest rates at the level that expands nominal demand at the rate required to hit a target rate of growth for the economy. For a given productivity trend, this also determines the rate of employment growth.

An important implication of this model is that, subject to its conditions, the NAIRU, as traditionally understood, loses its role as a guideline for monetary policy (see Hein, 2004). So-called 'structural reforms' (lowering unemployment benefits, weakening trade unions and so on) whose aim, in different ways, is to reduce the NAIRU become superfluous, if not harmful. This is the result, of course, of the assumed ability of wage-setters to set the pace of nominal wage growth autonomously. For this model and the policy prescriptions associated with it to be considered relevant, we cannot duck the question of how long a process of nominal demand expansion *cum* stability-oriented wage development can continue. Otherwise, it would appear that there is no limit to the increase in output and employment. We return to this question in Section 3a. Before doing so, we must consider some implications of the fact that, in EMU, wages and fiscal policies are largely set at national level, while monetary policy is set at the level of the currency area as a whole.

b. A Multi-Level Model

Moving one step closer to reality, any consideration of the case of a single monetary policy with multiple wage-setting and fiscal 'authorities' gives rise to some complications. They are not those that might appear at first sight, however. It is frequently argued, for instance, that both productivity levels and trends and collective bargaining institutions in Europe are too diverse to permit wage coordination. This argument rests on a misunderstanding, however. Such diversity does not pose problems in itself: all that is required is for aggregate wage trends at the national level to conform to the national-productivity-plus-target-inflation-rate rule. This is easily shown.

Consider two countries in a monetary union. Let the rate of productivity growth in the first country be 2%, and in the second 3%. The (common) target inflation rate is 2%. Then a sufficient condition for medium-run price stability (and also for an unchanged competitive position between the two countries) is a nominal wage increase of 4% and 5% respectively.

For a currency area (*CA*) of *n* countries (*a*, *b* . . . *n*) we can write:

$$w_a = \pi_a + p^*,\ w_b = \pi_b + p^* \ldots\ldots\ldots w_n = \pi_n + p^* \Rightarrow w_{CA} = \pi_{CA} + p^*$$

Clearly, the result for prices in the currency area is independent of the relative size of the countries, as unit labour costs in all countries will grow at the same rate, namely the target rate of the central bank. Moreover, the institutional arrangement that generates this outcome in each country is, in principle, irrelevant.[8]

Matters are more complex, however. So far we have talked only in terms of average inflation rates. While this is the key concern of the central bank, this overall figure consists of the weighted average inflation rates in the member states. For various reasons these are likely to differ, and, moreover, the patterns of such differences will also change over time. This national rate is likely to be of greater interest to national wage-setters and fiscal policymakers. It can be argued, as in the above equation, that if all actors, in their respective national contexts, stick to the overall guideline based on the common inflation target, these inflation differentials will disappear. This is logically correct. However, it assumes that inflation differentials are 'a bad thing', that they should be eliminated. Or, to put it another way, that the initial competitive position of countries (their real exchange rates) in the currency area is in equilibrium and also remains that way. This is unlikely to be the case, however. Differential inflation rates remain, even within a developed monetary union, and certainly within an 'immature' union, an important adjustment mechanism for national economies.

Two cases can be considered.[9] The first is where countries enter the monetary union at an incorrect real exchange rate. Countries that enter at too high (low) a rate will have to undergo a period of below-average (above-average) inflation if they are to regain competitive equilibrium. If this adjustment is blocked by adhering to the above wage norms, the former countries will suffer higher (lower) unemployment, with knock-on and probably pro-cyclical effects on fiscal policy. The second case is where, even though countries enter at the right rate, subsequent developments necessitate an adjustment of the real exchange rate. Again, two main possibilities come to mind. One is the case of an asymmetric shock, a shift in commodity prices or a shift in demand for certain products, that disproportionately affect certain countries of the currency union. The other is the need to allow for what might be called 'historical' adjustment mechanisms. The obvious example here is the Belassa–Samuelson effect. Countries undergoing a catch-up phase tend to have a lower domestic price level at the exchange rate that ensures external balance. As their productivity in the traded sector rises, this pulls up wage levels also in the

non-traded-goods sector, and the price level rises. This is a normal and welcome adjustment process, and the wage norm should not seek to counteract it (and the inflation target of the central bank should be high enough to allow it).

