Wages And Competitiveness: The Need For Coordination*

Odile Chagny and Michel Husson, *Social Europe Journal*, 10/06/2013**

Wages are not the cause of the crisis, nor a tool to overcome it. But wage coordination is needed as an essential element of a Social Europe.

Wages as a problem ?

According to the mainstream analysis, excessive wage growth is the cause of imbalances within the Euro area. Yet there was a fall in the wage share in most countries. In other words, wages grew less than labour productivity and it is therefore not possible to speak of a wage drift. However, unit labour costs have diverged between the 'North' and 'South' of Europe. These two observations can be made consistent by decomposing the nominal unit labour costs (in Euros) as the product of the GDP deflator by the real unit labour costs, the latter being a proxy for the wage share.

1) The competitiveness lag between 'North' and 'South' is not the result of wage drifts but is mainly the consequence of differences in structural inflation. Its main determinants can be synthesized as follows:

1. inflation is higher in countries where growth is faster due to a catching-up process;

2. inflation is much higher when the increase in wages in the sheltered sectors is close to that of wages in the exposed sector (dissemination of productivity);

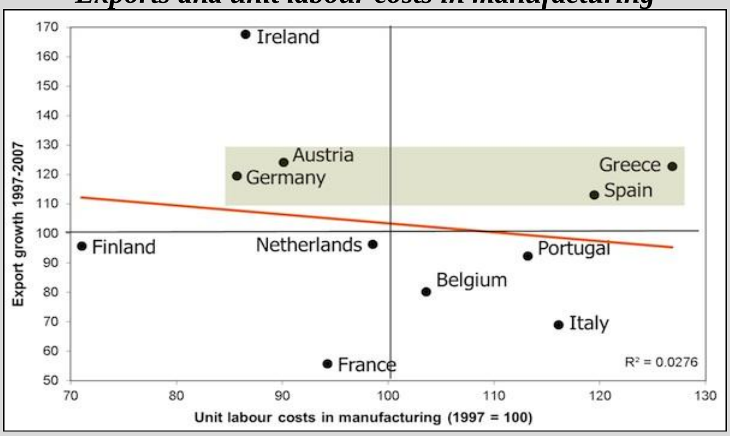
3. inflation is higher in countries where there is a high degree of inequality that generates more pronounced distributional conflicts.

The construction of the 'Euro system' has forgotten these structural determinations of inflation. It was based on the wrong assumption that a single currency, a 2% inflation norm and fiscal discipline would be sufficient to ensure the convergence of inflation rates across countries.

2) The development of relative unit labour costs cannot explain the relative export performances. As noted by the European Commission in the 2010 Competitiveness Report: 'If there is a relation between unitary labour costs and export performance, it is weak and of a secondary order of magnitude (…) and hence the former cannot be the cause of the latter'.

For example, Austria and Germany on the one hand, and Greece and Spain on the other hand, exhibited similar export performances during the ten years preceding the crisis, despite wide divergences in unit labour costs trends in manufacturing (see graph).

Exports and unit labour costs in manufacturing



1997=100. Source: Ameco database

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3) Unit labor cost growth was very different in exposed and in sheltered sectors.

4) The trajectory of Germany differs from that of other countries, with a steady decline in real unit labour costs (up to the crisis). This trend deepened during the years preceding the crisis, leading to a high decline in the wage share.

5) The competitive constraint has been bypassed by two ‘leak variables’. A large trade deficit could be sustained since there was no threat, by definition, for the value of the national currency. The convergence in nominal interest rates led to a sharp decline in real interest rates in the countries with higher inflation rates, favouring over-indebtedness and real estate bubbles.

Wages as a solution ?

Since the beginning of the crisis, there has hardly been any relationship between the slowdown in wages and the evolution of the wage share. The configurations are multiple, depending on national economic and institutional features, and also on the industrial specialization patterns.

The future dynamics of wages in Europe will be determined by two objectives:

• restoring the profit share in the countries where it fell;

• improving competitiveness as the only means to reduce external imbalances.

But this objective faces two contradictions:

• The ‘internal devaluations’ do not lead to a structural improvement in trade balances. The improved trade balances of the South countries are mainly explained by a decline in imports, with the partial exception of Spain.

• The recovery of the profit share does not lead to a recovery of the investment rate because demand remains depressed and the decline in wages will contribute to depress it more.

The fiscal austerity-recession cycle reinforces these two contradictions. In the case of France, a ‘heuristic’ scenario shows that restoring the profit share to its pre-crisis level requires a near zero growth of real wages. This scenario is built on a relatively ‘optimistic’ hypothesis for the growth of productivity (1.4% per year) and assumes a constant dividend share in added value. Other scenarios are of course possible but under the condition of changing the income distribution between wage-earners and ‘rentiers’.

Conclusions

1) The crisis has ultimately revealed a flaw in the design of EMU (its ‘original sin’) with its focus on nominal rather than real convergence, implicitly assuming that the latter would be achieved in a somehow spontaneous manner through the own virtues of implementing EMU and fiscal discipline.

2) Wages are not the cause of the crisis in the Eurozone. This crisis is primarily due to the fact that structural differences between national economies especially in terms of industrial specialization and inflation have been neglected. In retrospect, it appears that it is rather the declining wage share that must be considered as one of the main factors of this crisis.

3) Wage moderation is becoming the central axis of European policies and the European institutions in charge are taking wage policies to an always greater level. This orientation is not a coherent exit from the crisis and might instead lead to policies that increase the recessionary risks, paradoxically forgetting that Europe is an integrated economy that requires the coordination of economic policies.

4) Beyond the debt crisis, Europe is facing a crisis of wage coordination. This is why the debate on an optimal wage rule should now be a priority. A European wage rule should aim to combine three objectives: a fair distribution of productivity gains to the wage-earners, the reduction of structural disparities of wages across sectors, and maintaining the relative price competitiveness across countries.