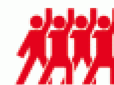


Economic discussion paper 2011/04

WHY EUROPE NEEDS A FAIRNESS PACT AND NOT A COMPETITIVENESS PACT.

A Competitiveness Pact to discipline wages

The "Competitiveness Pact' recently proposed by the German- French government is making its way and will be the key point on the agenda of the special Euro Area Council of the heads of government on the 11th of March.

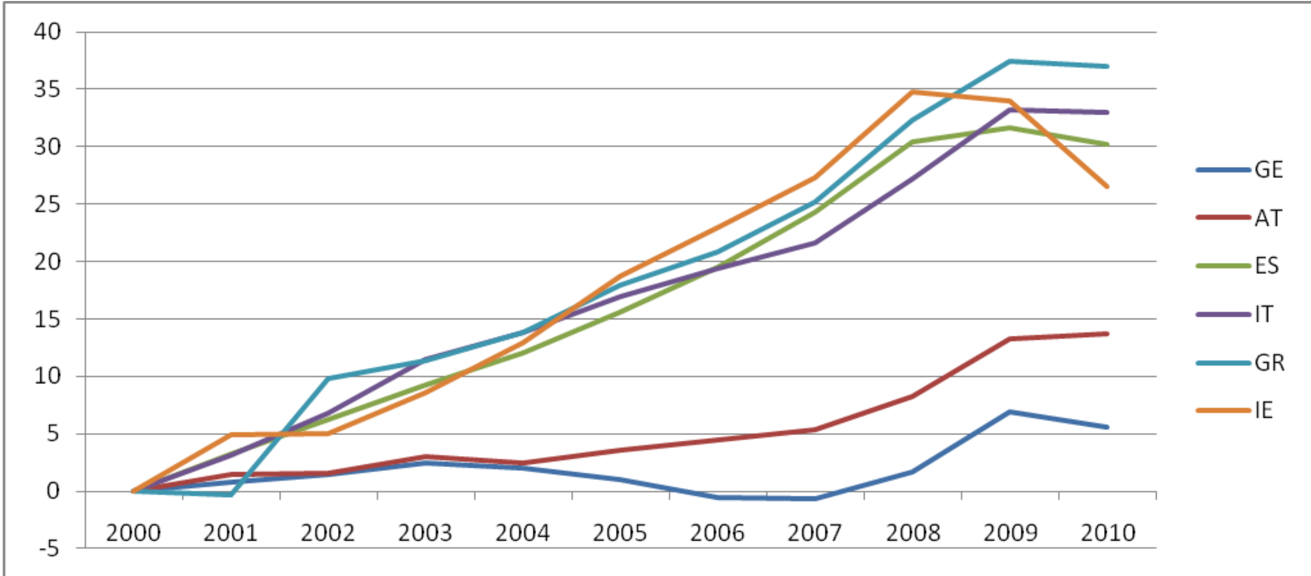
Wages are very much at the focus of this new European pact and they are so in a negative way. Indeed, one of the Pact's main intentions is to assess "large and sustained increases in unit labour costs that may indicate the erosion of competitiveness " , followed by the "adjustment of wage setting mechanisms and notably the degree of centralization in the bargaining process".

At the basis of this approach lies the idea that 'dysfunctional' wage setting is the ultimate culprit for the financial turmoil that is harshly hitting several members of the Euro Area. According to this view, huge current account deficits are the root cause of the high external debt burdens that several Euro Area members are facing. And these external deficits are, still according to this story, caused by the worsening of competitive positions that followed after wages spiraled out of control. In this view, there's not really a financial crisis but a competitiveness crisis caused by wage formation systems that are too rigid.

Using statistics to claim wages have been excessive.

