

The Political Economy of Wage-setting in the Eurozone

Bob HANCKÉ

*Lecturer in Political Economy, London School of Economics and
Political Science*

Introduction¹

This chapter deals with the current practice of wage-setting in the Eurozone. It starts from the assumption that, contrary to what is prescribed and implicitly predicted by the theory of optimal currency areas (OCA), labour mobility in Euroland will not significantly increase: it has been low even within the Member States prior to 1999 and is unlikely to take on proportions that meet the OCA criteria in the near future. Moreover, labour markets in most of the current Member States of the single currency will not suddenly undergo a dramatic deregulation either. The reasons are manifold and are as much related to the intrinsic resilience of wage bargaining institutions who do not simply adapt to (the OCA interpretation of) a new macroeconomic regime, as they are to how these labour relations systems operate to the benefit of employers in many of these countries, which would make a wholesale deregulation an irrational strategy from their part (Hall and Soskice, 2001). Adjustment of wage-setting institutions and outcomes will have to be understood within the context of existing labour market institutions.

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This chapter suggests that – for the foreseeable medium-term future – wages are no longer a source of inflationary pressures in the Eurozone: the existing labour market institutions in the six Eurozone countries included in this study (Germany, France, Italy, the Netherlands, Belgium, Ireland) are organised in such a way that wage settlements across the different Eurozone countries appear to have become fundamentally, and most likely structurally, disinflationary: wages are set as a function of competitiveness, thus leading to a decline in unit labour costs (or, put differently, nominal wages are lower than productivity, but real wages can and do rise). Highly centralised and/or co-ordinated forms of wage-setting avoid inflationary over-heating of the labour market (Calmfors and Driffil, 1988; Soskice, 1990), and where unions are important actors in wage-setting, the new wage-setting regime *de facto* forces them to co-operate with employers in assuring steadily rising labour productivity through skills policies, work reorganisation and training regimes.

This argument builds on a novel understanding of the institutional frameworks for wage bargaining. In the run-up to Economic and Monetary Union (EMU), wage bargaining in the current “ins” has followed a social pact logic, whereby the governments enlisted the labour unions in their own drives to meet the Maastricht criteria (Pochet & Fajertag 2000): centrally organised wage moderation became an instrumental macroeconomic strategy, which was accompanied by the hard sanction of failing to meet entry requirements for EMU. After 1999, however, the need for a low domestic inflation rate which converges with the aggregate Euro-wide inflation rate is considerably less stringent in each of the Member States. Individual Member States can run a short-term inflationary policy (for example in the run-up to an election), *de facto* free-riding on the “good conduct” of the others, while the European Central Bank (ECB) may be loathe to punish all Member States “if one misbehaves” (Gatti and Van Wijnbergen, 1999).

Pre- and post-entry social pacts should therefore be understood differently. While pre-entry social pacts and the wage settlements they produced were instruments in a broad macroeconomic strategy geared toward accession to EMU, post-entry social pacts are, because of the wage settlements they generate, organised on employers’ terms. A careful look at

actual wages in the EMU Member States demonstrates that they are within a range set by current inflation as the effective wage floor and labour productivity as the effective ceiling – or, put differently, by being aligned with productivity, real wages reflect and contribute to export competitiveness. The macroeconomic effects of such a wage bargaining system built on low and falling unit labour costs, are low aggregate inflation rates.

The chapter starts by raising the question of how to understand current wage-setting systems (section I), and then moves on to an analysis of developments in the Eurozone countries in section II. The material in this section reports both interviews with top wage-setters in the countries studied and recent statistical material that corroborates these findings. The chapter concludes by raising a series of issues that follow from this new situation, the politically most relevant of these is, perhaps, that if wage-setting systems can indeed be considered disinflationary, then the ECB ought to take that into account in its interest-rate policies, by rewarding “responsible” (*i.e.* non-inflationary) wage-setting.