On the other hand, it is clearly not the case that national wage norms should focus on the current national inflation rate. This would perpetuate inflationary (or disinflationary) processes that result from imported inflation, overheating and the like, and destroy the inflation-containing properties of the model.

From this we can draw the provisional conclusion that the national price component in the wage norm should normally lie *between* the central bank target rate and the national inflation rate. What is required is that the (weighted) average of the price components in national wage norms is consistent with the overall price target, that is, that countries in which wage and price inflation is above average are offset by those in which it is below, and that this reflects necessary adjustments in competitive position (and thus that they come to an end or are reversed as circumstances change).

Thus the wage-policy condition for a currency area with countries a to n needs to be rewritten as follows:

$$w_a = \pi_a + p_a^*,\ w_b = \pi_b + p_b^* \ldots\ldots\ldots w_n = \pi_n + p_n^* \Rightarrow w_{CA} = \pi_{CA} + p^*_{CA}$$

where p_n^* represents the country-specific target inflation rate for country n. In each case this rate will lie between the current national inflation rate and the target rate for the currency area as a whole, in other words either $p_a < p_a^* < p^*_{CA}$, or $p_b > p_b^* > p^*_{CA}$ for below and above-average inflation countries respectively. In addition the weighted average of the national price components must be equal to the overall price target: $\alpha p_a^* + \beta p_b^* + \ldots \theta p_n^* = p^*_{CA}$ where α, β, . . ., θ represent the relative weights of the countries in the inflation 'basket' of the central bank (and sum to 1).

c. A Consistent Trajectory of Nominal Wages and Nominal Demand for the Euro Area in such a Model

The model is clearly a gross simplification of reality. Nevertheless, before turning to consider ways in which it might be implemented, at least partially, in the real-world situation of EMU, it is useful to plug some numbers into the model, to see the orders of magnitude involved. Given that since 2000 the economic and employment policies of the EU and its member states are supposed to be occurring under the umbrella of the Lisbon Strategy, the parameters of that strategy are taken – arbitrarily – as the normative point of reference.

The Lisbon Strategy – running from 2000 to 2010 – was predicated on achieving economic growth of 3% and employment growth of 1% per annum (p.a.), implying productivity growth of 2%.[10] Price stability is defined as a medium-run ceiling of 2% p.a. increase in the price index (*HICP*). The above equation ($e = m–w$) indicates that, if productivity remains unchanged, there is only one consistent trajectory for the other variables: the rate of nominal demand growth should be around 5% p.a. on average, while nominal wages for the Euro Area as a whole should increase at around 4%. As indicated above, nominal wage growth in individual countries should be somewhat higher or lower to permit necessary adjustment processes.

Regarding the appropriate trajectories at national level, it is difficult to be more precise about the 'correct' price component for the wage settlement in each country. Determining the degree of intra-area adjustment required is an empirical matter. For instance, while some authors have expressed scepticism concerning the quantitative importance of the Belassa–Samuelson effect in the Euro Area (such as DIW, 2005), differences in national price levels remain significant. Eurostat purchasing power parity estimates indicate that between 1999 and 2004, the price level fell in Germany by around five percentage points (p.p.) with respect to the EU15 average (from roughly 110% to 105%) whereas it rose in Spain by about the same amount (from roughly 80% to 85%). On this basis, and assuming a slow but consistent trend towards a more equal price level within a monetary union, an extended period of above-average unit labour cost and price increases in Spain and lower-than-average in Germany would be expected and justified.