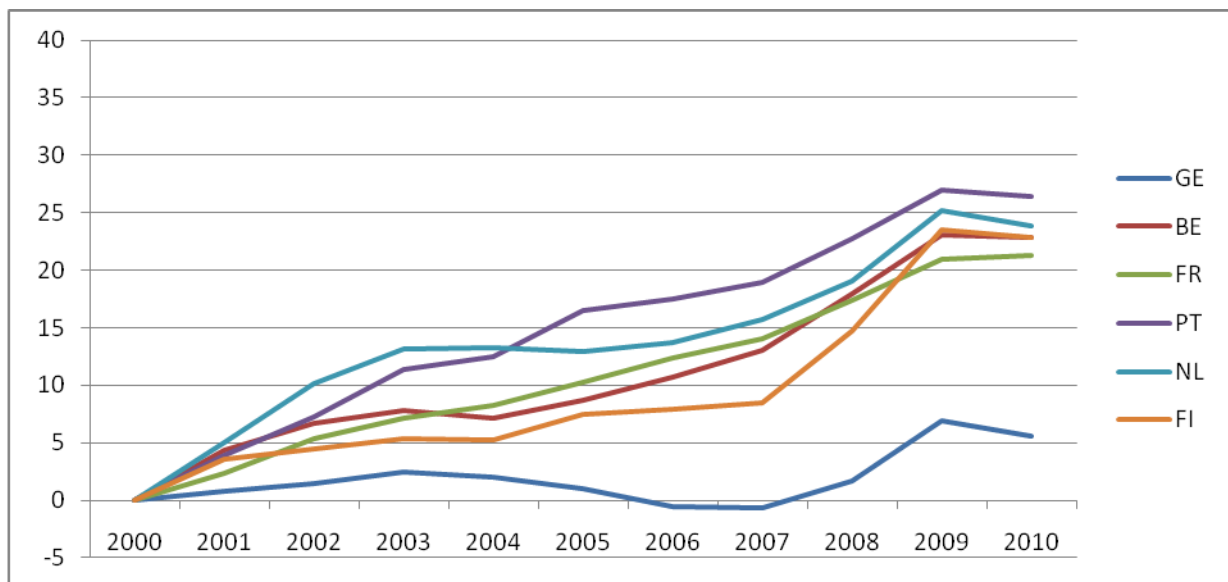
This view of events is usually illustrated by graphs such as the following ones. The first graph describes the huge 'explosion' of wages that took place in Spain, Greece, Ireland, and Italy, with unit wage costs increasing by more than 30% over the last decade. In Germany (and Austria) on the other hand, unit wage costs basically stagnated up to 2008, afterwards registering a limited increase in unit wage costs of 5%. In this way, wide gaps in cost competitiveness close to 30 % seem to have opened up between the core and the periphery. Meanwhile, all of these countries registering high unit labour cost dynamics (with the exception of Italy) have now become victims of financial market turmoil.

Increase in unit wage costs: Germany and the periphery 2000 = 100



Moreover, unit wage cost divergence did not remain limited to the Euro Area's southern and western periphery. Unit wage costs in France, the Netherlands, Belgium, Finland and Portugal also rose considerably faster compared to Germany, resulting in a wage gap of around 20% at the end of 2010 (see next graph).

Increase in unit wage costs: Germany and the rest of the Euro Area 2000 = 100



Graphs such as these along with the theory described above that links way wages, competitiveness, external deficits and debts with each other explain why policy makers across Europe have become so keen on disciplining wages and reforming wage formation systems.

Having these 'competitive wage gaps' on their minds, and with the additional complication that the option of devaluing the national currency is no longer available, member states are dead set on setting up an 'internal' devaluation. In several circles, in particular in central banking circles, wage cuts and deflationary wage/price spiral are now being advocated so as to close as quickly as possible wage gaps as high as 30%. To achieve these wage cuts, but also to prevent wages in future from undermining competitiveness and causing debt crises, the formal policy agenda becomes one in which wage formation systems and collective bargaining institutions themselves are to be weakened. The basic message here is that to save the single currency, Europe needs to give up on wages.

Danger of deflation and competitive downwards spirals.

By following the narrative of 'wage cost competitiveness', policy makers are in fact putting forward the German pattern of non wage dynamics as the standard to be followed by the rest of the Euro area: Wages across the whole of the Euro area (Europe), as is written down in this draft Competitiveness Pact, are to evolve in line with productivity. It's important to observe what has not been written in the draft text of the Pact: No mention whatsoever is being made to the issue of wage dynamics reflecting inflation and rising prices. One should also

stress the fact that this is exactly what has been happening in Germany for the last decade and a half. Indeed, the flat line in graph I for German nominal unit wage costs means that wages, nominal that is, were exactly in line with productivity, as is formulated in the European Pact. Since 2000, German wage increases were exactly matched by the increase in productivity, thereby leaving the margins resulting from price increases to the benefit of employers.