I. Convergence without Co-ordination

The analysis of this chapter starts from a central observation: co-ordination of wage-setting among trade unions across the Eurozone is, despite much energy spent on it, in fact very weakly developed both in terms of process and structures. There are many reasons for this. Trade unions have not transferred wage-setting authority to a supranational body, hard sanctions among trade unions for over- and under-shooting wage targets do not exist, and both short- and long-term defections from any multilaterally agreed wage level can still pay off for individual unions.

The attempts in industrial sectors such as metal and textiles, or the transparency instituted between the Dutch, German, Belgian and Luxemburg confederations as part of the so-call *Doorn* process, certainly lead to a high degree of informal information exchanges. However, precisely because hard sanctions for individual trade unions to align their wage demands with collectively decided ones are absent, single members can (and will) always defect from such informal agreements. Significantly, none of our interview partners (all top

trade union officials involved in wage-setting in their countries) used other unions as a guide for wage setting, and only in Belgium knows a law that explicitly forces unions and employers to take wage developments in other countries into account in wage negotiations. And while German unions are certainly concerned about wage developments (undercutting) in other countries, even they set wages using only national parameters.

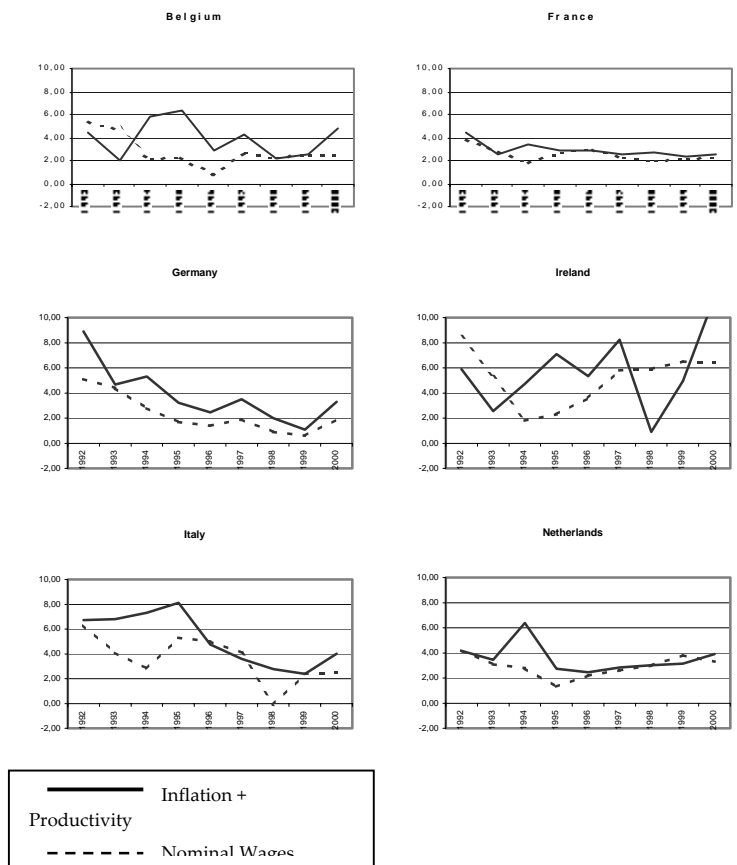
The European Metalworkers' Federation (EMF) thus has adopted a so-called "co-ordination formula", urging unions to set wages as a function of past (and expected) inflation and labour productivity. In this formula inflation acts as a wage floor and productivity growth as a wage ceiling. Applying this formula is supposed to lead to three outcomes simultaneously. One, real wages do not fall; two, wage competition would not occur; and, three, since unit labour costs would be stable (and probably slightly falling if real wages grow more slowly than productivity), inflation would tendentially fall as well. In the absence of hard sanctions, this appears as the second-best solution, and if member unions can agree to regularly monitor each other's wage setting behaviour, there is a fair chance of *de facto* convergence in relative wage-levels (corrected for productivity) across the Eurozone.

