



COLLECTIVE BARGAINING BULLETIN 2007/2

THE EURO AREA CAN AFFORD HIGHER WAGES FOR GERMAN WORKERS!

I. How European economic policy makers are turning wage moderation into an inflationary threat

Wage moderation is an important stylized fact of European monetary union. Over the period 2002-2006, average growth in nominal wages per head in the euro area has been limited to 2.4% a year. Taking into account an average inflation rate of 2.2% over the same period, this amounts to a stand still in real wages. And if productivity developments are also taken into account, this actually translates into a fall in real unit wage costs¹ by -0.4% a year.

However, this is not the end of the story. Behind these euro area averages hides the fact that nominal wage and productivity developments have been diverging widely between the different members of monetary union. Whereas Italy and Spain have been recording an annual growth in nominal wages per head of 3% a year, German wage earners have only seen an increase by 1.4%. In other words, the weakness of (nominal) wage growth at the level of the euro area level has been driven to an important extent by Germany.

In economic policy circles, in particular the European Central Bank

¹ Commission Economic Forecasts Autumn 2006. Over the previous five year period (1997-2001), there has been similar developments. Nominal wages per head have also grown by 2.4% and real unit wage costs fell by 0.3%. However, thanks lower inflation (1.7%), some but limited growth in real wages per head (0.7%) was recorded over this time period.

(ECB), the figures described above are looked upon in a particular way. Instead of drawing the conclusion that wage developments have been extremely moderate so that a certain acceleration of wage growth from a very low starting position does not pose a particular threat to price stability, the ECB is of the opposite opinion. The ECB is actually claiming that wages constitute an inflationary risk. In other words and in the ECB's view, wage behaviour in monetary union is on the threshold of causing galloping inflation.

Here's how the thinking goes: First of all, the ECB is of the opinion that the extreme extent of wage moderation in Germany is nothing to worry about: Cuts in real wages as they have been practised in Germany are even welcomed since they result in low inflation in Germany (1.6% over the 2002-2006 period), which in turn has been very helpful in pulling average euro area inflation down. In a second step, the ECB raises the question what would happen to euro area inflation if and when German wage growth would start accelerating, even from what are now pitiful low rates of wage growth². In that case, wage formation in other countries need to take over the moderating role that German wages have been playing thus far. If wages do not decelerate in other member states, more robust wage growth in Germany would push euro area inflation back

² Collectively agreed wages in 2006 in Germany rose by a mere 1.5%, translating into an even lower 0.7% for effective hourly wages increases, with inflation running around 1.8%.

over the 2% threshold the ECB has defined as its price stability objective.

Moreover, the ECB seems to be convinced that this scenario is unfolding itself at this very moment. While it observes that IG-Metall is demanding a wage increase of 6.5% and that IG-BCE³ has concluded an agreement on a 3.7% pay increase, the ECB does not think it is conceivable that Spanish, Italian or French wage bargaining systems would take over the disinflationary role German wages have been playing until now.

If this is how the ECB views wage developments in the euro area, then this certainly helps explaining why it is continuing with its policy to hike interest rates, even if this implies a renewed weakening of growth dynamics.

II. A crucial flaw in the ECB's analytical framework

The ECB's conclusion that an acceleration of wages in Germany necessarily needs to go together with a deceleration of wages in the rest of monetary union is seriously flawed. The ECB's argument is based on the assumption that average euro area wage developments in the euro area at this moment in time are already in line (or slightly above) with that particular growth rate that is compatible with price stability.

However, this is not the case. Euro area wage developments are now⁴

³ Chemicals sector trade union Germany.

⁴ Over the past five years, similar trends have been operating. Extreme wage moderation in Germany and some small countries has pushed euro area wide wage formation below the growth rate in wages compatible with price stability: Nominal unit wage costs in the euro area grew by 1.7%, below the threshold of a 2% price stability target. Over this period as

below the rate of wage increases compatible with 2% inflation. Indeed, this rate of stability compatible wage growth can be estimated by summing up the price stability target of the ECB (1.9%) and trend hourly productivity growth (around 1.6% - the long term average over the 1996-2005 period⁵). We arrive then at a reference rate of about 3.5%. Comparing this reference rate of stability compatible wage growth with the increase of hourly wage costs in 2006 (which was 2.5%) allows to conclude that wage growth in the euro area has room to accelerate without endangering price stability. Wage growth in the euro area can accelerate from 2.5% now by around 1 percentage before the point is reached at which one could start to discuss the question whether wage developments are a threat to price stability.

What do these figures imply for German wage formation? A 'back-of-the-envelope' calculation provides a reassuring answer. Since the economic weight of Germany in monetary union is around 30%, and given a 1% margin for wages to accelerate at the euro area level, hourly wage rates in Germany could expand from a rate of growth of 0.7% in 2006 to 3.7% in coming years without posing any risk to euro area wide price stability!

well, there was room for additional wage growth in Germany without endangering the overall objective of price stability.

