RESEARCH ON MONEY AND FINANCE

Discussion Paper no 29

Peripheral Europe's Debt and German Wages. The Role of Wage Policy in the Euro Area

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March 2011

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Abstract

The paper argues that the Greek debt crisis, as well as those of other Southern European countries and Ireland, has to be seen in macroeconomic context. The sum of the public sector balance, the (domestic) private sector balance and the current account deficit (or equivalently: the capital inflows) has to add up to zero. By implication in a country that has a current account deficit either the private sector or the public sector has to run a deficit. Therefore the peripheral countries can only solve their public debt problems if there is a change in German current account surpluses. The paper explores the implications of this for wage policy in the euro zone.

Keywords: Euro crisis, financial crisis, sovereign debt crisis, wage policy, wage coordination

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1 Introduction[1]

In May 2010 a crisis of the Euro system was triggered by a sovereign debt crisis of Greece. A EU and IMF rescue package came with conditionality of extensive austerity measures. Still, in December 2010 a sovereign debt crisis erupted in Ireland and at the time of writing (Jan 2011) there is mounting concern that Portugal, Spain and Italy might face similar crises. In reaction to the crisis the EU intends to tighten fiscal policy rules across the Euro zone. This is based on the interpretation of the Greek crisis as resulting from a lack of fiscal discipline. This paper argues that this is wrong analysis and leads to wrong policy conclusions. The Greek debt crisis (as well as those of other Southern European countries and Ireland) has to be seen in macroeconomic context.

The Greek debt crisis is often presented as a result of lack of fiscal discipline. There is some obvious truth in this as Greek deficits were higher than those of other Euro area countries. On the other hand, the fact that other peripheral countries (Portugal, Ireland, Italy, and Spain)[2] are experiencing similar crises suggest that a more general mechanism is at work. Indeed, we will argue, German export surpluses are a critical part of the story. A basic macroeconomic account identity states that the sum of the public sector balance, the (domestic) private sector balance and the current account deficit (or equivalently: the capital inflows) has to add up to zero. By implication, in a country that has a current account deficit either the private sector or the public sector has to run a deficit. Germany has pursued a policy of aggressive wage restraint resulting in large current account surpluses. German gains in competitiveness (since the introduction of the Euro) have not been founded on superior technological performance, but on more effective wage suppression. Germany's current account surpluses are some other countries' current account deficits (and capital inflows). In other words, in some countries (indeed most of this is going on within the Euro zone) some economic sectors have to increase their obligations to Germany: in Greece that was primarily the public sector, whereas in Spain it was the household sector. Simply put, German wage suppression rather than fiscal

[1] This paper has been presented at the conference *Economic policy: in search of an alternative paradigm*, Middlesex University, Dec. 2010. The author is grateful to the participants at the conference, Andrea Ingianni and an anonymous referee for comments. The usual disclaimers apply.

[2] These countries are now sometimes referred to as the PIIGS (Portugal, Italy, Ireland, Greece and Spain). We use the term 'Southern European periphery' or (old) 'peripheral Europe' to refer to this group of countries. The new periphery, i.e. the countries of Central and Eastern Europe, are not covered in our discussion and will only be mentioned occasionally for purposes of clarification.

profligacy is at root of the crisis of the Euro system (see Lapavitsas et al 2010a, 2010b for similar and Wyplosz (2010) for an opposing analysis). Europe needs a set of economic institutions and policy rules that addresses such imbalances and their underlying mechanisms.

The paper argues that the sovereign debt crisis in the European periphery has laid bare fundamental flaws in the architecture of the Euro system. The present economic policy package of the Euro zone consists of (1) a centralized and independent monetary policy aimed at price stability; (2) for practical purposes non-existing central fiscal policy; (3) national fiscal policies that are aimed at balanced budgets (in the medium term) and are severely restricted by the SGP (Stability and Growth Pact); (4) wage policy is hardly recognized as a policy area. This policy mix effectively institutionalizes the Monetarist vision of economic policy: a passive state aiming at price stability and an overwhelming trust in the market mechanism that presupposes, firstly, that wage are very flexible, and, secondly, that wage flexibility leads to full employment and to balanced current accounts. Neither long-lasting unemployment nor financial crises are supposed to occur in this view. In fact this policy setting has led to a mediocre economic performance, a declining wage share, rising current account imbalances - and eventually a sovereign debt crisis.