There are good reasons to doubt if even such a "soft" monitoring system can produce the expected results, precisely because it does not resolve the collective action issues at the basis of this co-ordination problem. Imagine a situation with two countries: a slightly lower wage rise in country A would, if country B with whom it trades a lot exploits the co-ordination formula to its full extent, lead to demand leakage since A's products are more competitive, and thus indirectly to an export of unemployment from A to B. Given this possible outcome and the knowledge that all have of it, no one co-ordinates and the attempt dies a quiet death. This probably explains why, in effect, very few of the labour unions in the Eurozone make explicit reference to the co-ordination formula in setting wage demands or negotiating wages (in fact only the Italians do).

There is a remarkable and surprising puzzle, however. Despite the failure of wage co-ordination to become institutionalised, wage settlements in the different countries since 1990 have consistently ended up at a level slightly below

the ceiling set by the sum of inflation and productivity. Wage inflation is therefore very low (and has been falling since the early 1990s), and unit labour costs have developed in a highly uniform (and seemingly co-ordinated) manner across the Eurozone. Thus the puzzle: despite the difficulties with soft co-ordination, and the practical neglect of the wage co-ordination formula by the labour unions when determining wages, the outcome of wage-setting is remarkably consistent with a strong form of wage co-ordination, including low and falling wage inflation. How can this be explained? Figure 1 presents these data for the EMU countries in this study.

Figure 1: Inflation, Productivity and Wages (1992-2000)



Source: OECD, 2001.

The answer suggested in this chapter is related to the way employers, especially in the tradable goods sector, are involved in and deploying wage-setting systems. The argument is relatively straightforward, and has two steps. The first is that employers may either not wish to deregulate labour markets because of the benefits it produces for their product market strategies (Wood, 2001; Hall and Soskice, 2001), or be unable to

do so because of their entrenched nature. Under these conditions – the second step – wage settlements that explicitly reflect competitiveness concerns, even under tight labour market conditions, become the second-best choice for employers: it secures export competitiveness without leading to falling real wages. Depending upon the specific context in each of the countries, competitiveness can be expressed in different ways –productivity, profitability or simply unit labour costs – but the basic logic is the same regardless of the particularities of the case.

Two further elements may help explain this outcome. First of all, there is a fundamental asymmetry between labour and capital in their degree of organisation or internal co-ordination. As Offe and Wiesenthal (1985) pointed out (1985), employers are able to co-ordinate more easily than unions; in contrast to labour, which has to be organised from the level of individual workers up, an employer is already organised capital with relatively transparent and monolithic interests, organised around being and remaining competitive.

The second element has to do with the difference between pre- and post-entry social pacts. In essence pre-entry pacts were attempts by governments to enlist unions and employers in their efforts to enter EMU. Frequently a new institutional framework was built for that. However, post-entry these institutions are no longer necessary for that purpose. Despite that, they did not disappear: since wage inflation targets were defined in roughly speaking comparative unit labour costs, the same institutional infrastructure can now be used by employers to safeguard or increase competitiveness. Put differently, the arrangements around the social pacts (centralisation, “technical” wage bargaining, and wage norms) work equally well for governments who are trying to keep inflation down as for employers who are trying to improve competitiveness.

If all countries agree to set wages as a function of relative competitiveness, then the aggregate situation is one in which all countries end up with a wage level that roughly reflects past inflation and current productivity (since competitiveness is, all other things being equal, a function of or a proxy for productivity). The co-ordination outcome of wage bargaining in the Eurozone is therefore driven by competitiveness – an employer- and not a union-driven wage target.

This argument will be developed through an examination of different, often novel and therefore not yet well-understood elements of the new bargaining systems in six countries in the Eurozone since the early 1990s. Combined they suggest that a new logic of wage bargaining has gained ground in the Eurozone, which is, in terms of its outcomes, highly articulated with the disinflationary macroeconomic regime heralded by the Euro, and simultaneously finely attuned to the competitive needs of employers.

II. The Logic of Wage-setting in the Member States of Euroland

Four empirical elements underpin the new wage-setting logic in Euroland: re-centralisation of wage bargaining, a growing technicality leading to relatively universal wage outcomes across different countries, a sharp distinction between the functions of central and de-central labour relations, and the articulation of this regime with employers' interests. The first two lead to moderate, centrally co-ordinated wage levels, the third articulates the central wage setting regime with microeconomic changes, and the fourth links the wage bargaining system to the tightness of the labour market in leading export sectors.

