Wage-setting, fiscal policy and political exchange in EMU

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Preface

EMU has been in existence for over four years now, which allows us to proceed with a first evaluation of this large experiment in macro-economic policy-making. This report, which was commissioned by the Hans-Böckler-Stiftung --the research foundation of the German trade union confederation DGB-- aims to contribute to the debate on how the macro-economic policy framework of EMU is shaping up. Our main focus is on how to move from the low-growth regime that seems to mark the start of EMU to a more growth-oriented framework which meets the ECB's low inflation requirements.

Our analysis and proposals differ substantially from the solutions suggested by mainstream economists --in many academic departments, in the OECD, or in the ECB. Both for pragmatic and for intellectual reasons, we are sceptical of the calls for structural reform that are often presented as a panacea for growth. It is unlikely that labour markets will rapidly become more flexible, it is probably not a good idea to do so anyway both for reasons of competitiveness and of social costs (Hall and Soskice 2001), and it is unclear if labour market reforms without a supporting macro-economic framework will produce higher growth and lower unemployment (Bean 1998).

In all, we are moderately optimistic about the chances for EMU to generate higher economic growth and employment. But that requires taking existing institutions, especially in labour markets, more seriously than has been done up until recently. Our research suggests that far from being obstacles to a smoothly functioning EMU, labour unions and centrally co-ordinated wage bargaining systems have become some of its most solid pillars. A move
toward a decentralised wage-setting systems and a flexible labour market may --and probably will-- endanger that achievement.

This report has received help from many corners. The most important support was given to us by the Hans-Böckler-Stiftung: the HBS not only funded the research, but Dr. Frank Gerlach's enthusiastic support and occasional prodding was a crucial part of our project. The members of our project steering group have played a significant part in the project, not only by discussing our ideas with us, but also by making sure we stayed on the right track --in an atmosphere of free exchange of (sometimes controversial) ideas and academic freedom. The Wissenschaftszentrum Berlin and the London School of Economics and Political Science, where the authors were based at the start of this project, as well as Duke university and Australia National University, who hosted David Soskice for the duration of this project, deserve special mention. Students and colleagues in seminars in these institutions helped us sharpen our arguments with their critical eye, and this input forced us to think through some of our arguments in more detail. A large project such as this is impossible without research assistance, and David Brown, Clara Crespo, Alexandra Hennessy, Carol St Louis, and Ralf Segeth provided that magnificently. We discussed the ideas in this project in several workshops, and thank the participants in them for taking the time to discuss our ideas with us. We want to single out a few colleagues in particular who have been very generous with comments and ideas and who gave us incisive feedback: Christopher Allsopp, Iain Begg, Richard Bronk, Wendy Carlin, Damian Chalmers, Stefan Collignon, Tom Cusack, Sebastian Dullien, Donatella Gatti, Anke Hassel, Simon Hix, Dermot Hodson, Waltraud Schelkle, Wolfgang Scheremet, and Daniela Schwarzer, Sotiria Theodoropoulou, and Andrew Watt. A word of thanks goes to all the people we interviewed for this project: they gave us insights into the mechanics of
wage-bargaining that were impossible to read off the statistics. And, as always, without the administrative and organisational skills of Ilona Köhler and Hannelore Minzlaff, we would have been lost more than once.

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Chapter 1
Introduction

The advent of EMU in 1999 profoundly changed the environment for labour markets in the Euro-zone. Decentralised monetary fiscal and wage policies were replaced by a system in which the ECB became the single monetary authority for Europe, the Stability and Growth Pact (SGP) imposed a framework for fiscal policy, and wages were determined in national wage settlements.

As the different graphs in figure 1.1 show, the balance sheet of this new macro-economic framework appears mixed at best. While rapidly accelerating inflation does not appear as a danger in the Euro-zone, it has consistently been above the ECB's target rate, which has held back the ECB in cutting interest rates and thus restrained economic growth. The SGP has come under pressure from individual governments in France and Germany, who appear unable to keep their targets under low-growth conditions. EMU-wide unemployment, in turn, has been rising steadily after a short-term fall in the first two years.

The interaction between wage-setting, fiscal policies under the SGP, and the tight monetary policies of the ECB seems to suggest that the Euro-sceptics were right after all. Labour unions all over Europe are concerned that, since governments are unable to respond to shocks because of the constraints imposed by the SGP, and the ECB has adopted a more restrictive stance than is warranted by the macro-economic situation, they will have to carry the burden of adjustment. Political parties all over EMU are concerned that the SGP has robbed them of the possibility of meaningful disagreements with their opponents over the direction of fiscal policy. And the tightness of
monetary policies is producing imbalances in the EMU macro-economy --with the spectre of deflation looming.

**Figure 1.1: Macro-economic performance in the Eurozone**

![HICP Eurozone graph](image)

Source: European Economy Spring 2003

![Unemployment Eurozone graph](image)

Source: OECD Employment Outlook 2002
**GDP Growth Eurozone**

Source: Eurostat

**Budget Balances Germany, France and Italy**

Source: European Economy Spring 2003
1.1. EMU: Two scenarios

We think that such pessimism is unwarranted. At the most general level, there are (at least) two scenarios embedded in EMU: one is the doom scenario alluded to above, the other a considerably more optimistic one, that has the potential to combine high growth with low inflation. Let us go through each of these scenarios.

The first scenario is the *systemic low-growth* and perhaps deflationary outcome that many observers are worried about. It has three mutually reinforcing elements. The first is a central bank that confuses political independence with non-cooperation, and attempts to coax other actors into adopting restrictive policies. While it is important to recognise that the ECB operates in an environment which combines *uncertainty* --it is unclear if the unions and fiscal authorities will adopt non-inflationary policies-- and *noise* --since wage inflation varies sharply within EMU-- it is nonetheless remarkable to what extent the ECB insists on *structural reforms* as the single answer to the Eurozone's economic woes and has been unable to adopt a more expansive interest rate policy.

The second element is an overly restrictive, and indeed almost masochistic, fiscal policy regime as it is embedded in the SGP. While an SGP-like arrangement certainly makes sense as an institutional means to avoid free-riding problems in a monetary union, the particular provisions in the SGP impose excessively restrictive pro-cyclical policies on EMU member-states who are facing fiscal problems.

Finally, wage competition appears to be taking hold in labour markets. National labour unions in different member-states increasingly are setting wages as function of wage developments (expressed in unit labour costs -- ULC) in other countries, and especially of their larger trading partners (and
therefore ultimately Germany). As a result of their larger export share in GDP, smaller economies use this mechanism to capitalise on the effects of lower ULC growth on exports and thus raise aggregate demand. The net effect is that lower ULC growth allows them to export unemployment to the larger EMU members.

Since these elements reinforce each other, EMU appears, under this scenario, caught in the worst of all worlds. Growth is stalling without monetary or fiscal expansion in sight, aggregate unemployment is rising, and while aggregate inflation is low, some member-states, especially the German economy, may well be on the way to a deflationary regime.

However, the particular institutional framework of EMU allows for a second scenario, which we will dub sustainable growth-oriented co-ordination. In this alternative scenario, wage-setters co-ordinate wage bargaining and secure low wage inflation (expressed as moderate ULC growth) in exchange for expansive monetary policies. Through some form of political exchange, low wage-push inflation opens up possibilities of a more expansive fiscal policy. If implemented correctly, such a fiscal policy has two effects. In the short term aggregate demand rises, while, as a result of public investment in training, innovation and infrastructure, the long-term equilibrium growth rate rises.

Finally, instead of being the Stackelberg leader in the system, cajoling other actors into a particular regime, the ECB adopts a strict interpretation of its price stability mandate, and responds to inflationary pressures only.

In this second scenario, the vicious circle is replaced by a virtuous one, in which low inflation follows from co-ordinated wage bargaining institutions, and the interaction between wage-setting and fiscal policy allows for adjustment to both symmetric and asymmetric shocks.
Since EMU is still in its formative stages, it would be misplaced for us to assume that we have the ability to predict the future --and therefore which one of these scenarios will ultimately prevail. What we will try and do is suggest ways to avoid the first scenario and move on to the second one. This study will rely on a comparative analysis of both the pre-EMU years (mostly since the signing of the Maastricht Treaty in 1991 but with some flashbacks to the 1980s where relevant), and the post-1999 period. Our report concentrates on three issues: wage-setting, fiscal policy and the interaction between the two.

1.2. The argument
The first aim of this study is to take stock of the shape of wage-setting in EMU. We have identified a system of national-level co-ordination based on transnational wage benchmarking, which itself is built on the institutions of collective bargaining that were developed in the member-states in the run-up to EMU. This system, while intrinsically disinflationary, has a few surprising outcomes. One is that small exogenously determined jumps in inflation rates take a long time to correct; the other is that the system is potentially deflationary as a result of the hierarchical nature of wage-setting in Euro-land with Germany at its center.

It is worth noting that the position we take here contrasts sharply with the dominant views on the future of labour markets and collective bargaining in EMU, which suggest deregulation and labour market flexibility as the solution to Europe's unemployment and growth problem. It is also critical of arguments that see pan-European wage co-ordination as the solution: not only is such a mode of co-ordination difficult to accomplish in the current setting, it may, because of the centrality of German wages and the possibility of deflation in that country, also lead to sub-optimal outcomes.
Our second aim is more policy-oriented. We argue that, since this particular mode of wage-setting is disinflationary, a system of political exchange could be developed between labour unions and governments. In this system, labour unions keep wage inflation low, which, in turn, offers governments degrees of freedom in fiscal policy that allow them to inflate the economy without breaching the ECB’s target inflation rate.

Moreover, adopting a *Golden Rule*-type approach to fiscal expansion (meaning that government borrowing only covers investment) implies that, in principle, fiscal policy is self-financing and therefore sustainable with regard to EMU-wide aggregate debt. Such a fiscal policy should be subject to several important criteria: sustainability with regard to EMU-wide aggregate debt, quick-acting with regard to asymmetric shocks, minimal spill-overs and demand leakage, avoiding pushing unemployment below the NAIRU, and influence the long-term growth rate through targeted supply-side interventions.

Thus, we argue that both ECB and fiscal authorities should exploit more fully the central wage co-ordination capacities of national unions in the member-states. The upshot of our analysis is that such a revised fiscal policy which concentrates on medium- and long-term supply-side measures, dovetails perfectly with the attention to labour productivity in the wage bargaining system in EMU member-states. We therefore advocate tight national co-ordination between wage bargainers and fiscal authorities, relying on the existing institutional frameworks in EMU member-states.

If they do so, we propose, the macro-economic regime could change from the current restrictive one, in which regressive wage competition remains a distinct possibility, into a virtuous one, where wage inflation is controlled by
unions, and within which both central bank and fiscal authorities can successfully respond to shocks.

One further note: for the sake of this argument, we will take the ECB reaction function as given in this study. While we believe that monetary policy in the Euro-zone is too restrictive, that restrictive framework is taken for granted and we analyse how wage and fiscal policies might interact with it. In the concluding chapter we will revisit the issue of the ECB’s inflation target and reaction function.

1.3. Outline
This argument will be developed in three steps in this report. Chapters 2 and 3 analyse the changes in and the logic of wage-setting in the ERM and EMU. Chapter 2 provides an analytical account of the main evolutions in wage-setting systems and demonstrates how wage-setting became re-centralised after 1991, and how wage bargaining increasingly took into account inflation constraints. It ends with a discussion of why, in the run-up to EMU, labour unions in different countries were involved in social pacts that imposed wage moderation.

Chapter 3 takes that analysis from the ERM to EMU. It answers the question how wage bargaining systems in EMU handle two very different types of pressures --the need for wages to compensate for past inflation, and the competitiveness concerns that lead to wage moderation. Under EMU --in contrast to the ERM-- none of these problems are easily resolvable, and chapter 3 addresses some of the dilemmas involved, in particular the problem of low inflation and potential deflation in a world where Germany acts as a Stackelberg wage leader.

Chapter 4 changes the focus to fiscal policy. After a short review of fiscal consolidation under Maastricht, the analysis moves on to the debate on the
Stability and Growth Pact (SGP). We suggest a limited number of substantive criteria for fiscal policy which, we think, ought to be included in the debate on a revision of the SGP --not least because they complement and reinforce the evolving institutions of wage bargaining.

Chapter 5, then, combines the analysis of wage bargaining and fiscal policy to develop the argument that a fiscal regime which is articulated with disinflationary wage-setting systems allows for both growth and low inflation --our second, more optimistic scenario.

Chapter 6 concludes by explicitly linking our analysis to the two scenarios above, and by offering a round of policy considerations for the different political-economic actors in EMU: the ECB, governments and labour unions.
Chapter 2
Wage-setting from Maastricht to EMU

Perhaps one of the most remarkable changes in the EU in recent decades has been --after a decade of singing the virtues of decentralised labour markets-- the (re-)emergence of centralised forms of wage determination (Pochet 2002, Crouch 2000, Hassel 2001). In this chapter, we will analyse these new developments, how different countries adopted this path, their outcomes, and why labour unions cooperated in arrangements that entailed substantial wage moderation. That analysis will provide the bridge to chapter 3, where wage-setting systems under ERM and EMU are compared.

The chapter is structured as follows. We start with an analysis of the run-up to EMU, and how wage bargaining systems were reconfigured to contribute to the convergence process. We then analyse this process in light of the debates on the nature and role of social pacts in the different countries. We conclude with a short summary that paves the way for chapter 3.

2.1. Wage-setting, social pacts, and the Maastricht process

The signing of the Maastricht Treaty in 1991 imposed a series of stringent convergence criteria on would-be EMU member-states: public debt below 60%, an inflation rate at 1.5% or less and an interest rate at maximum 2% above the best performing ERM members, and stable participation in the ERM for two years.

In the two years after the signing of the Treaty, wage bargaining systems were reorganised in most of the member states. As many observers have pointed
out, both processes were related. From the point of view of the so-called Maastricht process, social pacts contributed critically to resolving a series of macro-economic problems: they allowed governments to contain inflation, the public sector deficit could fall as a result of pattern bargaining (since public sector wages are linked to wages in the moderate export sector). And as a result of low inflation, central banks can adopt a less restrictive policy, thus bringing interest rates in line with the best performers in ERM.

The countries in the ERM and later EMU entered this process from different institutional starting points. For the sake of simplicity, we can organise the country cases along two dimensions: early and late adjusters (i.e. pre- and post-Maastricht), on the one hand, and those where adjustment took the form of a social pact or were government-imposed on the other. In the early adjusters, inflation was brought under control rapidly, regardless of the particular form it took. The late adjusters, in contrast, primarily relied on social pacts --occasionally complemented by new laws governing the procedures (though not the substance) of wage-setting-- for adjustment.

In the 1980s, several EU member-states adopted a new macro-economic policy framework, which paved the way for the arrangements that prevailed under the Maastricht process. At least six EU member-states, five of which were to join the EMU in 1999, had arrangements for wage bargaining in place which improved export competitiveness and contained inflationary pressures. In all these countries except Germany, a profound crisis in the mid-1980s, with both macro- and micro-economic dimensions, triggered a process of adjustment which led to a (reaffirmation of a) disinflationary wage-setting system.¹

¹ This section relies heavily on the analysis in Crespo 2001.
Early adjusters

The ERM system has had Germany at its core since the establishment of the EMS in the early 1980s. As a result of the central role of the Bundesbank in the EMS, Germany has *de facto* been able to impose inflation rates (and thus relative unit labour cost growth rates) on the other economies in the ERM. German wage-setters had always balanced forceful wage claims in the run-up to negotiations with moderate wage levels as a means to safeguard export competitiveness and in response to Bundesbank signals about optimal inflation and wage rates (Hall 1994). While Germany’s anchor position in monetary policy explains to a large extent the general disinflation in the EU in the 1980s, different institutional answers allowed countries to adopt this path.

In both The Netherlands and Ireland a profound (sense of) crisis was at the heart of efforts to bring wage developments under control. In the late 1970s, *The Netherlands* had been unable to accommodate inflation differentials with the rest of the then ‘currency snake’ through devaluations and its unemployment had increased dramatically. In 1982, the new center-right government and the social partners (led by the employers’ associations) explicitly linked labour market reform to the adoption of a ‘hard guilder’ regime. From then on, the Guilder closely followed the Deutschmark (DM). The Wassenaar Agreement, an early Dutch version of a social pact, combined a strongly coordinated wage bargaining system moderated wage claims, with a degree of decentralisation to allow for local diversity (Visser and Hemerijck 1997; Veersma 1998). As a result, Dutch wage-price pressure was below or closely followed the German for the entire period: unit labour costs fell 34% between 1982 and 1993 (Dølvik, 2000:27). Together with other measures (notably flexibilisation of working time) this system has decreased unemployment producing the ‘Dutch miracle’.
Ireland is a clear example of institutional shifts which involved higher coordination and of the unemployment cost of such a process of change. The country suffered inflation rates over 15% until 1983 (OECD Economic Outlook, several years). The 21.1% devaluation of the Irish Punt in the first period did not accommodate completely inflation differentials and unemployment started to increase. In 1983, Ireland adopted the price-stability regime (ad hoc devaluations became less accommodating, the Punt lost only 8.7% against the DM in 1986), inflation dropped to single digits the following year while unemployment rose to 17% by 1986.

Up until then the wage bargaining system had been decentralised and only moderately coordinated. In 1987, therefore, the main trade unions, employers and the government signed a centralised wage agreement as part of a program of economic recovery, with the explicit objective of reducing unemployment. Local and individual unions lost autonomy and centralised bargaining, expressed in three-year programs, became the core institutional feature until today. Collective bargaining not only became more coordinated, the wage level also changed from one in which the highly productive multinational large firms set signposts to one in which the less productive domestically based tradable goods sectors set the pattern for wage bargainers. The effect was that Irish wage-push inflation was below the German level during the 1980s, and unemployment decreased steadily. After the widening of the ERM fluctuation bands after the 1992-93 crisis, wage-price pressure rose above the German level (in part as a result of the dramatic economic boom in Ireland), but unemployment has decreased due to the expansion.