For the medium term, the Euro zone needs a policy setting that prevents long-lasting current account imbalances, guarantees full employment and an equitable distribution of income. This requires a re-writing of the Euro area rule book. We argue that an active coordination of wage policy has to be at the centre of a new policy mix. This requires institution building and a very different role for labour unions in economic policy making. Wage policy has to ensure that wages grow with (national) productivity growth, that wage growth is consistent with (properly defined) price stability (on the European average), and with sustainable current account positions within the Euro zone. This implies that wages have to grow at substantially higher rates in Germany than in the deficit countries. If Greece, Spain and other countries are not to be pushed into severe deflation, this would imply inflation rates in the range of 5-8%. Overall the Euro area inflation target will have to be revised upwards.

One clarification on the scope of the paper is necessary. This paper will not try to evaluate the merits of a debt default (or restructuring) as several authors have recently argued (Lapavitsas 2010b, Buiter and Rahbari 2010). Nor will we discuss whether Greece and other countries of the periphery should leave the Euro and devalue. Rather this paper analyses the sovereign debt crisis of the (old) European periphery as a crisis of the Euro system and explores the implications for economic policy in the Euro area. In other words, our question is, how economic policy and wage policy have to look in order to make the Euro system work. Debt restructuring may be useful (or even unavoidable), but, so the argument of this paper, without a structural change in European (in particular: German) wage policy similar crises are bound the reoccur in the future.

The paper is structured as follows. Section 2 presents the macroeconomic policy regime in the Euro zone and highlights early Keynesian criticisms of it. Section 3 situates developments in the EU within the finance-dominated accumulation regime and analyzes how two different growth models emerged. Section 4 discusses the origins and the development of the crisis that culminated (for now) in the Greek debt crisis. Section 5 revisits the policy regime in the EU and calls for a fundamental reform, highlighting in particular the need to rethink the role of wage policy, which is elaborated on in section 6. Section 7 comments on the actual recent developments in economic policy and section 8 concludes.

2 The EU policy regime

The economic policy mix in the Euro zone is enshrined in the Maastricht Treaty and the SGP. It can be summarized as follows: First, fiscal policy is essentially national policy. The EU budget, restricted in size (to 2% of GDP) and too small (and too inflexible) to serve a macroeconomic function such as providing an expansionary stimulus in the face of (symmetric) adverse shocks. Second, national fiscal policies are restricted in the short term as the budget deficit must not exceed 3% of GDP (except in severe recessions) and they must aim at a balanced budget in the medium term. Third, monetary policy is centralized and is effectively inflation targeting, with the ECB independently having decided that the inflation target close to or below 2%. Forth, financial markets are liberalized, internally as well externally, that is, the EU foregoes any instruments of controlling credit growth credit or allocating credit. Fifth, there is a no bailout clause, stating that neither other national governments nor the ECB will support individual countries which are facing problems in financing themselves.[3] Sixth, labour markets are supposed to be flexible. This is an essential part of the arrangement as the EU's policy regime essentially hinges on labour market to respond flexibly, efficiently and quickly to symmetric as well as to asymmetric shocks

[3] Buiter and Rahbari (2010) offer an interesting discussion on what the bail out clause precisely states.

because much of the traditional national means of dampening shocks such as exchange rate policy, (national) monetary policy or fiscal policy have been entirely given up or severely restricted.