On the one hand, the need to allow for competitive adjustment makes it harder to decide on the appropriate quantitative guideline for national wage policy in any given circumstances. The lack of clarity about whether prevailing inflation differentials are justified or need to be counteracted by wage policy will exacerbate the already difficult task of coordinating wage bargaining. On the other hand, such a guideline will be easier to follow in the sense that it reduces the extent to which social partners or trade unions need to impose settlements on their members, because the distance between the pay norm and the rate that market pressures will be pushing towards will be less – in both directions – if the price component of the wage increase is closer to the current country-specific inflation rate.[11]

We have so far considered the monetary union as a closed economy. However, prices depend not only on domestic costs but also on changes in the prices of imports. This need not be modelled explicitly. In fact, domestic actors should retain their (medium-run) orientation irrespective of changes in import prices. Consider the case of rising oil prices. In the past this has led either to an attempt to raise nominal wage demands with

an initially accommodative but subsequently all the more restrictive demand-side policy (a typical reaction pattern in the 1970s and 1980s) or a non-reaction by nominal wages but nevertheless a significant tightening of monetary policy, as occurred in 2000 in the Euro Area.[12]

In such a case, if aggregate nominal wage growth continues to be oriented towards trend productivity growth plus the target inflation rate, higher import prices will not be passed through into wages and domestic prices. Headline inflation will initially rise, but any increase will be contained by the 'anchor' function that nominal unit labour costs have on medium-run inflation.[13] There will, in short, be no second-round effects, and no need to tighten macropolicy. It is important that this neutrality by wage and aggregate demand policy is applied symmetrically, that is also in the case of a transitory deflationary external shock.

3. REAL-WORLD RELEVANCE OF THE MODEL

The model described above has certain properties derived from the identities used and, in particular, the assumptions made. This section considers the extent to which these assumptions either hold in the real world or can be made to do so by means of appropriate reforms and behavioural changes.

The relevance of the model for policy purposes can be called into question along five main lines:

a. the public authorities (or the central bank) cannot control the path of nominal aggregate demand
b. the social partners (or trade unions) cannot control the path of nominal wages
c. the link between wages and prices is too unreliable (control of wages does not ensure control of prices)
d. productivity is endogenous and cannot be assumed constant
e. the model requires coordination mechanisms between the actors that do not exist and are unlikely to be developed.

a. Controlling Nominal Demand

Post-Keynesian economists are united in, amongst other things, their rejection of theories of money and monetary policy centred on the exogenous control of monetary aggregates by the central bank, and their rejection of the neutrality of money. Beyond that there are considerable differences of opinion on issues such as the effectiveness of monetary policy in demand

management. The proposal advocated here is consistent with what is consensual in the post-Keynesian view.[14] On the effectiveness of monetary policy, it sides with those that believe that, at least in a large advanced economy, like the Euro Area, the central bank can steer nominal demand reasonably effectively in a medium-term perspective. It is clearly a difficult matter to assess the quantitative impact of monetary policy, because of the difficulty of isolating it from other influences, the self-fulfilling role of expectations in determining that influence, and so on. The ECB assumes an impact on real GDP of about 0.6 p.p. after three years from a 0.5 p.p. rise in base rates (ECB, 2002: 56). Whatever the precise estimate the key point is that the central bank can change rates costlessly, by any amount (subject to a lower bound) and at any time. This gives it operational advantages over fiscal policy. So even if the effect is weak, it merely means that rates must be shifted more often or more substantially. Certainly the ECB would find it easier to manage demand (and to cope with intra-area adjustment needs) if the inflation target were somewhat higher.[15] Of course the bank cannot reduce nominal rates below zero. But even here, it can purchase a whole range of assets from banks for central bank money, injecting nominal demand into the economy.

Clearly, monetary policy is not omnipotent. Its impact is always clouded by some uncertainty and is subject to lags. Moreover, while 'dear money' can be counted on to arrest a boom, if the 'animal spirits' of investors are sufficiently depressed, no amount of 'cheap money' will turn the economy around. In such situations there is a clear case for direct deficit-financed spending by government.