Denmark joined the ERM starting from an initial accommodating monetary policy-wage bargaining equilibrium (the typical Scandinavian model --see Iversen 1998b), which had produced high inflation rates and moderate unemployment in the 1970s. The government used the ERM as a crawling peg
In the first period, not being able to reduce inflation. Unemployment increased until 1983, but at roughly the same pace as it did in Germany in that period. In 1982 the new government announced the adoption of the price-stability regime: it pegged the Danish Krone to the DM, and simultaneously weakened the wage indexation mechanisms. That measure helped to reduce unemployment to German levels for two years, but the system remained unstable until 1993, with the associated unemployment cost.

Until 1990, Danish wage inflation was above the German rate. Labour unions maintained a confrontational position against the restrictive government measures, defending wage equality and increasing the central wage rate in the negotiations. The shift to the non-accommodating monetary regime in which wage bargaining remained centralised and militant produced extremely poor employment performance from the late 1980s until 1993. Part of the increase in unemployment was due to the generalised recession of the early 90s, but the initial jump in unemployment had already occurred before. In 1993, the new government implemented some reforms to make the labour market more flexible. While this implied an end to national bargaining, the system has kept a strong degree of coordination, which has allowed it to deliver wage restraint. After 1993, both unemployment and inflation fell sharply.

In contrast to these countries, where a severe crisis forced unions, employers and governments to restructure the framework for wage-setting, in France and Belgium disinflation was primarily a government-imposed process.

In the period of the EMS until 1992, France was unable to adopt a price-stability regime via political consensus. The shift in the macro-economic regime were therefore not adopted by social partners and government, but imposed by the latter on the former.
Wages were frozen in 1982 as part of the domestic measures accompanying the devaluation, but until 1983 inflation differentials were accommodated: the French franc lost 18.8% of its value against the DM (Gros and Thygesen, 1998:69). Consequently, since inflationary pressures were above German levels until 1983, unemployment rose slowly, as the central bank did not raise interest rates to protect the exchange rate.

The system only began to import the non-accommodating monetary policies of the Bundesbank with the decision by the French government to finish the ‘socialism in one country’ experiment, stay in the EMS and adopt the ‘franc fort’ regime in 1983. The problem was that the wage bargaining system was poorly coordinated and as result, wage-push inflation was above the German rate until 1985, which forced the central bank (politically dependent and run by the Treasury) to adopt highly restrictive policies. Not surprisingly, unemployment rose above 10%.

The adoption of a restrictive monetary policy and of a sharp rise in the unemployment rate combined to discipline trade unions, and after 1986 wage-price pressure has been below or close to the German rate. Accordingly, unemployment has followed the German trend as well. The unemployment cost of the dramatic shift in the macro-economic policy regime has been long lasting: the sharp rise in the unemployment rate in the mid-1980s has remained above the German level until 1997.

The Belgian wage bargaining system has been marked by state intervention since the early 1980s. Pochet (1999) argues that strong, non-encompassing labour unions have made the success of social dialogue more difficult. In 1982, after a period of sharply increasing unemployment, the wage indexation mechanism was weakened and the government imposed wage freezes until 1987 (Hancké, 1996). While such wage freezes are obviously not a sign of
strong coordination in wage bargaining, it provided the same result in terms of wage moderation.

Government intervention has remained a substitute for autonomous wage coordination in Belgium afterwards from 1987 to 1993. In 1988, the government imposed the first of two competitiveness laws, which controlled wages by imposing low wage growth rates. The result was that wage inflation fell rapidly and closely followed the German trend until 1993; unemployment also fell from its peak in 1983 until the 1991 recession.

Figure 2.1: Inflation Rates (HICP) EU-11, 1986 – 1992 (unweighted averages)

a – High Inflation Countries (I, E, P, GR), b – Low Inflation Countries (A, B, D, FIN, F, IRL, NL)

Source: OECD Employment Outlook 2002

As a preparation for EMU (and in response to another failed attempt at a social pact), the government enacted a new competitiveness law, stating that wage growth should not be above the weighted average of wage increases in
Germany, France and the Netherlands. If wages grow faster, the government will legislate on wages by decree (Pochet 1999). In 1998, a central wage agreement was concluded which established maximum wage increases for 1999-2000.

The effects of these different scenarios across the ERM/EMS member-states was a rapid fall in and a dramatic convergence of inflation rates among these EU member-states (Tsoukalis 1997: 149) toward the German rate. As figure 2.1 also shows, inflation differentials between this group of countries and the remaining ERM/EMS members increased significantly (Tsoukalis 1997: 138-162). In 1992, just before the ERM crisis, average inflation in the six ‘early adjusters’ ranged between 4 and 5%; in Spain, Portugal, Italy, and Greece, it varied between 5% (Spain) and 20% (Greece). Similarly, in 1992 nominal long-term interest rates were 8-11 % in the first six, and between 11 and 17% in the latter four.

The adoption of the Maastricht Treaty leading to monetary union forced the remaining EU countries rapidly to adapt their macro-economic policy framework as well. In countries with an unsuccessful history of macro-economic management such as Spain and Italy, governments initiated a reorganisation of wage bargaining in the immediate aftermath of the Maastricht Treaty.

Late adjusters
The Italian and Spanish experiences show the problems of combining non-accommodating monetary policies and a fragmented wage-setting mechanism. That precarious situation lasted in both countries until the 1990s because of the lack of political consensus to deliver wage restraint. According to Pérez (2000), in the late 1980s and early 1990s ‘governments in both countries sought to impose macro-economic stability without the benefit of
framework agreements, betting that wage-restraint could be achieved in a more de-centralized bargaining context by relying on a tight monetary policy and a strong currency stance. This strategy, however, backfired as employers found it difficult to control labor costs in a fragmented and decentralized bargaining context.’ During the 1990s, in both countries the social partners favoured a move towards coordination.

The Italian story during the 80s and early 90s suggest an incomplete shift in the institutional framework for wage-setting. While monetary policy became increasingly non-accommodating, devaluations reduced its credibility. Furthermore, during the 1980s there was no political consensus among the unions to adopt the price-stability regime. In 1983 there was an attempt to revise the *scala mobile*, an automatic wage indexation mechanism designed to produce upward wage compression. The agreement collapsed because the CGIL refused to sign (Pérez 2000). Until 1993 therefore, wage-price pressure was well above the German rates. In total, the Italian Lira lost 63.5% of its value against the DM (Gros & Thygesen 1998:69).

The main institutional innovation occurred in the early 1990s, in large measure in direct response to the adoption of the Maastricht Treaty. Dyson and Featherstone (1999) argue that there was not enough support for the modernisation of the labour market institutions until the EMU project was on the horizon (EMU was used as a ‘vincolo esterno’ or external tie to justify reforms). Until 1993, the Italian government tried to make the peg more credible by reducing the bands of fluctuation to +/-2.25%, but it did not have a strong effect on wages or inflation. After several failed attempts to abolish wage indexation, in 1992, in the middle of the recession, the unions agreed to abolish the *scala mobile* and freeze company-level bargaining for two years. The following tripartite agreement in 1993 reformed the wage bargaining system: adjustment to expected inflation is done at the industry level for the
national territory establishing a minimum wage increase, while local and company bargaining address productivity increases.

Spain joined the EMS in 1989. As in the cases of Ireland and Italy, the shift in the nature of monetary policy against a background of relatively uncoordinated wage bargaining proved highly problematic. After a period of declining real wages under a centralised agreement, negotiations to renew the agreement failed in 1988 (the year of a general strike) and real wage growth accelerated (Pérez 2000). Wage-inflation pressures had always been above the German rate, although from 1994 on inflation began to converge on the German level. The government adopted an extremely tight monetary policy (the result of which was that the Peseta was the closest to the upper band of all currencies until 1992) with the objective of imposing wage restraint and establishing the price-stability regime. As a result of this unbalanced regime, unemployment increased sharply to 24% by 1994.

In 1994, after several attempts to reinitiate national collective bargaining, the social partners signed an agreement to devolve regulatory competencies to the realm of collective bargaining. This had the effect of de-politicising industrial relations and supported the search for a low-inflation regime. Even though no social pacts regarding wage coordination were agreed (the 1996 and 1997 agreements referred to pensions, dismissal costs and temporary contracts), there have been some attempts at informal coordination at the national level since the mid-1990s. In particular since 1998 wage increases have been just above expected inflation. Besides, the social partners in the metalworking sector have signed a collective bargaining agreement (Pérez 2000). These attempts to rebalance the macro-economic framework led to a fall in unemployment since 1994.
As this suggests, the Spanish case presents some perverse combinations that help explain the dramatically poor unemployment performance in the country. Firstly, bargaining became more decentralised after the failure of the 1988 agreements, but this was immediately before the peseta joined the EMS. Afterwards, with rising unemployment, unions did not have an incentive to coordinate wage restraint, because the dual labour market (a large proportion of contracts are temporary) protected union members from unemployment. Lay-offs concentrated on workers in temporary contracts because of the lower dismissal costs of these contracts, while real wages in open-end contracts kept increasing. Without jumping to conclusions, it is remarkable that the major improvements towards wage bargaining coordination have occurred in the late 1990s, after the reduction of dismissal costs for open-end contracts.2

Portugal joined the EMS in 1992 and immediately devalued the Escudo in the ERM crisis. Even though unemployment increased between 1992 and 1996, the shift to non-accommodating monetary policy has not had the same dramatic unemployment effects as in other countries. That eased the path towards a social pact on coordination of wage increases in 1995 (which was signed only by one of the two main unions as the CGTP, close to the communists, refused to sign), which was followed by a second agreement, where wage increases consisted of the sum of expected inflation plus half of productivity growth. Wage-price pressure has surpassed the German figure in the 1990s, but unemployment has not increased (the widening of the ERM bands reduced the pressure on the central banks to ‘punish’ unions if inflationary pressure was above the German level).

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2 Another, at least equally plausible, explanation for the fall in unemployment is that the shifts in the wage bargaining system over the previous years have significantly improved
As this review of developments in wage bargaining in the 1980s and 1990s demonstrates, ERM member-states (and especially the prospective Euro-zone countries) have gone through dramatic changes in their attempts to meet the Maastricht criteria. Instead of a predicted move toward decentralised labour markets and flexible wages, we have seen a resurgence of central wage determination in many countries; moreover, labour unions agreed to wage moderation (in the form of social pacts) especially in those countries for whom macro-economic adjustment came late, and where they did not, governments imposed it. The end result was a stable, disinflationary macro-economic framework in many ERM/EMU countries.

Spain’s export competitiveness, which led to higher growth without the inflationary effects
2.2. Social pacts, political exchange and competitiveness

It is easy to see why governments and employers would be partisan to social pacts and other, often more formal arrangements that impose wage restraint. Since such arrangements lead to wage moderation, several of the Maastricht criteria are addressed simultaneously: wage moderation leads to low inflation (reducing the need for interest rate rises to stay within the ERM bands), and to a low public sector wage bill (thus reducing the pressure on the public deficit and debt). For employers, in turn, social pacts reduce wage pressures, and might avoid tax hikes to meet the Maastricht criteria, so they too stand to gain from them. Less clear is why, in some of the countries, labour unions were willing to go along with such arrangements. While centrally co-ordinated wage bargaining could relatively easily be construed as offering advantages to labour unions, a wage policy which imposes moderation is harder to understand.

The literature on the topic has come up with two related answers to this question. By introducing both a new level of bargaining and a new agenda, the social pacts grafted themselves onto existing wage bargaining systems and shifted both their meaning and organisation. Thus the social pacts combined a focus on micro-economic issues --most importantly competitiveness, flexibility, and training-- with the need to meet the Maastricht inflation and deficit/debt criteria (Rhodes 1998; Pochet and Fajertag 1997).

However, such an argument may describe what exists, but not why it exists. According to Hassel (2001), two conditions need to be met: (1) governments have to show commitment to the process and resolve to push through reforms, if necessary without the social partners; and (2) trade unions need to
develop strategic capacity to see how they might gain from social pacts. The latter condition is subject to two considerations. Governments might change; how can the trade unions be assured that the next one will hold up its end of the deal? Additionally, the benefits of a social pact may not be immediately visible to unions: unemployment may or may not fall as a result of a central agreement, while the costs --in the form of wage moderation-- are immediate.

Two points can help understand the calculus of trade unions when engaging in social pacts. The first one is the tangible political threat of labour market deregulation in the absence of a social pact. As Hassel (2001) points out, social pacts have regularly been concluded when government majorities shifted from Center-Left to Center-Right (Ireland and the Netherlands in the 1980s), or when social-democratic parties emulated their conservative counterparts by adopting a tight monetary stance and called for more flexible labour markets. Under these conditions, wage moderation via a social pact is undoubtedly the lesser of two evils.

The second strategic element is that a hard currency strategy (i.e. restrictive monetary policy) imposes immediate costs on unions as well, since inflationary wage increases are immediately punished by independent central banks (the appendix to chapter 3 gives a formal elaboration of this argument in the context of the ERM). Again, when faced with two options which lead to the same outcome, trade unions are likely to choose the one where their influence is largest (Hassel 2001).

These explanations which focus on the macro-political economy help us a long way in understanding why unions would get involved in social pacts. However, a crucial constraint that trade unions face --and, as we will argue in the next chapter, which has gained in importance after EMU entry was secured-- remains underdeveloped in these arguments. For while trade union
officials may understand the need for wage restraint in this novel political-economic environment, this is much less clear for their members.

The point we would emphasise is that this macro-strategy has been supported by micro-economic developments. In many countries in the ERM, the export sector sets wages taking into account the competitiveness of its sector (if they did not, growth would slow down and employment in the sector fall, with immediate real and tangible costs imposed on individual members). Through different mechanisms --existing forms of pattern bargaining, struggles with other unions, centrally imposed wage guidelines, or laws-- the export sector then imposes a commensurate wage target on other sectors.

It is easy to see why labour unions in the tradable goods sector have a strong incentive to impose wage restraint on other sectors: if they follow wage developments in the export sector, the result is overall wage restraint and therefore low inflation; if they do not, the central bank reacts with a restrictive policy to curb inflationary pressures, which hurts the export sector disproportionately more, since the exchange rate rises and growth falls. It is not a coincidence, in other words, that all social pacts which were concluded in the 1980s and 1990s, as well as more informal arrangements (as, for example, in Germany), and legal interventions (in France and Belgium) give a prominent place to competitiveness concerns alongside fulfilling the Maastricht criteria.

The social pacts of the 1980s and 90s are therefore not so much a form of 'political exchange', in which labour unions trade wage moderation for participation in and influence over the direction of macro-economic policy, as the 'old' neo-corporatist argument suggested. Instead they have two instrumental goals --macro-economic stabilisation under the Maastricht process as well as securing micro-economic competitiveness-- and labour
unions are involved in them as a result of rational calculus (under constraints imposed by the governments and central banks), since the shadow costs of not being involved in a social pact are at least as high as the actual costs imposed on them.

2.3. Conclusion

This chapter analysed the developments in wage-setting in the pre-EMU period. As we demonstrated, by 1999, many of the prospective EMU member-states had installed centrally co-ordinated wage bargaining systems, often in the shape of social pacts. While there were many routes into the new regime, the convergence among the different systems is remarkable.

With entry into EMU, however, the macro-economic logic that was at the basis of the social pacts has essentially disappeared. The countries are now in EMU, and there are no hard sanctioning mechanisms --along the lines of the Maastricht inflation criteria which precluded participation in EMU-- for those whose inflation record deviates from the ECB target. Why then do we still find social pacts?

Our answer, which will be developed in the next chapter, follows directly from the interpretation of the social pacts that we developed in the previous section. They have become means to secure competitiveness of the tradable goods sector, and have similar disinflationary effects as in the previous period because they impose a relatively uniform wage growth in the other sectors of the economy.
Chapter 3
Wage setting under ERM and EMU

Chapter 2 analysed the dynamics underlying the shifts in the wage-bargaining systems in the ERM member-states in the run-up to EMU. Often -- though not always-- these shifts took the form of social pacts, entailed a re-centralisation of wages, and led to disinflationary wage settlements. This in turn, fed into the fiscal consolidation path adopted by governments to meet the Maastricht criteria. As we also emphasised, labour unions were left with little choice: against a background of tight monetary and fiscal policies, 'irresponsible' wage behaviour would have been punished swiftly by the central banks, thus leading to rising unemployment, governments might have been convinced to adopt more deregulatory policies in the labour market, and export competitiveness would have come under pressure.

That analysis allows us to ask the question at the center of the current chapter: what has changed in the logic and operation of wage-setting after the introduction of EMU in 1999? How does this new centralised monetary regime interact with the still weakly transnationally co-ordinated systems of wage bargaining in the Euro-zone? After 1999, two high-powered incentives in particular, which kept wage developments in check, have disappeared: the Maastricht convergence criteria which imposed heavy costs on individual countries, and the power of national central banks (within the ERM) to punish inflationary wage settlements. This shift in the institutional framework has understandably led to an upward movement of inflation since the introduction of the Euro, but at the same time, the move upward has been less than could have been expected without credible sanctions.
Our main point in this chapter is that the EMU-wide system is subject to two highly contradictory pressures: while very few inflationary pressures emanate from the wage bargaining systems directly, external shocks, in actual fact the oil and food shocks of the first EMU years, have led to rising inflation. This outcome is explained by two very different logics within wage bargaining systems. The first relates to competitiveness concerns, which impose wage moderation (expressed in ULC terms); the other is that union members (and workers in general) expect some measure of compensation for past inflation in wage settlements. Since wages in the EMU member-states fall somewhere between current inflation and labour productivity, inflation does not accelerate, but external price shocks imply that inflation comes down only rapidly after such a shock-induced rise.

We develop this argument in four steps in this chapter. The first section discusses the different scenarios for the development of wage bargaining in EMU. We then move on to an analysis of how low-inflation incentives for wage-bargainers changed from the ERM to EMU, and in section 3.3. how these incentives were translated into new institutions of collective bargaining. We conclude with a review of possible pitfalls and problems with this arrangement.

3.1. Understanding wage-setting in EMU

For obvious reasons much attention has been paid to wage-bargaining systems, both in the run-up to and under EMU. The debate can be summarised in three positions: labour market deregulation, pan-European wage co-ordination, and German wage leadership. While the latter is closest to our understanding of wage-setting in EMU, it presents both German unions and the euro-zone as a whole with a set of thorny dilemmas. In the
following sections we will therefore build on the German wage leadership situation to present a scenario that has the potential of circumventing these.