However, this type of wage policy substantially weakens the role of wages as a nominal anchor for price stability. Pursuing a stagnation of nominal unit wage costs for each and every member and thus for the whole of the Euro Area would actually be in flagrant contradiction with the ECB's objective of price stability of a rate of inflation of below but close to 2% : **Zero unit wage cost dynamics imply zero inflation**. And zero inflation means exposing the Euro Area to the risk of deflation since there's no buffer to keep the economy out of deflationary territory when a negative demand shock hits.

Moreover, a 'competitive wage strategy' runs quickly out of control. The whole idea of a strategy of wage cost competitiveness is to undercut and become more competitive than the others. In an integrated market such as Europe, such a strategy can only work if it is implemented by some but not by all. Pushing all member states to become more 'cost competitive' does not make any sense. The competitive improvement of some will be immediately reflected in the competitive worsening of others. Member states, in trying to become the European champion that pushes down wages the most, will be like dogs chasing their own tail. This process may actually derail into unit wage cost dynamics becoming negative, triggering falling prices and leading the economy straight into a deflationary trap.

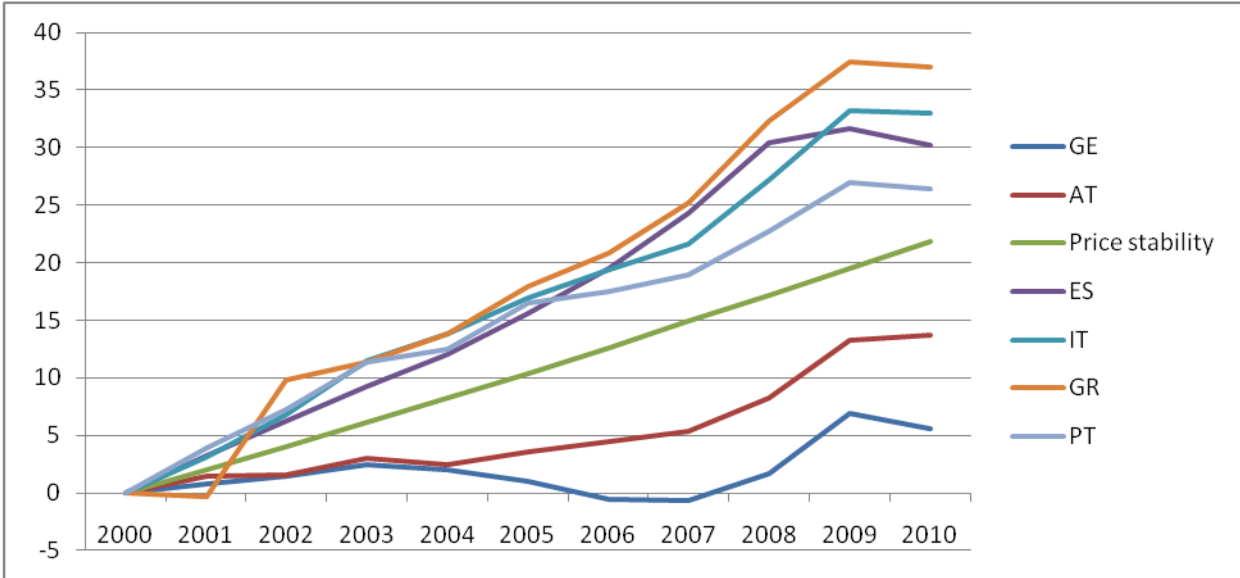
Approaching wage divergence in an intelligent way.

However, there exists another narrative that looks at the same wage statistics in an intelligent way. This narrative starts from the basic principle that what matters most from the point of view of a single currency in which many national wage settings coexist with one single monetary policy is to see whether national unit wage cost dynamics are in line with the ECB's price stability target.

Looking at internal Euro Area wage divergences from this point of view yields rather interesting results. In the next graph, the green line in the middle traces the pattern of unit wage cost developments if these would have stayed in line with the ECB's price stability target of 'below but close to 2%. This formulae of 'stability orientated wage dynamics' allows for a cumulated increase in unit wage costs by 22% from 2000 to 2010.

Confronting this outcome with the effective increase in unit wage costs now shows that both 'deficit' countries as well as 'surplus' countries have deviated from this formulae. The former have exceeded unit wage cost dynamics compatible with the objective of price stability by 10%, while the latter have underscored stability oriented wage dynamics by 15%. Reading wage statistics this way allows to see that the 30% wage gap is not the sole responsibility of the peripheral countries but a responsibility that is also shared by the Euro Area's hard core (1).