The EU policy package is characterized by a strong believe in the efficiency and self-healing properties of the market system and a strong distrust against state activity. From the very beginning Keynesian economists criticized its design (Arestis et al 2001, Arestis and Sawyer 2004, Huffschmied 2005, Euromemo Group (2010), Flassbeck and Spiecker 2005, Hein and Truger 2004, 2005). First, there is an excessive reliance on labour market flexibility in the adjustment to symmetric as well as to asymmetric shocks. This goes back to the old debates between Keynes and the classics (Pigou), where Keynesians have argued that labour markets are complex social institutions and wages have social norm aspects that makes them unlikely to react flexibly in the face of unemployment. And even if they did, the effect is not necessarily beneficial (see Stockhammer 2011a, 2011b as modern reformulations). The EU would thus be subject to prolonged unemployment. Second, the EU policy system would create a deflationary bias. In the case of divergences within the EU, with some countries running trade deficits and others running trade surpluses, the burden of adjustment effectively falls to the country with trade deficits. The adjustment of the surplus countries is inflationary (to stimulate their demand and imports and to increase their unit costs), whereas the adjustment of the deficit countries is deflationary as they have to dampen demand (to decrease imports) and lower their prices and wages (to restore competitiveness). As the ECB is committed to a low inflation target an inflationary adjustment is unlikely and would be counteracted by monetary policy. Third, the exclusive reliance on wages as the adjusting variable will create a downward pressure on wages. With macroeconomic policy having a deflationary bias and most of the traditional economic policy instruments constrained the relatively open EU member states would be prone to pursue wage restraint as a means of competitive (real) devaluation. Forth, there was no Plan B in case of a serious crisis. The effectiveness of monetary policy is limited in the case of severe crisis, but fiscal policy is limited by design in the EU. Moreover, the no bailout clause would hamper fiscal policy in times of severe crisis exactly at the time when countries would be unable to use either monetary or exchange rate policies. The EU policy package simply assumed that such a crisis would not occur.

With hindsight all these criticisms have been vindicated. First, the overall economic performance of the EMU countries has been disappointing, with growth rates below those of previous decades, which is of course in outright contradiction to the European Commission's promise of higher growth due to, first, the Single Market, and, later EMU. Second, there has been a strong decline in the wage share. Third, there has been a dangerous build up of imbalances within the Euro zone since the introduction of the Euro. The following sections will contextualize these imbalances in global transformations of capitalism and explain how they contributed to the crisis of the Euro system in the 2010.

3 A finance-dominated accumulation regime with export-led and credit-led growth models

The developments within the Euro zone form part of a global pattern, it is thus worth discussing broader developments before continuing our analysis of the Euro zone. The shift in economic policy that occurred in the early 1980s, often called Neoliberalism, lead to welfare state retrenchment and to the deregulation of the financial sector, both within countries and as regards international capital flows (Glyn 2005, Harvey 2004). Stockhammer (2010b) analyses these in term of a neoliberal mode of regulation that gave rise to a finance-dominated accumulation regime. Finance has critically shaped macroeconomic pattern: in many countries debt levels have risen dramatically; corporate governance structures have been transformed by institutional investors; international capital flows have grown much more rapidly than 'real' economic activity; an increasing share of profits is appropriated as financial profits and financial crises have become more frequent (Stockhammer 2010a). While these tendencies can be observed in all countries, there has been a notable divergence across countries in terms of the driving force of growth, which is reflected in the pattern of demand. Stockhammer (2010b) thus argues that a credit-led and an export-led growth model have emerged (see Table 1). In a first group of countries credit-financed consumption growth and residential investment have become the key source of demand growth. The most prominent example of this is of course the USA. On a global scale, these countries have provided the main source of growth and these countries have typically run substantial current account deficits. A second group of countries has, for various reasons not experienced an equally strong rise in household debt and consumption (in the 1990s and 2000s). Some of these countries increasingly relied on exports as the main growth engine, Germany, Japan and China being the most prominent and important examples. As this list makes clear, the routes to export-led growth are quite different: in Germany export orientation has been a characteristic of the post-war economy; Japan experienced its own phase of credit-led growth in the 1980 that turned sour in 1990s; in China (and other South East Asian countries) it is part of industrial development strategy, and in part a reaction to the Asian financial crisis which lead to a desire to build up foreign exchange reserves.