A. Re-centralisation between 1992 and 1998

After a decade of wide-spread decentralisation in collective bargaining systems (Katz, 1993; Katz and Darbshire, 1999), the 1990s have witnessed a remarkable re-centralisation of wage bargaining systems in many European countries. While it took different forms in the different countries, and in many cases was hidden under a rhetoric of decentralisation, the coverage of collective bargaining increased (or was stable at a high level) in the countries preparing for EMU (see Pochet and Fajertag, 2000).

These outcomes are confirmed in the shape institutional developments in different countries can take. In the first group of countries – Italy, Belgium, Ireland and to some extent Spain (?) – collective bargaining systems have explicitly re-centralised. Wages follow relatively strict central guidelines, and union (con)federations as well as employers federations play a central role in this process. In Italy, wages are set in two rounds: at the

central level agreement is reached on how wages should reflect past inflation; at the de-central level, unions negotiate how labour productivity is reflected in wages. In Belgium, wages are set according to a centrally negotiated “wage norm” (see below for more details). The effect has been that wage negotiations have *de facto* come to fall under the authority of the central union confederations, and that the – previously more powerful – branch organisations are left with very small negotiation margins.

The second group of countries are those where despite clamours of decentralisation, the practice of wage setting is and remains *de facto* highly co-ordinated and centralised: the Netherlands and Germany. While *prima facie* wages in the Netherlands are negotiated in the companies, up until 2001, final approval of a wage settlement had to be given by a small board of top-level union officials – with two important effects on wage-setting. The first was that negotiations mirrored central wage guidelines (precisely because they took place in the shadow of these centrally agreed wage guidelines); the second was that it gave the central union (the industry/branch federations) the authority to strike down wage deals if wage settlements were not in line with these central provisions.

The German wage setting system operates in a different way. It remains highly concentrated around pilot negotiations in the export/tradable goods sector, which are then transferred to the rest of the economy. In most of the wage rounds of the last decade, one IG Metall district led the wage round, that outcome was then extended to the entire sector, and the wage growth in the metalworking sector became the norm for all sectors. In large measure, this relative stability of the German wage-setting system is directly related to the benefits the system generates for large firms, the core of the German tradable goods sector and (as a result) also the leading firms in employers associations (Hassel and Rehder 2001): central wage moderation keeps labour costs down while de-central bargaining on “qualitative” issues such as working time, skills, and work organisation allows firms to flexibly reorganise.

The third category, which in this selection of countries only consists of France, bears some superficial resemblance to this large-firm centred set-up. The paradox to be explained in the French case is that unions are very weak – by most accounts too

weak to count for much in collective bargaining – but that the bargaining coverage rate (the proportion of eligible workers covered by collective bargaining is one of the highest in the OECD countries, higher than the traditionally highly organised systems in Scandinavia or Belgium. The answer to this paradox is that the wage bargaining system is largely organised around the needs of the large firms in France, who set wages for their workers as a function of relative unit labour costs, or, put differently, taking into account relative productivity of the French plants in their multinational organisation. These wages are then proposed to the unions in branch-level bargaining rounds, and extended by the Ministry of Labour to cover the sector as a whole. Co-ordinated wage bargaining thus can exist without unions (see Soskice, 1990 for a similar point on Japan).

In sum, all the Eurozone countries knew some form of centrally co-ordinated wage bargaining systems in the 1990s. Explanations for this recourse to central co-ordination come in two – complementary rather than competing – forms. The first emphasises the need for central social pacts in the run-up to EMU (Rhodes, 1998; Pochet and Fajertag, 2000; Hassel and Rehder, 2001). In a line of argument reminiscent of the literature on “neo-corporatism” in the early 1980s (Schmitter, 1981; Cameron, 1984; Flanagan *et al.*, 1983), macroeconomic performance – reduced to fiscal discipline and disinflation by the Maastricht Treaty – required a strict incomes policy. Central social pacts thus emerged, even in countries without a tradition and structure of central bargaining such as Italy and Ireland, as long as the political will toward EMU was strong enough.