⁵ The ECB estimates a trend productivity growth of 1.4% over the same period.

However, official statistics over this period are downwards biased because of events in Italy. Italy, like Spain, has recently undertaken a massive legalisation of undeclared work. This has added working hours to the denominator of the ratio GDP/hours worked. However, the nominator has not risen by the same amount because estimates of GDP already took into account the incidence of undeclared work.

Of course, these statistics should not be taken literally. On the one hand, other countries besides Germany have also delivered overly modest wage increases and the 1% margin at the level of the euro area should also accommodate their acceleration of wage growth as well. On the other hand, this concerns small countries like Austria, the Netherlands and Finland and having only a limited impact on euro area wide averages. Also, and as explained in footnote 5, estimates of trend productivity over the recent time period are highly likely to be underestimated because of special events in Italy and Spain.

However, the important thing is to go beyond these discussions on the details of statistics. What really matters is to draw instead the core conclusion for policy makers and collective bargainers: **Wages in the euro area, in particular in Germany, can accelerate significantly and support an increase in workers' purchasing power without posing any problem for price stability!** The idea of Spanish or Italian workers needing to do 'sacrifices' in order to make a wage raise for German or Austrian workers possible may certainly be tempting for the practitioners of the 'dismal science' of economics, but the idea does not stand up to the empirics of the actual situation in EMU.

III. Is the ECB blind to the particular culture of collective bargaining in Germany and lessons from past bargaining trends in Europe?

Even if the ECB were to recognize that there exists right now a certain room for wages to accelerate, the next argument would probably be to warn for an 'overshooting': Wage acceleration might be especially strong

in Germany, while wages might also accelerate in countries where they are already in line or close to the threshold of 'price stability compatible' wage growth.

A. How big is the danger that wage formation in Germany would overshoot? Will the IG-Metall wage demand of 6.5% drag the whole of German wages with it?

Here, it should be noted that the negotiating culture in Germany is based on trade unions setting very high wage demands, employer organisations offering peanuts and both social partner organisations to finally settle on an outcome that is much below the trade union initial wage demand but higher than what employers have been offering. On top of this comes the particular phenomenon of negative wage drift creating a big gap between wage increases agreed in sector agreements on the one hand and effective wage outcomes on the other hand. To illustrate both effects, the 2006 metal bargaining round started with a wage demand of around 5%. It resulted in a wage agreement in the metal sector of around 2.8% on an annual basis. In turn, this resulted in an increase in collective bargained wages for the whole of Germany limited to 1.5% only. And finally, taking negative wage drift and enterprise level concessional bargaining agreements into account, the effective increase in hourly wages throughout Germany was as low as 0.7%....In other words, 2006 initial wage demands of the metal sector in 2006 had to be divided by a factor of 6 to arrive at the effective wage outcome! Even if it would be probably wrong to apply a similar calculation to the 2007 wage demand of 6.5% in view of falling unemployment in Germany, the basic message is still that a 6.5% wage

demand is not the right yardstick to judge ongoing wage trends in Germany.

B. How big is the danger that there will be a general acceleration of wages in almost all countries of monetary union?

An overview of recently concluded bargaining agreements (see text box)

shows that there are indeed some signs of bargained wages to accelerate in certain sectors and parts of Europe. However, there are also countries and sectors where wage agreements seem to be decelerating, and also a big group of countries where wages are likely to show continuing stability and modesty.

| RECENT TRENDS IN COLLECTIVE BARGAINING AGREEMENTS | |
|--|---|
| SIGNS OF ACCELERATION | |
| IG-Metall wage demand | 6.5% (5% previous bargaining round) |
| IG- Chemicals | 5.5% wage demand/3.7% effective wage increase |
| German Steel | 3.8% in 2007/2.6% over entire time span of the agreement |
| Spanish Metal | 3.5% 2006 agreement concluded end 2006 |
| Spanish public sector | Minimum uplift for 2007 of 3% |
| Italian metal | Wage demands between 90 to 130 euro, up from 100 euro wage deal 2006 |
| FNV-Netherlands | Coordinates on 3% maximum wage increase in 2007, up from 1.3% in 2006 |
| SIGNS OF DECELERATION | |
| Austrian metal | 2.6% 2007 agreement (down from 3.1% in 2006) |
| Germany (VW, construction,) | Trend for longer and unpaid hours going on |
| Finland | No pay increase until September 2007 |
| France | Catching up effect of minimum wages (harmonisation because of 35 hour week) has ended |
| SIGNS OF CONTINUING MODESTY | |
| Belgium | 5% wage norm for 2007 and 2006 (2.4% in previous year), with an uplift of 4% for minimum wages |
| Spain | Intersectoral agreement for a wage norm of 2 to 3% bargained wage increases in 2007 |
| Italy | Boost in wages from delayed contract renewals not expected in 2007 (2.5% bargained wage outcome 2006 with such boost) |
| Germany (banks, post, hotels, paper, textiles) | Bargained wage increases ranging from 1.4 to 2.5% |
| Germany- provisional WSI estimate ⁶ | 1.9% |

So, the picture is a mixed one. Although bargaining is recovering in those countries and situations where moderation over the past years was excessive, it is not strengthening systematically throughout the whole of monetary union.