Table 1 about here

To what extent do these broad categories fit the European case? Table 2 summarizes the increase of household debt (as % of GDP) over the periods 2000-04 and 2000-08 (for some countries no data are available for this longer period). Here as in the following we look at Germany, Austria and the Netherlands as the core countries and Greece, Spain, Portugal, Italy and Ireland as the Southern periphery.[4] While household debt is falling in Germany and moderately increasing in Austria, it is dramatically increasing in the Southern periphery, with all countries well above the Euro (12) area average. In the Netherlands household debt increases rapidly as well, though not as fast as in Ireland and Spain.

Table 2 about here

Table 3 gives the current account position (as % of GDP) in the year 2007, i.e. right before the crisis. This shows substantial current account surpluses in Germany and the Netherlands and a moderate one in Austria; whereas all the peripheral countries show substantial current account deficits with Greece and Portugal above 8%, with Italy and Ireland more moderate.[5]

Table 3 about here

One important determinant of the current account positions is the development of competitiveness. Table 4 thus summarizes the development of nominal unit labour costs (ULC) in EU countries. Germany and Austria have increases of ULC well below the Euro

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[4] Other Euro member states, most notably France, are implicitly treated as intermediate cases.

[5] The current account consists of the net exports of goods and services and the factor incomes. It turns out that there are non-trivial differences between the current account positions and net export positions. The change is most dramatic for Ireland, for which the current account position is negative (-2%), but net exports are strongly positive (10% of GDP). In the case of Ireland this reflect repatriated profits of more than 10% of GDP

area average (and the Netherlands slightly above), whereas the peripheral countries all show increases well above the EU average.

Table 4 about here

Thus there is evidence of quite different developments in the core and the peripheral countries and the characterization as the Germany and Austria as export-led and the peripheral countries as finance-led seems to be broadly consistent with the data. Admittedly, the Netherlands don’t fit easily and could, in our framework be characterized as export-led as well as finance-led. Moreover, we have not included some intermediate cases, namely France, in our analysis. Given our focus on the Euro zone, we have not investigated the Central and Eastern European countries, i.e. the new periphery.[6]

These different growth models are not antithetical to the process of financialization, but intrinsically linked on two levels. First, financial globalization is an important dimension of financialization. It has allowed countries to run current account deficits larger in volume and over longer time periods than under the Bretton Woods system. International imbalances are thus a consequence of financialization. Second, trade imbalances have fuelled credit growth and bubbles in the credit-led economies as the current account surpluses of the export-led economies were flowing to credit-led economies and providing further liquidity.

The emergence of imbalances within the Euro system thus to some extent mirrors a regime of accumulation that is characterized by global imbalances. However, the European experience adds several specific twists. First, while on a global scale, the leading economies have been the credit-led economies, namely the USA and the UK; in Europe the core economies, namely Germany (and its small cousins), have been export-led while the peripheral, Southern European economies have become credit-led. (Adding the new, Eastern periphery further complicates the picture, as many of these countries are characterized by a strong export orientation as well as by rapid increases in household debt, albeit from low starting levels). Second, the Euro zone provided a direct mechanism for financialization as the common

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[6] The CEEC form an interesting group in our framework, or to be more precise: two groups. The Baltic states and Romania and Bulgaria would qualify as credit-led (however this characterization runs the danger of understating the extent of (dependent) industrialization that has occurred in these countries), whereas the Czech Republic, Slovenia and Hungary are closer to an export-led model.

currency reduced interest rates in the Southern European countries and financial integration by way of liberalization was explicit policy of the European Commission. Third, as discussed below, EMU (Economic and Monetary Unification) provided a unique set of policy constraints.

4 The crisis

When the Greek crisis culminated in May 2010 it was foremost conceived as a fiscal crisis. While Greek manipulation of government debt data clearly contributed to this perception, interpreting the crisis as a government debt problem misses its significance on several accounts. It neglects that markets' concern about government debt came after confidence had been shaken in private debt markets and after governments had stabilized these. But it also misses that the Greek crisis is at the same time a crisis of European private financial markets and institutions. To appreciate both aspects, let us rehearse the development of the crisis.

