From End-of-Pipe Solutions towards a Golden Wage Rule to Prevent and Cure Imbalances in the Euro Area

Andrew Watt 23/12/2010

2010 has been an *annus horriblis* for the euro area. In the spring, just when it appeared that it was emerging from the worst of the financial and economic crisis, panic returned in the form of a sovereign debt crisis. Despite frantic activity by European policymakers – the involvement of the IMF on European soil for the first time in decades, unprecedented actions by the European Central Bank, some ad hoc collective solidarity (contravening the spirit of the Lisbon treaty) and, most recently, a decision to re-write the Treaty and establish a permanent crisis-resolution mechanism – it has yet to be resolved. The end-of-pipe solutions have been an exercise in damage limitation.

2010 has changed Europe. And the issues thrown up this year – how to ensure that monetary union can generate stable growth that is balanced across countries, balanced socially, strong enough to create jobs for all who want one and yet ecologically sustainable – are the ones that will be the locus of political struggles and debates in 2011 and beyond.

There is some good news. The crisis has clearly revealed to even the market fundamentalists that Europe, and especially EMU, can only work with more coordination and policy integration. A naïve reliance on top-down but arbitrary rules in one narrow area – fiscal policy – plus a reliance on 'market forces' and uncoordinated national regulations that are in permanent competition with others, and thus subject to permanent erosion, has led us to the brink of disaster. The policymaking machinery has been cranked up, and at least some of the EU2020 and economic governance reform proposals issued since the summer go at least partly in the right direction.

It's not really fiscal, stupid

The most recent decisions by the European Council, establishing a permanent bail-out mechanism, were, on the surface, about rescuing sovereign governments from debt crises. In fact, in a monetary union, countries are not entirely "sovereign". The issue appears to be one of fiscal policy: hence the vitriol about fiscal backsliding and the need to toughen the Stability and Growth Pact. In fact, though, with the partial exception of Greece, the real underlying issue was the macroeconomic imbalances that had built up over the EMU period and which now, under the pressure of the crisis, need to be resolved. Prices and (nominal) wage levels in peripheral economies need to fall relative to those core countries with surpluses (above all Germany).

The question is how to achieve this result. The answer from both the European authorities and member states, both dominated currently by the liberals and conservatives is: fiscal pain in the deficit countries. Unfortunately, voters in surplus countries (including, no doubt, many potential social-democratic supporters), egged on by a rabid media and unchecked by statesmen or women with an understanding of the European economy and/or lacking the backbone to stand up to the populists, are demanding such 'pain' as a blood price for the provision of EU support. Never mind that that support is essentially costless (ECB money printing) or even a 'good deal' for surplus countries (borrowing cheap and lending dear). Even if it were to incur up-front costs, the fundamental point remains that Europe's economies sink and swim together. Imposing needless austerity on one's trading partners is not only morally reprehensible (especially when it hits the socially vulnerable hardest), it is nonsense also in terms of narrow self-interest. That message will doubtless sink in – if at all – only when surplus countries' export surpluses melt away as the periphery is forced to tighten its collective belt.

Complaining about human suffering is, of course, cheap talk unless it is indeed unnecessary, unless there are no alternatives. In columns and blogs during the course of this year I have discussed such alternatives repeatedly. They can be boiled down to three basic types of measure: firstly, the provision of European support in various forms without the imposition of drastic austerity measures and penal interest rates as a condition; secondly, a balanced adjustment in which surplus countries boost domestic demand and nominal price and wage growth to offset the mirror-image processes in deficit countries; and, thirdly, a deflation of wages and prices in deficit countries without demand deflation, by some form of social pact between government, unions and employers. Any combination of measures of these three types would bring about the needed adjustment at lower cost than the masochistic and potentially dangerous policies currently being implemented.

Towards more permanent solutions: a "Golden Wage Rule"

As the end of year is a time for looking forward, I want in this last column of 2010 to focus on a more fundamental issue of how to correct imbalances and also how to prevent them from arising in the first place.

Nominal wage-setting plays a crucial role in driving macroeconomic imbalances or in preventing them, within a monetary union, that is, an economic area without exchange rates. Competitiveness is actually about prices, especially of tradable goods. There is some scope for governments to influence price-setting (for instance by breaking up or regulating monopolistic structures), but it is rather limited. Empirically, (price) inflation in a country is closely correlated to changes in unit labour costs (the growth of money wages minus the rate of productivity growth). And, to a considerable extent, wages are set collectively in most European countries. Thus money wages are a decisive lever.

Used intelligently, (nominal) wage policy can help to correct existing imbalances. It can also help to prevent them from occurring in the first place. And we know now from this year's succession of crises – if we did not know it before – that prevention is a whole lot better than cure.

All that is required, in theory, is to follow a simple rule, the 'Golden Wage Rule' of monetary unions. [i]

Starting from a situation where national economies within a monetary union are 'in balance' (each with low unemployment and small current account deficits and surpluses), nominal wages should ideally grow at a rate equal to the sum of medium-run national labour productivity growth plus the rate of inflation that the monetary authority considers compatible with price stability. In such a situation all countries experience the same rate of growth of unit labour costs and inflation over the medium run, and these are close to 'price stability'. This enables the central bank – indeed *obliges* it, according to its secondary mandate – to allow the economy to grow vigorously and keep unemployment low or drive it down. Real wages in each country grow in line with the rate of productivity in that country. Workers' share of national income is stable. And workers with the same skills enjoy rising living standards irrespective of sector and region within a country, thereby also putting upward pressure on productivity growth. This is a policy mix, with wages at the centre, that not only avoids macroeconomic imbalances but also maximises growth and employment opportunities while maintaining price stability.

