COMPETING AGAINST GERMANY: UNIT LABOUR COSTS IN THE EUROPEAN MONETARY UNION

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In this essay, Jonas Peisker asserts the importance of Unit Labour Costs (ULC) in accomplishing the Jean Monnet's convergence objective. Examining the causes of divergent trends in ULC among Euro member states, most notably Germany's perfectly rational drive for competitive advantage, he concludes that implementation of common wage coordination in the spirit of 'ever closer union' is needed to achieve balance and stability going forward.

Introduction

'Ever closer union'-these iconic words constitute the first paragraph of the Treaty of Rome, forged by Jean Monnet, the intellectual father of the EU. His legacy is the so-called convergence objective that guides the actions of the European Commission to the present day. As a way to facilitate economic cooperation and convergence the third stage of the Economic and Monetary Union (EMU), the common currency, was introduced to 11 countries in 1999. The EMU now faces a prolonged crisis; a north-south divide characterises the economic conditions. Unilateral austerity measures have – unsuccessfully – been employed to mitigate the crisis. Every year it continues the crisis will become harder to solve, as workers, particularly skilled young people, are forced to emigrate in the face of over 50 per cent youth unemployment in Spain and Greece and over 40 per cent in Italy in 2014 (Eurostat, 2015). These are strikingly high figures compared to only 8 per cent of Germans under 25 who face the same predicament. 17 years after its introduction, it seems blatantly clear that the EMU has so far failed to achieve Jean Monnet's vision of a united Europe.

This essay draws an empirical sketch of the developments since the introduction of the euro in 1999. In all calculations 'euro area' refers to the initial 11 euro members plus Greece. First, the institutional framework of the EMU is examined. In order to investigate the effect of diverging unit labour costs (ULC) on price level and its consequences for monetary policy in the euro area, the essay then examines contrasts between Germany, France, and Italy, representative of the broad trends within the EMU. Italy, somewhat arbitrarily, accounts for the southern European countries as it exhibits a similar trend to Spain, Greece and Portugal. Special consideration is then given to Germany's export strength and labour market policies that are suggested to be the cause of imbalances in the euro area. Finally, the implications for macroeconomic policy in the euro area are derived. It is argued that the trends of the countries in the euro area are divergent, and that only a thorough redesign of the EMU institutions that strengthens supra-national elements can accomplish the convergence objective of the EC.

The Institutional Framework of the EMU

The Eurozone rests on three interdependent institutions (Cesaratto, 2010). Firstly, the Eurozone is an agreement on a common target inflation rate and currency which results in a nominally fixed exchange rate. The euro members therefore forego any independent monetary policy. Secondly, European fiscal policy only exists as a constraint, as a negative concept outlined in the treaties of Maastricht and Amsterdam where, for instance, limits to sovereign debt and price volatility are specified. However, since these provisions are commonly violated they have been degraded to rather vague guidelines. At the same time, growth and national competitiveness is explicitly left to the national and regional level (European Commission, 2014). The ongoing divergence indicates that pursuing national competitiveness strategies without considering the development relative to the other members within a common monetary policy is inherently contradictory.

In systems with flexible exchange rates, external imbalances are buffered by exchange rate adjustments. Countries with trade deficits would depreciate their currency in order to gain competitiveness, while currencies of countries with surpluses appreciate theirs, which makes their goods more expensive to purchase abroad. This, however, is not possible in the euro area due to the fixed nominal exchange rate. Therefore, deflationary policies must lead to an internal devaluation by which the country gains competitive advantage over the rest of the monetary union. The devaluing country is gaining at the cost of other countries who abide by the inflation agreement and thus pursues a beggar-thy-neighbour policy, a nail in the coffin of the common currency. In order to prevent such policies in the euro area additional macroeconomic coordination, particularly regarding the wage levels, is imperative.

Tendency of Divergence

The price level of goods is influenced by the cost of labour as well as capital input. While the free movement of capital eliminates differences in the costs of capital for entrepreneurs across Europe, wages are still determined on national level within the EMU. As a result ULC are the most important determinant of national price levels on the supply side. The ULC measures the nominal cost of labour relative to its productivity per hour.

The national level of competitiveness is then determined by ULC on the supply side in conjunction with exchange rate adjustments on the demand side. Since the latter has has been removed in the monetary union, the ULC has even more importance for the competitive position of countries in the EMU (Bibow, 2013). The divergence in ULC within the euro area is enormous, as annual differences in growth rates accumulate. Since the introduction of the euro the ULC in Germany have increased 37.6 per cent less than in Italy and 13.3 per cent less than in France, a country that is in line with the Eurozone. Indeed, this gap empirically has an effect on the national price development. While France moved along with the average of the Eurozone, Germany undercuts the inflation target clearly and Italy exceeds it, resulting a inflation gap of 14.7 per cent between Germany and Italy.