But, as the second argument suggests, there was more in it for employers than “just” entering EMU. In several countries, including Italy, the Netherlands, and Belgium, the re-centralisation of wage bargaining reflected growing concerns about trade and competitiveness. In Italy, the realisation that upon entrance into EMU the relative flexibility of the post-1992 Exchange Rate Mechanism (ERM) was gone, and competitive devaluations therefore were impossible, forced unions and employers to strike a framework deal in 1993 that took into account the competitiveness of the Italian economy.

In the Netherlands and Belgium, the dramatic changes in the legal and para-legal framework in the 1980s put competition on the agenda. The 1982 Wassenaar Agreement is rightly famous as

the foundation of the “Poldermodel”; less well-known, perhaps, are the 1988 and 1996 Belgian laws on competitiveness, which stipulate that social partners have to take developments in the main trading partners (Germany, France and the Netherlands) into account when setting wages (with direct government intervention as a stick to back up the threat). In fact, what has happened in these two countries is the equivalent of competitive devaluations, but in a narrow-band fixed-exchange rate regime. By firmly pegging the Guilder and the Belgian Franc to the Deutschmark, but with wage growth consistently below Germany, the tradable goods sectors in both countries managed to improve their relative competitiveness.

Thus, pressures from two sides led to the re-centralisation of wage-setting during the 1990s. One was the run-up to EMU, where central wage co-ordination became an instrument by governments to keep wage inflation under control, the other was the need for wage settlements that took into account export competitiveness, and was more closely aligned with employers’ concerns.

B. Wage Benchmarking through Technical Commissions

Alongside central co-ordination of wage bargaining as the organisational framework for wage-setting in the Eurozone, the substantive outcomes of wage bargaining have been subject to a form of wage benchmarking. This refers to the growing practice of transferring the authority for setting wage demands from the pre-existing (at least formally) more or less democratic model, whereby wage demands are ratified by the rank-and-file (or their local representatives on national labour union boards), to a small group of centrally appointed wage experts, inside and outside the labour unions, who propose more or less binding guidelines on wages. The increased technicality of wage-setting, and especially its outcome in many countries (a *de facto* wage ceiling), were direct results of the Maastricht criteria in the same way as the (re-)centralisation of wage bargaining: it allowed governments and wage negotiators to set wage targets commensurate with inflation.

The arrangement itself can take a variety of different forms. In a few Euro Member States the preparation of wage-setting has been transferred to a small group of outside experts, who base their advice on wage developments on a variety of

indicators, usually involving some measure of wage growth in trading partners, domestic competitiveness, and prospective inflation.

In Belgium, in the wake of the 1996 law, a small expert group in the Central Economic Council (CRB-CEC) sets a wage norm that is binding for all negotiations. Belgium being the only EMU Member State with a statutory wage indexation mechanism, the wage norm essentially concentrates on competitiveness (as the 1996 law prescribes). The outcome of wage negotiations – if they can still be meaningfully called that given the strict constraints on the system – therefore increasingly follow a simple arithmetic: the wage floor is given by the past/expected inflation rate, while the wage ceiling is given by the wage level consistent with stable or improving competitiveness.

In Italy, a small group of top union and employers experts determine, in co-operation with central bank officials, the past and expected inflation rate, and set a central wage norm. In Ireland, finally, the 1987 social pact has *de facto* transferred the determination of wages to a small group

As these national cases suggest, wage norms can be more or less binding. In Belgium, for instance, the wage norm imposes a statutory limit, in Italy it offers a focal point for negotiators. However, even where the wage norm is not binding, it offers a strong authoritative framework since it is *de facto* used (by governments, employers, unions).

In a group of other countries, the labour unions have kept control of the process, but have internally delegated the process to a small groups of internal experts, who decide what an appropriate wage level would be using similar indicators to those used by external experts in the first group of countries.

In Germany, IG Metall is the undisputed leader in wage negotiations. Within IG Metall, a small commission prepares the bi-annual wage rounds by calculating what it considers as the appropriate wage level on the basis of past inflation and prospective labour productivity. A pilot district – often the strong Baden-Württemberg regional union – then uses this centrally defined wage level as its regional benchmark in negotiations, and the bargaining result thus obtained is “recommended” by both central unions and central employers’ associations to the future negotiators.