In principle, the model could operate with fiscal policymakers setting nominal demand growth. However, I tend to the view that, in the medium run and in 'normal' circumstances, because of its greater flexibility monetary policy should normally take the lead, at the aggregate level, in managing nominal demand. In a monetary union such as EMU, especially, this would also facilitate the policy coordination process and require less of a change compared with the current 'regime'. There is thus no disagreement of principle with those post-Keynesians who are more sceptical about the capacity of monetary policy to generate sufficient aggregate demand.[16] The choice of monetary versus fiscal policy to manage demand can be seen as a balancing act, the outcome of which will depend on a number of specific features of the economy concerned at any given time.

What, then, is the role of fiscal policy, in such a model, and in the specific context of EMU? In a unified national context, there is, in my view, a strong case for a 'golden rule' for fiscal policy in 'normal times'.[17] This permits deficit-financing of 'capital spending'[18] while allowing the automatic stabilisers to help smooth the cycle. Such an approach also reduces the risk of

conflicts between monetary and fiscal policy concerning responsibility for demand management.

However, fiscal policy certainly needs to play a much more active role in the context of a monetary union. Given a common interest and exchange rate, it represents – along with the real exchange rate set, primarily, by wage-setters – the one main instrument left to national policymakers to offset shocks and promote necessary intra-area adjustments. It is mainly by constraining governments' ability to use this instrument that the Stability and Growth Pact has done so much damage. National fiscal policy can play a potentially important role in the model suggested here by using the national Phillips curve to help wages adjust to the desired national trajectory (for a more developed wage-fiscal strategy at national level see Hancke and Soskice, 2003). Indeed for countries lacking appropriate collective bargaining institutions this is the only way to steer nominal wage growth, and the policy recommendations linked to the 'NAIRU story', with all their negative social implications, become difficult to escape.

b. Controlling Nominal Wages

In the discussion so far, we have heroically assumed that nominal wages are autonomously set by wage-setters, implying a monopsonistic trade union, or at least a highly centralised and cooperative collective bargaining system able to prevent individual wage bargains that contravene the agreed norm. Wage-setters can thus make a credible commitment to other actors to ensure a given rate of nominal wage increases. Although there is no space here to discuss collective bargaining structures in detail (Schulten, 2004; Traxler *et al*., 2001; Janssen and Mermet, 2003), both common sense and historical experience in national economies with social pacts, social contracts and the like suggest that, while a degree of control can be exerted by organised collective bargainers, that control is limited. Even if formal bargaining coverage is high, actual wages differ in practice from collectively agreed pay rates (wage drift). The 'devil is in the detail' and it is very difficult to determine the exact value of pay settlements in such a way that it can be compared with the wage norm. More basically, it is undisputed that an expansion of demand and falling unemployment will, at some point, lead to a breakdown of nominal pay discipline and inflationary pressure.

Is this a valid argument against the policy approach advocated here? It certainly means that the model will never work in reality in the 'perfect' way illustrated above. But in terms of real-world policy-making, the argument, while it certainly poses challenges, is not a fatal one. For it merely means that it is not possible in reality to bring the NAIRU to zero (to render it entirely indeterminate). Yet this is not necessary either. The litmus test on

which the strategy, as a 'policy recommendation', must be judged is whether, by its use, *unemployment can be sustainably brought down below that prevailing under the existing, non-cooperative regime*.

Moreover, despite some recent trends towards decentralisation, most European workers continue to be covered by multi-employer collective agreements, typically at the sectoral level (Schulten, 2004). Contrary to what media reports might lead one to believe, not only does collective bargaining coverage remain high, but the 1990s saw a resurgence of 'social pacts', a new form of national corporatism that has led to a centralisation of wage negotiations in a number of European countries (Fajertag and Pochet, 2000). Indeed, there is an extensive literature suggesting that coordinated, centralised wage bargaining is associated with better macroeconomic outcomes (Traxler *et al*., 2001; OECD, 1997; IMF, 2003; Howell, 2004). This is not least because a coordinated wage policy avoids the economic fluctuations that arise from using the national Phillips curve, in both directions, to bring the economy back to a sustainable path.