The financial crisis broke out in spring 2007 in the derivative markets of a small segment of the US mortgage market, the so-called subprime market. Banks in the USA had increasingly issued credit to low quality borrowers and refinanced themselves by packaging and selling these loans. This was attractive to banks and investors on the assumption that house prices would keep rising. When house prices started falling, a sophisticated financial machinery came down and with it the credit-led growth model of the USA. Household debt had been rising rapidly based on rising house prices and expected further rises. Despite the prominence of the subprime market in debates and news coverage at the time, however, already at the early stages it was clear (IMF 2008, Table 1.1) that in terms of the volume of losses prime mortgages and commercial property were more important than subprime.

The subprime crisis turned into a fully blown financial crisis in September 2008 after the bankruptcy of Lehman Brothers. Private financial markets froze and even the major financial institutions had problems in raising short-term liquidity. Within a matter of days it became clear that if the private sector were left on its own, this would result in cascade of further failures. As a consequence a series of government interventions, historically unprecedented in its scale took place to stabilize financial markets. Major banks were recapitalized by the state and interbank markets were guaranteed.

In fall 2008 the real effects of the crisis became apparent. Outside the USA the 'real' economic activity had hardly been impacted upon, but now all major economies took a nose dive into the deepest recession since the 1930s. In this phase government deficits (or liabilities) increased, but this was widely welcome by markets. In the course of 2009 the recession deepened, but panic on financial markets receded.

In late 2009 and early 2010, as the recession seemed to bottom out, but as the scale of fiscal costs of the crisis became clear financial market increasingly started worrying about sovereign debt. Markets increasingly turned against those who had saved them. The weakest link among the (developed) states (leaving aside Iceland) turned out to be Greece, which had higher budget deficits than other countries (though not much higher than the US or the UK). Hungary, the Baltic states and Pakistan had already had to turn to the IMF, but the Greek situation was unique in that its policy options were constrained through Euro membership: it could not devalue and it did not have central bank of its own. But as if to illustrate that this was not primarily a Greek crisis but a Euro system crisis, other Southern peripheral countries came also under pressure. Things stabilized only after the European Financial Stability Facility (EFSF) had been set up and Greek government debt refinancing had effectively been taking off markets for three years.

But the Greek sovereign debt crisis was at the same time a crisis for the private sector. Government debt and private bank solvency have become intrinsically linked. It is instructive to quote from ECB's Monthly Bulletin from June 2010:

"on 6-7 May tensions in the sovereign debt markets of some euro area countries spread to other segments of the financial markets. Volatility in the financial markets increased sharply and liquidity conditions deteriorated significantly not only in sovereign bond markets, but also and to a critical degree in the money markets. Transactions within the interbank market declined rapidly and uncertainty among banks about counterparties' creditworthiness increased." (ECB 2010, 41)

As a consequence there were "heightened concerns about the probability of default of some European financial institutions. Indeed, the probability of a simultaneous default of two or more euro area large and complex banking groups, (...) rose sharply on 7 May, reaching values higher than in the aftermath of the collapse of Lehman Brothers." (ECB 2010, 38-39)

In other words, the Greek crisis was Europe's Lehman moment. Saving Greece was necessary to keep European banks afloat. However, it was not sufficient. Half a year later another country experienced a sovereign debt crisis: Ireland. The background was different in that the increase in public debt in the Irish case was directly linked to the financial crisis and a real estate bubble. Again, the EFSF and the IMF came to the rescue. And again it was a rescue of the European banks more than a rescue of the Irish people (Eichengreen 2010).

5 The macroeconomics of rebalancing

Europe faces two challenges: in the short run it has to stabilize fragile economies and their financial sectors and in the medium term it has to rebalance its internal current account positions. The focus of this paper is on the medium-term challenge. Simply put, the problem is that the core has lower unit costs and net exports whereas the periphery has higher costs and trade deficits. Short of a productivity miracle in the periphery, there are two ways that the rebalancing can occur: either through inflation and expansion in the core or through deflation and contraction in the periphery. The former comes with higher employment and latter with unemployment. In the first strategy Germany would have to stimulate demand and increase its wages, whereas in the second one Greece would have to dampen demand and decrease wages and prices.