In the Netherlands, a group of central union experts state at the beginning of every bargaining round the “appropriate” level of wage growth for the contract negotiations, and up until 2001 every contract (even though it is formally signed at the company level) was officially sanctioned by the labour union board. The benchmark for wages used by this group is the sum of two elements: current labour productivity and the changes in producers’ prices. In addition, three other elements can be taken into account: inflation, unemployment and corporate profitability.

France, finally, offers a functional equivalent without unions: since 1983, when the then Finance Minister Delors imposed a *de facto* ceiling on wages (as part of his policy of “competitive disinflation” which was linked to the political decision to keep the French Franc in the ERM), the structure of wage developments in France has been similar to other countries (compensating for past inflation, taking into account competitiveness). A small group of experts, consisting of members of the Finance Ministry, the Plan and the central bank, have sent strong (and, since the central bank was politically controlled by Delors, highly convincing) signals about what it considered appropriate wage growth levels.

C. The Search for Productivity

Picturing developments in the Member States solely as a re-centralisation, substantively guided by a centrally defined wage norm, does not entirely do justice the complexity of the new situation. The decentralisation of labour relations in the 1980s in most of the current EMU Member States has left its traces. The re-centralisation of wage bargaining was grafted upon an existing system in which so-called “qualitative” issues in labour relations, such as work organisation, training, working time, and job design, had been decentralised.

The current regime sanctions this existing arrangement, by offering labour unions strong incentives to co-operate in firm-level productivity drives. By taking into account competitiveness, the central wage-setting systems all over the Eurozone take productivity growth (a rough proxy indicator) as the *de facto* ceiling for wage demands. For the unions, this implies (under the current low inflation regime) that faster productivity growth allows for higher wage increases – hence

the (macro-economically determined and centrally sanctioned) incentive to join in local productivity drives.

Ultimately this led to a convergence of different industrial relations systems on the one that we have traditionally associated with the North-West European (“Swedish-German”) model, in which wages are set centrally, and unions participate in a company-level productivity drive. As a result of the shift in the macroeconomic regime associated with EMU, the microeconomic logic of the different models of capitalism in Europe therefore seems to have shifted as well. The result: in countries as diverse as Italy, Belgium, Ireland, the Netherlands, and Germany, unions have become active partners in the formation and development of skills, or have strengthened that role. In Germany, moreover, a debate is taking hold within IG Metall about the relation between skills and wages.

In Italy, this new division of labour between central and local labour relations structures is perhaps clearest of all. Wages are set centrally in the current Italian set-up, compensating for inflation and therefore protecting real wages, while de-central negotiations reflect productivity. The result of this division between central and de-central wage bargaining institutions in Italy has been a significant increase in company-level productivity coalitions, and an attempt by unions to position themselves in this debate (However, whereas this system works well for large exporting firms, the vast majority of Italian workers – some estimates go as high as 95% – are employed in companies with less than 10 workers and therefore fall beyond the boundaries of this system; the result is that wages in these small-firms put additional downward pressure on wages in the large firms).

The only exception, again, is France, where this process takes place not via unions, but via a functional equivalent of employer-led plant-level institutions which dramatically improved productivity in the 1980s and 1990s and have the structural potential to do so in the future (Hancké, 2002).

In sum, the new wage bargaining regime thus appears to have institutionalised a strict division between wages, which are bargained centrally bargaining level, and productivity- or competitiveness-enhancing measures, including skill formation, which are organised at the de-central level. This has led to a reorganisation of trade union structures, especially in those

countries where firm-level unionism was not highly developed, in order to accommodate the de-central labour productivity drives.

D. Tight Labour Markets and Centrally Co-ordinated Wage Bargaining

The driver of central co-ordination is – not without irony given the high aggregate unemployment rates in Europe – the tight labour market that employers in leading wage bargaining sectors face. Reliable quantitative indicators of industry-level labour markets are extremely hard to come by, but ILO data on unemployment in the manufacturing sector confirms that this sector (which is an important exporting sector in all the Eurozone countries) has indeed been facing a quasi-full employment regime since the mid-1990s, a picture confirmed by qualitative material obtained in interviews in the different countries.