Evaluating wage dynamics from the perspective of price stability: Germany and the Southern periphery



(1) Applying the price stability approach to France, Belgium, Netherlands, and Finland shows that wage behavior in these countries was 'close to perfect'. Unit wage costs neatly stayed in line with the ECB's price stability target. Some may be surprised to find out that Portugal does not deviate that much from the price stability scenario either.

Why the Euro Area's core should adjust more

The case for adjustment from the side of the countries of the core should be taken a step further. It's mainly the Euro Area's core that should deliver the adjustment.

Purely mathematically, this is already clear from the figures above. While Spanish and Greek wage dynamics have overshot the ECB's price stability target with an accumulated 10%, German wages deviated in a downwards way by 15%. The latter is very likely an underestimation since the 5% unit wage increase that Germany recorded has to do with the collapse in activity following the financial crisis and to which German companies responded by hoarding labour. As demand and growth dynamics return, labour hoarding will be unwound, bringing the German wage /price stability gap as high as 18%!

There is however more to this than just mathematics. There's also the single currency effect that closely connects the over- and undershooting of wages in the different parts of the Euro with each other. A decade of hollowing out wages in the Euro Area core is co responsible for causing the periphery's wage/price spiral. To understand this, one needs stop thinking in terms of 'competitiveness' and start looking at these matters through the lenses of the channel of 'financial debt'.

The story to be told again becomes very different. In Germany, the wage depression went hand in hand with a stagnation of internal demand which, in turn, pulled inflation in Germany much below 2%. Germany however, is the Euro Area's prime member and represents about 25% of the economic weight of the entire area. Given its importance, the ECB could simply not allow Germany's economy to tumble into deflation and felt forced to reduce and keep policy interest rates at low levels. The interest rate levels the ECB set were still too high to revive German growth in Germany but were at the same time much too low for the periphery. In this way, the periphery got saddled up with a huge financial boom, with households and banks accumulating huge debt loads on the basis of cheap credit. These booms drove economic activity forward and inflation upwards. Wage dynamics in the periphery ultimately had to react to this or otherwise face a decline of real wages. What happened in practice is that real wages stagnated in the periphery while nominal wages were driven up by the debt induced overheating of the economy.

All of this implies that the link between the events is completely different from the 'competitiveness' view. It's not wages in the periphery that suddenly went out of control and caused high current account deficits which then had to be financed by taking out more debt from the banks based in the core. The causality actually runs the other way around: The policy of depressing of wages in the Euro Area's core delivered the savings surplus but also (through the single interest rate regime) the cheap interest rates that started the financial boom and bust of the periphery. **Wages are not the cause of the periphery's debt**

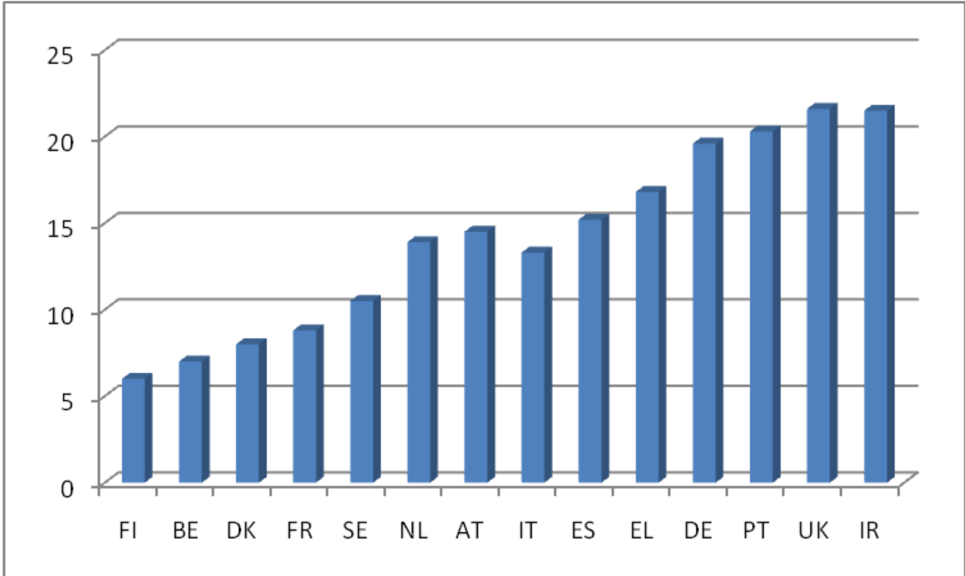
boom. It’s the other way around; it’s the debt boom that caused the strong acceleration of nominal wage dynamics.