The first way of understanding the evolution of wage-setting in EMU is the standard neo-classical one that both the ECB and OECD advocate, but which is also suggested (though not desired) by more pessimistic observers of a social-democratic persuasion (Martin 1999): EMU member-states will simply have to move towards a more flexible labour market. This standard economic recipe would include less centrally co-ordinated wage-setting, real wage flexibility, and generally a less prominent role of labour unions in both collective bargaining and corporate decision-making.

Despite the orthodoxy represented by this position, there are doubts whether this would be a solution to the low-growth high-unemployment problem that EMU faces (see Baker et al. 2002 for a critical review of the empirical evidence). Especially within EMU, both growth and unemployment rates vary widely between large and small member-states. The Netherlands, Austria, and Portugal, for example, all have very low unemployment rates, while Germany, France, and Italy appear saddled with stubbornly high unemployment rates. However, none of these high-growth, low-unemployment economies can meaningfully be interpreted as somehow approaching the textbook ideal of a deregulated, flexible labour market or restrictive welfare regime. In fact, Ireland, the only small country with low unemployment rates that could be categorised as such, has adopted a more rather than less co-ordinated wage bargaining system since the mid-1980s.

The main reason why these economies have not moved toward deregulation is that highly regulated labour markets and co-ordinated wage bargaining regimes allow them to choose a more competitive real exchange rate, which leads to higher (export-led) growth and lower unemployment --a scenario
open to them because of their small size, but not to the large economies, for whom exports constitute a considerably smaller proportion of GDP.

Assuming, however, that such a strategy might have the desired effects, it seems rather unlikely that EMU member-states would rapidly move to a fully flexible labour market similar to the one we find in the UK or the US. Even if governments were able to overcome the many political obstacles put up by labour unions and core social-democratic electorates to sustained labour market deregulation, decision-making in the core EMU economies precludes managerial unilateralism. While many employers in EMU member-states certainly would prefer more flexibility in the labour market, they are also very keen to keep institutionalised forms of workers' participation (such as the German works councils) and some form of coordinated wage bargaining in place. We identify two grounds for such a position.

In production regimes that rely on employee involvement and tacit skills, co-operative decision-making structures offer tangible benefits for employers when restructuring companies and reorienting product market strategies (Hall & Soskice 2001). While a deregulation of the labour market might lower wage costs for employers, it would also adversely affect incentive structures for skill acquisition, training and work reorganisation in sectors that concentrate on high value-added production and services and thus undermine some of the competitive advantages of the core EMU economies (Germany and Sweden, but increasingly also France and Italy).

In addition, centrally co-ordinated collective bargaining structures have direct effects on wage levels in fast-growing industries where the labour supply is inflexible because of the very nature of training systems: high-skill training often spans several years and the labour supply can therefore not simply be increased on a year-to-year basis to meet demand for labour. Central wage co-
ordination allow wages in these industries (and particularly in the large exporting companies) to be set below what would, given the labour market tightness and skills shortages in these sectors, be the going market rate (Hassel & Rehder 2001). Neither unions nor employers in the leading sectors are therefore strong supporters of labour market flexibility, and initiatives in that direction are likely to die a quick death on the continent (see Wood 2001 on such attempts in Germany in the 1980s).

The second scenario for wage-setting, which forms the cornerstone of the debate in labour union circles across Europe (Schulten 2002), seems to hold more promise. Pan-European wage coordination, involving either a transfer of wage-setting authority to a supranational union body, or some form of what has become known in Euro-speak as the 'Open Method of Coordination' among labour unions, would indeed match the structure of wage-setting (central co-ordination) to the structure of monetary policy, thereby replicating the robust interaction between the Bundesbank and the IG Metall which existed prior to EMU (Hall 1994; Hall & Franzese 1998).

Since 1995, in fact, two important attempts at transnational wage coordination have taken place. In 1998, German, Belgian, and Dutch unions signed, under the instigation of the Belgian unions whose wages were constrained by law to reflect wage developments in the two other countries (and France), what is known as the 'Doorn agreement'. Henceforth, labour union observers from the other countries would participate in domestic wage negotiations. The idea behind the co-operation was to mutually exchange information on how wages were set in the different countries and, more importantly, to assure that wage competition would be minimised as all unions would use the same basic calculus (inflation plus productivity) when negotiating domestic wages.
However, from interviews we conducted with labour union wage bargainers in the three countries it transpired that wages are still primarily set according to domestic parameters and that few unions use the wage formula to calculate appropriate nominal wages.1 Most observers seem to agree that the Doorn initiative was a highly idiosyncratic process, a child of the particular circumstances under which it was born, and not—as is suggested by the absence of other similar trans-national co-ordination attempts—the nub of a new pan-European labour union strategy.

The second, and perhaps more significant, initiative dates from 1997, when the member unions of the European Metalworkers Federation took up this idea and agreed to set wages as a reflection of past inflation and labour productivity (Industrial Relations Europe 1999). As in the case of the Doorn initiative, the main concern was to avoid wage dumping in the sector without endangering competitiveness. However, again, interviews with wage-setters suggested that this pan-European attempt was stronger on paper than in practice. While the outcomes of wage negotiations in EMU member-states, averaged over 1999-2002, appear to fall within the range set by inflation and productivity, explaining this with reference to wage co-ordination ignores the point that very few of the metalworkers unions in EMU negotiate on that basis. In fact, even in the highly internationalised and organised engineering sector, wage-setting remains a remarkably domestically determined process, reflecting more closely the institutional mechanisms developed in the 1990s (or earlier) than relative wage rates.

1 It is important not to confuse wage benchmarking—often of a competitive nature—with wage co-ordination. The first is a simple Stackelberg scenario, in which wages are first set in country A and their level or growth rate is reflected in subsequent agreements in other countries. Wage co-ordination requires that ex ante wage-setters in the different countries agree on (upper and lower boundaries of) wage growth levels, and then follow through on that agreement.
The main reason why wage-setting has failed to assume a pan-European character seems in large measure related precisely to the fact that in the low-growth environment of both EMS and EMU, small differences in the growth of unit labour costs can have large effects, especially for smaller economies, as a result of the shift in the real exchange rate and the subsequent export-led growth and employment that this generates. Furthermore, despite all good intentions, none of these transnational wage co-ordination attempts contain either a hard or a credible soft sanctioning mechanism: ultimate responsibility for wage-setting remains embedded within the national systems.

Since wage bargaining remains nationally embedded but implicitly takes into account competitiveness considerations, a third argument has emerged, in which the German engineering union IG Metall accepts that it has become (or remained) the leader in wage-setting for the entire Euro-zone, thus replicating at the EMU level the robust set-up that included the German unions and the Bundesbank (Iversen & Soskice 1998). To some extent this is exactly what is going in the Euro-zone, since wage-setters in the tradable goods sector in almost every EMU member-state take German wages as a point of reference.

However, for several reasons such a set-up is likely to pose unsustainable problems in the medium and long run. The reason why it may look attractive is that it replicates the robust IG Metall-Bundesbank set-up in the ERM and thus leads to more co-ordination between wage-setters and the ECB. Yet, as developments in 2002 have shown, the ECB sees itself as the central bank for the Euro-zone, not just for Germany: according to some estimates, Euro interest rates in that year may well have been almost 2 per cent above what Germany needed, and despite low inflation prospects in Germany (an annual inflation rate around 1% in 2003), there was no sign of monetary policy easing. Put differently, for an IG Metall-led European wage bargaining system to operate effectively, a clear signalling configuration between the
ECB and the labour unions would have to emerge, which includes a transparent incentive structure that rewards unions, in particular the leading IG Metall, for wage moderation -- precisely what seems to be absent from the current set-up.

There are, in addition, good reasons for why the German unions would generally prefer not to go along with such a replication of the pre-EMU arrangement. If German wages (or unit labour costs) act as anchors for others, Germany's real exchange rate is essentially fixed. Given that Germany entered EMU with a significantly overvalued exchange rate (a result of inflation in the aftermath of the post-unification boom and the exchange rate realignments in 1992), the real exchange rate for the German export sector would remain locked in at an uncompetitive level, without prospects of a realignment in its favour.

Most importantly, perhaps, such a German Stackelberg leader scenario may well be highly undesirable for EMU as whole, since low wage growth in Germany could then push the entire Euro-zone into deflation. Since the mid-1990s, German unit labour costs have been growing at a rate considerably below most of Germany's immediate trading partners within the Euro-zone, in part to compensate for the hike in the real effective exchange rate in the early years of the decade: between 1995 and 2000, German ULC remained almost stable (0.02%), while France (1.2%), Italy (1.8%) and The Netherlands (1.8%) witnessed much higher growth in ULC. However, if this situation is reversed, and all other EMU countries track German wage developments very closely, this might push an already fragile EMU economy very close to the deflationary threshold.

Where does this leave us? While none of the commonly proposed institutional solutions seem feasible within EMU, low growth, high unemployment, and
rigid wages which respond very slowly to falls in inflation are clear indications that the system is increasingly unsustainable in its current form. One final possibility is to build on the two components of macro-economic policy-making that are still under the control of national economic actors. By combining national wage co-ordination with the type of fiscal policy discussed earlier, we suggest that a deal could be struck between labour unions who keep wage inflation low, and governments who use the room to manoeuvre by these disinflationary wage policies to adopt a more expansive fiscal policy stance.

This argument will be made in three steps in the balance of this report. The next section in this chapter discusses in detail how wage-setting is organised in the euro-zone and what the likely implications of the existing wage regime are. The next chapter discusses fiscal policy and outlines criteria for a shift in the existing fiscal policy regime. Chapter 5, then, links the analysis of fiscal policy to the analysis of wage-setting systems in this chapter to produce an integrated framework for macro-economic policy in which wage-setting systems and fiscal policy interact.

3.2. Wage bargaining and inflation

How do wage bargaining and inflation interact? After a period of sustained and widespread disinflation in the run-up to EMU, wage inflation has again become an issue in EMU economies. In large part this is related to how collective bargaining systems in EMU member-states take the existing (i.e. past) inflation rate as a floor for wage contracts. While there is reason to believe that endogenous inflationary pressures are relatively small, both exogenous shocks and rapid economic growth, as we saw during the period 1999-2001, do lead to rising inflation. In both cases the result has been an
upward blip in inflation, which found its way into the wage-setting process and thus contributed to perpetuating inflation above the ECB target rate.

A comparison with the arrangements prior to the launch of the Euro in 1999 shed light on the shape and magnitude of the problem. In the period of the pre-EMU Exchange Rate Mechanism (ERM) two constraints acted on national-level inflation rates. The first is well-known in the recent political economy literature. German wage-setting was effectively constrained by the Bundesbank’s low-inflation strategy: German wages grew at a rate compatible with the Bundesbank’s target inflation rate (Hall 1994; Hall & Franzese 1998).

Through the ERM, this disinflationary regime was transmitted to the rest of the economies in the EMS. The rules of the ERM implied that the other member-states took the German inflation rate as an implicit target. This mechanism operated via the exchange market penalizing countries maintaining higher inflation rates and thus threatening their ERM limits against the ECU. Thus the other member-states needed to ensure that their inflation rates were sufficiently low. This reinforced the use of co-ordinated bargaining systems in those economies where they existed, and reinforced the use of social pacts to provide incentives to unions to introduce low inflation constraints into the co-ordinated bargaining. Member-states in which co-ordinated bargaining was weak or did not exist had two alternatives: one was to use interest rates to keep within the ERM limits --as the UK did up to 1992; the other was to develop or rebuild a system of co-ordinated bargaining as the Italians did in their 1993 industrial relations legislation in order to envisage eventually rejoining the ERM narrow band.

The second mechanism had to do with the Maastricht criteria, which imposed explicit inflation constraints on individual countries. Since accession to EMU was made conditional upon obtaining a domestic inflation rate below or equal to 1.5% above that of the best-performing member-state, governments
throughout Europe were forced to redesign their macro-economic regime and its supporting institutions, including wage-setting systems. In many countries, even those that did not have a strong tradition of tri-partite macro-economic concertation prior to the 1990s such as Spain and Italy, social pacts emerged, which enlisted labour unions in the fight against inflation in exchange for consultation and deliberation on macro-economic policy and welfare state reform (Rhodes forthcoming). In these countries and in the others where explicit social pacts failed (such as Belgium), new laws on collective bargaining, which imposed a disinflationary wage-setting mechanism, underpinned these arrangements.

**Figure 3.1: Eurozone Real Unit Labour Cost**

![Graph showing Eurozone Real Unit Labour Cost from 1991 to 2003](source:spring2003)

Between 1992 and 1999, all prospective EMU member-states (including France with a highly idiosyncratic non union-based solution) had introduced some form of explicit wage benchmarking, usually revolving around wage
evolution in Germany, which is the main trading partner of most EMU
countries, and had imposed a strict wage norm that set an upper limit on
wage negotiations. The effect was that wage growth levels in the second half
of the period 1992-99 corrected for past inflation, but remained below a ceiling
set by labour productivity growth --thus being both disinflationary and
roughly neutral with regard to competitiveness since relative unit labour costs
were stable or slowly falling (see figure 3.1). While variation existed in the
exact institutional mechanisms at work, the effects of these institutional
innovations in the current EMU member states was that in the 1990s the
growth of wages increasingly became a function of two parameters: domestic
labour productivity growth, on the one hand, and wage developments in
other prospective EMU member-states, especially Germany, on the other.
Table 3.1 summarises the institutional mechanisms in each of the EMU
member-states as well as the year when they were introduced.

Table 3.1: Wage benchmarking and wage norms in EMU member-states

<table>
<thead>
<tr>
<th>Country</th>
<th>Type of wage norm (law, social pact, agreement, …)</th>
<th>Effective control (late 1990s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>hard, via social pact</td>
<td>central</td>
</tr>
<tr>
<td>Belgium</td>
<td>hard, via law</td>
<td>central industry level</td>
</tr>
<tr>
<td>Finland</td>
<td>hard, via social pact</td>
<td>central</td>
</tr>
<tr>
<td>France</td>
<td>informal, via large firms</td>
<td>mix: decentral, and central via state</td>
</tr>
<tr>
<td>Germany</td>
<td>soft, tacit understanding between unions and employers</td>
<td>central industry level</td>
</tr>
<tr>
<td>Greece</td>
<td>soft</td>
<td>centralised wage bargaining</td>
</tr>
<tr>
<td>Ireland</td>
<td>hard, via social pact</td>
<td>central inter-industry</td>
</tr>
<tr>
<td>Italy</td>
<td>hard, via law</td>
<td>centralised</td>
</tr>
<tr>
<td>Netherlands</td>
<td>soft, via social pact</td>
<td>central</td>
</tr>
<tr>
<td>Spain</td>
<td>soft</td>
<td>central</td>
</tr>
</tbody>
</table>

Source: Own research based on Hassel & Ebbinghaus n.d. (see Appendix 2 to this chapter)
The ERM, constructed around the Bundesbank-IG Metall constellation, and the Maastricht process thus combined to produce a robust disinflationary macro-economic regime, which structurally contained inflation. Between 1992 and 1999, average Euro-zone inflation rates (HICP) fell from 3.8% to 1.1%, while the variation around the mean decreased to within two percentage points.

The creation of EMU on 1 January 1999 removed the hard constraints on both unions and governments that this macro-economic regime imposed. The disappearance of the Bundesbank as the de facto central bank for Europe has indeed increased the breathing room not just for the German unions whose wages today determine roughly only about one-third of the EMU aggregate wage inflation rate, but for all other unions as well, especially in the faster-growing smaller economies. The disappearance of national central banks with control over monetary policy has removed the risk of hard sanctions if domestic wage growth rises above the EMU-average, while the reduced impact of inflation rates within the member-states above the ECB’s 2% target rate on the aggregate Euro-zone inflation rate introduced the possibility of some member-states free-riding on the good behaviour of other member-states. Furthermore, in the absence of a highly developed pan-European central co-ordination mechanism in wage bargaining, a direct upward translation of the inflation-constraining Bundesbank-IG Metall set-up is missing from the current set-up.

The effects of this shift in the macro-economic policy setting have been rapidly noticeable since 1 January 1999. Oil shocks and food price shocks that led to inflationary pressures in 2000 and 2001 were transmitted into the wage bargaining system, and economic growth in EMU in 1999-2001 has led to additional inflationary pressures. Since wage negotiations in most EMU member-states use a (weighted) average of past and expected inflation as a
baseline for wage negotiations, usually topped up by a performance measure which reflects relative competitiveness (expressed by labour productivity), these inflationary supply shocks have rapidly found their way into wage growth levels and EMU inflation increased sharply from 1.1% in 1999 to 2.3% in 2000 and stabilised at this level in 2001 and 2002.

What is structurally different between the ERM/EMS and EMU that makes such a sharp rise in inflation possible? In essence it comes down the interaction between an EMU-wide (instead of German-based) inflation target which does not take into account specific conditions in member-states, and the way wage bargaining systems have adopted a leader-follower pattern with Germany at its core.

In both cases, other countries follow German wage-setting. As we discussed above, under the ERM/EMS, the German inflation rate was the *de facto* target rate for all of the ERM. The effect of this was that German wage-setters had an important disciplining effect on other wage-setters.

The situation is different under EMU. In contrast to the ERM/EMS, the German inflation rate ’only’ counts for about one third in the EMU aggregate inflation rate. The ECB’s target rate is fixed, which implies that when other economies grow faster than the German economy, and EMU-aggregate demand expands, German wage-setters are forced to reduce domestic wage inflation to such an extent that they compensate for the above-target inflation in the other EMU member-states (in fact, German as well as French wages, combined accounting for some 60% of EMU GDP, have been in this position over the last few years) to move the aggregate inflation rate down to the target rate.
The appendix to this chapter presents a simple formal model that analyses this interaction between wages and employment in a situation in which there is a Stackelberg wage leader, under both the ERM/EMS and EMU scenarios to produce these results.

3.3. Institutional frameworks: national wage co-ordination and social pacts
How realistic are the assumptions of monopoly union wage-setting and German wage leadership on which the argument and the model in appendix are built? Empirically, two conditions have to hold. The first is sustained co-ordination of wage-setting (via labour unions or a functional equivalent), expressed in wage moderation (in unit labour cost terms), both in negotiated and in effective wages; the second a wage-setting system that uses German wage rates as benchmarks for other EMU member-states.
As we will analyse below, three elements, which combined meet these conditions, underpin the new wage-setting logic in Euro-land: wage bargaining is increasingly centralised, technical wage commissions result in relatively uniform wage outcomes across different countries, and centralised and de-centralised elements in labour relations systems have sharply different but complementary effects on the regime. The stability of the system is provided by the articulation of this regime with the interests of employers. The first two lead to moderate, centrally co-ordinated wage levels, the third articulates the central wage setting regime with micro-economic changes, and the fourth links the wage bargaining system to the tightness of the labour market in leading export sectors.