The problem of reducing budget deficits has to be seen in the same international context. The budget deficit (BD) equals firms' saving (S_F) plus household saving (S_{HH})[7] minus the current account position (CA).

$$BD = S_F + S_{HH} – CA$$

This equation does, by itself, not say anything about the direction of causation and indeed some authors may use it to argue that excessive government deficits cause current account deficits or that labour market inflexibility causes current account deficits that also result in budget deficits (e.g. Moschovis and Servera 2010). We will use the equation illustrates the difficulties of balancing the economies of the periphery. In doing so, we will make two key assumptions: that some country, Germany, is successfully pursuing a policy that results in

[7] $S_F + S_{HH}$ is is total private *net* savings, i.e. total private saving less private investment.

current account surpluses. Second, we treat the euro area as closed economy. The first is a bold assumption, the main purpose of which is to highlight the interdependencies in a monetary union. The second is not so much an assumption as a crude approximation to illustrate our point. In fact 57% of Germany's net exports are to the Euro area and 54% of Greece's (negative) net exports are from trade with other Euro members (for 2006 according to OECD statistics).[8] In other words, what is going on within the Euro area is not the entire story, but almost literally, more than half of it.

In the past decade, the peripheral countries had current account deficits; therefore either public sector or the private sector had to go into a deficit. The degree to which these deficits occurred in the private sector or in the public sector varied by country (in Greece, it was the public sector, in Spain the private sector), but household savings were relatively low as household debt was soaring in all countries. Balancing budgets thus faces a big challenge: it has to be done in a time when household saving rates will increase.

In short, it will be very difficult, if not impossible, for peripheral countries to balance their books unless there is also a change in the core countries. More specifically, inflation has to be substantially higher in the core countries than in the periphery. Just to revert to the relative unit labour cost positions of 2000, German inflation would have to exceed inflation in the periphery by almost 3%-points a year for an entire decade. Unless one wants to push the periphery into a Japan-like deflationary stagnation this can only achieved at EU-wide inflation rates well above the ECB's inflation target.

The policy implications of this analysis are rather clear: first, wage policy has a critical role in the rebalancing of European economies. Simply put, what is needed to save the Euro zone is higher wages in Germany! German wages have to grow in excess of productivity growth and inflation for some time. Second, there are direct implications for monetary policy: the inflation target has to be revised upward such as to allow the core economies to exceed inflation in the South without pushing the latter into deflation.

6 A suggestion for European wage policy

[8] An important, and dynamically growing part of the non-Euro zone trade of Germany is to Central and Eastern Europe, to which we have referred to as 'new periphery' earlier. This is important as part of German wage decline is due to offshoring to Central and Eastern Europe (Marin 2010).

Wage policy has to ensure rising living standards, an equitable income distribution and a sustainable growth process. In the present context this latter requires that wage agreements take into consideration their Europe-wide effects and they are consistent with an overall growth strategy. This requires the national (or sectoral) wage agreements react to current account positions in a way as to insure a non-deflationary resolution of the imbalances. In practise, German (or core) wage would have to rise above productivity and the inflation target for several years. Institutionally, this requires a European coordination system of wage bargaining.

Wage growth (w) in country j would be based on productivity growth (x) of the country, the European inflation target (p^T) and it would depend positively on the ULC gap between the EU average and the country (Stockhammer 2008). The inflation target would have to be set such as to avoid deflation in all countries.

$$w_j = x_j + p^T + a(ULC_{EU} - ULC_j)$$

Such a wage policy may sound grossly unrealistic, and, indeed, it may be; however, if the Euro is to be saved, it is urgently needed. There may be three principal objections. First, it may be argued that wages cannot be influenced by governments but are rather determined by markets (a related argument, often voiced by trade unionists, is that wages are set in autonomous wage bargaining and the state should not interfere with it). But governments have always tried to influence wage developments. This has also been the case for the recent past. Schulten (2004, Table 10.1) lists no fewer than 29 wage pacts in 12 European countries since the early 1980s. These wage pacts usually were tripartite arrangements that aimed at moderating wage growth in the interest of national competitiveness. What Europe needs now, however, is wage pacts in the core that aim at increasing wage growth and harm competitiveness in the centre. This brings us to the second objection: there is no institutional basis for a European coordination of wage agreements. There is much truth in this objection. Neither are industrial relations in European countries similar, nor are there indications of the emergence of a transnational collective bargaining. This would require active state support. But EU treaties, for now, do not support such structures. True; the EU will have to change in response to the crisis.

