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Central banks and the labour market – an alternative interpretation of the euro area crisis*

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Bob Hancké:
Unions, Central Banks, and EMU: Labour Market Institutions and Monetary Integration in Europe,
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Bob Hancké, Associate Professor at the London School of Economics and Visiting Professor at the Central European University (CEU), seeks an answer to the following question: did the crisis of EMU at the end of the 2000s really have its roots in a lack of fiscal discipline in southern EMU members? The researcher of comparative political economy answers with a categorical No. The reasons are deep-rooted and lie in the differences between the labour market institutions of the member states of the Economic and Monetary Union (EMU).

EMU created a fairly similar economic policy framework conditions for all of its members. The truly important difference between EMU member states is the labour market's level of organisation. In this regard, there are enormous differences between northern EMU member states – with their highly organised labour unions, formalised training components and tripartite wage negotiations – and their southern counterparts (including Ireland) where labour markets are less organised.

How did individual countries adjust to the conditions created by EMU? First of all, we need to see, argues Hancké, that under the new conditions put in place by EMU, the prospects of the export sector and the public (non-exporting) sector underwent a profound change. While the fixed exchange rate regime of the single currency forces export sector participants to adjust their wage growth to productivity growth lest they price themselves out of the international market,

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wage demands in the public sector are not constrained either by the reaction of competitors or by a potential monetary policy retaliation of the central bank. While the established system was preserved in northern countries in the 2000s and wage claims in the public sector were aligned to the possibilities of the exporting sector, wage demands in the public sectors of southern economies and Ireland escaped the constraints previously imposed by the Maastricht regime. Wage growth in the public sector, however, implied wage claims in the export sector as well, and as a result of these two effects, EMU member states saw widely diverging rates of wage growth.

How did all this lead to the 2010 EMU crisis? In his reply, Hancké stresses the importance of the real exchange rate. The real exchange rate expresses the price of the same goods and services denominated in the same currency, as perceived in different countries. In other words, a lower real exchange rate in a given country translates to a lower price level in that country. While the real exchange rate depends on numerous factors, in developed capitalist economies such as EMU member states, wages are among the most important determinants. It appears that northern EMU member states managed to keep wage growth under control through wage coordination institutions, while in southern EMU members, where the previous social arrangements had been abandoned after the adoption of the euro, wages grew unchecked. And, in a more or less closed commercial zone, a relative decline in wages (or more precisely, unit labour costs – ULC – as Hancké suggests) in a country implies that the country concerned gains a competitive advantage over those recording rising wages.

Not surprisingly, in his conclusions and recommendations Hancké proposes a higher level of labour market organisation for southern member states facing balance of payments problems. The author dismisses the notion that labour market institutions take an extremely long time to develop and can only be established in a specific historical and social environment. Citing the example of Italy in the 1990s, he asserts that efficient institutions can be put in place through top-down arrangements even under unfavourable conditions. In other words, as opposed to arguments advocating labour market liberalisation, Hancké points out that greater efficiency can be achieved through a high level of organisation.

The greatest strength of Hancké's study is that it attributes the euro crisis escalating in 2010 to a single factor: the diverging effects of the labour market and financial integration across EU Member States. This makes his analysis elegant, coherent and logical. Ironically, this is also the weakness of his paper: the author neglects or barely touches upon several factors that had a profound effect on the stability of the euro area. For example, it is hard to provide a true explanation for Greece's bankruptcy or Spain and Portugal's protracted inability to recover from the economic crisis without analysing the differences between the financial sector's level of development and processes in the financial market.

Another weakness is Hancké's excessive optimism about the feasibility of the German labour market model identified by him in southern economies. In Hancké's model, the co-movement of three factors gave rise to an economic environment that ultimately resulted in improved competitiveness. One of these factors was labour market coordination which, on the one hand, ensured the dominance of the export sector over the public sector in wage setting and, on the other hand, encouraged both labour unions and employers to achieve an increase in revenues through a more efficient organisation of labour. The second component was tight budgetary control, which did not fuel inflation through excessive public expenditure. Finally, the third factor is a restrictive monetary policy orchestrated by conservative central banks, which acted as a backstop both for labour market participants and the government.

In the final chapter of his study, Hancké claims that this level of coordination can be implemented in southern member states as well. As partly recognised by Hancké himself, the trouble is that this adopted institutional system melted away in the 2000s after the switchover to the euro and the disappearance of the external constraint provided by the Maastricht criteria. Even if we conceded that southern states – which lack the historical tradition of a grassroots neo-corporatist system – may achieve a level of coordination commensurate to the German model, Hancké's argument has a logical fault. According to Hancké, the success of the German model hinged upon the indebtedness of southern countries. In his system, the EU is a more or less closed economic system where Member States trade mainly with each other. In this system, countries adopting the German model gained competitive advantage from their ability to sell their goods to southern countries. Hancké specifically mentions that in the 2000s the direction of the flow of goods was from the north to the south, while capital flowed to the north from the south. Indeed, if southern states had not become indebted during this period, northern economies would not have been able to accumulate the balance of payments surpluses they have achieved. Therefore, although Hancké's proposed neo-corporatist coordination may somewhat improve the situation of southern economies, it fails to find a solution to the root of the problem – i.e. the lack of a common fiscal power in Europe that is capable of offsetting regional imbalances with financial and other transfers.