**Re-centralisation between 1992 and 1998**

After a decade of wide-spread decentralisation in collective bargaining systems (Katz 1993; Katz & Darbishire 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 & Fajertag 2000).

These outcomes are confirmed in the shape institutional developments in different countries take. In the first group of countries --Italy, Belgium, Ireland and to some extent Spain-- collective bargaining systems have explicitly re-centralised. Wages follow 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 previsions.

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 wage growth in the metalworking sector became the norm for all sectors. Table 3.2 presents data on wage leadership in Germany, and shows that up until recently IG Metall set the pace; since 2000, the chemical union has taken over. 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 & 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.

**Table 3.2: Pattern Bargaining in Germany 1995-2000**

<table>
<thead>
<tr>
<th>Year</th>
<th>Pilot Settlement</th>
<th>Subsequent Settlements in Other Sectors</th>
</tr>
</thead>
</table>
| 1995 | Metal Industry Bavaria (07/03) 3,4/3,6% | Chemical Industry (09/03) 3,8%  
Banking Industry (16/03) 3,8%  
Construction (25/03) 3,8%  
Public Sector (03/05) 3,2% |
| 1997 | Metal Industry Lower Saxony (05/12/96) 1,5/2,5% | Chemical Industry (19/12) 1,5%  
Textiles and Clothing (17/01) 1,5/2,1%  
Printing (06/02) 1,5%  
Construction (16/05) 1,3% |
| 1999 | Metal Industry Baden-Württemberg (18/02) 3,2% | Public Sector (27/02) 3,1%  
Iron and Steel Industry (19/03) 3,3%  
Insurance Industry (20/03) 3,2%  
Construction (22/04) 2,9% |
| 2000 | Chemical Industry West (22/03) 2,2/2,0% | Metal Industry (28/03) 3,0/2,1%  
Construction (30/03) 2,0/1,6%  
Chemical Industry East (01/04) 2,8/2,8%  
Insurance Industry (04/05) 2,5% |
| 2002 | Chemical Industry West (30/04) 3,3% | Metal Ind. Baden-Württemberg (15/05) 4,0/3,1%  
Paper Processing Industry (27/05) 3,4%  
Printing Industry (29/05) 3,4%  
Deutsche Post AG (11/06) 3,5/3,2% |

Source: WSI-Tarifarchiv

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 Euro-zone countries have adopted 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 1997; Pochet & Fajertag 2000; Hassel 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), macro-economic 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 prevailed.

Yet 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 was gone, and competitive devaluations therefore 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 DM, but with wage growth consistently below Germany, the tradable goods sectors in both countries managed to improve their relative competitiveness.²

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 coordination 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

² The high unemployment rate in Belgium (above 10%) hides two very different regional unemployment rates: the rate for Flanders is between 4-5%, while unemployment in Wallonia (and Brussels) is of the order of 17%. While there are very few studies on this, the few available data suggest that the unemployment rate in the two regions developed very differently because of the way similar (national) moderate wage settlements interacted with the export structure of the country. Flanders accounts for over 75% of Belgian exports, which implies that wage moderation (expressed in ULC terms) leading to a significant depreciation of the real exchange rate allowed Flanders to grow much faster, while it had little direct effect on growth (and hence employment) in Wallonia. This interpretation is confirmed by the fact that the Flemish unemployment appears to be considerably more sensitive to the business cycle: it rose sharply with the 2001 downturn in Flanders but remained stable in Wallonia.
employers’ concerns. Tables 3.3 and 3.4 present data on bargaining coverage and wage co-ordination summarising these developments.

**Table 3.3: Bargaining Coverage and Wage Coordination**

<table>
<thead>
<tr>
<th></th>
<th>Bargaining coverage&lt;sup&gt;44&lt;/sup&gt; 1994, 2000, 2001</th>
<th>Coordination&lt;sup&gt;45&lt;/sup&gt; 1980</th>
<th>Coordination&lt;sup&gt;45&lt;/sup&gt; 1990</th>
<th>Coordination&lt;sup&gt;45&lt;/sup&gt; 1994</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>98</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Belgium</td>
<td>&gt;90</td>
<td>2</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Finland</td>
<td>95**</td>
<td>2+</td>
<td>2+</td>
<td>2+</td>
</tr>
<tr>
<td>France</td>
<td>90-95</td>
<td>2-</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Germany</td>
<td>67*</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Italy</td>
<td>82**</td>
<td>1.5</td>
<td>1.5</td>
<td>2.5</td>
</tr>
<tr>
<td>Netherlands</td>
<td>88</td>
<td>2</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Portugal</td>
<td>87*</td>
<td>2-</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>Spain</td>
<td>75*</td>
<td>2</td>
<td>2</td>
<td>2</td>
</tr>
</tbody>
</table>

Source: (a) EIRO, 2002 for data with no asterisk (2001) or one asterisk (2000); data with two asterisks relate to 1994 (see OECD, *Employment Outlook*, 1997, Table 3.3); (b) OECD, ibid.

**Table 3.4: EMU Wage Coordination Characteristics 1991-2001**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>State-imposed coordination</td>
<td>France</td>
<td>Belg, France</td>
<td>Belg, France</td>
</tr>
<tr>
<td>State-sponsored (peak-level) coordination</td>
<td>Belg, Fin, Italy, Eire, Neth, Port, Greece</td>
<td>Italy, Eire, Neth, Greece</td>
<td>Fin, Italy, Eire, Neth, Greece</td>
</tr>
<tr>
<td>Intra-associational coordination</td>
<td>Spain</td>
<td>Spain, Port</td>
<td>Spain, Port</td>
</tr>
<tr>
<td>Pattern bargaining</td>
<td>Ger, Austria</td>
<td>Ger, Austria</td>
<td>Ger, Austria</td>
</tr>
<tr>
<td>No coordination</td>
<td>Fin</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Put simply, Flanders has adopted a regime which is based on economic growth through a favourable real exchange rate, as the Dutch did in the 1990s.
**Wage benchmarking through technical commissions**

Alongside central co-ordination of wage bargaining as the organisational framework for wage-setting in the Euro-zone, 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 last column in table 3.1 earlier in this chapter gives an indication of the degree of central control over wage-setting.)

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 cooperation 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 group 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 has been the leader in wage negotiations for many decades. 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 other regions.
In the Netherlands, a group of central union experts determines the ‘appropriate’ level of wage growth for the contract negotiations at the beginning of every bargaining round, and up until 2001 every contract (even though it is formally signed at the company level) was officially sanctioned by the central 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 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 the Treasury, highly convincing) signals about what it considered appropriate wage growth levels.

The outcome of these institutional shifts are captured in Figure 3.3 and Figure 3.4, which demonstrate the convergence of wage-setting on a single growth rate and how the other countries in EMU follow German wage developments (expressed in ULC).
Figure 3.3: Inflation, Productivity and Nominal Wage Growth

**Germany**

![Graph showing inflation, productivity, and nominal wage growth for Germany.]

**France**

![Graph showing inflation, productivity, and nominal wage growth for France.]

**Italy**

![Graph showing inflation, productivity, and nominal wage growth for Italy.]

*a* – Productivity + Inflation, *b* – Nominal wages, % change on previous year
Ireland

a – Productivity+Inflation, b – Nominal wages, % change on previous year

Source: OECD Employment Outlook 2001
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 to 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 before.

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 Euro-zone 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 has 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 company-level productivity drives. As a result of the shift in the macro-economic regime associated with EMU, the micro-economic 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.³

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³ 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 90s 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, and productivity- or competitiveness-enhancing measures, including skill formation, 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.

**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, presented in Fig. 3.5, confirm that this sector (which is an important exporting sector in all the Euro-zone countries) has indeed been facing a quasi-full employment regime since the mid-1990s, a picture confirmed by the data in Fig 3.6 for the Finnish and German engineering sectors (both countries with high aggregate unemployment, but large numbers of unfilled vacancies) and by our interviews with labour unions and employers in the different countries.
Figure 3.5: Unemployment in the Manufacturing Sector

a – Total Unemployment, b – Unemployment in Manufacturing
* Includes Unemployment in Mining and Quarrying

Source: ILO Laborstat
a – Total Unemployment, b – Unemployment in Manufacturing
a – Total Unemployment, b – Unemployment in Manufacturing
Figure 3.6: Unfilled Vacancies, Germany and Finland, 1991-2001

Germany - Metal and Electrical Industries

Source: Gesamtmetall

Finland - Production and related work

Source: Finnish Ministry of Labour
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 in EMU member states; 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 that 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, as the debate on the benefits of co-ordinated wage bargaining suggests, frequently more beneficial to them than decentralised wage setting (see Calmfors & 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 Euro-zone countries. Unions in these sectors have to a large extent internalised the competitiveness requirements that are part and parcel of wage-setting today. This sector leads the negotiations, effectively paying the highest wages, and the other sectors follow.
The new wage-setting system is therefore not only macro-economically sound (by keeping inflation down), it also supports micro-economic adjustment and industrial restructuring, since it allows wage growth to remain stable, gives employers flexibility in the workplace (both centrally sanctioned and productivity-enhancing in nature), and ultimately contributes to an improvement in relative competitiveness.

3.4. Conclusion

The institutional shifts in the wage bargaining systems in the Euro-zone countries since 1992 have led to three broad outcomes. The first is that the set-up is fundamentally disinflationary without leading to trans-national wage competition. In contrast to many fears on how a social Europe is (not) developing (Streeck 1998; Martin & 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 Euro-zone 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.

Thirdly, while the new regime appears to be structurally disinflationary as a result of falling unit labour costs, it is emphatically not a result of a credible threat by the ECB. 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 IG Metall (Hall 1994). For any individual union, including 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 Euro-zone 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 Euro-zone, 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.

This has tremendous implications for EMU as a whole. 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 Euro-zone. In Italy, Belgium, Germany, and Ireland, for example, unions have always had or recently developed both functions, and the novel Euro-zone
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?

The second consequence relates to the position of the German unions. As we pointed out, they are 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
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.

The third question relates to the stability of the system as a whole. 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 see as their benefits 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 considerations. 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 & 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?

Before tackling these questions, another piece of the puzzle has to be put into place: the changing framework for fiscal policy-making in EMU. As we will demonstrate in the next chapter, the low-inflation environment resulting from the collective bargaining systems in the euro area have produced a counterintuitive possibility for fiscal policy.
Appendix 1:  
A simple model of German wage leadership in EMU

In this section a model is developed which provides a graphic interpretation of a central point in the last two sections – namely the infeasibility of German wage-setters to keep aggregate EMU inflation constant during an upswing in EMU, as compared with its feasibility during ERM. We assume in both cases that Germany is the wage leader and that the other member-states (of EMU and ERM respectively) know what money wage increase has been selected by German wage-setters. All wage-setters use rational expectations.

EMU: We show first the real wage cuts in Germany which would be necessary if Germany as wage leader was to avoid an increase in EMU inflation during an upswing. In the model, it is assumed that EMU is a closed world economy, consisting of N+1 individual economies. One economy, G, has a weight of γ in the EMU price equation

\[ P_{EMU} = P_G^γ \cdot P_r^{1-γ} = W_G^γ \cdot W_r^{1-γ} \]

the remaining N identical economies have a combined weight of 1-γ; productivity is assumed to be unity throughout and immobile labour is the only factor of production. Individuals have identical utility functions; the consumption price level is the EMU-wide price level, \( P_{EMU} \). The ith economy produces a single good with price level \( P_i \), so the terms of trade and the real exchange rate of the ith economy are \( P_i/P = p_i = \bar{w}_i \). In each economy, i, there is a monopoly union which maximises

\[ \frac{w_i e_i - \alpha}{2} e_i^2 \]

subject to a labour demand curve

\[ e_i = (1-γ)N^{-γ} \cdot w_i^{-η}.A \]

---

4 See Soskice & Iversen (2000) for the details of how the model is derived.
where \( w_i \) is the real wage, \( W_i/P \), \( e_i \) is the level of employment, and \( A \) is EMU-wide aggregate demand; (note that since \( w_i = p_i \) and \( e_i = y_i \), GDP in \( i \), (1.3) is also the aggregate demand equation for \( i \)). This implies a real wage bargaining schedule in which the real wage is proportional to employment,

\[
(1.4) \quad w_i = \frac{\alpha \eta}{\eta - 1} e_i
\]

and combining (1.3) with (1.4) we can write the real wage as a function of EMU aggregate demand:

\[
(1.5) \quad \ln w_R = \frac{1}{1+\eta} \ln \frac{\alpha \eta}{\eta - 1} + \frac{1}{1+\eta} \ln A
\]

where it is aggregated over the \( N \) economies for convenience. This is the upwards sloping line in Figure 1 where \( WSR \) stands for wage-setting by \( R \) given \( A \), EMU-wide aggregate demand, equation (1.5).

The equilibrium or price-setting real wage, \( \ln w^e \), is equal to zero: since labour productivity is unity, the price-setting real wage is unity. The equilibrium level of EMU-wide aggregate demand is denoted \( A^e \).

Now we construct the real wage which German wage-setters would have to set if the EMU inflation rate is not to change when EMU aggregate demand
changes. We showed in the last section that the percentage change is given by
\[ \dot{w}_G = -\frac{1-\gamma}{\bar{\gamma}} \beta \Delta^d \]
where \( \beta = 1/(1+\eta) \), so this can be rewritten as

\[ \ln w_G - \ln w^*_G = -\frac{1-\gamma}{\gamma} \frac{1}{1+\eta} \left( \log A - \log A^* \right) \]

This line, \( WSG \) in Figure 1, is therefore downwards sloping through
\( (\ln w^*_G, \ln A^*) \). In essence, for inflation to remain constant as aggregate demand
expands, the aggregate real wage bargaining schedule for EMU has to be
horizontal. Geometrically, adding the \( WSG \) schedule weighted by \( \gamma \) to the \( WSR \)
schedule weighted by \( 1-\gamma \) produces a horizontal line.\(^5\)

**ERM:** Under the ERM, Germany was constrained not to raise its inflation rate
by the Bundesbank, and the ERM then implicitly required other member-
states not to raise inflation rates for fear that they might be forced by foreign
exchange pressures outside the ERM bands. Hence under ERM,
\[ \Delta \pi_{EMU} = \Delta \dot{W}_G = \Delta \dot{W}_R = 0 \]
This can be seen in Figure 2. In this case both
Germany and the Rest have individual horizontal real wage bargaining

\[ d[\gamma \ln w_G + (1-\gamma) \ln w_R] \frac{d \ln A}{d \ln A} = \gamma \left( -\frac{(1-\gamma)}{\gamma(1+\eta)} \right) + \left( \frac{1-\gamma}{1+\eta} \right) = 0 \]

\(^5\) The requirement is
schedules; the aggregate real wage schedule is therefore also horizontal. In this case German wage-setters do not have to suffer a real wage cut. Hence as long as the ECB ceiling is positive they can also set positive money wage increases.

The organizational needs of unions make it very difficult --and often impossible-- to sell real and/or money wage cuts to their members. This explains why the ERM set-up makes low inflation possible during an expansion while the EMU set-up does not.6

---

6 Even though German wage-setters may be better off under EMU in choosing \( \theta \). If the alternative to choosing \( \theta \) is that the ECB raised rates and aggregate demand returned to \( A' \), there would be a Pareto improvement from choosing \( \theta \) if the indifference curve through \( \alpha \) cut the vertical \( \ln A' \) line below \( \theta \).
## Appendix 2: Wage guidelines and social pacts in Europe

### Wage guidelines tying wage increases to wage developments in other countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Contract</th>
<th>Year</th>
<th>Wage guideline</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgium</td>
<td>Law on competitiveness</td>
<td>1989</td>
<td>Wages must not grow faster than the average increase in seven countries (D, F, NL, I, UK, US, J).</td>
</tr>
<tr>
<td></td>
<td>Law</td>
<td>1996</td>
<td>Wages must grow slower than the expected increases in French, Dutch and German wages.</td>
</tr>
<tr>
<td></td>
<td>Collective Agreement</td>
<td>1998</td>
<td>Maximum of wage increases of 5.9% for two years, must not grow faster than French, Dutch and German wages.</td>
</tr>
<tr>
<td>Italy</td>
<td>Tripartite agreement on abolition of scala mobile</td>
<td>1993</td>
<td>Wage increases must be below expected rate of inflation. Plant level extra can be based on productivity growth.</td>
</tr>
<tr>
<td></td>
<td>Social Pact on Growth and Employment</td>
<td>1998</td>
<td>Wage increases must be below expected inflation rate; plant level supplement based on productivity growth.</td>
</tr>
<tr>
<td></td>
<td>Rehnberg-Agreement (Renewal)</td>
<td>1992</td>
<td>Reaps the wage guideline of 1992, wage drift of previous year is included in nominal wage increases.</td>
</tr>
<tr>
<td></td>
<td>Edin-Commission</td>
<td>1995</td>
<td>Edin Norm; 3.5% wage increase – reflecting the expected average of EU wage growth.</td>
</tr>
<tr>
<td>Denmark</td>
<td>Agreement on Social Partnership</td>
<td>1987</td>
<td>Wage increases must not be above the wage developments of other European countries (valid for four years).</td>
</tr>
</tbody>
</table>

### Countries with fixed wage guidelines

<table>
<thead>
<tr>
<th>Country</th>
<th>Contract</th>
<th>Year</th>
<th>Wage guideline</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portugal</td>
<td>Tripartite agreement</td>
<td>1996</td>
<td>Wage increases up to half of productivity growth.</td>
</tr>
<tr>
<td></td>
<td>Strategic Social Pact</td>
<td>1997</td>
<td>No wage guidelines.</td>
</tr>
<tr>
<td></td>
<td>Social Pact</td>
<td>1995-</td>
<td>Wage increases of 2% in 1995 and 1.7% in 1996; limited indexation to prices.</td>
</tr>
<tr>
<td></td>
<td>Social Pact</td>
<td>1997</td>
<td>Renews the wage guidelines.</td>
</tr>
<tr>
<td></td>
<td>2000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Ireland</td>
<td>Programme for National Recovery (PNR)</td>
<td>1987-</td>
<td>Wage guideline of 2.5% per year.</td>
</tr>
<tr>
<td></td>
<td>1990</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>1993</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Programme for Competitiveness &amp; Work (PCW)</td>
<td>1994-</td>
<td>Wage increase of 8% over 3 years; public sector has slower wage increases.</td>
</tr>
<tr>
<td></td>
<td>1997</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Informal wage guideline

<table>
<thead>
<tr>
<th>Country</th>
<th>Contract</th>
<th>Year</th>
<th>Wage guideline</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nether-</td>
<td>Wassenaar Accord</td>
<td>1982</td>
<td>Moderate wage agreements below productivity growth.</td>
</tr>
<tr>
<td>lands</td>
<td>New Course</td>
<td>1993</td>
<td>New commitment for a responsible wage development.</td>
</tr>
</tbody>
</table>

Source: Hassel & Ebbinghaus n.d.
Chapter 4
Fiscal policy and the Stability and Growth Pact

As we saw in the previous chapter, wage bargaining in the Euro-zone has assumed a novel character since the mid-1990s. To a large measure, we attributed that to the way labour unions had internalised considerations on the competitiveness of export industries in their wage demands. Wages thus grew at a rate below or equal to productivity growth almost everywhere in the Euro-zone, and since trade unions in most of the EMU member-states adopted de facto a similar logic in the definition of appropriate wage growth levels, they have been evolving in very similar ways, leaving the impression of a quasi-co-ordinated predictable, low-inflation wage-setting system in EMU as a whole.