Rewinding the Euro Area’s core wage depression is a matter of basic fairness

The wage depression of the Euro Area’s core did not only unbalance the periphery, it also unbalanced its own economy itself. Behind the macroeconomic phenomenon of stagnating unit wage costs hides a social calamity which has directly to do with the set of labour market that have been implemented. The liberalization of the agency work sector with temporary workers gaining only a fraction of the pay of regular workers, the crack down on the longer term unemployed to force them into jobs paying below the collectively bargained wage, the liberalization of product markets so as to intensify wage competition with workers from abroad, the state subsidizing those employers paying poverty wages and, last but not least, heavy political pressure on trade unions to hollow out sector bargaining agreements by using company opening clauses, all of these worked to increase social exclusion.

A number of figures can illustrate this. For instance, the relative share of low paid jobs in Germany has risen vastly since 2000 and is now at a level that is comparable with the more deregulated type of Anglo-Saxon labour markets (see graph).

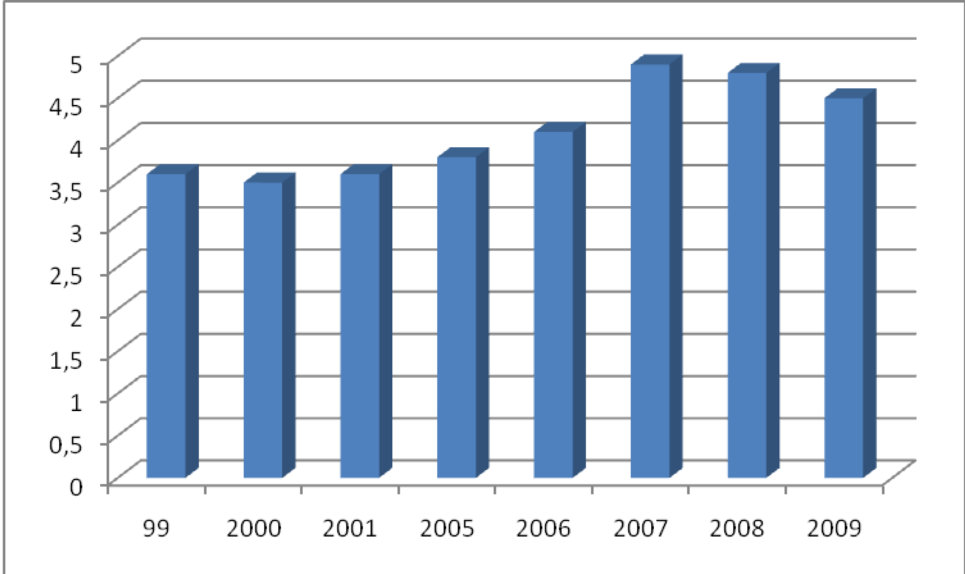
Germany: Share of low wage earners in total of all full time employees, 2006



Source: Euro stat, Statistics in focus, 2010 /3

The same holds for inequalities. Inequality, as measured by the difference in average earnings between the 20% highest and 20% lowest income earners, have shot up enormously (see graph). Meanwhile, child poverty increased from 12% in 2005-2006 to 15% in 2009.

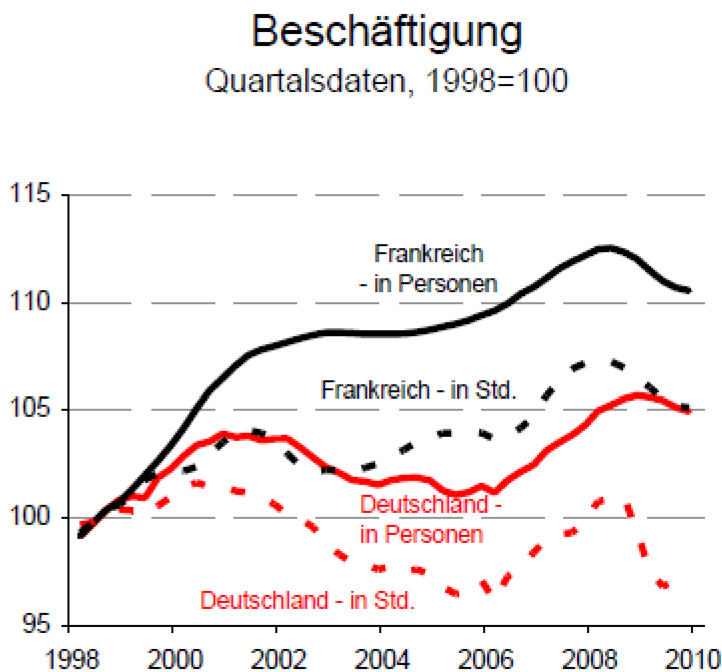
Germany: Income quintile share (Ratio of income of 20% highest earners over income of 20% lowest income earners)



