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European Economic Governance: The Next Big Hold Up On Wages

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One of the main purposes of the current drive for European economic governance is to transform wages into the main or even single instrument of adjustment under monetary union. Strangely, this idea appears to enjoy a high degree of consensus among both conservative and progressive economists. For the former, extreme wage flexibility including wage cuts and sub-regional deflation is necessary if the rest of the Euro area is to catch up rapidly in competitiveness with Germany. For the latter, the rebalancing of competitive positions is to proceed by setting up some kind of 'wage planification' process at the European level in which German wages are to go up while wages outside Germany are going down and stay down for many years to come.

Both views are based on the idea that there exists a direct and straightforward link between wages and competitiveness, as if one unit change in wage costs equals one unit change in competitiveness, or even jobs. However, a closer look at the German experience reveals that this assumption is totally flawed: competitive prices are not at the basis of Germany's massive exports boom. What really drives German exports is the growth of its exports markets: if those economies into which Germany is exporting enjoy an economic boom, then German exports closely follow. Here, a recent analysis from the European Commission (2010) finds that the dynamism of Germany's export markets explains almost the whole of the 7.3% annual average increase in its export volumes over the 1999-2008 period, whereas the contribution of more competitive pricing on German export performance is barely noticeable (0.3%).

How to explain the fact that a decade of real wage stagnation has barely had any impact on Germany's spectacular export boom? The reason has to do with the specialization pattern of its industry, focusing on products which the more dynamic (emerging) economies are most eager to buy (machinery, telecom equipment, transport infrastructures, etc.). This type of specialization pattern has the effect of making demand for German exports price inelastic: it is technical knowhow ('how to produce efficient machinery') and quality that count. In this equation, prices are a subordinated matter. Indeed, econometric studies (Artus, 2010) find that a 10% reduction in German export prices increases export volumes by 4% only. In the case of France, a similar price reduction would boost export volumes by as much as 12%.

The fact that the demand for exports is relatively irresponsive to prices also explains why German business opted not to pass on falling unit labour costs in manufacturing into lower export prices. Doing so would only have made a small difference in export demand and overall production, implying a limited increase in total profits. The alternative of boosting profit margins by maintaining output prices while squeezing wages was substantially more attractive. In other words, business mostly used the sacrifices that were forced upon German workers during an entire decade to increase its own profit margins and dividend pay outs instead of creating jobs by becoming more competitive. In the end, it is not surprising to observe that the share of profits in Germany's non financial sector has skyrocketed from 36.3% of gross added value in 2000 to 41.4% in 2008 (Eurostat, 2009).

All of this implies that the ongoing discussion on European economic governance should be turned completely upside down. Pushing for competitive wage deflation in the Southern part of the Euro area is a dead end road. Given the deeply ingrained structural features of German industry, wage cuts in Spain or Portugal will barely alter these countries' relative competitive positions with Germany. As argued above, the world is buying German exports not because they are cheap but because of their quality and of their type. By cutting wages, Southern Europe will mainly be competing for export demand with economies such as France, Eastern and Central Europe – or with themselves. However, the French economy, with high unemployment, is not exactly in the best position to digest the export shock that a wave of Southern wage deflation would bring about. Competing with Central and Eastern Europe on the basis of wages is also a lost cause: wages there are still much lower while most of these countries are outside the euro and may/will respond to a competitive wage devaluation by a competitive currency devaluation. This leaves workers in the South of Europe to compete with each other. The 'winner' will be the country that cuts wages the most in comparison with the rest of the South. However, the taste of this 'export' victory will be bitter since the gain will come at the expense of a deep depression of domestic demand in the entire South of the Euro area.

Unfortunately, the bad news does not end here. The mechanics of monetary union should not be forgotten either. With the economic weight of the South of Europe in the entire Euro area being limited to 15%, whereas the weight of Germany is as high as 25%, the response of monetary policy will necessarily be ambiguous. The European Central Bank is forced to set interest rates according to the average situation in the Euro area, not according to the situation in those parts of it that are in most trouble. This actually means that wage cuts in the South will be met with higher, not lower, interest rates as set by common Euro area monetary policy. With deflation taking hold while nominal interest rates are rising, the policy trap which these distressed economies find themselves in will be complete.

In a cynical way, history is extracting its own revenge. When the single currency project was being set up back in the 1990s, rumours inside the Delors Commission claimed that monetary union would in the end cause so many problems that politicians would have no other choice than to take Europe forward. At that time, this referred to policies such as a substantially higher European budget, European investment policy and European taxes. Europe indeed now finds itself into such a situation calling for emergency action. However, blinded by the old obsession with cost competitiveness, it is cracking down on workers. This will prove to be a fatal mistake: extreme wage flexibility, even if it is presented as a type of 'central wage planification' in co-management with trade unions, in the end boils down to a big hold up on wages.

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