We now move on to the second broad area of importance in the new macro-economic framework of EMU: fiscal policy-making. This chapter will analyse both the institutions involved in fiscal policy-making in the run-up to EMU, the Stability and Growth Pact (SGP) which followed the adoption of the single currency, and their operation over the four years since EMU became a reality. We make two substantive points. The first is that any of the different possible scenarios embedded in the current fiscal policy regime as it is defined by the Stability and Growth Pact (SGP), is likely to produce profoundly negative outcomes for the EMU macro-economy. Our second point is that in revising the SGP, the debate ought to take into account that the EMU fiscal policy regime is located within a broader institutional context, which consists of the ECB on the one hand, and wage bargaining systems on the other. We thus offer a series of criteria for fiscal policy which --as we will argue in chapter 5--
use the outcomes of the reconfigured wage bargaining systems as a starting point.

The chapter starts with a short review of fiscal consolidation in the run-up to EMU. We then discuss the SGP as the founding document for EMU’s fiscal policy and demonstrate how it fails to meet its own goals. Section 4.3 presents a series of more substantive criteria for fiscal policy under a revised SGP -- most of which can easily be accommodated by many of the procedural proposals that have entered the debate on the SGP over the last two years. The chapter concludes by preparing the ground for the next chapter.

4.1. Fiscal consolidation under the Maastricht convergence criteria

The consolidation process in the run-up to EMU can be analysed along two relevant dimensions. The first is the shape of fiscal consolidation itself, which can take two core forms and two mixed forms. Governments can reduce budget deficits to meet the Maastricht 3% criterion either as a result of a reduction of public expenditure, as a result of increasing revenue through higher taxes, or adopt a mixed strategy, reducing expenditure and increasing revenues at the same time, or switching over time as one strategy appears to be less effective.

The second relevant dimension is, in parallel to what was analysed in chapter 2, the timing of fiscal consolidation. Some of the member-states had already reduced their deficits prior to the Maastricht treaty, while for others the sanction of not being allowed to join EMU’s third stage in 1999 provided a hard incentive for fiscal consolidation. We will first analyse the form that consolidation took, and then turn to the timing issue. Note that the figures we present measure budget deficits in actual nominal terms, in line with the Maastricht criteria, without distinguishing between primary and secondary budgetary positions or between structural and nominal budgets.
Spain, Finland and The Netherlands met the Maastricht criteria through a strategy of expenditure-based adjustment. As the panels for these countries in figure 4.1 show, while the tax basis was stable in Spain, in Finland and The Netherlands government receipts fell roughly in line with the drop in expenditures. Between 1993 and 1998 the share of government expenditures in GDP fell from 59% to almost 51% in Finland, from over 47% to a little above 42% in Spain, and from above 54% to slightly above 46% in The Netherlands. As a result, the deficit fell to 0% in Finland and The Netherlands by 1998, and to around 2% in Spain.

For a large part of the 'Maastricht' period France and Portugal adopted a revenue-based adjustment path, in which taxes rose to meet government expenditures. In France, expenditures fell by only 2 percentage points in the 1990s, but receipts increased by almost 4 percentage points until 1997 and then slowly fell again. In Portugal, expenditures in fact rose from 42% in 1992 to almost 46% of GDP in 1998, but receipts increased as well, from a low of 38% of GDP in 1994 to a high of 43% in 1998. By 1998, the deficit in both countries was of the order of 2%.

Greece and Belgium consolidated budgets by adopting a mixed strategy: simultaneously reducing expenditures and increasing receipts. In Belgium, government expenditures as a share of GDP fell from a high of almost 56% in 1993 to 50% in 1998, while taxes increased from 47% of GDP to 52% in 1997 and 51% in 1998. In Greece the drop in expenditures was from 49% in 1993 to just above 43% in 1998, and receipts increased from 34% to 42% of GDP. The effect was that in both countries deficits had either disappeared (in Belgium) or fallen to around 1% of GDP.

Germany, Italy and Austria, finally, switched strategies halfway through the Maastricht period. Germany started off with a revenue-based consolidation strategy, when receipts rose from 45% of GDP in 1992 to almost 47% in 1996; however, since expenditures (mostly related to unification) had risen as well over this period, Germany continued to face a tenuous situation. In 1995 the
deficit was still above 3%, and in that year Germany switched to a *mixed strategy*, which simultaneously sharply reduced expenditures (from 49.5% of GDP in 1996 to below 48% in 1998) and raised taxes. The German deficit thus easily met the 3% Maastricht criterion.

Fiscal consolidation in Austria followed the same pattern: the country started off the Maastricht period with a 4% deficit, which widened over the next three years as a result of increased spending (only slightly compensated by increased tax revenues). In 1995, the strategy changed to include a drop in spending and a rise in revenue. By 1998, the Austrian deficit had fallen to around 2% of GDP.

Italy started out with an expenditure-based consolidation but added increased receipts after 1995. Between 1993 and 1995, government expenditure fell from over 57% of GDP to 54%. However, since tax receipts fell as well, the deficit remained, as in Germany, considerably above the Maastricht reference value (close to 9% of GDP, in fact), and in 1995 the Italian government sharply increased receipts alongside reduced spending --with, as a last sprint, the imposition of a Euro-tax in 1997. By 1998, the Italian deficit had fallen to less than 3% of GDP, and Italy joined the EMU club.

In terms of timing, the prospective EMU member-states can be divided into two large blocks. The first group consists of countries had faced a profound economic crisis before 1992 which often translated into or was triggered by a crisis in public finances. In response they had already reorganised their fiscal policies before the Maastricht Treaty: The Netherlands, France, Ireland, and Finland. The other countries, however, waited for --and needed the incentives of-- the convergence criteria to reduce debt and deficits. In order to meet the Maastricht criteria, the late adjusters disproportionately relied on *mixed* and *switching* strategies: Greece, Belgium, Italy, Germany, Austria.

Finally, and foreshadowing the analysis in the next chapter, what were the links between these two dimensions (strategies toward and the timing of consolidation) and the shifts in the wage bargaining systems analysed in
chapter 2? The most important link is that early adjusters relied on relatively soft forms of wage moderation, while wage bargaining systems among 'late adjusters' often were reorganised through hard wage benchmarks and wage norms, either through law or social pact. Italy, Belgium, and Austria thus imposed hard wage norms, while Germany, France, Ireland, and the Netherlands relied on soft wage co-ordination forms, which did not impose strict wage guidelines.

In large measure this seems related to the degree to which wage moderation had become a crucial ingredient of fiscal consolidation in late adjusters: moderate wage growth reduces domestic inflation, while as a result of some form of centralised or pattern bargaining the growth of the public sector wage sum is linked directly to (moderate) wage developments in the exposed sector.

Overall, then, the Maastricht convergence process led to two highly significant outcomes. The first was that all the prospective EMU member-states reorganised their public finances in order to meet the budget criteria, while countries such as Belgium and Italy also managed to improve their debt situation significantly. Secondly, as a result of the shifts in wage bargaining discussed in the previous chapters, trade unions actively contributed to the fiscal consolidation process, by restraining wages. Table 4.1 in Appendix to this chapter provides a graphic picture of the fiscal consolidation in each of the member-states.

In 1998, this adjustment process allowed EMU to start with a maximum number of participants: in effect, with the exception of Greece which met the Maastricht criteria in 2000, all applicants were admitted into EMU. This 'EMU-extra large' situation led to fears among some politicians and economists that countries would work hard to meet the Maastricht criteria but, since there were no hard sanctions or incentives once a member-state had joined, that the fiscal discipline would collapse after the introduction of the single currency in 1999.
In order to pre-empt such a scenario, the EMU member-states agreed to an additional arrangement, the Stability and Growth Pact (SGP) in Amsterdam in 1997. Its main aim was to enshrine the fiscal discipline associated with the Maastricht criteria into a treaty, which would impose hard sanctions on member-states who adopt profligate fiscal policies.

The SGP has been operating for roughly four years now, and has been the subject of criticism from many corners. In the next sections we present a preliminary evaluation of the SGP, including a review of the debate on how it could be improved.

4.2. The Stability and Growth Pact four years on
In EMU, centralised monetary policy in the ECB was linked to a decentralised fiscal policy in which individual countries retain the authority for taxation and expenditure. In order to deal with the co-ordination problems that might ensue as a result of this asymmetry in policy-making, the EMU member-states agreed to a model of policy co-ordination --the OMC-- through the SGP, which applied solely to EMU member-states, and the EU-wide BEPG (Hodson & Maher 2001).

The political history of the SGP is not without importance and explains why it appears, on paper at least, as a stringent monetarist disciplining device. In part to buy acquiescence from the Bundesbank to go ahead with EMU, and in part to alleviate German fears of southern-European lack of fiscal prudence, the SGP imposed strict fiscal discipline by turning the logic of the Maastricht criteria into an unwritten economic constitution for EMU. The SGP is part of the Treaty of Amsterdam (1997) and therefore a binding document for all EMU member-states.

The most important components of the SGP are that governments accept a 3% budget deficit maximum --except under very specific circumstances of
negative growth (the excessive deficit procedure), and a balanced budget over the cycle and within the foreseeable future. The institutional vehicle that assures compliance with these provisions is Ecofin (in collaboration with the Commission), which organises what is called ‘mutual surveillance’.

*Excessive deficit procedure.* When the budget deficit of an EMU member-state reaches 3%, a series of quasi-automatic procedures are set in motion: the Commission reports on the member-state’s transgression, Ecofin evaluates the Commission’s report and issues a warning. If no corrective action is taken, the member-state is provisionally fined (up to 0.5% of its GDP), a fine it foregoes if the deficit is not in line by the second year after the initial warning.

*Balanced budgets.* The SGP stipulates that government budgets have to be balanced both over the cycle and within a foreseeable future. The year initially proposed for balanced budgets was 2004, but that date appears untenable as a result of the low growth period in the EU since 2000. The idea underlying this policy is that a balanced budget offers states more freedom for a fiscal stimulus when growth slows without breaching the SGP.

*Mutual surveillance.* Formally, the SGP is part of the EMU framework only, and therefore in principle only applies the member-states in monetary union. However, its operation is embedded more broadly in the Broad Economic Policy Guidelines.¹ As a result, EU member-states that are not members of EMU, such as the UK, Sweden, and Denmark, participate in the implementation of the SGP in exchange for peer-monitoring their economies in Ecofin. Ecofin –the Council of EU Finance and Economics Ministers-- thus

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¹ Combined, the Mutual Surveillance mechanism and the set-up around the Broad Economic Policy Guidelines are a form of what has become known in the recent literature on European integration as the ‘Open Method of Co-ordination’ (Hodson & Maher 2000; Begg et al. 2003 provide good reviews of this).
becomes the institutional vehicle for the implementation of the BEPG in general and the SGP in particular.

Only three years in its existence, it is increasingly obvious that the SGP is operating along very different lines than those envisioned by its architects. We identify three types of problems with the SGP, each associated with a different scenario on how it is implemented. In the first scenario, it is followed literally by EMU member-states, in which case it risks producing a deflationary regime as a result of its pro-cyclical bias; the second scenario is one in which it is not implemented and then it will lose credibility quickly; in the third scenario it operates along more flexible lines, but then it runs the risk of imposing counterproductive inflation requirements on EMU member states. Let us deal with each argument in turn.

*A strict interpretation of the SGP: deflationary dangers*

The first type of problem is related to a strict interpretation of the provisions of the SGP. Note that the SGP is a binding international treaty, and according to the letter of the SGP, this implies that, except under special conditions, member-states have to keep their budget deficits at all times within a 3% limit or be subject to an alarm bell procedure which ultimately ought (but is politically unlikely) to lead to large fines. In practice, since growing deficits often reflect slowing growth (and automatic stabilisers raise government expenditure) this means that a country that finds itself heading toward a period of low growth or even a recession is forced to adopt a restrictive fiscal policy as a way of preventing its deficits to rise above the SGP limit (note that deficits are measured in actual, nominal terms, not in structural and/or cyclically adjusted terms). Put differently, the SGP imposes a restrictive macro-regime on a member-state precisely at a moment when more expansive
counter-cyclical policies are needed to avoid a prolonged economic downturn.²

This constellation is what we saw in 2003, when in several Euro-zone countries --Germany and France in particular-- deficits rose above the 3% limit. Germany vowed to restore fiscal discipline, while France ignored such calls. The danger in this situation is, of course, that --since France and Germany account for over half of Euro-zone GDP-- a restrictive stance in these countries would rapidly express itself as lower and falling overall EMU-wide growth as a result of falling exports to Germany and France, thus slowing down the other EMU member-states as well.³ In short, since a strict interpretation of the SGP leads to pro-cyclical restrictive policies, it runs the risk of imposing a permanent low-growth regime on all of EMU.

The issue is not just one of appropriate macro-economic policies. If the SGP indeed heralds a low growth regime in EMU, its political sustainability comes under pressure, as member-states progressively might ignore the letter of the SGP and adopt fiscal policies which reflect their own needs. In fact, by mid-2003, it is increasingly obvious that EMU consists of two large blocks of countries: those that have reorganised their domestic fiscal policy rules to avoid being confronted with the excessive deficit procedure of the SGP (Netherlands, Belgium, and Spain, for example), and another group of countries which, for reasons of structural incapacity (the fiscal burden of German unification) or political expediency (the French government keeping its electoral promises) appear unable to revise their fiscal policies. Obviously

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² The counterargument in defence of the SGP is that countries are supposed to balance budgets over the cycle. In that case the 3% deficit limit leaves enough room for fiscal policy to operate in a downturn. While this may be the case, it hardly helps countries such as France and Germany which run up against the SGP limit in 2003 and perhaps 2004.
³ Thanks to Waltraud Schelkle and Dermot Hodson for insisting on this point.
the one-size-fits-all logic of the SGP cohabits uneasily with this diversity in fiscal strategies.

**Ignoring the SGP: loss of credibility and free-rider problems**

Since the SGP limits --unreasonably in the eyes of many observers-- choices in economic policy, some member-states are adopting a position of outright defiance. France, as we mentioned earlier, has stated clearly that, in the morose economic climate of 2003, it does not consider itself subject to the strict provisions of the SGP. (In fact, the UK, outside EMU but inside the co-ordination arrangements for EU-wide economic policies, would be facing a similar problem with the plans for public investment adopted by the Chancellor Gordon Brown.)

In the short term, this scenario might be slightly more positive, in the sense that it does not impose restrictive policies during an economic downturn, but it produces a set of important medium- and long-term problems. It is important to keep in mind that the SGP has no automatic 'triggering' mechanism, since the Council of Finance ministers (Ecofin) has to collectively agree to 'name and shame' the delinquent country. Invoking the hard clauses of the SGP therefore is a profoundly political process, in which Ecofin is the arena.

Two elements limit the capacity of Ecofin to sanction its members. The first is related to the nature of decision-making in Ecofin. The imposition of fines and the hard sanctions in the SGP require a large majority in the Council of Ministers, while escape can be secured by a rather small number of votes. The voting procedures require a qualified majority for a member-state (a vote in which the targeted member-state participates as well): 71.2% or 62 out of 87 votes, as well as a two-third majority of the unweighted votes of the member-states, i.e. 10 out of 15. The second is that EMU member-states are in fact
reluctant to impose policies on other member-states, since the freedom offered to other member-states at one point can, when the tables turn, offer room for manoeuvre for the initially 'well-behaving' member-state as well. In other words, in the current set-up there is a built-in incentive for member-states to collude and take a lax view of the SGP.

If EMU member-states decide to ignore the SGP as a result of these processes, the problem is that the initial --correct-- rationale for the SGP (but note: not necessarily the particular rules agreed in 1997), namely that a monetary union such as EMU requires some form of co-ordination to avoid free-riding problems which might produce defections, will be lost.

Loss of credibility of the SGP has two potential consequences for EMU as a whole. The first is related to the reaction of the ECB to an undermining of the SGP: if the ECB insists on a literal interpretation of the Pact, it is likely to adopt a hard punishment strategy by keeping interest rates high. The second is that a progressive disregard of the SGP will lead to chaotic free-riding among member-states, which may result in an unsustainable EMU-aggregate debt position in the medium or long-term.

A flexible re-interpretation: the danger of fixed real exchange rates

There is a third, more dynamic, interpretation of the SGP: the SGP and the broader BEPG are embedded in a series of other institutions for economic policy-making at the EU/EMU level --the Commission, the Council of Ministers (Ecofin), and the ECB. The interaction between those different institutions, against a background of low inflationary pressures provided by the wage-bargaining systems analysed in the previous chapter, has produced a profoundly different policy framework from the one expressed associated with a literal reading of the SGP (Hancké 2003).