The previous conclusion can be reinforced by looking at what happened during previous upswings. Do collectively bargained wages indeed react immediately and robustly to a turnaround in the business cycle? The graph below is based on ECB data. It shows that there has been a structural break in collective bargaining behaviour since the mid nineties. Whereas collectively bargained wage growth was still highly cyclical in the beginning of the nineties (for example, 7% collectively

bargained wage growth in 1992 falling sharply afterwards in line with the 1993 recession), this is no longer the case. Since 1996 we observe moderate and stable trends and this in a continuing way. Since then, collectively bargained wage table on a compensation for 2% inflation and add a small extra to claim some part of in the increase in productivity. Cyclical upturns, like the one we had over the 1997-2000 period, do not change that picture very much. The ECB, with its tough language on wages and backing this up by hikes in interest rate, may be looking for collective bargaining strategies that are compatible with price stability. But it should urgently realise that such collectively bargaining strategies already exist since more than a decade!



Source: ECB statistics

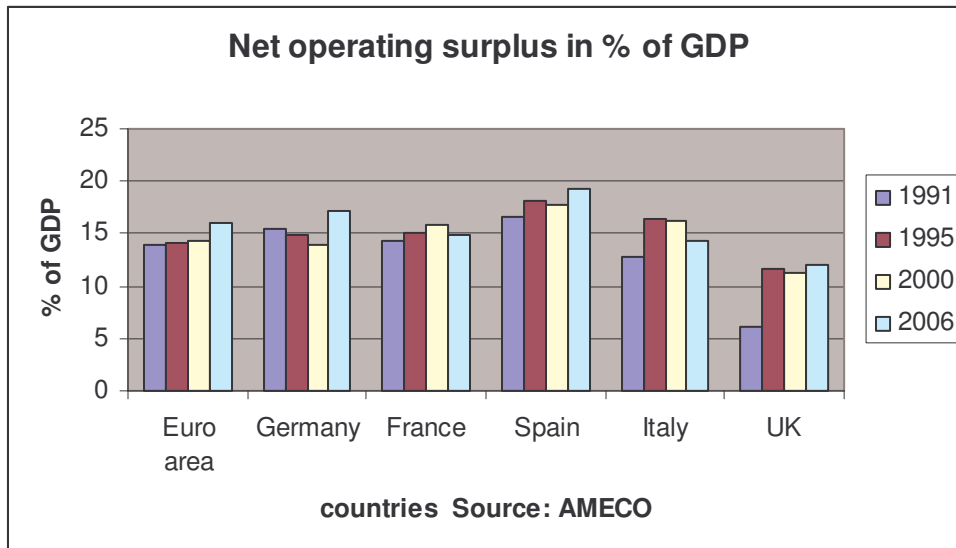
IV. The missing part of the equation: Business profits

The previous analysis shows that the ECB's focus on inflationary wage developments is not warranted at all. How is it possible that experienced monetary policy makers are unaware or ignoring such analysis?

A beginning of an answer to this question is the observation that by organising the discussion on wages and inflation in the way previously described, a crucial actor is simply missing. In the terms of the discussion as now presented by many economic policy makers at the European level, an acceleration of wage increases is not affordable ...unless other workers provide the finance for it: German wages can only increase harder if workers in the rest of Europe show

their 'solidarity' by engaging in more pronounced wage moderation. However, the question to which extent non-inflationary wage increases can be financed by business, by boosting productivity and granting wage earners a larger and complete share of productivity developments, or/and by having some redistribution from profits to wage earners, is rather absent from the discussion table.

This is conspicuous, certainly if one considers that business profits are at historically high rates. The graph below shows how the share of profits in GDP has increased over the past years. Strikingly, especially German and Spanish business – the two countries where workers are now being played out against each other on how to finance wage growth in the first country- have seen the biggest boost in profits.



So, behind the logic of pitching out German against Spanish wage earners against each other, another agenda can be found. By refusing German workers a raise in wages on the basis of the pretext that this would be a threat for euro area wide price stability, downwards pressure is put on both German as well as Spanish (and/or Italian) bargaining systems. The revealed interest here is the preservation of historical high profit rates in both countries.

Furthermore, if at a future point of time, wage bargaining systems in Spain or Italy would indeed get 'deregulated' as has been done in recent years in Germany by the introduction of enterprise based

concessional bargaining, then this can and will be used to extract even more wage moderation from German workers by claiming that wage moderation in Spain is starting to reduce the competitiveness of German business. The time has come for European economic policy makers to realise that this kind of ideological 'game' of 'divide and rule' workers is serving the interest of business profits while being detrimental to the process of European integration.

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