Source: Eurostat

Moreover, and importantly, this ”experiment” with deregulation is a classic example of how labour market reforms do not create more jobs but instead determine the nature and the quality of jobs and the distribution of revenue and income. It is stunning to observe that, the German economy did not add one single additional hour of work over the whole of this period. A decade of stagnating wages and continuous gains in cost competitiveness went together with a stagnation of the total number of hours worked (see graph). This stagnation of the volume of work, taken together with the rise in low paid and/or insecure jobs, implies that labour market deregulation mainly works to by having bad jobs and precarious contracts drive out good jobs.

Comparing Job Performance in Germany and France:



Source: IMK Policy Brief, March 2010

Conclusion: Europe needs a Pact for more Fairness and more Equality

The Competitiveness Pact is basically about imposing a non rational wage norm upon the whole of the Euro area (and not just the periphery only!). This European wage 'diktat' is to ensure that wages no longer include any inflation compensation, so that the financial margins resulting from increased output prices can flow into higher business profits. This corresponds exactly to the same type of wage pattern that German labour had to suffer over the last decade, a pattern that has been accompanied by an explosion of business profits and dividends but also soaring inequalities and job precariousness. The Competitiveness Pact has the ambition to "export" this pattern of stagnating wages into the rest of the Euro Area.

By signing up to such a pact, the Heads of State will repeat exactly the same mistake that led the Euro Area straight into the financial mess it is in today. Indeed, a closer analysis of wage dynamics in the Euro Area (thereby using 'stability oriented wage dynamics' as the criterion to judge appropriate wage developments) puts the main responsibility for causing wage divergences inside the Euro Area firmly with the 'surplus' countries.

Blinded by the quest for cost competitiveness, meanwhile identifying the opportunity created by the single currency regime of letting wage competition strategies go unsanctioned because of the lack currency revaluation, the continuing depression of wages managed to unbalance the Euro Area's economy in a profound way. Germany's wage depression worked to distort the Euro Area's monetary policy's transmission channel. The ECB could not simply stand by and allow its prime member state to move closer and closer to deflation and depression. To save Germany from its self inflicted wage policy errors, the ECB was forced to reduce and keep interest rates at levels that, in the end were still too high for Germany's depressed economy, but at the same time far too low for the periphery where the economy was already staging good growth dynamics. The German wage squeeze combined with the single interest rate regime saddled the periphery up with a gigantic asset price bubble and a debt based economic boom. This boom has now turned to bust, leaving the periphery to face a mountain of debt, dragging down the growth dynamics of these countries for many years to follow.

European heads of state are now thinking to get out of this mess by broadening the same type of zero wage policy to the whole of the Euro Area. This is a serious mistake. Zero unit wage costs will not save the single currency. Zero unit wage costs will instead unbalance the Euro Area's economy even more. Wage stagnation will distribute even more income than now is the case from wages to business profits and dividends, thereby weakening overall demand. Wage stagnation, as it is accompanied by labour market deregulation, will boost precarious work practices and increase inequalities. Wage stagnation will introduce a deflationary bias and will open the trap of debt deflation. Finally, zero unit wage costs do not constitute a stable system and will even lead to falling unit wage costs and falling wages since the key aim of a competitive wage strategy is to undercut each other.

Europe needs to change course. To correct internal Euro Area imbalances, those members that are primarily responsible for causing imbalances should be the first as well as the main actors to bring relief. 'Surplus' countries urgently need to start rewinding their policies of squeezing wages and replacing good jobs with precarious jobs. A good start is to introduce a legal minimum wage in those surplus countries where no effective decent wage floor exists. Another is to eliminate the practice of employers and agency work companies forcing workers to compete and underbid each others' wages by paying 'unequal pay for equal work". Europe needs a Pact for more fairness and more equality, not a competitiveness Pact.

RJ/ETUC/Brussels/10th of March 2011