In this interpretation, the SGP is interpreted very liberally, both by Ecofin and by the ECB as long as member-states contribute to the goal of low aggregate
EMU-wide inflation, either by pursuing explicitly disinflationary policies (frequently the result of domestic wage settlements) or at least by not adopting policies that incite inflation. In the case of inflationary pressures within member-states (especially the larger ones), however, which might have effects on the EMU aggregate inflation rate, the response to such a threat is in the first instance initiated by the Council of Ministers itself. Ecofin could thus be regarded as a delegated monitor for the ECB. Note that such policies support the ECB's stance without prejudging them. Generalised disinflationary policies allow the ECB to bracket out inflation and adjust monetary policy accordingly. If, however, the ECB judges Ecofin's decision to be insufficient, the central bank can always react independently by raising interest rates.

However, since even member-states that behave properly will face the negative consequences of an ECB reaction (Gatti & Van Wijnbergen 2002), Ecofin as a collective body faces very strong incentives to assure low inflation in EMU as a whole, but can be considerably more lenient on fiscal policy that does not endanger the ECB's inflation target. Comparing the decisions regarding the fiscal stances of Ireland in February 2001 and Germany in 2002 suggest that policy considerations very different from the strict monetarist interpretation of the SGP were at the basis of the decisions reached by the Council of Ministers: the Irish budget potentially endangered the low inflation target of the ECB (either directly or by setting a bad example for others), while the German budget plans did not. The reaction by Ecofin was therefore very different in the two cases, reflecting the different implications of fiscal policy in the two countries.

The crucial difference between the reaction of Ecofin to the fiscal position of Ireland in 2001 and Germany in 2002 was not its relation to the (letter of the) SGP, but their potential and real effects on the EMU inflation rate. Ireland's
policy was both inflationary and pro-cyclical. If it had not been kept in check, 
the entire EMU might have suffered as a result of a potential reaction by the 
ECB. Even though the Irish economy was too small in itself to weigh heavily 
in the aggregate EMU inflation rate, it set a bad example, since one defection 
could have led to more. (A comparison with the situation in The Netherlands 
in 2001/02 validates this point: for cyclical reasons the country also 
experienced higher than EMU-aggregate inflation, but government and wage-setters immediately acted to contain it, and Ecofin did not issue a reprimand.) 
Ecofin thus punished the Irish budget on the basis of its inflationary potential, 
not on its own merits.

Germany’s policy, in contrast, was anti-cyclical and did not pose threats to 
low inflation. It therefore did not put the credibility of the SGP and EMU at 
risk, but isolated any risks that might emerge. Even within EMU, German 
fiscal policy can still be singled out by capital markets, by raising the risk 
premium on German debt and not on others. Furthermore, since German 
policies were not leading to rising inflationary pressures (inflation in 
Germany fell, in fact, from 2.9% in 2001 to 1.6% in 2002, with further drops 
forecast for 2003 and 2004), there was no danger of the ECB reacting with a 
hike in interest rates, since its inflation target was not endangered as a result 
of the German policies, and consequently Ecofin could adopt a more lenient 
stance toward Germany.

There is, however, a significant problem with the logic behind this 
interpretation. Imposing a single inflation target on individual member-states 
may, in fact, be counterproductive, since it leaves no or little room for inter-
country adjustment through the real exchange rate. An inflation target of this 
sort implies that all countries are 'locked in' in the relative positions with 
regard to competitiveness; this means that large economies have little room to
use the real exchange rate as a means to lower unemployment, since inflation rates are supposed to be at or below the ECB target rate of maximum 2%.

**The SGP: from problems to solutions**

The unavoidable conclusion that these three interpretations of the SGP lead to is that it is simply not working properly. In its strict version it is a recipe for long-term slow growth, and perhaps sustained recession, in the Euro-zone. If it is ignored by the main economies of Europe, the very idea of fiscal co-ordination within EMU is lost. And a more flexible interpretation, which concentrates on sanctioning inflation targets among the Euro-zone countries, imposes rigidities which do not allow for inter-country adjustment via the real exchange rate.

Not surprisingly, by mid-2003, the SGP has become the subject of trenchant criticism from many corners. Professional economists, finance ministers, and Commission president Romano Prodi have pointed out the problems with it. Even usually more conservative observers such as the Financial Times and The Economist have argued against the current SGP and called for a revision.

The question then is not *if* but *how* to redesign the SGP. The major constraint is that some form of rule-based fiscal policy regime is necessary in EMU, if only simply to avoid individual countries free-riding on the good behaviour of others --or, conversely, to prevent interest rate externalities spilling over onto others, when the ECB punishes all member states by raising interest rates when one of them defects from the rule-based system (Gatti & Van Wijnbergen 2002). At the same time, however, the one-size-fits-all structure of the SGP does not take into account the different fiscal policy needs of different EMU member states.

A series of sensible adjustments to the SGP which have been proposed in the last year could relatively easily be accommodated within the existing
framework. A structural definition of budget deficits instead of the current actual deficit level would allow for a policy that takes into account the cyclical economic effects and thus increase the room for automatic fiscal stabilisers.\textsuperscript{4} Similarly, a proper accounting of public investment as opposed to government consumption would assure that necessary investment expenditures can take place --and serve as a short-term demand stimulus (Blanchard & Giavazzi 2003). One could even envision a deficit permit system (Casella 1999), which combines national-level fiscal flexibility with a stable and sustainable EMU-wide aggregate fiscal stance (if the pernicious problem of the appropriate 'exchange rate' of the permits can be sorted out).\textsuperscript{5}

However, all of these lines of argument, which have been part of the debate on the revision of the SGP in 2002 and 2003, treat the SGP --and thus the wider fiscal policy regime under EMU-- in isolation from the rest of the macro-economic framework. Our aim in the next section is to offer proposals for a revision of the EMU fiscal policy regime that can easily be related to the outcomes and institutions of wage-setting analysed in the previous chapters.

\textsuperscript{4} For a review of the debate, see Issing (2002), De Grauwe (2000); the articles in the EMU issue of Oxford Review of Economic Policy Vol.19, no 1, especially Allsopp & Artis (2003), Buti et al. (2003), and Buiter (2003).

\textsuperscript{5} There appear to be several types of problems with deficit permits. In addition to those identified in Buti et al. (2003: 103-104), we identify two, one of a more explicitly 'political' nature, the other questioning the core of the deficit permit system. The first is that fiscally conservative governments can try to impose a very high 'exchange rate' on their fiscally more profligate neighbours, i.e. de facto imposing a politically informed reservation price. While this could be circumvented through appropriate mandatory cooperation clauses in a treaty, the second issue, which has the characteristics of a market failure, seems harder to resolve. If country A expands fiscally when most of the others adopt a restrictive stancce, and contracts fiscally when the others run an expansive policy, A will pay a systematically lower price for the deficit permits it buys, and receive a systematically higher price for those it sells (we are ignoring the issue here whether country A strategically exploits its market power or happens to find itself in this situation by chance). If the distribution of benefits is so obviously skewed in favour of one participant, others will question the basic fairness of the system. Moreover, in a rational expectations world, this might lead to a situation where all countries \textit{ex ante} emulate A's strategy (knowing that A will opportunistically exploit its advantage), and thus the deficit permit system may become pro-cyclical rather than counter-cyclical as it was intended to be.
Building on those, chapter 5 will then propose how to link such a revised SGP to developments in wage bargaining systems to produce an integrated policy, where fiscal policy and wage developments are carefully articulated so that (a) they reinforce each other, while (b) contributing to low inflation.

4.3. Rethinking the EMU fiscal policy regime

Our proposals for rethinking the fiscal policy regime adopts the pragmatic philosophy at the basis of this report. We are therefore interested in practical changes in the operation of fiscal policy, as opposed to so-called ‘optimal’ fiscal policy that is built up from first principles. Practical changes are those that are both beneficial to the economy, and that are plausibly acceptable to other EMU member states, in particular the council of finance ministers Ecofin.

The relation between the ECB and the fiscal authorities adopts a what is now considered 'best practice' approach. The modern theory of central bank inflation targeting makes it clear that the operation of fiscal policy should not be a matter of concern for the central bank: the assignment of responsibilities to the central bank is to respond to current and forecast future inflation, (Allsopp & Artis 2003).

A sensible starting point is therefore to ask what the likely areas of change in the Stability and Growth pact (SGP) will be, and whether in addition to these areas there will be other aspects of national fiscal policy which Ecofin may be concerned about. It is implausible that there will be formal treaty changes in the SGP; instead the changes are likely to be informal and will have *grosso modo* to respect the broad outlines of the SGP. This means that the changes will primarily relate to the interpretation of the budget deficit rules. In relation to the interpretation of the budget deficit rules, there are two major candidates for change. Both relate to the calculation of the deficit.
**Structural rather than actual deficits**

The first candidate for change is to relate the deficit conditions to the structural deficit, i.e. excluding cyclical fluctuations. There are many difficulties about how the measurement of structural deficits, but this need not concern us for the moment. What is important is that this will allow automatic stabilizers to operate, and from the particular point of view of this report will put a premium on fiscal policies/projects that are self-correcting (and therefore sustainable with regard to debt) over the cycle.

**Public sector investment and debt sustainability**

The second rule relates to public investment. One of the major consequences of the fiscal consolidation path under the Maastricht process, which rapidly brought down deficits across the Euro-area from an average above 5% to below 3%, has been a collapse of public investment. Reducing public investment was the fastest and politically most expedient way to reduce deficits, since reducing public sector wages and other public consumption expenditures are hard to do without large political and social costs. The current logic of the SGP, which emphasises actual deficits, simply confirms this logic.

A major concern in setting up the fiscal rules governing the EMU member states has been the aggregate fiscal sustainability of national fiscal programmes (see Buiter 2003; Buti et al. 2003 for a summary of the debate). Sustainability (for an individual national economy) is the condition that its current and future programme of expenditure and taxation, given its current public debt, implies a path for future debt that converges to some finite percentage of GDP as opposed to increasing continuously. Why should this matter for EMU as opposed simply to the nation in question? The argument that it matters solely to the member state is that the ECB has maintained that member states who default on debt will not be bailed out. Each member state therefore has its own incentive to maintain sustainability. The counter-argument is that (a) the no-bailout insistence is not politically credible and (b)
the member state can always leave EMU and print its own currency. In any case, it clear that sustainability will remain important both EcofinX and to the individual economy.

If sustainability is seen as important, it may provide a justification for allowing certain public sector projects to be excluded from the calculation of public expenditure for deficit purposes. This would in particular be the case for projects which had a financial rate of return to the government greater than or equal to the government’s cost of borrowing. In this case expenditure could not worsen sustainability since at worst it would have no impact on the present value of the government’s net revenue streams.

**Non-inflationary deficits**

Short of the limiting case scenario of a monetary authority printing money to finance a deficit (unlikely in the context of a highly independent central bank such as the ECB), or monetising debt when a country defaults (marginally more likely but not part of the EMU problem --see Allsopp & Artis 2003), fiscal policy *per se* has few direct inflationary effects. However, in a monetary union which consists of one central monetary authority and decentralised fiscal policy, moral hazard problems, resulting from potential free-riding, do exist. If countries can gain from running deficits (and absent the financial market sanctions on doing so for economies with their own currencies), they will each adopt expansionary policies which individually have only a limited effect on the inflation rate of the whole monetary union but in aggregate do have such an effect. Since this will cause interest rates to be increased by the central bank of the monetary union, the collective interest of the national governments will be to maintain uniformly more moderate fiscal policies.

The nature of the free-riding problem is therefore quite transparent. Governments may not be concerned in general about inflationary consequences of the aggregate demand position of individual economies, since inflation is an important tool for appreciating the real exchange rate of an economy and hence allowing adjustment in a monetary union. This could
be seen as a standard way for the medium term resolution of asymmetric demand shocks. But if a major member country engages on a fiscally-induced expansion of aggregate demand, the inflationary consequences of this for EMU-wide inflation may be difficult to ignore. Thus there is likely in such cases for there to be concern about fiscal expansion. Large member states will be under pressure to ensure that expansion is sufficiently non-inflationary to ensure that the ECB target inflation rate is not put at risk.

4.4. Conclusion

This chapter reviewed fiscal policy in EMU. We proceeded in three steps. The first section described the adjustment paths of member-states, pointing out the differences in strategies and how they were articulated with the shifts in wage bargaining systems analysed in chapter 2. In the second section we critically analysed the SGP using three scenarios. The first was a literal implementation of the Pact, which had the likely effect of imposing a prolonged period of low growth on EMU. The second scenario was a progressive 'hollowing out' of the SGP through non-compliance; the problem here was that the ECB might react strongly against that, and that as a result of lack of discipline an unsustainable debt burden might emerge. In our third, more flexible interpretation, the problem was that it imposed rigid inflation criteria on member-states which precluded inter-country adjustment through the real exchange rate.

In the last section of this chapter we therefore built on existing positions in the debate on the reform of the SGP to propose a series of substantive criteria for fiscal policy which had the effect of reintroducing short-term demand stimuli and longer-term supply-side policies to raise the equilibrium growth rate.

The next chapter takes our argument to its logical conclusion by combining this analysis of fiscal policy with the arguments on the development of wage-
bargaining systems from chapter 3 to demonstrate how these could provide the conditions for a 'virtuous' flexible framework for macro-economic policy in EMU.
Appendix

Figure 4.1: Fiscal adjustment to EMU

Germany

France

a – Expenditures (cyclically adj.), b – Receipts (cyclically adj.), c – Budget deficit
Italy

Spain

a – Expenditures (cyclically adj.), b – Receipts (cyclically adj.), c – Budget deficit
Netherlands

Belgium

a – Expenditures (cyclically adj.), b – Receipts (cyclically adj.), c – Budget deficit
Ireland

Finland

a – Expenditures (cyclically adj.), b – Receipts (cyclically adj.), c – Budget deficit
a – Expenditures (cyclically adj.), b – Receipts (cyclically adj.), c – Budget deficit
a – Expenditures (cyclically adj.), b – Receipts (cyclically adj.), c – Budget deficit

Source: European Commission
Chapter 5
Political exchange: supply-side social pacts and fiscal expansion

The previous chapter argued --in line with current debates on the SGP-- that the existing fiscal policy regime in EMU may well be creating more problems than it is supposed to solve. In response, we not only sided with many of the procedural proposals that have been floated recently; we also suggested a series of ideas on fiscal policy that would combine a more expansive fiscal stance with sustainability regarding the aggregate debt situation in EMU.

In this chapter we take that analysis one step further and integrate it with our analysis of wage bargaining in the EMU member-states in the first chapters of this report. In short, our position is that the shape and outcomes of the wage bargaining process over the last decade allow for a form of political exchange in which wage-setters assure low wage inflation, and governments use the degrees of freedom thus obtained to adopt a fiscal policy which raises aggregate demand in the short term, while raising the equilibrium growth rate in the long term. One important attribute of such a political exchange regime is that it is neutral with regard to inflation, in order to prevent a restrictive reaction by the ECB.

We will develop this point by concentrating, first, on how the different elements in our analysis interact and thus produce the possibility of political exchange between labour unions and governments. The chapter moves on to discuss what we see as the main problems with this proposal and how they could be overcome. In the final section we will present this policy architecture as an integrated framework, pointing out how the interactions between wage-setters, fiscal authorities, and the ECB would operate to produce a low-inflation, high-growth regime in EMU.

5.1. Constructing political exchange
As a result of the analysis in chapters 2-4, the main building blocks for our final argument are in place now. Let us go through each of these: labour markets, fiscal policy, and the ECB.

Wage-systems, as we saw, have reorganised to minimise endogenously generated wage inflation through social pact-type arrangements or their functional equivalents either without governments or imposed by them. Labour markets, as a result, have not been deregulated, but have remained highly organised while introducing plant- and firm-level flexibility. Under this system, labour unions and employers have strong incentives to engage in 'productivity coalitions' which raise labour productivity --the de facto wage ceiling in the new wage bargaining systems.

Fiscal policy, in turn, is in the process of being reorganised. The criticisms of the SGP in the last few years have paved the way for a substantial revision of the Pact. Judging from the tone of the public debate in mid-2003, we can safely assume that deficits will be redefined from actual (nominal) to cyclical terms, and that the so-called 'structural' component will gain more weight in its definition. There are also encouraging signs that investment might be treated differently in this new SGP than in the current one. In the previous chapter we suggested three substantive criteria for such government investment: it should be geographically targeted, sustainable, flexible and counter-cyclical.

In the ECB, finally, a debate appears under way on several themes: on the decision-making process in the central bank, on the nature of the ECB's inflation target, and on how to adjust to the (expected) relatively early adoption of the Euro by some of the accession countries after EU enlargement (see the reports in Financial Times 5 March 2003; Economist 21 December 2002; Fitoussi & Creel 2002). While we are generally very sympathetic the direction this debate is taking, for the sake of our argument here we assume that very little change will occur in the short term, and that the ECB’s policy will remain a simple interest rate response function to deviations of inflation.
from its target, without reference to an equilibrium unemployment rate analysis or deviations from output (see Allsopp & Artis 2003 for an evaluation of the ECB’s policies).

Combining these three elements allows us to answer two questions that were at the basis of this report: how can EMU avoid both rising inflation (which prevents the ECB from taking a less restrictive stance) and a quasi-deflationary trap which results from wage-setters outside Germany following German wage moderation (in ULC terms)? As we argued in chapter 3, for a variety of reasons, labour market deregulation is both unlikely and not taking place. Pan-european co-ordinated wage reflation might be an alternative possibility, but --as we discussed in chapter 3-- institutionally unlikely, and without clearly predictable effects, since it undermines competitiveness and is likely to lead to adverse reactions from the ECB.

We suggest that a solution might reside in linking the outcomes in wage bargaining to a revision of the fiscal policy regime in EMU. Building on the existing institutional frameworks --which were encapsulated in our analysis of social pacts-- we propose that, if the ECB concentrates on its medium-term inflation target (thus responding to rather than leading other political-economic actors), a virtuous interaction between wage-setting and fiscal policy --two elements still under the control of national economic actors with a degree of democratic accountability-- becomes a distinct possibility. By combining national wage co-ordination with the type of fiscal policy discussed in the previous chapter, a deal could be struck between labour unions, who commit to keeping wage inflation low by exercising wage restraint and contributing to productivity increases, and governments who adopt a more expansive fiscal policy stance in response to low inflation. The argument is developed in three steps.