Meanwhile European trade unions are engaging in various activities to coordinate their wage demands and ensure that wage developments are consistent with non-inflationary growth, while ensuring workers a balanced share of rising national income. Space constraints preclude an extended description (see Schulten, 2004; Janssen and Mermet, 2003). Experience with these wage norms so far has been mixed. The coordination mechanisms rely on similar forces (benchmarking, peer pressure) as the EU's 'open method of coordination' and suffer from the same limitations: they are fine in good times, but when under pressure, they exert little binding power over trade unions concerned primarily with national priorities and constraints. It is not yet the case that national union federations see such forms of coordination as being in their vital interest.

Ultimately, though, the extent to which nominal wage trends can be controlled cannot be known in advance. It must, in practice, be the subject of an iterative social experiment in which confidence is built between the actors (social partners and monetary authorities) and demand is expanded slowly to the point where wage pressures start to occur. This iterative process must be managed: that is why coordination mechanisms are needed to underpin the process (see sub-section e).

c. Price–Wage Link

I will address the issue of the wage–price link, and the extensive literature concerning the distribution between wages and profits, merely by way of reference to the empirical evidence. There is a very close empirical relationship between changes in nominal unit labour costs (ULCs) and changes

in prices (Watt, 2006). This is very much in line with the Keynesian/post-Keynesian view that, as a class, workers cannot raise their real wage by raising nominal wages because the latter are the prime determinant of price developments (mark-up pricing).[19] It is true that the wage share has declined slowly but steadily in Europe during the last 20 years or so (ULCs below inflation). But this has reflected high unemployment in most countries: the wage share has stabilised or more recently risen in low unemployment countries such as the US and UK. Thus to the extent that growth is boosted and unemployment brought down within the strategy advocated, the link between ULCs and prices should become closer.

d. Productivity Impact

Productivity is assumed to be exogenous in the model purely for simplicity. Mainstream economists tend to assume that raising employment rates is associated with declining rates of productivity growth, because the additional labour brought into the production process will tend to be of below-average skill level. However, there are many reasons why faster demand and output growth might lead to faster productivity growth. These include higher capacity utilisation, economies of scale, faster growth of the capital stock and thus the incorporation of new technical knowledge, greater incentives to train workers and to undergo training, and so on (McCombie and Thirlwall in this volume, and Watt and Janssen, 2005).[20]

In any case, for the purposes of this exercise it is not necessary to take an *ex ante* view. Because of the difficulties of distinguishing between cyclical and structural changes in productivity, nominal wage growth should be based on medium-term productivity developments. This norm should be invariant to short-run changes, but be potentially adaptable once firm evidence emerges of a structural shift in productivity in either direction.

e. Need for Coordination

I have dealt with the issue of policy coordination at greater length elsewhere (Watt, 2006; Watt and Hallwirth, 2003). To put it most succinctly: a potentially appropriate coordination instrument – the Macroeconomic Dialogue (MED) – does already exist, and although it is currently not effective, it is politically feasible to make it so. Just as is the case with control over aggregate nominal demand and nominal wages, coordination mechanisms do not have to be perfect in order to generate growth and employment outcomes that are markedly superior to the prevailing situation.

The Macroeconomic Dialogue was established in 1999, just after the start of EMU.[21] Its aim is to contribute, via an improved macroeconomic

policy, to a 'sustainable reduction of unemployment'. The specific contribution of the MED is to institute a dialogue between the actors responsible for the policy mix – monetary, fiscal and 'wage' policies – to promote positive interaction between the actors.

The MED takes place twice a year at political level, in each case prepared by a meeting at technical level. The discussions are confidential and there is currently no provision for issuing formal statements or reports as an institution: 'The substantive core of the MED is an exchange of information and ideas' (Koll, 2005: 183). Participants discuss their analysis of the economic situation and prospects, formulate their own intended responses to the unfolding situation with a view to the goals of higher employment and non-inflationary growth and, lastly, state their expectations of how other actors should respond.

