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Change or lose Europe

by Frank Hoffer and Friederike Spiecker

When asked what he thought of Western civilisation, Mahatma Gandhi replied: "I think it would be a good idea."

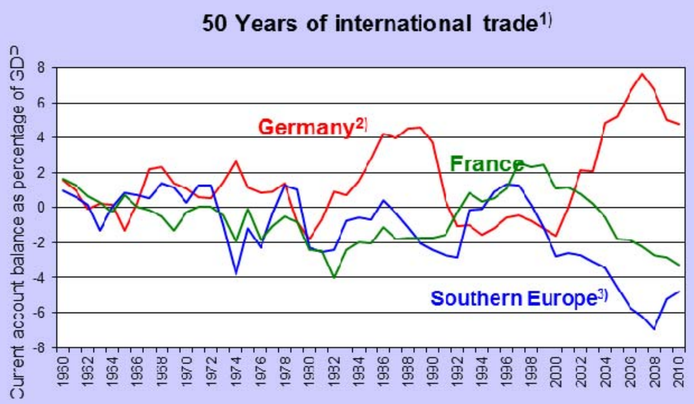
After an agonising depression and another devastating war, Europe finally followed Gandhi's advice and moved from centuries of antagonism, war and "beggar thy neighbour" policies to a world of cooperation and integration. Reintegrating post-nazi Germany, bringing the former Portuguese, Spanish and Greek dictatorships into a democratic Europe and opening up to Eastern Europe are milestones in this complex integration process based on political will, cooperation and regulated markets. But it was only after the ideological shift in the 1980s and 90s that mainstream thinking changed and concluded that the best form of cooperation was fierce competition and radical market liberalisation. However, deregulation, the common market and single currency did not create the promised land of prosperity, but resulted in declining wage shares and greater inequality.

The benefit of a single currency in a large market across several countries lies in a common employment and growth-oriented monetary policy for all member countries, rather than a monetary policy narrowly focussing on the needs and priorities of the anchor currency as in the former European exchange rate mechanism. However, in a world dominated by deeply rooted neoclassical and monetarist beliefs, this benefit had no chance of materialising.

Relinquishing internal exchange rate flexibility deprives governments of an adjustment mechanism to respond to unequal economic performance. This increases the need for 1) coordinated wage, fiscal and especially tax policies to avoid a race to the bottom which would inevitably have a negative impact on overall growth; and 2) joint infrastructure and industrial policies to improve productivity and reduce regional development differences.

With the euro, balanced trade requires that wages in all member states grow in line with national productivity plus targeted inflation rate of the ECB. Otherwise countries with relative higher growth in unit labour costs will systematically lose market share and build up trade deficits. The case for a coordinated wage policy to avoid imbalances, beggar thy neighbour policies and a waste of potential growth is overwhelming; it is alarming that it has been ignored for so long. Those who let unit labour costs rise too fast are equally responsible for the explosion of imbalances after the abolition of the exchange rate mechanism as those who gained market shares through wage restraint. This lack of policy coordination resulted in rapidly growing trade imbalances after 1998 (Table 1).

Table 1

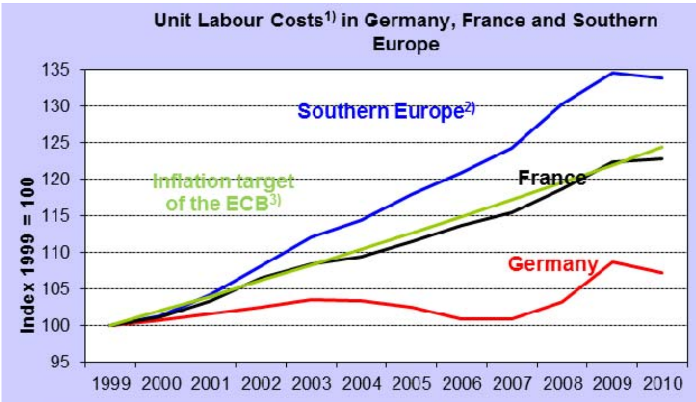


1) Current account balance in percentage of GDP ; negative value: deficit 2) Until 1990 West Germany 3) Greece, Portugal, Spain and Italiy. Source: AMECO Data

Prior to the euro, Germany's above-average productivity growth and export surpluses were frequently adjusted through currency appreciation. Trade imbalances stayed within 2% of GDP and – contrary to today – German workers benefited from German competitiveness as the 'Deutschmark' (DM) appreciation made imported goods and sunny holiday destinations abroad cheaper.

Under the new currency regime, however, it was almost exclusively businesses that benefited. This mercantilist strategy was costly to Germans. Wage dumping translated to export growth, depressed domestic demand, and the lowest growth rate in the Eurozone. Given these German wage developments, even France, who achieved wage growth in line with productivity (Table 2), suffers from a growing trade deficit with Germany (Table 1).