The Stackelberg leaders in this set-up are the wage-setters, as they provide the nominal anchor for the system as a whole. By targeting year-on-year nominal wage increases at or below the inflation target, wage-setters contribute to low
inflation. The way this is done is by accepting that nominal wage increases be set between past inflation and current productivity (or at least do not go beyond medium-term productivity trends).¹

As we discussed in chapter 3, this wage-setting rule has two immediate effects. Beside being disinflationary (in the sense that it is quite unlikely that wage inflation rises above its level in t-1), it also safeguards relative competitiveness levels across countries --if all wage-setters follow the rule-- or it can be used as a way of adjusting real exchange rates --if wage-setters accept wage increases below labour productivity (and profit rates are kept constant).

Nominal wage rises are thus constrained by increases in labour productivity, which gives labour unions a strong incentive to participate in initiatives (at the plant and firm-level, but also to support branch or regional level efforts) to raise productivity. Indeed, as we saw in many EMU countries over the last decade, labour unions have become active in such matters as new training initiatives, and regional innovation centers. Frequently, in fact, existing local institutions, such as works councils and firm-level union structures, were reconfigured to meet these new roles. In some countries --Italy is the prime example-- a new firm-level institution was created which played the same role as its northern European counterparts.²

The overall outcome of these reorganised systems of wage-determination is therefore positive on at least three counts: they are disinflationary, they are neutral with regard to relative competitiveness, and they create incentives for labour unions to participate in productivity- and growth-enhancing initiatives.

¹ The equation for wage-setters would be something along the following lines: \( \Delta W = \frac{1}{2} (\Delta LP_{t-1} + \Delta \Pi_{t-1}) + \frac{1}{2} (\Delta LP_{t} + \Delta \Pi_{t}) \), where \( W \) are nominal wages, \( LP \) labour productivity, and \( \Pi \) price inflation

² Note that these firm-level institutions can be related both logically and chronologically to the emergence of co-ordinated wage bargaining: it imposes a wage floor on companies but also offers institutional solutions that allow companies to retain internal flexibility and thus move into higher value-added market segments (Hall & Soskice 2001; Thelen 2001).
This is where governments come in. While there is little doubt that many of such productivity-enhancing initiatives are matters for private actors -- business and labour-- governments can play an important role in this process through a fiscal policy that targets supply-side adjustment. The basic idea follows directly from the discussion of fiscal policy in the previous chapter, where we identified three criteria for fiscal policy. The first was that deficits should be measured in structural (i.e. cyclically adjusted) rather than actual terms. The second criterion was that public investment in such a measurement ought to be neutral with regard to debt. Three, fiscal policy should be non-inflationary (in addition, we also argue that independent fiscal policy certification committees could see to it that these rules are actually followed).

In this set-up, the ECB has two functions. The first is the familiar one that we normally associate with a central bank in co-ordinated wage bargaining systems: it acts as a macro-economic constraint on wage-setters and governments. If wages growth adopts inflationary characteristics, the central bank intervenes, either preliminarily by sending strong signals to labour unions and employers (i.e. adopting a clear and credible reaction function), or post hoc by responding with an appropriate interest rate reaction. The situation is the same for fiscal policies that put the inflation target at risk.\(^3\) Thus the core task of the central bank is, commensurate with its current role as defined in the Maastricht Treaty, to adopt policies that enforce price stability.

The second way in which the central bank acts in this system is rather different from what both the ECB and to some extent its ideological predecessor, the Bundesbank, have seen their role to be. By adopting an appropriate reaction function, which rewards moderate wage-setters and prudent governments, and not only punishes them, the central bank can also

\(^3\) Although it is, except for the limiting case of loan default by governments, rather unclear how a fiscal policy which is neutral with regard to the aggregate debt situation (an important
support the system as a whole. This is, in fact, part of the constitutional basis of EMU. According to the Maastricht Treaty, the ECB is supposed to support the general economic policies of the governments in the Euro-zone, subject to the condition of price stability. This requires, as Allsopp and Artis (2003) point out, that the ECB becomes less preoccupied with its anti-inflationary credentials (which are remarkably strong anyway if we assume a de facto slightly more flexible reaction function than the officially presented asymmetric reaction function), and pays more attention to the size and volatility of output gaps.

Here the circle closes: meeting this condition requires cooperative action from governments and wage-setters along the lines of what was outlined above. As long as wage-setters and governments act together to keep inflation within the de facto inflation band that the ECB appears to have set itself (between 1.5 and 2.5% --this could be officially codified to make the reaction function more transparent), such actions in fact contribute to the task of the ECB in the Maastricht Treaty (Issing 2002), and it can reward wage-setters and governments for their contribution to stability by lowering interest rates. In the case when wage-setters and governments adopt inflationary policies, the ECB is still in a position to retaliate by raising interest rates.

We are particularly interested in the role of public training expenditures because of the role they might play in political exchange between government

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condition could have inflationary effects (see Carlin & Soskice forthcoming; Allsopp & Artis 2003).

4 For the architecture of this argument, we owe a debt to our colleagues Donatella Gatti & Christa Van Wijnbergen (2002), who show that a system in which the ECB rewards responsible fiscal policy yields more optimal outcomes than the asymmetric situation in which only 'bad' behaviour is sanctioned. Something similar can be said with regard to wage bargainers: responsible wage-setting requires rewards as well as sanctions in the shape of growth- and therefore employment-oriented monetary policy. In fact, there are increasing signs of desperation among labour unions in Europe at the moment, precisely because of the refusal of the ECB to reward them for several years of stability-oriented wage bargaining. For the time being, competitiveness considerations limit their ability to raise wages above productivity levels; however, it is unclear if rank-and-file unionists will remain convinced of such a strategy if the quid-pro-quo in the form of lower interest rates is not seen as forthcoming.
and unions in which the government develops appropriate training programmes in exchange for wage moderation.

What are the implications of our arguments with regard to fiscal policy debated earlier in this chapter and the previous one? First, how do training expenditures square with structural definition of deficits? The major implication is that additional public training expenditures (for example in the form of subsidies to the private sector) will ideally be designed so that they add as little as possible to the structural deficit while being maximally counter-cyclical. Thus changes in public sector training programmes which shifted expenditures from the upswing to the downswing would be of importance. With regard to debt sustainability, it is quite possible that public training expenditures, particularly those linked to the private sector, could have high financial rates of return. A standard point here is that if companies can be subjected to incentives to retain employees by subsidized training schemes, one element of the financial return to the government is that it does not have to pay unemployment benefit while retaining the income taxes of the employee. The third criterion, low inflation is, in fact, a prior condition for such a political exchange between government and wage-setters.

In addition to these criteria, there are a number of other reasons why training expenditures may, if properly constructed, be important for fiscal policy. The first is that they are supply-side supportive. By raising the general skill level of the working population and offering flexible retraining programs, training expenditures have a direct and long-lasting influence on the labour productivity growth rate. Furthermore, they also allow companies to rapidly reorient their human resources strategies underlying a possible shift in product markets. In both cases, therefore, training expenditures allow for a rise in the potential growth rate.

Secondly, training expenditures are exceptionally well-placed to avoid spill-overs to other economies. In order for fiscal policy to be effective, it should be sufficiently geographically targeted so that demand leakage and spill-overs
are minimal. It would make little sense, for example, for Germany to reflate in such a way that other countries with whom the country has developed close trade links would reap the bulk of the benefits. While trade assures some return for Germany through increased demand for German products and services in the trading partners, such an effect – the export multiplier – is likely to be relatively small on its own. Fiscal policies targeting skill formation (through training subsidies and general investment measures that improve the infrastructure for training systems), R&D through tax cuts, or infrastructure in decline are good examples. Their geographical impact is very likely to be limited to the country implementing the policies, thus raising demand in that country, with relatively small direct effects on demand for goods and services from other countries.

Thirdly, they may be relatively easy to turn on and off. Fiscal policy should, after all, be counter-cyclical, and it should therefore be abandoned when growth picks up. There is obviously a danger here that structural fiscal policies (such as the ones suggested above) may make companies too dependent on government policies and could therefore be counterproductive in the medium term because of market-distorting features. This suggests that fiscal policies need to be carefully calibrated to either complement existing efforts from the private sector (as in training and R&D investment) or geared toward infrastructure projects which are considered to fall in the government's domain.

Fourth, their counter-cyclical nature implies that they compensate for falling private sector investment in training during downturns; this has the effect of making the supply of skilled labour more responsive to upswings.

We emphasise the importance of the proper construction of training programmes. Much work shows that many training programmes are worse than useless, and it is for this reason that we believe that two elements are important in making training programmes credible. The first is employer involvement and contributory financing. If programmes are organized
between unions and employer organizations and involve partial finance by employers, there is some guarantee that the training will be focused on developing skills relevant to the future expansion of the company. Secondly, there is a strong case for setting up independent expert bodies to assess the financial rates of return to public investment within the context of the sustainability of the fiscal programme of the government (Buti et al. 2003).

5.2. Political exchange and its implications
We are aware that such a system of political exchange is not without problems, relying --as it does-- on cooperation between labour unions and governments, as well as between governments in EMU. The literature on policy coordination tells us quite convincingly that such (quasi-)cooperative arrangements are riddled with collective action problems, which may undermine their rationale. In the next section we discuss the main problems and how to deal with them.

The main problem with such a political exchange scenario follows from our assumption that the ECB will concentrate solely on its inflation target, but not change it. The scenario is therefore contingent upon the ECB meeting its target. One possibility, which we alluded to when discussing the more flexible interpretation of fiscal policy in the previous chapter, is to provide incentives for specific inflation targets, which are the same as the ECB's target, for all member-states.

However, there are three problems with introducing such specific inflation incentives into national wage bargaining systems. The first is that it may interfere with the use of real exchange rates as an adjustment mechanism since it depends on the ability to allow for differential inflation rates among member-states. This is a serious problem as can be seen from the variance of unemployment rates across the EMU member-states. The second problem is that, in any given economy, the incentive for wage setters to accept nominal wage settlements which are below what they could otherwise obtain in negotiations requires a political bargain with the government --at least in the
absence of imposed legislation. This, in turn, is likely to involve some compensation for labour unions in the form of tax cuts (to compensate for wage moderation) or increased government expenditures (to spur growth and employment). Obviously, this may run into problems with the SGP. The third is that a multi-country agreement to maintain suitably low inflation rates is likely to lead to free-rider problems: if N-1 member-states moderate inflation, the Nth state (if it benefits from higher national wage inflation --for instance to avoid the political cost of negotiating with unions) has an incentive to free-ride.

We put forward a policy framework in this section designed to take account of these problems. There are three components: (a) coverage and real exchange rate adjustments; (b) feasibility of political exchange under the SGP; and (c) how to limit free-rider problems.

Coverage and real exchange rate adjustments
There are two reasons for confining attention in any type of low inflation agreement to the largest economies of EMU: Germany, France, Italy and perhaps Spain. The first is that their weight in the HICP is very large: Germany accounts for 31%, France for 20%, Italy for 19% and Spain for 10% of the inflation rate in EMU (Eurostat, 2001). The total weight of all the small states is therefore only 20%. Since Spain’s industrial relations system appears less capable of delivering wage restraint over time, it almost certainly makes sense to focus on Germany, France and Italy alone. This is reinforced by the inflation spillover effect onto the remaining member-states.

In addition, at least in the foreseeable future, this would permit a beneficial adjustment of real exchange rates and lower unemployment in the larger economies. Within EMU, Germany (7.7%), France (8.5%), and Italy (9.4%) all have relatively high unemployment (OECD standardized unemployment

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5 We assume that monetary policy is not reconfigured to create country-specific incentives as with the Bundesbank under the ERM. This would constitute a radical change in the ECB’s monetary policy framework which we deem highly improbable.
rates for 2001). All the other member-states (as well as potential entrants Sweden and the UK) have, with the exceptions of Spain and Finland, considerably lower unemployment rates. If it were possible to develop a low inflation agreement --at least when the need arose-- across the three large economies, the real exchange rate adjustment mechanism would be unimpeded for the majority of member-states which needed to appreciate.

**Political exchange and the SGP**

How feasible is it to develop mechanisms to produce suitably low inflation in Germany, France and Italy? More importantly, if these countries rely on a fiscal expansion, can they be consistent with the SGP? Each country has developed some idiosyncratic form of wage restraint. In France, with weak unions, the state plays de facto a large indirect role in collective bargaining in conjunction with large companies. In Germany, wages are determined in industry bargains following a key bargain, usually in engineering. In Italy, there is a national bargain over cost-of-living increases and competitiveness, with supplementary company-level bargains over productivity.

We do not discuss the French situation here, since it is *sui generis*. Suffice to say that the outcomes of French wage bargaining are equally moderate as in Germany and Italy (see the panel for France in Figure 3.3). The German and Italian systems, on the other hand, have much in common. Unions in coordinated bargaining systems (though not necessarily their members) increasingly understand that real wage increases are driven by productivity improvements at company levels; this has reinforced union interest and participation in training systems and technology transfer systems. Thus at the same time as engaging in co-ordinated wage bargaining outside the company, unions cooperate closely with works councils (or their equivalents) on productivity-enhancing activities inside the company.

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*See Hancké (2002).*
This is where our argument in favour of concentrating on training subsidies in exchange for suitably low unit labour cost growth is relevant. From the point of view of government-union bargaining, training expenditures are likely to take the form of subsidies (or tax breaks) to companies: the major problem that wage restraint poses for labour unions is the strength of the works councils in profitable export-oriented companies, who can easily negotiate above-tariff wage increases. Training expenditures, particularly within companies, have a number of advantages in terms of fiscal policy. The first is that once an effective programme has been agreed, they can be implemented flexibly and quickly, so they are effective as a counter-cyclical device (by contrast to much government investment expenditure which requires long lead times). They also have relatively limited spill-over and thus limit demand leakage. Thirdly, if chosen correctly, they can have an adequate social rate of return, because --in addition to the return on human capital-- the shadow price of labour is low in a recession. Finally, if chosen correctly, training expenditures can be amortised over time, as they can both save on unemployment benefits and lead to higher government revenue than would otherwise be the case.

How feasible is such an exchange within the Stability and Growth Pact? That will depend on how the Pact is informally reinterpreted. It seems likely that a reinterpretation will embrace a number of topics: the acceptance that one size does not fit all; a move to a structural definition of deficits; greater concern about the sustainability of public finances; and perhaps greater transparency in accounting. This broad direction of reinterpretation may well be able to accommodate training expenditures which would otherwise have breached the zero deficit goal. If there is an over-riding benefit to the EMU member-states in terms of inflation, deficits arising from strictly training-related expenditures in the key economies may be accommodated by a more differentiated approach across the member-states: the move to cyclically-adjusted deficits may mitigate the problems caused by increased public expenditure on training in recessions, while training expenditures could focus
on areas in which they are fully or substantially amortised over time so that sustainability is not put at risk. This latter point ties in with the push by the Commission to greater transparency in fiscal policy. Governments will almost certainly reject recent suggestions to install national Fiscal Policy Committees that determine allowable budget deficits consistent with sustainability (Wyplosz 2001). But it is perfectly possible for independent committees of experts to examine whether proposed investment expenditures including expenditure on training are fungible.

**Multi-country agreements and the free-rider problem**

Assuming that such agreements are technically feasible, what guarantees that the leading economies stick to them? Might they not have an incentive to defect, given that the political cost of the agreement will almost certainly be high? There would clearly be a problem of free-riding if many countries were involved in a low inflation agreement. It would, for example, be difficult to sanction Ireland or The Netherlands if they dropped out of such an agreement, primarily because EMU member-states are reluctant to impose sanctions on each other, and it would not pay co-operators to punish Ireland or The Netherlands by defecting themselves since their cost would be great while the cost of a small country defection is very low.

However, an agreement can be self-supporting, especially in small groups, if defection by any one party implies that it does not pay the other parties to continue cooperating —thus considerably lowering or even destroying the initial potential benefits of defection. As argued in chapter 3, the EMU set-up makes it almost impossible for Germany to take responsibility for keeping EMU inflation within the ECB ceiling; the organizational cost for German unions of the implied real wage and perhaps money wage cuts would be unacceptable even within the framework of political exchange. Yet within the framework of a low-inflation agreement between Germany and other large member states which produces an acceptable political exchange scenario within Germany (as well as within the other member states), this situation is
different. Germany is then in a credible position to defect if one of the other member states defects (and vice versa). Clearly the larger the number of parties to a low inflation agreement the easier it is to solve the political exchange problem in each state. However, the larger the number of parties the greater also the opportunities for free-riding. The optimal size of an agreement is therefore the largest number of states such that if any one pulled out it would pay the others to pull out as well. It seems likely that in the current EMU that an optimal low inflation agreement would be between Germany, France and Italy.

5.3. Political exchange and the EMU macro-economic policy framework
The scenario of political exchange which we developed in the previous sections are predicated on a novel institutional arrangement. This combines a revision of the SGP to account for public investment, a quid-pro-quo agreement between wage-setters and governments that secures low inflation, and a low-inflation agreement between the large member-states which sends a strong signal to (and is rewarded by) the ECB.

How does this proposal relate to the current views on the EMU policy framework? Two broad positions can be identified in this debate. The first is concisely presented in Issing (2002), which identifies what the chief economist of the ECB calls the 'Maastricht assignment'. According to this view, the roles of the different parties in the EMU framework are very transparent. The ECB has only one contribution to make to macro-economic growth, and that is keeping inflation low and predictable. In order to do so, it sets interest rates in response to EMU-wide inflation developments. Fiscal authorities adopt prudent fiscal policies and social partners set moderate wages. Moreover, according to Issing, there are no strong arguments in favour of ex ante co-ordination of policies in EMU. If every actor sticks to its 'specific roles, mandates and responsibilities' (Issing 2002: 345) in the process, implicit co-ordination will simply follow ex post (Issing 2002:346). Consequently, he argues for little more than an informal exchange of views and of information.
between the ECB, national governments, and social partners. In fact, when it comes to growth, for Issing (2002: 354-356) the ball is in the camp of the social partners, who should embark on a path of 'structural reforms' to make labour and product markets more flexible.