Third, there may not be political support for a European collective bargaining system (or even for coordination across national bargaining across European states). True enough. The European Commission (as well as the OECD and the IMF) have advocated the dissolution of collective bargaining arrangements rather than their extension to the European level and employer organisation are hostile to the idea. Labour unions are sceptical about losing their power influence wages. The political obstacles are indeed formidable. The system of European collective bargaining, or of a EU-wide coordination of collective bargaining, would have to be part of a European institution building. More, it would have to come with a Europeanisation of trade union structures and would form part of a Europeanisation of civil society.

We thus reject the objections while acknowledging the obstacles. The existing institutions of the EU have served Europe ill. They have led to declining wage shares and to an economic growth regime characterized by imbalances and instability. The Greek and Irish crises, in a very profound sense, are a European crisis. Europe needs a fundamental overhaul of its institutional structure. It has to recognize that if there is to be an economic and monetary integration, it will also have to develop a European fiscal policy (not subject of this paper) and a European system of wage bargaining.

7 Reforming economic policy in the EU – where is the Euro area going?

There is little indication that the EU is moving in the direction advocated here (see Larch et al 2010 as a recent assessment by the European Commission). So what is our assessment of the EU policy? Any assessment is difficult as the policies have not always been consistent.

7.1 Fiscal policy

The good news is that, in the early stages of the recession fiscal policy was expansionary *despite* the SGP. While the EC put some pressure on governments to constrain spending, all countries allowed budget deficits to increase. However, once the sovereign debt crisis began, the EU switched course and pushed for deficit reduction in the periphery. It asked countries to abandon the most essential means of economic self defence in times of crisis. Worse still, the SGP is to be reformed and, with respect to fiscal policy, tightened. The wrong lessons have been learned: instead of expanding the (expansionary) role of centralized fiscal policy, national fiscal policy will be made more restrictive.

7.2 Monetary policy

The record of monetary policy is rather mixed. The ECB reacted swiftly (in summer 2007 as well as in summer 2008) to provide liquidity to markets once the crisis began. While the ECB reacted reasonably responsible with respect to private markets, the same is not true for governments. It initially put pressure on Greece rather than supporting it. Once the crisis hit, it, however, was flexible enough, to bend its rules and accept Greek government bonds. While this was due to its concern about the stability of the European banks rather than out of responsibility for European states, it was the right thing to do. Our biggest concern regarding monetary policy is about the medium term: there is no indication that the ECB is realizing that some parts of Europe will need a lot higher inflation than they have had (and the implications for the inflation target); and there is no indication that the ECB is rethinking its trust in financial market stability: there is no discussion of asset-specific reserve requirements or direct credit management despite the obvious failure of market to deliver socially desirable outcomes.

The no bail out clause. One of the more positive developments is that the EU has, if hesitantly, effectively acted against the no bail out clause and has created an institution for emergencies, the EFSF. The no bail out clause and the absence of any provision for the case of a sovereign debt crisis had been naive at best and, not the least under American pressure, the EU has put together a special purpose vehicle to finance governments cut off by markets. However, the bailout packages the EU is coming up with share the faults of classical IMF programmes: they rely on austerity measures to restore the confidence of private capital markets, thus deepening the economic crisis, while being oblivious to the social and distributional effects of its policy.

7.3 Wage policy

Developments regarding wage policy are among the most depressing. First, in the crisis wage are regarded as cost factor rather than as a source of demand. In Greece and Ireland, wage cuts are part of the rescue conditionality. Moschovis and Servera (2010) in a publication of the European Commission recommend a weakening of collective bargaining institutions. Second, Germany seems intent to proceed with its export-led growth model without recognition of the effects this has in currency union. Chancellor Merkel has repeatedly defended the German export model and praised it as a role model for other countries.