Where the starting point is one of imbalances, as is currently the case, the rate of nominal wage growth should be lower than indicated by the above formula in deficit countries and higher in surplus countries, so as to bring countries back into equilibrium. This wage norm – nominal wage growth in each country equals medium-run national productivity growth, plus the target inflation rate of the central bank, plus/minus a competitiveness correction in surplus/deficit countries – can be seen as the "Golden Rule" of a monetary union. There is one important caveat: in applying this rule, negative nominal wage growth (i.e. pay cuts) in deficit countries should be avoided in order to prevent the risk of deflation.

Simple in theory, difficult in practice

Wage-setting, as we know, is decentralised within EMU, and, to varying degrees, centralised/coordinated at national level. There is a very limited set of institutions and procedures, all of them extremely weak, to monitor and guide wage-setting in the member states at the transnational level. None of these weak coordination instruments, neither those within European trade unionism, nor the existing technical bodies, has been able to exert a significant influence on wage-setting. The obvious implication is that they need to be strengthened as part of a broader-based move towards more coordinated policy. Clearly, wage coordination cannot be pursued on its own and will certainly fail if, for example, national fiscal policy is not similarly constrained to reduce imbalances and boost growth and employment.

How can such wage outcomes be oriented towards such a golden rule in the context of the decentralised collective bargaining that is characteristic of Europe? Essentially there are two sets of measures. The first involves autonomous action by the organisations primarily responsible for setting wages in Europe, namely trade unions. The second consists of collective measures involving various policymaking actors driven by a common understanding of the need to put in place the right framework conditions to generate the needed outcomes. Let me make a few brief remarks on possible tools and motivations in each case.

European trade unions already monitor wage developments to some extent in various committees at the level of the European Trade Union Confederation (national trends) and the European Trade Union Federations (sectoral level). Such committees could be expanded and deepened to bring about a more comprehensive, rigorous and also more forward-looking monitoring of wage-setting by the European trade union movement itself. Why, one might ask, would national trade unions be willing to give up, to a limited extent, autonomy over collective bargaining in favour of a more European approach? Ultimately the answer is that the crisis has shown that in a monetary union such autonomy is, in the medium to longer run, illusory. There is a threat of either more direct imposition of top-down controls over nominal wage-setting at national level and/or the brutal use of deflationary policies to enforce wage cuts in deficit countries. Such developments are in the interest neither of European workers nor of unions. Far better for unions to perform the coordination function themselves, and then put themselves in a strong position to make demands on other European actors, regarding, for instance, monetary policy and national fiscal policy.

Autonomous coordination by unions is a necessary but not a sufficient condition. Wage policy cannot shoulder the entire adjustment burden. Much broader policy integration and coordination is required, most notably to ensure that national fiscal policy is appropriate to the country's situation and that there is a balance of constraints for more restrictive and more expansionary policies on, respectively, deficit and surplus countries. One specific recommendation can be made. The already existing Macroeconomic Dialogue, which was established in 1999 with the explicit aim of ensuring a balanced policy mix in the interest of maximising non-inflationary growth and employment, needs to be decisively strengthened and in particular articulated with national-level policy initiatives.

Conclusion

At the end of 2010 one can look forward to the coming year only with a sense of trepidation. Unemployment is extremely high and the underlying economic dynamic is weak (and even where it seems stronger, it is vulnerable). Across-the-board fiscal austerity threatens to condemn Europe to a weak, jobless recovery. In fact, there are easy-to-deploy measures that would permit Europe to emerge from the crisis and rebalance its regionally skewed economy. Unfortunately, the political situation is such that it seems unlikely that such measures – which would be cheap, indeed 'free' in anything but the most short-term and parochial calculation – will be enacted unless the crisis first gets a lot worse. That is because European politics (by which I mean, in this context, essentially the politics of Europe's conservative-led member states) are short-termist and parochial.

The real challenge for 2011 and beyond is to move to a higher level of coordination. The focus is very much on the fiscal, in line with the old IMF credo: "it's mostly fiscal, stupid". In fact: it's mostly about wages (and prices), stupid. There is *some* recognition of this amongst policymakers and *some* positive (but also many worrying) signs in the EU2020 strategy. Reflections are also ongoing within the European trade union movement, and the ETUC's four-yearly congress in May is an opportunity to launch new initiatives.

There are thus some small embers of optimism against the background of the big chill that, literally and metaphorically, is gripping Europe.

Very best wishes to all readers for the New Year.

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[i] For a more detailed and technical exposition see: Watt, A. (2007) 'The role of wage-setting in a growth strategy for Europe', Philip Arestis, Michelle Baddeley and John McCombie (eds.) *Economic growth. New directions in theory and policy*, Edward Elgar: 178-199