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The trinity of wage setting in EMU: A policy proposal☆

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Abstract

Diverging labor cost developments are often considered to be one of the most important factors that led to large current account imbalances in the euro area (EA) in the run-up to the global financial crisis. It has also been shown that wage growth differentials have significantly lowered the co-movement of EA countries' business cycles – the most widely used meta-criterion for optimum currency areas. Against this background, this paper develops a wage-setting benchmark that aims to keep the economy in internal equilibrium and to maintain price stability, while it also exhibits the capacity to correct for external imbalances. The proposed wage benchmark is very simple and may serve as an anchor for the macroeconomic dialogue in Economic and Monetary Union. In order to demonstrate the potentially beneficial effects of such a wage benchmark we present some simulations showing how current account balances and labor costs would have developed across EA countries if the rule had served as a benchmark already in the run up to the crisis.
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1. Introduction

The repercussions of the euro crisis have triggered substantial efforts to redesign the institutional framework so that it is better suited for a prospering and resilient monetary union. However, progress has been made at different speeds in different areas. In particular, issues of wage setting and its impact on relative competitiveness – with very few exceptions – have hardly been subject to a thorough debate. Possibly the heated blame game at the height of the crisis has scared off more serious attempts. Alternatively, comprehensible respect for the autonomy of wage bargainers may have elicited the false conclusion that issues of relative competitiveness cannot be tackled via recommendations with a focus on nominal wage developments.

This is a major omission as – one way or the other – wages and wage setting mechanisms are at the center stage of explanations for the crisis figuring either as the major culprit or as a failed backstop to dangerous misalignments (see, for instance, Johnston & Regan, 2016 and chapter 2 of this paper). While the discussion in this regard is still ongoing we set out on a more prospective path in this paper and derive a potential wage setting benchmark that might be used in the discussion henceforth. The "Five Presidents Report" and the envisaged introduction of competitiveness councils serve as an ideal backdrop for our discussion.

By focusing on a possible benchmark against which relative wage developments might be evaluated we situate ourselves at the juncture of two interesting – though thus far largely disconnected – streams of the economic literature. On the one hand, the optimum currency area (OCA) literature stresses the importance of wages and prices as an adjustment mechanism to business cycle divergence triggered by asymmetric shocks within a currency union. Recent contributions in the spirit of this literature have even identified wage developments as a prime driver of business cycle divergence (Gächter, Gruber, & Riedl, 2017). On the other hand, there is a broad literature on comparative capitalism that identifies differences in wage bargaining systems across EMU countries – and their divergent outcomes – as a major driver of pre-crises imbalances.While implicit wage setting benchmarks for the performance of wages at the national level exist Johnston, Hancke and Pant (2014) a benchmark for the assessment of optimal *relative* wage developments is missing thus far.

As a result, there is an urgent need to find a benchmark for wage developments not only in a national context but also in the context of broader developments within the monetary union. This might help to mitigate business cycle divergence thereby strengthening the resilience and stability of the monetary union. Beyond that, it can help to identify wage developments that risk pushing an economy into an excessive external position, such as excessively high current account deficits or surpluses, thus signaling the need for institutional overhaul in certain economies. Putting the freedom of the autonomy of bargaining beyond dispute, we nevertheless develop a country-specific wage growth benchmark as a rough guidance for wage bargaining. The literature in this regard is relatively scarce. Most of previous papers are based on the so-called "Golden Rule" that proposes wage growth equal to (medium-term) productivity growth plus the inflation target of the ECB. While such an approach is useful to stabilize the functional income distribution, it does not contain any mechanism to adjust to external shocks or imbalances. Our benchmark, on the contrary, extends the Golden Rule by an external correction term and thereby combines three crucial economic policy targets. This "trinity" of wage setting aims at (i) internal stability by stabilizing the functional income distribution, (ii) price stability as defined by the ECB's price stability target, and (iii) external stability as measured by the current account balance.

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