Thus, on the one hand the MED is clearly located – in the terms of our model – at the key nexus for improving growth and employment outcomes at the European level. If Europe suffers from coordination failures, especially those linking monetary and wage policies, then the MED is 'in the right place' to resolve them. On the other hand, it is extremely weakly institutionalised, characterised by a very loose form of 'soft' coordination. Thus its 'purchase' on actor behaviour is also extremely limited, even at the European level. On top of this comes the problem of the inadequate links between the European and the national level, where fiscal and wage policy decisions are very largely taken.

Reform proposals follow on from this:

- accelerate the rhythm of these meetings[22]
- shift their focus away from discussions about 'the facts' and their interpretation, to a more policy-oriented debate focused on consistent, quantitative development scenarios for the European economy and the mutually compatible actions by participants that are required to achieve them
- establish a permanent secretariat to manage coordination and oversee the accumulation of technical knowledge
- establish a parallel structure of national MEDs building on national social partnership traditions and structures but feeding into the EU-level MED.

The key concern must be to develop the institutional interactions and the expertise and knowledge at technical level on which an expanded Dialogue at political level would conduct an ongoing, intensified dialogue on macroeconomic issues. This would make the process more open, transparent and politically legitimate as its importance in policymaking increases. Alongside more

regular and structured discussions, ways should be developed to enable informal coordination in response to sudden developments.

CONCLUDING REMARKS

Economic growth and employment outcomes in Europe, and especially in the Euro Area, have been disappointing, contributing not least to widespread disaffection with European integration. Economists in the Keynesian tradition are convinced that this reflects, above all else, failures of macroeconomic policymaking.

Numerous recommendations for fundamental reforms of the economic policymaking architecture have been made, in particular changes to the 'rules of the game' for fiscal and monetary policy. However welcome they would be in strictly economic terms, however, they face the huge political problem that altering rules and institutions that have been established by intergovernmental Treaty between 15 or more member governments requires unanimity (Watt, 2005: 238 ff.).

Drawing partially on a tradition that used to belong to the core of post-Keynesian economics, this contribution has sought to point out a path towards higher growth and employment without requiring Treaty changes, developing that tradition under the circumstances of contemporary EMU. Undeniably, the prerequisites of this strategy are also considerable. Wage-setting plays a central role, and Europe's trade unions are making efforts to establish the information, reporting and coordination procedures necessary. Some limited progress has been made. A decisive breakthrough, though, will depend on macroeconomic policymakers, and especially the central bank, manifesting an interest in such a cooperative approach to policymaking. Currently central bankers have – not unjustified – doubts about the current ability of trade unions at European and national levels to commit memberships at lower levels. Policy is therefore locked in a low-confidence trap that is harming growth and employment. Trade unions, under the pressure of high unemployment and attacks on collective bargaining and welfare states, have started down the road to a more cooperative strategy that would permit faster growth. Meanwhile political opposition to and pressure on the ECB are mounting, even in quarters (the financial media, finance ministers) that were until recently fiercely loyal to the idea of an independent, conservative central bank. It is to be hoped that such pressure will force the bank to also embark on this path.

As regards theory, the model presented and the approach advocated here are compatible with other strategies that focus, for instance, more on the use of fiscal policy and the conditions necessary to expand the capital stock. It

does however suggest that Keynesian economists could usefully pay greater attention to wage determination in their theoretical work, where they can draw on a rich tradition.