The low unemployment in these sectors is the combined result of two processes. The first is related to the relatively high growth over the last four years in the tradable goods sectors; the second the relatively inelastic labour supply as a result of the skill requirements. In the existing skill formation systems in the manufacturing sectors in Europe, training systems often take more than two years to produce skills. Anecdotal evidence suggests that multinational companies may even make investment and location decisions dependent upon the capacity of a local employment system to supply the necessary labour.

Within such a tight labour market, and given the stable institutional frameworks for wage bargaining which are hard to change without disrupting a relatively peaceful social climate, centrally co-ordinated wage setting is the most favourable option for employers. It is in fact, despite what orthodox economics textbooks suggest, even more beneficial to them than decentralised wage setting (see Calmfors and Driffill, 1988; Soskice, 1990 for different, complementary, versions of this argument), because it allows companies to hire workers at a wage below the market rate (Hassel, 2001). Additionally, such a system acts as a productivity whip by rewarding firms that could pay above the going rate and punishing the others.

The tradable goods sector – in many cases the metalworking sector – leads wage negotiations, or is critically important in any

centralised wage-setting system in almost all the Eurozone countries. For a variety of reasons, often related to what was analysed in the body of this chapter, unions in these sectors have to a large extent internalised the competitiveness requirements that are part and parcel of wage-setting today (Rhodes, 1998; Hancké, 2000). This sector leads the negotiations, effectively paying the highest wages, and the other sectors follow.

The new wage-setting system is therefore not only macroeconomically sound (by keeping inflation down), it is also microeconomically sound, since it allows employers to keep wages in check, gives them centrally co-ordinated productivity-enhancing flexibility in the workplace, and ultimately contributes to an improvement in relative competitiveness.

Conclusion

The institutional shifts in the wage bargaining systems in the Eurozone countries since 1992 have led to three broad outcomes. The first is that the set-up is fundamentally disinflationary without leading to transnational wage competition. In contrast to many fears on how a social Europe is (not) developing (Streeck, 1998; Martin and Ross, 1999), the particular set-up of the system leads to simultaneously low and falling unit labour costs, and to low social dumping. Social dumping is avoided by the “floor” that inflation sets on wages: in principle wages rise at least at the rate of inflation, and real wages therefore should not fall. There may be variations reflecting the business cycle, but the lowest wage level is in principle given by the inflation rate (only the Dutch unions were debating lower real wages in 2001, to compensate for the temporarily high inflation rate).

The second outcome across the Eurozone countries is that this set-up safeguards an important role for trade unions, both at the central level in wage-setting and at the firm or company. Since the wage ceiling is *de facto* given by productivity (assuming other factors to be equal) labour unions have strong incentives to co-operate with employers in increasing functional flexibility and workplace reorganisation to increase productivity. Raising productivity allows unions to demand higher wages without jeopardising competitiveness, and offers employers co-operative workplaces to pursue new business strategies based on high value-added products. Put differently,

this may suggest a new version of the “old” European road to competitiveness (Streeck, 1992) – the so-called high-skills, high wages, high value-added economy, very different from the one heralded in much of the business literature and which relies almost solely on labour market deregulation and numerical flexibility.

Finally, while the new regime appears to be structurally disinflationary as a result of falling unit labour costs, it is emphatically *not* a result of the ECB’s credible threat. First of all, the signalling game between the ECB and the labour unions is significantly less transparent than its predecessor which involved the Bundesbank and the IG Metall (Hall, 1994). For any individual union, including the IG Metall, the ECB’s threat of raising interest rates in response to excessive wage settlements in individual Member States is not credible, since the ECB reacts to the Eurozone wide inflation rate, and individual countries can depart from that, at least in the short term. But this lack of explicit signalling is actually irrelevant in the existing wage-setting regime in the Eurozone, since the apparent co-ordination follows directly from the benefits it produces for employers. The disinflationary wage-setting outcome therefore may be very similar to an equilibrium reached in a signalling game between labour unions and the ECB, but the fundamental dynamic at its core is provided by the willingness of employers (especially in the tradable goods sector) to stick to the bargaining system.