8 Summary and conclusion

The Euro has long been a political project based on dubious economics. It was born out of the emergency of the 1992/93 EMS crisis and the experience of many European countries that they were at the mercy of the German Bundesbank. The Euro has been introduced with different ambitions by different social groups: while Jacques Delors may have regarded it as a first step to political unification, the financial sector aimed at establishing a world currency to rival the dollar. The European Commission (1990) had defended the Euro on the grounds that it would reduce transaction costs, with basically little serious consideration of the costs of giving up an independent monetary policy and an exchange rate policy.

The Euro, or more broadly, EMU has not delivered. The growth and employment performance of the Euro area has been mediocre and the Euro area institutions have proven incapable of preventing the build up of imbalances between as well as within member states. While some member states, the core around Germany, have pursued a strategy of export-led growth, others, namely the Southern European periphery and Ireland have adopted a credit-led growth model. The two growth models interact and depend on each other insofar as the export-led model presupposes a group of countries running current account deficits and the credit-led economies are usually also (next to domestic bubbles in asset and property prices) fuelled by capital inflows. The crisis that erupted in 2010 in Europe is a crisis of the imbalances that have build up over more than a decade and of fragile private financial institutions revaluating various financial assets including financial debt.

The reaction of economic policy in Europe has been half hearted. It has addressed some shortcomings of the economic policy regime of the Euro area, but has shied away from the fundamental reforms that are needed. While the ECB has eventually bent its rules to accept government papers of its member states as collateral after they have been downgraded by markets and the no bailout clause has been circumvented by the establishment of the EFSF, the bailout programs that have resulted are modelled after standard IMF programs that are ignorant to its social and distributional consequences and threaten to deepen the crisis.

The Euro's success or failure will eventually be judged at the political level. The economic policy structures that underpin it have long been criticized by Keynesians and proofed wanting the present crisis. Worse, the crisis is not being used for the fundamental overhaul that seems necessary. The bailout programs clearly undermine the European Social Model (using this term as a summary for actually existing welfare states and the social and distributional compromises they are built on). And they do little to protect states and their citizens from the pressures of an underregulated financial system that has caused a crisis second only to the Depression of the 1930s.

This paper has highlighted the need for a change in the role of wage policy within the EU's economic policy mix. Wage policy presently is almost synonymous with wage flexibility. Wage moderation is seen a way out of economic crisis. While this may work for (small) individual countries it is recipe for stagnation if generalized as it neglects the role of wages in demand formation. Indeed research indicates that an increase in the wage share in the Euro area as a whole has expansionary effects (Stockhammer et al. 2009). So Europe needs wages that rise at least with labour productivity in the medium term. They would need to rise *above* productivity growth and inflation in the centre. Second there is need for coordination in wage policy. Wage flexibility has proven incapable of preventing long-lasting divergences in the levels of competitiveness and of current account positions across Europe. Simply put, if Europe wants to avoid crises like the Greek and the Irish crises in the future, it needs higher wage growth in Germany.

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Table 1. Credit-led and export-led growth the centre and the periphery

	Credit-led	*Export-led*
Centre	US, UK	Germany, Japan
Periphery	Portugal, Ireland, Italy, Greece, Spain	China

Table 2. Increase in household debt (in % GDP) 2000/04 and 2000/08

	2000-04	2000-08		2000-04	2000-08
		-			
Germany	-2.74	11.34	Greece	18.26	
Austria	7.05	7.21	Spain	22.01	32.53
Netherlands	24.35	29.1	Portugal	14.08	21.31
			Italy	13.05	18.09
Euro (12) area	8.96		Ireland	35.07	61.72

Source: Eurostat, own calculations

Table 3. Current account (% GDP), 2007

Germany	3.8	Greece	-8.5
Austria	1.7	Portugal	-8.9
Netherlands	5.6	Spain	-5.8
		Italy	-1.3
		Ireland	-2.1

Source: OECD

Table 4. Unit labour costs (ULC) 2000-08

Germany	3%	Greece	26%
Austria	9%	Spain	30%
Netherlands	19%	Portugal	24%
		Italy	27%
Euro (12) area	16%	Ireland	33%

Source: AMECO, own calculations