Germany's Role in the EMU

The policy of wage deflation-more precisely disinflation-in the largest economy of the Eurozone and its according internal devaluation has succeeded in creating competitive advantages on international markets. While France and Italy alternate between periods of trade deficits and surpluses, Germany has accumulated a huge trade surplus since the introduction of the euro. Net exports accounted for 7 per cent of German GDP in 2015, in contrast to 3 per cent in Italy and –1.5 per cent in France.

Additionally, Germany's fiscal prudence contributes to its high current account since, a constitutional debt limit suppresses domestic demand. Germany has exceeded the intra-EU exports of the other member states only since 1999. The German goods, subsidised by low wages, greatly affect the other euro members. The EU imported 6.5 per cent more from Germany than from France before the onset of the crisis in 2008, underscoring the competitive dominance of Germany on the EMU-internal market. Germany's deflationary policy-just as much as unchecked inflation in the southern European countries-has created the immense external imbalances that are at the core of the euro crisis.

Both productivity increases and wage deflation have pushed down ULC in Germany. With the onset of the single currency Germany adopted the latter as a new strategy to tackle its persistently high unemployment. The 'Hartz reforms' re-organised the labour market in 2002 and increased the pressure on workers and wages by imposing sanctions on the unemployed if they turn down job offers, no matter whether those are suitable or not. The threat of sanctions has greatly increased temporary and precarious employment in Germany. 1.3 million German employees depended on unemployment benefits in 2014 because their wage did not even cover their subsistence minimum (Bundesagentur für Arbeit, 2015). The number of employees of subcontractors has increased by 170 per cent to 856,000 from 2002 to 2014 (Bundesagentur für Arbeit, 2015). The upsurge of temporary and low-wage employment created a labour force that is not able to unionise in order to represent their interest, namely a wage increase in line with productivity and target inflation. As a consequence, both labour costs and inflation stayed low in Germany. Therefore, Germany does not commit itself to the common inflation rate that is so crucial for the monetary union. This is ironic since the ECB was modelled after the Bundesbank.

Implications for the European Monetary Union

The core contribution of this essay to the public debate surrounding the euro crisis is that examining the trends in ULC are essential to understand its roots and possible solutions. What follows is that any strategy that credibly attempts to solve the euro crisis must be fundamentally multilateral in its approach. The implementation of common wage coordination or bargaining is of utmost importance in order to prevent asymmetric demand shocks and external imbalances in the euro area. Flassbeck and Spiecker (2011) suggest that the development of ULC should gradually converge, i.e. ULC growth of 3 per cent annually in Germany and of 1 per cent in the southern euro members while the Eurozone average remains just below 2 per cent, the inflation target of the ECB, like in France. A 'European wage standard' is conceivable to bring Europe back on the path of convergence (Brancaccio, 2012). This standard would induce nominal wage growth to be at least in line with national productivity increases, consider the trade balance, and establish an institution that can credibly enforce compliance. So far very little consideration has been given to the possible implementation of such an institution since this almost certainly incorporates relinquishing national sovereignty to a supra-national body of the EMU.

Two steps could contribute to a sustainable solution to the euro crisis and an ending of competitive deflation. First, the ECB's mandate, closely defined as targeting a 2 per cent inflation rate, must be extended so that it can consider employment and stability besides price stability, because the transition phase suggested by Flassbeck and Spiecker will probably lead to temporarily higher inflation. Secondly, the Eurogroup, the meeting of the ministers of finance and the governor of the ECB, should be institutionalised in order to create a political body that can coordinate macroeconomic policy across Europe. Doubtless, those are the first steps towards a federal Europe since such reforms would have far-reaching implications for wage bargaining and social policy, and these are some of the last policy domains largely untouched by EU law.

Conclusion

There is still an immense scope for literature that examines how such a transition from national to supra-national institutions can be implemented most efficiently as well as how such an endeavour can be communicated within the political process, considering eurosceptics gaining ground in virtually all euro member states. First and foremost, in order to equip decision-makers with practical advice, the data employed here needs to be disaggregated to differentiate between different sectors within economies, to give indication of the scope and naturof a possible wage standard.

When Jean Monnet advocated 'ever closer union' it was his emphatic narrative that brought Europe together, not strict rational necessity. Indeed, this exceptional project of supra-nationality succeeded in the early years because it was the former and not the latter. It is vitally important for the EMU to find a sustainable solution to its crisis, and the common overarching objective of a united Europe can only be achieved if national developments are balanced. A spirit of 'ever closer union' is what Europe needs once again, because Germany clearly has no incentive to give up its entrenched position of competitiveness out of rational self-interest.

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