Assuming that this analysis of wage-setting in the Eurozone stands a series of more rigorous academic tests and – perhaps most importantly – survives a downturn in the business cycle, a few issues would need to be resolved.

The first is that the novel division of labour between central (wages) and firm-level (productivity-oriented) labour market institutions is, because of the existing union structures, relatively easy to handle for many of the labour unions in the Eurozone. In Italy, Belgium, Germany, and Ireland, for example, unions have always had or recently developed both functions, and the novel Eurozone regime confirms and reinforces this internal division of labour. Some countries, however, have strong central unions but notoriously weak firm-level unions. France is a case in point, but the same can be said about unions in the Netherlands who have relatively weakly developed local unions. Without prejudging developments in both countries, it

is legitimate to ask to what extent these labour unions will be able to cope with this two-pronged regime. If the recent evolution of the French labour relations system offers an indication, then functional alternatives may exist in the capacity of employers to co-ordinate and enlist the state, but it is far from certain (as developments in France suggest) that labour unions will then be a central partner in the arrangement.

The UK is in a similar position: it has neither a “tradition” of nor an appropriate institutional framework for central wage co-ordination, and there are, with a few idiosyncratic exceptions, no firm-level institutions to include labour unions in the search for labour productivity increases. While it is certainly too early to assume the UK will join the Euro, the question remains how these institutional deficiencies will interact with an (eventual) participation?

Secondly, the German unions find themselves in a highly unfortunate position *vis-à-vis* the other labour unions in Europe. In contrast to monetary policy, which has moved from an asymmetric Bundesbank-centred system to the symmetric EMU, the labour market institutions still display a clear asymmetry, with the German labour unions in the “anchor” position. For all countries Germany is a significant trading partner, and every other country therefore *de facto* sets wages taking into account German wages as a benchmark. This implies that, while others are, in principle, free to move around the German wage rate, German wages themselves cannot move without forcing the others to move as well. The implications of the current set-up for the German wage bargaining system are therefore highly unclear, but they do suggest that as the leaders in the system, the German unions will have to find an “appropriate” wage rate on the basis of other parameters than wages in the trading partners. Put differently, defining what this appropriate wage rate is and how it is calculated, may well be the biggest challenge for the German labour relations system – and with wide-ranging implications for the rest of Europe.

Since the system appears to be built around the benefits it produces for employers in the tradable goods sector, how much of its medium- and long-term viability depends on the goodwill of employers, fed by what they are getting in this new system? Put differently, can and will they abandon this wage-setting regime when the cycle changes and/or when the current

tightness of the labour market is reduced (either through increases in the supply of skilled labour or labour saving technology)? Any answer to this question seems to have to take into account two conditions. The first is if employers' rationality is short-term or long-term. If short-termism prevails, any shift in the supply of labour would instantly lead to employers abandoning the system. However, this seems predicated on a second condition: are the firm-level labour market institutions sufficiently strong to convince employers to take a medium- to long-term view? If employers in different countries have indeed embraced a co-operative plant-level regime, and have used this as a platform to exploit higher value-added market segments in their product market strategies, the persistence of both the plant-level and the central wage bargaining structures does not depend on the narrow (almost Kaleckian) disciplining mechanism, but on a broader evaluation of outcomes within a set of stable institutional arrangements (Hall and Soskice, 2001). The system might have produced a series of strong and diverse feedback effects to keep it in place despite cyclical variations in the relative position of labour and capital.

Finally, and perhaps the most important immediate question, if wage-setters indeed adopt wage moderation and thereby reduce inflationary pressures, how does this alter the context within which monetary policy takes place? In other words, to what extent is this new disinflationary wage regime – assuming it is stable enough to persist – an invitation for the ECB to revise its *de facto* asymmetric reaction function and take a looser monetary policy stance to support growth in the Euro area?

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