NOTES

1. This article has benefited substantially from comments received during presentations in Cambridge, Brussels, Berlin and Bremen. The usual disclaimer applies.
2. Not least Joan Robinson: see essays 21 and 23 in Robinson 1979. In fact the tradition goes back to Kalecki's famous 1943 article 'Political aspects of full employment', in which Kalecki referred to full employment not only leading to the workers 'getting out of hand', but also to 'the price increase in the upswing'.
3. There are some exceptions in researchers with a direct link to the labour movement (for example Hein et al. (2005)). John Grieve Smith (2001: 114) also makes a brief reference to collective wage bargaining as part of his 'New economic agenda'.
4. This section develops previous work by the author (especially Watt 2006). See also Koll 2005.
5. The reader is reminded that this is a mathematical identity. The central bank sets interest rates and then the supply of money is determined endogenously by demanders of credit. The question of the ability of macroeconomic policy to control nominal demand is dealt with in Section 3.
6. In the model we abstract from external influences (exchange rates, import prices) on the domestic price level, but return to this important point in Section 3.
7. But see Section 3d below.
8. The actual value of w_{CA} and π_{CA} will depend, though, on the relative weights of the countries (see also below).
9. Further work is necessary to address this complex discussion in detail. The aim here is to set out some basic principles in the context of the policymaking approach advocated. Problems of competitiveness within the Euro Area and the appropriate adjustment mechanisms are beginning to tax the minds of economists and policymakers. For further discussion see Allsopp and Artis, 2003; DIW, 2005.
10. Although in the light of poor performance since 2001 these figures seem ambitious, they merely imply a continuation of what the EU achieved between 1997 and 2000. Employment growth of 1% p.a. is derived from the official goal of raising the employment rate to 70% over a ten-year period.
11. For instance, Spanish unions would not have to convince their members to base pay settlements on productivity plus 2% when price inflation in Spain is running at around 3.5%. That would imply real wage growth 1.5 p.p. below the rate of productivity growth, and that in a situation of a booming economy. Instead, allowing for adjustment effects, the wage guideline would be based on price inflation of, say, 3%. This would be offset by a lower target in, for instance, Germany, where unions find it very difficult to achieve pay increases as high as productivity plus 2%.
12. This helped bring to an untimely end the expansion of 1999–2000. Policy tightening occurred because of uncertainty on the part of the central bank about the future course of wage policy. This instructive episode is reviewed more fully in Watt and Hallwirth 2003.
13. In addition, unit labour costs will themselves be lower than if demand and output are curtailed by monetary tightening, as it is well established that in the short-to-medium run productivity is pro-cyclical. Cyclical falls in productivity caused by sudden drops in output are one reason why, in an *ex post* analysis, wages sometimes appear to overshoot in the year an economy begins to decline, leading to claims that wage policy has 'killed jobs'.
14. For instance: 'At the heart of Post Keynesian monetary policy, therefore, is not so much a body of technical analysis which cuts it off from the mainstream (or at least from its

more realistic practitioners) but a desire to rid the practice of policy from its deflationary biases, to reassert the value of discretion in responding to monetary shocks and to restore accountability in the conduct of monetary policy. At the heart of Post Keynesian policy is lower interest rates' (P. Howells in King, 2003: 260).

15. Note that this can be decided autonomously by the ECB and does not require treaty changes.
16. See for instance, Malcolm Sawyer's concept of the 'constant inflation level of output' (CILO) (Sawyer, 2005). The 'case for fiscal policy' is made by Arestis and Sawyer (2003). The former paper does, though, refer to the practical difficulties of using fiscal policy mentioned earlier.
17. As indicated above, if expectations are sufficiently depressed, only direct government spending is likely to get an economy out of recession.
18. Therefore, within this framework the level of public investment can be steadily expanded if considered desirable.
19. This view has just received confirmation by the ECB. In surveys covering almost the entire Euro Area 54% of surveyed firms reported setting prices as a margin over costs and 27% that they follow the lead set by competitors (ECB, 2005).
20. The US experience of the 1990s can be interpreted in these terms. Far from Greenspan 'seeing' higher productivity growth ahead of everyone else and then expanding demand, it seems more plausible to argue that his policy of low interest rates – for example, out of concern about the Asian crisis – was a proximate cause of the productivity increase in the 'roaring nineties'.
21. In theory, the MED covers the entire European Union. In practice, however, and also in this analysis, the focus is very much on EMU and its common monetary policy. See *The Presidency Conclusions of the Cologne European Council* (http://europa.eu.int/council/off/conclu/june99/june99_en.htm). For a more detailed description of the MED see in particular Koll, 2005.
22. An unpublished survey of ETUC affiliates conducted by the author revealed that, prior to EMU (and in some cases since), national union federations typically met with government and the central bank to discuss policy-mix issues on a monthly basis.

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