Table 2



1) Index of of economy wide Unit labour costs 1999 = 100. 2) Grreece , Portugal, Spain and Italy 3) Inflation of 2% Source: AMECO Datea base (November 2010), own calculation

Regardless of government actions, rebalancing is bound to occur. The question is how and with what consequences for growth, distribution and ultimately political stability. Realign-

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ment can be achieved through either wage cuts in deficit countries, a rise in wages in surplus countries, or constant transfers from the former to the latter. However, it makes a world of difference whether the realignment occurs by "deflationary" means, forcing everybody to follow the German example, or within an overall growth regime that avoids the pitfalls of wage deflation.

Three scenarios are possible:

1. Deflationary cost cutting

   This is what European institutions and surplus countries currently impose on deficit countries. The result will be a deflationary depression in deficit countries with high unemployment, negative growth, and public debts accelerating as share of GDP. Internal devaluation will require a massacre of public services and nominal wage cuts of 20 – 30% for countries like Spain, Greece, Italy or Ireland. Their economies will shrink and so will the inner-European export market for surplus countries. Ultimately, after having sold and privatised what is left of public assets in a depressed market, countries will default. Ironically, this "no bailout policy" will cause involuntary transfers, as creditors will have to write off part of the credits. These banks – mainly from surplus Germany – will again claim their systemic relevance and German taxpayers will be asked to save them. This "solution" might be as costly for taxpayers as direct transfers to Greece or Ireland. The outcome of such an austerity policy is unfortunately a negative sum game within Europe, and its only rationale is the unlikely prospect that the shrinking internal market will be overcompensated by export surpluses outside the Eurozone.

   If popular resistance does not force European governments and the EU to change policies, it is difficult to see how the Euro and ultimately European integration can hold.

2. Constant public transfers

   This is the reality within the German currency union since 1990. The constant "trade deficit" between West and East Germany is closed through a stream of public transfers. Such a transfer system on a European scale currently looks politically impossible, even if some form of European unemployment insurance would be desirable further in the integration process.

3. Wage-led growth

   A wage-led growth oriented policy coordinated by Eurozone member states is the only realistic way to avoid repercussions deriving from deflation. Such a policy must be based on 1) rapid extension of domestic demand in surplus countries through wage, income and fiscal policies; 2) giving all Eurozone governments access to low interest euro bonds; and 3) productivity-enhancing investment in pan-European infrastructure. Only if surplus countries drive economic growth and increase aggregate demand can deficit countries regain market shares and avoid a long and painful depression. However, even under the favourable conditions of economic growth, rebalancing will only be possible if deficit countries accept below average unit labour cost growth over a longer period of time, and if surplus countries change their aggressive export strategy and strengthen internal wage growth so that unit labour costs rise above average. During this period, nominal wage growth in deficit countries must stay positive. Wage policy must act as a barrier against downward pressures on wages that risk pushing countries into deflation, as seen in Japan. Realignment within an overall regime of nominal wage growth would allow the reduction and eventual reversal of permanent German trade surpluses.

The necessary policy changes cannot be understood within a narrow enterprise logic, viewing wages merely as costs and not as income and demand (an irreplaceable condition for sustainable, productivity-enhancing and equitable growth). Democratic governments need to focus on the common good of full employment and provide a framework to achieve collective bargaining wage settlements that ensure wages growing in line with productivity. This should include:

- a legal minimum wage at 50% of the average wage;
- government support for co-ordinated or centralised collective bargaining and universal application through legal extension mechanisms;
- labour market regulations minimising all forms of precarious atypical employment and limiting the excessive power of employers in the labour market;
- that governments, as the largest employer, investor and procurer ensure public sector wages grow in line with the defined wage norm and provide contracts only to companies that adhere to collective bargaining agreements;
- productivity enhancing public investment;
- a progressive European tax on trade surpluses overshooting 2% of GDP in two consecutive years to give surplus countries the choice either to stimulate their own economy or to provide transfers to neighbouring countries that pursued a balanced functional wage policy, but lost market shares because of the mercantilist strategies of surplus countries;
- a tax on enterprises that try to gain a competitive advantage through wage depression instead of innovation. Unlike the Polish government who introduced the Popiwek tax against wage inflation in the 1990s, enterprises would have to pay a 50% tax on the gap between the actual increase of the hourly wage and a wage increase fully reflecting productivity growth and targeted inflation rates to avoid wage deflation. This would encourage employers to share productivity gains with their employees and would ensure wage growth in line with macroeconomic requirements for sustainable growth.

To support such an inclusive rebalancing strategy, the European Central Bank should 1) raise its inflation target to 3-4% to provide more space to adjust without making deflationary nominal wage cuts; and 2) aim at co-ordinated exchange rate policies between the major trading blocks to ensure that internal balancing does not result in external imbalances.

For Europe, adopting a coordinated wage policy oriented towards lower inequality, balanced trade and economic growth is not only necessary and possible: it would in fact be a good idea.

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