The second position, which is reflected in the assessment by Allsopp & Artis (2003) is considerably different. Here the central bank has a more restricted role. Instead of being the anchor of the whole system, laying down the rules for other actors in the framework, the central bank leaves the leadership role to fiscal authorities and wage-setters, and responds with a transparent reaction function to inflationary developments that result from the interaction between fiscal policies and wages. As Allsopp & Artis (2003) point out, the current problems of EMU suggest that Issing's 'Maastricht assignment' is not operating very smoothly. They identify several problems: lack of clarity on the nature of the ECB's reaction function, an incorrect specification of broad fiscal policy stances (which leads to an over-emphasis on 'disciplining' in the SGP rather than on 'co-ordination' --see also Schelkle 2002), and a misunderstanding of what 'structural reforms' can achieve in the current state of EMU (Allsopp & Artis 2003: 24-28). Thus they argue for more transparency in monetary policy (especially about the economic models underlying the ECB's reaction function), and for a revision of the SGP that takes into account debt sustainability in order to make it more credible, and allows fiscal policy to interact with wage policies to support medium-term adjustment.

While our view is clearly closer to the Allsopp & Artis position, the weak point in their argument is the lack of a clear direction of supply-side policies. In this report, we therefore added a series of supply-side considerations which build on existing institutional frameworks for wage-setting. Since wage-setters are increasingly sensitive to competitiveness considerations, wage-setting systems have become structurally (note: not cyclically) disinflationary. At the same time, differential inflation rates across EMU allow for real exchange rate adjustments, which improve relative competitiveness (in the case of a depreciation) without endangering EMU-wide inflation.
The flip side of this macro-arrangement is that social partners are forced to search for improvements in labour productivity since that imposes a de facto ceiling on wage demands; and here the existing co-ordinated wage bargaining systems in the EMU member-states are a help rather than an obstacle. They allow companies and labour unions to collectively set goals and search for the instruments to implement those.

Within the context of a revised SGP, governments can play an important role here, by supporting these efforts through counter-cyclical training expenditures. This has the short-term effect of raising aggregate demand and the medium- to long-term effect of increasing the potential (equilibrium) growth rate of an economy.

Thus our proposal for a system of political exchange not only seems to be in line with the Allsopp & Artis (2003) framework; it also addresses the weak point in the debate --the nature of supply-side adjustment. It does so, however, by building on existing institutional frameworks rather than advocating their wholesale restructuring.

5.4. Conclusion
In this chapter we integrated the different elements in the previous chapters. We argued that the existing wage-setting systems, against the background of a revision in the SGP, has the potential of putting EMU on a growth-oriented track which does not simply rely on deregulated labour markets. Instead it builds on the existing systems of industrial relations (and how they developed since the early 1990s) and argued that strengthening those offers an at least equally convincing and probably more sustainable adjustment path.

The core element in the system is what we have termed political exchange. It builds on three essential points: the first is that the high degree of co-ordination of wage bargaining in each of the EMU member-states is less of an obstacle to economic adjustment than the dominant views on the labour
market often assume. If it were, countries such as The Netherlands, Sweden or Denmark, who have a wage bargaining system that shares many of the elements of the German system, would have a much higher unemployment rate than they have.

Secondly, the co-ordination of wage bargaining also allows for micro-level adjustment: by taking wages out of the company, these systems assure relatively peaceful workplace and firm-level labour relations and are thus conducive to cooperative problem-solving. It is no surprise that many employers and their organisations are highly reluctant to redraw the lines of wage bargaining systems, fully aware, as they are, of the (often intangible) benefits that they produce.

The third element is that this could be linked to an expansive fiscal policy under a revised SGP. We argued that training expenditures could be used as a counter-cyclical fiscal instrument, while at the same time producing clear signposts for unions and employers to deliver on low inflation in exchange for this expansive fiscal policy.

Such a system of political exchange is not only feasible, but --more importantly-- likely to lead to economic outcomes that are highly compatible with what we have termed the European 'social model' as well as its particular form of competitiveness, which relies disproportionately on skilled labour.

We also identified a series of problems with this idea, and suggested avenues to explore in the search for solutions. Our analysis suggests that the system could work --and would benefit-- if the ECB redesigned its reaction function to concentrate explicitly on its inflation target, and rewards low-inflation agreements, especially in the large economies.
Chapter 6
Conclusion

This report started with two possible scenarios that seem embedded in the current political economy of EMU. One was a deflationary scenario, based on wage competition, restrictive fiscal policy and tight monetary policy, which offered few prospects for growth. In this scenario, higher growth and falling unemployment could only come about as a result of labour market deregulation and other structural reforms, as the OECD and the ECB, among many others, suggest. Not surprisingly, given the heavy political costs borne by trade unions and workers in this scenario, it encounters stiff resistance from that corner, while many social-democratic parties in office have been reluctant to impose such a scenario.

The second scenario, which we developed in this report, started from the opposite considerations. Assuming an ECB focus on a symmetric 2% inflation target, it builds on an exchange between fiscal authorities and wage-setters: if wage inflation is contained, fiscal policies could become more expansive by linking wage moderation to expenditure related to investment in training (as well as in innovation and public infrastructure). By keeping wage inflation in check, the wage-setters thus buy, as it were, degrees of freedom for expansive policies by their governments, which boost demand in the short term, and raise the equilibrium growth rate through targeted supply-side policies.¹

¹ Far from being a dissident position, this emphasis on differential supply-side structures has become an important position in the comparative political economy literature (Hall & Soskice 2001). In essence, it shows that there is more than one possible competitive supply-side equilibrium, and that institutional frameworks such as wage-setting systems play an important co-ordinating role in securing different forms of competitiveness.
The changes in wage-bargaining systems that we analysed, as well as the direction of the debate on the SGP (and its likely revision), make us optimistic about the chances of avoiding the first and moving toward the second scenario. Most importantly, perhaps, our analysis suggests that EMU member-states do not have to go through a socially painful, politically costly, and economically uncertain restructuring process which dismantles the fundamental institutional framework that we have historically associated with the 'European social model(s)'. Instead of destroying those institutions, we suggest building on them, strengthening them, and constructing incentive structure that reward the political-economic actors for their contribution to macro-economic stability.

This final chapter will move beyond this analysis by pointing out the policy implications that could be drawn from it. In the discussion that follows we will start from the idea that, because the ECB is independent and has a strict inflation target that outranks any other goal in its preferences, fiscal and wage policies adopted ought to preserve low inflation in their pursuit of growth. We will start with recommendations to the ECB, then move on to governments, and finish with points for discussion for the labour unions.

6.1. The ECB
The ECB is undoubtedly the central actor in the new EMU policy framework, since it sets the hard constraints on the actions of each of the other macro-economic actors. As a result of the underperformance of the EMU economy, and the problems that a strict monetarist interpretation of economic policy seems to produce, the ECB is under a lot of pressure today to revise how it operates. Our recommendations below are in line with this debate, and reflect our own pragmatic concern that the ECB is an independent central bank (and ought to remain so), but that independence does not equal being oblivious to
the actions of others. The goal of what follows below is primarily to make sure that the ECB's own goal—an inflation target that reflects price stability—can be met more easily.

**Inflation target**

In our opinion the most important question the ECB should address is whether the de facto asymmetric 2% inflation target it uses is a proper target in the current EMU set-up. Two considerations are at the basis of our concern. The first is that the numerical value of the target is the lowest in the OECD countries: the Fed does not have an explicit target, the Bank of England a 2.5% target, and most other independent central banks also have a target above 2%. Under conditions of increased product market competition (as a result of internationalisation) which leads to a permanent upgrade in the quality of goods and services, a low inflation target of this kind in fact means that the ECB has adopted a strict price stability regime—potentially even including a slight deflationary bias.

Our second concern is that the ECB is the only large central bank that seems to have adopted an asymmetric inflation target: 'inflation above 2% would be considered inconsistent with price stability in the euro area' (Issing 2001:5 — although the ECB’s chief economist goes on to say that the ECB is 'concerned about both inflation and deflation, thereby signalling that the definition of price stability is symmetric'). Again, a comparison with the US and the UK is instructive: central banks in both these countries have a Taylor-rule based symmetric inflation target (although the UK has consistently undershot its target since central bank independence in 1997), and therefore flexibly adjust monetary policy in response to output gaps. Until the EMU inflation rate falls below the 2%, which is scheduled to happen this year, we do not know if the ECB will adjust its monetary policy. However, the concerns raised by the ECB in response to German wage negotiations in 2002 (Financial Times 3 May
2002; Guardian 3 May 2002) seem to suggest that the bank will be extremely cautious in loosening monetary policy.

**Transparency and accountability**

The independence of the ECB is institutionally safeguarded to a degree unseen in other OECD-countries. Whereas the Fed’s and the Bank of England’s statute of independence could be changed by simple law, the ECB’s position is enshrined in treaties governing the European Union. Any change in the position of the ECB would therefore require a unanimously voted amendment to these treaties, and ratification through parliament or popular referendums in many EMU member-states.

Because of its high degree of institutionally protected independence, the ECB should have no qualms to adopt an aggressive strategy regarding transparency and accountability. There are good theoretical reasons for doing this: the signals emanating from the ECB will be more consistently interpreted correctly by wage setters and governments, and therefore internalised in their own policy stances, if these actors have access to the relevant information (Stasavage 2003). Furthermore, transparency of this sort would not diminish the ECB’s credibility, and will in fact facilitate the ECB’s core task of assuring price stability, since the other actors will be able to anticipate the ECB’s stance and provide low inflation.

How precisely more openness would have to be organised is a point for discussion, but it seems to us several complementary routes could be pursued. The first is a Bank of England or Fed-style openness, including the publication of voting records and regular discussions with policy-makers regarding the arguments and considerations underlying monetary policy
decisions.\textsuperscript{2} A second could be a more active role in the Macro-economic dialogue to further a mutual understanding between central bank, governments and trade unions on the parameters that feed into their equations. The Swedish Riksbank, no less independent than the Bundesbank was, offers a good example of the potentially beneficial effects of such a policy of engaging directly with labour union officials and government. On regular intervals, the Swedish central bank holds a seminar with government and labour union officials in which they discuss each other’s reaction functions. The third route seems to be that the ECB should make an effort to engage existing academic debates on macro-economic policy in order to make transparent to outsiders the economic theories its decisions are based on while subjecting those to rigorous criticism.

Combined, these strategies for increasing transparency and accountability would not endanger the ECB’s independence, but certainly make the central bank more credible in academic, policy-making and financial market circles, and ultimately contributing to the legitimacy of the ECB’s actions.

\textbf{6.2. Governments}

In the broad macro-economic framework analysed in this report, the ECB sets the conditions for low-inflation economic growth in the euro area. The role of fiscal authorities, in contrast (but in complement), is to handle asymmetric shocks, which we operationally define as smoothing the business cycle in individual countries through automatic stabilisers and discretionary fiscal policy where possible. While under a strict reading of the SGP such policies

\textsuperscript{2} Note that simply publishing individual voting records is not a solution, since the members of the Governing Board may then come under pressure from their governments to vote in the 'right' way. Instead, aggregate voting records and a non-attributed digest of policy debates may be the option of choice.
are very difficult, the debate on the SGP appears to re-open possibilities in this field.

Ideally, fiscal policy ought to be organised so that it has both short-term demand stimulus effects and long-term structural (supply-side) effects. Simple tax cuts, for example, essentially only add to long-term public debt and therefore reappear as a liability on the balance sheet later. Tax cuts for R&D, in contrast, will stimulate investment today (raising aggregate demand) and improve conditions for competitiveness tomorrow, thus leading to higher growth, rising government revenue and falling expenditures as a result of falling unemployment. Generalising from this example and presenting the issues in a more analytical way, sensible fiscal policy ought to be subject to the following related but analytically distinct conditions which we developed in more detail in chapter 4.

**Targeted fiscal policy**

The first is that in order for fiscal policy to be effective, it should be sufficiently targeted so that demand leakage and other spill-overs are minimal. It would make little sense, for example, for Germany to inflate in such a way that other countries with whom the country has developed close trade links would reap the bulk of the benefits. While trade assures some return for Germany through increased demand for German products and services in the trading partners, such an effect --the export multiplier-- is likely to be relatively small on its own. Fiscal policies targeting skill formation (through improving the infrastructure for training systems), R&D, or infrastructure in decline are good examples. Their geographical impact is very likely to be limited to the country implementing the policies, thus raising demand in that country, with relatively small direct effects on demand for goods and services from other countries.
**Sustainable**

The second condition is that fiscal policy should pay for itself in the medium term: the sum of the expected increase in revenue and fall in expenditures as a result of the policy should be larger than or equal to the real cost of borrowing. Consider the example above, where simple tax cuts will lead to a rise in expenditures without a concurrent increase in revenue down the line and compare that with targeted tax cuts that improve the physical, skills and/or institutional infrastructure of a country. Obviously the latter is preferable to the former, since it will have neutral or positive effects on the budget over the cycle while improving the potential growth rate of the economy. Again, the types of expenditures (tax cuts) referred to above meet this condition: higher skills will lead to higher wages (and therefore higher tax revenue), lower unemployment (lowering expenditures) and improved competitiveness (which leads to higher growth and therefore higher revenue).

**Flexible implementation**

Fiscal policies should also be flexible: their implementation should be swift, and it should be easy to rapidly retract them. Fiscal policy should, after all, be counter-cyclical, and it should therefore be abandoned when growth picks up. There is obviously a danger here that structural fiscal policies (such as the ones suggested above) may make companies too dependent on government policies and could therefore be counterproductive in the medium term because of market-distorting features. This suggests that fiscal policies need to be carefully calibrated to either complement existing efforts from the private sector (as in training and R&D investment) or geared toward infrastructure projects which are considered to fall in the government’s domain anyway.

**Counter-cyclicality**

Finally, and building on this latter point, fiscal policy should be counter-cyclical. As soon as the growth rate increases, the policies should be scaled
back to avoid over-heating of the economy and triggering an inflationary spiral which might endanger growth as a result of the monetary response.

6.3. Labour unions

Our final set of recommendations pertains to labour union policies. Following an important and growing literature (Hall 1994; Soskice and Iversen 2000; Iversen & Soskice 1998; Franzese 2001), we see the primary macro-economic role of labour unions in EMU as providing the conditions for low inflation. In principle a single wage-setter for EMU (through 'hard' wage co-ordination) would be the most efficient way to handle inflation target signals from the central bank. However, as we pointed out in chapter 3, such a form of wage co-ordination does not currently exist in EMU, and is unlikely to emerge in the foreseeable future.

Far more important than the institutions are the instruments that could be used to obtain a low-inflation result. Low wage inflation is guaranteed if wage growth is lower than or equal to the sum of existing inflation and labour productivity. This leads to a slow growth in unit labour costs and therefore a downward trend in inflation. The main combined effect of this result is what we could call a 'Golden Trinity': competitiveness in the tradable goods sectors is safeguarded as a result of the sensitivity of wages to unit labour costs, the macro-economic effect of this wage-setting system is low inflation (on a downward trend), and real wages can rise to the extent that they reflect productivity. As we noted in chapters 2 and 3, because of their reorganisation in the run-up to EMU and the way they operate today, the existing wage bargaining systems in the member-states of EMU seem able to provide just that. Our recommendations below attempt to strengthen that strategy.
Wage moderation

The first of the two direct policy consequences of the 'Golden Trinity' arrangement for unions is that they would have to persist in an explicit form of wage moderation: as soon as wages grow at a rate that is higher than labour productivity, both competitiveness and inflation are endangered, and the reaction from both employers and the ECB might (for very different reasons) hurt labour market performance both in the short and the medium term. We are aware that this orientation to wage-setting might mean a break with a prevailing conception of wages in some union circles, who see rising real wages as a macro-economic tool because it increases private consumption. It seems to us that an informed discussion about the role of wages in stimulating aggregate demand in open economies such as the EMU member-states is necessary to disentangle the different elements in the union strategy.

Labour productivity

The second implication follows from the first: since the ceiling for real wage growth is given by the increase in labour productivity, engaging with companies and governments to raise labour productivity increases the degrees of freedom that labour unions have to set wages. If labour productivity rises, the de facto wage ceiling rises as well without detrimental effects on competitiveness and on the inflation rate.

Such a productivity-oriented strategy can have several elements. Unions could negotiate appropriate training policies with employers and governments, relying in part on taxes to finance those and restructure wage policies to reflect the growing concern with training as a strategic variable. It also implies that labour unions should work with companies --through their local sections and works councils-- to implement reorganisations and develop other means to increase labour productivity. As we pointed out in chapter 2,
labour unions in many EMU member-states have developed institutions to cope with this challenge. Countries where such firm-level institutions are weak or non-existent would therefore, if possible, have to start building or developing them.

6.4. Conclusion

Our aim in this report was two-fold: take stock of developments in the different component systems of EMU --wage bargaining, fiscal policy, and how these interacted with monetary policy. EMU is a unique experiment: it combines an incomplete macro-economic policy framework in which the monetary authority is centralised while wage and fiscal policies remain decentralised, with the broader project of forging a politically united Europe by tying the fate of different member-states to a single currency.

As we pointed out in the introduction to this report, the experiment is still in its formative stages, and the experience so far has been mixed. The macro-economic performance of EMU has been mediocre, while neither governments nor wage bargainers are entirely certain about their role in the new system. However, we also argued that there is no necessary reason for why EMU should be under-performing. Precisely because ultimately it is a political construction, rather than driven by economic necessity, we should be aware of the possibilities in reshaping the economic policy framework.

The most important concern from our part in this report was to demonstrate that the different elements interact, and that the goals of the economic actors, while analytically distinct, should be mutually compatible. This entails first of all that, given the strict inflation target of the highly independent ECB, wage and fiscal policies ought to be at least neutral with respect to inflation. This implies that wage-setting has to reflect labour productivity growth, and that levels of public debt do not rise (and indeed fall in the medium term). Fiscal and wage policies that meet these two criteria are therefore in principle
compatible with the ECB’s policy stance. Our advise to the ECB was to reconsider its stringent inflation target, and adopt a policy of increased transparency and openness to assure that governments and labour unions can incorporate central bank policies in their own. Given the importance of EMU as a political and economic project, its long-term sustainability should be a matter of great concern to all. It is in that spirit that we offer this analysis and our recommendations.
Literature


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